AFRICAN DEVELOPMENT BANK GROUP
GROUPE DE LA BANQUE AFRICAINE DE DÉVELOPPEMENT

COUNTRY FOCUS REPORT 2024

LESOTHO

Driving Lesotho's Transformation

The Reform of the Global Financial Architecture

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ACRONYMS AND ABBREVIATIONS

AfDB	African Development Bank
AEO	African Economic Outlook
AfCFTA	African Continental Free Trade Agreement
DFI	Development Finance Institution
FDI	Foreign Direct Investment
FY	Financial Year
GDP	Gross Domestic Product
GFA	Global Financial Architecture
ICT	Information and Communications Technology
IFI	International Financial Institution
MDB	Multilateral Development Bank
MtCO2-eq	Metric Tons of Carbon Dioxide Equivalent
NDC	Nationally Determined Contribution
NDP	National Development Plan
ODA	Official Development Assistance
PPP	Public-Private Partnership
R&D	Research and Development
SACU	Southern African Customs Union
SADC	Southern African Development Community
SDG	Sustainable Development Goal
SDRs	Special Drawing Rights
SME	Small and Medium-sized Enterprise
SSA	Sub-Saharan African
LMC	Lower Middle-Income Country
USD	United States Dollar
ZAR	South African Rand

EXECUTIVE SUMMARY

Chapter 1 of the Country Focus Report provides an overview of macroeconomic developments since 2022 covering growth, monetary and fiscal policies, public debt, outlook and risks, social developments. On macroeconomic developments, the report suggests that Lesotho is slowly but surely recovering from the impact of COVID-19. It notes that the balance of risks to the domestic outlook is tilted to the downside. The main risk to the macroeconomic outlook remains the fragile fiscal position, given the huge fiscal gap. Russia's invasion of Ukraine will also continue to present headwinds to growth by increasing imported inflation, weakening demand for Lesotho's exports, and reducing investor confidence (AfDB, 2023).

In terms of social developments, Lesotho's poverty rate fell from 56.6% to 49.7% between 2002 and 2017, driven by a reduction in inequality as a result of the expansion of the country's social protection programs and an increase in wage incomes among the poor. Poverty was estimated at 19.6% in 2021.

Chapter 2 takes stock of Lesotho's structural and economic transformation, unpacking it through labor productivity decomposition, rapid income and employment growth embodied in service exports and the associated drivers and bottlenecks to accelerating structural transformation. Drivers of Lesotho's structural transformation include technology, transport, human capital, trade policy and competitiveness, and natural resources.

The bottlenecks to Lesotho's structural transformation are identified as poor governance, low productivity in agriculture, lack of food and employment security, poor physical and social infrastructure, environmental degradation and climate vulnerabilities, population growth, poor fiscal management, political instability and financing constraints.

Structural transformation requires some considerable financing. For example, to the total financing needs to achieve the SDGs by 2030 is USD 0.812 billion with a financing gap of USD0.718 billion. In terms of total financing needs to achieve Agenda 2063, the amount required is 0.1421 billion with a financing gap of USD0.1257 billion. The required increase in tax/GDP ratio to close the financing gap by 2030 and 2063 are 26.4 and 6.3, respectively. It is critical that resources be mobilized to close the financing gap including by increasing domestic revenue collection and finding innovative sources such as climate finance.

Chapter three deals with the financing needed to accelerate Lesotho's structural transformation. It argues that the global financial architecture has failed to provide adequate development financing for Lesotho in particular and to Africa in general. It therefore calls for its reform It The chapter reiterates the importance of domestic resource mobilization, the role of the private sector in financing structural transformation, and the role of DFIs and MDBs in financing Lesotho's structural transformation. The country also needs to access debt and climate financing.

INTRODUCTION

Lesotho is a small, mountainous, and landlocked country, surrounded by South Africa. It is also economically dependent on the latter in areas such as trade and investments. South Africa supplies more than 80 percent of imported goods and many services, and buys more than a third of Lesotho's exports (AfDB, 2023).

Lesotho is a lower-middle-income country, with nominal gross national income per capita of $950.71 in 2023and a population of almost 2.3 million (30.9% living in urban areas and 34% under 15 years old) (African Development Bank, AfDB, 2023).[1] Lesotho's mountains offer great potential for wind and hydro power generation.[2] However, it is highly vulnerable to extreme weather conditions, including floods, droughts and early and late frosts. Heavy rainfall contributes to rapid soil erosion and deteriorating conditions of rangeland and arable land. Climate change is likely to increase the frequency and severity of adverse events.

The country's economic potential is not being adequately harnessed. For instance, gas and water contributed 5.55% to GDP in 2022. In addition, the concentration of diamonds, and the mining sector (6.25% of GDP in 2022) has attracted investment and stimulated growth and employment in recent years. The country has benefited from the African Growth and Opportunity Act (AGOA) trade agreement initiated at the early 2000s to boost the textile and clothing manufacturing sector. This agreement which facilitated the export of Lesotho's textile and clothing to the United States became an engine of growth and job creation. However, the country faces competition from Asian countries in the textile market, despite the extension of the AGOA agreement to 2025 in 2015, highlighting the challenge of diversification and sophistication of Lesotho's economy . The country is a member of the South African Customs Union (SACU), the Common Monetary Area (CMA) and the Southern African Development Community (SADC).

This Country Focus Report (CFR) is divided into in three chapters beginning with Macroeconomic Performance and Outlook. Chapter 2 takes stock of Lesotho's structural transformation; Chapter3 focuses on financing to fast-track Lesotho's structural transformation. It identifies structural transformation in national development plans, the financing needs and gaps; closing the financing gap through domestic resource mobilization; the role of the private sector in financing structural transformation; and the role of DFIs in supporting structural transformation. It posits that Lesotho's journey towards structural transformation requires significant investment in infrastructure, human capital and climate action. It argues that the global financial architecture has failed to provide development financing at a scale for Lesotho and to Africa in general. It asserts that Africa's growing importance in the global economy warrants commensurate treatment and representation in international financial governance and therefore calls for its reform.

[1]AfDB Statistics Department Databases (2023).
[2]Its lowest point is 1,400 meters above sea level.

MACROECONOMIC PERFORMANCE AND OUTLOOK

1

Key Messages

- Lesotho's economic growth decelerated to an estimated 0.9% in 2023 from 1.3% in 2022 This deceleration is due to the 25% decline in manufacturing and 2.1% decline in domestic demand. The lackluster economic growth of recent years may be attributed to the challenges facing Lesotho's textile industry, which accounts for about 21% of GDP and is now facing strong competition in the US market from Asian producers, and increasingly from Ethiopian and Kenyan producers, leading to a drop in export volumes to the United States.

- Domestic inflationary pressures have eased faster than expected, with inflation outcomes reaching their lowest level in three years in July 2023. Inflation declined to about 6.4% in 2023 from 8.3% in 2022, driven by to falling imported food and energy prices. Global food prices are moderating due to record grain production. To anchor inflation expectations and support the exchange rate peg, the Central Bank of Lesotho has continued to track the policy rate changes of the South African Reserve Bank, raising rates by 425 basis points since November 2021.

- Lesotho's currency (loti) is pegged at par to the South African rand. The loti depreciated against all major currencies in 2023, including the euro (12.58%), the pound (24.73%), and the dollar (29.63%) owing to the depreciation of the South Africa rand.

- In 2023, the fiscal balance was estimated at a surplus of 1.0% of GDP, compared with a deficit of 4.3% in 2022 due to recovery in SACU revenues. The fiscal deficit will be financed by both domestic and external borrowing, while the surpluses will lead to an accumulation of government deposits in the banking sector.

- The present value (PV) of public and publicly guaranteed (PPG) external debt-to-GDP reached close to the 40% threshold in FY 2020/21, about 10 percentage points higher than the 2019 debt sustainability analysis (DSA). The gross public debt-to-GDP ratio has increased by 4.1 percentage points to 59.8% of GDP in FY22/23, reflecting both exchange rate valuation effects on external debt and growing domestic debt issuance.

- Official reserves are estimated to accumulate and reach the equivalent of 4.7 months of import cover in 2023 and improve to 5.3 months of import cover in both 2024 and 2025. The increased SACU revenue is expected to boost reserve accumulation during 2023-2025. However, the increase is likely to be dampened by growth in government expenditure. The current level of reserves is sufficient to maintain the exchange rate peg, bolstered by the recent SDR allocation.

- The current account deficit was estimated to improve to 3.4% of GDP in 2023 down from 8.4% in 2022, driven by an increase in textile exports. The expected high imports of goods and services related to the second phase of the Lesotho Highlands Water Project (LHWP II) are expected to continue to drive the current account deficits. Most of the current account deficit will be financed through capital transfers associated with the LHWP II.

1.1 Lesotho's Macroeconomic Performance

1.1.1 Growth Performance

Lesotho's Economic growth in recent years remains weak, volatile, and insufficient to overcome its development challenges and vulnerabilities.

Economic growth in recent years has been weak, volatile, and insufficient to address Lesotho's development challenges and vulnerabilities. Lesotho's economic growth decelerated to an estimated 0.9% in 2023 from 1.3% in 2022 This deceleration was due to a 25% decline in manufacturing and a 2.1% decline in domestic demand. The lackluster economic growth of recent years can be attributed to the challenges facing Lesotho's textile industry, which accounts for about 21% of GDP and is now facing strong competition in the US market from Asian producers, and increasingly from Ethiopian and Kenyan producers, leading to a drop in export volumes to the United States. Recent macroeconomic performance also highlights the deep-rooted structural challenges, including poor governance, low agricultural and industrial productivity ; lack of food and employment security, poor physical and social infrastructure; acute environmental degradation and climate vulnerabilities; population growth, poor fiscal management and persistent political instability.

Mining industry is expected to drive primary sector growth in the medium-term, while adverse weather conditions continue to undermine agricultural production. The mining industry is projected to grow by an upwardly revised 11.5% in 2023.

