

Working Paper



Namibia vs. South Africa

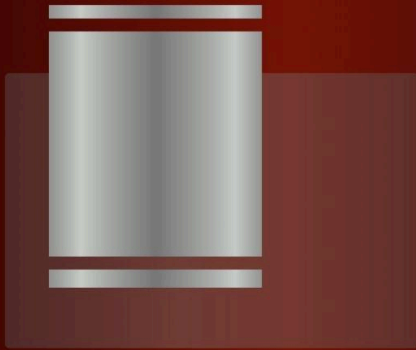
**ECONOMIC ASSESSMENT OF
A SHARED CURRENCY PEG**

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Introduction

Why is South Africa experiencing weakening economic growth, whilst economic growth in Namibia is rising, despite a shared currency peg? Namibia won its independence from South Africa in 1990. In 1994, South Africa abolished the system of apartheid and adopted the system of majority rule. Post independence, both countries enacted a state-owned, interventionist economic regime (Nellis, 2005).

Owing their intertwined sociopolitical history, Namibia remains economically dependent on South Africa. Post independence, because the Namibian economy was new to the world market, the Namibian dollar was pegged to the South African rand. This was done to prevent the Namibian economy from collapsing -- a complete economic separation from South Africa would have led to extremely high currency appreciation in Namibia because of high inflows of foreign capital towards Namibia's lucrative mining industry. This, in turn, would have had a negative impact on the Namibian economy as other non-mineral commodities would have become less price competitive in the export market. Had the Namibian dollar not been pegged to the South African rand post independence, high inflation rates would have decimated Namibia's economy.

South Africa, having had control over Namibia's lucrative mineral and mining sector since 1919, had a vested financial interest in ensuring that the Namibian economy did not collapse post-independence. South Africa's mining sector (the fifth-largest in the world) accounts for 8.3% of its annual GDP output. Namibia's mining sector (mainly diamonds and uranium) accounts for 12.3% of the annual GDP output. In terms of development, Namibia and South Africa rank high on the list of Africa's most advanced economies. Up until 2014, when Nigeria took the lead, South Africa had the largest GDP on the continent.

In spite of South Africa's burgeoning regional trade portfolio, and its high financial market development ranking (7th out of 144 countries), domestically, economic growth has been sluggish, the unemployment rate is the highest in the world, and inflation is on the rise. Despite its shared currency peg with South Africa, the Namibian economy shows a different trend: Unemployment is declining, inflation is moderate, and high investor confidence in Namibia's economic future has meant an influx of foreign investments, which has kept Namibia outperforming South Africa on several indicators for nearly one decade.

Perspective I : Neoclassical School of Thought

Hypothesis I (Neoclassical/Ricardo): Wage rates in South Africa have seen a steady increase, whilst wage rates in Namibia have declined. As a result, unemployment has risen in South Africa, whilst unemployment rates in Namibia are declining.

Neoclassical economists believe that individuals optimize their "human capital" based on their assets (skills, education, etc), market prices, and wage rates.

From the Ricardian perspective, factors of production are responsible for explaining income distribution - high wage rates beget high levels of productivity; conversely, low wage rates produce economies with low levels of productivity. Market imperfections force price adjustments and changes in individual incentives, which affect the labor market and unemployment.

The South African trade sector (non-mineral) has experienced low growth since 1990. Further, in the most recent decade, economic and employment growth rates have declined and wage rates have risen from 8.1% (2005) to 10.1% (2015). Today, South Africa registers the highest unemployment rate on a global scale. When the 2008 global crisis hit, unemployment rates in South Africa fell to a record low of 21.5%, however, in the first quarter 2015, the unemployment rate had risen to 26.4%. In addition, the annual GDP growth rate has fallen from 2.1% (2012) to 1.2% (2015).

The wage rate in Namibia has declined from 12.2%(2005) to 10.9%(2015). According to the Namibian Central Bureau of Statistics, the unemployment rate in Namibia is also on the decline, reaching a record high of 37.6% in 2008, during the global financial crisis, however, this rate dropped to 28.1% in 2014. Namibia has seen strong growth in the annual GDP from a negative 4.2% in 2012 to a positive growth rate of 14.4% in 2013, which has since leveled to a rate of about 4.2% (2015).

Perspective II: Classical Theory of Economics

Classical Economic Integration: Namibia limited its regional trade expansion policy to the SADC economic network and was able to capitalize on the strength of a trade expansion policy that was restricted to the SADC network. South Africa pursued an aggressive regional integration strategy that involved the expansion of trade relationships outside of the SADC framework, and although this enlarged its regional trade network, it weakened its domestic growth capacity.

According to the classical theory of economic integration, in order for a geographic region to become fully integrated, several stages of integration must be reached, beginning with the establishment of a preferential trade area; a free trade area; customs, monetary and fiscal unions and an eventual political union. The Southern African Development Community (SADC) was established in order to integrate the economies of its 15 member states, which include Namibia and South Africa. The objective of its member states is to strengthen: market integration, macro-economic convergence, financial and capital market gains, cooperation among monetary authorities, investment growth and global competitiveness. In 2009, intra-SADC trade reached approximately \$34 billion.

Namibia is a part of both the South African Customs Union (SACU), but has mainly strengthened its economic position via SADC trade protocols. Namibia has further strengthened its regional economic position by ratifying double tax avoidance partnerships with 11 SADC countries, including South Africa.

