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BACKGROUND TO THE 2009/10 BUDGET:

A REVIEW OF ECONOMIC PERFORMANCE, 2003 – 2008;

ECONOMIC PROSPECTS, 2008 – 2012; AND

MEDIUM-TERM FISCAL FRAMEWORK, 2009/10 – 2011/12

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INTRODUCTION

The purpose of this section is to note key alterations in methodology from previous Background Papers. This allows the reader to understand immediately the differences in information presented in this report compared with that in previous papers. The following changes have been made:

- The constant price base year has been updated from 1995 to 2004.
- The classifications have been made based on the 2001 version of the International Monetary Funds' Government Finance Statistics (GFS), rather than the previously used GFS 1986.
- The methodology for estimating current year (2008/09) outturn has been formalised and now uses revenue and expenditure data from the first three quarters of the financial year (rather than half year) as well as historical trends.

During the 2009/10 budget preparations, cabinet recognised the importance of budgeting on an outturn basis, and adopted that as a budgeting principle in future years. Despite this, the 2009/10 budget contains a large increase in budgeted expenditure with recurrent expenditures set at nearly M 2 billion above the estimated 2008/09 outturn, and capital expenditure set at over M 1 billion above the estimated 2008/09 outturn. This has largely been a result of responding to the current global economic downturn. Even upon this light, this background paper recognises the weaknesses in government capacity to absorb appropriated expenditures. The difference between appropriation and outturn is regrettable as the resulting large appropriation deficits forecast in the medium term leave little room for ministries to pursue new policies or programmes. Deficits are estimated to increase over the medium term making this problem more acute in the future. This Background Paper uses estimated outturn as a more reliable indicator of expenditure outcome, making this more useful for policy formulation.

It is important to recognise the oxymoron caused by the necessary response to the economic downturn on the one hand, and the revenue challenges in the medium and long term, on the other. Together with budgeting on an outturn basis and in order to avoid large fiscal deficits, the Medium Term Fiscal Framework (MTFF) that informed the 2009/10 budget preparations proposed more conservative expenditure levels. It is therefore critical that during 2009/10 and beyond, a deliberate expenditure restraint is undertaken to avoid any fiscal stress in future, while still recognising the need for funding high priority areas for attaining development goals.

The forecasting presented in this Background Paper has been undertaken by the Ministry of Finance and Development Planning (MoFDP) based on the Financial Programming modules developed, and maintained in-house. From 1st April 2009, the new Integrated Financial Management Information System (IFMIS), based on the new Chart of Accounts, will be introduced. This is based on the 2001 GFS and it is believed that this will allow for more accurate financial record keeping, improving the integrity of the data, and allowing for real-time observation of fiscal trends.

Chapter 1: A REVIEW OF ECONOMIC PERFORMANCE, 2002 – 2007

1.1 NATIONAL ACCOUNTS[1]

1.1.1 Main national accounting aggregates

National Accounts provide a comprehensive and detailed record of the economic activities taking place within the economy and with other economies and of the interaction between economic agents. For most countries, the key indicator of economic performance is the real rate of growth in the total value of all goods and services produced within the country as measured by Gross Domestic Product (GDP).

However, Lesotho receives substantial inflows of net income from abroad from citizens who work in other countries, which is added to GDP to calculate Gross National Income (GNI, previously known as Gross National Product). As a member of the Southern Africa Customs Union (SACU), Lesotho also receives net transfers from the SACU revenue pool. These transfers are added to GNI to calculate Gross National Disposable Income (GNDI), which is allocated between consumption and savings. Although the national accounts treat both net factor income and net transfers as additions to GDP, they have multiplier effects and contribute to the magnitude of GDP by allowing households and Government to spend more than they could afford solely through domestic income.

National Accounts data are collected in current prices. These values are converted into constant prices (with 2004 as the base) using sectoral GDP deflators based on quantity indicators, the consumer price index and other price indices. This enables the calculation of real economic growth rates, allowing assessment of trends over time. Table 1.1 contains data in current (nominal) prices (Panel A) and in constant (real) prices (Panel B). On the basis of the existing time series, the data provides final values for 2006 and provisional estimates for 2007.

Over the period 2002 – 2007, GDP measured in current market prices has grown by an annual average of 10.8%, whereas GNI has increased by 11.1%[2]. In nominal terms, net primary income has grown by an annual average of 12.5% and net transfers by 13.1%. As a result GNDI in nominal terms has increased by an average of 11.5% over this period.

The real average annual GDP growth rate has been 4.4% between 2002 and 2007. The main fluctuations around this level occurred in 2001, when the annual rate of 1.8% reflected a decline in agriculture (principally crops), in 2005 where large declines in agriculture and textiles led to the lower growth rate of 0.7% and in 2006 when the economy grew by 8.1% as a result of the continued strong performance of the diamond mines and the recovery of textile manufacturing following the downturn in 2005.

[1] It should be noted that the National Account numbers here are based on major update of the old National Accounts time series data. The new numbers have incorporated the newly available data from the Household Budget Survey 2003, the Population Census 2006 and from sources such as value added tax. Moreover the base of the data series in constant prices has change to 2004 from 1995 previously used.

[2] The annual average is calculated as the compound annual growth rate for each year between the start and the end of the quoted period.

Table 1.1: SUMMARY NATIONAL ACCOUNTS DATA, 2002-2007 (M million unless indicated)

A. Current Prices	2002	2003	2004	2005	2006	2007	Annual Ave. (%)
GDP at Producer prices	**6 610.3**	**6 979.6**	**7 709.6**	**8 187.8**	**9 658.7**	**11 099.4**	**10.9%**
Net taxes on products	449.2	602.6	810.6	834.8	928.4	1 098.8	**19.6%**
Subsidies on products	0.0	-60.6	-188.2	-272.2	-317.8	-420.5	**0.0%**
GDP at purchasers prices	**7 059.5**	**7 521.6**	**8 332.0**	**8 750.4**	**10 269.3**	**11 777.8**	**10.8%**
% annual change	15.3%	6.5%	10.8%	5.0%	17.4%	14.7%	**0.0%**
- receivable from the rest of the world	2 043.0	2 208.0	2 490.6	2 489.6	2 955.9	3 859.1	**13.6%**
- payable to rest of the world	-184.3	-156.6	-223.5	-298.5	-126.5	-509.3	**22.5%**
GNI at purchasers' prices	**8 918.2**	**9 573.0**	**10 599.1**	**10 941.6**	**13 098.7**	**15 127.6**	**11.1%**
Current transfers	0.0	0.0	0.0	0.0	0.0	0.0	**0.0%**
- receivable from the rest of the world	2 269.5	2 296.1	2 761.0	2 815.5	4 075.6	4 214.8	**13.2%**
- payable to rest of the world	-51.9	-75.2	-107.9	-110.4	-104.2	-111.8	**16.6%**
Gross national disposable income	**11 135.8**	**11 793.8**	**13 252.2**	**13 646.6**	**17 070.1**	**19 230.6**	**11.5%**
Savings	**760.2**	**810.1**	**1 559.6**	**1 193.4**	**3 349.9**	**3 585.9**	**36.4%**
Population (million)	1.9	1.9	1.9	1.9	1.9	1.9	**0.0%**
GDP per capita (M)	3 775.1	4 000.8	4 431.9	4 654.5	5 462.4	6 264.8	**10.7%**
GDP per capita (US$)	362.4	529.1	700.6	730.6	805.7	944.9	**21.1%**
GNI per capita (M)	4 769.1	5 092.0	5 637.8	5 820.0	6 967.4	8 046.6	**11.0%**
GNI per capita (US$)	457.9	673.4	891.2	913.5	1 027.6	1 213.7	**21.5%**
B. Constant 2004 Prices							
Primary Industries	700.8	738.6	813.2	800.1	1 032.7	1 075.5	**8.9%**
% annual change	-28.8%	5.4%	10.1%	-1.6%	29.1%	4.1%	
Secondary Industries	1 950.0	2 108.4	2 259.7	2 151.2	2 271.0	2 463.6	**4.8%**
% annual change	11.3%	8.1%	7.2%	-4.8%	5.6%	8.5%	
Tertiary Industries	4 430.7	4 584.8	4 674.9	4 804.6	5 126.7	5 302.4	**3.7%**
% annual change	5.3%	3.5%	2.0%	2.8%	6.7%	3.4%	
Imputed Financial Services	-56.2	-44.3	-38.1	-39.9	-51.1	-71.6	**5.0%**
GDP at Producer prices	**7 025.3**	**7 387.5**	**7 709.6**	**7 716.1**	**8 379.1**	**8 769.8**	**4.5%**
Net taxes on products	784.2	757.7	810.6	834.1	850.4	918.9	**3.2%**
Subsidies on products	-142.5	-175.9	-188.2	-161.3	-161.2	-161.1	**2.5%**
GDP at purchasers prices	**7 667.0**	**7 969.3**	**8 332.0**	**8 388.9**	**9 068.4**	**9 527.7**	**4.4%**
% annual change	1.6%	3.9%	4.6%	0.7%	8.1%	5.1%	
Trading gains/losses	908.8	138.7	0.0	-102.4	28.4	-242.6	**-176.8%**
Real GDP at constant prices	**8 575.9**	**8 108.0**	**8 332.1**	**8 286.4**	**9 096.9**	**9 285.1**	**1.6%**
Primary incomes	0.0	0.0	0.0	0.0	0.0	0.0	
- receivable from the rest of the world	2 295.8	2 303.6	2 490.6	2 393.5	2 651.8	3 116.0	**6.3%**
- payable to rest of the world	-207.1	-163.3	-223.5	-286.9	-113.5	-411.2	**14.7%**
Real GNI at purchasers' prices	**10 664.6**	**10 248.3**	**10 599.1**	**10 393.0**	**11 635.2**	**11 989.9**	**2.4%**
Current transfers	0.0	0.0	0.0	0.0	0.0	0.0	
- receivable from the rest of the world	2 550.3	2 395.5	2 761.0	2 706.8	3 656.4	3 403.2	**5.9%**
- payable to rest of the world	-58.3	-78.5	-107.9	-106.2	-93.4	-90.3	**9.1%**
Real Gross national disposable incom	**13 156.6**	**12 565.4**	**13 252.3**	**12 993.7**	**15 198.2**	**15 302.8**	**3.1%**
Growth							
GNI	0.3%	-3.9%	3.4%	-1.9%	12.0%	3.0%	
GNDI	-0.9%	-4.5%	5.5%	-2.0%	17.0%	0.7%	

Over the five-year period, the average annual growth rate of GNI[3] has been somewhat lower than GDP at 2.4% and more volatile, with a decline of 3.9% in 2003, followed by increases of

[3] Real GNI is derived by adding Net Primary Income to Gross Domestic Income (GDI). GDI is in turn derived by adjusting GDP by terms of trade- i.e. the rate at which exports can be traded against imports. If prices of a country's exports rise faster than the prices of its imports then there is a positive terms of trade effect. An improvement in terms of trade means that at a given level of domestic production of goods and services a larger portion can be reallocated from exports to consumption or capital formation.

3.4% in 2004, a decline of 1.9% in 2005, a sharp rise of 12.0% in 2006. The estimates for 2007 show an increase of 3.0%.

The negative growth of GNI in 2003 was predominately due to deterioration in the trading gains which declined from M908 million in 2002 to M138 million in 2003[4]. The other negative growth in GNI occurred in 2005 and is attributed to a 7 percent decline in net primary income from the rest of the world.

GNI grew by 12% in 2006, due to a 20% increase in net primary income from abroad and an improvement in trading gains from a negative of M102 million in 2005 to a positive of M28 million in 2006. 2007 also shows a positive growth rate of 3% for GNI as a result of 7% growth in net primary income from abroad.

GNI per capita is a more accurate indicator of household income than GDP per capita as it includes factor income from abroad. In nominal terms, due to the very slow population growth (0.1% per annum), GNI per capita has risen by an annual average of 11.0%, reaching M 8,046.6 in 2007. When expressed in US$ (using the annual average exchange rate), the GNI per capital has increase from $ 458 in 2002 to $ 1,213.7 in 2007 due to economic growth and appreciation of the currency against the dollar[5]. Although the Household Budget Survey shows that the national Gini coefficient[6] has fallen from 0.57 in 1994/95 to 0.52 in 2002/03 and that there has been a significant reduction in headcount poverty (from 66.6% to 56.6% respectively), the extent of income inequality means that the majority of the population is still living below the widely used poverty line of US $ 1 per capita per day.

1.1.2 GDP by economic activities

By broad economic category[7], in constant prices, Primary industries have grown by an annual average of 8.9% between 2002 and 2007. The agriculture sector has declined by 0.8% over the period (principally as a result of adverse weather conditions) but the mining sector recorded strong growth since 2004 as a result of the re-opening of Letŝeng diamond mining operations. However, recent decreases of over 50% in global mining prices mean that growth in the mining sector will slow down.

[4] The value of trading gains or losses are dependent on the choice of price index with which to deflate the current trade balance. In Lesotho the import deflator is used as it is the most preferred option globally.
[5] Lesotho is now classified as a lower-middle income country by the World Bank.
[6] Bureau of Statistics, 2002/03 and 1994/95 Household Budget Survey Analytical Report, Volume 1, 2006.

[7] Primary industries include agriculture, mining and quarrying; Secondary industries include manufacturing, electricity and water, and construction; and Tertiary industries include wholesale and retail trade, hotels and restaurants, transport and communications, financial intermediation (principally banking services), real estate and business services, public administration, education, health and social work and community, social and personal services.

Table 1.2 GDP by Industry (Constant 2004 Prices - Million Maloti)

Industry	2002	2003	2004	2005	2006	2007	Annual Ave. (%)
Agriculture	687.1	693.5	717.3	628.6	722.6	660.7	-0.8%
Crops	247.8	217.5	207.6	195.7	212.9	147.2	-9.9%
Livestock	331.7	371.1	403.5	329.0	401.0	416.8	4.7%
Services	53.7	50.7	44.7	37.2	41.6	27.6	-12.5%
Forestry	53.9	54.1	61.6	66.7	67.1	69.2	5.1%
Mining and quarrying	13.7	45.1	95.8	171.5	310.1	414.8	97.8%
Primary industries	**700.8**	**738.6**	**813.2**	**800.1**	**1 032.7**	**1 075.5**	**8.9%**
Manufacturing	1161.6	1322.7	1565.5	1405.9	1490.1	1637.6	7.1%
Food products and beverages	236.7	227.0	221.7	229.3	244.5	261.0	2.0%
Textiles, clothing, footwear and leather	807.6	998.6	1 230.0	1 071.6	1 137.6	1 227.8	8.7%
Other manufacturing	117.2	97.0	113.8	104.9	108.0	148.7	4.9%
Electricity and water	277.5	303.2	321.2	352.5	374.2	391.1	7.1%
Electricity	74.6	74.8	78.3	92.6	105.2	110.2	8.1%
Water	202.9	228.4	242.9	259.9	269.0	280.9	6.7%
WASA	27.5	30.9	34.9	30.6	33.1	35.9	5.5%
LHDA	175.3	197.5	208.0	229.3	235.9	245.0	6.9%
Construction	510.9	482.5	372.9	392.9	406.6	434.9	-3.2%
Secondary industries	**1950.0**	**2108.4**	**2259.7**	**2151.2**	**2271.0**	**2463.6**	**4.8%**
Wholesale and retail trade, repairs	954.3	1 005.5	1 012.4	1 014.2	1 065.1	1 096.2	2.8%
Hotels and restaurants	92.6	100.5	104.9	106.6	114.7	115.9	4.6%
Transport, and communication	373.5	390.6	423.9	471.7	500.4	531.6	7.3%
Transport and storage	208.3	217.3	225.4	241.0	240.9	244.6	3.3%
Post and telecommunications	165.2	173.4	198.5	230.7	259.4	286.9	11.7%
Financial intermediation	276.6	308.8	329.3	304.7	377.9	407.8	8.1%
Real estate and business services	1 037.3	1 058.4	1 088.2	1 147.6	1 224.5	1 293.4	4.5%
Owner-occupied dwellings	638.9	664.4	691.0	718.6	747.4	777.3	4.0%
Business services and renting	398.4	394.0	397.2	429.0	477.1	516.1	5.3%
Public administration	818.4	859.2	848.1	874.3	948.8	955.7	3.1%
Education	648.9	629.8	638.9	654.0	659.7	665.4	0.5%
Health and social work	151.2	153.4	149.3	151.1	155.3	155.7	0.6%
Community, social and personal services	78.1	78.6	79.8	80.3	80.3	80.8	0.7%
Tertiary industries	**4430.7**	**4584.8**	**4674.9**	**4804.6**	**5126.7**	**5302.4**	**3.7%**
Financial services indirectly measured	-56.2	-44.3	-38.1	-39.9	-51.1	-71.6	5.0%
All industries at producers' prices	**7025.3**	**7387.5**	**7709.6**	**7716.1**	**8379.1**	**8769.8**	**4.5%**
Net taxes on products	784.2	757.7	810.6	834.1	850.4	918.9	3.2%
Subsidies on products	-142.5	-175.9	-188.2	-161.3	-161.2	-161.1	2.5%
GDP at purchasers' prices	**7667.0**	**7969.3**	**8332.0**	**8388.9**	**9068.4**	**9527.7**	**4.4%**
GDP Growth	1.6%	3.9%	4.6%	0.7%	8.1%	5.1%	

The real annual average growth rate of the mining sector for the period 2002-2007 was 98%. Secondary industries generally recorded strong growth from 1998 to 2003 as a result of substantial construction activity and the growth of the textile industry. However, performance stagnated in 2004 and turned negative (-4.8%) in 2005 (reflecting both the slowdown in manufacturing as a result of the currency appreciation and the ending of the Agreement of Textiles and Clothing and the winding down of construction activity and construction-related transactions for the Lesotho Highlands Water Project). The latest figures indicate that the sector has recovered with a growth of 5.6% in 2006 and 8.5% in 2007. Tertiary industries have grown at an annual average of 3.7% over the period, with strong performance in 2002 (5.3%) and 2006 (6.7%). The growth rate in 2007 was closer to the period average standing at 3.4%.

The 2007 figures in Table 1.2 show that performance was driven by eight sectors which recorded growth above the aggregate rate of 5.1%: mining and quarrying (33.8%); other manufacturing (37.7%); textiles, clothing, footwear and leather (7.9%) financial intermediation (7.9%); construction (6.9%); food products and beverages (6.8%); transport and telecommunications (6.2%); and real estate and business services (5.6%).

All other sectors recorded below average but positive growth except for agriculture which registered a decline of 8.6%. Overall, GDP at basic prices grew by 4.7%, but the increase of 8.1% in Net taxes on products meant that growth at purchasers' prices was 5.1%.

Table 1.3 - GDP by expenditures in constant 2004 prices (Millions Maloti)

Expenditure category	2002	2003	2004	2005	2006	2007	Annual % Average
Final consumption expenditure	**11,600**	**11,620**	**11,693**	**12,060**	**12,403**	**12,855**	**2.08%**
Private consumption expenditure	8,651	8,641	8,911	9,124	9,313	9,664	2.24%
Government consumption expenditure	2,949	2,979	2,782	2,936	3,091	3,191	1.59%
Gross fixed capital formation	2,598	2,542	2,119	2,083	2,204	2,460	-1.09%
% annual change	-6.8%	-2.2%	-16.6%	-1.7%	5.8%	11.6%	
Changes in inventories	-96	-104	-54	17	66	22	
Gross domestic expenditure	**14,103**	**14,057**	**13,758**	**14,160**	**14,673**	**15,337**	**1.69%**
Exports of goods and services	3,159	3,722	4,522	4,280	4,683	5,364	11.17%
Less: Imports of goods and services	9,713	9,568	9,968	10,242	10,253	11,141	**2.78%**
Expenditure on GDP	**7,549**	**8,210**	**8,311**	**8,199**	**9,103**	**9,559**	
Discrepancy	118	-241	21	190	-35	-32	
GDP at purchasers' prices	**7,667**	**7,969**	**8,332**	**8,389**	**9,068**	**9,528**	**4.44%**

Looking at GDP by expenditure over the period 2002-2007, private consumption has grown by 2.24% while public consumption grew by 1.59% per annum in real terms. In aggregate, final consumption accounts for approximately 81% of GNDI (equal to 133% of GDP at market prices) while savings absorbed the remaining 19% (equal to 30% of GDP).

Gross fixed capital formation (GFCF = investment) is financed through domestic savings and the net resource balance from abroad. The total decreased by -1.09% per annum in real terms and the share of investment in GDP decreased from 32.7% in 2002 to 24% in 2007 which is mainly due to the winding down of the construction of the Lesotho Highland Project. However, GFCF ceased to decrease in real terms in 2005 and grew by by 5.8% in 2006 and 11.6% in 2007.

1.2 EXTERNAL TRADE AND THE BALANCE OF PAYMENTS[8]

1.2.1 Exchange Rate

Together with Namibia, Swaziland and South Africa, Lesotho is a member of the Common Monetary Area which recognises the South African Rand (R) as legal tender. Although Lesotho introduced its own currency, the loti (plural Maloti [M]), in 1980, it continues to be pegged at par to the Rand. These institutional arrangements limit the scope for an independent monetary policy but confer significant advantages in facilitating trade, investment and cross-border activities (such as tourism).

Panel A of Table 1.4 shows the annual average exchange rate against the currencies of major trading partners while Panel B shows the rate at the end of each calendar year. The change in rates is shown over the entire period and over the last year (NB: if more loti are required to purchase one unit of foreign currency, this represents a depreciation, indicated with a minus sign, while an appreciation means fewer loti are needed to buy one unit of foreign currency and is reflected in a positive change).

In recent years, foreign exchange market conditions in the sub-region have been volatile. Three periods can be identified:

- Between 1999 and 2002, the annual average exchange rate of the loti depreciated by nearly 40% against most major currencies, with smaller depreciations against regional currencies (21% against the pula and 15% against the Zimbabwe dollar). The depreciation was particularly rapid in the second half of 2001 and the first half of 2002, as a result of speculative attacks on the rand and negative sentiment caused by regional political developments and doubts about emerging markets.
- A dramatic reversal of this trend commenced in the last quarter of 2002 and continued throughout 2003 and 2004. This was the result of the weakness of the US dollar, the higher gold price and relatively high interest rates set by the Reserve Bank of South Africa. The bulk of this appreciation was recorded in 2003, but the annual average exchange rate shows that the currency continued to gain against all major trading partners in 2004.
- The data suggest that the exchange rate peaked late in 2004 and, although the annual average rate remained relatively stable throughout 2005, there was a depreciation against most major currencies in 2006 with the annual average rate showing declines of 5% - 7% (although there was an appreciation of 7.9% against the Pula). This negative trend was confirmed by the end-year rates, which recorded falls of 8% - 19%. In 2007, the loti continued to depreciate against the euro and sterling but appreciated against the dollar, pula, yen and IMF Special Drawing Rights (SDR). The changes in both directions were however, very small.

[8] Please note that the BOP data presented here are based on a new format that is to be adopted by Central Bank of Lesotho in the near future, in the meantime it is possible that this data may change.

Table 1.4: EXCHANGE RATES* 2002 - 2007								
A. Annual Average	2002	2003	2004	2005	2006	2007	Annual % Average	% change from 2006 to 2007
Botswana Pula	1.660	1.522	1.369	1.255	1.163	1.141	45.54	1.96
Euro	9.846	8.514	7.932	7.915	8.520	8.531	15.41	-0.13
Japanese Yen	0.083	0.065	0.061	0.058	0.058	0.057	44.60	1.05
Saudi Riyal	2.804	2.011	1.691	1.699	1.805	1.764	58.96	2.32
SDR	13.492	10.575	9.415	9.412	9.976	9.990	35.05	-0.14
UK Pound	15.677	12.344	11.742	11.577	12.507	12.704	23.41	-1.55
US Dollar	10.416	7.562	6.326	6.371	6.780	6.620	57.34	2.42
Zimbabwe Dollar	0.189	0.027	0.001	0.001	0.000	0.000	188900.00	0.00
Real Effective Index(2000=100)**	77.9	112.2	132.2	132.8	129.4	128.8	-39.5	0.5
B. As At 31st December								
Botswana Pula	1.570	1.486	1.325	1.155	1.164	1.125	39.55	3.43
Euro	8.973	8.274	7.660	7.547	9.213	10.651	-15.75	-13.50
Japanese Yen	0.074	0.061	0.055	0.054	0.059	0.060	23.79	-2.33
Saudi Riyal	2.275	1.750	1.519	1.698	1.864	1.812	n.a.	2.85
SDR	11.677	9.717	8.766	9.164	10.511	10.651	9.63	-1.31
UK Pound	13.800	11.743	10.988	11.117	13.727	13.589	1.55	1.01
US Dollar	8.568	6.563	5.699	6.369	6.993	6.796	26.07	2.89
Zimbabwe Dollar	0.161	0.008	0.001	0.000	0.000	0.000	161100.00	0.00

Over the six-year period shown in Table 1.4, the dominant trend has been the appreciation from the low-point recorded at the end of 2002. As a result, most exchange rates ended the period with substantial increases, especially when comparing the end-year rates. Even the annual average rate shows significant increase over the period.

The real effective exchange rate (REER)[9] index is taken from International Financial Statistics prepared by the IMF. The index declined by 22% between 2000 and 2002 and, since approximately two-thirds of Lesotho's exports are destined for the US market, this depreciation of the loti against the US dollar improved the country's export competitiveness. However, the subsequent appreciation of the currency caused the index to increase by 44.0% in 2003 and by 17.8% in 2004. This puts exporters under severe pressure from competitors in countries which have not revalued against the dollar. The REER has declined from 132.8 in 2005 to 128.8 in 2007, declining by 2.5% in 2006 and by 0.5% in 2007.

1.2.2 Balance of Payments

1.2.2.1 Current Account

As indicated in Table 1.5, the four components of the Current Account are merchandise trade, services, labour income from abroad and transfers to Government. The current account balance improved significantly from a deficit of 23% of GDP (M 1,652.1 million) in 2002/03 to a surplus of 3.7% (M 458.7 million) in 2007/08. The main contributor to this improvement has been an increase in transfers that has grown by an annual average of 13.1% during 2002/03-2007/08. In addition to this there has also been a substantial increase in net income from abroad

[9] The real effective exchange rate measures changes in the nominal exchange rate adjusted to take account of any difference in the rate of inflation in the two countries whose currencies are being exchanged. A depreciation of the nominal exchange rate may provide an initial improvement in export competitiveness but this may not be reflected in the real exchange rate if the temporary price advantage is subsequently eroded by domestic cost inflation at rates above our trading partners.

over the period 2005/06 to 2007/08, increasing by 70% from M1,985.06 million in 2005/06 to 3,374.1 million in 2007/08.

Merchandise Trade[10]

Exports:

Between 2002/03 and 2007/08, there has been rapid and sustained growth in exports (at a nominal rate of 9.3% per annum) whereas there has been relatively slower growth in imports (7% per annum). However, because imports started from a higher base value, these trends have not resulted in a reduction in the deficit on trade in goods, which has increased from M 4,811.7 million in 2002/03 to M 6,155.6 million in 2007/08.

Between 2000/01 – 2002/03, the nominal value of exports increased by 130% in response to strong demand from Lesotho's main trading partners, the United States and the Republic of South Africa, encouraged by the depreciation of the local currency against the US dollar and the application of the Africa Growth and Opportunities Act (AGOA) from the middle of 2000/01. However, exports declined by 2.7% in 2003/04 in Maloti terms (principally because the appreciation of the currency from late-2002 weakened textile demand). Although the appreciation continued in 2004/05, exports grew by 27.1% as a result of improvements in global trade (especially the US market) and the commencement of diamond exports. Despite the continued expansion of diamond sales, total exports fell by 11.4% in 2005/06, mainly because of the adverse impact on the textile industry of the currency movements and the ending of the Agreement on Textiles and Clothing with effect from 31st December 2004.

However, in 2006/07 the textile industry bounced back from the weak performance in the previous year and the mining sector continued to expand, resulting in an increase in exports of 27%. Exports increased by a further 12.2% in 2007/08 as a result of substantial increases in diamond exports which grew by 97%. The ratio of exports to GNI averaged 37.5% for the period between 2002/03 and 2007/08.

Imports:

Following a small decline in import values in 2004/05, imports grew by 3.5% in 2005/06, 23.5% in 2006/07 and by 10.3% in 2007/08. Historically, the trend in imports was correlated with the performance of the textiles industry, which imports intermediate goods used in production and the imports required for the construction of the Lesotho Highlands Water Project (LHWP). Given the completion of Phase I of LHWP and textiles industry reaching its peak in 2004/05, it is believed that the growth rate of imports is more correlated with the general performance of the economy in the latter years.

