

# Lesotho's integration into the world economy: challenges and opportunities<sup>1</sup>

First Draft, please do not quote

## 1. Introduction

A changing external environment will bring more competitive pressure for Lesotho's exports in the medium term. Future export growth will be challenged by the emergence of new low-wage competitors like Myanmar and the expected erosion of preferential market access in main export destinations over the next decade. In the United States, the Trans-Pacific Partnership (TPP) has been abandoned, but a potential US-Vietnam FTA based on the TPP commitments could grant duty free entry to apparel products from Vietnam - the highly efficient producer that competes against Lesotho in similar apparel products. The significant difference in tariffs paid by apparel exports from Lesotho – which have duty free access under the African Growth and Opportunity Act (AGOA) – and from Vietnam (which pays an average tariff of 18%) will likely be mostly eliminated in the next decade. Additionally, the current re-authorization of AGOA will expire in 2025. Although a new 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, its apparel exports will have to compete on equal footing against low-wage competitors like Bangladesh, Cambodia, and Myanmar that currently face high tariffs in the U.S. (16.3%, 17.8%, and 13.7%, respectively).

The main objective of this analysis is to propose policies that 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 policy recommendation will arise from the analysis focusing on the following three pillars:

- a) Analysis of trade policy and outcomes
- b) Assessment of potential impacts of the US-Vietnam FTA and phase out or replacement of the AGOA
- c) Identifying constraints to participation in global and regional value chains in goods and in services including barriers created by the regulatory environment

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<sup>1</sup> The views expressed in this paper are those of the authors and should not be attributed to the World Bank, its Executive Directors or the countries they represent.

The proposed analysis aims to contribute to and engage explicitly with Lesotho's existing policy framework. This includes the forthcoming National Trade Policy (see MTI 2015), as well as the recent AGOA Response Strategy (Molapo 2016). As such, it aims to contribute to the objectives inscribed in Lesotho's National Strategic Development Plan 2012–17 (NSDP), and particularly to achieve sustainable and inclusive growth in part by expanding and diversifying exports and promote foreign investment with a view.

The analysis of the current policy and institutional framework, as well as of tariffs and NTMs will provide a current picture of protection faced by the domestic producers, but also the tariff and non-tariff costs of importing inputs to support domestic value chains. The goal of this analysis is to provide the policy recommendations regarding liberalization of key products needed to support the development of local value chains. Further, the potential impacts of the TPP and the phase out of the AGOA preferences would be studied at aggregate level using a computable general equilibrium model and at a product level (HS6). The final section would suggest a response to potential negative impacts identified in the second section by investigating constraints to further integration of goods and services into global and regional value chains with a special focus on regulatory environment in services as key input to domestic value chains.

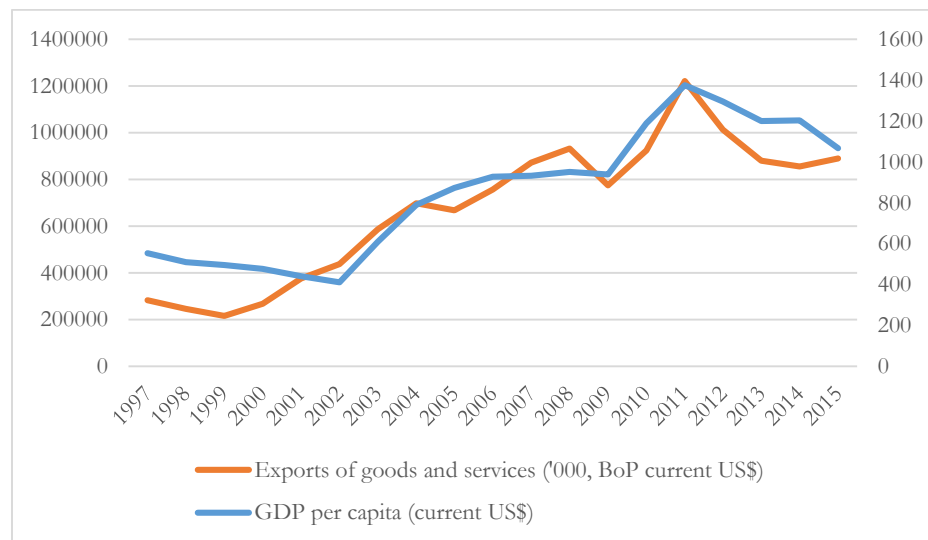
## 2. Overview of current policy and institutional framework: opportunities and challenges

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. While agriculture has been central to the livelihoods of most Basotho, there has always been extensive outward migration to South Africa, particularly for work in the mining sector.

The first arrival of foreign investment to produce exports came about in the 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.

