Tom Alweendo: Namibia's monetary policy framework

Annual address by Mr Tom Alweendo, Governor of Bank of Namibia, Windhoek, 6 November 2008.

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Introduction

Thank you for having accepted our invitation to come and listen to my annual address. This year I will focus my address on our monetary policy framework. This year's choice of topic is motivated by our desire to be transparent in our conduct of monetary policy.

International financial crisis

Allow me first to make few remarks on the global economic developments. By now we are all aware of the financial crisis that is afflicting the world economy and its adverse impact on economic growth world-wide. This crisis is made worse by the risk of high price-induced food and fuel crises. As a result, many countries are faced with the challenges of managing worsening balance of payments positions. For example, global economic growth is projected to decline this year and during 2009, potentially aggravating the financial crisis and thereby the loss of confidence in the financial markets. While the financial crisis is still only confined to the advance economies, there are uncertainties as to its impact on developing economies. Depending on how long it may last, there is a greater risk that the crisis will spill-over to developing economies and that we will see further tightening in the commodity markets that will pose risks to growth in many commodity-exporting developing countries.

In sub-Saharan Africa, for example, economic growth is projected to minimally slow from 6.9 percent in 2007 to 6.3 percent in 2008. In 2009 there is an expectation of a slow recovery to 6.7 percent, due mainly to the relative macroeconomic stability in many of the SSA economies. However, it is likely that the region will be negatively impacted by conditions of food insecurity and inflationary pressure. In many of our countries in the region, the key challenge is therefore how to address the medium to long-term implications of the crisis with respect to macroeconomic stability, fiscal and current account balance, and growth sustainability. It is imperative that our policy should aim at improving infrastructure and to increase investment that is supportive of growth, strengthening the macroeconomic framework, and improving the business environment in order to avoid loss of competitiveness.

The advanced economies that are affected by the financial crisis have responded by mainly using public funds to provide fiscal stimulus and liquidity support to their financial institutions. They argued that the long-term potential cost to society arising from the collapse of the financial sector will be much larger than the cost to the public of bailing out ailing financial institutions. We also now know that these policy interventions have had mixed results in stemming the crisis.

The main lesson to be learned from the financial crisis is that in the highly globalised financial markets, effective regulation is an indispensable tool to manage financial markets. It has been proven, on various occasions that the market is not always efficient. We must therefore except that there will always be occasions where the market will fail and when that happens there is a realistic expectation that governments should intervene. When markets are functioning as expected, proponents of minimal regulation generally consider regulation as an unnecessary constraint to the private sector. My view is that we need to be pragmatic and not wait until markets fail before governments intervene by having effective market regulation. Let me also hasten to add that when governments do intervene to correct market failures, such intervention must be temporary and targeted.

Our financial system has been relatively shielded from the immediate negative consequences of the financial crisis. Overall, therefore, there is no immediate concern about our financial stability. However, depending on how long the crisis may last, we are not altogether immuned from the long-term effects, such as slow economic growth. Moreover, although inflationary pressures have started to abate, the outlook remains uncertain. It is, thus, imperative to manage our resources prudently, both at a national and household levels.

It goes without saying that the financial crisis has created a challenge for monetary policy. A number of monetary authorities are faced with the difficult balance between maintaining price stability by tightening monetary policy without needlessly jeopardising economic growth.

Principles of monetary policy framework

Let me now return to my topic of discussion today, namely our monetary policy framework. Before elaborating on the specifics of our monetary policy framework, I would like to highlight some principle issues that guide monetary policy frameworks world-wide. Monetary policy has been acknowledged as one of the main tools that central banks and governments use for economic management. One can describe monetary policy as the action by the central bank to influence short-term interest rates, money supply and credit extension to achieve certain objectives. In many countries, including Namibia, the objective of monetary policy is price stability.

In an environment of stable prices, economic actors, both domestic and foreign, are able to plan better for the future. For instance, both domestic and foreign investors would be hesitant to invest in a high inflation environment for fear of loss of their investment values. Stable prices allow market participants to make informed decisions and adjust their decisions about spending, saving, and investing in welfare-enhancing ways. High inflation, on the other hand, invites bad economic decisions, which is harmful to long-term sustainable growth. Stable prices are also important in protecting the purchasing power of consumers, especially the poor.

One of the pertinent questions that economists and practitioners alike continue to battle with is what monetary policy can do and what it cannot do. In general, there is consensus that monetary policy, through low and stable prices, can assist in creating a conducive environment for sustainable economic growth and development. I would, however, like to note that stable prices do not mean that prices of good and services will not change at all. Relative prices in a market economy will always change in response to changes in relative scarcities. For example, during or after a drought food prices are likely to increase.

While monetary policy can succeed in maintaining stable prices, it is less successful in controlling real variables, such as the real interest rate or the unemployment rate.

