INTERNATIONAL MONETARY FUND

Setting Up Fiscal Rules in Lesotho

Qianqian Zhang and Motseki Khiba

SIP/2025/140

IMF Selected Issues Papers are prepared by IMF staff as background documentation for periodic consultations with member countries. It is based on the information available at the time it was completed on August 21, 2025. This paper is also published separately as IMF Country Report No 25/268.

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Setting Up Fiscal Rules in Lesotho

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ABSTRACT: Lesotho's fiscal policy has long been shaped by volatile SACU revenues and persistent expenditure pressures, calling for a more rules-based and forward-looking framework to ensure sustainability. Recent efforts to formalize a fiscal rules framework offer an opportunity to strengthen medium-term planning, anchor debt dynamics, and build resilience to shocks. The proposed framework should center on a debt ceiling of 60 percent of GDP, a debt anchor of 50 percent of GDP, and a structural deficit target of 3 percent of GDP, supported by operational expenditure and wage-bill rules. A savings fund (stabilization fund) should be set up and be anchored on the fiscal rules, serving both stabilization and investment purposes.

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Author's E-Mail Address:	QZhang@imf.org

SELECTED ISSUES PAPERS

Setting Up Fiscal Rules in Lesotho

Kingdom of Lesotho

Prepared by Qianqian Zhang and Motseki Khiba[1]

[1] Mr. Motseki Khiba is a senior economist at the Macroeconomic Policy Directorate of Ministry of Finance and Development Planning in Lesotho. The authors would like to thank Ms. Ann-Alice Ticha for her excellent research assistance.

A. Introduction

1. Lesotho's small, open economy faces persistent macroeconomic challenges, with structural vulnerabilities and slow policy implementation hindering reform progress. Heavy reliance on Southern African Customs Union (SACU) receipts makes the country's fiscal position highly volatile and vulnerable to regional economic conditions, while limited economic diversification exposes the economy to external demand shocks and competitiveness pressures. Fiscal management has been procyclical and is further complicated by the rigidity of public expenditures, particularly the large wage bill, which limits the government's ability to adjust spending in response to revenue fluctuations. As a member of the Common Monetary Area, Lesotho maintains a fixed exchange rate peg to the South African rand, restricting the use of monetary policy to respond to shocks. Limited access to international financing further reduces Lesotho's ability to buffer revenue shortfalls through borrowing. A relatively small private sector and episodes of political instability compound these challenges, creating a difficult environment for sustaining fiscal stability, maintaining uninterrupted delivery of key public services, and fostering resilient economic growth.

2. Recent fiscal surpluses provide an opportunity to rebuild buffers and improve sustainability. Latest developments indicate a notable shift in Lesotho's fiscal landscape with the emergence of a fiscal surplus starting from FY23/24, due to strong SACU receipts and a break from the previous pattern of procyclical spending. Another major development has been the renegotiation of water royalty rates under the Treaty with South Africa on the Lesotho Highlands Water Project (LHWP-II), which now provides a significantly higher and more stable revenue stream. This shift reduces Lesotho's reliance on SACU transfers and presents a unique opportunity to strengthen fiscal sustainability and support long-term growth. However, realizing these benefits requires disciplined fiscal management, particularly given low capital spending efficiency, chronic arrears, and still elevated debt-to-GDP ratios. Strengthening public financial management and ensuring that additional revenues are saved and invested strategically will be critical.

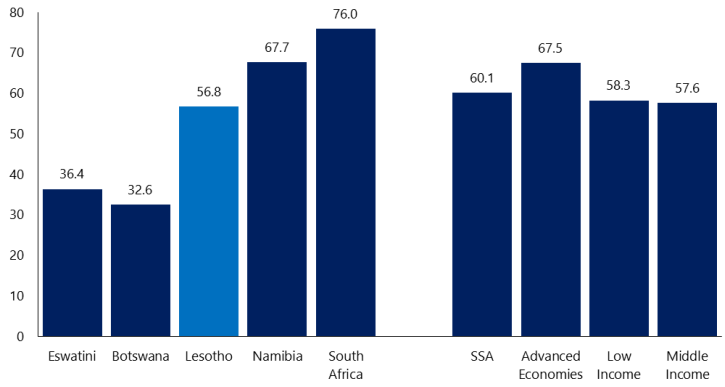
3. Institutionalizing fiscal discipline through a rules-based framework will mitigate procyclicality and enhance policy credibility. The authorities have recently advanced a policy paper stipulating a fiscal rules framework. Lesotho's history of fragile coalition politics and weak policy continuity have underscored the need for legally binding, well-calibrated, and enforceable fiscal rules. Such rules should be simple, transparent, and easy to operate (Eyraud et al, 2018), facilitating effective policy implementation while insulating fiscal decision-making from political cycles. Transitioning from discretionary fiscal adjustments to a structured rules-based framework will be critical to stabilizing the macroeconomy, enhancing debt sustainability, and fostering long-term economic resilience.

4. This paper provides an analysis of Lesotho's proposed fiscal rules and their implications. Section B discusses Lesotho current situation compared to international peers and outlines the latest fiscal rules put forward by the authorities. Section C evaluates the design and calibration of the debt rule and structural balance rule. Section D discusses strategic considerations in selecting appropriate fiscal rules. Section E explores options for the pace of savings accumulation and the proposed framework for managing these savings. AS a useful guide, section F discusses the experience of Chile. Section G concludes.

B. The Case for Fiscal Rules

5. Lesotho's public debt is elevated relative to some regional comparators, and is close to the average of Emerging Markets and Development Economies (EMDEs) (Figure 1). Public debt declined from 61.5 percent of GDP in FY23/24 to 56.8 percent of GDP in FY24/25 in Lesotho, thanks to a pickup in the pace of redemption of domestic securities and arrears clearance. Lesotho's debt carrying capacity (CI score) is medium, reflecting its economic fundamentals, debt management practices, and the external environment.[2] However, this capacity may be more constrained than in advanced economies, highlighting the need for sustained fiscal discipline and effective debt management policies to preserve macroeconomic stability.

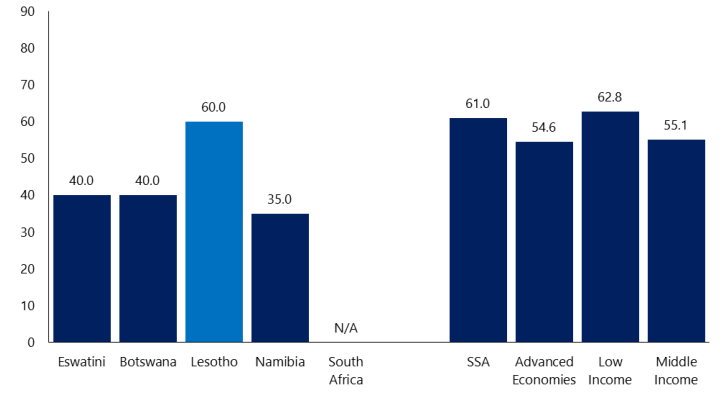
Figure 1. Lesotho: Public Debt
(2024; Percent of GDP)



Source: Authorities' data and IMF staff calculations.