When Lesotho became a beneficiary of AGOA in 2000, and could take advantage of its laxer rules of origin for textiles, 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%. While the role of AGOA, and its impact will be discussed more extensively in Section 3 (in general) and 5 (especially with respect to textiles), the benefits derived from this competitive advantage has been pivotal for the country's economic development. As shown in Figure 1, both GDP per capita and exports began to increase rapidly following the onset of AGOA in 2000 and throughout the first decade of the 21st century, before peaking in 2011. However, this has been driven by a reliance on very few products and markets. Apparel and diamonds accounted for 77% of exports in 2015 while SACU (mainly South Africa), US, and EU are the destinations for 99% of exports.

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

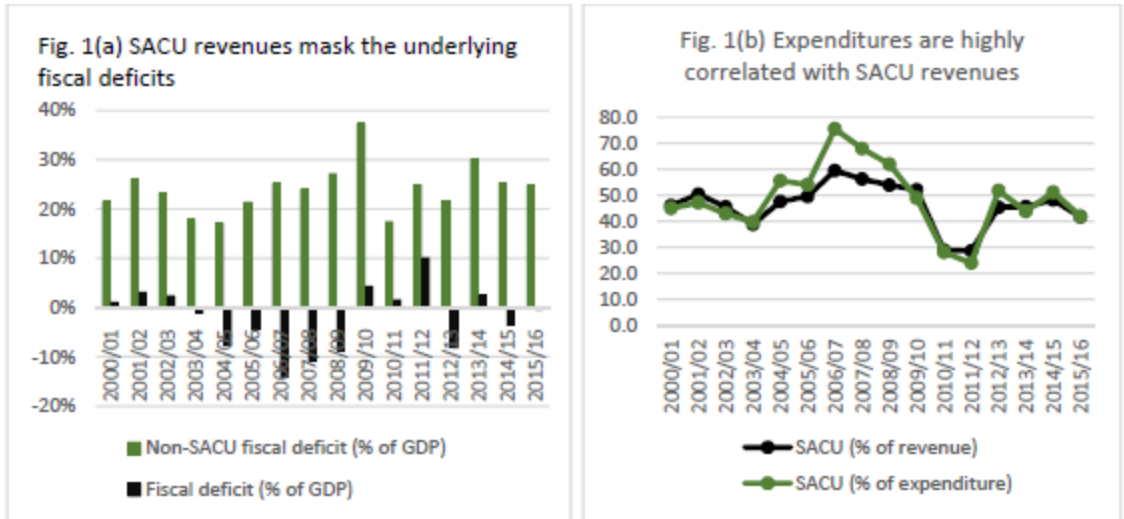


Source: World Development Indicators

The past years have been marked by a worsening of Lesotho's macroeconomic situation, driven in part by a decline of the main export industries. Recent and relatively comprehensive overviews of Lesotho's current economic situation can be found in several recent publications, including the SACU WTO Trade Policy Review (WTO 2015), the National Strategic Development Plan (Kingdom of Lesotho, 2012), the World Bank Country Partnership Framework (World Bank 2016a), as well as its most recent macro-economic outlook (World Bank 2016b).

Throughout these analyses, a few common themes emerge, including the high wage bill, the country's narrow tax base, and its high dependence on SACU revenues as well as on two primary export markets, the US and South Africa (WTO 2015, World Bank 2016b). The country's currency remains pegged to the South African rand, complicating the use of monetary policy and particularly in recent years, macro-fiscal developments have reached a point of crisis with large current account and fiscal deficits, to respond to declining SACU revenues and higher food prices, as well as a prolonged drought (World Bank 2016a). Particularly the decline in SACU revenues, from 33% of GDP in 2009/10 to only 15% the following year represented a shock to the budget, though this share has recovered slightly (see Figure 2).

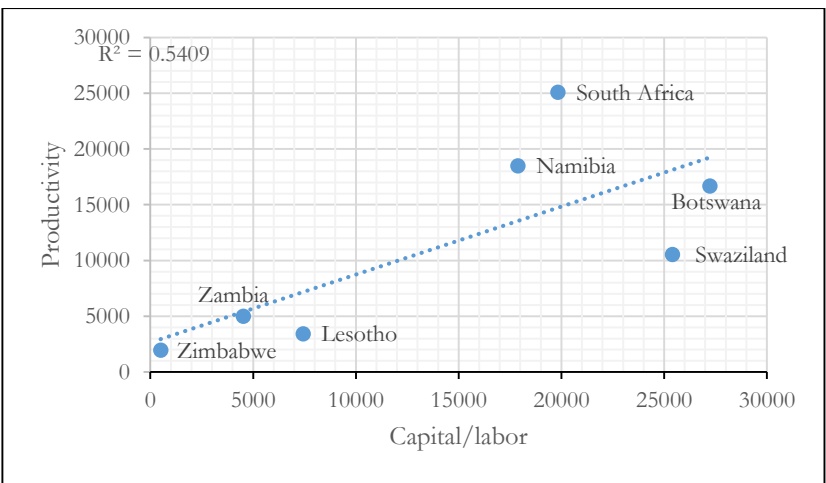
Figure 2: SACU revenues in relationship to government expenditure



