



Central Bank of Swaziland

***Annual Policy
Statement***

2006

MONETARY POLICY STATEMENT 2006

INTROUCTION

Swaziland's financial system has again proved resilient and stable despite global instability and the continued threat posed by inflation. The continued dual circulation of the lilangeni and rand, the existence of a peg arrangement between the two currencies, and mobility of capital within the Common Monetary Area (CMA) imply that Swaziland does not have independent control of its money supply. Under this arrangement, Swaziland has limited monetary policy autonomy. However, these arrangements have worked in Swaziland's favour as the economy has gained substantially particularly in terms of financial discipline and macroeconomic stability, partly reflected by maintenance of a low inflation rate in recent years, which, for instance averaged 4.8 percent in 2005.

Interest rates have been moving at relatively the same trend with indicative rates in South Africa. The Central Bank discount rate has been maintained at the same level as the South African Reserve Bank (SARB) repo rate, which has only been changed once during 2005 from 7.5 percent down to 7 percent. The continued policy of reducing interest rates from 2003 has had a significant impact on the growth of credit and money supply. The easing of the cost of credit has put significant upward pressure in the rate of increase in total credit extended by the banking sector. As at the end of December 2005, Money Supply – M1 increased by 19.4 percent following a peak of 24.8 percent in November.

During the 12 months to December 2005 strong domestic demand has been underpinned by growth in bank credit to the private sector, which

increased by 20 percent. The continued easing of monetary policy during the period under review, with its inherent increase in demand, has a potential of exerting pressure on demand for imports. This has, in part, a bearing on the continued role that the Central Bank has to play in maintaining an adequate external reserve position for the country.

Instruments available to the Central Bank to influence the level of credit creation and to control liquidity of the banking system are open market operations, the discount window facility, and liquidity and reserve ratio requirements. During 2005 the Central Bank saw no reason to use liquidity and reserve requirement to leverage the banking system's ability to create credit. The less restrictive monetary policy stance has shown its effect through a growing tight liquidity position as evidenced by growth in the loan to deposit ratio from 97 percent in January to 110.4 percent at the end of December 2005. Even at this level, however, banks still maintain surplus liquidity, which has declined by 37.7 percent from the beginning of 2005.

The maintenance of low interest rates during the year was threatened by signs of inflationary pressure coming from the persistent increase in the international price of crude oil. However, the continued stability and strength of the rand during the year helped to cushion the adverse effects of an increase in the price of oil. Having maintained an inflation rate of 5 percent and below during the first three quarters of the year, inflation rose to above 6 percent during the quarter ended December 2005.

The rate of growth in domestic demand will determine whether or not to continue with the less restrictive interest rate policy in 2006; whilst the inflation trend will be determined by two exogenous factors namely, oil and food price developments. The higher oil prices have already seen the

domestic petrol price being increased 6 times to E5.50 per litre in 2005. It is anticipated that the strength of the currency will be buoyed by strong capital inflows during the year. However, any weakness in the unit will see inflationary pressures at play, as the continued increase in oil prices does not show any signs of slowing down. This development may be a threat to the less restrictive interest rate policy.

Swaziland's continued membership to the CMA is being maintained as it has clearly demonstrated that such stance provides financial discipline. This relationship, despite the appreciation of the rand against major currencies, has undermined the country's competitiveness but has also proved to have a buffer against high inflation rates. Maintenance of low inflation rates is a pre-condition for growth and better living standards.

International, regional and domestic developments have strongly underpinned monetary policy stance during 2005, as comprehensively outlined below:

REGIONAL AND INTERNATIONAL DEVELOPMENTS

During 2005 the world financial system was relatively stable underpinning healthy economic growth. Global economic performance for 2005 is estimated at 4.3 percent with slightly reduced growth potential for the year 2006. In the Sub-Saharan Region, growth remained strong at 5 percent during the year 2005 despite increasing oil prices, growth remained strong at over 5 percent. Real gross domestic product growth in Sub-Saharan Africa is projected to be sustained at an estimated 5.3 percent in 2006. Despite this outstanding performance, economic growth levels still fall short for most countries to achieve the Millennium Development Goal (MDG) of poverty reduction. Average inflation in Sub-

Saharan Africa has edged up to double digits in 2005, reflecting, in part, an increase in oil prices, however the rate of increase is expected to fall in 2006.

The South African economic growth rate has continued to be robust over the past year. The gross domestic product is estimated to have increased in excess of 5 percent in 2005. The continuing low level of interest rates has stimulated consumer spending which has led to an increase in investments. The strong economic growth is a result of macro-economic stability, which has been strengthened by a healthy investment environment. There is a clear indication that fiscal and monetary policies continue to support growth. Higher growth rates will be recorded in the New Year. However, given a less restrictive monetary policy, imports have grown substantially and so is the current account deficit in the balance of payments. This has, however, been cushioned by ever increasing capital inflows from abroad.

SWAZILAND RECENT ECONOMIC DEVELOPMENTS

It is almost a decade now that the country last experienced growth levels in excess of 5 percent. These developments reflect, in part, political changes in the early 90's, which opened up Swaziland to compete with a well-advanced economy of South Africa. In addition, domestic factors, such as the poor performance of the agricultural sector as a result of continued drought, slowdown in manufacturing output, worsening of HIV Aids pandemic and changes in international trade arrangements affecting the country's major exports particularly sugar and textiles have exacerbated the slow growth rates.

Foreign direct investment has continued to decline from an annual average of 7.1 percent of GDP in 1985/93, 4.7 percent of GDP for the eight years ending 2002, to 2.5 percent of GDP in 2004. The worsening of the country's challenges are an indication that there maybe a need for some structural adjustment which will create an environment that will be conducive to economic growth.

