

Kingdom of Lesotho: Selected Issues



KINGDOM OF LESOTHO

SELECTED ISSUES

March 2018

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January 31, 2018

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MACROFINANCIAL LINKAGES IN LESOTHO¹

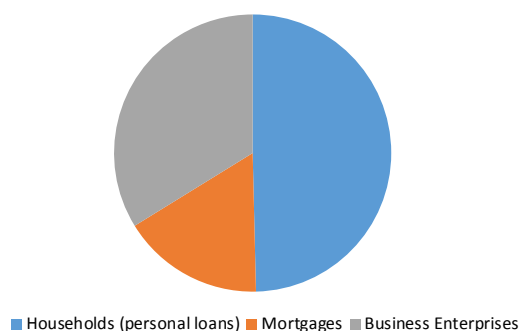
This paper provides further background on the macrofinancial sector analysis that informed Lesotho's 2017 Article IV consultation. Lesotho's financial sector is small, concentrated, and lacks financial inclusion, although mobile banking services and financial cooperatives offer some encouraging potential. Exposure to developments in South Africa and dependence on revenues from the Southern African Customs Union (SACU) are Lesotho's most important vulnerabilities. Shocks to SACU revenues can become a source of systemic risk by affecting the fiscal position and the balance of payments. The financial system will be affected by both channels, with substantial implications if the shock is permanent. While the available data are not sufficient to model and quantify the exact impact of a shock across all sectors, it is still possible to analyze the macrofinancial linkages and to assess resilience and buffers in the system. This paper focuses on two potential consequences of a severe SACU revenue shock for the financial system: A decline in reserves that may threaten the sustainability of the hard currency peg with the South African rand, and the impact of a forced fiscal consolidation on household income and the quality of credit to households, affecting both bank and nonbank lenders. It turns out that financial shallowness and lack of inclusion may be a defining feature of the formal banking system, raising questions about potential trade-offs between inclusiveness and financial stability. Hence, we further explore nontraditional instruments and institutions that have potential to foster financial inclusion.

A. Some Key Characteristics of the Financial Sector

1. Banks are the largest component of Lesotho's financial sector, but pension funds and insurance also play an important role. Three foreign-owned banks and one public bank hold 50 percent of the system's total assets (Table 1). Funeral and life insurance is popular in Lesotho, and insurance companies represent nearly a fifth of total assets, but this number includes assets on behalf of group pension products offered by insurance companies. The public pension fund and private collective investment schemes (such as mutual funds and other asset management companies) are also significant.

2. Bank lending is concentrated toward private resident households. Uncollateralized personal loans and mortgages make up 50 percent and 17 percent of the lending portfolio, respectively. Only one third of loans are directed to business enterprises. Banks are therefore significantly exposed to the financial health of private households. Households often borrow from multiples types of lenders, such as

Figure 1. Lesotho: Bank Loans by Type of Borrowers



¹ Prepared by Tobias Roy.

money lenders and financial cooperatives. The credit bureau, originally created in 2014, now covers most formal financial institutions, mitigating information asymmetries and allowing households to build up a credit record.

Table 1. Lesotho: Size and Structure of the Financial System
(in millions of maloti, unless otherwise indicated)

	December 2010				December 2016			
	Number of Firms	Assets	Assets as % of Total	Assets as % of GDP	Number of Firms	Assets	Assets as % of Total	Assets as % of GDP
Banks	4	8,010	56.7	45.9	4	13,725	48.8	40.7
Foreign Private	3	7,745	54.8	23.0	3	12,472	44.4	37.0
Domestic Public	1	265	1.9	0.8	1	1,253	4.5	3.7
Nonbanks	439	6,121	43.3	35.0	508	14,373	51.2	42.6
Insurance 1/	8	2,408	17.0	13.8	11	5,322	18.9	15.8
Public Pension Fund	1	2,377	16.8	13.6	1	4,700	16.7	13.9
Collective Investment Schemes 2/	8	1,198	8.5	6.9	7	3,035	10.8	9.0
Microfinance Institutions 3/	n.a.	n.a.	n.a.	n.a.	7	722	2.6	2.1
Other 4/	422	138	1.0	0.8	482	594	2.1	1.8
Total Financial System	443	14,131	100.0	80.9	512	28,098	100	83.4

1/ Includes private pension products.

