MONETARY POLICY REPORT

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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 monetary policy stance. In order to do this, the Bank has a medium-term inflation rate objective of 5 percent. However, to ensure that monetary policy's response to noisy supply shocks is minimized and in line with international best practice, RBM has adopted a symmetric band of 2.0 percentage points around the point target. Subject to meeting the inflation objective, the MPC is also required to support Government's economic policy, particularly its objectives for economic growth and employment.

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, describe the recent economic developments and outlook, and outline direction of monetary policy.

The Monetary Policy Committee:

Dr. Dalitso Kabambe, Governor **(Chairperson)**

Dr. Grant Kabango, Deputy Governor

Mr. Henry Mathanga, Executive Director, Corporate Affairs

Dr. Kisu Simwaka, Director, Economic Policy 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 for 2020 held on 29th and 30th January, 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 the decision, the Committee observed that although rising maize prices are likely to continue pushing up headline inflation in the first quarter of 2020, the elevation is deemed temporary and does not pose significant risks to the medium-term inflation outlook.

Real GDP is estimated to have grown by 5.0 percent in 2019 from 4.0 percent in 2018, driven largely by recovery in the agriculture sector. Real GDP growth is projected between 5.0 and 6.0 percent in 2020 owing to further recovery in the agriculture sector as well as favourable macroeconomic conditions.

Annual headline inflation for 2019 averaged 9.4 percent, marginally higher than 9.2 percent recorded in 2018 and the projection by the Reserve Bank of Malawi. The outturn largely reflected rising food inflation as non-food inflation remained low during the year. Food inflation remained in double digit throughout 2019 and averaged 14.3 percent compared to 9.8 percent in 2018. The rise in food inflation was mainly driven by increase in maize prices. Non-food inflation remarkably decreased, averaging 5.4 percent in 2019 from an average of 9.0 percent in 2018. The decrease in non-food inflation is on account of tight monetary conditions.

The Kwacha exchange rate has been broadly stable during the past three years and was trading at an average of K738.8731 per US dollar in December 2019. The stability of the Kwacha is expected to continue in 2020 on the back of adequate *foreign exchange reserves which stood at 4.1 months of imports at the end of December 2019.*

Private sector credit grew by 21.3 percent in 2019 compared to 11.5 percent in 2018. This development was supported by reduction in interest rates. A part from the tradition borrowers, notable expansions were observed in energy and mining sectors.

The global economic growth for 2019 and 2020 have been marked down by 0.1 percentage points to 2.9 percent and 3.3 percent from the October 2019 projections of 3.0 percent and 3.4 percent, respectively. The downward revision is on account of surprises to economic activity in some emerging market economies, notably India and social unrest in few other economies.

Brent crude oil prices are projected to average US$58.0 per barrel in 2020 lower than US$60.2 per barrel registered in 2019. Despite mounting geopolitical tensions, oil prices are projected to decline further to US$55.3 per barrel in 2021.

Inflation is projected to average 8.8 percent in 2020, premised on favourable weather conditions and continued exchange rate stability. Going forward, the RBM remains committed to a 5.0 percent inflation objective in the medium term. In line with international best practice, RBM has adopted a symmetric band of 2.0 percentage points around the point target.

In view of the above developments, MPC decided to maintain the policy rate at 13.5 percent, the LRR on domestic currency deposits at 5 percent and the LRR on foreign currency deposits at 3.75 percent. The adopted policy stance is deemed adequately tight to deal with emerging risks while also aiding the growth momentum.

1. RECENT ECONOMIC DEVELOPMENTS

1.1 Government Operations through the Reserve Bank of Malawi

In 2019Q4, total revenues amounted to K315.2 billion (5.3 percent of GDP), comprising K279.6 billion domestic revenues and K27.7 billion grants. Total expenditures in the quarter amounted to K390.6 billion (6.6 percent of GDP) against a quarterly budget of K348.9 billion (5.9 percent of GDP).

1.2 Foreign Exchange Reserves

Gross official reserves rose to US$846.6 million (4.05 months of imports) in December 2019 from US$656.0 million (3.14 months of imports) in September 2019. Similarly, foreign exchange reserves held by the private sector increased to US$324.1 million (1.55 months of imports) in December 2019 from US$310.3 million (1.48 months of imports) in September 2019.

