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The Kingdom of Lesotho: Letter of Intent, Memorandum of Economic and Financial Policies, and Technical Memorandum of Understanding

May 17, 2010

The following item is a Letter of Intent of the government of The Kingdom of Lesotho, which describes the policies that The Kingdom of Lesotho intends to implement in the context of its request for financial support from the IMF. The document, which is the property of The Kingdom of Lesotho, is being made available on the IMF website by agreement with the member as a service to users of the [IMF](#) website.

The Kingdom of Lesotho: Letter of Intent

May 17, 2010
Mr. Dominique Strauss-Kahn
Managing Director
International Monetary Fund
Washington, D.C. 20431
U.S.A.

Dear Mr. Strauss-Kahn:

Following several years of improving economic performance, Lesotho's economy has been buffeted by the global economic crisis. Economic activity has slowed owing to a significant reduction in our major exports and reduced workers' remittances from South Africa. In addition, a sharp decline in Southern African Customs Unions (SACU) revenues, which constitute a large proportion of government revenue, is expected to lead to sharply wider fiscal and external imbalances. To address these challenges, the Government of Lesotho has adopted a package of economic policies designed to achieve macroeconomic stability consistent with strong growth and poverty reduction and which is in line with our Interim National Development Framework. In undertaking these policies, the government will ensure social support to the most vulnerable is protected.

The attached Memorandum of Economic and Financial Policies (MEFP) sets forth the government's economic objectives and policies for the three-year period (2010-13) and its action plan for the first year of the program. In support of its program, the government hereby requests a three-year arrangement with the Fund under the Extended Credit Facility (ECF) in a total amount of SDR 41.88 million (equivalent to 120 percent of quota), with the first disbursement of SDR 7.78 million following approval of the program.

The Government of Lesotho believes that the policies set forth in the attached MEFP are adequate to achieve the objectives of the program, but it will take any further measures that may become necessary for this purpose including by strengthening governance and transparency and implementing measures resulting from the updated safeguards assessment of the Central Bank of Lesotho (CBL). Lesotho will consult with the International Monetary Fund (IMF)--at its own initiative or whenever the Managing Director of the IMF requests such a consultation--on the adoption of these measures and in advance of any revisions to the policies contained in the MEFP, in accordance with the IMF's policies on such consultations.

The Government will provide the IMF with such information as the IMF may request in connection with the progress made in implementing the economic and financial policies, and achieving the objectives of the program. The Government authorizes the IMF to publish this letter, the attached MEFP and TMU, and the related Staff Report, including placement of these documents on the IMF website.

Yours sincerely,

/s/

Hon. Timothy T. Thahane,
Minister of Finance and Development Planning

Attachment I

The Kingdom of Lesotho: Memorandum of Economic and Financial Policies 2010–2013

I. INTRODUCTION AND BACKGROUND

1. **This memorandum sets out Lesotho's economic and financial policies for the medium term and for the period April 2010–March 2011 for which the government is seeking support from the IMF under a three-year Extended Credit Facility (ECF) arrangement.** The policies are consistent with Lesotho's Interim National Development Framework (INDF) which outlines the country's medium-term development objectives for growth and poverty reduction. The government is preparing a comprehensive National Development Plan which is expected to be implemented starting in 2012/13.
2. **The main objective of the government's program is to restore macro-economic stability while limiting the adverse impact of fiscal consolidation on the poor and vulnerable Basotho in the face of a protracted decline in revenues.** Our program is anchored around three pillars: (a) restoring fiscal sustainability; (b) achieving external sustainability and broad-based growth for sustained poverty reduction; and (c) strengthening the financial sector and enhancing access to financial services. Without decisive actions, Lesotho faces severe fiscal and balance of payments pressures that could erode the recent gains the country has made on macroeconomic stabilization.

II. RECENT ECONOMIC DEVELOPMENTS

3. **After several years of favorable macro-economic management, Lesotho's economic performance deteriorated in 2009 in the wake of the global crisis.** Real GDP growth decelerated to 0.9 percent from 4.5 percent in 2008, mainly reflecting a marked decline in textile exports, slow recovery in diamond exports, and a decrease in workers' remittances from South Africa which lowered household disposable income and reduced consumption. This also led to a shift in the current account position from a surplus of 9.5 percent of GDP in 2008 to a deficit of 0.3 percent of GDP in 2009.
4. **On the fiscal front, after five consecutive years of surpluses, the fiscal position is expected to shift to a deficit of 2.7 percent of GDP in 2009/10 from a surplus of 1.6 percent in 2008/09.** This was on account of increased spending on (a) public sector wages; (b) new hiring in the education and health sectors; (c) social safety net for vulnerable groups; (d) funding of the newly-established defined contribution pension scheme; (e) developing a Minimum Infrastructure Platform to support private investments; and (f) strengthening institutions that will support sound economic management.

5. **Inflation slowed sharply to 4.2 percent (year-on-year) in December 2009 from 10.6 percent in December 2008, reflecting much smaller increases in food prices and falling international fuel prices.** Nevertheless, fertilizer prices and other input costs remain high, and this has had a negative impact on agricultural production. The rate of inflation is highly influenced by inflation developments in South Africa.