[10] It should be noted that there are problems affecting the accuracy and timeliness of trade data and an important policy objective is to ensure consistency between the Lesotho Revenue Authority, the Bureau of Statistics and the Central Bank.

Table 1.5a - Balance of Payments 2002/03-2007/08 (Millions Maloti)

	2002/03	2003/04	2004/05	2005/06	2006/07	2007/08	Annual % Average
I CURRENT ACCOUNT	**-1,652.1**	**-1,591.7**	**-103.3**	**-818.9**	**213.7**	**458.7**	
a) GOODS, net	**-4,811.7**	**-4,966.2**	**-3,904.9**	**-4,704.5**	**-5,665.8**	**-6,155.6**	**5.05%**
Merchandise Exports f.o.b	3,614.6	3,516.2	4,469.5	3,959.2	5,029.7	5,644.3	9.32%
% annual change	32.7%	-2.7%	27.1%	-11.4%	27.0%	12.2%	
Merchandise Imports f.o.b.	-8,426.3	-8,482.4	-8,374.4	-8,663.7	-10,695.5	-11,799.9	6.97%
% annual change	23.9%	0.7%	-1.3%	3.5%	23.5%	10.3%	
b) SERVICES, net	**-975.2**	**-899.7**	**-1,034.0**	**-885.8**	**-969.6**	**-1,189.8**	**4.06%**
% annual change	26.3%	-7.7%	14.9%	-14.3%	9.5%	22.7%	
c) INCOME, net	**1,894.4**	**2,016.0**	**2,082.8**	**1,985.1**	**2,482.9**	**3,374.1**	**12.24%**
% annual change	10.8%	6.4%	3.3%	-4.7%	25.1%	35.9%	
Compensation of employees, credit	1,837.8	1,989.5	2,016.0	1,939.6	2,384.3	3,009.9	10.37%
Investment income, net	56.6	26.5	66.9	45.4	98.7	364.2	45.09%
d) CURRENT TRANSFERS	**2,240.4**	**2,258.2**	**2,752.7**	**2,786.4**	**4,366.2**	**4,430.0**	**14.61%**
% annual change	7.0%	0.8%	21.9%	1.2%	56.7%	1.5%	
Government, net	2,102.9	2,101.4	2,600.0	2,596.1	4,155.3	4,273.6	15.24%
SACU, net	1,436.0	1,351.9	1,913.9	2,218.6	3,858.4	3,858.4	21.86%
% annual change	2.2%	-5.9%	41.6%	15.9%	73.9%	0.0%	
Other Sectors	137.5	156.8	152.7	190.2	210.9	156.4	2.61%
II CAPITAL & FINANCIAL ACCOUNT	**1,234.3**	**867.8**	**750.9**	**1,466.2**	**483.8**	**945.9**	**-5.18%**
e) CAPITAL ACCOUNT	**361.2**	**226.1**	**160.4**	**50.1**	**49.4**	**189.8**	**-12.08%**
Government: Grants in budget, credit	444.8	298.1	231.4	83.6	78.5	248.3	-11.01%
Other sectors: migrants' transfers, debit	-83.6	-72.0	-71.0	-33.5	-29.1	-58.5	-6.89%
f) FINANCIAL ACCOUNT	**873.0**	**641.7**	**590.5**	**1,416.1**	**434.4**	**756.1**	**-2.83%**
Direct investment in Lesotho, net	307.2	336.9	342.9	373.7	591.1	902.0	24.04%
Portfolio investment in Lesotho, net	-0.7	-4.2	-9.3	-11.0	-11.7	-12.7	
Other assets	600.2	258.1	288.2	818.9	-131.4	-74.8	-165.94%
Other liabilities	-33.7	50.9	-31.4	234.5	-13.5	-58.4	11.64%
III ERRORS AND OMISSIONS	**28.9**	**607.0**	**-256.0**	**-277.0**	**1,003.4**	**-211.6**	
IV TRANSACTIONS BALANCE	**-389.0**	**-116.9**	**391.6**	**370.3**	**1,700.9**	**1,192.9**	
V VALUATION ADJUSTMENT	**-843.1**	**-377.6**	**59.7**	**-31.8**	**437.9**	**410.7**	
VI OVERALL BALANCE	**-1,232.0**	**-494.5**	**451.3**	**338.6**	**2,138.8**	**1,603.6**	
VII RESERVE ASSETS	**1,232.0**	**494.5**	**-451.3**	**-338.6**	**-2,138.8**	**-1,603.6**	
GDP at purchaser's prices	**7,175**	**7,724**	**8,437**	**9,130**	**10,646**	**12,319**	
Current account in % GDP	-23.0%	-20.6%	-1.2%	-9.0%	2.0%	3.7%	
Capital & Financial account in % GDP	17.2%	11.2%	8.9%	16.1%	4.5%	7.7%	
Errors & Omissions in % GDP	0.4%	7.9%	-3.0%	-3.0%	9.4%	-1.7%	
Valuation adjustment in % GDP	-11.7%	-4.9%	0.7%	-0.3%	4.1%	3.3%	
Overall balance in % GDP	-17.2%	-6.4%	5.3%	3.7%	20.1%	13.0%	
GNI at current prices	**9,082**	**9,830**	**10,685**	**11,481**	**13,606**	**15,696**	
Exports / GNI	39.8%	35.8%	41.8%	34.5%	37.0%	36.0%	

Note: These data are currently in the process of being revised. It is believed that errors and omissions will be reduced once this work is completed.

Net payments for Services:

Since 2002/03, the annual deficit has been between M 900 – 1,1190 million. The major sub-item responsible for the deficit is travel, although this is partially offset by positive receipts received from water distribution.

Net Income from abroad:

Until 2000/01, this item (principally income from migrant workers in South Africa) made a more important contribution to the Current Account than exports. Since 2000/01, its relative importance has declined as it grew more slowly than exports.

However, it had an exceptional increase of 25.1% in 2006/07 (to M 2,482.9 million) and of 35.9% in 2007/08 (to M 3,374 million) which has raised the average annual growth rate for the six-year period to 9.5%. Although there has been a decline in the number of Basotho workers in South African mines, those that remain hold better paying jobs. The average wage of Basotho mineworkers has therefore increased.

Current Transfers:

The main source of transfers is the revenue pool established under the Southern African Customs Union (providing approximately 90% of total transfers). The Agreement has recently been renegotiated and the new revenue-sharing formula came into operation with effect from 1st April 2005. Under the old formula, receipts were linked to the value of all imports with a two-year lag (thus, the increase of 29.2% in SACU non-duty receipts in 2004 resulted from the acceleration in imports in 2002). Under the new formula, receipts are principally based on the relative shares of intra-SACU imports and the overall size of the revenue pool. Trends in these items generated further increases of 41.6% in 2004/05, 15.9% in 2005/06 and 73.9% in 2006/07. Overall, transfers have grown by 14.6% per annum since 2002/03.

1.2.2.2 Capital and Financial Account

The overall balance on the Capital and Financial Account is determined by the level of grants, net repayment/disbursement of foreign loans, migrant's capital transfers, net investment by the private sector and changes in assets/liabilities of the commercial banks.

The net balance of resources on the Capital and Financial Account has fluctuated between M 1,234.3 in 2002/03 and M. 945.9 millions in 2007/08 with minima in 2004/05 (M 750.9 millions) and in 2006/07 (M 483.8 millions). The average evolution all over the period is a slight decline of 5.18% per year. However, the decline expressed in % of GDP shows a more worrying trend: the 2002/03 inflow of M 1,234.3 million represented 17.2% of GDP whereas 2007/08 inflow of M 945.9 million was only 7.7% of GDP.

Capital Account

On average on the period the capital account decreases by 12.0% per year. On the credit side, the government Grants in Budget decreased from M 444.8 million in 2002/03 to M 78.5 million in 2006/07 but rebounded to M 248.3 million in 2007/08. On the debit side, migrant's transfer decreased from M 83.6 million in 2002/03 to M 29.1 million in 2006/07 but rebounded to M 58.5 million in 2007/08.

Financial Account

Direct investments

After four years of gradual progression (from M 307.2 million in 2002/03 to M 373.7 million in 2005/06) foreign direct investment increased steadily in 2006/07 and 2007/08 to M 591.1 million and then to M 902.0 million respectively, providing an annual growth rate of 24.0 % over the period.

Other assets

Other assets includes four items: trade credits, currency deposits nets, other sectors net, and unspecified assets which evolves as indicated in the table 1.5b below.

Table 1.5b: Detail of Financial Account - Other Assets

	2002/03	2003/04	2004/05	2005/06	2006/07	2007/08
OTHER ASSETS	**600.2**	**258.1**	**288.2**	**818.9**	**-131.4**	**-74.8**
1 Trade credits	**-8.6**	**-42.8**	**-85.4**	**-138.3**	**-147.4**	**-159.2**
2 Currency deposits, net	**-17.8**	**-236.7**	**-261.9**	**168.0**	**-723.8**	**-507.6**
Central Bank of Lesotho, net	-3.1	-2.7	-1.6	6.5	-2.3	-14.3
Commercial banks, net	-14.8	-234.0	-260.4	161.6	-721.6	-493.3
3 Other sectors, net	**628.5**	**547.4**	**645.5**	**781.6**	**731.7**	**583.2**
From 2005 Survey on Private Capital Flows	1.3	6.6	6.1	-7.3	-7.8	-8.4
Contra: migrant transfers, credit	83.6	72.0	71.0	33.5	29.1	58.5
Contra: resident expat remuneration, net	-111.5	-96.0	-94.7	-44.7	-38.9	-78.0
Contra: resident workers in SA net CoE	-982.8	-1069.9	-1078.1	-1037.2	-1275.0	-1609.6
Contra: non-res. Worker transfers to Lesotho (workers in SA), debit	-68.9	-74.6	-75.6	-72.7	-89.4	-112.9
Contra: imports of private shoppers, credit	212.0	199.1	203.0	182.8	201.9	224.0
Contra: imports of small traders, credit	1494.7	1504.3	1613.6	1727.3	1911.7	2109.6
4 Unspecified assets	**-2.0**	**-9.8**	**-9.9**	**7.5**	**8.0**	**8.7**

Other liabilities

The other liabilities includes five items: trade credits, currency and deposits, loans government net, loans of other sectors and unspecified liabilities which evolves as indicated in the table 1.5c below.

Table 1.5c: Detail of Financial Account - Other Liabilities

	2002/03	2003/04	2004/05	2005/06	2006/07	2007/08
OTHER LIABILITIES	**33.7**	**50.9**	**-31.4**	**234.5**	**-13.5**	**-58.4**
1 Trade credits	**11.8**	**59.1**	**103.6**	**132.7**	**141.4**	**152.7**
2 Currency and deposits, net	**-80.4**	**-8.4**	**-55.8**	**557.1**	**62.7**	**-2.7**
Central Bank of Lesotho, net	-70.4	-105.4	7.1	613.2	50.9	57.5
Commercial banks, net	-10.0	97.0	-62.9	-56.0	11.8	-60.2
3 Loans, government, net	**6.3**	**-34.9**	**-63.7**	**-278.2**	**-28.8**	**-4.5**
Borrowing, credit	235.5	170.4	178.0	108.2	206.4	210.9
Repayments, debit	-229.2	-205.3	-241.7	-386.4	-235.2	-215.4
4 Loans, other sectors, net	**28.0**	**31.8**	**-19.3**	**-177.0**	**-188.6**	**-203.7**
5 Unspecified liabilities	**0.6**	**3.2**	**3.8**	**-0.2**	**-0.2**	**-0.2**

1.2.2.3 Reserve Position

Valuation adjustment

Revaluation of foreign assets is undertaken to show the impact of movements in the exchange rate of the local currency against the currencies of official reserve assets. This takes place at the end of each quarter for balance of payments. When converted into Maloti, the value of a fixed stock of foreign assets goes up as a result of depreciation but an appreciation causes a decline. The depreciation of the currency against major currencies resulted in a massive surplus under the Valuation Adjustment in 2001/02 but the subsequent appreciation caused negative adjustments for 2002/03 and 2003/04. The exchange rate was relatively stable during 2004/05 and 2005/06 and small adjustments were made in both directions. The depreciation of Loti against major currencies (notably US$, Sterling and Euro) during 2006/07 and 2007/08 has meant a relatively large adjustment of M 437.9 million and M 410.7 million respectively.

Official net international reserves

The Balance of Payments shows the annual fluctuations in official reserve assets (i.e. those held by the Central Bank) resulting from developments in the Current Account and the Capital and Financial Account, Errors and Omissions and the Valuation Adjustment. Combining the positive developments in the Current Account with the deficit on the Capital and Financial Account, the overall outcome in 2007/08 was a surplus of M 1,603.6 million.

Lesotho is a small, open economy with a fixed exchange rate regime. Because a sustained decline in reserves would threaten the stability of the currency peg and might breed negative sentiment among creditors and foreign investors, Lesotho's monetary policy objective is to maintain the level of official net international reserves at or above the target of US$450 to US$500 million.

Gross foreign Assets

A further indicator of stability is to maintain the ratio of gross foreign assets (i.e. including official reserves held by the Central Bank and assets of the commercial banks) in excess of the internationally accepted threshold of 3-6 months cover of merchandise imports. Commercial bank assets increased from M 835.7 million in 2002/03 to M 2,448.4 million in 2007/08, an annual average growth rate of 24%. Gross foreign assets stood at M 10,008.8 million, equivalent to 10.2 months of import cover in 2007/08.

1.3 PUBLIC FINANCE

1.3.1 Overview of Fiscal Developments

Throughout most of the 1990s, Lesotho pursued the objective of macroeconomic stability with considerable success. Consistent fiscal surpluses and access to concessional external finance allowed the gradual reduction in commercial and domestic debt and the build-up of official reserves.

However, the civil riots in September 1998 disrupted economic activity and reduced domestic revenues and grants, while the need for reconstruction put pressure on public expenditure in subsequent years. In 1999/00, Government incurred an unprecedented fiscal deficit as a result of exceptional outlays to meet costs of M 575.7 million in the restructuring prior to sale of Lesotho Bank and of M 284.3 million to redeem commercial loans for the Lesotho Highlands Development Authority (LHDA). Financing the deficit led to the rapid depletion of Government's reserves from their peak in July 1999.

The Government requested the IMF to assist in re-establishing a sound fiscal policy framework and maintaining external reserves at about 6 months of imports. This resulted in arrangements under the Poverty Reduction and Growth Facility (PRGF) from March 2001 to October 2004. Since then, Lesotho has not had any arrangements with the Fund but, as shown in Table 1.5, which summarises budgetary operations covering financial years 2002/03 – 2007/08, significant progress has been maintained.

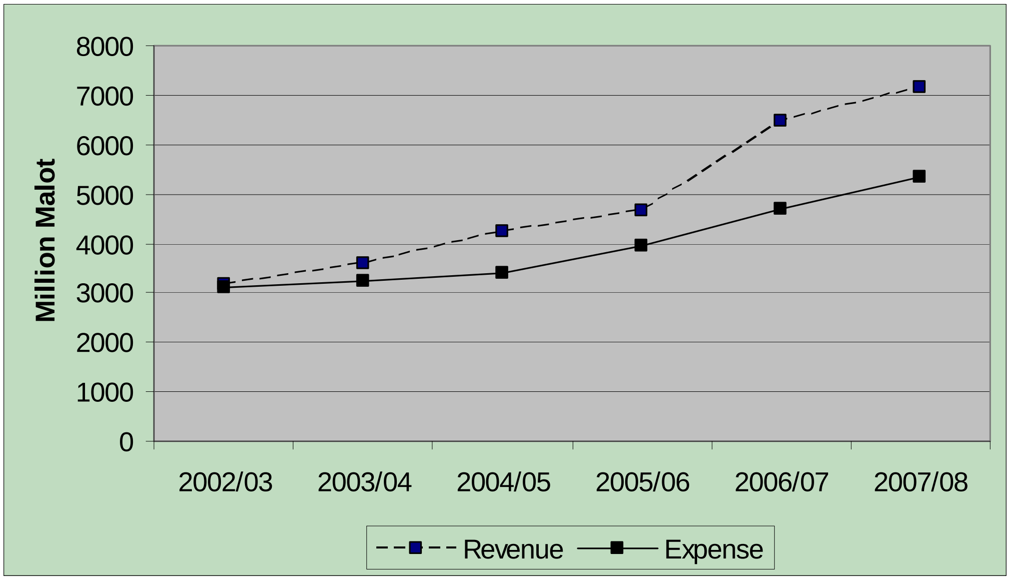
Table 1.6: GOVERNMENT BUDGET OPERATIONS, 2002/03-2007/08 (Maloti million)

Category	2002/03	2003/04	2004/05	2005/06	2006/07	2007/08	Annual Average
Revenue	**3173.6**	**3606.9**	**4248.2**	**4661.2**	**6464.5**	**7164.8**	**17.7%**
Tax revenue	1140.3	1571.4	1630.6	1755.0	1907.4	2232.1	14.4%
Social Contributions	0.3	0.1	0.0	0.0	0.0	0.0	
Grants	122.2	105.0	182.6	171.4	92.4	175.8	7.5%
Other revenue	440.9	508.7	422.7	428.7	519.8	659.2	8.4%
SACU	1470.0	1421.7	2012.4	2306.0	3945.0	4097.7	22.8%
Expense	**-3108.4**	**-3253.3**	**-3398.0**	**-3962.1**	**-4681.7**	**-5334.6**	**11.4%**
Compensation of Employees	-1245.6	-1282.9	-1429.0	-1513.0	-1645.3	-1937.2	9.2%
Use of goods and services	-1101.1	-1126.2	-1130.3	-1275.0	-1602.0	-1770.3	10.0%
Interest Payments	-209.5	-221.6	-152.0	-216.8	-308.1	-296.1	7.2%
Subsidies	0.0	0.0	0.0	0.0	0.0	0.0	
Grants	-270.3	-339.1	-375.9	-502.5	-650.0	-776.0	23.5%
Social Benefits	-9.2	-12.0	-10.9	-148.6	-170.9	-223.0	89.0%
Other expense	-272.7	-271.6	-299.8	-306.2	-305.4	-332.0	4.0%
Net Worth and its Changes	**-71.9**	**-423.0**	**-1021.1**	**-893.8**	**-1676.2**	**-1465.6**	**82.8%**
Nonfinancial assets	-263.6	-270.5	-214.2	-315.8	-376.3	-529.8	15.0%
Financial assets	558.5	-228.3	-144.4	-320.5	-1369.1	-955.0	-211.3%
Liabilities	-366.7	75.7	-662.4	-257.6	69.2	19.2	-155.4%
	0.0	0.0	0.0	0.0	0.0	0.0	
Overall Fiscal Balance	-163.3	83.1	643.6	393.2	1415.9	1312.0	
Balance as % GDP	-2.3%	1.1%	7.6%	4.3%	13.3%	10.7%	
Statistical Discrepancy	*-6.7*	*-69.4*	*-170.9*	*-194.8*	*106.6*	*364.6*	

In 2002/03, the Government ran a fiscal deficit of M 163.3 million. This became a surplus of M 83.1 million in 2003/04 with revenue increasing more sharply (by 13.7 %) than expenditure which grew by only 4.7%. This sharp increase in revenue was due to increases in tax revenue following the establishment of the LRA and increasing VAT to 14% from the initial Sales Tax of 10% to harmonise with the South African rate The Government balance increased in 2004/05 to M 643.6m (7.6% of GDP) and then declined to M 393.2m (4.3% of GDP) in 2005/06. This decline during 2005/06 was due to revenue growth of 9.7% being outstripped by expenditure growth of 16.6%. 2006/07 registered a surplus of M 1,415.9 million due to an increase in total revenue of 38.7% which overshadowed the expenditure growth of 18.2%. The increases in revenue were largely driven by an increase in SACU revenue which grew by over 70% during that year. This improved fiscal position was maintained in 2007/08 with a surplus of M 1,312 million (10.7% of GDP).

Figure 1 charts Government revenue and expenditure. Over the six years to 2007/08 revenue has increased by an average of 17.7% per annum, whilst expenditure has increased by 11.4% per annum on average. This has resulted in an increasing budget surplus and as a result Government reserves, as indicated by the growing gap between revenue and expenditure shown in figure 1.

Figure 1.1: Government Revenue and Expenditure



One concern for fiscal policy is that the public sector absorbs nearly half of GDP. This is exceptionally high by African and developing country standards. A major contributory factor is Lesotho's membership of regional customs and monetary arrangements. These set prices (including wages) at levels requiring a high level of expenditure, while the revenue-sharing arrangements under the Customs Union provide the required level of financing. In order to reduce this dependence, Government is pursuing the policy objective of encouraging rapid and sustained private sector development to diversify the economy and reduce the relative scale of public sector activity[11].

1.3.2 Revenue and Grants

A detailed breakdown of revenue and grants from 2002/03 to 2007/08 is shown in Table 1.7.

Domestic Revenues

Over this period, domestic revenue has been on average equal to 52% of GDP at market prices. The annual ratio has increased from 45.1% in 2002/03 to 58.6% in 2007/08 due to the exceptional increases in customs revenue. Domestic revenues have grown by an average annual rate of 18.0% against nominal GDP growth of 11.3% per annum since 2002. The institutional arrangements for tax collection were changed with the establishment of the Lesotho Revenue Authority (LRA) in January 2003 and this is considered to have contributed to the strong performance of domestic taxes.

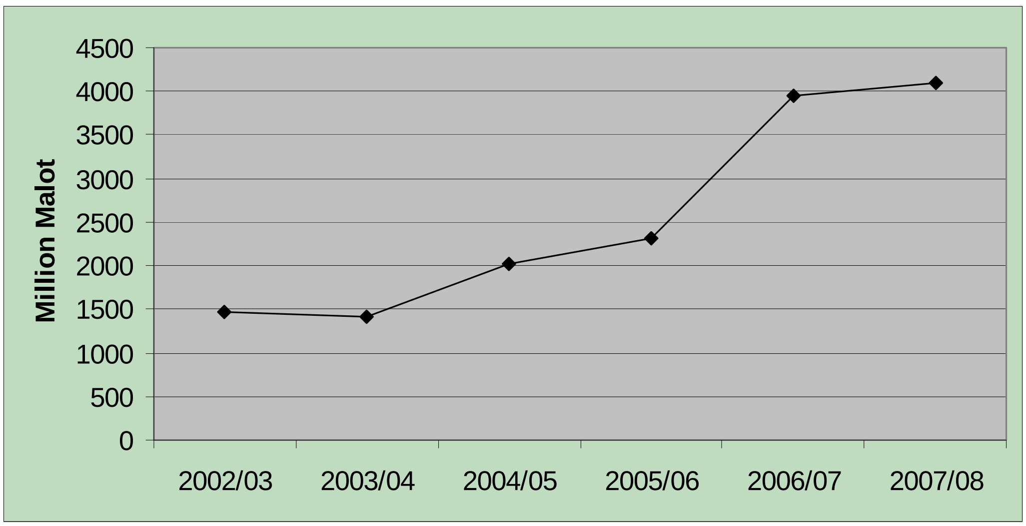
[11] In 2009/10, the estimated expenditure outturn is 64% of GDP.

SACU Revenue

There has been a considerable increase in *Customs* receipts from the SACU revenue pool, which have recorded an average annual growth rate of 22.8% over the period 2002/03 to 2007/08. SACU revenues had stabilised at around M 1.4 billion from 2001/02 to 2003/04 but jumped to M 2.0 billion in 2004/05 as Lesotho benefited from the impact of intermediate inputs imported for use in the textile industry. The new revenue-sharing formula came into operation with effect from 1st April 2005 and the application of the formula has combined with the expansion of both the Customs Pool and the Excise Pool to generate significantly higher revenues in both 2005/06 and 2006/07. In addition, Lesotho also received adjustment payments due under the previous SACU revenue-sharing arrangements.

Over the six financial years, this item has provided more than half of all domestic revenue (50.1%). SACU revenues rose to over M 4 billion in 2007/08. Figure 2 plots SACU revenue over the period 2002/03 to 2007/08.

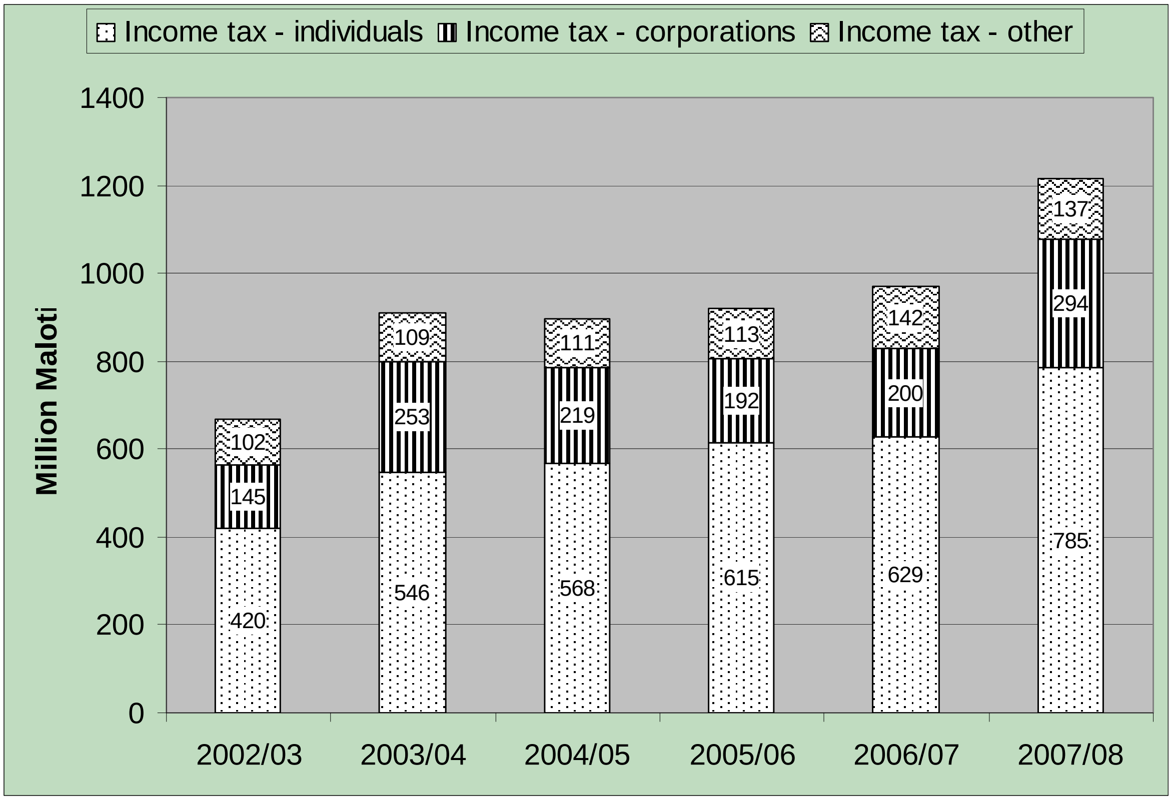
Figure 1.2: SACU Revenue



Income tax

Income tax has grown by an average annual rate of 12.8% for the period 2002/03-2007/08 and has generated 19.6% of total domestic revenue. There were strong increases in nominal collections of *Income Taxes* (culminating in the exceptional increase of 36.2% in 2003/04) but growth was actually negative at -1.2% in 2004/05, and then turned positive with 2.6% and 5.5% growth in 2005/06 and 2006/07 respectively. There was a large 25.3% increase in income tax revenue in 2007/08. In part, this reflects a lowering of the company tax rate which, after growing by 75% in 2003/04 following the establishment of LRA, declined for the two subsequent years by 13.4% and 12.4%, respectively. Contrary to a priori expectations company tax witnessed an increase in both 2006/07 and 2007/08 following a reduction in the standard rate of company tax from 35% to 25%; a reduction from 15% to 10% for manufacturing firms exporting within SACU; and a reduction from 15% to 0% for extra-SACU exporters in 2006/07. This was partly due to exceptional performance of a small number of large companies in the banking, telecommunication and mining sectors. Figure 3 plots income tax revenue over the period 2002/03 to 2007/08.