6. Lesotho's debt ceiling, set at 60 percent of GDP, is notably higher than the thresholds adopted by most of its regional and global peers (Figure 2). SACU peers in particular have adopted a more cautious approach to debt sustainability. While Lesotho's ceiling aligns with the average across sub-Saharan Africa and that of the low-income economies, it exceeds the average levels observed in advanced economies (AEs) and middle-income economies, considering its larger development gaps. An elevated ceiling provides space for countercyclical policy and critical development investments, but sustaining a high level of debt places an added premium on strong fiscal management, careful prioritization of spending, and prudent debt accumulation strategies. The authorities will need to ensure that any new debt is aligned with national development priorities, supported by robust project appraisal, and accompanied by sustained efforts to strengthen revenue mobilization and expenditure efficiency.

Figure 2. Lesotho: Fiscal Rule: Debt Ceiling
(Latest Available Value; Percent of GDP)



Source: Authorities' data and IMF staff calculations.

[2] Based on April 2025 World Economic Outlook and World Bank CPIA.

7. To strengthen fiscal discipline and enhance macroeconomic stability, the authorities have advanced a rules-based fiscal framework. This framework is anchored in a legally binding debt ceiling of 60 percent of GDP,[3] complemented by a debt anchor of 50 percent of GDP and a structural deficit rule set at 3 percent of GDP. The framework also includes indicative benchmarks on aggregate expenditure and the public wage bill, with automatic correction and escape clauses to reinforce compliance. The structural deficit rule adjusts for the volatility of SACU revenues to ensure consistency with the desired debt trajectory over the medium term. The legal underpinnings of the framework are embedded in the draft Public Finance Management and Accountability Bill and the existing Public Debt Management Act, which together formalize fiscal responsibility and enhance the credibility of budgetary processes. The authorities also propose establishing an independent Fiscal Council to strengthen oversight and transparency. These measures represent a welcome step toward institutionalizing fiscal discipline and reducing procyclicality.

8. To prevent fiscal slippages and to offset a historical bias towards recurrent spending, the framework incorporates indicative expenditure rules and pre-specified debt correction thresholds. Specifically, two expenditure benchmarks have been proposed: (i) a ceiling on total nominal expenditure growth of no more than inflation, and (ii) a limit on the wage bill to 60 percent of total revenues. Though indicative, both benchmarks aim to discipline expenditure growth and contain recurrent spending pressures, especially during revenue windfalls. If the debt-to-GDP ratio exceeds 45, 50, or 55 percent, the government would be required to adopt an adjustment plan, with increasing intensity depending on the breach. Once debt exceeds 60 percent, measures to produce short-term adjustments will be prioritized, including spending cuts and/or targeted revenue increases. Additionally, the framework includes escape clauses to accommodate exceptional events—such as large external shocks or natural disasters—subject to transparent justification and a requirement to return to compliance within three years.

9. Another key feature of the fiscal rule framework is the establishment of a Fiscal Council to provide independent oversight of rule compliance, fiscal forecasts, and the application of the framework's escape clauses. The Council will validate the macroeconomic assumptions underlying the budget, assess the government's fiscal performance, and publish compliance reports. It will also review the feasibility and integrity of proposed corrective actions and triggers for escape clauses, adding a layer of accountability and technical credibility to the fiscal framework. The Council's structure—comprising five members with at least one member being an external expert, and an outsourced secretariat—aims to ensure cost-effectiveness and independence.

10. To ensure credibility while accommodating institutional capacity, the fiscal rule framework may be subject to future revisions. Recognizing that this is Lesotho's first formal adoption of rules-based fiscal management, the policy paper emphasizes simplicity and ease of implementation within existing capacity constraints, with room for future refinement as data quality and forecasting tools improve. The framework allows for review and potential revisions, particularly in light of a rebasing of GDP statistics in the near future and ongoing improvements in macro-fiscal analysis. In parallel, the establishment of a Revenue Stabilization Fund is proposed as a key institutional complement to the rules, with the dual objective of saving volatile SACU

[3] The public debt level of 60 percent of GDP is also a limit set by regional practices and convergence criteria by Southern African Development Community (SADC), and is assessed in the IMF-World Bank Debt Sustainability Analysis (DSA) to be "with limited space to withstand shocks".

windfalls and shielding capital expenditure during downturns. Together, these elements are intended to support a gradual but credible transition toward a more stable, disciplined, and growth-friendly fiscal policy framework.

C. Fiscal Rules Calibration

11. Section C provides a quantitative basis for anchoring fiscal policy through debt and structural-balance rules tailored to Lesotho's macro-fiscal context. Using stochastic simulations and calibration tools, it evaluates feasible deficit ceilings consistent with medium-term debt targets and fiscal sustainability, validating the authorities' proposed framework.

Debt Ceiling and Anchor

12. Lesotho's proposed maximum debt ceiling of 60 percent of GDP in nominal terms is based on a combination of fiscal policy considerations, regional benchmarks, and debt sustainability risks. The 60 percent debt ceiling is aligned with SADC's fiscal prudence guidelines, which serves as a key regional debt benchmark. At the same time, according to the latest DSA, by 2045, Lesotho's nominal public debt-to-GDP ratio is projected remain close to this ceiling (61 percent), while its PV equivalent would be around 52 percent, close to the DSA's 55 percent threshold, leaving little room for error. Setting 60 percent of GDP as a debt ceiling provides a feasible safeguard against excessive debt accumulation while preserving fiscal space for development priorities.

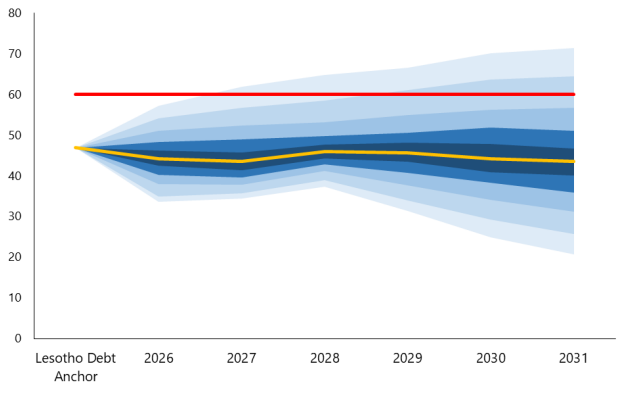
13. Given the debt ceiling, a robust debt anchor calibration requires a systematic simulation of possible macroeconomic shocks to assess the conditions under which this ceiling might be breached. Countries could experience sudden and sharp increases in debt due to adverse macroeconomic shocks and the realization of contingent liabilities. When calibrating the debt anchor, it is necessary to make sure that, with high probability, debt remains below a pre-defined maximum threshold even under adverse scenarios. In other words, the debt anchor should be set low enough to ensure that debt will remain below the debt ceiling with high probability even when negative shocks occur. Given Lesotho's economic structure and external dependencies, setting a conservative debt anchor is critical to maintaining fiscal sustainability and reinforcing policy credibility.

