Reserve Bank of Malawi

MONETARY POLICY STATEMENT # 6

FEBRUARY 2018

Definition and Acronyms

APM	Automatic Pricing Mechanism
LRR	Liquidity Reserve Requirement
MPC	Monetary Policy Committee
OMO	Open Market Operations
PR/MPR	Policy Rate/Monetary Policy Rate
The Bank	Reserve Bank of Malawi

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Executive Summary

The sixth bi-annual Monetary Policy Statement reviews the outcome of the monetary policy stance adopted during second half of 2017. It also provides the direction of monetary policy for the first half of 2018.

The economic environment during the period was characterised by general macroeconomic stability, and decline in food prices following favourable weather conditions and relatively tight monetary policy stance. Economic growth is estimated to have rebounded in 2017, from 2.7 percent in 2016. The rebound was premised on favourable weather conditions and improved macroeconomic environment.

During the second half of 2017, the RBM conducted monetary policy with the aim of keeping inflation on a declining path, and achieving a single digit inflation by December 2017. This is consistent with the price stability objective of the Reserve Bank of Malawi (RBM). Monetary policy achieved its December 2017 inflation objective, with end-2017 headline inflation rate recorded at 7.1 percent. This is the lowest rate recorded in recent years. The rate falls on the lower bound of the Banks's period end inflation target range of 7-9 percent in 2017. The foreign exchange reserves exceeded the floor of 3 months of prospective imports.

Headline inflation finally hit single digit at 9.3 percent in August 2017, after years of a double-digit rally. This development was largely due to the unwinding of earlier drought-related food price increases, a relatively tight monetary policy stance, and a broadly stable kwacha since mid-2016. The rebasing of the national consumer price index has increased the non-food component bias in the basket. Implicitly, this has widened the scope and leverage of monetary policy over inflation. However, this also entails a temporary upward drift in inflation considering that non-food inflation stood at 10.0 percent at December 2017, against a food inflation outcome of 4.3 percent in the same month.

There were sufficient foreign exchange reserves during the review period, as reserves closed the year 2017 at 3.7 months of imports. Relatively modest economic activity, which implied low demand for foreign exchange, and muted speculative activities, supported the

accumulation of reserves. In turn, the subdued demand, relatively tight monetary policy and muted speculative attacks on the currency supported continued exchange rate stability.

The Bank aims at achieving price stability so as to support sound and sustainable economic growth. Economic growth outlook for 2018 has weakened mainly due to the impact of dry spells, fall army worms, and intermittent power supply.

This sixth edition of monetary policy statement is themed *sustaining low inflation amid new risks*. The theme serves to highlight the fact that we have attained the single digit inflation with threats likely to emanate largely from both food and non-food items going forward. Regardless of the nature and magnitude of the threats, monetary policy will focus on maintaining price and exchange rate stability for a longer period. At the minimum, a three year stretch is desirable. This is critical for reigning in inflation and exchange rate expectations. With the successor IMF supported Extended Credit Facility (ECF) program, coupled with a supportive fiscal policy, the Bank remains confident that the current environment will be sustained.

1.0 Introduction

The sixth bi-annual Monetary Policy Statement reviews the outcome of the monetary policy stance adopted by the Monetary Policy Committee (MPC) in pursuit of the price stability objective, as well as economic developments during the second half of 2017. It also provides an outlook for the first half of 2018. Price stability remains the primary objective of the monetary policy formulation and implementation. Price stability supports investment and economic growth as well as employment creation.

The economic environment during the period was characterised by general macroeconomic stability, and decline in food prices following favourable weather conditions. Economic growth is estimated to have rebounded in 2017, from a subdued growth of 2.7 percent in 2016, on the back of favorable weather conditions and improved macroeconomic environment.

Monetary policy in the second half of 2017 was aimed at keeping inflation on the declining path towards its medium-term target of 7 percent. Prominence was placed on achieving a single digit inflation by December 2017. Specifically, monetary policy focused on achieving an inflation rate of not more than 9.0 percent in December 2017 and official international reserves above the minimum threshold coverage of 3 months of imports. This objective was necessary because inflation had been in double digit since 2012. Worse still, it was above 20 percent for most of the period, largely due to multiple external shocks.