The secondary sector is projected to contract by 1.7% in 2023 following a downward revision of the growth forecast for the textile and clothing industry. The textile and clothing industry is now projected to contract by 7.4% in 2023 (previously -2.8%). The downward revision of industrial growth reflects significantly lower-than-expected output in the first half of 2023. Lesotho's textile orders from the US continue to decline due to high material and input costs.

The services sector is estimated to grow by a revised 2.4% in 2023.. Overall, the sector is expected to be largely supported by the positive knock-on effects from the LHWP II activities over its implementation cycle. The expenditure on public administration and defense has been increasing over the years but it is essentially characterized by inefficiencies increasing the country's debt burden.

On the demand side, household consumption is not only the main component of GDP, but also a major contributor to GDP growth.. Lesotho has a very high wage bill (24% of GDP) which is three times the Sub-Saharan African average. Most of these employees are unproductive and have been employed on the bass of political patronage.

1.1.2 Monetary Policy – Inflation – Exchange Rate

At the core of Lesotho's monetary policy is the fixed exchange rate regime, which is characterized by the one-to-one peg of the local currency, the loti, to the South African rand, under the Common Monetary Area (CMA) Agreement. Domestic inflationary pressures have eased faster than expected, with inflation outturns in July 2023 reaching their lowest in three years. Inflation declined to about 6.4% in 2023 from 8.3% in 2022, driven by falling imported food and energy prices. Global food prices are moderating due to record grain production. To anchor inflation expectations and support the exchange rate peg, the Central Bank of Lesotho has continued to track the South African Reserve Bank's policy rate changes, raising rates by 425 basis points since November 2021. This has kept inflation at moderate levels, although it remains elevated in the US and eurozone.

Lesotho's currency (loti) is pegged at par to the South African rand. The loti depreciated against all major currencies in 2023, including the euro (12.58%), the pound sterling (24.73%), and the dollar (29.63%)

as a result of the depreciation of the South African rand.

1.1.3 Fiscal Policy

The fiscal position is expected to improve in the medium-term on account of higher SACU revenues and modest growth in domestic tax revenues. In 2023, the fiscal balance was estimated to improve to a surplus of 1.0% of GDP from a deficit of 4.3% in 2022, reflecting the recovery in SACU revenues. The government has spent more than half of SACU windfall in 2023 to increase public investment and recurrent spending by 2 percentage points of GDP each. SACU transfers exceeded a third and a quarter of GDP. The magnitude of these transfers makes public finances in Lesotho highly dependent on their evolution. The very high volatility of SACU transfers significantly complicates Lesotho's public financial management. The fiscal deficit will be financed by both domestic and external borrowing, while the surpluses will lead to accumulation of government deposits in the banking sector.

1.1.4 Public Debt

The present value (PV) of PPG external debt-to-GDP ratio reached close to the 40% threshold in FY 2020/21, about 10 percentage points higher than the 2019 DSA. The gross public debt-to-GDP ratio increased by 4.1 percentage points to 59.8% of GDP in FY22/23, reflecting both exchange rate valuation effects on external debt and rising domestic debt issuance. However, all of Lesotho's external debt sustainability indicators remain below their respective thresholds. The overall risk of public debt distress is moderate.

According to the World Bank, Lesotho's interest payments (% of revenue) were reported at 3.35 % in 2022. The primary balance to GDP ratio deteriorated from -4.0% in 2022 to -5.9% in 2023 and is projected at -5.3% and 3.8% in 2024 and 2025, respectively. Official reserves are projected to accumulate and reach the equivalent of 4.7 months of import cover in 2023 and improve to 5.3 months of import cover in both 2024 and 2025. Increased SACU revenues are expected to boost reserve accumulation over the period 2023-2025. However, the increase is likely to be dampened by increased government expenditure. The current level of reserves is sufficient to maintain the exchange rate peg, bolstered by the recent SDR allocation.

Current debt drivers include declining SACU transfers, growing public expenditure, new borrowing, and rising contingent liabilities, all of which have increased debt sustainability risks. Lesotho's debt indicators are expected to deteriorate in the near term before improving over the medium term, supported by recovering SACU transfers and slower growth in public expenditure relative to GDP. The country's moderate risk rating points to limited shock-absorption capacity.

External debt accounts for 74% of total public debt and is predominantly owed to multilateral partners on concessional terms. The main creditor is the International Development Association (IDA), followed by the African Development Fund (AfDF), the European Investment Bank (EIB), and the IMF. Debt owed to bilateral creditors accounts for less than 15% of total external public debt. Of this, China accounts for 70%. Debt projections suggest an increase of the debt burden, which will reach 59.80% and 60.4% in 2024 and 2025, respectively.

The Government of Lesotho is taking the following measures to contain the debt, including (i) fiscal consolidation; (ii) improving the efficiency of capital spending; (iii) building buffers against future shocks; (iv) preventing the crowding out of credit to the private sector; addressing contingent liability risks; (v) and deepening the domestic capital market.

Table 1: Macroeconomics Indicators

	2019	2020	2021	2022	2023(e)	2024(p)	2025(p)
Real GDP Growth	-1.4	-7.5	1.9	1.3	0.9	1.7	2.2
Inflation	5.2	5.0	6.1	8.3	6.4	5.5	5.0
Overall fiscal balance, including grants (% GDP)*	-5.4	0.0	-4.8	-4.3	1.0	-0.4	-3.3
Primary balance (% GDP)*	-4.0	1.6	-3.5	-2.4	3.4	2.0	-0.9
Current account (% GDP)	-3.0	-1.5	-4.8	-8.4	-3.4	-4.2	-5.4
Life expectancy at birth (years)	54.2	54.7	53.1	53.0	54.9	-	-

Source: Data from Domestic authorities; estimates (e) and prediction (p) based on authors' calculations. AfDB Statistics Department, April 2024
*Note: *Data in fiscal year 1 April (n-1)/ 31 March (n)*

1.1.5 External Position – External Financial Flows

The current account deficit was estimated to improve to 3.4% of GDP in 2023 down from 8.4% in 2022 due to an increase in the prices of exports of textiles. However, this also presents an opportunity for capital transfers associated with the LHWP II that can finance the current account deficit . The expected high imports of goods and services related to the second phase of the Lesotho Highlands Water Project (LHWP II) are expected to continue to drive the current account deficit. Most of the current account deficit will be financed through capital transfers associated with the LHWP II.

1.1.6 Social Developments

According to the UNDP Multidimensional Survey Lesotho's poverty rate fell from 56.6% in 2002 to 19.6% in 2021, driven by a reduction in inequality (as a result of the expansion of the country's social protection programs and an increase in the wage income of the poor). However, poverty remains widespread and economic vulnerability persists with more than 75% of the population either poor or at risk of poverty. Urban areas experienced a 13-percentage point reduction in poverty from 41.5% to 28.5%, while in rural areas, it decreased marginally from 61.3% to 60.7% over the period 2002-2017. Sixty eight percent of the population live in rural areas, while 32% live in urban areas. The main reasons for the disparity between rural and urban poverty levels are differences in education and health facilities as well as in access to infrastructure, energy and water supply. Rural areas are disadvantaged in terms of these facilities, which prevents them from participating in development.

1.2 Macroeconomic Outlook and Risks

1.2.1 Real GDP Growth

Real GDP growth is projected to rise to 1.7% in 2024 and 2.2% in 2025 from 0.9 in 2023 with the expected recovery in the mining and manufacturing sectors. The second phase of the Lesotho Highlands Water Project (LHWP II) and related knock-on effects will also continue to drive the projected growth trajectory.

Box 1.1: Impact of tighter international financial conditions on growth

Tighter international financial conditions in 2021 imply that global growth will continue slow amid tight monetary policy, restrictive financial conditions, and weak global trade and investment. The impacts of such tightening include an escalation of the recent conflicts in the Middle East, financial stress, persistent inflation, rising unemployment, trade fragmentation, and climate-related disasters. Global cooperation is needed to provide debt relief, facilitate trade integration, tackle climate change, and alleviate food insecurity. Among emerging market and developing economies (EMDEs), commodity exporters continue to grapple with fiscal policy procyclicality and volatility. Across all EMDEs, appropriate macroeconomic and structural policies and well-functioning institutions are critical to boosting investment and long-term prospects.

Tighter international financial conditions imply weak demand for Africa's exports, with negative implications for the current account. Subdued exports may also affect GDP growth, which will widen the fiscal deficit and increase debt levels. Exports as a proportion of GDP declined from 51.4% in 2021 to 48.34% in 2022. Lesotho's economic growth also decelerated to an estimated 0.9% in 2023 from 1.3% in 2022. The local currency weakened as a result of the foreign exchange shortage. The loti depreciated against all the major currencies in 2023, including the euro (12.58%), the pound sterling (24.73%) and the dollar (29.63%), owing to the depreciation of the South African rand. Interest payments on loans increased, thus exacerbating debt vulnerability. Interest rates and exchange rates became major drivers of debt accumulation in Lesotho.

Tighter international financial conditions in developed countries also imply that ODA to African countries will decline. Since 80% of Africa's development budget is externally financed, this will adversely affect Africa's development. Therefore, tighter international financial conditions do not augur well for Africa's development.

1.2.2 Inflation

Inflation is projected to moderate to 5.5% and 5.0% in 20204 and 20205, respectively, owing to a decline in food inflation and lower fuel costs.

1.2.3 Fiscal and Current Account

The fiscal balance is projected to deteriorate to a deficit of 0.4% of GDP in 2024 and then to 3.3% in 2025 from a surplus of 1% in 2023, due to increased expenditures associated with the second phase of the Lesotho Highlands Water Project.

The current account deficit is projected to deteriorate from 3.4% in 2023 to 4.2% in 2024 and 5.4% in 2025, also as a result of increased imports linked to the second phase of the Lesotho Highlands Water Project.