6. **The financial sector has weathered the global crisis well.** Our banks are well capitalized, profitable and liquid. The major vulnerability to our financial system stems from weakly supervised nonbank financial institutions (NBFIs) but efforts are underway to strengthen the CBL's supervisory role over NBFIs. Significant progress has been made in anti-money laundering reforms including implementation of "Know Your Customer" guidelines.

III. MEDIUM-TERM OBJECTIVES AND POLICIES

7. **Lesotho faces serious macro-economic challenges over the medium-term.** The severity of the global economic crisis has resulted in (a) steep declines in SACU revenues which account for the bulk of our revenues; (b) a sharp contraction in demand for our main exports of textile and diamonds; and (c) a reduction in workers' remittances following the retrenchment of Basotho workers in South Africa. Lower imports by South Africa are expected to result in a significant reduction of net SACU revenues by a total of 23.3 percent of GDP during 2010/11–2011/12 relative to 2009/10. Although some recovery in SACU receipts is expected in 2012/13, we anticipate a permanent loss of SACU revenues with receipts stabilizing at around 20 percent of GDP, levels prevailing prior to the change in the SACU formula in 2004/05 and before the economic boom in South Africa.

8. **The decline in SACU revenues comes at a time when expenditures are at historically high levels, and is projected to widen the fiscal deficit (excluding outlays for the Metolong dam) to an average of 15.0 percent of GDP in 2010/11–2011/12.** The government plans to finance the deficit mainly by drawing down its deposits at the CBL and by issuing domestic bonds. In addition, we have secured budgetary grants and concessional loans from some of our development partners.

9. **Starting with the 2010/11 budget, the Government has begun to take determined action to curtail recurrent spending with a view to reducing nonproductive expenditures over the medium-term to a level consistent with sustainable levels of revenues.** In this regard, the government intends to reduce total expenditure from around 68 percent of GDP in 2010/11 to around 49 percent of GDP by 2015/16, by cutting nonpriority expenditures while at the same time protecting spending on critical social programs. The reduction in capital spending in part reflects the completion of the Metolong dam in 2012/13. With medium-term revenues stabilizing at around 50 percent of GDP, we are targeting a balanced fiscal position by 2015/16.

10. **Specific measures to reduce recurrent spending include:**

- **Containing the wage bill by:** (a) restricting new recruitment to high-priority areas; (b) freezing the number of existing positions and reducing the size of the public service; and (c) eliminating posts that have remained vacant for more than 12 months. If there is need for any new positions, they will be assessed in the context of skills requirements in high-priority areas such as health and education. Given the general wage increases in each of the last three years, government will eschew further general wage increases during the program period. Any increases will be linked to performance and retaining key skills. In addition, the government will take advantage of the mandatory retirement scheme for civil servants that comes into effect in 2010/11 to reduce the size of the public service by carefully assessing whether the vacated positions can be eliminated without affecting efficient services delivery. We intend to carry out a comprehensive review of the public service to identify noncore functions of the government with a view to reducing certain nonessential operations.
- **Reducing expenditure on goods and services by:** (a) rationalizing diplomatic missions; (b) reducing international travel; and (c) cutting spending on furniture and equipment. In addition, we will be outsourcing noncore functions to enhance efficiency gains.

11. **By containing the growth in recurrent spending, we will create fiscal space to increase development spending and to raise the share of our spending allocated to capital projects.** This will release funds for developing a minimum infrastructure platform and institutions for investment, particularly small and medium scale enterprises, which is a key priority of the government.

12. **The external current account deficit (excluding outlays for the Metolong dam) is projected to widen to 20 percent of GDP in 2010 owing to the lower SACU revenues.** It should narrow thereafter to about 6.5 percent of GDP by 2014 as net SACU revenues recover and as we implement the fiscal adjustment measures. With the proposed adjustment, our international reserves should be sufficient to sustain the loti peg to the rand.

13. **Growth over the medium term is premised on the implementation of our macroeconomic and structural reforms aimed at increasing competitiveness and achieving diversification.** Real GDP is expected to accelerate from 0.9 percent in 2009 to an average of 4.3 percent per annum during the ECF-supported program (2010–2013). An expansion in private sector activities, complemented by public investment in infrastructure, including the construction of the Metolong Dam, the start up of the second phase of the

Lesotho Highlands Water Project (LHWP II) and development of further mining opportunities will help to underpin growth.

14. **There is limited scope for independent monetary policy due to our country's membership in the Common Monetary Area (CMA) and the peg of the loti to the South African rand.** The peg of the loti to the rand has facilitated transactions with South Africa and helped maintain low inflation. In this context, our efforts will continue to focus on preserving the fixed exchange rate system and maintaining price stability. Supported by the peg, inflation is expected to stabilize at around 5 percent over the medium term, broadly in line with inflation in South Africa. The CBL will maintain an adequate level of international reserves to protect the exchange rate peg.

