

# **MONETARY POLICY STATEMENT - 2007**

## **INTRODUCTION**

Since the last monetary policy statement in 2006, the outlook on the economy has shown no sign of improvement. Economic performance has slowed down, from 2.3% in 2005 to 2.1% in 2006. The decline is reflected by a low rate of growth in foreign direct investment, weaker performance of the manufacturing sector and low agricultural productivity as a result of a prolonged drought in the region.

The year 2007 has been declared “a year of action” by His Majesty King Mswati III. This was during the opening of the 4<sup>th</sup> session of the 8<sup>th</sup> Parliament. The declaration by His Majesty should be viewed as a call to redirect Swaziland’s economic policy to focus towards underpinning growth so as to return the country’s performance to the growth rates recorded in the 1980s, which exceeded 5%.

During 2007, the objective of monetary policy will be in support of fiscal policy in order to mitigate against the challenges faced by the country in creating and attracting investment opportunities through conducive market conditions. It is essential that emphasis should be on developing strategies that will empower the local business community so as to engender growth in domestic investment.

In an environment of low investor confidence in Africa, a small economy the size of Swaziland is faced with a difficult task of attracting foreign direct investment; and has to resort to domestic policy instruments to

grow the economy. Swaziland has therefore to gear up for “action” through policies that focus on Government investment programmes involving capital projects and privatisation in order to open up opportunities for local and external investors.

Monetary policy in Swaziland is effective to the extent that it has to underpin fiscal policy. Adherence to Common Monetary Area (CMA) policy trends does not mean that Swaziland’s monetary policy cannot leverage conditions conducive to the balanced growth of the economy. This is evident from 2001 when single digit inflation rates have been maintained, in contrast to some countries within the region where inflation rates have grown to double digits or even triple digits. Monetary policy during 2006 saw the Central Bank’s discount rate increase by 200 basis points to 9%. This policy stance was against the background of rising inflation during the year. In Swaziland, the average inflation increased from 4.8% in 2005 to 5.3% in 2006.

The pressure leading to a restrictive policy stance emanates from excessive demand for credit by individuals and the private sector. The unprecedented consumer demand is unsustainable as demand for imports may increase at a rate higher than the rate of growth of the country’s reserves. On the other hand, increased demand for credit through the expansion of mortgage finance has, in a small way, contributed to economic growth. At the end of 2006, personal loans and advances increased by 26%.

The limited monetary policy autonomy in Swaziland calls for the adoption of monetary policy tools that focus on the transmission mechanism, especially facilitated through open market operations, reserve requirements and discount facilities. During 2006, the Central

Bank maintained unchanged reserve requirements so as to stabilize the banking system's ability to create credit.

In the past, reserve requirements have been used extensively in an attempt to moderate or encourage credit creation. However, our experience has been that any stance taken by the Bank has had limited transmission effects. For instance, any easing of the reserve requirements which avails additional resources for the banking sector, is used for investments outside the country instead of being a catalyst to capital creation. On the other hand, notwithstanding the restrictive stance of increasing the Central Bank's discount rate, which would have had a dampening effect on credit extension to individual borrowers, the loan to deposit ratio has remained at high levels.

During 2006, the Bank continued to maintain an interest rate policy closely related to that existing in South Africa. The reason is that there is a direct relation between price movements in both countries. It is therefore essential that inflation levels in Swaziland are not extremely higher than those prevalent in South Africa. Maintaining higher levels of inflation in Swaziland may lead to the reduction of the country's competitiveness in attracting investments and promoting exports.

It is emerging that the authorities have embraced fiscal restraint during the past financial year. However, given that this comes at the back of an unexpected unsustainable increase in customs revenue, a much more longer trend has to be set to entrench fiscal discipline. This maybe possible in the light of the recent announcement in the budget speech relating to the creation of a Revenue Authority, which will be followed by the introduction of the Value Added Tax.

Fiscal policy is the main determinant of stability and growth in Swaziland. Government expenditure has manifested itself in the determination of movements in the number of financial aggregates. The expenditure pattern of Government will influence the liquidity in the banking system and the level of external reserves. Whenever Government expenditure substantially exceeds revenue, the drain manifests itself through a reduction in the level of foreign reserves. During the three-year period to 2005, Government's substantial deficits are mirrored in the level of the country's external reserves, which declined from 4.2 months of imports in 2001 to 1.9 months of imports in 2005.

In order to reverse the threat to the Lilangeni peg with the South African Rand, which was reflected by the lowest level of reserves ever recorded in 2005, it was essential that Government restrict expenditure and channel savings to build up external reserves. In 2006, these savings amounted to E400 million, which restricted the budget deficit to 2% of GDP.

The process is to continue during 2007, with a substantial injection into the foreign reserves through direct savings by Government; and the recapitalisation of the Central Bank. This policy stance is not in vain, as the country has maintained internationally acceptable levels of foreign reserves of up to 3 months of imports. Such levels do not only adequately support meeting our external obligations but also strengthen the peg. The recapitalisation of the Central Bank has little to do with the operations of the institution, but more to do with strengthening the resource base of the Bank to conduct monetary policy. The medium-term fiscal policy stance points to the maintenance of fiscal discipline, which should strengthen financial stability, underpin foreign reserves and, in turn, foster conditions for balanced growth in the economy.

