INTERNATIONAL MONETARY FUND

IMF Country Report No. 19/113

KINGDOM OF LESOTHO

April 2019

2019 ARTICLE IV CONSULTATION—PRESS RELEASE; STAFF REPORT; AND STATEMENT BY THE EXECUTIVE DIRECTOR FOR 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 2019 Article IV consultation with Kingdom of Lesotho, the following documents have been released and are included in this package:

- A **Press Release** summarizing the views of the Executive Board as expressed during its April 26, 2019 consideration of the staff report that concluded the Article IV consultation with Kingdom of Lesotho.
- The **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on April 26, 2019, following discussions that ended on February 5, 2019, with the officials of Kingdom of Lesotho on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on April 10, 2019.
- An **Informational Annex** prepared by the IMF staff.
- A **Statement by the Executive Director** for Kingdom of Lesotho.

The IMF's transparency policy allows for the deletion of market-sensitive information and premature disclosure of the authorities' policy intentions in published staff reports and other documents.

Copies of this report are available to the public from

International Monetary Fund • Publication Services
PO Box 92780 • Washington, D.C. 20090
Telephone: (202) 623-7430 • Fax: (202) 623-7201
E-mail: publications@imf.org Web: http://www.imf.org
Price: $18.00 per printed copy

International Monetary Fund
Washington, D.C.

Press Release No. 19/134
FOR IMMEDIATE RELEASE
May 2, 2019

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

IMF Executive Board Concludes 2019 Article IV Consultation with the Kingdom of Lesotho

On April 26, 2019, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation[1] with the Kingdom of Lesotho.

Over the past decade, capital intensive projects and government consumption have driven growth in Lesotho. Most recently, work is beginning on Phase 2 of the Lesotho Highlands Water Project, and together with a recovery in the diamond and textile sectors, has resulted in growth of around 3 percent of GDP in 2018/19. However, with SACU revenues below historical averages and government expenditure persistently high, the government has run into fiscal difficulties, leading to the emergence of government payment arrears.

The recently passed FY 2019/20 budget envisages strong fiscal consolidation which should ensure a fully financed deficit and allow space for the clearance of arrears. The authorities plan to increase the VAT on telecoms and introduce a levy on alcohol and tobacco. On the expenditure side, savings will be generated by a zero cost of living adjustment for civil servants, which will begin to address the issue of the wage bill, currently one of the largest in the world as a percent of GDP.

While external pressures have subsided, buffers have shrunk, and balance of payments weaknesses persist. The current account deficit is projected to widen to 8.4 percent of GDP in FY 2018/19, due to a fall in SACU revenues coupled with a depreciation of the loti. Reserves are projected to fall to 3½ months of imports at the end of FY 2018/19, down from 3¾ the previous year. However, the peg to the rand has supported monetary stability, and inflation has remained subdued.

The banking sector in Lesotho remains sound. Nevertheless, the sector's contribution to growth has been limited, and lending to the corporate sector and SMEs has been anemic. Reforms to improve the legal framework aim to encourage lending, while technological change, such as the

[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.

rapid growth in the mobile money sector, is providing new channels for households and small businesses to access the formal financial system.

Executive Board Assessment[2]

Directors welcomed the progress made in restoring peace and stability. Directors, however, noted that Lesotho continues to face significant challenges, stemming mainly from the declining Southern African Customs Union (SACU) revenues and high government expenditures. Against this background, Directors underscored the need for both short- and medium-term measures to preserve fiscal and external sustainability, as well as generate strong and inclusive growth.

Directors welcomed the ambitious FY 2019/20 budget and emphasized that its strict implementation will be key to preserving fiscal sustainability, especially in terms of clearing the accumulated domestic arrears and strengthening the external position. They underscored the importance of strengthening expenditure controls, resisting pressure to enact additional spending, and improving tax administration. Directors recommended improvements to debt management, a prudent approach to debt contracting, and addressing contingent liabilities related to the public sector pension fund to strengthen debt sustainability.

Directors emphasized that the fiscal adjustment needs to be reoriented to favor growth and efficiency. Reducing the high public wage bill over time will provide space for the authorities' strategic priorities. Directors also stressed the need for greater efficiency in health and education spending to ensure better outcomes. They further urged for enhanced public financial management, including through improved financial reporting and cash management, which will accelerate the clearance of arrears. Directors welcomed the authorities' efforts to protect the most vulnerable from the impact of the adjustment.

Directors welcomed the steps being taken to strengthen the financial sector's contribution to growth. They highlighted the need to continue to closely monitor household indebtedness and credit concentration as well as to further enforce the AML/CFT framework. Strengthening the regulation of the non-bank financial sector will also be needed to support the financial inclusion agenda.

Directors supported efforts to encourage job creation and underscored the need for continued improvements to the business climate. They highlighted the importance of a stable regulatory framework, with greater engagement with the private sector prior to the introduction of new regulations.

---

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

Table 1. Kingdom of Lesotho: Selected Economic Indicators, 2015/16–2023/24[1]

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

	2015/16	2016/17	2017/18	2018/19	2019/20	2020/21	2021/22	2022/23	2023/24
	Act.	Act.	Est.	Projections					
	(12-month percent change, unless otherwise indicated)								
National account and prices									
GDP at constant prices	2.1	2.7	0.5	2.9	3.1	-0.2	3.6	4.2	1.4
GDP at constant prices (exc. LHWP-2 project)	2.1	2.7	0.5	2.7	0.7	1.9	2.3	2.5	3.0
GDP at market prices (billions of Maloti)	32.1	34.1	34.8	37.6	41.0	43.4	47.3	51.9	55.6
Consumer prices (average)	4.3	6.2	4.5	4.8	5.9	5.7	5.5	5.5	5.5
Consumer prices (eop)	7.5	4.4	4.9	4.9	6.0	5.6	5.5	5.5	5.5
GDP deflator	7.7	3.5	1.6	4.9	5.7	6.1	5.3	5.2	5.7
External sector									
Terms of trade (deterioration -)	12.8	-3.9	0.4	-0.7	1.5	0.4	0.4	0.4	0.3
Average exchange rate (Local currency per U.S. dollar)	13.8	14.1	13.0	...	...	...	...	...	...
Nominal effective exchange rate change (– = depreciation)[2]	-8.9	-11.1	8.2	...	...	...	...	...	...
Real effective exchange rate (– = depreciation)[2]	-6.8	-6.8	11.4	...	...	...	...	...	...
Current account balance (Including official transfers, percent of GDP)	-4.3	-8.4	-4.8	-8.4	-14.2	-4.8	-9.1	-15.6	-9.2
Current account (exc. LHWP-2 project, percent of GDP)	-4.1	-7.9	-4.2	-7.3	-4.2	-1.9	-1.3	-1.2	-0.9
Gross international reserves (Months of imports, excluding imports for LHWP-2)	6.2	4.5	3.7	3.5	3.4	3.4	3.3	3.2	3.2
Money and credit									
Domestic credit to the private sector	8.2	5.8	8.3	9.6	8.7	11.0	...	...	...
Reserve money	22.7	3.1	9.0	3.5	4.5	8.8	...	...	...
Broad money	6.4	8.8	17.4	6.1	3.9	5.9	...	…	...
Interest rate (percent)[3]	6.3	7.0	7.0	...	...	...	...	...	...
	(in percent of GDP)								
Public debt	43.2	37.6	38.8	46.8	49.5	51.7	51.4	50.7	51.1
External public debt	38.7	33.1	30.7	36.1	36.1	36.5	35.7	34.7	34.8
Domestic public debt	4.6	4.5	8.2	10.7	13.4	15.2	15.7	15.9	16.3
Central government fiscal operations									
Revenue and grants	47.8	41.3	42.9	41.3	41.9	42.4	42.0	41.8	41.7
Of which: SACU revenue	20.0	13.3	17.7	14.7	15.2	15.9	15.6	15.4	15.4
Of which: grants	3.0	3.6	2.4	2.8	2.5	2.5	2.4	2.4	2.4
Recurrent expenditure	35.9	37.1	36.7	35.4	34.0	33.6	33.3	32.9	32.8
of which: wages, including social contributions	15.4	15.5	15.6	16.3	16.3	16.0	15.7	15.3	15.2
Capital expenditure	13.1	12.2	9.6	11.1	11.3	11.1	10.7	10.3	10.2
Overall balance	-1.2	-8.0	-3.4	-5.2	-3.4	-2.3	-2.0	-1.4	-1.3
(Excluding grants)	-4.2	-11.6	-5.8	-7.9	-5.9	-4.7	-4.4	-3.8	-3.6
Statistical discrepancy/Arrears	2.8	0.1	2.9	0.5	0.0	-0.5	-0.4	-0.4	-0.4

Sources: Lesotho authorities, World Bank, and IMF staff estimates and projections.

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

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

[3] 12-month time deposits rate.

INTERNATIONAL MONETARY FUND

KINGDOM OF LESOTHO

STAFF REPORT FOR THE 2019 ARTICLE IV CONSULTATION

April 8, 2019

KEY ISSUES

Context: A four-party coalition government took office in June 2017 and, with support from a regional peacekeeping force, has brought peace and stability. However, with SACU revenues below historical averages and government expenditures remaining high, the fiscal situation has deteriorated, leading to the emergence of government payment arrears. While international reserves are at adequate levels and banks remain well-capitalized, domestic arrears are beginning to impact the broader economy, exacerbating growth challenges posed by structural impediments. Unemployment, particularly among the young, is a major concern.

Outlook and challenges: The recently-passed FY2019/20 budget envisages an ambitious consolidation that could begin to lay the groundwork for a transition to private-sector driven growth. Construction related to the second phase of the Lesotho Highlands Water Project will support medium-term growth, and the diamond and textile industries have positive prospects. Political uncertainty, PFM weaknesses, and continued dependence on uncertain rainfall present downside risks, while attaining a stronger domestic consensus on reforms to strengthen governance and accountability could reap significant rewards.

Macroeconomic policies: Fiscal adjustment is needed to address government arrears, buttress debt sustainability, and safeguard the link to the rand. Given Lesotho’s relatively strong revenue collections, measures should be focused on expenditures, in particular bringing down the high public-sector wage bill over the medium term, while maintaining critical safety nets. Monetary and financial sector policies should focus on maintaining reserve adequacy and safeguarding stability while improving the legal framework to encourage private sector lending.

Structural Reforms: Generating strong and inclusive growth will require improved public service delivery and the private sector to become the primary engine of job creation. Better targeting of the government’s resources, PFM reforms, and reorienting both expenditures and the role of government in the economy will be critical to achieve these goals. Policy certainty and ensuring a level playing field will also be key.

Approved By
David Robinson (AFR) and Nathan Porter (SPR)

The team for the January 24–February 5 mission comprised Mr. Thornton (head), Messrs. Alonso and Massara (all AFR), Ms. Kostroch (STA) and Mr. Habib (ICD). Mr. Ntema (local economist) also participated in the mission, which was joined by Ms. Nainda (OED). This report was prepared with research support by Ms. Wang, and administrative support by Ms. Prado de Guzman at headquarters and Ms. Mphatsoe in Maseru.

CONTENTS

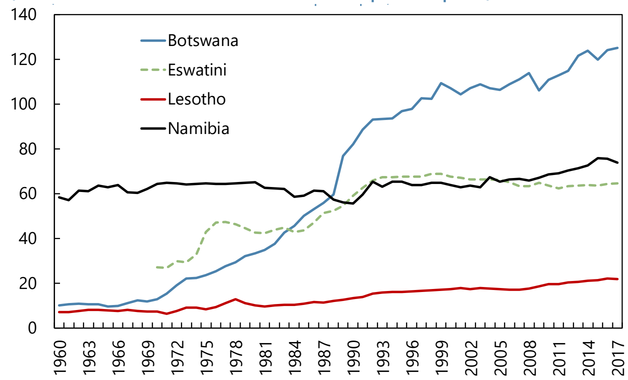
ANNEXES

CONTEXT

1. **A four-party political coalition came to power in 2017 with a mandate to cement peace and entrench reform.** Patronage-driven politics and military interference have resulted in decades of instability in Lesotho, while politicization of the civil service has compromised effective public service delivery. The coalition has been supported by a regional peace-keeping force, and a dialogue between the government and opposition parties began on reforms recommended by the Southern African Development Community (SADC) to depoliticize the civil service, increase Parliamentary oversight of the military, and amend the constitution to reduce chronic political instability.

Real GDP per Capita

(Percent of South Africa's GDP per capita)

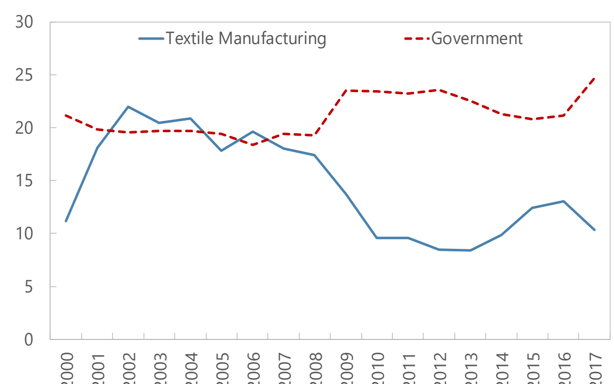


Source: Penn World Tables, IMF World Economic Outlook

2. **Lesotho's growth model has run into difficulties.** Despite a high degree of economic integration, Lesotho's standard of living remains far below that of the other Southern African Customs Union (SACU) members. Growth has recently been driven by capital-intensive industries such as mining and finance, with little impact on job creation. The textile industry, which expanded rapidly in the late 90s and early 2000s thanks to preferential access to US markets through the African Growth and Opportunity Act, has since stagnated. Political instability, low human capital, and unstable and burdensome regulations combine to constrain private sector development (Annex IV). Access to credit is also an issue in the context of a financial sector which is liquid and profitable but plays a limited role in intermediating credit to local entrepreneurs. With unemployment at around 25 percent, over half of the population living under the $1.90 poverty line, and one of the highest rates of HIV infection in the world, social indicators suggest the depth of the development challenge ahead (Table 6).

Value Added by Industry

(Percent of GDP)



Sources: Country authorities and staff estimates.

3. The public sector wage bill expanded to one of the largest in the world when revenues from the SACU were buoyant, creating fiscal rigidities that have resulted in financing issues.[1] From FY 2005/06 to FY 2013/14, SACU revenues increased from 14 percent of GDP to 24 percent. Over the same period, the wage bill doubled as a percent of GDP, largely due to salary hikes rather than an expansion of the public-sector work force. When SACU revenues fell after FY 2014/15, reflecting lower South African import growth, the wage bill remained high, resulting in a depletion of Lesotho's fiscal and reserve buffers over the following years. By late FY2017/18, the government had run out of space to draw down deposits further without threatening their reserve target (120 percent of M1 plus all callable deposits).[2] Rather than allow any risk to the peg to the rand, and with local debt markets shallow, the government began to delay certain domestic payments, resulting in a build-up of government payment arrears.[3]

RECENT ECONOMIC DEVELOPMENTS

4. The economy is recovering following very weak growth in 2017/18, though declining SACU revenues are putting pressure on the external position. Enhanced political stability, an increase in production in the diamond sector, and stronger growth in the textile sector (which benefited from a weaker rand) are expected to result in growth of just under 3 percent in FY 2018/19. Lower SACU revenues, however, offset stronger textile and diamond exports, resulting in a current account deficit of 8½ percent of GDP, and continued pressure on reserves. The external position has been weaker than the level consistent with medium term fundamentals and desirable policies (Annex I).

5. Lower SACU revenues and expenditure rigidities posed challenges for fiscal policy. The 2018/19 budget included some revenue measures, such as an increase in the VAT rate to bring it into line with other countries in the region, and an increase in VAT on telecommunications and electricity. However, these were insufficient to offset lower SACU revenues and higher expenditures, resulting in a deficit of over 5 percent of GDP. Moreover, attempts to finance the deficit also initially fell short, as bonds auctioned in the first half of the year were only 50 percent subscribed. The resulting financing gap led to further arrears accumulation, as the government sought to preserve government deposits at the CBL, and hence international reserves, at adequate levels.

6. Government payment arrears have begun to have an impact on the broader economy. While the banking system, dominated by South African banks, remains well capitalized and profitable, NPLs are expected to creep up, albeit from a low base (Table 5). Credit to the private sector remains broadly in line with nominal GDP growth, with the banks continuing to hold much of

---

[1] Customs and excise duties collected by SACU members are pooled and distributed quarterly, based on a revenue-sharing formula negotiated by the member countries. The allocation formula includes a correction mechanism that can exacerbate trends.

[2] While a reserve target of 120 percent of M1 plus all callable savings deposits ("M1 Plus") is a relatively conservative approach, it helps to account for the stability of the peg since its inception.

[3] In the absence of a comprehensive survey of arrears, staff have estimated a stock of arrears of just over 2 percent of GDP. However, this is subject to significant uncertainty.

their asset base in South Africa, and inflation remains subdued. The government's ad hoc issuance of 600 million in one-year paper in December helped to alleviate the domestic payment arrears and stabilize the situation.

OUTLOOK AND RISKS

7. Over the next three years, growth is expected to be driven by construction related to the second phase of the Lesotho Highlands Water Project (LHWP-II). In addition to the project (Box 1), production of diamonds and textiles have positive prospects. Inflation is expected to pick up somewhat as the VAT rate hike is passed-through and economic conditions improve mildly. Over the medium term, it is expected to converge to 5.5 percent, in line with South African inflation.

Box 1. The Lesotho Highlands Water Project

A new phase of the LHWP is about to start. The first phase of the LHWP was completed in 1998 and included dams and tunnels to export water to South Africa. Phase II will add another dam and tunnel with investments amounting to over 50 percent of Lesotho's GDP over the next 8 years, fully financed through capital grants from South Africa.[1] While the import component is expected to be high, the size of the project implies a substantial growth and employment impact. At its peak, LHWP-I employed over 3,000 workers.

Project cash flows are expected to have two peaks. Construction of a major road is expected to take place in FY 2019/20. After a low-activity year, construction of the dam and diverting tunnel will begin in FY 2021/22. After the project is completed, water will be delivered to South Africa in exchange for a royalty. These peaks are a major driver of the country's projected growth path.

[1] A hydropower component may be considered in the future and would have to be financed by Lesotho.

8. While overall risks are tilted to the downside, upside risks stem from the national reform agenda, which offers a roadmap to enhancing stability. The country is currently debating a multi-sectoral reform program which, if enacted, could strengthen governance and accountability. Such a program could also be supported by the international community, including a potential Millennium Challenge Compact,[4] and provide a more stable environment for investment. However, achieving substantial progress on economic and political reforms will require attaining a greater degree of consensus than has been evident in the recent past.

9. A deterioration of fiscal discipline would be the major downside risk. Fiscal consolidation is required to restore the external balance: a failure to consolidate the fiscus in line with the FY2019/20 budget would force the authorities to choose between a further depletion of government deposits at the CBL, with negative consequences for reserves and ultimately for the peg to the rand, or to maintain deposits at the cost of continuing to accumulate arrears, which could further undermine procurement, growth, and financial stability.

[4] In December 2018 Lesotho was re-selected to continue developing a second compact, a process which typically takes two to three years to complete. The amount of the second compact is not yet determined; the first compact totaled about $360 million, disbursed over several years.

PFM weaknesses also pose challenges to economic policy making, with lax expenditure controls potentially imperiling budget discipline.

10. External risks largely center on spillovers from South Africa. Downgrades of South African debt and disruptions to the power supply could induce capital flight and weaken growth, which could in turn depress SACU revenues and remittances. Political tensions and slow progress in South Africa's structural reforms could worsen the already declining longer-term trend for SACU revenues. On the upside, if structural reforms were accelerated after elections, growth and SACU revenues could be boosted (Annex II).

11. Another El Niño-related drought may hit Lesotho this year. The Food and Agriculture Organization has identified Lesotho as being at high risk of drought that could increase malnourishment among vulnerable populations and lead to higher expenditures on food subsidies and crisis management.[5] The cost of the response to the 2016 drought was estimated at 2 percent of GDP by the UN.

Authorities Views

The authorities acknowledged the downside risks. They noted the implications of insufficient fiscal consolidation, and clarified that discussions were underway to obtain external support in the event of a drought. However, they also noted large upside risks reflecting the underlying potential of the country, including in horticulture, medicinal cannabis, mining, and textiles.

POLICY DISCUSSIONS

Discussions focused on short term measures to improve fiscal discipline and bring expenditures into line with available resources. Over the medium term, the mission proposed measures to enhance public service delivery and to recast the role of the government with a view to enabling the private sector to act as the engine of growth.

A. Restoring Fiscal Discipline

12. The FY 2019/20 budget envisages a major adjustment aimed at addressing fiscal imbalances and bringing expenditures into line with available resources while expanding public works programs to increase employment opportunities (Box 2). The key expenditure measure is a zero cost of living wage adjustment, coupled with a hiring freeze. The government is attempting to lead by example, with Ministers taking a five percent pay cut. The budget also seeks to cut travel and per diem costs, which typically amount to 2 percent of GDP each year. On the revenue side, the authorities plan to increase the VAT on telecommunications from 9 to 12 percent, introduce a levy on alcohol and tobacco, and raise the levy on fuel. Taken together, staff assess that these measures would result in a projected deficit of 3.4 percent of GDP, compared to 5.2 percent in

[5] http://www.fao.org/3/ca2530en/CA2530EN.pdf

FY 2018/19.[6] The baseline also assumes some continued expenditure restraint over the medium term, reflected in a falling wage-to-GDP ratio and a narrowing of the fiscal deficit.

Box 2. The FY 2019/20 Budget

The FY 2019/20 budget, which aims for a near 4 percent of GDP consolidation, introduces several measures to bring the deficit in line with available resources. If implemented, the measures will reduce the level of arrears, align resource allocation with strategic priorities, and increase spending efficiency. Major elements of the budget include:

- The introduction of a 30 percent levy on tobacco and 15 percent levy on alcohol;
- A 30 cent per liter increase in the fuel levy;
- An increase in the VAT on telecommunications from 9 to 12 percent;
- Zero increase in civil service wages and a hiring freeze;
- An alignment of per diems with those used by the UN;
- Cuts to the number of international travel days and to the size of delegations.
- Elimination of the interest benefit provided on loans to parliamentarians and the possibility of loan write-off following a mid-term election.
- A M300 million public works program to provide 8,500 temporary jobs and internships.

	FY2018/19 Est.	FY2019/20 Budget	FY2019/20 Proj.
Revenue	**41.3**	**44.3**	**41.9**
Tax Revenue	18.8	19.2	19.1
Taxes on income, profits, and capital gain	10.5	10.5	10.4
Taxes on goods and services	8.2	8.8	8.8
Grants	2.8	2.5	2.5
Non-tax revenue	5.0	7.3	5.0
SACU	14.7	15.2	15.2
Expense	**35.4**	**32.8**	**34.0**
Compensation of employees	16.3	16.3	16.3
Use of goods and services	8.3	7.7	7.7
Interest payments	0.8	1.0	1.6
Subsidies	0.7	0.4	0.7
Grants	2.2	1.7	1.8
Social benefits	4.8	4.1	4.4
Other expenses	2.2	1.6	1.6
Nonfinancial assets	**11.1**	**12.6**	**11.3**
Net lending/borrowing	**-5.2**	**-1.2**	**-3.4**
Transactions in financial assets and liabilities	**-5.2**	**-1.2**	**-3.4**
Financial Assets	-0.4	3.9	1.6
Domestic	-0.4	3.9	1.6
Deposits	-0.4	3.9	1.6
Foreign	0.0	0.0	0.0
Financial Liabilities	4.7	5.0	5.0
Domestic	4.0	3.2	3.2
of which: Change in domestic arrears	0.6	0.0	0.0
Foreign	0.7	1.9	1.9

Sources: Country authorities and staff estimates.

13. **Absent a fiscal adjustment in 2019/20 the economy would face continued financing gaps and weakened medium-term growth prospects.** The expenditure cuts in the budget, while very much in line with previous Fund advice, have proven difficult to implement in the past. An alternate scenario includes additional wage and hiring pressures, and weak expenditure controls (Text table). Significantly higher deficits would prove difficult to finance, resulting in a possible reemergence of expenditure arrears, a continued drawdown of government deposits, and undesirable cuts to spending on social programs and capital investment.

[6] Staff have taken a more conservative stance on the projected FY 2019/20 fiscal outturn than the budget, assuming lower estimated returns on some measures, in particular those related to non-tax revenues as well as grant and social benefit spending, and higher interest payments.

Baseline scenario

	2018/19	2019/20	2020/21	2021/22
Real GDP (ex. LHWP-2)	2.7	0.7	1.9	2.3
Total revenue (percent GDP)	41.3	41.9	42.4	42.0
Recurrent expenditure (percent GDP)	35.4	34.0	33.6	33.3
Capital expenditure (percent GDP)	11.1	11.3	11.1	10.7
Fiscal balance (percent GDP)	-5.2	-3.4	-2.3	-2.0
Domestic arrears (percent GDP)	0.5	0.0	-0.5	-0.4
Public debt (percent GDP)	46.8	49.5	51.7	51.4
Current account (percent GDP, excluding LHWP-2)	-7.3	-4.2	-1.9	-1.3
Reserve coverage (months of imports, excluding LHWP-2)	3.5	3.4	3.4	3.3

Alternate scenario

	2018/19	2019/20	2020/21	2021/22
Real GDP (ex. LHWP-2)	2.7	1.2	1.4	0.3
Total revenue (percent GDP)	41.3	41.4	41.8	41.3
Recurrent expenditure (percent GDP)	35.4	35.5	35.9	35.7
Capital expenditure (percent GDP)	11.1	11.3	11.1	10.7
Fiscal balance (percent GDP)	-5.2	-5.4	-5.2	-5.1
Domestic arrears (percent GDP)	0.5	1.3	1.5	1.6
Public debt (percent GDP)	46.8	51.5	54.4	57.5
Current account (percent GDP, excluding LHWP-2)	-7.3	-5.8	-4.2	-3.8
Reserve coverage (months of imports, excluding LHWP-2)	3.5	2.7	2.2	1.6

Sources: Country authorities and staff estimates.

