35. **Available data suggest that Namibia's current account surpluses have contributed to a strengthening NFA position**. Again, however, data quality appears to be an issue, with no clear concordance between the modest recorded increases in NFA and the much larger estimated capital outflows. Given this, NFA projections are somewhat perilous, though a further rise appears likely, with a slowing pace as the projected current account surplus declines in the period ahead.

36. **The projected further strengthening of Namibia's NFA position, while of uncertain magnitude, does not appear to pose risks of abrupt shifts in capital flows**. The main risks would appear to concern possible investment repatriation in excess of the economy's absorption capacity. Given the unlikelihood of a major improvement in Namibian investment returns relative to those in South Africa, this does not appear a significant risk, though it does point up the importance of careful management of the regulations on domestic and overseas investments by the pension and life insurance industries (Chapter III).

III. Namibia's Domestic Investment Requirements: Policy Issues[5]

A. Introduction

37. **From 2004 to 2006, Namibia's gross national savings rate averaged 37 percent of GDP, almost double the average for sub-Saharan Africa and 60 percent higher than the lower-middle income country average**.[6] This level of savings supported domestic investments averaging 27 percent of GDP, about 50 percent higher than the sub-Saharan average and slightly above the lower-middle income country average. The excess of savings over domestic investment was invested abroad, largely by Namibia's pension and insurance industry. In light of Namibia's high unemployment and weak employment growth, the government is planning to tighten domestic investment regulations for the pension and insurance industries.

38. **This paper examines influences on the investment decisions of pension and insurance funds and the case for tighter domestic investment requirements**. It also examines alternative approaches to boosting domestic investments in Namibia. The paper concludes that tightening investment requirements may not be fully enforceable, and may not contribute to financial market deepening. There would likely be an increase in domestic investment, but the regulations would need to be phased-in cautiously to avoid inflationary pressures and a deterioration in asset quality. Given these considerations, a strong case can be made for market-based measures that would attract greater domestic investments by broadening the range of investable assets and by strengthening domestic returns on real sector investments.

B. Background

39. **Namibia has experienced large capital outflows in recent years**. From 2003 to 2005, outflows on the financial account exceeded US$500 million per annum (approaching 10 percent of GDP) and surged to US$1.3 billion in 2006 (19 percent of GDP). The largest part consisted of net portfolio outflows, which averaged 15½ percent of GDP. According to international investment position (IIP) data for mid-2007, total gross foreign assets amounted to an estimated 105 percent of GDP, with 70 percent made up of portfolio investment. South African assets made up approximately 80 percent of both total and portfolio investment. Pension and insurance funds are the main intermediaries of portfolio outflows. As of the latest data available (March 2004) the value of their total assets amounted to more than 100 percent of GDP. Using IIP data, staff estimate that total pension and

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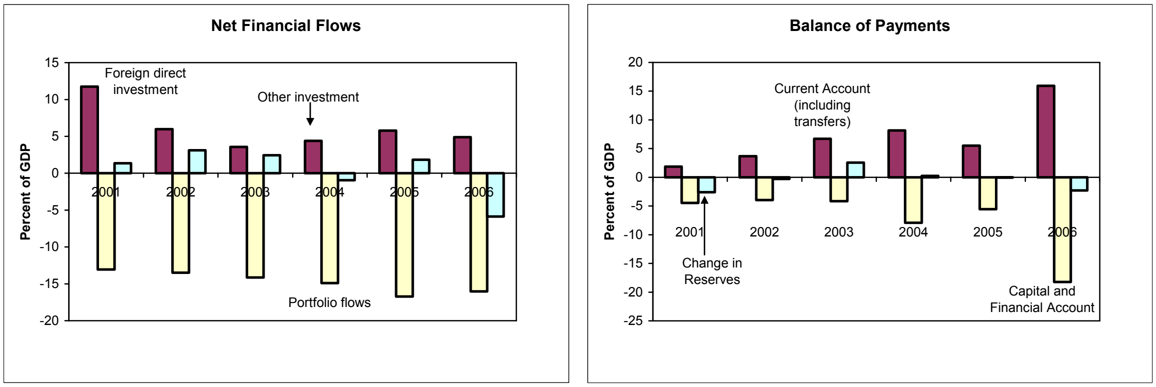
[5] Prepared by Lawrence Dwight (AFR). The author would like to acknowledge the generous comments and contributions of S. Erik Oppers to this chapter.

[6] This reflects, in part, Namibia's large SACU receipts (14 percent of GDP in FY2006/07).

insurance assets had risen to about N$58 billion (US$ 8.2 billion) in mid-2007 or about 110 percent of GDP.

