

International
Credit Analysis

Kingdom of Lesotho

Ratings

Foreign Currency

Long-term B+

Short-term B

Local Currency

Long-term BB

Outlook Stable

Country Ceiling

Peer Group

Ratings History

Date	LTFC	LTLC
Dd mmm yyyy		
Dd mmm yyyy		
Dd mmm yyyy		
Dd mmm yyyy		
Dd mmm yyyy		

Analysts

Veronica Kalema
Phone + 44 20 7417 6336
veronica.kalema@fitchratings.com

Richard Fox
Phone + 44 20 7417 4357
richard.fox@fitchratings.com

■ Summary

Type text here

■ Credit Outlook

Type text here

■ Strengths

- Relatively low political risk
- Strong AGOA-related investment and exports growth
- Common Monetary Area (CMA) membership enhances policy credibility
- Strong (albeit declining) fiscal revenues
- Strong external debt position and liquidity, net debt and debt service [current deficit is v. big]

■ Weaknesses

- Undiversified economy
- Weak fiscal expenditure control and management
- Weak public administrative capacity
- Low GDP/capita, high unemployment, HIV/Aids

Key Indicators for Lesotho

Population (2002): 2.0m		Population growth rate (1997-2002): 0.5% p.a.					
GDP (2002): USD0.7bn		GDP per head at market exchange rates (2002): USD814					
GNI per head at purchasing power parity (2001): USD2,710 (= 9% of USA level)							
Modern sovereign rescheduling history: None							
	1998	1999	2000	2001	2002	2003 ^f	2004 ^f
Domestic Economy and Finance							
Real GDP growth (%)	-4.6	0.2	1.4	3.4	4.2	4.2	4.4
Unemployment (% of labour force)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Consumer prices (annual average % change)	7.8	8.7	6.1	5.9	11.7	8.5	6.0
Gross domestic savings (% of GDP)	-33.5	-22.4	-20.4	-19.8	-19.4	-11.6	-6.4
Gross domestic investment (% of GDP)	47.1	48.6	42.1	40.5	30.4	37.6	41.6
Short-term interest rate (%) ⁽¹⁾	19.5	19.0	15.0	13.0	16.2	15.0	11.0
Broad money (% change Dec to Dec)	15.5	-5.1	1.4	17.2	8.8	8.8	6.4
LSL per USD (annual average)	5.53	6.11	6.94	8.61	10.54	7.90	8.50
REER (CPI, 1995=100)	85.3	83.6	80.2	69.6	61.0	64.1	59.9
REER: % change (+ = appreciation)	-9.1	-2.0	-4.1	-13.2	-12.4	5.0	-6.5
Public Finances							
General government balance (% of GDP)	-2.9	-16.7	-2.0	0.6	-3.8	-3.8	-2.4
General government debt (% of GDP)	69.3	80.0	84.3	102.8	72.2	69.8	71.3
General government debt maturities (% of GDP) ⁽²⁾	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
General government debt/revenue (%)	148.6	182.3	185.3	223.7	164.7	158.2	164.0
Interest payments/revenue (%)	5.6	7.5	9.5	6.8	6.7	6.7	6.1
Balance of Payments							
Current account balance (USDm)	-280.3	-220.9	-151.3	-95.2	-105.1	-247.0	-207.0
Current account balance (% of GDP)	-31.5	-24.3	-17.6	-12.7	-14.7	-22.7	-18.6
Current account balance <i>plus</i> net FDI (USDm)	-15.5	-57.6	-33.5	21.8	-22.6	-202.0	-147.0
Current account balance <i>plus</i> net FDI (% of GDP)	-1.7	-6.3	-3.9	2.9	-3.2	-18.6	-13.2
Gross financing requirement (% of official reserves) ⁽³⁾	53.4	42.7	37.6	31.5	39.1	66.5	60.5
Current external receipts CXR (USDm)	763	691	682	692	737	923	1030
Current external receipts CXR (annual % change)	-18.3	-9.5	-1.2	1.3	6.6	25.2	11.6
Current external payments CXP (USDm)	1043	912	834	787	842	1170	1237
Current external payments CXP (annual % change)	-13.3	-12.6	-8.5	-5.6	7.1	38.9	5.7
External Assets and Liabilities							
Gross external debt (USDm)	693.2	721.1	650.9	582.6	651.6	689.0	714.0
Gross external debt (% of GDP)	77.9	79.2	75.5	77.4	91.1	63.4	64.2
Gross external debt (% of CXR)	90.9	104.4	95.4	84.2	88.4	74.6	69.3
Net external debt (USDm)	45.2	141.2	152.6	131.0	169.0	209.0	234.0
Net external debt (% of GDP)	5.1	15.5	17.7	17.4	23.6	19.2	21.0
Net external debt (% of CXR)	5.9	20.4	22.4	18.9	22.9	22.6	22.7
Public external debt (USDm)	624.5	649.6	586.4	524.9	587.0	611.5	632.7
Public external debt (% of GDP)	70.2	71.3	68.1	69.8	82.1	56.3	56.8
Net public external debt (% of CXR)	6.5	21.7	24.7	20.0	24.5	22.9	22.6
Public FC denominated & FC indexed debt (USDm)	568.2	623.3	582.1	526.7	599.4	665.8	672.9
Short-term external debt (% of gross external debt)	4.3	3.8	3.9	3.4	3.1	2.9	2.8
External debt service (% of CXR)	5.5	5.8	8.1	6.8	9.4	3.9	4.6
External interest service (% of CXR)	2.2	2.2	2.7	1.6	3.2	1.4	1.2
Liquidity ratio (%) ⁽⁴⁾	983.1	924.5	702.4	686.5	504.4	855.3	716.4
Official international reserves including gold (USDm)	575	500	418	386	406	400	400
Official international reserves in months of CXP cover	6.6	6.6	6.0	5.9	5.8	4.1	3.9
Official international reserves (% of broad money)	190.5	183.2	185.9	235.2	161.9	135.6	140.2

