Economic Review June 2013

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1. Development Policy Operation for Lesotho

The Board of Directors of the World Bank approved a grant of US$20 million for the Government of Lesotho (GoL) for the First Growth and Competitiveness Development Policy Grant…

1.1 Background

Development Policy Operation (DPO) is the financial assistance by the World Bank extended to its clients in a form of a grant, loan or credit. It aims to support the implementation of the country's reforms program, which ensures the achievement of sustainable poverty reduction.

Before DPO is approved, the reforms supported by it are reviewed with the objective of identifying whether they are likely to have any significant poverty and social impacts.

The World Bank's use of DPO is, therefore, determined in the context of the Country Assistance Strategy (CAS). Thus, DPO supports progress towards CAS objectives.

As one of the World Bank's Country Assistance Strategy (CAS) recipient, Lesotho received a grant worth US$20 million aimed at supporting the implementation of the First Growth and Competitiveness Development Policy Operation program. This Operation is the first in a series of three single-tranche operations envisaged in the CAS covering the period 2010-14. It builds on the achievement and lessons of the preceding Poverty Reduction Strategy Credit series and aims to consolidate reforms supported by the previous operations.

The Operation is designed to assist the government in implementing a reform program aimed at promoting growth, competitiveness and public sector efficiency. Specifically, it supports three areas that are essential to the reform program. These are (1) improving private sector competitiveness, (2) improving the sustainability and efficiency of public spending, as well as (3) improving social production and monitoring systems. The operation also supports progress towards the CAS objectives of fiscal adjustment and public sector efficiency, and enhanced competitiveness and diversification.

Furthermore, the three strategic goals of the National Strategic Development Plan (NSDP) are also being supported by this operation. These are:

- Pursuing high, shared and employment creating economic growth
- Improving health, combating HIV/AIDS and reducing social vulnerability
- Promoting peace and democratic governance and building effective institutions.

The aim of this article, therefore, is to provide a brief overview of World Bank's CAS and the current CAS for Lesotho. This will be followed by the review of the Development Project Operation (DPO)'s relationship with other WB operations undertaken in Lesotho as a way of ensuring growth and development, and lastly the discussion on DPO as the central component of the World Bank's CAS in Lesotho for 2010-2014.

1.2 Review of the CAS

The CAS is the most important World Bank country document. It is tailored to the needs and circumstances of each country and lays down the WB Group's development priorities, as well as the level and type of assistance the WB will provide for a period of three to four years. This document also identifies the key areas in which the WB Group support can best assist a country in achieving development and poverty reduction. Thus, CAS aligns itself with the country's vision of its development goals, which is normally set out in the country's poverty reduction strategy of the country-led strategy process.

This document is prepared after consultation with the country's authorities, civil society and other stakeholders, with the aim of linking the country's development priorities to the selected WB Group support so as to promote coordination with other development partners. The CAS is prepared for active borrowers from International Development Assistance (IDA) and International Bank for Reconstruction and Development (IBRD).

The CAS preparation is a participatory process. Before its adoption, key elements of the strategy are discussed with government representatives, and, to ensure the widest possible involvement, public dialogues are also held, with Internet-based discussions taking place in many countries.

However, the CAS is not a negotiated document. Any differences between the country's own agenda and the WB's strategy are highlighted in the CAS document. A progress report is issued in the intervening year.

The CAS for Lesotho for the period 2010-14 was developed within the context of the Government's strategy for growth and sustainable development, as expressed in the 2002 "Vision 2020" and its Interim National Development Framework.

It seeks to support Lesotho's efforts to sustain economic growth and to address critical human development challenges by supporting government efforts to undertake fiscal adjustment and strengthen public finance management, improve efficiency, quality and equity in access to basic services, and strengthen the competitiveness of the country.

1.3 DPO's Relationship with other World Bank Operations

DPO is linked to Private Sector Competitiveness and Economic Diversification Project which supports the government in areas that are meant to improve business climate, competitiveness of the private sector as well as to promote access to finance. Although the operation was scheduled to end in June 2013, the follow-up project is already underway, which will continue to capacitate the government with technical assistance as a way of achieving greater private sector development.

Besides the above operation, the Bank also acts as an advisor on the four on-going Private Public Partnership (PPP) projects that have been put in place as an overall PPP framework. These operations include:

- Development of a PPP project at 170 public-health facilities aimed at improving health sector growth.
- Designing and development of health-care waste management PPP projects which will ensure the implementation of the Health Care Waste Management Strategic Plan, which was prepared in 2010.
- Development of a tourist program which will create a PPP framework for the country's tourist sector.
- Caring out of a feasibility study for two wind energy sides which will make it possible for the development of the PPP for growth and financing of private operator.

