Central Bank of Swaziland

Curriculum Vitae

Thembi Langa

Thembi Langa joined the Central Bank of Swaziland in 1982 as a research assistant in the Research Department and progressed over the years to Senior Economist in the same department, and currently heads the Domestic Finance Office. She is also a member of the Economics Association of Swaziland (ECAS).

She holds a BA in Social Sciences from the University of Botswana and Swaziland, a postgraduate Diploma in Management from McGill University in Montreal, Canada and a Master's in Economics from Concordia University in Montreal, Canada. The topic of her thesis was on Money Demand, and she also published a paper on macroeconomic convergence while studying for her degree.

E-mail: Thembil@centralbank.org.sz

MONETARY POLICY IN SWAZILAND

Paper to be presented at a conference on Monetary Policy Frameworks in Africa in Pretoria, 17-19 September 2001

BACKGROUND

The Monetary Authority of Swaziland (MAS) was established in 1974 through an Order of Parliament and became the Central Bank of Swaziland, under the Monetary Authority (Amendment) Act of 1978. It was anticipated that the 1974 Order would undergo legislative amendments to broaden the scope of the central bank's supervisory powers and to upgrade the prudential regulation in order to improve banking soundness and other financial institutions in the country. This would further facilitate a legal framework conducive to global trends.

Before the establishment of the MAS, Swaziland was a member of an informal monetary arrangement along with Botswana, Lesotho and South Africa. All circulating currency was issued by South Africa and bank deposits were denominated in the South African currency. Pension and provident funds invested their funds in the Johannesburg market. This loose monetary arrangement was only formalized in 1974 when the rand Monetary Area (RMA), which allows for a free flow of capital within member states, came into existence. Botswana opted to relinquish its membership of the RMA in 1976 because of a desire to pursue an independent monetary policy.

The establishment of the MAS came with the issuance of Swaziland's currency – lilangeni (emalangeni in plural), whose exchange rate is at unity with the rand. Domestic holdings of rand notes were converted into bank balances in the South African Reserve Bank (SARB) earning interest, and at the same time held as 100% backing for emalangeni issued as required by the RMA agreement.

The legal tender status of the rand did not change; with the rand circulating alongside the lilangeni. South Africa paid compensation to Swaziland for loss of seigniorage, based on a predetermined formula on the estimated amount of rands in circulation. However, in 1986, after a series of economic events in South Africa, including the huge depreciation of the rand in 1985, Swaziland renegotiated the RMA agreement, which changed to the present Common Monetary Area (CMA) agreement. This agreement resulted in the cessation of the legal tender status of the rand; consequently, Swaziland gave up its right to receive compensation from South Africa on account of the rands circulating in the country.

The important part of the CMA agreement is that Swaziland now has the liberty to delink the lilangeni from the rand, should circumstances so dictate. Swaziland has, however, opted to maintain the peg for the simple reason that it is still in the country's best interest to do so. It is understood that pegging the lilangeni at par to the rand means any change in the international exchange rate of the rand culminates in an equivalent movement in the lilangeni. In essence, the policies pursued by the country are to a large extent influenced by South African policy pronouncements.

This paper seeks to discuss Swaziland's monetary policy framework, with the discussion centering on the monetary policy instruments and practices for Swaziland, within the context of a monetary union – i.e. the Common Monetary Area (CMA).

The instruments discussed are the exchange rate and interest rate management, open market operations, indirect instruments (liquidity and reserve requirement), and the national payments system. First a brief review of Swaziland's financial institutions under the control of the Central Bank of Swaziland (CBS) is presented, as well as the monetary policy issues as dictated by membership of the monetary union.

REVIEW OF SWAZILAND'S FINANCIAL INSTITUTIONS

Swaziland's financial sector comprises three commercial banks, one building society and a development bank, which is fully owned by the Swaziland Government. The main objective of the development bank is to issue agricultural and commercial loans, whilst the building society specializes in mortgage financing.

