

<p>Kingdom of Lesotho</p>	<p>2014</p>
<p>The peer review based monitoring and surveillance of the SADC Macroeconomic Convergence (MEC) program was launched by the MEC Peer Review Panel at its first meeting in May 2013 in Maputo. To start the process the Panel agreed that Lesotho and Malawi would be the Pilot countries to be reviewed on a voluntary basis. Angola and Namibia also on a voluntary basis agreed to constitute the Review Team of Macroeconomic experts to undertake the Lesotho and Malawi country Review Mission.</p> <p>The SADC MEC Peer Review Team comprised the following Macroeconomic experts: from Angola, Mr Joao Boa Quipipa and Mr Manuel Tiago Dias; from Namibia, Mr Gerson Kadhikwa the nominated Team leader and Mr James Seibeb. Ms Busi Dlamini from the SADC Secretariat coordinated the process.</p> <p>The Team visited Lesotho during 6-7 November 2014 and is grateful to the Authorities for their demonstrated commitment to the review process and for giving - the necessary support to the Country Review Mission to undertake an independent assessment of the Country MEC Self-Assessment Report and the National Plan of Action.</p> <p>The Team met with the Deputy Minister of Finance Honourable, Ms Matsepo Ramakoae, Dr R. Matlanyane, Governor of the Central Bank of Lesotho and Senior Officials from the Ministry of Finance, Development Planning and Central Bank of Lesotho.</p> <p>The Review report contains information validated with the authorities of the Kingdom of Lesotho and is for consideration by the Peer Review Panel composed of Ministers of Finance and Central Bank Governors at its meeting in May 2015.</p>	<p>Peer Review Report on recent economic developments and the SADC Macroeconomic Convergence Program</p>

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EXECUTIVE SUMMARY

Lesotho's macroeconomic framework is sound and overall consistent with the SADC MEC objectives. As a result of pursuit of prudent macroeconomic management, Lesotho met the primary macroeconomic convergence benchmarks set by SADC. The inflation rate has been at a single digit for quite some time. Over the past five years, it has averaged approximately 6.0 percent, mainly due to the credibility of the South African monetary policy authorities since the bulk of Lesotho's inflation is imported from South Africa given the fixed exchange rate arrangement and the high degree of economic integration between the two economies. The fiscal balance has been low and within the target most of the time and this was motivated by the fiscal consolidation efforts by the authorities of Lesotho coupled with slow budget execution. Government is, however, committed to continue efforts to increase capital/development budget execution in order to improve the low execution rate.

Given the authorities' commitment to maintain the exchange rate peg to the South African rand, it is important to achieve a sufficient level of foreign reserves in order to underwrite the peg. A sufficient level of foreign reserves is important for Lesotho to continuously sustain the demand for foreign currency by the public holding maloti. Furthermore, as a small open economy, Lesotho is vulnerable to external shocks and will continue to benefit from the fixed exchange rate arrangement. In the short to medium term, Lesotho aims at achieving the reserve coverage of 5 months of imports by FY2017/18 through continued fiscal consolidation and this level of foreign reserves is deemed appropriate in light of Lesotho's vulnerability to exogenous shocks.

SADC MEC Review Team's views and overall Assessment: Although Lesotho's macroeconomic performance has been satisfactory in recent years, the country faces challenges regarding the need for the diversification of the economy, diminishing its vulnerability to SACU transfers and striking a balance between macroeconomic and fiscal stability, growth and development. Thus, the government developed a Five-year Rolling National Strategic Development Plan (NSDP) to address these challenges. The NSDP identified the critical growth sectors and encompasses measures aimed at addressing the structural inadequacies of the economy in order to attain macroeconomic and fiscal stability and spur sustainable growth and development.

Furthermore, the SADC MEC Review Team noted that the Authorities devised a remedial policy intervention strategy, namely, the National Action Plan for MEC to ensure compliance with the SADC MEC benchmarks.

Overall, Lesotho's performance against the primary SADC MEC benchmarks for 2013 was satisfactory and the country met some of the secondary MEC benchmarks.

