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Correction 1

CONTAINS CONFIDENTIAL
INFORMATION

November 19, 1985

To: Members of the Executive Board

From: The Secretary

Subject: Lesotho - Staff Report for the 1985 Article IV Consultation

The following corrections have been made in SM/85/283 (10/23/85):

Page 1, para. 2, line 2: for "August 28" read "August 29"

Page 3, Table 1, column 5, line 27: for "53.5" read "48.4"
column 6, line 27: for "48.4" read "49.5"

Page 5, line 11: for "2.5 percentage" read "6-7 percentage"
line 12: for 17.5 percent" read "22.0 percent"

Page 12, line 1: for "8.8 percent" read "18.3 percent"

Page 26: for "Attachment VII" read "Appendix VII"

Corrected pages are attached.

Att: (5)

Other Distribution:
Department Heads

SM/85/283
Corrected: 11/18/85

CONTAINS CONFIDENTIAL
INFORMATION

INTERNATIONAL MONETARY FUND

LESOTHO

Staff Report for the 1985 Article IV Consultation

Prepared by the Staff Representatives for the
1985 Consultation with Lesotho

Approved by A.D. Ouattara and S. Kanesa-Thasan

October 22, 1985

I. Introduction

The 1985 Article IV consultation discussions with Lesotho were held in Maseru during the period August 6-21, 1985. The representatives for Lesotho included the Minister of Finance (the Honorable Mr. Rakhetla), the Permanent Secretaries for Finance (Mr. Waddington) and Planning (Mr. Monyake), the Governor of the Central Bank (Mr. Schoenberg), and other senior officials of ministries and agencies concerned with economic and financial matters. The staff representatives were Mr. Emmanuel K. Martey (head-AFR), Mr. Joshua E. Greene (AFR), Mr. Michael E. Massourakis (AFR), Mr. A.L. Bovenberg (FAD), and Miss Olga E. Siwicky (secretary-RES).

The last Article IV consultation with Lesotho was concluded on August 29, 1984. Lesotho continues to avail itself of the transitional arrangements of Article XIV. Summaries of Lesotho's relations with the Fund and with the World Bank Group, and of outstanding statistical issues are provided in Appendices I, II, and III, respectively. Series on basic data, the medium-term fiscal and balance of payments outlook, and debt projections are presented in Appendices IV, V, VI, and VII, respectively.

II. Background

Lesotho is a small, mountainous kingdom with limited natural resources. Although subsistence agriculture and livestock rearing constitute the main economic activity for about 85 percent of the resident population, the soil has suffered extensive erosion, and only about 13 percent of the land is cultivable. The main known unexploited natural resource is upstream water; the known diamond deposits are presently uneconomical to exploit on a large scale at current world market prices.

Lesotho is a landlocked country surrounded by the Republic of South Africa (RSA) with which it is linked economically and financially through membership in the Rand Monetary Area (RMA) and the Southern African Customs Union (SACU); the latter also includes Botswana and

Swaziland. Over one half (about 140,000) of Lesotho's male labor force is employed in the RSA, primarily in mines, and their remittances exceed Lesotho's gross domestic product (GDP). About two thirds of government revenue derive from SACU receipts, representing primarily a reimbursement of customs and excise duties collected by the RSA on Lesotho's behalf. Lesotho's currency, the loti (plural maloti), is pegged to and fully convertible at par into the South African rand, which is also legal tender in Lesotho.

The Lesotho economy recorded impressive growth during the 1970s when the favorable impact of expansions in both migrant remittances and government expenditures resulting from increased SACU receipts were reinforced by a sharp increase in export receipts from a rapid growth in diamond production. Real GDP and GNP grew at an annual average rate of about 8 percent. The onset of droughts and a virtual stagnation in SACU receipts during 1980/81-1982/83 (April/March) contributed to a decline in real GDP during 1981/82-1983/84, while the growth of GNP eased to an average rate of 5.7 percent (Table 1 and Chart 1).

Indications are that there is considerable unemployment in the economy; the labor force is increasing by about 15,000-20,000 persons per annum, but domestic employment opportunities are increasing only marginally. More important employment opportunities in the RSA for Basotho have virtually stagnated, due to preferences being given increasingly to persons from RSA homelands and labor being displaced through mechanization of mining operations.