Structure: Financial Institutions

	1996/97	1997/98	1998/99	1999/200	2000/2001
Number of banks	5	4	4	4	4
Branch network (banks).............	37	33	31	32	30
Agencies (banks).......................	13	12	11	11	9
ATM Networks (banks)	40	36	37	40	42
Number of Building Societies	1	1	1	1	1
Branch Network (Building Soc.)..	5	5	5	5	5
Non-Banking Fin. Institutions......	5	4	5	5	5

Source: Central Bank of Swaziland

MONETARY POLICY ISSUES FOR SWAZILAND

The ultimate goal of monetary policy is the attainment of price stability, full employment, sustained economic growth and balance of payments equilibrium. Likewise, Swaziland's monetary policy objective as stated in the Central Bank Order, is to promote monetary (price) stability and financial stability, which ensures a stable and sound financial system, so as to foster financial conditions conducive to the orderly and balanced economic development of Swaziland.

Monetary policy formulation is to a large extent influenced by the country's historic membership of the Common Monetary Area (CMA), which allows for a free flow of capital among member states, notwithstanding the provisions in the preamble to the CMA, which states in part that " … each of the contracting states is responsible for its monetary policy and control of its financial institutions". Furthermore, Swaziland is a member of the Southern African Customs Union (SACU) that allows for the free movement of goods and services between Botswana, Lesotho, Namibia and Swaziland (BLNS). These countries have a common external tariff with the Republic of South Africa being the custodian of a common pool where these funds are kept for distribution amongst members annually. Swaziland has a strong trade linkage with South Africa – with 80% of its imports originating from South Africa and over 50% of exports destined for that country.

The monetary agreement has its own advantages which include freeing Swaziland from the need to make decisions concerning monetary and exchange rate policies, and thus allowing her to concentrate efforts on more pressing and immediate tasks, largely fiscal tasks. However, this agreement has disadvantages, including severely limiting the country's ability to formulate or influence monetary policy or respond to shocks affecting the country.

To facilitate the smooth implementation of the CMA agreement, member countries agreed to hold regular consultations with a view to reconciling their respective interests in the event of one member country deciding to formulate, modify and implement its monetary policies. The annual CMA commission meeting has the responsibility for looking into any matter arising under the CMA and all issues pertaining to changes in monetary and exchange rate policies by one country. Consultation among member states has in recent years increased with the formulation of the CMA Governors meetings, held quarterly prior to SARB Monetary Policy Committee meetings.

MONETARY POLICY TOOLS AND PRACTICES

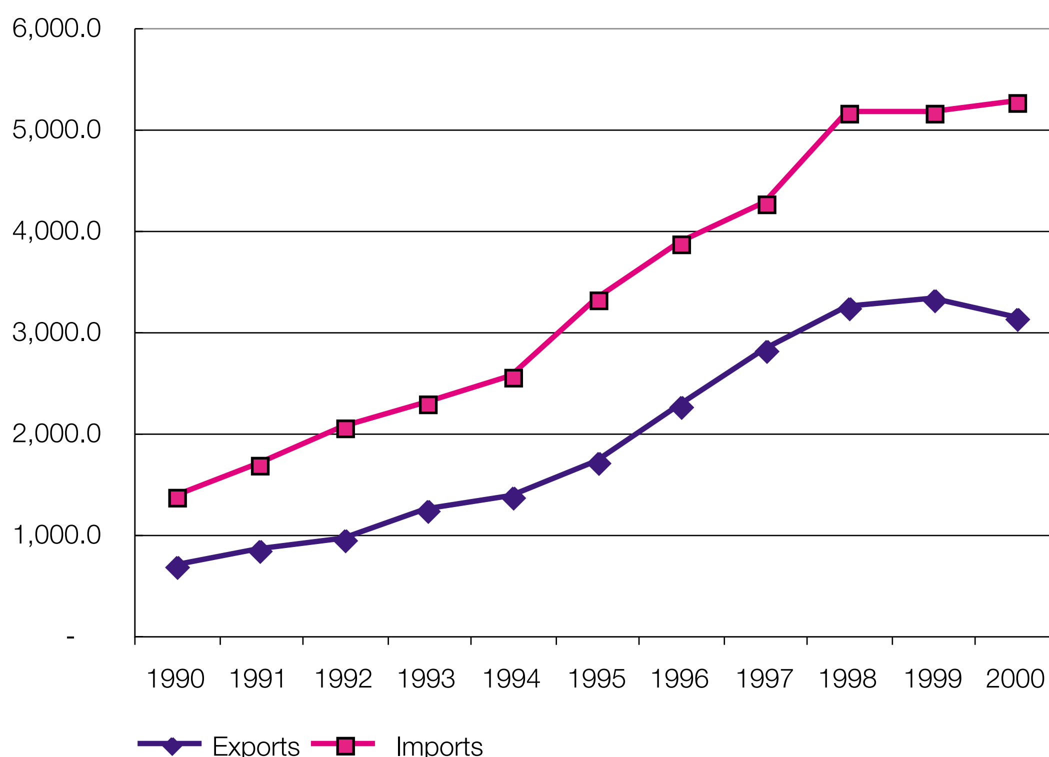
Membership of a currency union with full integration and a fixed exchange rate regime precludes monetary policy independence. It is therefore essential to note that in the case of the tools avail-

