Reserve Bank of Malawi

MONETARY POLICY STATEMENT # 2

March 2015

Definition of Acronyms

APM	Automatic Pricing Mechanism
ATAF	Automatic Tariff Adjustment Formulae
FY	Fiscal Year
GDP	Gross Domestic Product
IMF	International Monetary Fund
LRR	Liquidity Reserve Requirement
MERA	Malawi Energy Regulatory Authority
MPC	Monetary Policy Committee
MPR	Monetary Policy Rate
NDA	Net Domestic Assets
NEMC	National Economic Management Committee
NFA	Net Foreign Assets
OMO	Open Market Operations
PR	Policy Rate also referred to as MPR
PTA	COMESA’s Preferential Trade Area Bank
BANK	Reserve Bank of Malawi
SADC	Southern African Development Community
The Bank	Reserve Bank of Malawi

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Summary

The overarching objective of monetary policy is attainment of low and stable inflation. In view of this, this monetary policy statement seeks to inform the general public of the monetary policy stance and program in 2015 for the remainder of the 2014/2015 fiscal year and the understandings reached between the government and the International Monetary Fund (IMF) in the context of an Extended Credit Facility (ECF). It also reviews the implementation of the monetary policy program adopted in November 2013 following suspension of donor budgetary support.

Inflation targets for monetary policy are ordinarily set by the National Economic Management Committee (NEMC) chaired by the Minister of Finance and of Economic Planning and Development and are finalized during reviews of the ECF program. The inflation target for the fiscal year ending-June 2015 was set at 15.0 percent and an inferred end-December target of 12.0 percent. From the December 2014 inflation rate of 24.2 percent, this target translates to implementing monetary measures aimed at the attainment of an average inflation rate of about 17.3 percent for the calendar year 2015 for programming purposes. In addition the Bank aims at maintaining a 3-month import cover in foreign exchange reserves in the medium-term in order to anchor inflationary expectations.

The thrust of Monetary Policy Statement No.1 was fully implemented but had mixed results. The foreign exchange reserves target of 2 months of imports was attained through a careful balance of monetary tightening and exchange rate depreciation. However, the resulting inflationary pressures from the currency movement combined with a substantial increase in government domestic borrowing during the last half of 2013/2014 fiscal year made it extremely difficult to achieve the targeted 15.0 percent inflation for end-June, 2014. A major contributor to the outturn was the negative expectations fuelled by the donors' continuous announcements of their pullout from budget support due to the Cashgate scandal. In the event, inflation accelerated to 22.5 percent in June and 24.2 percent in December, 2014.

Against this background, the theme of this Monetary Policy Statement No 2 is *"managing inflation expectations."* To that end, the Bank will intensify implementation of its communication strategy and engage stakeholders as needed. The Bank will also continue to work on enhancing the transmission of monetary policy measures. In addition, existing systems for strengthening coordination of fiscal and monetary policies will be enhanced. Thus, the aim of monetary policy is to drive inflation to 15.0 percent by June 2015 and to around 12.0 percent in December 2015.

Furthermore, low domestic food prices, low and stable prices of oil and the consistent implementation of the Automatic Price Mechanism (APM) are necessary to achieve the inflation objective.

1.0. Background

The National Economic Management Committee (NEMC) under the leadership of Treasury is responsible for the production of projections of gross domestic product (GDP) growth and inflation that underpin the country's macroeconomic framework in a given year. The macroeconomic framework is generally announced by the Minister of Finance in the Budget Statement as presented before Parliament. The Bank issues a Monetary Policy Statement (MPS) to inform the general public about the monetary policy stance consistent with the fiscal stance and in the event of major changes in that framework. In formulating this policy, the Bank is more concerned about the projected inflation and its consistency with the planned financing of any budget deficit. The projected inflation rate is then taken as a target for monetary policy purposes. In addition, the Bank takes a position with regard to the long-term direction of the economy, including government commitments to regional integration. The instruments used by the Bank to implement monetary policy are described in Section 1.3.

