CENTRAL BANK OF SWAZILAND

UMNTSHOLI WEMASWATI

ANNUAL MONETARY POLICY STATEMENT

2012

- NATIONAL PAYMENT SYSTEMS
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ANNUAL MONETARY POLICY STATEMENT
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THEME: ***MONETARY POLICY IN CHALLENGING ECONOMIC CONDITIONS***

1. INTRODUCTION

The global economic climate in 2011 has remained volatile. Real growth continues to be weighed down by high government debt levels, impaired banking systems and weak confidence especially in developed countries. Dominating global economic developments in 2011 has been the debt crisis in the Euro zone. The European debt crisis has worsened over the past few months, despite numerous efforts by policymakers to restore confidence. Measures, including a deal to expand the European Financial Stability Fund, more extensive adjustments for Greek debt as well as new austerity measures across a number of countries were all seen as too little, too late by the markets.

The developing world has witnessed slow growth and is likely to disappoint in the short to medium term. In particular, those countries with close trade and financial ties to Europe and the United States are likely to experience further slowdowns.

Analysts have continued to downgrade global growth forecasts in recent months, with multilateral bodies such as the Organization of Economic Cooperation and Development (OECD) and the European Union (EU) portraying sharp slowdowns. In November the OECD put developed world growth at just 1.6 percent in 2012, dragged down by a slowdown in the Eurozone, where activity is now predicted to be flat.

The IMF, in its January 2012 World Economic Outlook, has projected the global economy to expand by 3.25 percent in 2012, a downward revision of about 0.75 percentage point from the 4 percent projected in September 2011. Global financial conditions have deteriorated, growth prospects have dimmed, and downside risks have escalated. This is largely because the euro area is now expected to go into a mild recession in 2012 as a result of the rise in sovereign yields, the effects of banks reducing their financing on the real economy, and the impact of additional fiscal consolidation.

The United States, going into election mode in 2012 showed signs of some recovery in the last quarter of 2011, with the auto industry which was bailed out by the Obama administration exhibiting improved performance. Employment numbers are on the upside and there is hope that more jobs will be created this year. However, there still exist insurmountable fiscal problems and unresolved issues in the housing market. Consumer spending, which makes up around 70% of total US economic activity, continues to be limited by high unemployment. This is likely to lead the Fed to maintain the fed-funds rate at the record low of between zero and 0.25 percent for an extended period until 2014. In 2011, the US recorded a real GDP growth rate of 1.7 percent from 3.1 percent in 2010.

The Euro zone has had the biggest challenge going into 2012. In-spite of positive growth in major economies France and Germany, the Euro zone economy shrank in the fourth quarter of 2011. GDP for the 17 nations fell 0.3 percent in the fourth quarter from the previous quarter, the first decline since the second quarter of 2009. This decline in GDP follows a 0.1 percent increase in the third quarter of 2011.

At the center of the Euro zone challenges is the Greece economy. The European Union has put in place austerity measures for Greece, covering tax increases, spending cuts and wage cuts which have pushed the country into a deep recession; the economy shrunk by almost 12 percent between 2009 and 2011 and is expected to shrink by up to 6 percent in 2012. The crisis has also stripped Greece’s political center of its last shreds of political legitimacy. With unemployment at a high of 21 percent, businesses closing down, scarce credit and the proposed new wage cuts expected to further decimate the declining middle class. The proposed austerity package includes 20-percent cuts to base pay for workers in private companies and a loosening of public sector job protection.

The implementation of these austerity measures by Greece is expected to unlock the 130 billion euros, or $172 billion, in new loans and save Greece from potentially disastrous default. The European Union statistical agency reported that Greece's debt rose to 159.1 percent of gross domestic product in the third quarter of 2011, from 138.8 percent a year earlier.

Even with the measures in place, for the first time in history, officials in Athens and Europe have started considering the consequences of a Greek default and exit from the euro zone.

In the first half of 2011, emerging economies were seen to be the alternative driving force of global economic growth underpinned by increased production and trade accompanied by strong capital flows. Growth was projected at 5.5 percent for 2011 against subdued growth in developed economies. Growth in emerging and developing economies has however slowed more than forecast, possibly due to a greater-than-expected effect of macroeconomic policy tightening or weaker external growth.

The IMF has projected the sub-Saharan Africa region to expand output by around 5½ percent in 2012. The region has been impacted by the global economic and financial meltdown, however such effects have been limited to a few countries; notably South Africa has been negatively affected by the Eurozone debt crisis due to its strong trade links with the Eurozone. The South African Reserve Bank has deemed growth prospects in South Africa to have weakened with a deteriorated outlook for inflation and risks to the domestic economy evenly balanced. The South African Minister of Finance in his 2012/13 budget speech indicated that the slowdown in the global economy may result in the country's real GDP growth falling from an annual average growth rate of 3 percent from 2009 to about 2.7 per cent in 2012, recovering to 3.6 per cent and 4.2 per cent in 2013 and 2014 respectively.

Swaziland's economic growth performance in 2011, being a country that has close trade and economic links with South Africa, remained subdued largely affected by the lackluster performance of global trade. These developments adversely affected external demand for its exports in the major trading economies particularly in the country's key export markets, namely South Africa, the United States, and the European Union. These countries remained in a state of economic paralysis throughout the review year. The Kingdoms' tepid economic performance is far weaker than its neighboring Southern African Customs Union (SACU) counterparts. Most of the SACU member states have benefitted from the relatively high international prices of commodities in the past year.

Though there was a negative impact of the fiscal crises on domestic growth, the agricultural and agro-processing manufacturing sector performed well cushioning the performance.