Finally the operation is linked to Lesotho Public Financial Management Reform Support Project which is aimed at refurbishing Integrated Financial

Management Information System (IFMIS) as well as linking it to the country's payroll management system so as to strengthen the public procurement system.

1.4 Strategic Areas of Engagement/Reform

DPO provides a direct budget support to the government for policy and institutional reforms aimed at achieving a set of specific development results. Thus, it provides rapid financial assistance to allow countries to deal with actual or anticipated development financing requirements. The three policy areas that the operation aims to support are:

A. *Improving Private-Sector Competitiveness*

The Government of Lesotho (GoL) recognizes that the mobilization of domestic and foreign investment and the development of private sector are key requirements to creating high and shared growth. The new Companies Act of 2011 aims, amongst others, to promote investment and innovation in Lesotho through strengthening education to encourage self-compliance to traders.

Again, the act seeks to promote efficiency of companies and their management as well as encouraging transparency and high standards of corporate governance in the business sector.

A number of initiatives have been carried out over the years as part of improving the business climate in Lesotho. For instance, Lesotho made starting a business easier by creating a one-stop shop for company incorporation in an attempt to create and enable regulatory and administrative environment in which a business can operate.

Furthermore, it has strengthened investor projections by increasing the disclosure requirements for related-party transactions and improving the liability regime for company directions in cases of abuse related-party transactions.

In order to improve cross-border trading, the GoL has implemented a Customs Modernization Strategy which provides a robust framework for coordinating and aligning customs-related activities, including coordination of border institutions.

Despite these initiatives, Lesotho's private sector growth has slowed down amid a number of factors, which would need to be addressed. These include uncompetitive business environment, accessing land, obtaining construction permits, as well as accessing finance.

B. *Improving the Sustainability and Efficiency of Public Expenditure*

As a means of ensuring high and sustainable growth and attracting Foreign Direct Investment (FDI) that would support such growth, the GoL remains committed to maintaining a stable macroeconomic environment. It has done this by making a decision to maintain the annual budget deficit below 3 per cent of GDP.

The country has been running a fiscal surplus in the past. However, the global financial crisis of 2008-09 impacted negatively on the government fiscal position, due to a fall in demand for import in the Southern African Customs Union (SACU) which resulted in shrinking of the SACU revenue. The drastic fall of the SACU revenue resulted in high levels of deficit since this is the major contributor of governments' revenue.

Nevertheless, there was a rebound in SACU revenue in 2012/13- 2013/14 which reduced the fiscal deficit.

In an attempt to strengthen the effectiveness of public spending and accountability framework, the government has compiled, in 2012, a Public Expenditure and Financial Accountability (PEFA) report, which has indicated that there is progress though slow.

C. *Improving Social Protection and Monitoring Systems*

i. <u>Strengthening of social protection</u>

As a way of strengthening social protection, the GoL has created the Ministry of Social Development with the aim of regrouping all social benefits under one administration. The creation of this Ministry, therefore, shows the increasing emphasis on social protection as well as the importance of establishing a coordinating body for social safety net interventions.

Existing social transfers programs in Lesotho include the old-age pension program, school feeding program, free primary education program and the fertilizer voucher and subsidy schemes.

Recently, the Government has also made some strides by developing a National Social Development Policy, which will be identify the most effective way of addressing the needs of the disabled people as well as strategies of their inclusion and meaningful participation in the economy. The Government is further intending to develop a Social Protection Strategy to lay out the overall objectives of the Social Protection programs.

ii. <u>Improving data and information monitoring systems</u>

Lesotho is one of the countries that still lags behind in terms of accurate and timely data. The poor quality statistics tends to lead to wrong decisions and inappropriate policy choices.

In an attempt to overcome this shortcoming, the Government has taken measures such as granting autonomy to Bureau of Statistics (BoS) which is envisaged to enhance its effectiveness in managing and coordinating the country's statistical activities.

The Government has also made some initiatives with regard to the establishment of the National Identity (ID) card. Prior to this establishment, improved and comprehensive registry is required to ensure that the issuance of the IDs, as a statistical platform upon which service delivery, can be planned and delivered.

