MONETARY POLICY REPORT

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Contents

The Reserve Bank of Malawi (herein 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) that extensively deliberates on macroeconomic developments and assesses the macroeconomic conditions and outlook, in order to decide on the appropriate course of monetary policy action. The Bank has a medium-term inflation rate objective of 5.0 percent with a symmetric band of 2.0 percentage points, such that all efforts are primarily 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, assess the recent economic developments and macroeconomic conditions, and outline the direction of monetary policy.

The Monetary Policy Committee

Dr. Wilson T. Banda, Governor **(Chairperson)**

Dr. Grant Kabango, Deputy Governor, Economics and Regulation

Mr. William Matambo, Executive Director, Corporate Affairs

Mrs. Audrey Mwala, Private Sector

Dr. Betty Chinyamunyamu, Private Sector

Dr. Levison Chiwaula, Academia

Dr. Kisu Simwaka, Director, Economic Policy and Research **(Secretary)**

INTRODUCTION

The Monetary Policy Committee (MPC), at its second meeting of 2021 held on 28th and 29th April, maintained the Policy rate at 12.0 percent; 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 MPC considered the need to support and sustain economic recovery, while at the same time managing upside risks to the inflation outlook.

Global growth is projected to recover from the COVID-19-induced recession. According to the World Economic Outlook Report of April 2021 by the International Monetary Fund (IMF), the global economy is projected to grow by 6.0 percent in 2021, following an estimated contraction of 3.3 percent in 2020. The projected recovery reflects the impact of fiscal stimuli in a few advanced economies and easing of the COVID-19 pandemic restrictions in most countries, following a successful rollout of coronavirus vaccines. Nevertheless, some countries are experiencing a surge in the number of cases for coronavirus infections, which poses a risk to the growth prospects.

Global oil prices averaged US$60.6 per barrel in 2021Q1, up from US$44.5 per barrel in 2020Q4. Prospects for the rest of the year indicate that oil prices will average US$58.5 per barrel in 2021, representing an annual increase of 42.0 percent. The rise in global oil prices reflects the impact of restrained production by the Organization of the Petroleum Exporting Countries (OPEC+) including Russia. In 2022, oil prices are expected to moderate to an annual average of US$54.8 per barrel and remain unchanged, in real terms, over the medium term.

On the domestic front, the COVID-19 pandemic continues to weigh heavily on economic activity. Nevertheless, the ongoing vaccination campaign, coupled with the above-average agricultural production during the 2020/21 season, as well as recovery of the global economy, provide optimism for economic turnaround. As such, domestic real economic growth is projected to strengthen to 3.8 percent in 2021, from an estimated growth rate of 0.9 percent in 2020.

The external position improved slightly during 2021Q1. The trade deficit improved to US$491.5 million in 2021Q1 from US$548.8 million in 2020Q4. Prospects for the near-term indicate that the trade balance could improve, mainly due to an increase in exports following the opening of the agricultural marketing season and a seasonal decline in imports of agricultural inputs.

The Malawi kwacha marginally depreciated by 2.2 percent against the US dollar in the first quarter of 2021. However, in the period ahead, exchange rate pressures are expected to moderate, on account of the realization of export proceeds during the agricultural marketing season.

Headline inflation rose to an average of 8.5 percent in 2021Q1 from 7.5 percent in the fourth quarter of 2020. The increase was driven by non-food inflation, which accelerated to 6.3 percent in 2021Q1 from 4.6 percent in 2020Q4. In contrast, food inflation remained unchanged at the 2020Q4 average of 10.6 percent. Meanwhile, inflation forecasts suggest an elevated inflation path in the period ahead compared to the First 2021 MPC forecasting round. Headline inflation is currently projected to average 8.4 percent in 2021, up from 7.6 percent projected during the previous MPC meeting. The revision has, among others, considered the impact of the lagged effects of the upward adjustments of fuel prices implemented on 9th March 2021 and the anticipated continued depreciation of the kwacha.