From an overall surplus equivalent to 4 percent of GDP (2.3 percent of GNP) in 1978/79, the fiscal situation deteriorated rapidly to a peak deficit equivalent to 17 percent of GDP (9.5 percent of GNP) in 1981/82, reflecting an expansionary fiscal stance. The ratio of revenue plus grants to GDP rose from 36.8 percent to 37.1 percent, while that of total expenditure to GDP expanded from 33.1 percent to 54.6 percent. Moreover, the deficit was financed largely by short-term external borrowing at high interest rates. During 1982/83-1983/84, in an effort to improve the fiscal situation, the authorities introduced a sales tax in 1982/83 and restrained total expenditure through a virtual freeze on recruitment into the civil service and reductions in capital outlays in real terms. The fiscal deficit was reduced to the equivalent of 10.6 percent of GDP in 1982/83 and further to the equivalent of 6.1 percent in 1983/84. The rate of expansion in domestic credit decelerated from 76 percent in 1981/82 to an average of 7 percent in 1982/83-1983/84, and the growth in broad money fell by more than one half to 12.4 percent. Moreover, the overall balance of payments, which recorded a large (SDR 36 million) deficit in 1981/82, shifted into surpluses in the two succeeding years. With increased migrant worker remittances the external current account position improved steadily, moving from a deficit equivalent to 16 percent in 1981/82 to only 2 percent of GDP in 1983/84. Long-term capital inflows also increased.

Table 1. Lesotho: Selected Economic and Financial Indicators, 1980/81-1985/86 1/

	1980/81	1981/82	1982/83	1983/84	1984/85	1985/86 Proj.
			(Annual percentage changes)			
National income and prices						
GDP at constant prices	4.5	-1.2	-0.5	-0.5	3.4	0.5
GNP at constant prices	5.9	6.2	8.7	2.3	3.0	--
GNP deflator	11.1	12.4	15.2	11.9	13.2	15.0
Consumer prices (low-income) 2/	17.3	9.5	19.1	9.8	14.3	15.0
External sector (on the basis of SDRs)						
Exports, f.o.b.	33.1	-25.1	-12.2	-8.4	-2.7	-16.0
Imports, f.o.b.	15.3	10.7	1.9	16.5	-6.2	-12.4
Migrant labor remittances	20.9	21.2	21.7	15.8	-5.5	-15.2
Nominal effective exchange rate (-depreciation)	-0.7	0.6	--	0.1	-1.3	...
Real effective exchange rate (-depreciation)	2.3	0.7	-1.3	-0.9	-2.0	...
Government finances						
Revenue (excluding grants)	11.2	6.5	21.3	26.0	27.9	12.2
Of which: SACU	(--)	(-0.8)	(8.3)	(43.3)	(37.9)	(6.3)
Revenue (including grants)	12.4	-0.6	15.5	24.2	30.9	11.3
Total expenditure	30.3	10.7	0.7	10.9	23.5	18.4
Money and credit						
Domestic credit	80.9	76.0	11.0	2.8	-4.2	10.1
Government	750.0	147.0	19.3	-12.8	-29.6	19.1
Nongovernment	6.2	29.2	0.6	26.2	21.8	5.0
Money and quasi-money (M2)	13.8	27.4	26.1	12.4	18.2	2.9
Velocity (GNP relative to M2)	4.2	3.9	3.9	4.0	3.9	4.4
Prime lending rate (annual average)	11.0	15.0	17.0	15.0	20.0	20.0
Savings deposit rate 3/	5.0	6.0	6.0	8.0	12.0	12.0
Time deposit rate 3/	9.5	11.0	6.0	13.0	17.5	14.0
			(In percent of GDP)			
Central government overall surplus or deficit (-) (including grants)	-13.4	-17.5	-10.6	-6.1	-3.8	-6.7
Domestic financing	9.9	11.9	4.1	-0.6	-0.2	-0.9
Of which: bank	(...)	(11.0)	(3.1)	(-2.2)	(-3.0)	(...)
Foreign financing	3.5	5.6	6.5	6.6	4.0	...
External current account balance	-4.9	-15.6	-7.8	-2.0	8.8	1.3
External debt	15.4	29.9	37.6	36.7	48.4	49.5
			(In percent of GNP; unless otherwise stated)			
External current account balance	-2.9	-8.5	-3.9	-0.9	4.3	0.6
External debt	9.0	16.2	18.7	17.7	25.8	23.8
Debt service ratio 4/	1.1	3.1	5.8	5.7	6.9	4.7
			(In millions of SDRs)			
Overall balance of payments surplus or deficit (-)	41.2	-36.3	12.7	25.2	0.7	-13.3
Gross official reserves (in months of imports, f.o.b.)	1.6	1.1	1.3	1.6	1.8	1.4 5/
Net foreign asset of banking system	64.7	36.3	74.1	96.1	105.5	132.3 5/