Figure 1.3: Income Tax Revenue



Taxes on goods and Services

Taxes on Goods & Services (principally Value Added Tax and the oil levy) have grown by 18.1% per annum over the six years to 2007/08 and provide 15.3% of total domestic revenue. Value Added Tax (VAT) replaced Sales Tax with effect from 1st July 2003. Although VAT only applied for nine months in 2003/04, collections were 47.0% higher than Sales Tax collections in 2002/03. This was achieved because the standard rate of VAT was set at 14% (thereby harmonising with the South African rate), as opposed to 10% under the Sales Tax; LRA improved administrative efficiency (assisted by active cooperation with the South African Revenue Service); and Government became liable to pay VAT. The improvement continued into the first full year of VAT operations, with a further increase of 22.2% in collections. However, collections stagnated in 2005/06 before growing by 9.0% in 2006/07 and 18.7% in 2007/08.

Non-tax revenue

Non-tax Revenue is composed of property income, which contributed 23% of non-tax revenue in 2007/08, and sales of goods and services, which contributed 67% of non-tax revenue. Amongst property income, "dividends" is the most important source, and amongst sales of goods and services, water royalties is the most important source.

Although non-tax revenue has grown at an annual average rate of 8.4% over the previous six years, its share of total domestic revenue throughout the six years to 2007/08 is only 11.1%. The improvement in fiscal outturn and the consequential increase in Government balances should result in a significant increase in property income (interest on bank deposits) in future.

Projects grants

The nominal value of *Project Grants* varies with the pace of implementation of capital projects and the quality of donor reporting to the Government accounting system. Between 2001/02-2004/05, Government received *Budget Support Grants* from the European Union.

Table 1.7: GOVERNMENT REVENUE AND GRANTS, 2002/03-2007/08 (Maloti million)

Revenue Item	2002/03	2003/04	2004/05	2005/06	2006/07	2007/08	Annual Average
Tax Revenue	**1140.3**	**1571.4**	**1630.6**	**1755.0**	**1907.4**	**2232.1**	**14.4%**
Income tax	**666.9**	**908.4**	**897.2**	**920.1**	**970.7**	**1216.4**	**12.8%**
Income tax - individuals	419.8	546.2	567.5	615.0	629.5	785.4	13.3%
Income tax - corporations	144.8	252.9	219.1	192.0	199.6	293.7	15.2%
Income tax - other	102.4	109.3	110.5	113.1	141.7	137.4	6.1%
Taxes on Property (RMC)	**43.7**	**49.5**	**0.0**	**58.6**	**66.5**	**0.0**	**-81.0%**
Taxes on goods and services	**425.6**	**606.3**	**719.7**	**750.2**	**788.5**	**977.4**	**18.1%**
Value Added Tax (Sales)	367.4	540.1	659.8	655.7	714.6	847.9	18.2%
Excises (Oil levy)	48.7	52.5	49.5	84.7	65.6	118.1	19.4%
Taxes on specific services	4.0	8.4	5.2	4.9	2.9	5.4	6.1%
Licensing	5.5	5.3	5.2	4.8	5.5	6.0	1.7%
Taxes on Int. Trade (exports)	**0.1**	**0.0**	**10.8**	**23.0**	**73.3**	**31.7**	**235.7%**
Other Taxes (stamp duty)	**3.9**	**7.2**	**2.9**	**3.1**	**8.4**	**6.6**	**11.0%**
Non-Tax Revenue	**440.9**	**508.7**	**422.7**	**428.7**	**519.8**	**659.2**	**8.4%**
Property income	**74.0**	**186.5**	**65.7**	**24.5**	**78.2**	**151.1**	**15.3%**
Interest on deposits	16.4	88.6	6.6	7.6	5.0	32.7	14.8%
Dividends	54.9	92.3	53.4	4.8	69.8	96.9	12.0%
Rent	2.7	5.6	5.7	12.1	3.3	21.5	51.2%
Sales of goods and services	**302.4**	**289.8**	**339.9**	**381.8**	**412.9**	**444.7**	**8.0%**
Electricity Muela	39.7	36.8	50.0	69.5	46.3	91.2	18.1%
Water royalties	201.1	189.7	194.5	236.0	286.7	292.4	7.8%
Administrative fees	13.8	20.4	19.2	24.4	27.0	26.3	13.8%
Incidental sales by nonmarket establishments	47.8	42.9	76.2	51.8	52.8	34.8	-6.2%
Fines	**6.6**	**16.3**	**6.3**	**6.8**	**17.1**	**0.8**	**-34.6%**
Miscellaneous Income	**57.9**	**16.2**	**10.8**	**15.6**	**11.6**	**62.6**	**1.6%**
SACU	**1470.0**	**1421.7**	**2012.4**	**2306.0**	**3945.0**	**4097.7**	**22.8%**
TOTAL DOMESTIC REVENUE	**3051.2**	**3501.8**	**4065.6**	**4489.7**	**6372.1**	**6989.0**	**18.0%**
Domestic revenue / GDP (%)	43%	45%	48%	49%	60%	57%	0.0%
Grants	**182.6**	**142.6**	**238.4**	**171.4**	**92.4**	**175.8**	**-0.8%**
Project grant outturn	122.2	105.0	182.6	171.4	92.4	175.8	7.5%
Budget Support	60.4	37.6	55.8	0.0	0.0	0.0	0.0%
REVENUE & GRANTS OUTTURN	**3233.7**	**3644.4**	**4304.0**	**4661.2**	**6464.5**	**7164.8**	**17.2%**

*RMC indicates Rand Monetary Compensation

1.3.3 Expenditure by Economic Classification

Table 1.8 reports Government expenditure by economic classification over the six years to 2007/08. Panel A reports expenditure values for each category and panel B reports shares as a proportion of total expenditure.

Total expenditure has increased from M 3108.4 million in 2002/03 to M 5334.6 million in 2007/08. This represents an average annual increase of 11.4% with all categories of expenditure registering increases.

In percentage terms, the largest single increase is in *social benefits*. These have increased from M 9.2 million in 2002/03 to M223.0 million in 2007/08 – an average annual increase of 89.0%. This increase is largely explained by the introduction of the national old-age pension in 2004/05.

Other large increases in expenditure include *grants to other general government units*, which have grown by an average of 24.8% per year from M 254.3 million in 2002/03 to M770.5 million in 2007/08. This is explained by the transfer of functions to autonomous agencies, such as the Lesotho Revenue Authority.

Compensation of employees has risen from M 1245.6 million in 2002/03 to M 1937.2 million in 2007/08 (an average increase of 9.2% per annum). *Interest payments* have increased by around by 7.2%, but the composition of these have changed with an increase of *interest payments to non residents* M 209.5 million in 2002/03 to M 296.1 in 2007/08, but a decline in payments to non-Government residents from M96.6 million to M49.5 million.

Expenditure on *use of goods and services* has increased by an average of 10.0% per year over the six years to 2007/08 and *other miscellaneous expenses* has seen a small increase over the period, largely due to funding students through the National Manpower Development Secretariat (NMDS) .

Focussing on each expenditure classification as a proportion of total expenditure (in panel B) reveals that the largest components of Government expenditure are *compensation of employees* (averaging 38.5% over the period); *use of goods and services* (averaging 33.8%); and grants (averaging 11.9%).

Over the period however, *compensation of employees* has declined in importance relative to total expenditure, with an average annual decline of 2.0%. Despite increasing in value, the relative importance of *use of goods and services* has also declined by an average of 1.3% per annum whilst *interest payments* as a proportion of total expenditure have declined by an average of 3.8% per annum.

Social benefits have seen the largest increase as a proportion of total expenditure as well as in value terms, albeit from a small base. These have increased by an average of 69.7% per year over the six years to 2007/08. *Grants to other general Government units* which provide grants to various autonomous implementing agencies such as LHDA, LEC, WASA and LNDC have seen an annual increase of 12.0%.

Table 1.8: ECONOMIC CLASSIFICATION OF EXPENDITURE, 2002/03-2007/08

Expense Item	2002/03	2003/04	2004/05	2005/06	2006/07	2007/08	Annual Average
A. Expense							
Compensation of Employees	**-1245.6**	**-1282.9**	**-1429.0**	**-1513.0**	**-1645.3**	**-1937.2**	**9.2%**
Wages and salaries	-1170.6	-1177.0	-1253.8	-1372.7	-1518.9	-1769.2	
Employer contributions	-75.1	-105.9	-175.3	-140.3	-126.4	-168.0	17.5%
Use of goods and services	**-1101.1**	**-1126.2**	**-1130.3**	**-1275.0**	**-1602.0**	**-1770.3**	**10.0%**
Interest Payments	**-209.5**	**-221.6**	**-152.0**	**-216.8**	**-308.1**	**-296.1**	
Nonresidents	-112.9	-95.7	-86.9	-171.0	-266.7	-246.6	
Residents other than general government	-96.6	-125.9	-65.1	-45.8	-41.4	-49.5	
Grants	**-270.3**	**-339.1**	**-375.9**	**-502.5**	**-650.0**	**-776.0**	**23.5%**
To international organisations	-16.0	-13.6	-11.3	-15.8	-30.2	-5.5	-19.3%
To other general government units	-254.3	-325.5	-364.5	-486.7	-619.9	-770.5	24.8%
Social Benefits	**-9.2**	**-12.0**	**-10.9**	**-148.6**	**-170.9**	**-223.0**	**89.0%**
Other expense	**-272.7**	**-271.6**	**-299.8**	**-306.2**	**-305.4**	**-332.0**	**4.0%**
Miscellaneous other expense	-222.8	-230.7	-252.6	-281.3	-280.8	-289.1	
Current	-222.8	-230.7	-252.6	-281.3	-280.8	-289.1	5.4%
Capital	-49.9	-40.9	-47.2	-24.9	-24.6	-42.8	
Total	-3108.4	-3253.3	-3398.0	-3962.1	-4681.7	-5334.6	

B. Percentage Shares	2002/03	2003/04	2004/05	2005/06	2006/07	2007/08	Annual Average	Annual Average Change
Compensation of Employees	**40.1%**	**39.4%**	**42.1%**	**38.2%**	**35.1%**	**36.3%**	**38.5%**	**-2.0%**
Wages and salaries	**37.7%**	**36.2%**	**36.9%**	**34.6%**	**32.4%**	**33.2%**	**35.2%**	**-2.5%**
Use of goods and services	**35.4%**	**34.6%**	**33.3%**	**32.2%**	**34.2%**	**33.2%**	**33.8%**	**-1.3%**
Interest Payments	**6.7%**	**6.8%**	**4.5%**	**5.5%**	**6.6%**	**5.6%**	**5.9%**	**-3.8%**
Subsidies	**0.0%**	**0.0%**	**0.0%**	**0.0%**	**0.0%**	**0.0%**	**0.0%**	
Grants	**8.7%**	**10.4%**	**11.1%**	**12.7%**	**13.9%**	**14.5%**	**11.9%**	**10.8%**
To international organisations	**0.5%**	**0.4%**	**0.3%**	**0.4%**	**0.6%**	**0.1%**	**0.4%**	**-27.6%**
To other general government units	**8.2%**	**10.0%**	**10.7%**	**12.3%**	**13.2%**	**14.4%**	**11.5%**	**12.0%**
Social Benefits	**0.3%**	**0.4%**	**0.3%**	**3.8%**	**3.7%**	**4.2%**	**2.1%**	**69.7%**
Other expense	**8.8%**	**8.3%**	**8.8%**	**7.7%**	**6.5%**	**6.2%**	**7.7%**	**-6.6%**
Miscellaneous other expense	**7.2%**	**7.1%**	**7.4%**	**7.1%**	**6.0%**	**5.4%**	**6.7%**	**-5.4%**
Current	**7.2%**	**7.1%**	**7.4%**	**7.1%**	**6.0%**	**5.4%**	**6.7%**	**-5.4%**
Capital	**1.6%**	**1.3%**	**1.4%**	**0.6%**	**0.5%**	**0.8%**	**1.0%**	**-13.0%**
Total	**100%**	**100%**	**100%**	**100%**	**100%**	**100%**		

1.3.4 Public Debt

Trends in external public debt outstanding have not been driven by new borrowing (indeed, repayment of principal has tended to exceed new disbursements) but by movements in the exchange rate. As shown in Table 1.9, the value of total external public debt peaked at M 5,130 million at the end of 2002. The appreciation of the currency, which commenced in the fourth quarter of 2002, meant that the value of external debt had fallen by 35.8% from the peak to M 4,011 million by the end of 2005. However, depreciation of the currency meant that the value increased to M 4,514 million at the end of 2006, and then rose to M 4,680m by the end of 2007. The ratio of external debt to GDP fell from 83.8% in 2002 to 45.6% in 2007.

Overall, total domestic debt outstanding has fallen by 40.4% from a peak of M 1,159.7 million in 2003 to M 674.6 million in 2007. The only long-term domestic debt has been Treasury Bonds issued to finance the restructuring of Lesotho Bank prior to its sale in 1999. Five-year bonds worth M 173.0 million were retired in 2004, leaving M 114.7 million of ten-year bonds outstanding which will be retired in September of 2009. Short-term debt held by banks and non-banks increased steadily to M 872.0 million at the end of 2003 as a result of increased use of short-term debt as an instrument of monetary policy by the Central Bank and some fiscal borrowing by Government. However, the healthy fiscal situation since 2003/04 has allowed a reduction in short-term borrowing, which was reduced to M 530.2 at the end of 2005, but has since risen slightly to M 559.9 at the end of 2007, due to increases in short-term borrowing by banks.

Table 1.9: PUBLIC DEBT, 2002-2007 (Maloti million)						
External Debt (at 31 Dec.)	**2002**	**2003**	**2004**	**2005**	**2006**	**2007**
Bilateral Loans	451.6	504.4	531.4	396.9	386.9	296.3
Multilateral Loans	4,139.4	3,485.8	3,183.7	3,399.1	3,968.4	4,220.8
Financial Institutions	383.8	343.8	315.8	141.5	101.1	98.8
Suppliers' Credits	155.7	98.0	81.9	74.1	57.8	64.7
TOTAL	5,130.5	4,432.0	4,112.8	4,011.6	4,514.3	4,680.6
External Debt Sustainability Indicators						
Debt Service / Exports of G+S (%)	3.2	5.3	10.6	15.4	6.4	10.4
Debt Outstanding / GDP (%)	83.8	62.8	54.7	48.1	51.6	45.6
Debt Outstanding / GNI (%)	57.5	46.3	38.8	36.7	34.5	30.9
Domestic debt (at 31 Dec.)						
Banks	815.3	982.5	543.6	474.6	588.0	585.0
Long-term	287.7	287.7	114.7	114.7	114.7	114.7
Short-term	527.6	694.8	429.0	359.9	473.3	470.3
Non-bank short-term	113.7	177.2	104.5	170.3	77.6	89.6
TOTAL	929.0	1,159.7	648.1	644.9	665.6	674.6
TOTAL DEBT OUTSTANDING	**6,059.5**	**5,591.7**	**4,761.0**	**4,656.5**	**5,179.9**	**5,355.2**
Total Debt / GDP (%)	**85.8**	**74.3**	**57.1**	**53.2**	**50.4**	**45.5**
Total Debt / GNI (%)	**67.9**	**58.4**	**44.9**	**42.6**	**39.5**	**35.4**

The debt to national income ratio has been steadily declining since 2002, when it stood at 85.8% of GDP and 67.9% of GNI. Although the GDP indicator was well above the internationally accepted prudent level of around 60%, the extremely favourable terms applying to nearly all external debt meant that other indicators of debt sustainability (such as the ratios of debt service payments to exports of goods and services and interest payments to total expenditure) remained within acceptable levels. The subsequent strengthening of the currency has caused the ratios to decline by the end of 2007 to satisfactory levels of 45.5% of GDP and 35.4% of GNI.

In 2007/08 Approximately 93% of total external debt has been provided by multilateral lending agencies, principally the World Bank and the African Development Bank, and are denominated in US$, Special Drawing Rights or in Units of Account. All of Lesotho’s external debt in 2007/08 has a maturity period of more than 10 years. As reflected in the consideration of debt sustainability indicators, at the end of 2007, 95% of the external debt stock has been provided on concessional terms (i.e. by comparison with commercial debt, the loan provides a combination of grace period, maturity and interest rate yielding a grant element of at least 35% of the face value).

In order to minimise its future debt service payments, Government has utilised the positive fiscal outcomes since 2003/04 to reduce debt incurred on non-concessional terms from foreign financial institutions, and these loans (most of which were related to the Lesotho Highlands Water Project) have fallen from M 383.8 million in 2002 to M 98.8 million by the end of 2007.

1.4 MONEY AND CREDIT

1.4.1 The Monetary Policy Framework

Together with Namibia, Swaziland and South Africa, Lesotho is a member of the Common Monetary Area. The Rand is recognised as legal tender and Lesotho's currency is pegged at par to the Rand. Membership provides significant economic benefits (it eliminates transaction costs and foreign exchange risk on trade between Lesotho and South Africa; it reduces exchange rate volatility by pegging to a relatively stable currency; sound macroeconomic management by the Reserve Bank contributes to low inflation throughout the CMA; and it encourages fiscal discipline as Lesotho must maintain an appropriate level of net international reserves to preserve the peg).

These institutional arrangements limit the scope for an independent monetary policy, although there is still a role for effective monetary management. This is exercised by the Monetary Policy Committee which ensures that an appropriate net international reserve target is achieved through the intermediate interest rate target and the operating target of reserve money. Excess liquidity poses the threat of increased inflationary pressures (if the excess is spent locally) or of a reduction in net foreign assets (if the excess is spent on imports or invested abroad). Prior to September 2001, excess liquidity was mostly held by the commercial banks in the form of surplus funds deposited with the Central Bank. There was considerable potential to undermine the CBL's net foreign asset position if these funds were transferred abroad. Open market operations were introduced in 2001 as part of a system of monetary policy implementation, allowing the Central Bank to control domestic liquidity by issuing treasury bills, thereby mopping up excess liquidity as banks converted their surplus funds into treasury bills. In addition, the decline in banks' surplus funds reduced reserve money and thus ensured that money supply did not reach a level that would exert inflationary pressure on the economy.

The new system allows commercial banks and individuals to bid for treasury bills by indicating the amount they want and the interest rate they are prepared to accept. In order to minimise the financing costs, the Central Bank accepts bids in reverse order (i.e. the bid with the lowest interest rate is accepted first). The Bank influences the bids by adjusting the volume of Bills that it offers for sale: a low volume indicates that bids with low interest rates are likely to secure an allocation whereas a high volume indicates that the Bank is willing to pay higher rates in order to sell more Bills. When a liquidity shortage is created by a fall in domestic assets, the CBL will buy treasury bills (i.e. redeeming more Bills than it offers at auction) from the commercial banks and the public whereas, if the shortage is caused by a fall in net foreign assets, the Bank will auction more treasury bills, accepting higher interest rates and attracting more funds from abroad.

The bidding process ensures that the treasury bill rate is competitively determined and that rates do not differ significantly from rates on similar instruments in the region, thereby encouraging commercial banks and the public to hold treasury bills rather than investing their assets abroad. As shown in Section 1.4.7, movements in the intermediate target (the Treasury Bill rate against trends in the region) suggest that this strategy has been successful.

Trends in the main monetary aggregates are shown in Table 1.10. The preferred measure of money supply is M2, which is the sum of money and quasi-money and which is equal to net foreign assets plus net domestic credit less other items.

1.4.2 Net Foreign Assets

In 2002/03, net foreign assets declined by M 1,301.1 million (25.9%) to M 3,722.3 million, primarily as the result of the appreciation of the loti against major reserves which led to the revaluation of foreign assets at the end of the year. There was a further decline of M 242 million (6.5%) by the end of 2003/04, resulting from the continued appreciation of the currency which led to a 12.8% reduction in the value of net foreign assets of the Central Bank of Lesotho. The strong fiscal position of the Government, together with increases in the assets of the commercial banks, led to an overall increase of M 786 million (22.6%) in 2004/05. There was a further increase of M 111.1 million (2.6%) in 2005/06. This was generated by an increase of M278.3 million (9.4%) in the net assets of the Central Bank (as a result of increases in other foreign investments) and despite a decline of M167.1 million (12.8%) in net commercial bank assets (as result of reduction in balances due from other foreign banks, not including South Africa). In 2006/07, there was a large increase of M 2,804.9 million in net foreign assets reaching a total of M 7,182.3 million. This was due an increase of M 2,111.5 million in Central Bank net assets as a result of higher export earnings, revaluation gains and recapitalisation. Moreover the net foreign assets of commercial banks also increased by M 693.4 million (61%) as they sought higher returns through holding South African investment instruments.

2007/08 witnessed a similar pattern with an increase of M 2,076.3 (28.9%) in net foreign assets. This was due to an increase of M1,537.4 (28.7%) million in the net assets of the Central Bank as a result of further fiscal surpluses and an increase of M 538.9 million (29.4%) in the net foreign assets of commercial banks due to increased investment in South African securities.

Lesotho has consistently achieved the quantitative targets for net international reserves set by the Central Bank in successive Statements by the Monetary Policy Committee.

1.4.3 Net Domestic Credit

Over the past decade, various reforms of the financial sector have been implemented, including the establishment of a commercial court, passing of the Financial Institutions Act and the Central Bank Act, restructuring of the former Lesotho Bank and measures to remove structural rigidities in the financial sector and to provide in-house credit bureau services. These reforms were intended to encourage banks to pursue a more aggressive lending policy, since loans to business enterprises had been depressed by the write-off of non-performing loans made by the former Lesotho Bank.

Between 2002/03 and 2007/08, private sector credit has grown at an average annual rate of 27.4%. Lending to households has grown by 36.4% annually with substantial increases of 47% and 61.9% in 2005/06 and 2007/08, respectively. This has been influenced by the surge in number of employees receiving salaries through commercial banks and being able to use these as collateral against lending. Although lending to enterprises has grown at an annual average rate of 24.6%, most of this growth occurred in 2005/06 and 2006/07 (70.6% and 44.5% respectively), principally as a result of loans to the transport, storage and communications sector.

The privatisation programme has reduced the number of enterprises classified as statutory bodies and contributed to a steep decline in credit to statutory bodies since 1997/98. Despite a temporary increase to M 62.8 million in 2004/05, it has subsequently resumed the downward trend. The figure for 2007/08 however, shows a steep increase of 185% reaching M 50.1 million.

Government has maintained a net creditor position with the banking system for several years (hence claims on Government have a negative sign). Deposits reached a low of M 190.3 million in 2002/03 following the peak of M 2,051.5 million in 1997/98, as a result of expenditure relating to the restructuring of state-owned banks, the repayment of LHDA loans and weak fiscal outturns.

However, the subsequent improvement in the fiscal position meant that balances increased to M 958.1 million by end of 2004/05, to M 1,027.2 million in 2005/06 and to M 2,275.3 million in 2006/07. In 2007/08, government balances reached an all time high of M 3,237.4 million.

Overall, these trends mean that Net Domestic Credit has increase to M 1,897.2 million at the end of 2007/08, from M -223.8 million in 2002/03.

1.4.4 Other Items

The capital account has increased by an annual average growth rate of 12.1% between 2002/03 and 2007/08. After declining by M 222.1 million in 2003/04, largely because of the revaluation of holdings of foreign assets by the Central Bank, the capital accounts has grown annually reaching M 3,240.8 million 2007/08. The largest increases were in 2006/07 and 2007/08 with a year on year growth of 40.1% and 35% respectively and again largely due to revaluation of central bank assets.

In 2003/04 and 2004/05, the value of “other items, net” (mainly unclassified assets and liabilities and bankers deposits) increased by M 180.5 million and M 62.5 million respectively. Between 2005/06 and 2007/08 this item declined by M 91.6 million to reach M 92.4 million in 2007/08.

1.4.5 Money Supply

The key money supply variable is M2, which is defined as money plus quasi-money (i.e. Maloti in circulation, demand, call, savings and time deposits, as well as deposits of official entities at the Central Bank). Although measurement of the Maloti component is an important indicator of the general trend in the growth of M2, there is, at present, no plausible method of measuring rand in circulation in Lesotho so it is difficult to obtain an accurate picture of movements in total money supply.

Most countries demonstrate a strong direct relationship between growth in money supply and growth in economic activity. However, this link is weaker in Lesotho because both the rand and Maloti circulate freely, allowing distortions to occur as residents can substitute currencies by holding rand instead of Maloti. Equally, trends in money supply are not directly reflected in the consumer price index, since inflation is driven primarily by prices in South Africa, which supplies nearly 90% of Lesotho’s imports for final consumption.

Over the period 2002/03 to 2007/08, the annual average growth of M2 was 13.8%, above the nominal growth of GDP of 11.3%. 2006/07 in particular witnessed a large increase, growing by M1,157.8 million (45.1%). This was followed by an increase of M 451.9 million (12.1%), reaching M 4176.6 million in 2007/08. This growth was concentrated in growth in money which grew by 16.6% during the period 2002/03-2007/08, compared to an annual growth rate of 7.3% for quasi-money for the same period.

Table 1.10: MONETARY SURVEY, 2002-2007 (Maloti million, at end of period)

Category	2002-03	2003-04	2004-05	2005-06	2006-07	2007-08	Annual Ave(%)
Net Foreign Assets	3 722.3	3 480.3	4 266.3	4 377.4	7 182.3	9 258.6	20.0
Commercial Banks	766.3	903.4	1 306.2	1 139.0	1 832.4	2 371.4	25.3
Central Bank of Lesotho	2 956.0	2 576.9	2 960.1	3 238.4	5 349.9	6 887.2	18.4
Net Domestic Credit	-223.8	-180.2	406.6	281.2	1 280.5	1 897.2	-253.3
Claims on private sector	377.4	454.1	488.7	716.6	967.2	1 264.0	27.4
Of which: enterprises	141.4	159.3	158.0	371.3	536.6	579.0	131.1
households	140.8	167.7	280.3	414.5	410.1	663.8	36.4
Claims on official entities	36.7	46.0	62.8	29.4	17.6	50.1	6.5
Claims on Government, net	-190.3	-319.9	-958.1	-1 027.2	-2 275.3	-3 237.4	76.3
Other Items							
Capital Accounts	1 830.5	1 608.4	1 726.8	1 713.2	2 400.8	3 240.8	12.1
Other items, net	75.8	256.3	318.8	184.0	223.7	92.4	4.0
Money Supply (M2)	2 191.3	2 308.4	2 451.8	2 566.9	3 724.7	4 176.6	13.8
Money	1 443.9	1 539.1	1 698.4	1 864.8	2 836.2	3 112.7	16.6
Maloti with public	178.6	207.6	212.6	247.4	293.1	331.0	13.1
Demand and call deposits	1 114.1	1 174.0	1 308.9	1 440.0	2 531.0	2 640.6	18.8
Official entities deposits with CBL	151.1	157.4	176.9	177.4	177.4	141.1	-1.4
Quasi-money	747.5	769.3	753.4	702.2	888.5	1 063.9	7.3
Time deposits & Savings deposits	747.5	769.3	753.4	702.2	888.5	1 063.9	7.3

Growth in money supply is strongly influenced by the impact on net domestic credit of changes in Government deposits with the banking system in the light of fiscal requirements. Between 2000/01 and 2002/03, deposits were reduced to finance expenditure but budget surpluses since 2004/05 have allowed Government to rebuild its deposits and are reflected by the higher growth rate money supply for the same period.

Cash held by the public accounts grew at an annual average rate of 13.1% between 2002/03 and 2007/08 and accounted for 8.5% of total money supply for the period. Demand and call deposits have increased at an annual average of 18.8%, with an exceptional rise of M 1,091 million 75.8% in 2006/07 reflecting the increase in commercial bank demand deposits. Deposits by official entities with the Central Bank appear to be stable with period average of M163.5 million.

Overall, Quasi Money has grown at an annual average rate of 7.3% and it now contributes to 25.5% of total money supply (against 34.1% in 2002/03). Saving deposits have declined by 5.3% annually between 2002/03 and 2007/08, while fixed term time deposits have grown by an average of 25.8% for the same period. Savings deposits' share of total Time and Savings

Deposits category has declined from 72.3% in 2001/02 to 38.7% in 2007/08. This is due to the disincentives inherent in the banking system to holding saving deposits such as minimum savings deposits requirements.

1.4.6 Liquidity

The Central Bank imposes a cash ratio of 3% and a liquidity ratio of 25% on the commercial banks. Liquidity of the commercial banks is measured by the ratio of their liquid assets (including treasury bills) to their total deposit liabilities. At the end of 2007, the liquidity ratio was recorded as being 73.6%, close to the value of 74.9% at the end of 2006, and above the values of 7.2% and 68.7% at the end of 2005 and 2004 respectively. This change reflected the holdings of short-term securities by commercial banks both domestically and abroad.

