FOR
AGENDA

SM/86/289

CONTAINS CONFIDENTIAL
INFORMATION

December 1, 1986

To: Members of the Executive Board

From: The Secretary

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

Attached for consideration by the Executive Directors is the the staff report for the 1986 Article IV consultation with Lesotho. A draft decision appears on page 28.

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

Mr. Callender (ext. 8750) or Mr. Kinyua (ext. 8753) is available to answer technical or factual questions relating to this paper prior to the Board discussion.

Att: (1)

Other Distribution:
Department Heads

CONTAINS CONFIDENTIAL INFORMATION

INTERNATIONAL MONETARY FUND

LESOTHO

Staff Report for the 1986 Article IV Consultation

Prepared by the Staff Representatives for the
1986 Consultation with Lesotho

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

November 26, 1986

I. Introduction

The 1986 Article IV consultation discussions with Lesotho were held in Maseru during the period August 19-September 1, 1986. The representatives for Lesotho included the Minister of Finance, Honorable E.R. Sekhonyana; the Minister of Planning and Economic Affairs, Honorable N.M. Sefali; the Principal Secretaries in the Ministries of Finance and Planning, Mr. E. Waddington and Mr. K. Manyeli, respectively; the Governor of the Central Bank of Lesotho, Mr. E. Karlsson; and other senior officials of ministries and institutions concerned with economic and financial policies. The staff representatives were Mr. C.V. Callender (Head-AFR), Mr. M.W. Bell, Mr. H. Futamura, Mr. J.K. Kinyua (all AFR), Mr. N. Rossi (FAD), and Miss M.L. Nepomuceno (Secretary-AFR).

During the discussions, and subsequently during the Annual Meetings, the authorities expressed interest in the possible use of Fund resources under the structural adjustment facility (SAF). In this context, the elements of a quantitative medium-term policy framework were discussed with the authorities. A World Bank economic mission which was in Lesotho at the same time as the Fund mission also participated in some of these discussions. The staff will continue to assist the authorities in preparing the policy framework paper (PFP), taking account of the views expressed by the Executive Board during the Article IV consultation discussions. It is envisaged that discussions on the PFP and the first annual arrangement will take place early in 1987.

The last Article IV consultation with Lesotho was concluded on November 20, 1985. During the discussions, Executive Directors expressed satisfaction with the overall performance of the Lesotho economy over the last several years, particularly the economic and financial policies pursued by the Lesotho authorities. They noted that because of these policies, Lesotho's internal and external financial situation had improved significantly. However, the Directors expressed serious concern about the likely adverse consequences of emerging fiscal policies since the latter part of 1984. In addition, they noted that the external payments position of Lesotho depended importantly on receipts from the Southern African Customs Union (SACU) and observed that the medium-term balance of payments outlook was fragile and vulnerable. In order to improve the budgetary position and the balance of payments outturn, they suggested that the authorities take corrective fiscal and financial policies.

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 appear as Appendices I and II, respectively, and outstanding statistical issues are reviewed in Appendix III. Appendix IV contains basic data on Lesotho. Lesotho has not used the Fund's general resources previously, but did receive loans under the Trust Fund.

II. Background

The Kingdom of Lesotho is small, landlocked, and mountainous, and its economy is sparsely endowed with natural resources. Apart from diamonds, of which large-scale extraction is not viable at current world prices, the only known major natural resource is upstream water, which is yet to be exploited. Subsistence agriculture and animal husbandry contribute at least partially to the incomes of about two thirds of the population, but the potential for development in this area is constrained by the availability of arable land (about 13 percent of the total) and the extensive soil erosion that has occurred in recent years.

Lesotho is completely encircled by the Republic of South Africa (RSA), with which it has close economic and financial links, including membership in the Common Monetary Area (CMA, formerly the Rand Monetary Area) and the Southern African Customs Union. 1/ Some two thirds of government revenue comes from SACU, consisting mainly of customs and excise duties collected on behalf of Lesotho by the RSA. The loti (plural maloti) is pegged at par to the South African rand, with which it is fully convertible; both currencies are legal tender in Lesotho. More than half of Lesotho's male labor force is employed in the RSA, mainly in gold and coal mines, and their remittances exceed Lesotho's gross domestic product.

During the 1970s, Lesotho's real GDP grew at an annual rate of over 7 percent, and GNP grew slightly faster at about 8 percent, a major contributory factor being the increase in gross fixed investment relative to GNP from 11 percent in 1975/76 to about 19 percent in 1979/80. This growth was sustained by the expansion of workers' remittances, expansion of diamond mining in the late 1970s, a large volume of external assistance, and growing revenues from SACU. Thus, the economy became increasingly dependent on these external sources of funds,

1/ Swaziland is also a member of both institutions, while Botswana belongs only to SACU.

thereby increasing its vulnerability to exogenous shocks. Nevertheless, until the early 1980s, Lesotho was able to avoid major fiscal or external financial imbalances, although its foreign reserves by 1980 were equivalent to little more than one month's imports. Domestic inflation ran at about 12-15 percent during the 1970s and reflected very closely developments in the RSA, the source of almost all its imports. Despite its impressive growth record, Lesotho was unable to create sufficient domestic employment opportunities to absorb the expanding labor force, an effect exacerbated by the contracting demand within the RSA for migrant labor, after a peak in the mid-1970s.

Since 1980/81 economic performance has been mixed. Having grown by about 5 percent in 1980/81, real GDP contracted at an average rate of 3.6 percent during 1981/82-1983/84, before recording modest growth in 1984/85 (Table 1 and Chart 1). This contraction largely reflected the onset of drought conditions, and the closure of the principal diamond mine when extraction became unprofitable at prevailing market prices. However, the extremely rapid increase in migrant remittances--made possible by rising real wage rates in the RSA, and administrative efforts to increase the proportion of migrant earnings that were remitted--sustained GNP growth at an average of 4 percent during 1981/82-1983/84. Much of the increased national income was devoted to consumption, and gross fixed capital formation fell from 18.6 percent of GNP in 1980/81 to 15.6 percent in 1984/85. Nevertheless, the proportion of national domestic investment financed by national saving rose from 12 percent in 1980/81 to 37 percent in 1984/85. Domestic inflation was about 13.5 percent on average through 1984/85, and continued to reflect price movements in the RSA.

Lesotho's fiscal performance improved in the first half of the 1980s (Table 2). The overall deficit (including grants) reached a peak of 9.3 percent of GNP (16.9 percent of GDP) in 1981/82, but declined thereafter, falling to 1.9 percent of GNP (4.0 percent of GDP) by 1984/85. This was achieved partly through expenditure restraint during 1982/83 and 1983/84, mainly by reducing capital expenditure in real terms and by permitting an erosion of real wages in the public sector. At the same time, there was strong revenue growth as SACU receipts expanded sharply. By 1984/85, there were signs of a resurgence of expenditure growth, caused in particular by the initial effects of a large salary adjustment effected on January 1, 1985, and by a sharp increase in capital expenditure associated with a new airport and road construction. However, the budgetary impact of this development was more than offset by a large increase in SACU receipts and external grants. With the reduction in the overall deficit, and substantial net foreign financing, the Government repaid the banking system during 1983/84-1984/85. This contributed to a sharp deceleration in domestic credit expansion, which slowed from 38.7 percent of the opening stock of broad money in 1981/82 to a contraction of 2.4 percent in 1984/85 (Table 3). Nevertheless, broad money continued to expand at a rate somewhat faster than nominal GDP, a reflection of favorable developments in the overall balance of payments.

Table 1. Lesotho: Selected Economic and Financial Indicators, 1981/82-1986/87 1/

	1981/82	1982/83	1983/84	1984/85	1985/86	1986/87 Est. 2/
	(Annual percentage changes; unless otherwise specified)					
National income and prices						
GDP at constant prices	-3.6	-5.6	-1.7	1.7	-0.4	1.5
GNP at constant prices	5.0	5.1	1.2	1.2	-4.6	-0.2
GNP deflator	12.4	15.2	11.9	12.7	17.0	18.0
Consumer prices 3/	12.5	15.1	12.3	11.8	18.9	18.0
External sector (on the basis of SDRs)						
Exports, f.o.b.	-18.7	-23.2	-3.5	-12.7	-16.8	3.7
Imports, f.o.b.	7.5	1.5	16.1	-16.6	-22.8	5.9
Migrant labor remittances	18.9	17.9	20.3	-17.6	-24.5	1.9
Nominal effective exchange rate (- depreciation)	-0.6	--	-0.1	-1.5	-1.4	...
Real effective exchange rate (- depreciation)	-4.7	2.9	0.8	-2.6	0.4	...
Government finances						
Revenue (excluding grants)	6.5	21.3	26.0	27.9	11.8	-0.7
Of which: SACU	(-0.8)	(8.3)	(43.3)	(37.9)	(6.3)	(-10.4)
Revenue (including grants)	-0.6	15.5	24.2	30.9	7.9	32.2
Total expenditure 4/	10.7	0.7	10.9	23.6	29.0	29.1
Money and credit						
Domestic credit	76.0	11.0	2.8	-4.3	41.2	35.0
Government	147.0	19.3	-12.8	-29.4	65.9	47.0
Private	29.2	0.6	26.2	21.8	26.6	25.7
Money and quasi-money (M^2)	27.4	26.1	12.4	18.2	21.4	26.3
Velocity (GNP relative to M^2)	4.3	4.0	3.8	3.9	3.7	3.2
Interest rates (end of fiscal year)						
Rediscount rate	12.0	12.0	15.0	21.0	10.0	...
Prime lending rate	15.0	14.0	16.0	22.0	14.0	...
Savings deposit rate 5/	5.0	4.0	8.0	12.0	7.0	...
	(In percent of GDP; unless otherwise stated)					
Central Government						
Overall surplus or deficit (-)	-16.9	-10.8	-6.2	-4.0	-13.3	-13.1
Domestic bank financing	10.7	3.2	-2.3	-4.0	5.3	...
Foreign financing	5.4	6.6	6.8	4.2	5.3	...
External current account surplus or deficit (-)	-12.2	-10.5	--	7.8	2.6	-6.1
External debt	33.1	38.8	42.9	59.2	67.2	71.4
Debt service ratio (in percent of exports of goods and services)	2.8	6.2	5.2	6.2	5.7	3.8
	(In percent of GNP)					
Central Government						
Overall surplus or deficit (-)	-9.3	-5.3	-3.0	-1.9	-6.7	-6.7
Domestic bank financing	5.8	1.6	-1.1	-1.9	2.7	...
Foreign financing	3.0	3.3	3.3	2.0	2.7	2.5
External current account surplus or deficit (-)	-6.7	-5.2	--	3.8	1.3	-3.1
External debt	18.1	19.1	20.5	28.4	33.7	36.4
	(In millions of SDRs)					
Overall balance of payments surplus or deficit (-)	-36.3	12.7	25.2	0.7	8.5	0.2
Gross official reserves (in weeks of imports, f.o.b.)	4.8	5.7	7.1	8.0	10.7	10.8
Net foreign assets of banking system	36.3	74.1	96.1	105.4	90.5	89.1

