THE BUSINESS PERSPECTIVE

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Main feature article in this issue:

Understanding the Developments in the Downward Trend of Inflation

Inflation rate developments in Malawi have come under great debate by various commentators in recent times in view of its continuous downward trend. The trend as reported by the Malawi National Statistical Office (NSO), shows that the latest rate is at 8.3 percent in October from 8.4 percent recorded in September 2017. This is 0.9 percent below 9.3 percent reported in August 2017. The Malawi Government, International Monetary Fund (IMF) and other economic authorities have hailed sound economic policies as responsible for such decline. In particular, Reserve Bank of Malawi (RBM) has been applauded for the good tight monetary policy that is being pursued. Nonetheless, important questions remain: firstly, is this downward trend of inflation contributing to the economic developments? Secondly, to what extent is it contributing to improvement of the business development in Malawi? Is this downward trend sustainable?

Inflation is casually defined as “too much money chasing a few goods”. Still, it is better to formally define it as increases in the general level of prices.

It is imperative in this case to understand what the inflation transmission mechanisms is in the whole process. There are different schools of thought in explaining inflation movements; others describe it as monetary phenomenon but others have viewed it from a structural point of view. Both views have theoretical perspectives to justify their cause but what can a Malawian case be?

Historical Trend of Inflation Rates in Malawi

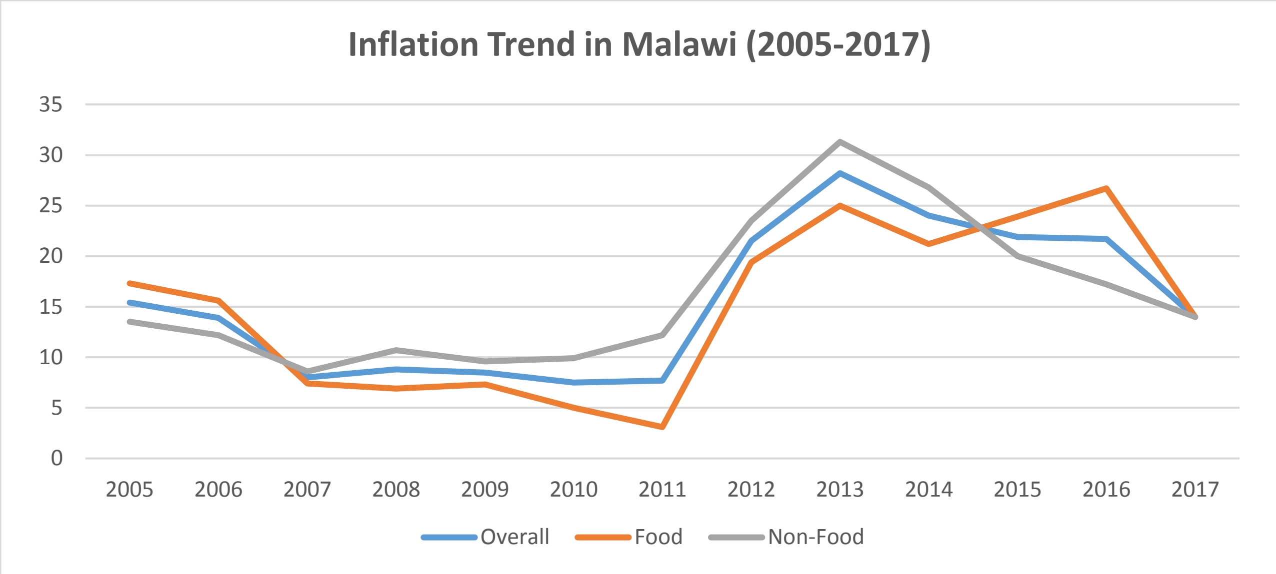
Food costs account for 50.2% of the Consumer Price Index whilst the remaining percentage is comprised of non-food costs. In light of this composition, the question of whether inflation in Malawi is a monetary phenomenon or not is not merely academic but has profound implications for economic policy. It is from this background that some authors in this area such as Simwaka and Ligoya conclude that it is the responsibility of the Reserve Bank of Malawi and the fiscal authorities to achieve price stability if inflation is a monetary phenomenon. But if it is primarily caused by food prices, it would appear that investments in real sector, should play a key role in containing inflation.

Contemporary growth theory examines the food grain prices as an important factor for saving and investment in the developing nations. High prices of food items hamper the growth of saving as well as investment. High food inflation gradually wears away the benefits of growth and leaves the poor worse off.

High food price levels and macroeconomic imbalances are a global concern and addressing sharp rises in food inflation has become a central macroeconomic policy concern for many countries.

In Malawi, inflation has been quite volatile in the 1990s to early 2000s but the volatility slowed down from around 2006 to 2009. Inflation rose sharply in 1995 to a peak of 95 percent due to a serious drought but declined abruptly and sharply to close the year 1996 at 6.7 percent. The decline was attributed to a rebound from drought, assisted by favourable weather conditions and fiscal adjustments implemented by Reserve Bank of Malawi, including the curtailment of automatic access by the government to central bank credit. Inflation picked up again in 1999 and remained volatile in early 2000s due to temporary loss of fiscal discipline and nominal exchange rate depreciation. From 2012, inflation has been very high following a massive devaluation of the kwacha that led to exchange rate volatility. The figure below shows the fluctuations of inflation in Malawi from 2005 to 2017.

