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Kingdom of Lesotho: 2007 Article IV Consultation—Staff Report; Staff Supplement; Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director for the Kingdom of Lesotho

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2007 Article IV consultation with the Kingdom of Lesotho, the following documents have been released and are included in this package:

- the staff report for the 2007 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on September 4, 2007 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 October 30, 2007. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.

- A staff supplement on the joint World Bank/IMF debt sustainability analysis.

- a Public Information Notice (PIN) summarizing the views of the Executive Board as expressed during its November 14, 2007 discussion of the staff report that concluded the Article IV consultation.

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

The document(s) listed below have been or will be separately released.

Selected Issues and Statistical Appendix

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

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INTERNATIONAL MONETARY FUND

KINGDOM OF LESOTHO

Staff Report for the 2007 Article IV Consultation

Prepared by the staff representatives for the
2007 consultation with the Kingdom of Lesotho

Approved by Robert Sharer and Anthony Boote

October 30, 2007

- The 2007 Article IV consultation discussions were held in Maseru August 22–September 4, 2007. The mission met with Finance Minister Thahane, Central Bank Governor Senaoana, other senior officials, and representatives of the private sector and the donor community.
- The staff team comprised Messrs. Cuevas (Head), Fontaine, Karangwa, and Yartey (all AFR), and Mr. Bartholomew (MCM). Mr. Nolan, Senior Resident Representative for South Africa and Lesotho, participated in some discussions. Ms. Lephoto (OED) attended the discussions.[1]
- Lesotho has accepted the obligations of Article VIII, Sections 2, 3, and 4, of the Articles of Agreement and maintains an exchange system free of restrictions on payments and transfers for current international transactions. The Lesotho loti is pegged at par to the South African rand, which is also legal tender in the country.
- Lesotho has participated in the Fund's General Data Dissemination System since August 2003. Data provision is generally adequate for surveillance purposes, although there are some deficiencies in the quality of core surveillance data, including national accounts, balance of payments statistics, and socio-economic data required to monitor progress toward the MDGs.

[1] From the World Bank, Ms. Preeti Arora, Pretoria-based senior country economist for Lesotho, and Ms. Aemro-Selassie participated in all the mission discussions.

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Abbreviations and Acronyms

AGOA	African Growth and Opportunity Act
CBL	Central Bank of Lesotho
CGER	Consultative Group on Exchange Rates
CMA	Common Monetary Area
CPI	Consumer price index
DSA	Debt sustainability analysis
FDI	Foreign direct investment
GDP	Gross domestic product
GNI	Gross national income
GSP	Growth Strategy Paper
IFMIS	Integrated Financial Management Information System
LHDA	Lesotho Highlands Development Authority
LNDC	Lesotho National Development Corporation
LRA	Lesotho Revenue Authority
MCC	Millennium Challenge Corporation
MDGs	Millennium Development Goals
MTEF	Medium-Term Expenditure Framework
MTFF	Medium-Term Fiscal Framework
NFA	Net foreign assets
PEMFA	Public Expenditure Management and Financial Accountability
PRS	Poverty Reduction Strategy
SACU	Southern African Customs Union
SADC	Southern African Development Community
SMEs	Small and medium enterprises
UN	United Nations
WFP	World Food Program

EXECUTIVE SUMMARY

Background

Lesotho made further progress toward macroeconomic stability in 2006. After sluggish economic activity in earlier years, real economic growth surged, reflecting accelerated mining production and the recovery of the textile sector. High Southern African Customs Union (SACU) revenue in 2006 contributed to a fiscal surplus, improved external accounts, and a significant increase in international reserves. Inflation has increased in the last year, driven by rising food and energy prices. The outlook is positive, but subject to risks arising mostly from the external environment.

Key Policy Issues

Maintaining a strong medium-term fiscal position will be key for macroeconomic stability and growth, given the fixed exchange rate and Lesotho's vulnerability to external shocks. Staff recommended prudent use of SACU revenues and urged the authorities to resist pressures for higher public expenditure across the board. The authorities concurred with the staff that the medium-term outlook is clouded by uncertainty about revenue sharing in SACU, global trade in textiles, and remittances from workers in South Africa. A slowdown in the U.S. poses short-term risks.

Sustained, rapid and broad-based growth is needed to reduce widespread poverty. Staff encouraged the authorities to implement vigorously their agenda to promote private sector development to unleash growth potential. Important measures include fostering financial intermediation, improving the legal and judicial environment, and improving infrastructure.

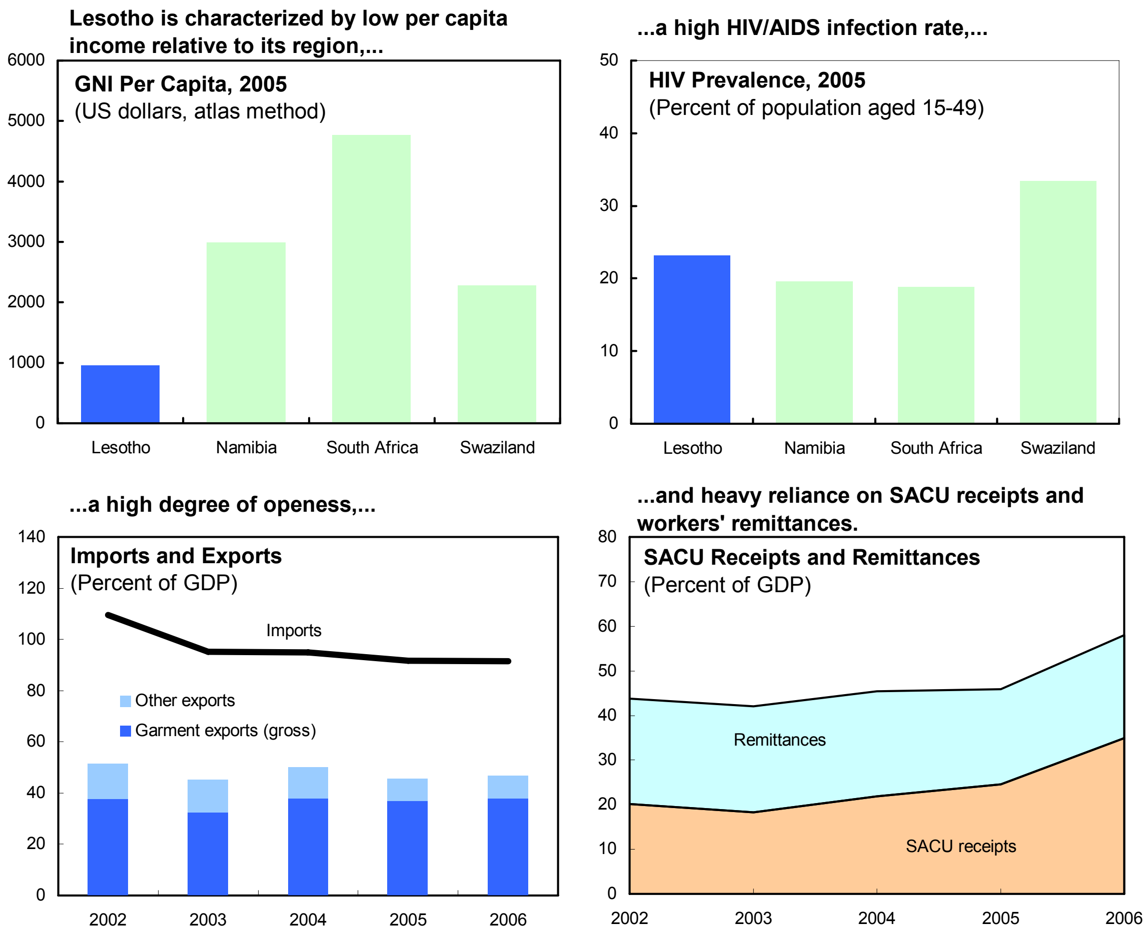
Macroeconomic policies are consistent with external and domestic stability, and there is no immediate threat to external stability.

Unlicensed deposit-taking entities pose risks to economic and social stability; the authorities expressed their intention to address this issue. The rapid growth of insufficiently regulated credit cooperatives gives cause for some concern; the authorities intend to strengthen the regulatory and supervisory framework of the financial sector.

I. Background

1. **Lesotho is a small, low-income country, with limited natural resources and a narrow production and export base, and with close economic linkages to South Africa.** A majority of the population lives on subsistence agriculture. The garment sector, which relies on imported inputs, plays a critical role in employment, output, and exports. With Namibia, Swaziland, and South Africa, Lesotho is a member of the Common Monetary Area (CMA). The Lesotho loti is pegged at par to the South African rand, which is also legal tender in Lesotho. CMA members and Botswana constitute the SACU. Economic growth has been inconsistent, poverty has declined from 67 percent of households in 1994/95 to a still high 57 percent in 2002/03, and HIV/AIDS prevalence is high.

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



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

II. Recent Economic Developments

2. **Macroeconomic performance in 2006 was strong.** After growing sluggishly in earlier years, real GDP rose 7.2 percent, driven by booming diamond production, a recovery of the garment industry, and good performance in the agriculture and services sectors. Reflecting high transfers from SACU and exports of textiles and diamonds, the current account balance registered a substantial surplus and gross international reserves increased to six months of imports.[2] The recovery of the garment industry was facilitated by the extension of the US African Growth and Opportunity Act (AGOA)[3], a cut in corporate tax rates, and a depreciation of the rand. Inflation has increased since the last quarter of 2006 owing to rising food and energy prices, but remains in the single digits, broadly mirroring trends in South Africa. In July 2007 Lesotho and the US Millennium Challenge Corporation (MCC) signed a compact for $363 million (23 percent of 2007 GDP) to be implemented over the next five years and covering the areas of water, health, and private sector development. Drought returned in 2007, prompting the government to activate its reserve for supplementary food imports and call for aid from development partners.[4]

Sources: National authorities and U.S. Department of Commerce.

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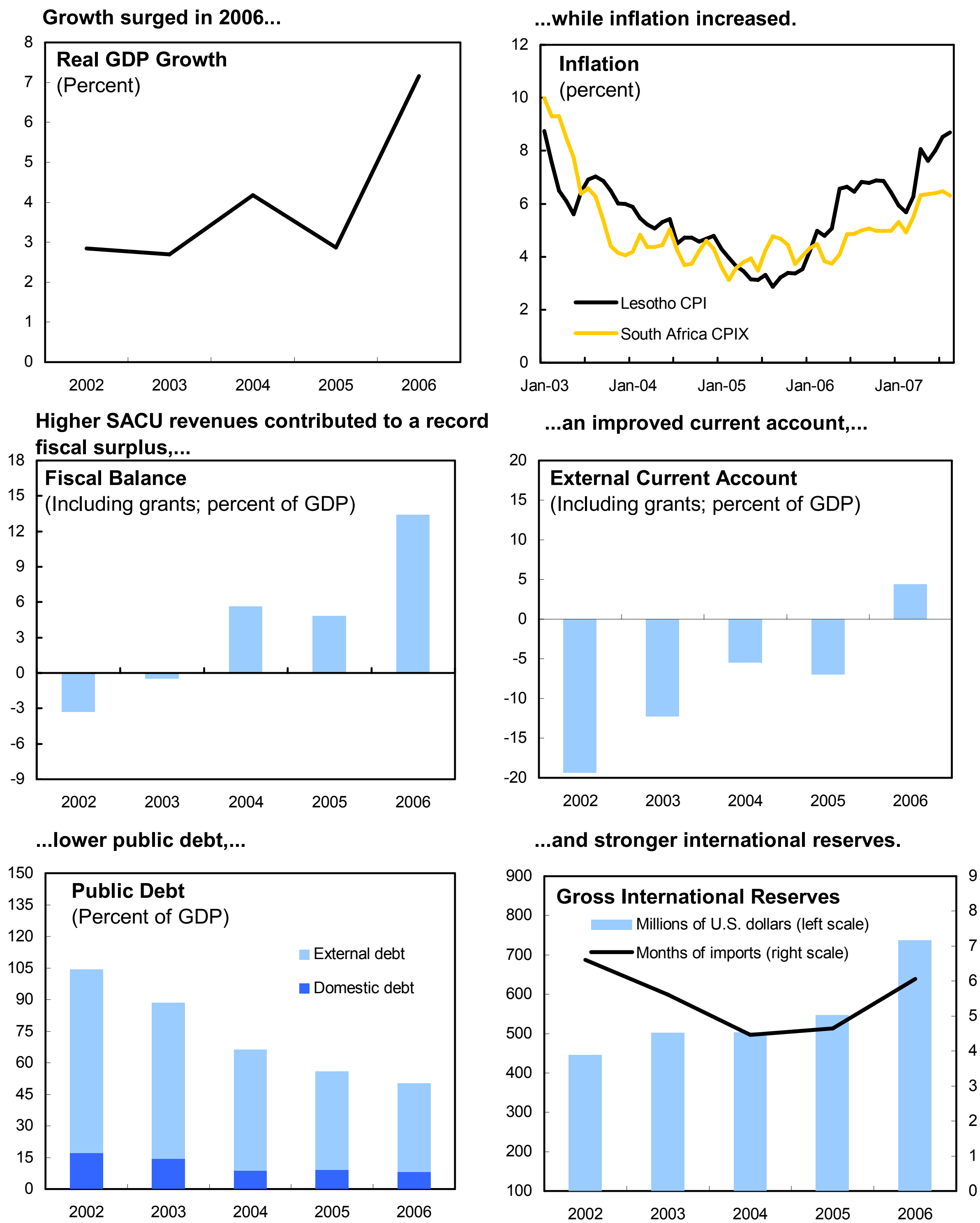
[2] Lesotho's SACU receipts have risen sharply since 2003/04, repeatedly exceeding budget forecasts and resulting in large "windfalls." The very large transfers in recent years reflect buoyant SACU revenue (mostly due to rapidly rising import duty and excise revenues collected by South Africa) and the transition from the old to a new revenue-sharing formula agreed in 2002 (IMF Country Report 05/437).

[3] At the time of the 2006 Article IV consultation, the prospects for the textile industry were unfavorable. The multi fiber agreement (MFA) ended in 2005, and AGOA's third-country provision was scheduled to lapse in 2007. However, this provision, allowing quota- and tariff-free entry to the U.S. of Lesotho's garments produced with third-country fabrics, has been extended through 2012.

[4] In July 2007, the UN called on the international community to help Lesotho cope with food shortages and drought. To date, $11.6 million has been provided by various donors, including the U.S., Canada, France, the European Commission, various UN agencies and the African Development Bank.

Figure 2. Recent Macroeconomic Performance



Sources: National authorities and IMF staff estimates.

3. **The fiscal position and public debt sustainability indicators have improved**. The overall balance registered a record surplus of 16 percent of GDP in 2006/07. This surplus (the third in a row and well above budget projections) is largely the result of an increase in SACU receipts and the limited execution of capital projects due to inadequate capacity in line ministries and complex procurement procedures, as well as one-off gains in domestic revenue that offset the decline in corporate tax rates. Most of the surplus was saved at the Central Bank of Lesotho (CBL)**.** The use of part of the SACU windfall to retire nonconcessional debt helped improve debt indicators, with ratios of external debt to GDP and debt service to exports of goods and nonfactor services falling, respectively, from 58 percent and 10 percent in 2003 to 43 percent and 6½ percent in 2006.

Lesotho: Key Fiscal Indicators

	2004/05	2005/06	2006/07	
		Est.	Budget	Outturn
		(Percent of GDP)		
Total revenue and grants	50.9	50.0	55.6	62.3
SACU revenue	23.2	24.7	30.4	37.9
Domestic revenue	24.9	23.5	22.3	23.5
Grants	2.8	1.8	2.8	0.9
Total expenditure	43.7	46.0	54.8	46.1
Current expenditure	36.4	38.6	42.1	39.2
Wages and salaries	13.6	13.7	14.2	13.8
Capital expenditure	7.2	7.5	12.8	7.0
Overall balance, incl. grants	7.2	4.0	0.8	16.1
Domestic balance	9.0	7.1	5.1	18.1
Memorandum items:				
Financing				
External	-0.4	-3.0	-1.3	-2.6
Domestic	-6.7	-1.1	0.6	-13.6

Sources: Ministry of Finance, and Fund staff calculations.

4. **Broad money grew by 35½ percent in 2006.** Coupled with a decline in net domestic assets reflecting the government surplus, among other factors, this resulted in a strong increase in net foreign assets (NFA) of the banking system. NFA and money growth also show the effect of rising workers' remittances.

III. Policy Discussions

5. The discussions focused on preserving fiscal sustainability to ensure macroeconomic stability given the fixed exchange rate; attaining sustainable and broad-based growth,

especially through private sector development; and strengthening external and internal economic stability.

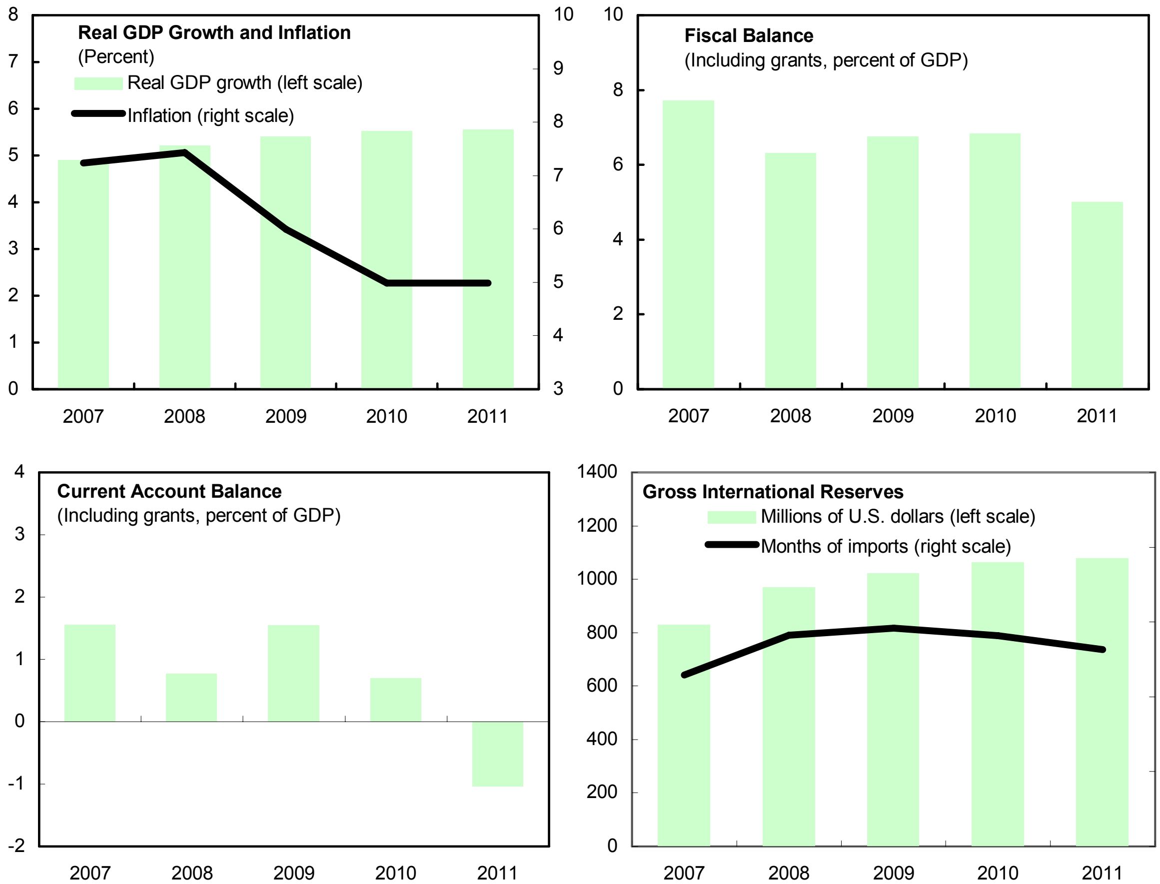
Box 1. Response to Previous Recommendations

Over the years staff and authorities have generally agreed on the main economic challenges facing Lesotho. In 2006 staff recommended preserving fiscal sustainability, improving public expenditure management, and accelerating reforms aimed at fostering private-sector led growth. The government delivered a substantial fiscal surplus in 2006/07, and has emphasized public financial management issues and private sector development in its structural reform agenda. The pace of structural reform has been slow mainly due to implementation constraints.

