Swaziland: *Policy Options and Strategies for Stimulating Fixed Capital Formation, Employment and Economic Recovery*

Hamid Rashid[1]

Abstract: Swaziland registered one of the lowest growth rates in Sub Saharan Africa during the past two decades, underpinned by falling fixed capital formation and low employment and labor productivity growth. Private fixed capital formation collapsed from 17% of GDP in 2001 to about 5% in 2010 while public sector fixed capital formation remained steady at around 6% of GDP. A number of factors – depletion of domestic savings, falling FDI and remittances, reduced share of bank credit to businesses – explain the sharp deterioration in fixed capital formation. The paper shows that the rapid and rising outflow of profits – which reached 14% of GDP in 2009 – was perhaps the single largest determinant of falling private fixed capital formation in Swaziland. Benchmarking Swaziland's key economic indicators against that of its neighbors – Botswana, Lesotho, Mozambique, Namibia, South Africa and Zambia – and taking into account it's monetary, fiscal and financial sector policies, the paper recommends a number of policy options, strategies and sectoral focus to increase private fixed capital formation back to 20% of GDP and bring down unemployment rate to 10% by 2020.

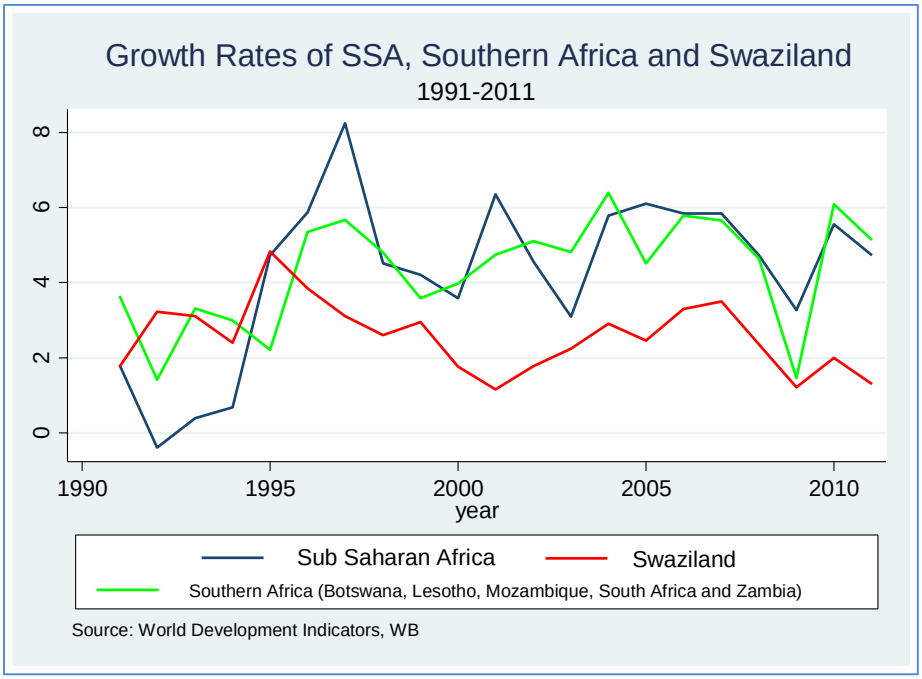
JEL Classification: E2, E6, O3, J2, J6

Keywords: Consumption and Investment; Macroeconomic Policy, Stabilization, Economic Growth and Productivity, Employment Creation, Unemployment

[1] Dr. Hamid Rashid is a Senior Advisor for Macroeconomic Policy in the United Nations Department for Economic and Social Affairs (UN-DESA) in New York. The findings and recommendations of this mission report are preliminary, based on data analysis and a scoping mission to Swaziland on 2-3 July 2012. The views and opinions expressed here are those of the author and do not necessarily reflect those of the United Nations Secretariat. The designations and terminology employed may not conform to United Nations practice and do not imply the expression of any opinion whatsoever on the part of the Organization. For questions or comments, please write to rashid12@un.org. The author is grateful to Mr Israel Dessalegne, UN Resident Coordinator and UNDP Resident Representative in Swaziland and Ms Zuzana Brixiova, Senior Economist, UNDP-Swaziland for their invaluable support. He also thanks Mr Ritwick Ghosh at Cornell University for his research assistance.

I. Introduction

Swaziland is in a prolonged recessionary trap, characterized by low investment, low growth and high unemployment. The economy grew by an average of 2.6% per year during 1991-2011, making it one of the slowest growing economies in Africa. In contrast, GDP of 46 Sub-Saharan economies on average grew by 4.3% annually during 1991-2011 and only eleven countries[2] in the region registered a slower average growth rate than Swaziland during this period. Until 1997, the Swazi growth rate outpaced that of Sub Saharan Africa but from 1998 onward, it lagged the average SSA growth rate by about 2.5% (Graph I). The gap widened to nearly 3% since the Swazi economy began to slow down in 2008. In 2011, the economy grew by only 1.3%. Only Cote d'Ivoire and Madagascar grew at a slower pace in Africa.



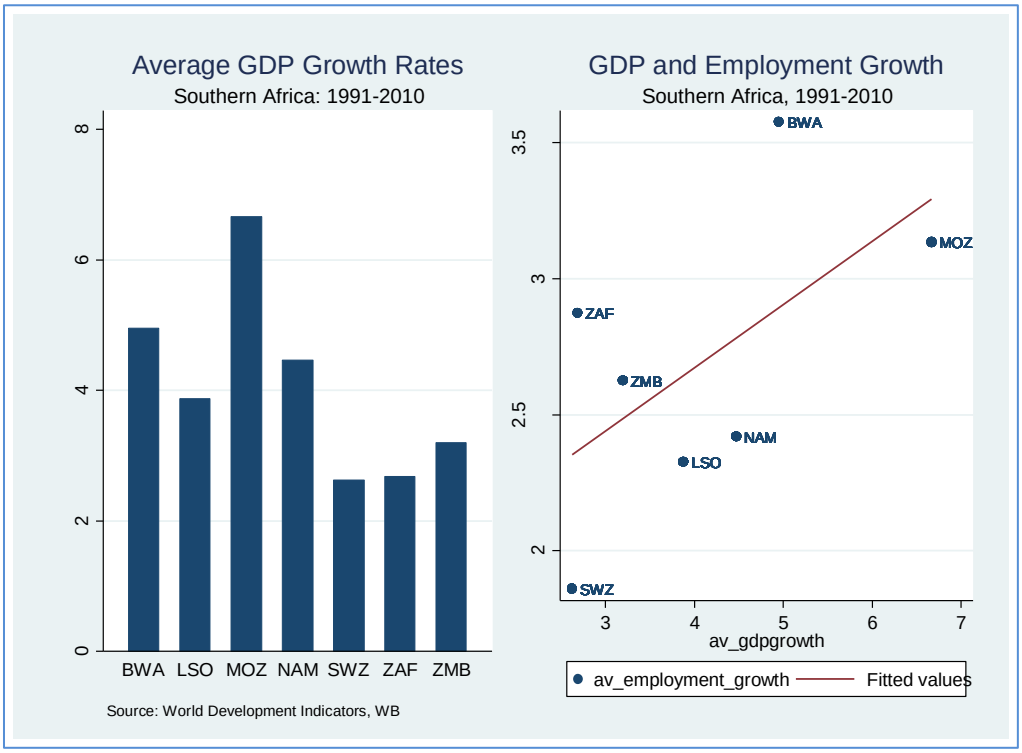
Graph I: Growth rates of Swaziland, Sub Saharan Africa and the Southern African Region

During 2009-11, Swaziland grew by only 1.5% while the neighboring economies of Botswana, Lesotho, Mozambique, Namibia, South Africa and Zambia grew by 4.2%. The Swazi economy is very closely linked to the South African economy - 90% of its imports come from South Africa while nearly 70% its exports go to South Africa. It also depends on its large neighbor for finance and investments. Despite close economic integration with South Africa, correlation between the growth rates of two economies was very weak until 2005 (+.04). The correlation between the growth rates has risen to + 0.9 during 2005-2010, suggesting greater convergence between the two economies.