Government planned to implement a zero-aid budget (that is, no direct donor budget support) in the 2014/2015 fiscal year. As such, enhanced fiscal discipline is critical to ensuring that spending is kept within available resources. The theme of this Monetary Policy Statement is "Managing Inflation Expectations", as it underscores the importance of policy coordination between the fiscal and monetary operations in signaling inflation expectations. The role of communication with stakeholders in managing inflation expectations will be enhanced.

1.1 Objectives of Monetary Policy

The main objective of monetary policy is to achieve low and stable prices, that preserve the value of the Kwacha, and encourages the investment needed to achieve sustainable economic growth and employment creation. The Bank also aims to build foreign exchange reserves in order to manage the exchange rate movements in a more credible manner and better cushion the market from shocks, and through that anchor inflation expectations.

1.2 Monetary Policy Framework

The Bank uses the monetary aggregates targeting framework. In this framework, a target is set for the growth of money supply that is consistent with the projected inflation and real GDP growth. In Malawi’s case, the monetary aggregates are discussed and agreed in the context of the ECF program with the IMF.

The targeted growth in money supply is pursued by setting an intermediate target on the growth of reserve money (RM) which, through a money multiplier, is directly linked to money supply. Reserve money is the sum of currency in circulation and commercial bank deposits with the central bank. To achieve the target reserve money, the central bank applies monetary policy instruments to influence changes in the level of its lending to banks and central government which together constitutes the Banks net domestic assets (NDA). The central bank may also adjust its foreign exchange reserves to influence bankers’ deposits, if doing so is consistent with foreign exchange reserves policy. Thus, in this monetary aggregates targeting framework, a ceiling is set on the Bank’s NDA and a floor is set on net foreign assets (NFA).

1.3 Instruments for Monetary Policy

The Bank uses a variety of monetary policy instruments that include Open Market Operations (OMO), the Liquidity Reserve Requirement (LRR) and Communication. Open Market Operations are purchases and sales of securities conducted through the Bank. The LRR is a proportion of deposits, which all deposit taking commercial banks are required to place at the Bank, as a proportion of savings made by their clients.

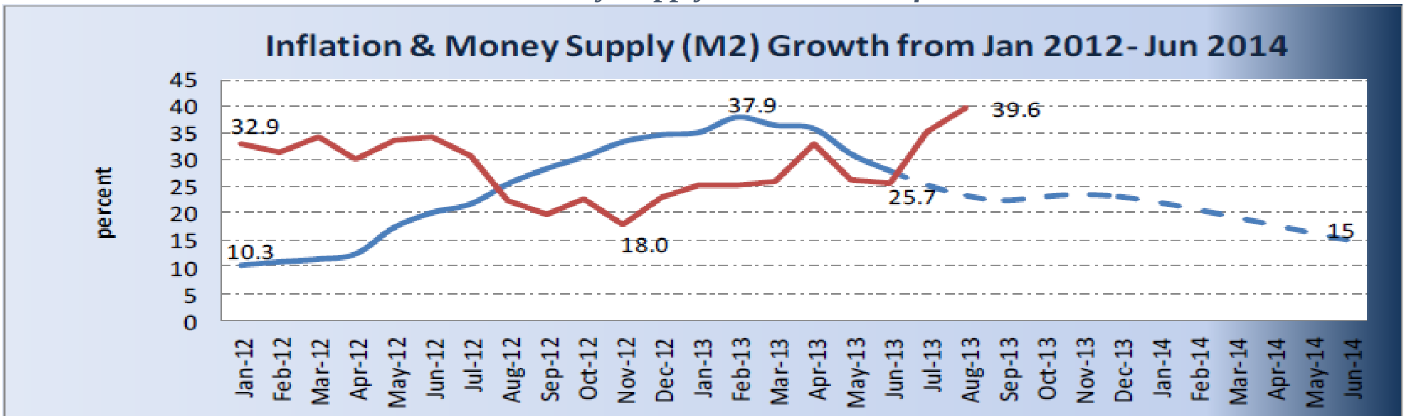
For signaling the stance of monetary policy, the Bank introduced the Policy Rate (PR). This rate was previously referred to as the Bank rate. In order to further enhance policy effectiveness, the Lombard facility was introduced. This facility offers a rate at which commercial banks borrow from the Bank. The facility is meant to assist commercial banks to better manage their liquidity. The Lombard rate is maintained at 2 percentage points above the PR. The Bank is also enhancing communication with stakeholders and the general public. The increasing use of communication helps to disseminate more widely monetary policy decisions thereby increasing efficiency of policy transmission.

