Bank of Namibia

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CORPORATE CHARTER

VISION
"Our vision is to be the centre of excellence - a professional and credible institution - working in the public interest, and supporting the achievement of the national economic development goals."

MISSION
"In support of economic growth and development our mandate is to promote price stability, efficient payment systems, effective banking supervision, reserves management and economic research in order to proactively offer relevant financial and fiscal advice to all our stakeholders."

VALUES
"Our Values guide us to be a centre of excellence and we value our contribution to the organisation."

"We uphold integrity, impartiality, open communication and transparency. We care for each other's well-being and value teamwork."

LIST OF ABBREVIATIONS

AACB	Association of African Central Bank
AML/CFT	Anti-money laundering and combating of financing of terrorism
BIS	Bank for International Settlement
BoN	Bank of Namibia
CAR	Capital Adequacy Requirement
CBS	Central Statistics Bureau
CIC	Currency in circulation
CMA	Common Monetary Area
EMEs	Emerging market economies
FIA	Financial Intelligence Act
FIC	Financial Intelligence Centre
FNB	First National Bank
FSR	Financial Sector Review
GC08	Government Internal Registered Stock Maturing in 2008
GC10	Government Internal Registered Stock Maturing in 2010
GC12	Government Internal Registered Stock Maturing in 2012
GC15	Government Internal Registered Stock Maturing in 2015
GC24	Government Internal Registered Stock Maturing in 2024
HI	Herfindahl Index
IMF	International Monetary Fund
IPPR	Institute of Public Policy Research
IRMC	International Reserves Management Committee
JSE	Johannesburg Stock Exchange
NAD	Namibia dollar
NISS	Namibia Interbanking institution Settlement System
NPL	non-performing loan
NSX	Namibian Stock Exchange
ODCs	other depository corporations
PAN	Payment Association of Namibia
RHS	right hand side (of graph)
SA	South Africa
SACU	Southern African Customs Union
SADC	Southern African Development Community
SARB	South African Reserve Bank
T Bill	Treasury Bill
UEPS	Universal Electronic Payment System
US(A)	United States (of America)

CONTENTS

INTRODUCTION

The Bank of Namibia has a mandate “to promote and maintain a sound monetary, credit and financial system in Namibia and sustain the liquidity, solvency and functioning of that system”. Of particular interest to the Banking institution, therefore, is the efficient functioning of the financial system. The main objective of a financial stability assessment is an early detection of possible risks and vulnerabilities that can lead to serious crisis.

Banking institutions are an important component of the financial system. Adverse shocks originating from the banking sector can spill over to both the rest of the financial system and the real economy. Much of the assessment of financial stability is, therefore, devoted to the health, strength and resilience of the four banking institutions because they play a crucial role in the stability of the payment system.

The review begins with a brief overview of recent developments in the real economy and financial markets that can affect financial stability, and ends with a summary of risks, possible future global and domestic developments, and the overall assessment.

All major sections conclude with a relative indication of the degree of perceived impact of developments and factors on financial system stability. The ratings are in ascending order of magnitude of impact and are as follows: low impact; moderate impact; and high impact.

1. SUMMARY OF THE STABILITY ASSESSMENT

The global financial markets have been volatile in the first half of 2008, as a result of conditions emanating from the subprime mortgage crisis in the US. These financial market conditions have adversely affected financial stability during the first half. According to the latest assessment of the International Monetary Fund, losses expected to adversely affect the financial markets a year ago have now been realized by financial institutions. In addition, the risks emanating from the US sub-prime have spread to other forms of credit. Across many loan classes, credit quality has begun to deteriorate, with declining house prices and slowing economic growth.

House prices have also started to decline in other developed economies, feeding concerns of possible future losses in the mortgage, construction, and commercial property areas. Banking institutions have come under “renewed pressure” to raise additional capital in the face of a sharp plunge in banking institution stocks. Additionally, the risk of the likelihood of a negative interaction between the banking institution system adjustment and the real economy has also increased. In this connection, the IMF projects global growth to moderate to 4.1 percent and 3.9 percent in 2008 and 2009 respectively.

The impact of turmoil in global financial markets has been insignificant on the Namibian financial system stability in the first half of 2008, although some ripple effects were experienced on the Namibian Stock Exchange.

The NAD depreciated against major currencies during the first half of 2008, mainly due to exogenous factors. Given that most of these factors are likely to continue in the second half of the year, it is expected that the currency weakness will continue. A weak currency would lead to high import prices and inflation and consequently high interest rates. Both results would stretch consumer budgets and compromise their debt repayment capacity. As noted in our previous FSR, this condition, combined with uncertain economic outlook, could result in an unfavourable situation for banking institutions and, hence, financial stability.

Nevertheless, the overall position of Namibia’s international reserves has improved markedly in the first half of 2008. This improvement has contributed to financial health and strengthened financial stability in Namibia. The possible fall in SACU revenues may not have a significant impact on the financial health of the country as long as the economy continues to produce a balance of payments surplus.

The Namibian banking system, during the review period remained sound although profits have fallen by 14.6 percent in the latest quarter and debts are rising as borrowing costs increase. In the six months to June 2008, non-performing loans in the banking sector increased by 9.7 percent to N$940.4 million. This situation warrants a closer monitoring.

At the same time, higher net interest expenses and higher consumer price inflation will lead to slower growth in household disposable income. Furthermore, lower global economic growth may erode export companies’ revenues in 2008. All these developments may have a negative impact on banking institutions and financial stability. Local banking institutions have no direct exposure to the global credit crisis, but domestic conditions could deteriorate due to tighter monetary policy and especially rising energy costs and food prices. However, there is no cause for alarm, with the capital adequacy ratio above 15 percent. The regulatory minimum is currently at 10 percent.

Most of the challenges facing the long-term insurance sector, as highlighted in our previous reports, remained in the first quarter of 2008. In addition, the surplus assets and CAR have declined. The overall operation of the industry was deemed to be sustainable, though warranting close monitoring, and does not, pose any sizable financial stability threats. Due to data constraints, no assessment was made on other non-banking sector institutions such as pension funds and micro-lenders.

With respect to financial infrastructure, the Bank of Namibia has undertaken a host of supervisory activities in the first half of 2008. The principal objective of the undertakings was to ascertain the safety, efficiency and timeliness of the National Payment System (NPS) in Namibia. To this end, the Bank assessed the performance of systems and participants. In addition, the Bank looked at developments in payment system projects, as well as developments in other areas of NPS.

2. EXTERNAL ENVIRONMENT

2.1 MACRO-FINANCIAL CONDITIONS

According to the IMF's July 2008 Global Financial Stability Market Update, the global financial system has continued to be characterised by fragility and systemic risk. Expected losses from the US sub-prime-related mortgage exposure remained high, although they have largely been realised. There were further concerns that the deterioration in loan quality could become more widely distributed, leading to rising delinquencies and foreclosures as house prices continued to decline. In addition, rising write-offs, in the US in particular, were fuelling uncertainty about possible future losses at major banking institutions. Although banking institutions in the US, Europe and Asia were successful in raising capital, losses disclosed so far exceeded capital raised and banking institutions face difficulties in keeping earnings due to falling credit quality.

Emerging Markets (EMs), which remained resilient so far to credit turmoil, might be severely dented by tightening external funding as the crisis remained protracted. This might, inter alia, constrain the EMs' ability to address inflationary pressures. At the same time, EMs equity markets have marginally underperformed. Mature market equities and outflows from EM equity funds have been concentrated in Asian markets where inflation and downside risks to growth remained most elevated.

The uncertainties in the global financial markets, in addition to compounding strains on capital have led to a slowdown in global economic growth in the first half of 2008. Consequently, the IMF revised global economic growth down to 4.5 percent in the first quarter of 2008, down from 5 percent in the third quarter of 2007. It is further expected that global growth will moderate to 4.1 percent in 2008 and 3.9 percent in 2009.

The US economy has been adversely affected by the credit crisis that began in the sub-prime mortgage market. During the first three months of 2008, real GDP growth in the US expanded by 0.9 percent compared with 0.6 percent recorded in the preceding quarter. On a year-on-year basis, GDP grew by 2.5 percent in the first quarter of 2008 compared with 1.5 percent in the corresponding quarter of 2007. According to the US Bureau of Economic Analysis, GDP growth was supported, in most part, by external demand and inventory accumulation. The Bureau estimated second quarter GDP growth at 3.3 percent from the first quarter, with the main drivers being exports and personal consumption expenditures, complemented by an increase in federal government expenditure. Domestic demand was, however, weak, while business fixed investment declined. The economy was expected to grow at 0.9 percent in 2009, a decrease from the forecasted 1.3 percent for 2008.

The Euro-zone economic growth rebounded in the first quarter of 2008, despite the sharp US economic slowdown and the close financial links between the two economies. The 15-nation bloc's economy grew 0.7 percent in the first quarter of 2008 from the previous quarter. Growth was mostly supported by investment. Growth in private consumption, however, remained weak. Most of the expansion came from Germany and France, while the Spanish economy grew at its slowest pace in many years. In the second quarter GDP in the Euro-zone contracted by 0.2 percent from 0.7 in the first quarter. The slowdown in real GDP growth during the second quarter was underpinned by weaker export performance resulting from a stronger Euro, complemented by slower global economic growth.

Real GDP growth in the UK slowed to 0.4 percent, on a quarter-on-quarter basis, in the first quarter of 2008 from 0.6 percent in the last quarter of 2007. The slowdown in the UK economic activities was mainly attributed to a deceleration in both manufacturing and services industries. In the second quarter of 2008, the U.K. economic growth slowed further to 0.2 percent from 0.3 percent in the first quarter, as the worsening housing slump and waning consumer confidence weighed on the economy. In addition, the fallout from the subprime crisis caused construction, manufacturing and financial services industries to decline. At the same time, rising commodity prices and slowing economic growth strangled the industrial sector.

In Japan, real GDP grew by 3.2 percent in the first quarter of 2008, aided by rising net exports to other Asian economies and emerging markets. Nevertheless, indicators suggest that the negative effects of the US economic slowdown would be felt more fully in the coming quarters. Furthermore, while merchandise exports continued to expand in the first quarter, labour markets remained weak and manufacturing activity softened. Japan's real GDP declined year-on-year, by 2.4 percent during the second quarter from 4.0 percent registered in the same period in 2007. The main contributors to the contraction in the world's second largest economy were primarily declines in exports and consumer spending. Quarterly, real GDP decreased by 0.6 percent in the second quarter from an increase of 0.8 percent registered during the first quarter.

According to the IMF, economic expansions in emerging and developing markets were also expected to lose steam, with growth projected to slow to around 7.9 percent in 2008-09, from 8 percent in 2007. In its annual report, the BIS warned that emerging economies ran the risk of being worse affected, than so far anticipated, by the slowdown in major industrial countries. It further noted that emerging markets in Asia and Latin America have been resilient and are forecast to grow at 6.7 percent in 2008. However, there was an increasing risk of a slowdown in emerging markets (EMs) resulting from the potential knock-on effects of financial market turmoil in the major financial centres. For instance, exports of EMs could be significantly affected by a deepening economic slowdown in the US.

Real GDP growth in China continued to soften year-on-year to register a growth rate of 10.6 percent in the first quarter of 2008, 0.6 percentage points below the rate of the final quarter of 2007. Growth slowed further to 10.1 percent in the second quarter. The softening was due largely to deteriorating external demand, with net exports making a progressively reduced contribution to growth in the past four quarters. Growth in China is now expected to ease from about 12 percent in 2007 to around 10 percent in 2008-09.

According to the World Bank's Global Development Finance Report, growth in Sub-Saharan Africa is likely to pick up in 2008, reaching 6.5 percent, the highest rate in 38 years, before falling to 5.9 percent in 2010.

On a quarterly basis, South Africa's real GDP grew by 2.1 percent in the first quarter of 2008. Several power outages in the first quarter of 2008 adversely impacted on output at mining, manufacturing, and water and power supply industries. Rising living costs, higher interest rates and high debt burdens contained activity levels in other industries. In the second quarter GDP grew by 4.9 percent, on quarterly basis. The key drivers behind the relatively strong growth were improvements in outputs in mining and manufacturing industries, which were severely affected by power outages in the first quarter. In addition, there was also strong growth in the agriculture and transport sectors.

According to the South African Treasury, the spill over of the sub-prime crisis into the South African financial system has been negligible. The economy is not expected to enter a recession in the foreseeable future, although commodity prices have started to fall and the current growth rate is lower than expected.

2.2 INFLATION RATES

Global inflation has risen notably, due to sharp increases in fuel and food prices. Supply uncertainties and strong demand, mainly from some emerging economies, continued to fuel the swell in international energy and food prices. However, after peaking in July, crude oil prices have been declining in August.

In the US, inflation risks remained elevated despite the sharp economic slowdown. Higher oil and food prices continued to exert upward pressure on headline inflation. The CPI rose to 3.9 percent year-on-year in April 2008 and went up by 1.1 percentage points in June.

Inflation in the UK climbed to 3.8 percent in June from 2.8 percent in April 2007, and rose to 4.4 percent in July. The key drivers to inflation in the UK were mostly increases in the prices of oil and food during the period.

Inflation in the Euro-zone rose to 3.3 percent in April 2008 from 2.8 percent in April 2007. The main driving forces were food, housing and transport prices, respectively. The annualized inflation rate was 4.0 percent in the second quarter, fuelled by soaring food and oil prices, despite continued signs of more slowing economic growth.

Japan's inflation rate rose to 1.2 percent in March 2008 from a negative rate of 0.1 percent in the corresponding quarter of 2007. The principal factors underpinning this development were mainly rising oil and food prices. The inflation rate was 5.0 percent in June 2008 but soared to 7.1 percent in July. Food and transport prices exerted upward pressures on the inflation rate during the second quarter.

The increase in inflation was more marked and broad in emerging and developing economies where headline and core inflation have risen to 8.6 and 4.2 percent, respectively. These were the highest rates since around the beginning of the current decade. The IMF, further, has projected the inflation rate in Sub-Saharan Africa at 8.5 percent in 2008.

