

# Policy Coordination in Lesotho

Kingdom of Lesotho

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*IMF Selected Issues Papers* are prepared by IMF staff as background documentation for periodic consultations with member countries. It is based on the information available at the time it was completed on [June 15, 2022]. This paper is also published separately as IMF Country Report No 22/162.

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**Policy Coordination in Lesotho**  
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**ABSTRACT:** In a country such as Lesotho with high capital mobility and leakages abroad, the relationship between both fiscal, monetary, and exchange rate policy is intertwined, such that public spending and reserves are strongly linked. The paper offers an overview of the economic institutions and arrangements in Lesotho, discusses a short primer on macroeconomic policies under a fixed exchange rate, stresses a vital role for macro policy coordination in Lesotho, and proposes a macro policy framework. While the paper is developed in context of Lesotho, the analysis should also be applicable to small open economies under the fixed exchange rate arrangement.

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**SELECTED ISSUES PAPERS**

# **Policy Coordination in Lesotho**

Kingdom of Lesotho

## Introduction

**1. The successful pursuit of a country's macro policy objectives requires efficient and effective coordination of macro policies including fiscal policy and monetary policy.** The structure of Lesotho's economy forces an important need for close coordination between the key macro policymakers within the country—the Ministry of Finance (fiscal) and the Central Bank of Lesotho (monetary). Specifically, Lesotho is a small open economy in which its currency is pegged to the South African rand. As a country with high capital mobility and leakages abroad, the relationship between both fiscal, monetary, and exchange rate policy is intertwined, such that public spending and reserves are strongly linked.

## An Overview of the Economic Institutions and Arrangements in Lesotho<sup>1</sup>

**2. Lesotho's history and geography has meant that it has maintained very close economic and financial ties with South Africa.** When Botswana, Eswatini, and Lesotho gained independence in the 1960s, they were already members of a common customs area—the Southern African Customs Union (SACU)—and also de facto members of a currency union with South Africa.<sup>2</sup> The currency union was formally established on December 5, 1974, with the signing of the Rand Monetary Area (RMA) agreement, and subsequently revised in April 1986 to establish the Common Monetary Area (CMA) of Eswatini, Lesotho, and South Africa. Under the terms of the CMA Agreement, the South African rand would continue to be legal tender in Eswatini and Lesotho, which would also have the right to issue their own national currencies.

**3. Under the rules of the CMA, both the South African rand and the loti (plural: Maloti) are legal tender in Lesotho and pegged at par.** Article 2 of the CMA Agreement permits SACU members to issue national currencies. Bilateral agreements with South Africa define the areas in which their currencies are legal tender. In general, the local currencies issued by the three members are legal tender only in their respective countries. The South African rand, however, is legal tender throughout the CMA. The national currencies issued by the three small countries are the loti in Lesotho, the lilangeni in Eswatini, and the Namibian dollar. Under the bilateral agreement between Lesotho and South Africa, both countries are required to allow authorized dealers within their territories to convert, at par, notes issued by the Central Bank of Lesotho (CBL) or the South African Reserve Bank (SARB) without restriction and subject only to normal handling charges.<sup>3</sup> Similar arrangements exist between the other two CMA members and South Africa.

**4. The CBL is required to maintain foreign reserves equivalent to the total amount of maloti currency that it issues.**<sup>4</sup> 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. Such reserves may comprise the CBL's holdings of rand balances, the rand currency the CBL holds in a Special Rand Deposit

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<sup>1</sup> This section draws heavily on the Selected Issues Papers of the 2005 Article IV Consultation for the Kingdom of Lesotho.

<sup>2</sup> SACU was established in 1910, with membership comprising South Africa, Bechuanaland (now Botswana), Basutoland (now Lesotho), Namibia, and Swaziland (now Eswatini). In 1921, after the establishment of the South African Reserve Bank, the South African pound became the sole medium of exchange and legal tender across all territories.

