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# Swaziland

## Preliminary Conclusions of the 2003 Article IV Consultation Mission

Mbabane, October 8, 2003

*Swaziland's socioeconomic situation remains difficult, with persistent high rates of HIV/AIDS, unemployment, and poverty. Widening macroeconomic imbalances are straining the country's resources and threatening macroeconomic stability. The main economic challenges are to regain macroeconomic stability and to raise the sustainable growth rate while ensuring that the benefits are spread widely across the population. To meet these challenges, it is essential to restore fiscal discipline and at the same time reorient spending toward social sectors. In addition, it is important that structural reforms be implemented to increase economic efficiency, including through restructuring public enterprises and continued prudent trade and financial integration; and that strategies be developed for improving the humanitarian situation, particularly with regard to HIV/AIDS, unemployment, food security, and poverty. Improvements in governance, particularly the rule of law, will be important in order for policies to be implemented effectively and their full benefits realized.*

# I. INTRODUCTION AND BACKGROUND

1. ***A mission of the International Monetary Fund visited Mbabane during September 29-October 10, 2003, to conduct the 2003 Article IV consultation discussions with Swaziland.*** Although the Cabinet of Ministers was dissolved on September 30, the mission was able to conduct discussions with a range of senior officials. The mission met with the outgoing Minister of Finance, the Governor of the Central Bank of Swaziland, the outgoing Acting Minister of Economic Planning and Development, other senior government officials, and representatives of the banking, business, labor, and donor communities.

2. ***Swaziland's socioeconomic situation is serious.*** An unresolved crisis in the judicial system, uncertainties over the new constitution, and concerns about governance in general are fueling social tensions and weakening donor sentiment, and a significant widening in the central government's fiscal deficit, through non-social spending, threatens macroeconomic stability and sustainability. Meanwhile, the country faces urgent humanitarian needs that are unmet. Although Swaziland is a lower-middle-income country, its income distribution is skewed and poverty is widespread, with an estimated two thirds of Swazis living on less than US$1 per day. A third of the labor force is estimated to be unemployed, and a third of adults are infected with HIV/AIDS. The food shortage that affected the country in recent years has abated somewhat in 2003, but access to food remains difficult for certain segments of society, and one fifth of the population may need emergency food aid by the end of the year.

# II. RECENT ECONOMIC DEVELOPMENTS

3. ***Swaziland's growth performance has weakened since the early 1990s, in part reflecting the erosion of its advantage as an investment location after South Africa emerged from economic and political isolation.*** The average annual rate of real GDP growth fell from 7¾ percent in the 1980s to 3¾ percent in the 1990s. After falling in 2000 and 2001, growth picked up in 2002, to 3.6 percent, as the completion of the Maguga Dam and some road and housing projects boosted construction; sugarcane production recovered, with knock-on effects on manufacturing output, particularly food processing; and clothing production continued to be supported by foreign investment inflows. A recovery in external demand, partly in response to the previous depreciation of the lilangeni/rand against other currencies, was accompanied by a policy-induced increase in domestic demand. In 2003, however, growth may be starting to slow in the absence of the one-off factors that occurred in 2002.

4. ***Notwithstanding recent gains in formal sector employment, the unemployment rate remains high at an estimated one-third of the labor force.*** Swaziland's participation in the U.S. Africa Growth and Opportunity Act (AGOA) since January 2001 has contributed to the emergence of an export-oriented clothing industry, which has created around 20,000 new jobs (equivalent to 21 percent of formal employment). In 2002, the sector contributed to a 3 percent gain in formal employment. However, limited investment in other labor-intensive industries and the slow pace of output growth on Swazi Nation Land have contributed to keeping overall unemployment high.

5. ***Inflationary pressures have eased since late 2002 in tandem with inflation trends in South Africa.*** The effects of increasing wage costs have been offset by a combination of external factors, particularly falling oil and food prices, and an appreciation of the lilangeni in line with the South African rand. From a peak of nearly 13 percent (12-month basis) in October 2002, CPI inflation has declined steadily to 6 percent in August 2003 (broadly the same as in South Africa). However, the continued fiscal expansion, particularly a retroactive public sector wage increase in August 2003, may now be starting to put upward pressure on prices.

