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To: Members of the Executive Board

From: The Secretary

Subject: Lesotho - Staff Report for the 1983 Article IV Consultation

Attached for consideration by the Executive Directors is the staff report for the 1983 Article IV consultation with Lesotho. A draft decision appears on page 15.

This subject will be brought to the agenda for discussion on a date to be announced.

If Executive Directors have technical or factual questions relating to this paper prior to the Board discussion, they should contact Mr. Reichardt, ext. 73720.

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INTERNATIONAL MONETARY FUND

LESOTHO

# Staff Report for the 1983 Article IV Consultation

Prepared by the Staff Representatives for the
1983 Consultation with Lesotho

Approved by J.B. Zulu and S. Kanesa-Thasan

July 6, 1983

## I. Introduction

The 1983 Article IV consultation discussions with Lesotho were held in Maseru during April 23-May 6, 1983. Lesotho continues to avail itself of the transitional arrangements of Article XIV. The representatives of Lesotho included Dr. Leabua Jonathan, Prime Minister; Mr. K.T.J. Rakhetla, Minister of Finance; Mr. E.R. Sekhonyana, Minister of Planning, Employment, Economic Affairs, and Foreign Affairs and Minister to the Prime Minister; Mr. S. Schoenberg, Governor of the Central Bank; and other senior officials concerned with economic and financial matters. The staff representatives were Messrs. M. Reichardt (head-AFR), M. Niebling (AFR), J. Modi (FAD), and Miss M. Simpson (secretary-AFR).

## II. Background to the Discussions

### 1. Overview of the economy

Lesotho is a small, landlocked country located within the geographical frontiers of the Republic of South Africa (RSA), with which it is closely linked through its membership in the Rand Monetary Area (RMA) 1/ and the South African Customs Union (SACU). 2/ In addition, more than half of the male Basotho labor force is employed in the RSA, mainly in mining, and their remittances account for over 40 per cent of GNP. Hence, economic developments in Lesotho are greatly influenced by developments in the RSA.

1/ Comprising South Africa and Swaziland as well as Lesotho. For background information, see Collings, F. d'A., The Rand Monetary Area, DM/83/6, February 17, 1983.

2/ Comprising Botswana, South Africa, and Swaziland as well as Lesotho.

Although agriculture is the largest domestic sector, the country's rugged terrain limits the arable land, while deforestation, overgrazing, and consequent erosion have reduced productivity and limited prospects for agricultural growth. Other natural resources are also limited. In recent years exports have covered little more than 10 per cent of imports, and exports of diamonds, hitherto the most important commodity, have now declined sharply due to the closure of the main mine in late 1982. The manufacturing and tourism sectors are still small.

In the recent past budgetary outlays have been expanding rapidly, particularly in the areas of infrastructure and general administration, whereas revenues have been increasing only moderately. 1/ This has led to rising budgetary deficits, financed mainly by increased foreign and domestic bank borrowing. The national currency, the loti (plural: maloti), introduced in 1980, is at par with and fully backed by the South African rand. The rand also circulates freely as legal tender. The data on the money supply are incomplete because the amount of rand in circulation in Lesotho is unknown. Lesotho's external payments position has traditionally been characterized by sizable trade deficits, which are largely offset by inflows of migrant labor remittances and official grants. Lesotho, along with the rest of the RMA, maintains an exchange system which is free of restrictions on payments and transfers for current international transactions.

## 2. Recent economic developments

After a period of rapid expansion, led by rising consumption and related commercial expansion, the pace of economic activity subsided in 1982/83 (April-March fiscal year). The slowdown reflected the spread of the international recession to the RSA in late 1981, the tapering off of a domestic construction boom in 1982, and initial efforts to contain a widening budgetary deficit. A severe drought and crop losses have followed since, especially in early 1983. Meanwhile, falling demand for diamonds brought about the closure of Lesotho's main mine. Budgetary cutbacks also led to a reduction in capital outlays, including suspension of work on a major office building project. Although the decline in these activities was partly offset by larger remittances from mine workers in the RSA, real economic growth, according to rough staff estimates, was virtually nil in 1982/83 as compared to some 5-6 per cent in the previous two years. The rate of inflation remained in the range of 13-15 per cent a year. Consumption, private as well as public, has been high and has risen rather rapidly, with the growth in private consumption being supported by increasing inflows of migrant workers' remittances. Although national accounts statistics are neither current nor fully reliable, staff estimates indicate that total consumption has continued to increase in nominal terms by about 20 per cent in 1982/83,

1/ Budgetary data remain provisional because the accounts after 1977/78 have not yet been closed.

while gross domestic investment declined by some 5 per cent. Despite the importance of workers' remittances, total expenditure now exceeds GNP by a wide margin, with the gap being financed mainly by official transfers, development credits, and short-term borrowing.

In 1982/83 fiscal developments generally reflected the authorities' successful attempt to reduce the overall budget deficit, which had reached some 10 per cent of GNP (after grant receipts) in 1981/82 (Table 1). Despite an equally large budgeted level for 1982/83, the actual deficit was held to about 6 per cent of GNP. This improvement was brought about in part by a 21 per cent increase in revenue other than grants, due largely to the introduction of a sales tax in December 1982 but also to the sale of surplus oil stocks. In addition, expenditure and net lending were contained to little more than the previous year's level, largely by strictly limiting the rise in recurrent expenditure and curtailing investment outlays slightly. Domestic bank borrowing was only M 9 million, or about 6 per cent of the maloti money stock at the beginning of the year, as compared to 30 per cent in the previous year. Total government debt nevertheless increased fairly rapidly in 1982/83, and debt service is estimated to have amounted to about 30 per cent of budgetary revenue.