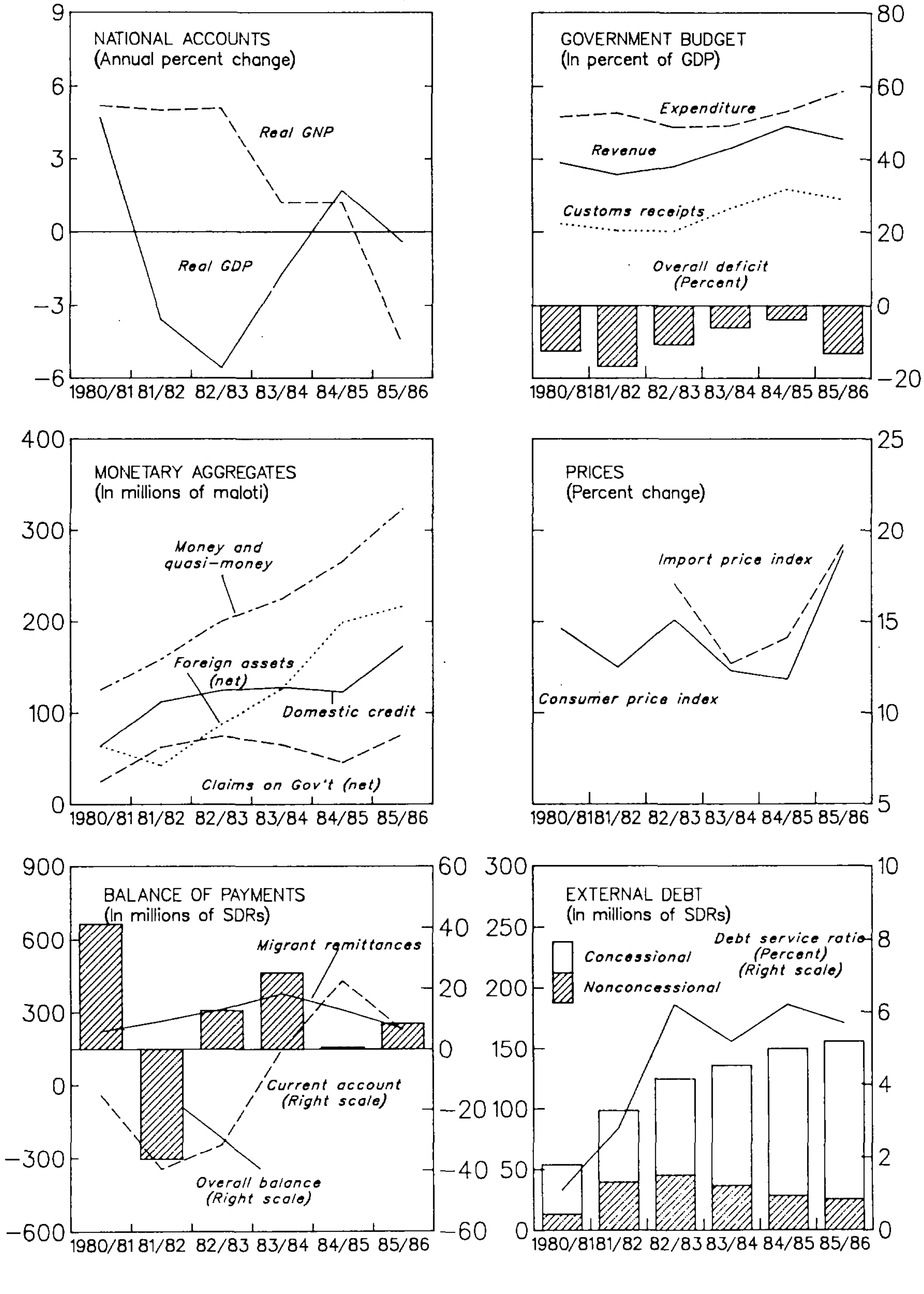
Sources: Data provided by the Lesotho authorities; and staff estimates.

1/ Fiscal years, April-March.
2/ With the exception of government finances which are 1986/87 budget estimates, the other estimates are staff estimates based on the assumption of a continuation of existing policies.
3/ Average of changes in low-income and upper-income indices.
4/ Includes net lending.
5/ Minimum rate.

CHART 1

LESOTHO

SELECTED ECONOMIC AND FINANCIAL INDICATORS, 1980/81 — 1985/86



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

Table 2. Lesotho: Summary of Government Operations, 1981/82-1986/87

	1981/82	1982/83	1983/84	1984/85	1985/86		1986/87	
					Budget	Prel. outturn	Budget	Staff estimates
				(In millions of maloti)				
Revenue and grants	124.8	144.2	179.1	234.4	297.2	253.0	334.6	262.4
Revenue	111.1	134.8	169.9	217.3	239.1	243.0	241.2	239.4
Customs	70.8	76.7	109.9	151.5	161.1	161.1	144.3	144.3
Other revenue	40.3	58.1	60.0	65.8	78.0	81.9	96.9	95.1
Grants	13.7	9.4	9.2	17.1	58.1	10.0	93.4	23.0
Expenditure and net lending	183.7	185.0	205.1	253.4	371.0	326.9	422.1	379.1
Current expenditure	117.1	121.9	141.5	161.4	206.5	224.0	224.2	251.6
Salaries	60.5	63.5	66.4	77.8	109.2	108.5	117.9	117.9
Interest	8.0	16.1	19.6	17.5	26.0	20.8	35.7	35.7
Other	48.6	42.3	55.5	66.1	71.3	94.7	70.6	98.0
Capital expenditure and net lending	66.6	63.1	63.6	92.0	164.5	102.9	197.9	127.5
Surplus/Deficit (-)	-58.9	-40.8	-26.0	-19.0	-73.8	-73.9	-87.5	-116.7
Financing	58.9	40.8	26.0	19.0	73.8	73.9	87.5	116.7
Foreign	18.8	25.1	28.5	20.0	...	29.6	32.8	50.1
Borrowing	20.9	39.0	36.1	37.4	...	57.9	50.4	70.8
Amortization	2.1	13.9	7.6	17.4	...	28.3	17.6	20.7
Domestic	40.1	15.7	-2.5	-1.0	...	44.3	54.7	66.6
Bank	37.1	12.0	-9.6	-19.1	...	30.0	...	...
Other	3.0	3.7	7.1	18.1	...	14.3	...	...
Memorandum items:				(In percent of GDP)				
Revenue and grants	35.8	38.0	43.0	49.1	53.4	45.5	50.2	39.4
Expenditure and net lending	52.7	48.8	49.2	53.1	66.7	58.7	63.3	56.9
Surplus/Deficit (-)	-16.9	-10.8	-6.2	-4.0	-13.3	-13.3	-13.1	-17.5
				(In percent of GNP)				
Surplus/Deficit (-)	-9.3	-5.3	-3.0	-1.9	-6.6	-6.7	-6.7	-8.9
				(Annual percentage change)				
Revenue and grants	-0.6	15.5	24.2	30.9	26.8	7.9	32.3	3.7
Of which: SACU	(-0.8)	(8.3)	(43.3)	(37.9)	(6.3)	(6.3)	(-10.4)	(-10.4)
Other	(22.5)	(44.2)	(3.3)	(9.7)	(18.5)	(24.5)	(18.3)	(16.1)
Expenditure and net lending	10.7	0.7	10.9	23.5	46.4	29.0	29.1	16.0
Current expenditure	12.8	4.1	16.1	14.1	27.9	38.8	0.1	12.3
Of which: salaries	(10.2)	(5.0)	(4.6)	(17.2)	(40.4)	(39.5)	(8.7)	(8.7)
Capital expenditure	7.1	-5.3	0.8	44.7	78.8	11.8	92.3	23.9

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

Table 3. Lesotho: Monetary Survey, 1981-86

	1981	1982	1983	1984	1985	1986	
			March			March	June
	(In millions of maloti)						
Foreign assets (net)	63.4	42.5	87.5	126.3	199.1	216.9	211.2
Central Bank	47.0	13.6	28.7	65.1	94.7	140.7	146.9
Commercial banks	13.9	27.1	57.2	59.3	102.5	73.0	60.9
Rand with banks	2.5	1.8	1.7	1.9	1.9	3.2	3.5
Domestic credit	63.6	111.9	124.2	127.7	122.3	172.7	192.2
Claims on Government (net)	25.2	62.3	74.3	64.8	45.6	75.7	91.4
Central Bank	0.7	25.0	24.3	6.4	1.7	7.7	18.2
Commercial banks	24.5	37.3	50.1	58.4	43.9	68.0	73.2
Claims on the rest of the economy	38.4	49.6	49.9	62.9	76.6	97.0	100.8
Private sector	28.4	39.5	38.6	49.1	64.7	85.6	89.3
Statutory bodies	10.0	10.1	11.3	13.8	11.9	11.4	11.4
Money and quasi-money	124.8	159.0	200.5	225.4	266.5	323.5	324.1
Money	50.8	65.2	83.0	88.5	106.5	135.8	131.9
Maloti with public	6.6	11.1	18.9	23.2	24.9	28.9	27.3
Demand and call deposits	44.2	54.1	64.1	65.3	81.6	106.9	104.6
Of which: MDPF 1/	(4.0)	(4.0)	(5.4)	(5.9)	(6.5)	(7.0)	(7.2)
Quasi-money	74.0	93.8	117.5	137.0	160.0	187.7	192.3
Time deposits	37.5	48.1	64.5	70.0	78.8	88.2	90.2
Of which: MDPF 1/	(22.8)	(36.3)	(48.5)	(53.1)	(58.4)	(63.4)	(64.6)
Savings deposits	36.5	45.7	53.0	67.0	81.3	99.5	102.0
Other items (net)	2.2	-4.6	11.2	28.6	54.9	66.0	79.3
Memorandum items:	(Annual percentage change)						
Broad money	...	27.4	26.1	12.4	18.2	21.4	...
Total domestic credit	...	76.0	11.0	2.8	-4.3	41.2	...
Government credit	...	147.0	19.3	-12.8	-29.6	65.9	...
Credit to private sector and statutory bodies	...	29.2	0.6	26.2	21.8	26.6	...
	(Change as a percentage of opening broad money)						
Net foreign assets	...	-16.8	28.3	19.4	32.3	6.6	...
Total domestic credit	...	38.7	7.8	1.8	-2.4	18.9	...
Net credit to Government	...	29.7	7.6	-4.8	-8.5	11.3	...