Lesotho's near-term growth has been downgraded as challenges in the manufacturing industry outweigh resilience in the mining industry. Sales data from the textile and clothing industry point to declining orders from the US market. The declining orders are due to a combination of high material and input costs.

1.2.4 Risks to the Outlook

The main risk to the macroeconomic outlook remains the fragile fiscal situation, given the huge fiscal gap and volatile SACU revenue weaken demand for Lesotho's exports and reduce investor confidence (AfDB, 2023). In addition, despite the recent moderation, inflation could remain high if some of the upside risks to inflation materialize. Global economic growth could be weaker than projected, negatively affecting Lesotho's export-oriented industries such as textiles. The downward revision of the near-term economic growth forecast due to declining activity in the manufacturing industry also poses a significant risk. Any further deterioration in this sector could negatively impact both economic growth and job opportunities. Overreliance on construction activity – especially that related to LHWP Phase II - to drive growth in the medium-term is risky, as construction can be affected by various factors, including project delays, funding issues and changes in demand. This is further compounded by the uncertainty surrounding renewal of AGOA. Stagnation in corporate credit, despite expected growth in key sectors, may hinder business expansion and economic development. Finally, persistence in South Africa's economic under-performance could spill over to Lesotho, given the close commercial ties between the two countries.

1.3 Conclusions and Recommendations

The Government of Lesotho should implement the following recommendations in the short, medium and long term:

Short Term

i) Sound macroeconomic policies: Lesotho should pursue sound monetary and fiscal polies tailored to its circumstances. Such policies should prioritize spending and take into account the fiscal space available, and avoid crowding out the private sector.

ii) Encourage local production: Lesotho is heavily dependent on food imports. It imports 80% of its food needs from South Africa. Encouraging local production has the potential to ease pressure on the loti, tame inflation, reduce its debt and improve the balance of payments.

Medium to Long Term

iv) Domestic resource mobilization: The Government should intensify domestic resource mobilization efforts by improving tax compliance and administration. Lesotho is actively engaging in tax reforms through initiatives such as the Bank- supported Lesotho Tax Modernization Project (LTMP), which focuses on modernizing tax administration and leveraging digital solutions to improve revenue collection.

v) Enabling environment: Lesotho was ranked 122nd out of 190 economies in the 2020 edition of Ease of Doing Business (World Bank, 2020). The country's lowest rankings were recorded in the following sub indicators: dealing with construction permits, getting electricity, protecting minority investors and resolving insolvency. This poor performance was due to from cumbersome business procedures, insufficient access to finance, inadequate digital infrastructure, and skill gaps, among others. To attract investment, Lesotho needs to improve its business environment. The Kingdom of Lesotho is open to and eagerly seeking to attract foreign direct investment (FDI). In recent years, the country has made major strides in improving its business environment in terms of licensing, business registration, water, and electricity connections. With the advent of the new government in October 2022, the Kingdom has announced its intention to strengthen the private sector and to welcome foreign direct investment focused on job creation, market diversification, and local capacity development.

vi) Accelerate structural reforms to build a resilient economy: Lesotho should implement structural reforms aimed at stimulating job creation and investment, and improving productivity. This will enhance the competitiveness and growth potential of the economy. The reforms may include improving the business environment regulations to support more flexible labour markets, streamline the tax system or reduce the red tape, making it easier for companies to do business and plan for the future.

PROGRESS MADE IN LESOTHO STRUCTURAL TRANSFORMATION

2

Key Messages

- The structure of Lesotho exports suggests that there has been some transformation characterized by an increase in the export of precious stones, despite the dominance of textiles in exports. However, this structural transformation has not translated into corresponding improvements in employment and poverty outcomes. The literature identifies a number of factors that explain this phenomenon.
- Economic growth should be supplemented with employment-generating economic structural transformation to have a meaningful impact on poverty reduction.
- Effective economic transformation can be achieved when there is an effective institutional structure in place to support the implementation of strategic development policies.
- Development of effective institutions could be the solution to Lesotho's sluggish implementation of strategic development policies. Lesotho needs to define the type of institutions that need to be developed to address all constraints to effective implementation of policies that have the potential to transform the economy, create jobs and reduce poverty.

2.1 INTRODUCTION

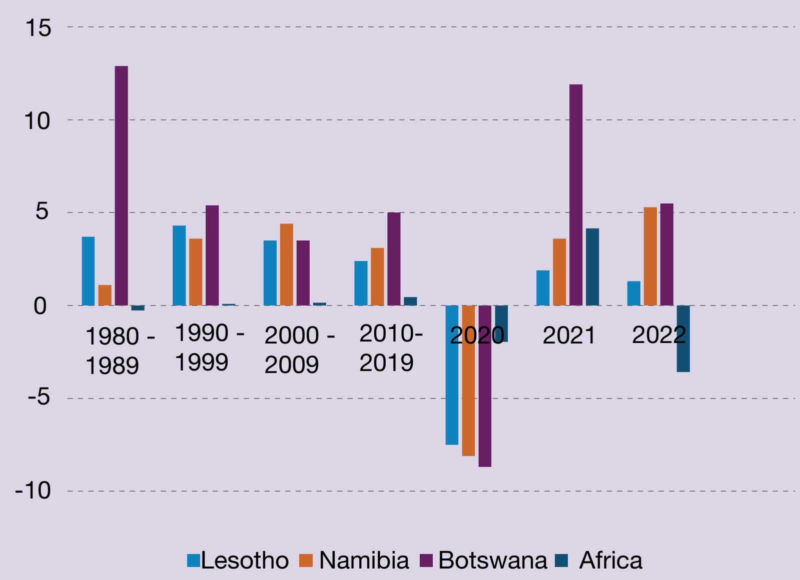
Lesotho's economy has undergone some structural transformation. The economy has benefited from government incentives, including a reduced corporate tax rate of 10%, subsidized costs for factory shells, and tax allowances for training. With the growth of the clothing industry, companies have begun to manufacture other labor-intensive products in Lesotho, such as car seat covers, clean cookstoves, and circuit breakers. New opportunities have emerged for companies to manufacture electronics and automotive components. The Lesotho National Development Corporation (LNDC) offers comprehensive incentive packages for manufacturing companies.

2.2 Economic Performance and Transformation in Lesotho

Structural transformation has been affected by the country's GDP performance as different sectors have different levels of productivity. For example, the economy was in recession for four years from 2017 to 2020, driven by contractions in the construction, transport and storage, and wholesale and retail trade sectors. In 2017, the economy entered a negative growth trajectory, with real economic growth reaching -3.14%, the first time after a decade of positive economic growth. Economic activity in 2015/16 suffered from drought, weak activity in South Africa (which penalized regional trade and limits SACU customs transfers) and uncertainties surrounding the renewal of the country's access to AGOA (which was eventually maintained for 2017 and 2018). Figure 2.1 shows that Lesotho's economy grew at an average of rate 4.3%. only between 1990 and 1999. The anemic GDP growth has had an impact on the living standards of the population. Lesotho's performance in terms of GDP per capita ranged from -8.6% to 3.4% between 1980 and 2022. Lesotho's GDP per capita in current prices rose from USD 331.5 in 1990 to USD 1265.9 in 2011 representing an increase of 282% and then declined to USD 969 in 2022. GDP per capita peaked in 2011 owing to AGOA, which boosted the country's exports. The main drivers of

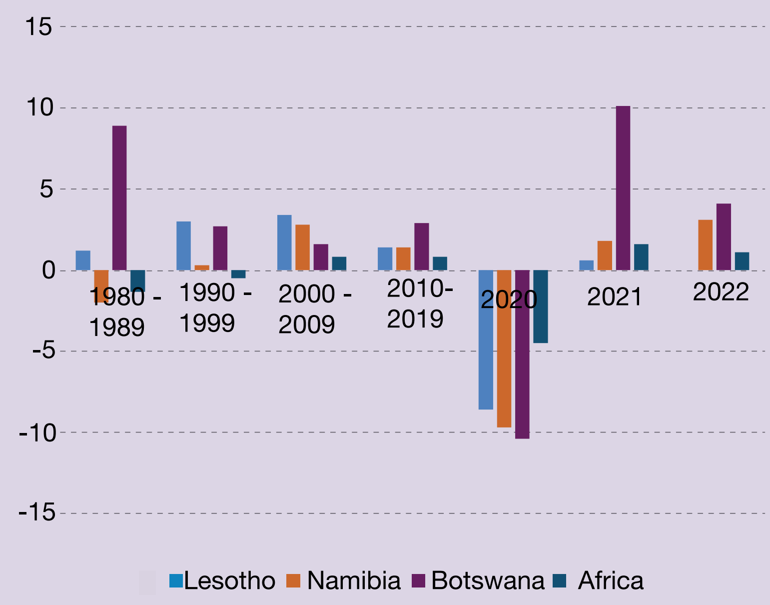
Lesotho's economy has undergone some structural transformation. The economy has benefited from government incentives, including a reduced corporate income tax of 10%, subsidized cost of factory shells, and tax allowances for training. With the growth of the apparel industry, companies have begun manufacturing other labor-intensive products in Lesotho, such as car seat covers, clean cookstoves, and circuit breaker switches.

Figure 2.1: Real GDP Growth



Source: AfDB, statistics Department

Figure 2.2: Real GDP per capita growth



Source: AfDB, statistics Department

this per capita growth are manufacturing, which grew from 13.2% of GDP in 1990 to about 22% in 2022, and mining, which grew by 30% over the same period.