The impact of low growth performance during the past two decades is evident in persistently high level of unemployment in Swaziland, which increased from 22.4% in 1991 to 31.2% in 2010. Total

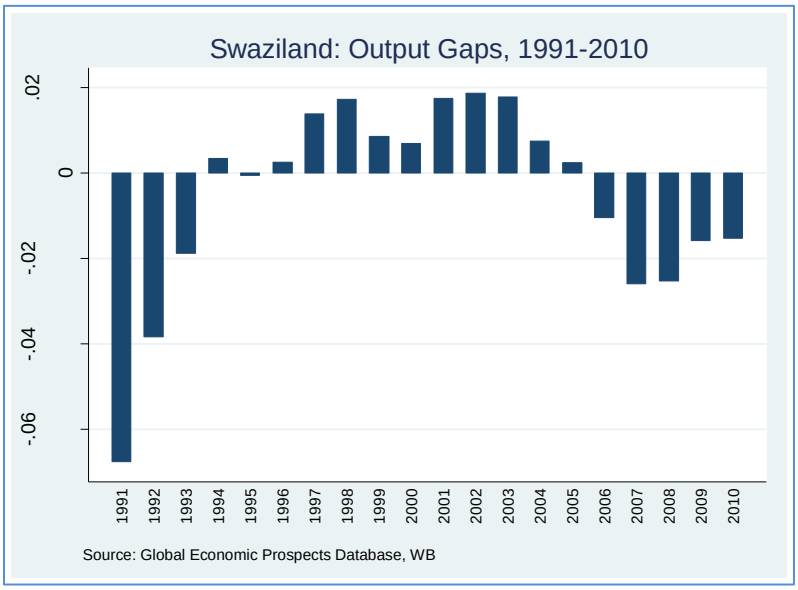
[2] The GDP growth rates of Burundi, Cameroon, Central African Republic, Comoros, Congo DR, Cote d'Ivoire, Gabon, Guinea Bissau, Madagascar, Togo and Zimbabwe averaged less than 2.62% during 1991-2010

employment grew by only 1.9% per year – the lowest rate of employment growth in Southern Africa. Although Swaziland (annual average GDP growth rate of 2.6%) and its large neighbor, South Africa (annual average GDP growth rate of 2.7%) had very similar growth rates during the past two decades, employment grew by 2.9% per year in South Africa (Graph II). In the region, Botswana and Mozambique managed to achieve employment-intensive growth, while Lesotho and Namibia experienced a largely jobless growth syndrome. Even when the Swazi economy briefly rebounded in 2005-06, there was no dent in its unemployment rate. Given the high level of unemployment, it is critical that the Swazi growth strategies target sectors of the economy that would maximize employment outcome in the short and medium runs and make necessary investments for job creation.



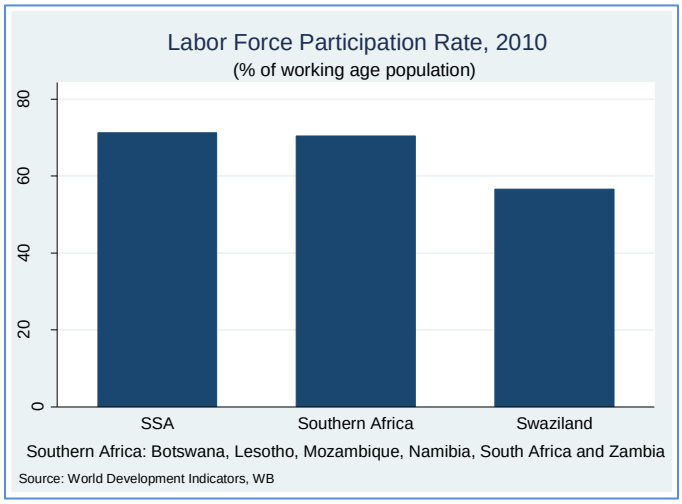
Graph II: GDP and Employment Growth

During 2006-10, the output gap in Swaziland averaged at about -2% of GDP, rising from +1.2% of GDP during the previous five years (Graph III). The magnitude of actual output gap is likely to be much larger, given the level of unemployment and under-employment in the economy. The negative output gap suggests a recessionary gap and possible deflationary pressures in the economy. In order to avoid a recession and put the economy on a high growth trajectory, Swaziland needs to implement a large stimulus package to increase investments, generate employment and boost aggregate demand. Given that employment prospects are particularly bleak for new entrants to the labor force, there needs to be a particular focus on generating employment for the youth population. According to the Swaziland Labor Force Survey, 2010, youth unemployment rate reached more than 52% -- four times higher than the unemployment rate for people aged 45–64 years.



Graph III: Swaziland Output Gaps, 1991-2010

Swaziland has one of the lowest labor force participation rate in Sub Saharan Africa, suggesting a possible supply-side constraint in employment (Graph IV). High prevalence of HIV/AIDS and out-migration of working age population partly explains its low labor force participation rate. In Sub-Saharan Africa, only Mali, Mauritania, South Africa and Sudan had a lower labor force participation rate than Swaziland in 2010. The labor force participation rate increased by an average of 0.04% during 1991-2010 compared to 0.34% annual increase in South Africa.



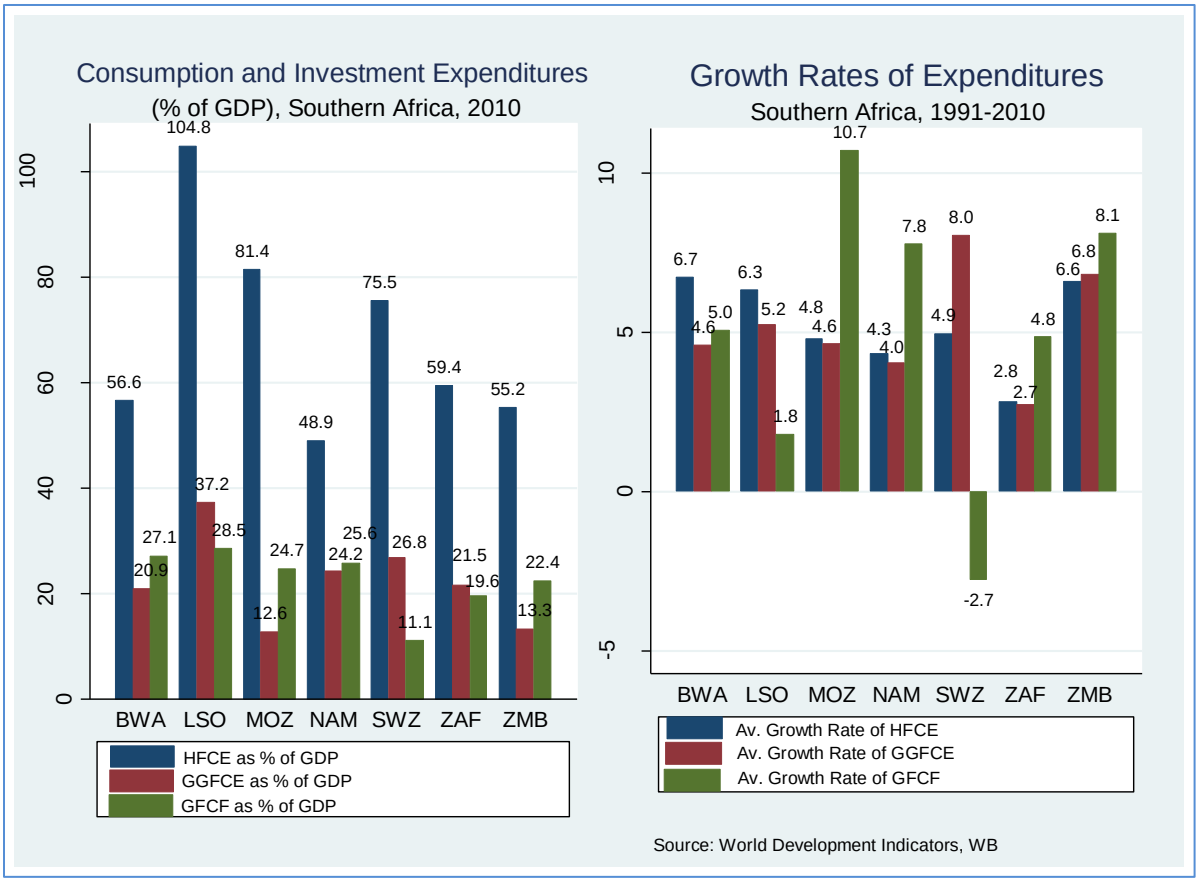
Graph IV: Labor Force Participation Rate in 2010

Labor force participation rate is likely to rise once the country manages to contain the spread of HIV/AIDS epidemic, which negatively impacted life expectancy and labour supply. Even a modest

increase in the labor force participation rate will push the unemployment rate even higher unless the economy manages to create sufficient number of new jobs. If the Swazi labor force participation rate would rise to the Southern African average of 70% by 2020 (Graph III), the economy would need to create additional 60,000 new jobs and employment growth would need to be at least 3% a year during 2012-2020 (against an average employment growth of 1.9% during 1991-2010) even to maintain the current level of 30% unemployment. In order to bring down unemployment to 10%, the annual employment growth would need to be around 6% a year during the next ten years.

II. Sources of Growth

Household final consumption (HFCE) and general government final consumption expenditure (GGFCE) have been the key drivers of Swazi growth during the past two decades. HFCE, on average accounted for 77.9% of GDP compared to the Southern African average of 69.8% during 1991-2010. It was 75.5% of GDP in 2010 (Graph V). Only Lesotho and Mozambique had a higher share of HFCE in GDP.



