UNIT 3
THE MONETARY SECTOR
OBJECTIVES

• Define money and explain the requirements of money
• Describe the functions of money
• Discuss the functions of a central bank and commercial banks
• Describe the money creation process
• Explain how the supply of money and the demand for money are determined
• Explain the instruments of monetary policy
DEFINITION OF MONEY

• Money is any generally acceptable or accepted medium of exchange that is accepted in the payment of debts, and/or for goods and services rendered.
DEFINITION OF MONEY

• Gold and silver were once used as money, but today money consists primarily of paper notes, coins made of various metals and cheque account deposits.

• Each country has its own system of money.
  – In Namibia we use the Namibian dollar,
  – South Africa uses the rand and
  – Botswana uses the pula.

  **We call the money in use in a country its currency.**
BARTER ECONOMIES

- Barter is the direct exchange of one good for another without using money as medium of exchange.
- If people want to trade, there has to be a double coincidence of wants.
- This means there is a need to find a match between what each of the two traders wants to obtain and what each wants to offer in exchange.
- Barter system is not efficient and is time consuming process and not suitable for a modern economy where a wide range of goods and services are produced.

What is money then?
REQUIREMENTS OF MONEY

Objects that we can use as money should meet the following requirements:

– **General acceptability:** It should be desired and accepted by all as medium of exchange.

– **Durability:** Money changes hands all the time and therefore it should not wear easily.

– **Manageability:** Its mass should be small relative to its value, i.e. it must be portable.

– **Homogeneity and divisibility:** The various denominations of a currency should be made of the same material and look the same.
REQUIREMENTS OF MONEY

– **Recognisability:** It should be easily recognizable and distinguishable from other materials.

– **Value:** It should be limited in supply because the relative scarcity of a currency determines its value.

– **A relatively fixed value:** Its value should be fairly constant. Money loses its value and purchasing power due to inflation.
FUNCTIONS OF MONEY

Money has several basic functions in the economy. These functions distinguish money from other assets such as stocks and bonds.

- **Medium of exchange:** We offer money in exchange for goods and services and it makes this exchange easier and more efficient.

- **Unit of account:** The prices of goods and services are stated in terms of money, in our case Namibia dollars. This enables us to compare the value of different goods and also to calculate the total value of the goods and services we wish to buy. We use money to specify price and value just as we use hours to specify time.
FUNCTIONS OF MONEY

- Money has several basic functions in the economy. These functions distinguish money from other assets such as stocks and bonds.

  - **Store of value:** People need to hold wealth in some form and the most common way of holding wealth is money. Other stores of value include gold, paintings, real estate, stocks and bonds. The advantage of using money as a store of wealth is the fact that money is more convenient and can be used immediately in exchange for other assets. Money is therefore the most liquid form in which wealth can be stored.

  - **Standard of deferred payment:** In modern economies many purchases are made on credit. In this case the credit grantor trusts that the purchasing power of money will remain fairly stable. Money is the measure of the value for future payments If you borrow money to buy a house today, your future commitment will be agreed in Namibian dollars.
DIFFERENT KINDS OF MONEY

• The money that we use a medium of exchange consists of notes, coins and demand deposits. However, in modern economies we make payments with cheques, debit cards and credit cards. Can we say that they are money?
  – **Cheques:** A cheque is not money. It is an instrument that is used to transfer money from one account to another.
  – **Debit cards:** Debit cards are used to transfer money electronically. It can also be used to draw money from an ATM.
  – **Credit cards:** Credit cards are not money, but proof that credit is available to a buyer. The buyer undertakes to repay the money to the bank at a later stage.

• There are many other cards that we use every day such as petrol cards and cards issued by private businesses such as Woolworths, Edgars, Truworths, etc. These technological innovations make it difficult to pinpoint exactly what money is.
Financial institutions specialize in financial transactions. They are also called intermediaries because they stand between borrowers and lenders. They take deposits from savers (lenders) and give loans to borrowers.