Figure 1: Inflation Trends in Malawi



Source: National Statistical Office

These trends show that from 2008 to 2011, there was a continuous decline in the food inflation but nonfood inflation was somehow stable. The figure also shows that from 2007 to mid-2014, non-food inflation has always been higher than the food inflation

Measurements and Controversy over the Inflation Trends

The National Statistical Office as an authority in the measurement of statistics measures inflation rates based on a fixed basket of goods and services consumed by a typical Malawian household. The current Consumer Price Index (CPI) is based on the household consumption patterns from the 2010/2011 Integrated Household Survey (HIS 3). The CPI compares the current month prices of consumption goods and services with a similar month in the previous year. Prices in the CPI are collected from 22 markets and trading centres selected to represent the rural part and the four cities of Malawi to represent the urban part.

The CPI is compiled for several uses such as; deflation of National Accounts, adjustment of wages and salaries, policy issues determination, general measure of inflation, target rate for central banks, general wage indexation, indexation of government benefits, indexation in legal contracts and regulations, taxation liability adjustment, among others. This underscores the importance of Consumer Price Index in economic development.

It is important to note that it is internationally recommended to rebase the CPI every 5 years because generally household consumption patterns change over time in response to changes in products and income of households. The current CPI for Malawi uses 2012 as its base year after the 2010/2011 IHS.

The current weights used compared to previous ones are shown in the figure below:

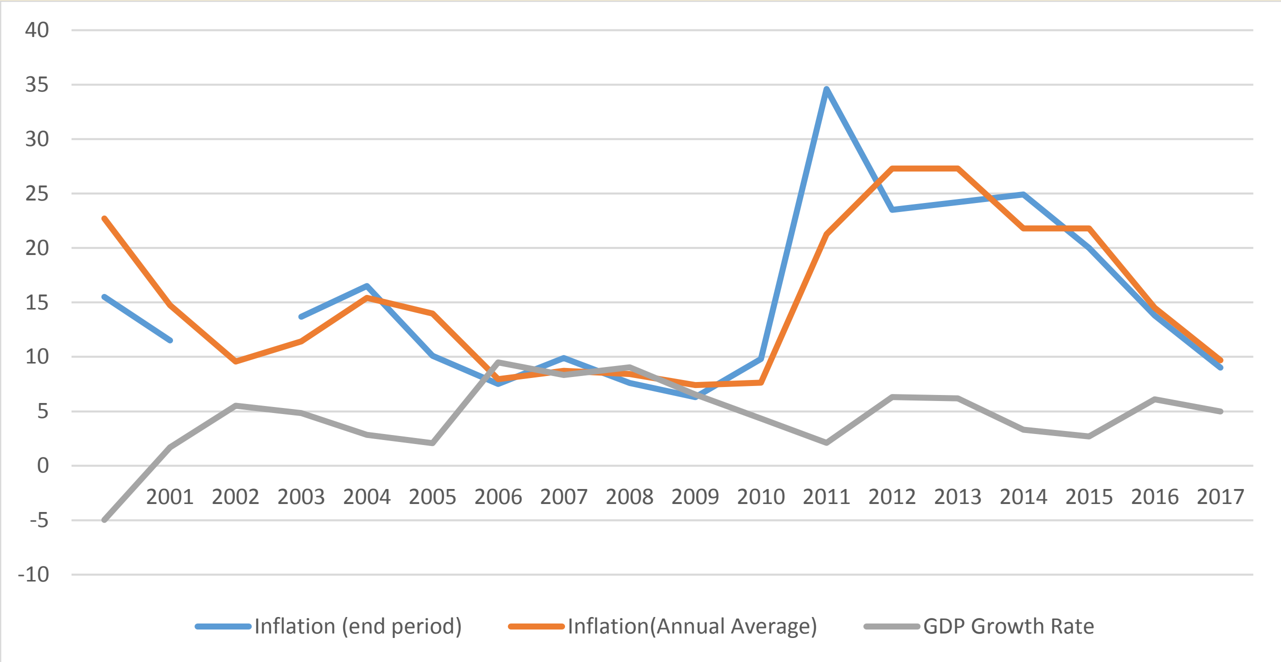
No	Classification	Weights Up To 2011	Weights from 2012
01	Food and Non- Alcoholic Beverages	54.1	50.24
02	Beverages, Tobacco and Narcotics	2.7	2.51
03	Clothing and Footwear	9.5	3.24
04	Housing, Water, Electricity, Gas and other Fuel	8.3	14.74
05	Furnishing, Household Equipment and Routine Household Maintenance	7.8	4.24
06	Health	1.2	1.44
07	Transport	6.5	6.63
08	Communication	0.9	5.84
09	Recreation and Culture	1.5	2.23
10	Education	2.9	4.52
11	Restaurants and Hotels	1.4	1.34
12	Miscellaneous Goods and Services to Personal care	3.2	3.03
	Total	**100.0**	**100.00**

Source: National Statistical Office Bulletins

The Relationship between Inflation Rates and Economic Growth

The figure below shows the relationship between economic growth rate and inflation rates.

