MONETARY POLICY REPORT

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Contents

The Reserve Bank of Malawi (The Bank) has a constitutional mandate to maintain price stability in Malawi. This mandate is achieved through implementation of monetary policy. To effectively carry out this role, the Bank has in place a Monetary Policy Committee (MPC) which extensively deliberates on macroeconomic developments and projections in order to decide on monetary policy stance. In order to do this, the Bank has set a medium-term inflation rate objective of 5 percent. Subject to meeting the inflation objective, the MPC is also required to support Government's economic policy, particularly its objectives for economic growth and employment.

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, describe the recent economic developments and outlook, and outline direction of monetary policy.

The Monetary Policy Committee:

Dr. Dalitso Kabambe, Governor and Chairman

Dr. Grant Kabango, Deputy Governor

Mr. Henry Mathanga, Executive Director, Corporate Affairs

Dr. Kisu Simwaka, Director responsible for Economic Policy Research

Professor Chinyamata Chipeta, Academia

Mr. Fredrick Changaya, Private Sector

INTRODUCTION

The Monetary Policy Committee (MPC), at its 4th meeting for 2019 held on 29th and 30th October, decided to maintain the Policy Rate at 13.5 percent and the Lombard Rate at 0.4 percent above the Policy Rate. The Committee also maintained the Liquidity Reserve Requirement (LRR) on local currency deposits at 5 percent, and the LRR on foreign currency deposits at 3.75 percent. In arriving at this decision, the Committee observed that although rising maize prices may marginally push up headline inflation in the near term, this elevation is deemed temporary and does not pose a risk to the medium-term inflation objective of 5 percent by 2021.

The economy has displayed notable resilience despite the adverse effects of Cyclone Idai and the weak performance of tobacco exports in 2019. Real Gross Domestic Product (GDP) continues to recover and is projected to grow by 5 percent in 2019; inflation has remained in single digit, and was recorded at 9.3 percent in the third quarter of 2019; the exchange rate remains remarkably firm, currently trading at around K740 per US dollar; lending rates continue to decline, with the base lending rate (now the reference rate) recorded at a historically low level of 12 percent in October 2019; and private sector credit continued to expand, having grown by an average of 19.1 percent in the third quarter of 2019 up from 15.1 percent in the preceding quarter and 9.9 percent in the corresponding quarter of 2018. The Committee therefore observed that the positive macroeconomic outlook envisaged during its first meeting of 2019 remains firm.

Inflation increased in the third quarter of 2019 to 9.3 percent from 9.0 percent in the second quarter of 2019. The increase was on account of food inflation which rose to 14.2 percent from 13.5 percent in the second quarter of 2019, and 9.9 percent *in the corresponding quarter of 2018. Food inflation has largely been driven by maize prices which rose to K227 per Kg in October 2019 from K130 per Kg in October 2018. Food prices pressure may marginally intensify during the lean period, but is expected to substantially decline at the onset of the next harvest season. Non-food inflation, on the other hand, has remained remarkably low as it declined further to an average of 5.4 percent in the third quarter of 2019 from 5.5 percent in the previous quarter, largely owing to stability in the exchange rate.*

Private sector credit has maintained a strong growth momentum, with the third quarter of 2019 registering a growth rate of 19.2 percent compared to 15.1 percent in the preceding quarter and 9.9 percent in the corresponding quarter of 2018. Recovery in private sector credit follows recent declines in interest rates as well as a generally improved macroeconomic environment. The annual growth rate of money supply has been remarkably contained and was recorded at 12.4 percent in August 2019, compared to 10.8 percent and 11.0 percent recorded in July 2019 and August 2018, respectively. The nominal growth of money supply has been consistently lower than the nominal GDP growth for 2019 which is currently estimated at 13.4 percent, signifying subdued demand pressures.