2/ Includes asset management companies.

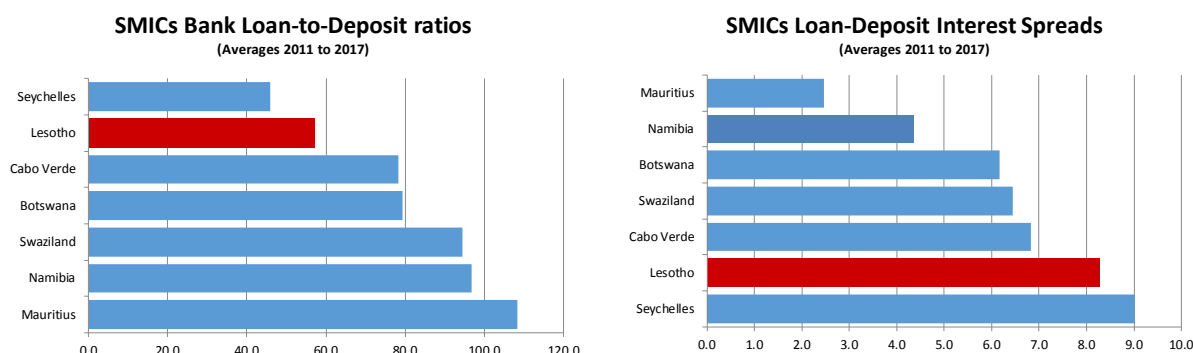
3/ Data not available for 2010.

4/ Money lenders, credit only institutions, exchange bureaus, money transfer companies, and insurance brokers. Includes financial cooperatives, for which data are not available for 2016.

Source: CBL and IMF Staff estimates

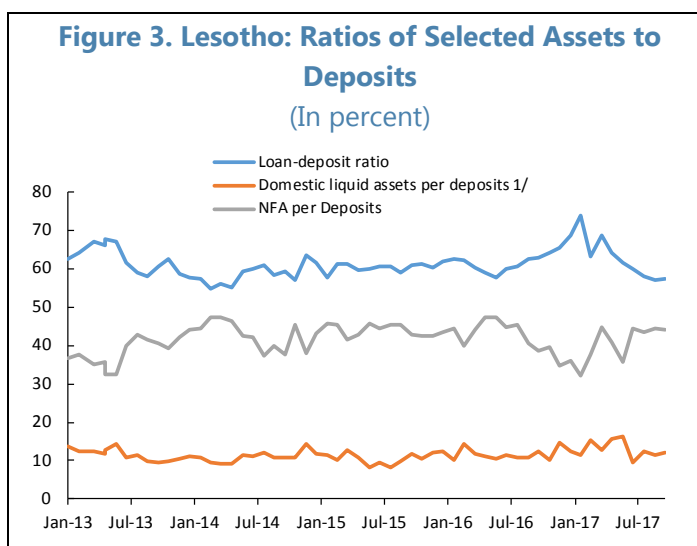
3. Compared with countries of similar size and income, Lesotho's loan-deposit ratio is low, averaging less than 60 percent over the past six years. Interestingly, the loan-deposit ratios of these countries are inversely correlated with the interest rate spread between loans and deposits (figure 2), a measure of the efficiency of financial intermediation (higher spreads signal higher costs of credit). The underlying cause appears to be the higher interest rate on loans that is needed to produce a comparable net interest margin, when the yield-producing loan base is small compared to the deposit base.

Figure 2. Lesotho: Commercial Banks Loan Deposit Ratios and Interest Spreads in Small Middle-Income Countries



4. Banks in Lesotho hold an unusually large share of liquid foreign assets placed at banks in South Africa.

An obvious question is whether banks' NFA holdings are high because the loan-deposit ratio is low, possibly due to the lack of bankable projects, or whether lending is subdued because of the large NFA holdings. One potential motive that may tilt banks' portfolio choice toward a large share of liquid foreign assets could be self-insurance under Lesotho's hard currency peg, given the absence of a lender of last resort. This issue will be pursued further in the next paragraph.