During 2006, the local currency unit lost 18% of its value against the US Dollar, having performed strongly during the two previous years. This has brought some relief to local exporters. The competitiveness of Swaziland, being an export reliant economy, has been enhanced. This, in a way, has slightly hedged against a further widening of the deficit in the balance of payments current account; and will be an added protection against the closure of textile manufacturing factories.

Turning to the financial sector, 2007 will see the commissioning of the Real Time Gross Settlements system (RTGS), which will underpin the efficiency of the payment and settlement system in the country. The Central Bank will continue to adopt a stringent supervisory and regulatory stance within the banking system.

The Central Bank will persist in its efforts to encourage banks to operate efficiently and reduce the cost of banking; and thus avail banking services to the public in Swaziland, particularly to that section of the population that remains un-banked because of low incomes. It will be essential in 2007 that the Central Bank works in partnership with Government and the banking sector to create a financial sector that is adequately regulated, efficient and serves the interests of the economy.

## **REGIONAL AND INTERNATIONAL DEVELOPMENTS**

Global expansion was broad based, with activities in most regions meeting or exceeding expectations. Growth in 2006 is expected to be around 5%. As expansion takes root, tighter monetary policies are expected to result in slower growth during 2007. In addition, any upsurge in economic activity is expected to be negatively influenced by

the high-energy costs that have prevailed for most of 2006. Commodity prices other than energy have come under pressure in recent months, signalling conditions that might further slow down global growth.

Sub-Saharan Africa has experienced its strongest period of economic expansion for three consecutive years, with regional growth expected at 5.2% for 2006. Projections for 2007 point to a growth rate estimated at 5.8%. However, while the persistent growth is expected to continue, there are a number of risks to the outlook. These include the threat of higher oil prices, continued unfavourable terms of trade and a sharper than expected decline in non oil commodity prices. The impressive growth performance in Sub-Saharan in recent years still falls short of the 7% annual growth needed to meet the Millennium developments Goals (MDGs) of halving poverty by 2015.

Nearer home, in South Africa, the robust economic growth over the past three years was accompanied by the strengthening of the Rand against currencies of its major trading partners, indicating a healthy external inflow to capital markets. In the second quarter of 2006, the Rand depreciated substantially after international investors became concerned about the rising current account deficit. The Rand has lost some 18% of its value against the U.S. dollar. Accompanying the weakness of the rand has been substantial private sector credit extension, growing at a higher rate than nominal GDP. This has underpinned inflationary pressures and the need for monetary policy adjustment which has seen the South African Reserve Bank effecting interest rate hikes of 200 basis points during 2006. The outlook points to a weaker currency and further inflationary pressure, which may dampen economic growth.

## **RECENT ECONOMIC DEVELOPMENTS**

### **Macro Indicators**

Following growth of 2.3% in 2005, revised projections indicate a slow down in economic activity in 2006. Official estimates put real GDP growth at 2.1%. 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 incomes.

The slow down in economic performance in 2006 reflects 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 is a result of a prolonged drought in the region, which resulted in a serious food shortage, particularly maize, the main staple crop. This development will exacerbate the already severe problem of high unemployment, income inequality and poverty.

Growth in manufacturing output slowed down in 2006 following the closure of some major companies notably in the textile industry. As a small open economy, Swaziland faces external shocks. Swaziland's clothing and textile industry, which significantly increased its exports and created thousands of jobs under AGOA, is threatened by the implementation of the Agreement on Textiles and Clothing. The Agreement, which came into effect in January 2005, lifted all quota restrictions on clothing and textile exports and paved 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 advent 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 will be spurred by positive performance of some export commodities, including sugar-based products and soft drink concentrates. Overall growth in 2006 has benefited from increased construction activities due to ongoing road and housing projects. Also, the strong economic performance by South Africa in 2006 boosted Swaziland's export demand since over 50% of country's exports are sold in South Africa. Further, the real depreciation of the domestic currency against the US dollar and other trading partners' currencies during 2006 increased the Emalangeni value of exports destined to markets outside the Common Monetary Area. The weaker Lilangeni exchange rate implies that the competitiveness of locally produced goods in the international markets improved during 2006. Also, the slight depreciation of the unit impacted positively on overseas tourists' inflow by increasing their purchasing power.

A quick look at other macroeconomic indicators shows that imbalances, which existed in the past, remain unresolved. Gross national savings as a percentage of GDP stood at 23.3% in 2006 largely bolstered by private national savings. On the other hand, Government national savings as a percentage of GDP was 8.4%, lower than previous year's level of 10.8%. Meanwhile, net current transfers from abroad, which comprise mostly

SACU receipts, continued to command a larger share of Government savings as a major source of 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 immediate future. Contributing to the lower Government savings has been the rising consumption expenditure matched with slower growth in non-SACU tax revenue. Government's inability to diversify its revenue base is a cause for concern as it might set a stage for unsustainable fiscal imbalances and a ballooning debt burden in later years. It might also have far reaching consequences on the country's ability to raise national savings and thus its ability to invest.

