



Namibia's Monetary Policy Framework

Bank of Namibia



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Published by the Bank of Namibia
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ISBN: 99916-61-50-6

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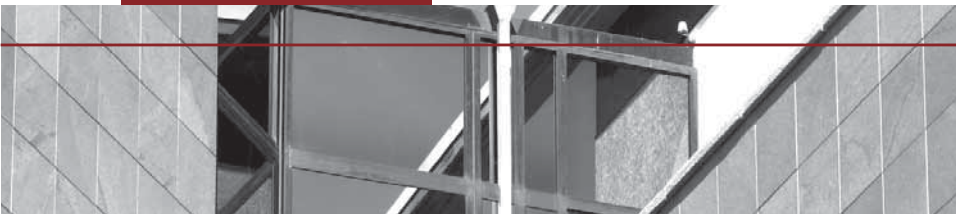
FOREWORD

This document describes Namibia's current monetary and exchange rate framework. Much of what is said in the document has been described in other Bank of Namibia policy papers. However, it was necessary to bring all aspects of our monetary and exchange rate management practices together into a single referencing document, in line with international best practices.

The ultimate aim of monetary policy in Namibia is to ensure price stability in the interest of sustainable economic growth. Namibia's monetary policy framework is underpinned by the exchange rate system linked to the South African Rand. This link, which requires that Namibia's currency in circulation is backed by international reserves, ensures that Namibia imports price stability from the anchor country. Under a fixed exchange rate regime, monetary policy remains submissive to the fixed peg. Maintenance of the fixed peg, which is the intermediate target, ensures that the goal of price stability is achieved by importing stable inflation from the anchor country. As a member of the Common Monetary Area, Namibia has opted to surrender its right of having a completely independent monetary system. Nevertheless, the country has some level of monetary policy discretion because of capital controls and other prudential requirements. These discretionary powers confer liberty upon the Bank of Namibia to maintain its Repo rate at a different level from the Repo rate of the South African Reserve Bank, when required.

An important aspect of a monetary policy framework is the legal and institutional framework for policy formulation. In Namibia, the Executive Committee, consisting of the Governor, Deputy Governor, Assistant Governor and three senior staff members, are responsible for the formulation of monetary policy. An increasingly important topic in monetary frameworks is communication, as communication plays an important role in managing expectations in order not to catch the market by surprise with respect to key decisions. In this connection, the Bank of Namibia uses an array of channels to communicate monetary policy decisions, of which this document is one example. Others include regular press statements after each Executive Committee monetary policy meeting, and the publication of a monetary policy review.

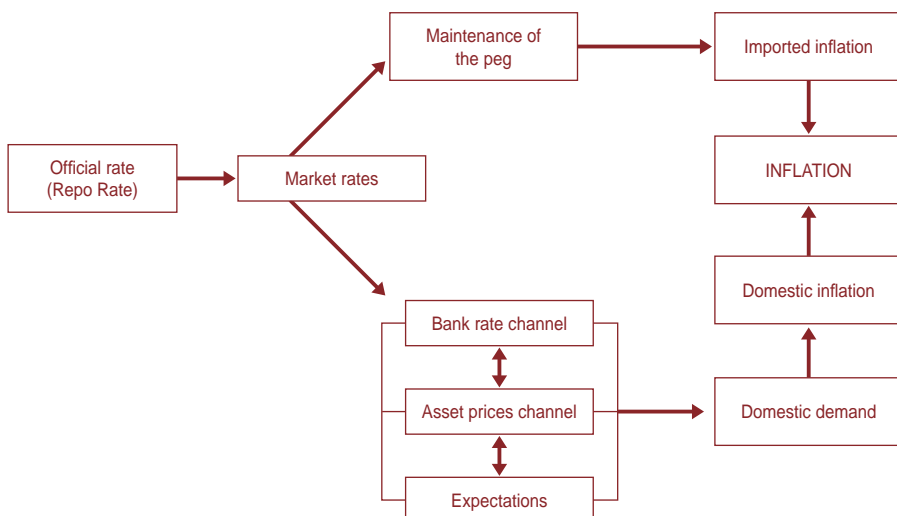
The Bank of Namibia believes that this document will contribute towards an enhanced understanding of the Bank's mandate among all its stakeholders.