The excess of the actual liquidity ratio over the required level indicates that there are surplus funds in the economy, as banks prefer to hold short-term Government securities than lend to the public. This may be because there is a shortage of suitable loan proposals or because potential borrowers are unable to provide the necessary collateral to ensure repayment. In either case, the economy is performing below its potential and financial intermediation is not effective (as also demonstrated by the large spread between deposit and lending rates).

Another important indicator of the performance of commercial banks is the credit/deposit ratio. This measures credit extended to the private sector and statutory bodies relative to their deposits with the banking sector. The ratio has declined from its peak of 47% in 2005 to 33% in 2006 and then increased to 37% in 2007. These changes were the net outcome of an increase in credit to the private sector and an even larger increase in demand and call deposits. While the aggregate remains relatively low, the increase in credit suggests that the banks have identified some profitable lending opportunities in the domestic economy, rather than relying on inter-bank investments and short-term securities as a more attractive use of funds.

1.4.7 Interest Rates

Money markets have been liberalised in recent years. Commercial banks have determined their own lending and deposit rates since 1998. Money market operations in Lesotho were transformed during the third quarter of 2001 when the Central Bank moved from the use of direct controls to indirect instruments of monetary policy[12]. The new system removes rigidities by introducing market determined interest rates and allowing those rates to reflect the true scarcity of savings in the economy. In general, rates in Lesotho are expected to be somewhat higher than for equivalent South African instruments, in order to reflect different liquidity conditions, differences in perceptions of risk and the lower frequency of auctions. Prior to 2001, Treasury Bill rates in Lesotho were lower than comparable instruments in South Africa but, by the end of 2001, rates, including those for Treasury Bills sold through open market operations, had reached 11% and were higher than the equivalent South African rate.

Table 1.11 shows the evolution of interest rates in Lesotho subsequent to this structural change. They have generally remained in line with developments in the Common Monetary Area (as measured by the movement of rates in South Africa) over the past six years. Interest rates had tended to fall until 2001, mainly because of the downward trend in inflation, but the Reserve

[12] This is why the Central Bank no longer pays interest on deposits by commercial banks.

Bank increased interest rates by approximately 3 percentage points in 2002 in response to the depreciation of the rand and an acceleration in the inflation rate (principally as a result of the regional food shortage). Between 2003 and 2005, the sustained appreciation of the currency and the easing of inflationary pressures allowed a series of rate reductions. In general, these trends were transmitted into the Lesotho money market. The Lesotho 91-day Treasury Bill rate ended 2005 at 6.95%, slightly higher than the equivalent rate in South Africa. However, it ended 2006 at 6.76%, the lowest level recorded since the introduction of the auction system in September 2001, and lower than the equivalent South African rate of 8.26%. In 2007, Lesotho's 91-day Treasury Bill rate ended the year approximately 2 percentage points higher as a result of rate increases in South Africa due to acceleration of inflation. The hike in Treasury Bill interest rates is expected to increase commercial bank profitability as they derive most of their interest income from holding Government securities.

Table 1.11: MAJOR MONEY MARKET INTEREST RATES*, 2002 - 2007

Central Bank (1)	2002	2003	2004	2005	2006	2007
TB rate (91 days)	12.19	9.83	7.86	6.95	6.76	8.82
CBL overdraft rate	16.19	14.99	13.00	13.00	10.26	12.82
Commercial Banks						
Time deposits						
31 days	4.75	3.75	3.10	3.50	3.50	4.88
1 year	6.25	6.00	4.00	4.75	6.50	8.00
Savings deposits	2.58-4.00	1.68-2.48	0.96-1.36	0.97-2.00	1.00-5.00	3.00-6.75
Prime lending	17.67	12.50	12.17	11.50	13.50	15.43
South Africa						
Prime lending	17.00	11.50	11.00	10.50	12.00	14.50
Call deposits (2)	8.75-9.50	7.70-7.72	7.70-8.72	6.00-6.50	7.50-8.50	10.00-10.50
TB rate (91 days)	12.42	7.54	7.32	6.80	8.26	9.96
SARB repurchase rate	13.50	8.00	7.50	7.00	8.50	10.50
SARB marginal lending rate	18.50	13.00	12.50	12.00	12.50	16.00

* Rates are expressed as the percentage per annum at the end of each period.
(1) From September 2001, the Central Bank does not pay interest on deposits by commercial banks.
(2) Maximum rates for deposits of R 1,000,000+

By contrast, commercial banks increased their deposit and prime lending rates by approximately 1.9 percentage points in 2007. Following the fall of prime lending in Lesotho from 17.67% in 2002 to 11.5% in 2005, the rate has increased to reach 14.53% in 2007. One-year deposit rates ended the year at 8%, up from 6.5% at the end of 2006. However, the acceleration in the inflation rate means that the real interest rate on savings has remained negative.

It is not possible to comment on the yield curve (the change in the interest rate relative to the term of the financial instrument), as Government has not tested the market with any long-term securities (other than the 10-year bond issued in 1999 for the Lesotho Bank).

1.5 INFLATION

The Bureau of Statistics collects price data on 200 commodity items in seven towns and one urban area. The consumption weights are based on the results of the 1994/95 Household Budget Survey. The Consumer Price Index for 2002 – 2007 is shown in Table 1.12. Since 2002, the index has been published on a monthly basis whereas it was previously available on a quarterly basis.

Inflation is driven primarily by prices in South Africa, which remains the source of almost 90% of the country's imports for final consumption (even though the textile industry has imported an increasing volume of intermediate inputs from Asia in recent years). Regional food shortages in 2002 caused a significant increase in prices of agricultural commodities and pushed the aggregate inflation rate up from 6.9% in 2001 to 12.6%. From this peak there was a rapid reduction to 7.2% in 2003[13], 5.0% in 2004 and a further reduction to only 3.4% in 2005, reflecting favourable price developments in South Africa linked to the achievement of an inflation target of 3-6% by the Reserve Bank and the sustained appreciation of the currency, which made imports relatively cheaper. However, this downward trend was reversed as the inflation rate increased to 6.0% in 2006 and further hiked to 8.0% in 2007, due to substantial increases in food and fuel prices.

Table 1.12: ALL ITEMS CONSUMER PRICE INDEX, 2002-2007

Month	2002	2003	2004	2005	2006	2007	2007/2006
January	142.3	156.6	165.8	172.9	180.2	190.9	5.94
February	145.1	157.9	166.5	173.1	181.7	192.0	5.67
March	147.6	159.0	167.3	173.4	181.7	193.1	6.27
April	149.0	159.8	167.9	173.7	182.5	197.2	8.05
May	149.7	160.0	168.5	173.8	185.2	199.3	7.61
June	150.9	160.6	169.2	174.6	186.2	201.1	8.00
July	151.7	162.2	169.5	175.1	186.4	202.3	8.53
August	152.4	163.1	170.8	175.7	187.7	204.0	8.68
September	153.1	163.6	171.3	176.8	188.8	205.1	8.63
October	154.1	164.1	171.6	177.4	189.6	206.5	8.91
November	155.1	164.4	172.1	177.9	190.1	207.8	9.31
December	155.4	164.7	172.6	178.7	190.2	210.1	10.46
Average Annual Index	150.5	161.3	169.4	175.3	185.9	200.8	
Annual Inflation Rate	**12.6**	**7.2**	**5.0**	**3.4**	**6.0**	**8.0**	

The monthly index shows that the rate of inflation bottomed out in August 2005 and has subsequently increased steadily, notably in the second half of 2007. This rising trend is associated with higher global oil prices (which directly impacts on transport costs and general retail prices), the acceleration in food prices as a result of emerging regional supply difficulties and some volatility in the exchange rate.

The three main categories of items in the consumer basket are Food and non-alcoholic beverages (accounting for 39.8% of the basket), Furnishings and house maintenance (17.0%) and Clothing and footwear (15.6%). In 2007 while the Food category has risen by 18.4%, significantly above the average annual rate of 8.0%, both Furnishings (1.9%) and Clothing (6.5%) have risen by less than average. There has been wide variation in the price increases of less important commodity groups, with Restaurants & Hotels increasing by 16.1%, Housing by 7.6%, Transport by 2.3% and education by 2.5% and there was a decline for leisure (-1.4%) and Health (-1.3).

[13] This was achieved despite the replacement of Sales Tax levied at a standard rate of 10% by Value Added Tax at the standard rate of 14% with effect from 1st July 2003, which increased the inflation rate by approximately 1% in 2003.

Between April 1997 (when the index was revised and rebased at 100) and December 2007, the All Items index has risen by 110.1%, an annual average inflation rate of 7.7%. There is a wide range in the index for the main commodity groups. Below average increases have been recorded for Education (31%), Health (42.9%), Leisure (51.5%), Communications (59.6%) and Clothing (67.1%). Major groups with above average increases include Restaurants & Hotels (183.8%), Food (150%), Alcoholic beverages (129%), housing (115.9%) and Transport (106.6%).

1.6 EMPLOYMENT AND WAGES

Table 1.14 (using data provided by the Central Bank) indicates that the two main sources of formal employment have created jobs at the rate of 1.1% per annum. While employment in the Government (including the civil service, teachers and the armed forces) has grown consistently (the data show a decline in 2003 but this was because former departments were established as autonomous agencies, such as the Lesotho Revenue Authority), there has been volatility in employment by LNDC-assisted companies. The increases of 13.5% and 16.9% in 2002 and 2003 respectively reflect the rapid growth of the textile industry, which has been the main driver for employment growth in recent years, while the decline of 14.8% in 2005 was caused by the squeeze on profitability of textile exports to the USA resulting from the appreciation of the local currency and the ending of the multilateral Agreement on Textiles and Clothing. However, the industry achieved a significant recovery in 2006 where some of the employment losses were regained and maintained in 2007.

Table 1.14: FORMAL SECTOR EMPLOYMENT, 2001 - 2006

Category	2002	2003	2004	2005	2006	2007	Annual Ave.(%)
Government Employees	36 787	36 146	36 555	37 908	39 065	40 649	2.02
% Annual Change	3.80	-1.74	1.13	3.70	3.05	4	
LNDC-Assisted Companies	43 773	51 187	50 607	43 131	44 213	44 213	0.20
% Annual Change	13.49	16.94	-1.13	-14.77	2.51	0	
Total	80 560	87 333	87 162	81 039	83 278	84 862	1.05
% Annual Change	8.85	8.41	-0.20	-7.02	2.76	2	

The tripartite Wages Advisory Board sets minimum wages annually for different occupations. The Board approved an increase of 3.5% in October 2005 and an increase of 5.5% in October 2006. The Government announced a salary award of 5.0% and 10.0% for civil servants in financial year 2006/07 and 2007/08 respectively.

1.6.1 Basotho Mineworkers

For several decades, high unemployment levels in Lesotho have been mitigated by the migration of Basotho to work on South African mines. For the five years 1992 to 1996, the number of mineworkers averaged 110,686. However, changes in South Africa and in the mining industry caused a rapid decline in the number of jobs and there were only 68,604 Basotho employed by 1999. Mines have increased the proportion of jobs held by South Africans, with a corresponding reduction in employment of citizens from other countries. A period of intense restructuring (driven by technological change, increases in average wages and the relatively low price of gold throughout the 1990s) also led to the scaling down of mining operations and the closure of several mines.

Over the six years 2002 to 2007, the average number of mineworkers was 56,474. As indicated in Table 1.15, after stabilising between 2001-2003, there have been steady annual reductions and the annual average number employed declined by 5.5% in 2004, by a further 9.6% in 2005 and by 2.1% in 2006. This reduction was however reversed in 2007 with an increase of 4.1% in the number of mineworkers.

Although the average number of Basotho employed in the South African mines has declined from 62,158 in 2002 to 53,467 in 2007, in financial terms, this fall in numbers has been offset by an increase of 90% in average earnings over the period. This average annual increase of 13.7% since 2002 is partly as a result of higher nominal wages and partly because the remaining mineworkers tend to have more experience and occupy more senior positions.

Table 1.15: BASOTHO MINEWORKERS, 2002 - 2007

Category	2002	2003	2004	2005	2006	2007	Annual Ave.(%)
Average number employed	62,158	61,416	58,014	52,450	51,341	53,467	-2.97
Annual change (%)	1.21	-1.19	-5.54	-9.59	-2.11	N/A	
Average earnings (M)*	35,326	38,513	42,116	44,758	53,859	67,135	13.70
Annual change (%)	10.29	9.02	9.36	6.27	20.33	25	
Deferred Pay (M '000)**	182,479	208,450	293,334	169,230	231,578	N/A	
Annual change (%)	19.36	14.23	40.72	-42.31	36.84	N/A	
Remittances (M '000)***	112,496	118,333	131,793	167,387	N/A	N/A	
Annual change (%)	9.44	5.19	11.37	27.01	-70.80	N/A	

* Annual average earnings per mineworker, including overtime
** Deferred pay represents miners' withdrawals processed through recruiting agencies
*** Remittances are part of miners' wages transferred through recruiting agencies

Source: South African Chamber of Mines

Note: Due to a lack of data from the current data source, a new methodology is being developed to estimate this from 2006.

Net income reached M 3,374 million in 2007/08 (see Table 1.4). The main component of this item is compensation of employees, which accounted for M 3,009.91 million (see Table 1.4). Although it is likely that there has been an increase in the number of Basotho engaged in other employment activities in South Africa, principally agriculture, mining remains the most remunerative opportunity for migrant workers. Total mineworker earnings were approximately M 2,585.6.2 million in 2007/08.

Chapter 2: ECONOMIC PROSPECTS, 2009 - 2012

2.1 REGIONAL AND INTERNATIONAL PERFORMANCE AND PROSPECTS

World Output and Trade: During a five year period, 2003-07, the global economy and merchandise trade have grown on average by 4.6% and 8% per annum, respectively, the highest sustained rate since the early 1970s. After years of strong growth, the world economy is now decelerating quickly as a result of a financial crisis. The crisis that erupted in September 2008, following more than a year of less acute financial turmoil, has substantially reinforced the cyclical downturn that was already under way. As a result global output and trade plummeted in the final months of 2008 bringing down IMF's World Economic Outlook (WEO) projections for world output growth for the year from 3.7% to 3.4%.

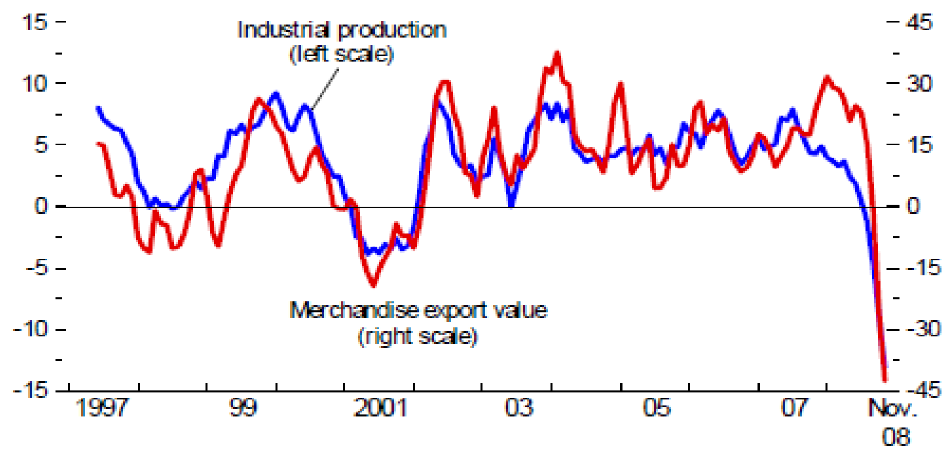
The financial crisis has forced unprecedented declines in equity markets in advanced economics and sharp declines in consumer confidence and spending. As export performance for advanced economies has subsided due to declining global demand, the Euro Area and Japan fell into technical recessions in Q3 of 2008 followed by the US which enter into its second consecutive quarter-on-quarter GDP decline in Q4 with a staggering 6.2% output contraction (Table 2.1). Slowing growth and import demand in the high-income economies, falling equity markets, and reduced international capital flows have impacted negatively on investment and growth in both developed and developing countries. These factors have also resulted in global industrial production and trade plummeting in the final months of 2008 (Figure 2.1).

Table 2.1: Quarterly Real GDP growth in 2008 in advanced economies (quarter on quarter)

	Q1 2008	Q2 2008	Q3 2008	Q4 2008
USA	0.9	2.8	-0.5	-6.2
Euro Area	0.7	-0.3	-0.2	-1.5
UK	0.4	0	-0.7	-1.5
Japan	0.2	-0.9	-0.6	-3.3
South Africa	1.7	5	0.2	-1.8

Source: Eurostat. US Bureau of Economic Analysis; South African National Treasury.

Figure 2.1: Growth in Global Industrial Production and Merchandise Trade



Source: IMF Global Economic Outlook Update, January 2009

Inflation and Commodity Prices: Sluggish economic activity and lower commodity prices have decreased inflation pressures in the second part of 2008. The global recession is projected to cause both commodity prices and inflation to ease further. According to the World Bank's Global Economic Outlook oil prices are expected to average about $75 a barrel (bbl) in 2009, and food and metal prices are projected to decline by about 23 and 26 percent, respectively, compared with their average levels in 2008. Nevertheless, commodity prices will remain well above the very low levels of the 1990s. In the advanced economies, headline inflation is expected to decline from 3.5 percent in 2008 to a record low 0.25% percent in 2009, before edging up to 0.75 percent in 2010. Moreover, some advanced economies are expected to experience deflation.

Financial markets: The financial crises that have now transformed into a global recession originated in 2007 in the US banking system due to rapidly rising defaults on sub-prime mortgages in the context of a major U.S. housing correction. This has increased pressure on spreads on securities backed by such mortgages, including on collateralised debt obligations structured to attract high credit ratings. The fallout rapidly spread through an excessively leveraged financial system, curtailing liquidity in the interbank market and deeply disrupting structured credit markets. This has badly shaken confidence in global financial institutions and markets. Most dramatically these events have triggered a cascading series of bankruptcies, forced mergers, and public interventions in the United States and Western Europe, which have resulted in a drastic reshaping of the financial landscape.

Following a series of efforts by central banks and governments to resolve the growing crisis through liquidity injections and various ad hoc measures, policy makers have now acted forcefully to restore confidence in the international banking system, including the partial nationalisation of nine banks and trillions of dollars in rescue plans introduced by governments in the United States and Europe.

As a result of insolvency of a large number of banks and financial institutions in the United States, Europe, and the developing world, financial conditions have become much tighter. Although financial institutions in developing countries are believed to have limited direct exposure to U.S. sub-prime assets and related securities, the financial turmoil has affected virtually all emerging-market economies as high-income-country banks and investment funds withdrew from emerging markets and converted a broad range of risky assets into safer liquid holdings. As the crisis intensified in 2008 and especially since mid-September, risk aversion (the absence of which had been the hallmark of the preceding boom) has increased, and capital flows to developing countries have significantly decreased. As a result, the currencies of a wide range of developing countries depreciated sharply, and developing-market equity prices have been significantly affected. The massive correction in equity prices was widespread across emerging market economies, with the largest declines found in a number of European and Central Asian economies - Ukraine (80 percent), Romania (75 percent), Bulgaria (75 percent), and the Russian Federation (73 percent). Other large emerging market economies, including Brazil, China, and India, experienced corrections of over 60 percent.

Prospects for 2009-10: The January 2009 update of the *IMF's World Economic Outlook* projects global growth to slow from just under 3.5 percent in 2008 to about 0.5% percent in 2009 before recovering somewhat in 2010. However, risks to this outlook remain on the downside. Advanced economies are suffering their worst downturn since World War II, with economic output expected to contract by over 1.75 percent in 2009. Growth is also expected to fall in China, India, Brazil, and other emerging market economies, dragged down from 6.25 percent in 2008 to about 3.25 percent in 2009 by falling export demand, decreasing capital inflows, and lower commodity prices (Table 2.2).

Table 2.2: Comparison of IMF Estimates of Real GDP Growth Rates in Lesotho and Large Economies 2006-10 (annual % change)

	2006	2007	2008	2009*	2010*
USA	2.8	2	1.1	-1.6	1.6
Euro Area	2.8	2.6	0.8	-2	0.2
UK	2.8	3	0.7	-2.8	0.2
Japan	2.4	2.1	-0.3	-2.6	0.6
India	9.8	9.3	7.3	5.1	6.5
China	11.6	11.9	9	6.5	8
Brazil	3.8	5.7	5.8	1.8	3.5
Sub Saharan Africa	6	6.25	5	3.25	5
South Africa	5.4	5.1	3	-0.5	2.5
World	5.1	5	3.5	0.5	3
Lesotho	*8.1*	*5.1*	*3.1*	*2.9*	*4.1*

***** Projections; Source: IMF Global Economic Outlook January 2009 Update; MFDP.

It is assumed that international trade will continue to decelerate sharply, with global export volumes declining for the first time since 1982. The World Bank's Global Economic Prospects forecast a global export volumes falling by 2.1 percent in 2009 - the first time they have declined since 1982. Export opportunities for developing countries will fade rapidly because of the recession in high-income countries and because export credits are drying up and export insurance has become more expensive.

The main mechanism for the slowdown in both developing and high-income countries will be through investment, which for 2009 is expected to decline 3.1 percent in high-income countries.

In developing countries, investment growth is projected to slow sharply to 3.4 percent in 2009 from more than 13 percent in 2007.

According to the IMF's forecasts financial markets are expected to remain strained during 2009. In the advanced economies, market conditions will likely continue to be difficult until firm policy actions are implemented to restructure the financial sector, resolve the uncertainty about losses, and break the adverse feedback loop with the slowing real economy. In emerging economies, financing conditions will also likely remain acute for some time - especially for corporate sectors that have very high rollover requirements. Policymakers in emerging economies must adjust to the increasingly challenging international environment by reducing vulnerabilities and maintaining a positive policy environment that will boost productivity growth (particularly in the more sheltered services sector) and encourage investment (e.g. reducing barriers to trade and reducing red tape).

Performance and Prospects for Sub-Saharan Africa: The countries of Sub-Saharan Africa have enjoyed their best period of sustained economic growth in the past 5 year with growth averaging almost 6% per annum. The IMF's outlook for economic growth in sub-Saharan Africa in 2009 has however significantly worsened in recent months. With the expectation of a more pronounced global downturn, lower commodity prices, and pressure on capital flows, the Fund now projects that growth will slow from just over 5 percent in 2008 to about 3.25 percent in 2009 - over 3 percentage points lower than forecast a year ago. Although annual inflation has started to decline, it remains high in many countries, largely because of the fuel and food price increases through mid-2008. Fiscal balances are expected to deteriorate significantly as tax revenues, especially those that are commodity-related, come under pressure because governments face additional demands for social spending

Aggregate projections mask stark differences from country to country. Oil and metal exporters have been hardest hit: oil prices have fallen. Oil exporters are going from fiscal and current account surpluses in 2007–08 to deficits in 2009, putting pressure on fiscal and external accounts. Oil importers benefit from falling oil prices but are affected (some countries positively and some negatively) by the decline in the prices of other commodities, such as coffee, cocoa, or cotton, minerals and by lower global demand. Foreign exchange reserves—generally adequate now in most countries—are likely to decline in several countries in 2009. The growing dependence of sub-Saharan Africa and other low-income countries (LICs) on export receipts from tourism and transportation services, which also tend to be procyclical, heightens the region's exposure to the global recession.

Because low-income African economies have less access to international capital markets, the slowdown will affect them mainly through indirect mechanisms, including reduced demand for their exports, lower commodity prices, and reduced remittance and aid inflows.

Implications for Lesotho: A protracted global economic slowdown significantly elevates downward pressure on economic growth forecasts in Lesotho. The past decade witnessed the emergence of two large export oriented sectors - garment industry and diamond mining – which together account for roughly 20% of GDP and 72% of total exports. It is these two industries that are most vulnerable to global recession. Falling demand in the United States, which is the recipient of almost 95% of Lesotho's garments, has already impacted negatively on the industry as exports in this sector have fallen by 11% in 2008. Given that the US economy is forecasted to contract by a further 1.6% in 2009, Lesotho garment exports are likely to witness another year of negative growth. Furthermore, as a result of credit crunch some of garment manufacturers are already facing difficulties obtaining trade credit for input financing from foreign banks.

Driven by high commodity prices mining became the ‘leading’ sector from 2004 onwards, with the opening of two diamond mines. As the international prices of diamonds decreased, along with other natural resources, so has production and exports of diamonds. Already one mining company, Liqhobong, has suspended production and is reassessing its operations, and another, Kao, which is just beginning production, is looking for potential investors - a task that is difficult in the current environment.

Furthermore, performance of the South African economy will have a direct impact on the resilience of Lesotho economy to withstand the recession as Lesotho’s economy is highly intertwined with that of its only neighbour. Firstly, South Africa is the recipient of virtually all Lesotho’s export other than garments destined to US and diamonds exported mostly to Belgium. Secondly, migrant workers remittances working in mines in South Africa – another export oriented industry exposed to global economic slowdown – account 20% of GNI. Thirdly, contraction of international trade can also have a significant effect on Lesotho’s government revenue as over 60% the budget is derived from Southern African Customs Union’s (SACU) Common Customs Pool (CRP). This pool is highly depended on South Africa’s import propensity as this country contributes a lion share towards the pool.

Economic growth in Lesotho has decelerated from 5.1 percent in 2007 to 3.1 percent in 2008 due to a slowdown of growth in mining and textile industries as well as slower than expected growth in the tertiary sector. In 2009, the economy is expected to grow by 2.9% but these estimates are likely to be revised downwards if the world recession widens. Most recent data from Lesotho’s main export markets indicate across the board contractions of GDP. As previously indicated, the US shrank by 6.2% in the last quarter of 2008 and South African by 1.8% over the same period. The Euro area – main recipient of Lesotho’s diamonds - contracted by 1.5%. Therefore, the negative effects of global recession are likely to be significant for Lesotho.

2.2 FORECAST OF ECONOMIC PERFORMANCE, 2008 – 2012

2.2.1 Introduction

The starting point for preparing the economic forecast is the analysis of trends in economic performance up to 2007 as described in Chapter 1. Salient features are:

- In real terms, Gross Domestic Product (GDP) has grown by 4.4% per annum since 2002, with provisional national accounts data showing growth of 2.9% in 2008.
- Manufacturing was the “leading” economic sector until 2003 (i.e. rapid growth in this sector encouraged strong performance from supporting, or other sectors). There was substantial foreign direct investment after 1999 as businesses exploited competitive opportunities arising from (i) the African Growth and Opportunities Act, which allows textile exports to enter the USA free of duties and quotas; and (ii) the 40-50% depreciation of a Loti against major currencies between 1997 - 2002.
- Manufacturing experienced a slow-down in 2004 and 2005 as producers were hit by the appreciation of the currency and the ending of the Agreement on Textiles and Clothing with

effect from 1st January 2005 but showed a strong recovery in 2006 and 2007. Textiles and clothing is however expected to slow down further in 2008 due to new challenges it faces and already did not perform well for the better part of 2008.

- Mining became the "leading" sector from 2004 onwards, with the opening of two diamond mines. This enabled the primary sector to grow by 10.1% in 2004, -1.6% in 2005, 29.1% in 2006 and 4.1% in 2007. It must be noted that these considerably high growth rates were realised even though agriculture was declining.
- Together with the recovery of manufacturing in 2006 and 2007, mining growth has enabled some other industries, principally service activities, to improve their performance.
- The appreciation of the rand since late-2002 has improved the terms of trade (meaning that Lesotho had to sell fewer exports to buy the same quantity of imports), but deteriorated in 2005, recovered in 2006 and further lost ground in 2007. This coupled with the fluctuations in primary income from abroad due to laying off of Lesotho miners to South Africa led to an average growth of 2.4% from 2002 to 2007. After recording consistent fiscal deficits until 2002/03, buoyant revenues (resulting from an increase in Customs receipts, the introduction of VAT at a standard rate of 14% and strong income tax collections) resulted in a surplus of 7.3% of GDP in 2004/05. Despite expenditure growth of 13.3% in 2005/06, a surplus of 4.1% was achieved while, in 2006/07, expenditure grew by 17.6% but an exceptional payment of Customs arrears at the end of the financial year contributed to a surplus of 14.1%. Fiscal year 2007/2008 also continued to register a surplus of 11.0% of GDP despite continued increases in expenditure by 13.8%.
- The appreciation of the currency and the policy of retiring expensive commercial debt have resulted in substantial falls in the value of public debt outstanding and all debt sustainability indicators are within internationally recognised parameters. The highly concessional nature of external debt means that annual debt service remains manageable.