Considering the need to support and sustain economic recovery, while at the same time managing upside risks to the inflation, the MPC agreed to maintain the Policy rate at 12.0 percent, 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.

1. RECENT ECONOMIC DEVELOPMENTS

1.1 Government Operations through the Reserve Bank of Malawi

Central government budgetary operations closed the FY 2020/21Q3 with a budget deficit of K189.23 billion compared to a deficit of K107.3 billion realized during FY 2020/21Q2 and K118.11 billion recorded in FY 2019/20Q3. Total expenditures for FY 2020/21Q3 amounted to K555.34 billion against a quarterly budget of K416.74 billion, representing a negative variance of K138.60 billion or 33.3%. Meanwhile, Revenues totaled K366.10 billion during FY 2020/21Q3 and were higher than K353.96 billion recorded in the preceding quarter and K313.03 billion realised during 2019/20 FYQ3.

1.2 External Sector Developments

The external position improved slightly during 2021Q1. The values of both exports and imports declined, such that trade deficit somewhat narrowed compared to the 2020Q4 position. Specifically, the value of exports dropped to US$201.6 million in 2021Q1 from US$204.3 million recorded in the preceding quarter. Similarly, import outlays, at US$693.1 million in 2021Q1, were lower than US$753.1 million recorded in 2020Q4, but higher than US$669.7 million registered during 2020Q1. This narrowed the trade deficit to US$491.5 million in 2020Q1 from a deficit of US$548.8 million in 2020Q4.

Meanwhile, foreign exchange reserves continue to be lower than the pre-COVID-19 pandemic levels. Gross official reserves declined persistently in all the months of 2021Q1 and this contributed to the continued depreciation of the kwacha. In particular, official reserves fell to US$410.16 (1.96 months of imports) as of end-March 2021 from US$483.38 (2.31 months of imports) registered at the end of February 2021, US$502.98 million (2.41 months of imports) as of end-January 2021, and compared to US$574.26 million (2.75 months of imports) recorded at the end of 2020Q4. The deterioration of the reserves was seasonal, but was exacerbated by the negative impact of the COVID-19 pandemic on domestic foreign exchange reserves accumulation. By 16th April 2021, gross official reserves had declined further to US$394.28 million (1.89 months of imports).

1.3 Banking System Liquidity

Banking system liquidity conditions eased during the first quarter of 2021, as evidenced by an increase in excess reserves before borrowing from the central bank (un-borrowed excess reserves) to K6.5 billion per day from minus K18.8 billion per day recorded in 2020Q4. Consequently, commercial banks increased utilization of the primary source of covering short-term liquidity shortfalls, the interbank market, and significantly reduced access on the window of last resort, the Lombard facility. However, the liquidity conditions tightened again in April 2021, with the un-borrowed excess reserves averaging negative K7.6 billion per day as of 18th April 2021. This development led to increased access on the Lombard Facility, thereby raising the average to K18.1 billion per day during the first 18 days of April 2021, from K17.8 billion in March 2021. In line with these developments, the average interbank market rate (IBR) gained 11 basis points and closed at 11.73 percent on 18th April 2021 from 11.62 percent at the end of March 2021.

1.4 Private Sector Credit Developments

The annual growth rate in private sector credit was subdued during the review period, as it closed 2021Q1 at 16.8 percent compared to 23.8 percent in 2020Q1, reflecting the commercial banks' caution in a highly uncertain environment. The quarterly average growth rates stood at 17.3 percent in 2021Q1 and 24.0 percent in 2020Q1.