**Functions**

- They create markets for debt (for borrowers and lenders).
- They facilitate the transfer of funds.
- They provide additional funds.
FINANCIAL INSTITUTIONS IN NAMIBIA

Monetary authority in Namibia
• The Bank of Namibia

Licensed Commercial banks in Namibia
• Bank Windhoek Limited
• First National Bank Namibia Limited
• Nedbank Namibia Limited
• Standard Bank Namibia Limited
• Trustco Bank Namibia Limited
• Banco Atlantico (branch of foreign banking institution)
• Bank BIC Namibia Limited
• Letshego Bank Namibia Limited

Other financial institution
• Agribank
• Development Bank of Namibia

Regulator
NAMFISA
THE BANK OF NAMIBIA

• The most important financial institution in any country is the central bank. The Bank of Namibia is our central bank, which was established on 16 July 1990.
SOLUTION

QUESTION 1 [4 marks]
1. N$ 12,00
2. N$ 2,00

QUESTION 2 [6 marks]
• 66.67
<table>
<thead>
<tr>
<th>Description</th>
<th>N$ millions</th>
</tr>
</thead>
<tbody>
<tr>
<td>Final consumption expenditure by households</td>
<td>10 914</td>
</tr>
<tr>
<td>Final consumption expenditure by government</td>
<td>4 957</td>
</tr>
<tr>
<td>Gross capital formation</td>
<td>6 156</td>
</tr>
<tr>
<td><strong>GDE</strong></td>
<td>22 027</td>
</tr>
<tr>
<td>Exports of goods and services</td>
<td>8 710</td>
</tr>
<tr>
<td>Less: Imports of goods and services</td>
<td>(10 718)</td>
</tr>
<tr>
<td>Less: Residual item</td>
<td>(1 070)</td>
</tr>
<tr>
<td><strong>GDP at market prices</strong></td>
<td>18 949</td>
</tr>
</tbody>
</table>
FUNCTIONS OF THE BANK OF NAMIBIA

• **Formulation and implementation of monetary policies:** BoN is responsible for the implementation of monetary and exchange rate policy. It is not autonomous in this regard, but will follow the SARB.

• **Service to the government:** Service provided are threefold:
  
  • **Banker and advise:** BoN holds government funds and issues cheques for government expenditure. It also deals with the issue of government securities to finance budget deficits.

  • **Custodian of gold and foreign exchange reserves:** It sets the level of reserves and acts as custodian of the reserves of banks. Gold coins and gold bullions are added to the reserves at a market-related price. The level of gold and other reserves is one of the main barometers of the state of the economy and prospects for future economic growth.

  • **Administration of exchange control:** Exchange control restrict the movement of foreign exchange in order to protect an economy from disruptive fluctuations in capital movements and other international economic shocks.
FUNCTIONS OF THE BANK OF NAMIBIA

• Provision of economic and statistical services:

• Maintaining financial stability
  – **Bank supervision:** The Bank of Namibia is responsible for bank regulation and supervision. They perform this function to achieve sound and an efficient banking system in the interest of depositors and the economy as a whole. This function is performed by issuing banking licenses to banking institutions and monitoring their activities.
  
  – **The National Payment System:** BoN is responsible for overseeing the safety and soundness of the National Payment System. The main aim is to reduce interbank settlement risk with the objective of reducing the potential of a systemic risk crisis emanating from settlement default by one or more of the settlement banks.
  
  – **Banker to other Banks:** BoN act as a clearing bank and lender of last resort.
  
  – **Banknotes and coins:** BoN has the sole rights to make, issue and destroy banknotes and coins.
COMMERCIAL BANKS

- Banks are privately owned and profit seeking institutions.
FUNCTIONS OF COMMERCIAL BANKS

- **Taking deposits:** Banks take deposits and use the money to finance lending. Money can be deposited in the following accounts:
  - Current (cheque) accounts
  - Savings accounts
  - Transmission accounts
  - Fixed deposits

- **Granting credit and creating money:** Banks lend money to their clients mainly by providing overdraft facilities on their cheque accounts. Mortgage bonds and term loans have also become important functions of banks.

