Bank of Namibia

Curriculum Vitae

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MONETARY POLICY FRAMEWORK IN NAMIBIA

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1. Introduction

At independence in 1990, Namibia opted to remain in the Common Monetary Area (CMA)[1], whereby South Africa continued to set monetary and exchange rate policies. The Namibian dollar, which was first issued in 1993, has been pegged to the South African currency on the basis of one-to-one parity. The South African rand is also legal tender in Namibia. Such an arrangement requires that a major proportion of the Bank of Namibia's monetary liabilities be backed by the reserve currency (the rand) or other foreign assets.

This paper outlines the monetary policy framework in Namibia, covering its historical evolution, its goals and instruments. As a member of a currency board arrangement, Namibia does not engage in any active discretionary monetary policy. This is primarily subordinated to South Africa's conduct of monetary policy. It is hoped that the paper will contribute to a better understanding of monetary policy issues and challenges, particularly in small open developing economies. This is especially important in view of the debate as to whether floating or pegged exchange rates are optimal policy choices in the case of small open economies.

The paper is arranged as follows. Part II describes the monetary policy framework in Namibia by giving its historical evolution, the objective of monetary policy, and instruments being used to achieve this goal. Part III deals with the question as to whether the monetary policy strategy adopted is effective in meeting the primary objective of low inflation and price stability. Part IV entertains the debate as to whether there is an alternative policy stance, and the final part contains conclusions. Overall, it is argued that the present policy framework is an appropriate mechanism for ensuring monetary stability in Namibia.

2. The framework of monetary policy in Namibia

2.1 Historical background

The German annexation of South West Africa (now Namibia) was abolished and mandated by the League of Nations to South Africa after World War I in 1920, resulting in the incorporation of Namibia into the South African monetary system. Major South African banking institutions were extended to Namibia, mainly to finance commerce and trade. The South African Reserve Bank (SARB) has maintained a branch in Windhoek since 1961. Its role was restricted to the distribution of currency (notes and coin), administration of exchange controls, provision of clearing facilities to commercial banks, and to being a banker to commercial banks.

At independence in 1990, Namibia faced a decision as to whether to remain a member of the CMA or whether to have an independent monetary system by leaving the CMA or going for some other options. The concerns of the new government about redressing the lop-sided dependence of the economy on South Africa, while not undermining the stability and confidence in the economic and domestic financial system, led to Namibia's officially joining the CMA. Namibia's membership of the CMA was formalized by accession to both the multilateral agreement between Namibia, Lesotho, Swaziland and South Africa in 1990 and a separate bilateral agreement with South Africa in 1992. Two dominant features of this arrangement are –

- a commitment by the Bank of Namibia to exchanging the domestic currency for a specified amount of the reserve currency, the rand, without restriction subject to a normal handling charge at a fixed exchange rate; and
- an explicit requirement that at least a proportion of its monetary liabilities be backed by the reserve currency or other foreign assets.

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1 The CMA is one of the oldest monetary integration schemes in sub-Saharan Africa. It involves Namibia, Lesotho and Swaziland (usually referred to as the LNS) and South Africa. Botswana left the then Rand Monetary Area (RMA) in 1976.

In addition, the bilateral agreement provides that either contracting party has the right to issue its own currency. It is also part of the agreement that either party may introduce measures for domestic resource mobilization in the interest of the development of their respective economies. Two issues are inherent in the first two clauses. First is the lack of flexibility in changing the exchange rate and second, the need to fulfil the backing rules.

2.2 Monetary policy strategy in Namibia: objective and instruments

Monetary policy can be broadly described as the action of the central bank to influence short-term interest rates and the supply of money and credit to achieve certain objectives. This is often referred to as discretionary monetary policy, i.e. monetary policy undertaken at the instance of the central bank based on a review of emerging economic conditions. The short-term interest rates referred to here are mainly the bank rate (the rate at which the central bank lends to commercial banks), the repo rate (the rate at which the central bank provides liquidity for commercial banks), and the inter-bank rate (the rate at which commercial banks borrow from one another). This is normally done through open market operations.