B. Potential Systemic Risks from the Currency Peg

5. The Central Bank of Lesotho (CBL) has successfully operated a fixed exchange rate regime since 1980. Under the rules of the Common Monetary Area, both the South African rand and the loti are legal tender in Lesotho and pegged at par. Maloti and rand cash circulates freely and in parallel in Lesotho's economy, and market confidence in the system is high, as indicated by the low share of rand-denominated bank deposits (about 2 percent). Given close trade links with South Africa, the arrangement has served Lesotho well, but it obviously imposes tight restrictions on monetary policy. In particular, the CBL needs to maintain a reserves position that will prevent the possibility of a self-fulfilling confidence crisis, in which loti cash and deposit holders would simultaneously try to convert their holdings into rand to protect against a depreciation.²

6. To enhance buffers and to allow for some domestic liquidity control, the CBL maintains a high share of coverage of monetary aggregates with international reserves. The coverage ratio is significantly higher than under a "classical" currency board, which would provide for a 100 percent coverage of the monetary base and let domestic currency fluctuate with the supply and demand for foreign currency. However, to maintain financial stability, reserves coverage should focus more broadly on transferable monetary assets rather than the monetary base.³

² A self-fulfilling run on maloti assets would be a low-probability "black swan" event. However, as the history of banking crises shows, the macrofinancial repercussions would be non-linear and severe: The balance of payments would register a massive capital outflow, the central bank would be forced to abandon the peg, credit supply would implode, with severe repercussions on household consumption, business investment, and economic growth. Fiscal revenue would collapse, potentially forcing a sovereign default, which would lead to additional private sector spillovers and further second-round effects in the financial system.

³ In fact, international reserves coverage of the monetary base is much higher than under a currency board, averaging 650 percent over the first ten months of 2017.

Coverage of M1 (currency in circulation plus transferable deposits) is indeed strong, though the trend has recently been declining (figure 4). Even when applying a wider measure of short-term bank liabilities ("M1 plus"), which includes callable deposits, coverage has remained comfortably above 100 percent (132 percent in September 2017), giving the central bank significant fire power to defend the peg.

7. The system's resilience is strengthened further by commercial banks' substantial holdings of liquid foreign assets. Adding banks' net foreign assets to the central bank's gross reserves increases the average coverage of "M1 plus" to 186 percent. Even the wider concept of broad money, which includes savings deposits, is more than completely covered by the whole system's foreign reserve assets (137 percent in September 2017).

8. As long as these strong coverage ratios persist, a self-fulfilling confidence crisis can be safely ruled out. Once certain coverage ratios fall below 100 percent, a confidence crisis, while theoretically possible, would still be an unlikely event. However, the recent declining trend is certainly not sustainable over the medium-term, and macroeconomic policies, in particular fiscal policy, need to be adjusted to stabilize coverage ratios at some point. In such a case, the timing of fiscal adjustment will be critical: Waiting too long could force a sharp and disorderly fiscal contraction, for example by a combination of running domestic arrears and/or drastic expenditure cuts. This would have severe implications for the financial system through the credit risk channel, as will be further explored in section C.

9. As to banks' substantial foreign asset holdings, it is difficult to tell if they are caused by the lack of bankable projects or if, conversely, the need to maintain high foreign liquid balances constrains credit growth. There is probably truth in both sides of the argument. Work by previous IMF teams and the World Bank has identified structural deficiencies that constrains credit growth, such as weak contract enforcement. However, there also seems to exist a genuine liquidity preference on the side of banks. For example, liquid treasury bills, whose total issue amount is capped at 700 million maloti and which are used only for sterilization purposes, are nearly always

Figure 4. Lesotho: Gross Reserves Coverage of Transferable and Callable Money Aggregates
(In percent, 3-month moving average)