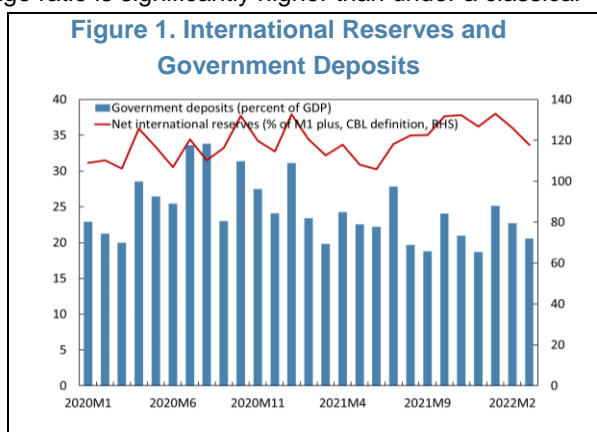
<sup>3</sup> Article 2 of the Lesotho–South Africa bilateral agreement.

<sup>4</sup> Article 4 of the Lesotho–South Africa bilateral agreement.

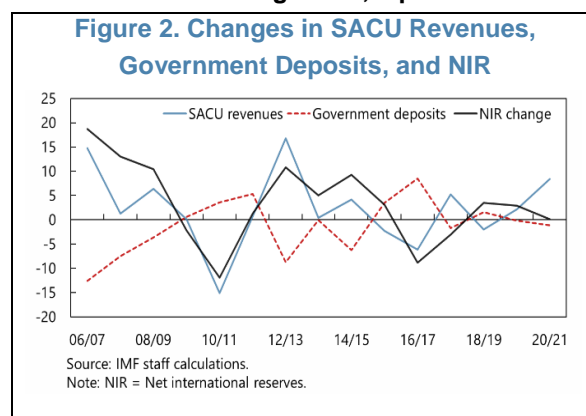
Account with the SARB, South African government stock (up to 10 percent of total reserves), and its investments with the Corporation for Public Deposit in South Africa.

**5. Lesotho's exchange rate arrangement under the CMA shares certain characteristics of a currency board but differs in one important respect.** All maloti currency issued by the CBL is backed entirely by the central bank's foreign exchange reserves. Such an arrangement has the advantage of insulating monetary policy from possible political interference and hence helps enhance the credibility of macroeconomic policies. However, currency boards are also typically prohibited by law from acquiring any domestic assets, so that all the currency it issues is automatically backed fully by foreign reserves. There is no such legal restriction for Lesotho under the CMA.

**6. To enhance buffers and to allow for some domestic liquidity control, the CBL maintains a high reserve coverage of monetary aggregates.** The coverage ratio is significantly higher than under a classical currency board, which would provide for 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. Even when applying a wider measure of short-term bank liabilities ("M1 plus"), which includes callable deposits, coverage has remained comfortably above 100 percent (130 percent as of December 2021), giving the central bank significant firepower to defend the peg (Figure 1).



**7. While the exchange rate peg eliminates a key lever for demand management, it provides a nominal anchor and occasional constraint on spending.** Exchange rate and monetary policy cycles in Lesotho are driven entirely by South African monetary and exchange rate policies. In the absence of a formal fiscal anchor, enforcement of a net international reserves (NIR) target has acted as a spending brake when SACU transfers dip, such that changes in reserves (and government deposits) closely track changes in SACU transfers. This has led to conflict between the Ministry of Finance and the Central Bank of Lesotho (CBL) on several occasions (Figure 2).



**8. The government has established some principles to guide the conduct of fiscal policy.**<sup>5</sup> These principles are documented in the government's budget strategy paper but are unenforced. Consequently, public expenditure, as managed by the Ministry of Finance (MOF), has typically been more discretionary than rules-

<sup>5</sup> See SIP: *Evaluating Fiscal Rules in Lesotho*.