The strong exchange rate of the rand/lilangeni against major currencies during the past two years has eroded the competitiveness of domestic exports and adversely affected the country's overall balance of payments which has deteriorated, resulting in three consecutive years of overall deficits. The country's net foreign assets as at the end of December 2005 declined by 8.9 percent, equivalent to 1.9 months of imports.

Macro Indicators

The expansion of economic activity slowed down in 2005 after growth of 2.1% in 2004. Official estimates put real GDP growth at 1.8% in 2005. Given the estimated population growth rate of 2.9%, the unimpressive economic growth implies a deterioration of the standard of living as measured by per capita income.

The downward trend in economic performance in 2005 is a reflection of the low growth rate in foreign direct investment, weaker performance of the manufacturing sector and low agricultural productivity particularly on Swazi Nation Land. The slump in agricultural production was a result of a prolonged drought in the region, which resulted in a serious food shortage particularly maize, the main staple crop. This development exacerbated the already severe problem of high unemployment, income inequality and poverty.

Growth in manufacturing output slowed down in 2005 following the closure of some major companies and weaker performance of the manufacturing sector emanating from the substantial real appreciation of the Lilangeni exchange rate. The real appreciation of the domestic currency against the US dollar and other trading partners' currencies during 2005 reduced the Emalangeni value of exports destined to markets outside the Common Monetary Area. Also, the strong local currency impacted negatively on overseas tourists' inflow by reducing their purchasing power, thereby making domestic goods expensive.

A downturn in FDI inflows notably in the textile industry contributed to the slowdown in manufacturing growth in 2005. Swaziland's clothing and textile industry, which significantly increased its exports and created thousands of jobs under AGOA, was threatened with the Agreement on Textiles and Clothing (ATC). The ATC's final implementation came into effect in January 2005, lifting all quota restrictions on clothing and textile exports and paving the way for more cost-effective producers, such as China and India, to increase their exports to global markets. The textile and apparel sector is now guided by a multilateral system of trade rules under the General Agreement on Tariffs and Trade. This multilateral trade regime aims at improved trade fairness and treats all countries equally. In the face of these changes, garments and apparels from Swaziland are increasingly becoming price uncompetitive, something that has caused factory closures in the country. This sector is gradually seeing buyers particularly from the US moving orders to the Far East. The closure of the factories and the resulting loss of jobs are serious threats to continued economic growth.

The above notwithstanding, the moderate growth in manufacturing output was spurred by positive performance of some export commodities including sugar-based products and soft drink concentrates. Overall

growth in 2005 also benefited from increased construction activities due to ongoing road and housing projects. Furthermore, the strong economic performance by South Africa in 2005 boosted Swaziland's export demand since over 50% of country's exports are sold in South Africa.

Other macroeconomic indicators re-affirm the sluggish performance of the economy. Swaziland's gross national savings as a percentage of GDP stood at 19.1% in 2005, showing a slight deterioration from the previous year's 20.5%. The fall is attributable to increased government spending as evidenced by the deterioration in Government net balances with the banking system. Also contributing to the lower rate of Government savings has been the rising consumption expenditure matched with lower growth in non-SACU tax revenue. Government's national savings was 3.7% of GDP in 2005. Meanwhile, net transfers from abroad, which comprise mostly SACU receipts, continued to command a large share of Government savings as a major source of Government revenue.

The dependence of government on SACU receipts is not healthy for the country in view of the likelihood of SACU-related revenue decreasing in the future. This problem has to be immediately addressed by Government, as it might not only have far reaching consequences on the country's ability to raise national savings and thus its ability to invest, but it might also lead to unsustainable budgetary pressures and an undesirable debt profile in later years.

Gross investment on the other hand remained very low despite the high level of private savings in the country. Private investment continued to dominate gross investment with a share of 10.5% of GDP in 2005, as opposed to 8% of GDP for public investment. The high savings by the private sector should have led to an increase in gross investment. However, this has not been the case as gross investment has continued

to fall due to a number of reasons. The relatively high returns in South African financial markets have resulted in net outflows from Swaziland to South Africa.

Employment projections indicate a contraction in formal employment, which is inline with the projected poor performance of the economy in 2005. The contraction in formal sector employment is attributed to the reduction in private sector employment. The strong lilangeni exchange rate, the loss of preferential markets and the reduction in the sugar price was responsible for the slowdown in employment during 2005. Companies continued to shed jobs due to the erosion of the competitiveness of export products, which in turn lowered their profitability. A number of textile companies closed their operations whilst others in the manufacturing and agricultural sectors scaled down their operations. Further more the ability of the economy to create employment opportunities has been hindered by the slowdown in FDI inflows mainly driven by the poor perception about the country coupled with the global economic recession.

Employment prospects for 2006 remain bleak largely as a result of the negative impact of uncertainties surrounding AGOA extension, as well as the implementation of the Agreement on Textiles and Clothing. Although there have been no large disinvestments from Swaziland, some clothing and textile firms have closed down during the first two months of 2006 and job losses in the textile sector are estimated at 10,000 in 2006. The sugar industry is also expected to shed a significant number of jobs during the course of 2006 as a result of unfavourable developments in the international sugar markets.

