

# Economics

## Lesotho: Annual economic outlook

### Heading for a recovery?

2 June 2010

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#### Projections for 2010:

- Real GDP growth of 3.0% expected.
- Annual average inflation to drop to 5%.
- Loti to strengthen to an annual average of LSL7.72/USD.
- Trade balance to deteriorate as export markets contract.
- Fiscal deficit of 11.1% of GDP projected.
- Global economic recovery could be more subdued than expected.

#### Recent trends

##### Production

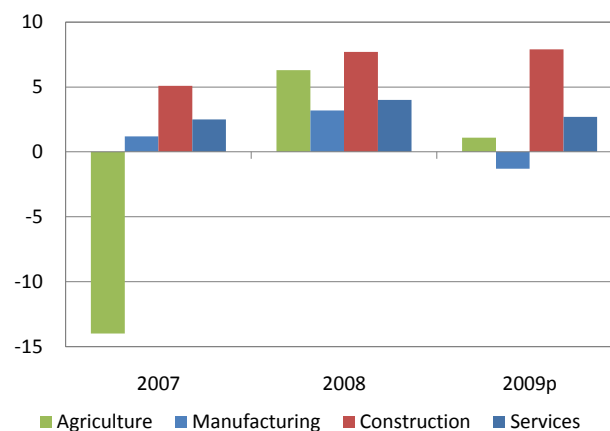
Lesotho's small, open economy is closely interconnected with South Africa's through trade links as well as membership of the Southern African Customs Union (SACU) and the Common Monetary Area (CMA).

Lesotho's economic data is frequently revised and moreover by large margins, which is problematic for economic analysis as different economic trends may be evident in the revisions. Publication of economic data is often delayed, which makes it difficult to discern recent trends. The economic picture revealed by the current data is therefore tentative and subject to amendment.

Figures (preliminary) published by the *Central Bank of Lesotho* (CBL) in February 2010 show that the agricultural sector contracted by 14% in 2007. To illustrate the above point, December 2008 data estimated a large contraction of 39.3% in the agricultural sector in 2007 and in February 2009 an actual contraction of 8.6% was published. A severe drought in 2007, which was the worst in 30 years, was the main cause of the sector's contraction.

In 2008 the agricultural sector grew by 6.3% and in 2009 by an estimated 1.1% (Figure 1).

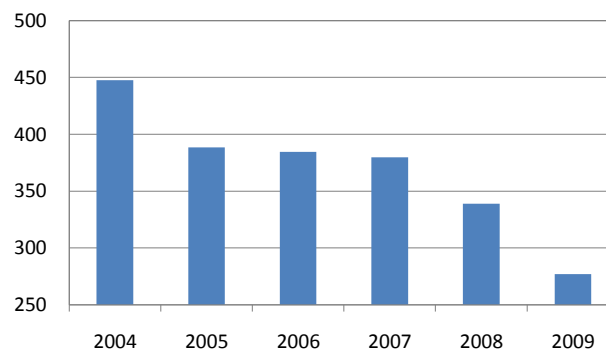
Figure 1: Real growth of the largest sectors (% change y/y)



Source: Central Bank of Lesotho (CBL)

Manufacturing of textiles and clothing, the largest part of the manufacturing sector, grew steadily under the *US African Growth and Opportunity Act* (Agoa) from 2000 (when it was signed into law) until 2004. Clothing and textiles accounted for about 87% of all manufacturing employment in the first half of 2009.

Figure 2: Clothing export earnings under Agoa (US\$ million)



Source: US International Trade Commission (USITC)

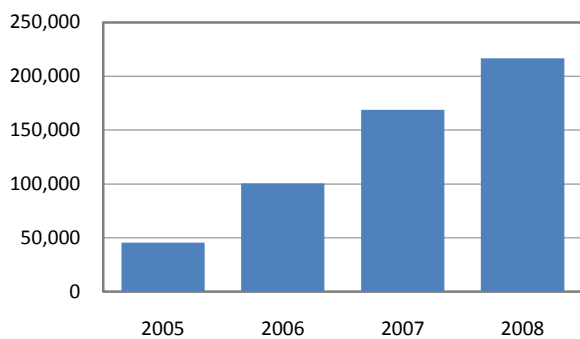
Since 2004 export earnings have declined dramatically as China's (and other low-cost producers) accession to the US market eroded Lesotho's advantage under Agoa (which gives tariff- and quota-free access to the US market). A relatively unfavourable exchange rate also hampered the sector at times. Export earnings dropped by 38% from US\$447.6 million in 2004 to US\$277.1 million in 2009. Consequently, the number of workers (mainly women) employed in the clothing sector also fell, from an average of 47 988 in 2004 to 41 753 in 2008, a 13% drop. In the first half of 2009 the numbers declined even more, during which an average of 32 937 workers were employed, and this decline is consistent with the decline in clothing and textile earnings under Agoa in 2009.

Lesotho's textile industry is, however, well integrated into the global industry, as a number of international brands source garments from the country. Some of these international brands are Levi Strauss, Wal-Mart Stores and Gap Inc.

CBL figures show that overall the manufacturing sector grew by an estimated 3.2% in 2008, but is estimated to have contracted by 1.3% in 2009. The slowdown is most likely to have been caused by the weaker clothing and textiles sector (see **Figure 2**).

The rejuvenated diamond mining sector has grown particularly strongly since 2006, producing some of the largest gem diamonds in the world. Output of Lesotho's three diamond mines (Letšeng Likhobong and Kao) is largely destined for Belgium and other European markets.

**Figure 3: Diamond production (carats)**

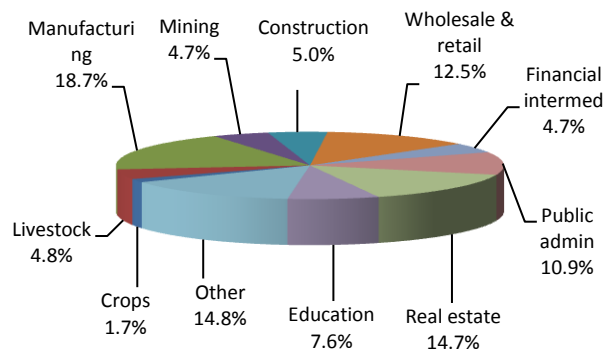


Source: CBL

According to the CBL, diamond production rose from 45 380 carats in 2005 to 216 546 carats in 2008, a 377% increase. However, in 2009 lower jewellery demand and diamond prices negatively affected the small sector, and some mines have suspended operations or reduced operations.

The tertiary sector contributed about 65% to GDP in 2007. Wholesale and retail trade, real estate, education, public administration and financial intermediation are the largest sub-sectors. CBL figures show that the services sector grew by 4% in 2008 and by an estimated 2.7% in 2009.

