April 8, 2020
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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 19/30-1

2:30 p.m., April 26, 2019

1. Kingdom of Lesotho—2019 Article IV Consultation

Documents: SM/19/79 and Correction 1; and Supplement 1

Staff: Thornton, AFR; Porter, SPR

Length: 19 minutes

Executive Board Attendance

T. Zhang, Acting Chair

Executive Directors	**Alternate Executive Directors**
D. Mahlinza (AE)	
	M. Sidi Bouna (AF), Temporary
	D. Vogel (AG), Temporary
	E. Amor (AP), Temporary
	P. Fachada (BR)
	P. Sun (CC)
L. Villar (CE)	
L. Levonian (CO)	
	S. Benk (EC)
	F. Bellocq (FF), Temporary
	K. Merk (GR)
S. Gokarn (IN)	
	T. Persico (IT), Temporary
	T. Ozaki (JA), Temporary
	M. Saadaoui (MD), Temporary
	P. Al-Riffai (MI), Temporary
	H. Etkes (NE), Temporary
	J. Sigurgeirsson (NO)
	P. Snisorenko (RU), Temporary
	W. Al Hafedh (SA), Temporary
	A. Srisongkram (ST), Temporary
	A. Urbanowska (SZ)
	A. Grohovsky, Temporary
	P. Pollard (US), Temporary

G. Tsibouris, Acting Secretary
H. Malothra, Summing Up Officer
B. Zhao / L. Briamonte, Board Operations Officers
L. Nagy-Baker, Verbatim Reporting Officer

Also Present
African Department: A. Habib, A. Massara. Finance Department: H. Nguyen. Strategy, Policy, and Review Department: N. Porter. Statistics Department: D. Kostroch. World Bank Group: J. Entwistle, E. Noubissie Ngankam. Alternate Executive Director: K. Obiora (AE), M. Siriwardana (IN). Senior Advisors to Executive Directors: O. Stradal (EC), A. Tivane

(AE), C. Williams (CO). Advisors to Executive Directors: A. Grohovsky (US), M. Ismail (AE), A. Nainda (AE), Y. Naruse (JA), E. Ondo Bile (AF), N. Vaikla (NO).

1. KINGDOM OF LESOTHO—2019 ARTICLE IV CONSULTATION

Mr. Mahlinza and Ms. Nainda submitted the following statement:

Our Lesotho authorities thank staff for the constructive engagement and policy advice during the recent Article IV Consultations and look forward to further interactions on policies that can help raise output and improve the economy's resilience. They broadly agree with staff's assessment of the macroeconomic challenges facing the economy and the policy recommendations.

The economy continues to grapple with vulnerabilities emanating from declining Southern African Customs Union (SACU)[1] revenues, a relatively undiversified economic base, a high public sector wage bill as well as a recent build-up of domestic arrears. Given these challenges, the authorities acknowledge that implementing adjustment measures has become critical. Accordingly, the recently tabled FY2019/20 National Budget proposes an ambitious reform agenda tailored towards addressing these development challenges. The authorities concur with staff on the importance of a well-executed reform agenda and are determined to implement the agreed measures, since broad political consensus has been established.

Lesotho has made significant progress towards restoring peace and stability since the coalition government took office in June 2017. This has been supported by the implementation of the National Reform Agenda. At the same time, a new National Strategic Development Plan (NSDP II) covering the period 2019—2023, whose theme is "inclusive growth, private sector–led jobs and reduced unemployment", has been launched. The Plan identifies four sectors – agriculture, manufacturing, technology, and tourism and creative industry– to drive job creation in the economy. Accordingly, allocations in the new national budget are focused towards development of these sectors. In addition, the Lesotho National Development Corporation (LNDC) will be restructured to better serve its mission of private sector development.

Recent Economic Developments and Outlook

Following weak growth in 2017, the Lesotho economy recovered modestly to 1.9 percent in 2018, owing to improved performance in mining, manufacturing, and financial services. Agricultural output remained subdued

[1] SACU is a customs union between Botswana, Eswatini, Lesotho, Namibia and South Africa. Among other things, SACU provides for free movement of goods among the five-member countries under a common external tariff.

due to prolonged dry spells, given the country's dependence on rain-fed agriculture. In the medium term, growth is expected to firm up, boosted by the construction sector, particularly the implementation of Phase II of the Lesotho Highlands Water Project (LHWP II), which is set to commence later this year. Downstream benefits of the LHWP II are expected to provide further growth impetus over the forecast horizon. Similarly, the primary sector is expected to pick up in the medium term supported by strong growth in the mining sector, reflecting strong demand and favorable prices.

Inflationary pressures continued to ease in line with global developments in recent periods, remaining below 5.0 percent throughout 2018. Going forward, inflation dynamics will be mainly affected by international oil prices and the exchange rate of the South African Rand. As a result, the average annual inflation rate is expected to increase from 4.7 percent in 2018, to 5.9 percent and 5.7 percent in 2019 and 2020, respectively.

The external sector position improved during the fourth quarter of 2018, boosted by surpluses in the capital and financial accounts that outweighed the effect of the widening current account deficit. Gross international reserves increased, reaching 4.5 months of imports at the end of 2018, from 3.9 months of imports in 2017. Going forward, the current account is expected to remain in deficit due to upward pressure on imports from construction activities related to mining investment and implementation of the LHWP II.

Fiscal Policy and Public Financial Management Reforms

To address underlying fiscal vulnerabilities and restore macroeconomic stability, the authorities are committed to implementing a set of fiscal stabilization measures. In this regard, they are taking steps aimed at containing spending and closing loopholes. Starting with the recently-passed FY2019/20 budget, significant spending adjustments have been made, amounting to a reduction equivalent to 2.2 percent of GDP. Importantly, the authorities are focusing on reducing the wage bill, through a hiring and wage freeze. To protect economic growth and employment, capital spending has been allowed to record a modest increase of 0.5 percentage points. These measures will see the fiscal deficit decline from 5.2 percent in FY2018/19 to 3.4 percent of GDP in FY2019/20.

To enhance domestic revenue mobilization, the authorities will implement a set of measures including the introduction of a levy on the sale of tobacco and alcohol, an increase in the fuel levy, and additional VAT on telecommunications. The authorities also intend to increase fees and charges that have remained stagnant over many years during the course of FY2019/20. As a result, revenues for FY2019/20, are expected to rise by 3.4 percentage points of GDP to 46.0 percent of GDP.

Government also plans to implement a Tax Modernization Program which will include, inter alia, the implementation of a VAT non-compliance detection solution, upgrading border IT infrastructure, introducing coordinated border management and launching a national single window. In addition, the Lesotho Revenue Authority (LRA) has implemented a Voluntary Disclosure Program (VDP)[2] and Small Business Taxation (SBT) scheme. As part of the 2019/20 budget, Government will further scale up the VDP program, replace the current zero rating on exports of natural resources with a VAT exemption, to reduce revenue leakages emanating from high VAT refunds claimed by the mining industry.

In an effort to strengthen Public Financial Management (PFM), on April 1, 2019, the authorities launched an upgrade to the Integrated Financial Management Information System (IFMIS) which aims to improve the quality of financial statements, reduce delays in payment of suppliers and enhance commitment controls. The new IFMIS will eliminate the need for the paper-based systems and introduce automated tracking of invoicing and payments. To enhance budget controls and better align spending with available resources, a Cash Management Unit has been established. Further, to regulate the volatility in SACU revenues and entrench debt sustainability, the Ministry of Finance will propose a fiscal rule to be passed into law, during the current fiscal year.

Financial Sector Development

Lesotho's financial sector remains sound with relatively low non-performing loans (NPLs). That said, the authorities remain vigilant in monitoring the emergence of vulnerabilities, including rising household indebtedness and credit concentration. They recognize the need to extend information coverage beyond the formal sector. For this reason, the credit bureau aims to improve information on informal lenders by licensing them as Microfinance institutions (MFIs). In addition, significant progress has been

[2] VDP allows taxpayers to correct their tax affairs and in return for coming forward voluntarily, the tax administration offers certain incentives such as the avoidance of criminal prosecution and reduced penalties and interest.

made in strengthening the supervision of the non-bank financial sector in view of its growing size and potential to develop systemic impacts. The authorities are also working with key stakeholders to strengthen the supervision of cooperatives. At the same time, the Central Bank of Lesotho (CBL) is undertaking extensive financial education and awareness campaigns to minimize the proliferation of Ponzi schemes. Further, the authorities have requested Fund technical assistance to facilitate the development of a secondary market for government debt.

To address challenges in the banking sector, including credit growth, the authorities have enacted the Security Interest and Movable Property and Insolvency bills. At the same time, a credit registry has been established with the aim of improving access to credit. A credit scoring system is currently being developed. Further, a securities market has been established and one commercial bank is considering issuing commercial paper. In addition, the authorities have taken significant steps to strengthen Anti-Money Laundering and Combating the Financing of Terrorism (AML/CFT) frameworks and practices with the assistance of Fund TA.