The global growth forecast has been revised downwards further by 0.3 percentage points to 3.0 percent in 2019. Growth in advanced economies is projected at 1.7 percent due to lower growth prospects in the United States and Euro area. Emerging market and developing economies are expected to grow by 3.9 percent in 2019. In sub-Saharan Africa, growth is projected at 3.2 percent in 2019 and 3.6 percent in 2020. In South Africa, growth will be weaker in 2019 than earlier projected, reflecting a larger-than-anticipated impact of labour strikes and energy supply issues in mining, together with weak agricultural production. Oil prices have been *relatively stable, trading within a narrow range in 2019 despite heightened geopolitical uncertainty. In September 2019, oil prices averaged $60 per barrel. Annual prices are expected to average $61.8 per barrel in 2019, a decrease of 9.6 percent from the 2018 average.*

The MPC noted the general improvement in macroeconomic conditions in 2019, which provided room to reduce the policy rate by 250 basis points in the first two sittings of the Committee, from 16 percent in December 2018 to 13.5 percent in May 2019. Inflation is projected to average 9 percent in 2019 and to gradually decline to 5 percent in 2021, contingent on favourable weather pattern in the next two growing seasons as well as prudent fiscal management. Meanwhile, rising food prices may slightly push up inflation in the fourth quarter leading to a marginally higher outcome than projected. The Committee considered this to be temporary. However, due to second round effects, the Committee considered that a gradual disinflation process is necessary and hence the decision to hold monetary policy unchanged. The Policy rate has thus been maintained at 13.5 percent, the LRR on domestic currency deposits at 5 percent and the LRR on foreign currency deposits at 3.75 percent.

1. RECENT ECONOMIC DEVELOPMENTS

1.1 Government operations through Reserve Bank of Malawi

Total revenues in the first quarter of 2019/2020 fiscal year were recorded at K296.20 billion (4.96 percent of GDP) comprising K276.93 billion domestic revenues and K15.52 billion grants. Total expenditures in the quarter were K386.81 billion (6.48 percent of GDP).

1.2 Foreign Exchange reserves

As at 30th September 2019, gross official reserves were recorded at US$656.04 million (3.14 months of imports) compared to US$704.14 million (3.37 months) in July 2019 while private sector reserves were recorded at US$310.25 million (1.48 months of imports). Meanwhile, the exchange rate remained broadly stable, trading at around K740 per US dollar.

1.3 Banking system liquidity

Un-borrowed excess reserves rose to an average of K32.21 billion per day in September 2019 from K8.95 billion in August 2019. The weighted average interbank rate (IBR) decreased by 70 basis points to 10.00 percent as at 30th September 2019 from the end of August position.

1.3.1 Treasury Bill Market

The primary market for Treasury bills for the period July to September 2019 attracted total subscriptions amounting to K288.29 billion. The subscriptions continued to skew towards the long end of the market whereby the 182 and 364-day tenors constituted 45.26 percent and 31.34 percent, respectively while the 91-day tenor attracted 23.41 percent of the funds subscribed. The Treasury bill average yields across all the three tenors marginally increased during the third quarter of 2019. Average yields for the 91, 182 and 364-day tenors rose by 0.18 percentage points, 0.29 percentage points and 0.03 percentage points to 9.13 percent, 9.77 percent and 10.03 percent, respectively. The all type yield for Treasury bill increased to 9.64 percent in September 2019 from end-June position of 9.48 percent at the end of June 2019.

1.4 Monetary and Private Sector Credit Developments

The annual growth rate of broad money (M2) was recorded at 12.4 percent in August 2019, compared to 10.8 percent and 11.0 percent recorded in July 2019 and August 2018, respectively. Private sector credit continues to recover, supported by low interest rates.

Credit expanded by 18.8 percent on annual basis following other notable growth rates of 21.2 percent and 12.1 percent in July 2019 and August 2018, respectively.

2. MACROECONOMIC ANALYSIS AND FORECASTING

MACROECONOMIC DEVELOPMENTS

The overall output gap for 2019 is in a negative cyclical position resulting from negative non-agriculture output gap while agriculture output gap is relatively neutral. Headline inflation picked up in 2019Q3 to 9.3 percent from 9.0 percent recorded in the previous quarter and 9.3 percent in 2018Q3. The increase was largely on account of food price developments. Propelled by high maize prices, food inflation averaged 14.2 percent in 2019Q3 from 13.5 percent in 2019Q2 and 6.2 percent in 2018Q3.