14. The calibration process relies on stochastic simulations incorporating a range of economic and financial variables. Leveraging the method by Baum et al (2017) when a maximum debt limit is known, stochastic simulations are used to calibrate the debt anchor by computing a safety margin below this debt limit. For Lesotho, key variables include GDP growth, interest rates on public debt, exchange rate fluctuations, terms-of-trade shocks, and external loan disbursements and concessionality—all factors that are particularly relevant for low-income developing countries (LIDCs). GDP growth volatility remains a key concern, particularly in light of the recent U.S. tariff shock, while economic activity continues to be heavily reliant on the LHWP-II. Revenue mobilization remains closely linked to SACU transfers, which could face heightened risks following the recent external shocks. Exchange rate risks, particularly depreciation pressures, could further amplify debt burdens, while fluctuations in concessional loan disbursements could impact the financing of capital projects. The calibration ensures that the debt anchor remains resilient to these economic shocks, preventing unsustainable debt accumulation and aligning fiscal policy with macroeconomic stability objectives.

15. Two complementary approaches are used to calibrate the debt anchor, ensuring alignment with fiscal response dynamics and macroeconomic conditions. [4] The first employs a fiscal reaction function (FRF), which models how fiscal policy historically adjusts to macroeconomic and fiscal conditions. The FRF is estimated econometrically using a panel of LIDCs, including Lesotho, to ensure the calibration reflects realistic fiscal adjustment patterns. The second approach adopts an ad hoc fiscal balance path, aligning fiscal targets with the latest macroeconomic framework over the medium term. This method allows for forward-looking policy assumptions while ensuring that the debt anchor remains consistent with fiscal sustainability objectives. By employing both approaches, the calibration process provides an assessment of Lesotho's fiscal resilience, ensuring that the debt anchor is set at a level that preserves debt sustainability while allowing fiscal policy to respond flexibly to economic shocks.

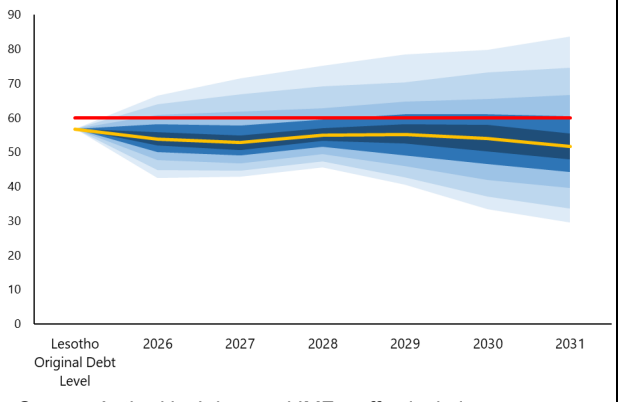
16. The FRF simulation results validate the proposed debt anchor. Figures 3 and 4 illustrate the debt path using the FRF approach, with 60 percent of GDP established as the upper limit that should not be breached. This approach incorporates fiscal shocks realized in each period, with debt trajectories summarized in the accompanying fan charts. The FRF model applied is particularly suited to LIDCs, where output gaps are difficult to measure—it thus specifies the reaction to terms-of-trade shocks and external financing disbursements, rather than to debt and the output gap as in advanced and emerging economies (Baum et al., 2017; Eyraud et al., 2018). Based on historical fiscal behavior and stochastic simulations of macroeconomic shocks, the debt anchor should be at approximately 47 percent of GDP (Figure 3), ensuring only a 15 percent probability of exceeding the 60 percent threshold while maintaining a low risk of debt distress, except under extreme shock scenarios. This aligns with the authorities' proposed multi-layered debt anchor framework—set at 45, 50, and 55 percent of GDP—by indicating that a more prudent and resilient anchor lies at the lower end of the suggested range. Figure 4, on the other hand, presents the debt simulation starting from the initial actual (observed) debt level at end-FY24/25, rather than from the debt anchor. It illustrates where current debt could evolve over the next six years under a sequence of adverse shocks. The results are broadly consistent with the DSA, suggesting that overall debt is likely to remain below but close to the 60 percent of GDP ceiling. The distribution also highlights a non-negligible probability of breaching the ceiling under adverse scenarios, underscoring the importance of maintaining fiscal prudence.

Figure 3. Lesotho: Debt Path from Simulated Debt Anchor



Source: Authorities' data and IMF staff calculations.

Figure 4. Lesotho: Simulation of Debt Path from Current Debt Level

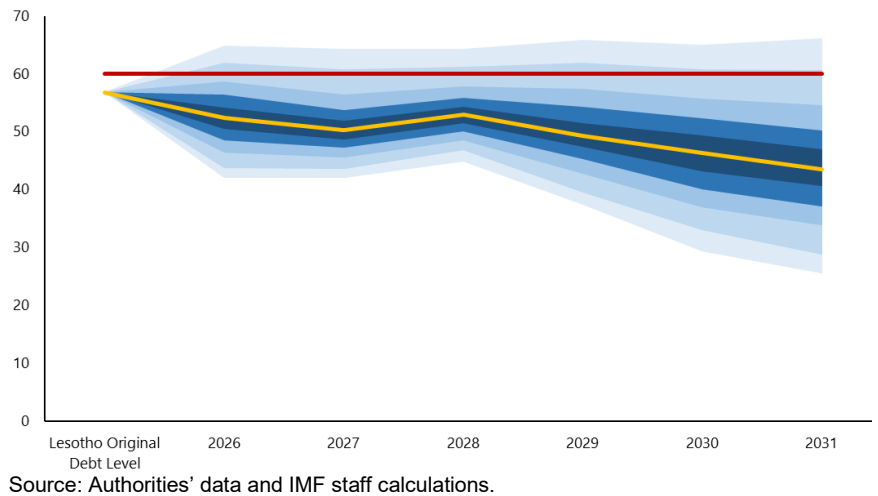


Source: Authorities' data and IMF staff calculations.

[4] Source: Fiscal Rules Calibration Tools, International Monetary Fund.