In line with the set objectives, the Bank pursued a tight monetary policy stance. This meant keeping the Policy rate above headline inflation and the inter-bank market rate (IBR) close to the Policy rate. The intentions were to keep liquidity conditions in the money market tight in order to suppress demand for foreign exchange and therefore support exchange rate stability. The RBM used open market operations and official foreign exchange operations to manage liquidity in the market. Evidently, the goals which were set for the second half of 2017 were successfully met. The success was largely supported by subdued food prices.

In the medium term, monetary policy will aim at attaining 5 percent headline inflation and maintaining foreign exchange reserves above the floor of 3 months of imports. Henceforth, the Bank's monetary policy will strive to sustain low inflation for a relatively longer period of time of about three to five years. In cognizance of the imminent pressures likely to emanate from both food and non-food items in the inflation basket, and the need to consolidate the gains made so far on the inflation front, this monetary policy statement is entitled *"sustaining low inflation amidst new risks."* The rest of the statement has been arranged in the following order: Section two assesses monetary policy implementation in the second half of 2017; objectives of the sixth monetary policy statement are outlined in Section three; and Section four discusses risks to inflation outlook in 2018.

1.1 Monetary Policy Framework

The RBM is committed to developing an interest-based monetary policy framework. Within this framework, the Bank has allowed interest rates to play a significant and expanded role.

The Bank considers an interest based monetary policy framework as better aligned with the financial system, and that it conveys the stance of monetary policy more clearly. The emphasis is on stabilizing short term interest rates, and keeping the interbank rate close to the Policy rate, in order to improve the transmission mechanism of monetary policy. Monetary aggregates targets will continue to play a critical supporting role.

The recent establishment of an interest corridor in the interbank market should yield greater control over long term rates, and provide influence over the entire interest rate structure. This should add more relevance to the Policy rate, reduce interest rate volatility, and improve the monetary policy transmission mechanism.

The Bank has made significant strides in improving its analytical capacity to assess the impact of monetary policy on inflationary expectations, a key sign post to gradually move towards a fully-fledged inflation targeting framework. To strengthen policy analysis, the Bank, with technical support from the IMF, has developed an in-house forecasting and policy analysis system (FPAS). The RBM will continue to expand its capacity in this regard, with the main aim being the eventual adoption of a fully-fledged inflation targeting regime in the medium term.

The Bank continued its regular interactions with stakeholders in the financial and real sectors as well as the media, in order to obtain feedback and to enhance the understanding of monetary policy decisions. Quarterly meetings with Chief Executive Officers of commercial banks were held to discuss the background informing the MPC's decisions. The Governor's media briefings after MPC meetings informed the press on the background to the MPC decisions and developments in the banking sector. The Bank will improve communication with stakeholders and the general public which should help raise policy credibility, increase efficiency of policy transmission, and better anchor inflation expectations.