Figure 2: Inflation and GDP Growth Rates Trends (Percent)

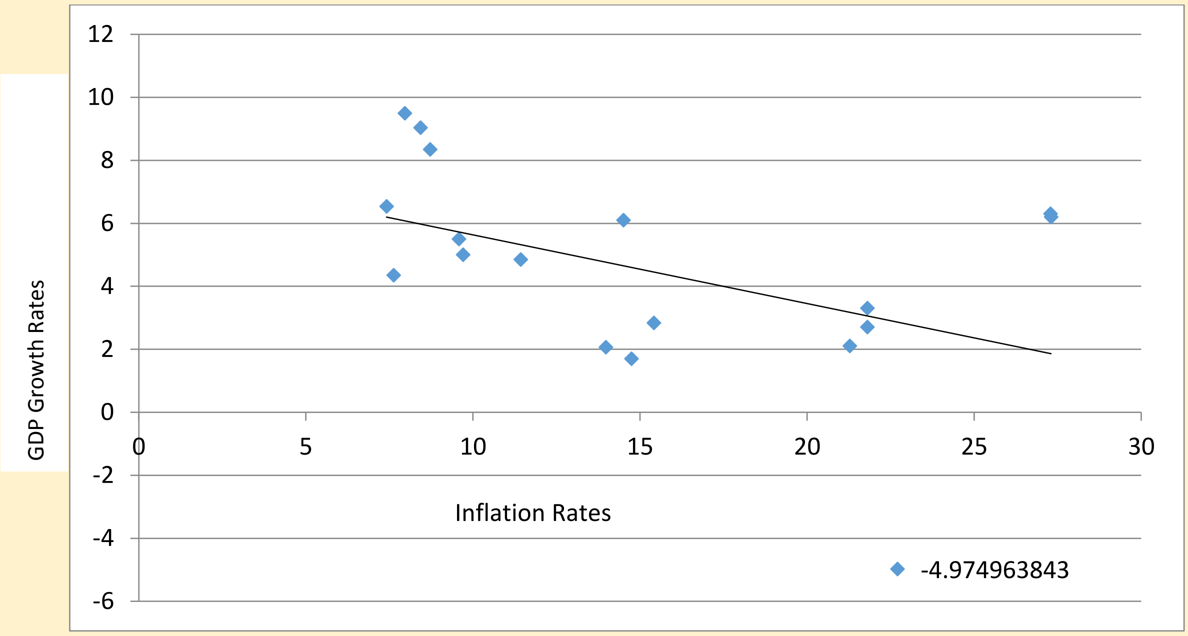


Source: NSO and World Bank Development Indicators

The figure 2 above show inflation and GDP Growth rates for a period 2001 to 2017. The graph clearly shows that higher inflation periods have been associated with lower economic growth particularly during the periods 2001- 2006 and 2010 -2016.

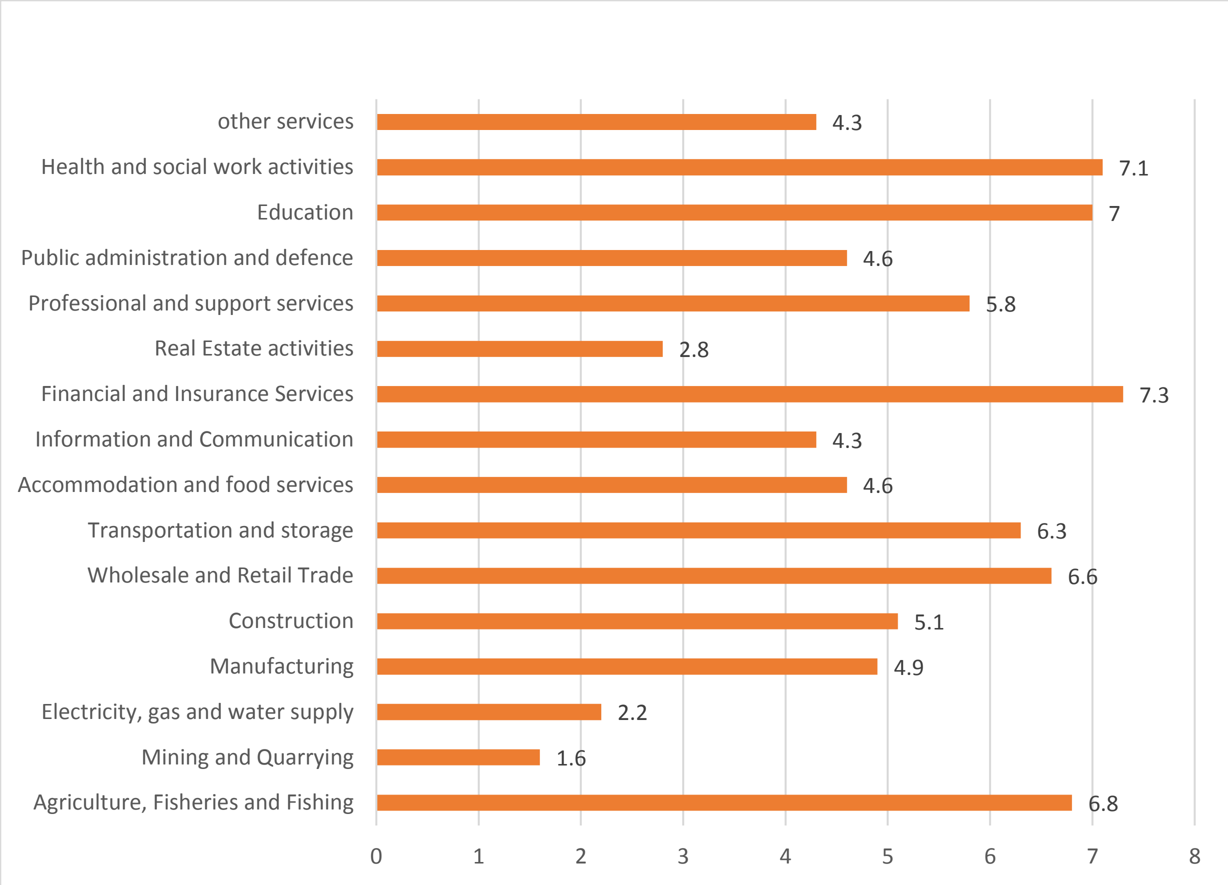
The figure 3 below demonstrates the negative relationship between inflation and economic growth using the same data from figure 2 above. As can be seen, there is a negative relationship between inflation and economic growth (-4.97). Lower inflation rates historically have also been associated with higher agricultural growth and this explains the reason economic growth is driven largely by agriculture. With a lot of risks in the agriculture sector, dependency on rain-fed agriculture for economic growth creates a growth that has not been sustainable.

