Lesotho

2011

www.africaneconomicoutlook.org


FREE STATE
SOUTH AFRICA
KWAZULU NATAL
SOUTH AFRICA
EASTERN CAPE
Butha-Buthe
Leribe
(Hlotse)
Maputsoe
Peka
Mapoteng
Teyateyaneng
MASERU
Mazenod
Roma
Mantsonyane
Morija
Tsa-Kholo
Mafeteng
Thaba
Tseka
Mokhotlong
Sehonghong
Semonkong
Sehlabathebe
Mohale's Hoek
Qacha's Nek
Mount
Moorosi
Quthing
Airport
Main Road
National Capital (210 000 In. 2007)
Main city
other main city
0 km
12.5
25
37.5 km
This map is for illustrative purposes and is without prejudice to the status of or sovereignty over any territory covered by this map.

Lesotho

Overview

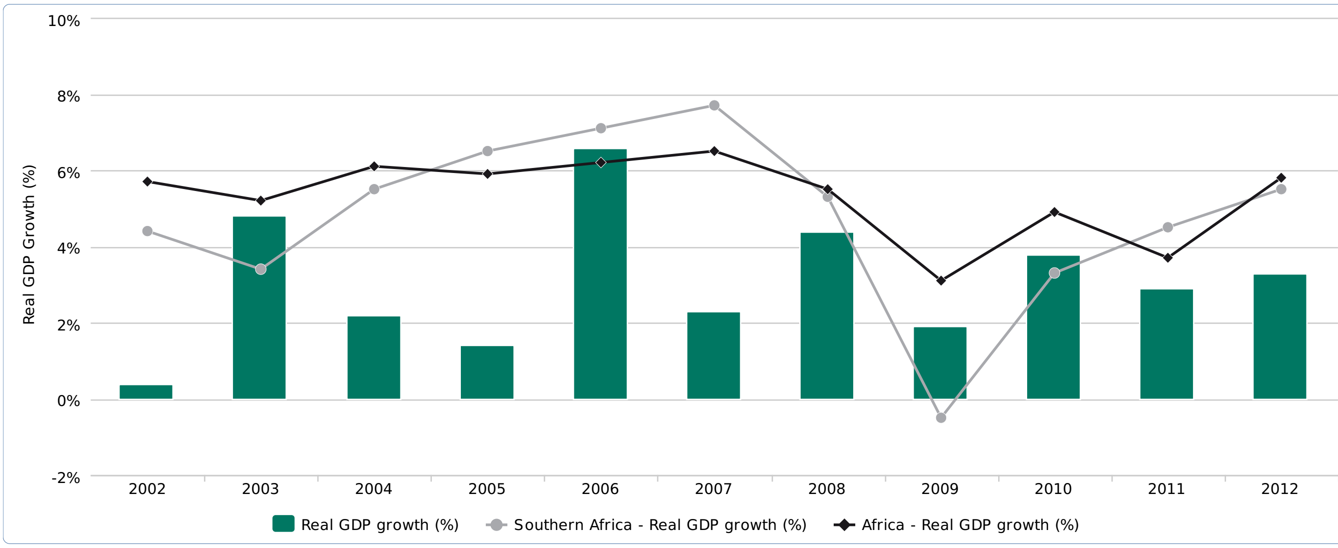
There are signs of Lesotho's economic recovery from the effects of the global financial crisis, but the damage caused to this small and open economy may last for a while. Lesotho's high export concentration left it vulnerable to the global economic downturn. This was exacerbated by Lesotho's dependency on South Africa, a country that was also affected by the collapse in commodity prices. Lesotho's economic growth declined by about 4.4% in 2008 to 1.9% in 2009. As the global economy began to recover, however, Lesotho's gross domestic product (GDP) in 2010 grew by an estimated 3.8%. This recovery in economic growth can be attributed to both firming commodity prices and high government capital expenditures. The mining and construction sub-sectors, in particular, experienced some buoyancy. In addition, rising commodity prices led to the improved viability of mining activities, resulting in the reopening of some of the mines that had shut down at the peak of the crisis. Furthermore, the government's focus on infrastructure development is driving activity in the construction sector.

Recent efforts by the government of Lesotho to diversify the economy are gaining traction. Thanks to the development of manufacturing, services and the export of water resources, the economy is relying less on subsistence agriculture and remittances. The textiles sector is now the largest employer in the manufacturing sector. Its competitiveness, however, has been negatively affected by the appreciating rand and increased competition from Asian suppliers, and both investment inflows and employment in the sector have declined. Net foreign private capital also fell in 2010, a trend likely to continue in 2011.

The country's growth is expected to be lower in 2011 than in 2010 as no major investments are expected, while recovery in the global economy remains weak. In addition, growth in 2011 is likely to be dampened because of a projected high current-account deficit resulting from higher imports to meet requirements for projects in the construction sector, compounded by continued low Southern Africa Customs Union (SACU) revenues. Slower growth in government expenditure is also a factor in the lower projected economic growth. The government has taken measures, amongst others, to reduce its current expenditure, which includes a freeze on government jobs, and has also committed not to fund new projects during the current fiscal year, 2010/11.

