KINGDOM OF LESOTHO

MINISTRY OF FINANCE

MEDIUM-TERM DEBT MANAGEMENT STRATEGY

November, 2022

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1. INTRODUCTION

The Public Debt and Aid Management Department (PDAMD) is required to produce an Annual Debt Management Report at the end of every fiscal year to evaluate the performance of debt management operations against the MTDS and the set Annual Borrowing Plan (ABP). This MTDS is therefore prepared by the Ministry of Finance to outline Government's plan in guiding public debt management operations over the medium-term from 2022/23-2024/25.

The production of this strategy and the ABP will assist the Ministry of Finance to execute its duties of implementing the fiscal policy effectively by regularly ensuring that debt acquired to fund the government operations is at manageable costs with prudent level of risk. The strategy will indicate a financing mix and instruments to be issued by the government to bridge its budgetary needs outlined in budgetary statement for each fiscal year.

The scope of the MTDS is the central government debt (both domestic and external) in the medium-term. MTDS Analytical Tool developed jointly by the World Bank (WB) and International Monetary Fund (IMF) was adopted. This tool evaluates the cost and risk characteristics of the existing debt and the medium-term alternative financing strategies. The 2022 MTDS incorporated macroeconomic indicators post COVID-19 and it has been prepared with recognition of the recent Debt Sustainability Analysis results which designated Lesotho in moderate debt distress, coupled with the World Bank classification as a lower middle-income country, implying lessening of concessional resources.

The Government aims to support the development of domestic debt market by issuing debt instruments with maturities preference gradually shifting from short to long-term dated instruments (bonds) in line with the market sentiments. To the extent possible, the Government will continue to borrow from semi-concessional sources while maximising financing resources from few commercial sources for capital projects with high economic rate of return. The targeted funds will be sourced from multilateral institutions, bilateral creditors and Export Credit Agencies (ECAs).

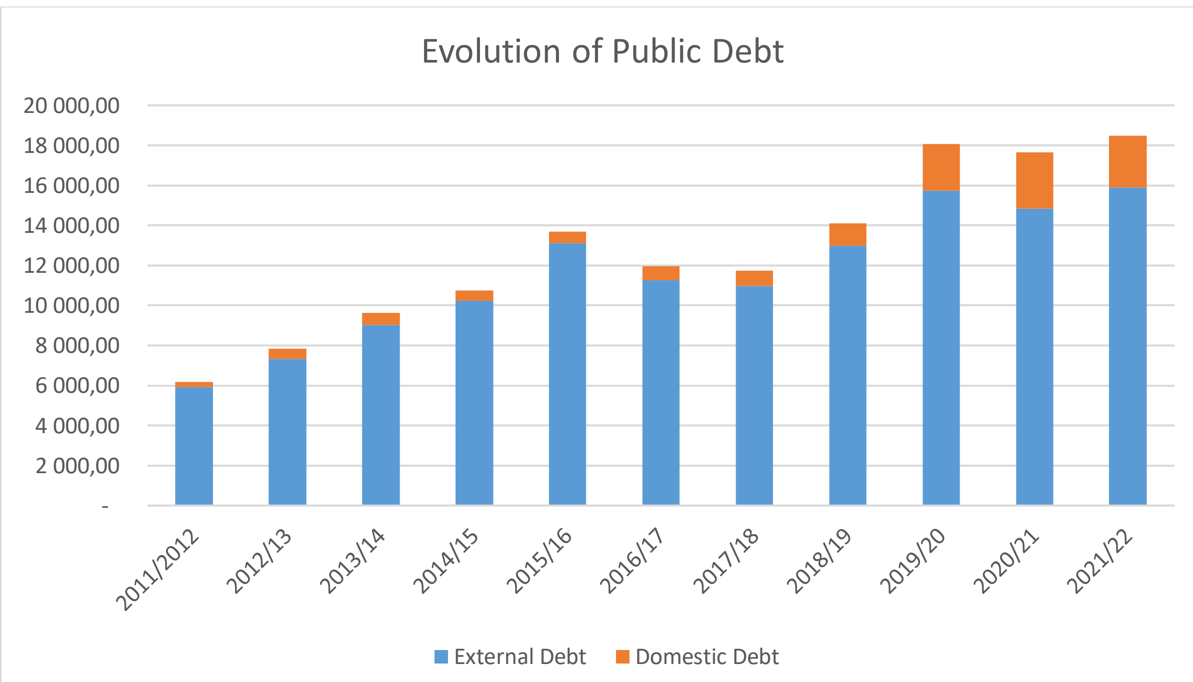
2. PUBLIC DEBT PORTFOLIO REVIEW

The total public debt is comprised of external debt and domestic debt. In March 2022, the total public debt was M18,906.2 million, of which extenal debt was estimated at M15,188.1 million and domestic debt at M3718.1 million. External debt dominates the composition of the total public debt at around 80-90 percent, and is expected to decline in the projected medium to long-term as the share of domestic debt increases.

