Reserve Bank of Malawi

MONETARY POLICY STATEMENT # 4

JULY 2016

Mzuzu Branch of Reserve Bank of Malawi: Officially opened on 25th May 2016

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 principal objective of the Reserve Bank of Malawi (RBM) is to attain price and financial stability. The RBM formulates and implements monetary policy to achieve low and stable inflation. This process is guided by Monetary Policy Statements (MPS). The current MPS reviews the Bank's implementation of monetary policy during the second half of the 2015/16 fiscal year – from January to June 2016 and seeks to inform the general public of the Bank's monetary policy stance for the rest of 2016 in line with government's fiscal stance outlined in the 2016/17 budget.

Inflation targets for monetary policy are ordinarily set by the National Economic Management Committee chaired by the Minister of Finance, 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 2017, as stated in the Budget Statement has been set at an average of 17.4 percent[1].

Monetary Policy Statement No.3 was fully implemented but with mixed outcomes. Foreign exchange reserves target of 3 months of imports was achieved. Nevertheless, although headline inflation started declining earlier than expected in January 2016, it also started accelerating earlier than usual in May 2016. Specifically, inflation declined from 24.9 percent in December 2015 to 20.9 percent in April 2016. The decline in headline inflation was largely due to developments in the non-food inflation following the tight monetary policy stance coupled with subdued oil prices on the international market. However, the declining trend was halted in May 2016 as inflation recorded an uptick to 21.5 percent and further up to 22.6 percent in June 2016, largely due to high food prices especially for maize following the drought experienced in the country for two consecutive years. Thus, the average headline inflation for FY2015/16 turned

[1] For monetary policy purposes, the average inflation rate contained in the government budget is used as a target level of inflation that must be achieved by the end of that fiscal year.

out to be 23.1 percent against a target of 16.2 percent as stated in the 2015/16 budget was therefore missed.

Against this background, the theme of this 4th MPS is *"Containing second round effects from food inflation and managing expectations."* According to estimates, about 6.4 million people (39 percent of the population) are food insecure. Government has however put in place measures aimed at managing the food situation. An amount of K35.5 billion in the 2016/17 budget was set aside for the procurement of maize. Furthermore, the authorities declared a national disaster in April 2016 and requested additional humanitarian assistance from development partners. Government efforts to ensure timely augmentation of maize stocks through imports is expected to tapper down food prices in the months ahead.

To complement these fiscal side activities, the Bank will continue to maintain a tight monetary policy in order to arrest second round effects from the rising food inflation and ensure that inflation remains on a declining trajectory during the second half of 2016. The Bank's communication strategy and interaction with stakeholders will continue in order to manage inflation expectations.

Going forward, the Bank will continue to maintain a minimum of 3 months of import cover in foreign exchange reserves in the medium-term. However, in the long term, the Reserve Bank of Malawi aim to achieve 6 months of import cover, which is also the SADC convergence criteria.

1.0 Introduction

The National Economic Management Committee (NEMC) under the leadership of the Treasury is responsible for the production of gross domestic product (GDP) growth and inflation rate projections that underpin the country's macroeconomic framework in a given year. The framework is generally announced by the Minister of Finance in the Budget Statement presented before Parliament. The Bank issues a Monetary Policy Statement to inform the general public about monetary policy stance consistent with the fiscal stance. In formulating policy, the Bank is more concerned with the projected inflation and its consistency with the planned financing of the budget deficit. In addition, the Bank focuses on attaining a desired long-term direction of the economy in terms of sustained economic growth and stable inflation rate. These are usually made in line with government's commitments to regional bodies such as SADC and COMESA.

In the 2016/17 national budget, Government continued with its fiscal program based on the assumption of no budget support from development partners. However, some off-budget support was expected. It is therefore critical to ensure that spending by Government is kept within available resources and efforts to enhance domestic resource mobilization remain a critical aspect in government operations. Key to the successful implementation of the budget will be a favourable inflation trajectory. With the expected continued inflationary pressures from the supply side due to limited availability of maize, it is paramount for monetary policy stance to remain tight in order to contain demand pull inflation and second round effects from the rising food prices.

1.1 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 sustainable economic growth and employment creation. The Bank also aims at building official 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 inflationary expectations in the economy.