This was evident in single digit inflation, manageable fiscal deficit and public debt as a proportion of GDP. Moreover, Lesotho fulfilled the benchmarks on domestic investment as well as the ceiling on central bank credit to government in relation to Government revenue. The main challenge for the country is to strike a balance between macroeconomic stability and development. Generally, Lesotho exhibits higher dependency on SACU receipts both in fiscal and balance of payments accounts. As a result, Lesotho needs to find ways to reduce reliance on volatile SACU receipts, which have been providing over 40.0 per cent of total government revenue over the past years. The recent reductions in the shares of Member States are a clear indication that SACU revenue is highly vulnerable to external shocks. It also means that future Customs Union revenue receipts would have to be somehow exclusively directed to strategic investments that set a platform for future growth. This would provide protection against future fiscal exposure to external shocks over which government does not have much control. Robust domestic revenue administration and identification of new sources remain inevitable. But effective expenditure policies, underpinning results, are now more compelling than ever, as well as reduction of inefficiencies in government operations.

The Authorities' views: The Authorities broadly shared and concurred with the SADC MEC Peer Review Team's assessment. Furthermore, the Authorities were somewhat more optimistic on the near-term outlook for growth, while recognizing downside risks to the outlook stemming from reliance on SACU receipts. In addition, it was highlighted that the country is exposed to uncertain global economic outlook, especially through textiles exports to the US, which was volatile in 2014/15 financial year, due to the expectation that the African Growth and Opportunity Act (AGOA) trade preferences would be phased out over the FY2015/16. Going forward, if investment efficiency improves and risks are mitigated, overall economic growth could increase to around 5.0 percent over the FY2015/16.

1. INTRODUCTION AND OVERVIEW

The aim of the SADC MEC programme is to promote macroeconomic stability, which is a necessary condition for financial sector development, attracting foreign direct investment and overall sustainable growth and poverty reduction in the region. Article 7 of Annex 2 to the Finance and Investment Protocol (FIP) provides that the Peer Review Panel shall establish a collective surveillance procedure to monitor MEC, determine specific targets, assess progress relative to those targets and provide advice on corrective actions, as set out in the Article. Against the above background, Lesotho volunteered to be reviewed as a pilot country under the MEC programme.

The SADC MEC Peer Review Team visited Lesotho during 6-7 November 2014 on behalf of the MEC Peer Review Panel. The objective of the mission was to validate Lesotho's national self-assessment report against the MEC benchmarks (Table 1) and determine whether the country is making progress towards the attainment of the SADC MEC benchmarks. Moreover, the review exercise was aimed at encouraging the authorities of Lesotho to improve its performance by implementing appropriate remedial policy intervention measures to enhance compliance with the SADC MEC benchmarks. To this end, the review focused on the following three areas:

- (i) Review of recent economic developments;
- (ii) Progress and performance relative to the MEC benchmarks; and
- (iii) Remedial policy intervention measures aimed at addressing identified structural imbalances in the economy.

The main focus in the short-term is on primary indicators, while the secondary indicators serve as guidelines to support the former. Table 1 represents the SADC MEC benchmarks over the period 2012-2018.

Table 1: SADC MEC Benchmarks

	2008	2012	2018
Primary Indicators			
Inflation - annual rate %	<10	<5	3-7
Fiscal Deficit - as a % of GDP	<5	<3	<3
Public Debt - as a % of GDP	<60	<60	<60
Secondary Indicators			
Current Account Balance - as a % GDP	<9	<9	<3
Economic Growth - annual rate %	7	7	7
Central Bank Credit to Govt - as a % of Revenue	10	5	5
External Reserves - months of import over	3	6	6
Domestic Savings - as a % of GDP	25	30	35
Domestic Investment - as a % of GDP	30	30	30

Source: SADC RISDP

2. RECENT ECONOMIC DEVELOPMENTS

Average economic growth has been above NSDP target of 5.0 percent per year over the past five years. However, unemployment is still high at around 24.0 percent. Real GDP increased at an annual average rate of 5.2 percent between 2008/09 and 2012/13. This was mainly driven by significant growth in construction (17.2 percent), mining (14.1 percent), services (4.0 percent) and agriculture (4.1 percent). The average growth rate of the GDP for the past ten years has been 4.3 percent. In 2013/14, real GDP was projected to register a lower growth of about 3.8 percent compared to 5.9 percent growth registered in 2012/13. This resulted from a significant decline in mining, manufacturing and construction activities.