- **Issuing credit instruments:** Credit cards and letters are examples of credit instruments. They also grant by lease agreements and hire purchase agreements.

- **Administration function:** Banks can help clients to draw up wills and execute the estate when the client dies.


FUNCTIONS OF COMMERCIAL BANKS

- **Payment guarantees:** If a contract requires a payment at a specific date, a bank can issue a guarantee that the payment will be made at that date.

- **Buying and selling shares:** A bank can be instructed to buy shares, through a registered stockbroker, for a client.

- **The custodian function:** At a fee, clients can keep valuable documents or jewellery in a bank’s safe.

- **The administration function:** Banks can help a client to draw up a will and can then be appointed as executors of the estate when the client dies.

- **Assisting clients with foreign transactions:** Banks can assist clients to arrange payments and to obtain funding abroad. They can also advise clients on exchange rates and conditions on international financial markets.
THE DEVELOPMENT BANK OF NAMIBIA

• The Development Bank of Namibia (DBN), was created in October 2002 by an Act of Parliament to promote economic growth and social development in Namibia.
• Incorporated under the Company’s act as public company with share capital.
• Currently, the Government of the Republic of Namibia is a 100% shareholder.

The main functions of the DBN are as follows:

– It must encourage economic growth and development, increase productivity and improve the standard of living of people in underdeveloped areas.
– It must try to eliminate inequalities in the levels of economic development in the various regions.
– It must encourage investment of private and public capital and these funds must be applied in development.
– It must make finance available for important development needs.
The Agribank of Namibia as we know it today was established by The Agricultural Bank Act, No.5 of 2003. This new act is an amendment of the old Agricultural Bank Act 13 of 1944 and provided for the restructuring of Agribank to meet the needs of an independent Namibia.

Agribank is a state-owned financial institution whose mandate is to advance money to persons or financial intermediaries for the promotion of agriculture and related activities.

The Government of the Republic of Namibia is the main shareholder in Agribank.

To finance loans, the Agribank takes deposits from agricultural institutions, receives interest on investment and loans, arranges loans from the government and it can receive contributions from the government.

The main function of Agribank is to provide agricultural finance:

- **Long-term loans**: These loans can be used for improvements of farms, to buy livestock and farming equipment and the purchase of farmland.
- **Medium-term loans**: Loans are given to farmers for the purchase of livestock and agricultural equipment such as machinery, vehicles and tractors.
- **Short-term loans**: These loans are seasonal and enable crop farmers to purchase seeds, fertilizers and fuel.
MONEY CREATION BY BANKS

• Banks take deposits from their clients and use the deposits to make loans to other individuals.

• They make profit by charging a higher interest on the money they lend out than they pay to the depositors.

• People accept the lower interest rates and keep their money in banks because this is safer and more convenient than other alternatives.

• Banks cannot lend out the total amount of deposits, but they are obliged to keep a certain percentage of all deposits with the Bank of Namibia in the form of cash reserves.
THE RESERVE REQUIREMENT

• **Definition:** The reserve requirement is the percentage of demand deposits banks are required to keep as cash reserves at the central bank.

• Banks keep the rest of the funds to pay depositors when they withdraw money.

• Banks know that depositors very seldom withdraw all their funds at the same time and they use these funds to give loans to borrowers.

• If banks give loans, the money supply will increase.
MONEY SUPPLY

- **Definition:** The money supply is the quantity of money in circulation at any given time.

- The following example explains the money creation process via cheque accounts:
  - John deposits N$1 000 at Standard Bank.
  - The cash reserve requirement is 20%.
  - Standard Bank gives a loan of N$800 to Bob.