2.0 Assessment of Monetary Policy Implementation in the Second Half of 2017

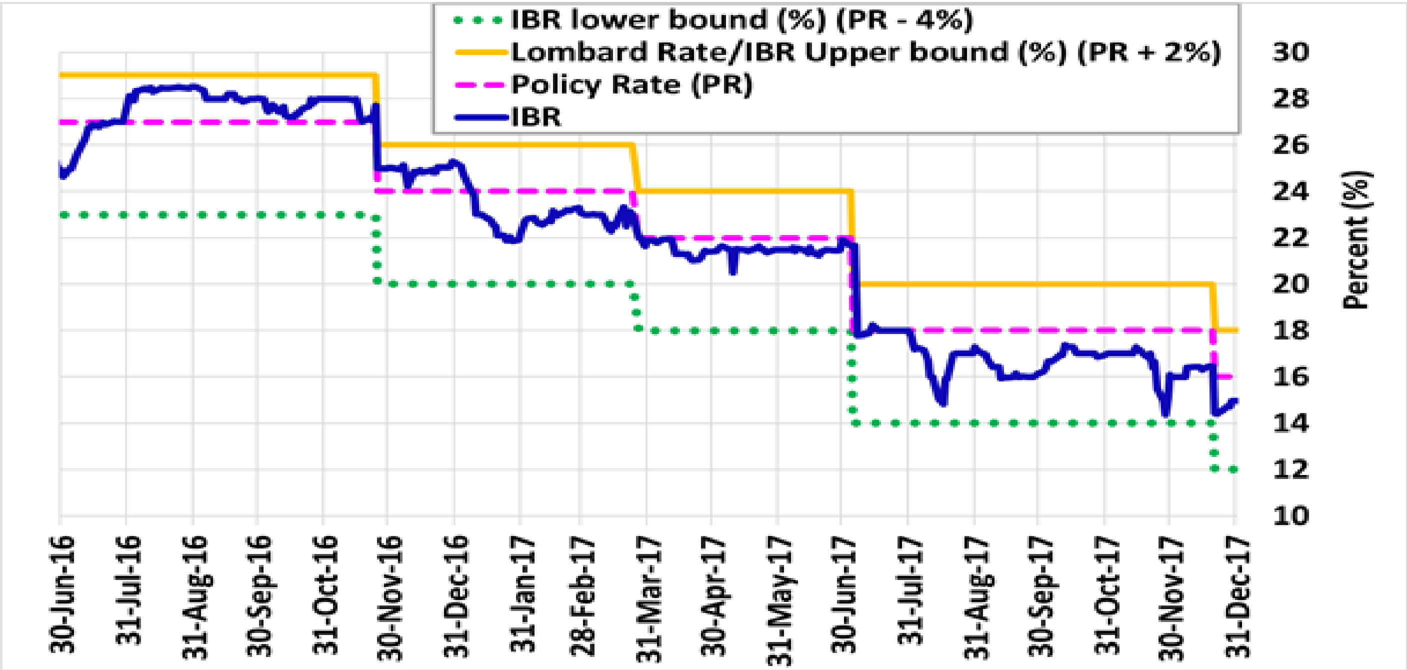
2.1 Objectives of the Fifth Monetary Policy Statement

The fifth edition of monetary policy statement had a short-term objective of attaining an end of period inflation ceiling of 9.0 percent by December 2017, and a minimum international reserve coverage of at least 3 months of import cover.

The Monetary Policy Committee (MPC) met three times since the publishing of the fifth Monetary Policy Statement, between June and December 2017, to review the outcome of its previous policy decisions and economic developments, and to put in place appropriate measures to maintain price stability. In response to a trend decline in non-food inflation and favourable inflation expectations, the MPC reduced the Policy rate by 400 basis points to 18 percent in July 2017, and by another 200 basis points to 16 percent in December 2017. Following these Policy rate reductions, commercial banks adjusted their lending rates downwards. There was no policy rate adjustment during the September 2017 MPC sitting, as the monetary authorities took a cautious stance in the face of prevailing inflationary risks at the time of the meeting. The liquidity reserve requirement (LRR), however, remained unchanged at 7.5 percent during the three meetings. Similarly, the Lombard rate was maintained at a premium of 200 basis points above the Policy rate at all the three sittings.

The liquidity management operations by the RBM ensured that short term money market rates remained aligned to the Policy rate. The interbank market rate (IB) closely tracked the Policy rate and remained within +/-2 percentage points. This entails that liquidity conditions were largely in line with the monetary policy stance. The sustenance of this trend should lead to a significant improvement in monetary transmission mechanism, and hence more effective and efficient monetary policy.