Another way to conduct monetary policy is through the discount rate mechanism. Banks can borrow reserves from the discount window of the central bank. When the demand for reserves by commercial banks is unusually high or the supply is unexpectedly low, banks can turn to the window for reserves. The interest they pay on the use of such funds is called the discount rate. This is an important policy instrument and the central bank may effect changes to this rate from time to time, depending on the emerging economic developments and liquidity conditions.

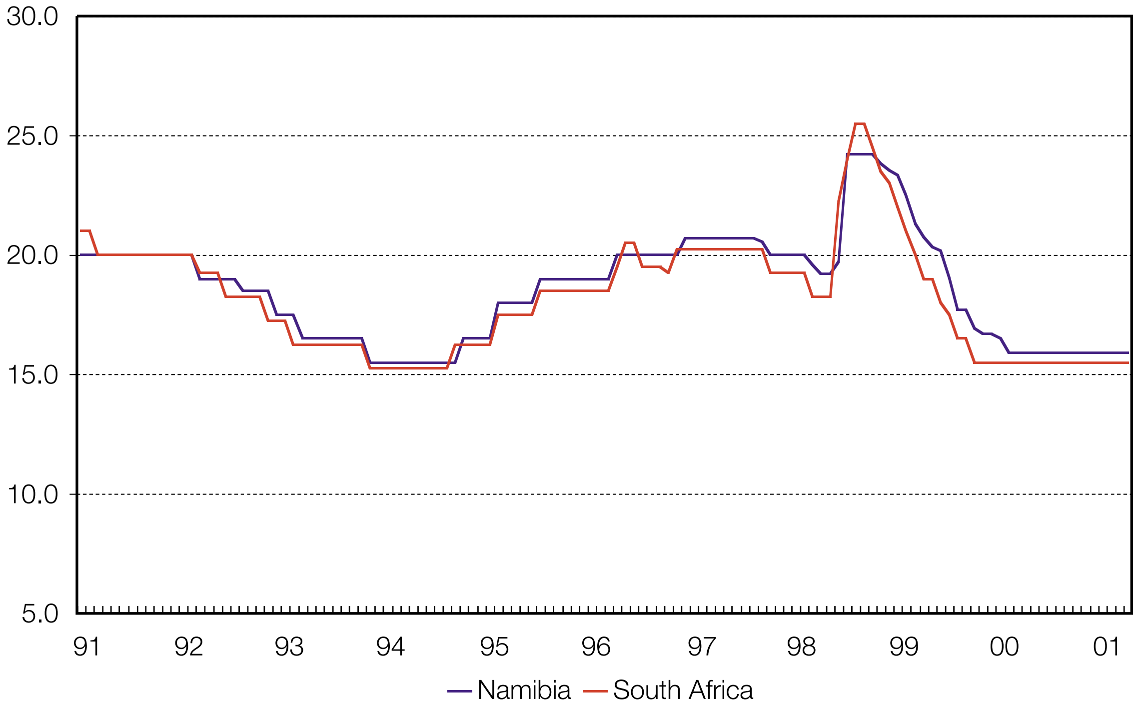
Monetary policy is also conducted through an increase or decrease in cash reserve requirements. Statutory regulations often require that banks hold a certain fraction of their deposits in reserve either as cash in their vaults or as a non-interest-bearing balance at the central bank. In addition to the three instruments discussed above, central banks may sometimes use other policy instruments such as supplementary reserve requirements, moral suasion, and directives in order to achieve the goals of monetary policy.

The Bank of Namibia does not generally use any of the instruments described above in the conventional sense to achieve its objectives of monetary and financial stability. Rather, by pegging the Namibian currency to the South African rand on a one-to-one basis, the objective of monetary stability is achieved. Monetary stability in its strictest sense is coterminous with ensuring price stability. By contrast, financial stability refers to the efforts of Bank of Namibia at promoting the development of sound and well-managed banking and other financial institutions as well as encouraging the development of efficient and well-functioning financial markets.