- Standard Bank will have the following balance sheet:
### BALANCE SHEET STANDARD BANK

<table>
<thead>
<tr>
<th>Assets</th>
<th>Liabilities</th>
<th>N$</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash reserves</td>
<td>Deposit John</td>
<td>200</td>
</tr>
<tr>
<td>Loan to Bob</td>
<td></td>
<td>800</td>
</tr>
<tr>
<td><strong>TOTAL:</strong></td>
<td><strong>TOTAL:</strong></td>
<td><strong>1 000</strong></td>
</tr>
</tbody>
</table>

Suppose Bob uses the loan to pay a debt to Sara and she deposits the cheque of N$800 in her account at Bank Windhoek.

The original amount has risen to N$1 800 (N$1 000 + N$800) and the money creation process has started.
The total increase in demand deposits is now N$1\,000 + N$800 + N$640.

The money creation process goes on and on. Each time a client deposits a cheque and a new loan is made more money is created. We can determine how much money is eventually created by the banking system by adding the money created by each bank, but this is a long process. A shorter method is to use the credit (money) multiplier.
THE MULTIPLIER

• Definition: The multiplier tells us how much money will ultimately be created by the banking system from an initial inflow of money.

• You can use the following formula to calculate the total amount of money that can be created by the initial deposit of N$1 000:

\[
D = \frac{1}{b} \times N$1 000
\]

\[
= \frac{1}{0.2} \times N$1 000
\]

\[
= 5 \times N$1 000
\]

\[
= N$5 000
\]

Where:

\( D = \) total increase in demand deposits; \( b = \) cash reserve requirement

credit multiplier = \( 1/b \)
THE MULTIPLIER

• The increase in the money supply thus depends on the credit multiplier. This size of the multiplier in turn is influenced by the cash reserve requirement.

• An increase in the cash reserve requirement from 20% to 25% will decrease the value of the multiplier from 5 to 4.

\[
\text{Multiplier} = \frac{1}{0.2} = 5 \quad \frac{1}{0.25} = 4
\]

• As the process of money creation continues, each bank receives less and less of the original deposit of N$1 000. The process comes to an end when there are no more surplus funds to lend out.

• If banks decide to hold excess reserves (i.e. more than they are required to hold) at the Bank of Namibia, it will decrease the multiplier in the same way as the required reserves.
Ester is a domestic worker and earns N$2000-00 per month. During her birthday month her boss decides to surprise her by paying her usual salary and a bonus of N$2000-00. The salary and the bonus are deposited at Nedbank and the reserve ratio is 10 per cent. After deducting the reserve amount Nedbank issues a loan to Mr Ekandjo for the remaining balance.

a) Your required to open up a balance sheet for the above provided transactions with Nedbank.

b) Calculate the value of the multiplier.
### SOLUTION

<table>
<thead>
<tr>
<th>Assets</th>
<th>N$</th>
<th>Liabilities</th>
<th>N$</th>
</tr>
</thead>
<tbody>
<tr>
<td>Reserve requirement</td>
<td>400</td>
<td>Ester</td>
<td>4000-00</td>
</tr>
<tr>
<td>Loan to Mr Ekandjo</td>
<td>3600</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Total:</strong></td>
<td><strong>4000-00</strong></td>
<td><strong>Total:</strong></td>
<td><strong>4000-00</strong></td>
</tr>
</tbody>
</table>

2. \( \frac{1}{b} = \frac{1}{0.10} = 10 \)
• **Supply of money**: The quantity of money in circulation at any given time.

• **Liquidity**: The ease with which an asset can be converted into money.

• **Demand deposits**: Balances in bank accounts that depositors can access on demand e.g. by writing a cheque.

• **Legal tender**: Anything that creditors are required to accept as payment for debt. It is declared as legal tender by the government.

• **The value of money**: This is reflected by its purchasing power. The higher the price level, the fewer goods and services can be purchased with each dollar.

• **Interest**: The payment made for the use of money.