Although the government of Lesotho is making efforts to reduce its budget deficit, it has maintained infrastructure development as a priority. This infrastructure is intended to link remote areas to markets and to enable new investments that would provide opportunities for value addition, especially in the agriculture sector. The country's business environment has remained poor, impacting negatively on inward investments and trade competitiveness. To a large extent, the poor business environment has curtailed the expansion of private-sector activities, and government still accounts for nearly 50% of Lesotho's GDP. Current efforts to improve the business environment are likely to increase private-sector activities. The fundamental elements of this process, however, are either in the very early stages of implementation or have yet to be fully developed and implemented. The passing of the Land Act (2010) and the establishment of the land register, with the pilot phase completed in 2010, will go a long way to address the challenges of financing small- and medium-scale enterprises (SMSEs) and improve the country's attractiveness for foreign investment. The government has also made substantial progress in drafting and completing its industrial and competition policies.

Figure 1: Real GDP growth (S)



Source: IMF and local authorities' data; estimates and projections based on authors' calculations.

Figures for 2010 are estimates; for 2011 and later are projections.

StatLink http://dx.doi.org/10.1787/888932412065

Table 1: Macroeconomic indicators

	2009	2010	2011	2012
Real GDP growth	1.9	3.8	2.9	3.3
CPI inflation	7.3	7.3	7.8	6.8
Budget balance % GDP	-4.9	-9.8	-11.3	-3.4
Current account % GDP	-0.2	-14.9	-14.5	-5.4

Source: National authorities' data; estimates and projections based on authors' calculations.
Figures for budget balance refer to fiscal year April (n)/ March (n+1).

Figures for 2010 are estimates; for 2011 and later are projections.

StatLink http://dx.doi.org/10.1787/888932414421

Recent Economic Developments and Prospects

Table 2: GDP by sector (in percentage)

	2005	2009
Agriculture, forestry, fishing & hunting	8.3	7.6
Agriculture, livestock, fishery, forestry and logging	-	-
of which agriculture	-	-
of which food crops	-	-
Mining and quarrying	3.8	8.3
Mining, manufacturing and utilities	-	-
of which oil	-	-
Manufacturing	19.5	18
of which hydrocarbon	-	-
Electricity, gas and water	5.3	4.3
Electricity, water and sewerage	-	-
Construction	4.9	4.7
Wholesale and retail trade, hotels and restaurants	8.8	8.5
of which hotels and restaurants	-	-
Transport, storage and communication	6.7	6.5
Transport and storage, information and communication	-	-
Finance, real estate and business services	19.4	20
Financial intermediation, real estate services, business and other service activities	-	-
General government services	-	-
Public administration & defence; social security, education, health & social work	-	-
Public administration, education, health	-	-
Public administration, education, health & other social & personal services	-	-
Public administration, education, health & social work, community, social & personal services	-	-
Public administration, education, health & social work, community, social services	23.4	22.2
Other community, social & personal service activities	-	-
Other services	0	0
Gross domestic product at basic prices / factor cost	100	100

Source: Data from Lesotho Bureau of Statistics.

Figures for 2010 are estimates; for 2011 and later are projections.

StatLink http://dx.doi.org/10.1787/888932415390

Although there was recovery in Lesotho's economic growth in 2010, the economy is likely to suffer another slowdown in growth in 2011 owing to a tight public-expenditure regime as well as to non-recovery in SACU revenues. GDP growth in 2011 is projected at 2.9%. The deterioration in the fiscal position following the government's expenditure expansion in response to the economic slowdown in 2009 raised questions on the sustainability of such a course of action. SACU revenues, in particular, which account for nearly 60% of total tax revenues, declined by about 23%, generating a 4.9% deficit in the fiscal balance in 2009. This deficit is expected to widen further to 9.8% and 11.3% in 2010 and 2011, respectively.

Significant recovery in the volume and prices of diamond helped to increase export revenues in 2010. The Liqhobong and Kao mines, which had suspended operations during the financial crisis, have resumed operations, and new mines, Mothae and Lemphane, have started up. On the other hand, exports from the textiles sector are likely to remain weak because of competition from Asia and slow recovery in the United States (US). Lesotho is also a relatively high-cost source for American buyers compared with its Asian and South American competitors. This is partly explained by the unit costs faced by Lesotho's producers, which in 2010 were almost 80% higher than those of Pakistan, the lowest-cost supplier. Appreciation of the rand, to which the loti (plural: maloti) is pegged, has also reduced the competitiveness of the textiles and clothing sector. The rand is reported to have appreciated by more than 8% in 2010. The Lesotho Textiles Exporters Association has requested government support to address this problematic situation in the short run. Such support is unlikely to be granted, however, as the government is facing a tight fiscal position.

While the recovery in the mining sector has helped absorb returnees from South Africa's mining sector, the growth in export receipts from this sector is not expected to offset the decline in remittances, which have been a major source of income for many Basotho families for decades. These factors, together with the low SACU revenues, are putting pressure on the current account balance. This is worsened by the fact that Lesotho is due to repay an estimated LSL 2.9 billion to the SACU Common Revenue Pool (CRP) in 2010 and 2011. Net SACU revenue flows are therefore expected to fall by 57%, from LSL 4.9 billion in 2009/10 to just LSL 2.1 billion in 2010. The current-account balance is estimated to worsen from its 2009 USD 7.9 million deficit by nearly USD 400 million more in 2010, widening the deficit from 0.2% to 14.9% of GDP during this period.

Despite economic recovery in South Africa and in the global economy, SACU revenues, which averaged 37% of GDP in 2006-08, are not expected to recover to pre-crisis levels in the future. Continuing trade liberalisation in the region, in particular the institution of a Southern African Development Community (SADC) customs union and other bilateral arrangements, along with a possible change in the revenue sharing formula may result in a decline in trade taxes as a share of total tax revenue. Projections suggest that SACU revenues will stabilise at around 20% of GDP in the medium term.

