International Monetary Fund

Lesotho and the IMF

Press Release:
IMF's Executive Board Completes the Sixth Review Under the ECF Arrangement for the Kingdom of Lesotho, and Approves US$8.6 Million Disbursement
September 9, 2013

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

August 14, 2013

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Letter of Intent

August 14, 2013

Ms. Christine Lagarde
Managing Director
International Monetary Fund
Washington, D.C. 20431
United States of America

Dear Ms. Lagarde:

This letter and the attached Memorandum of Economic and Financial Policies (MEFP) update and supplement my communication of April 20, 2012, describe performance under the government's economic program, and provide an update on our economic policies for 2013/14.

Our performance under the program supported under the Extended Credit Facility (ECF) has remained strong. We met all the end-March 2013 performance criteria and indicative targets (Table 1, MEFP). Although we are fully committed to our structural reforms under the program, administrative setbacks resulted in a delay in the completion of structural benchmarks (SBs), with one SB met with delay (the establishment of a cash management unit (CMU) in the treasury) and two others still in progress (the reconciliation of all treasury accounts on a monthly basis and the production of a monthly monitoring report; and the submission of the Public Debt Management Bill to Parliament). The reconciliation of all treasury accounts has been delayed, owing to the inability of line ministries and agencies to provide the reconciled bank statements. To enforce this important requirement under the Public Financial Management Act (PFMA), the Ministry of Finance, on a selective basis, has begun freezing accounts for which statements are not submitted. The CMU has been established since end-July, following a delay in the recruitment of all staff for that unit. Following internal consultations between the Ministry of Finance and the Central Bank of Lesotho, the draft Public Debt Management Bill has recently been sent to the attorney general for certification before final cabinet clearance and submission to Parliament. The bill is expected to be submitted to Parliament in September 2013 when Parliament reconvenes.

We therefore request completion of the sixth review of the ECF-supported program and associated disbursement, based on overall performance under the program and the government's policy intentions going forward. We consent to the publication, including on the IMF website, of this letter of intent, the attached MEFP, and the accompanying staff report.

The ECF arrangement has played an important role in the consolidation of macroeconomic stability following a series of exogenous shocks, mainly the decline in SACU revenues and adverse climatic conditions in 2010–12. Relatively robust growth has been maintained under the arrangement, which has helped to restore fiscal and external sustainability and facilitate structural reforms.

In light of our successes under the current ECF arrangement and given remaining challenges, particularly with respect to public financial management, the civil service reform and financial sector development, the government intends to continue implementing reforms, with the support of the IMF under a possible successor three-year arrangement. The government, therefore, plans to start negotiations with the IMF in the coming months.

To facilitate broad national dialogue on a key medium-term economic reform agenda, we plan to hold a national seminar in October 2013. The outcome of the dialogue would inform economic policies and reforms supported under a possible new three-year arrangement with the IMF.

Yours sincerely,

/s/	/s/
Hon. Dr. Leketekete Victor Ketso, Minister of Finance	Dr. Rets'elisitsoe Matlanyane Governor of the Central Bank of Lesotho

Attachments

Attachment I. Memorandum of Economic and Financial Policies

I. Recent Economic Developments and Outlook

1. **Despite the drought, Lesotho maintained robust growth in 2012/13, largely driven by construction.** Annual inflation has subsided to 4.6 percent in June 2013 in response to the continued easing of international commodity prices. Supported by the progress in fiscal consolidation and recovery of revenues from the Southern African Customs Union (SACU), the external balances continue to recover, with gross international reserves reaching US$1 billion, equal to 4¼ months of imports, at end-April 2013, up from 3½ months of imports in April 2012.

2. **We achieved an estimated fiscal surplus of 5¼ percent of GDP in 2012/13, while safeguarding spending on vulnerable groups and some priority infrastructure.** Our core SACU fiscal deficit (excluding externally financed capital projects) is estimated at 5⅔ percent of GDP,[1] helping to restore macroeconomic stability and further improve international reserves. These objectives were achieved by reducing non-priority outlays through stricter expenditure control. Tax revenues fell short of our projections, partly because investment cost in the mining sector reduced the corporate income tax.

3. **In the coming years, we are expecting robust economic growth to continue, though the Lesotho economy continues to face downside risks.** The growth prospects—above 4 percent—will be supported by recovery in agricultural production and continued expansion of diamond mining activities. The prospects, however, are subject to downside risks from uncertainties associated with the global and South African economies. Specifically, the uncertain global economic outlook poses risks to the regional economy and future SACU revenue, as well as external demand for Lesotho's key exports—diamonds and textiles. The low level of international diamond prices—which are already lowering export receipts—may also undermine the prospects of the mining industry. Exports of textiles could be affected by the impending expiration that the African Growth and Opportunity Act (AGOA) trade preferences will expire in 2015, though we are optimistic that the adverse impact will be mitigated by enhancing exports to the region and other areas (non AGOA exports).