The primary sector, which constitutes 10.3 percent of total GDP, grew by 4.3 percent supported by favorable weather conditions in the 2010/11 cropping season which resulted in an increase maize and cotton production. Sugarcane production also increased significantly in line with the completion and full utilization of Lower Usutu Smallholder Irrigation Project (LUSIP) and the Komati Downstream Development program (KDDP).
Agro-based processing benefited from the good performance of the agricultural sector notably sugar and sugar related products transforming the fortunes of the secondary sector in 2011.

The textile manufacturing sector continues to suffer from subdued performance of the major export market, the USA and general sluggish growth in global demand. The overall growth rate for the manufacturing sector remained positive and is estimated at 1.5 percent in 2011.

Going forward, real GDP growth is projected to decline to 0.7 percent in 2012 in Swaziland, against estimated population growth of 1.2 percent. The forecasted lower growth reflects continued weak performance in the public administration, construction, real estate, and hotels and restaurants sectors that will partly be offset by encouraging performance in mining, manufacturing and agriculture.

Higher SACU receipts in 2012/13, accounting for almost 25 percent of GDP, are expected to significantly boost economic growth prospects including paying for domestic arrears and replenish the country's foreign exchange reserve holdings.

The country's future growth prospects hinge on the fortunes of the global economy, still tottering from the global financial and economic crisis.

The Central Bank continued to play an important role in assisting government address the fiscal challenges that had emerged in 2011 as a result of the precipitous decline in SACU receipts in the previous fiscal year. The country continued to work closely with the International Monetary Fund, the World Bank, the African Development Bank, the European Union and other stakeholders to support the Government's Fiscal Adjustment Roadmap in various areas to meet the targets set.

The Bank welcomes the E400 million recapitalization by the Government announced by the Minister in his 2012 /13 Budget speech to augment the level of reserves to be closer to the critical three months level of import cover.

The Government has commissioned an economic diversification study assisted by the African Development Bank which seeks to diversify the production base and identify new export destinations from the traditional export destinations. The study also seeks to improve the country's competitiveness in order to promote sustainable economic growth and job creation. This will provide additional support to the existing work done by the Economic Recovery Strategy and work to improve the investment climate in the country. The Central Bank is actively participating in these initiatives to ensure that the financial sector plays its rightful role in ensuring that that these goals are achieved.

Though inflation remained in single digits throughout 2011 on the support of a strong domestic currency and generally moderate food inflation, inflationary pressures have since emerged. Inflationary pressure is driven by rising food prices, increases in electricity tariffs, and higher international oil prices. Furthermore, several pieces of tax-related legislation that has been recently passed by government could also trigger further inflationary upward pressure. These include the VAT Act and Sales Tax Amendment Act that brought many previously untaxed services into the tax net.

Swaziland remains susceptible to economic developments in South Africa, its major trading partner, and the continued upward inflationary pressure in the region may undermine growth prospects with possibilities of monetary policy tightening being an inevitable policy option.

The country has continued to attract limited flows of new capital to boost Foreign Direct Investments inflows. However, existing companies have continued to reinvest their earnings in the country and future prospects look promising with new projects in the mining sector coming with the issuance new mining licenses to exploit iron ore, coal and diamond deposits, the building of major rail line estimated at US$2 billion between South Africa and Swaziland and a number of other greenfield investments in the manufacturing sector producing starch and hydraulic drills amongst others.

Going forward, the economic growth hinges on the reigning-in of fiscal stability by government whilst implementing sustained reforms aimed at removing structural impediments to economic growth and development. The country remains vulnerable to exogenous shocks as a small open economy largely dependent on trade for its fortunes. These reforms need to be undertaken whilst taking cognizance of the need to protect the poor and vulnerable segments of our population.

During the year 2011, the Monetary Policy Consultative Committee (MPCC) continued with its bi-monthly meetings from which decisions on monetary policy were made. The issues discussed in these meetings focused mainly on international, regional and domestic economic developments to assist in the formulation of monetary policy. As mandated by the CBS order, the MPCC also discussed major issues which need the attention of the Minister for

Finance so that the objectives of monetary policy formulation are not neutralized. The highlights of discussions and decisions undertaken during these meetings are set out as follows:-

***Government Cash Flow Management*:** The MPCC commended the CBS and government for the joint establishment of a Cash Flow Management Committee (CFMC), which was set up as a combined effort to address the fiscal challenges facing the country. On the issue of raising domestic borrowing through the long-term bond issuance as one of the CFMC's objectives, the MPCC questioned the pricing criteria if it will bode well with market expectations in the event the price does not match rates prevailing in the markets. Further, the MPCC noted with concern to learn that the bond issuance programme has been halted due to waning confidence in the market.

The MPCC commended government for showing commitment to restore the country's fiscal sustainability by agreeing into a Staff Monitored Programme (SMP), which would enable the country to receive budget support loans from international institutions. However, the MPCC noted with concern government's failure to meet the SMP targets resulting in a delay in obtaining external budget support.

***Bridging Finance*:** The bond issuance programme was meant to provide bridging finance for government whilst it is still organizing itself for external support from the IMF and other international organizations. As government cash flow problems intensified whilst external budget support was not forthcoming, the CBS rescued government by extending credit as provided for in Section 45 of the CBS order. Whilst the MPCC raised concerns about the possibility of government defaulting in repayment, their fears were allayed after indicating that the law stipulates clearly the repayment period and that government has a clean record as in the past never defaulted.

***Crowding out of the Private Sector*:** The perception by the public that the sourcing of finance domestically by government might lead to the crowding out of the private sector has been discounted. This is the case because the resources being mobilized by government are below the observed excess liquidity in the domestic financial market. However, the situation may become complex as excess liquidity falls in the wake of the transfer of funds by savers out of the country.