1.3 Banking System Liquidity

Banking system liquidity was tight in December 2019 compared to November and October 2019 positions. The un-borrowed excess reserve averaged negative K17.7 billion per day in December 2019, higher than negative K4.1 billion in November 2019, and K26.1 billion in October 2019. The tight liquidity conditions were reflected in the weighted average interbank rate (IBR), which increased by 231 basis points to 13.70 percent on 31st December 2019 from 11.39 percent and 8.69 percent at the end of November and October 2019, respectively.

1.3.1 Treasury Bill Market

The primary market for Treasury bills between October and December 2019 attracted total subscriptions amounting to K225.7 billion from K288.3 billion the previous quarter. The subscriptions skewed towards the long end of the market, whereby the 364-day tenor constituted 51.6 percent, while the 182-day and 91-day tenors attracted 28.5 percent and 19.9 percent of the funds subscribed, respectively. A total of K72.7 billion Treasury bills were allotted in 2019Q4, representing 32.2 percent of the total subscriptions. The distribution of the allotment was also skewed towards the long end of the market, where 70.6 percent was allotted to the 364-day tenor, while 16.4 percent and 13.1 percent was allotted on the 182-day and 91-day tenors, respectively.

1.4 Monetary and Private Sector Credit Developments

The average annual growth rate of broad money (M2) was recorded at 10.9 percent in 2019, compared to 18.4 percent in 2018. Private sector credit continues to recover, supported by low interest rates. Private sector credit expanded by 21.3 percent in 2019, a significant increase from 11.5 percent recorded in 2018.

2. MACROECONOMIC ANALYSIS AND FORECASTING

MACROECONOMIC DEVELOPMENTS

Real GDP was estimated to be below its trend in 2019, with the overall output gap in a negative cyclical position. The development resulted from negative output gaps in both non-agriculture and agriculture sectors. Headline inflation rose in 2019Q4 and reached double digit. The upward trend in inflation was driven by food inflation, which picked up to 17.5 percent in 2019Q4, from 14.2 percent in 2019Q3.

2.1 Aggregate Demand

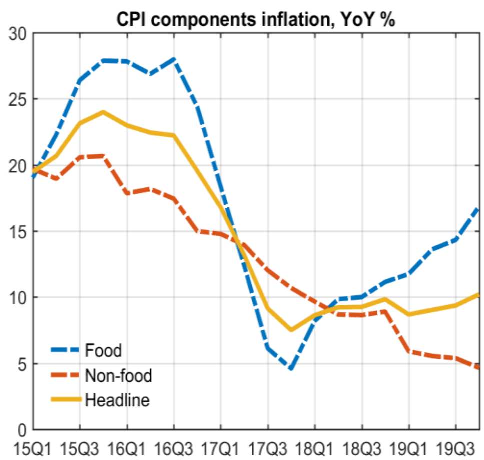
The domestic economy continues to recover. GDP is projected to grow in the range of 5.0 to 6.0 percent in 2020 from 5.0 percent in 2019, mainly on account of favorable agricultural output prospects in the 2019/20 season and improved electricity generation. Initial projections indicate that the agriculture sector will grow by 5.1 percent in 2020, up from the 3.9 percent in 2019. However, risks are tilted to the downside, mainly arising from the fall armyworm outbreak and flooding reported in some districts in the country. Despite the pickup of economic activity in 2019, overall output gap for the year was negative mainly driven by non-agriculture output gap.

2.2 Consumer Prices

Headline inflation has remained elevated. In 2019Q4, inflation was recorded at 10.5 percent from an average of 9.3 percent in 2019Q3 (Figure 1). Food inflation – representing 45.2 percent of the headline Consumer Price Index (CPI) basket - continued to influence developments in headline inflation, increasing to an average of 17.5 percent in 2019Q4 from 14.2 percent in 2019Q3. In 2019, average food inflation stood at 14.3 percent compared to 9.8 percent in 2018. The acceleration in food inflation reflected primarily a supply shock which triggered a shortage of grain in the country and hence a rise in maize prices. In contrast, non-food inflation declined to 4.6 percent in 2019Q4 from 5.5 percent recorded in the preceding quarter and was lower than the

2019 annual average of 5.4 percent. Non-food inflation has remained within 4-6 range since February 2019, anchored by the stability of the kwacha.

Figure 1: Inflation, Y-oY, %



2.3 Monetary Policy Assessment

2.3.1 Real Monetary Conditions

The real monetary conditions index was estimated to be stable between 2019Q3 and 2019Q4 as the real exchange rate and real interest rate dynamics had opposite forces.