The authorities continue to make progress in further deepening financial inclusion. The Ministry of Finance and the CBL are strengthening collaboration between all stakeholders in providing financial services, including the Banks, Mobile Network Operators, Micro-finance Institutions, NGOs, partner ministries and development partners. Mobile money, which has grown at a fast pace, provides a promising avenue to increase financial inclusion, where the majority of the rural population has limited or no access to financial services. The authorities will continue to closely monitor developments in this sector with a view to manage potential risks.

Structural Reforms

In line with the NSDPII, which focuses on private sector led development, our authorities have developed an agenda to actively attract investment, improve the business climate and enhance human capacity development. In this regard, government aims to roll out several initiatives to attract investment, including the development of industrial parks. They have organized an investment laboratory, to allow both investors and government to collaborate on the modalities necessary to boost investment. The laboratory, which has been operational since March 2019, has registered more than 80 investors, with potential for establishing businesses and creating employment. Thus far, investor interest has been expressed in agri-business, tourism and creative industry, technology and manufacturing. Further, the authorities plan to implement measures to deepen financial markets and develop the capital market.

To promote SME development, Government is implementing financial and business support initiatives to help start-ups and other small businesses. An apprenticeship strategy has been developed with the main objective to address the existing skills mismatch between training institutions and the needs of the industry. Through this strategy, an institutionalized program will expose graduates of universities and higher learning institutions to industry and business practices in order to match the needs of the market or enable self-employment. Furthermore, the authorities intend to roll-out an entrepreneurship training program across training institutions to strengthen education outcomes.

As part of an effort to strengthen the fight against corruption, the authorities are considering a new anti-corruption bill that will increase the independence of the Directorate of Corruption and Economic Offences (DCEO). They are also implementing an asset declaration framework for public servants. To mitigate the impact of droughts on agricultural production, the authorities, are scaling up irrigation infrastructure as a way to insulate climate disruptions. In this regard, support will be provided to the Smallholder Agricultural Development Project (SADP) to cater for scale and climate disruptions.

Conclusion

Having taken appropriate measures to respond to recent political and economic challenges, the authorities are progressing with efforts to implement a package of measures that will strike a balance between fiscal consolidation and protecting growth, employment and other social objectives. In addition, the authorities are exploring options to diversify revenue sources and reduce reliance on volatile SACU revenues. Overall, the recommendations proposed by staff in the fiscal, financial and structural reform areas are in line with the authorities' agenda to pursue rapid and inclusive growth within a stable macroeconomic environment. In this regard, they wish to express appreciation to the Fund for the valuable technical assistance that Lesotho has received through the years.

Mr. Lopetegui and Mr. Vogel submitted the following statement:

We thank staff for the reports and Mr. Mahlinza and Ms. Nainda their helpful buff statement.

We welcome the progress towards peace and stability over the last two years. As noted in the staff report, during this period, a four-party political coalition has governed the county, bringing essential political stability to address the critical challenges and vulnerabilities Lesotho is facing. The staff report depicts a very difficult situation overall, and highlights critical social problems, including the unemployment rate at around 25 percent, over half of the population living under the $1.90 poverty line, and one of the highest HIV infection rates in the world. While we are encouraged by the above-referred political stability, some observers indicate lack of political consensus on the implementation of reforms and fragility of the current coalition. Could staff elaborate on political risks and their implications on economic policymaking?

The new National Strategic Development's agenda constitutes an important step by clearly setting out the country's challenges. Efforts will aim to attract investment and diversify the export base. This could have benefits, among others, in the fiscal area, where revenues significantly depend from Southern African Custom Union (SACU) members. In the last few years, SACU revenues decreased, while the staff report notes that SACU revenues and remittances could be further depressed. Therefore, we welcome the staff's assessment that the FY2019/20 budget represents a good step towards restoring fiscal and debt sustainability, while, like staff, we consider that much more remains to be done regarding fiscal reforms, such as those related to rationalizing expenditures, and improving the tax system. Vulnerabilities in public financial management, such as those underscored in the report, should be urgently addressed. We are encouraged by the efforts towards enhancing the coverage and efficiency of social protection schemes; as underlined in the staff report, the authorities should protect vulnerable groups from the effects of the adjustment.

We note that the banking system is sound and profitable. At the same time, non-performing loans have increased, which should be closely monitored. Meanwhile, access to credit is one of the key factors that allow a country to accelerate growth, and especially to give more opportunities to the most vulnerable sectors to exit from poverty. In this regard, we observe that credit to the private sector has remained stagnant over the past five years; the authorities should understand what the obstacles to growth are, and prepare reforms to address them.

With these comments, we wish Lesotho and its people every success in their future endeavors.

Mr. Fachada and Mr. Coronel submitted the following statement:

We thank staff for the report and Mr. Mahlinza and Ms. Nainda for their statement. Over the last few years, Lesotho's economy has faced the effects of domestic political uncertainty, lower fiscal revenues, persistent high government expenditure and the emergence of payment arrears. Encouragingly, the new four-party coalition that ascended to power in June 2017 brought prospects of a stable and peaceful environment, favorable to address Lesotho's economic challenges.

The reduction of Southern African Customs Union (SACU) revenues has complicated Lesotho's macroeconomic landscape. The decline in SACU revenues has affected Lesotho's fiscal performance, amid a high and relatively inflexible expenditure structure marked by a large wage bill. Adhering to fiscal discipline by strictly implementing the FY2019/2020 budget is key to preserving fiscal sustainability. We acknowledge the authorities' commitment to reduce the wage bill via a freeze of wages and hiring, clear the payment arrears and enhance domestic revenue mobilization (increase in both VAT on telecommunications and fuel levy, and introduction of a levy on alcohol and tobacco). We emphasize that a medium-term fiscal approach as recommended by staff is crucial, particularly the gradual reduction of the wage bill, elimination of tax exemptions and incentives, and broadening the tax base. We also welcome the authorities' efforts to strengthen the country's social safety net to protect the most vulnerable from the impact of the fiscal adjustment.

We concur with staff that maintaining a robust level of international reserves is critical to safeguard the peg to the South African rand. The current account deficit widened to 8.4 percent of GDP in FY2018/19, amid declining international reserves. We take note that, according to staff, Lesotho's external position is weaker than the level consistent with medium-term fundamentals and desired policies. Accordingly, fiscal consolidation is warranted to restore the external position to a sustainable level and avoid further deterioration of the current account.

Growth in FY2018/2019 recovered from the previous year's weak performance. We take note that over the medium-term, real GDP will be supported by the implementation of the second phase of the Lesotho Highlands Water Project. However, Lesotho's growth model driven by large public investment and current spending seems to have reached its limits. In this regard, the authorities are commended for having articulated the Private Sector Competitiveness and Economic Diversification Project, supported by the World Bank and the African Development Bank, to improve the business environment and facilitate private investment. The authorities are encouraged to continue their efforts in removing other hurdles for doing business in the areas of governance and judicial efficiency.

Continued vigilance is necessary to preserve the soundness of the financial sector. We take positive note that the banking sector is generally sound and profitable. However, we urge authorities to closely monitor the high credit concentration and household indebtedness, and implement prudential measures to limit the associated risks, if necessary. Further, while we note that Lesotho has taken steps to strengthen its AML/CFT framework, we concur with staff that stronger enforcement is necessary to bring it in line with good international practice. Moreover, we welcome the passage of the draft bills on Security Interest and Movable Property and Insolvency, which would better facilitate credit to the private sector and bolster Lesotho's structural reforms.

While Lesotho has continued to make some progress in poverty reduction, more needs to be done to ensure social and economic stability. As documented by staff (Table 6), Lesotho has made moderate progress in achieving the Sustainable Development Goals (SDG), particularly in maternal and child health and access to sanitation. However, extreme poverty, undernourishment, low life expectancy, high incidence of HIV/AIDS and tuberculosis, and high unemployment—particularly among the youth—continue to affect the population. The magnitude and complexity of these social conditions will continue to require the authorities' full attention and the unwavering support of the international community.

Ms. Pollard and Mr. Grohovsky submitted the following statement:

Lesotho's economy faces significant challenges. Declining SACU revenues have contributed to the build up of arrears and are putting pressure on the external position. While the recent budget takes steps to bring expenditures in line with revenues, implementation is key and further steps may be needed. As a complicating factor, overall unemployment and youth unemployment are at high levels, posing a development challenge in the face of needed fiscal consolidation. We generally agree with the thrust of staff's report and offer the following comments for emphasis.

Lesotho continues to be impacted by declining SACU revenues and will need to undertake a significant adjustment. We commend the level of ambition in the FY2019/20 budget but the key will be implementation, particularly on the public sector wage bill. Does staff see any other obvious areas for expenditure cuts? Arrears have started to accumulate, and we note that there is no complete survey of the arrears and the estimated stock of arrears is subject to significant uncertainty. Better data quality and understanding of the arrears is needed to begin to tackle them in a comprehensive way.