I THE TRANSMISSION MECHANISM OF MONETARY POLICY IN NAMIBIA

The ultimate goal of monetary policy in Namibia is to ensure price stability in the interest of sustainable growth and development. Namibia's monetary policy framework is underpinned by the fixed currency peg to the South African Rand. Under a fixed exchange rate regime, monetary policy remains submissive to the fixed peg. Maintenance of the fixed peg, which is the intermediate target, ensures that the ultimate goal of price stability is achieved by importing stable inflation from the anchor country (see Figure 1). The relationship between monetary policy and the exchange rate policy in an open economy operating under a fixed exchange rate regime is better explained through the “impossible trinity” (Al-Raisi et al. 2007:2). The impossible trinity postulates that a country cannot simultaneously enjoy a fixed exchange rate, monetary policy independence, and an open capital account. Consequently, under a fixed

Figure 1: Schematic illustration of the monetary policy transmission mechanism for Namibia





exchange rate arrangement, a country cannot operate monetary policy independently from the anchor country, as this will eventually disturb the fixed peg through the workings of the capital account. However, a country with a fixed exchange rate policy could use sterilisation operations, capital controls and regulatory barriers to influence, to a certain degree, short-term interest rates, money supply and, possibly, credit extension to the private sector to control domestically induced inflation through expectations and aggregate demand.

Although Namibia has forgone the option of having a fully independent monetary system, the stance of monetary policy can deviate to a certain degree from that of the anchor currency by using capital controls and prudential requirements imposed on banking and other financial institutions. These powers make it possible for the Bank of Namibia to maintain a Repo rate different from the Repo rate of the South African Reserve Bank (SARB), when required, and allow it the discretion to control the domestic money supply. This discretion enables the Bank of Namibia to control domestically induced inflation, which is estimated to contribute about 35 per cent to the overall inflation in Namibia (Gaomab II 1998).

The credit/repo rate channel influences the pricing of retail financial products. In the case of Namibia, almost immediately after the official rate is changed, commercial banks accordingly adjust their lending rates. Theoretically, firms and individuals respond to the change in commercial bank lending rates by altering their spending and investment decisions. In Namibia's case, changes in the borrowing behaviour of individuals in response to interest rate changes are more pronounced than those of businesses. Changes in household demand patterns eventually filter through to output and domestic inflation. Thus, the credit/repo rate channel is the most important channel in Namibia in terms of influencing domestic inflation.

For equity and bond prices, an increase in the official rate results in individuals having less money to spend because of the erosion of disposable income. Theoretically, they would sell their stocks in order to increase their income, leading to a decline in stock and bond prices. An alternative argument put forth is that, assuming that investors borrow money to invest in stocks and bonds, a tightening of monetary policy will result in fewer funds being available for equity and bond investments. Provided other things remain constant, the prices for bonds and stocks will decline as demand decreases, resulting in reduced household wealth and, thus, less spending. These changes in demand and investment patterns eventually filter through to output and domestic inflation. The asset price channel through bonds and stocks prices is less effective in Namibia because the greater percentage of stocks and bonds are held by institutional investors, and not by households. Additionally, over half of the companies listed on the Namibian Stock Exchange (NSX) are listed on other stock exchanges as well. This means the overall performance of the NSX is largely influenced by external developments and to a lesser extent by developments in the domestic economy.

However, the asset price channel is effective in Namibia through physical assets such as real estate. For example, if the central bank tightens monetary policy, this results in the rise of mortgage rates, which are variable. Any rise in the mortgage rate reduces the remaining disposable income of those affected, and consequently reduces the flow of funds available for spending on goods and services in respect of any given income. The rise in interest rates also

tends to reduce the value of assets, and lower wealth leads to lower spending. The resulting lower spending will ultimately filter through to domestic inflation developments.

To conclude, other countries that adopt flexible or managed exchange rate systems can rely on other transmission channels, such as the exchange rate and asset price channels to implement monetary policy. In contrast, Namibia, due to its fixed exchange rate system and the characteristics of the Namibian securities market, only relies on the interest rate/repo rate channel and, to a lesser extent, the asset price channel to influence domestically induced inflation. Under a fixed exchange rate regime, monetary policy remains submissive to the fixed peg. The maintenance of the peg ensures that Namibia imports stable prices. However, due to existing prudential measures that limit the outflow of capital, Namibia can afford to deviate, albeit in a limited sphere, from the policies of the anchor country (i.e. South Africa) in order to affect domestically induced inflation. The decision of the central bank ultimately affects inflation through the repo rate/credit and asset price channels.