2.3.2 Monetary Policy Outcomes

During the fourth MPC meeting of 2019, the economic outlook was projected to remain resilient despite adverse effects of Cyclone Idai, particularly on maize prices, that elevated food inflation. Headline inflation increased to 9.3 percent in 2019Q3 from 9.0 percent in 2019Q2, solely on account of food inflation that rose to 14.2 percent from 13.5 percent in 2019Q2. In contrast, non-food inflation was stable at 5.4 percent. As such, the MPC 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 5.0 percent and the LRR on foreign currency deposits at 3.75 percent.

At the time of the fourth MPC meeting of 2019, maize prices were envisaged to continue rising in the last quarter of 2019, particularly on account of scarcity of the commodity in some parts of the country. This risk has since materialized as maize prices increased by an average of 6.3 percent during the fourth quarter of 2019. In contrast, exchange rate was expected to remain broadly stable in the last quarter of 2019, despite the weak performance of tobacco exports in 2019. Non-food inflation therefore remained low and stable at around 5 percent.

3. ECONOMIC OUTLOOK

3.1 External Sector

3.1.1 Real Output Developments

Global economic developments continue to be influenced by the US–China trade disputes. Based on the International Monetary Fund's (IMF) updated World Economic Outlook (WEO) of January 2020, the 2019 and 2020 global economic growth have been marked down by 0.1 percent to 2.9

percent and 3.3 percent from the October 2019 projection of 3.0 percent and 3.4 percent, respectively. The downward revision is on account of continued trade tensions as well as surprises to economic activity in a few emerging market economies, notably India, which led to a reassessment of growth prospects over the next two years and the impact of increased social unrest in few economies.

Advanced economies are projected to grow by 1.6 percent in 2020, a downward revision of 0.1 percent from the October 2019 projection. The projected sluggish growth in advanced economies reflects geographically broad-based slowdown in manufacturing and global trade. Further, higher tariffs and prolonged uncertainty surrounding trade policies have weighed on investment and demand for capital goods. Downward revisions have been made for the United States, euro area and the United Kingdom, and downgrades to other advanced economies in Asia, notably Hong Kong Special Administrative Region following protests.

Growth in the emerging market and developing economies was estimated at 3.7 percent in 2019 and projected to pick-up to 4.4 percent and 4.6 percent in 2020 and 2021, respectively. This was however, 0.2 percentage points lower for both years, than the October 2019 WEO projections. The growth profile for the group reflects a combination of projected recovery from deep downturns for stressed and underperforming emerging market economies and an ongoing structural slowdown in China.

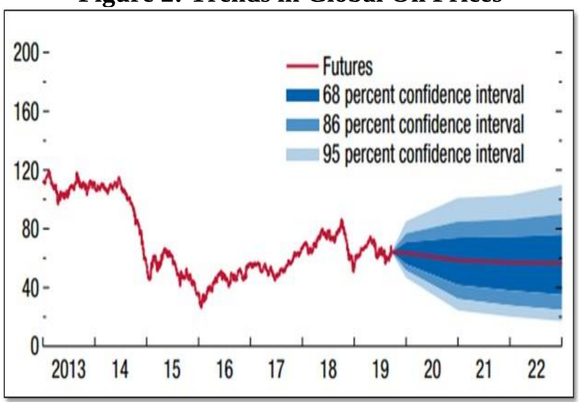
In Sub-Saharan Africa, growth is estimated at 3.3 percent in 2019 and projected to strengthen further to 3.5 percent in 2020 and 2021. South Africa's growth is estimated at 0.4 percent in 2019 and projected at 0.8 percent and 1.0 percent in 2020 and 2021, respectively. Meanwhile, growth in Nigeria is estimated at 2.3 percent in 2019 and projected at 2.5 percent in 2020 and 2021.

3.1.2 Global Oil Price Developments

The IMF's January 2019 WEO update projects that crude oil prices will average US$58.0 per barrel in 2020, lower than the US$60.2 per barrel registered in 2019. Further, the IMF projects that oil prices will decline to $55.3 per barrel in 2021, mainly on account of prospects for subdued medium-term demand (Figure 2). However, risks are tilted to the upside in the near term but balanced in the medium term. Upside risks to prices in the short term include escalation of geo-political tension in the Middle East, which could disrupt oil supply and contribute to rising insurance and shipping costs of oil cargoes.

On the other hand, higher United States of America production and exports, noncompliance among OPEC and non-OPEC members, and a downturn in demand due to deceleration in global economic activity are expected to exert downward pressure on oil prices in the medium term.