1.5 Conclusion

Improved investment climate to stimulate business growth, poverty reduction and high employment, are necessary but not sufficient conditions for the achievement of sustainable growth and development. This development operation has come at the opportune time for Lesotho, as the country is faced with the challenge of improving on the above mentioned goals. Successful implementation of this operation, therefore, represents a step towards the achievement of sustainable economic growth and development.

This featured article benefited from:

- IDA Country Assistance Strategy for the Kingdom of Lesotho, 2010.
- IDA Program Document for a Proposed Grant to the Kingdom of Lesotho for a First Competitiveness and Development Policy Grant, 2013.

2. Featured Definition

Monetary Transmission Mechanism: The monetary transmission mechanism refers to the process through which monetary policy decisions affect the economy as a whole.

The goals of the monetary policy include price stability, achieving economic growth and high levels of employment. These goals are attained using the monetary policy instruments such as Open Market Operations (OMO) and interest rates.

The monetary transmission mechanism is, therefore, a way through which these instruments translate into the above mentioned goals.

Monetary transmission mechanisms include the interest rate channel, other asset price channel, credit channel and exchange rate channel.

The interest rate channel is the most popular and has been the standard feature in the literature for over fifty years. According to this channel, changes in monetary policy, through changes in interest rates, lead to changes in consumption and investment. This will trigger the change in aggregate demand which will ultimately have an effect on aggregate output and employment.

The asset price channel stipulates that monetary policy effects on the economy not only focus on one asset price, interest rate, but on a variety of other asset prices. Thus, according to this channel, monetary policy actions have an effect on prices of various assets, in particular equities and real estates. Changes in these asset prices generate wealth effects that impact, through spending, on output and employment.

The credit channel, on the other hand, describes how the monetary policy changes affect the amount of credit that banks issue to firms and consumers for purchases, which in turn affects the economy. The credit channel affects the economy by altering the amount of credit firms and/or households have access to, which will have a direct bearing on output.

The exchange rate channel involves interest rate effects, which ultimately affects the flows of capital. This, in effect, will impact on the exchange rate (appreciation/ depreciation). Changes in the exchange rate have implications on exports and imports and ultimately aggregate demand.

This featured definition benefited from:

- Ireland, P. (2005). The Monetary Transmission Mechanism. Federal Reserve Bank of Boston, No. 06-1.
- Mishkin, F. (1996). The Channels of Monetary Transmission: Lessons for Monetary Policy. NBER Working Paper Series, W/P 5464.

3. Featured Economic Event

Croatia joins the European Union (EU): Croatia became the 28th EU member on the 1st July 2013, after long negotiations that lasted a decade. It is the first new member since Bulgaria and Romania joined in 2007. Croatia gained independence in 1991, after its split from Republic of Yugoslavia; a split that caused a devastating war between these two countries.

Since a decade ago, when Croatia started negotiating for entry, a lot has changed between Croatia and EU with regard to the performance of their economies. The joining of EU by Croatia takes place at the time of economic difficulty with Croatia in a fifth year of recession, and unemployment rate as high as 21 per cent, and with EU in a financial turmoil.

Being a member of EU will open doors for Croatia as customs posts will be removed from Croatia’s border with EU neighbours Slovenia and Hungary. This means Croatian consumers and producers will enjoy equal rights as EU consumers. This will bring new opportunities for the businesses and customers on both sides as trade will now be easier due to the Free Trade Area in the EU member countries.

Furthermore, Croatia will be better positioned and will have a stronger influence in the world and better chances for dealing with the process and consequences of globalization.

This featured economic event benefitted from ***Bloomberg***

4. Featured Descriptor

Real vs Nominal Valuation

Economic indicators at any point in time measure one of the following three things: value, price or quantity. The three metrics are related such that:

Value = price x quantity

Valuation can then be in real terms (also known as constant prices) or in nominal terms (also known as current prices).

Constant valuation excludes effects of inflation while nominal valuation is in current prices and as such inherently contains inflationary influences.

From the relationship above, changes in value can result from a change in price, or a change in quantity or a change in both price and quantity. Real valuation calculates value using base period prices (*see April 2013 Economic Review*). This permits changes in value to be driven by changes in quantities only. It is for this reason (fixing prices at base period) that real valuation is referred to as constant price valuation.

For instance, when considering the measure of economic growth within an economy, real GDP is used since it traces the movements in output/ quantity over time while fixing prices at some base year. This has made this valuation method the most useful and preferred.