Mr Alweendo discusses Namibia's current exchange rate arrangement and its implications for the country's monetary policy

Annual Speech 1999 given by Mr Tom K Alweendo, Governor of the Bank of Namibia, on 17 November 1999.

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Introduction

I would like to welcome you all to this first Annual Speech by the Governor of the Bank of Namibia. It is common in many countries that the Central Bank takes the opportunity once a year to inform the most important stakeholders of economic issues the Bank considers to be of particular importance. The intention is to also make this an annual event in Namibia.

The Annual Speech shall not be a review of economic developments in Namibia and abroad; that you will find in our Annual Reports. I will rather try to give the Central Bank's views and outlook on selected topics. Today, I will mostly deal with Namibia's exchange rate arrangement. From the outset, I would like to stress that there are no other reasons for this choice, other than the fact that it is important for many of our stakeholders to fully understand the current exchange rate arrangement. The issues involved are many and complicated, and it is my intention to give a comprehensive overview of the current arrangement and its implications for monetary policy in Namibia.

The CMA arrangement

As you all know, Namibia is a member of the Common Monetary Area (CMA). Within a monetary area, exchange rates between the participating countries are fixed and there are no payment restrictions. The CMA has many of the characteristics of a monetary union, as the exchange rates vis-à-vis other member states are fixed and capital flows are free. As a consequence, interest rates and the money supply cannot be directly influenced by the individual country. Monetary policy in such a system is at best subordinated to exchange rate policy, as domestic credit creation must be kept within limits in order to ensure a sufficient volume of net foreign assets of the banking system. In monetary unions there is usually also a high degree of policy coordination, which in my opinion could be improved in the current CMA arrangement. This is an issue I will return to later.

The formal agreement

Namibia's membership of the CMA was formalised by the accession to both the multilateral agreement with Lesotho, Swaziland and the Republic of South Africa in 1990 and a separate bilateral agreement with the Republic of South Africa in 1992. Two dominant features of this arrangement are:

(1) a commitment by the Bank of Namibia to exchange the domestic currency for a specified amount of the reserve currency - the rand - "without restriction subject to a normal handling charge" at a fixed exchange rate; and

(b) an explicit requirement that at least a major proportion of its monetary liabilities be backed by the reserve currency or other foreign assets. More specifically, Article 4, Section 1, of the bilateral monetary agreement states that, and I quote:

> "*Against the aggregate amount of Namibia dollar currency issued by the Bank of Namibia, the Bank of Namibia shall maintain a reserve equivalent thereto in the form of rand assets and freely usable foreign currencies in such proportion as the Bank of Namibia considers appropriate…*".

In addition, the bilateral agreement also provides that either contracting party has the right to issue its own national currency. It is also a part of the agreement that either party may introduce measures for domestic resource mobilisation in the interest of the development of their respective countries.

I will in particular draw your attention to two issues in the provisions cited above. First, there is under no circumstances room for changing the exchange rate, and second, the backing rules of the currency must be observed at all times. These two characteristics remain both the source of strength as well as the most limiting aspects of the present monetary arrangement. The fixed exchange rate and the backing rule confer a degree of credibility that is usually not found in the conventional pegged exchange rate arrangements. However, we must also clearly state that this credibility is obtained at a cost. In monetary policy decisions, as in most other aspects of life, there is "no free lunch"!

The decision to join the CMA was influenced by the long economic relationship with South Africa, and was perceived as the most appropriate arrangement under the prevailing circumstances. The extent to which the country has benefited from this arrangement will depend on a careful assessment of its merits and constraints.

Benefits of the CMA arrangement

Let me start by first analysing the benefits.

Price stability

By far one of the greatest benefits of a fixed exchange rate arrangement is that it provides price stability in the domestic economy. It is now widely accepted that the main objective of the monetary authorities in most countries is to achieve price stability. By pegging the domestic currency to the currency of a low-inflation country, its ability to maintain price stability is enhanced, provided there is a strong commitment on the part of the authorities to maintain the exchange rate. The arrangement constrains monetary expansion, restrains excessive government spending, and sends out credible signals to private agents about prospects for inflation. This is normally achieved when money growth in the peg currency country approximates that in the anchor currency country. The measured inflation rate may diverge because of the price of non-tradable goods, but in most cases they are cointegrated. In Namibia, the available evidence seems to support this conclusion. Since 1993 the domestic inflation rate has closely mirrored the prevailing rate in South Africa.

