



MONETARY POLICY REPORT

DOCUMENT ONE, 2021



January 2021

Monetary Policy Report January 2021

Contents

INTRODUCTION	4
1. RECENT ECONOMIC DEVELOPMENTS	6
1.1 Government Operations through the Reserve Bank of Malawi	6
1.2 External Sector Developments	6
1.3 Banking System Liquidity	6
1.4 Monetary and Private Sector Credit Developments	6
2. MACROECONOMIC ANALYSIS	6
2.1 Aggregate Demand	6
2.2 Consumer Prices	7
2.3 Monetary Policy Assessment	7
2.3.1 Real Monetary Conditions	7
2.3.2 Monetary Policy Outcomes	8
3. ECONOMIC OUTLOOK AND FORECASTS	8
3.1 External Sector	8
3.1.1 Real Output Developments	8
3.1.2 Global Oil Price Developments	9
3.2 Malawi's Terms of Trade	9
3.3 Baseline Forecast	10
3.3.1 Baseline Assumptions	10
3.3.2 Monetary Policy and Inflation in the Baseline	10
4. MONETARY POLICY DECISION	10

Monetary Policy Report January 2021

The Reserve Bank of Malawi (herein The Bank) has a constitutional mandate to maintain price stability in Malawi. This mandate is achieved through the conduct and 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. The Bank has a medium-term inflation rate objective of 5 percent with a symmetric band of 2.0 percentage points, such that all efforts are primarily geared towards attaining this objective.

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

The Monetary Policy Committee

Dr. Wilson T. Banda, Governor (**Chairperson**)

Dr. Grant Kabango, Deputy Governor, Economics & Regulation

Mr. William Matambo, Executive Director, Corporate Affairs

Dr. Kisu Simwaka, Director, Economic Policy and Research (**Secretary**)

Mrs. Audrey Mwala, Private Sector

Dr. Betty Chinyamunyamu, Private Sector

Dr. Levison Chiwaula, Academia

INTRODUCTION

The Monetary Policy Committee (MPC), at its first meeting of 2021 held on 25th and 26th January, decided to maintain the Policy rate at 12.0 percent; the Liquidity Reserve Requirement (LRR) ratio on domestic and foreign deposits at 3.75 percent; and the Lombard rate at 20 basis points above the Policy rate. In arriving at this decision, the Committee noted that the inflation outlook has remained broadly unchanged from what was envisaged during the fourth 2020 MPC meeting. Further, the MPC noted that there is need to allow the impact of the November 2020 Policy rate reduction to transmit through the economy. The decision was also deemed necessary to contain the impending inflationary pressures whilst at the same time providing space for supporting recovery of the economy in the wake of the second wave of the COVID-19 pandemic.

Global economic output is projected to recover from the collapse triggered by the COVID-19 pandemic in 2020. The International Monetary Fund (IMF), in its January 2021 World Economic Outlook (WEO) Update, indicate that the global economy will expand by 5.5 percent in 2021 from an estimated contraction of 3.5 percent in 2020. The recovery is premised on limited impact of the COVID-19 pandemic as most countries get access to vaccination as well as continued policy support in some large economies. This notwithstanding, there are significant downside risks to the projection, including a prolonged second wave of the COVID-19 pandemic.

Brent crude oil prices averaged US\$44.2 per barrel in 2020Q4 from US\$42.7 per barrel recorded in 2020Q3. The IMF projects the annual average for petroleum spot prices at US\$48.5 per barrel in 2021 from US\$41.4 per barrel in 2020, following an agreement by OPEC member countries to reduce production in 2021. However, the upward pressures on prices will be partly offset by high global oil inventory levels and subdued demand due to the COVID-19 pandemic containment measures.

Domestic real economic growth could remain subdued in 2021. Economic activity, which started to rebound in the second half of 2020, has moderated due to the second wave of the COVID-19 pandemic. Real GDP growth for 2021 will, therefore, depend on how fast the second wave of the pandemic dissipates.

Foreign exchange supply remains low due to unfavourable performance of major export commodities amidst the COVID-19 pandemic. Subsequently, the kwacha depreciated in the fourth

Monetary Policy Report January 2021

quarter of 2020 and traded at K773.11 per US dollar at the end of December 2020 from K756.92 per US dollar recorded at the end of September 2020.