Fiscal consolidation is also needed to improve the external balance, particularly in light of the risk of external debt distress being revised from low to moderate. We endorse staff's call for expanded coverage of fiscal data. We particularly welcome the focus on the need to cover contingent liabilities in debt reports, as well as the inclusion of large contingent liabilities in the DSA. Once again, improved data will be key to the authorities' efforts to tackle their fiscal problems. Additionally, while not a substitute for necessary fiscal consolidation, could staff provide details on the authorities' plans to seek external financing—concessional or otherwise—from various sources?

While undertaking this needed fiscal adjustment, the authorities will also have to tackle structural impediments to boost growth and lower the high unemployment rate. In particular, staff note that a quarter of potential gains from their structural reform recommendations could come from improving the business environment. We welcome the attention given to business climate reforms and, specifically, the fight against corruption. The authorities' efforts to strengthen the independence of the anticorruption agency and the ongoing implementation of public sector asset declarations are much needed steps in the right direction.

Finally, we would like to highlight Lesotho being re-selected for a Millennium Challenge Compact. We encourage the authorities to use the grant resources from MCC to pursue the needed structural reforms mentioned above.

Mr. Villar and Mrs. Del Cid-Bonilla submitted the following statement:

We thank staff for their comprehensive report and Mr. Mahlinza and Ms. Nainda for their useful buff statement. We broadly agree with the staff's appraisal and offer the following comments for emphasis.

The economy is recovering but macroeconomic conditions have deteriorated. Large fiscal deficits driven by declining SACU revenues and high public sector current expenditures have worsened the current account and depleted international reserves, while giving rise to domestic arrears. According to the external sector assessment, the external position is weaker than the level consistent with macroeconomic fundamentals and desirable policies. Without the possibility of the exchange rate to act as a shock absorber, strong fiscal consolidation and fiscal discipline are of utmost importance.

We welcome the authorities’ commitment to implement the fiscal adjustment contemplated in the approved budget, and their assurances that political consensus had been formed on the agreed measures. In this regard, does staff see greater possibility of success in comparison with previous similar efforts, in particular with respect to expenditure cuts? Can staff indicate if improvements coming from the strengthening in tax administration were included in the fiscal projections?

Continued improvement of Public Financial Management is crucial for enhancing efficiency and transparency in resource allocation and reducing fiscal contingencies. Expenditure control, financial reporting and the budgeting processes are areas in need of urgent attention and as such, their inclusion as key CD priorities is accurate. Coverage of fiscal data should be expanded to include all extra-budgetary spending and debt reports must comprise contingent liabilities and guarantees of extra-budgetary funds. Can staff explain if the authorities have concrete plans to start addressing these issues and elaborate on the feasibility for the implementation of a single treasury account?

We encourage the authorities to promptly adopt the resulting recommendations of the recent IMF TA to strengthen macroeconomic data and projections, to enhance the budgetary process. We note the authorities’ request for longer-term support on PFM issues, by providing a resident advisor, as they had one previously with IMF/EU support. Given the large PFM deficiencies, does staff see feasible to meet this request? What was the experience with the previous resident expert?

Over the medium term, the strategic implementation of the structural reforms described in the report, to ensure fiscal sustainability and more effective fiscal management, is warranted. This should include a comprehensive civil service reform as well as revision and potential elimination of fiscal measures that create economic distortions and an unleveled playing field for private actors. In the same vein, addressing fiscal contingencies causing the underfunding of the pension fund will be vital.

A profound transformation of the role of the public sector would enable Lesotho to achieve higher and equitable growth potential. We welcome the authorities’ plans for increasing private sector participation in SOEs and encourage them to promptly and firmly implement the needed strategic actions. Further private sector development will only occur if clear and transparent rules are in place, as well as a leveled playfield. Reforms must include the fight against corruption which the private sector considers a major obstacle for doing business.

Strengthening the regulatory frameworks for pension funds and financial cooperatives must be a priority to contain financial stability risks. We share staff's concern that non-banking financial entities that take deposits from the public are inadequately supervised. Staff highlights that even if the Financial Cooperative Bill is approved, capacity constraints of the Ministry of Small Business Development and Cooperative may limit its effectiveness and recommends transferring supervisory powers over all deposit-taking institutions to the CBL. Given that this draft bill is already in Congress, does staff still see room to make the corresponding changes?

Improving timing and reliability of macroeconomic statistics is vital to improve macroeconomic analysis and enhance policy decisions. TA has been provided in a number of areas including national accounts, and monetary and financial statistics. We encourage the authorities to implement the resulting recommendations within the agreed target completion dates.

With these remarks we wish the Lesotho's authorities success with their future endeavors.

Mr. Ozaki and Mr. Naruse submitted the following statement:

We thank staff for their detailed reports and Mr. Mahlinza and Ms. Nainda for their informative statement. It is encouraging that the economy is recovering, reflecting enhanced political stability, an increase in production in the diamond sector, and stronger growth in the textile sector. Also, we welcome the fact that international reserves are at adequate levels and banks remain well-capitalized. However, we are concerned that accumulated domestic arrears are beginning to impact the broader economy. Also, we are concerned that the unemployment rate remains high and the financial sector plays a limited role in intermediating credit. So, we encourage the authorities to continue fiscal adjustment and address structural impediments. We also encourage the authority to enhance data transparency and reliability. As we broadly concur with the thrust of the staff's appraisal, we will limit our comments to the following points:

Fiscal Policy

We agree with the staff’s view that the authorities need to reorient expenditures in favor of growth. We are concerned that with low revenues and high expenditures result in a build-up of government payment arrears. Among others, it is worrisome that the public sector wage bill expanded to one of the largest in the world. In this respect, we positively note that the FY2019/20 budget contains measures to reduce non-priority expenses, including civil service wages, and we welcome the authorities’ firm commitment to implementing the approved budget. In addition, we underscore the importance of addressing the public financial management deficiencies, including through strengthening debt management capacity and formulating a plan for arrears clearance.

When it comes to the Debt Sustainability Analysis, we note that Lesotho’s risk of external debt distress has been revised from “low” in the 2017 Article IV to “moderate”. As Ms. Pollard and Mr. Grohovsky in their gray, we endorse staff’s call for expanded coverage of fiscal data. We also have concern about the risk coming from PPP, lowering concessionality and the realization of a contingent liabilities shock.

Financial Sector Policy

While the banking system is sound and profitable, we expect the authorities’ continuous reforms to enhance the financial sector’s contribution to growth. We encourage the authorities to improve access to credit further, including through ensuring adequate legal frameworks and processes to settle financial disputes. In addition, credit concentration and household indebtedness require close monitoring. Furthermore, improving the regulation of the non-bank financial sector is needed to contain financial stability risks. Lastly, we welcome the steps taken by the authorities to strengthen the AML/CFT supervision, and we expect its adequate enforcement.

Structural Reform

We agree with the importance of advancing private sector growth and human capital development. We welcome the authorities’ ongoing efforts to attract investment and diversify the export base. Also, we agree with the staff’s call for strengthening the business climate, including through fighting against corruption and addressing market failures while promoting competition and efficiency. Furthermore, we note that many Lesotho’s labor force has at most a primary education despite large expenditure in education. As staff say, we see room for the authorities to improve efficiency in social spending and support labor force participation, especially among the young.

Mr. Johnston and Mr. Amor submitted the following statement:

We thank staff for their reports and Mr. Mahlinza and Ms. Nainda for their informative buff statement. Lesotho shares challenges similar to many developing states, including a lack of diversification, capacity constraints, and high levels of poverty and unemployment. With SACU revenues falling below historical averages, and government expenditures persistently high, fiscal difficulties are elevated, and government payment arrears are emerging. The renewed political stability is encouraging, and presents an opportunity to restore fiscal and external sustainability and enhance the investment climate to support private sector growth.

Given the downward trend in SACU revenue and the lack of a domestic debt market, a strong push is needed to realign spending. We welcome the steps the authorities have taken in this direction, including the substantial consolidation through both revenue and expenditure measures envisaged in the FY2019/20 budget. These include initiatives such as pay reductions, cuts to travel budgets, and a hiring freeze. The authorities can benefit from the Fund's TA to support PFM reforms, particularly in expenditure control, budgeting processes and debt management. Noting the absorptive capacity issues highlighted by staff, long-term TA may be more appropriate to ensure greater impact.

While Lesotho's DSA risk rating has been changed to "moderate," the authorities should continue utilizing concessional borrowing and grant financing as much as possible to balance fiscal consolidation objectives with the need to safeguard economic growth and poverty reduction.