The HIV / AIDS pandemic has continued to pose a major threat to economic growth and has had a severe impact on poverty levels, which

have been escalating over the years. HIV / AIDS statistics indicate that the prevalence rate among women attending ante-natal clinics increased from 39% in 2002 to 43% in 2004. The statistics also show an increase in the number of orphans being taken care of by the elderly people as well as an increase in the number of elderly people with no support mechanisms. The efforts by government through the National Emergency Response Committee on HIV and AIDS in coordinating a national strategy against the pandemic and the drive to provide free education for the increasing orphans and vulnerable children are commendable. However, much still remains to be done in the fight against the pandemic including the uninterrupted provision of anti-retroviral drugs to the critically ill.

External Sector

Swaziland's Balance of Payments has shown persistent deficits in the last 3 years. Revised balance of payments data for 2004 depicts an improved overall deficit of E237.4 million from E467.3 million in 2003. The narrowing of the deficit was due to surpluses recorded in the trade account, income account, and the current transfers account. Yet another deficit is envisaged for 2005, although it will be lower due to increased export volumes by major companies, which tended to cushion the negative impact of the appreciation of the Lilangeni exchange rate on export revenues.

The current account posted a surplus of E401.4 million in 2004, a notable decline from the surplus recorded the previous year, as the trade balance narrowed significantly. The services account deficit, after recording declining deficits for the past three years, increased by 40.3 percent on higher transportation services imports.

The trade account surplus declined from E623.7 million to E138.8 million in 2004. Despite the closure of some exporting companies in the manufacturing sector and the stronger rand/lilangeni exchange rate through out the year, merchandise export (f.o.b) are expected to grow by 4.8 percent to E12,593.3 million. Notwithstanding adverse developments in the textile sector, other exporting companies particularly in the beverage sector counteracted the negative impact of the appreciating rand/lilangeni by embarking on a more aggressive approach to improve sales and competitiveness in the international markets. The exports of soft drink concentrates, sugar, wood pulp, canned fruit products, and refrigerators recorded increases while sugar, cotton-yarn, textiles, meat products and zippers recorded declines.

Imports (f.o.b) are expected to increase by 9.4 percent to E12,437.1 million in 2004. The growth in merchandise imports were influenced by government expenditure on construction projects, increased automobile imports and higher oil prices.

Swaziland continued to be a net importer of services as the balance on the services account deficits grew from E346.3 million in 2003 to E486 million in 2004. Service receipts include income from tourism, financial services, insurance, and other business related services. Transportation services inflows, which include Swaziland Railways declined by 6.2 percent. Imported services are composed of mainly construction services, technical services, computer and information services, and miscellaneous and other business services.

The income account registered a net inflow of E124.8 million in 2004 from a net outflow of E25 million the previous year. Income inflows, which is comprised mainly of compensation of employees including

border and other seasonal workers, interest earned on investments abroad by both the official and private sector shrunk by 14.3 percent to E930.4 million in 2004. Income earned was affected by among others; lower interest rates prevailing in the investment markets including South Africa, and the generally strong exchange rate that eroded offshore earnings of the official sector. Disinvestments by several companies resulted in a swing in reinvested earnings and undistributed branch profits from an inflow to an outflow. Payments by government on interest and commitment fees declined slightly reflecting the sustained strength of the rand/lilangeni against the US dollar.

In the current transfers account, non-duty SACU receipts continued to dominate the current inflows in 2004 and as a result net current transfers improved from E421.8 million to E623.9 million. Contributions to international organizations usually paid in hard currencies, increased by 12.4 percent, as a result of higher subscriptions and an increase in the number of international organizations the country is affiliated to, while import duties collected by South Africa under the customs arrangement grew in line with imports.

The financial account excluding reserves posted an outflow of E931.6 million with significant outflows in both the portfolio investment and other investments accounts.

Investments in debt securities resulted in portfolio investments increasing to E70.9 million in 2004. Other investment outflows were dominated by contributions to the public sector pension funds and the repayment of a central bank liability. Commercial banks increased their foreign assets by E10.2 million and reduced their foreign liabilities by E10.7 million.

Monetary Sector

Monetary conditions were characterized by a generally stable and less restrictive monetary policy environment, reflecting low rate of inflation particularly in the three quarters ending September 2005 where the average inflation was 3.9 percent, compared with the last three months average inflation which was above 6 percent. Domestic interest rates were adjusted downwards only once during the year in April 2005. Central Bank discount rate was reduced by fifty basis points to 7 percent and the prime rate at 10.5 percent. In order to manage the flow of funds between Swaziland and South Africa, the objective of the Central Bank will continue to focus on closing the differentials in interest rates prevailing in both countries. However, domestic deposit rates remained relatively low and negative in real terms. Currently the 31 days and 12 months rates are on average at 3.41 and 3.46 percent respectively.

Reflecting relaxed money conditions, the only domestic money market rate, i.e. the Treasury bill rate was generally on the decline and stood at 6.8 percent in December 2005 compared to 7.6 percent in December 2004.

Outstanding treasury bills stood at E387 million in December 2005 compared to E474 million in December 2004. Local banks held 69.5% of treasury bills outstanding, 26.2% by Central Bank of Swaziland and 3.6% by non-banking financial institutions.

Net foreign assets fluctuated from month to month on a generally downward trend. During the year ended December 2005, net foreign assets recorded a decline of 8.9 percent, enough to cover only 1.9 months of estimated imports.

Escalation in government expenditure growth in excess of growth in revenues was the major contributor to the decline in reserves. The strong Lilangeni exchange rate led to revaluation losses on nominal foreign exchange reserves. In co-operation with the Ministry of Finance, the Central Bank of Swaziland's efforts will be devoted to strengthening the reserve management function in order to build up reserves to acceptable levels. In this regard, the Government has allocated E400 million towards the cushioning of the country's reserves. Coupled with the estimated budget deficit of 2% of GDP in 2006/07, this will go a long way into improving the reserve position.