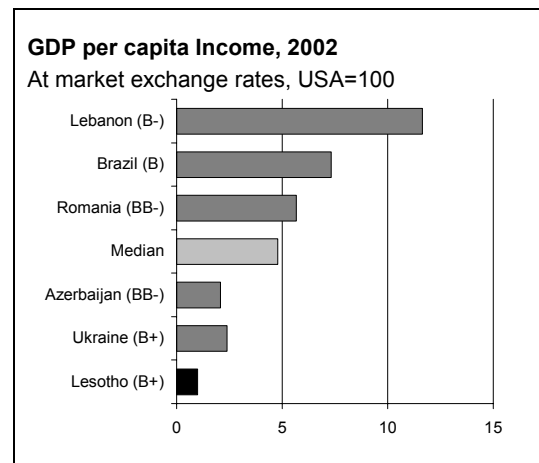
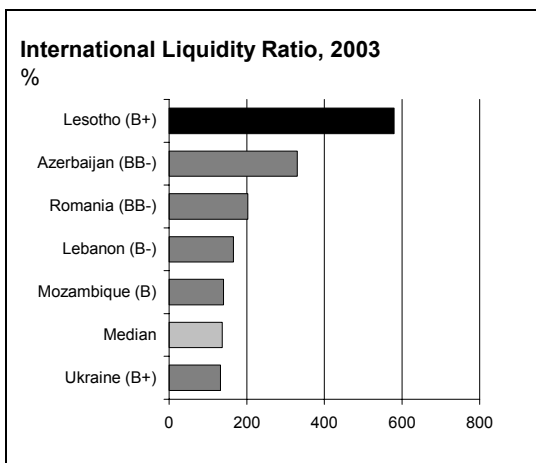
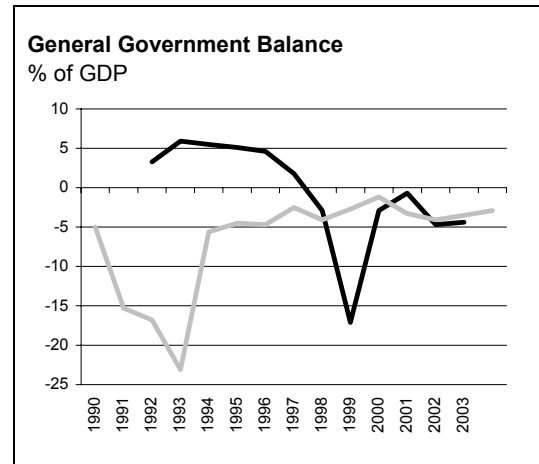
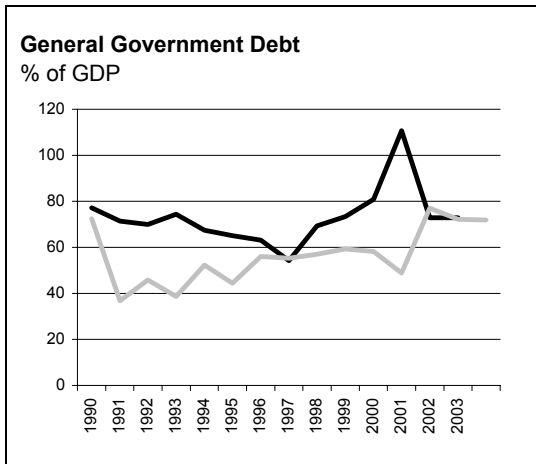
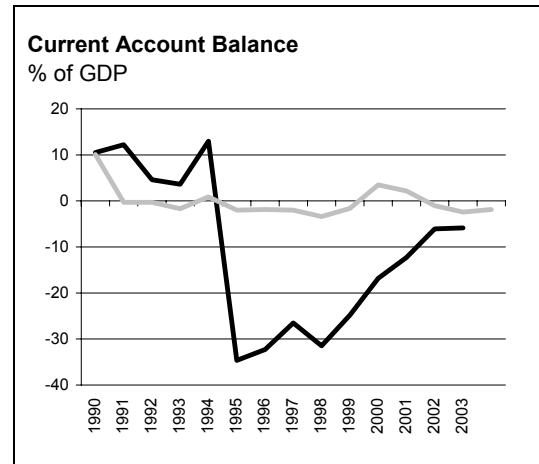
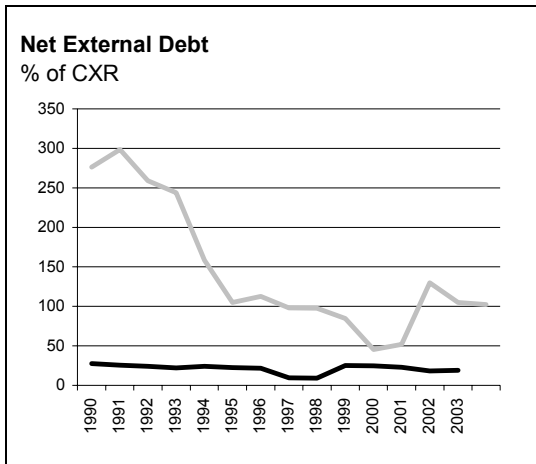
(1) This footnote should reference the appropriate money market or policy interest rate (annual average).