A. Economic Outlook

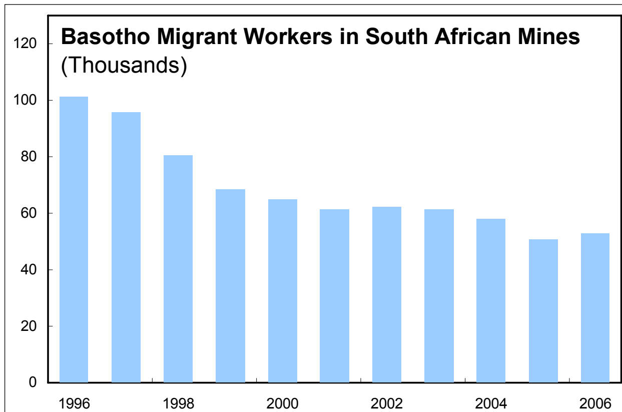
6. **Near-term economic prospects are favorable.** Real GDP growth is projected at about 5 percent in 2007 and could average nearly 5 ½ percent in the following years, propelled by continued expansion in mining, moderate growth of the garment industry (the recovery has taken place without new investments, and limited factory space is a bottleneck), and a pick-up in construction driven by high public investment. Agriculture is expected to make a negative contribution in 2007 due to the drought. The authorities project somewhat faster growth, especially in the garment sector. Growth will require diligent implementation of the investment projects included in the MCC compact. Staff agreed with the authorities that SACU revenues are likely to remain high at least through 2009/10 because of high economic activity in South Africa. Remittances are anticipated to rise in nominal terms—although diminishing as a ratio to GDP—as the increase in average pay should more than offset the decline in the number of workers resulting from structural changes in South African mines.

Figure 3. Medium Term Outlook



Source: IMF staff estimates and projections.

7. **The main risk to the real economy is the deterioration of the external environment**. The evolution of the global regime for trade in textiles will affect Lesotho's export sector. In particular, there is pressure to extend to non-African countries preferences similar to those established by AGOA, and Chinese exports to the U.S. and EU markets are expected to again be quota-free in 2008. The authorities are aware of these risks, and intend to strengthen infrastructure, notably electricity and water, to support productivity increases and vertical integration in the textile sector. Short run, the slowdown in the



Sources: National authorities.

U.S. economy could affect orders for garment producers. A steeper downward trend in remittances from abroad would affect consumption.

8. **A significant medium-term risk, especially for the budget, concerns the evolution of SACU revenues**. SACU revenues could be affected by a slowdown in South Africa and trade liberalization. More fundamentally, South Africa has called for a review of SACU's revenue-sharing arrangements, although it has not submitted a concrete proposal. In addition, the call for SADC to evolve into a customs union raises uncertainty about the durability of existing rules. The authorities believe that negotiations for a new revenue-sharing formula might be prolonged and it could take a long time to reach a consensus. Likewise, a SADC customs union would take time to materialize and the revenue implications for Lesotho would need to be taken into account.

9. **Authorities and staff agreed also that unlicensed deposit-taking entities pose significant risk to the financial system** (see paragraph 25 below). The growth of a weakly supervised credit cooperative sector is also worrisome.

B. Fiscal Policy and Reforms

10. **After the fiscal surpluses of recent years, the 2007/08 budget raises some concerns**. The high level of spending in the 2007/08 budget—an increase of 5 percentage points of GDP in current expenditure and a more than doubling of capital expenditure to 16 percent of GDP—could undermine fiscal sustainability and spending quality. Even if it is not expected that the budget will be fully executed, the amount of slack in the appropriations reduces the budget's usefulness as a programming instrument. The authorities confirmed that, taking into account actual spending capacity ("outturn basis"), they project a significantly better balance in 2007/08 than the approved budget suggests, and stated that current budgeting procedures tend to generate excessively high appropriations.

Lesotho: Fiscal Framework, 2006/07-2010/11

	2006/07	2007/08		2008/09	2009/10	2010/11
	Est.	Budget	Proj.	Projections		
			(Percent of GDP)			
Total revenue and grants	62.3	57.1	56.4	59.1	56.8	54.7
SACU revenue	37.9	31.8	33.0	31.7	29.7	27.9
Domestic revenue	23.5	21.2	21.9	21.9	21.9	21.9
Grants	0.9	4.1	1.5	5.5	5.2	4.9
Total expenditure	46.1	60.0	51.2	52.4	50.0	47.9
Current expenditure	39.2	44.1	41.6	40.0	38.5	37.1
Wages and salaries	13.8	14.5	14.5	14.2	13.8	13.6
Capital expenditure	7.0	15.9	9.7	12.4	11.5	10.8
Overall balance, incl. grants	16.1	-2.9	5.2	6.6	6.8	6.8

Sources: Ministry of Finance; and Fund staff projection

11. **Staff supported the medium-term fiscal stance represented in the authorities' projections on an outturn basis and under unchanged policies, while noting that implementing it will be challenging**.[5] Reflecting high SACU revenue, sustained non-SACU domestic revenue, and strict expenditure policies, the medium term fiscal framework (MTFF) projects fiscal surpluses (excluding grants) through 2010/11, even though government investment is substantially above its level of recent years. This projection implies a significant reduction in current expenditure as a ratio to GDP, which will be difficult to deliver; the projected revenue provides some margin of safety, but the risks to revenue itself advise against using up such margin.

12. **Avoiding a generalized expenditure increase is key to preserve fiscal sustainability, but spending pressures are significant**. Staff cautioned against using the SACU revenue windfall, temporary by definition, to raise recurrent spending. Specifically, staff recommended adopting a cautious approach to the introduction of the pension reform and the upcoming salary review, and limiting recruitment to priority areas. The authorities agreed in principle, but felt that pension reform will likely be costly and that Lesotho is losing qualified professionals such as nurses and teachers to South Africa and other countries, which suggests that increasing salaries for certain categories of civil servants may be justifiable.

13. **The envisaged increase in public investment poses challenges.** The under-spending of the capital budget in past years reveals weaknesses in the programming and execution of projects. The government intends to increase flexibility in its procedures to release resources to those projects moving fast. It is essential that the government redouble its efforts to improve project execution, especially in view of the fact that the MCC funds will be lost if they are not used within five years. To speed up the execution of some domestically-financed investments, the authorities have started using public-private partnerships (PPPs).[6] Staff agreed that PPPs could supplement government's implementation capacity, but recommended that PPPs only be used when they deliver higher value for money than traditional government investment. Moreover, managing PPPs requires careful contract drafting and close monitoring. The authorities are aware of these challenges, and indicated their intention to seek technical assistance from relevant agencies.

14. **Strengthening expenditure management will help ensure a good level and quality of spending**. Staff welcomed progress made in this area in the context of the Public Sector Improvement and Reform Program (PSIRP), which includes the introduction of a medium-term expenditure framework, strengthening budget planning and execution, and

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[5] The text table reflects the authorities' initial expenditure plans and staff's revenue and GDP projections.

[6] The construction and operation of the ministry of Health Headquarters and of a new national referral hospital are taking place as PPPs.

public procurement reform. All line ministries are preparing budget framework papers for the 2008/09 budget that will cover a three year period. However, due to capacity limitations in line ministries, the full MTEF is being piloted in six ministries. Staff encouraged the authorities to extend the MTEF to all ministries as soon as feasible, following the recommendations of the PEMFAR assessment. Staff and authorities agreed that the use of the MTEF would help further align the budget with development priorities.

15. **Debt and financial management needs to be reinforced**. Staff welcomed the decision to use part of the surplus to pay off expensive nonconcessional debt. Nevertheless, the payment of substantial amounts (totaling nearly 5 percent of GDP in the last two years) to retire debts accumulated outside the conventional budgetary framework underscores the need for tight control of government's obligations.[7] The authorities expect their financial management reforms to help prevent similar problems in the future.

16. **An updated DSA shows Lesotho's external and public debts to be sustainable, although there is a moderate risk of debt distress (see supplement 2).** In the baseline scenario debt should continue to decline over the medium term. However, in some adverse scenarios some debt indicators might rise above levels that are considered sustainable for low-income countries. The authorities generally agreed with this assessment.

C. Achieving Broad-based and Sustainable Economic Growth

17. **The authorities underlined their intention to continue to focus on pro-growth policies to achieve poverty reduction.** While the output growth observed in 2006 was strong, it reflected in part the performance of sectors with limited linkages to the rest of the economy and a favorable external environment. Reducing poverty, improving living standards, and more generally making progress towards the MDGs depend on achieving sustainable and broadly based growth. In this context, staff recommended looking beyond the lapse of AGOA in 2015 and giving due priority to the challenges of the rural economy. Authorities and staff agreed that attaining sustainable growth will require a major effort to improve the quality of Lesotho's institutions.

18. **The mission provided feedback on the authorities' draft Growth Strategy Paper (GSP).** The GSP seeks to identify binding constraints on growth and to collate prior development programs to derive policy recommendations, emphasizing the improvement of the investment climate, especially in key sectors, and the enhancement of infrastructure and skills. To be most useful, the GSP should be congruent with the Poverty Reduction Strategy (PRS), provide a strategic approach to the challenges and opportunities arising from the proximity to South Africa, and outline a multi-year implementation agenda that may be

[7] The retired debt had been contracted on commercial terms by the Lesotho Highland Development Authority—a public enterprise—on behalf of the government.

reflected in the MTEF. The authorities indicated that these are elements they intend to incorporate in their growth strategy.

19. **Staff welcomed the inclusion of a Private Sector Development Component in the compact signed with the MCC**. Effective implementation of this program and of the ongoing Private Sector Competitiveness Program should relieve some constraints on growth, notably inadequate infrastructure and low access to credit. In this regard, to improve the business environment and reduce "red tape," the authorities have launched a one-stop trade facilitation center for foreign investors, which is part of their private sector development agenda (Box 2).

Box 2. Private Sector Development Agenda

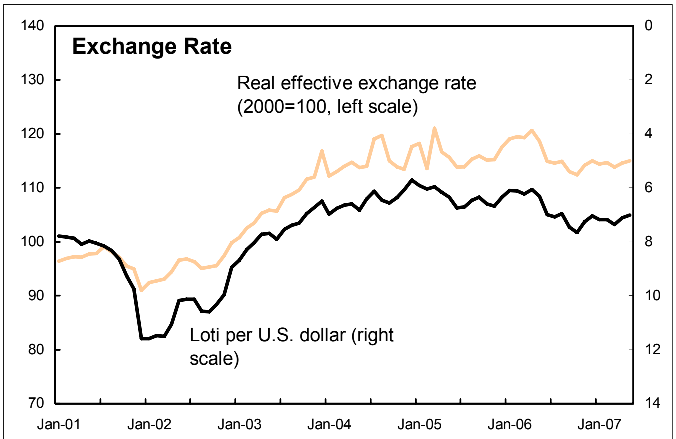
The current reform strategy aims at:

- mitigating structural constraints, such as high transport costs, availability of water and electricity;
- reducing the cost of doing business by improving the legal, judicial, and regulatory framework;
- raising labor productivity through improvements in education and health and demand-driven skills development programs; and
- increasing access to bank financing.

Many donors and international agencies are assisting the government in these reforms.

D. External Stability

20. **Economic policies have been consistent with external stability.** Staff shared the authorities' view that the current exchange rate system should be maintained. It promotes price stability in Lesotho and facilitates capital and current transactions with South Africa, Lesotho's most important economic partner. Prudent fiscal policies have underpinned the continued viability of this arrangement.



Sources: National authorities and IMF staff estimates.

21. **Standard assessments of the real exchange rate and the current account suggest no immediate threat to external stability (Box 3 and Selected Issues Paper).** While the appreciation of the rand between 2002 and 2005 reduced some measures of cost competitiveness in Lesotho, its depreciation in 2006 and so far in 2007 and recent adjustments in corporate tax rates seem to have stemmed that trend. The projections for the current account over the next few years are consistent with an improvement in Lesotho's NFA position. To the extent that it may be financed by capital transfers (such as some MCC grants) and FDI, a reduction in the current account balance would not raise significant concerns. Nevertheless, Lesotho's external stability is subject to uncertainty in the medium term (see paragraphs 7-8), which raises the margin of error of the methodologies used.

Box 3. Assessing the Real Exchange Rate

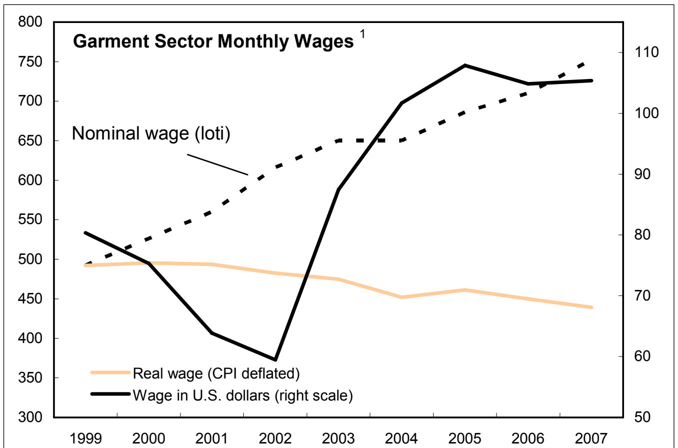
Lesotho pegs its currency to that of South Africa, from where most of its imports and inflation come, and sends most of its exports outside SACU. Thus, Lesotho's REER is essentially a smoothed version of South Africa's, and largely independent of its fundamentals. Conversely, Lesotho's current account and growth depend heavily on factors unrelated to its REER and outside the country's control, such as AGOA and SACU transfers. These factors are surrounded by a degree of uncertainty, especially in the outer years of the medium term projections. This suggests taking the estimates of current account norms shown below with caution. With these caveats, the various approaches used yielded no consistent evidence of misalignment.

When Lesotho's medium-term fundamentals are used, the *macroeconomic balance* approach, based on the regression estimates of CGER (http://www.imf.org/external/np/pp/eng/2006/110806.pdf, Table 1), produces a current account norm that is 1¾ points of GDP weaker than projected for 2007. The fundamentals used in this analysis are the medium term values of the fiscal balance (which incorporates a projected reduction in SACU transfers as a ratio to GDP), the old-age dependency ratio, population growth, oil balance and relative income.

The *external sustainability* approach indicates that the current account balance that would stabilize the ratio of net foreign assets to GDP at the 2006 level would be 1 percent of GDP weaker than projected for 2011 (also including the decline in SACU transfers mentioned above).

The *absolute version of the purchasing power parity* (PPP) approach estimates the deviation of the loti's REER from its "long-run level" based on an international comparison of price levels adjusted for productivity differentials. Under this approach, the loti was undervalued by 19 percent in 2006, but the margin of error (at a 90 percent confidence level) is larger than this.

On the other hand, Lesotho's dollar wage in the garment industry remains relatively high by the standard of the last decade, although below its 2005 peak.



Sources: National authorities and IMF staff estimates.

[1] Minimum wage for unskilled workers. For 2007, as of October with inflation assumed to be 8.6 percent.

22. **Staff supported further gradual accumulation of international reserves.** The CBL's net international reserves (NIR) target seeks to ensure the viability of the exchange rate peg of the loti to the rand, and should be considered a floor. Currently, reserves exceed the target, reflecting the saving of recent SACU revenue windfalls. The continuation of Lesotho's prudent fiscal stance should result in further accumulation of foreign assets in the near to medium term, provided that SACU transfers remain elevated. This is to be welcomed, in view of uncertainties that loom ahead. The authorities indicated that it might not be optimal to accumulate international reserves at the CBL indefinitely. Staff agreed that other options for managing the future accumulation of external assets should be considered as long as they held to high standards of governance and transparency.

E. Financial Sector Issues

23. **The banking system is solid, but access to banking services for households and SMEs remains limited**. The banking system, dominated by three South African banks, is profitable, well-capitalized, and liquid; nonperforming loans (NPLs) are moderate and well provisioned. Possible vulnerabilities might result from a relatively high and increasing concentration on the asset side of the banks' balance sheets. A challenge going forward is to increase the role, so far limited, of the banking system in financing domestic firms and households. The authorities indicated that the ongoing strengthening of Lesotho Postbank together with an ordered development of microfinance would increase population access to financial services. It is also expected that efforts to formalize land titling, build the credit bureau, and reform commercial courts will increase the availability and quality of bank credit to the economy.

Lesotho: Commercial Banks' Quarterly Performance Ratios, 2005-07

	2005	2006				2007
	Dec.	Mar.	Jun.	Sep.	Dec.	Mar.
Performance ratios			(Percent)			
Capital adequacy						
Basel capital ratio	22	25	23	19	19	20
Nonperforming loans to total capital	3	2	2	6	6	9
Top 20 exposures to total capital	100	84	63	98	117	116
Asset quality						
Loans to deposits ratio	29	30	17	30	26	26
Earning assets to total assets	93	94	95	94	95	95
Nonperforming loans to total loans	2	1	2	2	2	3
Reserve for losses to total loans	3	2	3	2	3	3
Reserve for losses to nonperforming loans	167	242	161	112	125	93
Liquidity Ratios						
Liquid assets to total deposits	120	112	132	88	100	98
Available reserves to total deposits	8	6	6	5	4	5
Liquid assets to total assets	77	75	83	75	78	78
Current assets to total current liabilities	86	85	95	83	85	84
Profitability ratios[1]						
Net income to average total assets (return on assets)	2	1	1	2	2	1
Net income to average total equity (return on equity)	15	7	8	20	27	8
Total expenses to total income	73	75	73	68	70	74
Solvency ratios						
Total debt ratio	10	12	12	10	7	8

Source: Central Bank of Lesotho.

[1] Since 2005, affected by the operations of two new banks.

24. **The rapid growth of the credit cooperative sector calls for better regulation and supervision**. Credit cooperatives have grown in response to the low access to bank credit. Taking advantage of loopholes in regulations, they often engage in financial intermediation with nonmembers without adequate supervision. The extent of the operations of these cooperatives is not well known, and the quality of supervision is limited at present. The authorities concurred with this assessment and stated that technical assistance is expected from the International Fund for Agriculture Development (IFAD). The measures currently contemplated include the revision of the regulation and supervision framework and a strengthening of the role of the CBL, which at present has no jurisdiction in this area.

25. **The operation in Lesotho of unlicensed deposit-taking entities poses significant risks to depositors and potentially to social stability**. These vehicles have attracted sizable deposits from the public by offering inordinately high rates of return (60 percent a year in one case), accumulating large and fast-growing liabilities that will be exceptionally difficult to meet. These vehicles face significant rollover risks, implying a high probability of failure with possible social and macroeconomic repercussions, as many thousands of savers could lose their investments. Their operation may create opportunities for money laundering and could undermine deposit-taking activities of the banks, although an eventual failure of those entities should not pose significant credit risk to banks. Staff noted that the liabilities of the largest vehicles had become quite large (about 8 percent of GDP) and that their unwinding might cause social tension. Staff encouraged the authorities to seek the support of regulatory agencies in partner countries with relevant expertise and take early action, and reiterated that the Fund is ready to help within the limits of its mandate and expertise. The authorities said they intend to address this issue and would approach some of their development partners for input should the need arise.

F. PRS Process

26. **The authorities are preparing a final report on the implementation of the PRS 2003/04–2006/07.** Staff noted that efforts made during that period were significant, but capacity limitations prevented the full implementation of the actions envisioned in the PRS. Staff observed that timely progress reports might have signaled implementation difficulties, and encouraged the authorities to improve the collection of economic and social statistics in support of monitoring the results of the PRS. The authorities intend to prepare a new PRS that will include some of the elements still pending and reflect the growth strategy under preparation and the results of the 2002 household budget survey. This PRS should be finalized by April, 2008; meanwhile, the PRS 2003/04–2006/07 remains operative.