The sectoral contributions to the outstanding private sector credit showed that the Community, Social and Personal Services sector surpassed the Wholesale and Retail Trade as the largest holder of outstanding private sector credit, with its share of 27.2 percent (K201.5 billion) of gross loans. The Wholesale and Retail Trade was second at 22.2 percent (K164.5 billion), followed by Agriculture, forestry, fishing and hunting at 17.2 percent (K127.4 billion). These three sectors had a combined holding of 66.6 percent of the industry credit as at end-2021Q1. The apparent growth in Community, Social and Personal Services sector over the quarter is largely attributed to a data cleaning exercise which has eliminated the "*other sectors*" category effective January 2021

2. MACROECONOMIC ANALYSIS

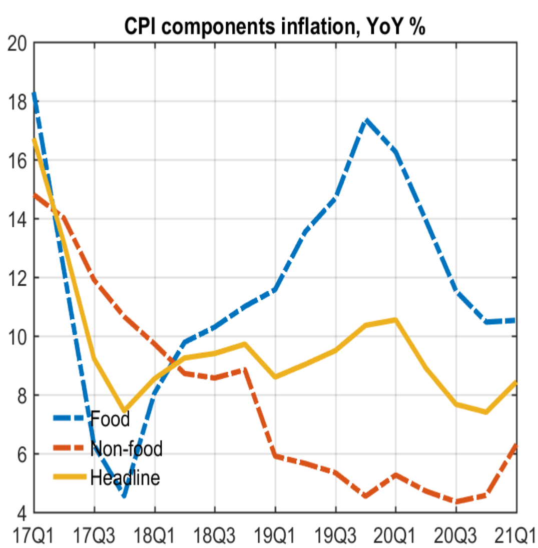
2.1 Aggregate Demand

The COVID-19 pandemic continues to weigh heavily on economic activity in Malawi. However, the ongoing vaccination campaigns, coupled with anticipations of improved agricultural production, as well as recovery of the global economy, offer optimism for economic turnaround. Domestic real economic growth is, therefore, projected at 3.8 percent in 2021, from an estimated growth rate of 0.9 percent in 2020.

2.2 Consumer Prices

Inflationary pressures surged in 2021Q1, as headline inflation averaged 8.5 percent, up from 7.5 percent recorded in 2020Q4. Pressures emanated from non-food inflation, which rose to 6.3 percent in 2021Q1 from 4.6 percent in 2020Q4, driven by lagged effects of the upward adjustment in domestic fuel pump prices effected in December 2020; a further increase in pump fuel prices implemented on 9th March 2021; as well as the continued depreciation of the kwacha. In contrast, food inflation remained unchanged at the 2020Q4 level of 10.6 percent (see Figure 1).

Figure 1: Inflation, Y-o-Y, %



2.3 Monetary Policy Assessment

2.3.1 Real Monetary Conditions

The Real Monetary Conditions Index (RMCI) is computed as the weighted average of the RIR gap and the inverse of the RER gap. A positive RMCI entails the presence of tight monetary conditions whilst loose conditions are represented by a negative RMCI. In 2021Q1, the RMCI was positive but declined relative to 2020Q4. This implies that the monetary policy stance remained tight in 2021Q1, but the degree of tightness was moderate compared to 2020Q4, reflecting the impact of rising inflation and exchange rate depreciation.

2.3.2 Monetary Policy Outcomes

During the First 2021 MPC meeting, there was still growing uncertainty regarding the macroeconomic outlook, as the fall out of the second wave of the COVID-19 pandemic remained unclear. Domestic economic activity, which had started to rebound in the second half of 2020, moderated. This notwithstanding, it was noted that the inflation outlook remained broadly unchanged from what was envisaged during the Fourth 2020 MPC, albeit with moderately higher inflation during the first half of 2021. Inflationary pressures were anticipated to emanate largely from a seasonal increase in maize prices. However, realising that monetary policy has no direct effect on maize prices, MPC members were of the view that implementing a Policy rate hike to contain such pressures could be counterproductive, especially considering that the anticipated inflationary pressures were transitory and likely to dissipate at the onset of the 2020/21 harvest season in 2020Q2.

