# Reserve Bank of Malawi

MONETARY POLICY STATEMENT # 5

*JUNE 2017*

## 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 |
| MoF | Ministry of Finance |
| 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 |
| 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

Malawi stands at a critical juncture following its recent progress on macroeconomic stability. The fifth monetary policy statement is being released against the backdrop of sharply declining inflation, a relatively more stable exchange rate, and manageable pressure on international reserves. In the second half of 2016, inflation came down much more rapidly than anticipated. The decline continued into the first and second quarters of 2017 as headline inflation reached 12.3 percent in May 2017. To date, headline inflation has declined consistently for ten consecutive months. This remarkable achievement is attributed to the tight monetary policy and the consequent stability of the Malawi Kwacha exchange rate as well as management of speculative pressures through timely communication especially on Government's efforts to address the food gap. Noticeably, the February 2017 Inflation Expectations Survey revealed that the market has toned down both its inflation and exchange rate expectations compared to results from the same survey in November 2016.

Headline inflation declined to a five-year low of 12.3 percent in May 2017. Core inflation -as measured crudely by the non-food component of the consumer price index (CPI) basket -fell to 14.5 percent at the end of the first quarter of 2017 from 17.8 percent at the end of 2016 first quarter and to 13.5 percent in May 2017. Similarly, food inflation declined steeply from 26.5 percent at the end of first quarter of 2016 to 14.7 percent at the close of 2017, first quarter and 11.2 percent in May 2017.

Despite gains on the inflation side, international reserves marginally slipped below their programmed threshold of 3.0 months of imports. International reserve coverage declined from 2.9 months of imports in December 2016 to 2.6 months of prospective imports in March 2017 but recouped to 2.9 months in May 2017 as the Reserve Bank purchased foreign exchange from the market. Important to this objective of building reserves is the preservation of the flexible exchange rate regime which has served the economy very well since 2012. To this effect, RBM's consistent application of a tight monetary policy, increased market confidence, coupled with the relatively low demand for foreign exchange guaranteed stability of the exchange rate.

Looking ahead, monetary authorities envisage continued slowdown in inflation and projects inflation at 10.7 percent and 8.5 percent in June and December 2017, respectively. Meanwhile, the upside risks are all at anticipated manageable levels. The Bank will continue supporting the disinflation by keeping the Policy rate above headline inflation.

## 1.0 Introduction

The fourth monetary policy statement was implemented with mixed results. At 12.3 percent in May 2017, inflation was below its anticipated path whilst international reserves declined albeit marginally, to close 2016 at 2.9 months of imports. The reserves dipped to 2.6 months in March 2017 but rebounded to 2.9 months in May 2017. The fourth statement had set an inflation target of 25.4 percent for December 2016 and import cover of 3.0 months. At 20.0 percent, the December 2016 headline inflation was 5.4 percentage points lower than its target. To achieve this, authorities maintained a tight monetary policy stance by keeping the Policy Rate (PR) above headline inflation as well as ensuring that the inter-bank market rate (IBR) always remained close to the Policy rate. Keeping the IBR close to the PR fostered tight liquidity conditions in the money market, thereby reducing pressure on the exchange rate.

For the most part, the Bank used open market operations and operations in the official foreign exchange market as instruments of monetary policy. During the fourth MPC meeting in November 2016, the Policy Rate was adjusted downwards by 300 basis points to 24.0 percent, and was further adjusted downwards by 200 basis points to 22.0 percent during the first MPC meeting of 2017. This was against the backdrop of consistently falling inflation during the second half of 2016 and the first quarter of 2017. This notwithstanding, the Policy Rate reduction was seen not to jeopardise the June and December 2017 expected inflation outturn as projections remain on a declining trend. Though the falling inflation was observed on both food and non-food inflation, the stability of the exchange rate contributed significantly to the stability in prices in general. Therefore, the marginal decline in foreign exchange reserves did not compromise the overall monetary policy objective of containing inflation.