Credibility

Many governments in developing and developed countries have for a number of reasons experienced difficulties in making their policies generally credible. The credibility problem arises from the fact that when the authorities announce a monetary policy objective in one period, they may have an incentive to deviate from the policy in subsequent periods. This is so because private agents have formed their expectations and entered into wage and other contracts. There may be possibilities for government to engage in surprise monetary expansion, even if that was considered not to be the best long-term solution. Another credibility problem arises from the fact that even if the current government is pursuing prudent macroeconomic policies, investors may fear future governments will not have the same preferences. Changes in government can bring forward interest groups, whose demands for subsidies could lead to a relaxation of fiscal policy.

Acquiring a reputation for fiscal prudence in a longer-term perspective is a lengthy process. Therefore, tying governments hands by either creating a policy rule or delegating control of certain policy instruments to an independent agent is a welcome arrangement, especially during the period when the country is passing through the learning curve and institutions are being put in place. Under these circumstances, membership of the CMA and the rule-based policies, such as the restrictions placed on government borrowing from the Bank of Namibia, are instrumental in raising the government's credibility and therefore making its policies time consistent. A time consistent policy is a policy that will be sustained as circumstances change over time. Time consistency bears the advantage of credibility because of the predictability of the future. It therefore reduces monetary disturbances and eliminates the doubts of the financial and real sector markets, thus creating a healthy and attractive environment for investment and economic growth.

Exchange rate fluctuations

Another major advantage of the current arrangement is that it helps to avoid exchange rate fluctuations and reduces the unfavourable effects of exchange rate uncertainty on trade and investment. As South Africa is Namibia's main trading partner, a major benefit of CMA membership for Namibia is the elimination of uncertainty associated with exchange rate variability. Since Namibia is a net importer of goods and services from South Africa, the benefits derived from CMA membership may in this respect be large.

The emphasis here is on exchange rate volatility, which is of a short-term nature and is not due to the flexibility of exchange rates by itself. Market determined exchange rates are prone to excess volatility that can be damaging to the real economy. Overshooting of the exchange rate could have some real negative economic effects. The elimination of such fluctuations promotes economic stability. This is particularly important given the volume of Namibian trade with South Africa. Overshooting of the exchange rate between countries doing little trade may not matter much, but between countries engaged in substantial trade, it does. A stable exchange rate will ensure the stability of the prices of traded goods and hence eliminate volatility - not only in the exchange rate - but also in wages and prices and hence enhance economic performance.

The advantage here is derived from the benefits of a fixed exchange rate arrangement and the suitability of the exchange rate as a nominal anchor. But this goes beyond that. At independence in 1990, the nation gained from this linkage to the rand as it ensured confidence in the fledging domestic financial system and the economy given its historical and trade association with South Africa.

Reduction of transaction costs

A related benefit is the reduction of transaction costs associated with the fixed exchange rate between the Namibia dollar and the South African rand. Transactions costs include the spread between the buy and sell price, computed as the difference between the rate at which banks buy foreign currency and the rates they charge for sales of foreign currency. Other costs involve the commission charges for engaging in foreign exchange transactions. The commission varies with the size of transactions, and there are usually different rates for various forms of foreign currency transfers.

The gains from the elimination of transaction costs are a function of trade flows between members of a monetary union. With high volumes of trade, the gains are substantial. Furthermore, if the country's direction of trade was highly diversified, fixing the exchange rate against the currency of only one of the trading partners would not eliminate all the transactions costs. Elimination of exchange rate risks removes the hedging of exchange rates as an argument in a firm's decisions regarding the geographical concentration of activities. It is difficult to arrive at precise estimates of the magnitude of savings involved. For small economies that are highly dependent on international trade and investments, these savings could be substantial.