27. **HIV/AIDS is highlighted as a cross-cutting challenge in the PRS.** Its impact on society and the economy is high, but difficult to quantify. Donor and budget resources are used to provide treatment and promote prevention, but implementation capacity is insufficient.

IV. Staff Appraisal

28. **Lesotho has continued to make progress in macroeconomic stabilization.** External developments have supported the acceleration of growth and the improvement in the balance of payments. Taking advantage of these trends, the maintenance of prudent macroeconomic policies has resulted in significant improvements in the fiscal and external balances and the buildup of international reserves, consolidating the exchange rate peg.

29. **Near-term economic prospects for Lesotho are positive, but there are a number of areas of uncertainty.** The major factors behind the surge in output in 2006 are likely to continue, and investment prospects have been boosted by the MCC compact. However, there are risks related to the worsening of the external environment, including a possible slowdown in export markets. The medium-term outlook is subject to uncertainty about SACU's revenue sharing regime, global trade in textiles and its regime, and remittances from workers in South Africa. These factors are largely beyond Lesotho's control, and the country should prepare for possible adverse developments. Consistent with this assessment, the DSA indicates that external debt would decline in the baseline scenario, although there is a moderate risk of debt distress.

30. **Large SACU revenue windfalls have been managed prudently so far, and pressures for generalized expenditure increases should be resisted**. The surge in spending envisaged in the 2007/08 budget is problematic, even if it is unlikely to be fully executed. As the DSA indicates, there seem to be limited immediate threats to fiscal sustainability and there is room to increase productive public investment in the next few years. Nevertheless, going forward it will be prudent to contain recurrent spending given the uncertainty about SACU revenues in the medium term. In particular, the upcoming salary review should be approached carefully, just as the pension reform. It is important to address weaknesses in the budget process and extend the MTEF to all ministries.

31. **The government should continue to use grants and own resources to boost public investment, especially in infrastructure**. Executing the desired public investment is a challenge that must be addressed to fully utilize MCC's resources. While PPPs have a role in public investment, the government needs to build up its capacity to manage them effectively.

32. **The authorities' effort to develop a growth strategy is welcome.** The government intention to draw up a strategy that may guide the formulation of medium term fiscal plans and institutional reform initiatives is appropriate. It will be necessary to ensure that such strategy is congruent with the PRS.

33. **Staff encourages the authorities to implement vigorously their structural reforms.** The Public Sector Improvement and Reform Program, the Private Sector Development Component of the MCC compact, and the World Bank-supported Private

Sector Competitiveness Program aim to relieve important constraints on growth. These programs target institution building, which is key to achieving sustainable growth.

34. **The monetary and exchange rate regime has been beneficial and should be preserved, along with the prudent policy mix that makes it viable.** Membership in the CMA and the peg of the loti to the rand have ensured stable and low inflation and facilitated capital and commercial exchanges with South Africa. Fiscal restraint in the face of strong SACU revenues has ensured external stability by helping keep NIR at levels consistent with the sustainability of the peg.

35. **The banking system appears solid, but access to banking services for households and SMEs is limited,** which has fostered the growth in weakly supervised credit cooperatives. Current efforts to improve their regulation and supervision and to increase access to banking services should be intensified.

36. **The operation of unlicensed deposit-taking entities gives cause for concern.** These vehicles have large and fast-growing liabilities, face constant rollover risks, and pose significant risks of failure. The longer they continue to operate, the larger their liabilities will grow and the higher the risk of social and financial repercussions. Staff urges the authorities to take prompt action to address this issue.

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

Table 1. Lesotho: Selected Economic and Financial Indicators, 2003-2011

	2003	2004	2005	2006	2007	2008	2009	2010	2011
				Est.	Projections				
	(Annual percentage change, unless otherwise indicated)								
National income and prices									
Real GDP	2.7	4.2	2.9	7.2	4.9	5.2	5.4	5.5	5.6
Real GNP	3.3	3.3	1.1	10.8	2.3	2.7	4.4	3.7	3.6
Consumer price index (period average)	7.3	5.0	3.4	6.1	7.2	7.4	6.0	5.0	5.0
Consumer price index (end of period)	5.9	4.8	3.5	6.4	8.0	7.0	6.0	5.0	5.0
GDP (millions of maloti)	7,862	8,522	9,065	10,120	11,273	12,723	14,341	15,891	17,585
GNP (millions of maloti)	9,793	10,523	10,997	12,690	13,789	15,184	16,958	18,459	20,056
External sector									
Exports, f.o.b.[1]	32.5	40.3	-1.4	7.5	6.1	10.0	6.7	6.7	6.7
Imports, f.o.b.[1]	31.2	26.8	4.4	4.6	7.9	8.4	4.6	6.5	5.3
Nominal effective exchange rate[2]	11.7	0.5	-1.8	-3.6	...	...	...	...	...
Real effective exchange rate[2]	17.1	0.7	-0.1	-2.2	...	...	...	...	...
Money and credit									
Net foreign assets[3]	-19.5	22.3	10.9	76.2	23.8	...	...	...	...
Net domestic assets[3]	25.5	-19.0	-1.8	-40.8	-12.4	...	...	...	...
Credit to the government[3]	7.1	-25.1	-7.1	-22.7	-15.4	...	...	...	...
Credit to the rest of the economy	-21.5	2.7	8.5	4.3	3.0	...	...	...	...
Broad money	6.0	3.3	9.1	35.4	11.4	...	...	...	...
Velocity (GNP/average broad money)	4.4	4.5	4.4	4.2	3.7	...	...	...	...
Interest rate[4]	12.0	8.5	7.2	6.9	...	...	...	...	...
	(Percent of GDP, unless otherwise indicated)								
Investment and saving									
Investment	33.2	31.4	28.0	24.3	26.2	28.9	28.9	28.4	27.7
Public	8.7	7.4	7.5	7.2	9.2	11.9	11.7	11.0	10.3
Private	18.3	18.1	19.1	17.1	17.0	17.0	17.2	17.4	17.4
Lesotho Highlands Water Project	6.2	5.9	1.4	0.0	0.0	0.0	0.0	0.0	0.0
Gross national savings (including remittances)	20.9	25.9	21.1	28.7	27.7	29.7	30.5	29.1	26.7
Public	8.1	13.1	12.3	20.4	16.8	18.1	18.4	17.8	14.8
Private	12.8	12.8	8.8	8.2	10.9	11.5	12.1	11.3	11.9
Government budget									
Revenue	42.2	46.7	48.7	58.4	56.6	54.0	52.0	50.3	47.6
Total grants	2.6	2.6	2.1	1.1	1.4	4.6	5.3	5.0	4.3
Total expenditure and net lending	45.3	43.7	45.9	46.2	50.3	52.3	50.5	48.4	47.4
Overall balance (excluding grants)	-3.1	3.0	2.7	12.3	6.3	1.7	1.5	1.9	0.3
Overall balance (including grants)	-0.4	5.6	4.8	13.4	7.7	6.3	6.8	6.8	4.5
Government debt[5]	72.6	55.8	54.5	51.4	49.4	45.6	43.0	42.1	41.5
Domestic debt	14.5	8.9	9.0	8.2	7.0	5.9	5.0	4.6	4.4
External debt[5]	58.1	46.9	45.5	43.1	42.4	39.7	38.0	37.4	37.1
External debt-service ratio[6]	9.8	7.6	10.9	6.4	5.2	3.7	3.2	3.0	2.8
Current account balance									
Excluding official transfers	-27.8	-23.5	-27.3	-20.5	-25.6	-25.7	-23.0	-23.1	-22.5
Including official transfers	-12.3	-5.5	-7.0	4.4	1.6	0.8	1.5	0.7	-1.0
Gross official reserves (end of period)									
Millions of U.S. dollars	501.6	503.3	546.5	737.6	829.2	970.1	1,021.9	1,063.5	1,079.1
Months of imports of goods and services	5.6	4.5	4.6	6.1	6.3	6.8	6.9	6.8	6.6

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

[1] U.S. dollars.

[2] End of period; a minus sign indicates a depreciation.

[3] Change in percent of broad money at the beginning of the period.

[4] The average effective rate on three-month treasury bills.

[5] The appreciation of the loti had a significant effect on the debt-to-GDP ratio in 2003.

[6] Percent of exports of goods and nonfactor services.

Table 2. Lesotho: Central Government Operations, 2003/04-2011/12 [1]

	2003/04	2004/05	2005/06	2006/07	2007/08		2008/09	2009/10	2010/11	2011/12
				Est.	Budget	Proj.	Projections			
	(Millions of Maloti)									
Revenue	3,416.7	4,169.9	4,495.8	6,386.8	6,393.0	6,384.0	7,032.1	7,593.9	8,125.3	8,455.4
Tax revenue	2,887.5	3,693.0	4,005.9	5,787.1	5,817.1	5,808.1	6,382.4	6,864.9	7,317.8	7,563.0
SACU revenue [2]	1,421.6	2,012.4	2,306.0	3,945.0	3,836.3	3,836.3	4,157.7	4,369.0	4,553.1	4,507.6
Of which: Non-duty receipts	1,160.4	1,483.5	1,915.0	2,571.7	…	3,055.2	3,226.9	3,403.8	3,517.9	3,516.0
Noncustoms tax revenue	1,465.9	1,680.6	1,699.9	1,842.1	1,980.8	1,971.8	2,224.6	2,496.0	2,764.7	3,055.4
Income taxes	852.5	901.8	924.6	973.1	1,042.5	1,033.5	1,166.0	1,308.2	1,449.1	1,601.5
Sales tax / value-added tax (VAT)	519.3	659.8	655.7	714.6	804.5	804.5	907.6	1,018.3	1,128.0	1,246.6
Petrol levy	80.6	88.3	82.5	65.6	83.9	83.9	94.7	106.2	117.6	130.0
Other tax revenues	13.5	30.7	37.1	88.8	49.9	49.9	56.3	63.2	70.0	77.3
Nontax revenue	529.2	476.9	489.9	599.7	575.9	575.9	649.7	729.0	807.5	892.4
Grants	177.8	238.4	171.4	92.4	490.0	180.0	720.2	770.5	797.9	734.0
Total expenditure and net lending	3,532.2	3,787.1	4,291.4	4,799.4	7,229.7	5,963.1	6,881.6	7,363.2	7,807.9	8,501.0
Current expenditure	2,906.8	3,147.8	3,604.0	4,075.5	5,315.5	4,836.6	5,253.3	5,673.0	6,048.1	6,683.1
Wages and salaries	1,123.2	1,178.6	1,282.1	1,433.2	1,745.8	1,689.6	1,858.2	2,033.4	2,217.9	2,451.1
Interest payments	216.4	157.0	225.1	96.7	366.6	116.6	105.3	98.4	93.0	88.6
External	90.5	91.9	179.3	55.3	304.3	54.3	52.3	53.4	54.7	56.1
Domestic	125.9	65.1	45.8	41.4	62.3	62.3	53.0	45.0	38.3	32.5
Other expenditure	1,567.2	1,812.2	2,096.8	2,545.6	3,203.1	3,030.4	3,289.8	3,541.3	3,737.3	4,143.4
Goods and services	935.9	991.0	1,119.2	1,436.3	1,733.6	1,558.3	1,735.9	1,890.3	2,047.5	2,262.9
Transfer and subsidies	631.3	821.2	977.6	1,109.3	1,469.5	1,472.1	1,553.9	1,651.0	1,689.8	1,880.5
Capital expenditure	634.9	625.2	697.3	733.3	1,924.2	1,136.5	1,638.3	1,700.2	1,769.8	1,827.8
Domestically funded	314.3	331.0	411.7	484.1	1,103.5	735.9	729.9	747.4	769.0	807.6
of which: Capital transfers	96.3	167.8	127.1	152.8	250.0	250.0	363.6	351.8	341.7	358.8
Externally funded	320.6	294.2	285.6	249.2	820.7	400.6	908.4	952.8	1,000.8	1,020.2
Grant funded	140.2	182.6	171.4	92.4	490.0	180.0	670.2	695.5	722.9	734.0
Loan funded	180.4	111.6	114.2	156.8	330.7	220.6	238.2	257.3	277.9	286.2
Net lending	-9.5	14.1	-9.9	-9.4	-10.0	-10.0	-10.0	-10.0	-10.0	-10.0
Overall balance, before grants	-115.5	382.8	204.4	1,587.4	-836.7	420.9	150.5	230.7	317.4	-45.5
Overall balance, after grants	62.3	621.2	375.8	1,679.8	-346.7	600.9	870.7	1,001.2	1,115.3	688.5
Domestic balance [3]	309.6	783.0	659.4	1,882.5	7.6	865.8	1,101.2	1,226.9	1,362.9	1,020.8
Total financing	-62.3	-621.2	-375.8	-1,679.8	346.7	-600.9	-870.7	-1,001.2	-1,115.3	-688.5
External financing	-25.7	-38.3	-276.6	-266.1	61.8	-298.3	53.9	58.6	72.8	69.8
Loan drawings	180.4	207.1	114.2	156.8	330.7	220.6	238.2	257.3	277.9	286.2
of which: Budget support loans	…	…	…	…	…	…	0.0	…	…	…
Amortization	-206.1	-245.4	-390.8	-213.1	-268.9	-268.9	-184.4	-198.7	-205.1	-216.4
Payment of arrears	--	--	--	-209.8	0.0	-250.0	--	--	--	--
Domestic financing	-36.7	-582.9	-99.2	-1,413.7	284.9	-302.6	-924.5	-1,059.8	-1,188.1	-758.3
Bank	-129.6	-605.2	-102.1	-1,248.0	284.9	-302.6	-924.5	-1,059.8	-1,188.1	-758.3
Nonbank	92.9	22.3	2.9	-165.7	0.0	0.0	0.0	0.0	0.0	0.0

continued

Table 2. Lesotho: Central Government Operations, 2003/04-2011/12 (concluded)

	2003/04	2004/05	2005/06	2006/07	2007/08		2008/09	2009/10	2010/11	2011/12
				Est.	Budget	Proj.	Projections			
	(Percent of GDP, unless otherwise indicated)									
Revenue	42.6	48.2	48.2	61.4	53.0	54.9	53.6	51.6	49.8	46.9
Customs revenue (SACU)[2]	17.7	23.2	24.7	37.9	31.8	33.0	31.7	29.7	27.9	25.0
Noncustoms tax revenue	18.3	19.4	18.2	17.7	16.4	16.9	16.9	16.9	16.9	16.9
Nontax revenue	6.6	5.5	5.3	5.8	4.8	4.9	4.9	4.9	4.9	4.9
Grants	2.2	2.8	1.8	0.9	4.1	1.5	5.5	5.2	4.9	4.1
Total expenditure and net lending	44.0	43.7	46.0	46.1	60.0	51.2	52.4	50.0	47.9	47.1
Current expenditure	36.2	36.4	38.6	39.2	44.1	41.6	40.0	38.5	37.1	37.1
Wages and salaries	14.0	13.6	13.7	13.8	14.5	14.5	14.2	13.8	13.6	13.6
Interest payments	2.7	1.8	2.4	0.9	3.0	1.0	0.8	0.7	0.6	0.5
External	1.1	1.1	1.9	0.5	2.5	0.5	0.4	0.4	0.3	0.3
Domestic	1.6	0.8	0.5	0.4	0.5	0.5	0.4	0.3	0.2	0.2
Other expenditure	19.5	20.9	22.5	24.5	26.6	26.0	25.1	24.0	22.9	23.0
Goods and services	11.7	11.4	12.0	13.8	14.4	13.4	13.2	12.8	12.6	12.6
Transfers and subsidies	7.9	9.5	10.5	10.7	12.2	12.7	11.8	11.2	10.4	10.4
Capital expenditure	7.9	7.2	7.5	7.0	16.0	9.8	12.5	11.5	10.8	10.1
Of which: domestically funded	3.9	3.8	4.4	4.7	9.2	6.3	5.6	5.1	4.7	4.5
Net lending	-0.1	0.2	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1
Overall balance, before grants	-1.4	4.4	2.2	15.3	-6.9	3.6	1.1	1.6	1.9	-0.3
Overall balance, after grants	0.8	7.2	4.0	16.1	-2.9	5.2	6.6	6.8	6.8	3.8
Domestic balance[3]	3.9	9.0	7.1	18.1	0.1	7.4	8.4	8.3	8.4	5.7
Total financing	-0.8	-7.2	-4.0	-16.1	2.9	-5.2	-6.6	-6.8	-6.8	-3.8
External financing	-0.3	-0.4	-3.0	-2.6	0.5	-2.6	0.4	0.4	0.4	0.4
Domestic financing	-0.5	-6.7	-1.1	-13.6	2.4	-2.6	-7.0	-7.2	-7.3	-4.2
Memorandum items:										
GNP at current prices (Millions of maloti)	9,975	10,642	11,420	12,965	14,516	14,138	15,628	17,334	18,858	20,255
GDP at current prices (Millions of maloti)	8,027	8,658	9,329	10,408	12,052	11,636	13,128	14,729	16,314	18,030

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

[1] On fiscal year basis (April - March)

[2] Adjustment receipts of M 330 million in 2005/06 included.

[3] Domestic balance excludes grants, foreign-financed capital spending, foreign interest payments, and exceptional factors.

