MONETARY POLICY REPORT

DOCUMENT THREE, 2019

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Contents

The Reserve Bank of Malawi (The Bank) has a constitutional mandate to maintain price stability in Malawi. This mandate is achieved through implementation of monetary policy. To effectively carry out this role, the Bank has in place a Monetary Policy Committee (MPC) which extensively deliberates on macroeconomic developments and projections in order to decide on the monetary policy stance. In order to do this, the Bank has set a medium-term inflation rate objective of 5 percent, such that all efforts are geared towards attaining this goal. Subject to meeting the inflation objective, the MPC is also required to support the Government's economic policy, particularly its objectives for economic growth and employment.

This Monetary Policy Report is published four times in a year, in line with the Monetary Policy Committee meetings and the forecast calendar of the Bank. The main purpose of the report is to review the outcome of the monetary policy stance, describe the recent economic developments and outlook, and outline of the direction of monetary policy.

The Monetary Policy Committee:

Dr. Dalitso Kabambe, Governor and Chairman

Dr. Grant Kabango, Deputy Governor

Mr. Henry Mathanga, Executive Director, Corporate Affairs

Dr. Kisu Simwaka, Director, Economic Policy and Research

Professor Chinyamata Chipeta, Academia

Mr. Fredrick Changaya, Private Sector

Ms. Evelyn Mwapasa, Private Sector

INTRODUCTION

The Monetary Policy Committee (MPC), at its 3rd meeting for 2019 held on 25th and 26th July, decided to maintain the Policy Rate at 13.5 percent and the Lombard Rate at 0.4 percentage points above the Policy Rate. The Committee also maintained the Liquidity Reserve Requirement (LRR) on local currency deposits at 5 percent and the LRR on foreign currency deposits at 3.75 percent. In arriving at this decision, the Committee observed that inflation is projected to remain broadly stable and within the medium-term target range, as emerging risks are deemed temporary. By maintaining the Policy rate at 13.5 percent, monetary policy is also intended to support diversification and higher economic growth.

The positive macroeconomic outlook envisaged during the second MPC of 2019 remains firm. Annual inflation is projected to slow down to 9.0 percent in 2019, from 9.2 percent in 2018. Non-Food inflation remains well anchored in single digit and averaged 5.5 percent in the second quarter of 2019, down from 5.8 percent in the preceding quarter and 8.5 percent in the similar quarter in 2018. Non-food inflation averaged 5.7 percent during the first half of 2019, significantly lower than the average of 9.0 percent during the same period in 2018. Going forward, non-food inflation is expected to remain low, supported by relatively tight monetary policy as well as continued stability of the exchange rate.

Food inflation remains elevated and rose to an average of 13.5 percent in 2019Q2, from 11.9 percent and 9.5 percent recorded in 2019Q1 and 2018Q2, respectively. The average food inflation for the first half of 2019 is recorded at 12.7 percent which is higher than 9.0 percent recorded in the first half of 2018. Despite an increase in maize production in the current year, maize prices remain elevated.

Global economic growth is projected to slow down from 3.6 percent in 2018 to 3.3 percent in 2019, before returning to 3.6 percent in 2020. In sub-Saharan Africa, growth is expected to pick up to 3.5 percent in 2019 and 3.7 percent in 2020 (from 3.0 percent in 2018), mainly driven by Nigeria while prospects for South Africa remain modest. The slowdown in global economic growth may affect demand for domestic exports and consequently export earnings. Brent crude oil prices have continued to oscillate between \$60 and \$70 per barrel since May 2019 and prices are expected to be lower in 2019 and 2020, averaging \$66 and \$65 a barrel, respectively.

Gross Domestic Product growth for 2019 is estimated at 5.0 percent, an improvement from the growth rate of 4.0 percent in 2018. The rebound in growth is expected to be supported by the agriculture sector which is expected to grow by 3.9 percent in 2019, improved power supply, continued macroeconomic stability as well as the easing of monetary policy.

