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The Namibian Economy
Liquidity and funding

February 2018

Contents

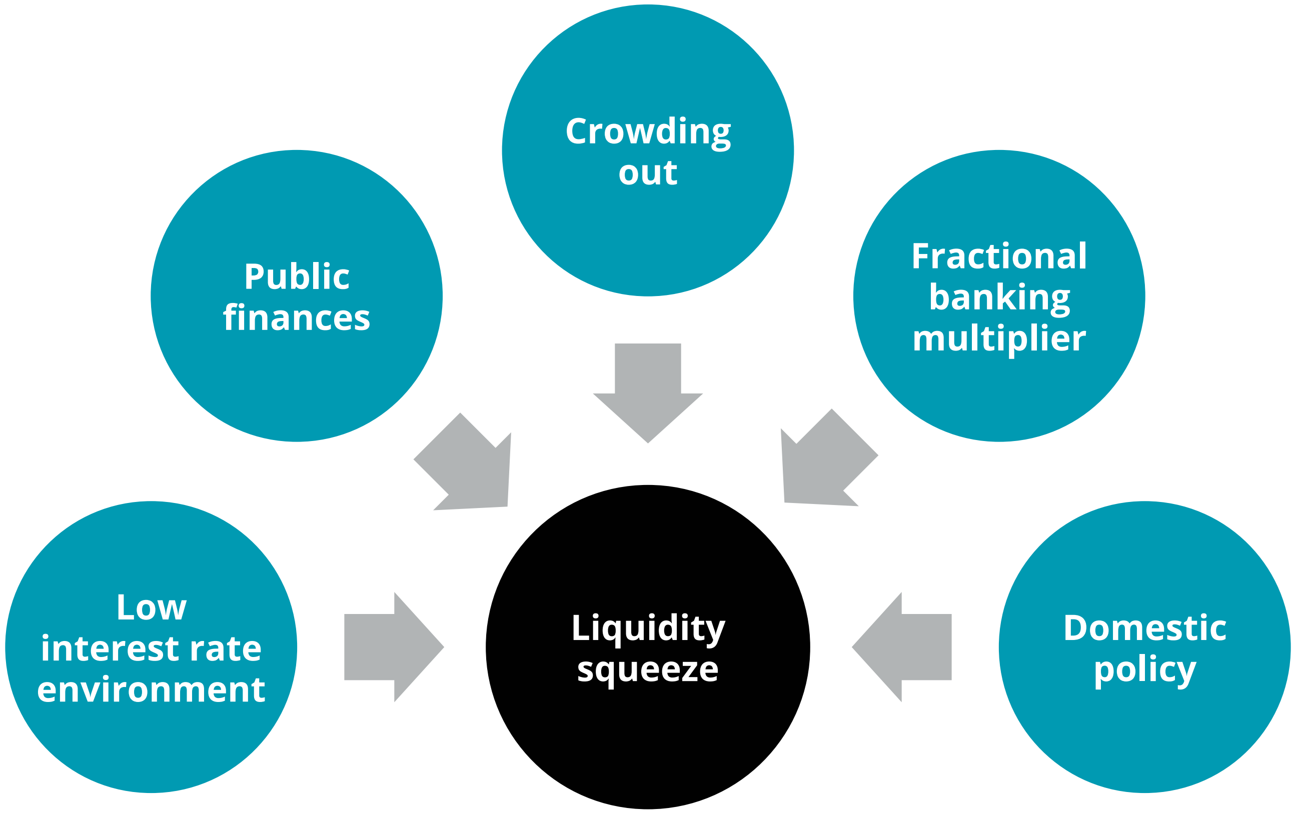
Historically, Namibia has been an economy characterised by an abundance of liquidity. This situation turned around abruptly in the latter half of 2016 and into 2017. At the same time the Namibian economy slowed dramatically, going from growth of between 5.1% and 6.4% for the six years from 2010 to 2015, to just 1.1% in 2016, with four of the past five quarters (to Q2 2017) showing contractions.

There are a number of reasons for the abrupt growth slowdown in the local economy, ranging from adverse weather conditions and commodity prices, to weakening domestic demand and investment.

However, liquidity is one of the major factors driving the recent economic slowdown. While initially a symptom, the lack of liquidity (i.e. funds available to the economy), particularly in government debt auctions and the commercial banks, contributed to the slowdown through 2016 and into 2017, and remains a drag on the local economy and a risk to the Namibian economic recovery.

The reasons for this slowdown, particularly focusing on the banking sector liquidity, are further discussed in this report.