Gross national savings remain dominated by private national savings whose contribution to GDP was 15 percent in 2006. On the other hand, gross investment remained very low despite high private savings in the country. Private investment continued to dominate gross investment with a share of 14.9% of GDP in 2006, as opposed to 8.5% of GDP for public investment. The high savings by the private sector should have led to an increase in gross investment through credit extension to the private sector. However, this has not happened because, predominantly, the commercial banks prefer to invest a larger proportion of their liquid assets in neighbouring South Africa.

Employment projections for 2006 indicate a contraction in formal employment. The fall in formal employment indicates that the increase in Government expenditure and the foreign direct investment (FDI) inflows in 2006 failed to create employment opportunities. Unemployment remains high at 29%. Although AGOA created more than 28 000 jobs in 2001, the projected reduction in the private sector employment as a result of the erosion of the AGOA preferences and the restructuring in

the sugar industry, coupled with the drive by other companies to shed workers in their endeavour to minimize costs and remain profitable. The situation was exacerbated by the strength of the lilangeni/rand exchange rate, which continued to exert pressure on competitiveness of the country's export commodities in international markets.

The formal sector absorbs approximately 30 percent of the labour force and continues to contribute significantly in creating employment opportunities for a larger proportion of the labour force. The promotion, encouragement and support of small and medium enterprises remain crucial for curbing unemployment. The challenge in this critical sector is the availability of finance as financiers view it as a more risky investment. It is crucial, however, for a country with a labour force characterised by excess supply to support this sector as it provides an alternative to dwindling foreign direct investment.

Although migrant labour has been declining over the years, it continues to be an important aspect of employment for the Swazi labour force. The increased mechanization of operations, the strengthening exchange rate and higher wages which have attracted South African labour have led to the reduction in employment prospect for Swazi workers in South African Mines.

The prevalence of HIV/AIDS continues to pose a threat on the labour market as it is estimated to be more prevalent among the most productive age groups. The efforts by Government through National Emergency Response Committee on HIV and AIDS in trying to address the pandemic, and the drive to provide free education for the increasing number of orphans and vulnerable children as a result of HIV/AIDS are commendable.

Local inflation, as measured by the consumer price index, showed a steady increase during 2006, continuing the upward trend observed in 2005. The annual average inflation rate increased by 0.5% to record 5.3%, from 4.8% registered the previous year. This rate was slightly higher than the Central Bank's forecast of 4.5%, indicating that inflationary pressures were slightly higher than expected. Swaziland price levels were affected by the depreciation of the lilangeni/rand exchange rate and higher crude oil prices. Imported inflationary pressure from South Africa, the country's main trading partner, continued to exert upward pressure on the domestic price levels.

Following upon rising inflationary pressures in the South African economy, the Reserve Bank adopted a tight monetary policy stance, increasing its repo rate by 200 basis points during 2006 and consequently succeeding in maintaining the CPIX within the target range of 3-6%. In line with developments in South Africa, the Central Bank of Swaziland also raised its domestic interest rates, which helped curb rising inflationary pressures.

Inflation during 2006 was mainly driven by increases in the price index for food, which accounts for almost 25% of the consumer basket and remains a key factor in the movement of the overall index. Food inflation surged to an annual average rate of 14.6% in 2006, from an annual average of 9.1% in 2005. Other notable increases were observed in the price indices for alcohol and tobacco, household operations and transport and communication. Higher crude oil prices were responsible for the rise in the price index for transport and communication as petrol prices were increased twice during the period under review. On the other hand, the continued higher than inflation wage settlements also contributed to the increase in inflation during the period under review.

Swaziland's consumer inflation, which chartered an upward trend in 2006, was in tandem with the increase in both the South Africa headline and core inflation. This upward trend is expected to continue as effects of rising crude oil and food prices, coupled with the weaker exchange rate, might push inflation higher in 2007.

## **External Sector**

Swaziland's preliminary balance of payments statement for 2006 depicts an overall surplus of E958.9 million, a significant improvement from the surplus of E11.8 million recorded in 2005. The surplus in 2006 was a result of the prudent allocation of resources in the official sector, coupled with savings by Government that saw E400 million being channelled to the Central Banks' official reserves during the year. Official reserves over the past four years reached unacceptably low levels, threatening the parity status between the lilangeni and the rand. As a direct result of the channelling of savings to reserves by the Government, the import cover for goods and services improved from 2.3 months in January 2006 to 3.2 months in December 2006. Increased export volumes by major companies and the weakening of the lilangeni/US dollar exchange rate also contributed positively to country's foreign exchange earnings during the year.

Revised 2005 current account figures show a deficit of E43 million whilst 2006 preliminary figures reflect a larger deficit of E318.8 million. The income account deteriorated from an inflow of E167.5 million in 2005 to an outflow of E267.5 million in 2006. Explaining this movement in the income account were dividends and royalties, which were paid out to multi national corporations with local investments.

The services account, on the other hand, recorded an improved deficit of E373 .8 million compared to a deficit of E595.2 million in 2005. This was attributed to an increase in income earned by the transport sector as more foreign companies opted to utilize the local railway and freight companies to transport goods into Swaziland.

