INTERNATIONAL MONETARY FUND

IMF Country Report No. 18/54

KINGDOM OF LESOTHO

2017 ARTICLE IV CONSULTATION—PRESS RELEASE; STAFF REPORT; AND STATEMENT BY THE EXECUTIVE DIRECTOR FOR THE KINGDOM OF LESOTHO

February 2018

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 2017 Article IV consultation with the Kingdom of Lesotho, the following documents have been released and are included in this package:

- A **Press Release** summarizing the views of the Executive Board as expressed during its February 14, 2018 consideration of the staff report that concluded the Article IV consultation with the Kingdom of Lesotho.
- The **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on February 14, 2018, following discussions that ended on November 15, 2017, with the officials of the Kingdom of Lesotho on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on January 31, 2018.
- An **Informational Annex** prepared by the IMF staff.
- A **Statement by the Executive Director** for Kingdom of Lesotho.

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Press Release No. 18/63
FOR IMMEDIATE RELEASE
February 23, 2018

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

IMF Executive Board Concludes 2017 Article IV Consultation with the Kingdom of Lesotho

On February 14, 2018, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation[1] with the Kingdom of Lesotho.

While Lesotho has grown faster than its regional peers over the last decade, partly driven by capital intensive mining and infrastructure projects, high levels of unemployment, poverty, and inequality persist. GDP growth is expected to be around 3 percent in FY 2017/18, below the average of 4.1 percent for the past decade, and driven by mining and agriculture. Over the next three years, GDP growth is expected to be led by mining and construction related to the Lesotho Highlands Water Project Phase II.

An expansionary fiscal stance has shielded the economy from external shocks recently, but at the cost of shrinking buffers. A steep decline in Southern African Customs Union (SACU) transfers, a major source of government revenue, will result in a fiscal deficit that is likely to exceed 6 percent of GDP for the second year. The government is financing the deficit by using its deposits at the Central Bank of Lesotho (CBL), causing a sharp drop in the CBL's international reserves. The drop in reserves is compounded by weaker remittances and demand for exports, particularly from South Africa.

With SACU revenues only expected to recover in FY 2020/21 in line with the cyclical upswing in South Africa, the outlook is fragile. Addressing the fiscal and external challenges remains difficult in an environment of high inequality and weak institutions. While tax revenues are already relatively high, there is scope for expenditure measures, including by reducing the very high public wage bill. However, efforts by the authorities to stabilize the political environment, including by implementing the recommendations of the Southern African Development Community (SADC), should contribute to macroeconomic stability.

The banking system is generally sound, but its impact on growth is limited and formal financial access remains low. While further work will be necessary to reduce the high levels of household

[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.

debt, banks' capitalization and liquidity are sufficient to weather major shocks. Rapid growth in the mobile money sector has brought a welcome increase in financial inclusion levels. Speedy implementation of the new supervision framework for the non-bank financial sector has the potential to further strengthen stability. Improvements to financial access and oversight would complement private sector development efforts, which are critical to reduce inequality. The new government's focus on promoting more labor-intensive sectors such as agriculture and tourism and reducing red tape to open a business also could help stimulate the demand for labor.

Executive Board Assessment[2]

Directors noted that even as recent expansionary fiscal policy has depleted fiscal buffers and undermined sustainability, adjustment will be politically challenging. Against this backdrop, Directors strongly encouraged the Lesotho authorities to undertake decisive fiscal adjustment to restore macroeconomic stability. They also encouraged the authorities to implement their development agenda and structural reforms to enhance resilience and lay the foundations for higher, inclusive growth.

Directors stressed that fiscal adjustment should prioritize expenditure measures. Reducing the high public wage bill is essential to achieve fiscal sustainability. Public financial management reform can help reduce spending inefficiencies and improve the quality of social services. These efforts can be complemented by measures to improve domestic resource mobilization, including selective measures to broaden the tax base and improve administration. In these efforts, steps should be taken to protect the vulnerable sections of society.

Directors noted the scope to increase financing over the medium term. Improvements in domestic debt management can help to reliably finance the budget while external financing offers opportunities to ease the impact of fiscal consolidation. However, external financing should be used to advance high quality infrastructure projects, with a significant grant element. External financing at commercial terms would add to vulnerabilities in an already fragile environment.

As regards the financial sector, Directors recognized that banks in Lesotho are well-positioned to absorb a negative shock while the newly-established credit bureau and a cap on payroll deductions are important steps towards tackling household indebtedness. Improved macroeconomic management, wider use of mobile money and an increased role for the Post Bank will support efforts to enhance private sector credit growth. Directors commended the Central Bank of Lesotho (CBL) for implementing the new supervisory architecture for the non-bank financial sector which has the potential to strengthen stability and improve the

[2] At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. An explanation of any qualifiers used in summings up can be found here: http://www.imf.org/external/np/sec/misc/qualifiers.htm.

contribution to financial inclusion. The CBL can reduce pressure on reserves by raising the cap on treasury bill issuances and adjusting the liquid asset requirement for banks.

Directors commended efforts to develop the private sector which are critical to create broad-based growth and ease the impact of fiscal adjustment. Competitive wages and proximity to a large neighbor provide business opportunities. Directors underscored that promotion of labor-intensive industries should be complemented by measures to reduce red-tape. Over the longer term, improving the quality of health and education spending will support human capital development and reduce inequality.

Table 1. Lesotho: Selected Economic Indicators, 2013/14–22/23[1]

Population (1,000; 2016 est.)	2,204
GNI per capita (U.S. dollars; 2016 est.)	1,270
Poverty rate (percent, 2011 est.):	57

	2013/14	2014/15	2015/16	2016/17	2017/18	2018/19	2019/20	2020/21	2021/22	2022/23
	Act.	Act.	Act.	Act.	Projections					
	(Percentage changes; unless otherwise indicated)									
National account and prices										
GDP at constant prices	2.2	3.0	2.5	3.1	3.1	1.7	2.6	2.1	2.9	3.5
GDP at market prices (millions Maloti)	25,385	29,274	32,405	34,325	37,687	40,591	43,929	47,218	50,923	55,240
Consumer prices (average)	5.0	4.6	4.3	6.2	5.6	5.5	5.5	5.0	5.0	5.0
Consumer prices (eop)	5.5	2.0	7.5	4.4	6.0	5.5	5.5	5.0	5.0	5.0
GDP deflator	10.0	12.0	8.0	2.8	6.5	5.9	5.5	5.3	4.8	4.8
External sector										
Terms of trade (deterioration -)	3.77	5.54	-1.97	-2.13	0.98	1.07	1.03	0.98	0.91	0.86
Average exchange rate										
(Local currency per U.S. dollar)	10.1	11.1	13.8	14.1	...	...	...	...	...	...
Nominal effective exchange rate change (– = depreciation)[2]	-13.0	-9.4	-8.9	-11.1	...	...	...	...	...	...
Real effective exchange rate (– = depreciation)[2]	-10.6	-6.5	-6.8	-6.7	...	...	...	...	...	...
Current account balance										
(Including official transfers, percent of GDP)	-5.5	-4.9	-4.5	-7.4	-6.5	-11.3	-11.6	-4.4	-7.0	-11.2
Current account (exc. LHWP-2 project, percent of GDP)	-5.5	-4.9	-4.5	-7.4	-5.5	-6.3	-6.8	-2.9	-2.3	-1.8
Gross international reserves										
(Months of imports, excluding imports for LHWP-2)	5.2	5.5	6.1	4.2	3.6	3.1	2.5	2.2	1.9	1.8
(Percent of M1)	248	294	284	208	169	136	114	102	91	88
Money and credit										
Domestic credit to the private sector	10.3	11.8	8.2	5.8	8.5	16.4	0.5	...	...	...
Reserve money	15.2	8.2	22.7	3.1	26.6	-15.7	-32.7	...	...	...
Broad money	31.5	1.5	6.4	8.8	10.0	9.3	1.8	...	...	...
Interest rate (percent)[3]	2.3	3.0	3.2	3.5	...	...	...	...	...	...
	(Percent of GDP, unless otherwise indicated)									
Public debt	37.4	36.9	41.3	35.4	35.4	38.8	43.2	45.3	47.0	47.7
External public debt	34.5	34.3	38.3	32.3	31.4	33.3	34.9	35.9	36.3	36.5
Domestic debt	2.8	2.6	3.0	3.1	4.0	5.5	8.3	9.4	10.7	11.3
Central government fiscal operations										
Revenue and grants	52.3	49.8	47.2	40.9	39.8	37.8	37.0	41.6	41.4	41.2
Of which: SACU revenue	23.9	24.0	19.7	13.2	16.3	13.6	11.4	15.7	15.6	15.5
Of which: grants	4.1	1.7	3.0	2.5	2.1	2.1	2.0	2.0	1.9	1.8
Recurrent expenditure	41.0	39.5	37.1	37.6	37.8	35.0	34.1	33.6	33.2	32.7
of which: wages, including social contributions	18.1	17.0	17.1	17.8	17.4	16.5	16.4	16.1	16.1	16.0
Capital expenditure	13.0	10.0	11.1	9.7	8.5	8.2	7.8	7.6	7.9	8.1
Overall balance	-1.7	0.3	-1.0	-6.3	-6.5	-5.3	-4.9	0.4	0.3	0.4
(Excluding grants)	-5.8	-1.4	-4.0	-8.9	-8.6	-7.4	-6.9	-1.5	-1.6	-1.4
Statistical discrepancy/Arrears (- = Accumulation)	-1.9	-1.4	2.3	1.8	0.0	0.0	0.0	0.0	0.0	0.0

Sources: Lesotho authorities, World Bank, 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] 12-month time deposits rate.

INTERNATIONAL MONETARY FUND

KINGDOM OF LESOTHO

STAFF REPORT FOR THE 2017 ARTICLE IV CONSULTATION

January 31, 2018

KEY ISSUES

Context: Following the sharp fall in SACU revenues, the fiscal deficit is likely to exceed 6 percent of GDP for the second year. The government has financed the deficit by using its deposits at the Central Bank of Lesotho (CBL), which is the root cause of the sharp drop in the CBL's international reserves. Political fragility has created a difficult environment for fiscal adjustment. The third government in five years was elected in June 2017 and formed a coalition of four parties. While some progress has been made in political and military reforms laid out by a SADC Commission report after a coup attempt in 2014, building a consensus on the fiscal policy response to the SACU revenue shortfall has been challenging.

Recommendations: Lesotho faces a challenging macroeconomic situation requiring urgent measures to restore fiscal and external sustainability, complemented with private sector reforms to mitigate the effect on growth, employment, and inequality.

- With SACU revenues only expected to recover in FY 2020/21 in line with the cyclical upswing in South Africa, a fiscal adjustment is urgently needed to stop the drain on international reserves, which are critical to preserve the Common Monetary Area. With tax revenues being already relatively high, expenditure measures should comprise the bulk of the adjustment, including by reducing the very high wage bill. Steps should be taken to limit the impact of measures on long-term growth and the poor.

- Reforms to promote broad-based private sector growth and to improve the efficiency of public education and health spending are necessary to make growth more inclusive. Large capital projects in the mining and water sectors have driven growth with little permanent impact on employment and poverty. The new government will focus on promoting more labor-intensive sectors such as agriculture and tourism and reducing red tape to open a business and cutting delays in cross-border transactions. Public Financial Management reform will contribute to addressing severe spending inefficiencies that hamper access to opportunities for low-income households.

- Increased financial access and oversight will complement private sector development efforts. Rapid growth in the mobile money sector has brought a welcome increase in financial inclusion levels. Speedy implementation of the new supervision architecture for the non-bank financial sector has the potential to further strengthen stability.

Approved By
Anne-Marie Gulde-Wolf (AFR) and Gavin Gray (SPR)

The team for the November 2–15, 2017 mission comprised Ms. Dieterich (head), Messrs. Alonso, Massara, Mhelele, Ramirez, and Roy (all AFR). Mr. Seleteng (local economist) also participated in the mission. Mses. Hammah, Mphatsoe, and Prado de Guzman provided research and editorial assistance for the preparation of this report.

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ANNEXES

CONTEXT: HIGH VULNERABILITIES AMIDST POLITICAL FRAGILITY

1. Economic performance in Lesotho is subject to spillover-driven volatility. Customs revenues, which are pooled at the Southern African Customs Union (SACU) level, are dominated by South Africa's import demand. Thus, Lesotho's fiscal revenues are subject to considerable external volatility. In addition, South Africa's economic conditions directly affect remittances. Lesotho's exports are concentrated (diamonds, textiles, and water), further increasing volatility.

2. In addition to these economic vulnerabilities, Lesotho has been suffering for decades from political fragility and military interference in politics. In 2017, Lesotho elected a new, four party coalition government—the third government in five years. Ambitious political reforms initiated by the new government are guided by Southern African Development Community (SADC) reform recommendations after the 2014 attempted military coup. They aim at addressing human rights violations, but also to mitigate political instability through constitutional reforms. However, political fragility persists as evidenced in the recent killing of the army commander by officers. In response, several SADC member countries deployed military to Lesotho at the government's request.

3. Political fragility has complicated much-needed reform efforts to make growth broad-based and inclusive. Strong growth of 4.1 percent on average over the past decade has not made inroads into unemployment, and poverty remains stubbornly high. At 23 percent, the HIV/AIDS rate is among the highest in the world (Figure 1).

4. Authorities' response to past policy advice has been mixed, reflecting the difficult political environment (Text Table 1).

5. Expansionary fiscal policy shielded the economy from a large SACU revenue shortfall (around 7 percent of GDP compared to the FY 2014/15 peak), but with buffers dwindling quickly, severe vulnerabilities developed:

- Real **growth** for the last three years averaged 3 percent, driven by textile manufacturing, which benefitted from the Rand/dollar depreciation, and more recently, by a strong recovery of agriculture after the severe droughts of 2015 and 2016 (Table 1 and Figure 2). Over the next three years, growth is expected to be driven by diamond mining and construction of the Lesotho Highlands Water Project Phase II (LHWP II).[1]

[1] LHWP's first phase was completed in 1998. This mega project included a dam and tunnels to supply drinking water to South Africa. The second phase, adding another dam, is expected to start in 2018 after several rounds of governance-related delays. The project, which is off budget, is expected to be completed by 2022 with total costs of $1.5 billion, equivalent to 57 percent of GDP. The increase in imports during the construction phase is broadly neutral for the stock of international reserves because South Africa finances the project through capital grants. There are discussions to complement the dam with a large hydro power project, which the government would need to finance itself. Chances for this project to advance are unclear until additional feasibility studies are available and thus it is not included in macroeconomic projections.

Text Table 1. Implementation of Fund Advice from the 2015 Article IV Consultation

Key Recommendations	Implementation Status
Implement gradual fiscal consolidation –including reducing the high wage bill– to address a severe and probably persistent drop in SACU revenues.	Only modest fiscal adjustments were implemented, leading the government to rely excessively on fiscal buffers. The wage bill remains at a very high level, but efforts were made to limit it in the budget for FY 2017/18.
Implement PFM reform to strengthen budget planning, execution, and monitoring.	PFM reform has been limited with basic functions still missing.
Provide for better conditions for private sector development by removing obstacles and fully implementing the National Strategic Development Plan (NSDP).	The NSDP expired in 2017 and its results are under evaluation. NSDP II is currently under discussion. The government has made progress in reducing red tape supported by the World Bank.
Build capacity for bank and nonbank supervision.	The supervision arquitecture for non-banks has been designed, but there have been delays in its implementation because of the lack of legislative approval.
Consider the use of a fiscal rule to deal with revenue volatility.	A fiscal rule has not been discussed.

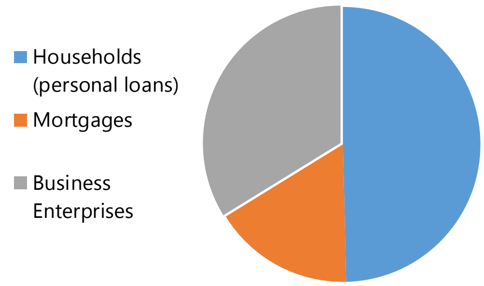
- **Inflation** peaked at 6.2 percent in March 2017, mainly on higher food prices after the droughts.

- The drop in SACU revenues, lower remittances, and weaker demand for Lesotho's exports are responsible for the widening of the **current account** deficit to 7.4 percent of GDP in FY 2016/17 from under 5 percent of GDP the previous fiscal year. The international reserves to import coverage has been declining from its 6-month peak in March 2016 to around 4 months by March 2017, reflecting spillovers from South Africa, the depreciation of CBL's Rand holdings, and the expansionary fiscal stance (Table 5 and Figure 3). The external position remains broadly in line with medium-term fundamentals and desirable policies (Annex IV).

- The government responded to the SACU shortfall by allowing the **fiscal deficit** to increase (Tables 2 and 3 and Figure 4). Lower-than-expected domestic revenues in the first half of FY 2017/18 added to the revenue shortfall. The fiscal deficit of around 6 percent of GDP for two consecutive years was financed by drawing down sizable buffers in form of government deposits at the CBL, which has been mirrored in the loss of international reserves. Measures in the FY 2017/18 budget to contain the wage bill—one of the highest in the world (Annex II)— were broadly offset by higher recurrent spending to implement a campaign promise to raise old-age pension.

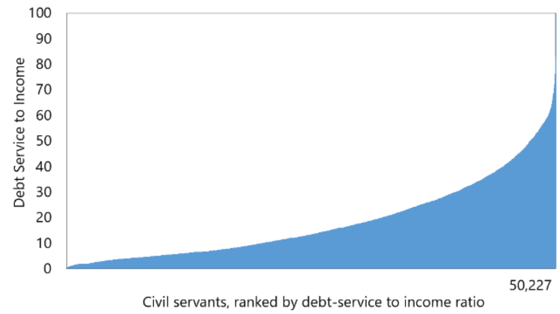
6. The banking system is generally sound and stable, but its impact on economic growth has been limited, and formal financial access remains low.[2] Non-performing loans (NPL) are fairly stable at low levels and profitability is high, although declining lately (Table 7 and Figure 5). The banking system is highly liquid, including by holding around 1/3 of deposits in form of short-term foreign assets with South African parent companies. The flipside is that the system is not showing any signs of financial deepening, with credit to the private sector growing barely in line with inflation in FY 2016/17.

Bank Loans by Type of Borrower
(as of October 2017)



Sources: Country authorities and IMF staff estimates

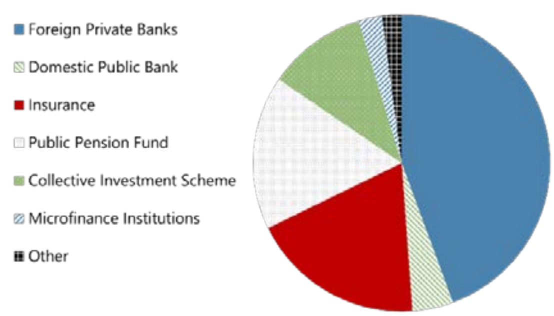
Civil Servants Debt Service to Income Ratio
(percent, as per October 2016 payroll data)



Source: Country authorities

7. Bank lending is concentrated on private resident households, most of it uncollateralized. Banks are therefore exposed to the financial health of private households. A system that allows lenders to withdraw debt service directly from civil servants' payroll has fueled high levels of indebtedness. The introduction of the credit bureau in 2016 has improved information available to lenders, but the direct debt service deduction at the source remains widely used.

Lesotho: Structure of the Financial System (2016)
Assets



Sources: Country authorities and IMF staff estimates

8. Non-bank financial institutions constitute around half of the financial sector's assets. Efforts are under way to revamp the supervision infrastructure for non-banks, which have been suffering from a weak regulatory and institutional framework, but progress has been slow due to delays in parliamentary approval of new laws.

OUTLOOK AND RISKS

9. The SACU revenue shortfall is projected to deepen further over the next two years, confronting the new government with large adjustment needs as buffers have already been used aggressively. Reserve coverage is projected to drop to 3.6 months of imports by the end of the current fiscal year, compared to an optimal reserve level of around 4½ to 5 months (Annex V). While SACU revenue projections are subject to a large margin of error beyond FY 2018/19, current projections anticipate a recovery only by FY 2020/21. Without decisive fiscal adjustment measures, government deposits available for deficit financing would be already depleted during FY 2018/19.

[2] See Selected Issues Paper: The Financial Sector and Macrofinancial Linkages and Financial Inclusion in Lesotho.

10. Growth prospects are tilted to the downside except for the positive growth effect from large foreign-financed investment projects. In case of fiscal adjustment, expenditure cuts would weaken growth prospects in the short term. Without adjustment, arrears accumulation and rising uncertainty would be a drag on growth over the medium term. There is also a risk that a delay of measures could force a drastic and disorderly fiscal adjustment later, which would create negative spillovers into the real economy and the financial sector. The growth impulse from mining and the LHWP II project will only create temporary employment during the construction phase. Finally, there is some scope to increase external financing with a sizable grant element for high quality public infrastructure projects, which would mitigate fiscal adjustment's drain on growth.

11. The main external risks would be channeled to Lesotho through the tight links with South Africa. Lower global growth and an increase in global financial volatility would weigh negatively on South Africa's economic outlook which would delay the cyclical recovery of SACU revenues and activity for Lesotho. In addition, South Africa's slow progress in structural reforms and political tensions could negatively impact the already declining longer-term trend for SACU revenues. While the new government's efforts to address human rights violations around the 2014 attempted coup reduced the immediate risk of losing African Growth and Opportunity Act's (AGOA) preferential access to the U.S., Lesotho's export concentration in textiles creates additional risk.

POLICY DISCUSSIONS

12. Discussions with the new government centered around the following priority reforms: (i) Establishing a fiscal framework that ensures sustainability in an environment vulnerable to external shocks and constrained by the Common Monetary Area (CMA) pegged to the Rand, while protecting the poor. (ii) Improving conditions for private sector employment and inclusive growth, including by advancing financial sector reform and access to finance. While discussions during the mission on how to address the current fiscal imbalance were productive, there are indications that reaching a political consensus on the way forward has been difficult.

A. Implementing Fiscal Consolidation

Size of Macroeconomic Imbalances

13. Restoring fiscal sustainability in a situation with serious imbalances and little buffers left is a formidable challenge in view of political fragility, weak institutions, and high poverty and income inequality. Although the country is at low risk of debt distress (see Annex VI), financing pressures pose significant risks. The government is confronted with a further SACU revenue decline in FY 2018/19 and while projection errors for SACU revenues are high, indications point to a further drop in FY 2019/20. Text Table 2 illustrates two scenarios on how to deal with this cyclical downturn, depending on the government's ability to advance fiscal adjustment:

Text Table 2. Comparison of Scenarios, 2017/18–2021/22[1]

	2016/17	2017/18	2018/19	2019/20	2020/21	2021/22
GDP at constant prices (percent change)						
Scenario 1	3.1	3.1	1.7	2.6	2.1	2.9
Scenario 2	3.1	3.1	1.1	2.1	1.7	4.4
Gross international reserves						
(Months of imports, excluding imports for LHWP-2)						
Scenario 1	4.2	3.6	3.1	2.5	2.2	1.9
Scenario 2	4.2	3.7	3.7	3.5	3.7	4.0
(Percent of M1)						
Scenario 1	208	169	136	114	102	91
Scenario 2	208	169	160	151	162	172
Overall balance (percent of GDP)						
Scenario 1	-6.3	-6.5	-5.3	-4.9	0.4	0.3
Scenario 2	-6.3	-6.5	-1.9	-2.1	5.0	4.7
Cumulative adjustment need (percent of GDP) [2]						
Scenario 1		-3.3	0.5	3.2	4.2	4.2
Scenario 2		-3.3	4.0	6.0	8.7	8.7

Sources: Lesotho authorities and IMF staff estimates and projections.
[1]The fiscal year runs from April 1 to March 31.
[2]This line shows the adjustment need through measures by calculating the change in the deficit exluding the change in SACU revenues, which is exogenous.

- **Scenario 1 depicts the baseline**, with political fragility preventing any substantial adjustment. Revenue projections include the introduction of a levy on alcohol and tobacco, spread over FY 2018/19 and 2019/20 (see Text Table 3), and a gradual improvement in tax administration. On the expenditure side, wages are expected to decline in percent of GDP in FY 2018/19 in line with measures taken under the previous budget. The baseline also incorporates a moderate reduction in capital spending. As liquid government deposits would fall to zero in FY 2018/19, new domestic borrowing is assumed to increase at the cost of rising interest expenses. However, realistically, the government would at least partly accumulate arrears, with a negative impact on growth. When SACU revenues recover in FY 2020/21 in line with import projections for South Africa, the fiscal deficit would turn broadly balanced, and CBL reserve coverage would level out at around 2 months of imports.

- **Scenario 2 depicts a policy adjustment scenario**, whereby the government undertakes substantial adjustment measures, sufficient to level out the international reserve to import coverage next fiscal year and restore it towards the optimal level over the medium term. This includes an increase in the VAT rate on electricity and telecommunications and in the fuel levy (see Text Table 3). On the expenditure side, the share of wages in total spending is steadily reduced. Additional savings would be created through cuts in spending for goods and services, which was the main source of savings during the 2010/11 SACU revenue shortfall. Domestically-financed capital expenditures are also reduced relative to the baseline. Deficits would fall to around 2 percent over the next two fiscal years and turn to surpluses when SACU revenues recover. Reserve coverage would stabilize in FY 2018/19 and recover to 4 months of imports by FY 2021/22. The size of the total adjustment over 5 years would reach 9 percent of GDP. It could be eased, or the recovery of the reserves accelerated, if the government decides to approach development partners for additional financing to support this ambitious fiscal program.

14. Political discussions on the unsustainability of the current situation are under way, but there are indications that it would be difficult to come to a political consensus on the need for fiscal adjustment with immediate negative implications for conducting fiscal policy. There are indications that the delay in approving a comprehensive reform package has triggered cash-rationing and arrears accumulation to slow down the depletion of government deposits and, consequently, CBL's international reserves. As arrears data is not collected on a regular basis, the amount of arrears accumulation is not clear. While budget preparations for FY 2018/19 are under way, no detailed information is available yet on how the government intends to react to the fiscal imbalances.

