Letter of Intent

Mbabane, July 20, 2020

Ms. Kristalina Georgieva
Managing Director
International Monetary Fund
Washington, D.C. 20431

Dear Ms. Georgieva,

1. The Government of the Kingdom of Eswatini hereby requests financial support from the IMF under the Rapid Financing Instrument (RFI) in the amount of SDR 78.5 million (100 percent of quota) to mitigate the urgent balance of payments needs arising from the adverse impact of the COVID-19 pandemic on the economy. The government also requests that, upon approval by the IMF's Executive Board, and following parliamentary approval of the loan, the full amount of the RFI purchase be made available as direct budget support to the Ministry of Finance's account at the Central Bank of Eswatini (CBE). This purchase is critical to help the government to address the impact of the pandemic on the economy.

2. The COVID-19 pandemic is having a severe impact on Eswatini. The virus is spreading rapidly, and Eswatini's relatively high HIV/AIDS prevalence and an already pressured health care system exacerbate risks that the pandemic could propagate even faster. To contain the pandemic, the government has swiftly put in place an array of containment measures. It has declared a national emergency and imposed a partial lockdown across the country, including travel bans, closure of schools and universities, and a suspension of all non-essential activities. These measures, combined with a sharp decline in external demand for Eswatini's key exports and spillovers from South Africa, are causing a dramatic fall in economic activity. Our preliminary assessment suggests a contraction in real GDP of 3.5 percent this year, 6 percentage points lower relative to our estimate from just a few months ago. Given the uncertainty as to the depths and duration of this crisis, this estimate comes with significant risks.

3. To support the economy and preserve financial stability, the CBE has adopted a more accommodative policy stance and supported liquidity provision. In the context of the peg, the CBE has followed the South African Reserve Bank and reduced the policy rate by 250 bps since mid-March and reduced banks' liquidity and reserve requirements.

4. Despite the policy response, our external position is under stress and urgent BOP needs have emerged. The current account surplus is projected to decline to about 1 percent of GDP compared to 4.2 percent of GDP in 2019, as a reduction in the country's key exports (beverages, sugar, and textile), and lower remittances and returns from investment abroad would only be partially offset by a slowdown in imports. SACU receipts still support a positive current account, but the financial account

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is posited to deteriorate largely because of a decline in FDI, temporary higher portfolio outflows, as investors search for safer investments, and lower external financing for government's capital projects. Despite a depreciation of the currency, we expect external financing needs of US$163 million for this year that, if not financed, will lead to a further decline in already low international reserves.

5. The COVID-19 pandemic is also severely affecting the budget. The economic recession is affecting domestic revenue, which are expected to fall short of the budget target by 2.6 percent of GDP. Moreover, to mitigate the impact of the pandemic, the government has put in place a response package at the cost of about 1.5 percent of GDP. The package includes additional health spending, ramped up food assistance programs, increased social protection transfers, and improved access to water and sanitation facilities for the vulnerable. Given the limited fiscal space, Cabinet has approved a supplementary budget for FY20/21 to accommodate the additional pandemic-related spending within the existing overall budget ceiling by curtailing spending authorization for capital outlays, selected operating expenses, including transfers to public entities, and limiting hiring plans. Despite this prudent approach, given the reduction in GDP, the fiscal deficit is projected to widen to about 8½ percent of GDP, compared to 4.7 percent targeted in the 2020 budget and gross financing needs are projected to approach 25.8 percent of GDP. While part of the budget financing needs will be covered in the domestic market, we estimate an additional US$207 million (5.3 percent of GDP) is required to close the fiscal financing gap for the year. We expect the immediate budgetary impact of the pandemic to subside towards the end of the year.