15. **With regards to the proposed loans for the Metolong dam and LHWPII, we are aware that these will raise our debt levels over the medium term.** However, these projects are critical to addressing sustained economic growth and poverty reduction. Nevertheless, we are aware of the risks of a rising debt burden and are committed to seeking grants and concessional financing for the LHWPII and other development projects during the program period.

IV. MACROECONOMIC OBJECTIVES FOR 2010/11

1. The government's economic program aims to achieve fiscal consolidation, external stability and broad based growth for poverty reduction, and a strengthening of the financial sector. Below we describe the specific policies we intend to put in place to achieve these broad objectives. The specific quantitative targets and structural policies underlying our adjustment program are summarized in Tables 1 and 2.

16. **The Government recognizes the urgent need to address emerging large fiscal imbalances given the steep and permanent decline in SACU revenues.** This will require a judicious balance between adjustment measures, external support and use of accumulated government deposits. The fiscal savings generated in recent years provide some scope to draw down reserves without jeopardizing the CBL's reserve position and the credibility of the loti peg to the rand. The bulk of the proposed fiscal adjustment will rely mainly on curtailing nonproductive and nonpriority expenditures while safeguarding vulnerable groups. The program includes a floor for spending on priority social programs.

17. **In the absence of policy adjustment, the decline in SACU revenues by 21 percent of GDP in 2010/11 would have resulted in a fiscal deficit (excluding outlays for the Metolong dam) of about 20 percent of GDP in 2010/11.** However, the government intends to implement bold measures to contain the fiscal deficit (excluding outlays for the Metolong dam) to 15.3 percent of GDP by reducing overall spending (excluding outlays for the

Metolong dam) by 4.9 percent of GDP. These spending cuts largely fall on recurrent expenditure as follows:

- Limiting the increase in the wage bill to 4.8 percent in nominal terms to cater for inflation and increased hiring in the health and education sectors;
- Reducing goods and services appropriation from 12.5 percent of GDP in 2009/10 to 11.2 percent of GDP, below the level of 2007/08; and
- Limiting spending on subsidies and transfers, mainly through the postponement to 2012 of the payment of M 250 million linked to pension reform, and reducing appropriation for the bursary scheme for tertiary education by M104 million.

18. **With regard to public investment, the government realizes there is scope to improve the efficiency of capital projects.** In this context, we intend to conduct a comprehensive review of all ongoing capital projects with a view to assessing their desirability and making recommendations to Cabinet on which projects should be retained or eliminated. This review, which will also look at recurrent expenditures, (including on the bursary scheme for tertiary education) will be submitted to Cabinet by September 2010 in order to help guide budget preparations for 2011/12. For new capital projects, the Project Appraisal Committee will continue to vet them to ensure that only those that meet the criteria for enhancing broad-based economic growth, poverty reduction, and attaining the MDGs are included in the budget.

19. **With reduced revenues, government recognizes the importance of improving public expenditure management (PEM) to enhance efficiency of expenditure.** With this in mind, for the first time in several years, the 2010/11 budget was framed based on the expected outturn rather than on the previous year's budget. This is a major improvement over the previous process, and will contribute to improved budget execution as resources are allocated to those ministries that have the capacity to execute their programs.

20. **We are also committed to building on the progress we have made in reforming our Public Financial Management (PFM) system.** The recent implementation of the Integrated Financial Management Information System (IFMIS) will help improve budget formulation, execution, and reporting. However, we are aware of the significant deficiencies in the functioning of the IFMIS and are committed to make progress in this area guided by the recommendations of the recent IMF Technical Assistance mission on PFM. Improving the functionality of the IFMIS will include actions to prevent over-commitment of resources

and to strengthen internal control.¹ These actions will be monitored through structural benchmarks.

21. **The government is aware that there has been an accumulation of domestic arrears, mainly because of teething problems with the IFMIS rather than due to lack of funds.** We are in the process of clarifying the size of the arrears as at end-March 2010, with a view to eliminating them within the program period. For the first year, 2010/11, we plan to eliminate up to M 200 million. We intend to undertake a survey from line ministries to complement information from the IFMIS in order to get a more accurate figure for domestic arrears. Lesotho has no external payments arrears.

22. **Given that non-SACU revenues are relatively high, at around 27 percent of GDP, there is limited scope for further increases.** However, as announced in the 2010/11 budget, the government will undertake a wholesale revision of rates, charges and fines, some of which have not been reviewed in 20 years. In addition, government believes there is some scope to increase non-SACU revenue by improving tax administration and compliance. To this end, with technical assistance from the United States, the Lesotho Revenue Authority (LRA) has taken steps to strengthen (a) collection of tax arrears; (b) intelligence and investigations; and (c) audit. The LRA is also profiling large tax payers to increase tax compliance. Implementation of the Integrated Revenue Management System, complemented with training of LRA managers and tax collectors, will help improve overall operational efficiency.