Figure III.1. Namibia: Net Financial Flows and Balance of Payments, 2001–06



40. **Pension fund investments account for about 60 percent of the combined pension/insurance total**. Overall pension fund assets under management measured N$21 billion (57 percent of GDP) as of March 2004 (there are no firm data subsequently). Pension funds have been able to achieve reasonable real returns, averaging a little over 3 percent between 2001 and 2004. While Namibia has more than 500 pension funds, the Government Institutions Pension Fund (GIPF), which covers government employees, held about 73 percent of the industry total. As of March 2005, 67 percent of this portfolio was in equities, 21 percent in fixed income, and the remainder in cash and property (Table III.1).

41. **Insurance company assets totaled N$14.4 billion (42 percent of GDP) in March 2004**. Of this amount 92 percent was held by long-term insurers. The life insurance industry in Namibia is privately run, and comprises 16 long-term insurers and 12 short-term insurers. The top three companies hold approximately 85 percent of the market. No data is available on the investment returns of the insurance industry, but with a similar regulatory framework, it is probably comparable to that of the pension fund industry.

42. **Pension and insurance funds invest the majority of their funds in South Africa.** The GIPF reported that, for end-2006, 46.5 percent of assets were invested in South Africa, 19.0 percent in other foreign countries, and 34.5 percent domestically. While recent data are not available for private fund managers, in early 2002, 48 percent of their portfolio was invested in South Africa, 17 percent in other foreign locations, and 35 percent domestically (Table III.2). Of domestic investments, nearly one-half was in foreign companies dual-listed on the Namibian exchange, reducing true domestic investments—largely comprising bonds and cash—to less than 20 percent of total portfolios.

Table III.1. Namibia: GIPF's Asset Allocation, March 2005
(In percent of total assets at book value)

	Namibia	South Africa	Other international	Total
Total	38.3	53.8	7.9	100.0
Equities	20.5	39.5	6.9	66.8
Fixed income	10.8	8.6	1.0	20.5
Cash	6.2	5.6	0.0	11.7
Property	0.8	0.2	0.0	1.0

Sources: GIPF and Fund staff estimates.

Table III.2. Namibia: Asset Allocation of Namibian Fund Managers, March 2002
(In percent of total assets at book value)

	Namibia	South Africa	Other international	Total
Total	35.4	47.5	17.1	100.0
Primary stocks	1.6			
Dual-listed stocks	15.7			
Bonds	9.0			
Cash	8.7			
Property	0.4			

Sources: NEPRU Research Report No. 26, March 2004.

43. **The Namibian stock exchange is primarily composed of dual-listed companies**. The seven local firms listed on the exchange comprise only 0.3 percent of market capitalization. Forty-four percent of market capitalization represents firms having primary listings in Johannesburg and 55 percent represents firms having primary listings in London. Nonetheless, dual-listed firms are considered domestic for the purposes of Namibia's domestic investment requirements, a rule established partly to stimulate domestic financial markets.

Regulations on foreign portfolio investments

44. **Namibia's international capital flows are governed by the Common Monetary Area (CMA) agreement with Lesotho, South Africa, and Swaziland**. Under the agreement, Namibia maintains free transfers of funds for current and capital transactions with other members. At the same time, CMA members are required to align exchange control provisions with South Africa's, including controls on capital flows outside the CMA. The latter include an individual limit of R2 million in investment outside the CMA and the requirement that the government approve outward direct investment of firms. Investment managers are allowed to invest up to 25 percent of total retail assets in non-CMA portfolio investments. Pension funds may only transfer up to 20 percent of their total retail assets to acquire non-CMA portfolio investments. These regulations are applied by the Namibian authorities to the pension and insurance industry in accord with the CMA agreement.

45. **The CMA agreement allows Namibia to introduce domestic investment requirements to promote domestic development and domestic industries**. In line with these provisions, in 1994 the government amended Regulation 28 of the Pension Fund Act and Regulation 15 of the Long-Term Insurance Act to gradually increase to 35 percent the share of portfolios that pension and insurance funds must invest in domestic assets. Shares of dual-listed companies on the Namibian Stock Exchange (NSX) are considered domestic if they are purchased on the NSX, and 7 local and 19 dual-listed companies on the NSX qualify. Unit trusts are not required to comply with the domestic asset requirements, but do so in practice to attract investments from pension funds and insurance companies.

46. **With large capital outflows continuing, the Namibian government plans to introduce measures to tighten domestic investment requirements**. Under preliminary proposals, institutional investors would be required to invest a minimum of 5 percent of assets under management in unlisted Namibian firms. In addition, the value of dual-listed companies that qualify for domestic status would be reduced from 100 percent to 10 percent in a phased manner over five years. The details of the phase-in have not yet been announced, but an initial plan indicated that the credit for domestic investments in dual-listed firms would fall to 30 percent in the first year of implementation, and by a further 5 percentage points each subsequent year, reaching 10 percent in the fifth year. The proposals would also subject unit trusts to same domestic investment requirements as pension and insurance funds and their tax-exempt status would be eliminated.

