

Small African Economies in a More Uncertain Global Trade Environment

The Potential Impact of Post-AGOA Scenarios for Lesotho

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Abstract

This paper provides a forward-looking view of trade and its relevance for Lesotho's medium- and long-term development. It does this through computable general equilibrium analysis of potential impacts based on specific trade-related scenarios. The scenarios include the potential loss of American Growth and Opportunities Act preferences and preference erosion against competitors through, for example, a United States–Vietnam Free Trade Area. An immediate loss of American Growth and Opportunities Act preferences would have a significant economic impact that far exceeds that of a potential future United States–Vietnam Free Trade Area. If these preferences were suspended in 2018, Lesotho would face a loss of 1 percent in income by 2020, relative to the baseline, and exports of textiles and

apparel would drop by 16 percent. The computable general equilibrium simulations stress the need to strengthen efforts to support structural transformation leading to diversification of export products and markets, improving backward and forward linkages, and lowering trade costs. The simulations also indicate that trade facilitation measures leading to an average decrease in trade costs of 2 percent per year would eliminate the negative consequences of the loss of American Growth and Opportunities Act preferences in terms of the loss of income. The changing external environment is likely to offer new opportunities to Lesotho's export industries in the medium term, including through regional integration under the Continental Free Trade Area.

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Small African Economies in a More Uncertain Global Trade Environment: The Potential Impact of Post-AGOA Scenarios for Lesotho¹

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1. Introduction

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 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. 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 countries' exports, though it is worth noting that almost all of these economies are much larger and the pace of poverty reduction in Lesotho does not seem to have accelerated as a result.

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 businesses have struggled to integrate into these 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 United States 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 re-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.

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 paper provides an overview of Lesotho's export competitiveness based on the analysis of publicly available data and evidence, by examining export dynamics and outcomes and using field interviews with representatives of the public and private sectors. 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.² It builds on this with CGE analysis of potential impacts based on specific trade-related scenarios. 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 poor.

As demonstrated in the paper, an immediate loss of AGOA preferences would have a significant economic impact 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 at which the industry operates. FTAs between the United States 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 a decrease of trade costs of an average 2% per year would eliminate the negative consequences of the loss of AGOA in terms of the loss of income.

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. This would include the following key issues: improving access to imported material inputs and technology in particular by i) pursuing tariff reductions within SACU and through bilateral agreements and ensuring that the country's duty drawback system functions more efficiently and effectively; ii) providing increased incentives to employers for training employees in the country's small but significant manufacturing sector in order to address skills gaps and the country's stagnant productivity; iii) improving market information on export opportunities to South Africa, Europe and other markets, as well as for products other than apparel to the United States through more effective export and investment promotion activities; iv) greater regional coordination on trade regulatory requirements and border management and v) removing restrictions on services. In this context, it would be advisable to review the existing institutional framework and determine to what extent it is still fit for purpose.

This paper is structured as follows. Section 2 analyzes the current policy and institutional framework. Section 3 examines the country's trade profile, including the role of trade preferences. Section 4 models the impacts of potential US policy changes. Section 5 concludes.

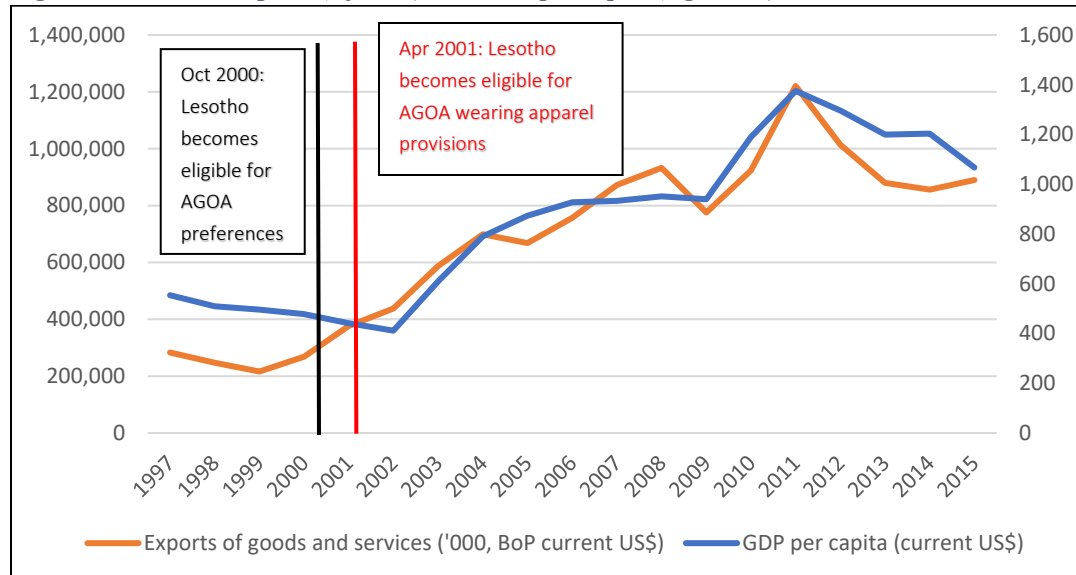
² Based on <http://mec.worldbank.org/buildercompare> these include Cambodia, the Dominican Republic, El Salvador, Honduras, Kyrgyzstan, Mauritius, Namibia and Vietnam. Based on discussions with officials and World Bank country experts, we have at times also added a few other TPP (Malaysia, Peru) and SACU countries (e.g. Botswana and Eswatini).