As the first step in merging the Medium Term Fiscal Framework (MTFF) with the Financial Programming Framework under Development and Implementation of Macro Model of Lesotho (DIMMOL) in consensus with the Central Bank of Lesotho was used to prepare a comprehensive and internally consistent forecast of key economic indicators for the calendar years 2008 – 2012 based on (i) historical trends in the real economy and in aggregate demand; (ii) provisional indicators for performance in 2008; extensive meetings and interviews with relevant sectors; and (iii) assumptions about key exogenous variables, such as the exchange rate and interest rates.

The main assumptions and results are summarised in Table 2.1. The forecasts show the likely movement of key economic indicators given current circumstances. These projections are based on expected movements in prices and developments in: production as recorded in the national accounts; the external accounts; monetary aggregates; and public finances (using the provisional 2008/09 outturn and the fiscal framework prepared for Budget 2009/10). It must be emphasised that this is a forecast trend of overall economic performance, not a target of desired outcomes. There will be variations around this trend as a result of changes in factors such as weather and commodity prices.

Table 2.3: ECONOMIC FORECASTS, 2006 - 2012

	2006	2007	2008	2009	2010	2011	2012
Nominal GDP (M Million)	10,269.3	11,777.8	13,979.0	15,022.1	17,005.2	19,025.2	21,687.6
Nominal GDP (annual change)	17.36%	14.69%	18.69%	7.46%	13.20%	11.88%	13.99%
GDP deflator	8.6%	9.2%	15.2%	4.0%	8.7%	6.5%	6.7%
Real GDP (annual growth)	8.1%	5.1%	3.1%	3.4%	4.2%	5.0%	6.9%
Primary	29.1%	4.1%	9.9%	5.6%	2.0%	4.4%	19.2%
Secondary	5.6%	8.5%	-2.5%	1.7%	4.9%	6.4%	6.7%
Tertiary	6.7%	3.4%	3.1%	3.5%	4.2%	4.5%	4.5%
Nominal GNI (M million)	13,098.7	15,127.6	17,437.9	18,541.3	20,562.7	22,762.1	25,014.5
Nominal GNI (annual change)	19.7%	15.5%	15.3%	6.3%	10.9%	10.7%	9.9%
GNI Deflator	6.9%	12.1%	9.6%	5.7%	4.8%	5.7%	6.4%
Real GNI (annual growth)	12.0%	3.0%	5.1%	0.6%	5.8%	4.7%	3.3%
Exchange rate (1US $:M)	6.780	6.630	8.260	9.350	10.100	10.423	10.715
Interest rate (91 day bills)	6.8%	7.8%	8.5%	8.1%	7.7%	7.2%	6.8%

2.2.2 Production

Real growth in GDP at purchasers' prices recorded 5.1% growth in 2007, slowed to 3.1% in 2008 and is expected to register a 3.3% growth in 2009. The 2008 growth is the aggregate outcome of an increase of 9.9% in primary industries (the poor harvest is expected to be offset by continued growth in the mining sector), a reduction of 2.4% in secondary industries and a further increase of 3.1% in tertiary industries.

For subsequent years, the forecast indicates that there will be moderate annual growth with real GDP increasing by 3.3% in 2009 improve to 4.2% in 2010 and accelerating by 5.0% and 6.9% in 2011 and 2012 respectively. Over the five years 2008 - 2012, the annual average growth rate will be 4.8%. Since this rate of growth significantly exceeds the rate of population growth derived from the provisional 2006 Census data, it signals improvement in GDP per capita and it may be assumed that Lesotho will achieve a sustained reduction in the incidence of poverty. However, much of this economic growth will be generated by mining, which is a predominantly foreign-owned enclave industry, and the wider economic benefits are likely to be quite limited. Thus, Lesotho needs to explore ways of shifting to a faster and more broadly-based economic growth path that creates more employment than currently projected.

In the **Primary Sector**, Agriculture is expected to slightly decline further by 0.4% in 2008 and is forecasted to recover back to its normal level by 10.8% in 2009 and thereafter to grow by 0.6%. These are based on the historical evidence which suggests that farmers who have exhausted their resources during a poor crop year are unable to take full advantage of improved weather conditions in the subsequent growing season, despite the public sector interventions. Thus, although future years should show an improvement in the crops sub-sector, full recovery may take 2-3 years. These annual growth rates are subject to uncertainty since farmers are vulnerable to inadequate and poorly distributed rainfall, the decline in the availability of arable land (compounded by problems with the land tenure system) and limited access to credit.

The mining and quarrying sub-sector has been relatively small but the resumption of diamond mining has seen the sub-sector growing from 0.2% as a share of GDP in 2002 to 4.4% in 2007 and expected to improve further to 5.3% in 2008. Just as the Letŝeng Diamond mine was doubling its capacity and as the other two mines (Kao and Liqhobong) which were at the prospecting stage were hoping to go into production, diamond prices slashed down by over 50% due to the world economic downturn. The resulting outcome is that the other two mines are struggling to acquire finance and that Letŝeng is facing low levels of revenue against high standard costs. Prospects are still positive though, more especially for Mothae diamond mine, which has finished prospecting and is awaiting the mining license because it had already acquired adequate financing before the financial crises began. The subsector is thus expected to register a negative growth of 1% in 2009 and thereafter recover by 4.1% in 2010, 9.7% in 2011 and 42% in 2012.

Trends in the **Secondary Sector** are heavily influenced by performance of the manufacturing sub-sector. After the decline of 10.2% in 2005 and the loss of approximately 10,000 jobs between December 2004 and June 2005 through factory closures and reductions in production lines (caused by the strong exchange rate and the end of quotas under the international Agreement on Textiles and Clothing with effect from 31st December 2004), there has been a significant recovery, with employment at LNDC-assisted companies increasing from 39,597 in September 2005 to 49,416 by June 2007 but declining to 46,328 in January 2008 and closing at 47,204 by December 2008. As a result, manufacturing is estimated to decline by 8.1 in 2008 and further trend downwards by 0.5% in 2009 but recover in 2010, 2011 and 2012 respectively by 3.5%, 7.0% and 7.1%. These fluctuations in manufacturing are at the back of the textiles, clothing, footwear and leather and came despite the 5.5% increase in other manufacturing in 2008, 25.1% increase in 2009 and 33.7% growth in 2010. This immense growth in other manufacturing will be driven mainly by the inception of the Phillips Bulb Company as part of Government's diversification initiative. The industry faces enormous challenge of a sudden reduction in demand due to the world economic downturn and great uncertainty as orders have not been forth coming, with only concrete orders only running up to May 2009. The industry could have been hit even harder, but the impact was offset by the depreciation of the rand against the dollar by around 30% from July 2008 to February 2009. The manufacturing sector has also been constrained as far as factory shell space is concerned and some firms were operating at full capacity hence unable to expand whereas a few were ready to come in and invest but were constrained by lack of shell space. Going forward, the industry is however expected to survive the prevailing storm as has been in the past and rebound by 2011. This will be achieved with the continued support to the sector by government in the form of allocations for extra shell space and development of the identified industrial sites by securing supplies of utilities and necessary infrastructure. The 2009/10 budget has allocated M60m plus a proportion of the economic stimulus package to fund infrastructure development at Ha Tikoe and Ha Nyenye industrial zones.

The construction industry is highly dependent on the level of private investment and Government's capital budget. The sector has drastically declined since 2001 as LHDA construction activities were being scaled down due to the conclusion of the construction phase of the project, but recovered and started to register positive growth in 2005 to 2007. It is expected that construction will grow further as the sector was further boosted by the Millennium Challenge Compact (MCC) that was signed between Lesotho and the United States of America. Major construction activities under the compact are expected to commence towards the end of 2009 to early 2010 and it is expected that the sector will grow by an average rate of 7% from 2008 to 2009. Although negotiations are only being concluded on the second phase of the Lesotho Highlands Water Project, it is worth noting that this will accelerate the sector further in the medium to long term.

The electricity and water sub-sector is projected to achieve real growth of 5.3% in 2008, and average annual real growth of 6.2% from 2008 to 2012. This is based on the continued implementation of projects by both the Lesotho Electricity Corporation and the Water and Sewerage Authority, which will significantly extend the coverage of their service provision. The electricity subsector however faces the challenge of supply constraint at least in the medium term and this may hamper with the Corporation's plan. An agreement to import electricity from Mozambique should help to ease the electricity supply problems in the short term.

Since achieving real growth of 6.7% in 2006, the tertiary industry has slowed to 3.4% in 2007 and projected to grow by an annual average of 4.2 from 2008 to 2012. This growth is expected to be driven by the following industries; telecommunications, financial intermediation, wholesale and retail trade and hotels and restaurants. Public expenditure on education and health is expected to grow in line with Government's commitment to achieve the Millennium Development Goals in these high priority sectors.

Overall, GNI is expected to grow at an annual average rate of 3.9% and this is expected despite the continuing downward trend in Basotho mine workers and hence the income receivable from abroad. The reduction in the income receivable from abroad is offset by the depreciation in the exchange rate between Loti and other major trading currencies. Intuitively, the depreciation implies the positive terms of trade effect or trading gains as exports are much cheaper but returns from the exports are higher when converted to the local currency.

This baseline growth forecast reflects the most likely economic performance by each sector. However, actual outcomes may be better or worse depending on the incidence of various threats and opportunities:

- Unfavourable weather condition and uncertainty in the agriculture industry may continue to lead to a reduction in agric output leading to a reduction in food security and hence increased poverty.
- The sudden reduction in diamond prices may continue and if prolonged, this may lead to suspension of production activities until the situation is reversed.
- Manufacturing faces great uncertainty in months to come and if the current situation is prolonged, further layoffs will be imminent.
- Inadequate supply of electricity and increased power cuts may deter investors confidence in Lesotho.
- The extension of LHWP to the second phase coupled with the MCC may offset the impact of the current economic downturn.
- Low levels of credit extension continue to undermine the potential of the economy but the Private Sector Development component of the MCC is expected to remove some constraints

2.2.3 External Accounts

There has been considerable volatility in the exchange rate with respect to major currencies in recent years. There was rapid depreciation in 2001 and 2002, followed by a substantial appreciation to the end of 2003, and depreciation from mid-2006 to the present. It is assumed that some stability will be achieved and that the annual average exchange rate for 2009 will be around $1=M10.51. Thereafter, it is assumed that the exchange rate will change in line with Lesotho's inflation adjusted by a quarter of a percentage point. This will affect the terms of trade by changing the relative prices of imports and exports. Exports will (at least in the short-term) become more attractive on international markets but import prices will be less favourable for domestic consumers.

The Balance of Payments which records transactions between the domestic economy and the rest of the world comprises of three important components namely; the current account, the capital and financial account and reserve assets. The **Current Account** which is composed of trade in goods and services, income from abroad and current transfers, is projected to move from a surplus of M 458.7 million in 2007/08 to M 362.8 million in 2008/09 (2.3% of GDP) before registering a deficit of M 2,538.5 million (-14.5% of GDP), M 3,620.8 million (-18.4% of GDP), and M 3,378.5 million (-20.8% of GDP) in 2009/10, 2010/11 and 2011/12 respectively. This is the net outcome of the rapidly widening trade balance, which is only partially offset by improvements in the balance on income and transfers.

The deficit comes after three consecutive years of significant surpluses, mainly due to an expected decline in exports in 2009 while imports grow faster. The reversal in the performance of merchandise exports is expected because of the recent global financial crisis which impacted negatively on the world market. Diamond exports are also projected to decline in 2009 by about 30.2 percent due to the recent sudden decline in commodity prices.

Textiles exports however, are expected to continue to rise marginally despite the recent global financial downturn as well as the recent decline in orders, mainly due to among other factors, the recent continued depreciation of the rand against the U.S. dollar. The overall performance of merchandise exports is however expected to improve in 2010.

The main component of **net factor income from abroad** is compensation of employees from mineworkers based in South Africa, which is determined by the numbers employed and the average wage they receive. Both labour income and investment income (principally interest earnings) have been strong in 2008. The Balance of Payments projections indicate that mineworkers' compensation of employees will increase in nominal terms from M 2,678.3 million in 2008/09 to M 3,206.1 million in 2011/12.

The main component of **current transfers** is receipts from the SACU revenue pool. Revised revenue-sharing arrangements came into operation with effect from 1st April 2005 and, as Customs collections are higher than previously expected, Lesotho has benefited from windfall receipts in 2006 and 2007. Future growth of the Customs Pool is dependent on levels of imports into the customs area (which will vary with trends in exchange rates and interest rates) and the average tariff rates applicable to those imports. Recent forecasts by South Africa show sustained levels of customs collections even though trade agreements will result in lower average tariff rates. On this basis, receipts are estimated to be M 4,900.9 million in 2008/09 and it is forecast to rise to M 5,308.1 in 2009/10. It is however estimated that in 2010/11 SACU receipts will decline to M 3,308.4 million before moving back to M 4,540.8 million in 2011/12 as a result of the current economic meltdown that is expected to influence imports into the customs area and therefore lower the SACU Revenue Pool, and a repayment of over M 900m to the central SACU revenue pool as a result of over-receipt of revenues in previous years.

The Capital and Financial account is projected to register positive net inflows due to among other factors, the significant increase in government project grants from M 233.8 million registered in 2008/09 to about M 1,238.8 million in 2011/12 as well as foreign direct investment, which is expected to grow from M798.1 million registered in 2008/09 to about M 1,303.1 million in 2011/12. Provisional data suggests that the capital and financial account will move from a surplus of M 916.6 million in 2008/09 to about M 3,205.9 million in 2011/12.

Reserve assets are expected to increase by M 1,279 million at the end of 2008/09 but are expected to decline by M 406.3 million in 2009/10 and continuing to draw down further through 2011/12 mainly due to continued financing of the current account deficit.

2.2.4 Monetary Aggregates

The growth of money supply, as measured by M2, is determined by relative movements in net foreign assets and net domestic assets. After the growth in money supply of 12% in 2007/08, preliminary estimates suggest that it will increase by 19% in 2008/09, still well above the rate of economic growth. This was driven mainly by an increase in net foreign assets held by the Central Bank. Overall, money supply is expected to grow by approximately 9% per annum between 2007/08 and 2011/12, which is above the projected rate of growth in nominal GDP of 5% per annum. Movements in net domestic credit will be determined by private sector credit and net claims on Government. Continuing reforms of the financial sector and greater competitiveness in the commercial banking sector are expected to reduce structural impediments in the financial system and should contribute to the projected growth of 22.0% per annum in private sector credit.

The anticipated fiscal deficit (see Section 2.2.5) should result in a decline in Government balances held at both the Central Bank and the Commercial Banks by M 499.6 million in 2009/10. Net claims on government are further threatened by the huge budgeted fiscal deficits for the years 2010/11 and 2011/12. If they occur, net claims on government will further be depleted by M 2,515.1 million and M 1,697.1 million in those years. Overall, these will lead to declines of 2.7% in 2009/10, 19.9% in 2010/11 and 14.6% in 2011/12. Although Net International Reserves at the central bank have been increasing, these rates are alarming and can put pressure on the central bank's target (US$ 450 to US$ 500 million) thereby threatening the current exchange rate arrangement.

2.2.5 Public Finances

Revenues

Total revenue (including grants) is estimated to increase from M 8,426.0m in 2009/10 to M 9,644.5m in 2009/10 moving from 59.2% to 62.2% of GDP. In following years, total revenue falls to M 8,497.2m in 2010/11 and then increases to M 10,426.3m in 2011/12. These changes are driven by several factors including higher tax revenue which increases from M 2,677.2m in 2008/09 to M 3,741.3m in 2011/12 – an average annual evolution of 11.3%.

Income tax comprises the largest share of tax revenue, averaging just over half of all tax revenue over the 4 year period from 2008/09 to 2011/12. Nominal VAT collections are forecast to increase by around 44% between 2008/09 and 2011/12 from M 991.5m to M 1,433.2m.

The largest single contribution to total revenue is made by SACU receipts, which are estimated to comprise 58.2% of total revenue in 2008/09. SACU receipts are estimated to increase from

M 4,900.9m in 2008/09 to M 5,308.1m in 2009/10. However, they fall dramatically to M 3,308.4m in 2010/11 due to a repayment of M 974.5m to the central SACU pool in this year.

The largest contributions to 'Other revenue' is made by water royalties and electricity sales which are forecast to rise exponentially to the period 2011/12. Dividends also make an important contribution to 'Other revenue'. Revenue from this source is expected to decline in 2009/10 compared with 2008/09 due to exceptional once-off payments received in 2008/09. Revenues are forecast to grow in line with average receipts over the previous 5 years.

Expenditure

On an outturn basis, total expenditure (excluding principal) is projected to increase from M 7,112.2m in 2008/09 to M 9,989.3m in 2009/10 – an increase of over 40%. This results in expenditure rising from 49.9% of GDP to 64.4% of GDP on an outturn basis, and results in a fiscal surplus of M 1,313.8m moving to a deficit of M 344.8m.

Total expenditures then reach M 10,929.5m in 2010/11. This higher increase in expenditure compared to revenue results in a large deficit of M 2,32.3m in 2010/11. The deficit in this year is driven largely by the reduction of over M600m of SACU receipts. The deficit declines to M 1,610.8m in 2011/12.

Year on year increases in both recurrent and capital expenditures are forecast, with recurrent expenditure increasing from M 4,498.4m in 2008/09 to M 7,731.8m in 2011/12 and capital expenditure rising by over 157% between 2008/09 from M 1,329.8m to M ,417.1m.

A 72% rise in recurrent expenditure over the same period is driven by increased spending on wages and salaries, which rise from M 1,944.9m in 2008/09 to M 2,636.6m in 2009/10 with over M 160m of this being the result of an 8.5% pay rise for public servants and the rest being the result of planned recruitment. Despite this increase the proportion of wages and salaries in total expenditure falls from 27.3% to 26.4%. Wages and salaries are then forecast to rise further to M 2,856.1m in 2010/11 and M 3,067.7m in 2011/12, but reduce as a share of total expenditure to 25.5% by 2011/12.

Goods and serves are estimated to rise considerably from M 1,394.9 in 2008/09 to M 2,220.3m in 2009/10 - an increase of 59%. Between 2008/09 and 2009/10, the largest budgeted increases arise in vehicle maintenance (M121.2m in 2008/09 to M145.3m in 2009/10); fuel (M70m to M103.6m); local subsistence (M59m to M117.9m); international fares (M48.8m to M86.9m); international subsistence (M47.9m to 90.7m); power (M66.3m to M83.5m); communications (M65.6m to M86.6m); maintenance of assets (M112.3m to M152.4m); purchase of materials (M132.5m to M319.9m); minor works (M37m to M62.4m); and drugs (M99.2m to M170m). In addition, the proportion of total spending used for goods and services increases from 19.6% in 2008/09 to 2009/10, and continues to rise to 24.4% by 2011/12.

On an appropriation basis, expenditure is considerably higher in 2009/10 and all future years leading to large budget deficits. The 2009/10 deficit on an appropriation basis is estimated at M 1,340.5m, and this rises to M 3,580.3m in the following year, before falling back to M 2,870.5m in 2011/12. Should ministries proof able to spend their budget allocations, then, in the absence of other funding sources, this will have to be funded by drawing down reserve balances at the Central Bank of Lesotho.

2.2.6 Prices

The forecast of nominal GDP is based on expected movements in the consumer price index. Generally, price developments are likely to move in line with those prevailing in South Africa, which supplies Lesotho with about 87% of its imported goods and services. Based on studies conducted by the Central Bank, imported inflation is estimated to constitute 60% - 70% of Lesotho's inflation, while the residual is domestically generated. One key factor is the exchange rate: depreciation of the currency puts up the price of imports and makes exports more attractive on international markets, thus shifting the terms of trade against domestic consumers, whereas an appreciation should reduce inflationary pressures but makes it harder to compete on export markets.

Inflation peaked at 12.0% in 2002 (as a result of the depreciation of the currency, the impact of rising oil prices and the price effect of regional food shortages) but inflationary expectations in South Africa have subsequently been contained by a slowdown in food prices, the appreciation of the exchange rate and the commitment of the Reserve Bank to attaining the inflation target of 3-6% (despite rising unit labour costs). Lesotho's inflation rate came down to 6.5% in 2003 (despite an exceptional increase of approximately 1% following the introduction of Value Added Tax at 14% in July 2003), to 5.0% in 2004 and to only 3.5% for 2005. However, higher food prices (which constitute the bulk of Lesotho's CPI basket) and the inflationary impact of higher oil prices have caused the index to rise to 6.1% in 2006 and to 8.0% in 2007.

For 2008, inflation in Lesotho increased further to 11.2% and this was among others at the back of increases in international oil prices, in food prices and in commodity prices. This highest inflation rate since 2002 was registered despite efforts by the Reserve Bank of South Africa to contain inflation within the target band of 3 to 6 percent. Inflation in 2009 is expected to slow down drastically to 6.8% as recession in world economies is looming leading to a fall in general demand and hence made evident by the recent reductions in international oil and food prices. For subsequent years, inflation is forecasted to slow down further by 6.3% and 5.7% in 2010 and 2011 respectively. These forecasts are based on those of South Africa with an additional 1 percentage point above that of South Africa as historical data suggests.

Chapter 3: MEDIUM-TERM FISCAL FRAMEWORK, 2009/10 – 2011/12

3.1 INTRODUCTION

The annual preparation of the Medium-Term Fiscal Framework (MTFF) has five main objectives:

- To prepare a realistic forecast of the main components of revenue and grants;
- To make an accurate assessment of statutory expenditure obligations;
- On the basis of the current policy framework, to forecast the requirements for discretionary ministerial expenditure;
- To use these forecasts of revenue and expenditure to recommend a budget balance and financing strategy which is consistent with the core objectives of fiscal policy; and
- To set indicative ceilings showing the division of future ministerial expenditure ceilings by economic classification (wages and salaries; goods and services; transfers and subsidies; and capital).

Using analysis of recent economic performance (Chapter 1), economic prospects 2008 - 2012 (Chapter 2) and the provisional fiscal outturn for financial year 2008/09, the MTFF provides an assessment of expected resource availability and expenditure commitments for the next three financial years. The first year of this forecasting period is based on the detailed Annual Estimates for 2009/10 and the MTFF contains indicative revenue and expenditure ceilings for the two subsequent financial years (2010/11 and 2011/12) based on current policy decisions.

It should be noted that estimates have been made on an outturn, rather than an appropriation basis for expenditure. Since budgeted appropriations tend to be significantly higher than actual expenditures, using these figures would result in large over-estimates of Government spending. The estimated outturn can therefore be viewed as a more reliable projection of the likely outcome at the end of the fiscal year. Using outturn estimates allow for more reliable data to be used when formulating policy.

3.2 THE FISCAL STRATEGY AND MACROECONOMIC POLICY OBJECTIVES

Lesotho is addressing the critical challenge posed by the high incidence of poverty by designing a comprehensive framework of macroeconomic, structural and social policies. The objective is to create income-generating opportunities for unemployed and underemployed members of the labour force by encouraging private sector growth. Core policy components include: responsible macroeconomic management; appropriate microeconomic policies; and continued improvements in public sector productivity, through reform of the public service.

Investors are reluctant to locate in countries with large fiscal deficits, increasing debt ratios and declining foreign exchange reserves as these indicators create expectations of tax increases and monetary instability. The attainment of positive outcomes based on sound macroeconomic policy and management is a necessary condition for sustained investment and economic growth. Lesotho must ensure stable fiscal, inflationary and balance of payments positions by creating an appropriate economic environment. This requires: ensuring macroeconomic stability; controlling domestic elements of inflation (which acts as a tax, especially on the poor); reforms to improve efficiency of revenue collections and financial management; and setting and adhering to an appropriate fiscal strategy. Since membership of the Common

Monetary Area effectively eliminates an independent monetary policy, Lesotho is especially dependent on fiscal strategy as the main instrument of macroeconomic policy and economic adjustment. The annual budget must be used as a fiscal mechanism to establish the foundations for rapid and sustained economic growth.

The main objectives of the macroeconomic policy framework are to:

- provide the basis for sound and consistent macroeconomic management;
- create an attractive macroeconomic environment for the private sector which will support efficient production and generate faster economic growth by attracting both domestic and foreign investment; and
- improve public sector performance by consistently applying the principles of sound public expenditure management (i.e. achieving aggregate fiscal discipline; concentrating public resources on a core set of activities including both poverty-targeted programmes and support for a pro-poor growth strategy; and improving operational efficiency).

Over the five financial years 1998/99 – 2002/03, expenditure pressures grew faster than revenue collections and the Government incurred deficits totalling M 1,635 million. These deficits were financed by a combination of declining reserve balances and an increase in domestic debt. This had undesirable effects on the budget: non-tax revenue declined (since the Government no longer earned interest on its balances); and Government was forced to divert an increasing share of expenditure away from productive activities in order to meet statutory debt service obligations. Government has responded to these concerns by running an overall surplus (including grants) from 2003/04 onwards, largely as a result of exceptional receipts under the SACU revenue-sharing arrangements. A surplus of M 408.0 million was recorded in 2005/06, followed by M 1,417.4 million in 2006/07 and M 1,388.0 million in 2007/08. Provisional fiscal data indicate that a surplus of M 1,313.8 million will be achieved in 2008/09. These surpluses have been used to retire outstanding commercial debt, thus minimising debt-service payments in future years, and to rebuild balances.

The core objective of Lesotho's fiscal strategy is to ensure that Lesotho maintains a sustainable fiscal stance[14]. In the medium-term, the projected SACU revenues decline threaten fiscal sustainability through increasing deficits, higher levels of domestic debt, declines in reserves and diversion of an increasing share of public expenditure to debt service in the event of increasing debt.

Resource utilisation in future years is based on the policy decisions being taken today. Since policy decisions that *appear* affordable in the short-term may create unsustainable obligations in future, it is vital that proper analysis is undertaken to assess the sustainability of the budget

[14] Several indicators can be used to assess the sustainability of the fiscal stance, including various balance concepts, the public sector borrowing requirement and key debt ratios. The overall fiscal balance is the difference between total revenue (including external grants) and total expenditure (including net lending) and is usually calculated on a cash basis. The primary balance measures the gap between revenue (including grants) and expenditure (excluding interest payments). A primary deficit indicates that the government has inadequate domestic resources to service its debts. The current balance measures the difference between recurrent revenue and recurrent expenditure (including interest). This concept is often interpreted as government saving and indicates the capacity to finance the public investment programme. A current deficit means that domestic revenues are inadequate to finance even the recurrent budget requirements (let alone any counterpart capital budget contributions) whereas a current surplus indicates that any new external debts can be justified by capital asset accumulation.

over the medium-term. In order to assess sustainability of the annual budget, Government prepares the Medium-Term Fiscal Framework (MTFF) which looks at revenues and expenditure over 3 to 5 years.

In order to ensure that the overall medium-term fiscal framework remains within sustainable limits, the principles underpinning the fiscal strategy are:

a) to maintain the real value of public expenditure by ensuring that the main categories of discretionary ministerial expenditure increase by at least the annual rate of inflation;
b) to ensure that the current increase in SACU revenues (and, hence, the ratio of revenue to GDP) does not give rise to an unsustainable level of aggregate public expenditure and that the public sector does not expand aggregate demand excessively;
c) to ensure that a primary surplus of revenue (including grants) over expenditure (excluding interest) is achieved;
d) to minimise the amount of commercial debt outstanding and to ensure that aggregate debt ratios do not exceed sustainability indicators;
e) to maintain a surplus of current revenue over current expenditure; and
f) to secure additional external finance on concessional terms.

Achieving these fiscal outcomes will have several beneficial effects on macroeconomic management and economic performance. A primary surplus will allow the Government to: reduce the level of public debt, keeping the ratio of public debt/GDP below 50%; generate savings from the resulting decline in debt service payments; and contribute to stability in the balance of payments. A current surplus indicates that public saving is being used to finance the acquisition of assets. Securing concessional external finance will limit public demand for domestic capital (ensuring that private sector borrowers have access to the domestic capital market on reasonable terms and that potential investors are not crowded-out). Reducing the long-term share of the economy controlled by the public sector should improve economic performance (e.g. releasing resources to the private sector will encourage additional investment).

