

MONETARY POLICY STATEMENT – 2009

INTRODUCTION

The past year has seen the global economy experiencing a deep downturn affecting the real and financial sectors in advanced, emerging and developing economies. While in many advanced economies, recession is already being experienced; activity in emerging and developing economies will, with the second round effects, reflect increased economic decline. A recent projection by the IMF World Economic Outlook points to world GDP growth projected to fall to 0.5% in 2009; while growth in emerging and developing economies is expected to slow sharply from 6.25 percent in 2008 to 3.25 percent in 2009.

Central banks in many developed countries have effected a number of policies that are intended to avoid adverse effects to the real economy as a result of the crisis in money and credit markets. They include the adjustment of interest rates for borrowing and lending, coupled with money market operation designed to inject liquidity. In order to support policy actions taken by central banks, to bring stability to financial markets, governments in major economies had to intervene by launching unprecedented financial stimulus packages. However, the provision of fiscal stimulus by the developed countries' governments, have so far had limited success to resolve the uncertainty in global financial markets in boosting aggregate demand.

It has become apparent that sustainable economic recovery can be achieved through the resuscitation of the financial sectors, thereby opening up credit markets. In the meantime, financial markets have not shown any potential for opening up in 2009 as there is continued strain on liquidity in the markets of advanced economies. These developments point to the need for implementation of comprehensive policy actions that will, in part, lead to restructuring of the

financial sector, resolve the uncertainty about potential losses in financial markets and break the conditions, that so far have led to a further slowing down of the real economy.

Developments in the global economy reflect substantial decline in production and trade during the last quarter of 2008. A substantial fall in consumer demand as a result of the persistent erosion of the wealth held by households has led to a collapse in commodity prices. On the other hand, the continued decline in demand for consumer and capital goods has resulted in uncertainty which has underpinned postponement of expenditure.

In the advanced economies, the successful implementation of financial policy actions that underpin gradual normalization of financial market conditions, together with sizable fiscal stimulus and large interest rates cuts are expected to lead to the recovery of output towards the end of 2009.

In Sub-Saharan Africa, the consequences of the crisis do not only imply economic contraction but the reduction in economic growth. In contrast to advanced countries, Sub-Saharan countries do not have the resources to bail out the financial and other sectors through structured stimulus measures. African countries face the prospect of a reversal of hard worn economic progress and stabilization and possible social and political strains. Given that the African region is strongly dependant on trade for growth, the crisis is expected to be devastating as a result of reduced exports, falling commodity prices, lower inflows of aid and private investment capital, falling remittances and limited access to credit.

In addition, the consequences will be exacerbated by the widening trade deficits dwindling reserves and large fiscal deficits. With the worsening of the crisis, debt burdens will rise restricting the ability of governments to take action that would alleviate the adverse effects of the crisis. As these developments unfold,

the outcome of economic contraction will overturn the positive achievements in poverty reduction, undermine government's social programmes, increase unemployment and endanger the programmes that were already in place for achieving the Millennium Development Goals (MDGs).

The major challenges facing many African countries include the need to sustain macro-economic discipline, implement policies to maintain jobs and economic activity, and diversify economies in a way that reduce vulnerability to external shocks.

As demand contracts, global inflationary pressures have eased significantly reflecting reduced real activity and lower commodity prices. Headline inflation is projected to deteriorate from 2.5% in 2008 to a low of 0.25% in 2009 in industrial economies. In emerging and developing economies, consumer prices are expected to slow to 5.7% in 2009 from 9.5% in 2008.

Swaziland is not immune from the ravages of the global financial crisis despite the time lag. The second round effect is gradually showing its head indicated by the decline in demand for the country's exports by developed countries. The most affected sector in Swaziland has been the manufacturing sector. Due to the direct dependency created by the favourable trade arrangements with the United States through AGOA, the textile industry has been the first to experience a sharp fall in demand for textiles. Major exports such as sugar and other sugar based manufactures, on the other hand, have been consistently declining in value since the EEC gradually removed the subsidy element in the pricing of sugar exports commencing from 2007.

Worsening external trade, relatively low inflows of foreign direct investment and almost no internally generated growth measures have been a recipe of persistent low growth rates in Swaziland.

Swaziland's economy recorded a growth rate of 2.6% in 2008 compared to 3.5% growth in 2007. The low growth rate is likely to persist and deteriorate further in 2009 when the full effects of the crisis would have worked its way through the real economy. The downward trend in economic performance comes at a time when Swaziland has continually performed below other regional economies in Southern Africa. The improvement recorded in 2007 estimated at a growth of 3.5% had been achieved through governments infrastructure development programme, involving road construction, which had been the only stimulus programme underpinning growth. However, with the projected decline in resources in 2008 and 2009, the economy will see a reversal of this hard-won and fragile economic progress and stability.

The external trade developments will exacerbate the decline in growth even further particularly the external accounts. Based on the preliminary figures for 2008, Swaziland's overall balance of payment surplus has shrunk by 58% as at the end of 2008. The current account deficit is estimated to have increased by E3,426 million. This was cushioned by increased inflows of transfers in the form of customs revenue. The country's net foreign exchange reserves grew by an annual rate of 31%, also largely reflecting an inflow of customs revenue from SACU together with revaluation gains, given the sharp depreciation of the local unit against major currencies. The reserves at E8.1 billion as at end December 2008 are equivalent to 5.7 months of imports compared to 4.4 months the previous year.