2.1 Evolution of Public Debt

Figure 1 below depicts the evolution of public debt historically over 10 years. Domestic debt increased sharply in the 2018/19 financial year, due to a M600 million issuance of Treasury bills for budget support. Prior to this year, Treasury bills were only issued for monetary policy purposes. Domestic debt is expected to continously increase in the subsequent years.

Figure 1: Evolution of Public Debt (Millions of Maloti)



Source: Ministry of Finance

The increase in the external debt in 2019/2020 was a result of new disbursements from the COVID-19 pandemic projects, financed by the International Development Association (IDA), as well as, the implementation of the Mpiti-Sehlabathebe Road and the Ramarothole Solar Project financed by the Export-Import Bank of China. In addition, the increase was due to depreciation of Loti against other currencies in which the external debt is denominated.

2.2 Public External Debt by Creditor Category

The external debt portfolio consists of various financiers, and is dominated by multilateral creditors. The disbursed outstanding debt (DOD) for mutlilateral creditors grew at a steady rate per year since 2017/18, with the exception of the pandemic period 2019/20 where the exchange rate fluctuations and new disbursements for COVID-19 related loans from the World Bank accelerated the increase. The multilateral creditors in the debt portfolio include the International Development Association(IDA), African Development Fund(ADF), International Fund for Agriculture Development(IFAD), European Investment Bank (EIB), etc.

Table 1: Public External Debt by Creditor Category (Millions of Maloti)

	2017/18	2018/19	2019/20	2020/21	2021/22
Bilateral	954.8	1,002.2	1,223.4	989.2	956.7
Multilateral	9,372.2	11,004.8	13,326.8	12,285.2	12,109.6
Commercial	0.3	0.3	-	-	-
Export Credits	650.7	987.7	1,176.8	1,574.4	2,121.8
Total External DOD	**10,978.0**	**12,995.0**	**15,727.0**	**14,848.8**	**15,188,1**

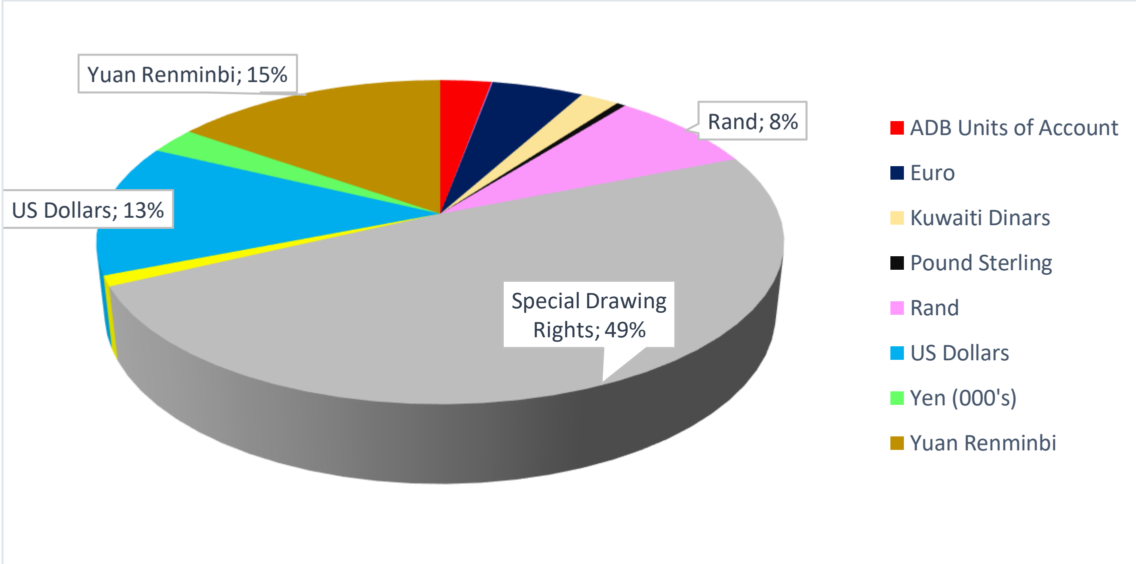
Source:Ministry of Finance

Debt owed to export credits grow while bilateral creditors' debt declines. The increase to export credits emanates from the implementation of the projects financed by the Export-Import Bank of China, which commenced in 2019/20.