Government does not currently have a formal programme with a multilateral agency (the Poverty Reduction and Growth Facility arrangement with the IMF expired in October 2004 and there have been no discussions on a successor programme)[15]. However, annual Article IV discussions take place with the Fund and the Government is in discussions with development partners on the provision of general budget support. This involves the joint preparation of a Performance Assessment Framework, covering public sector reforms and selected indicators of progress in core poverty-reduction sectors. Sustained political commitment will be required to ensure that the outcomes over the next three financial years are consistent both with the principles set out in this fiscal strategy and with the performance targets. However, failure to achieve these objectives would have an adverse effect on access to concessional resources: this would contribute to a negative cycle in which lower revenue and grants necessitate higher taxation (or more borrowing) and, by discouraging private investment, result in slower rates of economic growth and the failure to deliver a sustained reduction in poverty.

[15] Although access to the Poverty Reduction and Growth Facility did not generate additional funds on concessional terms from Lesotho's development partners, the experience of 1997 and 1998, when Lesotho ended the standby credit arrangements, demonstrates that remaining on-programme is a necessary condition for support from several bilateral and multilateral partners. It also sends a positive signal to potential foreign direct investors and is an important element in the country assessment by international rating agencies.

As noted in Section 1.3.1, the public sector in Lesotho absorbs an exceptionally high share of national resources. This implies that meeting the objectives of the fiscal strategy is a necessary but not sufficient condition to achieve national development objectives. In order to ensure that the ability of the private sector to deliver faster economic growth is not constrained, there must be sustained improvements in the quality of public expenditure management. Ministries must adhere to sustainable expenditure ceilings and improve the efficiency with which they utilise resources. Existing and additional ministerial public expenditure must be targeted effectively on activities identified by the Poverty Reduction Strategy (PRS) as (i) contributing to a pro-poor growth strategy by complementing private sector development (such as improving the amount and condition of social and physical infrastructure) and (ii) delivering poverty-targeted programmes. Raising public sector productivity can result in sustained improvements in the delivery of services and maintenance of the existing asset base. This can be achieved by implementing established standards of best practice, thereby ensuring that all expenditure programmes deliver outputs that are commensurate to their allocation of resources. Better allocative and operational efficiency will relieve some of the fiscal constraints, as an increase in public sector expenditure can be justified if it will make a positive contribution to the attainment of faster economic growth, employment creation and poverty reduction. Overall, these reforms will improve the macroeconomic environment and reduce the cost structure for domestic producers, making them more competitive in local, regional and international markets.

3.3 THE MEDIUM-TERM FISCAL FRAMEWORK, 2009/10 – 2011/11

3.3.1 Economic Forecasts by Financial Year

The fiscal forecasts have been prepared on the basis of the economic forecast presented in Chapter 2. The key macroeconomic outcomes have been converted from calendar years into financial years as shown in Table 3.1.

Table 3.1: ECONOMIC FORECASTS, 2005/06 - 2011/12

	2005/06	2006/07	2007/08	2008/09	2009/10	20010/11	20011/12
GDP at market prices (M million)	9,130.1	10,646.4	12,328.1	14,239.7	15,517.9	17,510.2	19,690.8
GDP growth % p.a. (current prices)	8.2%	16.6%	15.8%	15.5%	9.0%	12.8%	12.5%
GDP growth % (constant prices)	2.5%	7.3%	4.5%	3.1%	3.6%	4.4%	5.5%
GDP deflator %	5.4%	8.7%	10.7%	12.4%	5.1%	8.1%	6.6%
Exchange rate (1US $:M)	6.47	6.74	7.04	8.53	9.54	10.18	10.50
Interest rate (91 day bills)	6.9%	7.0%	8.0%	8.4%	8.0%	7.6%	7.1%
Nominal GNI (M million)	11,480.9	13,605.9	15,705.2	17,714.2	19,022.8	20,987.6	23,176.8

3.3.2 Revenue and Grants

The creation of the Lesotho Revenue Authority in January 2003 has generated significant improvements in the efficiency of tax administration, in particular ensuring greater compliance and collection of arrears. The introduction of Value Added Tax (VAT) in July 2003 also generated an increase in collections because it was applied at a standard rate of 14% (whereas the previous Sales Tax had a standard rate of 10%) and because Government, which had been exempt from paying Sales Tax, became liable to VAT on purchases of goods and services and acquisition of assets.

As shown in Table 3.2, domestic revenue is forecast to grow at an annual average rate of 7.4% from M 8,426.0 million in 2008/09 to M 10,426.3 million in 2011/12, equal to a revenue/GDP ratio of 53.0%. Over the period 2008/09 to 2011/12, the revenue/GDP ratio averages 55.7%. Despite the overall increase over the period, 2010/11 exhibits a decline in total revenue compared with 2009/10. This is due to lower SACU revenue receipts in this year, and is discussed below. The main components of revenue and their evolution as well as their relative importance are shown in figures 3.1 and 3.2 below:

Figure 3.1. Evolution of Main Sources of Tax Revenue 2005/06 to 2011/12

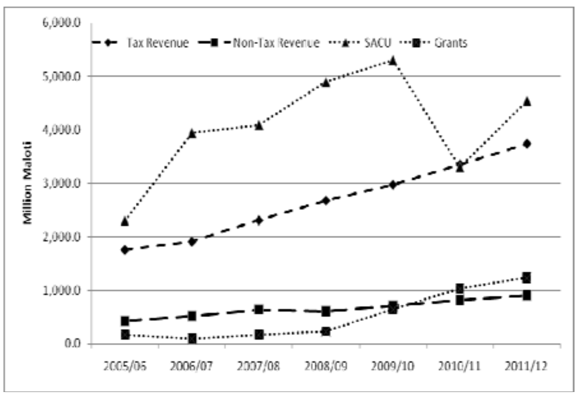
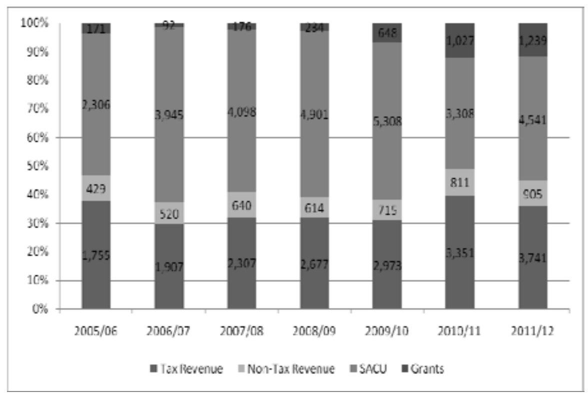


Figure 3.2. Relative Importance of Main Sources of Tax Revenue 2005/06 to 2011/12



SACU Revenue: The renegotiated Southern African Customs Union Agreement (SACUA) was approved in 2002. The new revenue-sharing formula became operational with effect from 1st April 2005. Part of the payments made to Lesotho in 2005/06, 2006/07 and 2007/08 related to adjustments due under the previous formula in respect of 2003/04 and 2004/05.

Table 3.2: REVENUE FORECASTS, 2005/06 - 2011/12

	2005/06	2006/07	2007/08	2008/09	2009/10	2010/11	2011/12
Tax Revenue	1,755.0	1,907.4	2,306.8	2,677.2	2,972.8	3,351.2	3,741.3
Income tax	920.1	970.7	1,216.4	1,376.3	1,528.4	1,703.9	1,900.2
Income tax - individuals	615.0	629.5	785.4	727.2	904.5	994.9	1,102.5
Income tax - corporations	192.0	199.6	293.7	387.0	406.6	462.0	519.8
Income tax - other	113.1	141.7	137.4	262.1	217.3	247.0	277.9
Taxes on Property (RMC)	58.6	66.5	74.6	74.6	83.6	96.0	102.0
Taxes on goods and services	750.2	788.5	977.5	1,079.2	1,256.6	1,403.0	1,553.8
Value Added Tax (Sales)	655.7	714.6	847.9	991.5	1,161.1	1,295.6	1,433.2
Excises (Oil levy)	84.7	65.6	118.1	76.9	83.0	94.3	106.7
Taxes on specific services	4.9	2.9	5.5	7.3	7.4	8.1	8.9
Licensing	4.8	5.5	6.1	3.5	5.0	5.0	5.0
Taxes on Int. Trade (exports)	23.0	73.3	31.7	139.7	97.4	140.7	177.0
Other Taxes (stamp duty)	3.1	8.4	6.6	7.4	6.9	7.5	8.3
Non-Tax Revenue	428.7	519.8	639.9	614.0	715.4	811.1	905.4
Property income	24.5	78.2	125.7	172.1	73.9	90.8	99.5
Interest on deposits	7.6	5.0	7.3	0.5	5.1	4.5	4.3
Dividends	4.8	69.8	96.9	167.8	59.5	76.4	85.6
Rent	12.1	3.3	21.5	3.8	9.3	10.0	9.6
Sales of goods and services	381.8	412.9	446.8	418.2	605.5	680.9	763.5
Electricity Muela	69.5	46.3	91.2	29.0	119.1	138.1	160.1
Water royalties	236.0	286.7	292.4	342.6	385.7	432.0	481.5
Administrative fees	24.4	27.0	27.9	21.8	37.1	42.5	48.7
Incidental sales	51.8	52.8	35.3	24.9	63.7	68.3	73.2
Fines	6.8	17.1	0.8	0.8	10.5	10.9	11.4
Miscellaneous Income	15.6	11.6	66.6	22.9	25.5	28.5	31.0
SACU	2,306.0	3,945.0	4,097.7	4,900.9	5,308.1	3,308.4	4,540.8
TOTAL DOMESTIC REVENUE	4,489.7	6,372.1	7,044.4	8,192.1	8,996.3	7,470.7	9,187.5
Domestic revenue / GDP (%)	49.2%	59.9%	57.1%	57.5%	58.0%	42.7%	46.7%
Grants	171.4	92.4	175.8	233.8	648.3	1,026.5	1,238.8
Project grant outturn*	171.4	92.4	175.8	151.9	321.1	351.1	381.9
Budget Support	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Millennium Challenge Account				82.0	327.2	675.4	856.9
REVENUE & GRANTS OUTTURN	4,661.2	6,464.5	7,220.2	8,426.0	9,644.5	8,497.2	10,426.3
Total revenue / GDP (%)	51.1%	60.7%	58.6%	59.2%	62.2%	48.5%	53.0%

* The figure for Project Grant Outturn is based on actual disbursements. Historically, this has been below Donor commitments, which is the figure used for setting budget appropriations.

The medium-term revenue projections have been calculated using the new formula which links receipts from SACU directly to the size of the customs and excise revenue pools[16]. The recent boom in imports into the SACU region caused a rapid expansion in collections for the Customs Pool. As a result, the period 2005/06 to 2009/10 has seen year-on-year increases in collections, rising at an average yearly rate of 23.2% from M 2,306.0m to M 5,208.1m. In addition, actual collections have typically been higher than forecast revenues in most of the previous years. In this case, positive adjustments are paid in the following year. Thus, actual collections in 2005/06 were significantly higher than the forecast used to determine quarterly payments in 2005/06, meaning that Lesotho was entitled to an adjustment payment, of which M 854.0 million was paid at the end of 2006/07. Positive adjustments of M 760.4m and M 254.9m were paid during 2007/08 and 2008/09

[16] Under the previous formula, Lesotho received a minimum of 17% of the value of total imports, although part of these revenues was paid in arrears. The new formula is more complex and there is considerable uncertainty about both the forecast collections and the respective shares. The revenue shares have three parts: the customs component is based on total collections of the customs revenue pool and the c.i.f. value of intra-SACU imports by each member state as a share of total intra-SACU imports; the excise component allocates 85% of the excise pool in accordance with the GDP of each country; and the development component allocates 15% of the excise pool on the basis of a formula including GDP per capita. Approximately 80% of Lesotho's share is determined by the customs component and 20% by the development component.

respectively due to higher-than-forecast revenues in the year prior to the adjustment payments.

During 2008/09 however, actual collections are estimated to be significantly lower than forecast. This results in a negative adjustment, meaning that Lesotho must repay an estimated M 974.5m to the central revenue pool. Typically, repayments – like positive adjustments – are made the following year, however, there is scope to make repayments to the central pool two years after the initial over-payment.

Approved SACU council revenue figures for 2009/10 are similar to those of 2008/09 resulting in a basic allocation to Lesotho of M 4,917.7m, slightly above the final SACU revenue in 2008/09 of M 4,900.9m. However, this is augmented by additional payments due to Lesotho under the old SACU revenue-sharing formula. Estimated receipts in 2009/10 therefore total M 5,308.1m.

After reaching their peak in 2009/10, SACU receipts are forecast to fall dramatically in 2009/10 by 37.7% to M 3,308.4m. This is due, in part to a M 974.5m repayment to the central pool due to over receipt of SACU revenues in 2008/09. In addition, total SACU customs revenue are estimated to decline by 11.2% in 2010/11 compared with 2009/10 due to falling import demand in the region – a result of the global economic slowdown.

An economic upturn in 2011/12 results in forecast SACU revenues of M 4,540.8m in this year.

Previous backgrounds to the budget speech forecast slowdowns in SACU revenues, and identified several emerging threats to the size of the SACU revenue pool. However, the previously projected slow-down in growth of revenue from this source are now estimated to be actual reductions in revenue. The rand depreciation and the world-wide economic slow-down are both likely to have contributed to this.

Although certain fears have now been realised, there remain several threats to the size of the SACU revenue pool. In the short-term, the recent depreciation of the Rand against major currencies is likely to reduce the value of imports from outside SACU (and this may be exacerbated by policy measures to reduce South Africa's current account deficit), which will reduce the size of the Customs Pool. In the long-term, threats include: the reduction of average tariff rates and the application of free trade agreements, such as that between the EU and RSA, which will increase the volume of goods entering the customs area free of all tariffs; the possibility that all SACU states will become members of a SADC customs union which is likely to have a significantly different mechanism for sharing customs collections[17]; and possible renegotiation of the formula.

Arrangements for management of the common revenue pool are currently being finalised (and will cover, *inter alia*, the timing of adjustment payments) but no provision has been made in this forecast for any management costs that Lesotho may incur.

Income Tax: Over the period 2005/06 to 2008/09, income tax revenue grew by an average of 14.4% per annum. In addition, actual income tax collections have consistently exceeded forecast revenue collections. For example, while estimates of income tax collections for 2006/07 were M 892.8 million, actual income tax remittances from LRA to Government totalled M 970.7 million in 2006/07, an increase of 5.5% over 2005/06 and 8.7% above the

[17] Even if the current revenue-sharing arrangements were retained in a larger SACU, there would inevitably be a reduction in the shares allocated to existing member states.

original estimate, mainly generated by withholding tax and some large payments by mining companies. Income tax revenue increased by a further 25.3% in 2007/08 to M 1,216.4m, and is estimated to increase further to M 1,376.3m in 2008/09 – an increase of 13.1%.

Over the medium term, estimated income tax revenue growth is expected to slow to 11.4% per year from 2008/09 to 2011/12.

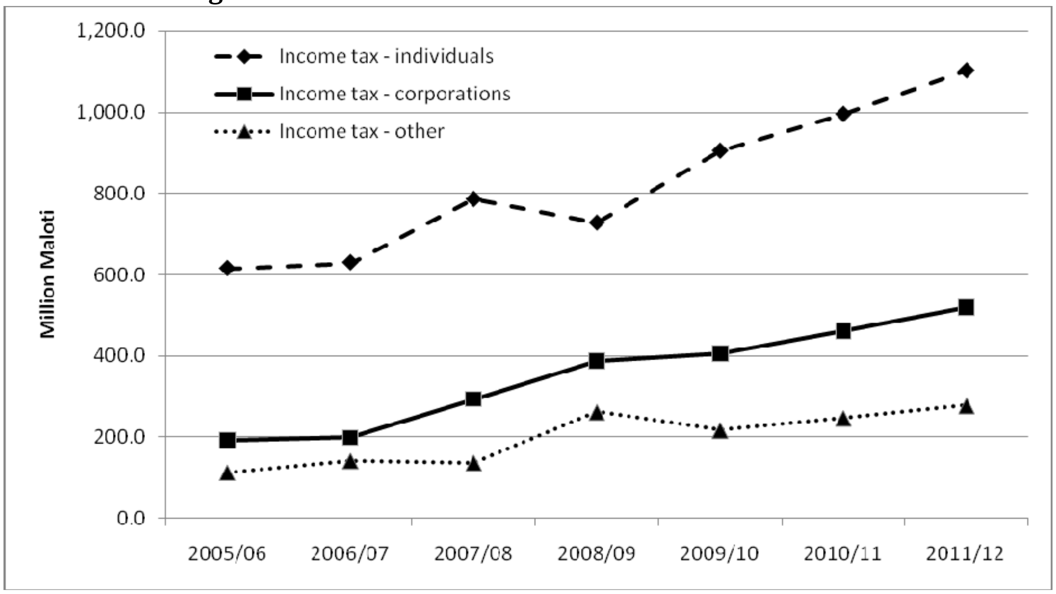
The 2006/07 estimates incorporated the projected outcome of a radical reform of company tax policy, with a reduction in the basic rate of company tax from 35% to 25%, a cut in the manufacturing rate from 15% to 10% and a zero tax rate for profits on exports outside the Customs Union. Lesotho operates in a highly competitive regional tax environment because, if other factors are equal, companies will invest in countries with low tax regimes. South Africa has been progressively reducing its rate (and it was cut again from 29% to 28% in February 2008) and Botswana has a basic rate of 25%. These tax cuts, together with complementary measures to improve the investment climate and the environment for doing business, were designed to attract more investment, thereby contributing to the growth of the tax base in the medium-term.

The Government aims to create an enabling environment for the private sector to invest and create jobs. The government recognises that currently, entrepreneurs across Lesotho are burdened with excessive regulation and undertakes to substantially increase the ease of doing business by 2012. To this end, a number of investment climate reforms will be undertaken during 2009/10 (i) To substantially reduce the time needed to register a business from over a month to under a week; (ii) To decrease the time needed to deal with the bureaucracy of licences and paying taxes, so that entrepreneurs can focus on running their businesses instead; and (iii) To improve trading across borders so that local businesses spend less time waiting on their supplies from abroad.

Despite the expected decline in company tax collections as a direct result of a reduction in company tax, company tax collections have actually increased since 2005/06 as a result of better performance by a small number of large companies in the key sectors of banking, telecommunications, insurance and mining, based on increased economic activity and improved profitability. For 2009/10 onwards, it is assumed that company tax revenue will grow in line with real economic performance. This requires careful monitoring throughout the 2009/10 fiscal year as the current world economic climate means that there may be significant risks on the downside. It should be noted however that many of the companies most likely to be effected by the current economic climate do not currently pay company tax since manufacturing firms that export outside the SACU region (notably textiles) are exempt from this tax.

Government has adopted the policy of increasing personal income tax bands in line with the projected inflation rate so that taxpayers do not face an increase in the real burden of tax. In 2007/08, Government increased the threshold at which the higher rate of tax becomes payable in line with inflation but increased the rebate (which benefits lower income taxpayers proportionately more) by 20%. The Government raised the rebate from M 3,500 to M 4,500 (28.6%) during the 2008/09 budget, increased the threshold in line with projected inflation and reduced the lower personal tax rate from 25% to 22%. While this package provided financial benefits to all taxpayers, it was especially designed to provide the maximum gain to lower income taxpayers. The index linking policy was continued in the 2009/10 budget, when the tax rebate was raised to M 5,000 – incorporating a small tax reduction in addition to the index linking – and tax threshold was raised from M 37,378 to M 40,268.

Figure 3.3. Evolution of Income Tax 2005/06 to 2011/12



Value Added Tax: The introduction of VAT in July 2003 resulted in a substantial increase in collections, both because a standard rate of 14% was imposed - higher than the 10% payable under sales tax – and because Government became liable to pay VAT on its purchases of goods and services and acquisition of assets. Collections would have been significantly higher, but for the application of zero-rating and below standard rates to a wide range of commodities. In the second full-year of operations, collections declined from M 659.8 million to M 655.7 million in 2005/06. This was partly because of the slowdown in economic performance but also reflected substantial refunds of over-payments made during the start-up period. Collections grew by 9.0% to M 714.6 million in 2006/07. For 2007/08, the revenue estimates were M 804.5 million but the final outturn showed VAT collections were 5.4% above this estimate at M 847.9m. .

Estimated collections in 2008/09 are M 991.5, an increase of 16.9% on the previous year. For 2009/10 onwards, it is assumed that VAT collections from the private sector will grow in line with nominal GDP, and VAT accumulated from Government spending will grow in line with Government expenditure. Finally, it is assumed that there will be no significant policy changes to the application of the current rates. This results in average yearly collection growth of 13.1% over the period 2008/09 to 2011/12.

Other tax revenue: This category includes the oil levy, licensing and other taxes. Oil levy collections are expected to grow in line with volume of sales (i.e. there will be no increase in the nominal tax rate), based on the forecast of real GDP (Table 3.1). Other taxes have increased as a result of exceptional collections from the sale of diamonds.

Taxes on international trade: This category represents Government income from royalties resulting from the sale of diamonds abroad. Individual agreements exist with each of the three current mines which guarantee the Government between 6% and 8% of revenue from diamond sales. Revenue from this category is estimated at M 139.4m in 2008/09 – higher than in previous years due to increased production and exceptional sales of large diamonds.

Revenue is forecast to fall to M 97.4m in 2009/10 due to the lower diamond prices as a result of the current economic slow-down, and the fact that two of the three main diamond mines have been placed on care-and-maintenance regimes and are not producing commercially. As of March 2009, only Letŝeng continues to produce diamonds for export. Over the medium term, diamond prices are expected to recover in 2010 resulting in increasing diamond production and export. In addition, positive results from prospecting at Mothae means that full-scale production is likely to begin at this mine, further increasing diamond exports and revenue.

Non-tax revenue: The main items of non-tax revenue include: water royalties derived from the Lesotho Highlands Water Project; dividends from the operations of organisations with public ownership (principally the Central Bank); departmental revenues; electricity sales; and compensation paid by the Reserve Bank of South Africa in respect of rand in circulation in Lesotho. Government has limited discretion in determining the revenue collections from these items and, although ministries could increase departmental revenues, few have initiated preparatory actions, such as reviewing legislation, to determine whether any nominal fees and charges should be uprated. Non-tax revenue has increased from M 428.7m in 2005/06 to an estimated M 614.0m in 2008/09. 2008/09 collections however represent a decrease of 4.1% compared with 2007/08. Non-tax revenue will grow in future years with dividends and rent growing at the 5 year average rate and interest growing at a 4 yearly average. Electricity sales by 'Muela, Administrative fees and Incidental sales are all forecast to grow at a log-linear rate over the medium term – this reflects the recent trend in these revenue sources. Water royalties are forecasted to grow in line with inflation.

Grants: Project grants have an equivalent book entry under capital expenditure. The annual estimates are based on ministerial project submissions and donor commitments but the recorded level of grant disbursements depends on the pace of project implementation and the quality of reporting by donors. In order to assess the likely fiscal outcome, the MTFF calculates the expected Project Grant Outturn by reducing the budget appropriation by 50% to allow for implementation delays and the failure to record expenditure in the public accounts. Anticipated disbursements under the Millennium Challenge Account are reduced by 25% since it is believed that programmes under the MCC will be better performers than those that benefit from other foreign aid.

Grant revenue is expected to increase from M 233.8m in 2008/09 to M 648.3 in 2009/10. A large increase is also expected for 2010/11 with grant revenue estimated at M 1,026.5m in this year. These large increases are largely the result of MCC disbursements which began during 2008/09.

Because the Customs Union provides more than half of total revenue, Government has limited discretion in the application of revenue policy measures. As long as SACU revenues are high, they provide fiscal discretion to reduce tax rates (e.g. company tax rate reductions in 2006/07 and personal income tax cuts in 2008/09) but it will be hard to achieve offsetting revenue increases when SACU revenues are relatively weak[18]. This reinforces the policy objective of achieving dynamic economic growth that will generate higher levels of tax collections without relying on rate increases.

[18] It would require an increase of 10% in all domestic tax collections to offset a 5% fall in SACU revenues. A rate increase of that magnitude would damage Lesotho's tax competitiveness and encourage firms to locate in other countries. The increase in domestic taxes will transfer resources from consumers and potential investors to the public sector and might also have a negative impact on economic performance.

3.3.3 Aggregate Fiscal Framework

The budget appropriation represents the formal authorisation of publicly funded activities. However, the actual budget outturn is more relevant for fiscal management as it determines the overall budget balance (and, therefore, the financing requirements and the implications for debt sustainability). In recent years, the appropriation has exceeded the final outturn, especially for capital spending where capacity constraints and delays in the implementation process mean that actual expenditure is significantly less than the appropriation. There is also likely to be some excess appropriation for wages (since the appropriation covers all established posts and the phased filling of vacant posts) and for goods and services.

Cabinet approved the use of outturn based budgeting for the current budget. Despite this change however, the 2009/10 budget contains a large increase in budgeted expenditure with recurrent expenditures increasing by nearly M 2 billion and capital expenditure increasing by over M 1 billion compared with estimated outturn in 2008/09. It is highly unlikely that ministries will succeed in spending all of their increased budgeted allocations, and, as previously stated, budgeted expenditures are discounted in order to project likely fiscal outturns.

Table 3.3 summarises the Aggregate Fiscal Framework by showing total Revenue & Grants and the various categories of expenditure, including both non-discretionary Statutory Charges and discretionary ministerial expenditure. Panel A presents actual data for past years, provisional estimates of the outturn for 2008/09 and forecasts of the expected outturn for 2009/10, 2010/11 and 2011/12.

For 2008/09, the provisional data indicates that Revenue & Grants will be M 8,426.0m while total expenditure (excluding principal repayments) will be M 7,112.2m, resulting in a surplus of M 1,313.8m. After adjusting the Budget Appropriation for 2009/10 onto an outturn basis, Revenue & Grants are estimated at M 9,644.5m, total expenditure at M 9,989.3m resulting in a budget deficit of M 344.8m..

Statutory Expenditure (excluding principal) is expected to be M 1,285.8m in 2007/08 (an increase of 92.1%). This increase is largely due to M 600m which has been set aside in order to fund accrued pensions liabilities, as well as a M 250m payment for the Government share of the defined contribution pension scheme. Statutory Expenditure has been budgeted at M 1,239.0m in 2009/10. This includes an additional M 250m to fund accrued liabilities for the defined contribution pension scheme, an additional M 160.7m for the Government share of the defined contribution scheme, and an increase in expenditure on the old age pension which has been raised from M 200 to M 300 per month for all Basotho aged 70 and above. The old age pension is estimated to cost a total of M 288m.

Discretionary ministerial recurrent expenditure is expected to total M 5,828.1m in 2008/09, higher than the M 5,325.2 million forecast in the previous Background to the 2008/09 budget. This is budgeted to rise to M 8,757.9m in 2009/10, an increase of 42.6% against the estimated 2008/09 outturn. Since this is substantially higher than the assumed rate of inflation of 6.8% it indicates a real increase in allocations.

