

Supporting Lesotho's Economic Diversification and
Trade Integration:
Structural transformation through greater export
competitiveness

FINAL REPORT

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Background and Acknowledgments

This report has been prepared as part of the 2nd phase of the Lesotho Private Sector Development and Economic Competitiveness Project at the request of the Lesotho Ministry of Trade and Industry. The incorporation of the input-output table for Lesotho into GTAP data was funded under the Southern Africa Regional Programmatic ASA on Jobs, Growth, and Competitiveness.

The report provides a multifaceted diagnostic overview of Lesotho's export competitiveness, including an assessment of medium-term impacts of potential trade policy changes, based on the analysis of publicly available data and evidence, by examining export dynamics and outcomes and using field interviews with the public and private sector. The report then formulates several recommendations that could enhance export competitiveness and deepen Lesotho's integration in global and regional value chains in goods and services. The policy recommendations will aim to strengthen the country's ability to respond to changing external environment.

The report was prepared by a World Bank team led by Maryla Maliszewska (GMTRI) under the guidance of Jose Guilherme Reis (Practice Manager, GMTRI) and Janet Entwistle (Representative, AFMLS). The following team members were part of the core team of the report: Guillermo Arenas (GMTRI), Jakob Engel (GMTRI), and Barbara Kotschwar (GMTCI). Research assistance was provided by Zhi (Ken) Gan. Administrative and logistical assistance was provided by Keneuoe Mofolo.

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Executive Summary

A challenging global context

For a small, landlocked country like Lesotho, improving its trade competitiveness and increasing regional and global integration are essential to growth and economic development. Compared to other countries in its region, Lesotho has benefited from globalization and the emergence of global value chains (GVCs). By taking advantage of the favorable trade preferences into the US market through the American Growth and Opportunities Act (AGOA), Lesotho has developed a substantial manufacturing capacity, particularly in apparel and footwear, and provided jobs for tens of thousands of low-skilled workers, most of whom have been women. Since 2000, GDP per capita has more than doubled.

However, while Lesotho has used trade to drive economic growth, this does not appear to have contributed significantly to poverty reduction in recent years. Moreover, Basotho-owned businesses have struggled to integrate into GVCs as suppliers, resulting in only limited backward linkages to the economy. A tough competitive environment and a slow pace of investment climate reform risk Lesotho losing its competitive edge in its core sectors. Finally, sustained domestic political instability has had a deterrent effect on foreign investors. Political instability is one of the main obstacles cited by firms doing business in Lesotho. These factors have created uncertainty about the sustainability of its current export-driven development model and have limited Lesotho's ability to further diversify its economy.

Lesotho's current trade strategy is not sustainable and requires a move away from reliance on exports of low-value added apparel to the US under AGOA. Uncertainty surrounding the future of Lesotho's AGOA privileges underscores the need for reform and a renewed sense of urgency. Future export growth will be challenged by the emergence of new low-wage competitors in Asia and Africa and the expected erosion of preferential market access in main export destinations over the next decade. Despite the withdrawal of the United States from the Trans-Pacific Partnership (TPP), the significant difference in tariffs paid by apparel duty-free exports from Lesotho under AGOA and from Vietnam and Malaysia will likely be mostly eliminated in the next decade. Additionally, the current authorization of AGOA will expire in 2025. Although a further re-authorization of AGOA is not ruled out, its potential phase-out or replacement is of key importance for Lesotho since, in the absence of this preferential program, apparel exports will have to compete on equal footing against other low-wage competitors. Computable General Equilibrium (CGE) analysis carried out for this study finds that the negative impacts due to a sudden suspension of AGOA privileges would reach 1% of GDP in 2020, while exports of textiles and apparel would drop by 16% leading to a drop of textiles and apparel output by 9%. The decline of average real consumption by 0.5% would have significant negative consequences for the population.

This changing external environment is likely to also offer new opportunities to Lesotho's export industries in the medium term. Through its location, a relatively educated and largely English-speaking workforce, low wages, and significant potential as a tourism destination, Lesotho has the scope to diversify into services industries and integrate into existing and emergent value chains in Southern Africa. Regional integration in sub-Saharan Africa is progressing rapidly, and greater integration and liberalization in SADC and among the tri-partite alliance, as well as movement towards a Continental Free Trade Area means that Lesotho can improve its market access throughout sub-Saharan Africa. This makes a multifaceted diagnostic overview of Lesotho's export competitiveness, including an assessment of medium-term impacts of potential trade policy changes, particularly salient, and would contribute to the development of the Second National Strategic Development Plan (2017/18-2020/21).

Objectives and structure of report

The report provides an overview of Lesotho's export competitiveness based on i) the analysis of publicly available data and evidence, ii) by examining export dynamics and outcomes and iii) by using field interviews with representatives of the public and private sector. It is intended to contribute to the formulation of an export diversification and trade integration strategy for Lesotho and propose policies that may deepen Lesotho's integration in global and regional value chains in goods and services, as well as to increase linkages from export sectors to the domestic economy. The policy recommendations will aim to strengthen the country's ability to respond to a changing external environment.

The report broadly follows the structure of the World Bank's *Trade Competitiveness Diagnostic* (Reis and Farole 2013). It examines the relevance of trade for the macroeconomic context, and vice versa, as well as the degree of diversification and sophistication of exports over time and relative to a series of relevant comparators.¹ It builds on this with CGE analysis of potential impacts based on specific trade-related scenarios as well as diagnostic tools to facilitate the analysis of GVC participation and integration (Taglioni and Winkler 2016). As such, it aims to provide a comprehensive and forward-looking view of trade and its relevance for Lesotho's medium- and long-term development.

Main findings

This report has five main messages:

1. **Lesotho remains reliant on very few products and markets for exports.** Apparel and diamonds accounted for 77% of total exports in 2015 and these two sectors account for 98% of exports to the US and the EU. Exports to South Africa are more diversified, encompassing several hundred products. However, it does not appear that South Africa provides a “learning-by-exporting” springboard for producers to gather experience in international trade, become more productive, and then sell to US and EU buyers. SACU's common external tariff complicates efforts for Lesotho's policy-makers to unilaterally make substantial liberalization reforms for key imported inputs, even if the investors Lesotho is hoping to attract require lower-cost inputs for Lesotho to be a competitive location. Therefore, it will be important to build consensus within SACU on the need for greater liberalization.
2. **As demonstrated using CGE analysis, an immediate loss of AGOA preferences would have substantial economic impacts that far exceeds that of a potential future US-Vietnam FTA.** If these preferences were suspended in 2018, the country would face 1% loss in income by 2020, relative to the baseline. However, to a large extent the impact of the sudden loss of AGOA privileges would depend on the behavior of the textiles and apparel companies, many of which are highly footloose and could decide to move their operations somewhere else given the tight margin with which the industry operates. FTAs between the US and Asian competitor countries would have a far less significant impact. The CGE simulations stress the need to strengthen the efforts to support structural transformation leading to diversification of export products and markets, improving backward and forward linkages and lowering trade costs. They also indicate that lowering trade costs 2% per year would eliminate the negative welfare consequences of the loss of AGOA.

¹ Based on <http://mec.worldbank.org/buildercompare> these include Cambodia, the Dominican Republic, El Salvador, Honduras, Kyrgyzstan, Mauritius, Namibia and Vietnam. Based on discussions with government officials and World Bank country experts, we have at times also added a few other TPP (Malaysia, Peru) and SACU countries (e.g. Botswana and Swaziland).

3. **While Lesotho's investment climate has improved, several issues make doing business in Lesotho expensive and difficult.** A series of surveys have identified access to finance and the inadequacy of relatively basic export promotion services as constraints to doing business. Firm interviews and other investor surveys bear this out and identify the unreliability of utility services as a major constraint. There is a lack of government- and employer-funded training to improve technical and managerial skills.
4. **Lesotho has used its preferential margin to successfully integrate into textile and apparel GVCs but has not managed to integrate into other value chains.** Moreover, compared to other large apparel exporters, only a small part of value in exports is embodied in wages, highlighting the significance of low-wage, low-skill, low-linkage manufacturing to Lesotho's competitiveness with most managerial positions still filled by foreigners and most services related to manufacturing carried out abroad. Due to the relatively low productivity in this sector, producers are unable to increase quality or lower prices and would face substantial difficulties to compete in the absence of preferential margins. Here diversification into the region provides the greatest potential. Furthermore, there is considerable scope to developing greater backward linkages for select inputs in some product segments. Interviews have documented that particularly some South African-owned firms are keen to invest in ensuring they can source upstream inputs locally.
5. **Over the past few decades, trade in services has been the most dynamic sector of international trade. Lesotho's services industries could be an increasingly important driver of economic growth.** Technological change has increased the scope and range of traded services and the service sector has become a key option for export diversification. Lesotho's services sector remains underdeveloped and there is substantial scope for expansion of industries through targeted support and the removal of restrictions. Retail and professional services face significant regulatory restrictions, particularly when it comes to licenses and hiring foreign workers. Interviews suggest that *de-facto* barriers exist even where legal restrictions are absent. Services sectors tend to contribute more through linkages, but service industries (except for tourism) have limited direct contribution to exports. More value in exports could be captured through services (especially financial services, telecoms/ICT and business services) that are better integrated into manufacturing supply chains. Restrictions on services that provide value-added to manufacturing activities may also be limiting Lesotho's ability to diversify its export base and to attract a wider range of investors.

Policy recommendations

These findings emphasize the need for a new approach to trade and trade policy that can provide export-driven growth that is more sustainable and inclusive. Building on Lesotho's recent DTIS Update (EIF 2012), this report identifies six primary policy recommendations that are intended to be both sufficiently specific and feasible that they can be addressed by relevant government agencies.

1. Improve access to imported material inputs and technology by i) pursuing tariff reductions within SACU and ii) ensuring that the duty drawback system functions more efficiently and effectively.
2. Pursue a sustained focus on increasing productivity in AGOA beneficiary sectors, most notably textiles and apparel, and aiming to increase spillovers and linkages from these sectors. This will also require a focus on addressing skills gaps, for example by more effectively linking post-secondary education to the labor market.

3. Enhance export promotion activities, including improving market information on export opportunities to South Africa, European and other markets, as well as for products other than apparel to the US.
4. Since a reduction in trade costs could substantially offset any risks from losing AGOA preferences, there would be substantial gains in a coordinated approach to meeting trade-related regulatory requirements and border management and to exploring cross-border coordination mechanisms with the South African authorities.
5. Undertake a comprehensive analysis of service sector performance in Lesotho and its implications for export-driven growth, identifying the most urgent regulatory issues that need to be addressed.
6. Develop a comprehensive trade and investment strategy linked to the NSDP II, focusing on i) how to retain and increase investment once AGOA margins have been eroded, ii) determine progress in the implementation of actions recommended in the 2012 DTIS Update and iii) supporting industrialization through participation in regional and global value chains.

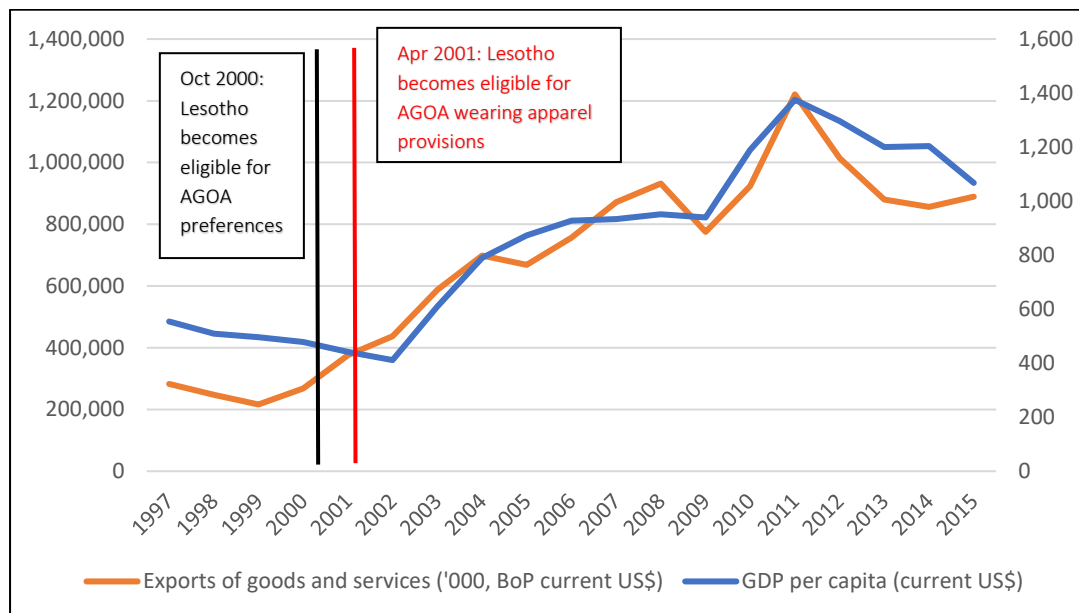
The remainder of the document is structured as follows. Section 1 analyzes the macroeconomic environment in which exporters and importers operate in Lesotho. Section 2 looks at level, growth, composition, and market share performance of Lesotho's exports, as well as the country's main trading destinations. It also briefly considers the evolution of FDI inflows and their sectoral composition, as well as Lesotho's participation in global and regional value chains. Section 3 focuses on the diversification of products and markets, as well as the quality and sophistication of Lesotho's exports. Section 4 provides a roadmap to more inclusive export-led growth moving forward for Lesotho.

1. Macroeconomic and political context

1.1. Stagnation and uncertainty after years of export-led growth

For Lesotho, a small landlocked country with limited natural resource reserves, trade and global integration are essential for economic development. Over the past two decades, Lesotho has taken advantage of many of the opportunities afforded by globalization. The country's export-led growth model relied in large part on the country's preferential market access to the US through the African Growth and Opportunities Act (AGOA, see Box 1). This access enabled Lesotho to attract large volumes of foreign direct investment (FDI) in the textile and apparel sector. As shown in Figure 1, both gross domestic product (GDP) per capita and exports began to increase rapidly following the country's AGOA eligibility in 2000 and throughout the first decade of the 21st century, before peaking in 2011 and declining during the past four years.

Figure 1: Lesotho's exports (left axis) and GDP per capita (right axis), 1997-2015



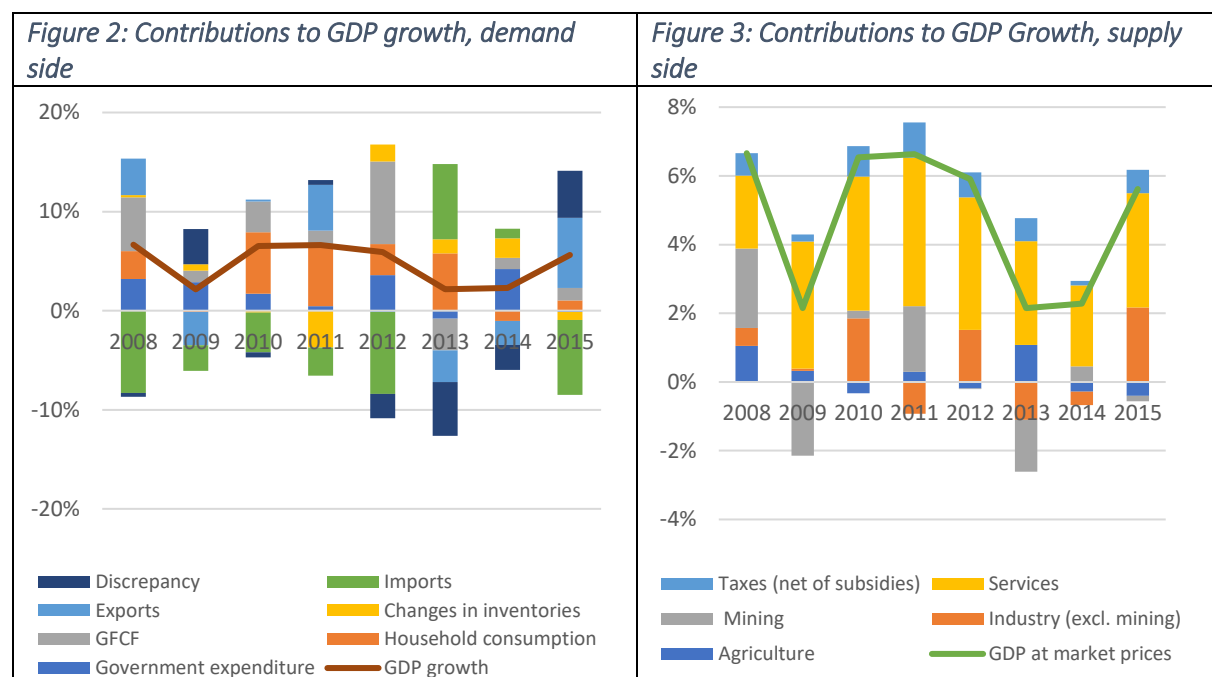
Source: World Bank World Development Indicators

However, over a decade of export-led growth has resulted in only limited poverty reduction, while inequality has worsened (World Bank 2017).² Moreover, the dynamism of Lesotho's export sectors has in recent years stagnated and contributed to a significant worsening of its macroeconomic situation. The country has faced unsustainably high budget deficits (9.3% in 2016/17). This has been exacerbated by political instability, high rates of HIV, tuberculosis and maternal and infant mortality,³ as well as significant exposure to climate-related stresses, including a prolonged drought in 2015/16. Social protection transfers targeted towards the poor have often not been effective.

² While Lesotho has seen some poverty reduction since the start of the century, there is little reliable data on the magnitude of this decline, and it is assumed to have been rather modest. The headcount poverty rate (\$1.90/ day PPP) fell from 61.3% in 2002 to 59.7 in 2011 and estimates suggest that 56.3% were in poverty in 2016. According to the most recent World Bank Macro Poverty Outlook (World Bank 2017), the slow pace of poverty reduction is likely to continue in coming years due to fiscal consolidation, declining remittances and droughts. More reliable data should be available once the results of a new household survey are published in early 2018.

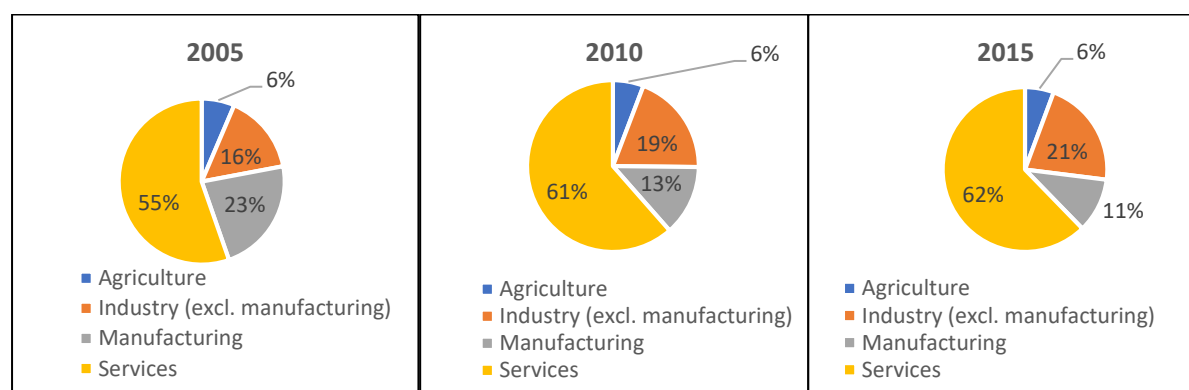
³ Driven primarily by the high mortality and morbidity rates caused by the HIV-AIDS crisis, life expectancy in 2015 (50.0 years) was almost ten years lower than it had been 1992 (59.6 years).

GDP growth has remained at or below 5% since 2008. Though drivers of growth have varied, household consumption and fixed capital formation have consistently played a significant role. Exports were a primary driver of growth in 2015 and 2013, though this was not the case in 2011 or 2014 (Figure 2). In terms of sectoral contribution, services have made a far more significant impact on growth than other sectors (see Figure 3). Following the discovery of significant diamond deposits, mining has grown substantially in significance compared to manufacturing, while agriculture remains marginal in terms of value added to GDP (see Figure 4).



Source: World Bank (2017, forthcoming)

Figure 4: Value added as a share of GDP for major economic sectors (2005, 2010, 2015)



Source: World Bank World Development Indicators.

Box 1: Examining the impact of AGOA preferences on Lesotho's exports

Lesotho's ability to take advantage of preferential US market access, and in particular the AGOA wearing apparel provisions have been pivotal for the country's economic development. The increased uncertainty over how long these will remain in place is a significant source of concern for the country's government.

The first foreigners seeking to invest in the textile industry arrived in late 1980s, when numerous Taiwanese and some South African firms moved from South Africa to Lesotho to avoid apartheid-era sanctions and take advantage of the country's unused apparel quotas (Lall 2005). Lesotho also benefited from duty-free access to the EU at the time under the Lomé convention, though changes in rules of origin to applying cumulation and double-transformation of exports in the mid-1990s led to the departure of some firms. By the time Lesotho became a beneficiary of AGOA in 2000 and was able to take advantage of its laxer rules of origin for apparel, Lesotho had a competitive advantage given the existence of prior trading networks importing inputs from Asia and linked to global lead firms on the buyer side. In 2000 alone, merchandise exports increased by over 120%.

At its outset, AGOA had five objectives: export growth and diversification, stimulation of light manufacturing industry, attraction of US FDI and joint ventures with local SMEs, development of sustainable apparel sector and employment creation. In his recent assessment of the impact of AGOA, Molapo (2016) argues that on balance these have been only partially achieved in Lesotho. Thus, while export growth has been successful, the country has struggled to diversify – particularly given the predominance of investment in the apparel sector focusing on “cut, make and trim” (CMT) sub-contracted from Asian multi-nationals. The stimulation of a light manufacturing sector has generally succeeded, while attracting joint ventures for American FDI has not occurred. Furthermore, given the tenuousness of AGOA benefits, sustainability remains a challenge. Finally, in terms of employment creation, AGOA objectives have been achieved – under the assumption that each worker in an AGOA-affected business earns a monthly wage of \$100, the yearly income generated was \$57.6 million 2013. Furthermore, assuming each worker cares for 5 other family members, this income benefited 240,000 people or 13% of the population (Molapo 2016). A recent report by the Congressional Research Service (Williams 2015) examines the evidence on AGOA's impact and finds Lesotho to be the second-greatest beneficiary for apparel in 2014, after Kenya. However, its apparel exports still constitute less than 4% of apparel exported to the US by the world's second-largest producer, Vietnam, and less than 1% of China's apparel exports to the US.