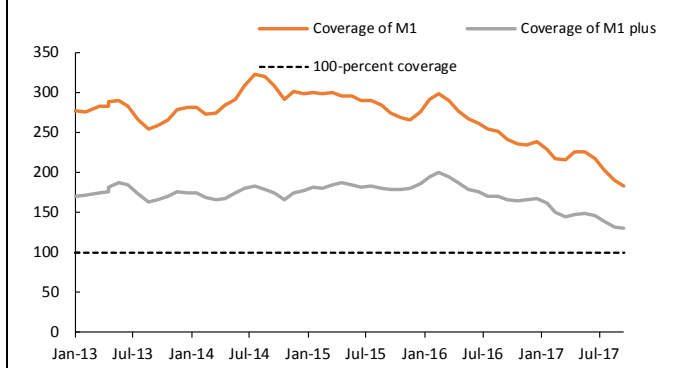
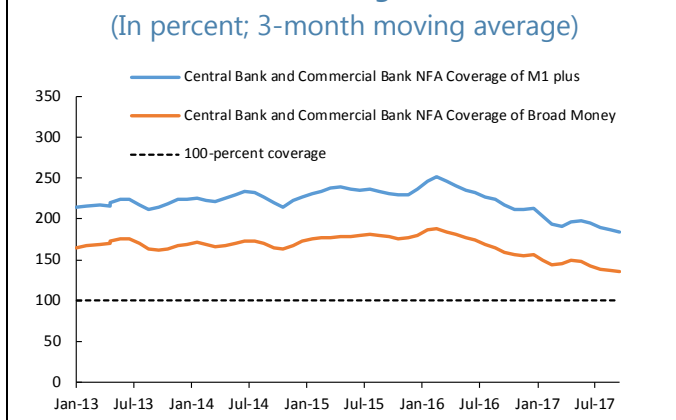


Figure 5. Lesotho: Gross Reserves and Bank NFA Coverage
(In percent, 3-month moving average)



oversubscribed by banks participating in the auctions. On the other hand, longer-term government bonds, which are used for financing the fiscal deficit, have experienced mixed results in the auctions, indicating banks' limited appetite for absorbing illiquid assets.⁴ Since there is little domestic excess liquidity in the system, banks seem willing to substitute liquid foreign assets for (higher-yielding) liquid treasury bills. It is also plausible that banks prefer high precautionary foreign balances, even at low yields, because they signal individual banks' capacity to guarantee maloti convertibility at all times. But either way, banks' liquidity preference implies that they are constrained in raising the share of loans in their asset portfolio, resulting in a low loan-deposit ratio and a high interest-rate spread. If this is the case, the need to maintain confidence in financial stability conspires against the potential to widen access to credit through the banking system.

10. While the overall liquidity of the system is secure, the CBL could strengthen its liquidity control by finetuning liquidity requirements. Under the present system, commercial banks must comply with a 3-percent cash reserve requirement (CRR) against the total amount of deposit liabilities and balances due to foreign and local banks, to be held in reserve balances with the central bank. On top of this, there is a 25 percent minimum liquid asset requirement (LAR). Among the qualifying liquid assets are cash, deposits with the central bank, short-term treasury bills, and (importantly) balances due from other banks in Lesotho. In practice, banks' claims on each other are not netted out against their liabilities. As a result, banks can create, by mutual agreement, liquid assets in unlimited amounts, rendering the constraint on the system meaningless. On the other hand, banks are highly liquid in the form of NFA, but these claims are not recognized by the LAR.

11. The CBL should consider amending the LAR and restrict the use of claims on other banks to a net basis only. In fact, a revised LAR regulation from 2016 already changed the definition of liquid assets to net balances only, but the new LAR is currently not applied because of some technical problems. Once the LAR has been amended, changes in the required ratio would give the CBL some limited room to influence banks' supply and demand for foreign exchange. In addition, the current ceiling on the issuance of treasury bills for sterilization purposes of maloti 700 million should be raised by at least 300 million. This would give the CBL more flexibility to provide banks with additional domestic instruments to cover the LAR and induce them to sell NFA.

C. Credit Risks from Lending to Households

12. A standard banking sector heatmap reveals that the system is solid and shows no signs of overheating. The credit-to-GDP ratio is steady relative to trend, NPLs are stable at low levels, and profitability is high (though declining lately). The flipside is that the system is not showing any signs of financial deepening—in fact, the credit-to-GDP ratio has been decreasing somewhat, indicating the system's poor capacity to foster financial development and inclusion.

⁴ The insurance and private pension industry may be better placed to absorb long-term government securities. Recently, the local asset requirement for insurance companies was increased from 15 to 30 percent. As a result, insurance companies have shifted a significant amount of assets into domestic bank deposits to comply with the higher required ratio, because there has been a lack of long-term investment material.