II LEGAL AND INSTITUTIONAL FRAMEWORK

Board of Directors

The Bank of Namibia is governed by a Board of Directors, consisting of the Governor of the Bank, who is also the Chairperson of the Board. Other Board Members include the Deputy Governor and six Non-executive Directors.¹ In terms of its functions and powers, the Board is responsible for policy, internal controls, risk management, and the general administration of the Bank (section 4(1) of the Bank of Namibia Act, 1997). The Board plays no role in monetary policy formulation, although it is regularly informed about monetary developments and the reasons for the current stance of monetary policy.

Monetary policy formulation

Institutional framework

The Bank of Namibia's Executive Committee (EC) is responsible for the formulation of monetary policy. The EC is a committee constituted by the Governor of the Bank of Namibia, and comprises the Governor as the EC Chairperson, the Deputy Governor, the Assistant Governor, and three senior staff members appointed on the basis of their expertise in the area of monetary policy. With the exception of the Governor, all EC members hold office for such period as determined by the Governor. The EC's Terms of Reference and Code of Good Conduct are attached as Annexures 1 and 2, respectively.

Major mandates in relation to monetary policy

The EC's key mandate in relation to monetary policy matters is derived from the Bank of Namibia Act, 1997 (No. 15 of 1997). According to the Act, one of the mandates of the Bank of Namibia is to ensure internal and external monetary stability and to assist in the attainment of national economic goals. Moreover, in terms of Article 4 of the Common Monetary Area (CMA) Bilateral Monetary Agreement between Namibia and South Africa, it is stipulated that "the Bank of Namibia shall maintain reserves equivalent in the form of Rand assets and freely usable foreign currencies in such proportion as the Bank of Namibia considers appropriate".

¹ The Assistant Governor also attends Board meetings as an advisor.

Monetary policy target

In terms of section 3(b) of the Bank of Namibia Act, the Bank enjoys operational autonomy in its decision-making on matters pertaining to monetary policy. In other words, no individual, group or institution – government or otherwise – is permitted to interfere with the Bank on monetary policy matters. The key objective that the EC focuses on is to maintain the parity of the Namibia Dollar to the South African Rand. However, since the ultimate objective of monetary policy is stable prices, the EC keeps a close watch on the inflation rate, defined domestically as the national consumer price index (NCPI), as measured by the NCPI produced and disseminated by the Central Bureau of Statistics (CBS) on a monthly basis.

Frequency and length of meetings

The EC meets six times a year to deliberate on monetary policy matters. At each such meeting, it decides on the appropriate stance of monetary policy for the next two months. The Governor may also call for extraordinary EC meetings at his/her discretion.

Process of decision-making and voting rights

During an EC meeting, members from relevant line departments in the Bank are invited to make presentations to the EC on recent economic developments in the world and domestic economies, and on the inflation outlook. In terms of domestic economic developments, indicators such as the performance of the real sector, interest and exchange rate developments, the balance of payments, and fiscal trends are taken into account. From time to time, the EC may also request additional presentations relating to monetary policy. At times, certain invited persons may sit in on EC deliberations in order to provide clarification on issues raised in their reports. However, only the views of EC members are taken into consideration when a decision on the stance of monetary policy is taken. All decisions relating to monetary policy matters are taken by consensus. Where consensus does not emerge, the Chairperson may exercise his/her casting vote. Each member also needs to state his/her decision clearly, along with the reasons for taking such decision.

Monitoring economic and financial trends

As a routine activity of the Bank, all major economic and financial indicators are monitored and the EC is briefed on these every month. The said indicators include the liquidity of the banking system, inflation and exchange rate trends, financial market developments, the foreign exchange reserve position, real sector indicators, the balance of payments, and fiscal trends. In addition, the Bank makes use of monthly and quarterly internal inflation forecasts. The forecasts are based on price developments in selected commodities, using econometric methods. The Bank does not publicly release these inflation forecasts because they are regarded as internal planning tools.