17. Under the second approach—the ad hoc fiscal balance scenario, debt is projected to decline steadily, provided current macroeconomic assumptions hold and surpluses are maintained. This approach simulates the debt trajectory under the baseline projections of real GDP growth, real interest rates, and primary balances, while maintaining the observed share of concessional borrowing. Figure 5 illustrates the resulting debt path, assuming a one-to-one relationship between the primary balance and public debt dynamics, with other assumptions held constant from the stochastic simulations under the fiscal reaction function. Under these conditions, public debt is projected to decline steadily to below 45 percent of GDP by the end of the medium term, provided sustained primary surpluses are realized and borrowing remains aligned with the fiscal path. The likelihood of breaching the 60 percent debt ceiling remains low—less than 10 percent—even under simulated shock scenarios. This result provides a counterfactual for the debt path, and assumes that the authorities' borrowing strategy is shaped by projected fiscal surpluses in the medium term. The conclusions of simulation focus on the need to protect a country's fiscal position against negative shocks. While the simulations underscore the importance of maintaining fiscal buffers to withstand adverse shocks, it is equally important to preserve fiscal space for growth-enhancing investment and other development priority areas.

Figure 5. Lesotho: Debt Path from Simulated Debt Anchor Lesotho Original Debt Level
(Percent of GDP)



Source: Authorities' data and IMF staff calculations.

Structural Balance Rule

18. A well-defined fiscal framework ensures consistency between debt and deficit targets, recognizing their intrinsic link through an accounting identity. Debt represents the cumulative stock of past deficits, while the deficit captures the annual change in debt levels. In practice, currency fluctuations, nondebt financing, and the accumulation of financial assets can temporarily disrupt this direct relationship, but over time, debt dynamics generally track deficit trends. Similarly, deficits are tied to government spending, reinforcing the need for coherence between debt rules and operational rules governing deficits and expenditures. A structural balance rule for Lesotho, which accounts for cyclical adjustments and revenue volatility especially for SACU receipts, provides a useful operational guide to ensure that fiscal targets remain credible and sustainable.

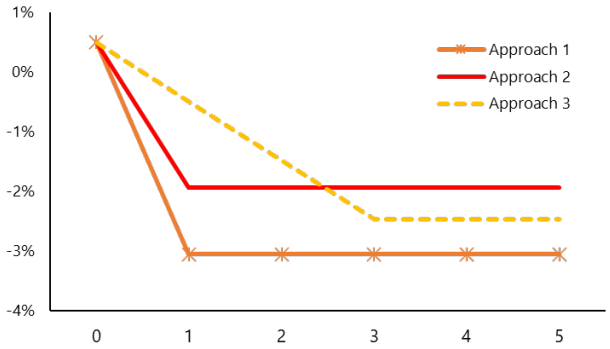
19. To properly set a fiscal target and anchor the structural balance rule, it is necessary to derive a stable and credible measure of underlying "structural" SACU revenues. From various options across varying windows of 4 to 20 years, the lower quartile of SACU receipts over the past 8 years emerges as the preferred measure—providing a relatively stable, conservative, and politically defensible benchmark for underlying SACU revenues. This choice reduces procyclicality and helps ensure that fiscal targets are met even in lower-revenue years. Going forward, this methodology could strengthen medium-term fiscal planning and provide a more prudent anchor for structural deficit rules.

20. Using the IMF fiscal rules calibration tool, three adjustment paths are simulated: These include: (i) a constant balance that stabilizes debt at its ceiling over the long term; (ii) a path that achieves convergence to a preferred debt anchor of 50 percent of GDP within five years; (iii) a more front-loaded adjustment path to reach the 50 percent of GDP debt target within five years (Annex I). As shown in Table 1, with a debt ceiling of 60 percent of GDP and a long-term trend nominal GDP growth rate of 6.5 percent: the first scenario implies a fiscal deficit of 3.1 percent of GDP annually, but debt will only converge to 50 percent of GDP in about 15 years. Under the second scenario, convergence within five years requires a tighter deficit of 1.9 percent of GDP annually. The third, more aggressive scenario entails an initial fiscal deficit of 0.5 percent of GDP in the first year, followed by a 1.5 deficit in the second year, and deficits averaging 2.5 percent of GDP thereafter. These alternative paths are presented in Figures 6 and 7 and aim to guide fiscal rule calibration while considering trade-offs between ambition and feasibility.

Table 1. Lesotho: Structural Balance Rule Methodology and Results

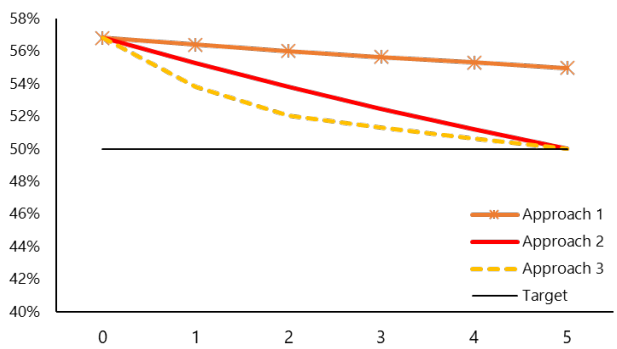
Methodology	Structural Balance Rule
(i)	-3.1 percent of GDP every year for five years
(ii)	-1.9 percent of GDP every year for five years
(iii)	-0.5 percent of GDP in year 1 → -1.5 percent of GDP in year 2 → -2.5 percent of GDP in year 3–5

Figure 6. Lesotho: Fiscal Balance Paths in Three Scenarios



Source: Authorities' data and IMF staff calculations.

Figure 7. Lesotho: Debt Paths in Three Scenarios

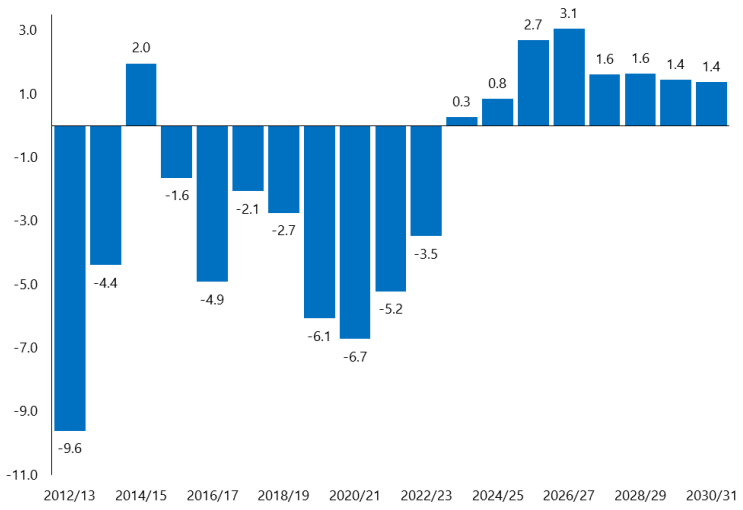


Source: Authorities' data and IMF staff calculations.