The point being that price stability is a necessary but not sufficient condition for economic growth. Growth in the long-term is determined by a range of factors, including supply side factors, government policies and the general macroeconomic environment that monetary policy contributes to.

The transmission mechanism of monetary policy in Namibia

At the heart of any monetary policy framework is the transmission mechanism. The transmission mechanism traces how monetary policy decisions impact on other economic variables, such as prices and output over time. For example, if the objective of monetary policy is to control inflation and the instrument used is interest rate, the transmission mechanism describes how higher interest rates are supposed to curb increases in the general price level. Increases in interest rates raise the cost of borrowing and depress corporate investment. Furthermore, high interest rates reduce the value of assets, which impacts negatively on wealth and therefore consumption.

We must, however, be aware that there are economies that are less market-oriented than others, where the behaviour of economic actors may be less sensitive to the price of money and where bottom-line considerations may not be of prime importance in business decisions. There is also the possibility of the borrowing and lending rates of the banks being less sensitive to changes in the key policy rates. For these and other reasons, the transmission mechanism, may be less efficient than would otherwise be the case. This may be so to such an extent that interest rate as a monetary policy instrument may not be an effective one.

The mechanism will also differ, depending on whether a country has adopted a fully flexible or pegged exchange rate arrangement. In an open economy operating under a fixed exchange rate regime, it is not possible to also have monetary policy independence and free capital mobility. However, a country with a fixed exchange rate policy could use sterilisation operations, capital controls and prudential requirements to influence, to a certain degree, short-term interest rates, money supply and credit extension to the private sector to control domestically induced inflation through expectations and aggregate demand.

As a consequence of being a member of the Common Monetary Area, Namibia is not in a position to set its monetary policy fully independent from South Africa, which is the anchor country. However, we still have the ability to deviate to some extent from South Africa by using capital controls and prudential requirements that can be imposed on our financial institutions. It is therefore possible for the Bank of Namibia to maintain a Repo rate different from the Repo rate of the South African Reserve Bank (SARB), when so required, and gives us discretion to control the domestic money supply. This discretion enables the Bank of Namibia to control domestically induced inflation, which is estimated to contribute about 35 per cent to the overall inflation in Namibia.

The institutional underpinnings of monetary policy in Namibia

Let me now say something about the process of conducting our monetary policy. Our Executive Committee, consisting of senior members of management and chaired by the Governor, is responsible for the formulation of monetary policy. In many countries, the setup is to have a legally constituted Monetary Policy Committee, where membership is not restricted to members of management. In my view this is a better arrangement and going forward, we should move to a similar arrangement.

The key mandate of the Executive Committee in relation to monetary policy matters is derived from the Bank of Namibia Act, which requires the Bank of Namibia to ensure internal and external monetary stability. By law, the Bank enjoys operational autonomy in its decision-making. The main objective that the Committee focuses on is the maintenance of the parity of the Namibia Dollar to the South African Rand. However, since the ultimate objective of monetary policy is stable prices, the Committee also keeps a close watch on the inflation rate.

The Committee meets six times a year and at each such meeting, it decides on the appropriate stance of monetary policy for the next two months. Before a decision is taken, relevant line departments in the Bank are invited to make presentations to the Committee on recent domestic and international economic developments, and on the inflation outlook. All decisions are taken by consensus and where consensus does not emerge, the Chairperson exercises a casting vote.

Monetary policy implementation and market operations

Our ultimate monetary policy objective, as I noted earlier, is to maintain price stability. In achieving this objective, the Bank of Namibia has an intermediate target to promote an economic and financial environment that will ensure that the parity between the Namibia Dollar and the South Africa Rand is not in any way threatened. For example, the parity could be threatened when, amongst others, large interest rates differential causes undue capital inflows or outflows.

You may also need to have an operational target, which is an economic variable that the central bank wants to influence on a day-to-day basis, through its monetary policy instruments. Although we do not have a formal operating target, we do monitor the level of our official reserves, as the fixed currency peg requires the country to fully back its currency in circulation with international reserves. Our current levels of the official reserves are more than sufficient to protect the fixed exchange rate arrangement. However, at the N$12 billion mark, the reserves are still minimal in comparison to similar economies. We therefore need to continue to intensify our efforts in accumulating more reserves.

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

The main tools that the Bank uses to reach its operational targets include the call account, repurchase operations, Bank of Namibia Bills and other monetary policy tools. For those who are interested in more details about these tools, I encourage you to read the booklet we have just issued. However, the main objectives of all these tools are to manage liquidity in the banking system.

Conclusion

In conclusion, ladies and gentlemen, I hope that I have clarified a number of issues, and that you will have a better understanding and appreciation of the monetary policy decisions of the Bank. I also encourage you to make time and read the booklet on monetary policy framework that we launched today. As you read, please remember that our doors at Bank of Namibia are open, should you want to engage us on certain issues that may be of interest to you. That will help us make strides in our efforts to being transparent in our dealings.

I thank you for your attention.