Maintaining the Country's Reserves**:** The MPCC noted with concern the continuously declining trend in reserves to levels below internationally accepted standards as a result of dwindling SACU receipts and payments of government's budgetary obligations. The depletion of the reserves raised concerns even when the parity between the Rand and Lilangeni is not threatened. To allay fears of a possible breakdown of the parity, the CBS indicated that any change to the parity relationship is guided by the Common Monetary Area (CMA) Multilateral Agreement.

The committee recommended that government should be discouraged from depleting the reserves to finance its expenditures but instead should be encouraged to adhere to the SMP targets in order to secure external funding.

Government Cost-Cutting Measures**:** The government is committed in cutting costs as evidenced by the announcement of the Prime Minister when presenting government's Policy Statement on certain key issues on 24 March 2011; and the 10 percent salary cut accepted by cabinet ministers. However the cost-cutting exercise by government was viewed by the MPCC as a process which will continue for some time since some expenditure cannot be eliminated in the short term. Expenditure cuts should ideally be done from a strategic perspective and not randomly and should be guided by a clear public financial management system.

Since government is a major player in the economy, if it reduces its expenditure economic activity will also decline. This is because companies which are getting tenders from government will slow down their production as government stops issuing tenders. However, this should be considered as a short-term cost to be offset by long-term gains as the economy recovers from an appropriate fiscal discipline.

2. RECENT DOMESTIC ECONOMIC DEVELOPMENTS

Real GDP Developments

Growth in economic activity slowed down in 2011. Official projections indicate that real GDP growth was at 1.3 percent in 2011, lower than the 2.0 percent recorded in 2010. Contributing to the slowdown was the poor performance by the tertiary sector which emanated from the Government cash-flow problems experienced in the 2010/11 and 2011/12 fiscal years. The Government fiscal crisis resulted from a sharp reduction in SACU revenue in 2011/12. The situation was exacerbated by the Government's inability to raise funds domestically and externally. As a result, the Government cash-flow problems resulted in reduced spending (mostly on capital projects) and accumulation of payment arrears to private sector suppliers. These developments in turn compromised service delivery and dampened growth prospects in most sectors particularly the secondary and tertiary sectors. On a positive note, agricultural production and agro-processing manufacturing performed well, partly cushioning the negative impact of the fiscal crises on domestic growth.

The primary sector, which constitutes 10.3 percent of total GDP, grew by 4.3 percent mainly due to increased production in both the Swazi Nation Land (SNL) and the Individual Tenure Farms (ITFs). In the SNL, favorable weather conditions, in the form of good rains in the 2010/11 planting season, resulted in an increase in both maize and cotton production. In the ITFs, sugarcane production increased significantly in line with the completion and full utilization of Lower Usutu Smallholder Irrigation Project (LUSIP) and the Komati Downstream Development programme (KDDP). These projects, which have benefited from the European Union (EU) financing, have resulted in an increase in area under cane cultivation. On the other hand, the mining and quarrying subsector contracted mainly due to a slower growth in coal production and a substantial decline in quarried stone production in line with slow demand in the construction sector.

The secondary sector, with a contribution of 38.5 percent to total GDP, picked up slightly in 2011 compared to the previous year. Agro-based processing benefited from the good performance of the agricultural sector notably sugar and sugar related products. On the contrary, the textile sector remained subdued due to sluggish growth in global demand. The overall growth rate for the manufacturing sector is estimated at 1.5 percent in 2011, up from a 0.7 percent contraction recorded in 2010. The electricity and water supply subsector recorded positive growth mainly as a result of increased power generation by both Swaziland Electricity Company (SEC) and sugar mills, which have invested a substantial amount of money in power generation projects. On a negative note, the construction sub-sector is estimated to have declined by about 10 percent in 2011. As a result of the fiscal crisis, the Government (the major player in the construction sector) decided to cut its spending on capital projects and to accumulate of payment arrears to some private entities involved in the construction sector. These developments suppressed the performance of construction sector during the year under review.

Growth in the tertiary sector, which comprises 51.2 percent of total GDP, decelerated to 1.4 percent in 2011 from 4.1 percent in 2010. The slowdown was mainly attributed to the subdued performance of the sub-tertiary sectors caused by the Government fiscal crisis. Uncertainties on future incomes emanating from the Government fiscal crises and a strong need for fiscal consolidation had a profound effect on spending patterns. The ‘wholesale and retail trade’ sector was one of the sectors of the economy that was negatively affected by the fiscal crises as consumers opted to curtail spending during the course of 2011. Meanwhile, the performance of the tourism industry dipped in line with lower global demand. The transport sector was adversely affected by the poor performance of the construction sector in 2011 as transport operators found themselves with little to transport. On a positive note, the Central Government grew by 2.5 percent (i.e. reflected by Government employment levels). Further, the communication sector improved significantly (fixed lines, mobile and internet) mainly driven by on-going huge investments towards New Generation Networks by both MTN Swaziland and Swaziland Posts and Telecommunications Corporation.

Prospects for 2012 are positive with the agricultural and manufacturing sectors expected to register positive growth rates as a result of increased investments in the sugar industry. Further, the mining sector is expected to perform well in 2012 with the expected re- operationalization of the iron ore, coal, gold and diamonds mines in the country. Revenue collected by the Swaziland Revenue Authority (SRA) and SACU receipts are expected to increase in 2012/13; this will assist the Government to reduce or pay off the accumulated payment arrears to the private sector. This will help to restore confidence on Government and will go a long way in stabilizing companies' balance sheets.

