Reserve Bank of Malawi

MONETARY POLICY STATEMENT # 3

JANUARY 2016

Mzuzu Branch

Head Office

Blantyre Branch

Definition and Acronyms

ADB	Authorized Dealer Banks
APM	Automatic Pricing Mechanism
ATAF	Automatic Tariff Adjustment Formulae
CEO	Chief Executive Officer
FY	Fiscal Year
GDP	Gross Domestic Product
LRR	Liquidity Reserve Requirement
MPC	Monetary Policy Committee
MPR	Monetary Policy Rate
NDA	Net Domestic Assets
NFA	Net Foreign Assets
OMO	Open Market Operations
PR	Policy Rate also referred to as MPR
PTA	COMESA’s Preferential Trade Area Bank
BANK	Reserve Bank of Malawi
RM	Reserve Money or base money or high powered money
SADC	Southern African Development Community
The Bank	Reserve Bank of Malawi

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Executive Summary

The Reserve Bank of Malawi formulates and implements monetary policy with the twin objectives of attaining price stability and financial system stability. This monetary policy statement seeks to inform the general public of the Bank monetary policy stance in 2015 in line with governments fiscal stance which was contained in the in the 2015/16 budget statement. It also reviews the implementation of the monetary policy stance in the previous fiscal year. The policy statement also incorporates understandings reached between the government and the International Monetary Fund (IMF) within the context of an Extended Credit Facility (ECF).

Inflation targets for monetary policy are ordinarily set by the National Economic Management Committee that is chaired by the Minister of Finance and of Economic Planning and Development and are finalized in the context of reviews of the Extended Credit Facility (ECF) program. The inflation target for the fiscal year ending-June 2016, as stated in the Budget Statement by the Minister of Finance, has been set at 14.2 percent. This target translates to implementing monetary measures aimed at the attainment of an average inflation rate of about 21.0 percent for the calendar year 2016 for monetary programming purposes. In addition, the Bank will aim at maintaining a minimum of 3 months import cover in foreign exchange reserves in the medium-term in order to anchor inflationary expectations.

The Monetary Policy Statement No.2 was fully implemented with mixed results. Foreign exchange reserves target of 3 months of imports was attained amidst exchange rate depreciation. Over the past six months, inflationary pressures mounted because the onset of depreciation was earlier than expected and also on account of rising food prices. Specifically, June 2015 inflation stood at 21.3 percent against a target of 15.0 percent. It is expected that inflation for December 2015 will be 26.2 percent compared to the initial projection of 12.0 percent. The rise in food prices was largely due to poorly informed market decisions by economic agents especially about the effects of the floods and drought experienced in some parts of the country. It was estimated

that a 223,723 metric tons of consumption deficit was experienced in 2015. Government however procured maize through ADMARC with resources from a World Bank grant to manage the deficit.

Against this background, the theme of this third monetary policy statement remains *"managing inflation expectations."* To that end, the Bank will intensify implementation of its communication strategy and engage stakeholders in order to manage inflation expectations. The Bank will continue to work on enhancing the transmission mechanism of monetary policy measures. In addition, existing systems for coordination of fiscal and monetary policies shall be enhanced. The aim of monetary policy is therefore to drive inflation down to around 14.2 percent by June 2016. Of essence in attaining these targets are low domestic food prices, low and stable domestic pump prices for petroleum products and minimal exchange rate volatility.

1.0 Introduction and Background

1.1 Background

The National Economic Management Committee (NEMC) under the leadership of Treasury is responsible for the production of projections of gross domestic product (GDP) growth and inflation that underpins the country's macroeconomic framework in a given year. The macroeconomic framework is generally announced by the Minister of Finance in the Budget Statement as presented before Parliament. The Bank issues a Monetary Policy Statement (MPS) to inform key stakeholders and the general public about the monetary policy stance consistent with the fiscal stance. In formulating this policy, the Bank is more concerned about the projected inflation and its consistency with the planned financing of any budget deficit. The projected inflation rate is then taken as a target for monetary policy purposes. In addition, the Bank takes a position with regard to the long-term direction of the economy, including government commitments to regional integration. The instruments used by the Bank to implement monetary policy are described in *Section 1.4*.