(continued...)

based. For example, while several budget principles specified in the FY21/22 Budget Strategy Paper, the FY22/23 budget tabled in Parliament in early March 2022 has large deficits over the next 3 years, with limited concrete adjustment measures nor financing plans. As a result, arrears are being accumulated.<sup>6</sup>

### **A Short Primer on Macroeconomic Policies Under a Fixed Exchange Rate**

**9. As a small open economy under a peg with perfect capital mobility, monetary policy is less effective.** The peg, the parallel circulation of the loti and rand, currency convertibility, and regional capital mobility mean that the central bank does not have independent control of its money supply. The demand for maloti depends importantly on the public's confidence in the exchange rate parity, given the extensive financial linkages between Lesotho and South Africa. Lesotho's monetary base basically expands (or contracts) in line with central bank purchases (or sales) of foreign exchange. Given the small size of its economy relative to that of South Africa, interest rate movements in Lesotho largely mirror those in South Africa, except for a spread that reflects country risk.

**10. Monetary policy is weaker as any expansion in domestic credit would be offset by an equivalent reduction in the level of net international reserves (NIR), leaving monetary aggregates unchanged.** Typically, an initial increase in the money supply following an expansion of domestic credit will prompt a drop in local interest rates. As a result, capital will tend to flow out of Lesotho given relatively lower domestic rates, which will in turn reduce the money supply and be reflected as a drop in NIR. The capital outflow will continue until local interest rates return to their original level. Ultimately, the only effect of the expansionary monetary policy will have been a change in the composition of reserves, with no change in the overall level of monetary aggregates or interest rates.

**11. On the other hand, fiscal policy can directly influence aggregate demand.** Fiscal policy is particularly effective in influencing aggregate demand since changes in the fiscal stance do not affect the interest rate (which will remain equal to the international interest rate) or the exchange rate (as it is pegged). In such circumstances, expansionary fiscal policy would not give rise to any crowding out of private sector activity.

**12. The degree of capital mobility and size of the nontradable goods sectors can alter the effectiveness of fiscal and monetary policies.**

- If capital mobility is less than perfect, fiscal policy will lose part of its effectiveness since domestic interest rates now will move in response to changes in the fiscal policy stance. This, in turn, would lead to some crowding out of the private sector. Monetary policy will gain some effectiveness, since interest rates can move following policy actions on the part of the monetary authorities, and thus will affect the level of aggregate demand.
- In the presence of nontradable goods, fiscal policy is also less effective, while monetary policy would affect aggregate demand. For example, an expansion in money supply would not only affect the balance of payments but also output of nontradable goods; the higher the share of nontradable goods in total output in the economy, the more effective monetary policy will be even under a pegged regime.

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<sup>6</sup> As of end November 2021, it is reported that LSL 1.25 billion (3.4 percent of GDP) new arrears had been accumulated.

**13. Even though under a peg regime, the economy is shielded from nominal shocks from abroad, it becomes more prone to real shocks.** Given the relative effectiveness of monetary and fiscal policies as discussed above, the role of shock absorber in the event of exogenous shocks would fall mainly (or entirely, in the case of small economy with perfect capital mobility and no nontradable goods) on fiscal policy.

**14. Nonetheless, there are limits to the use of fiscal policy, which if excessive can lead to pressure on the peg and even its eventual collapse.** These limits arise from the weakening of confidence on the exchange rate peg that could follow from an expansionary fiscal policy. Such a policy would lead to a current account deficit under the balance of payments; over time, a current account deficit becomes unsustainable, and market participants would expect a devaluation, which would lead to a hike in interest rates. Also, an expansionary fiscal policy would lead to inflation, which would erode competitiveness and even currency crises, for example, what happened in Indonesia and Thailand where local currencies used to be fixed/pegged with US dollars during 1997/98 East Asian Financial Crisis.

**15. Ultimately, an economy with an exchange rate peg and a lack of monetary independence will have to rely heavily on fiscal adjustment to cope with shocks.**

#### **A Vital Role for Macro Policy Coordination in Lesotho**

**16. In the case of Lesotho, any increase in money supply tends to find its way out of the economy, leaving monetary aggregates unchanged and reserves depleted.** For example, should the government draw down deposits to finance public procurement, a large proportion of these funds would eventually find their way out of the economy through either (i) businesses depositing payments from the government in bank accounts at the large foreign-owned banks, which then transfer the money to their parents in South Africa; or (ii) businesses using the payments on imports as inputs to the provision of contracted goods and services.