2.3 Lesotho's Structural Transformation: Drivers, Bottlenecks, Opportunities

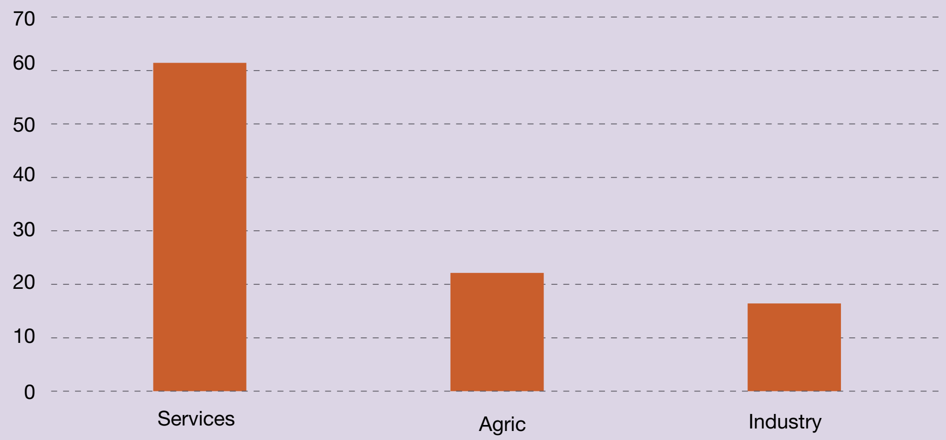
2.3.1 Role of Structural Change in Lesotho's Recent Growth

During the period 1990-2018, agriculture's share of total employment averaged 38.6%; mining 2.62%; manufacturing's share averaged 4.9%, utilities 0.65%; construction 6.32%; wholesale and retail 8.5%; transport 3.7%; business services 2.5%; financial services 0.29%; real estate 0.008; public services 12.9%; and personal services 14. 3%. The major industries in the manufacturing sector include textiles, clothing, footwear, food, and beverages. The sector is dominated by the textiles and apparel industries.

Agriculture is a small and diminishing contributor to GDP. From the roughly 80% of GDP that it contributed in the 1960s, agriculture's share fell to no more than 4.38% in 2018 and 2019. Productivity in Lesotho's agriculture is low by almost any standard, with the value added per worker averaging only about USD 400 per year. Despite this, almost 40% of the economically active population were still employed in agriculture in 2021, highlighting the poverty of most households that rely on agriculture as their main source of income compared to those whose income is derived mainly from other economic activities –services and industry for the most part. Fifty-seven percent of those working in agriculture are women. Women therefore make up a disproportionate percentage of the poorest economically active group in the country. Livestock production is the dominant contributor to agricultural GDP in value terms At (52%), followed by crops (28%) and – surprisingly, given the very small percentage of the country covered by forest - forestry at 20% . In the early 2000s, when agriculture still contributed more than 6% of GDP, livestock production accounted for about for 4.8% of GDP and crops for about 1.9%,

In 2020, agriculture contributed around 6.37% to the GDP, and accounts for most of

Figure 2.3: Sectoral Employment Shares (%)

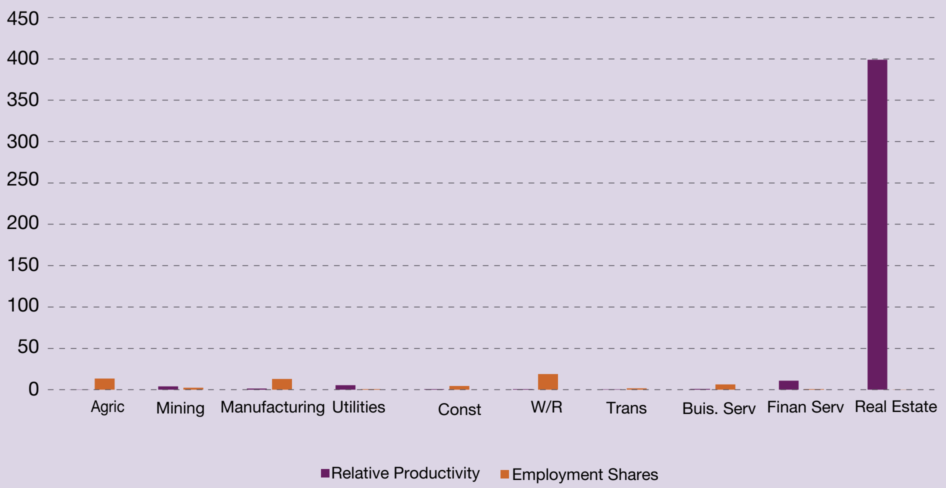


Source: AfDB, Statistics Department

the employment in rural areas, where over 70% of the population live. Crop farming is dominated by subsistence production of cereals. Agricultural production accounts for less than 10% of GDP, but for almost 30% of employment. Most of the jobs are in subsistence-oriented small family farms characterized by low production. An even larger area is seen as an opportunity to transform the rural economy and increase incomes. Lesotho's climatic conditions are favourable for the production of many vegetables and fruits. A crop suitability map identified 5,500 square kilometres (550,000 hectares) of micro-climate areas favourable for fruit cultivation and an even larger area is considered suitable for vegetable production in Lesotho.

The textile and apparel industry accounts for most formal manufacturing jobs in Lesotho. It employs more than 40,000 people and accounts for 92% of manufacturing jobs (Bcreatingtics 2018). The industry generates 43% of exports, mainly low-skilled and low-paying jobs. Although the industry is credited with creating thousands of jobs, there are concerns over job quality and the low employee-career advancement possibilities. Textile and apparel producers

Figure 2.4: Relative sector productivity & employment shares (%) in Lesotho



benefit from government incentives, including a reduced corporate tax of 10%, subsidized costs for factory shells, and tax allowances for training. In 2020, 29.89% of GDP came from the industry and 52.84% from services.

The value of service exports from Lesotho totaled to about USD11.5 million in 2022. Its service exports ranged from USD11.11 million in 2022 to USD 56.68 million in 2016. The term services includes such things as transport, tourism, financial and insurance services. The service sector is the largest, contributing about 60% to GDP, employs about 35.57% of the labour force and continues to play an increasingly important role in Lesotho's growth. It is thus a driver of structural transformation with great potential to provide employment opportunities over the medium term.

2.3.2 Unpacking the Country's Structural Transformation through Labour

Productivity Decomposition

In terms of labour productivity growth decomposition over the period 1990-1999, structural change within agriculture was 1.89, industry 1.98, services -0.71 and overall structural change was 0.56. In terms of labour productivity growth decomposition over the period 200-2009, structural change within agriculture was -0.53, industry 3.166, services -4.47 and overall structural change 1.155. However, total factor productivity has been rising since 1980. It increased from 0.49494 in 1980 to 0.97683 in 2019, due to growth in manufacturing. Within relative productivity, there is variation across sectors as shown in Figure 2.4. Real estate, financial services, utilities and mining have the highest within-sector productivity. The manufacturing sector grew due to the tripling of textile and apparel exports to South Africa and the US under AGOA. The textile and apparel sector is also a major employer of women, who account for 80% of textile workers in Lesotho.

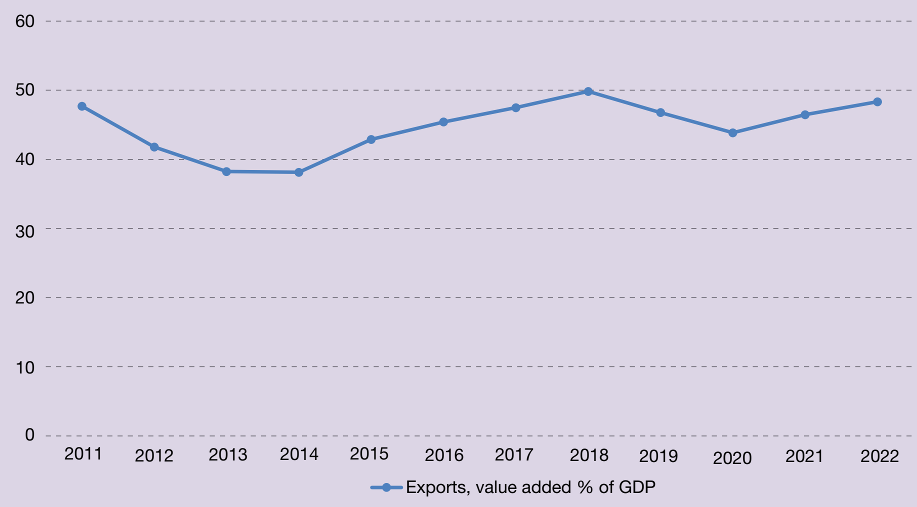
Textile exports into South Africa account for 30% of total apparel exports in terms of volume. With one exception, the factories import all of the raw materials they use to make garments, which means opportunities exist for other upstream industries. Beyond the U.S. market, Lesotho's products enjoy duty free access to SACU and SADC countries, with a total population of 277 million.

With the growth of the apparel industry, companies have begun manufacturing

Box 2.1: Structural Transformation Process in Lesotho

Lesotho's structural transformation has moved the country toward a competitive export-oriented economy led by a strong private sector. The labour force has moved from low-skilled and low productivity agriculture to industry which is dominated by textiles. Since the beginning of the 2000s, textile exports have continued to increase despite international competition, supported by AGOA agreements. The exploitation of diamond deposits has become the second source of financing for the economy since the 2000s. Favorable global diamond prices in 2015 and 2019 also had a positive impact on diamond exports. Lesotho's diamonds are exported to the European market and auctioned in Antwerp, Belgium (World Bank, 2021). However, the structure of the country's exports remains less diversified and is concentrated on a few products with limited value- added. Exports of services and electronic equipment remain weak and have not shown much dynamism over time. Lesotho's challenge will consist not only in strengthening its position in textile and gems, but also in diversifying its exports towards finished or semi-finished products in which it has a comparative advantage, in order to better fit into global value chains. Electronics and financial services are niche markets to be explored due to the strategic proximity to South Africa. Lesotho's latent basket of advantages remains well diversified.