[1] The core SACU fiscal balance—defined as the fiscal balance excluding the volatile component of SACU revenue and foreign-financed project loans—is the key policy anchor for fiscal consolidation efforts. The volatile component of SACU revenue is defined as the total SACU revenue minus the core component equal to 15 percent of GDP, which is close to the lowest annual SACU receipt in the last two decades.

II. Performance Under the Program

4. **Overall performance under the ECF-supported program has been strong.** We have met all the end-March 2013 quantitative performance criteria and indicative targets (Table 1). Despite our continued efforts on structural reforms, implementation of structural benchmarks (SBs) has been delayed through May 2013, with one SB met with delay and two others uncompleted (Table 2).

i. The cash management unit (CMU) has been established since end-July, following some delay in the recruitment process of staff for that unit. The CMU has been staffed, and an operational manual has been prepared based on assistance from AFRITAC South. Following its establishment, further IMF technical assistance has been provided to strengthen cash management operations.

ii. The reconciliation of the government's bank accounts has been delayed. Currently, government expenditure accounts held at the Central Bank of Lesotho (CBL) are being reconciled on a daily basis. The reconciliation of the commercial bank accounts and government revenue through the main revenue account (MRA) has been delayed, owing to challenges with the IFMIS and failures of budgetary agencies to submit necessary information for the reconciliation. The government is taking appropriate measures to resolve the problem, including the suspension of accounts, where ministries have not been compliant. We have also recently finalized the treasury regulations, which will help with the implementation of the PFMA, including the strengthening of the requirement for chief accounting officers to submit reconciled monthly financial statements.

iii. The Public Debt Management Bill will be submitted to Parliament by end-September 2013, notwithstanding the delays in concluding internal consultations on the operational aspects of this bill. The draft Public Debt Management Bill has recently been sent to the attorney general for certification before cabinet policy clearance and submission to Parliament.

III. Macroeconomic Policies Under the Program

5. **We remain committed to achieving fiscal and external sustainability over the medium term, while addressing our development and social needs.** As a small open economy, Lesotho is prone to exogenous shocks, and it will continue to benefit from the exchange rate regime fixed to the South African rand. We therefore continue to aim at securing an adequate level of international reserves for such future shocks (equal to above five months of imports).

6. **Building on the progress in securing fiscal and external sustainability, we are committed to promoting private sector development, to further reduce poverty and make growth more sustained and broad based.** As an implementation strategy for the National Vision 2020, the National Strategic Development Plan (NSDP) seeks to (i) pursue economic growth that is high, shared, and job-creating; (ii) develop priority infrastructure; (iii) enhance the

country's skills base, technology adoption, and foundations for innovation; (iv) improve health, combat HIV/AIDS, and reduce (social) vulnerability; (v) reverse environmental degradation and adapt to climate change; and (vi) promote peace and democratic governance and build effective institutions. To effectively implement the National Strategic Development Plan (NSDP), we recently finalized the *Public Sector Investment Programme* (PSIP), the *Implementation Plan*, and the *Monitoring and Evaluation Framework*. Subsequently, the government has initiated a dialogue with international partners to mobilize resources to assist the implementation of the NSDP. To strengthen social protection, we plan to develop a Social Protection Strategy to lay out the overall objectives of the Social Protection programs.

Macroeconomic Policies for 2013/14

7. **We target at achieving sustained growth, while we remain committed to rebuilding international reserves buffer in support of our exchange rate peg to the South African rand.** We will therefore maintain our fiscal consolidation efforts, while supporting economic growth and employment, protecting vulnerable groups, and proceeding with priority infrastructure projects under the NSDP. We aim to achieve our targeted deficit limit in the core SACU fiscal surplus of 4¼ percent of GDP for 2013/14. This target would facilitate adequate capital spending for growth, while we pursue further rationalization and efficiencies in recurrent spending (particularly on the wage bill and on goods and services) and strengthen revenue administration. With these consolidation efforts, the external balances are expected to further improve, and gross international reserves would reach US$1.1 billion, equal to 4⅔ months of imports by March 2014.

8. **In pursuit of our fiscal consolidation, we intend to (i) limit the filling of vacant posts and contain creation of new positions to a few posts (mainly at newly created ministries[2]), (ii) reduce non-priority outlays through stricter expenditure control, (iii) limit contingency spending to emergencies, and (iv) implement revenue administration measures following the completion of the Lesotho Revenue Authority (LRA) restructuring.** While we continue to restrain the overall wage bill, we have provided increases in wages and salaries to retain technically skilled workers, regularized the wage structure, and brought wages and salaries closer to the minimum income level for the lower grades. During the coming years, with the assistance of the World Bank, the government intends to undertake a full civil service audit, which would determine the exact number of public servants and assist in the clean-up of the payroll. The government will further conduct a review of the civil service to determine the optimal size of the civil service and restructuring needs to improve efficiency of the public sector and help achieve the goals of the NSDP.