2. Overview of current policy and institutional framework: Opportunities and challenges

2.1. 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 United States through the African Growth and Opportunities Act (AGOA). 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



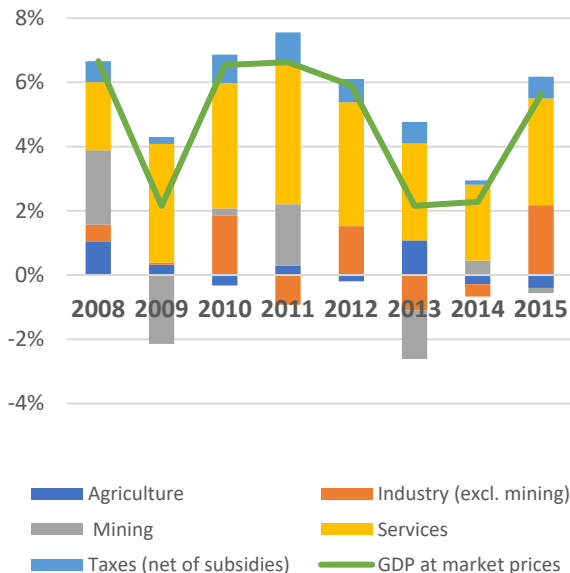
Source: World Bank World Development Indicators

However, over a decade of export-led growth has resulted in only limited poverty reduction, while inequality has worsened (World Bank 2017).³ Moreover, the dynamism of Lesotho's export sectors has in recent years stagnated and contributed to a significant worsening of its macroeconomic situation. GDP growth has remained at or below 5% since 2008. In terms of sectoral contribution, services have made a far more significant impact on growth than other sectors and following the discovery of significant diamond

³ 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.

deposits, mining has grown substantially in significance compared to manufacturing, while agriculture remains marginal in terms of value added to GDP (see Figure 2).

Figure 2: Contributions to GDP Growth, supply side



Source: World Bank (2017)

The country has faced unsustainably high budget deficits (9.3% in 2016/17). 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. This is exacerbated by political instability, high rates of HIV, tuberculosis and maternal and infant mortality,⁴ as well as significant exposure to climate-related stresses, including a prolonged drought in 2015/16. Social protection transfers targeted towards the poor have not been effective.

Reliance on revenue-sharing within SACU in order 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 in order 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.

⁴ Driven primarily by the high mortality and morbidity rates caused by the HIV-AIDS crisis, life expectancy in 2015 (50.0.years) was almost 10 years lower than it had been 1992 (59.6 years).

2.2. 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 modeled ILO estimates. Youth unemployment is almost 10% higher. The country has among the lowest labor productivity rates in the world and production remains very labor-intensive: compared to other Southern African countries. 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, the private sector remains small. Of this, MSMEs make up 85% 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).