23. **The government recognizes the importance of having unqualified audited financial statements for the purpose of strengthening governance and public accountability.** To this end, preparation of the annual public financial accounts for 2007/08 has been completed and the Statement of Affairs as at end-March 2008 is at an advanced stage. Once approved, this will set the stage for preparation of the annual public financial accounts for subsequent years, starting with 2008/09. The legal framework for budget execution is also being revised and the draft Public Financial Management and Accountability Bill will be submitted to Cabinet by June 2010.

V. STRUCTURAL REFORMS TO IMPROVE PRODUCTIVITY AND THE INVESTMENT CLIMATE

24. **Improving the investment climate to boost competitiveness and productivity by lowering unit labor costs is critical for broad-based shared-growth and diversification.**

¹ The IFMIS allows over commitments when it processes payment vouchers by reversing the related commitment, thereby releasing funds previously committed. In addition, users belonging to one ministry may be able to access the records of another ministry indicating inadequate access control.

To this end, the government is pursuing reforms that will make it easier to start, operate and expand businesses. A number of these reforms are supported by development partners including the Millennium Challenge Corporation (MCC), which is pursuing reforms in the following areas: (a) modernize civil legal procedures to expedite resolution of commercial disputes; (b) undertake land reform to facilitate use of land as an economic asset; (c) introduce national identification cards; (d) establish a credit reference bureau; (e) develop an automated payments and settlement system; and (f) reform the Postbank to expand access to financial services in the rural areas.

25. **The government is committed to improving the investment climate in order to attract increased private sector investment and create employment opportunities for any retrenchment arising from public sector reform.** Effective implementation of the MCC's private sector component and the World Bank's ongoing Private Sector Competitiveness and Diversification Program, among other projects, should help reduce the cost of doing business and boost Lesotho's regional and global competitiveness. To this end, we intend to submit to Parliament both the Companies (a structural benchmark under the program) and the Industrial Licensing Bills by end-September 2010.²

26. **Since government intends to maintain the loti peg to the rand, achieving external sustainability will rely on fiscal consolidation, fast-tracking of key structural reforms to enhance productivity growth in tradables, wage restraint to reduce costs, and improvement of infrastructure.** In light of Lesotho's close proximity to South Africa and comparatively lower unit labor costs, we will intensify our efforts to take advantage of this large market as a way of developing our manufacturing industry.

VI. STRENGTHENING THE FINANCIAL SECTOR

27. **Deepening the money and capital markets will be a key priority of the government.** The development of a domestic bond market will help extend the yield curve, deepen the securities market, and provide government with an alternative source of financing for priority projects. The government believes there is significant demand from the banking sector and institutional investors for longer-dated investment instruments. The CBL plans to issue bonds by December 2010. This is a structural benchmark under the program.

28. **The CBL is reviewing the Financial Institutions Act (FIA) and also intends to strengthen the framework for prudential regulations of savings and credit cooperatives**

² The Companies Bill will enhance the ease of starting business by improving procedures and reducing cost. It will also improve on investor protection, specifically minority shareholders. The Industrial Licensing Bill will reduce the cost of doing business by facilitating registration of companies and easing licensing requirements. Both reforms are being supported by the World Bank.

(SACCOs), and other NBFIs including pension funds. The review of the FIA has been mostly completed, and incorporates amendments which deal with the legal framework to underpin the CBL's supervision of NBFIs, and prohibition of unlawful business practices, including Ponzi schemes. The CBL expects to submit to Parliament the amendments to the FIA by end-September 2010. This is a structural benchmark under the program.

29. **The legal and supervision status of SACCOs that mobilize deposits from nonmembers is under review by the CBL and the Commissioner of Cooperatives.** The intention is to delete, by end-December 2010, Article 68 of the Cooperatives Societies Act which legalizes cooperatives to mobilize deposits from nonmembers. If a decision is taken to allow cooperative banks to take deposits from nonmembers, those institutions would have to be supervised by the central bank and would be subject to the same prudential and anti-money laundering requirements established for regular banks.

30. **The Financial Intelligence Unit, which was established in 2008 following parliamentary approval of the Anti-Money Laundering (AML) Act, is currently being set up in consultation with development partners.** Draft regulations for the unit's mandate and for the broader AML regime are being prepared by the CBL with technical assistance from the US Treasury Department, and final drafts are expected by end-September 2010.

31. **The government, with the support of MCC and the International Fund for Agricultural Development (IFAD) is committed to improving access to financial services for rural areas.** In this context, the Postbank has started to provide micro-lending products to individuals and will expand this service to small and medium-size enterprises. It will also introduce Smart-cards which will make it easier for pensioners to receive and withdraw funds. As the size of its micro-lending operations increases, the CBL will closely monitor the Postbank's operations.

VII. POVERTY REDUCTION STRATEGY

32. **The government's economic program to be supported by the ECF is consistent with the strategy of achieving broad based growth and poverty reduction set out in the Interim National Development Framework (INDF) (2008/09–2010/11).** The INDF is based on the priorities and objectives contained in the original Poverty Reduction Strategy Paper (PRSP) (2004/04–07/08). It identifies as a key priority the need to address Lesotho's vulnerability to over-reliance on remittances from South Africa as well the significant dependence of the budget on SACU revenues.