Inflation has been a major concern throughout 2008 and as early as the first quarter of 2009; the double digit average inflation in 2008 of 12.6% was 4.5 percentage points higher than the previous year. The major sources of such high inflation rates had been food and transportation. The high food prices have been fueled by drought and high import prices of cereals, while increased transportation costs emanate from high petrol prices, which have since abated. There is a strong indication that inflation is on downward spiral, given the

strong monetary policy measures taken and the effect of the international financial crisis on demand. It is expected that by the end of 2009, the inflation rate is likely to return to single digit levels.

Given the continuous unsuccessful pursuit of economic development policies and the evident recordings of low growth rates during the past five years; global financial turbulence has exacerbated this adverse environment for growth. Despite the fact that Swaziland's financial sector has been unaffected by the crisis, because of its highly liquid and profitable position, intermediation to create investment and growth has not happened. The growth in credit to the private sector was 6.6% in January 2009 compared with growth of 17.3% during the same period in 2008.

Despite the potential inflows from long-term savings guaranteed through the recent 30 percent local asset requirement, set in the recent legislation on insurance and pension funds; the investment of these funds into the real economy has not played any significant role in economic growth, as there has been no planned infrastructure in the form of projects or other investment vehicles to absorb this added liquidity; infact, there has been a reversal of the inflows through the banking system. Other factors that play against the promotion of growth have been the persistent unfavourable competitiveness of Swaziland vis-à-vis countries within the region.

Despite inadequate resources to provide stimulus in growth, the budget for the financial year 2009 was presented to facilitate the provision of developed infrastructure through giving priority to health, education, water, upgrading of road network, agriculture and other socio-economic projects whose implementation would generate jobs and reduce poverty levels The financing of these programmes is expected to translate to a budget deficit equivalent to 8% of GDP, following an outturn for 2008/09 budget deficit of 1% of GDP.

In the same vein, the central bank has positioned itself to ease its monetary policy stance. This, however, has followed a period where the posture of monetary policy was that of targeting inflation. In April 2008, for instance, the Central Bank's discount rate was increased by 50 basis points to 11.5%. This still allowed the base rate to be 50 basis points below that of the South African repo rate. This differential, though not effectively underpinning the rate of increase in credit extension, reflects the expectation by the Central Bank, that with comparatively lower rates vis-à-vis South Africa, the lower cost of borrowing would be an incentive for growth in the business sector.

As the global financial crisis effects on the economy began to be evident, the policy stance has been that of relaxing interest rates to underpin the stimulus measures in some limited way. The discount rate was reduced by 150 basis points between December 2008 and February 2009. Given the volatile movements in major economic aggregates that sustain our economies, the Central Bank will follow the South African Reserve Bank decision to review its monetary policy stance on a monthly basis. There are no guarantees that the economy will be responsive to these measures; however, with the expectation that in the latter part of 2009, the financial sectors in more developed countries would be responsive to the measures taken by major central banks, this may set a stage for recovery through the impetus created by our stimulus programme.

In addition, given that Swaziland has continued to receive limited inflow of foreign direct investments, stimulus measures may be a solution for growth generated through domestic measures rather than a growth solution dependent on external sources of investment.

RECENT ECONOMIC DEVELOPMENTS

Macro Indicators

After recording an impressive growth rate of 3.5% in 2007 official estimates put real GDP growth at 2.6% in 2008.

Dampening growth in 2008 was the negative performance of some export commodities notably in the textile industry and the persistent slow growth in foreign direct investment. The slow down in the textile industry is attributed to the decline in the economies of trading partners partly because of the second round effects of the global financial crisis on developing countries. The shrinkage in the trading partners' economies has been translated to lower demand for domestic exports hence a decline in the volumes of exports. Consequently, given the country's heavy reliance on export for growth, the country experienced a decline in overall real GDP growth. Also, the sharp downturn in the South African economy in 2008 has undermined Swaziland's export demand given that more than 50% of the country's exports are destined to the South African markets. With a restrictive monetary policy during 2008, the high cost of borrowing has led to a slow down in the construction sector as high interest rate dampened demand for housing and credit in general for construction purposes. Further compounding the slow down in the construction sector was the high prices of raw material resulting from the hike in oil prices that occurred for the better part of the period under review.

The above notwithstanding, there were mitigating factors which helped to cushion the economy from declining further in 2008. One of these mitigating factors is the depreciation of the real effective exchange rate in 2008 which implies that the competitiveness of domestic exports destined to markets outside the Common Monetary Area (CMA) improved. The agricultural sector which showed signs of recovery in light of the good rains received during the

planting season and the higher price for maize has also helped to underpin growth in 2008.