Fiscal Space to Restore Sustainability

15. The adjustment need is large, but it can be achieved while limiting the impact on long-term growth and poverty, if large spending inefficiencies are addressed. Tax policy measures that have already been quantified would contribute around 2 percent of GDP (Paragraph 21 and Text Table 3) to the total adjustment of around 9 percent of GDP. Depending on availability of additional financing in line with a prudent debt management strategy (see Annex VI), the brunt of the remainder would have to come from expenditures, with wage bill savings contributing around 3 percent of GDP (Paragraph 18). With recurrent spending of close to 38 percent of GDP and severe spending inefficiencies, the overall adjustment need is demanding but feasible.

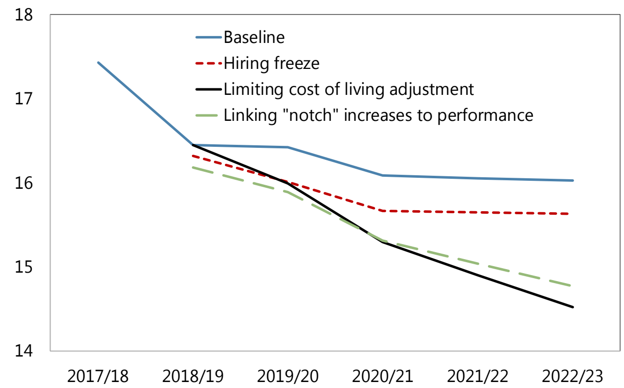
16. Looking for the best option to restore fiscal sustainability, cross-country analysis illustrates that Lesotho has a relatively high tax-to-GDP ratio; consequently, the low-hanging fruits for adjustment are on the expenditure side (Annex III). There is sizable scope for recurrent expenditure cuts, which were also the main source of adjustment during the FY 2010/11 SACU revenue shortfall. The authorities agreed that the bulk of the adjustment must come from the expenditure side. However, they emphasized that in view of the large adjustment need and the difficult political dynamics regarding spending cuts, tax measures should also be taken into consideration. The government also emphasized financing needs for ambitious plans to address infrastructure bottlenecks to improve conditions for private sector investment, but agreed with IMF staff that there could be some scope for cuts in low-quality projects that have been dragging on for a long time.

Possible Measures to Reduce Spending

17. The government and Fund staff agreed that prominence should be given to improving spending efficiency and, hence, preserving longer-term growth potential, and protecting low-income households. Ongoing work by the Ministry of Social Development in partnership with UNICEF, the EU, and the World Bank to establish a comprehensive database of low-income households will allow the government to improve the targeting of the social safety net. Once the household survey currently under preparation has been completed, Fund staff suggested that a detailed fiscal incidence analysis on poverty and inequality would allow policy makers to identify adjustment measures least harmful to the poor.

18. Fund staff emphasized the need to continue the efforts to reduce the wage bill initiated in the FY 2017/18 budget, but it appears that the government has not taken a decision in this regard. FAD technical assistance provided cost saving estimates. A combination of these measures would bring the wage bill to a more reasonable range over the medium term (Text Chart).

Wage Bill under Alternative Policies
(percent of GDP)



Source: IMF staff estimates

- Implementing a temporary **hiring freeze** for the next two fiscal years would save 0.4 points of GDP.

- **Limiting the cost of living adjustment** to half the rate of inflation between FY2019/20 and FY2022/23 would cut the wage bill by 1.5 points of GDP in five years.

- **Linking "notch" increases**, currently awarded to everyone, **to performance,** and limiting them to one out of three workers would reduce the wage bill by 1.3 points of GDP by FY2022/23.

The authorities noted that reforms to complete an effective establishment list with the objective to calibrate employment to government priorities are under way. Ongoing work with the World Bank on biometric audits will contribute to a resolution of the ghost worker issue. While transforming the notch increase, which is currently granted to all civil servants, into a performance management tool will take time, the authorities are weighing a cost of living adjustment for FY 2018/19 below the inflation rate.

19. The draft World Bank Public Expenditure Review points to sizable scope to cut spending in health and education due to large inefficiencies in these sectors (see also cross-country analysis in Annex III).

- The wage bill in **education** accounts for more than a third of the government's wage bill due to high teachers' salaries. Primary school teachers receive an average wage that is 8 times the per capita GDP in Lesotho, as opposed to just 3 in South Africa.[3] In addition, starting salaries are 30 percent higher for teachers with a college diploma in education, although the higher salary does not convey higher responsibilities.

[3] Lesotho: Systematic Country Diagnostic, World Bank, 2015, Draft Public Expenditure Review, World Bank, 2017

- Lesotho has almost doubled its expenditure in **health** care in the last decade, but health outcomes have not improved. Low quality of services, lack of equipment, skilled staff, and commodities, and a weak referral system have led to low and unequal utilization of health facilities.[4] A recently-announced "test and treat" program will attempt to finally address the HIV problem.

- The government spends 2 percent of GDP on **student loans**, which could be reduced significantly with the introduction of means testing and strengthening of loan recovery.

- **Goods and services** have a lot of slack, including travel and government car fleet expenses equivalent to 3 percent of GDP. Travel subsistence, which accounts for more than 5 percent of goods and services, is very generous with per diems significantly higher than South African public servants'.

20. Improving public financial management (PFM) is a core element of the government's efforts to improve spending efficiency, but also to reduce risks to financial integrity and facilitate macroeconomic management. Despite TA by the EU Commission, World Bank, African Development Bank, and IMF, basic systems are still missing, as evidenced in the 2016 PEFA update (Text Chart). At the request of the government, a FAD TA mission condensed past TA recommendations in a reform plan with the following reform priorities:

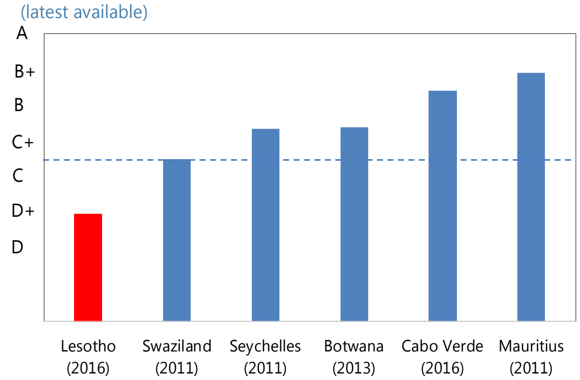
- Ongoing efforts to reconcile accounts and improve monitoring of numerous accounts in commercial banks will reduce the risk of fraud and improve the quality of fiscal reporting. Moving forward, a Treasury Single Account would facilitate account reconciliation and cash management. Persistent IT problems with the CBL's Core Banking System need to be addressed swiftly to facilitate account reconciliation.

- Improving commitment control and cash management would go a long way to ensure that payments are made on time which would reduce the drag of government arrears on businesses.

- The upgrade of the IFMIS system with support from the World Bank is an opportunity to revamp reporting.

Average PEFA Scores for Small Medium Income Countries

(latest available)



Source: PEFA Secretariat.

Note: The dashed line represents the average PEFA score for 38 SSA countries in the sample.

The government has already taken steps to improve procurement by granting permission to circumvent regular procurement procedures only for exceptional cases stipulated in the law.

[4] Lesotho: Systematic Country Diagnostic, World Bank, 2015.

Possible Measures to Improve Domestic Revenue Mobilization

21. Discussions on tax policy measures focused on how to widen the tax base:

- While no detailed information is available yet, the government is in the process of approving a levy on **tobacco and alcohol** products following World Bank recommendations.

Text Table 3. Revenue Potential of Tax Measures

Policy	in millions of Maloti	in percent of GDP
Introducing levy on alcohol and tobacco	200	0.5
Raising levy on gasoline	300	0.8
Alignining VAT rate for telecoms and electricity	180	0.5
Total	**680**	**1.8**

Source: IMF staff estimates

- While IMF staff argued that raising the levy for **gasoline** from 60 to 200 lisente per liter would still leave a sizable margin compared to prices across the border in South Africa, there appears little appetite for this measure in the government.

- Aligning the VAT rate for **telecoms and electricity** to the regular VAT rate of 14 percent is under consideration by the government. However, there are concerns about redistributive effects of higher prices, which require more analysis as a basis to design mitigating measures. Staff pointed out that the redistributive effect would be mitigated by low electrification rates (Table 6).

- The government is considering the introduction of a presumptive tax for **small-scale/informal businesses**, which has some revenue potential and would free up administrative capacity at the LRA for larger taxpayers.

- IMF staff urged the authorities to revisit **tax incentives provided in the law**. For example, the insurance sector benefits from a corporate income tax (CIT) exemption for life insurance. While no data was available to assess the fiscal costs of this exemption, it could be quite large in view of the size of the insurance sector (equivalent to 1.1 percent of GDP). The government expressed some interest in this measure.

- The Ministry of Trade provided in the past **discretionary CIT holidays** to foreign investors. IMF staff commended the new government for not granting such incentives anymore and suggested to also assess revenues lost from old tax holidays and explore options to phase them out.

22. On the tax administration front, the recent appointment of a new LRA Board is an important step towards accelerating reforms, which is a government priority after relatively weak outcomes over the last two years. Some progress has already been made in reconciling tax payments received through the banking system with taxpayer liabilities. This should help in phasing out tax payments in cash that come with high administrative costs. However, the government and IMF staff agreed on the need to accelerate long-delayed reforms, including through a recently signed TA program with the African Development Bank. Reforms with immediate revenue potential include:

- **CIT shortfalls from large taxpayers** contributed to poor revenue performance this fiscal year. Better monitoring of quarterly financial statements would allow the LRA to challenge requests to delay CIT pre-payments. Imposing interest charges on delayed payments would further reduce the incentive to delay pre-payments. For mining companies, automatic data exchange should be established between the LRA and the Ministry of Mining, which oversees royalty administration and has staff on-site to monitor mining activities.

- The LRA's weak **risk management** is a severe obstacle to efficient revenue administration, partly caused by IT challenges. On the customs side, the ASYCUDA system, which is the IT workhorse in tax administrations in many low-income countries, is sometimes down for weeks. Some features are not fully functioning and, therefore, information about irregularities observed in inspections is not feeding back regularly into the risk assessment. For tax administration, the situation is worse with risk management being done manually. Without strong risk management, the risk of being caught by an audit is slim, which has severely eroded tax compliance.

Sources of Deficit Financing

23. With the Debt Sustainability Analysis (DSA) indicating a low risk of debt distress, there is some scope to ease the effect of fiscal adjustment on growth by mobilizing additional external financing, if it has a high grant element (Annex VI). The government is in the process of negotiating sizable externally financed infrastructure projects to improve conditions for private sector development, using the fiscal space from relatively low, predominantly concessional external debt. Staff and the authorities agreed that with a narrow export base and risks from South Africa's economic performance, that affect the Rand exchange rate, a relatively high grant element of external debt portfolios should be preserved. The government pointed out that the decision by the Millennium Challenge Corporation (MCC) to re-select Lesotho as eligible in December 2017 after a two-year hiatus has opened an avenue to significant grant financing.

24. The low domestic debt level indicates fiscal space in form of additional domestic borrowing, but using this space at reasonable interest rates requires restoration of sustainable fiscal policy and improvements in debt management. Interest in government bonds has been spotty over the last years, but there seems to be some appetite for maloti-denominated assets, partly driven by increases in domestic investment requirements for insurance companies and pension funds. However, developing the domestic debt market into a reliable and cost-efficient source of government financing first requires confidence in the sustainability of government finances. In addition, improvements in debt management are needed to develop the primary market, in particular, predictable size, terms, and timing of bond issuances. Developing the secondary market will attract players that need flexibility in their liquidity management and, over time, reduce interest rates. The authorities agreed that there may be scope for larger and more frequent issuances, but cautioned that it is limited by the need to contain borrowing costs.

B. Possible Monetary Policy Measures

25. While Lesotho's margin for monetary policy measures is limited, given the CMA, providing the CBL the tools to mop up liquidity could counteract some of the pressures on reserves. For years, the banking system has been characterized by high liquidity, with a large part of the liquid assets held abroad with South African banks. The CBL's issuance of short-term treasury bills for monetary policy purposes, currently capped at 700 million maloti, are usually oversubscribed at the auctions. Staff encouraged the authorities to raise the ceiling on T-bill issuances to 1 billion maloti, which would allow the CBL to mop up more liquidity and induce banks to repatriate liquid assets held abroad, mitigating pressures on international reserves. The authorities welcomed the proposal, but noted that its implementation would require further discussion between the CBL and the Ministry of Finance.

26. The CBL agreed that efforts to mop up liquidity should be complemented by a revision of regulations for the liquid asset requirements (LAR). At present, the CBL allows banks to account gross claims against each other as liquid assets against their gross liabilities with each other. This gives banks the possibility to create, by mutual agreement, liquid assets, and renders the constraint by the LAR on the system meaningless.

C. Private Sector Development

27. The government's focus on private sector development has the potential to ease the pain of the fiscal adjustment. Discussions focused on how to prioritize reforms with a focus on widening growth beyond capital-intensive projects to strengthen the growth-employment nexus and ease poverty and inequality (Annex VII). The government is in the process of developing a new National Strategic Development Plan (NSDP II) that will reflect these priorities.

Reducing Red Tape

28. A comprehensive strategy to abolish red tape will be part of the NSDP II, but some progress is already under way. The government pointed to ongoing reform efforts like the implementation of the one-stop shop for business registration, even though further work is necessary to integrate all elements of the registration process. With assistance from a World Bank project, the cost and time for obtaining construction permits has dropped; guidelines for a risk-based inspection regime for new businesses are being developed. Preparations are also underway to establish product standards so that local producers would gain access to new export markets, and for local agricultural producers to be able to sell to large retail chains in Lesotho.

29. Staff cautioned the government regarding changes under consideration in the draft Minerals and Mining Bill. Duplicating regulatory structures, imposing local participation requirements, and forcing domestic processing and beneficiation in a very specialized sector would increase costs and thereby create disincentives for future investment. Instead of trying to enforce mines to source locally, the government should focus on a fiscal regime that ensures a fair share of economic rents to the public. A rent tax in line with international best practice would be a more efficient tool to achieve this objective than the current practice of government equity participation according to IMF TA.

Sectoral Reform Focus

30. In view of high unemployment, especially youth unemployment, the government is aiming at developing productive, labor-intensive sectors. The government has identified tourism, technology and innovation, agriculture, and manufacturing as priority sectors for the NSDP II. While the Fund team acknowledged that there is strong evidence of the growth potential of these sectors,[5] the government should evaluate existing programs before deciding on potentially costly new programs to promote these reforms. This would also address concerns in the business community that these programs are vulnerable to corruption. The government pointed out that based on recommendations of a World Bank sponsored review, the Lesotho National Development Corporation is being restructured to serve better its mission of private sector development, but agreed that a comprehensive review of existing instruments would be useful.

31. Over the long-term, the government and Fund staff agreed that better education and health spending efficiency will not only contribute to fiscal adjustment, but is also essential to improve labor productivity, facilitate access to opportunities, and, consequently, reduce inequality. Despite strong economic integration with South Africa, wages in Lesotho remain very low. For instance, anecdotal evidence suggests that manufacturing wages in Lesotho range from a fifth to a third of what South African workers receive. Low wages reflect a deficient labor productivity caused by weak human capital. Improving the quality of education and health care is therefore critical to raise labor productivity and living standards.

D. Strengthening Financial Sector's Contribution to Growth[6]

32. While the CBL's stress testing underlines banks' resilience even in case of a major deterioration in the loan portfolio, there was agreement that high household indebtedness needs to be addressed. Using end-2016 data, the CBL found that 30 percent of the system's performing loan portfolio, would have to become non-performing to breach the system's minimum capital adequacy ratio of 8 percent compared to 1.6 percent NPL as of the second quarter of 2017.[7]

[5] Lesotho: Systematic Country Diagnostic, World Bank, 2015.

[6] See Selected Issues Paper: The Financial Sector and Macrofinancial Linkages and Financial Inclusion in Lesotho.

[7] Even if all highly indebted civil servants were to default, the additional NPLs would account for less than 10 percent of the loan portfolio.

With these buffers, banks should be able to weather even a severe fiscal shock, characterized by a combination of public expenditure cuts, salary freezes, retrenchment. and increasing arrears to service suppliers. To address the problem of high indebtedness of civil servants collateralized through the payroll withdrawal system, the authorities recently started applying a 70 cap on payroll deductions. Moving forward, staff asked to explore options to gradually reduce this cap to phase out the payroll deduction system. With the newly established credit bureau now offering an alternative option to reduce risks for lenders, it should be possible to gradually reduce reliance on the payroll deduction without major impact on lending volumes.

33. Commercial banks' strong preference for highly liquid assets dampens financial intermediation and consequently their contribution to economic growth. There are multiple reasons for the low level of intermediation, including problems in the business environment, as exemplified by the limited number of projects from small and medium-size enterprises that meet banks' lending criteria. However, IMF staff also pointed out that the high level of banks' liquid asset holding abroad might reflect the pegged exchange rate and the need to maintain convertibility of loti deposits into Rand at all times. Within the constraints of this institutional environment, prudent fiscal policies, that allow the CBL to preserve a high level of international reserves, would also have a positive impact on long-term conditions for financial intermediation.

34. Fast-growing mobile money services have been the major driver of improving of financial access in Lesotho. The CBL emphasized that offering of mobile payment services through mobile network operators is deliberately regulated lightly, to give the new services a chance to reach broad customer cycles and reduce operating costs. However, the CBL monitors closely the sector, both to evaluate the impact on financial inclusion and to prevent, at an early stage, the build-up of financial risks. Banks are catching up, and all of them have plans to extend their services through mobile solutions. The Post Bank is expecting to launch an application that will allow micro savings and borrowing services beyond mere payments transactions. Mobile wallets offer the potential for low-income households to reduce excessive fees from holding traditional accounts in banks, but the current cap on mobile payments is quite low (Text Table 4) and could discourage a more prominent role of mobile payments.

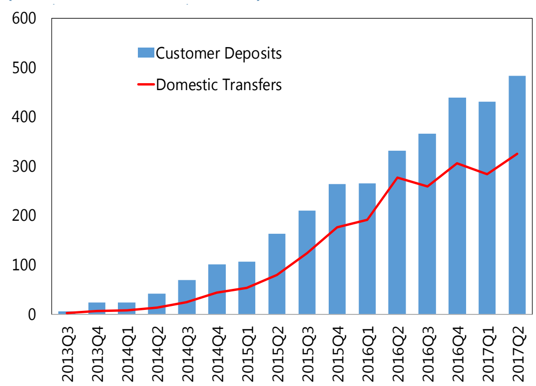
Text Table 4. Daily Cap in on Mobile Payments

	in USD
Tanzania	1,775
Uganda	1,300
Kenya	1,250
Ghana	300
Nigeria	300
Lesotho	**195**

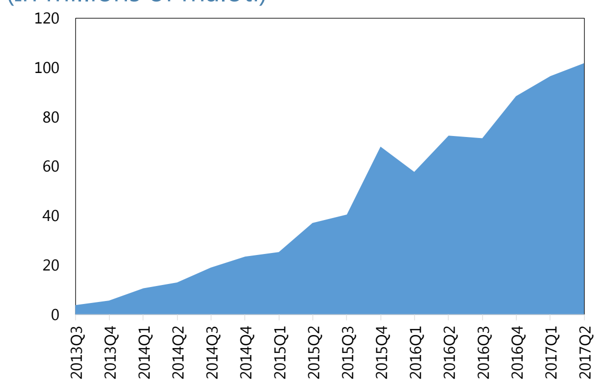
Note: The cap in Lesotho is 2,500 maloti daily and 10,500 maloti weekly.

Source: Telecom tariff reports

Mobile Money Usage
(In millions of maloti)



Mobile Money Trust Account Balances
(In millions of maloti)



Source: Central Bank of Lesotho

35. The government is discussing options to make the state-owned Post Bank a more active player in providing financing for small businesses. With the financial situation of the Post Bank improving, Fund staff agreed that there is scope to strengthen its role of facilitating access to financing for small businesses, but emphasized that sound banking principles need to be respected. Plans to cooperate with mobile operators to offer affordable banking services are well placed to promote financial inclusion in an environment of very high banking fees. In case the government considers an explicit development mandate for the Post Bank, government-funded credit lines and/or capital would be needed to protect private deposits.

36. A new supervision architecture for non-banks is a major step forward but implementation has been slow due to delays in the legislative approval, and challenges remain in enforcing the new framework. While the new Pensions Bill still remains to be approved by parliament, the CBL has now wide-ranging supervision authority for the insurance sector. The Ministry of Small Businesses, Cooperatives and Marketing will remain responsible for the supervision of financial cooperatives, except for large ones which are to be supervised by the CBL. The Ministry is in the process of closing crucial data gaps and improving stability and efficiency through mergers. However, staff expressed concern that a large deposit-taking cooperative, which is highly relevant in providing access to financial services, has so far refused to comply with the requirements of the new supervision architecture and remains insufficiently supervised.

OTHER SURVEILLANCE ISSUES

37. While data quality is broadly adequate for surveillance purposes, urgent work must be done to improve data transparency and reliability. MCM TA identified problems with the Core Banking System and gaps in the CBL's domestic debt data, including internal and publicly-available government securities data. Implementation of STA TA on national accounts and price data has been slow and data gaps like employment data remain unaddressed, hampering policy formulation. Legal requirements in the IMF's Article of Agreement to compile general government data cannot currently be met in view of limited capacity.

STAFF APPRAISAL

38. After two years of expansionary fiscal policy that has almost depleted fiscal buffers, the pressure to restore fiscal sustainability is rising, which is very challenging in the fragile political environment. Restoring fiscal and, consequently, external stability requires decisive fiscal adjustment. This is a formidable challenge in Lesotho's political environment and a frustrating experience for a new government that comes with an ambitious development agenda. However, further delaying these decisions would put at risk economic stability that has been anchored for decades in the CMA. Instability and widespread arrears accumulation would derail the development agenda this government tries to pursue.

39. Fiscal adjustment should prioritize expenditure measures, especially by addressing severe spending inefficiencies, complemented by measures to improve domestic resource mobilization, while seeking to protect the poor. To achieve the fiscal adjustment necessary right now, but also to make Lesotho's public finances more flexible in future cyclical swings, there is no way around addressing the high wage bill. Addressing spending inefficiency, including by PFM reform, will not only contribute to fiscal adjustment, but is also a precondition to improve the quality of health and education services and, consequently, reduce inequality. Selective revenue measures, aimed at broadening the tax base and improving tax administration efficiency, should complement the reform package.

40. The DSA findings underline some scope to increase external financing until the projected cyclical upswing eases fiscal pressures over the medium term. This offers opportunities to ease the negative impact of fiscal consolidation by advancing high quality infrastructure projects, financed by development partners with a significant grant element. However, external financing at commercial terms to finance the deficit is strongly discouraged as it would add a source of future vulnerability to an already fragile environment.

41. The CBL can reduce some of the pressure on reserves. Increasing the cap on treasury bill issuances has some potential to ease pressure on reserves in combination with improving the LAR.

42. Developing the private sector is critical to create broad-based growth and ease the impact of fiscal adjustment on the economy. Having low wages and being surrounded by a large and relatively more developed economy like South Africa provides Lesotho with tremendous opportunities for businesses. The authorities are promoting labor-intensive industries to foster broad-based growth, which should be complemented by measures to reduce red-tape and a comprehensive evaluation of existing private sector development programs. Over the long term, improving the quality of health and education spending will support human capital development and reduce inequality.

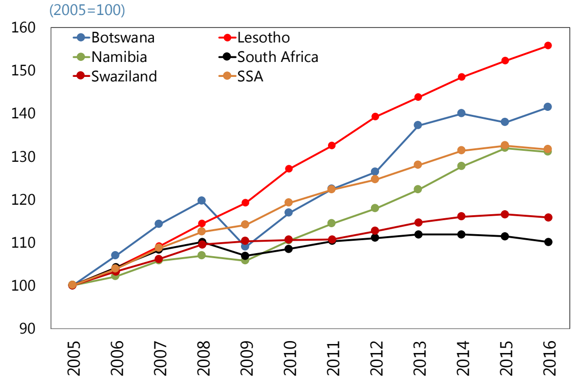
43. Strengthening the financial sector's contribution to growth will reinforce efforts to promote the private sector. Banks in Lesotho are well-positioned to absorb a negative shock. Staff welcomes the newly established credit bureau and a cap on payroll deductions as important steps in tackling the issue of household indebtedness. Improved macroeconomic management, more widespread use of mobile money, and an increased role for the Post Bank will support efforts to improve the relatively low level of private sector credit. The new supervisory architecture for the non-bank financial sector has the potential to strengthen stability and improve the contribution to financial inclusion.

44. Staff recommends that the next Article IV consultation for Lesotho be held on the standard 12-month cycle.

Figure 1. Social Indicators

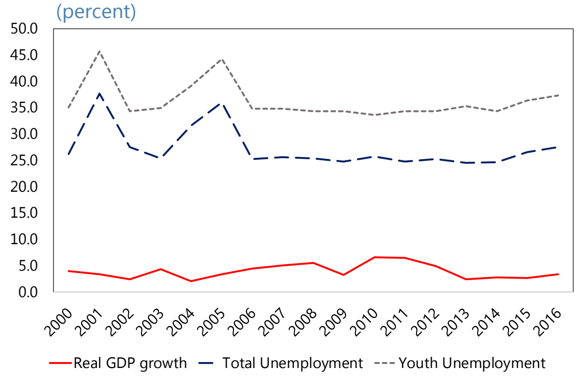
Lesotho has grown strongly over the past decade…

Real GDP per Capita
(2005=100)



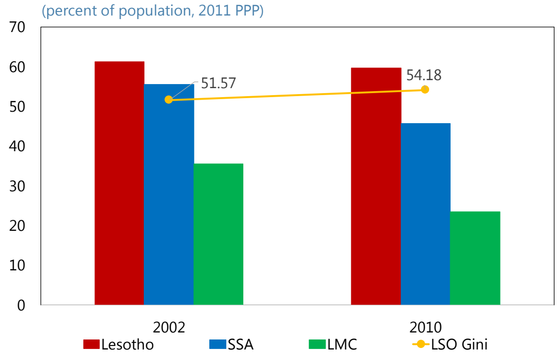
… but with little effect on unemployment.