End-period headline inflation target[1] for monetary policy is 12.3 percent in December 2017. Meanwhile, the import cover target remains 3.0 months. However, the Bank projects headline inflation at 10.7 percent and 8.5 percent in June and December 2017, respectively.

The fourth monetary policy statement had a theme *"containing second round effects from food inflation and managing expectations."* This was based on the assessment that the major threat to the inflation outlook was runaway food prices, which were in turn adversely affecting expectations. The disinflation in the second half of 2016 and first quarter of 2017 reversed the hostile outlook and now points to more favorable prospects. It is against this background that the fifth monetary policy statement carries the theme of *"Maintaining the declining path of inflation."*

## 2.0 Assessment of Monetary Policy Implementation in the Second Half of 2016

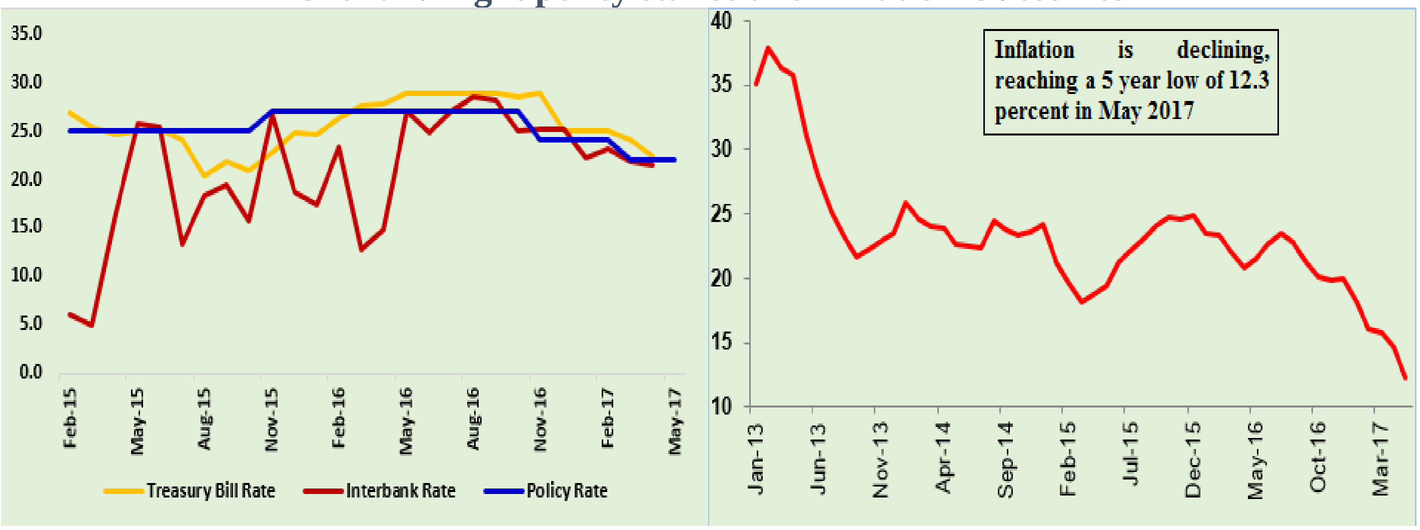
### 2.1 Objectives of the Fourth Monetary Policy Statement

The fourth monetary policy statement had a medium term target, i.e. by 2018, of single digit headline inflation and a minimum international reserve coverage of at least six months of import cover. From the date of issuing the fourth monetary policy statement, the Monetary Policy Committee met three times, on 29th July 2016, 24th November, 2016 and 24th March 2017 to review the outcome of its previous policy decisions and examine prevailing economic developments in order to put in place appropriate measures to maintain price stability. While the policy rate (PR), Lombard rate and liquidity reserve requirement (LRR) were maintained during the July 2016 MPC sitting, the November 2016 and March 2017 MPC sittings resolved to revise downwards the Policy Rate by 300 basis points to 24.0 percent and by 200 basis points to 22.0 percent, respectively, in line with declining inflation expectations. This was also aimed at stimulating the real economy through a corresponding reduction in commercial

[1] As set out in the macroeconomic framework for the national budget.

banks' nominal lending rates. Consequently, the Lombard rate was also revised downwards by the same margins. The LRR ratio remained unchanged in all sittings at 7.5 percent.