The 2015/16 national budget was formulated on the basis of no budget support from development partners with some off-budget support. Key to the successful implementation of the budget will be an environment of favorable inflation trajectory. However, inflation developments between April and June 2015 implied that realization of such favorable rate of inflation was difficult to attain. The gap between the targeted inflation path and realized headline inflation continue to widen as of October 2015. It will therefore be critical to ensure that spending is kept within available resources and government borrowing is limited. This will help contain demand-pull inflation and second-round effects of the rising food prices.

1.2 Objectives of Monetary Policy

The main objective of monetary policy is to achieve low and stable prices, that preserve the value of the Kwacha, and encourages investment needed to achieve sustained economic growth and employment creation. The Bank also aims to build foreign exchange reserves in order to manage exchange rate movements in a more credible manner and better cushion the market from shocks, and ultimately anchor inflation expectations.

1.3 Description of Monetary Policy Framework

Since January 2014, the Bank uses an interest rate targeting framework. The Policy Rate (PR) is set in the context of an inflation forecast. The Liquidity Reserve Requirement (LRR) and open market operations (OMO) are used to manage liquidity in the money market in order to keep short term interest rates closer to the policy rate. Thus operationalizing this framework entails active management of excess reserves in the banking system such that Treasury bills and the Inter-Bank Market rate are kept around the policy rate.

The excess reserves are a portion of commercial bank deposits with the Reserve Bank over and above what they are statutorily required to maintain at any given point in time given the level of their deposit balances. High excess reserves signifies that the inter-bank market is awash with liquidity or money. Therefore, the Bank implements measures that are aimed at keeping the excess liquidity as low as possible.

However, the Bank is still observing net foreign assets (NFA) and net domestic assets (NDA) as part of the IMF's ECF program which is a transitory arrangement. Targeted growth in money supply is pursued by setting an intermediate target on the growth of reserve money which, through a money multiplier, is directly linked to money supply. Reserve money is the sum of currency in circulation and commercial bank deposits with the central bank. To achieve reserve money target, the Bank applies monetary policy instruments to influence changes in the level of its lending to banks and central government which together constitutes the Bank's net domestic assets (NDA). The Bank may also adjust its foreign exchange reserves to influence bankers' deposits, if doing so is consistent with foreign exchange reserves policy. Thus, in the ECF program, a ceiling is set on the Bank's NDA and a floor is set on net foreign assets (NFA).

1.4 Instruments for Monetary Policy

The Bank uses a variety of monetary policy instruments that include the Policy Rate (PR), the Liquidity Reserve Requirement (LRR), the Open Market Operations (OMO) and Communication. For signaling the stance of monetary policy, the Bank introduced the Policy Rate (PR) which previously was referred to as the Bank rate. In order to further enhance policy effectiveness, the Lombard facility was introduced. The Bank provides liquidity to commercial banks through this facility which is meant to assist commercial banks to better manage their liquidity. The Lombard rate is maintained at 2.0 percentage points above the PR. The LRR is the proportion of deposits by commercial bank's clients that must be placed at the Reserve Bank. Open market operations are purchases and sales of securities conducted through the Bank.

The Bank is also enhancing communication with stakeholders and the general public. Increasing use of communication helps to disseminate monetary policy decisions more widely thereby increasing efficiency of policy transmission mechanism.

2.0 Targets of Monetary Policy for 2016

For the year 2016, monetary policy will aim to bring down annual headline inflation to the target of 14.2 percent in June. Achieving this target will however require a concerted effort as RBM projection for end June 2016 is 19.3 percent.

Chart 1: Inflation Performance and Projections for 2016

Source: Reserve Bank of Malawi

In addition to the inflation target, the Bank will aim at maintaining foreign exchange reserve coverage of at least 3 months of imports by June 2016.

3.0 Assessment of Monetary Policy Implementation in 2015

3.1 Objectives of MPS Number II and Measures Implemented

The objective of monetary policy in 2014/15 was to bring inflation to 15.0 percent by June 2015 with an inferred target of 12.0 percent in December 2015. Commensurate with these projections, annual average headline inflation for the calendar year 2015 was projected to be around 17.3

percent. International reserve coverage was set at a minimum of 3.0 months of import cover for the period July 2014 and June 2015.