Growth outlook for 2009 is, on the downside, clouded by the gradual cut in EU sugar prices, the expected decline in SACU transfers amid a new revenue sharing formula, the continued deteriorating world economic environment which risks domestic export growth, slow down in FDI inflows which is mostly likely to be exacerbated by the second round effects of the financial crises, fiscal pressures and the impact of HIV/AIDS. On the positive side the economy may benefit, from low cost of borrowing provided financial institutions open up credit extension with no risk aversion. The agricultural sector is also expected to underpin growth in 2009 due to the implementation of the Lower Usuthu Smallholder Irrigation Project (LUSIP) and the good rains which saw the Maguga Dam overflowing.

A quick glance at other macroeconomic indicators confirms the not so impressive performance of the domestic economy. Swaziland has maintained relatively low savings and investment rates, which have hardly been above 20% of GDP in recent years. As a proportion of GDP, national savings stood at 17.3% in 2007 and is expected to grow at a slower rate owing to the slowing down of the SACU receipts. National savings growth has been over the past years sustained by SACU receipts but could be reversed by Government's increased recurrent expenditure currently at above 70% of the budget coupled with the dwindling SACU receipts.

The dependence syndrome of the country on SACU receipts is a major concern and needs government's action to counter the consequences of the declining SACU revenue. With the prevailing situation, Government deficit is likely to escalate to unsustainable levels which in turn will compromise Government savings. It is with this state of the fiscus that government is intensifying her

efforts to enhance tax collection to diversify her revenue through the establishment of a Revenue Authority.

Meanwhile gross investment has remained relatively low in the recent years. Total investment stood at 19.4% of GDP in 2007 and is expected to have declined in 2008 owing to high borrowing costs, and continuing slow down in FDI inflows exacerbated by the stiff competition in the region coupled with the world wide credit crunch. Whilst the Government's newly passed legislation recalling 30% of the life insurance companies and pension funds assets invested offshore was meant to boost domestic savings and hence investment in the country, its positive effects are yet to be seen.

On inflation, upward trend in inflation in Swaziland continued unabated for the better part of the year 2008. Average inflation for 2008 recorded a double-digit figure of 12.6% which was 4.5% points higher than the previous year's rate of 8.1%. However this rate was insignificantly higher than the Central Bank's forecast of 12.5% for 2008. During the course of the year, inflation increased from 10.6% in January to a peak of 14.7% in August before declining to 12.9% in December. Major factors behind the growth in prices and the subsequent decline were transport costs and food prices. Domestic price levels were also affected by the weakening of the lilangeni/rand exchange rate. In tandem with rising inflation in South Africa (SA), the country's main trading partner, imported inflationary pressure from SA continued to exert upward pressure on the domestic inflation. The downward trend currently observed in domestic inflation is also in line with the more accommodative policy stance taken by the Bank to contain inflation in the latter part of 2008.

The growth in transport prices which was observed from the last quarter of 2007, triggered by high oil prices, was maintained into 2008. In 2008, the growth was even higher, increasing from 21.2% in January to a peak of 45.6% in August. This happened on the backdrop of a cumulative 245 cents and 350

cents per litre increases in petrol and diesel prices respectively to August. Growth in petrol and diesel prices mainly affected transport expenses. In August 2008, the passenger transport services' component more than doubled, to record a growth rate of 109.4% as Government awarded an increase to public transport operators.

Food prices on the other hand have maintained a high growth rate during the year. Food items that showed a higher growth, include; oil and fats, bread and cereal and fruit components. Fats and oils' growth increased from 24.8% in January 2008 to a peak of 59.3% in June before declining to 42.4% in December. Though high, growth in bread and cereal products remained stable with a growth rate ranging between 22.2% and 33.4% during the course of the year. Fruit prices on the other hand peaked at 36.4% in May, before declining to 16.1% by the end of the year.

The January inflation rate recorded 12.3%, 0.6 percentage points down from the previous month's rate. The major source of the downward trend was the reduction in the growth rates for transport and food prices, which more than off-set higher growth rates in the restaurants and hotels, household furnishing and equipment and education categories. Growth in transport costs declined by 5.2% points to 14.8%, whilst food prices declined by 1.8% points. This downward trend is expected to continue into the first quarter of 2009 as the effects of declining crude oil and food prices might push inflation even lower.

External sector

Based on preliminary figures for 2008, Swaziland's overall balance of payments surplus was maintained, though reflecting a decline from a surplus of E2, 574.3 million in 2007 to E1, 061.2 million in 2008. This was despite a large estimated outflow of E3, 426.8 million recorded in the current account for the year under review. The positive balance of payments development resulted mainly from a large inflow of transfers, principally in the form of revenue from

the Southern Africa Customs Union (SACU) coupled with a re-allocation of the government's investments abroad to the custody of the Central Bank of Swaziland.

The services account has been affected by the recent global economic crisis. The rise in energy costs influenced high freight and transportation costs resulting in the services account deficit swelling to a record E1, 176.9 million compared to the E212.6 million deficit recorded the previous year.

Estimated export figures registered an increase of 5.4% in 2008 from E12, 292.6 million in 2007. The slower rate of increase in export earnings could be attributed to more subdued growth in both the volume and the emalangeni value of merchandise exports. The much anticipated deceleration in global demand and decline in international commodity prices have however encouraged local producers to curtail their output in 2008.