2.3 Public External Debt by Currency Composition

The proportion of debt denominated in XDR has continuously accounted for the largest share of external debt and currently contributes almost half of the entire portfolio (49%). The Yuan Renminbi and the US Dollar are also significant.

Figure 2: Public External Debt by Currency Composition



Source: Ministry of Finance

2.4 Public External Debt Service

The external debt service increased steadily in the past five years. The increase in 2019/20 was attributed largely to the depreciation of Loti to other currencies during the COVID-19 pandemic period.

Table 2: Public External Service (Millions of Maloti)

	2017/18	2018/19	2019/20	2020/21	2021/22
Principal Repayments	528.6	591.9	765.0	742.9	644.1
Interest Payments	215.9	226.6	239.8	261.8	238.1
Total Debt Service	**744.5**	**818.5**	**1,004.8**	**1,004.7**	**882.2**

Source: Ministry of Finance

2.5 Debt Service Suspension Initiative (DSSI)

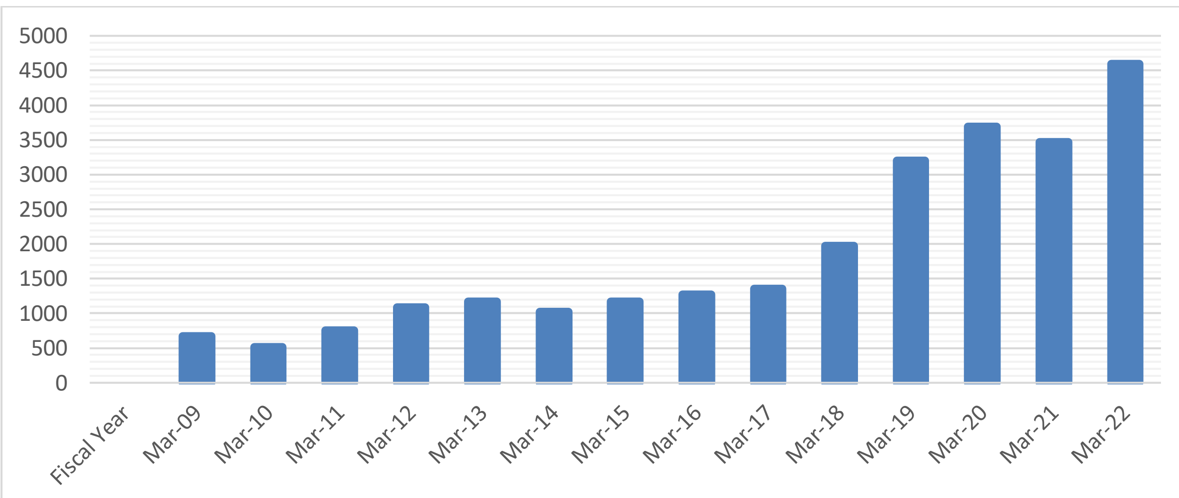
As a response to COVID-19 pandemic, the G20 established Debt Service Suspension Initiative (DSSI) for developing countries. The DSSI helped countries in the fight against the pandemic. Lesotho participated in this initiative between May 2020 and June 2021. However, few bilateral creditors contributed towards this initiative; Natixis, Saudi Fund for Development, and Kuwait Fund for Arab Economic Development. They collectively contributed approximately 6 percent (M128 million) of the total public debt service during the DSSI period. This implies that Lesotho did not benefit much from the DSSI as there was very little saved.

2.6 Domestic Debt Portfolio Review

2.6.1 Trends in Domestic Debt

The stock of domestic debt increased from M2592.9 million as at March 2021 to M3718.1 million in March 2022, reflecting increased borrowing to finance the budget.