At the end of June 2019, total reserves amounted to US\$1,105.6 million (5.3 months of imports) which was higher than US\$1,095 million (5.2 months of imports) recorded at the end of June 2018. Total official reserves stood at US\$765.4 million (3.66 months of imports) higher than US\$728.9 million (3.48 months of imports) recorded at the end of June 2018. Private sector reserves amounted to US\$343.3 million (1.64 months of imports) in June 2019, a marginal drop from US\$383.8 in June 2018. In the first quarter of 2019, the kwacha was relatively stable, with marginal depreciation of 0.7 percent trading at K738.7942 per US dollar at end March 2019. In the subsequent quarter, the Kwacha depreciated moderately by 7.6 percent between April and June 2019 and traded at K785.2228 per US dollar. Against healthy foreign exchange reserves, the depreciation was primarily driven by speculation amidst perceptions of lower export proceeds. Meanwhile, the depreciation has largely been contained and the Kwacha has recouped some losses and was trading at K763.8595 per US dollar by 22 July 2019.

The banking system liquidity was tight during the second quarter of 2019. Consistent with the monetary policy stance, the interbank rate has since April 2019 been contained within the Policy rate corridor.

Annual growth in credit to the private sector has been steadily picking up on account of easing monetary policy. Private sector credit grew by 17.1 percent year-on-year in June 2019, from 11.8 percent in March 2019 and 2.1 percent in June 2018. Money supply growth averaged 12.3 percent during the first five months of the year. At that level, monetary growth was below the expected nominal Gross Domestic Product (GDP) growth for 2019 of 13.4 percent, reflecting subdued demand pressures.

The 2019 annual inflation projection has been revised upwards from 8 percent in the previous MPC meeting to 9 percent currently due to elevated maize prices. MPC observed that this is temporary and will likely unwind in the near term. Meanwhile, non-food inflation remains well anchored. The Monetary Policy Committee therefore decided to maintain the Policy rate at 13.5 percent, the LRR on domestic deposits at 5 percent and the LRR on foreign deposits at 3.75. This policy stance will allow the recent monetary policy easing decisions to filter through the market while further supporting expansion in private sector credit.

1. RECENT ECONOMIC DEVELOPMENTS

1.1 Government operations through Reserve Bank of Malawi

Total revenues in the 2018/19 fiscal year were recorded at K1,151.3 billion (19.5 percent of GDP), marginally lower than the target of K1,173 billion (19.6 percent of GDP). Of this amount, K981.3 billion (16.6 percent of GDP) were domestic revenues while K104.8 billion (1.8 percent of GDP) were grants. Total expenditures in the fiscal year amounted to K1,481.1 billion (25.1 percent of GDP), higher than the target of K1,429 billion (23.9 percent of GDP). Of this amount, K1456 billion (24.6 percent of GDP) were recurrent expenditures while K25 billion (0.4 percent of GDP) were development expenditure.

1.2 Foreign Exchange reserves

Total official reserves stood at US$765.4 million (3.66 months of imports) as at end June 2019 higher than US$728.9 million (3.48 months of imports) recorded at the end of June 2018. Private sector reserves amounted to US$343.3 million (1.64 months of imports) in June 2019, a marginal drop from US$384.0million in June 2018. In the first quarter of 2019, the kwacha was relatively stable, depreciating marginally by 0.7 percent to K738.7942 per US dollar at end March 2019. Meanwhile, the volatility that was experienced during the second quarter of 2019 has largely been contained and the Kwacha has recouped some losses and was trading at K763.8595 per US dollar by 22 July 2019.

1.3 Banking system liquidity

Banking system liquidity was tight during the period April to June 19. Net government injections into the banking system amounted to K120.9 billion. During the same period, the Reserve Bank of Malawi intensified mop up operations to withdraw liquidity. The un-borrowed excess reserves increased in the negative territory to an average of negative K14.55 billion per day in June 2019, from a positive position of K16.2 billion per day in March 2019. In line with liquidity levels, the interbank rate rose significantly to 13.4 percent in June 2019, from 5.00 percent in March 2019. The IBR has since April 2019 been contained within the Policy rate corridor and traded closer to the upper margin.

1.3.1 Treasury Bill Market

The average yields of Treasury bills across all tenors fell with the all-type yield closing at

9.84 percent in June from 10.58 percent at the end of March 2019. The subscriptions continued to skew towards the long end of the market, with 364-day and 182-day tenors constituting about 93.03 percent of the total subscriptions.