Source: World Bank (2016a)

In recent years the country has faced soaring budget deficits (9.3% in 2016/17) – a path the recent CPF (World Bank 2016b) has called “unsustainable”. This is exacerbated by political instability, high rates of HIV, tuberculosis and maternal and infant mortality, as well as significant exposure to climate-related stresses. The country has high and stagnant rates of poverty and inequality with social protection transfers poorly targeted towards the poor. An overarching concern remains the relatively small size of the private sector, making up just 14.7% of GDP (Nseera and Bahtia cited in Molapo 2016). Unemployment remains high, at 28% (42% for youths) with over one in three households working in low-productivity agriculture. Public expenditure, including for a well-paid public sector, has in the past years acted as a main driver of growth, with the government wage bill coming to 23.1% of GDP, the highest in the world. The country has among the lowest labor productivity figures in the world and has low intensity of capital in production. Among Southern African countries, the capital/labor ratio in Namibia is more than double that of Lesotho’s and that of South Africa, Botswana and Swaziland is substantially higher (see Figure 3).

Figure 3: Labor productivity and capital-labor ratios in Southern Africa



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

Recently international organizations have urged, and the GoL itself has recognized, a need to shift towards a more private sector-led growth model. However, the private sector remains small. Of this, MSMEs make up 85% of the private sector and employ approximately 200,000 people. While there are several larger firms, especially in the textile/apparel and mining sector, there remains a missing middle with only 6% of firms considered medium-sized. Many 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% nationals and foreigners have ventured together (Bureau of Statistics 2016).

A large part of the 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 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 Figure 4).

Figure 4: 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           |
| <b>Total Output (million Maloti)</b>            | <b>9007.1</b>    | <b>9035.0</b>    | <b>9066.4</b>    | <b>9100.8</b>    |
| <b>Population projections</b>                   | <b>1,896,833</b> | <b>1,902,707</b> | <b>1,909,321</b> | <b>1,916,573</b> |

Source: Matsoso (2015), p. 8

### 3. Impacts of AGOA

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 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 and further assuming that each worker cares for 5 other family members, this income benefited 240,000 people or 13% of the population. A recent report by the Congressional Research Service (Williams 2015) examines the recent evidence on AGOA's impact and finds Lesotho to be the 2nd greatest beneficiary for apparel, after Kenya in 2014. However, its apparel exports still constitute less than 4% of the second-largest apparel exporter, Vietnam, and less than 1% of China's apparel exports to the US.

This is supported by the 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 particular impact on Lesotho, Kenya and Madagascar. The aforementioned article by Sanjay Lall (2005) is skeptical about whether Lesotho can be “the torchbearer of a renaissance in African manufacturing competitiveness”(p. 1018) as the country continues to suffer from low productivity, poor skills and weak local links. Olarreaga and Ozden (2004) estimate that AGOA-benefiting African exporters receive only 1/3 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 driving prices for garments lower for 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 and several product categories for African exporters. 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).<sup>2</sup> 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 translated into success in other clothing markets or in success in exporting other labor-intensive products” and 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 poor Sub-Saharan could survive without the special rule.”

In terms of moving forward, the AGOA report (Molapo 2016) argues for an urgent need to upgrade the textiles and apparel industry, as buyer demands are becoming greater and to focus on increasing backward and forward linkages – for example through the establishment of a knit fabric mill to increase vertical integration of apparel. A related problem here is that other sub-sectors with high export potential, such as footwear and leather, horticulture and agro-processing, wool and mohair, mining, quarrying and handicrafts have not been exploited. Beyond ensuring sustained access to the US market through AGOA, the country thus needs to address its low labor productivity, engage in process upgrading, reduce import

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<sup>2</sup> For a systematic review of the impacts of AGOA on increasing trade from LDCs, see Condon and Stern (2011)

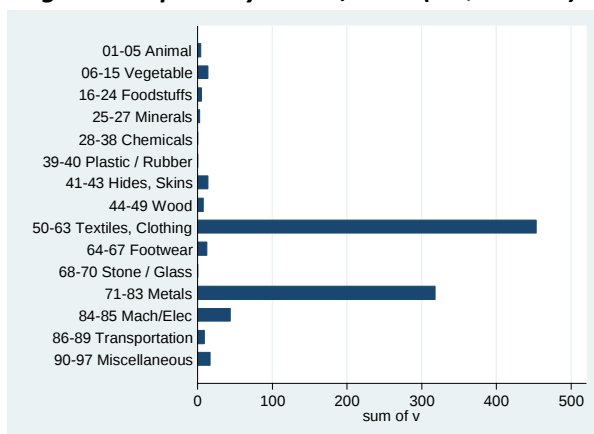
and export costs, invest in trade facilitation and infrastructure, and reduce the reliance on expatriate staff. In the medium term, this will also require the development of technical support institutions. Thus, in the context of a domestic enclave industry with weak economies of scale that is reliant on very foot-loose FDI and trade preferences there are substantial risks not only due to the loss of AGOA, but also because of sustained recent political and economic instability, as well as improving market access for Asian exporters, the future of the sector is at risk.