This is the case for Namibia. Due to its membership of the CMA, Namibia saves on the transaction costs involved in exchanging the Namibia dollar into the South African rand and the spread between rates charged for sales and purchases of foreign currency. This benefit is increased due to the fact that the rand is legal tender in Namibia and there are no costs involved in converting the Namibia dollar into the South African rand. An estimated saving of 3.8% of GDP has been suggested in a previous study. Compared to an estimated saving of 0.5% of GNP from the common currency in the EU, the magnitude of this advantage for Namibia appears to be quite sizeable. This is to be understood given the fact that close to 90% of Namibian imports come from South Africa.

Access to financial markets

Though not the least important, a major benefit from the CMA arrangement is the free flow of capital between the member countries. This provides wider access to financial markets and thus helps in satisfying extraordinary financial requirements for the infrastructural projects in the country. It is a challenge for the private sector in Namibia to make full use of this advantage.

Costs

Against these benefits of the CMA arrangement, we shall now consider the costs which can be associated with the present system.

Loss of autonomy in monetary policy

By far the most often discussed setback of the arrangement is the loss of autonomy in monetary policy. A major cost of CMA membership to Namibia is foregoing the use of a nominal exchange rate or interest rate policy as an instrument of macroeconomic adjustment. The Central Bank cannot control the supply of money because the money supply is determined wholly by the balance of payments. With increased capital mobility, there exists limited scope for influencing the interest rate. These two conditions also apply to any fixed but adjustable peg arrangement.

The exchange rate is a key determinant of the balance of payments, and can serve as a nominal anchor for the price level. Therefore, movements of exchange rates in response to balance of payments shocks affects output and price stability. For instance, a country may experience faster growth in productivity, say in agriculture due to more abundant rainfall compared to other countries, or the discovery of new mines that bring in additional export revenues or save on imports. In such cases, a real appreciation of the exchange rate is called for. Under the present arrangement, the country cannot use the exchange rate as a policy tool to control the increase or decrease in the supply of money. This has often been a source of resentment against this exchange rate arrangement as economic management is taken out of the hands of the domestic monetary authorities.

Related to this is the whole issue of the ability of the Namibian economy to absorb external shocks. Namibia is a highly open economy and - given its membership of the CMA - it can hardly use exchange rates or interest rates to mitigate the impact of external shocks. Namibia has had a number of unfavourable shocks in the past 20 years. The cumulative net loss in income due to the terms of trade shocks is estimated to have amounted to an average of 2.1% of GDP. The export earnings and investment were also negatively affected.

From time to time a country could also suffer shocks that are specific to it. The inability of the country to embark on appropriate and timely policies, through for instance the use of exchange rate policy, to escape such shocks creates a feeling of frustration. But there can also be a trade-off between monetary policy credibility and smooth economic adjustments promoted by the exchange rate. The question is whether this trade-off exists in the case of Namibia and South Africa. Flexible exchange rates hasten a country's adjustment to country specific economic shocks by facilitating rapid changes in the terms of trade. However, when two countries experience broadly similar economic shocks, changes - if any - in the bilateral terms of trade may not significantly aid adjustments of specific economic shocks in any one country.

Moreover, if factors of production, particularly capital, are highly mobile, the use of the terms of trade as an adjustment mechanism may prove to be inadequate. Finally, where the reserve currency country is also the peg currency country's major trading partner, as in the case of South Africa and Namibia, exchange rate flexibility as a policy tool becomes less effective.

Stability of the rand as a reserve currency

The issue of a choice of reserve currency is very crucial in deciding to peg the domestic currency. Among factors that may have determined the choice of the rand as a reserve currency are the direction of trade flows, the denomination of imports and exports, the deep financial market offered by South Africa and the correlation among cyclical movements between the economy of Namibia and South Africa. One other important consideration, which in recent times has become a source of deep concern, is the stability in the value of the rand. South Africa has in recent years experienced rapid deterioration of the rand: the Namibia dollar has depreciated in tandem with the rand, particularly during the financial crisis that engulfed South Africa in the early part of 1998. The exit by investors from the emerging markets, South Africa included, led to a speculative attack on the rand. The subsequent depreciation affected the Namibia dollar. The response to the crisis by the South African monetary authorities translated into high interest rates, which led to an increase in the cost of borrowing.