(2) Maturities of medium and long-term debt during year *plus* short-term debt outstanding at the beginning of the year.

(3) Current account balance *plus* amortization of medium and long-term debt, over official international reserves.

(4) Official reserves incl. gold *plus* banks' foreign assets/ Debt service *plus* liquid external liabilities.

Peer Comparison



— Lesotho

— xx Median

Source: Fitch Sovereign Comparator

■ Rationale

Three main factors have strengthened Lesotho's creditworthiness over the past year. Much reduced political risk following peaceful national elections in May 2002; continued strong AGOA-related investment and export growth; and the implementation of fiscal reform measures – establishing the Lesotho Revenue Authority (LRA) and VAT introduction – that will help counter a prospective decline in revenues from the South African Customs Union (SACU)¹ in the medium term. Lesotho's reasonably sound macroeconomic environment, historically low net external debt and strong external liquidity continue to offer strong support to the rating.

Structural weaknesses in Lesotho's fiscal system however continue to be a weakness for the rating. Progress on strengthening public financial management and control has been slower than expected. This will once again result in a higher than expected budget deficit of 3.8% of GDP in FY2003/2004 and continued concerns about fiscal sustainability until this area is fully addressed. Social factors such as the relatively low per capita income of USD800² in 2002, the very high incidence of HIV/Aids and high unemployment will also continue to constrain the rating. Food insecurity over the past three years requires a revisit of the government's agriculture strategy.

By far the main factor currently driving Lesotho's creditworthiness is the AGOA trade initiative. Because of a labour intensive export-led strategy which started in the late 1980's Lesotho was able to take advantage of AGOA very quickly as investors expanded their existing operations. Aided by subsequent new investment, textiles exports to the US have doubled since 2000 (the year prior to joining AGOA), to USD316mn [best expressed as a share of all exports] in 2002, employment in the sector has more than doubled to 45,000 and Lesotho is the largest garments exporter from sub-Saharan Africa to the US. For the first time since the political riots in 1998, which also coincided with the slowing down of investment into the Lesotho Highlands Water Project (LHWP), growth rose to above 4% in 2002 and is expected to remain above (but close to) that level over the medium-

¹ Comprising South Africa, Botswana, Swaziland, Namibia and Lesotho

² As a result of the strong exchange rate movement of the loti – pegged to the rand - per capita income in USD terms doubled [when??] compared to the previous year. Lesotho is at the top end of Least Developed Countries on this measure.

term. AGOA export revenue is also helping reverse the decline over the past two decades of miners' remittances. Overall goods and services exports (CXR) have been growing since 2001.