We welcome the authorities' plans to implement policies that improve the business climate and support private sector growth in the new National Strategic Development Plan (NSDPII). The NSDP's focus on supporting labor-intensive industries like manufacturing and tourism could address unemployment and poverty issues. Diversification of the highly-concentrated exports sector would help to lower vulnerabilities and broaden the benefits of growth. Initiatives to facilitate business registrations, shorten the process to obtain permits and improving access to export markets should continue. We also commend the authorities for pursuing anti-corruption measures and encourage continued efforts to strengthen the role of the Directorate of Corruption and Economic Offences, and implement an asset declaration framework for public servants.

We note that another El-Nino related drought is expected to hit Lesotho this year, which could trigger a food security crisis and impose substantial costs from food subsidies and crisis management. The last drought in 2016 resulted in response cost of 2 percent of GDP. Can staff comment on what actions the authorities are taking to enhance agricultural resilience to these climate-induced events?

Ms. Levonian and Mr. Williams submitted the following statement:

We thank staff for their informative report, which has articulated a coherent mix of policy advice to advance fiscal sustainability and external viability and stimulate job-rich growth. The authorities are advised to take advantage of the improved political environment to accelerate much-needed macrofiscal and structural reforms. In this regard, we note with optimism the remarks in Mr. Mahlinza and Ms. Nainda’s insightful buff statement of significant progress to restore peace and political stability, as well as the government’s recognition of the criticality of undertaking adjustments to address vulnerabilities. We broadly concur with staff’s assessments and recommendations and offer the following remarks for emphasis.

We welcome recent actions to tackle fiscal imbalances, however, further efforts will be needed to entrench fiscal discipline and support debt sustainability. Budgeted measures to contain current spending - particularly reducing the sizeable wage bill - are steps in the right direction. We also welcome plans to raise consumption taxes and make revenue flows less reliant on Southern African Customs Union (SACU) sources. These adjustments once implemented will be key to tightening the lid on domestic payment arrears, fostering budget credibility, and scaling up spending on social services. Looking ahead, the authorities’ consideration of a fiscal rule is welcome. We encourage staff to provide the requisite support to the authorities to ensure that the fiscal rule is designed to take account of capacity constraints and data limitations and is sufficiently tailored to Lesotho’s circumstances.

Reducing the state’s footprint in the economy and easing structural impediments will be integral to invigorating inclusive growth over the medium term. Public sector activity remains a key driver of growth and Lesotho’s economic base is narrow, limiting job opportunities. Against this backdrop, we welcome the slate of initiatives set out in the National Strategic Development Plan (NSDP II) geared toward promoting private sector-led growth. In this regard, we encourage the authorities to prioritize efforts to improve the business environment, including stepping up the fight against corruption. At the same time, the authorities should seek to reorient the budget toward growth-friendly expenditure while preserving social protection. Public sector reform aimed at, inter alia, reducing the wage bill will free of resources to upgrade the country's infrastructure and improve human capital. To boost growth and employment prospects, we urge the authorities to push ahead with efforts to further deepen financial inclusion.

Mr. Agung and Mr. Srisongkram submitted the following statement:

We thank staff for the concise report, and Mr. Mahlinza and Ms. Nainda for their informative buff statement.

We note that the Lesotho economic recovery is underway, and growth is expected to be driven largely by government infrastructure projects over the next couple of years. The outlook is nevertheless subject to major downside risks stemming from fiscal-related challenges including the impact of declining SACU revenues on the fiscal balance, and buildup of domestic arrears. Policy priority should therefore be to strengthen the country's fiscal and external positions, and to promote job creation through private sector development. We agree with the broad thrust of staff's appraisal and offer the following comments for emphasis.

Fiscal restraint will be key to put fiscal balance on a firmer footing and strengthen the country's external position. Under prospects of lower SACU revenues, expenditure rigidities could contribute to further build up of government arrears and could put the credibility of the currency peg at risk. In this regard, we welcome the authorities' commitment to implement the ambitious fiscal consolidation plans under the FY2019/2020 budget which seeks to better realign spending with available resources. The planned expenditure cuts are necessary steps towards reducing the country's public sector wage bill which is among the largest in the world. Revenue measures to broaden the tax base are also welcomed as it capitalizes on the Lesotho's strong revenue mobilization. We agree with staff on the need to consider additional measures to foster stronger fiscal discipline and ensure debt sustainability over the medium term including by reforming the civil service, rationalizing expenditure to make room for needed social and capital expenditures, implementing a fiscal rule to entrench debt sustainability, and address weaknesses in public financial management. We note that expenditure cuts in the budget 'have proven difficult to implement in the past'. In staff's view, has today's context changed in a way that present a better chance for more successful fiscal consolidation aside from the political consensus? If so, how? What would be staff's recommendation in the alternate scenario on page 9?

Policies should focus on fostering an environment conducive to advancing private sector's role for stronger and more inclusive growth. We agree with staff that reducing the country's large wage bill is needed not only to free up budgetary resources for public agencies to carry out their core functions, but also to encourage greater employment in the private sector where skills could be better matched. This combined with SME development initiatives should help address skill mismatch and high unemployment to an extent. On competition, we concur with staff that the imposing new regulations on key domestic industries must be carefully considered and discussed with stakeholders to avoid unintended consequences and welfare losses that may arise from creation of new market dominance. More broadly, we share staff's view that the government should take a backseat role in driving industry growth, focusing on creating a stable business climate and providing time-limited support as needed.

We support staff's call to expeditiously enact authorities' agenda to enhance financial sector's contribution to growth, and to strengthen supervision of NBFIs. We take positive note of the passing of two draft bills on Security Interest and Movable Property, and Insolvency, and encourage authorities to address remaining impediments to improve broader access to credit. We are pleased to learn that the authorities are working closely with different stakeholders to broaden access to financial services, particularly to help ensure sound mobile money platforms which is instrumental to deepen financial inclusion especially among rural populations. Given the large roles of NBFIs, it is imperative that relevant regulations and standards are put in place to ensure that they perform their intermediary functions prudently and that consumer protection is adequate. To this end, we look forward to the timely approval of the Financial Cooperative Bill to empower the MoSBDCM in addressing troubled cooperatives. While we see merit in staff's suggestion to eventually transfer supervisory power to the CBL, there may be scope for the CBL to play advisory roles in alleviating some of the MoSBDCM's capacity constraint as appropriate.

We wish the authorities every success in their future endeavors.

Mr. Sigurgeirsson and Mr. Vaikla submitted the following statement:

We thank staff for the report and Mr. Mahlinza and Ms. Nainda for their informative buff statement. While we commend the authorities for their significant efforts in restoring peace and stability, the economy continues to be vulnerable to challenges. In light of the fiscal pressures resulting from declining Southern African Customs Union (SACU) revenues, we encourage the authorities to implement a strong fiscal adjustment to narrow the fiscal deficit, clear government arrears, protect the peg, and secure debt sustainability. We broadly share staff's appraisal and agree that given the fiscal vulnerabilities, policies should aim at cutting expenditures while protecting the most vulnerable.

A decisive fiscal adjustment is needed following the sharp fall in SACU revenues to clear government arrears, safeguard the peg, and secure debt sustainability. We take note of the implementation of fiscal measures in the recently-passed FY2019/20 budget and welcome the authorities' declared commitment towards implementing further fiscal stabilization measures. We also welcome the authorities' plans to embark on a tax modernization overhaul program and establish a fiscal rule aimed at regulating volatility in SACU revenues and protecting debt sustainability. Given the very high public wage bill, it is clear that significant efforts will be needed to cut public wages in order to reduce fiscal spending and foster private sector labor participation. We also encourage the authorities to broaden the tax base, enhance revenue collection, and improve public administration to complement expenditure measures. Moreover, we agree with staff that the authorities should make efforts to improve debt management and address contingent liabilities.

We welcome the authorities' commitment to implement economic reforms and foster private sector growth, which should enhance potential economic growth. We commend the authorities for developing a comprehensive structural reform agenda for private sector led growth based on tourism, agriculture, manufacturing, and technology. However, we fully share staff´s view that realizing the economy´s full potential requires a significant transformation of the role of the public sector. In that regard, it is vital that the government provides a stable and business-friendly environment.

Reducing corruption would enhance the business climate and attract foreign investments. We commend the authorities for their declared efforts to strengthen the fight against corruption with their plan to consider a new anti-corruption bill that will increase the independence of the Directorate of Corruption and Economic Offences (DCEO). While these initiatives are welcome, we concur with staff that it is also important to improve the collaboration between the DCEO and the Directorate of Public Prosecutions. Finally, the strong enforcement of the AML/CFT supervision framework will be necessary to address identified shortcomings in that field.

An enhanced effort to imporve statistics is needed to guide policy making. We urge the authorities to enhance data transparency and reliability by strengthening national account statistics, including largest extra budgetary units to fiscal data and adding contingent liabilities and guarantees to debt reports.