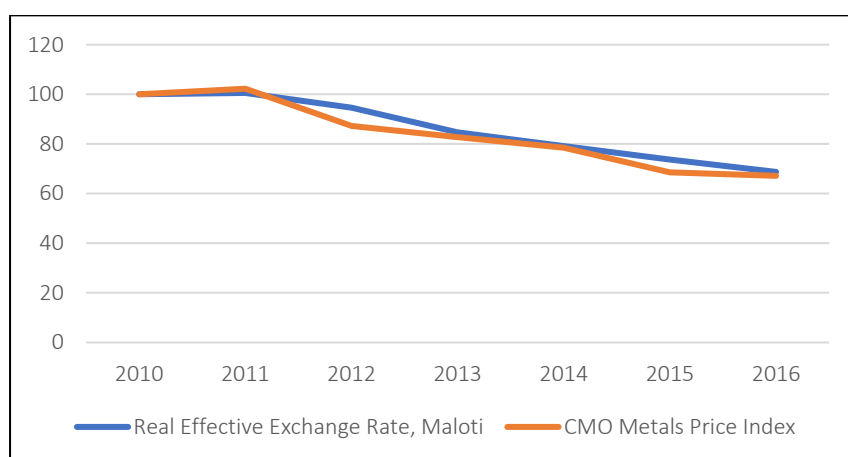
There is a substantial academic literature on AGOA dating back to the early 2000s. Brenton and Ikezuki (2004) and Brenton and Ozden (2005) find that the relaxation of rules of origin through AGOA had a particularly beneficial impact on Lesotho, Kenya and Madagascar. Olarreaga and Ozden (2004) estimate that AGOA-benefiting African exporters receive only one third of the rent and smaller exporters receive less than larger and established ones due to the degree of market power enjoyed by US importers when facing African exporters. As such, AGOA has largely had the effect of reducing prices for garment importers.

Tadesse and Fayissa (2008) find that the AGOA has contributed to the initiation of new and the intensification of existing U.S. imports in both manufactured and non-manufactured goods. Lesotho was identified as one of the main beneficiaries for which AGOA “has enhanced the propensity of U.S. imports from eligible SSA countries by initiating imports in several sectors and product categories.” However, this has remained a relatively small share in terms of overall US apparel imports and the authors argue that “increasing SSA exports to the U.S. markets depends on the ability of African policy makers to build on the trade-initiation momentum generated by the Act” (p. 939). More recently, Edwards and Lawrence (2010) find that the success of Lesotho (and a few other AGOA beneficiary countries) in entering the US clothing market has not resulted in success in other markets or in exporting other labor-intensive products. Beneficiary countries have mostly remained specialized in a small number of categories that embody low value-added in sewing and are relatively intensive in fabric. They conclude that though AGOA has operated for a decade, it is unlikely that most of the industry in these countries could survive without the special rule.

1.2. Monetary and fiscal policy

Lesotho's economic development has been shaped by its unique geography. Surrounded entirely by South Africa, the country's location has had a profound impact on the emergence of industries, the development of the private sector, its trade relations, and the country's political economy. This is particularly true in relation to its highly constrained fiscal and monetary policy framework. Lesotho's currency, the Maloti, is pegged to the South African rand. This has resulted in Lesotho's real effective exchange rate being closely tied to the commodity cycle, and particularly South Africa's reliance on metals exports (see Figure 5). However, the recent depreciation of the rand (and thus the Maloti) has made Lesotho's exports far more competitive in its main export markets outside southern Africa.

Figure 5: Lesotho's rand-pegged exchange rate is strongly linked to global metals prices



Source: World Bank World Development Indicators and Commodity Markets Annual Series

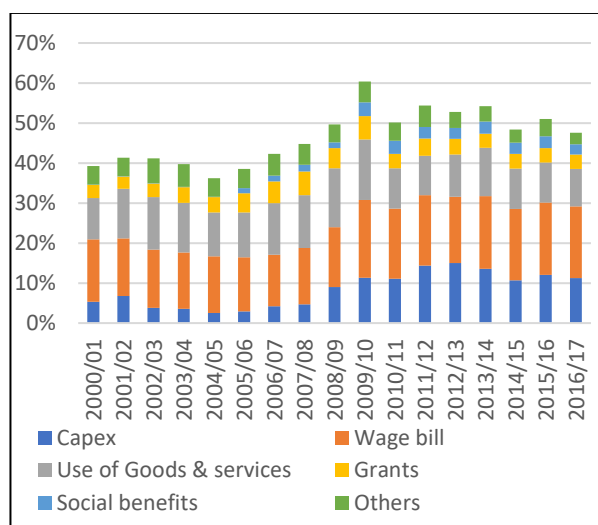
Public expenditure has in the past years acted as a leading driver of growth. This has been particularly driven by the government wage bill, which comes to over 18% of GDP in recent years, among the highest in the world (World Bank 2016). This dwarfs the amount spent on grants and social benefits, as well as capital expenditure, though particularly the latter has been increasing significantly as a share of total expenditure in recent years (Figure 6).

Moreover, as a member of the Southern African Customs Union (SACU), Lesotho relies heavily on revenues from tariffs. SACU revenues are determined through a complex revenue-sharing mechanism re-negotiated periodically with the four other SACU members, Botswana, Namibia, South Africa, and Swaziland. Particularly the recent decline in SACU revenues, from 33% of GDP in 2009/10 (52% of total expenditure) to only 15% (29%) the following year, represented a shock to the budget, though this share has recovered slightly (see Figure 7). Lesotho nonetheless has high and largely stable revenue sources other than SACU compared to the other countries in the region and when compared to countries with similar income levels. The country further benefits from the developmental component of SACU, which is volatile. Due to the way the revenue sharing mechanism is designed, most of the time, SACU revenue volatility enhances the boom-and-bust cycle (Figure 7). However, more problematic than the volatility is the management of revenues and particularly high recurrent expenditures.

Reliance on revenue-sharing within SACU to fund public expenditure means that fiscal policy is also in part outside of Lesotho's control. It also makes trade liberalization a very difficult sell. These factors combine to greatly complicate any efforts for Lesotho's policy-makers to make substantial liberalization reforms for key imported inputs, even if the investors Lesotho is hoping to attract require lower-cost

inputs for Lesotho to be a competitive location. However, the substantial depreciation of the Maloti in recent years creates an opportunity for exporters to exploit its increased currency competitiveness. Furthermore, while Lesotho has only limited leverage within SACU, it could pursue targeted negotiations with South Africa and other SACU members on removing tariffs on inputs to access specific regional value chains that may also benefit the region. There are precedents for this approach in other customs unions, such as the Central American Customs Union. This would be supportive of the recently developed SADC Industrialization Strategy and Roadmap (SADC Secretariat 2017), which is focused on increasing manufacturing value-added within Southern Africa through the development of regional value chains. This will be discussed in more depth in Section 2.5.

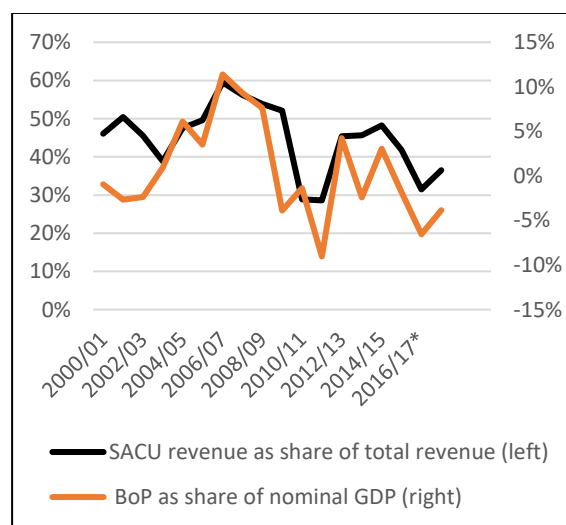
Figure 6: Government expenditure is driven by a growing wage bill



Source: Lesotho Ministry of Finance

* indicates revenues and BoP based on projections

Figure 7: SACU revenues have an important impact on Lesotho's balance of payments



1.3. Employment dynamics

Trade has had a significant impact on employment-intensive industries, most notably in textiles and apparel. However, Lesotho's unemployment rate remains high, at over 25%, and has not declined in recent years according to modelled ILO estimates. Youth unemployment is almost 10% higher (see Figure 8). The country has among the lowest labor productivity rates in the world and production remains very labor-intensive: compared to other Southern African countries; Namibia and South Africa's capital-labor ratio is more than double that of Lesotho's (see Figure 9). However, these countries have a greater share of income from industries that are inherently more capital-intensive (most notably mining).

An overarching concern remains the relatively small size of the private sector. This makes up just 14.7% of GDP (Molapo 2016). Recently international observers have urged, and the Government of Lesotho itself has recognized, a need to shift towards a more private sector-led growth model (see e.g. World Bank 2016). However, MSMEs make up 85% of all firms and employ approximately 200,000 people. While there are several larger firms, especially in the textile and apparel and mining sectors, there remains a missing middle with only 6% of firms considered medium-sized. A large number of manufacturing firms are also single enterprises according to the most recent Manufacturing Census,

and over half (50.8%) are foreign-owned, though in about 20% of these nationals and foreigners have a joint venture (Bureau of Statistics 2016).

Figure 8: Unemployment is high and stagnating

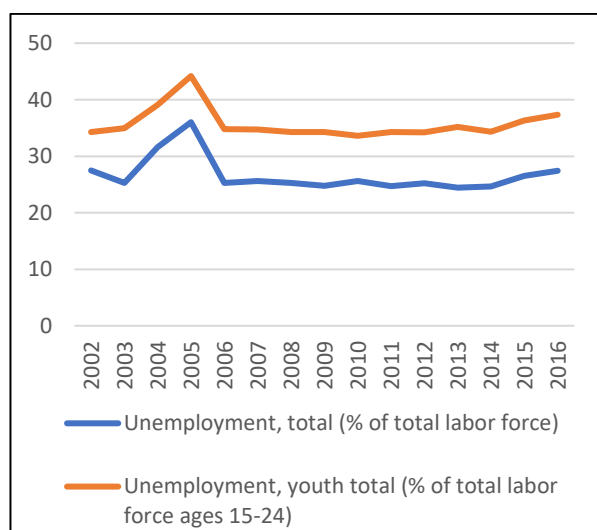
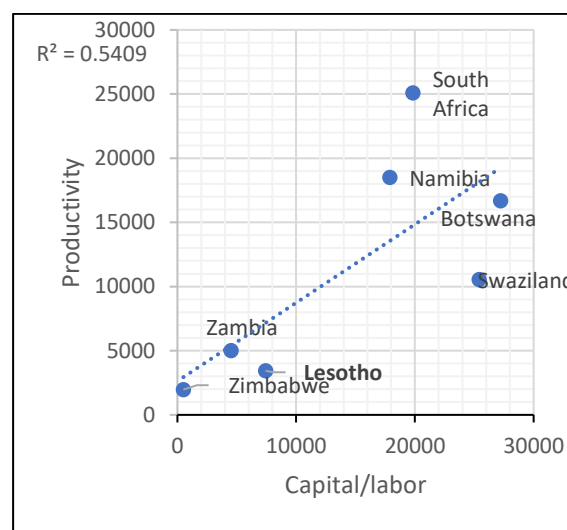


Figure 9: Labor productivity and capital-labor ratios in Southern Africa



Source: World Development Indicators (WDI) and World Bank staff calculations, based on ILO employment estimates

A large part of Lesotho's economy is made up of informal businesses, with few efforts to measure their significance. One notable exception is Matsoso (2015) who used household surveys and census data to establish that the informal sector makes up a substantial but declining share of GDP, estimated at 55.4% of GDP in 2011 and 44.2% by 2014. The industries with the most substantial informal sector are agriculture, hunting and forestry, wholesale and retail trade, hotels and restaurants and "other community, social and personal activities" (see Table 1).

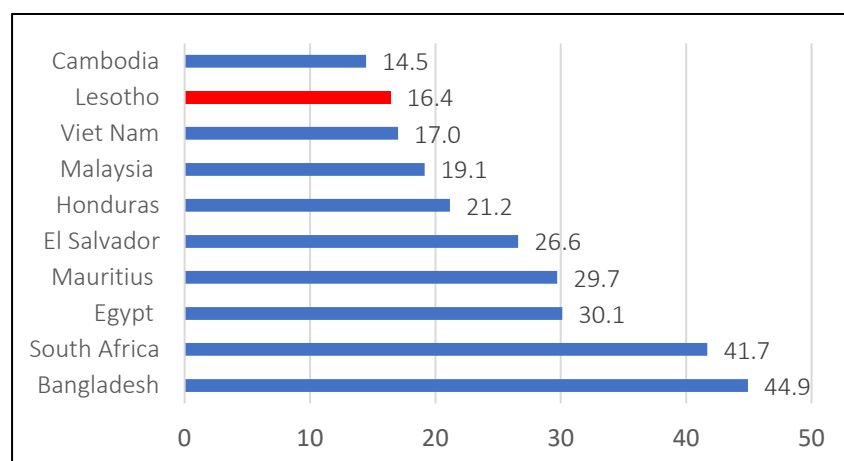
Table 1: Informal economy output at current prices by industry and absolute values of population projections

Industry	2011	2012	2013	2014
Agriculture, hunting and forestry	1436.6	1441.0	1446.0	1451.5
Manufacturing	826.1	828.7	831.6	834.7
Construction	520.1	521.7	523.6	525.5
Wholesale and retail trade	1910.3	1916.2	1922.9	1930.2
Hotels and restaurants	1220.8	1224.5	1228.8	1233.5
Transport, storage and communications	919.6	922.4	925.6	929.2
Education	389.1	390.3	391.6	393.1
Health and social work	276.5	277.3	278.3	279.3
Other community, social and personal activities	1508.1	1512.7	1518.0	1523.8
TOTAL OUTPUT (million Maloti)	9007.1	9035.0	9066.5	9100.8
Population projections	1,896,833	1,902,707	1,909,321	1,916,573

Source: Matsoso (2015)

The dominant manufacturing sector in terms of employment and output remains textiles and clothing, employing 33,686 people in the fourth quarter of 2015. However, this represents a decline of 25.7% against the previous year (Bureau of Statistics 2016).⁴ The sector has considerably lower average wages than other manufacturing sectors such as leather and footwear, food and beverages and other manufacturing sectors. Compared to other large apparel exporters, only a small part of value in exports is embodied in wages (see Figure 10). Lesotho remains stuck in a low-wage, low-skill, low-linkage segment with many foreign firms (especially from Asia) investing little in skills training or in developing backward linkages to domestic suppliers (Morris and Staritz 2017).

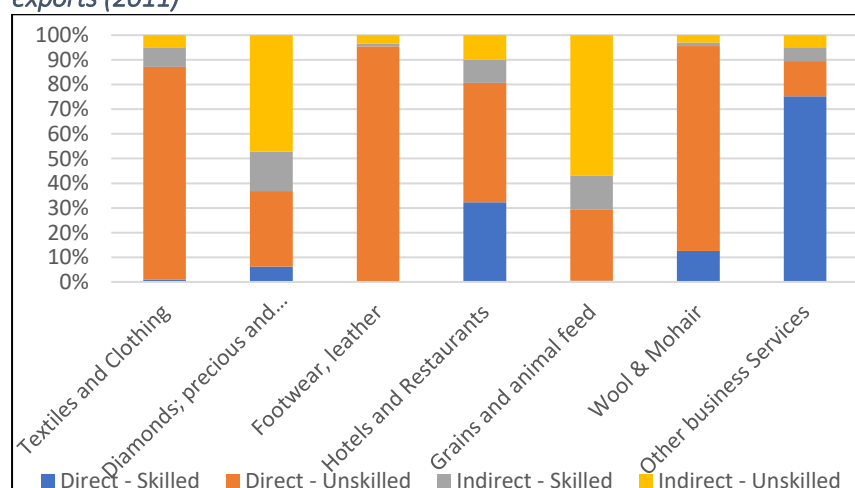
Figure 10: Textile/apparel labor value added as share of total export value (in %)



Source: Own calculations based on Lesotho's Social-Accounting Matrix and LACEX database

According to the country's recent input-output table (2011), unskilled labor makes up 87% of labor value added in textile and apparel exports (Figure 11).⁵ This indicates that sustaining apparel exports – or similar types of jobs – are essential to poverty reduction in Lesotho.

Figure 11: Direct and indirect contribution of skilled and unskilled workers to labor value added in exports (2011)



Source: Own calculations based on Lesotho's Social-Accounting Matrix and LACEX database

⁴ A recent compilation of data on the textiles and apparel sector, based primarily on surveying 57 individual firms, found that the sector provides 41,706 jobs and supports many more individuals indirectly.

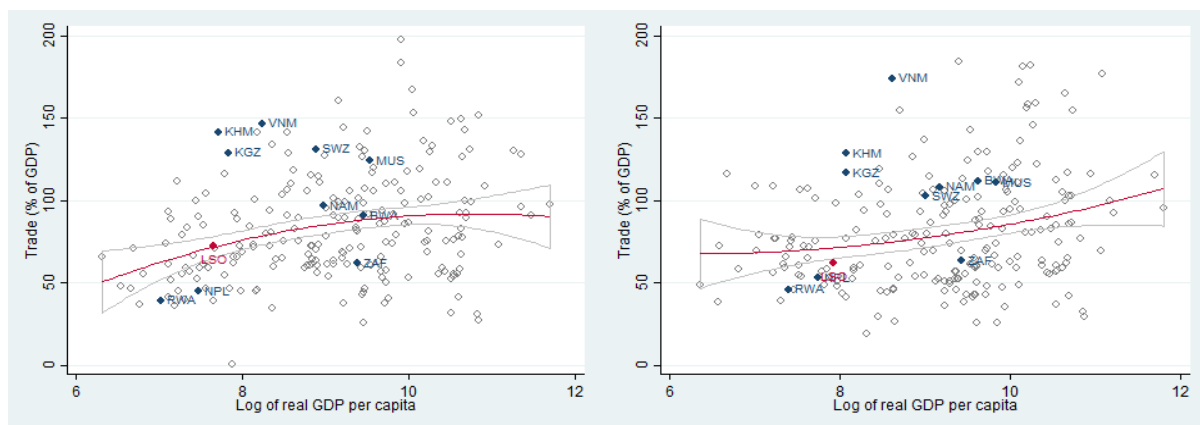
⁵ The large of indirect labor value added in exports in the diamond industry is notable. This is primarily concentrated in related services sectors as well as the transport industry, given the capital-intensity of production.

2. Analysis of trade outcomes

2.1. Trade openness

Lesotho has become more open to international trade in goods and services although it is still less open than expected given its level of economic development. Lesotho's location in the chart has moved below the predicted line between 2006-7 and 2014-15, indicating that considering its income level, the country trades substantially slightly less with the world than expected (Figure 12). Lesotho is less integrated in global markets than Botswana, Swaziland, Namibia and far less than Cambodia and Vietnam. It shows similar trade-to-GDP ratios as other larger African economies such as South Africa.

Figure 12: Trade openness and per capita GDP, 2006-07 vs 2014-15



Source: World Bank World Development Indicators

Lesotho's tariff structure may put producers in its leading sectors at a competitive disadvantage. The simple average of bound tariffs is 9.3% as agreed with the WTO, whereas the simple average most favored nation (MFN) tariff is 7.6%, which is low for world standards (Table 2). The highest trade-weighted tariffs are for footwear and hides and skins at over 25%. More worryingly, the trade-weighted average (MFN and non-MFN) for intermediate goods remains relatively high, at 15%, and for textiles and apparel this is over 18%. For instance, in the textiles sector, the average applied tariff by key competitors like Vietnam (9.6%), Cambodia (5.4%), and Sri Lanka (3.3%) are significantly lower than in Lesotho. Furthermore, a larger percentage of textile tariff lines are duty-free in Cambodia (25.6%) and Sri Lanka (81.2%) than in Lesotho (18.1%). Although importers of inputs should not be paying duties on inputs to exports, in practice the duty drawback system is not fully effective and exports end up absorbing input duty costs making them less competitive in global markets.

Table 2: Summary of tariffs by sector and product group.

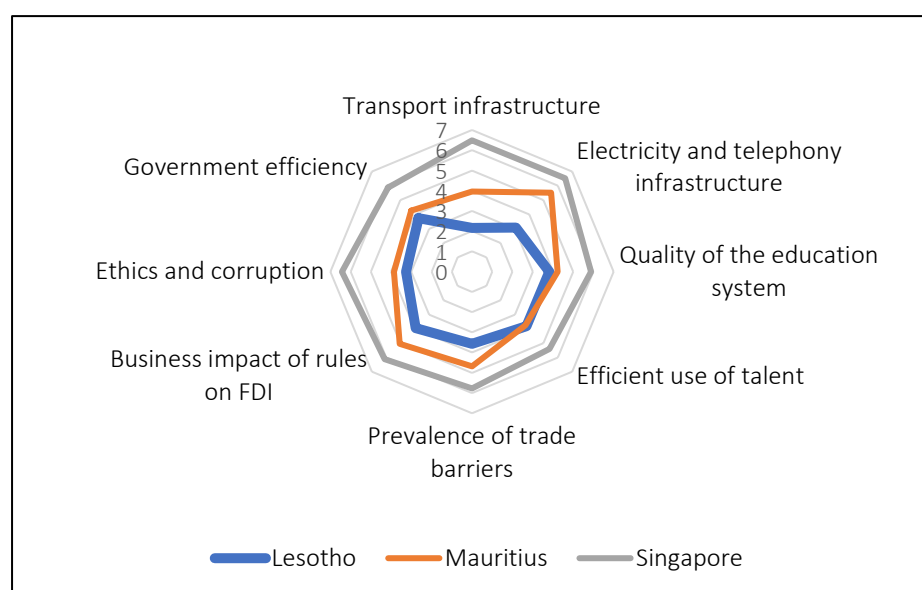
Product Group	Import Product Share (%)	AHS Simple Average (%)	AHS Weighted Average (%)	MFN Simple Average (%)	MFN Weighted Average (%)	MFN Duty Free Tariff Lines Share (%)
All Products	100	9.26	13.08	7.59	13.41	56.3
Capital goods	15.02	2.37	2.87	1.97	3.12	74.37
Consumer goods	47.57	15.08	13.9	15.6	14.4	33.96
Intermediate goods	23.48	9.79	15.06	5.33	15.28	63.98
Raw materials	9.62	2.15	6.47	4.06	7.57	70.99
Animal	4.14	0	0	7.98	6.27	62.02
Chemicals	8	1.55	0.84	1.61	0.9	84.85
Food Products	8.58	3.93	1.57	11.99	11.28	21.55
Footwear	0.92	25.53	28.19	22.37	28.19	18.29
Fuels	12.27	0	0	2.7	0	58.97
Hides and Skins	0.35	28.57	29.65	11.52	29.65	45.65
Machinery & Electric	10.81	2.61	7.62	2.25	7.62	73.53
Metals	4.88	7.36	7.58	4.11	7.58	62.45
Minerals	0.72	0	0	0.1	0	98.18
Miscellaneous	6.47	5.94	9.71	3.89	9.76	67.73
Plastic or Rubber	7.49	11.08	11.23	7.82	11.33	46.76
Stone and Glass	1.36	7.22	3.27	5.89	3.28	50.97
Textiles and Clothing	14.32	30.66	18.56	23.37	18.9	18.06
Transportation	7.3	12.35	13.31	5.83	14.12	48.96
Vegetable	8.19	0.13	0.63	6.32	0.63	43.33
Wood	4.23	7.86	8.38	5.29	10.75	66.67

Source: WITS

While manufacturing continues to be an important driver of growth, there is growing evidence that specializing in services may present an alternative growth path for developing countries. A key driver of services growth is foreign direct investment, which is the main vehicle for international trade in services (Mode 3) and provides an important means for upgrading the services sector. Services are also key inputs to the manufacturing sector. As such, Lesotho should ensure that restrictions on investment in services not curtail its ability to develop promising services or manufacturing expansion opportunities. While regulation is often necessary, particularly in developing countries, where market failures may prevail, regulatory measures may also be used to protect domestic firms, often hindering the development of a competitive economy. Restrictions such as those on foreign ownership, market access or the operation of service providers stifle competition, resulting in high costs and low quality of services (Molinuevo and Saez, 2014). Policymakers have two compelling reasons to get services regulation right. First, developing a competitive services sector can help an economy diversify into services exports, creating more jobs and potentially creating positive economic spillovers. Just as important is the impact of the state of competitiveness of the services sector on other sectors. Extensive empirical evidence shows that services liberalization matters crucially for labor productivity and total factor productivity growth. The regulatory balance in the services sector helps explain why the services sector of some counties thrives while in others it remains undeveloped.