**Figure 4: GDP by type of activity (2007)**



Source: IMF

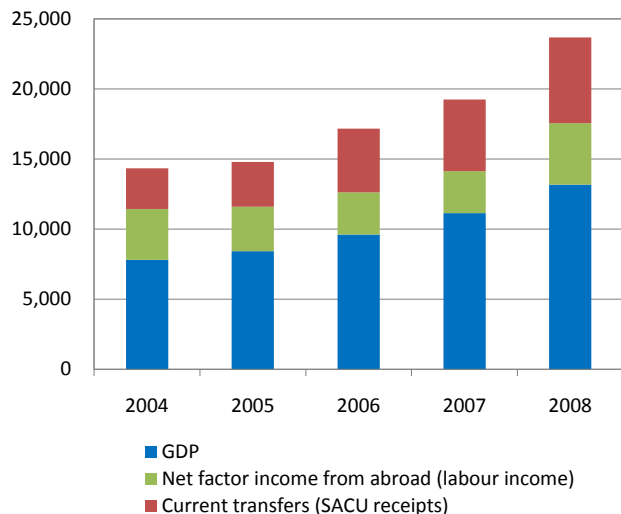
The small tourism sector (whose contribution to GDP is not directly measured in the system of national accounts and whose total contribution through transport, accommodation, catering, recreation, other services, etc. must be extracted from these accounts through the satellite accounting system) has shown moderate growth in recent years. The *Lesotho Tourism Development Corporation (LTDC)* found that about 293 000 tourists visited the country in 2008. Some 88.3% of the visitors were from South Africa, followed by 2.3% from Germany. Many travellers cannot strictly be classified as tourists as they were visiting family and friends. Although the industry has great potential, limited tourism facilities are available, according to the LTDC, which hampers the development of the nascent sector.

**Domestic expenditure**

Lesotho's gross national product (GNP; output produced by Lesotho nationals) is larger than its gross domestic product (GDP; output produced within Lesotho's borders) because of Basotho miners' wages remitted from South Africa to Lesotho. For example, in 2008 Lesotho's (nominal) GDP was M13 175 million, and net factor income from abroad (labour income) was M4 382 million, resulting in gross national income (GNI) of M17 557 million, according to Lesotho's *Bureau of Statistics (BOS)*. About 52 700 migrant mineworkers were employed in South Africa in 2008. Unrecorded inflows may imply that the remittances are even larger. This is a significant source of income for poor families, thus assisting generally with poverty reduction.

In addition, GNI is augmented by current transfers (mostly SACU receipts), which means higher gross national disposable income (GNDI). In 2008, net transfers amounted to M6 104 million, resulting in GNDI of M23 661 million. Therefore, GNDI – the national income that can be spent by Lesotho's citizens – is almost 80% larger than GDP (see Figure 5). The larger GNDI significantly raises the overall standard of living.

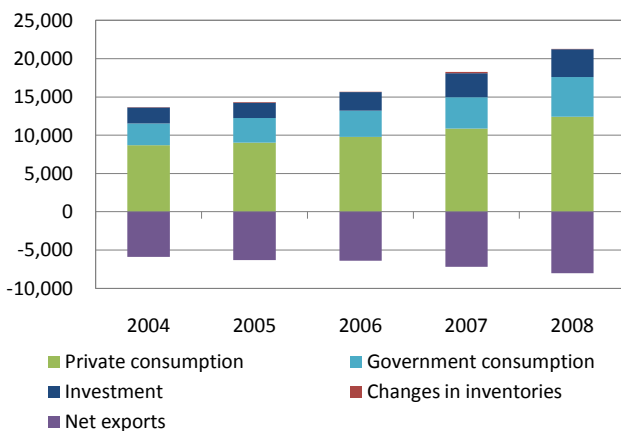
**Figure 5: GDP, gross national income (GNI), and gross national disposable income (GNDI) (M million, current prices)**



Source: Bureau of Statistics (BOS)

This is one possible reason that Lesotho is classified as a lower-middle-income (rather than low-income) country (according to the World Bank's classification), with gross national income per capita of US\$1 060 in 2008. This is generally on par with the sub-Saharan Africa (SSA) average (US\$1 082), but Lesotho is nevertheless a poor country with high levels of poverty and unemployment.

**Figure 6: Expenditure on GDP (M million, current prices)**



Source: BOS

Private consumption expenditure grew by about 8.5% annually between 2000 and 2008. Underpinned by labour income from abroad and current transfers, consumption expenditure remained buoyant over this period. In 2009 consumption is expected to have remained relatively strong as labour income and SACU transfers continued to support consumption. Interest rate cuts in 2009 aided consumption expenditure. Government also combated the economic contagion from the global recession and South Africa's contraction by means of counter-cyclical spending by increasing employee compensation, grants to local governments and social benefits. Civil servants' salary increases in particular are expected to have contributed to consumption expenditure. Government spending grew by 13.4%

annually between 2000 and 2008, but is generally at low levels. However, in 2009/10 the government raised overall expenditure by 29% over the previous tax year, with recurrent expenditure increasing by 27% and capital expenditure by 38%.

Gross fixed capital formation (investment) has a small share of expenditure on GDP and grew by 5.9% annually between 2000 and 2008. This was mainly driven by the construction of the first phase of the large *Lesotho Highlands Water Project* (LHWP), which has now been completed. Bridges were constructed, linking mountains and lowlands, and roads were improved, according to the 2010 budget. In 2009 the construction sector is expected to have increased moderately.

Lesotho has received a number of much-needed investments from its various development partners. In July 2009 the World Bank and the government signed a US\$25 million financing agreement, including a US\$8.5 million grant, to secure water supply to the capital Maseru and surrounds. Lesotho also received a US\$25 million equivalent for the *Second Poverty Reduction Support Credit and Grant Program* to support the government's development programme and growth strategy.

Exports, which grew by 19% annually between 2000 and 2008, have helped drive economic growth. Imports grew by 10% annually over the same period, offsetting to some extent the export sector's boost to GDP growth. Exports in 2009 are expected to have been boosted by diamond export earnings (rising production volumes, albeit offset to some extent by lower diamond prices), but the steep drop in clothing and textile export earnings (see Figure 2) will have dampened export earnings. Imports are expected to have remained high, as Lesotho's small production base necessitates imports of consumer goods and services from South Africa. Negative net exports, therefore, are increasingly a drag on economic growth (see Figure 6).

