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# **MONETARY POLICY STATEMENT – 2008**

## **INTRODUCTION**

The global financial crisis, triggered by the US sub-prime mortgage market debacle, has been a major factor in growth expectations in the world economic outlook. According to the April 2008 IMF World Economic Outlook, global economic growth is projected to fall from 4.9% in 2007 to 3.7% in 2008. It is expected that the major effects of deteriorating global prospects will affect mainly the US and most developed countries. On the other hand, developing and emerging market economies, including Sub-Sahara Africa, have been resilient to the effects of the turbulence in international financial markets. Africa continued to register and sustain one of the highest growth rates. Sub-Sahara Africa experienced its strongest growth and low inflation in 30 years. Growth is projected to stabilize at a high of 6.2% in 2008. However, there is a strong need to take an appropriate policy stance against the pronounced global economic decline induced by financial market turbulence, credit crisis and continued inflationary pressure caused by high food prices and unprecedented high oil prices which, to date, have broken the \$100 per barrel price barrier. The outlook for growth in the Sub-Sahara Africa region may be bright; however, the prolonged economic decline in developing countries will induce the risk of a significant fall in commodity prices and a decline in Foreign Direct Investment (FDI).

The year 2007 saw substantial growth in Swaziland's foreign reserves spurred by substantial inflows arising from custom revenue receipts. Rapid economic growth has, however, continued to elude the Swazi economy as real GDP, which stood at 2.3% in 2005 and is projected at 2.8% in 2007 showing no substantial change from the average of just over 2% registered during the past six (6) years. These growth rates are substantially inferior compared to developments in Sub-Sahara Africa.

The constraints that confront Swaziland from recording higher growth rates relate to a number of factors, which include continued drought experienced in the years preceding 2007 resulting in low agricultural productivity. In addition, low growth in manufacturing, a snail pace in growth of domestic and foreign investments, in part reflecting the stringent requirements for prospecting in the mining sector, have been major factors discouraging growth. In the international arena, Swaziland has lost preferential treatment for its major exports. Despite all the adverse developments, the country's fiscal position improved, cushioned by 'wind-fall' Customs revenue receipts which saw an improved outturn recording a surplus of 10.1% of GDP in 2006/07. However, a deficit equivalent to 0.5% of GDP is estimated for 2007/08; and the budget for 2008/09 projects a deficit of 1.4% of GDP.

During the year 2007, the country's mission was that of instilling action to deliver rapid economic growth. However, this has been adversely affected by major exogenous factors influenced by global turbulence in international financial markets and an upsurge in commodity prices. In addition, taking positive action to promote growth has consistently eluded the country's authorities. In terms of international competitiveness, the cost of doing business in Swaziland is relatively unfavourable compared with neighbouring countries.

Inflation has been a major concern for regional and domestic central banking institutions. In Swaziland, inflation broke the single-digit barrier in January 2008 to record 10.6% and stood at 11.6% at the end of March, 2008. In order to address this scourge, beginning first-half of 2007, the Central Bank increased its indication rate, that is, the discount rate, by 250 basis points to 11.5%. This is in line with the policy of inflation targeting followed by the Southern African Reserve Bank in an attempt to mitigate inflation pressures. Inflation targeting is the most effective way of arresting demand for credit which in turn will

reduce prices. However, there are those goods whose price movements are not responsive to interest rates movements such as food and fuel. Food prices are set by supply factors such as production, while the price of fuel is a phenomenon of international commodities markets.

The effect of an interest rate adjustment to target inflation should be transmitted mainly through the financial sector such that the demand for credit increases or declines depending on the pricing (interest rates) for loans and advances. The Central Bank is investigating the effects of the high interest rate policy stance that has been adopted since the beginning of the first half of 2007, and is expected to continue through 2008; to establish whether it has had positive effects on inflation and economic growth. Swaziland can not attain real economic growth if inflation rates exceed or are in double digit levels. On the other hand, targeting inflation through high interest rates without the transmission mechanism having effective throughput may be a recipe of stagflation, that is, high inflation rates and low economic growth. The Central Bank will in future comprehensively examine the transmission of money policy stance for its effectiveness in reducing inflation and creating opportunity for growth.

The most vexing issue about inflation is that of the ever increasing food prices internationally and regionally, including Swaziland. The unprecedented increases in food prices are of great concern: The production of cereals for producing bio-fuels may be one of the reasons that have taken food prices through the roof internationally. In the case of Swaziland, for instance, drought, the land tenure system and substantially reduced real investment towards food production are the major causes for the low production of cereals such as maize, sorghum and others.

The Central Bank can only advise that it is time for maximum usage of land for food production. The increased prices of maize and other cereals

have now made this a profitable venture which we see as a bankable investment. This may be the right time for our entrepreneurs to venture into agricultural production through joint ventures with experienced farmers. It is also essential for financial institutions, including banks, to give the same support to food production as they enthusiastically do to support the sugar farming sector.

In the meantime, we should brace ourselves for more belt-tightening; consumers should be rational and avoid the temptation to use any debt instrument to make up for any short-fall in the consumption patterns that they have been used to during the last two or three years. Debt creation for consumption through credit cards, higher-purchase and direct borrowing should be avoided at all costs. However, incurring debt for capital projects with a return in excess of the cost of debt is encouraged. Statistics indicate that there are, so far, few foreclosures by financial institutions on property to recover debt. However, there is a strong indication that this may not be for long as the squeeze is gradually taking its effect.

It is with these developments that consumers are strongly advised not to over commit themselves to debt. The Central Bank will continue to watch the position of debt as it affects the general public. Even though we have seen that, despite high interest rates, demand for credit by individuals and households has increased by 27% for the twelve months ended March, 2008, the position does not yet warrant the introduction of a “National Credit Act”.