The monetary policy committee (MPC) met four times to deliberate on economic developments and decide on the course of monetary policy in 2015. The Committee took a tight monetary stance by maintaining the Policy Rate (PR) at 25.0 percent in the first three meetings. However, at the MPC's third sitting, the liquidity reserve requirement ratio (LRR) was adjusted downwards to 7.5 percent in order to enable banks lower the spread between the prime lending rate and the Policy Rate (PR). At the fourth meeting, the MPC adjusted upwards the policy rate by 2.0 percentage points in order to contain second round effects of rising food inflation. Further, the high inflation implied heightened expectations in the near term. Meanwhile, the Lombard rate was maintained at a premium of 2.0 percentage points against the PR at all the MPC meetings. The kwacha continued to be determined by demand and supply conditions on the market.

The Bank continued to use its liquidity forecasting framework to determine optimal market intervention and used open market operations to adjust liquidity in the system in line with the inflation objective. The Bank also actively engaged its communication with stakeholders on monetary policy issues including Governors' meetings with CEOs of commercial banks and the second MPS released on 27th March, 2015. Furthermore, a series of media activities were implemented to engage with stakeholders and to provide information to the general public.

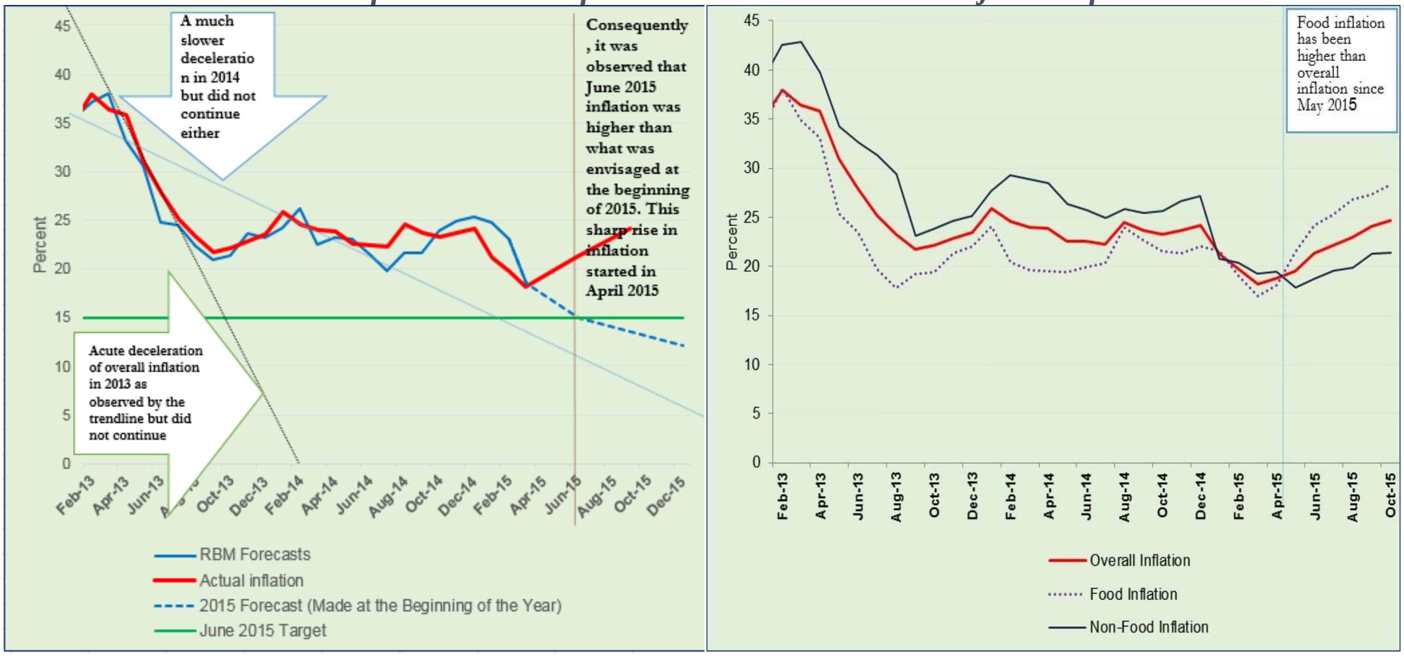
3.2 Assessment of Policy Outcomes

3.2.1 Review of Inflation Developments since January 2015

Overall inflation moved in line with its projected path from July 2014 up to March 2015. In fact, headline inflation undershot its target beginning January 2015 up to March 2015. Two factors contributed to this development: Firstly the exchange rate appreciated even during the lean months of November and December 2014. Hence the lagged effects of the appreciation of the domestic currency were reflected in the domestic price developments. Secondly, the pump prices for fuel were revised downwards as the international oil prices reached below their symbolic prices of US$50.0 per barrel in December 2014. This triggered a downward adjustment in the pump prices through the Automatic Pricing Mechanism. These developments resulted in the inflation to start the year with a relatively lower base which if maintained could have resulted in headline inflation undershooting its June 2015 target of 15.0 percent.

However, the disinflation reversed in April 2015 on account of rising food prices and unexpected exchange rate depreciation. The implementation of fiscal policy was difficult given the additional social spending following the floods and sporadic drought conditions which was exacerbated by the shortfalls in external financing. This led to higher than programmed domestic financing of the deficit, which fuelled inflation expectations as noticed by rising non-food inflation *(See chart 2 below)*. This trend continued until June 2015. Hence, the June 2015 target of 15.0 percent was missed as the realized inflation stood at 21.5 percent. In a nutshell, Malawi experienced two shocks that derailed the desired inflation trajectory. These were floods and drought, leading to expectations of food price increase, and the continued shortfall in external financing. Weighing the two against the stable and appreciated kwacha as well as the low international oil prices, the balance tilted towards inflationary pressures since April 2015. Headline inflation for October and November 2015 was recorded at 24.7 percent and 24.6 percent, respectively.