Prices

Consumer inflation charted an upward trend in 2011, largely driven by high food and transport prices. The average headline inflation rose to 6.1 percent in 2011; this was 1.6 percentage points higher than the 4.5 percent average inflation rate recorded in 2010. Food inflation which accounts for 37.7 percent of the consumer basket registered an average of 6.0 percent in the 12 months to December 2011. This indicates an increase of 5.6 percentage points from the 0.4 percent recorded in 2010. Food inflation benefited from increases in the prices of rice, bread, cereals and meat.

Petrol prices rose from an average 748 cents per litre in 2010 to an average of 936 cents per litre in 2011. Diesel prices rose from an average of 759 cents per litre to 982 cents per litre over the same period. Higher international oil prices coupled with the depreciation of the Lilangeni/Rand against the US dollar and other major currencies provided upward pressure on fuel prices over the year. Transport prices rose in line with the higher fuel prices averaging 13.3 percent in 2011. This rate was 8.3 percentage points higher than the average of 5.0 percent recorded in 2010.

The above increases were partly offset by slower increases in the price indices for ‘housing and utilities’ and ‘recreation and culture’. The price index for ‘housing and utilities’ grew by a slower average rate of 6.7 percent in 2011 compared to an average of 8.8 percent recorded in 2010. The slowdown mainly benefited from a slower increase in the prices for actual rentals. Meanwhile, the price index for ‘recreation and culture’ decreased significantly from an average of 16.3 percent in 2010 to an average of 3.2 percent in 2011. The sharp decline was mainly due to lower increases in the prices of audio-visual and photographic processing equipment.

Swaziland’s consumer inflation is expected to chart an upward trend in the short to medium term. International developments characterized by high food and oil prices continue to put pressure on the Swaziland inflation outlook. Fuel prices have continually increased over the recent months in addition to the persistently high administered prices in the housing and utility sectors. The threat of food shortage in the region, especially maize, will impact negatively on the prices of food. These developments tend to drive input prices and distribution costs upwards and will soon manifest in price hikes in the other components of the consumer basket. The introduction of new taxes on certain goods and services in December 2011 (such as air time for mobile phones) will also exert upward pressure on consumer inflation in the short to medium term.

Monetary Sector

Similar to the stance adopted by the South African Reserve Bank, the Central Bank of Swaziland maintained a generally accommodative monetary policy stance as it left interest rates unchanged throughout 2011. Despite mounting inflationary pressures particularly during the last quarter of the year, monetary policy remained stable following concerns over deteriorating global (particularly Eurozone), regional as well as domestic economic growth outcomes. Accordingly, the Bank’s policy rate was kept at a low of 5.5 percent while the prime lending rate was at 9 percent.

Short-to-medium term forecasts point to accelerating inflationary pressures as well as worsening global economic growth prospects. Monetary policy will therefore be geared towards balancing the risks to both price stability and economic activity.

Over the year ended January 2012, the country's net foreign assets reflected a decline of 27.4 percent to E4, 090.9 million. The fall in net foreign assets was registered in both the official sector and commercial banks. Banks' net foreign holdings fell by a marked 78.5 percent to E367 million, partly to finance government cash shortfalls through purchase of government securities and to comply with higher statutory requirements. In July 2011, the banks' reserve and liquidity requirements were revised upwards from 2.5 percent and 13 percent to 6 percent and 20 percent, respectively. Net official assets on the other hand decreased by 5.1 percent as a result of a draw down in reserves to finance budgetary expenditures following the government's fiscal crisis. In line with the fall in official assets, the estimated import cover of the reserves dropped from 2.9 months recorded the previous year to 2.4 months at the end of January 2012.

Throughout the year 2011, the external reserves were maintained below the internationally recommended level of 3 months. Another reserves adequacy measure, the ratio of reserves to GDP ratio reached 15 percent in January, notably below the required threshold of 17 percent. The deteriorating position of the external reserves poses a threat to the level of confidence by markets on the country's ability to meet external obligations as well as to absorb external shocks.

The short term outlook for the country's external reserves is positive due to the substantial increase in SACU revenue for the 2012/13 fiscal year and the E400 million reserves replenishment pledge by the government as outlined in the current 2012/13 budget. However, in order for the reserves to revert back to a healthy position, it is fundamental for the government to swiftly implement the planned expenditure control measures as well as the other policy interventions outlined in the recently delivered Budget Speech and the Fiscal

Adjustment Roadmap. Implementation of these measures will further assist the country to access external financing from international financial institutions and cooperating partners.

Annual credit extended to the private sector trended upwards by 16.2 percent compared to growth of 12.3 percent recorded the year before. The notable increase was largely underpinned by the low interest rate environment combined with increased demand from expanding industries and the household sector. Credit to the industry sector, the main driver of economic growth, recorded an annual increase of 43.3 percent. The credit was mainly absorbed by the mining and quarrying sector as well as the manufacturing sector. Credit extended to the household sector increased by 12.2 percent and was mainly channeled towards personal and housing finance.

Despite the increase in credit extended to the private sector, broad money supply (M2) fell by 0.2 percent over the twelve months to January 2012 compared to an annual increase of 5.7 percent registered the previous year. The decline was mainly on account of the significant decline in net foreign assets as well as the emerging competition for deposits from the rapidly growing non-bank financial institutions. Quasi money supply, comprising savings and time deposits, recorded a decline of 1.2 percent over the year while narrow money supply, comprising emalangeni in circulation and demand deposits, rose by 2.1 percent.