The expiry of the Multi-Fibre Agreement (MFA) under the World Trade Organization's multilateral trading system on the 1<sup>st</sup> January 2005 continued to impact negatively on the economy. As a result, the trade balance deteriorated from a surplus of E587 million in 2004 to a deficit of E123.8 million in 2005. However, 2006 preliminary figures reflect a narrowed deficit of E50.4 million. The Duty Credit Certificate Scheme, through improved cash flows in the form of discounts, further enhanced competitive pricing for the textile industry in Swaziland. In addition, the weaker exchange rate of the lilangeni to the US dollar in the latter half of the year also contributed positively to the country's export earnings.

Imports (f.o.b.) in 2006 show a projected growth of 6.7% from the level of the previous year. The growth in imports reflected the inflationary pressures associated with higher transportation costs transmitted through higher oil prices during the year. Also, the increased importation of cars from outside the SACU region boosted import growth during 2006.

Income outflows registered E1, 173.1 million in 2006 from inflows of E658.9 million recorded the previous year. Net income outflow were E267.5million from an inflow of E167.5 million in 2005. Contributing to the net outflow position were dividends and distributed branch profit payments to parent companies. Furthermore, disinvestments, as a result of closure of some major companies, also negatively affected the net income earned during the year.

The current transfers account inflows, which continue to be dominated by non-duty SACU receipts, recorded a net inflow of E372.9 million in 2006, from an inflow of E508.6 million recorded the previous year. The increase in current transfers outflows were more pronounced in 2006 as a result of increased duties collected by the South African Revenue Services.

The financial account, for the first time, recorded an inflow of E1, 204.7 million in 2006, compared to an outflow of E415 million the previous year. The positive turnaround in the financial account was influenced by the withdrawal of Government assets abroad and increased reinvestment of earnings by the private sector. Commercial Banks increased their investments abroad as their foreign asset holdings rose by E464.1 million.

During 2006, foreign direct investment inflows recovered slightly in the manufacturing sector, particularly the textile industry. The recovery was a result of profits generated locally and inter-company loans being extended to local companies by their head offices abroad.

## **Monetary Sector**

During the first half of 2006, monetary conditions were characterized by general stability. However, a restrictive monetary policy stance was pursued from June 2006 up to the end of the year. The restrictive policy stance was focussed on the rising inflationary trend largely due to the rapid escalation in international oil prices combined with the effect of the depreciation of the rand/lilangeni.

In effecting a tight monetary policy, the Central Bank's discount rate was increased by a cumulative 200 basis points over the year under review, to reach 9%. Commercial banks responded by increasing their prime lending rate by similar margins to reach 12.5% while deposit rates increased by slightly lower rates. Treasury bill rates on the other hand increased by a lower margin of 164 basis points over the year. During the first quarter of 2007, the monetary policy stance remained unaltered as inflationary pressures continued unabated.

Over the year to January 2007, the country's net foreign assets reflected an increase of 88.4% to E4, 325.9 million, with an estimated import (goods and services) cover of 3.8 months. The increase in net foreign assets was registered in both the official sector and commercial banks. Official reserves were up, mainly reflecting a 28.1% rise in customs union revenue for the year 2006/2007, deliberate saving by Government of E400 million to re-build the country's reserves as well as the depreciation of the lilangeni against major trading currencies since May 2006. The country's foreign exchange reserves are projected to improve further during the 2007/2008 fiscal year following the current budget estimates of a sizeable 56.6% increase in customs union revenue. In addition, Government's pledge for further savings of E705 million as well as re-capitalization of the Central Bank by E142 million will further improve the level of external reserves. These developments, combined with the anticipated implementation of measures to control expenditure and broaden the revenue base will go a long way to ensure that the reserves are maintained at sustainable levels.

Over the year under review, credit extended to the private sector continued to rise but at a slower pace of 4.7% compared to growth of 21.5% recorded the year before. This was attributed largely to sluggish demand from the private sector. The increase in credit largely emanated

from the household sector mainly to finance the acquisition of houses and motor vehicles. Credit to the industry sector, however, recorded a decline, particularly discernible in agriculture and forestry.

Broad money supply (M2) grew rapidly by 34.7% over the twelve months to January 2007, from 5% registered the previous year. This was mainly attributed to the substantial rise in foreign assets. A small portion was due to growth in credit extended to the private sector over the review period. Quasi money supply, comprising savings and time deposits, reflected the highest increase of 45.2% while narrow money supply, comprising Emalangeni in circulation and demand deposits, rose by 17.1%.

Liquid assets maintained by banks increased by 39.7 percent over the review period to close at E721.6 million. The rise is mainly a reflection of an increase in the rate of growth of deposits vis-à-vis credit extension. Surplus liquidity increased by 62.9 percent to E124.8 million. The liquidity ratio stood at 15.3 percent up from 14.7 percent recorded the previous year.

Outstanding treasury bills amounted to E443.9 million at the end of February 2007 compared to E392.6 million in February 2006. Participation continued to be dominated by local banks holding 80 percent, followed by Central Bank's open market operations at 12.6 percent. Holdings of non-bank financial institutions stood at 5.6 percent while individuals and private organizations held 1.1 percent and at 0.7 percent, respectively.

## **Fiscal Sector**

The estimated outturn for 2006/07 depicts a budget deficit of 2.1% of GDP, an improvement from the original budget deficit of 4.1% in the previous fiscal year. The improvement in the budgetary position is largely a result of efficient collection of revenue coupled with an unexpected windfall from SACU receipts.