2.0 Assessment of Monetary Policy Implementation in 2014

2.1 Key Objectives

At the time of release of the first monetary policy statement in November 2013, the inflation targets for December 2013 and June 2014 were set at 23.1 percent and 15.0 percent, respectively *(see chart 1)*. The targets took into account expected seasonal rise in food prices and inflationary impacts of the donor postponement of budget support disbursements. The inflation targets were considered to be consistent with real GDP growth of 5.0 percent in 2013 and 6.1 percent in 2014. Consistent with this framework was a programmed import coverage of at least 2.0 months.

Chart 1: Money Supply Growth and Inflation



	Jan-12	Feb-12	Mar-12	Apr-12	May-12	Jun-12	Jul-12	Aug-12	Sep-12	Oct-12	Nov-12	Dec-12	Jan-13	Feb-13	Mar-13	Apr-13	May-13	Jun-13	Jul-13	Aug-13	Sep-13	Dec-13	Jun-14
inflation	10.3	10.9	11.4	12.4	17.3	20.1	21.7	25.5	28.3	30.6	33.3	34.6	35.1	37.9	36.4	35.8	31	27.9	25.2	23.3	22.4	23.1	15
M2 Growth	32.9	31.4	34.3	30.1	33.6	34.3	30.7	22.4	19.9	22.7	18.0	22.9	25.4	25.1	25.8	33.0	26.3	25.7	35.1	39.6			

Source: Reserve Bank of Malawi

2.2 Measures Implemented

The monetary policy committee (MPC) met six times to deliberate on economic developments and decided on the course of monetary policy. The risks resulting from low budget support required a response from monetary policy that would accommodate a level of government domestic borrowing while ensuring an early return to the programmed disinflation path. Therefore, throughout the 2013/14 fiscal year, the Committee took a tight monetary stance by maintaining the Bank Rate (BR) and the liquidity reserve requirement ratio (LRR) at 25.0 percent and 15.5, respectively. The kwacha continued to be determined by market forces given the low level of foreign exchange reserves in the context of reduced donor inflows.

When inflation accelerated between December 2013 and January 2014 and government increased recourse to domestic borrowing, the Bank implemented the following additional measures effective 1st January 2014:

1) LRR was tightened by eliminating vault cash as an eligible asset and banks were further required to maintain a minimum of 12.0 percent LRR deposits per day.
2) A PR was introduced to anchor inflation expectations.
3) The Lombard rate (PR plus 2 percentage points) was introduced, replacing the Bank rate.

The introduction of the Policy Rate and Lombard rate aimed at enhancing the effectiveness of monetary policy through better alignment of money market rates, while fostering the development of alternative money market instruments. In this context, the Treasury bills market was aligned with the PR.

In order to increase effectiveness in implementing the monetary program, the Bank increased usage of liquidity forecasting to determine optimal market intervention. Open market operations were used to adjust liquidity in the system in line with the inflation objective.