Down stream investment – into a denim milling plant due to be completed towards the end of the year and a cotton yarn-spinning mill by the middle of next year – will leave Lesotho relatively well placed when fabric imports from non AGOA countries are scheduled to cease in September 2004. But other threats to Lesotho's textiles sector will follow. All quotas on textiles and clothing product under the Multi-Fibre Agreement?Arrangement (MFA) will be phased out by January 2005, enabling more efficient producers in the Far East to compete on more equal terms. Tariff exemptions under AGOA are also scheduled to end in September 2008. These threats nonetheless are most likely to be mitigated by the US-SACU free trade agreement currently being negotiated which is eventually expected to extend for the foreseeable future the benefits of AGOA.³ The government is also seeking to diversify its markets for example to Canada and Australia. Hence Fitch's fairly optimistic view on continued good prospects for textiles exports from Lesotho. Other risks to the sector include infrastructure issues such as shortage of water and frequent power cuts which if not addressed will in the medium-term start to constrain expansion of the sector.

As a result of SACU revenues which account for 50% of total of non grant revenues Lesotho's revenues as a percent of GDP of 42% (38.7% excluding grants) are high by the standards of its rating peers (XX, 22%) and comparable to countries much higher up the rating scale. The debt to revenue ratio, which is another indicator of the government's ability to repay debt using domestic resources, of 164% in 2002, is much lower than the median the XX rating of 220%. Thus strong fiscal revenues represent a rating strength.

Chart: Lesotho's revenues compared to medians of rating categories.

However fiscal sustainability has been a concern for some time because of two main reasons. First is the prospective decline of SACU revenues in the medium-term because of tariff reductions under various trade agreements – South Africa's trade

³ There is also a high likelihood of the US extending the [?? Free trade or AGOA??] provision more generally to all countries.

agreement with the EU, the SAD[A]C⁴ protocol and the US SACU trade agreement which is currently under negotiation. This has been partly addressed over the past year by the introduction of the LRA and VAT in January and July respectively. These tax administration measures are expected to generate an increase of revenues of about 10% for each of the next three years.

The second is the added need to cut expenditure. Easy revenues from SACU have encouraged expenditure laxity. There is a need for much better expenditure control and management, which will help improve transparency and over time aid fiscal flexibility, and formulation of a stronger fiscal strategy. There has been some progress in this area over the past year but not to the level planned. For example an accountant general was appointed and accounts for 2001/2002 were submitted for audit (for the first time since 1995) but had some deficiencies and had to be submitted again later on in the year. Though addressing this area has become more urgent for the government and as is evident from faster progress on expenditure reforms last year, setting up and implementing a financial information system takes time and this will be a medium-term challenge. Beyond strengthening management systems, there is a need to build a broad based consensus on sustainable fiscal policies and this process will be strengthened by the Poverty Reduction Strategy Paper due for completion in November.

Table: Peer comparator

Owing to strong international reserves – to safeguard the pegged exchange rate – but also because of a cautious external borrowing policy and Lesotho's success at attracting foreign investment to the LHWP in the 1990s and the current pick up owing to AGOA – net external debt ratios have been historically low. Net external debt of 24% of GDP and 23% of CXR is well below Lesotho's rating peers. In addition, because of a high level of concessional debt, debt service (of the public sector) is very low at around 4% in 2003-2004. Similarly external liquidity is very strong. These external strengths support Lesotho's rating and mitigate the relatively high current account deficit.

⁴ Has broader coverage and other objectives than SACU. It includes non-SACU Malawi, Mozambique, Zambia, Zimbabwe and Tanzania.

■ Political & Social Situation

Peaceful national elections in May 2002 and a new electoral system that combines first-past-the-post with proportional representation, have resulted in a more stable political system, although it will take time for a fully functioning democracy to emerge. Ten political parties are represented in parliament with the ruling Lesotho Congress for Democracy (LCD) holding 77 seats and the main opposition party, the Basotho National Party (BNP) holding 21 seats out of a total of 120 seats. The BNP used the courts to indicate dissatisfaction with the results, but failed to get broader support even from the other opposition parties. Local elections scheduled for December will further deepen the democratic process. Thereafter, they will run concurrently with the national elections.

Relatively low political risk has boosted confidence in the economy which saw higher than expected growth of 4.2% in 2002 despite problems with agriculture. Following a restructuring/reshuffling of government in March, which strengthened the technocratic base, efficiency of government is expected to improve.

