FOR AGENDA

SM/85/186

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INFORMATION

June 27, 1985

To: Members of the Executive Board

From: The Secretary

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

Attached for consideration by the Executive Directors is the staff report for the 1985 Article IV consultation with Swaziland, which will be brought to the agenda for discussion on a date to be announced. A draft decision appears on page 17.

Mr. Stillson (ext. 6941) is available to answer technical or factual questions relating to this paper prior to the Board discussion.

Att: (1)

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INTERNATIONAL MONETARY FUND

SWAZILAND

Staff Report for the 1985 Article IV Consultation

Prepared by the Staff Representatives for the
1985 Consultation

Reviewed by the Committee on Article IV Consultations
Approved by A. D. Ouattara and S. Kanesa-Thasan

June 26, 1985

I. Introduction

The 1985 Article IV consultation discussions with Swaziland were held in Mbabane during the period April 21 to May 4, 1985. The representatives of Swaziland included Mr. B. D. Dlamini, Minister of Finance, and Mr. G. B. B. Oliver, Governor of the Central Bank. The staff representatives were Messrs. R. Stillson (head-AFR), U. R. Gunjal (AFR), M. Massourakis (AFR), Ms. G. Bartoli (FAD), and Mrs. E. Telson (secretary-ETR).

Swaziland received a Trust Fund loan in 1979, purchased its reserve tranche in March 1982, and made further purchases under the buffer stock and compensatory financing facilities in January and June 1983, respectively. In February 1985, Swaziland repurchased SDR 0.975 million, or 3.94 percent of quota, in respect of its purchase under the buffer stock facility because of the release in December 1984 of its required sugar stock under the International Sugar Agreement (ISA), following the dissolution of the ISA at the end of 1984. As of end-May 1985, the Fund's holdings of Swazi currency subject to repurchase amounted to 36.4 percent of quota, all of which was in respect of the compensatory financing facility. Appendix I contains additional information on Fund relations; Appendix II provides data on Swaziland's relations with the World Bank group, and Appendix III contains certain basic data on the Swazi economy.

II. Background to the Discussions

1. Overview of the economy

Swaziland is a small, landlocked country that shares common borders with Mozambique and the Republic of South Africa (RSA). It has an unusually pronounced dual economy, with the majority of its population (estimated at about 625,000 and growing at an estimated annual rate of

3.6 percent) residing in rural areas and engaged primarily in subsistence farming, and about one-third of the labor force employed in the modern sector which is dependent on wage labor, exports, and foreign investment. The modern sector includes commercial agriculture, in which sugar is the most important crop contributing almost 40 percent of domestic export earnings; manufacturing, in which agro-based industries are the most important; tourism; and mining.

Economic policies and developments are strongly influenced by several institutional factors. Swaziland is a member of the Southern African Customs Union (SACU) and the Rand Monetary Area (RMA), 1/ which greatly facilitate the smooth flow of trade and finance among the members. 2/ In accordance with provisions of the RMA, Swaziland's currency, the lilangeni (plural: emalangeni), is pegged to the South African rand at par; the rand is also legal tender in Swaziland and forms a substantial but unknown proportion of the Swazi currency supply. The Central Bank of Swaziland holds a 100 percent Rand backing for emalangeni notes and coins outstanding. Also in accordance with the RMA and SACU agreements, there are no exchange or trade controls between Swaziland and the RSA. Swaziland is severely constrained in its monetary, credit, exchange rate, and pricing policies because of its small size relative to the RSA and the free movement of goods and capital within the RMA and the SACU.

2. Recent economic developments

Economic developments in 1984 were greatly affected by a cyclone which caused widespread damage in January of that year, the most significant of which was to railroad bridges, the secondary road system, and irrigation systems. By May 1, 1984, emergency repairs had been made on the rail line to Maputo, Mozambique, which carries the bulk of Swaziland's exports, including all sugar exports; the other major rail line was operational by July. 3/ Paradoxically, the cyclone did little physical damage to crops (except to citrus) and the increased rainfall improved yields. Thus, sugar exports marginally increased, there were bumper maize and pineapple crops, and cotton production almost doubled.

1/ A description of the customs union and the formula used for SACU reimbursements is contained in Appendix I of SM/84/92, April 30, 1984; a description of the background and concept behind the RMA is contained in DM/76/66, "The Rand Monetary Area and the Monetary Systems of Botswana, Lesotho, and Swaziland", July 30, 1976, and DM/83/6, "The Rand Monetary Area", February 17, 1983.

2/ Swaziland, Lesotho, and the RSA are members of the RMA, and these three countries along with Botswana are members of SACU.

3/ The rail line to Maputo is still disrupted to a certain extent by insurgents in Mozambique.

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/ Residual.

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 prime lending rate in the RSA.

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 capital account deteriorated: net long-term capital inflow was down by 40 percent, primarily due to the decline in public sector disbursements, and the short-term capital inflow of 1983 reversed to a small net outflow.

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.