Figure 2: Trends in Global Oil Prices



Source: IMF WEO

3.1.3 Malawi's Terms of Trade

Overall, Malawi's Terms of Trade growth is projected to deteriorate, mainly due to the weak performance of the tobacco industry during the year 2019 compared to the preceding two years. In 2019, all type tobacco prices averaged US$1.43 per kilogram compared to US$1.67 per kilogram in 2018. Besides tobacco, other major exports for Malawi are sugar and tea whose prices remained flat as well. Meanwhile, the prices of Malawi's main imports-oil and fertilizer-declined in 2019. The average oil prices declined to US$60.2 per barrel in 2019 from US$68.6 per barrel in 2018. Similarly, average prices of fertilizer declined to US$224.5 per metric ton in 2019 from US$249.4 per metric ton in 2018. Developments in the country's export and import prices suggest that terms of trade will still be driven by developments in prices of the traditional exports and imports in the forecast horizon.

3.2 Baseline Forecast

3.2.1 Baseline Assumptions

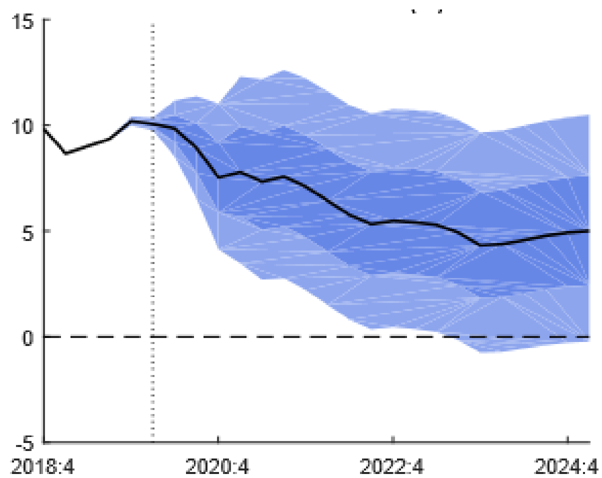
RBM maintains 5 percent inflation objective in the medium term. However, in order to minimize policy response to noisy data, a symmetric margin of 2.0 percent on the inflation objective is introduced. This adjustment also represents continued central bank drive to align monetary policy conduct with best practices. Further, the forecasts have taken into account the GDP growth projection of 5 to 6 percent for 2020. The forecasts have also considered the prevailing higher than expected maize price pressures. The forecast also assumes that exchange rate stability will continue and that there will be delayed fiscal consolidation.

3.3 Monetary Policy and Inflation in the Baseline

Annual headline inflation projection for 2020 is at 8.8 percent (Figure 3). Headline inflation developments will be driven mainly by food inflation whilst non-food inflation will remain stable and in single digit in 2020. At 8.8 percent, the 2020 average inflation forecast is 0.6 percentage points lower than the annual average for 2019. Food inflation is projected to moderate in the short term due to government led humanitarian assistance program and the recent removal of import duty on maize flour imported from South Africa. Furthermore, weather forecasts indicate that the 2019/2020 weather conditions will be comparatively better than in the previous growing season. However, taking into account the reports of flooding and recurring of fall armyworms in some parts of the country, food inflation is being projected to display some rigidity as it slows down in 2020.

Although the latest forecast reconfirms the outlook for inflation rate to remain above the desired and announced objective of 5±2 percent in the forecast horizon, the pressures appear to be supply-driven. Additionally, non-food inflation, remarkably decreased, averaging 5.4 percent in 2019. The outlook suggests that non-food inflation will remain low and stable over the forecast horizon.

Figure 3: Headline Inflation Outlook



4. MONETARY POLICY DECISION

Inflation pressures in 2020 are expected to subside as inflation is projected at 8.8 percent compared to 9.4 percent in 2019. The improvement is predicated on projected favourable agricultural output in 2020. Although currently shoring up inflation, the elevated maize prices are expected to be short-lived, and will start to decline at the onset of the next harvest season. Risks to this projection include the reported fall armyworms and flooding reported in some parts of country. However, the full impact of these risks will only be known once the first-round crops estimates have been made. On the other hand, exchange rate is expected to remain stable in the short to medium term.

The stability of exchange rate is likely to ensure that utility tariffs and domestic currency costs of imports including fuel, remain well anchored and hence keeping the non-food inflation at bay.

While inflation projections and inflation expectations are higher than the medium-term objective, the current pressures are perceived to mostly be supply based and temporary. Therefore, the Monetary Policy Committee decided to maintain the Policy rate at 13.5 percent, the Liquidity Reserve Requirements on domestic currency and foreign currency deposits at 5 percent and 3.75 percent, respectively.