Lesotho has had its third consecutive year of poor weather conditions which have caused an erosion of food safety, mainly in the highlands. During the past year the government, with the support of agencies such as WFP and other donor partners, has provided inputs – seeds, equipment and fertiliser – and famine relief to the most vulnerable, and has been able to alleviate the food shortage. Lesotho has always been a net importer of food, importing around 40% of its needs in a good year and 70% in a bad year. However, agriculture has also been in long decline. Per hectare productivity has declined by 40% in 20 years due to over use of land, over planting of maize (which needs a lot of water), soil erosion and degradation. Productivity of this sub-sector has also begun to be affected by HIV/Aids. The food insecurity situation over the past three years is causing the government to revisit its agriculture strategy. For example, it is looking into diversification into high value crops for export to South Africa and ways in which it can refocus the economy away from agriculture.

Other social issues are poverty – a poverty reduction strategy should be outlined in the Poverty Reduction Strategy Paper (PRSP) due out in November – and HIV/Aids where the response has been inadequate so far. However efforts to combat HIV/Aids are picking up. The government signed an agreement with the Global Fund in July, which will give USD10.5mn over five years. As Lesotho has free access to South Africa's health care system [really??] HIV/Aids victims should benefit from

the decision by the South African government, in early August, to provide anti retroviral treatment (ART) through the public health service.

Lesotho is completely surrounded by South Africa: they have a shared cultural and historical background (Basotho are given preferential treatment for university education) and given principals of democracy and sound economic management in South Africa, this is a rating strength for Lesotho compared with other countries in the region. The South African government was instrumental in restoring order after political riots in 1998 and then ensuring a more stable political system for Lesotho. A Joint Bilateral Commission on Cooperation (JBCC) is working on ways in which Lesotho can graduate out of Least Developed Country Status (LDC) - Lesotho is currently at the top end. The South African government has also made huge infrastructure investments such as the Lesotho Highlands Water Project (LHWP) to provide water to the Johannesburg area which not only provides revenue for the Lesotho government but also involved the upgrading of Lesotho's roads.

■ Short-term Prospects

Lesotho is expected to achieve robust growth of just over 4% in 2003-2004, as a result of expansion of textiles exports to the US, spurred by AGOA and related investment. Miners' remittances will be hit slightly because of lower profitability in rand terms of the mining sector in South Africa as a result of the strong recovery of the rand since Q4 2002. Preliminary data for the first quarter also indicate the stronger rand (loti) may have started to impact on AGOA exports. Inflation is already falling quite rapidly because of lower imported inflation and a slowdown in food inflation and is expected to fall further in line with inflation in South Africa and remain relatively low in 2004. Similarly interest rates will fall as those in South Africa are cut. The current account deficit will widen this year reflecting machinery imports for the textile sector, but will narrow in 2004-2005 as these fall back and exports expand.

■ Structural Issues

As a result of a labour-intensive export-led growth strategy which started in the late 1980s, centred mainly around textiles, Lesotho has been able to benefit quickly from the US AGOA trade initiative. The textiles and apparel sector is now driving growth and generating employment, helping to offset the completion of the LHWP this year (previously the main driver of growth), a fall in

agriculture output and retrenchment of around one-half of Basotho miners over the past decade.

The Lesotho National Development Corporation (LNDC) had been relatively successful at attracting investment from East Asia, notably Taiwan and also South Africa into the apparel sector. However investment increased as a result of AGOA which gives enhanced access to the US market. Six new garment factories opened up in 2002, following on from 13 in 2001 and textiles and apparel exports earnings have more than doubled from USD140mn in 2000 (before AGOA) to USD318mn in 2002, making Lesotho Africa's largest textiles exporter to the US. The sector is now the largest employer in Lesotho, with employment expanding to 45,000 people in 2002, from 21,000 at the end of 2000. Furthermore downstream investment has started. A USD100mn denim rolling mill due for completion by the end of 2003 will hire another 8,000 people. A USD40mn cotton yarn-spinning mill will be completed in mid-2004.

There are some risks to AGOA exports. The Special Apparel Provision which allows AGOA eligible countries to import fabric from anywhere in the world, enabling them to use the most competitive fabrics, is due to end in September 2004. After that countries can only import fabrics from AGOA countries and the USA. This will be followed by the phasing out of all textiles and clothing under the Multi-Fibre Arrangement (MFA) by January 2005, enabling highly efficient Asian producers to compete on more equal terms, although they will still be moderately constrained by the remaining tariffs on countries not benefiting from OECD Generalised System of Preference (GSP) tariffs. Finally tariff exemptions under AGOA are scheduled to end in September 2008. Other risks relate to infrastructure issues such as shortage of water, and frequent power cuts which if not addressed will in the medium-term constrain the expansion of the sector.