• **Interest rate**: The amount of interest paid per unit of time and expressed as a percentage of the amount borrowed.
THE SUPPLY OF MONEY

• The supply of money is made up of coins, notes and demand deposits. These are the items that are generally accepted as payment for goods and services.

• Formula: $M = C + D$

• Where:
  – $M$ = money supply
  – $C$ = coins and notes
  – $D$ = demand deposits

• The Bank of Namibia uses two definitions of money to determine the quantity of money:
  – $M_1$: This consists of coins and notes in circulation plus all demand deposits with banking institutions.
  – $M_2$: This is referred to as the broad money supply and consists of $M_1$ plus all short- and medium-term deposits.

• Please note that all coins, notes and deposits held at the Bank of Namibia do not form part of the supply of money since they are not in circulation.
The money supply can be influenced by foreign trade, international capital movements and by government transactions.

- Export earnings increase the money supply.
- Payments for imports decrease the money supply.
- Capital inflows increase the money supply.
- Capital outflows decrease the money supply.
- Money collected from taxes and deposited at the BoN decreases the money supply.
- Government expenditures increase the money supply.
THE SUPPLY OF MONEY

The MS curve is perfectly inelastic because it is controlled by the BON and not influenced by the interest rate.
THE DEMAND FOR MONEY

• The demand for money can be defined as the amount that the various participants in the economy plan to hold in the form of money balances.
THE CLASSICAL QUANTITY THEORY OF MONEY

• The quantity theory of money assumes that any money received is spent directly or indirectly to buy goods and services, the so-called transactions demand.

• Classical economists believed that changes in the money supply affect the price level in the economy. In its simplest form it states that the general price level (P) depends on the money supply (M).

• We can express this theory as follows:
  – \( MV = PQ \)

• Where:
  – \( M \) = the money supply
  – \( V \) = the velocity of money, i.e. the speed with which it circulates
  – \( P \) = the average price level
  – \( Q \) = the number of transactions that occurred during the year

• \( MV \) represents the total spending in the economy
• \( PQ \) represents the total value of all transactions.
THE CLASSICAL QUANTITY THEORY OF MONEY

• Two assumptions are;
  – the velocity of money (V) is relatively stable and predictable in the short run
  – Q is fixed in the short run

• If V and Q are constant, we could predict that changes in M will bring about changes in P.

• In other words, the quantity theory predicts that changes in the money supply will bring about proportional changes in the price level.

• Therefore, these economists believed that monetary policy can be used very effectively to control the total demand in the economy.
KEYNES’ LIQUIDITY PREFERENCE THEORY

• The classical view that money is demanded for transaction purposes was accepted for many years, but around 1930 Keynes formulated a new theory called the liquidity preference theory.

• Keynes identified three motives for holding money:
  – the transaction motive
  – the precautionary motive
  – the speculative motive

• The first two explain why people hold money as a medium of exchange and the last one explains why people hold money as a store of value.

• Because money is the most liquid of all assets, he referred to the demand for money as the liquidity preference.
I) THE TRANSACTION MOTIVE

• We demand money as a medium of exchange.
• For instance, you need money for daily transactions such as buying petrol, groceries, cigarettes, newspapers, etc.
• Firms require money to buy materials, equipment and to pay for labour. This demand depends on income.
• The more income you earn, the more cash you will hold to buy goods and services.
II) THE PRECAUTIONARY MOTIVE

- We hold a certain amount of money for unexpected expenses, such as a car breaking down or illness of a family member.
- Businesses and households provide for unpredictable expenditures over and above the normal expenditures.
- This motive also depends on people’s income.
- The transaction motive and the precautionary motive indicate that money can be used actively.
III) THE SPECULATIVE MOTIVE

• The third reason why people demand money, according to Keynes, is the speculative motive. The speculative motive shows that money is used passively. In this case people hold money as a financial asset.

• The choice between holding financial assets in the form of money or bonds will depend on the interest rate.

• The opportunity cost of holding money is the interest that could be earned by holding bonds. This is because people can earn interest on bonds, while little or no interest is earned by holding money.