The South African Consumer Price Index (CPIX), which excludes mortgage costs, rose to 9.4 percent in first quarter of 2008 from an average of 7.9 percent in the final quarter of 2007. The increase was attributed to increases in the transport-subcategory, which in turn, was influenced by rising international oil prices. The inflation rate rose to 11.6 and 13.0 percent in June and July, respectively.

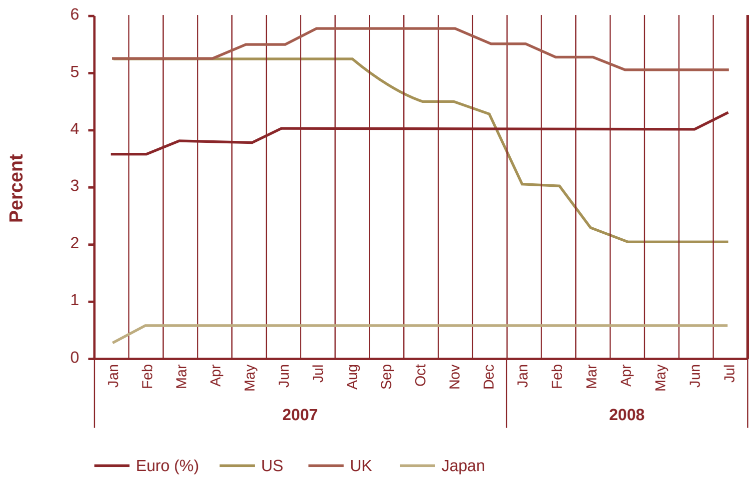
2.3 INTEREST RATES

The Fed cut its discount rate in January 2008 by 75 basis points to 3.5 percent (Chart 1). The cut was its biggest emergency move in two decades and came as the country was wrestling with moderate economic growth and rising inflation risks. The rate was again lowered from 2.25 percent to 2.0 percent in April 2008, as downside growth risk persisted.

The Euro-zone benchmark lending rate remained unchanged at 4.0 percent between June 2007 and June 2008. However, the inflation outlook had deteriorated significantly in June, jumping to 4.0 percent on annual basis. The ECB eventually raised its refinancing rate by a quarter point to 4.25 percent in early July 2008.

In January 2008, the Bank of England left its overnight lending rate unchanged at 5.5 percent. However, the rate was cut in February to 5.25 percent and again in April to 5.0 percent.

Chart 1: Major policy interest rates



Source: Bloomberg

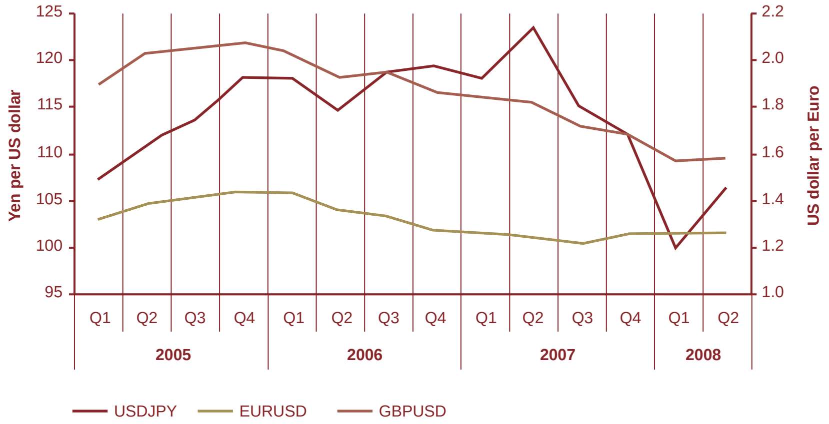
Emerging market economies such as China, Korea and Thailand had kept their policy rates unchanged throughout the first half of 2008. Brazil, India and South Africa had kept their policy rates unchanged only in the first quarter. In the first half of 2008, central banks in many emerging economies were generally tightening monetary policy out of concern about inflation. There had been increases in policy rates in Chile, Israel, Romania, Russia, Taiwan, Turkey and Ukraine in both the first and second quarter of 2008, while in Brazil, India, Mexico and South Africa policy rates were only raised in the second quarter.

2.4 EXCHANGE RATES

The US dollar has started to weaken against the euro early in 2008, as economic data pointed towards a recession (Chart 2). The main reasons for the US dollar weakness, which continued in March, was a combination of: a deteriorating outlook for the US economy; lower interest rates; negative impact on market sentiment of emergency measures by the Fed to restore stability to the US financial system (after the collapse of the nation's fifth-largest US investment banking institution); and tight credit markets.

The British pound has been generally stable against the dollar during the first six months of 2008. Growing fears that a slowdown in the UK economy would force the BoE to make pre-emptive rate cuts kept the currency somewhat subdued.

Chart 2: Currencies per US dollar

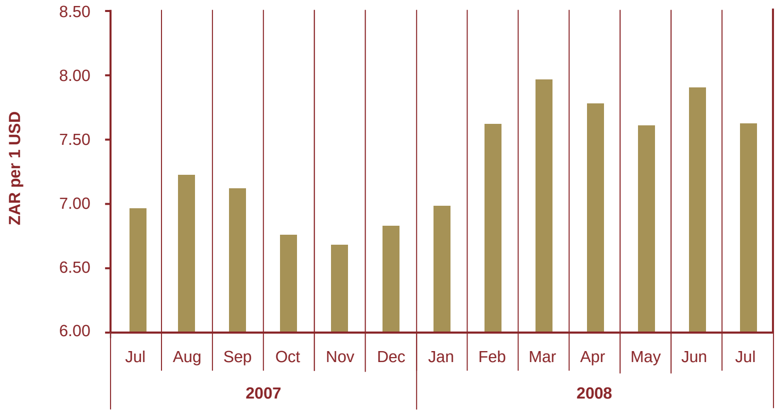


Source: Bloomberg

The strength of the euro against the dollar in the first quarter was mainly driven by strong economic fundamentals in the euro-zone (especially in France and Germany), and by the economic boom led by the export sector. The euro also strengthened against the dollar due to a host of anti-dollar sentiment in the currency market. In addition, the euro was also supported by the favourable interest differential between the dollar and the euro and by the expectations of further US rate cuts. The Euro-zone's superior balance sheet position vis-a-vis the US balance sheet also aided the euro.

In the first part of the first quarter of 2008, the Japanese yen strengthened against the dollar. The rapid appreciation of the yen was mostly driven by risk aversion dynamics. Another major cause of the yen's strength was the rally in the Asian stocks, which gave investors more confidence in high yielding securities from the money borrowed in Japan. The yield spread between the two-year Japanese and US debt also widened, assisting the yen. However, the yen started to slide against the dollar in the second part of the first quarter.

Chart 3: South African Rand (ZAR) to one US Dollar (USD)



Source: South African Reserve Bank

In first quarter of 2008, the South African Rand has weakened sharply against the Dollar reaching a low level of 7.94 per dollar in March, partly as a result of the energy supply fears (Chart 3). The rand weakened further by 13.8 percent against the US dollar by the end of June, 2008. The deficit on the South African current account has swollen to 9.0 percent of GDP in the first quarter of 2008, putting additional pressure on an already weaker currency. In the second quarter, the rand has depreciated against the Euro and Pound by 7.6 percent and 2.7 percent, respectively.

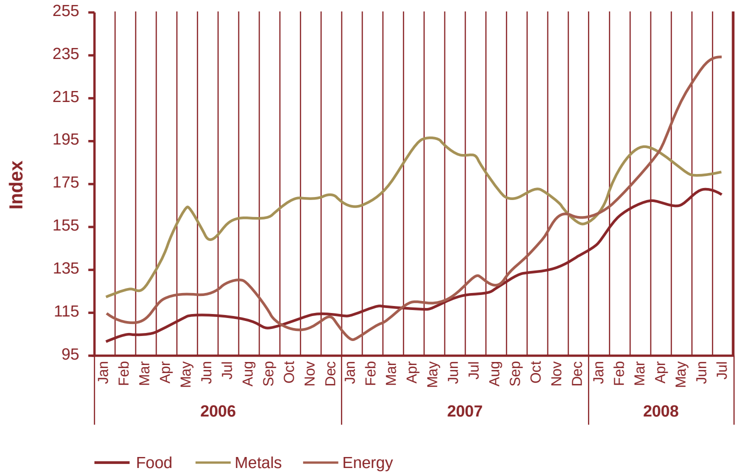
Overall, the first part of 2008 was marked by volatility that has remained a key feature of the exchange rate markets in advanced countries, highlighting the level of uncertainty in these markets.

2.5 COMMODITY MARKETS

Commodity prices continued to increase during the first quarter of 2008 due to strong demand, particularly in emerging markets of China and India (Chart 4). The gold price rose from approximately USD650 an ounce at the start of 2008 to reach a record high level of USD1, 030.80 an ounce in March. By the end of May 2008, gold price has gained 35 percent in the past 12 months as oil price doubled and the dollar fell 16 percent against the euro, boosting the appeal as a hedge against inflation. Uranium price declined from USD88 per pound in January to about USD69 per pound in March. Uranium prices decreased further from USD69 per pound in April to USD59 per pound in June. The sharp decline in the price of uranium came after supplies became available and exceeded demand by about 50 percent.

The trend in commodity prices was mixed during the second quarter of 2008. The price of copper rose by 10.5 percent on an annual basis during the second quarter to US$8292 per metric tonne from US$7514 in the corresponding quarter of 2007. The increase in the price of copper during the period was mainly ascribed to robust demand from China for purposes of infrastructure development, automobile manufacturing, as well as electronic appliances. Quarter-on-quarter, the price of copper declined marginally by 1.7 percent to reach US$8292 per metric tonne at the end of June from US$8434 per metric tonne at the end of March 2008. According to the Diamond Trading Company, the price of unpolished diamonds rose by 16 percent cumulative in August 2008. Lead prices declined by 23.6 percent to US$1861 per metric tonne in June 2008 from US$2437 per metric tonne registered during the corresponding period of 2007.

Chart 4: Selected commodity price index



Source: IMF

The zinc price decreased by 47.5 percent, on a year-on-year basis, or 24.1 percent, on a quarterly basis, during the second quarter of 2008. The decrease in the price of zinc could be explained by a combination of global supply surplus and sluggish demand. Increased demand from emerging market economies of India and China could not offset weak demand from the US. Furthermore, increased production from Australia, Bolivia, Canada, China and Peru contributed to oversupply, thereby placing downward pressure on prices.

The price of oil, which began 2008 at US$96 a barrel, has been supported, in most part, by: increases/growth in oil demand, particularly from China, India, and other developing nations; oil supply factors (e.g., supply disruption concerns, resulting from, say geopolitical tensions or weather-related, e.g., hurricanes); and the weaker US dollar.

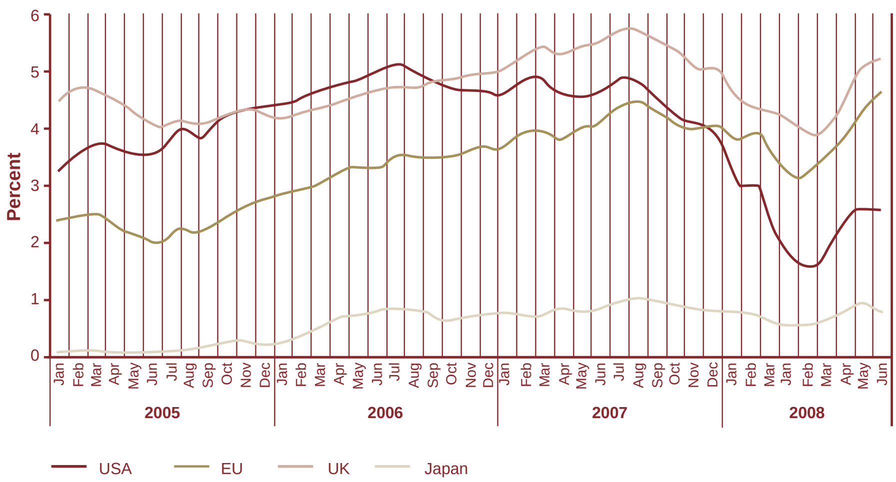
At the end of May 2008, oil prices doubled as the dollar fell by 16 percent against the euro. By the end of the first half of 2008, oil prices have climbed to US$143.67 a barrel, mainly driven by worries over possible supply disruptions from OPEC's second-largest oil producer, and the falling value of the U.S. dollar. Some have also offered speculation as part of the reasons for high oil prices.

Crude oil prices struck a record peak level above US$148 a barrel in July but have started to decline recently, reaching a level of US$113 per barrel in August. The decline in prices was mainly a result of increased supplies and weaker demand from members of the Organisation for Economic Co-operation and Development (OECD).

2.6 BOND MARKETS

Bonds in the major international markets displayed a high level of volatility, reflecting prevailing uncertainty, during the first half of 2008 (Chart 5). Bond yields in the USA, UK, Euro-zone and Japan were in general affected by: economic outlook; interest rates (differentials) and interest rates expectations; oil prices; risk preference; and inflation expectations. For instance, the US bond yield declined 28 basis points in January after the Federal Reserve made a surprise 75 basis-point cut to interest rates. Further, in June, the Euro-zone bond yields rose by 25 basis points on expectations that the ECB would raise interest rates in July to curb inflationary pressure.