Mr. Rashkovan and Mr. Etkes submitted the following statement:

We thank staff for the well-written Article IV report as well as Mr. Mahlinza and Ms. Nainda for their enlightening buff statement. We broadly agree with staff's appraisal and provide the following comments for emphasis.

Lesotho's main challenge is the structural deficit, which stems from the very high public sector premium achieved when the SACU revenues were larger. This structural fiscal deficit weakens the fiscal and external positions, depletes the country's reserves, and may threaten the peg to the rand. Staff advises reducing the public wage bill by a combination of a hiring freeze and canceling cost of living increases. These steps are likely to reduce the public wage bill only gradually. We wonder whether other steps could reduce the public wage bill more effectively and rapidly. For instance, can a very progressive income tax reduce the net public sector premium? Similarly, can a devaluation of the Maloti reduce the share of public wage bill in the GDP, boost exports by the private sector and improve the external position? Staff comments are welcome.

Staff cites the Food and Agriculture Organization's indication that another El-Nino-related draught may hit Lesotho this year. The 2016 draught worsened malnourishment and as a result, food subsidies increased, and the cost of the draught came to about 2 percent of GDP. A similar draught in the future might have another devastating fiscal effect due to the initially weaker fiscal position. We think, that creating fiscal space for events like a draught is another reason for an upfront, rather than a gradual, fiscal consolidation. We recall staff's findings that investment in a natural-disaster-resilient-infrastructure is expected to increase growth in the Caribbean countries (REO briefing April 2019), and wonder whether Lesotho invested or can invest in water preserving technologies and draught-resilient-crops, which could reduce the adverse impact of future draughts.

We commend the authorities for the steps they undertook to strengthen their AML/CFT strategy while we expect the implementation of the planned anti-corruption measures. We particularly agree with staff's advice to cement the independence of the FIU and provide it with adequate resources. The AML/CFT measures together with the anticipated anti-corruption law are also likely to improve the easiness of doing legitimate business (Annex IV) and may eventually help mitigating the fiscal deficit. We wonder whether Lesotho's FIU formally cooperates with FIU's in other jurisdictions, particularly in the rand zone, and if it is efficient to avoid moving proceeds of corruption to neighboring territories?

Mr. Sun and Ms. Cai submitted the following statement:

We thank staff for the informative report and Mr. Mahlinza and Ms. Nainda for the useful buff statement. Capital intensive projects and government consumption have driven growth in Lesotho over the past decades. Nevertheless, below-historical-average Southern African Customs Union (SACU) revenues and persistently high government expenditure have led to the emergence of government payment arrears. Going forward, continued actions are needed to further improve fiscal resilience. We broadly agree with staff's appraisal and would like to limit our comments to the following for emphasis.

Fiscal discipline is the central pillar for sustainable and inclusive growth. Lower SACU revenues and expenditure rigidities have put pressures on fiscal policy. The revenue measures such as increasing VAT rate are steps in the right direction. More efforts are needed to address the deficit, including comprehensive civil service reforms in the medium term. We are encouraged to see that the authorities remain strongly committed to implementing the 2019/20 Budget and the Tax Modernization Program. Given the difficulties to implement expenditure cuts, we encourage the authorities to develop contingent plans to ensure the success of the fiscal adjustment. Meanwhile, fiscal consolidation should be conducted in a growth-friendly way and ensure better protection of the most vulnerable people.

Debt management should be further strengthened to reduce risks and enhance efficiency. Debt risk is still under control, although the risk of debt distress has been revised from low to moderate. We encourage the authorities to closely monitor domestic contingent liabilities to have a more comprehensive view of debt. Developing the domestic debt market can provide an alternative financing source and reduce exchange rate risks. We see merit in staff's suggestions, including more frequent issuances and imposing domestic asset requirements on pension funds without hampering their abilities to optimize asset allocation.

Notwithstanding Lesotho's stable financial sector, more needs to be done to address low financial intermediation and concentration risks. Credit to the private sector has remained stagnant at about 17 percent of GDP in the past five years, calling for the needed structural reforms. It is encouraging that a credit registry has been created and a credit scoring system is being developed. Meanwhile, more efforts are needed to lower credit costs and enhance legal frameworks and processes to settle financial disputes.

Addressing structural impediments is also important for long-term growth. Raising the efficiency of education and health spending should be a priority to improve labor productivity and reduce inequality. More efforts are needed to address high unemployment, including developing productive and labor-intensive sectors and increasing wage flexibility and their link to productivity. We concur with staff that government intervention in the economy should seek to address market failures while promoting competition.

With these remarks, we wish the authorities every success in their policy endeavors.

Mr. Benk and Mr. Stradal submitted the following statement:

We thank staff for their informative paper and Mr. Mahlinza and Ms. Nainda for their helpful statement. We concur with the thrust of staff's appraisal and policy recommendations.

The social outcomes of Lesotho's economic policy are very weak and economic growth is grossly insufficient to lift a large share of the population out of poverty. We welcome the recent relative political stability but note its fragility which makes the set of necessary reforms difficult to legislate and implement. The risks are skewed to the downside and include a loss of tariff-free access to the US market under the African Growth and Opportunity Act conditional on imminent constitutional, political, and public sector reforms recommended by the Southern African Development Community. Could staff assess the likelihood and potential impact of this particular risk?

Restoring fiscal discipline by realigning the expenditures to the permanent decrease in the South African Customs Union's revenues is essential for preserving macroeconomic stability. The consolidation projected in the 2019/2020 budget is a welcome step in the right direction, but steadfast implementation is of utmost importance. The public wage bill should bear the brunt of the consolidation to preserve space for much needed investments. Broadening the tax base, enhancing revenue collection, and improving the public administration should complement the expenditure side measures. We encourage the authorities to stem the accumulation of arrears expeditiously before they become a systemic problem.

Structural reforms aimed at improving the business climate are key for the declared goal of accelerating the private sector led growth. Strengthening the legal certainty and contract enforcement, simplifying the complex regulation, as well as tackling the pervasive corruption should be prioritized. We also encourage the authorities to enhance competition by privatization of state-owned companies not considered strategic.

We call on the authorities to improve the quality of data which are essential for informed policy making. We support the capacity development efforts aimed at enhancing the fiscal reporting including the domestic arrears and contingent liabilities and encourage the authorities to use this opportunity for knowledge transfer to have a lasting impact.

Mr. Inderbinen and Ms. Urbanowska submitted the following statement:

We thank staff for the informative report and Mr. Mahlinza and Ms. Nainda for their helpful buff statement.

Lesotho continues to face significant vulnerabilities. Growth has slowed in recent years, resulting in low job creation, and inequality remains high. While we note the improved performance in the mining and textile industries, reliance on volatile SACU revenues is strong, the public sector is dominant, and weaknesses in public financial management translate into an ineffective service provision. Therefore, we encourage the authorities to press ahead with the needed reform agenda to restore fiscal and external sustainability, complemented by steps to facilitate private sector development. We note the broad agreement between staff and the authorities and welcome the acknowledgement by the authorities that adjustment has become critical.

Fiscal consolidation remains essential to restore macroeconomic stability. The decline in SACU revenues and the singularly high public wage bill have contributed to a substantial weakening of the fiscal position and have led to the emergence of government arrears. We agree with staff’s recommendation that decisive measures on both the revenue and expenditure sides are of the utmost importance. In particular, a reduction in the wage bill, including via a hiring freeze, as intended by the authorities, would help bring spending more in line with available recourses. We echo staff’s call for a comprehensive civil service reform. Furthermore, addressing the PFM inefficiencies outlined in paragraph 20 of the staff report would seem critical. The authorities' intention to introduce legislation on a fiscal rule, as mentioned in the buff, is encouraging. Is the Ministry of Finance's proposal in line with staff's work cited in the report; and has FAD provided TA? We would welcome staff's comments.

Strengthening the business climate and promoting SMEs development would attract private investment and generate growth. We welcome the ambitious reform agenda based on the new National Strategic Development Plan—NSDP II for private sector-led growth, including the development of industrial parks, as highlighted in the buff. As flagged by staff in Annex IV, efforts toward strengthening governance, reducing red tape and corruption, and promoting competition in the goods market will be crucial to build domestic capacity, attract investment, and achieve higher growth.

Structural reforms will be critical to increase the banking system's role in providing credit to the private sector. Access to credit is one of the main factors for allowing the country to grow and reduce the poverty level. We take note that mortgages have been the fastest growing financial product, which calls for a closer monitoring of the rising household indebtedness. In this context, we welcome the creation of a credit registry. While the increased access to financial services remains a top priority, the authorities' financial inclusion agenda needs to be further streamlined and calls for better supervision. Moreover, we acknowledge the progress made in establishing the framework for non-banking supervision; however, as staff emphasize, the enforcement of the AML/CFT provisions is key. We welcome the Fund's continued TA engagement in this regard.

Mr. Raghani and Mr. Diakite submitted the following statement:

We thank staff for the comprehensive reports and Mr. Mahlinza and Ms. Nainda for their informative buff statement.