When the alternative recommendation of loosening the stance of monetary policy to support economic recovery was considered, the meeting agreed to, first of all, allow the impact of the November 2020 Policy rate reduction to transmit through the economy. Additionally, MPC members were concerned that implementing another Policy rate reduction during the First 2021 meeting could lead to financial system distress considering that the banking industry was already being impacted by the COVID-19 pandemic through, among others, growth in NPLs. Therefore, the MPC decided to maintain the Policy rate at 12.0 percent, 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.

Meanwhile, a number of upside risks that were envisioned during the First 2021 MPC, materialized during 2021Q1. Notably, the kwacha depreciated by 2.2 percent (K17.18 movement), slightly higher than the anticipated depreciation rate of 2.0 percent. Similarly, domestic fuel pump prices were raised by almost double the rate of increase anticipated during the First 2021 MPC forecasting round (that is, 11.25 percent versus 6.0 percent). The fiscal deficit widened to K189.23 billion from K107.3 billion recorded in the preceding quarter, while gross official reserves continued to deteriorate on account of the underperforming external sector. This notwithstanding, maize prices declined by K19.33 per kilogram to an average of K182.00 per kilogram in 2021Q1, contrary to anticipations of a seasonal increase during the review quarter. However, since the upside risks were stronger than the downside risks, the outturn for the average headline inflation rate, at 8.5 percent in 2021Q1, was higher than the projection of 8.1 percent and above 7.5 percent recorded in 2020Q4.

Reflecting the pass-through effects of the MPC decisions made during the Fourth 2020 meeting to reduce the Policy rate, the growth rate in private sector credit increased, albeit marginally, to 16.8 percent at the end of 2021Q1 from 15.2 percent recorded at the end of 2020Q4.

3. ECONOMIC OUTLOOK AND FORECASTS

3.1 External Sector

3.1.1 Real Output Developments

According to the World Economic Outlook (WEO) Report released by the International Monetary Fund's (IMF) in April 2021, there is an improved outlook compared to what was projected in the October 2020 WEO. Specifically, after an estimated contraction of 3.3 percent in 2020, the global economy is projected to grow by 6.0 percent in 2021 but will moderate to 4.4 percent in 2022. The projections for 2021 and 2022 are 0.8 percentage points and 0.2 percentage points stronger than those of the October 2020 WEO, respectively, and this is largely attributed to fiscal stimuli in a few advanced economies as well as the anticipated vaccine-driven recovery during the second half of 2021. Global growth is expected to moderate to 3.3 percent over the medium term on anticipation of a projected damage to supply potential and forces that predate the pandemic, including aging-related slow labour force growth in advanced economies and some emerging market economies. As a result of the unprecedented policy response, the COVID-19-induced recession is likely to leave smaller scars than the 2008 global financial crisis. Nevertheless, emerging market economies and developing countries have been hit harder and are expected to suffer more significant medium-term losses than advanced economies.

For the advanced economies group, real GDP growth rate is projected to strengthen to 5.1 percent in 2021 from a contraction of 4.7 percent in 2020. Specifically, stronger growth is expected from the United States of America and Spain (6.4 percent each); France (5.8 percent); the United Kingdom (5.3 percent); Canada (5.0 percent); Italy (4.2 percent); Germany (3.6 percent); and Japan (3.3 percent).

Within the Sub-Saharan Africa (SSA) region, real economic activity is projected to expand by 3.4 percent in 2021, from an estimated contraction of 1.9 percent in 2020. The strength of the projected recovery will vary across countries, depending on the severity of the health crisis, the extent of domestic disruptions to activities, exposure to cross-border spillovers, and the effectiveness of policy support to limit the damage. Specifically, in South Africa, growth is projected to strengthen to 3.1 percent in 2021 from a contraction of 7.0 percent in 2020. Similarly, growth is projected at 2.5 percent in Nigeria, compared to a contraction of 1.8 percent in 2020, as peaking up of economic activity across countries is expected to induce global demand for oil.

