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THE FEASIBILITY OF ESTABLISHING AN OFF-SHORE BANKING FACILITY IN THE KINGDOM OF SWAZILAND

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EXECUTIVE SUMMARY

1. The consultants concluded that while several of the elements of offshore banking (such as reduced taxation on banking and other financial transactions, the elimination of foreign exchange controls, and the lessening of regulations on business and finance in general), were desirable, the establishment of an offshore banking program in and of itself would not benefit the Swazi economy sufficiently to justify the costs and efforts involved.

2. Most of the benefits of off-shore banking (such as increased levels of finance and business transactions, the introduction of investment capital and technical expertise, and the enhancement of foreign investment into Swaziland) could better be achieved by other means, such as the approval and implementation of new and liberalized foreign exchange, companies act, taxation rationalization, and foreign investment programs and legislation.

3. The special circumstances of Swaziland, in particular the close economic ties with South Africa, present distinctive problems to economic policy-makers. The Common Monetary Agreement (CMA) and the Southern Africa Customs Union (SACU), especially, stand as treaty obligations which would prevent many of the liberalizing steps necessary to establish an off-shore banking program. The renegotiation of these agreements, which developing events in South Africa now make inevitable, make the development of an overall Government economic policy, with supporting legislation and implementation, a matter of national imperative for Swaziland.

4. The consultants found virtually unanimity amongst those interviewed in Swaziland concerning the desirability of liberalized economic policies and a re-thinking and re-negotiation of the economic and policy relationship with South Africa. All of those interviewed agreed that rather than focusing on a narrow program of off-shore banking, the Government should concentrate on an overall revision and updating of economic policy and business, tax, and financial legislation.

5. A potentially profitable off-shore banking facility might be realized only if the Government of Swaziland (GOS) would significantly reduce or eliminate the current foreign exchange control regime in the kingdom. However, such a decision would have the following undesirable results.

(a) The lilangeni would devalue vis-a-vis hard currencies and the rand because of the lilangeni's overvaluation, and because of the continued, rigid foreign exchange control regime maintained by South Africa.

(b) At least in the short run, a devaluation of the lilangeni vis-a-vis the rand would lead to a somewhat chaotic situation in local (Swazi) markets, where the rand and the lilangeni have been used interchangeably.

(b) A devaluation of the lilangeni would also mean that all imported goods and services from both South Africa and other countries would become more expensive. Given the significant volume of Swazi imports, such a broad and significant increase in prices would be a real economic hardship for the people of Swaziland.

(c) Given the large proportion of imported components and other inputs in Swaziland's production processes, a devaluation of the lilangeni would also lead to an increase in the producer prices of a number of domestically produced products, further burdening the Swazi consumer.

(d) In theory, a devaluation of the lilangeni would make Swaziland's exports more competitive in the world marketplace. However, given the anticipated price and income elasticity of the major types of Swaziland's exports (sugar, wood pulp, and soft drink concentrates, all known to have rather inelastic price and income effects), the additional export income to be expected from a devaluation of the lilangeni would be rather small.

(e) The Government of Swaziland, Swazi parastatals, and some private sector corporations have foreign loan servicing obligations. A devaluation of the lilangeni would mean that foreign loan servicing by all these parties would become more difficult. The Swaziland Government's foreign borrowing is primarily in hard currency. This loan servicing would become more difficult with a devaluation because elimination of Swaziland's foreign exchange control system would imply a greater devaluation of the lilangeni vis-a-vis hard currencies than the rand, since the rand itself will continue to be overvalued vis-a-vis hard currencies. Most of the parastatals already face very difficult but necessary adjustments, and these adjustments will become even more difficult with a devaluation.

(f) The rise in the rate of inflation resulting from a devaluation of the lilangeni could very well spark demands for wage increases and demands for a raising of administered prices. This in turn would cause the rate of inflation to accelerate upward even further. An ever-increasing spiral of inflation and devaluation could be set in motion. A number of countries around the globe, including nearby Zimbabwe, have experienced this unpleasant lesson.

(g) An extremely tough set of macro-economic policies, including high interest rates, selective tax increases, cuts in government spending, and reductions in consumer spending would be required to counteract an increasing spiral of inflation and devaluation, possibly resulting from an elimination of foreign exchange controls in Swaziland. Developing nations provide many examples of devaluations that have not had the intended effects, and which have led to the implementation of drastic measures to counteract untoward and unanticipated effects and the resulting severe economic hardships (e.g., Bolivia, Argentina, Mexico, Indonesia, and a number of NIS countries).

(h) Though a devaluation of the lilangeni would increase the local currency value of the customs union revenue, the anticipated inflation would completely negate the Government's added purchasing power from this source of public revenue.

(i) On the political front, a significant reduction in, or elimination of the foreign exchange control system in Swaziland would jeopardize good relations with South Africa, because the latter would not appreciate the development of an "escape route" for capital flight that such a reduction or elimination would provide. Moreover, it is difficult to visualize how Swaziland could eliminate its foreign exchange control regime and still belong to the CMA. Swaziland would have to follow the same route as Botswana and leave the CMA countries. It must be realized, however, that Botswana's economic conditions were quite different from Swaziland's at the time with respect to foreign exchange earnings, balance of payment position, and economic dependence on a single large nation.

Given these negative possibilities, it is not recommended that Swaziland significantly reduce or eliminate its foreign exchange control system for the sake of possibly capturing the potential benefits and profitability of an offshore banking facility.

6. Of the alternatives considered, the one considered most promising for encouraging Swaziland's economic growth and development would be the implementation of an export processing zone. Such a zone could attract significant direct foreign investment and result in the creation of a large new employment sector.

I. Introduction and Background

At the request of the Central Bank of Swaziland, the U.S. Agency for International Development (USAID) has contracted with LABAT-ANDERSON Incorporated (LAI) to study the desirability of establishing an off-shore banking facility in Swaziland, and to sketch out the implications of various possible versions of such a facility for Swaziland's economic growth and development. This report summarizes the work of a two-person team which performed the requisite interviews with GOS and business/financial community leaders, and which studied recent data for and trends in the Swazi economy between January 24 and February 5, 1994.

The study's methodology included interviews with government officials, business leaders, banking executives, and professional, trade, agricultural, and manufacturing representatives in the Swazi community, in Mbabane and Manzini. Discussions were held with representatives of both the indigenous and international communities in Swaziland. Also, an off-shore banking "workshop" for all interviewees was presented by the consultants in Mbabane to review and discuss the study's findings.

In addition to the interviews and discussions, a broad range of economic, business, and legal written materials were studied. As further questions developed from these activities, the consultants broadened the study's inquiry to include monetary and fiscal issues critical to any proposed system of off-shore banking. These issues included Swaziland's obligations in the context of the Common Monetary Agreement (CMA) and the Southern Africa Customs Union (SACU); domestic foreign exchange regulations and practices; banking and taxation legislation; and the development of Swazi Government policies in light of likely changes in the local economy and in the neighboring South African economy.

II. Results of Interviews and Research Activities

A. Interviews

In consultation with officials from the Central Bank of Swaziland, USAID, and the U.S. Embassy in Swaziland, the consultants identified and arranged appointments for interviews with key GOS and Swazi financial and business sector leaders, as well as other interested parties, to discuss the desirability of establishing off-shore banking facilities in Swaziland. Though only 20 such interviews were expected (see Terms of Reference, paragraph 2), the consultants deemed it desirable to arrange as many appointments as possible, in order to ensure no opinions or concerns of any interested parties were overlooked. A list of those interviewed appears in Appendix I.

Over 37 concerned individuals and/or organizations were identified within the Swazi community -- from the GOS and from the Swazi finance and business sectors -- for direct interviews and consultations concerning the desirability of establishing off-shore banking operations. In addition, interested American officials were interviewed at the USAID Mission and at the U.S. Embassy. Discussions were also held with resident representatives of foreign banks and international businesses with operations in Swaziland.

The interviews and discussions did not deal with off-shore banking exclusively. Because of the important general economic and financial issues involved in the consideration of such a banking facility, these discussions also encompassed monetary and fiscal policies, economic development matters, trade and foreign exchange issues, and international concerns, particularly economic relations and treaty obligations with the Republic of South Africa (RSA).

These interviews, meetings, and other discussions revealed a general consensus among the interviewees regarding the desirability of off-shore banking in Swaziland. The main conclusions may be summarized as follows:

1. None of those interviewed had any objections to the concept of off-shore banking, nor to the introduction of some form of off-shore banking in Swaziland. They also did not questions the desirability of its underlying assumptions, characteristics, and goals (the elimination or reduction of foreign exchange controls and taxes and the enhancement of overall economic development through the promotion of increased financial, investment, and business activities).

