SM/85/186
Correction 2

CONTAINS CONFIDENTIAL INFORMATION

August 15, 1985

To: Members of the Executive Board

From: The Secretary

Subject: Swaziland - Staff Report for the 1985 Article IV Consultation

The following corrections have been made in SM/85/186 (6/27/85):

Page 4, Table 1, footnote 4: for "Residual."
read "Purchases of treasury bills by nonbank financial institutions."

Page 5, para. 1, last line: for "the prime lending rate in the RSA."
read "the interbank and treasury bill rates."

Page 6, lines 1-4: for "However, the capital...net outflow."
read "However, the long-term...in 1984."

Corrected pages are attached.

Att: (3)

Other Distribution:
Department Heads

Industrial production, not substantially affected by the cyclone, declined in large part due to the bankruptcy of the Swaziland Chemicals Industry (SCI), a large company whose fertilizer exports accounted for about 10 percent of total exports, and due to the closing of three firms that left Swaziland for production in the "homelands" in the RSA. Altogether, the closing of these firms resulted in the loss of over 1,000 jobs. Inflation, which is primarily determined by the cost of imports from the RSA accelerated to about 17 percent during 1984.

The fiscal outturn on a cash basis in 1983/84 was a deficit of E 19.8 million, 3.1 percent of estimated GDP, about the same as this ratio in 1982/83 (Table 1). However, the figures for the past several fiscal years are distorted because of a buildup of expenditure-related domestic arrears. An inventory of domestic arrears completed in 1984/85 showed a total of E 13.7 million (about 7 percent of total expenditure in 1983/84), some of which had been outstanding for 5 years; the authorities were not able to allocate these arrears for each of the past several fiscal years. The financing of the 1983/84 deficit (not counting the increase in domestic arrears) was primarily from the domestic banking system, in which net government deposits declined by E 17.3 million (about 11 percent of the beginning period money supply). 1/

The preliminary outturn in 1984/85 shows a much reduced deficit, of E 5.4 million, or less than 1 percent of estimated GDP, even with the liquidation of the E 13.7 million of arrears outstanding at the end of 1983/84. Domestic revenue and grants increased about 14 percent, in part because a new sales tax was implemented in September 1984 and accounted for E 4.4 million, or about 2 percent of the full year's tax revenue. Recurrent expenditures increased by about 9 percent, 9 percentage points less than the estimated inflation rate. The sum of capital expenditures and net lending declined by about 13 percent and were 36 percent less than budgeted (compared to an implementation rate of 85 percent over the previous two fiscal years). The main reason for the large shortfall in capital expenditures and net lending was that expenditures on ongoing capital projects were postponed because of the emergency created by the cyclone and permanent repairs of cyclone damage were delayed. The financing of the deficit was totally from the domestic banking system, as net foreign financing was negative. In December 1984, an E 10.0 million liability to the IMF, representing the counterpart of a compensatory financing facility purchase in June 1983, was transferred from the books of the Central Bank to the Government, with the counterpart credited to government deposits; this transaction had a monetary impact in 1984 identical to domestic bank financing. Including this claim, net domestic bank financing was E 5.7 million in 1984/85 (about 3 percent of the beginning period money supply).

1/ All money supply figures exclude rand in circulation.

Table 1. Swaziland: Summary of Central Government Operations, 1980/81-1985/86 1/

(In millions of emalangeni)

	1980/81	1981/82	1982/83	1983/84	1984/85 Rev. budget	1984/85 Prel. outturn	1985/86 Budget
Revenue and grants	163.3	134.2	182.1	185.3	214.5	216.5	229.1
Tax revenue	139.9	119.6	163.3	166.8	192.9	188.6	203.9
Nontax revenue	14.0	10.2	13.4	12.8	15.2	16.2	13.8
Grants	9.4	4.4	5.4	5.7	6.4	11.7	11.4
Expenditure and net lending	142.2	182.2	199.4	205.1	258.3	221.9	244.5
Current expenditure	84.5	109.1	124.0	136.6	149.6	148.9	157.2
Capital expenditure	45.3	61.9	57.7	53.9	69.8	45.0	81.1
Net lending	12.4	11.2	17.7	14.6	22.9	14.3	6.2
Payments of arrears	--	--	--	--	16.0 2/	13.7 2/	--
Overall surplus/deficit	21.1	-48.0	-17.3	-19.8	-43.8	-5.4	-15.4
Financing	-21.1	48.0	17.3	19.8	43.8	5.4	15.4
Foreign (net)	6.2	6.3	0.8	4.2	9.5	-5.5	14.5
Gross borrowing	(11.0)	(12.3)	(10.5)	(13.5)	(20.2)	(8.6)	(33.6)
Amortization	(-4.8)	(-6.0)	(-9.7)	(-9.3)	(-10.7)	(-14.1)	(-19.1)
Domestic (net)	-27.3	41.7	16.5	15.6	34.3	10.9	0.9
Domestic banks 3/	(-29.5)	(39.4)	(16.5)	(17.3)	--	(5.7)	--
Other domestic 4/	(2.2)	(2.3)	(--)	(-1.7)	--	(5.2)	--
Memorandum item:							
Overall surplus/deficit as a percentage of GDP	4.3	-8.5	-2.9	-3.1	-5.9	-0.7	-2.1

Sources: Ministry of Finance; and staff estimates.