Table 3. Lesotho: Balance of Payments, 2003- 2011
(Millions of U.S. dollars)

	2003	2004	2005	2006	2007	2008	2009	2010	2011
				Est.			Projections		
Trade balance	-517.8	-592.5	-656.6	-667.4	-732.3	-782.0	-800.9	-851.9	-883.6
Exports, f.o.b.	470.3	660.0	650.7	699.5	742.4	816.3	871.0	929.0	990.8
Of which: garments	337.8	501.3	527.7	567.2	589.9	644.0	682.9	725.1	769.7
Imports f.o.b [1]	-988.1	-1,252.4	-1,307.3	-1,366.9	-1,474.7	-1,598.3	-1,671.8	-1,780.9	-1,874.4
Of which: garment inputs	-145.4	-215.8	-227.1	-244.2	-253.9	-277.2	-293.9	-312.1	-331.3
Services (net)	-34.7	-36.9	-46.7	-35.4	-47.1	-31.1	-11.8	21.4	53.2
Receipts	49.6	61.1	56.6	59.8	60.6	77.0	90.0	111.9	132.5
Of which: water royalties	14.7	17.0	18.1	18.4	23.3	35.5	47.0	57.6	58.6
Payments	-84.3	-98.1	-103.4	-95.2	-107.7	-108.1	-101.8	-90.6	-79.2
Income (net)	255.3	309.8	303.8	379.5	354.4	340.9	351.3	334.3	311.8
Labor income (net)	254.4	304.2	302.2	345.2	317.7	310.4	302.4	275.9	256.6
Receipts	281.3	333.8	319.1	356.6	334.2	339.9	337.6	313.1	292.9
Of which: miners' wages	229.7	271.0	253.8	292.8	242.9	249.6	250.9	242.8	239.9
Payments	-26.9	-29.5	-16.9	-11.4	-16.6	-29.5	-35.2	-37.2	-36.4
Investment income (net)	0.8	5.5	1.6	34.3	36.7	30.4	48.9	58.4	55.3
Receipts	27.9	38.3	50.2	55.5	54.3	47.5	67.6	76.9	73.2
Payments	-27.0	-32.8	-48.6	-21.2	-17.6	-17.0	-18.7	-18.6	-17.9
Of which: interest on debt	-12.8	-11.9	-37.9	-13.8	-13.5	-12.5	-13.7	-13.3	-12.2
Unrequited transfers	169.7	247.2	300.4	389.2	449.7	485.8	491.0	510.8	495.6
Official	161.5	238.1	289.7	371.6	431.6	467.2	472.1	491.5	476.0
SACU nonduty receipts	143.0	216.1	274.4	358.0	424.5	440.5	451.9	457.6	444.8
Rand compensation	8.7	9.9	11.5	11.5	0.0	0.0	0.0	0.0	0.0
Other	9.7	12.0	3.8	2.0	7.1	26.7	20.2	34.0	31.2
Private	8.2	9.1	10.6	17.6	18.1	18.7	18.9	19.2	19.6
Current account (including official transfers)	-127.6	-72.4	-99.1	65.9	24.7	13.6	29.7	14.5	-23.0
Current account (excluding official transfers)	-289.0	-310.5	-388.9	-305.6	-406.9	-453.6	-442.4	-477.1	-499.0
Of which: LHWP [2]	-62.3	-53.0	-26.3	-15.4	-2.8	-0.2	0.0	0.0	0.0
Capital and financial account	176.1	56.0	19.9	-213.5	-24.6	-13.6	-29.7	-14.5	23.0
Capital account (transfers received)	18.3	22.4	21.0	11.1	22.3	81.0	101.7	103.0	94.6
Financial account	157.7	33.6	-1.1	-224.7	-46.9	-94.6	-131.4	-117.4	-71.6
Direct investment (excl. LHDA) [3]	41.9	53.2	57.3	57.0	57.0	58.5	59.0	59.5	60.0
Financing LHWP (net)	73.0	70.8	35.3	20.3	5.3	0.0	0.0	0.0	0.0
Other investment	-25.5	-88.7	-50.4	-110.8	-17.6	-12.3	-138.6	-135.2	-116.1
Assets	-37.1	-95.0	1.9	-89.1	-54.0	-37.5	-114.4	-123.3	45.3
Liabilities	11.6	6.3	-52.3	-21.7	36.4	25.2	-24.2	-12.0	-161.4
Change in reserve assets	68.3	-1.6	-43.2	-191.1	-91.6	-140.8	-51.8	-41.6	-15.5
Valuation adjustment	49.9	33.4	14.6	53.5	0.0	0.0	0.0	0.0	0.0
Errors and omissions	-98.4	-17.0	64.7	94.1	0.0	0.0	0.0	0.0	0.0
Memorandum items:	(Percent of GDP, unless otherwise indicated)								
Trade balance	-49.8	-44.9	-46.1	-44.7	-46.1	-44.4	-41.6	-41.2	-39.8
Net remittances	24.5	23.1	21.2	23.1	20.0	17.6	15.7	13.3	11.6
Current account (including official transfers)	-12.3	-5.5	-7.0	4.4	1.6	0.8	1.5	0.7	-1.0
Current account (excluding official transfers)	-27.8	-23.5	-27.3	-20.5	-25.6	-25.7	-23.0	-23.1	-22.5
Excluding LHWP	-24.0	-20.3	-26.7	-20.7	-26.9	-27.7	-25.4	-25.9	-25.1
Total SACU receipts	189.5	288.7	351.1	522.1	544.2	564.7	579.4	586.6	570.2
Gross official reserves (Millions of U.S. dollars)	501.6	503.3	546.5	737.6	829.2	970.1	1,021.9	1,063.5	1,079.1
Gross official reserves (Months of imports of goods and services)	5.6	4.5	4.6	6.1	6.3	6.8	6.9	6.8	6.6

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

[1] Adjusted for SACU duty receipts

[2] Lesotho Highlands Water Project.

[3] Lesotho Highlands Development Authority.

Table 4. Lesotho: Monetary Survey, 2003-07

	2003	2004	2005	2006	2007
	Dec.	Dec	Dec	Dec	Dec
				Est.	Proj.
	(Millions of maloti, unless otherwise indicated)				
Net foreign assets	3,460.7	3,972.4	4,231.4	6,205.3	7,039.0
Central bank	2,837.5	2,846.8	3,076.2	4,373.6	5,024.2
Commercial banks	623.2	1,125.6	1,155.2	1,831.7	2,014.9
Net domestic assets	-1,162.8	-1,599.4	-1,641.4	-2,697.4	-3,131.3
Domestic credit	380.6	-133.9	-100.5	-576.8	-1,010.7
Claims on central government (net)	-167.0	-742.7	-910.1	-1,498.8	-2,037.7
Central bank	-1,090.1	-1,228.3	-1,199.9	-1,973.9	-2,512.9
Commercial banks	923.1	485.7	289.8	475.2	475.2
Claims on the rest of the economy	547.7	608.7	809.6	921.9	1,027.0
Other items (net)	-1,543.4	-1,465.4	-1,540.9	-2,120.6	-2,120.6
Money and quasi-money (M2)	2,297.8	2,373.0	2,590.0	3,507.9	3,907.8
Money	1,537.7	1,589.4	1,829.5	2,688.8	3,080.7
Of which: currency outside dep. mon. banks	183.5	204.5	212.8	309.4	354.5
demand deposits	1,185.2	1,197.5	1,427.9	2,379.4	2,726.2
Quasimoney	760.1	783.6	760.5	819.1	827.1
Of which: time and savings deposits	760.1	783.6	760.5	819.1	827.1
Net foreign assets [1]	-19.5	22.3	10.9	76.2	23.8
Central bank	-16.8	0.4	9.7	50.1	18.5
Commercial banks	-2.8	21.9	1.2	26.1	5.2
Net domestic assets [1]	25.5	-19.0	-1.8	-40.8	-12.4
Claims on central government (net)	7.1	-25.1	-7.1	-22.7	-15.4
Claims on the rest of the economy	-21.5	2.7	8.5	4.3	3.0
Claims on the rest of the econ. (yearly change)	-46.0	11.1	33.0	13.9	11.4
Other items (net)	39.9	3.4	-3.2	-22.4	0.0
Money and quasimoney (M2) [1]	6.0	3.3	9.1	35.4	11.4

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

[1] Annual change in percent of beginning-of-year M2, unless otherwise indicated

Table 5. Lesotho: Indicators of External Vulnerability, 2002-06
(Percent of GDP, unless otherwise indicated)

	2002	2003	2004	2005	2006
Financial indicators					
Public sector debt [1]	104.5	72.6	55.8	54.5	51.4
Broad money (M2; annual percent change)	8.8	6.0	3.3	9.1	35.4
Private sector credit (annual percent change)	1.3	-21.5	2.7	8.5	4.3
Domestic credit	9.6	4.8	-1.6	-1.1	-5.7
Treasury-bill yield (percent) [2]	11.3	12.0	8.5	7.2	6.9
Treasury-bill yield (real, percent) [3]	-1.1	4.7	3.5	3.8	0.8
External indicators					
Exports of goods and services (U.S. dollars, annual percent change)	6.4	34.0	38.7	-1.9	7.4
Imports of goods and services (U.S. dollars, annual percent change)	2.0	33.3	25.9	4.5	3.6
Current account balance	-19.4	-12.3	-5.5	-7.0	4.4
Capital and financial account balance	10.7	14.9	3.7	1.4	-14.7
Of which: inward foreign direct investment	3.3	3.5	3.5	4.0	3.9
Net foreign assests of the banking sector (millions of U.S. dollars)	79.1	93.8	199.9	182.6	262.8
Foreign assets of the banking sector (millions of U.S. dollars)	114.0	155.9	262.2	234.6	309.6
Foreign liabilities of the banking sector (millions of U.S. dollars)	34.9	62.0	62.3	51.9	46.8
Gross official reserves (millions of U.S. dollars)	406.4	501.6	503.3	546.5	737.6
Gross official reserves (months of imports of goods and services)	4.5	5.6	4.5	4.6	6.1
Ratio of reserve money to reserves (percent)	9.4	10.5	13.1	15.8	13.2
Ratio of broad money to reserves (percent)	61.8	69.0	83.8	74.9	68.2
Total external debt [4]	73.0	58.1	46.9	45.5	43.1
Ratio of total external debt to exports of goods and services (percent)	157.0	132.3	98.5	92.2	82.5
Nominal exchange rate (maloti per U.S. dollar, period average)	8.6	6.6	5.6	6.3	7.0
REER depreciation (-) (end of period, CPI-based)	9.7	17.1	0.7	-0.1	-2.2
Memorandum items:					
GDP (millions of U.S. dollars)	838.4	1,184.0	1,513.7	1,433.2	1,451.9
Nominal exchange rate (maloti per U.S. dollar, end-of-period)	8.6	6.6	5.6	6.3	7.0

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

[1] National government debt.

[2] End of period.

[3] Backward-looking with actual CPI.

[4] Excludes private debt within the Common Monetary Area.

Table 6. Lesotho: Millennium Development Goals [1]

	1990	1994	1997	2000	2003	2005
Goal 1: Eradicate extreme poverty and hunger						
Income share held by lowest 20%	...	*3.0*	...	...	...	...
Malnutrition prevalence, weight for age (% of children under 5)	...	21.0	*16.0*	18.0	...	...
Poverty gap at $1 a day (PPP) (%)	...	*20.0*	...	...	...	...
Poverty headcount ratio at $1 a day (PPP) (% of population)	...	*43.0*	...	...	...	...
Prevalence of undernourishment (% of population)	...	...	14.0	...	12.0	*13.0*
Goal 2: Achieve universal primary education						
Literacy rate, youth total (% of people ages 15-24)	87.0	...	...	...	...	...
Persistence to grade 5, total (% of cohort)	...	...	...	67.0	63.0	*73.0*
Primary completion rate, total (% of relevant age group)	55.9	60.4	63.8	61.2	67.8	66.9
School enrollment, primary (% net)	...	...	...	82.0	87.0	87.0
Goal 3: Promote gender equality and empower women						
Proportion of seats held by women in national parliament (%)	...	...	5.0	4.0	12.0	11.7
Ratio of girls to boys in primary and secondary education (%)	...	...	...	105.8	103.8	102.8
Ratio of young literate females to males (% ages 15-24)	125.8	...	...	...	...	...
Goal 4: Reduce child mortality						
Immunization, measles (% of children ages 12-23 months)	80.0	82.0	80.0	74.0	85.0	85.0
Mortality rate, infant (per 1,000 live births)	81.0	...	...	86.0	...	102.0
Mortality rate, under-5 (per 1,000)	101.0	...	...	108.0	...	132.0
Goal 5: Improve maternal health						
Births attended by skilled health staff (% of total)	...	*49.6*	...	59.8	...	*55.4*
Maternal mortality ratio (modeled estimate, per 100,000 live births)	...	...	...	550.0	...	...
Goal 6: Combat HIV/AIDS, malaria, and other diseases						
Contraceptive prevalence (% of women ages 15-49)	...	...	...	30.0	...	...
Incidence of tuberculosis (per 100,000 people)	179.4	275.8	409.2	566.0	667.2	695.8
Prevalence of HIV, female (% ages 15-24)	...	...	...	...	...	14.0
Prevalence of HIV, total (% of population ages 15-49)	...	...	...	...	24.0	23.0
Tuberculosis cases detected under DOTS (%)	...	...	82.9	74.4	75.3	84.8
Goal 7: Ensure environmental sustainability						
Improved sanitation facilities (% of population with access)	37.0	...	...	...	...	*37.0*
Improved water source (% of population with access)	...	...	...	...	...	*79.0*
Nationally protected areas (% of total land area)	...	...	...	...	...	*0.2*
Goal 8: Develop a global partnership for development						
Aid per capita (current US$)	87.4	69.1	52.8	20.5	44.1	38.3
Fixed line and mobile phone subscribers (per 1,000 people)	7.8	9.4	13.8	24.5	75.9	163.3
Internet users (per 1,000 people)	0.0	...	0.1	2.2	16.7	*23.9*
Unemployment, youth female (% of female labor force ages 15-24)	...	...	58.5	...	...	...
Unemployment, youth male (% of male labor force ages 15-24)	...	...	37.9	...	...	...
Unemployment, youth total (% of total labor force ages 15-24)	...	...	47.4	...	...	...
Other						
Fertility rate, total (births per woman)	4.8	...	4.1	3.8	3.5	3.4
GNI per capita, Atlas method (current US$)	640.0	770.0	810.0	630.0	590.0	950.0
GNI, Atlas method (current US$) (billions)	1.0	1.3	1.4	1.1	1.1	1.7
Gross capital formation (% of GDP)	52.7	55.6	54.0	42.2	44.8	40.7
Life expectancy at birth, total (years)	57.4	...	48.2	41.2	*36.5*	35.2
Literacy rate, adult total (% of people ages 15 and above)	78.0	...	...	...	...	...
Population, total (millions)	1.6	1.7	1.7	1.8	1.8	1.8
Trade (% of GDP)	139.3	134.9	138.8	122.2	154.7	135.9

Source: World Development Indicators database, April 2006

[1] Figures in italics refer to periods other than those specified.

INTERNATIONAL MONETARY FUND

KINGDOM OF LESOTHO

Staff Report for the 2007 Article IV Consultation—Informational Annex

Prepared by the Staff Representatives for the
2007 Consultation with the Kingdom of Lesotho

Approved by Robert Sharer and Anthony Boote

October 30, 2007

- **Relations with the Fund.** Summarizes the 2006 Board discussion on Lesotho, describes financial and technical assistance by the IMF, and provides information on the exchange rate system. Lesotho's last Fund arrangement, a PRGF, expired in 2004.
- **Relations with the World Bank**. Describes the World Bank group's strategy and portfolio.
- **Statistical Issues.** Assesses the quality of statistical data. Economic data are adequate for surveillance purposes, though some deficiencies remain. Lesotho subscribes to the GDDS.

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I. LESOTHO: RELATIONS WITH THE FUND

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

II. **General Resources Account**:	SDR million	Percent Quota
Quota	34.90	100.0
Fund holdings of currency	31.32	89.73
Reserve position in Fund	3.62	10.37

III. **SDR Department**:	SDR million	Percent Allocation
Net cumulative allocation	3.74	100.0
Holdings	0.06	1.54

IV. **Outstanding Purchases and Loans**:	SDR million	Percent Quota
PRGF arrangements	22.40	64.18

V. **Financial Arrangements**:

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

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

	Forthcoming				
	2007	2008	2009	2010	2011
Principal		3.15	3.85	4.90	4.55
Charges/Interest	0.09	0.24	0.23	0.20	0.18
Total	0.09	3.39	4.08	5.10	4.73

VII. **Exchange Arrangement**:

Lesotho's currency, the loti (plural maloti), is pegged to the South African rand at par. The Central Bank of Lesotho (CBL) deals with commercial banks mainly in South African rand. As of August 6, 2007, the rand (maloti) rate per U.S. dollar was M 7.06.

VIII. **Article IV Consultation**:

The Executive Board concluded the last Article IV consultation on October 6, 2006 (EBM/06/85-1; 10/06/2006). Executive Directors commended the authorities for their continued efforts to maintain macroeconomic stability under difficult circumstances. They welcomed the continued improvement in the fiscal balance and the external current account position, as well as the prudent use of the SACU revenue windfall. Directors considered that finding the basis for consistent high growth over the medium term to help address poverty, achieve the Millennium Development Goals, and confront the high incidence of HIV/AIDS, will be the primary challenge for the authorities in the period ahead. Directors observed that the further loss of trade preferences and declining revenues from the South African Customs Union (SACU) were significant downside risks over the medium term. In that light, Directors considered that the key policy challenges were to implement structural reforms aimed at stimulating broad-based growth and to strengthen the medium term fiscal position.

IX. **Technical Assistance Missions**:

Monetary policy implementation	MAE	short-term	2001
Public accounts	FAD	short-term	2002
GDDS project for Anglophone Africa	STA	short-term	2002
Balance of payments	STA	short-term	2002
Safeguards assessment	FIN	short-term	2003
Monetary policy and AML/CFT	MFD	short-term	2003
Government finance statistics	STA	short-term	2003
National accounts	STA	short-term	2003
National accounts statistics	STA	short-term	2004
GDDS project for Anglophone Africa	STA	short-term	2004
Legislative drafting/FIU	LEG	Short-term	2005
Monetary operations / payments issues / banking supervision	MFD	short-term	2005
Government finance statistics /GDDS	STA	short-term	2005
Banking law	LEG	short-term	2005
National accounts statistics / GDDS	STA	short-term	2005
Monetary operations	MFD	short-term	2005
Payments issues	MFD	short-term	2005
Banking law	LEG	short-term	2005
BOP statistics / GDDS	STA	short-term	2005
GDDS consultation	STA	short-term	2005
Government Finance Statistics: GDDS Project for Anglophone African Countries	STA	short-term	2006
Payments System Reform	LEG	short-term	2006
Central Banking and Banking Law	LEG	short-term	2006
Bank Supervision/Monetary Operations/Payments & Settlements	MFD	short-term	2006
Legal drafting, AML/CFT, FIU, supervisory and institutional	LEG	short-term	2006
Regional workshop on the statistical treatment of SACU transfers	STA	short-term	2007
Monetary and Financial Statistics	STA	short-term	2007

Missions planned for 2007-2008

Non-bank supervision	MCM	short-term	2007
Bank supervision	MCM	short-term	2007
Monetary operations / Bank supervision	MCM	short-term	2007
Payments systems	MCM	short-term	2007
Government Finance Statistics: GDDS Project for Anglophone African Countries	STA	short-term	2008
Monetary operations	MCM	short-term	2008

XI. **Resident Representatives**:

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

II. Lesotho: Relations with the World Bank

A. Partnership in Lesotho's Development Strategy

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

2. Several limitations and risks in the implementation of the PRS related to its translation into actual work plans, possible further shocks to the economy, weak governance, and a lack of political will were identified during the preparation of the Joint Staff Assessment Note. It was suggested that the development of a comprehensive medium-term macroeconomic framework, taking into account Lesotho's external vulnerability and competitiveness, and improving the monitoring and evaluation framework would facilitate PRS implementation. The Government is currently reviewing progress made in the implementation of the PRS, and plans to update the PRS based on further analysis from newly available poverty and census data, in consultations with key stakeholders.

3. Lesotho's key Development Partners are working together to develop a common framework of support around the PRS. They are currently engaged with the Government in strengthening national systems and improving public sector institutions to pave the way for providing joint budget support.

B. Bank-Fund Collaboration in Specific Areas

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

The Bank Group's Country Assistance Strategy

5. The Bank Group's assistance strategy (CAS) for Lesotho for FY 06-09 was approved in April 2006 and is guided by the government's PRS and the MDGs. The CAS proposes

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

Poverty Assessment, Monitoring and Evaluation

6. A Poverty, Gender and Social Assessment has being initiated with the objective of providing an analysis of the key opportunities, constraints, and risks to sustainable poverty reduction from the perspective of households, communities, the government and institutions by analyzing the past and present and drawing lessons for the future. The assessment will provide policy and program recommendations on how to achieve more inclusive and accountable institutions and sustainable poverty reduction. A review of the Concept Note has been undertaken and the draft shared with the Government and other Development Partners. The assessment will draw on the data recently released on the Household Income and Expenditure Survey and the preliminary Census data among other sources. The Report is welcomed by all parties as current poverty analytics are weak and outdated. The findings from the report will feed into the annual PRS progress report and the proposed Poverty Reduction Support Credit.

7. The Bank is also supporting government efforts at establishing a National Monitoring and Evaluation system.

Public Sector Reform and Public Expenditure Management

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

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

Decentralization and Empowerment of Local Communities

10. The Bank has finalized a report entitled, Decentralization and Demand Driven Service Delivery in support of the ongoing decentralization process in Lesotho. It supports Lesotho's PRS and CAS Strategic Objective of "improving governance through decentralization and empowerment of local communities." The report has been prepared jointly with the GOL and GTZ. The objectives were (1) to strengthen local governance and the ability of communities and individuals to access services and hold service providers accountable; (2) to strengthen the ability of service providers to effectively respond to the demand and scale up their service and infrastructure provision; and (3) to assist the local governments and other local actors to strengthen the management of natural resources and improve agricultural and livestock productivity. Five components of the sector work were identified: (i) Review the Status of Decentralization; (ii) Service Delivery, Community Empowerment, and the Dynamics of Local Institutions through a Community Profiling Study; (iii) Legal Harmonization; (iv) Fiscal decentralization, including a specific study on Fiscal Grants and Revenue Raising Capacity of Local Governments; and (v) The identification of promising agriculture and natural resource management practices. The report briefly reviews the changing international context for local governance. It then describes the Lesotho Local Government system. Each of the five components is the subject of an individual chapter. A concluding chapter includes a policy matrix bringing the recommendations of the report together.