The worsening fiscal and current account deficits have led the government of Lesotho to embark on policy- and structural-reform processes aimed at fostering private-sector activity. Such reforms include the enactment of a new Land Act and revisions to the Financial Institutions Act. While fiscal adjustments are necessary for macroeconomic stability, expenditures on social sectors also need to be maintained. Maintaining high social expenditures, particularly in the health sector, is important because of the high prevalence of HIV/AIDS. In addition, Lesotho is the smallest and the only low-income country (LIC) in the SACU region. This means that stimulating private-sector investments is imperative for accelerating growth and productivity in the economy, all of which are important for raising per capita income. The need for a vibrant private sector is even more critical in a context of fiscal constraints, which argue against increasing the role of government in propelling economic growth in the medium term, especially given its current high share of GDP.

Inflation in 2010 stood at 7.3%, the same as in 2009, but increases in electricity tariffs and the projected depreciation of the rand in the year ahead are likely to push up inflation in 2011 before declining to 6.8% in 2012. Inflation is therefore not expected to meet the targeted 3-6% policy range. Regarding the exchange rate, the projected macroeconomic imbalances would have implied a higher depreciation of the loti than that projected due to its pegging to the rand. The focus on improving the business environment to a level similar or better than that of neighbouring countries is therefore important for Lesotho to attract foreign capital. This would compensate the policy limitations that the country is facing given the existing arrangements in the Common Monetary Area (CMA), in which the South African Central Bank determines monetary policy for the region.

Although the agricultural sector is vital for the rural livelihoods of the Basotho, its importance as a growth driver has been dominated by services and industrial activities. Almost 74% of the rural population depends on agriculture for its livelihood, but at the sectoral level, agriculture currently constitutes less than 8% of total GDP compared with more than 42% for services and about 19% for manufacturing. Agriculture is largely based on small-scale farming with little mechanisation. This is explained by the land-tenure system and to some extent by the terrain of the country. Moreover, the sector is vulnerable to seasonal rainfall levels. As a consequence, productivity in the agriculture sector is low. Income derived from agriculture is therefore minimal, partly explaining the high poverty rates in the rural areas. In response, the government is promoting block farming, where land holdings belonging to different owners are combined into larger blocks that would allow single-crop production so that it becomes viable to use machinery and benefit from extension services.

Lesotho is also food insecure and relies on maize imports from South Africa, even during good seasons. In this context, the government, in conjunction with the United Nations Food and Agricultural Organization (FAO), instituted an input-supply scheme. In particular, the government introduced a subsidy of between 30 and 50% on seeds and fertiliser in 2009 while FAO provided inputs to vulnerable families. As a result of these interventions, yields for maize increased by 90% and output for cereals rose by more than 79% in 2009. These interventions were continued for the 2010 season. However, the crops were affected by excessive rain in January 2011.

Recent investments in industry, especially in the textiles and clothing sub-sector and in mining and quarrying, have generated new job opportunities in the country. Textiles and clothing, which accounts for over 80% of all manufacturing jobs, was hit by the global financial crisis. Employment in the textiles and clothing sector declined as a result, shedding about 13% of jobs in 2009 compared with the 2008 level. A slight recovery in employment occurred in 2010, with employment increasing from just over 31 000 jobs to 32 000. Current total employment in the sector remains significantly low compared with the peak of about 48 000 jobs in 2004. Women, who constitute more than 80% of the textiles-sector workforce, have been most affected by these job losses. With about 87% of manufacturing jobs being provided by the textiles sector, job losses in this sector are more visible than in others despite the fact that wages in it are lower than in others. Moreover, the increasing competition from producers in Asia is making the clothing-sector contribution to future economic growth uncertain. In contrast, the mining and quarrying sector is expected to grow by an average of 14.3% from 2009 to 2012. Activity at the Letšeng-la-Terae mine is expected to anchor growth in the sector. The Liqhobong mine, which reopened at the end of 2009, and the new Mothae mine, which started operations in 2010, are both expected to produce at full capacity in 2012.

Construction services have shown strong growth – almost 7% between 2007 and 2009 – but slowed down in 2010. Overall, services have grown at an average rate of about 3% between 2008 and 2010. This growth has been supported by investments in infrastructure, especially in the Metolong Dam, which is also receiving joint financing from the Millennium Challenge Account (MCA) and the Lesotho Highlands Water Project II (LHWP II), a Lesotho and South Africa bi-national water project. The Metolong Dam, which is expected to cost about USD 413 million is scheduled to be completed by 2013 and will help to meet the increasing domestic demand for water resulting from rapid urbanisation. Another flow of about LSL 12 billion (USD 1.7 billion using the December 2010 exchange rate) in investment for the LHWP II, planned for 2012 to 2017, is likely to make infrastructure projects a dominant factor in supporting Lesotho’s growth over this period.

Phase 2 of the LHWP includes the construction of the Polihali Dam at Tlokoeng in the Mokhotlong District. The Polihali Dam involves the construction of a 165-metre-high dam wall and a 2.2 billion cubic metre reservoir. Water harvested from Polihali will flow into South Africa through a series of transfer tunnels via the Ash river in Free State and then into the Vaal river system. When completed, this project is expected to generate significant revenues for Lesotho.

Other services sectors have also grown significantly in recent times. Transport and communications, and the financial sector grew by more than 11% between 2008 and 2010, while the wholesale and retail sector recorded 4.7% over the same period. The financial services reform and innovations expected to simplify transactions might result in further growth of the sector in the next three years.