Figure 3: Relationship between Inflation and GDP Growth rates



Growth transmission has run from agriculture to non-tradeables and only minimally to domestic manufacturing. This is despite strong demand for consumer imports. Malawi experienced macroeconomic instability between 1995 and 2003 which suppressed investment through high inflation and cost of credit which prevented growth transmission, and this has been repeated the later years between 2011 and 2016 as shown in the figure 4 below.

Figure 4 Sectoral GDP Growth Rates 2017 (Percent)



Source: 1 Annual Economic Report, Ministry of Finance Economic Planning and Development

During the year 2017 forecasts of high growth rates has been perceived on Financial and Insurance services (7.3 percent), wholesale and retail activities (6.6 percent), education (7.1 percent), agriculture (6.8. percent) and health and social work activities (7.1 percent). Growth rate (4.9 percent) in the manufacturing sector is affected by energy challenges.

Understanding the Transmission Mechanism in Inflation rates

Low and stable inflation is the long-run primary objective of the monetary policy pursued by a Central Bank. Understanding the transmission mechanism therefore reveals channels of inflation rates and helps policy makers to focus on such sources to tame inflation. Broadly, monetary transmission mechanism is the process by which asset prices and general economic conditions are affected as a result of monetary policy decisions. Such decisions are intended to influence the aggregate demand, interest rates, and amounts of money and credit in order to affect overall economic performance. This transmission therefore refers to the process by which a central bank's monetary policy decisions are passed on, through financial markets, to businesses and households. The simple story about this is that reduced level of economic activity would be consistent with lower inflation because lower demand usually means lower prices. Tight monetary policy is where a Central Bank authority adopt a policy that decreases money supply and raises interest rates as a means to slow down economic activity. Restriction of money supply in an economy by the central bank works through mechanisms such as tightening of credit, soaking up cash by selling government bonds, and/or raising the banks' reserve requirements. The mechanisms are applied in Malawi with the purpose of containing inflation. This is done as a cautionary approach because of lack of prudence in the fiscal policy on one hand. All these center on lack of trust that has been built by economic authorities to stimulate economic activity.

Non Monetarists hold a view that opportunities for growth are curtailed by the tight monetary policy in Malawi since the economy is not at full employment. On the other hand, Monetarists contend that excess money is a cause of increasing inflation instead of stimulating investment. Non-monetarists therefore practically argue that movements in the inflation rates are due to performance of the real sector and particularly the agriculture sector which constitutes a large part of the inflation basket and further that the good performance of the agriculture sector does not depend on good policies but good weather.

Economic Development Updates

1.1. World Economic Growth Report

a) Global recovery has weakened further amid increasing turbulence according to the September 2017 World Economic Outlook (WEO) of the International Monetary Fund.

b) World economic growth has been revised up for 2017 to 3.5% from 3.4%, while the growth forecast for 2018 remains unchanged at 3.4%. Organization of Economic Corporation and Development (OECD) growth has performed better than anticipated in the current year particularly the Euro-zone and to some extent in the US – and is now forecast to grow by 2.2% in 2017 and 2.0% in 2018. India is expected to grow by 6.9% in 2017 and 7.5% in 2018. China is expected to grow by 6.7% in 2017 and 6.3% in 2018.

c) The global impact of the unwinding of prior excess in China's economy as it transitions to a more balanced growth path after a decade of strong credit and investment growth, along with signs of distress in other large emerging markets, including from falling commodity prices are additional concerns to the economic projections.

d) Growth in emerging market and developing economies still accounts for the lion's share of projected world growth in 2017 while prospects across countries remain uneven and generally weaker than over the past two decades.

e) A number of large emerging markets including Brazil and Russia are still mired in deep recessions. In spite of this, the two countries are both forecast to expand their recovery to 0.5% and 1.5% in 2017 respectively followed by growth of 1.5% and 1.4% in 2018. Others, including several oil-exporting countries, face a difficult macroeconomic environment with sharply weaker terms of trade and tighter external financial conditions.