Given the low interest rate environment, credit extended to the private sector grew at a remarkable rate of 20 percent. Most of the credit growth was to agriculture, manufacturing and household sectors.

The net creditor position of government with the banking system fell by 9 percent during the review period as government continued to draw down on its balances to finance expenditure.

Consequent to the credit expansion during the review period, broad money balances grew by 8.7 percent and the increase was in narrow money i.e. demand deposits and currency in circulation. Interest earning deposits only showed a marginal increase in response to the low interest rate environment.

Bank's total liquid assets declined by 2.2 percent to close at E548.7 million. The decline is a reflection of the continued decrease, which has increased credit suppression, and a lower rate of growth in deposits due to the prevailing low interest rate structure.

Price Developments

Price developments in Swaziland, as measured by the consumer price index, showed that inflation increased steadily during 2005, reversing the downward trend observed in 2004. The annual average inflation rate increased by 1.4 percent to record 4.8 percent from 3.4 percent registered the previous year. However this rate was less than the Central Bank's forecast of 5.3 percent indicating that inflationary pressures remained lower than expected. The strong lilangeni/rand exchange rate coupled with lower imported inflation from South Africa, the country's main trading partner helped cushion inflationary pressures emanating mainly from the hike in food and crude oil prices.

Responsible for the increase in inflation during 2005 were increases in the price indices for food, education and transport and communication. Food prices, which account for almost 25 percent of the consumer basket, remained a key factor in the movement of the overall index. Food inflation surged to an annual average of 9.1 percent in 2005 from an annual average of 6.9 percent the previous year. Inflationary pressures also came from high crude oil prices which increased from a low of US \$28/barrel to a peak of US \$70/ barrel in August and is currently hovering around US \$60/ barrel. However the full impact of the rise in crude oil prices was dampened by the strong lilangeni/rand exchange rate. The rise in crude oil prices resulted in an increase in petrol prices in Swaziland, which culminated in 50 percent rise in commuter fares. Consequently, the index for "transport and communication" rose by 5.4 percent compared to an increase of 0.5 percent in 2004. The continued inflation related wage settlements are set to harm the economy, as there

is a potential of putting further pressure on prices, exacerbating the competitiveness of the country as a favourable investment destination.

Fiscal Sector

The budget deficit for 2004/05 stood at E778 million, 4.5 percent of GDP, a worsening position when compared to the budget deficit of 2.9 percent of GDP recorded the previous fiscal year. The estimated outturn for 2005/06 shows a deficit of 4.3 percent, mainly due to unexpected increase in SACU receipts.

Public expenditure continues to increase faster than revenue. This has resulted in persistently deteriorating government cash flow position from quarter to quarter. The largest share in total expenditure is recurrent expenditure. Personnel costs alone accounts for about 60 of recurrent expenditure whilst expenditure on goods and services are also rising rapidly. The ever-increasing recurrent expenditure is undesirable as it is mostly consumption than pro-growth. There is an urgent need for government to implement fiscal reforms particularly reviewing the procurement procedures and alternative service delivery. The unsustainability of the current level of personnel expenditure, as a result of increasing salaries, has resulted in an urgent need to reduce the size of the civil service. The rightsizing project will start with the Voluntary Early Retirement Scheme proposed to start in 2006/07. The end result is to bring the share of personnel expenditure to about 35 percent of the recurrent budget.

Government revenue including grants is projected to rise by 12.1 percent to about E5,429.7 million in 2005/06. The reliance in SACU receipts, which contribute more than 50 percent of government revenue, is not

good for the country since there is a growing international pressure to reduce dependence on trade taxes. Customs Union receipts are expected to decline because of the number of free trade agreements, which are under negotiation and this has negative fiscal implications. This calls for government to diversify the revenue base.

The 2006/07 budget projects a lower deficit of E373 million, 2 percent of GDP. This is an improvement from previous fiscal years. Personnel expenditure, which includes the recent salary review for civil servants, implementation of salary increments awarded to members of parliament and the Voluntary Exit Packages constitutes 58 percent of the recurrent expenditure.

Government hopes to attain the deficit of 2 percent of GDP by implementing cuts in recurrent expenditure for line ministries and departments, and thereby improve service delivery. This will eliminate the problem of approving a high budget and even supplementary budgets knowing very well that there are no resources to implement some of those activities. Also, one or two big capital projects will be stalled and no new projects will be undertaken in 2006/07. Revenue collection will be strengthened to reduce the dependency on SACU receipts. This will include establishment of a Revenue Authority before the end of fiscal year (2006/07). In addition government is expected to introduce VAT within two years.

Swaziland's external debt in Emalangeni terms recorded a slight increase primarily due to disbursements to finance huge government projects. At the end of December 2005, preliminary figures for total external debt stock including private sector non-guaranteed debt stood at E2,991.6

million, denoting an increase of 9.5 percent from E2,732.8 million recorded in December 2004.

Multilateral organizations constituted the largest share of the public debt portfolio with E1,460.9 million outstanding, followed by bilateral and private creditors (mainly commercial banks) with E910.1 million and E228.9 million outstanding, respectively. Public and publicly guaranteed external debt stood at E2,599.9 million at the end of December 2005, reflecting an increase of 11.2 percent from the previous year. The central government debt, which constitutes the largest share at 77.6 percent of the total debt stock, stood at E2,321.4 million, an increase of 15.4 percent. During the year, government has hedged part of the external debt denominated in hard currencies as part of the debt strategy, in order to mitigate the impact of the volatility of the exchange rate. Total external debt as a ratio of GDP stood at 18.4 percent, while public debt service to export of goods and services stood at 22.4 percent at end of 2005.