33. **To address this vulnerability, the INDF focuses on achieving sustained economic growth as a way to diversify its revenue base and generate alternative employment opportunities for Basotho.** The INDF growth strategy points to specific sectors for diversification as manufacturing, mining, tourism and agriculture. Growth would be driven

by the private sector, while the government's role would be to provide an appropriate environment through (i) sound macro-economic management; (ii) a conducive investment climate; (iii) provision of infrastructure; and (iv) a sound financial system. The INDF also acknowledges the need for reducing government spending to align it with sustainable revenues, and emphasizes the importance of improving the effectiveness and efficiency of the remaining expenditure, while at the same time protecting vulnerable groups such as pensioners and those with HIV/AIDS.

34. **The proposed ECF would support these objectives in the INDF as follows:** (i) it aims to achieve macro-economic stability through an orderly fiscal adjustment that addresses the reduction in SACU revenues; (ii) it focuses on raising non-SACU revenues and improving public expenditure and financial management; (iii) it calls for accelerating structural reforms in order to increase productivity and competitiveness which would facilitate economic diversification; and finally (iv) the program targets to strengthen the financial sector by addressing vulnerabilities from NBFIs and improving access to financial services in rural areas. The ECF-supported program also protects the vulnerable by putting a floor on critical social expenditures, including on HIV/AIDS.

35. **The INDF is a precursor, to a comprehensive five-year National Development Plan (NDP) which is planned to be implemented starting 2012/13.** By mid-2010, we plan to embark on the process of developing the NDP with wide participation of key stakeholders across the country. The NDP will aim at achieving Lesotho's development objectives of strong sustained growth for poverty reduction, as a way towards achieving the MDGs.

VIII. RISKS AND CONTINGENCY PLANS

36. **Although there are some signs of a regional and global recovery, some downside risks to the program remain.** These risks relate to: (i) the pace of the global and regional economic recovery; (ii) potentially lower SACU revenues because of: a change in the SACU revenue-sharing formula; a reduction in tariff rates due to trade liberalization; and the creation of a SADC customs union. If such risks were to materialize, the government, in close consultation with IMF staff, stands ready to take additional fiscal measures while safeguarding social spending to ensure the achievement of a sustainable fiscal position and to prevent a large reduction of reserves.

IX. SAFEGUARD ASSESSMENT

37. **The CBL welcomes the IMF's safeguards assessment and we believe it will help the CBL strengthen its internal control systems.** The CBL's financial statements are externally audited by an independent external audit firm. We look forward to the findings and recommendations of the safeguards report and CBL will work with IMF staff in the

coming months to ensure the smooth completion of the safeguards assessment by the time of the first review of the ECF in February 2011.

X. PROGRAM MONITORING

38. **Semi-annual disbursements under the ECF arrangement will be based on the observance of quantitative performance criteria.** Completion of the first and second reviews of the arrangement, by February 23, 2011 and August 17, 2011, respectively, will be based on the observance of quantitative performance criteria through end-September 2010 and end-March 2011, respectively (Table 1). The targets for end-June 2010 and December 2010 will be indicative. The definitions of the variables monitored as quantitative performance criteria are provided in the Technical Memorandum of Understanding (TMU).

39. **Government is committed to ensuring that the program remains on track, and has set up a task team chaired by the Ministry of Finance and Development Planning to monitor implementation.**

**Table 1. Lesotho: Quantitative Performance Criteria, Benchmarks, and Indicative Targets
March 2010–March 2011**

**Table 1. Lesotho: Quantitative Performance Criteria, Benchmarks, and Indicative Targets
March 2010 - March 2011**

	December, 2009 Actual	2010			2011	
		March Est.	June Benchmarks	September Perf. Criteria	December Benchmarks	March Perf. Criteria
(In millions of Maloti)						
Ceiling on the domestic financing requirement of the central government ^{1, 2, 3}	...	0.0	-217.5	311.5	779.9	1,877.0
Ceiling on the net domestic assets of the Central Bank of Lesotho ^{1, 2, 3}	-	-	1,170	1,884	1,752	3,032
(In millions of US dollars)						
Floor on the stock of net international reserves of the Central Bank of Lesotho ^{2, 3}	1,118	1,027	992	956	884	827
Ceiling on the amount of new non-concessional external debt contracted or guaranteed by the public sector (cumulative from end-March 2010 ^{2, 4}						
Maturity of less than one year	...	0	0	0	0	0
Maturity of one year or more ^{1, 5}	...	0	182	182	182	182
Ceiling on the stock of external payments arrears ⁴	...	0	0	0	0	0
(In millions of Maloti)						
<i>Indicative targets:</i>						
Floor on the central government social expenditures ⁶	...	0	170	170	170	170
Ceiling on gross cumulative payments of domestic arrears	...	0	200	200	200	200
<i>Memo items:</i>						
Net disbursements ^{1, 2}	...	0	212.2	198.9	208.0	396.3
General budget support	...	0	298.0	358.0	448.0	718.0
Debt service payments	85.8	159.1	240.0	321.7
Unused outstanding Metolong balances ¹	1279.1	1123.4	984.2	1144.4
Metolong loan disbursement	1,370.9	1,370.9	1,370.9	1,716.6
Use of Metolong loan	91.9	247.5	386.8	572.2

Sources: Ministry of Finance and Development Planning; Central Bank of Lesotho; and Fund staff estimates.