1.2 Description of Monetary Policy Framework

The Bank uses an interest rate based monetary policy framework. Under this framework, a change in the policy stance is communicated by changing the policy rate. However, monetary aggregates are still discussed and agreed in the context of the ECF program with the IMF. The 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 broad money supply.

Excess reserves are a portion of commercial banks' 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 signify downward pressure on interbank rates, weakening the effectiveness of the policy rate. Therefore, the Bank implements measures that are aimed at keeping excess liquidity at levels that support keeping the Inter-Bank Market Rate (IBR) and the Treasury Bills (TB) rate within a defined corridor of the policy rate.

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).

1.3 Instruments for Monetary Policy

The Bank pursues its monetary policy objectives using a variety of instruments that include the Policy Rate, open market operations (OMO), foreign exchange market operations, the liquidity reserve requirement (LRR) and Communication.

- The **Policy rate** is the bedrock of monetary policy. It is reviewed and announced by the Monetary Policy Committee (MPC). Movements in the Policy rate, both in direction and magnitude, signal the monetary policy stance. A reduction in the Policy rate signals an easing of monetary policy and a desire for market interest rates to move downwards.
- In order to further enhance policy effectiveness, the **Lombard facility** was introduced. The Bank provides liquidity to commercial banks through this facility. The Lombard rate is maintained at 2 percentage points above the policy rate.
- **Open market operations** refer to actions by the RBM through purchases and sales of eligible securities to regulate money supply and credit conditions in the economy. OMO is also used to stabilise short term interest rates. When the RBM buys securities on the

open market, it increases commercial banks' reserves, making it possible for them to expand their loan portfolios thereby increase money supply.

- The RBM can also inject or withdraw liquidity into or from the banking system by engaging in **foreign exchange transactions**. A sale of foreign exchange to banks withdraws liquidity from the system and vice versa. The RBM however does not participate in the foreign exchange market to defend a particular value of the Kwacha but may intervene to moderate excess volatility.
- The **Liquidity Reserve Requirement (LRR)** is a proportion of deposits by commercial banks' clients that must be placed at the Reserve Bank. An increase in the LRR signifies RBM intention to withdraw liquidity from the system and the opposite is true.
- The Bank also uses **communication** with its stakeholders and the general public in order to disseminate monetary policy decisions more widely thereby increasing efficiency of the monetary policy transmission.

2.0 Assessment of Monetary Policy Implementation during first half of 2016

The main objective of monetary policy as contained in the MPS III and in line with the 2015/16 was to bring inflation down to 16.2 percent[2] by June 2016, despite initial projections of headline inflation of 19.3 percent for the same period. International reserve coverage was set at a minimum of 3.0 months of import cover for the period between January and June 2016.

From the last issue of the Monetary Policy Statement in January 2016, the MPC met twice to review developments in the domestic and global economies and decide on the course of monetary policy. During both sittings, the committee maintained the policy rate at 27.0 percent. The liquidity reserve requirement was also maintained at 7.5 percent and so too the premium of the Lombard rate over the monetary policy rate was maintained 2.0 percent. Short term outlook

[2] This target was later revised during the Mid-Year Review of the National Budget in January 2016 to 16.2 percent

which indicated that upside risks to inflation in 2016 were prominent in the second half of the year, hence the maintenance of a tight monetary policy stance during the first half of 2016.

Liquidity forecasts guided the conduct of open market operations. This largely entailed smoothening out the path for monetary aggregates so that they remain within their programed trajectory. During the period from January t June 2016, net government operations injected K165.1 billion into the banking system. The Reserve Bank withdrew K15.2 billion through foreign exchange operations and K129.1 billion through open market operations, resulting into a net injection of K35.9 billion.

Communication with stakeholders on monetary policy issues included Governors' meetings with CEOs of commercial banks, the third MPS released on 6th January, 2016 and several press statements which were made to clarify on emerging issues particularly those on exchange rate developments that were perceived to jeopardize the inflation objective.