The operations of nonfinancial public enterprises have impinged on the budget in a variety of ways, although the impact is not fully quantifiable from available data. First, hardly any of the enterprises have paid dividends on the Government's equity holdings, and few have been servicing their borrowings from Government; in several instances, there appear to be distinct possibilities of the invocation of government guarantees against their borrowings from other sources. Second, some of these enterprises require annual operating subventions (amounting to at least M 12 million in total), only a small part of which is attributable to the provision of training and extension services beyond their commercial needs; in other cases accumulated losses erode the Government's equity holdings and prospects of loan recovery. Third, delays in tariff adjustments have been such as to hamper the self-financing of their development programs. Fourth, the operational results of some enterprises have shed doubt on their prospects for financial viability.

Developments in monetary aggregates largely reflected the more restrictive fiscal policy in 1982/83. Net claims on Government increased by only 17 per cent, as compared with 150 per cent in 1981/82. Credit to the private sector increased by only 6 per cent, with a slight decline actually occurring after mid-1982, due largely to the slowdown in commercial activity, the closure of the diamond mine, and the completion of some construction projects; this compared to an almost 40 per cent increase in 1981/82. The interest rate structure of the Central Bank and the commercial banks has been flexible and responsive to rate movements in the money market of the RMA. The spread between lending

Table 1. Lesotho: Government Budgetary Operations, 1978/79-1983/84

(In millions of maloti)

| Fiscal year (April-March) | 1978/79 | 1979/80 | 1980/81 | 1981/82 | 1982/83 | | 1983/84 |
|---|---|---|---|---|---|---|---|
| | Preliminary actuals | | | | Budget | Est.actuals | Budget |
| Revenue and grants | 92.0 | 111.7 | 125.5 | 124.8 | 186.2 | 144.2 | 225.6 |
| Revenue | 80.5 | 93.8 | 104.3 | 111.1 | 138.5 | 134.8 | 166.4 |
| Customs | (56.1) | (71.4) | (71.4) | (70.8) | (76.7) | (76.7) | (109.9) |
| Other | (24.4) | (22.4) | (32.9) | (40.3) | (61.8) | (58.1) | (56.5) |
| Grants 1/ 2/ | 11.5 | 17.9 | 21.2 | 13.7 | 47.7 | 9.4 | 59.2 |
| Expenditure and net lending | 82.8 | 127.4 | 166.0 | 183.7 | 245.4 | 185.0 | 283.0 |
| Recurrent expenditure | 43.5 | 65.9 | 103.8 | 117.1 | 123.7 | 121.9 | 136.9 |
| Salaries | (31.2) | (36.6) | (54.9) | (60.5) | (66.0) | (63.5) | (65.5) |
| Interest payments | (0.1) | (4.6) | (4.2) | (8.0) | (12.2) | (16.1) | (20.2) |
| Other | (12.2) | (24.7) | (44.7) | (48.6) | (45.5) | (42.3) | (51.2) |
| Capital expenditure 2/ ) Net lending ) | 39.3 | 61.5 | 62.2 | 66.6 | 121.7 | 63.1 | 146.1 |
| Overall surplus/deficit 2/(-) | 9.2 | -15.7 | -40.5 | -58.9 | -59.2 | -40.8 | -57.4 |
| Total financing | -9.2 | 15.7 | 40.5 | 58.9 | 59.2 | 40.8 | 57.4 |
| Foreign financing 2/3/ | ... | 9.9 | 10.5 | 8.8 | 64.1 | 25.1 | 32.7 |
| Domestic financing | ... | 5.8 | 30.0 | 50.1 | -4.9 | 15.7 | 24.7 |
| Bank financing 3/ | (-3.0) | (-2.3) | (24.4) | (37.1) | (...) | (9.3) | (...) |
| Other (residual) | ( ...) | (8.1) | (5.6) | (13.0) | (...) | (6.4) | (...) |
| Memorandum items: | | | | | | | |
| Amortization: foreign | ... | 0.3 | 1.8 | 7.1 | 18.9 | 18.9 | 7.5 |
| domestic | ... | 2.3 | 2.0 | 4.3 | 4.9 | 4.9 | 14.2 |
| Overall surplus/deficit as percentage of GNP | 1.4 | -3.5 | -7.9 | -9.8 | -8.8 | -6.0 | -7.5 |

Sources: Budget Estimates; and data provided by the Lesotho authorities.

1/ Excludes grants received in kind.
2/ Data exclude projects financed by direct donor contributions.
3/ Foreign financing excludes borrowing from South African banks channeled through the Central Bank of Lesotho and the Lesotho Bank, which is shown as a part of domestic bank financing. Such financing amounted to M 23 million in 1981/82 and nil in 1982/83.

and deposit rates nevertheless widened in 1982; the rates peaked during mid-1982, but fell back thereafter by about 3-5 percentage points through March 1983.