¹ Values are cumulative from end-March 2010.

² Definitions and program adjusters are specified in the TMU.

³ Excludes unused outstanding balances from the EIB loan for the Metolong dam.

⁴ Continuous performance criteria

⁵ New nonconcessional borrowing is limited to financing the Metolong dam.

⁶ Includes spending on school feeding program, old age pension and HIV/AIDS

Table 2. Lesotho: Structural Benchmarks

Benchmarks	Test Date	Macroeconomic rationale
I. Public Financial Management		
Prepare monthly monitoring reports assessing the impact of modification to the IFMIS to prevent over-commitment.	End-September 2010	Support expenditure control and medium-term fiscal consolidation
Complete an audit of user access rights to the IFMIS and assign user access rights on a "need-to-use" basis	End-June 2010	Support expenditure control and medium-term fiscal consolidation
Submit to Cabinet a comprehensive review of all on-going capital projects, assessing their desirability and make recommendations on projects to be retained or eliminated	End-September 2010	Enhance the efficiency and quality of public expenditure
II. Structural Reforms		
Submit to Parliament the Companies Bill	End- September 2010	Improve the business climate to facilitate private sector-led growth, and increase productivity and competitiveness
III. Financial sector regulation		
Issue domestic bonds	End-December 2010	Development of the domestic money and capital markets
Submit to Parliament the amended Financial Institutions Act	End-September 2010	Strengthen prudential regulations and reduce systemic risks to the domestic financial sector

Attachment II**The Kingdom of Lesotho: Technical Memorandum of Understanding**

May 17, 2010

1. This memorandum sets forth the understandings between the government of Lesotho and the IMF staff regarding the definitions of the quantitative performance criteria and benchmarks for a new three-year arrangement supported under the Extended Credit Facility (ECF), as well as the respective reporting requirements. These performance criteria and benchmarks are reported in Table 1 of the government's Memorandum of Economic and Financial Policies (MEFP).

**A. Ceiling on the Domestic Financing Requirement (DFR)
of the Central Government**

2. **Definition.** The central government includes the central administration and all district administrations. The domestic financing requirement of the central government is defined as net credit to the government from the banking system (that is, the Central Bank of Lesotho and the commercial banks) plus holdings of treasury bills and other government securities by the nonbank sector. For program monitoring purposes, the domestic financing requirement will be calculated as the change from end-March 2010 of net credit to the government by the banking system and of holdings of treasury bills and other government securities by the nonbank sector. In particular, the calculation of the domestic financing requirement shall include changes in (i) balances held in the privatization account or balances of other accounts into which proceeds from the sale of public enterprises are deposited; (ii) the amount of outstanding treasury bills issued by the Central Bank of Lesotho for monetary policy purposes; and (iii) the balance of the blocked government deposit account used by the Central Bank of Lesotho to sterilize reserve money absorbed by monetary policy operations. The calculation of the domestic financing requirement shall exclude changes in balances held in any account into which revenues collected by the customs department are held pending their transfer to the SACU revenue pool. External debt service, amortization, disbursements and external grants will be calculated at an exchange rate of M 8.55 per U.S. dollar.

3. **Supporting material.** The Central Bank of Lesotho will provide the monetary survey and other monthly monetary statistics, as well as a table showing the details of all government financing operations from the nonbank public, on a monthly basis and within 30 days of the end of the month. The following information will be presented as memorandum items in the monetary survey: (i) the outstanding balances in the privatization account or accounts; and (ii) details of any monetary operations with treasury bills, including changes in government deposits as a result of such operations. The Central Bank of Lesotho will also provide a table showing the details of government debt by type and holder. The

Ministry of Finance and Development Planning will provide detailed monthly budget operation reports and tax arrears reports.

B. Ceiling on the Stock of Net Domestic Assets of the Central Bank of Lesotho

4. **Definition.** The net domestic assets (NDA) of the Central Bank of Lesotho are defined as the difference between reserve money (currency in circulation plus total bank deposits at the central bank) and NFA (as defined in paragraph 5). The NDA thus includes net claims by the Central Bank of Lesotho on the government (loans and treasury bills purchased less government deposits), claims on banks, and “other items net” (other assets, other liabilities, and the capital account).

5. **Definition.** The net foreign assets (NFA) of the Central Bank of Lesotho are defined as foreign assets minus foreign liabilities, and include all foreign claims and liabilities of the central bank. The values of all foreign assets and liabilities will be calculated in U.S. dollars at the end of each quarter using the program exchange rates.