Imports on the other hand have been threatened by the volatile oil prices with a negative spill-over effect on agricultural input and food prices. In 2008, merchandise imports estimates rose by 4.1 per cent from E14, 202.2 million the previous year. This sluggish growth in imports was driven by weak consumption that resulted from the high international fuel and food prices, which led to the region realizing an average inflation rate of 12.6% in 2008 compared to 8.3 % in 2007. As a result, the merchandise trade deficit narrowed from E1, 910.1 million to E1, 833.6 million in 2008.

The income account shows a deficit for the first time in four (4) years, registering a net outflow of E1, 773.1 million in 2008 from E449.3 in 2007. This sudden turnaround was influenced by corrections made in the Balance of payments classification from a payment of "Legal, accounting and management fees" in the services account, to dividends and profits remitted abroad.

A slightly lower net inflow of E1, 356.7 million was registered in the current transfers account compared to a net inflow of E1, 366.6 million recorded in 2007. SACU receipts continued to dominate this account as the share in the revenue pool was revised to the country's advantage.

Preliminary data reveal that the financial account excluding reserves posted a net inflow of E4, 517.0 million in 2008, depicting a significant improvement from the E2, 918.8 million the previous year. Accounting for this increase was a rise in commercial banks' liquid assets as reflected in bank's balances with the Central Bank, which suddenly raised their foreign liabilities by E1, 445.8 million. Portfolio investment inflows and outflows remain low as few companies dealt in debt and equity securities. Net foreign direct investment inflows recovered slightly during the review period, but do not represent new investments into the economy instead short-term capital inflows extended to local companies from their foreign head offices.

Monetary Sector

The year 2008 was mainly characterised by tight monetary conditions following accelerating inflationary pressures stemming from high prices of oil and food. Domestic inflation increased from an average of 8.1% in 2007 to 12.6% in 2008 recording an all time high of 14.7% in August 2008. The Central Bank's policy response was to pursue a contractionary monetary policy stance through increasing interest rates.

The discount rate was increased by 50 basis points in April 2008 to 11.5% and remained at that level up to November 2008. Up until December, the policy was that of inflation targeting, but as the economic climate changed because of the adverse effects of the global financial crisis, it became apparent that the easing of monetary policy may be a solution towards stimulating the economy through the financial sector. Domestic inflation had decelerated to a level of 12.9% in December 2008 and 12.3% in January 2009. Following the decision to ease

monetary policy stance, the Central Bank, thus, reduced the discount rate by 50 basis points in December and by another 100 basis points in February 2009.

Though domestic economic conditions are expected to deteriorate further in the short to medium term due to deeper economic recession in major economies, the resulting positive developments in inflation outlook are anticipated to lead to further interest rate relief during the rest of 2009.

The impact of the tight monetary policy stance pursued by the Bank since mid-2006 manifested itself through deceleration of credit to the private sector. Annual growth in private sector credit fell from 17.3% in January 2008 to 6.6% in January 2009. At this level the growth in credit was far below the annual inflation rate, implying a fall in real terms. The corporate sector was the hardest hit as credit growth fell from 20.7% in 2008 to negative territory at -5.5% in 2009. Growth in credit to households also declined though slightly from 16.3 to 16.1% over the same period.

In line with the slowdown in private sector credit demand, year-on-year broad money supply growth also decelerated from predominantly double-digit levels to reach 9.5% in January 2009. This was largely reflected in a fall in quasi money growth from 41.6% in January 2008 to 4.4% in January 2009.

The country's net foreign assets grew by an annual rate of 31% largely attributed to customs union revenue inflows combined with revaluation gains from the depreciation of the rand/lilangeni exchange rate over the review period. Gross official reserves alone increased by 31.1% over the year to reach E8.1 billion. At this level, the reserves were enough to cover 5.7 months of imports compared to 4.4 months covered the previous year.

Outlook for the country's official reserves in the short to medium term is not encouraging as indications are that there will be a reduction in customs union revenue for all SACU member countries including Swaziland during the fiscal year 2009/10 onwards. The situation will be worsened by the negative impact of the global financial crisis as global demand and prices, for domestic exports remain depressed. The effects of these developments can be minimized by the government's critical role to fast track the implementation of measures designed to broaden the country's revenue base and promote efficient management of public expenditure.

Over the year under review, the banking sector's liquid assets increased by 9.8% to reach E862.3 million. In an effort to create more local investment instruments for banks as well as to indirectly limit cross-border outflows, the Central Bank, since December 2008 introduced a new 56-day paper issued at E30 million per week. This paper is issued along side with the 28-day paper whose amount on offer has also been increased from E30million to E40 million. Banks' demand for the new paper has been overwhelming as the issue has been regularly over-subscribed. Total CBS bills outstanding in January 2009 stood at E187 million, comprising 28-day at E87 million and 56-day at E97 million.

There were no changes in treasury bills issued and the outstanding amount stood at E362.2 million at the end of January 2009. Participation continued to be dominated by commercial banks, with 92% holdings. Individuals held 5.2% and the remaining 2.8% was held by Central Bank Open market Operations and non-bank financial institutions.