Low interest rate environment

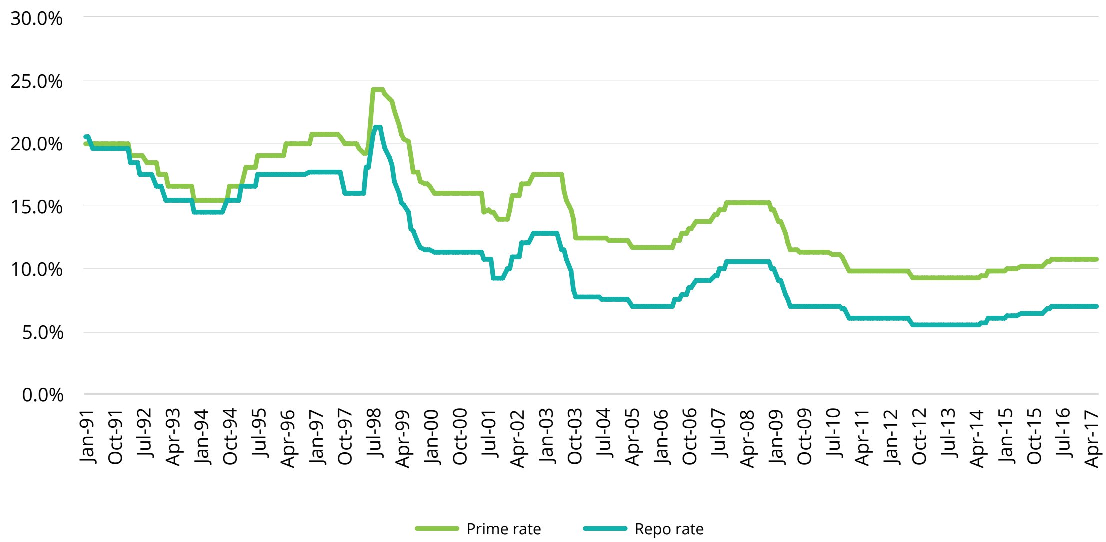


The persistence of historically low interest rates for an extended period of time, has, by nature, incentivised borrowing and disincentivised saving within the population. Generally, this is the intent of such policy, as lower interest rates stimulate household consumption and corporate investment, thus stimulating growth in the short term. However, the policy's effectiveness has limits.

The incentivised uptake of credit can only be sustained so long as banks have money to lend, and households and corporates have capacity to borrow. An accommodating monetary policy environment thus becomes less effective as average indebtedness rises, as was the case in Namibia.

Further, reduced liquidity tends to drive interest rates higher, and adds strain to the economy as relatively highly indebted individuals and corporates are required to service debt at a higher rate, implying larger interest payments.

Interest rates



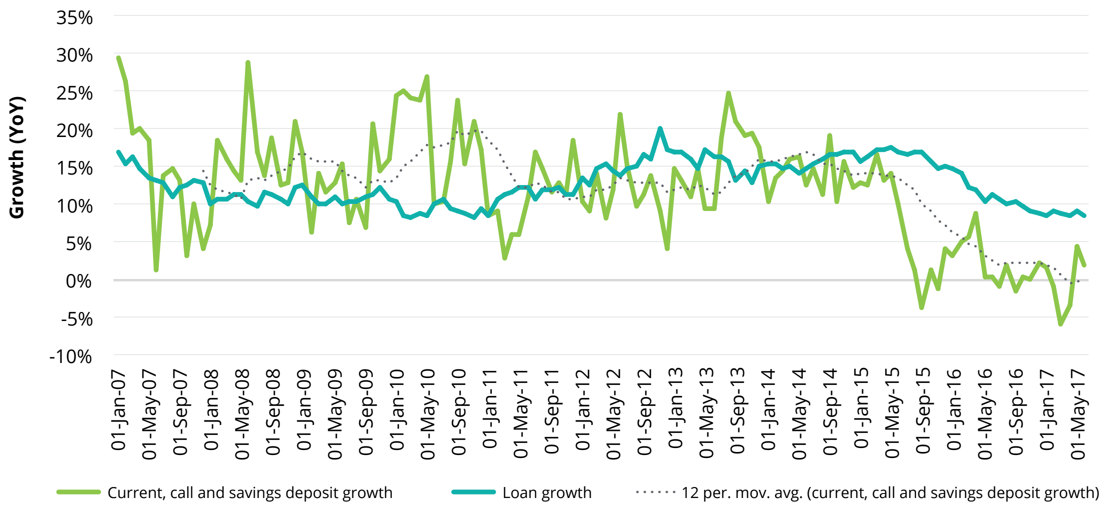
Source: Bank of Namibia, Cirrus Capital

In Namibia, the monetary stimulus introduced in 2008 was relatively successful in the short term, largely due to the fact that household debt levels were relatively low, and banks had surplus liquidity and therefore capacity to lend.

However, the prolonged period of low interest rates saw imbalances develop, with banking system deposits growing by approximately 180% since interest rates were first cut in mid 2008, while advances, or loans, expanded by nearly 200%. Similarly, since mid-2009, retail deposits in the banking system have grown by 107%, while loans extended to households have expanded by 134%.

This became particularly pronounced from mid-2015, as the oil price collapse started to filter through to the local economy through a reduction in Angolan demand for goods and services sourced from Namibia, and as the Namibian budget deficit widened on weaker than expected revenue collection, prompting a withdrawal of government deposits from commercial banks in order to fund this shortfall.