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

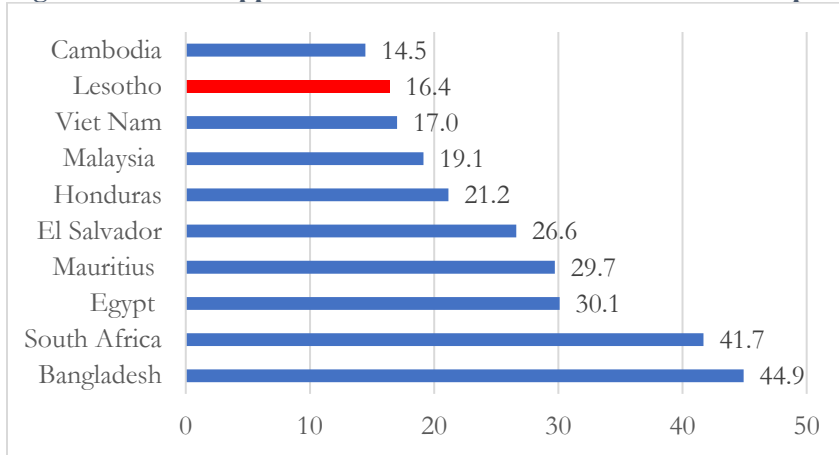
Source: Matsoso (2015)

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).⁵ The sector has considerably lower average wages than other manufacturing sectors such as leather and footwear, food and beverages and other manufacturing sectors.

⁵ 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.

Compared to other large apparel exporters, only a small part of value in exports is embodied in wages (see Figure 3). 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 2016).

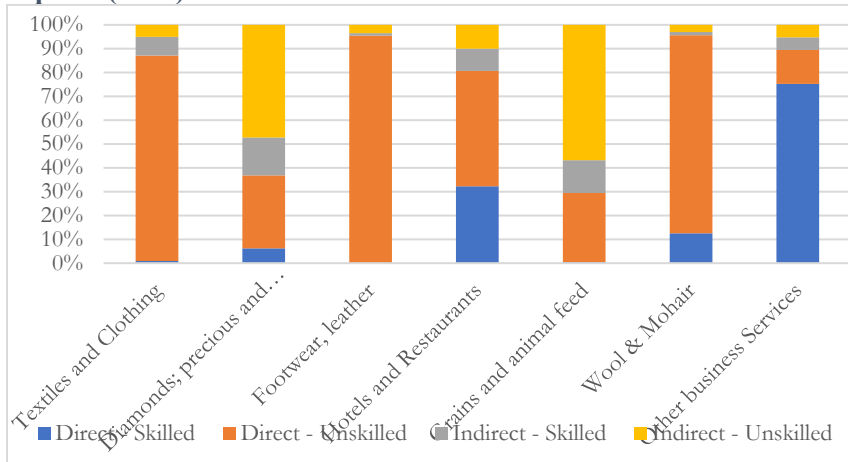
Figure 3: Textile/apparel labor value added as share of total export value



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 4). This indicates that sustaining apparel exports – or similar types of jobs – is essential to poverty reduction in Lesotho.

Figure 4: 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 database⁶

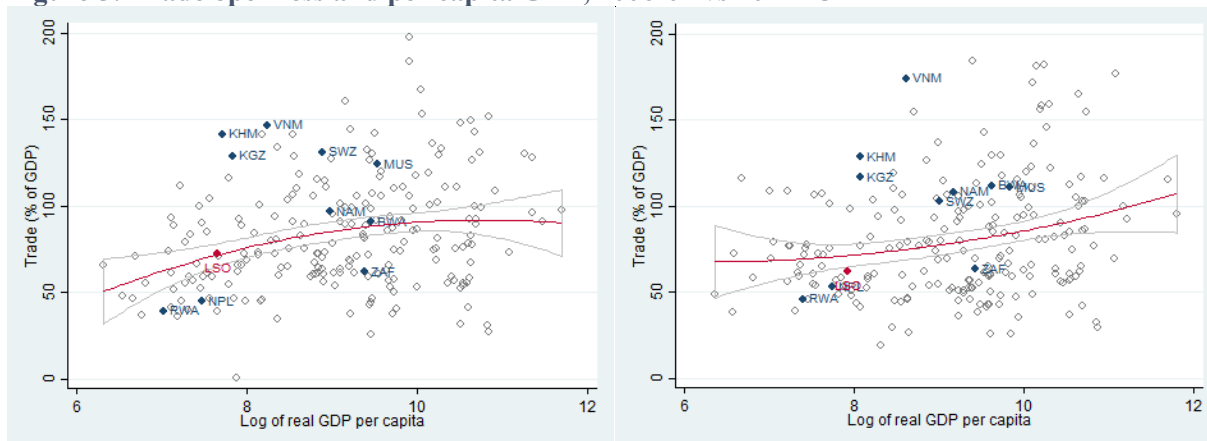
⁶ The Labor Content of Exports (or LACEX) database was developed by Cali et al. (2016) on the basis of a panel of global input-output tables and exports from the Global Trade Analysis Project (GTAP) and employment data from the ILO. The database measures the contribution of labor to a given country’s exports measured as employees’ compensation or wages (LACEX).