47. **The government has expressed several rationales for tightening domestic investment requirements**. By keeping capital at home, domestic investment requirements would promote local economic and financial market development. As the Bank of Namibia stated in its June 2007 Quarterly Bulletin:

> *Outflows of resident capital from Namibia have been rising and the argument can be raised that, had this capital been available domestically, it could have encouraged domestic investment and enhanced economic development (p. 48).*

48. **Internationally, a number of other factors have favored domestic investment requirements**. In many cases, prudential concerns about foreign currency exposure are a major consideration. In addition, limits have been presented as contributing to financial market development and as a curb against speculative capital flows.

Namibia as a Destination for Capital Flows

49. **Before considering the case for intervention, we consider how Namibia might expect to benefit from its high savings rate**. Several factors could favor the domestic investment of these funds. Namibia has seen relatively robust economic growth in recent years and private sector investment has risen from 15 to 21 percent of GDP, suggesting the presence of good investment opportunities. Indeed, Namibia's underdeveloped capital base relative to more advanced economies should indicate the possibility of high rates of return on

capital. At the same time, international experience suggests that portfolio managers have a strong "home bias" in their investment behavior. As a result, foreign investment managers may be reluctant to invest in Namibia and Namibia could benefit from the substantial portfolios under domestic management. These considerations are explored below.

The Lucas Paradox and Namibia

50. **According to economic theory, capital should flow from richer to poorer countries, reflecting the higher returns on capital in the latter**. Moreover, capital should flow to the fastest-growing countries with the best investment opportunities. On this basis, theory would suggest that capital should flow from South Africa to its poorer, but somewhat faster-growing neighbor, Namibia (Table III.3).

Table III.3. Namibia: Comparison of Namibia and South Africa

	Namibia	South Africa
PPP per capita GDP (2005)	$2,990	$4,770
Real growth rate (2001–06)	4.7	4.1

51. **Global flows have been the reverse, however**. In what has become known as the Lucas Paradox, capital flows to poor countries have been found to be modest, and much lower than predicted (Lucas, 1990). Moreover, there is no clear evidence that capital is attracted to the fastest-growing countries (Prasad, 2007). Recent research has tried to explain the reasons for the Lucas Paradox. One approach has emphasized the importance of fundamental economic causes, including differences across countries in technology, human capital, government policies, and institutional structure. Lucas himself emphasized that differences in human capital mean that returns to capital are not as starkly different as neoclassical growth theory would suggest. Meanwhile, Alfaro (2005) cites differences in institutional structures as critical for explaining capital flows. Another approach has emphasized imperfections in international capital markets, including the risks that sovereign governments will not repay their loans or will expropriate foreign owned assets. Finally, asymmetric information with regard to the risks and returns of investment projects may deter foreign investors.

52. **By implication, Namibia may be able to capitalize on its strong growth rates by strengthening the institutions that investors believe are important**. Relevant areas for consideration include the protection of investor rights, flexible labor markets, and a good education system.

Portfolio allocation and home bias

53. **A different approach to modeling capital flows starts with finance theory and portfolio allocation decisions**. According to the capital asset pricing model (CAPM), investors should allocate portfolios according to market capitalization. For international portfolios, this implies diversification based on the size of countries' capital markets. Thus, in a truly global portfolio, investments in the United States would have a 39 percent share, those in developed European capital markets a 26 percent share, with investments in Africa at just 1½ percent, reflecting the small size of African capital markets. In practice, investment funds are rarely truly global, and most have a majority of their investments in domestic assets, even when not required to do so by regulations. This effect has been dubbed "home bias".[7]

54. **Namibia's pension and life insurance portfolios show very modest home bias**. Funds are close to the 20 percent limit on non-CMA assets and are not much higher than the 35 percent floor on domestic investments. This suggests that the regulations are binding and that foreign investment would be higher and domestic investment lower in their absence. Several factors may contribute to limited home bias. First, Namibia's market capitalization is small, even when compared just to South Africa. Indeed, if investors are restricted to investment in the CMA area, the CAPM would imply that 98 percent of Namibian portfolios should be invested in South Africa. A further factor limiting home bias is the absence of exchange rate exposure for Namibia's investment in CMA assets. Given these considerations, the absence of a strong home bias in Namibia's case is perhaps not a surprise.

C. The Case for Domestic Investment Requirements

International experience

55. **A number of countries have imposed domestic investment requirements (or equivalently limits on foreign investment) on their pension and life insurance funds**. These include Argentina, Chile, Hungary and Poland, for example, as well as the advanced economies of Germany, Japan, and Canada. Many of these limits are more stringent than those proposed by the Namibian authorities (Table III.4).

[7] For a good survey of the theoretical issues related to home bias, see Karen K. Lewis. "Trying to Explain Home Bias in Equities and Consumption," *The Journal of Economic Literature*, Vol. 37, No. 2 (Jun., 1999), pp. 571–608. For a discussion of recent trends in home bias, see the IMF's Global Financial Stability Report, April 2007, pp. 68–71.