In order to export services, a number of domestic enabling factors must be in place. For example, logistics services depend on the interaction among transportation, freight-forwarding services, warehousing, and cargo handling. Successful BPO operations require an efficient telecommunications infrastructure and a trained workforce. A successful tourism industry is dependent on an adequate physical infrastructure, such as airports and roads, and increasingly reliable internet access; high quality human capital and sound and secure governance. A good environment for trade and investment is also a key factor, as service providers may need imported inputs; may locate in the country to service existing or potential manufacturing investors and as openness to outside competition signals a high degree of competitiveness in the sector. In Figure 13, Lesotho's index scores on eight indicators corresponding to the quality of infrastructure, human capital and governance are plotted against those of the global and African frontier countries on the World Economic Forum's Global Competitiveness Index (GCI).

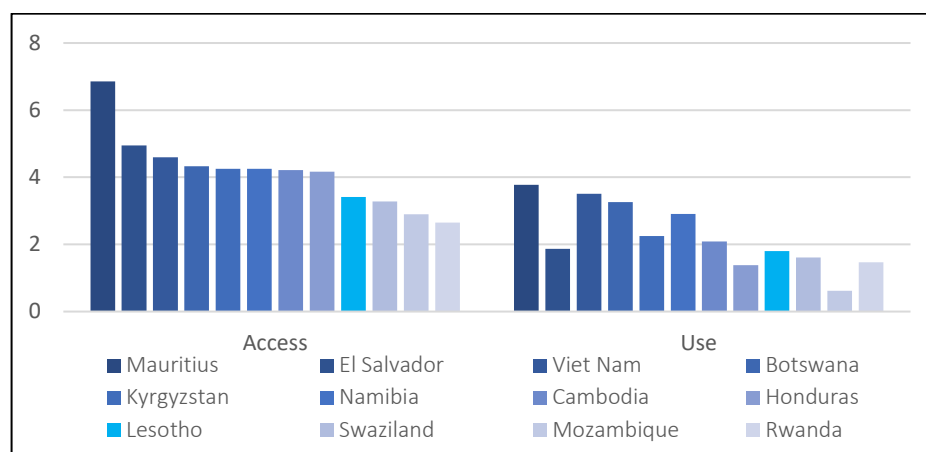
Figure 13: Factors affecting services export success: Lesotho vs frontier countries



Source: WEF Global Competitiveness Index 2016-17

The state of infrastructure in Lesotho has long been described as below par even in comparison with other low-income countries and the SACU economies (UNCTAD 2013). An international benchmarking study of infrastructure performance in Lesotho in the areas of electricity, water and sanitation, information and communication technology and roads (transportation) found limited investment in infrastructure. Lesotho performs rather poorly on the ITU's ICT development index, which reflects the level of networked infrastructure and access to ICT. Figure 14 illustrates Lesotho's score and position against comparator countries. A key issue is the low levels of internet connectivity. In 2016, about 16 percent of the population used the internet; there were only .10 broadband subscriptions per 100 inhabitants. Lesotho performs rather low on the ITU's ICT development index, which reflects the level of networked infrastructure and access to ICTs.

Figure 14. Access and use indexes in selected countries



Source: ITU. ICT Development Index 2016

There has been a certain degree of liberalization in services at the multilateral level, through the **General Agreement on Trade in Services (GATS)**. Lesotho was an active participant in this initiative, undertaking extensive commitments for the liberalization of services (Box 2). Its specific commitments cover 85 among the 160 subsectors included in the WTO Services Sectoral Classification List (UNCTAD 2013).

Box 2: Lesotho's GATS Commitments

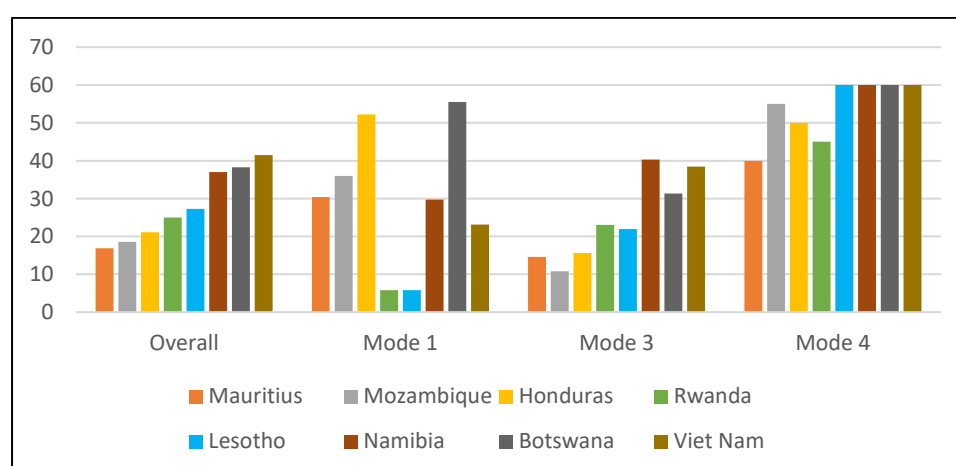
In the GATS Negotiations, Lesotho undertook significant commitments, particularly compared to other LDCs. Lesotho undertook liberalizing commitments in the following sectors: business services, communication services, construction and related engineering services, distribution services, educational services, environmental services, financial services, tourism and related services and transport services. Lesotho did not undertake any commitments in health and related social services, recreational, cultural and sporting services, and the catch-all category of "other services not included elsewhere".

According to GATS/SC/114 30 August 1995, Lesotho's horizontal commitments state that foreign-owned enterprises, including joint-venture enterprises with Lesotho, must satisfy minimum capital outlay and foreign equity requirements. The agency established must have authority to negotiate and conclude contracts on behalf of the foreign parent company. Finally, the schedule states that automatic entries and work permits are granted for up to four expatriate senior executives and specialized skill personnel in accordance with relevant provisions in the laws of Lesotho. Approval is required for any additional expatriate workers beyond the automatic level. Enterprises must also provide for training in higher skills for locals to enable them to assume specialized roles. Lesotho does not specify commitments relating to business visitors (or services salespersons) or for contractual service suppliers (be they employees of a juridical person or independent professionals).

Lesotho is negotiating services liberalization within the SADC negotiations. SADC countries affirmed their intention to liberalize trade in services at the time of the signing of the Trade Protocol in 1996. Negotiations have taken the shape of sectoral protocols and regional commitments, including in tourism, but SADC countries have not yet adopted and ratified the stand-alone protocol for the liberalization of services in the region. Given the importance of the trade relationship with South Africa, particularly in the tourism sector, it is critical for Lesotho to work together with South Africa to develop a tourism policy that will allow greater ease of access between the two countries as well as joint marketing efforts.

Following its GATS experience, Lesotho's legal and regulatory framework is relatively open, *de jure*, in trade in services. The World Bank's Services Trade Restrictions Database provides comparable information on services policy measures for 103 countries, five sectors (telecommunications, finance, transportation, retail and professional services) and key modes of delivery. The database includes regulatory data for Lesotho from the year 2008. On a scale of 0-100, with 0 being completely open and 100 completely closed, Lesotho's overall services trade restrictiveness index is relatively low, at 27.3 (Figure 15). This is, however, higher than some neighboring countries and countries that have successfully increased their services exports. Mauritius, for example, has the least restrictions on services trade among the African countries; Botswana is the most restrictive. Of the comparator countries, Vietnam is the most restrictive.

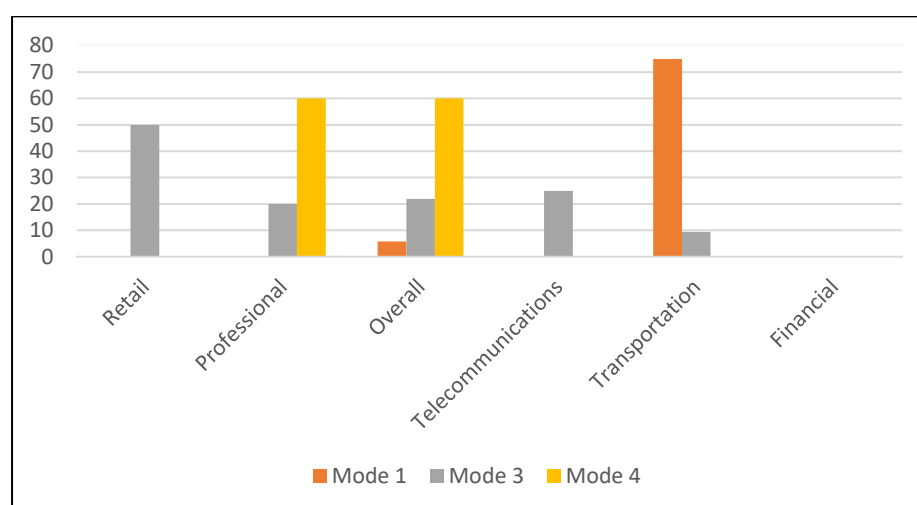
Figure 15: Services Trade Restrictiveness Index (STRI), Overall and by Mode



Source: World Bank Services Trade Restrictions Database

Lesotho's main restrictions in services trade vary considerably by sector and mode but are particularly prevalent in Mode 4, the movement of persons. This is worth reviewing, as such restrictions may keep out talent that could help increase the competitiveness of the services sector. One of Lesotho's main constraints is in adequate human capital. Therefore, relaxing or eliminating unnecessary restrictions in skilled expatriates could be economically beneficial. Figure 16 shows restrictions by sector. The main restrictions are seen in the retail sector, which has a score of 50 (out of 100), indicating significant restrictions as well as in professional services, with a score of 37. In retail, FDI is allowed but licenses are determined by a Trading Enterprise Board consisting of private sector representatives. Several activities are reserved for local ownership under the Trading Enterprises Regulations 2011. These include: agent of a foreign firm; barber; butcher; snack-bar; domestic fuel dealer; dairy shop; general café or dealer; greengrocer; broker; mini supermarket (floor area < 250m²); and hair and beauty salon (US Department of State 2014). In transportation, the main obstacle is a limit of 70% foreign equity in state owned entities. Professional services face restrictions main in mode 4, with limits placed on recognition of credentials of professionals from other countries, obstacles to obtaining a license.

Figure 16: Lesotho Services Trade Restrictiveness Index score by sector



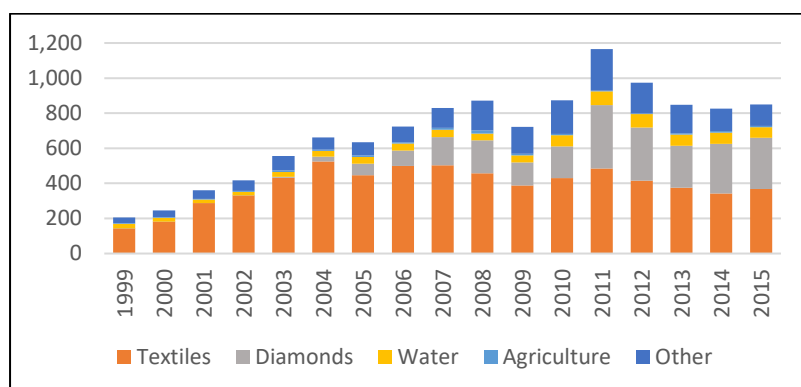
Source: World Bank Services Trade Restrictions Database

2.2. Overview of trade growth and orientation

Lesotho's exports quadrupled over the last 15 years with two distinct growth periods: before and after the global financial crisis of 2008-09. Exports surged from US\$205 million to US\$827 million annually between 1999 and 2008. Then, after a sharp decline and subsequent recovery between 2009-2011, exports declined or largely remained unchanged until 2015. During the fast-growing period in the first half of the last decade, apparel and textile products drove the expansion of exports while diamonds started to emerge as an important export sector. Apparel and textile exports reached a peak of US\$ 525 million in 2004 and have declined almost every year since the Multi-Fiber Agreement came to an end in 2005. On the other hand, diamond exports have increased almost every year after 2005 and are now the second-largest export sector (US\$ 292 million) after apparel and textiles (US\$ 367 million).

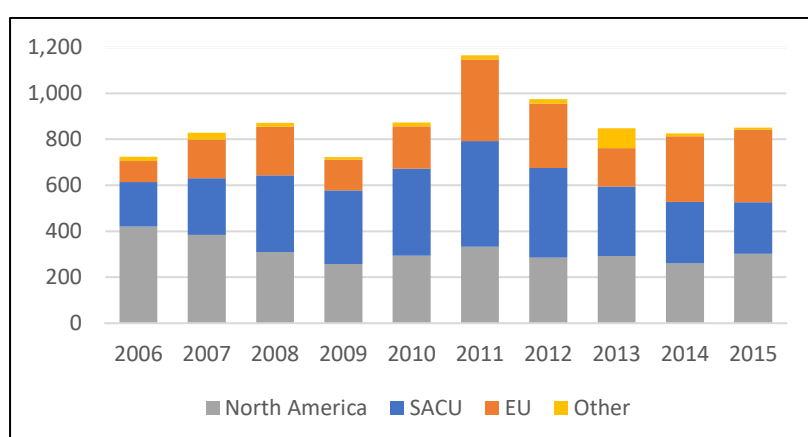
Lesotho shows a high reliance on a few products and markets for its exports (see Figure 17 and Figure 18). In 2015, apparel and textiles accounted for 43% of exports, diamonds for 35% of exports and water distribution to South Africa was responsible for 7.2% of exports (Figure 17). Agricultural exports never represented more than 2% of total exports over the last decade and a half. In terms of destinations, SACU (mainly South Africa), US, and EU are destinations for 99% of exports (Figure 18). Additionally, there is virtually no product diversification outside South Africa since exports to the US were mainly apparel (90.9%) and diamonds (8.9%), while exports to the EU were almost solely in diamonds (99%) in 2015.

Figure 17: Exports by sector (US\$ billion)



Source: IMF

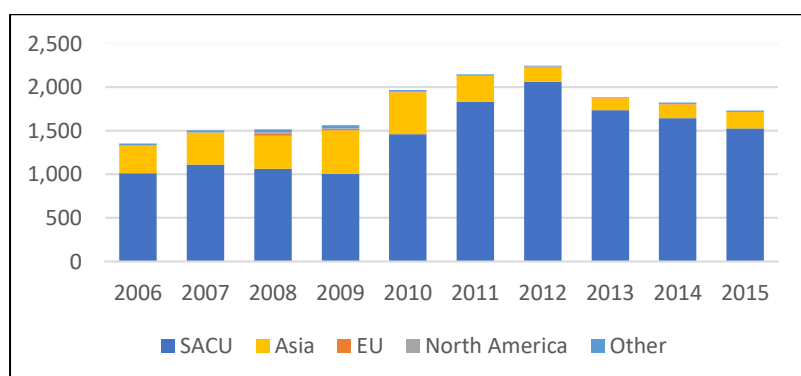
Figure 18: Exports by region (US\$ billion)



Source: IMF

Imports are more concentrated than exports in terms of trade partners. SACU (mainly South Africa) increased its relative importance as the main origin of imports and accounted for 88% of imports in 2015 (from 75% in 2006). Asia, on the other hand, saw its share of imports decline from 23% to 11% during the same period. Throughout this period the EU and the US accounted for less than 1% of imports.

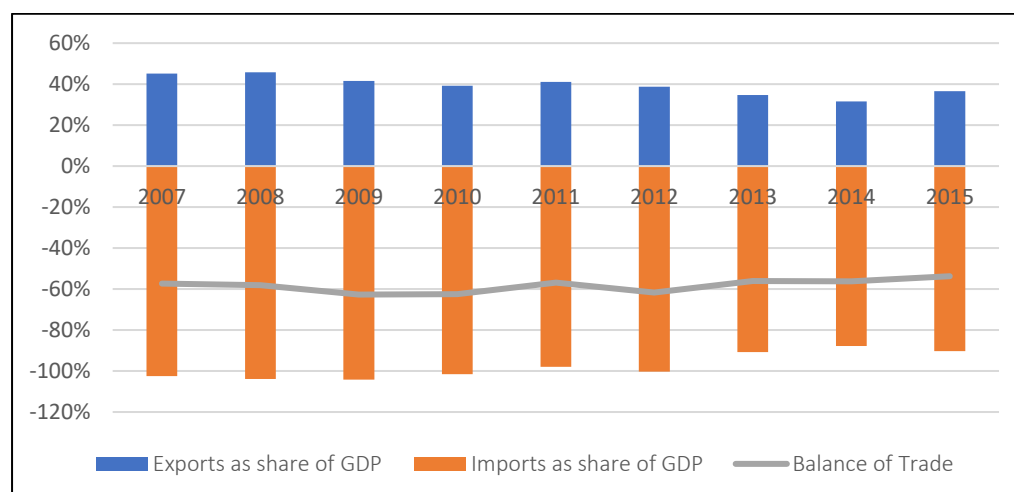
Figure 19: Imports by region (US\$ billion)



Source: IMF

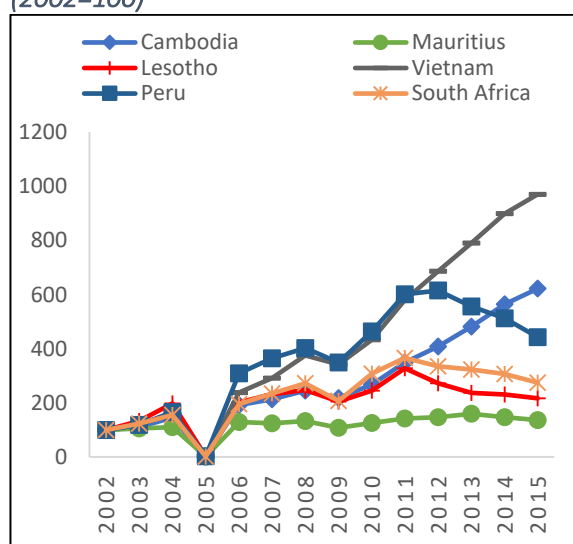
Lesotho's trade balance has been consistently negative over the last eight years, at over 60% of GDP (Figure 20). Moreover, imports make up almost 100% of GDP in recent years (and slightly more before 2010) while exports have generally hovered around 40% of GDP. Although export and import values (in nominal terms) have steadily increased in the past ten years, their performance as share of GDP has been fairly stable. Lesotho still has much to gain from further integration in the global markets. As shown in Figure 21 and Figure 22 respectively, it trails select comparators in terms of overall merchandise and services growth, exceeding only Mauritius among this group of (mostly middle-income) textile exporters and far behind market leaders like Vietnam, Cambodia and Peru.

Figure 20: Exports, imports and trade balance (as a share of GDP)



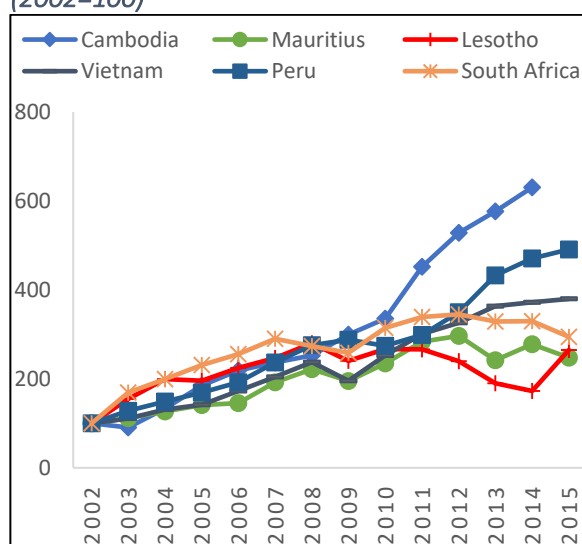
Source: Lesotho Bureau of Statistics

Figure 21: Merchandise export growth, 2002-15 (2002=100)



Source: World Bank World Development Indicators

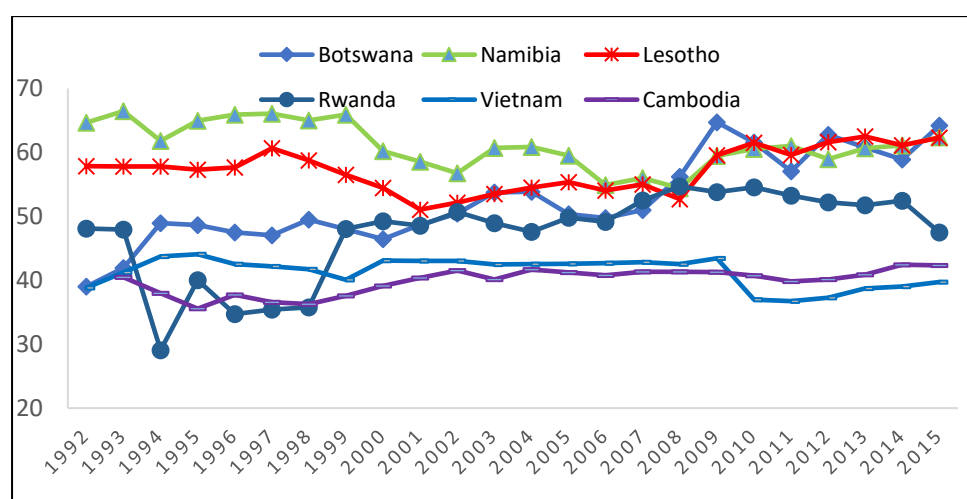
Figure 22: Services export growth, 2002-15 (2002=100)



The services sector has long played a dominant role in Lesotho's economy, contributing about 60 percent to GDP. Lesotho is not a major exporter of services, ranking 193rd in the world in terms of commercial services exports (it is 154th for goods). However, exports of services have been rising steadily in recent

years, doubling between 2011 and 2015 (albeit from a low base) and have accounted for almost one-third of total exports. It is notable that, like most comparators, Lesotho experienced a far less significant decline in services than in goods exports during the 2008 global financial crisis and its aftermath. As seen in Figure 23, services currently represent about 60 percent of Lesotho's economy, on the upper bound of the comparator countries depicted in the figure. The main services sectors in Lesotho are education, wholesale and retail trade, financial intermediation, public administration, and transport and communication. Construction has also been a dynamic sector.