Authorities' Views

The authorities expressed their firm commitment to implementing the approved budget, noting that political consensus had been formed on the agreed measures, reflecting a widespread acknowledgement of the gravity of the country's macroeconomic situation.

Medium-Term Fiscal Objectives

14. The FY2019/20 budget represents a good step towards restoring fiscal and debt sustainability, but further reforms will be needed over the medium term to entrench stability and lay the foundation for more effective fiscal management. Reform of public sector employment will remain the overarching priority. With SACU revenues volatile and likely on a long-term downward trend, Lesotho cannot afford a wage bill-to-GDP ratio at current levels. In this context, it will be important to ensure that the proposed new measures in the budget to create a M300 million public works and internship program represent a temporary (two-year) arrangement, as currently envisaged. In addition to lowering salaries in real terms and controlling new hires, broader comprehensive civil service reforms are desirable, including improving payroll control and a review of establishment lists to match jobs to existing skills within the civil service, as well as to identify redundancies and overstaffing.[7] Over the longer term, the goal should be instituting a performance-based wage system.

15. Savings could also be generated by rationalizing expenditures in other areas. Costs have greatly outpaced projected demand under the PPP contract with the largest hospital, and there may be room to save funds by making greater use of local health facilities. An expensive tertiary student loan program costs around 2 percent of GDP and subsidizes the richest segment of the population. Many of the beneficiaries, study and remain in South Africa, while the majority of the rest work in the public sector in Lesotho. Loan repayment rates are extremely low.

16. While domestic revenue mobilization is relatively high, there is some room to broaden the tax base. In particular, eliminating special incentives such as discretionary reduced rates for mining royalties would provide a more level playing field for business. Addressing issues of profit shifting, removing the exemption for income related to life insurance, and introducing recurrent property taxes could also provide additional revenues without undue burden on the private sector.

17. Ensuring that the most vulnerable are protected from the impact of adjustment will require a stronger social safety net. The authorities are currently implementing a number of initiatives to enhance the coverage and efficiency of social protection schemes, with support from international donors (text table). Eliminating ghost pensioners and limiting access for individuals with a private pension is expected to increase the efficiency of the Old Age Pension, which is the largest component of the social safety net with a budget of M700 million. Data collection to extend the National Information System for Social Assistance (NISSA) to all rural areas is expected to be completed by April, which will support this process. The government is currently attempting to expand the Child Grant Programme (CGP), albeit at a slower pace than hoped. The CGP has the potential to be a very effective tool for protecting the most vulnerable from economic fluctuations. Its effectiveness could be enhanced through accelerating its expansion, increasing the size of the benefits, and integrating the program with the bursary scheme for secondary school students to reduce drop-out rates.

18. On current policies, Lesotho's risk of debt distress is assessed to be moderate, with some space to absorb shocks. The risk of external debt distress is being revised from "low" in the 2017 Article IV to "moderate", weaker GDP growth projections, arrears, expanded debt coverage and data revisions, and inclusion of large contingent liabilities (Annex III). The assessment highlights the importance of addressing underfunding of the pension fund, preserving a conservative debt management strategy – including continuing to rely on concessional external financing where available, and gradually developing the domestic debt market.

[7] Both the Fund and the World Bank have provided technical assistance on broader civil service reform.

Main Social Assistance Program
(As of end FY 17/18)

Program	Number of Beneficiaries	Target Group	Implementing Ministry	Budget (millions Maloti)	Percent of GDP
Old Age Pension	90,000	Universal to all above 70 not receiving civil service pension.	Finance	721	2.1
Child Grant Programme	30,000	Poor households with children under 18.	Social Development	58	0.2
Orphans and Vulnerable Children Bursary Programme	23,000	Orphan/vulnerable children under 18 enrolled in secondary school.	Social Development	61	0.2
Public Assistance	12,000	Poor under 70.	Social Development	63	0.2
School Feeding	400,000	All children attending primary school.	Education	180	0.5

Sources: Country authorities and staff estimates.

19. Over the medium-term, implementation of a fiscal rule could smooth volatility and entrench debt sustainability. A rule could facilitate efforts to i) preserve international reserves at desirable levels, ii) ensure long-term debt sustainability, and iii) mitigate the volatility resulting from SACU revenues.[8] However, given the weaknesses in public expenditure management and a complicated political environment, there will be a premium on simplicity and traction when designing the rule. Improvements in expenditure controls, budget credibility, and data reporting will be important preconditions for the establishment of an effective fiscal anchor.

Authorities' Views

The authorities noted their intention to bring down the wage bill as a share of GDP over the medium term, including by addressing workforce issues. They are also committed to cutting waste in government expenditures, and stressed that the FY2019/20 budget contains a number of measures to reduce non-priority expenses. They agreed with the importance of enhancing the social protection system, noting the ongoing initiatives to modernize the social grants systems underway at the Ministry of Social Development, with the support of the World Bank. The authorities concurred with the DSA and the "moderate" risk rating, and announced that they are considering introducing a fiscal rule.

Public Financial Management

20. Although some progress has been made since the last Article IV, Lesotho continues to suffer from PFM weaknesses. The authorities recently began enforcing the closure of monthly

[8] See "Fiscal Rules: Coping with Revenue Volatility in Lesotho and Swaziland", African Departmental Paper No.17/05 for a discussion of potential fiscal rules which could be appropriate for Lesotho. The report suggests that the use of a structural balance target could smooth the growth impact from revenue shocks while helping preserve reserve adequacy.

accounts, which has helped stabilize fiscal reporting. A newly-established Cash Management Unit is helping to better utilize cash balances and prepare warrant releases that reflect available resources. A planned April 2019 upgrade to the IFMIS offers potential for more rigorous and comprehensive financial management, but requires careful implementation to avoid problems during the transition. The following PFM areas also need urgent attention:

- *Arrears management.* A survey of arrears is needed to assess the size of the problem, and formulate a plan for arrears clearance.

- *Expenditure controls.* Lack of enforcement of expenditure discipline undermines budgetary and cash management. Line ministries should be incentivized to provide Treasury with monthly reconciled bank and payroll statements, as well as quarterly cash and procurement plans. This should also facilitate the avoidance of arrears going forward.

- *Budgeting processes.* Budgeting practices are often delayed, leaving little time to ensure that the proposed budget aligns with desired policy measures. More timely and reliable macroeconomic data and projections, drawing on recent IMF TA, would strengthen fiscal analysis and budget projections.

- *Bank reconciliation.* Attempts to ensure reconciliation of even current flows have not yet proved successful. It will be vital to ensure that reconciliation takes place after the adoption of the new IFMIS.

- *Debt management.* Stronger debt management capacity would help better match the government's financing needs with available sources of financing. This will involve careful assessment of market appetite during budget planning, and consideration of how best to access the potential demand from longer term institutional investors (Box 3), much of which is currently channeled to South Africa.

21. While there are technical solutions to the PFM issues identified above, progress will also require strong political consensus. A politicized environment undermines accountability and complicates efforts to ensure budget discipline and service delivery. It has, for example, proven difficult to impose sanctions on officials that approve procurement outside of proper budgetary channels, or failed to meet their reporting obligations.[9] Clarifying responsibilities and holding officials to account for results will be essential to improve public financial management.

Authorities' Views

The authorities noted that they have increased pressure on spending units to respond to the arrears survey. Month-end procedures by the Treasury are becoming a more regular practice, and measures are underway to extend the maturity of domestic debt issuances. However, the lack of compliance by spending units on reporting requirements complicates efforts to control spending. They noted the

[9] Principal Secretaries of Ministries are political appointees in Lesotho.

government's commitments under the SADC reform process to attain a more professional public service, including through strengthening of the Public Service Commission

Box 3. Developing the Domestic Debt Market

With external debt terms hardening, and SACU revenues lumpy and volatile, there is a need to develop domestic bond markets. While Lesotho is still eligible for concessional finance, it is facing increasingly hardened terms as its income has grown (e.g. it has now graduated to IDA blend terms). Domestic debt will offer a substitute financing source and reduce exposure to exchange rate risk present even in concessional external debt.

Demand is currently concentrated in shorter maturities and largely confined to the banking sector. The average bid-to-offer ratio between 2014 and 2017 was 2.4 for T-bills, while demand for longer-term bonds has tended to fall short. There is a need to expand the market beyond the commercial banks, whose asset profile steers them towards T-bills. Non-bank financial institutions account for around half of financial sector assets, a large proportion of which is invested abroad, and with very low exposure to domestic government bonds.

Measures could be considered to support market development:

- More frequent issuances than the current quarterly auctions could create more pricing reference points and facilitate cash and debt management.
- Issuance in South Africa could be investigated to take advantage of the larger supply of funds and greater liquidity of the Johannesburg Stock Exchange, while limiting exposure to exchange rate risk.
- A draft Pension Bill may impose domestic asset requirements on the industry. However, it will be important that any new framework does not hamper pension funds from optimizing their asset allocation. Better aligning the instruments offered with potential demand would be the preferred way to increase take-up.

B. Advancing Private Sector Growth and Human Capital Development

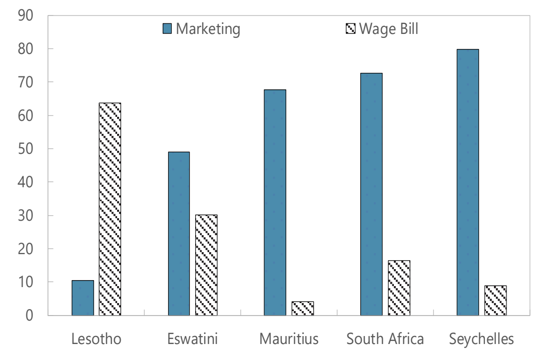
22. **With one-quarter of the labor force – and one-third of youths – unemployed, job creation is a key economic challenge facing Lesotho.** The new National Strategic Development Plan (NSDP-II) sets out an agenda for private sector led-growth, identifying tourism, agriculture, manufacturing, and technology and innovation as the key drivers of job creation. It envisages supporting measures to improve the business climate, governance, human capital, and infrastructure. Staff welcomes this approach, and notes the efforts underway to attract investment and diversify the export base. However, realizing Lesotho's full potential will require a significant transformation of the role of the public sector. In particular, the government must ensure that expenditures are aligned with policy goals; that the private sector is provided with a clear, transparent and stable policy environment, and that public services are provided in a transparent, equitable and efficient manner.

23. **Reorienting expenditures in favor of growth will require addressing the high public sector wage bill, which also distorts the skills available in the economy.** For example, 64 percent of the tourism development agency's budget goes toward wages, while only 11 percent is used for marketing, falling far below peer countries. In education, the wage bill grew from

69 percent of the recurrent ministerial budget in FY 2011/12 to 77 percent in 2016/17, while the School Feeding program declined from 12 to 8 percent. While the number of public employees in Lesotho is in line with peers, the wage premium, particularly the 60 percent premium for highly-educated workers, is a drag on private sector employment. The high wage bill discourages the acquisition of skills relevant to the private sector, resulting in a significant pool of unemployed graduates. At the same time, only 10 percent of secondary students are able to benefit from scholarships covering tuition, books and boarding, resulting in many students dropping out due to financial constraints (Figure 3).

Marketing and Wage Bill in Tourism Promotion Agencies

(Percent)



Sources: Country authorities and staff estimates.

24. Private sector growth will also be strongest in the context of policy stability, where new regulations are considered carefully prior to implementation. The introduction of a wool and mohair licensing requirement has proved disruptive for farmers (Box 4). In mining, the authorities are creating a new regulatory authority and considering additional regulations to increase domestic beneficiation. Staff agrees on the importance of an independent, well-resourced agency that can effectively regulate the industry and limit political interference and governance concerns. However, further regulations aimed at increasing domestic beneficiation need to be discussed with stakeholders, and only implemented on the basis of a careful study of the technical and economic feasibility.

Box 4. Wool and Mohair Licensing Regulations

Lesotho's wool and mohair were traditionally auctioned in South Africa. Around 100,000 farmers own sheep and goats in Lesotho, producing around USD 30 million per year in wool and mohair. The farmers are mostly located in the highlands and, for many of them, wool and mohair are their major source of livelihood. Historically, after the wool and mohair was sheared in government or association-operated sheds, it was shipped to Port Elizabeth, to be auctioned through a South African broker.

In 2018, the authorities introduced new licensing requirements to trade wool and mohair. Only licensed agents may now export wool and mohair produced in Lesotho and obtaining such a license requires an extremely large storage facility, which constitutes a significant barrier to entry. Only one company has secured a license, creating a de-facto monopsony through whom farmers have to market their production. The authorities have, however, noted that other companies have expressed interest in applying for licenses.

While the full effect of the regulations remains to be seen, farmers have expressed strong opposition. The authorities noted that farmers will benefit from lower transportation costs and brokering commissions under the new regulations. They also noted that additional beneficiation will take place in Lesotho, including warehousing and marketing. However, mohair farmers have reported long delays in receiving payments, and a lack of transparency in pricing and payments.

25. The need for policy certainty also extends to industrial relations. In the textile industry, the government intervened in the conflict between workers and employers in mid-2018, mandating a 67 percent increment that was later reversed in court. The resulting unrest reportedly led to the suspension of two large investment projects. The authorities should provide a stable and flexible framework for industrial negotiations. There is also room to enhance the wage determination process (Annex IV).

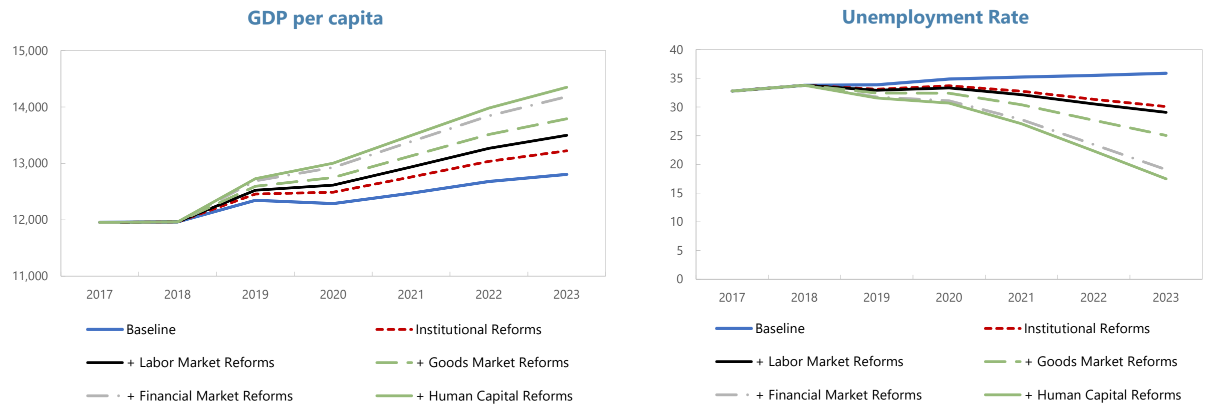
26. Government intervention should focus on addressing market failures, enhancing competition, and time-limited programs to support innovation. While the government has attempted to drive growth through the Lesotho National Development Corporation (LNDC, whose mandate is focused on inward and large-scale investment) and the Basotho Enterprises Development Corporation (BEDCO, which focuses on SMEs), governance concerns, instability, and an unwillingness to cut off support from underperforming endeavors has at times undermined their objectives. In the last decade, the LNDC has had 7 different heads, and is currently being restructured in line with World Bank advice. BEDCO has maintained some of the same companies in its incubators for decades. The government should divest from businesses that have already prospered, or where underperformance has been chronic, for example through privatization. The authorities should be cautious in ensuring that the latest support programs for entrepreneurs announced in the FY 2019/20 budget do not replicate the challenges described above.

27. Business climate reforms must include strengthening the fight against corruption. The private sector considers corruption a major obstacle for doing business (Annex IV). The Directorate on Corruption and Economic Offences (DCEO) is implementing an asset declaration for public servants, and Cabinet is considering a new anti-corruption bill that would increase the independence of the DCEO. While staff welcomes these reforms and urges their timely implementation, it is also important to improve the collaboration between the DCEO and the Directorate of Public Prosecutions with a view to ensuring that prosecutions take place expeditiously.

28. Structural reforms could result in a significant payoff in terms of jobs and growth. Staff estimates suggest that the measures discussed to facilitate business, promote competition, and review spending inefficiencies in health and education could, if combined with the financial sector reforms discussed below, raise GDP per capita by over 10 percent over the medium term.[10] They could also have a significant impact on unemployment. In the short term, the largest share of the gains would come from a better business environment, while labor market, goods market, and financial markets reforms would also contribute (Annex IV). Over the long-term human capital reforms, such as containing HIV and improving the quality of primary education, could drive higher growth.

[10] The elasticities of growth and unemployment to a series of reforms were estimated using a panel regression. The resulting coefficients are then used to calculate the potential impact of Lesotho moving to the 75th percentile of the sample of developing and emerging economies.

Impact of Structural Reforms in Lesotho



Source: Staff estimates.

Authorities' Views

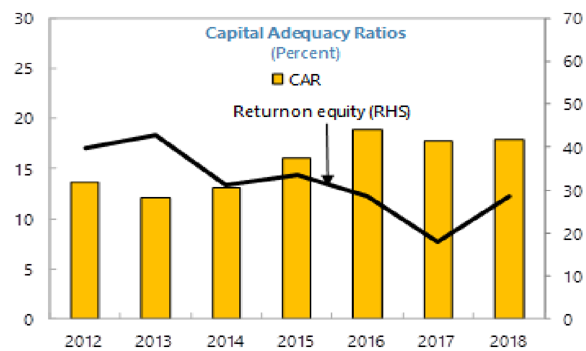
The authorities agreed that competition is a key driver of growth, but considered that regulations may be justified in the short run to induce domestic beneficiation. They noted their intention to consider additional licenses in the wool and mohair sector. The authorities expressed their commitment to consult stakeholders on reforms to the mining regulatory framework and noted their goal of limiting discretionary powers in setting royalties. They reiterated their commitment to fighting corruption. They noted that increasing private sector participation in SOEs is being considered, which could boost the Maseru Securities Market and the domestic capital market. They recently announced the creation of an investment lab, which will seek out and facilitate greater private sector investment, and an apprenticeship strategy to address the skills needs of industry.

C. Increasing Financial Sector Stability and Inclusion

29. While the banking system is sound and profitable, indebted households and concentration risks require close monitoring. Profitability remains high, driven by significant intermediation margins with returns on equity in the range of 28 percent as of December 2018. Bank lending is highly concentrated, with the ratio of large exposures to capital of some banks reaching 220 percent. The credit bureau considerably improved information availability, but currently only covers information from formal financial

Capital Adequacy Ratios

(Percent)



Sources: IMF Financial Soundness Indicators and IMF staff.
Note: The minimum CAR is 8%.

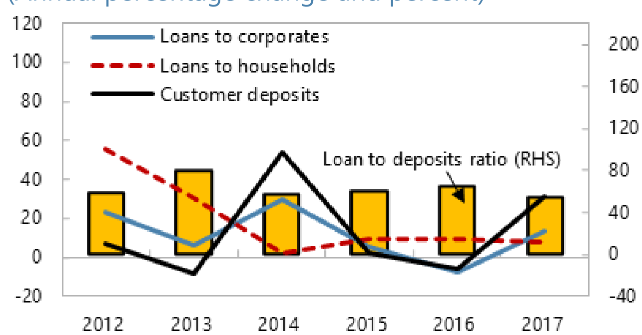
institutions on households.[11] Since household borrowing from informal sources is unobserved, banks may not have a full picture of household indebtedness.

30. Progress has been made on the frameworks for AML/CFT supervision of financial institutions, but strong enforcement will be necessary. Lesotho has taken a number of steps to strengthen its Anti-Money Laundering and Combating the Financing of Terrorism (AML/CFT) framework in line with Fund TA. However, the recent national assessment identified AML/CFT supervision of financial institutions and Designated Non-Financial Businesses and Professions (DNFBPs) as a major vulnerability and there have been no prosecuted case so far. To intensify AML/CFT supervision, Lesotho's Financial Intelligence Unit (FIU) should be independent and adequately resourced. Supervisory arrangements between the CBL and the FIU should be clear and streamlined. Demonstrating effective implementation will be essential ahead of the next assessment by the FATF regional body.

31. The banking system's contribution to growth remains limited. Credit to the private sector has remained stagnant at about 17 percent of GDP in the past five years, well below income group peers. To improve access to formal credit, structural reforms are necessary. The lack of bankable projects, high credit costs, inadequate legal frameworks and processes to settle financial disputes and property rights all contribute to anemic levels of credit to the private sector, with corporate lending concentrated in the few larger firms. The passage of the two bills on *Security Interest and Movable Property* and *Insolvency* are a good step towards resolving some of these issues. However, current land registries, property rights and lengthy financial dispute settlements render collateralized lending de facto uncollateralized. With settlements taking years and losses being recognized as per IFRS 9 long before the collateral can be claimed, banks are hesitant to extend further credit to the private sector.

Loans and Deposit Growth

(Annual percentage change and percent)



Sources: IMF Financial Soundness Indicators and IMF staff.

32. Strengthening regulatory frameworks for pension funds and financial cooperatives must be a priority to contain risks and protect the poorest (Annex V). NBFIs[12] in Lesotho represent almost half of the country's financial system, excluding the CBL. The authorities noted that the *Pensions Bill* is expected to be passed by Parliament in 2019. However, delays in the approval of

[11] Information on indebtedness of businesses is not included in the credit bureau. Also, ongoing efforts to include MFIs and money lenders should be finalized.

[12] NBFI include all financial institutions operating in Lesotho except for banks: Financial cooperatives, insurance corporations, pension funds, money market funds (MMF) and non MMF investment funds (referred to as collective investment schemes), microfinance institutions, asset management companies, brokers and money lenders.

the Financial Cooperative Bill continue to leave financial cooperatives[13] inadequately supervised. The largest financial cooperative, Boliba, exists in a regulatory limbo, continuing to accept deposits despite governance concerns, while the disclosure of 2017 and 2018 audits is still pending. The passage of the *Financial Cooperative Bill* will provide the Ministry of Small Business Development, Cooperatives, and Marketing (MoSBDCM) with more powers to address troubled financial cooperatives, but capacity constraints may limit the effectiveness of supervision. Instead, transferring supervisory powers over all deposit-taking financial institutions to the CBL would be a better approach. This way, structural issues could be addressed, and financial cooperatives could potentially enhance financial inclusion.

Authorities' Views

The authorities noted that credit concentration is closely monitored and within stipulated prudential limits. The authorities are extending the credit bureau to include information on informal lenders by licensing them as MFI. There is progress in NBFI supervision towards the implementation of the risk based supervisory approach. The establishment of Boliba's new committee was noted as a milestone in addressing governance issues. The authorities stressed the importance of developing the secondary market for government debt, and requested additional technical assistance.

OTHER SURVEILLANCE ISSUES

33. While data are broadly adequate for surveillance, there remains room to enhance data transparency and reliability. In addition to the PFM issues noted above, which constitute the key priority area for capacity development (see Annex VI), there are several data issues that require attention:

- Strengthening national account statistics is a priority which should be institutionalized through MOUs among government units. TA recommendations on national accounts should be implemented.
- Coverage of the fiscal data should be expanded to include the largest extra budgetary units. In addition, contingent liabilities and guarantees of extra-budgetary funds should be included in debt reports. Guarantees should also be fully and transparently disclosed.
- To improve financial surveillance, the coverage of monetary and financial statistics should be expanded to include the NBFIs' financial accounts. TA recommendations on monetary and financial statistics should be implemented within the agreed target completion dates.

[13] The *Financial Institution Regulation* stipulates in Article 4, section 1, that financial cooperatives with total deposits or assets equal to or more than 5 million maloti should apply for a license to the CBL to operate. Financial cooperatives below this threshold remain with the MoSBDCM.

Authorities' Views

The authorities agreed on the importance of institutionalizing data sharing arrangements and supporting compilation of national accounts. They noted ongoing improvements in the recording of fiscal guarantees.

STAFF APPRAISAL

34. **The prospect of permanently lower SACU revenues presents Lesotho with both a challenge and an opportunity.** Buoyant inflows over the past years were used to finance the creation of a large public sector. Yet this public sector has provided too little in the way of public goods. With government wages and benefits, travel, and generous tertiary education allowances consuming so much of the budget, outcomes in health, education, and infrastructure remain inadequate. Now with buffers depleted, the pension fund underfunded, and debt assessed as at moderate risk of distress, an adjustment is needed to allow for the clearance of payment arrears, buttress debt sustainability and international reserves, and strengthen the external position.