## 4. Lesotho 's export trends and diversification

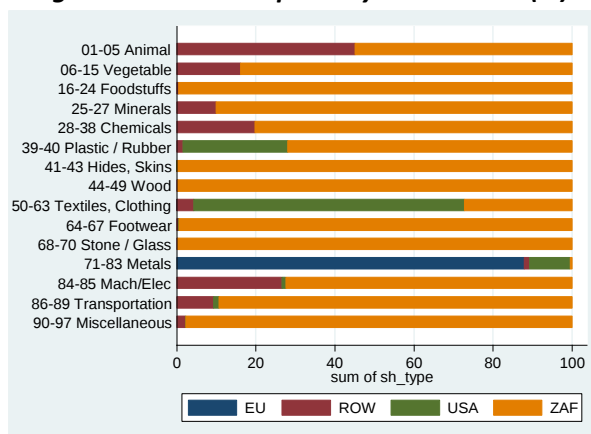
**Lesotho's exports are highly concentrated as the country relies on very few products and markets for its exports.** Figure 5 shows Lesotho's export value by sectors in 2015 with apparel and mineral (diamonds) products accounting for 77% of total exports and very few sectors showing significant exports. Similarly, Lesotho's exports are concentrated in only three export markets with SACU (mainly South Africa), the United States, and the EU accounting for 99% of exports on average over the last decade. In reality, 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 6).

**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 emerging as the destinations of choice for the new emerging products.

**Figure 5. Exports by Sector, 2015 (US\$ million)**



**Figure 6. Sectoral Exports by Destination (%)**

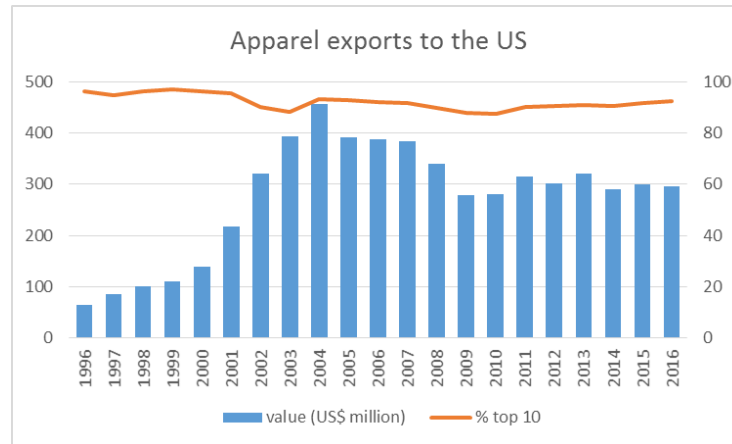


Source: Authors' elaboration using mirror data from WITS (2016).

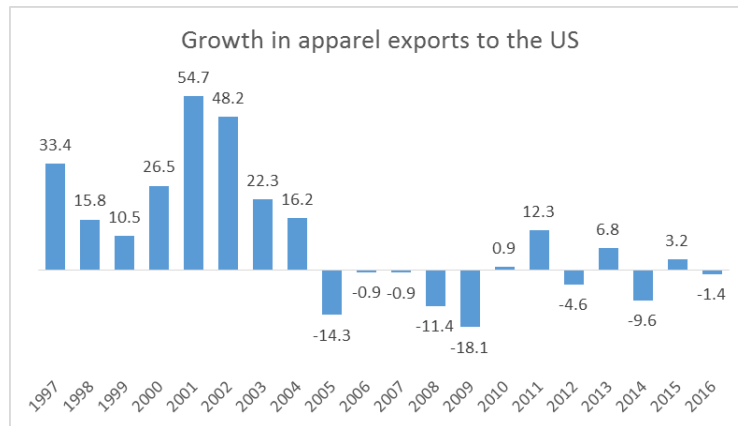
### 4.1. Exports to the United States

**Lesotho's exports to the US are highly concentrated in terms of sectors and products.** Apparel (90.9%) and diamonds (8.9%) dominate exports to the US. Inside apparel, ten products defined at the HS 8-digit level account for 83% of total exports to this country (Figure 5). 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 8).