1.4 Monetary and Private Sector Credit Developments

Money supply growth averaged 12.3 percent during the first five months of the year. At that level, monetary growth was below the expected nominal Gross Domestic Product (GDP) growth for 2019 of 13.4 percent, reflecting subdued demand pressures. Annual growth in credit to the private sector has been steadily picking up. Private sector credit grew by 17.1 percent year-on-year in June 2019, from 11.8 percent in March 2019 and 2.1 percent in June 2018.

2. MACROECONOMIC ANALYSIS AND FORECASTING

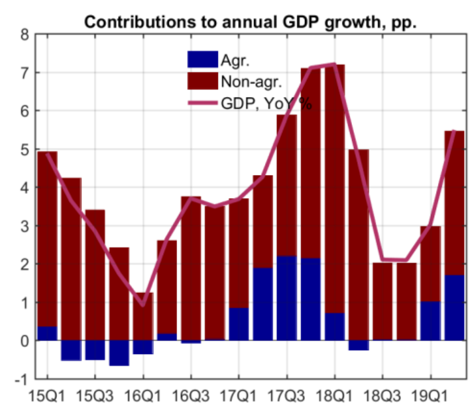
MACROECONOMIC DEVELOPMENTS

Economic activity is projected to rebound in 2019 after slowing down in 2018. Recovery is premised on improvement in both agriculture and non-agriculture sectors. The economy is therefore estimated to be experiencing positive output gap in 2019Q2 on account of both sectors. Inflation picked up in 2019Q2 to 9 percent from 8.7 percent recorded in the previous quarter. The increase was largely on the account of food price developments. Food inflation averaged 13.5 percent in 2019Q2 from 11.9 percent in 2019Q1 propelled by high maize prices.

2.1 Aggregate Demand

Despite the Cyclone Idai, the weather conditions were relatively benign in the 2018/19 growing season compared to the 2017/18 growing season which has contributed to recovery in the agriculture sector. In the non-agriculture sector, improved performance was driven by relatively accommodative monetary conditions, the pass-through of improved performance in the agriculture sector as well as improved electricity supply.

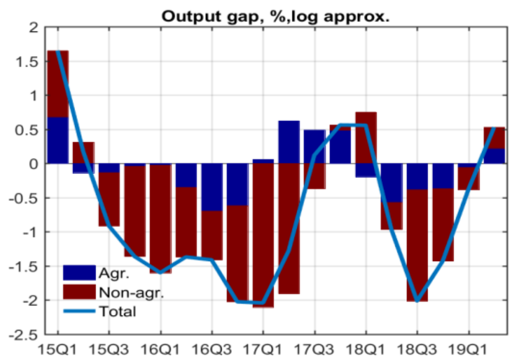
Figure 2a: GDP growth, yoy, %



These factors will shore up growth in the manufacturing, Electricity, Gas and Water Supply; Construction; Transportation and

Storage and Information and communication, among others. Real GDP growth for 2019 is thus projected at 5 percent. Due to these factors, output gap continued to recover in 2019Q2.

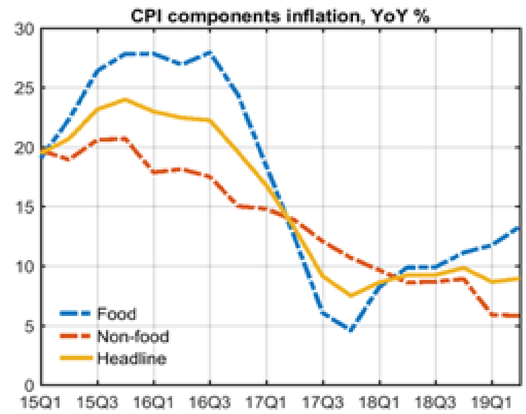
Figure 2b: Output gap, %



2.2 Consumer Prices

Inflation remains anchored in single digit and averaged 9.0 percent in 2019Q2, which is 0.1 percentage points lower than 9.1 percent recorded in 2018Q2, but 0.3 percentage points higher than 8.7 percent recorded in 2019Q1. Meanwhile, the average inflation for the first half of 2019 is 8.8 percent and is similar to the average for the first half of 2018. Food inflation remains elevated and averaged 13.5 percent in 2019Q2, which is 4.0 percentage points and 1.6 percentage points higher than 9.5 percent and 11.9 percent recorded in 2018Q2 and 2019Q1, respectively. The average food inflation for the first half of 2019 is recorded at 12.7 percent which is again higher than 9.0 percent recorded in the first half of 2018. Non-Food inflation remains well anchored in single digit and averaged 5.5 percent in 2019Q2 compared to 8.5 percent in 2018Q2 and 5.8 percent in 2019Q1. The average non-food inflation for the first half of 2019 is 5.7 percent which is lower than 9.0 percent recorded in the first half of 2018.

