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 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 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 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, describe the recent economic developments and outlook, and outline 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

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INTRODUCTION

The Monetary Policy Committee (MPC), at its fourth meeting of 2020 held on 5th and 6th November, decided to reduce the Policy rate by 150 basis points to 12.0 percent. The MPC 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. In arriving at this decision, the Committee noted that headline inflation has been declining since January 2020 and the inflation outlook was favourable. This decision was undertaken to support economic recovery and job creation.

According to the October 2020 World Economic Outlook (WEO) Report of the International Monetary Fund (IMF), global economic activity remains subdued, but is slowly recovering from the impact of the COVID-19 pandemic. The global economy is projected to contract by 4.4 percent in 2020 compared to a contraction of 4.9 percent projected in June 2020. The revision reflects better-than-anticipated growth outcomes in the second quarter of 2020, especially in advanced economies. However, the resurgence in COVID-19infections and the re-introduction of strict containment measures, particularly in Europe, pose a threat to the recovery process. Meanwhile, the Sub-Saharan Africa is projected to contract by 3.0 percent, lower than a contraction of 3.2 percent projected in June 2020.

Brent crude oil prices averaged US$42.7 per barrel in 2020Q3 from US$31.4 per barrel recorded in 2020Q2. The recovery in oil prices was due to increasing demand as most countries eased travel restriction. The IMF projects that petroleum prices will average US$41.7 per barrel in 2020 and $46.7 per barrel in 2021.

Domestic real GDP growth is projected at 1.2 percent in 2020 from 5.1 percent in 2019, reflecting the adverse impact of the COVID-19 pandemic. The hard hit sectors include manufacturing, tourism and accommodation, health services and wholesale and retail trade sectors.

The kwacha depreciated in the third quarter of 2020 and traded at K756.92 per US Dollar at the end of September 2020 from K743.05 per US Dollar recorded at the end of June 2020. The weakening of the kwacha reflects the disruption of foreign exchange supply to the Authorized Dealer Banks (ADBs) amidst the COVID-19 pandemic.

Private sector credit continues to grow, although at a slower rate than 2019 due to the impact of the COVID-19 pandemic. The annual growth rate of private sector credit edged up to 16.4 percent in September 2020 from 12.8 percent in June 2020 but remained lower than 17.7 percent recorded in September 2019.

Headline inflation has declined from a peak of 11.5 percent in January 2020 to 7.1 percent in September 2020, partly due to relatively low food prices compared to 2019. Meanwhile, non-food inflation has been generally low and stable, anchored by relatively stable exchange rate and energy prices. Inflation is now projected to average 8.6 percent in 2020 from 9.8 percent projected during the Third MPC Meeting of 2020. In 2021, it is anticipated that inflation will continue to decline.

The MPC, therefore, resolved to reduce the Policy rate to 12.0 percent; maintain 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 K318.08 billion in the first quarter of the FY2020/21 against total government expenditures of K380.05 billion. Government, therefore, closed the quarter with an overall deficit of K61.97 billion, albeit lower than the budgeted deficit of K204.73 billion. The COVID-19 pandemic continues to affect revenues collection.

1.2 External Sector Developments

The external balance continues to be in deficit as imports remain above exports. 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 recorded a mild depreciation and traded at K756.92 per US dollar as of end-September 2020 from K743.05 in June 2020.

1.3 Banking System Liquidity

Banking system liquidity tightened further in the third quarter of 2020, as evidenced by a larger decline in un-borrowed excess reserves than in the previous quarter. Specifically, the un-borrowed excess reserves dropped to an average of negative K18.6 billion in 2020Q3 from negative K7.9 billion in 2020Q2. Reflecting the tight liquidity conditions, the interbank market rate (IBR) remained above the Policy rate and stood at 13.61 percent in September 2020 from 13.59 percent in August 2020 and 13.58 percent in July 2020.

1.4 Monetary and Private Sector Credit Developments

The September 2020 annual growth rate in broad money (M2) increased to 14.0 percent from 13.1 percent in August 2020, 11.2 percent in June 2020, and 11.6 percent in September 2019. Similarly, private sector credit continued to expand in 2020, albeit more slowly than in 2019. Specifically, the annual growth rate of private sector credit edged up to 16.4 percent in September 2020, from 12.8 percent in June 2020 but remained lower than 17.7 percent recorded in the corresponding month in 2019. The relatively slow growth in 2020 is attributed to the impact of the COVID-19 pandemic.