Graph V: Household and Government Consumption Expenditures and Capital Formation, 1991-2010

In 2010, government expenditures in Swaziland accounted for 26.8 % GDP against the regional average of 21.6% of GDP. In the region, only Lesotho had a higher share of government expenditure in GDP. Low

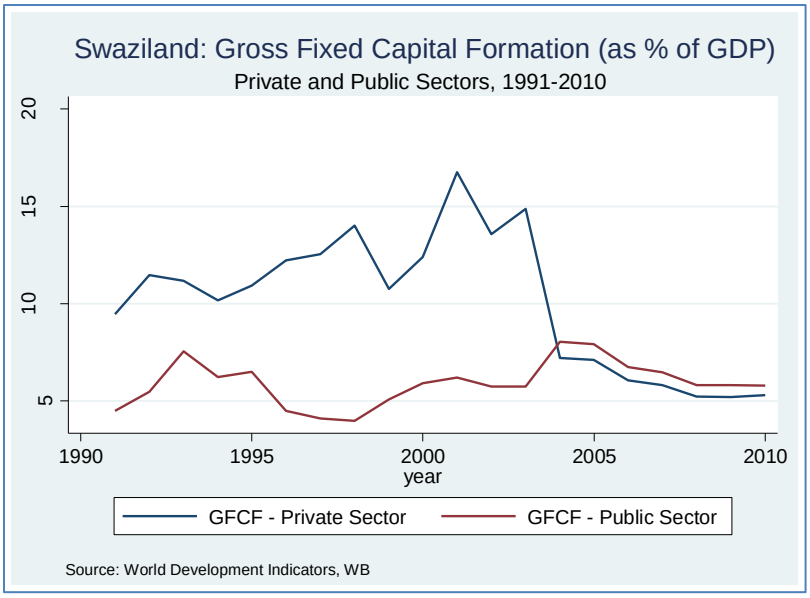
level of employment and economic opportunity largely explain the relatively high share of household and government consumption expenditures. As income stagnated, households exhausted their income and depleted their savings to prevent a loss of consumption. It is also likely that government salaries and transfers, including pensions, helped households maintain their living standards during 1991-2010, which can partly explain the large share of GGFCE in GDP.

During 1991-2010, household consumption grew by 4.9% while general government expenditure grew by 8 %, both outpacing the GDP growth rate. The significantly higher rate of growth in government expenditures, relative to that of its neighboring countries, is due to a surge in 2010 when government expenditure grew by 89.4%. If we exclude 2010, GGFCE growth averaged 3.8% during 1991-2009, which was below the regional average growth rate of 4.8%. With the exception of South Africa, the growth rates of government expenditure of the neighboring countries outpaced that of Swaziland during the past two decades. The average growth rates of GGFCE, however, mask the volatility in government expenditure. GGFCE growth rates of Swaziland exhibited a very high degree of volatility compared to other countries in the region. For example, it grew by 30.5% in 1992 and 89.4% in 2010 and declined by 21.5% in 2001. The correlation between GDP and GGFCE growth rates was .47 during 1991-2010, suggesting that government expenditure growth has been generally pro-cyclical. It increased during good economic times and declined during downturns. Swaziland's excessive dependence on revenue from the Southern African Customs Union (SACU) - a rather volatile source of revenue – largely explains the high degree of volatility in government expenditure.

While consumption, both household and government, sustained the Swazi economy, gross fixed capital formation (GFCF – fixed investment) actually fell during 1991-2010. Swaziland is, in fact, the only economy in our sample of seven countries that registered a negative growth rate in fixed investment during 1991-2010. GFCF fell by -2.7% a year when fixed investments in other countries of the region registered an average growth rate of 6.3% during this period. In Mozambique, fixed investment grew by 10.7% a year, making it the fastest growing economy in Southern Africa. The negative investment growth is perhaps the single most critical factor that explains the weak economic performance of Swaziland during 1991-2010.

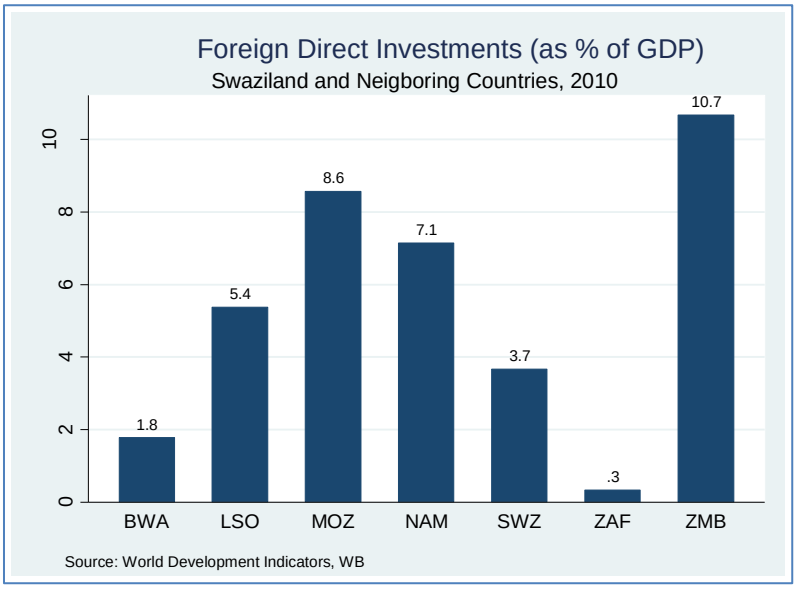
III. Why Private Fixed Capital Formation Fell?

Swaziland experienced a steady decline in fixed capital formation (GFCF) during 1991-2010, after reaching a peak of 22.9% of GDP in 2001 and then declining to 11.2% by 2010. More strikingly, private sector fixed capital formation – a key determinant of economic growth – virtually collapsed since 2001, falling from 17% in 2001 to 5% of GDP in 2010. In one year between 2003 and 2004, private GFCF declined from 14.8 % to 7.2% of GDP (Graph V). Despite slowing economic growth and volatile tax revenue, public sector GFCF in Swaziland remained steady at around 6% of GDP during this period. In other Southern Africa economies, private fixed capital formation increased considerably, which helped them achieve higher GDP growth rate than Swaziland.



Graph V: Private and Public Gross Fixed Capital Formation

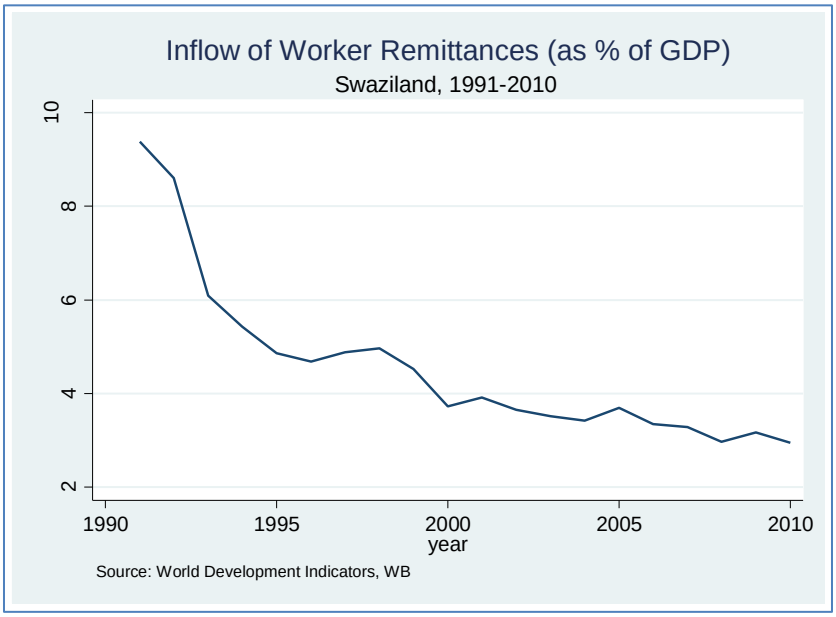
Falling domestic savings rate partly explains the sharp decline in private fixed capital formation in Swaziland. Gross domestic savings, as percentage of GDP, declined from high 19.6% in 2003 to -2.3% in 2010. Savings rate was 11% in 2007, just before the current round of economic downturn. Given the absence of growth, employment and adequate social protection, it is not surprising that domestic savings declined so rapidly, which in turn, depressed private fixed capital formation.



Graph VI: Foreign Direct Investments as % of GDP in 2010

The large drop in private fixed capital formation can also be partly explained by the gradual decline in foreign direct investments (FDI) during 1991-2010, which dropped from 9.7% in 1998 to 3.7% of GDP in 2010 (Graph VI). FDI for the region averaged at 5.6% of GDP in 2010. Given that Swaziland lacks mineral resources, it is not surprising that it lags behind other countries in the region in attracting FDI. During the period (2003-2010) when private sector GFCF dropped, FDI averaged at 2.3% and private sector GFCF averaged 5.9% of GDP, suggesting that roughly 40% of total private fixed capital formation came from foreign investments. While FDI can be an important source of new investment, competition for attracting FDI tends to be intense and it can be very costly for countries to attract new FDI. Swaziland may instead pursue appropriate policies to ensure that existing FDI stay in the country and reinvest their profits.