Sources: Data provided by the Lesotho authorities; and staff estimates.

1/ April/March. Money and credit data for 1985/86 relate to developments during the first quarter of 1985/86.
2/ End period.
3/ Highest rates on savings and time deposits at end of period.
4/ Ratio of debt service on government external debt relative to exports of goods and factor services. Excludes debt service for loans contracted by Central Bank and on-lent to Government.
5/ As of August 15, 1985.

III. Economic and Financial Developments During 1984/85

The economic and financial situation of Lesotho improved significantly during 1984/85. Domestically, real GDP recovered, the fiscal deficit fell, and inflation (as measured by the GDP deflator) remained relatively modest notwithstanding a large depreciation of the rand and, hence, the loti. In the external sector, the overall balance of payments recorded a surplus for the third consecutive year, but the level of external debt and debt service payments increased substantially.

After three successive years of decline, real GDP rebounded in 1984/85, with a growth of about 3.4 percent; real GNP also rose by 3 percent, while the population growth is estimated at 2.3 percent. The expansion in economic activity reflected primarily a marked increase in government investment (53 percent), which was heavily concentrated on the construction sector, and strong export growth following the recovery of the agricultural sector from years of drought. Although the resource gap widened, the deterioriation was not as marked as in the preceding year, since imports in local currency terms rose less rapidly and export receipts, as noted earlier, improved.

Notwithstanding a sharp increase in total expenditure in 1984/85, the overall budget deficit declined to 3.8 percent of GDP from 6.1 percent in 1983/84 (Appendix IV). While total expenditure rose rapidly (24 percent), total revenue and grants were even more bouyant, with the largest single increase in customs union receipts in recent years, M 41.6 million, accounting for 88 percent of the increase in total revenue. Moreover, foreign grants nearly doubled to M 17.1 million. The accelerated growth in total expenditure reflected largely a 45 percent increase in capital outlays, mostly for large construction projects. Although there was a 40 percent average increase in civil service salaries in January 1985 resulting in a 17 percent rise in the wage bill for 1984/85, recurrent expenditure rose by only 14 percent or about the same rate as domestic inflation because of lower interest payments made possible by prepayment of some commercial debt during the year. Subventions and transfers, however, rose by about 22 percent. In financing the deficit, the Government relied on external resources.

Monetary and credit developments were broadly in line with the general economic situation. Total domestic credit fell by 4 percent on account of a reduction in claims on Government, but claims on the private sector and parastatals rose by 22 percent. With continued increases in deposits of miners' deferred pay 1/ and substantial expansion in savings deposits, broad money rose by 18 percent, compared with 12 percent in

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1/ The existing understanding between the RSA mines and the Lesotho authorities requires that 60 percent of a miner's income be deferred and transferred to Lesotho to be made available to the miner when he returns home.

1983/84. In the event, the commercial banks, faced with considerable surplus funds, invested substantial resources abroad, and, together with increased net foreign assets of the Central Bank, contributed to an almost 58 percent increase in the net foreign assets of the banking system. In concert with interest rate developments in the RSA, interest rates were adjusted flexibly during 1984/85: the Central Bank's call money rate was adjusted periodically from 15.5 percent to 19 percent, and its 31-day deposit rate was raised by 3 percentage points. In response, the commercial banks raised their time deposit rates by 1-4.5 percentage points to 11-17.5 percent, the maximum time deposit rate by 4.5 percentage points to 17.5 percent, and the prime lending rate by 6-7 percentage points to 22.0 percent.