## **RECENT ECONOMIC DEVELOPMENTS**

### **Macro Indicators**

Official estimates put real GDP growth at 2.8% in 2007, which is unchanged from the growth rate recorded in 2006.

Supporting growth in 2007 was the positive performance of some export commodities, including sugar-based products, meat products, soft drink concentrates, fruit canning and zippers. Activity in the services sector (mainly driven by Government spending) was also robust during the year under review. Also, the stronger-than anticipated economic performance by South Africa in 2007 boosted Swaziland's export demand since 50% of the country's exports are sold in South Africa. Furthermore, the real depreciation of the domestic currency against the US dollar and other trading partners' currencies during 2007 increased Emlangeni value of exports destined to markets outside the Common Monetary Area (CMA). The weaker Lilangeni exchange rate implies that the competitiveness of locally produced goods in international markets improved during 2007. Also, the moderate depreciation of the domestic currency impacted positively on overseas tourists' inflow. Overall growth in 2007 also benefited from the continued construction activities due to ongoing road and housing projects.

Growth in economic activity could have been higher during 2007 had it not been for the severe drought conditions and forest fires that were experienced by the country during the 2006/07 cropping season. These developments significantly reduced the volume of output from the agricultural sector. Furthermore, performance by the sugar industry was sluggish as the sector continued to experience further erosion of its export price to the European Union.

The outlook for 2008 is subject to several risks and depends crucially on the implementation of policies that promote growth and address key

challenges facing Swaziland. Downside risks to the economy include continued lower EU sugar prices, uncertainty surrounding SACU transfers, recurring droughts (low agricultural productivity), inadequate external competitiveness, fiscal pressures and the impact of HIV/AIDS and poverty, as well as the continued slow down in FDI inflows due to stiff competition for new investments in the region. The priority is for Government to resolve the blockages that prevent fresh FDI into the country and this remains the key for the country's economic growth and development.

Other macroeconomic indicators re-affirm the sluggish performance of the economy. Swaziland has relatively low savings and investment rates, which have both varied between 15% and 20% of GDP in recent years. As a proportion of GDP, national savings grew from 13.2% in 2006 to 17.3% in 2007. National savings growth has always been sustained by net official transfers from abroad particularly, the SACU receipts which constitute a bulk of Government savings. Government savings as a percentage of GDP was 10.5%, lower than the previous year's level of 17.8%.

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 investment on the other hand remained relatively low. Total investment stood at 19.4% of GDP in 2007 compared to 16.9% in 2006. The share of private investment to GDP was 9% as opposed to 10.4% for

public investment. The low investment rate has been partially the result of the continued slow down in FDI inflows due to stiff competition for new investments in the region; potential investors now see South Africa and Mozambique as ideal investment destinations in the region. Furthermore, as a direct result of the free flow of funds within the CMA, excess funds in the economy continue to be channelled to South African money markets where they earn a higher return than would have been the case if these funds were kept in Swaziland. The situation has been worsened further by the commercial banks' reluctance to extend credit to small to medium enterprises because they are perceived to be more risky.

The low level of domestic savings is exacerbated by the fact that much of those savings are held in the form of pension fund contributions, and the majority of these pension fund assets are invested outside the country due to the shortage of suitable domestic investment instruments. In response to this capital outflow, the Government has introduced legislation that will compel life insurance companies and pension funds to maintain at least 30% of their assets domestically. In the short term this will lead to capital inflows as offshore investments are recalled, and in the medium term it will reduce capital outflows as the external investments of pension funds are restricted.

In an attempt to comply with the SADC recommendations for comparison purposes, the Central Statistics Office adopted a new methodology for calculating the consumer price index in 2007. This exercise involved, firstly, a change in formula from the simple Laspeyres Index to the Geometric Laspeyres Index, and secondly, a reclassification of the main groups using the Classification of Industrial Consumption by Purpose as recommended by the United Nations. The adoption of the new methodology in turn led to a reduction on the consumer basket commodity groups from thirteen to twelve, re-weighting of the commodity groups based on the 2001 Swaziland Household and Expenditure Survey

(SHIES) from the 1995 SHIES, and finally, re-basing the index to April 2007.

Inflation maintained an upward trend in 2007, as it rose from an average of 5.6% in the first quarter to an average of 9.6% in the last quarter of 2007. The average rate for 2007 was 8.1%, significantly higher when compared to the average rate of 5.3% recorded in 2006.

The three major drivers for inflation in 2007 were food, transport and education prices. Food prices alone accounted for over 80% of overall price increases during the course of the year. Food inflation increased from an average of 13.4% in the first quarter of 2007 to 19.6% in the last quarter due to both regional and international factors, which all limited supply of cereal products. Unfavourable weather conditions, which did not only affect Swaziland, but the region at large, resulted in a decline in the maize yield across the region. Both maize and wheat prices increased substantially in 2007 partly due to increasing competition for land with the advent of bio-fuel production. Global growth in food prices was also reflected by the IMF commodity price index, which increased by 26.8% in 2007 compared to 10.1% in 2006.

Coming second after food prices were transport prices, which were influenced by increasing crude-oil prices. According to the IMF, petroleum prices grew by 67% in 2007 compared to an increase of 2% the previous year. Domestic transport prices grew from an average of 2.8% in the first quarter to 15.9% in the last quarter of the year, contributing an average of about 10% to overall prices during the course of the year. Finally, education prices had an impact of over 2% on overall prices. As usual, education prices are mostly felt at the beginning of the year, and then decline gradually during the course of the year. In 2007, education prices contributed an average of 0.5 of a percentage point in the first quarter of the year and fell to zero in the last quarter.