Figure 3: Evolution of Domestic Debt

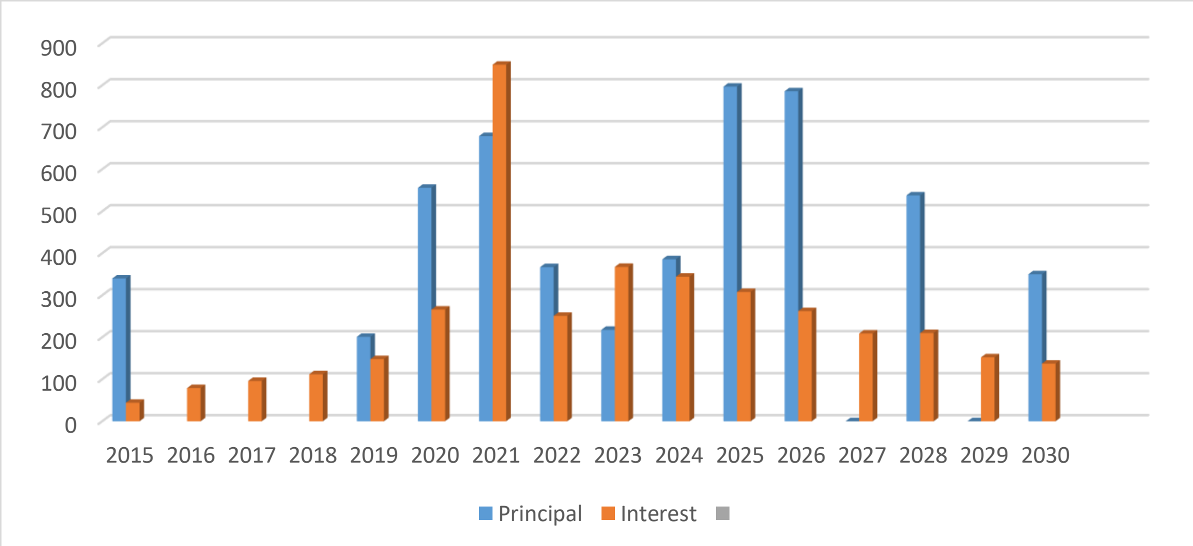


Source: Ministry of Finance

2.6.2 Domestic Debt Redemption Profile

The debt service profile depicts a smooth profile of existing debt. However, there was debt servicing pressure between 2020 and 2021 because of the augmented issuance of Treasury bonds and Fiscal bills to bridge the fiscal gap during the COVID-19 pandemic. Nonetheless, the debt service forecast show less pressure on debt service in the projection years.

Figure 4: Domestic Debt Redemption profile



Source: Ministry of Finance

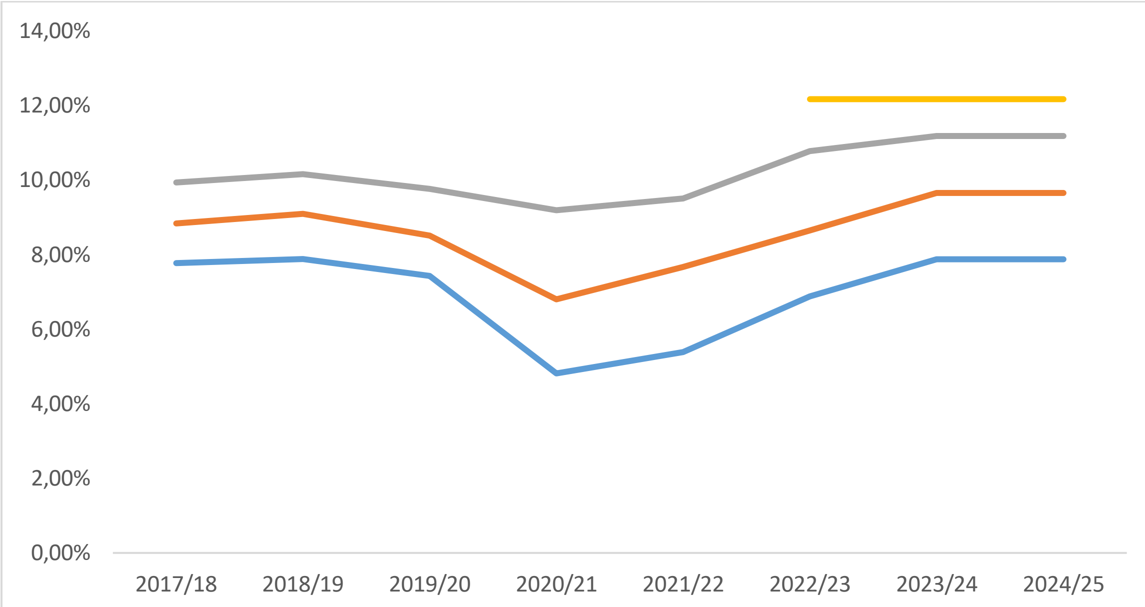
2.6.3 Yield Curve Trend

Prior to COVID-19, the yield curve's trajectory showed a downward slope. The reduction is linked to the adoption of prudent monetary and fiscal policies, as well as increased demand for Government securities.

Between the fiscal years 2020/21 and 2021/22, the yields have been increasing amid COVID-19 and the Russia-Ukraine war. Therefore, using the three-year average and interest rate differentials, the yields are expected to continue rising during the first projection year, albeit by marginal percentage points, as the conditions of the past three years still prevail currently (COVID-19 and Russia-Ukraine war).