A large current account deficit, equivalent to some 10 per cent of GNP, was registered in Lesotho's balance of payments in 1981, as workers' remittances (which account for over half of current receipts) failed to keep pace with import growth while exports and grant receipts stopped growing altogether (Table 2). In 1982 the deficit widened slightly in absolute terms but remained about unchanged in relation to GNP. Although there was an estimated 21 per cent rise in workers' remittances in 1982 (in terms of maloti) and a slowdown in import growth (representing a decline in real terms) due to the more restrictive budget policy and the cooling off in business activity, exports and transfer receipts declined. The overall balance was in surplus (equivalent to around 1 per cent of GNP), as during the previous year, but only because of official recourse to short-term foreign borrowing on commercial terms.

Although available debt data are only approximate, external public debt is estimated to have reached about M 120 million (about SDR 100 million) at the end of 1982, 1/ or 18 per cent of GNP, compared with less than 14 per cent of GNP the year before. Over one third of the amount outstanding consists of short-term debt (under five years' maturity) to the South African Reserve Bank and to commercial banks in that country and elsewhere contracted by or on behalf of the Government, mainly in 1981 and 1982, to cover budgetary deficits. External debt service, including repayment of short-term borrowings, was still low in 1982, at about 7 per cent of current account earnings (including workers' remittances), but, as mentioned above, total debt service absorbed 30 per cent of government revenues in 1982/83.

## III. Report on the Discussions

### 1. Development policies and production prospects

In discussing development policies, the Lesotho representatives stated that, in view of the present economic difficulties, the Government's strategy was aimed mainly at containing the growth of imports and promoting exports. Agriculture retained priority, and the Food Self-Sufficiency Program (FSSP), begun in 1980/81, would continue. The FSSP is a food-grain project aimed at proving the value of modern farming techniques by raising yields and thus reducing imports. The Lesotho representatives were aware that the project has proved very costly; nevertheless, they had decided to continue with it during 1983/84 unless continued drought were to preclude planting. In response, however, most donors to the ongoing Basic Agricultural Services Program

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1/ The 1982 external debt includes some M 25 million in external funds from the RMA channeled through the Central Bank.

Table 2. Lesotho: Balance of Payments Summary, 1979-83

(In millions of maloti or South African rand) 1/

| | 1979 | 1980 | 1981 | 1982 Prelim. | 1983 Proj. |
|---|---|---|---|---|---|
| Merchandise trade | -226.0 | -266.6 | -336.5 | -377.6 | -465 |
| Exports, f.o.b. | 38.9 | 46.6 | 44.6 | 42.0 | 30 |
| Imports, f.o.b. | -264.9 | -313.2 | -381.1 | -419.6 | -495 |
| Services and income | 166.7 | 186.3 | 207.3 | 244.4 | 285 |
| Receipts | 248.3 | 283.8 | 324.9 | 380.0 | 440 |
| Workers' remittances | (178.9) | (205.0) | (240.[illegible]) | (290.0) | (330) |
| Other receipts | (69.4) | (78.8) | (84.[illegible]) | (90.0) | (110) |
| Payments | -81.6 | -97.5 | -117.6 | -135.6 | -155 |
| Unrequited transfers | 59.1 | 73.6 | 72.0 | 67.3 | 80 |
| Private | 1.5 | 1.7 | 1.8 | 2.0 | 2 |
| Official | 57.6 | 71.9 | 70.2 | 65.3 | 78 |
| Current balance | -0.2 | -6.7 | -57.2 | -65.9 | -100 |
| Long-term capital | 20.5 | 27.7 | 31.5 | 31.0 | 30 |
| Private inflows | ... | 3.5 | 4.2 | 4.0 | 5 |
| Official (net) | 20.5 | 24.2 | 27.3 | 27.0 | 25 |
| Basic balance | 20.3 | 21.0 | -25.7 | -34.9 | -70 |
| Short-term capital | -10.0 | 20.4 | 19.0 | -9.4 | 40 |
| Commercial banks | -10.0 | 20.4 | -1.0 | -21.4 | 25 |
| Official (net) 1/ | -- | -- | 20.0 | 12.0 | 15 |
| Errors and omissions (net) 2/ | -10.4 | -7.1 | 8.3 | 53.5 | -- |
| Official reserves (overall surplus -) | 0.1 | -34.3 | -1.6 | -9.2 | 30 |
| Ratio of current account deficit to GNP (in per cent) | -- | -1.4 | -9.9 | -10.0 | -13.7 |

Sources: Central Bank of Lesotho; and staff estimates.

1/ The maloti is fully convertible at par into South African rand.
2/ All commercial borrowing, including some over one year but under five. Includes central bank borrowing from South African banks for on-lending to Government, which appears as domestic bank financing in budgetary and monetary accounts.
3/ Includes small credits for SDR allocations in 1979-81. Reflects, inter alia, changes in rand circulating in Lesotho (increase -) as well as unrecorded private capital.

