



## **ECONOMICS ASSOCIATION OF MALAWI**

Area 14/113  
Off Presidential Highway  
P.O Box 31722  
Capital City, Lilongwe  
Tel: 0885-280-198  
E-mail: [secretariat@ecamamw.com](mailto:secretariat@ecamamw.com)  
Website: [www.ecamamw.com](http://www.ecamamw.com)

### **WHAT DOES THE DOWNWARD REVISION OF THE POLICY RATE MEAN TO THE MALAWI ECONOMY?**

#### **Introduction**

The Reserve Bank of Malawi during their Monetary Policy Committee (MPC) meeting held on 29<sup>th</sup> and 30<sup>th</sup> January 2019 resolved to revise the Policy rate (PR) and other rates with immediate effect. This decision follows the improvement in the country's macroeconomic conditions as characterized by declining inflation, stable exchange rate, improved foreign reserves, projected better crop yield for 2019 and favorable global developments including stable global oil prices. Subsequently, PR was revised by 150 basis points to 14.50 percent, Lombard Rate was revised to 40 basis points above PR (14.9 percent) from a minimum of 400 basis points above the PR. Furthermore, Liquidity Reserve Requirement (LRR) was revised from 7.5 percent to 3.75 percent for foreign currency denominated accounts and to 5.0 percent for local deposits. Unlike in the previous periods where commercial banks were left to decide their base lending rates solely based on risk profile of the borrowers and other factors, now banks are required to benchmark their base lending rate against the Lombard Rate. Consequently, minimum base lending rate for banks is now at 14.9 percent against an average 24.8 percent in January 2019.

#### **What is the Role of the Reserve Bank in Economic Policy Formulation?**

On the outset, it has to be emphasized that the mandate of the Reserve Bank of Malawi is to formulate and implement monetary policy to ensure price and financial stability in the country. And when

price and financial stability objectives are in conflict, the new RBM Act (2018) stipulates that price stability will take prominence over financial stability. Implied in these objectives, is the role of the RBM to support economic growth in the country.

Following the assessment of the country's macroeconomic development, the MPC observed that the country registered negative output gap in the second half of 2018 and projected to persist in the first quarter of 2019. The issue of output gap<sup>1</sup> is of interest to the RBM because it is an indicator of inflationary dynamics as positive output gap signals inflationary pressures while negative output gap signals deflationary pressures within an economy. Therefore, the decision was taken to respond to the prevailing developments in a bid to sustain and support effective operation of the economy.

#### **Statement of Intent**

This brief does not endeavor to merit or demerit the monetary policy decision that was taken based on the performance and prospects of the economy but rather provides a synopsis of what this development means to the economy? Neither does this brief consider the effect of the policy on banks' operations i.e. effect of the policy on loan supply.

#### **What does the Policy Rate Revision Mean to Enterprises and Individual Borrowers?**

First and foremost, reduction of PR, Lombard Rate and subsequent direction that base lending rate of

---

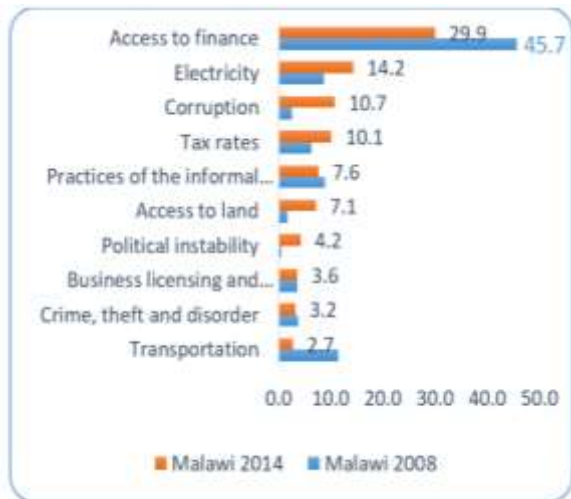
<sup>1</sup> A negative output gap indicates that actual economic output is below the economy's full output capacity while a positive

output indicates an economy that is outperforming its expectations but below its maximum potential.

commercial banks be at 40 basis points above the Lombard Rate implies that the cost of borrowing or finance will significantly decline to around a minimum of 14.9 percent from an average of 25.0 percent in January 2019. This notwithstanding, the cost of borrowing will largely depend on risk profile of the respective borrowers.

- This development means that those with existing loans will have their loan obligations significantly reduced. A low interest rate means that when making monthly loan repayments, more of the repayment goes toward the principal balance instead of toward interest. The implication is that the probability of the levels of non-performing loans to decline is likely to increase.
- It is generally argued that access to and cost of finance remains a major bottleneck to doing business in the country. Survey findings by World Bank Malawi Investment Climate Assessment (ICA) shows that access to finance is a biggest challenge to doing business in Malawi (Chart1). The decline in cost of borrowing is therefore expected to allow new borrowers to borrow from banks to finance their investments.