A slowdown in total investment and consumption, as well as the projected high current–account deficit, is expected to result in low growth in 2010 and 2011. Growth in public and private consumption in 2010 has been estimated at 6% and 4.8%, respectively, down from more than 16% for both expenditure components in 2009. The sharp slowdown in private consumption was a result of an 8% fall in remittances from South Africa in 2010 compared to 2009. In spite of a projected recovery in remittances in 2011, remittance flows are expected to remain below their 2008 level until 2013. The slowdown in total investment expenditures was less than that recorded for consumption; investment growth in 2010 was 5% lower than levels realised before the financial crisis. Foreign direct investment (FDI) has also been declining, from its peak of USD 106 million in 2007 to USD 64 million in 2010. Economic growth in Lesotho would have been severely affected were it not for the continuing infrastructure investment projects, which are being supported by donors and government loans.

Recent economic developments suggest that while agriculture remains important for ensuring broad-based growth, diversifying production and generating jobs in other sectors, manufacturing and services in particular, have a greater potential to reduce poverty. Experience from the investments in the textiles and clothing sector, and more recently in mining and electronics, has demonstrated Lesotho’s potential to address its unemployment problem. To realise increased investment flows, however, the country has to do more to establish an investment-friendly environment, a process that has already begun but might need to be accelerated.

Table 3: Demand composition

	Percentage of GDP (current price)		Percentage changes, volume			Contribution to real GDP growth		
	2002	2009	2010	2011	2012	2010	2011	2012
Gross capital formation	30.9	27.4	8.7	3.8	2.5	3.6	1.6	1.1
Public	10.9	13	10	2.5	-2	1.9	0.5	-0.4
Private	20.1	14.4	7.5	5	6.5	1.6	1.1	1.5
Consumption	145.9	132.8	5.3	2.5	2.3	6.6	3.2	2.9
Public	37.1	39.3	6	4	3	3	2	1.5
Private	108.8	93.5	4.8	1.6	1.8	3.6	1.2	1.3
External sector	-76.8	-60.2	-	-	-	-6.4	-1.9	-0.6
Exports	65.1	56.8	2.3	3	3.2	1.8	2.4	2.5
Imports	-141.9	-117.1	5.6	2.9	2.1	-8.2	-4.3	-3.2
Real GDP growth rate	-	-	-	-	-	3.8	2.9	3.3

Source: Data from Lesotho Bureau of Statistics and Central Bank of Lesotho; estimates (e) and projections (p) based on authors' calculations.

Figures for 2010 are estimates; for 2011 and later are projections.

StatLink http://dx.doi.org/10.1787/888932416359

Fiscal Policy

The Lesotho government scaled up infrastructure investments with the aim of fostering shared growth and poverty reduction by improving competitiveness, facilitating domestic and international trade, and enhancing the continent's integration into the global economy. The share of capital expenditure rose from 13.0% of GDP in 2007 to 14.6% in 2010. However, the increase in capital investments coincided with a sharp drop (57%) in SACU revenues. As a result, after five straight years of budget surpluses, Lesotho incurred its first fiscal deficit in 2009. As stated above, the fiscal deficit is projected to widen in 2010 and 2011. Lesotho is committed to maintaining a sustainable macroeconomic environment. To do so, the government has started implementing measures intended to contain its expenditure, even though it is also committed to completing ongoing infrastructure projects. Financing of infrastructure projects is mainly expected to come from drawing on government deposits at the central bank and issuing domestic bonds, as well as securing grants and concessional funding from development partners.

In addition to cutting down expenditure, the government of Lesotho is also taking steps to enhance its revenue mobilisation. Various measures came into effect in 2010, which include restrictions on new recruitments and freezing the number of civil-service positions. Further saving is planned through changes in diplomatic missions, restrictions on international travel, cuts on furniture and equipment purchases, and outsourcing of non-core functions. The savings realised thanks to these measures are expected to be channelled into capital expenditure aimed at enhancing the business environment for small- and medium-scale investors, whose role in job creation is critical.

The government acknowledges that SACU revenue flows have been unpredictable, hence the need to identify alternative internal revenue sources. There is general consensus amongst analysts that SACU revenues may never recover their pre-crisis levels given the ongoing changes to regional and global trade arrangements. In this regard, the government has decided that SACU revenues would not finance current expenditure. Enhancing internal revenue collection has therefore become a priority. The government has taken steps to enhance the Lesotho Revenue Authority tax collection capacity with technical assistance from the US Treasury Department. In addition, rates, charges and fines have been revised upwards. The Lesotho Revenue Authority is also in the process of profiling tax payers and collecting outstanding tax arrears.

The budget deficit for 2010 is expected to be 9.8% of GDP. Any underperformance in revenue collection or failure to control expenditure, however, could see the deficit rise to 11.3% in 2011. Efforts to contain any increase in expenditure are therefore critical in ensuring a quick return to a sustainable fiscal position.