The US government has mentioned that it is looking into renewing the Special Apparel Provision. Fitch is of the view that given that imports from sub-Saharan Africa account for only 1% of US imports and the visible benefits in terms of employment, investment and exports that have been derived from countries that have taken advantage of AGOA, this provision is likely to be extended. Nevertheless until there is certainty, investment into Lesotho's textile sector will slow. Concerns about the effect of the removal of the provision on Lesotho's apparel sector are also mitigated by the denim rolling mill due to be completed at the end of this year which will enhance Lesotho's capacity to meet the new criteria. If the Special Apparel Provision is

renewed, the phasing out of the MFA, will have less of an immediate impact.

Lesotho's textiles and apparels sector may also be shielded from the heightened competition from Asia by the US South Africa Customs Union (SACU)⁵ trade agreement currently being negotiated which is expected to extend for the foreseeable future the benefits of AGOA. There are also opportunities to diversify away from the US market. For example, Lesotho is now eligible to export to Canada on AGOA terms and there is a possibility that Australia may sign up to a similar agreement. Lesotho has duty free access to the EU, although rules of origin are very rigid.

Other areas for possible diversification and expansion are tourism as a result of the opening up of the mountains following the water project – which has increased potential for eco-tourism. A ski resort which will attract South Africans is expected to be complete by next winter (May – September 2004). Diamonds, not mined since De Beers closed a mine 10 years ago are to be re-exploited. Already one mine is operational and there are three leases in the pipeline. The mining and quarrying sector has trebled over the past three years albeit from a very small base. Both these sectors will continue to be very small.

Agriculture – animal husbandry and subsistence farming – accounted for 16.5% of GDP in 2002 and employs over 50% of the population. However agriculture production is constrained by limited arable land – only 9% of the total. Agricultural production has fallen from around 50% of GDP in the 1970s as a result of soil erosion and a decline in soil fertility. In the past three years it has also been affected by poor weather conditions – mainly drought. In the medium term the former two factors as well as the HIV/Aids epidemic are expected to continue to constrain the sector.

Miners' remittances remain a major contributor to GNP. Retrenchment is largely over following restructuring of South African mines over the past decade which has caused the number of Basotho miners working in South Africa to fall to around 60,000 from 140,000 ten years ago. Miners' employment (and remittances) did rise slightly in 2002, reflecting stronger profitability of the South African mining companies because of a relatively weak currency and high gold and platinum prices. But with most of their costs in rand and earnings in USD, mining companies have become less profitable this year because of the strong recovery

⁵ SACU consists of Botswana, Lesotho, Namibia, Swaziland and South Africa.

of the rand. Hence short-term prospects for an increase in employment of Basotho miners are poor. In the medium term employment in the sector will depend on profitability of the South African mining sector and the possible expansion of sectors such as platinum. Still employment (and remittances) are unlikely to rise much above current levels.

Out of the major state-owned companies banking, airlines and telecoms have been privatised, and the Privatisation Unit is in the process of restructuring the electricity company in preparation for privatisation. Of the above utilities, privatisation of the banking sector in 1999-2000 and telecoms which has included the licensing of two mobile phone companies and where there has been a fast growth in services, have been successful. The airline was liquidated in 1998. Progress has been made to improve the efficiency of the electricity company but it is still a drain on the budget owing to the need to increase tariffs which have not been put up for 10 years. What exactly is the drain on the government's budget? The government's desire to have rural electrification will involve a huge investment, and has caused the electricity privatisation strategy to be put under review. The remaining privatisations are much smaller and include hotels, an insurance company and a pharmaceuticals company.

■ Financial Sector

Lesotho's banking system consisting of Nedbank, Standard Bank Lesotho and Lesotho Bank has since 1999, been almost fully owned by Nedcor and Standbic, two of the four major banks in South Africa which are strong and well regulated. Thus the contingent liability to the government is limited. The Lesotho banking system is supervised by Central Bank of Lesotho (CBL).

Since then the CBL has implemented a series of reforms aimed at strengthening the banking sector and encouraging financial intermediation. These included the revision of legislation on bank regulation and supervision (1999), improvements to the payments system (2000), introduction of open market operations (2001) and commercial courts (to encourage the extension of credit to private companies, 2000). These have generally strengthened the banking system which had a capital adequacy ratio of 27% at end-2002 and has a small non performing loans ratio, although this also reflects limited lending – also reflected in high liquidity. Despite setting up many schemes such as rural banking and micro financing (UNDP-sponsored?), progress on increasing credit