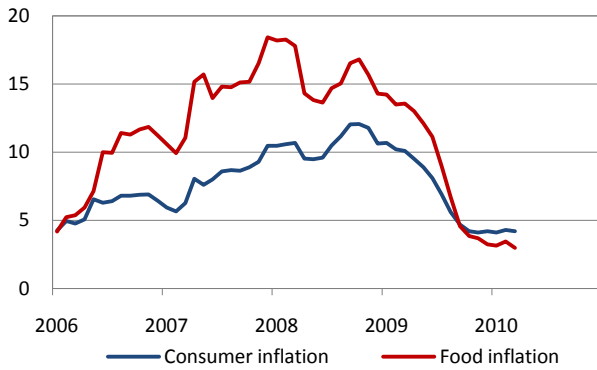
### Monetary policy

Inflation has risen over the past few years, from an average of 3.4% in 2005 to 10.7% in 2008, but eased to 7.3% in 2009. Food prices (the food group is weighted at 39.8% in the consumer price index (CPI) and is the main driver of consumer inflation) eased markedly, thus driving down the overall inflation rate in 2009. Food inflation averaged 9% in 2009, down from 15.8% in 2008 and 14.3% in 2007.

From an import perspective, overall inflation is largely imported from South Africa, whose inflation rate dropped from an average of 11.5% in 2008 to 7.1% in 2009.

Transport inflation has also eased on the back of lower international crude oil prices. Lesotho is land-locked and entirely surrounded by South Africa, factors which impact negatively on the country's overall inflation rate, as transport costs add significantly to overall import costs.

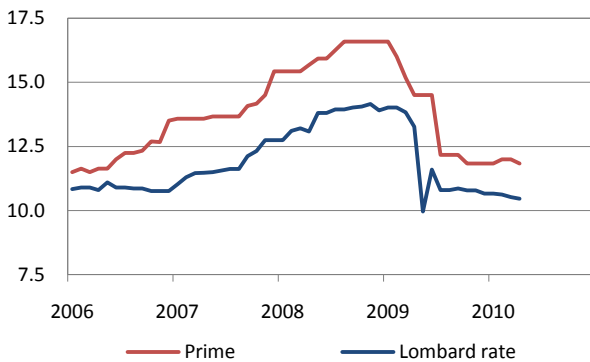
**Figure 7: Inflation (y/y change)**



Source: BOS

Interest rates have eased on the back of lower inflation. In addition, concerns about economic growth in 2009 – as the global recession gained momentum – also helped drive interest rates lower. As in the case of inflation, interest rates in Lesotho also follow South African trends, largely through the joint membership of the CMA (see below).

**Figure 8: Interest rates (%)**



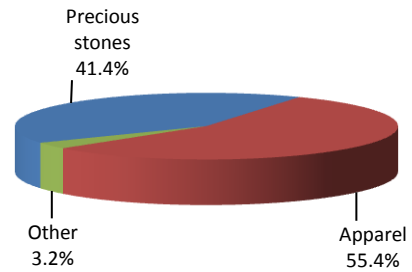
Source: BOS

The Lombard rate, the policy rate, dropped from an average of 13.6% in 2008 to 11.8% in 2009. Similarly, the prime rate dropped from an average of 16.1% in 2008 to 13.6% in 2009. In comparison, South Africa's prime rate averaged 15.13% in 2008, dropping to 11.81% in 2009. The marginally higher prime rates can be explained by Lesotho's higher risk profile and shallow financial markets.

**International trade**

Lesotho's export profile has changed over the past few years, as diamond production and exports started rising steeply in 2004. In 2008 Lesotho's exports were dominated by textiles and clothing, accounting for more than half (55.4%) of total exports, and diamond exports accounted for 41.4%. In comparison, in 2003 diamond exports, just prior to the take-off in 2004, accounted for less than 1% of total exports.

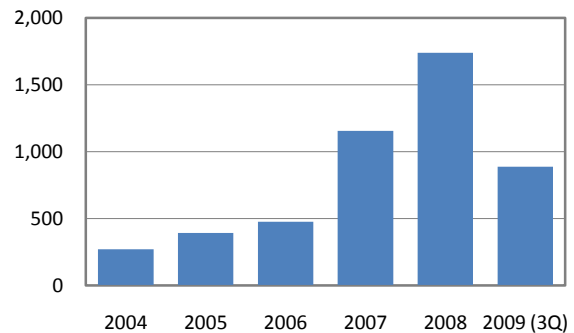
**Figure 9: Composition of exports (2008)**



Source: ITC

The US was Lesotho's largest export destination in 2007, and received 51% of its exports, according to BOS data. The SACU, mostly South Africa, absorbed 26% of Lesotho's exports, followed by the European Community (EC) with 20%. The EC's share is expected to have risen in 2008 as diamond export earnings rose during the period (see Figure 3). However, diamond export earnings dropped in the first three quarters of 2009 compared to the same period in 2008.

**Figure 10: Diamond export earnings (M millions)**



Sources: CBL, IMF

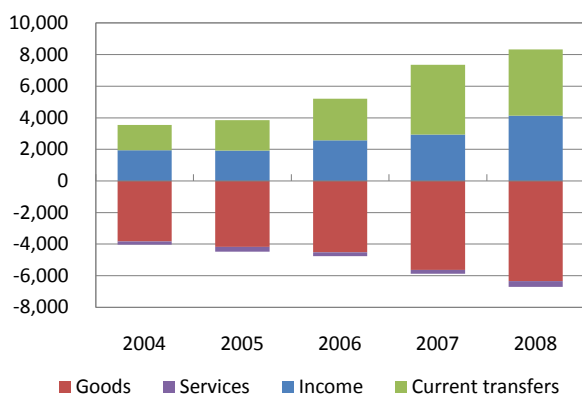
The manufacturing export sector benefited under Agoa, as exports of textiles and apparel increased up to 2004. Since then these exports have dropped continuously, as discussed above (see Figure 2).

Seventy-seven per cent of Lesotho's imports were from the SACU (largely South Africa), and 21% were from Asia in 2007. Lesotho's imports are mostly consumer goods (including food), vehicles, building materials, machinery, fuel, medicines; and raw materials for the manufacturing sector as domestic production is largely export orientated. The country also imports fabric and cotton to be processed for export.

**External sector**

Lesotho has run large trade deficits for a number of years. In 2008 the trade deficit (goods and services) amounted to M6 705 million (US\$796 million), up from M4 038 million (US\$628 million) in 2004. The growing trade deficit is mainly caused by the drop in clothing and textile exports, as they make up the largest export sector. Rising diamond export earnings failed to offset the decline in clothing and textile export earnings.