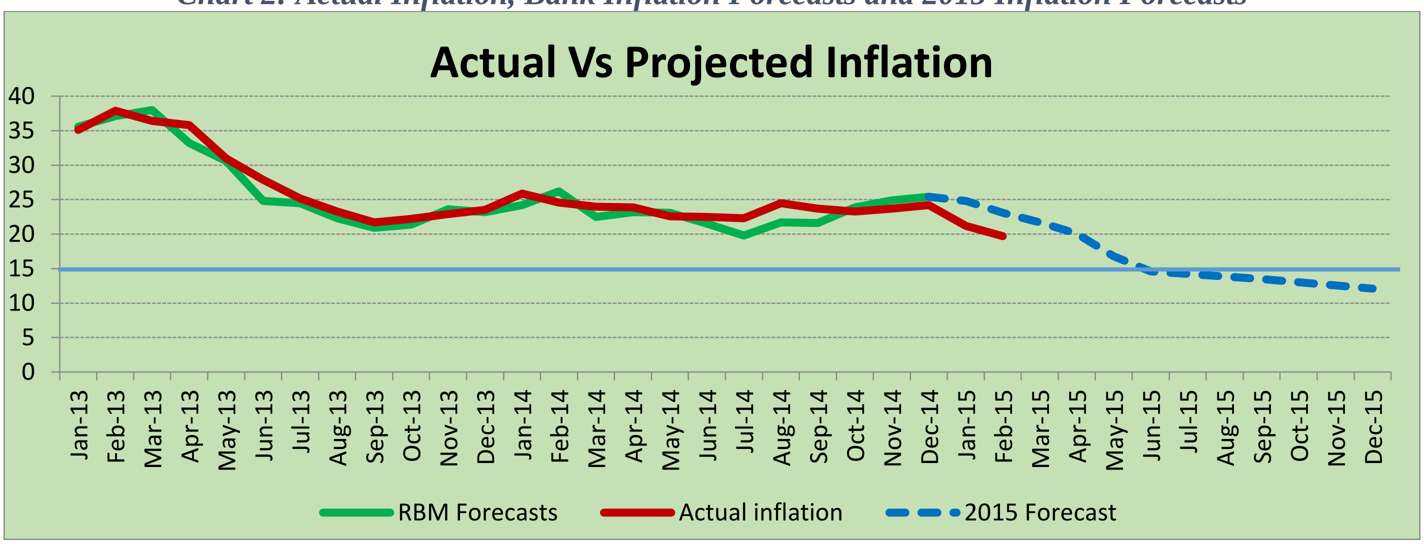
The Bank also intensified communication with stakeholders on monetary policy issues in order to help steer expectations in line with the objectives of monetary policy. The first ever conference on the Malawian experience in formulating and implementing monetary policy was held in August 2014. A series of media activities were implemented to provide information to the general public.

2.3 Assessment of Policy Outcomes

2.3.1 Inflation

Before assessing effectiveness of monetary policy measures, it is important to recall that the inflation projections alluded to earlier were set prior to the events of September 2013 when government was still receiving direct budget support. As depicted in the chart below, the Bank's inflation forecasts were on the whole accurate, with a mean forecast absolute error of 1.3 percentage points. With this experience, the Bank continued to use its inflation forecasting model in informing monetary policy decisions and to anchor expectations through the PR.

Chart 2: Actual Inflation, Bank Inflation Forecasts and 2015 Inflation Forecasts



Source: Reserve Bank of Malawi

The inflation outturn for December 2013 at 23.5 percent was in line with the projected 23.1 percent. However, the gap between the inflation target and actual outturn widened in June 2014 as inflation stood at 22.3 percent, compared to the projection of 15.0 percent.*(Chart 2)*.

A number of factors contributed to missing the inflation target. On the fiscal front, it would be recalled that Government embarked on a zero net domestic borrowing policy. This was quickly compromised by the donor suspension of direct budget support. This resource gap created a twofold problem in terms of monetary policy implementation: i) it raised the level of domestic financing requirements by government which created more liquidity in the economy ii) it

heightened pessimistic inflation expectations by the public and precipitated exchange rate depreciation. These developments propelled a rise in growth rate of money supply and inflation.

A second reason was failure to consistently apply the APM on energy prices in the second half of the fiscal year. Although oil prices declined in 2014, the benefits for disinflation were not fully realized as the APM was not applied consistently. The third main factor was that contrary to expectations, food prices particularly for maize did not go down significantly during the harvest season.

Despite inflation turning out higher than anticipated, the seasonal amplitude *(Chart 1)* of inflation in December 2013 and January 2014 moderated from a high of 37.9 percent in March 2013 to 22.3 percent in July 2014. This indicated that in spite of the shocks that the economy experienced, inflation fighting measures worked.