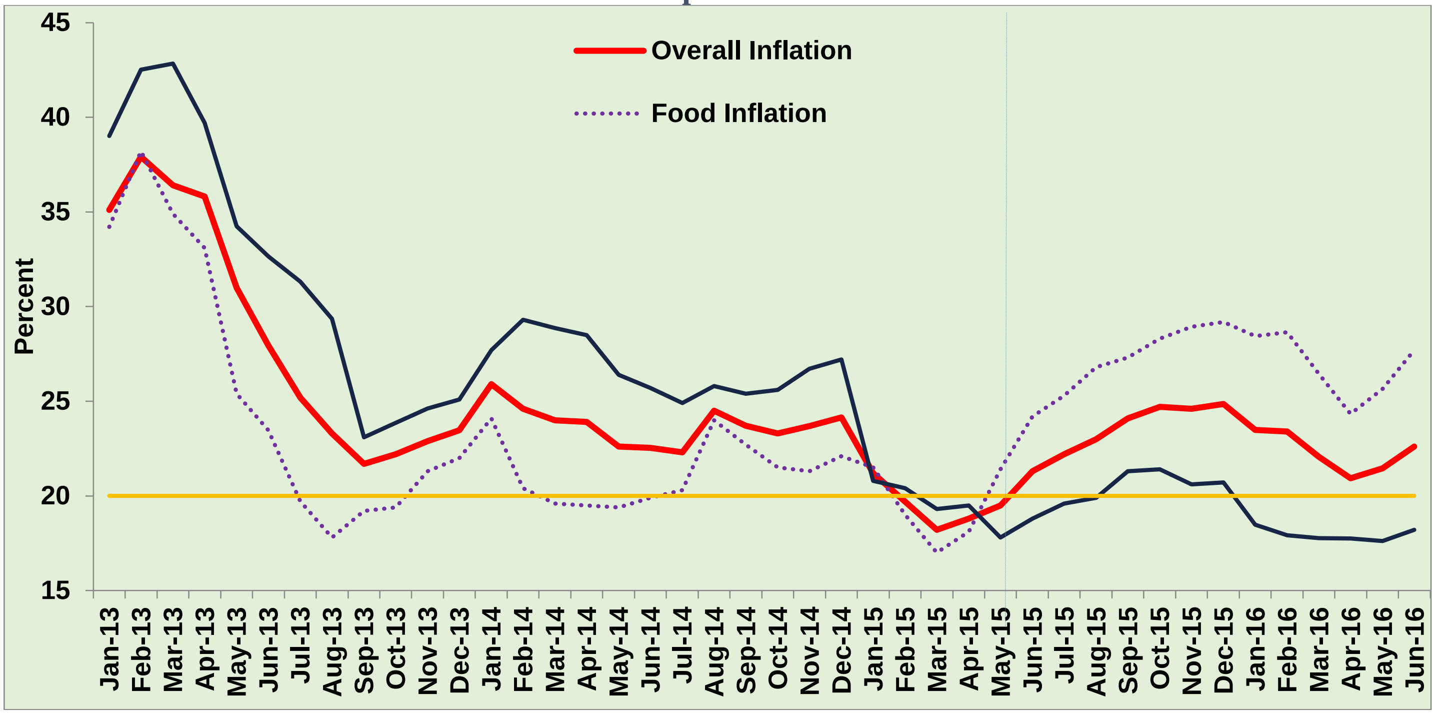
3.0 Assessment of Policy Outcomes

3.1 Review of Inflation Developments since January 2016

Considerable disinflation was recorded between January and April 2016. Headline inflation declined from 24.9 percent in December 2015 and troughed at 20.9 percent in April 2016. However, this trend was reversed in May 2016 as headline inflation stood at 21.5 percent, and rose further to 22.6 percent in June 2016. The slowdown was largely attributed to a sizeable disinflation in non-food inflation whilst food inflation slowed down albeit moderately save for June 2016 when non-food inflation edged slightly upwards partly reflecting the upward adjustment of fuel pump prices. It is worth noting that food inflation has continued to keep overall inflation high since April 2015. Notably, overall inflation has been hovering within the 20.0 to 25.0 percent range since August 2013, save for the period from February to May 2015 when it ranged between 18.2 percent and 19.7 percent (*see chart 1 below*).