Chart 2: Inflation Outturn for June 2015 and Bank's Projections for 2015

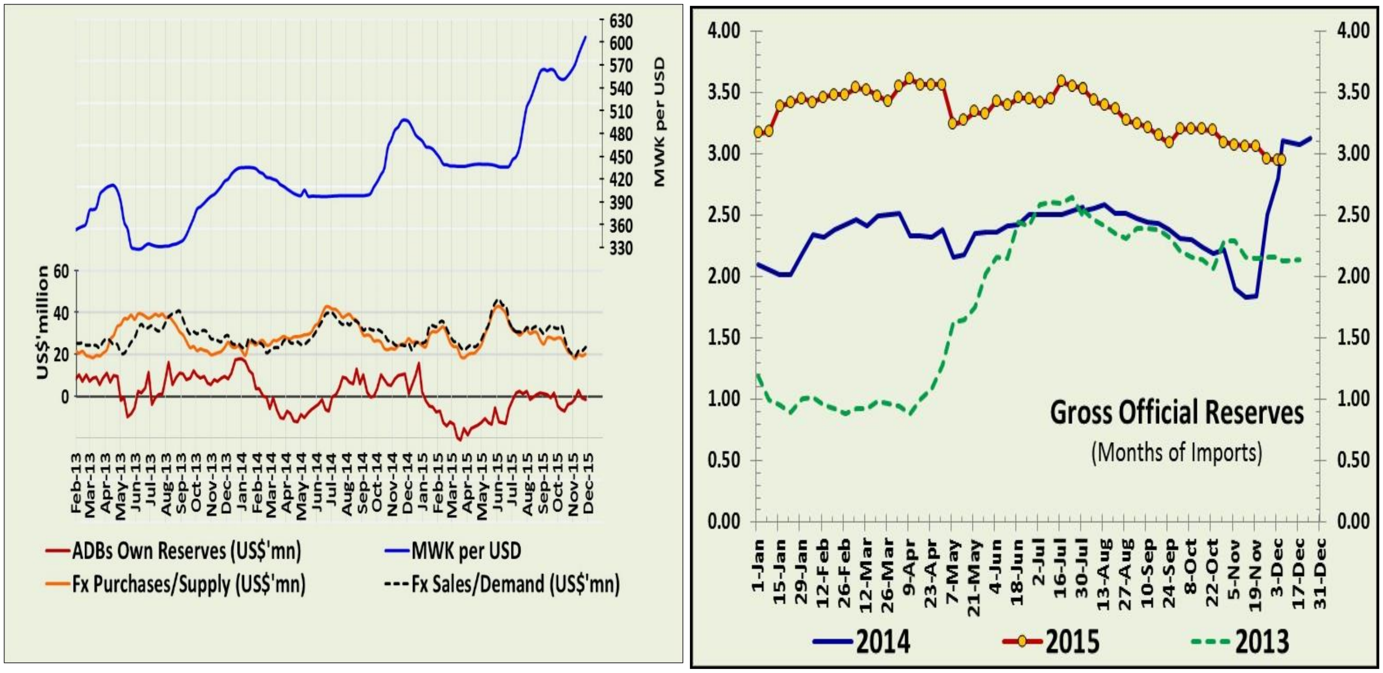


Source: Reserve Bank of Malawi

3.2.2 Official Foreign Exchange Reserves and Exchange Rate Developments since January 2015

The Bank managed to maintain gross official import coverage at a minimum of 3 months of prospective imports in 2015. The Reserve Bank has also been supporting the market throughout the year through sales of its foreign exchange to the banks. The buildup in gross official reserves gave monetary authorities more flexibility to intervene in the foreign exchange market in order to absorb adverse shocks.

Chart 3: Official Foreign Exchange Reserves, Private Sector Foreign Exchange Balances and Exchange Rate Developments since 2013



Source: Reserve Bank of Malawi

Following the imposition of the LRR on foreign exchange liabilities in November 2014, commercial banks started taking short positions, i.e. sold the foreign exchange to the market, as much as they could in order to gain from further expected appreciation of the Kwacha during the tobacco selling season when they could buy back from the market. This was augmented by the motivation to keep the liquidity reserve requirements as low as possible. This therefore provided platform for exchange rate appreciation during the first quarter of 2015 despite persistent demand pressures on the market. The Kwacha remained relatively stable for the most part of the second quarter of 2015 but depreciated significantly in July 2015. It traded at K512.1368 per United States dollar as at end July 2015, representing a depreciation of 16.1 percent from June 2015. 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 minor stability in September and October 2015 when the exchange rate appreciated by 0.5 percent and then depreciated by 0.8 percent, respectively. This recent spate of the weakening of the kwacha has largely reflected the strengthening of the United States dollar and other major currencies on the international market.

It is worth noting that the fluctuations in the exchange rate have been relatively higher this year compared to experiences of 2014. Noticeably, excess demand for foreign exchange arose when commercial banks started unwinding short positions i.e. replenishing foreign exchange which they had sold to the market just before the on-set of the tobacco selling season. Panic buying of foreign