6. ***The central government fiscal balance (including grants) has been in deficit since 1999/2000, and in 2002/03 the deficit remained substantial (4½ percent of GDP).*** The weakening in public finances has reflected both a decline in tax receipts as a share of GDP and a rise in expenditure on public wages and subsidies to parastatals, particularly the Central Transport Authority (CTA). In 2003/04, the substantial increase in public wages and spending on the SMART partnership summit in August have raised budgetary expenditure. The growing deficit is straining available financing resources and has been financed in part by a drawdown in the government's foreign exchange reserves, which fell by E217 million during March-August 2003. In an effort to stem the fall in reserves, the limit on domestic government borrowing was raised from E300 million to E1 billion in September.

7. ***The scope for the Central Bank of Swaziland (CBS) to pursue an independent monetary policy is limited by the peg of the lilangeni to the rand and Swaziland's membership in the Common Monetary Area (CMA).*** The CBS has reduced short-term interest rates by 350 basis points (cumulative) during June-September 2003, in step with monetary easing by the South African Reserve Bank. Credit to the private sector has continued to increase substantially, growing by nearly 30 percent (12-month rate) in August, the same as in December 2002.

8. ***After depreciating substantially in 2001 and the first half of 2002, the lilangeni has appreciated over the last year or so, reflecting the strengthening of the South African rand vis-à-vis the U.S. dollar.*** In July 2003, the lilangeni was 3 percent stronger in nominal effective terms than a year previously. With higher inflation in Swaziland relative to its trading partners, the real effective exchange rate appreciated by 5 percent. In 2002, the external current account deficit narrowed as a percent of GDP, to 4 percent, as a decline in foreign income and transfers was more than offset by

a reduction in the goods and services deficit. External debt rose to 32 percent of GDP (E 3.3 billion), and the ratio of external debt service payments to exports rose slightly to 1½ percent. Net international reserves fell to US$216 million (2½ months of imports) in 2002. Through August 2003, they remained roughly unchanged in U.S. dollar terms as the positive effects of the stronger exchange rate were offset by the government's reserve drawdown (E300 million).

## III. POLICY ISSUES

9. ***The Fund's policy discussions with the Swazi authorities in recent years have focused on the central policy challenge of addressing the impediments to growth and a broad-based improvement in living standards.*** In particular, the Fund has emphasized the need for fiscal adjustment to restore macroeconomic stability and preserve external viability, and for structural reforms, particularly in public enterprises, the financial sector, and land tenure. The authorities have broadly agreed with the advice, and have moved forward with structural reforms in areas such as the financial sector. But substantive progress remains to be made, particularly in fiscal policy, and key vulnerabilities still have to be addressed. The policy response has been hampered by governance problems, which have slowed down the passage of needed legislation, and by limitations in institutional capacity.

10. ***Against this background, the mission feels that the key policy issues include:***

• the macroeconomic outlook and, in particular, the policies needed to preserve macroeconomic stability and raise the sustainable growth rate;

• fiscal policy adjustments that are critical for ensuring external viability and macroeconomic stability, addressing key social needs, and meeting prospective medium term pressures on the budget arising from HIV/AIDS, other social priorities, and contingent government liabilities (such as the Public Service Pensions Fund);

• the continued usefulness of the pegged exchange rate arrangement in providing a nominal anchor;

• the health of the banking system, and particularly reform of Swazi Bank;

• strategies for improving the humanitarian situation, particularly dealing with HIV/AIDS, enhancing food security, and reducing poverty, including measures to improve the efficiency of land use; and

• improvements in governance, which will be critical for the effective implementation of reforms and a strengthening of the socioeconomic situation.

## A. Economic Outlook

11. ***The economic outlook in the near term is for a moderation in GDP growth to 2¼ percent this year,*** as the effect of the weakening private investment environment offsets that of expansionary financial policies and higher public sector wages on investment and consumption. A modest improvement in agricultural output may add to the temporary boost provided by the initiation of new capital projects, although the absence of the one-off factors that drove growth last year is likely to be reflected in a slowdown in the secondary and tertiary sectors. A further decline in growth to 1½-2 percent is expected in 2004 in the absence of improved supply side fundamentals. Inflation can be expected to rise to over 8 percent by the end of 2003, reflecting wage increases and growing demand pressures in the nontraded goods sector due to the relatively loose fiscal policy, and to remain above the level in South Africa in 2004. The external current account deficit would be expected to widen to over 4½ percent of GDP in 2003 and 2004, reflecting domestic demand pressures.