How does this arrangement ensure monetary stability? Does the stability of the exchange rate (stability of the external value of the currency) necessarily coincide with the stability of the internal value of the currency (price stability)? The experience of countries with a fixed exchange rate has generally demonstrated that (provided the exchange rate is fixed to a low inflation rate and a stable currency), the attainment of exchange rate stability (implied by pegging the Namibian dollar to the rand) will help to ensure that domestic prices approximate prices in South Africa.

On a limited basis, the Bank of Namibia uses the ***bank rate*** to affect commercial banks' reserves. The bank rate is fixed at 25 basis points below the South African repo rate, and other interest rates in Namibia use this as their reference point. The fixed exchange rate arrangement encourages arbitrage that tends to keep interest rates at roughly the same level in the two countries (see Chart 1).

Chart 1: Prime lending rate (Namibia and South Africa)



Source: Bank of Namibia, South African Reserve Bank

Domestic real interest rates may be higher than real interest rates in South Africa by a fairly narrow margin resulting mainly from perceptions of risk and higher operating costs for commercial banks. However, arbitrage will always ensure that interest rate trends in the two countries follow the same pattern.

In addition to the bank rate, Bank of Namibia also uses the ***call rate*** as a policy tool. The call rate is the interest paid to commercial banks for keeping their funds on a short-term basis with the central bank. Commercial banks may be tempted to take advantage of relatively more attractive higher money market rates in South Africa due to the availability of more attractive instruments in that market. To forestall this, and with a view to ensuring that financial requirements in Namibia are not adversely affected, the Bank of Namibia pays a money market related rate to commercial banks that opt to keep their funds with the Bank for relatively short periods of time. The manipulation of this rate could help to affect commercial banks' holdings of excess reserves and expectedly their credit extension. Encouraging domestic banks to keep their excess funds with the central bank also enhances reserve management.

Reserve requirement is another tool that is available to Bank of Namibia for affecting reserves. As discussed earlier, changes in reserve requirements could affect commercial bank reserves in the direction considered desirable by the central bank. However, the use of this instrument has been limited for obvious reasons. Most commercial banks operating in Namibia are subsidiaries of South African banks. Thus, any attempt to set reserve requirements at levels which are substantially at variance with the rates in their headquarters, will result in capital inflows/outflows that might put pressure on the exchange rate arrangement.

Given the exchange rate arrangement, the Bank of Namibia's monetary policy is undertaken with a view to keeping prices (consumer and interest rates) in line with South African rates. This strategy is driven by the desire to achieve and maintain stable and low levels of prices. As long as South Africa remains a low-inflation country (and recent developments point in this direction), the pegged exchange rate should continue to be an appropriate intermediate target[2] for ensuring price stability. It constrains monetary expansion, restrains excessive government spending, and sends out credible signals to economic agents about prospects of inflation.

Economists of all persuasions are now fairly agreed on the fact that price stability is a prerequisite for economic growth. Although price stability does not guarantee that the real economy will perform at the optimum level, the Bank of Namibia believes that this is an important precondition for the attainment of the economic growth potential. Of course, this should be supported by other economic and non-economic factors such as government's taxing and spending policies, skills and productivity levels, etc. In spite of these factors, monetary instability will be detrimental to economic growth. More important, an unstable financial system will exacerbate the negative impacts of these other factors on economic growth.

3. Effectiveness of Bank of Namibia's monetary policy

Empirical evidence suggests that there are costs and benefits associated with pegged exchange rate arrangements. By far the most debated cost is the foregoing of the use of the nominal exchange rate as an instrument of macroeconomic adjustment. Related to this is the increased exposure of the domestic economy to shocks from the anchor country as well as the inability to mitigate the impact of other external shocks. Any policy conclusion as to whether such costs outweigh the benefits or vice versa, largely depends on the relative importance of different macroeconomic variables to researchers and policy makers alike. It is beyond the scope of this presentation to discuss the costs and benefits of Namibia's membership of the CMA[3]. Instead, the paper tries to explain the extent to which this monetary policy strategy is effective in achieving its objective of price stability.