Table 2. Lesotho's Banking Sector Heat Map

Lesotho	2014Q3	2014Q4	2015Q1	2015Q2	2015Q3	2015Q4	2016Q1	2016Q2	2016Q3	2016Q4	2017Q1	2017Q2	Latest
Overall Financial Sector Rating	L	L	L	L	L	L	L	L	L	L	L	L	L
Credit cycle	L	L	L	L	L	L	L	L	L	L	L	L	L
Change in credit / GDP ratio (pp, annual)	-0.1	-0.6	-0.5	-0.7	-0.9	-0.9	-0.4	-0.1	-0.6	-0.4	-0.3	-0.6	-0.6
Growth of credit / GDP (% , annual)	-0.6	-3.2	-2.9	-4.0	-5.0	-4.9	-2.5	-0.6	-3.3	-2.4	-1.9	-3.7	-3.7
Credit-to-GDP gap (st. dev)	-1.6	-2.0	-2.2	-2.0	-1.1	-1.1	-0.9	-0.6	-0.2	0.0	0.3	0.4	0.4
Balance Sheet Soundness	L	L	L	L	L	L	L	L	L	L	L	L	L
Balance Sheet Structural Risk	L	L	L	L	L	L	L	L	L	L	L	L	L
Deposit-to-loan ratio	134.8	174.2	169.0	177.1	165.2	163.1	158.2	168.1	156.9	149.4	161.5	161.8	161.8
FX liabilities % (of total liabilities)	3.7	3.0	2.4	3.0	3.8	3.7	2.6	2.0	2.7	2.8	2.6	3.3	3.3
FX loans % (of total loans)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Balance Sheet Buffers	L	L	L	L	L	L	L	L	L	L	L	L	L
Leverage	L	L	L	L	L	L	L	L	L	L	L	L	L
Leverage ratio (%)	10.7	11.1	12.2	10.6	9.9	10.5	11.4	11.7	12.1	13.2	12.9	13.2	13.2
Profitability	L	L	L	L	L	L	L	L	L	L	L	L	L
ROA	3.9	4.3	4.4	4.3	3.4	4.5	4.1	4.3	4.6	4.5	4.1	3.5	3.5
ROE	37.0	40.5	37.9	37.6	39.6	40.1	37.7	38.4	40.2	38.0	31.7	27.3	27.3
Asset quality	L	M	L	L	L	L	L	L	L	L	L	L	L
NPL ratio	3.9	4.1	4.1	3.9	4.0	3.9	3.8	3.9	3.7	3.6	4.0	4.0	4.0
NPL ratio change (% , annual)	-5.2	12.2	-3.2	-10.7	1.5	-5.0	-6.4	-0.6	-6.1	-8.0	5.0	1.7	1.7
Memo items:	2014Q3	2014Q4	2015Q1	2015Q2	2015Q3	2015Q4	2016Q1	2016Q2	2016Q3	2016Q4	2017Q1	2017Q2	Latest
Credit-to-GDP (%)	18.2	17.8	17.2	16.8	17.3	17.0	16.8	16.7	16.8	16.6	16.5	16.1	16.1
Credit-to-GDP gap (%; HP filter)	4.5	4.0	3.3	2.8	3.2	2.8	2.5	2.4	2.3	2.1	1.9	1.9	1.9
Credit growth (%; annual)	14.3	12.3	11.8	9.8	7.8	7.3	8.0	8.2	3.5	2.8	5.7	6.1	6.1
CAR (in %)	13.4	13.7	19.5	17.7	15.4	15.2	19.9	19.3	17.5	18.0	23.2	17.2	17.2
Tier 1 CAR (in %)	12.7	13.0	18.7	16.9	13.7	13.8	19.6	18.6	17.0	17.1	22.1	21.2	21.2