1.2. Economic Growth Performance in Sub-Saharan Region

a) According to the September 2017 World Economic Outlook (WEO) of the International Monetary Fund, economic growth in sub-Saharan Africa is projected to reach 2.6 percent in 2017 and 3.4 percent in 2018 (broadly in line with the April 2017 forecast), with sizable differences across countries. Downside risks have risen because of idiosyncratic factors in the region's largest economies and delays in implementing policy adjustments.

b) Beyond the near term, growth is expected to rise gradually, but barely above population growth, as large consolidation needs to weigh on public spending.

c) Nigeria is expected to emerge from the 2016 recession caused by low oil prices and the disruption of oil production. Growth in 2017 is projected at 0.8 percent owing to recovering oil production and ongoing strength in the agricultural sector. However, concerns about policy implementation, market segmentation in a foreign exchange market that remains dependent on Central bank's interventions (despite initial steps to liberalize the foreign exchange market), and banking-system fragilities are expected to weigh on economic activity in the medium term.

d) In South Africa, growth is projected to remain subdued at 0.7 percent in 2017 and 1.1 percent in 2018 despite more favorable commodity export prices and strong agricultural production as heightened political uncertainty saps consumer and business confidence.

e) In Angola, growth in 2017 has been revised upward to 1.5 percent (1.3 percent in April 2017) because a downward revision of oil production in 2016 has raised the extent of the expected rebound. The outlook for fuel-importing countries is generally brighter with an aggregate growth rate of 3.9 percent in 2017 and rising to 4.4 percent in 2018.

1.3. Global Inflation Outlook

a) Headline inflation rates are projected to increase in both advanced and emerging market and developing economies though somehow less briskly than anticipated in the April 2017 World Economic Outlook partly reflecting weaker-than-expected oil prices. In advanced economies, inflation is forecast to pick up from 0.8 percent in 2016 to 1.7 percent in 2017, reflecting the continued cyclical recovery in demand and the increase in commodity prices in the second half of 2016.

b) Headline inflation is expected to stay at 1.7 percent in 2018 before converging to 2 percent over the medium term. Inflation in emerging market and developing economies (excluding Argentina and Venezuela) is projected to remain roughly stable in 2017 and 2018 (at 4.2 percent and 4.4 percent, respectively—close to the 2016 estimate of 4.3 percent).

1.4. Global External Sector Outlook

a) Global trade is estimated to have grown by 2.4 percent in 2016 in volume terms, the slowest pace since 2009, with weak growth in both advanced economies and emerging market and developing economies. In the former, weaker trade growth was related to an investment slowdown and inventory adjustment especially during the first part of the year. In the latter, persistent weakness in trade growth was related to a protracted trade slowdown in China and a sharp import contraction in some commodity exporters facing macroeconomic strains, notably Latin America, sub-Saharan Africa, and the Commonwealth of Independent States.

b) Global trade growth picked up meaningfully in late 2016 and early 2017 reflecting a recovery in global demand and especially capital spending. Consequently, global trade growth is projected to rebound to about 4 percent in 2017 and into the medium term, about 1 percentage point higher than GDP growth at market exchange rates.

2. Local Economic Developments

2.1. Inflation and Interest Rates

a) Headline inflation for October slowed down to 8.3 percent from 8.4 percent recorded in September 2017. There is a decrease of 0.9 percent from August 2017.

b) The headline inflation for the same period last year (September 2016) was significantly higher at 21.2 percent.

c) The urban and rural inflation rates stand at 8.2 percent and 8.9 percent respectively.

d) Overall food inflation stands at 5.1 percent from 11.6 percent in August 2017. Food inflation has decreased due to the increase in the supply of cereals.

e) The Reserve Bank of Malawi maintained the policy rate and Liquidity Reserve Requirement (LRR) at 18 percent and 7.5 percent respectively with commercial bank lending and savings rates concurrently spinning at averages of 25 percent and 12 percent respectively during the month under review

2.2. Foreign Currency Market

a) In the month of October 2017, the Malawi Kwacha has been stable against all its major trading currencies on a month-to-month basis (See annex page figure 3).

b) The local unit slipped by a non-significant percent of its value against the United States Dollar (USD), trading at MK725.22 per USD at the close of last week of October 2017 from MK725 at the close of August 2017. It was also almost stable against the British Pound and South African Rand.

c) Malawi's import cover jumped above the internationally accepted three months of imports attributed to the inflow of tobacco dollars. According to the Reserve Bank of Malawi, financial market development report for August 4, 2017, gross official reserves increased slightly during the week ending July 28, 2017. According to the RBM, as at August 2, 2017, gross official reserves stood at US$695 million or 3.33 months of imports.

d) The situation further improved in the month of October 2017 as Gross official reserves increased during the week ending 13th October 2017. The official reserves closed at US$749.75 million (3.59 months of imports) compared to US$726.79 million (3.48 months of imports) recorded on 6th October 2017. As at 18th October, Gross Official Reserves stood at US$777.41 million (3.72 months of imports). The World Bank US$80 million (MK58 billion) budget support to Malawi and tobacco foreign exchange reserves could be attributed to the reported level of reserves at the beginning of the lean period. There is also a strong likelihood that it could be due to reduced demand by industries because of power challenges.

