Economic Review **May 2013**

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1. An Assessment of the Extended Credit Facility (ECF) Program

1.1 Background

Prior to 2009, Lesotho enjoyed several years of macroeconomic stability. The economy grew at an average rate of 4.0 per cent between 2003 and 2008, driven largely by the buoyant textile and clothing industry. Over the same period, the Government of Lesotho (GoL) also recorded huge fiscal surpluses driven by strong SACU receipts and prudent fiscal management. The fiscal surplus as a proportion of GDP was 4.5 per cent in 2008/09. However, following the advent of the global financial and economic crisis, economic performance deteriorated due to weak external demand for textiles and diamonds exports, and a significant decline in workers' remittances from South Africa. In 2010, the economy faced yet another blow as South African Customs Union (SACU) which accounts for a substantial share of total government revenue plummeted as the global financial crisis intensified. The slide in SACU revenue posed challenges of both balance of payment and fiscal unsustainability. As a result, the GoL in collaboration with International Monetary Fund (IMF) entered into a three year programme under the title ''The Extended Credit Facility Programme'' aimed at addressing these challenges. Specifically, the ECF programme focused on restoring fiscal and external sustainability, achieving broad based growth and strengthening the financial sector. Key reform measures pursued were: containing expenditure to levels consistent with sustainable revenue flows, while safeguarding social expenditure for the poor and vulnerable groups, further strengthening of the public expenditure and financial management, improving the business climate to facilitate private sector development and strengthening the regulatory framework for the financial sector and deepening financial intermediation. To that end, the Executive Board of the IMF approved an amount equivalent to SDR 41.88 million (about US$61.4 million) under the ECF. This funding was aimed at supporting Lesotho's efforts to achieve macroeconomic stability and help reduce balance of payments risks. The programme started in June 2010 and came to an end in May 2013. This article is an assessment of how Lesotho has performed against the set benchmarks under the program and also suggest way forward.

1.2 Programme Performance to March 2013

Targets on key macroeconomic variables were set for each quarter and performance on these targets was used as a condition for the disbursement of the ECF loan amount. These targets were amongst others set on Net Domestic Financing (NDF), Net Domestic Assets (NDA) and Net International Reserves (NIR). The technical memorandum of understanding defined the targets as follows:

- The NDF was defined as net credit to from the banking system plus holding of treasury bills and bonds by the non-bank sector.
- The NDA was defined as loans and treasury bills purchased by government less government deposits with the banking system and claims on the commercial banks.
- The NIR target was defined as the Central bank of Lesotho's liquid, convertible foreign assets minus its short-term foreign liabilities.

NDF and NDA targets were set to limit government expenditure and ensure that government is financially sustainable and viable in line with the programme objectives. The NIR target, on the other hand, was set to ensure that the country maintains enough foreign reserves to underwrite the fixed exchange rate arrangement whereby the loti is fixed to the South African rand. Structural benchmarks were set to remove bottlenecks to economic growth and broaden the base for poverty reduction. There were also targets on (1) the amount of new non-concessional external debt contracted or guaranteed by the public sector, (2) ceiling on the amount of new external debt contracted or guaranteed by the public sector, and (3) ceiling on the stock of external payment arrears. Furthermore, a floor target was also set on Government social expenditure which includes spending on school feeding program, old age pensions and HIV/AIDS.

As Table 1 below depicts, the NDF, NDA and NIR targets were met throughout the ECF programme. For instance, at the end of September 2012, Government achieved a M950.0 million build-up in its deposits with the Central Bank against a set ceiling of M346 million expenditure which continued to reflect commitment to fiscal consolidation efforts. However, it is also important to indicate that the exceptionally good performance since the fiscal year 2012/13 was also reflective of a rebound in SACU revenue which rose by more than 50.0 per cent. In an effort to meet the NIR target, the Central Bank continued to undertake open market operations in order to mop-up the excess liquidity and stem the outflow of capital into South Africa. Actual NIR as at March was 1093 compared with a target of US$987.

Table 1: Quantitative Benchmarks under the ECF Programme

	2011 Mar		2011 Sep		2012 Mar		2012 Sep		2013 Mar	
	PC	Act.	PC	Act.	PC	Act.	PC	Act.	PC	Act.
NDF	1670	1231	1385	482	1564	1284	346	-950	-966	-1480
NDA	1551	1397	1264	9	1210	515	237	-1065	-499	-1791
NIR	776	897	641	892	745	851	707	973	987	1093
Ceiling on the stock of external payment arrears	0	0	0	0	0	0	0	0	0	0
Ceiling on the non-concessional debt	182	242	182	242	182	274	182	274	182	na

1.3 Structural Benchmarks

In addition to quantitative benchmarks, there were also structural benchmarks in the following area; public financial management, financial sector regulation, debt management and other structural reforms. In the area of public financial management, some progress has been made although challenges still remain. Significant progress has been made in strengthening the legal and regulatory frameworks of the financial sector. The new Financial Institutions Act (FIA) has empowered the CBL to deal effectively with unlawful business practices and to regulate and supervise non-bank financial institutions. To implement the FIA work is already underway to prepare regulations for nonbank financial institutions. Work is also underway to improve supervision and regulation of insurance companies.