35. **A fiscal adjustment should not just restore macroeconomic sustainability, but also lay the groundwork for stronger and more inclusive growth.** A gradual reduction in the wage bill will encourage private sector labor force participation and will free up resources to support the priorities of the NSDP-II. In this context, a large public works and internship program could be a step backwards. Addressing PFM deficiencies and a selective broadening of the tax base, complemented by improvements to tax administration, will reduce arrears while easing the burden of adjustment. Improving efficiency in health and education can support better outcomes at a lower cost to the fiscus. Improving debt management, maintaining a cautious approach to external debt contraction, and addressing contingent liabilities such as that of the public-sector pension fund will complement the fiscal consolidation and underpin debt sustainability.

36. **As well as reorienting expenditures in support of growth, the government should take measures to strengthen the business climate.** A stable regulatory framework is critical to attract investment. Existing licensing requirements could be re-evaluated, implementation of disruptive new regulations avoided, and early and regular consultation with the private sector could limit uncertainty. Government intervention in the economy should seek to address market failures while promoting competition and efficiency, and avoid creating new monopolies and opportunities for rent-seeking.

37. **The authorities' agenda to enhance the financial sector's contribution to growth should be enacted expeditiously.** The passage of the draft bills on *Security Interest and Movable Property* and *Insolvency* will be an important step in ensuring that the sector can provide the support necessary for structural reforms to bear fruit. Strong enforcement of the AML/CFT framework will demonstrate that the regulatory regime is in line with good international practice. Legislation to improve the regulation of the non-bank financial sector is needed to underpin the financial inclusion agenda.

38. The FY2019/2020 budget contains many positive elements that should help to restore fiscal, and hence external, stability. However, consistent and rigorous implementation will be key to ensure that the envisaged measures are fully effected. Moreover, it should be one element in a series of broader reforms that can allow Lesotho to fulfil its potential and attain higher and more inclusive growth for its population.

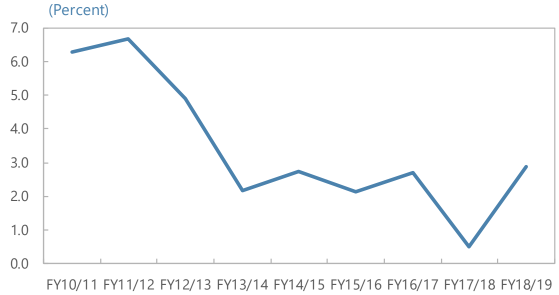
39. Staff recommends that the next Article IV consultation for Lesotho be held on the standard 12-month cycle.[14]

[14] An assessment of the implementation of the previous Article IV recommendations can be found in Annex VII.

Figure 1. Lesotho: Recent Economic Developments

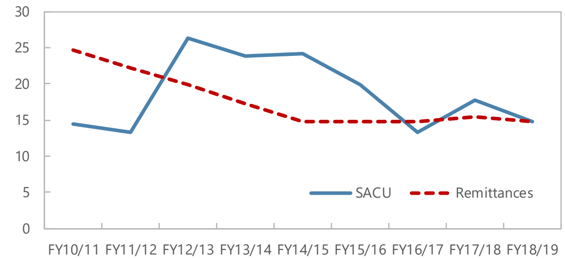
Lesotho's economy has slowed in recent years…

Real GDP Growth
(Percent)



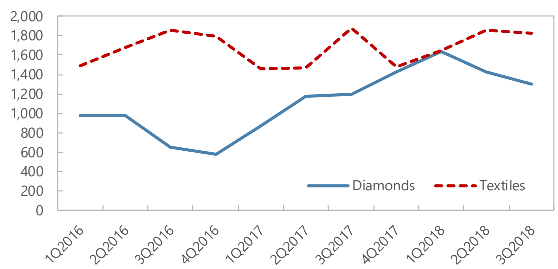
… while spillovers from South Africa have taken the form of lower SACU revenues and remittances.

SACU Revenues and Remittances
(Percent of GDP)



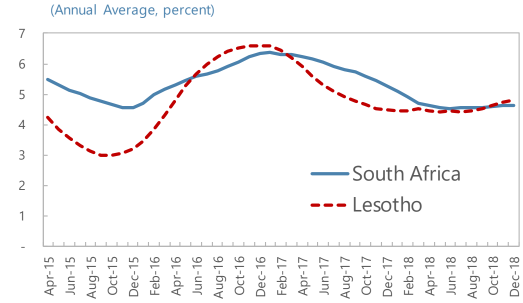
`While there are positive developments in mining and textiles…

Exports of Diamonds and Textiles
(Million Maloti)



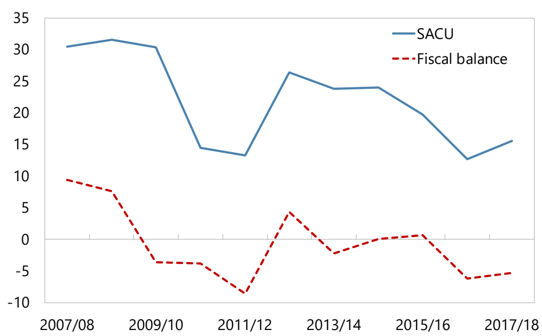
… and inflation remains subdued.

Consumer Price Index
(Annual Average, percent)



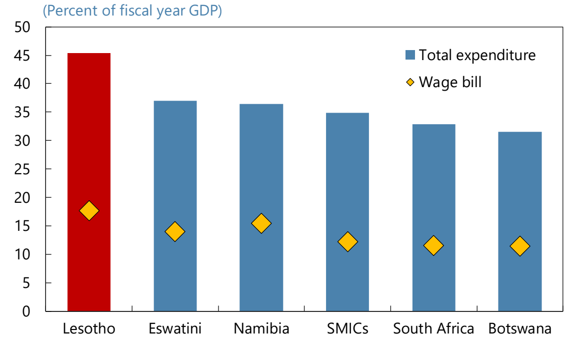
Declines in SACU revenue have driven fiscal imbalances…

SACU Revenue and Fiscal Balance
(Percent GDP)



…resulting from high structural expenditures.

Total Expenditure and Wage Bill, 2017
(Percent of fiscal year GDP)

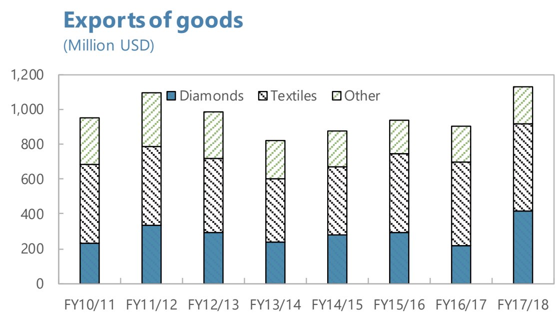


Sources: Country authorities and staff estimates.
Note: SMICs include Botswana, Cabo Verde, Lesotho, Mauritius, Namibia, Seychelles, and Eswatini.

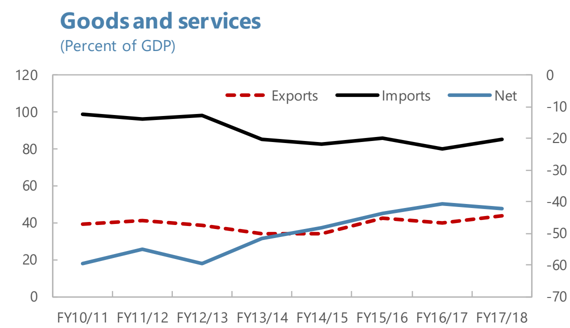
Sources: Country authorities, WDI, and staff estimates.

Figure 2. Lesotho: External Imbalances

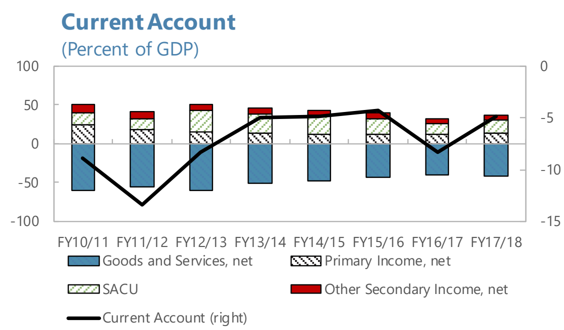
Exports rose, driven by diamonds and textiles…



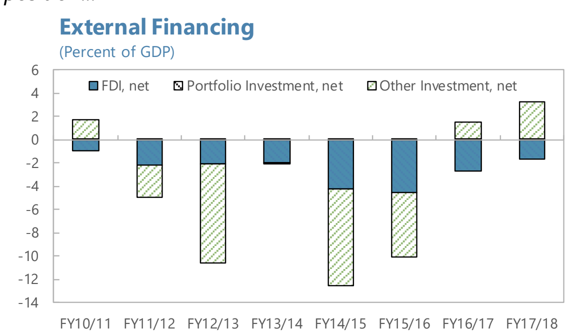
… but high imports offset the impact on the trade balance.



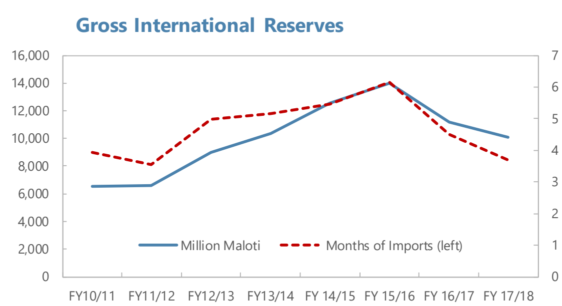
Temporarily higher SACU revenues improved the current account deficit…



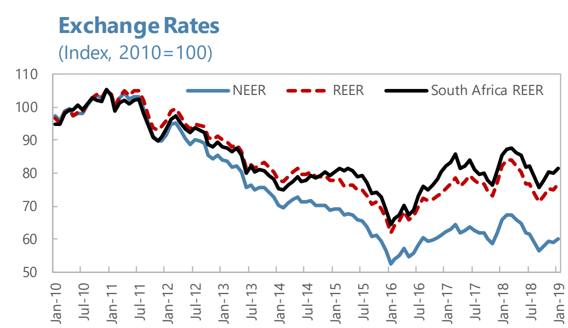
… but lower FDI and increased banks' net foreign position…



… continued to deteriorate the external position…



… while real exchange rate dynamics mirror those in South Africa.

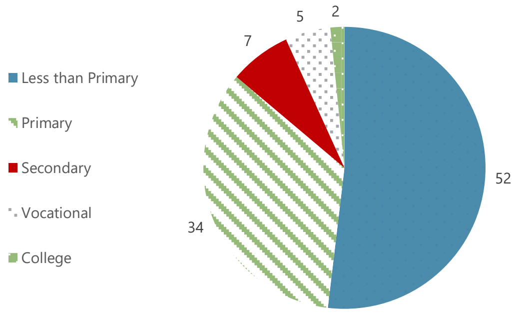


Sources: Country authorities and staff estimates.

Figure 3. Lesotho: Inefficient Expenditure Explains Weak Educational Outcomes

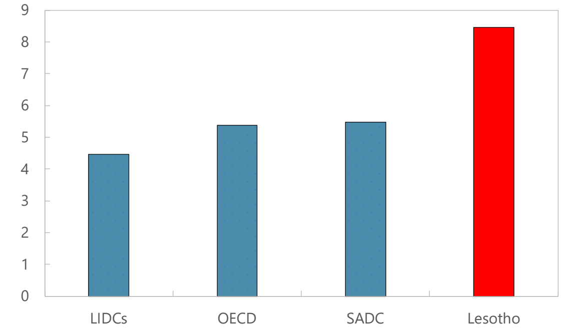
Over 85 percent of Lesotho's labor force has at most a primary education…

Educational attainment of the labor force
(Percent)



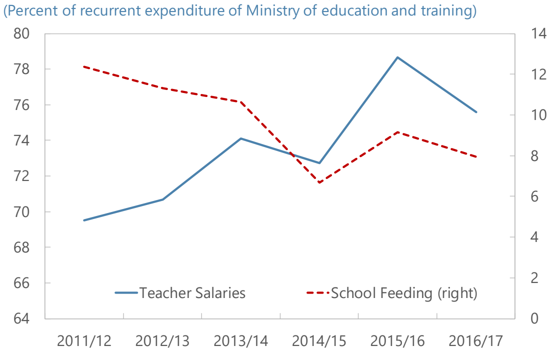
… despite large expenditure in education…

Government expenditure on education
(Percent of GDP)



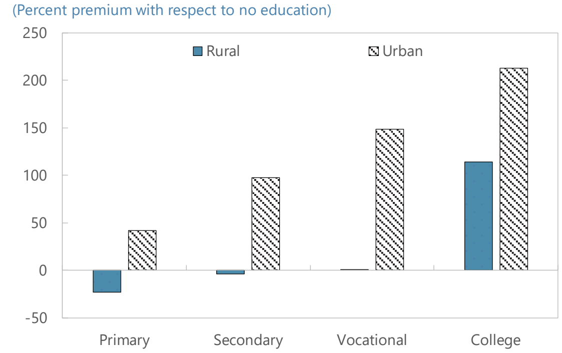
… where the large wage bill crowds out other expenditures.

Teacher salaries and school feeding
(Percent of recurrent expenditure of Ministry of education and training)



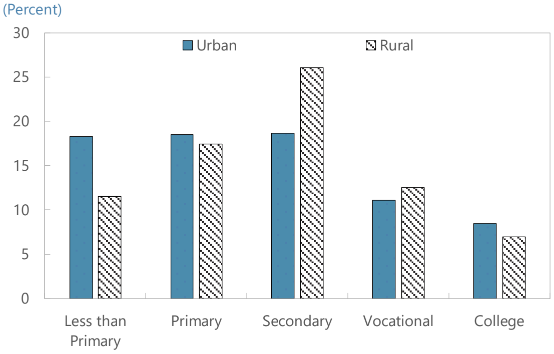
While there are large returns to education…

Returns to Education
(Percent premium with respect to no education)



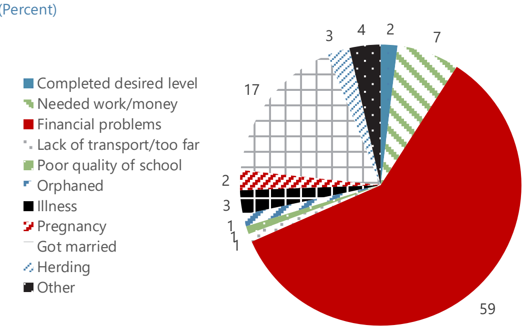
… and lower unemployment incidence in urban areas,

Unemployment rate by educational attainment
(Percent)



… students drop out because of financial constraints.

Reasons for dropping out of secondary school
(Percent)

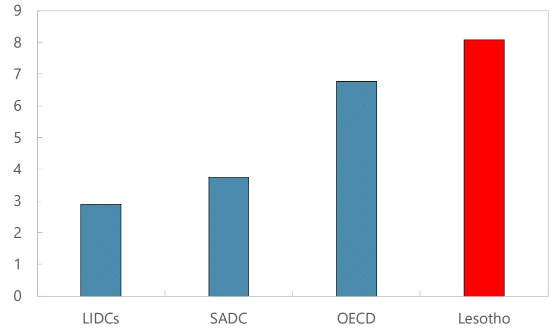


Sources: Country authorities, WDI, and staff estimates.

Figure 4. Lesotho: Inefficient Expenditure Explains Weak Health Outcomes

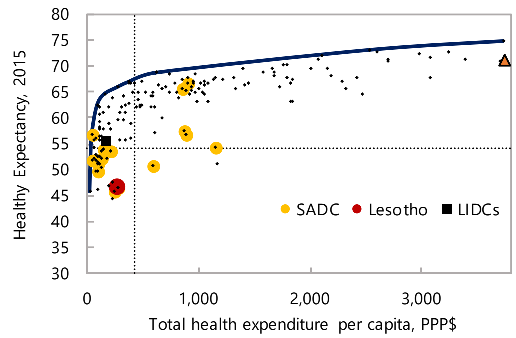
Lesotho's health expenditure is relatively high…

Government expenditure on health
(Percent of GDP)



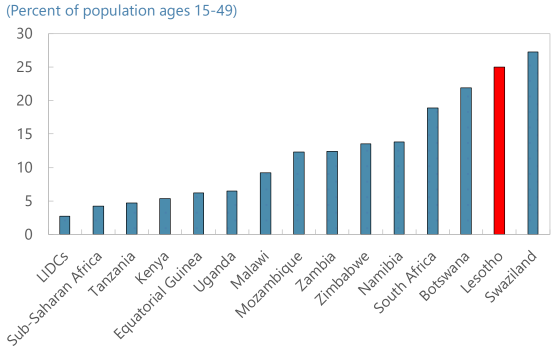
… but is inefficient.

Health Efficiency Frontier



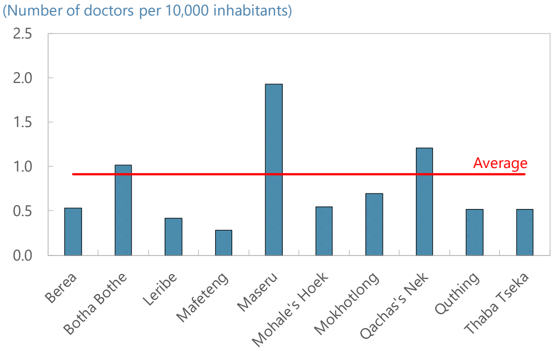
While weak outcomes are partially explained by one of the highest HIV prevalence in the world…

HIV prevalence
(Percent of population ages 15-49)



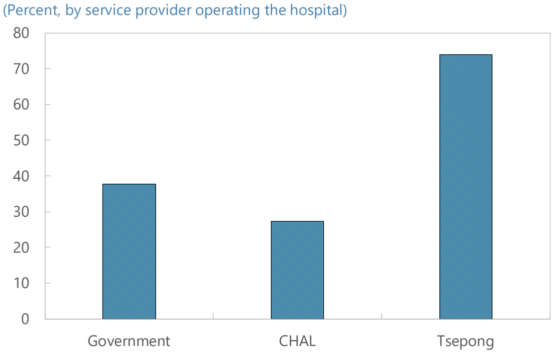
… they also reflect unbalanced distribution of resources…

Distribution of doctors per district
(Number of doctors per 10,000 inhabitants)



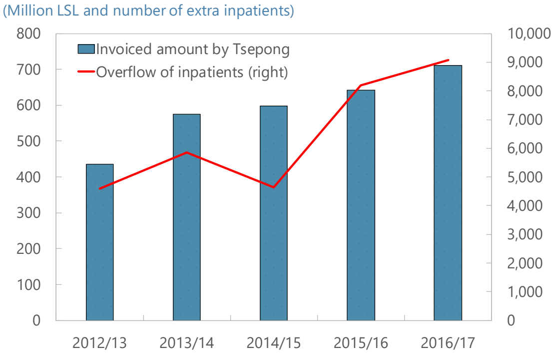
… and weak incentives for some private-sector providers…

Bed occupancy rate in secondary and tertiary hospitals
(Percent, by service provider operating the hospital)



… that have led to massive overruns in the PPP hospital.

Overflow and costs in Tsepong-operated hospital
(Million LSL and number of extra inpatients)



Sources: Country authorities, World Bank, IMF FAD Expenditure Assessment Tool (EAT), and staff estimates.

Table 1. Lesotho: Selected Economic Indicators, 2015/16–2023/24[1]

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

	2015/16	2016/17	2017/18	2018/19	2019/20	2020/21	2021/22	2022/23	2023/24
	Act.	Act.	Est.	Projections					
	(12-month percent change, unless otherwise indicated)								
National account and prices									
GDP at constant prices	2.1	2.7	0.5	2.9	3.1	-0.2	3.6	4.2	1.4
GDP at constant prices (exc. LHWP-2 project)	2.1	2.7	0.5	2.7	0.7	1.9	2.3	2.5	3.0
GDP at market prices (billions Maloti)	32.1	34.1	34.8	37.6	41.0	43.4	47.3	51.9	55.6
Consumer prices (average)	4.3	6.2	4.5	4.8	5.9	5.7	5.5	5.5	5.5
Consumer prices (eop)	7.5	4.4	4.9	4.9	6.0	5.6	5.5	5.5	5.5
GDP deflator	7.7	3.5	1.6	4.9	5.7	6.1	5.3	5.2	5.7
External sector									
Terms of trade (deterioration -)	12.8	-3.9	0.4	-0.7	1.5	0.4	0.4	0.4	0.3
Average exchange rate									
(Local currency per U.S. dollar)	13.8	14.1	13.0	...	...	...	...	...	...
Nominal effective exchange rate change (– = depreciation)[2]	-8.9	-11.1	8.2	...	...	...	...	...	...
Real effective exchange rate (– = depreciation)[2]	-6.8	-6.8	11.4	...	...	...	...	...	...
Current account balance									
(Including official transfers, percent of GDP)	-4.3	-8.4	-4.8	-8.4	-14.2	-4.8	-9.1	-15.6	-9.2
Current account (exc. LHWP-2 project, percent of GDP)	-4.1	-7.9	-4.2	-7.3	-4.2	-1.9	-1.3	-1.2	-0.9
Gross international reserves									
(Months of imports, excluding imports for LHWP-2)	6.2	4.5	3.7	3.5	3.4	3.4	3.3	3.2	3.2
Money and credit									
Domestic credit to the private sector	8.2	5.8	8.3	9.6	8.7	11.0	...	...	...
Reserve money	22.7	3.1	9.0	3.5	4.5	8.8	...	...	...
Broad money	6.4	8.8	17.4	6.1	3.9	5.9	...	...	...
Interest rate (percent)[3]	6.3	7.0	7.0	...	...	...	...	...	...
	(in percent of GDP)								
Public debt	43.2	37.6	38.8	46.8	49.5	51.7	51.4	50.7	51.1
External public debt	38.7	33.1	30.7	36.1	36.1	36.5	35.7	34.7	34.8
Domestic public debt	4.6	4.5	8.2	10.7	13.4	15.2	15.7	15.9	16.3
Central government fiscal operations									
Revenue and grants	47.8	41.3	42.9	41.3	41.9	42.4	42.0	41.8	41.7
Of which: SACU revenue	20.0	13.3	17.7	14.7	15.2	15.9	15.6	15.4	15.4
Of which: grants	3.0	3.6	2.4	2.8	2.5	2.5	2.4	2.4	2.4
Recurrent expenditure	35.9	37.1	36.7	35.4	34.0	33.6	33.3	32.9	32.8
of which: wages, including social contributions	15.4	15.5	15.6	16.3	16.3	16.0	15.7	15.3	15.2
Capital expenditure	13.1	12.2	9.6	11.1	11.3	11.1	10.7	10.3	10.2
Overall balance	-1.2	-8.0	-3.4	-5.2	-3.4	-2.3	-2.0	-1.4	-1.3
(Excluding grants)	-4.2	-11.6	-5.8	-7.9	-5.9	-4.7	-4.4	-3.8	-3.6
Statistical discrepancy/Arrears	2.8	0.1	2.9	0.5	0.0	-0.5	-0.4	-0.4	-0.4

Sources: Lesotho authorities, World Bank, and IMF staff estimates and projections.

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

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

[3] 12-month time deposits rate.

Table 2a. Lesotho: Fiscal Operations of the Central Government, 2015/26–2023/24[1,2]

(In millions of Maloti)

	2015/16	2016/17	2017/18	2018/19	2019/20	2020/21	2021/22	2022/23	2023/24
	Act.	Act.	Act.	Projections					
Revenue	15,321	14,052	14,914	15,534	17,150	18,408	19,891	21,707	23,209
Tax revenue [3]	6,328	6,397	6,314	7,057	7,839	8,253	8,958	9,854	10,544
Taxes on income, profits, and capital gain	3,644	3,726	3,487	3,960	4,240	4,442	4,798	5,245	5,602
Taxes on property	0	0	0	0	0	0	0	50	54
Taxes on goods and services	2,683	2,669	2,826	3,097	3,598	3,810	4,158	4,558	4,887
Taxes on international trade	0	0	0	0	0	0	0	0	0
Grants	966	1,229	822	1,047	1,023	1,072	1,150	1,241	1,316
Budget support	15	368	211	212	213	214	214	215	215
Project grants	952	862	611	835	810	858	936	1,026	1,100
Non-tax revenue	1,628	1,906	1,624	1,891	2,062	2,183	2,383	2,612	2,800
Property Income	699	851	544	754	822	871	950	1,042	1,117
Sales of goods and services	916	1,041	1,070	1,124	1,225	1,297	1,416	1,552	1,664
Other non-tax revenue	13	15	10	13	14	15	17	18	19
SACU	6,399	4,519	6,154	5,538	6,226	6,900	7,400	8,000	8,550
Expense	11,514	12,623	12,770	13,290	13,925	14,575	15,767	17,062	18,273
Compensation of employees	4,930	5,277	5,436	6,141	6,675	6,933	7,425	7,954	8,469
Wages and salaries	4,592	4,884	4,933	5,596	6,154	6,386	6,834	7,313	7,788
Social contributions	338	393	503	545	522	547	591	641	681
Use of goods and services	2,920	3,466	3,323	3,114	3,149	3,193	3,433	3,690	3,967
Interest payments	267	247	327	313	649	833	963	1,092	1,200
Domestic	76	38	113	116	384	542	657	772	848
External	191	209	214	197	265	290	307	320	352
Subsidies	251	415	310	280	280	297	324	355	381
Grants	1,106	1,258	1,112	827	730	773	844	925	991
Social benefits	1,354	1,415	1,568	1,792	1,794	1,860	2,030	2,225	2,385
Other expenses	687	544	693	821	648	686	748	820	880
Gross operating balance	3,807	1,429	2,145	2,244	3,225	3,834	4,124	4,646	4,937
Nonfinancial assets	4,195	4,158	3,343	4,180	4,624	4,814	5,079	5,366	5,651
Domestically financed	2,570	2,702	2,260	2,408	2,480	2,626	2,866	3,142	3,369
Externally financed	1,624	1,456	1,083	1,572	2,144	2,288	2,412	2,624	2,882
Net lending(+)/borrowing (-) (Overall fiscal balance)	-388	-2,729	-1,198	-1,936	-1,399	-981	-955	-720	-714
Transactions in financial assets and liabilities	-1,270	-2,750	-657	-1,936	-1,399	-981	-955	-720	-714
Financial assets	-734	-2,554	289	-155	666	730	513	737	863
Domestic	-734	-2,554	289	-155	666	730	513	737	863
Deposits	-734	-2,570	270	-155	666	730	513	737	863
Central bank	-775	-2,536	281	-155	666	730	513	737	863
Commercial banks	41	-34	-11	0	0	0	0	0	0
Loans	0	16	19	0	0	0	0	0	0
Financial liabilities	536	196	945	1,781	2,065	1,710	1,467	1,457	1,577
Domestic	408	41	888	1,500	1,300	900	700	700	800
of which: Change in domestic arrears	0	0	700	200	0	-200	-200	-200	-200
Foreign	128	155	57	281	765	810	767	757	777
Disbursements	673	595	472	769	1,400	1,430	1,476	1,597	1,782
Amortization	-434	-388	-415	-456	-569	-620	-709	-840	-1,005
Statistical discrepancy	882	21	-542	0	0	0	0	0	0

Sources: Lesotho authorities and IMF staff estimates and projections.