(BASP) withdrew their support because of the competition for local resources with FSSP. The Lesotho representatives emphasized that overlapping of projects would be avoided in future. The authorities' efforts to expand agricultural production and exports have also been hindered by exogenous factors, such as adverse weather conditions and high wages in RSA mines. During past years mine labor income has consistently grown faster than small farmers' income in Lesotho; the level of mine labor income is several times higher than farmers' income at present. In order to overcome this problem, the authorities intend to increase their efforts to raise farm productivity and income. The mission proposed that, in addition to these efforts, a shift of emphasis from crop farming to efficient livestock raising could be advantageous. It would probably provide higher income to the family than traditional farming, while the ablebodied men could continue working in the mines. The Lesotho representatives agreed that this would be a desirable shift in development strategy also because livestock raising was more in line with Basotho inclinations.

In order to strengthen the balance of payments, the preparation of the Highland Water Scheme is being speeded up. This major project, estimated to cost at least US$1 billion, would provide substantial net foreign exchange earnings through the sale of water to the RSA, large-scale production of electrical energy, and irrigation of farmland. The feasibility study, Lesotho's half of which is being financed by the EC and the UNDP, is expected to be completed by end-1984. Policy measures in other areas will include promotion of agro-based export-oriented and import-substitution industries, in particular quick-yielding projects. As construction activity was at a low level, the authorities intended to revive the government building complex and to go ahead with the construction of the US$50 million international airport.

Although recession had spread to most sectors by the latter part of 1982 and adverse weather had reduced crop output, the growth of manufacturing continued to be satisfactory, the Lesotho representatives reported. A brewery and an ice cream factory have opened recently, and other plants are expected to be completed soon. Demand for domestic manufactures, especially building materials, had recently been less buoyant than a year or two ago, but it was hoped that these conditions were transitory, and the expansion of capacity and production levels remained satisfactory. Although the recession abroad had somewhat reduced immediate interest on the part of prospective foreign investors, and while new South African investment incentives offered stiff competition in some areas, Lesotho continued to offer several fiscal and marketing advantages. Prospects for continued growth in manufacturing, while still not sufficient to absorb the rise in the labor force, were nevertheless fairly encouraging. The sector's relatively favorable performance and outlook were felt to be the result of the Government's recognition that it should serve mainly as a catalyst and foster the much-needed entrepreneurship for the expansion of the private enterprise sector.

Reforestation, soil conservation, and other labor-intensive programs were also receiving urgent attention; it was agreed that only strong private motivation would make them successful in the long run. In addition, family planning was receiving official encouragement for the first time.

For the immediate future, the Lesotho representatives felt, prospects were for continued overall sluggishness in the economy. The impact of the drought and of the closure of the diamond mine would be felt in full. Lower interest rates, on the other hand, could stimulate investment, and the continuing budgetary consolidation should improve business confidence. An actual business upturn, however, would probably not occur before recovery began in the region generally.

## 2. Prices, employment, and wages

There is no official intervention in setting consumer prices. It is the policy of the Government not to subsidize goods, but social services, including education, health, transportation, and water supply, are subsidized either directly or indirectly because changes in tariffs have lagged behind increases in costs. However, the Lesotho representatives said that the hitherto almost nominal fees for education and health services will be raised gradually to cover an increasing part of the costs involved.

Because the Basotho miners working in RSA mines are the main wage earners of Lesotho, any decline in their employment opportunities in the mines immediately threatens to increase unemployment in Lesotho. Therefore, the authorities have been very concerned about the policy change in RSA mines to replace foreign migrant labor by local labor. So far, the Basotho workers' share in total mine employment has declined only very slightly, to just below 20 per cent, but recruitment of new entrants has dropped sharply and prospects are uncertain. On the other hand, the leveling off in new recruitment has not affected the wages of the miners on the job; to the contrary, real mine wages have increased by about 5-6 per cent annually during the last seven years. Consequently, the miners' remittances have continued rising--at a pace that augments consumer demand while also reducing incentives for farming.

Within Lesotho, the Government is the main employer. Largely due to its financial situation, new recruitment was limited to 3 per cent in 1982/83. For the current year, the authorities intend to freeze recruitment completely. Regarding salaries, the Government has followed a policy of occasional large pay raises, which, when averaged out over seven years, have almost covered the cost-of-living increases during the same period. For 1983/84, no further pay raise is contemplated.

3. Fiscal policies

The 1983/84 budget has been designed to continue the policy of austerity. Compared with the previous year's budget (Table 1), it projects a slight reduction in the overall deficit to M 57 million (7.5 per cent of GNP) from the budgeted amount for 1982/83 of M 59 million (8.8 per cent of GNP). Because of spending restraint, especially on capital items and net lending, and revenue increases, the actual deficit in 1982/83 turned out to be much lower than budgeted, about M 41 million (6.0 per cent of GNP), and a similar result could well materialize in 1983/84. Although the budgeted grants appear high in light of past experience, and noncustoms revenues may suffer from the recession, actual capital outlays have seldom exceeded half of the budget estimates. However, given the authorities' desire to speed up certain projects in light of current difficulties in the region, a deficit approaching the budgeted amount cannot be ruled out. The Lesotho representatives explained that, in addition to a 43 per cent increase in SACU receipts (a firm projection), 1/ they intended to contain the budgetary deficit by raising additional revenue, mainly through vigorous and efficient tax collection, including arrears of unpaid taxes, and by strictly controlling recurrent expenditures.