Table 4: Public finances (percentage of GDP)

	2002	2007	2008	2009	2010	2011	2012
Total revenue and grants	47	62.3	66.7	66.2	44.1	40.5	45.5
Tax revenue	36.3	55.4	58.2	56.9	30	26.9	33.5
Oil revenue	-	-	-	-	-	-	-
Grants	4.2	1.6	2.2	4.4	8.3	7.7	6.2
Other revenues	-	-	-	-	-	-	-
Total expenditure and net lending (a)	51.5	50.8	57.8	71.1	53.9	51.8	48.9
Current expenditure	40.5	39.9	41.4	51.6	40	39.1	37.8
Excluding interest	37.4	37.4	40.6	50.8	39.1	38.4	37.5
Wages and salaries	15.3	15.6	16.5	20	15.5	14.7	13.9
Goods and services	15	11.4	14.1	15.3	12.3	12.2	12
Interest	3.1	2.5	0.9	0.9	0.9	0.7	0.4
Capital expenditure	11	10.8	14.8	19.3	13.2	12.5	11.7
Primary balance	-1.5	14.1	9.8	-4	-8.9	-10.6	-3
Overall balance	-4.6	11.6	8.9	-4.9	-9.8	-11.3	-3.4

a. Only major items are reported.
Source: Data from Ministry of Finance, Lesotho; estimates (e) and projections (p) based on authors' calculations.
Fiscal year July (n-1)/June (n)

Figures for 2010 are estimates; for 2011 and later are projections.

StatLink http://dx.doi.org/10.1787/888932417328

Monetary Policy

Primarily, the Central Bank of Lesotho is mandated to maintain stable prices. The exchange rate is pegged to the South African rand under the fixed exchange-rate arrangements of the CMA. Domestic interest rates also follow those in South Africa. The only instrument that the central bank can use to control money supply is through open-market operations. Money supply increased by 5.8% in the third quarter of 2010 compared with 1.2% in the previous quarter. On an annual basis, the broad money supply had grown by 2.3% in September 2010. The increase in money supply during the quarter was largely driven by a rise in total domestic credit, mainly credit to the private sector. Credit to the private sector rose by almost 12% during the third quarter of 2010.

Repeated oversubscription for all classes of Treasury bills is an indicator of excess liquidity in the system. Oversubscriptions were however higher at the short end than at the long end, with the May 2010 91-day Treasury bills recording 100% oversubscription compared to the 364-day bills, at just over 25%. As a result, the key interest rate (the 91-day Treasury-bill rate) fell from 5.91% in 2009 to 5.89% in September 2010.

In its efforts to raise funding for infrastructure development, the government of Lesotho, in conjunction with the central bank, introduced Treasury bonds in October 2010. The issue amount was LSL 250 million to the end of the fiscal year on 31 March 2011. Bond issues were expected to tap into the savings of the Basotho for investment into the local economy. The Basotho average savings rate was 31% of gross national income (GNI) compared with a 21% investment-to-GNI ratio. In the absence of appropriate local investment vehicles, excess savings over investments were flowing into South Africa. The development of a capital market in Lesotho was therefore seen in a context of broadening investment instruments that could benefit the Basotho people. Small savers benefited from a low threshold for non-competitive bidding that was set at LSL 5 000 or multiples thereof. This development became possible after the 2009 amendments to the 2001 Loans Act. Maturities for the bonds were set at between three and five years, with plans to increase maturities as the market developed.

The debut issue of 27 October 2010 was for three-year bonds intended to raise LSL 50 million with a coupon rate of 8.25% paid semi-annually. As in the case of Treasury bills, the bonds were oversubscribed by about LSL 17 million. Similarly, the LSL 75 million five-year bonds with 9% yields at maturity received total bids of LSL 117.1 million.

In 2010, the Central Bank of Lesotho was able to maintain the 2009 inflation rate of 7.3%. A rundown of foreign currency reserves could not be avoided because of the sharp decline in SACU revenues, which had been previously used to build reserves. Given the importance of international reserves for the maintenance of parity between the rand and the loti, the Monetary Policy Committee (MPC) raised its target for net international reserves to USD 956 million for 2010, the equivalent of six months' import cover. This action put the reserve position in line with the target set to enable Lesotho to access International Monetary Fund (IMF) Extended Credit Facility (ECF) resources.

While the primary objective of the Central Bank of Lesotho is to maintain price stability, it does not have a domestic inflation target. Nor is there an official bank rate (repo rate) at which it would buy government securities. The central bank uses a Lombard rate, however, set for overnight accommodation for commercial banks. The Lombard rate tracks changes in South African interest rates in order to reduce capital outflows. The Central Bank of Lesotho adjusts its Lombard rate so that it is in line with interest-rate developments in South Africa.

External Position

Lesotho's external balance, which recorded surpluses for the greater part of the last decade, turned negative in 2009 and the current account position is projected to deteriorate over the next two years. The trade balance had been negative overall but was covered by large inflows of remittances from Basotho miners in South Africa, SACU revenue transfers and FDI. All three types of inflows declined substantially in 2009/10, with net labour income falling from about USD 501 million in 2008 to USD 430 million in 2009. Further decline has been estimated for 2010, though slower compared with the previous year, with net labour income amounting to about USD 416 million. Miners' wages are estimated to have recovered by a marginal 1% in 2010 and projected to continue to rise in 2011-12. On the other hand, SACU revenue transfers for 2010 have been estimated to be 43% lower than in 2009 and projected to drop further in 2011 before they start to recover. Consequently, the current account moved into a deeper deficit position than in 2009 and has been projected to remain in deficit in 2011 and 2012. Net FDI inflows also declined by about 18% in 2009. Overall, FDI in 2010 was expected to be USD 64 million before rising marginally to USD 66 million in 2011.

As a result of the deterioration in the current account position, Lesotho ran down its external reserves to a level equal to 5.6 months of import cover during the third quarter of 2010 compared with 6.8 at the end of December 2009. As this outcome was contrary to the performance criteria set for access to the ECF of the IMF, the Monetary Policy Committee decided in September 2010 to raise the level of foreign reserves to USD 956 million.