In the area of public financial management, comprehensive inventory of all government accounts, including those at the commercial banks has been completed, however the challenge that still remains is the non-reconciliation of accounts of Treasury with those of the CBL. Furthermore, an audit of domestic arrears has been completed and to help prevent the emergence of new domestic arrears, outstanding payables are now reported on a monthly basis. To improve the cash management system, circulars have been issued to ensure that line ministries properly record expenditures in the system.

On debt management, the Debt Management Committees have been resuscitated to ensure debt sustainability and prudent debt management. Legislation of a Public Debt Management Act is also underway and is expected ensure sound debt management.

To improve the business climate and to facilitate private sector-led growth and enhance competitiveness, a partial credit Guarantee scheme was launched in

August 2011, with a view to allowing greater access to credit by the small and medium enterprises. The new Companies Act of 2011 also come into operation since June 2012 and has introduced a short, simple and cost-effective mechanism for incorporation and registration of companies. The Industrial Licensing Bill has been submitted to Parliament and is expected to streamline the process of granting manufacturing licenses.

1.4 General Macroeconomic Performance and Challenges

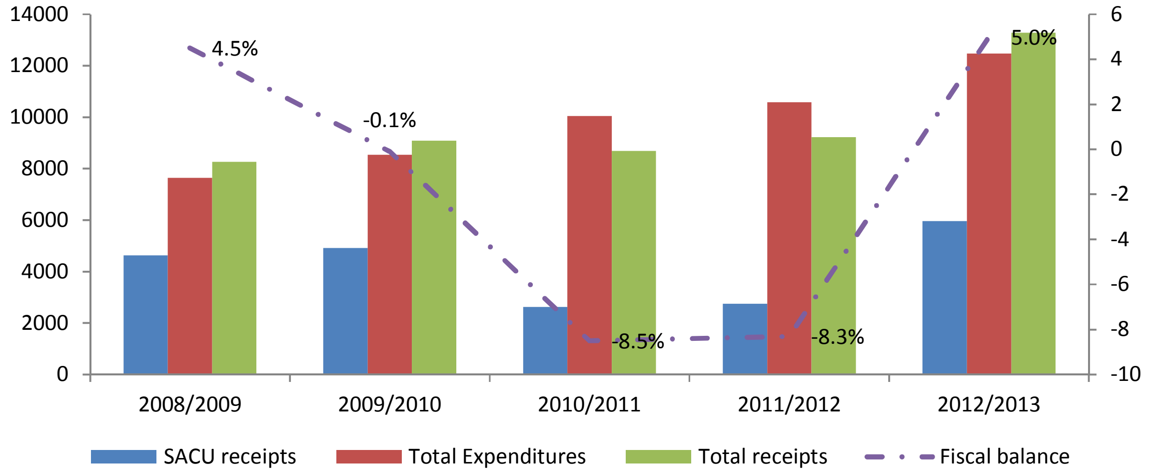
Growth Performance

In 2009, prior to the adoption of the ECF programme, real GDP growth was 3.7 per cent. From 2010 to 2012, real GDP growth averaged 5.0 percent. Growth during that period continued to be bolstered by buoyant construction and mining activity. Manufacturing, which over the last decade has been the mainstay of Lesotho's economy, continued to shrink reflecting intensifying competition from other textile and clothing producers especially from the Asia and other AGOA eligible countries. The weak global economy and hence demand continued to negatively affect demand for Lesotho's exports. The other challenge on growth performance during the programme period was the impact of weather-related shocks such of floods experienced in 2010 and drought in 2012 which continued to constrain agricultural production.

Fiscal Performance

Fiscal performance also remained prudent anchored on fiscal consolidation and revenue mobilization efforts. Recurrent expenditures on goods and services and non-productive sectors were cut. However social expenditures, aimed at protecting the vulnerable and the poor continued to receive priority. Expenditure on capital projects was increased which is essential for spearheading the necessary growth and were largely limited to the core-SACU revenue and government was successful in containing other recurrent expenditures. The fiscal surplus as proportion of GDP was 5.0 per cent for the period 2012/13. While the fiscal deficit reflected fiscal consolidations efforts, it was also reflective of poor execution of the budget. The position also reflected higher SACU receipts during the 2012/13 fiscal year. Figure 1 below is a depiction of fiscal performance over the programme period.