**Figure 11: Current account components (M million)**

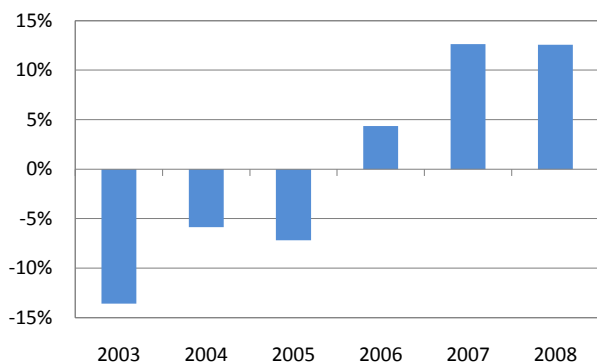


Sources: CBL, BOS

However, the trade deficit has been more than fully offset by the income and current transfers' components of the current account of the balance of payments, giving rise to current account surpluses since 2006.

Jointly, income, comprising compensation of employees (i.e. labour income from Basotho workers' remittances from SA) and investment income, amounted to M4 130 million in 2008 (US\$490 million). Current transfers, largely SACU receipts, amounted to M4 082.2 million (US\$484 million) in 2008.

**Figure 12: Current account balance (% of GDP)**



Sources: CBL, IMF

The current account surplus of M1 624 million (US\$192 million) in 2008 is equivalent to 13% of GDP, which is on par with the previous year's surplus.

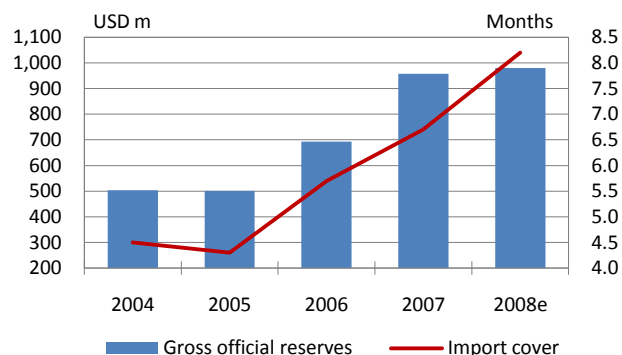
The current account surpluses since 2006 followed on large deficits between 2003 and 2005. SACU receipt windfalls – it was widely expected that SACU receipts would stabilise or even fall rather than rise – are the main cause of the elimination of the current account deficits since 2006. The volatile current account balances demonstrate the swings in trade, income and transfer inflows into the country.

The current account surplus is expected to have moderated in 2009 as exports, SACU earnings as well as labour income will have suffered from the delayed fallout from the global recession, which reached full force in 2009, but which now appears to be over. Of

concern is that SACU payments in 2008 as well as 2009 were based on over-optimistic trade projections, resulting in over-payments to the recipient countries. Also, SACU revenue over-payments may have to be refunded, which will put additional fiscal strain particularly on the union's smaller members. South Africa's minister of finance recently announced that SACU transfers to members will be reduced by about 20%. Similarly, labour income, and hence remittances, is expected to have fallen as unemployment rose in South Africa on the back of its economy contracting by 1.8% in 2009.

The current account surplus achieved since 2006 aided the improvement in the country's foreign exchange reserves. Lesotho's gross official reserves rose from US\$501.6 million in 2003 to US\$957.7 million in 2007 and import cover rose from 5.6 months of imports in 2003 to 6.7 months in 2007 (IMF data). In 2008 it is estimated that reserves as well as import cover improved.

**Figure 13: Gross official reserves and import cover**



Sources: IMF, Standard Bank est.

More recent data from the CBL shows that gross reserves dropped to M7.9 billion in the third quarter of 2009, from M8.8 billion in the second quarter. Net International Reserves (NIR) also dropped to US\$819.3 million in the third quarter of 2009 compared with US\$896.7 million registered in the second quarter. In terms of months of import cover, gross official reserves dropped to 6.5 months in the third quarter of 2009 from 7.3 months recorded in the second quarter.

Lesotho received *Special Drawing Rights* (SDR) allocations of SDR29.1 million (about US\$43 million) from the IMF in August and September 2009. The SDR allocations were made to all 186 IMF members, supplementing their foreign exchange reserves, thus providing liquidity to the global financial system.

The loti (rand) weakened against the US dollar between 2005 (average of LSL6.33/USD) and 2009 (average LSL8.42/USD). The strengthening of the loti during 2009 – from a monthly average of LSL9.89/USD in January to LSL7.48/USD in January 2010 – is a consequence of global risk appetite for emerging market assets reviving in 2009 after suffering a severe curtailment during the peak of the global financial crisis in 2008. In the first four months of 2010 the currency traded in a relatively narrow band of LSL7.34–LSL7.67 to the US dollar.

The exchange rate of the rand/loti only briefly aided the export sector between the fourth quarter of 2008 and the first quarter of 2009, when it weakened to above LSL9.00/USD over this period, dropping to a low of LSL10.16/USD in November 2008 (see Figure 14).

**Figure 14: Exchange rate (LSL/USD)**



Source: Bloomberg

Fitch Ratings is the only ratings agency to rate Lesotho's sovereign credit profile. On 27 April this year the agency revised Lesotho's ratings. The Long Term Issuer Default Rating of BB- was affirmed as Stable; the Short Term Issuer Default Rating of B was affirmed. The Country Ceiling A rating was also affirmed. However, the Local Currency Long Term Issuer Default Rating of BB was revised downward to Negative from Stable. The drop in SACU revenue and resulting pressure of the fiscal balances can be cited as reasons for the downward revision. Lesotho's sovereign ratings fall into the speculative category, implying that investor protection may be moderate.

#### Fiscal sector

Minister of Finance Timothy Thahane presented the 2010/11 budget on 12 February 2010. The minister said that Lesotho has been buffeted by these economic storms and called for belt-tightening. He argued that wasteful expenditure must be cut, public services must be delivered and taxes must be collected efficiently, corruption must be eliminated and more domestic revenues need to be raised.

On the positive side, the minister said that the European Union (EU) – currently a very small trading partner – granted Lesotho duty- and quota-free access to the EU markets under the *Interim Economic Partnership*. This agreement should aid Lesotho in diversifying its export base.

In reviewing the projected outturn of the 2009/10 budget, the minister said that demand for clothing and textiles' exports had already started to decline, firms had retrenched workers and mining operations had been curtailed. He projected the economy to have grown by 2.1% in 2009, compared to 4.4% in 2008. In 2010 growth is expected to recover to 3.6%.

SACU receipts are projected at M4 917 million, equivalent to 52.4% of total revenue (including grants) of M9 377 million. SACU receipts are also equivalent to 33.4% of GDP, indicative of the dependence of the economy on this source of income. Income tax is projected to

contribute M3 149.8 million, or 33.6% of total revenue and grants. The grant element is relatively large at M627.3 million, or 6.7% of total revenue and grants.