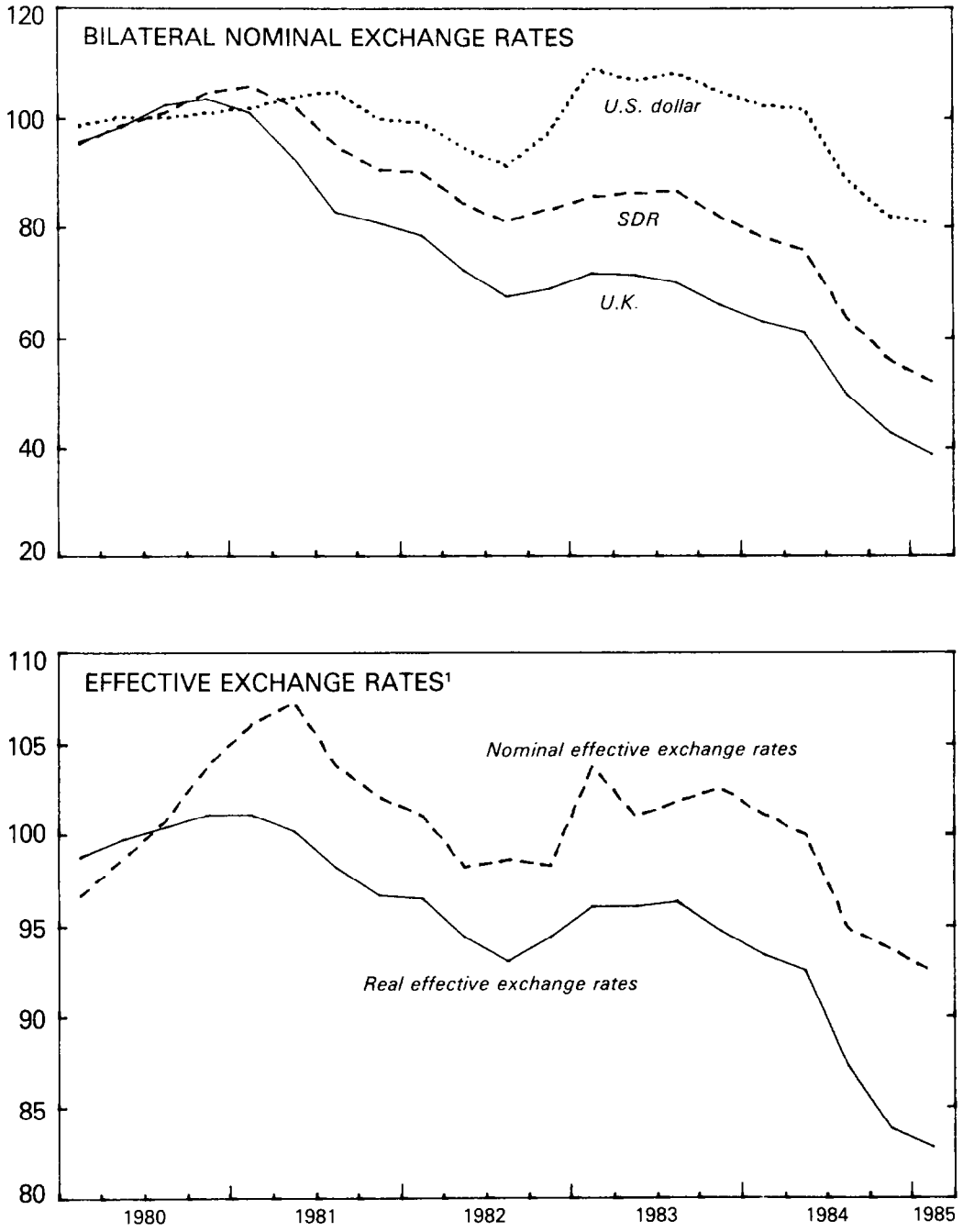
The sales tax was introduced at a single rate of 5 percent, collected at the point of entry for imports, at the wholesale level for domestic manufactures, and on sales for hotels and restaurants. There are substantial exemptions including sales from firms with under

CHART 1

SWAZILAND

EXCHANGE RATE DEVELOPMENTS, 1980-MARCH 1985

(Period average, 1980 = 100; foreign currency per Swaziland lilangeni)



Sources: IMF, *International Financial Statistics*, and staff estimates

10 employees, and basic food items. During the second half of 1984/85 only E 4.5 million was collected as there were some start-up problems, and sales tax revenues are estimated (conservatively) at E 10 million in the 1985/86 budget. The effect of the tax on the consumer price index is estimated by the authorities to be about 2 percentage points.

In April 1984, a committee was established to do an inventory of domestic arrears, authorize payment for legitimate arrears, and recommend improvements in expenditure controls. The primary causes for the payment delays were failure to control payments vouchers and improper accounting. Two administrative measures implemented to improve these areas were better control of order books by the Treasury and a quarterly, rather than annual, release of funds to spending ministries. In addition, accountants who will report directly to the Accountant General are being hired to be controlling officers in the four ministries with the worst control problems. The computer system is also being upgraded. Although most problems were found to be due to nonadherence to existing regulations, the Finance and Audit Act is being amended, among other objectives, to further clarify and prescribe authority for public expenditure, and to provide for a disciplinary tribunal to deal with cases of unauthorized public expenditures.

The 1985/86 budget estimates show a 6 percent increase in revenue and grants, and a 10 percent increase in expenditures and net lending, resulting in a deficit of E 15.4 million, or about 2 percent of projected GDP. Revenues from income taxes are not expected to increase because of the stagnant economy and low current profit levels, but those from taxes on goods and services are expected to increase by 11 percent mainly because of the first full year's receipts from the sales tax. On the expenditure side, recurrent expenditures are budgeted to increase by about 6 percent while capital expenditures and net lending are budgeted to rise by about 47 percent, as capital projects set aside because of the cyclone emergency get back on track and expenditures on permanent repairs of cyclone damage are made. The mission felt the actual outturn may be less expansionary than the budget because sales tax revenue is likely to be higher than estimated and because it is unlikely that capital expenditures and net lending will expand as rapidly as budgeted.