Appropriated recurrent expenditure is estimated to increase by 23.2% to E5 billion in 2006/07 and is 32.8% of GDP. Like in previous recurrent expenditure provisions, the major contributors to this increase include personnel costs, transfers to parastatals and social sectors (education, health and drought relief programs). Expenditure in public investment is estimated to increase by a mere 2.9% in 2006/07. The programme includes infrastructural development (road networks, schools and new hospitals) water supply to communities and other Government projects (Millennium Projects).

On the other hand, the ratio of revenue to GDP is estimated to have improved to 42.2% in 2006/07, compared to 29.1 percent recorded in 2005/06. It is gratifying to note that for the first time, the revenue/GDP ratio is above the 30% ratio recorded in the 1980s. However, this jump is unsustainable, as its source is the windfall from SACU.

The 2007/08 budget projects a surplus of E551 million, which translates to 2.6% of GDP. The positive turnaround in the budgetary position emanates from improved performance and efficiency in revenue collection as well as an unexpected increase in SACU receipts. Government revenue, including grants, is projected to rise by 37.5% to E8.9 billion in 2007/08.

To sustain the positive fiscal position, Government is committed to undertake economic reforms that were identified in previous budgets.

These programs are aimed at improving the Government budgetary position by exploring the diversification and enhancement of revenue as well as expenditure control. These include the implementation of VAT in 2007/08, merging the major revenue collecting departments under one Revenue Authority, strengthening of the legal framework on public enterprises, privatising some of the public enterprises and re-orientating Government expenditures, with the downsizing of the civil service being the first priority.

Swaziland's external debt in Emalangeni terms recorded an increase, primarily due to disbursements to finance huge Government projects. At the end of December 2006, preliminary figures for total external debt stock, including private sector non-guaranteed debt, stood at E3.1 billion, denoting an increase of 14.8% from E2.7 billion recorded in December 2005. The ballooning size of the official sector external debt also reflects, in part the, depreciation of the local currency against the US dollar and other major currencies in which most of external liabilities are denominated.

Multilateral organisations constituted the largest share of the public debt portfolio with E1.6 billion outstanding, followed by bilateral and private creditors (mainly commercial banks) with E627.5 million and E394.2 million outstanding, respectively. The Central Government debt, which constitutes the largest share at 77.4% of the total loan portfolio, stood at E2.4 billion at the end of December 2006, an increase of 20% from E2 billion recorded in December 2005.

The public debt stock is expected to increase in the near future once the externally funded projects such as Lower Usuthu Smallholder Irrigation Project, Komati Downstream Development Project, and Mbabane Bypass Road have been fully funded. Also expected to increase external liabilities

is the new loan contracted from the Arab Bank for Economic Development for Africa amounting to US\$6.6 million for the construction of the link road to Sikhuphe International Airport.

## **BANK SUPERVISION**

### **Performance Trends in the Swaziland Banking Sector**

Banks were adequately capitalised; and the average risk-weighted capital-adequacy ratio for the banking system as a whole was 26.3% at the end of December 2006, compared to 18% in December 2005. The statutory required minimum capital adequacy ratio is 8%.

### **Total Assets of Banks**

Total balance sheet growth remained strong throughout the year under review. By the end of December 2006, the total assets of banks comprising, amongst other things, notes and coins, loans and advances, investments and other assets had increased by 17.6%, to a level of E5,132.5 billion. Total net loans and advances showed a growth of E79.2 million, from E3,098.1 billion in December 2005 to E3,177.3 billion in December 2006. At the end of 2006, the three commercial banks accounted for about 84.4% of the total assets of the banking sector, compared to 80.7% at the end of December 2005.

### **Profitability Indicators**

Profitability indicators improved during 2006. By the end of December 2006, the average return on net qualifying capital and reserves was

21.2%, up from 19% in December 2005, whereas the return on assets increased from 2.7% in December 2005 to 2.9% in December 2006. The efficiency (cost-to-income) ratio of the banking sector also started showing signs of improvement during the year under review, reducing from 68.5% in December 2005 to 65.2% in December 2006.

It is evident that banks benefited from and contributed positively to the solid and consistent performance of the Swaziland economy. It remains important, however, for bankers to focus on the various stages of a banking cycle and prepare themselves for the effects of any future downturn. The benign conditions during the year under review prompted the banking industry to improve not only its profitability, but also to compare favourably to the all-important internationally acceptable cost-to-income ratios, or the efficiency ratio.

Throughout 2006, the average monthly liquid assets held to total liabilities for which liquidity is required (liquidity ratio) for Swaziland banks exceeded the statutory requirement of 13%. In December 2006, banks' liquidity ratio stood at 18.6%, compared to a level of 15.6% in December 2005.

### **Asset Growth in Core Products**

Besides banks experiencing strong asset growth in their core products, gross amounts of non-performing loans also decreased during 2006. Expressed as a percentage of total loans and advances, gross amounts of non-performing loans improved from 8.7% in December 2005 to 6.5% in December 2006. Banks' provisioning against these non-performing loans was considered adequate.