Lesotho's inflation rate continues to be anchored to that of South Africa given, the fixed exchange rate arrangement and high degree of economic integration between the two economies. Over the past five years, it has hovered between 3-6 percent. The rate of inflation slowed down to an average of 5.0 percent in 2013 from 6.1 percent recorded in 2012. A significant portion of Lesotho's inflation is explained by price behaviour in South Africa, given that a significant portion of Lesotho's imports originate from South Africa. Given its largest weight within the CPI basket, the deceleration in the average annual inflation rate was underpinned by a slowdown in food prices in 2013 relative to 2012. Therefore, the trajectory of food prices is mirrored in Lesotho's overall inflation rate. According to the Food and Agricultural Organization (FAO), the global food price and cereal price indices declined by 1.6 percent and 7.2 percent in 2012 and 2013, respectively. This was on account of the increase in global food supplies following record of high harvest

of cereals in 2013, which continued to exert a downward pressure on the international prices of oils, sugar and maize in particular. Therefore excess food supply in the face of weak domestic demand explains the deceleration in food prices. Notwithstanding, the moderation in the annual average inflation rate, there were inflationary pressures emanating from the housing, electricity, gas and other fuel, and transport services categories. The upward movement in prices of these categories was responsive to revision in the domestic pump prices of petrol, diesel and paraffin. The movement in the latter was a consequence of elevated international crude oil prices and the weak exchange rate of the Loti against the US dollar since 2012.

The overall fiscal balance is considerably affected by the volatility of SACU receipts. The Government ran deficits between 2010/11 (-3.3 percent) and 2011/12 (-10.2 percent), while in 2012/13 a surplus (4.6 percent). In 2010/11, government recorded fiscal deficit of 3.3 percent of GDP only a year after recording a surplus of 2.4 percent in 2009/10. This transition confirms the extent and severity of the financial crisis that hit the economy after 2008. Although the crisis was of a sizeable magnitude, its adverse effects only lasted two fiscal years, due to strong fiscal consolidation of the government and sound fiscal strategy to turn around the situation. The other year that a deficit was observed in the back of financial crisis was 2011/12 where 10.2 percent of GDP was recorded. In 2012/13, a fiscal surplus of 4.6 percent of GDP was achieved, while 2013/14 a deficit of 3.6 percent is recorded.

Gross official reserves, in months of import cover, rose in 2013. It increased to 6.1 months of imports in 2013, compared with 4.6 months of imports in 2012. The increase in foreign reserves was underpinned by growth in SACU receipts coupled with a fiscal discipline, which led to a moderation in expenditures and, therefore, exerted downward pressure on foreign reserves.

3. ASSESSMENT OF LESOTHO'S PERFORMANCE AGAINST THE SADC MEC BENCHMARKS

3.1 PRIMARY BENCHMARKS

Lesotho performed well against the SADC MEC primary benchmarks as reflected in Table 2 below.

