SM/86/289
Correction 1

CONTAINS CONFIDENTIAL INFORMATION

January 5, 1987

To: Members of the Executive Board

From: The Secretary

Subject: Lesotho - Staff Report for the 1986 Article IV Consultation

The following corrections have been made in SM/86/289 (12/1/86):

Page 12, para. 4, line 8: for "interest rates" read "interest payments"
para. 5, line 10: for "adverse affect" read "adverse effect"

Page 17, first full para., lines 6-9: for "one of whose...South African Development Bank."
read "whose terms of reference... central development fund."

Corrected pages are attached.

Att: (2)

Other Distribution:
Department Heads

January 1980. Swaziland, which had signed a similar agreement in March 1974, began issuing its currency, the lilangeni, in September 1975. The two currencies were pegged to the rand at par, and in both cases currency issued was to be fully backed by rand deposits at the South African Reserve Bank.

Economic and financial developments in South Africa, particularly the sharp depreciation in the exchange rate of the rand (and hence the loti) since late 1984, prompted the participating countries to review the existing Monetary Agreement. Negotiations among the three member countries led to the amendment of the Rand Monetary Agreement, which was renamed the Trilateral Monetary Agreement, between South Africa, Lesotho, and Swaziland, and to the conclusion of new bilateral agreements between South Africa and each of the other two contracting parties. Although signed on April 18, 1986, the agreements came into effect retroactively on April 1, 1986. 1/ The Trilateral Monetary Agreement replaced the RMA with the Common Monetary Area (CMA). While the new agreement provided for substantial changes in the arrangements between Swaziland and the other member countries, 2/ as it affects Lesotho there were only limited changes from the original agreement. The withdrawal notice period was reduced from twelve months to six months, and the definition of reserve cover for the loti currency in circulation was extended to include investments by the Central Bank of Lesotho in the South African Corporation for Public Deposits (established in 1984). In addition, the Central Bank of Lesotho now has the right to hold gold and non-South African rand foreign exchange reserves up to a maximum of 35 percent of the total of its gold and foreign exchange reserves and rand holdings. Previously, Lesotho could not maintain any non-South African rand foreign exchange holdings at all. A full comparison between the new and the previous agreement appears in Appendix V.

1/ As with the previous arrangements, the Trilateral Monetary Agreement and the implementing bilateral agreement between South Africa and Lesotho contain limitations on the rights of the contracting parties to transfer certain balances of each other's currencies for the making of payments and transfers for current international transactions. The consistency of these monetary arrangements with the Articles of Agreement of the Fund, in particular Article VIII, Section 2(a), will be reviewed in detail in a separate Board paper at a later date.

2/ As described in SM/86/192, 8/5/86.

IV. Report on the Discussions

In view of the interest expressed by the authorities in considering the use of resources under a SAF arrangement, discussions focused on medium-term economic and financial prospects, in addition to an assessment of prospects for the current financial year.

1. Prospects for 1986/87

The staff representatives observed that the prospects for the Lesotho economy in 1986/87 (April-March) were uncertain, particularly in view of economic and political developments in southern Africa. Nonetheless, the forecast pointed to a partial recovery in real GDP growth in 1986/87, a shift in the external current account from a surplus in 1985/86 to a significant deficit in 1986/87, and a substantial budgetary deficit in 1986/87.

Assuming favorable weather conditions, real GDP is forecast to grow by about 1.5 percent in 1986/87 as a result of an increase in output of all major agricultural crops, as well as significant gains in the livestock sector, particularly of wool and mohair. At the same time, formal sector employment is expected to show a modest increase, partly because the number of migrant mine workers is expected to increase by about 3 percent, reflecting expanding demand for mine labor in the Republic of South Africa.

The budget estimates for 1986/87 show an overall budgetary deficit of M 87.5 million (equivalent to 13 percent of GDP), about 18 percent higher than the outturn for 1985/86. Total revenue and grants are estimated at M 335 million, about 32 percent higher than the outturn for 1985/86, with the entire increase stemming from a sharp rise in grants. Total expenditure and net lending are estimated to increase by 29 percent to M 422 million. Recurrent expenditure is estimated to remain almost unchanged, despite sharply higher interest payments and an increase of 9 percent in wages and salaries, because expenditure on goods and services is budgeted to fall by about 26 percent from the abnormally high level of 1985/86, or by 43 percent in real terms. In contrast, capital expenditure is estimated to increase by 92 percent.