Growth and Unemployment
(percent)



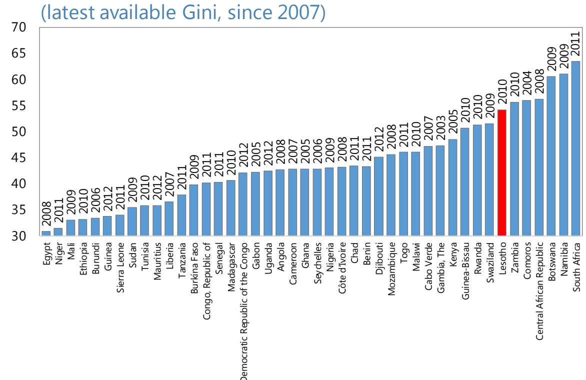
Poverty remains stubbornly high….

Gini Coefficient and Poverty Headcount Ratio at $1.90/Day
(percent of population, 2011 PPP)



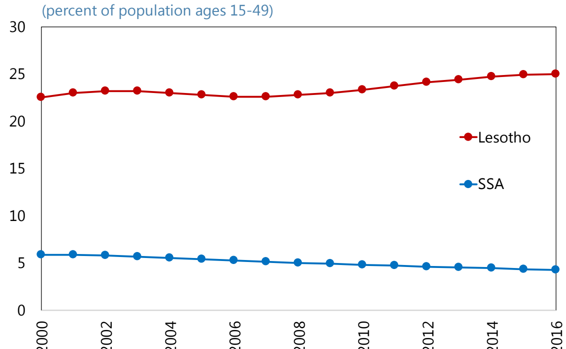
… and inequality is among the highest in the world.

Countries with Highest Income Inequality
(latest available Gini, since 2007)



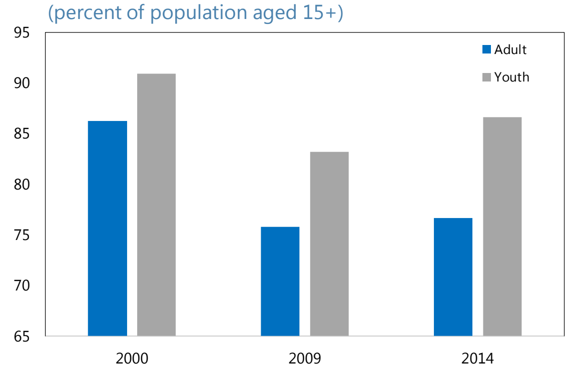
HIV/AIDS prevalence continues to affect almost a quarter of Lesotho's population…

Prevalence of HIV, Total
(percent of population ages 15-49)



… and education outcomes have stagnated, or even, worsened

Literacy Rates
(percent of population aged 15+)

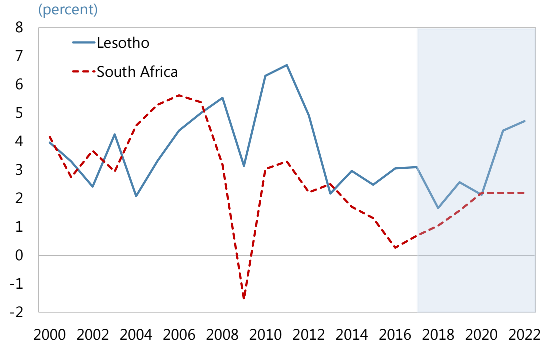


Source: World Bank Development Indicators, IMF staff calculations

Figure 2. Recent Economic Developments

Growth in Lesotho has been affected by South Africa's slowdown…

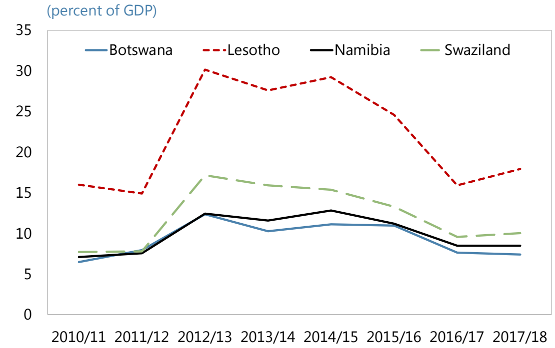
Real GDP Growth
(percent)



Note: The shaded area represents forecast periods

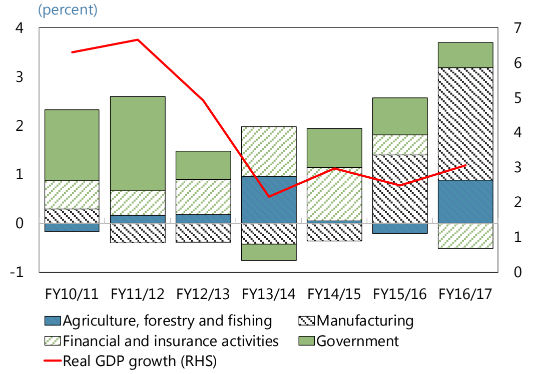
… which has translated into lower SACU revenues

SACU Revenues
(percent of GDP)



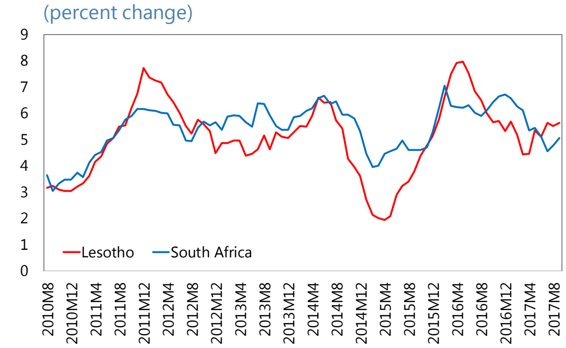
Fiscal stimulus has shielded the economy from the external shock…

Sectoral Contributions to GDP Growth
(percent)



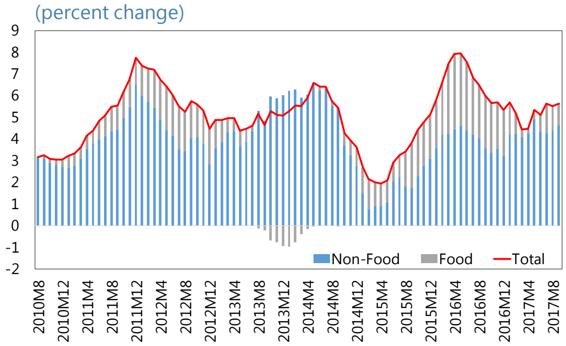
… while inflationary pressures have declined after agricultural production recovered from the drought….

Inflation
(percent change)



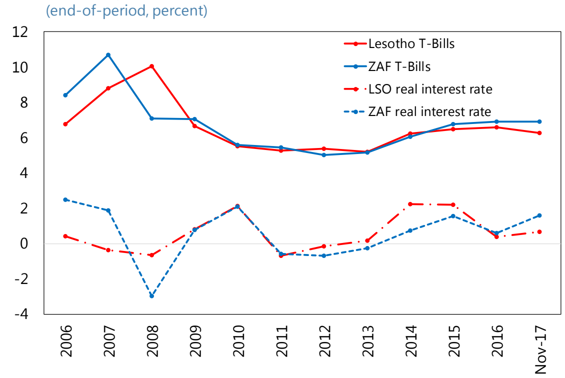
…and food inflation subsided.

Inflation Components
(percent change)



Interest rates are mainly driven by rates in South Africa.

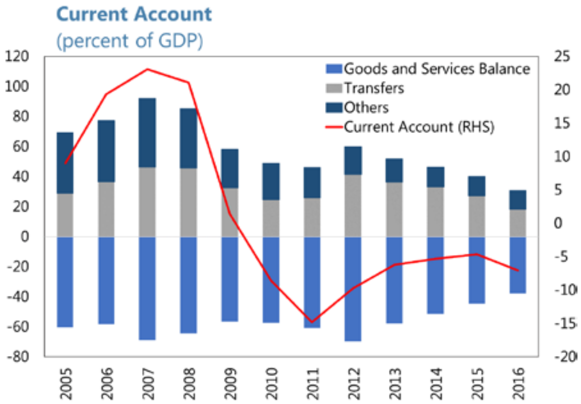
Treasury Bills Rate: Lesotho and South Africa
(end-of-period, percent)



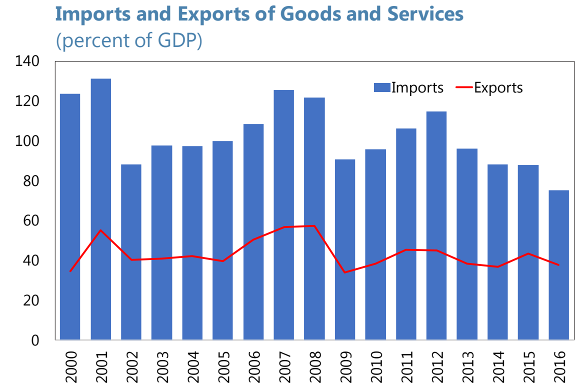
Sources: Country authorities and IMF staff estimates

Figure 3. External Vulnerabilities

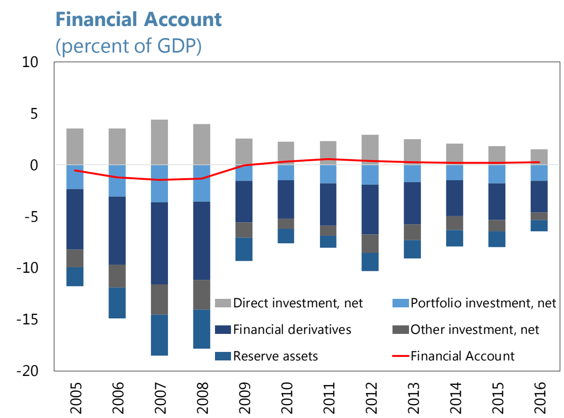
The decline in SACU revenues has worsened the current account deficit....



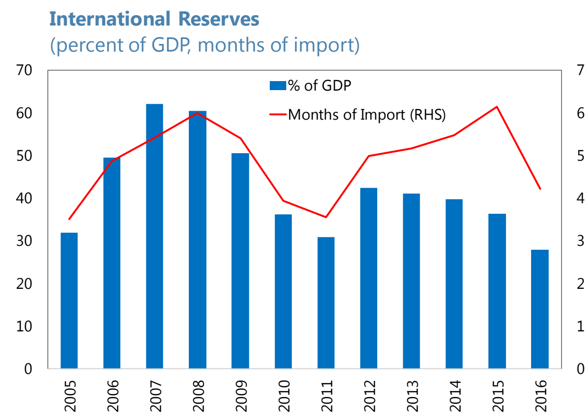
... with imports remaining structurally very high...



... and FDI inflows declining as major mining projects are completed



Thus, international reserves are on a declining trend.

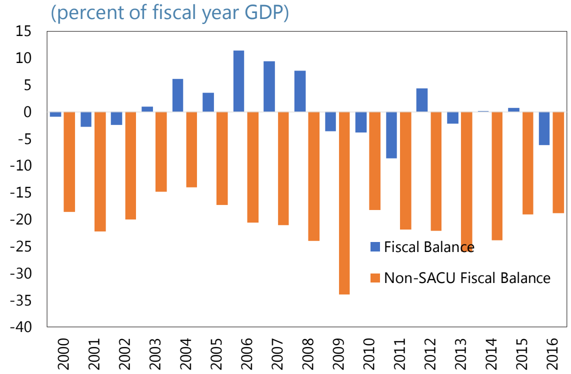


Source: Country authorities and IMF staff calculations

Figure 4. Fiscal Imbalances

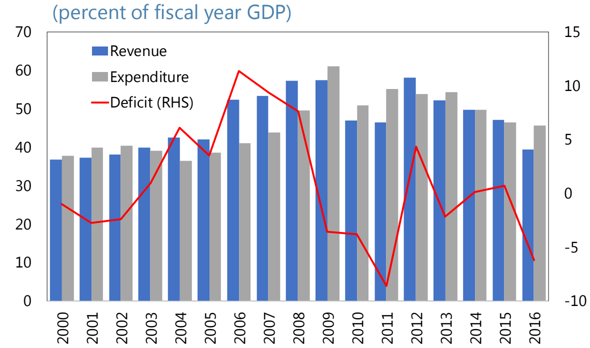
The public sector is extremely dependent on SACU revenues…

Fiscal Balance
(percent of fiscal year GDP)



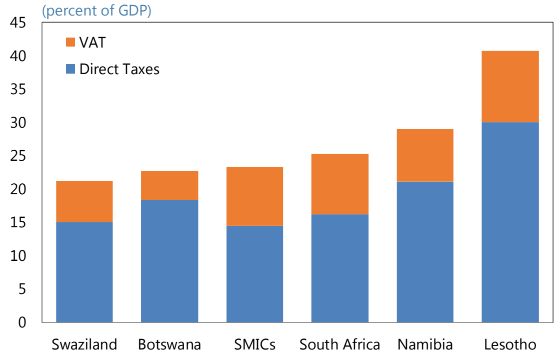
…whose recent drop has widened the deficit

Budget Deficit
(percent of fiscal year GDP)



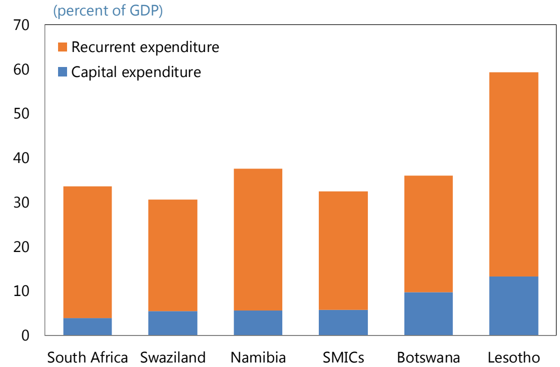
Lesotho already collects higher taxes than its neighbors…

Tax Revenue, 2016
(percent of GDP)



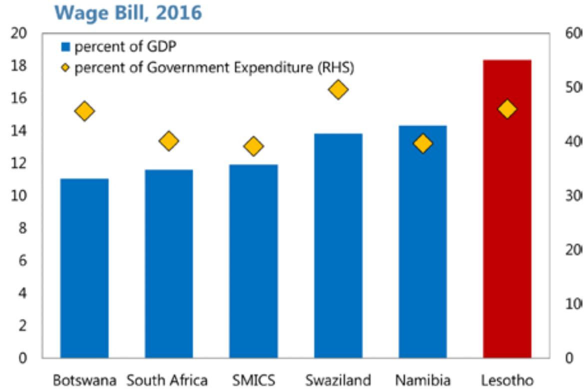
… but it also outspends them….

Expenditure, 2016
(percent of GDP)



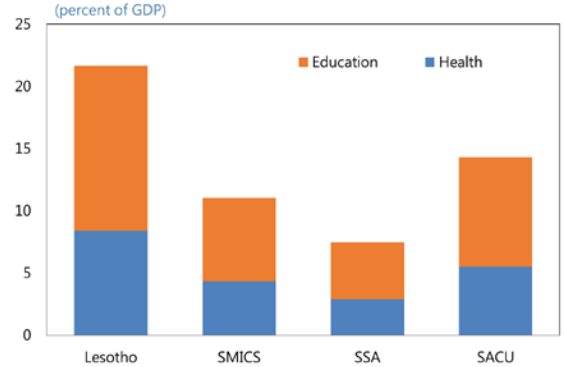
… with one of the largest wage bills in the world…

Wage Bill, 2016



… and high and inefficient social spending

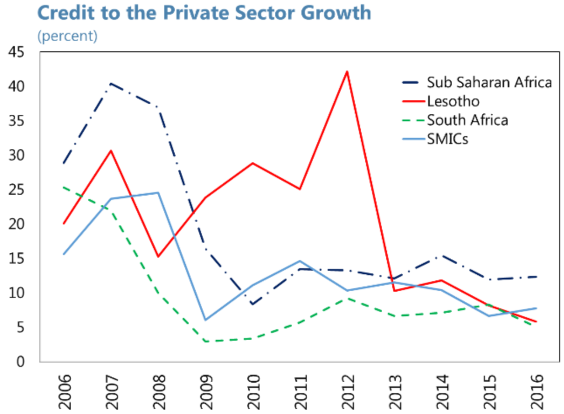
Expenditure on Health and Education, 2010-2014
(percent of GDP)



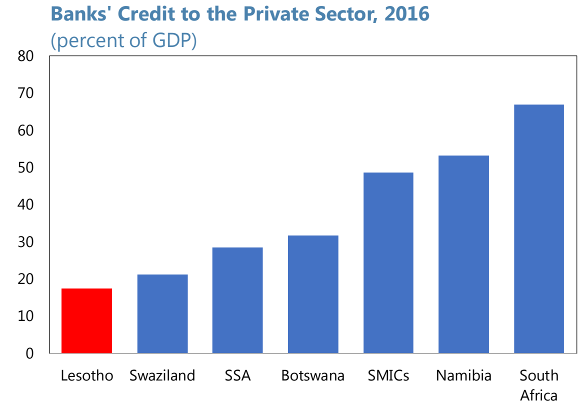
Source: Country authorities and IMF staff calculations

Figure 5. Monetary and Financial Developments

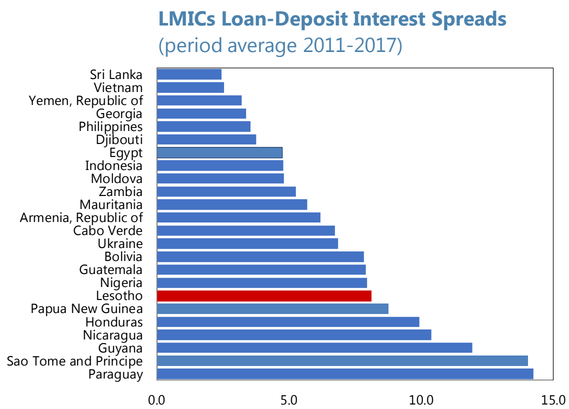
Credit to the private sector has decelerated…



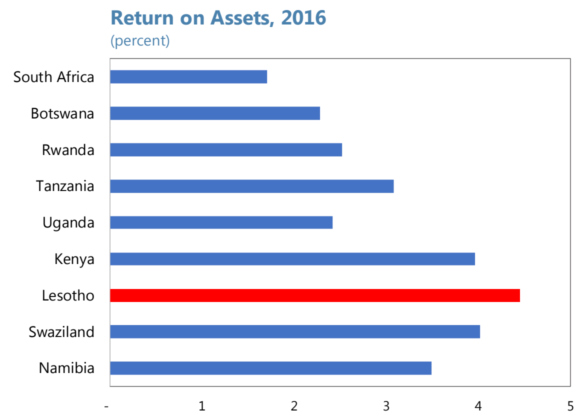
.... and remains very low compared to the region…



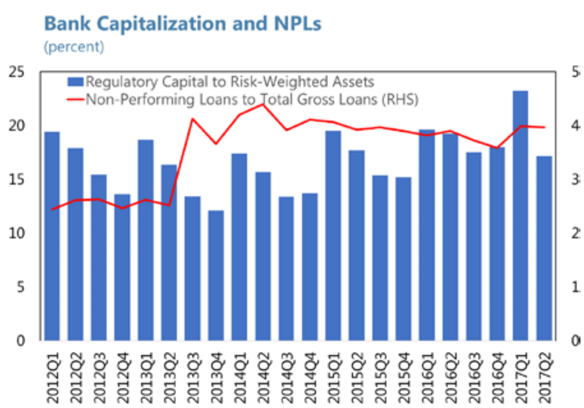
… despite having high interest rate spreads....



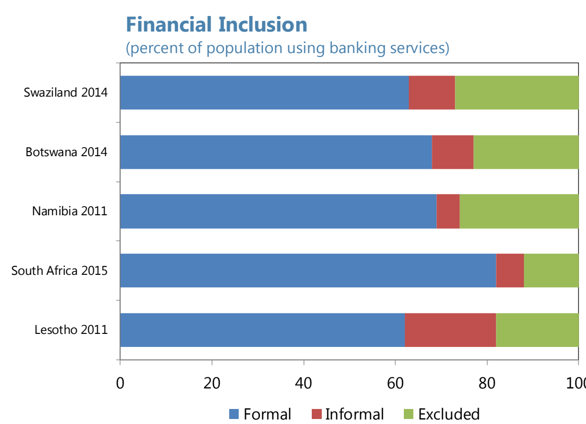
…and a very profitable banking sector…



… which is stable and well-capitalized....



…but has failed to foster formal financial inclusion



Source: Country authorities and IMF staff calculations

Table 1. Scenario 1: Lesotho: Selected Economic Indicators, 2013/14–2022/23[1]

Population (1,000; 2016 est.)	2,204
GNI per capita (U.S. dollars; 2016 est.):	1,270
Poverty rate (percent, 2011 est.):	57

	2013/14	2014/15	2015/16	2016/17	2017/18	2018/19	2019/20	2020/21	2021/22	2022/23
	Act.	Act.	Act.	Act.	Projections					
	(Percentage changes; unless otherwise indicated)									
National account and prices										
GDP at constant prices	2.2	3.0	2.5	3.1	3.1	1.7	2.6	2.1	2.9	3.5
GDP at market prices (millions Maloti)	25,385	29,274	32,405	34,325	37,687	40,591	43,929	47,218	50,923	55,240
Consumer prices (average)	5.0	4.6	4.3	6.2	5.6	5.5	5.5	5.0	5.0	5.0
Consumer prices (eop)	5.5	2.0	7.5	4.4	6.0	5.5	5.5	5.0	5.0	5.0
GDP deflator	10.0	12.0	8.0	2.8	6.5	5.9	5.5	5.3	4.8	4.8
External sector										
Terms of trade (deterioration -)	3.77	5.54	-1.97	-2.13	0.98	1.07	1.03	0.98	0.91	0.86
Average exchange rate										
(Local currency per U.S. dollar)	10.1	11.1	13.8	14.1	...	...	...	...	...	...
Nominal effective exchange rate change (– = depreciation) [2]	-13.0	-9.4	-8.9	-11.1	...	...	...	...	...	...
Real effective exchange rate (– = depreciation) [2]	-10.6	-6.5	-6.8	-6.7	...	...	...	...	...	...
Current account balance										
(Including official transfers, percent of GDP)	-5.5	-4.9	-4.5	-7.4	-6.5	-11.3	-11.6	-4.4	-7.0	-11.2
Current account (exc. LHWP-2 project, percent of GDP)	-5.5	-4.9	-4.5	-7.4	-5.5	-6.3	-6.8	-2.9	-2.3	-1.8
Gross international reserves										
(Months of imports, excluding imports for LHWP-2)	5.2	5.5	6.1	4.2	3.6	3.1	2.5	2.2	1.9	1.8
(Percent of M1)	248	294	284	208	169	136	114	102	91	88
Money and credit										
Domestic credit to the private sector	10.3	11.8	8.2	5.8	8.5	16.4	0.5	...	...	...
Reserve money	15.2	8.2	22.7	3.1	26.6	-15.7	-32.7	...	...	...
Broad money	31.5	1.5	6.4	8.8	10.0	9.3	1.8	...	...	...
Interest rate (percent) [3]	2.3	3.0	3.2	3.5	...	...	...	...	...	...
	(Percent of GDP, unless otherwise indicated)									
Public debt	37.4	36.9	41.3	35.4	35.4	38.8	43.2	45.3	47.0	47.7
External public debt	34.5	34.3	38.3	32.3	31.4	33.3	34.9	35.9	36.3	36.5
Domestic debt	2.8	2.6	3.0	3.1	4.0	5.5	8.3	9.4	10.7	11.3
Central government fiscal operations										
Revenue and grants	52.3	49.8	47.2	40.9	39.8	37.8	37.0	41.6	41.4	41.2
Of which: SACU revenue	23.9	24.0	19.7	13.2	16.3	13.6	11.4	15.7	15.6	15.5
Of which: grants	4.1	1.7	3.0	2.5	2.1	2.1	2.0	2.0	1.9	1.8
Recurrent expenditure	41.0	39.5	37.1	37.6	37.8	35.0	34.1	33.6	33.2	32.7
of which: wages, including social contributions	18.1	17.0	17.1	17.8	17.4	16.5	16.4	16.1	16.1	16.0
Capital expenditure	13.0	10.0	11.1	9.7	8.5	8.2	7.8	7.6	7.9	8.1
Overall balance	-1.7	0.3	-1.0	-6.3	-6.5	-5.3	-4.9	0.4	0.3	0.4
(Excluding grants)	-5.8	-1.4	-4.0	-8.9	-8.6	-7.4	-6.9	-1.5	-1.6	-1.4
Statistical discrepancy/Arrears (- = Accumulation)	-1.9	-1.4	2.3	1.8	0.0	0.0	0.0	0.0	0.0	0.0

Sources: Lesotho authorities, World Bank, 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] 12-month time deposits rate.