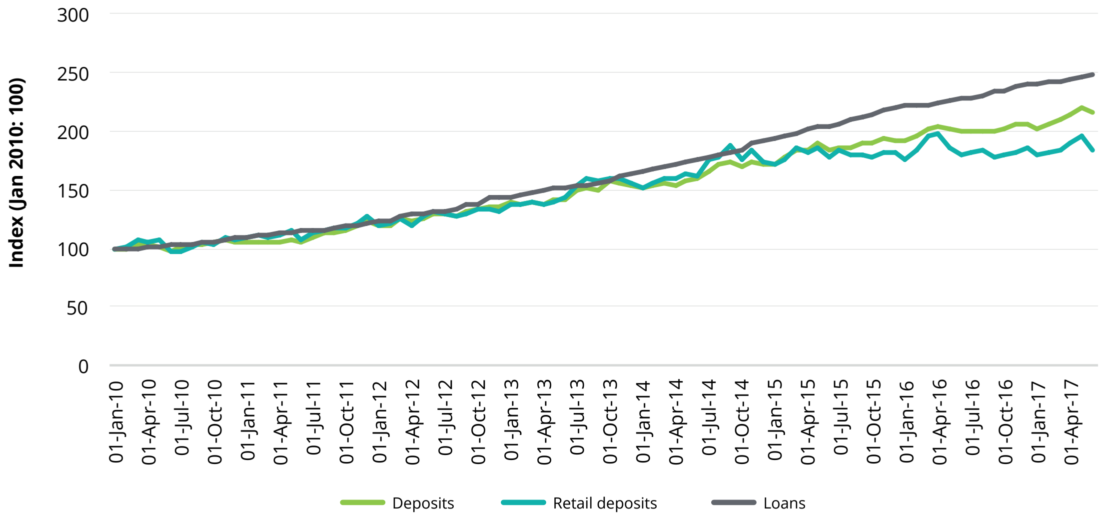
Loan and deposit growth



Source: Bank of Namibia, Cirrus Capital

Moreover, retail deposits, conventionally one of the cheapest sources of funding for commercial banks, have seen virtually no growth since September 2014, while loans have expanded by approximately 37% over the same period.

Banking sector loans and deposits



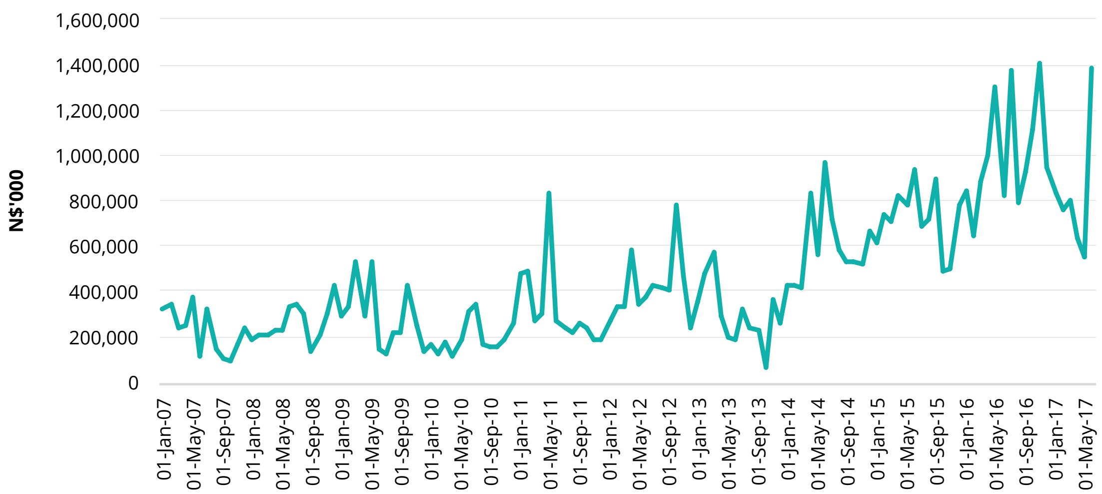
Source: Bank of Namibia, Cirrus Capital

As a result of the disparity in loan and deposit growth, the loan to deposit ratio in the banking sector has come under pressure over recent years, requiring that the banks move towards funding sources other than conventional deposits. As a result, a larger percentage of bank funding was sourced through issuance of debt securities and negotiable certificates of deposit, largely issued to willing money market funds.

Similarly, the commercial banks have become more likely to make use of the interbank market, with interbank borrowing increasing 21-fold between the level recorded at the low in October 2013 and the recent high in November 2016. This tight liquidity situation also prompted the most aggressive use of the central bank's repo window seen in over a decade, with various commercial banks utilising the facility to meet liquidity requirements.

