SPEECH

BY

THE GOVERNOR OF THE RESERVE BANK OF MALAWI

Mr CHARLES CHUKA

AT A

BUSINESS DINNER ORGANISED BY MCCCI

10TH AUGUST, 2016

- The MCCCI President, Mr Karl Chokoto
- Co-Convenors
- Councillors
- The Chief Executive of MCCCI, Mr Chancellor Kaferapanjira,
- Business Captains
- Distinguished Ladies and Gentlemen

I thank you for organizing this dinner and for your presence. I do hope my remarks will give you some hope and enlighten your week-end.

Mr President, you have clearly outlined the issues which the Chambers view as real bottlenecks to private sector growth. And I want to thank you for making my job a difficult one. In the interest of time, I will not attempt to repeat what you said. I will just try to respond to the issues and in so doing prove hopefully that I am worth the dinner.

I want to start by reminding ourselves that the mandate of the Central Bank is very clear and specific, and that is attainment of price and financial stability. Consistent with that twin objective, we are responsible for the country's foreign exchange reserves to preserve the value of the Kwacha, the issuance of currency, banker to government, and supervisor/regulator of the financial system. The legal framework provides for operational independence of the Bank with a proviso that we will do so in the national interest.

The pursuit of financial stability is through the control of developments in money stock, defined as currency in circulation and deposits in the banking system. The instruments used are the Policy Rate and Liquidity Management instruments. Through consistent use of these instruments, money stock as a ratio of GDP has been brought down from 24% in 2012 to just under 20%. On the asset side, gross credit to the private sector has contracted from 14% of GDP in 2012 to about 10% and so stands at about K400 billion. Banking system's net lending to government picked at 5.5% of GDP in 2013/14 fiscal year and dropped to 2% in 2015/16. However, government domestic debt to GDP ratio which had declined to10% in 2012/13, rose to 14% in 2014/15 before moderating to 13.2 in 2015/16.

The tight monetary policy stance we have pursued has helped to attain a reasonable level of foreign exchange reserves. As a matter of fact, reserves of the banking system now stand at $748 million end-May from just $223 million (excluding payments arrears) same month in 2012. This has assisted to improve the country's international credit rating, thereby reducing external borrowing and trade financing costs for the private sector. Indeed, Malawi now borrows internationally at between 6% and 9% in dollar terms. This is comparable to rates on sovereign bonds issued in some African countries. I need not mention how improved access to foreign exchange is enabling businesses to import inputs, remit loan interest, dividends and pay for other services.

The effectiveness of monetary policies should also be seen in the fact that although the Kwacha depreciated by as much as 320% from April 2012 or 162% percent from May 2012, the general price level in the economy has only increased by 101%. Thus, Kwacha depreciation has not been passed on to domestic prices fully. In other words, if monetary policies were too accommodative, inflation would have been much higher, with serious ramifications to our wellbeing.

Thus, the current level of interest rates reflect both the Reserve Bank's efforts to contain monetary expansion and increase foreign exchange reserves. High interest rates also reflect the increase in government recourse to domestic resources. The recent moderation is highly commendable as it demonstrates government's commitment to macroeconomic stability as a foundation for sustainable growth and job creation. Continued decrease in government domestic debt to GDP ratio should facilitate monetary easing and a reduction in interest rates in future.

There's no denying that the high interest rates have contracted the private sector and inhibits investments which this country needs to grow. In a way I am arguing that this squeeze was inevitable given the amount of borrowing government needed in the wake of three major shocks: cashgate and two droughts plus flooding. But I have also shown that all is not lost, the indications are that we are now getting closer to breaking the inflation cycle and to begin reducing interest rates. The timing of that reduction will be dependent on developments in food prices, especially if the 2016/17 growing season experiences normal rains. Indeed, we are looking at inflation averaging 16% in 2017 if the assumptions hold out.

The Chambers have also questioned Reserve Bank's independence. The contention is that an independent central bank would have prevented government from borrowing. That is true, up to a point. Firstly, it is not technically possible to stop government from borrowing because government cheques are encashed at commercial banks and IFMIS is not yet linked online to Government No.1 accounts. But work is underway to do so. Secondly, following the withdrawal of donor budget support, compounded by the fiscal pressures emanating from weather related shocks, the Reserve Bank took the view that government borrowing was in our national interest while recognizing that inflationary pressures would remain elevated for much longer than was anticipated in the economic reform program. But as stated earlier, we have been able to manage the liquidity situation appropriately. Moreover, the Reserve Bank's ability to implement consistently a tight monetary policy stance renders some credibility to our operational independence.

Mr President, Distinguished Ladies and Gentlemen, you all must be asking whether we have considered the merits and replicability of unconventional monetary policies as practiced in the US, Europe, and Japan. The short response is that we have; and as a matter of fact, we have implemented elements of unconventional policies, at a high cost.

You will recall how we prevented a major financial crisis in Malawi when we provided liquidity to the banking system in 2014. You may also regard the forbearance accorded to some ailing banks - giving them adequate time to restore capital ratios - as unconventional. Given inflationary pressures, the reduction in the LRR to narrow interest spreads could also qualify as unconventional monetary policy. These measures were not without cost but I think a collapse of the banking system would have contracted economic activity by much more than the high interest rates have done. I think the inflationary impact of the liquidity we created through these measures has now dissipated.