Fiscal Sector

The budget outturn for the fiscal year 2007/08 shows a budget surplus of E787.8 million, equivalent to 3.7% of GDP. This is a decline from the surplus of 10.1% of GDP recorded in 2006/07. The decline was mainly a result of

collection of taxes falling below target due to delays in implementing tax reforms and a decline in custom duties.

The estimated outturn for 2008/09 indicates a budget deficit of E240.7 million or 1% of GDP, a slight improvement from the initial estimated budget deficit of E330 million or 1.4% of GDP. This improvement is attributed to savings arising from the low implementation rate of capital projects and expenditure control measures that government has put in place. In these difficult times, government is also facing challenges of sluggish growth and the implementation of the country's constitution, which recommends free education after five years of its adoption.

The 2009/10 budget has been drawn on the basis of policy reforms articulated in previous budgets including the Medium Term Budget Policy Statement (MTBPS) for 2008/09 to 2010/11. The MTBPS outlines the fiscal policy considerations that underlie government budget proposals for three years with identified expenditure patterns taking priority in terms of delivery. Key priority areas this budget focuses on include; provision of safe water and sanitation, access to health care, fight against HIV and AIDS, education, economic growth, curbing corruption and strengthening national security.

The budget estimates for 2009/10 project a deficit of E1.986 billion, which translates to 8% of GDP. The huge deficit is mainly attributed to the decline in SACU revenue as a result of reductions in tariffs on trade in line with WTO requirement; implementation of on-going capital projects with new capital projects also taken on board plus the general increase in expenditure pattern to meet government operations.

Public expenditure continues to grow faster than revenue. In 2009/10, it is projected that government revenue, including grants, is to decline by 3% to E9.37 billion in 2009/10 when compared to the revised budget for 2008/09.

On the contrary, total expenditure is expected to increase by 20.4% to E11.52 billion over the same period. Government continues to explore means of enhancing revenue collection in a bid to mitigate the imminent decline in SACU revenue which has been felt even in the current budget. This will be achieved through enhancing the internal revenue resources leading to the establishment of the Revenue Authority.

Government is cautioned to explore prudent means of financing the deficit instead of opting to drawdown on reserves since such is not sustainable in the medium to long-term. Financing the deficit through expanding the domestic market by introducing new instruments with longer maturity may be an ideal solution at this point. This could further bring investment avenues for the Insurance and Pension Funds in meeting the requirement which call on these Funds to invest at least 30% of their total assets locally by November 2009.

On expenditure pattern, recurrent expenditure is projected to rise by 13.1% to E8.27 billion in 2009/10. The wage bill accounts for about 54% of recurrent expenditure and this is significantly higher than the internationally recommended 35%. In an effort to address this, government has decided to enhance the voluntary exit scheme that it had set-up to reduce the size of the civil service. The capital budget for 2009/10 is E3.08 billion, reflecting an increase of 36.5% 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 with new identified capital projects also taken on board. These include the completion of Mbabane By-pass Road, Sikhuphe Airport, rehabilitation of SBIS building and Hlathikulu Hospital, construction of water treatment plants for supply of water to Siteki-Lomahasha and Nhlanguano. New big projects expected to commence in the coming financial year include the construction of Sicunusa-Nhlanguano Road and Lubombo Regional Hospital.

Swaziland external indebtedness in Emalangeni terms worsened in 2008. At the end of December 2008, total external debt stock, including private sector non-guaranteed debt, stood at E3.98 billion, denoting an increase of 17.4% from E3.39 billion recorded in December 2007. The increase was primarily due to disbursements of loans for ongoing projects such as the Lower Usuthu Smallholder Irrigation Project (LUSIP) and the Mbabane By-pass Road Project. Further putting pressure on the debt stock was the huge depreciation of the local unit against the US Dollar and other major currencies in which most of the country's external liabilities are denominated.

Public external debt (which includes public and publicly guaranteed debt) stood at E3.58 billion or 18.5% of GDP at the end of December 2008, reflecting an increase of 21.4% from the E2.95 billion recorded the previous year. The external debt for central government, which constitutes the largest share of the total loan portfolio, stood at E3.36 billion from the E2.76 billion recorded at the end of December 2007.

The public debt stock is expected to increase in 2009 as loans for big government projects such as LUSIP, which has reached its completion stage, continue disbursing. During 2009/10, government is also hoping to contract new loans from the OPEC Fund and BADEA for the financing of Sicunusa-Nhlangano Road, and the Government of Kuwait for the construction of access road to Sikhuphe International Airport, to be jointly financed with BADEA.

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 and to keep expenditure focused on productive undertakings.

BANK SUPERVISION DIVISION

The financial sector performance

The over-arching objectives of Banking Supervision are twofold:

- (i) To ensure the safety and soundness of the financial sector.
- (ii) To protect the stability of the financial system.

Swaziland's financial sector is still stable even after developed countries economies have seen bank failures and financial losses. To place reliance in an economy like that of Swaziland, investors consider the above mentioned objectives and the performance of the financial sector as a whole. In the twelve months to December 2008, banking financial institutions maintained capital adequacy ratios above the minimum statutory requirement of 8.0 percent. The capital adequacy ratio for the banking sector stood at 42.0 percent at the end of December 2008, compared to 24.0 percent reported in December 2007. This is a positive sign particularly as the balance sheets of the financial institutions are likely to remain healthy. The industry's growth depends in part on the ability to generate profit. On that note, the financial sector's profitability ratios remained strong throughout the year 2008.