III POLICY IMPLEMENTATION

Ultimate objective and intermediate target

The ultimate objective of monetary policy in Namibia is to maintain price stability. In achieving this objective, the Bank of Namibia has an intermediate target to promote an economic and financial environment that will ensure that the parity between the Namibia Dollar and the South Africa Rand is not in any way threatened. The parity between the two currencies may be threatened when, amongst others, interest rates move away from each other, which may lead to undue capital inflows or outflows, and/or divergent macro-economic developments between the two countries.

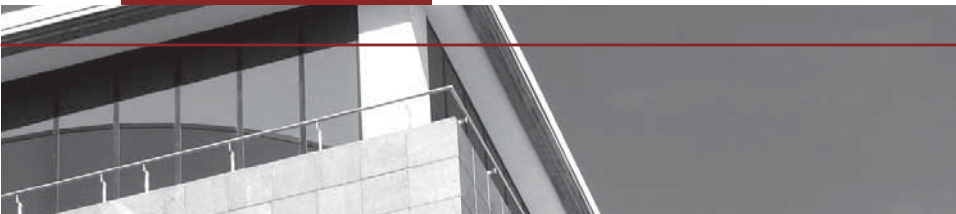
Operational target

The operational target is an economic variable that the central bank wants to influence, largely on a day-to-day basis, through its monetary policy instruments. Although there is no formal operating target in Namibia, the Bank of Namibia monitors the level of official reserves, as the fixed currency peg requires the country to fully back its currency in circulation with international reserves in order to import stable prices from South Africa.

The Bank would use its best endeavours to maintain the international reserves at a level which, in its opinion, is adequate for Namibia's international transactions. In this regard, a minimum threshold obtains at which foreign reserves are considered inadequate. The minimum threshold is defined as the currency in circulation plus 30 day moving average of commercial bank net foreign transfers. If international reserves are at such a level that the Bank considers its adequacy to be in jeopardy, it would submit a report to the Minister of Finance on the reserve position, together with recommendations on measures that the Bank considered necessary to forestall or otherwise remedy the situation.

Key policy rate

The main policy tool that the Bank of Namibia uses to influence monetary conditions in the country is the Repo rate, which is kept close to the South African Reserve Bank's repo rate. The Repo rate is the interest rate at which commercial banks borrow money from the Bank of Namibia, and this, in turn, affects other interest rates in the economy. Changes to the Repo rate usually take into account not only the SARB's decision about its repo rate, but also domestic economic conditions, international economic conditions, and future prospects.



IV MARKET OPERATIONS

A monetary policy instrument is a tool that central banks use to reach their operational targets. Central banks use various measures to meet such targets. In the case of the Bank of Namibia, the following key operational tools are employed to meet its monetary objectives.

Call account


With this facility, banking institutions can place funds with the Bank of Namibia on a daily basis, at an interest rate which may vary from day to day. There is no specific maturity attached to the call account facility at the Bank of Namibia. The call account has been used both as a standing facility and as a discretionary facility at the Bank's request. As the interest rate on this account can be varied daily, the call account may be used as a prime intervention instrument. Currently, the interest payable on the call account facility is 25 basis points below the Repo rate; however, this scenario can be changed at the Bank's discretion. Modifications in the call account rate are dictated mainly by changes in the liquidity position of the Namibian banking system.

Seven-day repurchase transactions

The Bank has three systems of accommodation, namely the seven-day repo, the overnight repo, and the intraday repo. All facilities are only available to assist commercial banks (or participants in the Namibia Interbank Settlement System) to meet their settlement obligations. As such, the facilities are not meant to aid in funding banking institutions' credit extension.

The seven-day refinancing facility, based on repurchase agreements (repos), was introduced by the Bank of Namibia on 1 July 2008 as its main system of accommodating banking institutions. The current practice is that banking institutions are allotted the full amounts that they require at auctions. Nonetheless, the Bank has the discretion to determine the size of the amount to be allotted at any auction, depending on the local liquidity situation. The rate at which the main repurchase auctions are conducted is equivalent to the prevailing Bank rate set by the Bank's EC.

The implementation of the seven-day repo implies that other standing facilities, such as the intraday and overnight repos, have ceased to be the main refinancing facilities. The latter are now only used to square off daily positions if the funds which commercial banks have drawn from the seven-day repo are insufficient during the seven-day cycle. A penalty is charged on



the overnight repo. This penalty is periodically reviewed by the Bank. The Bank also reserves the right to change the penalty if borrowing under the overnight facility implies permanent lending to banking institutions. The primary objective of the Bank's seven-day repo facility to banking institutions is to ensure that its refinancing operation is administered in a timely and effective manner, and according to agreed service levels. In addition, the seven-day repo aims at encouraging active and efficient interbank lending among the banking institutions themselves. The interbank market plays a signalling and feedback function and can expand the Bank's scope in respect of managing liquidity. It offers the Bank of Namibia a 'real-time window' on the liquidity condition of the banking system.

