



**MALAWI CONFEDERATION OF CHAMBERS OF COMMERCE AND
INDUSTRY**

**ASSESSING THE IMPACT OF THE COVID-19 SHOCK ON MALAWI'S
ECONOMY USING THE EXTERNAL SECTOR ANALYSIS**

**A POLICY BRIEF PREPARED BY THE BUSINESS ENVIRONMENT AND
POLICY ADVOCACY DIRECTORATE**

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1. Introduction

Over the course of this year 2020, the world has changed dramatically due to a rare global health disaster caused by the COVID-19 pandemic. Specifically, the pandemic has tragically led to a loss of a large number of human lives, with official statistics from the World Health Organization (WHO) showing the current global human death toll at over 1 million lives. Worse still, the pandemic has not only caused a global health crisis but a global economic crisis as well.

The subsequent global economic crisis that followed the onset of the pandemic is on account of necessary pandemic related containment measures that continue to be implemented by most countries across the globe. The containment measures implemented include: quarantines, social distancing practices, partial lockdowns as well as full lockdowns. In addition, because the containment measures have pretty much been implemented on a global scale, the magnitude as well as speed of the collapse in global economic activity that has followed, is unlike anything experienced in our lifetimes. Furthermore, based on the current trajectory of global economic activity, it is safe to say, the global economy is currently passing through uncharted territory, whereby there is currently little room for economic policy to aid in the recovery process as this largely depends on stopping the pandemic.

The present economic crisis constitutes an intense shock that has caused a sharp decline in global trade, lower commodity prices and tighter external financing conditions - all of which have had adverse implications on the current account balances and currency pressures for many countries. Even though, global pandemic related restrictions have somewhat eased over the second half of this year 2020, the continued presence of the risk of transmission and the possibility of the resurgence of a second wave of global infections remain major obstacles to the resumption of normal economic activity globally. As a result, it is expected that the ascent of the global economy will likely be long, uneven, and uncertain. This outlook is bad news for economies like Malawi who have preexisting vulnerabilities, such as persistent current account deficits, a high share of foreign currency debt, and limited international reserves, as this is likely to exacerbate the already existing Balance of Payment (BOP) financing pressures in these economies.

2. Macroeconomic context in regards to the impact of the COVID-19 shock on Malawi's economy

In regards to Malawi, prior to the onset of the pandemic, the economy was already experiencing persistent, pre-existing external imbalances and these have since worsened due to the impact of the pandemic (as we will see in the [section 3](#)). In light of this, over the course of this year 2020, the International Monetary Fund (IMF), has approved two separate disbursements to Malawi under the Rapid Credit Facility (REF), to help finance Malawi's urgent Balance of Payment (BOP) and fiscal needs. The first disbursement amounting to **US\$91 million** which was made in May, 2020 was purely to help Malawi meet its urgent BOP needs. While the second disbursement made in October, 2020 which amounted to **US\$101.96 million** was intended to finance Malawi's urgent BOP and fiscal needs.

Specifically, the impact of the pandemic on the domestic economy has come from two fronts as follows:

- a) External shocks, and
- b) Domestic social distancing measures arising from public health interventions to combat the spread of the pandemic.