[2] These include the ministries of development planning, mining, and social development.

Structural Reforms

Enhancing Revenue Administration

9. **To improve domestic revenue collection, we will continue to strengthen tax administration and broaden the tax base.** As a part of restructuring of the LRA, a full-service large tax payer unit has been established. Furthermore, the LRA has been undertaking further efforts to improve recovery of unpaid taxes, expand the taxpayer's registration, and strengthen compliance and service delivery. The government plans to undertake a comprehensive review of the income taxes and the VAT to improve tax efficiency. With IMF technical assistance, we also aim to review the mining taxation regime by fall-2013 to ensure that the regime is consistent with international best practices.

Improving Public Financial Management (PFM)

10. **Notwithstanding the challenges that we face in cash management and treasury reconciliation, we have made further progress in improving the regulatory frameworks and institutional management of PFM reforms, based on the PFM action plan.**[3] The treasury regulations are at a final stage and soon will be sent to Parliament for adoption. These regulations—assisting the implementation of the PFMA Act—are expected to further ensure that chief accounting officers of line ministries submit reconciled monthly financial statements. The Audit Act is also being finalized and has been submitted to Parliament. This act will enforce the timely submission of audits to Parliament, in light of the backlog of unaudited public accounts for 2010/11 and 2011/12. To ensure the timely implementation of the PFM Action Plan, the secretariat for the plan has been identified, and, with funding from the EU, the IMF will support a technical assistance expert to assist the secretariat. Areas of technical assistance in PFM are being coordinated with Lesotho's international partners (e.g., IMF, EU, World Bank, AfDB). Furthermore, the Ministry of Finance plans to strengthen the monitoring and oversight of public agencies' financial reporting, as envisaged under the PFMA Act.

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[3] This plan—prepared with assistance by the IMF's Fiscal Affairs Department (FAD) and AFRITAC South and in full coordination with all the key donors—details the reform deliverables for the next three years. The reforms aim at achieving the following objectives: (i) developing and implementing a modern PFM regulatory framework; (ii) improving transparency and effectiveness of fiscal policy by enhancing macro-fiscal projections and strengthening the links between fiscal strategy and budget appropriations; (iii) strengthening internal controls, accounting and fiscal reporting to achieve full compliance with the regulatory framework; and (iv) improving governance and institutional management of PFM reforms.

Strengthening Debt Management

11. We have made progress in strengthening debt management. With technical assistance from the IMF, legislation is being formulated to safeguard debt sustainability and modernize the debt management framework. Based on the Debt Management Performance Assessment (DEMPA), we are developing a broader reform plan and a medium-term debt management strategy, with the assistance from the World Bank. Because of our moderate risk of debt distress, we will continue to seek external financing through grants and concessional loans to support the implementation of the NSDP. Looking forward, we also are assessing options for the medium-term financing of the second phase of the Lesotho Highlands Water Project, which may not be available on concessional terms. To focus on key priority projects with high economic rates of return and consistent with Lesotho's debt service capacity (to avoid debt distress), all capital projects continue to be appraised by the project appraisal committee before being allocated in the budget.

Supporting Financial Sector Development

12. **We will continue our efforts to strengthen the legal and regulatory frameworks necessary for financial deepening.** The new Financial Institutions Act (FIA) has empowered the CBL to regulate and supervise nonbank financial institutions (money lenders, foreign exchange bureaus, microfinance institutions, cooperative banks). Supported by IMF TA, we are finalizing a draft of revised banking regulations under the Financial Institutions Act 2012 (including licensing regulations, asset classification regulations, liquidity requirements regulations, lending limits regulations). Based on further technical assistance from the IMF, other financial institutions regulations (e.g., risk management regulations, prompt corrective action regulations, disclosure of financial information regulations) are being developed, and we will also improve supervision and regulation of the insurance sector. Moreover, we have been closely monitoring potential risks associated with a rapid private sector credit growth. To this end, we will review the adequacy of our current loan classification, provisioning rules, and collateral valuation practices. In accordance with the NSDP, we aim to review and improve other related legal frameworks, including pension legislation, bankruptcy, and leasing laws. These measures will help improve confidence in the financial system and further spur financial sector development. More broadly, to facilitate financial intermediation and promote private sector development and inclusive growth, we have, with assistance from the IMF and World Bank, prepared a comprehensive draft Financial Sector Strategic Development Plan (FSSDP) that we expect to be finalized by September 2013.