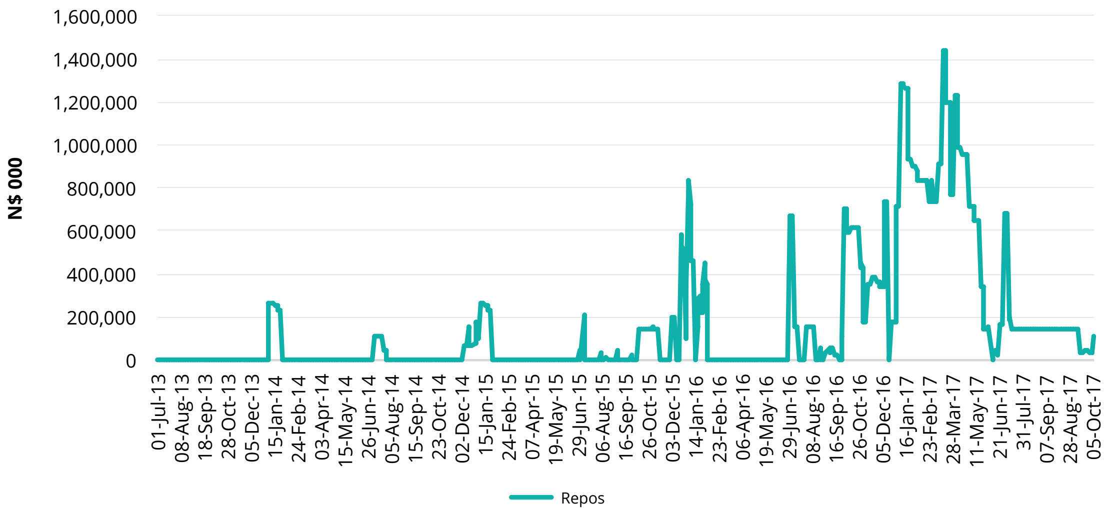
This became particularly evident in late 2016 and early 2017, when the banking sector consistently had between N$800 million and N$1.45 billion in liquidity sourced from the central bank.

Interbank lending



Source: Bank of Namibia, Cirrus Capital

Repos



Source: Bank of Namibia, Cirrus Capital

While Namibia's expansive monetary policy was effective in the short term, over the long-term, it is proving to be less effective than in many other countries. The reason for this is that the stimulus is subject to enormous leakage. This is due to a number of different factors, however the primary reason is as follows: The majority of the credit issued in the local economy is issued to the relatively wealthier, i.e. those with access to banking and credit.

As a result, the marginal dollar of credit extended is often utilised to purchase luxury goods, of which Namibia produces very few. As a result, increased credit extension tends to fuel consumer imports, most notably vehicles, consumer electronics and furniture. From a commercial perspective, commercial credit often results in the import of machinery or specialised equipment. Namibia does not, for the most part, produce these goods, and thus, local deposits and money generated by the fractional banking system, is quick to leave the country in pursuit of imported items.

Thus, the long-term impact of low interest rates is relatively small, as the majority of the debt issued does not result in increased consumption of locally produced goods.

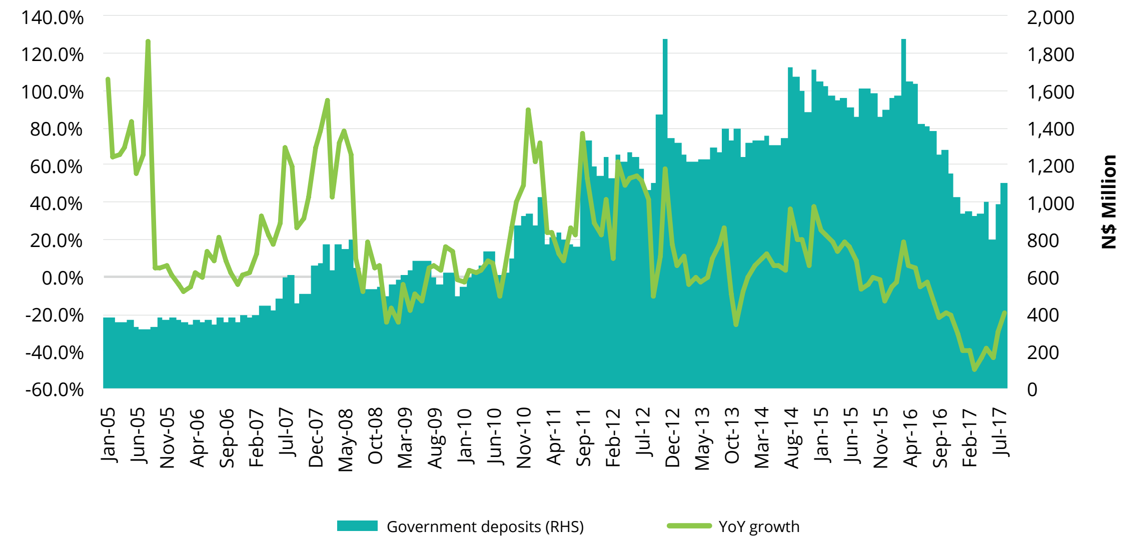
Public finances

Through the back-end of 2015 and into 2016, Government finances came under immense pressure, ultimately manifesting in a series of large budget deficits, and highly constrained cash flows. These fiscal constraints had a notable impact on the banking sector, as the initial response was to enact efforts to consolidate the funds of Government from the various commercial banks in which they were deposited, back to the central bank (where the bulk of Government funds were housed). This saw withdrawals from many of the "satellite" accounts of government, including central government offices, ministries and agencies, as well as regional government and state-owned enterprises. The second response from Government was to issue large amounts of debt in order to fund the budget deficit.

Over a period of just 18 months, the public debt stock doubled, with the domestically issued debt stock nearly doubling between the end of 2014 and the end of 2016. However, in late 2015, through 2016 and into 2017, the conventional buyers of Government securities could no longer keep up with the issuance thereof (the assets of the pension funds and life insurance companies expanded by approximately 35% over the period that the debt stock doubled), and the appetite for government debt waned, leaving government with major cash-flow constraints. These cash flow constraints became a crisis, resulting in non-payment of a number of invoices, particularly construction sector related, many for a period of over six months.