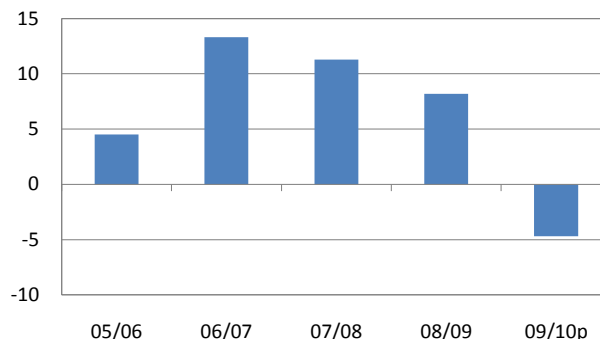
In terms of total expenditure of M7 536.7 million, expenditure on wages and salaries is projected at M2 548.5 million, a massive 33.8% share of total expenses and a 17.3% share of GDP. Lesotho's public sector wage bill is one of the highest in SSA and is evidently not sustainable, given the expected drop in SACU receipts.

Projected recurrent expenditure of M7 535.6 million is equivalent to about three-quarters of total expenditure. Capital expenditure of M2 529.1 million is projected. This allocation is reasonably balanced.

The minister was concerned about the low absorption rate of the capital budget and this is the same problem that was mentioned in last year's budget. Only 73% of the capital allocation was utilised, leaving the balance of the funds unspent and undermining the potential growth impact on the wider economy.

A fiscal deficit of M687.7 million is projected, equivalent to 4.7% of GDP for 2009/10. The fiscal balance reversal from surplus to deficit is largely the result of lower economic growth, resulting in stagnant SACU receipts, as well as the rising wage bill (see Figure 15).

**Figure 15: Fiscal balance (% of GDP)**

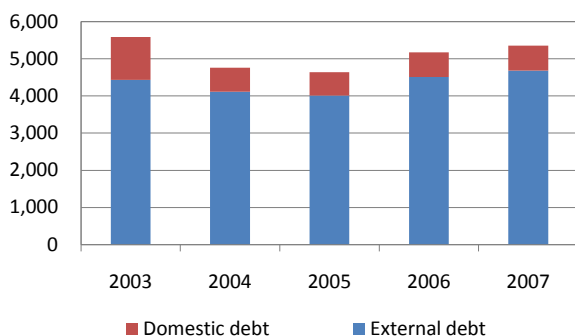


Sources: CBL, Ministry of Finance and Development Planning (MFDP)

Lesotho's external debt dominates its total debt profile and averaged about 48% of GDP between 2003 and 2007. Domestic debt averaged about 9% of GDP over the same period.

In 2007 external debt of M4 680.6 million accounted for 87% of total debt, whereas domestic debt of M674.6 million accounted for 13% of the total debt of M5 355.2 million. External debt is composed largely of multilateral loans (e.g. by the World Bank) and granted on concessional terms (very long-term loans with interest rates of well below market rates).

Figure 16: External and domestic debt (M million – year-end)



Source: MFDP

Domestic debt is largely made up of loans to the domestic banking sector in the form of short-term Treasury bills (TBs). Given these characteristics, Lesotho's debt situation is not a cause for concern as the majority of external debt is long term and concessional. Also, the debt to GDP ratio has dropped, from almost 75% of GDP in 2003 to about 45% of GDP in 2007, a significant reduction to a more manageable level. In 2008 and 2009 the ratio is expected to have stabilised at 2007 levels.

### National policy assumptions and the international environment

Lesotho's national policy development document, *Lesotho Vision 2020*, was initiated in 2000 and adopted in 2004. The government stated that all national development plans and programmes will be based on Vision 2020, which envisages that: "By the year 2020 Lesotho shall be a stable democracy, a united and prosperous nation at peace with itself and its neighbours. It shall have a healthy and well-developed human resource base. Its economy will be strong, its environment well managed and its technology well established."

The *Poverty Reduction Strategy* (PRS), which was aimed at implementing Vision 2020 and which covered the three-year period of 2004/05 to 2006/07, was developed. The strategy's priorities were to create employment; improve agricultural production and food security; develop infrastructure; deepen democracy, governance, safety and security; improve access to health care and social welfare; improve quality and access to education; manage and conserve the environment; and improve public service delivery. It appears that no further plans are as yet in place.

According to the 2010/11 budget speech, some of the strategy's objectives have been achieved, but funding from development partners fell short of the plan's requirements. The *Medium Term Expenditure Framework* (MTEF) has also been used to implement some of the Vision 2020 goals. This year the government, led by the Ministry of Finance and Development (MFDP), will start preparing for a five-year *National Development Plan*, the implementation of which will commence in April 2012.

### Monetary sector

Lesotho is a member of the CMA with Namibia, South Africa and Swaziland. Consequently, Lesotho's monetary policy is largely determined by the South African Reserve Bank (SARB) and its interest rates follow similar trends to South Africa's. Lesotho's CMA membership is based on trade links and close financial ties with South Africa.

Because of CMA membership and the fact that three-quarters of its imports are from South Africa, Lesotho largely imports inflation from its largest trading partner. Inflation in Lesotho has, however, been above South Africa's over the past decade, because of higher transport costs for imports (Lesotho is land-locked) and the larger weight of the food component in the CPI.

The central bank's main monetary policy objective is to support the currency peg with the South African rand at par (1:1) by maintaining adequate foreign exchange reserves. Membership of the CMA limits the monetary authorities' scope for an independent monetary policy. According to the central bank, price stability is "attained through the maintenance of an adequate level of foreign reserves and fighting domestically generated inflation".

The CBL adopted the Lombard rate in July 2002. It is the CBL's lending rate to commercial banks and is a penalty rate on overnight borrowing. The CBL does not set interest rates after the SARB monetary policy meetings and announcements; rather, the commercial banks in Lesotho determine their own prime lending rates. The Lombard rate is linked to the TB rate (the 91-day TB discount rate plus 400 basis points).

Under the CMA agreement the loti (plural: maloti (M)) is pegged at par to the South African rand. Developments in the exchange rate are dependent on the underlying events and factors affecting the South African rand's performance against other currencies. Economic events and factors in Lesotho do not affect the value of the currency. The rand, however, is a free floating and market-determined currency. The rand is legal tender in Lesotho, but not vice versa.

### External sector

Lesotho is a member of the SACU, as mentioned. Other members are South Africa, Swaziland, Namibia and Botswana. Trade barriers between these countries have been eliminated, but the customs union maintains a unified tariff structure with non-SACU trading partners.