• The speculative demand for money is therefore influenced by the interest rate. If the interest rate is high, the speculative demand for money will be lower as people will prefer to hold bonds.

• If the interest rate is low, the speculative demand for money will be higher as people will hold more money and fewer bonds. The speculative demand for money is, therefore, inversely related to the interest rate.
The diagram shows the demand for active balances (transactions and precautionary motives) and passive balances (speculative motive).

The curve D1M1 represents the active balances, in other words money we use as medium of exchange. The vertical curve simply means that the demand for active balances is not sensitive to interest rates.

The curve D2 shows that there is an inverse correlation between the interest rate and the speculative demand for money.

The total demand for money will be the sum of the transaction-, precautionary- and speculative demand for money. The total demand for money curve is illustrated below.
To summarize we can say that according to Keynes the level of income as well as the interest rate determine the total demand for money.
## TOTAL DEMAND FOR MONEY

<table>
<thead>
<tr>
<th>Function</th>
<th>Motive</th>
<th>Active/passive</th>
<th>Main determinant</th>
</tr>
</thead>
<tbody>
<tr>
<td>Medium of exchange</td>
<td>Transaction</td>
<td>Active balances</td>
<td>Income</td>
</tr>
<tr>
<td>Store of value</td>
<td>Speculative</td>
<td>Passive balances</td>
<td>Interest rate</td>
</tr>
</tbody>
</table>
According to the liquidity preference theory, the interest rate adjusts to balance the demand and supply of money.
EQUILIBRIUM IN THE MONEY MARKET

• The diagram shows that money market equilibrium is reached at point E where the interest rate is 10%. At the equilibrium interest rate, the quantity of money demanded is equal to the quantity of money supplied.

• If the interest rate is above the equilibrium interest rate:
  – The quantity of money demanded is less than the quantity supplied by the Bank of Namibia and,
  – People holding surplus money will buy interest-bearing bonds or deposit the money in an interest-bearing account.
  – Bond issuers and banks respond to this by lowering the interest rates they offer.
  – At lower interest rates people become more willing to hold money until at the equilibrium interest rate they hold exactly the same amount that the Bank of Namibia has supplied.
EQUILIBRIUM IN THE MONEY MARKET

• At interest rates below the equilibrium level:
  – The quantity of money that people want to hold is greater than the quantity supplied by the Bank of Namibia.
  – People will reduce their holdings of bonds and try to increase their holdings of money.
  – Bond issuers will then offer higher interest rates to attract buyers and the interest rate will rise.

• The Bank of Namibia can use monetary policy to influence the supply of money. In such a case the equilibrium point will change.
MANAGING THE SUPPLY OF MONEY

• The supply of money curve is a vertical line. The reason for this is because the central bank controls the supply of money by using monetary policy.

• **Definition:** Monetary policy can be defined as the measures taken by the monetary authorities (central bank) to influence the money supply or the rate of interest to achieve stable prices, full employment and economic growth.

• The monetary authority in Namibia is the Bank of Namibia.
OBJECTIVES OF MONETARY POLICY:

– Relative price stability
– Stable and full employment of the labour force
– A satisfactory economic growth rate
– Equilibrium in the balance of payments and a fairly stable exchange rate

• Monetary policy can be restrictive or expansionary.
Restrictive (Contractionary) Monetary Policy:

- These measures are used to combat inflation and will be aimed at decreasing the money supply. It tends to raise interest rates and reduce income.
EXPANSIONARY MONETARY POLICY:

• These measures are used to stimulate the economy during a slump or recession and high unemployment and will be aimed at increasing the money supply. It tends to reduce interest rates and increase income.
The Instruments of Monetary Policy

• **Definition:**
  – A monetary policy instrument is a tool that central banks use to achieve their operational targets. They can be divided into indirect measures and direct measures.
INDIRECT MEASURES

• **The Repo rate**: The Repo rate is the interest rate at which commercial banks borrow money from the Bank of Namibia. Changes in the Repo rate affect all other interest rates in the economy.