This caused a double-whammy effect on the commercial banks. Firstly, not only did expected deposits not materialise, but many large institutions found themselves knocking on the doors of commercial banks for short-term facilities with which to manage working capital and in some instances, to remain above water. Although somewhat alleviated during the second half 2017 with the receipt of the African Development Bank loan, and a recovery in Southern African Customs Union receipts, public finances and the requirement for fiscal discipline are expected to remain topical and will continue to have an impact on the country's liquidity position, particularly through late 2018 and into 2019.

Government deposits with commercial banks



Source: Bank of Namibia, Cirrus Capital

Crowding out

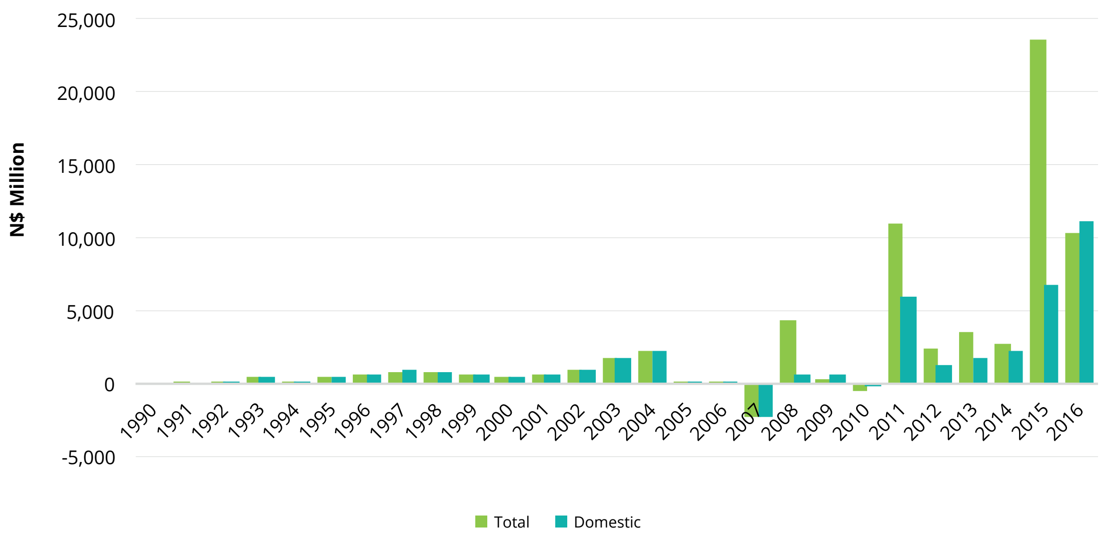
In the wake of the global recession in 2008, the Federal Reserve in the US introduced a policy of large scale asset purchases, named quantitative easing. This policy was designed to stimulate the economy through a large-scale liquidity injection, thereby driving down long-term interest rates.

This was ultimately achieved by the central bank printing money, and using that money to buy long term government bonds, thereby exchanging illiquid bonds for liquid cash.

In Namibia, however, a reverse phenomenon was witnessed, whereby the domestic funding of large budget deficits in 2015 (net issuance of N$6.8 billion worth of domestic debt) and 2016 (net issuance of N$11.1 billion worth of domestic debt), saw huge competition for the limited capital available in the country.

In essence, the large budget deficits saw the inverse of the US quantitative easing, whereby a large amount of Government debt was issued into the economy, mopping up a large portion of the liquidity available to the market in a phenomenon known as "crowding out".

Government debt issued



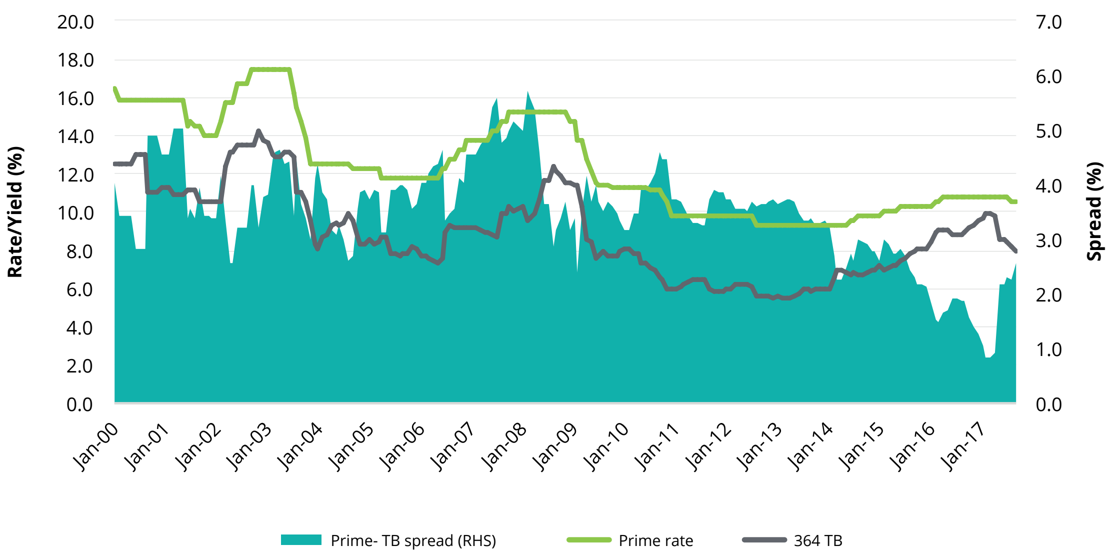
Source: Bank of Namibia, Cirrus Capital

As expected, the increase in competition for limited capital resulted in increased capital costs, to a point where capital raising through debt issuance particularly, became un-viable for corporates with a profit motive.