3. Lesotho 's trade profile and the role of preferences

3.1. 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 5). A comparison of the two panels also shows a decline in this regard, with Lesotho moving from being about on the best-fit line to substantially below the average for its level of development. Lesotho is less integrated in global markets than Botswana, Eswatini, and 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 5: 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 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 tariffs by key competitors like Vietnam (9.6%), Cambodia (5.4%), and Sri Lanka (3.3%) are significantly lower than in Lesotho. Furthermore, a significant 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.

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 to upgrading the services sector. Services are also key inputs to the manufacturing sector. As such, Lesotho must ensure that restrictions on investment in services do 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 & Saez, 2014). Policy makers 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 countries thrives while in others it remains undeveloped. 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. Its specific commitments cover 85 among the 160 subsectors included in the WTO Services Sectoral Classification List (UNCTAD 2013).

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. The main restrictions are seen in the retail sector, which has a score of 50, 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 mainly in mode 4, with limits placed on recognition of credentials of professionals from other countries, obstacles to obtaining a license.

3.2. Overview of trade growth and orientation

Lesotho's exports quadrupled over the last decade and a half with two different 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 recovery in 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).

Lesotho shows a high reliance on a few products and markets for its exports. 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. 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), the United States, and the European Union are destinations for 99% of exports. Additionally, there is virtually no product diversification outside South Africa since exports to the United States were mainly apparel (90.9%) and diamonds (8.9%), while exports to the European Union were almost solely diamonds (99%) in 2015.

Imports are more concentrated than exports in terms of trade partners. SACU (mainly RSA) 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 European Union and the United States accounted for less than 1% of imports.

3.3. Export diversification

Lesotho's exports are highly concentrated, as the country relies on very few products and markets for its exports. Apparel and mineral (diamonds) products account for 77% of total exports and very few sectors show 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.

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 United States and South Africa under AGOA and SACU, the average preferences granted to Lesotho's apparel exports in the United States 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 6 shows the decomposition of the total price paid in the United States 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 United States, it is clear that Lesotho's exports benefit significantly from tariff preferences. For instance, importers of synthetic women's trousers in the United States 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 be compensate for the effect of tariffs on the price of their landed exports in the United States.

Figure 6. Cost decomposition of landed duty-paid value of exports in the US (2015)



Source: Authors' calculations based on data from USITC

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. More significantly, while the number of products going to the European Union is greater than to the United States, over 30 products are greater than \$100,000 for the United States, and only nine go to the European Union – this is a decline of 50% compared to 2010.

Most apparel export products to the United States had stagnant or declining market share over the last decade. For one, Lesotho has been losing market share in the United States in 10 of its most exported products against Asian and Latin American competitors such as Vietnam, Malaysia, Bangladesh and Cambodia. The potential expiration 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 is granted duty-free status under the Generalized System of Preferences (GSP), the other major U.S. preferential program available to Lesotho.

Exports to the European Union are highly concentrated, with diamonds representing 98% of exports in 2015. The number of products exported to the European Union outside diamonds and the value of exports is very small. Fewer than 20 products over EUR 5,000 were exported to the European Union in any given year over the last decade and only four products recorded exports over EUR 1 million in 2015. Non-diamond exports were only able to surpass the EUR 3 million threshold twice in the last decade. Among non-diamond exports, the agricultural sector is the most important for the European Union. 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 despite the fact that apparel products benefit from zero duties and generous rules of origin in the European Union as a result of the preferences under the Everything But Arms (EBA) agreement. Lesotho has recently concluded EPA negotiations with the European Union that improve market access and may enable Lesotho to diversify into new exports.

Exports to South Africa are more diversified than to the United States and the European Union 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%.