**Chart 1: Tight policy stance and Inflation Outcomes**




*Source: Reserve Bank of Malawi and National Statistical Office*

Interbank rates responded to the tight liquidity conditions and remained close to the policy rate of 22.0 percent. It suffices to note that the policy rate has been kept positive in real terms throughout the period. The Treasury bill rates also converged towards the policy rate, as further evidence of tight monetary policy stance. As expected therefore, inflation steeply slowed down over this interest rates convergence period.

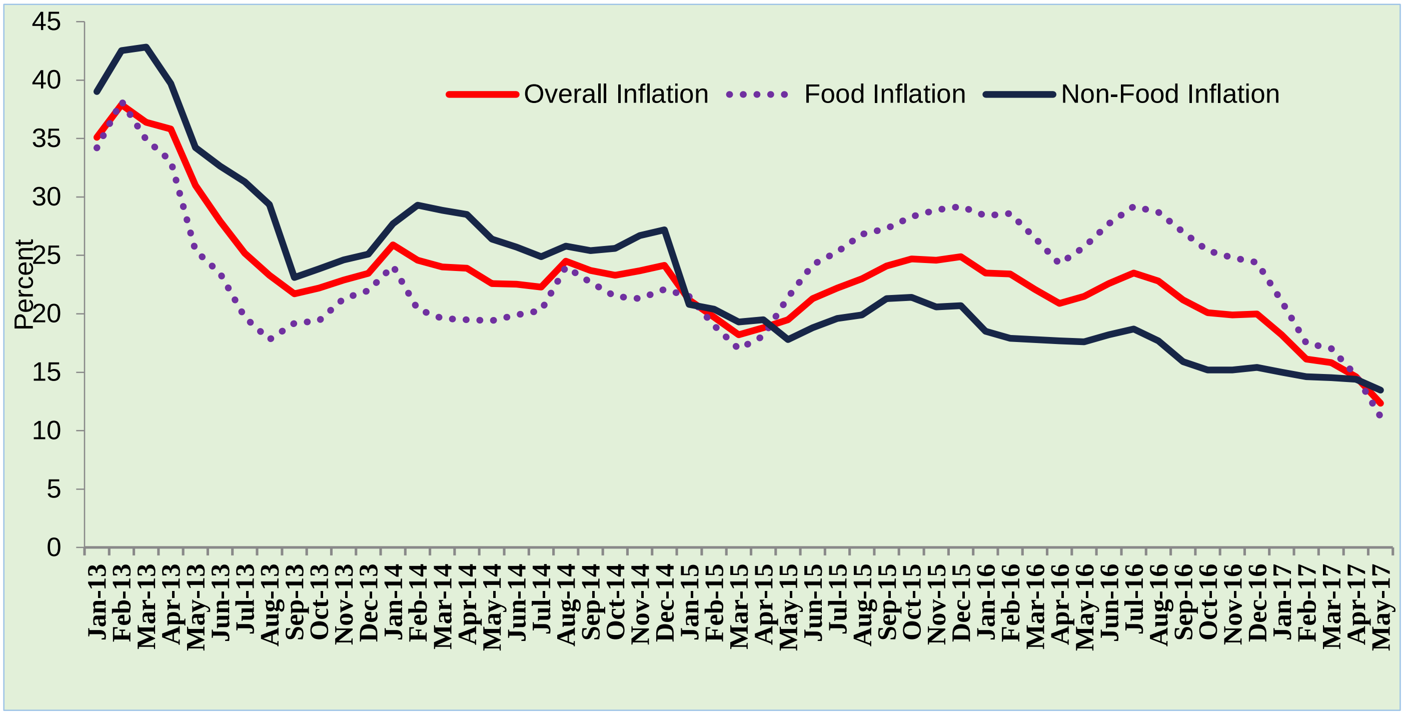
**Table 1: Assessment of Objectives of Fourth Monetary Policy Statement-Dec 2016**