Containing second round effects from food inflation and managing expectations

Chart 1: Inflation developments Jan 2013 – June 2016



Box 1: RBM has successfully controlled Non-food Inflation

The chart above shows that non-food inflation has fallen from 42.8 percent in March 2013 to 17.6 percent in May 2016, whereas headline inflation has fallen from 37.9 percent to 21.5 percent. Before May 2015, headline inflation was anchored high by non-food inflation. After May 2015, food inflation has been persistently higher than non-food inflation. Monetary policy is not well suited to dealing with food inflation as its instruments employ demand management, whereas food price shocks come mainly from the supply side.

Evidence points to the non-durability of spillover effects from food inflation to non-food inflation. However in a situation where food expenditures by an average Malawian household constitute 50.2 percent of the inflation basket and where the shocks to food supply are repetitive, the spill-over effects from food inflation to non-food inflation are persistent and significant. It is thus important to use monetary policy to control the feedback effects from non-food inflation to food inflation, which empirical work shows to be durable.

Put differently, the Bank cannot ignore food inflation. However, it is useful to recognise that monetary policy cannot directly control food inflation because its sources are largely controlled by climatic conditions like rainfall distribution. In this regard, the role of the Bank in the formulation of monetary policy becomes limited to managing food price expectations by communicating appropriately to the general public. Over and above this, monetary policy attempts to control the subsequent increases in overall inflation. The Reserve Bank therefore has systematically done this by maintaining a tight monetary stance whereby it sets the policy rate above inflation. The beneficial outcome from this initiative are evidenced by the declining trend on non-food inflation. The overall inflation would therefore have been much lower if food inflation had also taken this trend.

The inflation outcome for June 2016 at 22.6 percent, meant that RBM missed the inflation target of 14.2 percent by a wide margin. The RBM projection of 19.3 percent was also missed. For the two years – 2015 and 2016, inflation trends have been contrary to their seasonal pattern, picking up in around May or June which are the main harvesting and crop marketing months, as opposed to during the after-marketing season in September or October.

One notable reason for this change in the seasonal pattern is that the two consecutive years with unfavourable climatic conditions have heightened speculative behaviour in both the food and foreign exchange markets. Speculation and panic buying as well as hoarding have resulted into excessive pressure on prices and the exchange rate before actual scarcity of food items and foreign exchange kicks in, hence an earlier than normal reversal of the downward inflationary trajectory. The lagged effects of the Kwacha depreciation between July 2015 and February 2016 coupled with rising food prices are the main reason for missing the inflation target.

3.2 Official Foreign Exchange Reserves Developments since January 2016

On average, during the first half of 2016, the Bank maintained gross official reserves above its target at a minimum of 3 months of prospective imports though at times, reserves fell below the set target (in April and May 2016) following RBM interventions in the market to ensure Kwacha stability. . As at end June 2016, gross official reserves represented 3.1 months of imports. The sufficiency in gross official reserves gave monetary authorities more flexibility to intervene in the foreign exchange market in order to absorb adverse shocks.

3.3 Exchange Rate Developments since January 2016

The foreign exchange market was relatively stable during the six months to June 2016. The Kwacha depreciated by around 2.3 percent from January to February 2016 before appreciating by 7.2 percent in April 2016 to trade at K692.31 per US$. Thereafter, the Kwacha depreciated again to trade at K719.18 per US$ by the end of June 2016. On a longer term basis, the Kwacha depreciated by more than 50 percent from July 2015 to June 2016, a trend similar to experiences in some countries in the region that was largely attributed to the strengthening of the US dollar. For the Malawi Kwacha, it was likely that negative expectations played a role as IMF supported