Source: Data provided by the Lesotho authorities.

1/ Miners' Deferred Pay Fund.

After 1981/82 when there was a large overall deficit, the balance of payments recorded overall surpluses of varying magnitudes (Table 4). 1/ Exports declined in 1982 when the diamond mine was closed, and imports continued to rise through 1983/84 reflecting the need for food imports caused by drought, and rising demand for other consumption goods. However, these trends were more than offset by the sharp rise in migrants' remittances which occurred in the early 1980s. The current account improved from a deficit of 6.7 percent of GNP (12.2 percent of GDP) in 1981/82 to a surplus of 3.8 percent of GNP (7.8 percent of GDP) in 1984/85. Substantial external borrowing was undertaken during this period, including some on commercial terms, causing an increase in the debt service ratio from 2.8 percent (of exports of goods and services) in 1981/82 to 6.2 percent in 1984/85.

III. Developments during 1985/86

1. Economic and financial developments

In many respects, some of the gain in economic and financial stability achieved through 1984/85 was reversed in 1985/86. Real GDP declined marginally in 1985/86, mainly as a result of a fall in the output of the agricultural sector, particularly in crop production. Real GNP fell sharply--nearly 5 percent--reflecting a slowdown in the nominal growth of migrant remittances, even though the number of miners employed in the RSA rose during the year, and the increase in their wage rates matched the rate of inflation. Although gross investment rose slightly relative to GNP, the ratio of national saving to investment fell moderately. Inflation accelerated from about 12 percent in 1984/85 to 19 percent in 1985/86, following price developments in the RSA.

The Government's financial position deteriorated sharply as the overall deficit widened from 4.0 percent of GDP in 1984/85 to 13.3 percent in 1985/86 (from 1.9 percent to 6.7 percent of GNP). Total revenue and grants increased by 8 percent compared with a budgeted increase of 27 percent. The shortfall was caused by considerably lower-than-budgeted grants. Revenue increased by 12 percent compared with an increase of 25 percent in the previous year, due mainly to a marked slowdown in SACU receipts. Total expenditure and net lending increased by 29 percent, substantially below the 46 percent envisaged in the budget. The shortfall is attributable entirely to a decline in the growth of project-related capital expenditure associated with lower-than-budgeted grant receipts. Recurrent expenditure increased by 39 percent over the outturn for the previous year, reflecting a 40 percent rise in civil service salaries, higher debt service payments (caused largely by the depreciation of the loti), and large extrabudgetary expenditure on transportation and foreign travel. Gross disbursements from foreign

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1/ The overall balance is defined on the basis of the change in net official reserves.

Table 4. Lesotho: Balance of Payments, 1981/82-1986/87 1/

(In millions of SDRs)

	1981/82	1982/83	1983/84	1984/85	1985/86	1986/87
Current account	-39.6	-31.6	0.1	22.5	6.1	-15.5
Goods and services	-101.7	-72.1	-75.4	-63.0	-52.3	-58.9
Exports, f.o.b.	40.5	31.1	30.0	26.2	21.8	22.6
Imports, f.o.b.	-390.6	-396.4	-460.3	-383.9	-296.3	-313.7
Shipment charges	-16.2	-16.2	-18.8	-15.7	-12.2	-11.4
Other transport (net)	-2.3	-2.6	-3.8	-3.2	-2.7	-3.0
Travel (net)	4.2	2.6	3.8	2.8	2.2	2.2
Other official (net)	-8.5	-6.6	-7.2	-5.3	-4.4	-4.7
Other private (net)	6.3	4.7	5.6	4.4	3.5	4.1
Workers' remittances	265.6	313.2	376.8	310.3	234.4	238.8
Investment income (net)	-0.7	-1.9	-1.5	1.3	1.5	6.2
Unrequited transfers	62.1	40.4	75.5	85.6	58.4	43.4
Official	60.2	38.4	73.3	83.8	57.4	42.3
Of which: SACU compensation	(23.0)	(8.8)	(33.0)	(44.9)	(28.7)	(16.8)
Private (net)	1.8	2.0	2.2	1.7	1.0	1.1
Long-term capital	29.3	23.4	19.9	15.8	15.4	25.7
Official (debt)	26.0	20.5	16.1	12.0	12.6	22.7
Disbursements	29.3	24.9	22.9	22.5	24.7	29.5
Payments	-3.3	-4.4	-6.8	-10.5	-12.1	-6.8
Private	3.9	3.5	4.5	4.2	3.1	3.3
Other official 2/	-0.7	-0.6	-0.7	-0.5	-0.3	-0.3
Short-term capital	-7.9	-10.5	-8.1	-2.8	-3.4	5.0
SDR allocations	0.5	--	--	--	--	--
Errors and omissions	-18.6	31.3	13.3	-34.8	-9.6	-15.0
Overall surplus/deficit	-36.3	12.7	25.2	0.7	8.5	0.2
Financing:	36.3	-12.7	-25.2	-0.7	-8.5	-0.2
Change in net official reserves	36.3	-12.7	-25.2	-0.7	-8.5	-0.2
Memorandum items:						
Change in banking system net foreign assets	-18.4	27.6	23.3	9.9	-15.3	-0.1
Gross official reserves						
In SDRs	33.1	46.4	58.0	51.7	59.6	59.7
In weeks of imports	4.8	5.7	7.1	8.0	10.7	10.8
Current account deficit as percent of: GDP	-12.2	-10.5	--	7.8	2.6	-6.1
GNP	-6.7	-5.2	--	3.8	1.3	-3.1
Debt and debt service ratios						
As percentages of exports of goods and nonfactor services:						
Debt service	13.1	41.3	40.1	46.5	38.8	24.8
Interest	10.4	11.1	8.9	17.7	9.1	8.5
As percentages of exports of goods and services:						
Debt service	2.8	6.2	5.2	6.2	5.7	3.8
Interest	2.2	1.7	1.2	2.4	1.3	1.3
Debt outstanding as percentage of: GDP	33.1	38.8	42.9	59.2	67.2	71.4
GNP	18.1	19.1	20.5	28.4	33.7	36.4

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

1/ Fiscal years, April-March.
2/ Subscriptions to international institutions by the Government of Lesotho.

loans increased by nearly 55 percent, but net inflows did not rise commensurately because of a sharp rise in the amortization of commercial loans contracted in previous years, and the Government relied heavily on domestic financing, primarily recourse to bank credit; net credit to the Government increased by 66 percent (or by about 11 percent of opening broad money stock). Budgetary transfers to the public enterprises accounted for 2-3 percent of total expenditure in 1985/86. Part of this was to finance investment, but part was to cover operating costs. It appears that the profitability of the utility companies (in particular electricity) may have been reduced by an insufficiently flexible tariff policy. The largest corporation, the Lesotho National Development Corporation (LNDC), became profitable in 1984/85 and 1985/86, but continues to draw on government support for its investment.

The dominant feature in monetary and credit developments was the financing of the budgetary deficit by recourse to bank credit as described above. Total domestic credit expanded by 41 percent, having contracted by 4 percent in 1984/85, while broad money increased by 21 percent, compared with an increase of 18 percent in 1984/85. Net foreign assets of the banking system rose by 9 percent to M 217 million, but there was a substantial change in composition with the commercial banks' holdings falling by about M 30 million, and the Central Bank's holdings rising by M 46 million. This resulted from a decision by the authorities to enforce the minimum local assets ratio. 1/ Given the continued inflows from miners' remittances and the limited opportunities for domestic investment, the domestic banking system remained highly liquid, and the commercial banks continued to increase their deposits with the Central Bank. The existence of excess liquidity, together with downward movements in South African interest rates, encouraged the authorities to reduce the general level of interest rates, while at the same time narrowing the spread between lending and deposit rates. Consequently, deposit rates were reduced by about 5 percentage points, and lending rates by about 6 percentage points during 1985/86. As in the RSA, the continuation of a rate of inflation of about 19 percent meant that deposit interest rates became substantially negative in real terms.

In 1985/86 the overall balance of payments recorded a surplus of SDR 8.5 million compared with a surplus of SDR 0.7 million in 1984/85. However, the current account weakened considerably, from a surplus of 3.8 percent of GNP in 1984/85 to a surplus of 1.3 percent in 1985/86 (from 7.8 percent of GDP to 2.6 percent), largely because imports did not contract (in foreign currency terms) as sharply as the combined total of migrants' remittances and compensation payments from the

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1/ Financial institutions are required to maintain local assets equivalent to at least 85 percent of their liabilities to the public plus paid-up capital and reserves.

Customs Union. 1/ Net long-term capital inflows remained virtually unchanged from the previous year. Lesotho's external public debt rose by about SDR 6 million to SDR 156 million or 34 percent of GNP (67 percent of GDP). However, debt service fell slightly to 6 percent of exports of goods and services (39 percent of goods and nonfactor services), reflecting the completion of repayment of certain short-term commercial loans contracted in the early 1980s for budgetary support. Lesotho's external public debt has risen rapidly during the 1980s, from 9.8 percent of GNP in 1980/81 to 33.7 percent in 1985/86, but in recent years most new borrowing has been concessional, so that the proportion of outstanding debt that is on concessional terms has increased from about 60 percent in 1981/82 to 84 percent in 1985/86.

In the year through March 1986 the loti appreciated by 0.4 percent in real effective terms, but depreciated by 1.4 percent in nominal terms. The relative stability of the real effective rate observed during the 1980s reflects the dominance of the RSA in its external trade, the peg to the rand, and the similarity of the inflation rate in the two countries. During 1985/86 the loti depreciated by 19 percent against the SDR, and by 5 percent against the U.S. dollar (Chart 2).

In September 1985, Lesotho introduced a dual exchange system following the re-introduction of the "financial rand" mechanism by South Africa. Under the "financial rand" mechanism, local sales proceeds of common monetary area securities and other investments owned by nonresidents cannot be transferred in local currency, but must be retained in "financial rand" balances. Such balances are transferable among nonresidents at a freely-determined exchange rate.

