FOR AGENDA

SM/10/32

February 9, 2010

To: Members of the Executive Board

From: The Secretary

Subject: **Kingdom of Lesotho—Staff Report for the 2009 Article IV Consultation—Response of the Authorities**

Attached for consideration by the Executive Directors is the response of the authorities to the staff report for the 2009 Article IV consultation with the Kingdom of Lesotho. The response, together with the staff report (SM/10/31, 2/9/10), is part of the pilot on innovating Article IV consultations and is tentatively scheduled for discussion on **Monday, February 22, 2010.** At the time of circulation of this paper to the Board, the Secretary's Department has not received a communication from the authorities of the Kingdom of Lesotho indicating whether or not they consent to the Fund's publication of this paper; such communication may be received after the authorities have had an opportunity to read the paper.

Questions may be referred to Mr. Thugge (ext. 39761) and Ms. Morgan (ext. 37798) in AFR.

Unless the Documents Section (ext. 36760) is otherwise notified, the document will be transmitted, in accordance with the procedures approved by the Executive Board and with the appropriate deletions, to the WTO Secretariat on Thursday, February 18, 2010; and to the African Development Bank and the European Commission, following its consideration by the Executive Board.

This document will shortly be posted on the extranet, a secure website for Executive Directors and member country authorities.

Att: (1)

Other Distribution:
Department Heads

INTERNATIONAL MONETARY FUND

KINGDOM OF LESOTHO

Staff Report for the 2009 Article IV Consultation─Response of the Authorities

February 4, 2010

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FIN/FISC/C.9/1/2 8th January, 2010

Mr. Takatoshi Kato
Deputy Managing Director
International Monetary Fund
Washington DC

Dear Mr. Kato

THE GOVERNMENT OF LESOTHO'S RESPONSE AND COMMENTS ON THE 2009 IMF ARTICLE IV CONSULTATION

I am pleased to confirm that the Government of Lesotho is in broad agreement with the conclusions of the IMF Article IV Mission that visited Maseru from November 4 to 18, 2009.

Lesotho's economic performance has been improving in recent years. As a result, it is beginning to be classified as low middle income, although other social indicators still leave it in the category of Least Developed Countries.

Despite this, Lesotho has made good progress towards the attainment of some of the MDG goals. It has introduced Free Primary Education and Old Age Social Pension scheme for every person aged 70 years and over; expanded village water supplies, sanitation and electricity connections into the rural areas; and, it has mounted an HIV and Aids awareness and testing programme known as "**Know-Your-Status (KYS)**" campaign, which is led by the Head of State, Cabinet and Church leaders.

But these achievements have been put at risk by the current economic and financial crisis which has negatively affected Lesotho's near-term economic outlook through:

a) steep declines in SACU revenues;

b) collapse of US demand for textile and clothing exports under AGOA;

c) retrenchment of migrant labour from South African mines and industries and the consequent reduction in remittances; and,

d) collapse in the prices of diamonds and associated public revenues.

As a result, employment in the textile and clothing sector (though small signs of recovery are beginning to show up) fell from about 50,000 to about 38,000; agricultural productivity continued its downward trend due to drought and poor farming practices while tourism and other services held their own.

Because of the integrated nature of the economies of Lesotho and South Africa, the expected slow economic recovery globally and in South Africa will have a positive impact on Lesotho's recovery in the next two to three years. But economic growth and SACU revenues are not likely to return to their former levels. The policy challenges and Government objectives in the near term, therefore, are to:

- promote high, sustainable, broad-based private sector-led economic growth aimed at reducing poverty and social vulnerability;

- create a conducive investment climate and economic competitiveness focused on reducing delays and the cost of doing business;

- develop a Minimum Infrastructure Platform and institutions for investment, particularly small and medium scale enterprises;

- mobilize more domestic financial resources and savings and manage public expenses in such a way that social achievements of the past are protected;

- promote efficiency in all Government operations and ensure that growth of the wage bill and non-productive recurrent expenses are curtailed; and,

- seek external financial and budgetary support from Lesotho's Development Partners and multilateral financial institutions including the Fund.