exchange ensued and consequently bid up the competitive market exchange rate. This was exacerbated by the perceived lower realization from the tobacco marketing season. Excess demand pressures also emanated from panic payment of bills by importers to take advantage of the relatively lower par value of the kwacha on the market. On the other hand, FCDA holders pulled to the other side by holding on to their balances with the aim of making profit. A combination of these factors resulted in earlier than expected exchange rate depreciation and increased exchange rate volatility.

4.0 Inflation Projection Path up to June 2016

In view of the current trends, it is expected that headline inflation will stand at 26.2 percent in December 2015. With a better crop in the 2015/16 growing season, inflation is forecasted to decline to 19.3 percent in June 2016. However, this inflation rate is higher than the government's target of 14.2 percent. Hence, monetary policy will have to be tighter in order to bring down the higher inflation projection in line with government's aspirations.

5.0 Monetary Policy Direction for the Current Fiscal Year

5.1 Policy Objectives and Monetary Policy Stance

The overriding objective of monetary policy in the near term is to rein in inflation and stabilize expectations and exchange rate volatility. Given that headline inflation had significantly risen up to the fourth quarter of 2015 (between April and October 2015) on account of food scarcity and exchange rate pressures that mounted following the importation of agricultural inputs in readiness for the readiness for the 2015/16 growing season, it is very likely that inflationary pressures will remain elevated in the first quarter of 2016. ***Therefore, monetary policy stance will remain tight in the coming months while ensuring sufficient foreign exchange reserves***

to support private sector activities. Increasing credit flows to the private sector will depend on reduced government recourse to domestic resources. The policy rate will be set to keep real interest rates positive (above inflation rate). The LRR will also be used proactively to moderate liquidity levels in the money market. Monetary authorities recognize that the current sources of the high inflation pressures emanate from the supply side bottlenecks than demand side fundamentals which tend to have second round effects on the overall process.