able to effect price stability, the CBS has limited powers to influence price movements as enumerated below:

I) EXCHANGE RATE MANAGEMENT

Due to the currency parity, trade between South Africa and Swaziland takes place without the uncertainty and costs that would arise from changes in the exchange rate and from speculation on exchange rate. This is a positive macroeconomic implication for the Swazi economy in that it has facilitated cross-border trade with CMA states. Swaziland has particularly attracted tourism from South Africa and guaranteed the continued profitability and competitiveness of its export sector. This has manifested itself in steady growth of exports to South Africa over the years as reflected in the graphs below.

Swaziland's Bilateral Trade with South Africa ('000)



The steady increase in Swaziland's exports to South Africa has undoubtedly been the result of the 1 to 1 exchange rate between the rand and lilangeni which built certainty in cross-border trade. The decision by Swaziland to retain the parity status between the lilangeni and the South African rand over the past 15 years has benefited the country. Be that as it may, it is important to note that movements of the rand are monitored continuously.

As mentioned earlier – the fixed exchange rate has the disadvantage of precluding the use of monetary policy by the CBS. The high proportion of South African imports results in imported inflation, which is partially caused by the depreciation in the rand.

It is important to note that the depreciation of the rand exchange rate also tends to put enormous pressure on the country's external debt obligations in emalangeni terms. The CBS, on behalf of Ministry of Finance, controls and monitors all external currency transactions. Swaziland is part of the CMA's single exchange-control arrangement where no restrictions are applied to payments within the territory and, in principle, payments are not restricted. In relation to countries outside the CMA, Swaziland applies exchange controls that are generally similar to those of South Africa. In this

regard, the CBS continues to closely monitor the unveiling of the South African exchange control relaxation programme and follows suit.

II) MONEY SUPPLY

The legal tender status of the rand was terminated in 1986 and as a result the country forfeited compensation in respect of rand currency circulating in Swaziland. However, Swaziland now had a wider scope in the management of her reserves by freeing the rand backing. Swaziland has no influence over South Africa's exchange rate policy, which is largely influenced by market forces with little regard to the needs of the Swazi economy.

The rand's continued circulation alongside the lilangeni has rendered the measurement of the money supply to be understated by the amount of rands circulating within the economy. Money supply manipulation to influence economic growth and performance is therefore effectively a tool outside the scope of the authorities, for as long as the lilangeni remains pegged to the rand. Moreover, free access to the South African money and capital markets also limits the CBS's control over money supply.