3.1.2 Global Oil Price Developments

Global oil prices averaged US$60.6 per barrel in 2021Q1, up from US$44.5 per barrel in 2020Q4. Prospects for the rest of the year indicate that oil prices will average US$58.5 per barrel in 2021, representing an annual increase of 42.0 percent. The rise in global oil prices reflects the impact of restrained production by the Organization of the Petroleum Exporting Countries (OPEC+) including Russia. In 2022, oil prices are expected to moderate to an annual average of US$54.8 per barrel and remain unchanged, in real terms, over the medium term.

3.2 Malawi's Terms of Trade

Malawi's terms of trade are expected to deteriorate in 2021, as the average price of its imports is, generally, expected to be higher than the average price of domestic exports. Tobacco prices, the country's major export commodity, are anticipated to increase in 2021 compared to 2020 prices. This assumption is conditioned on the anticipation that the current demand for tobacco, at 132.3 million kilograms, which is higher than the estimated crop size of 124.3 million kilograms, will push up prices.[1]However, prices of oil on international market, the countries major import commodity, are projected to rise by 42.0 percent to US$58.5 per barrel in 2021 and are expected to remain above US$50 per barrel over the medium-term. Similarly, the price of fertilizer is also projected to increase in the short to medium term, thereby leading to deterioration of terms of trade against the domestic economy in the short to medium term.

3.3 Baseline Forecast

3.3.1 Baseline Assumptions

A number of assumptions have been adopted to guide the determination of the baseline forecasts. Notably, it is assumed that the RBM will remain committed to the 5.0 percent inflation objective in the medium-term, with a symmetric band of 2.0 percentage points. Additional assumptions include that the domestic economy will grow by 3.8 percent in 2021; the average of maize prices will fall by 14.3 percent to K150.0 per kilogram by 2021Q2 from an average of K175.0 per kilogram recorded in at the end of 2021Q1; the 2021Q2 electricity tariffs will remain at K104.46/kWh effected from 30th March 2021; domestic fuel pump prices will rise by 4.0 percent in 2021Q2; the exchange

[1] The tobacco estimates quoted here are based on the second-round estimates by the Tobacco Commission.

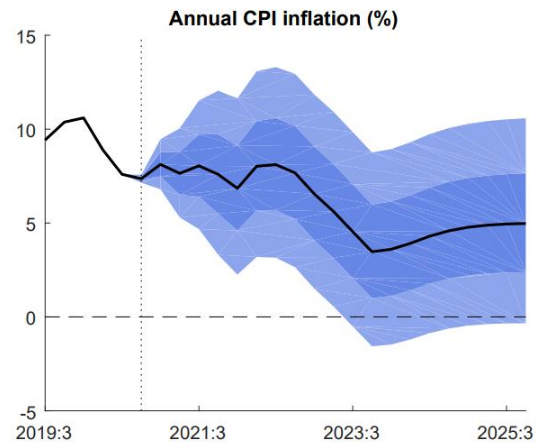
rate will depreciate by about 2.2 percent in 2021Q2; and that the budget deficit will be equivalent to 8.8 percent during the 2020/21 FY.

3.3.2 Monetary Policy and Inflation in the Baseline Scenario

Headline inflation is forecasted to average 8.4 percent in 2021, 0.6 percentage points higher than what was forecasted during the First 2021 MPC. In terms of the quarterly profiles, headline inflation is anticipated to decline to an average of 8.1 percent in 2021Q2, supported largely by low food prices at the onset of the 2020/21 food crop harvest, but could rise to 8.6 percent in 2020Q3 and 8.9 percent in 2021Q3