Table 2: Lesotho's performance against the SADC MEC indicator benchmarks

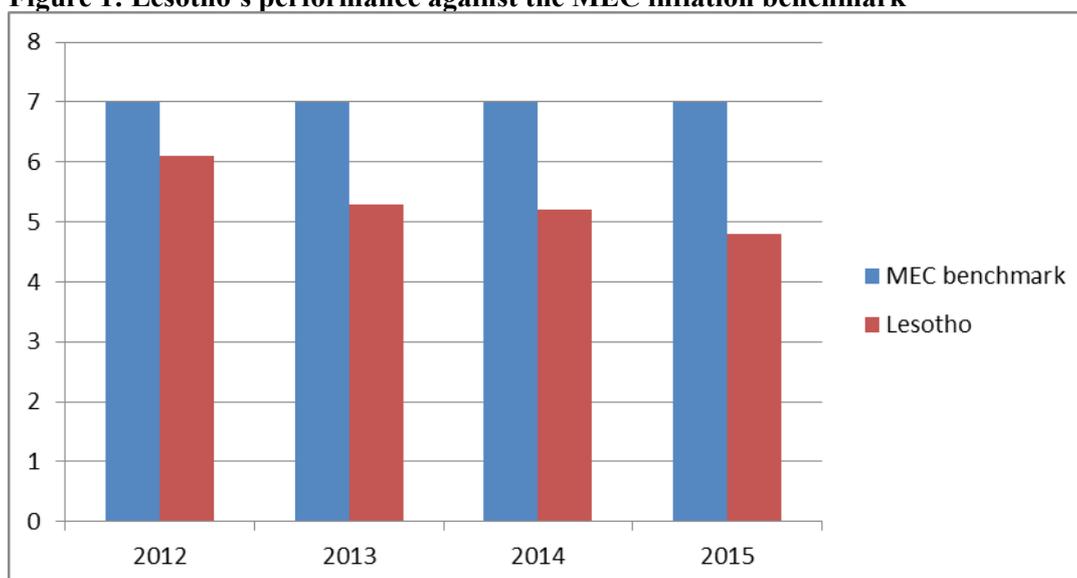
Convergence indicator	2010	2011	2012	2013	2014	2015
Inflation - Annual rate %	3.8	5.1	6.1	5.3	5.3	4.8
Fiscal Deficit - as a % of GDP	-3.1	-10.2	4.6	-3.6	0.4	-2.9
Public Debt - as a % of GDP	35.2	36.9	41.9	41.3	41.3	48.3

Source: Government of Lesotho

3.1.1 Inflation (3-7 percent)

Lesotho registered an inflation rate of 5.0 percent in 2013, which is in compliance with SADC MEC benchmark. Over the past five years, Lesotho's inflation rate hovered between 3-6 percent. The country's inflation rate is anchored to that of South Africa given the fixed exchange rate arrangement and high degree of economic integration between the economies of the two countries. (Figure 1)

Figure 1: Lesotho's performance against the MEC inflation benchmark



Source: SADC MEC Peer Review Team and Lesotho Authorities, November 2014

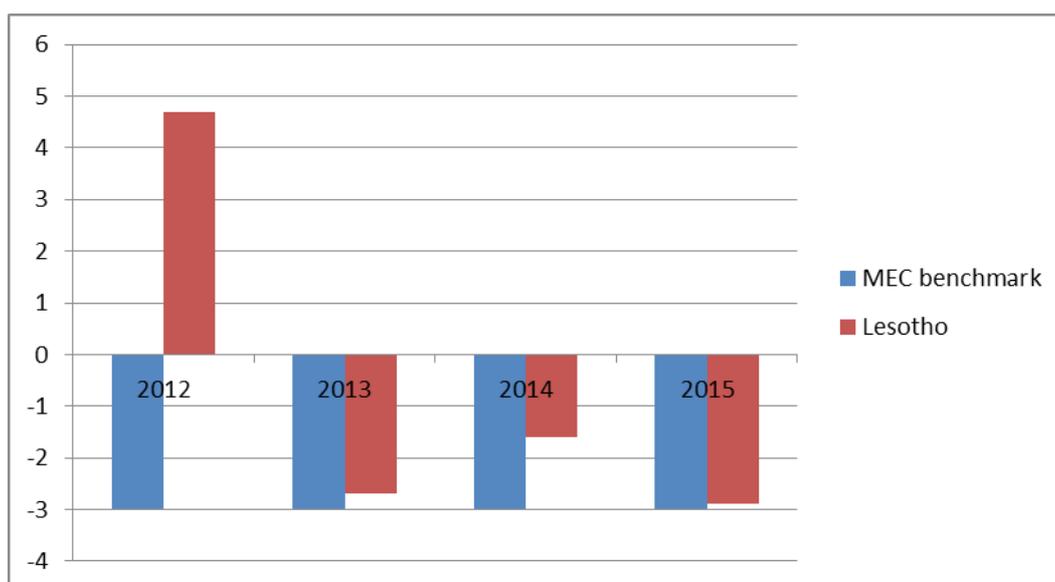
Overall, Lesotho performed well against the set SADC MEC benchmarks. Although **inflation** in 2013 was below the benchmark, it remained a single digit as it averaged 5.0 percent in 2013 compared to 6.1 percent in the previous year. Lesotho's inflation is imported from South African given the high degree of economic integration between Lesotho and South Africa as well as the fixed exchange rate arrangement between the Loti and the South African Rand. Therefore, Lesotho's role in achieving the target for inflation is