It is the Government's expectation that the pursuit of the above policies and strategies, with the support of the Fund and other Development Partners, will restore growth, reduce poverty and social vulnerabilities and maintain macro-economic stability and debt sustainability.

In conclusion, I wish to express my Government's appreciation of the frank, professional and productive policy dialogue we have had with the Mission and the African Department in general.

Yours sincerely

/s/

Timothy T. Thahane
MINISTER OF FINANCE AND
DEVELOPMENT PLANNING

cc: Mr. Samuel Itam. Executive Director. Africa Group I Consultancy
Ms. Antoinette Sayeh. Director of the African Department of IMF
Mr. Kamau Thugge. Mission Chief

LESOTHO
Government's Response to the Fund Mission's Concluding Statement for the Article IV Consultation Discussions, November 4-18, 2009

The Government of Lesotho welcomes this opportunity to respond in writing to the Fund mission's Concluding Statement for the 2009 Article IV Consultation Discussions. We agreed with the topics chosen for this year's consultations, namely the need for medium-term fiscal consolidation, external stability, the need for broad-based economic growth to reduce poverty, and the impact of the recent global financial crisis on our banking sector and more broadly the domestic financial sector. Addressing fiscal and external stability issues is critically important given the expected sizeable reduction in Southern African Customs Union (SACU) revenue. This reduction in revenues will affect all the members of the Customs Union, and therefore, a solution involving all members will have to be found.

Our specific comments on the mission's Concluding Statement are presented below.

I. Medium-Term Fiscal Consolidation

Lesotho's strong fiscal performance over the past several years facilitated an accumulation of considerable fiscal savings and international reserves which were intended to be a buffer against unexpected shocks. However, the severity of the recent global crisis was such that larger than previously expected fiscal and external current account deficits are now likely during the 2010/11 and 2011/12 fiscal years. Therefore, the government agrees with the Fund mission on the need to contain overall expenditure, in light of the sharply lower SACU revenues and to move toward a more sustainable level of spending over the medium-term. It will also be critical to maximize collection of non-SACU revenue by improving tax administration and compliance.

While we agree that containing expenditures is critical for macro-economic stability, it will be important to protect spending on: key infrastructure projects needed for sustained economic growth; the vulnerable groups; and other priority social programs. The government remains committed to cutting unproductive spending, redoubling efforts to improve the quality of expenditure, and prioritizing capital spending. In this context, the government has operationalized the Project Appraisal Committee which is responsible for vetting new capital projects before inclusion in the budget using specific criteria related to the government's development objectives.

The Government agrees that the wage bill has risen sharply in recent years, although this occurred in the context of strengthening the quality of policy making and building institutions critical for effective fiscal policy formulation and management. Going forward, we agree on the need to limit the growth of the wage bill through: natural attrition; freezing the number of existing positions; and eliminating posts that have remained vacant for more than 12 months. If there is a need for any new recruitment, it will be assessed in the context of skill requirements in high-priority areas such as health and education.

We also agree that there has been a significant increase in spending on goods and services and this need to be brought under control. In this regard, we are looking at: rationalizing our diplomatic missions; reducing international travel; cuts in local transportation and purchase of office furniture and equipment; and outsourcing of some government functions to the private sector.

Given the large fiscal deficits over the next few years owing to the SACU revenue shock, we intend to use a judicious amount of net domestic financing and to cut spending to help cover the deficit. However, to avoid destabilizing expenditure cuts or an exhaustion of our external reserves which are needed to defend the Loti peg to the Rand, we are also looking to our external development partners, including the IMF, for additional budgetary support.

II. External Stability Issues

We agree with the mission's findings on the need to increase productivity in order to boost competitiveness, and would note ongoing efforts to improve the business climate and upgrade key infrastructure projects in order to attract increased investment. We believe there is significant scope for Lesotho to take advantage of its relatively attractive labor costs and close proximity to the large South African market. The recent investment by Philips to manufacture energy-saving light bulbs for sale to the regional market is an excellent example of the sort of project that Lesotho is well-placed to attract.