**17. Three scenarios are set out to help illustrate the interaction between monetary and exchange rate policies in the absence of coordination.** The links between fiscal policy (summarized by the fiscal deficit) and the sources for its financing, which are determined by debt, the money supply, and arrears, can be expressed as in the following equation:

$$FD_t = (B_t - B_{t-1}) + (M_t - M_{t-1}) + (A_t - A_{t-1}),$$

where at time  $t$ :  $FD_t$  is the fiscal deficit;  $B_t$  is government's borrowing from financial markets (including both domestic and external);  $M_t$  is the central bank's net claims on government, and  $A_t$  is arrears.

- **Scenario 1: The Ministry of Finance and the fiscus dominate.** The fiscal authority determines the size of the fiscal deficit without consideration for the exchange rate peg (i.e., without consulting the central bank). Where financing is limited in domestic debt markets, the central bank can also be directed to supply whatever amount of financing is needed in the form of monetary base. In the case of Lesotho, the government maintains sizeable deposits (7 percent of GDP as of end 2021), which can be drawn down. If this exceeds the expansion of demand for real base money at the target price level—either the domestic price level or external price level (the exchange rate)—increased inflationary pressures, pressures on international reserves and the exchange rate, or arrears would arise. If the government directs financial institutions and institutional investors, such as the Pension Fund, to finance the deficit and/or withhold payments to contractors, this will distort the normal functioning of the economy through financial repression and the accumulation of arrears.

- **Scenario 2: The central bank and exchange rate policies dominate.** The monetary authority determines base money independently of the financing needs of the government. The capacity to borrow from domestic and external markets and raise revenues would then constrain the size of the fiscal deficit. Assuming limited domestic market depth, as in Lesotho, the government might also be forced to rely excessively on external borrowing, which, if unchecked, could lead to a high risk of external debt distress. The government could also turn to aggressive domestic revenue mobilization through heavy taxation, which would also weight on incomes and activity. Ultimately, the government could be forced to reduce its fiscal deficit to match available financing with the danger of not paying due regard to expenditure needs, which could jeopardize growth, social protection, and overall development.
- **Scenario 3: Both the central bank and Ministry of Finance act autonomously and do not coordinate.** As a result, the monetary and fiscal authorities make inconsistent decisions regarding the base money supply and the size of fiscal deficit, respectively. Either the fiscal or monetary authority would need to assume a subordinated role. Inconsistency of fiscal targets with the goals of monetary and exchange rate policies leads to an unstable equilibrium and depending on the relative power of the two institutions, would bring us back to one of outcomes under the previous two scenarios-most likely through political will. The longer the period of policy inconsistency, conflict, and stalemate, the greater the loss in confidence, the greater the risk to the exchange rate, the longer the delays to reforms, and the more growth will stagnate. The result is likely to be high financing costs and arrears for the government and growing pressure on the exchange rate for the central bank.

**18. History has provided many examples of exchange rate crises caused by policy coordination failures:**

- **1992/93 UK Exchange Rate Mechanism Crisis.** Like Lesotho, the UK in 1991 was experiencing a progressive deterioration in economic conditions: weak growth, high unemployment, and competitiveness problems. In the face of contractionary monetary policy to fend off higher inflation in Germany, speculators determined that country's policy stance was inconsistent with the current exchange rate value, i.e., domestic policy needs were inconsistent with the interest rates required to defend the peg.<sup>7</sup>
- **1994/95 Mexico Peso Crisis.** The expansionary fiscal policies and monetary policies pursued by the government and the central bank in 1994 in Mexico were ultimately inconsistent with the pegged exchange rate rule. These were seen as the root cause/ultimate trigger of 1994/95 Mexico Peso Crisis and collapse of the peg arrangement (Lustig, 1995).
- **1997/98 East Asian Financial Crisis.** The decade-long strong growth record of Thailand, Indonesia, the Philippines, and South Korea before the crisis masked a significant buildup of vulnerabilities. In particular, years of overreliance on foreign savings, reflected in mounting current account deficits and a build-up in external debt. Heavy foreign borrowing, often at short maturities, also exposed corporations and banks to significant exchange rate and funding risks-risks that had been masked by longstanding currency pegs. Rapid credit growth and inadequate supervisory oversight had resulted in a significant build-up of financial leverage and doubtful loans. When investor confidence evaporated