Also contributing to the growth in food and transport prices were the higher weights given to these groups from April 2007. The weight of the food component increased from 25.324% to 37.73%, whilst that of the transport component increased from 7.937% to 8.6%. On the contrary, the education component declined from 6.083% to 5.38%. Downward pressure, though minimal, came from the communication and clothing and footwear components. Declining communication prices can be largely explained by the reduction in both fixed and mobile phone tariffs in 2007.

In the first quarter of 2008 prices maintained the previous year's upward trend, increasing from 10.6% in January to 11.6% in March. The persistently increasing fuel prices, in excess of 90 cents to over E8.00 per litre by the end of the March, saw transport prices growing by an average of 22.8% in the quarter. On the other hand, food prices grew by an average of 20.1% in the quarter, slightly higher than the 19.6% recorded in the previous quarter. Another contributing factor to increasing prices was the household furniture and maintenance category, which doubled its growth to 5.3% in the first quarter of 2008, from 2.7% in the last quarter of 2007, as the prices of household consumables continued to grow.

### **External Sector**

Swaziland's net official reserves grew significantly in 2007. The overall balance of payments position recorded a surplus of E3,851.9 million, depicting a marked improvement from the overall surplus of E957.2 million recorded in 2006. The huge surplus can be attributed to a windfall in SACU receipts received by Government in the second quarter of 2007. Furthermore, a number of exporting companies in the manufacturing sector also recorded notable increases in both export volumes and earnings, thus contributing positively to the country's reserves. Company earnings were enhanced by a favourable lilangeni/rand exchange rate prevailing during the year. The domestic

currency averaged E7.05 against the US dollar in 2007 versus an average of E6.77 in 2006.

Preliminary data for 2007 show that the current account registered a net outflow of E1,513.8 million, after registering moderate inflows during the past three years. The deterioration in the current account balance can be attributed to substantial deficits recorded in the trade account, services account and income account during the year under review.

The trade account registered a deficit outflow of E1,247.9 million in 2007 compared to a larger deficit of E2,140.1 million recorded the previous year. Continued low yields in local agricultural production due to the persistent drought spells in the country, continued to impact negatively on the trade account. Exports grew by 17.4% to E12,669.2 million from E10,791.5 million in 2006. Export commodities that registered positive performance during 2007 include soft drink concentrates, meat products, sugar-based products and zippers.

A number of challenges continued to face the country in 2007. The sugar industry continue to be negatively affected by the enactment of the European Union (EU) sugar sector reforms effected in 2006, which will result in prices of local sugar sold to the EU being slashed by 36 percent over a four a year period. Furthermore, the implementation of the Agreement on Textiles and Clothing continued to have adverse effect on the performance of the textile sector in 2007. Orders for local garments and apparels fell during the year under review, as competition to export textile products to the United States (under AGOA) intensified; with most orders given to cost-effective producers such as China and India.

Imports increased by 7.6% to E12,663.3 million in 2007. The increase in imports was necessitated by the need to bolster domestic supply that was adversely affected by the relentless drought spell, which has negatively affected production in recent years. Adding to the already

volatile situation were inflationary pressures associated with higher transportation costs.

The services account recorded a net outflow of E567 million in 2007 compared a higher net inflow of E1,103.9 million recorded in 2006. The deficit in the services account was a result of increases in royalties and license fees as well as payments for legal, accounting and management services rendered by non-residents. Outflows for royalties and license fees rose by 9.1% to reach E780.9 million while outflows for legal, accounting and management services increased by 91.6% to reach E338.9 million in 2007.

The income account widened considerably, from a net outflow position of E117.7 million in 2006 to a net outflow of E1,125.4 million in 2007. Higher dividends and distributed branch profits paid to South African owners of shares in Swaziland companies contributed substantially to the deterioration in this account. Income inflows declined by 5.3% to E1,077.8 million in 2007 whilst investment income outflows increased significantly to E1,809.2 during the same period. The worsening income account was partially cushioned by an increase in income received as compensation of workers during 2007.

During the year under review, a surplus of E1,426.4 million was recorded in the current transfers account, representing a 51% increase from the E944 million recorded in 2006. The improvement in the current transfers account relates to the E1.3 billion SACU revenue refund in April 2007, coupled with the inflow of the quarterly SACU revenue over the review year.

A substantial net inflow of E4,927.3 million was recorded in the financial account in 2007 compared to a lower net outflow of E528.4 million recorded in 2006. The marked improvement in the financial account net outflow position was due to net other investments, which rose from an inflow of E307.7 million in 2006 to a larger inflow of E4,848.2 million in

2007. The huge inflow in the financial account was a result of the substantial revenue windfall received by the country from the SACU Common Revenue Pool during the second quarter of 2007.

Foreign direct investment shrank from a net position of E221.8 million in 2006 to a net position of E110 million in 2007 due to a decline in reinvested earnings by most companies in the manufacturing sector. A number of companies opted to remit their profits to their head offices abroad during the year under review.

### **Monetary Sector**

Interest rates were kept at a constant level for the first five months of 2007. Monetary policy tightening, however, was adopted between June 2007 and April 2008, with the discount rate increasing by a cumulative 250 basis points. The restrictive monetary policy stance taken by the Central Bank was aimed at combating further deterioration in the inflation outlook, propelled largely by escalating food and oil prices.

The discount rate was raised from 9% in May 2007 to 11.5% in April 2008. As a consequence to the hike in interest rates, commercial banks raised the prime-lending rate by a similar margin to reach 15%. Deposit rates also reflected increments, although at lower levels, with the average 31 days and 12 months deposits increasing by 225 and 217 basis points, respectively.