Chart 1: The Policy Rate and Inter-Bank Market Rate



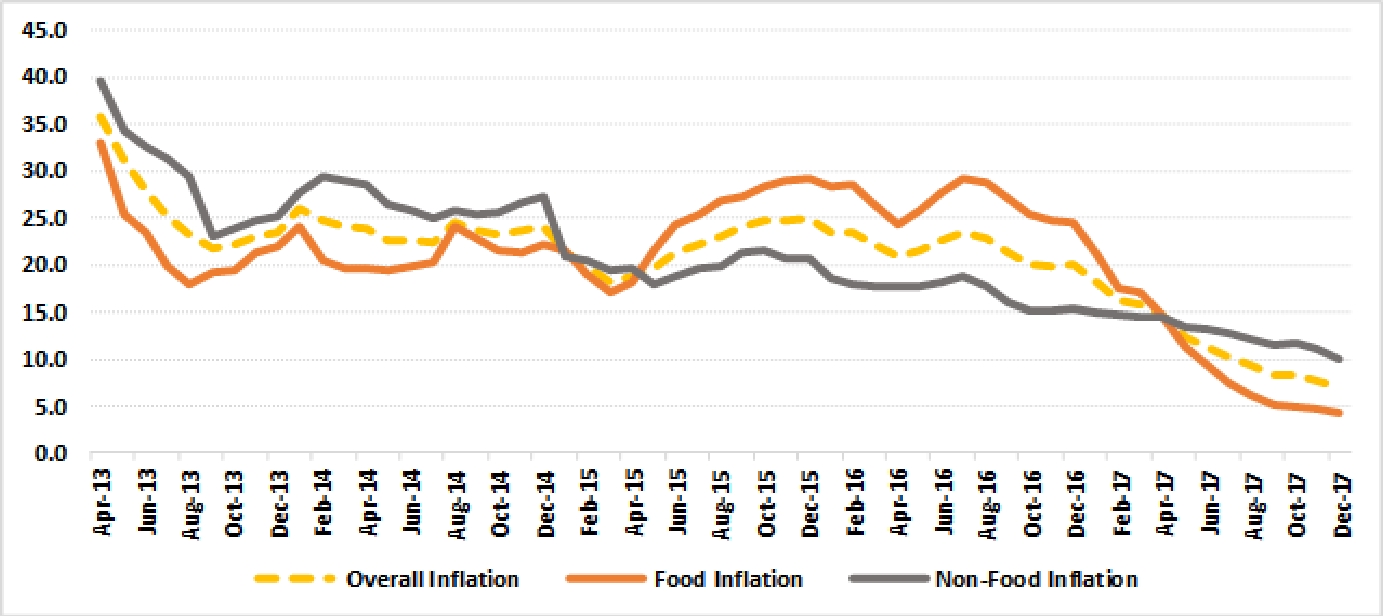
Source: Reserve Bank of Malawi

Money supply growth stood at 20.6 percent as at December 2017, higher than 15.2 percent recorded during the same period in 2016. Nevertheless, the underlying pace of monetary expansion was below the projected nominal GDP growth of 22.6 percent for 2017, implying restrained demand pressures. Growth in real credit has remained negative since mid-2012, due in part to tight bank lending conditions. Credit to the private sector is expected to rise as the sustained low inflationary pressures pushes down lending interest rates, and the increase in private sector confidence stimulates investment spending.

2.2 Inflation Outcome

The primary objective of monetary policy formulation and implementation is price stability. During the second half of 2017, the pace of disinflation was faster than earlier anticipated. This notwithstanding, the disinflation in non-food inflation was relatively sluggish compared to food inflation. Specifically, while food inflation fell by 4.9 percentage points to 4.3 percent in December 2017, from June 2017, non-food inflation on the other hand decelerated by 3.3 percentage points to 10.0 percent during the same period.