Fiscal Sector and Public Debt

The actual outturn for 2010/11 reflects a budget deficit of E2.6 billion or 9.4 percent of GDP. This reflects an improvement against an appropriated budget deficit of 13 percent of GDP. The original budget estimates for 2011/12 indicated an overall budget deficit of E2.2 billion or 7.5 percent of GDP. The supplementary budget indicates a deficit of E2.8 billion or 9.5 percent of GDP.

A closer look at the 2011/12 supplementary budget reveals that total revenue and grants have been reviewed downwards by a total of E1.1 billion to E7.3 billion from the original budget estimate of E8.4 billion. The reduction in revenue was necessitated by the slower economic activity both domestically and internationally. Grants were also revised downwards to accommodate only those that are matched by budgeted expenditure.

Total expenditure in 2011/12 has also been reduced by E556 million to E10.1 billion from the original budget of E10.7 billion. This development is attributable to cuts in non-priority capital expenditure by E448 million and recurrent expenditure by E108 million. Lack of financing, accumulation of domestic arrears and a large wage bill are amongst the many challenges faced by the Government in 2011/12. As a result of these challenges, Government failed to achieve fiscal stability during the fiscal year.

Estimates for 2012/13 indicate a budget surplus of E200 million or 1 percent of GDP. The improvement was a result of a 145 percent increase in SACU revenue share for Swaziland coupled with the E1 billion once-off payment realized from the Common Revenue Pool's 2010/11 surplus. On the other hand, the total Common Revenue Pool is projected to grow by 15 percent in 2012/13, a development which has resulted in Swaziland's expected share to increase notably in the same fiscal year. The overreliance on SACU revenue is not sustainable hence the country has to prepare itself for any negative impact that may occur to this resource envelope.

Total revenue and grants in 2012/13 are projected to be E12.2 billion, with SACU revenue accounting for E7.1 billion or 59.6 percent of total revenue. The Swaziland Revenue Authority is expected to introduce VAT at the beginning of 2012/13 financial year which is estimated to generate E1.5 billion or 12.6 percent of total revenue.

Total expenditure (including statutory expenditure) for 2012/13 is estimated to be E12 billion, of which E4.6 billion or 40 percent represents the wage bill. At this level, the wage bill accounts for 97 percent of non-SACU revenue, which is not sustainable. To guarantee fiscal sustainability, Government is targeting a wage bill of less than 60 percent of non-SACU revenue by 2014/15. Government hopes to achieve this by continuing with the wage and hiring freeze.

Recurrent expenditure is projected to reach E9.7 billion, denoting an increase of about 12.4 percent from the revised figure of E8.5 billion presented in the supplementary budget. Capital expenditure is estimated at E2.3 billion, with more focus on completing existing projects. The largest on-going projects catered for in the 2012/13 budget include Sicunusa-Nhangano Road, Lubombo Regional Hospital, Sikhuphe International Airport and Sikhuphe-Mbadlane Road.

At the end of December 2011, total public debt recorded E4.5 billion, an equivalent of 15.7 percent of GDP. This reflects an increase of 18.4 percent from the E3.8 billion (an equivalent of 13.9 percent of GDP) recorded in December 2010. The surge was a result of 5 new bonds issuances in 2011 coupled with the depreciation of the local currency against the US Dollar and other major currencies in which most of the country's external liabilities are denominated.

Of the outstanding total debt, public domestic debt accounted for E1.7 billion or 5.9 percent of GDP, reflecting an increase of 41.7 percent from the E1.2 billion recorded in December 2010. The domestic debt outstanding is divided into Treasury Bills and Government Bonds; E720 million was accounted for by the 91 and 182-Days Treasury Bills while E963.6 million accounted for Government Bonds (fixed and floating) of various tenors; i.e. 2-7 years.

The domestic debt market underperformed in 2011 resulting in under-subscriptions for all the bonds issued during the year. There was no activity in the 273 and 364-Days Treasury Bills offered. Only negligible activity was realized in the 182-Days paper. The 91-Days Treasury Bills showed more activity; largely dominated by the commercial banks to meet their statutory requirements. The lack of interest by investors in most of the domestic debt instruments is partly a result of fiscal challenges, which has resulted in Government accumulating domestic arrears amounting to E1.06 billion at end of June 2011. To address the situation, Government in consultation with the

Bank is preparing to issue a suppliers' bond. This is work in progress which is yet to be agreed by the commercial banks and the affected suppliers.

At the end of December 2011, total public external debt stock (which includes public and publicly guaranteed debt) stood at E2.8 billion, denoting an increase of 12 percent from the E2.5 billion recorded in December 2010. This development was largely due to the depreciation of the local currency against the US Dollar and other major currencies in which most of the country's external liabilities are denominated. The external debt for the central government, which constitutes the largest share of the total loan portfolio, increased to E2.7 billion from E2.4 billion recorded the previous year.

In terms of the prevailing debt ratios, the external public debt stock to exports of goods and services increased from 16.8 percent in the previous year to 18.4 percent at the end of December 2011. The ratio of public external debt service to exports of goods and services was estimated at 2.6 percent from 2.4 percent the previous year. All these ratios are still within internationally acceptable standards.

However, for a small economy like Swaziland, it still remains important for Government to ensure that its debt remains within sustainable levels in view of the fiscal projections which confirm that Swaziland will be contracting more debt in the short to medium term.

Balance of Payments

Latest available data reflect that for the first three quarters of 2011 Swaziland's Balance of Payments recorded an overall deficit of E903.8 million. The overall deficit mainly reflects the decline in reserves as government run down reserves to finance its obligations. The country's balance of payment statement indicates that the overall deficit mainly emanates from a persistently high deficit in the services and income accounts during the three quarters of the year. Current transfers continued to record net inflows in the first 3quarters of 2011.