Several new fiscal measures will be introduced during 1985/86 including new investment incentives and changes in corporate and personal income taxes. The major new investment incentive is a 5-year tax holiday on profits less than 150 percent of fixed assets for all new firms in manufacturing industries not previously represented in Swaziland. The current investment allowance scheme, in which 30 percent of investment costs could be deducted from taxable profits, is being replaced by an initial allowance scheme whereby 50 percent of new investment can be depreciated in the first year. Also, there will be company tax allowances for training and housing expenditures. The

authorities feel that the tax holiday is not expected to cause much of a revenue loss as most eligible new investment would not likely be made in Swaziland without the incentive. The replacement of the investment allowance by the initial allowance will cause a higher first-year write-off for all new investment and may reduce company tax in the first year of implementation by about E 4 million, although in subsequent years company taxes will be higher under the new system.

The new income tax measures include a higher level of exemptions, separate taxation of wages and salaries of married women, and a new system of tax payments by companies based on estimated profits during the tax year (previously companies paid taxes on profits a year in arrears). The personal income tax measures are not expected to have a large impact on collections, and the new system of company tax payments is expected to improve collections by about E 1 to 2 million.

The staff commented that the 1985/86 budget was broadly appropriate in Swaziland's circumstances. Capital expenditures in 1984/85 were abnormally low and should rise considerably in 1985/86. The new administrative measures were designed to ensure that existing regulations were followed and it was particularly important that the effects of these measures were carefully monitored to ensure they were achieving the desired results.

2. Balance of payments analysis and projections

a. Special factors in the 1984 balance of payments

The mission analysed the reasons for the balance of payments surplus which occurred in 1984 with a view to estimating the sustainable elements and the special factors which were not likely to be repeated in 1985 and future years. The surplus was primarily the result of a large drop in imports which was due in large part to the low capital expenditure in 1984/85 and the general recession in the economy. Based on the budgeted level of capital expenditure of E 69.8 million, the normal implementation rate of 85 percent, and the assumption (based on past experience) of an import content of capital expenditures of about 85 percent, the import shortfall due to the low capital expenditures, was about E 12 million, or SDR 8 million. Another special factor reducing imports was the cessation of operations of Swaziland Chemical Industry, which was mostly a mixing plant which imported almost all its raw materials. Its normal annual import level was about E 40 million or SDR 27.1 million; SCI exports, on the other hand were at the normal level in 1984 as all of its inventories were exported as part of its liquidation.

Other special factors not related to imports were the cyclone-related re-insurance claims, amounting to about E 8 million (SDR 6 million); additional worker's remittances due to extraordinary wage increases in South African mines, amounting to about E 10 million (SDR 7 million); and additional sugar export receipts due to special contracts. The special sugar contracts in markets other than the EEC and the U.S., and the 23 percent depreciation of the lilangeni against the U.S. dollar, allowed the Swaziland Sugar Association to raise the Emalengeny value of its sugar exports by 22 percent over the 1983 level despite the severe decline in the world price of sugar during the year. A detailed analysis shows a decline in U.S. dollar prices realized by Swaziland of about 16 percent between June 1984 and January 1985 compared to the annual average of 1983; the U.S. dollar decline in world market prices on an equivalent basis was about 30 percent.

The above considerations indicate that the effects of special factors on the 1984 balance of payments were about E 86 million, or SDR 58 million, equivalent to 67 percent of the improvement in the current account.

b. Balance of payments projections and sensitivity analysis

Taking into account the effects of the special factors on the likely outturn of the balance of payments for 1985 and 1986, the assumptions of the Fourth Plan, and other assumptions regarding exports and capital flows based on the mission's discussions, the mission projected the balance of payments through 1989. It then examined several alternative sets of assumptions concerning world market prices and exchange rates, to assess their effects on the overall balance of payment outturn. The initial projection (the base scenario) is shown in Table 2, and the results of the alternative scenarios (shown in the form of a sensitivity analysis of the overall balance of payments outturn) are shown in Table 3.

The base scenario assumes an inflation rate in the RSA and Swaziland of 10 percent per year and a real GDP growth in Swaziland of 1 percent in 1985 and 2.2 percent (the Plan forecast) thereafter. World inflation measured in U.S. dollars is assumed to be 4 percent. Imports related to capital flows are assumed to be 85 percent of gross public sector borrowings, and projections for these borrowings are based on the authorities' estimates. Projections of other imports assume an income elasticity of .95, largely reflecting possible import substitution in maize. Export projections were made for each major commodity and market and an estimate of new manufacturing exports was based on specific private and public sector investments expected to become operational within a year. SACU receipts are estimated at 20 percent of total imports. Receipts for services reflect the opening of a new railroad line to the north, which is expected to carry South African traffic, and new hotel projects for which agreements have been signed.