The elevated baseline path for inflation compared to the First 2021 MPC outlook is mainly attributed to four factors. Firstly, domestic fuel pump prices were increased by 11.25 percent on 9th March 2021, exceeding the projected rate of increase of 6.0 percent. The impact of this adjustment is expected to fully transmit to inflation in 2021Q2. Secondly, the exchange rate depreciated by a rate slightly larger than projected and the depreciation is likely to continue. Thirdly, the mid-year revised fiscal budget suggests that the fiscal deficit will be worse than projected. Fourthly, the upward revision in electricity tariffs that was announced at the end of March 2021 could take effect in 2021Q2. The combined effect of these factors are expected to exert upside pressures on non-food prices, thereby raising non-food inflation

Figure 2: Headline Inflation Outlook



3.3.3 Alternative Scenario: A 10.0 percent increase in Domestic Fuel Pump Prices

The MPC also considered the possibility of a larger increase in domestic fuel pump prices in 2021Q2 than the baseline scenario anticipates. This is justified by recognizing that global economic activity could peak up faster than projected, thereby inducing a higher-than-anticipated demand for global oil. The increase in global oil prices resulting from this development, coupled with materialization of the anticipated exchange rate depreciation locally, could trigger an upward adjustment in domestic fuel pump prices of more than the baseline assumption of 4.0 percent. In this alternative scenario, it is assumed that domestic fuel pump prices could be raised by an average of up to 10.0 percent in 2021Q2. If this risk materializes, headline inflation could rise to a peak of 9.2 percent in 2021Q4 before decelerating thereafter. The annual average inflation is projected to increase to 8.6 percent in 2021 and further, albeit marginally, to 8.7 percent in 2022. In order to bring down inflation towards the medium-term objective, monetary policy will have to raise the Policy rate progressively to around 14.0 percent by 2021Q4.

4. MONETARY POLICY DECISION

The MPC noted that a number of upside risks to inflation, which were envisaged during the First 2021 MPC, materialized during the quarter under review. Notably, domestic fuel pump prices rose by an average of 11.25 percent in March 2021, almost double the rate of quarterly increase anticipated during First 2021 MPC forecasting round. Furthermore, although the external sector's trade deficit narrowed during the quarter under review, the improvement was insufficient to result in accumulation of foreign exchange reserves and, therefore, cushion the exchange rate against further depreciations. In addition, the fiscal deficit continued to widen as expenditures grew faster than revenues during the review quarter. Consequently, the average headline inflation of 8.5 percent in 2021Q1 was higher than the 8.1 percent projected during the First 2021 MPC and the 2020Q4 average of 7.5 percent.

A review of the macroeconomic outlook revealed that inflationary pressures were tilted on the upside, largely on account of rising fuel prices, the continued exchange rate depreciation, and fiscal slippages. This is in addition to the impact of the recent upward adjustments in fuel prices and electricity tariffs effected in March 2021, which are expected to fully pass-through to inflation in 2021Q2. Meanwhile, the MPC noted that food inflation could somewhat dampen inflationary pressures in the short term, particularly during 2021Q2, as the 18.3 percent estimated annual increase in maize crop production, in addition to favourable production for other food crops, could translate into low food prices.

Although indications were that the upside risks to the inflationary outlook could outweigh the downside risks, thereby leading to a higher 2021 annual average inflation rate than projected during the First 2021 MPC meeting, the MPC noted that the projected average rate of 8.4 percent for 2021 was lower than the actual average of 8.6 percent for 2020, implying that there was still progress in bringing down inflation towards the medium-term objective. This created some policy space to consider supporting and sustaining economic recovery in the short-term. Since economic activity had been restrained in 2021Q1 due to the measures which Government introduced to contain the spread of the coronavirus, the MPC were of the view that realization of the said domestic economic growth prospects hinged much on increased activity during 2021Q2. Thus, to avoid interrupting the economic recovery process, whilst at the same time managing the upside risks to the inflation outlook, the **MPC decided to maintain the Policy rate at 12 percent, the Lombard rate at 20 basis points above the Policy rate, and the Liquidity Reserve Requirement (LRR) ratio on both local currency and foreign currency deposits at 3.75 percent.**