However, given the uncertainty and instability existing in the markets today, the 2022/23 to 2023/24 projection years are fixed. With the assumption that the phase of the crises will have levelled out and the rates will therefore even out. The over 10-year yield is projected to be constant in the review period once it is issued.

Figure 5: Yield Trends



Source: Central Bank of Lesotho

2.7 Cost and Risk Indicators of Existing Debt

Lesotho's current borrowing is skewed towards external financing (figure 6 and table 5 in the appendix), which generally exposes it to considerable amounts of foreign exchange rate risk, little interest rate and refinancing risks coming from 364-day Treasury bills.

2.7.1 Interest Payments

Domestic debt takes up the larger share of the total interest payment as a percent of GDP, and carries more weight of the total weighted average, which makes it considerably more expensive. This is not worrisome as domestic borrowing has a smaller share of the total borrowing.

2.7.2 Refinancing Risk

The Average Time to Maturity (ATM) of total existing debt is 9 years, which is relatively low and as such, the current portfolio is exposed to refinancing risk. This is more attributed to domestic debt with the ATM of 3 years and it puts the most pressure on the government to repay. Debt maturing in one-year accounts 7.6 percent of the total debt and constitutes 6 percent of GDP.

2.7.3 Interest rate Risk

The existing portfolio is dominated by fixed rate instruments which shields it against interest rate risk exposure. The proportion of fixed rate debt to total debt is 99.8 percent. The share of debt with interest rate re-fixing in one year is 7.7 percent of the total debt of which 3.7 percent is short-term debt (Treasury bills). Average Time to Re-fixing (ATR) for the whole portfolio is 9 years. The share of debt with interest rate re-fixing in one year is 7.7 percent of the total debt.

2.7.4 Foreign Exchange rate Risk

The existing debt portfolio is dominated by external debt accounting to 78.4 percent of the total debt, which makes it prone to exchange rate volatility. Short-term external debt accounts for 8.5 percent of the reserves.

3. OVERVIEW OF ECONOMIC PERFORMANCE

3.1 Recent Economic Developments

Following the emergence of the pandemic, stringent restrictions were executed that led to demand and supply disruptions globally and locally. There were closure of international diamond trading centres and non-essential businesses, suspension of construction activities and operations of most local mines while others operated at half capacity. Additionally, growth potential was derailed further as authorities reallocated funds from development to recurrent budget to curb the spread of the coronavirus disease. These adverse effects prompted economic growth to shrink by 3.9 percent in 2020/21. However, the economic growth recovered by 1.8 percent in 2021/22, owing largely to the reopening of the economy. Similarly, the economy is expected to show a slower growth of 2.1 percent in 2022/23 and average 3.1 percent in the medium-term.

3.2 Medium-term Macroeconomic Projections and Assumptions

The economy is projected to grow by 2.1 percent in 2022/23, before reaching an average growth of 3.1 percent in the medium horizon**.** Key drivers to growth prospects comprise of two mega projects; LHWP II and MCC II. The LHWP II will bolster the construction and tertiary industries while investment in climate smart driven horticulture through the MCC II is envisaged to enhance crop production.

Furthermore, the Government has embarked on ways to improve domestic tax revenue mobilisation by rectifying inefficiencies that create leakages for revenue collection in tax laws and regulations. Consequently, the following bills have been tabled before parliament for approval; value added tax amendment bill, company income tax bill and alcohol and tobacco bill. The enactment of these bills is anticipated to significantly enhance tax revenue collection in the medium-term.

3.3 Downside risks to medium-term outlook

Lesotho has been struggling to maintain macro-fiscal stability attributed to several risks that were intensified by COVID-19 outbreak in 2020/21. These risks include among others, volatile Southern African Customs Union receipts, accelerating recurrent expenditures, declining donor support, accelerating energy and fuel prices, political instability, climate change and natural disasters.

4. FINANCING STRATEGIES

4.1 Debt Management Objectives

The Government's debt strategy for 2022/23-2024/25 is derived from the assessment of four strategies geared towards meeting Government's medium-term debt management objectives. The adopted financing strategy was selected in terms of cost, risk and feasibility, which meets Governments cost and risk appetite but also ensures debt sustainability.

The 2022-2024 MTDS objectives are;

i) Manage the domestic debt refinancing risk by issuing more longer dated securities and reducing the issuance of Treasury bills,
ii) Reduce the external sources of financing and consequently increase domestic financing sources, and
iii) Develop domestic debt market by introducing the 15-year Treasury bond.

4.2 Key Assumptions

The modelling of MTDS utilises forecasts of the Government's fiscal balances and macroeconomic projections in the medium-term fiscal framework (MTFF), to produce baseline estimates for portfolio cost and risk indicators under alternative financing strategies. The key assumptions of the desired financing mix under this

MTDS are discussed below. The changing scenario of economic status will impact the country's potential funding sources and the costs and risks associated with financing availed from different sources.