Table 2. Swaziland: Balance of Payments Projections, 1984-89

(In millions of emalangeni)

	1984	1985	1986	1987	1988	1989
Exports, f.o.b.	393.3	352.7	386.7	423.2	446.0	470.4
Imports, f.o.b.	-515.5	-603.4	-622.5	-697.7	-778.8	-871.7
Related to capital flows	-60.9	-105.6	-72.3	-82.5	-91.0	-102.8
Other imports	-454.6	-497.8	-550.3	-615.2	-687.8	-768.9
Imports, c.i.f.	-599.7	-693.9	-715.9	-802.3	-895.7	-1,002.5
Adjustments for SACU	64.7	60.3	62.3	69.8	77.9	87.2
Other adjustments	19.5	30.2	31.1	34.9	38.9	43.6
Trade balance	-122.2	-250.7	-235.8	-274.4	-332.8	-401.3
Services and income: credit	147.6	154.8	183.9	205.2	215.4	221.5
Services and income: debit	-112.6	-115.9	-123.8	-137.9	-151.9	-167.8
Balance of goods, services, and income	-86.1	-211.8	-175.7	-207.2	-269.3	-347.6
Official unrequited transfers (net)	32.8	33.2	33.4	34.2	35.1	35.5
Private unrequited transfers (net)	--	--	--	--	--	--
Nonduty SACU receipts	65.7	60.3	62.3	69.8	77.9	87.2
Current account balance	12.4	-118.2	-80.1	-103.2	-156.3	-224.9
Long-term capital (net)	25.3	75.8	34.2	42.3	48.2	56.5
Public sector (net)	25.6	68.1	28.1	35.6	40.8	48.3
Disbursements	39.2	83.3	45.5	56.1	64.6	77.2
Amortization	-13.6	-15.2	-17.4	-20.5	-23.8	-28.9
Private sector (net)	-0.3	7.7	6.1	6.7	7.4	8.2
Basic balance	37.7	-42.4	-45.9	-60.9	-108.1	-168.4
Other capital movements	-7.6	25.0	25.0	25.0	25.0	25.0
Overall balance	30.1	-17.4	-20.9	-35.9	-83.1	-143.4
Memorandum items:						
Debt service ratio (in percent of exports and services receipts)	4.6	5.2	5.4	6.1	6.9	8.0
Gross official reserves (in months of imports f.o.b. and service payments	3.1	2.4	2.0	1.3	0.1	-1.6
Gross official reserves	161.6	144.2	123.3	87.4	4.3	-139.1
GDP assumptions:						
Nominal GDP (E million)	697.8	767.6	852.8	958.8	1,077.8	1,211.6
Real GDP (percent growth)	--	1.0	2.2	2.2	2.2	2.2
GDP deflator (percent change)	10.0	10.0	10.0	10.0	10.0	10.0

Source: Staff estimates.

Table 3. Swaziland: Simulations of the Overall Balance of the Balance of Payments, 1985-89

(In millions of emalangeni; and percentage change)

	1985	1986	1987	1988	1989
1. Import elasticities					
(a) .9	-15.3	-15.7	-26.3	-67.7	-120.7
(b) .95 (base)	-17.4	-20.9	-35.9	-83.1	-143.3
(c) 1.14	-25.6	-41.0	-73.4	-143.6	-234.0
2. Nominal GDP growth rate 1/					
(a) 10	-17.4	-16.0	-18.0	-48.0	-86.1
(b) 12.2 (base)	-17.4	-20.9	-35.9	-83.1	-143.4
(c) 15	-17.4	-38.3	-70.7	-140.9	-231.5
3. Sugar price 2/					
(a) 7 after 1986	-17.4	-20.9	-31.6	-73.6	-127.7
(b) 4 after 1986 (base)	-17.4	-20.9	-35.9	-83.1	-143.3
(c) 1 after 1986	-17.4	-20.9	-39.2	-90.2	-155.1
4. Exchange rate 3/					
(a) 5 (depreciation)	-4.2	8.4	13.6	-9.2	-40.0
(b) 0 (base)	-17.4	-20.9	-35.9	-83.1	-143.3
(c) -2 (appreciation)	-22.7	-32.2	-54.4	-109.9	-179.9
5. New exports					
(a) Base assumption	-17.4	-20.9	-35.9	-83.1	-143.4
(b) 20% higher after 1986	-17.4	-20.9	-25.2	-69.6	-126.7
(c) 40% higher after 1986	-17.4	-20.9	-14.5	-56.1	-110.0

Source: Staff estimates.

1/ Annual percentage change after 1985.
2/ Annual percentage change in U.S. dollars.
3/ Annual percentage change in lilangeni per U.S. dollar.

The result of the base scenario projection is a turnaround in the overall balance in 1985 and 1986 leading to a drop in reserves of about E 38 million in the two years. In part the projected deterioration reflects the reversal of the special factors that improved the outturn in 1984; market deterioration, particularly in woodpulp; and hail damage to the citrus crop. These deficits could be financed without reducing gross official reserves below the level equivalent to two months of imports of goods and services. However, beyond 1986, although the influence of the special factors disappears, the outturn deteriorates further, to unsustainable levels. This reflects in part the fact that nominal import levels are determined by overall growth and inflation in the RSA while export levels are dependent on market conditions outside of the RSA. These relatively pessimistic projections depend crucially on the assumptions of a higher level of inflation in the RSA than in the rest of the world and on the relatively large increases in capital inflows projected by the authorities.