In spite of ongoing efforts to diversify its economy in recent years, Lesotho's export base remains very narrow. Moreover, almost 60% of the country's exports are directed to the US market, with another 20% going into the SACU region. The clothing and textiles and the diamonds sectors account for more than 93% of total export earnings, 73% of which from the clothing sector alone. Given the current challenges to the textiles and clothing sector, it is important that the pace of diversification be accelerated, and this needs to be supported by policy reforms. Investments in the water sector, for instance, have demonstrated the potential that Lesotho has for widening its export-revenue base. Water royalties, which earned the country USD 19 million in 2008, are estimated to rise to USD 22 million in 2010 and are expected to rise on completion of the second phase of the LHWP in 2017.

On the import side, food accounts for about 27% of total merchandise imports while garment inputs constitute 17% of total imports. As with exports, Lesotho's imports originate in a small number of countries, with SACU supplying more than 85% of total imports. Garment inputs are largely imported from Asia, also the source of the largest investments in the country. Lesotho's apparel sector is dominated by East Asian and South African investors. The number of firms operating in the textiles sector is falling. Out of 25 firms at the beginning of 2010, only 20 were still operating by the end of the year.

With regards to services, Lesotho has a long history of labour exports to South Africa, especially of unskilled mine workers. Although there are signs of recovery, the number of Basotho miners in South Africa has been declining since the outset of the global financial crisis in 2008, dropping by more than 15% between the second quarter of 2008 and the first quarter of 2010. Since then, there has been a slow recovery in these numbers.

Lesotho's external debt increased during 2006 as it borrowed to meet its share of financing of the LHWP I. External debt has since declined. Total external debt in 2010 has been estimated at LSL 5.2 billion, the same as in 2009/10, compared with LSL 6.3 billion in 2008. As Lesotho's debt stock rose, interest payments increased by 273% in 2007. In 2010, interest payments are estimated to have dropped to about LSL 61 million. The country's net current debt-to-GDP position is projected to remain slightly above the 40% threshold and its debt-service ratio is projected at less than 5% in the next three years. Lesotho's debt-risk situation is nonetheless rated as moderate. Lesotho thus needs to pay special attention to containing its fiscal expenditure and consolidating the fiscal position.

Table 5: Current account (percentage of GDP)

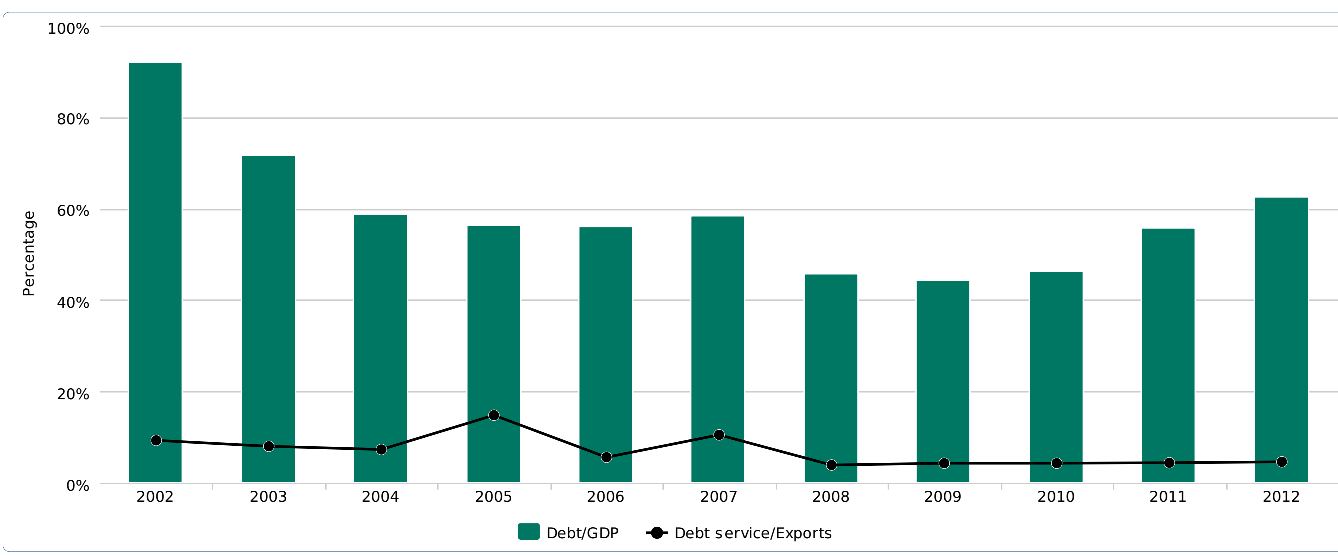
	2002	2007	2008	2009	2010	2011	2012
Trade balance	-60.4	-50.6	-50.9	-54.6	-48	-48	-45.9
Exports of goods (f.o.b.)	53.2	50.9	54.1	43.9	34.5	35.3	35.3
Imports of goods (f.o.b.)	113.6	101.6	105	98.5	82.4	83.3	81.3
Services	-3.1	-2.2	-2.6	-2.1	-2.7	-1.6	-1.8
Factor income	24.1	26.5	31.2	25.6	19	20.5	21.3
Current transfers	18.2	39.7	31.8	31	16.9	14.6	21
Current account balance	-21.2	13.4	9.4	-0.2	-14.9	-14.5	-5.4

Source: Data from Central Bank of Lesotho; estimates (e) and projections (p) based on authors' calculations.