## **New Developments In Banking Supervision**

### ***BASEL II Implementation Issues***

The Macro Economic and Financial Management Institute of Eastern and Southern Africa's (MEFMI) Financial Sector Management Programme conducted a fact-finding mission to the Central Bank of Swaziland (CBS) at the invitation of the Bank. The mission was aimed at assisting CBS and the financial institutions regulated and supervised by the CBS with the Basel II Implementation.

The main objective of the MEFMI technical assistance visit was to assist and guide the Central Bank of Swaziland with developing and planning a road map for the implementation of Basel II Capital Measurements and Capital Standards. The expert team held discussions with the Basel II Project Team comprising of representatives from the Central Bank and banking institutions.

The MEFMI team also reviewed the laws and regulations governing the supervision of banking institutions in Swaziland, together with the guidelines and directives that the Central Bank has issued to the market to date. The idea was to have an appreciation of the current regulatory and supervisory framework, assess compliance to Basel Core Principles, evaluate the extent of implementation of risk-based supervision, and ascertain progress in terms of the implementation of Basel II.

In summary, the mission observed that the Central Bank is largely compliant with all the twenty-five (25) Core Principles, save for Core

Principle 25 on Home-host relationships, where the Central Bank is materially non-compliant. Although the Financial Institutions Act, 2005 provides for the exchange of information with other central banks and supervisory authorities, the Central Bank of Swaziland has not yet established home-host relationships with the Reserve Bank of South Africa, which is home country supervisor of those banks whose subsidiaries operate in Swaziland. The Central Bank is to engage the Reserve Bank of South Africa with a view to entering into a Memorandum of Understanding (MOU) covering among other things, the sharing of supervisory information.

As recommended by MEFMI, the Bank Supervision Division concurs with the view that the implementation of Risk-based supervision and Basel II will require a critical mass of dedicated, well-trained and experienced supervisors. There is a need for a deliberate policy decision to diversify the supervisory skills base, at the same time ensuring improved staff retention in the Banking Supervision Division. The Central Bank is set to benefit from the many courses and workshops on risk-based supervision and Basel II organized by the BIS Financial Stability Institute (FSI) and MEFMI in an endeavour to build capacity on supervisory skills.

### ***BSA Solution***

The Bank Supervision Application (BSA) system has since stabilized; and the Central Bank has discontinued the hard copy submission by banks. One of the benefits of the BSA system is the automation process of the submission of statutory returns. This will help the Bank Supervision Division to fully utilize the predetermined prudential ratios.

### ***Enhancement of Corporate Governance in Banks***

The Central Bank of Swaziland subscribes to the principles of good corporate governance and expects the banks to practice and uphold those principles.

## **NATIONAL PAYMENT SYSTEMS**

Safe and efficient payment systems are critical to the effective functioning of the financial system. Robust payment systems are, therefore, a key requirement to maintaining and promoting financial stability. Over the past few years, there has developed a broad international consensus on the need to strengthen payment systems by promoting internationally accepted standards and practices with particular regard to system design and high availability.

### **The Clearing and Settlement System**

#### ***Payment Systems Reforms***

Participating Banks stand to benefit from the various reforms including Electronic Funds Transfers (EFT) and the introduction of the second clearing session that has featured in the automation of the clearing house, now commonly referred to as SAECH. Based on the successful introduction and smooth operations of the second clearing, Swaziland banks are expected to pass on the benefit to customers by cutting back the clearing cycle and also ensure that cheques deposited in a bank where they are drawn get same day value instead of holding-up value in line with a four-day clearing cycle.

With regard to these reforms and systems developments that will now feature the Swaziland Inter-bank Payment and Settlement System (SWIPSS), it would be of great importance that the benefits that come with these reforms and all bank tariffs are publicized for customers to realize and appreciate value added.

## **Real Time Gross Settlement System (RTGS)**

The Bank is pleased to formally advise that this project has now taken-off, after successful negotiations with the identified vendor, being one of the SADC approved vendors for implementation of RTGS solutions within the region.

According to the project plan, the live date of the RTGS system is scheduled for the second quarter of this year. It is worth noting that the implementation of the RTGS system is a challenging exercise that embraces many departments in all participating banks, including the Central Bank.

## **International Aspects of Reforms**

### ***i. Cross-Border Flows - CMA Cross Border Payment Oversight Committee (CPOC)***

Swaziland banks are expected to develop agreements amongst themselves for clearing of cross-border paper based instruments. It is worth noting that the correspondent agreements to govern cross-border payments would require rules and procedures and a sound legal framework. In this regard, the National Clearing and Settlement System

(NCSS) Bill 2005 seeks to establish a sound legal basis for these reforms and the modernization of payment systems in the country.

**ii. Oversight of Payment & Settlement Systems**

The oversight function, which is an essential function for the Central Bank, aims to ensure the smooth, safe and efficient functioning of payment systems. The Central Bank does this for a number of reasons. Firstly, the Bank aims to maintain systemic stability in payment systems through risk mitigation measures. Indeed, a major malfunctioning of payment system could undermine the stability of financial institutions and markets. For example, failure of one participant to meet its obligations in the system can result in other participants being unable to meet their obligations, thus leading to a chain reaction.

Secondly, the Central Bank is concerned with the efficiency of payment systems, which is a complimentary objective to systemic stability.