Generally, we would expect a depreciating rand to translate into increased exports for the Namibian economy as domestic goods become more competitive in the international markets. These benefits have been limited as Namibian exports consist mainly of commodities whose prices are determined in the international commodity markets.

The answer to the question about the stability of the rand is not obvious. First, events since the crisis that shook the rand in 1998 have proved the resilience of that currency as witnessed by the rapid rate of recovery of the South African economy and the present stability of the rand. International experiences tell us that most currencies undergo periods of strength and weaknesses. It is their ability to survive such tremors that determine their relevance. Secondly, even if the Namibia dollar is not pegged to the rand, it would still have to occasionally undergo shocks that could lead to its depreciation like any other national currency. The fact that such depreciation cannot be translated to windfall gains for the economy has more to do with the export structure than the pegging to the rand.

Persistence of capital outflows

One other disadvantage of the present arrangement is the persistence of capital outflows in favour of South Africa. Inter-country movement of labour is minimal, but market related net movements of capital tend to be one-sided in favour of South Africa. Among the CMA countries, South Africa has by far the most sophisticated financial markets, suggesting that capital flows are likely to be concentrated in that market to the detriment of the countries at the periphery, where financial markets are still at the early stages of development.

This, in turn, could hamper the development of financial markets in Namibia. For example, Namibian pension and portfolio funds are channelled to South Africa, which deprives the local economy of investible funds and makes the regional disparities even worse. This, however, has to be balanced against the advantage of the pooling of risk and the availability of investment opportunities created by the free flow of funds within the CMA, which eventually could also give depth to financial markets in Namibia. Moreover, a significant portion of Namibia's foreign direct investment inflow has been coming from South Africa, thus partly offsetting the outflows in the long-term funds. Further, Namibia's savings continue to be in excess of the country's present investment demand, implying that efforts must be made to create investment opportunities in order to increase the level of investment. Here, the government and the private sector have a joint responsibility.

Loss of seignorage

Joining the CMA has also involved costs such as the loss of seignorage. The issue could be viewed from two perspectives. In a growing economy, there is a need for individuals and businesses that participate in economic activities to increase their holdings of financial balances for economic transactions. A part of these balances will be in the form of currencies issued by the Central Bank, for which the Central Bank pays no interest. Secondly, the government may "tax" existing real balances by creating additional money and causing inflation. Inflation tax - as it is often called - is a kind of forced savings, which enables the government to acquire goods and services. In a number of countries, inflation tax revenue is an important part of government income.

As a member of the CMA, the scope for inflationary financing is limited. Based on our discussions earlier, the ability to increase real balances in line with growing productivity, and hence generate seignorage, could be constrained by strict backing rules. The second aspect of seignorage payment has to do with the payment to Namibia for the circulation of the rand in her territory. With the decline in the circulation of the rand after the introduction of the Namibian national currency, the compensation derived by Namibia for the use of the rand has also contracted significantly. However, this second factor may not have contributed to the overall contraction in the earnings from seignorage. Nevertheless, the crucial question to ask here is whether inflation tax - or the benefits from earning seignorage - are significant enough to warrant foregoing the advantages of a stable financial system. Inflation tax has been a major source of financial instability in many countries since it constitutes a tax on the financial system.

Lender of last resort

One principal criticism against the present arrangement, is that it limits the ability of the Bank of Namibia to perform the role of "lender of last resort". Though the system guarantees the convertibility of domestic currency at a fixed exchange rate, and thus enhances monetary credibility, a guarantee of the convertibility of bank deposits is not explicitly dealt with in the formal agreement. As we all know, no country can fully protect itself from a banking crisis that could lead to substantial macroeconomic shocks. I do not intend to spend too much time on this argument for a number of reasons. There is nothing in the CMA arrangement that precludes the Bank of Namibia from undertaking an appropriate lender of last resort function should the need arise. All that is needed is an adjustment in its foreign reserve coverage beyond the current 100% minimum. Secondly, the Bank of Namibia Act specifically empowers the Bank to undertake a lender of last resort function if there is a need for it. Third, a major antidote for bank failures is an adequate prudential and supervisory arrangement. In the past few years, the Bank Supervision Department together with commercial banks have been engaged in standardising prudential requirements. Commercial banks have also complied with these requirements. To us, this is a more relevant factor in the prevention of bank failures.