| | **Target** | **Outcome** | **Verdict** |
|---|---|---|---|
| *Headline Inflation (%)* | 25.4 | 20.0 | Met |
| *International Reserves (months of imports)* | 3.0 | 2.9 | Near miss |

## 2.2 Inflation Outcome

Headline inflation outlook at the time of publishing the fourth monetary policy statement was that inflationary pressures would persist due to adverse effects of the droughts which had hit the economy for two consecutive years. To the contrary, inflation only peaked at 23.5 percent in July 2016 and has since declined consistently to 20.0 percent in December 2016, and further down to 12.3 percent in May 2017. This is explained by developments in both food and non-food inflation components, with a more noticeable disinflation in food inflation.

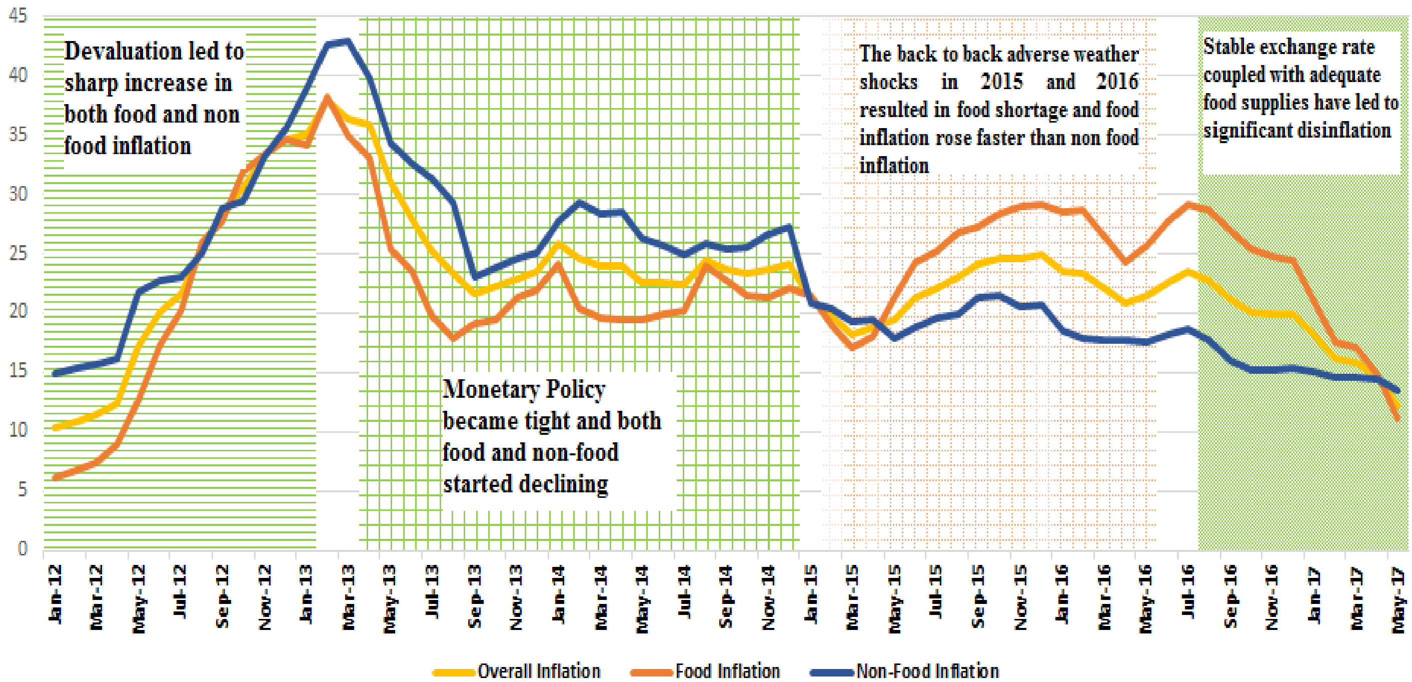
**Chart 2: Inflation Developments: January 2013 and May 2017**