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<sup>7</sup> According to second-generation currency models, if economic fundamentals deteriorate sufficiently then the government has an escape clause allowing it to change its exchange rate (e.g., float or devalue), which the private sector knows (Obstfeld 1994).



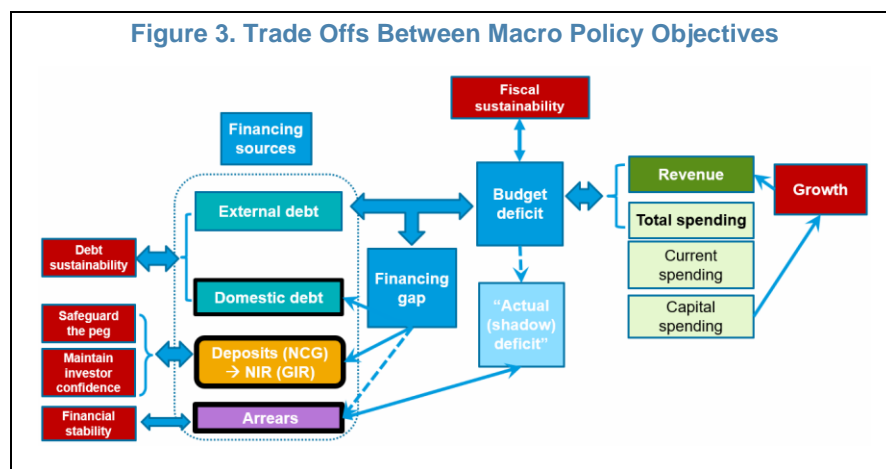
and the pegs proved unsustainable, firms saw sharp increases in the local currency value of their external debts, leading many into distress and even insolvency. Months of speculative pressures had substantially depleted central banks' foreign exchange reserves, triggering a twin balance-of-payments and banking crisis-and the collapse of pegs across the region (Carson and Clark, 2013).

**19. Hong Kong SAR offers a successful case of policy coordination that helped support the peg in the midst of the East Asian Financial Crisis.** Hong Kong SAR also faced several large speculative attacks but eventually weathered these attacks and successfully defended the peg mainly for the following reasons: (i) Hong Kong SAR had very strong fiscal stance, which had remained in surplus for decades. (ii) Hong Kong SAR adopted decisively critical structural reforms (e.g., cutting wages) to restore its competitiveness quickly.

### A Macro Policy Framework in Context of Lesotho

**20. Lesotho can be seen as a small economy with perfect capital mobility and a small (informal) nontradables sectors under a peg regime.** As discussed, there are trade-offs and synergies between key macro policy objectives such as preserving debt sustainability, safeguarding the peg, maintaining investor confidence, protecting financial stability, maintaining fiscal sustainability, and achieving high growth (Figure 3). For example:

- *Preserving debt sustainability, safeguarding the peg, maintaining investor confidence, and protecting financial stability.* Debt sustainability requires limits to borrowing, which implies (i) greater use of government deposits and lower reserves, undermining confidence in the ability to defend the peg; or (ii) accumulating greater arrears, inducing NPLs, and undercutting financial stability. Likewise, enhancing the peg or enhancing financial stability will have similar trade-offs.
- *Preserving fiscal sustainability versus achieving high growth.* High growth through investment requires a larger fiscal deficit when current spending is sticky. This will undercut fiscal sustainability. Likewise, enhancing fiscal sustainability by cutting spending can harm growth.