21. The simulated results suggest that a 3 percent of GDP structural deficit rule is feasible for Lesotho. Using the preferred measure of underlying revenue—calculated using the lower quartile of SACU and

grant revenues over the past eight years—baseline projections suggest that the structural fiscal balance will remain in surplus over the medium term (Figure 8). This would provide an opportunity to save revenue windfalls and allocate resources toward retiring costly domestic debt, thereby strengthening fiscal buffers and reducing debt vulnerabilities. Note that a deficit rule in the face of Lesotho's fiscal surpluses would typically assume a one-to-one relationship between the fiscal balance and the debt trajectory. Given that the authorities have not revised their future borrowing plans nor committed to financing capital spending from domestic resources, it would be prudent to begin repaying costly debt. This would help build fiscal space and enhance resilience to future shocks.

Figure 8. Lesotho: Structural Balance
(Percent of GDP)



Source: Authorities' data and IMF staff calculations.

D. Fiscal Rules Selection

22. The selection of the type of fiscal rule is an equally critical step that shapes how fiscal policy is anchored and implemented. Selection decisions determine the operational character of the framework—whether it emphasizes debt sustainability, expenditure discipline, or deficit management—and therefore influences the kind of calibration that follows. In Lesotho's case, the choice of a debt anchor complemented by a structural balance rule reflects both the country's exposure to revenue volatility and its need for a credible operational guide. A debt rule provides a transparent signal of long-term sustainability, while the structural balance rule introduces flexibility to accommodate cyclical fluctuations and revenue shocks, particularly those tied to SACU transfers. The interplay between these rules ensures that operational fiscal targets remain aligned with broader debt objectives, providing both macroeconomic stability and space for development spending. The two indicative expenditure rules also serve as important operational tools to reinforce fiscal discipline—placing ceilings on total expenditure growth and the wage bill—thereby limiting procyclical spending pressures and supporting credible medium-term consolidation.

23. Calibration and selection interact in an iterative process. The calibration of Lesotho's debt anchor—based on stochastic simulations and fiscal response functions—helps validate the feasibility of the

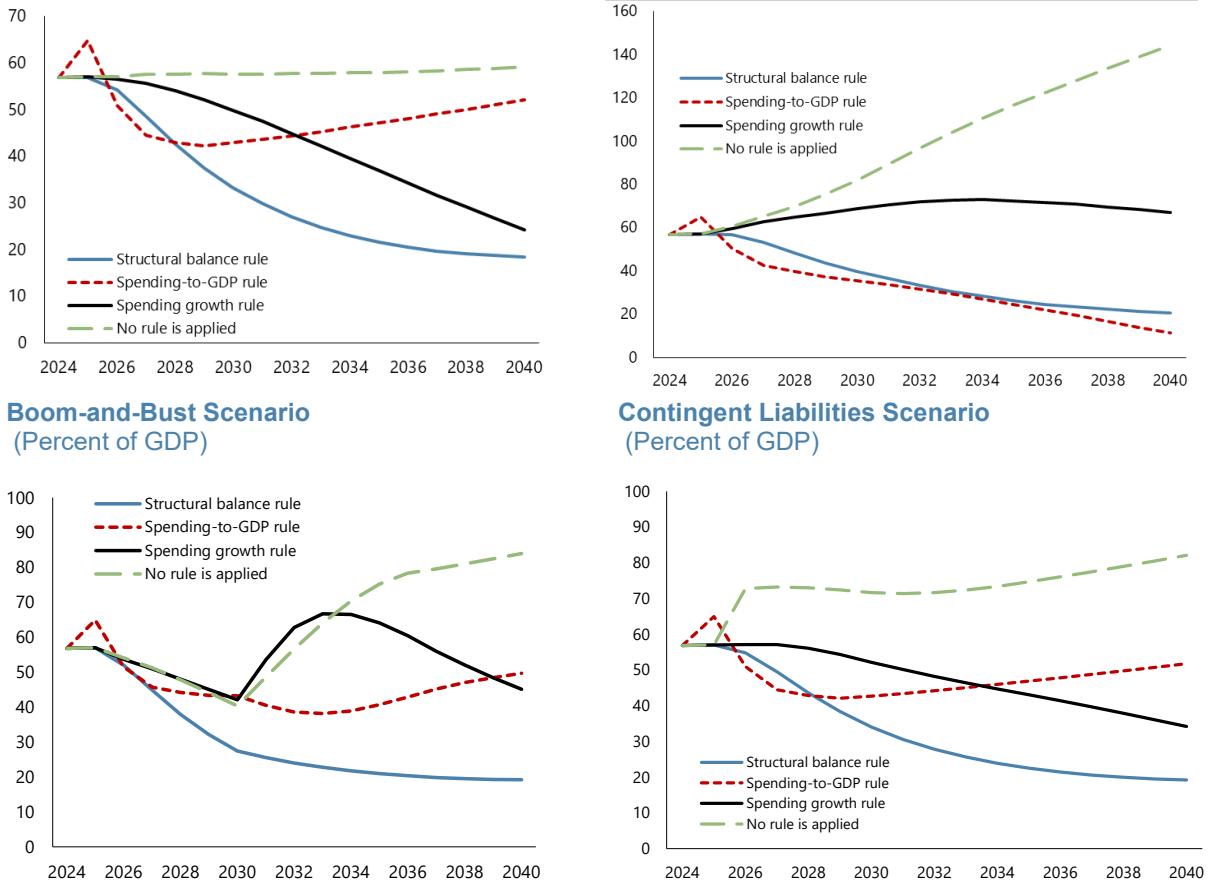
selected rule set under different macroeconomic scenarios. At the same time, the selection of rule types must be informed by institutional capacity, data quality, and economic structure. For instance, selecting a structural balance rule necessitates reliable estimates of potential output and structurally adjusted revenues, which in turn influences how stringently the rule can be calibrated and enforced. Ultimately, the credibility of the fiscal framework depends not only on technically sound calibration but also on the strategic selection of rules that are implementable, well understood, and suited to the country's fiscal risks and policy priorities.

24. Forward-looking scenario analysis outlines how different fiscal rules perform under alternative macroeconomic shocks. [5] The simulation is conducted over the forecast horizon and assumes the rule is introduced in the first year. Figure 9 shows the simulation results of the impact on debt levels from applying different operational rules, under four scenarios: a baseline scenario that is consistent with the macroframework discussed in the 2025 Article IV Staff Report; a low-growth scenario that envisages a large and temporary shock to growth in the first year of the projection, with no permanent effect on the level of real GDP over the long run; a boom-and-bust scenario that assumes a long period of strong growth followed by a decline in growth with permanent effects on the level of real GDP; and a contingent liabilities scenario where contingent liabilities amount to 15 percent of GDP in the first year while all other macroeconomic variables remain the same as in the baseline. For each of these scenarios, there are three types of operational rules being applied: a structural deficit rule of 3 percent of GDP, a spending-to-GDP rule of 55 percent, and a real spending growth rule capped at 0 percent indicating nominal spending growth at inflation rate.