Table III.4. Namibia: Pension Fund Investment in Domestic Assets, 2001–02
(In percent of total assets)

	Required Minimum	Actual
Mature Markets		
United Kingdom	P	77.1
United States	P	89.0
Germany	70	93.0
Japan	70	77.1
Canada	70	85.0
France	--	95.0
Italy	P	100.0
Weighted Average 1/		87.2
Emerging Markets		
Argentina	90	91.1
Brazil	100	--
Chile	75	83.6
Colombia	90	--
Hungary	70	97.5
Mexico	90	--
Namibia*	35	35.4
Peru	92	92.8
Poland	95	99.7
Weighted Average 1/		94.2

P = prudent person rule applies
* = includes dual listed stocks as domestic
1/ Weighted by GDP

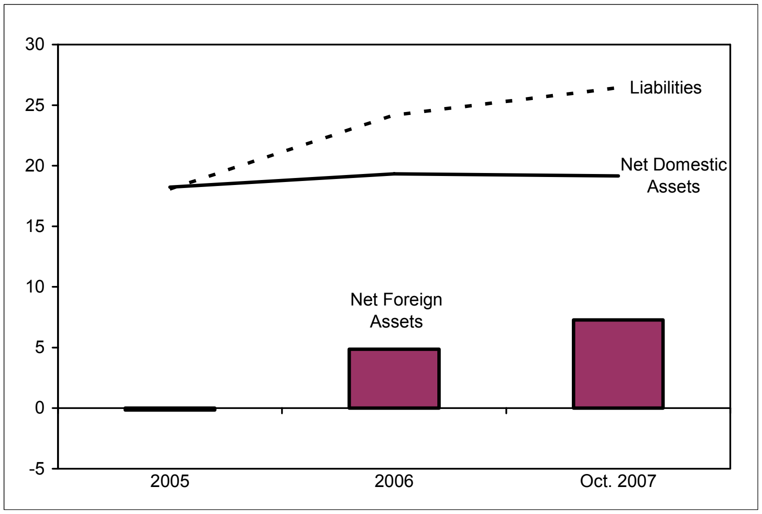
Source: IMF Global Financial Stability Report, April 2004, p. 131.

Exchange rate considerations

56. **Tightened domestic investment requirements would not contribute substantially to management of the exchange rate peg**. Initially, reduced net outflows could permit the authorities to accumulate a higher pool of international reserves. However, capital mobility would remain largely unrestricted under the CMA agreement, with individuals and banks free to circumvent the tighter regulations governing pension and insurance funds. For example, individuals could invest directly abroad to compensate for the shift toward domestic assets in their total portfolio of wealth (i.e., including pensions). Similarly, if pension and insurance funds start to provide capital for local enterprises, replacing banks as a source of funding, banks may shift their operations out of the local market. Banks could then offer domestic liabilities to the pension and insurance companies for the later to compy with the domestic investment requirements. The banks could then invest abroad themselves. This would effectively circumvent the tighter domestic investment requirements. The current practice of banks to place excess liquidity abroad underscores this possibility. In 2006 for

example, the increase in the bank's liquid liabilities exceeded increases in net domestic assets. The banks placed the difference abroad.

Figure III.2. Namibia: Increasing Net Foreign Assets of the Banking System, 2005–07
(N$ Billions)



Implications for portfolio returns and risk

57. **Requirements to increase domestic portfolios may have implications for portfolio returns and risk**. The Canadian experience with local investment rules illustrates some of the issues. In the province of Quebec, two major pension plans are required to invest at least 70 percent of their assets in Canada, with a dual mandate to: (i) provide strong returns for investors and (ii) promote the economic development of Quebec.[8] The *Caisse de Depot et Placement du Quebec* (CDP) has been involved in several takeovers designed to retain Quebec ownership of important companies (a grocery firm in the late 1980s, and *Le Groupe Videotron* in 2001). Unfortunately, these investments resulted in substantial losses to the pension fund. At the same time, the pension funds expressed concern that the domestic investment requirements could contribute to a bidding up of Canadian asset prices and prevent adequate portfolio diversification.

58. **The World Bank finds that pension funds subject to unrestricted investment regimes earned higher returns than those under more restrictive regimes**.[9] For example, during 1984–96, the average real pension return in Ireland, the Netherlands, the UK and the

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[8] The *Caisse de Depot et Placement du Quebec* (CDP) is a pension fund operated by the province of Quebec, while the Canada Pension Plan Investment Board (CCPIB) provides pensions for Canadians who do not live in Quebec.

[9] See World Bank,. "Portfolio Limits: Pension investment restrictions compromise fund performance," in the *World Bank Pension Reform Primer* at www.worldbank.org/pensions.

US was 9½ percent. By comparison, the average real return over the same period in the more tightly-regulated countries of Belgium, Denmark, Germany, Japan, Sweden, and Switzerland was 6½ percent. The difference was not due to national stock market performance, as average real stock returns were marginally higher in the more restrictive than in the less restrictive countries (4 percent vs. 3½ percent). Pension funds in the more liberal countries were somewhat more volatile, but an investor would have to be extremely risk adverse to want to forgo an additional three percentage points in average annual returns.

