Press Statement

Malawi Kwacha Depreciation and Near-Term Prospects

28 January 2016

The Reserve Bank of Malawi has issued this statement to inform Malawians about the causes of the Kwacha depreciation and outlook in the near term. The statement has been necessitated by the sharp and longer than anticipated depreciation of the Kwacha since July, 2015.

The Kwacha was devalued in May 2012 by 49% to K250/US$ and thereafter allowed to be determined by market forces of demand and supply. The main objective was to correct once and for all the exchange rate misalignment and create long-term conditions for a more resilient, productive and exporting country.

As Malawians would recall, the exchange rate misalignment was so serious that the country had very limited foreign exchange reserves and accumulated huge external payments arrears (estimated to be in excess of US$600 million) held by both Government and the private sector. This created persistent and widespread shortages of fuel and other critical imports. Indeed, the exchange rate misalignment diverted foreign exchange transactions to the parallel or black market. Prior to the devaluation the official exchange rate was K169/US$

compared to over K250/US$ in the parallel market.

To support the misalignment, exchange controls were intensified and pervasive. With non-bank foreign exchange bureaux closed, access to foreign exchange by the general public was extremely difficult. To cut a long story short, the economy was in a precarious state and had the exchange rate misalignment continued, the government would have lost the Kwacha as legal tender currency and the country could have become completely dollarized.

By June 2013, the end of the 2012/2013 fiscal year, the Kwacha had lost a further 32% to K330/US$. The central bank's net foreign exchange position had improved from negative US$161.1 million in June 2012 to US$147.5 million, implying an increase in terms of months of import cover from 0.6 to 2.4. All external payments arrears had been cleared by September 2013. This improvement in the country's external position was made possible not just by the liberalization of the foreign exchange market but also by the fact that government did not borrow from the domestic market that financial year.

Malawians will recall that cashgate came to light in September 2013 and donor direct budget support gradually dissipated thereafter. Thanks to the liberalized exchange rate system, and tight monetary policies, the country forged ahead and the Reserve Bank's net foreign exchange position reached US$158 million by end-June 2014. The country's external position could have been much more improved, however, had government not abandoned the zero domestic borrowing policy implemented in 2012/2013 fiscal year. Instead government borrowed some K120 billion during 2013/2014 fiscal year. It should therefore not be surprising that the Kwacha depreciated to K398/US$ or 20% during that fiscal year.

In addition to withdrawal of aid, the fiscal year 2014/2015 saw another calamity as the country experienced drought and floods in many parts of the country. As a result, government's intention to sustain fiscal prudence became unattainable and recourse to domestic resources increased by another K95 billion. Again, the fiscal imbalance increased pressure on the Kwacha which fell further by 10% to K437/US$ by the end of that fiscal year. However, the central bank's net foreign exchange position remained healthy at US$474 billion or an equivalent of 3.4 months of imports.

Intent on stabilizing the economy and improving the welfare of Malawians, Government tried to restore fiscal prudence during 2015/2016 but hopes for a better year did not materialize as the debilitating impact of the drought experienced during the 2014/2015 growing season came to light after the budget had been passed. Data collected by the Reserve Bank shows that the drought reduced the country's export receipts through the banking system by about US$300 million to US$700 million. In the meantime, suspension of direct budget support continued. And with rumors that tobacco auctions would generate less foreign exchange compared to the previous year, the private sector panicked and demand for foreign exchange shot up in July 2015. The situation got fueled with the news that Government domestic borrowing exceeded its target in June, resulting in the IMF-supported economic reform program getting off-track. In the circumstances, therefore, the Kwacha depreciated precipitously from K437/US$ in June 2015 to K581/US$ in November 2015. Reserve Bank's efforts to support the market continued, however. Thus, the central bank's net foreign position dropped to US$366 million or 3 months of imports during the period.

In normal circumstances, the Kwacha should have started stabilizing at about K600/US$. Instead the depreciation has continued unabated. This is because the Kwacha exchange rate is also influenced by global developments and the stance of monetary policy. Reduced demand in global commodity markets and expectations for an increase in US interest rates have caused havoc in the exchange rates of many economies, including Malawi. The Malawi situation is exacerbated by proximity and dependency on the South African economy for imports. The sharp collapse of the Rand has resulted in the Kwacha appreciating against it, implying increased demand for South African goods. At the same time, imports from China have also picked up with the strengthening of trade linkages.