2.3. 2016 Tobacco Market Season Developments

a) The 2017 tobacco market opened in April 2017 at Lilongwe Auction Floors and closed in July 2017. Cumulatively over 99 million kilogrammes of the 124 million kilogrammes of tobacco grown this year had been traded at the auction floors at an average price of US$2 per kilogramme as at July 25. By then the commodity had realized US$198.9 million (Daily Times, July 2017).

b) The second round of crop estimates showed that tobacco production had dropped by 35% from 195 million kilogrammes in 2016 to 152 million kilogramme in 2017.

3. General Economic Outlook

a) The economic outlook for Malawi economy is still overshadowed by the gloomy global economic environment, mostly due to weak economic activity in most of its trading partners like the Republic of South Africa and China.
b) Such developments should be expected to have devastating effects on the already worsened country's trade balance.
c) The economic variables such as inflation rates, exchange rates have assumed a good direction and trend but it is essential to sustain them. However, market challenges of some exports such as pulses to India shall persist due to the weak export base of the country as a result of inability to diversity the export market.
d) The Reserve Bank of Malawi is expected to maintain the tight monetary policy.

4. Economic Indicators Annex Page

Table 1: Real GDP Growth

YEAR	2012	2013	2014	2015	2016	2017p	2018p
GDP Growth (%)	2.1	6.3	6.2	3.3	2.7	6.1	5.0

Source: Reserve Bank of Malawi and National Statistical Office

Table 2: Selected Sectoral Contribution to Economic Growth (Percent)

Sector	2014	2015	2016	2017projection	2018projection
Agriculture, Fisheries and Fishing	29.9	28.6	27.9	28.1	27.7
Mining and Quarrying	0.9	0.9	0.9	0.9	0.8
Manufacturing	9.5	9.6	9.4	9.3	9.4
Construction	2.8	2.8	2.8	2.8	2.8
Wholesale and Retail Trade	15.8	16	15.9	16	15.8
Transportation and storage	2.6	2.7	2.7	2.7	2.8
Information and Communication	4.1	4.3	4.4	4.3	4.3
Financial and Insurance Services	5.0	5.2	5.21	5.5	5.4
Real Estate activities	7.8	7.7	7.7	7.5	7.3

Source: Annual Economic Report by Ministry of Finance, Economic Planning and Development

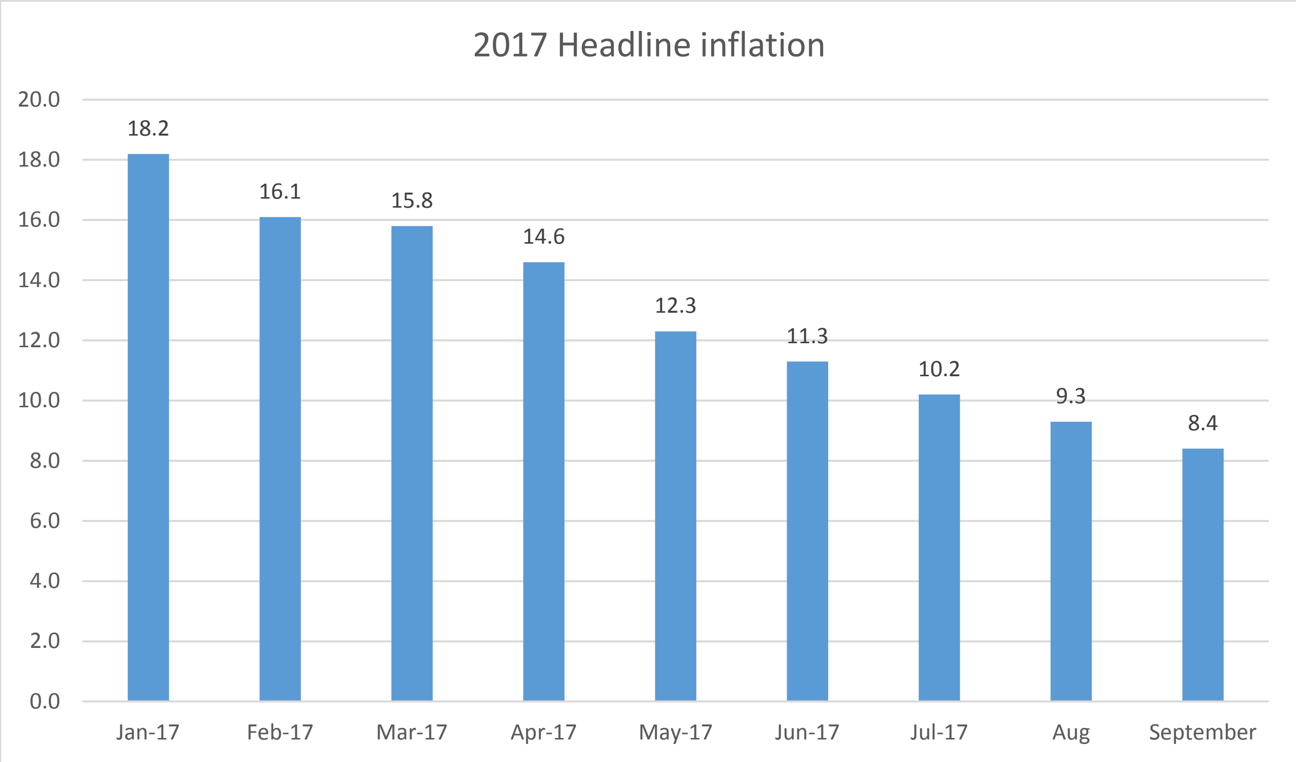
Table 3 Sectoral Growth Rates (Percent)