The SACU, which is a century old this year, has promoted fiscal stability and prosperity for its members. Several modifications to the agreement have been implemented since inception and the most recent changes were introduced in 2002. Negotiations are ongoing to continue the modernisation process.

The steep rise in SACU receipts during the boom period up to 2007 is largely based on South Africa's high economic growth rate, as it accounts for about 60% of intra-SACU imports, according to the IMF.

The revenue-sharing formula, which determines the member country's revenue allocation, is based on three components: customs' revenues, excise revenues and the level of economic development. The change in the revenue-sharing formula also boosted the receipts of the smaller SACU members, such as Lesotho, Namibia and Swaziland.

SACU payments are based on projected variables and actual payments to members do not as yet reflect the sharp deceleration in trade in 2008.

### International environment

The IMF's economic growth revisions (published in April) projected that a global recovery is imminent. The global economy contracted by 0.6% in 2009, with most countries showing negative growth. Of the advanced economies, all the largest ones contracted. A number of emerging and developing countries, however, showed positive growth, as shown in **Table 1**. SSA grew by 2.1% in 2009, below the 5.5% recorded in 2008.

**Table 1: Global economic outlook**

	Real GDP growth (year-on-year)			
	2008	2009	2010p	2011p*
World	3.0	-0.6	4.2	4.3
Advanced economies	0.5	-3.2	2.3	2.4
United States	0.4	-2.4	3.1	2.6
Euro-area	0.6	-4.1	1.0	1.5
United Kingdom	0.5	-4.9	1.3	2.5
Japan	-1.2	-5.2	1.9	2.0
Emerging and developing economies	6.1	2.4	6.3	6.5
China	9.6	8.7	10.0	9.9
India	7.3	5.7	8.8	8.4
Brazil	5.1	-0.2	5.5	4.1
Russia	5.6	-7.9	4.0	3.3
Sub-Saharan Africa	5.5	2.1	4.7	5.9
Developing Asia	7.9	6.6	8.7	8.7

Source: IMF

The April growth revisions are generally more upbeat than the January projections. Global growth is expected to average 4.2% in 2010, with the advanced economies growing by 2.3%, and emerging and developing economies at a significantly faster pace of 6.3%. There is, however, a significant risk to the global outlook as the probability of a double-dip recession is growing steadily in view of the fiscal and other problems being experienced in the EU and the US.

Developing Asian countries' growth outlook is particularly optimistic and signals a gradual shift of economic power and influence to Asia, mainly China. Asian exports to the industrialised countries are particularly important for sustained growth in that region. African countries' robust growth outlook is predicated on the region's natural resource abundance and the expectation that commodity prices will continue to recover. SSA is expected to grow by 4.7% in 2010.

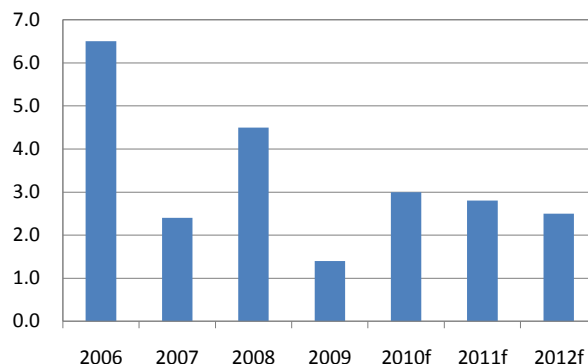
Standard Bank forecasts that South Africa will grow by 2.9% this year, 3.7% in 2011 and 4.1% in 2012. In 2009 the South African economy contracted by 1.8%, after growing by 3.7% in 2008.

## Forecast summary

### National accounts

Lesotho's economic growth is directly linked to South Africa's growth performance, as South Africa is one of Lesotho's main trading partners, particularly regarding imports, as discussed above. Lesotho's exports, however, were destined for the US (51%), SACU (26%) and the European Community (EC; 20%) in 2007. Therefore, global and regional economic growth, particularly in the US and EC, is an important factor, as the growth of the export sector (clothing and textiles and diamonds) is linked to economic growth and consumer demand in the US and other developed markets. Although South Africa contracted in 2009, Lesotho grew by a 1.4% (IMF data), one of the few countries in the world to have avoided economic contraction.

**Figure 17: Real GDP growth (annual %)**



Sources: IMF, Standard Bank est.

We expect real GDP growth to recover and to average 3.0% in 2010. Thereafter annual average growth of 2.8% is expected in 2011 and 2.5% in 2012. The recovery is expected to be subdued as diamond export earnings may not deliver the required economic boost, as the US consumers, who purchase about half of the world's diamond jewellery, are in a protracted process of rebuilding their balance sheets through higher savings and lower consumption expenditure. High unemployment of just below 10% and a lacklustre housing market contribute to the weak US outlook. A record-high fiscal deficit and mounting government debt are other factors underscoring a bleak outlook for the US consumer. Luxury purchases may be the last to recover fully from the global recession.

In the longer term, the diamond export sector may be boosted by the opening of the new Mothae mine, which is expected to be as productive as Letšeng mine. It is expected to be operational in two years' time, according to the 2010 budget speech. The Letšeng mine, which re-opened in 2004, has produced four of the world's 20 largest rough gem diamonds, according to *Gem Diamonds*, which owns 70% of the mine (the Lesotho government owns the remaining 30%).

The clothing and textile sector could remain in the doldrums for some time, as international trade competition is intensifying between export-dependent countries. Lesotho's clothing sector has so far failed to recover from the 2004 shock, when China's clothing exports gained tariff- and quota-free access to the US market, despite Lesotho's favourable access to the large US market under Agoa. Furthermore, some of the Agoa benefits may not be available after 2012, such as the third-country provision for sourcing inputs. This provision currently allows Lesotho to use imported fabrics for its local production, but still qualify for Agoa benefits. Also, current proposals to extend Agoa benefits to all least-developed countries (LDC) may strangle Lesotho's remaining clothing and textile industry.

However, in June 2009 the clothing and textile sector was boosted by the signing of the *Economic Partnership Agreement* (EPA) with the EU, allowing Lesotho's garment exports duty- and quota-free access to EU markets. The new agreement allows the use of fabrics imported from third countries – previously garments had to be manufactured from fabric produced in Lesotho.

The implementation of the LHWP Phase II is progressing. A new dam, Polihali Dam, with a capacity of 2.2 billion cubic metres, will be constructed, as will a tunnel to transfer water to South Africa's Vaal River and the Gauteng province. Electricity, roads and other infrastructure will also be constructed. The estimated cost of M7.3 billion (about US\$913 million at an exchange rate of LSL8/USD) is to be borne by South Africa, according to the *Lesotho Highlands Development Authority*. Additional hydropower components are to be phased in and financed by Lesotho (provided funding can be found), estimated at between M4.5 billion and M6 billion (about US\$750 million). Construction of the dam is to commence in 2011 and it is expected to be completed in 2017, according to reports.