Contrary to popular discourse in the business community, the monetary policy stance eased somewhat in 2015. Based on the earlier positive outlook for the economy, and the need to ameliorate conditions facing the private sector, monetary policy got relaxed somewhat in July 2015 with the reduction in the liquidity reserve requirement (LRR), which led to a reduction in the prime lending rates by about six percentage points. Although the Monetary Policy Committee subsequently increased the policy rate to 27 percent, prime lending rates still remained lower than in June 2015. Indeed, credit to the private sector increased thereafter, adding to pressure on the Kwacha. Thus, while the Kwacha remained relatively stable for the most part of the second quarter of 2015, it depreciated suddenly and sharply to K512/$ at end July 2015, representing a depreciation of 16.1 percent in a month. In August, November and December 2015, the exchange rate recorded monthly depreciations of 8.7 percent, 8.1 percent and 9.8 percent, respectively. There was a short-lived stability in September and October 2015. And the Kwacha resumed its depreciation and now trades at about K740/$, or a 60% depreciation. It is noteworthy that government has managed to contain its domestic borrowing during the last quarter of 2015. This implies that the Kwacha exchange rate could have been more depreciated by now had government not contained allocation to available resources.

Thus, at the current exchange rate, the Kwacha has lost value by 338% from K169/US$ or 196% since the devaluation in May 2012. At face value, it might seem obvious that the Malawi Kwacha is the worst performing currency in Africa, but it is important to note that the Kwacha depreciation is not strictly comparable to other currencies. There are two distinct aspects to the story of Malawi Kwacha.

First, this is the first and longest time the Kwacha exchange rate has been allowed to find its international value. Malawians may wish to note that when other countries liberalized their currencies in 1980's and 1990's, their own experiences were much worse than what Malawi is going through. For instance, Ghana liberalized in 1983 and the Cedi fell by 990%; Uganda shilling was floated in 1987 and it lost a whopping 1078% ; the Tanzanian shilling was floated in 1987 and depreciated by 407%; and in 1989 the Zambian Kwacha was let loose and it depreciated by 327%. Today, we marvel the economic conditions in these countries. Until the recent turmoil in global markets, these countries experienced stable macroeconomic conditions, low and relatively stable inflation and low interest rates. When viewed from this perspective, and when the devastation of cashgate and unfavorable weather conditions are taken into consideration, it is only fair to conclude that the Kwacha has fared reasonably well. More importantly, Malawi can join these countries and achieve the SADC target of 3-7% inflation only if we persevere in the current situation while supporting the government's efforts to implement prudent fiscal policies going forward.

The second aspect in the story of the Malawi Kwacha is that the economy is now more integrated into the regional and global markets. At regional level, the general reduction in tariffs within SADC and COMESA is also impacting Malawi negatively in the short- to medium-term. A surge in cheaper imports should be expected for a while. At global level, reduced demand for the country's imports and the appreciation of the US dollar against most currencies have had the effect of worsening the performance of the Kwacha.

At this stage, and despite likely negative impacts of the El Niño weather pattern, the outlook is that the Kwacha exchange rate will stabilize sooner than later. First, the Reserve Bank of Malawi believes the Kwacha exchange rate has over-depreciated given the current level of foreign exchange reserves. Second, and as alluded to earlier, government fiscal operations have been significantly curtailed and domestic borrowing is now being contained in line with the IMF-supported economic program. Third, the central bank has strengthened its instruments of monetary policy and expects to tighten monetary conditions without raising interest rates further. With these efforts in train, combined with continued use of available foreign exchange reserves, the Kwacha should stabilize soon. Prospects are even more improved in the medium-term as government continues to strengthen financial management systems.

In conclusion, therefore, the Kwacha depreciation is hurting low-income earners and is creating undue uncertainty in the business community. It is however misleading to portray a collapse of the economy. Despite the debilitating exogenous shocks, the Kwacha has performed relatively better than in other countries when they also floated their currencies in the 1980's and 1990's. Malawi continues to pay for its international obligations and foreign exchange reserves have never been better, especially taking into account the loss of donor direct budget support. Fiscal and monetary policy coordination has been strong despite daunting fiscal pressures. In particular the Reserve Bank has demonstrated capacity to implement needed monetary policies and is committed to take any actions to stabilize the Kwacha in weeks ahead.