Table 1: Monetary Aggregates June 2013 to November 2014

	June 2013	**December 2013**	**June 2014**	**December 2014**
Broad Money (M2)	448	522	559	616
Reserve Money	127	157	193	212
Credit to Private Sector	232	250	270	293
Credit to Government (net)	403	452	518	152
Memorandum items				
End of Period Position				
M2 Growth	25.7	35.1	24.8	18.0
Reserve Money Growth	24.8	38.6	52.6	35.3
Private Sector Credit Growth	11.5	14.4	17.0	17.2
Inflation	27.9	23.5	22.5	24.2

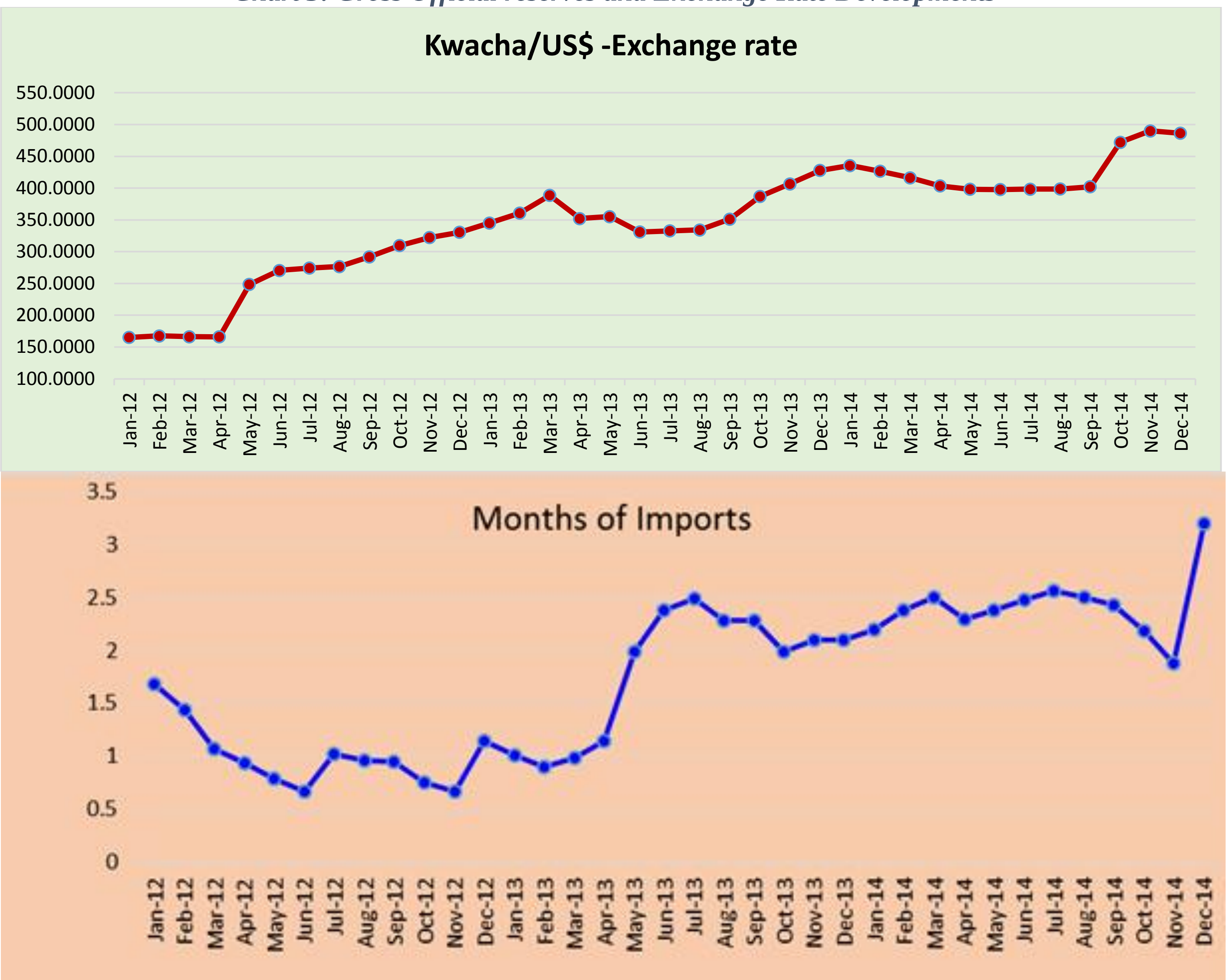
Source: Reserve Bank of Malawi

NB: 1. Figures presented in billions of kwacha whilst growth rates presented as percentages. Annual growth rates are reported in this table