4.2.1 Macroeconomic Assumptions

The table below highlights key macroeconomic assumptions that impact Governments financing. A decrease in revenues coupled with an increase in expenditure would increase the deficit during the year thus affecting the debt management objectives stipulated above. The credibility of the strategy therefore depends on Governments commitment to keep within the year's projected macro-economic parameters.

Table 3: Macroeconomic Indicators

MILLION LSL	EST.	PROJ.	PROJ.	PROJ.
REVENUE AND GRANTS	**17,569**	**18,537**	**19,109**	**21,747**
O/W GRANTS	1,757	2,263	1,850	1,985
PRIMARY EXPENDITURE	18,730	19,786	20,072	21,446
INTEREST PAYMENTS	442	766	792	820
PRIMARY BALANCE	-2,044	-2,781	-2,547	-1,339
OVERALL FISCAL BALANCE	-1,602	-2,015	-1,755	-519
IN PERCENT OF GDP				
TOTAL REVENUE	50.0	52.8	54.4	61.9
PRIMARY EXPENDITURE	50.3	48.3	44.1	42.5
INTEREST PAYMENTS	1.2	1.9	1.7	1.6
PRIMARY BALANCE	-5.5	-6.8	-5.6	-2.7
OVERALL FISCAL BALANCE	-4.3	-4.9	-3.9	-1.0
REAL GDP GROWTH	1.8	2.1	3.6	3.8
NOMINAL GDP AT MARKET PRICE(LSL)	37,216	40,995	45,484	50,466
NIR (USD)	792	751	729	742
CPI	5.7	8.7	7.6	7.2

Source: Ministry of Finance

4.2.2 Financing Assumptions

i) Gradual decrease of the share of external debt to total debt from 87 percent to 70 percent.

ii) Maximum utilisation of external concessional financing based on projected disbursements of existing financing facilities.

iii) Gradually decrease the reliance on short-term Treasury bills and increase stock of long-term treasury instruments in the medium-term.

iv) In addition to the existing 10-year T-bond tenure, the strategy assumes introduction of a 15-year T-bond to the domestic market from 2023/24. This will assist the Government to reduce its refinancing risk by lengthening the debt portfolio's ATM.

4.3 Analysis of the Proposed Financing Strategies

Alternative financing strategies reflect various means and scenarios that can allow financing a specific gross borrowing requirement level, including sources of financing and associated impact on the ratio of new external and domestic debt borrowed throughout the analysis period (from FY 2022/23 to 2024/25). Based on the MTDS Tool's ability to simulate different alternative scenarios, outcomes can then be compared to assess various risk and cost indicators associated with simulated strategies. To meet the overall budget deficit, four feasible strategies were analysed. These strategies are based on Governments' existing borrowing practices; probable creditors for ongoing projects and some of the loans that have been negotiated. A strategy entails a different composition of debt instruments and will influence the debt portfolio over the strategy period. The costs of different strategies change under different assumptions regarding interest and exchange rates.

The following four strategies have been identified and complied using MTDS tool:

Strategy 1: Status quo strategy: Continue current borrowing practices - Around 80 percent Gross Financing Needs to be raised from external sources and 20 percent from domestic sources.

Strategy 2: Domestic debt market development: More reliance on longer term domestic Issuances - 30 percent of financing needs to be raised from domestic sources, with relatively more reliance on T-bonds (all maturities including 3,5,7 and 10 years, along with the new 15 years).

Strategy 3: More semi-concessional: More reliance on semi-concessional loans-restructuring of external debt composition by increasing the variable semi-concessional loans from 0.2 percent to 14 percent, at the expense of concessional loans from 18 percent to 15 percent.

Strategy 4: (extreme case): More reliance on commercial loans – characterised by a significant decline in both concessional and semi-concessional loans and borrowing more from commercial sources.

4.4 Considerations for Choice Strategy

The elected strategy will assist the Government in achieving its medium-term debt management targets which addresses portfolio risks arising from exposure to external currency and hikes in redemption profile. In particular, the strategic reduction of annual external borrowings' ratio over the medium-term and increasing the issuance of longer-term domestic instruments will help achieve the set targets.