Thirdly, it is concerned with the security of payment system instruments used by the public, which is material to both the confidence of the users of the payment instruments and, ultimately, to the maintenance of public confidence in the currency.

Fourthly, since payment systems are an essential vehicle for the implementation of monetary policy, oversight is aimed at safeguarding the transmission process.

**Core Principles for Systematically Important Payment Systems**

The Central Bank of Swaziland has adopted international standards embraced by the Bank of International Settlements (BIS) for safe and efficient payment systems. These international standards are intended to be sufficiently broad in scope to apply to a wide range of circumstances

and to be useful over time (futuristic). These standards apply to all systematically important payment systems that involve credit and debit transfers, electronic and manual processing.

The Central Bank cannot succeed in promoting payment system safety and efficiency in isolation. It is therefore appropriate to adopt a collaborative approach with other central banks and other relevant authorities, particularly in the region.

## **CAPITAL MARKETS DEVELOPMENT**

### **Market Developments**

#### ***Equities***

Performance on the Swaziland Stock Exchange during 2006 was not satisfactory when compared to other markets in the region. Although the SSX All Share Index ended higher at 175.21 points when compared to 157.1 points recorded at the end of 2005, the volume and value of shares traded continues to be disappointing. During the year, 70,840 shares worth E427,575 exchanged hands in 27 deals.

Market capitalisation ended the year at E1.4 billion, an increase of E147 million when compared to the end of 2005. A single counter dominated trading activity in both value and volume terms, accounting for 34.7% of total volume traded and 56.6% of total value traded.

There were no major developments on the equity markets as the number of listed companies remained at six. Generally, the market is faced with tight supply and demand conditions. Liquidity is still a major problem;

and the market is not in a position to meet the high demand for some counters.

The market continues to anticipate the promulgation of the securities legislation. It has been agreed with stakeholders to implement free-float requirements for all listed companies after the passage of the legislation; and the move will, in all probability, stimulate liquidity.

In the same vein, the market is looking forward to the privatisation of some state owned enterprises. Our view is that the most efficient and transparent way of transferring wealth to ordinary citizens is through an initial public offering (IPO) on the exchange. Given the size of the assets involved, the listing of publicly owned companies would induce market activity and foster the development of capital markets in Swaziland.

### ***Bonds***

There were no new bonds listed during the year under review. The number of listed Government stocks remained unchanged at two (2), with an outstanding nominal value of E50 million.

The number of listed corporate bonds declined to two (2) during the year, with one (1) debenture maturing in April. The remaining two (2) debentures have a nominal outstanding amount of E95 million.

### ***Public Awareness Campaigns***

The SSX has continued to intensify its public awareness campaign. During the year under review, the SSX participated in the Swaziland International Trade Fair, embarked on an educational tour to schools and continued informing the public about developments in the market through the print and electronic media.

The Schools Challenge was held for the third consecutive year. The Challenge has helped participating students not only to understand the jargon involved in the market but also to appreciate the essential role the Swaziland Stock Exchange can play in contributing to the development of capital markets as an alternative source of investment finance.

The exchange, through its open door policy, has welcomed visitors to its offices throughout the year, and explained its operations.

## **Regional Integration**

### ***Committee of SADC Stock Exchanges (COSSE)***

#### ***COSSE MOU***

The COSSE MOU has been incorporated into the SADC Finance and Investment Protocol. In terms of Annexure 11 to the Protocol, member exchanges shall extend multilateral co-operation and assistance to one another in, but not limited to, the following areas:

- Communication and Exchange of Information.
- Information Sharing
- Training
- Development of Securities Exchange Professionals
- Surveillance and Self-Regulation
- Cross-Border Listings; and
- New Investors

#### ***Project Thusanang***

Seeing that the original JSE offer for automation (Project Thusanang) has stalled due to lack of donor funding, several COSSE members are procuring and installing individually customised trading platforms. The

understanding is that the platforms so installed will be capable of interconnectivity and integration to the rest of SADC.

The SSX is considering a small platform for itself in this regard, including the installation of central securities depository. However, much will depend on the availability of finance and the passage of the long awaited securities legislation.

### ***Harmonisation***

Harmonisation of regulatory frameworks amongst COSSE members remains on the agenda. Various aspects of the process continue to be considered with a view to promoting cross-border listings, trading, clearing and settlement among member exchanges. However, there are, among others, regulatory, legislative, exchange control and currency disparities between COSSE members that are considered to pose serious challenges to the attainment of this objective.

### ***Committee of Insurance, Securities and non-bank financial authorities (CISNA)***

#### ***Meeting***

For the first time since joining as a member, Swaziland hosted the sixteenth official meeting of CISNA during October 2006.

### ***SADC Finance and Investment Protocol***

Although Swaziland has signed the SADC Finance and Investment Protocol, it has yet to pass the necessary legislation in order to bring its regulatory framework in line with other SADC countries. The SADC directorate of Trade, Industry, Finance and Investment has specific Action Plans for CISNA to install a harmonized regulatory framework within the region.

### ***SADC Capacity Building programme***

Swaziland is likely to benefit from the programme, which will involve a consultant spending some time with regulatory authorities in the region. The main areas of focus will include supervisory manuals, an update on regulatory powers and directives, writing policies and guidelines, and aligning regional issues, including international standards.