Private Sector Development (PSD)

11. To support the government's efforts on the PSD front, the World Bank has prepared a Private Sector Competitiveness project. The key objective of the project is to increase private sector participation in the economy by increasing its productivity and competitiveness. The project consists of three components aimed at: (i) improving the business environment through reducing cost of doing business and strengthening legal framework; (ii) supporting economic diversification through development of skills, institutions and market linkages; and (iii) improving MSMEs' access to finance. The Project was presented to the Bank's Board in March 2007.

Infrastructure

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

subsectors with a view towards more integrated and coordinated transport sector management.

13. The World Bank has been providing support to the GoL in defining the context for long-term support to the water sector by supporting essential institutional reforms and immediate infrastructure investments under Phase 1 of the Water Sector Improvement Project (WSIP) APL. The APL includes provision for supporting the GoL in developing the identified long-term solution for bulk water supply, indicating the availability of US$25 million under Phase 2 of the WSIP APL. A regional water supply master plan study of the Lowlands and a full feasibility study have identified the next least-cost, long-term solution for bulk supply to Maseru to be the Metolong Dam on the South Phuthiatsana River some 35 kms from Maseru. A detailed Environmental and Social Impact Assessment has shown no unmanageable impacts. Once constructed, the Metolong Dam, along with the associated treatment plant and infrastructure, will increase the water supply capacity of Maseru and surrounding towns by 80ML/day. This will ensure a secure supply of 125 ML/day that will enable Maseru to meet domestic and industrial requirements up to the year 2020 or beyond through conjunctive use.

14. The Government has approached the Bank to cover an estimated financing gap of US$25.2 million for the construction of the Metolong Dam (total cost US$190 million) to provide water for both domestic and industrial purposes. The Government has secured US$83 million from the MCC, US$39 million from the Arab Fund and US$32.8 million from own sources. In response to the Government's request, the Bank is preparing an IDA project for $5-10 million. The Bank is looking at other possible ways to fill the remaining financing gap, including the Africa Catalytic Growth Fund and the possibility of lending on IBRD terms for this particular project only (while Lesotho will remain an IDA country). Apart from the World Bank, the Government is looking for other sources to fund the gap.

HIV/AIDS

15. In response to the high adult HIV prevalence rate in Lesotho (approx 24%), the Government adopted the multi-sectoral National HIV/AIDS Strategic Plan and the National AIDS Policy Framework in 2000. Political commitment in the fight against HIV/AIDS has increased and legislation to create a National AIDS Commission has been enacted. Several other development partners and agencies are active in supporting the HIV/AIDS program, including Development Corporation Ireland, the Clinton Foundation, and Bristol Myers Squibb.

16. To support the Government's efforts in fighting HIV/AIDS and in effectively using the resources made available by other donors, including the Global Fund, the Bank has been providing a technical assistance grant to increase the capacity of government and nongovernmental institutions responsible for the national response to HIV/AIDS. However, while the Government has made some progress and Church leaders have committed to support the program, the National Aids Commission (NAC) is not empowered enough to coordinate the fight against the pandemic leading to a fragmented effort. The "Know your Status" campaign appears not to be delivering the expected results, and HIV prevention and

impact mitigation seem to be greatly underfunded. The Government relies on nearly 90% of donor funding in its HIV response, but only half of those allocations are in fact spent. Although the Government has declared HIV as a national emergency, the commitment, leadership and oversight responsibility for monitoring is weak. The World Bank will start preparing a new HIV/AIDS project this year for FY09 delivery (US$10.0 million).

Human Development

Health

17. The Bank is supporting a Health Sector Reform Program with the objective of achieving a sustainable increase in access to quality preventive, curative and rehabilitative health care services. The Bank's support to the health sector is structured in three Phases of an Adaptable Program Loan (APL). Currently in Phase II, the focus is on improving access to quality health services through strengthening decentralized service delivery and improving human resources management in the sector.

18. Replacing the obsolete and collapsing Queen Elizabeth II national referral hospital is one of the major activities under the country's health sector reform. As the country also faces primary and secondary health care challenges at lower levels and to ensure a wise and effective use of the limited health resources, the Government decided to build and manage a new national referral hospital using a PPP arrangement in order to take advantage of resources and skills from the private sector. With the facilitation of the IDA health task team, IFC was engaged by the Government to provide technical and advisory services on the PPP over the past 18 months.

19. Using a PPP arrangement to replace the obsolete and collapsing national referral hospital is a major undertaking in the health sector. The Government has requested that IDA fund a Partial Risk Guarantee that would support a planned PPP for a new national referral hospital in Maseru. This would be the first PPP in Lesotho. IDA and IFC are working closely on this PPP and feel that it constitutes a vital input into improving health care in Lesotho. The Guarantee will amount to approximately US$10 million of which only 25% would need to be underwritten, meaning that Lesotho would need to borrow only US$2.5 million.

Education

20. The education sector is supported through an APL which began in 1999 and extends to 2011. Its broad objective is to assist the Government of Lesotho in its efforts to increase access to quality education and the efficiency of the education system. In that context, it aims to: (a) increase enrollment in and completion of primary education; (b) improve learning achievement in primary education; (c) increase enrollment in secondary education; (d) build capacity in the education sector, including for early childhood care and development, technical and vocational education and training, higher education, Non-Formal Education, and Ministry of Education and Training core functions. The second phase is expected to close in December 2007.

21. In conjunction with the development partners, the MoET is planning a series of analytic studies which will provide the underpinnings for the development of a sector program in the education sector. This process has been assisted by 2 joint review meetings (held in March and November 2006) and a National Dialogue on education (November 2006). These studies will include an overall sector analysis, a study of monitoring and evaluation systems in the MoET, a study of the management structures within the MoET, and a study of the cost and financing of the education sector. The development of the sector program is intended to improve efficiency of external support and to assist in attracting further funds.

C. Bank Group Assistance Summary

22. The World Bank's first operation in Lesotho was approved in February, 1966. As of July 31, 2007, the Bank Group has disbursed US$396.3 million. IDA has approved 35 credits amounting to US$ 389.3 million, of which US$ 301.2 was disbursed; US$ 60.6 million was canceled; and US$ 38.6 million remains undisbursed. To date, the World Bank has financed six projects in education; five in roads and road rehabilitation and maintenance; four in agriculture; three in industry; three in water supply (including support to the Lesotho Highlands Water Project); three in urban development; five in health, two in privatization; and one in community development.

23. The World Bank has seven ongoing IDA projects, as well as a Global Environment Facility (GEF) project. Active projects include the Health Sector Reform Project, the HIV/AIDS Capacity Building and Technical Assistance Project; Phase 2 of the Education Sector Development Project, Utilities Reform Project, Water Sector Improvement Project, Integrated Transport Project and Private Sector Competitiveness and Economic Diversification Project.. In addition, the World Bank will be working with other donors over the next several years to assess the possibility of and to prepare Government systems for budget support for Lesotho's Poverty Reduction Strategy.

24. Currently, the IFC has no outstanding investments in Lesotho. However, IFC is advising the Government of Lesotho on the structure and implementation of a public-private partnership for the replacement of the Queen Elizabeth II hospital. The project has been undertaken in cooperation with the World Bank's ongoing health sector reform project. This is a pioneering joint initiative by IDA and IFC in Sub-Saharan Africa.

Contact Persons

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III. LESOTHO: STATISTICAL ISSUES

The statistical database is adequate for surveillance, although there are some deficiencies in core surveillance data.

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

National accounts

GDP data may need to be revised on account of gaps in source data on manufacturing activity and the accounting of the transfers received under the SACU agreement. First, there are concerns that data on manufacturing activity from the Bureau of Statistics of Lesotho (BSL) are underestimated, when compared to customs data on manufactured exports. Second, staff's understanding is that taxes on products included in the calculation of GDP on the production side include the "duty element" (lagged by two years) of the transfer received by Lesotho under the Common Revenue Pool transfer formula underpinning the SACU agreement. Further analysis is needed to assess the methodology employed for calculating this duty element.

BSL is responsible for the national accounts and compiles annual current price estimates of GDP, expenditure, and income. Annual estimates of GDP at constant (1995) prices are compiled by economic activity and expenditure; a rebasing of national income at constant prices (2004) is expected to be finalized by end-2007. Annual estimates are published on their web site for 1993 to 2005. Other macroeconomic indicators, such as industrial production indices, are used to monitor developments during the year.

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

Prices

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

Government finance statistics

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

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

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

Annual cash data for fiscal year 2005/06 have been submitted for publication in the *Government Finance Statistics Yearbook 2007.* Some recommendations for improving the coverage and classification of revenue and expenses were implemented. Follow up technical assistance in 2007 will work towards further improvements in both the annual and high frequency data. Currently, no high frequency data are reported for publication in the *International Finance Statistics.*

Monetary statistics

Most TA recommendations have been adopted. Monthly reporting of data for *IFS* publication is timely and has improved in terms of classification of instruments, sectorization of the domestic economy, and compilation of the monetary aggregates. Lesotho started compiling monetary statistics based on the Standardized Report Forms (SRFs), which provide improved classification and sectorization of the accounts, and reported these data to STA beginning in December 2004. Monthly data following this new presentation are disseminated in the *International Finance Statistics* Supplement .

Despite the progress achieved, the missions' recommendations to expand the institutional coverage of the other depository corporations sector and to value all financial instruments at market value are yet to be implemented. The monetary and financial statistics mission that visited Maseru in September 2007 found out that work had started on the inventory of all financial corporations (deposit-taking and others), and that it was expected that credit cooperatives would be fully covered in the other depository corporations survey by October 2008. The compilation of the other financial corporations survey is targeted for February 2009.

Balance of payments and external debt

The Central Bank of Lesotho (CBL) compiles quarterly balance of payments statistics, usually with a lag of three months. However, some timeliness issues remain in forwarding these data to the Fund.

A STA mission in July-August 2002 found that the methodology underlying the compilation of the balance of payments data suffers from the use of outdated benchmark surveys and deterioration in the coverage and timeliness of some of data sources. The main recommendations of the mission were as follows:

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

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

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

Under the GDDS project for Anglophone Africa, Lesotho has participated in a series of regional workshops to plan and implement surveys for the recording of private capital flows and stocks. An exploratory balance of payments survey was conducted by the CBL in 2006.

Lesotho: Table of Common Indicators Required for Surveillance

(As of October 15, 2007)

	Date of latest observation	Date received	Frequency of Data[6]	Frequency of Reporting[6]	Frequency of Publication[6]
Exchange Rates	Sep. 2007	Oct. 2007	D	M	D
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	May 2007	July 2007	M	Q	Q
Reserve/Base Money	July 2007	Sep. 10, 2007	M	Q	Q
Broad Money	July 2007	Sep. 10, 2007	M	Q	Q
Central Bank Balance Sheet	July 2007	Sep. 10, 2007	M	Q	Q
Consolidated Balance Sheet of the Banking System	July 2007	Sep. 10, 2007	M	Q	Q
Interest Rates[2]	July 2007	Sep. 10, 2007	M	M	M
Consumer Price Index	July 2007	Sep. 2007	M	M	M
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	N/A	N/A	N/A	N/A	N/A
Revenue, Expenditure, Balance and Composition of Financing[3]– Central Government	Mar 2007	June 2007	M	I	Q
Stocks of Central Government and Central Government-Guaranteed Debt[5]	Dec 2006	June 2007	M	I	Q
External Current Account Balance	Q1 2007	Oct 2007	Q	Q	Q
Exports and Imports of Goods and Services	Q2 2006	June 2006	Q	Q	Q
GDP/GNP	2006	June 2007	A	A	A
Gross External Debt	Dec 2006	June 2007	M	Q	Q

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

INTERNATIONAL MONETARY FUND AND
INTERNATIONAL DEVELOPMENT ASSOCIATION

KINGDOM OF LESOTHO

Joint World Bank/IMF Debt Sustainability Analysis

Prepared by the staffs of the International Monetary Fund and
the International Development Association

Approved by Robert Sharer and Anthony Boote (IMF)
and Brian Pinto and Sudhir Shetty (IDA)

October 30, 2007

This debt sustainability analysis is based on end-2006 data for external and domestic debt provided by the Lesotho authorities, and World Bank and IMF staff estimates for debt outstanding to multilateral creditors. The overall staff assessment is that Lesotho is at a moderate risk of debt distress and remains vulnerable to exchange rate changes and other shocks, although debt appears sustainable in a baseline scenario.

Introduction

This debt sustainability analysis has been prepared jointly by IMF and World Bank staff. It comprises external and domestic debt, and is based on the framework for low-income countries approved by the respective Executive Boards.[1] The framework takes into account indicative thresholds for debt burden indicators determined by the quality of the country's policies and institutions,[2] and comprises baseline and alternative scenarios.

Lesotho's nominal public and publicly guaranteed (PPG) debt declined from 89.1 percent of GDP in 2002 to 51.4 percent of GDP (US $746.0 million) at the end of 2006, reflecting in part, the early repayment of non concessional loans, limited new

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[1] See "Staff Guidance Note on the Application of the Joint Fund-Bank Debt Sustainability Framework for Low-Income Countries," http://www.imf.org/external/np/pp/2007/eng/041607.pdf

[2] The World Bank Country Policy and Institutional Assessment (CPIA) has ranked Lesotho for the last three years as a "medium performer" in terms of policy and institutions with a rating of 3.5. The applicable indicative thresholds for debt sustainability, proposed under the framework for low-income countries are: (i) 40 percent for the NPV of debt-to-GDP ratio, (ii) 150 percent for NPV of debt-to-exports ratio; (iii) 250 percent for the NPV of debt-to-fiscal revenues ratio; (iv) 20 percent for the debt service to exports ratio; and (v) 30 percent for the debt service to revenue ratio.

borrowing, and an exchange rate appreciation between 2003 and 2006. Of the total public sector debt, US $626.3 million was externally owed, with about 89 percent of the total (US $560.0 million) owed to multilateral creditors, mainly IDA and the African Development Fund.[3] Government also has domestic debt held by residents in the amount of US $119.4 million. For private sector debt, only obligations toward countries outside the Common Monetary Area are recorded. At end 2006, these obligations were estimated at US $2.3 million.

Lesotho: External and Domestic Nominal Debt Outstanding at end-2006

	In millions of U.S. dollars	In percent of GDP
Total Domestic and External PPG Debt	745.7	51.4
Total Domestic Debt	119.4	8.3
Total External Public PPG Debt	626.3	43.0
Multilateral sources	560.0	38.6
World Bank Group	268.4	18.5
African Development Fund	184.8	12.7
EU	34.3	2.4
IMF	35.2	2.4
Others	37.3	2.6
Bilateral sources	43.1	3.0
Commercial sources	23.2	1.6
Total Private External Debt	2.3	0.1
Memo Item		
NPV of Total External Debt	459.7	31.8

The baseline, medium-, and long-term scenario

The baseline scenario is based on a number of macroeconomic projections and financing terms, which are summarized below in Box 1. Compared to the DSA from previous years, the 2007 DSA assumes a higher level of real GDP growth and current

[3] The nominal public debt data does not include debt issued by the Lesotho Highlands Development Authority (LHDA). The liabilities of the LDHA are equal to about 10 percent of GDP and are not included since LHDA gets financing from South Africa to cover debt service.

account surpluses from 2007 to 2011 (Text Table). Real GDP growth is now forecast to average 5.2 percent up to 2012 with long-term growth remaining at 4.5 percent, compared to

Comparison of Key Variables in Debt Sustainability Analysis 2005 -07

	Non-interest Current Account (% of GDP)				Real GDP growth			
	2005 DSA	2006 DSA	2007 DSA	Actual	2005 DSA	2006 DSA	2007 DSA	Actual
2005	-7.2	-1.0	...	**-5.2**	-0.7	1.3	...	**2.9**
2006	-10.1	-3.2	...	**5.4**	2.2	2.5	...	**7.2**
2007	-10.3	1.8	2.1	...	1.7	1.4	4.9	...
2008	-11.5	-1.4	1.2	...	2.1	1.4	5.2	...
2009	-10.6	-4.7	2.0	...	2.5	2.6	5.4	...
2010	-10.7	-6.0	1.1	...	2.6	2.7	5.5	...

average growth rates of 2.1 in the medium-term projected in the last DSA. The last two DSAs assumed growth and current account balances somewhat under the historical average in view of the end of the MFA and the expectation of the expiration of trade preferences under AGOA in 2007.

However, major favorable developments have taken place since then. The positive growth performance, especially strong in 2006 (7.2 percent), was driven by booming diamond production (not fully anticipated in the previous DSAs), a recovery of the garment industry helped in part by the extension of AGOA trade preferences through 2012, and good performance in the agriculture and services sectors. In addition, the Millennium Challenge Corporation (MCC) compact was signed in 2007. The government is expected to receive large grants during the next five years, allowing it to undertake significant capital investment in the development of the country's health infrastructure and water supply, and is actively promoting private sector development. In particular, the construction of Metolong dam with support of MCC and other donors is expected to increase the potential for the location of "wet industries" such as fabric production, which would allow Lesotho to take fuller advantage of AGOA beyond 2012. These recent developments, which were not previously considered, largely account for the change in growth projections for this year's DSA.

The current account balance after recording a surplus of 5.4 percent of GDP in 2006 is forecast to remain strong due to high diamond and garment exports, and continued large South Africa Customs Union (SACU) revenues to 2010. Then it is projected to deteriorate somewhat as SACU revenues revert back to more normal levels. In the baseline scenario, Lesotho starts facing "IDA-hardened" terms in 2010 as a result of the growth in its GNI per capita. Under the Atlas method, Lesotho's GNI per capita stood at US $1,070 in 2006.

Taking into account the lags included in this methodology and the assumptions about growth, Lesotho would no longer be able to borrow at standard IDA terms after 2010.[4]

Box 1. Main Assumptions Under the Baseline Scenario

- Real GDP growth is assumed to increase from 2.8 percent over the last ten years to about 5.2 percent in 2007–12 and then from 2013 to stabilize at 4.5 percent.

- Inflation (as measured by the implicit GDP deflator) is assumed to move from an average of 4.4 over the last ten years, and then to stabilize slightly above 4 percent as prices converge to that of South Africa's.

- Fiscal surpluses are projected to remain strong up to 2012 reflecting large SACU revenues, and are assumed to weaken somewhat in subsequent years when SACU revenues are assumed to decline.

- Imports and exports of goods and services and transfers are assumed to grow in line with GDP (in US dollar terms). FDI is assumed to grow slightly more rapidly, taking into account the reduction of the corporate income tax rate in 2006 to attract foreign investment.

- The current account balance (including official transfers) is determined by the above trends, declining gradually from a 4.4 percent of GDP surplus in 2006 to smaller surpluses over the medium term and eventually reaching a deficit as SACU transfers and diamond exports decline. Net income is also assumed to decrease gradually over the long term as remittances from South Africa continue to grow less important over time.

- Net external public sector financing is assumed to rise to about 2.8 percent of GDP by the end of the current decade and then to stabilize at this level. Foreign grants are assumed to increase to about 4.6 percent of GDP in the medium term, reflecting the MCC compact, and thereafter to decline. After 2010, it is assumed that borrowing from IDA would be at hardened terms. The DSA assumes that new borrowing would be contracted on highly concessional terms during the projection period.

- Domestic debt is projected to fall in nominal terms gradually over time. Private sector debt is projected to increase only marginally in terms of GDP, to 0.5 percent by 2027.