2. At the same time, none of those interviewed could see any particular or significant economic advantage to Swaziland from the introduction of off-shore banking in its more limited definition; that is, involving only non-residents, currencies other than the Rand area currencies, and transactions outside Swaziland.

3. When discussions focused on more liberal definitions of off-shore banking, involving limited or full access by residents as well as non-residents to all transactions and services in either local or foreign currencies, most participants noted the following theoretical advantages to the local economy (assuming for purposes of the discussions that such arrangements could legally, practically, and profitably be established):

(a) the introduction of foreign investment or loan capital and investment projects and related opportunities into the local economy;

(b) increased banking competition and efficiency, due largely to the introduction of new products and procedures (and not necessarily to an increase in the number of banks involved); and

(c) enlarged involvement by Swaziland in international finance and trade, including the transfer of financial technology to the Swazi financial and business sectors, with the probable effect of an aggregate increase in business and trade activity.

4. Existing companies with international business did not see any additional advantage in the presence of off-shore banks in Swaziland. Transactions in foreign currency, such as trade finance, capital investments, and loans can and are being authorized for such companies by the Central Bank under existing rules and regulations. While the easing of such foreign exchange restrictions was viewed as desirable, most interviewees felt this could be accomplished more easily and directly by changes in the existing Swazi foreign exchange laws and regulations rather than by the introduction of off-shore banks.

5. All of those interviewed were acutely aware that current Swazi legislation and regulations, especially those concerning foreign exchange transactions, would have to be significantly modified to allow any participation by residents or by the economy of Swaziland in any offshore banking arrangement.

6. All of those interviewed agreed that, as a matter of priorities, off-shore banking in and of itself should not be an urgent matter for the GOS. Several economic policies usually associated with offshore banking, such as the elimination of foreign exchange controls, relaxation of regulations in general, and a substantial reduction in taxes were strongly endorsed. In addition, the need for a foreign investment code, a securities law, and a coordinated program to encourage and finance domestic investments were all viewed as more urgent and important for economic development.

7. Most of those interviewed were also generally aware that the Common Monetary Agreement (CMA) commits Swaziland to policies of strict foreign exchange controls and to close cooperation with South Africa concerning monetary matters in general and foreign exchange management and control in particular. In addition, government officials, bankers, and lawyers were aware that the terms and conditions of the CMA very probably would prevent Swaziland from introducing the liberalizing economic and de-regulatory steps necessary to establish off-shore banking in a more liberal and desirable format.

8. The importance of economic and political relations with South Africa were uppermost in the minds of all those interviewed. While the Common Monetary Agreement and the South African Customs Union together constitute the monetary and trade foundations of the economy of Swaziland, almost all of those interviewed recognized that the restrictive controls of the South African economy will have to be relaxed, if not totally eliminated. The implications for Swaziland are immense and all parties agreed that new policies and economic programs are needed urgently.

B. Researched Materials and Results of Research Activities

In addition to conducting interviews, the consultants researched official documents and statistics and published economic and political information on the Swazi economy and those financial and business sectors relevant to the possible establishment of off-shore banking facilities. The following three parts of this report cover each of these components:

1. Relevant Information on the Swazi Economy

Recent data published by the Central Bank of Swaziland reflect declining economic performance. The continued recession in most countries around the globe and the effects of the recent severe drought in southern Africa are the principal reasons for this decline. In contrast to the negative growth rate of the early 1990s, recovery from the drought is expected to result in a positive growth rate for real gross domestic product. However, the lack of economic progress in South Africa can have significant negative implications for the Swazi economy. On the positive side, the lessening of hostilities and possible economic recovery in Mozambique may open new market opportunities for Swazi exporters.

a. Fiscal trends, customs revenue, and trends in RSA

The recent budgetary trends of the GOS indicate that public expenditure is growing at a high and increasing rate while revenue prospects are deteriorating. Recurrent expenditure of the Swazi Government accounts for nearly 50 percent of gross domestic product, compared to approximately 29 percent for economies with a favorable economic growth rate. The largest single change in future revenue is expected to result from changes in the Southern African Customs Union (SACU) agreement between Swaziland, South Africa, Botswana, Lesotho and Namibia.

Customs revenue has traditionally been a major component of GOS receipts, accounting for over 40 percent of total revenue. This is obtained from the Customs Union Pool. The Government of South Africa (GOSA) is currently examining a different tariff structure. These planned reforms are expected to reduce the size of the Customs Union Pool and to decrease Swaziland's share. Swaziland is likely to experience a substantial loss in revenue from this source.

The development in South Africa of a more attractive environment for long-term investment in coming years may also result in lower revenue income for the GOS from company taxation, which presently accounts for approximately 20 percent of all tax revenue. Positive economic development and political stability in South Africa would mean stiffer competition for Swaziland, possible disinvestment, and the necessity for greater tax concessions in the kingdom.

b. Exchange rate agreements with RSA

The one-to-one exchange rate between the Swazi lilangeni and the South African rand has been maintained even though Swaziland negotiated the right to alter this exchange rate in 1986. This right has not yet been exercised and hence, the lilangeni has remained at par against the rand. As noted in a study by Phaleng Consultancies (Pty) Ltd., the one-to-one exchange rate between the lilangeni and the rand has several advantages:

- trade, investment, and other financial flows between the two countries is facilitated because of the absence of exchange rate risk between the two countries;

- the rand can freely circulate in Swaziland, which significantly facilitates the important tourist trade from South Africa; in addition to which South Africans do not have to use their scarce travel allowances when traveling to Swaziland;

- payments in rand for goods and services from South Africa can be made with checks drawn on bank accounts in Swaziland without a commission or banker's margin charged when converting one currency into another;

- receipts for goods and services supplied to South Africa are similarly free of additional charges; and,

- most important, the relatively significant remittances to Swaziland from migrant Swazi workers in South Africa are converted at par without additional costs and without exchange rate risk.[1]

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[1]. Phaleng Consultancies (Pty.) Ltd., et al., (January 1994) **Review of the Swaziland Monetary System**, Government of the Kingdom of Swaziland, pp. 14 & 15.

There are also some potential disadvantages of the one-to-one exchange rate relationship:

- Swaziland's exchange rate against the rest of the world is determined entirely by movements in the rand, but Swaziland has no influence over South Africa's exchange rate policy;

- inflation in South Africa is imported virtually intact into Swaziland (however, given the very large volume of Swazi imports from South Africa, the imported inflation effect would still occur even without the one-to-one exchange rate arrangement; and,

- since 1986, rand circulating in Swaziland do not generate any revenue for the Swazi Government.[2]

There are additional problems associated with the fact that the South African rand continues to be artificially overvalued as a result of the RSA's strict exchange control regime. Though the International Monetary Fund is likely to place some pressure on the GOSA to abolish these controls, this is unlikely to happen in the next two to three years, because a new government could not bear the very significant risk of accelerated capital flight. The South African rand will consequently continue to be overvalued, and the Swazi currency will therefore also be overvalued during the next two to three years if the current exchange arrangement is not broken.

At the present time, the breaking up of the one-to-one exchange rate is not expected to be beneficial for the Swazi economy.

c. Comparative advantage for attracting investment

Swaziland's main comparative advantage in the region for attracting investment, including an off-shore banking facility, is its peace, security, and political stability. In its 1993 budget speech, made by the Honorable Solomon M. Dlamini, Minister for Economic Planning and Development, the Government indicated its intention to maintain this advantage by stating that it requires reinforcement with infrastructural development, cost-effective and reliable utilities and services, a competent and literate labor force, an enabling environment for growth and development, and good industrial relations. In this speech, the minister also stated that "a free market policy, a tax system which can compare favorably with the rest of the region, and a clearly defined development strategy which also provides for the role of the private sector are all needed to ensure that Swaziland's investment position is improved."

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[2]. Ibid., p. 15.

d. Implications for off-shore banking facility

The potential success of an off-shore banking facility depends, inter alia, on the political stability and economic health of the host country, particularly with respect to attracting foreign investment. The sound stability of the Swazi political situation is certainly a significant plus for the establishment of an off-shore banking facility. However, the current status of the Swazi economy suggests that establishing such a facility is somewhat premature.