• Banks borrow from the central bank when their reserves are low or if they need more money to give loans. This is where the Bank of Namibia functions as ‘lender of last resort’.

• **Restrictive (contractionary) policy:**
  - The Bank of Namibia will increase the Repo rate.
  - Commercial banks will increase their prime lending rates and the cost of borrowing will increase.
  - Persons who already have loans will pay more interest on these loans and will have less money to spend.
  - The private sector will borrow less at higher interest rates, i.e. less money will be created.
  - The supply of money will decrease.
EXPANSIONARY POLICY

– The BoN will decrease the Repo rate.
– Commercial banks will decrease their prime lending rate and the cost of borrowing will decrease.
– Existing loans will become cheaper and leave borrowers with more money for spending.
– The private sector will borrow more and more money will be created.
– The supply of money will increase.
RESERVE REQUIREMENT

• The reserve requirement is the percentage of a bank’s deposits that must be kept at the central bank. The aim of the reserve requirement is to limit the ability of banks to create money and to protect depositors.

• The reserve requirement determines the value of the credit multiplier and changes in the reserve requirement will change the value of the multiplier.

• Suppose the reserve requirement is 10%. The value of the multiplier will then be 10 (1/0.10). A N$1 000 deposit can be increased to N$10 000 (10 x N$1 000 = N$10 000).
RESTRICTIVE POLICY

– The Bank of Namibia will increase the reserve requirement.
– The value of the multiplier will decrease and less money can be created.
– The supply of money will decrease.

Example:
• Suppose the reserve requirement is increased to 12%. This will reduce the value of the multiplier to 8.3 (1/0.12) and a deposit of N$1 000 will be increased to only N$8 300 (8.3 x N$1 000).
EXPANSIONARY POLICY

– The BoN will reduce the reserve requirement.
– The value of the multiplier will increase and more money can be created.
– The supply of money will increase.

Example:
• Suppose the reserve requirement is reduced to 8%. The value of the multiplier will increase to 12.5 (1/0.08) and a deposit of N$1 000 will be increased to N$12 500 (12.5 x 1 000).
OPEN MARKET OPERATIONS

• Open market operations refer to a central bank’s buying and selling of government securities on the ‘open’ market to influence the liquidity of banks, the money supply and the interest rate.

• **Terms:**
  – A security is a credit instrument e.g. a government bond.
  – The primary market is a market where stocks and bonds are issued for the first time.
  – A secondary market is a market where previously issued securities are traded. Open market operations occur in the secondary market.
A bond is a financial instrument that promises that the issuer (the borrower) will regularly pay the holder interest and will repay the capital amount at a certain date. The government, for example, issue bonds to finance part of its expenditure.

**Features of a bond:**

- **The principal:** Amount that the issuer will repay to the bondholder when the bond expires.
- **The maturity date:** Date on which the bond will expire (date at which the issuer will repay the principal amount to the bondholder).
- **The coupon rate:** Interest (expressed as an annual rate—eg 10%) that the issuer promises to pay the bondholder until the maturity date. Coupon rate is usually fixed and the coupon payment dates are specified.

Bondholder do not have to keep the bond until they mature. Bonds can be traded in the secondary markets.

Examples of government securities include:

- GC23
- GI23
- GT23
OPEN MARKET OPERATIONS

- The Bank of Namibia places advertisements on its website, on the Reuters System, and send e-mails officially inviting the public to participate in tenders for Government securities.
- Advertisements inviting tenders for Treasury Bills and bonds are placed one week prior to auction date.
- Tender forms may be obtained from the website and Bank of Namibia.
EXAMPLE OF A GOVERNMENT SECURITY
RESTRICTIVE (CONTRACTIONARY) POLICY:

– The BoN will **sell** government securities on the open market.