5.2 Projection of Monetary Aggregates

Commensurate with the 2015/16 national budget, the respective growth rates of broad money and reserve money in the monetary program will be set at 15.0 percent and 16.5 percent in March 2016. Meanwhile, the respective June 2016 projections for reserve money and broad money are set at 2.0 percent and 23.4 percent. Broad money growth is expected to be maintained at 21.3 percent in the calendar year 2016. This level of broad money growth is in line with the relatively higher growth envisaged in 2016, while inflation is expected to moderate in 2016.

5.3 Assessment of Risk Factors and Expected Direction of Monetary Policy

It is worth noting that rising food inflation experienced during the second and third quarter of 2015, the sharp exchange rate depreciation from July to December 2015 and expectations in the near term point towards further tightening of monetary policy. Inflation expectations will continue to be dictated by perception of fiscal budget implementation and the outlook for the food situation. The Bank will also continue to weigh the balance between demand and supply-side factors.

Box 1: Assessment of Risk Factors

There is continuing uncertainty about food availability on the market, resulting into noticeable speculation on food prices between April and November 2015 when inflation diverged significantly from its anticipated path. Should this speculation continue, inflation outturn for June 2016 may vary substantially from the set target of 14.2 percent. Therefore effective communication on the adequacy of food supplies in the country will be key to managing speculative expectations. Much of the actual impact of food deficit on inflation should ordinarily be felt during the lean season in the second and third quarter of 2015/16 fiscal year i.e. between November 2015 and February 2016. In August 2015, however, the Ministry of Finance, Economic Planning and Development made clarifications on the food situation in the country that the deficit will be done away with through procurement of maize through ADMARC using resources from a World Bank facility.

A second risk factor is the earlier than anticipated exchange rate depreciation. In July 2015, the kwacha depreciated sharply contrary to its seasonal pattern. Much as the year-on-year exchange rate depreciation stood at 11.6 percent in November 2015 which is below the average for the past three years, it was also noticed that it depreciated by 32.1 percent between March and November 2015 compared to a depreciation of 28.0 percent in the same period in 2014. This evidently implies that volatility increased in 2015. Consequently, inflation expectations have also increased in the near term. The combined effects of the exchange rate depreciation and volatility due to low export receipts following poor weather pattern and declining commodity prices alongside rising food prices is that underlying inflation may also rise.

Thirdly, implementation of the 2015/16 budget is in itself a potential risk to the attainment of price stability. In particular, the financing of budget deficit through increased government borrowing may pile further inflationary pressures.

5.4 Essential Role of Fiscal-Monetary Policy Coordination

Continued tight monetary policy and fiscal restraint are needed to contain aggregate demand, stabilize the exchange rate and prices, and boost international reserves. Over reliance on monetary policy to stabilize the exchange rate and contain inflation results in high real rate of interest that constrain private sector recovery. Hence, fiscal tightening is needed to support monetary policy while at the same time allowing domestic resource flows to the private sector.

Sustained fiscal restraint contributes substantially to lowering inflation expectations thereby reducing real interest rates. In this context, most helpful are government's continued efforts to explain management of the food situation and progress in the implementation of fiscal measures outlined in the budget statement.

6.0 Conclusion

The Bank is committed to use monetary policy to place inflation on a clear downward path. ***Therefore, monetary policy stance will remain tight in the coming months while ensuring sufficient foreign exchange reserves to support private sector activities. Increasing credit flows to the private sector will depend on reduced government recourse to domestic resources.*** To achieve this, the Bank will ensure that the Policy Rate remains above inflation rate. The Bank will also intensify its communication with commercial banks and other stakeholders to strengthen monetary policy transmission process and publicize commitment to regaining price and exchange rate stability. Monetary Policy Statements which the Bank will continue to issue, form part of RBM communication strategy and are intended to clarify policy decisions as well as evaluate past monetary policy decisions.

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