III) INTEREST RATE POLICY

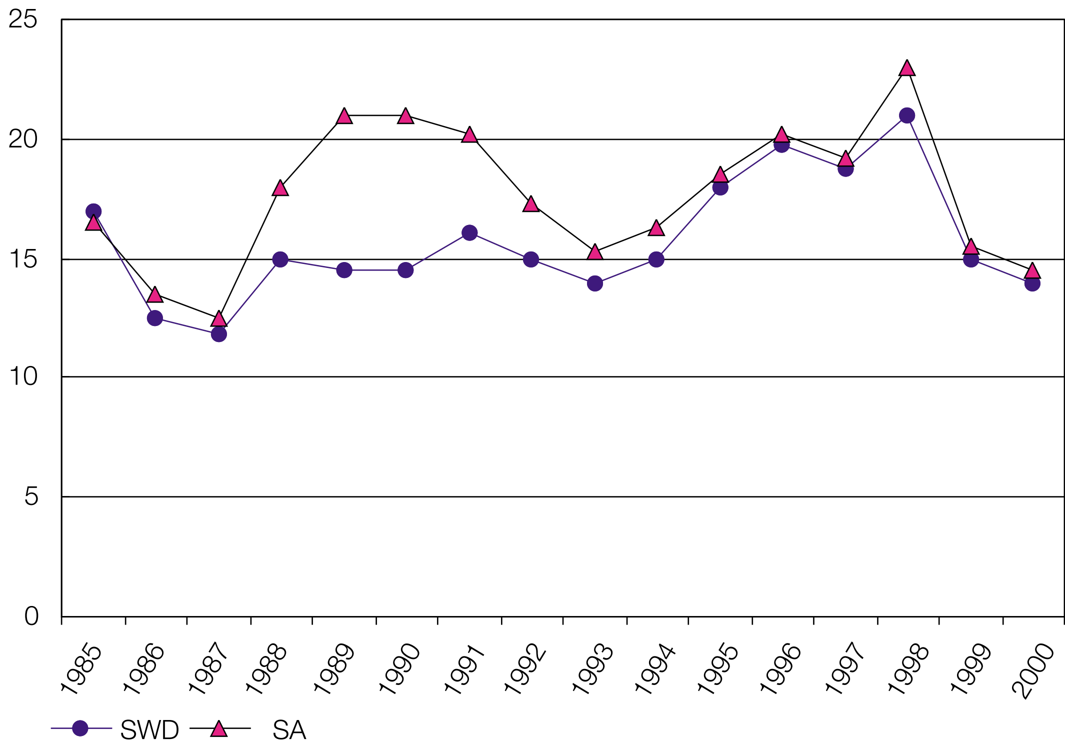
Given that Swaziland's membership of the CMA is characterized by the free flow of capital between member states and a de facto fixed unitary exchange rate with the South African rand (ZAR) (which eliminates the threat of exchange rate risk), it is clear that there is very little scope for Swaziland's interest rate to deviate substantially from those ruling in the CMA. If domestic rates were higher than say, those of South Africa, there would be the fear that Swaziland might attract more capital than could be absorbed, whilst the reverse could be true with Swaziland losing capital to South Africa.

Despite tracking the South African interest rate structure, Swaziland's interest rate management is largely through moral suasion, where the CBS uses this instrument to encourage the local banking sector to lend to the private sector. In practice, there have been occurrences of wide differentials in interest rates between South Africa and Swaziland, whose consequences are not a subject of this paper.