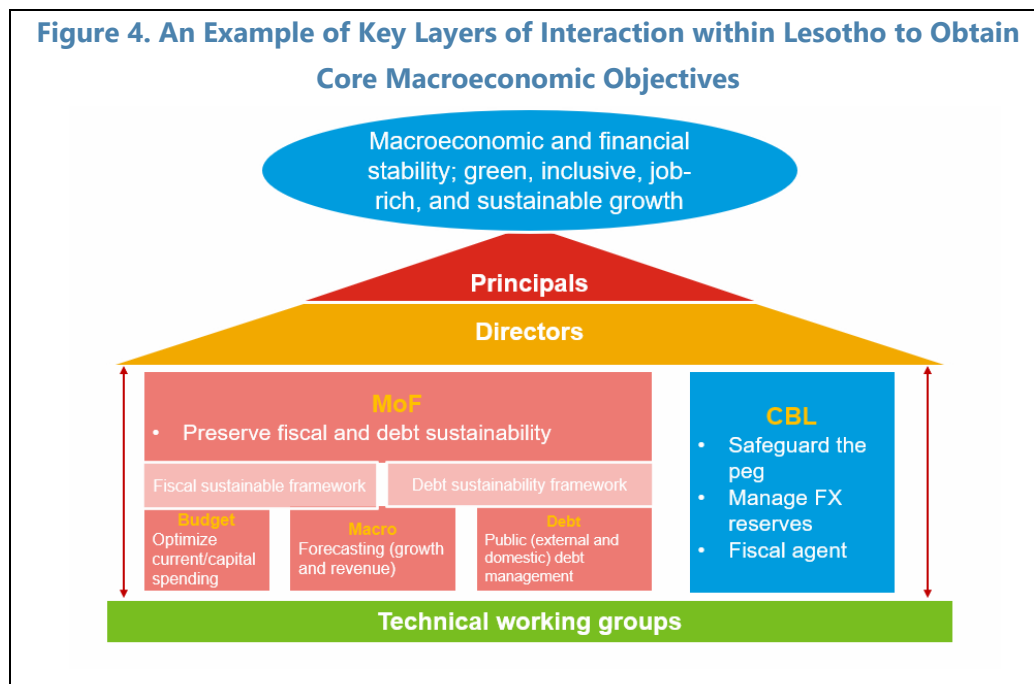
**21. Policy coordination would be instrumental to help depoliticize macroeconomic policies enabling the Ministry of Finance to pursue its fiscal mandate in coordination with the CBL.** Policy coordination and consultation should not, however, entail subordination or compromise both the independence and accountability of the CBL. Key fiscal and monetary policies can be determined as follows:

- a. **Debt limits.** The debt office and the macro department at the Ministry of Finance should determine how much debt the government can take on. This should be informed by estimates of debt sustainability.
- b. **Reserve levels.** CBL should determine the reserve level required to safeguard the peg. The CBL can consult with the Ministry of Finance. The reserve requirement will determine the floor on net claims on government (NCG).
- c. **Fiscal deficit.** Safeguarding peg and preserving debt sustainability should determine the affordable fiscal deficit.
- d. **Spending composition.** The government optimizes the composition of spending within the fiscal deficit envelop informed by the CBL to achieve the macro policy objectives--sustainable and inclusive growth.

**22. The current institutional setup in Lesotho could be formalized to strengthen communication and coordination to achieve better macroeconomic outcomes** (Figure 2). Lesotho has the institutional channels in place for coordination—for example, the inter-Ministerial Macro Working Group—which must be reinvigorated to enhance coordination. While the policy remits must remain independent—including the institutional independence of the central bank—the implications of policy choices must be discussed across both institutions to provide a well-informed, consistent policy decision. For example, setting up a debt policy committee under the Debt Department of the Ministry of Finance, with members from both the MoF and CBL, would bring together knowledge on external financing needs and financial markets. At the same time, capacity must be developed within the Macroeconomic Policy and Coordination Department of the Ministry of Finance for debt sustainability analysis.

**23. Interaction at multiple layers (principals, directors, and technical staff) are recommended to ensure effective communication, data dissemination, modelling, and informed decision-making** (Figure 4).