Net foreign assets, on the other hand, recorded an annual increase of 93.4% to reach E6.5 billion at the end of March 2008. The rise in net foreign assets was mainly reflected in net official reserves on account of a E1.3 billion SACU revenue refund in April 2007, combined with the inflow of the quarterly revenue over the review period. The allocation of funds towards rebuilding of reserves as a commitment by Government to raise the country's external reserves was put into effect during the year, resulting in a further boost in net foreign assets. The higher level of

reserves has ensured that the import cover is maintained at internationally acceptable levels, reaching 4.2 months of estimated imports in March 2008. Net foreign holdings by Other Depository Corporations also increased slightly over the year under review.

Private sector credit totalled E5.5 billion, reflecting an increase of 20.6% over the year, and significantly higher than the 6.9% rise recorded in March 2007. The increase was mainly reflected in the 'other non financial corporations' (industry) sector. The credit was also channelled towards distribution and tourism as well as agriculture and forestry. Household credit also increased notably over the year, mainly reflected in housing loans.

Broad Money Supply (M2) increased by 18.2% over the year to March 2008, slightly higher than the 16.5% increase recorded the previous year. The increase in M2 was supported by the rise in private sector credit. Quasi money grew by 23.4%, with a 37.5% rise in time deposits. Savings deposits, however, fell by 5%. Narrow money supply (M1), increased by 7.2% with demand deposits increasing by 10.4%, while currency in circulation fell by 8.2%.

Liquid assets amounted to E893.8 million, recording an annual increase of 3.8%. The increase in liquid assets was driven by a rise in deposits with the Central Bank, together with an increase in cash (Emalangeni and Rands) in bankers vaults. Consequently, the liquidity ratio was at 17.3%, 0.7 percentage points higher than the 16.6% level reached in March 2007. Surplus liquidity, however, declined by 5.4% to reach E241.5 million.

In June 2007, the Central Bank re-introduced the issue of its own paper (CBS Bills), which were last issued in October 2003. The CBS bills are mainly to supplement the limited issues of Government treasury bills in an effort to mop up excess liquidity in the banking system.

Outstanding treasury bills amounted to E390 million at the end of April 2008 compared to E398.4 million recorded in April 2007. Participation continued to be dominated by commercial banks, with 95.3% of total holdings. Non-bank financial institutions and individuals had respective holdings of 0.3% and 4%, while holdings of private organizations were at 0.3%. The Central Bank also held 0.1% of the total amount.

### **Fiscal Sector**

The actual outturn for 2006/07 shows a massive budget surplus of E1.958 billion, which is 10.1% of GDP, the largest fiscal surplus in the country's history. The significant improvement was mainly a result of an adjustment in SACU receipts by E1.3 billion received in March 2007 which had originally been budgeted for 2007/08. The improvement in the budgetary position was also due to improved expenditure control measures put in place by Government during 2006/07.

Estimates for 2007/08 indicate a budget deficit of E109 million or 0.5% of GDP. Government continues to give priority to fiscal discipline by ensuring that limited resources are allocated efficiently to key sectors and that the expenditure pattern remains within the approved budget by the end of each financial year. As part of its expenditure control strategy, Government is streamlining the procurement system and has introduced a computerized commitment/order and tour advances systems to ensure that controlling officers do not only allow ceilings under their respective votes to be exceeded, but also make commitments only where money does exist.

In line with priorities for the medium term, expenditure will be targeted on priority areas like safe water and sanitation, access to health care, fight against HIV/AIDS, hunger and food security, education and economic growth, infrastructure development, poverty reduction and rural development.

The 2008/09 budget has been drawn on the basis of policy reforms articulated in previous years, including the medium term budget policy for 2008/09 to 2010/11, with identified expenditure patterns taking priority in terms of delivery. The budget for 2008/09 marked the mainstreaming of the Poverty Reduction Strategy and Action Programme approved in May 2007 as the planning and budgeting tool for the medium to long term.

The budget estimates for 2008/09 project a deficit of E330 million, which translates to 1.4% of GDP. Government continues to explore means of enhancing revenue collection in a bid to mitigate the imminent decline in SACU revenue. This will be achieved through enhancing the internal revenue sources comprising mainly of income taxes, sales tax and various user fees as well as the establishment of a Revenue Authority. In an attempt to increase compliance and more effective tax administration, a Tax Payer Unit will be set up in the Department of Taxes whose aim is to focus effort on large tax payers that account for a large proportion of total tax collection. Government revenue, including grants, is projected to rise by 17.9% to E9.2 billion in 2008/09.

Recurrent expenditure is projected to rise by 23% to E7.34 billion in 2008/09. The wage bill accounts for 53.6% of recurrent expenditure and this is significantly higher than the internationally recommended 35%. Government has decided to take steps to reduce the size of the civil service by setting aside E153 million for the Voluntary Exit Package. Setting up the Revenue Authority will cost E200 million. The capital budget for 2008/09 is E2.23 billion, reflecting an increase of 1% from the previous year's budget. This year's capital budget is aimed at completing the already on-going projects as a matter of priority.

Swaziland external indebtedness in Emalangeni terms worsened in 2007. At the end of December 2007, total external debt stock, including private sector non-guaranteed debt, stood at E3.406 billion, denoting an

increase of 10.7% from E3.077 billion recorded in December 2006. The increase was primarily due to disbursements of loans for ongoing projects such as the Lower Usuthu Smallholder Irrigation Project and the Mbabane By-pass Road Project.