Chart 1: Top 10 challenges to doing business in Malawi



Source: World Bank Presentation, ECAMA Annual Conference, 2017

- It would be more beneficial if more borrowing will go towards financing productive sector as this will spur growth. It is observed that most small and medium enterprises and even some large enterprises fail to expand their operations or production due to lack and cost of finance. It is therefore

expected that the reduction in base lending rates will unlock and unleash the finances. In the event that new borrowing is channeled towards consumption, the end result is inflationary pressures as there is more money in the economy chasing few goods.

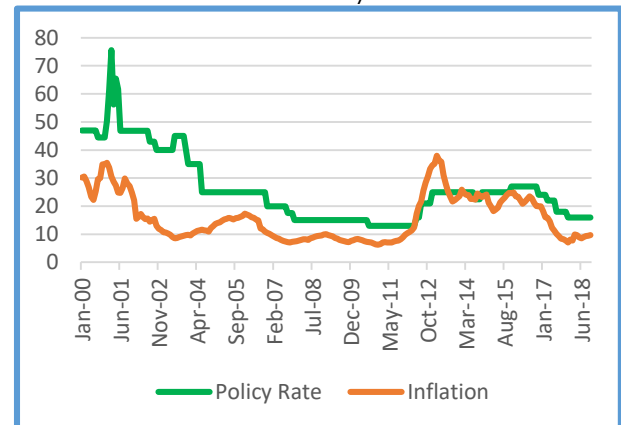
Reduction of the LRR implies that around K47.0 billion will be immediately available as loanable funds (January 2019 Monetary Policy Press Briefing).

- This means that the available funds would increase access to finance in the credit market.
- Secondly, this also means banks will be able to earn some returns on the funds that would otherwise remain idle thus increasing economic efficiency.

### What are the expected benefits to the entire economy?

Theoretically, in the long run inflation and interest rate exhibit a positive relationship, meaning that sustained decline in inflation is supposed to be followed by a decline in interest rate (Chart 2). In a bid to support growth and reduce the existing output gap, the RBM followed the conventional wisdom by revising the Policy Rate downwards with the ultimate goal of reducing the cost of borrowing. This is expected to spur economic growth from increased investments more especially in real sector, as among others, allows entrepreneurs and investors to venture into business with more economic returns at a lower cost of financing. For a long time, borrowers and investors have been looking forward to such opportunity so that business can ride on lower cost of funds to expand their operations and even to establish new enterprises.

Chart 2: Inflation and Policy Rate Movements



Reduced interest rates also means reduced cost of borrowing and debt on the part of government. On a positive note, this means the government will have reduced loan repayment obligations on loans

obtained from the domestic market. However, if not handled well, this may result into insatiable borrowing due to cheaper loans and may end up crowding out private sector borrowing and also disturbing the hard earned macroeconomic stability. The government has, in recent past, shown fiscal prudence by consistently meeting most of the quantitative targets of the Extended Credit Facility (ECF) Program and the government remains geared to remaining on track with the ECF program, hence the appetite to borrow is likely to be controlled.

### **What Do We Learn from the Previous Policy Rate Cuts?**

It is also interesting to know what the previous interest rate cuts meant to credit extension. RBM Monetary Survey data shows that previous interest rate cuts have, on average, resulted into increase in credit to both government and private sector, albeit with some lags. However, domestic credit declined in real terms despite its nominal increase, this was due to the fact that the increase was lower than the rise in inflation. This implies that such private sector increases were meant to offset the loss in the purchasing power of the kwacha but not necessarily a response to reduced cost of borrowing. This development could further imply that despite the decrease in lending rates, they remained relatively high to induce more borrowing.

In terms of sectoral allocation of credit to private sector, Wholesale and Retail trade, Agriculture and Manufacturing, respectively benefit the bulk of the credit with minimal percentage being channeled towards households.

This means that the credit is mostly accessible to medium and large enterprises that are predominantly in the aforementioned sectors.

Secondly, our country is still lagging behind in financing more productive sectors as more credit went to Wholesale and Retail trade (26.0 percent) than to Agriculture (23.0 percent) and Manufacturing (19.0 percent) between January 2017 and November 2018. **This notwithstanding, private sector borrowing is largely used to finance investment activities as opposed to consumption.**

A noteworthy is that the RBM Monetary Survey statistics reveal that the decline in Policy Rate from 27 percent to 16 percent between November 2016 and December 2017 resulted into more rapid increase in government credit than in private sector credit. This development has a potential to crowd out private investment and this would be a cause for concern.

### **Conclusion**

In conclusion, it is believed that for this policy direction to achieve the intended purpose, there is a need for incentivizing productive industries by coming up with more financial products on part of financial institutions and conducive policy interventions/environment by authorities to support productive sectors such as agriculture and manufacturing.