Issues emerging from the present arrangement

Let me now turn to a discussion of some broader economic issues that emerge in relation to the present arrangement.

Stability at the expense of development

An important question to be asked is whether the relative stability achieved through the current exchange rate regime has been obtained at the expense of development.

(a) Slower economic growth?

It has been argued that this arrangement in ensuring price stability tends to constrain domestic growth. The arrangement can impose a contractionary bias to domestic money supply, as this may not expand in step with growing domestic production. The question we must ask is whether price stability necessarily constrains long term economic growth. Strong empirical evidence abounds to show that the long-run trade-off between price stability and growth does not exist. On the contrary, increasing empirical evidence is emerging which suggests that a reduction in the rate of inflation is beneficial to economic growth. If it is the case that stable prices can help to generate a faster trend rate of economic growth, whatever short run costs a country may initially incur in attaining the objectives of price stability, would have to be balanced against the long run benefits of economic growth.

In a recent study, comparisons made on macroeconomic performance between countries with this kind of monetary arrangement and less extreme forms of exchange rate arrangements show that inflation is about 4 percentage points lower in the former. On average, data from countries with this arrangement over a ten-year period show that these countries are growing faster than countries with either pegged or floating arrangements. It is true that an exchange rate arrangement alone could not have been responsible for the observed differential, but at the same time, the evidence does not lend credence to the assertion that this exchange rate arrangement leads to sluggish growth.

(b) Impediments to trade diversification

There are, however, other aspects of this potential conflict between stability and development. In this regard, I would like to draw on experiences from the Irish currency arrangement, which has strong similarities with our CMA arrangement. The Irish pound was introduced in 1927 at a one-for-one parity with sterling and the arrangement lasted until Ireland decided to participate in the European Monetary Arrangement in 1979. Full convertibility with sterling was ensured and all notes issued were to be backed 100% by a reserve consisting of gold and sterling balances.

One consequence of the sterling link was that trade to a large extent was directed towards the sterling area. It has been argued that for this reason Ireland did not benefit from the "post-war dynamism" in Europe following the Second World War. Having the alternative to avoid the costs of currency risk and foreign exchange transaction, the Irish exporting enterprises were reluctant to establishing trading relationships with other markets in continental Europe and elsewhere. Because of the one-for-one link, trade with the sterling area involved no greater financial complexity than internal trade.

The analogue to the Namibian situation is striking. As mentioned, Namibia is still importing close to 90% from the CMA countries. The arrangement therefore requires vigilance and determination to diversify our pattern of trade and commerce.

(c) Capacity building

A similar argument can be made with regard to the financial system. The limited use of monetary policy instruments under the currency board arrangement and the use by the local banks of the London money market for their liquidity needs, were not conducive to the development of risk management and trading skills in Ireland. The acquisition of such skills was largely delayed until the emergence of a domestic money market in the early-1970s and of a foreign exchange market even later.

Again, these are relevant points when analyzing the Namibian situation. One point that is often overlooked by those arguing for an adoption of an independent monetary policy, is the issue of preparedness. The development of an active interbank market and secondary markets as well as local capacity in liquidity forecasting and management is a pre-requisite for the successful implementation of monetary and exchange rate policy. This process requires active promotion and assistance by the Central Bank. While some progress has been made in this direction by the consolidation of government bonds, the fine-tuning of reserve requirements and the introduction of a call account facility at the Bank of Namibia, more needs to be done to equip the bank to intervene in the domestic money market. The capacity of the Bank to formulate and implement appropriate and timely monetary policy measures also needs to be built up. The appropriate channel for the transmission of monetary policy has to be investigated. There is a need to examine carefully the choice of intermediate and ultimate targets of monetary policy, and other operational variables that are appropriate to the local economy. Building adequate capacity to undertake the aforementioned functions in the bank takes time and effort. Thus, there is a need for caution in this regard until appropriate institutional capacity is put in place.