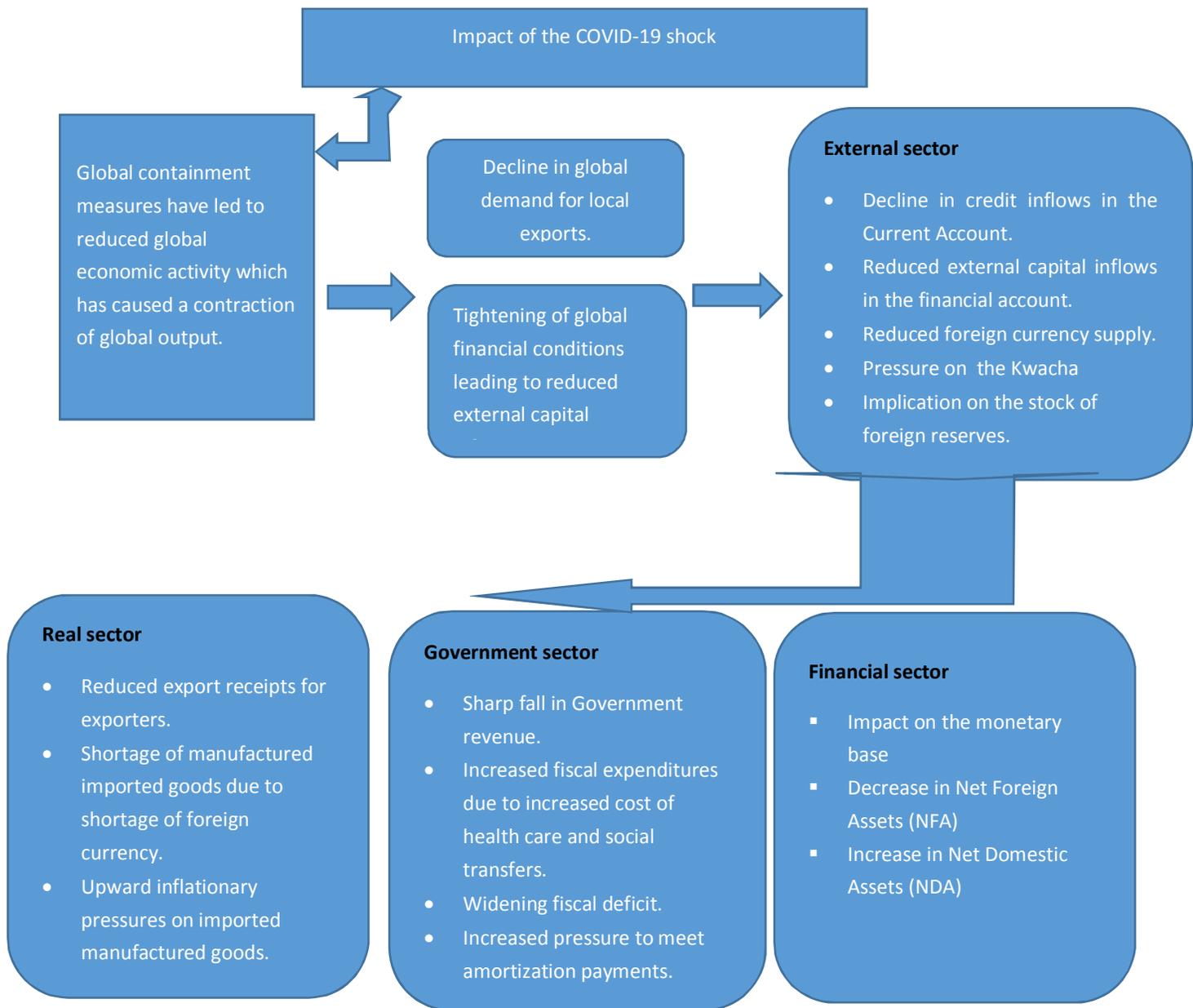
In light of this, the focus of this brief is to investigate how the COVID-19 shock has affected the interrelation between the domestic economy and the rest of the world (external sector developments). Specifically, the brief will focus on how the shock has influenced the evolution of BOP financing pressures in the economy. Over the first two quarters of 2020, data from the Reserve Bank of Malawi (RBM) shows that the domestic economy experienced worsening external imbalances in terms of the International Investment Position (IIP) balance and the trade balance. The worsening imbalances are a result of transmission effects of the global economic shock on the external sector account for Malawi. Therefore, this section will analyze how the worsening external imbalances have influenced developments in the economy.

2.1 Transmission effects of the COVID-19 shock on Malawi's economy

In Malawi, the impact of the COVID-19 shock has no doubt affected developments in all four accounts of the macro-economy namely: real sector, government sector, financial sector and the external sector. However, the ultimate goal of this brief is to investigate how the shock has influenced external sector developments in the economy and how these developments have in turn affected the domestic economy's ability to meet its external sector financial obligations. In line with this, this section will briefly give an overview of how the pandemic has affected the external sector and then how developments in the external sector have impacted the other three sectors.

Specifically, this section will speculate on how reversals to external sector variables such as capital inflows in the financial account and credit inflows in the current account have influenced developments in the three other accounts of the macro-economy. Due to the unavailability of BOP quarterly data for the current account and financial account, the brief makes a speculative analysis in regards to the impact of the shock on these two BOP accounts and how developments in the accounts have in turn influenced developments in the economy.

Figure 1 below shows a diagrammatic presentation of the structure of Malawi's economy segmented into macroeconomic accounts and how the shock has influenced developments in these accounts.



The analysis in the diagram above makes a speculative analysis as to how the COVID-19 shock is likely to have influenced developments in the economy through the external sector.

To begin with, according to the latest revised IMF statistics (October, 2020 World Economic Outlook), global output which creates demand for local exports is projected to contract by **4.4 percent** in 2020, owing to the impact of the COVID-19 shock. The current downward trend of global output is not so good news for Malawi's economy as this has affected the balance sheets of both Government and private businesses, as the external sector is a market for local exports as well as a source of capital (external capital inflows).