2.1 Aggregate Demand

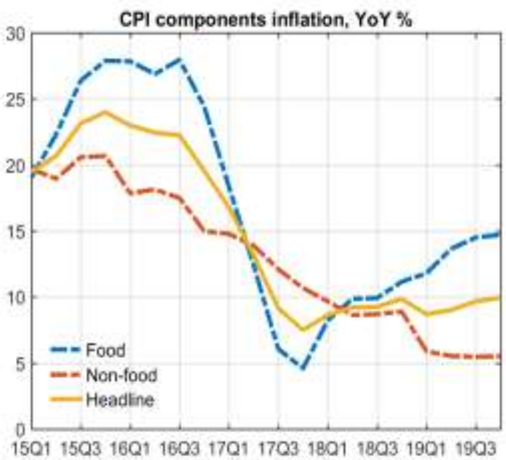
The domestic economy is projected to grow by 5.0 percent in 2019, a pick up from 4.0 percent in 2018, and expand further by 5.1 percent in 2020, conditional on favourable weather and supported by rising infrastructure investments. The growth in 2019 is supported by an improvement in agriculture sector which is projected to grow by 3.9 percent from 0.9 percent in 2018.

2.2 Consumer Prices

Inflation in 2019Q3 remained elevated following continued inflationary pressures on food items, largely emanating from increasing maize prices. Inflation picked up sharply during the first two months of third quarter, led by rising maize prices, before slowing down in September 2019. Average food inflation in the quarter was recorded at 14.2 percent from 13.5 percent in the previous quarter. Average food inflation for the period January to September 2019 stands at 13.2 percent from an average of 9.3 percent recorded during the corresponding period in 2018. While year-on-year food inflation slowed down in September 2019, the month-on-month food inflation suggests that food price pressures remain strong. Specifically, month-on-month food inflation was recorded at 1.5 percent, 3.0 percent and 3.0 percent in July, August and September 2019.

The contribution of food inflation has increased steadily since 2019Q1 while that of nonfood inflation has remained stable. Anchored by stability in the exchange rate, non-food inflation, has averaged 5.6 percent for the period January to September 2019 compared to an average of 9.0 percent during the same period in 2018.

Figure 1: Inflation, Y-oY, %



2.3 Monetary Policy Assessment

2.3.1 Real Monetary Conditions

The real monetary conditions suggest that monetary policy stance has become slightly tighter in 2019Q3 compared to 2019Q2 due to the positive real exchange rate gap.

2.3.2 Monetary policy outcomes

The Malawi economy has remained relatively resilient despite being affected by Cyclone Idai and low tobacco export revenues in 2019. The Cyclone Idai-induced floods occurred after the country was affected by Fall army worm attack in 2018. These have led to relatively elevated food inflation which was recorded at 14.2 percent in 2019Q3 from 13.5 percent in 2019Q2. Non-food inflation on the other hand was stable at 5.4 percent in 2019Q3. Overall, headline inflation increased further during 2019Q3 to 9.3 percent from 9 percent in 2019Q2.