Table 2. Scenario 1: Lesotho: Fiscal Operations of the Central Government 2013/14–2022/23[1]

(Millions of Maloti)

	2013/14	2014/15	2015/16	2016/17	2017/18	2018/19	2019/20	2020/21	2021/22	2022/23
	Act.	Act.	Act.	Act.				Projections		
Revenue	13,274	14,583	15,300	14,051	14,994	15,354	16,253	19,634	21,103	22,771
Tax revenue [2]	5,148	5,785	6,578	7,009	6,690	7,413	8,675	9,476	10,219	11,086
Taxes on income, profits, and capital gain	2,680	3,059	3,644	3,726	3,484	3,887	4,107	4,414	4,761	5,164
Taxes on property	128	139	0	363	213	242	271	291	314	340
Taxes on goods and services	1,887	2,344	2,683	2,669	2,746	2,895	3,875	4,316	4,655	5,049
Taxes on international trade	451	243	250	249	246	387	422	453	489	530
Grants	1,047	496	966	867	793	834	878	922	968	1,016
Budget support	149	4	15	5	0	0	0	0	0	0
Project grants	898	492	952	862	793	834	878	922	968	1,016
Non-tax revenue	1,025	1,267	1,357	1,657	1,356	1,569	1,694	1,821	1,964	2,131
Property Income	164	347	428	602	280	412	443	476	514	557
Sales of goods and services	856	912	916	1,041	1,063	1,145	1,240	1,332	1,437	1,559
Other non-tax revenue	5	8	13	15	13	12	12	12	13	14
SACU	6,055	7,034	6,399	4,519	6,154	5,538	5,006	7,416	7,951	8,539
Expense	10,415	11,564	12,031	12,904	14,254	14,213	14,962	15,849	16,908	18,050
Compensation of employees	4,589	4,984	5,538	6,112	6,569	6,678	7,213	7,592	8,175	8,855
Wages and salaries	3,938	4,219	4,718	5,169	5,514	5,661	6,126	6,435	6,940	7,528
Social contributions	651	766	821	942	1,055	1,017	1,087	1,157	1,235	1,327
Use of goods and services	2,972	3,649	3,086	3,320	3,761	3,775	3,899	4,002	4,117	4,266
Interest payments	189	177	274	255	343	417	394	677	758	744
Domestic	80	45	76	45	93	241	229	458	540	527
External	108	133	198	210	303	176	164	219	218	217
Subsidies	232	201	251	415	310	310	310	310	334	362
Grants	899	1,037	1,106	1,258	1,392	1,078	1,125	1,171	1,263	1,370
Social benefits	763	779	898	893	1,049	1,103	1,148	1,234	1,331	1,444
Other expenses	772	736	878	652	830	852	872	862	930	1,009
Gross operating balance	2,860	3,018	3,269	1,147	740	1,141	1,292	3,785	4,194	4,722
Nonfinancial assets	3,297	2,927	3,594	3,325	3,191	3,312	3,436	3,575	4,043	4,490
Domestically financed	2,596	1,653	3,029	2,735	2,580	1,885	2,093	2,478	3,189	3,580
Externally financed	701	1,274	565	590	611	1,427	1,343	1,098	855	911
Net lending(+)/borrowing (-) (Overall fiscal balance)	-438	91	-325	-2,178	-2,451	-2,170	-2,144	210	151	231
Transactions in financial assets and liabilities	40	512	-1,085	-2,788	-2,451	-2,170	-2,144	210	151	231
Financial assets	22	1,484	-917	-2,569	-1,650	-614	-307	1,411	897	982
Domestic	20	1,481	-918	-2,570	-1,650	-617	-309	1,409	897	982
Deposits	20	1,481	-918	-2,570	-1,650	-617	-309	1,409	897	982
Central bank	13	1,481	-959	-2,536	-1,650	-617	-309	1,409	897	982
Commercial banks	8	1	41	-34	0	0	0	0	0	0
Loans	0	0	0	0	0	0	0	0	0	0
Financial liabilities	-18	973	168	219	801	1,557	1,836	1,200	746	751
Domestic	-408	10	40	64	450	695	1,178	840	640	640
Foreign	390	962	128	155	351	861	658	360	106	111
Disbursements	701	1,274	565	590	611	1,427	1,343	1,098	855	911
Amortization	-311	-312	-437	-435	-260	-566	-684	-737	-749	-800
Statistical discrepancy	-478	-420	760	610	0	0	0	0	0	0

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.

Table 3. Scenario 1: Lesotho: Fiscal Operations of the Central Government 2013/14–2022/23[1]

(Percent of GDP)

	2013/14	2014/15	2015/16	2016/17	2017/18	2018/19	2019/20	2020/21	2021/22	2022/23
	Act.	Act.	Act.	Act.	Projections					
Revenue	52.3	49.8	47.2	40.9	39.8	37.8	37.0	41.6	41.4	41.2
Tax revenue[2]	20.3	19.8	20.3	20.4	17.8	18.3	19.7	20.1	20.1	20.1
Taxes on income, profits, and capital gain	10.6	10.4	11.2	10.9	9.2	9.6	9.3	9.3	9.3	9.3
Taxes on property	0.5	0.5	0.0	1.1	0.6	0.6	0.6	0.6	0.6	0.6
Taxes on goods and services	7.4	8.0	8.3	7.8	7.3	7.1	8.8	9.1	9.1	9.1
Taxes on international trade	1.8	0.8	0.8	0.7	0.7	1.0	1.0	1.0	1.0	1.0
Grants	4.1	1.7	3.0	2.5	2.1	2.1	2.0	2.0	1.9	1.8
Budget Support	0.6	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Project grants	3.5	1.7	2.9	2.5	2.1	2.1	2.0	2.0	1.9	1.8
Non-tax revenue	4.0	4.3	4.2	4.8	3.6	3.9	3.9	3.9	3.9	3.9
Property income	0.6	1.2	1.3	1.8	0.7	1.0	1.0	1.0	1.0	1.0
Sales of goods and services	3.4	3.1	2.8	3.0	2.8	2.8	2.8	2.8	2.8	2.8
Other non-tax revenue	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
SACU	23.9	24.0	19.7	13.2	16.3	13.6	11.4	15.7	15.6	15.5
Expense	41.0	39.5	37.1	37.6	37.8	35.0	34.1	33.6	33.2	32.7
Compensation of employees	18.1	17.0	17.1	17.8	17.4	16.5	16.4	16.1	16.1	16.0
Wages and salaries	15.5	14.4	14.6	15.1	14.6	13.9	13.9	13.6	13.6	13.6
Social contributions	2.6	2.6	2.5	2.7	2.8	2.5	2.5	2.5	2.4	2.4
Use of goods and services	11.7	12.5	9.5	9.7	10.0	9.3	8.9	8.5	8.1	7.7
Interest payments	0.7	0.6	0.8	0.7	0.9	1.0	0.9	1.4	1.5	1.3
Domestic	0.3	0.2	0.2	0.1	0.2	0.6	0.5	1.0	1.1	1.0
External	0.4	0.5	0.6	0.6	0.8	0.4	0.4	0.5	0.4	0.4
Subsidies	0.9	0.7	0.8	1.2	0.8	0.8	0.7	0.7	0.7	0.7
Grants	3.5	3.5	3.4	3.7	3.7	2.7	2.6	2.5	2.5	2.5
Social benefits	3.0	2.7	2.8	2.6	2.8	2.7	2.6	2.6	2.6	2.6
Other expenses	3.0	2.5	2.7	1.9	2.2	2.1	2.0	1.8	1.8	1.8
Gross operating balance	11.3	10.3	10.1	3.3	2.0	2.8	2.9	8.0	8.2	8.5
Non-financial assets	13.0	10.0	11.1	9.7	8.5	8.2	7.8	7.6	7.9	8.1
Domestically financed	10.2	5.6	9.3	8.0	6.8	4.6	4.8	5.2	6.3	6.5
Externally financed	2.8	4.4	1.7	1.7	1.6	3.5	3.1	2.3	1.7	1.6
Net lending(+)/borrowing (-) (Overall fiscal balance)	-1.7	0.3	-1.0	-6.3	-6.5	-5.3	-4.9	0.4	0.3	0.4
Transactions in financial assets and liabilities	0.2	1.7	-3.3	-8.1	-6.5	-5.3	-4.9	0.4	0.3	0.4
Financial assets	0.1	5.1	-2.8	-7.5	-4.4	-1.5	-0.7	3.0	1.8	1.8
Domestic	0.1	5.1	-2.8	-7.5	-4.4	-1.5	-0.7	3.0	1.8	1.8
Deposits	0.1	5.1	-2.8	-7.5	-4.4	-1.5	-0.7	3.0	1.8	1.8
Central bank	0.0	5.1	-3.0	-7.4	-4.4	-1.5	-0.7	3.0	1.8	1.8
Commercial banks	0.0	0.0	0.1	-0.1	0.0	0.0	0.0	0.0	0.0	0.0
Loans	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Financial liabilities	-0.1	3.3	0.5	0.6	2.1	3.8	4.2	2.5	1.5	1.4
Domestic	-1.6	0.0	0.1	0.2	1.2	1.7	2.7	1.8	1.3	1.2
Foreign	1.5	3.3	0.4	0.5	0.9	2.1	1.5	0.8	0.2	0.2
Disbursements	2.8	4.4	1.7	1.7	1.6	3.5	3.1	2.3	1.7	1.6
Amortization	-1.2	-1.1	-1.3	-1.3	-0.7	-1.4	-1.6	-1.6	-1.5	-1.4
Statistical discrepancy	-1.9	-1.4	2.3	1.8	0.0	0.0	0.0	0.0	0.0	0.0

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.

Table 4. Scenario 1: Lesotho: Monetary Accounts 2013/14–2019/20[1,2]

(Maloti millions, unless otherwise indicated)

	2013/14	2014/15	2015/16	2016/17	2017/18	2018/19	2019/20
	Act.	Act.	Act.	Act.	Projections		
				I. Monetary Survey			
Net foreign assets	12,871	14,877	15,795	13,268	12,152	11,435	10,579
Central bank	8,955	11,131	12,267	9,602	8,574	7,865	7,079
Commercial banks	3,915	3,746	3,528	3,667	3,578	3,570	3,500
Net domestic assets	-3,766	-5,637	-5,966	-2,573	-395	1,412	2,496
Central bank	-7,570	-9,632	-10,428	-7,706	-6,173	-5,841	-5,716
Claims on central government (net)	-3,569	-5,130	-3,972	-1,368	660	1,734	3,002
Central bank	-4,250	-5,731	-4,772	-2,198	-620	-196	-86
Commercial banks	681	600	800	830	1,280	1,930	3,088
Claims on private sector	4,562	5,101	5,519	5,842	6,337	7,375	7,410
Other items (net)	-4,771	-5,623	-7,592.54	-7,421	-7,804	-8,140	-8,395
Broad money (M2)	9,105	9,240	9,829	10,692	11,756	12,846	13,075
Currency outside banks	840	907	907	935	1,095	1,168	1,183
Deposits	8,265	8,333	8,922	9,757	10,661	11,678	11,892
				II. Central Bank			
Net foreign assets	8,955	11,131	12,267	9,602	8,574	7,865	7,079
Gross reserves	10,326	12,533	13,984	11,155	10,074	9,207	8,266
Net domestic assets	-7,570	-9,632	-10,428	-7,706	-6,173	-5,841	-5,716
Claims on central government (net)	-4,250	-5,731	-4,772	-2,198	-620	-196	-86
Claims on private sector	52	61	77	90	98	106	115
Other items (net)[2]	-3,373	-3,963	-5,733	-5,598	-5,651	-5,751	-5,745
Reserve money	1,385	1,499	1,839	1,896	2,401	2,024	1,363
Currency in circulation	984	1,093	1,167	1,200	1,386	1,502	1,545
Commercial bank deposits	392	350	621	649	1,015	522	-182
Liabilities to other sectors	8	56	52	47	0	0	0
Memorandum items:			(12-month percent change, unless otherwise indicated)				
Reserve money	15.2	8.2	22.7	3.1	26.6	-15.7	-32.7
Broad money	31.5	1.5	6.4	8.8	10.0	9.3	1.8
Narrow money (M1)	24.5	2.6	15.5	6.6	11.1	13.2	7.0
Narrow money (M1) (Maloti millions)	4,156	4,266	4,927	5,254	5,837	6,608	7,070
Credit to the private sector	10.3	11.8	8.2	5.8	8.5	16.4	0.5
Credit to the private sector (percent of GDP)	18.0	17.4	17.0	17.0	16.8	18.2	16.9
Velocity (GDP/broad money)	2.8	3.2	3.3	3.2	3.2	3.2	3.4
Gross international reserves to M1 (in percent)	248	294	284	208	169	136	114
Gross international reserves minus M1 (in percent of domestic currency deposits)	74.7	99.2	101.5	60.5	39.7	22.3	10.1

Sources: Lesotho authorities and IMF staff estimates and projections.

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

[2] Including valuation changes.

Table 5. Scenario 1: Lesotho: Balance of Payments 2013/14–2022/23[1]

(US$ millions, unless otherwise indicated)

	2013/14	2014/15	2015/16	2016/17	2017/18	2018/19	2019/20	2020/21	2021/22	2022/23
	Act.	Act.	Act.	Act.			Projections			
Current account	-138	-131	-105	-182	-181	-333	-359	-140	-233	-390
Trade balance	-975	-954	-759	-725	-867	-936	-924	-900	-984	-1,110
Exports, f.o.b.	820	874	935	913	1,047	1,134	1,210	1,281	1,362	1,444
Imports, f.o.b	1,794	1,828	1,694	1,638	1,914	2,070	2,135	2,181	2,347	2,554
Services (net)	-315	-312	-253	-247	-323	-381	-398	-379	-431	-509
Primary income (net)	343	320	294	318	360	382	402	417	437	456
Secondary income (net)	808	815	613	472	649	602	562	721	746	772
Official transfers	667	679	498	352	513	457	410	564	581	600
Of which: SACU revenue	627	649	502	307	449	394	344	491	506	523
Other transfers	142	136	115	120	136	145	152	158	165	172
Capital account	109	30	50	37	76	215	250	90	213	412
Current and capital account	-30	-100	-55	-145	-105	-118	-109	-50	-19	22
Financial account	88	-128	-110	-310	-105	-118	-109	-50	-19	22
Foreign direct investment	-48	-112	-106	-77	-56	-60	-63	-65	-68	-71
Portfolio investment	3	3	2	2	2	2	3	3	3	3
Other investment	-5	-217	-130	31	29	2	17	48	70	71
Of which:										
Public sector (net)	39	87	9	11	26	62	46	24	7	7
Disbursements	69	115	41	42	45	103	94	75	56	57
Central government	73	117	44	40	45	102	92	73	54	56
Other public sector	-3	-2	-3	2	0	2	2	2	1	1
Amortization	-31	-28	-32	-31	-19	-41	-48	-50	-49	-50
Change in reserve assets	139	199	124	-266	-79	-63	-66	-35	-24	19
Errors and omissions	118	-27	-55	-165	0	0	0	0	0	0
Memorandum items:				(Percent of GDP, unless otherwise noted)						
Current account	-5.5	-4.9	-4.5	-7.4	-6.5	-11.3	-11.6	-4.4	-7.0	-11.2
Current account (exc. LHWP-2 project)	-5.5	-4.9	-4.5	-7.4	-5.5	-6.3	-6.8	-2.9	-2.3	-1.8
Trade balance	-41.8	-38.1	-31.0	-30.5	-31.7	-32.7	-30.9	-29.1	-30.7	-33.2
Current and capital account	-1.3	-4.0	-2.2	-6.1	-3.8	-4.1	-3.7	-1.6	-0.6	0.6
Official grants	26.6	25.7	21.2	14.4	18.5	15.6	13.3	17.6	17.5	17.3
Exports of goods and services										
Percent change (Maloti terms)	-1.3	15.8	35.6	1.0	11.0	9.7	10.0	9.4	10.4	10.2
Percent change ($US terms)	-17.1	6.1	8.8	-0.9	14.6	8.1	6.7	5.7	6.2	5.9
Imports of goods and services										
Percent change (Maloti terms)	-2.4	10.6	14.6	-0.5	14.8	11.1	6.6	4.6	12.6	14.5
Percent change ($US terms)	-18.0	1.3	-8.0	-2.5	18.5	9.4	3.4	1.2	8.4	10.1
Gross international reserves										
(US$ millions)	976	1,029	949	825	745	683	616	581	557	576
(Months of imports)	5.16	5.47	6.14	4.18	3.40	2.91	2.49	2.07	1.72	1.63
(Months of imports, excluding imports for LHWP-2)	5.16	5.47	6.14	4.24	3.61	3.08	2.53	2.18	1.92	1.80
(in percent of M1)	248	294	284	208	169	136	114	102	91	88
National currency per US$	10.1	11.1	13.8	14.1	13.6	13.8	14.2	14.7	15.3	15.9

Sources: Lesotho authorities and IMF staff estimates and projections.

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

Table 6. Lesotho: Sustainable Development Goals

	2000	2005	2010	2014	2015
Goal 1: No Poverty					
Poverty headcount ratio at $1.90 a day (2011 PPP) (% of population)	…	…	59.7	…	…
Poverty headcount ratio at national poverty lines (% of population)	…	…	57.1	…	…
Urban poverty headcount ratio at national poverty lines (% of urban population)	…	…	39.6	…	…
Goal 2: Zero Hunger					
Prevalence of undernourishment (% of population)	13	11	11.4	11.2	11.2
Prevalence of underweight, weight for age (% of children under 5)	15	…	…	10.3	…
Prevalence of wasting, weight for height (% of children under 5)	6.7	…	…	2.8	…
Goal 3: Good Health and Well-Being					
Immunization, measles (% of children ages 12-23 months)	74	83	88	90	90
Maternal mortality ratio (modeled estimate, per 100,000 live births)	649	746	587	513	487
Mortality rate, neonatal (per 1,000 live births)	37.7	35.2	34.8	33.4	32.7
Mortality rate, under-5 (per 1,000)	116.8	123.4	100.7	92	90.2
Goal 4: Quality Education					
Adult literacy rate, population 15+ years, both sexes (%)	86.3	…	…	…	79.4
Lower secondary completion rate, both sexes (%)	27.5	31.4	40.5	42.9	…
Gross enrolment ratio, tertiary, both sexes (%)	2.3	3.7		9.8	…
Pupil-teacher ratio in primary education (headcount basis)	47.9	41.6	33.8	32.8	…
Goal 5: Gender Equality					
Nondiscrimination clause mentions gender in the constitution (1=yes; 0=no)	…	…	…	…	1
Proportion of seats held by women in national parliaments (%)	3.8	11.7	24.2	26.7	25
Goal 6: Clean Water & Sanitation					
Improved sanitation facilities (% of population with access)	23.9	26.2	28.5	30.2	30.3
Improved water source (% of population with access)	79	79.9	80.8	81.6	81.8
Goal 7: Affordable and Clean Energy					
Access to electricity (% of population)	5	…	17	…	…
Access to electricity, rural (% of rural population)	2.7	…	7.4	…	…
Access to electricity, urban (% of urban population)	14.3	…	43.2	…	…
Goal 8: Decent Work and Economic Growth					
GDP growth (annual %)	5.1	2.7	7.9	3.6	…
Unemployment, total (% of total labor force)	26.6	36.4	28.3	26.2	…
Unemployment, youth total (% of total labor force ages 15-24) (modeled ILO estimate)	34.7	44.7	35.6	33	…
Goal 9: Industry, Innovation and Infrastructure					
Investment in telecoms with private participation (current US$)	2800000.0	3000000.0	11000000.0	0.0	…
New business density (new registrations per 1,000 people ages 15-64)	…	0.8	1.5	1.6	…
Goal 10: Reduced Inequalities					
Average transaction cost of remittances (%)	…	…	…	16.7	14.6
Personal remittances, received (% of GDP)	61.9	43.8	27.9	17.4	…
Goal 11: Sustainable Cities and Communities					
Urban population (% of total population)	19.5	22.2	24.8	26.8	27.3
Urban population growth (annual %)	3.5	3.3	3	3.2	3.2
Population living in slums (% of urban population)	…	35	…	50.8	…
Goal 12: Responsible Consumption and Production					
Renewable electricity output (% of total electricity output)	100	100	100	…	…
Renewable energy consumption (% of total final energy consumption)	100	5.4	4.1	…	…
Water productivity, total (constant 2010 US$ GDP per cubic meter of total freshwater withdrawal)	…	…	…	59.1	…
Goal 13: Climate Action					
PM2.5 air pollution, mean annual exposure (micrograms per cubic meter)	10.1	10.4	10.6	…	…
PM2.5 air pollution, population exposed to levels exceeding WHO guideline value (% of total)	53.1	78.3	89.4	…	…
CO_2 emissions (kg per PPP $ of GDP)		0.5	0.5	…	…
Terrestrial and marine protected areas (% of total territorial area)	0.5	…	…	0.5	…
Goal 14: Life Below Water					
Aquaculture production (metric tons)	8	1	300.4	900.5	…
Capture fisheries production (metric tons)	32	45	45	52	…
Total fisheries production (metric tons)	40	46	345.4	952.5	…
Goal 15: Life on Land					
Forest area (% of land area)	1.4	1.4	1.4	1.6	1.6
Goal 16: Peace, Justice and Stong Institutions					
Tax revenue (% of GDP)	36.1	46.2	…	…	…
Overall level of statistical capacity (scale 0 - 100)	…	71.1	65.6	72.2	65.6
Goal 17: Partnerships for the Goals					
Individuals using the Internet (% of population)	0.2	2.6	3.9	11	16.1
Net official development assistance and official aid received (current US$)	36670000.0	67490000.0	255920000.0	103610000.0	…

Source: World Bank SUSTAINABLE Development Goals (SDGs Database)

Table 7. Lesotho: Commercial Bank Performance Ratios, 2009–17

(End-period; percent)

	2009	2010	2011	2012	2013	2014	2015	2016	2017Q1	2017Q2
I. Capital adequacy										
a) Basel capital ratio	13.5	14.9	16.0	14.1	12.6	13.9	15.2	18.0	23.2	17.2
b) Nonperforming loans net of provisions to capital	-9.3	0.5	-6.3	-6.6	11.0	8.0	7.8	7.4	7.6	8.9
c) Top 20 exposures to statutory capital and reserves	359	522	528	456	495	580	609	...	655	345
II. Asset quality										
a) Loans to deposit ratio	32.4	35.4	43.6	57.1	55.8	60.4	58.4	...	56.9	56.8
b) Earning assets to total assets	86.0	91.3	92.0	87.5	87.4	84.9	87.5	...	86.9	83.6
c) Nonperforming loans to total assets	3.2	3.1	2.2	2.5	3.7	4.1	3.9	...	1.7	1.6
d) Reserve for losses to total loans	4.3	3.1	2.7	3.0	3.5	3.8	3.5	...	3.5	3.6
e) Reserve for losses to nonperforming loans	136.2	98.3	124.0	117.3	89.6	87.3	86.5	...	84.8	87.6
III. Liquidity										
a) Liquid assets to total deposits	95	99	96	76	86	86	89	...	32	29.1
b) Available reserves to total deposits	3.5	3.6	2.3	3.0	3.7	6.8	2.9	...	7.7	8.2
c) Liquid assets to total assets	70	72	68	56	35	41	40	31	33.9	31.2
d) Current assets to current liabilities	107	108	109	111	109	110	114	...	112	109
IV. Profitability										
a) Interest margin to gross income	6.2	5.2	5.4	6.7	55.9	58.4	3.8	58.0	1.2	2.5
b) Cost to income	56	56	58	59	58	57	66	...	72	75.5
c) Return on assets (ROA)	2.8	2.7	2.8	3.0	4.9	4.5	4.5	1.1	4.1	3.5
d) Return on equity	33.3	30.9	29.0	30.4	42.7	40.5	40.1	61.5	31.7	27.3

Source: Central Bank of Lesotho.

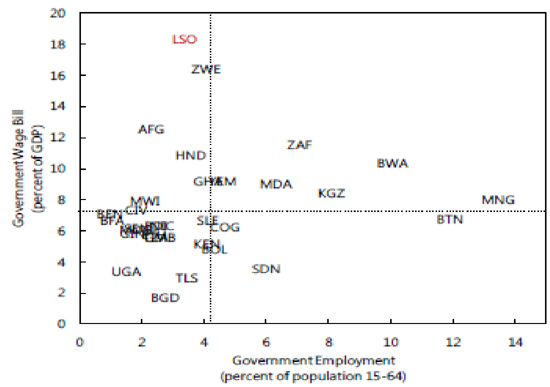
Annex I. Risk Assessment Matrix

Source of main risks	Relative Likelihood	Expected impact on the economy if risk is realized	Relative Impact	Possible remedial policy
Global Risks				
Tighter and more volatile global financial conditions, associated with sharp rise in risk premia, or further unanticipated tightening of U.S. monetary policy.	**Medium**	While Lesotho has no access to international capital markets, the spillovers would be strong due to the dependence on South Africa (SA). Rising capital costs would weigh negatively on the economic outlook for SA, leading to a slowdown in activity in Lesotho and weaker SACU transfers. Stronger U.S. dollar could increase the import bill for Lesotho, leading to further deterioration of the current account.	**Low**	Advance structural reforms to increase competitiveness and diversification, and reduce income inequality to develop domestic markets.
Weaker-than-expected global growth, including significant slowdown in China, large EMS, or key advanced and emerging economies.	**Medium**	Depressed global demand translates into weaker Lesotho exports to the rest of the world, in particular to the main trading partner, SA, and to a lesser extent, the U.S. and EU. An economic slowdown in SA would reduce SACU transfers, which form a substantial portion of fiscal revenues.	**Medium**	Advance structural reforms to increase competitiveness and diversification, and reduce income inequality.
Domestic Risks				
Continued political instability.	**High**	Political instability would delay reform implementation, particularly for the urgently-needed fiscal consolidation efforts. Failure to address the SADC recommendations may also jeopardize AGOA access.	**High**	Produce the roadmap for SADC recommendations by the end-November deadline, and implement the reforms accordingly.
Insufficient fiscal adjustment to sharp decline in SACU transfers.	**High**	Lesotho's fiscal and external position would decline sharply with negative repercussions for the stability of the peg to the Rand.	**High**	Implement fiscal consolidation and seek concessional financing by reengaging with donors.

Annex II. Lesotho's Large Wage Bill[1]

1. The government wage bill in Lesotho is one of the highest in the world at 18 percent of GDP. While public employment is not disproportionate (Chart), wages are very high. The average wage in the public sector is 13.6 times GDP per capita compared to only 4.1 in South Africa. With respect to GDP per capita, wages in Lesotho are higher than in South Africa for all the grades in the civil service pay scale, but the difference is largest for the highest grades. Indeed, real wages to middle and high grades are competitive with South African levels after adjusting for purchasing power differences.

Wage Bill and Employment in Low Income and Southern African Countries, 2015 or more recent years



Source: IMF staff estimates

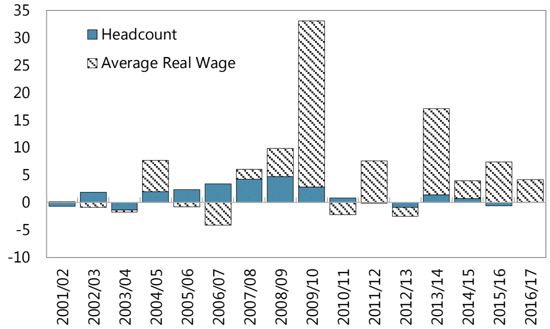
2. Aggressive wage increases are at the root of the problem. Wages in the public sector grew faster than inflation in eight of the last ten years. The dynamic is explained by generous cost of living adjustments and "notch" increases that shift workers automatically to the next higher point-value of their grade regardless of their performance.

3. Almost a third of the employees are in the bottom two grades. The perception from management in some ministries is that there is overemployment in the bottom two grades and underemployment in the middle grades. The implementation of an effective establishment list is critical to assess the real manpower needs of the different ministries and improve the quality of government services.

4. Public employees receive 43 percent higher wages than comparable workers in the private sector. The public wage premium is estimated using the Continuous Multipurpose Survey of 2013/14 and controls for individual characteristics such as education, age, and gender. After the 2013/14 pay structure review, a large wage premium has emerged for public employees with tertiary education. The structural review of public sector wages aimed at raising salaries to attract and retain skilled employees who usually find competitive work opportunities in South Africa. After its implementation, public employees with a tertiary education are paid 60 percent more than their peers in the private sector, whereas the difference was insignificant in FY2010/11. The public-sector premium remains minimal for employees with a primary education and around 40 percent for employees with a secondary education.