Chart 2: Inflation Developments: January 2013 and November 2017

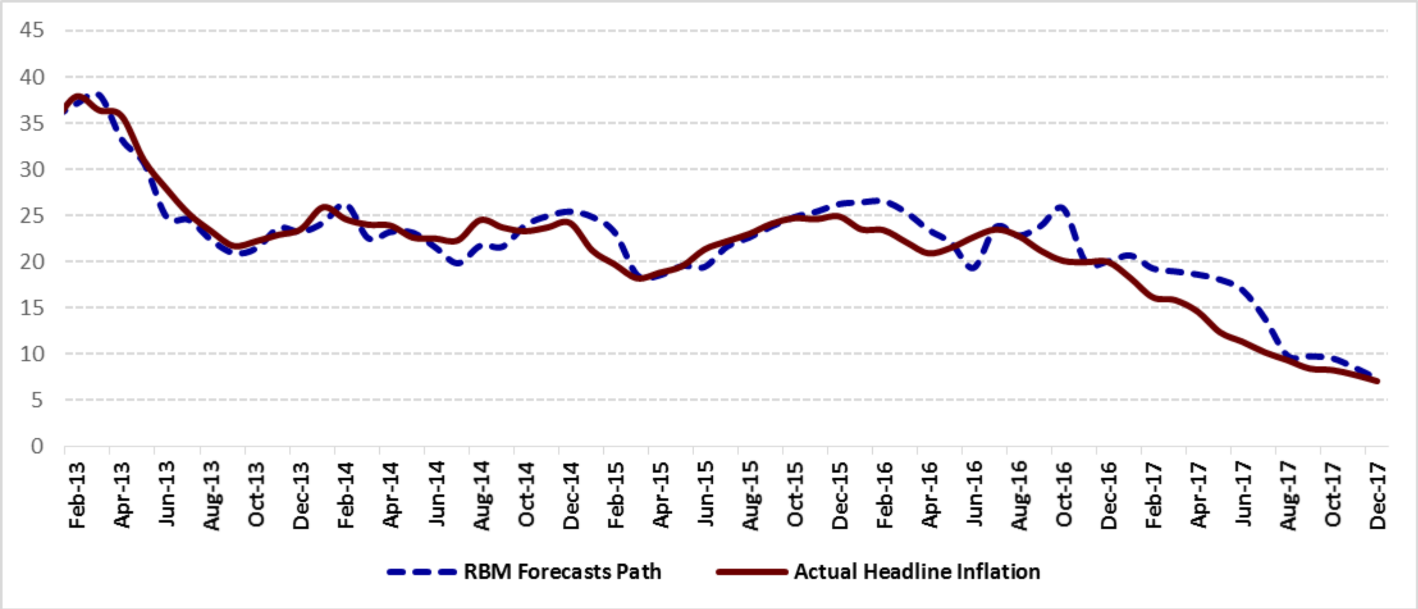


Source: Reserve Bank of Malawi

Our analysis suggests that the sluggish deceleration in non-food inflation has been largely attributed to rising administered prices – prices that often do not respond to forces of demand and supply – particularly the housing and utility sub-category. The lagged effects of such upward price adjustments have kept non-food inflation relatively higher in 2017. This partly explains why subdued aggregate demand following tight monetary policy stance has not adequately pushed non-food inflation down as fast as food inflation.

Nevertheless, RBM's inflation projections have been overshooting the actual inflation, suggesting that prices decelerated faster than earlier anticipated. This was due to a tighter monetary policy stance than suggested by the forecast path and also mild inflationary pressures that ensued during the period. The tighter stance also helped to keep inflation expectations low.

Chart 3: Inflation Developments: Projections versus Actual (%)