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

[2] Data for 17/18 and 18/19 are presented on a modified cash basis to correctly reflect current year expenses.

[3] Other taxes are not shown in the table.

Table 2b. Lesotho: Fiscal Operations of the Central Government, 2015/16–2023/24[1,2]

(Percent of GDP)

	2015/16	2016/17	2017/18	2018/19	2019/20	2020/21	2021/22	2022/23	2023/24
	Act.	Act.	Act.	Projections					
Revenue	47.8	41.3	42.9	41.3	41.9	42.4	42.0	41.8	41.7
Tax revenue[3]	19.7	18.8	18.1	18.8	19.1	19.0	18.9	19.0	19.0
Taxes on income, profits, and capital gain	11.4	10.9	10.0	10.5	10.4	10.2	10.1	10.1	10.1
Taxes on property	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.1	0.1
Taxes on goods and services	8.4	7.8	8.1	8.2	8.8	8.8	8.8	8.8	8.8
Taxes on international trade	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Grants	3.0	3.6	2.4	2.8	2.5	2.5	2.4	2.4	2.4
Budget Support	0.0	1.1	0.6	0.6	0.5	0.5	0.5	0.4	0.4
Project grants	3.0	2.5	1.8	2.2	2.0	2.0	2.0	2.0	2.0
Non-tax revenue	5.1	5.6	4.7	5.0	5.0	5.0	5.0	5.0	5.0
Property income	2.2	2.5	1.6	2.0	2.0	2.0	2.0	2.0	2.0
Sales of goods and services	2.9	3.1	3.1	3.0	3.0	3.0	3.0	3.0	3.0
Other non-tax revenue	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
SACU	20.0	13.3	17.7	14.7	15.2	15.9	15.6	15.4	15.4
Expense	35.9	37.1	36.7	35.4	34.0	33.6	33.3	32.9	32.8
Compensation of employees	15.4	15.5	15.6	16.3	16.3	16.0	15.7	15.3	15.2
Wages and salaries	14.3	14.3	14.2	14.9	15.0	14.7	14.4	14.1	14.0
Social contributions	1.1	1.2	1.4	1.5	1.3	1.3	1.2	1.2	1.2
Use of goods and services	9.1	10.2	9.5	8.3	7.7	7.4	7.3	7.1	7.1
Interest payments	0.8	0.7	0.9	0.8	1.6	1.9	2.0	2.1	2.2
Domestic	0.2	0.1	0.3	0.3	0.9	1.3	1.4	1.5	1.5
External	0.6	0.6	0.6	0.5	0.6	0.7	0.6	0.6	0.6
Subsidies	0.8	1.2	0.9	0.7	0.7	0.7	0.7	0.7	0.7
Grants	3.4	3.7	3.2	2.2	1.8	1.8	1.8	1.8	1.8
Social benefits	4.2	4.2	4.5	4.8	4.4	4.3	4.3	4.3	4.3
Other expenses	2.1	1.6	2.0	2.2	1.6	1.6	1.6	1.6	1.6
Gross operating balance	11.9	4.2	6.2	6.0	7.9	8.8	8.7	9.0	8.9
Non-financial assets	13.1	12.2	9.6	11.1	11.3	11.1	10.7	10.3	10.2
Domestically financed	8.0	7.9	6.5	6.4	6.1	6.1	6.1	6.1	6.1
Externally financed	5.1	4.3	3.1	4.2	5.2	5.3	5.1	5.1	5.2
Net lending(+)/borrowing (-) (Overall fiscal balance)	-1.2	-8.0	-3.4	-5.2	-3.4	-2.3	-2.0	-1.4	-1.3
Transactions in financial assets and liabilities	-4.0	-8.1	-1.9	-5.2	-3.4	-2.3	-2.0	-1.4	-1.3
Financial assets	-2.3	-7.5	0.8	-0.4	1.6	1.7	1.1	1.4	1.6
Domestic	-2.3	-7.5	0.8	-0.4	1.6	1.7	1.1	1.4	1.6
Deposits	-2.3	-7.5	0.8	-0.4	1.6	1.7	1.1	1.4	1.6
Central bank	-2.4	-7.4	0.8	-0.4	1.6	1.7	1.1	1.4	1.6
Commercial banks	0.1	-0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Loans	0.0	0.0	0.1	0.0	0.0	0.0	0.0	0.0	0.0
Financial liabilities	1.7	0.6	2.7	4.7	5.0	3.9	3.1	2.8	2.8
Domestic	1.3	0.1	2.6	4.0	3.2	2.1	1.5	1.3	1.4
of which: Change in domestic arrears	0.0	0.0	2.0	0.5	0.0	-0.5	-0.4	-0.4	-0.4
Foreign	0.4	0.5	0.2	0.7	1.9	1.9	1.6	1.5	1.4
Disbursements	2.1	1.7	1.4	2.0	3.4	3.3	3.1	3.1	3.2
Amortization	-1.4	-1.1	-1.2	-1.2	-1.4	-1.4	-1.5	-1.6	-1.8
Statistical discrepancy	2.8	0.1	0.9	0.0	0.0	0.0	0.0	0.0	0.0

Sources: Lesotho authorities and IMF staff estimates and projections.

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

[2] Data for 17/18 and 18/19 are presented on a modified cash basis to correctly reflect current year expenses.

[3] Other taxes are not shown in the table.

Table 3. Lesotho: Monetary Accounts, 2015/16–2020/21[1,2]

(Maloti millions, unless otherwise indicated)

	2015/16	2016/17	2017/18	2018/19	2019/20	2020/21
	Act.	Act.	Act.	Projections		
			I. Monetary Survey			
Net foreign assets	15,795	13,268	13,385	13,070	13,521	13,840
Central bank	12,267	9,602	8,658	9,143	10,114	11,083
Commercial banks	3,528	3,667	4,727	3,927	3,407	2,757
Net domestic assets	-5,966	-2,573	-831	253	315	810
Claims on central government (net)	-3,972	-1,368	-1,630	-808	-1,389	-1,893
Central bank	-4,772	-2,198	-2,734	-2,711	-3,592	-4,497
Commercial banks	800	830	1,104	1,904	2,204	2,604
Claims on private sector	5,519	5,842	6,327	6,932	7,534	8,366
Other items (net)	-7,593	-7,421	-5,607	-5,957	-5,924	-5,761
Broad money (M2)	9,829	10,692	12,554	13,323	13,836	14,650
Currency outside banks	907	935	1,054	1,176	1,200	1,271
Deposits	8,922	9,757	11,500	12,147	12,636	13,379
			II. Central Bank			
Net foreign assets	12,267	9,602	8,658	9,143	10,114	11,083
Gross reserves	13,984	11,155	10,098	10,688	11,528	12,370
Net domestic assets	-10,428	-7,706	-6,591	-7,003	-7,878	-8,649
Claims on central government (net)	-4,772	-2,198	-2,734	-2,711	-3,592	-4,497
Claims on private sector	77	90	89	96	105	111
Other items (net)[2]	-5,733	-5,598	-3,947	-4,388	-4,390	-4,263
Reserve money	1,839	1,896	2,066	2,139	2,236	2,434
Currency in circulation	1,167	1,200	1,350	1,490	1,527	1,617
Commercial bank deposits	621	649	678	649	709	816
Liabilities to other sectors	0	0	0	0	0	0
Memorandum items:	(12-month percent change, unless otherwise indicated)					
Reserve money	22.7	3.1	9.0	3.5	4.5	8.8
Broad money	6.4	8.8	17.4	6.1	3.9	5.9
Narrow money (M1)	15.5	6.6	22.9	6.9	3.7	5.9
Narrow money (M1) (Maloti millions)	4,927	5,254	6,457	6,902	7,157	7,578
Credit to the private sector	8.2	5.8	8.3	9.6	8.7	11.0
Credit to the private sector (percent of GDP)	17.2	17.2	18.2	18.5	18.4	19.3
Velocity (GDP/broad money)	3.3	3.2	2.8	2.8	3.0	3.0

Sources: Lesotho authorities and IMF staff estimates and projections.

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

2 Including valuation changes.

Table 4. Lesotho: Balance of Payments, 2015/16–2023/24[1]
(US$ millions, unless otherwise indicated)

	2015/16	2016/17	2017/18	2018/19	2019/20	2020/21	2021/22	2022/23	2023/24
	Act.	Act.	Act.	Projections					
Current account	-93	-204	-126	-236	-394	-135	-274	-501	-306
Trade balance	-756	-729	-795	-815	-929	-760	-857	-1,011	-891
Exports, f.o.b.	940	901	1,137	1,199	1,257	1,378	1,466	1,561	1,661
Imports, f.o.b	1,696	1,631	1,932	2,014	2,187	2,138	2,323	2,571	2,553
Services (net)	-255	-260	-330	-331	-397	-342	-423	-541	-507
Primary income (net)	300	311	351	340	333	335	345	354	369
Secondary income (net)	619	475	648	569	599	633	661	697	723
Official transfers	502	354	512	433	458	488	508	534	553
Of which: SACU revenue	464	321	473	401	422	452	471	495	514
Other transfers	117	120	136	135	141	144	153	163	170
Capital account	49	40	40	55	354	122	303	568	352
Current and capital account	-44	-164	-86	-181	-41	-13	30	67	46
Financial account	-111	-247	-18	-71	-41	-13	30	67	46
Foreign direct investment	-107	-65	-44	-40	-46	-47	-50	-53	-55
Portfolio investment	2	2	2	2	2	2	2	3	3
Other investment	-129	34	86	8	-41	-16	45	72	46
Of which:									
Public sector (net)	17	10	13	21	41	40	38	39	47
Disbursements	49	41	53	56	94	93	94	99	107
Central government	49	42	38	56	94	93	94	99	107
Other public sector	0	-1	15	0	0	0	0	0	0
Amortization	-32	-31	-40	-34	-53	-54	-56	-60	-60
Change in reserve assets	123	-217	-61	-40	44	47	33	46	52
Errors and omissions	-67	-83	68	111	0	0	0	0	0
Memorandum items:									
Nominal GDP (millions of Maloti)	32,060	34,059	34,797	37,573	40,964	43,375	47,341	51,893	55,634
Nominal GDP (millions of USD)	2,326	2,423	2,677	2,717	2,775	2,843	3,015	3,213	3,344
Gross international reserves									
(US$ millions)	949	841	851	692	705	734	745	769	798
(Months of imports)	6.14	4.50	3.69	3.09	3.32	3.11	2.79	2.93	3.10
(Months of imports, excluding imports for LHWP-2)	6.17	4.53	3.74	3.45	3.43	3.40	3.27	3.21	3.16
National currency per US$	13.8	14.1	13.0	13.8					
				(in percent of GDP)					
Current account	-4.3	-8.4	-4.8	-8.4	-14.2	-4.8	-9.1	-15.6	-9.2
Current account (exc. LHWP-2 project)	-4.1	-7.9	-4.2	-7.3	-4.2	-1.9	-1.3	-1.2	-0.9
Trade Balance	-32.5	-30.1	-29.7	-30.0	-33.5	-26.8	-28.4	-31.5	-26.7
Current and capital account	-1.9	-6.8	-3.2	-6.7	-1.5	-0.5	1.0	2.1	1.4
Official grants	21.4	14.6	19.0	16.2	16.5	17.2	16.9	16.6	16.5
				(12-month percent change)					
Exports of goods and services									
Percent change (Maloti terms)	35.6	-0.3	12.3	12.3	12.1	13.1	9.4	9.5	9.6
Percent change ($US terms)	9.0	-2.7	21.9	5.0	5.1	9.4	6.4	6.5	6.4
Imports of goods and services									
Percent change (Maloti terms)	14.6	-0.5	8.8	10.3	17.7	-0.7	13.8	16.5	1.3
Percent change ($US terms)	-7.9	-2.5	17.8	3.4	10.2	-3.9	10.6	13.3	-1.6
Imports of goods and services (excl. LHWP)									
Percent change (Maloti terms)	14.3	-0.8	8.7	9.7	6.5	7.6	7.7	8.6	8.2
Percent change ($US terms)	-8.2	-2.7	17.6	3.0	-0.3	4.1	4.7	5.5	5.1

Sources: Lesotho authorities and IMF staff estimates and projections.

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

Table 5. Lesotho: Financial Soundness Indicators 2013–2018
(End of period, percent)

	2013	2014	2015	2016	2017	2018
			(In percent)			
Core FSIs						
Regulatory capital to risk weighted assets	12.1	13.1	16.1	18.9	17.8	17.9
Regulatory Tier 1 capital to risk-weighted assets	11.4	12.2	14.4	17.2	20.9	20.2
Non-performing loans net of provisions to capital	11.0	5.5	6.5	5.8	6.4	5.8
Non-performing loans to total gross loans	3.7	3.8	3.9	3.7	4.4	3.7
Return on assets	4.8	3.1	3.4	3.3	2.4	3.4
Return on equity	42.7	31.4	33.6	28.4	18.0	28.6
Interest margin to gross income	55.9	58.3	58.3	58.0	59.6	60.4
Non-interest expenses to gross income	52.8	52.3	52.8	54.7	62.2	60.7
Liquid assets to total assets	35.3	41.9	40.4	31.9	36.3	36.1
Liquid assets to short-term liabilities	71.6	59.8	62.9	47.3	52.8	52.9
Net open position in FX to capital	32.1	5.5	14.4	31.9	24.6	23.6
Sectoral distribution of loans						
Domestic residents		100.0	100.0	100.0	100.0	100.0
Deposit takers		0.2	0.0	0.0	0.0	0.0
Central bank		0.0	0.0	0.0	0.0	0.0
Other financial corporations		0.0	0.5	0.5	0.4	1.9
General government		0.0	0.0	0.0	0.0	0.0
Nonfinancial corporations		40.0	39.1	35.0	36.3	30.8
Households		59.7	60.4	64.4	63.4	67.3
Nonresidents		0.0	0.0	0.0	0.0	0.0
Additional FSIs						
Capital to assets (leverage ratio)		12.6	10.9	11.9	11.1	11.5
Large exposures to capital	154.7	182.8	124.4	107.1	80.7	82.1
Gross assets position in derivatives to capital	0.1	0.3	0.8	1.6	4.6	0.2
Gross liabilities position in derivatives to capital	7.0	3.7	6.7	0.1	0.3	3.4
Trading income to total income	4.8	4.8	4.6	3.6	3.1	3.8
Personnel expenses to total income	51.8	52.1	49.5	48.9	46.1	46.1
Customer deposits to total non-interbank loans	125.1	172.9	163.6	154.6	184.6	179.8
FX loans to total loans	0.0	0.0	0.0	0.0	0.0	0.0
FX liabilities to total liabilities	3.9	0.0	0.1	0.1	0.3	0.0

Source: IMF Financial Soundness Indicators.

Table 6. Lesotho: Sustainable Development Goals

	2005	2010	2015	2016	2017
Goal 1: No Poverty					
Poverty headcount ratio at $1.90 a day (2011 PPP) (% of population)	..	59.6	..	..	..
Urban poverty headcount ratio at national poverty lines (% of urban population)	..	39.6	..	..	..
Goal 2: Zero Hunger					
Prevalence of undernourishment (% of population)	11.7	12.7	12.9	12.8	..
Prevalence of wasting, weight for height (% of children under 5)	..	..	..	..	..
Goal 3: Good Health and Well-Being					
Maternal mortality ratio (modeled estimate, per 100,000 live births)	746	587	487	..	..
Mortality rate, neonatal (per 1,000 live births)	43.4	41.6	39.3	38.7	37.9
Goal 4: Quality Education					
Literacy rate, adult total (% of people ages 15 and above)	..	..	..	..	..
Lower secondary completion rate, total (% of relevant age group)	31.3	41.0	..	42.0	43.2
Pupil-teacher ratio, primary	41.6	33.8	33.1	33.8	32.9
Goal 5: Gender Equality					
Nondiscrimination clause mentions gender in the constitution (1=yes; 0=no)	..	..	1	..	1
Proportion of seats held by women in national parliaments (%)	11.7	24.2	25	25	22.9
Goal 6: Clean Water and Sanitation					
People using at least basic sanitation services (% of population)	19.6	31.8	43.8	..	..
People using at least basic drinking water services (% of population)	68.1	69.9	71.6	..	..
Goal 7: Affordable and Clean Energy					
Access to electricity (% of population)	10.3	18.9	27.9	29.7	..
Access to electricity, rural (% of rural population)	4.6	9.9	14.8	15.7	..
Goal 8: Decent Work and Economic Growth					
GDP growth (annual %)	3.5	6.1	2.8	3.2	-2.3
Unemployment, youth total (% of total labor force ages 15-24) (modeled ILO estimate)	47.8	36.3	38.0	39.0	38.5
Goal 9: Industry, Innovation, and Infrastructure					
New business density (new registrations per 1,000 people ages 15-64)	..	1.5	..	..	..
Goal 10: Reduced inequality					
Average transaction cost of sending remittances to a specific country (%)	..	..	13.8	15.9	15.9
Personal remittances, received (% of GDP)	35.6	25.8	14.8	14.8	15.6
Goal 11: Sustainable Cities and Communities					
Urban population (% of total)	22.2	24.8	26.9	27.3	27.7
Urban population growth (annual %)	3.4	3.1	2.9	2.8	2.8
Population living in slums (% of urban population)	35.1	..	..	..	..
Goal 12: Sustainable Consumption and Production					
Renewable electricity output (% of total electricity output)	100	100	100	..	..
Renewable energy consumption (% of total final energy consumption)	55	53	52	..	..
Goal 13: Climate Action					
PM2.5 air pollution, mean annual exposure (micrograms per cubic meter)	26.4	22.4	26.5	26.9	..
CO2 emissions (kg per PPP $ of GDP)	0.6	0.5	..	..	..
Terrestrial and marine protected areas (% of total territorial area)	..	..	..	0.3	0.3
Goal 14: Life Below Water					
Aquaculture production (metric tons)	1	300	1,001	1,050	..
Total fisheries production (metric tons)	46	345	1,053	1,102	..
Goal 15: Life on Land					
Forest area (% of land area)	1.4	1.4	1.6	1.6	..
Goal 16: Peace, Justice, and Strong Institutions					
Tax revenue (% of GDP)	37	38	41	34	37
Overall level of statistical capacity (scale 0 - 100)	71	66	66	58	62
Goal 17: Partnerships for the Goals					
Individuals using the Internet (% of population)	2.6	3.9	25.0	27.4	..
Net official development assistance and official aid received (current US$ millions)	68.4	256.1	83.1	112.3	146.8

Source: World Development Indicators

Annex I. External Sector Assessment

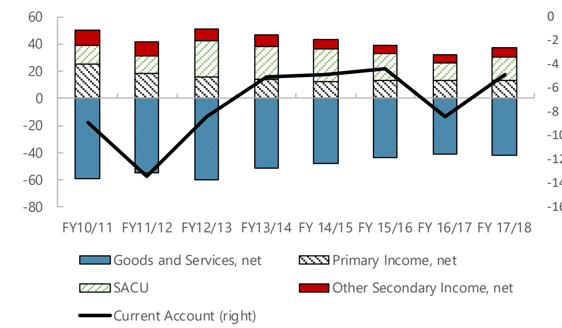
The external position of Lesotho in FY 2018/19 was weaker than the level consistent with medium term fundamentals and desirable policies. Fiscal consolidation is required to restore the external balance and to stem the drawdown of international reserves.

Background

1. **The current account deficit increased to 8.4 percent of GDP in 2018/19 reflecting a fall in SACU revenues.** SACU revenues increased to 17.7 percent of GDP in FY 2017/18 from 13.3 in FY 2016/17, still significantly below the recent peak of 24.1 in FY2014/15. SACU revenues have declined again in FY 2018/19 and are expected to remain subdued owing to sluggish growth in South Africa. Rapid import growth, even in a depressed economic context with fiscal cash rationing, and weaker export of services offset stronger diamond exports and led to a worsening of the trade balance. For the medium term, imports are expected to grow rapidly as construction of the Lesotho Highlands Water Project Phase II begins leading to a worsening of the current account. However, the project will be financed with capital grants from South Africa.

Current Account Balance

(In percent of GDP)

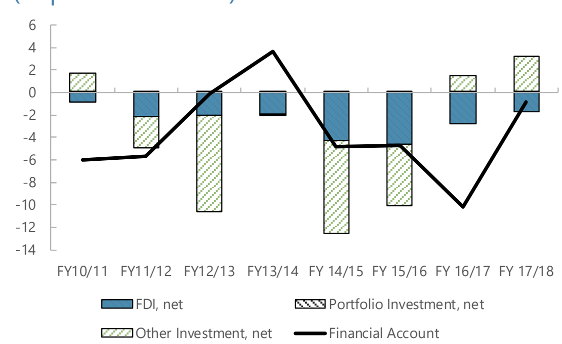


Source: Country authorities.

2. **Foreign direct investment (FDI) inflows slowed and other investment outflows grew, putting pressure on international reserves to finance the current account deficit.** FDI inflows reached 4.6 percent of GDP in FY 2015/16, reflecting investments in diamond mines, but have since declined to less than 2 percent. Other investments have shifted from an inflow of 8.2 percent of GDP in FY 2014/15 to an outflow of 3.2 in FY 2017/18 as commercial banks have significantly increased their net foreign assets.

External Financing

(In percent of GDP)



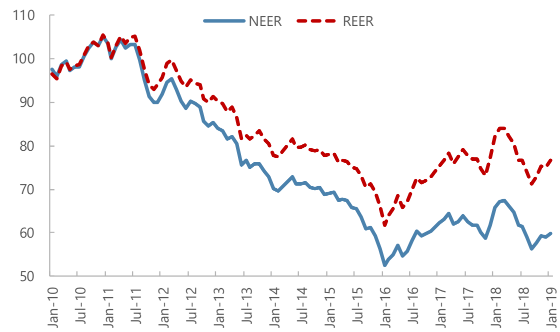
Source: Country authorities.

3. **As a result, gross international reserves have continued to decline in months of imports.** In March 2018, gross international reserves stood at USD 851 million, a slight increase with respect to the previous year because of the appreciation of the rand. However, coverage in terms of months of imports is estimated to have fallen to 3.5 in FY 2018/19 from a peak of just over 6 in FY 2015/16, and as of January 2019, gross international reserves had declined further to USD 792 million. Maintaining a robust level of reserves is critical to sustaining confidence in the peg to the rand. A cost-benefit panel model suggests an

optimal level of reserves to be around 4 months of imports.[1] The authorities have targeted reserve coverage of at least 120 percent of M1 plus callable deposits, which they believe provides confidence that the link to the rand can be maintained.[2] Staff concur that this level would be adequate to maintain the peg, but note that the government has only maintained reserves at the target at the cost of running up delays in making domestic payments. Fiscal consolidation will be required to eliminate the arrears while keeping reserves at an adequate level.

4. Real and nominal effective exchange rate movements continue to follow South African developments closely. The depreciation trend from 2011 to 2015 was partly offset by a slow appreciation that accelerated in December 2017 and early 2018. Global turmoil in flows to emerging markets contributed to a sharp depreciation of the rand that extended until September 2018. The exchange rate has appreciated slightly since.

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



Source: Staff estimates.

Assessment

5. Staff assesses that Lesotho's position in FY 2018/19 is weaker than the level consistent with medium-term fundamentals and desired policies. The EBA-lite current account deficit norm of 4.3 percent of GDP is significantly lower than the expected 8.4 percent for FY 2018/19. The difference is driven by a substantial policy gap, particularly on fiscal stance and public health expenditure. Similarly, the real exchange rate is found to be overvalued. The estimated 9.4 percent REER gap for FY 2018/19 represents an increase from the 2.6 percent in FY 2016/17 reflecting strong import growth despite the slowdown in economic activity and inflation. The expected further deterioration of the current account calls for fiscal consolidation to restore the external position to a sustainable level. Reducing public sector wages in real terms would, over the medium term, reduce the distortions in the labor market and help to enhance competitiveness.