2. MACROECONOMIC ANALYSIS

2.1 Aggregate Demand

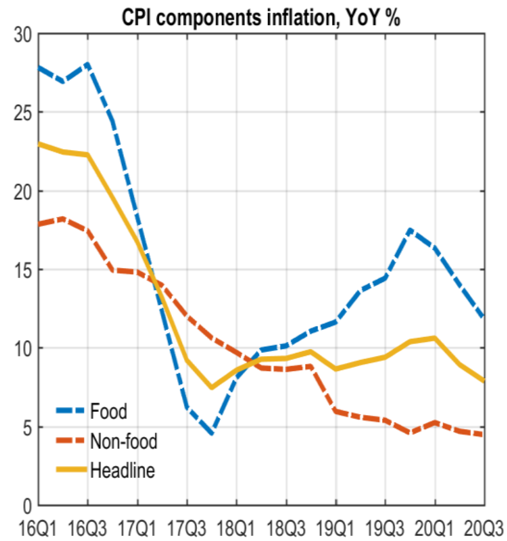
The COVID-19 pandemic continues to affect global and domestic economic activity. Real GDP for the domestic economy is projected to grow by 1.2 percent in 2020. This represents a downward revision of 0.7

percentage points from the April 2020 projection and reflects more severe impact of the COVID-19 pandemic than earlier anticipated. Activity in the non-agriculture sector has been the mostly affected by the pandemic, notably, the manufacturing, tourism and accommodation, health services, wholesale and retail trade, financial services, real estate, and construction sectors. Despite a better agriculture production, marketing disruptions for some cash crops like tobacco and pulses have also had some adverse effects on the agriculture sector's overall performance.

2.2 Consumer Prices

The downward trend in inflation observed since 2020Q1 continued into 2020Q3. Specifically, the average headline inflation dropped to 7.6 percent in 2020Q3 from 8.9 percent in 2020Q2 and 9.3 percent in 2019Q3 (Figure 1). The decline was largely influenced by food inflation, which moderated to an average of 11.3 percent in 2020Q3 from 13.9 percent in the preceding quarter. The moderation in food inflation is primarily reflective of improved production of maize during the 2019/20 agricultural season, coupled with subdued industrial demand for maize amidst the COVID-19 pandemic and benign basal effects from high food prices in 2019.

Figure 1: Inflation, Y-oY, %



2.3 Monetary Policy Assessment

2.3.1 Real Monetary Conditions

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 third quarter of 2020, the RMCI marginally decreased, implying that monetary conditions were relatively more accommodative than in the previous quarter.

2.3.2 Monetary Policy Outcomes

During the Third MPC meeting of 2020, there was increased uncertainty concerning the impact of the COVID-19 pandemic to the economy. It was anticipated that the domestic economy would register a slower growth rate compared to the 5.5 percent projected in February 2020. Inflationary pressures were expected to intensify in the second half of 2020, mainly on account of rising global oil prices and the subsequent pass-through to domestic fuel prices; a gradual pick-up in food prices; exchange rate depreciation; supply bottlenecks; and increased public sector financing requirements. As such, the annual average inflation for 2020 was projected at 9.8 percent.

Despite the COVID-19 pandemic circumstances demanding an economic recovery policy, the need to contain the above perceived upside risks to inflation compelled the MPC to preserve the status quo, with the Policy rate maintained at 13.5 percent and the Lombard Rate at 0.2 percentage points above the Policy Rate. The MPC also maintained the Liquidity Reserve Requirement (LRR) ratio on both local currency and foreign currency deposits at 3.75 percent.

Contrary to the projections, however, the inflation outturn for 2020Q3 showed that the intensity of the pressures was not as high as anticipated. Food inflation continued to decline and non-food inflation also dropped, albeit marginally, leading to a lower average headline inflation of 7.6 percent than projected. The outturn reflected largely the joint effects of a bumper maize harvest during the 2019/20 agricultural season; suppressed prices due to the COVID-19-induced weak demand for maize; and basal effects from high food prices in 2019. Private sector credit also continued to grow and recorded an annual increase of 16.4 percent at the end of 2020Q3, up from 12.8 percent as of end-2020Q2, reflecting partly the favourable interest rates.

3. ECONOMIC OUTLOOK AND FORECASTS

3.1 External Sector

3.1.1 Real Output Developments

According to the October 2020 WEO update, global real GDP is projected to contract by 4.4 percent in 2020, slightly lower than a contraction of 4.9 percent forecasted in the June 2020 WEO Update. The improved outlook reflects largely better-than-anticipated second quarter GDP outturns, particularly in advanced economies. Specifically, stronger growth than anticipated in the June 2020 WEO update is expected from the United States (3.7 percent); France (2.7 percent); Italy (2.2 percent); Germany (1.8 percent); and Canada (1.1 percent). Indications are that the recovery which has taken root in the 2020Q3 will strengthen gradually into 2021 and yield a global growth of 5.2 percent.

For the Sub-Saharan Africa (SSA) region, the contraction is projected to be slightly lower at 3.0 percent than 3.2 percent projected in the June 2020 WEO update. Nevertheless, SSA's economic activity is expected to modestly recover in 2021 with growth projected at 3.1 percent, albeit lower than the June 2020 WEO projection of 3.4 percent. The revision for 2020 projections partly reflects a better-than-initially projected economic performance in Nigeria, owing to the partial recovery in international oil prices.