We welcome the ongoing economic rebound in Lesotho and the favorable medium-term growth forecasts amid downside risks which require vigilance. The positive prospects are supported by the important Lesotho Highlands Water Project and developments in the textiles and diamonds sectors. Notwithstanding, the outlook is subject to risks stemming notably from weak fiscal discipline and public financial management, external spillovers and precarious rainfalls. Against this backdrop, it is important that the authorities pursue sound macroeconomic policies aimed notably at addressing domestic arrears and the high wage bill, ensuring debt sustainability and securing a sustainable external position. Structural reforms will also be needed to promote private sector development and tackle the high unemployment rate, notably among the youth. While implementing their policies and reforms agenda, the authorities should seek the broadest consensus possible on ways to enhance governance and accountability which would help foster strong and inclusive growth.

We broadly agree with staff's assessment and policy advice and would like to make the following comments for emphasis.

We commend the authorities for their revenue collection efforts and welcome the recent fiscal consolidation measures which should help address fiscal challenges. The adjustment measures aimed at bringing the fiscal deficit in line with available financing should be steadfastly implemented to reduce the level of arrears and improve expenditure efficiency, including the raise in some excise taxes, the freeze in civil service hiring and wages, and reduction in travel costs. We also urge the authorities to take measures to protect the most vulnerable from the negative impact of the adjustment. We agree that medium-term reforms will be needed to strengthen fiscal sustainability in a durable manner going forward. This will entail notably the reform of public sector employment to put the wage bill on a sound footing, improving public financial management to strengthen budget processes, enhancing expenditure controls and strengthening debt and cash management. We concur that once these reforms are carried out, adopting a fiscal rule would help reduce the volatility of revenue from the South African Customs Union (SACU), reinforce debt sustainability and consolidate the credibility of fiscal policy.

While Lesotho's financial sector remains sound and profitable, it will be important to continue monitoring closely household indebtedness and credit concentration. We note positively the efforts to improve information from the credit bureau and extend information coverage beyond the formal sector as indicated in the buff statement. In this regard, we would appreciate staff's comments on practical ways in which the credit bureau could collect data on informal entrepreneurs and make this information available to financial institutions. Adopting a risk-based approach in non-bank financial institutions (NBFI) supervision is warranted given the significant share of NBFI in the financial system. We view the enactment of the bills on Security Interest and Movable Property as important steps to ease access to credit and foster deeper financial inclusion. Can staff elaborate on policies to promote activities of microfinance institutions if any? While the enhancing of the AML/CFT framework is commendable, further steps should be taken to strengthen enforcement and institutional effectiveness.

The authorities' policy efforts should also focus on improving human capital, social indicators and unemployment, particularly among youth. Enhancing the efficiency and delivery of public services by reforming the public sector will ease the implementation of the National Strategic Development Plan (NSDP-II) and contribute to achieving a conducive environment for growth. In addition, the authorities should tackle the impediments to private sector development, by notably improving the business climate and implementing a stable regulatory framework.

With these remarks, we wish the authorities of Lesotho success in their endeavors.

Mr. Palei and Mr. Snisorenko submitted the following statement:

We thank staff for the reports on Lesotho and Mr. Mahlinza and Ms. Nainda for their helpful buff statement. The Lesotho economy modestly recovered in 2018 from the weak growth in 2017. However, the authorities face significant policy challenges stemming from the declining Southern African Customs Union (SACU) revenues, high government expenditures, and the lack of diversification in the economy. High poverty, income inequality, and the prevalence of HIV/AIDS put additional pressures on social spending. We broadly agree with staff's appraisal and offer the following comments for emphasis.

Fiscal consolidation is crucial to maintaining macroeconomic sustainability. High wage-bill and low expenditure efficiency put a drag on economic development. The reduction of fiscal buffers limits the policy space and calls for urgent fiscal adjustment. We welcome the fiscal measures aimed at 4 percent of GDP consolidation envisaged in the recently passed FY 2019/20 budget. At the same time, we note that, according to staff estimates, the implementation of these measures may deliver less than 2 percent of GDP. Could staff provide more details on the main reasons for discrepancy between staff's and authorities' estimates? We agree with staff that establishment of an effective fiscal anchor should smooth the growth impact from revenue shocks and preserve debt sustainability. As authorities are considering introducing a fiscal rule, could staff elaborate on its possible design?

We agree that, at this stage, the fixed exchange rate regime provides a credible monetary policy anchor and supports low and stable inflation. However, according to the EBA-lite model, the external position of Lesotho is estimated to be weaker than the level consistent with medium term fundamentals and desirable policies. More flexible exchange rate regime could have facilitated the macro adjustment needed to sustain external balance. Could staff elaborate on whether the possible benefits of the fixed exchange rate outweigh its costs? At what point, in staff's view, moving to a more flexible exchange rate regime would be advisable for Lesotho?

Continued vigilance is integral to preserving financial sector soundness. While rising use of mobile money services indicates progress in financial access and inclusion, the authorities should continue to closely monitor any build-up of financial risks. At the same time, traditional banking system could facilitate growth based on acceleration in reforms of the legal framework, more reliable and streamlined processes to settle financial disputes, and better defined property rights. Regulatory framework for pension funds and financial cooperatives also requires strengthening. Deepening of the capital market should further enhance the financial sector's contribution to growth.

In order to increase the economic potential, the authorities need to advance private sector development and transform the role of the public sector. Ensuring that public expenditures are aligned with policy goals, while the private sector is provided with a clear, transparent and stable policy environment, is among the key prerequisites for sustainable private sector led-growth. The new National Strategic Development Plan (NSDP-II) rightly prioritizes the improvement of the business climate, governance, human capital, and infrastructure. Given the high unemployment, especially among the youth, its focus on the development of labor-intensive industries, such as manufacturing and tourism, is highly relevant. Anti-corruption initiatives, such as asset declaration for public servants and strengthening the independence of the anticorruption agency, are the steps in right direction.

Mr. de Villeroché submitted the following statement:

We thank staff for its insightful and comprehensive set of reports. We also thank Mr. Mahlinza and Ms. Nainda for their helpful buff statement.

We broadly agree with staff's appraisal and we would like to highlight the following points for emphasis.

After a slowdown in 2017/18, economic growth is recovering. However, poverty remains high, especially in rural areas, and one-third of youths are unemployed. Moreover, high prevalence rate of HIV/Aids is a major social and economic challenge that has to be addressed. Against this background, the efforts made for improving the SDG indicators, as laid out in table 6, have to be continued.

Regarding the growth outlook, the Lesotho Highlands Water Project (LHWP) should result in positive spillover effects for the economy, especially through the construction sector. Indeed, the second phase of the LHWP represents an investment amounting 50 percent of GDP fully financed with grants coming from South Africa. Could staff indicate if the funding of this project through grant instruments is fully secured? We also note that the diamond and textile sectors have positive prospects. Having said that, we think that the growth projection remains rather low for a country with a GNI per capita at 1,270 USD. Looking forward, the National Strategic Development Plan (NSDP) covering the period 2019-2023 will have to promote a broad-based economic growth through a strengthening of the private sector. In that regard, we value the analysis provided on the Annex IV about the growth impact of the structural reforms which could be done under the NSDP.

The risk of debt distress has been revised from low to moderate since the last Article IV review and we agree with staff that the authorities have to implement a fiscal adjustment to restore fiscal sustainability and preserve the peg to the South African rand (as underlined in the External Sector Assessment). We note positively the expected measures under the FY2019/20 budget but we consider that a medium-term fiscal objective is warranted to preserve macro stability and enable economic growth acceleration. This is critical because SACU revenues will remain volatile and could stay on a downward trend over the long run. As staff, we consider that there is room to rationalize the public wage bill, the management of PPP contracts, the social targeting of the student loan program, as well as to tackle Based Erosion and Profit Shifting issues in extractives. Regarding social protection, we welcome the authorities' initiatives to enlarge the coverage and efficiency of social protection programs in order to protect the poorest from the impact of the fiscal consolidation. As staff, we consider that the fiscal adjustment should consolidate macro stability while enabling a more inclusive growth path, notably through better targeted expenditure.

We note that the priorities of the Capacity Development strategy laid out in Annex VI are focused on three main sectors: Public Financial Management, National Accounts and Government Finance Statistics, as well as Financial Sector Supervision. It seems that major expenditure-side issues are not addressed as such, in particular in the field of social expenditure management and targeting which is however considered as critical by staff.

Could staff indicate how the CD strategy addresses the need to protect the most vulnerable of the impacts resulting from the fiscal consolidation?

The Acting Chair (Mr. Zhang) made the following statement:

As the gray statements pointed out, Lesotho has been facing severe fiscal difficulties for some years, and during these years, attaining political consensus on the necessary adjustment and reforms also proved to be elusive. But in recent years, particularly this year, the authorities came to understand that the delay of these adjustments or reforms could further jeopardize macroeconomic stability, so they passed a budget which includes some strong measures for fiscal consolidation, which is a welcome step.