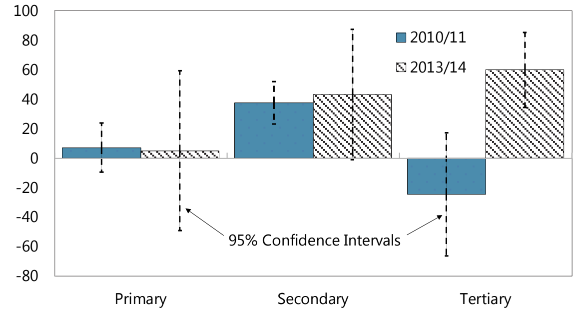
[1] Prepared by Cristian Alonso.

Decomposition of Changes in Compensation of Employees
(Percent)



Source: MOF

Public Sector Wage Premium by Education Level
(Percent)



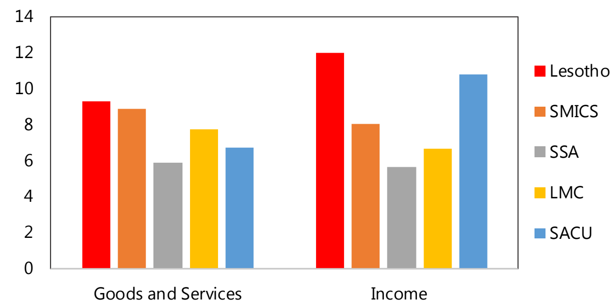
Sources: IMF staff calculations based on household surveys
Note: Dashed lines represent 95% confidence intervals

Annex III. Restoring Fiscal Space[1]

This annex examines two channels for creating fiscal space: increasing tax revenues and improving spending efficiency, by comparing Lesotho's with similar countries.[2]

1. Lesotho collects relatively more than comparable countries in income and consumption taxes, indicating narrow scope for further revenue measures. Tax potential is defined as the projected tax revenue level that a country can achieve given its macroeconomic fundamentals. Predicting tax potential both with a standard fixed-effects panel and with stochastic frontier regressions shows that Lesotho mobilizes more domestic taxes than comparable countries in the region. The performance is particularly strong for income taxes which might be at least partly explained by the relatively high tax rate.

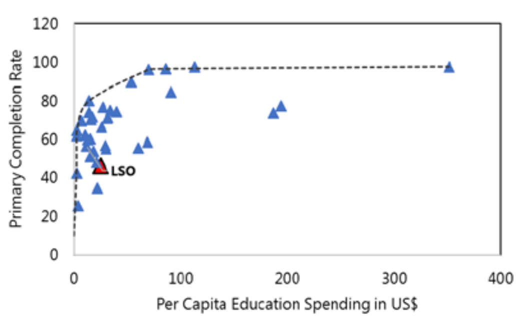
Tax Categories, 2015



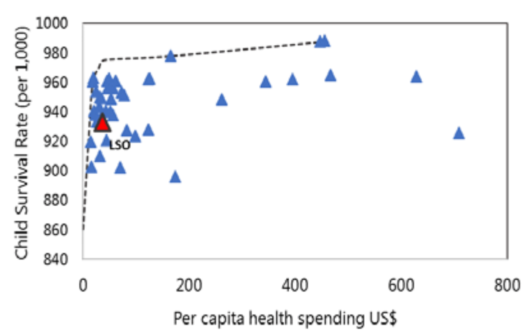
Sources: Country authorities and IMF staff caclulations

2. Lesotho spends large amounts on social sectors, but spending is inefficient. Despite spending over 8 percent of GDP in health care, outcomes in Lesotho are extremely weak with low life expectancy, high prevalence of HIV/AIDS and tuberculosis, and high and rising infant and maternal mortality rates. The education sector is faced with similar challenges, receiving about 13.2 percent of GDP in funding in recent years while outcomes have remained stagnant or even deteriorated. Both in health and education Lesotho could attain better outcomes with even lower spending levels, demonstrated by the countries along the "best practice frontier" in the region.

Efficiency of Education Spending: Primary Completion vs. per Capita Education Spending, 2010–2014



Efficiency of Health Spending: Child Survival vs. per Capita Health Spending, 2010–2014



[1] Prepared by Nana Hammah, Research Analyst.

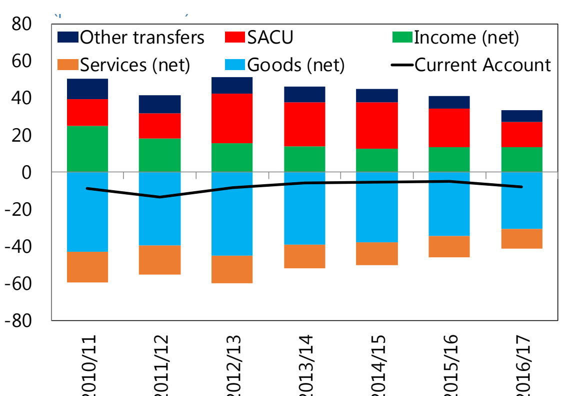
[2] SMICS include Botswana, Cabo Verde, Lesotho, Mauritius, Namibia, Seychelles, and Swaziland. LMC refers to low middle income countries as defined by the World Bank. SSA and SACU refers to countries in Sub-Saharan Africa and the SACU region,

Annex IV. External Sector Assessment

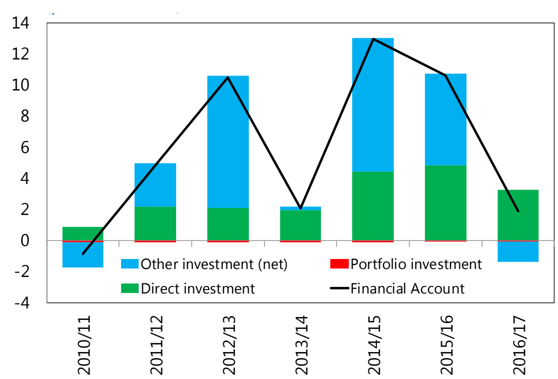
The external position of Lesotho weakened in 2016/17 because of a decline in SACU revenues and lower exports, but remained broadly in line with medium-term fundamentals and desirable policies. Over the medium term, the large current account deficit is expected to persist as the new government deals with the vulnerabilities associated to spillovers from South Africa. Rand volatility and weaknesses in competitiveness pose challenges for policy making in Lesotho.

1. The current account deficit deteriorated in 2016/17 due to a steep drop in SACU transfers of about 7 percent of GDP and lower diamonds exports. SACU transfers dropped by almost half in FY 2016/17 compared to the peak of 24 percent of GDP in FY2014/15. Lesotho's imports represent about 90 percent of GDP and their financing is highly dependent on SACU transfers. As SACU transfers are highly correlated with South African imports, they will decline further in FY 2018/19 and are expected to bottom out only in FY 2019/20. Over the medium term, they are projected to recover in line with the cyclical upswing in South Africa. The current account will also be subject to large capital grants in the near term with the beginning of the Lesotho Highlands Water Project Phase II, which will be only partly offset by imports of capital goods. Over the long term, the project will contribute to exports. Risks also arise from Lesotho's export concentration with over 25 percent (mainly textiles) directed to the United States, exposing the country to volatility in the Rand/dollar exchange rate.

Current Account Balance
(Percent of GDP)



External Financing
(Percent of GDP)

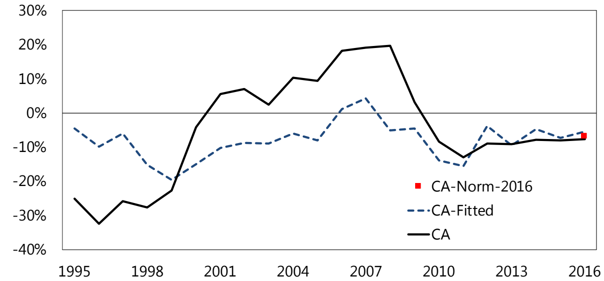


Sources: Country authorities and IMF staff calculations

2. FDI inflows have contributed to financing in recent years, but cannot offset the drop in SACU transfers. FDI inflows reached about 4 percent of GDP in 2014/15 and 2015/16, partly reflecting investments in diamond mining. Moving forward, international reserves in months of prospective imports are projected to decline as there are no offsetting factors to the sharp drop in SACU revenues.

3. The EBA-lite current account model points to an exchange rate that is broadly in line with Lesotho's fundamentals.[1] For the EBA-lite current account approach, the current account norm is based on a cross country panel regression, cyclical factors, and desirable medium-term policy levels. It considers a broad set of factors such as desirable level of policies, cyclical factors, aid and remittances. The EBA-lite current account deficit norm of 6.6 percent of GDP is just slightly lower than the 7.4 percent of GDP deficit for FY 2016/17.

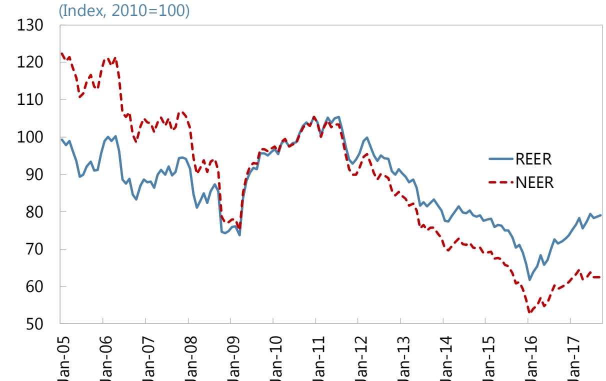
Current Account Estimates
(percent of GDP)



Source: IMF Staff Estimates.

4. Real effective exchange rate developments are driven by factors that originated in South Africa and broadly mirrors nominal exchange rate movements. The depreciation trend from 2011 to 2016, has been partly offset by the recent Rand appreciation.

Real and Nominal Effective Exchange Rates
(Index, 2010=100)



Sources: IMF Information Notice System and staff calculations.

5. Considering the effect of the importance of SACU transfers and the currency peg on the EBA-lite models, the Loti appears to be broadly in line with current fundamentals. Lesotho's external position is heavily determined by the economic developments in South Africa, in particular the outsized influence of SACU transfers and the volatility of the Rand vis-à-vis the dollar.

Table 1. Real Exchange Rate Assessment Results
(Percent of GDP)

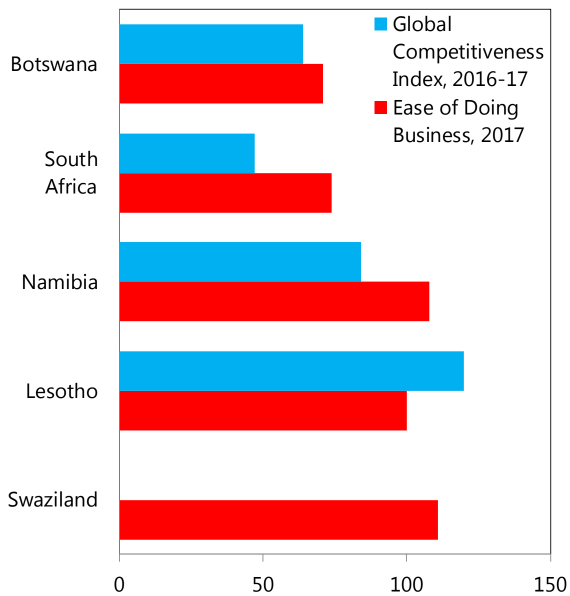
	EBA-lite Current Account Regression
Current account reference	-7.7
Current account norm	-6.6
Current account gap	1.1
o/w Policy gap	1.5
Real exchange rate gap	2.6

Source: IMF staff estimates.

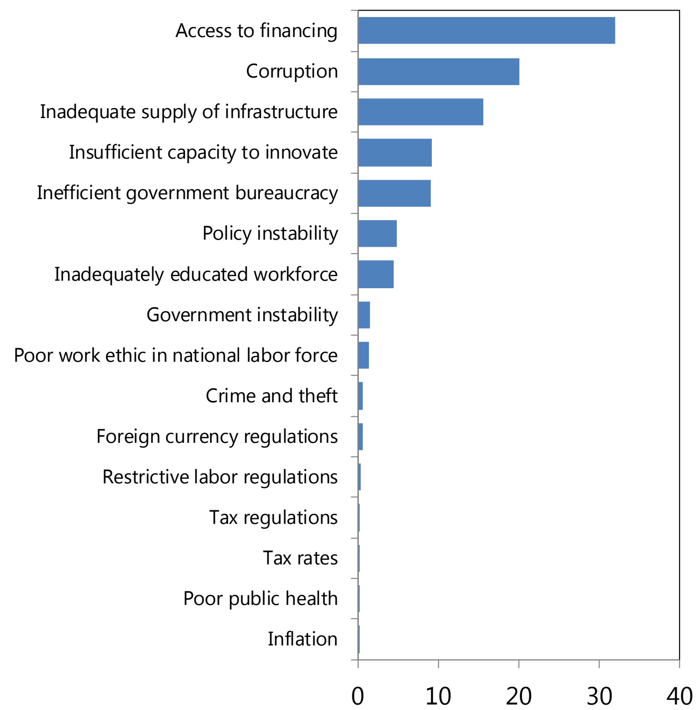
6. The World Bank and the World Economic Forum competitiveness indicators highlight Lesotho's struggles. Lesotho is among the worst ranked SACU members in both the 2017 Ease of Doing Business and the 2016-17 Global Competitiveness Report overall rankings. Access to financing is pointed out as the most problematic factor for doing business in Lesotho, followed up by corruption and inadequate supply of infrastructure.

[1] The I-REER (Index-REER) approach is not discussed in detail in this assessment. It points to a large undervaluation of the exchange rate (47 percent). These findings are not consistent with the results of the EBA-lite and difficult to reconcile with the substantial current account deficit.

Competitiveness Rankings, 2016–2017
(Rank out of 189 and 138)



Major Problematic Factors for Doing Business, 2016
(Weighted Response)



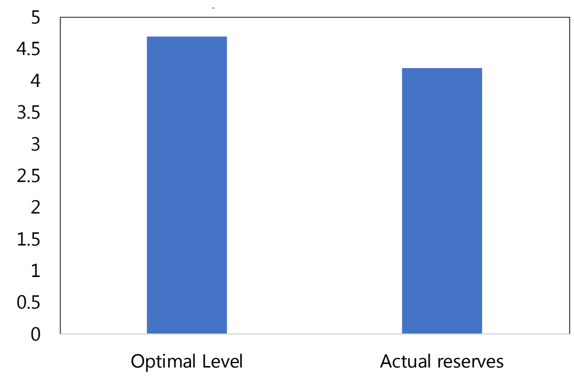
Sources: World Bank, World Economic Forum

Annex V. Reserve Adequacy

1. Lesotho's international reserves have been on a declining trend since the August 2014 peak of US$1.1 billion. Reserves at end-August 2017 were US$864 million, equivalent to around four months of prospective imports. The optimal level of reserves for Lesotho is estimated to be around 4.7 months of imports. However, reserves remained above the minimum threshold of traditional metrics (3 months of imports, 100 percent of short-term debt, and 20 percent of broad money) as they cover 185 percent of short-term debt and more than 100 percent of broad money.

2. Based on a cost-benefit panel model regression, Lesotho's reserves coverage is below optimal. A panel regression is estimated for countries with limited or no access to the international capital markets. The model proposed by Dabla-Norris et al. (2011) and adapted for credit constrained economies (2013)[1] estimates the optimal level of reserves based on: i) the possibility of a crisis (a probit model) to determine the role of reserves in preventing the crisis, and; ii) a "loss regression", to measure the role of reserves in reducing the severity of a potential crisis. The model results point to an optimal level of reserves of 4.7 months of imports, assuming a cost of holding reserves of about 3.5 percent.[2]

Figure 1. Reserve Adequacy Assessment
(Reserves in months of imports)



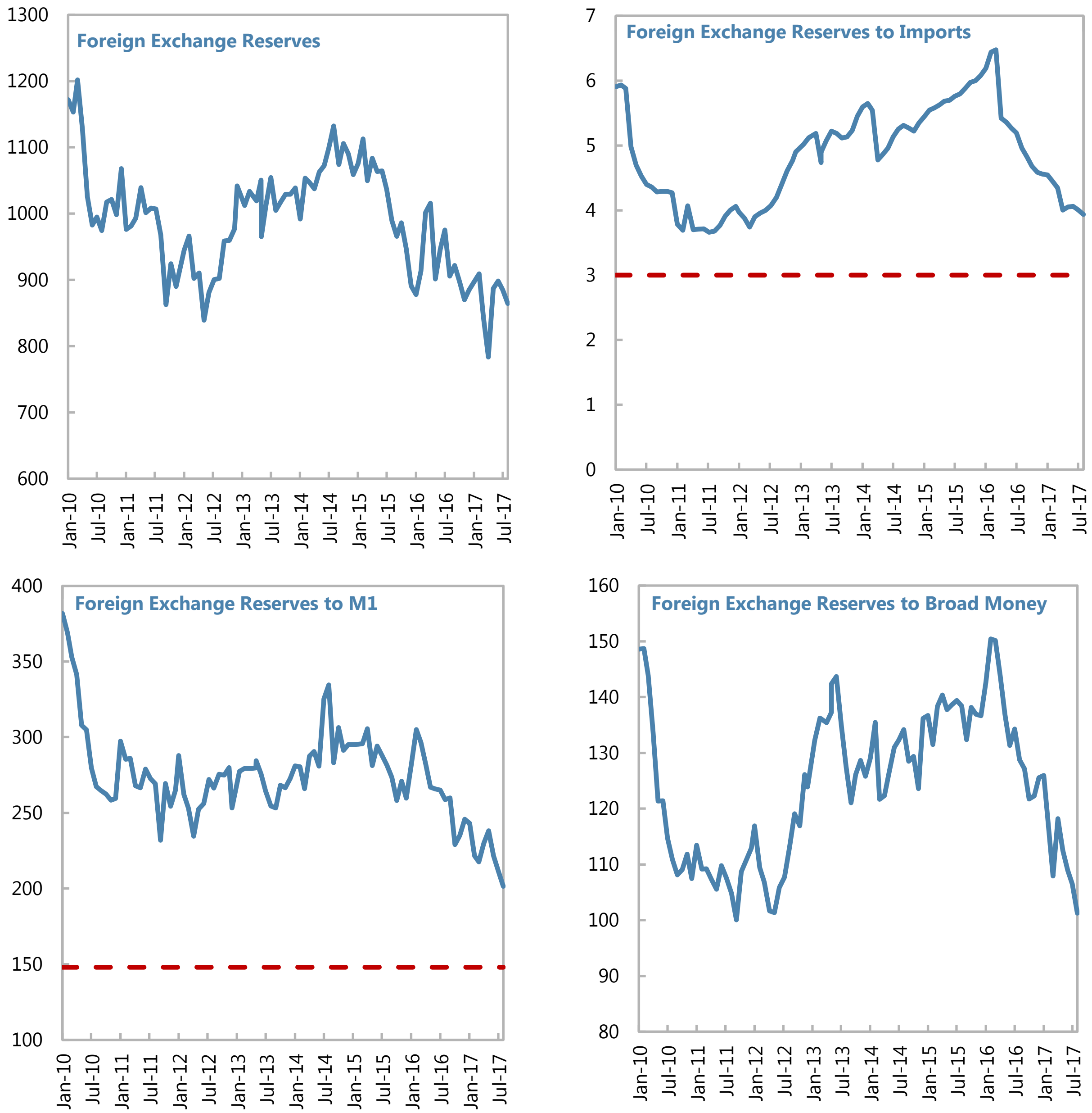
3. This approach emphasizes the need for a heightened level of reserves for countries like Lesotho, having a fixed exchange rate regime and the need to build resilience against external shocks. A robust level of reserves is especially critical for Lesotho due to its external situation. The trending decline in SACU transfers as well as uncertainties surrounding other foreign exchange receipts underscore the need for authorities to maintain adequate buffers. Imports from South Africa account for more than 80 percent of Lesotho's imports. Therefore, the CBL keeps a significant share of foreign reserves as South African Rand.

[1] See "Assessing Reserve Adequacy (ARA)" board papers (IMF 2011,2013,2014) and "Guidance Note: Assessing Reserve Adequacy in Credit-Constrained Economies" (IMF 2016).

[2] For a country like Lesotho, a credit-constrained economy, the opportunity cost of holding reserves could be proxied by the marginal product of capital. In the recent past, it is estimated at around 3.5 percent if taken as a residual between real GDP average growth and population (labor) growth.

Figure 2. Lesotho: Reserve Adequacy Indicators

(3-month moving average)



Source: Lesotho Authorities and IMF staff calculations.

Annex VI. Debt Sustainability Analysis[1,2]

Lesotho's risk of external debt distress has been revised from "moderate" in the 2015 Article IV to "low" in 2017, [3] *mainly due to the recent rebasing of GDP*[4]*, but also to solid GDP growth and revisions to the assessment for new borrowing requirements-the latter tied to non-inclusion of a hydropower project in the current analysis. Under the baseline scenario, all indicators remain below their corresponding thresholds throughout the projection period, with the present value of external public and publicly guaranteed (PPG) debt-to-GDP ratio reaching a peak of around 24 percent by 2020, well below its threshold of 40 percent of GDP. Under stress tests, a large negative shock to exports constitutes the main risk for a possible deterioration of external debt indicators, but even under the most extreme simulated shocks, debt ratios remain below their corresponding thresholds. These findings illustrate that Lesotho has some scope to address challenges from the severe cyclical downswing of Southern African Customs Unions (SACU) revenues by new external borrowing. However, the sensitivity to export shocks illustrates the need for a sizable grant component in new external debt as part of a prudent debt strategy to preserve the low risk of debt distress. Domestic debt is low at around 3 percent of GDP in 2016, with additional domestic contingent liabilities from the underfunded pension system adding about 3.5 percentage points of GDP in present value terms.*

A. Recent Developments and Underlying Assumptions

1. **Lesotho's total public debt declined from 41.3 percent of GDP in 2015 to 35.4 percent in 2016.** This drop is the result of a decline in the valuation of foreign-exchange denominated external debt due to a 10 percent Rand appreciation, limited new borrowing, and solid GDP growth. External debt represented 88.7 percent of total debt, with a substantial share contracted with multilateral creditors. The stock of domestic debt could increase if large pension fund liabilities, estimated at 3.5 percent of GDP in present value terms, remain unfunded, but the government has initiated work with World Bank assistance to address this issue. Technical assistance has been provided in 2017 to assist the government in developing a medium-term debt strategy.

[1] Prepared by the staffs of the International Monetary Fund (IMF) and the International Development Association (IDA). Approved by Anne Marie Gulde (AFR), Gavin Gray (SPR) and Paloma Anos Casero (IDA).

[2] The DSA updated the previous Join DSA dated January 12, 2016 (IMF Country Report No. 16/33). The DSA follows the IMF and World Bank Staff Guidance Note on the Application of the Joint Fund-Bank Debt Sustainability Framework for Low-Income Countries (November 5, 2013). The DSA uses the unified discount rate of 5 percent set out in Decision No. 15462 (October 11, 2013). For the purpose of defining debt burden thresholds under the Debt Sustainability Framework (DSF), Lesotho is classified as a medium policy performer. Lesotho's average rating on the World Bank's Country Policy and Institutional Assessment (CPIA) for the period 2014-16 is 3.37. The corresponding indicative thresholds are: 40 percent for the NPV of PPG external debt-to-GDP ratio; 150 percent for the net present value (NPV) of debt-to-exports ratio; 250 percent for NPV of debt-to-revenue ratio; 20 percent for the debt service-to-exports ratio; and 20 percent for the debt service-to-revenue ratio.

[3] The years refer to fiscal years running from April 1st.

[4] Rebased national accounts were published in October 2016. The base year is 2012. Nominal GDP at local current prices was revised upwards by about 10 percent on average, from previously reported national accounts.

2. The previous DSA (2015) assessed Lesotho's risk of external debt distress as moderate. The moderate rating was driven by a decision to include financing for a potential hydropower project that could be added to the second phase of the Lesotho Highlands Water Project (LHWP-II)—a mega infrastructure project to export drinking water to South Africa. While LHWP II is grant funded, the hydropower project would probably be financed mostly on commercial terms. Assumptions regarding possible external borrowing associated with this project pushed the PV of PPG external debt-to-GDP, in the 2015 DSA, to a level close to the 40 percent threshold by 2025. Consequently, the stress test yielded a protracted breach, maintaining Lesotho's debt rating at moderate. While there were indications at the 2015 Article IV that this project was clearly specified and the government indicated strong interest in pursuing it, the project turned out more complicated than expected. Therefore, the government initiated new feasibility studies to explore different technical options with very different cost and economic implications. Only once these feasibility studies are completed, the government will be able to decide to pursue the project or not. With discussions still at an early stage, this project is not included in the macroeconomic baseline projections for the 2017 DSA.

Lesotho: Public Outstanding Debt
(As of end-March, 2017)

	US$ million	Percent of total
Domestic debt	100	11.3
External debt	788	88.7
Mulitlateral	662	74.6
IDA	282	31.7
ADF	122	13.8
EIB	116	13.1
IMF	65	7.3
BADEA	32	3.6
IFAD	30	3.4
OFID	15	1.7
Bilateral	120	13.5
China Exim Bank	50	5.6
Kuwait Fund	27	3.1
Saudi Fund	23	2.6
Abu Dhabi Fund	15	1.6
India Exim Bank	6	0.6
Commercial	6	0.6
Total	888	100.0

Source: Country Authorities.

3. Lesotho's public debt sustainability analysis assumes that the fiscal stance will remain loose during the cyclical downturn in SACU revenues. SACU revenues have been well below historical levels and this cyclical downturn will probably last for two years due to the projected slow cyclical recovery in South Africa. After that, SACU revenues are projected to recover in line with projections for South Africa, leading to broadly balanced budgets. The DSA results are based on a macroeconomic baseline scenario, discussed with the authorities during the 2017 Article IV consultation mission, that has embedded no significant fiscal adjustment in response to the SACU revenue shortfall. The DSA is based on the following assumptions:

- **Macroeconomic assumptions.** Real GDP growth is projected to reach 3.1 percent in 2017/18, but ease to 1.7 percent in 2018/19 due to the difficult macroeconomic environment, before benefitting over the medium term from mining and the construction of the construction of the LHWP II. By 2025, when LHWP II is finalized, the current account deficit is expected to narrow gradually, helped by the additional water exports and weaker capital goods imports. Over the long term, real GDP growth is conservatively projected to average about 3½ percent a year, broadly in line with the previous DSA and below the 4.1 percent growth average over the last 10 years. Annual CPI inflation is expected to remain broadly unchanged at 5.5 percent until 2019/20 and to remain around 5 percent in the medium term. Exports are expected to be mainly driven by diamonds, textiles, and water, while imports incorporate the effects of large investment projects.