The substantial expansion in aggregate demand, together with the large depreciation of the loti, contributed to considerable domestic inflationary pressures which were, however, moderated by the improved food crop situation and an increase in rand-denominated imports. Besides the larger government expenditures, including higher salaries for civil servants, minimum wage rates in the economy at large were raised by an average of 39 percent effective October 1984. In the event, the GDP deflator rose by 13.2 percent, compared with 11.9 percent in 1983/84.

In 1984/85 the overall balance of payments recorded a surplus amounting to SDR 0.7 million, compared with SDR 25.2 million in 1983/84. The sharply reduced surplus, notwithstanding a major turnaround in the current account position to a surplus of SDR 30 million, reflected a significant reduction in official long-term capital inflow, increased debt amortization, and substantial short-term capital outflows from commercial banks seeking investment outlets for surplus funds. In terms of foreign currency, the trade deficit narrowed largely on account of a reduction in imports, and migrant remittances fell. Unrequited transfers, primarily customs union compensation, rose by one third to SDR 98 million, leading to the current account surplus noted above. Net long-term capital inflow fell by 39 percent to SDR 16.5 million, as official net capital inflow declined by half and loan repayments nearly doubled to SDR 11.8 million.

Lesotho's external disbursed public debt, in foreign currency terms, increased by 19 percent in 1984/85 to SDR 142.4 million or triple the stock of debt at end-1980/81 (Appendix VII). Some 82 percent of the external debt, however, represents concessional obligations mainly to multilateral organizations. Except for 1984/85, most of the nonconcessional obligations were contracted in 1981/82, and in 1984/85 the Government paid off nearly SDR 6.6 million of these obligations to financial institutions, raising the ratio of debt service to exports of goods and factor services for the year to 6.9 percent from 5.7 percent in 1983/84.

The effective exchange rate of the loti depreciated by 1.3 percent in nominal terms and 2.0 percent in real terms during the 12-month period ended March 1985, when the loti depreciated by 30 percent in foreign currency terms with respect to the SDR (Table 1 and Chart 2). The RSA continued to be Lesotho's dominant trading partner, accounting for an estimated 93 percent of Lesotho's external trade. For the 16 months ended July 1985, the nominal effective depreciation of the loti amounted to 2.7 percent while the depreciation against the SDR reached 42 percent.

Since the return of the mission, Lesotho has, together with other members of the RMA, adopted a two-tier exchange rate system following the reintroduction of the 'financial rand' mechanism by the RSA effective September 2, 1985. Under the 'financial rand' mechanism, local sales proceeds of Rand Monetary Area securities and other investments owned by nonresidents cannot be transferred in foreign currency, but must be retained in the form of 'financial rand' balances. Such balances are transferable among nonresidents at a freely-determined exchange rate. It might be noted that Lesotho was not party to the suspension of foreign debt repayments which was imposed by the RSA.

IV. Report on the Discussions

1. Supply-oriented policies

In reviewing recent economic developments, the Lesotho representatives conceded that the Third Five-Year Development Plan (1980/81-1984/85) had effectively lapsed and there was currently no comprehensive national development plan. The prevailing policies for the various sectors of the economy, primarily agriculture and livestock, manufacturing, and tourism, would need to be incorporated into a single document that reconciles policy objectives, implementation procedures, and domestic and external financing requirements. To this end, the authorities were preparing a document to be presented to prospective donors in 1986. The authorities expect to cooperate with the World Bank in the preparation of this document.

In reviewing current developments and policies with respect to the agricultural and livestock sectors, the Lesotho representatives stated that, besides improved weather conditions, the recovery of agricultural output in 1984/85 also reflected a reorientation to agricultural policy that gives greater emphasis to farmer participation in crop production under government-supported programs. Farmers now undertook preparation of the land as well as weeding. The Technical Operations Unit (TOU) of the Ministry of Agriculture was employed in planting, in order to attain optimum results. *Pari passu* with phasing down the role of the Food for Self-Sufficiency Program (FSSP), which aimed at transforming subsistence agriculture through the application of capital-intensive methods, the authorities were now employing the Agricultural Development Bank to provide financial credit to farmers while Coop Lesotho was providing farmers with packaged inputs--including seeds, fertilizer, and insecticides--at subsidized prices. For the period ahead, the authorities anticipated concentrating on expanding output of various horticultural crops, and high value fruits for export. In this connection, the authorities were seeking FAO technical assistance. With respect to livestock, the decision to improve the quality of the herd and reverse the soil in the RSA would not have long-term adverse consequences for migrant earnings, particularly considering the highly experienced Basotho mine labor force. In the final analysis, Lesotho's membership in the RMA and the SACU and its geographical location all severely constrain the Lesotho authorities' capacity to influence external economic and financial policies, including adjusting the exchange rate.