BANK SUPERVISION DIVISION

Organisation of the Banking Supervision Division

The Bank's responsibilities are to promote the safety, soundness and stability of financial institutions in Swaziland. The objective is to promote depositor's interest, maintain financial stability and promote competition and efficiency. These supervisory functions are carried out through a consistent and continuous monitoring of the operations of the banks and the enforcement of prudential regulation, policies and practices.

Financial Sector Performance

The performance and condition of the industry is based on the level and trends in capital, asset quality, earnings and liquidity management. The industry appears to be well-capitalised, supported by sufficient earnings and strong liquidity. All banks during the period ended 31 December 2005 remained well-capitalized with the average risk weighted capital adequacy ratio for the system as a whole reported to be well above the required minimum of 8.0 percent of total risk weighted assets.

The continued viability of a financial institution depends on its ability to generate sufficient and appropriate returns on its assets and capital. Good earnings performance enables a financial institution to fund its expansion, remain competitive and replenish and or increase its capital base. All the banking institutions reported marginal profits in their quarterly returns to the Central Bank of Swaziland during the year 2005.

Liquidity remains to be one of the most fundamental aspects used to determine the soundness of a bank. Several indicators show that the Swaziland banking sector had sufficient liquid assets and that these are continuously maintained at a healthy position with liquid assets to total liabilities to the public in Swaziland higher than the minimum statutory requirement of 13.0 percent for commercial banks and 10.0 percent for the Swaziland Development and Savings Bank. Furthermore, the issuing of lucrative government securities, which are classified as liquid assets, attracted banks and financial institutions to hold them in their investment portfolios. Average industry liquidity ratio for the year 2005 remained slightly above 17.0 percent. Banks that were noted and considered to be maintaining consistent bare minimums are monitored

closely and encouraged to improve funds management and internal controls with the aim of remaining sound and liquid at all times.

On-Site Examination

A full scope on-site examination was carried out on an institution. The examination covered an appraisal of the institution's management oversight, capital adequacy, assets quality, earnings performance, liquidity position, and assessment of its compliance with legislation. It also covered the assessment of proper maintenance of records and adequacy of systems of internal controls. These factors were found to be satisfactorily managed.

The Bank Supervision Division has just commenced an on-site inspection of another and the targeted completion date of the inspection is end of March 2006 and the final report would be ready before the end of April 2006.

Off-Site Examination

The Bank receives prudential returns from banks and the Swaziland Building Society for analysis and consolidation to enable it to determine the institutional as well as the industry growth patterns and compliance with statutory and regulatory requirements. This process assists the Division to be able to track any early warning signs of incipient operational weaknesses and allows for prompt intervention.

On governance issues, during the year 2005, the Central Bank of Swaziland received seven (7) applications seeking for prior approval and appointment to Board of Director positions in the banking sector. All

appointments were sanctioned and the banking industry saw a change in executive positions of two commercial banks.

Furthermore, the Division continued to monitor the expansion of the banks' branch networks and approved the establishment of one new branch in Manzini. This resulted in the representation of banks changing during the year in terms of branch network, encashment points and Automated Teller Machines (ATMs). Some banks introduced mini ATMs to expand their representation. The total number of ATMs including mini ATMs as at the end of December 2005 was 75 indicating an increase of 28 from December 2004. This huge increase can be attributed to the introduction of Automated Teller Machines by the Swaziland Development and Savings Bank, which installed 17 machines countrywide.

No bank license applications were received in the year under review, although the Bank received a number of enquiries on the establishment of banking operations in Swaziland.

Legislation and Regulation

The Financial Institutions Bill has been gazetted into law and its effective date is 17 December 2005. This new law entitled the "Financial Institutions Act, 2005", seeks to address among other things the following issues; -

- Incorporation of the Basle Core Principles for Effective Bank Supervision as endorsed by the SADC Committee for Bank Supervisors;
- Implementation of consolidated supervision;

- Exchange of information with other Central Banks or Supervisory authorities;
- Investigations of institutions taking illegal deposits;
- Enhancements of auditors duties;
- Seizure, winding up and re-organisation of financial institutions;
- Prudent and sound corporate governance for financial institutions.

With regard to Non-Bank Financial Institutions, the draft Financial Services Regulatory Authority Bill (FSRA) has been submitted to the Ministry of Finance and awaits Cabinet approval. Through the recommendations of the IMF the Bank is looking into ways of setting up appropriate measures for transition to FSRA by creating capacity in the Banking Supervision Division to train supervisors to supervise non-bank financial institutions.

New Developments in Banking Supervision

New issues keep coming up that require the attention of Bank supervisors worldwide. Within Swaziland some of the issues that have pre-occupied the Division are the introduction of the New Capital Accord (Basle II) and the implementation and stabilization of the Bank Supervision Application System (BSA). In that respect, some members of staff attended courses and conferences on these developments in a bid to enhance supervisory knowledge and skills amongst staff.

Bank Supervision Application (BSA) System

The BSA system has been operationalised and all the banks have started sending their prudential returns electronically. The Swaziland Building Society is set to finalise their full take-on utilization of the BSA system. The Swaziland Building Society will have a three months testing phase commencing end of January 2006.