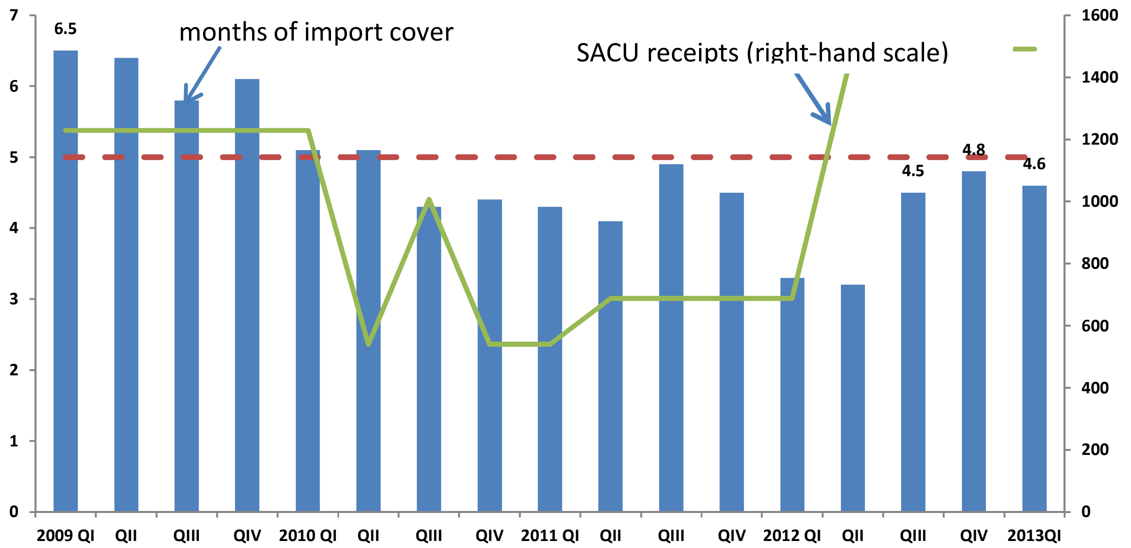
Figure 1: Fiscal Performance



External Sector Position

Although the level of reserves relative to the size of imports remains low, the fiscal consolidations were very much in line with the objective of achieving a build-up in foreign reserves. Prior to the huge fall in SACU revenue, reserves in months of import coverage were above 6 months, however that deteriorated on account of the contraction in SACU revenue, which feel by more than 40 per cent in the fiscal year 2010/11. In the fiscal year 2012/13 there has been a rebound in SACU revenue which led to a gradual improvement in months of import coverage.

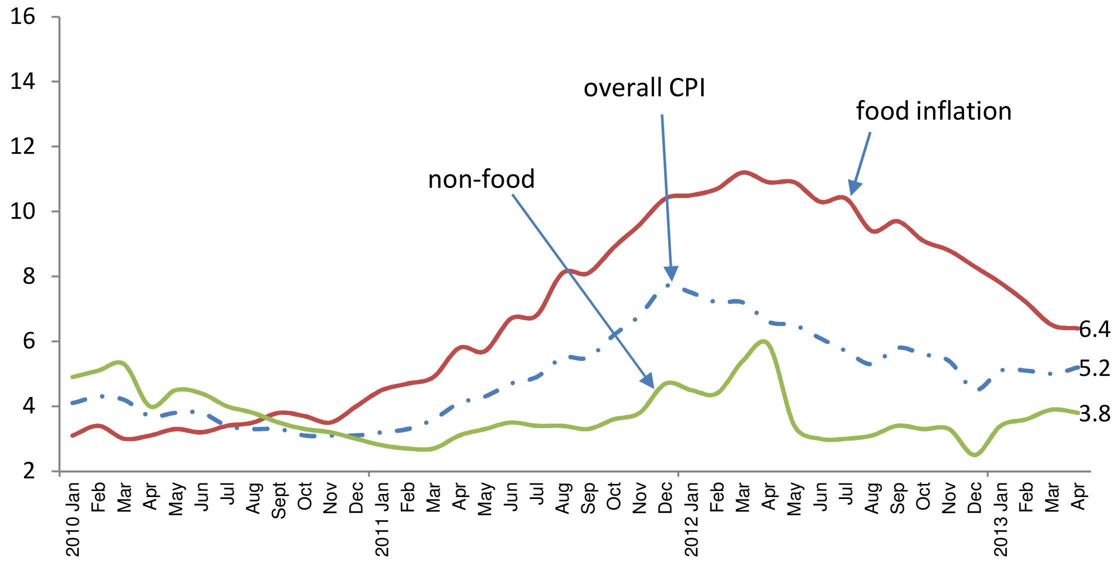
Figure 2: Months of Import Cover



Price Stability

Given the importance of price stability in poverty reduction efforts, it is important to obverse developments concerning inflation. The price stability objective continued to be pursed within the broader policy framework under the CMA whereby the loti is fixed to the rand at the 1 to 1 ratio. Inflation remained relatively stable for the entire programme period. The surge in the rate of inflation from 2011 was driven largely by food and oil price developments.