The overvaluation of the Swazi currency would not invite confidence in the Swazi economy in the international financial community. The overvaluation of the local currency, the prevailing foreign exchange controls in both Swaziland and South Africa, and the fear of capital flight in RSA all imply that an off-shore bank in Swaziland can only be realized in its most narrow sense. This would be a bank which engages in banking transactions with non-residents in a currency other than the currency of the host country, for use outside the host country. Because of the one-to-one exchange rate relationship with the rand and the foreign exchange controls in South Africa, such an off-shore bank could not be used by South Africans.

Such a narrow interpretation of an off-shore banking facility cannot contribute to the well-being of the Swazi economy. On the other hand, a broader interpretation of an off-shore banking facility -- one which, for example, would include banking transactions with residents -- is difficult to visualize for Swaziland at the present time. Such a facility traditionally requires that the local currency is stable and there must be ease of use of international currencies. In most established off-shore facilities, either a particular historical on-shore association or a dominant trade relationship induced the establishment of such a facility. Neither of these appears to be the case in Swaziland, however. Growth in deposits and attracting trading companies themselves require a strong local presence of accountants, auditors, stockbrokers, lawyers and sophisticated financial management services, so that the off-shore banking facility will have effective access to transnational business networks. Compared to other global locations, these skills are relatively scarce in Swaziland.

Furthermore, effective operation of an off-shore fund industry in an efficient off-shore banking facility usually requires the conjoint but separate existence of investment management companies that make the investment decisions with respect to the fund, and of custodian/trustee/depository institutions that are charged with representing the interests of the fund's unit holders. Currently, such professional expertise is not entirely present in Swaziland. It would need to be drawn to the off-shore banking facility if the investment interests of non-resident clients are to be catered for.

e. Recommendations

The GOS's budgetary constraints should assign a higher priority to activities which enhance capital investment. In this light, the finalization of the Investment

Code under the Ministry of Commerce and Industry is important. This Code is designed to make explicit the conditions under which prospective investors can operate in the economy, and ensures fair and equal treatment for different categories of investors. One activity which attracts investments, and foreign investments in particular, is establishment of a free trade zone or export processing zone. Such a zone, presently not in existence in Swaziland, would be significantly more beneficial for the Swazi economy than an off-shore banking facility.

An off-shore bank does not contribute to the gross domestic product of an economy and it competes for highly specialized labor rather than creating employment opportunities. Contrariwise, a free trade zone or processing zone can contribute to the gross domestic production and create employment opportunities in an economy.

2. Swaziland's Financial Sector

a. Structure

The most important institution in this sector is the Central Bank of Swaziland. The Central Bank issues the national currency, advises the Government, manages the country's official reserves, and deals in foreign exchange markets. Activities in the forex markets involve both spot trading and dealings in the forward market. The Central Bank provides clearing facilities for the commercial banks. During 1991, the Central Bank introduced the Export Financing and Guarantee Scheme and the Small Scale Enterprise Loan Guarantee scheme.

Under the Export Financing and Guarantee Scheme, the GOS guarantees bank loans of between 75 and 85 percent of the value of exports. Pre- and post-export finance credits are provided to participating firms. Applications under this scheme are processed by the commercial banks, with details of approved cases forwarded to the Central Bank's Development Finance Department for a guarantee cover. From its commencement to February 1993, 76 loans were extended, ranging in size from 5,000 Emalangeni (E) to E2.5 million. Up to March, 1993, guarantee commitments were a total of E15.2 million, facilitating export credits of E24.4 million. Thus far there have been no defaults and 64 percent of the total loan amount was already repaid in February, 1993. More than half of the beneficiaries of this sound scheme have been small scale exporters. At this time, the Government has placed E5.5 million in the scheme's fund, of which E500.000 came from the Central Bank. An additional capital injection of E4 million is being made in the 1993/94 budget.

Applications under the Small Scale Loan Guarantee Scheme are processed by the commercial banks with details of approved cases forwarded to the Development Finance Department of the Central Bank. Under this scheme government guaranteed loans are extended to small businesses (i.e., businesses with assets under E150,000) that otherwise would have found obtaining credit an obstacle. Up to March, 1993, E4.3 million in guarantees were committed, allowing a total loan commitment of E5.7

million. Claims in respect of only 0.8 percent of the total disbursed amount were made.

In recent years, Swaziland's commercial banks have been characterized by highly liquid conditions. They are therefore capable of financing all bankable projects. During 1993, this liquidity further increased, with money previously deposited in South Africa being repatriated to Swaziland due to a smaller interest rate differential between South Africa and Swaziland. (Recently, this differential was as much as 6 percent, but is now only 2 percent.) The commercial banks usually grant finance in the form of overdrafts but will consider other loan facilities as well. Companies which are more than 25 percent foreign owned are required to apply to the Central Bank through a commercial bank for loan facilities, but no reasonable proposition will be turned down.

Banking facilities and services are available throughout Swaziland, with the greatest concentration in the more densely populated areas around Mbabene, Manzini, and Matsapha. Swazi's commercial banks include Barclays Bank of Swaziland, Standard Chartered Bank, Stanbic Bank (formerly Union Bank), and Meridien BIAO Bank Swaziland.

<u>Barclays Bank of Swaziland</u> is part of a worldwide group with representation in 70 nations. Hence, global business transactions can be performed for local clients. Barclays Bank has been in Swaziland for more than 95 years and has the largest banking network in the kingdom with 11 branches, four agencies and a head office which was recently renovated. The head office incorporates an efficient foreign exchange section with worldwide forex links and catering mostly for import/export finance. Barclays also operates a specialist branch at Matsapha which caters for the specific requirements of corporate clients. A number of new products and services were launched during 1993. These include automatic teller machines at the Mbabane and Swazi Plaza branches; a new loan package for individual clients; a comprehensive guide for aspiring entrepreneurs; and over-the-counter insurance options.

<u>Standard Chartered Bank</u> has worldwide representation, with more than 700 outlets in over 50 countries, so it has the capacity to perform global business transactions. Standard Chartered Bank has been in Swaziland for more than 66 years and is represented throughout the kingdom with five branches in Mbabane, Matsapha and Manzini, plus a number of agencies. Standard Chartered Bank was the first to introduce automated teller machines in Swaziland (at the four Mbabane and Manzini branches). Standard Chartered Bank is the only financial institution listed on the Swazi stock exchange. Its products include, <u>inter alia</u>, the Sivuno Savings Scheme with tiered interest rates, the No-Nkinga personal loan scheme, and an educational assistance program for financially disadvantaged parents. The Standard Chartered Bank has coverage in most of the countries belonging to the Southern African Development Council (SADC) and the Preferential Trade Area for Eastern and Southern African States (PTA).

Stanbic Bank (formerly Union Bank) was founded in Swaziland in 1988 and offers a range of sound products backed by good service. Stanbic Bank pays attractive rates on deposits and offers staggered interest on savings accounts and interest-bearing current accounts. It has a sound reputation for investments and has recently opened the new treasury operation within the Trade Center, which ensures that clients have ready access to current market information and expert advice. The bank has established a special department to support the small business sector.

Meridien Bank Swaziland, part of the international group Meridien BIAO, opened in Swaziland in 1991. Meridien Bank Swaziland has two Mbabane branches, one branch in Manzini, and a fourth branch at the Matsapha industrial estate. This last branch directs its services toward the export-oriented clients in that area. Meridien Bank presently operates in 23 countries in sub-Saharan Africa, where it has a network of approximately 100 branches. In the industrialized world, Meridien Bank BIAO has a branch in Hamburg, and offices in London, Paris, and New York. Technically, Meridien Bank BIAO is not a bank, but a banking network. It has neither a banking license, nor a home supervisor, nor a central bank as a bank of last resort. This network includes, inter alia, a number of developing country banks with significant bad debt positions.

Meridien Bank BIAO is owned by ITM International, which is registered in Luxembourg. In Swaziland, the Meridien Bank has been rather aggressive in obtaining a market share and also has got involved in merchant banking. For example, it was the only bank which successfully underwrote the first issue of the Swaziland Stock Brokers.

Swaziland Development and Savings Bank (SDSB) operates eight branches and several agencies throughout the kingdom. Since its establishment 28 years ago, the bank has traditionally provided agricultural and household credit. Assistance to small and medium- sized farmers on title deed land is a major area of activity. Nevertheless, it covers all the traditional activities of the banking profession. In 1992, the SDBC became eligible for an E20 million line of credit from the African Development Bank. This line of credit enables SDBC to provide for credit ranging from E51,000 to E300,000 at concessionary interest rates. Applicants must provide conventional collateral before loan finance will be granted.