Figures for 2010 are estimates; for 2011 and later are projections.

StatLink http://dx.doi.org/10.1787/888932418297

Figure 2: Stock of total external debt (percentage of GDP) and debt service (percentage of exports of goods and services)



Source: IMF and local authorities' data; estimates and projections based on authors' calculations.

Figures for 2010 are estimates; for 2011 and later are projections.

StatLink http://dx.doi.org/10.1787/888932412065

Structural Issues

Private Sector Development

In spite of Lesotho's liberal investment framework, absence of controls on capital-account transactions and its openness to foreign investors, these latter are facing huge challenges for doing business in the country. These challenges include lack of access to financing, inadequate skills and infrastructure, and a poor regulatory environment. The banking sector is small and dominated by three South African banks, and small businesses continue to rate access to finance as the biggest constraint to business start-ups and expansion. The main challenge lies, however, in providing third-level skills, even though there has been progress in primary and secondary education. With respect to infrastructure, Lesotho has no rail network, only 20% of its total road network (7 091 kilometres) is paved, electricity supplies only 3% of energy needs, and 57% of urban households and about 4% of rural households have access to piped water.

Given that Lesotho is a landlocked country, inadequate infrastructure, coupled with a poor regulatory environment, presents a challenge for business operators, especially in the transport sector. With Lesotho facing the highest costs for doing business in the SACU region, its ability to attract investment, which is critical for growth and job generation, is limited. In the World Bank's *Doing Business* report for 2011, the country is ranked 138th out of a total of 183 countries and territories for "Ease of doing business", comparing poorly to Swaziland's 118th or Namibia's 69th ranking. Moreover, the main focus in the development area, infrastructure, is the one most adversely affected, as dealing with construction permits is associated with the highest costs. In order to address the challenges and in order to be in keeping with the regional trends, the authorities have embraced reforms targeted at reducing the cost of doing business and attracting much needed investments to enhance the competitiveness and productivity of production. The government's approval in 2010 of the Land Reform Bill, supported by the MCA and the World Bank through their private-sector programmes, was one of the major milestones of the year. The Land Reform Act provides for private ownership of land by both Basotho and foreign entities.

Following the coming into force of the Land Reform Act, a target was set to register 8 000 properties by the end of 2010 in both rural and urban areas. By October 2010, almost 6 000 properties had been registered and issued with leasehold certificates. These documents provide holders with legal rights to land ownership, thus acceptable as collateral when borrowing from banks. The Land Reform Act has, as planned, also allowed ownership of land by foreign entities.

Further efforts to reduce business start-up costs are underway. Through the Lesotho National Development Corporation, commercial and industrial sites have been developed and serviced for lease. Factory shells have also been built in the capital, Maseru, and neighbouring areas such as Nyenye, some 80 kilometres north of Maseru.

Other Recent Developments

Lesotho's financial sector is underdeveloped. As access to finance remains a critical constraint for businesses in the country, measures have been implemented to strengthen and enhance access to financial services in conjunction with improvements in the prudential regulation framework. In this regard, in 2010 the Central Bank of Lesotho submitted to parliament the revised Financial Institutions Act and amended the Cooperative Societies Act. These measures were meant to address issues related to the supervision of non-bank financial institutions such as savings and credit co-operatives, and unlawful operations such as Ponzi schemes. In addition, the central bank finalised preparations of the Anti-Money Laundering Act and regulations intended to guide the Financial Intelligence Unit.

Furthermore, there are efforts to introduce an Automatic Clearing House (ACH) designed to broaden access to financial services and reduce the cost of doing business by improving the business climate. The ACH, which is being developed with support from the MCA, is expected to result in significant improvement of the financial infrastructure thereby reducing the clearing cycles of checks, transaction costs of access to cash shared Automated Teller Machines (ATMs) and point of sale (POS) terminals. Although the National Payments Bill of 2009 had not yet been enacted by the end of 2010, preparations for the rolling out of the infrastructure are in process. Together with other reforms in the country, financial-sector reforms are beginning to produce positive results. Credit to the private sector has grown, rising by about 23% in 2010 compared with the 2009 level. The reopening of the Post Bank has also expanded coverage and rural communities' access to banking services.

In 2010, the government of Lesotho concluded negotiations for a three-year Extended Credit Facility (ECF) with the IMF worth USD 64 million. This facility is aimed at helping the country to adjust to the impact of the financial crisis, and more especially to support the balance of payments to offset the sharp decline in SACU revenue transfers. During the first year (2010) of implementation of the ECF, Lesotho is required to implement measures aimed at fiscal consolidation and external stability, including reinforcement of the country’s international reserves position. The ECF will also support policies intended to ensure broad-based growth in order to place Lesotho at par with other countries in the region.

Emerging Economic Partnerships

In the last decade, Lesotho has diversified its economic activities with support from new partners from the Asian bloc. These new partners are conspicuous in the textiles, construction and trading arenas. In the textiles and clothing sector, for instance, Chinese Taipei and mainland Chinese investments have changed the trade scenario significantly, with the US becoming a major trading partner in the past decade. To date, 60% of all exports from Lesotho are destined for the US market. India and Pakistan have also become important trading partners, especially for inputs into the textiles and clothing sector.