[4] In the DSA, IDA-hardened terms are incorporated and substituted for standard IDA terms after 2010, and implies a charge of 0.75 percent, grace period of 10 years and a maturity period of 20 years (including the grace period), compared to the 40-year maturity of standard IDA terms.

At end-2006, the NPV of external debt stood at 31.7 percent of GDP (Table 1). Under the baseline scenarios, Lesotho's external debt indicators remain well below the thresholds throughout the projection period. The NPV of debt-to-GDP ratio, which was fractionally above the threshold in 2006, is expected to gradually decrease to 21 percent in 2017, below the policy-based indicative threshold (40 percent); and the NPV of debt-to-export ratio would also fall gradually to 41 percent by 2017, significantly below the 150 percent threshold. Both ratios will however increase marginally in the later years of the projection period reflecting harder financing terms as Lesotho would no longer have access to borrowing from IDA at standard terms. Borrowing, however, is expected to still be on broadly concessional terms. The highly concessional nature of the existing debt and new borrowing contributes to debt service ratios below the indicative threshold throughout the projection period. The Government undertook to repay early a significant amount of non concessional debt resulting in lower scheduled interest payments and hence a declining effective interest on debt.

At end-2006 domestic debt contributed only marginally to the baseline scenarios for Lesotho's public debt ratios (Table 3). Lesotho has a low level of domestic debt, and so public debt indicators are very closely aligned to those of public external debt. Domestic debt, which was at 7.5 percent of GDP at the end of 2006, is expected to be gradually reduced to about 3 percent of GDP by 2017. Domestic debt has been issued by government mostly to provide an impetus to the formation of a money market. The proceeds from the sale of T-bills are held in deposits at the Central Bank of Lesotho; therefore these bills have not represented additions to net debt. The fiscal deficit is projected to remain largely externally financed on concessional terms, and expenditure levels are assumed to be financed from grants and tax revenue.

Sensitivity Analysis

External Public debt indicators

Sensitivity tests show that while Lesotho's debt burden would worsen in the event of an adverse macroeconomic shock or weaker economic performance, it would remain below the indicative thresholds in most cases (Table 2 and Figure 1). In the event of key macroeconomic variables reverting to their pre-2007 levels throughout the projection period, the evolution of debt would be significantly affected. With output and export growth at their historical averages, public debt ratios would fail to improve. The more stringent test of current account balances at historical averages would cause external debt to breach the indicative thresholds.

The debt indicators in the historical scenario (scenario A1) are more elevated than under the baseline scenario, and the threshold of the NPV of debt-to-GDP is breached. The real GDP growth in the ten-year period up to 2006 averaged 2.8 percent, about half that assumed in the projection period. The noninterest current account was also significantly weaker than that projected under the baseline scenario due to the lower level of earlier SACU transfers. These combined effects projected through 2027 would yield significantly worse debt indicators, compared to the baseline scenario.

Borrowing on less favorable terms (scenario A2) would lead to some deterioration of the external debt indicators. The impact however would not be as severe as that under the A1 scenario. Under this scenario, the NPV of debt-to-GDP ratio would reach 25 percent in 2017, still well below the indicative thresholds. Similarly, the NPV of debt-to-exports ratio while higher than under the baseline scenario remains below the indicative threshold.

The bound tests reveal that Lesotho would face the most distress if there were to be a much lower rate of growth and a much lower level of nondebt creating inflows such as FDI in 2007-2008 (scenario B5). Under this scenario, the NPV of debt-to-GDP ratio first increases to 71 percent of GDP in 2009 before falling to 49 percent of GDP in 2017. There are also underlying vulnerabilities with respect to export growth. A shock to exports would lead to higher NPV of debt-to-GDP and NPV of debt-to- exports ratios.

Total Public Debt Indicators

Public debt appears robust in the standard sensitivity tests (Table 4 and Figure 2). The indicators are most sensitive to deviations from the baseline growth path. In the scenario with variables at historical averages ratios initially rise but eventually declines. A similar pattern is observed with more extreme shocks of shorter duration. Although significant pressures would be exerted on total public debt for a number of years, the indicators would remain on trajectories that eventually decline later in the projection period. It should be noted that in the analysis the public debt alternative scenarios are not defined the same way for those of the external debt and are therefore not directly comparable.

The trajectory of gross debt understates somewhat the decline in Lesotho's net indebtedness especially in the next few years. This trajectory takes into account the disbursement of loans in the pipeline even in periods when fiscal surpluses would permit a net reduction of debt. It is also assumed that the authorities will stick to the original schedule for the repayment of the highly concessional debt. This implies that the public sector will accumulate some assets over the medium term. Alternatively, the analysis could be said to show that somewhat lower primary surpluses would also be consistent with the reduction in gross debt shown in Figure 2. However, because of limited implementation capacity, the authorities are not expected to significantly increase their level of capital investment making it more likely that they will accumulate assets rather than significantly increase their investment levels.

Conclusion

Lesotho faces a moderate risk of debt distress although in the baseline scenario key debt ratios are below the indicative thresholds for a country with Lesotho's performance rating. The risk would materialize if variables such as economic growth and the current account deficit were to revert to their historical levels. The results therefore underscore the need for the authorities to continue to pursue prudent debt policies combined with sound macroeconomic policies and structural reforms. Policies should focus on growth enhancing measures and investments, while continuing to seek grants and highly concessional loans in order to mitigate the likelihood of debt distress.

Table 1. Lesotho: External Debt Sustainability Framework, Baseline Scenario, 2005-2027 [1]
(Percent of GDP, unless otherwise indicated)

	Actual		Historical Average [6]	Standard Deviation [6]	Projections									
	2005	2006			2007	2008	2009	2010	2011	2012	2007-12 Average	2017	2027	2013-27 Average
External debt (nominal) [1]	**45.5**	**43.1**			**42.4**	**39.7**	**38.0**	**37.4**	**37.1**	**36.5**		**33.2**	**29.4**	
o/w public and publicly guaranteed (PPG)	45.4	43.0			42.2	39.5	37.8	37.3	36.9	36.3		33.1	29.4	
Change in external debt	-1.4	-2.4			-0.8	-2.7	-1.7	-0.5	-0.4	-0.6		-0.3	-1.5	
Identified net debt-creating flows	5.6	-9.1			-7.3	-6.2	-6.7	-5.6	-3.7	-2.4		-2.1	-2.3	
Non-interest current account deficit	**5.2**	**-5.4**	**12.4**	**10.6**	**-2.1**	**-1.2**	**-2.0**	**-1.1**	**0.8**	**1.7**		**1.7**	**1.6**	1.6
Deficit in balance of goods and services	49.1	48.4			50.5	47.5	43.4	41.3	38.5	29.0		29.0	29.0	
Exports	49.4	52.3			52.1	52.2	51.4	51.8	52.1	50.9		50.9	50.9	
Imports	98.4	100.7			102.6	99.7	94.8	93.1	90.6	79.9		79.9	79.9	
Net current transfers (negative = inflow)	-21.0	-26.8	-19.1	4.3	-29.2	-28.4	-26.3	-25.4	-23.0	-20.0		-13.9	-6.5	-11.6
o/w official	-20.2	-25.6			-28.0	-27.3	-25.2	-24.5	-22.1	-19.2		-13.3	-6.2	
Other current account flows (negative = net inflow)	-22.9	-27.0			-23.5	-20.3	-19.2	-17.0	-14.8	-7.3		-13.5	-21.0	
Net FDI (negative = inflow)	**-4.0**	**-3.9**	**-3.8**	**0.6**	**-3.7**	**-3.4**	**-3.2**	**-3.0**	**-2.8**	**-2.6**		**-2.8**	**-3.0**	-2.8
Endogenous debt dynamics [2]	**4.4**	**0.3**			**-1.5**	**-1.6**	**-1.6**	**-1.6**	**-1.6**	**-1.5**		**-1.1**	**-0.8**	
Contribution from nominal interest rate	1.7	0.9			0.5	0.4	0.4	0.3	0.3	0.3		0.3	0.4	
Contribution from real GDP growth	-1.4	-3.2			-2.0	-2.0	-2.0	-2.0	-1.9	-1.8		-1.4	-1.3	
Contribution from price and exchange rate changes	4.1	2.6			…	…	…	…	…	…		…	…	
Residual [3]	**-7.0**	**6.7**			**6.5**	**3.6**	**5.0**	**5.1**	**3.3**	**1.8**		**1.9**	**0.9**	
NPV of external debt [4]	...	31.8			30.1	27.5	25.5	24.4	23.5	22.6		20.9	21.5	
In percent of exports	...	60.8			57.8	52.8	49.6	47.1	45.1	44.4		41.0	42.3	
NPV of PPG external debt	**...**	**31.7**			**29.9**	**27.4**	**25.3**	**24.2**	**23.3**	**22.4**		**20.8**	**21.5**	
Percent of exports	**...**	**60.5**			**57.5**	**52.5**	**49.3**	**46.7**	**44.8**	**44.0**		**40.8**	**42.2**	
Percent of government revenues	**...**	**54.2**			**52.9**	**50.7**	**48.7**	**48.1**	**49.0**	**49.7**		**44.8**	**46.3**	
Debt service-to-exports ratio (percent)	**11.4**	**6.5**			**5.3**	**3.9**	**3.4**	**3.1**	**2.9**	**2.8**		**1.7**	**1.3**	
PPG debt service-to-exports ratio (percent)	**11.3**	**6.4**			**5.2**	**3.7**	**3.2**	**3.0**	**2.8**	**2.7**		**1.7**	**1.3**	
PPG debt service-to-revenue ratio (percent)	**11.4**	**5.7**			**4.8**	**3.6**	**3.2**	**3.1**	**3.1**	**3.0**		**1.8**	**1.4**	
Total gross financing need (billions of U.S. dollars)	0.1	-0.1			0.0	0.0	-0.1	0.0	0.0	0.0		0.0	-0.1	
Non-interest current account deficit that stabilizes debt ratio	6.6	-3.0			-1.3	1.4	-0.2	-0.5	1.1	2.3		1.9	3.0	
Key macroeconomic assumptions														
Real GDP growth (percent)	2.9	7.2	2.8	3.5	4.9	5.2	5.4	5.5	5.6	5.1	5.3	4.5	4.5	4.5
GDP deflator in US dollar terms (change in percent)	-8.0	-5.5	4.4	26.0	1.3	5.5	3.6	1.8	1.6	1.6	2.6	4.3	4.3	4.2
Effective interest rate (percent) [5]	3.5	1.9	2.4	0.5	1.2	1.1	1.0	1.0	0.9	0.8	1.0	1.1	1.5	1.3
Growth of exports of G&S (US dollar terms, percent)	-1.9	7.4	14.2	17.7	5.8	11.2	7.6	8.3	7.9	4.3	7.5	9.0	9.0	8.9
Growth of imports of G&S (US dollar terms, percent)	4.5	3.6	4.3	15.6	8.2	7.8	3.9	5.5	4.4	-5.8	4.0	9.0	9.0	8.9
Grant element of new public sector borrowing (percent)	...	...	...	...	47.4	48.9	48.7	48.5	48.5	49.3	48.6	42.5	41.6	39.1
Aid flows (in billions of US dollars) [7]	0.2	0.1			0.2	0.6	0.8	0.8	0.8	0.7		0.9	1.5	
o/w Grants	0.0	0.0			0.0	0.1	0.1	0.1	0.1	0.1		0.1	0.3	
Grant-equivalent financing (in percent of GDP) [8]	...	...			2.9	6.1	6.8	6.5	5.8	5.1		4.9	4.4	4.9
Grant-equivalent financing (in percent of external financing) [8]	...	...			63.8	79.4	81.0	79.8	77.9	79.7		76.9	74.1	74.0
Memorandum items:														
Nominal GDP (billions of US dollars)	1.4	1.5			1.5	1.7	1.9	2.0	2.2	2.3		3.5	8.3	
(NPVt-NPVt-1)/GDPt-1 (percent)					0.2	0.5	0.3	0.6	0.6	0.4	0.4	1.5	1.3	1.7

Source: Staff simulations.

[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 NPV 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 NPV of new debt).

Table 2. Lesotho: Sensitivity Analyses for Key Indicators of Public and Publicly Guaranteed External Debt, 2006-27
(Percent)

		Projections							
	2006 Est.	2007	2008	2009	2010	2011	2012	**2017**	2027
NPV of debt-to-GDP ratio									
Baseline	32	30	27	25	24	23	22	**21**	21
A. Alternative Scenarios									
A1. Key variables at their historical averages in 2007-27 [1]	32	35	38	41	43	44	44	**49**	53
A2. New public sector loans on less favorable terms in 2007-27 [2]	32	30	28	27	26	26	25	**25**	29
B. Bound Tests									
B1. Real GDP growth at historical average minus one standard deviation in 2007-08	32	30	28	27	26	25	24	**21**	22
B2. Export value growth at historical average minus one standard deviation in 2007-08 [3]	32	33	38	43	41	39	38	**30**	23
B3. US dollar GDP deflator at historical average minus one standard deviation in 2007-08	32	39	50	46	44	42	40	**35**	37
B4. Net non-debt creating flows at historical average minus one standard deviation in 2007-08 [4]	32	39	45	42	40	39	37	**29**	23
B5. Combination of B1-B4 using one-half standard deviation shocks	**32**	**34**	**56**	**71**	**68**	**66**	**63**	**50**	**34**
B6. One-time 30 percent nominal depreciation relative to the baseline in 2007 [5]	32	42	39	36	34	33	31	**27**	29
NPV of debt-to-exports ratio									
Baseline	61	58	52	49	47	45	44	**41**	42
A. Alternative Scenarios									
A1. Key variables at their historical averages in 2007-27 [1]	61	67	73	80	84	85	87	**96**	105
A2. New public sector loans on less favorable terms in 2007-27 [2]	61	58	54	52	51	50	50	**49**	57
B. Bound Tests									
B1. Real GDP growth at historical average minus one standard deviation in 2007-08	61	58	53	49	47	44	43	**38**	40
B2. Export value growth at historical average minus one standard deviation in 2007-08 [3]	61	71	95	109	103	99	97	**78**	60
B3. US dollar GDP deflator at historical average minus one standard deviation in 2007-08	61	76	52	49	46	44	43	**38**	40
B4. Net non-debt creating flows at historical average minus one standard deviation in 2007-08 [4]	61	75	86	82	78	74	73	**58**	45
B5. Combination of B1-B4 using one-half standard deviation shocks	**61**	**65**	**98**	**125**	**119**	**114**	**113**	**88**	**60**
B6. One-time 30 percent nominal depreciation relative to the baseline in 2007 [5]	61	81	52	49	46	44	43	**38**	40
NPV of debt-to-revenue ratio									
Baseline	54	53	51	49	48	49	50	**45**	46
A. Alternative Scenarios									
A1. Key variables at their historical averages in 2007-27 [1]	54	62	70	79	86	94	101	**107**	118
A2. New public sector loans on less favorable terms in 2007-27 [2]	54	53	52	52	53	55	56	**54**	63
B. Bound Tests									
B1. Real GDP growth at historical average minus one standard deviation in 2007-08	54	53	53	52	52	52	52	**45**	47
B2. Export value growth at historical average minus one standard deviation in 2007-08 [3]	54	59	70	82	81	83	84	**65**	51
B3. US dollar GDP deflator at historical average minus one standard deviation in 2007-08	54	70	92	89	87	88	89	**76**	80
B4. Net non-debt creating flows at historical average minus one standard deviation in 2007-08 [4]	54	69	83	81	80	81	82	**63**	50
B5. Combination of B1-B4 using one-half standard deviation shocks	**54**	**60**	**104**	**136**	**136**	**138**	**140**	**107**	**73**
B6. One-time 30 percent nominal depreciation relative to the baseline in 2007 [5]	54	75	72	69	68	68	69	**59**	62

Continued…

Table 2. Lesotho: Sensitivity Analyses for Key Indicators of Public and Publicly Guaranteed External Debt, 2006-27 (concluded)
(Percent)

	2006	2007	2008	2009	2010	2011	2012	2017	2027
	Est.	Projections							
Debt service-to-exports ratio									
Baseline	6	5	4	3	3	3	3	**2**	1
A. Alternative Scenarios									
A1. Key variables at their historical averages in 2007-27 [1]	6	6	5	5	5	5	4	**4**	6
A2. New public sector loans on less favorable terms in 2007-27 [2]	6	6	5	5	5	4	4	**3**	4
B. Bound Tests									
B1. Real GDP growth at historical average minus one standard deviation in 2007-09	6	6	5	5	4	4	4	**2**	3
B2. Export value growth at historical average minus one standard deviation in 2007-09 [3]	6	6	6	7	7	6	6	**5**	4
B3. US dollar GDP deflator at historical average minus one standard deviation in 2007-09	6	8	5	5	4	4	4	**2**	3
B4. Net non-debt creating flows at historical average minus one standard deviation in 2007-09 [4]	6	6	5	6	5	5	5	**4**	3
B5. Combination of B1-B4 using one-half standard deviation shocks	**6**	**6**	**6**	**7**	**7**	**6**	**6**	**6**	**5**
B6. One-time 30 percent nominal depreciation relative to the baseline in 2007 [5]	6	8	5	5	4	4	4	**2**	3
Debt service-to-revenue ratio									
Baseline	6	5	4	3	3	3	3	**2**	1
A. Alternative Scenarios									
A1. Key variables at their historical averages in 2007-27 [1]	6	5	5	5	5	5	5	**5**	6
A2. New public sector loans on less favorable terms in 2007-27 [2]	6	5	5	5	5	5	5	**3**	4
A3. New public sector loans on less favorable IDA terms	6	5	4	3	3	3	3	2	1
B. Bound Tests									
B1. Real GDP growth at historical average minus one standard deviation in 2007-08	6	5	5	5	5	5	5	**2**	3
B2. Export value growth at historical average minus one standard deviation in 2007-08 [3]	6	5	5	5	5	5	5	**4**	4
B3. US dollar GDP deflator at historical average minus one standard deviation in 2007-08	6	7	9	9	8	8	8	**4**	5
B4. Net non-debt creating flows at historical average minus one standard deviation in 2007-08 [4]	6	5	5	6	5	5	5	**4**	4
B5. Combination of B1-B4 using one-half standard deviation shocks	**6**	**6**	**6**	**7**	**8**	**8**	**8**	**7**	**6**
B6. One-time 30 percent nominal depreciation relative to the baseline in 2007 [5]	6	7	7	7	6	6	6	**3**	4
Memorandum item:									
Grant element assumed on residual financing (i.e., financing required above baseline) [6]	37	39	39	39	39	39	39	**39**	39

Source: Staff projections and simulations.

[1] Variables include real GDP growth, growth of GDP deflator (in U.S. dollar terms), non-interest current account in percent of GDP, and non-debt creating flows.
The full presentation of the alternative scenario is in Table 1c.

[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.