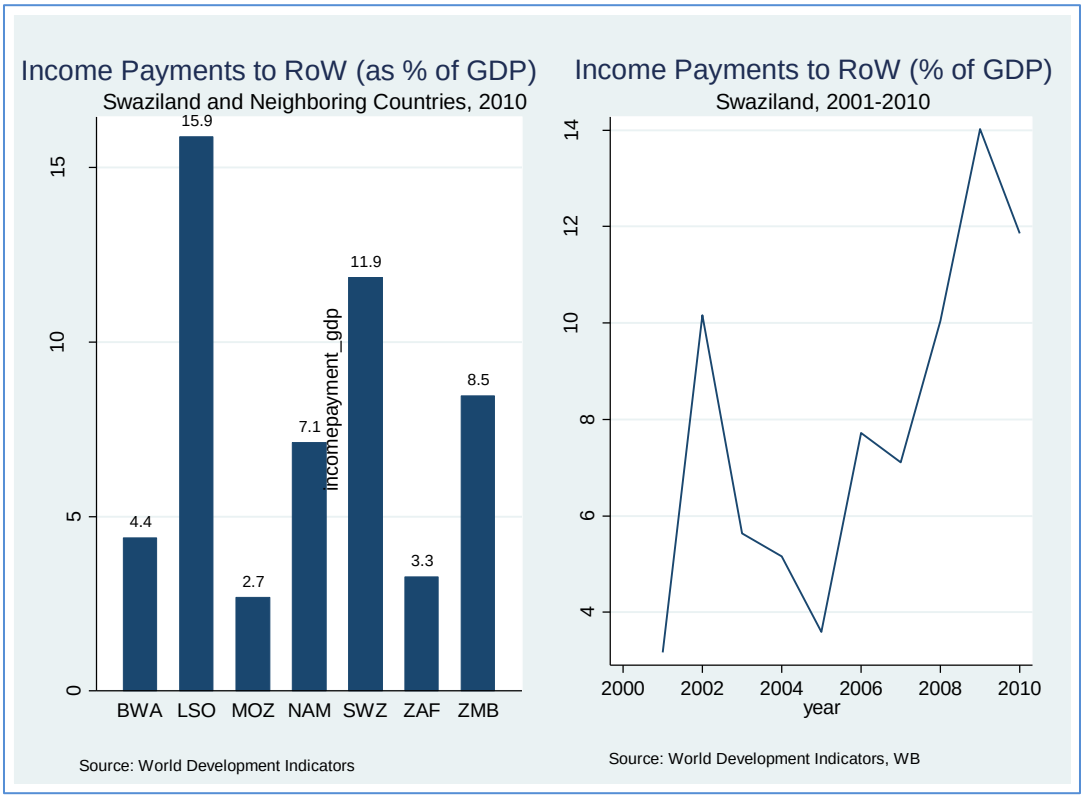
The problem of falling domestic savings rate and private fixed capital formation is exacerbated by the sharp decline in inward flow of remittances from the Swazi nationals working abroad. In 1991, remittances accounted for 9.4% of GDP but fell to 2.9% of GDP in 2010 (Graph VII). It is surprising that inward remittances should drop precipitously given that the actual number of Swazis working abroad increased significantly during this period. The declining trend in inward remittances is also puzzling given the fact that most of the Swazis work in South Africa, the currencies of the two countries are pegged at one to one and the interest rates in Swaziland is typically higher than it is in South Africa. There needs to be specific policy measures to revive inward remittances to increase domestic savings and investment.



Graph VII: Inflow of Worker Remittances to Swaziland, 1991-2010

In addition to falling FDI, the sharp decline in reinvestment of profits offers another plausible explanation for the precipitous fall in private fixed capital formation since 2003. Data shows that income payments from Swaziland increased almost four-fold from 3.2% in 2001 to 11.9% of GDP in 2010 (Graph

VIII). Income payments are employee compensation paid to nonresident workers and investment income earned on FDI, portfolio investment and other investments. Repatriation of investment income i.e. profit accounted for more than 95% of total income payments from Swaziland in 2010.



Graph VIII: Income Payments to Rest of the World

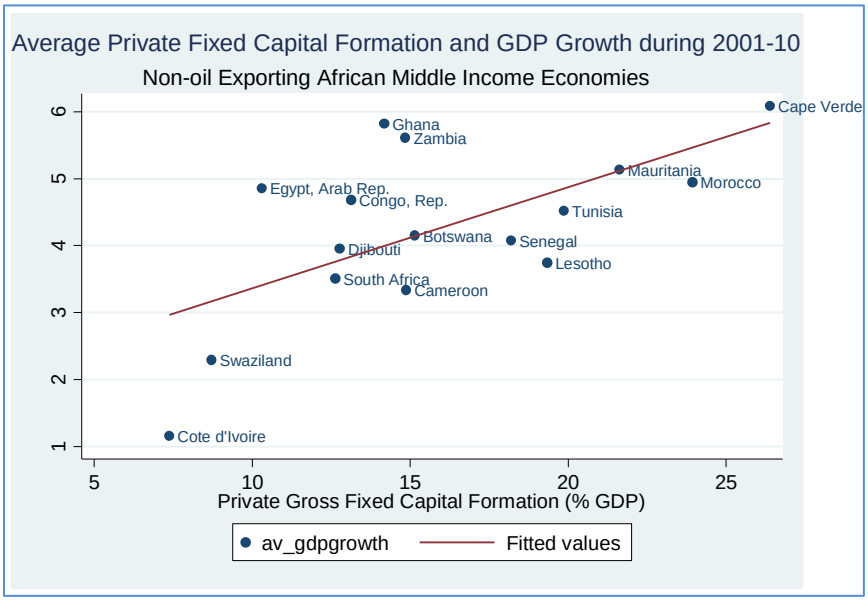
We find a negative correlation (-0.48) between income payments and gross fixed capital formation for Swaziland during 1991-2010. But the correlation significantly increases to - 0.89 for the period 2003-2010, suggesting an almost one-to-one relation between the increase in repatriation of profits and the decline in private fixed capital formation during 2003-2010. For other countries in the region, except for Lesotho, the correlation is weakly negative (-.09), which indicates that gross fixed capital formation in these countries are less dependent on reinvestment of profits.

We also find that income payments from Swaziland are generally counter-cyclical – outflows increase when the economy slows down and decrease when growth resumes. For the period 1991-2010, the correlation between GDP growth rate and income payment was -0.38 for Swaziland and +0.05 for other Southern African countries in our sample. The correlation increases to -0.99 for Swaziland during 2005-2010 and to +0.14 for other countries in Southern Africa. For South Africa, the correlation between income payments and GDP growth is +0.39 during 1991-2010 and +0.01 during 2005-2010. This indicates the possibility that other Southern African countries have safeguards and regulations in place that can reduce the outflows of profits during economic downturns. It is likely that the current slowdown of Swazi economy was largely a function of the rapid increase in the outflow of profits as it increased to 14% of GDP in 2009, which depressed private fixed capital formation and GDP growth and

possibly exacerbated the fiscal crisis in 2011. Other countries in the region did not experience a similar level of outflow and their GDP growth rates remained robust during 2009-2011. Swaziland needs to consider appropriate incentive structures to ensure that foreign investors reinvest their profits to stimulate investment and growth.

IV. How Falling Private Fixed Capital Formation Affected Economic Performance?

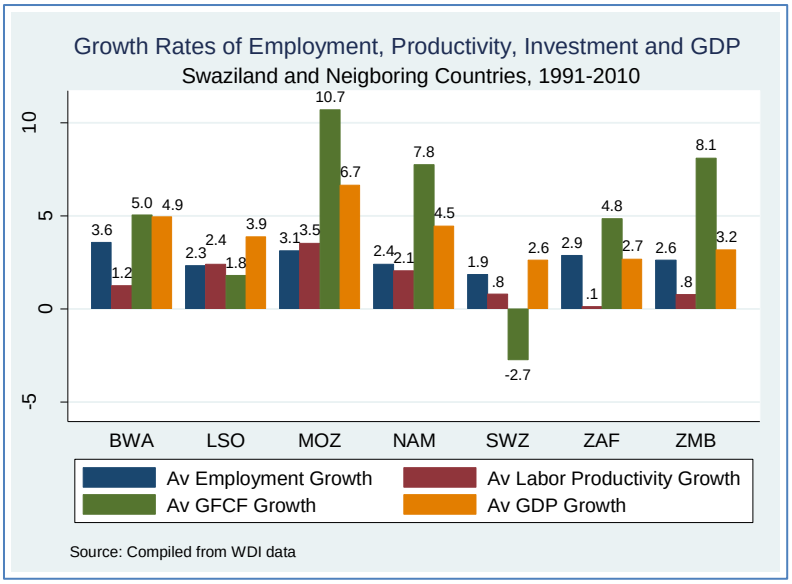
Private fixed capital formation is a critical determinant of Growth. Among 16 non-oil exporting middle income countries in Africa, Swaziland had the second lowest levels of private fixed capital formation and GDP growth rates during 2001-10. Only Cote d'Ivoire had a lower level of average private investment and corresponding lower GDP growth rate in this period (Graph IX).