Current Account

The country's current account remained in a deficit position in the first three quarters of 2011. The current account for the third quarter of 2011 posted a deficit of E570.2 million which is about 2 percent of GDP from a deficit of 2.4 percent of GDP in the second quarter. The improved deficit in the current account is largely due to inflows in the income and current transfers.

Trade Account

The trade account turned around from a surplus of E152.9 million in June 2011 to register a deficit of E45.9 million in the third quarter. The country's exports increased from E4, 125.9 million, 14.2 percent of GDP, in second quarter 2011 to E4, 181.7 million, 14.4 percent of GDP, in the third quarter. This was in line with the prevailing dynamics in the international markets, which were characterized by stagnant demand and over-supply in some destination markets - resulting in falling prices for consumer goods. Miscellaneous edibles, comprising soft drinks and other edible commodities continues to be the country's main export revenue earner contributing 40 percent to total exports receipts during the first three quarters of 2011.

Sugar remained the second highest export revenue earner for the country in the first three quarters of 2011, with total earnings amounting to E1,607.5 million. Sugar exports contributed 12.6 percent to total exports during the first three quarters of 2011. Sugar exports continued to enjoy the favorable price afforded by the preferential market especially in Europe.

Other major exports for country during 2011 included textile, citrus, canned fruit and meat, products destined for the world markets. The continuing trend of weak global demand impacted negatively on some of the country's exports. This situation was exacerbated by the stronger lilangeni/rand against currencies of major trading partners. The need to support the export sector cannot be over emphasized considering that it has been the engine for economic growth in the past years.

Merchandise imports during the first three quarters of 2011 amounted to E12,215.9 million, which is 42.1 percent of GDP. Mineral, fuel and lubricants, chemical and chemical products as well as machinery and transport equipment continued to dominate the country's import bill. South Africa remained the main source of the country's imports during 2011, accounting for more than 89 percent of the total import bill.

Services Account

The country continued to be a net importer of services in 2011 with the services account recording a deficit of E3,174.5 million in the first three quarters of 2011; a much low deficit compared to a services deficit of E3,807.2 million in the initial three quarters of 2010. Services inflows amounted to E1,395.1 million in the first three quarters of 2011 against outflows of E3,807.2 million in the same period. Receipts from Swaziland railways and tourism remain the major contributors to the country's services inflows. In the third quarter of 2011 the deficit on the services account continued to increase as has been the trend in the first and second quarter. It showed a 13.2 percent increase from E1, 065.5 million in the second quarter to E1, 205.8 million in the third. Services outflows include transportation, communication, information technology, legal and accounting services as well as royalties and other services.

Income Account

The income account recorded a deficit of 978.6 million in the first three quarters of 2011 against a deficit of E1,057.4 million in the corresponding period last year. Major contributors to the net outflow in the income account are profit remittances by some major exporters who remained profitable over the period. Income outflows declined from E2200.4 million in the first 3 quarters of 2010 to E1, 869.2 million in the corresponding period in 2011. Income inflows stood at E890 million in the first 3 quarters of 2011. Inflows in the income account include compensation of employees which is on a declining trend as the number of Swazis employed in South African mines is falling since South Africa has adopted a policy of reducing foreign workers in favor of locals. Other contributors to income inflows are interest earned by the official sector, pension funds, banks and other sectors.

Current transfers

Receipts from the Southern African Customs Union (SACU) continued to dominate current transfers, with net current transfers recording a net inflows of E2, 727.7 in the first three months of 2010 compared to a net inflow of E2,152.00 in the three quarters to September 2011. Further contributing to current transfers inflows are workers and grants for humanitarian purposes from international donor agencies and governments.

Covered in current transfers outflows which are a significant item in the balance of payments are gifts and contributions to international organizations.

Financial Account

The financial account recorded a net inflow in the quarter ending September 2011 with direct investment, portfolio investment and other investment posting net inflows. The financial account net inflow stood at E1,53.6 million against a net inflow of E1,859 million in the third quarter 2010. Despite low levels of fresh FDI inflows, reinvested earnings continued to be positive underpinning the direct investment category of the financial account.

The portfolio investment account recorded an increased net inflow of E392.2 million in the third quarter, 2011 against a higher net inflow of E490.1 million in the same period the previous year. Dominating movements in portfolio investment are local pension funds who invest some of their assets in South Africa. Movements in portfolio investment are quite volatile reflecting the movements of assets held in South Africa.

The other investment category of the financial account is a volatile item reflecting the movements in trade credits, currency and deposits, banking sector assets and liabilities and other short term assets. Other investment registered a net inflow of E412.4 million in the quarter ending September 2011, down from an inflow of E897.5 in the third quarter of 2010.

3. BANK SUPERVISON

The Central Bank of Swaziland is entrusted with the responsibility of regulating and supervising the banking system under the provisions of the Financial Institutions Act, 2005. This responsibility is discharged through the Bank Supervision Division (BSD), which currently supervises four commercial banks, one building society and four credit institutions.

Core Functions

The Banking Supervision Division conducts the supervisory role through the following activities:

i) Undertaking scheduled and special on-site inspections of banks, off-site surveillance and post inspection follow-up on compliance.
ii) Determining the criteria for bad debt provisioning, capital and liquidity adequacy.
iii) Enforcing financial sector and public compliance with provisions of the Financial Institutions Act, 2005.
iv) Exercising supervisory intervention in the implementation of regulations which includes among others – appointments of external auditors, board and senior management, issuance of directives and taking punitive action where necessary.