XX

However, expenditure also needs to be cut to offset the SACU decline. Governance has been especially weak. Some progress has been made over the past year in terms of improving institutions and systems. For example, a new Accountant General has been appointed and is being supported by three deputies; monthly financial reports are being produced while a new financial information system is created over the next 3-4 years. These steps are already starting to close leakages and improve governance. The government's 2001/2002 accounts were submitted for audit but had some deficiencies - the main ones being improper treatment of below-the-line accounts (suspense accounts where unspent balance/aid money are recorded) and problems of assigning vehicle lease costs to responsible ministries – and has not yet been signed off. The government intends to submit the 2002/2003 accounts in September and subsequently submit all accounts since 1995/1996. This should help improve transparency. Beyond strengthening management systems, the government is making efforts to build a broad based consensus on sustainable fiscal policies and this process should be strengthened by the completion of the Poverty Reduction Strategy Paper due in November.

The budget deficit for FY2002/2003 was 3.8% of GDP, 2% higher than planned mainly due to measures to address the food security situation: agriculture support (1½% of GDP) which assisted farmers with seed, fertilizer and ploughing of which farmers will pay back 50% when they harvest in August; and famine relief which involved giving free or subsidized food for the more vulnerable people. A similar deficit is projected for 2003/2004 [my notes say 4-5%] owing to a fall in SACU revenues and the cost of local government elections estimated at 2% of GDP. These will be only partially offset by efficiency gains from LRA and VAT. Thereafter the government aims to keep deficits low at around 2% of GDP.

In the short to medium-term the government intends to finance the 2003/2004 deficit from domestic sources: deposits with the domestic banking system will be drawn down further and issuance of treasury bills to a liquid banking system began in June. Gross public domestic debt is estimated at 13% of GDP at the end of FY2003/2004 and is projected to rise steadily to 22.1% by end 2008/2009. Most of the government's debt is however external. As a result of the strengthening of the rand over the past year and a half, the general government debt:GDP ratio

has fallen to 72% at end FY20002/2003, from 102% at end FY2001/2002. We expect the general government debt ratio to continue to fall in the medium-term in part reflecting the government's financing strategy which by avoiding external debt will reduce vulnerability to exchange rate depreciation – the rand and loti are projected to depreciate against the USD in the medium-term, in line with the inflation differential with the US.

Contingent liabilities???? – electricity company as a % of GDP.
What else??

Sources and Uses table

■ Monetary & Exchange Rate Policy

Along with Namibia, Swaziland and South Africa, Lesotho is a member of the Common Monetary Area (CMA). Under this arrangement Lesotho's loti is pegged one-to-one with the rand and the currencies circulate alongside each other in Lesotho. Thus monetary policy is effectively in the hands of the South African Reserve Bank (SARB) and this has enhanced credibility of Lesotho's monetary policy. The Central Bank of Lesotho's (CBL) main monetary policy objective is to preserve the peg. This has been successful for over 30 years.

Over the past year, monetary policy has been driven by the need to offset the liquidity impact of expansionary fiscal policy and the boom in the exports sector. However by June, massive t-bill sales had resulted in a widening of the rate differential between Lesotho at 13% and South Africa at 9.7-10%. This has raised concerns about budget interest costs and has forced the central bank to use moral suasion with the fiscal authorities to rein in expenditure or increase the T-bills available to CBL for monetary operations. Since then the repo rate in South Africa has been cut by a total of 2.5 percentage points to 11.5%. Declining interest rates in South Africa will help reduce interest rates in Lesotho but whilst the prime rate in South Africa has declined from 17% in May to 15.5% in June and 14.5% in August, in Lesotho it has declined by less from 17.67% in May to 16.5% in June.

Inflation has dropped from a peak of 13.7% in March 2002 to 6.4% in July 2003 in line with trends in South Africa (accounts for 80% of Lesotho's imports) which has benefited from a stronger rand and a slowdown in food prices which account for 40% of the CPI in Lesotho. The

outlook is for further decline of inflation in South Africa which will help contain prices in Lesotho. Introduction of VAT at 14%, rather than the 10% general sales tax which it replaced in July has added temporary inflationary pressures, but these will subside. The drought has continued, food security remains a problem this year and this is likely to put upwards pressures on food prices. End-year inflation in Lesotho is projected at around 5.5% (South Africa 2.9% ??so low??). The consensus is that South Africa's CPIX will meet the inflation target of 4-6% on average next year, indicating relatively low inflation for Lesotho.

■ External Finance

Textiles exports under AGOA rose 53% in 2002 to USD215mn. Miners' remittances are also expected to have risen slightly reflecting increased numbers of migrant miners as a result of improved profitability of the mining sector in South Africa. These however were offset by a high increase in imports for agricultural support and the textile industry. The current account deficit is estimated to have deteriorated slightly to 14.7% of GDP, compared with 12.7% in 2001.