Public and publicly guaranteed external debt stood at E2.966 billion (or 17.8% of GDP) at the end of December 2007, reflecting an increase of 13.2 percent from the E2.621 billion recorded the previous year. The external debt for central Government, which constitutes the largest share of the total loan portfolio, stood at E2.717 billion from the E2.375 billion recorded at the end of December 2006.

The public debt stock is expected to increase in 2008 as loans for big Government projects such as the Mbabane By-pass Road continue disbursing. Also expected to start disbursing during 2008 is a loan obtained from BADEA for the construction of an access road to the Sikhuphe Airport. Government is also hoping to contract new loans from the OPEC Fund and BADEA for the financing of Sicunusa-Nhlangano Road during 2008/09.

Based on critical ratios established by the Brettonwoods Institutions (the IMF and World Bank) for Highly Indebted Poor Countries, Swaziland's debt ratios have been comparatively low compared to other African countries. However, for a small economy like Swaziland, it still remains important for Government to ensure that its debt remains within sustainable levels.

## **BANK SUPERVISION**

The Bank Supervision Division continued to oversee and safeguard the stability, integrity and efficiency of the banking industry. The Division's strategic objectives include licensing, regulating and supervising commercial banks and other financial institutions as empowered by the Central Bank of Swaziland Order, 1975 and the Financial Institutions

Act, 2005. Other goals of the Division include protecting depositor's funds and promoting a stable and efficient banking system which is essential for the overall economic development of the country. This is achieved through on-site and off-site supervision of financial institutions.

### **Developments and Projections**

As one of the Division's objectives is to issue and renew licenses for existing banks and other financial institutions, no new entrants into the industry were licensed to date. However, some investors have shown interest to venture into the Swaziland market with the intention to be licensed as financial institutions other than banks. During the year to March 2008, the Bank Supervision Division also received an application for a credit institution which is currently being considered and processed.

The banking sector's improved performance continues to benefit mainly from the domestic economy in terms of expanding business opportunities and the emergence of a regulated insurance industry. Financial institutions are expected to continue rolling out new products as they expand their operations networks, while competition is expected to increase with the entry of more non-bank financial institutions into the market.

The Bank Supervision Division continues to witness the emergence of rapidly developing non-banking financial institutions (NBFIs). There is a noticeable increase in monetary activity in this industry yet there is still no legal framework to supervise these institutions. The requisite legislation, the Financial Services Regulatory Authority Bill, has still not been promulgated. The Bank is concerned about the increasing number of unregulated non-bank financial institutions in view of the amount of assets that they control.

On the prudential side, the Bank is in the process of revising some of its prudential requirements and regulations to align them with the Basel

Core Principles for Effective Bank Supervision and the provisions of the Financial Institutions Act, 2005.

### **Bank Charges**

The Bank is taking the issue of bank charges seriously and has engaged the commercial banks with a view to respond to the public outcry on high banks charges. Section 41(1)(a) of the Central Bank Order of 1974 provides for the regulation of the banking industry's 'minimum and maximum commissions, service charges and other fees'. However, the Bank has chosen to engage the commercial banks in a dialogue' in the normal course of business and in fulfilling its mandate.

### **Structure of the Banking Sector**

There are four commercial banks and one building society operating in Swaziland. Total branch network of the commercial banks is 35 while the building society has 5 branches. The period under review was characterized by a rapid expansion of ATM networks, from 93 to 101 across the country. The branches and ATM networks remain concentrated in the Manzini-Matsapha-Mbabane corridor. However, the year saw an expansion of ATMs into rural areas of the country. This development is envisaged to boost commercial activities in areas outside of the main towns.

### **Financial Sector Performance**

It is in the interest of the Bank to see the performance of the banking industry thriving and remaining competitive. Good performance is generally measured by trends in levels of capital, asset quality, earnings and liquidity. All banks remained well capitalized in the period ending 31 December, 2007, with capital adequacy ratios above the statutory requirement of 4.0% for Tier 1 Capital and 8.0% for total Capital.

One of the main challenges to banks is ensuring that liquidity is maintained at all times and that it remain in a healthy and sound position. The banking sector maintained a steady liquidity position

during the period under review, with levels above 13%, which is the minimum statutory liquidity requirement.

A broad evaluation of asset quality is one of the most important components in assessing current conditions and future viability of a bank. The quality of the bank's assets impacts all components of a bank's financial performance. High levels of classified assets can have a negative impact on earnings through lower interest income and higher provisions to the loan loss reserve.

Asset quality problems can lead to a negative impact on the adequacy of a bank's capital. The industry ratio of specific provision for bad debts as a percentage of advances improved from 8.6% in December, 2006 to 6.8% in December, 2007. This underscores the need for banks to continue to put in place comprehensive and robust policies to manage their overall credit risk.

Growth in balance sheets remained strong in the period under review. The long term growth and soundness of the banking industry is dependant on its ability to generate profits on a sustainable basis. Banks are always encouraged to adopt robust and stringent cost containment approaches to improve their profitability in both the short and long-run.

### **On-Site Monitoring**

The Bank Supervision Division continues to conduct on-site inspections on all banks and other financial institutions under supervision of the Bank. A full-scope on-site examination of a financial institution normally focuses on the evaluation of the following essential components:

- i. Capital Adequacy- Financial institutions are expected to maintain capital commensurate with the nature and the extent of risks envisaged in their operations and the ability to control those risks. The minimum capital adequacy ratio is 8%.