**Figure 7. Apparel exports to the US, 1996-2016 (US\$ million)**



**Figure 8. Growth in apparel exports to the US, 1997-2016 (%)**



**Most apparel export products to the US had stagnant or declining market share over the last decade.** Lesotho has been losing market share in the U.S. in these ten products against TPP competitors (Vietnam, Malaysia, and to a lesser extent Peru) and non-TPP competitors like Bangladesh and Cambodia (Annex 1 **Error! Reference source not found.**). The potential expiration of AGOA could also result in a significant disadvantage for Lesotho's apparel exports as they would revert to the MFN (NTR) 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 other major preferential program granted by the U.S. to Lesotho (Table 1).

**Table 1. Top ten apparel export products to the US (2015)**

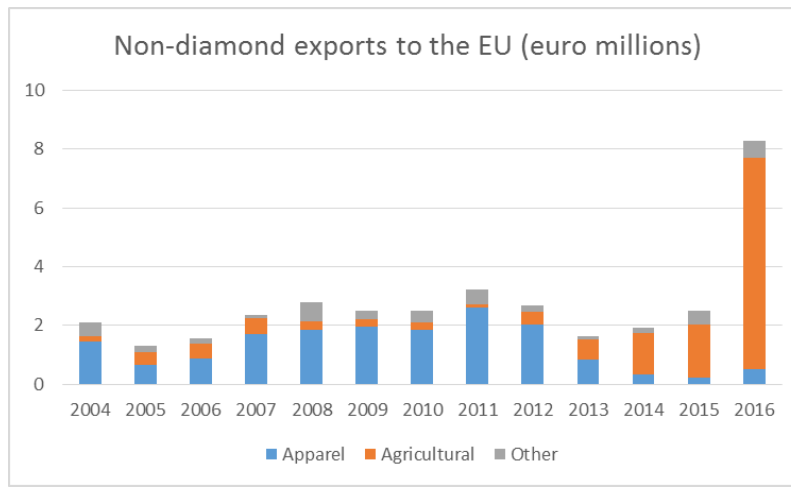
| HS8      | Product description                                                                                                                  | Exports | % exports | % US imports | NTR tariff |
|----------|--------------------------------------------------------------------------------------------------------------------------------------|---------|-----------|--------------|------------|
| 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, nesoi                                    | 71,000  | 21.5      | 5.1          | 28.2       |
| 61103030 | Sweaters, pullovers and similar articles, knitted or crocheted, of manmade fibers, nesoi                                             | 39,034  | 11.8      | 0.7          | 32.0       |
| 61052020 | Men's or boys' shirts, knitted or crocheted, of manmade fibers, nesoi                                                                | 34,440  | 10.4      | 3.9          | 32.0       |
| 62046240 | Women's or girls' trousers, breeches and shorts, not knitted or crocheted, of cotton, nesoi                                          | 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, nesoi                                       | 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, nesoi                                                     | 4,636   | 1.4       | 0.1          | 16.5       |

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

## 4.2. Exports to the European Union

**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 5,000 euros were exported to the EU in any given year over the last decade and only four products recorded exports over 1 million euros in 2015. All non-diamond exports were only able to surpass the 3 million euro threshold 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. the majority of products are not exported for more than two or three years in a row). This 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.

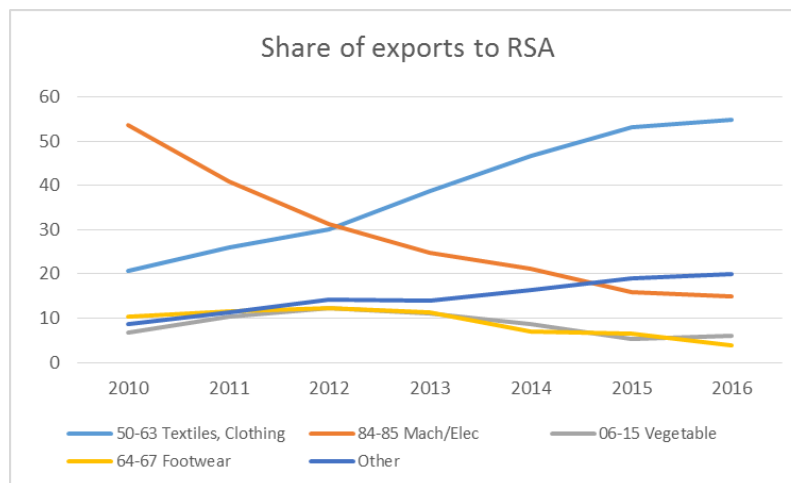
**Figure 9. Non-diamond exports to the EU (euro millions)**



#### 4.3. Exports to South Africa

**Exports to South Africa are more diversified than to the US and the EU but are still dominated by apparel.** 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%.