2. Changes in the monetary arrangement

The Rand Monetary Agreement, which came into effect on December 5, 1974, represented the formalization of the *de facto* monetary union that existed among Lesotho, South Africa, and Swaziland long before these states became independent. The Agreement provided for circulation of only a single currency, the South African rand, throughout the Rand Monetary Area (RMA), but it also allowed the other two members to issue their own national currencies for circulation parallel with the rand within their own territories subject to prior agreement with South Africa. In accordance with this provision, Lesotho signed an agreement with the Government of South Africa on January 12, 1979 and issued its national currency, the loti, in

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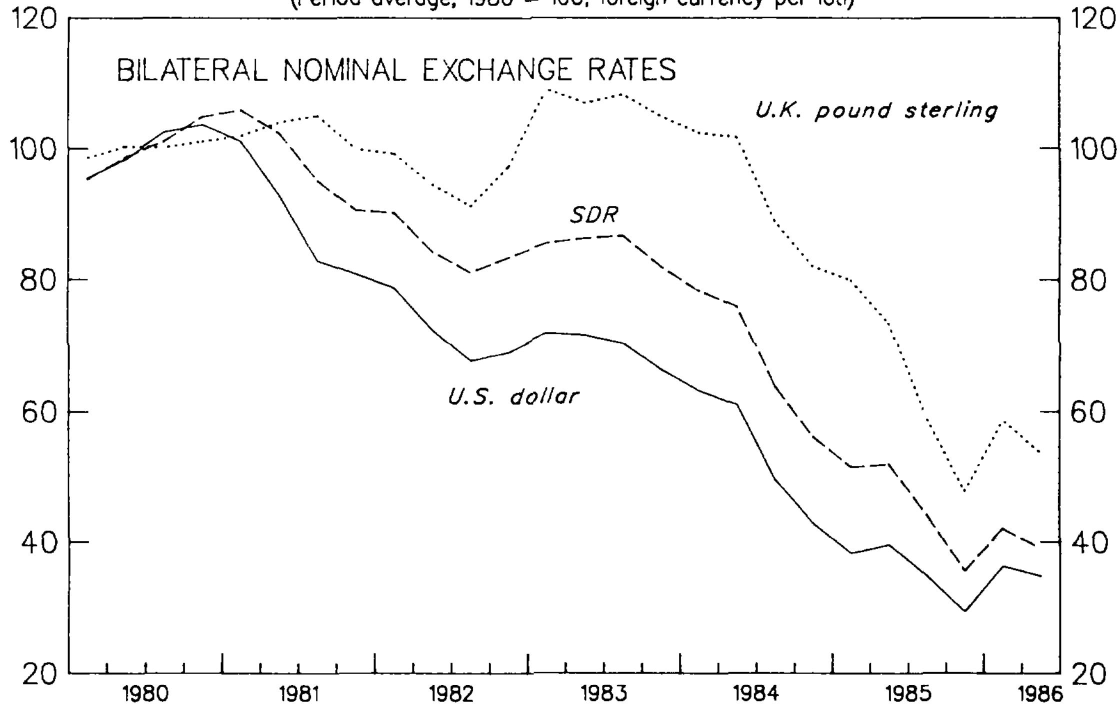
1/ Since the loti depreciated sharply against the SDR, but most of Lesotho's international transactions are conducted with the RSA, most components of the balance of payments contracted in SDR terms. Expressed in domestic currency, imports rose by 9 percent and migrants' remittances by 7 percent while SACU compensation payments fell by 10 percent. Since domestic and import prices were rising by over 15 percent, there was an implicit sharp contraction in import volume.

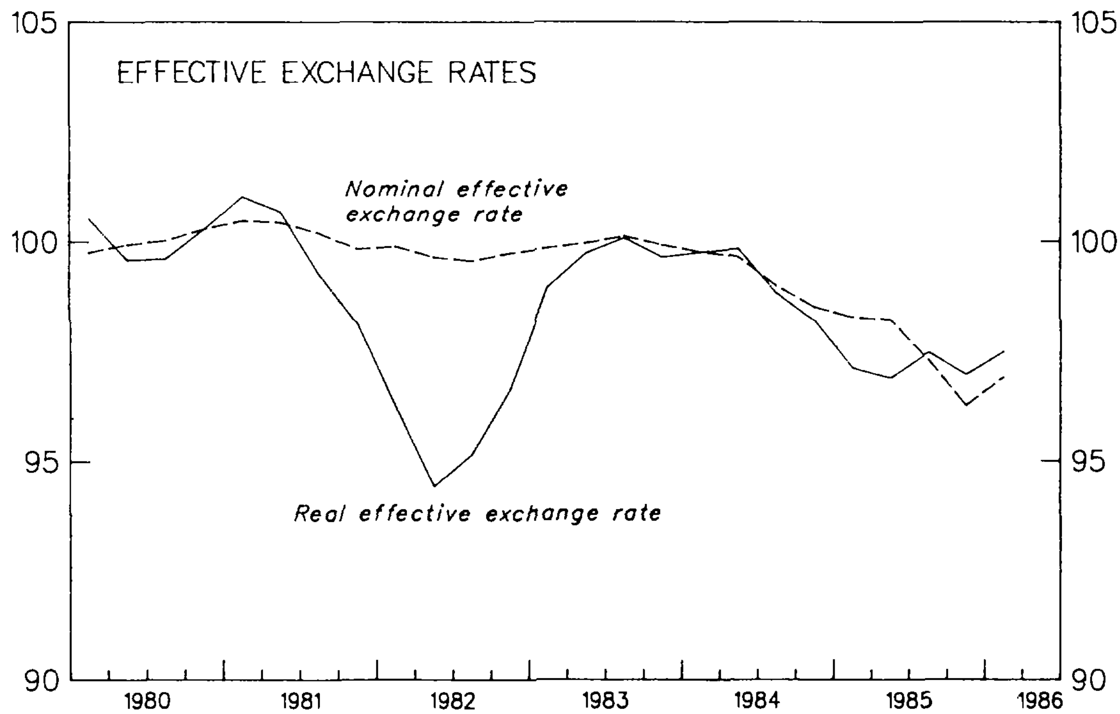
CHART 2

LESOTHO

EXCHANGE RATE DEVELOPMENTS, Q1 1980 – Q2 1986

(Period average, 1980 = 100; foreign currency per loti)[1]





Sources: IMF, *International Financial Statistics;* and staff estimates.

[1] The loti is pegged to the South African rand at par.

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 rates 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 affect on Lesotho's balance of payments and growth, the staff representatives emphasized that the authorities should intensify their efforts to restrain expenditure, particularly recurrent expenditure. The Lesotho representatives replied that they were concerned with the growing budget deficit and had increased the sales tax rate from 9 percent to 12 percent for all transactions except liquor for which there was a rate of 25 percent. However, the yield from the increase in sales tax would be more than offset by the sharp contraction in customs (SACU) receipts, which was estimated to decline by 11 percent in 1986/87. They also acknowledged that the budget for 1986/87 may have been unduly ambitious and that certain categories of expenditure (particularly on other goods and services) were likely to be exceeded, possibly by a substantial amount. However, they had set in train certain measures to reduce the number of casual employees and expenditure on foreign travel which would begin to have an impact in the latter part of 1986/87.

Commenting on prospective monetary and credit developments in 1986/87, the Lesotho authorities said that the existence of excess liquidity in the banking system was likely to persist and that it was an indication that demand for credit from the nongovernment sector was low at current lending rates. They said that they were concerned at the sluggish growth of credit to the private sector and, therefore, wished to ensure that lending rates were not a constraint to agricultural and industrial development. However, they recognized the paradox of using interest rates to attract savings in a situation of surplus liquidity on the one hand and to stimulate investment on the other. They would continue to monitor interest rate developments in the RSA and adjust rates in Lesotho to ensure that deposit rates remained competitive so as to provide adequate incentives for migrant workers to hold their savings in Lesotho. At the same time, they intended to continue to reduce the spread between lending and deposit rates, which are higher in Lesotho than in South Africa, because of higher administrative costs and limited competition.

The overall balance of payments surplus recorded in 1985/86 is forecast to be eliminated in 1986/87. The external current account is forecast to shift from a significant surplus in 1985/86 (equivalent to 1.3 percent of GNP) to a deficit of SDR 15.5 million (equivalent to 3.1 percent of GNP) in 1986/87. Imports are forecast to rise by 6 percent in nominal terms, while exports are expected to grow by less than 4 percent.

Migrant remittances are forecast to rise by less than 2 percent, representing a decline in real terms, because of apparent leakages from the established system of deferred pay and remittances. The capital account is expected to benefit from a decline in debt amortization reflecting the gradual increase in the concessional component of debt, but this will be inadequate to prevent a deterioration in the overall balance of payments. The authorities reaffirmed their intention to adhere to the provisions of the CMA under which the loti would remain pegged to the rand at par. They also emphasized that Lesotho would continue to operate a system free of restrictions on current international transactions.

2. Medium-term prospects

Lesotho's medium-term prospects were considered in the context of certain structural characteristics which need to be modified in order to strengthen the economy and achieve a viable balance of payments in the medium term. The main structural weaknesses included the absence of a diversified domestic productive base; the heavy dependence of the economy on migrant workers' remittances; and the volatility of customs union receipts, which tend to determine the pattern of the central government budgetary position.

The staff representatives had hoped to be able to use the Fourth Five-Year Development Plan (1986/87-1990/91) as the basis for discussions for a SAF. Although the draft document, which is expected to be published by the end of December, was not available for the discussions, the authorities outlined the targets of the plan and some of the policy measures that were being considered.

In discussing the medium-term prospects with the authorities, the staff representatives presented two scenarios covering the five-year period through 1991/92: one based on the continuation of present policies, and the other reflecting the introduction of economic and financial measures. 1/ The discussions focused on policies relating to production, employment, earnings, and prices, on financial policies, and on the external sector.

a. Production policies and prospects

The staff representatives suggested that, to stimulate production in the future, a number of measures needed to be taken to diminish existing constraints to production, including the following: a more effective system of land allocation; the expansion of extension services; greater use of irrigation facilities; the introduction of new high value crops; improvements in marketing and distribution; and, in view of the extensive cattle overstocking, a reduction in the national herd and improvement in quality. The Lesotho representatives replied that the Land Act of 1979, which provided the basis for reforming the allocation of land, had only been implemented in the urban areas, but that revisions to cover the rural areas were now under way. The objective is to consolidate fragmented land holdings into economically viable units, while protecting the rights of the current holder. Thus, the land tenure reform is proposed to enhance efficient utilization of land by allowing traditional holders to lease land to other individuals if they cannot use it productively. Outright sale would not be permitted; ownership would remain, nominally, in the hands of the King as trustee. Concerning crop diversification, the authorities intend to concentrate on crops with a high unit value, principally horticultural crops; some success has already been achieved with asparagus production

1/ These scenarios are discussed in Section IV.2.e. below.

and canning for export (mainly to the RSA and the Federal Republic of Germany). The authorities felt that the rehabilitation of the land, and increased emphasis on grain feed and forage production would contribute toward a reduction of the livestock population to an appropriate size. An abattoir had been opened in December 1985, and plans were in progress to establish a scheme where large numbers of cattle would be bought quickly, and held in an adjacent feedlot for fattening prior to slaughter. The Government is currently negotiating for a European Community (EC) quota under the terms of the Lomé III convention.