It is observed that the changing economic dynamics are impacting not only the country's economic development but its diplomatic relations as well. The increasing importance of China as an economic partner has resulted in Lesotho's severing diplomatic relations with Chinese Taipei. China has since opened an embassy in Maseru. According to a Chinese embassy official in Maseru, China-Lesotho relations are a friendship co-operation that values the strengthening of economic and political relations. Indeed, China has taken steps to enhance its co–operation with Lesotho and, in return, Lesotho has demonstrated its commitment to strengthen this co-operation by opening a visa office in China. In addition, Lesotho currently has had access to the Chinese market almost completely on a duty-free basis since 2008. Almost 95% of Lesotho's exports, made up of 45 products, but mainly of wool, are allowed into China duty-free.

Data on Chinese investments are not readily available, but estimates put the current figure at more than USD 80 million, up from USD 8 million in 1990. Most of these investments have gone into the textiles sector. An influx of investments in the retail sector (shops and services), however, has taken place recently. Such investments have raised the ire of the Basotho who consider the Chinese as invading sectors that should be reserved for them. Other than private investments, officials from the Chinese embassy indicated that aid from China has also been increasing without giving any specific numbers. The most noticeable projects financed with Chinese aid include the convention centre, a library, a hospital and the new parliament building in Maseru. China is also contributing to human-capital development by building schools, offering the Basotho scholarships to study science in China, and supplying doctors. There are also plans to provide loans for developing the communications network in Lesotho, to support to the government's land-use and settlement projects, to digitalise the television and radio stations, and to support the development of low-priced housing on a commercial basis.

As in other parts of Africa, Chinese investments have been welcomed in Lesotho. Chinese development aid has come with no strings attached and there is no co-operation with the traditional donors. This is considered an important element that may have long-term effects on the delivery of aid to Africa. The civil society organisations in Lesotho, however, have viewed China's approach to aid in Africa with suspicion, especially the fact that there is very little transparency and that most discussions have taken place at the highest levels of government. In the private sector, there is increasing resistance to the low wages paid to local workers. In Lesotho, for instance, the lowest paid textile worker in 2010 was paid LSL 790 (about USD 95) per month compared to about USD 148 in South Africa. Although China's partnership with Lesotho is at its nascent stage, there is evidence that it has had an impact that will have long-term development implications. Future benefits from this emerging partnership will therefore depend on how Lesotho engages with China strategically to ensure a win-win outcome, especially given the increasing levels of public co-operation and private-investment flows.

Political Context

Although the 2007 election results were contested and required SADC mediation, the current parliament is expected to live its full term, with opposition parties now preparing for the next election. New parliamentary elections are scheduled for 2012, when the ruling Lesotho Congress for Democracy (LCD) will face competition from the two main opposition parties (National Independent Party and All Basotho Convention). Lesotho has had some political scares in the recent past, such as the attempted assassination of the prime minister in 2009, but 2010 has been stable.

Fears about possible attempts to suppress freedom of speech and of the press were addressed after the ruling party agreed to opposition amendments to the Public Meetings and Procession Bill before it was passed by parliament in 2010. The country scored 3.0 out of a possible 7.0 on both political and civil rights and was ranked as "partly free" by Freedom House in the 2010 assessment. Labour unions are allowed and private-sector unions have the right to strike, but such actions are illegal for public-sector employees. In the 2010 Bertelsmann Transformation Index the country is ranked 74 out of 128, but falls in the 43.1 percentile in the 2009 World Bank Political Stability indicator. Relative to other sub-Saharan countries, Lesotho is ranked 9th out of 50 countries and far ahead of Swaziland, which is ranked 15th and is the only SACU country below Lesotho. In addition, the country generally respects the rule of law though there are perceptions that the judiciary is not completely independent from the executive.

Social Context and Human Resource Development

Lesotho is the only country in the SACU region listed among the world's 49 least developed countries (LDCs) and is ranked 141st out of 169 countries in the 2010 Human Development Index. The latest available statistics show that about 62% of its 2.1 million population lives on less than USD 2 per day. Most the poor were found in rural areas where 75% of the population lives. In the 2010 United Nations *Human Development Report*, Lesotho is reported to have the lowest life expectancy, at 46 years, in sub-Saharan Africa. The high HIV/AIDS prevalence rate in the country, together with a high poverty rate, contributes to the low life expectancy. The 2010 *Human Development Report* gives, for Lesotho's infant mortality rate, 63 per 1 000 live births. Moreover, Lesotho has one of the highest income inequalities in Africa, with a Gini coefficient of 0.66.

In education, some progress has been registered in recent years and Lesotho compares well with other regional countries. Government introduced free primary education resulting in improvements in net enrolments but only 57% of the pupils who begin primary school continue to the last grade and performance is very poor because of a high pupil-to-teacher ratio of 37 to 1. School life in the country averages 10.3 years compared to 8.1 for other countries in the region. Similarly, in spite of gender disparities, net enrolment in secondary schools is 29% for boys and 19% for girls, the same as the regional average of 29% for boys but lower than the 24% for girls.

The poor social and human development indicators are a reflection of the poor infrastructure development in the country. It is in light of this that the government is focusing on infrastructure development, in view of linking the remote rural settlements to urban markets and increasing job opportunities in these settlements. Employment data in Lesotho are scarce, but in 2010, the unemployment rate is estimated to have been greater than 40%. Labour shedding in South Africa's mines worsened the situation in the country. In response, the United Nations Development Programme and the International Labour Organization are assisting government efforts to reduce unemployment through a programme intended to enhance entrepreneurial skills amongst college and university graduates, which would enable them to start their own businesses.