- ii. Asset Quality- This is reflected in the quantity of existing and potential risks associated with the loan and investment portfolios. Financial institutions are expected to maintain adequate reserves for bad debts and be able to set up mechanism to collect or correct problem assets as well as setting up sound lending policies and credit administration procedures.
- iii. Management- Management is evaluated against all factors considered necessary to operate a bank within expected banking standards and practices in a safe and sound manner.
- iv. Earnings Performance- earnings are considered to be the quantity and trend of earnings and financial institutions are also expected to ensure the sustainability and the quality of their earnings.
- v. Liquidity- Liquidity position is considered very important in the short-run and long-run prospects of a financial institution. Consideration should be given to the current levels and prospective sources of liquidity compared to funding needs and the adequacy of funds management practices relative to the bank's size and risk profile.
- vi. Sensitivity to Market Risk- Financial institutions are expected to identify, measure and monitor market risk associated with the size, nature and complexity of their activities. Management of banks must be able to manage and control the degree to which interest rate, foreign exchange rates, commodity prices can adversely affect the banks' earnings and economic capital.

### **Off-site Inspection**

Off-site monitoring is a core component of prudential supervision activities and the Division continued to use off-site monitoring in assessing the performance of financial institutions on an ongoing basis. This is done by analyzing statutory returns submitted by the financial institutions on weekly, monthly, quarterly and yearly basis. Both

quantitative and qualitative trend analysis are performed and the results are presented to management for corrective action. The off-site data analysis is also utilized by the Division in the preparation of the on-site examination scope. The off-site process also helps to detect early signs of weaknesses in the respective financial institutions. There was generally an acceptable level of compliance by the banks in terms of meeting all the statutory requirements.

### **Basel II implementation**

As part of the preconditions of implementing Basel II, it has been necessary for the Bank to engage an independent party to assess Swaziland's preparedness and readiness in terms of implementing Basel II. MEFMI conducted the assessment and presented a Basel II implementation roadmap. As a starting point, MEFMI has committed to offer technical assistance to the Bank by engaging a consultant who will assist with the implementation of Risk-Based Supervision Framework, which is a pre-requisite for Basel II implementation. This exercise is expected to commence during the month of April, 2008.

The Basel II Project Team will continue to draft the road map to Basel II and consider issues of national discretion, including implementation timelines.

### **Bank Supervision Application System**

Bank Supervision Application (BSA) is an automated system used by the Bank to receive statutory returns from reporting financial institutions. The system was developed through a joint effort by SADC Central Banks and is currently used in more than eleven SADC countries and Eastern African countries, including countries such as Uganda and Kenya.

The System was installed at the Central Bank in 2004 and, to enhance usability, a new version has been developed. During March 2008, the deployment team from the Bank Supervision Application (BSA) Support

Office (BSO) located in Mozambique will deploy the new version (Version 2.1) of BSA in Swaziland. This version comes with the concept of the web-based interface whereby the commercial banks and the Building Society will use a web page to electronically submit their statutory returns. This improved version comes with some added advantages e.g. security, it will enable banks and other financial institutions to check the status of the returns submitted etc, which features when put to maximum use, will benefit all parties involved.

## **NATIONAL PAYMENTS SYSTEM**

### **Payment Systems Reforms**

The Bank, in conjunction with commercial banks, continued to focus on enhanced safety and efficiency of the national payment systems to foster and support financial stability in the country. The safety and efficiency was enhanced through successful implementation of the Real Time Gross Settlement System (RTGS) that is now locally referred to as the 'Swaziland Inter-bank Payment and Settlement System' (SWIPSS), alternatively referred to as Masheshisa.

The average activity level from mid June 2007 to end December 2007 shows that over E143 million is transacted through SWIPSS per day while cheques show an average of about E62 million per day in the same period. In view of this statistic, the activity level would be expected to grow as commercial banks continue to cast the net wider, through public awareness campaigns on the benefits of SWIPSS that include safety and efficiency of this payment system. The next phase in the SWIPSS project will focus on developments of the automated interface of SWIPSS to the various banking systems to facilitate minimal paper-work and the introduction of the Ministry of Finance module.

In line with the policy statement made in 2006, the introduction of SWIPSS was complemented by the introduction of **capping of cheques**

and debit EFTs at E1 million to enhance management of financial risk in clearing and settlement of cheques. However, based on current statistical data, this cap would require review for further reduction of financial risk to manageable levels. While SWIPSS remains free from value restrictions, no payments above the cap would be allowed in cheques.

The **clearing cycle** was also reviewed in the past year from four (4) to three (3) days, counting from date of presentation. The reduction of the clearing cycle is also aimed at reducing financial risk that include reduced cash float in the banking system.

### **Payment Systems Oversight**

In line with the ongoing reforms in payment systems and in view of the important role of payment systems in the financial infrastructure, the Central Bank formerly established an Oversight Office under the National Payment Systems Division. This office will be responsible for monitoring and fostering safety and efficiency of payment systems with the view of reducing chances of systemic risk. Systemic risk could result from various risks such as legal, liquidity, credit, operational, settlement and reputation risk. In this regard, the outstanding promulgation of National Clearing and Settlements Bill 2005 continues to deprive the country of the ultimate supporting legal framework. However, the Ministry of Finance has undertaken to ensure that this bill progresses to an Act of parliament.

The scope of oversight will be the application of policy requirements and standards in a consistent way that would not create inappropriate competitive distortions between comparable systems. Workshops will be arranged for commercial banks to create wider awareness of the oversight function.

The standards applied will be based on international standards such as the core principles for systematically important payment systems advocated by the Bank for International Settlements. The oversight

standards will contribute to transparency and consistency where the objectives alone would be insufficient to give payment systems providers and users a clear indication of how they are going to be assessed.

## **CAPITAL MARKETS DEVELOPMENT**

### **Regulatory Framework**

There have been consistent delays in passing into law a number of enabling pieces of legislation relating to capital market development in the country. Critical bills at this end include the long-outstanding Securities Bill and the Financial Services Regulatory Authority (FSRA) Bill. These two draft bills appositely map out the developmental path of the local capital market. The urgency in finalizing them cannot, therefore, be overemphasized.