*Source: National Statistical Office*

The disinflation has been supported by three factors: tight monetary policy stance; food shortage management of 2016; and communication which moderated speculation on both maize pricing and the exchange rate. The interventions on food gap management included timely publicizing of planned importation of maize and declaration of state of national disaster by the State President as well as a call for humanitarian assistance from development partners who responded positively. The communication helped to moderate speculation, panic buying and hoarding of maize which could have piled pressure on prices on the market. Maize prices have been stable since June 2016 in line with increased importation and distribution of humanitarian food items by development partners.

**Chart 3: Inflation Developments: January 2012 and May 2017**

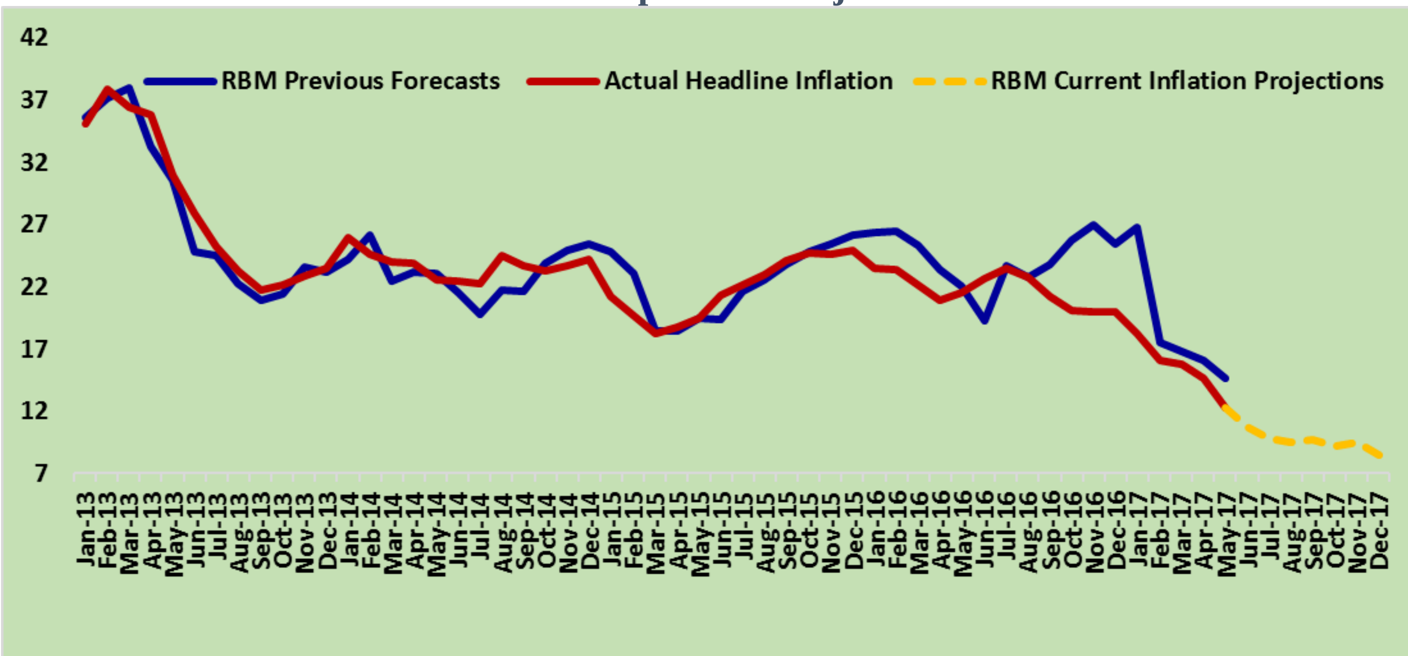



*Source: National Statistical Office*

Similarly, the Bank supported the foreign exchange market by timely communications about foreign exchange reserves developments with the authorized dealer banks (ADBs). The exchange of information with ADBs yielded positive results as evidenced by continued stability of the kwacha without speculative attacks.