This was particularly true of the commercial banks, where the aforementioned compression in loan-to-funding ratios, as well as constraints in conventional deposit funding sources meant that the banks were left with little choice but to issue debt and relatively expensive negotiable certificate of deposit (NCD) to compensate for lost retail deposits and ultimately, slow lending.

At the same time, the administered rate of capital – the repo rate, as set by the central bank, increased at a dramatically slower rate, resulting in margin compression for the commercial banks, ultimately disincentivising the issuance of the marginal loan, as the marginal net-interest margin could no longer warrant the duration and credit risk that was associated with such in a slowing and increasingly indebted economy.

Prime vs TB rates



Source: Bank of Namibia, Cirrus Capital

Fractional banking

Namibia, as is the case with most countries in the world, operates a fractional reserve banking model and system. This system requires that only a portion (10%) of all deposits in the banking system have to be held in liquid reserves in order to cover short-term liabilities to the public. In effect, this allows banks to lend out 90% of all deposits they receive, with only a fraction being held in reserve.

Due to the fact that most of the funds lent out end up finding their way back into the banking system, and once again 90% of these deposits can be on-lent again, the system has a deposit multiplier effect of approximately 10x (the multiplier is the inverse of the reserve requirement).

As a result, for every N$100m that is deposited into the banking sector, there is a 10x multiplier effect over time, ultimately implying that a N$100m deposit into the sector can provide up to N$1bn in loans over time, assuming no leakages.

However, the same is true in inverse, whereby major withdrawal of deposits from the banking sector can have a similar multiplier effect, particularly should such withdrawals form a system leakage, as experienced when funds are taken out of the country.

It is believed that this was a notable problem through 2016 given the drawdown of Government deposits as well as drawdown on private sector reserves to continue operations in the wake of a build-up of Government arrears.

Domestic policy

Namibia has, for many years, imported more merchandise goods than we have exported. As a result of this, we have become increasingly reliant on foreign capital flows in order to support not just our balance of payments, but also liquidity and long term funding in our banking system.

Through 2016, however, two pieces of legislation, one proposed and one enacted, caused ripples within this conventional fabric of capital flows. These were the New Equitable Economic Empowerment Bill, and the Investment Promotion Act. While a challenging matter to discuss, as many view assessment of the policy outcomes and potential as criticism of their purported objectives, these pieces of proposed and enacted legislation are viewed to have added to the challenging funding and liquidity environment in 2016.

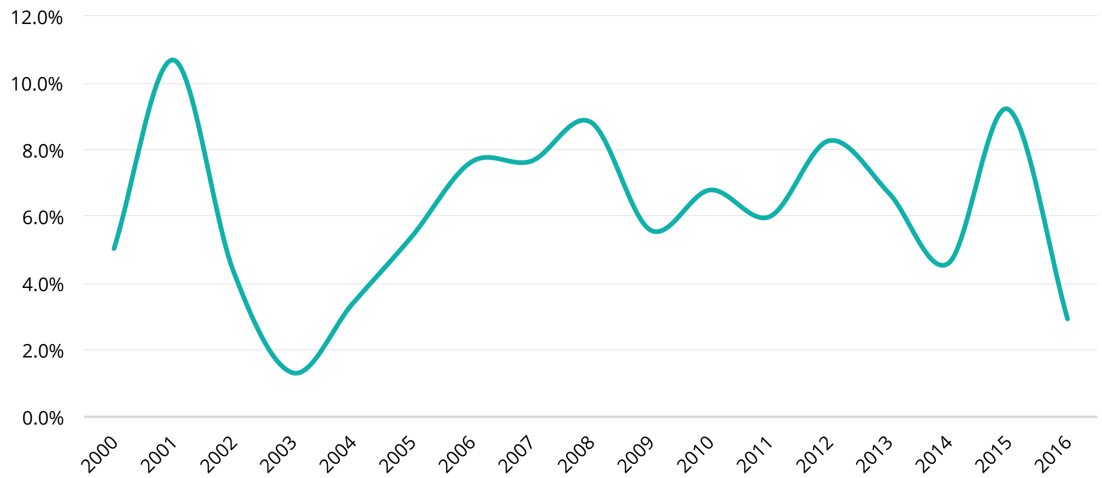
While arguably well intentioned, and certainly aiming to address critical issues of investment and empowerment in our local economy, these pieces of legislation were not well received by many local, and foreign investors. While not clearly supported in statistical evidence due to data aggregation, anecdotal evidence suggests that abnormally large outflows of retail capital were experienced from the economy through 2016, as a number of domestic investors showed concern around the ownership and management control pillars of the proposed empowerment legislation.