The sensitivity analysis indicates the effects on the overall balance of different assumptions concerning factors beyond the control of the authorities, such as world market prices, inflation, and exchange rates, and of those variables affected by policy, such as the import elasticities and the growth rate of new exports. Each scenario represents the projections of the base model as modified by the introduction of a single alternative assumption. Scenarios are grouped in five categories with each group involving assumptions about the values of individual variables that are slightly higher and lower than in the base scenario. An outline of the results is as follows:

(a) With respect to the income elasticity of imports, the two alternative assumptions were .9, reflecting improved import-substitution in agricultural products, and 1.14, the value used in the forecasting model of the Plan. The lower import substitution assumption yields an overall balance of payments deficit by 1989 that is almost half the deficit under the Plan's assumption.

(b) With respect to nominal GDP growth, the analysis highlights the sensitivity of the overall balance to inflation in both Swaziland and South Africa. Even a small reduction, of 2.5 percentage points, would cause a 10 percent reduction in the overall deficit.

(c) The base model assumes no change in the U.S. dollar value of the lilangeni. A two percent appreciation worsens the overall deficit with respect to the base forecast by about 25 percent, whereas continued further depreciation dramatically improves the outturn. The effects of further exchange rate changes will be inversely related to the effects of changes in inflation (and higher inflation in the RSA will likely result in further depreciation) and the joint effects of the two variables will partly offset one another.

(d) With respect to the price of sugar, the base forecast assumes a slow recovery during 1985 and 1986, of 4 percent per year in U.S. dollar terms. The alternative assumptions are 3 percentage points higher and lower and compared to the base projection result in an improvement of 8 percent, and a deterioration of 10 percent, in the overall balance, respectively.

(e) New exports are assumed alternatively to be higher than the base forecast assumption by 20 percent and 40 percent after 1986; the overall balance would improve by 12 percent and 23 percent, respectively. It is assumed that the bulk of the investment needed to produce these exports would be financed abroad and thus not affect significantly the overall balance.

These projections and scenarios were discussed with the authorities who generally agreed that they highlighted the main problems. Overall, the main conclusion is that the imbalances that produced the unsustainable deficits beyond 1986 shown in the base scenario would be significantly reduced with the accelerated development of new export industries and increased maize production; however, if this development does not come about, the balance of payments would become a severe constraint to growth in Swaziland.

3. Medium-term policies

Given the above analysis, the discussions centered around the need for adopting policies that would lead to growth consistent with the necessary reduction in the import elasticity and the development of new export industries. Of first priority is the achievement of the fiscal policy goals in 1985/86 and effective control of government expenditures. Another short-term measure that should be carefully considered is to reduce the interest rate differential between Swaziland and the RSA, which widened in 1984, a year in which there was a small capital outflow. In the current situation of high reserves, this outflow was not serious, but given the likely future balance of payments constraints, the interest differential should be narrowed if short-term outflows increase. The current level of international reserves should not be considered excessive in light of Swaziland's vulnerability to weather and changes in import and export prices.

The key to medium-term policy in Swaziland is to attract more investment oriented toward exports and to improve agricultural output. To this end, the World Bank and donors are coordinating their efforts to see how they can effectively expand their lending programs. Also, there is an active policy to promote foreign private investment.

The World Bank staff visited Swaziland in December 1984 to complete work on a new Economic Memorandum, which will be discussed with the authorities in the summer of 1985, and has recently conducted sector reviews on Manpower, Population and Health, Industry, and Transportation.

Other studies will be made in the agricultural and energy sectors. Key development concerns of the World Bank staff are population growth and the attendant growth in unemployment, agricultural developments and the difficulties that have been encountered in raising output on Swazi Nation Land (SNL), 1/ overcoming a shortage of skilled and professional manpower, and promoting private investment. The World Bank staff has looked at the Swazi investment program and feels that there is a crucial weakness in preparing projects well in advance according to clearly established priorities and in planning their execution. This has resulted in an inadequate pipeline of projects and a substantial gap of unallocated investments (60 percent of planned investment for 1985/87).

The consultation mission also discussed with the authorities the role of the Plan in guiding investment. The Fourth Plan contains a forecast over the next five years based on past trends estimated from an econometric model, and a statement of general macroeconomic strategy. The mission suggested that the Plan might be more useful if it provided a more specific connection between its macroeconomic strategy and the preparation of annual capital budgets. The objective would be to determine the sectors and industries in which Swaziland has a comparative advantage in order to provide a more specific guide to spending ministries in their project selection, and to guide a more active policy of investment promotion.

The mission also pointed out that the banking system, in which there was considerable excess liquidity, did not have a way of converting this liquidity into medium-term finance for profitable development projects. Commercial banks specialize in short-term finance, primarily trade credit, while medium- and long-term finance is provided through the Government's capital budget and net lending. The Swazi authorities acknowledged that there were no medium-term debt instruments and the two institutions designed to deal with medium-term finance (the Swaziland Development and Savings Bank, and the National Investment Development Corporation) were small and currently unprofitable. The mission suggested that priority should be given to improve these corporations and to develop them to the extent that they could issue financial liabilities competitively and thus establish a market in medium-term debt instruments.

1/ Swazi Nation Land is owned by the Swazi Nation and administered by a system of tribal chiefs, mostly on the basis of traditional tenure rights. The Government, with World Bank and other donor assistance, expended a great deal of effort to develop the SNL through the Rural Development Area Program (RDAP), which was not successful in increasing output of the SNL. A third stage of the RDAP is being prepared.