Credit risk is the single largest factor impacting the soundness of the financial system as a whole. Lending is the principal business activity for the financial institutions that are supervised by the Central Bank. The loan portfolio is typically the institutions largest asset class and it is the main source of revenue. For this reason, lending and credit administration form the critical aspect of financial sector supervision. The credit ratios for the period under review have deteriorated. Total net loans and advances increased from E4,666.7 million in December 2007 to E5,003.6 million in December 2008.

Non-performing loans and advances increased from E349.3 million recorded in December 2007 to E554.1 million as at end of December 2008.

The liquid assets held by the banking system exceeded the statutory liquid asset requirement throughout the year 2008. An indication that the financial institutions were well positioned to meet their financial obligations.

Risk-based Supervision

In preparation for the adoption and implementation of Basel II, the supervisory authority is planning to adopt the risk based supervision framework approach. The Bank Supervision Division has since completed the development of the Risk-Based Supervision Framework. With the assistance of the Financial Sector Management Department of Macroeconomic and Financial Management Institute of Eastern and Southern Africa (MEFMI) the next phase would be the actual implementation of Risk-Based Supervision.

In general terms, the risk based supervisory approach is intended to result in an effective and efficient process for monitoring and assessing, on an ongoing basis, the safety and soundness of banks. A risk-based process seeks to achieve an accurate assessment of individual banks' financial condition and managerial strength, in order to facilitate a prompt and timely response to emerging weaknesses/risks.

The key benefits of the risk-based framework for both the supervisory authority and the banks would include: cost effective use of supervisory resources through focusing on risk, in turn resulting in better use of bank resources, a consistent framework for evaluating banks through the segregated assessment of inherent risks and risk management processes; early identification of emerging risks at individual banks and on a sectoral basis; a better appreciation by supervisors of the characteristics of the bank's business, of the risks they face; and of the quality of their management.

An important focus in the risk-based approach is the potential impact that a bank's failure would have on the overall financial system.

Non-bank financial institutions (including mushrooming pyramid schemes)

During the year under review, the Bank continued to perform its responsibility of protecting and educating members of the public by alerting them, through press statements in the local media on the dangers of conducting deposit taking business through unlicensed institutions or individuals.

The Central Bank, on 25 November 2008 issued a seizure declaration notice in terms of section 8 (2) of the Financial Institutions Act, 2005 (FIA) wherein the Bank took possession of the accounts of companies and or individuals that were found to be involved in illegal deposit taking activities.

This notice was issued to the banks where these companies or individuals held and operated their business accounts. As a consequence to the Seize and Desist Order, there is a matter pending judgement in the High Court of Swaziland.

New entrants in the market

In terms of Section 6 of the Financial Institutions Act, 2005, Blue Financial Services (Pty) Ltd Swaziland was granted a license to operate as a Credit Institution. Blue Financial Services (Pty) Ltd Swaziland is a subsidiary of Blue Financial Services South Africa (Pty) Limited. The company is well capitalized with a start up capital of E8.0 million as per the requirements of Section 20 of the Financial Institutions Act, 2005.

As a regulating authority we believe that the licencing of credit institutions will act as a catalyst in financing the credit needs of the small businesses and individuals to stimulate growth.

Loan evaluation

To enhance sound credit assessment and valuation of loans and fully provide supporting collateral documentation by banks and financial institutions the Bank had to revise the Circular No.8 which is a Bylaw on loan classification and minimum provisioning requirements for bad and doubtful debts. Circular No.8 provides the necessary framework and guidelines for banks and other financial institutions by which loans and other assets are to be evaluated and graded in a consistent manner.

Non-bank financial institution's legislation

The Bank still awaits the promulgation of the Financial Services Regulatory Authority's Bill into law. The crafting of this Bill intends to create an authority to regulate non-bank financial institutions, to minimize regulatory arbitrage between the banking sector and non-bank financial institutions.

NATIONAL PAYMENTS SYSTEMS DIVISION)

1. Overview of operational activity levels

Operations of national payment systems continued to run smoothly during the twelve month period ending December 2008 save for minor operational challenges in the message carrier, the Society for Worldwide Inter-bank Funds Transfers (SWIFT) System.

In line with international best practice, large value items continued to be characterized by low volumes in the Swaziland Inter-bank Payment and Settlement System (SWIPSS/RTGS) while activities at the Automated Clearing House (ACH) continued to record high volumes of low value items. This trend indeed reflected the desired decline associated with the introduction of the maximum limit for cheque amounts to facilitate further mitigation of financial risk associated with retail payment systems.

The introduction of maximum limits for cheques in 2007 will be followed by maximum limits for electronic funds transfers (EFTs), particularly domestic EFTs processed at the ACH, for further financial risk mitigation and to enhance speed in settlement of payments. Transactions in excess of the maximum limits would be channelled through SWIPSS.