So far in 2003 textiles exports have been hit by the strength of the rand and loti against the USD. The strong recovery of the rand since Q4 2002 has caused profits for the mining sector to fall and thus miners' remittances this year are likely to decline. This could change in 2004 if the rand becomes more competitive and the global environment more conducive. Capital imports of the textile sector are expected to rise going towards the USD100mn denim mill due for completion at the end of 2003. Hence the current account balance is expected to widen this year, before narrowing in 2004 owing to lower investment into the textiles sector and as a result of continued fast textiles exports growth. The current account will continue to be covered by FDI, FDI-related debt and concessional loans.

Chart – trend overall exports earnings and merchandise export earnings

The gross external debt: GDP ratio rose to 91% in 2002 from 63% in 2001 largely because of exchange rate depreciation. It is expected to fall to 63.5% in 2003 because of the strong recovery of the rand and loti exchange rates since then. Hence in an effort to reduce the impact of a fluctuating exchange rate, the government is keeping net external borrowing to a minimum and is paying back the more expensive commercial loans that it took out for the LHWP which is now nearing completion. The official statistics do not include

private sector debt. We assume that most of the FDI related debt has gone to the LHWP and therefore is captured under public debt. Increasingly however, and with enhanced investment prospects because of AGOA, private sector debt is expected to rise. As this will be directed at export-oriented companies that are expected to generate sufficient foreign exchange earnings, this lessens concerns about the rise in external debt. In addition most of this debt will be inter-company debt.

Because of large reserves and foreign assets of the banking sector, Lesotho's net debt ratios are relatively low. Lesotho's NXD:GDP ratio of 24% and NXD:CXR ratio of 23% are well below the median of the XX rating and represent a major rating strength. Moreover AGOA exports will most likely continue to more than offset the future declines in miners' remittances and SACU revenues, thereby helping to improve solvency ratios. Because of the high level of concessional debt Lesotho's public sector debt servicing is very low at 4% of CXR in 2003-2004.

Chart: Rating comparison NXD/CXR with countries in same peer group.

At over 800% Lesotho has one of the highest liquidity ratios – measured as foreign reserves plus banks' foreign assets/short-term debt plus debt service – of all countries rated by Fitch. This reflects a rapid build up of reserves over the past decade because of investment into the LHWP, low debt servicing costs and short-term external debt. The central bank targets import cover (international reserves/imports) of 6 months, so as to preserve the exchange rate peg.

Copyright © 2002 by Fitch, Inc. and Fitch Ratings, Ltd. and its subsidiaries. One State Street Plaza, NY, NY 10004. Telephone: 1-800-753-4824, (212) 908-0500. Fax: (212) 480-4435. Reproduction or retransmission in whole or in part is prohibited except by permission. All rights reserved. All of the information contained herein is based on information obtained from issuers, other obligors, underwriters, and other sources Fitch believes to be reliable. Fitch does not audit or verify the truth or accuracy of any such information. As a result, the information in this report is provided "as is" without any representation or warranty of any kind. A Fitch rating is an opinion as to the creditworthiness of a security. The rating does not address the risk of loss due to risks other than credit risk, unless such risk is specifically mentioned. Fitch is not engaged in the offer or sale of any security. A report providing a Fitch rating is neither a prospectus nor a substitute for the information assembled, verified, and presented to investors by the issuer and its agents in connection with the sale of the securities. Ratings may be changed, suspended, or withdrawn at any time for any reason at the sole discretion of Fitch. Fitch does not provide investment advice of any sort. Ratings are not a recommendation to buy, sell, or hold any security. Ratings do not comment on the adequacy of market price, the suitability of any security for a particular investor, or the tax-exempt nature or taxability of payments made in respect to any security. Fitch receives fees from issuers, insurers, guarantors, other obligors, and underwriters for rating securities. Such fees generally vary from US\$1,000 to US\$750,000 (or the applicable currency equivalent) per issue. In certain cases, Fitch will rate all or a number of issues issued by a particular issuer, or insured or guaranteed by a particular insurer or guarantor, for a single annual fee. Such fees are expected to vary from US\$10,000 to US\$1,500,000 (or the applicable currency equivalent). The assignment, publication, or dissemination of a rating by Fitch shall not constitute a consent by Fitch to use its name as an expert in connection with any registration statement filed under the United States securities laws, the Financial Services Act of 1986 of Great Britain, or the securities laws of any particular jurisdiction. Due to the relative efficiency of electronic publishing and distribution, Fitch research may be available to electronic subscribers up to three days earlier than to print subscribers.