(d) Regional cooperation

The experience of the 14 sub-Saharan African countries belonging to the CFA franc zone can provide some interesting lessons with regard to the benefits and shortcomings of regional cooperation in the area of exchange rate management. Since 1948, these countries have made up a monetary union with a fixed exchange rate against the French franc. The French Treasury guarantees the convertibility of the CFA franc into French franc, which is effectuated through the establishment by regional central banks of an operational account with the French Treasury with market related yields and charges.

Initially, this arrangement appeared to work well. Following some 30 years of strong growth and low inflation compared with other sub-Saharan African countries, the growth performance of the CFA franc zone countries began to weaken from mid-1980, mainly due to a sharp deterioration of the terms of trade. Moreover, fiscal imbalances and external public debt increased substantially in relation to GDP. These countries also experienced a major weakening of the soundness and financial position of the banking system.

Against this background, a decision was made in January 1994 to devalue the CFA franc by 50% and to implement restrictive incomes and credit policies and a range of structural and institutional reforms. This policy package has contributed to a resumption of growth in real per capita incomes and a reduction in inflation and fiscal imbalances. Despite the progress made since 1994, the CFA countries are still struggling with heavy external debt burdens and their economies are suffering under structural rigidities.

A relevant question for us here is why these countries have not managed to take more advantage of the stability provided through the fixed exchange rate regime. One important limitation has been that until 1994, the degree of economic and financial interaction and regional cooperation among the countries of the CFA franc zone was relatively limited. There are surely many reasons for this, partly related to various administrative restrictions, different tax treatments and protectionist trade policies. But also political considerations, influenced by a perceived need to maintain special economic and political links to France, appear to have dominated at the expense of regional economic considerations. After 1994, efforts have been made to strengthen regional economic and monetary integration. The objective is to establish a common market based on a customs union and the harmonization of the tax system. Economic policy coordination through regional surveillance has also been put on the agenda.

One overriding lesson I will draw from these experiences is that the current exchange rate regime can be a basis for stability and economic growth. However, economic development does not follow automatically from this monetary policy arrangement.

Consequences of inflation targeting in South Africa

As monetary conditions in Namibia are so closely linked with those in South Africa, the conduct of monetary policy in that country is naturally of special interest to us. The adoption of *a formal inflation targeting framework* for monetary policy is a move which the monetary authority and the financial community in Namibia has to follow closely.

First, it is important for us to understand what inflation targeting is all about. Under this system, a specific target for inflation in the medium term is publicly announced. Inflation targeting is therefore a monetary policy framework that explicitly recognizes price stability as a medium-term objective. With inflation targeting, monetary policy decisions are guided by expected future inflation relative to the announced inflation target. This system has been adopted in a number of countries in recent years, replacing either a formal intermediate monetary target or an exchange rate target.

Second, we have to ask ourselves whether the adoption of an inflation targeting system will have any consequences for monetary conditions in the CMA countries. One important reason given by the South African authorities for the change is that an explicit inflation targeting framework will be more transparent than the previous framework. To the extent the inflation targeting system and the monetary policy decision-making process is perceived by market participants to be more transparent, this will be a positive development for the other CMA countries and for Namibia. This should reduce unwarranted market reactions, which at times result in disruptive movements in exchange rates and interest rates, with negative consequences for trade and other economic activities.

It is also important for us to note that the adoption of inflation targeting will not in any significant way change the practical implementation of monetary policy. The main operational instrument will continue to be the repo mechanism and the Reserve Bank does not foresee any need to change the instruments used today for the fine-tuning of the liquidity and interest rates in the South African market.