Figure 23 Services contribution to GDP (%) 1992-2015



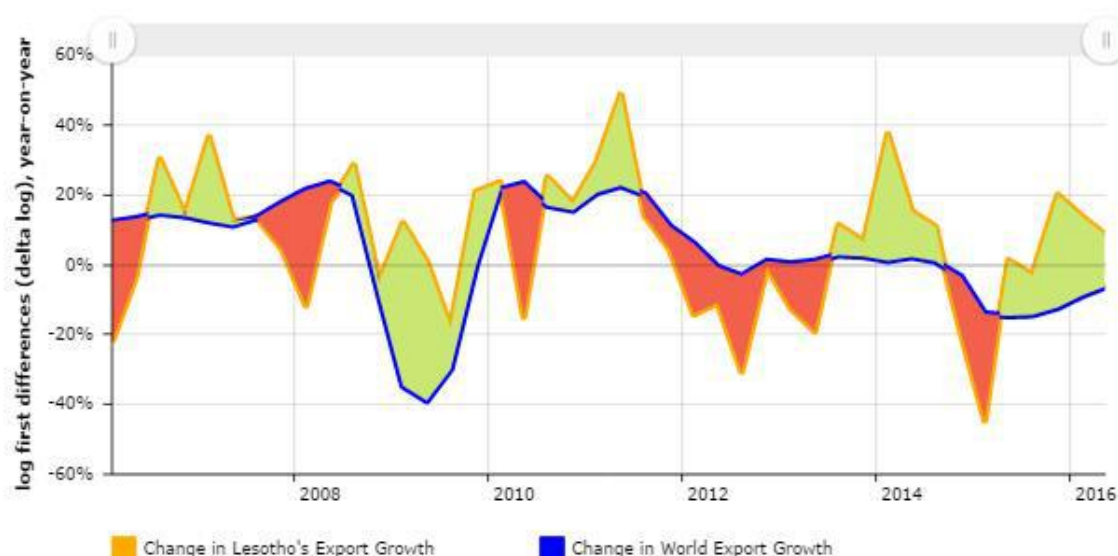
Source: World Bank World Development Indicators databank

The World Bank's 2016 Enterprise Survey of Lesotho provides a snapshot of services firms in Lesotho, as compared to manufacturing firms. Services firms are roughly equivalent in age, 15 years for the average services firm compared to 14 for the average manufacturing firm. They tend to be much smaller, with 34 workers on average, compared to 175 for manufacturers. The proportion of private domestic ownership is higher than in manufacturing – 90 percent compared to 72 percent. Sixty percent identify as sole proprietorship, as opposed to 49 percent of manufacturers. 92 percent of services firms surveyed formally registered when starting operations in Lesotho; nearly 50 percent (lower than 64 percent for manufacturers) cite practices of informal sector competitors as a constraint to doing business. Electricity and transportation are less significant constraints to services firms than to manufacturing firms. Only 16 percent of services firms have their own website and 43 percent use email to interact with clients or suppliers.

2.3. Export market shares

The analysis of export market shares is complementary to the analysis of export growth both in goods and services. The period of analysis, 2002–2015, is one in which world trade expanded dramatically. How much of that expanded market did Basotho producers secure? In 2015, four cents of every \$1000 exported globally comes from Lesotho – a slight decline from previous years (in 2002 Lesotho had .06% of global exports). As shown in Figure 24, using data on merchandise export growth, Lesotho's export growth was generally greater than global export growth for most time periods between 2006-2016, though there were several periods where Lesotho lost market share (most notably in 2008, 2010, 2012-13 and for part of 2015).

Figure 24: Export growth in relation to world exports, 2006Q1-2016Q2

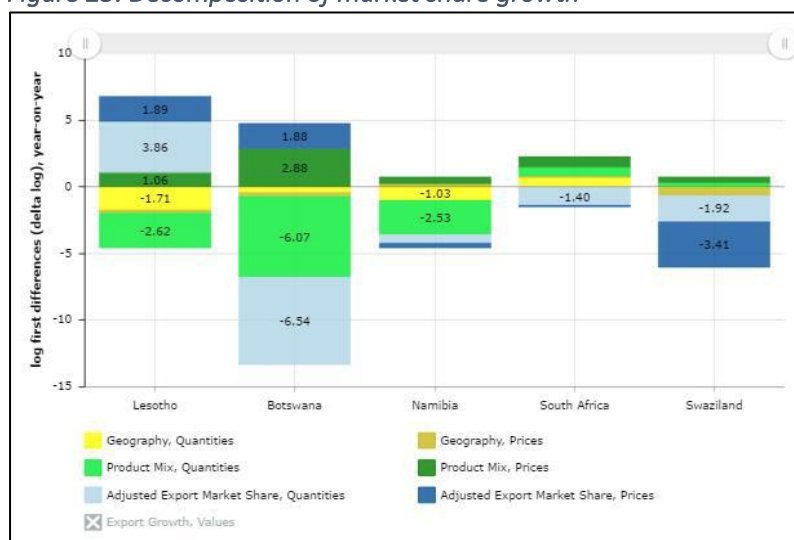


Source: World Bank Measuring Export Competitiveness Database

Note: Indicators are expressed in log-difference form, which allows for additivity across indicators.

In comparison to its SACU neighbors, however, Lesotho was able to substantially increase its export market share. In breaking this down, it becomes clear that Lesotho's market share expansion is driven primarily by supply-side "push" factors, while "pull" factors became less significant (Figure 25). Push" factors describe a country's own supply-side capacity to expand export market shares, assuming equal market and sectoral export composition across all countries. Moreover, gains arose primarily from volume, rather than price changes. All in all, this provides some basis for optimism as volume factors identify push factors that are independent of price changes related to the commodity boom that are more likely to be caused by currency fluctuations. Pull factors relate to increased sectoral specialization and demand in export markets. In the case of Lesotho this was almost exclusively driven by one sector (textiles, see yellow circle in Figure 26) and one major market (the United States) as well as one minor market (the Eurozone, see Figure 27).

Figure 25: Decomposition of market share growth



Source: World Bank Measuring Export Competitiveness Database

Note: Indicators are expressed in log-difference form, which allows for additivity across indicators.

Figure 26: Contribution of different export markets to market share changes and relative price changes

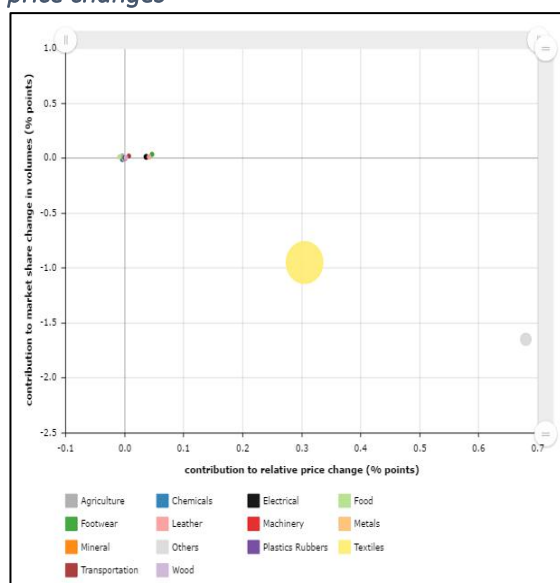
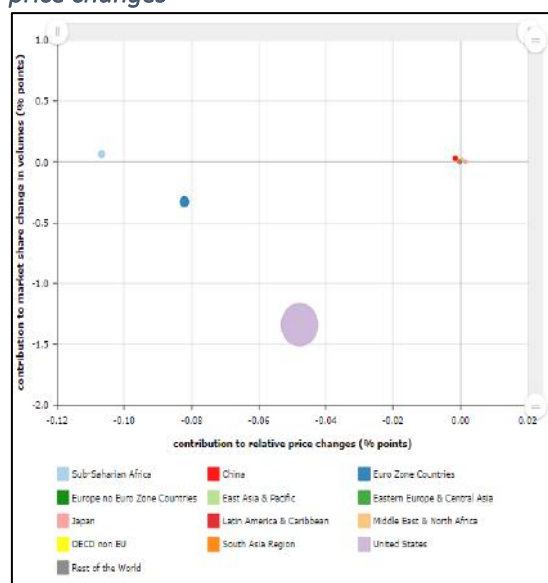


Figure 27: Contribution of different export markets to market share changes and relative price changes



Source: World Bank Measuring Export Competitiveness Database

Note: Indicators are expressed in log-difference form, which allows for additivity across indicators. The size of the bubbles (weight) is equal to a country's market/sector orientation.

2.4. Export diversification

Lesotho's exports are highly concentrated as the country relies on very few products and markets for its exports. Table 3 shows Lesotho's export value by sectors in 2015 with apparel and mineral (diamonds) products accounting for 77% of total exports and very few sectors showing significant exports. Despite the traditional dominance of apparel and diamond exports, an incipient product diversification can be observed mainly directed towards South Africa. Other sectors like small electrical parts and machinery, auto parts, and miscellaneous items have started to emerge in the last couple of years, with South Africa as the destination for these new emerging products.

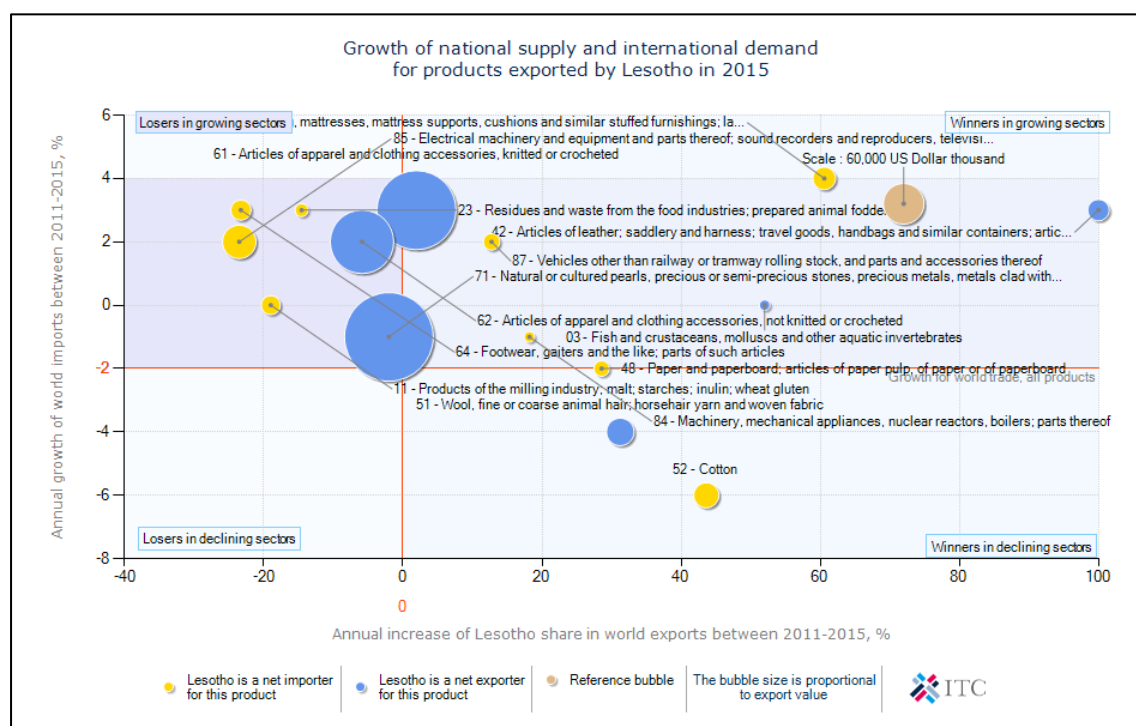
Table 3: Lesotho's Export by Sector (2010-2015)

	US\$ million		% total		CAGR, 10-15
	2010	2015	2010	2015	
50-63 Textiles, Clothing	381	454	47.6	50.2	3.6
71-83 Metals	203	318	25.4	35.2	9.4
84-85 Mach/Elec	149	44	18.7	4.9	-21.7
90-97 Miscellaneous	3	17	0.4	1.9	41.7
41-43 Hides, Skins	0	14	0.0	1.6	217.1
06-15 Vegetable	19	14	2.3	1.6	-5.1
64-67 Footwear	28	13	3.5	1.4	-14.2
86-89 Transportation	4	9	0.4	1.0	20.8
44-49 Wood	2	8	0.3	0.8	29.9
16-24 Foodstuffs	5	5	0.7	0.6	-1.1
01-05 Animal	1	4	0.1	0.4	29.7
25-27 Minerals	3	3	0.3	0.3	0.9
28-38 Chemicals	1	1	0.1	0.1	-5.3
39-40 Plastic / Rubber	1	1	0.1	0.1	-6.4
68-70 Stone / Glass	1	0	0.1	0.0	-19.1
Total	800	905	100	100	2.5

Source: Authors' elaboration with mirror data from UN-COMTRADE.

Growth in world imports in sectors of Lesotho's specialization is picking up pace. Figure 28 compares the top 20 export sectors of Lesotho with worldwide exports of the same sectors. The y-axis plots annual growth of world imports for Lesotho's top 20 export sectors between 2011 and 2015, while the x-axis shows the annual increase of Lesotho's export share in world exports for these sectors over the same period. The size of the bubble indicates the sector's export value. Most of Lesotho's leading export sectors have seen increasing shares in global exports in this 4-year period, and the majority have seen stagnant shares in global exports and growth in imports (such as apparel and precious metals). Lesotho has had a few products –electrical machinery and wool – with growing world demand and declining world market export shares ("losers in growing sectors", top-left quadrant).

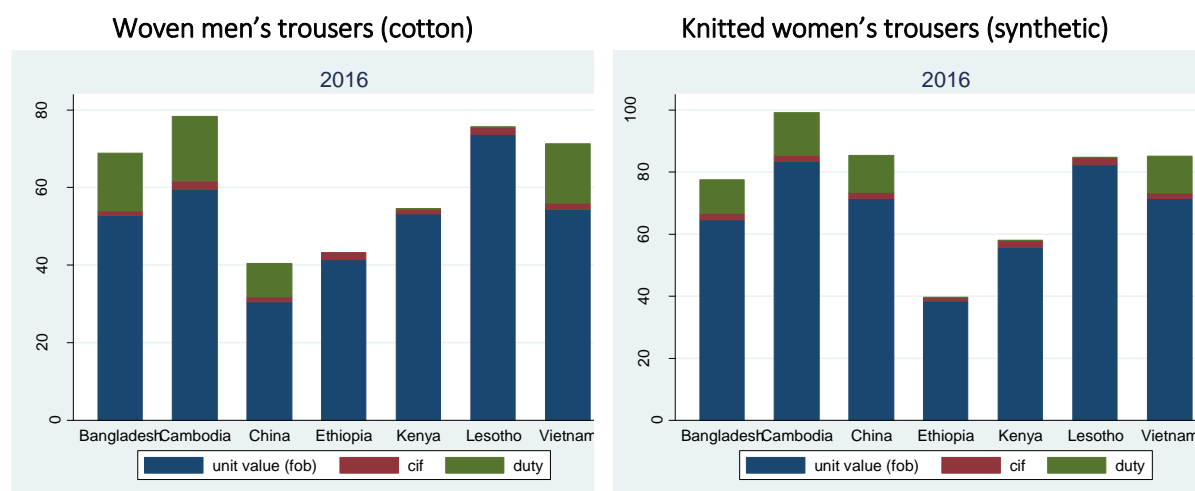
Figure 28: Growth orientation of top 20 export sectors for Lesotho, 2011-2015



Source: International Trade Centre

Lesotho's apparel exports have traditionally relied on significant preferences in its main destination markets. Because tariffs on apparel products are high and Lesotho has duty-free entry into the U.S. and South Africa under AGOA and SACU, the average preferences granted to Lesotho's apparel exports in the US and South Africa range between 15%-30% and 40%, respectively. These generous preferences have been one of the main reasons that allowed Lesotho's exports to remain competitive in foreign markets. Figure 29 shows the decomposition of the total price paid in the US for imports of two of the main apparel products exported by Lesotho into three components: duties (green), freight, insurance and other shipment costs (red) and the price received by the exporter (blue). When benchmarking Lesotho to other important suppliers of apparel to the US, it is clear that Lesotho's exports benefit significantly from tariff preferences. For instance, importers of synthetic women's trousers in the U.S. pay a similar price for exports from Lesotho and Vietnam. However, assuming that the quality of exports for both countries is the same, Vietnamese exporters need to be at least 15% more productive to compensate for the effect of tariffs on the price of their landed exports in the U.S.

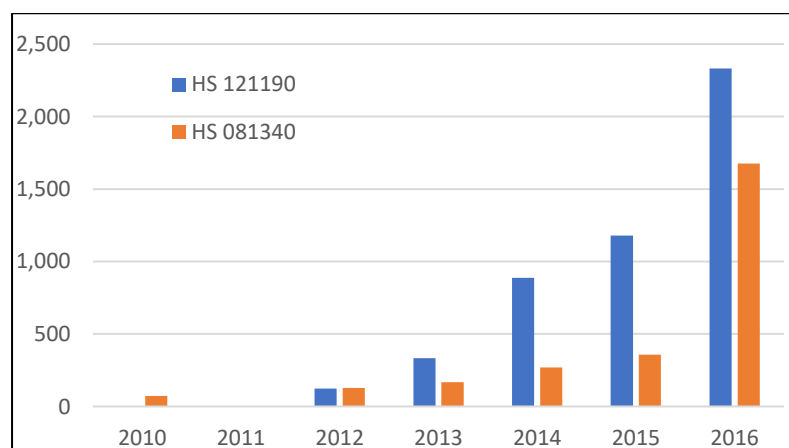
Figure 29: Cost decomposition of landed duty-paid value of exports in the US (2015)



Source: Authors' calculations based on data from USITC

There are a few new export products that can compete in demanding export markets without preferences. Figure 30 shows the evolution of exports values for two products that were only recently introduced by Lesotho exporters into the EU: dried fruit (HS 081340) and plants used for pharmaceutical purposes (HS 121190). Exports of both products to the EU have increased from less than EUR 100,000 in 2012 to over EUR 1.5 million in 2016. Furthermore, one of these products (plants used for pharmaceutical purposes) has started to diversify destinations and is now exported to Germany, France, Poland, and the UK.

Figure 30: New exports to the European Union (EUR '000)



Source: Authors' calculations based on data from Eurostat

The number of products at the HS-6-digit level exported globally in the past five years has declined for Lesotho while it has remained relatively constant for most comparators (Table 4). However, the decline in terms of products over \$100,000 is less significant, though Lesotho exports far fewer products than comparators and its share of products that are at a large scale is lower than for all other countries.

Table 4: Total products at HS-6 level exported and products with an export value of over \$100,000

	All		over US\$ 100,000		Share of exports that have are more than \$100,000	
	2010	2015	2010	2015	2010	2015
Botswana	2,659	2,272	519	277	19.5%	12.2%
Cambodia	1,408	2,358	381	626	27.1%	26.5%
Lesotho	1,706	1,323	158	186	9.3%	14.1%
Mauritius	3,060	3,061	700	666	22.9%	21.8%
Namibia	3,119	2,979	549	427	17.6%	14.3%
Swaziland	2,706	2,295	458	419	16.9%	18.3%
Vietnam	4,093	4,334	2,683	3,041	65.6%	70.2%
South Africa	5,077	4,799	3,786	3,657	74.6%	76.2%

Source: Authors' calculations based on data from UN Comtrade

There is considerable variation among export destinations in this context. Lesotho has by far the greatest variety of exports going to South Africa, with only Namibia and Botswana exporting more. While the overall number of products has decreased between 2010 and 2015, the number of exports greater than \$100,000 in value has increased (Table 5). More significantly, while the number of products going to the EU is greater than to the US, over 30 products are greater than \$100,000 for the US, while only 9 go to the EU – this is a decline of 50% compared to 2010. There is a need for more nuanced analysis at the product level for why this has occurred.

Table 5: Number of products exported by destination

	South Africa				European Union				United States			
	All		over US\$ 100k		All		over US\$ 100k		All		over US\$ 100k	
	2010	2015	2010	2015	2010	2015	2010	2015	2010	2015	2010	2015
BWA	1,941	1,289	206	143	205	233	18	13	33	40	6	10
LSO	1,584	1,194	122	146	74	79	18	9	56	53	35	31
KHM	150	183	11	29	513	1,646	154	249	299	385	139	213
MUS	648	423	65	80	1,134	2,141	277	266	225	262	49	77
NAM	2,150	1,506	249	164	571	1,746	86	69	76	81	8	13
NPL	245	117	2	1	731	1,552	126	140	376	386	61	82
SWZ	2,046	1,176	147	149	265	617	34	32	140	139	42	14
VNM	804	806	164	227	2,417	3,248	1,129	1,349	1,548	1,914	881	1,174
ZAF	0	0	0	0	3,007	3,401	1,363	1,241	1,442	1,436	625	641

Source: Authors' calculations based on data from UN Comtrade

The concentration of Lesotho's export basket has decreased along the product dimension but has increased in terms of markets served. The Hirschman-Herfindahl Index (HHI) allows comparing export concentration across countries. Figure 31 shows the HHI for market destinations and Figure 32 shows the HHI for products for the period 2010 and 2015.⁶ The latter shows that concentration has decreased over the past five years, as diamond exports became more significant, and that in relation to comparators, Lesotho's exports are relatively concentrated in terms of products. Lesotho outperforms some of its peer countries, such as Nepal and Swaziland, which are significantly more concentrated in terms of export basket composition. The decline in concentration, moreover, appears to be a trend

⁶ Reliable export data is not available for Lesotho on Comtrade prior to 2010.

shared by all benchmark countries as most (with the exception of Vietnam and Swaziland) are resource-rich and their export patterns were affected by the end of the commodity price boom. Regarding destinations, Lesotho was relatively concentrated compared to benchmark countries and experienced an increase in its HHI.