Improving Investment Climate

13. We have embarked on implementing measures to promote private sector development, in a comprehensive plan to improve the business climate in the NSDP. In collaboration with the World Bank, we will seek to improve the business climate and promote private sector development, specifically in accessing land, obtaining construction permits, engaging in cross-border trade with South Africa, and accessing finance. We began to issue security-enhanced national identification cards in July 2013. This project will aid in the establishment of a credit rating agency and foster bank lending to the private sector. We will continue our ongoing land titling program and fully implement the 2010 Land Administrations Act.

IV. Program Issues

14. **Safeguard assessment**. We remain committed to implementing all safeguards recommendations from the 2010 and 2012 assessments. Specifically, the CBL will continue the practice of appointing international audit firms with experience in auditing central banks for the duration of this and any successor arrangements, and thereafter for as long as IMF's credit remains outstanding. We will also continue to publish the CBL's audited annual financial statements within one month after audit completion. Finally, we allocated sufficient resources in the 2013 budget of the CBL to strengthen internal audit capacity in the near term.

Table 1. Lesotho: Quantitative Performance Criteria, Benchmarks, and Indicative Targets, March 2011–March 2013

	2011						2012						2013				2014
	March		Status	Sep.		Status	March		Status	Sep.		Status	Mar.		Status	Sep.	Mar.
	PC	Act.		PC	Act.		PC	Act.		PC	Act.		PC	Act.		Proj.	Proj.
Ceiling on the domestic financing requirement of the central government [1, 2]	1,453			1,435			1,629			227			-966			-586	-1,172
Adjusted benchmark	1,670	1,231	Met	1,385	482	Met	1,564	1,284	Met	346	-950	Met	-953	-2,085	Met		
Ceiling on the net domestic assets of the Central Bank of Lesotho [1, 2]	1,335			1,314			1,275			118			-499			-1,075	-1,809
Adjusted benchmark	1,551	1,397	Met	1,264	9	Met	1,210	515	Met	237	-1,065	Met	-486	-1,796	Met		
							(US$ millions)										
Floor on the stock of net international reserves of the Central Bank of Lesotho [2]	805			634			736			723			987			1,157	1,220
Adjusted benchmark	776	897	Met	641	892	Met	745	851	Met	707	973	Met	985	1,096	Met		
Ceiling on the stock of external payments arrears [3]	0	0	Met	0	0	Met	0	0	Met	0	0	Met	0	0		0	0
Ceiling on the amount of new non-concessional external debt contracted or guaranteed by the public sector (cumulative from end-March 2010) [2, 3]																	
Maturity of less than one year	0	0	Met	0	0	Met	0	0	Met	0	0	Met	0	0	Met	0	0
Maturity of one year or more	182	242	Not Met [5]	182	242	Not Met [5]	182	274	Not Met [5]	182	274	Not Met	274	274	Met	274	274
							(Maloti millions)										
Indicative targets:																	
Floor on the central government social expenditures[4]	170	205	Met	170	170	Met	170	170	Met	183	147	Not Met	183	195	Met	216	216
***Memorandum items*:**																	
Net disbursements [1,2]	304	272	…	-18	32	…	-122	-57	…	-65	-185	…	-104	-118	…	-102	-201
General budget support	552	530	…	154	162	…	207	302	…	120	0	…	300	196	…	162	323
Debt service payments	249	258	…	172	131	…	329	359	…	185	185	…	404	314	…	263	524
SACU receipts [1]	2,628	2,628	…	1,376	1,376	…	2,752	2,752	…	2,983	2983	…	5,966	5,966	…	3,027	6,055

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

[1] Values are cumulative from April 1st (beginning of the fiscal year).

[2] Definitions and program adjusters are specified in the TMU.

[3] Continuous performance criteria.

[4] Includes spending on school feeding program, old age pension, war veterans, and HIV/AIDS.

[5] At the time of the 4th review under the ECF arrangement for Lesotho on November 27, 2012 the Board granted a waiver of nonobservance of the continuous PC on contracting/guaranteeing of new nonconcessional debt up to 274 million cumulative from March-2010.

Table 2. Structural Benchmarks through May 2013

Benchmarks	Test date	Status
I. Public Financial Management		
Establish a Cash Management Unit in the Treasury.	End-May 2013	Met with delay. Established in late-July 2013.
Reconcile all Treasury (Revenue and Expenditure) Accounts on a monthly basis and produce a monthly monitoring report.	End-May 2013	Not met. Steps are being taken to enforce reconsiliation reporting by line ministries.
II. Debt Management		
Submit to Parliament the amendments of the Loans and Guarantees Act	End-May 2013	Not met. The Public Debt Management bill has been sent to the attorney general and will be submitted to the parliament by end-September.