Graph IX: Private Fixed Capital Formation and GDP Growth

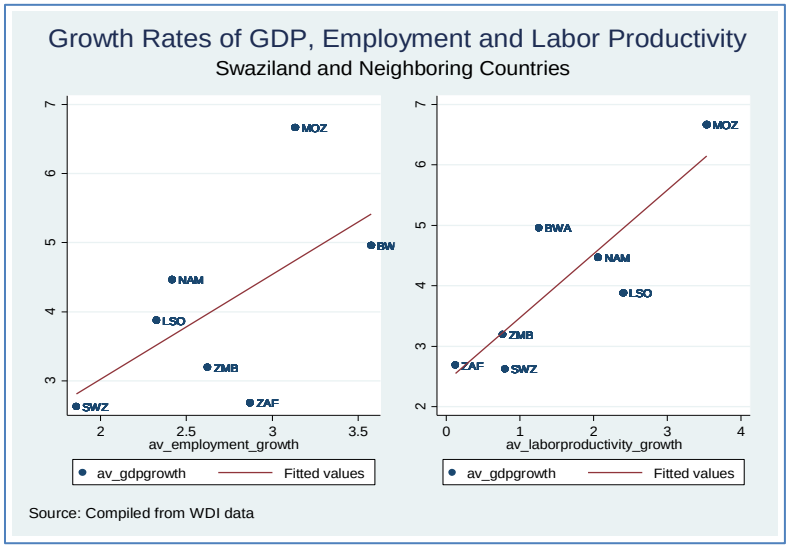
Private fixed capital formation influences GDP growth directly through employment generation and also through improvements in labor and total factor productivity. Employment in Swaziland grew by an average of 1.9% per year during 1991-2010 compared to 3.6% in Botswana or 3.1% in Mozambique. It also had one of the lowest growth rates in labor productivity. There is no estimate of total factor productivity for Swaziland and without the number of hours worked, we measure labor productivity as GDP per person employed. While the level of Swazi labor productivity is reasonably high compared to that of Lesotho, Mozambique and Zambia, it registered the slowest growth rate, except for South Africa, during 1991-2010 and increased by 0.8% annually compared to the labor productivity growth rate of 3.5% in Mozambique, 2.4% in Lesotho and 2.1% in Namibia (Graph X). Capital labor ratio is usually a good predictor of labor productivity – higher the capital-labor ratio, higher the labor productivity on average. Although we do not have an estimate for capital labor ratio in Swaziland, it is reasonable to

assume that capital labor ratio remained stagnant or even fell as private fixed capital formation declined during 2003-2010, which in turn explains the very low growth rate of labor productivity.



Graph X: Average Growth Rates of Employment and Labor Productivity, 1991-2010

In case of Botswana, Namibia, South Africa and Zambia, higher level fixed capital formation led to higher rates of employment growth relative to productivity growth while in Mozambique and Lesotho, fixed capital formation resulted in higher labor productivity outcome relative to employment outcome (Graph X). Negative growth rate of fixed capital formation depressed both labor productivity and employment growth in Swaziland, resulting in the lowest GDP growth rate among these countries. Improving labor productivity will be critical for Swaziland to ensure that its currency is not over-valued given the pegged exchange rate and limited availability of monetary policy tools to influence exchange rates.



Graph X: Employment and Labor Productivity Growth and GDP

Our regression analysis (Table I) confirms that growth rates of labor productivity and employment are critical determinants of GDP growth. The coefficient of fixed capital formation does not assume significance because it affects GDP growth rates via the growth rates in employment and labor productivity. The coefficients of employment growth and labor productivity growth are highly significant (at 1% level) and positive in all specifications when we control for growth rates in fixed capital formation, household final consumption, government final consumption expenditure, GDP per capita and inflation.

VARIABLES	(OLS)	(RE)	(FE)	(PCSE)	(FGLS)	(GMM)
Lag GDP growth	-0.02	-0.02	-0.03	-0.03**	-0.03	0.05
	(0.031)	(0.031)	(0.034)	(0.013)	(0.031)	(0.066)
Growth rate of Household Final	-0.00	-0.00	-0.00	-0.00	-0.00	-0.04
Consumption Expenditure	(0.012)	(0.012)	(0.013)	(0.006)	(0.012)	(0.042)
Growth rate of Gross Fixed	0.01	0.01	0.01	0.01***	0.01	0.00
Capital Formation	(0.007)	(0.007)	(0.007)	(0.003)	(0.007)	(0.047)
Growth rate of General	0.00	0.00	-0.00	0.00	0.00	0.00
Government Expenditure	(0.007)	(0.007)	(0.007)	(0.002)	(0.007)	(0.020)
Inflation	-0.00	-0.00	-0.01	-0.01***	-0.01	-0.00
	(0.005)	(0.005)	(0.005)	(0.002)	(0.005)	(0.008)
GDP per capita	-0.00	-0.00	-0.00	-0.00*	-0.00	0.00
	(0.000)	(0.000)	(0.000)	(0.000)	(0.000)	(0.000)
Growth rate of employment	0.99***	0.99***	0.98***	0.97***	0.97***	0.92***
	(0.042)	(0.042)	(0.045)	(0.026)	(0.041)	(0.164)
Growth rate of labor productivity	0.98***	0.98***	0.97***	0.96***	0.96***	0.85***
	(0.033)	(0.033)	(0.037)	(0.013)	(0.033)	(0.175)
Constant	0.18	0.18	0.30	0.32*	0.32	
	(0.278)	(0.278)	(0.379)	(0.167)	(0.301)	
Observations	114	114	114	114	114	114
R-squared	0.91		0.89	0.90		
Adj. R-squared	0.90	.	0.88	.	.	.
Number of countries		7	7	7	7	7
Number of instruments						16
Sargan test of over-identifying						Valid
Sargan test p-value						0.154
Arellano-Bond AR(2) test: p-value						0.314

Standard errors in parentheses, *** p<0.01, ** p<0.05, * p<0.10

RE: Random Effects, FE: Fixed Effects, PCSE: Panel Corrected Standard Errors, FGLS: Feasible Generalized Least Squares, GMM: Generalized Methods of Moments

Table I: Determinants of GDP Growth Rates

Taking into account the potential problem of endogentiy in the sense that causality can also run from GDP growth to employment growth and labor productivity growth, we include the lagged growth rate of

GDP as an explanatory variable and estimate our equation also in fixed effects and system GMM. In all our estimations, the coefficients of the growth rate of employment and the growth rate of labour productivity are significant at 1% level. The system GMM estimation follows an AR2 process to correct for possible auto-correlation in the data. The Sargan test confirms that the model, estimated in system GMM, is not over-identified. The coefficients of employment growth and labor productivity growth suggest a one-to-one relationship with GDP growth – GDP growth increases by almost 1% if labor productivity or employment grows by 1%.

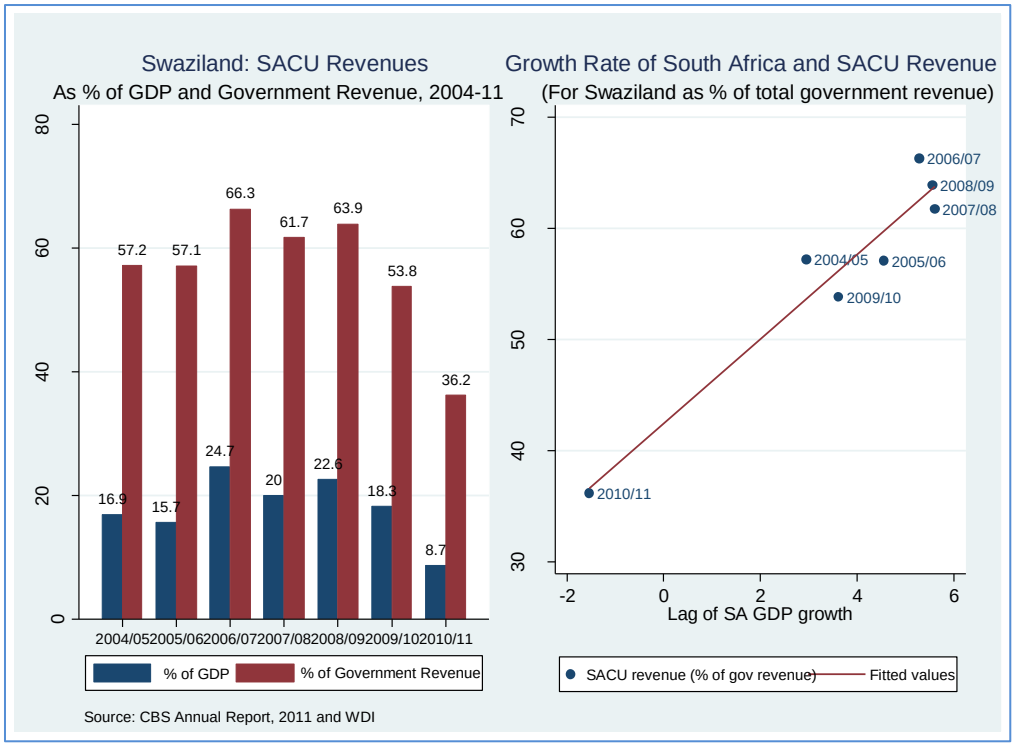
The key challenge for Swaziland will be to identify fixed capital investments that would increase both labor productivity and employment, without reducing labor demand. Swaziland would need to target the development of labor intensive sectors – tourism, agriculture and agro-processing – to increase employment and labor productivity in these and other related sectors.

V. Macroeconomic Policy Framework

The Swazi Government experienced a severe fiscal crisis in 2011 largely because of the sudden drop in revenues from the Southern African Customs Union (SACU). At the outset of the economic downturn, SACU revenue accounted for 22.9% of GDP and 63.9% of total government revenue (Graph XI). Its share of GDP and government revenue fell to 8.7% and 36.2% respectively. In terms of the share of GDP, SACU revenue marked a 62% decline in just two years. Fiscal management becomes extremely difficult because of excessive dependence on SACU revenues which tend to be highly volatile. SACU revenue is also pro-cyclical and highly correlated to the GDP growth rates of South Africa. The correlation between SACU receipts (as % of total government revenue of Swaziland) and one-year lag GDP growth rate of South Africa is +0.96. As the South African economy plunged into a recession during 2010, SACU revenue fell from 53.8% to 36.2% of total government revenue of Swaziland in 2010/11. This makes the fiscal policy of Swaziland extremely dependent on the growth performance of South Africa.