Lesotho. Macroeconomic Assumptions (Averages)

	2015 DSA 2015-20	2017 DSA 2017-22	2015 DSA 2021-35	2017 DSA 2023-37
Nominal GDP (US$) million	2317.0	3158.0	4252.0	5661.8
Real GDP Growth (Percent)	3.8	3.1	3.5	3.4
Inflation (Percent average)	5.0	5.5	5.0	5.1
Domestic Primary Deficit (Percent of GDP)	1.2	1.6	-0.6	-0.6
USD Export Growth (Percent)	5.0	7.9	5.8	7.3
USD Import Growth (Percent)	1.3	8.6	5.2	4.6
Non-interest Current Account Balance (Percent of	-8.5	-8.3	-5.7	-2.1
External Debt (Percent of GDP)	44.0	34.5	47.0	30.3
Public Sector Debt (Percent of GDP)	48.4	42.6	52.1	40.8

Sources: IMF Country Report No. 16/33 and IMF and World Bank staffs calculations.

- **Fiscal assumptions.** Fiscal year 2016/17 ended with a deficit of 6.3 percent of GDP. Despite a moderate rise in SACU revenues, the FY 2017/18 deficit will likely reach about 6.5 percent of GDP due to domestic revenue shortfalls. A cyclical upswing in SACU revenues is expected to take place by FY 2020/21 in line with a recovery for South Africa, leading to broadly balanced budgets.

- **Financing assumptions.** The DSA outcomes result from assuming a borrowing plan for the medium term consistent with the need for highly concessional external financing. The large grant element contained in the borrowing of recent years is expected to continue in the medium term. With 75 percent of total outstanding debt owed to multilateral creditors carrying a large concessional component, the 2017 DSA assumes that the grant element in the new borrowing is expected to remain high.

B. External Debt Sustainability Analysis

Baseline

4. **All external debt sustainability indicators remain below their corresponding thresholds in the baseline scenario (Table and Figure 1).** The present value (PV) of PPG external debt-to-GDP is expected to reach a maximum of 23.6 percent by 2020. The debt path is supported by a large grant element assumed in the new borrowing (42 percent) in line with past borrowing practices. In addition to the ongoing projects and their implied disbursements, the government is planning to borrow on average US$45 to 50 million per year to finance new projects in the medium term. The

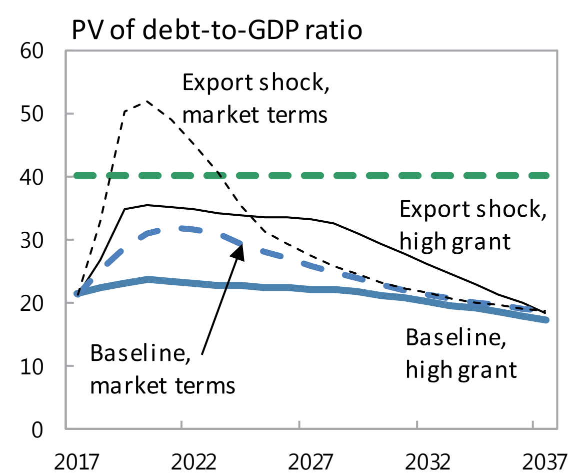
new financing is a mix of foreign development assistance and partly concessional loans (IDA, African Development Bank, EU, Saudi Fund, Abu Dhabi, BADEA and China), aimed at projects to cover the expansion of the airport, roads (Mpiti-Sehlabathebe), water supply (Lowlands Water Project), tax modernization, and other infrastructure projects (Mesitsaneng-Ha TSepo). In addition, Lesotho's eligibility for the Millennium Challenge Corporation, which was approved in December 2017, should open up access to significant grant financing.

Sensitivity Analysis

5. Stress tests show that Lesotho's external debt vulnerabilities would increase significantly, in particular in the event of a major shock to exports, like a terms-of-trade shock (Table 2). In a scenario where export values grow at one standard deviation lower than the historical average (terms-of-trade shock), the shock would likely bring the PV of debt-to-GDP ratio close to the 40 percent threshold in 2020, and remain near threshold for a few years. An export shock would also carry adverse effects to other main external debt indicators, but without breaching the relevant thresholds. The PV of external debt-to-export ratio would peak at 120.2 percent by 2019. In a scenario in which the key variables are set at their average of the past 10 years, Lesotho's external debt ratios fall relative to the baseline, reflecting an average fiscal surplus over the past years thanks to large SACU revenues, strong GDP growth and inflation averaging about 5 percent. However, given the structural breaks in Lesotho's economy, especially the cyclical character of the currently very low SACU revenues, the historical scenario could be considered less relevant for the analysis. In addition, the LHWP II will increase exports once finalized by the end of the medium term.

6. The risk of debt distress is sensitive to the assumption regarding the concessionality of new borrowing, which should be defined in the government as part of a new debt strategy. The text figure highlights differences in debt indicator outturns should new borrowing be transacted at similar terms to that of the current portfolio, vis-à-vis that the current portfolio is replaced by new borrowing at market terms. For the latter, the PV of debt-to-GDP would reach a maximum of 32 percent, still below the threshold. However, under a shock to exports the threshold would be breached (See Figure). This underlines the urgency for the government to develop a medium-term debt strategy that defines the appropriate financing mix.

Lesotho. Impact of Lower Grant on External Debt



C. Public Sector Debt Sustainability

7. Domestic debt is relatively small, and the total public sector debt trajectory is largely determined by external debt developments. A continuous, moderate increase in domestic debt will help finance the projected fiscal deficits in the coming years. Domestic debt would remain at 4 to 5 percent of GDP throughout the projected period unless contingent liabilities from the pension fund materialize.

8. The PV of public sector debt stood at 24.6 percent of GDP in 2016 (Table 3). The standard sensitivity tests for public debt distress point to a higher vulnerability to a real depreciation of the exchange rate (Table 4), pushing the ratio upward but below its benchmark for the forecast period. Adequate buffers would help to keep stressed debt indicators well below the critical levels. The inclusion of contingent liabilities from unfunded pension funds (about 3.5 percent in present value terms) would increase the public debt ratios, but they remain below the indicative benchmark. While guarantees for external debt are monitored well by the Ministry of Finance, weak monitoring of state-owned enterprises limits information about possible domestic contingent liabilities which are, therefore, not included in the DSA. However, based on World Bank analysis, the range of possible contingent liabilities would not have a major impact on the DSA.

9. The fixed primary balance simulation leads to a sharp increase in public debt. The upward trend in public debt under this scenario is driven by the large cyclical upswing in the primary fiscal deficit estimated for 2017. In this simulation, the deficit is kept unchanged at 5.7 percent of GDP for the whole forecast period, generating very large financing needs that continue to grow over time. In contrast, a more realistic assumption is reflected in the baseline, including a gradual recovery in South Africa's GDP which is the major determinant of SACU revenues.

D. Conclusion

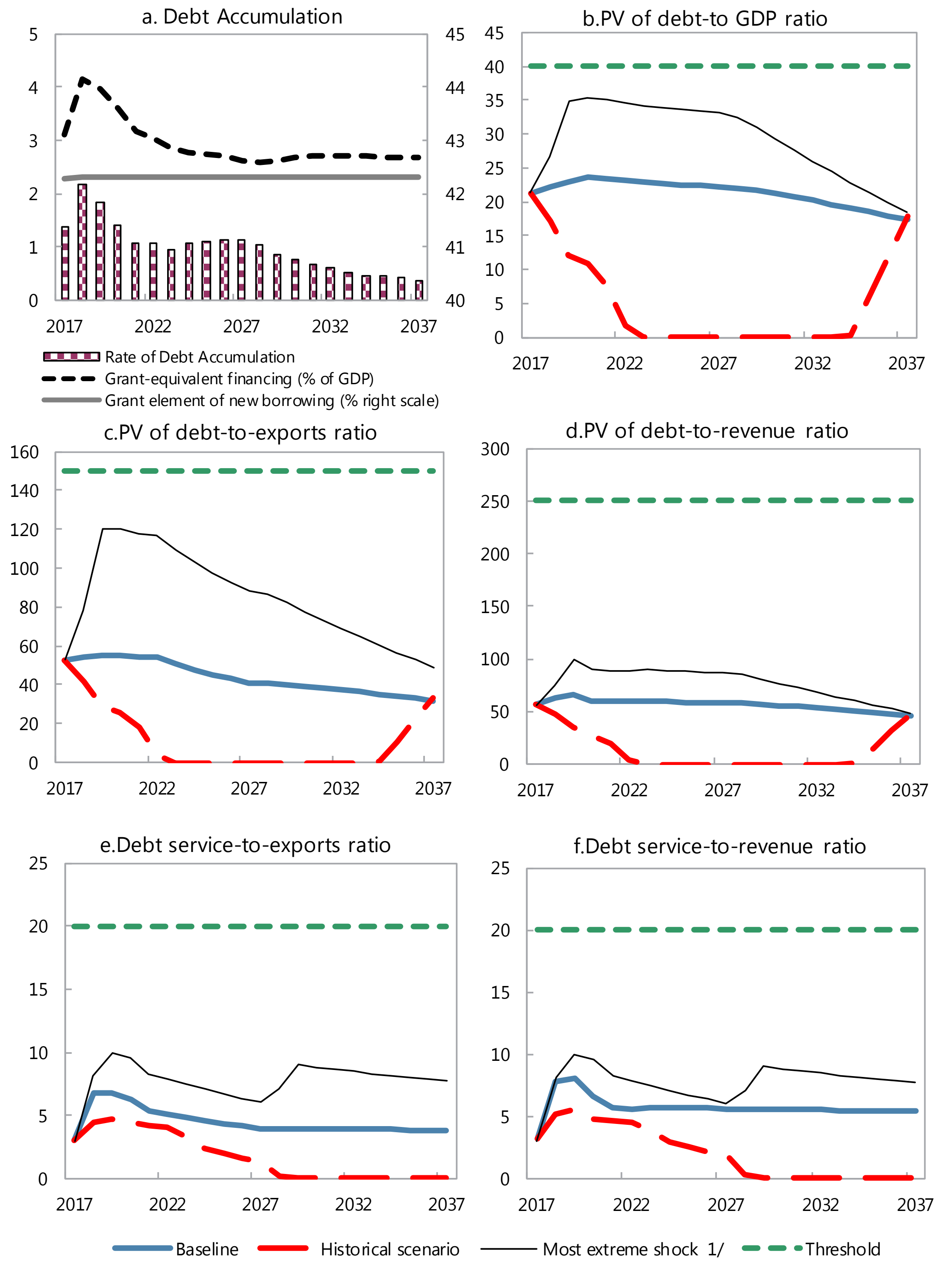
10. Lesotho's risk of debt distress has been revised from moderate to low in 2017. All external debt and debt service indicators for the baseline and the simulated shocks remain below their respective thresholds. A large shock to exports would pose the larger risk to debt sustainability, but even the most extreme shocks do not bring the debt ratios above the threshold.

11. These simulations suggest that there is some —though limited— scope for additional non-concessional borrowing to finance large infrastructure projects with large economic returns. Careful cost-benefit analysis and debt sustainability implications must be considered in future government investment plans, including discussions of the large hydropower project for which feasibility studies are under way. Maintaining the significant grant element in the financing will avoid risks for future fiscal deficit and international reserves. The sensitivity to financing assumptions also underlines the need for the government to prepare a medium-term debt strategy.

Authorities views

12. Authorities concurred with the DSA analysis and the "low" risk rating. They agreed with the need to better monitor domestic contingent liabilities to have a comprehensive view of the debt. They also agreed that prudent debt management must continue in the medium term, in particular by pursuing financing with a significant grant element.

Figure 1. Lesotho: Indicators of Public and Publicly Guaranteed External Debt under Alternative Scenarios, 2014–37[1]



Sources: Country authorities and IMF staff estimates and projections.

[1] The most extreme stress test is the test that yields the highest ratio on or before 2027. In figures b, c, d, e, and f it corresponds to an exports shock.

Table 1. Lesotho: Public and Publicly Guaranteed External Debt Sustainability Framework, Baseline Scenario, 2014—37 1/

(In percent of GDP, unless otherwise indicated)

	Actual			Historical 6/ Average	Standard 6/ Deviation	Projections									
	2014	2015	2016			2017	2018	2019	2020	2021	2022	2017-2022 Average	2027	2037	2023-2037 Average
External debt (nominal) 1/	**34.3**	**38.3**	**32.3**			**31.4**	**33.3**	**34.9**	**35.9**	**35.7**	**35.5**		**32.7**	**25.2**	
of which: public and publicly guaranteed (PPG)	34.3	38.3	32.3			31.4	33.3	34.9	35.9	35.7	35.5		32.7	25.2	
Change in external debt	-0.2	3.9	-6.0			-0.9	1.9	1.5	1.1	-0.2	-0.3		-0.6	-0.7	
Identified net debt-creating flows	-1.1	4.3	2.9			3.6	8.8	8.8	1.6	3.7	8.0		-2.6	-4.7	
Non-interest current account deficit	**4.5**	**3.9**	**6.8**	**0.9**	**11.4**	**6.0**	**10.8**	**11.1**	**3.9**	**6.7**	**11.1**		**0.3**	**-1.9**	2.1
Deficit in balance of goods and services	47.9	43.1	39.8			43.0	44.8	42.9	39.9	42.2	46.0		22.9	22.9	
Exports	34.1	41.8	39.9			40.3	41.0	41.7	42.4	42.7	42.8		54.1	54.1	
Imports	82.0	84.8	79.7			83.3	85.9	84.6	82.3	84.9	88.8		77.0	77.0	
Net current transfers (negative = inflow)	-30.8	-26.1	-19.3	-30.7	6.8	-23.4	-20.5	-18.2	-22.5	-22.1	-21.7		-22.3	-24.6	-23.0
of which: official	-25.7	-21.2	-14.4			-18.5	-15.6	-13.3	-17.6	-17.2	-16.8		-15.8	-12.9	
Other current account flows (negative = net inflow)	-12.5	-13.1	-13.6			-13.5	-13.5	-13.5	-13.5	-13.4	-13.2		-0.4	-0.2	
Net FDI (negative = inflow)	**-4.2**	**-4.5**	**-3.1**	**-1.8**	**2.5**	**-2.0**	**-2.0**	**-2.0**	**-2.0**	**-2.0**	**-2.0**		**-2.2**	**-2.2**	-2.1
Endogenous debt dynamics 2/	**-1.4**	**5.0**	**-0.8**			**-0.4**	**0.0**	**-0.3**	**-0.2**	**-1.0**	**-1.1**		**-0.7**	**-0.7**	
Contribution from nominal interest rate	0.5	0.6	0.6			0.5	0.5	0.5	0.5	0.5	0.5		0.4	0.2	
Contribution from real GDP growth	-1.0	-1.0	-1.1			-0.9	-0.5	-0.8	-0.7	-1.5	-1.6		-1.1	-0.9	
Contribution from price and exchange rate changes	-0.9	5.3	-0.3			...	...	...	...	...	...		...	...	
Residual (3-4) 3/	**0.9**	**-0.4**	**-8.9**			**-4.5**	**-6.9**	**-7.3**	**-0.6**	**-3.9**	**-8.3**		**2.0**	**4.0**	
of which: exceptional financing	0.0	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/	...	...	21.8			21.3	22.3	23.0	23.6	23.3	23.1		22.2	17.3	
In percent of exports	...	...	54.7			52.9	54.3	55.2	55.5	54.7	54.0		41.1	32.0	
PV of PPG external debt	**...**	**...**	**21.8**			**21.3**	**22.3**	**23.0**	**23.6**	**23.3**	**23.1**		**22.2**	**17.3**	
In percent of exports	**...**	**...**	**54.7**			**52.9**	**54.3**	**55.2**	**55.5**	**54.7**	**54.0**		**41.1**	**32.0**	
In percent of government revenues	**...**	**...**	**56.7**			**56.5**	**62.3**	**65.7**	**59.4**	**59.4**	**59.3**		**58.3**	**45.4**	
Debt service-to-exports ratio (in percent)	**4.1**	**4.4**	**4.9**			**3.0**	**6.8**	**6.8**	**6.2**	**5.3**	**5.1**		**4.0**	**3.8**	
PPG debt service-to-exports ratio (in percent)	**4.1**	**4.4**	**4.9**			**3.0**	**6.8**	**6.8**	**6.2**	**5.3**	**5.1**		**4.0**	**3.8**	
PPG debt service-to-revenue ratio (in percent)	**2.9**	**4.2**	**5.1**			**3.2**	**7.8**	**8.1**	**6.7**	**5.8**	**5.6**		**5.6**	**5.4**	
Total gross financing need (Millions of U.S. dollars)	268.8	240.6	291.3			256.4	459.6	493.6	274.2	371.2	545.7		213.6	185.8	
Non-interest current account deficit that stabilizes debt ratio	4.7	-0.1	12.8			6.9	8.9	9.6	2.8	6.9	11.4		0.9	-1.2	
Key macroeconomic assumptions															
Real GDP growth (in percent)	3.0	2.5	3.1	4.1	1.7	3.1	1.7	2.6	2.1	4.4	4.7	3.1	3.5	3.5	3.4
GDP deflator in US dollar terms (change in percent)	2.6	-13.3	0.8	-0.7	10.6	10.0	4.4	2.4	1.8	1.1	0.8	3.4	2.0	2.0	2.1
Effective interest rate (percent) 5/	1.4	1.7	1.7	1.4	0.2	1.7	1.7	1.5	1.5	1.4	1.4	1.5	1.1	0.8	1.0
Growth of exports of G&S (US dollar terms, in percent)	6.1	8.8	-0.9	1.8	12.2	14.6	8.1	6.7	5.7	6.2	5.8	7.9	9.8	5.6	7.3
Growth of imports of G&S (US dollar terms, in percent)	1.3	-8.0	-2.5	0.6	11.9	18.5	9.4	3.4	1.2	8.8	10.5	8.6	3.5	5.6	4.6
Grant element of new public sector borrowing (in percent)	...	...	...	...	...	42.3	42.3	42.3	42.3	42.3	42.3	42.3	42.3	42.3	42.3
Government revenues (excluding grants, in percent of GDP)	48.1	44.2	38.4			37.7	35.8	35.0	39.6	39.3	38.9		38.1	38.1	38.1
Aid flows (in Millions of US dollars) 7/	123.8	78.8	73.3			84.4	35.0	45.6	41.6	46.5	57.7		53.3	43.3	
of which: Grants	44.8	70.1	61.6			58.3	60.3	61.6	62.6	63.3	63.9		83.7	144.0	
of which: Concessional loans	79.0	8.7	11.7			26.1	-25.4	-16.0	-21.0	-16.7	-6.2		-30.4	-100.7	
Grant-equivalent financing (in percent of GDP) 8/	...	...	...			3.1	4.1	4.0	3.6	3.2	3.1		2.6	2.7	2.7
Grant-equivalent financing (in percent of external financing) 8/	...	...	...			69.6	59.3	59.7	61.6	64.0	63.8		69.8	68.8	68.5
Memorandum items:															
Nominal GDP (Millions of US dollars)	2646.6	2350.9	2442.0			2768.1	2937.6	3083.9	3205.3	3381.8	3571.0		4682.7	8051.9	
Nominal dollar GDP growth	5.6	-11.2	3.9			13.4	6.1	5.0	3.9	5.5	5.6	6.6	5.6	5.6	5.6
PV of PPG external debt (in Millions of US dollars)			563.7			597.3	657.9	712.0	755.7	790.0	825.6		1041.6	1394.0	
(PVt-PVt-1)/GDPt-1 (in percent)						1.4	2.2	1.8	1.4	1.1	1.1	1.5	1.1	0.4	0.8
Gross workers' remittances (Millions of US dollars)	183.3	155.4	153.2			166.8	242.1	270.9	251.3	296.4	299.5		412.7	784.0	
PV of PPG external debt (in percent of GDP + remittances)	...	...	20.5			20.1	20.6	21.2	21.8	21.5	21.3		20.4	15.8	
PV of PPG external debt (in percent of exports + remittances)	...	...	47.2			46.0	45.2	45.6	46.8	45.4	45.1		35.3	27.1	
Debt service of PPG external debt (in percent of exports + remittances)	...	...	4.2			2.6	5.6	5.6	5.3	4.4	4.3		3.4	3.2	

Sources: Country authorities; and staff estimates and projections.

1/ Includes both public and private sector external debt.

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

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

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

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

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

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

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

Table 2. Lesotho: Sensitivity Analysis for Key Indicators of Public and Publicly Guaranteed External Debt, 2017–37[1/]

(In percent)

	Projections							
	2017	2018	2019	2020	2021	2022	**2027**	2037
PV of debt-to GDP ratio								
Baseline	21	22	23	24	23	23	**22**	17
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2017-2037 1/	21	17	12	11	8	2	**0**	18
A2. New public sector loans on less favorable terms in 2017-2037 2/	21	20	19	17	14	11	**-3**	-32
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2018-2019	21	22	23	23	23	23	**22**	17
B2. Export value growth at historical average minus one standard deviation in 2018-2019 3/	21	27	35	35	35	35	**33**	18
B3. US dollar GDP deflator at historical average minus one standard deviation in 2018-2019	21	26	31	32	32	31	**30**	24
B4. Net non-debt creating flows at historical average minus one standard deviation in 2018-2019 4/	21	22	21	21	21	21	**20**	17
B5. Combination of B1-B4 using one-half standard deviation shocks	21	26	32	33	33	32	**31**	21
B6. One-time 30 percent nominal depreciation relative to the baseline in 2018 5/	21	31	32	33	33	32	**31**	24
PV of debt-to-exports ratio								
Baseline	53	54	55	56	55	54	**41**	32
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2017-2037 1/	53	42	29	26	18	4	**0**	33
A2. New public sector loans on less favorable terms in 2017-2037 2/	53	49	45	40	33	27	**-5**	-58
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2018-2019	53	55	55	56	55	54	**41**	32
B2. Export value growth at historical average minus one standard deviation in 2018-2019 3/	53	78	120	120	118	116	**88**	49
B3. US dollar GDP deflator at historical average minus one standard deviation in 2018-2019	53	55	55	56	55	54	**41**	32
B4. Net non-debt creating flows at historical average minus one standard deviation in 2018-2019 4/	53	54	50	50	50	49	**37**	32
B5. Combination of B1-B4 using one-half standard deviation shocks	53	65	82	83	81	80	**61**	41
B6. One-time 30 percent nominal depreciation relative to the baseline in 2018 5/	53	55	55	56	55	54	**41**	32
PV of debt-to-revenue ratio								
Baseline	57	62	66	59	59	59	**58**	45
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2017-2037 1/	57	48	35	28	20	5	**0**	47
A2. New public sector loans on less favorable terms in 2017-2037 2/	57	57	54	42	36	29	**-8**	-83
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2018-2019	57	62	66	59	59	59	**58**	45
B2. Export value growth at historical average minus one standard deviation in 2018-2019 3/	57	74	100	89	89	89	**87**	48
B3. US dollar GDP deflator at historical average minus one standard deviation in 2018-2019	57	74	90	81	81	81	**79**	62
B4. Net non-debt creating flows at historical average minus one standard deviation in 2018-2019 4/	57	61	60	54	54	54	**53**	45
B5. Combination of B1-B4 using one-half standard deviation shocks	57	72	92	83	83	83	**81**	55
B6. One-time 30 percent nominal depreciation relative to the baseline in 2018 5/	57	88	93	84	83	83	**82**	64

Table 2. Lesotho: Sensitivity Analysis for Key Indicators of Public and Publicly Guaranteed External Debt, 2017–37 (continued)

(In percent)

Debt service-to-exports ratio

Baseline	3	7	7	6	5	5	**4**	4
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2017-2037 1/	3	5	5	4	4	4	**1**	0
A2. New public sector loans on less favorable terms in 2017-2037 2/	3	4	5	4	4	4	**1**	-3
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2018-2019	3	7	7	6	5	5	**4**	4
B2. Export value growth at historical average minus one standard deviation in 2018-2019 3/	3	8	10	10	8	8	**6**	8
B3. US dollar GDP deflator at historical average minus one standard deviation in 2018-2019	3	7	7	6	5	5	**4**	4
B4. Net non-debt creating flows at historical average minus one standard deviation in 2018-2019 4/	3	7	7	6	5	5	**4**	4
B5. Combination of B1-B4 using one-half standard deviation shocks	3	8	9	8	7	7	**5**	6
B6. One-time 30 percent nominal depreciation relative to the baseline in 2018 5/	3	7	7	6	5	5	**4**	4

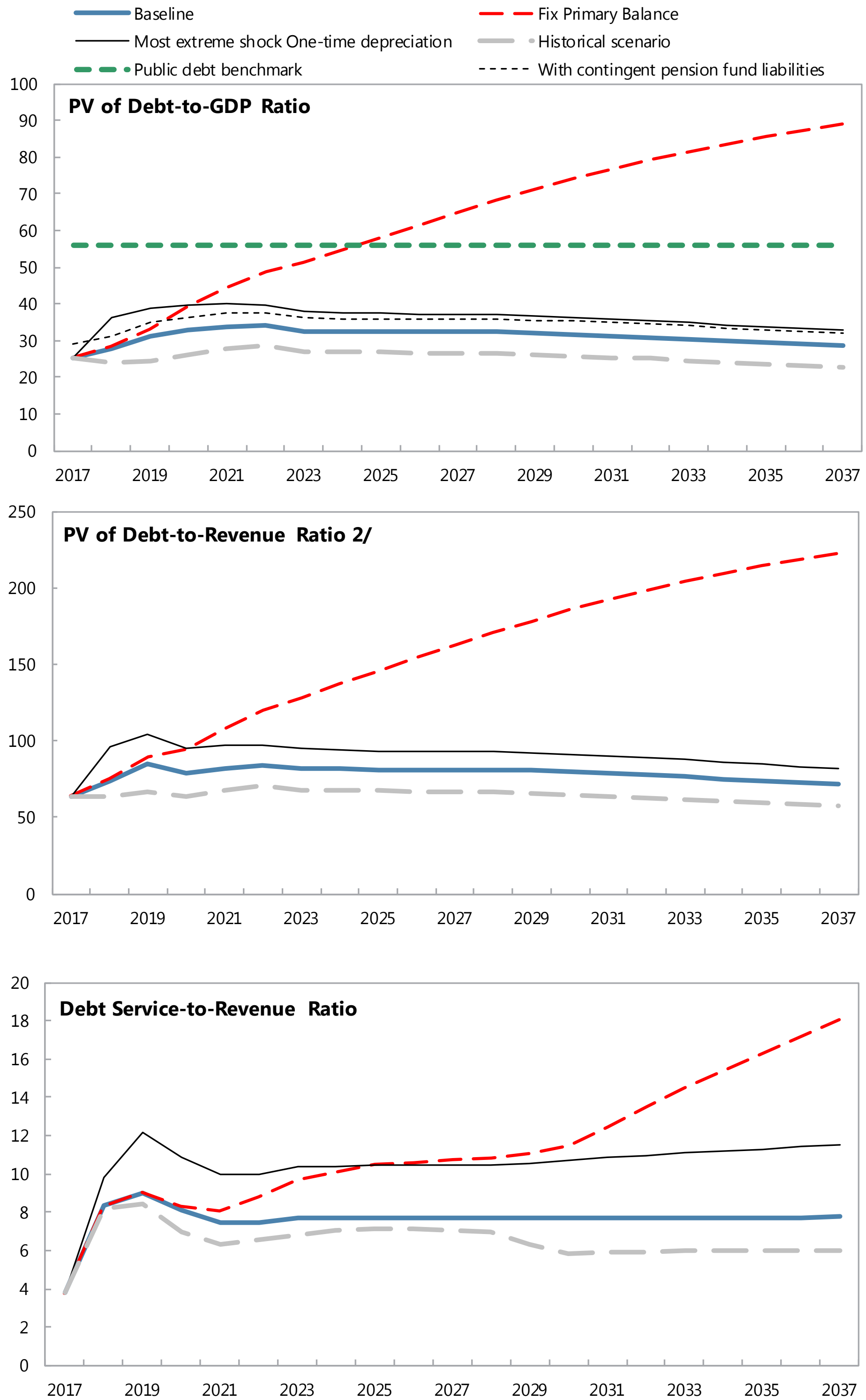
Debt service-to-revenue ratio

Baseline	3	8	8	7	6	6	**6**	5
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2017-2037 1/	3	5	6	5	5	4	**2**	0
A2. New public sector loans on less favorable terms in 2017-2037 2/	3	5	5	5	4	4	**2**	-4
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2018-2019	3	7	7	6	5	5	**4**	4
B2. Export value growth at historical average minus one standard deviation in 2018-2019 3/	3	8	10	10	8	8	**6**	8
B3. US dollar GDP deflator at historical average minus one standard deviation in 2018-2019	3	7	7	6	5	5	**4**	4
B4. Net non-debt creating flows at historical average minus one standard deviation in 2018-2019 4/	3	7	7	6	5	5	**4**	4
B5. Combination of B1-B4 using one-half standard deviation shocks	3	8	9	8	7	7	**5**	6
B6. One-time 30 percent nominal depreciation relative to the baseline in 2018 5/	3	7	7	6	5	5	**4**	4
Memorandum item:								
Grant element assumed on residual financing (i.e., financing required above baseline) 6/	40	40	40	40	40	40	**40**	40

Sources: Country authorities; and staff estimates and projections.