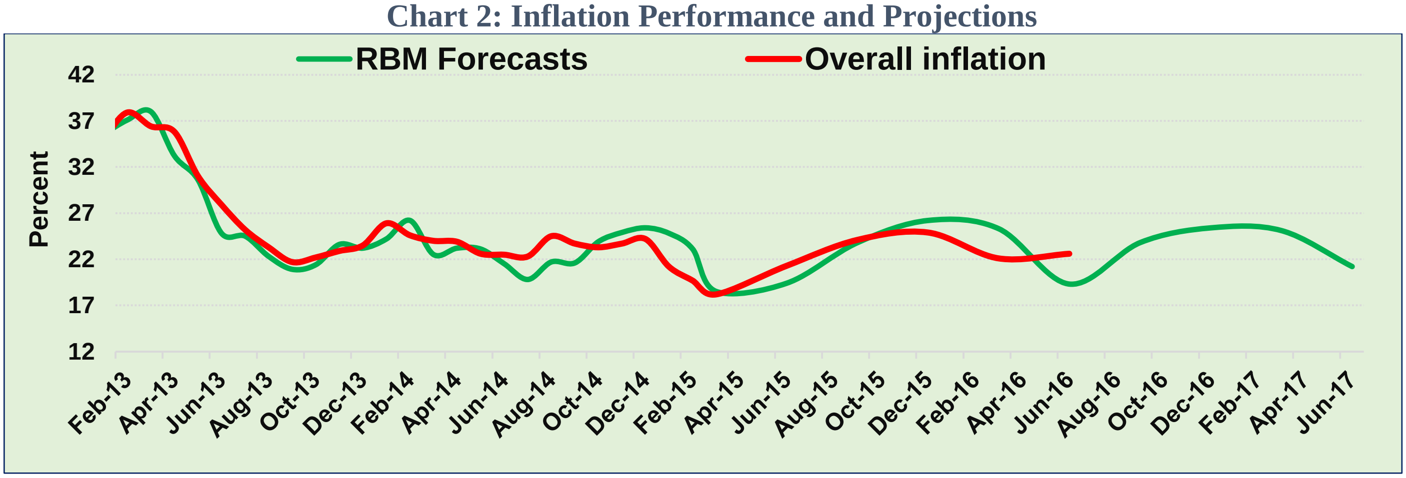
ECF program went off-track. The Bank periodically intervened to dampen volatility, while allowing the kwacha to move in line with market conditions.

4.0 Objectives of Monetary Policy Statement Number IV

4.1 Inflation targets during the 2016/17 fiscal year

The overriding objective of monetary policy in the near term is to rein in on inflation and stabilize expectations and exchange rate volatility. Specifically, monetary policy will aim to achieve a single digit inflation by 2018 and improve international reserve coverage to a minimum of six months of import cover within the same time period. Attaining this objective implies that headline inflation should broadly move in line with the Bank forecasts i.e. the single digit inflation is achievable if inflation outturn for December 2016 does not diverge significantly from the 25.4 percent projection. Authorities have also taken note that the current outturn has been exacerbated by high food inflation and this will continue to weigh negatively on the outlook for overall inflation especially in the second half of 2016. However, continued tight monetary policy through its money market operations, the Bank expects to limit the transitions of second round inflationary effects from food inflation to overall inflation.

Chart 2: Inflation Performance and Projections



Source: Reserve Bank of Malawi

For the 2016/17 fiscal year, monetary policy will aim at bringing down annual average headline inflation to 17.4 percent by June 2017 as stated in the budget. Meanwhile, current conservative projections from the Bank puts average headline inflation for this fiscal year at

22.9 percent with an end period inflation rate of 25.4 percent by December 2016. This calls for a continued tight monetary policy in order to achieve the targeted rate of inflation.

Box 2: Risk factors to inflation rate in the near term

- The economic outlook remains difficult in the face of uncertainties related to weather conditions, the on-going suspension of budget support, and the persistently high inflation. The major risk to the inflation trajectory for the remainder of 2016 is expected to emanate from rising food prices, reflecting a decline in domestic food production due to El Nino-induced drought. Government has firmed up that about 6.5 million people (39.0 percent of the total population) are food insecure this year, compared to 2.1 million people in 2015. However, food aid would somewhat help mitigate the militating food shortage speculations. Furthermore, the tight monetary policy stance that was implemented during the first half of 2016 is expected to contain second round effects of the rising food inflation.
- Additional risks arise from weaker global demand which could hurt Malawi's exports. The tobacco market outturn has been characterised with low prices and volume compared to the previous season. Cumulative tobacco prices as at 5th August 2016 averaged US$1.57 per kilogram, 11.7 percent lower than the price registered in a similar period in 2015. Total realization from tobacco sales amounted to US$185.8 million, lower than US$271.1 million realized during a similar period in 2015. Cotton output has fallen by about 33 percent to 15,000 metric tonnes relative to last year production largely due to the dry spell. This output will only bring US$2.3 million, from last year's US$13 million. Low export proceeds may lead to exchange rate instability and depreciation that might exert inflationary pressure especially on the non-food inflation. Its potency has multiplier effects manifested in the automatic pricing mechanism of fuel.
- The current account deficit is expected is widen substantially in 2016, due to higher imports of food supplies (about 13 percent of GDP) for humanitarian relief coupled with weak export performance. It is projected to remain in the range of 7 – 9 percent of GDP, reflecting the slow pace of export diversification, demand for imports associated with development projects and rapid population growth.
- Over expenditure in the 2015/16 budget as was evidenced by increased domestic borrowing, thereby increasing money supply in the economy is another source of risk that can eventually pile pressure on inflation. As of April 2016, the annual growth of money supply was at 25.7 percent, of which net credit to Government was a major determinant, responsible for 17.9 percent of the growth in money supply.