Basle II

The first Project Team meeting on the implementation of Basle II was held at the Central Bank of Swaziland on 7th February 2006. The Project Team comprises of representatives from all the banks and the Swaziland Building Society and all staff members of the Bank Supervision Division. The Project Team meetings shall be held once in two months and the frequency of the meetings will be reviewed, as the implementation date gets closer. It is worth noting that all subsidiaries of South African Bank Holding Companies are required to ensure that their implementation date for Basle II is 2008. These are Standard Bank Swaziland Limited, Nedbank (Swaziland) Limited and First National Bank of Swaziland Limited.

The transition from Basel I to Basel II in the Swaziland banking industry presents some unique challenges for financial institutions and supervisors alike. Once implemented, the objective of maintaining a strong, stable and vibrant financial system will be achieved.

NATIONAL PAYMENT SYSTEMS

Payment and settlement systems operated by the financial institutions in Swaziland are closely monitored by the Central Bank of Swaziland. This

is mainly to ensure the stability of the financial system and implementation of monetary policy.

The Clearing and Settlement System

The Swaziland Automated Clearing House (SAECH) continues to operate smoothly and the participating banks are successful in both their submissions and receipts to and from SAECH together with the accurate and timely distribution of data to the Central Bank for settlement.

The introduction of the second clearing session in June 2005 has seen a tremendous increase in volume and value of paper-based instruments presented and processed through SAECH on a daily basis.

High Value Payments

In order to allow for high value payment instructions to reach finality and irrevocability, on the same day, the Bank will introduce a capped value limit of E1, 000,000.00 on cheques cleared through SAECH. The electronic funds transfer system, which is now fully operational and other payment streams soon to be introduced e.g. The Real Time Gross Settlement System, will cater for payments above this limit.

Introduction of a Real Time Gross Settlement (RTGS) System

The Bank has initiated the process to implement an RTGS system. The RTGS ensures that transactions are electronically settled with finality and irrevocability on gross (i.e. item by item) being on continuous bases

throughout the day. It will be the core mechanism through which large value inter-bank payments and final net settlement obligations, submitted by the Swaziland Automated Clearing House are settled.

Once in operation, the system will significantly reduce systemic risk in the country's payment environment and enabling participants in the system to make immediate settlement and monitor their payment flows and settlement account balances, held with the Central Bank in real time.

International Aspects of Reforms

- **Cross-Border Flows**

Recent developments in emerging markets around the world have resulted in a gradual shift of economic power from western nations to emerging economies. This shift has in turn increased the complexity of demands for correspondent banking. This expansion has been helped along by favourable policies on liberalization and deregulation (reduction in tariffs). Liberalization has taken the form of reduced exchange controls culminating into higher volumes in cross border investment flows.

- **Oversight of Payment & Settlement Systems**

The oversight of payment & settlement systems has become one of the key responsibilities of a Central Bank, whereby the objectives of safety and efficiency are promoted by monitoring existing and planned systems, assessing them against these objectives and where necessary induce change. The Central Bank of Swaziland is in the process of developing a fully-fledged unit with qualified personnel to carry out this function.

- **Financial Sector Assessment Programme (FSAP)**

The Central Bank of Swaziland, together with other member countries in the SADC region will in the near future be engaged in a programme which is aimed at evaluating and identifying strengths and weaknesses in observance of the Core Principles for Systemically Important Payment System(s), prescribed by the Bank for International Settlements, as part of cooperative initiatives in national payment systems worldwide.

CAPITAL MARKETS DEVELOPMENT UNIT

Regulatory Framework

- **Securities bill**

The bill has yet to be presented to parliament. When passed, the draft legislation will provide an infrastructure for the licensing, registration and regulation of securities exchanges, dealers and their representatives, investment advisers and their representatives, collective investment schemes, managers and trustees or custodians under collective investment schemes, central securities depositories and nominees. It will also regulate the conduct of securities business and public offers of securities and outlaw improper trading practices and insider dealing in securities.

All necessary consultations have been held with the Ministry responsible; and we are optimistic that the process will be taken forward without further delay. The Bank is keen to see the development of a vibrant capital market in Swaziland.

- **Financial Services Regulatory Authority Bill**

The bill, which is also outstanding, brings under one regulatory net all non-bank financial institutions in the country such as insurance companies, retirement funds, building societies, capital markets and intermediaries.

- **Other legislation**

We welcome the promulgation of the Retirement Funds and the Insurance Acts. We hope that other pending legislation which impact on the financial services sector such as the Companies Bill (No. 7 of 2004), the Competition Bill, the Anti-Money Laundering Bill, 2004, and the National Clearing and Settlement Systems bill will also be passed in the near future.

International cooperation

- **Committee of Insurance, Securities and Non-Bank Financial Authorities (CISNA)**

CISNA, established in 1998, consists of the regulators of capital markets, retirement funds and insurance services in the Southern African Development Community (SADC) region. CISNA's strategy, first developed in 2000, has since been revised. There are, in particular, four priority areas that have been identified:

- **Regulatory gaps**

Each member country must identify regulatory gaps within its jurisdiction and draw plans how to address all the weaknesses identified.

We are however, unable to participate meaningfully in this exercise in the absence of the requisite legislation.

- **Consumer/investor education policies and practices**

Members have agreed to collaborate with other consumer-related bodies to look at ways of identifying community consumer financial education needs within each country; and implement appropriate consumer education strategies.

- **Training and development programme**

A report on the training needs of members is being compiled. Meanwhile, First Initiative has approved funding for a project that will introduce and rollout a comprehensive and sustainable multi-year training package for non-bank financial institutions regulators in the region. The purpose of this project is to put in place a comprehensive multi-level and multi-year training programme for non-bank financial institutions regulators within the SADC region that will address their shared training needs.