Added to this, foreign direct investment inflows were lower than normal, with anecdotal evidence suggesting that this was, at least in part, due to foreign investors' concerns surrounding their ability to repatriate invested capital and profits following the enactment of the Investment Promotion Act.

While the magnitude of these outflows and foregone inflows is hard to quantify, the aforementioned fractional banking system ensures that even relatively small outflows can have a significant impact on bank funding and liquidity.

In total, foreign investment fell to just 2.9% of GDP in 2016, the lowest level seen in over a decade. Given Namibia's dependency on foreign direct investment inflows to fund the current account deficit, the major reduction in such flows seen in 2016 presents issues for more than just the banking sector.

Foreign direct investment, net inflows (% of GDP)



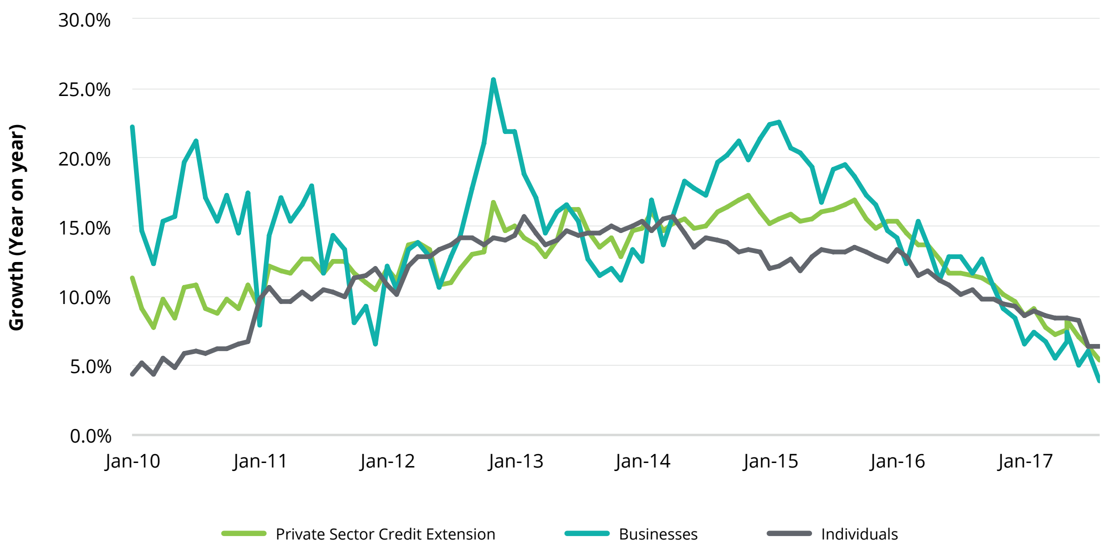
Source: World Bank

The implications of the liquidity constraints viewed through 2015, 2016 and early 2017, have been that credit extension growth has slowed dramatically since late 2015.

After peaking out at 18.4% in late 2012, the rate of growth in credit to the private sector remained fairly constant until September 2015, after which growth has slowed, almost without exception, in each subsequent month.

By mid 2017, the rate of growth in credit extension had fallen to 1/3rd of what it was at its peak in 2012, at just 5.4% in September 2017, with business credit uptake under 4% for the first time on record.

Private sector credit extension



Source: Bank of Namibia, Cirrus Capital

Recent developments

Since May 2017, the liquidity situation has reversed completely. In a space of a few months, the commercial banks have gone from borrowing from the central bank via the repo-window (commercial bank liability, Bank of Namibia asset), to depositing funds with the central bank (commercial bank asset, Bank of Namibia liability) via the BON-bill auctions.

In little over seven months, the commercial banks have gone from a net repo facility with the central bank of over N$1 billion, to net BON-Bill position of over N$3bn, a N$4bn turn-around.

This has been driven by a number of factors, starting from slight improvements, in Government finances, particularly driven by a major (almost 40%) increase in payments from the Southern African Custom Union pool, one of the largest sources of revenue for Government, as well as the highly-favourable loan secured by the Government from the African Development Bank (AfDB) – both external sources of funding. At the same time, the transaction that was done between key shareholders of the Capricorn Investment Group and the Government Institutions Pension Fund saw a notable inflow of funds into the country, both for the share transaction and the commitment of the two parties to provide long-term funding to the banking group.