Current Account and Real Exchange Assessments
(Index, 2010=100)

Current Account Actual	-8.4%
Current Account Norm	-4.3%
Current Account Gap	-4.0%
o/w Policy gap	-3.8%
REER Gap	9.4%

Source: Staff estimates.

[1] See "Guidance Note: Assessing Reserve Adequacy in Credit-Constrained Economies (IMF 2016).

[2] Reserves are adequate by other metrics: as of end-December 2018, they stood at almost 80 percent of broad money and 500 percent of short-term debt, compared with a rule-of-thumb threshold of 20 percent and 100 percent respectively.

Annex II. Risk Assessment Matrix

Source of main risks	Relative Likelihood	Expected impact on the economy if risk is realized	Relative Impact	Possible remedial policy
Global Risks				
Rising protectionism and retreat from multilateralism.	High	Higher tariff and non-tariff barriers will reduce competitiveness and weaken demand for Lesotho's exports.	Medium	Advance structural reforms to reduce income inequality and increase competitiveness and diversification. Implement the remaining SADC recommendations in a timely manner.
Weaker-than-expected global growth, including significant slowdown in China, or key advanced and emerging economies.	Medium	Depressed global demand translates into weaker Lesotho exports to the rest of the World, in particular to the main trading partner, SA, and to a lesser extent, the U.S. and EU. An economic slowdown in SA would reduce SACU transfers, which form a substantial portion of fiscal revenues.	Medium	Advance structural reforms to reduce income inequality and increase competitiveness and diversification.
Domestic Risks				
Renewed political instability.	High	Political instability would delay reform implementation, particularly for the needed fiscal consolidation efforts.	High	Implement the remaining SADC recommendations in a timely manner, ideally by the May 2019 deadline.
El-Nino related drought materializes.	Medium	Weaker-than-expected harvests result in food shortages and a spike in food prices. Food security, particularly in rural areas, could be compromised.	High	Implement fiscal consolidation to create fiscal space for additional food subsidies and crisis management. Mobilize concessional/grant financing to support food security action plan.
Insufficient fiscal adjustment to stagnation in SACU transfers.	High	Lesotho's fiscal and external position would decline sharply with negative repercussions for the stability of the peg to the rand and domestic arrears.	High	Implement fiscal consolidation and seek concessional financing by reengaging with donors.

Annex III. Debt Sustainability Analysis[1,2]

Lesotho: Joint Bank-Fund Debt Sustainability Analysis	
Risk of external debt distress	*Moderate*
Overall risk of debt distress	*Moderate*
Granularity in the risk rating	*Some space*
Application of judgement	*No*

Lesotho's risk of external debt distress has been revised from "low" in the 2017 Article IV to "moderate," reflecting weaker GDP growth projections, expanded debt coverage, larger deficits, and the inclusion of large contingent liabilities. The overall risk of debt distress is also assessed to be moderate. The moderate risk tool suggests some space to absorb shocks. The results of the DSA highlight the importance of addressing underfunding of the pension fund, preserving a cautious debt management strategy, and developing the domestic debt market. Fiscal consolidation, particularly addressing the high public-sector wage bill, are needed to reduce external imbalances and mitigate vulnerabilities.

Public Debt Coverage

1. **Lesotho's public debt data covers the central government, the central bank, and publicly-guaranteed debts for SOEs (Table 1).** Debt coverage is similar to the previous DSA, but the tailored contingent liability shock captures the unaccounted subsectors of the public sector. Specifically, the contingent liability shock captures shortfalls of the pension fund, estimated to be between 10.3 and 20.7 percent of GDP,[3] and applies the default 2 percent GDP shocks to capture non-guaranteed SOE debt since comprehensive estimates of non-guaranteed SOE debt are not available. The contingent liability stress test also includes 5 percent of GDP for a financial market shock and 35 percent of the PPP capital stock, which is estimated to be 3.2 percent of GDP. External debt is defined based on currency-criterion as there is no foreign holdings of local-currency debt. Domestic arrears are included in the debt stock.

[1] Prepared by the staffs of the International Monetary Fund (IMF) and the International Development Association (IDA). Approved by David Robinson (AFR), Nathan Porter (SPR), and Paloma Anos Casero (IDA).

[2] This DSA updates the previous Joint DSA dated February 14, 2018 (IMF Country Report No. 18/54). This DSA applies the revised joint Bank-Fund Debt Sustainability Framework for Low-Income Countries. Under this framework, Lesotho's debt carrying capacity remains at medium based on the composite indicator consistent of the 2018 October WEO and the 2017 CPIA.

[3] These estimates are based on two valuations conducted by actuarial firms, with the larger gap calculated on a solvency basis, the smaller on a funding basis.

Table 1. Lesotho: Coverage of Public Sector Debt and Design of the Contingent Liability Stress Test

	Subsectors of the public sector	Sub-sectors covered
1	Central government	X
2	State and local government	
3	Other elements in the general government	
4	o/w: Social security fund	
5	o/w: Extra budgetary funds (EBFs)	
6	Guarantees (to other entities in the public and private sector, including to SOEs)	X
7	Central bank (borrowed on behalf of the government)	X
8	Non-guaranteed SOE debt	

1	**The country's coverage of public debt**	The central government, central bank, government-guaranteed debt			
		Default		**Used for the analysis**	**Reasons for deviations from the default settings**
2	Other elements of the general government not captured in 1.	0	percent of GDP	20.7	
3	SoE's debt (guaranteed and not guaranteed by the government) 1/	2	percent of GDP	2.0	
4	PPP	35	percent of PPP stock	1.1	
5	Financial market (the default value of 5 percent of GDP is the minimum value)	5	percent of GDP	5.0	
	Total (2+3+4+5) (in percent of GDP)			28.8	

1/ The default shock of 2 Percent of GDP will be triggered for countries whose government-guaranteed debt is not fully captured under the country's public debt definition (1.). If it is ready included in the government debt (1.) and risks associated with SoE's debt not guaranteed by the government is assessed to b negotiable, a country team may reduce this to 0 percent.

Background

2. **Lesotho's total public debt increased to 38.8 percent of GDP in FY 2017/18 from 37.6 percent (Table 2).**[4] The increase was observed in both domestic and external borrowing and was partially offset by growth in nominal GDP and appreciation of the rand. External debt continues to account for most of total debt (79.1 percent) and is largely owed to multilateral creditors. Domestic debt grew from 4.5 to 8.2 percent of GDP in FY 2017/18 as authorities issued new bonds of M400 million and accumulated arrears of M700 million. The gradual increase in the share of domestic debt, by tapping into the large pool of assets held by the pension fund and insurance companies, is a goal of the authorities for the medium-term.[5]

Assumptions

3. **The macroeconomic framework is broadly in line with the previous DSA, though GDP growth is now slightly lower (Table 3).** Real GDP growth for the medium term has been revised downwards from an average of 3.1 percent to 2.6 percent, reflecting delays in the second phase of the Lesotho Highlands Water Project (LHWP-II) and in implementing fiscal consolidation. Long run real GDP growth is revised downwards to around 3 percent, reflecting recent evidence of tighter domestic constraints and a more adverse external environment. Inflation projections are slightly higher at around 5.5 percent in line with monetary developments in South Africa. A primary fiscal deficit of 0.8 percent on average is expected for the medium term based on the consolidatory stance envisaged in the FY 2019/20 budget. Over the long run, fiscal deficit is now projected to average 0.4 percent of GDP as opposed to a 0.6 percent surplus in the previous DSA, reflecting higher capital expenditures. On the external sector, weaker export

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

[5] A medium-term Debt Management Strategy (DMS) is under development and is expected to be completed and released with the FY 2019/20 budget.

growth and the secular decline in remittances from South Africa are expected to deteriorate the current account balance slightly over the medium term with respect to the previous DSA, with the large deficit still reflecting the high import component of the LHWP-II. Over the long run, the current account balance is expected to remain negative.

4. **Debt assumptions take account of the latest information on new borrowing.** The government has recently signed a semi-concessional loan of M1.4 billion with the Export-Import Bank of China to build a road of 92km connecting Ha Mpiti and Sehlabathebe. Signature of a USD 20 million World Bank loan in the context of the Agriculture Productivity Program for Southern Africa is expected in the next few months.

5. **External borrowing at concessional terms is expected to decline moderately, while remaining significant.** Concessionality is assumed to be lower than in the previous DSA, reflecting the latest terms Lesotho has obtained. Furthermore, as Lesotho grows and graduates from some concessional borrowing sources and the domestic market develops, concessionality is expected to further decline over time. However, concessional external borrowing will remain critical for financing large investment projects, as was discussed in the previous DSA. In line with the authorities' medium-term goals, the development of the domestic market is assumed to continue. By FY 2038/39, domestic borrowing is expected to account for around one-third of total debt.

6. **The realism of the macroeconomic framework is confirmed by several checks (Figures 3 and 4).** The path for external debt accumulation remains largely unchanged with respect to the previous DSA. The current account deficits, which have in the recent past been partly funded by the drawdown of international reserves, are expected to be financed in the medium-term with the support of capital transfers, in particular those financing the LHWP-II (which is administered by the Lesotho Highlands Development Authority, which is not consolidated with the fiscus). With respect to the previous DSA, higher public debt is expected for the medium term as GDP growth has been lowered, while a larger domestic debt component will result in higher interest rates. The DSA projects a significant shift in borrowing assumptions towards less concessional external borrowing and more domestic debt, reflecting the likely availability of financing. The fiscal multiplier is assumed to be small due to high import content, and the negative impact of fiscal consolidation on GDP growth is expected to be partially offset by the beginning of the LHWP-II (unless the project experiences further delays) and positive developments in mining and textiles. Real exchange rate depreciation is also expected to contribute to the projected increase of the public debt. Unexpected changes in debt have not been significant over the past 5 years.

Table 2. Lesotho: Stock of Outstanding Debt, 2013/14–2017/18

	2013/14	2014/15	2015/16	2016/17	2017/18
			(in million USD)		
Domestic Debt	111	120	120	104	214
External Debt	828	825	841	849	899
Multilateral	724	692	709	727	775
IDA	308	273	292	295	331
ADF	191	167	167	159	165
EIB	67	102	95	127	135
IMF	79	68	70	65	61
Other	78	83	85	82	83
Bilateral	98	129	132	123	124
China EXIM Bank	43	57	54	50	49
Kuwait Fund	25	29	29	27	26
Saudi Fund	14	23	23	23	22
Abu Dhabi Fund	3	10	16	15	17
India EXIM Bank	7	7	6	6	5
Other	6	4	3	3	6
Commercial	6	5	0	0	0
Total	**939**	**945**	**961**	**953**	**1,114**
			(in percent of GDP)		
Domestic Debt	4.0	4.4	4.6	4.5	8.2
External Debt	34.5	34.5	38.7	33.1	30.7
Multilateral	30.2	28.9	32.6	28.3	26.4
IDA	12.9	11.4	13.4	11.5	11.3
ADF	8.0	7.0	7.7	6.2	5.6
EIB	2.8	4.2	4.4	5.0	4.6
IMF	3.3	2.8	3.2	2.5	2.1
Other	3.3	3.4	3.9	3.2	2.8
Bilateral	4.1	5.4	6.1	4.8	4.2
China EXIM Bank	1.8	2.4	2.5	1.9	1.7
Kuwait Fund	1.1	1.2	1.3	1.1	0.9
Saudi Fund	0.6	0.9	1.1	0.9	0.7
Abu Dhabi Fund	0.1	0.4	0.7	0.6	0.6
India EXIM Bank	0.3	0.3	0.3	0.2	0.2
Other	0.3	0.2	0.2	0.1	0.2
Commercial	0.2	0.2	0.0	0.0	0.0
Total	**38.5**	**38.8**	**43.2**	**37.6**	**38.8**

Sources: Country authorities and staff estimates.
Note: Domestic Debt includes arrears and guarantees.

Table 3. Lesotho: Macroeconomic Assumptions

	2017 DSA 2017-22	2018 DSA 2018-23	2017 DSA 2023-37	2018 DSA 2024-38
Real GDP Growth (Percent)	3.1	2.5	3.4	2.9
Inflation (Percent)	5.5	5.5	5.1	5.5
Primary Deficit (Percent of GDP)	1.6	0.8	-0.6	0.4
USD Export Growth (Percent)	7.9	6.5	7.3	6.3
USD Import Growth (Percent)	8.6	5.3	4.6	5.2
Non-interest Current Account Balance (Percent of GDP)	-8.3	-9.6	-2.1	-2.7
Net FDI (negative = inflow)	-0.7	-1.6	-0.7	-1.7
Grant element of new public sector borrowing (in percent)	42.3	26.9	42.3	20.8
External Debt (Percent of GDP)	34.5	35.7	30.3	34.5
Public Sector Debt (Percent of GDP)	42.6	50.2	40.8	51.0

Sources: IMF Country Report No. 18/54 and staffs estimates and projections.

Country Classification and Determination of Scenario Stress Tests

7. **Lesotho has a medium debt carrying capacity (Table 4).** Debt carrying capacity is determined by a composite indicator that includes the World Bank's Country Policy and Institutional Assessment score, world economic growth, and Lesotho's real growth rate, import coverage of reserves, and remittances. Lesotho's debt carrying capacity is assessed to be medium.

8. **Lesotho does not qualify for other tailored stress tests.** Apart from the contingent liability tailored shock described above, Lesotho's economic characteristics do not trigger any of the tailored stress tests on natural disasters, commodity prices, and/or market financing risk module.

Table 4. Lesotho: Debt Carrying Capacity

Debt Carrying Capacity and Thresholds

Country	Lesotho
Country Code	666
Debt Carrying Capacity	Medium

Final	Classification based on current vintage	Classification based on the previous vintage	Classification based on the two previous vintages
Medium	Medium 2.94	Medium 2.90	Medium 3.33

Note: Until the April 2019 WEO vintage is released, the two previous vintages ago classification and corresponding score are based solely on the CPIA per the previous framework.

Applicable thresholds

APPLICABLE	
EXTERNAL debt burden thresholds	
PV of debt in % of	
Exports	180
GDP	40
Debt service in % of	
Exports	15
Revenue	18

APPLICABLE	
TOTAL public debt benchmark	
PV of total public debt in percent of GDP	55

Calculation of the CI Index

Components	Coefficients (A)	10-year average values (B)	CI Score components (A*B) = (C)	Contribution of components
CPIA	0.385	3.375	1.30	44%
Real growth rate (in percent)	2.719	2.141	0.06	2%
Import coverage of reserves (in percent)	4.052	37.032	1.50	51%
Import coverage of reserves^2 (in percent)	-3.990	13.714	-0.55	-19%
Remittances (in percent)	2.022	7.423	0.15	5%
World economic growth (in percent)	13.520	3.579	0.48	16%
CI Score			2.94	100%
CI rating			Medium	

New framework	Cut-off values		
Weak	CI <	2.69	
Medium	2.69	≤ CI ≤	3.05
Strong	CI >	3.05	

Reference: Thresholds by Classiciation

EXTERNAL debt burden thresholds	Weak	Medium	Strong
PV of debt in % of			
Exports	140	180	240
GDP	30	40	55
Debt service in % of			
Exports	10	15	21
Revenue	14	18	23

TOTAL public debt benchmark	Weak	Medium	Strong
PV of total public debt in percent of GDP	35	55	70

External Debt Sustainability Analysis

9. All external debt sustainability indicators remain below their corresponding thresholds in the baseline scenario (Table 5 and Figure 1).[6] In the medium term, the present value (PV) of PPG external debt-to-GDP is expected to reach a maximum of 27.4 percent by FY 2020/21 from a level of 25.0 percent in FY 2017/18. In the longer term, it is expected to increase modestly to 28.0 percent. All other indicators of external debt sustainability remain well below the thresholds.

10. Stress tests show that Lesotho's external debt vulnerabilities could emerge in the event of a realization of a contingent liabilities shock or a major shock to exports (Table 7 and Figure 1). The threshold of PV of PPG external debt-to-GDP would be breached if a large contingent liabilities shock, emerging mainly from the unfunded pension fund, were to be realized. Even absent the contingent liabilities shocks, the threshold would still be breached in the case of a large negative exports shock or other flows. All other indicators of external debt sustainability remain below the thresholds.

Overall Risk of Public Debt Distress

11. All public debt sustainability indicators remain below their corresponding thresholds in the baseline scenario (Table 6 and Figure 2). The PV of public debt-to-GDP is expected to reach a maximum of 44.4 percent by FY 2024/25 from a level of 31.0 percent in 2017/18. Afterwards, it is expected to decline gradually, stabilizing around 44.0 percent in the long term. All other indicators of public debt sustainability also remain well below the thresholds.

12. The realization of a contingent liabilities shock would expose Lesotho's public debt vulnerabilities (Table 8 and Figure 2). The threshold of PV of public debt-to-GDP would be breached in the event of a large contingent liabilities shock, as the ratio would rise to 66 percent in 2019/20. Real GDP growth, primary balance, exports, and other flows stress tests also lead to breaches. All other indicators of public debt sustainability remain below the thresholds.

13. The mechanical signal for the overall risk of public debt distress is moderate. This result reflects the moderate risk signal for PPG external debt and the public sector debt stock indicator breaching the threshold under some shocks.

Risk Rating and Vulnerabilities

14. Lesotho's risk of external debt distress has been revised from "low" to "moderate," with some space to absorb shocks. All external and public debt and debt service indicators for the baseline remain below their respective thresholds, but shocks to contingent liabilities, exports and other flows lead to breaches. The DSA results highlight the importance of addressing the financing gap at the pension fund and continuing with a cautious debt management strategy

[6] The LHWP II project is financed by capital grants, which are a key driver of the residuals.

focused on financing projects with high economic returns through concessional sources. Development of a domestic debt market would also prove critical to deal with contingent liabilities shocks.

Authorities' Views

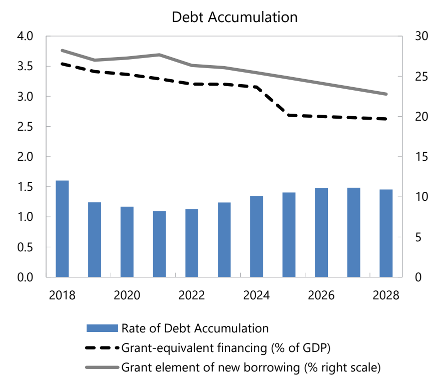
Authorities concurred with the DSA and the "moderate" risk rating. They agreed with the need to better monitor domestic contingent liabilities in order to have a comprehensive view of the debt. The authorities highlighted the need for the Debt Department and the public pension fund to agree on a strategy to address the underfunding of the latter. They also agreed that prudent debt management must continue in the medium term, in particular by pursuing financing with a significant grant element and that stronger capacity in the Cash Management Unit would support the forecasting of financing needs. Finally, authorities noted that work has begun on developing a Debt Policy Framework that will guide new decisions on guarantees, contingent liabilities, and unsolicited proposals.

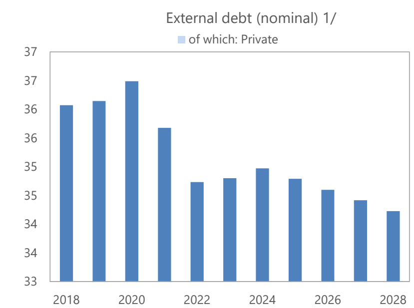
Table 5. Lesotho: External Debt Sustainability Framework, Baseline Scenario, 2017–2038

(In percent of GDP, unless otherwise indicated)

	Actual	Projections								Average 8/	
	2017	2018	2019	2020	2021	2022	2023	2028	2038	Historical	Projections
External debt (nominal) 1/	30.7	36.1	36.1	36.5	35.7	34.7	34.8	34.2	34.4	32.9	35.2
of which: public and publicly guaranteed (PPG)	30.7	36.1	36.1	36.5	35.7	34.7	34.8	34.2	34.4	32.9	35.2
Change in external debt	-2.4	5.4	0.1	0.3	-0.8	-0.9	0.1	-0.2	0.0		
Identified net debt-creating flows	-0.1	6.3	11.5	3.2	6.2	12.5	7.0	1.8	-0.7	0.3	5.0
Non-interest current account deficit	4.1	8.2	13.6	4.1	8.4	15.0	8.5	3.7	1.0	3.4	6.8
Deficit in balance of goods and services	42.0	42.1	47.8	38.8	42.4	48.3	41.8	37.1	31.7	52.0	40.6
Exports	43.7	45.3	46.6	49.7	49.9	49.8	50.9	51.6	58.5		
Imports	85.8	87.4	94.4	88.5	92.3	98.1	92.8	88.6	90.2		
Net current transfers (negative = inflow)	-24.2	-20.9	-21.6	-22.3	-21.9	-21.7	-21.6	-21.9	-20.6	-29.5	-21.8
of which: official	-19.1	-15.9	-16.5	-17.2	-16.9	-16.6	-16.5	-16.8	-15.6		
Other current account flows (negative = net inflow)	-13.7	-13.0	-12.6	-12.4	-12.1	-11.6	-11.7	-11.4	-10.1	-19.2	-12.0
Net FDI (negative = inflow)	-1.7	-1.5	-1.7	-1.7	-1.7	-1.7	-1.7	-1.7	-1.7	-2.6	-1.6
Endogenous debt dynamics 2/	-2.5	-0.3	-0.4	0.7	-0.6	-0.8	0.2	-0.3	-0.1		
Contribution from nominal interest rate	0.6	0.5	0.6	0.7	0.6	0.6	0.6	0.7	0.9		
Contribution from real GDP growth	-0.2	-0.9	-1.1	0.1	-1.3	-1.4	-0.5	-1.0	-1.0		
Contribution from price and exchange rate changes	-3.0	...	...	...	...	...	...	...	...		
Residual 3/	-2.3	-0.9	-11.4	-2.8	-7.0	-13.5	-7.0	-2.0	0.8	-1.4	-4.7
of which: exceptional financing	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0		
Sustainability indicators											
PV of PPG external debt-to-GDP ratio	25.0	26.2	26.9	27.4	26.8	26.2	26.4	26.7	28.0		
PV of PPG external debt-to-exports ratio	57.1	57.9	57.7	55.0	53.8	52.6	51.8	51.8	47.8		
PPG debt service-to-exports ratio	4.8	3.5	5.4	5.1	5.0	5.0	4.8	4.5	4.6		
PPG debt service-to-revenue ratio	5.2	4.0	6.4	6.4	6.3	6.3	6.2	5.6	6.5		
Gross external financing need (Million of U.S. dollars)	120.9	224.3	401.1	141.3	279.8	507.3	311.6	189.9	150.1		
Key macroeconomic assumptions											
Real GDP growth (in percent)	0.5	2.9	3.1	-0.2	3.6	4.2	1.4	3.0	3.0	3.7	2.6
GDP deflator in US dollar terms (change in percent)	9.9	-1.3	-1.0	2.7	2.3	2.3	2.7	2.4	2.4	0.4	1.8
Effective interest rate (percent) 4/	2.1	1.7	1.8	1.9	1.9	1.8	1.9	2.3	2.8	1.4	2.0
Growth of exports of G&S (US dollar terms, in percent)	21.9	5.0	5.1	9.4	6.4	6.5	6.4	6.5	7.0	3.7	6.0
Growth of imports of G&S (US dollar terms, in percent)	17.8	3.4	10.2	-3.9	10.6	13.3	-1.6	5.6	5.7	2.3	4.8
Grant element of new public sector borrowing (in percent)	...	28.2	27.0	27.3	27.7	26.3	26.1	22.8	16.1	...	25.7
Government revenues (excluding grants, in percent of GDP)	40.5	38.6	39.4	40.0	39.6	39.4	39.4	41.5	41.5	45.9	40.1
Aid flows (in Million of US dollars) 5/	703.5	103.6	96.2	98.6	95.4	76.9	79.1	81.6	139.0		
Grant-equivalent financing (in percent of GDP) 6/	...	3.5	3.4	3.4	3.3	3.2	3.2	2.6	2.5	...	3.1
Grant-equivalent financing (in percent of external financing) 6/	...	64.9	58.0	58.6	59.4	58.6	57.5	51.7	45.1	...	56.6
Nominal GDP (Million of US dollars)	2,677	2,717	2,775	2,843	3,015	3,213	3,344	4,293	7,315		
Nominal dollar GDP growth	10.5	1.5	2.1	2.4	6.1	6.5	4.1	5.5	5.5	4.1	4.4
Memorandum items:											
PV of external debt 7/	25.0	26.2	26.9	27.4	26.8	26.2	26.4	26.7	28.0		
In percent of exports	57.1	57.9	57.7	55.0	53.8	52.6	51.8	51.8	47.8		
Total external debt service-to-exports ratio	4.8	3.5	5.4	5.1	5.0	5.0	4.8	4.5	4.6		
PV of PPG external debt (in Million of US dollars)	668.9	711.8	745.5	777.9	809.0	843.0	882.8	1147.1	2046.9		
(PVt-PVt-1)/GDPt-1 (in percent)		1.6	1.2	1.2	1.1	1.1	1.2	1.5	1.7		
Non-interest current account deficit that stabilizes debt ratio	6.5	2.8	13.5	3.7	9.2	15.9	8.5	3.9	1.0		

Definition of external/domestic debt	**Currency-based**
Is there a material difference between the two criteria?	**No**





Sources: Country authorities; and staff estimates and projections.