– If a commercial bank buys the securities, the central bank will deduct the selling price from the bank’s reserves. This will reduce the bank’s reserves and its ability to give loans and create money.

– The supply of money will decrease.

– To encourage banks to buy, BoN will decrease the price of the securities and this will cause interest rates to increase.
EXPANSIONARY POLICY:

– BoN will buy government securities on the open market.
– The reserves of banks will increase and they will be able to give more loans and create money.
– The supply of money will increase.
– To encourage banks to sell, the BoN will increase the price of the securities and this will lead to lower interest rates.
ACTIVITY

Ceteris paribus, what will happen to the money supply in each of the following cases? Explain each of your answers.

1. The Monetary Policy Committee of the Bank of Namibia lowers the Repo rate.
2. The Monetary Policy Committee of the Bank of Namibia raises the required cash reserve ratio.
ACTIVITY

1. What would happen to the money supply in each of the following cases, ceteris paribus?
   a) The BON lowers the required cash reserve ratio from 5% to 4%.
   b) The Executive Committee of the BON raises the repo rate.

2. Suppose BON pursues an aggressive open market policy by purchasing government bonds. What will happen to (a) the price of bonds and (b) the interest rate?

3. If you expect that interest rates are going to fall, would you hold cash or buy bonds?
DIRECT MEASURES

• In addition to the policy instruments discussed above, the monetary authorities can use a number of other direct policy instruments.
1. CREDIT CEILINGS

• The central bank can restrict the amount of loans that banks may give to the private sector.
2. INTEREST RATE CONTROL

• Limits can be placed on both deposit rates and lending rates. If this measure is used, interest rates do not reflect demand and supply conditions in the market.
3. REGULATING CONSUMER CREDIT

• This measure refers to credit agreements such as hire purchases. It regulates the term of repayment, the percentage of the purchase price that must be paid as a deposit and the classes of goods that are affected.
4. MORAL PERSUASION

• The Bank of Namibia can use discussions, explanation and persuasion to prompt banks and other financial institutions to help achieving monetary policy goals.
MONETARY POLICY VERSUS FISCAL POLICY

• Experience has shown that fiscal policy tends to be more successful to stimulate the economy when unemployment is a problem while monetary policy has been more effective to cool down an overheated economy and curb inflation.
MONETARY POLICY PRACTICE IN NAMIBIA

• The main goal of monetary policy in Namibia is to ensure price stability in order to promote sustainable growth and development.

• Namibia maintains a fixed exchange rate agreement with South Africa where the Namibian dollar is pegged to the South African rand at a 1:1 ratio.

• Under a fixed exchange rate regime, the primary goal of a Central Bank is to defend the peg.
• By defending the peg, the ultimate goals of price stability is achieved by importing stable inflation from South Africa.

• Namibia does not have a completely independent monetary system but it can control domestic money supply and keep its Repo rate slightly different from South Africa’s Repo rate if local economic conditions so demand.
Due to the exchange rate arrangement, Namibia cannot operate monetary policy independently from South Africa, as this will disturb the fixed peg through the capital account. However, Namibia could use capital control and regulatory barriers to influence short-term interest rates, money supply and credit extension to the private sector in order to control domestic induced inflation through expectations and aggregate demand.
The main instrument is the Repo rate but BoN also uses open market operations.

The open market operations tool is less effective in Namibia because:
- Large amount of bond/stock are held by institutional investors and not by households.
- Half of the companies listed on the Namibian Stock Exchange (NSX) are also listed on other stock exchanges. Therefore, the performance of the NSX is influenced by external developments.

There is no formal operational target, but the BoN monitors the level of official reserves, as the fixed currency peg requires the country to fully back its currency in circulation with international reserves.

The Executive Committee (EC) is responsible for the formulation of monetary policy in Namibia and meets six times a year to deliberate on monetary policy issues.

Its members are the Governor, Deputy-Governor, Assistant-Governor and three staff members based on their expertise.
THE END...

QUESTIONS???