1/ Variables include real GDP growth, growth of GDP deflator (in U.S. dollar terms), non-interest current account in percent of GDP, and non-debt creating flows.
2/ Assumes that the interest rate on new borrowing is by 2 percentage points higher than in the baseline., while grace and maturity periods are the same as in the baseline.
3/ Exports values are assumed to remain permanently at the lower level, but the current account as a share of GDP is assumed to return to its baseline level after the shock (implicitly assuming an offsetting adjustment in import levels).
4/ Includes official and private transfers and FDI.
5/ Depreciation is defined as percentage decline in dollar/local currency rate, such that it never exceeds 100 percent.
6/ Applies to all stress scenarios except for A2 (less favorable financing) in which the terms on all new financing are as specified in footnote 2.

Figure 2. Lesotho: Indicator of Public Debt Under Alternative Scenarios, 2017–37 1/



Sources: Country auhtorities and IMF staff estimates and projections.
1/ The most extreme stress test is the test that yields the highest ratio on or before 2027.
2/ Revenues are defined inclusive of grants.

Table 3. Lesotho: Public Sector Debt Sustainability Framework, Baseline Scenario, 2014–37

(In percent of GDP, unless otherwise indicated)

	Actual					Estimate	Projections								
	2014	2015	2016	Average 5/	Standard Deviation 5/	2017	2018	2019	2020	2021	2022	2017-22 Average	2027	2037	2023-37 Average
Public sector debt 1/	36.9	41.3	35.4			35.4	38.8	43.2	45.3	46.2	46.4		42.9	36.3	
of which: foreign-currency denominated	34.3	38.3	32.3			31.4	33.3	34.9	35.9	35.7	35.5		32.7	25.2	
Change in public sector debt	-0.5	4.4	-5.8			0.0	3.4	4.4	2.2	0.9	0.2		-0.5	-0.6	
Identified debt-creating flows	-0.7	4.0	0.4			3.7	3.5	2.9	-2.3	-2.8	-3.0		-1.9	-1.6	
Primary deficit	-1.0	0.2	5.4	-0.6	6.1	5.7	4.5	3.9	-1.7	-1.5	-1.5	1.6	-0.7	-0.6	-0.6
Revenue and grants	49.8	47.2	40.9			39.8	37.8	37.0	41.6	41.2	40.7		39.9	39.9	
of which: grants	1.7	3.0	2.5			2.1	2.1	2.0	2.0	1.9	1.8		1.8	1.8	
Primary (noninterest) expenditure	48.8	47.4	46.4			45.5	42.3	40.9	39.9	39.7	39.2		39.3	39.3	
Automatic debt dynamics	0.3	3.8	-5.0			-2.0	-1.0	-0.9	-0.6	-1.4	-1.5		-1.3	-1.0	
Contribution from interest rate/growth differential	-1.3	-0.7	-0.8			-1.0	-0.6	-0.9	-0.8	-1.7	-1.9		-1.3	-1.0	
of which: contribution from average real interest rate	-0.2	0.2	0.4			0.0	0.0	0.1	0.1	0.2	0.2		0.2	0.2	
of which: contribution from real GDP growth	-1.1	-0.9	-1.2			-1.1	-0.6	-1.0	-0.9	-1.9	-2.1		-1.5	-1.3	
Contribution from real exchange rate depreciation	1.5	4.5	-4.2			-0.9	-0.4	0.0	0.2	0.3	0.4		...	...	
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	0.3	0.4	-6.3			-3.7	-0.1	1.4	4.4	3.7	3.2		1.4	1.0	
Other Sustainability Indicators															
PV of public sector debt	...	...	24.9			25.3	27.8	31.3	33.0	33.8	34.0		32.4	28.5	
of which: foreign-currency denominated	...	...	21.8			21.3	22.3	23.0	23.6	23.3	23.1		22.2	17.3	
of which: external	...	...	21.8			21.3	22.3	23.0	23.6	23.3	23.1		22.2	17.3	
PV of contingent liabilities (not included in public sector debt)	...	...	...			...	...	...	...	...	...		...	...	
Gross financing need 2/	0.7	2.3	7.7			7.2	7.6	7.2	1.7	1.6	1.5		2.4	2.5	
PV of public sector debt-to-revenue and grants ratio (in percent)	...	...	60.9			63.7	73.4	84.6	79.2	82.2	83.6		81.2	71.4	
PV of public sector debt-to-revenue ratio (in percent)	...	...	64.9			67.3	77.6	89.5	83.1	86.1	87.4		85.1	74.7	
of which: external 3/	...	...	56.7			56.5	62.3	65.7	59.4	59.4	59.3		58.3	45.4	
Debt service-to-revenue and grants ratio (in percent) 4/	3.3	4.4	5.5			3.8	8.3	9.0	8.1	7.5	7.5		7.7	7.7	
Debt service-to-revenue ratio (in percent) 4/	3.4	4.7	5.8			4.0	8.8	9.5	8.5	7.8	7.8		8.1	8.1	
Primary deficit that stabilizes the debt-to-GDP ratio	-0.5	-4.2	11.3			5.7	1.1	-0.5	-3.8	-2.3	-1.7		-0.1	0.1	
Key macroeconomic and fiscal assumptions															
Real GDP growth (in percent)	3.0	2.5	3.1	4.1	1.7	3.1	1.7	2.6	2.1	4.4	4.7	3.1	3.5	3.5	3.4
Average nominal interest rate on forex debt (in percent)	1.4	1.7	1.7	1.4	0.2	1.7	1.7	1.5	1.5	1.4	1.4	1.5	1.1	0.8	1.0
Average real interest rate on domestic debt (in percent)	-2.6	1.2	7.6	3.1	3.9	3.4	3.9	4.3	3.9	4.3	3.9	3.9	4.8	4.8	4.6
Real exchange rate depreciation (in percent, + indicates depreciation)	4.6	13.2	-11.2	1.5	13.4	-3.0	...	...	...	...	...	...	...	...	...
Inflation rate (GDP deflator, in percent)	12.0	8.0	2.8	6.6	3.6	6.5	5.9	5.5	5.3	5.0	4.9	5.5	5.0	5.0	5.1
Growth of real primary spending (deflated by GDP deflator, in percent)	-5.6	-0.5	0.8	-0.5	1.9	1.1	-5.4	-0.9	-0.3	3.8	3.5	0.3	3.5	3.5	3.5
Grant element of new external borrowing (in percent)	...	...	...	...	...	42.3	42.3	42.3	42.3	42.3	42.3	42.3	42.3	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 4. Lesotho: Sensitivity Analysis for Key Indicators of Public Debt, 2017–37

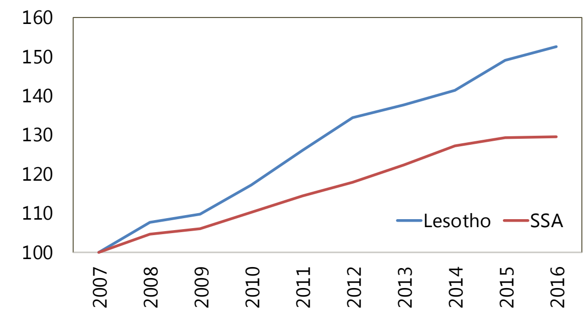
	Projections							
	2017	2018	2019	2020	2021	2022	2027	2037
PV of Debt-to-GDP Ratio								
Baseline	25	28	31	33	34	34	32	28
A. Alternative scenarios								
A1. Real GDP growth and primary balance are at historical averages	25	24	24	26	28	29	27	23
A2. Primary balance is unchanged from 2017	25	29	33	39	45	49	65	89
A3. Permanently lower GDP growth 1/	25	28	32	34	35	36	37	44
B. Bound tests								
B1. Real GDP growth is at historical average minus one standard deviations in 2018-2019	25	27	31	32	33	33	30	24
B2. Primary balance is at historical average minus one standard deviations in 2018-2019	25	28	33	35	35	36	34	29
B3. Combination of B1-B2 using one half standard deviation shocks	25	26	29	30	30	30	26	18
B4. One-time 30 percent real depreciation in 2018	25	36	39	40	40	40	37	33
B5. 10 percent of GDP increase in other debt-creating flows in 2018	25	34	37	39	40	40	38	32
PV of Debt-to-Revenue Ratio 2/								
Baseline	64	73	85	79	82	84	81	71
A. Alternative scenarios								
A1. Real GDP growth and primary balance are at historical averages	64	64	66	63	67	71	67	57
A2. Primary balance is unchanged from 2017	64	75	90	95	108	120	162	223
A3. Permanently lower GDP growth 1/	64	74	86	81	85	87	93	109
B. Bound tests								
B1. Real GDP growth is at historical average minus one standard deviations in 2018-2019	64	72	83	77	79	80	75	61
B2. Primary balance is at historical average minus one standard deviations in 2018-2019	64	75	89	83	86	87	85	74
B3. Combination of B1-B2 using one half standard deviation shocks	64	69	77	71	73	73	64	46
B4. One-time 30 percent real depreciation in 2018	64	96	104	95	97	97	93	82
B5. 10 percent of GDP increase in other debt-creating flows in 2018	64	90	101	94	97	98	95	80
Debt Service-to-Revenue Ratio 2/								
Baseline	4	8	9	8	7	7	8	8
A. Alternative scenarios								
A1. Real GDP growth and primary balance are at historical averages	4	8	8	7	6	7	7	6
A2. Primary balance is unchanged from 2017	4	8	9	8	8	9	11	18
A3. Permanently lower GDP growth 1/	4	8	9	8	8	8	8	10
B. Bound tests								
B1. Real GDP growth is at historical average minus one standard deviations in 2018-2019	4	8	9	8	7	7	7	7
B2. Primary balance is at historical average minus one standard deviations in 2018-2019	4	8	9	8	8	8	8	8
B3. Combination of B1-B2 using one half standard deviation shocks	4	8	9	8	7	7	7	6
B4. One-time 30 percent real depreciation in 2018	4	10	12	11	10	10	10	12
B5. 10 percent of GDP increase in other debt-creating flows in 2018	4	8	10	9	8	8	8	9

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.

Annex VII. Growth in Lesotho: Strong, Narrow, Volatile, and Unequal

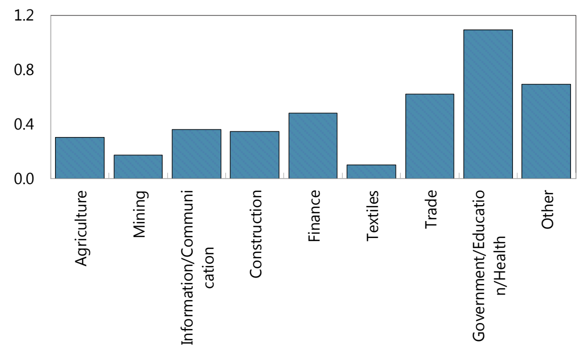
1. Lesotho's growth rates have been strong but volatile, driven by the public sector—financed by SACU transfers, diamond mining, and large capital projects. Since 2007, Lesotho averaged real growth of 4.2 percent, with real per capita GDP growing by more than 50 percent, substantially faster than the SSA region (Figure 1). However, sectoral performance in Lesotho has been uneven, adding to volatility (Figure 2). Mining and quarrying contributed to fast growth in the late 2000s, but also explained the slowdown in FY09/10 and FY13/14. The contribution of the public sector to GDP follows fiscal policies' boom and bust cycles. The performance of the manufacturing industry has been weak. Value added by textile manufacturing, boosted by preferential access to US markets via AGOA[1], is limited due to the slim margins of Lesotho's position on the textile value chain implied by the high import share of the final output. Despite a recent recovery, value added as a fraction of GDP has declined by almost 7 points since the peak in 2004. This reflects Lesotho's failure to use the preferential trade deal to upgrade its position in the sector by establishing local companies that provide inputs and services to the sector.[2]

Figure 1. Real per Capita GDP Growth
(2007=100)



Source: World Development Indicators

Figure 2. Contribution to Growth
2007–2016



Source: Bureau of Statistics.

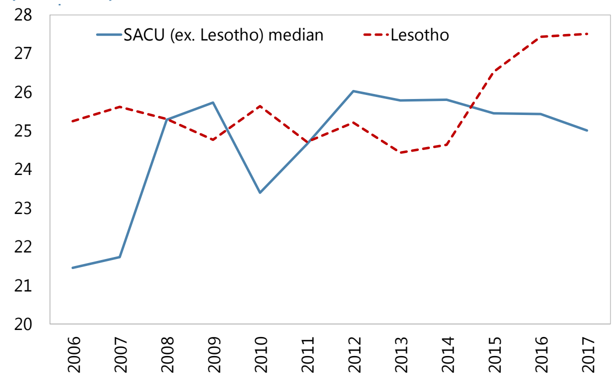
2. With growth being narrow, employment creation was limited. Lesotho's labor market shows similar characteristics as many SACU members, especially a low employment-to-working-age population ratio, high unemployment, and a high proportion of employment in South Africa (Figure 3). Subsistence farming employs over 40 percent of workers though only 10 percent of the land is suitable for cultivation. Public sector employment growth decelerated after the rapid hiring

[1] The African Growth and Opportunity Act (AGOA) was signed into law in 2000 as Title 1 of The Trade and Development Act. The Act offers incentives for African countries to continue their efforts to open their economies and build free markets. In 2015, it was extended for another ten years.

[2] Factory Southern Africa? SACU in Global Value Chains, World Bank, 2016.

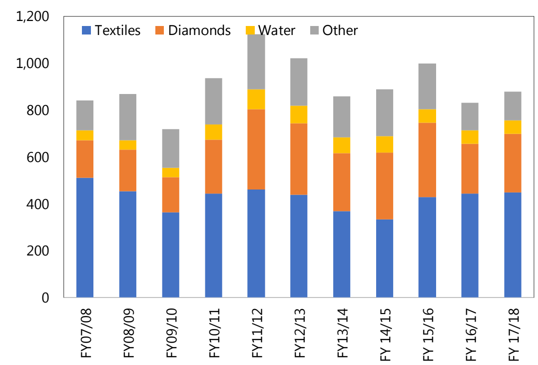
of the late 2000s, which was focused on low-skilled jobs, contributing to public sector inefficiency. The textile industry has also generated a substantial amount of formal sector jobs for women, especially in the early 2000s, but employment has been declining over the last few years, contributing to the rise in unemployment.

Figure 3. Unemployment Rates
(Percent)



Source: ILO

Figure 4. Merchandise Export Composition
(USD millions)



Source: Country authorities

3. **The weak growth-employment nexus contributed to high poverty and inequality levels that are among the highest in SSA.** While poverty rates in SSA and lower middle income countries have declined, rates in Lesotho continue to exceed half the population (Figure 5). Lesotho is among the most unequal countries in SSA, ranking fifth in the region. High inequality is also an obstacle to faster and more durable growth.[3] Lesotho also ranks in the bottom quartile of SSA income group peers in several health and education indicators.

4. **The narrow growth base is also reflected in high export concentration, contributing to external instability which, in turn, negatively affects growth.** Textiles and diamonds have dominated exports (Figure 4). As such, textiles and footwear are Lesotho's most important export product, representing 95 percent of exports to the US and 56 percent of exports to South Africa.

5. **This analysis underlines the need to complement capital-intensive projects with broad-based, employment-creating growth, driven by the private sector.** Thus, new industries must be developed to reduce volatility and support the private sector's contribution to employment and poverty reduction.

Obstacles to Private Sector Growth

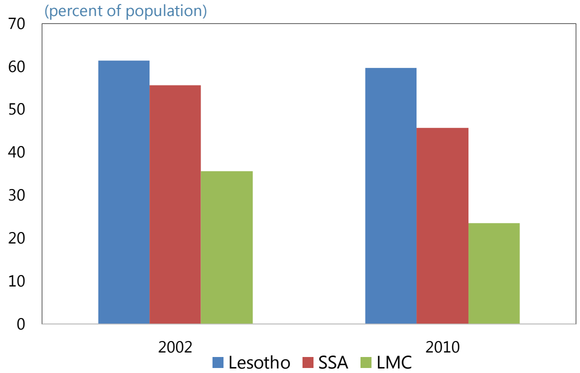
6. **In view of limited institutional capacity, the authorities need to prioritize reforms to promote private sector growth.** The range of problems that require attention is large. Using a growth diagnostic from Hausmann (2004) can help identify the most binding constraints

[3] For example, Ostry, Berg, and Tsangarides, (2014).

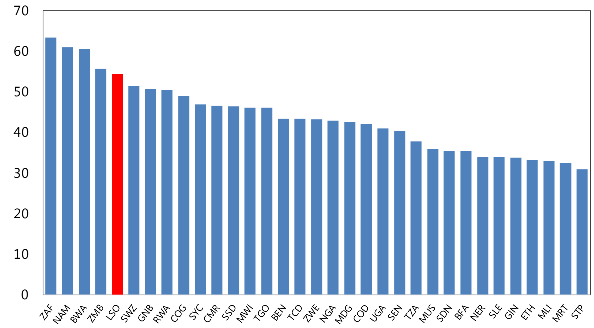
to prioritize some of these reforms (Figure 6). The growth diagnostic identifies two major obstacles: (i) the cost of finance is too high or (ii) the returns to investment are too low.

Figure 5. Poverty, Inequality, and Social Indicators

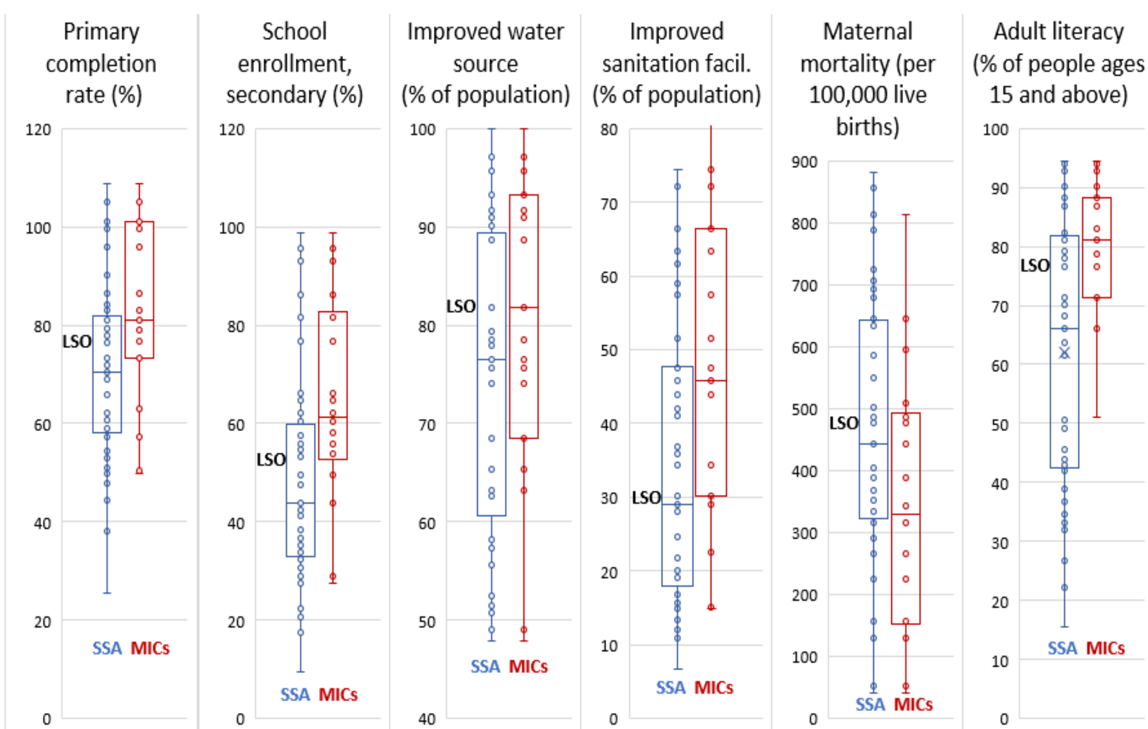
Poverty headcount ratio at $1.90 a day (2011 PPP)
(percent of population)



Inequality
(Gini coefficent, 2014 or latest available)



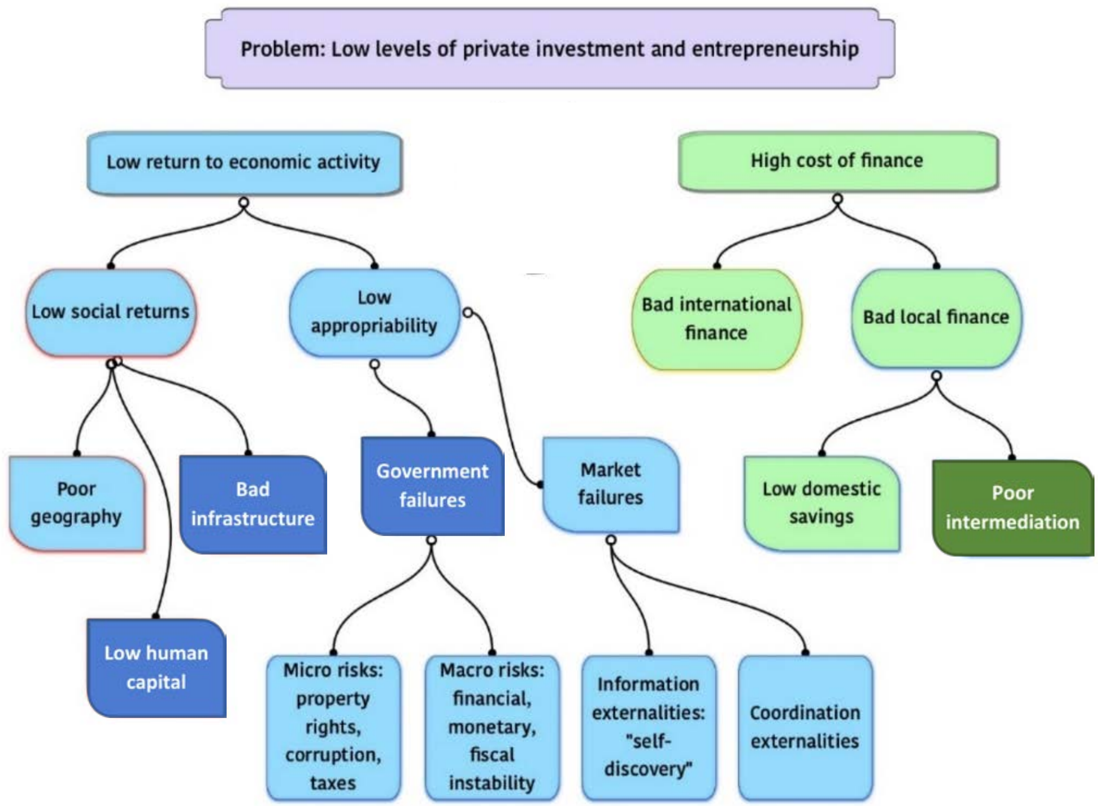
Core Social Indicators: Lesotho versus regional and income group peers, 2016



Note: The plotboxes show the SSA and MICs, lower and upper quartiles (boxes), and extreme values.