Sector	2014	2015	2016	2017p	2018p
Agriculture, Fisheries and Fishing	6.3	-1	-0.2	6.8	3.4
Mining and Quarrying	-4.6	1.1	0.4	1.6	2.3
Manufacturing	6.3	3.8	1.4	4.9	6.0
Construction	4.8	3.5	3.4	5.1	5.9
Wholesale and Retail Trade	6.3	4.9	2.0	6.6	3.8
Transportation and storage	4.8	4.3	4.7	6.3	5.9
Information and Communication	12.2	8.6	4.8	4.3	3.5
Financial and Insurance Services	5.5	5.6	5.5	7.3	8.1
Real Estate activities	3.7	1.9	3.1	2.8	2.7

Source: Annual Economic Report by Ministry of Finance, Economic Planning and Development

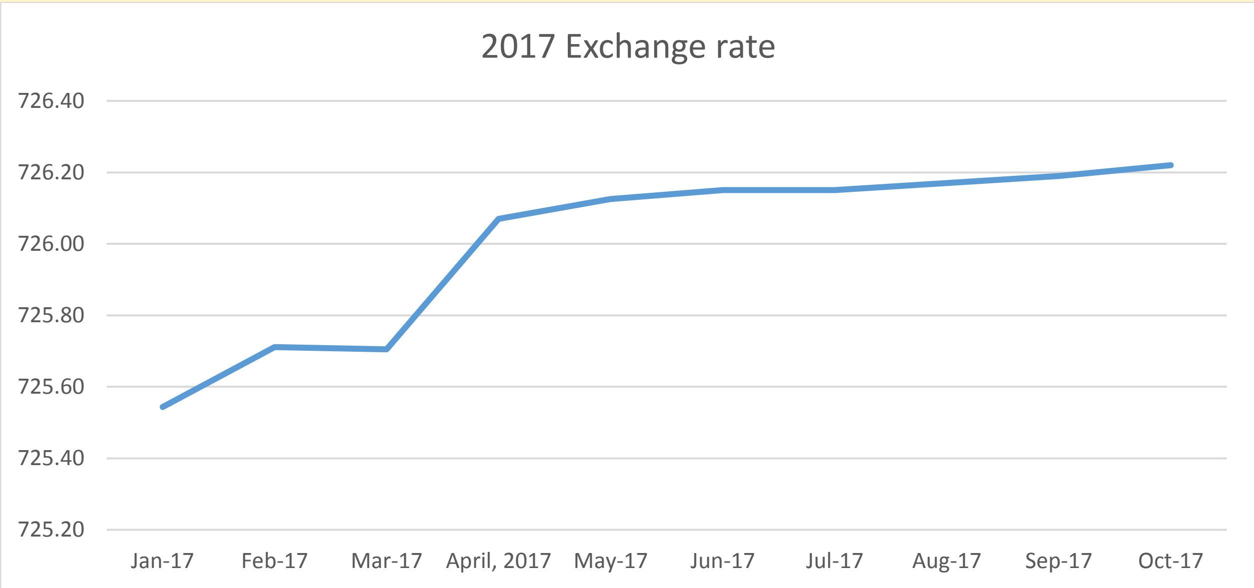
Source: Ministry of Finance, Economic Planning and Development Annual Economic Report 2017