6. **Supporting material.** The Central Bank of Lesotho will provide detailed data on its balance sheet on a monthly basis within 21 days of the end of the month. The central bank will also provide a table of selected monetary indicators covering the major elements of its balance sheet on a weekly basis.

C. Floor on the Stock of Net International Reserves of the Central Bank of Lesotho

7. **Definition.** The net international reserves (NIR) are defined as the Central Bank of Lesotho’s liquid, convertible foreign assets minus its convertible foreign liabilities. Pledged or otherwise encumbered assets, including, but not limited to, assets used as collateral or as guarantee for third-party external liabilities are excluded from reserve assets. Reserve assets include cash and balances held with banks, bankers’ acceptances, investments, foreign notes and coins held by the Central Bank of Lesotho, Lesotho’s reserve position in the Fund, and SDR holdings. Reserve liabilities include nonresident deposits at the Central Bank of Lesotho, use of IMF credit, and any other liabilities of the central bank to nonresidents. The stock of NIR at the end of each quarter is defined in U.S. dollars and will be calculated using the program exchange rates.³

³ Program cross exchange rates are: South African rand per U.S. dollar: 7.; U.S. dollars per pound sterling: 1.5; U.S. dollars per euro: 1.3; Swiss francs per U.S. dollar: 1.1; Swedish kronor per U.S. dollar: 7.3; and Botswana pula per U.S. dollar: 6.8. Program maloti per U.S. dollar exchange rate: 7.3.

8. **Supporting material.** The Central Bank of Lesotho will provide data on its NIR on a monthly basis within one week of the end of the month. The NIR data will be provided in a table showing the currency breakdown of the reserve assets and reserve liabilities of the Central Bank of Lesotho converted into U.S. dollars and maloti at the program exchange rates.

D. Ceiling on the Amount of New Nonconcessional External Debt Contracted or Guaranteed by the Public Sector, with Original Maturity of One Year or More

9. **Definition.** For purposes of the ECF, concessionality requirements will be applied to foreign-currency denominated debt regardless of the residency of the creditor. The public sector comprises the central government, the Central Bank of Lesotho, and all public enterprises and other official sector entities with majority state ownership. This performance criterion applies not only to debt as defined in point No. 9 of the Guidelines on Performance Criteria with Respect to External Debt in Fund Arrangements, adopted by Decision No. 6230-(79/140), as revised on August 24, 2000, as amended effective December 1, 2009, but also to commitments contracted or guaranteed for which value has not been received. Included in this performance criterion are all current liabilities that are created under a contractual arrangement through the provision of value in the form of assets (including currency) or services, and that require the public sector (obligor) to make one or more payments in the form of assets (including currency) at some future point(s) in time to discharge principal and/or interest liabilities incurred under the contract. In effect, all instruments that share the characteristics of debt as described above (including loans, suppliers' credits, and leases) will be subject to the ceiling. New nonconcessional borrowing is limited to the Metolong dam, a high-return public investment project. The performance criterion will be evaluated on a continuous basis as the cumulative change in the amount of new nonconcessional debt contracted or guaranteed from end-March 2010 onward.

10. **Definition.** A loan is concessional if its grant element is at least 35 percent of the value of the loan, calculated using a discount rate based on commercial interest reference rates (CIRRs) reported by the OECD. For loans of maturity of greater than 15 years, the grant element will be based on the ten-year average of OECD CIRRs. For loans of maturity of 15 years or less, the grant element will be based on the six-month average of OECD CIRRs. Margins for differing repayment periods would be added to the CIRRs: 0.75 percent for repayment periods of less than 15 years, 1 percent for repayment periods of 15 to 19 years, 1.15 percent for repayment periods of 20 to 29 years, and 1.25 percent for repayment periods of 30 years or more.

11. **Supporting material.** Details of all new commitments and government guarantees for external borrowing, with detailed explanations, will be provided by the Ministry of Finance and Development Planning on a monthly basis within 30 days of the end of the month.

E. Ceiling on the Amount of New External Debt Contracted or Guaranteed by the Public Sector, with Original Maturity of Less than One Year

12. **Definition.** The public sector comprises the central government, the Central Bank of Lesotho, and all enterprises with majority state ownership. This performance criterion applies not only to debt as defined in point No. 9 of the Guidelines on Performance Criteria with Respect to External Debt in Fund Arrangements, adopted by Decision No. 6230-(79/140), as revised on August 24, 2000, as amended effective December 1, 2009, but also to commitments contracted or guaranteed for which value has not been received. Included in this performance criterion are all current liabilities that are created under a contractual arrangement through the provision of value in the form of assets (including currency) or services, and that require the public sector (obligor) to make one or more payments in the form of assets (including currency) at some future point(s) in time to discharge principal and/or interest liabilities incurred under the contract. In effect, all instruments that share the characteristics of debt as described above (including loans, suppliers' credits, and leases) will be subject to the ceiling. Excluded from this performance criterion are normal short-term import credits. The performance criterion will be evaluated on a continuous basis as the cumulative change in the amount of new nonconcessional debt contracted or guaranteed from end-March 2010.

