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 the conduct and 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. The Bank has a medium-term inflation rate objective of 5 percent with a symmetric band of 2.0 percentage points, such that all efforts are 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, describe the recent economic developments and outlook, and outline direction of monetary policy.

The Monetary Policy Committee

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

Dr. Grant Kabango, Deputy Governor, Economics & Regulation

Mr. Henry Mathanga, Deputy Governor, Operations

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

Mrs. Audrey Mwala, Private Sector

Dr. Betty Chinyamunyamu, Private Sector

Dr. Levison Chiwaula, Academia

INTRODUCTION

The Monetary Policy Committee (MPC), at its 3rd meeting for 2020 held on 30th and 31st July, decided to maintain the Policy Rate at 13.5 percent and the Lombard Rate at 0.2 percentage points above the Policy Rate. The Committee also maintained the Liquidity Reserve Requirement (LRR) ratio on both local currency and foreign currency deposits at 3.75 percent. In arriving at this decision, the committee noted that although inflation developments were favorable in the first half of the year, there are emerging upward risks to the medium-term inflation path. The cautious policy stance is therefore aimed at containing the impending inflationary pressures whilst at the same time providing space for supporting recovery of the economy, in the wake of the COVID-19 pandemic.

According to the June 2020 World Economic Outlook (WEO) of the International Monetary Fund (IMF), global economic growth is projected at minus 4.9 percent in 2020 compared to 2.9 percent in 2019. This is a mark down of 1.9 percentage points from an earlier projection of minus 3.0 percent released in April 2020. The downward revision is on account of COVID-19 pandemic, which has had a more negative impact on global economic activity in the first half of 2020 than earlier anticipated. Growth in advanced economies is projected at minus 8.0 percent, reflective of deep recessions in USA, UK, Japan and the Euro area. In emerging markets and developing economies, growth is projected at minus 3.0 percent while Sub-Saharan Africa (SSA) economic growth is projected at minus 3.2 percent. The sharp drop in global and regional growth, particularly for economies of key trading partners for Malawi implies weaker demand for the country's exports.

Brent crude oil prices picked up to around US$43 per barrel in mid-July 2020 from US$22.40 per barrel at the end of March 2020. The recovery in global oil prices followed easing up of COVID-19 lockdown restriction measures including travel restrictions in some economies across the globe. Meanwhile, Brent crude oil price is *projected to average US$40 per barrel in 2020 and US$45 per barrel in 2021, before rising to US$50 per barrel in 2022.*

Domestic real GDP growth is projected to fall to 1.9 percent in 2020 from an estimated 5.0 percent in 2019. The 2020 projection has been revised downwards by 3.6 percentage points from the earlier projection of 5.5 percent on account of the impact of protracted political uncertainty in the first half of the year and the COVID-19 pandemic including the associated containment measures. The pandemic has significantly affected most sectors of the economy such as the manufacturing, tourism and accommodation, health, wholesale and retail trade, financial services, real estate and construction sectors.

Inflation has been on a downward path since peaking at 11.5 percent in December 2019. Headline inflation decelerated to an average of 8.9 percent in the second quarter of 2020 from an average of 10.6 percent in the first quarter of 2020 and 9.0 percent in the corresponding quarter of 2019. This development was supported by food inflation, which declined to an average of 13.9 percent in the second quarter of 2020 from 16.4 percent in the previous quarter. The decline in food inflation is primarily reflective of improved maize production during the 2019/20 agricultural season, coupled with subdued industrial demand for maize due to COVID-19 lockdown restrictions. Similarly, non-food inflation decelerated to 4.7 percent in the second quarter of 2020 from 5.2 percent in the preceding quarter on the back of declining domestic pump fuel prices and stable exchange rate.

The kwacha exchange rate remained broadly stable in the second quarter of 2020. The kwacha depreciated marginally to trade at MWK743.0485 per US Dollar at end June 2020 from MWK741.0166 per US Dollar at end March 2020 and MWK738.8732 per US Dollar as at end December 2020. However, pressures on the exchange rate are mounting due to disrupted supply of foreign exchange to the Authorized Dealer Banks (ADBs) following COVID-19 pandemic.