1/ Includes both public and private sector external debt.

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

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

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

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

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

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

8/ Historical averages are generally derived over the past 10 years, subject to data availability, whereas projections averages are over the first year of projection and the next 10 years.

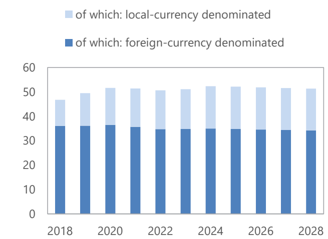
Table 6. Lesotho: Public Sector Debt Sustainability Framework, Baseline Scenario, 2017–2038

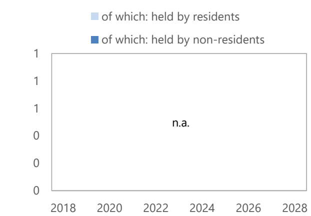
(In percent of GDP, unless otherwise indicated)

	Actual	Projections								Average 6/	
	2017	2018	2019	2020	2021	2022	2023	2028	2038	Historical	Projections
Public sector debt 1/	**38.8**	**46.8**	**49.5**	**51.7**	**51.4**	**50.7**	**51.1**	**51.4**	**50.0**	**37.7**	**51.0**
of which: external debt	**30.7**	**36.1**	**36.1**	**36.5**	**35.7**	**34.7**	**34.8**	**34.2**	**34.4**	**32.9**	**35.2**
Change in public sector debt	1.2	7.9	2.7	2.2	-0.2	-0.7	0.4	-0.2	-0.1		
Identified debt-creating flows	**-0.8**	**8.3**	**1.1**	**0.5**	**-1.3**	**-2.2**	**-1.1**	**-0.3**	**-0.1**	**0.9**	**0.3**
Primary deficit	**2.5**	**4.3**	**1.8**	**0.3**	**0.0**	**-0.7**	**-0.9**	**0.5**	**0.5**	**2.4**	**0.5**
Revenue and grants	42.9	41.3	41.9	42.4	42.0	41.8	41.7	43.4	43.4	**48.6**	**42.4**
of which: grants	2.4	2.8	2.5	2.5	2.4	2.4	2.4	1.9	1.9		
Primary (noninterest) expenditure	45.4	45.7	43.7	42.8	42.0	41.1	40.8	43.9	43.9	**50.9**	**42.9**
Automatic debt dynamics	**-3.3**	**4.0**	**-0.7**	**0.1**	**-1.3**	**-1.5**	**-0.3**	**-0.8**	**-0.6**		
Contribution from interest rate/growth differential	0.1	-1.4	-1.0	0.5	-1.3	-1.5	-0.2	-0.7	-0.5		
of which: contribution from average real interest rate	0.3	-0.3	0.4	0.4	0.5	0.6	0.5	0.8	0.9		
of which: contribution from real GDP growth	-0.2	-1.1	-1.4	0.1	-1.8	-2.1	-0.7	-1.5	-1.5		
Contribution from real exchange rate depreciation	-3.4	...	...	...	...	...	...	...	...		
Other identified debt-creating flows	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**
Privatization receipts (negative)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0		
Recognition of contingent liabilities (e.g., bank recapitalization)	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		
Other debt creating or reducing flow (please specify)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0		
Residual	**2.1**	**5.0**	**1.9**	**1.3**	**1.1**	**1.5**	**1.5**	**0.0**	**0.0**	**-1.2**	**1.3**
Sustainability indicators											
PV of public debt-to-GDP ratio 2/	**31.0**	**37.9**	**40.7**	**42.9**	**42.9**	**42.5**	**43.1**	**44.2**	**44.0**		
PV of public debt-to-revenue and grants ratio	**72.3**	**91.7**	**97.3**	**101.0**	**102.2**	**101.7**	**103.3**	**101.9**	**101.4**		
Debt service-to-revenue and grants ratio 3/	**5.6**	**14.7**	**9.5**	**9.5**	**13.2**	**12.8**	**13.0**	**14.3**	**13.4**		
Gross financing need 4/	4.9	10.4	5.8	4.4	5.5	4.6	4.5	6.7	6.3		
Key macroeconomic and fiscal assumptions											
Real GDP growth (in percent)	0.5	2.9	3.1	-0.2	3.6	4.2	1.4	3.0	3.0	**3.7**	**2.6**
Average nominal interest rate on external debt (in percent)	2.0	1.6	1.9	1.9	1.9	1.9	1.9	2.3	2.8	**1.4**	**2.0**
Average real interest rate on domestic debt (in percent)	5.6	-0.8	3.6	3.6	4.4	4.9	4.3	4.7	4.8	**0.2**	**3.9**
Real exchange rate depreciation (in percent, + indicates depreciation)	-10.4	...	...	...	...	...	...	...	...	**0.3**	**...**
Inflation rate (GDP deflator, in percent)	1.6	4.9	5.7	6.1	5.3	5.2	5.7	5.5	5.5	**6.1**	**5.5**
Growth of real primary spending (deflated by GDP deflator, in percent)	-6.1	3.6	-1.3	-2.3	1.7	2.0	0.7	3.0	3.0	**5.3**	**2.3**
Primary deficit that stabilizes the debt-to-GDP ratio 5/	1.3	-3.6	-0.9	-1.8	0.2	0.0	-1.3	0.7	0.6	**3.4**	**-0.6**
PV of contingent liabilities (not included in public sector debt)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0		

Definition of external/domestic debt	**Currency-based**
Is there a material difference between the two criteria?	**No**

Public sector debt 1/





Sources: Country authorities; and staff estimates and projections.

1/ Coverage of debt: The central government, central bank, government-guaranteed debt. Definition of external debt is Currency-based.

2/ The underlying PV of external debt-to-GDP ratio under the public DSA differs from the external DSA with the size of differences depending on exchange rates projections.

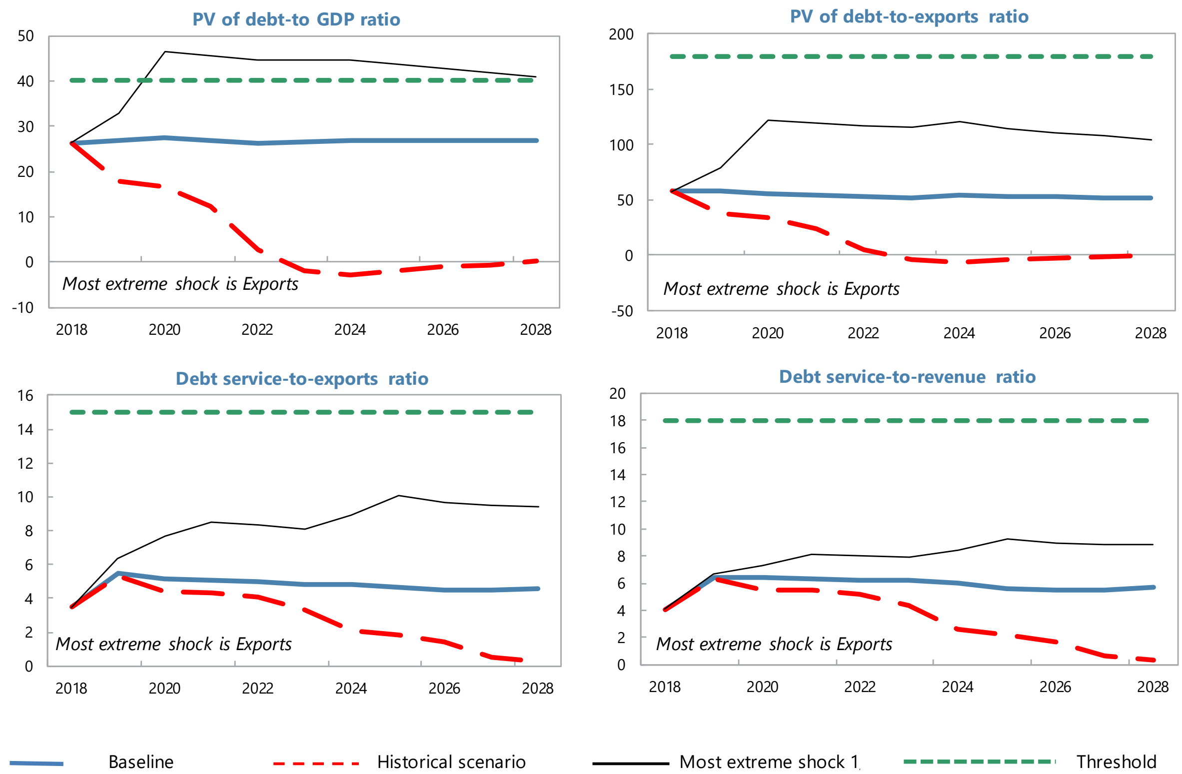
3/ Debt service is defined as the sum of interest and amortization of medium and long-term, and short-term debt.

4/ 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 and other debt creating/reducing flows.

5/ Defined as a primary deficit minus a change in the public debt-to-GDP ratio ((-): a primary surplus), which would stabilizes the debt ratio only in the year in question.

6/ Historical averages are generally derived over the past 10 years, subject to data availability, whereas projections averages are over the first year of projection and the next 10 years.

Figure 1. Lesotho: Indicators of Public and Publicly Guaranteed External Debt under Alternative Scenarios, 2018–2028 1/



Customization of Default Settings	Size	Interactions
Tailored Tests		
Combined CLs	Yes	
Natural Disasters	n.a.	n.a.
Commodity Prices [2/]	n.a.	n.a.
Market Financing	n.a.	n.a.

Note: "Yes" indicates any change to the size or interactions of the default settings for the stress tests. "n.a." indicates that the stress test does not apply.

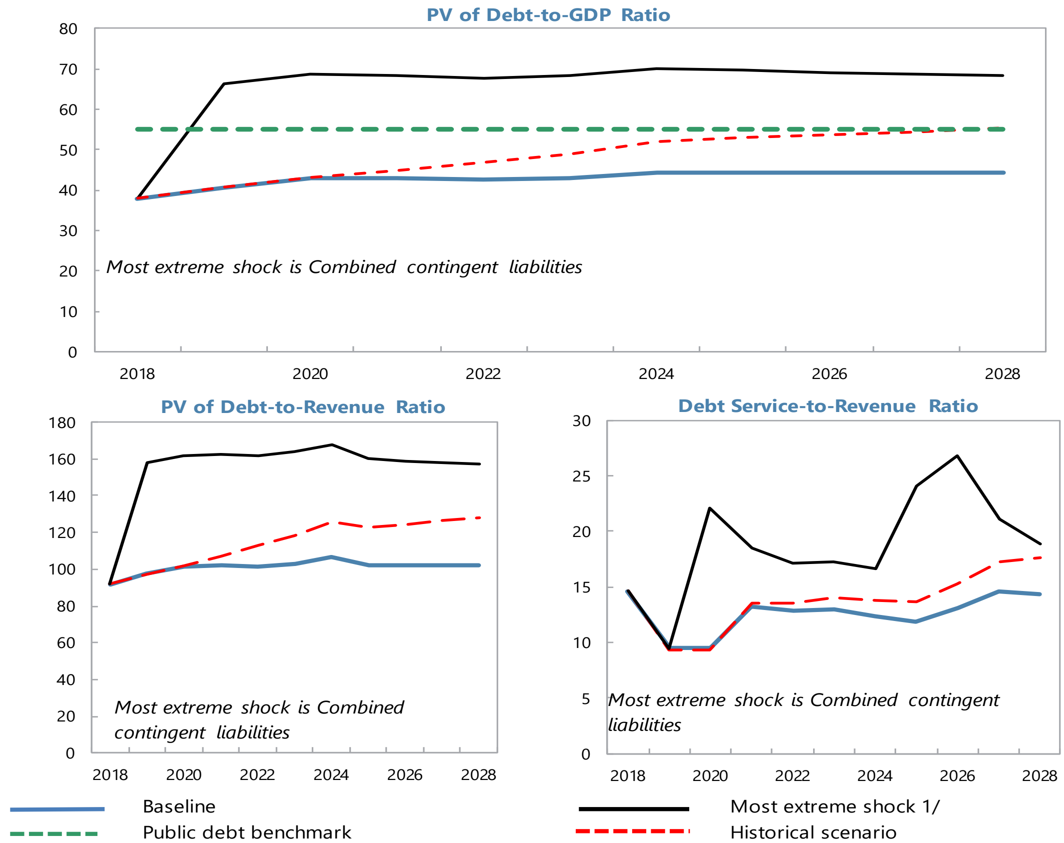
Borrowing Assumptions for Stress Tests*	Default	User defined
Shares of marginal debt		
External PPG MLT debt	100%	
Terms of marginal debt		
Avg. nominal interest rate on new borrowing in USD	2.6%	2.6%
USD Discount rate	5.0%	5.0%
Avg. maturity (incl. grace period)	24	24
Avg. grace period	4	4

* Note: All the additional financing needs generated by the shocks under the stress tests are assumed to be covered by PPG external MLT debt in the external DSA. Default terms of marginal debt are based on baseline 10-year projections.

Sources: Country authorities; and staff estimates and projections.

1/ The most extreme stress test is the test that yields the highest ratio in or before 2028. Stress tests with one-off breaches are also presented (if any), while these one-off breaches are deemed away for mechanical signals. When a stress test with a one-off breach happens to be the most exterme shock even after disregarding the one-off breach, only that stress test (with a one-off breach) would be presented.
2/ The magnitude of shocks used for the commodity price shock stress test are based on the commodity prices outlook prepared by the IMF research department.

Figure 2. Lesotho: Indicators of Public Debt under Alternative Scenarios, 2018–2028



Borrowing Assumptions for Stress Tests*	Default	User defined
Shares of marginal debt		
External PPG medium and long-term	48%	48%
Domestic medium and long-term	52%	39%
Domestic short-term	0%	13%
Terms of marginal debt		
External MLT debt		
Avg. nominal interest rate on new borrowing in USD	2.6%	2.6%
Avg. maturity (incl. grace period)	24	24
Avg. grace period	4	4
Domestic MLT debt		
Avg. real interest rate on new borrowing	4.6%	4.6%
Avg. maturity (incl. grace period)	7	7
Avg. grace period	5	5
Domestic short-term debt		
Avg. real interest rate	1.6%	1.6%

* Note: The public DSA allows for domestic financing to cover the additional financing needs generated by the shocks under the stress tests in the public DSA. Default terms of marginal debt are based on baseline 10-year projections.

Sources: Country authorities; and staff estimates and projections.

1/ The most extreme stress test is the test that yields the highest ratio in or before 2028. The stress test with a one-off breach is also presented (if any), while the one-off breach is deemed away for mechanical signals. When a stress test with a one-off breach happens to be the most exterme shock even after disregarding the one-off breach, only that stress test (with a one-off breach) would be presented.

Table 7. Lesotho: Sensitivity Analysis for Key Indicators of Public and Publicly Guaranteed External Debt, 2018–2028

(In percent)

	Projections 1/										
	2018	2019	2020	2021	2022	2023	2024	2025	2026	2027	2028
PV of debt-to GDP ratio											
Baseline	26.2	26.9	27.4	26.8	26.2	26.4	26.7	26.7	26.7	26.7	26.7
A. Alternative Scenarios											
A1. Key variables at their historical averages in 2018-2028 2/	26	18	17	12	3	-2	-3	-2	-1	-1	0
B. Bound Tests											
B1. Real GDP growth	26	28	29	29	28	28	28	28	29	29	29
B2. Primary balance	26	29	33	33	33	33	33	34	34	35	35
B3. Exports	26	33	**46**	**45**	**44**	**45**	**45**	**44**	**43**	**42**	**41**
B4. Other flows 3/	26	33	39	39	38	38	38	37	37	36	35
B5. Depreciation	26	34	25	25	24	24	24	25	26	26	27
B6. Combination of B1-B5	26	35	37	37	36	36	36	35	35	35	34
C. Tailored Tests											
C1. Combined contingent liabilities	26	37	40	40	39	40	**40**	**42**	**43**	**44**	**44**
C2. Natural disaster	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
C3. Commodity price	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
C4. Market Financing	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Threshold	40	40	40	40	40	40	40	40	40	40	40
PV of debt-to-exports ratio											
Baseline	58	58	55	54	53	52	55	53	53	52	52
A. Alternative Scenarios											
A1. Key variables at their historical averages in 2018-2028 2/	58	38	34	24	5	-4	-6	-4	-2	-1	0
B. Bound Tests											
B1. Real GDP growth	58	58	55	54	53	52	55	53	53	52	52
B2. Primary balance	58	63	67	66	65	65	69	67	68	68	67
B3. Exports	58	79	123	120	117	115	121	115	111	108	104
B4. Other flows 3/	58	70	79	77	76	74	78	74	72	70	68
B5. Depreciation	58	58	40	39	38	37	40	39	40	41	41
B6. Combination of B1-B5	58	77	71	84	83	81	85	81	80	78	76
C. Tailored Tests											
C1. Combined contingent liabilities	58	80	80	79	78	78	82	83	86	86	85
C2. Natural disaster	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
C3. Commodity price	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
C4. Market Financing	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Threshold	180	180	180	180	180	180	180	180	180	180	180
Debt service-to-exports ratio											
Baseline	3	5	5	5	5	5	5	5	4	4	5
A. Alternative Scenarios											
A1. Key variables at their historical averages in 2018-2028 2/	3	5	4	4	4	3	2	2	1	1	0
B. Bound Tests											
B1. Real GDP growth	3	5	5	5	5	5	5	5	4	4	5
B2. Primary balance	3	5	5	5	5	5	6	6	6	6	6
B3. Exports	3	6	8	8	8	8	9	10	10	10	9
B4. Other flows 3/	3	5	6	6	6	5	6	6	6	6	6
B5. Depreciation	3	5	5	5	4	4	4	3	3	3	4
B6. Combination of B1-B5	3	6	7	7	7	6	7	7	7	7	7
C. Tailored Tests											
C1. Combined contingent liabilities	3	5	6	6	6	6	6	5	5	5	6
C2. Natural disaster	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
C3. Commodity price	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
C4. Market Financing	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Threshold	15	15	15	15	15	15	15	15	15	15	15
Debt service-to-revenue ratio											
Baseline	4	6	6	6	6	6	6	6	5	6	6
A. Alternative Scenarios											
A1. Key variables at their historical averages in 2018-2028 2/	4	6	5	5	5	4	3	2	2	1	0
B. Bound Tests											
B1. Real GDP growth	4	7	7	7	7	7	6	6	6	6	6
B2. Primary balance	4	6	7	7	7	7	7	7	7	7	7
B3. Exports	4	7	7	8	8	8	8	9	9	9	9
B4. Other flows 3/	4	6	7	7	7	7	8	8	8	8	8
B5. Depreciation	4	8	8	7	7	7	7	5	5	5	6
B6. Combination of B1-B5	4	7	7	7	7	7	8	7	7	7	7
C. Tailored Tests											
C1. Combined contingent liabilities	4	6	7	7	7	7	7	7	7	7	7
C2. Natural disaster	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
C3. Commodity price	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
C4. Market Financing	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Threshold	18	18	18	18	18	18	18	18	18	18	18

Sources: Country authorities; and staff estimates and projections.
1/ A bold value indicates a breach of the threshold.
2/ Variables include real GDP growth, GDP deflator (in U.S. dollar terms), non-interest current account in percent of GDP, and non-debt creating flows.
3/ Includes official and private transfers and FDI.

Table 8. Lesotho: Sensitivity Analysis for Key Indicators of Public Debt, 2018–2028

	Projections 1/										
	2018	**2019**	**2020**	**2021**	**2022**	**2023**	**2024**	**2025**	**2026**	**2027**	**2028**
					PV of Debt-to-GDP Ratio						
Baseline	38	41	43	43	43	43	44	44	44	44	44
A. Alternative Scenarios											
A1. Key variables at their historical averages in 2018-2028 2/	38	41	43	45	47	49	52	53	54	55	**55**
B. Bound Tests											
B1. Real GDP growth	38	43	49	52	53	**56**	**60**	**62**	**64**	**67**	**69**
B2. Primary balance	38	46	**56**	**56**	**55**	**56**	**58**	**57**	**57**	**57**	**57**
B3. Exports	38	46	**59**	**59**	**58**	**59**	**60**	**59**	**58**	**57**	**56**
B4. Other flows 3/	38	47	55	55	54	55	**56**	**55**	54	54	53
B5. Depreciation	38	44	43	41	38	36	35	32	30	28	25
B6. Combination of B1-B5	38	43	47	44	43	43	44	44	44	43	42
C. Tailored Tests											
C1. Combined contingent liabilities	38	**66**	**69**	**68**	**68**	**68**	**70**	**70**	**69**	**69**	**68**
C2. Natural disaster	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
C3. Commodity price	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
C4. Market Financing	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Public debt benchmark	55	55	55	55	55	55	55	55	55	55	55
					PV of Debt-to-Revenue Ratio						
Baseline	92	97	101	102	102	103	107	102	102	102	102
A. Alternative Scenarios											
A1. Key variables at their historical averages in 2018-2028 2/	92	98	102	107	113	118	126	122	124	126	128
B. Bound Tests											
B1. Real GDP growth	92	103	116	122	127	134	143	143	148	153	158
B2. Primary balance	92	111	132	133	132	134	138	132	132	131	130
B3. Exports	92	109	139	140	139	141	144	136	133	131	129
B4. Other flows 3/	92	112	130	130	129	131	134	127	125	123	122
B5. Depreciation	92	107	103	98	91	87	84	75	69	64	59
B6. Combination of B1-B5	92	103	111	104	102	103	106	102	101	99	98
C. Tailored Tests											
C1. Combined contingent liabilities	92	158	162	163	162	164	168	160	159	158	157
C2. Natural disaster	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
C3. Commodity price	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
C4. Market Financing	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
					Debt Service-to-Revenue Ratio						
Baseline	15	9	10	13	13	13	12	12	13	15	14
A. Alternative Scenarios											
A1. Key variables at their historical averages in 2018-2028 2/	15	9	9	14	14	14	14	14	15	17	18
B. Bound Tests											
B1. Real GDP growth	15	10	11	15	15	16	16	16	19	21	22
B2. Primary balance	15	9	13	18	15	15	15	17	21	21	18
B3. Exports	15	9	10	14	14	14	14	15	16	17	17
B4. Other flows 3/	15	9	10	14	14	14	14	14	15	17	16
B5. Depreciation	15	10	11	13	13	13	12	11	11	12	12
B6. Combination of B1-B5	15	9	9	15	13	13	13	12	15	16	14
C. Tailored Tests											
C1. Combined contingent liabilities	15	9	22	19	17	17	17	24	27	21	19
C2. Natural disaster	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
C3. Commodity price	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
C4. Market Financing	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.

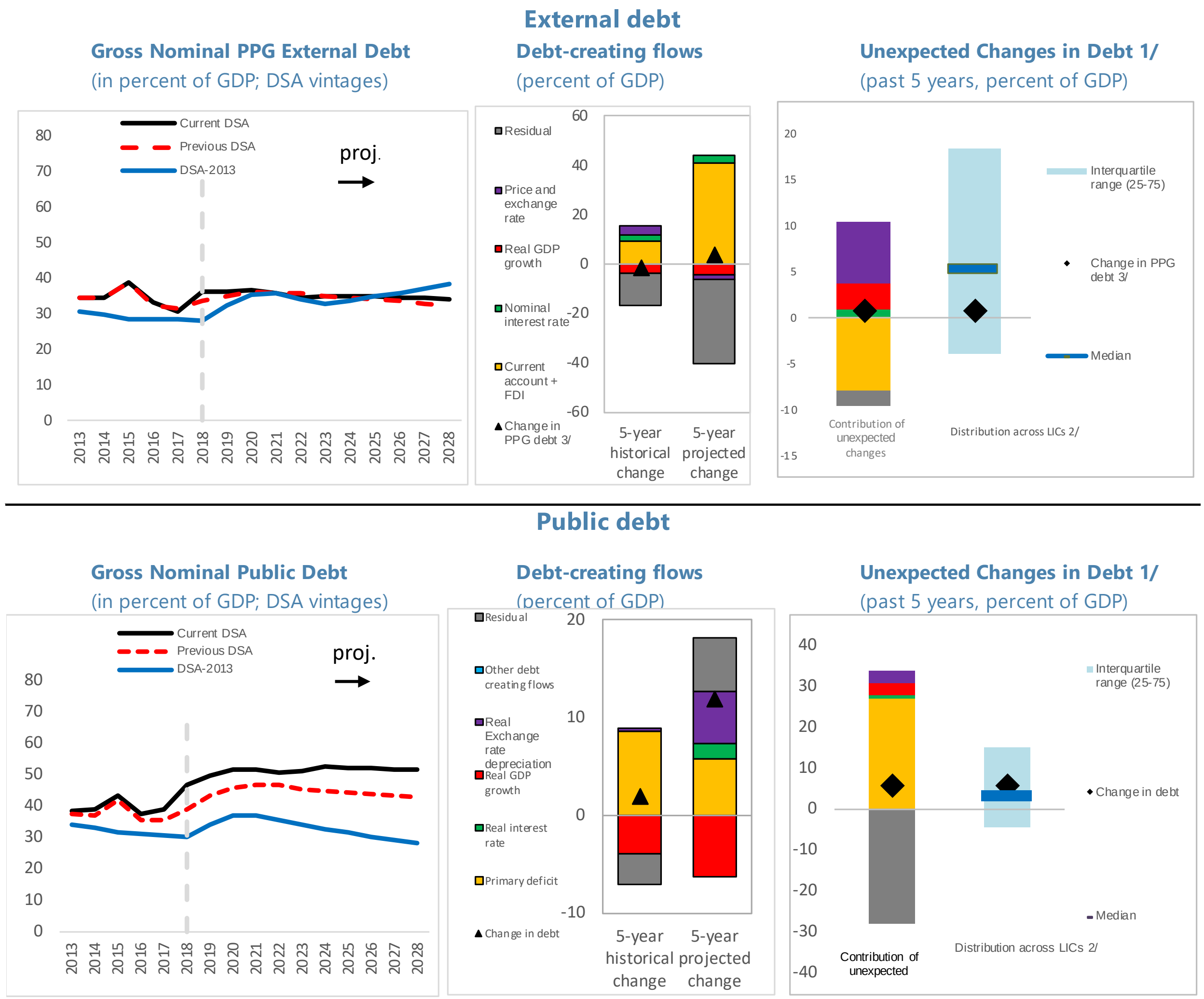
Sources: Country authorities; and staff estimates and projections.