Figure 5: Inflation Movements



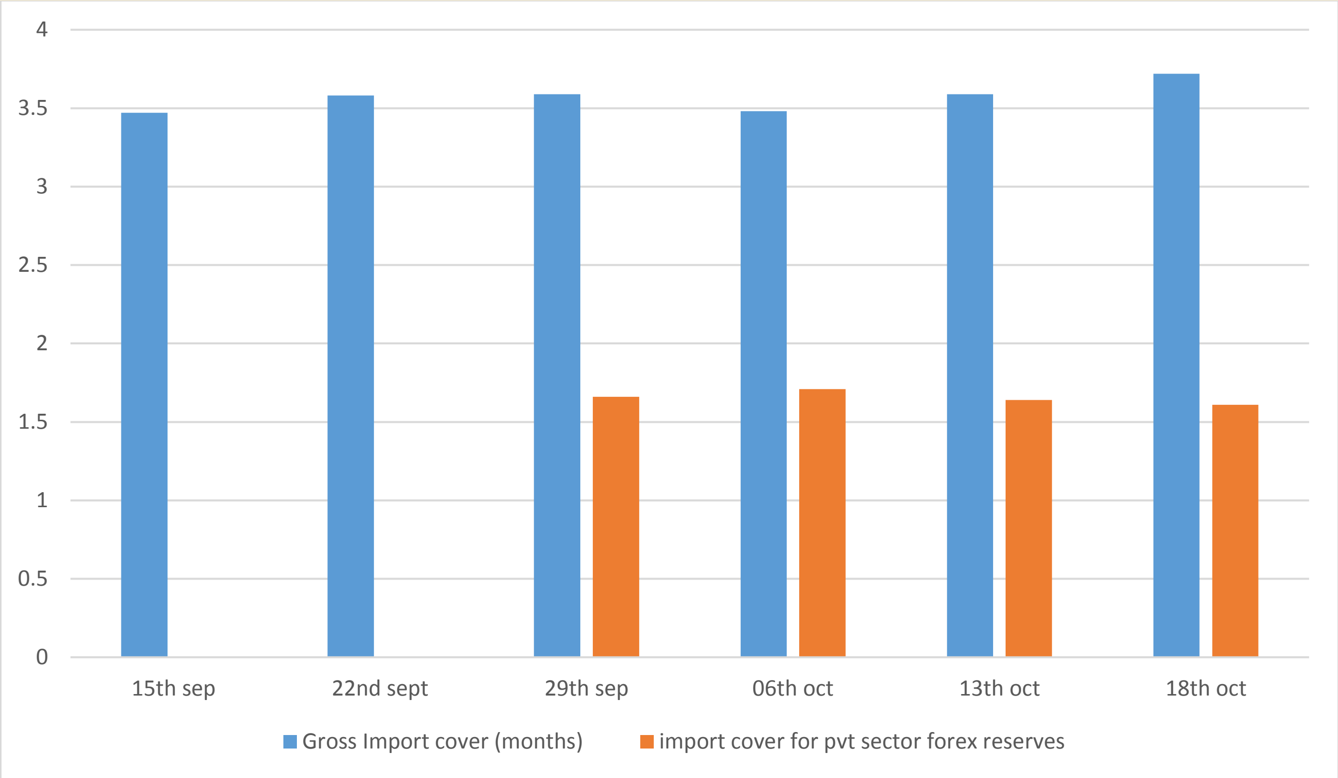
Source: National Statistical Office

Figure 6: Exchange Rate Movements

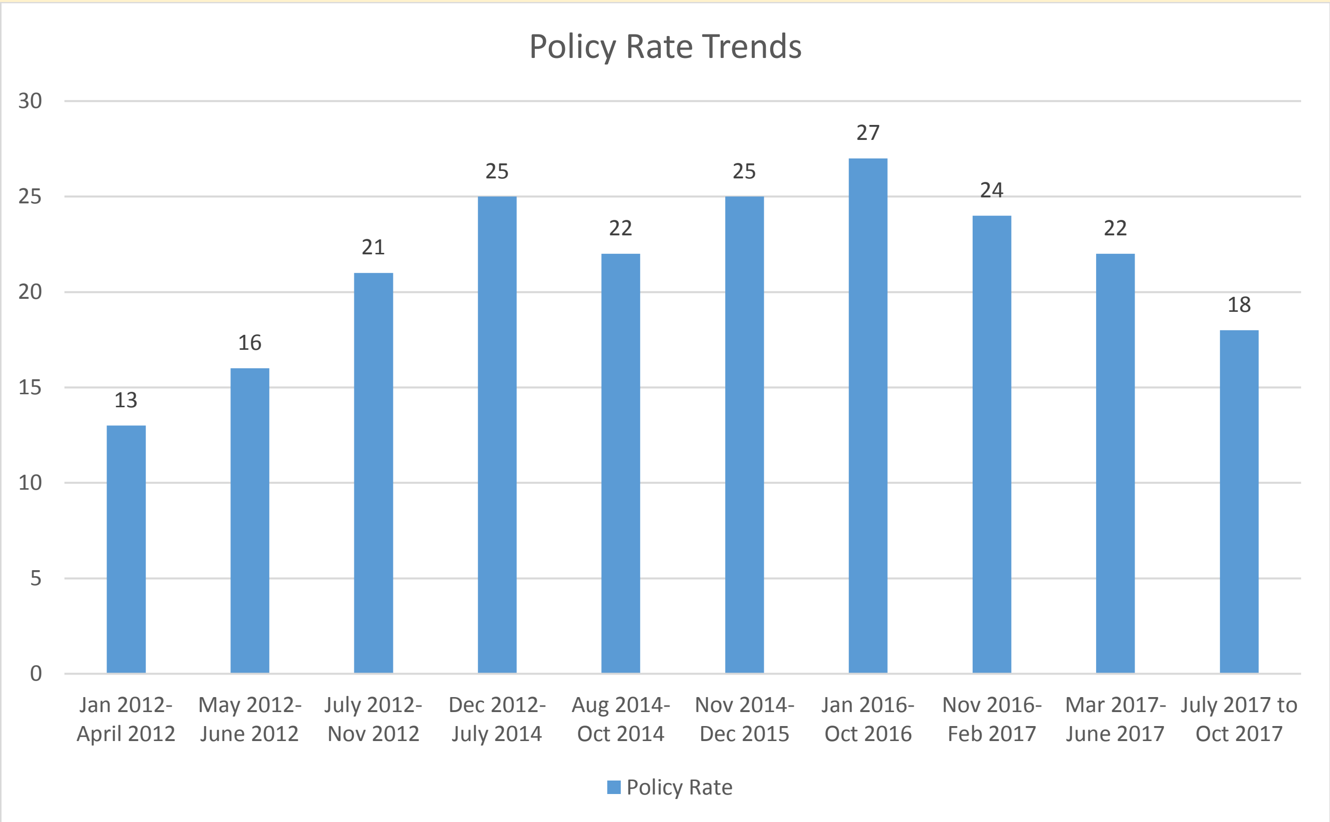


Source: Reserve Bank of Malawi

Figure 7: Import cover for September and October 2017



Source: Reserve Bank of Malawi



Source: Reserve Bank of Malawi

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