Figure 2.5: Exports, value aded % of GDP



Source : AfDB, Statistics Department

other labor-intensive products in Lesotho, such as car seat covers, clean cookstoves, and circuit breakers. There are also opportunities to manufacture electronics and automotive components. The Lesotho National Development Corporation (LNDC) offers comprehensive incentive packages for manufacturing companies.

The value of service exports from Lesotho totaled about USD11.5 million in 2022. Its service exports ranged from USD11.11 million in 2022 to USD 56.68 million in 2016. The term services covers such areas as transport, tourism, financial and insurance services. The services sector is the largest, contributing about 60% to GDP. It employs about 35.57% of the labour force and continues to play an increasingly important role in Lesotho's growth. The sector is thus a driver of structural transformation with great potential to provide employment opportunities in the medium term. The services sector in Lesotho is dominated by public administration and defense, which account for almost a third of the sector's contribution to GDP.

2.3.3 Drivers of Structural Transformation.

There are several determinants of structural transformation, including technology, human capital trade policy and ICT.

- **Technology:** Technology has propelled Lesotho into a positive development trajectory. It has enabled businesses to lower their costs, heighten productivity and earnings, and introduce new products and business lines, thus increasing employment opportunities. Therefore technology has accelerated economic transformation by enabling within-sector productivity gains.

- **Information, communication and technology (ICT)/digital economy:** This sector accounts for 5% of GDP and features prominently in NSDP II as a catalyst for growth. Lesotho must develop a culture of innovation to successfully transition to an information-oriented society. The digital economy and ICT have helped to generate employment and inclusive growth. The country has engaged in driving digital finance and financial inclusion by improving access to reliable digital services. The above analysis indicates that the poor state of Lesotho's infrastructure has impeded the structural transformation process.

- **Human capital:** The Human Capita Index (HCI) value for Lesotho increased from 0.34 in 2010 to 0.40 in 2020. Ninety-two out of 100 children born in Lesotho survive to the age

Box 2.2: Successful experiences in supporting growth and structural transformation

Oyelaran-Oyeyinka, (2014) argued that attempts at industrialization by all regions of the world hack back to the success first of Great Britain, followed by Western Europe and thereafter North America during the 19th and early 20th centuries. The literature on the experiences of these countries seems to agree that, although the early industrializing countries started out at different stages of growth, they followed a more or less similar format of change that led to their transformation. Romer (1952) describes this process as marked by the shift from a subsistence/agrarian economy towards more industrialized/mechanized modes of production; hallmarks of industrialization include technological advance, widespread investments into industrial infrastructure and a dynamic movement of labour from agriculture into manufacturing.

There is agreement that a dynamic process of industrialization is fundamental to overall economic development of countries, given that it promotes growth-enhancing structural change, which is the gradual movement of labour and other resources from agriculture to manufacturing, as accompanied by productivity increases. Szirmai, (2012) argues that manufacturing is construed as critical in most such expositions because of the empirical correlation between the degree of industrialization and the per capita income in countries. Since productivity is higher in the case of manufacturing than agriculture, the transfer of resources to manufacturing should normally provide a basis for higher rates of productivity-induced growth structures.

of 5. Lesotho's human capital score increased from 1.42 to 1.69 over the period 1960-2019, thus facilitating structural transformation.

- **Trade policy:** Lesotho's National Trade Policy Framework is aligned with the NSDP II strategic goals, and seeks to transform Lesotho from a consumer- based economy to a producer- and export-driven economy. This framework provides transparent guidelines for the implementation of Lesotho's trade agenda, which can contribute immensely towards the country's structural transformation.

- **Lesotho's competitiveness** has constrained private sector development and structural transformation (AfDB study, 2023).

2.3.4 Key Bottlenecks to Fast-Paced Structural Transformation

There are a number of factors that constitute bottlenecks to Lesotho's structural transformation. These include poor governance, low agricultural productivity; lack of food and employment security, poor physical and social infrastructure; acute environmental degradation, population growth, poor fiscal management and persistent political instability, and financing constraints.

Poor governance and political instability: Although Lesotho has held regular democratic elections since 1993, the country has experienced political instability due to weak state and governance institutions; continuous splintering of coalition government arrangements and politicization of security institutions. Lesotho has been plagued by slew of coup d'etats and the collapse of coalition governments.

Low agricultural productivity: This situation reflects a structural anomaly arising from the use of rudimentary technology, the predominance of small farm holdings, low investment in agriculture, the poor quality of extension and advisory services, and inadequate access to credit and fertilizers, among others. A daunting challenge facing the agricultural sector is the lack of value addition and processing,

Box 2.3: Potential and existing opportunities

Lesotho has certain opportunities which it can exploit to become a fully-fledged middle-income country. It can take advantage of AGOA. It can revitalize the manufacturing sector and add value to diamonds to create employment opportunities. The private sector can engage in value chain development in the agro-processing industry to take advantage of the regional market opportunities. Horticulture presents offers remarkable opportunities for the country to scale up participation in the regional value chain and agro-processing. The country has fertile soils supported by abundant water resources, conducive for agricultural production which in turn can lead to food security. It is also a cost-effective supplier of water to South Africa and Botswana, which can improve its fiscal position. It has potential for mohair and value addition in diamond processing. It has unfettered access to the range of South Africa's expertise and advanced technology, which it can use to further its development agenda.

which has constrained employment in the sector. The sector is also vulnerable to risks such as environmental hazards, which contribute to low productivity and heavy reliance on food imports.

Lack of food and employment security: Food insecurity remains a chronic challenge, hindering the country's development and progress towards zero hunger. Despite some economic growth, Lesotho has been unable to address rural poverty and promote inclusive social development. In 2023, about 245,000 people in rural Lesotho were facing high levels of acute food insecurity due to persistent droughts

Poor physical and social infrastructure: Infrastructure is a major constraint on Lesotho. Given that only 12% of the land is arable, there a need to improve farming systems to help combat flooding, frost, hail and storms, soil erosion, desertification and reduced soil fertility, which undermine food security and, by extension, the country's development and structural transformation efforts.

Poor fiscal management: Poor budget execution, a high public sector wage bill (24% of GDP) and a highly inefficient grant system are major challenges in Lesotho's public sector financial management system. Addressing these various issues could potentially reduce waste, leakage and misuse of available resources and thereby increasing actual expenditure in priority sectors without requiring additional financing.

Financing constraints: Overall credit to the private sector has been volatile and declining since 2004, and much lower than in neighboring countries. As a share of GDP, bank loans to the private sector have been three times smaller in Lesotho (20%) than in South Africa and Namibia (60% on average). The situation is complicated by the fact that most of the banks in Lesotho are foreign-owned and therefore the local population finds it difficult to access credit. According to the most recent household budget survey, just over 6% of Basotho report receiving loans from formal sources. This situation has impeded the country's development and structural transformation.

Currency undervaluation (overvaluation) enhances (stymies) structural transformation. In this case, a competitive exchange rate is crucial for structural transformation (AfDB 2023). Well-defined and functioning institutions can positively drive structural transformation by reducing transaction costs and information externality (AfDB study, 2023). Indeed, institutions, governance, and fiscal reforms are essential drivers of structural transformation in Africa. Similarly, capital accumulation drives structural transformation.

Box 2.4: The Bank assistance for structural transformation in Lesotho through the High 5s:

The Bank has mainstreamed the High 5s as follows:

- Under improving the quality of life for the people of Africa, the Lesotho Lowlands Rural Water Supply and Sanitation Project (USD 12.26 million) and the Lesotho Lowlands water Development and Sanitation Phase III (USD 13.3 million) have enabled 86.8% of households to have access to improved water supply from a baseline of 82% (2019). The target is to reach more than 90% by end2024. Nationally, the current access to improved water supply currently stands at 79%. In terms of sanitation, the project has contributed to about 50% of households having access to improved sanitation facilities, from a baseline of 45% (2019). The target is to reach 55% in 2024. The current national access to improved sanitation facilities is at 48%.

- Under industrialize Africa, the e-Government Infrastructure Phase 1 Project (USD 10.4 million) increased internet access coverage from 11% in 2013 to 25% in 2022, thereby strengthening institutions and building capacity to enhance service delivery. This project has helped increase broadband penetration by 56% against a target of 57.5%. It has increased government digital services in rural areas by 50% against a target of 150%. It is expected to increase electronic financial transactions by 40% against a target of 90% by end-2024. ue to the success of the first phase, the Bank approved a second phase in October 2019 (USD 13.5 million) to increase broadband penetration and government digital services in the rural areas.

- In addition, the Economic Diversification Support Project has enhanced entrepreneurship and improved capacity for standards and certification of products. The key results at project completion include the following: (i) the contribution of tourism and leather sector to GDP growth reached 16.2% (2024) compared to a target of 1.5% in 2020; (ii) 1204 new jobs created (52% held by women) at end-2023, compared to a target of 1,200 jobs (approx. 50% for women) in 2020; (iii) 4.2% of MSMEs have access to loans at end-2023 compared to a target of 40% in 2020.; and (iv) 110 SMMEs created through the business plan competition (53.6% by women entrepreneurs) compared to a target of 50(with 50% by women entrepreneurs) in 2020.

- Under light up and power Africa, the Urban Distribution and Transmission Expansion has contributed to the reduction of transmission and distribution losses. From a baseline of 15% (2019), the reported percentage of total losses was 12% (2022), against a target of 10% (2024). The project achieved the target of rehabilitating 188 km of distribution line and 13 substations in 2022. The remaining activity is the upgrade of Khukhune substation which was delayed by a cost overrun. The Government has requested supplementary financing from the Bank to complete the project. A Bank appraisal mission is scheduled for April 2024, which will clear the way for Board consideration of the loan proposal in the third quarter of 2024. Upon completion of the substation, 74 MWh of new clean electricity generation capacity will be added to the grid.