Table 4: Cost and Risk of Alternative Financing Strategies

COST-RISK INDICATORS - Baseline Scenario

Risk Indicators		2021	As at end 2024			
		Current	S1	S2	S3	S4
Nominal debt as percent of GDP		53.1	58.326	58.340	58.339	58.363
Present value debt as percent of GDP		42.8	45.01	45.34	45.65	45.51
Interest payment as percent of GDP		1.8	1.63	1.672	1.647	1.670
Implied interest rate (percent)		3.3	2.95	3.088	3.032	3.109
Refinancing risk2	Debt maturing in 1yr (percent of total)	7.6	9.9850	9.9460	9.9838	9.9818
	Debt maturing in 1yr (% of GDP)	6.0	5.8238	5.802	5.825	5.826
	ATM External Portfolio (years)	9.9	11.9	11.8	11.8	11.5
	ATM Domestic Portfolio (years)	3.4	3.2527	3.8496	3.2535	3.2547
	ATM Total Portfolio (years)	9.0	11.125	10.943	11.019	10.780
Interest rate risk2	ATR (years)	9.0	11.1	10.9	10.7	10.6
	Debt refixing in 1yr (percent of total)	7.7	10.1	10.0	12.0	12.4
	Fixed rate debt incl T-bills (percent of total)	99.8	99.870	99.874	98.001	97.579
	T-bills (percent of total)	3.7	0.452	0.4150	0.4527	0.4545
FX risk	FX debt as % of total	78.4	88.108	86.347	88.106	88.103
	ST FX debt as % of reserves	8.5	12.01	12.01	12.01	12.01

Source: Ministry of Finance

Even though strategy 1 performs marginally better in terms of cost-risk trade-offs and in terms of standalone risk exposures, it may not remain feasible for long. As it is expected that the concessional financing window may no longer be open for Lesotho due to graduation from IDA-only to IDA-blended. Moreover, this strategy would result in the highest exposure to currency risks which may be an important consideration from a long-term perspective. Thus, while strategy 1 remains the dominant strategy in the medium-term, the Government needs to consider other alternative strategies with relatively lower reliance on external concessional financing.

Strategy 4 has the highest interest rate risk and refinancing risk. This is because most commercial credit is offered at variable interest rates. In terms of maturity, they are relatively shorter in nature compared to the status quo, hence the refinancing risk. Strategy 3 is more costly in terms of interest rates and has shorter maturity than concessional loans.

Strategy 2, while a little costly, has the lowest currency risk and refinancing risk of all the four strategies. The cost emanates from the high interest rates as the strategy gradually increases the share of gross domestic financing needs. However, strategy 2 is the most preferred and recommended strategy given that the authorities are keen to strengthen the development of the domestic debt market. In addition, since Lesotho is graduating from IDA-only to IDA-blended, it needs to create room and take necessary measures to develop the domestic bond market in order to keep pace with economic growth through maintaining fiscal sustainability and avoiding the middle-income trap as a developing country. Furthermore, the difference between commitment and actual disbursement of concessional financing is significant and graduation from IDA-only may reduce the inflow of concessional external funds even further. Overall, strategy 2 seems to align with the MTDS objective by increasing the share of marketable securities in the medium-term.

4.5 Strategy Implementation and Recommendations

The implementation of the strategy would be a challenge for the debt management entities if the recommended reforms are not possible to carry forward. Implementation challenges arise when actual borrowing operations are not properly aligned to the approved strategy. However, the review of MTDS on an annual basis should address this challenge. Furthermore, formally adopting a debt management strategy facilitates a proper structure of delegation and accountability. The MTDS provides an opportunity to communicate important reforms/policy measures that would require to be initiated to support the strategy. This would work only in conjunction with solid accountability, requiring accurate and timely reporting. It also needs active coordination among the debt management office. Importantly though, the strong commitment to implementing the debt management strategy from the highest policy level remains unwavering and will go a long way to implement the current MTDS.