As government expenditures – including investments in fixed capital that remained steady at around 6% of GDP – is fairly pre-determined, the excessive dependence of the Swazi budget on SACU revenues compels the Swazi government to resort to deficit finance during economic downturns just to maintain its predetermined level of expenditures. This critically limits the ability of the government to undertake any kind of counter-cyclical measures to steer the economy to recovery. As its monetary policy has few tools to influence the real economy, it would be important for Swaziland to retain the full independence and efficacy of its fiscal policy and require Swaziland to reduce its excessive dependence on SACU revenue. One possible policy option may be to adopt a fiscal rule that would limit the use of SACU revenue. Swaziland can prepare its budget, assuming a threshold level GDP growth for South Africa, say 3.0% or 3.5% and set aside any excess SACU revenue in a “Fiscal Stabilization Fund” in the event the South African economy grows in excess of 3%. This may help to prevent growth in discretionary spending during good economic years. The Government should be able to borrow from the Stabilization Fund to undertake counter-cyclical measures should the South African economy grow at slower than 3%

in a particular year. The Fiscal Stabilization Fund could also make resources available, on preferential terms, for private sector investments in priority sectors.

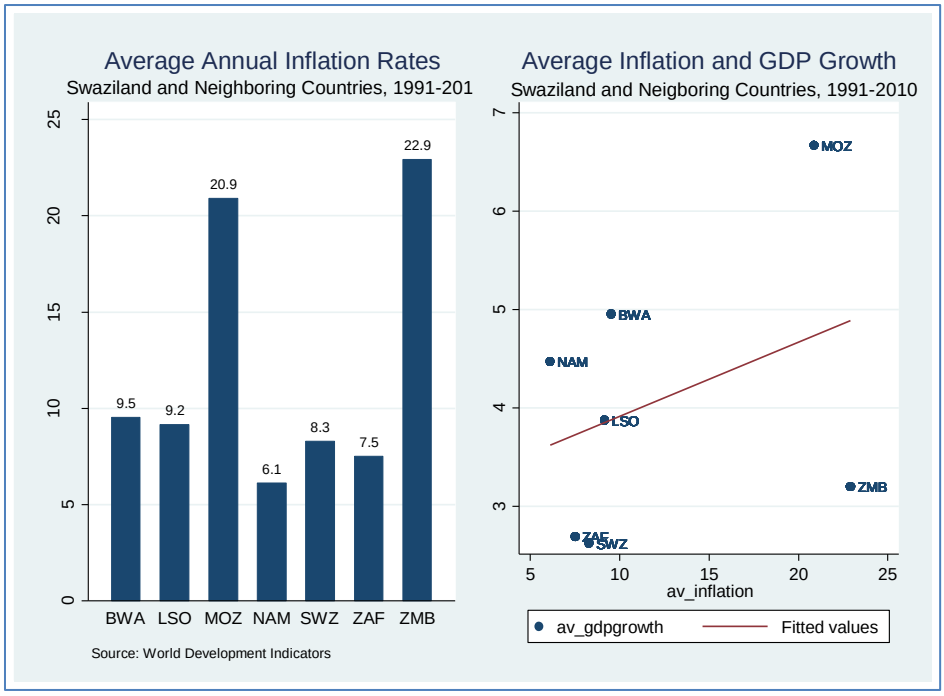


Graph XI: Excessive Dependence on SACU Revenues

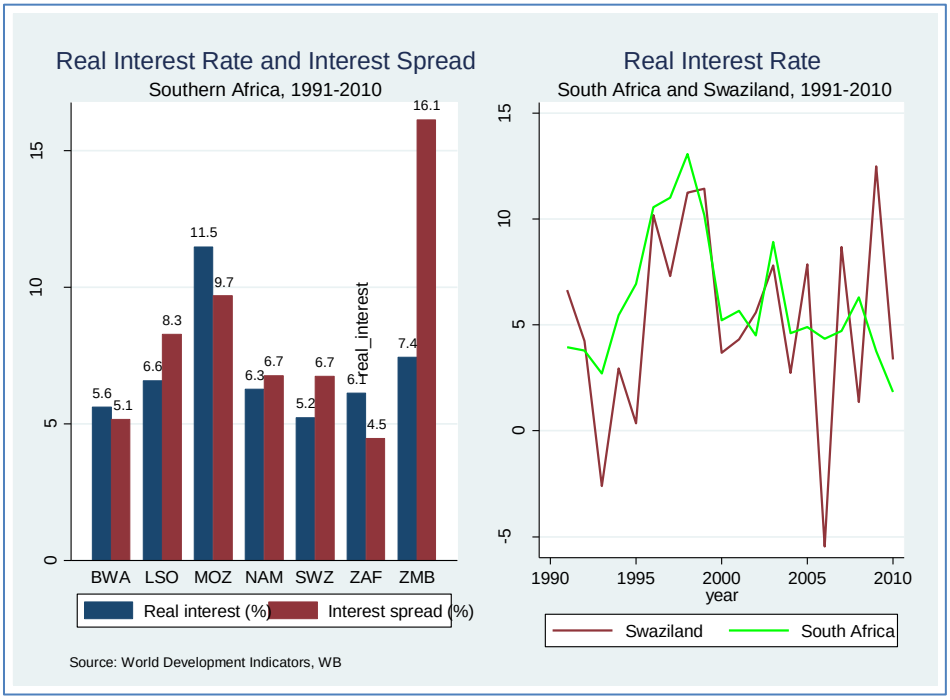
Given the pegged exchange rate and open capital market, Swazi monetary policy is virtually tied to the monetary policy of the South African Reserve Bank. Following the lead of the South African Reserve Bank (SARB), the Central Bank of Swaziland managed to keep inflation at reasonably low levels during the past two decades. Inflation averaged 8.3% in Swaziland compared to 7.5% in South Africa and 6.1% in Namibia. Faster growing economies like Botswana and Mozambique experienced considerably higher level of inflation during this period, suggesting that inflation had generally little negative impact on growth in the region (Graph XII). Our regression analysis, as presented in Table I, also finds no effect of inflation on GDP growth.

It is, however, likely that a relatively tight monetary policy that maintained inflation reasonably low (compared to other fast growing economies in the region) discouraged reinvestments of profits in Swaziland as money-holding remained attractive relative to investment. It is also likely that low level of inflations kept the exchange rate over-valued, which adversely affected export competitiveness but made repatriation of profits attractive. According to IMF estimates, Emalangeni is overvalued by about 20-30% because of fiscal imbalances, high wages, and weak business environment. Arguably, fiscal imbalances and deficit spending should lead to devaluation, not overvaluation, of the currency. Furthermore, it is difficult to ascertain the direction of causality between high wages and overvalued exchange rate. It is likely that a persistently low level of inflation kept the real interest rates low in Swaziland, which averaged 5.2% compared to 6.1% in South Africa during 1991-2010 (Graph XIII). Low

real interest rates and the one on one peg, in turn, kept the real exchange rate over-valued relative to the South African Rand.



Graph XII: Inflation and GDP Growth



Graph XIII: Real Interest Rates, 1991-2010

We observe a high degree of volatility in real interest rate in Swaziland, compared to the real interest rate volatility in South Africa. The size of the Swazi economy and volatility in flows, especially outflows of profits, can partly explain the real interest rate volatility. The real interest rate soared to 12.5% in 2009 when income payments (outflow of profits) reached 14% of GDP, perhaps to stem the outflow. Low real interest rate can be necessary but not sufficient to stimulate investment in the economy. It is the volatility of real interest rates that represents the risk in the economy and consequently determines the level of investments.

In order to stimulate investment and generate employment, Swaziland may need to carefully weigh the cost of maintaining low inflation, which keeps the real exchange rate overvalued and discourages investments and facilitates repatriation of profit (and possibly capital), especially during economic downturns. It will remain necessary for Swaziland to improve labor productivity to prevent over-valuation of its real exchange rate and maintain export competitiveness. Given the limited scope of fiscal and monetary policy instruments, Swaziland will require large-scale investments to improve labor productivity. It may consider pursuing a targeted fiscal expansion programme as a short-term measure to stimulate investment and labor productivity. This may require tolerance for a slightly higher level of inflation. A stimulus package to increase investments in priority sectors of the economy will be a critical first step to revive growth and employment in Swaziland.