restraint, given that it lost monetary policy independence through the fixed exchange regime arrangement. The major threats to inflation continue to be uncertainty concerning the oil price developments and the movement in the rand exchange rate as well as food prices.

3.1.2 Fiscal balance /GDP (< -3 percent)

Lesotho recorded fiscal deficit of 3.6 percent of GDP in 2013, following a surplus of 4.6 percent in 2012. The country's overall fiscal balance is affected considerably by the volatility of SACU receipts. The fiscal balance has been low and within the target most of the time and this was motivated by the fiscal consolidation efforts by the authorities, that is, in addition to the slow budget execution rate. The Government is committed to redressing the latter weakness, by enhancing the execution rate of the development budget. (Figure 2)

Figure 2: Lesotho's performance against the MEC fiscal balance benchmark



Source: MEC Review Team, November 2014

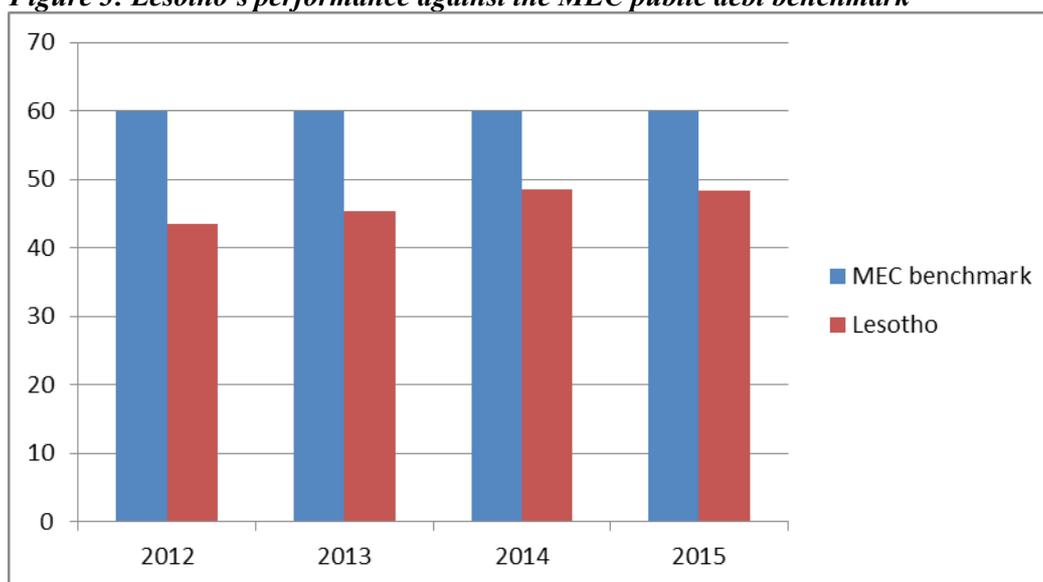
Lesotho continued to meet the **fiscal deficit** target from 2012. It registered a fiscal surplus of 4.6 percent as a share of GDP in 2012/13 and a deficit of 3.6 percent in 2013/14. The fiscal balance reflects prudent fiscal policy management as the Government of Lesotho continues to undertake fiscal consolidation efforts which have yielded a build-up in Government deposits. Since the fiscal shock experienced in 2010, whereby SACU transfers to Lesotho dropped sharply, Government committed itself to a build-up in government reserves so as to buffer possible future shocks.