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. In 2015, Lesotho was ranked 129 of 141 countries by the World Economic Forum's Tourism Competitiveness Index (WEF 2015). Among comparator countries, Lesotho has the third lowest ratio of foreign to domestic spending on tourism, after two other landlocked countries, Eswatini and Malawi. Lesotho could differentiate itself from other Southern African countries, with mountain ranges, clear water and snow in winter. To capitalize on its tourism potential, Lesotho needs to take some steps to enhance its infrastructure and train its human resources. Of 82 accommodation enterprises surveyed by a group of World Bank economists (Yiu and Saner 2015), less than 40% were considered "market ready".

4. Impacts of potential future external trade policy changes

4.1. Data, Modeling Framework and Scenarios

The CGE analysis aims to assess potential impacts based on specific trade-related scenarios, incorporating Lesotho in the GTAP database for the first time. 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 the Russian Federation, 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. We then 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:

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 modeling framework allows for the incorporation of complex interactions between producers, consumers and the government. It captures productivity differences at the country, sector and factor levels, shifts in demand as income rises, as well changes in comparative advantage and trade flows following trade liberalization. The analysis includes 17 sectors and 35 trading partners (see Table 2) 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) database⁷ version 9.2, benchmarked to 2011.⁸ The key macroeconomic variables and trade flows were then updated to the most recent data available for Lesotho (primarily from 2015).

Table 2: 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
Utilities	Vietnam
Construction	Brazil
Trade and transport	Russian Federation
Finance and other business services	India
Communication and business services	China
Social services	South Africa
	EU28
	Egypt, Arab Rep.
	Colombia
	Turkey
	Thailand
	Korea, Rep.
	Philippines
	Indonesia
	Bangladesh

⁷ <https://www.gtap.agecon.purdue.edu/>

⁸ We are grateful to Badri Narayanan for the incorporation of Lesotho SAM to the GTAP database.

	Cambodia
	Lao PDR
	Lesotho
	Ethiopia
	Sri Lanka
	Tanzania
	Southeast Asia
	Rest of Africa
	Rest of the world

Baseline

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

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 United States with greater 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 United States depending on investors’ assessment of the likelihood of Lesotho retaining the AGOA privileges.

Potential changes to Lesotho’s preferential margin have informed our analysis of select scenarios. The first hypothetical scenario analyzes the potential impacts of the sudden loss of AGOA privileges by Lesotho in 2018. Further, Lesotho’s export competitiveness could be eroded by potential free trade agreements between the United States and Lesotho’s major competitors. As documented in Section 3.3, 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. Finally, the last

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

scenario includes the implementation of trade facilitation measures that would reduce the trade transaction costs by 2% annually.

US-Vietnam FTA

This scenario assumes that the United States 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 the percentage NTM 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 United States 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. Moïsé and Sorescu (2017) estimate that a full implementation of the WTO Trade Facilitation Agreement could reduce trade costs in Sub-Saharan Africa by 18.3%.

4.2. Results

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 of textiles and apparel by 9%. 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-a-vis Vietnam is a legitimate reason for concern (the unit 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 3. 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: Authors' calculations based on LINKAGE.

To a large extent, the impact of the sudden loss of AGOA privileges would depend on the behavior of the textiles and apparel companies. Several 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 United States disappeared completely, our simulations indicate dramatic impacts on welfare. Under the hypothetical scenario of a complete elimination of exports to the United States (not reported here), total exports would drop by 15% relative to the baseline, which leads to a 5% decline in real consumption in 2020.

The above 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. Our simulations indicate that a decrease of trade costs of an average 2% per year would eliminate the negative consequences of the loss of AGOA in terms of the loss of income. Under the loss of AGOA privileges with trade facilitation scenario, 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 export 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 as a result 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 the 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 European Union, 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 European Union, 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 European Union is uncertain.

5. Conclusion

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 a number of 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 maximize 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, which can help improve gains for the poor, especially in rural areas; and iv) managing and mitigating risks faced by the poor through better data collection on the nature of the informal economy, the participation of women in trade, and of the trade-related constraints in general, which many countries face and continue to be large.

The challenges caused by a changing global economy and a growth model that has not done enough for the poor are 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 great strides in using trade and investment as a driver for growth, its growth has not been sufficiently inclusive.

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 United States and the European Union. 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. Policy recommendations moving forward include

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. 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.
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 United States.
4. Since a reduction in trade costs could substantially offset any risks from losing AGOA preferences, there would be substantial gains to a coordinated approach to trade regulatory requirements and coordinated border management and exploring cross-border coordination mechanisms with the South African authorities, among others.
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.

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