Institutions other than banks belonging to Swaziland's financial sector include the Swaziland Building Society, the Swaziland Royal Insurance Corporation, the Swaziland National Provident Fund, and Swaziland Stockbrokers Limited.

The Swaziland Building Society (SBS) was established in 1962 and is the kingdom's major source of housing loans. Housing loans are available for most income groups and the development of affordable housing is encouraged. The SBS has introduced employee- assisted mortgage schemes which are supported by employers' investments. Furthermore, it provides loan finance for large housing development projects. The SBS depends for its funds on short-, medium-, and long-term products at competitive interest rates. The SBS is equipped to handle large volumes of investments and home loans through its two branches in Mbabane, two branches in Manzini, and one branch in Matsapha.

The Swaziland Royal Insurance Corporation (SRIC) has effectively been privatized, with the government's previous 51 percent shareholding reduced to 41 percent. The monopoly status of the SRIC was removed in an act in 1993, thereby allowing other insurers to operate in the country. Given the greater potential competition, the SRIC has gone on line with a major South African insurance company, thereby benefitting from previously unavailable software. Also, it is currently assessing new insurance products for Swaziland.

The Swaziland National Provident Fund (SNPF) is a compulsory savings scheme for employees which invests most of its assets in real estate, including housing projects. This scheme enables employees to amass savings which are repayable with interest upon retirement or upon leaving the country permanently to live abroad. Plans are in the works to convert the SNPF into a pension fund during the next few years.

Swaziland Stockbrokers Limited was licensed in 1990 to fill a gap in the financial market, by providing stock-brokering services to institutional investors for the equities of a limited number of listed companies on the newly-formed Swazi exchange. Standard Chartered Bank was the first company in Swaziland to go public, followed by Swazi Spa Holdings (the nation's major hotel group), and Royal Swaziland Sugar Corporation. This was followed by debentures of Swaziland Brewers, as well as of the Swaziland Sugar Assets and of the (Swazi) Post and Telecommunications Corporation. The only under-subscribed issue was the one of the Royal Swaziland Sugar Corporation.

The Swaziland stock exchange, which is managed by Swaziland Stockbrokers Limited, is ranked the 43rd in size among the approximately 50 stock exchanges in emerging economies around the world. Like other stock exchanges in its class, the Swaziland exchange has very limited buy-and-sell activities. Nevertheless, it has had a sound beginning with a keen market interest in buying new issues. Security transactions with foreign investors, as well as transactions involving investments in foreign securities, need the foreign exchange approval of the Central Bank. Given the current regulations of the foreign exchange control system it is very difficult, if not impossible, to obtain permission as a resident to invest in hard currency denominated securities.

b. Opinions/views of leaders of Swazi financial sector

The consultants visited top management of all institutions in Swaziland's financial sector to explain the concept of an off-shore banking facility and its variations, and to make inquiries about the perceived need for and feasibility of an off-shore banking facility.

The replies to the team members' inquiry can be summarized as follows:

1. While none of those interviewed objected to the idea of offshore banking in Swaziland, they felt that the current type, nature, and volume of financial transactions does not require an offshore banking facility in Swaziland.

2. None of those interviewed could see any distinct or special advantages to the Swazi economy as a whole from such an off-shore facility.

3. Management of the commercial banks expressed willingness to cooperate if an off-shore banking facility were to be established in Swaziland.

4. Given the status of South Africa's economy, the interdependence between the Swazi and the RSA economies, and the prevailing foreign exchange control regime between the two countries, several of those interviewed found the economic feasibility of an offshore banking facility quite limited. Others simply stated that it would be very difficult to quantify the potential benefits and costs.

The consultants are in agreement with the answer summaries outlined in Nos. 1, 2, and 4 above, based on the summarized description of Swaziland's financial institutions, together with the available economic data reviewed. The consultants' judgement regarding point 3 above is that it is irrelevant.

3. Swaziland's Business/Manufacturing Sector

In its broadest interpretation, the Swazi business sector includes the food and beverage industry, manufacturing, trading, and the service industry. The most important service industry in Swaziland is the foregoing financial sector. The food and beverage industry and processing sectors of Swaziland's industry often overlap with agriculture, as such operations draw extensively on the local raw materials; sugar in particular. Also, the food and beverage industry is well-supported by warehousing, packaging, and distribution services. Industry includes, <u>inter alia</u>, the Swaziland Bottling Company, which bottles Coca-Cola, Schweppes, and Sparletta products such as Appletiser apple and grape juices; Swaziland Brewers, which produces five brands of beer; Bromor Foods, which produces soft drink concentrates, a range of jellies, and glace cherry products in a sister operation; Cadbury Swaziland, with a range of popular confectionery products, as well as Chappies Bubblegum; and the technically advanced Ngwane Mills, Swaziland's first flour mill to produce five varieties of the Bakers Pride brand of flour.

III. Plan of Action and Recommendations: Results of Workshop and Investigations

The consultants drew up a plan of action and recommendations based on their own research and interviews, and on the discussions that took place in the February 3, 1994 workshop. These are presented following.

All of the participants in the February 3, 1994 workshop -- officials from the Central Bank of Swaziland, the USAID Mission, and the U.S. embassy -- were in agreement with these conclusions.

- Given the CMA treaty and Swaziland's foreign exchange control system, only an offshore banking facility in its most limited interpretation is technically feasible in Swaziland at the present time; that is, a facility to which only non-residents have access for transactions only in currencies other than the local currency.

- To use an economist's terminology, a "quick and dirty" estimation of the potential benefits and costs of an offshore banking facility in its most limited interpretation in Swaziland indicates that the costs would be greater than the benefits. One rather significant, non-quantifiable cost would be a potential diminution in Swaziland's excellent international reputation if an effort to establish an offshore banking facility ended in failure. Given the stiff global competition for transactions in offshore banking facilities, such an outcome -- though non-quantifiable -- must be considered as a possibility.

- The only way in which the potential profitability of an offshore banking facility in Swaziland could possibly be captured would be through installation of a "broader interpretation" facility, but this would entail the elimination of, or at least significant reduction in Swaziland's foreign exchange control system. This broader interpretation implies that residents would also be eligible to participate in the facility's transactions. However, at the present time, it is not recommended that Swaziland significantly reduce or eliminate its current foreign exchange system for the sake of possibly capturing the potential net benefits (i.e., benefits minus costs) of an offshore banking facility. (For a detailed reasoning behind this conclusion, please refer to Section 6 of the summary report used in the February 3, 1994 workshop, which is reproduced in Appendix B of this report.)

- Given the foregoing observations, at the present time, no further steps should be undertaken to explore the feasibility of an offshore banking facility in Swaziland. The feasibility could be re-visited at a future time when most of the present foreign exchange controls have been eliminated (a situation not envisioned in the foreseeable future). It would also be wise to wait until such time as the South African economy has attained sufficient strength and de-regulation such that RSA citizens and institutions -- a potentially lucrative market for a Swazi off-shore banking facility -- could have access to it services and transactions.

- Significant potential benefits can be captured from steps other than those related to the establishment of an off-shore banking facility at the present time. It was concluded during the workshop, as well as during meetings with officials of Swaziland's Central Bank, the USAID Mission, and the U.S. embassy that the following steps should, at a minimum, be seriously considered:

(1) Completion of the Swazi investment code as soon as possible and assurance that this code is truly attractive for both local and direct foreign investments.

(2) Assessment of other laws and regulations possibly affecting foreign and domestic capital investments and drafting of desirable changes to ensure an optimal climate for these investments.

(3) Initiating action to ensure the availability of globally competitive credit swaps and currency swaps to favorably influence the flow of foreign direct investments into Swaziland.

(4) Evaluation of the feasibility of establishing an export processing zone (a "free trade zone" or a "foreign trade zone") for Swaziland. Evaluation in particular of the various possible interpretations of such a zone, and identification of the zone type that would optimally benefit Swaziland. In this aspect, it is interesting to note that South Africa and at least one other member nation of the CMA announced during the most recent CMA meeting the intent of thoroughly exploring the potential net benefits of an export processing zone. Swaziland should not lag behind in what appears to be a potentially profitable area.

(5) Consideration of initially limiting and gradually lifting of foreign exchange controls. For example, commercial banks could be given the authority to provide credit to a domestic exporter and cover the hard currency loan via a forward contract (in order to lower the interest rate charged to the exporter) up to a certain amount per annum (or

other time span) without the necessary paperwork and approval process for each transaction.