Regarding revenue, they regretted that the RSA had turned down the latest proposed revision to the SACU formula, which would have meant about 10 per cent higher receipts from this source. In regard to the recently introduced 5 per cent sales tax, the Lesotho representatives felt that a properly staffed sales tax administration, together with an improvement of the accounting practices of the small traders, should yield revenue higher than the projected M 12 million. Furthermore, rents in the large government housing sector were planned to be increased by 40 per cent during the course of 1983/84. They endorsed the mission's stress on broadening the revenue base and agreed that the time had come to attempt to tax miners' income, despite the fact that doing so remained difficult politically. Discussions had already been held with South African officials with a view to the RSA's collecting such taxes on Lesotho's behalf, and studies of various proposals were under way.

On the expenditure side, the Lesotho representatives confirmed that there was scope for further reducing the expansion of current outlays. Debt servicing, education, defense, and health absorbed the largest portions. Debt servicing was unavoidable in view of past borrowings, and defense spending would be difficult to contain in present circum-

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1/ The amount of SACU receipts is based on the level of imports recorded two years earlier, with small subsequent adjustments. The recent stagnation of Lesotho's receipts reflects changes in the pattern of RSA imports and also the fact that the revenue sharing formula has not been revised.

stances. Nonetheless, they saw considerable scope for reducing the expenditures on subsidies for education and health, as mentioned above. The Lesotho representatives were also committed to allowing only a 3 per cent increase in personnel expenditure, to withholding general salary adjustments for some time, and to continuing to penalize officials for unauthorized expenditures. The revenue diversification and recurrent expenditure control measures should, in the Lesotho representatives' view, make it possible to generate sufficient resources to step up productive development expenditures. Development projects would be strictly scrutinized before inclusion in the capital budget, so as to give priority to sound, quick-yielding projects and to minimize requirements for domestic counterpart funds and subsequent recurrent spending. They agreed that a substantial improvement in the fiscal performance of the country would be needed to avoid adding to the outstanding debt. As far as possible, short-term nonconcessional borrowing would be avoided in future and efforts made to lengthen the maturity structure of outstanding debt. To help alleviate shortcomings in debt recording and management, the Fund has agreed to provide short-term technical assistance. In recognition of the problems caused by the backlog in preparing final budgetary accounts, a task force has been established and outside assistance is being employed.

Regarding the problems identified in the nonfinancial public enterprises, the Lesotho representatives indicated that they were contemplating measures to revive the enterprises concerned, by improving their financial control and adjusting their tariffs more promptly, or alternatively to sell them to the private sector.

## 4. Monetary policies

Legislation transforming the Lesotho Monetary Authority into a Central Bank became effective on August 1, 1982. The amendment also made possible central bank advances to the Government on a limited basis, although the principal vehicle used continued to be borrowing abroad by the Central Bank on behalf of the Government. Provisions of the RMA agreement continue to require rand deposits to be made with the South African Reserve Bank equivalent to all maloti issued.

Membership in the RMA and the peg to the South African rand, the Lesotho representatives stated, remained on balance satisfactory to them in economic terms. Given the high degree of integration of the economy with the RSA, these were the only realistic options for Lesotho at present. The 100 per cent rand cover was also seen as providing useful discipline in the context of an exchange and payments system free of restrictions. They agreed that in this context the Central Bank's scope for monetary policy was limited and that budgetary policy was the principal tool of financial control.

After a period of rapid expansion during the first half of 1982, credit to the public and the private sectors slackened in the second half and in early 1983. The Lesotho representatives expected that credit demand of the public sector would continue to slow down because of the budgetary measures taken during this fiscal year. For the private sector, they also foresaw a further slackening of credit demand because of the closure of the diamond mine and the lower level of construction. Interest rates rose to a peak by mid-year 1982 and eased thereafter. Within the context of the RMA, Lesotho's minimum and maximum rates are set by informal "gentlemen's agreement" among the commercial banks, a system which the Lesotho representatives regard as more appropriate to Lesotho's liberal economic framework than central bank controls or ceilings. They explained that mainly exogenous factors had pushed up the rates, in particular the lending rates, and banks justified the widening spread between lending and deposit rates by arguing that the small volume of credit required a high profit margin. However, with money market and lending rates settling down in 1983, they expected that a normal profit situation would return.

5. External financial policies

Although the decline in the actual fiscal deficit in 1982/83 and the rising miners' remittances served to prevent a further significant erosion of the external current account position in 1982, the Lesotho representatives acknowledged that the balance of payments outlook for 1983 was not favorable at this stage. Exports were projected to decline by more than one fourth because of the diamond mine closure. Imports were forecast to increase by almost 20 per cent, as continued strong private consumption demand generated by rising workers' remittances would be reinforced by the need to import substantially more foodstuffs due to the drought. This could not be outweighed by the Government's efforts to dampen demand through the imposition of the sales tax and the salary freeze for government employees during 1983. Therefore, the current account deficit is estimated to widen from about 10 per cent of GNP to around 14 per cent if no additional measures are taken. The overall balance is also expected to shift into deficit. The Lesotho authorities are currently negotiating for official financing from South African banks. At this stage, however, it is still uncertain to what extent they will be able to cover the deficit from this source.

The Lesotho representatives recognized that the current external debt service obligations, which amounted to about 6 per cent of foreign earnings from exports and services in 1982/83, are expected to rise rapidly. They agreed that additional efforts are needed to reduce the current account deficit as well as to limit external borrowings as far as possible, to those on concessional terms. In that effort, an improvement in the fiscal situation would be of the utmost importance.