13. **Supporting material.** Details of all new commitments and government guarantees for external borrowing, with detailed explanations, will be provided by the Ministry of Finance and Development Planning on a monthly basis within 30 days of the end of the month.

F. Ceiling on the Stock of External Payments Arrears

14. **Definition.** During the period of the arrangement, the stock of external payments arrears of the public sector (central government, Central Bank of Lesotho, and all enterprises with majority state ownership) will continually remain zero. Arrears on external debt-service obligations include any nonpayment of interest and/or principal *in full and on time* falling due to all creditors, including the IMF and the World Bank.

15. **Supporting material.** Details of arrears accumulated on interest and principal payments to creditors will be reported within one week from the date of the missed payment.

G. Ceiling on Domestic Arrears

16. **Definition:** Domestic arrears are overdue payment obligations of the central government other than external payment arrears, including on wages and salaries, pensions, transfers, domestic interest, goods and services, obligations arising from court cases, legally established compensation claims, and tax refunds. Payments on wages and salaries, pensions, transfers, court-established obligations, and compensations are in arrears when they remain

unpaid for more than 45 days beyond their due date. Domestic interest payments are in arrears when the payment is not made on the due date. Payments for goods and services are deemed to be in arrears if they have not been made within 45 days of the date of invoice, or—if a grace period has been agreed—within the contractually agreed grace period.

17. **Supporting material:** Information regarding domestic arrears is to be compiled through audits of the accounts of spending Ministries and agencies, conducted by the Internal Audit division of the Ministry of Finance and Development Planning. The audits will be completed and data submitted to IMF staff within six weeks of the end of each quarter. This audit information will be cross-checked with the data obtained from the IFMIS with a view to improving the functionality of the IFMIS.

H. Floor on the Central Government Social Expenditures

18. **Definition:** There will be a floor on the Central Government Social Expenditures. The observance of this floor is an indicative target. Social expenditures comprise spending on the following programs: school feeding program, old age pension, and HIV/AIDS.

Social Expenditures 2010/11				
(in millions of Maloti)				
	Jun-10	Sep-10	Dec-10	Mar-11
Social Expenditures	170.0	170.0	170.0	170.0
Social Benefits	88.8	88.8	88.8	88.8
<i>o/w</i> Old Age Pension	73.8	73.8	73.8	73.8
APC Pension	5.5	5.5	5.5	5.5
Public Assistance Cash & Kind	9.5	9.5	9.5	9.5
School Feeding Program	54.5	54.5	54.5	54.5
HIV/AIDS	26.7	26.7	26.7	26.7
<i>o/w</i> Anti-Retroviral Therapies	23.7	23.7	23.7	23.7
2. Source: Ministry of Finance and Development Planning				

19. **Supporting material:** Data on social spending will be compiled by the Ministry of Finance and Development Planning and will be provided on a quarterly basis, to be submitted no later than six weeks after the end of each reporting period.

I. Adjusters

20. The quantitative performance criteria specified under the program are subject to the following adjusters:

A. Southern African Customs Union Revenues

- The program targets for the NIR, NDA, and DFR in any quarter will be adjusted upward by the amount of any advance receipts from the Southern Africa Customs Union (SACU) in that quarter, where such advance receipts constitute amounts that would otherwise have been received in a subsequent quarter. It will be adjusted for accounting practice changes implemented by the Central Bank of Lesotho that are recommended by the IMF's Statistics Department or are made in response to the IMF safeguards assessment.

21. **Supporting material:** The Central Bank of Lesotho will provide data on SACU receipts on a quarterly basis within the first month of the quarter.

B. Budgetary Support net of Debt Service⁴

- The ceilings on NDA and DFR will be adjusted downward (upward) by the full amount of the excess (shortfall) in budgetary support net of debt service relative to the programmed levels specified in Table 1 of the MEFP.
- The floor on the NIR of the Central Bank of Lesotho will be adjusted upward (downward) by the full amount of the excess (shortfall) in budgetary support net of debt service relative to the programmed levels specified in Table 1 of the MEFP.

22. **Supporting material:** Data on budget support and debt service will be compiled by the Ministry of Finance and Development Planning and will be provided on a quarterly basis, to be submitted no later than six weeks after the end of each reporting period.

C. Payment of Arrears

- The ceilings on NDA and DFR will be adjusted downward (upward) by the full amount of the excess (shortfall) in payments of arrears relative to the programmed levels specified in Table 1 of the MEFP.
- The floor on the NIR of the Central Bank of Lesotho will be adjusted downward (upward) by the full amount of the excess (shortfall) in payment of arrears relative to the programmed levels specified in Table 1 of the MEFP.

23. **Supporting material:** Data on domestic arrears will be compiled by the Ministry of Finance and Development Planning and will be provided on a quarterly basis, to be submitted no later than six weeks after the end of each reporting period.

⁴ General budget support consists of grants and loans received by the Central Government for financing its overall policy and budget priorities.