IV. Staff Appraisal

There were substantial policy initiatives taken during 1984 that contributed to turning around the economic situation: emergency repairs of damage caused by a cyclone in January 1984 have been effected, financing has been obtained for permanent repairs, the fiscal deficit declined to a marginal level in 1984/85, domestic arrears have been settled through end-1983/84 and controls have been implemented to prevent the occurrence of further arrears, and a new sales tax was implemented. Partly as a result, the external current account and the overall balance of payments showed a surplus in 1984, resulting in a large overall surplus in SDR terms. However, the balance of payments surplus was also due to several special factors that are not likely to be repeated in 1985 and subsequent years, and the medium-term outlook in the balance of payments points towards increasing difficulties. Substantial new private investment will be required to lift manufacturing exports and agricultural output to provide sustainability to the balance of payments.

In addition to the measures listed above, which primarily concern reversing past difficulties of expenditure control and the narrow domestic tax base, new financial incentives for foreign investment have been prepared and will be presented to Parliament in the summer of 1985. These measures include a corporate tax holiday for five years on investment in new industries in Swaziland, accelerated depreciation, and certain training and housing allowances. The measures are designed to provide encouragement to new foreign investment without extreme sacrifices in future revenue; they are not designed to compete with the extremely large subsidies given by the RSA for new investment in the "homelands." The staff feels that the new measures are reasonable and may provide some encouragement to new investment; however, by themselves, they are not likely to provide a sufficient boost to new investment.

The outturn of the 1985/86 fiscal year will show whether the expenditure control measures are adequate and how buoyant the new sales tax will prove to be. The staff commends the authorities for the quick action taken after the large level of domestic arrears became apparent in early 1984. The new measures are designed to ensure compliance to existing regulations and to improve accounting. The staff places great importance on the accounting and reporting aspects of the control measures, particularly the development of relatively quick estimates of expenditures and revenues that can be reconciled with the bank financing figures. The 1985/86 budget shows a larger deficit than in 1984/85, but this is because of a very large budgeted increase in capital expenditures resulting from the postponement of many of these expenditures in 1984/85. The budgeted level is not excessive in light of historical trends in capital expenditures (it is about 24 percent above the average of 1982/83 and 1983/84), but the staff believes that actual capital expenditures will fall short of the budgeted level.

The balance of payments prospects for the next five years are likely to show a considerable deterioration from the surpluses of 1983 and 1984, unless, as mentioned above, capital inflows and the resulting import growth are less than projected. The staff's analysis shows that the reversal of the special factors that helped provide the current account surplus in 1984 will lead to an increase in imports and deficit in 1985. More importantly, given the new investment currently known, an imbalance may be caused by the fact that changes in the cost of imports are primarily related to developments in the RSA, but export prospects are primarily related to international markets outside the RSA. Thus, if one expects a higher rate of inflation in the RSA than in the rest of the world, not fully compensated by exchange rate changes, there would be a deterioration in Swaziland's balance of payments, other things being equal.

Swaziland's development will depend on attracting further investment leading to increased exports and agricultural output, and policies must be geared toward that goal. The planning process could be used to determine areas of comparative advantage, identifying exploitable opportunities and complementary infrastructure projects, and guiding an active investment promotion policy. Also, sources of medium-term finance must be developed, both within the local capital markets and from abroad. This will require strengthening the administration and financial position of the Swazi Bank and the National Investment Development Corporation.

An increased interest rate differential, of about 3 percentage points, emerged in 1984 between Swaziland and the RSA. During the same year, there was a small short-term capital outflow following the large inflow of 1983. Although a small differential can be maintained between the countries without inducing a large outflow, the staff feels that it would be prudent to reduce the differential in light of the likely turnaround in the balance of payments.

The staff commends the authorities for maintaining exchange, trade and price systems which are relatively free of restrictions. Although Swaziland's membership in the RMA and the SACU restricts its ability to pursue independent monetary and pricing policies, the staff feels that the free flow of goods and capital that these agreements encourage provides a significant net benefit to Swaziland.

In view of the prospective difficulties in the balance of payments, it is recommended that the next Article IV consultation with Swaziland be held on the standard 12-month cycle.

V. Proposed Decision

The following draft decision is proposed for adoption by the Executive Board:

1. The Fund takes this decision in concluding the 1985 Article XIV consultation with Swaziland, in the light of the 1985 Article IV consultation with Swaziland conducted under Decision No. 5392-(77/63), adopted April 29, 1977 (Surveillance over Exchange Rate Policies).

2. The Fund notes with satisfaction that Swaziland continues to maintain an exchange system that is free of restrictions on payments and transfers for current international transactions.

SWAZILAND - Relations with the Fund
(As of May 31, 1985)

I. Membership status

a. Date of membership: September 22, 1969
b. Status: Article XIV

A. Financial Relations

II. General Department (General Resources Account)

a. Quota: SDR 24.7 million

	Amount (In millions of SDRs)	Percent of quota
b. Total Fund holdings of emalangeni	32.0	129.4
c. Use of Fund credit:		
Compensatory financing facility - exports	9.0	36.4
d. Reserve tranche position	1.7	...

III. Current Stand-by or Extended Arrangement and Special Facilities

Swaziland has not made use of Fund resources to date under stand-by or extended arrangements. A purchase under the buffer stock financing facility equivalent to SDR 0.975 million was made on January 6, 1983 and repurchased on February 7, 1985. A purchase of SDR 9.0 million under the compensatory financing facility was made in June 1983.