Figure 3: CPI Percentage Changes



1.5 Conclusion

Performance under the program has been satisfactory as all the quantitative benchmarks were met throughout the program. The program did help restore macroeconomic stability following a sudden and unexpected deterioration in SACU revenue. Efforts towards structural reforms are continuing even though full execution remains slow. Full implementation of the structural reforms is key to creation of jobs and bringing an end to poverty. While it is recommended that Government continues with this program in order to maintain the momentum in terms of fiscal consolidations efforts and a build-up in foreign reserves, more focus should be placed on the structural reforms which are critical in bringing down poverty levels. Commitment to fiscal consolidation will help strengthen Lesotho's resilience to external shocks and foster economic growth and poverty reduction. The program should also be broadened to focus more on the execution of the budget. The observed fiscal surpluses not only reflect fiscal consolidation efforts, but mostly importantly inefficiencies in executing the budget.

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2. Featured Definition

Exchange Rate: exchange rates are among the most important prices in an economy and each country has a currency in which the prices of goods and services are quoted. Just like other prices in the economy, exchange rates are determined by the interactions of households, firms, and financial institutions that buy and sell foreign currencies to make international payments. A bilateral exchange rate is the price of one currency in terms of another currency. It can be defined as the price of a domestic currency in terms of foreign currency or alternatively as the price of foreign currency in terms of domestic currency. In the latter definition, an increase in the exchange rate refers to *depreciation* and a decrease in the exchange rate refers to an *appreciation*. Another important distinction that is made with regard to exchange rates is the distinction between nominal vis-à-vis real exchange rate. The nominal exchange rate is the price of one currency in terms of another currency while the real exchange rate is the a measure of the relative price of a country's goods and services relative to those of another, when both are expressed in the same currency.

3. Implications of the Depreciation of the South African rand on the Lesotho economy

The South African rand has been weakening vis-à-vis the major international currencies since the beginning of the year. However, in May it reached its lowest level in 2 years at 9.66 per US dollar. The persistent weakening of the rand has been ascribed to a number of factors including external developments and changes in the global risk perceptions as reflected by portfolio capital flows. The recent crisis in Cyprus generated further impetus to the depreciation of the rand as investors sought out safe heavens and the US dollar appreciated as its demand increased. The SA rand has also been influenced by domestic economic and political developments. The widespread labour market instabilities, the trade deficit and ratings downgrade by Fitch Rating Agency all contributed to the depreciation of the rand.

The depreciation of the rand has implications for countries that have close trade ties with South Africa and that have fixed their currencies to the SA rand. The depreciation of the rand has implications for Lesotho 1 to 1 fixed rate between the loti and the rand as well as the strong trade ties. The immediate impact of the movement in the exchange rate is felt on the balance of payments. Therefore the depreciation of the rand will boost Lesotho' exports especially diamond and textile and clothing exports which account for about 70.0 per cent of overall exports. The depreciation of the rand will of much relief to the textile producers, who have in recent years been facing a numbers of challenges, inter alia, severe competition from other textile producers in Asia. The depreciation of the rand will therefore ensure that textile and clothing manufactures in Lesotho remain competitive and that their operations remain sustainable. The sustainability of the operations of the textile producers is particularly important as they the second largest employer in the economy.

On the hand, the depreciation of the rand threatens the inflation outlook. Since the bulk of inflation in Lesotho is imported from SA, this implies that inflation risks posed by the depreciation of the rand will also be felt by Lesotho. Since 2012 inflation has been driven by rising oil and food prices. The depreciation of the rand will amplify the persistently high level of crude oil prices. The depreciation of the rand also has implications on a country's foreign exchange obligations. Lesotho's foreign debt obligations account for about 90.0 per cent of total public debt and therefore the movement in the exchange rate has a bearing on total public debt and in particular, the depreciation implies an increase in foreign public debt.

This featured economic event befitted from ***Monetary Policy Review (MPR) June 2013***

4. Featured Descriptor

Year-to-date: Usually abbreviated YTD, this is the period from the beginning of the year (a calendar, a financial or a fiscal year) to the present time (day, week, month or quarter). YTD is used in many contexts, mainly for recording results of a business or economic activity in the period between the beginning of the year and a particular date. The following are some examples of the use of the phrase: Nationally, YTD vehicle sales are up by 8 per cent. The Loti registered a YTD depreciation of 13 per cent against the US dollar.