Over the past decade, inflation in Namibia has declined from an all time high of 18 per cent in 1992, reaching a low level of 6,2 per cent in 1998. Although it increased again to 9,3 per cent in 2000, it can be argued that the rate has been relatively low and stable. *Chart 2* shows inflation rates in Namibia and South Africa since 1995.

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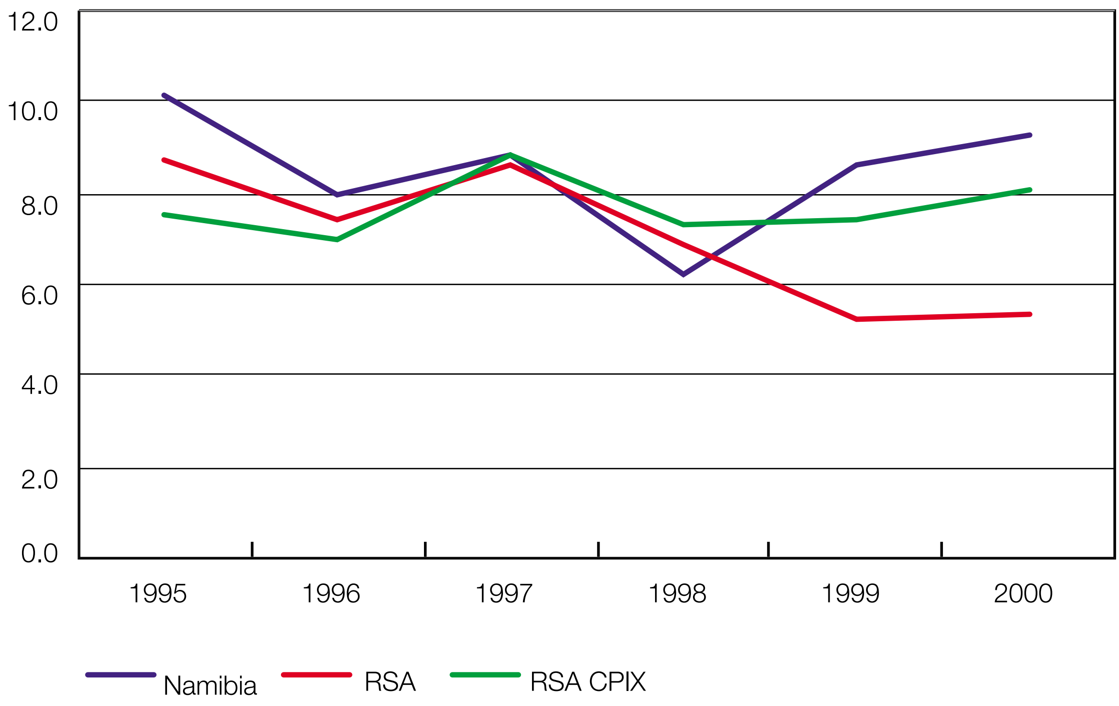
2 Since February 2000, South Africa has adopted a policy of inflation targeting. A target range of 3 – 6 per cent has been set to be achieved on average for the year 2002.

3 For further discussions on the issue see Tjirongo (1998)

Chart 2: Inflation (Namibia vs South Africa)



Source: Bank of Namibia, South African Reserve Bank

There have been relatively similar trends of annual rates of inflation in Namibia and South Africa. Even before 1995, the general price levels in the two countries had been moving closer and in the same direction except for certain isolated periods. The reasons for the price differentials between the two countries could be traced in the treatment of the basket of goods in the CPIs of the two countries as well as other domestic factors (Gaomab II, 1998).

4. Alternative policy stance

There is a widely held view in Namibia that the economic benefits of this monetary policy framework outweigh the economic costs (Alweendo, 2000). However, there is no doubt that the present arrangement, like any other exchange rate regime, has its shortcomings. Although price stability will guarantee long-term growth, the relationship might just be the opposite in the short run. The loss involved in not making use of the nominal exchange rate as an instrument for macroeconomic adjustment may be adverse in the short run. Even though monetary policy cannot affect either output or employment in the long run, it can affect them in the short run. The inability of Bank of Namibia, under the present arrangement, to undertake discretionary monetary policies to offset such developments has often been cited as a major shortcoming[4]. This has often led to calls for an alternative arrangement.