59. **In Namibia, tighter domestic investment requirements could raise similar concerns about diversification, returns, and risk**. A mandate to invest 5 percent of portfolio assets in unlisted companies implicitly assumes that there are sufficient investment opportunities to absorb the increased investment. If, however, the demand for such capital is low, and the prospects for new start-up companies is limited on account of factors other than availability of finance, then major new investments by pension and insurance companies would be possible only by moving into lower return or higher risk investments. The lack of reliable financial information for unlisted companies would also be a concern, particularly where pension funds have limited in-house capacity to differentiate between investment opportunities.

60. **Experience with Namibia's Development Capital Portfolio (DCP) suggests these risks are applicable in the Namibia context**. The DCP was set up by the government pension fund (GIPF) in 1995 to promote investment in domestic unlisted companies. The GIPF aimed to invest 5 percent of its assets under management in the DCP. However, a decade later the government concluded that the DCP had failed to meet expectations due to a lack of sound management (Bank of Namibia, 2005), and it was forced to write off 84 percent of the value of its investments in unlisted companies (N$630 million of its N$750 million investment). The GIPF is now investing in unlisted firms via venture capital firms and government institutions. It hopes these will be better able to monitor its investments.

61. **Other developments suggest a limited pool of strong unlisted companies**. Namibia Harvest Investments (NHI), an investment holding company that invested in asset management, unit trusts, a commercial bank, and an abattoir, raised N$200 million in 1998 for venture capital but returned two-thirds of this money to investors in 2001 due to lack of investment opportunities (NEPRU, 2004).

Modeling the new regulatory requirements

62. **The proposed new rules would require substantial new investments, stretching absorption and institutional capacities**. If dual-listed companies are scored at 10 percent (rather than 100 percent) for domestic investment purposes, their contribution to the 35 percent domestic investment rule would fall from around 15 percent (currently) to 1½ percent. As a result, fund managers would need to shift at least 13½ percent of their portfolios out of foreign capital or dual-listed companies to finance new domestic

investments. Moreover, if the new regulations cause the scoring of dual-listed companies to fall from 100 to 30 percent in the first year, the required shift of capital over the first 12 months would be equivalent to 10½ percent of total portfolios (Table III.5). With total portfolios more than 100 percent of GDP, the shift in assets could be significantly more than 10 percent of GDP.

Table III.5. Namibia: Impact of Tightening Domestic Investment Requirements

	Current	Year 1	Year 2	Year 3	Year 4	Year 5
A. Domestic Status of Dual-Listed Companies	100%	30%	25%	20%	15%	10%
Dual-Listed Companies (% of Portfolio) 1/	15.0%	15.0%	15.0%	15.0%	15.0%	15.0%
Contribution to Domestic Investment Requirement (DIR)	15.0%	4.5%	3.8%	3.0%	2.3%	1.5%
Asset Shift Need to Meet the DIR	0.0%	10.5%	11.3%	12.0%	12.8%	13.5%
in N$ Billions	$0.0	$7.6	$9.3	$11.4	$13.8	$16.7
in percent of GDP	0.0%	11.8%	12.8%	13.9%	15.0%	16.2%
B. Investment Requirement in Unlisted Namibian Companies	0%	5%	5%	5%	5%	5%
Unlisted Companies (% of Portfolio) 2/	1.5%	2.2%	2.9%	3.6%	4.3%	5.0%
New Investment in Unlisted Companies	0.0%	0.7%	0.7%	0.7%	0.7%	0.7%
in N$ Billions	$1.0	$1.6	$2.4	$3.4	$4.6	$6.2
in percent of GDP	1.7%	2.5%	3.3%	4.2%	5.1%	6.0%
Memo Items						
Portfolio Assets (N$ Billion)	58.0	64.9	72.7	81.6	91.5	103.0
% of GDP	111	112	114	116	118	120
GDP (N$ Billion)	52.2	58.0	63.8	70.3	77.5	85.8

1/ Assuming no portfolio shift away from dual listed companies.
2/ Assuming 5-year phase-in of 5% requirement.

63. **Where would these repatriated assets be invested?** Some would be invested in unlisted companies to move toward the proposed 5 percent minimum requirement. Since unlisted companies currently make up about 1½ percent of pension fund assets, a further shift into such companies of 3½ percent of fund assets would be needed, though the time scale for this adjustment is not clear. The remaining part of the overall shift in assets would be split between listed Namibian equities, government bonds, cash, or other investments (such as property).

64. **Namibia's capacity to absorb these investments could be an issue, particularly in the short run**. Capital inflows equivalent to 10½ percent of GDP would likely result in considerable inflationary pressures (and associated real exchange rate appreciation) unless phased in over a large number of years. Indeed, the inflationary risks would be particularly marked. In addition, the capital inflows would add to the upward pressures that Namibia's real exchange rate already faces, as a result of record levels of SACU receipts and high mineral exports.