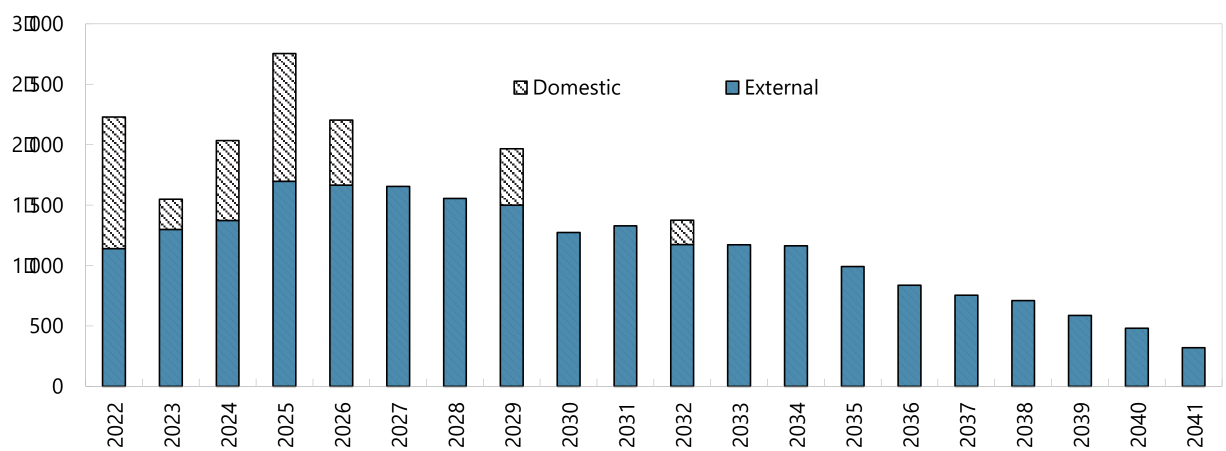
APPENDIX

Table 5: Cost and Risk of Existing debt

Risk Indicators		External debt	Domestic debt	Total debt
Amount (in millions of LSL)		15,188.1	3,718.1	18,906.2
Amount (in millions of USD)		1,048.9	288.6	1,337.4
Nominal debt as percent of GDP		40.8	10.0	50.8
PV as percent of GDP[1]		31.3	11.5	42.8
Cost of debt[2]	Interest payment as percent of GDP[3]	**0.8**	**0.9**	**1.8**
	Weighted Av. IR (percent)	**2.0**	**8.2**	**3.3**
Refinancing risk[2]	ATM (years)	**9.925**	**3.4**	**9.0**
	Debt maturing in 1yr (percent of total)	**4.5**	**25.5**	**7.6**
	Debt maturing in 1yr (percent of GDP)	**3.1**	**2.9**	**6.0**
Interest rate risk[2]	ATR (years)	**9.920**	**3.4**	**9.0**
	Debt refixing in 1yr (percent of total)	**4.7**	**25.5**	**7.7**
	Fixed rate debt incl T-bills (percent of total)	**99.8**	**100.0**	**99.8**
	T-bills (percent of total)	**0.0**	**25.5**	**3.7**
FX risk	FX debt (percent of total debt)			78.4
	ST FX debt (percent of reserves)			8.5

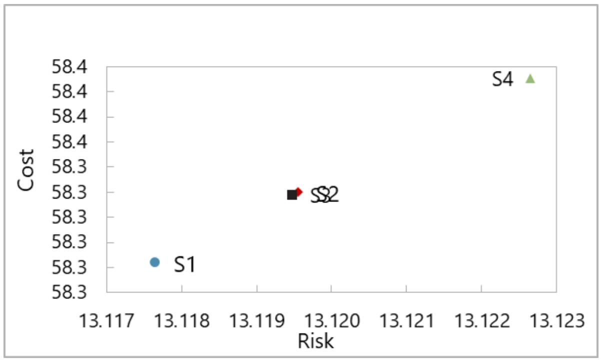
Source: Ministry of Finance

Figure 6: Redemption Profile of Existing External and Domestic Debt



Source: Ministry of Finance

Figure 7: Debt to GDP



Source: Ministry of Finance

Figure 8: Interest to GDP

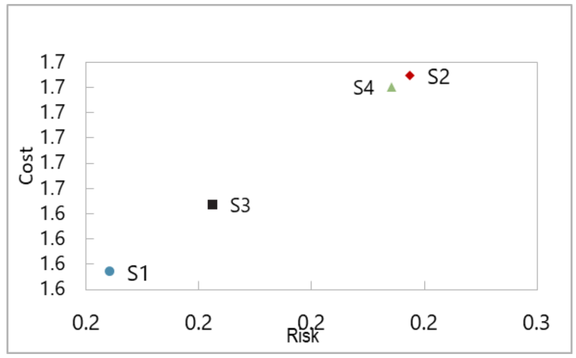
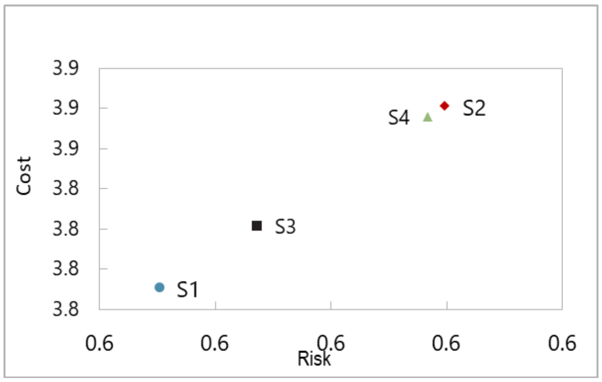


Figure 9: Interest to Revenue



Source: Ministry of Finance