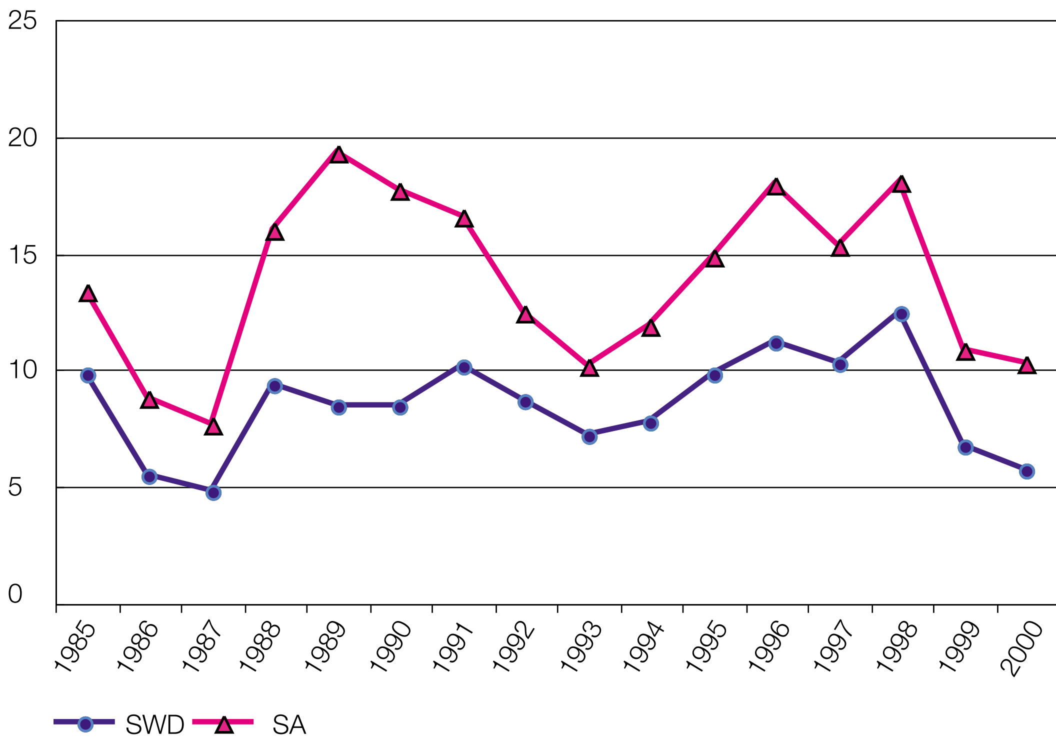
Whilst the objective is to minimize the interest rates differentials, there has been direct control on the movement of interest rates against the trend in South Africa in some years. In 1998 for instance when the rand was depreciating and interest rates were going up within the CMA, the differential between SD and SA interest rates reached six percentage points. At that time the CBS felt that raising local rates to the SA levels would put too much pressure on the economy and be contrary to the objective of stimulating investment in the real sector. The general policy is to maintain a differential of 0,25 – 0,50 percentage points. It should be noted that this policy has serious implications, particularly with regard to the huge capital flows that ensue as a response to the differential.

A related objective is that of ensuring that depositors are remunerated positive net returns. However, due to inflationary pressures in the past, it was not possible to remunerate depositors' positive net returns except since 1999/2000 when single-digit inflation levels were achieved.