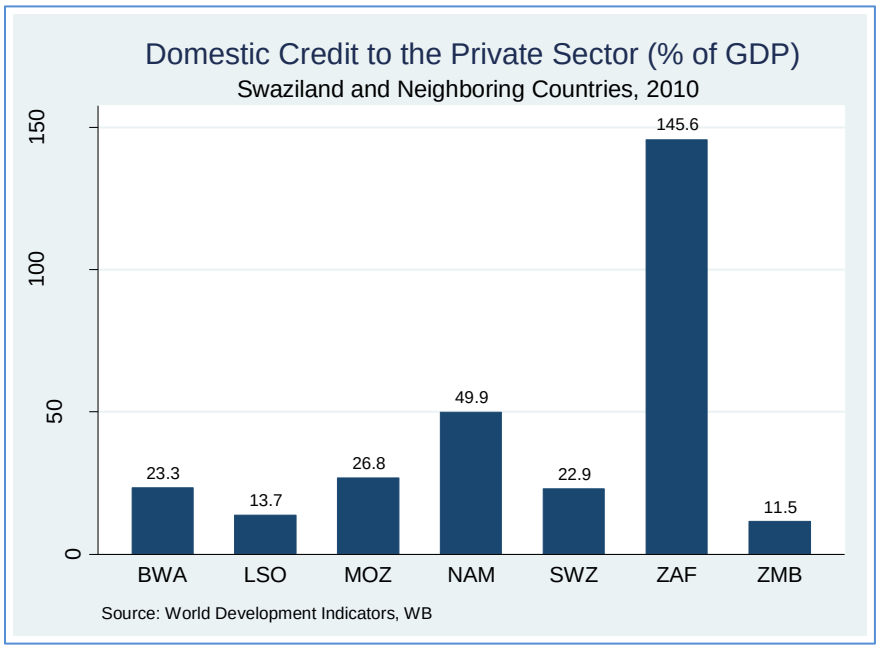
VI. Finance and Financial Sector Policies

While the Swazi economy experienced a slowdown since 2006 and domestic savings depleted, it was unable to increase borrowing from external sources to meet its investment requirements, even though it had a relatively low level of external debt. Between 2008 and 2010, its external debt went up by 1.7% of GNI. External debt inflows have been largely pro-cyclical for Swaziland. Even a very high real interest in 2009 failed to compensate for the risk premium and attract foreign capital into Swaziland when it needed the most as the economy unraveled.

Financial sector plays an important role in intermediating savings and investments in an economy. It appears that despite a modest level of financial development in Swaziland, access to credit remained a constraint for investment. Credit to private sector (as % of GDP) stood at 22.9% in 2010 - almost the same level in Botswana and higher than the levels of private credits in Lesotho and Zambia (Graph XIV). During 1991-2010, credit to private sector as percentage of GDP averaged 17.4% in Swaziland – a higher level of private credit to GDP ratio than all other countries in the region except for Namibia and South Africa.

Despite a modest level of credit to the private sector, interest rate spreads remained high compared to that of South Africa despite the fact that the Swazi banks are largely owned and operated by South African banks. The low level of domestic savings and associated higher cost of funds and risks in lending largely explain the differences in interest rate spread between the two countries. There is a clear need to reduce the spread to encourage investments in productive sectors of the economy.

The real challenge, however, is not the level of credit to the private sector or interest rate spreads but rather the sectoral composition of loans offered by banks. Banks are increasingly giving loans to the household sector displacing loans to businesses. In 2007, loans to businesses accounted for 60% of the total loan portfolio of Swazi banks but the share fell to 44% by 2011 while the share of household loans increased from 35% to 42% during this period. Household loans generally tend to be more profitable as banks are able to charge higher interest rates on consumer loans. On the other hand, businesses can choose not to borrow especially when the interest rate exceeds their expected returns on investments. Moreover, higher interest rates can induce the problems of moral hazard among, and adverse selection of, borrowers. It is important to ensure that Swaziland pursues a financial sector policy to prioritize credit to priority sectors of the economy and offers appropriate incentives to banks to increase the share of loans to productive sectors of the economy.

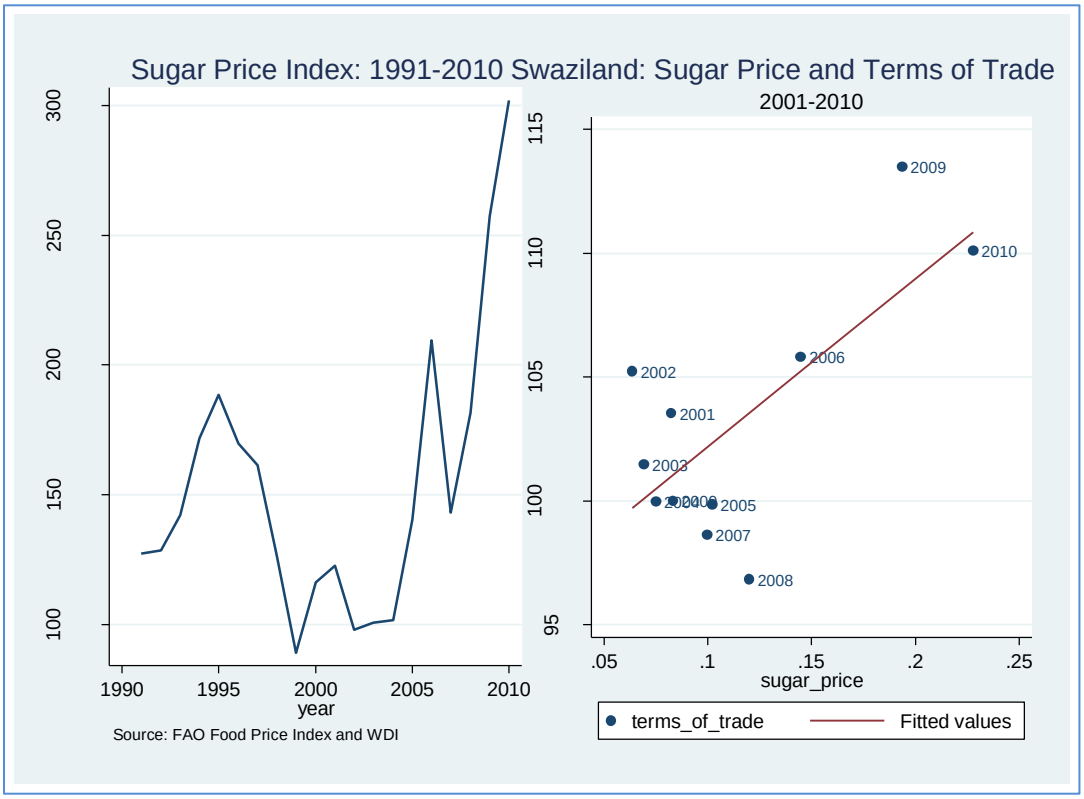


Graph XIV: Domestic Credit to Private Sector as percentage of GDP, 2010

The level of domestic credit to the private sector does not reflect the actual level of credit extended by banks as banks operating in Swaziland are required to only lend one-third of their credit portfolio to clients in Swaziland and the rest can they lend overseas. It is likely that banks collect deposits in Swaziland and lend it cross border or invest in short-term securities in South Africa to earn quick profits. Swaziland may reconsider this provision and may introduce appropriate policy measures – such as asset based reserve requirements – to discourage cross border lending or investments in trading securities.

VII. Sugar Price and Terms of Trade

Though growth rate plummeted, Swaziland's terms of trade improved considerably during 2009-10 largely because of sharp increase in sugar prices in the global market. International prices of sugar increased from $ 0.125 in January 2009 to $ 0.306 in December 2010 – a 245% increase in 24 months. FAO Sugar Price Index also more than doubled during this period (Graph XV). The correlation between international sugar price and Swaziland's terms of trade was 0.7 during 2001-2010, which confirms that high sugar price leads to higher terms of trade. It is also likely that an over-valued real exchange rate helped Swaziland achieve a favorable terms of trade. More importantly, as standard economic theory predicts negative productivity shocks can raise the terms of trade of a country by reducing output and increasing relative prices. It is likely that low growth in labor productivity and high real wages have been key contributing factors in improving Swaziland's terms of trade.

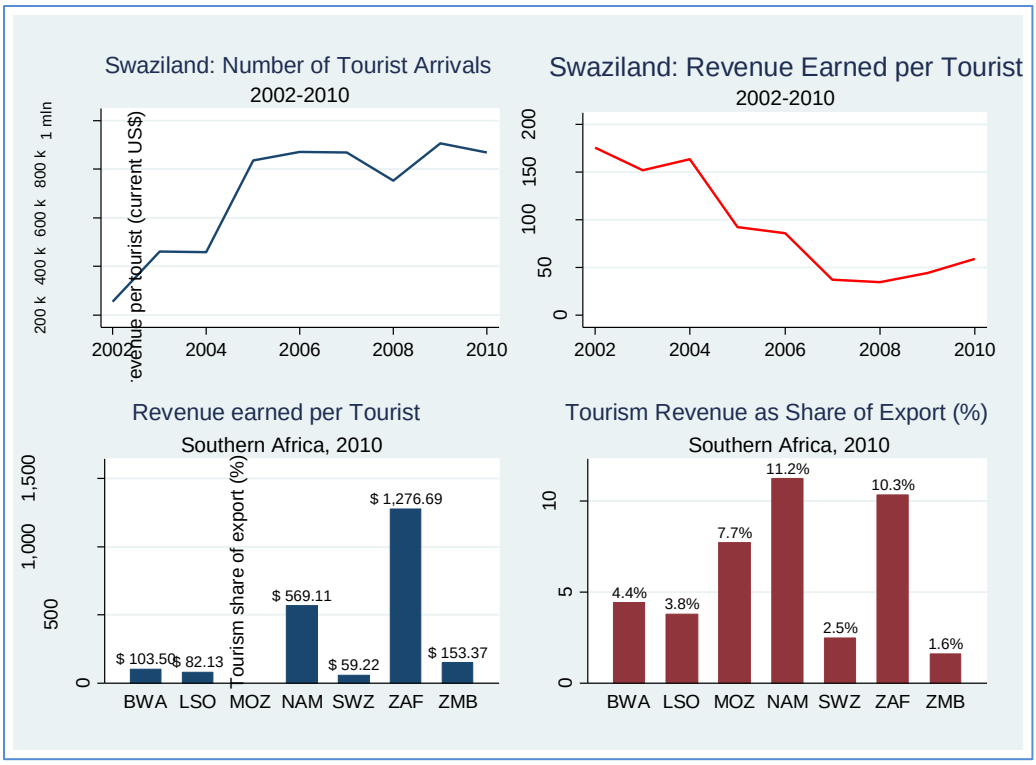


Graph XV: Sugar Price and Terms of Trade

It would be important to assess whether the Swazi sugar can remain competitive against negative price shocks. Improving labor productivity of the sugar sector and making it more price-competitive would be critical to ensure that Swaziland is able to increase its current level of exports should sugar prices would fall. This may lead to some downward adjustment in its terms of trade, which may help boost export of other goods and services, particularly tourism, which can be an important source of growth and employment generation. Improving labor productivity in sugar production would also help to prevent overvaluation of its real exchange rate.