(6) Formulation of strategies to minimize the risk of large capital losses resulting from the past strategy of borrowing abroad primarily in hard currencies and investing abroad in a weak currency, i.e., the rand. The risk of capital losses is caused by the further devaluation of the rand, and in particular, when the rate of devaluation exceeds the interest rate differentials between the rand and hard currencies. The time allocated for the workshop did not permit further elaboration on this important point. At the request of the Governor of the Central Bank, however, the consultants did provide some very detailed recommendations to him and his senior staff. These recommendations were shared with the director of the USAID Mission and were very well received by both institutions.

(7) Design of economic policies geared towards diversifying Swaziland's international trade patterns and lessening economic dependence on South Africa. This economic dependence creates risk for breaking up the one-to-one foreign exchange arrangement between the lilangeni and the rand; yet this foreign exchange tie limits Swaziland's independence in formulating monetary and foreign exchange policies. Therefore, economic policies should be formulated to enable Swaziland to eventually break off from this relationship in the foreseeable future without the significant risk currently associated with such a step.

(8) Preparation of documentation for a well-defined strategy for the forthcoming negotiations regarding possible changes in the Southern Africa Customs Union (SACU) and Common Monetary Area (CMA). The total revenue collected from customs duties will be smaller in the foreseeable future as a result of the progress made by the General Agreement on Trade and Tariffs (GATT). Each SACU member nation should expect a smaller revenue from this source as a result. (Resulting duties currently total approximately 40 percent of all revenue for the GOS). A related matter is how to possibly change the formula used by SACU to allocate the total revenue among the member states. Hopefully, Swaziland may be able to obtain a favorable share.

APPENDIX A: OFF-SHORE BANKING IN MAURITIUS

APPENDIX A: OFF-SHORE BANKING IN MAURITIUS

Of the offshore centers currently in operation, one of the newest, Mauritius, is also the closest to Swaziland geographically.

The off-shore banking program in Mauritius is integrated with an overall plan for a business, manufacturing, shipping and overall trade/free port "off-shore center." The legislation was enacted in 1989 as a coordinated effort to attract foreign investment. Success of the off-shore banking sector to date has been disappointing, but the establishment of the underlying liberalized economic policies has been given credit for improved, though modest, economic performance in general.

The Mauritius legislation includes the following key elements:

- An initial income tax of 5 percent, which has been reduced to zero
- Free repatriation of profits
- Elimination of all foreign exchange controls
- Personal income tax of expatriate staff established at half the usual rate in Mauritius
- Zero withholding tax on dividends and other payments from off-shore entities
- Waiver of withholding tax on interest payments on deposits by non-residents
- Strict bank secrecy laws

As of 1993, only seven banks had set up offshore operations, and six of these were already established banks with existing local operations:

1. Barclays Bank

2. Bank of Baroda

3. State Bank International (a joint venture of the State Bank of Mauritius and the State Bank of India)

4. Banque Nationale de Paris Intercontinental (BNPI)

5. The Hong Kong and Shanghai Bank

6. Banque Internationale des Mascareignes (a joint venture of Credit Lyonnais, Banque de la Reunion, and the Mauritius Commercial Bank)

7. Banque Privee de Edmond de Rothschild (Ocean Indien)

Government figures published in early 1993 put total off-shore banking deposits at only US$161 million. Though the off-shore center effort has not achieved its goals, Mauritian government officials continue to back the program, as do international observers, who particularly endorse the fundamental, liberalized economic policies established to permit the effort.

Because of the center's disappointing and slow development, the Government of Mauritius enacted a new, integrated legislative program in June of 1992, designed to broaden the overall banking, financial, and business activities authorized in the off-shore center. These legislative acts included the Mauritius Offshore Business Activities Act, the Offshore Trusts Act, and Merchant Shipping (Amendment Act). In addition to traditional off-shore banking business, the new program is designed to promote a wide variety of "off-shore" business activity:

- Insurance
- Funds management
- Pension funds
- International consultancy services
- Shipping and ship management
- Aircraft financing and leasing
- International licensing and franchises
- International data processing
- International information technology

The incentives offered to these various business areas are identical to those offered to the off-shore banking units and are intended to promote expansion of the "off-shore center" concept, to include the entire spectrum of business and financial activities.

Conclusion

The results of the efforts in Mauritius to develop off-shore business have been disappointing. Nonetheless, the Mauritian Government remains committed to the liberalization process necessary to allow these activities, and indeed, has extended these policies to the domestic sector in an attempt to promote business development.

APPENDIX B: THE CONCEPT AND PRACTICE OF OFF-SHORE BANKING

APPENDIX B: THE CONCEPT AND PRACTICE OF OFF-SHORE BANKING

Reproduced following is a two-page briefing paper explaining the concept and practice of off-shore banking that the two-person LAI team prepared prior to its arrival in Swaziland.

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19 JANUARY 1994

OFF-SHORE BANKING BRIEFING PAPER

I. The concept and practice of off-shore banking

The term "off-shore banking" refers to commercial and investment/merchant banking business operating in a specifically designed, separate legislative and tax regime that is exempt from all of most banking regulation, foreign exchange controls, and taxes on banking business otherwise applied in the rest of the local economy.

In their pure form, off-shore banks deal only in foreign currencies and only with non-residents, though some off-shore banking arrangements allow limited business involvement with domestic companies and resident citizens, in both local and foreign currencies.

Authorized off-shore banking transactions usually include foreign exchange, lending, inter-bank deposit trading, derivatives (such as futures, swaps, and options), and investment and insurance activities.

An additional characteristic of several (but not all) off-shore banking centers is the element of secrecy or confidentiality, especially regarding the occurrence of taxable transactions, the existence and ownership of assets, and the transfer of money to and from various international and domestic accounts.

II. Potential costs and benefits of off-shore banking

The "costs" of an off-shore banking system tend to be theoretical, inasmuch as the perceived gains or losses to the government or economy as a whole would never have occurred were it not for the establishemnt of the off-shore banking activity in the first place. Such costs include tax revenues foregone and reduced monetary control.

The benefits of off-shore banking are generally accepted as including additional tax revenues from new banking transactions, increased employment, related stimuli to the local economy (such as new investment in office space and equipment), and the introduction of technical expertise to the local economy.

III. Experience in other countries

The concept and practice of off-shore banking originated in London in the 1960s. A related form of off-shore banking involving mostly secrecy and security has existed in Switzerland for over a century. Another financial center, combining the elements of London's de-regulation and Switzerland's secrecy, has developed in Luxembourg.

Developing country off-shore banking centers have become well-established and notably successful in Singapore, Hong Kong, Bahrain, Vanuatu, Panama, Lebanon, and various countries in the Caribbean, such as Grand Cayman., the Netherlands Antilles, and the Bahamas. Recently, other developing countries have established, or are actively exploring, off-shore banking arrangements, including Thailand, Indonesia, and the Philippines.

IV. Investigating the feasibility of off-shore banking in Swaziland

The current investigation will produce a study of the feasibility of off-shore banking in Swaziland and will begin with consultations with government, banking, and business leaders in Swaziland in order to assess the desirability and practicality of establishing an off-shore financial center.

In addition, the investigation will review the potential economic effects of establishing an off-shore financial center, and will review the practical issues involved in Swaziland, including legislative changes.

The investigation will also relate Swaziland's circumstances to the experience of other off-shore banking centers, with particular attention to developing countries, especially Bahrain, Singapore, and Hong Kong. In light of the significance of South Africa and its economy to Swaziland, special attention will also be given to the economic, banking, and business circumstances and plans of that country, and to Swaziland's membership in SACC.

A workshop will be arranged in Swaziland for government, banking, and business leaders to explain and review the concept and practices of off-shore banking, and to discuss the potential overall economic and practical business effects of such a center on Swaziland.

A plan of action will be recommended which may propose further steps to explore the feasibility of off-shore banking in Swaziland. This report will be provided to the Government of Swaziland and to USAID.

APPENDIX C: WORKSHOP SUMMARY REPORT

APPENDIX C: WORKSHOP SUMMARY REPORT

A workshop sponsored by the Central Bank of Swaziland was held in Mbabane on February 3, 1994, to give the consultants an opportunity to present their findings, conclusions, and recommendations to a critical audience of GOS officials and senior representatives of the Swazi private sector.

Prior to this workshop, the consultants presented their conclusions in separate meetings with the following individuals and their senior staff members: the Governor of the Central Bank, the U.S. ambassador to Swaziland, and the USAID Mission director. A summary report produced for these meetings was also used as a handout at the workshop.