Supervisory Strategy

The supervisory methodology which, besides retaining the importance of on-site inspections, also focuses on three other key areas:

- Off-site monitoring through a set of statutory returns;
- Strengthening of the risk management and internal control systems through the risk-based supervision approach, and
- The use of the work external auditors in the financial institutions.

The off-site monitoring and surveillance system primarily involves analyses of the financial condition of the institutions in between on-site inspections. The statutory returns received from financial institution cover a wide range of data pertaining to assets, liabilities and off-balance sheet exposures, exposure to systemic sensitive sectors, exposure of banks to interest rate and liquidity risks. This serves as a tool to refine regulatory as well as monetary policy positioning so as to achieve a fine balance between growth and financial stability.

The Risk Based Supervision (RBS) approach to inspection, envisages the monitoring of banks by allocating supervisory resources and focusing supervisory attention according to the risk profile of each institution. The process also involves the continuous monitoring and evaluation of the appropriateness of the risk management systems and control environment of the supervised institution in relation to its business strategy and exposures, with a view to assessing its riskiness.

To stay in touch with international banking supervision best practices, the Bank is guided by the Basel Core Principles for Effective Supervision which serves as a supervisory reference for international banking supervisors in order to discharge consistent and effective supervisory and regulatory roles. In that vein, the Central Bank continues to participate in international and regional bodies to collaborate and share in matters of common interest which include supervisory and accounting standards, training and skills sharing of supervisors, development of IT systems, the promotion of soundness within banking institutions and on issues of anti-money laundering.

Performance of the Banking Sector

Balance Sheet

Despite the slow growth and uncertainty in the economy during 2011, the banking system remained robust with a 10.6 percent year-on-year growth in assets. Total assets amounted to E11,877 million in December 2011 compared to E10,738 million in December 2010.

As compared to the previous period where lending appeared to be restrained, 2011 saw a more liberal approach by the banking sector as loans and advances grew by 29.3 percent in 2011. The difficult economic situation had an impact on the performance of loans as non-performing loans increased from 6.4 percent in 2010 to 8.0 percent in December 2011.

The Bank Supervision continued to be vigilant on capital adequacy ratios which are an indication of how well positioned the banking institutions are to absorb temporal losses, to which the institutions are most vulnerable during difficult economic cycles. The banking sector remained well capitalised during 2011 with Tier 1 Capital at 20.3 percent and total capital ratio of 40.8 percent. These ratios compare favourably with the statutory requirements of 4 percent and 8 percent, respectively.

Profitability

Profitability indicators of the banking industry showed a generally slight deterioration trend in 2011. However, strong cost containment and asset management practices by the banks ensured continued profitability of the banking sector. Total industry after-tax profit grew from E261,0 million in 2010 to E285,3 million in December 2011. The Bank Supervision Division is continually strengthening the off-site monitoring system in which banks are required to submit quarterly performance returns which allows for early detection of stress in the institutions and the industry as a whole.

Liquidity

During 2011, the Central Bank took a proactive supervisory approach to mitigating liquidity risk by reviewing the minimum liquidity requirement of the banking sector. This policy change was on the basis that the banking sector’s role in financial intermediation makes them inherently susceptible to the risk that creditors’ demands for repayment may outstrip the ability of the banks to liquidate their assets. The statutory minimum requirements serve to maintain a balance in the trade-off in liquid assets and the utilization of customer deposits by banks.

The prescribed minimum liquidity requirement is 20 percent for the commercial banks and 17 percent for the development bank. The banks were in compliance with the new liquidity requirements level with the industry recording 27.2 percent in December 2011.

Credit Institutions

The Central Bank views credit institutions as important players in financial intermediation and that regulation and supervision of sector players will ensure an overall safe and sound financial system. Prudential standards are being developed to effectively regulate and supervise this sector.

Currently, there are four credit institutions licenced under the Financial Institutions Act, 2005, namely: Blue Financial Services, Letshego Financial Services, First Finance Company and Relief Financial Services.

National Payment System (NPS)

In line with its statutory mandate, the Bank continues to promote, regulate and supervise operations of payment systems to support financial sector stability conducive to development in the country. The country also remained unrelenting to the adoption of international standards and best practice and as a result recorded year on year reduction in payments by cheque, achieved growth in electronic payments, saw the introduction of mobile money transfer services. The major milestone was the recent enactment of the National Clearing and Settlement Systems Act 2011. This Act mainly provides for recognition, operation, regulation and supervision of payment systems for clearing and settlement of transfer instructions between financial institutions.

In an effort to enhance risk reduction in the payment systems landscape, the Bank will introduce cheque limits for cross-border payments at R500, 000.00 in the CMA countries and review the current domestic cheque limit from E1, 000,000 to E500, 000.00. These limits will effectively reduce financial risk exposure associated with cheques and grow electronic payments as the alternative payment channel for payments. Electronic payments facilitate credit push and achieve faster transfer of funds that impact positively in the speed of economic activity.

This year, the Bank will continue to monitor and conduct inspections to ensure safety, efficiency and effectiveness of national payment system operations including the recently introduced mobile money transfer system operated by Swazi MTN. The Bank will also continue to support the ongoing regional payment system integration projects to bring reform and modernize processing of cross-border payments in the CMA countries, SADC and COMESA regions.

4. CAPITAL MARKETS DEVELOPMENTS

Securities Regulatory Framework

The enabling legislation namely, the Financial Services Regulatory Authority (FSRA) Act, 2010 and the Securities Act, 2010, that set the securities regulatory and supervisory framework are in place. Also the Chief Executive Officer for FSRA has appointed to work with the Board of Directors which was constituted in December 2010. In the meantime and until advice to the contrary is received from the Ministry of Finance, the office of the Registrar of Capital Markets vests with Governor of the Central Bank. It is envisaged by the Bank that this shall be the case until FSRA is in a position to assume its legal mandate of being Registrar of non-bank financial institutions. It is at stage that the transition of Capital Markets Development Unit (CMDU) together with the Swaziland Stock Exchange (SSX) to FSRA is expected to commence.