3. ECONOMIC OUTLOOK

3.1 External sector

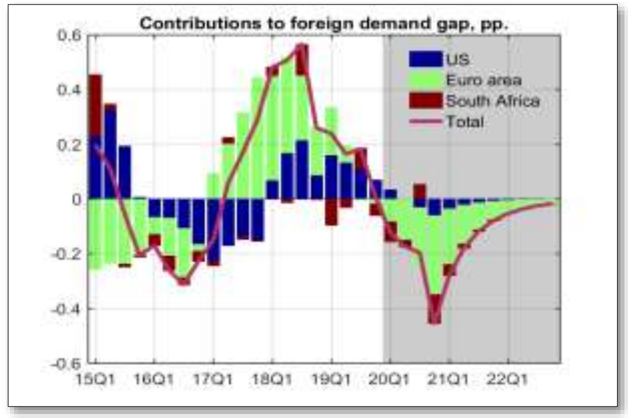
3.1.1 Real Output Developments

The October 2019 IMF's World Economic Outlook (WEO) report has revised global growth forecast to 3.0 percent for 2019, its lowest level since the financial crisis and a 0.3 percentage point downgrade from the April 2019 World Economic Outlook. Growth is projected to pick up to 3.4 percent in 2020, reflecting primarily a projected improvement in economic performance in a number of emerging markets.

For advanced economies, growth is projected to soften to 1.7 percent in 2019 and 2020. The forecast is 0.1 percentage point lower for 2019 than in the April 2019 WEO. In the United States, growth in 2019 is expected to be 2.4 percent and moderating to 2.1 percent in 2020. The projected moderation reflects the assumed shift in the fiscal stance from expansionary in 2019 to broadly neutral in 2020. In the euro area, weaker growth in foreign demand and a drawdown of inventories (reflecting weak industrial production) have kept a lid on growth since mid-2018. Growth is projected at 1.2 percent in 2019 (0.1 percentage point lower than in April) and 1.4 percent in 2020.

Growth in the emerging market and developing economy group is expected to bottom out at 3.9 percent in 2019, rising to 4.6 percent in 2020. The forecasts for 2019 and 2020 are 0.5 percentage point and 0.2 percentage point lower, respectively, than the April 2019 WEO projections, reflecting downward revisions in all major regions except emerging and developing Europe. In sub-Saharan Africa, growth is expected at 3.2 percent in 2019 and 3.6 percent in 2020, slightly lower for both years than in the April 2019 WEO projection. Higher, albeit volatile, oil prices earlier in the year have supported the subdued outlook for Nigeria and some other oil-exporting countries in the region. In South Africa, despite a moderate rebound in the second quarter, growth is expected to be weaker in 2019 than earlier projected, following a very weak first quarter, reflecting a larger-than-anticipated impact of labor strikes and energy supply issues in mining, together with weak agricultural production. The slowdown in global growth, particularly for economies of key trading partners, implies weaker demand for Malawi's exports.

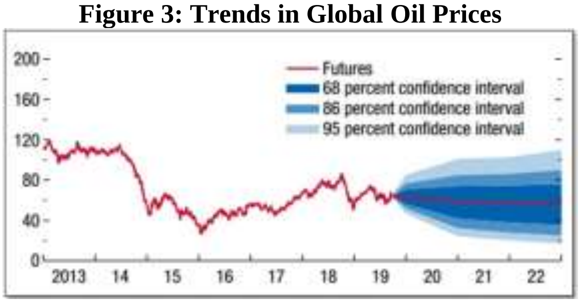
Figure 2: Foreign Output Gap and Growth rates, %



3.1.2 GLOBAL OIL PRICE DEVELOPMENTS

Oil prices have been relatively stable, trading within a narrow range in 2019 despite heightened geopolitical uncertainty. In April 2019, prices surpassed $71, their highest for 2019, and hit their recent bottom of $55 in August 2019 before rising to above $60 per barrel in September 2019. Initially, prices were pushed higher by the recovery of financial conditions as well as outages in Venezuela and US tensions with Iran. But in late spring, a weaker global economy raised concern about the strength of global oil demand, which was amplified by a build-up of US crude oil stockpiles. Supply outages and geopolitical tensions, however, masked the oil demand weakness and temporarily supported prices. On the demand side, weaker global economic fundamentals have contributed to lower prices. As at the close of third quarter of 2019, oil futures contracts indicate that Brent prices will gradually decline to $55 per barrel over the next five years. Baseline assumptions based on futures prices suggest average annual prices of $61.8 a barrel in 2019, a decrease of 9.6 percent from the 2018 average and $57.9 a barrel in 2020.