12. ***The medium-term outlook is clouded by the difficult fiscal picture, the high incidence of HIV/AIDS, and uncertain prospects for the implementation of reforms to address social priorities and raise economic efficiency.*** Two alternative scenarios were conducted by the mission. The first scenario assumes no change in policies. In particular, the fiscal deficit continues to widen, leading to a doubling of public debt as a percent of GDP and a sharp contraction in private sector credit and investment. In this scenario, per capita GDP growth may fall away during the medium term and, with the slowing in population growth as a result of HIV/AIDS, this could imply a decline in annual real GDP growth to only around ½ percent. Inflation would remain higher than in South Africa, and the current account balance and external sustainability would deteriorate sharply. Alternatively, under a scenario in which fiscal policy is set on a sustainable trend and a range of structural reforms undertaken, the real GDP growth rate could rise to around 2½ percent. This would imply per capita growth of 1½ percent annually, which is somewhat higher than what Swaziland experienced during the 1990s. Inflation could be expected to remain at the South African level, the current account deficit to narrow to 2½ percent of GDP, and the external position to be more viable.

## B. Macroeconomic Policies

### Fiscal policy

13. ***Greater fiscal discipline is urgently needed to preserve external viability and competitiveness, ensure macroeconomic stability, and improve growth prospects while maintaining a sustainable public debt position.*** In addition, a reduction in the fiscal deficit is needed to prepare the budget for the looming medium-term pressures associated with HIV/AIDS, other social priorities, and contingent liabilities.

14. ***The mission is greatly concerned by the expansion in the fiscal deficit in 2003/04.*** While the February 2003 budget envisaged a reduction in the deficit (including grants) to 4¼ percent of GDP in 2003/04, the mission estimates that on current policies the deficit would increase to over 6½ percent of GDP (nearly E950 million), largely reflecting lapses in expenditure control and substantial spending on a few projects such as the SMART partnership summit in August. The mission urges the authorities to keep the deficit within the original budget target, which may still be achievable if pressures are resisted to undertake significant additional expenditures, such as another round of public wage increases and construction of a new airport as part of the Millennium Projects.

15. ***The pressure on available resources to finance the deficit is of immediate concern, since a continued drawdown of foreign reserves would threaten external viability.*** The mission advises the authorities to address any financing shortfall through expenditure control as the main response and, in the short term, by raising domestic debt issuance to the private sector rather than drawing down foreign exchange reserves. In this context, the recent increase in the domestic debt limit is appropriate, provided that it is not simply matched by higher expenditure and that the debt is sold on a voluntary, market basis.

16. ***The mission welcomes the government's intention, announced in the February 2003 budget, to undertake fiscal adjustment so as to achieve a primary surplus over the medium term.*** It is important that the fiscal adjustment be firmly implemented and front-loaded in order to ensure that the prospective medium-term pressures on the budget do not compromise macroeconomic sustainability. In this regard, the authorities' ongoing efforts to move toward a medium-term framework for fiscal policy are helpful, and should be accompanied by greater fiscal transparency and accountability. Since the expansion in fiscal expenditure this year largely reflects one-off items, the mission believes that it is realistic and feasible to aim for a return to the adjustment path originally envisaged in the budget. In particular, the mission recommends a reduction in the fiscal deficit to around 2½ percent of GDP in 2004/05, and a further reduction so as to achieve a primary surplus by 2007/08.

17. ***A further broadening of the tax base, building on the measures initiated in 2001/02, would help to compensate for the envisaged decline in SACU-related trade taxes over the medium term, reduce the budget deficit, and improve efficiency.*** Moves such as the inclusion of benefits in kind in the tax base, implemented in July 2003, are helpful in this regard although the authorities need to remain sensitive to their social impact. The incoming cabinet is urged to consider further measures to broaden the tax base, particularly to eliminate the income tax exemption of Tibiyo Taka Ngwane, parastatals, and commercial activities on Swazi Nation Land and to reduce the use of tax concessions for developmental purposes. The mission welcomes the planned introduction of a VAT in 2006, and encourages the authorities to make timely preparations for it, including by bringing the utilities sector into the tax net. There remains a need to strengthen tax administration,

particularly audit and enforcement, and to step up efforts to collect the sizable tax arrears.

18. ***The bulk of the fiscal effort would need to focus on the source of the problem, namely high expenditure. In addition, there is an urgent need to reorient spending toward critical social sectors such as education and health, allocations for which have been falling as a share of total expenditure.*** The mission urges restraint over the wage bill and transfers to public enterprises, which together accounted for over two-thirds of recurrent expenditure in 2002/03. Efforts need to be stepped up to strengthen expenditure management. The announcement in July that plans to acquire a personal airplane for His Majesty the King had been dropped was welcome. However, the government's participation in some of the Millennium Projects—such as the new airport, international trade fair, and sports complex—threaten to crowd out budgetary resources for meeting the country's urgent social needs and to weaken sentiment among donors. The authorities are urged to abide by their original intention to devolve upfront most Millennium Projects to the private sector and to ensure the economic viability of the few projects where government participation may be warranted.