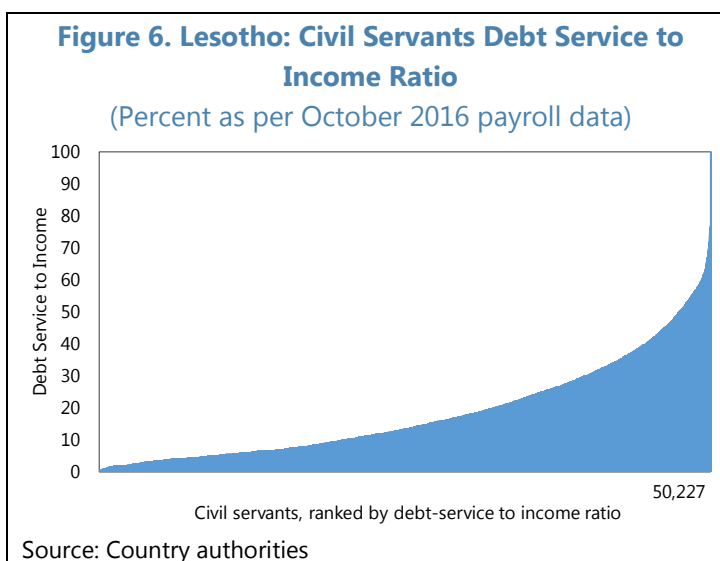
13. CBL stress testing confirms that bank capital positions are quite resilient to shocks. In a recent exercise, using data from end-2016, the CBL found that a severe shock, which raises NPLs by 180 percent, would still leave all banks comfortably capitalized. Reverse stress-testing revealed that 30 percent of the system's performing loan portfolio would have to become non-performing to breach the system's minimum capital adequacy ratio of 8 percent. Even in the event of a severe fiscal shock, characterized by some combination of expenditure cuts, salary freezes, retrenchment of personnel, and increasing arrears to service suppliers, banks should be easily able to withstand the first-round impact of the shock.

14. The direct interaction between sovereign and banking risks is not very pronounced. Banks' exposure to sovereign risk is fairly limited: Government domestic securities (treasury bills and bonds) represent only 5.6 percent of their assets (and about 2.4 percent of GDP). Conversely, the banking sector is not very large, particularly when compared to financially highly integrated economies, which limits the potential fiscal fallout from a bank bail-out scenario.

15. However, banks are heavily exposed to households, and there are indications that the financial position of households is vulnerable. Households borrow from multiple formal and informal sources. For civil servants, many loans are secured by deduction of debt service at the source of salary payment, implying that their received disposable incomes are net of taxes, social contributions, and debt and insurance payments. This system substitutes collateral with a direct claim on salary, which is an effective commitment mechanism when there are no other signaling

devices about the quality of a borrower. But with the recent advent of the credit bureau, there are suddenly new ways of signaling creditworthiness. Anecdotal evidence implies that weak borrowers, whose credit requests were rejected on the basis of their credit record, have increasingly turned to money lenders that do not require credit history and simply rely on deduction of debt service at source. Their deteriorating net salary in the current account has prompted formal lenders to turn to deduction-at-source, too, creating a rush toward source deduction particularly for financially weaker households.⁵

16. Payroll data indicate that in 2016 more than 20 percent of civil servants took home less than 50 percent of their pay, the remainder being deducted at source for debt and insurance payments. This indicates significant financial vulnerability of households. While banks may have significant buffers to face external and fiscal shocks, households do not. As a consequence, second-round effects of shocks affecting households could reverberate quite intensely through the financial system, the real sector, and public finances.



17. The nascent mortgage market could exacerbate household vulnerability. Mortgage lending has picked up in recent years, following improvements of the land registry system. Between 2009 and now, the share of mortgage loans in total lending has increased from six to seventeen percent of the total loan portfolio. There is some anecdotal evidence of booming construction and rising house prices.⁶ And while there is not sufficient evidence to confirm a housing price bubble, a sudden retrenchment of house prices would certainly accelerate and aggravate any financial shock hitting households and banks' loan portfolio.

18. Households' financial fragility and income exposure to the public sector could lead to harmful dynamics in the case of a disorderly fiscal adjustment. First-round effects of the shock could be easily absorbed by banks, as earlier discussed. But since households have little buffers to withstand the shock, their financial predicament would reverberate across the whole economy,