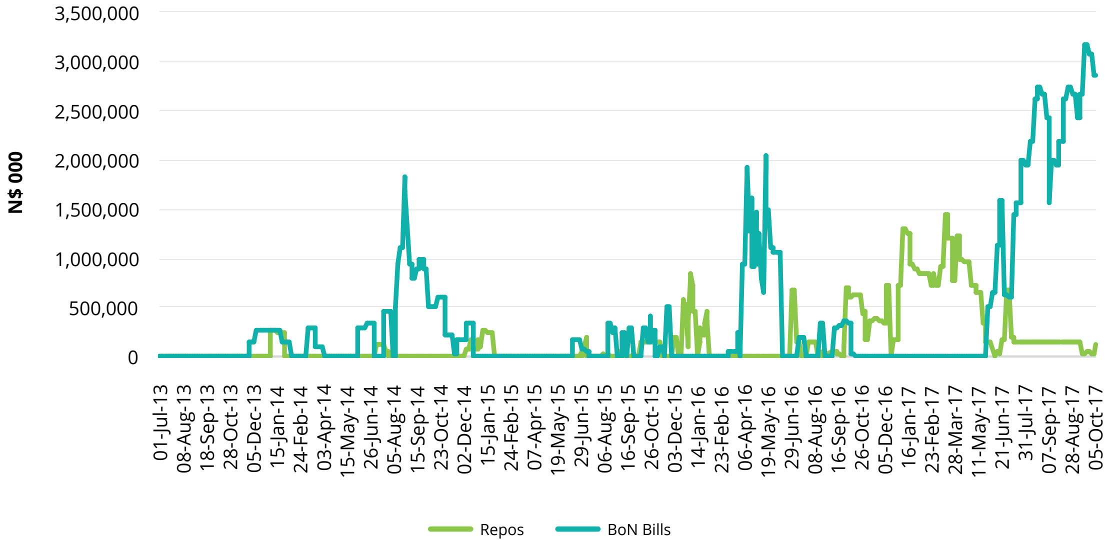
Due to the interbank market and the fact that banks are happy to lend surplus liquidity to other banks and earn a return thereon, this liquidity for Bank Windhoek has resulted in improved liquidity in the sector as a whole. Furthermore, ongoing localisation requirements imposed on the Namibian pension fund and long-term insurance industries, particularly with regards to the regulated reduction in dual-listed holdings on the Namibian Stock Exchange. Going forward, the outlook for the liquidity and funding situation remains somewhat more buoyant over the next 18 months than was the case through the second half of 2015 and the year 2016. This is expected to be driven, primarily, by inflows from the AfDB, and the repatriation of pension fund assets. Despite the positive developments above, this will be somewhat mitigated by the financial situation in Namibia in 2018, where the risk of insufficient liquidity recurs given the possibility of revenue pressure from a SACU repayment/undershoot as well as a negative revenue feedback loop from the current economic slowdown (a slowing economy sees corporates making less profit, employing fewer people and lower vatable expenditure in the shops, thereby reducing corporate, personal and value added tax collection in real terms), as well as over-expenditure by Government due to demands from the civil service employees, as well as ailing state owned enterprises.

The latter, particularly, is highly exposed to the economic downswing, and many that experienced financial difficulty through the boom-years in the economy, may find themselves requiring government assistance to remain afloat. This may result in budget deficits being larger than currently expected, which will likely be partially funded from the second tranche of the AfDB loan, and partially from local sources. This will once again increase competition for local capital, and once again drive up the cost thereof.

At the same time, despite an improving funding and liquidity situation in the country, the banks appear to remain "once-bitten, twice shy", and credit extension number continue to plummet. Furthermore, remaining policy uncertainty, leakage from the capital, current and financial accounts and uncertainty surrounding the liquidity recovery continues to over-shadow the industry.

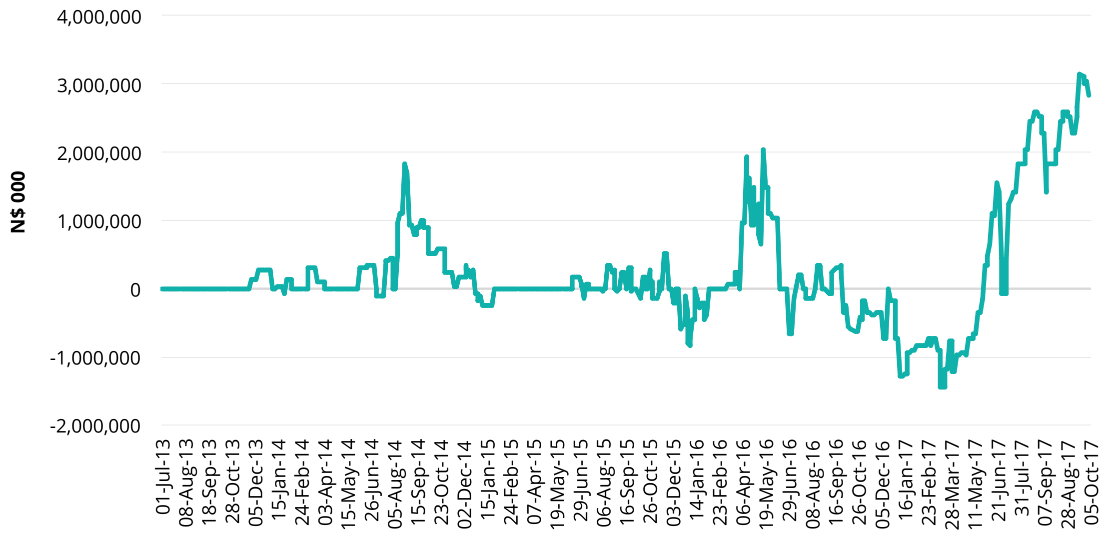
In this regard, the current weak sentiment in the country, from households and businesses, continues to reduce demand for credit, as well as growth in deposits placed with the banking sector. Thus, despite the positive signs seen at present, recovery may still be a long way off, with the 2017/18 financial year remaining challenging for the sector.

Repos, BON bills and liquidity



Source: Bank of Namibia, Cirrus Capital

Net BON bills – Repo



Source: Bank of Namibia, Cirrus Capital

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