19. ***A careful sequencing of civil service reform is needed in order to improve the efficiency of the public services while avoiding an increase in the public wage bill.*** Wider wage dispersion in the public sector could help to attract and retain skilled employees, but the mission urges that this should await a reduction in the overall size of the civil service. The Public Sector Management Program could be speeded up to identify alternative approaches to right sizing the civil service while ensuring adequate staffing in key social sectors. Meanwhile, the authorities are strongly advised to avoid public wage increases of the scale seen in the recent past as these, in addition to worsening the public finances, influence private sector wages, raise economy-wide labor costs, and reduce competitiveness.

**Monetary policy and the exchange rate**

20. ***The mission supports the pegged exchange rate system of the lilangeni to the rand, in light of the financial discipline that it entails and the close economic integration between Swaziland and South Africa.*** In order to ensure the credibility of the peg it is important to have in place financial policies that secure an adequate level of international reserves. Monetary policy is largely passive in Swaziland, but situations could arise in which the CBS needs to be proactive in influencing liquidity and foreign reserves. The mission welcomes the effort that the CBS is making, with technical assistance from the Fund, to strengthen the capacity for monetary operations, including open market operations. In the meantime, the CBS could consider using the discount rate more actively to tighten liquidity conditions when warranted. A recent deterioration in the financial position of the CBS may come to compromise the central bank's ability to absorb liquidity, and the mission urges the authorities to monitor the situation closely and seek technical assistance if necessary.

## C. Structural Issues

21. ***In addition to sound macroeconomic policies, an improvement in growth prospects requires structural reforms across a broad front that will help to raise economic efficiency, improve the investment environment, and generate employment.*** Key areas include the public sector, the rural economy, and HIV/AIDS.

22. ***Importantly, improved governance will be critical for supporting structural reforms, providing the foundations for stronger growth, and attracting donor support for humanitarian needs.*** Of particular concern in recent years have been weaknesses in fiscal transparency and accountability, the slow pace of legislative change, and lapses in the rule of law. The mission strongly supports the view expressed in the CBS annual report that improvements in governance, particularly a restoration of the rule of law, would go a long way toward strengthening domestic and foreign confidence in the Swazi economy, attracting investment and assistance, and generally improving Swaziland's economic prospects.

### Public Sector

23. ***Public enterprise restructuring and privatization need to be accelerated.*** The mission welcomes the submission of the government's privatization policy to parliament in early 2003, and encourages early action to approve and implement the policy once the new parliament and cabinet are in place after the elections. The government would be advised to follow a transparent and collaborative approach in order to ensure broad social acceptance of the policy. In the meantime, the mission urges the government to press ahead with other elements of public enterprise restructuring. In particular, the CTA should now start to be restructured (as approved by the cabinet in 1999), given its significant drain on government resources and public sector efficiency. The monopoly of the National Maize Corporation over maize imports could be lifted as it raises maize prices in Swaziland compared with neighboring countries.

24. ***The finances of the Swaziland Public Service Pensions Fund (PSPF) could represent a significant future liability to the government if they are not addressed.*** The latest actuarial evaluation (April 2002) estimated the actuarial deficit of the fund to be E 2 billion (16 percent of annual GDP). The mission encourages the authorities to initiate measures to put the fund on a sustainable path, including the Actuary's recommendations to increase statutory contribution rates and adjust other parameters of the pension plan. The trend of substantial public wage increases adds to the financial burden that the PSPF will have to bear in the future. The proposed amendments to the Retirement Fund Act that would recall investments held abroad by domestic pension funds should be reconsidered as they could reduce the return and raise the risk profile of the PSPF's asset portfolio.

### Financial Sector

25. ***The banking system in Swaziland is well developed and its financial indicators appear healthy.*** Nonperforming loans of the three commercial

banks fell further to an average of 1¼ percent in June 2003, from 1½ percent a year previously, their overall profitability remained at around 15 percent (pre-tax return on capital), and their capitalization, risk management, and provisioning appear to be sound. More timely data on banks' financial indicators would be helpful for better tracking developments in the sector. The recent and proposed changes in banking legislation, such as with regard to single borrowers, are in line with international practice, but the implications for financial and business institutions need to be carefully monitored and the authorities are encouraged to request any further technical assistance from the Fund that they may find useful in this context.