Figure 31: Hirschman-Herfindahl Index – Markets

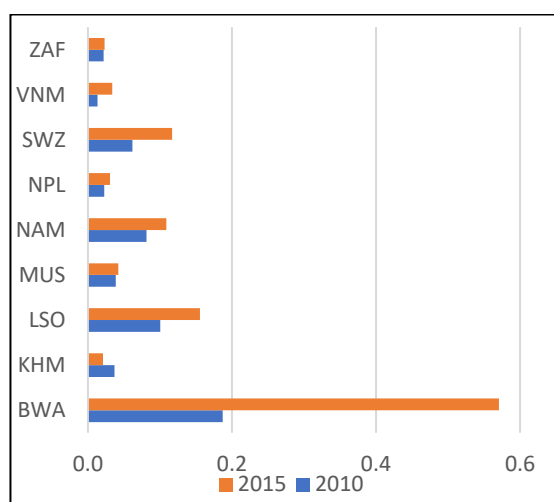
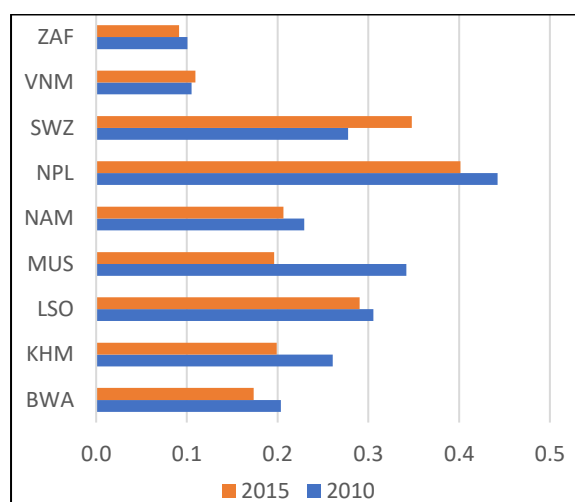
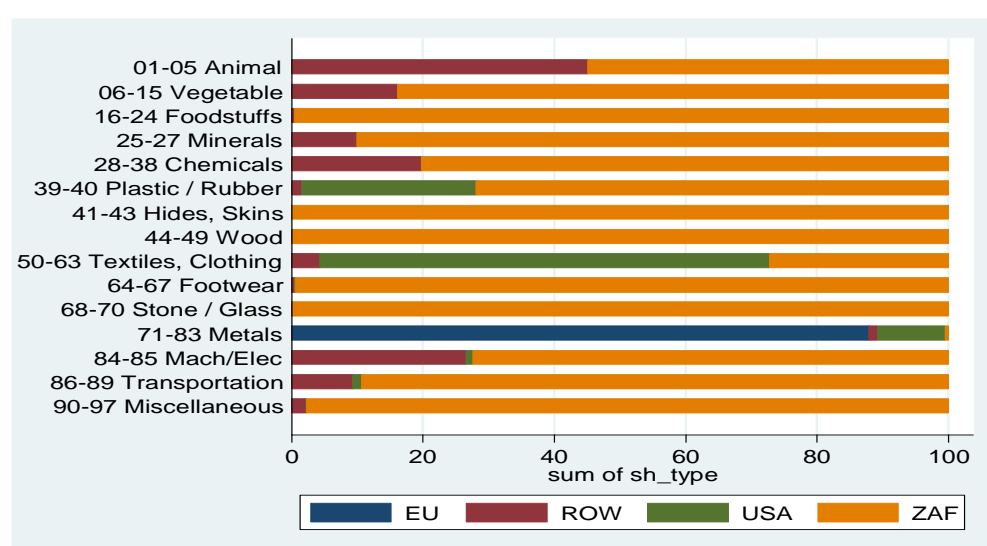


Figure 32: Hirschman-Herfindahl Index - Products



Source: Authors' calculations based on data from UN Comtrade

Figure 33: Sectoral Exports by Destination (%)



Source: Authors' calculations based on data from UN Comtrade

Similarly, Lesotho's exports are concentrated in only three export markets. SACU (mainly South Africa), the United States, and the EU account for 99% of exports on average over the last decade. There is very little export product diversification in any destination outside of South Africa since apparel and diamonds account for 98% of exports to both respectively the US and the EU (Figure 33). Apparel (90.9%) and diamonds (8.9%) dominate exports to the US. Inside the apparel sector, ten products defined at the HS 8-digit level account for 83% of total exports to this country. Apparel is concentrated in the top-10 products (>90%) and most apparel products had stagnant or declining market shares

(Figure 34). Furthermore, after growing at double digit rates for nearly a decade, growth in apparel exports to the US declined sharply after the end of the MFA in 2005 (Figure 35).

Figure 34: Apparel exports to the US, 1996-2016 (US\$ million)

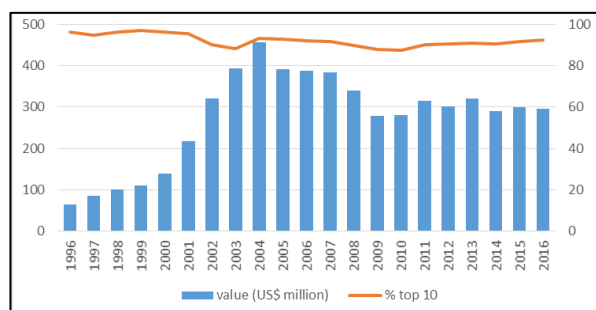
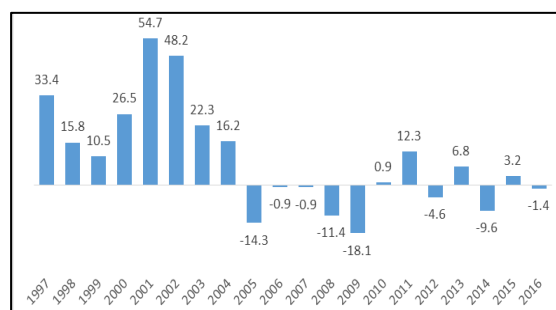


Figure 35: Growth in apparel exports to the US, 1997-2016 (%)



Source: Authors' elaboration using data from USITC (2016).

Most apparel export products to the US had stagnant or declining market share over the last decade. For one, Lesotho has been losing market share in the US in ten of its most exported products against Asian and Latin American competitors such as Vietnam, Malaysia, Bangladesh and Cambodia. The potential end of AGOA could also result in a significant disadvantage for Lesotho's apparel exports as they would revert to the MFN tariff - which is slightly higher than 20% on average - since none of these products are granted duty-free status under the Generalized System of Preferences (GSP), the US's other major preferential program to Lesotho (Table 6).

Table 6: Top ten apparel export products to the US (2015)

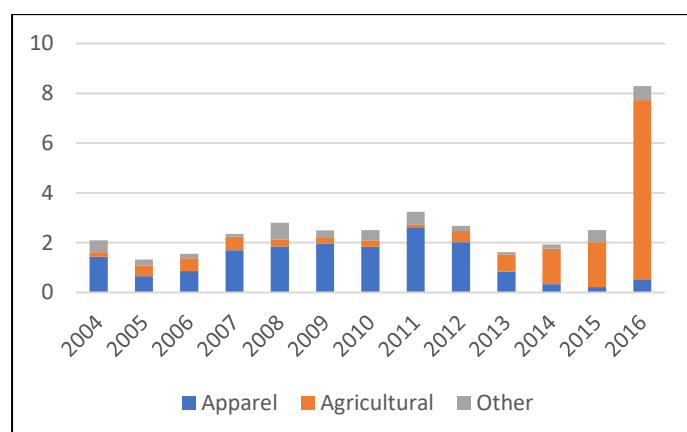
HS8	Product description	Exports (\$'000)	% exports	% US imports	NTR tariff
62034240	Men's or boys' trousers and shorts, not bibs, not knitted or crocheted, of cotton, not containing 15% or more by weight of down, etc	75,047	22.8	1.4	16.6
61046320	Women's or girls' trousers, breeches and shorts, knitted or crocheted, of synthetic fibers, nes	71,000	21.5	5.1	28.2
61103030	Sweaters, pullovers and similar articles, knitted or crocheted, of manmade fibers, nes	39,034	11.8	0.7	32.0
61052020	Men's or boys' shirts, knitted or crocheted, of manmade fibers, nes	34,440	10.4	3.9	32.0
62046240	Women's or girls' trousers, breeches and shorts, not knitted or crocheted, of cotton, nes	15,672	4.8	0.3	16.6
61099010	T-shirts, singlets, tank tops and similar garments, knitted or crocheted, of man-made fibers	14,584	4.4	0.9	32.0
61046220	Women's or girls' trousers, breeches and shorts, knitted or crocheted, of cotton	8,143	2.5	0.5	14.9
61034315	Men's or boys' trousers, breeches and shorts, knitted or crocheted, of synthetic fibers, nes	6,602	2.0	0.6	28.2
61051000	Men's or boys' shirts, knitted or crocheted, of cotton	5,386	1.6	0.4	19.7
61102020	Sweaters, pullovers and similar articles, knitted or crocheted, of cotton, nes	4,636	1.4	0.1	16.5

Source: Authors' elaboration using data from USITC (2016).

Exports to the EU are highly concentrated with diamonds representing 98% of exports in 2015. The number of products exported to the EU outside diamonds and the value of exports is very small. Less than twenty products over EUR 5,000 were exported to the EU in any given year over the last decade and only four products recorded exports over EUR 1 million euros in 2015. Non-diamond exports were

only able to surpass the EUR 3 million thresholds twice in the last decade. Among non-diamond exports, the agricultural sector is the most important for the EU. Surprisingly, apparel exports were less than half a million euros in 2015 and are not persistent (i.e. most products are not exported for more than two or three years in a row). This is despite the fact that apparel products benefit from zero duties and generous rules of origin in the EU as a result of the preferences under the Everything But Arms (EBA) agreement (Figure 36). Lesotho has recently concluded Economic Partnership Agreement negotiations with the EU that improve market access and may enable Lesotho to diversify into new exports.

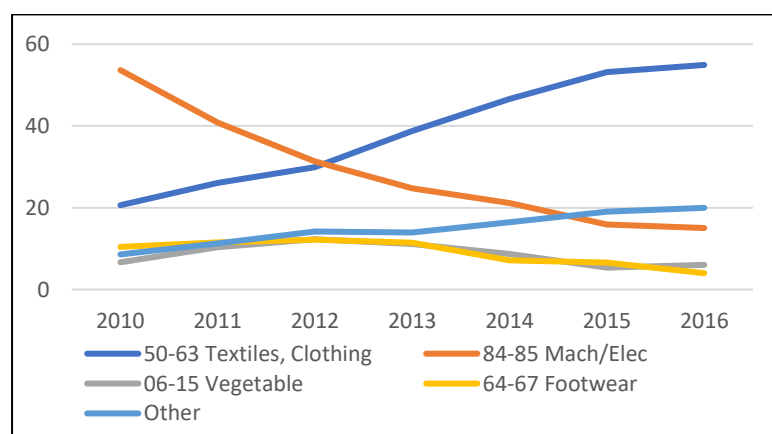
Figure 36: Non-diamond exports to the EU (EUR millions)



Source: Authors' calculations based on data from Eurostat

Exports to South Africa are more diversified than to the US and the EU but are still dominated by apparel (Figure 37). Apparel and machinery have traditionally accounted for the biggest share of exports to South Africa although they have followed different trajectories since 2010. Machinery exports declined by 40% in nominal terms between 2010 and 2016 and the sector lost relative importance dropping from accounting for about 55% of exports to South Africa in 2010 to less than 15% in 2016. On the other hand, apparel exports increased five-fold in nominal terms during the same period and increased its share of exports from 20% to 55%.

Figure 37: Exports to South Africa by Sector (% total exports)

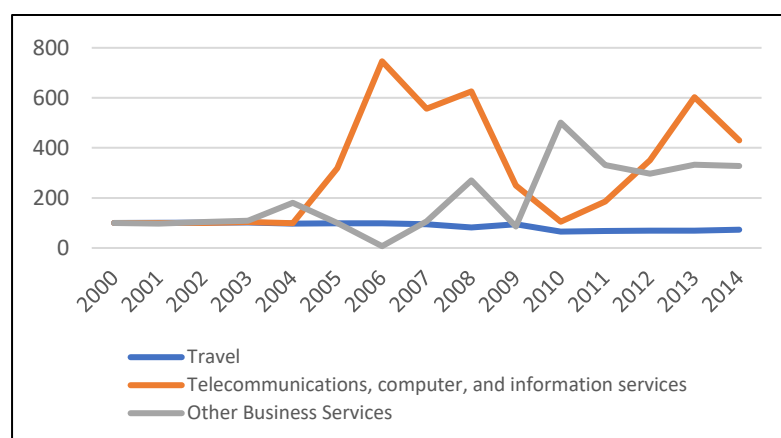


Source: SARS

Lesotho has not taken steps to exploit potential services export expansion. Despite the sector's growing importance to GDP and employment, Lesotho's tourism sector continues to underperform, and has seen a decline (Figure 38). In 2015, Lesotho was ranked 129 out of 141 countries by the World Economic Forum's Tourism Competitiveness Index (WEF 2015). Among comparators countries, Lesotho has the third-lowest ratio of foreign to domestic spending on tourism, after two other landlocked countries, Swaziland and Malawi. Lesotho could differentiate itself from other southern African countries, offering mountain ranges and snow in winter. To capitalize on its tourism potential, Lesotho needs to take some steps to enhance its infrastructure and train personnel. Of 82 accommodation enterprises surveyed in a World Bank study (Yiu and Saner 2015), less than 40% were considered "market ready".

Another potential area for expansion is accessing the offshore services industry. Lesotho's leading services export sector, by far, is the travel industry. In 2014 this sector accounted for over 60 percent of commercial services exports. The other main exports were other business services (22% of total exports), telecommunications (8%) and transport services (7%). Figure 38 shows growth in both the ICT services sector and in other business services, which includes legal, accountancy and tax services, architectural and engineering and management consultancy and advertising services. Lesotho could use its lower wage and human capital advantage to piggyback on some of South Africa's back office support and ICT services industries. It would benefit Lesotho to focus on skills development and ICT infrastructure enhancement to expand into an industry that has served as a source of employment and potential linkages up the skills value-added chain for other developing countries such as the Philippines, El Salvador and Kenya. More disaggregated services data would be helpful in making a more thorough diagnostic of Lesotho's services potential.

Figure 38: Growth in exports of selected services, % 2000-2014



Source: IMF ITS-CAN database

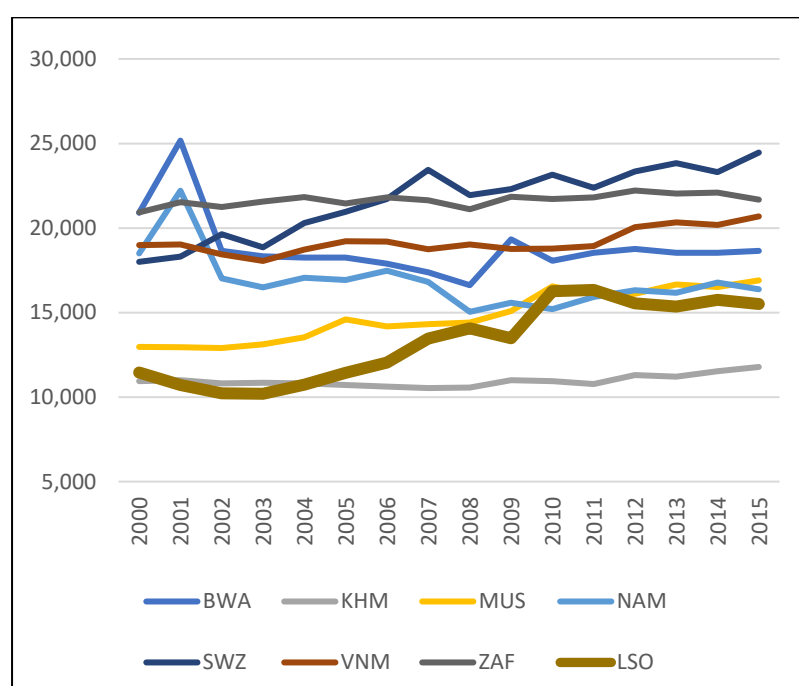
2.5. Sophistication and complexity of exports

What countries produce and how they produce them matters for export-led growth. All else equal, goods that embody greater complexity, as well as value added in terms of ingenuity, skills, and technology fetch higher prices in world markets. Producing complex products, and upgrading sophistication and quality of its export basket can be a secure source of export and economic growth. Analysis of the Lesotho's evolving comparative advantage shows a moderate level of structural transformation over the past two decades.

Lesotho's exports have increased in sophistication over time as measured by Hausmann, Hwang, and Rodrik's EXPY indicator. However, they are still far below those of comparators, with the exception of

Cambodia. Figure 39 shows the evolution of EXPY, a proxy for export sophistication, jointly with the evolution of per capita GDP for Lesotho and comparator countries. Unsurprisingly, it is the countries with the largest share of manufactures and the smallest share of commodities in their export baskets – Swaziland, Vietnam and South Africa – that score highest on this measure. When looking at Lesotho’s largest single export product, knitted and crocheted clothing and accessories (SITC 8414) Lesotho has consistently occupied the lower end of the quality segment according to unit values and the WB-IMF (Henn et al. 2017) quality indicator (Figure 40: **Measures of product quality for “Clothing and accessories, knitted or crocheted” (SITC 8414), unit values (left) and Henn et al. 2017 quality indicator (right)**). Here it primarily competes with lower quality producers such as Cambodia, Bangladesh and the Dominican Republic.

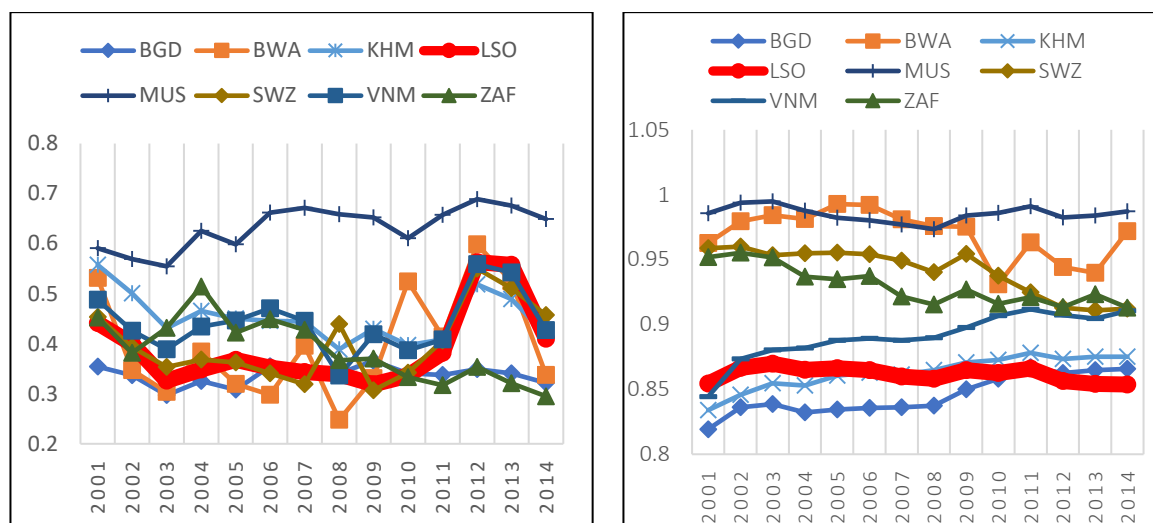
Figure 39: Export sophistication as measured by the EXPY indicator, Lesotho and comparators



Source: Authors’ calculations based on data from UN Comtrade

Lesotho could explore further its comparative advantage in labor intensive and animal/vegetable products. We used the analytical tools proposed by Hausmann, Klinger and Lopez-Calix (2010) to scan the product space for opportunities to develop a revealed comparative advantage in high potential export sectors for Lesotho (Annex 2). Following this methodology, we provide a list of products selected by two strategies: a ‘low-hanging fruit’ strategy that only involves products that are very close to Lesotho’s productive structure, and another strategy -that can be thought as more aggressive or a medium-term strategy - that includes products that are father from Lesotho’s current productive capabilities. The two strategies would result in different sectoral focus: the ‘low hanging fruit’ strategy relies on labor-intensive industries (miscellaneous manufactures, textiles and fabrics, metallic manufactures) and some animal/vegetable products (fruits and vegetables, fish). The more aggressive strategy also focuses more on labor intensive industries liked footwear and travel goods and handbags but also includes other manufacturing industries like furniture, electrical machinery and miscellaneous edible products and preparations.

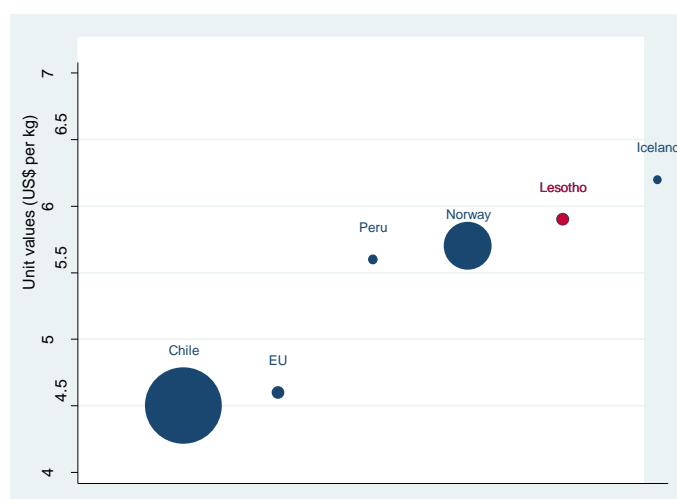
Figure 40: Measures of product quality for “Clothing and accessories, knitted or crocheted” (SITC 8414), unit values (left) and Henn et al. 2017 quality indicator (right)



Source: Own calculations based on Henn et al. (2017)

However, there are products where Lesotho is among the highest-quality producers. Figure 41 shows the quality ladder for another product that has entered a lucrative niche based on its high quality: exports of frozen trout to Japan. The y-axis shows the relative quality (measured by unit values) of countries that export frozen trout to Japan sorted from lowest to highest quality along the x-axis (i.e. increasing quality rank from left to right). Two facts are worth highlighting. First, very few countries have been able to enter the Japanese market to export frozen trout which speaks to the demanding nature of this market for fish products. Second, Lesotho’s exports of this product (measured by unit value in the y-axis) is higher than that of important suppliers in world markets like Chile, the EU, and Norway, and is only surpassed by the quality of exports from Iceland. The ability to export to high-quality segments in very discerning markets, such as trout to Japan, means there is potentially a lot to learn from these experiences for other exporters in terms of meeting standards, finding buyers, and finding reliable transport companies.