The staff representatives expressed concern at the large budgetary deficit in 1985/86, and the projected sharp increase in 1986/87, which would, as in the previous year, be financed mainly by domestic bank borrowing. Moreover, staff estimates suggest that the outturn for the 1986/87 budget is likely to be considerably higher than budgeted (17.5 percent of GDP compared with 13.1 percent, Table 2), partly because it was unlikely that nonwage recurrent expenditure (other than interest) would decline by the 25 percent (43 percent in real terms) indicated in the budget. Given that these budgetary developments are likely to have an adverse effect on Lesotho's balance of payments and growth, the staff representatives emphasized that the authorities should intensify their efforts to restrain expenditure, particularly recurrent producer prices in South Africa) and some public utility tariffs. They acknowledged that there was a need for more timely reviews of these tariffs, with full pass-through of costs to consumers.

c. Financial policies

The Lesotho representatives expressed concern at the Government's heavy reliance on SACU receipts, especially in view of its volatility and the likelihood of a secular decline in such receipts. This concern was heightened by considerable uncertainty over the future of the customs union. No specific proposals have yet been made, but the South African authorities had commissioned an extensive study, whose terms of reference included the possibility of stopping the distribution of the compensation element 1/ directly to the member Governments, paying it instead to a central development fund. Such a procedure was probably intended to enable resources to be transferred to the "homelands" as well as to the existing SACU members.

The staff representatives said that in order to improve the budgetary situation and to redress some of the financial imbalances, it would be necessary to implement both revenue and expenditure measures. On the revenue side, such measures could include enlargement of the company tax base to cover public enterprises currently exempted; improved collection of taxes on income, and on goods and services; higher user fees for health and education; and the introduction of grazing fees, or a head tax on all animals. The last measure would also contribute to reducing the national livestock herd. The staff representatives observed that the tax base was narrow; in particular, workers' remittances were not subject to taxation, but acknowledged that it might be administratively difficult to implement such a tax, and that it would be counterproductive if migrants were discouraged from remitting savings by a fiscal disincentive. Instead, it would be preferable to attempt to use attractive financial instruments to stimulate an inflow of remittances. With respect to expenditure, the staff representatives suggested that consideration be given to the following: the rationalization of public employment to allow essential technical and managerial posts to be filled, while reducing the number of casual or daily paid workers; greater coordination between current and capital budgets to improve financial planning; the reduction of expenditure on other goods and services (a measure that seems to have been envisaged in the 1986/87 budget); and reductions in subsidies to parastatals through an improvement in their operations and adjustments to tariffs to enable them to recoup some of their capital costs. They

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1/ The compensation element constitutes a payment of 42 percent over and above the normal customs receipts accruing to the Governments of Botswana, Lesotho, and Swaziland to compensate them for the economic cost of their membership in SACU, such as diminished fiscal discretion and the diminished potential for development because of free trade with a much more developed economy.

also observed that in view of the system of annual merit increases, there was no room for implementing any general increase in salaries. Finally, it was particularly important that expenditure control mechanisms be strengthened. The staff representatives said that with the implementation of the above measures (as indicated in the medium-term scenario, Table 5), the ratio of expenditure and net lending to GDP would decline from 57 percent in 1986/87 to 47 percent in 1991/92.

The Lesotho representatives acknowledged that substantial measures were needed, but had reservations about certain proposals. In general, they felt that tax rates were high, and, although the base was narrow, resistance was likely if new taxes were introduced. They believed that there was little prospect for introducing a tax on migrants' earnings, indicating that this was politically a most sensitive issue. They felt that there was considerable scope for improving collection from existing taxes; in the case of the sales tax, potential revenue could be 2-3 times the budgeted amount of M 30 million, but with an open border, the prevention of smuggling was very difficult. They emphasized that measures were being instituted to rationalize sales tax and income tax collection, bringing them under a common administration with shared records. With respect to user fees, the authorities would be prepared to consider adjustments to certain fees. On expenditure, the Lesotho representatives said that they intended to pursue a two-pronged policy. They intend to institute a more comprehensive system of expenditure control which will enable them to monitor and control expenditure, particularly recurrent expenditure, more effectively. In addition they were considering a full scale review of the civil service focusing on size, composition and skills. They were also currently reappraising the past policy of giving highest priority to social infrastructure, and, instead, would put the emphasis of future policy on promoting investment in areas which would generate a high and immediate return. While agreeing with the need to improve the profitability of the parastatals, even to the extent of considering divestment where necessary, the Lesotho representatives said that certain enterprises had a symbolic national significance.

The discussions on monetary and credit policies focused on a number of interrelated areas: the implications for the nongovernment sector of an unrestrained budget; the introduction of appropriate financial instruments to mobilize savings; the structure of interest rates; and the excess liquidity in the banking system. The staff representatives said that although Lesotho had reduced interest rates during 1986 following the movements of rates in the RSA, growth in private sector credit, especially to business enterprises, remained low. Nevertheless, considerable surplus liquidity remained in the banking system indicating that there were more fundamental issues which needed to be addressed, in particular the need to channel domestic savings into productive investment. This pointed to the need to formulate an appropriate investment strategy, with incentives directed toward priority industries--for instance those with an export orientation--to promote investment in