Table 3.3: AGGREGATE FISCAL FRAMEWORK, 2005/06 - 2011/12

A. Outturn Basis (M million)	**2005/06**	**2006/07**	**2007/08**	**2008/09**	**2009/10**	**2010/11**	**2011/12**
Revenue & Grants	4,661.2	6,464.5	7,220.2	8,426.0	9,644.5	8,497.2	10,426.3
Principal Repayments	586.3	229.0	186.6	243.5	385.1	334.8	360.3
Statutory Charges (exc. Principal)	520.5	645.8	669.3	1,285.8	1,239.9	858.2	895.9
Total Ministerial Expenditure	3,742.7	4,410.7	5,175.7	5,828.1	8,757.9	10,079.5	11,149.0
Recurrent Expenditure	3,053.4	3,660.4	4,028.4	4,498.4	6,415.1	7,050.2	7,731.8
Wages and salaries	1,289.4	1,392.8	1,652.7	1,944.9	2,636.6	2,856.5	3,067.7
Goods and services	1,063.7	1,402.0	1,394.5	1,394.9	2,220.3	2,546.1	2,930.2
Recurrent subventions	700.4	865.7	981.2	1,158.5	1,558.2	1,647.6	1,733.9
Capital Expenditure	689.2	750.3	1,147.3	1,329.8	2,342.8	3,029.3	3,417.1
Net Lending	-9.9	-9.4	-12.7	-1.8	-8.5	-8.1	-7.8
Total Expenditure (exc. Principal)	4,253.2	5,047.1	5,832.2	7,112.2	9,989.3	10,929.5	12,037.1
Total Expenditure / GDP (%)	46.6%	47.4%	47.3%	49.9%	64.4%	62.4%	61.1%
Budget Balance (Outturn Basis)	408.0	1,417.4	1,388.0	1,313.8	-344.8	-2,432.3	-1,610.8
B. Expenditure as % of Total Expenditure							
Statutory charges / Expenditure	12.2%	12.8%	11.5%	18.1%	12.4%	7.9%	7.4%
of which: Interest / Expend.	5.1%	6.1%	5.1%	1.8%	1.5%	1.1%	1.0%
Wages / Expenditure	30.3%	27.6%	28.3%	27.3%	26.4%	26.1%	25.5%
G&S / Expenditure	25.0%	27.8%	23.9%	19.6%	22.2%	23.3%	24.3%
Transfers / Expenditure	16.5%	17.2%	16.8%	16.3%	15.6%	15.1%	14.4%
Capital / Expenditure	16.2%	14.9%	19.7%	18.7%	23.5%	27.7%	28.4%
Net lending / Expenditure	-0.2%	-0.2%	-0.2%	0.0%	-0.1%	-0.1%	-0.1%
C. Appropriation Basis (M million)							
Revenue & Grants Appropriation		5,791.7	6,893.1	8,714.4	10,074.7	9,073.5	11,093.8
Statutory Charges (exc. Principal)		531.0	807.8	1,331.6	1,239.9	858.2	895.9
Total Ministerial Appropriation		4,982.7	6,418.6	7,682.3	10,183.8	11,803.7	13,076.2
Recurrent Appropriation		3,730.5	4,494.4	5,525.2	6,769.4	7,446.9	8,174.4
Wages and salaries		1,440.2	1,750.4	2,136.8	2,768.0	3,009.4	3,245.5
Goods and services		1,396.0	1,694.2	2,151.8	2,443.2	2,789.9	3,194.9
Recurrent subventions		894.4	1,049.8	1,236.6	1,558.2	1,647.6	1,733.9
Capital Appropriation		1,252.1	1,924.2	2,157.1	3,414.5	4,356.8	4,901.8
Net Lending		-9.4	-12.7	-1.8	-8.5	-8.1	-7.8
Total Appropriation		5,504.2	7,213.7	9,012.1	11,415.3	12,653.8	13,964.3
Total Appropriation / GDP (%)		51.7%	58.5%	63.3%	73.6%	72.3%	70.9%
Budget Balance (Appropriation Basis)		287.5	-320.6	-297.7	-1,340.5	-3,580.3	-2,870.5

Discretionary ministerial capital expenditure is estimated at M 1,329.8m in 2008/09, lower than the M 1,578.6m forecast in the 2007/08 Background to the Budget Speech. Capital expenditure is budgeted to rise by 76.2% in 2009/10 to M 2,342.8m. Ministries typically "fast-track" their capital budget submissions but they experience significant delays in project implementation. The estimated capital outturn allows for under-implementation equal to 1/3 of the appropriation for Acquisition of Assets. The Capital Estimates include some exceptional provisions, including counterpart funding of the Metolong Dam, the continuing of projects funded by the Millennium Challenge Corporation, the Likalaneng-Thaba Tseka and Literapeng-Tsehlanyane roads and financing of the construction of a new hospital to replace Queen Elizabeth II hospital.

Figure 3.4. Expenditure Categories as a Proportion of Total Expenditure

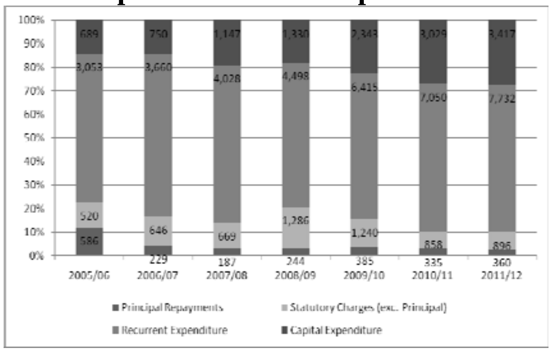
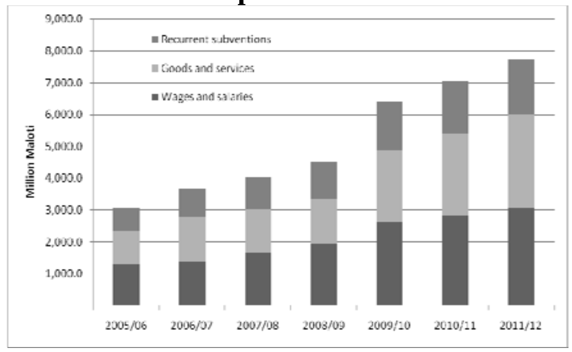


Figure 3.5. Evolution of Recurrent Expenditures



Net Lending records the net difference between new loans made to parastatals and repayments from parastatals of loans received from the central government. Loans made by Government have a positive sign as they indicate higher expenditure while repayments to Government have a negative sign as they reduce total expenditure.

At M 7,112.2m, total expenditure on an outturn basis in 2008/09 is lower than the M 8,227.5m forecast in the previous Background. Total expenditure is projected to grow to M 9,989.3m in 2009/10 – an increase of 40.5%. As a result, the expenditure/GDP ratio will increase from 49.9% to 64.4%. Total expenditure is forecast to rise further to M 10,929.5m in 2010/11, and then to M 12,037.1m in 2011/12. However, as a share of GDP, total expenditure declines to 62.4% in 2010/11 and further to 61.1% in 2011/12.

Panel B shows the relative shares of the major expenditure categories as a proportion of total expenditure (excluding principal repayment). These shares fluctuate in response to allocations to each specific category and to changes in the allocations to other categories. Thus, the exceptional appropriation of M 600.0 million as a one-off payment to deal with accrued liabilities for civil servants who convert to the defined contribution pension scheme resulted in a large increase in the share for Statutory Charges in 2008/09 and means that the shares of other categories will tend to be below their long-term average level. This exceptional payment will drop out of the base and this category should decline from 18.1% in 2008/09 to 12.4% in 2009/10, and further to 7.9% in 2010/11. Despite the salary award, the share of Wages declined by one percentage point from 28.3% in 2007/08 to 27.3% in 2008/09. The share of wages is forecast to continue to decline in 2009/10 to 26.4% and reduce still further over the medium term reaching 25.5% in 2011/12. Goods & Services declined substantially in 2008/09 from 23.9% to 19.6% as a result of the higher share of statutory charges and underspend on this category. It is projected to increase back in line with longer run levels to 22.2% in 2009/10, and increase further over the medium term, reaching 24.3% of total expenditure in 2011/12.

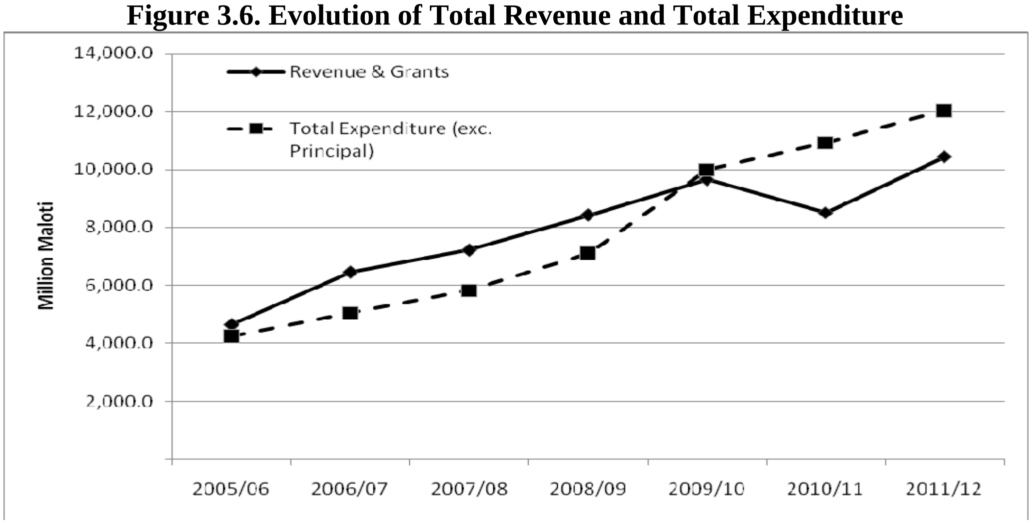
Transfers are expected to decline from 16.3% in 2008/09 to 15.6% in 2009/10 and to decline further to 14.4% in 2011/12. Capital shows a substantial jump from 18.7% in 2008/09 to 23.5% in 2009/10. It is then projected to increase further over the medium term to 27.7% in 2010/11, and reach 28.4% in 2011/12. A large part of this increase is due to disbursements from the Millennium Challenge Compact.

Panel C shows the budget appropriations over the medium-term, assuming unchanged expenditure policies. The total expenditure appropriation is M 11,415.3m in 2009/10. It is expected to grow to M 12,653.8m in 2010/ and to grow further to M 13,964.3m in 2011/12. The recurrent Budget estimates for 2009/10 are M 6,769.4m, and this appropriation is forecast to grow by 10.0% in 20010/11 and 9.8% in 2011/12. The capital budget appropriation for 2009/10 is M 3,414.5m and it is expected to increase by 27.6% in 2010/11 and by 12.5% in 2011/12.

3.3.4 Budget Balance and Financing Strategy

The Overall Budget Balance (including grants) shows the fiscal surplus or deficit by calculating the difference between total government expenditure (including interest payments but excluding principal repayments on the outstanding stock of public debt) and total receipts, including tax and non-tax revenue and grants. Figure 3.6 shows the evolution of total revenue and expenditure from 2005/06 to 2011/12. Over recent years, the Government has registered strong fiscal surpluses of M 408.0m in 2005/06, M 1,417.4m in 2006/07 and M 1,388.0m in 2007/08. Recent surpluses have been used to retire expensive commercial debt, thereby reducing the future burden of interest payments. These debts include M 273.0 million of domestic debt linked to the restructuring of the old Lesotho Bank, external debt incurred for construction of the Post Office building and external borrowing by the Lesotho Highlands Development Authority (LHDA). In addition, Government reserves at the Central Bank have also been accumulated. A large fiscal surplus of M 1,313.8m is also estimated for 2008/09.

Figure 3.6. Evolution of Total Revenue and Total Expenditure



However, on an outturn basis a deficit of M 344.8m is forecast for 2009/10, resulting in a drawdown of Government funds equal to the value of the deficit. This drawdown funds the M 250m payment to cover accrued pensions liabilities, an estimated M 4.9m increase in holding of gold and/or IMF Special Drawing Rights (SDRs), and a non-financial deficit of M 89.9m.

A significantly larger deficit of M 2,432.3m, or around 14% of GDP is projected for 2010/11. This is the result of a decline in SACU revenue of nearly M 2 billion in this year, and an increase in total expenditure of nearly M 1 million compared with 2009/10. The deficit is forecast to decline to M 1,610.8m or around 8% of GDP in 2011/12.

Thanks to large surpluses over the recent past, Lesotho is in a good position to cope with this projected negative reversal in the fiscal position over the short to medium term. However, care must be taken to ensure prudent spending policies are enacted over the coming years in order to guarantee long term sustainability. Any factors resulting in permanently lower SACU receipts will result in reduced revenue flows over the foreseeable future, and will therefore require lower expenditure. Government should take steps to develop a strategy to manage this revenue slow-down and ensure that limited financing is targeted towards the most important sectors in order to maximise economic growth.

3.4 EXPENDITURE BY ECONOMIC CATEGORY

3.4.1 Overview

The definition of expenditure used in economic analysis is different from that used in preparing the Estimates, mainly because debt repayment and loan disbursements, which are included in the appropriations, are treated as financing transactions. For economic analysis, expenditure is split into six groups: statutory charges (excluding principal); three categories of recurrent expenditure (wages; goods and services; and transfers); capital expenditure; and net lending to public enterprises.

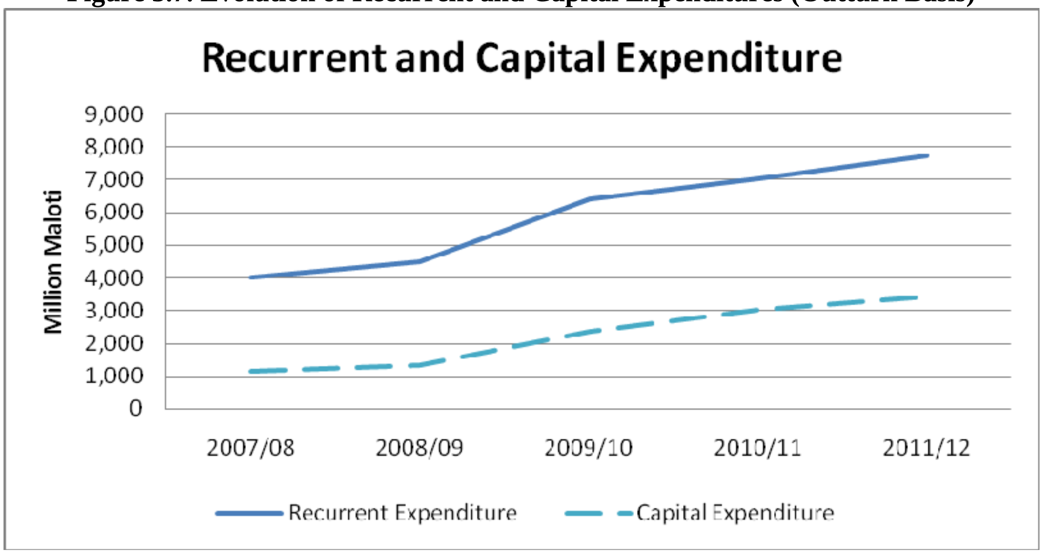
Table 3.4: BUDGET BALANCE AND FINANCING STRATEGY, 2005/06 - 2011/12 (M Million)

Row	Item	2005/06	2006/07	2007/08	2008/09	2009/10	2010/11	2011/12
1	Domestic Revenue	4,489.7	6,372.1	7,044.4	8,192.1	8,996.3	7,470.7	9,187.5
2	Grants	171.4	92.4	175.8	233.8	648.3	1,026.5	1,238.8
3	of which: Project Grants	171.4	92.4	175.8	151.9	321.1	351.1	381.9
4	Total Expenditure (exc. Principal)	4,253.2	5,047.1	5,832.2	7,112.2	9,989.3	10,929.5	12,037.1
5	of which: Interest	216.8	308.1	296.1	128.6	153.9	122.3	121.7
6	Capital Expenditure	689.2	750.3	1,147.3	1,329.8	2,342.8	3,029.3	3,417.1
7	Budget Balance excluding grants	236.6	1,325.1	1,212.2	1,080.0	-993.1	-3,458.8	-2,849.6
8	Balance excluding grants/GDP (%)	0.0	0.1	0.1	0.1	-0.1	-0.2	-0.1
9	Budget Balance including grants	408.0	1,417.4	1,388.0	1,313.8	-344.8	-2,432.3	-1,610.8
10	Balance including grants/GDP (%)	0.0	0.1	0.1	0.1	-0.0	-0.1	-0.1
11	Repayment of domestic principal					-114.7		
12	Repayment of external principal	-586.3	-229.0	-186.6	-243.5	-270.4	-334.8	-360.3
13	Public sector borrowing requirement	-178.3	1,188.4	1,201.3	1,070.3	-729.9	-2,767.0	-1,971.1
14	External financing	70.2	182.0	220.6	386.6	229.8	251.3	273.3
15	of which: Project Loans	70.2	182.0	220.6	386.6	229.8	251.3	273.3
16	Budget Support Loans							
17	Domestic Financing	108.1	-1,370.4	-1,421.9	-1,456.9	500.1	2,515.8	1,697.9
18	of which: Domestic borrowing	435.0	6.8	-420.9				
19	Change in Domestic balances	-326.9	-1,377.2	-1,001.0	-1,456.9	500.1	2,515.8	1,697.9
20	Total domestic debt	644.8	700.7	647.7	647.7	533.0	533.0	533.0
21	Total domestic debt/GDP (%)	0.1	0.1	0.1	0.0	0.0	0.0	0.0
22	Total external debt*	3,898.7	4,689.9	5,654.9	6,848.4	7,772.9	8,207.7	8,360.7
23	Total external debt/GDP (%)	0.4	0.4	0.5	0.5	0.5	0.5	0.4
24	Expenditure - Interest	4,036.4	4,739.0	5,536.1	6,983.6	9,835.4	10,807.2	11,915.5
25	Primary balance (inc. Grants)	624.8	1,725.6	1,684.1	1,442.4	-190.9	-2,309.9	-1,489.2
26	Primary balance/GDP (%)	0.1	0.2	0.1	0.1	-0.0	-0.1	-0.1
27	Expenditure - Capital	3,564.0	4,296.8	4,684.9	5,782.4	7,646.5	7,900.3	8,620.0
28	Current balance (exc. Project Grants)	925.8	2,075.3	2,359.5	2,491.7	1,676.9	245.9	1,424.4
29	Current balance/GDP (%)	0.1	0.2	0.2	0.2	0.1	0.0	0.1
30	GDP at market prices	9,130.1	10,646.4	12,328.8	14,241.8	15,517.7	17,509.0	19,689.4

* The estimated future stock of external debt is adjusted by the change in the exchange rate (Table 3.1).

The primary focus for effective expenditure control is the sustainable level of recurrent expenditure. Sustainability is demonstrated by a current surplus (i.e. recurrent revenue collections excluding both capital grants and any one-off receipts from the sale of assets are greater than recurrent expenditures). The recurrent ceiling must make adequate provision for the continuation of ongoing programmes and their expansion to meet increasing demands resulting from policy decisions, population growth and the budget requirements of servicing completed projects. Inadequate resources will result in a service deficit (e.g. the lack of teaching materials in schools or of drugs in health facilities) and in a deteriorating standard of physical assets (e.g. public buildings and the road network). Reforms currently being introduced to the planning and budget process are intended to ensure that these recurrent requirements are accurately identified and that the budget provides adequately for: increased staff numbers; associated personnel costs such as allowances and pensions; other operating costs; and the costs of maintaining the asset base.

Figure 3.7. Evolution of Recurrent and Capital Expenditures (Outturn Basis)



Within the ministerial expenditure ceiling, it is necessary to establish an indicative allocation of resources between recurrent and capital expenditure. Within the recurrent budget, it is necessary to establish an appropriate balance between allocations for wages and salaries and for goods and services.

3.4.2 Statutory Expenditure

Statutory Charges include debt service, pensions and other constitutional obligations. They are non-discretionary expenditures since the Government is required by law to meet them as a first charge on the Consolidated Fund. As shown in Table 3.5, the main components are:

External interest payments: The projected stock of outstanding external debt (shown in Table 3.4) is based on the value of debt at the start of each year, annual repayments of principal, disbursements of new loans and the projected exchange rate (Table 3.1). External interest expenditures have been kept low by mobilising concessional loans and retiring commercial debt, so that future payments are calculated by applying an average interest rate of 1.0% (down from 1.2% in previous years) to the total debt stock. External interest was inflated by payments of M 209 million in 2006/07 and M 189 million in 2007/08 to clear an accrued liability resulting from borrowing by the Lesotho Highlands Development Authority.

Table 3.5: STATUTORY EXPENDITURE, 2005/06 - 2011/12 (M Million)							
	2005/06	**2006/07**	**2007/08**	**2008/09**	**2009/10**	**2010/11**	**2011/12**
Domestic Principal repayment					114.7		
External Principal repayment	586.3	229.0	186.6	243.5	270.4	334.8	360.3
Foreign interest	171.0	266.7	246.6	66.9	66.8	82.1	83.6
Domestic interest	45.8	41.4	49.5	61.7	87.0	40.3	38.0
Pensions and gratuities	288.9	297.4	356.0	1125.9	1032.2	697.3	736.6
Statutory	11.0	11.2	13.4	14.9	18.2	16.5	17.8
Subscriptions	3.7	29.1	3.7	16.4	35.5	22.0	19.9
TOTAL	1106.8	874.8	855.9	1529.3	1625.0	1192.9	1256.3
TOTAL exc. Principal	520.5	645.8	669.3	1,285.8	1,239.9	858.2	895.9

Domestic interest payments: Payments increased to M 49.5 million in 2007/08 and a provisional level of M 61.7 million in 2008/09 as a successful outcome of Government's policy of retiring commercial debt. Although the appropriation has been increased to M 87.0 million in 2009/10, based on the outstanding stock of domestic debt (Table 3.4) and the prevailing interest rate (Table 3.1), it is expected that the lower level and declining trend will resume in subsequent years.

Pensions and gratuities: As shown in Table 3.6, this item includes pensions and gratuities due to civil servants, gratuities to contract officers, payments to members of the African Pioneer Corps and the national old-age pension.

All permanent and pensionable staff are members of the existing defined-benefit pay-as-you-go scheme, the cost of which has been increasing rapidly. Although this system generates savings while the civil service is young and growing, Government accrues substantial unfunded liabilities that will impose a severe fiscal cost once the civil service stabilises and ages. In order to reduce these fiscal risks, Government decided to introduce a defined-contribution scheme for civil servants in 2008/09. A fund has been established in 2008/09 with an initial capital injection of M 600.0 million to cover the liabilities accrued as a result of the years of service by those officers joining the scheme. Initially, all employees under 40 years of age converted to the scheme and it has been proposed in the Budget Speech 2009/10 that employees in age group 40 to 45 be included. This has been allocated an extra capital amounting to M 250 million. The contingent liability for incorporating this group will be reduced over two years by M 500 million while annual payments will be increased by only M 32 million per annum, as the Government's contribution is 11.2%. An actuarial study concluded that an aggregate contribution rate of 16.2% of salary (of which Government will pay 11.2% and employees will contribute 5%[19]) was required to ensure financial sustainability of the scheme.

[19] A salary award of 5% has been made in 2008/09 to avoid a worsening of their terms and conditions of employment.

Table 3.6: PENSIONS AND GRATUITIES, 2005/06 - 2011/12 (M Million)	2005/06	2006/07	2007/08	2008/09	2009/10	2010/11	2011/12
Old Age pension	137.7	148.5	172.6	205.4	288.0	284.0	284.0
Civil Service pensions	83.1	75.3	100.8	125.3	135.0	150.5	166.8
GoL share of defined contribution p	0.0	0.0	0.0	122.6	160.7	182.4	202.7
Accrued Liability for Defined Contri	0.0	0.0	0.0	600.0	250.0	0.0	0.0
Civil Service Gratuities	57.3	51.2	66.7	53.2	175.0	69.9	73.5
Compensation	1.2	0.3	0.3	1.3	1.5	0.5	0.5
African Pioneer Corps	9.7	22.1	15.5	18.2	22.0	10.0	9.0
TOTAL	288.9	297.4	356.0	1125.9	1032.2	697.3	736.6

Civil servants who do not convert to the defined-contribution scheme will remain on the current scheme. Government will have to meet these obligations, which will continue to grow in nominal terms for several years.

The national old-age pension was introduced in November 2004 and currently provides 78,900 citizens aged 70 and over with a pension of M 200 per month and has been proposed in Budget Speech 2009/10 to increase to M300 per month. All surviving members of the African Pioneer Corps and their dependents receive the APC pension and, if they are over 70 years of age, the old-age pension.

Statutory salaries: This item includes His Majesty's civil list and salaries and allowances for a number of constitutional positions.

Subscriptions: These represent Government's obligations to international organisations, including the World Bank, IMF, African Development Bank, Southern African Development Community and the Commonwealth.

3.4.3 Wages and Salaries

Table 3.7 shows the budget allocations for: the cost of the existing civil and teaching services; net recruitment for the civil and teaching services; and the cost of wage awards. However, it should be noted that comparisons of historical data with budget appropriations may be misleading for two reasons:

- the allocations for the wage bill and for recurrent transfers have been distorted by transfers of significant numbers of established positions from ministries to autonomous agencies in 2003/04 and to local authorities in 2006/07 (and back to ministries in 2007/08); and
- accounting returns show that actual expenditure on wages has been significantly below the budget ceilings in recent years. This is likely to occur because the budget provision assumes (i) that all occupied posts will remain filled whereas a number of personnel leave the public service during the year and (ii) that most vacant posts will be filled during the financial year.

Table 3.7: PUBLIC SERVICE WAGES AND SALARIES, 2004/05 - 2010/11 (M Million)	2005/06	2006/07	2007/08	2008/09	2009/10	2010/11	2011/12
MINISTERIAL SALARIES (budget)	1,408.0	1,440.2	1,750.4	2,136.8	2,768.0	3,009.4	3,245.5
Base Wages	1,320.4	1,402.0	1,508.5	1,769.9	2,356.5	2,636.6	2,856.5
Adjusted provision*		-59.5					
Incremental increases	6.0	16.1	8.6	15.2	20.2	22.6	24.5
Projected recruitment (base is 1%)	20.2	16.7	87.4	96.1	190.4	192.3	194.2
Nominal wage increase	61.4	64.9	145.9	255.6	200.9	157.9	170.3
Less underspend**	-118.6	-47.4	-97.7	-191.9	-131.4	-152.9	-177.8
MINISTERIAL SALARIES (actual/projected)	1,289.4	1,392.8	1,652.7	1,944.9	2,636.6	2,856.5	3,067.7
Plus Transfer Salaries (sub-head 5, item 1-3)	9.5	57.6	59.7	98.4	117.2	139.6	166.4
Plus Statutory Salaries	5.8	6.8	7.1	6.9	9.2	7.6	8.0
Plus Training	-3.6	-4.7	-6.8	-4.0	-4.3	-4.6	-5.0
GFS Wages & Salaries (actual/projected)	1,301.1	1,452.5	1,712.8	2,046.3	2,758.7	2,999.1	3,237.0
Salary Review Contingency							

Provisional data indicates that the Budget appropriation for 2008/09 will be underspent by approximately M 190 million as a result of a higher than anticipated vacancy rate.

The annual appropriation has increased from M 2,136.8 million in 2008/09 to M 2,768.0 million in 2009/10. This is the aggregate impact of a salary award of 8.5% and provision of M 190.4 million for projected recruitment. Despite the significant improvement in average wages in 2008/09 and 2009/10, Government is unlikely to be able to recruit and retain the budgeted number of personnel and the gap between annual appropriations and outturn is expected to remain at around M 197 million.

The forecasts for future years have been prepared assuming that:

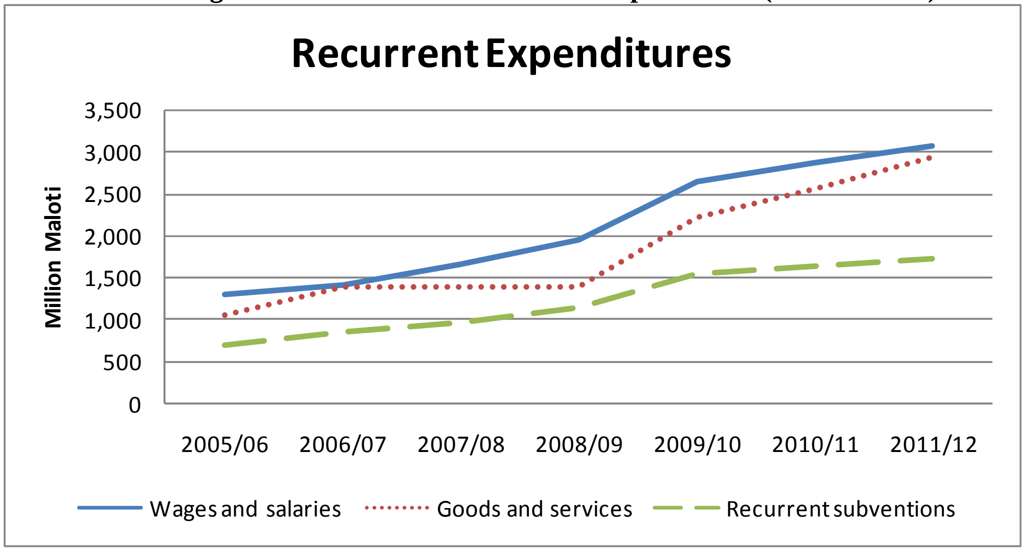
- average wage costs increase by 2% per annum (to allow for annual increments, promotions etc.);
- there is minimal net recruitment of approximately 1% per annum; and
- future annual salary awards are based on the prevailing inflation rate (Table 3.1).

The net impact is that actual expenditure on wages (which had declined to 13.1% of GDP in 2006/07) increased to 13.4% of GDP in 2007/08 and is estimated to reach 13.7% in 2008/09. However, the share is budgeted to increase to 17% in 2009/10. It is then forecast to decline to 16.3% in 2010/11 and decline further to 15.6% in 2011/12.