Namibia's regional trade relations have not only improved its current account position but has created a sizable financial accounts surplus for the country.

As a result of its SADC partnerships, Namibia's domestic capital market has grown relatively strong - the Namibian Stock Exchange (NSX) , with a 2013 market capitalization of NAD 1.44 billion (approximately \$1 billion), is one of the largest in Africa - after South Africa's Johannesburg Stock Exchange.

The SADC, SACU, Tripartite Free Trade Area (T-FTA), Common Market for Eastern and Southern Africa (COMESA), and the East African Community (EAC) are some of the main channels through which South Africa spearheads its regional development objectives. South Africa's trade relations span 26 African countries with a combined GDP of \$1 trillion.

In spite of South Africa's high financial market development ranking (7th out of 144 countries), domestically, access to finance is restricted for several reasons - nearly 12 million adults in South Africa do not have a bank account, and millions more have little or no access to formal financial services.

Recently, the rise in unsecured household lending led to the collapse of African Bank Investments Limited (ABIL), a publicly listed company on the Johannesburg Stock Exchange. During the 2014 fiscal year, ABIL reported a loss of approximately \$600 million. In an attempt to prevent a complete collapse, the Reserve Bank of South Africa pumped nearly \$1.6 billion into ABIL, which is currently in recovery. The ABIL collapse prompted Moody to downgrade the credit rating of two unsecured lenders and four major South African commercial banks.

The downward trend in domestic GDP growth rate has also contributed to lackluster tax revenues, which will likely result in lower customs payments to South Africa's SACU partners at the end of the 2015 fiscal year.

Perspective III: Monetarist Position

Hypothesis III (Monetarists): Monetary authorities Namibia and South Africa tightened their monetary policies, however, inflation was rising in South Africa (against a backdrop of rising unemployment); whilst in Namibia, inflation rates were moderating (against a backdrop of declining unemployment).

The Phillips curve proposes that a theoretical tradeoff exists between the inverse relationship between income and unemployment. The economic reality in Namibia and South Africa tells a different story.

Import prices have remained marginally stable in Namibia since the third quarter of 2012, however, rising transportation and food prices have remained tough pressure points in the delicate dance to control inflation rates, particularly in light of a currency peg and a heavy trade relationship with South Africa. The Bank of Namibia recently implemented specific percentage point increases in repurchase agreement (security buy back) rates, over a specific time period, in order to stabilize consumer prices and buffer the effects of a devaluing South African rand. Inflation pressures are expected to keep monetary policies tight in Namibia.

Although economic growth in South Africa has declined, monetary authorities agreed to tighten the country's monetary policy in the first quarter of 2014 because the rand exchange rate was being affected by pessimism, which stemmed from U.S. quantitative easing and the deceleration of growth in the Chinese market (South Africa's largest trading partner). Also, labor unrest and xenophobia attacks threatened the inflation outlook of the rand in 2014. Inflation reached a high of 6.1% in April 2014 and rose further to 6.6% in May 2014.

Rising wages have also affected inflation rates. As aforementioned, South Africa has seen an increase in wage rates, with the opposite being true in Namibia. The rand remains volatile due to a high current account deficit, rising unemployment, sluggish economic growth, and a pessimistic outlook. The Namibian dollar weakened against its major international trading currencies in the first half of 2014, however, Namibia has been able to maintain its currency valuation, mainly because of its strong import sector and the Bank of Namibia's relentless efforts to curtail private sector indebtedness. Namibia has managed to stay on target in terms of achieving its budget deficit, government debt, and current account goals. Also providing a boost to the Namibian dollar is its growing influx of foreign direct investment, mostly towards the mining sector, which has allowed Namibia to outperform South Africa for close to a decade.

The South African Reserve Bank (SARB) has made the stabilization of the financial sector, prices, and inflation rates its paramount monetary strategy. The rand was devalued twice in 2014, which prompted the SARB to raise interest rates in order to slow down spending and thereby reduce inflation. The SARB also expected structurally low investment levels to be positively affected by the interest rate hike.

The demand for higher wages by public sector unions continues to be problematic and presents fiscal challenges. The South African government has enacted several budget consolidation measures aimed at curtailing the growth of expenditures to a targeted rate of 1.3% (revised from an earlier 2015 target of 3.2%) by downsizing government spending.

Also potentially problematic is the fact that in previous years, additional budget resources were used to cushion above inflation wage increases in the public sector. The reality that this is unlikely to happen in the future, increases the threat of public sector wage strikes, amidst wage increase demands from public sector unions. Standard and Poor's downgraded both the sovereign and local credit rating of South Africa by one level, respectively, in June 2014. This negative rating is regarded as one level above junk by investors, which may be contributing to South Africa's lackluster performance against Namibia in terms of attracting foreign capital in the mining sector. South African financial analysts predict a continued deterioration of the country's financial parameters, which will likely drive the current inflation rate higher.

Concluding Statements

The economic situation in Namibia and South Africa presents an antithesis to the theoretical Phillips curve, which predicts an inverse relationship between inflation and unemployment. In Namibia, unemployment decline is coupled with a moderate rate of inflation; whilst in South Africa, high unemployment appears in tandem with rising inflation rates.

Overall, in spite of South Africa's burgeoning regional trade portfolio, and its high financial market development ranking, the South African economy appears sluggish next to its Namibian trade and currency partner.

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