6. The requested RFI purchase will finance part of the projected external financing needs arising from the COVID-19 shock in 2020. It will also play a catalytic role in securing additional support from our development partners. Beyond a commercial loan already secured to partially repay past domestic arrears, we expect additional financing from the World Bank and the African Development Bank to address the impact of the COVID-19 emergency and contribute to fully finance the FY20/21 budget and cover part of the financing needs for the following years as SACU revenues are expected to decline. We are also developing a contingency plan, should the need emerge, to further scale up pandemic-related government spending, to be financed through reductions in non-priority expenditures. Finally, if there is any remaining budget financing gap in FY20/21, in the context of the October 2020 Mid-year Budget Review, we will issue a supplementary budget to avoid the accumulation of new arrears.

7. Going beyond the current year, the government of the Kingdom of Eswatini remains fully committed to its Recovery Roadmap and to implement policies to preserve macroeconomic stability.

- First and foremost, we have developed a detailed medium-term fiscal consolidation plan to stabilize public debt and bolster external buffers, while protecting the most vulnerable. Cabinet has approved a plan to adopt consolidation measures of 6½ percent of GDP over the next three years starting in FY21/22, which are part of the government's Medium-Term Recovery Strategy. The current economic recession and the expected slow recovery will require us to implement the adjustment gradually, backloading some measures. Our fiscal adjustment strategy is centered around four pillars. We will contain public wage spending, continuing our policies of gradual employment reduction and lower-than inflation salary

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adjustments. We have commissioned an external review of the extra budgetary sector with the aim of rationalizing spending and transfers to key state-owned entities and merge entities with similar mandates over time. We will also continue to pursue new ways to reduce our operational expenditures, and intend to improve the targeting of our main social assistance programs. In addition, about 40 percent of our adjustment plan relies on boosting our domestic revenue by broadening tax bases, increasing some tax rates such as personal taxation and VAT, and continuing strengthening tax administration. To protect revenue collection, we also commit not to introduce measures that would reduce corporate income tax revenue. This strategy will allow us to broadly preserve capital spending and domestic capital accumulation, and caring more effectively for the most vulnerable members of the society.

- We are committed to support the peg and enhance the banking system liquidity management. The CBE has issued a public notice to communicate its objective to stabilize excess liquidity in the banking system, including liquidity injected through the expected external flows to finance public spending, and its enhanced liquidity management instruments. It has advised the market that it is reactivating weekly auctions of CBE bills as the main tool to stabilize excess liquidity and stands ready to modify reserve requirements as needed. As part of the effort to modernize the liquidity management strategy, the CBE has also improved the terms on which banks can obtain liquidity by reducing the cost of its overnight lending facilities, and has introduced a term discount window facility and will continue to develop its liquidity forecasting capacity.

- Preserving financial stability remains a key policy objective. The CBE has recently introduced temporary regulatory relief measures for COVID-19 affected loans, including payment holidays and forbearance measures. It has also enhanced reporting requirements on banks' liquidity and deposits, introduced more frequent stress tests for key categories of risk in bank's balance sheets, including for COVID-19 affected loans, and required banks to more frequently conduct portfolio reviews and risk assessments. To ensure risks in the banking sector are well managed, the CBE has suspended plans to increase single exposure limits, has taken steps to ensure that loan classification and provisioning standards are maintained. To further strengthen the regulatory framework, the CBE intends to introduce over the next months an early intervention regime. We are also improving the coordination between the CBE and the Financial Services Regulatory Authority (FSRA), by fast-tracking the establishment of the planned Financial Stability Panel. Moreover, to bolster our crisis management framework, we intend to eventually extend the emergency liquidity assistance toolkit to non-bank financial institutions.

8. The government will intensify reforms to strengthen governance, transparency and accountability, and reduce vulnerabilities to state-capture and other forms of corruptions. We have taken a multi-pronged approach.