- **Principals' meeting.** This is a high-level platform involving top officials from the MoF, the CBL, and other Ministries, Departments, and Agencies (MDAs), who would meet regularly to discuss strategic policy issues and responses to recent macro developments.
- **Directors' meeting.** This would include the Macro Director, Budget Controller from the MOF; director of research, director of market operation from CBL; head of the debt office. Members could change depending on local situation/feedback from the authorities. They meet regularly to implement the agreement reached at the principals' meetings. Senior policy makers from relevant MDAs can be included as needed.
- **Technical task forces and working groups** on specific technical issues. This would include the existing Macroeconomic Working Group. Technical staff would work closely to provide technical inputs/support for Directors and Principals, for example, on forecasting (growth, inflation, revenue, reserves, etc.).



#### An Example of Policy Coordination: The 2021 SDR Allocation

24. On August 23, 2021, the IMF allocated US\$650 billion of Special Drawing Rights (SDR) to member countries in proportion to their quota shares in the IMF.<sup>8</sup> About US\$275 billion is going to emerging and developing countries, of which low-income countries will receive about US\$21 billion – equivalent to as much as 6 percent of GDP in some cases. Lesotho received about US\$ 95 million of new SDR allocation. The IMF does not impose restrictions on the use of SDR allocation.

25. Theoretically, there are two ways for the government to access the SDR allocation—direct access by the government or indirect access. Both approaches have their pros and cons (Box 2, Table 1).

- Direct access.** This is on-lending the SDR allocation to the government, subject to Article 42 of the Central Bank of Lesotho Act, which specifies: (i) the total credit of central bank to the government shall not exceed 5 percent of the Government's actual revenue in the previous year's budget; (ii) any advance from CBL to the Government should be repaid within 93 days from the end of the Government's financial year to which it relates, and where any such advance remains unpaid after the due date, the power of the Bank to make further advances in any subsequent financial year shall not be exercised unless the amounts due in respect of outstanding advances have been repaid.
- Indirect access.** Given that the government of Lesotho has positive balance of deposits with the CBL, part of these can be drawn down to indirectly access the SDR allocation. Specifically, the SDR allocation automatically increases NIR (above the current target), which creates additional space for

<sup>8</sup> <https://www.imf.org/en/News/Articles/2021/08/23/pr21248-imf-managing-director-announces-the-us-650-billion-sdr-allocation-comes-into-effect>

the government to potentially draw down part of its deposits with the CB. Given perfect capital mobility and a high degree of leakage, the draw down in deposits will lead to a reduction in reserves.

**26. In the absence of policy coordination, the cheaper option of indirectly drawing on the allocation will not be available.** Without agreement over the size of the deposit drawdown and an understanding of the impact on reserves, the fiscal authority risks endangering the peg. The amount to be withdrawn must be determined within the context of safeguarding the peg, preserving debt sustainability, and maintaining external stability, as indicated by reserve targets (e.g., maintaining an adequate level of 4 months of import cover).

**Table 1. Lesotho: Direct vs. Indirect Access**

	Pros	Cons
<b>Direct access</b> On-lend SDR allocation to government (according to CBL Act)	<ul style="list-style-type: none"> <li>• Direct debt to the government, potentially increasing accountability.</li> </ul>	<ul style="list-style-type: none"> <li>• Drawing on SDRs incurs interest costs at SDR rate (holdings &lt; allocation).</li> <li>• Incur exchange risk.</li> <li>• Direct increase external debt</li> <li>• Repay within 93 days of the end of the government's financial year (CBL Act).</li> </ul>
<b>Indirect access</b> Retain SDR allocation on CBL balance sheet	<ul style="list-style-type: none"> <li>• Creates space for government to draw down deposits at CBL.</li> <li>• SDR allocation is not drawn down directly, saving interest costs at SDR rate.</li> <li>• Avoid exchange rate risk.</li> </ul>	<ul style="list-style-type: none"> <li>• Hides the actual debt burden.</li> <li>• Requires positive balances at the CBL.</li> </ul>

## Conclusions

**27. Macro policy coordination matters, given Lesotho' economic institutions and arrangements.** Lesotho is small open economy with a large foreign-owned banking sector and pegged exchange arrangement. The peg has served Lesotho well by anchoring macroeconomic policy and inflation. However, limited scope for nominal exchange rate adjustment calls for fiscal policy and structural reforms to play the key role in external adjustment. Without sound policy coordination, the government's spending and cash management plans are at odds with (i) the minimum level of international reserves needed to safeguard the peg, (ii) the level of borrowing needed to preserve debt sustainability, and (iii) minimizing arrears.