Over the medium term the balance of payments outlook is, at best, mixed. The authorities recognized that stringent additional measures would be required to bring the balance of payments back to equilibrium, and appropriately their main efforts are directed at reducing the budget deficit. In addition to some form of income tax on miners' wages, measures under consideration include a head tax on livestock, which would not only raise revenues but also induce the culling of herds, with beneficial effects of livestock raising in general. It is also planned to provide long-term leaseholds for selected agricultural areas, which would be an incentive for better soil conservation and in the longer run lead to higher yields, which in turn may be taxed. On the expenditure side of the budget, the substantial reductions planned in subsidies on services should help dampen aggregate demand. The authorities are aiming at reducing the budget deficit over the medium term to a level that can be financed solely by concessional development credits, so as to limit the debt burden. In addition, they intend to maintain an environment favorable to foreign investment. Tax and credit incentives and disincentives would also be used to stimulate and direct investment and production in the desired directions.

Regarding exchange rate practices, the Lesotho representatives stated that, as a member of the RMA, Lesotho had followed along with the RSA's unification of the exchange rate in early February 1983, which eliminated the discounted "financial rand." They believed that the effect of the loss of the incentive for non-RMA investors provided by the previous discounted rate would be outweighed by their increased confidence from being able to retransfer invested capital at a unified rate in future. The depreciation of the rand during 1981-82 had increased the fiscal burden of debt repayment in local currency terms, while inflation had offset most of the potential stimulus to exports outside the RMA. In any event, given South Africa's overwhelming predominance in Lesotho's trade, exchange rate changes vis-à-vis the rest of the world have a relatively small impact on the effective exchange rate and on incentives in Lesotho.

Lesotho has no bilateral payments agreements. The authorities have continued to eschew restrictions on current international transactions.

Lesotho is a member of the Southern African Development Coordination Conference, a grouping of nine regional states seeking to promote mutual cooperation and reduce the weight of the RSA in their economic relationships. Due to Lesotho's geographic location, its membership appeared from the Lesotho representatives' viewpoint to have only limited economic significance for the country. They welcome regional development projects and would benefit from some donor initiatives in this regard but are obliged to regard them as supplements to, rather than substitutes for, existing arrangements.

## IV. Staff Appraisal

The growth of Lesotho's migrant-labor-dependent economy has subsided, and the economic structure remains unbalanced and vulnerable. Gross national savings are substantially negative, and developments in recent years make it clear that Lesotho will have to adopt stringent policies to reduce its expenditures, especially on consumption, to a level more in line with its resource availability. Miners' wages have continued to increase more rapidly than the cost of living, and their remittances have also been rising substantially. With the ongoing localization policy in South Africa and the further mechanization of RSA mining, however, job opportunities for Basotho will very likely diminish over the medium term, whereas, due to the growth of the population, proportionally more school leavers will come to the labor market. Therefore, the authorities' initiative in family planning is well taken.

The agricultural sector, the second in importance in the economy, has shown lack of growth despite substantial public investments, since the wide and growing gap between farmers' and miners' income has caused a long-continuing drain of manpower from farming to RSA mines. This divergence has so far undercut all efforts and investments by the authorities to increase the output and incomes of local farmers, as evidenced by the limited impact which a long series of agricultural projects has had. This situation may be reversed if, as seems likely, employment opportunities in the RSA mines decline; nevertheless, a shift of emphasis from farming to well-managed livestock raising appears to be desirable. The authorities' policy of creating an environment favorable to private investment in industry and trade is to be welcomed, in particular because their emphasis is on export promotion and selective import substitution, which would strengthen the balance of payments. It is particularly important to increase the level of productivity in agriculture, in order to reduce dependence on food imports.

The authorities have realized the seriousness of the financial situation and are eager to reverse the recent trend toward larger budget deficits, a higher debt service burden, and continuing increases in imports in the face of weakening exports. Some action has already been taken in this respect during the last year. The introduction of a sales tax is an important step in the right direction because it falls on all elements of the population, including miners and their families, whose incomes account for over 40 per cent of GNP but have hardly been taxed at all so far. By including this group in the income tax net as well, the tax burden would be much more equally shared by the whole population. Such a tax would also help to dampen excessive private demand and reduce imports.

In the monetary field the authorities have little scope for an independent policy, but a rise in bank deposit rates within the existing interest rate structure of the RMA is likely to mobilize some additional savings and narrow the spread between lending and deposit rates.

While the staff welcomes the authorities' efforts to reduce the budget deficit, it must be recognized that the present measures for the fiscal year 1983/84 will at best contain the deficit to the previous year's level, most likely at the cost of investment expenditures. Meanwhile, the deficit of the current external balance could well increase by as much as one half in reflection of the worsening trade balance. Therefore, additional fiscal measures will need to be implemented speedily. Only an improvement of the fiscal position will have a marked impact on the balance of payments, especially in reducing the demand for imports.

If the authorities are to reduce the budget deficits, it is imperative not only to broaden the tax base but also to reduce subsidies further, strictly enforce the recruitment and salary freezes for government employees, and improve the profitability of nonfinancial public enterprises by means of suitable pricing policies and tighter financial control. Also the authorities can ill afford to carry on with costly infrastructure projects like the government office complex at a time when scarce financial resources are needed for more productive activities. Likewise, although the noneconomic appeal of increased autonomy in food production and air transport is understandable, the cost of the FSSP and the international airport appear to far exceed their economic value, and pursuit of such projects in present financial circumstances is highly questionable.