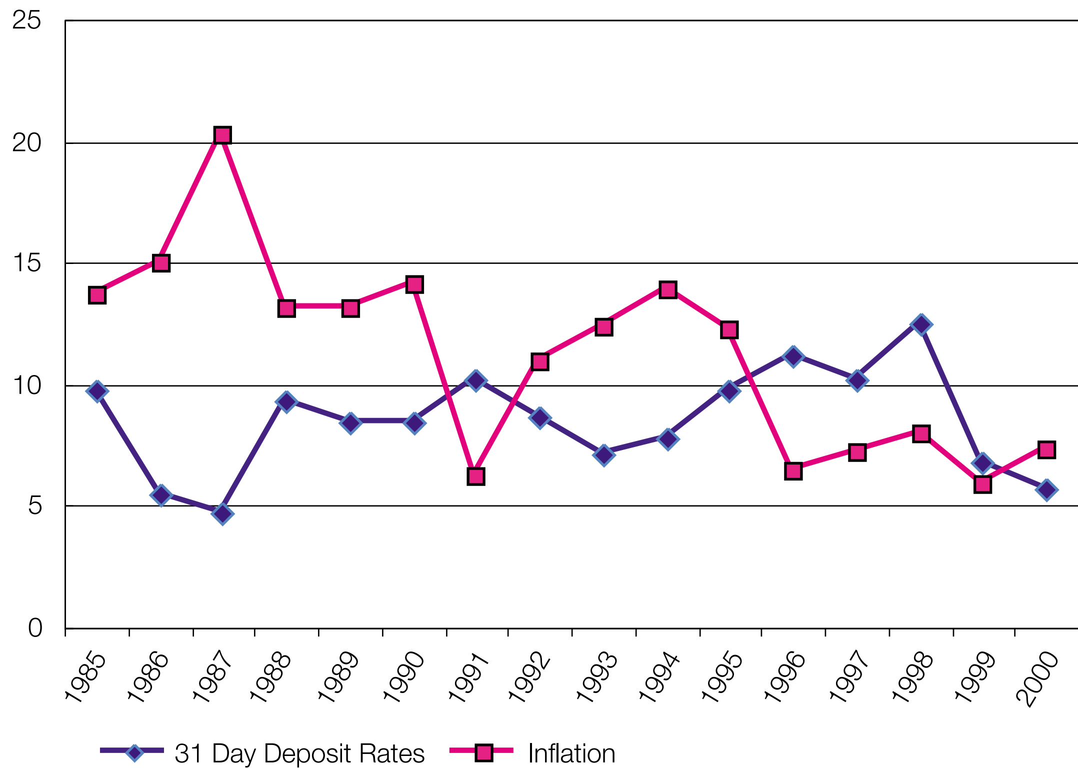
1) Comparative prime SD vs. SA



2) Comparative depositors' rates (31 days)

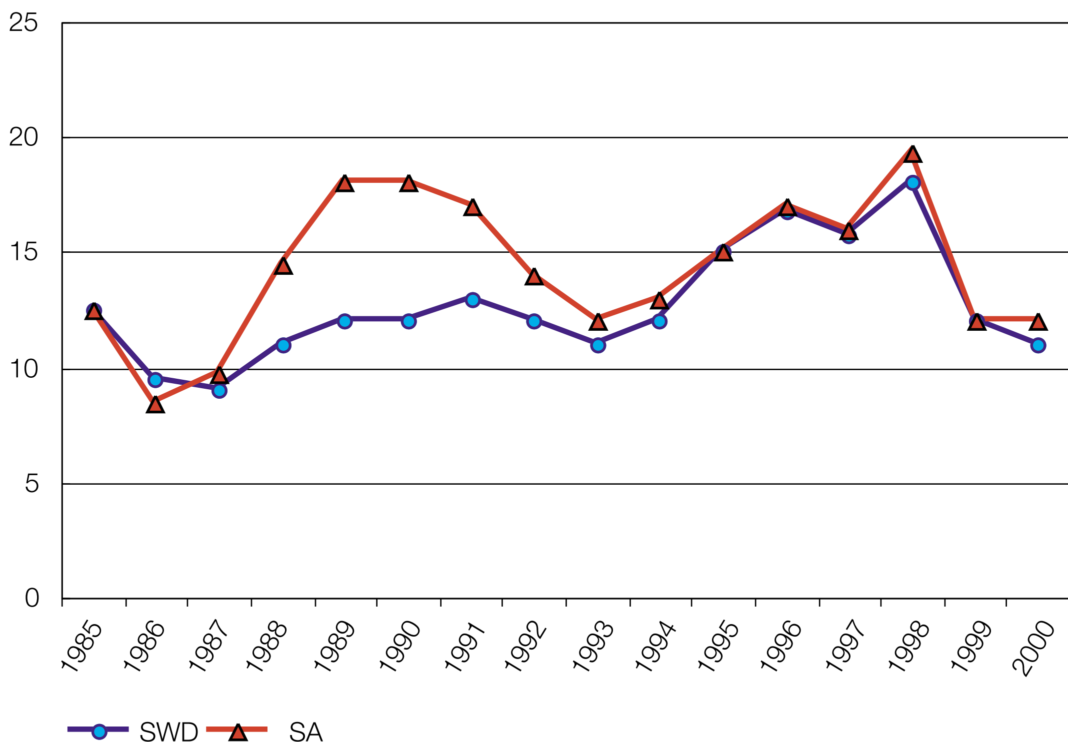


3) **Inflation versus 31-day deposit rates for SD**



The Central Bank of Swaziland uses the discount rate to signal which direction interest rates should move and the banks are expected to respond accordingly.

Discount Rates in Swaziland (SWD) and South Africa (SA)



IV) OPEN MARKET OPERATIONS

Ideally, banks with a cash surplus as has been the case with the highly liquid domestic banking system, can invest in an array of assets that include placements with deficit banking institutions, placement with the central bank under its open market operations, purchase of short-term securities etc.