The Lesotho representatives said that a further objective of the fourth plan will be to increase production of staple food crops, and to promote exportable commodities. They believe that the use of producer price increases to raise production levels would have only a limited effect because of the strong influence of prices in the RSA which limit Lesotho's freedom to implement policies significantly different from those in the RSA. Therefore, judicious use would be made of input subsidies for farmers who use approved techniques in selected crops.

The Lesotho representatives attached considerable importance to industrial development, particularly agriculturally based concerns. To date, the focus of industrial development has been on import substitution, but the authorities recognize that greater attention should be paid to export promotion. The Lesotho National Development Corporation (LNDC), financed mainly by external aid agencies, would continue to be the focus of Lesotho's industrial development, offering loan finance and equity participation, as well as providing industrial buildings for rent. Other incentives include a six-year tax holiday, cheap loans (in the range 8-13 percent), and skill training. One major agroindustrial development that is currently under consideration is a wool-scouring plant, which would process most or all wool and mohair, Lesotho's principal export. This would involve an abrupt change in marketing as Lesotho would have to assume greater responsibility for exporting finished or semifinished products, rather than relying on bulk handling through the auction system in the RSA. Other policies for increasing investment in the industrial sector currently under consideration include the establishment of an investment promotion unit in the LNDC, and the introduction of a loan guarantee scheme for Basotho Enterprises Development Corporation (BEDCO) to enable small-scale entrepreneurs to use the resources of Lesotho Bank. The Lesotho representatives said that they hoped to benefit from the World Bank's industrial sector study which is expected to begin in early 1987.

The Lesotho representatives said that in their efforts to diversify the economy, greater attention would be devoted to the development of the tourist sector. In this regard, efforts were being made to rehabilitate and expand hotels and lodges, to develop national parks and historical and cultural sites, and to attract more tourists from Europe and Africa. The Lesotho Tourist Board is preparing feasibility studies of various tourist projects for EC approval and funding.

b. Employment, earnings, and pricing policies

The Lesotho representatives said that about 110,000 Basotho (about 50 percent of the labor force) are currently employed in South Africa, mainly in the gold and coal mines. They did not expect the number of Basotho workers in South Africa to increase significantly because of the political and economic situation there. Therefore, they were concerned about the growing unemployment in Lesotho and were taking steps to alleviate the situation through expansion of the agricultural and industrial sectors. They explained that there was currently a shortage of skilled labor, but expected that the improvement in the educational system, including the development of technical skills, which is being undertaken with World Bank assistance, would ease the situation. They recognized, however, that a reduction in the dependence on migrant labor and their remittances could only be achieved over a long period of time and through sustained efforts to develop the Lesotho economy.

Official estimates are that migrants' remittances constitute over 50 percent of GNP, but because of freedom of movement across the borders, the large number of unregistered workers in the RSA, and the virtual absence of exchange control, accurate data are not available. At present, this income source is not taxed and very little can be mobilized by the Government. The authorities have attempted to increase the proportion of miners' earnings that are remitted, by negotiating arrangements with all the major mine employers of Basotho workers, under which 60 percent of earnings are withheld at source, and are then remitted automatically to the Deferred Pay Fund (held by the Lesotho Bank) to be made available once the miner returns. On the basis of current information, although considerable improvement had taken place up to 1984/85, it is estimated that less than half of the amount which should be remitted is actually received by the Deferred Pay Fund. The Lesotho representatives suggested that part of this leakage might be a result of the excessive use of an emergency remittance provision, which allows a miner to request a reduction in the pay withheld for bona fide emergencies, but they acknowledged that this was not a complete explanation. The staff representatives said that there was clearly need for increasing the remittances both by stricter enforcement of the arrangements with the mines and through the introduction of new financial instruments with stronger incentives such as savings bonds. This would provide a means of mobilizing domestic resources, and might be a more appropriate option in this regard than the taxation of remittances (or the Deferred Pay Fund) which would only encourage avoidance of the formalized channels for remittances.

The Lesotho representatives said that they did not anticipate any significant change in pricing policy, noting that price levels are largely determined by prices in South Africa. There is no significant price control, except for the five major food crops, for which minimum producer prices are set administratively (largely by reference to 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, one of whose recommendations was to cease the distribution of the compensation element 1/ directly to the member Governments, paying it instead to the South African Development Bank. 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

Table 5. Lesotho: Gross Domestic Expenditure, Saving, and Fiscal Targets, 1986/87-1991/92

	Without Further Policy Measures						With Suggested Policy Measures					
	1986/87	1987/88	1988/89	1989/90	1990/91	1991/92	1986/87	1987/88	1988/89	1989/90	1990/91	1991/92
	(As percent of GNP)											
Total consumption	95.3	94.8	94.4	94.1	94.2	94.7	95.3	94.0	93.2	92.5	91.9	91.4
Gross domestic investment	17.5	17.7	17.9	18.1	18.3	18.5	17.5	18.0	18.3	18.5	18.7	18.9
National saving	4.7	5.2	5.6	5.9	5.8	5.3	4.7	6.0	6.8	7.5	8.1	8.6
Foreign saving	12.9	12.5	12.3	12.2	12.5	13.2	12.9	12.0	11.4	11.0	10.6	10.3
Central Government surplus/deficit (-)	-8.9	-8.8	-8.0	-7.8	-8.1	-8.9	-8.9	-7.0	-5.2	-4.5	-4.2	-4.2
	(As percent of GDP)											
Central Government												
Revenue and grants	39.4	37.4	38.3	38.2	38.0	37.7	39.4	38.9	40.8	40.6	40.0	39.2
Revenue	35.9	34.0	34.8	34.7	34.5	34.3	35.9	35.4	37.3	37.2	36.7	35.9
Expenditure and net lending	56.9	54.4	53.6	52.9	53.0	53.9	56.9	52.4	50.7	49.0	47.7	46.8
Current expenditure	37.7	35.2	34.3	33.7	33.8	34.9	37.7	33.7	32.0	30.4	29.4	28.7
Capital expenditure and net lending	19.1	19.3	19.2	19.2	19.1	19.0	19.1	18.7	18.7	18.6	18.3	18.1
Surplus/Deficit (-)	-17.5	-17.0	-15.3	-14.7	-15.0	-16.2	-17.5	-13.5	-9.9	-8.4	-7.7	-7.5

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

enterprises which would be profitable at prevailing rates of interest. As a complement to this strategy, the staff representatives suggested that the Lesotho authorities explore the feasibility of creating suitable instruments for financing productive investment projects. Moreover, measures would be necessary to diminish other constraints identified by the Lesotho authorities such as risk aversion among the banks, the lack of acceptable collateral outside the formal sector, and a legal system which inhibits debt recovery from defaulting borrowers. The Lesotho authorities replied that one of the reasons for the surplus liquidity was the implementation of the minimum local assets requirement, which had resulted in a large inflow of funds and a rise in commercial banks' domestic liquidity. However, they felt that as the spread between the deposit and lending rates narrowed, the commercial banks would be encouraged to pursue a more aggressive lending policy. This process could be helped by judicious changes in the rates paid to commercial banks on their deposits with the Central Bank. With respect to the future, the Lesotho representatives responded favorably in principle to the idea of savings bonds to promote saving, particularly from migrant earnings, but noted certain reservations about its practicality, given the lack of familiarity with that type of instrument and its relative illiquidity. Commenting on the staff representatives' observation that the low rate of migrant remittances may reflect the response of the miners to more attractive deposit rates and financial services in the RSA, the Lesotho representatives said that they believed that domestic rates for small deposits (such as those held by miners) were competitive with those in South Africa.

d. External policies

The scope for independent external and monetary policy is tightly constrained by the existing currency arrangement. Even under the new Trilateral Monetary Agreement, the loti remains pegged at par with the RSA rand, and is fully backed by rand or foreign currency deposits. The Lesotho representatives reaffirmed their intention to adhere to this system, although they recognized that it meant allowing domestic inflation to be determined by the rate prevailing in the RSA and that almost no benefit for exports could be derived from the depreciation of the loti because the RSA is the dominant trading partner. While recognizing that an independent exchange rate policy would enable the authorities to pursue export diversification more vigorously, the staff representatives acknowleged that such an approach was ruled out by the existing monetary arrangements. They stressed that the consequence of this policy was that it required the conduct of appropriate domestic demand-management policies, particularly in the public sector, to avoid pressure on the external current account. The external position could be improved through incentives directed toward selected sectors for export promotion or import substitution. In this regard, the staff representatives encouraged the authorities to intensify their efforts to attract new investment to Lesotho, and to establish agroindustrial projects using domestic raw materials (such as the wool-scouring plant), provided these are financially viable. They stressed that an important element in maintaining external balance viability would be to minimize the contracting of new nonconcessional debt.

With respect to the Trilateral Monetary Agreement, the authorities noted that the provision permitting Lesotho's non-rand foreign exchange holdings up to 35 percent of its holdings of gold, foreign exchange, and rand, was an improvement over the previous arrangement, when no such holdings were permitted. Moreover, the renegotiation of this ratio is permissible without abrogating the whole agreement. Finally, the Lesotho representatives confirmed that Lesotho had not introduced the restrictions on external debt payments following the introduction of such a restriction by the RSA during 1985, and that Lesotho had remained current in respect of all external payments.

e. Medium-term scenarios 1/

The first scenario assumes the continuation of present policies. Investment as a proportion of nominal GDP would decline, and average growth in real GDP would be about 2 percent, implying a decline in real per capita income. The ratio of the overall budget deficit to GDP is projected to rise sharply in 1986/87 and decline slightly thereafter, reflecting expected trends in revenue and expenditure, including the Government's practice of implementing general wage increases at five-year intervals (Table 5). Revenue growth is expected to be slow (12 percent on average) on account of the slow growth of SACU receipts, the narrow tax base, and the inadequate machinery for tax collection. The somewhat faster growth in expenditure (14 percent) would be the result of the annual merit increases to civil servants' salaries and an annual increase in outlays on goods and services of 1.5 percent in real terms.