Chart 5: Two year bond yields



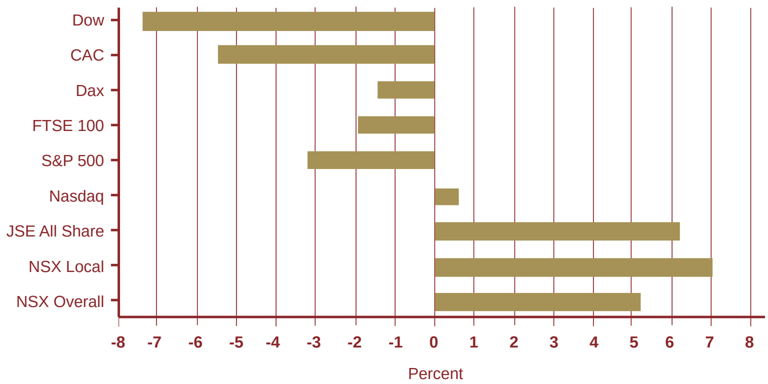
Source: Bloomberg

2.7 STOCK MARKETS

Volatility has been the key feature of the major international stock markets in the first half of 2008. This volatility was a reflection of the uncertainties in the global financial markets deriving from uncertain economic and financial markets outlook. Stock prices in the US, Euro-zone, UK and Japan fluctuated heavily in the first half of 2008 (Chart 6). The heaviest price falls came in January and June, while the highest price increases came after the end of the first quarter. Stock prices are usually influenced by, inter alia: economic outlook; commodity and oil prices, inflationary expectations; borrowing costs (interest rates); corporate earnings; and consumer spending.

US, FTSE, Japanese and Euro-zone stock prices fell in the first quarter following low corporate earnings estimates, falling commodity and oil prices, and slowing consumer spending, respectively. Between April and May, stock prices in the US and Japan rose sharply on hopes of US economic recovery. Stock prices fell significantly in May and June following record high oil prices, and falling US dollar.

Chart 6: Quarterly growth rates (USD terms) global exchanges June 2008



Source: Investment House Namibia

As a consequence of uncertainties in the first half of 2008, most global stock markets recorded negative quarterly growth rates (Chart 7). In the second quarter, for instance, the Dow Jones index and the CAC index recorded the negative growth rates of -7.4 and -5.4 percent, respectively. Conversely, the Nasdaq index (0.6 percent) and the JSE All Share index (6.2 percent) are among the few that experienced positive quarterly growth rates in the second quarter of 2008.

2.8 SUMMARY ASSESSMENT

The impact of the US sub-prime crisis and the subsequent global economic slowdown on the Namibian economy remained minimal in the first six months of 2008. However, emerging markets are expected to face the risk of tighter external funding, as the global financial crisis continues. Namibian banking institutions and their South African parent banking institutions could also be adversely affected. This risk will, however, be minimised by the fact that Namibian banking institutions depend chiefly on domestic deposits for their lending.

Rising global oil and food prices have pushed up import prices for net importers of fuel and food commodities. In Namibia, the sharp rise in import fuel and food prices has been a key driver of domestic inflation in recent months. Mounting inflationary pressures could eventually compel the monetary authorities in Namibia to raise their policy rates. In addition to dampening domestic economic growth, high interest would also lead to high debt repayment for banking institutions' borrowers.

Most major stock prices fell sharply in the second quarter of 2008, mostly on concerns that record high oil prices will lead to higher borrowing costs, slow economic growth, and erosion of company earnings. However, Namibian exposure to international equity markets is very limited. Hence, the impact of adverse developments in such markets on financial stability in Namibia was equally limited, although global economic slowdown could still affect stock exchange performance going forward.

3. DOMESTIC ECONOMY

3.1 ECONOMIC CONDITIONS AND FINANCIAL MARKETS

3.1.1 Economic performance

Quarterly volume indicators for the first quarter of 2008 suggest that the first quarter was particularly difficult for certain sectors. Declines in agriculture and hotels and restaurants were partly due to seasonal effects, while manufacturing was affected by the closure of a garment manufacturer (Ramatex). However, construction rose after the summer break.

The second quarter of 2008 saw real sector activities in Namibia adversely affected by record high petrol, diesel prices and electricity shortages. The agricultural sector delivered an expected rise in livestock marketed, but disappointing crop and horticulture yields. Higher fuel prices have impacted the fishing sector the hardest, and the newly announced TACs remained largely the same as for the last fishing season, with the exception of a reduction for horse mackerel.

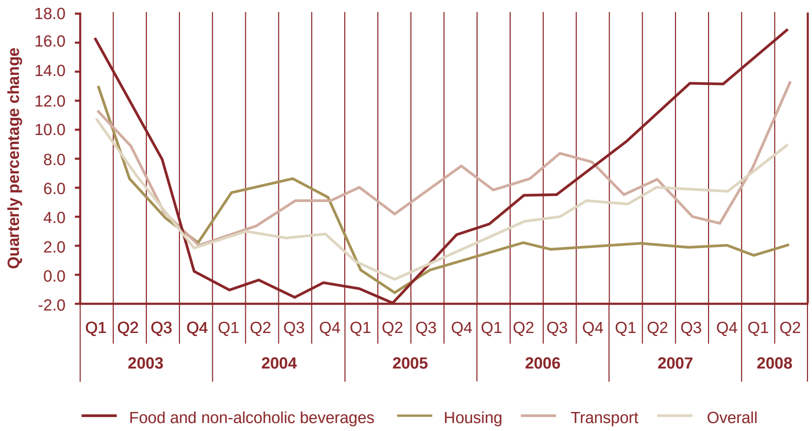
Mining has had to cope with tight electricity supply and a spate of industrial action but uranium output rose. In addition, mining exploration remained buoyant. The levels of production of refined zinc and blister copper seen in the first quarter have been sustained in the second quarter. Domestic electricity generation rose substantially in the second quarter although significant net imports from a variety of sources continued to be required to meet growing domestic demand.

Vehicle sales dipped slightly from the first quarter to the second quarter on account of reduced passenger vehicle sales. Judging by indicators from TransNamib and Namport, the transport sector did not appear to have been too severely squeezed by higher fuel prices with freight maintaining relatively robust levels. Although the forecasted growth for 2008 was revised downwards, from 4.7 to 3.9 percent, Namibia's economy continues to demonstrate a certain amount of resilience.

3.1.2 Consumer prices

During the first quarter of 2008, the overall inflation continued its upward trend, which prevailed since the second quarter of 2005, but steepened after December 2007 (Chart 7). The principal drivers behind the rise in the overall inflation have been high and rising food, non-alcoholic beverages, and fuel pump prices. The overall inflation attained a quarterly average of 8.0 percent in the first quarter of 2008 from 6.9 percent in the fourth quarter of 2007. It further rose by 1.8 percentage points to 9.8 percent at the end of the second quarter of 2008. The NCPI has reached an annual percentage change of 10.3 and 11.9 percent at the end of June and July 2008, respectively.

Chart 7: Contributions to CPI



Source: Central Bureau of Statistics

As Chart 7 shows, of the three sub-categories of the NCPI, the transport sub-category rose the steepest, followed by the food and non-alcoholic beverages sub-group. The transport sub-category rose from 4.9 percent in the last quarter of 2007 to 8.5 percent during the first quarter of 2008, before surging to 13.7 percent at the end of June 2008. The food and non-alcoholic beverages category, on the other hand, rose from 13.6 percent to 15.4 and 16.8 percent, respectively, over the same period.

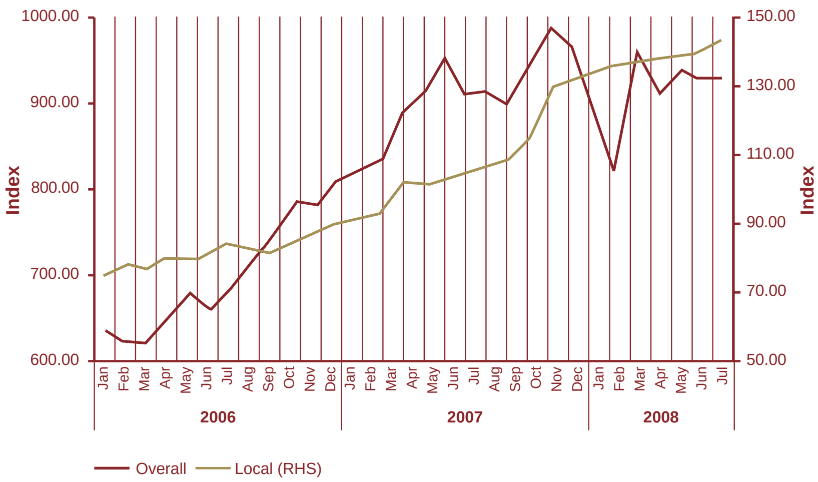
The sharp rise in food price inflation in the first half of 2008 was, in most part, related to a combination of three factors: use of crops for bio-fuel production; adverse climatic conditions; and a change in dietary patterns in developing countries in favour of animal-based proteins (for example China, India). Speculative activities in agriculture commodity markets might also have played a role in rising food prices.

3.1.3 Equity market

After dipping dramatically to 837 points in January 2008, the overall price index of the Namibia Stock Exchange (NSX) rose by 2.9 percent from 929 points at the end of the fourth quarter of 2007 to average 956 points at the end of the second quarter of 2008 (Chart 8). The overall price index measures the performance of the local and dual listed companies. The latter are companies listed on both the Johannesburg Stock Exchange (JSE) and the local stock exchange (NSX).

The dramatic fall in the beginning of the year took place at a time when international banking institutions just started to report sub-prime losses and oil prices began the historic rise. The overall index eventually recovered some of its earlier losses, to end the second quarter at 2.9 percent gain compared with December 2007.

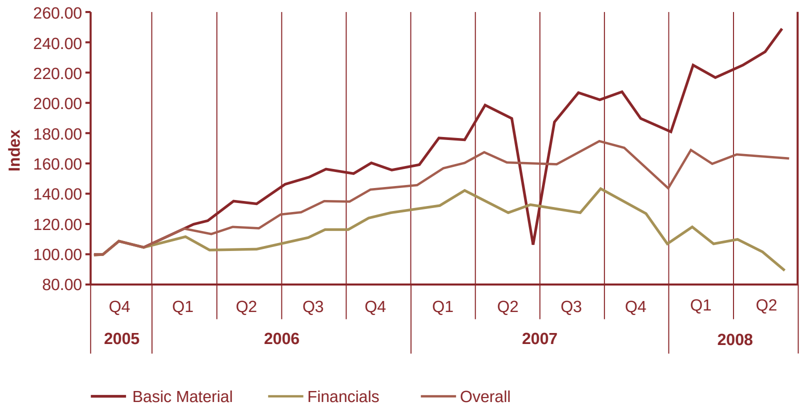
Chart 8: Namibia stock exchange price indices



Source: Namibia Stock Exchange

The recovery came as the financial markets eventually realised that the losses for the banking institutions were not as bad as initially thought. However, the recovery in the overall index was dampened by the poor performance of the financial stocks that dominated the positive performance of the basic materials stocks (Chart 9).

Chart 9: Overall index vs basic materials and financials indices



Source: Namibia Stock Exchange

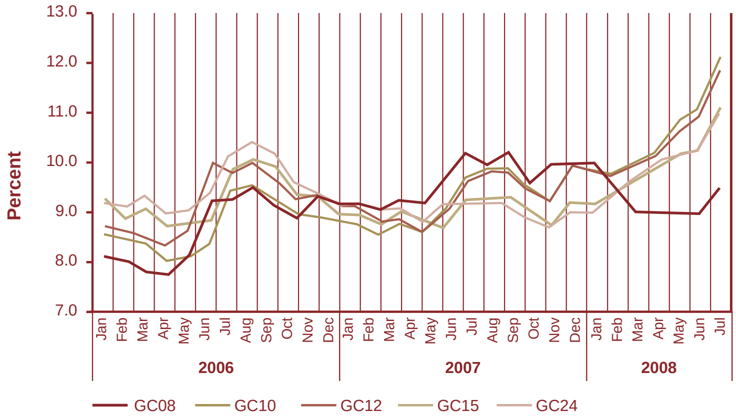
The local index of the NSX increased (by 8.3 percent) from 133 points at the end of December 2007 to 144 points at the end of June 2008. This was the index's longest gaining streak since the second quarter of 2006. As shown in Chart 7, the NSX local index achieved a quarterly growth of 7.0 percent, compared to a quarterly growth rate of 6.2 percent for the JSE All share index in the second quarter of 2008. Consequently, the NSX's local market capitalisation rose from N$4.8 billion in December 2007 to N$5.2 billion in June 2008. The stellar performance of the local index was principally driven by the exceptional performance of the local companies. The latter have no significant foreign investments or operations and are therefore not materially affected by the sub-prime mortgage crisis.

The return on the local index rose by 5.0 percent in the second quarter of 2008, compared to the first quarter. The overall index's return increased by 2.6 percent over the same period. The overall market capitalisation, on the other hand, remained largely unchanged over the same period. The impact of developments in the NSX has an insignificant impact on Namibian fund investors and, therefore, a moderate risk impact on financial stability.

3.1.4 Bond market

The yields on Government bonds rose throughout the first half of 2008, with the exception of the yield on the GC08 bond that only increased in the second quarter of 2008 (Chart 10). The increases could be ascribed to expectations of (further) interest rate increases. Banking institutions generally hold government bonds on their balance sheets for statutory liquid assets. The yields for the GC10, GC12, GC15, and GC24 rose by 2.6, 2.1, 2.0, and 2.0 percentage points, at December 2007, to 12.1, 11.9, 11.1, and 11.0 percent, respectively, at the end of June 2008. The yield on the GC08 was relatively flat in the first quarter of 2008. It, however, rose from 8.98 percent in the first quarter to 9.48 percent at the end of the second quarter.

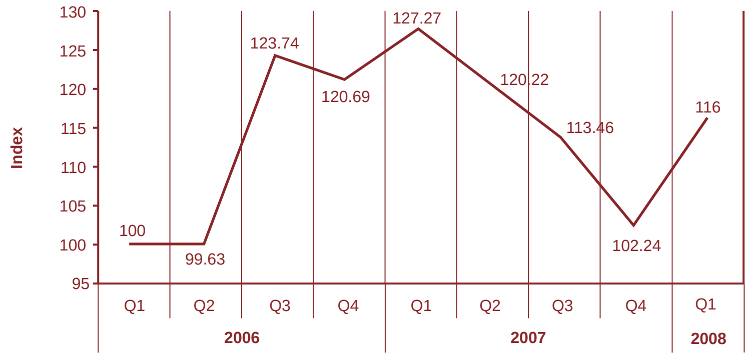
Chart 10: Government Bond yields



3.1.5 Housing sector

Chart 11 shows that the Windhoek house price index has recovered somewhat, in the first quarter of 2008, after falling significantly during the last three quarters of 2007, to grow by 13.5 percent during the first quarter of 2008. However, the overall credit demand has slowed in the second quarter of 2008 and this could consequently put downward pressure on property prices, going forward.