1/ A bold value indicates a breach of the benchmark.

2/ Variables include real GDP growth, GDP deflator and primary deficit in percent of GDP.

3/ Includes official and private transfers and FDI.

Figure 3. Lesotho: Drivers of Debt Dynamics – Baseline Scenario



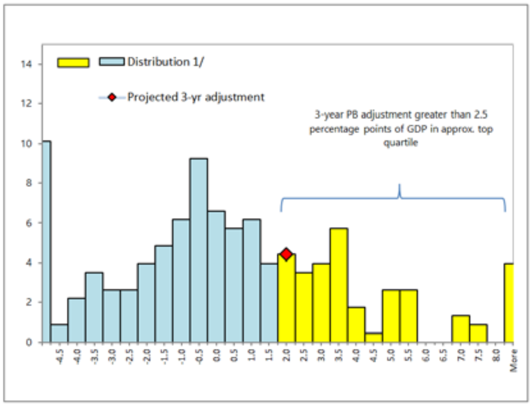
1/ Difference between anticipated and actual contributions on debt ratios.

2/ Distribution across LICs for which LIC DSAs were produced.

3/ Given the relatively low private eternal debt for average low-income countries, a ppt change in PPG external debt should be largely explained by the drivers of the external debt dynamics equation.

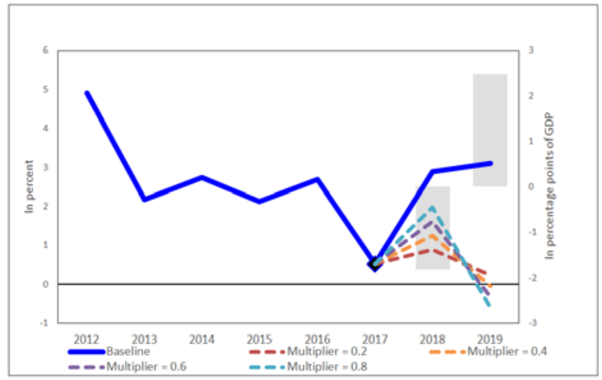
Figure 4. Lesotho: Realism Tools

3-Year Adjustment in Primary Balance
(Percentage points of GDP)



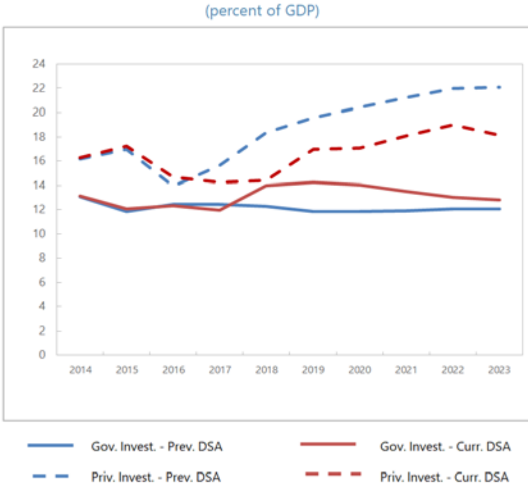
1/ Data cover Fund-supported programs for LICs (excluding emergency financing) approved since 1990. The size of 3-year adjustment from program inception is found on the horizontal axis; the percent of sample is found on the vertical axis.

Fiscal Adjustment and Possible Growth Paths 1/



1/ Bars refer to annual projected fiscal adjustment (right-hand side scale) and lines show possible real GDP growth paths under different fiscal multipliers (left-hand side scale).

Public and Private Investment Rates
(percent of GDP)



Contribution to Real GDP growth
(percent, 5-year average)

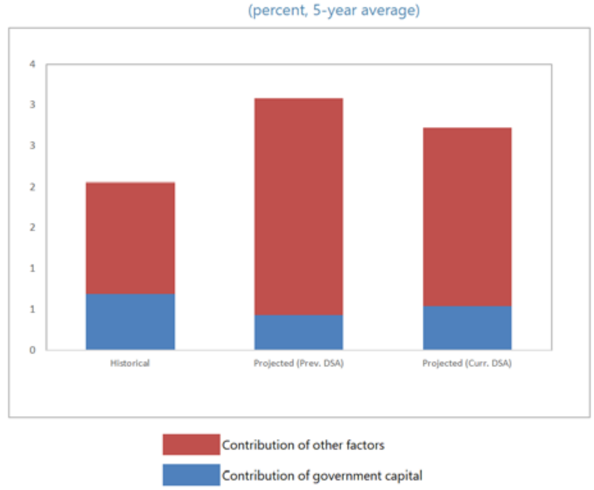
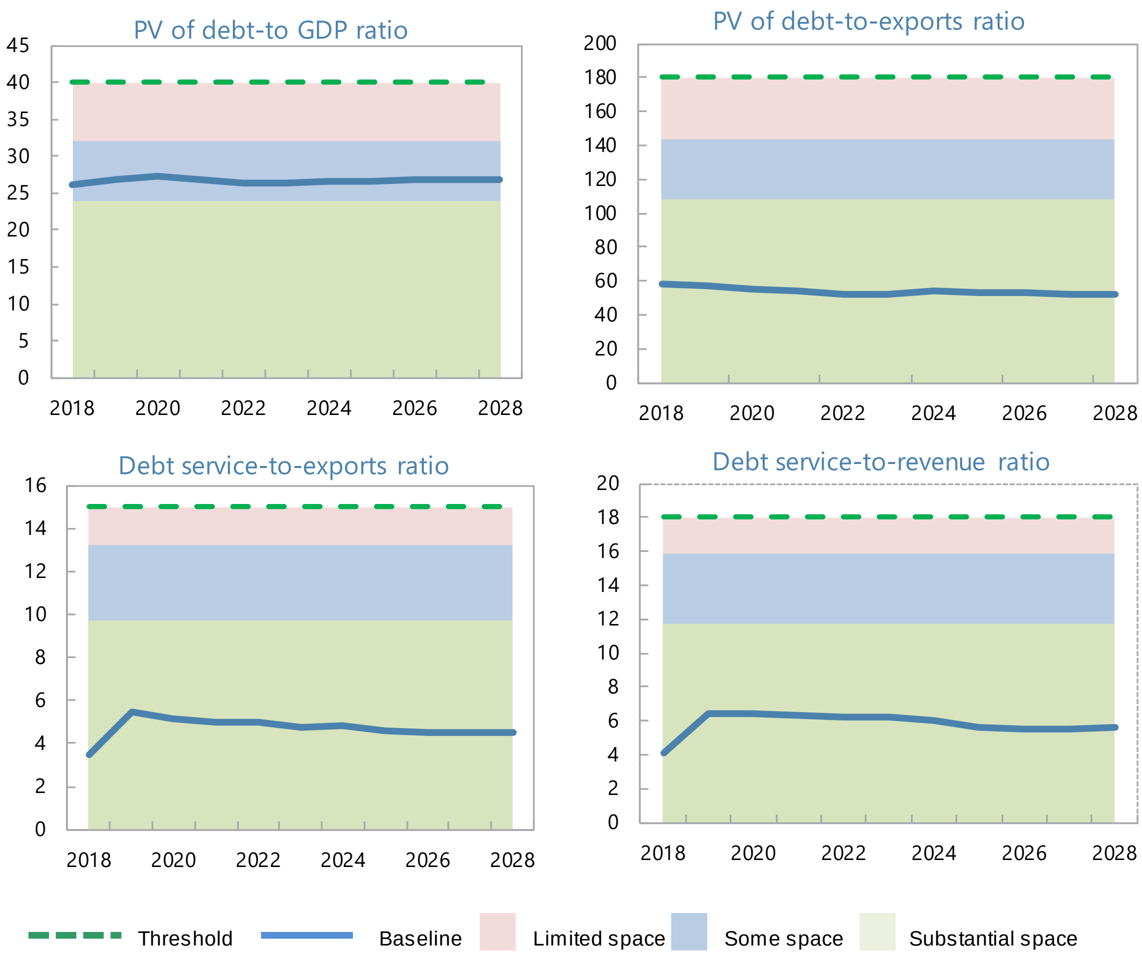


Figure 5. Lesotho: Qualification of the Moderate Category, 2018–2028 1/



Sources: Country authorities and staff estimates and projections.

1/ For the PV debt/GDP and PV debt/exports thresholds, x is 20 percentand y is 40 percent. For debt service/Exports and debt service/revenue thresholds, x is 12 percent and y is 35 percent.

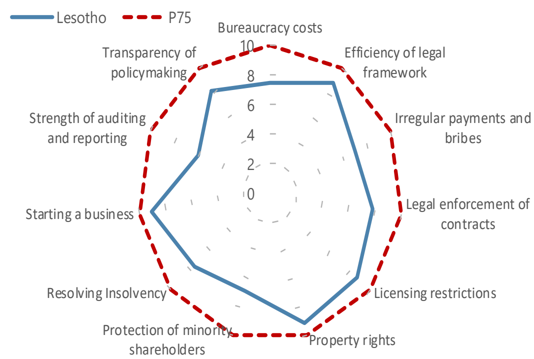
Annex IV. Growth Impact of Structural Reforms

The new National Strategic Development Plan (NSDP-II) aims to support inclusive, private sector-led growth by improving the business climate, accumulating human capital, building enabling infrastructure, and strengthening governance and accountability systems. This annex considers structural reforms in those areas and quantifies their potential impact on growth and job creation.

1. Corruption is a significant institutional weakness in Lesotho. Corruption is perceived as a major obstacle to doing business by the private sector in Lesotho, with high prevalence of bribes and lack of transparency in policymaking.[1,2] The authorities understand the concern and are working to address it with a new law to strengthen the independence of the anticorruption agency and the ongoing implementation of an asset declaration requirement for public servants first legislated in 2006.

Institutions in Lesotho

(Index, 10=P75)



Sources: World Bank, World Economic Forum, Frasier Institute.
Note: P75 = 75th percentile of developing and emerging countries.

2. The legal framework fails to solve disputes efficiently. Politicization of the judiciary is a concern. The Court of Appeal was paralyzed for almost two years because of a legal battle over its presidency, which drew significant international attention. Enforcement of contracts is weak and resolving insolvency takes 2.6 years with a recovery rate of 28 cents per dollar on average, as opposed to 2 years and 43 cents of recovery on average in the rest of the SACU region.[3] A new insolvency bill is expected to streamline the process and reduce costs.

3. Burdensome and unstable regulations hinder private investment. An onerous license regime exists, and new licenses are created without full buy-in of relevant stakeholders. The 2018 wool and mohair regulations have disrupted the market and raised strong opposition among farmers. Discussions on a new mining bill are still ongoing, creating uncertainty for the industry. Under the Private Sector Competitiveness and Economic Diversification Project, supported by the World Bank and the African Development Bank, the authorities have worked extensively on reducing red tape, e.g. with the introduction of a one-stop shop (OBFC) for licensing. There is room to expand the role of the OBFC, for instance to cover work permits for foreigners, and to streamline regulations. In the case of work permits, removing the requirement of signatures by the PS and

[1] Caution must be exercised with interpreting perception-based indicators as the ones presented in this annex. Given their standardized nature, these indicators may not be a comprehensive measure of the business environment. Concerns about sample size and geographic coverage may also be in order.

[2] Corruption is ranked as the second most problematic factor for doing business in the World Economic Forum's 2017 Executive Opinion Survey and the third one for medium firms in the World Bank's 2016 Enterprise Survey.

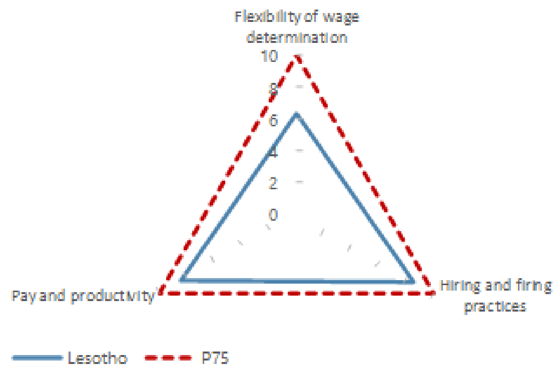
[3] World Bank's 2019 Doing Business.

Minister could significantly speed up the process, which sometimes takes more than 6 months for a 2-year permit. The authorities are working on a new licensing bill to introduce a risk-based approach and replace pre-inspection with post-inspection requirements to further reduce the number of days needed to start a business, currently 29. The need for trading licenses and annual renewal of tourism licenses can also be reconsidered.

4. There is room to strengthen flexibility of the labor market. The labor movement in Lesotho is fragmented and strikes are rare. However, wages are inflexible and their link to productivity is weak. The minimum wage in the textile industry is binding and was subject of controversy lately when the government intervened ad-hoc after negotiations stalled. Limiting the role of the government to mediating between the parties in industrial relations conflicts, as stipulated by law, while guaranteeing the unions right to pursue peaceful industrial action would lead to more efficient labor market outcomes. The industry could boost productivity by introducing a wage structure that combines a fixed amount and bonuses for meeting production targets. Companies already operating under such a system are reporting positive results. The weak link between pay and productivity in Lesotho also emerges from the massive public wage bill. Public servant wages are significantly higher than those of workers in the private sector, particularly for the highly-educated. Wage increases in the public sector are not linked to productivity and every worker receives an automatic annual notch increase of around 2.5 percent until they reach the highest pay point for their category, in addition to the cost of living adjustment paid to everyone.

Labor Market Flexibility in Lesotho

(Index, 10=P75)



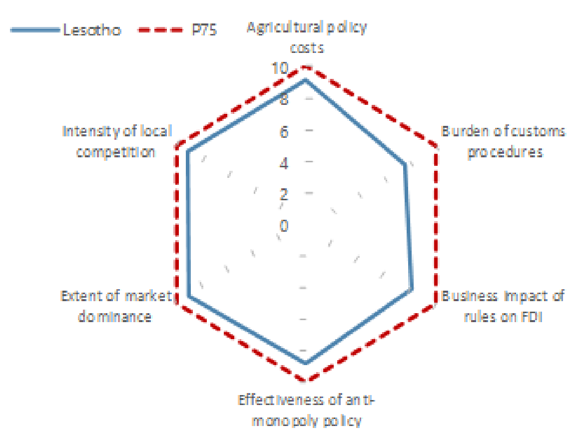
Source: World Economic Forum.

Note: P75 = 75th percentile of developing and emerging countries.

5. Monopoly power limits productivity growth across the economy. Market concentration is high in Lesotho owing to extensive regulations and significant participation of the public sector in the production of goods and services. The new wool and mohair license left local farmers with only one broker through whom they can sell their production. The dairy industry is characterized by monopolies in processing and distribution. Distribution fees collected by the Lesotho National Dairy Board have in the past been used to bailout the processing plant, in what amounts to a

Competition in the Goods Market in Lesotho

(Index, 10=P75)



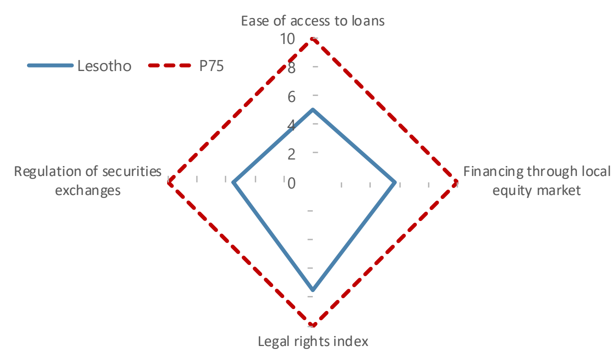
Source: World Economic Forum.

Note: P75 = 75th percentile of developing and emerging countries.

regressive tax. Staff welcomes the authorities' desire to promote competition in the industry through new processing plants and the use of distribution fees to provide technical assistance to farmers. Staff encourages authorities to not raise the distribution fees as that tax would disproportionately hurt the poor. The government owns shares in a number of companies that do not provide essential services such as a hotel, a brewery, and a brick manufacturer, among others. Underperformance of some of these companies has been chronic, and the authorities are considering divesting by selling their shares on the Maseru Securities Market with the dual goal of promoting economic efficiency and boosting domestic market development. The authorities are encouraged to consider the introduction of regulations to promote competition and consumer protection, noting that even if the market size in Lesotho is small, the strong integration with the other SACU countries offers opportunities to leverage economies of scale. Price intervention is also discouraged as it promotes misallocation of resources.

6. Access to credit is a major impediment for small and medium enterprises. The financial sector in Lesotho is liquid and profitable, yet its ability to intermediate capital between savers and local entrepreneurs is very limited. With credit to the private sector at the lowest level in the region, the financial sector channels domestic savings outwards to South Africa. For example, the pension fund for public employees owns assets for M5 billion, of which only 3 percent is invested in Lesotho. High fees for banking services also hurt financial inclusion and limit the possibility for poor people to borrow formally. The authorities have already taken some measures to improve access to credit. A credit registry has been created and a credit scoring system is being developed. At present, it mainly covers individuals, particularly public employees, but it is expected to be extended to companies. CBL regulations have directed banks to offer a zero-cost bank account for low-income households to foster financial inclusion. The Maseru Securities Market has been created but has no listings. A commercial bank is considering issuing commercial paper. Mortgages, the financial product with the fastest growth recently in the country, are an example of success of reforms after the 2010 Land Act was passed and registration of land titles was streamlined.

Financial Market's Contribution to Growth in Lesotho
(Index, 10=P75)

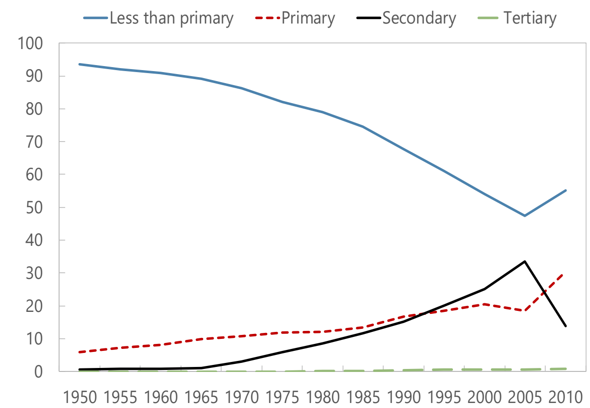


Sources: World Bank and World Economic Forum.
Note: P75 = 75th percentile of developing and emerging countries.

7. Lesotho's labor force suffers from a lack of relevant skills. Educational outcomes are poor despite large spending (Figure 3). While primary completion has risen, over half of the labor force has not completed primary education. Public expenditures in education are large but unproductive. In primary and secondary education, the wage bill accounts for close to 80 percent of the ministerial budget leaving marginal amounts to provide for materials, school feeding, and capital expenditures. While there may be some overstaffing of primary teachers, the high wage bill mostly reflects high teacher wages, which are on average 8 times the GDP per capita, whereas in South Africa the ratio is 3. Teachers with a college diploma receive a substantially higher wage without additional responsibilities. Limited incentives exist for teachers to relocate to rural areas leading to a very uneven distribution of teachers across the country. Lack of skills is a major concern for the private sector, particularly in skilled occupations such as managers, chefs, engineers, and technicians. The authorities are encouraged to partner with the private sector to develop the specific skills needed in the labor market.

Educational Attainment in Lesotho

(Percent)

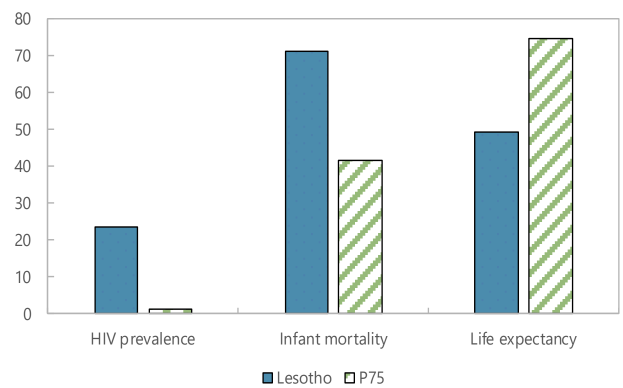


Source: Barro-Lee Educational Attainment Data.

8. Spending inefficiencies contribute to poor health outcomes. Health outcomes deteriorated dramatically in the 1990s with the spread of the HIV epidemic. At 23.6 percent, Lesotho has the second highest HIV prevalence in the world, just after Eswatini. While new infections have been curbed and treatment has expanded with support from the Millennium Challenge Corporation, costs for the health system are high and labor productivity is low. HIV-associated diseases, such as tuberculosis, are also very prevalent. In addition, payments to private health providers are not linked to performance, leading to uneven and low-quality service delivery (Figure 4). The authorities should review the health expenditure framework to better align incentives and improve service delivery with support from the World Bank.

Health Outcomes

(Lesotho vs. comparators)



Source: World Bank.
Note: P75 = 75th percentile of developing and emerging countries.

9. An ambitious program of reforms could deliver large gains in growth and employment. We estimate the gains in output and employment of an ambitious reform package that addresses the weaknesses discussed in this appendix using panel data analysis.[4] Implementing

[4] The methodology follows Prati, A., Onorato, M. G., and Papageorgiou, C. 2010. "Which reforms work and under what institutional environment? Evidence from a new data set on structural reforms." Review of Economic Studies. Reforms are defined using different indicators as discussed in this annex and their return in terms of per capita growth rate is estimated with a panel regression including lagged per capita GDP, and country and time fixed effects. Reforms are calibrated to reach the levels of the 75th percentile of the sample of developing and emerging economies. Reforms are assumed to be implemented over the medium term, with human capital reforms to take place over a longer horizon.

these reforms could raise GDP per capita by more than 10 percent over the medium term, while slashing unemployment. Over a quarter of these gains would come from a better business environment to promote private sector development most importantly through tackling of corruption and strengthening auditing standards. Labor market, goods market, and financial markets reforms would contribute a fifth of the gains each, mainly via enhanced flexibility of wage determination, easier access to loans and venture capital, and development of the domestic equity market. Human capital reforms, such as containing HIV prevalence and improving the quality of primary education, would take longer to materialize, but even partial progress attained within a 5-year horizon would contribute 11 percent of the gains.

Growth Impact of Individual Structural Reforms in Lesotho

Institutions	
Bureaucracy costs	
Efficiency of legal framework in settling disputes	
Irregular payments and bribes	
Licensing restrictions	
Property rights	
Protection of minority shareholders' interests	
Resolving Insolvency	
Strength of auditing and reporting standards	-2
Transparency of government policymaking	
Labor Market	
Flexibility of wage determination	
Hiring and firing practices	
Pay and productivity	
Financial Market	
Ease of access to loans	
Financing through local equity market	
Legal rights index	
Regulation of securities exchanges	
Venture capital availability	
Goods Market	
Agricultural policy costs	
Burden of customs procedures	
Business impact of rules on FDI	-2
Effectiveness of anti-monopoly policy	
Extent of market dominance	
Intensity of local competition	
Human Capital	
HIV prevalence	-2
Quality of primary education	-2

Source: Staff estimates.
Note: A darker color denotes stronger impact on growth.

Annex V. Leveraging Lesotho's Financial System

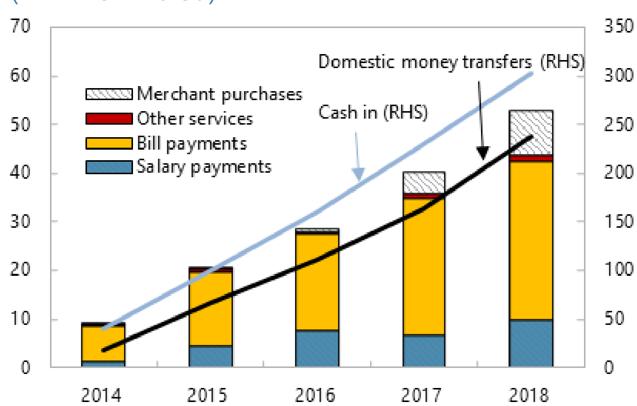
While the banking system is sound, emerging risks require close monitoring. To leverage the full potential of Lesotho's financial system, structural reforms, a deepening of the capital market and the practical implementation of regulatory frameworks are key. These efforts combined with the newly established financial inclusion agenda have the potential to increase financial access and inclusion.