1/ Fiscal year is April-March.
2/ The arrears refer to several previous years, as a precise breakdown is not available.
3/ Includes E 10.0 million of the counterpart of a transfer of Fund liabilities from the books of the Central Bank to the books of the Government.
4/ Purchases of treasury bills by nonbank financial institutions.

The monetary accounts show an increase in domestic credit of about 9 percent during 1984; however, there was a 20 percent increase in broad money supply due to an E 37.8 million increase in net foreign assets. Credit developments during the year were strongly affected by a moderate increase in private credit demand combined with a large increase in time deposits. This caused an increase in the liquidity of the commercial banks, which by December 1984 was 42.1 percent of total deposits compared to a requirement of 13.7 percent. The profits of the banks were not greatly affected, however, because of the policy of the Central Bank to pay an interest rate on excess reserves roughly competitive with the interbank and treasury bill rates.

There were substantial increases in interest rates during 1984 because of the even larger increases in interest rates in the RSA. These interest rate changes created increased interest rate differentials between Swaziland and the RSA (with Swaziland about one percentage point lower in 1983 compared to about 3 percentage points lower in 1984) and increased interest rate differentials between Swaziland and London (with Swaziland about one percentage point higher in 1983 compared to about 3 percentage points higher in 1984). 1/

There were relatively large overall balance of payments surpluses in both 1983 and 1984. 2/ In 1983 the current account deteriorated by SDR 26.5 million (52 percent) as exports declined by 6 percent due primarily to a sharp decline in nonsugar exports, but imports increased by about 12 percent as the drought caused an increase in food imports. Long-term capital inflows also declined, by about 35 percent, as long-term private sector capital inflows (primarily direct investment) fell to very small amounts. However, the deteriorations in the current account and long-term capital were more than made up for by increases in short-term capital and errors and omissions, which increased by SDR 62.7 million. The largest part of this increase is in errors and omissions and is thought to be due primarily to short-term capital inflows.

In 1984 the current account greatly turned around from a deficit of SDR 77.9 million to a small surplus of SDR 8.1 million, primarily on account of an improvement in the trade balance. The main reasons related to a 21 percent decline in imports due to the delay in expenditures on capital projects and the improvement of agricultural output, and an increase in net services inflows primarily because of reinsurance claims on damages to the irrigation system and some sugar in transit, and an

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1/ These interest rate comparisons are between the annual averages of one-month deposit rates in Swaziland and the RSA, and between this rate and the annual average one-month LIBOR rate.

2/ The discussion of the balance of payments reflects amounts denominated in SDRs.

increase in workers' remittances. However, the long-term capital account deteriorated primarily because of a 28 percent decline in public sector disbursements. Other short-term capital flows and errors and omissions reversed from a large net inflow in 1983 to a small net outflow in 1984.

The effective exchange rate of the lilangeni depreciated by about 9 percent in real terms and by about 12 percent in nominal terms during the 12-month period to end-March 1985 (Chart 1). In the same period, the exchange rate with respect to the SDR depreciated by about 34 percent. Since almost all imports come from the RSA, exchange rate changes most directly affect exports; based only on export weights, the real and nominal effective depreciation during this period was 15 percent and 23 percent, respectively. These relatively large exchange rate changes have made an important positive impact on the financial position of export industries.

III. Report on the Discussions

Economic developments in 1984 turned out very differently than had been expected during the previous consultation, the discussions of which took place directly after the cyclone. At that time, the mood was pessimistic and large deficits were projected in the fiscal accounts and in the balance of payments. In fact the budget deficit declined sharply and the balance of payments showed a surplus. In part this was due to policy actions of the Government, particularly actions taken to improve control of recurrent expenditures and the implementation of the sales tax; however, in large part, it was due to special factors which are not likely to be repeated in 1985 and future years. The mission attempted to identify and quantify the effects of the new fiscal policies and the special factors, and to project the balance of payments through 1989 as a guide to the identification of potential future problems and corresponding policies.

1. Fiscal policies

The main fiscal measures that were implemented in 1984/85 were the newly introduced sales tax and an improvement in procedures for expenditure control. Further fiscal measures were included in the submission of the 1985/86 budget to Parliament in March 1985. These were a strengthening of expenditure control procedures through amendments to the Finance and Audit Act, changes in financial incentives to new investors, and revisions to the income tax, and to nontax fees and charges.

The sales tax was introduced at a single rate of 5 percent, collected at the point of entry for imports, at the wholesale level for domestic manufactures, and on sales for hotels and restaurants. There are substantial exemptions including sales from firms with under