Private sector credit continues to grow, supported in part by the low interest rates and pickup of economic activities towards the end of 2020. The annual growth rate of private sector credit edged up to 20.1 percent in 2020Q4 from 16.4 percent in 2020Q3 and compared to 21.3 percent in 2019Q4.

Headline inflation decelerated to an average of 7.5 percent in the fourth quarter of 2020 from 7.6 percent in the third quarter, driven by a decline in food inflation. In contrast, non-food inflation increased in the quarter, albeit marginally, due to effects of the upward adjustment in domestic fuel pump prices effected in mid-December 2020. Meanwhile, headline inflation is projected to average 7.8 percent in 2021.

The MPC, therefore, resolved to maintain the Policy rate to 12.0 percent; the LRR ratio on domestic and foreign deposits at 3.75 percent and the Lombard rate at 20 basis points above the policy rate.

1. RECENT ECONOMIC DEVELOPMENTS

1.1 Government Operations through the Reserve Bank of Malawi

Total Government revenues amounted to K354.0 billion in the second quarter of the FY2020/21 against total Government expenditures of K543.7 billion. Government, therefore, closed the quarter with an overall deficit of K189.8 billion. The COVID-19 pandemic continues to affect revenue collection amidst elevated Government expenditures in response to the pandemic.

1.2 External Sector Developments

The underperformance of the external sector continued into 2020Q4 as demand for imported goods remained higher than the amount of exports receipts required to finance them. As such, the market continues to experience foreign exchange supply shortages and the COVID-19 pandemic has exacerbated the situation. Reflecting this development, the kwacha depreciated further and traded at K773.11 per US dollar as of end-December 2020 from K756.92 in September 2020.

1.3 Banking System Liquidity

Banking system liquidity progressively improved in the fourth quarter of 2020, as evidenced by an increase in un-borrowed excess reserves. Specifically, the un-borrowed excess reserves rose to an average

of K10.8 billion in December 2020 from negative K34.1 billion in September 2020. Owing to the improved liquidity conditions, the average interbank market rate (IBR) declined and closed 2020Q4 at 11.34 percent from 13.61 percent recorded at the end of 2020Q3.

1.4 Monetary and Private Sector Credit Developments

Annual growth rate of broad money (M2) rose to 19.4 percent in 2020Q4 from 14.0 percent in 2020Q3 and 4.6 percent 2019Q4, mainly owing to an increase in Net Domestic Assets (NDA). Similarly, private sector credit growth continued to recover in the 200Q4. In November 2020, private sector credit accelerated to 20.1 percent from 16.9 percent in the preceding month and 15.4 percent in the corresponding month of 2019. The increase is partly reflective of low interest rates and pickup of economic activity in the quarter.

2. MACROECONOMIC ANALYSIS

2.1 Aggregate Demand

In 2020, performance of the domestic economy was largely affected by the COVID-19 pandemic and its associated containment measures. Consequently, the overall output gap for 2020 was in a negative cyclical position and this was attributed to

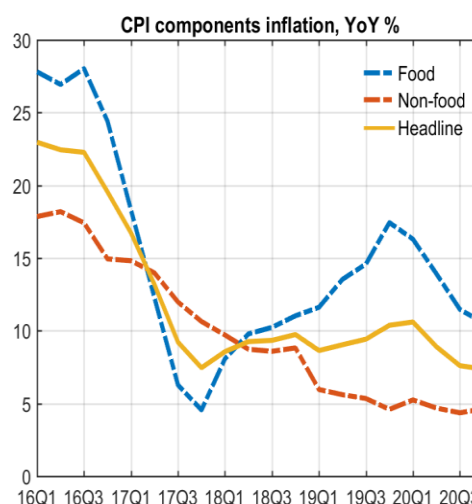
both agriculture and non-agriculture output gaps.

In 2021, growth prospects remain uncertain. Economic activity, which started to rebound in the second half of 2020, has moderated due to the second wave of the COVID-19 pandemic. Real GDP growth for 2021 will, therefore, largely depend on how fast the second wave of the pandemic dissipates. This notwithstanding, the anticipated improved agriculture production and recovery of the global economy are expected to benefit the domestic economy.

2.2 Consumer Prices

Headline inflation averaged 7.5 in 2020Q4, down from 7.6 percent in 2020Q3, mainly driven by lower food prices. Food inflation decelerated to 10.6 percent during the quarter from 11.3 percent in 2020Q3, partly reflecting subdued food prices due to weak demand. In contrast, non-food inflation increased marginally to an average of 4.6 percent in 2020Q4 from 4.4 percent in 2020Q3 due to effects of the increase in fuel pump prices effected in mid-December 2020 (see Figure 1).