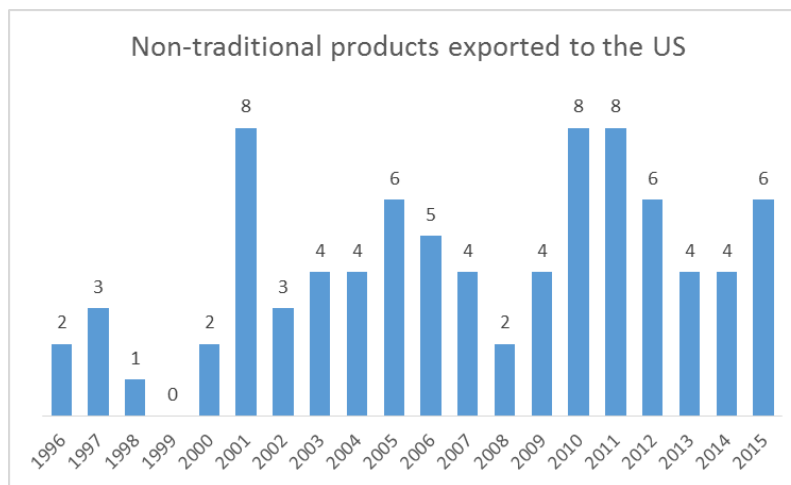
**Figure 10. Exports to South Africa by Sector (% total exports)**



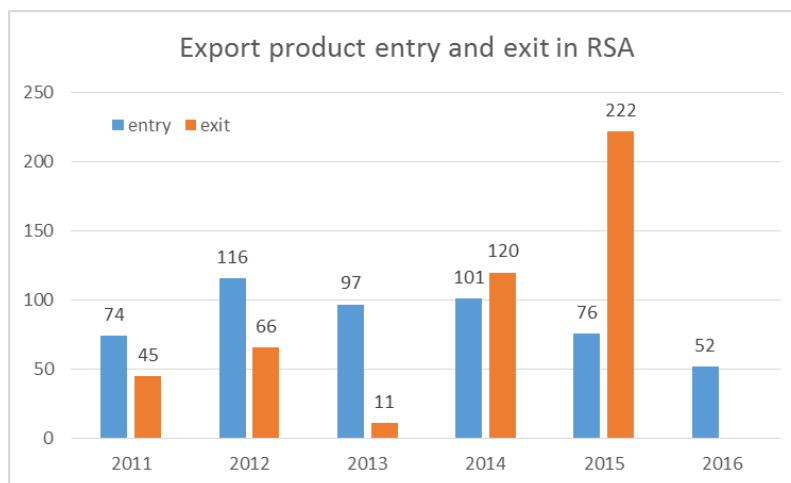
#### 4.4. The problem of export dynamism: Very few new products

**Despite generous preferential access to several large markets in developed countries, Lesotho has failed to introduce new export products in those destinations with the exception of South Africa.** There has been a lack of export experimentation in Lesotho despite duty-free access to the US and EU: there were less than 10 non-traditional (i.e. non-diamond/non-apparel) products exported to the US in any given year over the last decade while the number of non-diamond export products exported to the EU never reached more than twenty. The number of export entries in South Africa is large in comparison with other two main destinations (about 75 new export products on average), but there has also been an increasing number of export exits (i.e. products that are no longer exported) which resulted on a net decrease of export products over the last two or three years.

**Figure 11. Number of non-traditional products exported to the US**



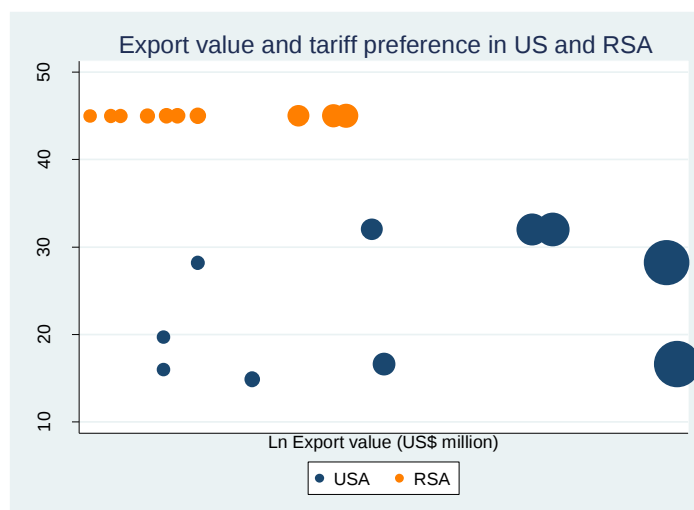
**Figure 12. Exports product entry and exit in South Africa**



## 5. The role of preferences in Lesotho's exports

**Lesotho's apparel exports have traditionally relied on significant preferences in its main destination markets.** Figure 13 show the value of main apparel exports in the x-axis and the MFN tariffs paid for those products in the US (blue bubbles) and South Africa (orange bubbles). Because Lesotho has duty-free entry into those two markets (under AGOA and the SACU Customs Union), the MFN tariffs represent the protection level that Lesotho's products have in these markets. A cursory view reveals that the preferences are relatively large for apparel in the US (15% -30%) and South Africa (+40%). These generous preferences have been one of the main reasons that allowed Lesotho's exports to remain competitive in foreign markets. Figure 14 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 would not be price competitive vis-à-vis these countries if they were not exempted of customs duties.