	Amount (In millions of SDRs)
IV. SDR Department	
(a) Net cumulative allocation	6.4
(b) Holdings	0.8 (or 12.3 percent of net cumulative allocation)

SWAZILAND - Relations with the Fund (concluded)

A. Financial Relations (concluded)

V. Trust Fund Loans Outstanding

(a) Disbursed	4.5
(b) Outstanding	4.3
Overdue Obligations to the Fund	--

B. Nonfinancial Relations

VII. *Exchange rate arrangement*

The Swazi lilangeni (plural: emalangeni) is pegged to the South African rand at E 1 = R 1. The rand is legal tender in Swaziland. The intervention rate is the U.S. dollar: exchange rates for the U.S. dollar are based on the floating middle rate of the South African rand against the U.S. dollar. The rate on April 30, 1985 was E 1 = US$0.51758.

VIII. Last Article IV consultation and consultation cycle

The 1984 Article IV consultation discussions took place in Mbabane during February 5-17, 1984. The Executive Board discussed the reports (SM/84/77 and SM/84/92) on May 14, 1984. The following decision was taken:

"1. *The Fund takes this decision in concluding the 1984* Article XIV consultation with Swaziland, in the light of the 1984 Article IV consultation with Swaziland conducted under Decision No. 5392-(77/63), adopted April 29, 1977 (Surveillance over Exchange Rate Policies).

2. The Fund notes with satisfaction that Swaziland continues to maintain an exchange system that is free of restrictions on payments and transfers for current international transactions."

Swaziland is on the standard 12-month cycle for Article IV consultations.

IX. Technical assistance

In the past, the Fund has provided Swaziland with technical assistance in the central banking and fiscal fields. The Fund is currently providing three advisors to the research and general administration departments of the Central Bank.

SWAZILAND - Financial Relations with the World Bank Group

Since 1962 the World Bank Group has approved 13 IBRD loans, two IDA credits, and three IFC investments for a total of US$94.6 million. The Group has helped finance five road projects, three power projects, four education projects, and projects for rural development, water supply and sewerage, a development finance company, a textile company and an irrigated sugar estate and factory. As of March 31, 1985 there were active loans of US$17.2 million to be disbursed in education (US$3.8 million), power (US$3.2 million), road rehabilitation (US$8.6 million) and development finance (US$1.6 million) while the amount of outstanding loans totaled US$61.7 million.

Swaziland: Status of Lending by the World Bank Group
as of March 31, 1985 (except IFC as of May 31, 1985)

(In millions of U.S. dollars)

	IBRD (loans)	IDA (credits)	IFC (loans/equity)	Total
Number of projects	13 1/	2 2/	3 3/	18
Amount approved	75.7	8.4	10.5	94.6
Less: Cancellations	2.4	--	--	2.4
Repayments	12.6	0.7	--	13.3
Undisbursed	15.6	--	1.6	17.2
Education	(3.8)	(...)	(...)	(3.8)
Power	(3.2)	(...)	(...)	(3.2)
Road rehabilitation	(8.6)	(...)	(...)	(8.6)
Financing company	(...)	(...)	(1.6)	(1.6)
Amount outstanding	45.1	7.7	8.9	61.7

Source: World Bank Group.

1/ These include four projects on roads, three on education, three on electricity, one on rural development, one on water supply/sewerage and one on NIDCS.
2/ These include projects on roads and education.
3/ These include a sugar factory/irrigation scheme project, a textile company project, and a financing company project.

SWAZILAND - Basic Data

Area, population, and GDP per capita

Area	17,360 square kilometers
Population: Total (1983)	610,000
Growth rate	3.6 percent
GDP per capita (1983)	SDR 874

	1980	1981	1982	1983	1984
GDP	(In millions of Emalangeni)				
GDP at current market prices	466	554	584	634	...
	(In percent)				
Real GDP at factor cost	3.2	8.3	3.0	-1.8	...
Agriculture/GDP	24.1	24.9	23.2	23.8	...
Manufacturing/GDP	21.8	22.3	22.8	23.5	...
Government/GDP	16.7	16.7	17.5	17.4	...
Gross fixed capital formulation/ GDP at market prices	31.8	25.3	26.1	26.7	...
Prices					
GDP deflator	18.3	12.2	5.3	9.5	...
Retail prices	18.6	21.0	11.7	11.2	13.0

	1981/82	1982/83	1983/84	1984/85 Budget	1984/85 Prel.
Central government finance	(In millions of emalangeni)				
Current revenue	129.8	176.7	179.6	208.1	204.8
Current expenditure 1/	109.1	124.0	136.6	165.6	162.6
Current surplus	20.7	52.7	43.0	42.5	42.2
Capital expenditure	73.1	75.4	68.5	92.7	59.3
External grants	4.4	5.4	5.7	6.4	11.7
Overall surplus/deficit (-)	-48.0	-17.3	-19.8	-43.8	-5.4
	(In percent of GDP) 2/				
Overall surplus/deficit (-)	-8.5	-2.9	-3.1	...	-0.7
External borrowing (net)	1.1	0.1	0.7	...	-0.8
Domestic bank borrowing (net)	7.0	2.8	2.7	...	0.8

1/ Includes payments of arrears in 1984/85.
2/ For 1983/84, in percent of 1983 GDP; for 1984/85, in percent of 1984/85 GDP as estimated by the staff.

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1/ Includes payments of arrears in 1984/85.
2/ For 1983/84, in percent of 1983 GDP; for 1984/85, in percent of 1984/85 GDP as estimated by the staff.