Inflation has consistently undershot the Bank projections between July and December 2016 *(see Chart 4 below)*. This implies relatively moderate inflationary pressures in 2017, in sharp contrast to a relatively gloomy case at the beginning of 2016. Assuming no any unexpected negative shocks in the months ahead, inflation is expected to continue declining gradually, reflecting seasonal improvement in food supply, stability of the exchange rate, and low international oil prices. Then headline inflation will steadily converge to single digit by fourth quarter 2017.

**Chart 4: Inflation Developments: Projections versus Actual**




*Source: Reserve Bank of Malawi and National Statistical Office*

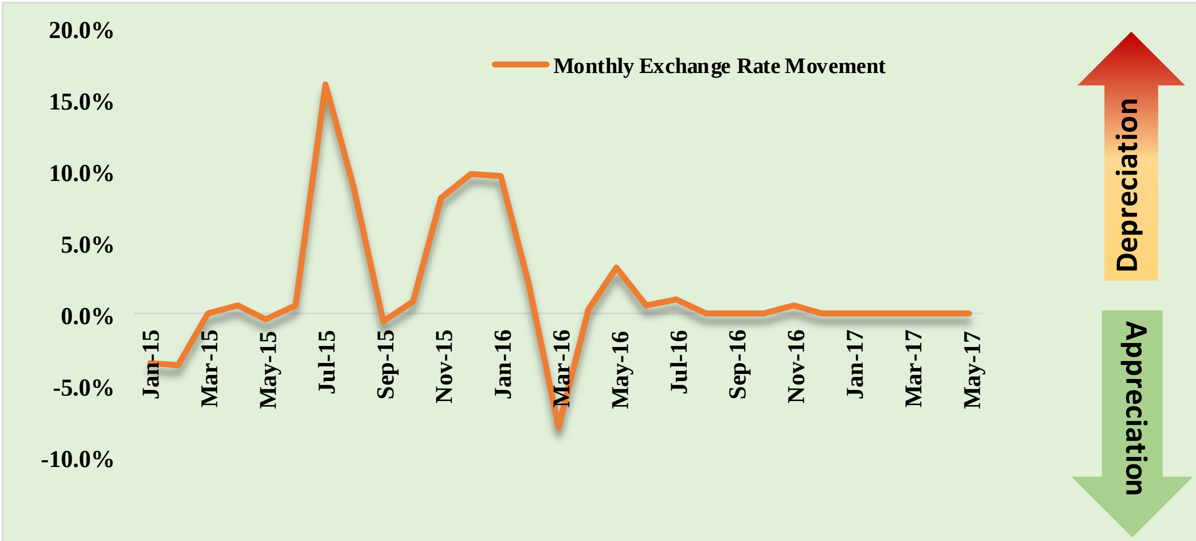
### 2.3 Official Foreign Exchange Reserves Developments since July 2016

Broadly, international reserves have been maintained at programmed levels of at least 3.0 months of import cover since July 2016 save for the last quarter of 2016 when they were at 2.9 months and during the first quarter of 2017 at 2.6 months of imports. The underperformance was attributed to the lower than expected export receipts due to the poor agriculture season. However, the Reserve Bank accumulated reserves to 2.9 months of import cover as at end-May 2017, following purchases from the market. Meanwhile, the market remained confident with the liquidity levels as evidenced by continued release of foreign exchange on to the market even during the lean period. Demand also declined symbolizing the tight monetary policy stance maintained by the monetary authorities.