**Figure 13. Export value and tariff preferences in the US and South Africa**

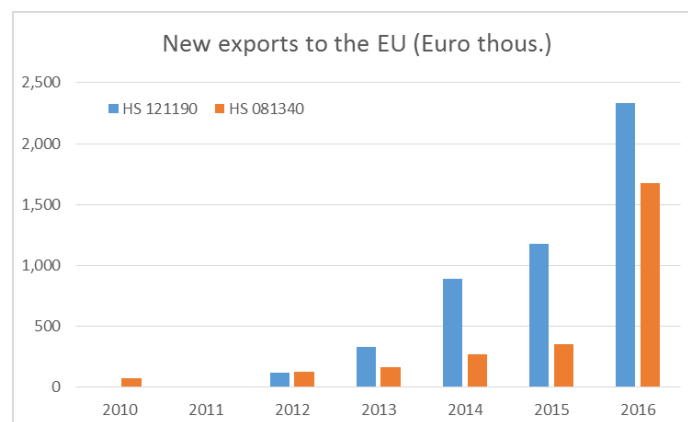


**Figure 14. Cost decomposition of landed duty-paid value of exports in the US (2015)**

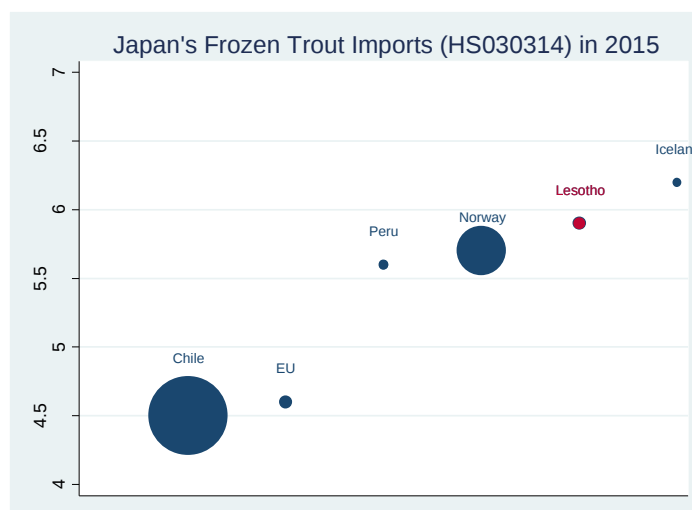


However, there are a few new export products that are able to compete in demanding export markets without preferences. Figure 14 shows the evolution of exports values for two products that were only recently introduced by Lesotho exporters into the EU: dried fruit (HS 081340) and plants used for pharmaceutical purposes (HS 121190). Exports of both products to the EU have increased from less than 100,000 euros in 2012 to over 1.5 million euros in 2016. Furthermore, one of these products (plants used for pharmaceutical purposes) have started to diversify destinations and is now exported to Germany, France, Poland, and the UK. Similarly, Figure 16 show the quality ladder for another product that has entered a lucrative niche based on its high quality: exports of frozen trout to Japan. The relative quality of 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.

**Figure 15. New exports to the EU (euro thousands)**



**Figure 16. Japan's Frozen Trout Imports (2015)**



## 6. Impacts of potential future US trade policy changes

The recent changes in the application of AGOA policy create big uncertainty for Lesotho's exporters and their partners. The quarterly review of Lesotho's compliance with AGOA conditions, could lead to lower orders from the US depending on investors' assessment of political situation in the country. The first scenario analyses the impact of the complete removal of AGOA preferences. This could happen due to deteriorating political situation before 2025 or in 2025 when the preferences are due to expire. Given the importance of exports under AGOA along with a heavy reliance on tariff preferences to remain competitive on the US market, we analyze the impact of the complete loss of AGOA preferences in 2018. Second scenario looks at the impacts of the potential US-Vietnam FTA based on the tariff and NTM liberalization as negotiated under the TPP. The US-Vietnam FTA, along with the potential phase out or replacement of the AGOA preferences by 2025, would result in an increased competitive pressures on Lesotho. Both scenarios serve only illustrative purposes and should not be treated as projections of future developments.