This summary report is reproduced below in its entirety.

OFFSHORE BANKING WORKSHOP

February 3, 1994

<u>Summary Report</u>

Content Outline

1. Definitions of "Off-Shore Banking"
2. Costs and Benefits to the Host Country
3. Characteristics of Off-Shore Banking
4. Competition from Existing Off-Shore Centers
5. Relevant Legislation and International Treaty Obligations of the Kingdom of Swaziland and Changes which May Become Necessary
6. Implications of a Broader, Potentially Profitable Off-Shore Banking Facility

7. Alternative Suggestions

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1. Definitions of Off-Shore Banking

* A NOTE DEFINING THE BUSINESS OF OFFSHORE BANKING

Authorized offshore banking transactions usually include deposit taking, lending, foreign exchange, interbank deposit trading, investment and merchant banking activities (including equity investments for the banks' accounts and corporate financial and investment advise), derivatives and derivative trading (such as futures, swaps and options), funds management, and in some cases insurance activities.

* THE MOST LIMITED DEFINITION OF OFFSHORE BANKING

In its simplest, most restricted form, "offshore banking" refers to commercial and investment/merchant banking business operating in a specifically designed, separate legislative and tax regime, exempt from all or most banking regulations, foreign exchange controls and taxes and duties on banking business otherwise applied to the rest of the local economy.

In their pure form, offshore banks deal only with non-residents and only in currencies other than that of the host country. To state it differently, offshore banks are financial institutions licensed to use the host country as a base for transacting banking business which occurs outside the host country, with customers who are not residents of the host country, in currencies other than the local currency.

* THE MORE LIBERAL VERSIONS OF GENERAL OFFSHORE BANKING

There are a wide variety of different forms of offshore banking, ranging from the restrictive, limited form described above, to the more liberal centers, where very few restrictions apply. Of the large "offshore" centers, London and Hong Kong are probably the most liberal and allow banking business with resident and non-resident customers, with no significant foreign exchange restrictions. Generally accepted banking standards and close overall supervision from the authorities, however, are usually applied in these centers, as they do in several other centers, such as Singapore and Bahrain.

* THE SPECIALIZED TYPE OF OFFSHORE CENTER - PERSONAL OR PRIVATE OFFSHORE BANKING (THE TAX HAVEN)

A final type of offshore banking takes the form of a personal banking center, with the host country providing complete freedom from foreign exchange restrictions, as well as specialized banking and tax laws which offer non-residents the ability to engage in banking transactions in secrecy, with few if any taxes allowed to apply, either on-shore or from offshore. Although famous as centers of individual banking, corporations and large investment funds also avail themselves of the advantages of confidentiality and tax avoidance. The most famous such center, of course, is Switzerland, with later entrants in the Caribbean gaining considerable popularity, such as Grand Cayman, the Bahamas, and the Netherlands Antilles. Other examples include the British offshore islands of Jersey and Guernsey, Gibraltar, and Vanuatu and the Cook Islands in the Pacific.

* WHY CUSTOMERS SEEK OFFSHORE BANKING

Banking customers, whether individuals, corporations, or institutions (and sometimes governments themselves) have a wide variety of reasons for seeking offshore banking assistance. These reasons frequently involve one or a combination of the following two major characteristics:

- Relief from general economic and political difficulties and government regulation of financial, industrial, and general business activities

These difficulties could include political instability and government corruption, or inappropriate economic policies resulting in low or negative growth rates, or runaway inflation.
In addition, over-regulation of business activity by some legislative programs and government bureaucracies can drive business activities to offshore locations to reduce the administrative burdens and costs of doing business.

- Legal tax avoidance or tax minimization

Tax avoidance or minimization is, of course, a time-honored pursuit of individuals and businesses everywhere. When the methods followed are legal, offshore centers can have useful roles in promoting business success and frequently sound economic growth that might not otherwise have occurred.

2. Costs and Benefits to the Host Country

"The number of countries willing to act as offshore centers is clearly related to their perceptions of the costs and benefits involved. Ideally, a country's decision to specialize in offshore business - to introduce the requisite legislation, to invest in telecommunications and infrastructure, and to accept the potential indirect costs - would depend upon an explicit assessment of the expected future net welfare gain, discounted over time. In practice, however, there are many uncertainties and inherent difficulties in quantifying many of these costs and benefits. All that a country's authorities can do is to list the potential costs and benefits and make an ad hoc assessment as the opportunities occur to host these banks." (Dr. Ian McCarthy, IMF Economist)

COSTS

In one sense, many of the "costs" of an off-shore banking center tend to be theoretical, inasmuch as the perceived gains or losses to the government or to the economy as a whole would never have occurred were it not for the establishment of the off-shore banking activity in the first place. Other costs and incremental expenditures, however, both direct and indirect, are quite real and may include:

* Telecommunications improvements
* Education expenditures
* Bank supervision
* Overall government oversight responsibilities
* Potential competition with local banks
* Tax revenues foregone (income taxes, withholding taxes, and stamp duties)
* Transport and other infrastructural improvements
* Tax evasion schemes

* Illegal business transactions or money "laundering"
* Potential reduced control over monetary policy
* Potential reduced control over foreign exchange flows
* Promotional and establishment expenses
* Potentially inflationary effect of demand for office space, housing, and professional services

Costs to the private sector participants would depend significantly upon the size and staffing of the new off-shore facilities. For established banks, most of these costs would be minimal, but for new entrants the costs would be significant. For example, one high cost component would be the leasing of telecommunications equipment and capabilities, in particular the dedicated telecommunication lines to leading financial centers throughout the world.

BENEFITS

Assuming a restricted or narrow definition of "offshore banking" (allowing only offshore business with non-residents in foreign currencies), the benefits to the host country are decidedly limited.

* Payment of salaries and other local expenditures
* Additional tax revenues and fees from new banking transactions and profits (note limitations due to the necessity of incentives)
* Increased employment (also quite limited)
* Multiplier effect to the local economy
* Introduction of financial, business, professional and technical expertise to local economy
* If successful, enhanced reputation of the host country and synergies

  to its foreign investment and other development programs

In the case of expanded or more liberal versions of "offshore banking," (allowing some forms of banking business with residents in local as well as foreign currencies, for instance), the impact on the local economy and the benefits to the host country can be significant. Such benefits might include:

* Introduction of new investment capital to the local economy

* Expansion of currently available banking services and the introduction of new banking products and activities

The establishment of a more liberal offshore banking center, such as Hong Kong and to some extent Singapore, which would allow business with local residents in local and foreign currencies, and which thus would have the additional and more significant benefits to the local economy noted above, would require the elimination or significant reduction of foreign exchange controls.

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3. Characteristics of Off-Shore Banking

NON-RESIDENT CUSTOMERS - NOW CHANGING TO ALLOW LOCAL CUSTOMERS

TRANSACTIONS OUTSIDE THE HOST COUNTRY - ALSO CHANGING TO ALLOW LOCAL TRANSACTIONS

TAX FREE

NO FOREIGN EXCHANGE CONTROLS

MINIMAL REGULATION

SECRECY - VARIES

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* Transact a full range of banking and other financial products or may specialize.

* Business restricted to non-residents in currencies other than the local

currency. Some versions allow business with local residents, in local currencies.

* Free from foreign exchange restrictions.

* Subject to no income taxes (or minimal income taxes).

* Other taxes, such as withholding taxes on interest, are also eliminated or reduced to a minimal level.

* Free from most banking regulations, such as host country reserve requirements and reporting. Also exempted from most other regulations.

* Usually (though not always) remain subject to some form of generally accepted bank supervision by the host country (often in cooperation with the supervisory authorities of the bank's home country.

* Banking secrecy or at least a high degree of confidentiality is usually maintained.

4. Competition from Existing Off-Shore Centers

Competition from existing offshore banking facilities is stiff and has been increasing during recent years. The global territorial pattern that has emerged from the competitive forces has four primary offshore core regions, located in proximity to, and usually within the same business time-zone. Each of these four primary offshore core regions has a principal global/regional capital market at its epicenter. These four primary offshore regions and their principal global/regional capital markets are:

(1) The European enclave, coastal enclave, and "independent" islands within the London and continental European time-zone longitudes.

(2) Certain Persian Gulf states servicing Middle Eastern oil-rich countries.

(3) The Caribbean/Central American basin, servicing the North and South American continents largely within the New York time-zone longitude.

(4) Hong Kong, Singapore, Vanuatu and Nauru servicing the Asian-Pacific basin and the sub-region of Oceana, largely within the Tokyo time-zone longitude.