With respect to external debt, the Lesotho representatives noted that the recent depreciation of the loti had raised substantially current debt service obligations and the potential burden (in terms of local currency) of the stock of debt; debt service payments in 1984/85 were equivalent to 7 percent of exports of goods and factor services, and the stock of disbursed debt was equivalent to 48 percent of GDP (Appendix VII). They noted, however, that the Government virtually eliminated debt relating to suppliers' credit and prepaid a substantial portion of existing nonconcessional obligations (SDR 6.6 million) to foreign financial institutions during 1984/85. Nevertheless, the Government had guaranteed considerable amounts of external loans to parastatals, and it was not certain that these entities could service these obligations in the period ahead. In the circumstances, the authorities intended to abstain from incurring new nonconcessional obligations to the extent possible in the period ahead.

Finally, the Lesotho representatives stated that the Lesotho authorities intend to continue to maintain a trade and payments system that is free of restrictions on current international transactions.

V. Medium-Term Outlook

On the basis of economic and financial policies in effect at the time of the mission, the financial situation of Lesotho for the medium-term is likely to be difficult. The staff's assessment of the medium-term outlook of the Government's fiscal operations and the balance of payments are summarized in Appendices V and VI. The results would, however, be sensitive to developments in the RSA, particularly prospects regarding migrant labor remittances and the evolution of the formula relating to SACU receipts. No account has been taken of the financial implications of the Highland Water Project on which firm financial decisions have yet to be made.

1. Fiscal outlook

On the basis of current wage commitments and assuming no increase in the size of the civil service, but allowing for assumed rates of inflation or a 13 percent increase in recurrent and development outlays in 1986/87 and 10 percent thereafter, the fiscal situation is likely to come under considerable pressure in the medium term. Based on official estimates, which assume a constant level of real capital expenditure, nominal capital outlays in 1989/90 will reach M 137.5 million or equivalent to 13.2 percent of GDP, compared with 18.3 percent in 1984/85. In the event, in the five years ending 1989/90, total expenditure (excluding interest from any new debt commitments) will increase by two thirds or at an annual average rate of 11 percent. By contrast, revenue (excluding grants) is likely to increase at an annual average rate of 9.5 percent to M 339 million. Accordingly, the ratio of the overall budget deficit to GDP will rise from 3.8 percent in 1984/85 to 9 percent in 1986/87 before declining to 6 percent in 1989/90.

Given known prospective disbursements from existing external commitments as well as likely resource flows from the civil servants' compulsory savings program, the resulting financing gap will reach some M 55 million or 5.3 percent of GDP by 1989/90. Implicit in this estimate is the assumption that the public enterprises will be able to service their government-guaranteed debt from their own resources. Moreover, the servicing of debt procured to meet the financing gap from year to year will add to the overall fiscal financing requirements.

As stated earlier, the above estimates have not taken into account the financial aspects of the Highland Water Project. The project, which is estimated to cost US$1.5 billion (at 1983 prices), is intended primarily to export water to RSA. Hydroelectricity for local consumption is also expected to be generated as a by-product of the scheme. The water project, which is anticipated to be fully self-financing, is expected to be financed largely by loans from commercial sources not yet determined, with possible participation by the World Bank. The second and final phase of the feasibility study of the project, financed by the EC and the UNDP, is expected to be completed this year. The first construction phase is scheduled to start in mid-1988, following the preparation of detailed designs and the establishment of a project authority in 1986-88 with possible financing (about US$40 million) from IDA, EC, UNDP, and bilateral sources.

2. Balance of payments prospects

The balance of payments projections have taken into account the above levels of government expenditure, prospective SACU receipts, and probable migrant remittances, assuming current levels of migrant employment, but adjusting salaries for projected rates of inflation--13 percent in 1986/87 and 10 percent thereafter. In general, the overall balance of payments position is likely to be difficult for the medium term as a whole (Appendix VI).