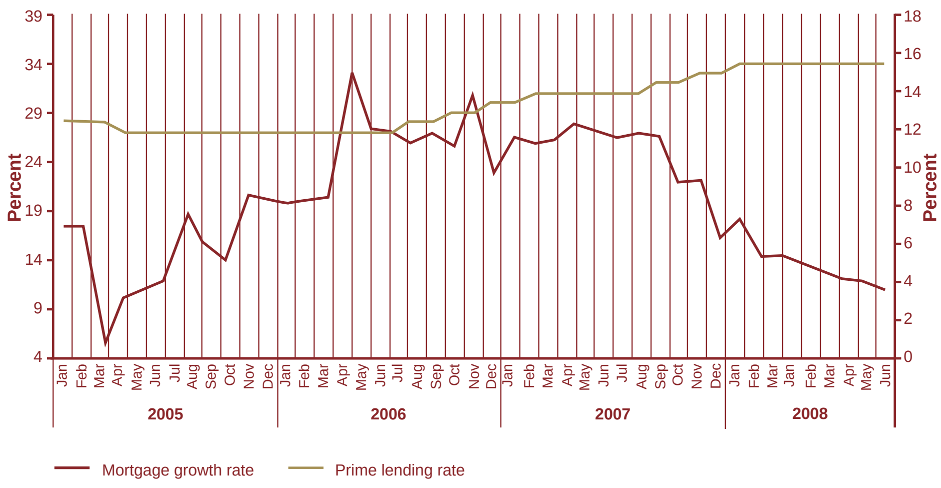
Chart 11: Windhoek House Price Index



Source: First National Bank

Chart 12 shows the trend in changes in banking institutions' mortgage loan portfolio, together with the prime lending rate. The growth rate in mortgage loans began a downward trend at the end of the second quarter of 2007 in response to rising lending rates. In the first quarter of 2008, the growth in total mortgage loans edged up slightly to 3.3 percent from 3.2 in the preceding quarter of 2007. However, growth slumped in the second quarter of 2008 to a mere 0.6 percent. Mortgage growth in the first quarter was more pronounced in the business category, which grew by 7.2 percent compared with that of individuals of 2.6 percent.

Chart 12: Mortgage growth and prime lending rate



Source: Bank of Namibia

In the second quarter, however, the growth of the business sector turned negative, while that of individuals slowed. The drop in mortgage growth was indicative of the negative impact of high lending rates on mortgage borrowing.

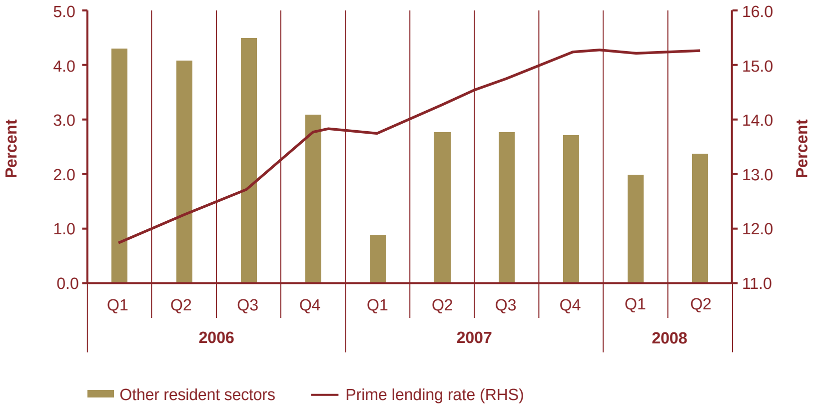
3.2 BANKING INSTITUTIONS' BORROWERS

3.2.1 Household sector

The proportion of loans to households in total loans to the private (non-financial) sector has been high in recent years. It has risen from 65.6 percent in March 2008 to 66.6 percent in June. Loans to the household sector grew by 2.0 and 2.4 percent in the first and second quarter of 2008, respectively (Chart 13). The expansion was mainly a result of growth in both mortgage lending and in loans and advances. The latter category comprised mainly personal loans. Expansion was also aided by a marginal increase in instalment credit.

Growth in mortgage loans to individuals slowed to 0.9 percent at the end of the second quarter of 2008 compared a growth rate of 2.6 percent attained at the end of the first quarter. The scanty growth in mortgage loans to individuals was a result of pressure exerted on banking institution borrowers by the combined effects of high interest rates and rising cost of living. The impact of this pressure is also reflected by FNB's latest housing index, which showed a notable increase in distress borrowing and a slackening in residential mortgage loans.

Chart 13: Claims on individuals



Source: Bank of Namibia

The ratio of household debt to GDP[1], one of the widely adopted indicators of the vulnerability of household sector debt, declined slightly from 35.8 percent in June 2007 to 34.2 percent at the end of June 2008. At this level, current household debt is significantly lower than its peak level of 38.5 percent at December 2006. The relatively low level of household indebtedness may suggest that households are better able to afford debt payments now than in the recent past.

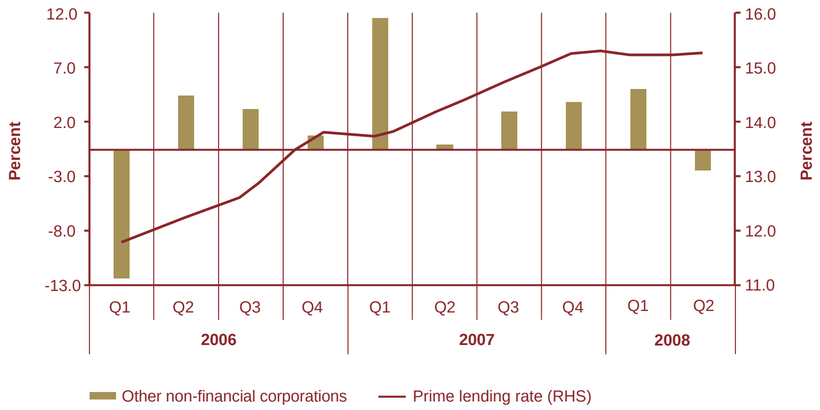
3.2.2 Corporate sector

In June 2008, loans to businesses accounted for 33.4 percent of total loans, down from 33.6 percent in the fourth quarter of 2007 and unchanged from March 2008. After growing by 5.8 percent in the first quarter of 2008, the growth in business loans fell to a negative 1.9 percent in the second quarter (Chart 14). The fall in business loans could be attributed to higher interest rates over the period under consideration.

Increased costs, in particular high energy costs, are beginning to put pressure on corporate results. Businesses that generate their revenue primarily in US dollars are vulnerable if the dollar remains weak. At the same time, a drop in export mineral prices would reduce export benefits. Furthermore, lower global economic growth may erode export companies' revenues in 2008.

[1] The GDP figures for each quarter refer to the full year's GDP.

Chart 14: Claims on businesses



Source: Bank of Namibia

Although it is likely that slower growth in export markets and a slightly weaker domestic outlook will put a damper on corporate profits, the capacity for businesses to service their debt will probably remain solid in 2008.

3.3 OVERALL ASSESSMENT

Rising global fuel and food prices have raised import prices and fuelled inflation in the first half of 2008. The overall inflation was propelled high mainly by transport and food inflation. The overall index of the NSX was affected, through the JSE, by global financial market turmoil. However, the overall impact on the NSX so far has been moderate, although future impact is possible.

Housing prices recovered in the first quarter of 2008, although unfavourable interest rates, rising inflation, escalating cost of living, and uncertainties over economic outlook may constrain demand and, therefore, house prices, going forward. The sharp rise in house prices in the first quarter, however, does not raise concerns about the risk of overheating in the housing market and its impact on financial stability is, therefore, low.

Households and corporates were affected by rising energy and food costs. Rising consumer inflation and fuel costs have meant that households have less left for debt repayments. Similarly, higher costs of energy and other inputs have reduced corporate profits and put pressure on the ability of corporates to repay debts. However, the capacity of both corporate and household borrowers to repay their debts seems reasonably strong at the moment. The impact of high costs on banking institution borrowers has, thus, been moderate.

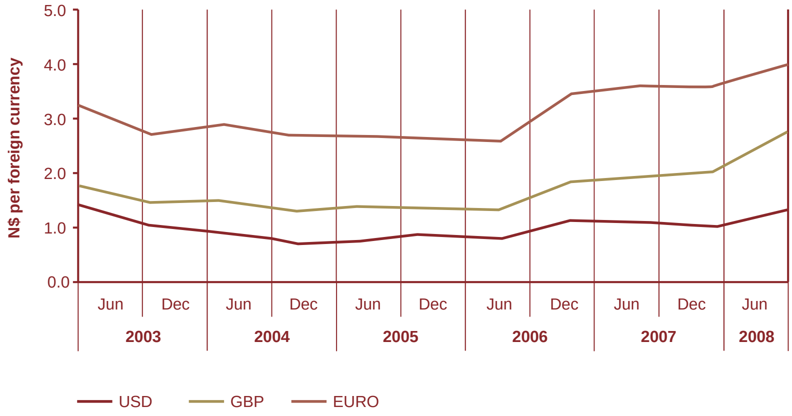
3.4 MONETARY AND FINANCIAL SECTOR

3.4.1 Exchange rates

The Namibia Dollar (NAD) tracked the South African Rand[2], which has depreciated against the major currencies in the last six months to June 2008 (Chart 15). Over the six-month period, the NAD fell 10.3, 7.1 and 19.8 percent against the US dollar, the British Pound and the Euro, respectively. Since about June 2006, the NAD has lost more against the Euro than against either the pound or the dollar. At the same time, the currency depreciated by 9.5 and 8.6 percent against the dollar and pound, year-on-year, respectively.

[2] Footnote: The Namibia Dollar trades one to one against the South African Rand (ZAR) and is therefore referred to interchangeably against international currencies. The rates being referred to are six-month end of period averages, per one foreign currency.

Chart 15: Namibia dollar per foreign currency



Source: South African Reserve Bank

The weakness in the NAD emanated from: uncertainties in the international markets (leading to risk aversion towards emerging markets), economic slowdown (e.g., weaker than expected South African GDP growth for the first quarter), and political uncertainties in the Southern African region. Furthermore, given the size of the South African current account, the currency remains vulnerable. In addition, high inflation, weak commodity prices, JSE and bond weaknesses also contributed to the weakening of the currency during the second quarter of 2008.

A weaker local currency, apart from exacerbating the impact of high international oil prices, would lead to imported inflation. The latter would in turn compel the monetary authorities to raise interest rates, with negative consequences for the banking institution borrowers and, hence, for financial stability.

3.4.2 Interest rates

The Bank of Namibia (the Bank) raised its Bank rate in October 2007 from 9.50 percent to 10.50 (Chart 16) but kept it constant since that period. The Bank opted not to adjust its monetary policy stance at its two MPC meetings in the first half of 2008; justifying its decisions by the fact that the economy was still responding to earlier rate cuts, with noticeable demand slowing, as well as a strengthening in the reserve position of the country. By the end of the second quarter, the Banking institution rate was 150 basis points lower than the South African Repo rate, which has risen by 100 basis points in the first six months of 2008.

On the other hand, commercial banking institutions adjusted their rates in the first half of 2008. In January 2008, the average deposit rates decreased (by 15 percentage points or 0.15 percent) to 8.13 percent from 8.28 percent at December 2007. However, by March, the rate had risen to 8.35 percent, although it edged down slightly to 8.33 percent at the end of June 2008. This marginal reduction in the average deposit rate could be ascribed to higher liquidity position of the banking institutions.

Chart 16: Interest and inflation rates

Source: Bank of Namibia

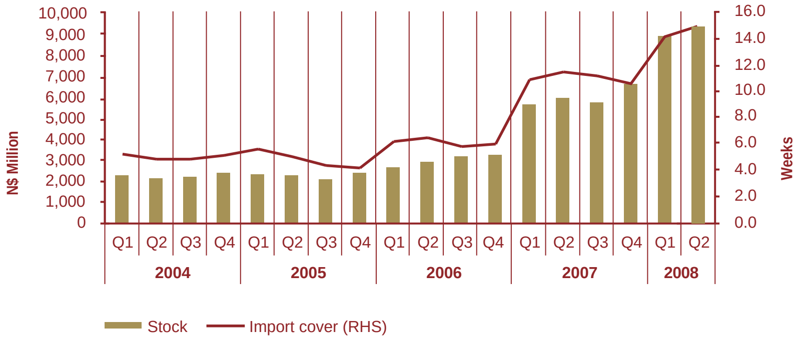
The average lending rate of the banking institutions had risen to 13.59 percent at the end of the fourth quarter of 2007. In the first quarter of 2008, it climbed further to 13.93 percent before it dropped to 13.49 at the end of the second quarter. The fall in the average lending rate could be attributed to efforts by the banking institutions to expand their customer base by making their lending rates more attractive.

Given the high inflation condition that prevailed throughout the period, real deposit rate turned negative, in particular, from mid-March to June. The real lending rate and the real spread also decreased over the same period. The inflation rate has risen monotonically from 7.10 percent in the fourth quarter of 2007 to 10.30 at the end of June 2008.

3.4.3 Reserve adequacy

The total foreign exchange reserves level rose significantly from N$ 6.5 billion at the end of 2007 to N$9.5 billion at the end of June 2008. By the end of July, the reserves had risen further to N$11.6 billion. The increase in reserves in 2008 could mainly be attributed to the following factors: SACU revenues; interest income received; and ZAR notes repatriated to South Africa. Another important factor that contributed to the increase in reserves in 2008 was the currency revaluation of N$1.7 billion, which resulted from the weakening of NAD against major currencies.