In the case of Swaziland, the financial market is both small and shallow due to a number of factors. The key factor is the absence of a large market for securities. This results from the fiscal surpluses and net creditor position that government has enjoyed for a long time (up until 1993/1994), which led to the feeling that there was no need to sell securities for financing. There are some small amounts of both Treasury bills (E40 million) and bonds (E30 million) that have been issued regularly purely for the purpose of encouraging the money market. These have not been adequate and from time to time the CBS also issues its own bills for the same purpose. The quantities are also small (E10 million) and the interest rate paid is below the market rate when compared to similar rates in South Africa. The Treasury and CBS bills are auctioned on a weekly and monthly basis. Each issue has been oversubscribed.

In the absence of adequate investment instruments, combined with persistent and continuous excess liquidity in the domestic banking system, banks have traditionally looked towards the SA markets to manage their liquidity. Funds shifted to SA are typically invested in short maturing deposits with the parent bank.

A capital markets development unit was established in 1998 and the CBS's preoccupation in this regard has been the development of an appropriate regulatory framework for the capital market industry in Swaziland. The functions of the unit include the development of capital markets in Swaziland, the creation, maintenance and regulation of a market in which securities can be issued and traded in an orderly and efficient manner.

V) NATIONAL PAYMENT SYSTEM

The CBS seeks to foster the stability of the financial system by ensuring the integrity of the payment system. To that end the Bank is presently engaged in strengthening the legal and regulatory framework necessary for the soundness and international/regional compatibility of the payment system. The bank's liquid assets, particularly reserve balances, are instruments in which the bulk of domestic obligations are finally settled, hence the need for the CBS to play a leading role.

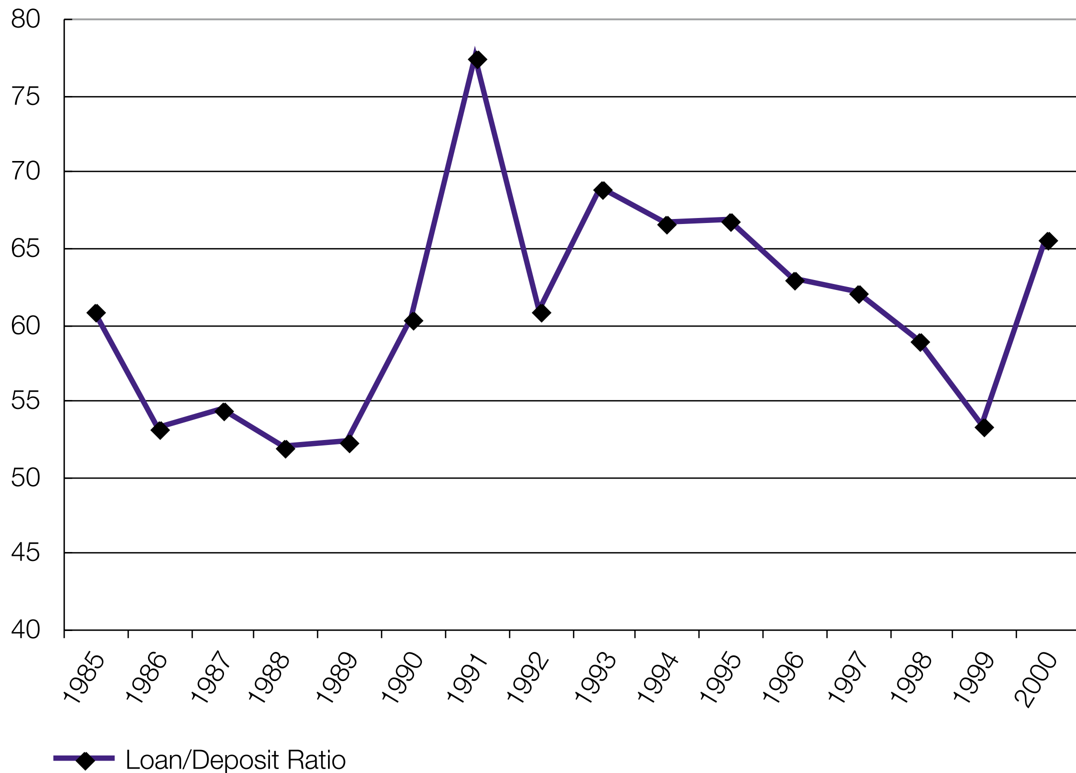
VI) REDISCOUNT WINDOW

The CBS Act makes provision for the financial sector – especially the commercial banks – to borrow from the central bank's discount window on a short-term basis against the security of trade bills or any paper specified by the CBS and eligible for rediscount. The rate charged at the discount window is the discount rate and is determined by the CBS from time to time, depending on the desired policy stance – whether expansionary or contractionary.