65. **Institutional capacity is also a concern**. With only 7 locally-listed firms, the Namibian stock exchange cannot be expected to intermediate large new investments to this sector. Similarly, with the government budget close to balance in the short-term, the supply of government debt is not expected to rise substantially. Given these considerations, the risks of asset price inflation would appear high. Even if funds were able to carve out safe investments in domestic bonds and cash (possibly crowding out banks), their returns would likely be lower than in their current foreign equity holdings, reducing returns to savers.

Incentives for market development

66. **It is unclear what effect tightened domestic investment requirements will have on the development of Namibia's capital market**. The government securities market is already well-developed, with active secondary trading in Treasury bills.[10] In the face of limited supply on account of relatively small government deficits, excess demand may develop, which could diminish secondary market liquidity and force a scarcity premium, reducing bond yields. This has been the experience in Chile, where pension fund assets are growing much faster than the stock of high quality bonds.

67. **The impact of tightened domestic investment requirements on the Namibia Stock Exchange (NSX) is hard to predict**. With incentives for new investments in both listed and unlisted domestic companies, the net incentives to list is unclear. However, it is clear that the incentives will decline for the 19 existing dual-listed companies, which account for approximately 95 percent of market capitalization. If a portion of the latter delist, capitalization of the NSX could decline.

D. Policies to Encourage Financial Flows to Namibia

68. Given the risks associated with a regulatory approach to strengthening domestic investment, market-based options are explored below.

Broadening the range of investable assets

69. **To attract greater domestic investments, a broader pool of investments would be an advantage**. Options would include mortgage securitization, development of the public agency and corporate bond market, securitization of funding of existing public enterprises, and development of the factoring and leasing sector.

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[10] Outstanding government securities amounted to 22 percent of GDP in mid-2007.

Mortgage securitization

70. **Since a great deal of wealth is tied up in property, mortgage securitization can provide access to a new asset class for institutional investors**. In many developing countries, housing finance is relatively expensive and rationed. Pension and insurance funds provide a potentially large source of funding for housing. Because they have long-term liabilities these funds can, in theory, manage the liquidity risk of housing loans more effectively than depository institutions that rely on short-term funding. However, mortgage securitization requires a strong legal and institutional infrastructure and well-developed primary mortgage markets. In addition, there must not only be demand from institutional investors but willingness by lenders to seek access to the capital markets to manage capital and risk. In many cases, funding through deposits may be less expensive for banks than funding through mortgage securities. Thus, mortgage securitization may not be attractive for banks with access to low cost deposits.

71. **The government can perform an enabling role in promoting mortgage securities**. Most importantly, the government can create and maintain a strong legal system that supports collateralized lending. It could also accept mortgage-backed securities as collateral at the central bank discount window.

72. **The experiences of emerging markets carry several lessons for the development of mortgage backed securities markets** (Box 1). It is important to gain investor acceptance and build a strong legal and regulatory framework. While government backing and privileges (e.g., acceptance at the central bank window and discounted risk weightings) can help develop the market, subsidization makes the schemes more expensive and hinders the development of private sector markets. Excessive liquidity can also make commercial banks reluctant to sell mortgages to mortgage security intermediaries.

73. **Namibia appears well placed to develop a mortgage backed securities market**. Namibia's financial market is relatively sophisticated and well regulated. Banks have a high concentration of assets in residential mortgages, which may create an incentive for diversification through securitization. In addition, Namibia is closely tied to South Africa which has already has a market for mortgage securities. This should make it easier to develop products and tap expertise in the development of this market.

Box III.1. Experiences with the Introduction of Mortgaged Backed Securities Markets

Several emerging markets have introduced mortgage securities with mixed results. In Chile and Malaysia, mortgage securities markets have been relatively successful and helped to promote housing finance. In Hong Kong and Hungary, mortgage securities helped to fund the housing market but circumstances have led to problems in implementation.

- ***Chile***: As in Namibia, pension and life insurance funds became major investors. Mortgage securities became popular because of the lack of alternative investments. Pensions funds were initially not allowed to invest in stocks, the budget had been in surplus reducing the supply of government debt, and fixed income investments had the disadvantage to require ratings from at least two agencies. Partly as a result, in recent years about 70 percent of mortgage financing in Chile has come from mortgage securities; these securities now make up about 15 percent of pension fund portfolios.

- ***Malaysia***: In 1987, the Malaysian government created the Cagamas Berhad. Cagamas purchases mortgage loans from mortgage originators at fixed or floating rates for 3 to 7 years. Its debt is rated AAA by the Malaysian rating agency and carries a risk weighting of 10 percent, compared with a 50 percent rating for housing loans. In Malaysia, Cagamas has successfully provided liquidity to mortgage lenders, reduced market risks, and helped develop private fixed-income markets.