2.4 Financing Needed to Fast-Track Lesotho's Structural Transformation Lesotho's commitments to structural change

The quest for structural change is embedded in Lesotho's second National Strategic Development Plan which seeks to create private sector jobs and eradicate extreme poverty through a shift from "a state-led to a private sector/export-led growth model; from public consumption-driven growth to investment-driven growth (public and private); from macro imbalances to pro-growth macro fiscal stability; from the inefficiency and ineffectiveness of state interventions to a more effective public sector management; and from a high climate risk-exposed economy to a climate change-resilient and sustainable growth economy". Achieving these structural changes will require investing in human capital and institutions and fostering private sector growth.

The country has, therefore, adopted a new growth strategy to achieve structural transformation anchored in productive sectors. The creation of such growth and jobs will require political stability and resilient institutions; stable macroeconomic environment; stable labour markets characterized by a competitive, flexible, healthy, and skilled labour force; stable and efficient public sector that is insulated from undue political interference; access to minimum infrastructure; savings and investment; access to technology and capacity for innovation; and access to markets through global and trade integration.

2.4.1 Financing Needs and Gap

Lesotho's financing needs for the achievement of the SDGs and Agenda 2063 targets (Figure 2.6): In terms of total financing needs to achieve the SDGs by 2030, the amount required is USD 0.812 billion, with a financing gap of USD0.718 billion. The amount required to achieve SDG4 is USD 0.1157 billion with a financing gap of USD 0.7236 billion. The amount required to achieve SDG 7 is USD 0.06595 billion, with a financing gap of USD 0.05514 billion. The amount required to achieve SDG 8 is USD 0.0468 billion, with a financing gap of USD 0.0465 billion. The amount required to achieve SDG 9 is USD 0.5840 billion, with a financing gap of USD0.5442 billion.

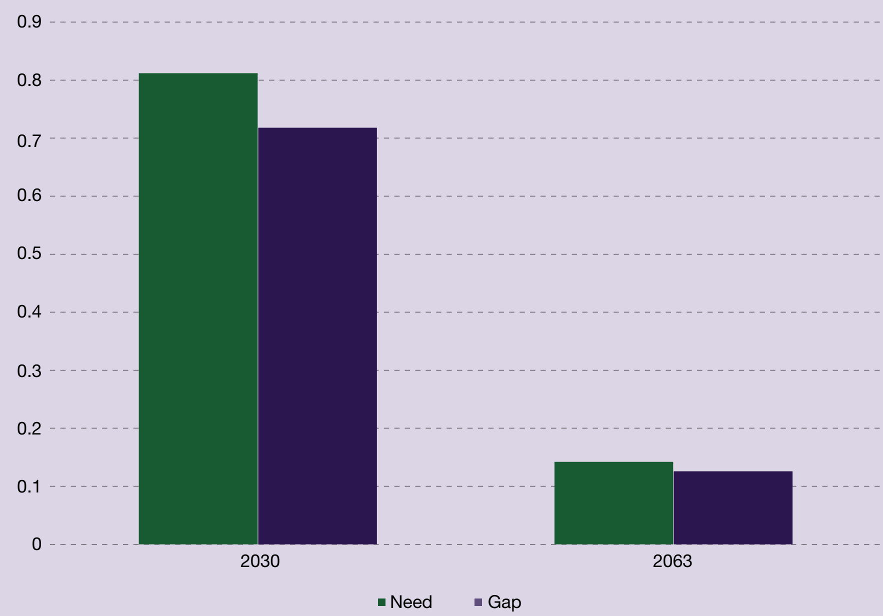
In terms of total financing needs to achieve the SDGs by 2063, the amount required is 0.1421 billion with a financing gap of USD0.1257 billion. The amount required to achieve SDG 4 is USD 0.02025 billion with a financing gap isUSD0.01266 billion, SDG 7 financing needs stands at 0.01154 billion with a financing gap of USD0.0096 billion; SDG 8 financing needs stands at USD0.00819 billion with a gap of USD 0.00814 billion; SDG 9 financing needs stands at USD0.10221 with a financing gap of USD0.09525 SDG 4 financing.

2.4.2 Closing the Financing Gap Through Domestic Resource Mobilization

The government's revenue mobilization efforts in support of structural transformation include (i) improving the efficiency of tax administration by introducing cashless tax collection systems, and (ii) improving compliance by enhancing transparency and auditing and maintaining the integrity of existing taxes, particularly the VAT.

The Government of Lesotho can close the financing gap through domestic resource

Figure 2.6: Financing need and gaps in Lesotho in USD billion.in 2030 and 2063



Source: AfDB, ECMR

mobilization using the savings and investment, political stability and stable institutions, macroeconomic stability, minimum infrastructure platform, stable labour markets, and stable and efficient public sector. The required increase in tax-to-GDP ratio in Lesotho to close the financing gap is 26.4% and 6.3% in 2030 and 2063, respectively (Figure 2.7).

Lesotho's tax-GDP ratio has been unstable and volatile. The highest tax-to-GDP ratio reported for Lesotho since 2000 was 21.3% in 2018, with the lowest being 14.4% in 2006. Lesotho's[1] tax-to-GDP ratio in 2021 (20.7%) was higher than the average of the 33 African countries in 2023 (15.6%) by 5.1 percentage points.

Lesotho has great potential for increasing tax revenue. Contracts with diamond mining companies could be renegotiated to raise more revenue from the sector.

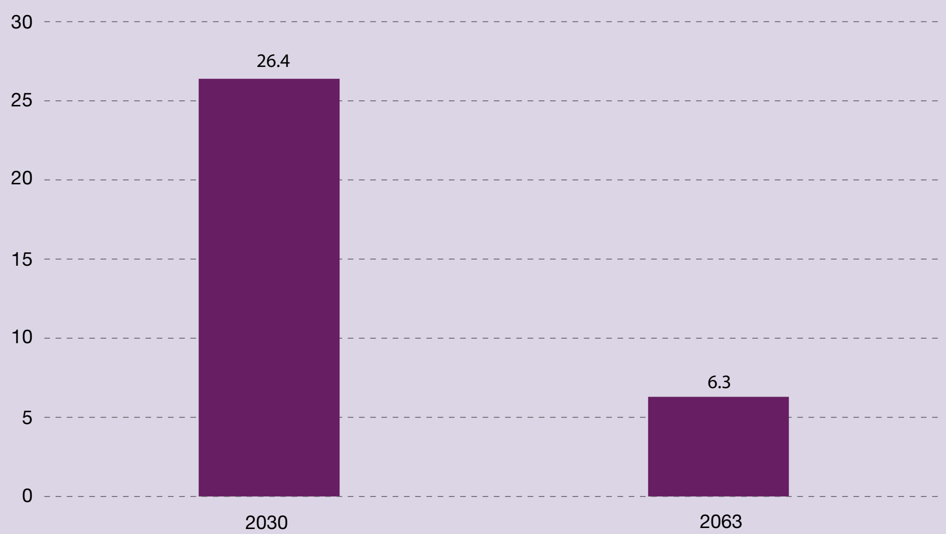
2.5 Concluding remarks and policy recommendations.

(a) The Government's role in building strong institutions and implementing critical measures: Formulating and institutionalizing national development plans and policies tailored to its comparative advantage: Lesotho's national development plans should reflect its priorities and comparative advantage. Currently the country seems to have a comparative advantage in textiles which has contributed immensely to its structural transformation. The country's planning commission should help the country to develop a set of national priorities which are consistently implemented without any policy reversals.

Private sector flows: The private sector should take center stage as the engine of growth. In that regard, the Government should create an enabling environment for it to thrive by facilitating access to information and credit, and improving the legal and regulatory environment. An enabling environment should help catalyze private capital flows to support Lesotho's structural transformation.

Prioritizing investment needs: This financing gap of USD 0.718 billion to achieve the SDGs by 2023 presupposes that Lesotho prioritizes investment needs in education, energy, productivity, and infrastructure. It should invest heavily in key

Figure 2.7: The required increase in tax-to-GDP ratio to close the financing gap (%)



Source: AfDB, ECMR

Box 2.5: Bank Support for Lesotho's Structural Transformation

Lesotho's structural transformation The Bank is supporting agenda through two initiatives:

The first initiative is the Climate Facility. The African Development Bank has provided Lesotho with support from the Africa Climate Change Fund (ACCF) to enable the country to adapt to the impacts of climate change. The lessons learned inform the design of adaptation activities using the Local Climate Adaptive Living Facility (LoCAL), and its funding mechanism, which uses performance-based climate resilience grants to channel financing to local governments for locally-led adaptation to the impacts of climate change. The implementation of adaptation projects is a joint effort between the District Technical Team (DTT) and Community Councils. The DTT provides technical assistance and guidance to community councils, including on the use of data and information on climate change risks and vulnerability, and on developing an annual activity program for LoCAL using existing adaptation plans.

However, it is the communities themselves that are responsible for identifying adaptation activities, monitoring implementation and expenditure, and ensuring compliance with minimum conditions and performance measures. The Community Council Secretary plays an advisory role to the council and assists in developing council plans, coordinating the implementation of the plans, and reporting. The lessons learned from the pilot phase relate to the size of grants, the alignment and use of country systems to ensure the scalability and sustainability of the mechanism, and the development of a list of eligible investments.

The second initiative is through the Lesotho Highlands Water Project (LHWP) Phase II. The Bank is supporting Lesotho's regional integration agenda through the Lesotho Highlands Water Project (LHWP) Phase II. The development objectives of the project are to ensure water security for the Gauteng Region of South Africa and to support the socioeconomic development of Lesotho by improving infrastructure and developing hydropower potential. Specifically, the project will aim to increase the transfer of water from Lesotho to the Republic of South Africa from the current 780 million m3 /year to 1,260 million m3/year, and to provide opportunities for additional hydro power generation in Lesotho. The project is being financed by AfDB, NDB and TCTA/GoRSA. The AfDB loan of ZAR 1.3 billion and NDB loan of ZAR 3.2 billion will finance, on a pari-pasu basis, part of Component B – Main works - which covers Polihali Dam and Polihali Transfer Tunnel works. The loan from the NDB was approved in March 2020. GoRSA will contribute the remaining 86.2% of the total project cost. TCTA will raise these funds from other banks and local bond issues.