As stated above, the size of the allotment amount in all auctions is always determined at the discretion of the Bank. The Bank uses the repo facility to inject short-term liquidity into the banking system. The discretionary power vested in the Bank may also be used to create liquidity shortages by not allocating the full amount required by the banking institutions. This might happen in cases when, through liquidity forecasting and monitoring, the Bank realises that a further liquidity injection into the system may destabilise the market, leading to outflows that usually have a negative impact on the level of official reserves.

Bank of Namibia bills

Bank of Namibia bills were first issued in April 2007. For the time being, these bills are used to assist banking institutions to meet their statutory liquidity requirements, following the current shortage in available Government securities in the primary and secondary markets. These bills are benchmarked on the 91-day Treasury bill rate, and are issued every two weeks. Currently, the Bank of Namibia bills are only available to banking institutions.

Other operational tools

Other tools that the Bank of Namibia can use to withdraw surplus liquidity from the market or inject liquidity into it in the case of a shortage include engaging in open market operations. Through such engagements, the Bank buys and sells debt securities in the market in an attempt to influence the liquidity situation.



V MONETARY POLICY COMMUNICATION

Principles of monetary policy communication

The Bank's monetary policy communication strategy is aimed at developing support amongst relevant stakeholders for the Bank of Namibia's monetary policy framework, as well as for its decisions and actions. The Bank strives to adhere to the principles of clarity, transparency, and predictability in the way it communicates its monetary policy decisions. Clarity is necessary to allow a broad understanding of the rationale for the Bank's policy decisions. Transparency ensures that policy decisions and explanations are predictable over time. Predictability in policy decisions give guidance to the markets so that expectations can be formed efficiently and rationally.

Announcement of policy decisions

The day after an EC meeting, a formal announcement of policy decisions taken is made through a press release at a press conference held by the Governor or, in his/her absence, by the Deputy Governor, and is simultaneously posted on the Bank's website at www.bon.com.na. Only the consensus view of the EC is communicated to the press, along with comprehensive reasons for the decision taken.

Inflation and economic forecasts

The EC considers quarterly inflation forecasts at its meetings and approves the assumptions needed to update the inflation model. The inflation forecast is revised prior to every EC meeting, although it is currently not made public. The Bank of Namibia does, however, publish an annual economic forecast at the beginning of each year. The latter forecast is revised in the middle of the year and published again.

Other channels of monetary policy communication

In addition to press releases, the other main channels of monetary policy communication include speeches by the Governor and special interviews. From 2009 the Bank will also publish a monetary policy review report twice a year.



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ANNEX 1 TERMS OF REFERENCE OF THE BANK OF NAMIBIA MONETARY POLICY COMMITTEE

Background

The Governor of the Bank of Namibia has the right to appoint committees to assist in the implementation of the Bank's policies. In this connection, the Governor has decided to establish a Monetary Policy Committee, responsible for the formulation of monetary policy of Namibia. **This committee shall be formally known as the Executive Committee.**

The Executive Committee shall have the power and responsibility to formulate the monetary policy of Namibia. However, in terms of accountability, the Governor of the Bank of Namibia remains ultimately responsible for the soundness and effectiveness of monetary policy.

This document outlines the composition and terms of reference of the Executive Committee of the Bank of Namibia with respect to monetary policy matters.²

Composition of the Executive Committee


The Executive Committee shall consist of:

- (a) the Governor, who shall be the chairperson;
- (b) the Deputy Governor;
- (c) the Assistant Governor; and
- (d) three staff members based on their expertise.

Terms of office

The Committee members, with the exception of the Governor, shall hold office for such period as may be determined by the Governor of the Bank of Namibia. It is expected that in addition to the normal line responsibilities, the EC members will devote a significant portion of their time to monetary policy matters.

² The Executive Committee shall also be responsible for other policy matters of the Bank. This document focuses on the monetary policy functions of the Executive Committee.