Credit to the private sector continued to expand in the second quarter of 2020, partly supported by low interest rates. The annual growth rate of private sector credit remained strong at 18.6 percent in May 2020, compared to 18.9 percent and 13.5 percent recorded in April 2020 and May 2019, respectively.

Annual inflation projection for 2020 has been revised down to 9.8 percent from the earlier projection of 10.1 percent during the first MPC. The downward revision is mainly on account of lower inflation path in the first half of 2020 and lower growth projection than earlier envisaged. However, the annual inflation projection is higher than 9.4 percent recorded in 2019 and the medium-term inflation target of 5 percent with a symmetric band of 2.0 percentage points. Inflationary pressures in the near term are expected to emanate from a gradual pick-up in food prices particularly maize, increased short term pressure on the exchange rate, increase in global oil prices and increased public sector financing requirements, amidst subdued growth prospects due to the pandemic.

In view of these developments, MPC decided to maintain the Policy Rate at 13.5 percent, the Lombard Rate at 0.2 percentage points above the Policy Rate and the LRR on both domestic currency and foreign currency deposits at 3.75 percent. The cautious policy stance is deemed appropriate to deal with emerging risks while supporting the economic activity amid COVID-19 pandemic. The MPC remains committed to ensuring that the medium-term inflation objective is achieved.

1. RECENT ECONOMIC DEVELOPMENTS

1.1 Government Operations through the Reserve Bank of Malawi

Total revenues in the last quarter of 2019/20 fiscal year amounted to K308.6 billion against total expenditures of K449.7 billion. Fiscal operations in the quarter were largely affected by the COVID-19 pandemic and its containment measures.

1.2 External Sector Developments

External sector imbalances intensified during the quarter. Imports continue to surpass exports leading to continued pressure on the exchange rate. This notwithstanding, the kwacha exchange rate remained broadly stable, trading at MWK743.0485 per US Dollar at the end of June 2020. Disruption to supply of foreign exchange to Authorized Dealer Banks (ADBs) following COVID-19 pandemic is adversely affecting the exchange rate outlook.

1.3 Banking System Liquidity

Banking system liquidity tightened during the second quarter of 2020 compared to the preceding quarter as evidenced by progressive decline in un-borrowed excess reserves. The un-borrowed excess reserves declined to an average of negative K17.6 billion per day in June 2020, from negative K10.4 billion in May 2020, and K4.1 billion in April 2020. In line with the tight liquidity conditions, the overnight inter-bank market rate (IBR) remained close to the policy rate and stood at 13.60 percent in June 2020 compared to 13.43 percent and 13.46 percent in May and April 2020, respectively.

1.4 Monetary and Private Sector Credit Developments

The annual growth rate of broad money (M2) decelerated to 14.0 percent in May 2020 from 15.6 percent in April 2020 but was higher than the 9.4 percent recorded in a corresponding month in 2019. Meanwhile, credit to the private sector continued to expand, partly on the back of low interest rates. The annual growth rate of private sector credit remained strong at 18.6 percent in May 2020, comparing favorably to 18.9 percent recorded in April 2020 and was higher than 13.5 percent registered in April 2019.

2. MACROECONOMIC ANALYSIS AND FORECASTING

MACROECONOMIC DEVELOPMENTS

Real GDP is projected to remain below its trend in 2020, with the overall output gap in a negative cyclical position. This is due to negative output gaps in both non-agriculture and agriculture sectors. Headline inflation continued on the downward trajectory in the second quarter of 2020 and averaged 8.9 percent in the quarter from 10.6 percent in the first quarter of 2020. The downward trend was largely supported by food inflation, which moderated to 13.9 percent in the second quarter of 2020, from 16.4 percent in the preceding quarter.