The experience of these centers, especially the better-known, long-established ones such as Singapore, Hong Kong and Bahrain has been very successful. Other large financial centers have de-regulated to such an extent that they are for all intents and purposes "offshore" as well as "onshore" (London and more recently New York). Several smaller, tax-oriented centers have also been successful; these include Switzerland, Grand Cayman, Luxembourg, the Bahamas, Vanuatu and the Netherlands Antilles.

Some recent entrants, however, have experienced only limited success, due to strong competition, the world-wide trend to de-regulation and liberalization of financial markets, and faulty programs of incentives and promotion.

5. Relevant Legislation and International Treaty Obligations of the Kingdom of Swaziland

FOREIGN EXCHANGE CONTROL

* THE EXCHANGE CONTROL ORDER, 1974 (KING'S ORDER-IN-COUNCIL NO. 40 OF 1974).
* THE EXCHANGE CONTROL REGULATIONS, 1975 [DATE OF COMMENCEMENT: 24 JANUARY 1974].
* THE MANUAL OF EXCHANGE CONTROL RULINGS.
* THE TRILATERAL MONETARY AGREEMENT BETWEEN THE KINGDOM OF SWAZILAND, THE KINGDOM OF LESOTHO, AND THE REPUBLIC OF SOUTH AFRICA, DECEMBER 5, 1974, AS AMENDED BY THE TRILATERAL AGREEMENT, APRIL 18, 1986 (THE "COMMON MONETARY AREA" OR THE "CMA").
* THE BILATERAL AGREEMENT BETWEEN THE KINGDOM OF SWAZILAND AND THE REPUBLIC OF SOUTH AFRICA, APRIL 18, 1986.

A. Swaziland's foreign exchange laws and regulations

1. "Except with permission granted by the minister [of finance] and in accordance with such conditions as the minister may impose, no person other than an authorized dealer shall buy or borrow any foreign currency or

any gold from, or sell or lend any foreign currency or any gold to any person not being an authorized dealer." (The Exchange Control Regulations, 1975, Section 3. Paragraph (1)).

2. " No authorized dealer shall buy, borrow or receive or sell, lend or deliver any foreign currency or gold except for such purposes or on such conditions as the Minister may determine."(The Exchange Control Regulations, 1975, Section 3. Paragraph (2)).

B. Administration of Swaziland's foreign exchange controls

" The [the Central Bank of Swaziland] will ... act as agent for the government in the administration of exchange controls in accordance with such regulations, instructions and directives as the minister of finance ... shall issue from time to time." (Explanatory note to the exchange control regulations, 1975).

C. International Treaty Obligations - the Common Monetary Area

1. Transfer of Funds Within the Area - "A contracting party shall not apply any restrictions on the transfer of funds, whether for current or for capital transactions, to or from the area of any other contracting party ...." (The Trilateral Monetary Agreement, 1974, hereinafter referred to as the "CMA," Article 3, first paragraph).

2. Each Country May Prescribe Its Own Rules for Domestic Financial Resources - "Provided that the Governments of Lesotho and Swaziland may introduce measures, including measures relating to the investment of funds or portions of funds in domestic securities, for the mobilization of domestic resources in the interest of development of their respective areas." (the CMA, Article 3, second paragraph).

3. Compliance With the Monetary, Investment and Securities Policies of all Three Countries - "Provided ...that, whenever a contracting party has reason to believe that the effect of an inward or outward transfer of funds may be, is or has been to evade any such requirements prescribed or measures introduced by any other contracting party, it shall consult such other contracting party with a view to rectifying the matter." (The CMA, Article 3, third paragraph).

4. Foreign Exchange Control - "The exchange control provisions of the Governments of Lesotho and Swaziland shall be in material aspects be in accord with exchange control provisions in force in South Africa

as amended from time to time...." (The CMA, Article 5, paragraph 3).

5. Substantive Amendments to Swaziland's Foreign Exchange Controls Require "Consultation" with South Africa - "Whenever [Swaziland] desires to amend any part of the [foreign exchange controls] [it] shall notify the Government of South Africa of its intent to enter into consultations for the purpose of amending [its foreign exchange controls." (The Bilateral Agreement Between The Kingdom of Swaziland and the Republic of South Africa, April 18, 1986 (hereinafter referred to as the "Bilateral Agreement").

TAXATION AND DUTIES APPLICABLE TO FINANCIAL TRANSACTIONS

* THE INCOME TAX ORDER 1975 (KING'S ORDER IN COUNCIL No. 21 OF 1975), AS AMENDED,INCLUDING AMENDMENTS CONTAINED IN THE INCOME TAX (AMENDMENT) BILL No. 7 OF 1987.

* STAMP DUTIES ACT (ACT No. 37) OF 1970 AND THE STAMP DUTIES (AMENDMENT OF SCHEDULE) NOTICE, 1990.

A. Income Tax

1. "There shall be charged, levied and paid an income tax, known as "normal tax", in respect of the taxable income, received by or accrued to or in favor of any person during the year of assessment... and each succeeding year of assessment thereafter." (The Income Tax Order of 1975, as Amended, Part II, paragraph (1)).

2. Rates applicable to taxable income are established as a schedule to the tax law. Rates currently applied (1993/94) range from 12% to 39%, which compare favorably to rates in many countries. Offshore banking centers, however, frequently do not apply an income tax to income resulting from offshore business. Hong Kong and the offshore centers in the Caribbean, for instance, do not charge an income tax on offshore income, while Singapore assesses only 10%.

B. Withholding Tax on Interest Payments

Swaziland currently applies a 10% withholding tax on the payment of interest to non-residents. This would have no immediate effect on possible offshore interest, but it should be noted that as in the case of income taxes, most offshore banking centers have eliminated the withholding tax on interest.

OTHER RELEVANT LEGISLATION AND TREATIES FOR DISCUSSION AND REVIEW

* CUSTOMS UNION AGREEMENT BETWEEN THE GOVERNMENTS OF SWAZILAND, BOTSWANA, LESOTHO, AND SOUTH AFRICA (COMMONLY REFERRED TO AS "SACU"), DECEMBER 11, 1969.

* THE MONETARY AUTHORITY OF SWAZILAND [NOW THE CENTRAL BANK OF SWAZILAND] ORDER, 1974 (KING'S ORDER-IN-COUNCIL No. 6 OF 1974), AS AMENDED.

* THE FINANCIAL INSTITUTIONS (CONSOLIDATION) ORDER 1975 (KING'S ORDER-IN-COUNCIL No. 23 OF 1975.

* THE FINANCE ACT, 1975 (ACT No. 8 OF 1985).

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6. Implications of a Broader Off-Shore Banking Facility in Swaziland

The only way in which the potential profitability of an offshore banking facility in Swaziland could possibly be captured is through elimination of, or at least significant reduction in Swaziland's foreign exchange control system, because the broader interpretation of such a facility would be followed (i.e., residents could also partake in the facility's transactions). The forthcoming observations should be recognized for following such an avenue:

(1) The South African rand continues to be overvalued for as long as the foreign exchange control system in that country will prevail (a further, gradual devaluation of the rand can also be expected during this time span of foreign exchange control).

(2) Given the serious economic problems in South Africa, one should not expect that the government in this country will abolish the exchange control system within the next two to three years, or, quite possibly, an even longer time span. The new government to be elected next April could not afford the tremendous legal capital flight resulting from abolishing the foreign exchange control system.

The International Monetary Fund is not likely to pressure the South African Government for immediate elimination of the foreign exchange control system.

(3) Given the one-to-one relationship between the lilangeni and the rand, and the artificially overvalued rand, one must conclude that the lilangeni is also overvalued.

(4) The current treaty obligations between the governments of Swaziland and South Africa require that the Swaziland Government advise, or consult with the South African Government of an intended reduction or elimination of Swaziland's foreign exchange control system.

A decision by the Government of Swaziland to significantly reduce or eliminate the foreign exchange control system in the Kingdom (needed to capture the potential profitability of a broader interpretation of an offshore banking facility) would have the following expected results and implications:

(1) The lilangeni would devalue vis-a-vis the hard currencies and the rand, because of the lilangeni's overvaluation and the continued South African foreign exchange control system.

(2) A devaluation of the lilangeni vis-a-vis the rand would mean, at least in the short run, a somewhat chaotic situation in the local markets where the rand and the lilangeni have been used interchangeably.