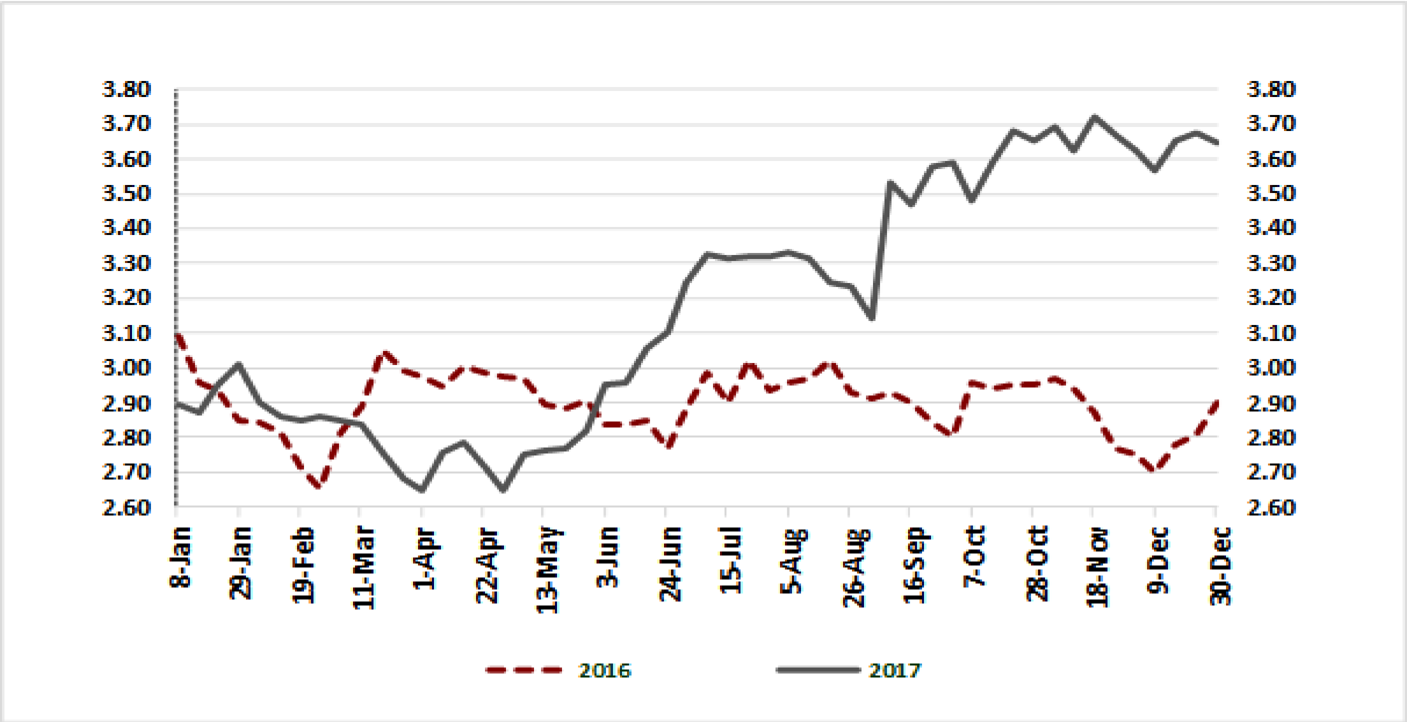


Source: Reserve Bank of Malawi

2.3 Official Foreign Exchange Reserves Developments since June 2017

The foreign exchange market remained stable during the second half of 2017, supported by high levels of both official and private sector foreign exchange reserves. The gradual accumulation of international reserves helped enhance confidence in the market. The international reserves have been above programmed levels of a minimum of three months of import cover since June 2017, thereby providing a cushion to the foreign exchange market against shocks. Comparatively, the 2017 international reserves performance has improved significantly in relation to 2016, with import cover closing the year at 3.7 months in December 2017 compared to 2.9 months in December 2016. The build-up in foreign exchange reserves was due to the Bank's increased purchases from the market, low demand for foreign exchange, and relatively increased donor inflows in 2017. These reserves continued to provide an adequate buffer against short term shocks in the foreign exchange market.