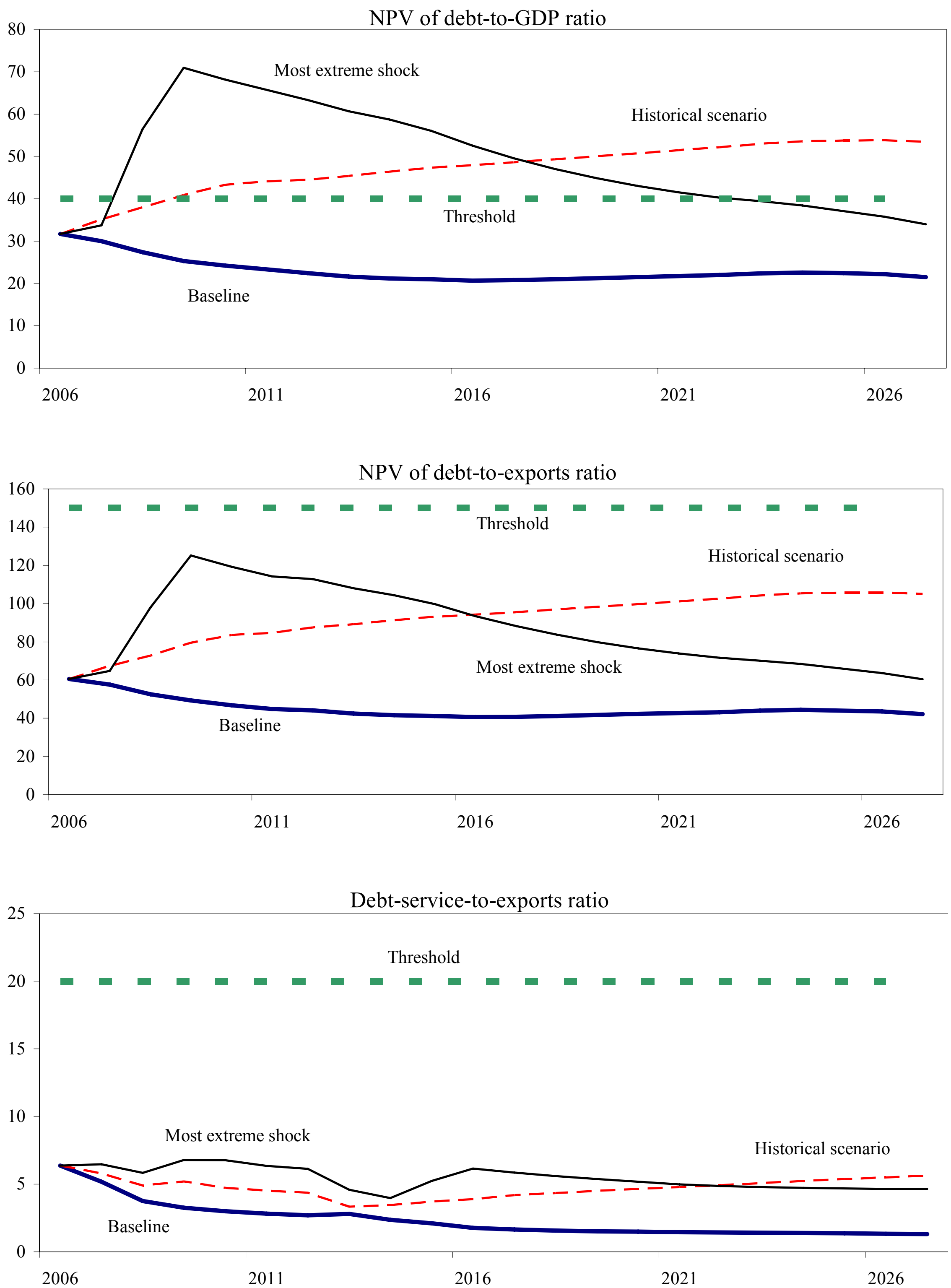
[3] Exports values are assumed to remain permanently at the lower level, but the current account as a share of GDP is assumed to return to its baseline level after the shock (imp
an offsetting adjustment in import levels).

[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 1. Lesotho: Indicators of Public and Publicly Guaranteed External Debt Under Alternative Scenarios, 2007-2027



Continued…

Figure 1. Lesotho: Indicators of Public and Publicly Guaranteed External Debt
Under Alternative Scenarios, 2007-2027 (cont'd)

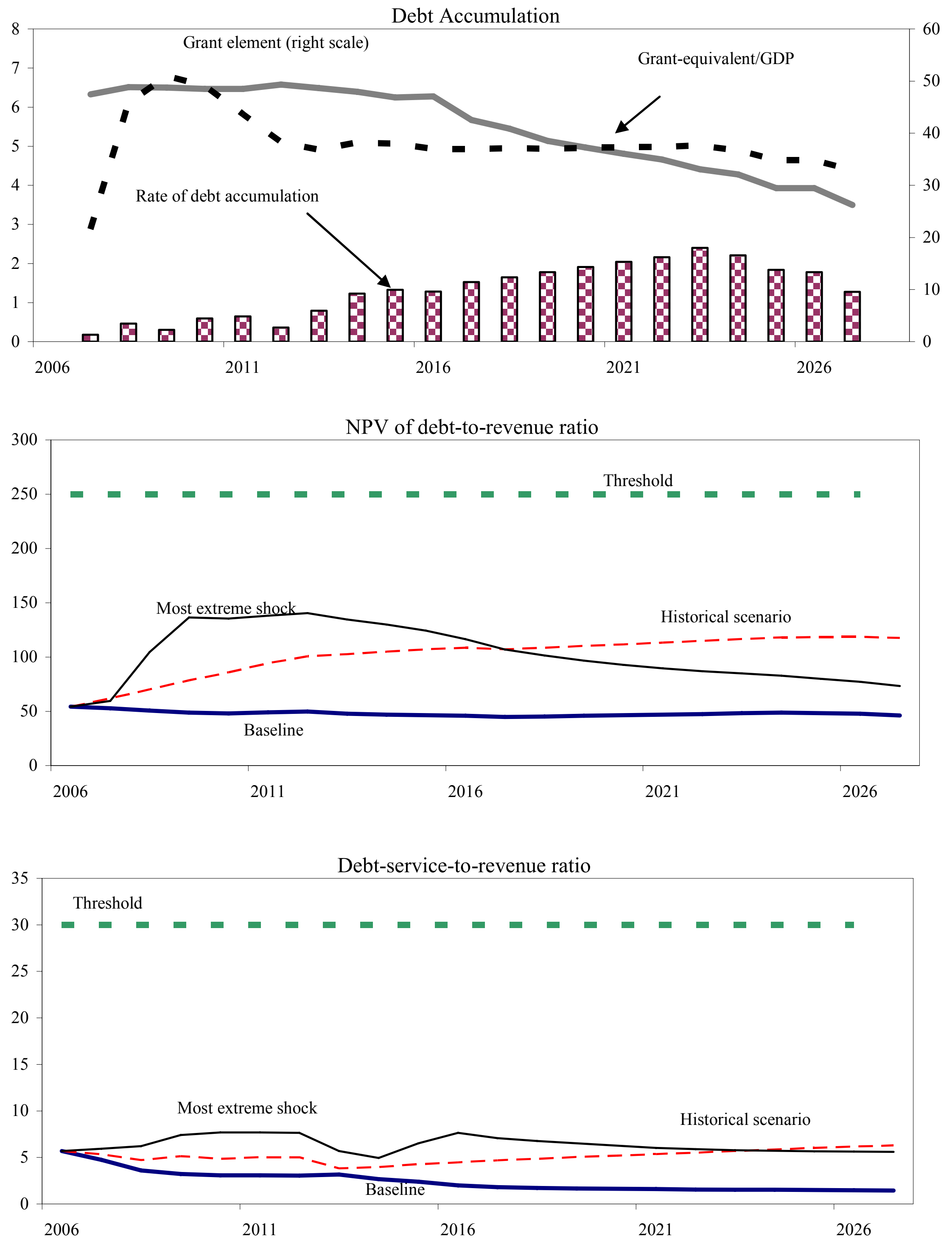


Table 3.Lesotho: Public Sector Debt Sustainability Framework, Baseline Scenario, 2004-2027
(Percent of GDP, unless otherwise indicated)

	Actual			Historical	Standard	Estimate	Projections								
	2004	2005	2006	Average [5]	Deviation [5]	2007	2008	2009	2010	2011	2012	2007-12 Average	2017	2027	2013-27 Average
Public sector debt [1]	55.8	54.5	51.4			49.4	45.6	43.0	42.1	41.5	38.9		35.7	30.9	
o/w foreign-currency denominated	46.9	45.5	43.1			42.4	39.7	38.0	37.4	37.1	36.5		33.2	29.4	
Change in public sector debt	-16.8	-1.4	-3.1			-2.0	-3.8	-2.7	-0.9	-0.6	-2.5		1.9	-1.2	
Identified debt-creating flows	-19.6	-2.5	-14.8			-11.1	-11.3	-10.8	-9.9	-7.5	-5.2		-2.8	-2.7	
Primary deficit	-7.7	-7.1	-14.7	-2.8	6.5	-8.7	-7.2	-7.5	-7.4	-5.0	-2.9	-6.4	-0.4	-0.4	-0.8
Revenue and grants	49.3	50.8	59.5			58.0	58.6	57.3	55.3	51.9	49.0		47.5	51.0	
of which : grants	2.6	2.1	1.1			1.4	4.6	5.3	5.0	4.3	3.8		2.0	2.0	
Primary (noninterest) expenditure	41.7	43.7	44.9			49.3	51.4	49.8	47.8	46.8	46.1		47.1	50.6	
Automatic debt dynamics	-11.9	4.6	-0.2			-2.4	-4.1	-3.3	-2.5	-2.5	-2.3		-2.4	-2.3	
Contribution from interest rate/growth differential	-2.6	-0.6	-3.2			-2.4	-2.5	-2.6	-2.6	-2.6	-2.5		-1.7	-1.1	
of which : contribution from average real interest rate	0.3	1.0	0.5			0.0	-0.1	-0.3	-0.3	-0.4	-0.5		-0.2	0.3	
of which : contribution from real GDP growth	-2.9	-1.6	-3.6			-2.4	-2.4	-2.3	-2.2	-2.2	-2.0		-1.5	-1.4	
Contribution from real exchange rate depreciation	-9.4	5.2	3.0			0.1	-1.6	-0.7	0.1	0.2	0.2		-0.7	-1.2	
Other identified debt-creating flows	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Privatization receipts (negative)	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Recognition of implicit or contingent liabilities	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Debt relief (HIPC and other)	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Other (specify, e.g. bank recapitalization)	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Residual, including asset changes	2.8	1.1	11.7			9.1	7.5	8.1	9.0	6.9	2.7		4.6	1.5	
NPV of public sector debt	34.1	33.9	39.9			37.0	33.3	30.4	28.8	27.5	24.5		22.0	21.8	
o/w foreign-currency denominated	25.2	24.9	31.7			30.0	27.4	25.4	24.2	23.1	22.0		19.4	20.3	
o/w external	25.2	24.9	31.7			30.0	27.4	25.4	24.2	23.1	22.0		19.4	20.3	
NPV of contingent liabilities (not included in public sector debt)	...	...	...			...	...	...	...	...	...		...	...	
Gross financing need [2]	-2.9	-0.9	-10.8			-5.5	-4.7	-5.4	-5.6	-3.3	-1.3		0.7	0.6	
NPV of public sector debt-to-revenue and grants ratio (percent)	69.1	66.7	67.0			63.7	56.9	53.0	52.1	53.0	49.9		46.2	42.8	
NPV of public sector debt-to-revenue ratio (percent)	73.0	69.6	68.3			65.3	61.7	58.4	57.2	57.8	54.2		48.3	44.5	
o/w external 3/	53.9	51.2	54.2			52.9	50.8	48.8	48.1	48.6	48.8		42.7	41.4	
Debt service-to-revenue and grants ratio (percent) [4]	9.7	12.2	6.4			5.6	4.2	3.6	3.4	3.3	3.2		2.4	1.9	
Debt service-to-revenue ratio (percent) [4]	10.2	12.7	6.5			5.7	4.6	4.0	3.7	3.6	3.5		2.5	2.0	
Primary deficit that stabilizes the debt-to-GDP ratio	6.3	-4.6	0.2			2.4	4.1	3.3	2.5	2.5	2.3		2.4	2.3	
Key macroeconomic and fiscal assumptions															
Real GDP growth (percent)	4.2	2.9	7.2	2.8	3.5	4.9	5.2	5.4	5.5	5.6	5.1	5.3	4.5	4.5	4.5
Average nominal interest rate on forex debt (percent)	2.0	3.9	2.1	2.6	0.8	1.2	1.1	1.1	1.0	0.9	0.9	1.0	1.1	1.5	1.3
Average real interest rate on domestic currency debt (percent)	2.9	3.1	1.0	5.4	5.5	0.6	-0.3	-0.7	0.5	-0.2	-1.0	-0.2	17.1	0.2	2.4
Real exchange rate depreciation (percent, + indicates depreciation)	-16.8	11.2	7.0	3.0	24.9	0.2	...	...	...	...	...	...	...	...	...
Inflation rate (GDP deflator, percent)	4.0	3.4	4.2	5.8	4.0	6.2	7.3	6.9	5.0	4.8	4.8	5.8	4.3	4.3	4.2
Growth of real primary spending (deflated by GDP deflator, percent)	2.0	7.8	10.2	3.7	10.0	15.2	9.7	2.1	1.4	3.4	3.4	5.8	6.8	7.6	5.2
Grant element of new external borrowing (percent)	39.0	39.0	39.0	39.0	0.0	39.0	39.0	39.0	39.0	39.0	39.0	39.0	39.0	39.0	...

Sources: Country authorities; and Fund staff estimates and projections.
[1] Covers gross debt of the general government.
[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 2006-2027

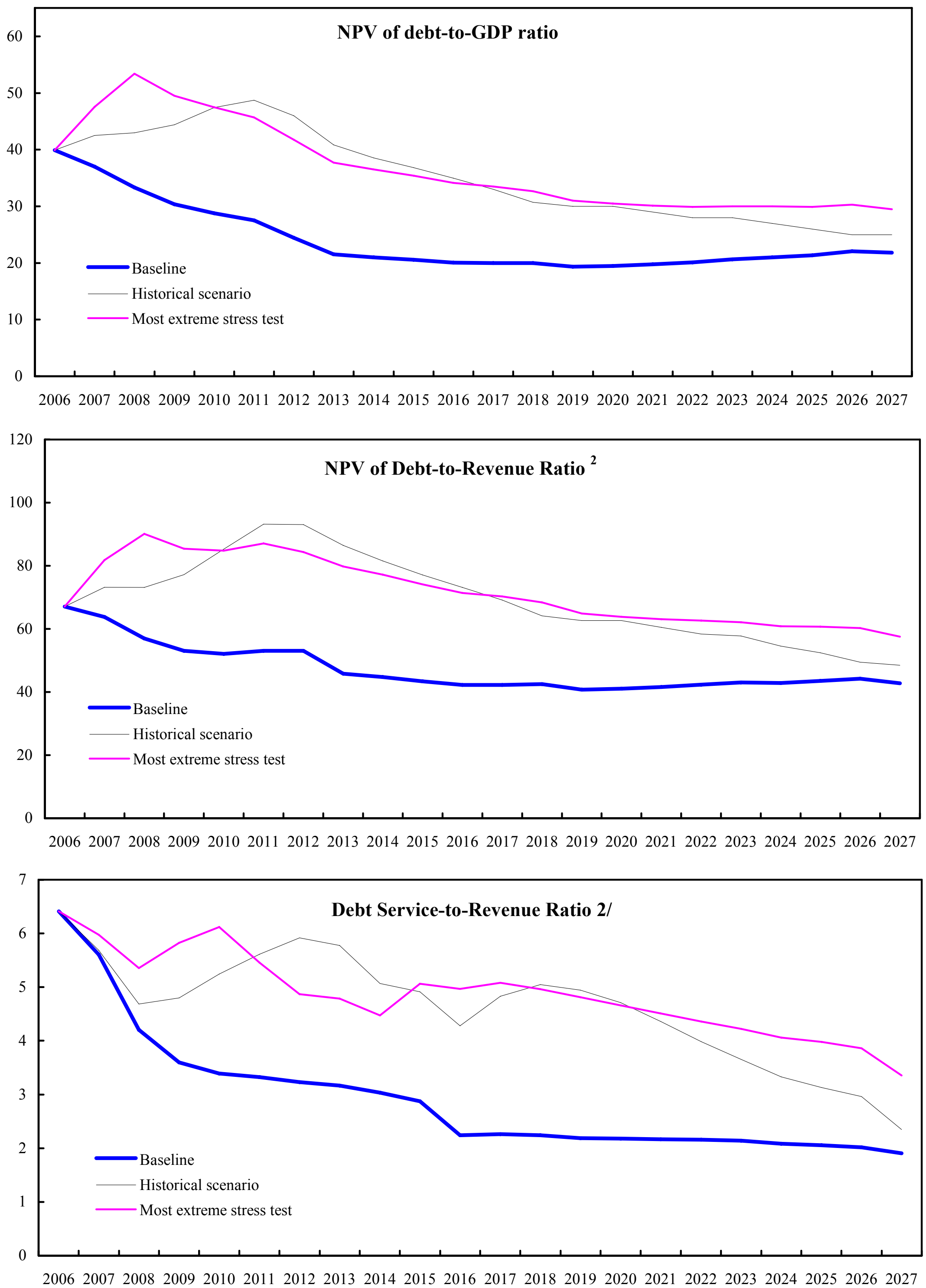
	2006	2007	2008	2009	2010	2011	2012	2017	2027
	Est.				Projections				
NPV of Debt-to-GDP Ratio									
Baseline	40	37	33	30	29	28	24	**22**	22
A. Alternative scenarios									
A1. Real GDP growth and primary balance are at historical averages	**40**	**42**	**43**	**44**	**47**	**49**	**46**	**35**	**25**
A2. Primary balance is unchanged from 2007	40	37	32	28	26	21	14	...	...
A3. Permanently lower GDP growth [1]	40	37	34	32	32	32	30	**36**	32
B. Bound tests									
B1. Real GDP growth is at historical average minus one standard deviations in 2007-2008	40	39	37	34	32	31	27	**25**	24
B2. Primary balance is at historical average minus one standard deviations in 2007-2008	40	47	52	48	46	44	41	**35**	29
B3. Combination of B1-B2 using one half standard deviation shocks	**40**	**48**	**53**	**50**	**47**	**46**	**42**	**35**	**30**
B4. One-time 30 percent real depreciation in 2007	40	50	45	41	38	35	31	**25**	23
B5. 10 percent of GDP increase in other debt-creating flows in 2007	40	47	42	38	36	34	30	**26**	23
NPV of Debt-to-Revenue Ratio [2]									
Baseline	67	64	57	53	52	53	53	**46**	43
A. Alternative scenarios									
A1. Real GDP growth and primary balance are at historical averages	67	73	73	77	85	93	93	73	48
A2. Primary balance is unchanged from 2007	67	64	55	49	46	41	28	...	...
A3. Permanently lower GDP growth [1]	67	64	58	56	57	61	61	**77**	63
B. Bound tests									
B1. Real GDP growth is at historical average minus one standard deviations in 2007-2008	67	64	57	53	52	53	50	**46**	43
B2. Primary balance is at historical average minus one standard deviations in 2007-2008	**67**	**81**	**89**	**84**	**83**	**85**	**82**	**73**	**57**
B3. Combination of B1-B2 using one half standard deviation shocks	67	82	90	85	85	87	84	**74**	58
B4. One-time 30 percent real depreciation in 2007	67	87	77	71	68	68	64	**54**	45
B5. 10 percent of GDP increase in other debt-creating flows in 2007	67	81	72	67	65	65	62	**54**	46
Debt Service-to-Revenue Ratio [2]									
Baseline	6	6	4	4	3	3	3	**2**	2
A. Alternative scenarios									
A1. Real GDP growth and primary balance are at historical averages	**6**	**6**	**5**	**5**	**5**	**6**	**6**	**5**	**2**
A2. Primary balance is unchanged from 2007	6	6	4	4	3	3	3	**6**	9
A3. Permanently lower GDP growth [1]	6	6	4	4	4	4	4	**4**	3
B. Bound tests									
B1. Real GDP growth is at historical average minus one standard deviations in 2007-2008	6	6	4	4	3	3	3	**2**	2
B2. Primary balance is at historical average minus one standard deviations in 2007-2008	**6**	**6**	**5**	**6**	**6**	**5**	**5**	**5**	**4**
B3. Combination of B1-B2 using one half standard deviation shocks	6	6	5	6	6	5	5	**5**	3
B4. One-time 30 percent real depreciation in 2007	6	6	5	4	4	4	4	**3**	3
B5. 10 percent of GDP increase in other debt-creating flows in 2007	6	6	4	4	3	3	3	**2**	2
Debt Service-to-GDP Ratio									
Baseline	4	3	2	2	2	2	2	1	1
A. Alternative scenarios									
A1. Real GDP growth and primary balance are at historical averages	**4**	**3**	**3**	**3**	**3**	**3**	**3**	**2**	**1**
A2. Primary balance is unchanged from 2007	4	3	2	2	2	1	1	1	1
A3. Permanently lower GDP growth [1]	4	3	2	2	2	2	2	2	2
B. Bound tests									
B1. Real GDP growth is at historical average minus one standard deviations in 2007-2008	4	3	3	2	2	2	2	1	1
B2. Primary balance is at historical average minus one standard deviations in 2007-2008	4	3	3	3	3	3	2	3	2
B3. Combination of B1-B2 using one half standard deviation shocks	4	3	3	3	3	3	2	2	2
B4. One-time 30 percent real depreciation in 2007	4	3	3	2	2	2	2	1	1
B5. 10 percent of GDP increase in other debt-creating flows in 2007	4	3	2	2	2	2	2	1	1

Sources: Country authorities; and Fund staff estimates and projections.