- **Corporate governance standards and practices**

A survey is being conducted on practices in member countries. It should be noted that the listings requirements adopted by the SSX already incorporate best practice in the field.

Collective Investment Schemes (Unit trusts)

The number of authorised management companies remained at two (2) during the period under review; and schemes under management decreased to seven (7).

The Swaziland Stock Exchange

- **Market Developments**

During 2005, performance was somewhat disappointing when compared to performance in other regional exchanges. The All Share Price Index ended the year lower at 156.68 points from 157.1 points registered at the end of 2004. The decline in the index was attributed to a fall in the share price of one major counter, which was, however, partially cushioned by the increase in the share price of three counters.

The year under review saw the listing of a new corporate bond, issued by a commercial bank. This brings the number of listed bonds at the close of 2005 to five (5). The nominal outstanding value of the remaining bonds stands at E259 million.

There were no major developments on the equities market as the number of listed companies remained at six (6). At the end of the period under review, market capitalisation declined marginally to E1,245.2 million from E1,250.9 million recorded at the end of 2004.

The volume and value of shares traded continued to decline. A total of 63,273 shares worth E187,484 were traded in 2005 compared to a total of 72,485 shares worth E245,405 traded during 2004.

- **Public Awareness**

The SSX intensified its education and awareness campaign. To this end, a brochure titled “How to List on the Exchange” was published. It is used by the exchange to create awareness amongst companies about the opportunities of funding their operations through the medium of the exchange.

Further, the Schools Challenge was held for the second year running and the exchange was represented at the International Trade Fair. A number of presentations were made to various groups of people.

The exchange continues to disseminate information through both print and electronic media. The exchange's website was revamped to make it more user friendly and the Developments Report was published and distributed to various stakeholders.

- ***Regional and international affiliations***

Committee of SADC Stock Exchanges (COSSE)

The SSX has aligned itself very closely with the initiatives of the Committee of SADC Stock Exchanges. One of COSSE's main objectives is to harmonise listings requirements and attain integrated computer linkages among its members by 2008.

World Federation of Exchanges (WFE)

Further, the SSX is a correspondent member of the World Federation of Exchanges, which has laid down a set of Market Structure Best Practices that provide guidance to the minimum level of organisation, regulation and supervision a securities market need to have in order to qualify as an organised market. These Practices also serve as a checklist for those security markets wishing to become members of the WFE. The SSX has adopted and incorporated the WFE of Principles into its Action Plan, 2005-2008 and shall be guided by them in its endeavours to develop the securities market in Swaziland.

- ***The SSX Development Strategy, 2005-2008***

The SSX undertook a performance appraisal over the last sixteen years through a selected number of indicators to demonstrate movements and trends. It reviewed the evolution of market capitalisation as a percentage of GDP, growth in the number of listed equity companies, performance of the index, and the liquidity ratio, which measures the turnover of shares as a percentage of market capitalisation.

The strategy document attempts to identify constraints and challenges facing the exchange. These include poor liquidity, concentration of trading activities on few counters, a free float that is below the agreed minimum for COSSE members (at twenty (20) percent), the behavioural patterns of local investors who are used to saving through a bank account or other cultural assets such as cattle, lack of savings, accompanied by high unemployment and lower disposable incomes, lack of institutional participation as the majority of institutional funds are held outside the country, particularly in South Africa, a manual based trading infrastructure, a depository and settlement infrastructure which falls short of minimum international standards. The legal framework, through the absence of dedicated legislation to regulate capital markets, continues to impact negatively on initiatives by the exchange to deepen the market. Indeed, most actions contemplated in the strategy document assume that a regulatory infrastructure will be promulgated shortly.

In mapping out the strategy, the Committee targets identified constraints and challenges facing the exchange. Accordingly, it addresses both supply and demand factors that impact on the development of a viable securities market for Swaziland, where issuers and investors may interact in an orderly, efficient and transparent manner.

On the supply side, the strategy considers those actions or initiatives that can be implemented or introduced in order to increase the supply of securities to the market. On the demand side, the strategy seeks to influence the behavioural patterns of investors through educational campaigns to sensitise members of the public about the operations of the exchange, encourage stronger participation of institutional investors, increase foreign/regional investment, and introduce suitable products and facilities such as exchange traded funds and an over the counter market.

In particular, the exchange will endeavour to introduce and maintain an adequate organisational infrastructure and operational resources, improve access to the market in a manner equitable to all who access it; monitor and improve the listing of and disclosure on traded financial products, create transparency with respect to the capacity in which dealers and other intermediaries operate, improve the clearing and settlement facilities within internationally accepted standards, introduce market IT systems with adequate capacity to meet the needs of market users, reinforce mechanisms to ensure that the information necessary to conduct adequate surveillance of the market for supervisory and enforcement purposes is available on a timely basis, improve investor protection mechanisms, and adopt international best practice in the conduct of business by intermediaries.

EXCHANGE CONTROL

Relaxations

Although there were no exchange control relaxations during the 2005/06 financial year, the Bank stands ready to respond to demands by the financial sector, particularly with regard to institutional investors'

demand for foreign portfolio investments. The current foreign exchange limits have not been fully utilized, thus giving an indication on demand. However, it is anticipated that the current improvement in macroeconomic stability and increased activity in the financial sector will result in increased demand.

BoP Reporting System

The direction of foreign exchange controls has changed in recent years, and is expected to change even further in the future, both within the region and beyond. Cognizant of this eventuality, the Bank successfully completed the first phase of the Balance of Payments project, which seeks to ensure an efficient information flow system for cross border transactions.