- First, we fully recognize the importance of ensuring that financial assistance and budget allocations to support COVID 19-related spending are used for intended purposes. To that

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end, we will: (i) use specific budget lines to facilitate the tracking and reporting of the release of funds of all crisis-mitigation spending, and (ii) publish on the National Disaster Management Agency (NDMA)'s website (www.ndma.org.sz) bi-monthly reports on funds released and expenditures incurred for health, social and other crisis-mitigation spending; (iii) regularly publish, on the Eswatini Public Procurement Regulatory Agency (ESPPRA)'s website (www.sppra.co.sz), signed public procurement contracts for crisis-mitigation spending, along with the names of awarded legal persons and their beneficiary owners, and ex-post validation of delivery; in addition, (iv) the Auditor General will undertake a financial and compliance audit of all crisis-mitigation spending and related procurement processes using independent external audit companies and will publish the results within six-months from the end of the 2020/21 fiscal year. Moreover, the Eswatini Public Procurement Regulatory Agency (ESPPRA) will undertake separate compliance and value-for money audits of all procurement activities related to COVID-19 spending, and publish the result on its website.

- Second, we have set up a transparent strategy to start clearing domestic arrears. All claims will be subject to the standard internal budget spending verification process, including validation of delivery, and the process will be subject to an ex-post review by the Auditor General as part of the budget audit certification process. Cabinet has approved the clearance strategy, which includes Cabinet's approval of any detailed liquidation schedule before payments occur. Moreover, before clearing any arrears, we will publish on the government's website (www.gov.sz) the liquidation strategy and schedule, and all pending claims, both verified and not, with information on claiming legal entities.

- Moreover, to strengthen our PFM framework, we have submitted regulations to fully implement the 2017 PFM law to the Attorney General's Office for final review, and we expect these regulations to be approved by Cabinet in the second half of July 2020, before being presented to Parliament for approval. The full implementation of the law will overhaul PFM processes, strengthening budget credibility and medium-term fiscal planning, and tightening budget execution processes.

- Finally, the government continues to support the strengthening of the Anti-Corruption Commission. Despite the fiscal constraints, the funding to the agency has increased in the last two years to support the upgrading of its systems, building staff capacity, and accelerate the solution of pending cases.

9. As the crisis abates, the government will scale up structural reform implementation to facilitate private investment and support more inclusive and stronger growth. Our objective is to create an enabling business environment focusing on the ease of doing business by leveraging the Recovery Strategy and the 2019 National Development Plan. We are facilitating the setting up of large foreign investment projects by providing factory shells, and will continue developing the recently created special economic zones. We also intend to accelerate reform implementation to improve Eswatini's low doing business ranking, amongst others, by setting up a one-stop shop for businesses, and simplifying license requirements, and property registration. The regulatory

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framework is being reviewed and will be amended in line with international best practice, including to improve protection of minority investors, and taxpayers' appeal rights.

10. As we request the RFI's purchases to be made available as budget support, the Ministry of Finance and the Central Bank of Eswatini have signed a Memorandum of Understanding on their roles in the timely servicing of Eswatini's financial obligations to the Fund.

11. The Kingdom of Eswatini does not have outstanding credit from the Fund and its capacity to repay the RFI purchase is adequate. Repayments will peak at 1.1 percent of GDP and 2.5 percent of exports of goods and services and will remain manageable. The government intends to meet its financial obligations to the IMF on a timely basis. Moreover, our external and public debt sustainability indicators will not change significantly because of the additional financing to cope with the current crisis.

12. In line with IMF safeguards policy, we commit to undergoing a safeguards assessment conducted by the Fund. To this end, we authorize IMF staff to hold discussions with external auditors and provide IMF staff access to the CBE's most recently completed external audit reports. Moreover, we do not intend to introduce measures or policies that would exacerbate balance of payments difficulties. We do not intend to impose new or intensify existing exchange rate and trade restrictions.

13. We are determined to meet the challenge the COVID-19 pandemic has created and the support of the international community will be critical. We look forward to an early approval of financial assistance by the IMF—which will help our effort to bring Eswatini's economy back on a strong path and sustain our fight against poverty. Beyond this much needed immediate financial assistance, we reaffirm our willingness to fully remain engaged with the IMF, to benefit from its policy advice, its technical assistance and, if needed, financial support.

14. In line with our commitment to transparency in government operations, we agree to the publication of this letter and all the documents submitted to the Executive Board in relation to this request.

Sincerely yours,

Neal Rijkenberg

Minister of Finance

Majozi V. Sithole

Governor, Central Bank of Eswatini