The Securities legislation is motivated by its uniqueness in breaching the information needs of investors. It attempts to ensure that investors have accurate information on the securities they are purchasing. Without such a law, the Bank is greatly impeded in delivering on its mandate.

For a market to be a satisfactory barometer in the development of capital markets there needs to be an agency that will closely monitor the industry. The FSRA bill intends to provide for a consolidated regulatory regime for all non-bank financial institutions in Swaziland. Amongst other objectives, FSRA will provide for the licensing and regulation of non-bank financial institutions, the monitoring of their activities and ensure that they comply with international best practice in their operations.

Other regulatory developments that will impact on capital markets development include the proposed establishment of the Public Enterprise Authority (PEA) which will manage public enterprises and further implement the Privatization Policy for Swaziland. When the legislation is

in place, the Bank will motivate a case for the floatation of the privatised entities on the local stock exchange.

Other pieces of legislation which impact on the financial services industry include the Companies Bill, the Competition bill and the National Clearing and Settlement Systems bill, which is also sponsored by the Bank. The Bank remains optimistic that these draft bills will be promulgated into law soon.

## **Regional Cooperation**

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

Swaziland as a member of CISNA continued to consolidate relationships with other regional regulators. With the passing into law of the Insurance and Retirement Funds Acts, local participation in CISNA activities has been strengthened. Although there are still regulatory gaps due to the absence of relevant legislation, there are hopes that convergence of processes is within sight.

CISNA members are currently deliberating on the implications of the SADC Protocol on Finance and Investment. The Protocol articulates clearly the state-of-play of each member and how the region can position itself to harmonizing financial and investment policies of member states, to be achieved through facilitation of regional integration, cooperation and coordination within finance and investment sectors of the economy, inclusive of trade enhancement in the region.

### ***Consumer/Investor education***

The Bank is in preparatory stages of engaging institutional support in crafting consumer educational policies and guidelines. There are intentions to engage the Consumer Association of Swaziland, trade unions and other stakeholders in coming up with a clear framework of

involving every stakeholder in furtherance of educating consumers and investors alike. Regional partners have agreed to assist in such an endeavour.

To this end, the Bank is finalizing capacity issues that come with the requirements of such an exercise. There is also a need to synergize relations with already established entities dealing in financial services matters, specifically in the private sector.

### ***CISNA Training Programme***

Training needs of CISNA members have been identified, and there now remains implementation. It is hoped that this kind of training will be wide ranging on critical issues facing non-bank financial institutions regulators. In engaging on regional lessons, there are motivations that the training will be relevant and will assist in removing some bottlenecks in local markets.

The rolling out of the training programme now remains with FIRST Initiative. After operating independently, FIRST has been re-integrated into the World Bank system. The move has rendered the programme inactive at present.

### **Collective Investment Schemes**

In 2007 Collective Investment Schemes (CIS) Guidelines became operational. These guidelines are filling a void that persistently prevails due to pending legislation. Controls have been put in place to manage the conduct of investment schemes. The Guidelines also cover, among other things, returns that are expected to be filed and capital adequacy requirements of management companies.

Management companies authorized by the Bank remain at two (2), with nine (9) funds under management to date. These schemes are now worth about E3.5 billion, a proportion of about 18% to gross domestic product.

## **Swaziland Stock Exchange (SSX)**

### ***Market Developments and Regulation***

Performance of the local exchange fared modestly relative to previous periods. Market Indices recorded higher positions by the end of 2007. The SSX All Share Price Index closed the year 15% higher in local currency and 23% higher in US dollar terms. There was also organic growth in terms of listed companies. All counters recorded share price increases by the end of December 2007.

An amendment to Section 7.26 of the SSX Rule Book meant that the exchange did away with the determination of share price movements through tick sizes. This process, as brought about by concerns of dealing members, contributed to the stagnation of the exchange, heavily discouraging investors in participating in the trading of securities. The Index is now compiled using the bid/offer prices, as they closely represent prevailing market sentiment.

One listed company duly complied with free float requirements during 2007. Companies listed after November 2004 are expected to conform to the 20% free float rule. Another disposed of their stake in another listed company in order to comply with the rule. This saw E24 million worth of shares being transferred to 'new' investors.

The Bank conducted its first on-site inspections on dealing members during 2007. These examinations involved a three-dimensional approach (prevention, corporation and confidentiality). Over time, the bank will roll out a risk-based approach to supervision. This will allow a specific focus

on issues that are most likely to impact on its supervisory objectives, thereby providing a much more efficient use of the Bank's resources.

There were two (2) bonds listed on the SSX during 2007, bringing the total number of listed debt instruments to eight (8).

### ***Public Awareness***

There are prospects of streamlining the SSX public awareness campaign with consumer educational activities. The Bank continues to honour invitations by external groupings, including schools, on the operations of the stock exchange and generally promoting investing into equities and other securities. The fourth Schools Investment Challenge was concluded during 2007 and the bank rewarded the best performing schools. Other information mediums are exploited, including the SSX website and the local press.

### **Regional and International Affiliations**

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

The SSX continues to appreciate its affiliation to CoSSE, which provides the local market an opportunity to share information on developments and experiences with other regional exchanges. Through the CoSSE Technical Committee, the SSX is to benefit on automation expertise from other members. Currently, the SSX is conducting a needs assessment on the feasibility of introducing a central securities depository (CSD). The draft Securities bill explicitly outlines the governance and operational issues of a CSD.