26. ***The Swaziland Development and Savings Bank ("Swazi Bank") remains a source of supervisory concern.*** The bank's financial situation has strengthened since 2001 with its recapitalization from the budget, full provisioning of its nonperforming loans, and the adoption of new risk management procedures. However, its future commercial viability will depend on the observance of these procedures and on the profitability of its banking services. The mission is hopeful that the CBS will implement the recommendation of the February 2003 Fund technical assistance mission that it undertake an on-site examination of Swazi Bank and develop a comprehensive supervisory action plan for the bank. Consideration may need to be given to restructuring or privatizing the institution in the future.

27. ***The mission commends the authorities for their ongoing efforts to implement the August 2002 legislation to combat money laundering.*** Going forward, the authorities are encouraged to continue to develop the capacity to implement the legislation and to collaborate with other members of the Eastern and Southern African Anti-Money Laundering Group in combating money laundering and the financing of terrorism.

**Social Issues**

28. ***The mission welcomes the authorities' recent progress in the fight against HIV/AIDS.*** In particular, the National Emergency Response Committee on HIV/AIDS (NERCHA) appears to have been successful in coordinating a national strategy against the pandemic and acting as a liaison with the donor community and international organizations, and these efforts have been recognized by donors in the form of a grant from the Global Fund. The mission notes, however, that much remains to be done in the fight against the massive pandemic, including in the near term the provision of anti-retroviral drugs to the critically ill (35,000 people). A determined focus by the government, including through the reorientation of expenditure toward social sectors, would help through both its direct impact on the affected people and its contribution to further improving donor sentiment.

29. ***The food security situation in Swaziland remains fragile.*** Although as a result of higher cereal production and improved import capacity no aggregate food shortage is expected this year, the mission is concerned about the vulnerable sections of society where over 150,000 people are estimated to need food aid by the end of the year. In addition to ensuring adequate food imports and aid, it is important to address the factors that have

contributed to the run of poor harvests in recent years. The mission considers that reform of the land tenure system is important in this regard, and it recommends early enactment into law of measures, such as the Land Policy Act (approved in 1999), that would provide greater security of land tenure and institute long-term leases for agricultural land. In addition, allowing the use of landholdings as collateral would contribute to investment and productivity gains, enhance farmers' access to commercial credit, and help alleviate poverty.

30. ***The mission underscores the need for a strategy to reduce unemployment.*** Analysis of the labor market in Swaziland is hampered by data limitations, but in the mission's view policies to improve the investment environment and control the rapid growth in public sector wages, which influence economy-wide wages, would help to reduce implicit and explicit labor costs and contribute to raising employment and growth. Completion of the skills development study that the authorities initiated in 2002 would help to identify the extent to which skills mismatches impede employment.

### External Trade

31. ***Swaziland's external trade policy is largely determined by its membership in SACU and the Southern African Development Community (SADC).*** The mission welcomes the continued progress with trade liberalization in recent years, and continues to support efforts to reduce trade barriers among SADC countries and to reduce SACU tariffs. It encourages the authorities to remove, or replace with tariffs, the remaining non-tariff barriers, which apply mainly to the importation of some agricultural products. The mission also encourages the authorities to reconcile Swaziland's membership in COMESA and SACU in a timely manner.

## D. Statistical Issues

32. ***The authorities are making efforts to address the lack of timely and comprehensive economic data that hampers effective policymaking and surveillance.*** Significant benefits could be realized through addressing the inadequacies in the economic data, particularly the national income, balance of payments, and government accounts, and improving data quality and communication. The mission encourages the authorities to implement the recommendations of recent Fund technical assistance missions, and to improve the timeliness of data reporting to the Fund. In this context, the mission warmly welcomes Swaziland's decision to participate in the Fund's General Data Dissemination System (GDDS) in 2002 and the provision of metadata in 2003. It urges the authorities to pay close attention to the ongoing GDDS assessment of statistical practices, which will form a sound basis for future technical assistance.

## E. Outreach

33. ***The mission appreciated the opportunity to hold discussions with both officials and a broad representation of Swaziland's economic community,*** and is grateful for the constructive and informative discussions. The authorities' decision to allow publication of last year's Article IV staff report was most helpful in further enhancing the outreach and transparency of the Article IV consultation process, and the mission welcomes the authorities' agreement in principle to publication of the forthcoming staff report.

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