Figure 1: Inflation, Y-oY, %



Annually, headline inflation averaged 8.6 percent in 2020 compared to 9.4 percent in 2019. Both food and non-food inflation contributed to the decline.

2.3 Monetary Policy Assessment

2.3.1 Real Monetary Conditions

The Real monetary conditions index (RMCI) is derived as the weighted average of the real interest rate gap and the inverse of the real exchange rate gap. A positive RMCI entails the presence of tight monetary conditions whilst loose conditions are represented by a negative RMCI. In the fourth quarter of 2020, the RMCI was still positive but marginally decreased, implying that monetary conditions were relatively less tight than in the previous quarter.

2.3.2 Monetary Policy Outcomes

During the fourth MPC meeting of 2020, there was still high uncertainty towards the impact of the COVID-19 pandemic on the economy. The real GDP growth projection for 2020 was revised downwards to 1.2 percent from 1.9 percent. It was noted that inflation had been declining since January 2020 and that the outturns were persistently better than projected. The outlook also pointed to favourable inflation, in single digit, despite threats of heightened upside risks in the short-term. These developments compelled the MPC to reduce the Policy rate to 12.0 percent and maintained the Liquidity Reserve Requirement (LRR) ratio on domestic and foreign deposits at 3.75 percent and the Lombard rate at 20 basis points above the Policy rate. The decision was aimed at supporting economic recovery and job creation amidst the COVID-19 pandemic.

However, inflation outturn for 2020Q4 at 7.5 percent was higher than 7.3 percent projected during the fourth 2020 MPC forecasting round. The uptick was on account of materialization of some of the upside risks to inflation anticipated during the fourth 2020 MPC meeting, particularly an increase in domestic fuel pump prices; exchange rate depreciation; supply bottlenecks and increased public sector financing

requirements. Fuel pump prices rose by an average of 28.0 percent, higher than the 10.0 percent predicted during the fourth 2020 MPC meeting; the exchange rate depreciated by an average of around 2.09 percent in 2020Q4; while government operations persistently resulted into fiscal deficits. Nevertheless, the 2020Q4 headline inflation outturn was lower than 7.6 percent recorded in 2020Q3. Further, as projected during the fourth 2020 MPC forecasting round, the annual headline inflation averaged 8.6 percent in 2020. In addition, the growth in private sector credit surged to 20.1 percent in 2020Q4 from 16.4 percent in 2020Q3, partly reflecting the relatively lower cost of borrowing following the Policy rate reduction during the fourth 2020 MPC meeting.

3. ECONOMIC OUTLOOK AND FORECASTS

3.1 External Sector

3.1.1 Real Output Developments

According to the January 2021 WEO update, the global economic output is projected to recover 2021 from the collapse triggered by the COVID-19 pandemic in 2020. The global economy is projected to expand by 5.5 percent in 2021 from an estimated contraction of 3.5 percent in 2020. The

Monetary Policy Report January 2021

recovery is premised on limited impact of the COVID-19 pandemic as most countries get access to vaccination as well as continued policy support in some large economies.

Specifically, stronger growth than anticipated in the October 2020 WEO update is expected from the United States (5.1 percent) and Japan (3.1 percent) while growth in the Euro area is projected at 4.2 percent, 1.0 percentage point lower than earlier projected. Emerging markets and developing economies are projected to grow by 6.3 percent mainly driven by China (8.1 percent) and India (11.5 percent).

The Sub-Saharan Africa (SSA) region is also projected to recover and grow by 3.2 percent from a contraction of 2.6 percent in 2020. The projected growth for 2021 is 0.1 percentage point higher than the October 2020 WEO projection of 3.1 percent.

In terms of the risks to the outlook, fundamental uncertainty surrounding the evolution of the pandemic remains a key factor shaping the economic outlook. Growth could turn out weaker than projected if the virus surge (including from new variants) proves difficult to contain; infections and deaths mount rapidly before vaccines are widely available; and voluntary distancing or lockdowns prove stronger than anticipated.

Slower-than-anticipated progress on medical interventions could dampen hopes of a relatively quick exit from the pandemic and weaken confidence. Specifically, vaccine rollout could suffer delays; widespread hesitancy could hamper vaccine take-up; vaccines could deliver shorter-lived immunity than anticipated; and advances on therapies could be limited.