[4] For example, Sherbourne & Orford (1995) advocate the devaluation of the Namibian dollar as the appropriate means of improving the competitiveness of Namibian exports. Botha (2000) finds their argument questionable citing that it was based on little economic rationale. Nevertheless, the Namibian dollar has substantially depreciated since the latter half of the 1990s.

Such calls become more strident in a period such as this, when the Namibian dollar (NAD) is observed to suffer depreciation against major currencies like the US dollar[5]. The immediate option would of course be that the Bank of Namibia could pursue or chart an independent monetary policy since it is argued that this would enable the monetary authorities to take actions to stem the tide in the depreciation of the Namibian dollar. In reaching this decision, a number of issues should be taken into consideration.

Over 80 per cent of Namibia's imports are sourced from South Africa. If NAD were to depreciate against the rand, imports would become expensive and Namibia would accordingly be importing higher inflation. With the high import demand from South Africa, naturally Namibians would be demanding rands, and this would result in a tendency of the NAD to depreciate against the rand. Under these circumstances, Namibians might have to worry not only about NAD depreciating against the US dollar but also NAD depreciating against rand. The resulting high inflation would probably inhibit domestic economic growth.

Currently, investors and domestic securities market participants derive market confidence in the NAD through the peg to a stable trading-partner currency. At the same time, it shuts out possible currency speculators. Namibia will, however, not avoid currency volatility by de-linking from the rand as it will remain part of emerging markets and therefore will continue to suffer from emerging-market jitters. This view is accentuated by the fact that financial markets, particularly in Namibia and South Africa, are highly integrated and both are integrated with the global financial market. In fact, the volatility of the NAD might be more pronounced given the country's low level of reserves and therefore its inability to withstand financial shocks. With Namibia's current trade deficit, one would expect the NAD to depreciate.

Therefore, strong trade links with South Africa mean that even if the country de-links and manages the value of the currency based on a basket of trading partners, the rand will still weigh substantially in the basket and therefore the NAD will tend to move in tandem with the rand. For example, Atta et al. (1995) argue that, on average, 70 per cent of the change in South African prices fed into Botswana within a year. This seems to suggest that a free-float will also be skewed towards the rand as demand for rands in Namibia will continue to be strong, not only because of imports but also because of portfolio flows into South Africa.

The current arrangement enhances fiscal discipline in Namibia. At the core of the present arrangement is the requirement to back every NAD issued with foreign reserves. This limits money creation, particularly the possibility of the monetization of fiscal deficits. Experience with the CFA Franc suggests that these countries, in comparison to the rest of Africa, have generally benefited from low levels of inflation, at least until the mid-1980s. This is largely explained by the fix of their exchange rate (Clement et al., 1996).

5. Conclusion

In the light of these and the aforementioned advantages of the current stance of monetary policy, the current monetary policy arrangement seems favourable for the objective of price stability and, therefore, economic growth as long as South Africa pursues the path of low inflation. This is particularly true, given the fact that achieving low inflation has become an explicit and overriding objective of monetary policy in South Africa (Mboweni, 1999).

An alternative independent monetary policy framework does not seem particularly attractive at the present moment. Furthermore, any plans for the alternative option are contingent on the fact that one should be able to clearly establish that the payback from such a move would outweigh the benefits derived so far from the present arrangement. At present, it is difficult to establish such clear and substantive arguments for moving towards an alternative arrangement.

5 It is important to note that the current depreciation of the Namibian dollar is not peculiar to the domestic currency. Generally the US dollar has been strong against other currencies not only against the rand. The depreciation should therefore not be the reason to opt out of the present arrangement. Even if the local currency was not linked to the rand, it is highly probable that it would have depreciated against the US dollar at roughly the same or worse rate than the rand.

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