4.2 Foreign Exchange Reserves Target

In addition to the inflation target, the Bank will also aim at maintaining foreign exchange reserve coverage of at least 3 months of imports up to June 2017. In the long run to 2018, the Bank aims at attaining a 6 months of imports coverage in line with the SADC convergence criteria.

4.3 Projection of Monetary Aggregates

Commensurate with the 2016/17 national budget, the respective growth rate of broad money and reserve money in the monetary program were set at 16.7 percent and 19.8 percent by December 2016. Furthermore, private sector credit growth of 20.3 percent is estimated to be consistent with this monetary framework. Growth in credit to private sector, which has been negative in real terms since mid-2012, due to persistently high inflation, economic uncertainties, and tighter banking lending conditions, turned positive at the beginning of the year and stood at 4.7 percent in May 2016, compared to -5.6 percent in May 2015.

5.0 Essential Role of Fiscal-Monetary Policy Complementarity

The RBM will continue to work closely with Treasury to ensure the effectiveness of monetary policy through policy coordination. An appropriately tight fiscal policy is needed to support monetary policy actions aimed at containing aggregate demand, stabilizing the exchange rate and prices, and maintaining a sound international reserves position. This is feasible with timely performance monitoring on the execution of the budget by ministries and departments and appropriate communication with commensurate actions on management of the food situation in the country.

6.0 Conclusion

The RBM remains vigilant to risks posed by developments in both the domestic and global economies on its overall price stability objective. The Bank is committed to use monetary policy to place inflation on a clear downward path as well as manage second round effects from food inflation. To this end, the Bank will ensure that the policy rate remains above overall inflation. The Bank will also intensify its interaction with stakeholders in the financial and real sectors in order to strengthen monetary policy transmission process, obtain feedback, and publicize commitment to regaining price and exchange rate stability. Monetary Policy Statements which the Bank will continue to issue, form part of the RBM communication strategy and are intended to clarify policy decisions as well as evaluate past monetary policy decisions.

There are many challenges to monetary policy implementation going forward. The tobacco market in 2016 is relatively subdued in terms of both prices and volumes when compared to last year. This points to increased pressure on the exchange rate and reserves in the next six months. The situation might worsen after the close of the tobacco season. However, with the successful review of the implementation of the Extended Credit Facility and the subsequent disbursement of US$76.8 million as approved by the IMF Board, it is hoped that this may cushion foreign exchange reserves position. A further positive observation is that exchange rate volatility has also subsided during the second half of 2016. Specifically, the monthly standard deviation for the daily exchange rate which was double digit during the fourth quarter of 2015 and first quarter of 2016 has declined to 1.1 points as of June 2016.

It is very clear that food inflation will dictate overall inflation developments in the next six months to December 2016. Inflation is expected to trend upwards due to rising food prices and the expected depreciation of the Kwacha. Therefore, in its monetary policy formulation, the Reserve Bank of Malawi will focus on containing second round effects from food inflation to headline inflation. The Bank will also intensify its communication on monetary policy issues to ensure well informed decision making process by market players in order to manage and contain inflationary pressures through ill-informed expectations. This, supported by timely and efficient management of the food situation, as well as exercising prudence in government expenditure should help in ensuring a declining inflation trajectory into 2017.

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