Chart 17: Quarterly international reserve stock and import cover



Source: Bank of Namibia

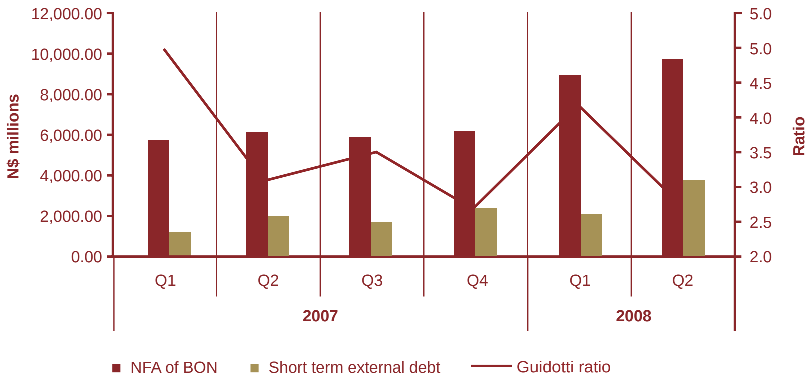
Sufficiency of reserves is a key of a country's ability to withstand external shocks. This ability is chiefly judged using the equivalent number of months of imports. This measure determines how long a country would continue importing goods and services if all other inflows of foreign exchange were to dry up. As measured in weeks of import cover, the total foreign exchange reserves increased from 11 weeks of import cover in December 2007 to 15 weeks of import cover as at the end of June 2008 (Chart 17). This means that it will take Namibia 15 weeks to continue importing goods and services without falling short of reserves. This level of foreign exchange reserves, by being above the international target of 12 weeks, is a confidence booster.

Another widely used measure of external vulnerability of an economy is the so-called Guidotti ratio: the ratio of official reserves to short-term external debt/liabilities falling due within twelve months. Chart 18 illustrates Namibia's Guidotti ratio between June 2007 and June 2008. As a norm, a country should hold reserves such that its resulting Guidoti ratios are greater than unit. As is clear from the chart, the country's ratio has been variable over the period depicted, declining from 5.0 at the end of 2006 to 2.6 at the end of June 2008.

A value of 2.6, for example, implies that Namibia's reserve holdings were enough to cover 260 percent (or 2.6 times) of its short-term liabilities should foreign borrowing become inaccessible. By comparison, South Africa's equivalent ratio was 1.20 at the end of 2007.

The accumulation of foreign exchange reserves can lessen the impact of a foreign exchange liquidity crisis. The stability of the ratio should, therefore, be a source of comfort. Additionally, the Bank of Namibia has recently negotiated uncommitted lines of credit with several international banking institutions. All these measures are designed to avoid or at least minimize the impact of a possible liquidity crisis.

Chart 18: Guidotti ratio



Source: Bank of Namibia

3.5 OVERALL ASSESSMENT

The NAD depreciated against the US dollar, pound and euro in the first part of 2008, in most part because of exogenous factors. Given that most of these factors are likely to continue in the second half of the year, it is expected that the currency weakness will continue. A weak currency would lead to high import prices and inflation and consequently high interest rates. Both results would stretch consumer budgets and compromise their debt repayment capacity. As noted in our previous FSR, this condition, combined with uncertain economic outlook, could result in unfavourable situation for banking institutions and, hence, financial stability.

The overall position of Namibia's international reserves has improved markedly in first half of 2008. This improvement has contributed to financial health and strengthened financial stability in Namibia. Although SACU revenues contributed significantly to the increase in reserves, the possible fall in the revenues may not have a significant impact on the financial health of the country as long as the economy continues to produce a balance of payments surplus.

3.6 BANKING SECTOR PERFORMANCE

3.6.1 Banking structure

The structure of the banking system is used as an indicator of potential credit access and borrowing costs. The number of banking institutions in the system has remained unchanged, at 4 banking institutions, for many years. A fifth banking institution has just been awarded a provisional license to start banking operations. If indeed it starts banking operations, its impact on the baking system will be reflected in the next stability report. Two other widely used indicators of banking structure (the HHI and Gini index) also point to a highly concentrated banking sector. The Gini index and the HHI index remained high at 12 and 2,705 points, respectively, at June 2008.

The Gini index is used to estimate the degree of inequality, in this instance, how equally or un-equally the banking assets are distributed among the four banking institutions. A value of zero represents equality of asset distribution, and a value of 100, perfect asset inequality. For financial institutions, an industry is concentrated when the Gini index exceeds 10 percent. Similarly, an HHI of 2,705 compares very unfavourably with an HHI of 1, 000 points, which is considered an indication of limited concentration.

As was the case in the September 2007 report, a banking sector with such concentration levels is considered less competitive. Banking access could, therefore, be limited and banking services relatively costly.

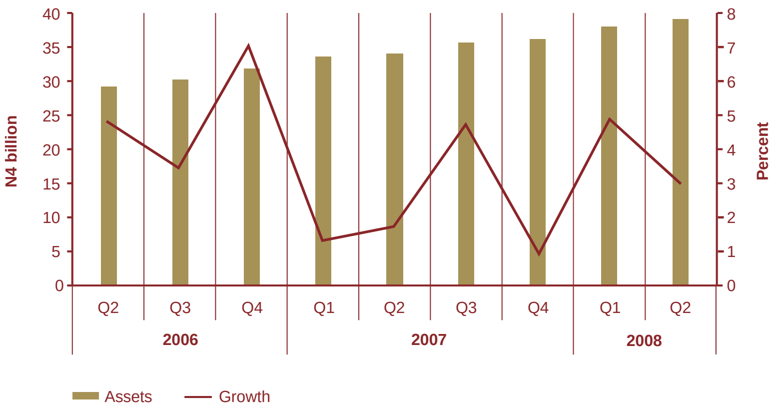
Table 1: Banking sector indicators
Income statement ratios are annualised

	Amounts in N$ '000				
Structure	**Jun '06**	**Dec '06**	**Jun '07**	**Dec '07**	**Jun '08**
Number of banks	4	4	4	4	4
Total assets of banks	30,130,094	33,397,304	34,448,220	36,504,795	39,443,450
Gini concentation index	13.2	14.1	12.5	11.6	12.2
Herfindahl index	2,712	2,730	2,769	2,678	2,705
Capital adequacy (%)					
Tier 1 leverage ratio	8.2	7.5	7.4	7.9	7.9
Tier 1 capital ratio	11.8	11.2	10.9	11.8	11.9
Total RBC (regulatory capital RWA's)	14.8	14.2	14.9	15.8	15.8
Asset quality (%)					
NPL's/Total gross loans	2.9	2.6	3.0	2.9	3.2
Gross overdue/Total loans and advances	3.7	3.3	3.8	3.8	3.9
Provisions/Total loans	2.2	2.4	2.3	2.1	2.1
Provisions/NPL's	65.7	90.3	78.9	77.2	49.2
Specific provisions/NPL's	28.4	45.6	41.8	37.0	27.3
Earnings and profitability (%)					
Return on assets	2.0	1.0	2.1	2.4	1.9
Return on equity	20.3	10.9	24.0	26.6	20.0
Interest margin to gross income	4.8	5.4	5.0	5.7	5.0
Cost to income ratio	56.3	63.7	57.5	56.9	59.2
Liquidity (%)					
Liquid assets to total assets	9.5	9.1	9.8	9.2	9.3
Total loans/Total deposits	93.7	92.8	98.4	95.9	91.6

3.6.2 Assets and lending

The balance sheet of the banking sector grew by 8 percent to N$39.4 billion in the first half of 2008 (Chart 19). This growth rate compares very favourably with the 6 percent rate in the second half of 2007. However, in the second quarter, assets rose by a mere 3.0 percent, as opposed to 4.9 percent in the first quarter. In the latter period, asset growth was driven by increases in cash and balances with banking institutions and loan and advances, which rose by 36.1 and 3.8 percent, respectively. Conversely, asset growth in the second quarter was mostly a result of a 42.3 percent increase in the other assets category.

Chart 19: Bank sector assets and growth rate

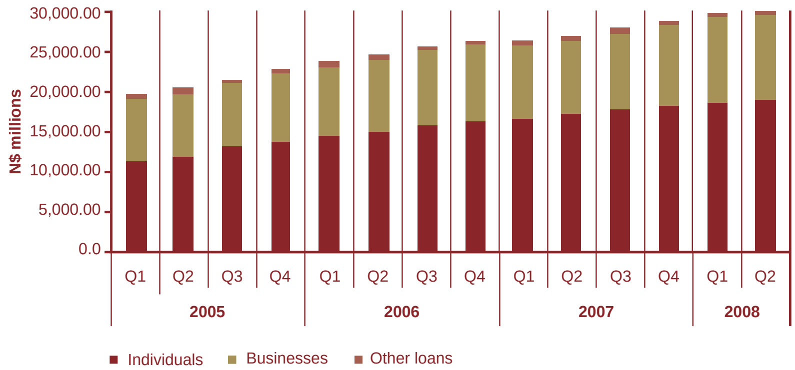


Source: Bank of Namibia

The total loan stock of the banking sector grew by 3.8 and 1.3 percent in the first and second quarter, to N$28.7 and N$29.1 billion, respectively. These growth rates mirrored the corresponding increases in the net loans and advances category.

Total loans constituted about 74.2 percent of total assets at the end of June 2008. At the same time, loans and advances to individuals were disproportionately about 55.8 percent of total loans (Chart 20). This was followed by Real Estate and Business sector, at 15.2 percent, and Finance and Insurance sector, at 6.5 percent.

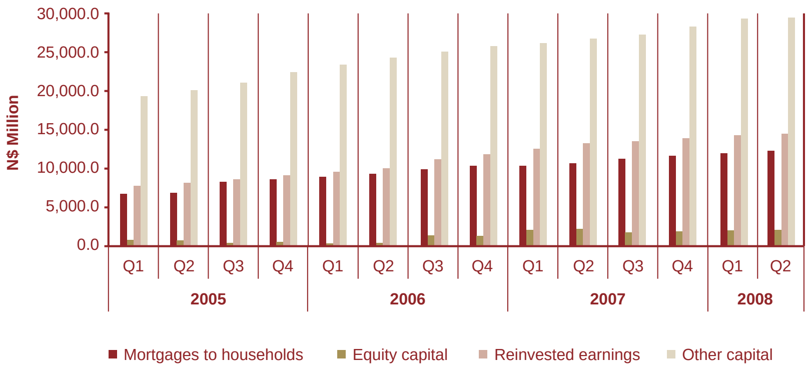
Chart 20: Sector lending by banking institutions



Source: Bank of Namibia

Lending activity by banking institutions continued to increase exposure to the households in 2008. The share of loans to households declined slightly to 63.4 percent in June from 63.6 percent at December 2008 (Chart 20). Developments in the household credit risk are, therefore, of key importance to banking institutions' earnings and financial stability.

Chart 21: Mortgage lending by banking institutions



Source: Bank of Namibia

Mortgage lending to individuals as a proportion of total banking lending was 42 percent in June, largely unchanged from December (Chart 21). However, 66.2 percent of loans to individuals were mortgage loans. This fraction averaged about 64 percent in 2007. In the second quarter of 2008, mortgage loans to individuals were 84.4 percent of total mortgage loans, up from 83.9 percent in the first quarter of 2008. The ratio averaged more than 82 percent between June 2007 and June 2008. This concentration in mortgage lending exposes the banking sector to events that reduce the ability of consumers to service their debt. Banking lending to businesses, on the other hand, were at 34.7 percent at the end of June. Inversely, the fraction of business mortgage loans remained modest, at 15.7 percent at the close of the second quarter of 2008.

3.6.3 Profitability and capitalisation

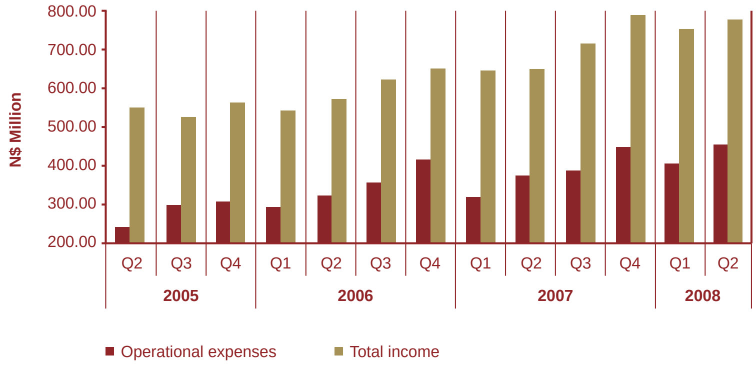
A profitable banking sector would be in a position to sustain operations and to maintain adequate capital levels required for solvency and financial stability. In general, improvements in profitability are a function of increases in total income, reductions in provisions, and cost containment.

After-tax income dropped by 17.2 percent from December 2007 to the end of June 2008. The decline for the first and second quarter was 3.0 and 14.0 percent, respectively. The culprit, marginal advance (0.6 percent) in net interest income, was a result of a 6.4 percent increase in interest expenses compared with a 4.2 percent rise in interest income. Higher interest expenses were driven by interest on demand deposits, NCD's, and fixed and notice deposits. Weighing most heavily on net income after-tax, however, was non-interest expenses that rose by 12.8 percent (Chart 22), while non-interest income only went up by 6.3 percent.

Cost efficiency

The ratio of banking institutions' operating costs to generated income is generally utilised as a measure of cost efficiency. A ratio of 50 percent or less is the international benchmark. The cost-to-income (C/I) ratio for the industry improved to 54.2 percent in the first quarter of 2008 from 56.9 percent in the last quarter of 2007, but deteriorated to 59.2 percent in the second quarter of 2008 (Table 1). The rise in the C/I ratio was partly a result of the introduction of modern banking products such as cell phone and internet banking. The ratio was also influenced by an increase in staff costs.