- ***Hong Kong***: The Hong Kong Mortgage Corporation (HKMC) was established in 1997 to reduce real estate asset concentration and stimulate the development of the housing market. At end-2002, the HKMC was responsible for 5 percent of outstanding residential mortgages and 7 percent of the corporate debt market. However, the development of Hong Kong's mortgage backed securities market has been hampered by excess liquidity which makes commercial banks reluctant to seek wholesale funding. Institutional investors have also been reluctant to invest in the market due to their short-term bias. The government attempted to address these concerns by allowing government housing agencies to sell mortgages to the HKMC. While this increased the HKMC's portfolio of mortgages, it also meant that the HKMC effectively became a government funding mechanism instead of a method to promote development of the private mortgage market.

- ***Hungary***: The government created a mortgage bond market in 1997. There are three mortgage banks of which the largest is government owned. However, the government provides subsidies for loans less than Euro 380,000. Thus, the lending rate for mortgages is less than the yield on treasury bonds. The subsidy causes several problems. The subsidy is not targeted and does not leverage private or government spending. In addition, below market interest rates prevent the development of a private sector mortgage market.

Development of the public agency and corporate bond market

74. **Development of the corporate bond market could provide additional assets for domestic investment and improve the functioning of Namibia's financial markets**. As countries develop, firms typically go through a number of stages with regard to financing needs. Initially, firms rely on self-generated funds. Later, they rely on lending from banks. Finally, as they become larger firms can rely on direct financing through corporate debt and equity markets. By moving to this last stage, firms diversify their capital structure, spread risks, and promote competition.

75. **While Namibia has a large government bond market, development of the corporate bond market has lagged**. As of end-2006, the value of all bonds outstanding on the Namibia Stock Exchange was N$8.2 billion. Of this amount, government bonds accounted for 82 percent, commercial bank bonds (Bank Windhoek, First National Bank, and Standard Bank) for 9 percent, and state owned enterprise bonds (Nampower and the Road Fund) for 8 percent. As of end-2007, the value of corporate and public enterprise bonds was approximately 4 percent of GDP. Given this relatively low level, there appears to be room for additional development of the local corporate bond market.

76. **The government's foremost role should be to ensure that the legal and regulatory infrastructure promotes growth of the corporate bond market**. This includes maintaining a well functioning clearing and settlement system; a regulatory structure that provides for adequate disclosure, accounting standards, and corporate governance; the availability of credit rating agencies; and a clear policy with regard to corporate bond market development.[11] Namibia already has many of these elements, including a well-functioning legal system and regulatory structure, but some fine-tuning may provide additional benefits.

77. **In addition, the government could provide a catalyst by encouraging credit worthy public enterprises to issue local currency bonds**. Nampower's successful issuance of N$500 million in 13-year corporate bonds provides an illustration. This was the first of what is expected to be a total issuance of N$3 billion in bonds to fund infrastructure investment. The bond was oversubscribed by 70 percent and priced at 105 basis points above the year 2020 South African government bond. This indicates that there is demand for local currency bonds backed by credit-worthy borrowers.

78. **Yet, such efforts would need to be carefully implemented to avoid increasing the contingent liabilities to the government**. Only public enterprises that have reliable income streams and good credit should be allowed to borrow. In addition, the government should also make clear that such bonds are not implicitly backed by a government guarantee.

[11] For an additional discussion of the challenges of developing local corporate bond markets see Luengnaruemitchai and Ong (2005).

Privatization

79. **The limited number of listed domestic companies could be broadened by diversifying the ownership of public enterprises**. In 2006, the government successfully sold 34 percent of the mobile phone provider MTC, raising N$648 million in public funds. Ownership diversification could contribute to broadening the equity market, and to the extent that investment opportunities strengthen under private management, the demand for financing would progressively increase.

Factoring and leasing

80. **Promoting factoring and leasing could also help develop the non-government securities markets**. Factoring and leasing companies could fund their operations by issuing commercial paper or medium-term bonds. This would expand the financial markets by providing additional investment opportunities for investors. At the same time, factoring and leasing companies can improve access to finance by providing funds to small and medium enterprises that have trouble qualifying for traditional forms of finance.

Private equity

81. **Another potential method to promote investment in Namibia is through development of a private equity market**. Private equity can provide an alternative vehicle for institutional investment and deepen Namibia's financial markets. Private equity also has the potential to fill a gap in the capital markets for firms that have outgrown family or self-financing but whose risk profile is not attractive to banks or securities markets. In addition, experienced private equity investors can provide management expertise that enhances firm value. For investors, private equity provides another asset class that enhances diversity and has the potential for high returns.

82. **In some developing countries the promise of private equity has not been fulfilled; in this respect, proper regulation and implementation is crucial**. Three main areas have been of concern: (i) the quality of information available to investors, (ii) regulatory and legal standards, and (iii) the ability of investors to exit. For private equity markets to work well, firms must provide accurate and timely information to investors on both operations and financing. These must be provided not only at the initial investment stage but on an ongoing basis so that investors can monitor fund performance. In some cases, entrepreneurs are not used to providing such information or are reluctant to subject themselves to the judgments of outsiders. This can hinder the development of private equity markets.