Figure 41: Japan’s Frozen Trout Imports (2015)

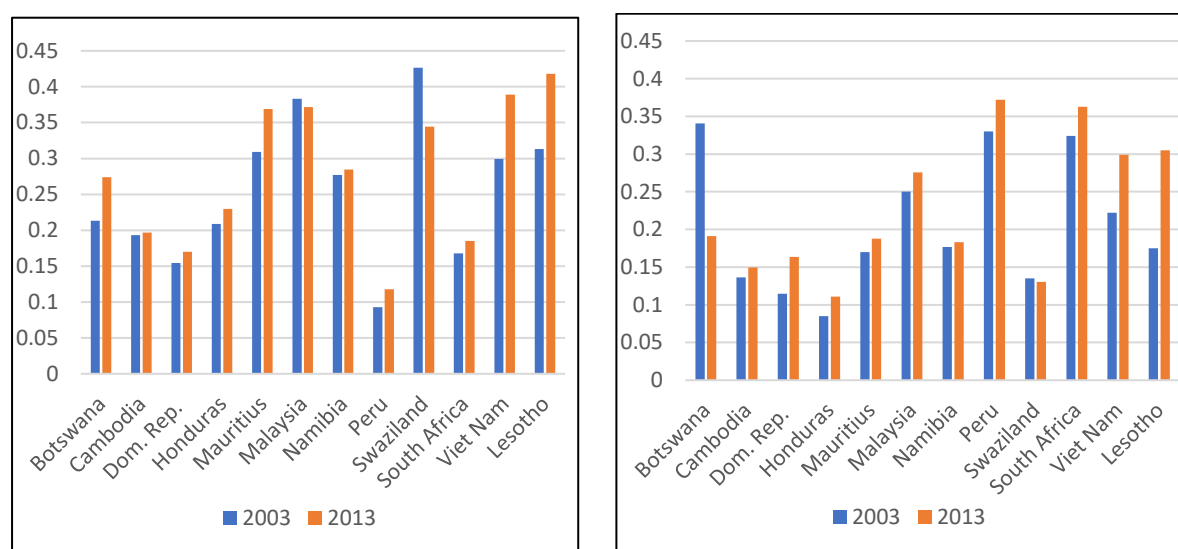


Source: Authors’ calculations based on data from UN Comtrade

2.6. Leveraging GVC participation for improved trade outcomes

Lesotho has been one of the most successful countries in sub-Saharan Africa in terms of increasing participation in value chains. Lesotho has managed to increase its domestic contribution in terms of value added in exports by almost 12% per year, and has made the most rapid improvements against comparators in terms of the share of imported inputs in its exports, and the value of its exports in other country's exports, though it is worth noting that almost all of these economies are much larger (see Figure 42). This has benefited low-skill labor, but direct export gains to workers have lagged other countries.

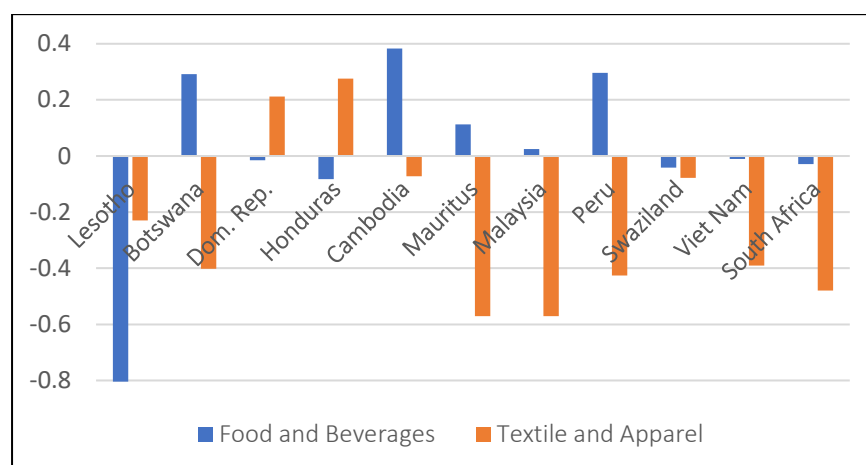
Figure 42: Foreign VA in exports as a share of total exports and VA in third-country exports as share total exports (2003 and 2013)



Source: Eora MRIO

Between 2003 and 2015, the country has seen a decline in the number of production stages carried out domestically in its two leading export sectors, food and beverages and textiles and apparel. Figure 43 looks at the difference between where in a given value chain Lesotho imports and exports using the upstreamness and downstreamness measures. On the one hand – especially for food and beverages – this could mean a change in the intra-sectoral composition of the export basket but does suggest that relatively few downstream and upstream tasks within the value chain have been brought to the country. As argued in the Trade Policy Review (WTO 2015), Lesotho could take more advantage of GVC integration by diversifying into other products and markets with higher value added – especially in light of increased competition from abroad. Currently the sector already benefits from numerous preferences vs other industrial activities (a lower corporate tax rate and the SACU rebate).

Figure 43: Change (2003-15) in number of stages of Textiles & Apparel Supply-Chain carries out domestically



Source: Own calculations based on Comtrade

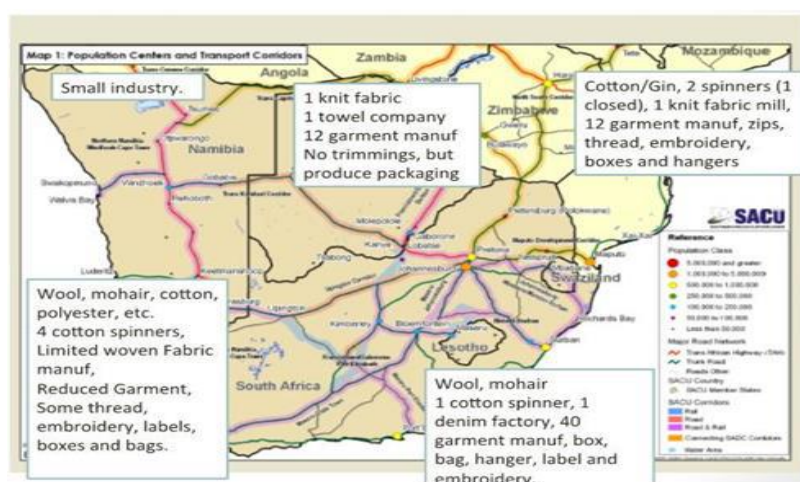
What could be driving these dynamics in the textiles and apparel sector? As it has been the most dynamic export sector in recent years, much of the literature, including some articles and reports mentioned above focus on textiles and apparel.⁷ From a value chain upgrading perspective, Morris and Staritz (2017) examine a diverse set of primary and secondary data as well as firm interviews and interviews with various government ministries' and agencies, and find that "the nature of the value chain and triangular manufacturing network in which Taiwanese-owned firms operate relative to their South African-owned counterparts appears to be the major reason for the limited levels of industrial upgrading and skills development within the Lesotho apparel sector." Thus, the South Africa-driven value chain offers greater potential for upgrading and for local linkages as South African firms – in their analysis – appear more interested in transferring more production functions from South African plants. They argue that there is an opportunity for Lesotho's apparel sector to occupy an intermediate industrial space between the low-level cut, make and trim (CMT) assembly preferred by Taiwanese investors, and high-end apparel found among many Cape Town-based firms. However, this requires, they argue, an "appropriately directed and capacitated industrial policy" that aims to both expand the base of skilled labor and management, and foster a culture to raise the operational competitive levels of manufacturing operations. All in all, this suggests that increasing penetration of the South African market (and seeking other export markets) may offer just as much, if not more potential than trying to expand the scope from the more footloose Taiwanese investors.

Lesotho also has substantial opportunities to integrate into RVCs in SACU. The mapping of the industry in World Bank (2015) notes pressure on South Africa-based producers to lower production costs and the growing regional retail market (see Figure 44). However, problems remain due to lack of available fabric undermining opportunities for cost competitiveness and speed, skills at the technical and management level, access to finance and high transport costs. A key constraint in the case of Lesotho is container availability with only one shipping company having a container terminal in Lesotho and a

⁷ A mapping exercise carried out for the World Bank report *Factory Southern Africa: SACU in Global Value Chains* (World Bank 2015) provided detailed sector-level overviews of the opportunities and constraints for greater GVC integration across the region in 12 sectors (more detailed summaries applicable to Lesotho below). Generalizing its findings across 12 sectors the report notes that the region as a whole remained at the margins of most production networks and faces serious challenges of distance, with potential agglomeration effects not well exploited. This is compounded by the dominance of South Africa and the marginalization of the other four SACU members. This is compounded by low productivity, a restrictive trade policy environment that undermines downstream competitiveness. Therefore, the report concludes that the best opportunities are likely to be found in services sectors and increasing downstream value added for sectors like jewelry and crafts.

need to improve rail facilities between Lesotho and Port Elizabeth. This, according to interviews conducted for this study, is compounded by management issues in the container unloading terminal, which often lacks operating equipment, experiences frequent breakdowns of cranes and equipment, among other issues. A key trade-related issue remains the high SACU duties on fabrics levied on the textile sector (22%). While reducing these could have severe detrimental impacts on the existing upstream providers, the precise implications would need to be assessed. All in all, this suggests that increasing penetration of the South African market (and seeking other export markets) may offer just as much, if not more potential than trying to expand Taiwanese investment.

Figure 44: Map of SACU Textile and Apparel Sector

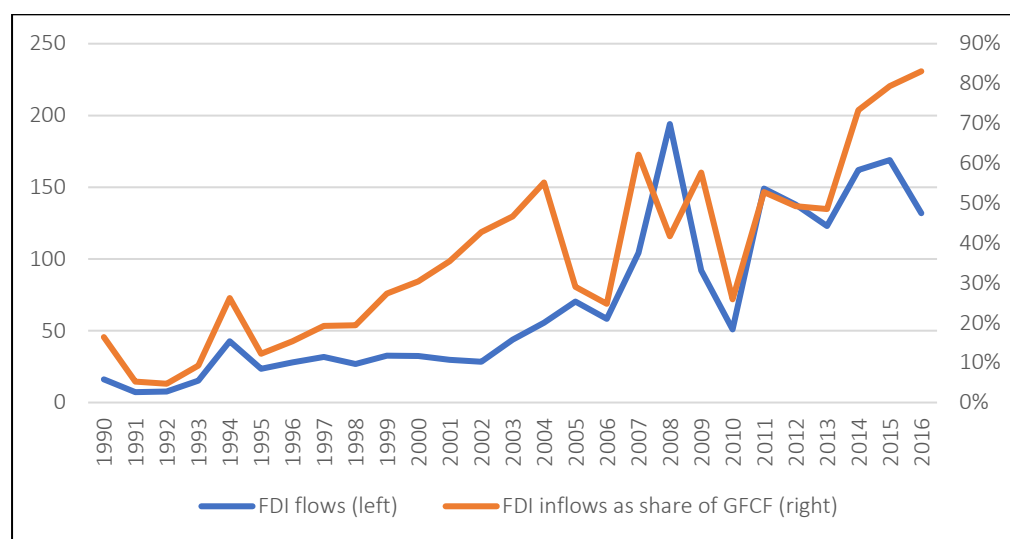


Source: World Bank (2015)

In a world of regional and international production networks, trade and investment are inextricably linked. Given the right conditions, FDI inflows have been found to be typically associated with technology and knowledge spillovers, with improvements in export quality and increase in diversification. How has Lesotho performed in attracting FDI? As can be seen in **Figure 45**, FDI flows to Lesotho increased rapidly during the late 1990s and early-mid 2000s, before a massive decline during the global financial crisis. However, Lesotho has recovered in terms of FDI flows and the country continues to see growth in foreign investment even in light of the political uncertainty of the past few years. Moreover, FDI has grown from being less than 20% of gross fixed capital formation, during the 1990s to more than 80% in 2016. This was likely driven by the influx of capital in the apparel sector and following the recent discovery of diamond deposits.

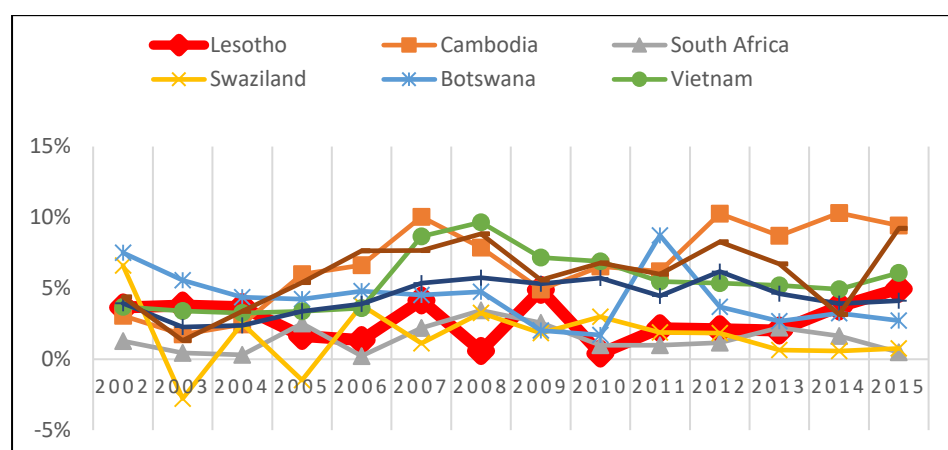
Lesotho has positioned itself as an attractive investment destination, with FDI flows recovering from a post-crisis decline in the past few years. The significant drop in FDI that we saw after the financial crisis has been made up and the country continues to see growth in foreign investment even in light of the political uncertainty of the past few years. In relation to comparators, Lesotho receives a relatively high share of FDI in relation to GDP. What is notable is that most of the comparators did not experience the same decline in 2007-09, so this may be attributable to country-specific factors (Figure 46). As a share of GDP, FDI has remained relatively constant at approximately 4% though it has in some years declined to less than 2%.

Figure 45: Foreign direct investment flows and share of gross fixed capital formation, 1990-2015



Source: UNCTAD

Figure 46: Foreign direct investment flows as a share of GDP, 1997-2015



Source: World Bank World Development Indicators

3. Linking determinants to outcomes

3.1. Lesotho ties its hands through a restrictive policy framework

Through its SACU membership, Lesotho's trade policy has to a large extent been determined by the common policies adopted at the regional level. SACU is the world's oldest customs union and is composed of Botswana, Lesotho, Namibia, South Africa, and Swaziland. Imports originating outside SACU are subject to a common external tariff. Beyond being a member of the WTO and SACU, Lesotho is a member of the Southern African Development Community (SADC), which launched a free trade area with the Common Market for Eastern and Southern Africa (COMESA) and the East African Community (EAC), comprising 26 member states. Lesotho also has regional trade agreements through SACU with the European Free Trade Association (EFTA) and with the US and Mercosur, though none of these agreements have been ratified. Lesotho recently concluded negotiations of an Economic Partnership Agreement with the European Unions as part of SADC. There are ongoing negotiations for a trade agreement between SACU and India. It further receives LDC preferences from numerous other countries though none of these have had an impact comparable to AGOA in terms of stimulating exports.

Lesotho's ability to develop the most advantageous policies is impacted through its close relationship to South Africa, both through its rand-pegged exchange rate and its reliance on SACU revenues. Reliance on revenue-sharing within SACU to fund public expenditure means that fiscal policy is also in part outside of Lesotho's control. It also makes unilateral trade liberalization challenging – even if the investors Lesotho is hoping to attract require lower-cost inputs for Lesotho to be a competitive location, the ability of Lesotho to influence its exchange rate is limited. However, the substantial depreciation of the Maloti in recent years creates opportunities for exporters to exploit its increased currency competitiveness.

Trade and trade-related issues are split across numerous ministries, though the Ministry of Trade and Industry (MTI) is main institution for trade policy. The MTI also chairs an inter-ministerial textile and apparel industry task team and was most recently in the process of developing a new Strategic Development Plan (WTO 2015). The MTI is currently in the process of developing a trade policy with support from SADC and through the EU's Trade Related Facility program.

Lesotho does not have a national investment policy nor a foreign investment law. The main institutions involved in implementation and formulation of investment policies are the Ministry of Trade and Industry (MTI), which oversees the Lesotho National Development Corporation (LNDC) and houses the investment promotion agency. This is the main agency responsible for interacting with investors, and it also provides factory space and other facilities, often at a below-market cost. Other agencies with a role in investment policy are the Lesotho Tourism Development Corporation (LTDC) and the Basotho Enterprises Development Corporation (BEDCO).

There are a few policies targeted towards promoting exports. For one, there is a partial credit guarantee scheme through LNDC that provides a 50% guarantee on loans worth up to M5 million for all sectors and sizes.⁸ The government offers two main trade rebates, one of which allows importing certain inputs duty-free for producing goods for the domestic market and secondly a SACU general incentive scheme covering goods produced exclusively for exports outside of SACU that is granted for any component or material used in the manufacture, processing, finishing, equipping or packing of goods for export outside of SACU (470.03 of Schedule 4 in Tariff Book). However, as indicated in interviews carried out

⁸ Work is ongoing through the World Bank's Second Private Sector Development Project to assess the effectiveness of these schemes as well as of the investment promotion structure more broadly.

for this study, the implementation of this duty-drawback scheme is often inadequate due to lengthy administrative delays and uncertainty (see Section 3.3.).

3.2. EU and US trade policy changes and their impact on Lesotho

More recently, there has been an increased institutional focus on the future role of the AGOA agreement. The recent AGOA summary report argues that the Inter-Ministerial Textile and Apparel Task Team, set up in 2004, has been effective but needs a strengthened governance structure due to weaknesses and inconsistency in management, lack of focus and weak coordination mechanisms as well as a lack of monitoring and evaluation (Molapo 2016). The report therefore advises restructuring this towards an AGOA Secretariat focused on the planning, coordination and monitoring of this agreement. The report further identifies substantial challenges relating to both political and macro instability, inadequate political commitment, and lack of private sector buy-in. Similar issues are covered in the most recent Diagnostic Trade Integration Study (DTIS) update (EIF 2012).

Furthermore, the congressional AGOA Extension and Enhancement Act of 2015 has created greater uncertainty for Lesotho's exporters and their trading partners. The Act provides the US with more flexibility in reviewing countries on an ongoing basis, allowing the privileges to be either withdrawn or suspended throughout the calendar year. The possibility of quarterly reviews of Lesotho's compliance with AGOA requirements could lead to lower orders from the US depending on investors' assessment of the likelihood of Lesotho retaining its AGOA privileges.

Potential changes to Lesotho's preferential margin have informed our analysis of select scenarios. The first hypothetical scenario analyses the potential impacts of the sudden loss of AGOA privileges by Lesotho in 2018. Further, Lesotho's exports competitiveness could be eroded by potential free trade agreements between the US and Lesotho's major competitors. As documented in Section 2.4, Lesotho enjoys a significant preferential margin in the US market without which it might not be able to compete. The second scenario looks at the impacts of a potential US-Vietnam FTA based on the tariff and NTM liberalization as negotiated under the Trans Pacific Partnership (TPP). Under this scenario, Vietnam is gaining duty free access to the US market. Both events, the suspension of AGOA privileges and a US-Vietnam FTA, would result in increased competitive pressures on Lesotho. Both scenarios serve only illustrative purposes and should not be treated as indications of future developments.

Potential impacts of the US-Vietnam FTA and loss of AGOA preferences on trade, growth and welfare were estimated using a global dynamic computable general equilibrium (CGE) model. This modelling framework allows for the incorporation of complex interactions between producers, consumers and the government. It captures productivity differences at the country, sector and factor level, shifts in demand as income rises, as well changes in comparative advantage and trade flows following trade liberalization. Building on recent work of Petri and Plummer (2016) and World Bank (2016b and 2016c), the backbone of the economic modelling was conducted with the use of a global dynamic CGE model LINKAGE (van der Mensbrugghe, 2011). The analysis includes 17 sectors and 35 trading partners (see Table A1) and simulates the impacts of policy changes up to 2030, including reductions in tariffs, NTMs, and regulatory barriers in trade in services. For this analysis, the 2010 social accounting matrix (SAM) for Lesotho has been updated to 2011 and incorporated into the Global Trade Analysis Project (GTAP) database⁹ version 9.2, benchmarked to 2011.¹⁰ The key macroeconomic variables and trade flows were then updated to the most recent data available for Lesotho (primarily from 2015). Details of the data, modeling framework and scenarios are provided in Annex 1: LINKAGE Global Dynamic CGE Model.

⁹ <https://www.gtap.agecon.purdue.edu/>

¹⁰ We are grateful to Badri Narayanan for the incorporation of Lesotho SAM to the GTAP database.

Our results indicate that the negative impacts due to a sudden suspension of AGOA privileges in 2018 would have been much higher than losses resulting from the potential US-Vietnam FTA. The decline of income would reach 1% relative to the baseline in 2020, while exports of textiles and apparel would drop by 16% leading to a drop of output in the textiles and apparel sector by 9% (see Table 7). Given that employment in textiles and apparel accounted for 4.4% of total employment and 10.5% of female employment in 2014 with several other family members believed to be supported by these jobs, these impacts are significant. The decline of average real consumption of 0.5% would have significant negative consequences for the poor.

While the impact of AGOA suspension is immediate, the implementation of a US-Vietnam trade agreement is assumed to be gradual over 10 years. The declining preferential margin of Lesotho vis-à-vis Vietnam is a legitimate reason for concern (the unit labor costs of Lesotho are much higher than those of its competitors), but other major exporters such as China, Indonesia, Bangladesh or Jordan would continue to pay MFN rates. The impact of Lesotho's exports of apparel and textiles is a 3.4% decline relative to the baseline in 2020, but the impacts on average income or real consumption are negligible.