The fundamental question on the table is whether or not we need a shift in paradigm, or should we stay the course established prior to the global financial crisis (GFC) of 2008. To answer this question, I want to draw from Dr Ngozi Ikonjo-Ewela, the former Managing Director at the World Bank and former Minister of Finance in Nigeria, from her recent Golden Jubilee Joseph Mubiru Memorial Lecture (JMML) presented in Uganda. After discussing the practice of non-conventional monetary policy in the west, she discussed experiences in China, Brazil and India. In the interest of time, I will concentrate on Brazil and India.

"Between 2001 and 2008, Brazil painstakingly rebuilt its macroeconomic credibility by sustained adherence to old-fashioned policies, such as ramping up primary fiscal surpluses to improve debt dynamics. It created a good climate for private investment and promoted social inclusion and poverty alleviation. By the time the GFC occurred, macroeconomic volatility and high inflation appeared relics of the past.
"But after the GFC, Brazil took unorthodox steps to shore up growth. In addition to cutting the SELIC, the central bank's policy rate, by a huge 525 basis points between Aug 2011 and Oct 2012, a much bigger role was carved out for Brazil's National Bank for Economic and Social Development, BNDES, and other public sector banks, whose market share increased from 34% to 45% of total credit between Dec 2007 and July 2012. Various targeted tax breaks were also implemented as part of so-called rules-based industrial policy. There was obvious merit to some measures, such as some loosening of fiscal policy for a country which had earned an investment grade credit rating in 2008, and a push to increase private investment in infrastructure. But something clearly went wrong."

"Brazil's potential growth has dropped considerably with private sector confidence taking a beating. Actual growth came in at minus 3.6% in 2015 with minus 3.3% expected for 2016. The SELIC has been hiked to 14.25%, by far the highest policy rate among the world's large economies, at a time when most central banks are cutting rates. 2015 inflation came in at over 10%, well above the upper end of the target inflation range of 4.5% ± 2% with a similar inflation outcome expected this year." ...."Brazil's credit rating has been slashed substantially below investment grade and its proudest accomplishments, taming inflation and restoring sustainability to public debt dynamics, have been compromised. The country is now embroiled in a serious political crisis and corruption scandal involving Petrobras, with the President suspended in May amidst impeachment proceedings. "

"I come now to the case of India, which has clearly been doing things right while sticking to orthodoxy. Indian economic growth is one of the few bright spots in the global economy. India formally adopted an inflation targeting regime in March 2015, setting a target for CPI-based inflation of 4% with a band of plus or minus 2% beginning in the 2016/17 financial year. But this was preceded by meticulous preparation to build credibility under the Reserve Bank of India's Governor, Raghuram Rajan. Rajan took the helm of India’s monetary policy in 2013, a year which saw the county bracketed together with Brazil, Indonesia, Turkey and South Africa as the Fragile Five. The first challenge was to exit the Fragile Five by lowering the current account deficit, bolstering foreign exchange reserves by attracting dollar deposits from the Indian diaspora overseas and establishing RBI’s seriousness about lowering consumer price index- or CPI-based inflation, which was in double digits, by hiking rates; with wage awards being based on the CPI, India was rapidly losing competitiveness relative to China and other emerging markets. Rajan’s goal was simple: make the Indian Rupee a credible store of value, thus dulling the seduction of gold, and raise interest rates above CPI inflation, making rupee- denominated assets attractive. Intermediate targets were also set for inflation: less than 6% by January 2016, which was met, and less than 5% by January 2017."

"Rajan reminds us of the reasons why low inflation is important........ First, low and predictable inflation makes the currency a credible store of value. Second, the ones who benefit from negative real interest rates are rich industrialists and the Government, with the inflation tax hurting the middle class savers and the poor. Inflation is a tax that hurts the poor. But what struck me most is Rajan’s call for staying the course and adopting tried-and-tested orthodoxy—because it works. It enables sustained growth and lowers volatility. To quote him—and recall that he is a former IMF chief economist—“Decades of studying macroeconomic policy tells me to be very wary of economists who say you can have it all if only you try something out of the box. Argentina, Brazil, and Venezuela tried unorthodox policies with depressingly orthodox consequences."

Mr President, Business Captains, Distinguished Ladies and Gentlemen, I rest my case. I fully subscribe to Rajan's conclusions. This economy has been well served and catastrophe has been put off. Should rains return to normality during the 2016/17 season, and Treasury continues to reduce domestic debt/GDP ratio, we should expect a sharp drop in inflation to average 16% in 2017 and a significant drop in interest rates. When that day comes, the private sector will vindicate the central bank actions this far. Time for serious investment will come when policy consistency and coordination will have broken the inflationary cycle, bringing about much needed macroeconomic stability. In the long-term, the issue of food prices and export diversification will be addressed by private sector investment if the right sectoral and fiscal policies are put in place. These are matters for the fiscal authorities. We all need to join hands with them.

I am thankful to my team for their dedication to duty and I want to ask the private sector to trust the central bank. I thank you for this dinner and for your patience. I can now take questions.

I thank you all for your attention.

Charles Chuka