#### ***World Federation of Exchanges (WFE)***

There are only two (2) securities exchanges in Africa which are full members of the WFE, the JSE Limited and the Stock Exchange of Mauritius. The SSX is a corresponding member of the WFE. There are intentions, however, to progress into affiliate status once the draft bill is

enacted into law, coupled with positive developments of the liquidity level of the local market.

## **EXCHANGE CONTROL**

### **Relaxations**

Exchange Control relaxations introduced during the financial year were on advance payments for imported goods.

Advance payments for goods up to an equivalent amount of E250 000 may now be made by Authorized Dealers on behalf of their clients without application to Central Bank.

This is indicative of more relaxations to follow given the regional initiative for relaxations as driven at SADC level. Targets set for the SADC Exchange Control Committee were to have all current account transactions fully liberalized by the end of 2007, with controls on capital account following suit by 2010. This will manifest itself in a paradigm shift in the Exchange Control Division's operations from that of controlling to surveillance.

It is important to note that Exchange Control relaxations must be approached from a position where information loss is minimized and data accuracy is not comprised. This can be achieved through offsite surveillance by the Division.

### **Anti Money Laundering**

The Anti-Money Laundering / Combating the Financing of National Terrorism Bill was reviewed by members of the Anti-Money Laundering National Task Force to align it with FATF standards.

Challenges for the year ahead include the following:

- That the appointment of Anti Money Laundering National Task Force should be gazetted so that it may pursue its mandate;
- That the AML/CFT Bill of 2004 be tabled in Parliament so that the regulatory environment is strengthened; and
- Increase public awareness campaigns and co-ordination amongst stakeholders.

## **RISK MANAGEMENT**

The Bank has established a Risk Management function with the objective of protecting stakeholders' interests through a process of continuously identifying, evaluating, controlling and monitoring its business environment to minimize adversities and take advantage of potential opportunities. In order to create a stable and efficient financial system for sustainable economic growth, the Bank has to be stringent in embedding the principles of corporate governance in its culture. The responsibility of the Risk Management function therefore is to ensure compliance to best practices as a means to achieving the Bank's strategic objectives.

## **CONCLUDING REMARKS**

*The financial turbulence experienced beginning the second half of 2007 has reduced the pace of global expansion, and restoration of confidence in the world's financial systems will be a medium to long term process. The effect of this slow-down has been pronounced in the developed economies, while emerging and developing economies, including sub-Sahara Africa, has not yet experienced accelerated decline in growth. However, the risk outlook is more towards the downside as the crisis phenomena unfolds in the international financial markets. The risk will require, on the part of developing economies, appropriate policy*

*formulation against the effects of the international financial crisis in order to sustain high growth levels.*

*In Swaziland, the risk of sharp inflationary pressures is already evident. In addition, growth prospects have eluded the economy for the last five years; while there are very slim prospects of growth in the scale experienced by the rest of sub-Saharan Africa. The need for appropriate economic tools is paramount. Food security should form the corner-stone of future investments given the favourable international prices for food, particularly cereals, and the potential availability of funding through Government, for infrastructure, and financial institutions, for production.*

*The Central Bank's restrictive policy stance to target inflation, which has seen recent increases in the discount rate by 250 basis points, is a traditionally acceptable monetary policy tool. However, given that the factors that influence the spiralling of prices are increases in food prices and a rise in fuel prices; the use of inflation targeting has had a less effective transmission mechanism in mitigating inflation and economic growth. If monetary policy tools are applied but lead to stagflation, that is, high inflation and low growth, then it is essential to examine the Bank's monetary policy stance. There are several ways in which the Bank can react to failure of the transmission mechanism of monetary policy. The first is to adopt a less restrictive stance which will focus on growth. In this instance, growth in the agricultural sector may improve production and alleviate high food prices. Secondly, is to use other tools such as liquidity and reserve requirements so as to restrict the ability of the banking sector to increase credit extension. Of these two approaches, the first may be practical for Swaziland as a substantial proportion of inflation is imported. As expectation for the second half of 2008 point to a*

*continued restrictive monetary policy stance, with interest rates possibly increasing in June; the Central Bank stance will be to examine closely the effects of another interest rate hike against its mitigation effects on spiralling prices and underpinning economic growth.*

*The Central Bank will continue to monitor the performance of the banking industry which has been satisfactory during 2007. There is continued concern about the emergence of a rapidly growing non-bank financial sector which, if not closely regulated and supervised, will be a potential threat to the banking system. Legislation to supervise and regulate the non-bank financial institutions was drafted some ten years ago, but is awaiting promulgation into law. The Bank, following an outcry by the general public about the pricing of bank products, has closely used its function of morale suasion to attain bank charges that are reasonable and would provide an opportunity for the un-bankable public to access banking facilities.*

*As reported in the last policy statement, Government recapitalization of the Bank in 2007 was E142 million, while injecting an additional saving of E705 million to boost the country's reserves. The role of Government in effecting these transactions has restored the confidence in the Emalangenzi peg with the Rand.*

*During the year, central banks in the Common Monetary Area (CMA) continued to cooperate in a number of monetary policy issues. The proposal for the creation of a monetary union within the CMA has almost been concluded by the Banks in the region. The reports on these conclusions are expected to be channelled to the ministries of finance of the member countries.*

***To conclude: A after a number of years of average performance, the Central Bank has substantially improved, particularly in its management of foreign exchange reserves; fostering efficient National Payment System and effective bank regulation and supervision.***

***May I, on behalf of the staff extend the Bank's appreciation for the cooperation we have received from all stake holders in the financial sector and the Minister of Finance and his staff.***

**MARTIN G. DLAMINI  
GOVERNOR**