Domestic debt market

Even though Government has been in a budgetary deficit position for a number of years, the situation has been exacerbated by the advent of the financial and economic crisis that began in 2008 and the concurrent decline in the revenue receipts from SACU, upon which Government relied heavily.

Following the enhancement of its ceiling for domestic borrowing from E1 billion to 25% of GDP during 2011/2012 Financial Year by Parliament, Government has issued and listed six (6) bonds on the SSX with a total outstanding nominal value of E694.2 million.

The Bank observed that the greater the number of bonds, the longer the tenor and the higher the nominal amount involved in Government issuances, the more investors were progressively becoming wary of investing in Government bonds. When investors submit bids for Government bonds, they sought higher coupon rates because of the perceived growing risks they associated with lending to Government, such that their bids were rejected by the Bank.

This trend resulted in a significant decline in the subscriptions to and allotment of Government bonds. Consequently, the Bank considered alternative sources of funding the deficit and, it has assisted Government to raise E100 million from various local institutions by making private placement. This is in addition to E788.5 million raised through regular Treasury Bills issuances it manages on behalf of Government.

Thus, the total outstanding domestic debt that the Bank has assisted Government raise is approximately E1.6 billion. The Bank continues and shall continue to explore other avenues of assisting Government extricate itself from the deficit budget position. Also it is hopeful that Government will heed and, as matter of urgency, implement the recommendations made by the IMF as means to improve its overall fiscal position.

Strengthening Fiscal Discipline

In the 2012/2013 Budget Speech, the Minister of Finance articulated the need to implement reforms to introduce fiscal discipline by, among others: Repaying arrears, boosting reserves, reducing the wage bill, reforming public finance management.

Of particular interests to the Bank is the commitment by Government to increase reserves to acceptable international levels so as to facilitate international settlements and sustain the linkage of the local currency to the South African Rand.

The Bank also acknowledges the existence of the Public Finance Management Bill. Admittedly the Bill is yet to be piloted at Parliament and its noble objectives are to introduce accountability in Government expenditure and transparency in its operations.

The Bank's policy position is that any measures, including the IMF recommendations, implemented by Government towards managing or even reducing its expenditure and inculcating fiscal discipline are commendable and worthy of national support.

Automation capital and financial markets operations

The Bank recognizes the important role that automating the operations of capital and financial markets to world-class standards. Such would facilitate the management of treasury bills, Government bonds and other securities dealt in by the general investing public at large. During the 2011/2012 financial year, the Bank appointed a task team to research the logistics and costs related to the procurement and implementation of a central securities depository (CSD), funds permitting.

It is also policy of the Bank to participate in regional initiatives and familiarize itself with international developments aimed at improving the regulation and operations of both capital and financial markets.

5. EXCHANGE CONTROL

Relaxation of Exchange Controls

In November 2011 the Central Bank increased the limit of "33 1/3 %" advance payments on capital goods to be imported to 50 % of the ex-factory cost.

Automation of exportation forms F178

The Division has initiated the automation of Forms F178. This project will enable the receipt of F178 export data on-line as opposed to the manual submission. This will be an improvement on the Central Bank's responsibility of monitoring and controlling receipt of export proceeds. Authorized Dealers will be relieved from the burden of administering the monitoring and controlling of the receipt of export proceeds. The implementation of the project will have cost and time saving benefits in the sense that there will be no acquittal and attestation of F178 by exporters and Authorized Dealers.

This exercise will involve the South African Reserve Bank, Swaziland Revenue Authority, Central Bank of Swaziland and other stakeholders.

Further enhancement of Cross Border Foreign Exchange Transaction Reporting System (CBFETRS)

The Division is in the process of upgrading the Reporting System. The intention is to have an on-line reporting system with most of the major transacting entities. This process will eliminate late reporting, reduce errors etc. As an added advantage, it will allow the reporting of transactions which the system is currently unable to capture such as point of sale, internet and credit cards transactions.

6. CONCLUSION REMARKS

The road ahead is full of challenges largely due to the uncertainties associated with the performance of the country's key trading partners, the EU, USA and South Africa. Furthermore, the slump in global trade means that future SACU flows remain unpredictable further aggravating the negative sentiments in the markets. This also means Government, going forward, will remain saddled with the challenge to meet the growing demands to meet social expenditure, create jobs and create the enabling environment for the country to chart a sustained economic growth.

Whilst the country's financial sector has remained sound and strong, surviving the global economic crisis, there are emerging challenges in the sector. There is need to adequately regulate and strengthen supervision of the non-bank financial sector. Strong support for government to bring back fiscal stability will underpin financial sector stability. In this vein, the Central Bank welcomes the promulgation of the Financial Services Regulation Authority (FSRA) and looks forward to working closely with the authority to address these emerging challenges and fulfill its mandate. The Bank is committed to further broadening and deepening the financial sector, improve financial inclusion through providing increased formal financial services to the unbanked population of the country.

In conclusion, on behalf of the Board of Directors of the Bank and staff I wish to extend the Bank's appreciation for the assistance and cooperation from the Minister of Finance and his officials, my colleagues in the Common Monetary Area and all stakeholders in the financial sector who has continued to support the work of the Bank in carrying out its mandate of ensuring financial stability in Swaziland.