Looking ahead, challenges remain, particularly in terms of engineering the fiscal adjustment together with the structural reforms that could deliver economic diversification and create more jobs. There are a wide range of issues highlighted in Directors' gray statements, but the structural reforms to tackle the constraints for private sector participation, including to tackle corruption, would be key.

Mr. Al Hafedh made the following statement:

We thank the staff and Mr. Mahlinza and Ms. Nainda for their buff statement and the staff for the report. We broadly share the staff's conclusions and policy recommendations. We did not issue a gray statement, but we would like to highlight a few points for emphasis.

First, restoring fiscal discipline is a key priority in the short-term, and we welcome the budget approval and passage, which would address major fiscal imbalances and help bring expenditure in line with available resources. As Ms. Pollard highlighted, implementation is key, and further steps may be needed. Particularly, the authorities should effectively address public financial management (PFM) deficiencies, inefficient public spending, and broaden the tax rate to reduce arrears while easing the burden adjustment on the vulnerable, all of which are necessary steps to underpin fiscal sustainability.

Second, we concur with the staff on the need to enhance governance. The authorities are also encouraged to incentivize the private sector by enhancing access to credit, maintaining regulatory stability, reforming the public sector's role and governance, and tackling low human capital.

Finally, we share Mr. Lopetegui's view on the fundamental challenges, the extreme high unemployment, high poverty, and HIV infections, thus requiring further fiscal and structural measures. In this context, we urge the authorities to step up their efforts to address these challenges. With these remarks, we wish the authorities well. Thank you.

The staff representative from the African Department (Mr. Thornton), in response to questions and comments from Executive Directors, made the following statement:[3]

I would like to respond to questions raised by Directors on three policy areas: the feasibility of the fiscal adjustment, the potential fiscal rule, and the role of the exchange rate peg.

Directors asked the staff to elaborate on the potential implications of political risks for the envisaged fiscal consolidation. The authorities widely recognize the need to buttress macroeconomic stability and reduce vulnerabilities, and their determination to implement an ambitious budget has been reiterated in the buff statement. A number of measures have already taken effect, including the zero cost of living adjustment for civil servants and an increase in the tax on fuel. Other measures, such as the increase in tobacco and alcohol levies, will require additional legislation.

As noted in the staff report, the political environment is a complex and evolving one with the ruling coalition constituting a grouping of four political parties. In such an environment, political consensus is always delicate. However, the budget as described in the staff report, has now been approved by parliament and some of the key measures enacted.

Directors inquired about the role of a fiscal rule in Lesotho. The objective of a fiscal rule would be to better insulate the economy from the volatile SACU revenues that constitute such a large share of their receipts. This is a common problem to all South African Customs Union (SACU) countries, particularly the smaller ones, and is in part dictated by the design of a revenue-sharing formula. The authorities in Lesotho have indicated their willingness to adopt a fiscal rule, and the staff have provided the authorities with background material and a scenario database on fiscal rules, but the final decision on the design of a fiscal rule has yet to be taken. At the same time, discussions are ongoing at the SACU level on potential changes to the revenue-sharing formula.

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[3] Prior to the Board meeting, SEC circulated the staff's additional responses by email. For information, these are included in an annex to these minutes.

Finally, Directors asked about the benefits of the exchange rate system in Lesotho. The authorities view the peg to the rand, which has been in place since the currency was first conceived, as having served the country well. Staff concurs that the peg has provided a valuable anchor for macroeconomic stability and note that it is important to continue to improve the business climate to ensure the maintenance of competitiveness.

Mr. Mahlinza made the following concluding remarks:

On behalf of my authorities, I thank Directors for their support toward the completion of the 2019 Article IV consultation for Lesotho. Their constructive views and recommendations will be conveyed to the authorities. In their written statements and gray statements, Directors have welcomed the progress made in restoring peace and stability. Building on this, the current government has taken steps to put in place measures to ensure macroeconomic stability, generate growth, and create employment. As a result, the economic growth outlook is positive, with an expected improvement in the performance of the construction sector, supported by the second phase of the Lesotho Highlands Water Project and strong growth in the mining sector. In this context, the authorities wish to assure Directors of their commitment to steadfastly implement the national reform agenda.

Directors have underscored the need to achieve the comprehensive fiscal adjustment by reducing the high public wage bill, amongst other things. My authorities recognize this challenge and are focusing on reducing the public sector wage bill through a wage and hiring freeze that commenced in the current fiscal year. This is further supported by strong commitment at the leadership level, demonstrated by a pay cut for ministers and the reduction of benefits for senior officials.

On the expenditure side, the authorities have proposed significant spending adjustments in the 2019-20 budget. In addition, the new integrated financial management system would enhance budget controls and better align spending with the available resources to improve debt management. The government is finalizing a public debt and aid management act. This will clearly ensure that the government's borrowing needs and payment obligations are met at the lowest cost over the medium term with an acceptable and prudent degree of risk. At the same time, the government established a securities market to support the overall development of the domestic debt market. Further complementing this, the authorities have requested Fund technical assistance to facilitate the development of a secondary market for debt.

Implementing structural reforms aimed at improving the business climate and promoting private sector-led growth is a component of the national strategic development plan. The authorities recognize that the high levels of unemployment are the main causes of poverty and also contribute to the low levels of domestic demand in the economy. To ease the current pressure, the government has established a public works and internship program to help the beneficiaries establish their own businesses or find new jobs. Furthermore, the authorities recognize that creating more employment and income-generating opportunities should be driven by the private sector and facilitated by appropriate interventions and policies of the government.

In conclusion, I wish to thank the new mission chief, Mr. Thornton, and his team for the robust engagement with the Lesotho authorities during the discussions and for responding to Directors' comments this afternoon. The authorities continue to welcome strong collaboration with the Fund as well as bilateral and other multilateral partners, and in this respect, also wish to thank the United States for Lesotho's recent actions in the Millennium Challenge Compact.

The Acting Chair (Mr. Zhang) noted that the Kingdom of Lesotho is an Article VIII member and maintained an exchange restriction. The staff did not recommend approval of those restrictions, and no decision was proposed.

The following summing up was issued:

Executive Directors agreed with the thrust of the staff appraisal. They welcomed the progress made in restoring peace and stability. However, Directors noted that Lesotho continues to face significant challenges, stemming mainly from the declining Southern African Customs Union (SACU) revenues and high government expenditures. Against this background, Directors underscored the need for both short and medium-term measures to preserve fiscal and external sustainability, as well as generate strong and inclusive growth.

Directors welcomed the ambitious FY 2019/20 budget and emphasized that its strict implementation will be key to preserving fiscal sustainability, especially in terms of clearing the accumulated arrears and strengthening the external position. They underscored the importance of strengthening expenditure controls, resisting pressure to enact additional spending, and improving tax administration. Directors recommended improvements to debt management, a prudent approach to debt contracting, and addressing contingent liabilities related to the public-sector pension fund to strengthen debt sustainability.

Directors emphasized that the fiscal adjustment needs to be reoriented to favor growth and efficiency. Reducing the high public wage bill over time will provide space for the authorities' strategic priorities. Directors also stressed the need for greater efficiency in health and education spending to ensure better outcomes. Enhanced public financial management, including through improved financial reporting and cash management, will accelerate the clearance of arrears. Directors welcomed the authorities’ efforts to protect the most vulnerable from the impact of the adjustment.

Directors welcomed the steps being taken to strengthen the financial sector's contribution to growth. They highlighted the need to continue to closely monitor household indebtedness and credit concentration as well as to further enforce the AML/CFT framework. Improvements to the regulation of the non-bank financial sector will also be needed to support the financial inclusion agenda.

Directors supported efforts to encourage job creation and underscored the need for continued improvements to the business climate. They highlighted the importance of a stable regulatory framework, with greater engagement with the private sector prior to the introduction of new regulations.

It is expected that the next Article IV consultation with the Kingdom of Lesotho will be held on the standard 12-month cycle.

APPROVAL: April 15, 2020

JIANHAI LIN
Secretary

Annex

The staff circulated the following written answers, in response to technical and factual questions from Executive Directors, prior to the Executive Board meeting:

Outlook/Risks

1. ***Could staff elaborate on political risks and their implications on economic policymaking?***

- Staff will address this in the oral intervention.

2. ***The risks are skewed to the downside and include a loss of tariff-free access to the US market under the African Growth and Opportunity Act conditional on imminent constitutional, political, and public sector reforms recommended by the Southern African Development Community. Could staff assess the likelihood and potential impact of this particular risk?***

- Losing AGOA would have a severe negative impact on Lesotho's manufacturing sector, which currently serves as a major source of employment. The authorities have taken action in recent years to address some of the major issues that could have affected AGOA's status, and these actions have also enabled Lesotho to restart negotiations with the Millennium Challenge Corporation on a new compact.