The authorities' efforts to manage the public debt better are welcome. In order to preclude an onerous increase in the debt service burden, they will need in particular to avoid future recourse to expensive commercial borrowing.

The pegging of the loti to the South African rand with full rand backing for the currency has been helpful in providing monetary discipline, and the staff agrees that, on balance, it continues to be beneficial to Lesotho. The country's continued liberal system of trade and payments for current international transactions is also to Lesotho's benefit.

It is recommended that the next Article IV consultation with Lesotho be held on the standard 12-month cycle.

## V. Proposed Decision

The following draft decision is proposed for adoption by the Executive Board:

1. The Fund takes this decision in concluding the 1983 Article XIV consultation with Lesotho, in the light of the 1983 Article IV consultation with Lesotho concluded under Decision No. 5392-(77/63), adopted April 29, 1977 (Surveillance over Exchange Rate Policies).

2. The Fund notes with satisfaction that Lesotho continues to maintain an exchange system which is free of restrictions on payments and transfers for current international transactions.

## Lesotho--Relations with the Fund
(As of May 31, 1983)

### Fund data

| | |
|---|---|
| Date of membership | July 25, 1968 |
| Status | Article XIV |
| Quota | |
| Present | SDR 10.5 million |
| Proposed | SDR 15.1 million |
| Fund holdings of currency as per cent of quota | 99.2 per cent |
| Net cumulative allocation of SDRs | SDR 3.7 million |
| Holdings of SDRs | SDR 0.8 million, equivalent to 22.3 per cent of the net cumulative allocation |
| Trust Fund loans | SDR 4.9 million |
| Direct distribution of profit from gold sales | US$0.79 million |
| Gold distribution | 4,278.3 ounces |
| Intervention currency | U.S. dollar |
| Exchange rate | M 1 = R 1 = US$0.93120 |
| SDR/Local currency equivalent | SDR 1 = M 1.15694 |

### Previous Article IV consultation discussions

The previous Article IV consultation discussions were held during the period March 25-April 8, 1982; Board discussion of the staff report (SM/82/104) took place on June 30, 1982.

### Technical assistance

Since April 1982 the Central Banking Department has been providing an advisor to the Research Department of the Central Bank.

Lesotho--Relations with the World Bank Group

As of the end of March 1983, IDA had approved 12 credits for a total of US$70.20 million, of which US$42.66 million were disbursed. These credits were provided for agricultural, educational, road, and urban development; rural water supply projects; and the financing of the Lesotho National Development Corporation. In addition, IFC provided a loan and obtained equity, totaling US$0.33 million, for a quarry project.

Currently, IDA has included in its lending program six additional projects totaling about US$75 million, of which three are in an advanced stage of preparation: highways, US$17 million; education, US$10 million; and population, health, and nutrition, US$3 million.

The World Bank is considering participating in the Highland Water Scheme. This is a project to divert water into the Vaal Valley, South Africa's industrial heartland. At present, preparations for a feasibility study are in an advanced stage; it will be financed by the European Development Fund and UNDP and is expected to take close to two years. The total cost of the project is estimated to amount to at least US$1 billion, for which financing is expected from South Africa, the EC, and possibly the World Bank.

## LESOTHO: Basic Data

| | |
|---|---|
| **Area, population and income** | |
| Area | 30,444 square kilometers |
| Population: | |
| Total (mid-1982 estimate) | 1.4 million |
| Annual growth rate | 2.3 per cent |
| GNP (1982/83 estimate) | SDR 559 million |
| GNP per capita | SDR 399 |
| GDP per capita | SDR 226 |

| | 1978/79 | 1979/80 | 1980/81 | 1981/82 | 1982/83 |
|---|---|---|---|---|---|
| **National income and expenditure 1/** | | | (In millions of maloti) | | |
| Levels in current prices: | | | | | |
| Gross domestic expenditure | 471.5 | 540.7 | 641.3 | 745.0 | 859.0 |
| Final consumption | (391.8) | (437.1) | (525.7) | (627.0) | (747.0) |
| Gross domestic investment | (79.7) | (103.6) | (115.6) | (118.0) | (112.0) |
| Goods and nonfactor services: | | | | | |
| Exports | 44.4 | 58.4 | 47.2 | 55.0 | 52.0 |
| Imports | -266.1 | -338.5 | -386.6 | -452.0 | -529.0 |
| GDP at market prices | 249.8 | 260.6 | 301.9 | 348.0 | 382.0 |
| Net factor income from abroad | 156.2 | 181.8 | 212.4 | 252.0 | 294.0 |
| GNP at market prices | 406.0 | 442.4 | 514.3 | 600.0 | 676.0 |
| | | | (In per cent) | | |
| Annual growth rates | | | | | |
| GNP at current prices | 22.3 | 9.0 | 16.3 | 16.6 | 12.7 |
| Final consumption | 23.6 | 11.6 | 20.3 | 19.3 | 19.1 |
| Gross domestic investment | 1.2 | 30.0 | 11.6 | 2.1 | -5.1 |
| GNP deflator | 7.1 | 11.4 | 11.1 | 10.0 | 12.0 |
| GNP at 1970/71 prices | 14.2 | -2.2 | 4.6 | 6.0 | 0.6 |
| Ratios to nominal GNP | | | | | |
| Gross domestic investment | 19.6 | 23.4 | 22.5 | 19.7 | 16.6 |
| Net imports of goods and services | 54.6 | 63.3 | 66.0 | 66.2 | 70.6 |
| **Central government finances** | | | (In millions of maloti) | | |
| Preliminary actuals 2/ | | | | | |
| Revenue and grants | 92.0 | 111.7 | 125.5 | 124.8 | 144.2 |
| Total expenditure and net lending | 82.8 | 127.4 | 166.0 | 183.7 | 185.0 |
| Overall surplus/deficit (-) | 9.2 | -15.7 | -40.5 | -58.9 | -40.8 |
| Foreign financing (net) | ... | 9.9 | 10.5 | 8.8 | 25.1 |
| Domestic financing (net) | ... | 5.8 | 30.0 | 50.1 | 15.7 |
| Ratios to nominal GNP | | | | | |
| Overall surplus/deficit (-) | 1.4 | -3.5 | -7.9 | -9.8 | -6.0 |
| Overall deficit before grants | -1.4 | -7.5 | -12.0 | -12.1 | -7.4 |