3.1.2 Global Oil Price Developments

The average petroleum spot prices per barrel are projected at \$48.5 in 2021 from \$41.4 per barrel in 2020. The projected recovery is on account of an agreement by OPEC member countries to restrain production in 2021. In 2021Q1, oil prices are projected at US\$47.0 per barrel and are expected to rise to US\$50.0 per barrel by 2021Q4. However, the upward pressures on prices will be suppressed by high global oil inventory levels.

3.2 Malawi's Terms of Trade

Malawi's terms of trade are largely driven by tobacco developments. In 2020, tobacco prices rose, albeit marginally, to an average of US\$1.53 per kilogram from US\$1.43 per kilogram registered in 2019. In contrast, the international prices for the other key export commodities for Malawi, notably tea and sugar, declined during the year and this reflected largely the broad-based commodity price fall amid the COVID-19 pandemic. On

the other hand, international prices for Malawi's main imports, oil and fertilizer, also fell substantially in 2020. Looking ahead, it is expected that commodity prices will gradually improve as global economic growth picks up. Over the forecast horizon, the terms of trade are projected to remain flat.

3.3 Baseline Forecast

3.3.1 Baseline Assumptions

RBM remains committed to a 5 percent inflation objective in the medium-term, with a symmetric band of 2.0 percentage points. The conduct of monetary policy conduct is, therefore, expected to be consistent with this objective.

The forecasts have considered the threats to maize prices in 2020Q1 as well as growing foreign exchange demand and delayed domestic fiscal consolidation due to the second wave of the COVID-19 pandemic and its containment measures.

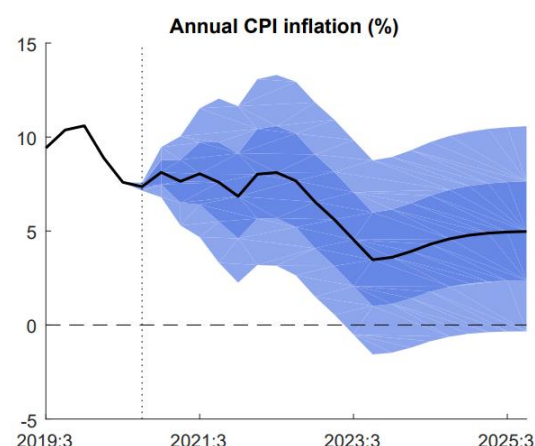
3.3.2 Monetary Policy and Inflation in the Baseline

The average inflation for 2021Q1 is projected at 8.1 percent, which is 1.0 percentage points above the fourth 2020 MPC forecast round. The slightly higher projections in the current forecast round than those of the fourth 2020 MPC are primarily attributed to two main factors: Firstly, a larger-than-projected

increase in domestic fuel pump prices of 28.0 percent effected on 16th December 2020 implies a larger pass-through into 2021, particularly in 2021Q1. Secondly, food prices are anticipated to increase by slightly more than what was anticipated during the fourth 2020 MPC meeting as the lean period takes root. However, food inflation is projected to decelerate at the onset of the harvest season.

Annually, inflation is projected to average 7.8 percent in 2021 before declining to 7.6 percent in 2022 (see Figure 2).

Figure 2: Headline Inflation Outlook



4. MONETARY POLICY DECISION

Headline inflation averaged 8.6 percent in 2020, precisely as projected during the 2020 fourth MPC, but lower than the annual average of 9.4 percent for 2019. Meanwhile, the inflation outlook remains broadly unchanged as envisaged during the fourth

Monetary Policy Report January 2021

2020 MPC albeit with moderately higher inflation in the first half of 2021.

The upside risks to the inflation outlook include the persistently low supply of foreign exchange amidst elevated demand which continues to exert pressures on the exchange rate as well as the continued widening of the fiscal deficit. However, it is likely that the effects of the pressures arising from the aforementioned upside risks could be offset by the benefits of relatively low food prices due to a projected better food crop harvest during the 2020/21 season.

Therefore, the Committee decided to maintain the Policy rate at 12.0 percent, the Liquidity Reserve Requirement (LRR) ratio on domestic and foreign deposits at 3.75 percent and the Lombard rate at 20 basis points above the Policy rate. This decision will allow the impact of the November 2020 Policy rate reduction to transmit through the economy. This position is also meant to support economic recovery.