Fiscal Policy

3. ***We welcome the fiscal measures aimed at 4 percent of GDP consolidation envisaged in the recently passed FY 2019/20 budget. At the same time, we note that, according to staff estimates, the implementation of these measures may deliver less than 2 percent of GDP. Could staff provide more details on the main reasons for discrepancy between staff's and authorities' estimates?***

- As discussed in footnote 6 of the Staff Report, staff have taken a more conservative view on the projected FY 2019/20 fiscal outturn. The largest difference is with regard to non-tax revenue, where staff do not see strong ground for the very large increase. In the absence of concrete measures, staff have also retained higher projections for subsidies and social benefits.

4. ***Does staff see greater possibility of [fiscal consolidation] success in comparison with previous similar efforts, in particular with respect to expenditure cuts?***

- Staff will address this in the oral intervention.

5. ***In staff's view, has today's context changed in a way that present a better chance for more successful fiscal consolidation aside from the political consensus? If so, how? What would be staff's recommendation in the alternate scenario on page 9?***

- Staff will address this in the oral intervention.

6. ***Does staff see any other obvious areas for expenditure cuts?***

- One key area for expenditure cuts is travel and international missions: per diems for government workers are significantly higher than international comparators, vehicle entitlements could be reduced, and diplomatic missions and compensation of overseas employees could be rationalized. Measures to improve service delivery, for example by making better use of district facilities, could enable savings in healthcare expenditures without impacting health outcomes. The college bursary scheme costs roughly 1.5 percent of GDP: improving repayment rates and introducing means-testing could significantly reduce expenditures.

7. ***While not a substitute for necessary fiscal consolidation, could staff provide details on the authorities' plans to seek external financing—concessional or otherwise—from various sources?***

- Staff are not aware of any planned external financing in the near term that goes beyond project loans and grants from existing bilateral and multilateral creditors.

8. ***The second phase of the LHWP represents an investment amounting 50 percent of GDP fully financed with grants coming from South Africa. Could staff indicate if the funding of this project through grant instruments is fully secured?***

- Under the terms of the LHWP II agreement, the South African authorities have committed to finance the water transfer project through a grant. They in turn are raising their required financing through Multilateral Development Banks as well as commercial and institutional investors through debt issuance by the Trans-Caledon Tunnel Authority. The financing of any future hydroelectric component is yet to be determined, though the World Bank has supported analysis of the various options.

9. ***Can staff indicate if improvements coming from the strengthening in tax administration were included in the fiscal projections?***

- As is usually the case, staff did not include improvements to tax administration in fiscal projections.

10. ***We wonder whether other steps could reduce the public wage bill more effectively and rapidly. For instance, can a very progressive income tax reduce the net public sector premium?***

- Lesotho's income tax collection is already among the highest in its income-group. Staff see addressing wages directly, such as through the zero cost of living adjustment, as the most targeted way to address the wage bill issues. While additional progressive income taxation could potentially improve equity, the implications for tax evasion, wage bill pressures, and private sector growth would also have to be carefully considered.

11. ***The authorities' intention to introduce legislation on a fiscal rule, as mentioned in the buff, is encouraging. Is the Ministry of Finance's proposal in line with staff's work cited in the report; and has FAD provided TA? We would welcome staff's comments.***

And

12. ***We agree with staff that establishment of an effective fiscal anchor should smooth the growth impact from revenue shocks and preserve debt sustainability. As authorities are considering introducing a fiscal rule, could staff elaborate on its possible design***

- Staff will address this issue in the oral intervention.

PFM

13. ***Can staff explain if the authorities have concrete plans to addressing these [PFM] issues and elaborate on the feasibility for the implementation of a treasury single account?***

- The new IFMIS infrastructure includes enhanced expenditure control and cash management modules. The Fund will also provide additional TA this fiscal year to assist in the arrears survey and in the bank reconciliation exercise. The authorities do have a Treasury Single Account, through which the bulk of the government's financial transactions take place. While some line ministries continue to operate commercial bank accounts, the authorities have successfully closed hundreds of accounts over the past two years. To improve the coverage of government finance statistics, the Fund provided TA in early 2019 and will conduct a follow-up mission next year.

14. ***Given the large PFM deficiencies, does staff see feasible to meet this request [providing a resident advisor]? What was the experience with the previous resident expert?***

- Discussions are ongoing as to the availability of additional PFM TA financing, such as the resident advisor that had been financed by the EU. The experience with the previous resident advisor was mostly positive and very well regarded by the authorities. The advisor made progress in improving cash management, bank reconciliation, fiscal reporting, and preparing the groundwork for the new IFMIS. However, staffing at the Treasury during the advisor's tenure was not complete so the authorities were not able to fully absorb the TA. A number of important positions have now been filled, although a permanent Accountant General has not yet been appointed.

Monetary and Exchange Rate Policies

15. ***Could staff elaborate on whether the possible benefits of the fixed exchange rate outweigh its costs? At what point, in staff's view, moving to a more flexible exchange rate regime would be advisable for Lesotho?***

And

16. ***Similarly, can a devaluation of the Maloti reduce the share of public wage bill in the GDP, boost exports by the private sector and improve the external position***

- Staff will address this in the oral intervention.

Financial Sector

17. ***Staff highlights that even if the Financial Cooperative Bill is approved, capacity constraints of the Ministry of Small Business Development and Cooperative may limit its effectiveness and recommends transferring supervisory powers over all deposit-taking institutions to the CBL. Given that this draft bill is already in Congress, does staff still see room to make the corresponding changes?***

- The authorities' view is that the Ministry of Small Business is best-suited to manage smaller financial cooperatives. Staff will continue to discuss the issue with the authorities to ensure that the sector is well-regulated.

18. ***We would appreciate staff's comments on practical ways in which the credit bureau could collect data on informal entrepreneurs and make this information available***

to financial institutions.

- Capturing data on the informal sector is always a challenge. However, the credit bureau has made good progress on the number of firms reporting to it, as all banks, large microfinance institutions (MFIs), the two largest savings and credit cooperatives (SACCOs) and many smaller MFIs are reporting data to the bureau. Data could be further enhanced by incorporating information from the utilities, and talks are ongoing with the telecoms and water utility to make progress in this regard.

19. ***Can staff elaborate on policies to promote activities of microfinance institutions if any?***

- The World Bank is providing TA on developing the microfinance sector in support of Lesotho's Financial Sector Development Strategy. This involves support to create an appropriate legal, regulatory, and supervisory framework.

20. ***We wonder whether Lesotho's FIU formally cooperates with FIU's in other jurisdictions, particularly in the rand zone, and if it is efficient to avoid moving proceeds of corruption to neighboring territories?***

- International and regional cooperation is part of the core mandate of Lesotho's FIU. Lesotho is a member of the Eastern and Southern Africa Anti-Money Laundering Group (ESAAMLG). The authorities have recently taken steps to strengthen its AML/CFT framework, including a national assessment of risks and an associated action plan, and the Fund provided technical assistance in 2018 with a view to capacitating the FIU, including with regard to international cooperation.

Structural Reforms

21. ***Can staff comment on what actions the authorities are taking to enhance agricultural resilience to these climate-induced events?***

And

22. ***We recall staff's findings that investment in a natural-disaster-resilient-infrastructure is expected to increase growth in the Caribbean countries (REO briefing April 2019), and wonder whether Lesotho invested or can invest in water preserving technologies and draught-resilient-crops, which could reduce the adverse impact of future draughts***.

- The authorities have made climate change a policy priority and have incorporated measures into their second National Strategic Development Policy, including the development of a National Climate Change Policy with the support of development partners. The main interventions will be driven by a climate smart agriculture policy framework and will include developing irrigation infrastructure, disseminating drought-tolerant seeds, and growing drought-resistant trees and shrubbery. The World Bank will also support water resource management to bolster resilience, relying on a recently-developed master irrigation plan.

23. ***Could staff indicate how the CD strategy addresses the need to protect the most vulnerable of the impacts resulting from the fiscal consolidation?***

- The IMF has provided support on key expenditure issues in the last several years, most notably on addressing the public sector wage bill. However, the World Bank has been taking the lead in providing assistance on social expenditure management and targeting in Lesotho. Their Social Assistance Project is supporting the government to improve the targeting, efficiency and equity of key social assistance programs. This project is supporting the creation of a new national database - the National Information System for Social Assistance (NISSA) – to act as a single registry for all social protection programs, which can serve as an integrated system for more effective targeting of beneficiaries, and will also allow for the scaling up of social assistance during natural disasters. The project is also supporting the rolling out of the Child Grants Program nationwide.

- The World Bank's Public Sector Modernization Project also contained support for a new Household Budget Survey. The AFR country team is working with the Commitment to Equity Institute to use the results of this survey to assess the impact of envisaged fiscal consolidation measures.