In terms of the risks to the outlook, fundamental uncertainty around the evolution of the pandemic remains a key factor shaping the economic outlook. The forecasts are highly dependent on public health and economic factors that are inherently difficult to predict. On one hand, progress with vaccines and treatments for the pandemic, as well as changes in the workplace and by consumers to reduce transmission of the virus, may allow economic activity to return more rapidly to pre-pandemic levels than currently projected without triggering repeated waves of infection. On the other hand, if the second wave of the virus continues, progress on treatments and vaccines is slower than anticipated, or countries' access to the vaccines remain unequal, economic activity could be lower than expected, with renewed social distancing and tighter lockdowns.

3.1.2 Global Oil Price Developments

International oil prices have picked up since May 2020. Brent crude oil prices averaged US$42.7 per barrel in 2020Q3 from US$31.4 per barrel recorded in 2020Q2. Nevertheless, crude oil prices declined by 7.8 percent to an average of US$41.1 per barrel in September 2020. The IMF projects that petroleum spot prices will average US$41.7 per barrel in 2020 and $46.7 per barrel in 2021, and thereafter remain stable over the medium term. The projected decline in oil prices in 2020 is due to weak demand caused by COVID-19 mitigation measures and this has sharply curtailed travel and transport, which account for around two-thirds of oil demand.

3.2 Malawi's Terms of Trade

The broad-based commodity price declines amidst the COVID-19 pandemic has resulted into neutral Terms of Trade for the country. On the one hand, while the domestic tobacco prices rose in 2020 and averaged US$1.53 per kilogram compared to US$1.43 per kilogram in 2019, international prices for other key export commodities for Malawi, notably tea and sugar, have declined in 2020.

On the other hand, international prices for Malawi's main imports, oil and fertilizer, have also tumbled. Average prices of fertilizer have declined to US$234.0 per metric ton in 2020 from US$247.9 per metric ton in 2019. Similarly, oil prices have declined and are projected to average US$41.7 per barrel in 2020 from US$61.4 per barrel in 2019. Over the medium term, Malawi's Terms of Trade growth is projected to remain neutral.

3.3 Baseline Forecast

3.3.1 Baseline Assumptions

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

The forecasts have taken into account the revised GDP growth projection of 1.2 percent in 2020. The forecasts have also considered threats to maize prices as well as growing foreign exchange demand and delayed domestic fiscal consolidation due to the lingering pandemic and its containment measures.

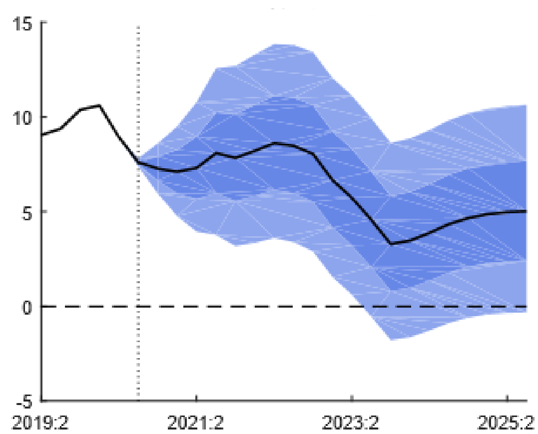
3.3.2 Monetary Policy and Inflation in the Baseline

The average inflation for 2020Q4 is projected at 7.3 percent, which is 3.3 percentage points below the third 2020 MPC forecast round. The revised inflation path reflects the influence of lower-than-expected actual inflation rates in 2020Q3, non-materialization of the anticipated upward adjustment in domestic pump prices in 2020Q3, smaller than anticipated exchange rate depreciation and anticipation of less severe food inflationary pressures in 2020Q4 than earlier envisaged.

Food inflation is projected to rise in 2020Q4, albeit marginally than earlier anticipated, reflecting downcast demand due to the COVID-19 pandemic, commencement of maize sales by ADMARC and benign basal effects of high food prices in 2019.

Meanwhile, non-food inflation is projected to remain subdued in 2020Q4, averaging 4.5 percent in the quarter, before rising to 5.4 percent in 2021Q1 on account of the anticipated further weakening of the local currency. However, non-food inflation is projected to remain restrained in the forecast horizon, hovering around 5 percent. Headline inflation is, thus, expected to average 8.6 percent in 2020, implying a downward revision of 1.2 percentage points from the third 2020 MPC projections (Figure 2).

Figure 2: Headline Inflation Outlook



4. MONETARY POLICY DECISION

The adverse effects of the COVID-19 pandemic are still being felt in both the global and domestic economy. Domestically, this is evidenced by the projected real GDP growth of 1.2 percent for 2020, the lowest since 2001.

Inflation continued to decline and averaged 7.6 percent in 2020Q3 from 8.9 percent in 2020Q2. The decline is a reflection of joint effects of bumper maize harvest during the 2019/20 agricultural season; suppressed prices due to the COVID-19-induced weak demand for maize; and basal effects from high food prices in 2019.

Subsequently, the projected annual average headline inflation for 2020 was also lowered to 8.6 percent from 9.8 percent projected during the Third 2020 MPC forecasting round. Inflation is projected to decline further in 2021.

As a result of the favourable inflation developments, the MPC decided to reduce the Policy rate to 12.0 percent. The Committee also resolved to maintain the 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 has been undertaken to support economic recovery and job creation.