2. Supporting legal framework

One of the international standards for payment systems provides that payment systems should operate under a well-founded legal basis. Pending promulgation of the National Clearing and Settlements (NCSS) bill, the Central Bank of Swaziland continued to rely on the Central Bank of Swaziland order of 1974 (as amended) to promote, supervise and regulate payment systems while operations were governed through signed-off service level agreements, rules and procedures to ensure safety and efficiency of national payment systems.

Towards the end of 2008 NCSS Bill has progressed in the promulgation path from Cabinet to the House of Assembly.

3. Oversight of payment systems

The establishment of the Central Bank oversight function was formerly launched during the period under review to create stakeholder awareness on the Central Bank's mandate to promote, regulate and supervise the efficient and secure operation of payment systems in line with international best practice, standards and applicable legislation. The targeted stakeholders were the Commercial Banks, Swaziland Building Society, Swaziland Automated Electronic Clearing House and the Swaziland Government.

4. Future developments and projects

The Central Bank of Swaziland in conjunction with commercial banks and the Swaziland Government will continue to foster the safety and efficiency of payment systems to ensure support of financial stability in the country. In line with regional reform and modernization programme, the Central Bank will focus on the following developments:

4.1 Ministry of Finance Module Development Project - The Central Bank of Swaziland in conjunction with the Swaziland Government will develop and implement the Ministry of Finance (MOF) Module on the Real Time Gross Settlement (RTGS) platform. This module will enhance reduction of financial risk associated with paper-based instruments and to facilitate speedy settlements for time critical payments.

4.2 Regional Payment and Settlement System Project (REPSS)

Project - The Central Bank of Swaziland continued to participate in the ongoing implementation of the Regional Payment and Settlement System Project (REPSS) under the auspices of the Common Market for Eastern and Southern Africa (COMESA) with the aim of promoting trade between member countries. The live date of REPSS is scheduled to the end of March 2009.

4.3 Local Switch for ATM/POS Activities - Although activity levels of plastic cards are relatively low when compared to cheque activities, the development of a local clearing switch for domestic ATM/POS activities will be explored during the upcoming financial year. This would entail local settlement of domestic inter-bank transactions (mainly card transactions) as opposed to settlement of domestic transactions through third party service providers in the Republic of South Africa. This arrangement will enable Swaziland to manage

and control her own domestic risk exposures associated with payment systems.

CAPITAL MARKETS DEVELOPMENT

1. Draft Enabling Securities' Legislation

Whereas the Financial Services Regulation Authority Bill, (FSRA) and the Securities Bill were finalised in 2007, both draft legislation have still not been passed into law.

The object of the FSRA Bill is to establish an integrated regulatory regime in Swaziland for the non-bank financial services industry including insurance, retirement funds, savings and credit cooperatives, building societies, capital markets and collective investment schemes. Similarly, the object of the Securities Bill is to promote and facilitate the development of orderly, fair and efficient capital markets in Swaziland. Undoubtedly, these Bills constitute the most crucial pieces of draft legislation in as far as the regulation of non-bank financial industry is concerned.

The Bank views the protracted delays in the promulgation of both Bills into law in very serious light. This is even more so because the continued absence of enabling securities' legislation undermines the development, promotion, regulation, supervision, operations, reputation and credibility of the non-bank financial services industry in the country. Consequently, the Bank shall, during the ensuing fiscal year, explore and pursue all avenues at its disposal to persuade the authorities to get these Bills passed into law, failing which it shall seek and obtain a credible timeline when these shall be so passed.

2. Participation in Regional Capital Markets Development Initiatives

The Capital Markets Development Unit (CMDU) as regulator of capital markets in the country is affiliated to the Committee of Insurance, Securities and Non-bank Authorities (CISNA) of SADC. Likewise, the Swaziland Stock Exchange (SSX) is a member of the Committee of SADC Stock Exchanges (COSSE).

Both the CMDU and the SSX participate actively in periodic consultative conferences and have benefited greatly in various developmental initiatives of these SADC Committees. The harmonisation of the regulatory framework, listings requirements and the free sharing of technical expertise are examples of the benefits accruing to CMDU and SSX being members thereof. COSSE has, for long, been and still continues to pursue its goal of attaining ICT interconnectivity of member exchanges with a view to promoting cross border listings and trades amongst and between them.

Both the CMDU and the SSX have signed Multilateral Memoranda of Understanding with the Committee of Insurance, Securities and Non-bank Authorities (CISNA). Broadly, the objective of such MOUs is foster cooperation among regulators and securities exchanges in matters of mutual interest including the harmonisation of listings requirements, members rules, regulatory frameworks and the automation plus the interconnectivity of regulatory and exchange operations, enhancement of cross-border listings and trades.

In addition to the multilateral MOUs, the Central Bank of Swaziland has, through the CMDU, signed an agreement which includes all the CISNA Member States and four (4) Bi-lateral Memoranda of Understanding with Namibia, FSB South Africa, Uganda and Zambia aimed at facilitating and

improving the exchange of information, technical expertise and consultation between securities regulators and exchanges.

The policy of the Bank is to promote cooperation with regional capital markets' regulators and operators of securities exchanges in order to foster networking partnerships and technical cooperation.