There is, however, one possible consequence which we should be aware of and prepared for. In the economic literature on inflation targeting, a concern has been expressed that direct inflation targeting could easily lead to excessive short-term - and even medium-term - fluctuation in the nominal (and real) exchange rate. This has been a common experience in inflation targeting countries. There are many causes for the observed fluctuations in the exchange rates. In some countries strong fiscal and structural policy adjustments have given a support to such changes, as well as portfolio shifts. In the case of South Africa, the exchange rate is included as an important element in the macroeconomic monetary policy model used by the Reserve Bank. Exchange rate changes come out as a result of the policy process and not as an independent objective.

Greater nominal exchange rate changes, if these should materialize, is a concern for Namibia for reasons I already have touched upon. However, these consequences are not likely to be severe. Exchange rate fluctuations are nothing new to the financial and commercial community in Namibia. It should also be emphasized that an inflation target could in itself promote considerable stabilization of the nominal exchange rate. So far, experiences with inflation targeting regimes indicate that the largest fluctuations are prompted by a lack of credibility of the regime. As credibility improves, the exchange rate variability should generally be limited to normal fluctuations in the real exchange rate.

International trends in exchange rate arrangements

As we are entering a new decade, fixed exchange rate systems seem generally to be replaced with floating exchange rates. The international foreign exchange market is now dominated by three major currencies - the US dollar, the Yen and the euro - which are floating against each other. None of these three will have explicit inflation targets as the objective for monetary policy, but in practice their orientation of monetary policy is one of implicit inflation targeting. In the US, for example, the Federal Reserve has made it very clear that it is its assessment of inflationary pressures and the outlook for inflation that is the major determinant of any monetary policy adjustments. Although the European Central Bank has adopted a system of monetary targeting, in practice the monetary policy regime resembles inflation targeting quite closely. It is more difficult to classify monetary policy in Japan, but the fact is that inflation has been brought down to very low levels. The trend among industrial countries and emerging economies appears to be the adoption of formal inflation targeting.

Although it can hardly be characterised as a trend, some countries still adopt a pegging of their exchange rate and groups of countries are opting for cooperation in a currency area or monetary union.

Alternatives for Namibia

Namibia is indirectly linked to what appears to be the present norm in exchange rate arrangements. This is because the Namibia dollar is linked to the rand, which is floating and its fluctuations will in the future be influenced by a monetary policy based on inflation targeting. If for some unknown reasons the present arrangement should be terminated some time in the future, the most relevant alternative would be that Namibia adopts a floating exchange rate of its own. It is the Bank of Namibia's view that the benefits of the present membership of the CMA outweigh the costs. A peg arrangement will also continue to remain the optimum as the country battles with an attempt to reduce fiscal deficit. For the foreseeable future, therefore, Namibia should not take any initiatives to terminate its membership.

But there is another alternative. The present arrangement should - to the extent possible - be managed in such a way that the stability is utilised in promoting the development of the national economy. In my opinion, Namibia would benefit from evolution of the CMA arrangement toward a full monetary union. As mentioned earlier, this would require a closer coordination of economic policy in the currency area. Political structures would have to be established and made operational. The group of countries that comprise the CMA could be extended to include countries in our region with similar economic structures and development priorities.

I am fully aware that the realisation of this objective can only be achieved in a long-term perspective. In the meanwhile, Namibia's benefits from the CMA arrangement could be increased by extended consultations between the member countries. For example, the adoption of the inflation targeting framework in South Africa would be a good occasion for extending the discussion on the framework itself and, later, on the implementation of monetary policy in response to the monetary authorities' expectation of future inflation. Such extended consultations should not be limited to monetary matters, but apply to other areas of economic policies as well.

In the end, the achievement of monetary union will require that countries in the region commit themselves to confront the process of solving conflicting national interests in a fair and democratic manner. In order to reach a common objective of monetary stability and economic prosperity, a regional solution may also be the route to take for us here in Southern Africa.

Conclusion

In conclusion, I hope that my explanation of this complex issue has raised your awareness of the problems involved and given you a basis for further discussions. It is also my hope that this explanation will create a better understanding of the actions of the Bank of Namibia with regard to monetary policy related matters.