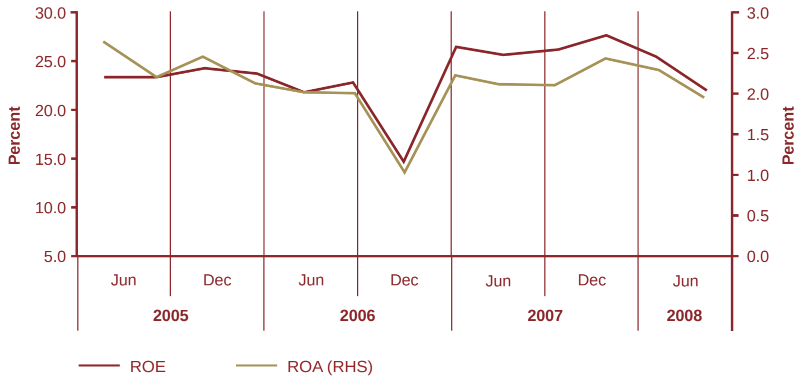
Chart 22: Banking costs and income



Source: Bank of Namibia

Following a plunge of 14.6 percent in the sector's after-tax income, both return on equity (ROE) and return on assets (ROA) fell to 1.9 and 20.0 percent in June 2008 from 2.3 and 24.5 percent in March 2008, respectively (Chart 23).

Chart 23: Pre-tax return on assets and return on equity



Source: Bank of Namibia

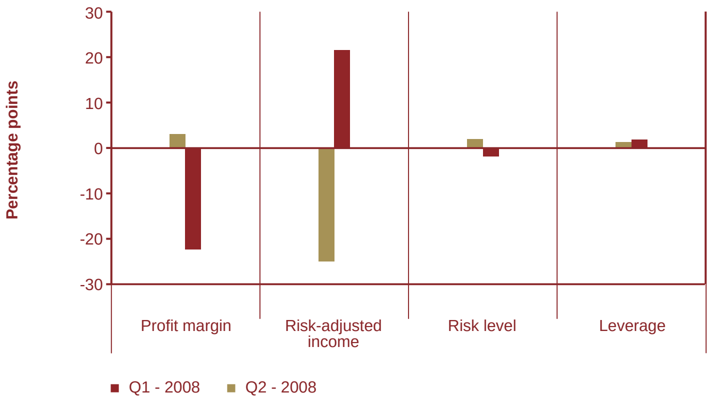
To obtain a clearer picture of the driving forces behind the negative development of profitability, in the latest six months of 2008, pre-tax ROE is decomposed into: profit margin, risk adjusted income, risk level and leverage[3].

$$\text{Pre-tax ROE} = \overbrace{\frac{\text{Pre-tax profit}}{\text{Operating income}}}^{\text{Profit margin}} \times \overbrace{\frac{\text{Operating income}}{\text{Risk-weighted assets}}}^{\text{Risk-adjusted income}} \times \overbrace{\frac{\text{Risk-weighted assets}}{\text{Total assets}}}^{\text{Risk level}} \times \overbrace{\frac{\text{Total assets}}{\text{Equity}}}^{\text{Leverage}}$$

An increase in the first two components can be assumed to strengthen a banking institution's resilience. A larger profit margin implies a greater difference between incomes and expenditures, while higher risk-adjusted incomes means that income has risen relative to risk-weighted assets. An increased risk level or higher leverage, on the other hand, usually indicates that the banking institution is taking greater risks, in which case it does not necessarily represent an increase in financial resilience.

In the first quarter of 2008, the decline in profitability came mainly from lower risk-adjusted income, which fell by 25 percentage points (Chart 24). The only positive contribution to profitability in the first quarter, therefore, came from profit margin (3.2 percentage points). In the second quarter, while risk-adjusted income rose by 22 percentage points, profit margin fell by almost an exact amount. Risk level went up by about 2 percentage points in the last three months, but leverage declined by one and a half percentage points during the same period. This might indicate that the banking institutions have not taken greater risks in the second quarter compared with the first, which is a positive sign for financial stability.

Chart 24: Composition of pre-tax ROE



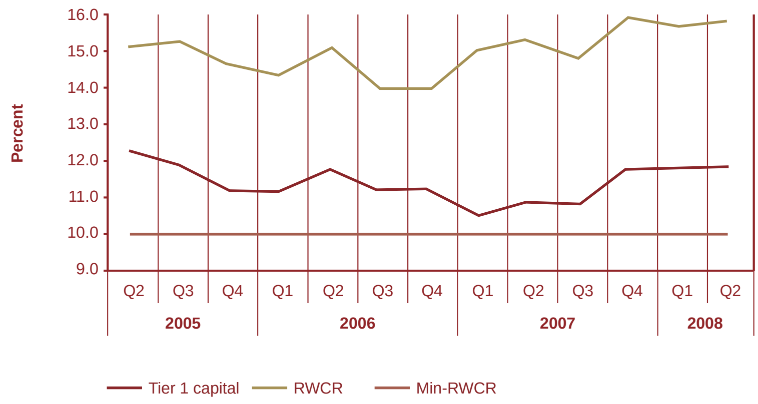
Source: Bank of Namibia

The Banking Institution Determination 5 (BID-5) requires all banking institutions to hold prescribed capital minima. The regulatory risk-weighted capital ratio (RWCR) of no less than 10 percent is prevailing. Of this ratio, 7.0 percent should comprise of tier 1 or primary capital. The tier 1 leverage ratio, another measure of capital adequacy, is currently set at 6.0 percent. The RWCR and Tier 1 capital ratio in the banking sector stood at 15.8 and 7.9 percent, respectively, at the end of the second quarter of 2008 (Chart 25).

The moderate rise in RWCR was paced by the total qualifying capital that rose by 3.6 percent as opposed to 3.4 percent advance in risk-weighted assets. Total qualifying capital, in turn was boosted by some transfer to general reserves in the second quarter and by additions to retained earnings in the first quarter.

[3] The components are subscribed in more detail in a box on pp. 26-27 of Financial Stability Report, March 2008.

Chart 25: Capital adequacy for banking institutions

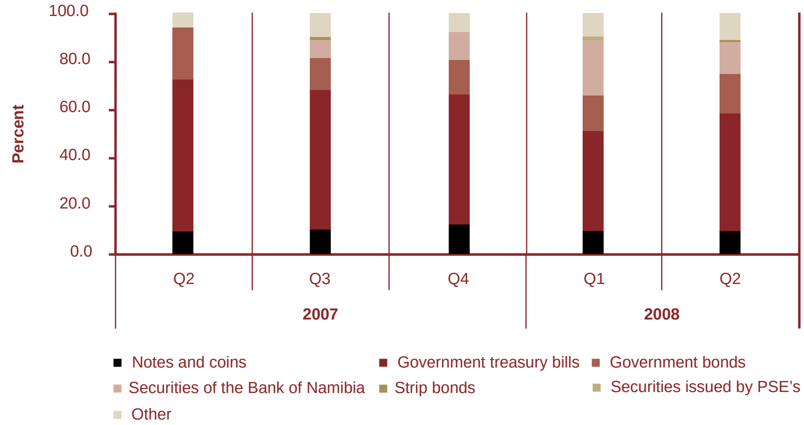


Source: Bank of Namibia

3.6.4 Liquidity

The liquid asset holdings in the industry remained unchanged at N$3.7 billion at the end of June 2008, compared with the previous quarter. Chart 26 illustrates the structure/composition of liquid assets. At the end of the second quarter of 2008, Government Treasury Bills, at 48.5 percent, and Government Bonds, at 16.5 percent, were the first and second largest shares in total liquid assets, respectively.

Chart 26: Stucture of liquid assets

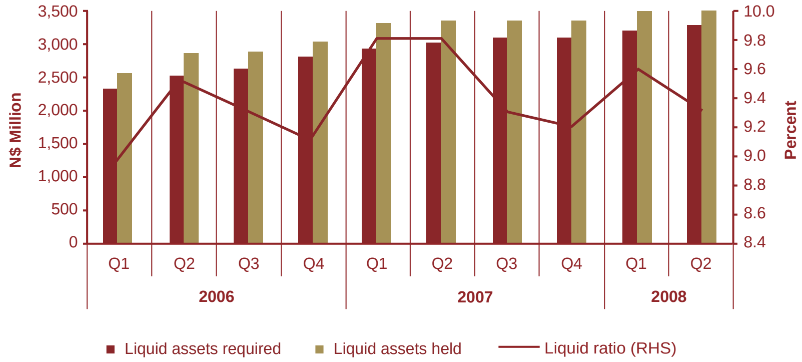


Source: Bank of Namibia

Banking institutions are inevitably subject to liquidity risk because of their role as intermediaries, transforming deposits into illiquid loans. It is, therefore, critical to continuously monitor such risk and to ensure that banking institutions hold sufficient liquidity to fulfill both expected and unexpected financial commitments as they come due. The banking institutions' holdings of liquid assets are not a cause for concern at the moment. At the current level (N$3.7 billion), liquid assets held substantially exceeded liquid assets required (N$3.3 billion) at the end of the first half of 2008 (Chart 27). However, the liquid ratio fell to 9.3 percent in June after rising to 9.6 percent in March from 9.2 percent in December.

Liquidity conditions in the interbank market could be a major determinant of banking institutions' vulnerability to liquidity risk, as they govern how easily banking institutions can raise funds on short notice through interbank borrowing. Interbank exposure among Namibian banking institutions is small relative to industry capital funds. (At June 2008, inter-banking institution borrowings and deposits comprised about 1.5 percent of industry capital and liabilities.) Given the small size of the local inter-bank market, and therefore less interdependence, it is unlikely that a liquidity problem in one banking institution could spill over to other banking institutions and cause a systemic liquidity risk/problem.

Chart 27: Liquid assets and liquid ratio



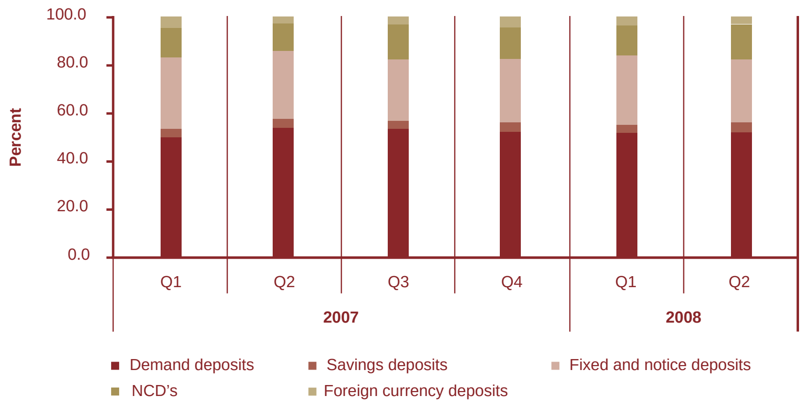
Source: Bank of Namibia

Exposures to foreign banking institutions, on the other hand, have been growing in recent quarters. Deposits, in particular, have risen from 37 percent of industry capital funds in the fourth quarter of 2007 to 59 percent in the second quarter of 2008. However, the interbank market in Namibia appeared stable. Box A looks at the interbank exposures in Namibia and their implications for systemic risk.

The liquidity risk of banking institutions is also affected by the composition of customer deposits. Among the different types of deposits, fixed and notice (time) deposits are usually more stable than savings deposits, which are in turn more stable than demand deposits. Since March 2008, there has been a slight shift from foreign currency deposits to time deposits and NCDs. Reflecting this, the share of foreign currency deposits fell to 3.1 percent in June, whereas those of time deposits and NCDs increased to 26.7 and 16.1 percent, respectively (Chart 28).

However, the share of stable deposits, at about 55 percent, was a mitigating factor. Additionally, liquidity risk may not be a concern since the banking sector as a whole has not experienced more rapid growth in lending than deposit taking.

Chart 28: Composition of customer deposits



Source: Bank of Namibia

The structure of liabilities is a longer-term factor influencing the degree of liquidity in banking institutions. Customer deposits, which are typically less costly and less volatile than most other funding sources remained the principal sources of banking institutions' funding and their share of total liabilities was stable at about 97 percent in the first half of 2008.

Banking liquidity level also depends on the extent to which customer deposits are utilised to finance illiquid loans. Deposits from customers are regarded as a stable source of funding and account for the largest share of Namibian banking institutions. The banking system as a whole has in recent years maintained a positive "customer funding gap", with the amount of customer deposits being larger than the amount of customer loans. The ratio of non-financial customers' loans to deposits (LTD ratio) fell to 91.6 percent in June 2008 from 95.9 percent at the end of December 2007. As long as banking institutions manage to maintain a high deposit-to-loans ratio, they will have limited exposure to turbulence in financial/credit markets.

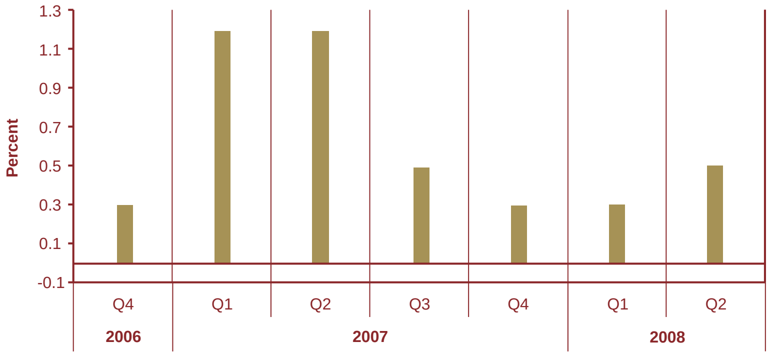
Since the LTD ratio was still well below the 100 percent threshold (above which "external" funding might be required), the banking institutions could still increase their lending without having to call on non-deposit funding sources. Furthermore, the loan-to-assets ratio averaged 75.4 percent between June 2007 and June 2008, just slightly above the international benchmark of 75.0 percent. In 2008, the ratio declined from 76.2 percent at December 2007 to 75.4 percent at March 2008, and to 74.2 percent at the close of the second quarter.

With the current levels of loan-to-deposit ratios, (averaging 94.3 percent between June 2007 and June 2008) the liquidity risk is not a major concern. The banking sector's vulnerability to liquidity risk and, hence, financial stability is, therefore, minimal.