In an effort to ensure proper and efficient utilization of the system, the Exchange Control Division, with the support of the South African Reserve Bank Exchange Control Department team of experts conducted systems audits on some of the authorized dealers in the following key areas: -

- Same source reporting principle
- Reportable and non-reportable transactions by individuals
- Reversals
- Cancellations
- Delayed reporting of inward transactions by individuals
- Rejections.

The audit process confirmed the need to up grade the BoP Reporting System.

In order for the Exchange Control to fully address the challenges brought by cross border information flow and relaxations to exchange controls, it is imperative that the current system be upgraded to the next phase, which has been enhanced to be more user friendly and compatible with regional trends. The upgrade of the system would also make possible the production of a variety of reports that would make some economic decision-making easier.

Anti-Money Laundering

Developments in Anti-Money Laundering initiatives during the year 2005 were minimal. The Money Laundering and Financing of Terrorism (Prevention) Bill of 2005 is still awaiting Cabinet approval and will no doubt set the ground for effective dealing with money laundering offences.

Measurable progress was made in the financial sector with all banks and the building society embarking on the task of implementing the “Know Your Customer” principle. This follows a general statement issued by the Central Bank where June 30, 2005 was set as a deadline for all banks to have completed the campaign. Flowing from the above, all banks are required to report to Central Bank on the status of their anti-money laundering program on a quarterly basis.

Posing as a challenge in the customer identification initiative is the lack of formal physical addresses in the rural areas. The Central Bank is yet to give clear directives to the banking industry on how best to deal with customers under such circumstances to ensure effectiveness of the exercise.

With regard to combating the financing of terrorism (CFT), the Central Bank issued a circular to the banks giving them the list of names of suspected terrorist organizations and individuals with whom they should have no financial dealings. This list is provided by the United Nations and is continuously updated as new information becomes available.

The Central Bank continued to receive suspicious transaction reports from banks throughout the period under review.

Way Forward

The International Monetary Fund and World Bank have pledged their willingness to provide Swaziland with Technical Assistance in the implementation of anti-money laundering initiatives. Swaziland as a country has to pronounce itself on the establishment of the Financial Intelligence Centre, which would in the process define the role of the Central Bank in combating money laundering.

CONCLUDING REMARKS

The limited monetary policy autonomy in Swaziland brings to the fore the importance of the role of fiscal policy. The support that has to be provided by prudent fiscal policy should be geared to underpin macro-economic stability and in-turn sustainable economic growth. Though not in a strong position to control inflation, as this is mostly imported, the Central Bank is obligated to maintain policies that will not lead to inflation levels that are higher than those prevalent in other members of the Common Monetary Area (CMA), as this will reduce the country's competitiveness in attracting investment and promoting exports.

The continued practice during the past three financial years to 2005/06 of allowing government budget deficits to grow to unsustainable levels has the potential to exacerbate the threat of inflation. In this three-year period, the deficits have been largely a manifestation of the persistent wage increase demand by civil servants and other political structures. The wage bill has increased to the extent that it constitutes 58 percent of total recurrent expenditure. This practice has a tendency to stimulate demand and allow Swaziland's inflation rate to be significantly higher than the rate prevailing in South Africa. During the quarter ending December, the differential between Swaziland inflation rate and the South African headline inflation index widened by 2.7 percentage points from 0.6 percent. Leading to that period, Government had allowed wages and salaries of security forces to increase by 38.3 percent. Had fiscal policy been supportive of monetary policy, which was less restrictive during the review period, such action, resulting in increased demand, would have been avoided.

The 2006/07 budget points to a reduction of the deficit to 2 percent of GDP and a moderate rate of growth in personnel costs. This is a step in the right direction. It would be prudent to maintain this level of expenditure without resorting to supplementary budgets during the year; given previous years' experiences when personnel expenditure provision were increased during the financial year leading to deficits reaching unsustainable levels. The authorities are therefore urged to adhere to strict fiscal discipline.

Exchange rate developments have been crucial in determining the level of inflation during 2005. The strength of the currency, though hurting our export trade, acted as a buffer to the threat posed by the persistent increase in the oil prices. Against this background, it was possible to

maintain inflation at levels below 6 percent. The continued maintenance of low inflation rates and the stable exchange rate has already been discounted for 2006. The possibility of moving towards a more restrictive monetary policy stance that would see a gradual upward movement of interest rates during 2006 is seen as a remote possibility. 2006 will see a period of stable interest rates with an upward movement only possible through major threats arising from inflation or acute adverse movements in capital flows that would lead to severe downward fluctuation in the lilangeni exchange rate.

Turning to the Financial Sector in Swaziland: 2006 promises to be a continuation of stability within the financial sector. During the past two years, certain institutions have been aggressively expanding their operations. The future dictates that over time, a consolidation of operational activity is required so that the financial sector maintains stability and provides confidence within the economy. The Central Bank will continue with its programme of financial sector reform to build the pillars that would modernize and instil efficiency in the operations of the financial sector. Strong supervision and regulation will continue; it is with this stance that preparation for the introduction of Basle II is in an advanced stage. Government is therefore urged to move swiftly and enact the outstanding relevant pieces of legislation that have been prepared by the Central Bank.

Finally, on behalf of the Board of Directors of the Central Bank, myself and the staff, I would like to place on record the Bank's appreciation of the co-operation received from the multilateral international financial institutions that have given technical support in the programme of financial sector reform, the Minister of Finance and his officials, Managing Directors and staff of banks operating in Swaziland, and Chief Executive Officers of other registered financial institutions.

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GOVERNOR