Source: World Development Indicators.

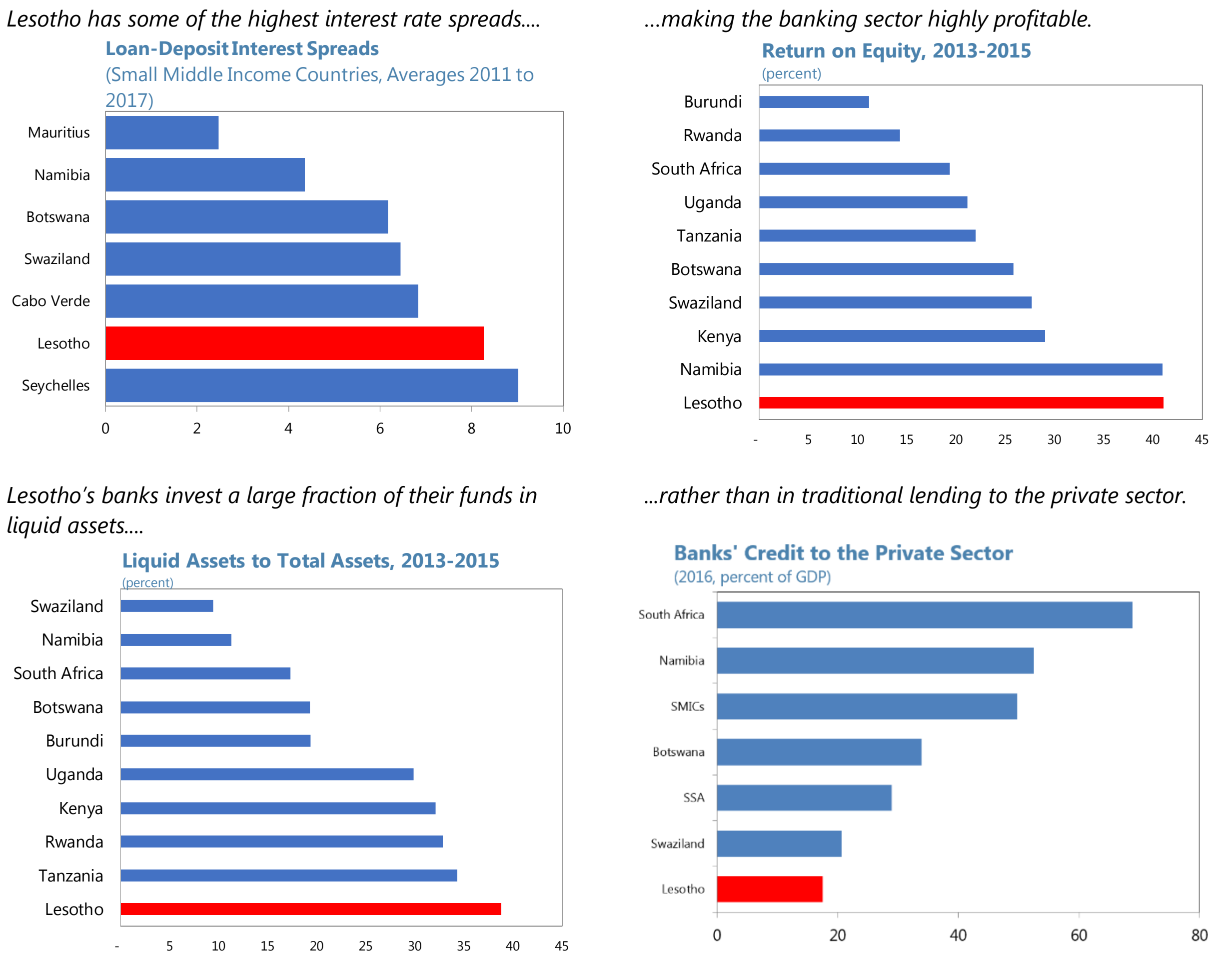
Figure 6. Growth Diagnostic Decision Tree



Source: Adapted from Hausmann (2004)
Note: The most critical obstacles to growth in Lesotho are shaded in dark blue, with a secondary obstacle highlighted in dark green.

7. **While some cross-country indicators on the business environment include limited access to finance as a major constraint, financial sector indicators suggest that low return of economic activity is the more binding constraint**. Loan to deposit interest spreads are very high in Lesotho compared to other countries in the region pointing out to high profitability in the industry. Nevertheless, Lesotho's private credit to GDP is relatively low as banks have historically preferred to invest excess liquidity in South Africa, thus draining savings out of Lesotho. Indeed, the return on equity of banks in Lesotho is the highest in the region, but it is derived largely from liquid assets. Indeed, the return on equity of Lesotho's banks is the highest in the region, but it is derived largely from liquid assets, rather than long-term loans to productive sectors (Figure 7). Bank executives emphasized the lack of quality investment projects as the main reason behind dormant domestic lending activity. Weak credit growth may also reflect a risky investment climate with weak contract enforcement, forcing banks to add a significant risk premium, which few projects are profitable enough to afford.

Figure 7. Lesotho's Banking Sector



Source: Country authorities, IMF Financial Soundness Indicators database, IMF staff estimates.

8. Low return to investment is the main impediment to private sector development in Lesotho:

Social returns

- ***Human capital***. Human capital indicators are broadly in line with the SSA median, but far weaker than other low-middle income countries. High maternal mortality rates, HIV prevalence, and low life expectancy point to a lack of access to quality health care. Education quality in Lesotho also ranks toward the bottom of the region despite large government expenditures. Literacy, an area where Lesotho scored highly, deteriorated by 7 percentage points over the last 15 years. Skill mismatches are a significant problem in Lesotho's labor market and indicate structural issues in the allocation of human capital.[4]

[4] For example, Stepanyan and others (2013)

- ***Infrastructure***. Cross country indicators on the business environment unanimously point to the need to improve infrastructure. Lesotho's mountainous geography necessitates high-quality roads yet just 22 percent of roads are paved. Access to electricity is another key infrastructure component that is lacking in Lesotho per the World Bank's Doing Business report, which ranks Lesotho 150 out of 190 in getting electricity.

- ***Geography***. Lesotho is a landlocked country with a small domestic market, which prevents economies of scale and increases transport costs. Nonetheless, Lesotho is situated in the middle of South Africa, providing a large market, and enjoys strong regional integration.

Private returns (appropriability):

- ***Government failures***: Lesotho performs poorly in areas such as political stability and public financial management, both of which hinder private sector entrepreneurship. The government is the largest single employer in the country and civil servants receive a sizeable wage premium, which acts as a disincentive to private sector growth. Finally, Lesotho imposes tariff and non-tariff restrictions on imports as part of the common SACU external trade policy as well as bilateral restrictions on certain intra-SACU goods, raising costs for import-intensive industries. Despite the lingering presence of these issues, political fragmentation often prevents meaningful reform efforts.

- ***Market failures***: Productivity and innovation levels are low across the economy. The lack of opportunity beyond traditional activities such as low productivity agriculture reduces returns on private sector investment. However, export-oriented industries such as mining and textiles indicate that it is possible to identify and build profitable businesses to attract new investments.

9. Private sector representatives agreed on the diagnostic of obstacles to growth. They highlighted political instability, insufficient infrastructure, unskilled labor force, lack of quality standards, and cumbersome government procedures as major concerns for private sector development. Access to finance was also pointed out as a significant obstacle for small and medium businesses. There is also a perception of public employment crowding out private sector initiatives.

Potential Applications of Growth Diagnostic: Sectoral Examples

10. The main weaknesses identified in the growth diagnostic would be also very relevant for tourism and manufacturing—two employment intensive industries identified in various studies as having significant potential in Lesotho.[5]

- **Tourism.** Unlike the mining and water sectors, tourism is a labor-intensive industry. Lesotho's biodiversity creates many attractive tourism destinations that could generate

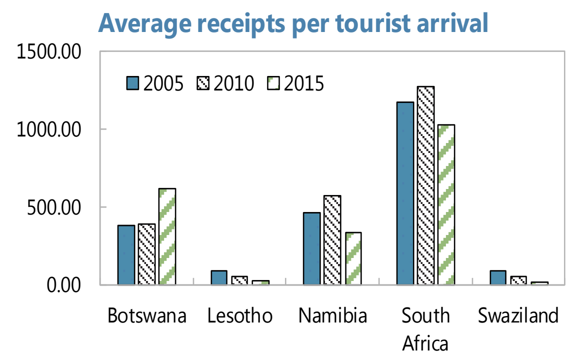
[5] See World Bank Lesotho: Systemic Country Diagnostic (2014) and Factory Southern Africa? SACU in Global Value Chains (2016).

significant employment, particularly in rural areas. As of 2016, travel and tourism already contributed more than ten percent of both GDP and employment in the country, highlighting the importance of the industry. However, Lesotho ranks last in the SACU region and in the bottom quartile globally in tourism competitiveness (Figure 8).[6] The World Economic Forum noted that lack of skilled labor, political instability and insufficient air and road networks play a role in the low average receipts per tourist arrival in Lesotho compared to other SACU countries.

Figure 8. Tourism competitiveness and receipts

Lesotho ranks poorly compared to other SACU countries in tourism competitiveness…

…which contributes to some of the lowest tourism receipts in the region.



Sources: World Economic Forum and World Bank World Development Indicators

Integration into regional and global value chains. Lesotho's proximity to South Africa puts the country in a unique position to integrate into both regional and global value chains. South African value chains benefit from logistic capabilities, institutions, human and financial capital, and proximity to markets comparable to those available in ASEAN economies. South Africa and its neighbors, including Lesotho, show complementarities in their capability mix, suggesting a 'hub and spoke' model that could work effectively in industries such as automotive parts and agricultural processing. Integration into regional and global value chains would not only support employment but would also improve Lesotho's long-term productivity by requiring firms to meet demanding standards and technical regulations imposed by buyers. So far, the development of global value chains is hampered by Lesotho's trade barriers, lack of political will, and poor infrastructure. Low levels of human capital may provide Lesotho with a competitive advantage at the low end of value chains but will be a long-term hindrance to upgrading within the chain.

[6] A 2017 report by the World Economic Forum on tourism competitiveness ranked Lesotho 128 out of 136 countries. The World Bank has pointed to poor roads as a hindrance to the development of the tourism sector.

KINGDOM OF LESOTHO

STAFF REPORT FOR THE 2017 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

January 31, 2018

Prepared By

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

CONTENTS

RELATIONS WITH THE IMF

(As of January 12, 2018)

Membership Status

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

General Resources Account	**SDR Million**	**% Quota**
Quota	69.80	100.00
IMF holdings of currency (Exchange Rate)	57.19	81.93
Reserve Tranche Position	12.61	18.07

SDR Department:	**SDR Million**	**%Allocation**
Net cumulative allocation	32.88	100.00
Holdings	30.21	91.90

Outstanding Purchases and Loans	**SDR Million**	**% Quota**
ECF[1] arrangements	42.99	61.59

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	09/22/1997	7.17	0.0

Projected Payments to the IMF

(SDR Million; based on existing use of resources and present holdings of SDRs)

	Forthcoming				
	2018	2019	2020	2021	2022
Principal	8.42	10.12	9.34	7.99	5.42
Charges/interest	0.02	0.02	0.02	0.02	0.02
Total	**8.44**	**10.14**	**9.36**	**8.01**	**5.44**

[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 2016 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). The *de facto* and *de jure* exchange rate arrangement are classified as a conventional peg 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. 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 January 10, 2018, the maloti rate per U.S. dollar was M12.42.

Article IV consultation

The 2015 Article IV consultation was concluded by the Executive Board on January 29, 2016. 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 2013 are the following:

Fiscal Affairs Department		
Public financial management	Short-term	2018
Managing the government wage bill	Short-term	2016
Medium-term budget planning, cash management, and fiscal reporting	Short-term	2016
Compliance risk management	Short-term	2016
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
Legal Department		
Tax legislation	Short-term	2017
Monetary and Capital Markets Department		
Medium-term debt strategy	Short-term	2017
Risk-based supervision	Short-term	2017
Payment systems	Short-term	2017
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	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
Statistics Department		
National accounts statistics	Short-term	2017
Price statistics	Short-term	2017
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	Short-term	2013

THE JMAP BANK-FUND MATRIX

(As of January 30, 2018)

Title	Products	Provisional Timing of missions	Expected Delivery date
A. Mutual information on relevant work programs			
Bank work program in next 12 months	• HIV/AIDS Project	• Ongoing regular missions	• Implementation ongoing
	• Strengthening Insurance and Pension Regulation and Supervision	• Ongoing regular missions	• Implementation ongoing
	• Smallholder Agriculture Project	• Ongoing regular missions	• Implementation ongoing
	• Transport Infrastructure and Connectivity Project	• Ongoing regular missions	• Implementation ongoing
	• Public Expenditure Review	• Ongoing regular missions	• March 2018
	• Climate Smart Agriculture Potentials	• Ongoing regular missions	• FY 2019
	• Financial Inclusion Project	• Ongoing regular missions	• FY 2019
	• Social Protections Role in Disaster Response	• Ongoing regular missions	• FY 2019
	• Lowlands Water Project	• Ongoing regular missions	• FY 2019
	• Productive Inclusion Project	• Ongoing regular missions	• FY 2019
	• Smallholder Agriculture Project Phase 2	• Ongoing regular missions	• FY 2019
	• Public Expenditure Review Volume 2	• Ongoing regular missions	• FY 2019
	• Supporting the Development of an Integrated Health Care Delivery System	• Ongoing regular missions	• FY 2020
IMF work program in next 12 months	• **Surveillance**		
	• Staff visit	• March 2018	• Ongoing
	• Article IV mission	• Sep/Oct 2018	• December 2018
	• **Technical assistance**		
	• Public financial management reform	• May 2018	• Ongoing
	• Tax policy and revenue administration	• November 2018	• Ongoing

Title	Products	Provisional Timing of missions	Expected Delivery date
	• Risk-based supervision	• April 2018	• Ongoing
	• National accounts and price statistics	• February 2018	• Ongoing
	• Monetary and financial statistics	• July 2018	• Ongoing
B. Requests for work program inputs			
• Fund request to Bank	• Finalize the existing PER; start the second round of the PER, focusing on areas as agreed and of joint interest.	• Ongoing	• March 2018 (PER Volume I)
• 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	

STATISTICAL ISSUES

As of January 2018
I. 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: The Bureau of Statistics (BOS) compiles and reports national accounts statistics on an annual basis—in current prices and volume terms, from the activity and expenditure sides. Statistical methods used to derive GDP have improved and new sources of data have been developed, although serious challenges remain. Revised and rebased national accounts were published in October 2016. The base year is 2012. The source data need to be improved, in particular, for the estimates of the expenditure side. Poor quality of imports data has been a long-standing problem hampering the expenditure estimates. Private consumption and gross fixed capital formation are now estimated independently. A new Household Budget Survey (HBS) was started in 2017 and is expected to provide a new benchmark for household consumption as well as improved estimates of the informal sector. Estimates of quarterly GDP by the production approach are being developed and are expected to be released in April 2018.
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 December 2016 = 100. The work on developing producer price indices is ongoing. In the meantime, the national accounts rely on South Africa's producer price index and import price indices.
Government Finance Statistics (GFS): The Ministry of Finance compiles and disseminates GFS consistent with GFSM 2001 for the budgetary central government. Monthly GFS for the budgetary central government are reported on a regular basis on the national summary data page (NSDP). Data quality issues remain, as indicated by significant discrepancies between transactions above and below the line. Neither GFS for extrabudgetary units and local governments, nor balance sheet data for any level of government. are currently compiled. Technical assistance by STA is supporting further improvement of the data quality and broadening the coverage of GFS, which should lead to data on general government transactions and stock positions.
Monetary and Financial Statistics (MFS): The Central Bank of Lesotho (CBL) reports monetary data on a regular basis using the Standardized Report Forms (SRFs), with monthly data disseminated through the IFS. Improved data sources helped enhance the classification and sectorization in the accounts. The institutional coverage of MFS, however, needs to be expanded to include other financial corporations. The CBL is working on expanding coverage and, to that effect, insurance companies have been trained on MFS template and beginning January 2018 they will be reporting through the Banking Supervision Application (BSA). The next phase of coverage improvement is pension funds. The CBL has begun the process of compiling consistent financial sector indicators (FSIs) from 2006 onwards. FSIs on depository corporations are reported on a quarterly basis, but FSIs on non-financial corporations, households, and real estate markets are not available. Efforts are underway to compile FSIs for the insurance sector and real estate markets.
Balance of payments: Since January 2017, Lesotho has improved the timeliness of submitting BPM6-based balance of payments and (partial) IIP data to STA. To further enhance data quality, improvements are needed in coverage, methodological soundness, and consistency between the balance of payments and IIP. A technical assistance mission is expected to be conducted in FY 2018. The CBL is currently being assisted by the Macro-economic and Financial Management Institute

(MEFMI) to undertake a private capital flow survey to collect financial account transactions and position data.	
II. Data Standards and Quality	
Lesotho is a GDDS/e-GDDS participant since 2003. Lesotho has implemented the recommendations of e-GDDS in 2016. It disseminates twelve of the fourteen relevant data categories needed for surveillance on its NSDP (a stock market is still being developed). This puts Lesotho in Baseline 2 of the e-GDDS thresholds. We encourage the authorities to disseminate the remaining data categories, general government operations and external debt, and improve periodicity and timeliness to move up the e-GDDS thresholds.	No Data ROSC mission has been conducted in Lesotho.

Lesotho: Table of Common Indicators Required for Surveillance

As of December 14, 2017

	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	Nov. 2017	Dec-14-2017	D	D	I		
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[2]	Nov. 2017	Dec-14-2017	D	D	Q		
Reserve/Base Money	Oct. 2017	Dec-04-2017	D	D	Q		
Broad Money	Oct. 2017	Dec-07-2017	M	M	Q		
Central Bank Balance Sheet	Oct. 2017	Dec-07-2017	D	D	Q		
Consolidated Balance Sheet of the Banking System	Oct. 2017	Dec-07-2017	D	D	Q		
Interest Rates[3]	Oct. 2017	Dec-01-2017	M	M	Q		
Consumer Price Index	Nov. 2017	Dec-20-2017	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	Sept-30-17	Nov-2017	M	M	A		
Stocks of Central Government and Central Government-Guaranteed Debt[6]	Mar-31-2017	Nov-2017	M	I	A		
External Current Account Balance	Q2-2017	Oct-2017	Q	Q	Q		
Exports and Imports of Goods and Services	Q2-2017	Oct-2017	Q	Q	Q		
GDP/GNP	2016	Dec-04-2017	A	A	A		
Gross External Debt	Mar-31-2017	Nov-2017	M	I	A		
International Investment Position[7]	Q2-2017	Oct-2017	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.

Statement by Mr. Mahlinza, Ms. Tshazibana, and Mr. Tlelima on Kingdom of Lesotho
February 14, 2018

1. Our Lesotho authorities appreciate the constructive engagement with staff during the recent Article IV Consultation mission. They broadly concur with staff's asessment of the macroeconomic challenges facing the country and the need to take steps to maintain macroeconomic stability.

Context

2. Lesotho's macroeconomic developments should be understood within the context of the country's strong relationship with its regional partners in the Common Monetary Area (CMA)[1] and the Southern African Customs Union (SACU)[2]. Under the CMA, Lesotho's currency, the loti, is fixed at par with the South African Rand, which is also legal tender in Lesotho. At the same time, SACU provides for free movement of goods among the members and a common external tariff on imports from outside the customs union.

3. Lesotho's membership in these two groups carries significant benefits and opportunities, as well as challenges and vulnerabilities. The exchange rate parity under the CMA has ensured relatively low and stable inflation rates. At the same time, free trade facilitated by the SACU Agreement is critical for Lesotho, especially given that the country is completely surrounded by South Africa, which is the largest member of the group. In addition, historically, significant numbers of Basotho have provided labor to the South African mining industry, which implies a sizeable amount of remittances to Lesotho.

4. Heavy reliance on benefits accruing, in particular, from SACU combined with a relatively undiversified economic base has tended to magnify Lesotho's vulnerability to external shocks. Given that SACU revenue is the main source of fiscal revenue and an essential inflow in the balance of payments, its volatility complicates macroeconomic management. In addition, the country is vulnerable to extreme weather conditions, including droughts and floods, which impact negatively on the agricultural sector.

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[1] The CMA comprises South Africa (SA), Lesotho, Namibia, and Swaziland (LNS), whose domestic currencies are fixed at par to the SA rand. The rand co-circulate with the local currencies within LNS.

[2] SACU comprises CMA and Botswana. Among others, SACU provides for free movement of goods among the five member countries and a common external tariff on imports.

5. In 2010/11, a sharp decline (47 percent relative to 2009/10) in SACU revenue induced a severe deterioration in both the fiscal and balance of payments positions. In response, the government took swift action to restore fiscal sustainability, supported by the IMF's Extended Credit Facility arrangement. While the current decline in SACU revenue is relatively small in magnitude, the authorities are aware that implementing adjustment measures is even more critical. In this context, the coalition government, which was formed after the elections in June 2017, is currently discussing measures to address the situation.

6. Against this background, the Government of Lesotho is making efforts to design and implement a package of measures that would strike a balance between fiscal consolidation and protecting growth, employment and other social obectives. Further, the authorities are exploring options to insulate the economy from high volatility in SACU revenue.

Recent Economic Developments

7. While the government has made significant progress towards development, poverty, inequality and unemployment remain significant challenges. Meanwhile, government remains the largest formal employer and a significant client to the majority of the business sector. In this context, maintaining a healthy fiscal position becomes critical, as the contrary may pose large negative implications for the entire economy.

8. Lesotho's economic growth has been anemic in the past years. Following 2.4 percent growth in 2016, a modest recovery is projected in the medium term to an average growth of 2.9 per cent. The growth recovery is largely supported by the services sector and a rebound in the primary sector, driven mainly by the mining industry. Looking ahead, the construction sector will benefit from the recently commenced Phase 2 of the Lesotho Highlands Water Project (LHWP II). Despite this uptick, the projected growth will not be sufficient to attain the country's development objectives.

9. The year-on-year consumer inflation rate declined to 5.7 percent in December 2017, compared to 6.2 percent in March 2017. At the same time, a minor uptick in credit extension to both the private and househould sectors was recorded.

Fiscal Policy and Public Financial Management

10. The authorities concur on the need to undertake fiscal consolidation to restore fiscal and macroeconomic stability. They also agree that spending cuts will have to be undertaken. However, as these carry significant economic and social costs, broad political consensus is needed. In this regard, consultations are currently underway, mostly focused on reducing the budget deficit for 2018/19 from about 6.9 percent of GDP by close to half, through a combination of revenue and expenditure measures. .

11. On tax administration, the recent appointment of the new Board of the Lesotho Revenue Administration (LRA) is expected to strengthen governance of the LRA and improve tax administration. Following its inauguration in November 2017, the new Board resolved to lift the suspension of the Commissioner General of the LRA. This is expected to have a positive impact on revenue collection and result in improved management and administration of the LRA.

12. The authorities place high priority on public financial management (PFM) reforms. To demonstrate their determination, as soon as the new government assumed office, they requested the Fund FAD to help condense recommendations from past TA into a reform plan, to facilitate follow-up on outstanding actions. The authorities continue to prioritise implementation of the action plan.

13. Notwithstanding the country's structural weaknesses, the country's debt management strategy seeks to maximize grants and concessional financing, which has kept the risk of debt distress low. While this creates an opportunity to borrow and reduce the speed of fiscal adjustment, the authorities remain focused on maintaining debt sustainability. To this end, they will continue to rely on grant financing and concessional borrowing mainly to finance priority growth-enhancing social and physical infrastructure. In this context, the decision by the US Millennium Challenge Corporation in December 2017 to re-select Lesotho as eligible to develop a second Compact is expected to boost the country's development agenda.

14. The authorities concur on the need to urgently commence the fiscal consolidation process. However, it is important to acknowledge that the economic costs associated with fiscal consolidation may be politically difficult, especially in an environment in which government is the dominant economic player and employer.

15. That said, the authorities appreciate staff's policy advice. However, they are concerned with the continued references to delays or difficulties to reach consensus on policy direction as a sign of political fragility. These references are not helpful in raising the traction of staff's advice, especially in the context of a coalition government. Under Lesotho's current electoral model, coalition governments are highly probable and the likelihood of differences among the coalition partners impacting on governance is high.

Financial Sector Development

16. Lesotho's financial sector remains strong with high soundness indicators and relatively low non-performing loans (NPLs). That said, the authorities remain vigilant in monitoring the emergence of vulnerabilities including rising household indebtedness. Nonetheless, one of the key structural challenges is addressing low financial intermediation. The financial sector is dominated by three banks – subsidiaries of South African banks – which are highly liquid and profitable but tend to prefer holding liquid assets to extending credit. However, staff's suggestion that the banks' preference for holding net foreign assets (NFA) could be self-insurance due to absence of lender of last resort may not be accurate. The banks' behavior reflect, among others, the structural trade deficit between Lesotho and South Africa, shallow financial markets in Lesotho compared to South Africa, and the perceived higher risk in Lesotho than SA, which constrains credit supply.

17. Mobile money, which has grown at a fast pace, provides a promising avenue to increase financial inclusion in the country, where the majority of the rural population has limited or no access to financial services. The authorities will continue to closely monitor developments in this sector, to ensure early detection and management of potential risks. Furthermore, the authorities have made significant progress towards improving the supervision and regulatory framework. Going forward, determined efforts will continue to be made to seek legislative approval.

Private Sector Development

18. The Government is in the process of developing the second version of the national Strategic Development Plan (NSDP II), following the end of the first NSDP (2012/13-2016/17). The draft NSDP II has prioritised the need to promote private sector development and identifies four sectors – agriculture, manufacturing, technology, and tourism and creative art – to drive job creation in the economy. It is therefore expected that the national budget allocations will be aligned with the development of these sectors. To support development in these sectors, the Lesotho National Development Corporation is being restructured to serve better its mission of private sector development.

Conclusion

19. Our Lesotho authorities value Fund advice and agree with staff on the need to implement fiscal consolidation. This will not only restore macroeconomic stability and generate sustainable growth, but will contribute to addressing poverty and inequality. They reiterate, however, that due to the social and economic costs, building political consensus may take time.