Figure 3: Trends in Global Oil Prices

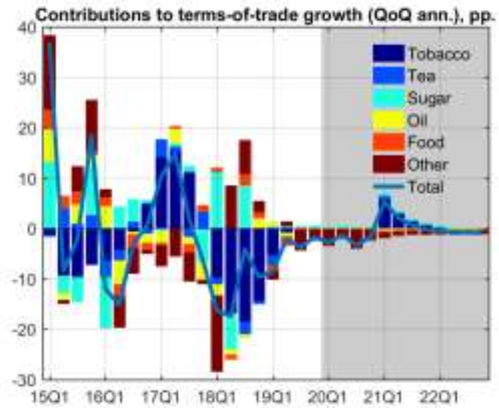


Source: IMF WEO

3.1.3 Malawi's Terms of trade

The performance of tobacco prices during the 2018/19 season has been unsatisfactory compared to the previous two seasons. The average price for tobacco was $1.43/kg for 2019 lower than $1.67/kg fetched in 2018 and $2.0/kg in 2017. The lower prices in 2019 have been attributed to over production. Terms of Trade growth is therefore assumed to be around neutral position in the forecast horizon because of subdued performance of tobacco industry.

Figure 4: Terms of Trade Growth, % Q-o-Q annualized



3.2 Baseline forecast

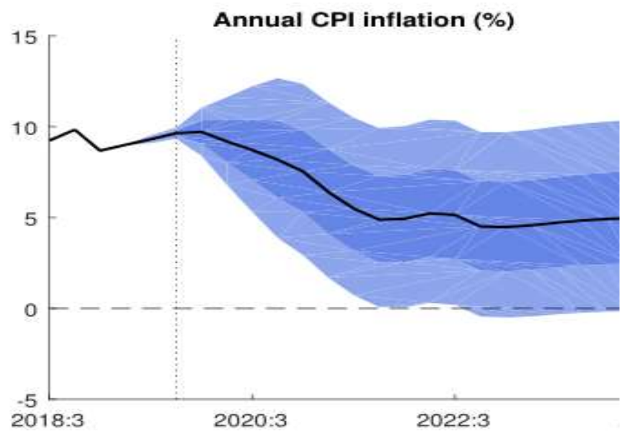
3.2.1 BASELINE ASSUMPTIONS

RBM maintains 5 percent inflation objective in the medium term. The forecasts have taken into account the GDP growth projection of 5 percent for 2019. The forecasts have also considered the prevailing higher than expected maize price pressures. The forecast also assumes that exchange rate stability will continue and that there will be delayed fiscal adjustment.

3.3 Monetary policy and inflation in the Baseline

Annual headline inflation projection for 2019 remains at 9 percent. However, slightly upgraded risks to food prices suggest that food price developments will dominate the inflation dynamics in the short term Meanwhile, the non-food inflation is expected to remain stable in the short term. While food prices pose threat to headline inflation, the development will only be temporary. The forecasts therefore suggest that the 5 percent policy objective is still attainable as earlier predicted, contingent on good weather outcomes in the next two growing seasons, as well as appropriate fiscal adjustments.

Figure 5: Headline Inflation Outlook



4. MONETARY POLICY DECISION

Despite being adversely affected by Cyclone Idai and the low tobacco proceeds, the economy has remained resilient. Real GDP continues to recover, the exchange rate remains firm, lending rates are declining, private sector credit in picking up and inflation is still in single digit.

However, inflationary pressures remain elevated, particularly owing to food prices. Furthermore, liquidity conditions, continue to pose risks to inflation outlook.

Although currently shoring up inflation, the elevated maize prices are expected to be short-lived. Furthermore, the exchange rate is expected to remain stable in the short to medium term. Moreover, a weaker global economy suggests weaker global oil demand, which may ensure continued stability in international crude oil prices. The Monetary Policy Committee therefore decided to maintain the Policy rate at 13.5 percent, the Liquidity Reserve Requirements on domestic and foreign deposits at 5 percent and 3.75 percent, respectively.