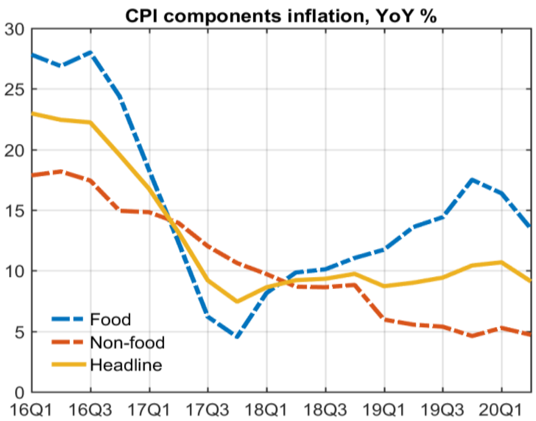
2.1 Aggregate Demand

The domestic growth prospects have sharply weakened due to protracted political uncertainty in the first half of the year and the COVID-19 pandemic and its containment measures. Prior to the COVID-19 shock, growth was projected to rise to 5.5 percent in 2020 on account of improved agricultural production during the 2019/2020 agricultural season. However, following the outbreak of COVID-19 pandemic, the growth outlook has deteriorated significantly and real GDP growth is projected to decline to 1.9 percent in 2020, from an estimated 5.0 percent in 2019. The revised growth is significantly below the national long-term trend growth. The downward revision is as a result of the effects of the protracted political tension and the COVID-19 pandemic, which have significantly affected most of the sectors of the economy including the manufacturing, tourism and accommodation, health, wholesale and retail trade, financial services, real estate, construction and agriculture sectors.

2.2 Consumer Prices

Inflation has been on a downward trajectory since peaking at 11.5 percent in December 2019. Headline inflation dropped to an average of 8.9 percent in the second quarter of 2020 from an average of 10.6 percent in the first quarter and 9.0 percent in the second quarter of 2019 (Figure 1). This development was influenced by food inflation, which moderated to an average of 13.9 percent during the quarter from 16.4 percent in the preceding quarter. The moderation in food inflation is primarily reflective of improved production of maize during the 2019/20 agricultural season, coupled with subdued industrial demand for maize due to COVID-19 lockdown restrictions. Maize production is estimated to have increased by 8.8 percent to 3.7 million metric tons. Similarly, non-food inflation declined to 4.7 percent in the second quarter of 2020 from 5.2 percent in the previous quarter. This development was driven by declining domestic pump fuel prices and stable exchange rate.

Figure 1: Inflation, Y-oY, %



2.3 Monetary Policy Assessment

2.3.1 Real Monetary Conditions

Real monetary conditions index (RMCI) is calculated as the weighted average of the real interest rate gap and the real exchange rate gap (inverse). Tight conditions entail that the monetary stance is contractionary whilst loose conditions entail an expansionary monetary stance. In the second quarter of 2020, the RMCI marginally increased such that the overall monetary conditions were neutral from a marginally loose position in the previous quarter.

2.3.2 Monetary Policy Outcomes

During the second MPC meeting of 2020, there was still some optimism with the economy projected to grow by 5.5 percent in 2020 as COVID-19 pandemic was envisaged to spread modestly. The relatively strong growth was premised on an improved agricultural production during the 2019/20 season with expectedly positive feedstock into related sectors. The exchange rate stability was expected to continue and inflation was projected to average 10.1 percent in 2020. Accordingly, MPC decided to cut the Liquidity Reserve Requirement (LRR) ratio on domestic deposits by 1.25 percentage points to 3.75 percent from 5.0 percent. The MPC further resolved to reduce the Lombard rate by 50 percent to 0.2 percentage points above the Policy rate in order to reduce the cost of accessing funds from the central bank by the commercial banks.

These decisions were deemed necessary to ease banking system liquidity constraints and incentivise commercial banks to adequately support the sectors which are hit by the COVID-19 pandemic. Consequently, private sector credit continued to grow in the subsequent months such that the annual growth rate was recorded at 18.6 percent in May 2020.