The overall balance of payments is projected to come under increasing pressure (Table 6). Export volume is projected to grow by 1 percent, while workers' remittances are projected to contract by about 2 percent in real terms (or to increase by 10 percent in nominal terms), owing to leakages in the existing system of deferred pay and remittances or the more favorable incentives for savings in the RSA. Import volume is projected to remain approximately constant, reflecting the projected decline in the real value of remittances. Under these assumptions, the external current account deficit is projected to increase progressively from 3.1 percent of GNP in 1986/87 to 5.7 percent in 1991/92. Given the net capital inflows projected from commitments at the end of 1985 and the assumption of a level of gross reserves equivalent to 2.5 months of

1/ Neither scenario incorporates the economic and financial effects of the Highland Water Project (see Appendix VI), possible revisions to the SACU agreement, or the indirect effect of sanctions against the RSA.

Table 6. Lesotho: Balance of Payments and External Debt, 1986/87-1991/92

(In millions of SDRs)

	Projections Without Further Policy Measures						Projections With Suggested Policy Measures				
	1986/87 Est.	1987/88	1988/89	1989/90	1990/91	1991/92	1987/88	1988/89	1989/90	1990/91	1991/92
Current account	-15.5	-20.4	-26.8	-31.3	-37.8	-47.3	-18.9	-22.2	-21.7	-20.0	-20.4
Exports	22.6	23.5	26.4	29.3	32.1	35.2	24.7	28.8	33.1	37.6	42.7
Imports	-313.7	-329.4	-373.6	-416.7	-458.0	-504.1	-333.0	-380.5	-427.9	-471.6	-520.4
Workers' remittances	238.8	248.7	278.5	306.4	330.9	357.4	253.1	288.5	323.1	355.4	390.9
SACU compensation	16.8	17.5	23.6	28.6	33.4	37.8	17.1	22.8	29.1	35.2	40.7
Other services and transfers	20.0	19.4	18.3	21.0	23.8	26.5	19.2	18.2	20.8	23.4	25.7
Capital account (net)	12.1	23.8	19.5	15.6	11.7	8.6	24.1	20.1	16.5	12.9	10.2
Financing requirement	3.7	5.5	16.5	24.7	34.8	48.3	4.4	12.1	15.1	16.2	20.4
Overall surplus/deficit 1/	0.2	8.9	9.2	9.0	8.6	9.6	9.7	9.9	9.9	9.1	10.2
Memorandum items:											
Current account deficit as percent of: GDP	-6.1	-7.5	-8.4	-8.6	-9.3	-10.3	-6.8	-6.9	-5.8	-4.6	-4.1
GNP	-3.1	-3.8	-4.4	-4.6	-5.0	-5.7	-3.5	-3.6	-3.1	-2.5	-2.3
(As a percentage of exports of goods and nonfactor services)											
Debt service	24.8	23.5	21.8	20.8	19.9	19.9	22.9	20.7	19.2	17.7	16.7
Interest	8.5	8.8	8.6	8.7	9.0	9.3	8.6	8.1	7.9	7.6	7.2
(As a percentage of exports of goods and services; unless otherwise indicated)											
Debt service	3.8	3.6	3.4	3.2	3.1	3.2	3.5	3.2	3.0	2.8	2.7
Interest	1.3	1.3	1.3	1.4	1.4	1.5	1.3	1.3	1.2	1.2	1.2
Debt outstanding as a percentage of: GDP	71.4	68.4	67.8	68.3	70.1	72.7	67.3	64.6	61.5	58.1	54.5
GNP	36.4	35.3	35.5	36.4	38.0	40.1	34.6	33.7	32.7	31.5	30.1

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

1/ Under both scenarios, it is assumed that gross official reserves are held equal to 2.5 months of imports. The overall balance is financed by drawdown on net foreign assets of the monetary authorities.

imports, the additional annual net financing requirement would rise progressively from SDR 4 million in 1986/87 to SDR 48 million in 1991/92, a total of SDR 130 million for the five years. Even if these inflows are financed entirely on concessional terms, this would cause a rise in the ratio of external debt to GNP (from 36 percent in 1986/87 to 40 percent in 1991/92), with the prospect of rising debt service in the longer term.

The above scenario implies that Lesotho's present policies are likely to result in growing domestic and external, economic, and financial imbalances thereby jeopardizing the prospects for increasing real per capita income and placing greater pressure on the balance of payments. Therefore, it will be important to introduce a number of policy measures to increase investment and growth, reduce domestic financial imbalances, particularly with respect to the Government's budget, and to strengthen the balance of payments by export promotion and import substitution and by steps to increase the proportion of workers' earnings that are remitted. Such an approach is depicted in the second scenario.

With such policies Lesotho could aim to increase national savings and investment; growth of real GDP is projected at an annual average rate of 3.5 percent, which would allow real GDP per capita to increase by about 1 percent annually. Investment would rise gradually from 17.5 percent of GNP in 1986/87 to 18.9 percent in 1991/92, with the proportion of this investment financed by national saving risings from 28 percent to about 47 percent (Table 5).

With respect to the government budget, the growth of revenue (excluding grants) would rise to 14 percent (36 percent of GDP), while expenditure growth would be restricted to about 12 percent (47 percent of GDP) (Table 6). This would allow a gradual reduction in the overall budget deficit from 18 percent of GDP in 1986/87 to 8 percent in 1991/92 (from 9 percent of GNP to 4 percent). 1/ Under this scenario, the need for domestic financing would be reduced considerably. In turn, this would reduce substantially the need for domestic bank financing by the end of the period, assuming that the more modest net foreign borrowing needs (equivalent to 6 percent of GDP by 1991/92) can be met. This would enable the nongovernment sectors to have substantially greater access to financial resources than implicit under the passive scenario.

The projections of the external accounts assume that workers' remittances can be held constant in real terms, while export growth could be increased to about 5 percent. Total import volume is projected to rise by slightly less than 1 percent. The reduction in real terms of total government expenditure will permit a modest rate of growth in private sector imports. If workers' remittances remain constant in real

1/ For a description of some of the measures to achieve this, see Section IV.2.c. above.

terms, then the volume of consumer imports is unlikely to rise significantly, allowing imports of intermediate and capital goods to grow at a rate of about 2 percent annually. The effect of these assumptions is that the current account deficit would rise slightly from 3.1 percent of GNP (6.1 percent of GDP) in 1986/87 to 3.6 percent in 1988/89 (6.9 percent of GDP), and would decrease gradually thereafter to about 2 percent of GNP in 1991/92 (4 percent of GDP), a level which appears to be sustainable if financed on concessional terms. A significant requirement for financing from newly contracted debt would emerge only in 1988/89, and total additional financing required during the five-year period would be SDR 68 million. Lesotho's external debt would decline to about 30 percent of GNP by 1991/92. If financed on concessional terms, debt service would fall from 3.5 percent of exports of goods and services in 1985/86 to 2.7 percent in 1991/92.

The staff representatives emphasized that the projections are highly sensitive to relatively small variations in the assumptions, particularly concerning the growth of workers' remittances. A deviation of 1 percentage point in the average growth of remittances would result in a difference of about 2.3 percent of GNP in the current account deficit by 1991/92.

V. Staff Appraisal

Lesotho's recent progress toward restoring economic growth and financial stability faltered in 1985/86. GDP fell slightly, due in large part, to a decline in agricultural output. More seriously, national income, as measured by GNP, is estimated to have fallen significantly even though the number of migrant workers was little changed, and wage increases were substantial. The overall budget deficit increased more than threefold relative to GDP in 1985/86, because of expenditure overruns, but also because SACU revenue receipts fell sharply in nominal terms. This shortfall also contributed to the deterioration in the external current account in 1985/86. Exports, which had declined sharply in 1983 following the cessation of large-scale diamond production, remained stagnant (now representing less than 10 percent of imports), while imports contracted less rapidly than the combined total of workers' remittances and compensation payments.

The decline of income and output illustrate the fragility of the economy caused by its narrow productive and export base, the extraordinary degree of concentration in migrant workers' remittances, and the vulnerability of the economy to the drought conditions that have persisted for much of the decade. The staff envisages that a medium-term adjustment program would have to incorporate the following policies and measures: (a) increasing and diversifying production; (b) promoting private sector activity; (c) strengthening the external accounts through export promotion and import substitution; (d) containing the Government's budgetary deficit; (e) maximizing the use of the monetary and credit policy instruments available within the existing monetary arrangement; and (f) strengthening economic management and planning capabilities.

One of the most serious long-term problems faced by the economy is the soil erosion that has resulted from the combination of drought and animal overstocking. Measures are needed to increase efficient land utilization; one such measure would be to reduce the difference between the social and private costs of livestock ownership by user fees for grazing land or a head tax on cattle. Moreover, there is a pressing need for rapid reform of the existing system of land tenure which has led to fragmentation of holdings to the point of nonviability. A key element of structural reform would be to increase the role of the market in allocation, through leasing arrangements.

With respect to the external sector, four broad issues arise in the effort to ensure medium-term viability: the containment of import demand, the promotion of merchandise exports to shift away from excessive reliance on migrants' remittances, and the limitation of foreign commercial borrowing. Import-substituting and some export activities can be promoted to the extent that adequate incentive packages can be offered to potential investors, although it must be recognized that the openness of the country's economy and the smallness of the domestic market tend to place Lesotho at some disadvantage with its big neighbor. Yet on balance, given the importance of Lesotho's close links within the Common Monetary Area, and the stability and trade and other benefits associated with membership, there appears to be little alternative at present to the continuation of the present exchange system.

In view of the limited scope for conducting independent monetary or external policies, the implementation of an appropriate fiscal policy is of great importance. It is, therefore, particularly worrying that the budget outturn for 1985/86 and prospects for 1986/87 indicate a substantial deterioration in the government budget. If a sustainable external position is to be established, appropriate measures will have to be introduced promptly. This is the more so since the receipts from the customs union are not expected to keep pace with inflation, and there is the prospect of a fundamental reform of the SACU agreement, which could result in a sharp decline in Lesotho's receipts. Some means also need to be found of increasing the budgetary contribution of the largest component of national income, migrants' remittances. Taxation does not appear to be an acceptable option, so the Government will need to devise some financial instrument, such as a savings bond, which is attractive both in terms of returns and marketability. Extensive efforts need to be made to contain expenditure, and, in the budgeting process, to ensure much greater coordination of the recurrent and capital budgets.