3. Collective Investment Schemes and SSX Bye-laws

In the absence of the applicable regulatory legislation, management companies under collective investment schemes are managed through the Collective Investment Schemes Guidelines, 2007. The SSX Listings Requirements and Members' Rules serve the same purpose for listed securities and market participants, respectively. Even though these bye-laws have served the CMDU very well and the affected market participants have been cooperative, the Bank is of the opinion that the byelaws would even be more effective if they had the full backing of the enabling securities legislation.

4. Risk Based Approach to Supervision

The CMDU together with the Bank Supervision Division are in the process of finalising a framework and guidelines for introducing a risk-based approach to supervision. The process of implementation will involve carrying out of on-site reviews of all licensed managers, dealers and trustees and the development of a risk matrix to help identify risks and mitigating controls applicable to all intermediaries. The Bank supports the introduction of the risk-based vis-a-vis the current compliance-based approach to supervision because the former is the latest trend worldwide as it has been found to be the more effective regulatory framework.

5. Public Awareness and Enhancement of Capital Market Products and Services

In a bid to promote public awareness and enhance the level activity of collective investment schemes and listings, CMDU is engaged in public awareness and consumer education campaigns. CMDU has created and a Consumer Education and Investor Protection Office, whose main functions include consumer education, public awareness and investor protection. CMDU have routinely participated in the annual Swaziland International Trade Fair, Schools' Investment Challenge and mass media coverage through all of which it has distributed promotional material and disseminated information on capital products and services. CMDU promotes public awareness on the operations of capital markets, the benefits and risks involved in such investment.

EXCHANGE CONTROL DIVISION

Anti Money Laundering

The Central Bank of Swaziland in its drive to fight Money Laundering and Financing of Terrorism in the country is in the process of setting up an office which will include a Financial Intelligence Unit (FIU), whose responsibility is to strengthen the supervisory role of the Bank on enforcing compliance with the Money Laundering (Prevention) Act 2001.

In its simplest form, FIUs are agencies that receive reports on suspicious transactions from financial institutions and other persons and entities, analyze them, and disseminate the resulting finance intelligence information to local law-enforcement agencies and other foreign FIUs where appropriate.

Introduction of Authorized Dealers with Limited Authority (ADLA)

Following the approval by Central Bank of licensing Authorized Dealers with Limited Authority (ADLAs) commonly known as Bureau de Change, in the country, Authorised Dealers and other stakeholders will be informed accordingly through circulars and press statements of the implementation procedures and underlying guidelines.

Guidelines on the application procedures for aspiring ADLA operators, and the press statement is to sensitize the general public on business opportunities for those qualifying Swazi Nationals.

CONCLUDING REMARKS

As the global crisis takes its toll, the central bank and government will be called upon to foster economic condition through stimulus measures, for sustained economic development. Monetary policy will remain an important ingredient in the revival of the financial sector. The continued easing of restrictive monetary policy stance is expected to enhance the financial conditions that will underpin credit creation and in turn lead to the restoration of the functionality of the credit markets. In Swaziland the low rate of intermediation through savings that have been repatriated as a result of the local asset requirement for pension funds and long term insurances calls for concerted government intervention in identifying investment opportunities that will create growth and employment. In addition, such investment opportunities should have element of rendering self sufficiency and less dependency on consumer goods importation. The need for diversification can not be over-emphasised as the recent developments in the manufacturing sector points to job losses created by the reduced demand for our exports.

The Central Bank's easing of monetary policy through gradual reduction of interest rates may continue; however, fiscal policy the most effective policy tool in Swaziland has to compliment the Bank's policy stance. In the current circumstances, the timely implementation of fiscal stimulus in Swaziland will be vital in underpinning economic growth. In addition, given the high liquidity of the financial sector, the Central Bank's stance of gradually reducing interest rates may fall on barren ground as banks have been persistently risk averse.

The Central Bank will not issue directives on credit allocation but will remain steadfast in allowing market forces to determine the banking system's role in intermediation. The success of intermediation in encouraging domestic investment will underpin the effectiveness of Central Bank's decision of easing interest rate on a more regular basis. The banking industry has proved to be stable and highly profitable in 2008. However, higher interest rates during the three quarters of 2008 have given way to an increase in bad debts. The provision made by the bank for bad debts have however not substantially reduced commercial banks bottom line. In order to maintain continued stability, the Central Bank will continue to monitor and introduce a risk based approach bank supervision. Banks have played an important role in the national payment system; it is encouraging that substantial progress has been achieved in improving the efficiency of the payment system.

Finally, legislation that has been outstanding for a number of years, which has been impeding the effectiveness of the Central Bank, in regulating and supervision of the financial sector is expected to go through the various legislative steps through to parliament. The legislation includes the Securities Bill which is expected to underpin confidence and growth in the investment climate in Swaziland; the Financial Services Regulatory Authorities Bill and the National Clearing and Settlements Bill.

May I on behalf of the Board of Directors and staff of the Central Bank extend the Bank's appreciation for the cooperation and support received from the Minister of Finance and his officials and all stakeholders in the financial sector.

MARTIN G. DLAMINI
GOVERNOR