The project will provide secure and sustainable water sources to the population living in the Gauteng Region, covering five provinces (Guateng, Freestate, Mpumalanga, Northwest and Northern Cape Provinces) of South Africa with a combined population of 26 million and 60% of South Africa's economy. The water supplied and transferred to the Vaal River system will ensure the availability of water domestic consumption, irrigation, industries, and mining. On the Lesotho side, more than 85,000 people will benefit from the project upon its completion. Also, the project will have a positive impact on community development activities, private sector growth through improved infrastructure, and contribute to Lesotho's socioeconomic development.

Sustainable Development Goals (SDGs) such as education, health and energy and infrastructure to achieve structural transformation. Lesotho should invest its resources form diamond and textile exports in these areas.

Human Capital: Lesotho's human capital index is low at 0.4, underscoring the need to invest more in education, nutrition and health. This investment should be tailored to local realities, circumstances and development priorities, including the provision of appropriate skills training to prepare the workforce for the future. There is a dearth of skilled manpower in Lesotho, hence the mismatch between the demand and supply of labour. The curriculum in the educational institutions should be geared towards the needs of the labour market and industry.

Formalizing the informal sector: The informal sector in Lesotho accounts for 21.4% of GDP. The Government should assist informal sector operators to move into the formal sector. This has the advantage of increasing tax revenue and growing the economy. The Government should facilitate access of the informal sector to finance and training.

Scaling up domestic resource mobilization (DRM) and prioritizing prudence in public finance management (PFM): The government's revenue mobilization efforts to support structural transformation include; (i) improving the efficiency of tax administration by introducing cashless tax collection systems, and (ii) improving compliance by enhancing transparency and auditing and maintaining the integrity of existing taxes, especially the VAT. The following measures could be implemented to enhance domestic resource mobilization:

- Contract negotiation capacity needs to be strengthened and contracts with diamond mining companies renegotiated with the objective of implementing the statutory royalty rate and government equity interest in Lesotho's diamond mines along the lines of Botswana and Namibia. This has the potential to increase royalty revenues by 42.9%, double corporate tax revenues and raise dividend revenues.

- An introduction of a tax, similar to a licence fee of M100.00 per year for small/ informal businesses could generate a meagre M8.83 million per year. This is too little to be worth the effort, especially since the experience of other African countries shows that collection is highly likely to fall short of this potential, despite the high financial cost of implementation.

Lesotho needs to build and deepen national and regional markets for goods, services, capital, and finance: The African Continental Free Trade Area (ACfTA) comes in handy. It offers Lesotho an opportunity to expand its export markets beyond SADC. It is also a unique opportunity for the private sector to boost its textile exports beyond AGOA.

Lesotho, as a producer of diamonds and water, needs to invest in the valuation and conservation of natural capital and include it in the national accounts system in order to expand the size of the economy.

Investing in youth entrepreneurship development programs: Due to the high youth unemployment rate (24.51%) in Lesotho, it needs to harness the continent's demographic dividend by creating employment opportunities through the formulation of entrepreneurship development programs. This can be done through skills training and facilitating access to finance.

b) The role of the private sector in driving structural transformation

While the role of the state remains vital to facilitating structural transformation, developing a dynamic private sector that supports inclusive growth, reduces poverty, creates jobs, and provides access to essential goods, basic services and tax revenues is also critical to achieving structural transformation.

The private sector can be a catalyst for the productive capacity development and structural transformation required to achieve sustainable development in Lesotho. Fostering entrepreneurship and stimulating private sector development and competitiveness through supportive policies and strategic actions should be a priority, given the limited contribution of the private sector to GDP (20%). The Government can, for example, facilitate access to finance and provide business support. The private sector can contribute to the development of productive capacity which in turn can contribute to growth.

Lesotho can use a number of action areas and policies to support the private sector to contribute to structural transformation, including creating an enabling business environment, expanding access to finance, improving access to markets, attracting foreign direct investment and improving human capital.

When the business environment is not conducive, it can increase enterprises' direct and indirect production costs, inhibit the adoption of new technologies, deter investment, weaken competitiveness and reduce market sizes. Lack of access to finance is another major constraint to entrepreneurship and private sector development, particularly for small and medium-sized enterprises in LDCs. To ensure improved access to finance, governments need to build functional financial institutions, strengthen the banking sector and turn small and medium-sized enterprises and entrepreneurs into viable investment targets.

Market access is also a cornerstone of the growth of enterprise and the inability to take advantage of such access is a constraint on private sector development. Expanding access to foreign markets and enhancing the export potential of firms can increase business opportunities, technological spillovers, the learning of new skills and overall productivity. In Lesotho, trade costs and barriers are generally high due to the lack of market information, weak transport infrastructure, cumbersome administrative procedures and the lack of investment. Many firms are also constrained in their ability to comply with international standards. Addressing these constraints requires the implementation of enhanced trade facilitation measures, compliance with international standards, and the provision of training, to increase the competitiveness of the private sector. Such efforts to harness international trade need to be complemented by consistent policies aimed at attracting domestic and foreign direct investment and fostering linkages between the latter and private firms. Limited human capital development in Lesotho also significantly hinders private sector competitiveness. The lack of highly skilled human capital and skills mismatches between the labour force and industry have a negative impact on labour productivity and technological progress. Skilled labour and new technologies drive the structural changes necessary to improve production systems and allow for diversification into more complex products. In Lesotho, the lack of skilled labour is therefore one of the main obstacles to enterprise growth and upgrading into higher value-added segments of the value chain. To stimulate the private sector, governments need to refocus investments in education, skills training and knowledge development.

c) The role of regional institutions in supporting Lesotho's structural transformation agenda?

The African Development Bank promotes regional integration in the continent by financing regional integration projects. It has formulated a regional integration strategy paper for each sub region in the continent. It is clear that regional integration is indispensable to building the economies of scale and achieving the international competitiveness necessary for Africa's structural transformation. Indeed, regional integration has been part of the Bank's mandate since its creation in 1963.

The Bank is supporting Lesotho's regional integration agenda through the Lesotho Highlands Water Project (LHWP) Phase II. The development objectives of the project are to ensure water security of the Gauteng Region of South Africa and improve the socioeconomic development of Lesotho through improved infrastructure and potential for hydropower generation. The project will specifically aim to increase water transfers from Lesotho to the Republic of South Africa.

The Bank continues to support Lesotho's development agenda. Currently, the Bank's active portfolio in Lesotho comprises 8 projects (with 10 financing instruments) for a total value of UA 50.42 million (equivalent to USD 67.04 million). The portfolio is 100% sovereign. There are 7 investment projects (93.4% of total commitments) and one institutional support project (6.6%).

d) The role of Development Financial Institutions (DFIs) and Multilateral Development

Banks (MDBs) financing in supporting Lesotho's structural transformation

DFIs can help channel private investments into new technologies and enable emerging markets to accelerate their efforts to achieve the sustainable development goals. The Bank held a business opportunities seminar in Lesotho in February 2019, during which it interviewed more than 50 SMES. The most daunting challenges facing SMES include lack of access to finance, training and mentoring. DFIs can provide lines of credit to local banks for on-lending to SMES in Lesotho. This will be particularly useful as there is only one local bank in Lesotho - the Post Bank. The SMEs can invest in productive sectors of the economy, thus facilitating structural transformation.

DFIs can also provide technical assistance and training to Lesotho's private sector and Government in the areas of governance, public finance management procurement, project management, etc.

FINANCING STRUCTURAL TRANSFORMATION IN LESOTHO: THE NEEDFOR REFORMS OF THE INTERNATIONAL FINANCIAL ARCHITECTURE

3

Key Messages

- Lesotho is a lower middle-income country with significant development challenges, including poverty, inequality and unemployment. According to the Bank's classification, it is considered an ADF country and is therefore eligible for grants. The Kingdom has limited fiscal space and therefore depends largely on donor funding to finance its development. However, this external financing has not been sufficient to fund its development programs.

- Therefore, Lesotho's journey towards structural transformation demands a significant amount of resources that must be raised externally as it has limited fiscal space. Additional resources would be available to Lesotho if the IMF changed its allocation system which is based on quotas rather than needs. This will enable Lesotho to scale up its development interventions. Fiscal stimulus from the private sector will also provide the country with more resources.

- The failure of the global financial architecture to deliver development financing at scale to Lesotho has constrained the country's ability to achieve structural transformation. For example, of the SDR allocation of 65 billion in 2021 to contain COVID-19, Lesotho received only a meagre USD 66.9 million. Yet, to achieve the SDGs by 2030, it will have to close an annual financing gap of USD0.718 billion. This underscores the need to reform the international financial architecture.

- For Lesotho, reforms should include measures to prevent global tax evasion by multinational corporations (e.g., tax avoidance and profit base shifting) and illicit financial flows (IFFs) (e.g., trade mis-invoicing, transfer pricing, contraband, corruption, money laundering, human and drug trafficking). The reforms will make more resources available for Lesotho and significantly raise the country's debt restructuring ceiling, thus enabling it to restructure its debt and achieve debt sustainability.

- **Direct private capital to where it is most needed and create investment pipelines:** This will help local incubators, start-ups and businesses to know which sectors to target to match with investors where there is potential for deep development impact.

- More **climate finance:** More climate finance will be available to Lesotho under the **Bridgetown Initiative**, launched by Barbadian Prime Minister Mia Mottley in 2022. The initiative is a major multilateral push for finance and trade to work together to support the transition to low-carbon, resilient economies in the Global South.