3.1.3 Public debt as a percentage of GDP (< 60 percent)

Lesotho recorded public debt of 41.3 percent as a percentage of GDP in 2013 (which is below the MEC benchmark of 60.0 percent), compared to 41.9 percent in 2012, indicating that the country maintains sustainable levels, overall. Since over 80.0 percent of Lesotho’s debt is foreign it’s highly susceptible to exchange rate movements. The increase in overall public debt between 2012 and 2013, mirrored changes in the exchange rate of the loti vis-à-vis the US Dollar in which the debt is denominated. This reflects prudent fiscal policy and management. The largest portion of overall public debt is foreign owed and is highly concessional. (Figure 3)

Throughout the period 2008/09 to 2013/14, the bulk of the external debt (89.0 percent) was sourced from multilateral sources. This is in line with the government’s policy of seeking funding in the form of grants first, and failing which, debt is sourced from concessional sources, most of which constitute the multilateral category of creditors.

Figure 3: Lesotho’s performance against the MEC public debt benchmark



Source: MEC Review Team, November 2014

3.2 SECONDARY BENCHMARKS

Lesotho’s performance against the SADC MEC secondary indicator benchmarks is reflected in Table 3 below.

Table 3: Lesotho's performance against MEC indicator benchmarks

Convergence indicator	2010	2011	2012	2013	2014	2015

Current Account Balance - as a % GDP	-7.9	-7.5	-14.6	-6.4	-6.9	-11.6
Economic Growth - annual rate %	6.0	4.0	5.9	3.8	3.0	4.9
External Reserves - Months of import over	4.6	4.6	4.7	6.1	6.1	6.3
Central Bank Credit to Govt - as a % of Revenue	0.0	0.0	0.0	0.0	0.0	0.0
Domestic Savings - as a % of GDP	11.2	18.7	29.8	23.0	21.1	24.5
Domestic Investment - as a % of GDP	25.2	25.4	32.5	31.3	34.2	37.6

Source: Government of Lesotho

3.2.1 Current Account Balance/ GDP (< 3 percent)

In terms of the current account balance, Lesotho recorded a deficit of 6.4 percent in 2013 (compared to -14.6 percent in 2012) which was higher than the MEC benchmark of 3.0 percent. The major source of Lesotho's financing of the current account is current transfers from abroad (SACU transfers), a situation that lends it highly susceptible to external shocks.

3.2.2 Economic Growth (>= 7 percent)

The country registered GDP growth rate of 3.8 percent in 2013 (which was below the MEC benchmark of 7.0 percent) compared to 5.9 percent in 2012. At 5.2 percent, the average economic growth has been above the NSDP target of 5.0 percent per year over the past five years, mainly driven by significant growth in construction (17.2 percent), mining (14.1 percent), services (4.0 percent) and agriculture (4.1 percent).

3.2.3 International Reserves/Import Cover (= or > 6 Months)

Lesotho recorded 6.1 months of import cover in 2013 (which was marginally higher than the MEC benchmark of 6. months), compared to 4.7 months in 2012. The increase in foreign reserves was underpinned by growth in SACU receipts coupled with a fiscal discipline, which led to a moderation in expenditures and therefore exerted downward pressure on foreign reserves. At that level, it was twice the minimum threshold recommended by the IMF.

3.2.4 Central Bank Credit to Government as a Percentage of Revenues (<5 percent)

The country recorded 0.0 percent for Central Bank credit to Government as a percentage of Revenues over the period 2010-2013, as the Central Bank does not offer credit to the government.

3.2.5 Domestic Savings - As a percentage of GDP (= or > 35 percent)

Lesotho registered 23.0 percent for Domestic Savings-to-GDP ratio in 2013, compared to 29.8 percent in 2012, which is lower than the MEC benchmark of 35.0 percent.