The programme will also look at proper licensing requirements and follow up, governance issues, reporting requirements, approval and role of professionals, on site inspections, basic supervision, complaints handling, delegation, and the philosophy and issues around self-regulation.

### ***Risk-Based Supervision***

CISNA members are in the process of implementing a risk based supervisory approach towards regulating their markets. Consultations with stakeholders will take place and efforts will be made to empower staff in this holistic approach towards the supervision of industry participants.

### **Consumer Education**

Present efforts towards educating the public on the available products have in the past been focussed on the stock exchange. A consumer education policy will be crafted in consultation with, among others, service providers, relevant ministries of Government, NGO's, labour unions and the Consumer Association of Swaziland.

The policy will focus on product knowledge and consumer rights and remedies. To be effective and meaningful, the consumer education

strategy will be reinforced and supported by a consumer protection framework.

## **Collective Investment Schemes**

The number of management companies remains unchanged at two (2); and the number of schemes remains at seven (7).

## **EXCHANGE CONTROL**

### **Compliance by Authorized Dealers**

The Exchange Control Division in its supervisory function has to continuously monitor compliance by Authorized Dealers through on-site and off-site inspections.

During the year under review two on-site inspections were carried out on the banks. These inspection exercises yielded an acceptable level of compliance.

Given the continued relaxation of exchange control, there is a need for more market information dissemination in order to raise awareness on foreign exchange controls to all stakeholders.

### **Relaxations**

Exchange Control relaxations made during this financial year were on emigration facilities and foreign investment.

The limit on the facility granted to permanent residents leaving Swaziland to take up permanent residence in any country outside the CMA was increased from E750,000 to E1.5 million for private individuals and from E1.5 million to E4 million for family units.

The limit for foreign investment per private individual was increased from E750,000 to E2 million.

In line with the policy of moving towards total exchange control relaxation, the Central Bank has seen a significant increase in applications received and approved in accordance with existing regulations.

### **Anti-Money Laundering**

The Central Bank role in monitoring Money Laundering is to receive reports on suspicious transactions from financial institutions.

There has been commendable progress made by banks in submitting reports relating to “know your customer” (KYC) aimed at combating money laundering.

In developing a programme of combating money laundering, the Central bank with the assistance of the World Bank, conducted a training program, which focuses on building core skills on financial analysis and investigation. The long term objective of the programme is to deliver country specific training to relevant Government agencies as well as relevant financial and non-financial institutions responsible for Anti-Money Laundering and Combating the Financing of Terrorism (AML/CFT).

It is hoped that this training program will help speed up AML/CFT initiatives in the country.

## **CONCLUDING REMARKS**

*The limited role of the Central Bank in formulating monetary policy has increasingly shifted focus to the function of the Central Bank in fostering financial stability. This emphasis, in part, points to the large cost that a financial crisis may entail; and it also underscores the responsibility of the Bank to be lender of last resort and its role in the country's payment, clearing and settlements systems. In a number of countries, financial stability has provided:*

- (a) Effective regulatory infrastructure;*
- (b) Effective financial markets; and*
- (c) Effective sound financial institutions.*

*In the 2006 Article IV Consultation Report of the IMF, concern was raised on the failure by Swazi Monetary Authorities to regulate and supervise non-bank financial institutions, particularly cooperative credit schemes. This concern was raised in the light of the collapse of the Central Cooperatives Union. The Central Bank, in collaboration with the Ministry of Finance will be working towards setting up a supervisory and regulatory institution with the passage of the Financial Services Regulatory Authority Bill.*

*The bill will consolidate the regulation and supervision of all institutions that have an element of deposit taking.*

*In 2007 it is expected that the Central Banks resources will substantially increase following the proposed recapitalisation of the Bank by E142 million. This in part will be a measure of controlling Government expenditure and will also provide the Central Bank the opportunity to effect monetary policy through open market operations and other measures that will enhance the effectiveness and efficiency of financial markets in Swaziland. The Bank will work towards encouraging banking institutions operating in Swaziland to avail banking facilities to all income-earning members of the public so as to encourage the creation of savings in Swaziland.*

*For the last three years, there has been a concerted move towards close integration within the CMA. Central Banks of Namibia Lesotho, South African and Swaziland have worked closely to find ways to cooperate in introducing economic convergence policies that will enhance the common purpose of developing a Monetary Union.*

*Membership of Swaziland to the CMA has had its advantages and disadvantages. The strengthening of the exchange rate of the Rand against Swaziland's major trading partners from 2003 to the first quarter of 2006 has had an adverse effect on our competitiveness involving the export trade. On the other hand, monetary policy targeted to inflation has had a positive effect in maintaining the affordability of goods and services.*

*Although inflation trends have shown a slight upward movement in 2006, single digit inflation rates have been maintained, confirming that Swaziland's membership to the CMA still exerts financial discipline. This re-emphasizes the Central Bank's stance that, for now, the continued membership of Swaziland to CMA has been yielding more benefits than disadvantages.*

*To conclude, may I on behalf of the Board of Directors and staff of the Central Bank extend the Bank's appreciation for the cooperation we have received from all stakeholders in the financial sector and the Minister of Finance and his officials.*

**MARTIN G. DLAMINI**  
**GOVERNOR**