### 6.1. Methodology and data

Potential impacts of the TPP and AGOA phase-out on trade, growth and poverty reduction will be estimated using a global dynamic computable general equilibrium (CGE). This modelling framework would allow to incorporate the complex interactions of productivity differences at the country, sector or 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 (2016a and 2016b), the backbone of the economic modelling would be obtained by using a global dynamic computable general equilibrium model called LINKAGE. The analysis would include 17 sectors and 35 trading partners (see Table A1) and would simulate the impacts of policy changes up to 2030, including reductions in tariffs, NTMs, and regulatory barriers in services trade.

For the purpose of this exercise the 2010 social accounting matrix (SAM) for Lesotho has been incorporated into a Global Trade Analysis Project (GTAP) database<sup>3</sup>. The key macro variables and trade flows will be updated to the most recent data available for Lesotho. Details of the modeling framework are provided in Annex 1.

### 6.2. Simulation results

Our results indicate that the negative impacts due to a sudden suspension of AGOA privileges in 2018 would have been much higher than those of the potential US-Vietnam FTA. The decline of income would reach 4% relative to the baseline in 2020, while exports of textiles and apparel would almost disappear with a decline of output of textiles and apparel of 26%.

While the impact of AGOA suspension is immediate, the implementation of US-Vietnam (modelled after the actual bilateral TPP commitments), the liberalization is gradual. Also Lesotho continues to enjoy preferential access relative to other major competitors like China or Bangladesh. There are legitimate reasons for concern (the unit costs of Lesotho are much higher), but the key competitors are China, Vietnam, Indonesia, Bangladesh, Jordan, which other competitors continuing to pay MFN rates. The

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<sup>3</sup> <https://www.gtap.agecon.purdue.edu/>

impact of Lesotho's exports of apparel and textiles is significant at 12% decline relative to the baseline in 2020, but the impacts on average income or real consumption are negligible.

**Table 2. Impact of AGOA suspension and US-Vietnam FTA in 2020**

|                 | Deviations from the baseline in 2020 |                  |                |                |               |               |
|-----------------|--------------------------------------|------------------|----------------|----------------|---------------|---------------|
|                 | Income                               | Real consumption | Exports of t/a | Imports of t/a | Total exports | Output of t/a |
| AGOA suspension | -4%                                  | -2.1%            | -84%           | -11.7%         | -3.7%         | -26.3%        |
| US-VTM FTA      | -0.3%                                | -0.2%            | -12%           | -6%            | -0.40%        | -3.7%         |

Another attenuating factor limiting the impact of a potential US-Vietnam FTA are more stringent ROO under the TPP. The agreement included a Triple Transformation rule in textiles and apparel, also known as 'yarn forward' rule which states that only fabric/clothes produced from yarn made by a TPP country would be granted duty-free status. If this rule was to be adopted, it would make it difficult for Vietnam to immediately qualify for reduced duties. Currently Vietnam imports most of the inputs it uses for its wearing apparel from outsider countries, and structural adjustment would require time.

## 7. Policy recommendations

The key challenge: moving away from AGOA dependence and seeking new opportunities in the EU, emerging markets and especially Southern Africa.

1. Negotiate lower tariffs on inputs to exports within SACU CET.
2. Develop a comprehensive services export strategy.
  1. Identify and address barriers to implementation
  2. Investigate competitiveness and anti-monopoly practices
3. Focus on low-hanging fruits, for example
  1. More reliable implementation of the duty drawback system.
  2. Focusing trade facilitation on the 2 main border crossings where 95% of imports and exports pass through.
  3. LNDC responsiveness to firm complaints.
  4. A better functioning market intelligence operation.
4. Improve the business climate
  1. Provide investors with reliable and transparent information – this may entail some reforms to the one-stop business facilitation centers.

2. Assist investors with documentation and facilitate foreigners with acquiring work and residence permits.
5. Continue investing in infrastructure and human capital
  1. Particularly transport and ICT services remain underdeveloped and could benefit from targeted investments.
  2. Continue to build a human capital base that can support services expansion and services export.
  3. Assess the visa and work permit system to facilitate talent attraction.

## 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 Serven (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) database<sup>4</sup>. 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:

### 1. 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)<sup>[3]</sup> report.

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<sup>4</sup> <https://www.gtap.agecon.purdue.edu/>

<sup>[3]</sup> For China, we replicate the growth projections of World Bank (2014).

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 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.

## **2. EU-Vietnam FTA**

This scenario will analyze the impacts of tariff and NTM reductions in goods and services as a result of the US-Vietnam FTA consistent with the bilateral concessions under the TPP. Tariff commitments are available in ITC database. 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 will be based on Jafari and Tarr (2015). We run a central scenario with percentage NTMs reductions similar to those as in Petri and Plummer (2016).

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        |