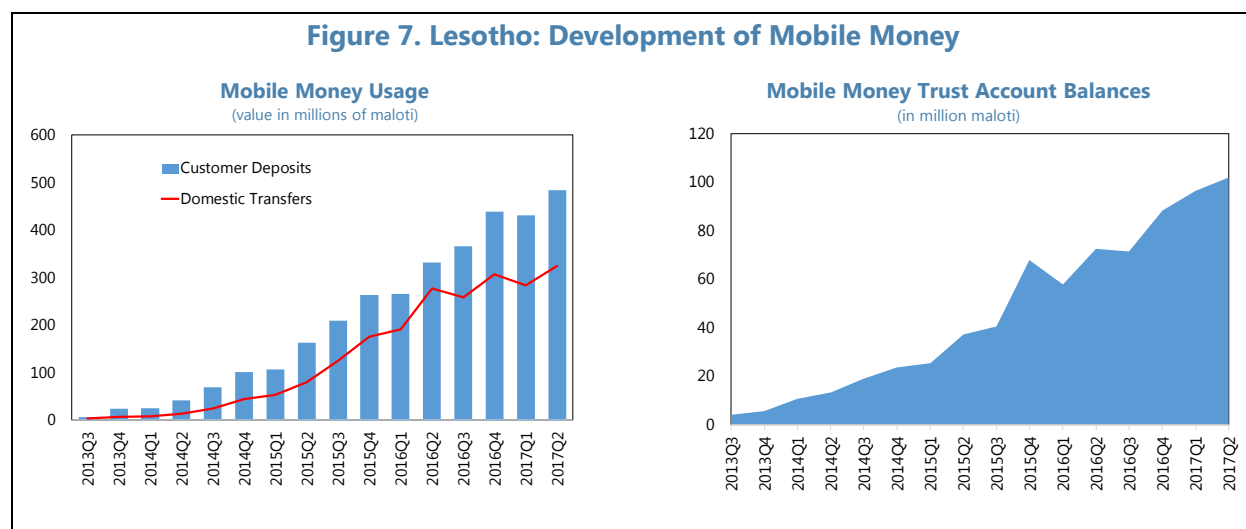
⁵ The authorities have started to address the problem by implementing the legally required minimum for the take-home pay of 30 percent of salaries. Since October 2017, the information system of the company that administers the debt-service deduction at source (CEDAS) has been linked to the payroll database, allowing CEDAS to reject requests from lenders for deduction at source once the 70-percent threshold has been reached.

⁶ A house price index does not exist at this stage, but the CBL is exploring the development of a database on housing and real estate prices.

including the real sector.⁷ This would be quickly translated into the private business sector, a large part of which is dependent not only on household spending, but also on government contracts. The financial crunch would be exacerbated by public sector payment arrears, which in turn would sharply curtail investment and private sector spending, erode banks' profitability, drive down tax revenue, and force further fiscal spending or payments cuts. If these dynamics continue for an extended time, the financial system's buffers might be exhausted, forcing a bank bailout that would drive up public debt, activating a negative bank-sovereign feedback loop. To minimize these potential spillovers, it is important to phase in an orderly fiscal adjustment as soon as possible. Establishing confidence in the effectiveness of the proposed fiscal adjustment path would not only stabilize the financial sector, but could also open up sources of external financing that would be consistent with a more gradual and well-structured consolidation plan.

D. Mobile Banking and Financial Inclusion

19. Mobile banking and nonbank financial institutions offer the largest potential for fostering financial inclusion in Lesotho. Since its introduction in July 2013, the use of mobile financial services has exploded, and 60 percent of Lesotho's total population are now registered mobile money users. The industry is dominated by two companies (EcoCash and M-Pesa), but given the increased significance of e-payments, nearly all banks surveyed have indicated that they plan to offer mobile banking services, too.⁸ The CBL supervises mobile payments operators, and a new set of regulations has been enacted in March 2017.



⁷ Macroprudential tools, such as the gradual phasing in of debt-service-to-income ceilings on consumer lending, are usually recommended to contain the risk of credit overheating. While there are few signs, if any, of a credit bubble in Lesotho's financial system, such tools could be used to gradually enhance household resilience to income shocks.

⁸ For 2018, the Postbank plans to introduce a mobile banking application that includes savings products and nano loans for customers in rural areas.

20. The wide diffusion of mobile money in the past four years is an indicator for progress in financial inclusion. Unfortunately, the last comprehensive data for Lesotho available from the World Bank's financial inclusion database is from 2011, so it is not possible to compare the ascendance of mobile money with progress in other areas.⁹ In the absence of conclusive data, it is worthwhile to take a look at the potential of other nonbank financial institutions to widen and improve access to credit and other financial services.