25. The results show that across all four scenarios, the structural balance rule consistently yields the strongest debt reduction path, ensuring a steady and significant decline in the debt-to-GDP ratio over time. The spending growth rule offers moderate debt containment, performing better than having no fiscal rule, but with greater vulnerability to shocks, especially under the boom-and-bust scenario. The spending-to-GDP rule tends to stabilize debt but is less effective at putting debt on a downward trajectory, particularly under adverse or volatile conditions. The no rule scenario results in rising or flat debt paths across all simulations, underscoring the importance of adopting fiscal rules. Overall, the analysis suggests that rules anchored in fiscal balances offer the strongest safeguard against debt escalation, especially when countries face growth volatility or contingent fiscal pressures.

[5] Source: Fiscal Rules Selection Tools, International Monetary Fund.

Figure 9. Lesotho: Debt Scenarios Under Different Rules



Source: Authorities' data and IMF staff calculations

E. Considerations for a Stabilization Fund

26. The authorities are strongly encouraged to swiftly operationalize a well-governed stabilization fund, anchored by credible fiscal rules. With gross international reserves expected to surpass six months of import coverage in FY25/26—a level deemed appropriate for Lesotho—staff recommends fiscal surpluses be redirected toward reducing public debt. Reducing debt to 50 percent of GDP over the next five years would significantly lower the risk of a shift to high-risk of debt distress.

The comfortable level of reserves for Lesotho is calculated using a forward-looking, tailored framework for reserve needs in credit-constrained economies. The IMF Assessment of Reserve Adequacy for Credit Constrained Economies (ARA-CC) framework was developed to address the unique vulnerabilities of credit-constrained economies, particularly LICs, whose reserve needs are largely driven by current account shocks (such as declines in aid, remittances, or terms-of-trade). Unlike traditional metrics that focus on capital flow risks, the ARA-CC approach uses a cost-benefit optimization model that balances the absorption-smoothing role of reserves during crises against the opportunity cost of holding reserves. The adequate reserve level is derived as the point at which the marginal benefit of holding an additional dollar of reserves equals its marginal cost—proxied by indicators such as borrowing costs, sterilization costs, or the marginal product of capital. This

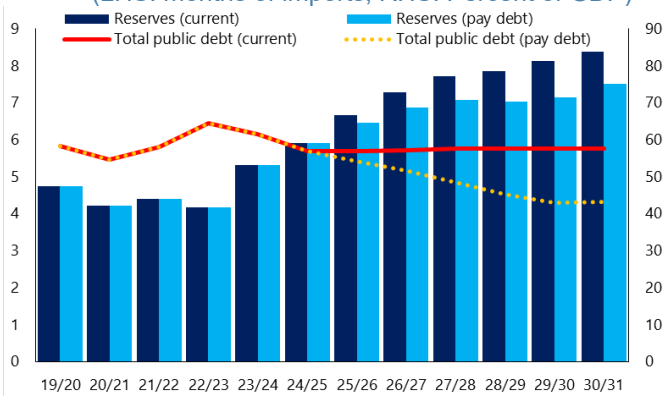
makes the ARA-CC approach well-suited for LICs where fiscal space is tight and holding excessive reserves can be costly to development.

27. In Lesotho's case, the marginal opportunity cost of further reserve accumulation is approximated by the cost of external borrowing. The marginal benefit reflects the economic value of holding one additional unit of reserves, particularly in helping Lesotho absorb external shocks—such as smoothing imports or maintaining exchange rate peg during crises. In contrast, the marginal cost captures what the country gives up by holding that extra dollar in reserves instead of using it elsewhere. For credit-constrained countries like Lesotho, this cost is often proxied by the external borrowing rate, since reserves are typically accumulated by external borrowing, which is often in concessional rates[6]. Thus, reserve levels are considered optimal when the benefit of added insurance against shocks equals this borrowing cost, ensuring neither under- nor over-accumulation.

28. Based on the simulation, the optimal level of reserves is about 4.5 to 6 months of imports for Lesotho. This takes into account Lesotho's limited access to international capital markets, its exposure to large and frequent current account shocks—particularly from volatile SACU revenues—and the high economic costs associated with reserve depletion in crisis scenarios. The range reflects a balance between the stabilization benefits of holding reserves to smooth absorption during external shocks and the opportunity cost of holding those reserves, proxied by the cost of external borrowing. This level also incorporates a precautionary buffer to reflect emerging risks.

29. From this estimate of the optimal level of reserves, the options for rapid debt repayment can be explored further. Placing debt on a declining path to around 45 percent of GDP would still allow reserve accumulation to reach 7.5 months of imports at the end of the forecast horizon (Figure 10). And according to the LIC-DSF framework, this level of adjustment would improve Lesotho's status from "limited space to absorb shocks" to "some space to absorb shocks." In establishing a more rapid pace of debt repayment, the authorities would then have to assess the appropriate mix and sequencing of redemptions. On one hand, domestic debt carries a significantly higher interest cost, but this should be weighed against the fact that gradual repayment of external debt could help reduce external debt vulnerabilities, and that maintaining some issuance of domestic debt would support the development of the local securities market.

Figure 10. Lesotho: Reserve Accumulation and Public Debt
(LHS: months of imports; RHS: Percent of GDP)



Source: Authorities' data and IMF staff calculations.

[6] From Lesotho's current creditors, the concessional rates range from zero to 2.5 percent.

30. The stabilization fund should be firmly anchored within the broader fiscal rules framework. A credible fund requires strong commitment to fiscal discipline, which should be enforced directly at the budget level and fully integrated into the medium-term fiscal framework (MTFF). Transparent and rule-based deposit and withdrawal mechanisms are essential to ensure predictability and safeguard against ad hoc political pressures. Such design features also enhance fiscal credibility and build public trust.

31. Given Lesotho's macroeconomic volatility and development needs, the fund could be structured with dual objectives: stabilization and investment. The stabilization component would serve to mitigate revenue volatility and support counter-cyclical fiscal policy—accumulating savings during periods of revenue windfalls and providing resources to finance temporary fiscal shortfalls during downturns. This would support expenditure smoothing and avoid procyclical fiscal adjustments. In parallel, the investment component would aim to build long-term fiscal buffers that could later be deployed to support growth-enhancing capital expenditure. Importantly, the dual-purpose design must ensure that stabilization needs are not crowded out by longer-term savings goals, particularly in a low-capacity, high-volatility environment like Lesotho's.