Members of the Executive Committee shall at all times adhere to the Executive Committee Code of Good Conduct set out in Annex 2 of this document.

Members of the Executive Committee shall before commencing to perform monetary policy functions take an oath or affirmation.

Frequency of meetings

The Executive Committee shall meet six times a year to deliberate on monetary policy matters and take a decision on the appropriate stance of monetary policy for the next two months.

The dates of the monetary policy meetings shall be communicated in advance to all EC members and the public at large.

The Governor may call for extraordinary meetings of the Executive Committee related to monetary policy matters.

A minimum of four members present shall be required to constitute a quorum.

Manner of decision-making

All decision related to monetary policy matters shall be taken by consensus. The Chairman shall have a casting vote in case consensus does not emerge. It is expected of each member to clearly state his/her decision and reasons for taking such decision.

Publication of statement of decisions

After each monetary policy meeting, the Executive Committee shall publish a statement of its decision in a manner which the Bank deems fit.

In addition to the statement referred to in the prior sentence the Executive Committee shall twice a year publish a Monetary Policy Review conveying information about macro-economic, monetary, inflation and financial developments in Namibia.



ANNEX 2 EXECUTIVE COMMITTEE CODE OF GOOD CONDUCT

1. Fundamental principles and core values


Executive Committee (EC) members shall act with loyalty to the Bank, be honest, objective, and impartial and subscribe to the highest standards of professional ethics, diligence, good faith and integrity. They shall avoid any action, or inaction, which could in any way impair the Bank's capacity to carry out its duties, or compromise its standing in the community and its reputation for integrity, fairness, honesty and independence.

2. Conflict of interest

- (1) In the performance of their duties, EC members shall avoid any situation that may give rise to a conflict of interest. No discrepancies may exist between a member's official responsibilities and any kind of personal or external interests which could jeopardise his or her impartiality and integrity in performing his or her responsibilities. Acceptance of gifts and favours that have the appearance of influencing their performance should be avoided.
- (2) EC members may not undertake remunerated activities outside the Bank, without the consent of the Chairman and in accordance with the general rules and procedures of the Bank on extra-mural activities. Remunerated activities that have a bearing on monetary policy matters must be avoided at all times. More especially, EC members shall not become a shareholder, director, manager, or officer in any banking or other financial institutions.

3. Declaration of interests

- (1) To assist in the fulfilment of obligations in relation to conflicts of interests, EC members shall upon appointment make a full written disclosure of the nature of their direct or indirect interests which may give rise to conflict of interest.
- (2) The matters to be covered by the member's statement shall include but not be limited to the disclosure of:
 - (a) any financial or business interest of the member and that of his or her immediate family members; and/or
 - (b) investments in companies, partnerships or joint ventures.

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- (3) An update of such a statement on an annual basis shall be provided to the Chairman of the EC.

4. Immunity from personal liability

The EC members shall not be personally liable for any civil or criminal proceedings, arrest, imprisonment or damages for anything done in the discharge of their duties unless it is established that it was done in bad faith.

5. Compliance

- (1) Compliance with this Code of Good Conduct will be monitored by the Chairman of the EC. If EC members (or members of the public) become aware or suspect that a member(s) of the EC has, or may have, contravened this Code, this information should be reported immediately to the Chairman of the EC, preferably in writing and in a confidential manner. The Chairman shall initiate a mechanism to investigate the alleged breach of its own violation or upon request.
- (2) Deviation from the standards of this Code shall be dealt with as misconduct on the part of the member concerned and such a member will be disciplined in accordance with the rules and procedures of the Bank.
- (3) For the duration of any investigation into any allegation of a contravention of this Code, the Chairman of the EC reserves the right to suspend the member concerned from carrying out duties for the EC and the Bank.
- (4) Any investigation into a suspected or possible contravention of this Code shall be kept confidential.

6. Independence

- (1) EC members shall be independent from any political influence in the performance of their duties.
- (2) The EC members shall not act as delegates or representatives of any interest groups or industry in the discharge of their duties.

7. Confidentiality

Members of the EC are required to maintain strict confidentiality of the information discussed at EC meetings and not to divulge any confidential information obtained by members in the performance of their duties: provided that such confidentiality shall be lifted one year after they have ceased to be members of the EC. Members shall also avoid any situation where they might be perceived as having acted with the benefit of knowledge not available to the general market, for their own interests.

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Signature



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