At the time of the second MPC meeting of 2020, projections were made subject to substantial uncertainty on the severity and duration of the COVID-19 pandemic. Meanwhile the uncertainty remains as Malawi has the second highest number of COVID-19 infections in the SADC region and the cases are rising. Real GDP growth projection for 2020 has therefore been revised downwards to 1.9 percent due to slowdown in economic activity. The slowing down in economic activity is also evidenced by lower money supply growth in May 2020.

However, the risk has moderately been mitigated by the improved agriculture production in the 2019/20 season such that food inflation is generally lower compared to 2019. Non-food inflation has continued to be stable partly due to lower fuel price and stable exchange rate. This has contributed to a decline in overall inflation in the second quarter of 2020.

3. ECONOMIC OUTLOOK

3.1 External Sector

3.1.1 Real Output Developments

According to the June 2020 WEO Update of the IMF, global growth is projected at minus 4.9 percent in 2020 compared to 2.9 percent in 2019. The June 2020 projection is 1.9 percentage points below an earlier projection of minus 3.0 percent released in the April 2020. The downward revision is on account of COVID-19 pandemic, which has resulted into more negative impact on global economic activity in the first half of 2020 than anticipated. However, the global economy is projected to recover in 2021 and grow by 5.4 percent, contingent on the evolution of the COVID-19 pandemic.

Growth in advanced economies has been marked down by 1.9 percentage points to minus 8.0 percent in 2020. This is reflective of projected deep recessions in the United States (-8.0 percent); Japan (-5.8 percent); the United Kingdom (-10.2 percent); Germany (-7.8 percent); France (-12.5 percent); Italy and Spain (-12.8 percent). In 2021, growth in advanced economies is projected to recover to 4.8 percent.

In emerging market and developing economies, growth is projected at minus 3.0 percent in 2020, 2.0 percentage points below the April 2020 IMF WEO forecast. Similar to developments in major economies, economic activity is projected to contract for Mexico (-10.5 percent), Brazil (-9.1 percent), Saudi Arabia (-6.8 percent), Russia (-6.6 percent) and India (-4.5 percent). Meanwhile, China is projected to grow modestly by 1.0 percent in 2020.

In sub-Saharan Africa (SSA), economic growth is projected at minus 3.2 percent, a downward revision of 1.6 percentage points from the April 2020 WEO. The 2020 growth projection reflects downward revisions for South Africa (due to COVID-19 pandemic) and for Nigeria (on account of disruptions due to the pandemic, as well as significantly lower disposable income after the dramatic fuel price decline). In 2021, growth in SSA is projected at 3.4 percent, 0.7 percentage points lower than envisaged in April 2020.

In terms of the risks to the outlook, fundamental uncertainty around the evolution of the pandemic is a key factor shaping the economic outlook. The downturn could be less severe than forecast if economic normalization proceeds faster than currently expected in areas that have reopened. Downside risks, however, remain significant. Outbreaks could recur in places that appear to have gone past peak infection, prolonged decline in activity could lead to increase in unemployment levels. The sharp drop in global growth, particularly for economies of key trading partners, implies weaker demand for Malawi's exports.

3.1.2 Global Oil Price Developments

The June 2020 WEO has broadly maintained the assumptions on oil prices from the April 2020 WEO. The average petroleum spot prices per barrel are projected to average US$40 per barrel in 2020 and US$45 per barrel in 2021, before rising to US$50 per barrel in 2022. In 2019, the average price of oil was US$61.39 per barrel. The projected decline in oil prices in 2020 is due to the collapse in demand as a result of COVID-19 mitigation measures which have sharply curtailed travel and transport that account for around two-thirds of oil demand. As of 14th July 2020, crude oil price stood at US$43.12 per barrel. The risk to the oil price arises from a pick-up in economic activities in several countries following gradual reopening of these economies which may increase the demand for oil.