We also agree with the mission on the long-term challenges facing the textiles sector. The sector has been hit hard by the global recession, and will undeniably continue to face strong competition in the key U.S. market from cheaper producers in Asia over the medium-term. This will be especially the case if the AGOA provisions expire according to the current timetable. However, we believe that there is considerable potential in the regional market, with local firms increasingly looking toward South Africa as part of their diversification strategy in the aftermath of the decline in demand in the U.S. In fact, one of the major exporters of jeans has made a breakthrough into the South African and SADC markets. We note the mission's recommendation to take a cautious approach toward directly intervening in the sector, but the challenges facing the industry are not straightforward, and have important social implications - the textiles sector remains the largest employer in Lesotho, with well-developed links to the rest of the economy.

III. Medium-Term Broad-Based Growth and Economic Diversification

There is need to foster strong broad-based growth as a prerequisite to reducing poverty levels and vulnerability on a sustained basis in Lesotho. While noting the limited employment opportunities in the mining sector, the government sees scope to further develop sectors such as manufacturing, tourism, commercial agriculture, and to support small and medium-size enterprises (SMEs). Attracting private sector investment will be critical in all instances and this will require the provision of adequate basic infrastructure (water, roads and electricity), and improvements in the business environment as well as sound institutions. In this context, a dedicated task force at the Ministry of Finance and Development Planning is currently taking the lead in improving the business climate by addressing issues such as ease of starting a business, registering property and paying taxes, among other things. Development in tourism will also require focused marketing of the country's natural attractions, development of amenities and training of hoteliers and tour guides. The proposed Land Administration Reforms will facilitate attraction of foreign investors in hotel and sport facilities development.

On SMMEs, the Ministry of Trade and Industry has already launched a survey to collect some basic information for the preparation of a policy paper which should cover issues of access to finance, basic infrastructure needs, investment climate and the role of the Lesotho National Development Corporation (LNDC). The World Bank and IFC have been asked to assist with the role and effectiveness of the LNDC. The development of commercial agriculture will require increases in financial and human capital, in addition to adequate regional market integration, while taking into account issues of land degradation and the environment.

A number of ongoing structural reforms should further support broad-based growth in the country. With the support of the Millennium Challenge Corporation, Chinese Government and the Arab Funds, the Government is developing basic infrastructure—such as rehabilitation of old water systems in all ten districts, the construction of the Metolong Dam, updating of telecommunications equipments, rural water supply systems and clinics across the country—and pursuing key reforms in the following areas: Civil legal reforms to provide faster, fairer and less expensive resolution of commercial disputes, Land Reform to facilitate use of land as an economic asset that can be used to improve access to financial services; introduction of a national identification card; establishment of a credit bureau; and reforming the Postbank to enhance access to financial services in the rural areas. We are also pursuing a gender equality and economic rights program in consultation with the World Bank.

IV. Financial Sector Stability and Development

We agree with the mission's assessment that the banking system was relatively unaffected by the global financial crisis and that the banks are adequately capitalized, profitable, and liquid. In the near-term, our goal is to strengthen the framework for prudential regulation of savings and credit cooperatives, and other non-bank financial intermediaries, including pension funds. We also concur with the mission's assessment that there is significant scope for deepening the market for government securities, which should provide an alternative source of funding our infrastructure requirements.

On the Ponzi Scheme (MKM), the government is pursuing the various legal procedures to resolve the issue. The complexities involved are vast including the fact that very many poor

Basotho were involved and for a long period of time before Government intervened to close the scheme. Given that there was a legitimate funeral service business provided by MKM, which had a large membership and included social groups with limited means, it may be necessary to address some of the concerns of this group taking onto account our limited resources. However, Government will not bail out the investors in the various illegal Ponzi schemes.

V. IMPROVING THE QUALITY OF ECONOMIC STATISTICS

We welcome the mission's acknowledgment of the government's efforts to improve the quality of macroeconomic statistics. We believe that good and timely data are critical for evidence-based policy design and execution. Timely production of statistics should also foster better accountability by policymakers, particularly in the case of the government's financial accounts which, historically, had been produced with unduly long lags and weak adherence to best international accounting and budgeting practices.