**28. The current institutional setup in Lesotho could be formalized to strengthen communication and coordination to achieve better macroeconomic outcomes.** The inter-Ministerial Macro Working Group should be reinvigorated to enhance coordination. The institutional independence of the central bank needs to be preserved within a cohesive, well-coordinated, and commonly agreed macroeconomic framework.

**29. Current practices can be augmented and formalized to enhance the policy coordination.** (i) The Ministry of Finance should determine public debt limits based on prudent debt sustainability analysis; (ii) the CBL should determine a ceiling on NCG that secures the peg; (i) and (ii) will determine the fiscal deficit, the composition of which can be optimized by the Ministry of Finance to achieve key macro policy objectives-- sustainable and inclusive growth.

### Box 1. Understanding the Interactions between Debt, Spending, and Reserves

- a. Debt limits (determined by debt sustainability analysis) suggest a path for the debt stabilizing primary balance. (Ministry of Finance, Debt Department and Macro Department).
- b. In parallel:
  - The central bank can determine a ceiling on the net credit to government (change in government deposits) that will safeguard the peg by maintaining a certain level of NIR and GIR coverage.
  - The Ministry of Finance can review spending needs and determine the composition—i.e., current (including social) vs. capital spending—based on socioeconomic and development priorities, in coordination with other key development stakeholders.
- c. Revenue mobilization (both domestic and external) is estimated by the Ministry of Finance and the Lesotho Revenue Authority.
- d. Potential financing from domestic financial markets is determined by the central bank, in coordination with the Ministry of Finance's Debt Department
- e. (a), (b), (c), and (d) jointly determine total potential financing sources.
- f. This resource envelope determines a maximum for total public expenditure for the Ministry of Finance. However, it is not advisable to spend up to this ceiling as fiscal space must be preserved to allow for response to shocks.

## **Box 2. Understanding the Impact of the SDR Allocation on Monetary Aggregates**

### **A. SDR allocations and the external (BOP) sector**

- “Holdings of SDRs”: Increase long-term debt liabilities (other investment inflows) under the Financial Account by the amount of SDR allocation.
- “Allocations of SDRs”: Under official reserve assets, Increase gross international reserves (GIR) by the amount of the SDR allocation below the line of the BOP.

As a result, both above-the-line and below-the-line under the BOP will increase accordingly.

### **B. SDR allocations and the monetary sector**

- Foreign Assets under the Net Foreign Assets (NFA) will increase by the amount of SDR allocation in local currency. This can be fed through the change of reserves from the BOP.
- Foreign liabilities under NFA also increase by the amount of the SDR allocation (in local currency)

Therefore, as SDRs are recorded as assets and liabilities in the central bank's balance sheet, net foreign assets will be unchanged. The SDR holdings would directly increase GIR. Net interactional reserves (NIR) will also increase provided assuming only short-term foreign exchange debt liabilities are not subtracted from GIR.

### **C. The impact on base money largely depends on the exchange rate regime.**

- Under a peg/currency board monetary regime, money supply (reserve money) is usually driven by the GIR and NIR. With the increase of GIR and NIR, money supply (reserve money) should increase accordingly (assuming no leakages).
- In some circumstances or some monetary regimes, the monetary authority can forcefully break the link between the GIR/NIR and money supply. In that case, a jump in either the ratio of GIR/reserve money or the ratio of NIR/reserve money should be observed.

Therefore, one of the following phenomena should be observed: (i) a jump in money supply (reserve money), or (ii) a jump of GIR/M1 ratio or NIR/M1 ratio.

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