Figure 3: Inflation, yoy, %



2.3 MONETARY POLICY ASSESSMENT

2.3.1 Real interest rate position

For the first time since 2016, real interest rate is estimated to be below its trend in 2019Q2, suggesting that, from the interest rate perspective, the current monetary policy is accommodative.

2.3.2 Real exchange rate developments

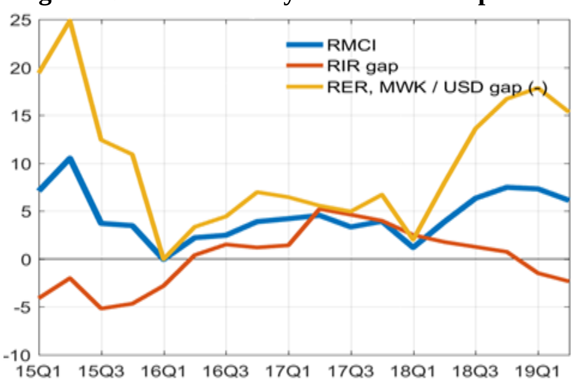
Real Exchange Rate (RER) gap for 2019Q2 suggests that there was a slight correction of real exchange compared to 2019Q1. Specifically, there was a real depreciation of the RER in 2019Q2, albeit marginal, of 0.4

percent. This follows the depreciation of the nominal exchange rate observed in 2019Q2.

2.3.3 Real Monetary Conditions

Real monetary conditions are calculated as the weighted average of the real interest rate gap and the real exchange rate gap, where both variables are defined as deviations from their trend values. The real monetary conditions suggest that monetary policy stance, though still tight, has moderated in 2019Q2 compared to 2019Q1.

Figure 6: Real Monetary Condition Components



2.3.4 Monetary policy outcomes

Risks that engulfed the year 2018 have largely subsided in 2019. During the first two Monetary Policy Committee Meetings for 2019, the economic outlook was broadly positive with inflation being projected to continue on its declining trend and agricultural output projected to improve following favorable weather conditions. The MPC therefore resolved to reduce policy rate cumulatively by 2.5 percentage points from 16 percent in January 2019 to 13.5 percent in April 2019 in order to support macroeconomic activity. Over the same period, the LRR for local currency was reduced to 5.0 percent from 7.5 percent and LRR for foreign currency was reduced to 3.75 percent from 7.5 percent in order to address entrenched liquidity bottlenecks in the banking systems. During the second MPC, two key risks to inflation outlook were identified. First, was the effect of Cyclone Idai. Second was exchange rate depreciation. On the first one, there has been general heightened expectations about food shortfall due to the cyclone which has contributed to sticky maize prices. In terms of the exchange rate, modest pressure has been experienced. As a result of these factors, maize prices increased by 5.2 percent thereby contributing to high and sticky food inflation. The exchange rate slightly depreciated in the second quarter of 2019. However, the exchange is recovering from this depreciation and it has appreciated by about 3.0 percent since end June 2019. These factors contributed to a rise in headline inflation to 9.0 percent in 2019Q2 from 8.7 percent in 2019Q1.