Export performance is likely to improve, partly on account of exports of meat products and partly from growth in horticultural products, wool, and mohair. However, notwithstanding the recent coming on stream of some import-substituting industries, mainly textiles, import payments are likely to grow in nominal terms by at least 10 percent per annum, contributing to a widening of the trade deficit. SACU receipts are projected

Lesotho: Medium-Term Balance of Payments, 1985/86-1989/90

(In millions of SDRs)

	1985/86	1986/87	1987/88	1988/89	1989/90
Current account surplus/ Deficit (-)	3.9	-11.6	-12.6	-9.1	-14.8
Exports (f.o.b.)	24.2	27.3	30.2	33.3	36.8
Imports (f.o.b.)	-387.0	-425.0	-463.7	-507.8	-555.9
Trade balance	-362.8	-397.7	-433.5	-474.5	-519.1
Workers' remittances	301.4	340.6	374.7	412.1	453.3
Other services and income (net)	-5.8	-9.7	-15.6	-18.1	-21.4
Unrequited transfers	71.1	55.2	61.8	71.4	72.4
Capital account	-17.1	12.5	13.8	4.3	4.8
Long-term capital	11.9	20.1	20.4	11.5	12.8
Official (net)	(9.0)	(16.8)	(16.7)	(7.4)	(8.3)
Private (net)	(2.9)	(3.4)	(3.7)	(4.1)	(4.5)
Short-term capital) Errors and omissions)	-29.0	-7.6	-6.6	-7.2	-8.0
Overall surplus or deficit (-)	-13.3	0.9	1.2	-4.8	-10.0

Source: Staff estimates.

Lesotho: External Public Debt 1/, 1981/82-1989/90

(In millions of SDRs; end of period)

	1981/82	1982/83	1983/84	1984/85	1985/86	1986/87	1987/88	1988/89	1989/90
						Projections			
Concessional	44.6	79.2	92.1	117.3	124.3	135.1	151.9	161.2	172.1
Multilateral	42.0	74.8	87.0	108.8	115.0	125.7	141.5	150.9	161.6
Of which: IDA	(13.5)	(39.9)	(47.6)	(58.3)	(60.5)	(65.1)	(70.9)	(72.5)	(74.3)
Bilateral	2.6	4.4	5.1	8.4	9.3	10.4	10.4	10.3	10.5
Nonconcessional	41.3	43.3	27.7	25.1	19.5	24.8	26.2	24.8	22.8
Suppliers' credit	1.7	6.1	3.4	2.2	0.5	0.1	--	--	--
Financial institutions	15.1	12.5	11.5	6.4	--	--	--	--	--
Multilateral	1.7	2.3	3.3	13.7	17.2	23.9	25.8	24.2	22.0
Bilateral	0.3	3.0	3.1	2.9	1.9	0.8	0.5	0.7	0.8
Central Bank 2/	21.4	19.8	6.4	--	--	--	--	--	--
Total	85.9	123.0	119.8	142.4	143.8	160.9	178.1	185.0	194.8
Debt service	8.7	21.9	22.1	22.1	16.3	10.4	10.0	11.0	11.1
Amortization	1.8	16.0	17.2	13.7	12.7	6.5	5.9	6.8	6.8
Interest	6.9	5.9	4.9	8.4	3.6	3.9	4.2	4.2	4.3
Memorandum items				(Ratios - in percent)					
External debt/GDP	29.9	37.6	35.7	48.4	49.5	46.6	44.8	40.9	37.5
External debt/GNP	16.2	18.7	17.7	25.8	23.8	23.4	23.1	21.5	20.1
Debt service/Exports of goods and nonfactor services	15.3	38.7	43.5	53.7	36.5	20.5	18.0	17.8	16.3
Debt service/Exports of goods and factor services	3.1	5.8	5.7	6.9	4.8	2.7	2.4	2.4	2.2

Source: Data provided by the Lesotho authorities.

1/ Disbursed and outstanding. Excludes publicly guaranteed debt on which comprehensive data are not available.
2/ Relates to resources procured by the Central Bank and on-lent to the Government.