21. Financial cooperatives (SACCOs) suffer from structural problems, but offer potential for enhancing financial inclusion. SACCOs are supervised by the Cooperatives Department in the Ministry of Small Business, Cooperatives, and Marketing (MoSBCM). There is currently a gap in the reporting of financial data due to some hardware problems that occurred during a recent move, but the Ministry has established a new reporting template that will cover all districts of Lesotho, and the new Cooperative Data System is scheduled to come alive in early 2018. Many of the SACCOs of older generations face demographic challenges, as they are closed to new members, and the MoSBCM is organizing workshops to advise them on how to merge. The MoSBCM is also encouraging the creation of a single financial cooperatives league, which would allow younger and older SACCOs to join forces and share infrastructures and members. The medium-term objective is to strengthen the SACCOs such that they can provide financial services not only to their individual members, but also to other nonfinancial cooperatives. However, this will require more differentiated legislation than the General Cooperatives Act. A draft law for financial cooperatives has been prepared in the MoSBCM, and it should be brought to the cabinet level as soon as possible.

22. Appropriately, the 2012 Financial Institutions Act now requires the supervision of large financial cooperatives by the Banking Supervision Department of the CBL. But Boliba Savings and Credit, the largest financial cooperative with more than 65,000 members, has not yet completed its licensing process and is currently supervised neither by the CBL nor by the MoSBCM. Moreover, it appears that the governance structure of Boliba is not appropriate for an institution with more than 65,000 members.¹⁰ Boliba has been recapitalized a few years ago; while an eventual bailout, if required, could pose some moderate fiscal risk, there is no systemic risk for the financial system.

23. Microfinance Institutions. While serving a similar client base, microfinance institutions (MFIs) are regulated separately from financial cooperatives and report to the CBL. The regulation also provides for deposit-taking MFIs, but there are currently only credit-only MFIs operating in Lesotho. The industry is in an infant stage and it is too early to assess their impact, but they, too, hold potential to foster financial inclusion.

⁹ In 2011, Lesotho ranked in the bottom half of selected low middle-income countries, with only 18 percent of the population over 15 years old owning an account at a formal financial institution.

¹⁰ Boliba's entire Board of Directors is to be elected every year, ballots are secret but can be cast only in person at Boliba's Annual Meeting, and there is no requirement to provide statements by the candidates to every member by e-mail or postal service.

E. Conclusions

24. Under the baseline scenario, the financial system is well endowed with ample foreign-exchange and capital buffers, which are sufficient to prevent a confidence crisis or systemic spillovers to the rest of the economy. This is confirmed by the results of the CBL's stress-testing exercises, which subjected the banking system to significant hypothetical credit and liquidity shocks. In the baseline scenario used for Lesotho's 2017 Article IV consultation, the current shock to the SACU revenues recedes in 2020–22. Under these assumptions, gross international reserves of the CBL would gradually decrease from 3.6 months of imports (2017/18) to 1.9 months of imports (2021/22). Over the same period, the overall fiscal balance would improve from -6.5 to 0.3 percent of GDP.

25. Under an extended shock scenario, the fall in SACU revenues would be permanent, raising questions over the medium-term sustainability of the exchange rate peg. Predicting the timing of a speculative attack under rational expectations has been a widely researched topic, going back for nearly 40 years. In practice, it is difficult to specify the exact reserves threshold under which a confidence shock with an ensuing speculative attack becomes likely. But it is an established finding that a foreign currency run would occur well before international reserves have fallen to zero. Such a nonlinear event would come with severe and multiple repercussions in the real economy, including a contraction of bank credit, default by households and private sector business, a collapse of fiscal revenues, bank failures, and further next-round spillovers and spillbacks.

26. To prevent the dire consequences of such an extended shock, proactive fiscal consolidation will need to be the principal policy instrument. An orderly adjustment, initiated in time, is necessary to maintain confidence and mitigate the negative impact of fiscal consolidation on domestic demand, household income, and economic growth. Fiscal measures should be complemented by monetary policy instruments that strengthen domestic liquidity control. Macroprudential measures, such as debt-service-to-income ceilings for consumer lending, could also be used to enhance household resilience to income shocks.

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