3.1 INTRODUCTION

To accelerate structural transformation, multilateral development institutions (MFIs) can scale up contingency financing for vulnerable countries in need like Lesotho, which are frequently hit by drought and other shocks. Lesotho received an average of USD 238 million per year in climate finance over 2019–20. Estimated cumulative financing needs for Lesotho to adequately respond to climate change range from USD 1.18 billion to USD 1.89 billion, with an average USD 0.307 billion per year over 2020–30, and a low and high amounts of USD 0.51 billion and USD 0.58 billion, respectively.

Therefore, Lesotho's journey towards structural transformation demands significant amount of resources which must be sourced externally as it has limited fiscal space.

In terms of total financing which Lesotho needs to achieve the SDGs by 2030, the amount required is USD 0.812 billion with a financing gap of USD 0.718 billion. In terms of total financing the country needs to achieve the **SDGs by 2063, the amount required is USD 0.1421 billion** with a financing gap of USD 0.1257 billion.

There is need to prevent global tax evasion by multinational corporations (e.g., tax avoidance, profit base shifting, etc.) and illicit financial flows (IFF) (e.g., trade mis-invoicing, transfer pricing, contraband, corruption, money laundering, human and drug trafficking, etc.). This will make more resources available for Lesotho.

MFIs should also increase up development and climate finance to benefit a resource-poor country like Lesotho. On the home front, Lesotho should enhance domestic resource mobilization and public finance management (PFM). It should also build fiscal buffers using diamond export revenues. The country should also prioritize highly concessional financing, including the restructuring of its existing debt under the G20 Common Framework to achieve debt sustainability. It should also focus on non-debt financing instruments such as carbon trading, enhancing private sector financing, including by deepening the domestic financial sector and accessing cheaper foreign financing through blended financing instruments. Finally, the Government should restore fiscal sustainability through fiscal consolidation.

3.2 Lesotho's Stand on the Need to Reform the International Financial Architecture

Lesotho has not explicitly joined the rest of the international community in calling for reform of the international financial system, but has called on the international community to reduce the cost of remittances which constitute about 25% of its GDP. However, the greatest impediment to increasing the flow of remittances is the cost of remittances to Africa compared to other regions of the world - as high as 25% of the amount remitted. Governments should encourage the flow of remittances through formal banking channels and reduce the cost of remittances. This would significantly increase the amount of remittance flows which can be leveraged to improve access to the capital markets.

3.3 Mobilizing Additional Resources for Lesotho's Structural Transformation

Lesotho's economy has undergone some structural transformation since the 1990s. Between 1990 and 2022, manufacturing grew from 13.2% of GDP to about 22%, and the service sector's share expanded from 40.3% to about 60%. At the same time, agriculture's share in GDP plummeted, from 20% to 5.12%. The main driver of it structural transformation has been the industrial sector which is dominated by textiles. In Lesotho, total factor productivity has been rising since 1980. It rose from 0.49494 in 1980 to 0.97683 in 2019 driven by growth in the manufacturing sector. The main driver of Lesotho's structural transformation is the manufacturing sector. The manufacturing sector grew by tripling of textile and apparel exports to South Africa and the US under AGOA. The textile and apparel sector is also a key employer of women, who make up 80% of Lesotho's textile workers.

The policy therefore requires that priority be given to the industrial sector in order to boost the entire economy and create more jobs. The textile industry has the potential to generate sufficient wealth for Lesotho's structural transformation. There is thus a need for more investments and incentives in the sector.

SACU resources are crucial. As a member of SACU, Lesotho benefits from the free trade agreement with the SACU countries. SACU revenues made up about 40% of total revenues in Lesotho's 2023/24 budget. These revenues can help the country achieve structural transformation by investing in infrastructure and human capital. Similarly, the ACFTA offers significant opportunities for the private sector to expand its market base, especially given the limited size of Lesotho's domestic market. In view of Lesotho's small population and market size, the country is seeking to achieve economic growth through exports, targeting markets beyond its borders. In that context, the AfCFTA represents a significant market, encompassing approximately 1.3 billion people, with Africa's collective GDP reaching around USD 3 trillion.

Remittances also have the potential for accelerating structural transformation. They account for about 24% of GDP. If properly managed, they could drive Lesotho's structural transformation.

3.4 Dealing with Lesotho's Debt

Lesotho's level of debt distress is moderate. The country's debt indicators are expected to deteriorate in the near term before improving over the medium term, supported by recovering SACU transfers and slower increase in public expenditure relative to GDP. The moderate risk rating suggests limited space for absorbing shocks. The DSA highlights the importance of fiscal consolidation to stabilize debt levels, build buffers against future shocks, and prevent the crowding out private sector credit. Controlling current expenditure and improving the efficiency of capital spending will be critical for fiscal consolidation. Contingent liability risks, mainly stemming from the underfunding of the pension fund, also need to be addressed.. Finally, the authorities should also prioritize developing domestic debt markets and avoid contracting expensive commercial debts.

3.5 - Financing Climate Action

Lesotho's total financing needs amount to USD 49.7 million. The public sector contributes about USD 272 million, while the private sector accounts for USD 16.4 million during the period 2019-2020. The private sector's share has declined since 2018, dropping from USD 19.9 million in 2019 to USD 0.27 million in 2020. Commercial financial institutions account for as much as 3% (USD 6.97 million), while corporate sources contribute 1.2% (USD 2.99 million). As for institutional investors, their share is negligible at 0.058% (USD 0.14 million). For Lesotho to achieve green growth, it has to mobilize private capital on a significant scale. In this regard, it is estimated that to adapt to the effects of droughts and floods the country will have to deploy 13% of its GDP.

Although the climate financial flows in Lesotho are serrated, there is a consensus that the country's overall attributed climate finance has decreased owing to limited local capacity to mobilize finance. Climate action finance flow accounts for 5% of

Lesotho's sustainable development goals (SDGs) financing (OECD, 2023). Analysis of the climate finance landscape in Africa by the Climate Policy Initiative (CPI, 2022) has indicated a significant decline in Lesotho's climate finance between 2019 and 2020. In 2020, the country received USD 14 million against USD 461.84 million in 2019 of which public sector finance accounted for 98% in 2020 and 86% in 2019. On average, the country received USD 238 million for 2019-2020.

In line with the government's Vision 2020 goals to increase private sector investment in infrastructure and promote the increased use of renewable energy, the country's investment in the Scaling-Up Renewable Energy Program (SREP) aims to enable the increased adoption of priority technologies: wind, solar, and small hydropower.

The country is implementing the climate finance readiness by building national capacities to directly access financing from the Green Climate Fund (GCF) by establishing the GCF- NDC (Nationally Determined Contributions) /focal point and enhancing coordination mechanisms); and Developing a national program or plan including fundable project proposals, based on national priorities, with the involvement of key stakeholders.

Its main policy actions include the following:

- Establishing climate change fund meant to support climate change related innovations and actions;
- Encouraging the establishment of development financing institutions (e.g., banks, micro-finance institutions) to provide financing for climate change related program;
- Building Lesotho's capacity for mobilization of the necessary climate financing;
- Developing climate change programs and initiatives that could easily attract regional and International climate financing; and
- Developing the capacity for executing budgetary allocation (domestic and foreign) including accountability measures.

3.6 Conclusions and recommendations

The following are recommendations for the adoption of e short, medium and long term measures:

Short-Term Measures

Reducing the debt burden through governance reforms to strengthen debt management capacity: The Government should adopt a debt strategy with clearly defined fiscal rules. This will avoid overspending and keep debt under control. It should also diversify debt sources and avoid commercial debt as much as possible.

Medium- to Long-Term Measures

Reforming the current global financial architecture to make it more responsive to financing needs of African countries: Lesotho has a financing gap of USD 0.718 billion to achieve the SDGs by 20230. The current state of the global financial architecture constrains Lesotho to close this gap. Lesotho is disadvantaged in terms of accessing funds from the global financial architecture. This calls for the need to overhaul the aid architecture. Lesotho can benefit from this overhaul by avoiding global tax evasion by multinational corporations and illicit financial flows (IFFs). IFFs include trade misinvoicing, transfer pricing, contraband, corruption, money laundering, and human and drug trafficking. Lesotho lost USD 9.537 million between 1980 and 2019 (Africa Growth Initiative, Illicit Financial Flows in Africa: drivers, destinations and policy Options).

Scaling up domestic resource mobilization and structural transformation: Lesotho should scale up domestic resource mobilization to close the financing gap. As mentioned in 3.6a, the government's revenue collection efforts in support of structural transformation include: (i) improving the efficiency of tax administration by introducing cashless tax collection systems; and (ii) improving compliance by enhancing transparency and audit and maintaining the integrity of existing taxes, notably the VAT.

Creating an enabling environment is crucial for attracting and scaling up external financial flows as complementary sources of financing: The Government should improve the business environment to attract both foreign direct investment (FDI) and official development assistance (ODA). The Kingdom is open to and eagerly seeking FDI. The Government, business, labor, and civil society leaders all strongly agree that attracting FDI is vital to Lesotho's future. In 2021 the Government of the Kingdom of Lesotho (GOKL) took many promising initiatives to make it easier to do business in Lesotho.

Among the important reforms undertaken in 2020, GOKL introduced new e-licensing and e-registration platforms that promise to greatly reduce the time it takes to start and license a business. New protocols for customs procedures promise to streamline importing and exporting. And at the highest levels the GOKL has announced that it will focus on making Lesotho an attractive destination for foreign direct investment to help the country recover from the COVID-19 pandemic.

Accelerating structural transformation measures and financing their implementation will be key to unlocking Lesotho's development potential: Boosting domestic resource mobilization plays a critical role in that regard as African governments are the primarily responsible for financing their development. Private flows particularly in the form of foreign direct investment can further make a significant contribution to `scale up financing and support faster transfer of technology and skills, job creation, and innovation, important ingredients to accelerate Lesotho's structural transformation. Lesotho should also invest more in innovation and technology, ICT and human capital.

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