LESOTHO: Basic Data (concluded)

| | 1978 | 1979 | 1980 | 1981 | 1982 |
|---|---|---|---|---|---|
| **Prices** | | (Changes in per cent) | | | |
| Consumer prices (low-income) | 13.0 | 15.0 | 17.8 | 16.6 | 13-15 3/ |
| Import prices | 15.0 | 12.8 | 12.6 | 12.8 | 16.7 |
| **Money and credit** | | (In millions of maloti) | | | |
| Levels, end of year | | | | | |
| Claims on Government (net) | 3.7 | 8.2 | 22.8 | 51.1 | 65.4 |
| Claims on other sectors | 28.7 | 32.4 | 30.7 | 47.6 | 57.9 |
| Money and quasi-money (M2) 4/ | 76.1 | 95.9 | 117.1 | 144.9 | 185.4 |
| | | (In per cent of opening M2) 5/ | | | |
| Changes during year | | | | | |
| Claims on Government (net) | ... | 5.9 | 15.3 | 24.2 | 9.9 |
| Claims on other sectors | ... | 4.9 | -1.8 | 14.4 | 7.1 |
| Money and quasi-money (M2) 4/ | ... | 26.0 | 22.1 | 23.7 | 28.0 |
| Interest rates (year end) | | (In per cent per annum) | | | |
| Prime overdrafts | 11.0 | 11.0 | 11.0 | 15.0 | 17.0 |
| Savings deposits (minimum) | 3.0 | 3.5 | 2.5 | 5.0 | 5.0 |
| **International transactions** | | | | | |
| | | (In millions of SDRs) | | | |
| Balance of payments | | | | | |
| Exports, f.o.b. | 26.4 | 35.8 | 46.0 | 43.5 | 35.1 |
| Imports, f.o.b. | -192.3 | -243.5 | -309.3 | -371.3 | -350.7 |
| Workers' remittances | 141.7 | 164.5 | 202.5 | 233.9 | 242.4 |
| Other service and income receipts | 50.5 | 63.8 | 77.8 | 82.7 | 75.2 |
| Service and income payments | -62.2 | -75.0 | -96.3 | -114.6 | -113.3 |
| Unrequited transfers | 40.8 | 54.3 | 72.7 | 70.2 | 56.3 |
| Current balance | 4.9 | -0.2 | -6.6 | -55.7 | -55.1 |
| Long-term capital | 8.8 | 18.8 | 27.4 | 30.7 | 25.9 |
| Short-term capital | -4.4 | -9.2 | 20.1 | 18.5 | -7.9 |
| Errors and omissions (net) | -9.4 | -9.6 | -7.0 | 8.1 | 44.8 |
| Overall balance | -0.1 | -0.1 | 33.9 | 1.6 | 7.7 |
| External public debt (year end) | ... | 31.9 | 48.2 | 70.9 | 100.7 |
| Ratio external public debt service to exports and service receipts 6/ | ... | 0.2 | 0.3 | 2.4 | 4.9 |
| | | (In per cent) | | | |
| Ratios to nominal GNP | | | | | |
| Workers' remittances | 39.9 | 41.3 | 42.3 | 41.8 | 44.1 |
| Current account balance | 1.4 | -- | -1.4 | -10.0 | -10.0 |
| External public debt | ... | 8.0 | 9.5 | 13.7 | 18.2 |
| | | (In SDR per loti) | | | |
| Exchange rates | | | | | |
| Period average | .9185 | .9194 | .9876 | .9744 | .8359 |
| End of period | .8827 | .9181 | 1.0508 | .8981 | .8443 |

1/ National accounts for 1980/81 - 1982/83 are staff estimates.
2/ All actuals are provisional, pending closing of books.
3/ Staff estimate; change in index (10.1 per cent) understated due to incomplete updating.
4/ Excluding rand in circulation, for which reliable estimates are not available.
5/ Changes in absolute terms in per cent of money and quasi-money at start of year.
6/ Rough staff estimates.