SWAZILAND - Basic Data (concluded)

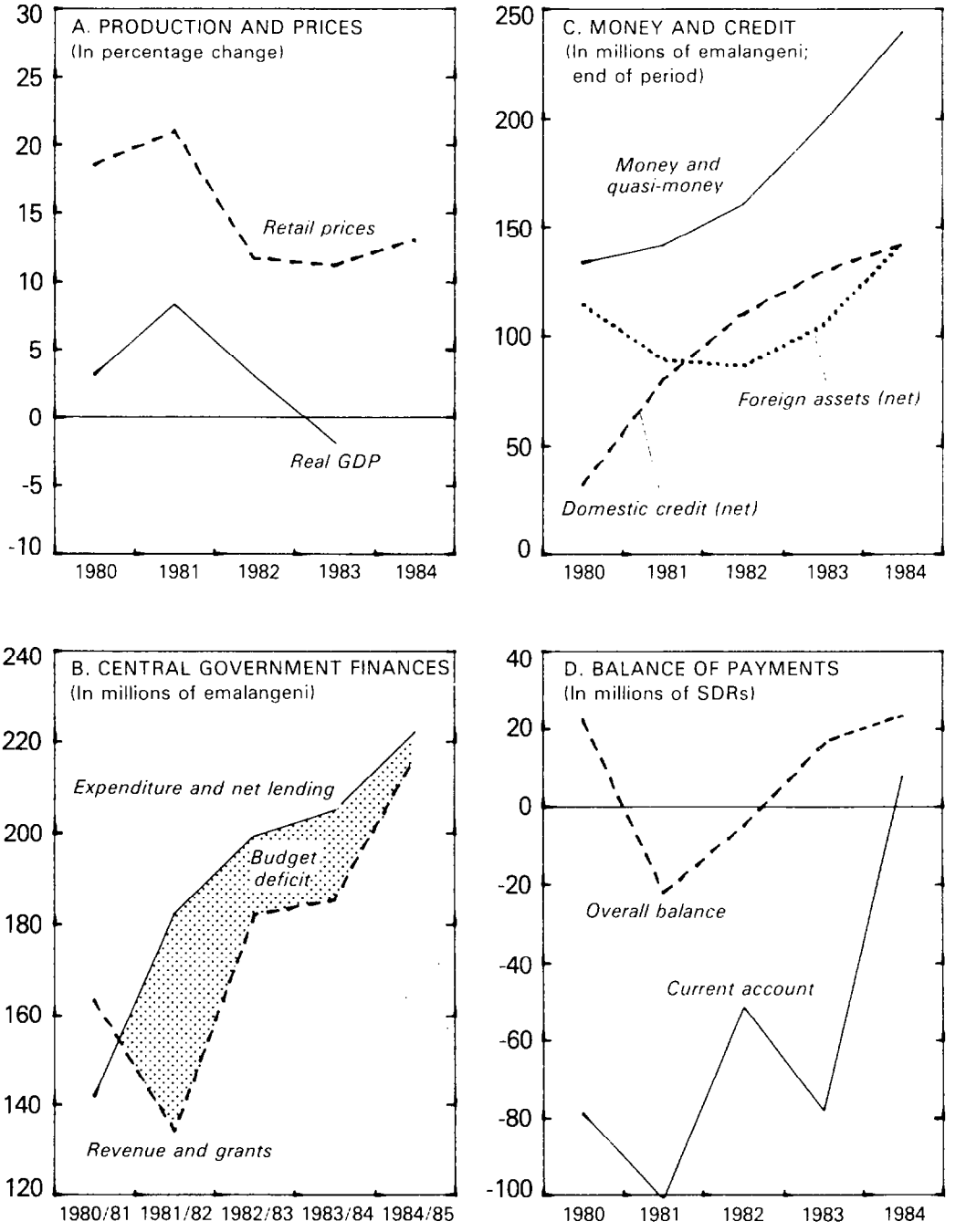
	1980	1981	1982	1983	1984
Money and credit		(In millions of emalangeni)			
Net foreign assets	114	89	86	105	143
Domestic credit	32	80	110	130	142
Government (net)	-66	-52	-31	-16	-14
Nongovernment	98	132	141	146	156
Money and quasi-money	134	142	161	198	239
Balance of payments		(In millions of SDRs)			
Exports, f.o.b.	283	329	307	290	267
Imports, f.o.b.	-400	-433	-397	-443	-350
Trade balance	-117	-104	-90	-153	-83
Services and private transfers and net SACU receipts (net)	38	3	39	75	91
Current account balance	-79	-101	-51	-78	8
Capital account (net)	33	37	43	30	17
Official	16	10	17	26	17
Private	17	27	26	4	--
Errors and omissions 1/	68	42	3	64	-5
Overall surplus or deficit (-)	22	-22	-5	16	20
Current account deficit as percent of GDP	-17	-19	-10	-15	2
Gross official foreign reserves (end of period)	120	79	70	91	83
In weeks of imports of goods and services	10	8	7	10	13
External public debt					
Disbursed and outstanding (end of period)	130	139	154	175	191
Debt service as percent of exports of goods and services	3	3	4	5	5

1/ Includes short-term capital other than from deposit money banks.

CHART 2

SWAZILAND

SELECTED ECONOMIC INDICATORS



Source: Data provided by the Swazi authorities