[1] Assumes that real GDP growth is at baseline minus one standard deviation divided by the square root of 20 (i.e., the length of the projection period).

[2] Revenues are defined inclusive of grants.

Figure 2. Lesotho: Indicators of Public Debt Under Alternative Scenarios, 2007-2027 [1]



Source: Staff projections and simulations.
[1] Most extreme stress test is test that yields highest ratio in 2017.
[2] Revenue including grants.

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Washington, D. C. 20431 USA

IMF Executive Board Concludes 2007 Article IV Consultation with the Kingdom of Lesotho

On November 14, 2007, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with the Kingdom of Lesotho.[1]

Background

Lesotho made further progress toward macroeconomic stability in 2006. After sluggish economic activity in recent years, real economic growth surged to about 7 percent, driven by booming diamond production, a recovery of the garment industry, and good performance in the agriculture and services sectors. Poverty has declined, but remains high, and Lesotho has a high prevalence of HIV/AIDS. The pace of structural reform has been slow.

Reflecting high transfers from the Southern African Customs Union (SACU) and exports of textiles and diamonds, the external current account balance registered a substantial surplus and international reserves rose to about six months of imports, even after significant external debt repayments. The recovery of the garment industry was helped by the extension of the US African Growth and Opportunity Act (AGOA), a depreciation of the rand, and a cut in corporate tax rates. Inflation has increased since the last quarter of 2006 owing to rising food and energy prices, broadly mirroring trends in South Africa. In July 2007 Lesotho and the US Millennium Challenge Corporation (MCC) signed a “compact” for US$363 million (23 percent of 2007 GDP)

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

to be implemented over the next five years and covering the areas of water, health, and private sector development. A drought hit agriculture in 2007; the government has appealed to development partners for assistance.

The fiscal position and public debt sustainability indicators have improved although the 2007/08 budget envisages a high level of spending. The overall fiscal balance registered a record surplus in 2006/07, the third in a row. The surplus was the result of high SACU receipts, and the continuing sub-execution of capital expenditure projects. Most of the surplus in 2006 was saved at the Central Bank of Lesotho (CBL)**.** The use of part of the SACU windfall to retire nonconcessional debt contributed to a decline in external debt-to-GDP ratio to 43 percent of GDP in 2006. The 2007/08 budget envisages a surge in current spending and a more than doubling of capita expenditure.

Broad money grew by 35½ percent in 2006, with net foreign assets of the banking system rising strongly. NFA growth largely reflected high SACU receipts and workers' remittances, as well as the relatively good performance of the textile industry**.**

The outlook is broadly positive, but subject to risks arising mostly from the external environment and emerging financial sector vulnerabilities.

Executive Board Assessment

Executive Directors commended the Lesotho authorities' commitment to prudent macroeconomic policies, which have contributed to the country's strong economic performance. In particular, Directors noted the marked acceleration in growth in 2006, the significant improvements in the fiscal and external balances, and the build up of international reserves—which have helped consolidate the country's exchange rate peg.

Nevertheless, Directors stressed that the country faces the considerable challenge of sustaining rapid and broad-based growth to reduce widespread poverty and make progress towards the MDGs, and to help tackle the high incidence of HIV/AIDS. Achievement of these objectives will call for an acceleration of the pace of structural reforms with a focus on promoting private sector development, while ensuring strong medium-term fiscal and external positions.

Directors considered that the medium-term outlook for Lesotho is positive but subject to several risks. These include a possible slowdown in markets for Lesotho's exports as well as uncertainty about the revenue-sharing regime of the Southern African Customs Union (SACU), prospects for global trade in textiles, and the outlook for remittances from workers in South Africa. While acknowledging that these factors are largely beyond Lesotho's control, Directors encouraged the authorities to prepare for possible adverse developments through strengthened fiscal policy and public financial management, and prudent reserves policies.

Directors welcomed Lesotho's prudent management of SACU windfalls so far, and urged the authorities to resist the surge in spending envisaged in the 2007/08 budget. Looking forward, they noted that containment of recurrent spending over the medium term would help keep fiscal policy sustainable while allowing the use of available fiscal space for increasing productive public investment. Directors also underscored the importance of approaching the upcoming salary review and the possible pension reform with caution, and more generally, of addressing existing weaknesses in the budget process and extending the Medium-Term Expenditure Framework to all ministries. Equally, Directors welcomed the authorities' intention to pursue prudent debt management policies.

Directors encouraged the authorities to continue to use grants as well as domestic resources to boost public investment, especially in infrastructure. They called for efforts to improve project execution and full utilization of external assistance, including the resources of the Millennium Challenge Corporation (MCC)—drawing on donor technical assistance. Directors welcomed the authorities' recognition that, while public-private partnerships have a role in public investment, they need to build the necessary capacity to manage them effectively.

Directors encouraged the authorities to accelerate the pace of structural reforms, and welcomed the preparation of a Growth Strategy Paper (GSP). They noted that envisaged programs—namely, the Public Sector Improvement and Reform Program, the Private Sector Development Component of the MCC compact, and the World Bank-supported Private Sector Competitiveness Program—would be key to relieving constraints on growth and enhancing productivity. In particular, these programs aim at strengthening institution building, establishing an appropriate legal and institutional framework, and improving the investment climate for domestic and foreign investors. Consistency between the GSP and Lesotho's Poverty Reduction Strategy would be important.

Directors agreed that Lesotho's monetary and exchange rate regime has been beneficial and should be preserved, along with the prudent policy mix that makes it viable. In particular, they underscored that membership in the Common Monetary Area and the peg of the loti to the rand have ensured stable and low inflation, and facilitated capital and commercial exchanges with South Africa. Fiscal restraint in the face of strong SACU revenues has ensured external stability by helping keep net international reserves at levels consistent with the sustainability of the peg. A few Directors advised that careful attention be paid to the risks associated with the volatility of the rand, and the inflation differential between Lesotho and South Africa.

Directors noted that, while the banking system appears solid, the limited access to its services by households and small businesses has fostered the growth of weakly supervised credit cooperatives. In this respect, Directors called on the authorities to step up their current efforts to improve the regulation and supervision of credit cooperatives and to increase access to banking services.

Directors expressed concern over the operation of unlicensed deposit-taking entities promising inordinately high rates of return. They observed that these vehicles have large and fast-growing liabilities, face constant rollover risks, and pose significant risk of failure. The continued operation of these entities would result in further growth in their liabilities and higher risk of social and financial repercussions. Accordingly, Directors urged the authorities to take prompt action to address this issue.

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

Lesotho: Selected Economic Indicators, 2003–07

	2003	2004	2005	2006	2007
				Est.	Proj.
	(Annual percent change, unless otherwise indicated)				
Real Economy					
Real GDP growth (percent)	2.7	4.2	2.9	7.2	4.9
Nominal GDP (millions of maloti)	7,862	8,522	9,065	10,120	11,273
Inflation (period average, percent)	7.3	5.0	3.4	6.1	7.2
	(Percent of GDP)				
National Accounts					
Gross domestic investment	33.2	31.4	27.4	24.3	26.2
Gross national savings	20.9	25.9	20.5	28.7	27.7
Central Government					
Revenue and grants	44.8	49.3	50.8	59.5	58.0
Revenue	42.2	46.7	48.7	58.4	56.6
Total grants	2.6	2.6	2.1	1.1	1.4
Total expenditure and net lending	45.3	43.7	45.9	46.2	50.3
Overall balance (excluding grants)	-3.1	3.0	2.7	12.3	6.3
Overall balance (including grants)	-0.4	5.6	4.8	13.4	7.7
	(Annual percent change, unless otherwise indicated)				
Money and Credit					
Net domestic assets [1]	25.5	-19.0	-1.8	-40.8	-12.4
Money and quasi-money (M2)	6.0	3.3	9.1	35.4	11.4
	(Percent of GDP)				
External Sector					
Current account balance (excluding grants)	-27.8	-23.5	-27.3	-20.5	-25.6
Current account balance (including grants)	-12.3	-5.5	-7.0	4.4	1.6
External debt [2]	58.1	46.9	45.5	43.1	42.4
External debt-service ratio [3]	9.8	7.6	10.9	6.4	5.2
Gross official reserves (millions of US dollars)	501.6	503.3	546.5	737.6	829.2
Gross official reserves (months of imports)	5.6	4.5	4.6	6.1	6.3

Sources: Lesotho authorities; and IMF staff estimates and projections.
[1] Change in percent of M2 at the beginning of the period.
[2] Government only. The appreciation of the loti significantly affected the debt-to-GDP ratio in 2003.
[3] Percent of exports of goods and nonfactor services.

Statement by Peter Gakunu, Executive Director for the Kingdom of Lesotho and Leonia Lephoto, Advisor to Executive Director
November 14, 2007

1. Introduction

On behalf of the Lesotho authorities, we would like to thank staff for the constructive dialogue during the last Article IV consultations, as well as the Board and management for their continued support. The authorities value the advice provided by the Fund and are in general agreement with the thrust of the staff reports.

The authorities' commitment to prudent macroeconomic management has contributed to the consolidation of macroeconomic stability. Over the past year, the strong rebound in economic growth is the result of policy measures taken by the authorities that were supported by a favorable external economic climate. Fiscal and external stability was strengthened through prudent use of fiscal surpluses to reduce public indebtedness and to augment reserves. The surplus was mainly driven by the significant increase in SACU receipts as well as growth in exports of textiles and clothing and diamonds. Near term macroeconomic prospects also seem positive. These notwithstanding, macroeconomic management in Lesotho remains challenging due to the country's continued vulnerability to exogenous shocks. New developments in the textile trade regime could have grave implications for the country's export sector, while the uncertainty surrounding SACU revenues poses a threat to fiscal stability in the long term.

Achieving the sustainable, broad based economic growth necessary for the improvement of the livelihoods of the majority of the Basotho people, remains a challenge. The authorities are committed to implementing the policies and structural reforms needed to preserve macroeconomic stability and promote sustainable growth and poverty reduction. Private sector development will be a key element of this reform program. Further support from the international community and understanding of the special circumstances of small emerging developing countries like Lesotho, which is likely to face "IDA-hardened" terms in 2010 as its GNI improves, could assist mitigate further challenges to the development agenda.

2. Recent Economic Developments

In 2006, Lesotho's economic performance was strong and broad based. Further improvements to macroeconomic stability were realized. Real GDP Growth estimated at 7.2 percent in 2006, was supported by the recovery in manufacturing output, a flourishing mining sector and improved performance in the agriculture and services sectors. In the mining sector, increased output was facilitated by increased production in the diamond mines. At the same time, in manufacturing, the negative impact of the expiry of the Multi Fiber Agreement (MFA) on the textile and clothing sector was mitigated by the extension of

AGOA by the US, the depreciation of the loti and measures undertaken by Government.

Consumer inflation has been on the rise due to external factors including the general increase in oil and cereal prices. Nevertheless inflation has remained in single digits. Meanwhile, fiscal consolidation remained strong in 2006/07**,** with government budgetary operations recording a surplus for the fourth consecutive year as a result of strong SACU and domestic revenues, and measures taken to ensure moderate growth in expenditure. The fiscal surplus for the year 2006/07 is estimated at around 16 per cent of GDP.

The balance of payments position remained positive in 2006 with the overall balance in surplus. This facilitated the accumulation of foreign reserves to almost 7 months of import cover. The improvement in the balance of payments position largely reflected the turnaround in the current account balance from a deficit in 2005 to a surplus in 2006.

3. **Macroeconomic Outlook and Policies**

Macroeconomic prospects remain broadly favorable. Growth is expected to remain strong, supported by the vibrant mining sector and manufacturing, as well as increased construction activity due to scaled up public investments. Investment projects to be implemented under the recently signed Millennium Challenge Corporation (MCC) compact are expected to contribute significantly to growth. Fiscal and external stability will benefit from the expected continuation of large inflows of SACU revenues, in the medium term.

Downside risks include the negative impact of the persistent drought on agriculture and potential unfavorable developments in the external environment. Developments in the global regime for textiles, such as the erosion of trade preferences, would have significant consequences for Lesotho's export sector. In the short run, garment and mineral exports could also be adversely affected by the slowdown in the US economy. The uncertainty of SACU revenue poses a challenge to fiscal management as these receipts continue to account for the bulk of government revenue; hence, the authorities' recognition of the need to continue strengthening the domestic revenue effort while containing expenditures. Inflationary pressures are expected to continue to rise in line with oil prices and increases in food prices emanating from drought-induced food shortages, as well as the global cereal shortages created by the increased use of biofuel.

Fiscal Policy

Lesotho's membership in the Common Monetary Area (CMA) dictates that fiscal policy be the most important tool for macroeconomic management. The core objective of Lesotho's fiscal strategy is to ensure the maintenance of a sustainable fiscal stance and maintenance of external stability. The authorities' commitment to prudent fiscal policies and sustained fiscal surpluses has facilitated their success in achieving these objectives. The authorities continue to exercise prudence in the allocation of these surpluses towards improving the country's debt sustainability and external stability.

In the medium-term, the projected exceptional SACU revenues will help to ensure favorable fiscal outcomes. However, the authorities are cognizant of the fact that, if these revenues decline in the future, sustainability will necessitate a substantial reduction in the share of public expenditure relative to GDP as well as stronger domestic revenue performance. The authorities will therefore endeavor to strengthen their domestic revenue effort through continued implementation of measures to improve revenue administration of the Lesotho Revenue Authority (LRA).

In an effort to strengthen public expenditure management and enhance the effectiveness of public services the authorities have launched a public sector improvement and reform program (PSIRP). Progress made under the PSIRP includes strengthening of budget planning and execution, public procurement reform and the introduction of the medium term fiscal framework. The principles underpinning the authorities' fiscal strategy are to: maintain the real value of public expenditure by ensuring that the main categories of discretionary ministerial expenditure increase by at least the annual rate of inflation; ensure that the current increase in SACU revenues (and, hence, the ratio of revenue to GDP) does not give rise to an unsustainable level of aggregate public expenditure and that the public sector does not expand aggregate demand excessively; ensure that a primary surplus of revenue (including grants) over expenditure (excluding interest) is achieved; minimize the amount of commercial debt outstanding and to ensure that aggregate debt ratios do not exceed sustainability indicators; maintain a surplus of current revenue over current expenditure; and secure additional external finance on concessional terms. This should ensure that the overall medium term fiscal framework remains within sustainable limits.

Monetary Policy and Financial Sector Issues

Price stability in Lesotho has been facilitated by the country's membership in the CMA, which provides for the loti to be pegged at par to the rand and for free movement of capital within the CMA. Monetary policy in Lesotho continues to be aimed at maintaining a strong external reserve position that is adequate to support the exchange rate parity with the South African rand as well as to meet the country's external obligations. The viability of this arrangement has also been supported by prudent fiscal policies.

The banking sector remains strong, with banks being profitable, well-capitalized and liquid and with relatively moderate and well provisioned non-performing loans (NPLs). Downside risks to the banking sector are posed by the relatively high and increasing concentration on the asset side of the banks' balance sheets, and a rising trend in NPLs. However, these risks are mitigated by the fact that most of the loans to the top twenty borrowers are fully collateralized. The authorities continue to implement measures geared towards strengthening prudential supervision including the review of the legal and regulatory framework as well as their own supervisory practices and procedures.

Financial intermediation continues to be limited as banks remain risk averse. The low access of financial services to the population has encouraged the rapid growth of credit cooperatives. These often engage in financial intermediation with non-members, and pose a challenge to the ability of the authorities to supervise and regulate them as they are not covered by the current financial institutions laws. The extent of their operations is not well known, and the quality of regulatory oversight is limited under existing arrangements. The authorities are currently making efforts to strengthen this sector as well as to regulate and supervise it. Technical assistance from the International Fund for Agricultural Development (IFAD) is expected to assist in this regard.

The strengthening of the Lesotho Postbank, which currently does not extend credit, and the development of the microfinance sector, which are also to benefit from IFAD assistance, is expected to increase access to financial services. Other efforts geared towards the improvement of financial intermediation include the creation of the credit reference bureau and reform of the commercial court. These measures will be supported by the World Bank and MCC funded private sector development projects.

The operation of unlicensed financial entities, which have attracted sizable deposits from the public by promising very high rates of return and accumulated large and growing liabilities that could become very difficult to meet, poses a challenge to the authorities. These entities also face significant rollover risks thus presenting substantial risks to depositors. Measures to deal with these institutions and to minimize any adverse impact are already at an advanced stage. The authorities have requested Fund advice and initiated a public education campaign to raise public awareness of the dangers of such schemes and to discourage more people from engaging in them.

The authorities have also submitted an Anti-Money Laundering Bill to parliament for enactment.

Growth Policies

The authorities continue to place emphasis on the need for pro-growth policies aimed at achieving sustainable broad-based growth that is required to reduce poverty, improve the living standard of Basotho and more generally ensure progress towards achieving the MDGs.

The authorities are currently developing a Growth Strategy Paper (GSP). The GSP will identify both opportunities and binding constraints to growth. The PRS will be compatible with the GSP and together they will serve as a roadmap that guides work in support of the long term goals presented in Vision 2020. The GSP would be linked to the budget, therefore helping inform the formulation of medium term fiscal plans and institutional reform initiatives, which in turn should guide annual budgets as well as the Medium Term Expenditure Framework.

Private sector development is the key ingredient to growth and poverty reduction. Hence, the authorities' plans to promote private sector led growth through measures aimed at improving the investment climate and incentives as well as enhancing international competitiveness. Measures already taken in this regard include the reduction of company tax rates during the 2006/07 fiscal year, and the establishment of the trade and investment facilitation centre to serve as a one stop shop for potential investors and to reduce regulatory impediments and facilitate investment.

Efforts to improve the investment climate will be reinforced by the World Bank supported

Private Sector Competitiveness Program as well as the private sector development component of the compact signed with the MCC earlier this year. Key reforms would include removing regulatory constraints posed by registration, licensing, immigration and tax processes and improving private sector access to credit through the establishment of a comprehensive property registry, development of a national identification system, reform of the judiciary and administration of justice as well as the simplification of land transfer procedures. To facilitate access to credit, parliament passed a Married Persons Act in 2007, which allows for married women to access bank credit without their husbands' permission. The authorities are also taking measures to improve labor productivity and economic infrastructure, as well as to diversify the economy and markets in order to reduce the country's vulnerability to shocks.

4. Conclusion

In conclusion, we would like to reiterate the authorities' commitment to macroeconomic stability and the promotion of high and sustainable economic growth. They appreciate the continued support of the Fund and the international community in general in addressing the enormous challenges that they face. This support is particularly important for the country, if it is to reduce poverty and make headway towards achieving the MDGs. Further support from the international community to small emerging developing countries like Lesotho, which is likely to face "IDA-hardened" terms in 2010 as its GNI improves, could assist mitigate further challenges to the development agenda.