83. **It is also important to provide a sound legal and regulatory environment for private equity investments**. When investors do not have direct control over the firms in which they invest, they need access to a legal system that can enforce contracts if there are disputes. Thus, the development of a strong private equity market requires statutory

protection for minority shareholder rights. Without such systems, private equity investors can suffer serious losses or avoid investments altogether.

84. **Finally, development of private equity markets requires a method for investors to exit profitably**. Exits usually take the form of initial public offerings, sales to strategic investors, or management buyouts. In mature markets, initial public offerings have been the dominant method for investors to exit private equity and such exits tend to be more profitable than strategic or management buyouts. In developing countries, it has been more difficult to carryout initial public offerings.

Strengthening the business sector

85. **On a parallel track, efforts can be made to strengthen returns on investments in Namibia**. Where the business environment and Namibia's comparative advantages offer high rates of return, these will be competitive with foreign investments in attracting financing. The challenge is to identify the aspects of the business environment that are open to improvement through government policies.

86. **Namibia has many strengths as a location for business**. The World Bank's *Doing Business 2008* survey ranked Namibia 43 out of 178 countries, with Namibia rated positively by businesses in regard to the licensing framework, enforcing contracts, and credit availability. Slightly less favorably, the World Economic Forum's Global Competitiveness Report 2007–08 rated Namibia 89 out of 131 countries, yet with strong ratings for the macroeconomy, infrastructure, and institutions.

87. **There are no guaranteed steps to a more attractive business climate**. Surveys of the business environment produce different results depending on their design and their survey populations. Thus, each country needs to work with businesses to identify local bottlenecks and disincentives. In Namibia's case, a place to start might be the World Bank's recent Foreign Investment Advisory Service (FIAS) assessment, which suggested that Namibia focus on labor skills and protection for property rights. It suggested that Namibia's foreign investment law is outdated and should be replaced as it no longer plays a meaningful role in investors' decisions. It also found that special business incentives have not been effective and a simpler and less discretionary regime with a lower corporate tax rate would be preferable. Steps to improve the quality of education and make the labor market more flexible would also be helpful (see Chapter V).

88. **An additional priority is to make existing investments more productive**. Since Namibia's domestic investment ratio of around 27 percent is already above the average of 25 percent for lower middle-income countries, higher total returns may not come from further increases in the investment ratio, but from making existing investments more productive. This again comes back to the investment climate, as well as to the merits of extending the privatization program.

E. Conclusion

89. **Summarizing the above discussions, the staff would offer the following observations on the planned tightening of Namibia's domestic investment requirements:**

- **Similar (and even higher) requirements are applied in other countries**. However, in many cases, these rules are driven by prudential concerns about exchange rate exposure, which do not apply in Namibia's case;

- **Where countries have adopted tight domestic investment requirements, this has often been at the expense of rates of return and the risk profile**. In cases, it has also encouraged politically-motivated investment decisions that proved financially costly. Thus, steps should be taken to make sure that there are sufficient assets to meet the demand generated by such requirements and projects are adequately screened;

- **Domestic investment rules do not necessarily promote financial market deepening**. Financial markets work best with a balance of willing buyers and sellers. Where the supply of finance is artificially increased, this can actually distort yields and retard market development. The impact on the Namibian stock exchange is particularly unclear given the competing incentives for local companies to list or remain unlisted, and the clear loss of incentive for the larger foreign companies to remain listed;

- **Tighter domestic investment rules will not necessarily reduce capital outflows**. The proposed regulations can be readily circumvented (and thus offset) by private individuals and banks, resulting in financing flows that are less easily monitored. Moreover, if markets perceived the regulations as an effort to persuade capital to remain in the country, it could have perverse effects;

- **The phasing and macroeconomic impact of regulatory changes require careful scrutiny**. The proposed rules would, if strictly enforced, require a large, short-run repatriation of capital. In all likelihood, this would be inflationary (for asset prices, and for the underlying investments) and fuel pressures for real exchange rate appreciation. Given the high levels of foreign currency inflows from mineral exports and the SACU regime, the timing of the proposed capital repatriation does not appear opportune;

- **Market-based incentives for investment repatriation are attractive**. Because they would be associated with the development of new patterns of financial intermediation (mortgage financing, factoring and leasing, etc), they would likely channel investments to areas of unmet demand for financing, thereby reducing inflationary risks;

- **A strengthened business environment would also serve the interest of pension and insurance clients**. By raising the rate of return on domestic investments, funds could invest in the local market without undermining the real return on their clients' savings, a criterion for successful continued growth of the sector; and

- **Namibia's investment ratio is already high, and one priority is to make more of these existing investments**. This suggests reforms to further strengthen the domestic investment climate, as well as to diversify ownership of public enterprises.