3.4.4 Goods and Services

Actual expenditure on Goods & Services is provisionally estimated at M 1,394.9 million in 2008/09 and budgeted for M 2,443.2 million for 2009/10. This growth is spread across a wide range of items and includes provision both for above-inflation price increases and volume increases. Particularly large increases are recorded for fuel, drugs, subsistence (local), fares (international), subsistence (international), purchase of material, maintenance of assets and vehicles maintenance. In recent years, the budget appropriation has not been fully utilised so, for fiscal and macroeconomic analysis, it is assumed that there will be an underspend of M 160 million per annum.

Figure 3.8. Evolution of Recurrent Expenditures (outturn basis)



The basic Goods & Services budget for 2010/11 and 2011/12 is assumed to grow in line with the projected inflation rate. In addition, the totals contain some provision for real growth in expenditure by assuming that half of the annual contingency reserve is allocated to specific recurrent activities in the course of each financial year and that this amount will enter the expenditure base in subsequent years. Provision in future years may be adjusted as activities (and the associated resource allocations) are decentralised to local authorities.

The expected allocation by item has been used to calculate the amount of VAT payable in respect of Government's purchases of Goods & Services.

Ensuring optimal levels of operations and maintenance expenditure can make a major contribution to greater economic efficiency. Ministries are expected to make sustainable improvements in the productivity of their expenditure on goods and services by utilising management information both in setting resource allocations (preferably at decentralised facility level) and in monitoring performance against clearly defined targets. Resources released by improving productivity can be reallocated to activities targeted at national development priorities as defined in the Poverty Reduction Strategy.

3.4.5 Transfers and Subsidies

As shown in Table 3.8, this expenditure category includes recurrent subventions & transfers, pensions (see Section 3.4.2) and capital transfers (see Section 3.4.6). Recurrent subventions have increased significantly in recent years. Major cost drivers have included: the creation of autonomous bodies in 2003/04 (the Lesotho Revenue Authority, the Lesotho College of Education and Lerotholi Technical Institute), as they are funded through transfers rather than being allocated funds for specific line-items; the cost of scholarships and bursaries provided to students by the National Manpower Development Secretariat; the creation of the National AIDS Commission in 2005/06; and the creation of 139 local and district councils following the elections in April 2005 (subventions to councils totalled M 170.2 million in 2008/09, excluding the cost of ministerial staff who reverted to their parent ministries).

For 2009/10, transfers are expected to grow by 26.0% to M 1,558.2 million. The main ministries and agencies behind this growth are Education and Training, Local Government and National Manpower Development Secretariat.

Table 3.8: TRANSFERS AND SUBSIDIES, 2004/05 - 2010/11 (M Million)								
	2004/05	2005/06	2006/07	2007/08	2008/09	2009/10	2010/11	2011/12
Pensions and gratuities	175.7	288.9	297.4	356.0	1,125.9	1,032.2	697.3	736.6
Recurrent subventions & transfers	619.9	700.4	865.7	981.2	1158.5	1558.2	1647.6	1733.9
Capital subventions & transfers	68.1	117.3	136.9	192.5	103.9	404.6	523.1	590.1
TOTAL	863.6	1,106.6	1,299.9	1,529.7	2,388.4	2,995.0	2,868.0	3,060.7

3.4.6 Capital Expenditure

The nominal value of capital expenditure is shown in Table 3.9. The expected outturn for 2008/09 is M 1,329.8 million, against the original Capital Estimates of M 2,157.1 million[20]. The appropriation for 2009/10 is M 3,414.5 million. Capacity constraints will make it difficult to implement this level of expenditure (and, from a budgetary perspective, achieving the capital budget ceiling would create severe pressure on the recurrent budget to service and maintain the additional assets in subsequent years).

Acquisition of Assets: This category is disaggregated on the basis of the source of funds. Government asset funding includes both fully-funded Government of Lesotho projects (including secondary school construction, rehabilitation of border posts, bridge construction, contingency provision for a claim relating to a road construction project, village water supply and electricity access) and counterpart funding of projects with donor grants and loans (including health sector reforms, education sector development, Likaleng – Thaba-Tseka road, the Integrated Transport Project and Metolong Dam). The 2008/09 figures are taken from the Capital Estimates while the forecast for future years assumes that the base level of expenditure will grow by 8% per annum. The expected outturn (i.e. appropriation less one-third to reflect delays in implementation) of GoL Funded Acquisition of Assets is used to calculate the amount of VAT payable by Government.

[20] The Capital Estimates includes expenditure that will not create new non-financial assets and should properly be classified as recurrent activities. Efforts are being made to improve the classification system and transfer these expenditures to their appropriate place in the Estimates.

Table 3.9: CAPITAL PROJECT EXPENDITURE, 2005/06 - 2011/12 (M Million)							
	2005/06	2006/07	2007/08	2008/09	2009/10	2010/11	2011/12
Budget Appropriation	1,043.4	1,252.1	1,924.2	2,157.1	3,414.5	4,356.8	4,901.8
Government of Lesotho			1,103.5	1,111.8	1,953.0	2,335.3	2,540.1
o/w transfers			200.0	310.6			
Loans			330.7	354.8	383.0	418.8	455.5
Grants		429.8	490.0	581.2	642.3	702.2	763.8
Millennium Challenge Account				109.3	436.2	900.6	1,142.5
Underspend actual/potential	354.2	501.9	776.9	827.4	1,071.6	1,327.6	1,484.7
Unallocated new projects	33.9%	40.1%	40.4%	38.4%	31.4%	30.5%	30.3%
Capital Projects Outturn/Projection	689.2	750.3	1,147.3	1,329.8	2,342.8	3,029.3	3,417.1
Expense	437.5	445.9	685.7	511.4	1,421.1	1,837.5	2,072.7
Compensation of Employees	71.0	66.2	72.3	85.4	189.8	245.4	276.8
Use of goods and services	249.2	242.9	420.8	322.1	826.7	1,069.0	1,205.8
Transfers	77.4	112.3	149.7	100.4	307.4	397.5	448.4
Other expense	39.9	24.6	42.8	3.5	97.2	125.6	141.7
Nonfinancial assets	251.7	304.4	461.6	818.3	921.7	1,191.8	1,344.4
Capital Projects Source of funds	689.3	750.2	1,147.5	971.8	2,342.8	3,029.3	3,417.1
Government of Lesotho	447.7	475.8	751.2	351.3	1,464.8	1,751.5	1,905.0
Foreign loans	70.2	182.0	220.6	386.6	229.8	251.3	273.3
Foreign grants	171.4	92.4	175.8	151.9	321.1	351.1	381.9
Millennium Challenge Account				82.0	327.2	675.4	856.9
* For 2009/10 onwards, External Financing (Table 3.4) is equal to Loan commitments less the projected underspend of 40%							
** For 2009/10 onwards, Grant Funded revenue (Table 3.2) is equal to Donor commitments less 50% underspend							
*** Estimated outturn from MCA funding is discounted by 25%							

The provisional outturn of Loan-funded capital expenditure in 2007/08 was only M 220.6 million, against the appropriation of M 330/7 million. However, a number of large projects are being implemented so M 354.7 million was appropriated in 2008/09 and M 383.0 million in 2009/10. Significant disbursements are anticipated on roads (notably, upgrading of the Likalaneng – Thaba-Tseka road), water (Maseru peri-urban water supply and the Water Sector Improvement Project) and health. For 2009/10 and subsequent years, the projected outturn of donor commitments less 40% is used to measure the expected actual disbursement of external loans (shown in Table 3.4).

The provisional outturn of Grant-funded capital spending for 2007/08 was only M 175.8 million, against the appropriation of M 490.0 million. Appropriations (including the Millennium Challenge Account) of M 581.2 million for 2008/09 and M 652.3 million for 2009/10 are based on optimistic implementation schedules and, even if the donor-funded activities are implemented, the expenditure may not be recorded in the Government accounting system. For 2009/10 and subsequent years, the projected outturn of donor commitments less 50% is used to measure the expected actual disbursement recorded under revenue (Table 3.2). Funds provided by the Millennium Challenge Corporation are shown separately, and assume that appropriations for MCC-funded activities in health, private sector development and water are fully implemented. Major areas of grant-funded activity include: HIV and AIDS, public financial management, water supply, health and local government. Expenditures under the MCC are discounted by 25%.

Capital Transfers: This category represents funding by Government of projects which are implemented by non-government organisations, including public enterprises and private partners. A major activity will be the construction of a new referral hospital through a public-private partnership, with Government providing 40% of the M 1 billion capital cost. Other transfers include the Road Fund (matched by revenue items recorded in Table 3.2 under Oil Levy and Other Taxes), Lesotho Highlands Water Commission, the Lesotho Highlands Development Authority (in respect of operational expenses, maintenance and operation of ‘Muela hydropower and implementation of the environmental action plan), and a development fund for local councils and urban roads upgrading.

Government continues to experience problems with the quality of development expenditure, including the slow pace of implementation (which means that projects take too long to complete) and poor design (which means that some projects fail to deliver assets equivalent to the cost of producing them and do not minimise life-cycle costs). Effective project cycle management will ensure that approved projects achieve their objectives in a cost-effective manner. This will be achieved through institutional reforms to improve: screening of initial project profiles; design and appraisal; financial and physical monitoring of implementation; and evaluation procedures. Until these reforms are firmly embedded, Government should consolidate the existing asset base rather than expanding it. Even though there are substantial shortfalls in both social and physical infrastructure, it is wasteful to implement projects unless there is an appropriate and sustainable increase in the recurrent budget so that new facilities can be properly serviced and maintained. Capital resources must be used to complete ongoing projects, especially those in priority sectors, and to implement rehabilitation projects which protect the value and condition of existing assets. The adoption of the Medium-Term Expenditure Framework approach will improve the integration of recurrent and capital budgeting.

3.4.7 Net Lending

Net lending captures both new loans made to parastatals and repayments from parastatals of loans received from the central government. There have been net receipts in recent years (mostly associated with the recovery of debts from the old Lesotho Bank that had already been written off). From 2009/10 onwards, it is assumed that public enterprises will adhere to the repayment schedules for existing loans and that no new loans will be made. However, there is a significant risk that unanticipated liabilities will require Government to provide additional funding under this category.

3.5 MEDIUM-TERM EXPENDITURE FRAMEWORK

Based on the Ministerial Estimates for 2009/10 and using the aggregate growth assumptions underpinning the forecasts of revenue and expenditure contained in Sections 3.2 and 3.4, Table 3.10 presents forecasts of the Appropriations of revenue and expenditure by Ministry over the medium-term fiscal framework period. It should be noted that these forecasts are based on the assumption that there are no changes in the structure of ministerial budgets or in the relative shares allocated to each ministry.

The Revenue forecasts have been prepared by applying the assumptions for each revenue item (Table 3.2) to the Budget Estimates for each item by each Ministry for 2009/10. The Table demonstrates the dependence on SACU and tax revenues collected by the Ministry of Finance & Development Planning. Other ministries generate limited amounts of revenue and sustained efforts will be needed to increase collections of non-tax revenue.

The Recurrent Expenditure ceilings have been derived by applying the aggregate growth in each economic category of expenditure to the appropriations contained in the Estimates 2009/10. Thus, the current wage bill in each ministry has been increased by the average annual projected increase in aggregate wages, notch increase and adjusted for under spend (Table 3.7); the goods and services allocation by the projected linear estimates based on past performance (time trend) (these ceilings exclude the real expansion of the base since that cannot be attributed to specific ministries); and subventions grow in line with inflation.

Table 3.10: Medium-Term Expenditure Framework by Ministry, 2007/08 - 2010/11 (M million)													
Head	**Ministry**		**REVENUE**				**RECURRENT EXPENDITURE**				**CAPITAL EXPENDITURE**		
		Budget				**Budget**			**Indicative**	**Budget**			
		Est.	**Ceiling**	**Forecast**	**Forecast**	**Est.**	**Ceiling**	**Ceiling**	**Ceiling**	**Est.**	**Ceiling**	**Ceiling**	**Ceiling**
		2008/09	**2009/10**	**2010/11**	**2011/12**	**2008/09**	**2009/10**	**2010/11**	**2011/12**	**2008/09**	**2009/10**	**2010/11**	**2011/12**
1	Agriculture & Food Security	5.9	5.5	5.9	6.4	158.2	170.5	183.2	195.6	50.6	45.0	36.9	0.0
2	Health & Social Welfare	14.4	23.5	25.2	27.0	698.0	841.0	898.3	953.9	242.4	200.0	305.6	0.0
3	Education & Training	5.7	6.7	7.1	7.7	1 224.4	1 565.7	1 686.8	1 804.9	250.1	215.3	142.7	0.0
4	Finance & Devt. Planning	7 815.8	8 756.8	8 501.6	10 276.1	795.0	1 311.7	1 394.8	1 475.2	332.9	260.2	219.0	0.0
5	Trade & Industry	4.5	2.5	2.5	2.5	60.3	71.9	76.9	81.7	42.5	52.0	30.0	0.0
7	Justice	2.1	8.5	9.0	9.5	209.3	266.0	285.9	305.6	11.5	8.4	2.2	0.0
8	Home Affairs	16.5	28.4	32.1	36.3	365.7	420.5	452.5	483.7	12.5	15.0	32.0	0.0
9	Prime Minister's Office	0.0	0.0	0.0	0.0	125.9	136.2	145.3	154.2	0.0	5.0	0.0	0.0
10	Communications, Science & Tech.	4.2	4.8	5.4	6.1	86.1	112.6	120.3	127.9	5.0	259.8	0.0	0.0
11	Law & Constitutional Affairs	0.4	0.8	0.9	1.0	60.9	74.6	79.9	85.0	1.0	0.0	5.0	0.0
12	Foreign Affairs	0.0	0.0	0.0	0.0	240.7	341.1	365.4	389.0	0.0	9.5	0.0	0.0
13	Public Works & Transport	15.8	11.8	12.6	13.5	201.0	235.7	252.2	268.2	436.0	761.7	142.7	0.0
14	Forestry & Land Reclamation	0.0	0.2	0.2	0.2	46.6	63.2	67.7	72.0	13.0	112.0	13.0	0.0
15	Natural Resources	127.3	90.2	102.0	114.2	74.7	90.2	96.8	103.2	436.0	760.7	440.2	0.0
16	Employment & Labour	2.8	4.0	4.6	5.3	37.7	45.4	48.6	51.8	0.0	0.0	0.0	0.0
17	Tourism, Environment & Culture	1.3	9.7	10.6	11.6	56.1	68.5	73.0	77.4	34.9	21.0	19.0	0.0
18	Auditor General	0.2	0.1	0.1	0.1	16.1	18.1	19.5	20.9	0.0	0.0	0.0	0.0
19	His Majesty's Office	0.0	0.0	0.0	0.0	8.4	8.8	9.4	10.1	2.0	10.0	15.0	0.0
20	Public Service Commission	0.0	0.0	0.0	0.0	5.6	6.4	6.9	7.3	0.0	0.0	0.0	0.0
34	Highlands	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	98.0	97.8	105.0	0.0
37	Defence	1.7	8.6	9.2	9.9	341.0	436.1	467.9	499.1	23.0	15.0	28.0	0.0
38	National Assembly	0.0	0.0	0.0	0.0	55.2	58.8	63.5	68.0	0.0	0.0	0.0	0.0
39	Senate	0.0	0.0	0.0	0.0	15.2	16.4	17.6	18.8	0.0	0.0	0.0	0.0
40	Ombudsman	0.0	0.0	0.0	0.0	6.3	8.9	9.5	10.1	0.0	0.0	0.0	0.0
41	Independent Electoral Comm.	0.0	0.0	0.0	0.0	27.1	135.1	32.2	34.2	0.0	0.0	0.0	0.0
42	Local Government	3.7	11.1	12.2	12.9	373.0	388.6	414.7	440.1	136.8	309.5	73.8	0.0
43	Gender, Youth, Sports & Rec.	0.1	0.1	0.1	0.1	61.5	83.7	89.2	94.6	29.0	29.3	25.1	0.0
44	Public Service	1.5	2.5	2.6	2.8	25.5	33.7	36.3	38.7	0.0	0.0	0.0	0.0
	Contingencies	0.0	0.0	0.0	0.0	150.0	160.0	160.0	160.0	0.0	0.0	0.0	0.0
	APPROPRIATION (Budget Format)	8 023.9	8 975.6	8 743.9	10 543.1	5 525.2	7 169.2	7 554.2	8 031.1	2 157.1	3 187.1	1 635.1	0.0
	Annual growth	0.00	0.12	-0.03	0.21	0.00	0.30	0.05	0.06	0.00	0.48	-0.49	~
	Adjustment from Budget Format	-17.9	-8.5	-8.1	-7.8	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
	APPROPRIATION (MTFF Format)	8 192.1	8 975.6	8 743.9	10 543.1	5 525.2	6 769.4	7 446.9	8 174.4	2 157.1	3 414.5	4 356.8	4 901.8
	Difference	-186.2	-8.5	-8.1	-7.8	0.0	-399.8	-107.3	143.2	0.0	-227.3	-2 721.7	-4 901.8

Note: Statutory Expenditures are not included

Excluding contingencies, in 2011/12, Education absorbs the largest share of the recurrent budget (22.9%), followed by Finance & Development Planning (18.7%), Health & Social Welfare (12.%), Defence (6.3%), Home Affairs (6.1%) and Local Government (5.6%).

The Capital Expenditure ceilings are based on the indicative value and phasing of expenditure as captured on the relevant project forms submitted by ministries for the 2009/10 Estimates. However, it has not been possible to reconcile these submissions with the aggregate capital appropriations ceiling (Table 3.10). The amounts are heavily front-end loaded because (i) ministries have not adjusted their financial requirements in line with the impact of capacity constraints on implementation schedules and (ii) virtually no new projects are currently scheduled to start implementation in 20010/11 and 2011/12 as proposals have not been adequately defined to allow their appraisal and inclusion. Thus, the ministerial totals decline very rapidly in 2010/11 because ongoing projects will have been completed. Table 3.9 presents a more realistic pattern of expenditure, which recognises that actual implementation in 2009/10 to 20011/12 will be lower than appropriations, necessitating the carry-over of project activities (and the associated financing) into future years.

Over the three financial years, the largest capital appropriations are to Natural Resources (26.9%), Health & Social Welfare (18.7%), Finance & Development Planning (13.%), followed by Education and Public Works & Transport both registering (8.7%).

3.6 SUMMARY AND CONCLUSIONS

Table 3.11 summarises the main outcomes of the Medium-Term Fiscal Framework with respect to revenue, expenditure and the budget balance. The forecasts of revenue and expenditure are based on the forecast of economic performance and an extrapolation of the current fiscal policy environment. Recent years have seen a significant improvement in the overall fiscal stance and a highly positive outturn (a surplus of M 1,313.8 million) is expected for 2008/09. These surpluses are however expected to turn to deficit over the medium turn, with a M 344.8m deficit forecast for 2009/10, and deficits of 14% and 8% of GDP in the following two years.

Table 3.11: SUMMARY OF THE MEDIUM-TERM FISCAL FRAMEWORK, 2005/06 - 2011/12 (M Million)

	2005/06	2006/07	2007/08	2008/09	2009/10	2010/11	2011/12
Revenue & Grants	4,661.2	6,464.5	7,220.2	8,426.0	9,644.5	8,497.2	10,426.3
of which: Grants	*171.4*	*92.4*	*175.8*	*233.8*	*648.3*	*1,026.5*	*1,238.8*
External Principal Repayments	586.3	229.0	186.6	243.5	385.1	334.8	360.3
Statutory Charges (exc. Principal)	520.5	645.8	669.3	1,285.8	1,239.9	858.2	895.9
Total Ministerial Expenditure	3,742.7	4,410.7	5,175.7	5,828.1	8,757.9	10,079.5	11,149.0
Recurrent Expenditure	3,053.4	3,660.4	4,028.4	4,498.4	6,415.1	7,050.2	7,731.8
of which: Wages & Salaries	*1,289.4*	*1,392.8*	*1,652.7*	*1,944.9*	*2,636.6*	*2,856.5*	*3,067.7*
Goods & Services	*1,063.7*	*1,402.0*	*1,394.5*	*1,394.9*	*2,220.3*	*2,546.1*	*2,930.2*
Transfers & Subsidies	*700.4*	*865.7*	*981.2*	*1,158.5*	*1,558.2*	*1,647.6*	*1,733.9*
Capital Expenditure	689.2	750.3	1,147.3	1,329.8	2,342.8	3,029.3	3,417.1
Net Lending	-9.9	-9.4	-12.7	-1.8	-8.5	-8.1	-7.8
Total Expenditure exc. Principal	4,253.2	5,047.1	5,832.2	7,112.2	9,989.3	10,929.5	12,037.1
Budget Balance (Outturn basis)	408.0	1,417.4	1,388.0	1,313.8	-344.8	-2,432.3	-1,610.8
Primary Balance	624.8	1,725.6	1,684.1	1,442.4	-190.9	-2,309.9	-1,489.2
Current Balance	925.8	2,075.3	2,359.5	2,491.7	1,676.9	245.9	1,424.4
Total Debt Outstanding	4,543.5	5,390.6	6,302.6	7,496.1	8,305.9	8,740.7	8,893.7
of which: Domestic Debt	644.8	700.7	647.7	647.7	533.0	533.0	533.0

Over the medium-term, Revenue including grants are expected to grow at an average annual rate of 7.4% while, on unchanged expenditure policies, Total Expected Expenditure (excluding Principal Repayment) will grow on average by 14.0% per annum. The projected surplus for 2008/09 is M 1,313.8 million but this is expected to turn into a deficit of M 344.8 million in 2009/10. Due to declining SACU revenues and large increases in budgeted expenditure, the deficit is expected to increase to M 2,432.3 million in 2010/11 (14% of GDP) and then M 1,608.8 million in 2011/12 (8% of GDP).

Table 3.12 shows these key fiscal variables as a proportion of GDP. Revenue & Grants will decline from the record outturn of 60.7% in 2006/07 to 53.0% in 2011/12 as a result of slower growth in receipts from SACU and the strong growth in nominal GDP. This ratio remains exceptionally high by developing country standards and reflects the dependence on SACU revenues. Meanwhile, Total Expected Expenditure is budgeted to rise from 49.9% of GDP in 2008/09 to 64.4% of GDP in 2009/10. This is estimated to remain at over 60% for the following two years, and represents an exceptionally high and sustained share of national income that is used for public expenditure.

Table 3.12: KEY FISCAL VARIABLES, 2005/06 - 2011/12 (% of GDP)

	2005/06	2006/07	2007/08	2008/09	2009/10	2010/11	2011/12
GDP (M Million)	9,130.1	10,646.4	12,328.8	14,241.8	15,517.7	17,509.0	19,689.4
Domestic Revenue / GDP	49.2%	59.9%	57.1%	57.5%	58.0%	42.7%	46.7%
Grants / GDP	1.9%	0.9%	1.4%	1.6%	4.2%	5.9%	6.3%
Revenue & Grants / GDP	51.1%	60.7%	58.6%	59.2%	62.2%	48.5%	53.0%
Statutory Charges / GDP	5.7%	6.1%	5.4%	9.0%	8.0%	4.9%	4.6%
Recurrent Expenditure / GDP	33.4%	34.4%	32.7%	31.6%	41.3%	40.3%	39.3%
Wages and Salaries / GDP	*14.1%*	*13.1%*	*13.4%*	*13.7%*	*17.0%*	*16.3%*	*15.6%*
Goods & Services / GDP	*11.7%*	*13.2%*	*11.3%*	*9.8%*	*14.3%*	*14.5%*	*14.9%*
Transfers / GDP	*7.7%*	*8.1%*	*8.0%*	*8.1%*	*10.0%*	*9.4%*	*8.8%*
Capital Expend. / GDP	7.5%	7.0%	9.3%	9.3%	15.1%	17.3%	17.4%
Total Expenditure / GDP	46.6%	47.4%	47.3%	49.9%	64.4%	62.4%	61.1%
Budget Balance / GDP	4.5%	13.3%	11.3%	9.2%	-2.2%	-13.9%	-8.2%
Primary Balance / GDP	6.8%	16.2%	13.7%	10.1%	-1.2%	-13.2%	-7.6%
Current Balance / GDP	10.1%	19.5%	19.1%	17.5%	10.8%	1.4%	7.2%
Domestic + External Debt/GDP	49.8%	50.6%	51.1%	52.6%	53.5%	49.9%	45.2%

The projected outcomes are based on a realistic assessment of the expected resource envelope and of current trends in each expenditure category. However, these outcomes are highly sensitive to unexpected shocks, some of which (such as access to budget support grants and concessional loans) could result in more favourable outcomes of revenue, expenditure and financing. Alternatively, actual outturns could be worse than these forecasts if:

- any policy measures were implemented that caused aggregate expenditure to increase above the forecast levels in 2010/11 and 2011/11;
- changes to the SACU revenue-sharing formula caused a reduction in customs revenue;
- any unexpected shocks led to a deterioration in economic growth and, therefore, revenue collections e.g. if recession in major economies had an adverse impact on demand for textile products; or
- Government failed to secure and disburse the anticipated amounts of grants and concessional loans.

The outcomes generated by the MTFF (on the assumption that the policy environment remains broadly unchanged) indicate that Lesotho is likely to experience a negative medium term fiscal outcome due to declining SACU revenues and increasing expenditures. Although

Lesotho can cope with this during the medium term thanks to previously accumulated reserves, beyond that period, Lesotho's dependence on SACU is a major cause for concern since revenues have already begun to decline to a lower level as a result of the reduced imports. The lower revenue trend may be exasperated in the future as a result of the impact of lower average tariff rates. Indeed, the future of SACU may be threatened by the proposed SADC customs union, which is likely to allocate customs collections on the basis of destination, rather than retaining the current SACU revenue sharing formula.

The overall fiscal environment is precarious with a small budget deficit estimated on an outturn basis during 2009/10, and extremely large deficits forecast in the following two years. Whilst Lesotho is in an exceptionally good position to deal with this, minimum reserves will be put under severe pressure if large deficits continue into 2010/11. In order to cope with this situation in the longer run, during the current MTFF period, Lesotho **must** improve the revenue and expenditure policy environment by:

- implementing major public financial management reforms;
- creating a positive environment for investment and sustained economic growth; and
- improving the quality and productivity of public expenditure by targeting resources at high-priority activities that contribute to accelerating the rate of economic growth and by enhancing the operational efficiency and effectiveness (value-for-money) of all ministerial programmes and projects.

An assessment of the fiscal risks should be undertaken, including studies related to debt sustainability (currently being undertaken) with particular attention paid to the risks of holding external debt in the case of a large exchange rate depreciations.

Specifically, it is extremely necessary to reduce the projected share of public expenditure relative to GDP. Within the aggregate budget ceilings, productivity can be improved by identifying low-priority expenditure programmes and by reallocating resources from programmes and projects which are under-performing to high-priority activities which contribute effectively to the attainment of national development objectives. However, since cutting back existing expenditure commitments has consequences for both service providers and the intended beneficiaries, these reallocations will require difficult political decisions. In addition, budgetary provision must be made for any costs incurred in closing down activities, retrenching staff and terminating contracts for the construction of development projects.

Measures are also required to increase collections of domestic revenue (excluding SACU). In view of the limited revenue policy options (see Section 3.3.2), this depends on expanding and diversifying the revenue base, principally through encouraging faster economic growth. The measures that have been taken on tax policy (complemented by actions to improve the business climate) will create a more favourable investment environment even though Lesotho will continue to face significant external threats to competitiveness. Current efforts include the potential for VAT to be paid quarterly instead of monthly.

Lesotho's position in the Doing Business Indicators has steadily declined over recent years. This loss of relative competitiveness is likely to have a negative impact on economic growth as investors seek friendlier climates for doing business. The current world economic climate, the reduction in SACU revenue receipts, and the large deficits forecast over the medium term mean that it is extremely important to encourage commerce in order to stimulate the economy, provide employment, and widen the revenue base. To this end, greater efforts should be made to accelerate investment climate reforms.

In summary, the Government should improve the prospects for long-term economic and fiscal outcomes through firm and sustained political commitment to:

- maximise revenue collections within the current rate structure by implementing sustained improvements in administration of tax and departmental collections;
- ensure that the full financial costs of any new expenditure programmes can be offset by corresponding savings elsewhere in ministerial budgets;
- make savings on existing resource allocations and reallocate those resources to expanding service provision and the delivery of poverty-targeted programmes;
- improve the quality of capital expenditure by strengthening project cycle management;
- quantify and budget for the financial requirements of contingent liabilities.
- Undertake frequent budget reviews to maintain a close check on performance.

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