Chart 3: Official foreign reserves as months of import of Cover



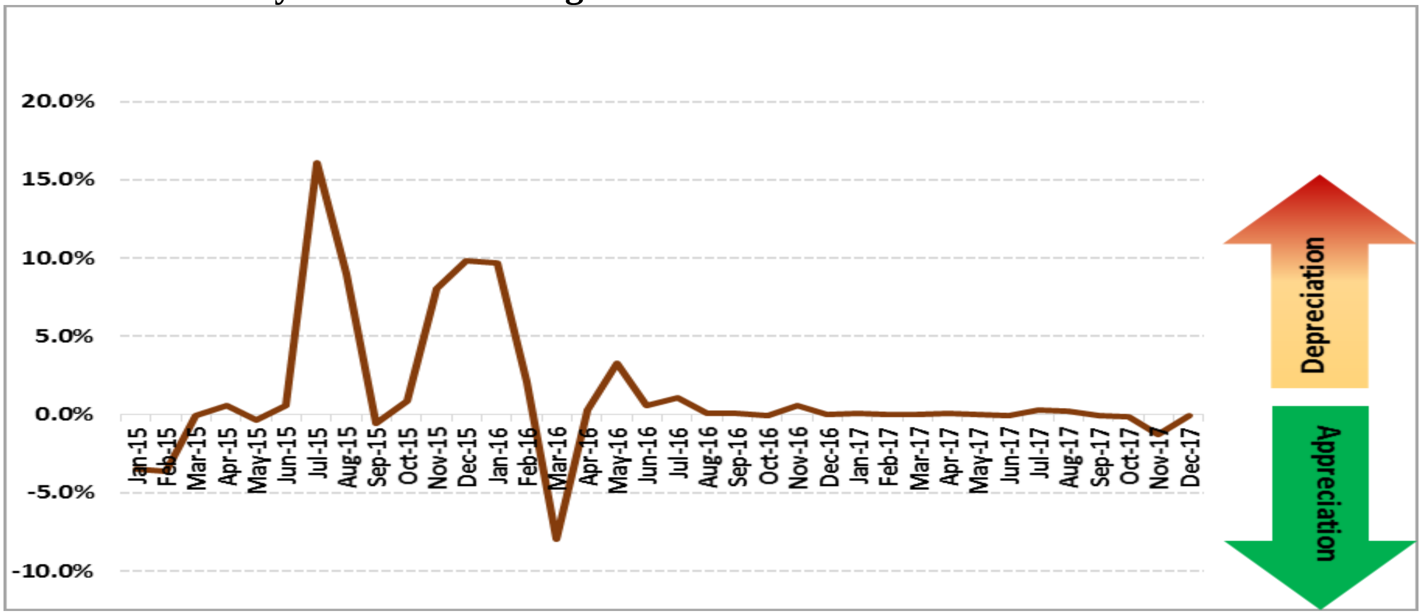
Source: Reserve Bank of Malawi

2.4 Exchange Rate Developments since June 2017

The RBM is committed to a floating exchange rate regime, which serves as a cushion for external shocks. The Bank's participation in the foreign exchange market is guided by the need to maintain adequate level of foreign exchange reserves, meeting the Government's external obligations, and ensuring stability in the foreign exchange market.

The foreign exchange market has continued to be relatively stable during the second half of 2017. This has been supported by favourable foreign exchange supply coupled with efforts by the RBM to absorb excess liquidity from the banking system and maintain positive real interest rates. In light of these policies, the exchange rate has remained broadly stable against the US$ since mid-2016. The kwacha appreciated against the rand for a lengthy part of the second quarter of 2017, but depreciated by 9.3 percent in December 2017. The appreciation was largely explained by sovereign rating downgrade of South Africa amidst the socio-political tension in the country. The stability in exchange rate during the period moderated any threat of imported inflation and helped to anchor inflation expectations in the economy in the recent months.

Chart 4: Monthly Mk/US$ Exchange Rate Movements from Jan 2015 to December 2017



Source: Reserve Bank of Malawi

3.0 Objectives of the sixth Monetary Policy Statement

The monetary policy stance during the first half of 2018 will focus on entrenching disinflation and attaining the targeted 5 percent inflation in the medium term, and maintain a minimum of three months import cover of official foreign exchange reserves. The price stability objective aims at supporting a strong and sustainable growth in the medium term. Tight monetary policy will be kept in place by ensuring that the Policy rate remains above inflation rate and by using liquidity operations to maintain positive interest rates in the interbank and Treasury bill markets.

Headline inflation is projected to average 10.5 percent in 2018, and expected to close the year at around 9.5 percent. Therefore, monetary policy actions in 2018 will focus on ensuring that inflation is kept within a corridor of 9 to 10 percent. In addition, monetary policy will continue to aim at maintaining a stable and sustainable foreign exchange market that continues to foster a market determined par value of the Malawi currency. This means that the Bank will continue to aim at maintaining international reserves of at least three months of prospective imports in the short to medium term while interventions will be restricted to manage excessive volatility.