3.1.3 Malawi's Terms of Trade

Malawi's Terms of Trade growth is projected to remain neutral over the medium term, mainly due to the weak performance of the tobacco industry during the year 2019 compared to the preceding two years. In 2019, all types of tobacco prices averaged US$1.43 per kilogram compared to US$1.67 per kilogram in 2018. Besides tobacco, other major exports for Malawi are sugar and tea whose prices remained flat as well. In terms of imports, Malawi's main imports are oil and fertilizer. Average prices of fertilizer in 2019 declined to US$224.5/metric ton from US$249.4 per metric ton in 2018.

3.2 Baseline Forecast

3.2.1 Baseline Assumptions

RBM remains committed to a 5 percent inflation objective in the medium term, with symmetric band of 2.0 percentage points.

Therefore, monetary policy conduct is expected to be consistent with this objective.

The forecasts have taken into account the revised GDP growth projection of 1.9 percent in 2020, which 3.6 percentage points lower than the pre-COVID-19 projection of February 2020. The forecasts have also considered threats to maize prices as well as growing foreign exchange demand. Further, the forecasts have considered the effects of recovery in advanced economies on global crude oil prices as well as delayed domestic fiscal consolidation due to the lingering pandemic and its containment measures.

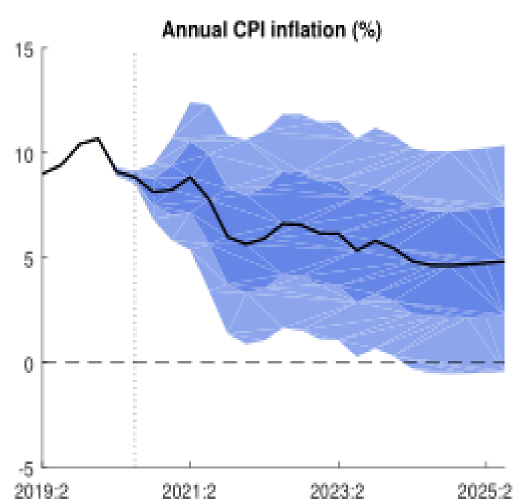
3.3 Monetary Policy and Inflation in the Baseline

Annual inflation projection for 2020 has been marked down, albeit marginally, to 9.8 percent from 10.1 percent reported in the previous MPC meeting. The downward revision reflects a lower GDP projection of 1.9 percent than anticipated during the previous MPC (5.5 percent) as the COVID-19 pandemic continues to destabilize economic activity.

Generally, it is expected that food prices, particularly maize prices, will be lower this year compared to 2019 since ADMARC purchased more maize this year. Furthermore, maize for industrial use is projected to be on the lower side due to the impact of COVID-19 pandemic. In addition, neighboring countries have produced enough maize this year which may limit cross border sales. Risks to food prices are therefore based on seasonal trends.

On the other hand, pressures on non-food inflation may arise from COVID-19 related trade constraints and delayed fiscal consolidation. These notwithstanding, inflation is still projected to converge to the medium-term target of 5±2 percent.

Figure 3: Headline Inflation Outlook



4. MONETARY POLICY DECISION

The COVID-19 pandemic and its containment measures continue to affect both global and domestic economic activity. At the global level, the pandemic has plunged the global economy into an unprecedented economic downturn. On the domestic front, the pandemic has also negatively affected economic activity, with real GDP projected at 1.9 percent, the lowest outcome in 17 years.

Headline inflation declined to an average of 8.9 percent in the second quarter of 2020 from 10.6 in the previous quarter. This was on account of combination of the slowdown in economic activity and hence subdued demand, improved food availability following the commencement of the harvest season, the double reduction in domestic pump fuel prices and the stable exchange rate. Looking ahead,

Annual headline inflation is projected to average 9.8 percent in 2020, slightly higher than 9.4 percent recorded in 2019. The current projection is above the medium-term target of 5±2 percent.

Therefore, the Monetary Policy Committee decided to maintain the Policy rate at 13.5 percent, the Lombard rate at 0.2 percentage points above the Policy rate, and the Liquidity Reserve Requirement (LRR) ratio on both local currency and foreign currency deposits at 3.75 percent. This policy stance is aimed at balancing the need to contain inflationary pressures and stimulate economic activity amidst the pandemic.