2.3.2 Official Foreign Exchange Reserves and Exchange Rate

A 3.5 months of import cover of official foreign exchange was programed for June 2014. This was not achieved as the Bank increased support to the market due to the continued suspension of direct budget support from donors. The Bank therefore revised its reserves target and sought to maintain at least 2.0 months of imports during the 2013/2014 fiscal year. Thus, foreign exchange reserves averaged US$435.2 million during the 2013/2014 fiscal year, almost double an average of US$220.1 million recorded in the preceding fiscal year. A stronger foreign exchange reserves position, and a tight monetary policy stance, led to a slightly lower average monthly depreciation of the Malawi Kwacha/United States dollar of 1.6 percent compared to a monthly average of 1.8 percent in the previous year.

Chart 3: Gross Official reserves and Exchange Rate Developments



Source: Reserve Bank of Malawi

3.0 The Context of Monetary Policy implementation in the FY 2014/15

3.1 Global Economic Trends

Global economic trends also present important issues to consider when crafting and implementing monetary policy as well as determining its effectiveness. The first trend is that of crude oil prices. The price is projected to remain low for the next 12 months. Equally important are the growth prospects and monetary policies of the developed countries and emerging markets, which affect global economic growth and interest rates. Most developed countries and emerging markets are experiencing good recoveries and growth rates. But the Euro zone has been caught in a deflationary situation. This led the ECB to re-introduce quantitative easing with higher targets and longer time horizon, with the impact of keeping interest rates low. These policies are likely to lead to stronger growth in the Eurozone, and support more imports from other parts of the world including Malawi. Ceteris paribus, this could have a positive impact on reserves position and the exchange rate positive benefits for disinflation.

3.2 Domestic Economic developments

An important context for implementing monetary policy in the FY 2014/2015 is the continuing inflation dynamics underpinned by the dominance of agriculture in economic activities. Inflation decelerates with improved food availability and tobacco auctions from April to September of every year. Inflation then accelerates with food scarcities and excessive demand for foreign exchange from October to March. Monetary policy does not seek to address these underlying dynamics but rather to achieve balance between output growth and monetary aggregates as well as to smoothen the exchange rate movements. The Bank forecasts that these inflation dynamics will improve over time as production structures respond to macroeconomic stability in the context of a market-determined exchange rate.

Initial government's budget framework for FY 2014/2015 programed inflation target of 15.0 percent for June 2015 and economic growth at 5.8 percent for 2015. The budgeted deficit was K107.0 billion, of which K15.0 billion was expected to be financed by borrowing from the domestic market while K92.1 billion was expected to be sourced externally. Implementation to date has revealed a K37.0 billion shortfall in revenues and grants largely due to non-disbursement of dedicated grants. Consequently, an additional domestic borrowing of K10.0 billion will be required whilst the remaining part will be met through additional grants and additional tax revenue.

In line with this, the implementation of monetary policy will manage risks to the disinflation process that may arise from unplanned domestic borrowing requirements and shortfalls in programmed donor grants. In general, broad money will be programmed to grow in line with growth in nominal GDP forecast that will be made clear after taking into account the impact of the floods and the dry spells experienced in some parts of the country. The impact of these natural occurrences will most likely affect the December 2015 inflation outcome and less so for the June 2015 inflation. On the institutional side, the consistent implementation of the APM will help to transmit gains from falling international oil prices and exchange rate developments into lower inflation.

4.0 Monetary Policy Framework for 2015

4.1 Policy Objectives and Measures

Monetary policy aims at bringing down inflation to the targeted 15.0 percent by June 2015 and to around 12.0 percent by December 2015. To anchor firmly inflationary expectations in the medium-term, the Bank also aims at maintaining foreign exchange reserves of at least 3 months of imports by December 2015.

4.2 Projection of Monetary Aggregates

In the medium term, monetary policy aims at bringing down headline inflation with a view to gradually move towards the Southern African Development Community (SADC) macroeconomic convergence criteria of 5.0-7.0 percent.