3.2.6 Domestic Investment – As a percentage of GDP (= or > 30 percent)

The country recorded 31.3 percent for Domestic Investment-to-GDP ratio in 2013, compared to 32.5 percent in 2012, which is higher than the MEC benchmark of 30.0 percent.

4. OUTLOOK AND POLICY INTERVENTIONS

It is estimated that the rate of **inflation** will drop to 5.3 percent in 2014 and decrease further to 4.8 percent in 2015. Lesotho has been recording stable inflation rates over the past 5 years due to the credibility of South African monetary policy authorities since the bulk of Lesotho's inflation is imported from South Africa given the fixed exchange rate arrangement and the high degree of economic integration between the two economies. The major threats to inflation continue to be uncertainty concerning the oil price developments and the movement in the rand exchange rate as well as food prices.

It is estimated that the rate of **fiscal balance** will improve to 0.4 percent in 2014 and deteriorate marginally to -2.9 percent in 2015. Overall, the fiscal balance reflect prudent fiscal policy management as the Government continues to undertake fiscal consolidation efforts which yield a build-up in Government deposits. Since the fiscal shock experienced in 2010 (when SACU transfers dropped sharply), Government has committed itself to a build-up in reserves to buffer possible future shocks.

The fiscal strategy over the next three years will continue reinforcing long-term fiscal sustainability and providing a sufficient fiscal and/or foreign reserve buffer against domestic

and external shocks and imbalances. The following are the key measures to achieve fiscal sustainability:

- Maintaining adequate reserves to provide 5 months of import cover as a buffer for ameliorating fiscal shocks and imbalances;
- Reducing the high and unsustainable level of recurrent spending by exerting tighter control over recurrent expenditure budgets linked to measures to ensure that existing resources are utilised more effectively and efficiently.
- Improving mobilization of domestic non-tax revenues. This will require identification and assessment of new revenue sources and adjustment of selected fees and charges that have not been revised for several years.
- Securing additional grant financing for public investment expenditures. This will entail the adoption of a focused and robust approach to dialogue with the Development Cooperating Partners to achieve policy coherence and ensure that aid is directed to national priorities.

Government budgetary operations are projected to register an average deficit equivalent to 3.1 percent of GDP over the medium term. This results from Government's commitment to intensify the implementation of the NSDP.

It is estimated that **public debt** as a percentage of GDP is expected to remain constant at 41.3 percent in 2014 and, thereafter, increase to 48.3 percent. The projected increase in public debt would be due to increased and targeted investment in the priority sectors of mining, tourism, agriculture and manufacturing (as outlined in the NSDP) in order to enhance sustainable and job-creating economic growth over the medium term period.

Furthermore, the Authorities devised a remedial policy intervention strategy, namely, the National Action Plan for MEC to ensure compliance with the SADC MEC benchmarks.

5. CONCLUSION AND RECOMMENDATIONS

The performance of Lesotho's **primary indicators** (inflation, fiscal deficit and public debt) reflected compliance with the SADC MEC benchmarks for 2013 and is, furthermore, within the set margins regarding the projections for 2014.

Regarding the **secondary indicators**, the country complied with the SADC MEC benchmarks in respect of the Current account balance as a percentage of GDP (-6.4 percent in 2013 and -6.9 percent in 2014) ; External Reserves (6.1 months in 2013 and 2014) and Domestic Investment as a percentage of GDP. However, the country missed the benchmarks in respect of the following secondary indicators:

- Central Bank credit to Government (0 percent instead of 5)Economic growth rate/GDP (3.8 percent instead of 7.0 percent);
- Domestic savings as a percentage of GDP (23.0 percent instead of 35.0 percent)

It is against the above backdrop that the SADC MEC Peer Review Team makes the following recommendations:

- That the Authorities should intensify the implementation of the National Strategic Development Plan (NSDP) and improve the low execution rate of the development/capital budget in order to address the structural inadequacies of the economy and bring about macroeconomic and fiscal stability that would spur sustainable growth and development.
- That the Authorities should implement their remedial policy intervention strategy, namely, the National Action Plan for MEC to ensure compliance with the SADC MEC benchmarks.