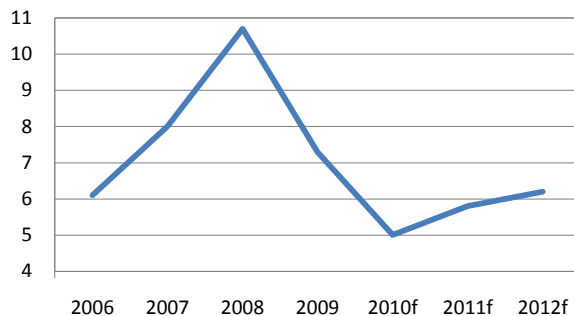
The construction sector will be boosted for the duration of the project. Over time, the tourism sector could benefit and water royalties earned by the government should increase.

The small travel and tourism sector can be developed over the longer term to attract foreign visits from South Africa as well as long-haul tourists from developed markets. The Soccer World Cup, to be hosted in South Africa from 11 June to 11 July this year, is unlikely to benefit Lesotho's tourism sector.

### Monetary sector

Lesotho's inflation is largely imported from South Africa and driven by food prices. South Africa's inflation rate is expected to average 5.2% in 2010, 5.4% in 2011 and 5.5% in 2012, according to Standard Bank forecasts. Lesotho's inflation rate is typically marginally higher than its neighbour's. We expect Lesotho's annual inflation to rise slightly over the next three years and to average 5% in 2010, 5.8% in 2011 and 6.2% in 2012.

Figure 18: Consumer inflation (annual average %)

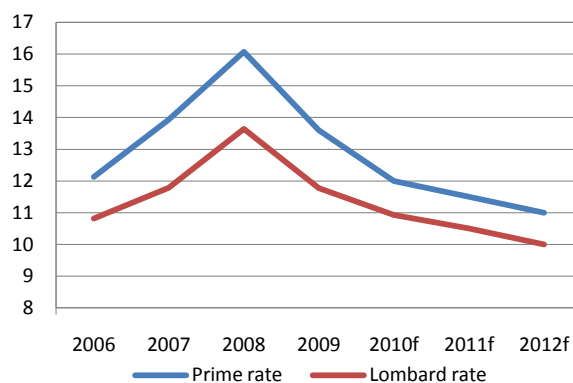


Sources: IMF, BOS, Standard Bank est.

Lesotho's consumer price trends will be affected by similar factors to South Africa's. Higher inflation in Lesotho is expected to emanate from a combination of factors, such as higher commodity prices, including crude oil, rising transport costs and structural factors, such as higher administered prices.

Interest rates are, however, expected to drop as in South Africa, as Lesotho's monetary policy is largely imported and determined by the SARB, as discussed above. Lesotho's interest rates cannot diverge too far from South Africa's and lower interest rates are expected in South Africa as inflation is expected to remain below the SARB's inflation target ceiling of 6% over the forecast period. Lesotho's higher inflation rate may imply higher interest rates, but Lesotho's interest rate and monetary policy is constrained by the SARB's policy.

Figure 19: Interest rates (annual average %)



Sources: CBL, Standard Bank est.

South Africa's prime rate is expected to average 10.1% in 2010, 10.7% in 2011 and 11.5% in 2012, according to Standard Bank forecasts. South Africa's policy rate, the repo rate, at 6.5% is the lowest in almost 30 years. It is unlikely that the repo rate will change in 2010. Interest rates are expected to remain low and to start to rise by small increments only in 2011.

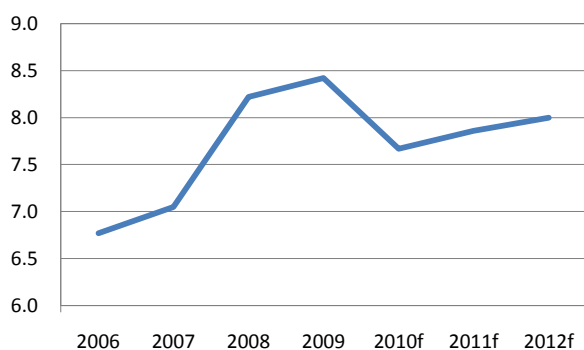
Lesotho's Lombard rate is expected to average 10.9% in 2010, 10.5% in 2011 and 10% in 2012. The prime rate is expected to average 12% in 2010, 11.5% in 2011 and 11% in 2012.

## External sector

The loti (rand) exchange rate is expected to strengthen in 2010 to average LSL7.72/USD, compared to LSL8.42/USD in 2009, according to Standard Bank forecasts. In 2011 and 2012, a weaker trend is expected. The currency is expected to trade at an average of LSL8.20/USD in 2011 and LSL8.50/USD in 2012.

Fluctuations in the international value of the loti (rand) are largely driven by capital flows and the changing risk appetite towards emerging markets. A weaker loti (rand) may be the result of greater risk aversion towards emerging markets. The positive inflation differential vis-à-vis the main trading partners also tends to weaken the exchange rate over time as is the case at present. However, high commodity prices may have supported positive sentiment towards the rand, which should help prevent a sharply weaker exchange rate.

**Figure 20: Exchange rate, LSL/USD (annual average)**



Sources: Bloomberg, Standard Bank est.

The weaker projected exchange rates in 2011 and 2012 should help to boost export earnings and could support economic growth. Unlike some developing countries that undervalue their pegged currencies to promote exports, it is unlikely that the free-floating and market-determined rand will be managed weaker by the South African authorities to support the export sectors.

## Government sector

Lesotho's fiscus is heavily dependent on SACU income. A new SACU revenue-sharing formula was adopted in 2002 to distribute the customs receipts more equitably to the smaller members. However, SACU revenues are expected to decline in the longer term – despite recent windfalls – as tariffs, which are taxes on international trade, are expected to decline over the next few years under the *World Trade Organisation* rules. The revenue-sharing pool is also expected to decline if global trade remains weaker than expected.

In the 2010/11 budget speech, the minister said that, in the context of the weak global and regional economy, SACU revenue – typically contributing 60% to total revenues – has been severely affected. In 2010/11 SACU revenue is budgeted at M2 162 million, a 56% (M2 755 million) drop from the projected revenue of M4 918 million in the previous tax year. SACU revenue falls to 26.1% of total revenue in 2010/11 from 52.4% in the previous tax period.