Table 7. Impact of AGOA suspension and US-Vietnam FTA

	Income	Real consumption	Total exports	Exports of textiles and apparel	Imports of textiles and apparel	Output of textiles and apparel
Deviations from the baseline in 2020 (percent)						
AGOA suspension	-1	-0.5	-3.7	-16	-6.9	-9.3
AGOA suspension with TF	0	0	+2.9	-8.6	+15	-3.9
US-Vietnam FTA	-0.2	-0.1	-0.4	-3.4	-1.4	-1.8
Deviations from the baseline in 2030 (percent)						
AGOA suspension	-0.8	-0.3	-1.4	-14.6	-6.6	-8.4
US-Vietnam FTA	-0.37	-0.2	-0.6	-7	-2.8	-3.8

Source: Staff calculations based on LINKAGE.

To a large extent, the impact of the sudden loss of AGOA privileges would depend on the behavior of several large apparel companies. Footloose Taiwanese firms could decide to move their operations somewhere else as the industry operates at a very tight margin. The South African companies would be likely to remain at least for some time, but in the event that exports to the US disappeared completely, our simulations indicate dramatic impacts on welfare. Under the hypothetical scenario of a complete elimination of exports to the US (not reported here), total exports would drop by 15% relative to the baseline, which lead to a 5% decline in real consumption in 2020.

The above simulations once again stress the need to strengthen the efforts to support structural transformation leading to diversification of export products and markets, improving backward and forward linkages and lowering trade costs. Our simulations indicate that a decrease of trade costs of an average 2% per year would eliminate the negative welfare consequences of the loss of AGOA. Under a scenario simulating the loss of AGOA privileges along with a reduction in trade costs, total exports would increase by almost 3% relative to the baseline in 2020, but growth would be based on the sectors

where the initial trade costs are highest. The loss of AGOA privileges would still mostly impact the textiles and apparel sector leading to the replacement of domestic output by imports and the partial loss of exports markets, but the consequences of the loss of AGOA privileges when trade costs are lower are much less severe. Further alleviation of the negative consequences of the loss of duty free access to the US market either because of a sudden change of US policy or change in assessment of Lesotho's eligibility or due to the ultimate phase out of the AGOA in 2025 could be achieved through pan-African integration under Continental Free Trade Area (CFTA). Mevel and Karingi (2012) find that the CFTA could significantly increase intra-African trade and its degree of sophistication, but these positive outcomes can only be achieved through elimination of non-tariff measures and reduction of the intra-African costs of trade.

Finally, the EU-SADC EPA does not significantly improve market access for Lesotho's main export products. Almost all Lesotho exports were granted zero duty treatment under the Everything but Arms (EBA) agreement before the EU-SADC EPA. Diamonds, the main export from Lesotho to the EU, has an MFN tariff of zero so even in the absence of preferences it would pay no tariffs. Similarly, the EPA rules of origin for apparel and preserved food, the other products besides diamonds exported in significant volumes to the EU are the same that Lesotho experienced under EBA – which already granted a very liberal “single transformation” rule of origin to Lesotho as an LDC since 2011. Therefore, the potential for the EPA to stimulate diversification of exports to the EU is uncertain.

3.3. Summary of stakeholder interviews

As part of this study, the World Bank team also conducted a week-long mission to the country to meet with representatives from the public and private sector, and other experts. These were conducted in Maseru, Maputsoe and at the campus of Lesotho National University in Roma between November 14-18, 2016. In addition to meeting with representatives from numerous relevant ministries and related government agencies,¹¹ the team also met with managers from a variety of domestic and multinational firms of different sizes in industries ranging from textiles and apparel, footwear, machinery, telecoms, food and beverages, software, as well as private sector associations, representatives from foreign governments and multilateral development agencies, and academics and consultants. Broadly, findings fell into four different areas: i) AGOA and the future of Lesotho's textile, apparel and footwear industry; ii) the development of backward linkages from manufacturing industries; iii) the prospects for product and market diversification; and iv) the institutional structure of trade policy and the strategic vision moving forward.

It was widely acknowledged that loss of AGOA through a US suspension would have a strong negative impact for the entire economy. However, among firms investing to take advantage of AGOA preferences, there is some heterogeneity between very footloose Taiwanese firms and more “Africanized” Asian firms that have been here since the 1990s and earlier. Any kind of preference erosion will likely not lead to a uniform departure of all light manufacturing to the US and is likely to also depend on where firms have other operations (for example, *Nien Hsing* has subsidiaries in Vietnam, Nicaragua and elsewhere, so barriers would be lower). Representatives from some of the main Taiwanese and Chinese supplier firms may leave within weeks. This was a concern not only due to the first-order impacts in terms of jobs lost, but more indirect given the remittances to families paid by workers, existing linkages to utility firms and other service providers, as well as for the LNDC from a

¹¹ This included representatives from the Ministry of Trade and Industry, the Private Sector Foundation of Lesotho, the Lesotho Revenue Authority, the Lesotho Bureau of Statistics, the Ministry of Public Works and Transport, the Lesotho Chamber of Commerce and Industry, the Lesotho Ministry of Development Planning, the Lesotho National Development Corporation, the Lesotho Communications Authority, the Ministry of Tourism, the Lesotho Tourism Development Corporation, and the Basotho Enterprises Development Corporation.

revenue perspective. Further, it was felt that Lesotho would be unlikely to make for these losses as quickly as Swaziland recently did, when its AGOA preferences were suspended. However, coming on the heels of the US presidential election, interviewees did feel that the AGOA extension and the likely delay of TPP gave Lesotho an unexpected window of opportunity to push ahead with overdue reforms.

Regarding the prospects for developing backward linkages, interviewees felt that gains that were achieved via the export-led growth model in Asia has passed Lesotho by, in part for structural reasons and in part due to policy decisions. In many cases, there had been fundamental problems in putting in place more processing steps in country (cutting and polishing of diamonds, bottling water, basic cleaning of mohair, meals and lodging for tourists, etc.). However, developing each of these steps is a complex process that often lacks the economies of scale required. There are often good reasons much of this takes place in South Africa and in this context a focus on horizontal rather than sectoral industrial policies seem like a more important first step, especially given the problems with prioritization that Lesotho's policy-making bodies face. Finally, an area of significant concern across stakeholders concerns the structuring of incentives for foreign investors and that these may be over-subsidized, i.e. that attracting investors has been prioritized at the cost of ensuring spillovers, either through taxation or through specific hiring or sourcing requirements.

Among many interviewees there was a perceived tension between ensuring the survival of the apparel industry and making diversification gains in a few emergent sectors (tourism, mohair, water, among others). Particularly the need to provide a more functional environment for low-skill manufacturing to survive and thrive in the regional market was deemed as essential. However, for many firms, business intelligence services are seen as inadequate. There has been limited consideration of the EU market and the opportunities from the new EPA despite many firms' desire to learn more about opportunities in this market. Extensive efforts are made for visits to trade fairs and MOUs with emerging markets, especially in the Middle East and Asia, but it is not clear that these are delivering results. On the services side, there is some emergent activity in terms of digital economy start-ups and other ICT-enabled industries but connectivity is a binding constraint to take this to any scale. In terms of access to utilities and other essential services, there were concerns raised about excessive prices, especially in comparison to South Africa.¹² Overall, a constraint that is mentioned most relates to managerial and technical skills.

In terms of the institutional framework for trade and industry, private sector interviewees and external experts generally felt that the right language and policies are already in place but that implementation is lacking. This includes but is not limited to the duty drawback system, LNDC responsiveness to firm complaints for rented property, or the one-stop business facilitation centers. There has been extensive focus on developing individual sectoral and issue-specific strategies and there are a large number of institutions involved in some way with trade promotion, supporting exporters, and improving the investment climate. However, in many cases coordination could be better and the nature of their precise mandates could be more clearly defined.

¹² While there is only very limited research on pricing behavior and the functioning of consumer markets in Lesotho, a study by Nchake (2014) found that in the retail sector the frequency and size of price changes in Lesotho differ substantially from those in South Africa, despite the presence of common retail chains and their joint membership in a customs union and common monetary area

4. Conclusion: Supporting inclusive growth through trade

4.1. Overview

Lesotho's trade-led economic development faces numerous challenges. The rapidly changing nature of trade, production and work, the maturation of GVCs and rapid improvements in information and communications technologies are changing where international lead firms and investors locate production and threaten disruptions in employment. Global trade volumes are stagnating and concerns about protectionism in many of Lesotho's main export destinations are increasing.

Furthermore, the country's export-led growth model has only had a small impact on poverty reduction – something that Lesotho has had in common with many other countries in sub-Saharan Africa. While trade can drive poverty reduction through increased growth, this is not an inevitable outcome or a uniform process and is mediated by several channels, including the extent to which trade opens up new employment opportunities, provides better access to external markets for the goods that the poor produce and through structural changes that increase the employment of low-skilled, poor workers in the informal sector. A recent WTO/World Bank report (2016) focuses on this relationship and argues that the impact on poverty reduction will come through a coherent approach that lowers trade costs in ways that maximizes the gains for the extreme poor. This includes i) lowering trade costs for deeper integration of markets; ii) improving the enabling environment and cross-sector coordination; iii) bringing a greater focus on the poverty impact of integration policies to facilitate activities of poor and small traders, can help improve gains for the poor, especially in rural area; iv) managing and mitigating risks faced by the poor through and better data collection on the nature of the informal economy, the participation of women in trade, and of the trade-related constraints in general that many countries face continue to be large.

The challenges caused by a changing global economy and a growth model that hasn't done enough for the poor is exacerbated by the uncertainty surrounding the future of Lesotho's AGOA privileges. This underscores the need for reform and a renewed sense of urgency. Future export growth will be challenged by the emergence of new low-wage competitors in Asia and Africa and the expected erosion of preferential market access in main export destinations over the next decade. Moreover, while Lesotho has made grade strides in using trade and investment as a driver for growth, its growth has not been sufficiently inclusive.

This report aims to strengthen the country's ability to respond to the changing external environment by providing analytical inputs and policy recommendations to enhance Lesotho's export competitiveness and deepen its integration into global and regional value chains. This is intended to support the development of a new, more sustainable trade strategy, that supports diversification and addresses the country's reliance on exports of low-value added apparel to the US under AGOA. This approach has not contributed significantly to poverty reduction and given that it is based on a preferential margin, is also likely to be eroded over the medium term, even if Lesotho remains part of AGOA. On the other hand, exploiting South African, EU and other markets (as well as other products in US) is a better option for sustainable and inclusive export driven growth. To help the Government of Lesotho meet these challenges, this report has focused on how trade policy reforms can help drive growth and jobs, and how Lesotho can diversify and improve the quality of its exports.

Five main findings emerge from this analysis:

1. **Lesotho remains reliant on very few products and markets for exports.** Apparel and diamonds accounted for 77% of total exports in 2015 and these two sectors account for 98% of exports to the US and the EU. Exports to South Africa are more diversified, encompassing several hundred products.

2. **The immediate loss of AGOA preferences would have a significant economic impact that far exceeds that of a hypothetical US-Vietnam FTA.** If these preferences were suspended in 2018, the country would face 1% loss in income by 2020, relative to the baseline. However, even a small decrease in trade costs could offset these impacts.
3. **While Lesotho's investment climate has improved, several issues make doing business in Lesotho expensive and difficult.** Particularly notable are access to finance and the inadequacy of relatively basic export promotion services as constraints to doing business, the unreliability of utility services, particularly water and electricity, and a lack of government- and employer-funded training to improve the technical and managerial skills.
4. **Lesotho has not managed to integrate into other regional and global value chains besides apparel.** Moreover, compared to other large apparel exporters, only a small part of value in exports is embodied in wages, highlighting the significance of low-wage, low-skill, low-linkage manufacturing to Lesotho's competitiveness with most managerial positions still filled by foreigners and most services related to manufacturing carried out abroad.
5. **Lesotho's services sector remains underdeveloped and there is substantial scope for expansion of industries through targeted support and the removal of restrictions.** Retail and professional services face significant regulatory restrictions, particularly when it comes to licenses and hiring foreign workers. Interviews suggest that de facto barriers exist even where legal restrictions are absent.

These findings emphasize the need for a new approach to trade and trade policy that can provide export-driven growth that is more sustainable and inclusive.

4.2. Policy recommendations

This report identifies six primary policy recommendations that are intended to be both sufficiently specific and feasible that they can be addressed by relevant government agencies:

1. **Improve access to imported material inputs and technology:** This has two components i) pursuing tariff reductions within SACU and through bilateral agreements and ii) ensuring that the duty drawback system functions more efficiently and effectively. In the case of the former, SACU's common external tariff complicate efforts for Lesotho's policy-makers to unilaterally make substantial liberalization reforms for key imported inputs, even though many investors that Lesotho is hoping to attract require lower-cost inputs to be competitive. However, there is scope for Lesotho to advocate within SACU for improving access to specific inputs for targeted regional value chains that are unlikely to compete with industries from the region. Regarding the duty drawback scheme, in practice exporters end up absorbing input duty costs making them less competitive in global markets. Addressing bottlenecks in this system and determining why reimbursements are frequently not paid out quickly enough (if at all), should be a high priority.
2. **A sustained focus on increasing productivity and improving skills in export sectors for more inclusive export-led growth:** Due to the relatively low productivity in this sector, producers are unable to increase quality or lower prices and would face substantial difficulties to compete in the absence of preferential margins. Assessing the main causes of Lesotho's low productivity and providing increased incentives to employers for training employees should be central. This will also require a focus on addressing skills gaps. Interviews carried out with research institutions have demonstrated a growing interest in linking education and training to the realities of present-day labor force needs. Here improved integration with universities both for market-focused research and analysis, and for the development of skills to build a more capable human capital base that can support expansion of exports should be a cross-government

priority. This can help promote greater spillovers and linkages from the main export sectors and support more inclusive growth. Empirically it would be valuable to i) assess demand for local procurement among lead firms in the SEZs, ii) better understand current supplier development programs, and iii) diagnose supplier capabilities near the SEZs.

3. **Enhance export and investment promotion activities as well as the institutions working in this area:** Improving market information on export opportunities to South Africa, Europe and other markets, as well as for products other than apparel to the US through more effective export and investment promotion activities is central. A review should be undertaken and concrete actions put into place to ensure that investors can access reliable and transparent information and can easily submit documentation. Issues such as the quick processing of work and residence permits, where necessary, should be a priority. This also includes improving linkages from local producers to interested investors (for example through better functioning one-stop business facilitation centers). Especially in the context of the new EU EPA, providing firms with information on administrative and documentation requirements to participate in these emerging preferential trade agreements would be valuable. Here the government can take a role in facilitating contacts and developing capacity to support firms in ensuring they have the appropriate documents to export to Europe. Furthermore, while the government focuses heavily on attracting FDI, far less effort is put into responding to complaints and demands by firms already in the country. LNDC capacity needs to be bolstered so that Lesotho can attract and retain quality investors and address problems before this leads to investors' departure.
4. **Since even a minor reduction in trade costs could offset the negative impacts from losing AGOA preferences, removing the most significant constraints to cross-border trade should be prioritized.** Compared to other landlocked countries in sub-Saharan Africa, Lesotho is far less remote given its proximity to the ports of Durban and Port Elizabeth. Assessing how costs could be reduced on this route would be valuable. This includes ensuring a coordinated approach to trade regulatory requirements (e.g. the single electronic submission of data by traders for all government regulatory purposes as opposed to the current paper-based, transactional approach for most regulatory requirements) and coordinated border management (e.g. coordinated targeting of high-risk goods and inspections to reduce the time spent at border posts) and exploring cross-border coordination mechanisms with the South African authorities such as the electronic exchange of customs data and jointly agreed facilitation benefits for traders who have demonstrated high levels of compliance. Operationally, there is also a need to ensure that proper infrastructure and equipment, as well as well-trained officials, are in place at border posts to fast-track inspections, and to consult with traders on the opening hours of border posts (in case of extension, this will need to be discussed with the South African government to also extend accordingly on their side of the border). Finally, it makes sense to focus these operational efforts at the two crossings where over 90% of goods come through and improve export and import times in these.
5. **The government of Lesotho should develop a comprehensive export promotion program for the services sector.** Lesotho does not have a high level of services trade restrictions overall. However, where restrictions do exist, for example in key professional services, these restrictions could have a multiplier effect on the economy. Key services, particularly transport and ICT remain underdeveloped and could benefit from targeted investments. Here the government of Lesotho should undertake a comprehensive analysis of service-sector performance in Lesotho and its implications for export-driven growth to identify the most urgent regulatory issues that need to be addressed. This may also require an assessment of the visa and work permit system, as importing skilled technicians and specialized knowledge holders can have a multiplier effect on the domestic skills base and of requirements in

professional services, to ensure that implementation is not preventing the attraction of talent from outside. Here improving the legislative framework, and providing transparency in terms of fee structures and lead times is important. Furthermore, findings from this report suggest there is need for more nuanced analysis of the competition environment in many key industries as well as, potentially, more support for the finalization of the competition bill and the establishment of a competition commission.

6. **In the context of the new NSDP II, there is a need for a comprehensive trade and investment strategy linked to the new development plan.** This should focus i) on how to retain and increase investment once AGOA margins have been eroded, ii) determining progress in the implementation of actions recommended in the 2012 DTIS Update, and iii) supporting industrialization through participation in regional and global value chains. The recent AGOA summary report (Molapo 2016) argues that the Inter-Ministerial Textile and Apparel Task Team, set up in 2004, has been effective but needs a strengthened governance structure due to weaknesses and inconsistency in management, lack of focus and weak coordination mechanisms as well as a lack of monitoring and evaluation. The report therefore advises assessing whether the current institutional framework is still fit for purpose. Lesotho's 2012 DTIS Update listed over 80 specific priority actions across 20 thematic areas. Some progress has been made towards achieving these but much remains to be done and they remain highly relevant as a framework for achieving greater trade integration. Finally, in terms of market diversification, a particular focus on Lesotho's current and potential role in regional value chains would be valuable, especially within the context of SADC's new "Industrialization Strategy and Roadmap".

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Annexes

Annex 1: LINKAGE Global Dynamic CGE Model

The core specification of LINKAGE replicates largely a standard global dynamic CGE mode (van der Mensbrugghe, 2011 and 2013). Production is specified as a series of nested constant elasticity of substitution (CES) functions for the various inputs – unskilled and skilled labor, capital, land, natural resources (sector-specific), energy and other material inputs. LINKAGE uses a vintage structure of production that allows for putty-semi putty capital. In the labor market we assume full employment, and allow for rural-urban internal migration.

Demand by each domestic agent is specified at the so-called Armington level, i.e., demand for a bundle of domestically produced and imported goods. Armington demand is aggregated across all agents and allocated at the national level between domestic production and imports by region of origin.

The standard scenario incorporates three closure rules. First, government expenditures are held constant as a share of GDP, fiscal balance is exogenous while direct taxes adjust to cover any changes in the revenues to keep the fiscal balance at the exogenous level. The second closure rule determines the investment-savings balance. Households save a portion of their income, with the average propensity to save influenced by elderly and youth dependency rates, as well as GDP per capita growth rates. The savings function specification follows Loayza, Schmidt-Hebbel, and Servén (2000) with different coefficients for developed and developing countries. In the case of China and Russia, we impose projections of investment or savings rates up to 2030 from World Bank regional reports. Since government and foreign savings are exogenous, investment is savings driven. The last closure determines the external balance. We fix the foreign savings and therefore the trade balance, hence changes in trade flows result in shifts in the real exchange rate.

For the purpose of this exercise the 2010 social accounting matrix (SAM) for Lesotho has been incorporated into a Global Trade Analysis Project (GTAP) database¹³. The key macro variables and trade flows will be updated to the most recent data available for Lesotho.

We first generate the long-term baseline, then run a number of counterfactual scenarios. By comparing the two, we can isolate the impacts of various policy changes:

Baseline

The GTAP data base is benchmarked to 2011. We run the model to 2018, replicating the key macroeconomic aggregates from the World Bank's *Global Economic Prospects* (GEP 2016)^[3] report. Population growth is based on the medium fertility variant of the 2012 UN's population projections. Labor force growth follows the growth of the working age population – defined here as the demographic cohort between 15 and 64 years of age. The evolution of supply of skilled and unskilled workers is consistent with the IIASA constant educational trends (CET) scenario, where growth rates of the supply of skilled workers exceed that of unskilled. Capital accumulation is equated to the previous period's (depreciated) capital stock plus investment. Productivity growth in the baseline is "calibrated" to achieve the growth rates for the baseline scenario (as in the GEP (2016)) up to 2018, then we fix the productivity growth for 2018-2030 to be equal to its 2017 value. These productivity growth rates remain fixed in the counterfactual scenarios. The baseline scenario also incorporates tariff and NTM reductions

¹³ <https://www.gtap.agecon.purdue.edu/>

^[3] For China, we replicate the growth projections of World Bank (2014).

in existing FTAs. These will be based on the data set provided by International Trade Center, including all TPP members FTA commitments up to 2046 (MacMaps, 2016).

EU-Vietnam FTA

This scenario assumes that the US signs a bilateral FTA with Vietnam in 2018. The tariff and NTM reductions in goods and services are consistent with the bilateral concessions under the TPP. Tariff commitments originate from the ITC database (MacMaps, 2016). NTMs in goods estimates are based on the ongoing work of DECTI of Kee et. al. (2016). These estimates are based on the surveys of NTMs conducted in 2015/2016. Estimates of NTMs in services are based on Jafari and Tarr (2015). We run a central scenario with percentage NTMs reductions similar to those as in Petri and Plummer (2016).

Suspension of AGOA

This scenario studies the impact of the loss of duty free access to the US market under AGOA in 2018. As a result, Lesotho starts paying the GSP rates on its exports to the US and its trade weighted import duty on wearing apparel sector increases to 24 percent.

Suspension of AGOA with trade facilitation

This scenario studies the impact of the loss of duty free access to the US market under AGOA in 2018 as in the previous scenario, but it includes a reduction of bilateral trade costs between Lesotho and all its trading partners at 2% per year. The reduction is calibration to make sure that the overall income level remains unchanged.

Table A1: Sectors and countries/regions included in the global CGE model.