3. ECONOMIC OUTLOOK

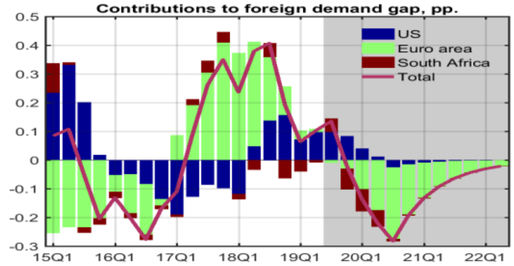
3.1 External sector

3.1.1 REAL OUTPUT DEVELOPMENTS

According to the April 2019 World Economic Outlook (WEO), global growth is projected to slow down from 3.6 percent in 2018 to 3.3 percent in 2019, before returning to 3.6 percent in 2020. In the United States, growth is expected to decline to 2.3 percent in 2019 and soften further to 1.9 percent in 2020 with the unwinding of fiscal stimulus. Growth in the euro area is set to moderate from 1.8 percent in 2018 to 1.3 percent in 2019 and 1.5 percent in 2020. Growth rates have been marked down for many economies in the Euro area, notably in Germany and Italy. In sub-Saharan Africa, growth is expected to pick up to 3.5 percent in 2019 and 3.7 percent in 2020 (from 3.0 percent in 2018), mainly driven by Nigeria while prospects for South Africa remain modest. Growth in South Africa is thus estimated to fall to 0.8 percent in 2018 from 1.3 percent in 2017 and expected to pick up in 2019 to 1.2 percent. The slowdown in global economic growth may affect demand for domestic export commodities.

At 3.6 percent, global growth for 2018 was revised down by 0.1 percentage point relative to the October 2018 WEO, reflecting weakness in the second half of the year, and the forecasts for 2019 and 2020 are now marked down by 0.4 percentage points and 0.1 percentage point, respectively. The current forecast envisages that global growth will level off in the first half of 2019 and firm up after that. The projected pickup in the second half of 2019 is based on an ongoing buildup of policy stimulus in China, recent improvements in global financial market sentiment, the waning of some temporary drags on growth in the euro area, and a gradual stabilization of conditions in stressed emerging market economies, including Argentina and Turkey. Improved momentum for emerging market and developing economies is projected to continue into 2020, primarily reflecting developments in economies currently experiencing macroeconomic distress. By contrast, activity in advanced economies is projected to continue to slow gradually as the impact of US fiscal stimulus fades and growth tends toward the modest potential for the group.

Figure 7: Foreign Output Gap, %

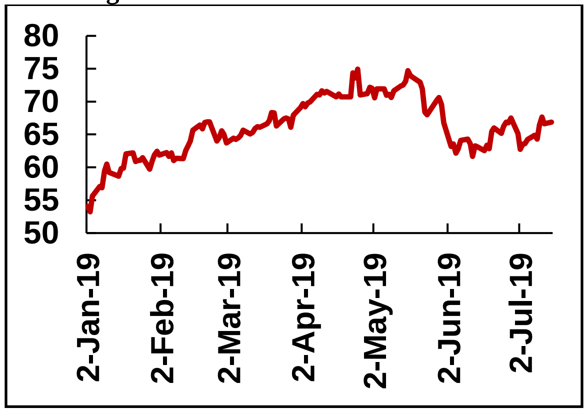


Beyond 2020, global growth is set to plateau at about 3.6 percent over the medium term, sustained by the increase in the relative size of economies, such as those of China and India, which are projected to have robust growth by comparison to slower-growing advanced and emerging market economies

3.1.2 GLOBAL OIL PRICE DEVELOPMENTS

Brent crude oil prices continue to oscillate between \$60 and \$70 per barrel since May 2019 and prices are expected to be lower in 2019 and 2020, averaging \$66 and \$65 a barrel, respectively. The lower prices are on account of weaker-than-expected global growth outlook and greater-than-anticipated U.S. production. Although risks are balanced, substantial uncertainty on oil price projections remains because of high policy uncertainty. Upside risks to prices in the short term, include geopolitical events in Middle East, civil unrest in Venezuela, a tougher US stance against Iran and Venezuela, and slower-than-expected US production growth. Downside risks include stronger-than-expected US production and noncompliance among OPEC and non-OPEC countries.