3.6.5 Interest rate risk

Debt securities are a significant item in banking balance sheets. This means that banking institutions face risks of capital losses in the event of a rise in market interest rates. However, most banking institutions in Namibia hold their bond portfolios to maturity, thus minimising the risk of capital loss. Net open position in foreign currency is a common measure of exchange rate risk. The net open position in foreign currency as a percentage of capital funds increased from 0.3 percent in March 2008 to 0.5 percent at the end of June 2008 (Chart 29).

Chart 29: Net open position



Source: Bank of Namibia

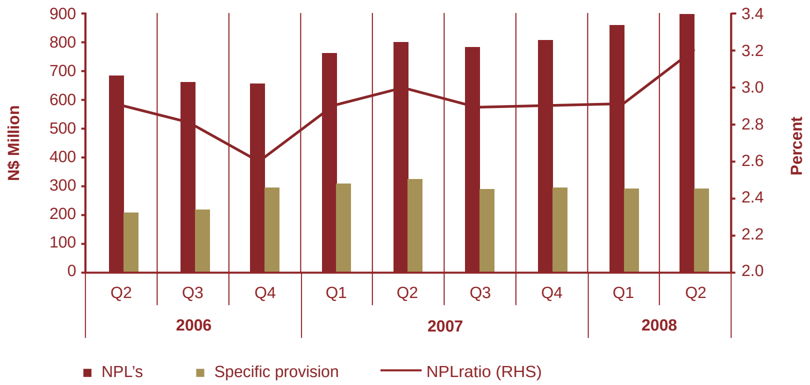
The ratio rose as a result of the net open position that increased more (76.6 percent) than the capital funds (4.2 percent). Given the rise in the above ratio, the exchange rate risk of the banking sector is deemed to have risen in the previous quarter compared with the second quarter, although the ratio is still below the regulatory limit.

3.6.6 Credit risk

Relatively strong lending growth means that the potential for future loan losses is increasing. The loan quality at the banking institutions deteriorated at the end of the first half of 2008, with the ratio of non-performing loans to total loans rising from 2.9 percent, at the end of the second half of 2007, to 3.2 percent (Chart 30). As a result, by the end of June 2008, bad loans had grown to N$940.4 million. The NPL ratio, which has averaged 2.98 percent between June 2007 and June 2008, was lifted by a 9.7 percent increase in non-performing loans that outpaced the 1.3 percent rise in loans and advances. The proportion of overdue loans in total loans has fallen to 3.9 percent in June 2008 after having risen to 4.4 percent in March from 3.8 percent in December 2007.

The mortgage category of non-performing loans has been on the rise since December 2007, reaching 53 percent of total NPL in June 2008 from 42 percent in September 2007. The concentration of NPLs in this category, therefore, exposes the banking system to events that reduce the ability of banking borrowers to service debt. The upward trend is a concern, especially in an environment of high lending rates (Chart 16). The situation, therefore, calls for a closer monitoring.

Chart 30: Banking asset quality

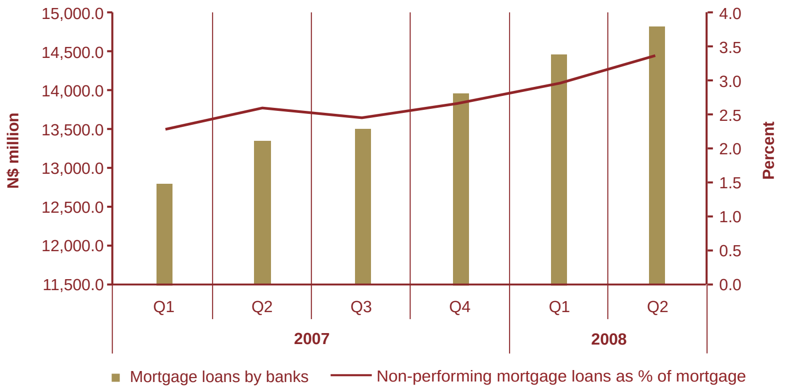


Source: Bank of Namibia

The proportion of non-performing mortgage loans out of total mortgage loans has been relatively low over the past six years (Chart 31). However, the proportion has been on a steep upward movement. For instance, it rose from 2.4 percent in September 2007 to 2.9 and 3.4 percent in March and June 2008, respectively. This trend, if maintained, could be a cause for concern.

The share of NPLs under the overdrafts category was significant although it has been declining in recent quarters.

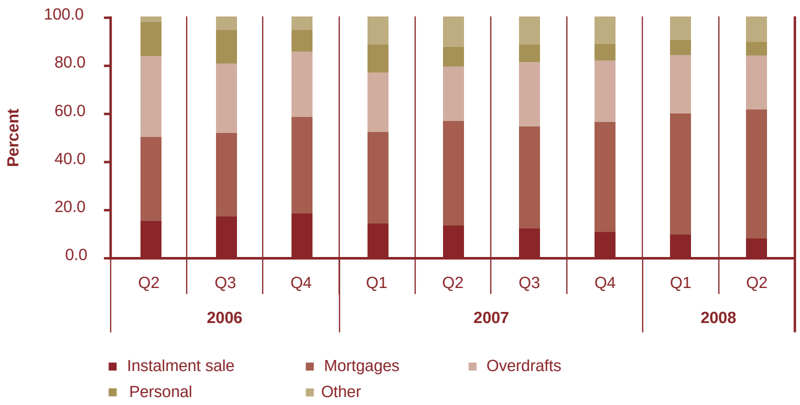
Chart 31: Non-performing mortgage loans as percent of total mortgage loans



Source: Bank of Namibia

On the other hand, the number of civil debt cases has been rising during the first half of 2008. It reached its highest level since the start of the year in March. The number of cases fell to 712 cases in May, before rising to 868 cases in June 2008. The rise in the number of civil debt cases could be indicative of borrowers' diminishing ability for debt repayments in the face of relatively higher interest rates.

Chart 32: Non-performing loans by category



Source: Bank of Namibia

In the first quarter of 2008, large exposures rose by 9.3 percent to N$5.2 billion and consequently accounted for 17.6 percent of the total loan portfolio of banking institutions. As a percentage of industry capital funds, large exposures stood at 129.2 percent compared with the 800 percent limit set out in the Determinations on Single Borrower Limit (BID 4).

In the second quarter of 2008, statutory large exposures[4] decreased by 5.2 percent to N$4.9 billion from N$5.2 billion in the first quarter. The decline brought the large exposures to 16.2 percent of the total loan portfolio of the banking industry. As a proportion of total industry capital funds, large exposures stood at 116.3 percent and well within the 800 percent limit allowed under the Determinations on Single Borrower Limit (BID 4). By comparison, large exposures were 123.5 percent of qualifying capital at the end of 2007. Although one banking institution exceeded the statutory limit of 30 percent of the banking institution's capital funds in the second quarter, large exposures for the industry as a whole do not appear to pose any significant financial stability concerns.

3.7 OVERALL ASSESSMENT

The overall impact of the global financial market turmoil on the local banking sector in the first half of 2008 has been low, thanks in most part to limited exposures to sub-prime-related investments by local banking institutions. Furthermore, the financial position of Namibian banking institutions remained strong in the first half of 2008 as banking institutions continued to be liquid, well-capitalised, and solvent.

The average ROE for the banking industry, however, declined significantly in the first six months of 2008 following a fall in profit. Similarly, unfavourable developments in household and corporate finances have led to a marked increase in non-performing loans. In addition, the industry cost-to-income ratio has also been rising, with possible future negative implications for banking institution profitability.

The above-mentioned concerns notwithstanding, the banking sector has performed satisfactorily in the first half of 2008. The overall assessment of the sector, therefore, as was the case in the previous reporting periods, is that the banking sector is generally stable.

Box A: Inter-bank exposures and systemic risk

Introduction

The distribution of exposures among banking institutions affects vulnerability of the banking system to adverse shocks. If a problem emerges in a banking institution or banking sector, links between banking institutions could transmit shocks through the system. Such links arise as a result of various activities, including direct lending, derivatives trading, and participation in payment and settlement systems.

But if a banking institution were to lose a large exposure, it could have problems with solvency. The severity of the solvency problem, in the event of a counterparty failure, depends on the exposure's size and on how much of the original claim the banking institution manages to recover. For financial stability, counterparty and settlement exposures are of particular concern when the counterparty is a banking institution because there is then a risk of problems for one banking institution spreading to other banking institutions.

This box article focuses mainly on the direct exposures between banking institutions via the interbank market. In particular, the article reviews the patterns in the interbank exposures in the Namibian banking system and their implications for systemic risk and financial stability[5].

Interbank exposures are regulated by the Determination on Interbank Placement (BID-15), which was introduced in 2004. The purpose of the determination is to limit the potential for contagion risk that results when a banking institution fails or a banking institution is unable to repay its obligations to other banking institutions in a timely manner. Exposures with a settlement period of seven calendar days or less to a single counter-party banking institution are limited to 50.0 percent of a banking institution's capital funds, while exposures with a settlement period of more than seven calendar days to a single counter-party banking institution are limited to 30.0 percent of a banking institution's capital

[4] Large exposures refer to all loans or credit facilities granted to a single banking institution borrower or a group of related banking institution borrowers that are equal to or exceed 10% of the banking institution's capital funds (regulatory capital). Statutory large exposures, on the other hand, refer to the higher of the approved limit and the outstanding balance.

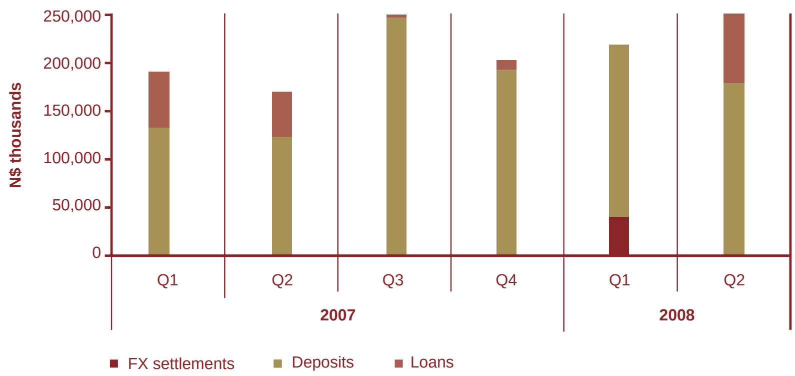
[5] This box article is a watered-down version of a method used by the Sveriges Riksbank, in an article in Financial Stability Report 2006:1

funds. Individually, all banking institutions in Namibia complied with both regulatory limits in the first half of 2008.

Overall size of exposures

The combined interbank domestic exposures of the four Namibian banking institutions in the first quarter of 2008 were about N$221 million, compared with about N$203 million in the fourth quarter of 2007. By the second quarter, the figure had risen to N$276 million. The deposit category remains the most sizeable of all interbank exposures throughout the period covered, averaging about N$180.3 million.

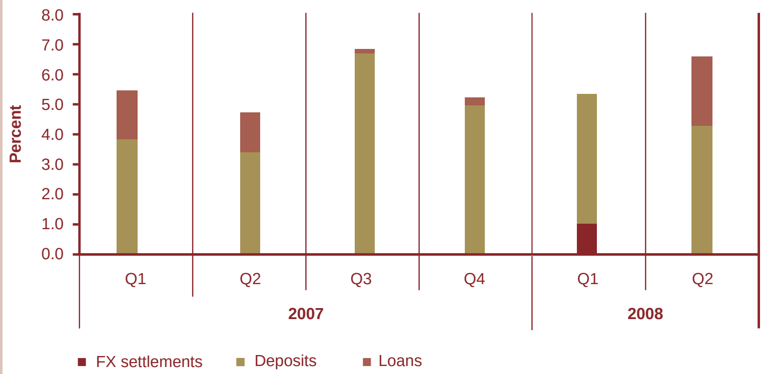
Chart B1: Reported domestic counterparty/interbank exposures by Namibian banks



Source: Bank of Namibia

Figure B1 depicts the developments of interbank exposures, while Figure B2 shows the distribution of the four banking institutions' domestic exposures relative to industry qualifying capital.

Chart B2: Namibian bank's domestic exposure in relation to capital



Direct contagion effects within the Namibian banking system

To estimate the risk of contagion between the banking institutions, tests are made on interbank exposures which the banking institutions report at quarter ends. The test assumes that one banking institution suspends payments and that the other three banking institutions lose 70 percent of their exposure to the defaulting banking institution. The assumption that 30 percent can be recovered is considered conservative. A banking institution becomes insolvent if its RWCR falls below the statutory requirement of ten (10) percent.

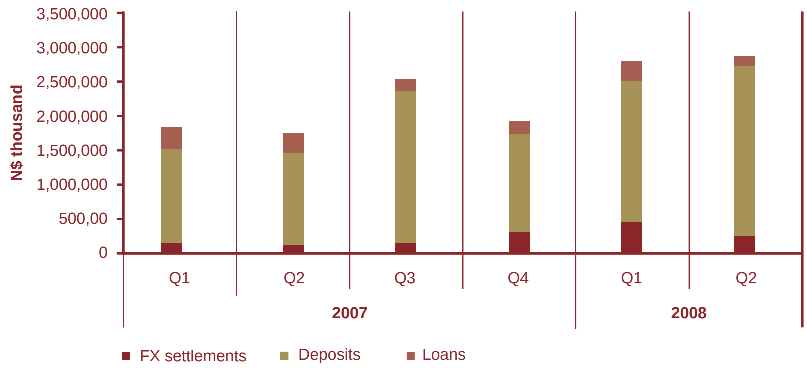
The plots in Figure B3 represent the banking institution with the lowest RWCR in each period after the test of interbank exposures, that is, after banking institution has defaulted. No calculated ratio was below the statutory requirement over the period covered. Only two interbank exposures were so large that they were close to leading to insolvency. From this result, it can be concluded that the risk of contagion between the four Namibian banking institutions was modest over the period covered by the graph.