There is a need to improve economic management and planning capability, so as to avoid implementation of investment projects that are uneconomic. Moreover, the lack of attention to long-term financial requirements has led to the failure of projects once donor support has ceased. The authorities acknowledge that previous development plans have not been fully effective, in part because of inadequate attention to a macroeconomic framework, and the inability to review and implement plans in a flexible manner. The fourth development plan is being prepared for publication in December 1986, and it is hoped that these shortcomings will be addressed. The staff of the World Bank is currently analyzing a preliminary draft of this document.

A program for structural adjustment would need to assess the level of interest rates, to make sure that deposit rates are sufficiently attractive to provide an incentive for miners to transfer their deposits from the RSA to Lesotho. At present, deposit rates are strongly negative in real terms, but with the excess domestic liquidity of the banking system, savings mobilization is not an immediate problem. It is, however, a matter which would have to be kept under review. The low level of credit to the private sector indicates other more fundamental constraints on private sector activity. In particular, there is a need to improve incentives to industry, to diminish the commercial banks' aversion to risk, and to reduce the legal obstacles to prompt debt recovery.

Lesotho maintains a relatively liberal price regime, the Government controlling only utility tariffs and establishing minimum producer prices for the five principal food crops, and setting prices and charges for some of its services. Nevertheless, some parastatals have made losses requiring government support, largely because tariffs have not been adjusted adequately or frequently enough, and there is clearly scope for increasing user fees for certain government services. Lesotho's exchange and payments system is closely linked to that of South Africa and Swaziland on account of the monetary arrangements between the three countries under the Trilateral Monetary Agreement and the implementing bilateral agreement between South Africa and Lesotho. The staff will review the implications of the new monetary arrangements for the exchange and payments systems of Lesotho and the other two member countries in a separate paper that will be prepared for the consideration of the Executive Board at a later date. The "financial rand" scheme which was re-introduced in September 1985 gives rise to a multiple currency practice applicable solely to capital transactions.

Lesotho faces a highly uncertain future given its geopolitical situation. Its economy is highly concentrated and dependent upon the neighboring RSA, indicating a need for medium-term structural adjustment to reduce its vulnerability to exogenous events. Domestic financial imbalances are emerging, in particular the government budget where the performance in 1984/85-1985/86 shows a growing deficit. The authorities are aware of the need for adjustment, and have expressed interest in the use of Fund resources under the structural adjustment facility. Preliminary discussions were held on the policy framework within which arrangements under the SAF might be set. The staff proposes to continue discussions on a policy framework paper, based on the guidance received from the Executive Board on the staff's assessment. Close contacts are being maintained between the staffs of the Fund and the World Bank, including parallel missions which visited Lesotho in August 1986.

The staff proposes that the next Article IV consultation with Lesotho be held on the standard 12-month cycle, in view of the uncertain prospects for the balance of payments, and the high value placed on these contacts by the authorities.

VI. Proposed Decision

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

1. The Fund takes this decision, relating to Lesotho's exchange measures subject to Article VIII, Section 2(a) in concluding the 1986 Article XIV consultation with Lesotho and in the light of the 1986 Article IV consultation with Lesotho conducted under Decision No. 5392-(77/63), adopted April 29, 1977 (Surveillance over Exchange Rate Policies).

2. The Fund finds that the exchange system of Lesotho is free of restrictions on payments and transfers for current international transactions, subject however to a review by the Executive Board at a later date of the consistency with the Fund's Articles of Agreement of certain provisions of the monetary agreements between Lesotho, South Africa and Swaziland.

Lesotho--Relations with the Fund
(As of September 30, 1986)

I. Membership Status

a.	Date of membership	July 25, 1968
b.	Status:	Article XIV

A. Financial Relations

II. General Department (General Resources Account)

a.	Quota:	SDR 15.1 million
b.	Fund holdings of Lesotho maloti:	SDR 13.8 million (91.7 percent of quota)
c.	Fund holdings subject to repurchase and charges:	--
d.	Reserve tranche position:	SDR 1.25 million
e.	Current operational budget:	--
f.	Lending to the Fund:	None

III. Current Stand-By or Extended Arrangement and Special Facilities

a.	Current stand-by or extended arrangement:	None
b.	Stand-by and extended arrangements during last ten years:	None
c.	Special facilities	None

IV. SDR Department

a.	Net cumulative allocation:	SDR 3.74 million
b.	Holdings:	SDR 0.85 million (22.61 percent of net cumulative allocation)
c.	Current designation plan:	--

V. Administered Accounts

a.	Trust fund loans:	
	1. Disbursed	SDR 4.89 million
	2. Outstanding	SDR 2.63 million
b.	SFF Subsidy Account:	--

VI. Overdue Obligations to the Fund — None

Lesotho--Relations with the Fund (concluded)
(As of September 30, 1986)

B. Nonfinancial Relations

VII. Exchange Rate Arrangement

The currency of Lesotho, the loti (plural maloti), is pegged at par to the South African rand at a rate of M 1 = R 1.

VIII. Article IV Consultation

The 1985 Article IV consultation discussions with Lesotho were held in Maseru during the period August 6-21, 1985. The staff report (SM/85/283) was discussed by the Executive Board on November 20, 1985, and the following decision was adopted:

1. The Fund takes this decision in concluding the 1985 Article IV consultation with Lesotho, in the light of the 1985 Article IV consultation with Lesotho conducted 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 is on the standard 12-month cycle for Article IV consultations.

IX. Technical Assistance

(a) CBD: CBD has provided to the Central Bank of Lesotho a bank supervision inspector during July-December 1984, a Research Advisor (beginning October 1984), and a Director of Bank Supervision (beginning February 1985). On June 10, 1985 management agreed to the appointment of a General Manager for the Central Bank. The Government has also requested an external debt adviser to be stationed in the Ministry of Finance.

(b) FAD: None

(c) The Bureau of Statistics conducted an extensive review of the statistical bureau in Lesotho during February-March 1985.

X. Resident Representative/Adviser: None

Lesotho - Relations with the World Bank

Lesotho: World Bank Lending Operations
September 26, 1986

As of August 31, 1986, IDA had approved 15 credits amounting to US$99.8 million (original principal), of which US$66.5 million had been disbursed, US$32.5 million remained undisbursed, and US$67.6 million in borrower's obligations 1/ were outstanding. These credits were in respect of educational, road, agricultural, rural, and urban development; rural water supply; and health and population projects as well as the financing of the Lesotho National Development Corporation.

The following table summarizes the World Bank's lending operations as of August 31, 1986:

Sector	Fully disbursed 2/	Effective Credits		Sub-total	Total
		Disbursed	Undisbursed		
		(In millions of U.S. dollars)			
Education	11.5	7.8	12.7	20.5	32.0
Transportation	10.5	13.3	12.1	25.4	35.9
Agricultural/Rural development	9.5	--	--	--	9.5
Industry	2.3	2.0	2.0	4.0	6.3
Water supply	5.0	--	--	--	5.0
Urban development	--	4.4	1.6	6.0	6.0
Health and population	--	0.4	4.1	4.5	4.5
Total disbursed and undisbursed 3/	38.8	27.8	32.5	60.4	99.1
Total borrower's obligation 1/	...	...	...	...	67.6

Source: IBRD, External Debt Division.

1/ Total disbursements less repayments adjusted for exchange rate changes.
2/ Original principal less cancellations.
3/ Totals may not add due to rounding.

Lesotho--Statistical Issues

1. Outstanding Statistical Issues

a. Prices

The present consumer price index has weights based on the expenditure patterns of October 1975. The authorities intend to revise these weights using the results of a Household Budget Survey to be conducted shortly.

b. Government finance

The 1985 GFS Yearbook includes central government data for the period 1973-77 and for 1983. Data for the statistical and derivation tables for 1984 were received recently. These data include, for the first time, tables on outstanding debt. The 1984 data will be published in the 1986 GFS Yearbook; however, 1982 figures arrived too late for inclusion in the Yearbook. The GFS correspondent has indicated that 1985 data will be provided in the near future.

c. Interest rates

Data on interest rates have been obtained through the Article IV consultation mission and will be published regularly beginning with the November IFS.

2. Coverage, Currentness, and Reporting of Data in IFS

The table below shows the currentness and coverage of data published in the country page for Lesotho in the October 1986 issue of IFS. The data are based on reports sent to the Fund's Bureau of Statistics by the Central Bank of Lesotho, which during the past year have been provided on a timely basis.

Status of IFS Data

		Latest Data in October 1986 IFS
Real Sector	- National Accounts	1983
	- Prices (Consumer)	January 1986
	- Production	n.a.
	- Employment	n.a.
	- Earnings	n.a.
Government Finance	- Deficit/Surplus	1983
	- Financing	1983
	- Debt	n.a.
Monetary Accounts	- Monetary Authorities	June 1986
	- Deposit Money Banks	June 1986
	- Other Financial Institutions	June 1986
Interest Rates	- Discount Rate	n.a.
	- Bank Lending/Deposit Rate	n.a.
	- Bond Yields	n.a.
External Sector	- Merchandise Trade: Values	1985
	Prices	n.a.
	- Balance of Payments	1985
	International Reserves	August 1986
	- Exchange Rates	August 1986

LESOTHO - Basic Data

Area, population, and income

Area	30,444 square kilometers
Population	
Total (1985/86)	1.4 million
Growth rate	2.3 percent
GDP per capita (1985/86)	SDR 175
GNP per capita (1985/86)	SDR 350

	1981/82	1982/83	1983/84	1984/85	1985/86
National accounts	(In millions of maloti)				
GDP at current market prices	348.5	379.0	416.7	477.6	566.6
Of which: agriculture	(67.1)	(77.4)	(94.3)	(119.8)	(141.8)
GNP at current market prices	(636.2	770.3	872.4	994.6	1,110.2
Of which: migrant labor income	(287.7)	(391.3)	(455.7)	(517.0)	(553.6)
Gross domestic expenditure at current market prices	742.8	860.8	963.9	1,099.6	1,232.7
External resource gap	-394.3	-481.8	-547.2	-622.0	-676.1
Employment	(In thousands of maloti)				
Mine workers 1/	123.5	117.3	115.3	114.1	116.4

	1981/82	1982/83	1983/84	1984/85	1985/86 Prel.
Central government finances	(In millions of maloti)				
Revenue and grants	124.8	144.2	179.1	234.4	253.0
Revenue	111.1	134.8	169.9	217.3	243.0
Of which: Customs Union	(70.8)	(76.7)	(109.9)	(151.5)	(161.1)
Grants	13.7	9.4	9.2	17.1	10.0
Total expenditure	183.7	185.0	205.1	253.4	326.9
Current	117.1	121.9	141.5	161.4	224.0
Capital and net lending	66.6	63.1	63.6	92.0	102.9
Overall surplus/deficit (-)	-58.9	-40.8	-26.0	-19.0	-73.9
Financing	58.9	40.8	26.0	19.0	73.9
Foreign (net)	18.8	25.1	28.5	20.0	29.6
Domestic (net)	40.1	15.7	-2.5	-1.0	44.3
Banking system	(37.1)	(12.0)	(-9.6)	(-19.1)	(30.0)
Other	(3.0)	(3.7)	(7.1)	(18.1)	(14.3)

1/ In the RSA at end of calendar years beginning 1981.