Figure 8: Trends in Global Oil Prices

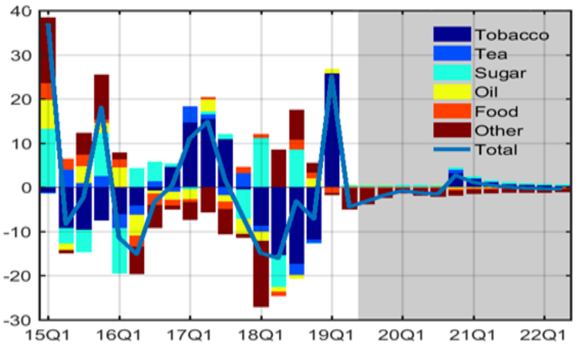


Source: Thomson Reuters

3.1.3 Malawi's Terms of trade

Tobacco marketing for 2018/19 season opened on 25th April 2019. So far, prices for all types of tobacco have been comparably lower than those observed during the preceding marketing season. Total production estimation for 2019 is 205.5 million kilograms total 202.0 million kilograms produced in 2018. With an estimated 111.4 million kilograms remaining to be sold, total realization for 2019 is estimated at US\$303.5 million compared to US\$337.5 million realized in 2018 tobacco marketing season.

Figure 9: Terms of Trade Growth, % Q-o-Q annualized



3.2 Baseline forecast

3.2.1 BASELINE ASSUMPTIONS

Firstly, the Reserve Bank of Malawi remains committed to the announced 5.0 percent inflation objective in the medium term[1]. Therefore, monetary policy is framed to be consistent with this objective.

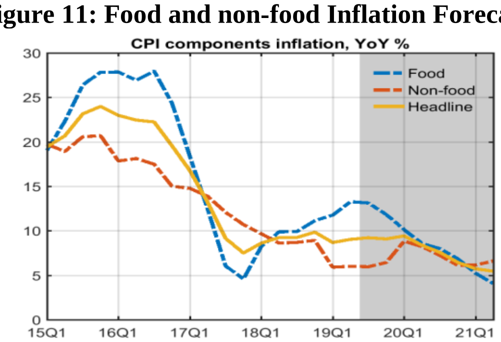
Secondly, real GDP is assumed to grow by 5.0 percent in 2019, driven mainly by relatively better performance in the agriculture sector. The third and final crop estimates indicate an increase in production of most major crops in the 2018/2019 season. For example, maize production estimates point to a 25.7 percent increase to 3.4 million metric tonnes (against a national requirement of 3.1 million metric tonnes) from 2.7 million metric tonnes produced in 2017/2018 agricultural season. The floods are estimated to have affected only 6 percent of maize farmland. Despite the reported surplus, maize prices registered an increase in June 2019. Pressure on maize prices is largely attributed to big traders who, motivated by expectations about food shortage, are buying to stockpile.

Thirdly, forecasts assume that the exchange rate will continue to be stable on account of adequate exchange rate reserves and lower than demand.

3.3 Monetary policy and inflation in the Baseline

The annual headline inflation projection for 2019 has been revised upwards to 9.0 percent, from 8.0 percent during the last MPC meeting. This is on account of upgraded risks particularly on food price developments. This notwithstanding, it is expected that the current elevated maize prices will slow down during the lean period as consumers will have stocked for the lean period while all traders might compete to offload to a saturated market.

Figure 11: Food and non-food Inflation Forecasts



[1] The forecast horizon is from 2019Q2 to 2022Q1.

Headline inflation trend is on track towards a 5 percent objective as previously predicted. Inflation has averaged 8.8 percent in the first half of the year. Inflation is projected to average 9.0 percent in 2019 which is 0.2 percentage points lower than the average for 2018.

The GDP projection for 2019 according to the National accounts and Balance of Payments Committee is 5.0 percent, an improvement from the growth rate of 4.0 percent in 2018. The growth is expected to be supported by continued macroeconomic stability and relatively accommodative monetary policy conditions.

4. MONETARY POLICY DECISION

While the macroeconomic outlook broadly remains stable, moderate risks to inflation remain. These have shifted annual inflation forecasts for 2019 to 9.0 percent in the baseline. MPC observed that the bulk of the pressure on inflation is related to food supplies.

The MPC therefore decided that the policy rate should be maintained at 13.5 percent. This stance will further support the recent policy easing whose liquidity effects are yet to fully transmit in the economy as well as preserve financial market stability. The Committee further decided to maintain the Liquidity Reserve Requirements at 5 percent for local currency deposits and 3.75 percent for foreign currency deposits.

The Reserve Bank of Malawi will continue with prudent liquidity management through market operations which have so far proved vital for the stability of the exchange rate and nonfood inflation.