### 2.4 Exchange Rate Developments since July 2016

The exchange rate was relatively stable during the second half of 2016 and first three months of 2017, supported by low kwacha liquidity levels and relatively less demand for foreign exchange. As noted from Chart 2 below, the monthly exchange rate movements were much smaller during the period compared to similar period in 2015.

**Chart 4: Monthly Exchange Rate Movements between January 2015 and May 2017**




*Source: Reserve Bank of Malawi*

Despite the exchange rate stability, the Malawi kwacha depreciated albeit marginally against the United States dollar, South African Rand and the Zambian kwacha but appreciated against the Pound sterling and Euro after the BREXIT vote. The local currency depreciated by 1.7 percent to K725.0093 per US dollar at the end of December 2016. As at 28 April 2017, the kwacha traded at K726.3108 per US dollar.

## 3.0 Objectives of the Fifth Monetary Policy Statement

Monetary policy will continue to be geared towards achieving price stability and a single digit by the end of 2017, supporting a build-up of international reserves, and providing room for sufficient credit to the private sector. The fifth monetary policy statement will therefore aim at attaining an end-of-period inflation rate of 8.5 percent in December 2017. The Bank will also continue to aim for a minimum of three (3) months import cover in foreign exchange reserves.

## 4.0 Risks to the 2017 Inflation Outlook

The outlook remains broadly positive. Following the good agriculture season and the subsequent expected bumper yield, inflationary pressure from the food component has actually subsided significantly. As is usually the case, this will also have positive spillover effects to the non-food inflation.

However, the outlook is subject to some negative risks. Weaker global demand could lead to lower prices for Malawi's export commodities and an eventual pressure on the kwacha. Therefore, developments in the export market and their implications for the domestic economy will be carefully monitored. The 2016/17 tobacco season was marred by low prices which could adversely affect the 2017/18 season's supply of foreign exchange. The comfort is that demand for foreign exchange remained subdued even during the lean season and is expected to remain so during the rest of 2017 which implies that the current levels of foreign exchange can adequately accommodate such pressures.

Suffice to note that the November 2016 pump price hike had a subdued effect on overall inflation between December 2016 and April 2017. Meanwhile, the recent decision by OPEC and non-OPEC member states to cut crude oil production in a bid to stabilize international oil prices will exert pressure on domestic pump prices in the medium to long term as it will likely affect the In-Bond Landed Cost of fuel which is one of the triggers of the automatic pricing mechanism. However, the international oil prices are currently below a trigger price of US$60.0 per barrel and expected to remain below this level for the rest of 2017 according to projections by British Petroleum (BP).

## 5.0 Conclusion

Monetary policy stance will aim at cementing low inflation expectations while exploiting the scope for further gradual easing. The objectives set out in the fourth monetary policy statement were met with a near-miss on international reserves. Inflationary pressures have eased due to developments in food inflation aided by tighter monetary conditions and stable exchange rate. It is generally expected that headline inflation will continue to decline in 2017 on account of a better harvest and stability of both the exchange rate and international oil prices.

International reserves narrowly missed the 3 months of import cover objective as they stood at 2.9 months of imports in May 2017. The exchange rate remained relatively stable compared to its performance in 2016.

Inflation is currently projected to reach 10.7 percent in June 2017 and 8.5 percent in December 2017. Rapidly declining inflation create room for gradual easing of monetary policy. The precise path of monetary easing will remain data-dependent while being conditional on inflation being on track to reach its target of 12.3 percent or below by December 2017. The Bank will continue supporting the disinflation process by keeping the Policy rate above the headline inflation. In parallel, the Bank will continue improving its communication with market participants and the general public to convey its commitment to price stability and enhance the transparency and credibility of its monetary policy to better anchor inflation expectations.

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