(3) A devaluation of the lilangeni would mean that all of the imported goods and services, from both South Africa and other countries, would become more expensive in Swaziland. Given the significant volume of imports in Swaziland, this increase in prices would translate in a rather significant economic hardship for the people of Swaziland.

(4) Given the imported inputs and components in Swaziland's production processes, the devaluation of the lilangeni would also imply that a number of domestically produced products would increase in price, thereby further enhancing the sacrifice to be made by the commonality.

(5) The devaluation of the lilangeni would imply that Swaziland's exports become somewhat more competitive in the world market. However, given the anticipated price and income elasticity of the major types of Swaziland's exports (sugar, wood pulp, and soft drink concentrates, all known to have rather inelastic price and income effects), the additional export income to be expected from a devaluation of the lilangeni is rather small.

(6) Swaziland's Government, parastatals, and some private sector corporations have foreign loan servicing obligations. A devaluation of the lilangeni would mean that the foreign loan servicing by all these parties will become more difficult. Swaziland Government's foreign borrowing is primarily in hard currency, which

implies that this loan servicing, in particular, will become more difficult (because elimination of Swaziland's foreign exchange control system would imply a greater devaluation of the lilangeni vis-a-vis hard currencies than vis-a-vis the rand, since the rand will continue to be overvalued vis-a-vis the hard currencies). Most of the parastatals already face very difficult but necessary adjustments, and these adjustments will become even more difficult with a devaluation of the lilangeni.

(7) The rise in the rate of inflation resulting from a devaluation of the lilangeni could very well spark off demands for wage increases and demands to raise administered prices, which would cause the rate of inflation to accelerate upwards An ever increasing spiral of inflation and devaluation could be set in motion. A number of countries around the globe, including nearby Zimbabwe, have experienced this unpleasant lesson.

(8) An extremely tough set of macro-economic policies, including high interest rates, selective tax increases, cuts in government spending, and reductions in consumer spending, would be required to counteract an increasing spiral of inflation and devaluation, possibly resulting from an elimination of foreign exchange control in Swaziland. Developing nations provide many examples of devaluations that have not had the intended effects and called for drastic measures to eventually overcome the awful economic conditions (e.g., Bolivia, Argentina, Mexico, Indonesia, and a number of NIS countries).

(9) Though a devaluation of the lilangeni would increase the local currency value of the customs union revenue, the anticipated inflation would wash away the purchasing power of this source of income for the Government.

(10) On the political front, a significant reduction in, or elimination of the foreign exchange control system in Swaziland would jeopardize good relationships with the South African Government, because this latter Government would not appreciate the "escape route" for capital flight provided by such a reduction or elimination. It is hard to visualize how Swaziland could eliminate the foreign exchange control and still belong to the CMA nations. Swaziland would have to follow the same route as Botswana and leave the CMA countries. One must realize, however, that Botswana's economic conditions were quite different from Swaziland's (e.g., with respect to foreign exchange earnings, balance of payment position, and economic interdependence with one large nation only).

Given the foregoing expected results and implications, it is not recommended that Swaziland significantly reduce or eliminate its foreign exchange control system for the sake of possibly capturing the potential benefits and profitability of an offshore banking facility.

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7. Alternative Suggestions

The lack of significant potential benefits and profitability of an off-shore banking facility in the foreseeable future does not mean that Swaziland has no attractive alternatives. On the contrary, the following potentially beneficial avenues are strongly recommended for follow-up:

(1) Complete the investment code as soon as possible and ensure that this code is attractive for direct foreign investments in Swaziland.

(2) Ensure the availability of globally competitive credit swaps for foreign direct investments.

(3) Assess the feasibility of establishing an export processing zone or free trade zone (also known as "foreign trade zone") in Swaziland. Such a zone could attract important direct foreign investments to Swaziland and render this kingdom less economically dependent on one country only (i.e.: South Africa). Furthermore, such a zone could be considered together with a special banking facility, which, eventually (i.e.: after several years) could grow into the broader concept of an offshore banking facility.

(4) Consider an initially limited and gradual lifting of foreign exchange control. For example, commercial banks could be given the authority to provide credit to a domestic exporter and cover the hard currency loan used by the bank via a forward contract (in order to lower the interest rate charged to the exporter) up to a certain amount per year (or other time span) without the necessary paper work and approval process for each transaction. A similar arrangement could be made for foreign investors (like the Nigerian Government for a previous transaction) willing to invest in securities available at the Swaziland stock exchange.

(5) Together with the gradual changes in the foreign exchange control system, on a coordinated basis, assess other laws and regulations possibly affecting foreign direct investments. Where necessary, ensure desirable changes.

(6) Prepare thorough documentation for a well-defined strategy for forthcoming negotiations regarding changes in the South African Customs Union (SACU) and Common Monetary Area (CMA). One should recognize that, on a per capita basis, the balance-of-payments position and the status of government debt and deficit, is much healthier in Swaziland than in South Africa. This recognition may facilitate Swaziland's position during the negotiations.

(7) Formulate economic policies geared toward further diversification of Swaziland's international trade pattern and lessening its economic dependence on South Africa.

APPENDIX D: LIST OF INDIVIDUALS INTERVIEWED

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John T. Sprott
U.S. Ambassador to Swaziland

Mrs. Valerie Dickson-Horton
Director, USAID/Swaziland

Dr. James Nxumalo, Governor
Central Bank of Swaziland

Edward Baker, Senior Manager
USAID/Swaziland

Muntu P.N. Mswane, Minister
Ministry of Commerce and Industry
Government of Swaziland

J.S. Shabangu
Minister of Finance
Ministry of Finance
Government of Swaziland

Louis D. Nxumalo
Sr. Projects Analyst

Tibiyo Taka Ngwane
A Nation in Progress

Mike D. Nkosi
Personal Asst. to G.M.

Philip M. Jones
Deputy Chief of Mission
U.S. Embassy
Swaziland

Mary T. Gudjonsson
Attache for Political & Economic Affairs
U.S. Embassy
Swaziland

Jamie L. Raile
Sr. Project Mgr., Private Enterprise
USAID/Swaziland

Donald Henry, General Mgr.
Swazi Business Growth Trust

Tony Sturges, Manager
Foreign Exchange Services
Stanbic Bank Swaziland

Gavin R. Knox
Asst. to Managing Director
Stanbic Bank Swaziland

Peter N.L. Dart
Executive Director, Finance
Standard Chartered Bank Swaziland Ltd.

Christopher Evans
Managing Director
Meridien BIAO Bank Swaziland
Limited

Mark S. Teversham
Managing Director
Barclays Bank of Swaziland Limited

Uditha H. Palihakkara
Financial Specialist
Swaziland Development & Savings Bank

J.J. Dlamini
Deputy Managing Director
Swaziland Development & Savings Bank

Obed N. Maziya
Financial Analyst
Swaziland Development & Savings Bank

Andrew McGuire
Chief Executive Officer
Swaziland Stockbrokers Limited

Robin K. Blackburn
Representative Swaziland
Commonwealth Development Corp.

Michael Black
Chief Operations Officer
Swaziland Royal Insurance Corporation

Andrew Colhoun
General Manager
Swaziland Sugar Association

John R. Masson
Executive Director
Swaziland Cane Growers' Assn.

Glenn T. Magagula
Pro Vice-Chancellor
University of Swaziland

Dennis B. Punt
Managing Director
Swaziland Posts & Telecommunications Corp.

Ray Thomas
Director of Finance & Supplies
Swaziland Posts & Telecommunications Corp.

P.M. Shilubane
P.M. Shilubane & Associates

N.R. Caplen, Director
Swaziland Building Society

Hon. T. Masuka, Minister of Economic Planning
Government of Swaziland

Michael Mmema, President
Sibakho Chamber of Commerce

Absalom Thwala
Attorney General
Government of Swaziland

M.B. Samketi
Asst. to Governors
Central Bank of Swaziland

Zakhele W. Lukhele
Assistant Manager
Central Bank of Swaziland

Sydney M. Kumalo
Secretary to the Board
Central Bank of Swaziland

Martin G. Dlamini
Deputy Governor
Central Bank of Swaziland

Bongani Vilakazi
Consular Assistant
U.S. Embassy

Siphiwe M.T. Dlamini
Central Bank of Swaziland

Stephen L. Simelane, Mgr.
Bank Supervision
Central Bank of Swaziland

Peter K. Thamm
Swaziland Industrial Development Company Ltd.

Tladl Ramushu
Head of Project Appraisal
Swaziland Industrial Development Company Ltd.

Shelton M. Tsabedze
Financial Controller
Swaziland Industrial Development Company Ltd.