32. Each component of the fund will require a distinct asset allocation strategy. Assets held for stabilization purposes should be liquid and readily available to support the budget, and should therefore usually be invested in low-risk, highly liquid instruments. Conversely, the investment tranche can tolerate a longer time horizon and may pursue higher returns through a diversified portfolio, subject to prudent risk management. Clear operational guidelines, strong governance arrangements, and regular reporting will be critical to safeguard the fund's integrity and effectiveness.

F. Experience from Chile

33. Chile is recognized as a key international example for setting up a stabilization fund. Since the introduction of its fiscal rule in 2001, Chile has demonstrated a strong track record of sound intertemporal fiscal management. The rule is frequently cited as a benchmark for fiscal responsibility and effective management of commodity-related revenue volatility (IDB, 2008; Sanchez, 2011). Of particular relevance to Lesotho, Chile successfully transitioned from high dependence on volatile copper revenues to a framework characterized by fiscal discipline, macroeconomic stability, and resilience to external shocks. Importantly, Chile's fiscal rule and stabilization mechanisms helped maintain debt levels well within sustainable thresholds over an extended period, offering valuable lessons for countries seeking to anchor fiscal policy amid revenue volatility.

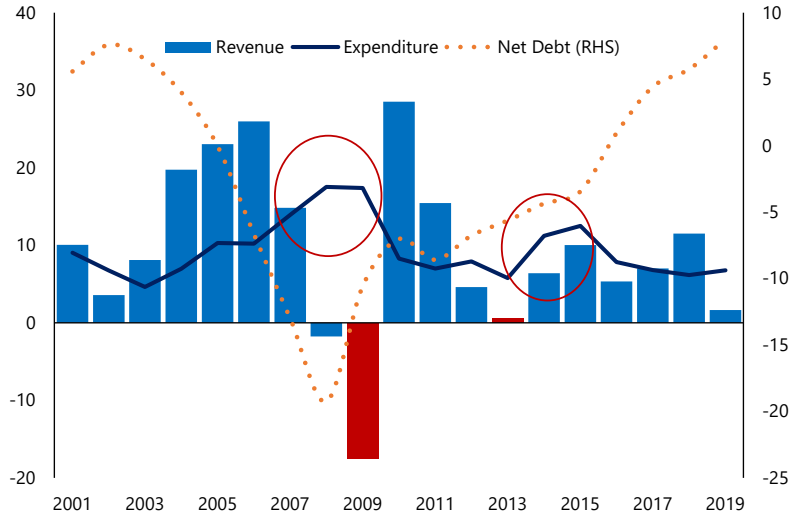
34. Chile's adoption of a structural fiscal rule marked a pivotal shift toward strengthening fiscal sustainability and shock resilience. In the aftermath of the early 1980s financial crisis, the country faced persistent fiscal deficits, including a widening pension system imbalance. In response, the authorities introduced a fiscal rule in 2001 that targeted a structural surplus of 1 percent of GDP—serving as a self-insurance mechanism to mitigate fiscal risks and reduce dependence on debt. The rule was anchored on estimates of potential output and long-term copper prices, provided annually by two independent expert panels, lending credibility and transparency to the framework.

35. The structural balance rule helped address procyclical fiscal management and allowed Chile to smooth expenditures across economic cycles. Prior to the reform, fiscal policy had mirrored copper price

cycles—expanding in booms and lacking sufficient adjustment in downturns. The rule corrected this by adjusting revenues cyclically while keeping expenditure fixed, enforcing discipline and predictability (Sanchez, 2011; Marcel, 2013). Structural surpluses were saved in two sovereign wealth funds—the Economic and Social Stabilization Fund (ESSF) and the Pension Reserve Fund (PRF)—which helped preserve macroeconomic stability and build buffers for future downturns.

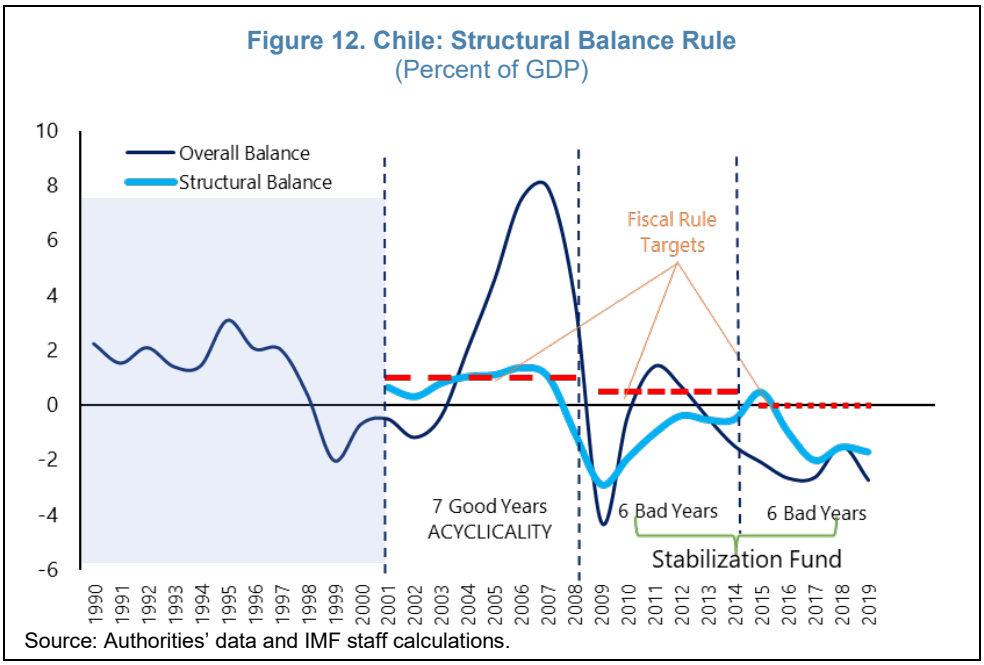
36. The rule's countercyclical design proved effective during major shocks, enabling Chile to maintain fiscal credibility while adapting to changing conditions (Figure 11). Surpluses accumulated during copper price booms were deployed to finance deficits during the 2008 Global Financial Crisis and the 2014 commodity price crash, allowing the government to avoid abrupt austerity measures. Despite a temporary decline in the overall fiscal balance to -4.3 percent of GDP, Chile maintained prudent fiscal management and adjusted its structural target over time—from 1 percent to 0.5 percent, and later to balance—demonstrating the rule's built-in flexibility while preserving its anchoring role for fiscal policy.