To achieve the 15.0 percent inflation target for June 2015, the monetary program should achieve an average inflation of 17.3 percent in 2015. Inflation is programmed to close 2015 at 12.0 percent. Correspondingly, the respective average growth rate for broad money supply and reserve money in the monetary program are 20.7 percent and 27.2 percent. In consequence, at December 2015, the respective year-on-year growth of broad money supply and reserve money are programed at 21.5 percent and 21.4 percent. As a corollary, these monetary aggregates entail an average net central government borrowing from the banking system of K144.0 billion.

Private sector's uptake of loans is expected to grow by an average of 18.6 percent in 2015. This represents a stock of K331.0 billion loans availed to private enterprises during the year.

Table 2: Monetary Targets for March to December 2015

	March 2015	June 2015	December 2015	Average 2015
Broad Money (M2)	626	671	730	-
Reserve Money	223	244	261	-
Credit to Private Sector	313	324	355	-
Credit to Government (net)	141	126	166	-
Memorandum items				
M2 Growth	20.6	19.9	21.5	20.7
Reserve Money Growth	32.1	26.2	21.4	27.2
Private Sector Credit Growth	18.3	19.8	17.6	18.6
Inflation	21.7	15.0	12.0	17.3

Source: Reserve Bank of Malawi

NB: 1. Figures presented in billions of kwacha whilst growth rates presented as percentages. Annual growth rates are reported in this table.
2. The figures presented as discussed and agreed with the IMF during Article IV Consultations

All the policy tools in the arsenal of the Bank will be used when appropriate. The conduct of open market operations will be enhanced by developing new tenor classes and bonds to manage structural liquidity. The basic operating framework will be to keep short term interest rates around the PR.

Prospects for meeting the foreign exchange reserves target are high, primarily on account of planned market purchases. In this regard, the official reserves were boosted in December 2014 by a portfolio inflow amounting to US$250.0 million through the purchase, by the PTA Bank, of a 3-Year Treasury note from the Bank. Going forward, communication will further be intensified to moderate speculative behavior on the foreign exchange market during the lean season. The private sector has demonstrated resilience in sourcing and managing reserves to complement the official reserves position. During the lean period, private sector foreign exchange reserves are therefore expected to continue to support the foreign exchange market. The Bank will continue to facilitate importation of strategic imports such as fuel through appropriate foreign financing facilities.

Going forward, the Bank will modernize its monetary policy framework to make it more forward looking. Initially, the framework will be a hybrid of monetary aggregates and interest rate targeting. Gradual transition to inflation targeting lite will be based on meeting the prerequisites for implementing that kind of framework. A key requisite is the reduction of fiscal dominance in the monetary policy framework.

4.3 Risk Assessment and Expected Policy Outcomes

The prospect of achieving 15.0 percent inflation in June 2015 and 12.0 percent in December 2015 could be undermined by the following risks:

1) Failure to finance fiscal deficit as planned. The 2014/2015 budget has a planned deficit of K107.1 billion, expected to be financed largely through external resources. Failure to finance the deficit as planned plus weak cash flow management present serious risks for the monetary policy framework. This risk can be mitigated by enhanced coordination of monetary and fiscal operations.
2) Rising food prices as a result of reduced maize production due to the flooding in some parts of the country Mitigation of this risk depends on how government manages food price expectations as well as how it finances the food gap caused by the floods and the drought.
3) A sudden turnaround in international commodity prices (crude oil). On present prospects this risk appears unlikely to materialize with increased output in Saudi Arabia. Nonetheless, it is important that the APM continues to be implemented as designed in order to ensure full transmission of low crude oil prices to the local pump price.

5.0 Conclusion

The outlined monetary policy stance and program is needed to achieve an inflation of 15.0 percent in June 2015 and around 12.0 percent in December 2015. The Bank also aims to maintain foreign exchange reserves for 3.0 months of import cover up to December 2015. The measures are also consistent with a real GDP growth of 5.8 percent in 2015.

The successful implementation of the 2014/2015 budget is germane to attaining these objectives. At the same time, the efforts to bring down inflation are more likely to be successful if the APM continues to be consistently implemented. However, risks remain in the months ahead depending largely on how government intends to finance emergency response as well as how the food situation is managed to contain speculative price behavior. The Bank will continue to monitor the situation and the impact will be fully assessed in our next issue of the Monetary Policy Statement when Government has made its plans public during the next budget session.

Charles S.R. Chuka
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