1. **While the banking system is sound and profitable, government payment arrears are an emerging concern for both the financial system and the private sector.** Profitability remains high, driven by significant intermediation margins. Banks' capital buffers appear sufficient but have shrunk in the last year (according to the CBL's latest stress test). Government arrears are slowly translating into financial difficulties for businesses in Lesotho, a significant part of which depend on government contracts. Banks are reporting a moderate pick-up in NPL levels which may impact banks' profitability. NPL's could lead to curtailed investment, drive down tax revenue, and force additional cuts to fiscal spending, if arrears were to accumulate further.

2. **Notable progress has been made in establishing the regulatory framework for banking supervision, but implementation will be key.** Following the successful issuance of guidelines, the practical implementation of Basel II requirements should be established and the supervision of all deposit taking financial institutions centralized at the CBL. The CBL should closely monitor whether banks conduct business in line with sound corporate governance and accounting principles. More granular data to enable comprehensive financial surveillance would be desirable to support above efforts.

3. **The increased provision of mobile money services is an indicator of progress in financial access and inclusion.** Transaction values and volumes, the number of agents, mobile money accounts and the type of usage (salary, bill payments) are steadily growing, allowing previously-excluded socioeconomic groups to access financial services. Telecommunication companies are providing insurance products and are also planning to extend microloans in the next months. Banks are catching up by launching e-wallets and establishing their own agent networks. Post Bank is awaiting CBL approval to start issuing mobile money, and a decision is expected soon. While the increased access to financial services contributes to financial deepening and inclusion, the authorities should continue to closely monitor any potential build-up of financial risks.

Mobile money usage
(In million maloti)



Sources: Country authorities and IMF Staff estimations.

4. The low income "saving account" offers formal financial access but awareness needs to be increased to expand usage. In December 2017, the CBL issued a *Directive on Banking Fees and Charges* instructing banks to offer saving accounts to individuals earning a monthly gross income of less than M3,000 at zero cost. In practice, banks started to offer transactional accounts, rather than saving accounts, for which few individuals have yet applied. The reason appears to be a lack of awareness among qualifying individuals and Know Your Customer (KYC) practices which require verifying documents when opening new accounts. Obtaining these takes time and chief officers providing them are not always available. The *Electronic Signature Bill* is being considered to provide a digital solution to procedural challenges. Given that banks must comply with KYC implying costs, outreach should be driven by national authorities.

5. Liquidity requirements need to be reviewed. Banks currently meet their LAR mainly through the holding of T-bills and gross deposits with other banks. The latter inflates liquid reserves. As previously recommended, the regulation should be amended to include net interbank positions to obtain a meaningful measure of liquidity. The limited number of liquid assets in Lesotho may suggest a need for a reduction in the minimum liquidity requirement - South Africa, for example, has an LAR of 20 percent. The mission understands the desire to encourage development of longer-term financing instruments. However, it believes that artificially classifying government bonds as liquid in the absence of a secondary market would be inappropriate.

6. The capital market should be deepened. Commercial banks short-term funding structure naturally limits their appetite for medium and long-term treasury bonds. The large asset base of the pension and insurance sectors offer a more natural source of demand. For planned auctions to be successful it will be key that the MOF and CBL liaise closely with asset managers of the respective institutions and align auction calendars, maturity profiles, and interest rates with market appetite. Supporting local capital market development as described above would help introduce competition and lower costs. Developing a secondary market for government paper could also incentivize banks to participate in longer-term auctions.

Annex VI. Capacity Development Strategy

Public financial management is the key priority area for CD in Lesotho. Weak expenditure controls, financial reporting, and budgeting processes hinder the efficient allocation of resource and hamper surveillance. Other key weaknesses are in non-bank supervision,[1] where the enforcement of AML/CFT provisions will be important ahead of the ESAAMLG assessment in 2022. Further progress in deepening the government securities market and national accounts will also be critical. TA providers, in coordination with the country team, should consider potential synergies across CD providers to better leverage Fund resources.[2]

Key Overall CD Priorities Going Forward

Priorities	Objectives
Public financial management	Budget execution and control
Public financial management	Fiscal reporting
Strengthen macroeconomic and financial statistics compilation and dissemination for decision making	National accounts and government finance statistics
Financial sector supervision	Oversight of non-bank sector, enforcement of AML/CFT regulations, and deepening of government securities market development

Main Risks and Mitigation

1. The authorities' ownership of and the commitment to implement TA recommendations on a technical level is quite strong. However, in the context of a four-party coalition, elements that require cooperation from line ministries complicates implementation of some TA recommendations. Capacity and resource constraints can also limit the effectiveness of TA. Functional departments should consider the speed with which the authorities can absorb and implement TA recommendations when planning missions. Factoring in political appetite for reform and election cycles would also help mitigate some of these risks.

Authorities' Views

The authorities are eager to benefit further from IMF TA, and broadly share AFR's views on TA priorities. Absorption capacity can be limited at times due to resource constraints, but the scope and timing of the missions are generally in line with needs. The authorities also actively participate in a range of training modules, both online and in person, which help supplement and reinforce TA recommendations. The authorities have stressed the need for longer-term support on PFM issues and noted the importance of a resident advisor as they had previously had with IMF/EU support.

[1] The CBL would be the main recipient of TA on non-bank supervision.

[2] For example, AML/CFT CD from LEG in coordination with bank supervision CD from MCM.

Annex VII. Implementation of Recommendations from 2017 Article IV Consultation

Recommendation	Status of Implementation
Accelerate fiscal consolidation, with focus on expenditure measures, complemented by selective revenue measures.	The FY 2019/20 budget strives for a substantial consolidation through both revenue and expenditure measures. The VAT rate on telecommunications was increased, a levy on alcohol and tobacco was introduced, and fuel levies were raised. On the expenditure side, the budget proposes zero wage adjustment and a hiring freeze, as well as several measures that aim to cut travel and operating costs of government. The overall deficit is projected to fall by nearly 2 percent of GDP.
Address chronic PFM weaknesses.	Some progress was made in addressing PFM issues. The authorities began closing the monthly accounts to produce more stable fiscal data. Monthly reconciliation has proceeded but at an uneven pace. Expenditure controls continue to be weak and a quarterly survey of arrears has yet to be finalized.
Increase external financing, with a focus on grant and/or concessional borrowing.	The authorities did not access significantly higher levels of external borrowing. Instead, increased financing came through domestic channels.
Increase cap on treasury bill issuances.	The authorities raised the cap on t-bill issuances from M 700 million to M 1.5 billion.
Cut red tape and evaluate existing private sector development programs to create more broad-based growth.	A new NSDP was introduced in December 2018, which will support development of labor-intensive industries such as manufacturing and tourism. However, the authorities introduced contentious regulations in the mohair industry and a disruptive increase in the minimum wage for textile workers, which may discourage future foreign investment.
Introduce supervisory architecture for non-bank financial institutions to support financial stability and increase the financial sector's contribution to growth.	The Pension Bill, Financial Institutions Act, Financial Cooperatives Act, Insolvency Bill, and Security Interest in Movable Property Bill have been drafted but have yet to be tabled in Parliament.

INTERNATIONAL MONETARY FUND

KINGDOM OF LESOTHO

STAFF REPORT FOR THE 2019 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

April 8, 2019

Prepared By | African Department (In consultation with other departments)

CONTENTS

RELATIONS WITH THE IMF

(As of March 20, 2019)

Membership Status

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

General Resources Account	**SDR Million**	**% Quota**
Quota	69.80	100.00
IMF holdings of currency (Exchange Rate)	57.16	81.893
Reserve Tranche Position	12.61	18.07

SDR Department:	**SDR Million**	**%Allocation**
Net cumulative allocation	32.88	100.00
Holdings	21.85	66.47

Outstanding Purchases and Loans	**SDR Million**	**% Quota**
ECF[1] arrangements	34.58	49.54

Financial Arrangements:

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

Projected Payments to the IMF

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

	Forthcoming				
	2019	2020	2021	2022	2023
Principal	10.12	9.34	7.99	5.42	1.70
Charges/interest	0.09	0.13	0.13	0.13	0.13
Total	**10.22**	**9.47**	**8.12**	**5.54**	**1.83**

[1] Formerly PRGF.

Safeguards Assessment

An updated safeguards assessment, completed in November 2012, confirmed that the CBL has taken steps to strengthen safeguards since the 2010 assessment, but also that risks remain. Deloitte (South Africa), appointed as the CBL's external auditor in 2010, has since completed the audits of financial years 2010 to 2016 within the three-month statutory deadline and issued an unqualified audit opinion following each audit. Since the 2012 assessment, aspects of the monetary data reporting process have been strengthened with IMF technical assistance. However, audit oversight and internal audit remain areas where improvements are needed to strengthen overall governance and accountability.

Exchange Arrangement:

Lesotho is a member of the Common Monetary Area (CMA). The de facto and de jure exchange rate arrangement are classified as a conventional peg at par to the South African Rand, which is also legal tender in the country. Lesotho has accepted the obligations of Article VIII, Sections 2, 3, and 4, of the Articles of Agreement. Lesotho maintains one exchange restriction arising from single discretionary allowances of M1 million per individual per calendar year, for residents over 18, and of M200,000 on the same basis for residents under 18. The availability of foreign exchange beyond these limits is subject to a discretionary approval on a case by case basis. As of March, 20 2019, the maloti rate per U.S. dollar was M14.5.

Article IV Consultation

The 2017 Article IV consultation was concluded by the Executive Board on February 28, 2018. Lesotho is on the standard 12-month Article IV consultation cycle.

Technical Assistance

The Fund has been providing Lesotho with technical assistance and training to help authorities strengthen their capacity to design and implement effective policies. Technical assistance covers wide range of areas in macroeconomic, fiscal, and monetary. Specific technical assistance projects since 2016 are the following:

Fiscal Affairs Department		
Public financial management (IFMIS)	Short-term	2019
Post clearance audit	Short-term	2018
Tax policy	Short-term	2018
Public financial management	Short-term	2018
Financial reporting	Short-term	2018
Managing the government wage bill	Short-term	2016
Medium-term budget planning, cash management, and fiscal reporting	Short-term	2016
Compliance risk management	Short-term	2016

Legal Department		
AML/CFT	Short-term	2018
Tax legislation	Short-term	2017
Monetary and Capital Markets Department		
Medium-term debt strategy	Short-term	2017
Risk-based supervision	Short-term	2017
Payment systems	Short-term	2017
Statistics Department		
Government finance statistics	Short-term	2019
Price statistics	Short-term	2019
Government finance statistics	Short-term	2018
Monetary and financial statistics	Short-term	2018
National accounts statistics	Short-term	2017
Price statistics	Short-term	2017

RELATIONS WITH OTHER INTERNATIONAL FINANCIAL INSTITUTIONS

- World Bank: https://www.worldbank.org/en/country/lesotho
- African Development Bank: https://www.afdb.org/en/countries/southern-africa/lesotho/
- Regional Technical Assistance Center for Southern Africa: http://www.southafritac.org/

STATISTICAL ISSUES

As of March, 2019
I. Assessment of Data Adequacy for Surveillance
General: Data provision is broadly adequate for surveillance with some key data shortcomings in fiscal and national accounts statistics**.**
National Accounts: The Bureau of Statistics (BOS) compiles and reports national accounts statistics on an annual basis—in current prices and volume terms by the Production and expenditure. Statistical methods used to derive GDP have improved and new sources of data have been developed, although serious challenges remain. Revised and rebased national accounts were published in October 2016. The base year is 2012. The source data need to be improved, in particular, for the estimates of the expenditure side. Poor quality of imports data has been a long-standing problem hampering the expenditure estimates. Private consumption and gross fixed capital formation are now estimated independently. A new Household Budget Survey (HBS) was conducted in 2017, but the results are of poor quality and cannot be used in the rebase of national accounts. Estimates of quarterly GDP by the production approach are being developed and are expected to be released in April 2019.
Price Statistics: The official monthly consumer price index (CPI), a composite of urban and rural price data, is available on a timely basis. The index has been re-referenced to December 2016 = 100. The work on developing producer price indices is ongoing. In the meantime, the national accounts rely on South Africa's producer price index and import price indices.
Government Finance Statistics (GFS): The Ministry of Finance compiles and disseminates GFS consistent with the *GFSM 2001* for the budgetary central government. Monthly GFS for the budgetary central government are reported on a regular basis on the national summary data page (NSDP); and annual GFS have consistently been reported to the GFS yearbook. Long standing data quality issues pertaining to discrepancies between transactions above and below the lines have improved, but classification issues remain however, for some revenue items. The authorities have started compiling GFS for local governments, with help from technical assistance by STA, and are expected to start disseminating those data annually going forward. Compilation of consolidated general government GFS remains challenging, for lack of comprehensive data on extrabudgetary units. No comprehensive balance sheet data is currently compiled, and public-sector debt statistics compiled only cover the budgetary central government but have not been disseminated.
Monetary and Financial Statistics (MFS): The Central Bank of Lesotho (CBL) reports monetary data on a regular basis using the Standardized Report Forms (SRFs), with monthly data disseminated through the IFS. Improved data sources helped enhance the classification and sectorization in the accounts. The institutional coverage of MFS, however, needs to be expanded to include other financial corporations. The CBL is working on expanding coverage and, to that effect, insurance companies have been trained on MFS template and beginning January 2018 started to report through the Banking Supervision Application (BSA). The next phase of coverage improvement is pension funds. **Financial Sector Surveillance** The CBL has begun the process of compiling consistent financial sector indicators (FSIs) from 2006 onwards. FSIs on depository corporations are reported on a quarterly basis, but FSIs on non-financial corporations, households, and real estate markets are not available. Efforts are underway to compile FSIs for the insurance sector and real estate markets. Lesotho reports data on some series and indicators of the Financial Access Survey (FAS), including the two indicators of the U.N. Sustainable Development Goals.

Balance of payments: Since January 2017, Lesotho has improved the timeliness of submitting BPM6-based balance of payments and (partial) IIP data to STA. To further enhance data quality, improvements are needed in coverage, methodological soundness, and consistency between the balance of payments and IIP. The CBL is being assisted by the Macro-economic and Financial Management Institute (MEFMI) in conducting a private capital flow survey to collect financial account transactions and position data.	
II. Data Standards and Quality	
Lesotho became, in 2003, a participant of a GDDS, which was superseded by the enhanced GDDS (e-GDDS) in 2015. Lesotho has implemented the recommendations of e-GDDS in 2016. It disseminates twelve of the fourteen data categories needed for surveillance on its National Summary Data Page (NSDP). We encourage the authorities to disseminate the remaining data categories, general government operations and external debt, and further improve periodicity and timeliness.	No Data ROSC mission has been conducted in Lesotho.

Lesotho: Table of Common Indicators Required for Surveillance

(As of March 20, 2019)

	Date of Latest Observation	Date Received	Frequency of Data[1]	Frequency of Reporting[1]	Frequency of Publication[1]
Exchange Rates	Feb-2019	March-2019	D	D	I
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[2]	Jan-2019	March-2019	D	D	Q
Reserve/Base Money	Jan-2019	March-2019	D	D	Q
Broad Money	Jan-2019	March-2019	M	M	Q
Central Bank Balance Sheet	Jan-2019	March-2019	D	D	Q
Consolidated Balance Sheet of the Banking System	Jan-2019	March-2019	D	D	Q
Interest Rates[3]	Jan-2019	March-2019	M	M	Q
Consumer Price Index	Nov-2018	Dec-2018	M	M	M
Revenue, Expenditure, Balance and Composition of Financing[4]—General Government (GG)[5]	N.A.	N.A.	N.A.	N.A.	N.A.
Revenue, Expenditure, Balance and Composition of Financing[4] – Central Government	Sept-30-17	Nov-2017	M	M	A
Stocks of Central Government and Central Government-Guaranteed Debt[6]	Mar-31-2017	Nov-2017	M	I	A
External Current Account Balance	Q3-2018	Dec-2018	Q	Q	Q
Exports and Imports of Goods and Services	Q3-2018	Dec-2018	Q	Q	Q
GDP/GNP	2017	Dec-2018	A	A	A
Gross External Debt	Mar-31-2017	Nov-2017	M	I	A
International Investment Position[7]	Q3-2018	Ded-2018	Q	Q	Q

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

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

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

[4] Foreign, domestic bank, and domestic nonbank financing.

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

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

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

Statement by Mr. Dumisani H. Mahlinza, Executive Director for Kingdom of Lesotho and Ms. Abigail Nainda, Advisor to the Executive Director for Kingdom of Lesotho
April 26, 2019

1. Our Lesotho authorities thank staff for the constructive engagement and policy advice during the recent Article IV Consultations and look forward to further interactions on policies that can help raise output and improve the economy's resilience. They broadly agree with staff's assessment of the macroeconomic challenges facing the economy and the policy recommendations.

2. The economy continues to grapple with vulnerabilities emanating from declining Southern African Customs Union (SACU)[1] revenues, a relatively undiversified economic base, a high public sector wage bill as well as a recent build-up of domestic arrears. Given these challenges, the authorities acknowledge that implementing adjustment measures has become critical. Accordingly, the recently tabled FY2019/20 National Budget proposes an ambitious reform agenda tailored towards addressing these development challenges. The authorities concur with staff on the importance of a well-executed reform agenda and are determined to implement the agreed measures, since broad political consensus has been established.

3. Lesotho has made significant progress towards restoring peace and stability since the coalition government took office in June 2017. This has been supported by the implementation of the National Reform Agenda. At the same time, a new National Strategic Development Plan (NSDP II) covering the period 2019–2023, whose theme is "*inclusive growth, private sector–led jobs and reduced unemployment*", has been launched. The Plan identifies four sectors – agriculture, manufacturing, technology, and tourism and creative industry– to drive job creation in the economy. Accordingly, allocations in the new national budget are focused towards development of these sectors. In addition, the Lesotho National Development Corporation (LNDC) will be restructured to better serve its mission of private sector development.

[1] SACU is a customs union between Botswana, Eswatini, Lesotho, Namibia and South Africa. Among other things, SACU provides for free movement of goods among the five-member countries under a common external tariff.

Recent Economic Developments and Outlook

4. Following weak growth in 2017, the Lesotho economy recovered modestly to 1.9 percent in 2018, owing to improved performance in mining, manufacturing, and financial services. Agricultural output remained subdued due to prolonged dry spells, given the country's dependence on rain-fed agriculture. In the medium term, growth is expected to firm up, boosted by the construction sector, particularly the implementation of Phase II of the Lesotho Highlands Water Project (LHWP II), which is set to commence later this year. Downstream benefits of the LHWP II are expected to provide further growth impetus over the forecast horizon. Similarly, the primary sector is expected to pick up in the medium term supported by strong growth in the mining sector, reflecting strong demand and favorable prices.

5. Inflationary pressures continued to ease in line with global developments in recent periods, remaining below 5.0 per cent throughout 2018. Going forward, inflation dynamics will be mainly affected by international oil prices and the exchange rate of the South African Rand. As a result, the average annual inflation rate is expected to increase from 4.7 percent in 2018, to 5.9 percent and 5.7 percent in 2019 and 2020, respectively.

6. The external sector position improved during the fourth quarter of 2018, boosted by surpluses in the capital and financial accounts that outweighed the effect of the widening current account deficit. Gross international reserves increased, reaching 4.5 months of imports at the end of 2018, from 3.9 months of imports in 2017. Going forward, the current account is expected to remain in deficit due to upward pressure on imports from construction activities related to mining investment and implementation of the LHWP II.

Fiscal Policy and Public Financial Management Reforms

7. To address underlying fiscal vulnerabilities and restore macroeconomic stability, the authorities are committed to implementing a set of fiscal stabilization measures. In this regard, they are taking steps aimed at containing spending and closing loopholes. Starting with the recently-passed FY2019/20 budget, significant spending adjustments have been made, amounting to a reduction equivalent to 2.2 percent of GDP. Importantly, the authorities are focusing on reducing the wage bill, through a hiring and wage freeze. To protect economic growth and employment, capital spending has been allowed to record a modest increase of 0.5 percentage points. These measures will see the fiscal deficit decline from 5.2 percent in FY2018/19 to 3.4 percent of GDP in FY2019/20.

8. To enhance domestic revenue mobilization, the authorities will implement a set of measures including the introduction of a levy on the sale of tobacco and alcohol, an increase in the fuel levy, and additional VAT on telecommunications. The authorities also intend to increase fees and charges that have remained stagnant over many years during the course of FY2019/20. As a result, revenues for FY2019/20, are expected to rise by 3.4 percentage points of GDP to 46.0 percent of GDP.

9. Government also plans to implement a Tax Modernization Program which will include, inter alia, the implementation of a VAT non-compliance detection solution, upgrading border IT infrastructure, introducing coordinated border management and launching a national

single window. In addition, the Lesotho Revenue Authority (LRA) has implemented a Voluntary Disclosure Program (VDP)[2] and Small Business Taxation (SBT) scheme. As part of the 2019/20 budget, Government will further scale up the VDP program, replace the current zero rating on exports of natural resources with a VAT exemption, to reduce revenue leakages emanating from high VAT refunds claimed by the mining industry.

10. In an effort to strengthen Public Financial Management (PFM), on April 1, 2019, the authorities launched an upgrade to the Integrated Financial Management Information System (IFMIS) which aims to improve the quality of financial statements, reduce delays in payment of suppliers and enhance commitment controls. The new IFMIS will eliminate the need for the paper-based systems and introduce automated tracking of invoicing and payments. To enhance budget controls and better align spending with available resources, a Cash Management Unit has been established. Further, to regulate the volatility in SACU revenues and entrench debt sustainability, the Ministry of Finance will propose a fiscal rule to be passed into law, during the current fiscal year.

Financial Sector Development

11. Lesotho's financial sector remains sound with relatively low non-performing loans (NPLs). That said, the authorities remain vigilant in monitoring the emergence of vulnerabilities, including rising household indebtedness and credit concentration. They recognize the need to extend information coverage beyond the formal sector. For this reason, the credit bureau aims to improve information on informal lenders by licensing them as Microfinance institutions (MFIs). In addition, significant progress has been made in strengthening the supervision of the non-bank financial sector in view of its growing size and potential to develop systemic impacts. The authorities are also working with key stakeholders to strengthen the supervision of cooperatives. At the same time, the Central Bank of Lesotho (CBL) is undertaking extensive financial education and awareness campaigns to minimize the proliferation of Ponzi schemes. Further, the authorities have requested Fund technical assistance to facilitate the development of a secondary market for government debt.

12. To address challenges in the banking sector, including credit growth, the authorities have enacted the *Security Interest and Movable Property* and *Insolvency* bills. At the same time, a credit registry has been established with the aim of improving access to credit. A credit scoring system is currently being developed. Further, a securities market has been established and one commercial bank is considering issuing commercial paper. In addition, the authorities have taken significant steps to strengthen Anti-Money Laundering and Combating the Financing of Terrorism (AML/CFT) frameworks and practices with the assistance of Fund TA.

13. The authorities continue to make progress in further deepening financial inclusion. The Ministry of Finance and the CBL are strengthening collaboration between all stakeholders in providing financial services, including the Banks, Mobile Network Operators, Micro-finance

[2] VDP allows taxpayers to correct their tax affairs and in return for coming forward voluntarily, the tax administration offers certain incentives such as the avoidance of criminal prosecution and reduced penalties and interest.

Institutions, NGOs, partner ministries and development partners. Mobile money, which has grown at a fast pace, provides a promising avenue to increase financial inclusion, where the majority of the rural population has limited or no access to financial services. The authorities will continue to closely monitor developments in this sector with a view to manage potential risks.

Structural reforms

14. In line with the NSDPII, which focuses on private sector led development, our authorities have developed an agenda to actively attract investment, improve the business climate and enhance human capacity development. In this regard, government aims to roll out several initiatives to attract investment, including the development of industrial parks. They have organized an investment laboratory, to allow both investors and government to collaborate on the modalities necessary to boost investment. The laboratory, which has been operational since March 2019, has registered more than 80 investors, with potential for establishing businesses and creating employment. Thus far, investor interest has been expressed in agri-business, tourism and creative industry, technology and manufacturing. Further, the authorities plan to implement measures to deepen financial markets and develop the capital market.

15. To promote SME development, Government is implementing financial and business support initiatives to help start-ups and other small businesses. An apprenticeship strategy has been developed with the main objective to address the existing skills mismatch between training institutions and the needs of the industry. Through this strategy, an institutionalized program will expose graduates of universities and higher learning institutions to industry and business practices in order to match the needs of the market or enable self-employment. Furthermore, the authorities intend to roll-out an entrepreneurship training program across training institutions to strengthen education outcomes.

16. As part of an effort to strengthen the fight against corruption, the authorities are considering a new anti-corruption bill that will increase the independence of the Directorate of Corruption and Economic Offences (DCEO). They are also implementing an asset declaration framework for public servants. To mitigate the impact of droughts on agricultural production, the authorities, are scaling up irrigation infrastructure as a way to insulate climate disruptions. In this regard, support will be provided to the Smallholder Agricultural Development Project (SADP) to cater for scale and climate disruptions.

Conclusion

17. Having taken appropriate measures to respond to recent political and economic challenges, the authorities are progressing with efforts to implement a package of measures that will strike a balance between fiscal consolidation and protecting growth, employment and other social objectives. In addition, the authorities are exploring options to diversify revenue sources and reduce reliance on volatile SACU revenues. Overall, the recommendations proposed by staff in the fiscal, financial and structural reform areas are in line with the authorities' agenda to pursue rapid and inclusive growth within a stable macroeconomic environment. In this regard, they wish to express appreciation to the Fund for the valuable technical assistance that Lesotho has received through the years.