The operational objectives considering the inflation and international reserves targets are set around the reserve money path. Therefore, the RBM will be programming reserve money at around K298.2 billion with a tolerance band of +/-3 percentage points. This means that deviations from the benchmarked path will be at +/-3 percentage points around K298.2 billion in 2018. Further, in observing the minimum of three months import coverage, the RBM will be raising its holding of net international reserves, defined as official reserves excluding long term liabilities but taking into account all short term obligations. This implies creating a more resilient and robust external shock buffer. All else constant, observing this programmed path will most likely deliver inflation within the desired band.

A fundamental tenet underpinning the inflation path and accumulation of sufficient reserves is government's supportive fiscal framework. At best, government will be spending within the available resources as much as possible. Recourse to financing from the Reserve Bank will only be on a short term basis.

4.0 Risks to the 2018 Inflation Outlook

The inflation outlook is subject to potential upside risks, emanating from delayed fiscal adjustment in the lead-up to elections in 2019, and an upward adjustment in utility tarrifs. Monetary policy does not expect severe adverse shocks to food prices in 2018. Nevertheless, the fall army worms and sporadic dry spells as well as a generally uneven rainfall distribution in the 2017/18 agriculture season may weigh negatively on the macroeconomic trajectory. Enough maize stocks in the national silos and the carryover stocks from the 2016/17 yield held by farmers and the private sector are expected to provide sufficient cushion against the said adversaries. Government's communication on these matters will contain any negative speculation about maize prices.

There are mixed risks to non-food inflation. The electricity and water tariff adjustments may adversely affect the inflation outlook for 2018 especially in the first half of 2018. Pressure on pump prices has started easing as global crude oil prices ceded from US$70 per barrel lately to the current US$65 per barrel. The consensus outlook is that international oil prices will remain around the US$60-65 range, which should ordinarily not pose any threats to the automatic pricing mechanism. Furthermore, the price stabilization fund has sufficient resources to absorb any transient pressures on the triggers for automatic pricing mechanism (APM). Inflation expectations are also expected to remain mild in 2018. However, the rebasing of the consumer price index, with a relatively higher weight on the non-food component of the consumer price index, could potentially lead to an upward tilt in the inflationary process in 2018. Nevertheless, the RBM's outlook already takes this into account in its baseline projections for inflation. Above all, the continued exchange rate stability, coupled with the relatively weak economic activity will support stability of prices. Monetary authorities will continue to monitor all these developments closely and take necessary actions to preserve the current low inflation.

5.0 Conclusion

The monetary policy measures adopted by the RBM during the second half of 2017 moderated demand-driven inflationary pressures, while stability of the exchange rate moderated any possible effects of imported inflation on the price level. The RBM will continue to monitor developments in the domestic and global economy and take appropriate measures as and when required to sustain price stability.

The RBM's monetary policy stance aims at cementing low inflation expectations, while exploiting the scope for further gradual easing. Inflation is expected to remain low in 2018, with an annual average of 10.5 percent and a fourth quarter 2018 average of 9.5 percent. Continued exchange rate stability, relatively subdued aggregate demand, and restrained inflation expectations are expected to assist monetary policy in preserving the low inflation. After meeting all the objectives of low inflation and 3 months minimum import cover requirement that were set in the fifth monetary policy statement of June 2017, monetary policy will now work to safeguard and consolidate these gains. Further easing should be conditional on inflation being on track to reach the medium term inflation target of 5 percent. The foreign exchange market is expected to remain buoyant with adequate foreign exchange reserves. Consequently, this will entrench exchange rate stability in the short to medium term. The aim is to keep price and exchange rate stability for a relatively longer period of about three to five years.

While there are realistic threats to achieving the policy objectives in 2018, including sporadic drought conditions and pressures on non-food inflation as outlined above, the RBM will make every effort to make sure that these are transitory phenomenon. This entails that monetary policy remains tight. This policy path augmented with government's pursuit of a sustainable fiscal framework through the next IMF supported ECF program will ensure that macroeconomic gains made so far are not reversed. The Bank will continue communicating its monetary policy decisions to the public to reinforce requisite transparency and credibility which are critical when anchoring inflation expectations.

Dalitso Kabambe, PhD.
Governor