Sectors	Countries/Regions
Agriculture	Australia
Natural resources / mining	Brunei Darussalam
Food, beverages, tobacco	Canada
Textiles	Chile
Wearing apparel and leather	Japan
Chemical, rubber, plastic products	Malaysia
Metals	Mexico
Transport equipment	New Zealand
Electronic equipment	Peru
Machinery and equipment	Singapore
Other manufacturing	United States of America
Utilities	Viet Nam
Construction	Brazil
Trade and transport	Russian Federation
Finance and other business services	India
Communication and business services	China
Social services	South Africa
	EU28
	Egypt
	Colombia
	Turkey
	Thailand
	Korea
	Philippines
	Indonesia
	Bangladesh
	Cambodia
	Laos
	Lesotho
	Ethiopia
	Sri Lanka
	Tanzania
	Southeast Asia
	Rest of Africa
	Rest of the world

Annex 2: Product space analysis

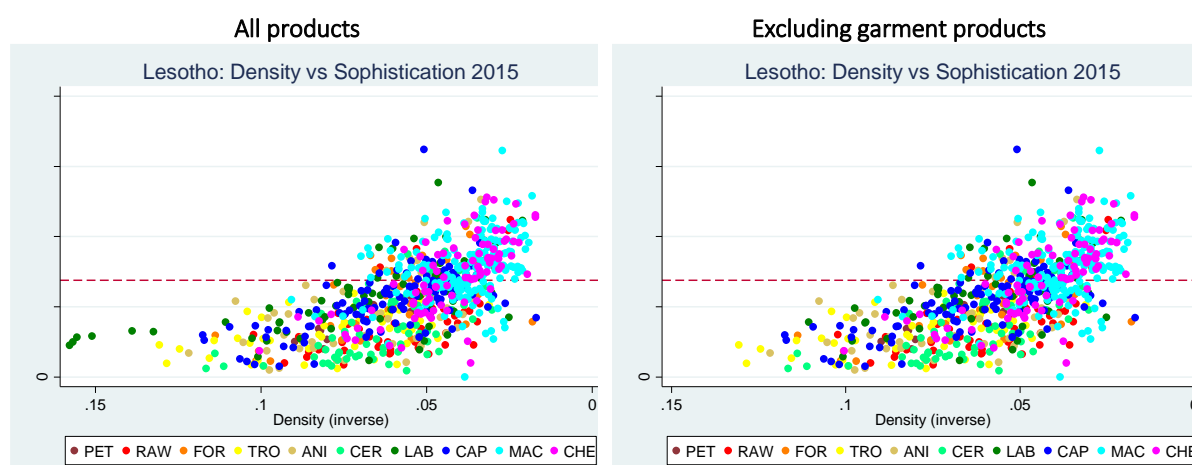
Lesotho could explore further its comparative advantage in labor intensive and animal/vegetable products. We used the analytical tools proposed by Hausmann, Klinger and Lopez-Calix (2010) to scan the product space for opportunities to develop revealed comparative advantage in high potential export sectors for Lesotho. Following this methodology, we provide a list of products selected by two strategies: a 'low hanging fruit' strategy that only involves products that are very close to Lesotho's productive structure, and another strategy -that can be thought as more aggressive or a medium-term strategy - that includes products that are father from Lesotho's current productive capabilities. The two strategies would result in different sectoral focus: the 'low hanging fruit' strategy relies on labor-intensive industries (miscellaneous manufactures, textiles and fabrics, metallic manufactures) and some animal/vegetable products (fruits and vegetables, fish). The more aggressive strategy also focuses more on labor intensive industries liked footwear and travel goods and handbags but also includes other manufacturing industries like furniture, electrical machinery and miscellaneous edible products and preparations. It is worth mentioning that producing and exporting some of these products might not be feasible in Lesotho given its natural endowments or human resources so this list should be revised to exclude such products.

The analysis is based on two important dimensions measured at the product level: sophistication ('PRODY') and proximity to the current productive structure ('density'). The methodology allows for the construction of a list of products into which a particular country could expect to develop revealed comparative advantage more easily. The products are then aggregated at the industry level and weighted by their respective world trade share to provide a sense of which sectors are the most attractive in terms of world demand. The methodology provides a list of products/industries that: a) are easier for Lesotho to develop revealed comparative advantage in; and b) represent attractive opportunities in terms of world trade. As a first step we calculate the distance ('density') from each non-occupied¹⁴ product to Lesotho's current productive structure as represented by its pattern of revealed comparative advantage. The density of each non-occupied product measures how easy it is to develop revealed comparative advantage in that particular product given that the country has develop it in other products. Intuitively, products with higher density are easier to 'move to' (develop RCA) as they use similar capabilities than those sectors that Lesotho has already mastered (i.e. has developed RCA).

The following graphs show the density and sophistication of each non-occupied product for Lesotho in 2015. The x-axis measures the density or proximity of each non-occupied product to Lesotho current productive structure with closer products to the left (the x-axis has been inverted). The y-axis measures the level of sophistication or PRODY, with higher values indicating greater product sophistication and a line indicating Lesotho's export basket average sophistication. Products above this line represent an improvement over Lesotho's current export basket in terms of sophistication. The colors represent Leamer commodity groups which provide a rough sector classification. Because Lesotho already has comparative advantage in several garment products, the 'closest' products to which it can jump are also in the garments industry (depicted by the dark green dots closer to the origin in the left panel graph below). However, because Lesotho wants to find opportunities for export diversification outside the garments industry, the analysis in the following section will exclude products within this industry (see right panel graph below).

¹⁴ We define non-occupied products as those products in which Lesotho does not have revealed comparative advantage in 2015 and might or might not currently export. Conversely, occupied products are those in which Lesotho has revealed comparative advantage in 2015.

Figure A2.1: Lesotho: Density vs. Sophistication of non-occupied products, 2015



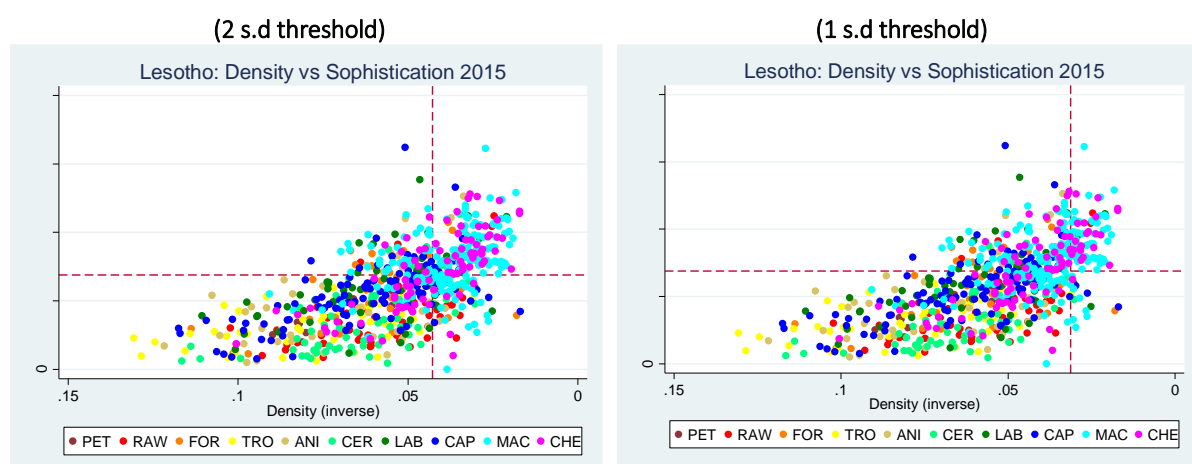
PET = Petroleum, RAW = Raw Materials, FOR = Forest Products, TRO = Tropical Agriculture, ANI = Animal Agriculture, CER = Cereals, LAB = Labor Intensive, CAP = Capital Intensive, MAC = Machinery, CHE = Chemicals

Source: Authors' elaboration using data from USITC (2016).

The graph reveals a trade-off between density and sophistication. The products that are closest to Lesotho's current productive structure (further to the left) are easiest to move toward, yet some of them are not very sophisticated. Ideally, the products closest to a country's productive structure that are below the horizontal red line would not be a priority, and we would focus only on those above the horizontal line. However, because the main goal of this exercise is to diversify Lesotho's export basket by identifying other products it could export, the analysis will include all products regardless of sophistication level.

Because it is unlikely that a given country can develop enough capabilities to have comparative advantage in all products we need a threshold value to indicate how far a country can go from its current productive structure. The vertical lines in the following graphs indicate the thresholds of 2 and 1 standard deviations over the mean density of non-occupied products and indicate likely limits for Lesotho's attempts at developing RCA. Thus, products to the left of the vertical line represent the products into which Lesotho can more easily develop RCA. The first strategy (2 sd) can be named the 'low hanging fruit' strategy since it only involves products that are very close to Lesotho's productive structure, the other strategy could be thought as more aggressive or a medium-term strategy.

Figure A2.2: Lesotho: Density vs. Sophistication of non-occupied products, 2015



Source: Authors' elaboration using data from USITC (2016).

Following this methodology we can provide a list of products selected with these two strategies. The list of selected products with the 2 standard deviation threshold ('low hanging fruit') is presented below with products arranged in descending order by density, so 'closer' products appear at the top (see Table A4.2) for a list of additional products selected with the 1 s.d. threshold).

Table A2.1: Lesotho: Selected products above 2 σ Average Density

SITC	Product name	Exports in 2015 (US\$ thou.)	PRODY	Leamer Group	Density
611	Sugars,beet and cane,raw,solid	137	4,516	Agriculture	0.131
711	Coffee,whether or not roasted or freed of caffeine	29	1,936	Agriculture	0.128
615	Molasses,whether or not decolourized	0	3,977	Agriculture	0.124
360	Crustaceans and molluscs,fresh,chilled,frozen etc.	82	3,369	Animal Products	0.122
6584	Bed linen,table linen,toilet & kitchen linen etc.	10	5,938	Capital Intensive	0.118
2225	Sesame (sesamum)seeds	0	1,179	Cereals	0.117
6581	Sacks and bags,of textile materials	11	5,209	Capital Intensive	0.117
752	Spices (except pepper and pimento)	21	2,650	Agriculture	0.116
579	Fruit,fresh or dried, n.e.s.	1,333	5,187	Agriculture	0.114
1211	Tobacco,not stripped	0	3,317	Cereals	0.114
6354	Manufactures of wood for domestic/decorative use	0	5,919	Forest Products	0.114
2631	Cotton (other than linters),not carded or combed	155	1,500	Cereals	0.111
8973	Jewellery of gold,silver or platinum	30	7,813	Labor Intensive	0.111
6589	Other made-up articles of textile materials,n.e.s.	17	7,128	Capital Intensive	0.109
371	Fish,prepared or preserved,n.e.s. including caviar	189	10,775	Animal Products	0.108
545	Other fresh or chilled vegetables	13	5,477	Agriculture	0.107
6115	Sheep and lamb skin leather	0	2,526	Capital Intensive	0.106
341	Fish,fresh(live/dead)or chilled,excl.fillets	78	4,919	Animal Products	0.105
589	Fruit otherwise prepared or preserved,n.e.s.	11	9,337	Agriculture	0.104
6116	Leather of other hides or skins	0	2,156	Capital Intensive	0.104
548	Vegetable products,roots & tubers,for human food	0	4,789	Agriculture	0.103
577	Edible nuts(excl.nuts used for the extract.of oil)	0	1,727	Agriculture	0.103
2882	Other non-ferrous base metal waste and scrap,n.e.s	239	6,030	Raw Materials	0.102
6575	Twine,cordage,ropes & cables.& manufactur.thereof	1	7,246	Capital Intensive	0.102
6592	Carpets,carpeting and rugs,knotted	1	1,749	Capital Intensive	0.102
542	Beans,peas,lentils & other leguminous vegetables	15	2,376	Agriculture	0.101
2472	Sawlogs and veneer logs,of non coniferous species	3	2,287	Forest Products	0.101
2483	Wood of non-coniferous species,sawn,planed,tongued	12	3,667	Forest Products	0.101
6673	Oth.precious & semi-precious stones,unwork.cut etc	0	2,846	Labor Intensive	0.101
565	Vegetables,prepared or preserved,n.e.s.	13	8,482	Agriculture	0.100
5513	Essential oils,concretes & absolutes;resinoids	37	3,705	Chemical	0.100
586	Fruit,temporarily preserved	0	5,415	Agriculture	0.099
721	Cocoa beans,whole or broken,raw or roasted	0	1,542	Agriculture	0.099
1212	Tobacco,wholly or partly stripped	2	1,531	Cereals	0.099
6123	Parts of footwear	17	5,667	Capital Intensive	0.098

Source: Authors' elaboration using data from USITC (2016).

Figure A2.3: Lesotho: New Products above 2σ Average Density

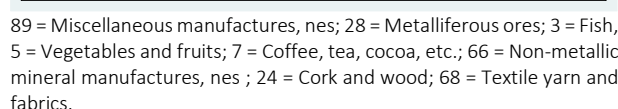
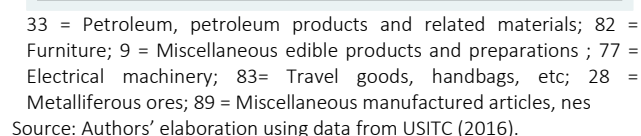
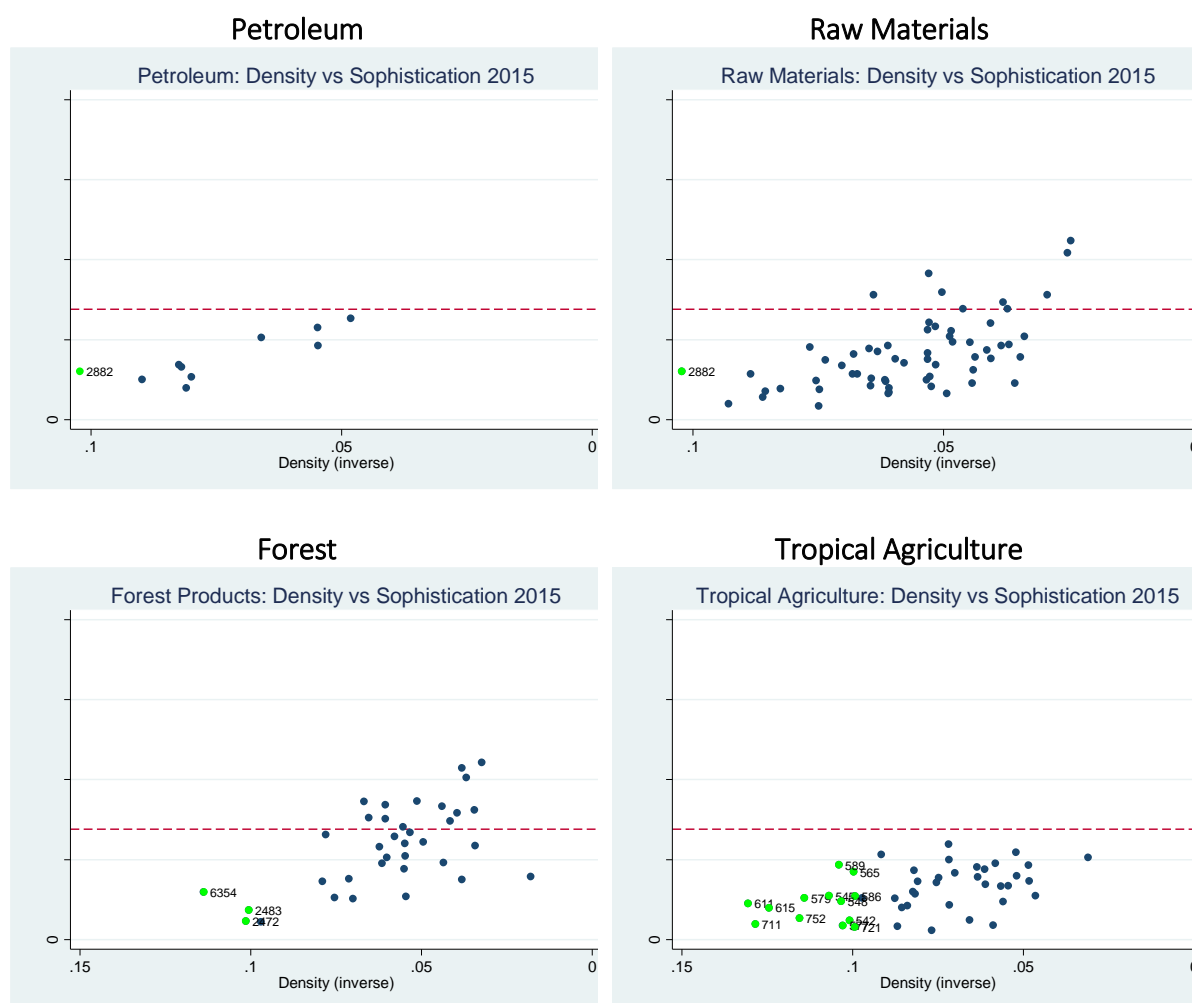


Figure A2.4: Lesotho: New Products above 1 σ Average Density

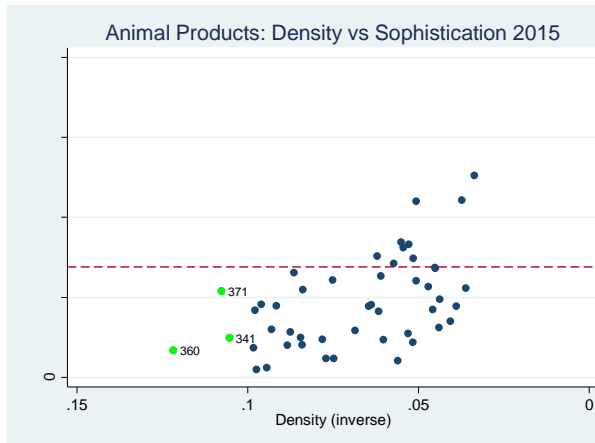


In summary, these graphs show a different sectoral focus for the two strategies: the ‘low hanging fruit’ strategy relies on labor-intensive industries (miscellaneous manufactures, textiles and fabrics, metallic manufactures), and some animal/vegetable products (fruits and vegetables, fish) as well as some natural resources that are not well suited for Lesotho (metalliferous ores). The more aggressive strategy also focuses more on labor intensive industries liked footwear and travel goods and handbags but also includes other manufacturing industries like furniture, electrical machinery and miscellaneous edible products and preparations.

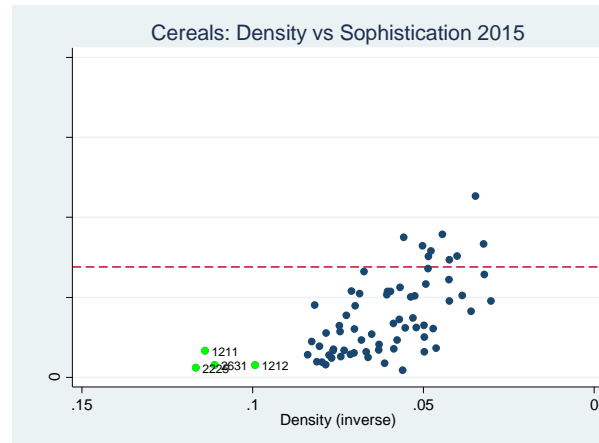
Figure A2.5: Lesotho: Proximity vs. Density, 2015 by Leamer classification (2 s.d threshold)



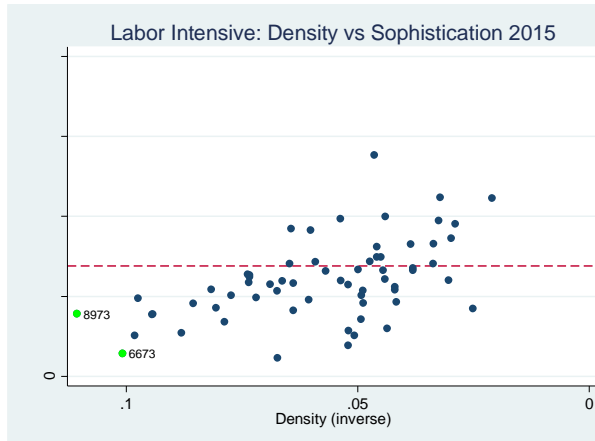
Animal Products



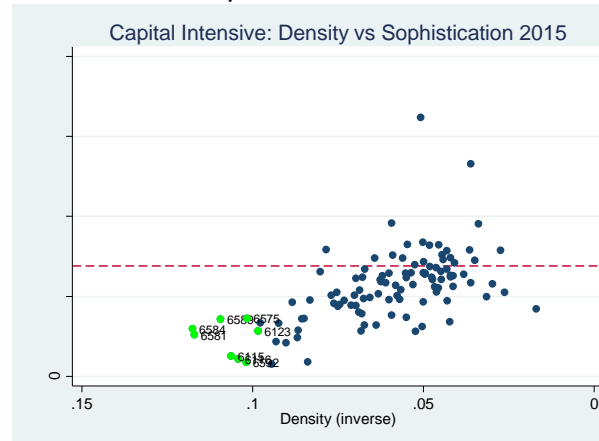
Cereals



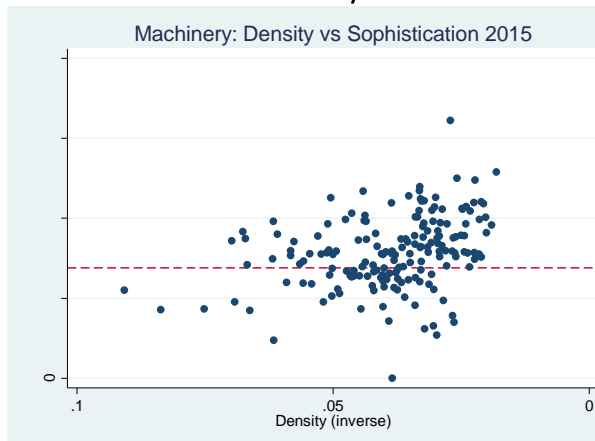
Labor Intensive



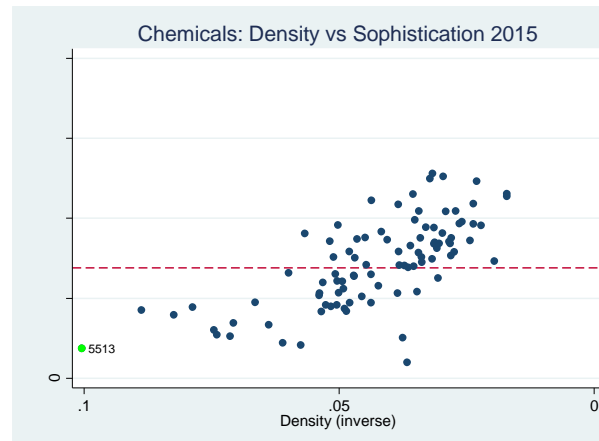
Capital Intensive



Machinery



Chemicals



Source: Authors' elaboration using data from USITC (2016).