VIII. Can Tourism Promotion be a Short-term Strategy to Revive Economic Growth?

Tourism can be a major source of growth and employment, especially youth employment, in Swaziland. Revenue from tourism accounted for over 3.7% of GDP in 2002 but fell to 1.3% in 2010 while the number of tourist arrivals increased from 256,000 to 868,000 during the same period (Graph XVI). It appears that the share of tourism revenue in GDP fell because the average amount spent per tourist declined from $ 175 (current dollar) in 2002 to $ 59 in 2010 (current dollar). In real terms, the revenue per tourist fell by over 300 percent although the number of tourist arrivals actually increased by nearly 250% during this period. In 2010, tourists to South Africa on average spent $ 1276 dollars[3] while those visiting Namibia and Zambia spent an average of $ 569 and $ 153 respectively. Tourist arrivals to South Africa, Namibia and Zambia were 8,100,000, 984,000 and 815,000 respectively. Number of tourist arrivals in Swaziland is comparable to those coming to Namibia and Zambia but it is likely that tourists spend fewer days in Swaziland than they do in these neighboring countries.



Graph XVI: Number of Tourists and Tourism Revenue

If Swaziland were able to make necessary investments to ensure that tourists spent $ 300 on average, its 2010 GDP would have increased by $ 210 million. This would have resulted in additional 5.7% GDP growth over and above the 2% growth rate that Swaziland achieved in 2010.

[3] The amount is not substantially higher because the World Cup Football held in South Africa in 2010., Tourists visiting South Africa spent an average of $ 1038 in 2009 and $ 958 in 2008

In order for tourism to become a major source of youth employment, Swaziland would need to make necessary investments both on physical infrastructure and human capital. Given that tourism is a labor intensive sector, large scale investments in tourism will help to significantly reduce youth unemployment in the short-run. Swaziland may learn from the experiences of Namibia and also from Bhutan, on how to strengthen the tourism sector of its economy. This does not necessarily mean that Swaziland should exclusively rely on tourism to steer economic recovery. It would also need to make necessary investments in agriculture – sugar and other agricultural products – to generate employment, improve productivity and rejuvenate growth.

IX. Required Growth Rates to Reduce Unemployment

In this section, we present a preliminary estimate of growth rates that Swaziland would need to achieve to bring down unemployment rate from 31.2% in 2010 to 10% in 2020. We assume that the population will grow by 1.2% a year (population growth rate was 1.24% in 2010 and averaged 1.02% during 1991-2010) and the share of working age population (age 15-64) will stabilize at 60% of the total population (working age people represented 58.6% of the population in 2010, steadily rising from 49.2% in 1991) and labor force participation rate will rise and remain stable at 60% from 56.6% in 2010. We further assume that unemployment rate would be 30% in 2013 - the initial year for projection. We also assume that during the first three years (2013-15), 80% of the required growth would come from employment growth and the remaining 20% will come from improvements in productivity, meaning employment elasticity of growth will average 0.8 during 2013-16. During the remaining four years (2017-20), productivity growth would account for 40% of GDP growth and employment growth would account for the remaining 60%. This means, employment elasticity of growth will average 0 .6 during 2017-20. According to our estimates, employment elasticity of growth averaged 0.74 during 1991-2010.

	2013	**2014**	**2015**	**2016**	**2017**	**2018**	**2019**	**2020**
Total population	1,094,474	1,107,608	1,120,899	1,134,350	1,147,962	1,161,738	1,175,678	1,189,787
Population, age 15-64	656,684.4	664,564.6	672,539.4	680,609.9	688,777.2	697,042.5	705,407.0	713,871.9
Total labor force	394,010.6	398,738.8	403,523.6	408,365.9	413,266.3	418,225.5	423,244.2	428,323.1
Unemployment rate	30%	27%	24%	21%	18%	15%	12%	10%
Number of employed	275,807	291,079	306,678	322,609	338,878	355,492	372,455	385,491
Employment growth rate	2.6%	5.5%	5.4%	5.2%	5.0%	4.9%	4.8%	3.5%
Required GDP growth rate	**3.3%**	**6.9%**	**6.7%**	**6.5%**	**8.4%**	**8.2%**	**8.0%**	**5.8%**

Table II: Required Growth Rates of GDP

Under these assumptions, employment and GDP would need to grow at an average of 4.6% and 6.7% a year during 2013-2020 to reduce unemployment rate from 30% in 2013 to 10% in 2020. This estimate is, of course, highly sensitive to underlying assumptions, especially to assumed employment elasticity of

growth. In order to increase employment growth to over 4%, Swaziland would need to increase private fixed capital formation to at least 20% from its current level of about 5% of GDP.

Swaziland may pursue a combination of strategies to boost the share of private fixed capital formation to achieve the required rate of employment growth. Strategies to incentivize reinvestment of profits would be critical to increase fixed capital formation. It may target to limit, through appropriate incentives, the repatriation of profits to 5% of GDP during 2013-20. This would help private fixed capital formation to increase by 8-10% a year. Foreign firms operating in Swaziland may be offered tax credits, tax holidays and preferential access to credit and subjected to high dividend payout taxes, to encourage them to reinvest their profits. It may learn from the experiences of Mauritius, Cambodia and Lao PDR on how to incentivize and ensure that foreign firms reinvest their profits. Targeting reinvestment of profits may be more cost effective than targeting new FDI, which usually takes a long time to materialize.

Swaziland may offer specific tax and non-tax incentives to its expatriate population to increase the inflow of remittances. Remittances can be an important source for savings and private investments in the economy. Specific measures may include introduction of GDP or inflation indexed bonds or tax-free bonds for remitters, which would offer them a guaranteed rate of return on their investments in Swaziland. The Government may use the proceeds of these bonds to develop public-private partnerships for investment projects. It may target to increase remittance inflows to about 8% of GDP, which may help to increase private fixed formation by a magnitude of 4-5% of GDP. Experiences of the Philippines and Sri Lanka on how to incentivize remittances and convert them into savings instruments can offer useful policy guidance to Swaziland.

Swaziland may undertake specific policy measures to ensure that banks increase lending for investments that promote job creation. There can be special incentives – such as refinancing, lower reserve requirements or partial guarantees – to ensure that banks extend credit to sectors with the highest potential for job creation. There can be also disincentives to discourage consumer and housing loans, which typically have low employment and growth outcomes, especially if consumption demand is met through imports. Tourism, agriculture and SMEs can be identified as priority sectors of the economy and banks may be required to maintain at least 40% of its assets as loans to these priority sectors. In addition, banks may be required to meet higher reserves if they would extend credit to entities outside Swaziland. Bank credit, targeting priority sectors of the economy, can help boost fixed capital formation by another 4-5% of GDP.

In reducing the volatility of SACU receipts, Government may establish a Fiscal Stabilization Fund. This would help reduce pro-cyclicality of government revenues and expenditures and provide access to funds for counter-cyclical measures during economic downturns. Swaziland may estimate the size of SACU revenues under different growth scenarios for South Africa and adopt a fiscal rule that its budget would be based on SACU receipts assuming that the South African economy would grow by 3% a year. If the South African economy should grow faster than 3% in a particular year and SACU receipts should be higher than the projected level, the government would set aside the surplus in its Fiscal Stabilization Fund. Should South Africa experience a lower growth rate than 3% and a shortfall in SACU receipts, the government should be able to borrow from the fund to smooth its expenditure. This would help reduce

government borrowing from commercial source during economic downturn. In addition to stabilizing budget and enforcing a rule to minimize pro-cyclical and discretionary government spending, the Fund would also invest in public-private partnerships to boost fixed capital formation and employment. It may take fixed-term equity positions in new projects that would offer the high potential for employment and productivity growth. Government may also establish a “Productivity Fund” under the auspices of the Stabilization Fund to track labor and total factor productivity and incentivize investments in productivity growth. Government may issue long-term inflation-indexed bonds to raise new resources for targeted investments in productivity growth. Banks may be required to maintain a portion of its statutory liquidity requirements in long-term government bonds to increase access to finds for productive investments. Improving productivity would remain critical to ensure that Swaziland can maintain its pegged exchange rate without inducing over-valuation of its currency.

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