Figure 11. Chile: Revenue and Expenditure Growth
(LHS: Percent Growth: RHS: Percent of GDP)

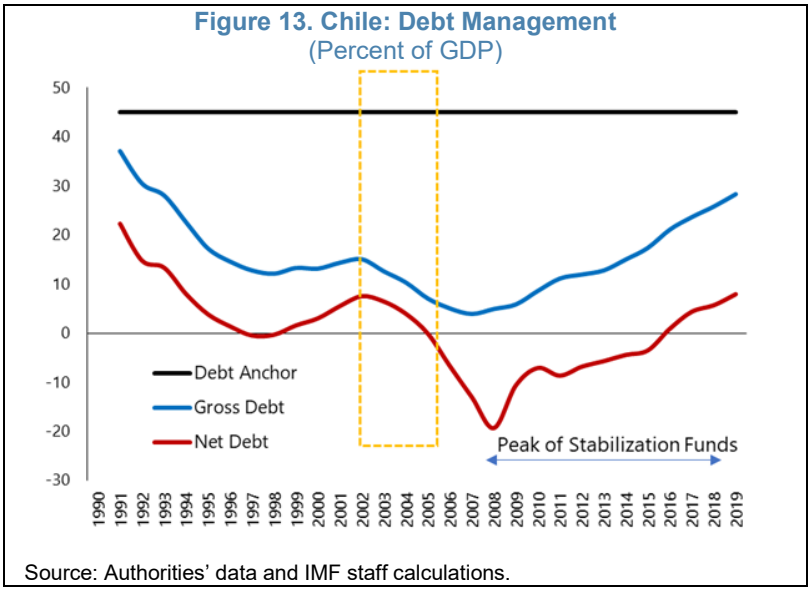


Source: Authorities' data and IMF staff calculations.

37. Chile's fiscal rule successfully delinked public expenditure from revenue cycles, particularly during commodity-driven booms, and helped maintain prudent fiscal management (Figure 12). Prior to the rule, expenditure growth often outpaced revenues, reinforcing procyclical patterns. However, in the first six years after the rule's adoption, despite average revenue growth of around 15 percent driven by rising copper prices, expenditure growth was contained to under 9 percent. During subsequent shocks—such as the 2009 global financial crisis and the 2014 copper price collapse—the government avoided abrupt fiscal consolidation by drawing on savings accumulated in the ESSF. This allowed Chile to preserve priority expenditures and maintain macroeconomic stability. Debt levels were kept within prudent bounds, with gross debt declining to as low as 4 percent of GDP in the pre-crisis period and net debt contained within a 20 percent anchor (Figure 13). The stabilization fund served as an effective buffer, enabling a countercyclical response and sustaining investor confidence in the fiscal framework.



38. Chile's experience offers valuable lessons for the design and implementation of fiscal rules and stabilization fund in Lesotho. First, Chile addressed revenue volatility—stemming largely from copper exports—by adopting a structural balance rule that adjusted revenues for long-term trends in copper prices, thereby limiting fiscal fluctuations outside of large external shocks. A similar approach in Lesotho, where SACU transfers are highly volatile, would help smooth budget execution and support more stable expenditure planning. Second, Chile's fiscal rule helped embed discipline into the budget process, curbing procyclical and ad hoc spending while channeling windfall revenues into the ESSF. This approach not only enhanced macro-fiscal stabilization but also strengthened budget credibility and reduced the scope for off-budget mechanisms—reforms that could usefully support Lesotho's efforts to curb arrears and improve PFM practices. Finally, Chile anchored its fiscal framework with a debt sustainability objective, maintaining public debt well below its 45 percent of GDP target for much of the pre-pandemic period. This offers a relevant example of how a credible fiscal rule can help maintain investor confidence, contain financing costs, and provide a durable anchor for long-term fiscal sustainability.



G. Conclusion

39. Lesotho currently faces a critical opportunity to strengthen its fiscal framework and enhance macroeconomic resilience through the adoption of a credible, legally binding fiscal rule. The recent emergence of fiscal surpluses—unusual in a context of longstanding fiscal pressures and mounting external risks—offers a rare chance to anchor expenditure to structural revenues and save excess receipts for future stabilization. The government should seize this momentum to institutionalize fiscal discipline by establishing a rules-based framework and a stabilization fund. Doing so would help address entrenched challenges such as wage bill rigidities, domestic arrears, and debt accumulation. As demonstrated by international experience—particularly Chile—countercyclical fiscal frameworks can yield durable macroeconomic benefits and improve fiscal management credibility.

40. Model-based calibration results suggest that a fiscal framework anchored on a debt ceiling of 60 percent of GDP, a debt anchor around 50 percent of GDP, and a structural deficit rule of 3 percent of GDP—alongside expenditure operational rules—would support fiscal sustainability while preserving space for priority spending and cyclical responses. Implementing such a framework would promote greater fiscal transparency, strengthen medium-term budgeting, and reinforce political ownership of fiscal consolidation. Over time, these institutional improvements can help break the cycle of procyclical spending and foster a more predictable fiscal environment. Periodic—but infrequent—review of the rule parameters may be appropriate to maintain relevance while preserving credibility.

41. The stabilization fund should be explicitly anchored within the fiscal rules framework and designed to serve dual purposes—short-term stabilization and long-term investment. This dual objective will allow the fund to cushion economic shocks, maintain the exchange rate peg, and support capital spending once implementation capacity improves. International experience underscores the importance of adequate liquidity buffers in enhancing policy space during downturns. Chile's example illustrates that combining fiscal rules with a well-managed stabilization fund can help build solvency, credibility, and institutional resilience. For Lesotho, embedding such a framework will be essential to address structural bottlenecks, improve investment planning, and strengthen the role of fiscal policy in promoting inclusive and sustainable development.

Annex I. Calibration of Overall Balance and Primary Balance[1]

Approach 1: Convergence in the Long Term

This approach derives the fiscal balance that would lead to a gradual convergence toward the debt target in the long term. Overall balance or primary balance can be given as:

$$b^* = \lambda d^*$$

where b^* represents either balance in percent of GDP, d^* is a given debt-to-GD target, and λ takes the form of $\frac{-\gamma}{1+\gamma}$ for an overall balance target, or $\frac{i-\gamma}{1+\gamma}$ for a primary balance target, where γ is the nominal GDP growth over the long term. i represents the nominal interest rate paid on public debt.

Approach 2: Convergence by a Given Date

This approach is similar to Approach 1, except that the b^* is calibrated that that debt ratio hits its target d^* after N years. The equation is given as:

$$b^* = \frac{\lambda}{(1+\lambda)^N - 1}[d_0(1+\lambda)^N - d^*]$$

Approach 3: Convergence by a Given Date Following a Transition Period

This approach adds another layer of flexibility compared to Approach 2 by allowing for an initial transition period in which the balance gradually converges to its target. The numbers of years of the transition T is exogenously given. The equation is given as:

$$b_t = \begin{cases} \alpha t + b_0, when\ 0 < t < T \\ \alpha T + b_0 = b_T^*, when\ T \leq t \leq N \end{cases}$$

where α represents the annual constant amount adjusted until it reaches the target b_T^* after T years. If b_T^* is maintained afterward, this will ensure convergence to the debt target by the end of year N.

[1] Eyraud et al, 2018.

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