Chart B3: The lowest RWCR among the other three banks after the fourth has suspended payments, assuming 30 percent recoveries

Direct contagion from abroad

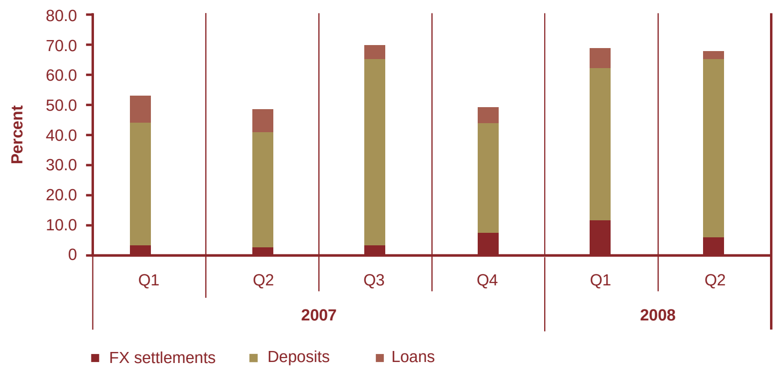
The banking institutions' largest counterparty exposures are not necessarily only to other Namibian banking institutions (Figure B4 and Figure B5). There is even a major possibility of risk of Namibian banking institutions encountering problems if a foreign banking institution were to suspend payments, given the relative magnitude of the exposures.

Chart B4: Namibian banking institutions' exposures to foreign counterparties/banking institutions



Given the same assumptions as in the test above, if the largest counterparty were to default, the banking institutions would incur insolvency in three (3) of the cases (with one on the verge). However, because these counterparties are reputable banking institutions, the risk of contagion is moderate.

Chart B5: Namibian banking institutions' exposure to foreign counterparties/banking institutions relative to industry capital



The plots in Figure B6 represent the banking institution with the lowest RWCR after the largest counterparty (banking institution) has defaulted.

Chart B6: The lowest RWCR among the four banking institutions after the largest counterparty has defaulted

Summary and policy conclusions

Data on interbank exposures shows that internal direct contagion effects are less. In most cases, where one of the four banking institutions fails, the other three banking institutions will not suffer direct losses that would reduce RWCR below the regulatory level. Exposures are measured at the end of the quarter, so they are probably underestimated compared to exposure at peak levels, particularly intraday exposures. A reduction in interbank exposures between the Namibian banking institutions is required in order to limit the risk of contagion within the Namibian system. However, banking institutions with large exposures in the interbank market need to be observed more closely.

The risk of direct contagion from abroad arises in a number of cases where failure of a foreign counterparty causes one of the Namibian banking institutions to be hit by a loss that makes its RWCR decrease below the regulatory level. However, as noted before, the risk of direct contagion from abroad is modest, given the good standings of most of these foreign counterparties. Furthermore, Namibian banking institutions' exposures are well diversified to a large number of large international banking institutions. Diversification helps mitigate the risk of direct contagion from abroad.

3.8 NON-BANKING FINANCIAL INSTITUTIONS

3.8.1 Insurance companies

There are still 16 long-term insurance companies registered in Namibia as at March 31, 2008, of which three companies hold about 88 percent of the premium market share and dominate in assets and membership.

The total assets of life insurers grew by 8 percent from N$19.8 billion in the fourth quarter of 2007 to N$21.3 billion in the first quarter of 2008[6]. Most of the increase came from the foreign asset category, which rose by 37 percent during the same period. However, total investments declined by nearly 1 percent between the fourth quarter of last year and the first quarter of this year. The decline in total investments came mainly from falls in investment in unlisted shares (-73 percent) and investment in listed shares (-21 percent). The fall in investment was attributed to unfavourable local and global financial market conditions. Expenditure on the other hand, rose by 13 percent from March 2007 to March 2008.

Gross premium income increased by 57 percent to N$1.1 billion, from the first quarter of 2007 to the first quarter of 2008. Total new premiums rose to 52,309, or N$203.4 million, during the first quarter of 2008. Over the same period, the number of policy lapses rose to 22,770, or N$5.4 million. However, investment income and other income decreased by 74 percent and 113 percent, respectively, during the same period.

Total liabilities were covered 1.1 times by total assets between the fourth quarter of 2007 and the first quarter of 2008. During the same period, policyholder liabilities also increased by 13 percent. From the

[6] This section is based on data provided by Namfisa; the Bank of Namibia does not, however, guarantee the accuracy of the data from external sources.

first quarter of 2007 to the first quarter of 2008, excess assets and Capital Adequacy Requirement (CAR) declined by 20 and 40 percent, respectively.

The number of policyholders and new policies rose by 11 and 4 percent, respectively, over the twelve months to March 2008. At the same time, lapses, maturities and terminations declined by 5 percent. The total number of policyholders grew by 35 percent between the last quarter of 2007 and the first quarter of 2008.

The amounts paid out in relation to deaths, disabilities, maturities and retirement benefits increased by an average of 12 percent from the first quarter of 2007 to the first quarter of 2008. The level of group member withdrawal claims rose by 68 percent, over the same period. Retirement benefits have decreased by 98 percent, in the first quarter of 2008.

The general outlook of the industry appears to have deteriorated from the previous report. The claims in which HIV/AIDS is the principal cause of death remained elevated. The surplus assets, and, hence, the CAR have been falling. This has a negative impact on industry solvency. The industry is also affected by the uncertainty surrounding international financial markets, causing both investment and investment income to fall. As noted in our previous reports, the long-term insurance industry remains vulnerable to a slowdown in economic activity and high interest rates.

3.9 OVERALL ASSESSMENT

Most of the challenges facing the long-term insurance sector, as highlighted in our previous reports, remained in the first quarter of 2008. In addition, the surplus assets and CAR have declined. The overall operations of the sector were deemed to be sustainable, though warranting close monitoring.

3.10 FINANCIAL INFRASTRUCTURE AND REGULATORY DEVELOPMENTS

3.10.1 Financial infrastructure

The Bank has undertaken a host of supervisory activities in the first half of 2008. The principal objective of the undertakings was to ascertain the safety, efficiency and timeliness of the National Payment System (NPS) in Namibia. To this end, the Bank assessed the performance of systems and participants. In addition, the Bank looked at developments in payment system projects, as well as developments in other areas of NPS.

Consequently, the Namibia Inter-bank Settlement System (NISS) was available for settlement and transactions 99 and 96 percent of the time in the first and second quarter, respectively, with only very few cases of outages reported. Similarly, the Bank profiled the behaviour of payment system participants with a view to identify possible systemic crisis posed by their actions to the NPS. The profiling also allowed for the assessment of compliance with payment system requirements and standards.

Additionally, participants made few or no insufficient funds or failed batches. Their redundancy and disaster recovery sites were active during the period under review. There were also few extension requests of the settlement window in the second quarter, an improvement from the first quarter. The Smart Switch Namibia switching solution continued to perform well, based on the number of transactions being routed through the system. Transactions, facilities and stock values rose, in particular, during the second quarter.

The availability of the systems and transactions cleared through them are utilised to assess risks and performance of retail and payment clearing systems. All clearing retail payment systems at Namclear (Pty) Limited were available most of the time. The Bank also monitored compliance with payment system regulations. Here, the Bank has observed that a satisfactory number of participants complied with directives. In addition, the Banking institution has entered into a Memorandum of Understanding with the Payment Association of Namibia (PAN) under which terms the chairmanship and administration of the PAN will reside with the Banking institution.

In line with our assessment in the previous report, the National Payment System in Namibia continued to function satisfactorily. The system posed no systemic or financial stability concerns. All systems continued to be resilient and robust, and enabled transactions to be processed without any major disruptions. In addition, key payment system reform projects remain on track.

Participants did not pose any serious threats to the payment systems, in terms of the number of failed transactions (single and batches) and extension requests posted with the Bank. Participants were also compliant with Bank and industry regulations.

Consequently, the Payment System Division will be preoccupied with the following issues during the third quarter of 2008:

- Streamlining the collection of payment system statistics from participants and service providers;
- Ensuring compliance with the electronic funds transfer (EFT) directive and sensitization thereof; and
- Rolling out the self-assessment and onsite inspection for Namclear (Pty) Limited and Namibia Post Limited.

3.10.2 Regulatory developments

Determination on the localization of core banking systems

In August 2008, the Banking institution of Namibia has issued a determination on the localization of core banking systems. The purpose of the determination is to ensure that the core banking systems are located in Namibia, in order to provide the Bank with an efficient access to accounting and other banking records. This Determination applies to all banking institutions authorised by the Bank to conduct banking business in Namibia, and covers all their fault tolerant core banking systems. In addition, it will contribute to ensuring the efficiency and safety of the National Payment System, support effective payment system oversight and banking supervision.

The determination also provides for a transition period. During this period, the non-complying banking institutions should provide a complying implementation schedule. They all should be compliant by December 31, 2009. The determination became effective on August 11, 2008.

Anti-Money Laundering

The Parliament of the Republic of Namibia passed the Financial Intelligence Act (FIA) on July 20, 2007. Regulations accompanying the FIA have also been recently finalised and endorsed by the legal drafters and are waiting to be published in the Government Gazette. They will be made operational once the Prevention of Organised Crime Act is operational. The amendments to the latter Act, which will criminalise money laundering, are currently waiting to be tabled in Parliament in the fourth quarter of 2008.

4. OUTLOOK, RISKS AND OVERALL ASSESSMENT

4.1 GLOBAL OUTLOOK

According to the IMF, global financial risks are expected to remain elevated in the second half of 2008. The downside risk to the forecast continues to be financial market conditions resulting from the US sub-prime mortgage crisis and its impact on global financial stability.

Uncertainties in the global financial markets could further negatively impact the real economies and exacerbate the current global economic slowdown. Rising food and fuel prices are also expected to continue to fuel global inflation, which is forecast to reach 3.7 percent in 2008, but will accelerate to 9.1 percent in emerging and developing countries during the same period. As a result, many countries will face the dilemma of high inflation outlook and slowing economic growth.

The IMF expects global economic growth to slow to 4.1 percent in 2008, 0.9 percentage points from its 2007 level, and further to 3.9 percent in 2009. While growth in the advanced economies is generally expected to fall well below potential, the emerging economies are projected to grow at a slower pace.

4.2 DOMESTIC OUTLOOK

The Namibian economy is expected to grow at 3.9 percent during 2008, after having slowed to 3.6 percent in 2007. The revision from an earlier projection of 4.7 percent reflected the effects of adverse developments in the external and internal economic environment.

Growth is projected to be mainly underpinned by increased uranium production and the continued strong growth in the construction, transport and communication, and the manufacturing sectors.

However, the risks to the outlook remain on the downside. These include: the marked slowdown in the global economy; rising inflation rates and fuel prices; and the potential negative impact of energy shortages. Despite these risks, the impetus to growth would remain the mining sector, particularly an increased uranium production linked to good mineral prices.

4.3 SUMMARY ASSESSMENT

The overall global financial markets continue to be characterised by immense volatility in the first half of 2008, as the aftermath of uncertainties due to the US sub-prime crisis. The resulting illiquidity and restrained banking institution lending adversely affected the real economies. As a result, global economic growth slowed, although more so in the advanced economies than in the emerging economies in the last six months of 2008.

There were no significant signs of spill-over from the US sub-prime mortgage crisis on the local credit markets, thanks in part to limited exposures to sub-prime-related investments and to heavy dependence on domestic funding. At the same time, the banking sector continued to be liquid and well capitalised. Profitability, although it slowed significantly, has contributed to a further increase in banks' solvency and resilience in the past six months of 2008. The capital adequacy ratio for the banking sector also increased sizeably. The average ROE for the sector in the industry, however, declined significantly in the six months of 2008 after improving in 2007. In addition, unfavourable developments in household and corporate finances have led to a marked increase in non-performing loans as a share of total lending by banks since the first quarter of 2008.

Most major stock prices fell sharply in second quarter of 2008, mostly on concerns that record high oil prices will lead to higher borrowing costs, slow economic growth, and to erosion of corporate earnings. The impact of the global financial markets turmoil on the NSX, which came through the JSE, has been minimal due to the limited exposure to international equity markets. Hence, the impact of movements in such markets to financial stability in Namibia is equally limited.

Housing prices recovered in the first quarter of 2008. However, the overall credit demand for residential property has slowed significantly. Unfavourable interest rates, rising inflation, the escalating cost of living, and uncertainties over economic outlook may have constrained demand and might, therefore, lead to a decline in house prices. The sharp rise in house prices in the first quarter, however, does not raise concerns about the risk of overheating in the housing market.

Rising consumer inflation and fuel costs have diminished households' capacity for debt repayment. Similarly, higher costs of energy and other inputs have reduced corporate profits and hurt ability to repay debts. Furthermore, higher costs continue to exert pressure on inflation and, consequently, may create a need to raise interest rates. High rates could, in turn, have adverse effects on financial stability.

The NAD depreciated against the US dollar, pound and euro in the first part of 2008, in most part because of exogenous factors. Given that most of these factors are likely to continue in the second half of the year, it is expected that the currency weakness will continue. A weak currency would lead to high import prices and inflation, both of which would stretch consumer budgets and compromise their debt repayment capacity. A combination of uncertain economic outlook and unfavourable situation for banking institutions could negatively affect financial stability.

A depreciating currency could, however, have a positive impact on the reserves. The overall position of Namibia's international reserves has improved markedly in the first half of 2008. This improvement has contributed to financial health and strengthened financial stability in Namibia.

Most of the challenges facing the long-term insurance sector, as highlighted in our previous reports, remained in the first quarter of 2008. Total investments and investment income have fallen. In addition, the surplus assets and CAR have declined. The overall operations of the industry were deemed to be sustainable, though warranting close monitoring, and do not, however, pose any sizeable financial stability threats.

In summary, the global and domestic economic environment has weakened since the last publication of the FSR. Growth in most advanced countries and in Namibia have started to fall. The uncertainties in the global financial markets due to the sub-prime crisis in advanced economies particularly in the US and UK have contributed to the poor growth in these economies. In addition, higher energy and food prices have caused higher inflation in many countries, particularly emerging economies such as Namibia. This has adversely affected the operating environment for domestic banking institutions as non-performing loans have risen. However, despite these challenges, banking institutions in Namibia continue to be stable. Therefore, the impact of exogenous factors notwithstanding, the Bank sees no immediate threats to financial stability.

Bank of Namibia