Due to high liquidity in the banking system, the discount window is rarely used. In practice the discount rate is only used as an indication rate by the central bank to indicate the direction of interest rate movement.

The trend in Swaziland has been that growth in bank loans and advances has persistently outpaced growth in domestic deposits. This is evident from the declining loan/deposit ratios and high liquidity ratios. Therefore, historically, there has been very little or no recourse to the central bank by commercial banks through the discount facility as banks have persistently been liquid.

Loan/Deposit Ratio Trend



The local asset ratio which prior to 1996 was used as a mechanism to discourage an outflow of short-term capital by requiring local commercial banks to keep a minimum of 95% of their liquid assets within the country, has been relaxed. The bank balances kept at the central bank to meet the 6% reserve requirement are adequate to meet the daily clearing/settlement needs. Any large withdrawals require advance notice and can be met through a transfer of funds from South Africa. Interbank activity in Swaziland is limited due to the high levels of liquidity within the local market.

VI) INDIRECT INSTRUMENTS

The CBS has at its disposal two kinds of indirect instruments – namely liquidity and reserve requirements. Both instruments are not directly used for monetary control purposes, but mainly for prudential reasons and to activate the domestic money market.

The reserve requirement was first imposed in 1975 by the Financial Institutions Order [1975] (at 3,5% of deposits) during which time the CBS was not fully operational. The reserve requirement was aimed at encouraging banks to use balances previously held in South Africa. The reserve requirement is met by meeting the prescribed ratio on an averaging basis with no specific proportions to be held in cash or deposits. Balances held as required reserves do not earn interest. Up until 1996, interest was paid at a call rate on the amount by which the average daily balances with CBS exceeded the required amount. Thereafter the CBS ceased to pay interest on reserves in excess of requirement in an effort to encourage interbank activity. A penalty of 1 per cent above discount rate is charged on those banks that cannot meet the requirement.

The liquidity requirement is designed to ensure a prudent distribution of the individual banks' assets and not as a means to control monetary aggregates. It ensures that a reasonable proportion of any increase in deposit liabilities is placed in official hands, or otherwise employed in instruments recognized to represent priority uses for the available funds and to be readily convertible to primary liquidity in the event that an individual bank finds itself called upon to accept a fall in its deposit liabilities. Liquid assets acceptable for this purpose include, in addition to cash and balances held on

reserve account, Treasury bills and other government securities maturing within 370 days or any other paper that the Minister for Finance may approve.

The liquidity requirement was last reduced in February 1999 to lessen the negative tax effect this has on banks' intermediation. However, thus far, the desired effects of increased domestic lending have not come forth, but instead, banks have increased their investments in South African markets and reduced domestic excess liquidity.

	Reserve Requirements*		Liquidity Requirements*				
	Minimum Portion (%) to be held at the CBS		Demand Deposits	Savings Deposits	Time Deposits		
					Short	Medium	Long
1973 July 1			30	20	30	5	20
1974 Jan. 2			25	15	25	5	15
1975 Jan.1	3.5	50					
1975 June 1	4.5	50					
1975 Aug. 1			21	12	21	5	12
1975 Sept. 1	4.5	50					
1975 Dec. 1	5	50					
1976 March 1	5.5	50					
1976 May 7			25	12			14.5
1976 July 1	6	50					
1976 Dec. 1	6	no requirement					
1981 July 31			10	10	10	10	10
1983 March 1			15	10	15	15	15
1987 June 1			25	10	25	25	10
1989 Jan. 31**			17.5	17.5	17.5	17.5	17.5
1992 April 1	5	no requirement					
1994 Jan. 1	6	no requirement					
1999 Feb.1**	4	no requirement	15	15	15	15	15

* As % of deposits and other liabilities

** These Liquidity Requirements do not apply to the Savings and Development Bank, which is required to maintain a minimum liquidity of 10%