The minister called for “aggressive belt-tightening” as government expenditure will be reduced by this amount. International travel spending, furniture purchases, training and workshops, and vehicle hire are some of the areas which came under the scalpel.

According to data published in *Annex 1* to the budget, of the total expenses of M10 318 million, M6 748 million (65.4%) will be allocated to recurrent expenditure and M3 570 million (34.6%) to capital expenditure. Recurrent expenditure will drop but capital expenditure will increase over the previous year's budget. Compensation of employees (mostly wages and salaries) will rise by 7.6% in 2010/11 over the projected outturn for 2009/10, despite the large wage bill, even though total recurrent expenditure drops. The savings are being made by the reduction in most other expenditure items.

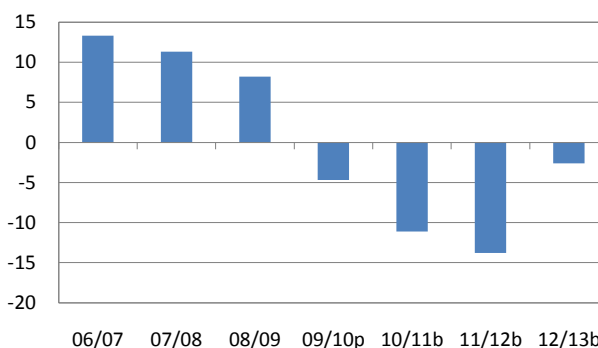
Wages and salaries make up almost 40% of total government expenses and are equivalent to about 16% of GDP, absorbing an unsustainable share of government resources. The minister sounded this warning in the budget speech, reiterating that investment should take priority over recurrent expenditure.

Total revenue of M8 284 million is budgeted to finance the above expenditure projections, made up of tax revenue of M3 449 million (41.6% contribution), grants of M1 809 million (21.8%), SACU revenue of M2 162 million (26.1%) and other revenue of M863 million (10.4%).

The minister budgeted for a budget deficit of M2 034 million, equivalent to about 12.2% of GDP in 2010/11. The large deficit is cause for concern as fiscal sustainability may be jeopardised if the deficit projections are too optimistic. In current circumstances, however, the deficit projections are realistic.

The minister expected a budget deficit of 13.8% in 2011/12, predicated largely on the continued drop in SACU revenue. In 2012/13 a more balanced budget is expected, mostly predicated on a mild recovery of SACU revenue.

**Figure 21: Budget balance (% of GDP)**



Sources: MFDP, CBL, Standard Bank est.

Over time the large wage bill needs to be reduced and the capital absorption capacity raised dramatically. A large wage bill encourages a culture of dependency and a low capital absorption capacity robs the country of the necessary investment for building and expanding the capital base and raising productivity. Both problems are partly the

result of deficiencies in education and training, resulting in low levels of human capital, which hamper labour productivity growth and keep the overall standard of living from rising in the long run. Yet, Lesotho's literacy rate of about 80% is relatively high in an SSA context. Public expenditure on education was on average 13.3% of GDP (2002-08), also a relatively high figure in southern Africa. These relatively good educational indicators point to other institutional and policy factors which could diminish the efficiency of the work force.

Lesotho's public debt can be further augmented by additional external and concessional finance from multilateral donors. Concessional support may be necessary in present circumstances as high levels of poverty, unemployment and HIV prevalence continue to afflict the population.

## Outlook

The global economy, SSA and South Africa are all expected to grow in 2010. These favourable contexts are expected to help Lesotho grow by 3% in 2010, after it narrowly avoided an economic contraction in 2009 by growing 1.4%.

There are several caveats to the positive growth outlook. Falling SACU receipts are the main vulnerability as they inhibit the government from continuing its counter-cyclical fiscal policy, which will force it to reduce social spending on health, education and infrastructure. The rising budget deficit is cause for concern, but the finance minister expects that the deficit will return to more sustainable levels in 2012/13, if SACU receipts improve. There are risks to the projections as a double-dip global recession cannot be ruled out. The over-sized government wage bill at current levels is not sustainable, but can serve as a temporary buffer against rising poverty levels in times of economic hardship by boosting consumption expenditure. However, a high degree of dependency on the main breadwinner(s) can help redistribute income to poorer and unemployed individuals.

Labour income from Basotho migrants working on South African mines is also under pressure. According to the budget speech, more than 50 000 Lesotho citizens are employed on South African mines and in South African industries, excluding those in services and other tertiary sectors. South Africa's improved expected economic growth rate and high gold and platinum prices in 2010 and beyond should, however, help shelter Basotho workers, at least temporarily, from large-scale retrenchment.

The export-dependent country is also at the mercy of external trade regimes and its clothing and textiles industry has contracted despite the favourable trade agreement with the US's Agoa. The new agreement with the EU may help Lesotho expand its clothing and textiles industry to its former status as the most important private employer. However, the current fiscal and other problems experienced in the EU do not bode well for increased trade with the region despite the new agreement, but, in the longer term, economic benefits are expected to materialise.

The commencement of the LHWP Phase II will boost the construction sector and hence economic growth over the next few years. Earnings from water royalties from South Africa over the medium- to long term will help strengthen the balance of payments and fiscus. The expansion of the diamond mining sector will also help support the balance of payments and increase foreign exchange earnings.

The marginally weaker exchange rate expected over the next few years should underpin export sector earnings to some extent. However, exchange rate volatility remains a cause for concern, as earnings' projections in local currency terms become less reliable, thus making forward planning a difficult, if not futile, exercise.

Lower inflation rates, particularly of food price increases, should bring relief to the poor and unemployed (estimated at about a quarter of the work force).

Lower interest rates in Lesotho – which will continue to be tied to South Africa's – will help speed up the economic recovery. Higher interest rates are expected only next year, which gives borrowers a window of opportunity to get their finances in order.

## Lesotho

### Standard Bank forecasts of selected indicators

	2007	2008	2009e	2010f	2011f	2012f
<b>National accounts</b>						
Gross domestic product (M million in constant 2004 prices)	9,528	9,957	10,096	10,399	10,690	10,957
% change	2.4	4.5	1.4	3.0	2.8	2.5
<b>Prices</b>						
Inflation (%) – annual average	8.0	10.7	7.3	5.0	5.8	6.2
<b>Monetary sector</b>						
Interest rate (%) – prime rate (average)	13.9	16.1	13.6	12.0	11.5	11.0
Exchange rate (LCU/USD)	7.05	8.22	8.42	7.72	8.20	8.50
<b>Government sector</b>						
Budget balance (% of GDP)	11.3	8.2	-4.7	-11.1	-13.8	-2.6

Sources: Central Bank Lesotho, Ministry of Finance and Development Planning, Bureau of Statistics, IMF, Standard Bank est.

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