LESOTHO - Basic Data (concluded)

	1981/82	1982/83	1983/84	1984/85	1985/86
Monetary survey (end of period)			(In millions of maloti)		
Foreign assets (net)	42.5	87.5	126.3	199.1	216.9
Domestic credit	111.9	124.2	127.7	122.3	172.6
Government (net)	62.3	74.3	64.8	45.6	75.6
Statutory bodies	10.1	11.3	13.8	11.9	11.4
Private sector	39.5	38.6	49.1	64.7	85.6
Money and quasi-money	159.0	200.5	225.4	266.5	323.5
Other items (net)	-4.6	11.2	28.6	54.9	66.0
Balance of payments			(In millions of SDRs)		
Current account surplus/ deficit (-)	-39.6	-31.6	0.1	22.5	6.1
Exports	40.5	31.1	30.0	26.2	21.8
Imports (f.o.b.)	-390.6	-396.4	-460.3	-383.9	-296.3
Workers' remittances	265.6	313.2	376.8	310.3	234.4
Other services and income (net)	-17.2	-19.9	-21.9	-15.7	-12.2
Unrequited transfers	62.1	40.4	75.5	85.6	58.4
Capital account	21.9	13.0	11.8	13.0	12.0
Long-term capital (net)	29.3	23.4	19.9	15.8	15.4
Short-term capital (net)	-7.9	-10.4	-8.1	-2.8	-3.4
SDR allocation	0.5	...	...	...	...
Errors and omissions	-18.6	31.3	13.3	-34.8	-9.6
Overall balance	-36.3	12.7	25.2	0.7	8.5
Gross official reserves	33.1	46.4	58.0	51.7	59.6
External debt					
Disbursed and outstanding	98.4	124.5	135.8	149.8	156.0
Debt service (as percent of exports of goods and factor services)	2.8	6.2	5.2	6.2	5.7
Debt service (as percent of exports of goods and nonfactor services)	13.1	41.3	40.1	46.5	38.8

Lesotho: Amendments to the Monetary Agreement

The Rand Monetary Agreement	The Trilateral Monetary Agreement
A. <u>Legal tender</u>	
1. The South African rand was legal tender throughout the RMA (Article 2).	The rand remained legal tender in Lesotho, but it ceased to be legal tender in Swaziland effective July 1, 1986.
2. However, Lesotho had the right to issue its own currency provided:	This provision was retained.
(a) It was legal tender only in Lesotho.	
(b) Lesotho's notes and coins were clearly distinguishable in size and appearance from the rand notes and coins.	This provision was retained.
(c) The currency (the loti) was convertible, at par, to the rand.	This provision was maintained.
(d) The aggregate amount of the maloti currency issued was required to be backed 100 percent by a reserve comprising rand currency held by the Central Bank of Lesotho (CBL), CBL's Special Rand Deposits maintained with the South African Reserve Bank, and CBL's holdings of South African Government stocks.	While the 100 percent backing requirement was maintained, the composition of reserve cover was diversified to include also CBL's investments in the South African Corporation for Public Deposits established in 1984.

The Rand Monetary Agreement	The Trilateral Monetary Agreement
B. <u>Transfer of funds within the RMA</u>	
The agreement allowed for the free transfer of funds without restrictions (whether for current or capital transactions) within the RMA (Article 3).	This provision has been maintained.
C. <u>Access to the South African capital and money markets</u>	
The Government of Lesotho, corporations, and statutory bodies owned or controlled by Lesotho Government, local authorities, public utilities, financial institutions, and business enterprises in Lesotho had a right of access to the South African capital and money markets (Article 4).	This provision was retained.
D. <u>Gold and foreign exchange transactions</u>	
The agreement stipulated that South Africa was responsible for the management of gold and foreign exchange of the RMA, but stressed that each contracting party was the sole authority responsible for authorizing gold and foreign exchange transactions in its territory (Article 5). However, Lesotho's foreign exchange regulations were supposed to be in accord with exchange control provisions in force in South Africa.	The new agreement confers the responsibility to manage gold and foreign exchange reserves of Lesotho and South Africa to both the Central Bank of Lesotho and the South African Reserve Bank, respectively, provided the gold and foreign exchange reserves of Lesotho shall not exceed 35 percent of the total of gold and foreign exchange reserves and rand holdings of Lesotho. However, as was the case with the original agreement, foreign exchange transactions of Lesotho are expected to be consistent and in accord with the exchange control policies of the CMA.

The Rand Monetary Agreement	The Trilateral Monetary Agreement
E. <u>Compensatory payments</u>	
Lesotho received, on an annual basis, payments from South Africa as compensation for its use of the rand.	This provision has been maintained.
F. <u>Consultations and the Rand Monetary Area Commission</u>	
To facilitate implementation, the agreement provided for regular consultations held by the member countries under the auspices of the Rand Monetary Area Commission comprising representatives of the three countries (Article 8).	Apart from the change of name of the commission to the Common Monetary Area Commission, this provision was retained.
G. <u>Settlement of disputes</u>	
Should any disputes arise between the contracting parties concerning the interpretation or application of this agreement, the affected parties were expected to settle the dispute amicably and in good faith. However, major disputes were to be settled through an <u>Arbitral Tribunal</u> consisting of three arbitrators; one to be appointed by each of the parties to the dispute and the third, who would be the President of the Tribunal, to be appointed by agreement of the affected parties. If they fail to agree on the appointment of the President of the Tribunal within 60 days, the Managing Director of the International Monetary Fund, or failing him, the President of the Bank for International Settlements, shall appoint the third member (Article 9).	This provision was maintained.

The Rand Monetary Agreement	The Trilateral Monetary Agreement
H. <u>Termination and withdrawal</u>	
1. A contracting party could withdraw from this agreement by giving 12 months' notice of its intention to the other contracting parties, unless the contracting parties otherwise agree (Article 10).	The withdrawal notice period has been reduced to six months.
2. In the event of such withdrawal, the Government of South Africa would exchange any rand currency which at the relevant date is in circulation in the area of such contracting party or held on deposits in South Africa and is presented by it for exchange within 24 months of such date, for acceptable rand assets and acceptable convertible foreign currency in a ratio equivalent to the ratio of the total amount of the domestic assets of the South African Reserve Bank to the total amount of gold, special drawing rights and foreign exchange of the South African Reserve Bank.	The formula used to determine the proporation of rand and rand-denominated deposits exchangeable for acceptable rand assets and convertible acceptable foreign exchange has been changed. The proportion of holdings and currency repatriated for conversion to acceptable foreign assets would be equal to the ratio of the gold, SDRs, and foreign exchange of the South African Reserve Bank to its total assets.
3. The exchange rates used in making any such payments could be the preferential rate of exchange applicable to transactions of the respective contracting parties.	This provision was maintained.

The Lesotho Highlands Water Project (LHWP)

The principal purpose of the project is to supply water to the Johannesburg/Witwatersrand connurbation in the Republic of South Africa, but it would have spinoffs for Lesotho in the form of hydroelectric power generation, water supply, irrigation, and other activities such as fishing and tourism. There would clearly be an employment creation effect during the construction phases of the project.

Water of the Sengu/Orange River system drains from the eastern highlands of Lesotho, south into South Africa, thence into the Atlantic, and is, at present, largely untapped in Lesotho. It is proposed to dam the river in Lesotho and divert the water northward through more than 80-km of tunnels into the Ash River, which feeds the Vaal dam near Johannesburg.

The distribution of the benefits is based on the difference in the cost of LHWPW and that of the alternative scheme which would involve tapping the Orange River in South Africa and pumping the water over a much longer distance. These benefits will be shared on the basis of 56 percent for Lesotho and 44 percent for the RSA. The cost of the alternative scheme would be about twice that of the LHWP. The financial benefit to Lesotho will take the form of a royalty calculated from the discounted present value (in 1985) of the difference in costs; this royalty is expected to amount to about M 20 million (in 1985 prices) in the first year, tripling by the time the project is delivering its full output. The net present value of the stream of benefits (in 1983 prices) is M 1,300 million, paid over 50 years starting in 1985. The discount rate used is 6 percent. Benefits will start to flow before 1995 because of the SACU receipts arising from the increased imports. If construction starts in 1989, then receipts would start in 1991, and would be offset against future royalty payments.

The cost of the project (including implementation, operation and maintenance) relating to water transfer will be borne fully by the RSA, and is expected to amount to over 80 percent of total. Lesotho will be responsible for financing the domestic components of the project, principally the hydroelectric development.

After the engineering studies, the project will be developed in three phases spread over thirty years, by the end of which water transfers will amount to 70 m^3/sec, a major part of the total of 115 m^3/sec flowing from the highlands. The treaty and associated commitments to be signed in October 1986 incorporate a contractual commitment to the project in the first phase. A final decision on the hydro-electric scheme will be based on the results of optimization studies to be carried out under the engineering project.

The total cost of the project is estimated at US$1,890 million in 1985 prices. With the exception of the engineering studies, the financing has not yet been worked out. The engineering study is expected to be financed by the Lesotho Government, the World Bank which will organize the cofinancing, the RSA. the EC, as well as the USAID, UNDP, ODA, and the Germany agency CIM. Although the water transfer project costs will be covered by the RSA, Lesotho will have to find financing for the hydroelectric scheme.

The annual distribution of investment through 1995 (the first phase) is projected as follows:

1987	1988	1989	1990	1991	1992	1993	1994	1995
(In millions of maloti)								
25	70	60	160	200	250	275	230	160

Source: Data provided by the Lesotho authorities.