Conversely, the negative growth trend of global output has led to the following, ceteris paribus:

- Declining levels of international trade which has in turn caused weak external demand for Malawi's exports, as well as the
- General tightening of global financial conditions due to low investor confidence, which has in turn caused reversals to external capital inflows in Malawi's economy.

These two causal outcomes have then affected developments in all four accounts of the macro-economy as follows, *ceteris paribus*:

i. COVID-19 shock and the external sector

Export-import balance

Global pandemic related containment measures have negatively affected Malawi's external sector to the detriment of Malawi's trade balance position. The measures have not only resulted in a fall in the volume of merchandise trade in goods relative to previous years but also a decline in receipts from the tourism sector. The impact of the shock on export receipts has been quite huge, with official export data from the Reserve Bank of Malawi showing that over the first two quarters of 2020, the domestic economy realized 316.8 US\$ million compared to 563.9 US\$ million realized over the same period in 2019 (refer to figure 4). Furthermore, even though import volumes have also declined over the first two quarters of 2020 relative to 2019, their decline is not as huge as exports. According to RBM statistics, over the first two quarters of 2020, the country recorded imports amounting to US\$ 1.2 billion compared to US\$ 1.4 billion recorded in 2019 over the same period. The domestic economy's heavy reliance on imports like petroleum, fertilizer and pharmaceutical products, means that demand for imports has remained strong amid the dwindling export receipts, hence the increase in BOP pressures.

Foreign exchange supply and exchange rate stability

The tightening of global financial conditions has caused a reversal to external inflows like direct investment, portfolio investment and external transfers (credit and remittances) while the decline in foreign travels have similarly caused a reversal to tourism receipts. Both of these channels of financing are important, as they are a source of foreign currency to the domestic economy on top of export receipts. Therefore, reversals to these inflows have no doubt had adverse implications on the foreign exchange market in the domestic economy by causing imbalances in the form of foreign currency supply shortages and downward foreign exchange market pressures on the Kwacha.

As such, contemplating the fall in foreign currency earnings and the subsequent imbalances in the foreign exchange market, the monetary authorities in Malawi, most likely resorted to providing a foreign currency supply cushion to the market. A move that in the short run, ensured the steady supply of foreign currency on the market, and hence, the overall stability of the exchange rate throughout the COVID-19 period. However, as is normally the case, foreign exchange market interventions come at the cost of depleted official foreign reserves. Therefore, the continued

market intervention by the monetary authorities has led to the dwindling of the central bank's foreign reserves ([section 3.2](#) will explain more on this). Furthermore, considering that foreign currency earnings from important sources like tobacco sales has been underwhelming this year relative to previous years, it would be correct to assume that foreign reserves have not been restocked adequately. This would then explain why there is currently an acute shortage of foreign currency in the domestic economy.

ii. Covid-19 shock and the real sector

Market operations in the real sector have been affected by the shock both on the demand side and the supply side. On the supply side, international lock-downs, curtailment of international travel and other measures have disrupted industry supply chains, including acquisitions of intermediate and capital goods, which has in turn slowed down domestic production. While on the demand side, the dwindling levels of disposable income caused by subdued business activity for small-scale traders as well as loss of income earning capacity caused by job losses, have led to declining demand for domestic consumption expenditures.

In an economic environment like the one at present which is marred by uncertainty in regards to future income. Consumers and businesses often resort to precautionally saving and reduce expenditures in the process. However, for an economy like Malawi whereby private savings are generally low due to low disposable income levels for the majority of the population, it is most likely that the resultant reduced consumption expenditures are due to the lack of income rather than the increased savings alternative.

In regards to the impact of the external sector imbalances on the real sector, developments in the external sector have influenced this sector as follows, *ceteris paribus*:

- Shortage of foreign currency is causing a shortage of imported consumer goods on the domestic market relative to domestic demand, and this is in turn exerting upward pressures on Nonfood inflation.
- The shortage of foreign currency supply is creating financing pressures for the domestic economy to purchase imports like petroleum, fertilizers and pharmaceutical products which are paid in foreign currency and have inelastic domestic demand.

iii. Covid-19 shock and the fiscal sector

The shock caused by the pandemic has exacerbated already existing fiscal pressures for the Government of Malawi by simultaneously reducing revenues and increasing the fiscal expenditure outlay which is necessary to fight the pandemic, causing an increase in the fiscal deficit.

The pandemic has affected fiscal developments as follows, *ceteris paribus*:

- Caused a reduction of fiscal revenue. According to data from the Ministry of Finance, during the first half of this year 2020, average monthly tax revenue collections dropped from K90.8

billion per month during pre-Covid-19 period to a monthly average of K59.1 billion during the post-Covid-19 period, representing a 35.0 percent drop.

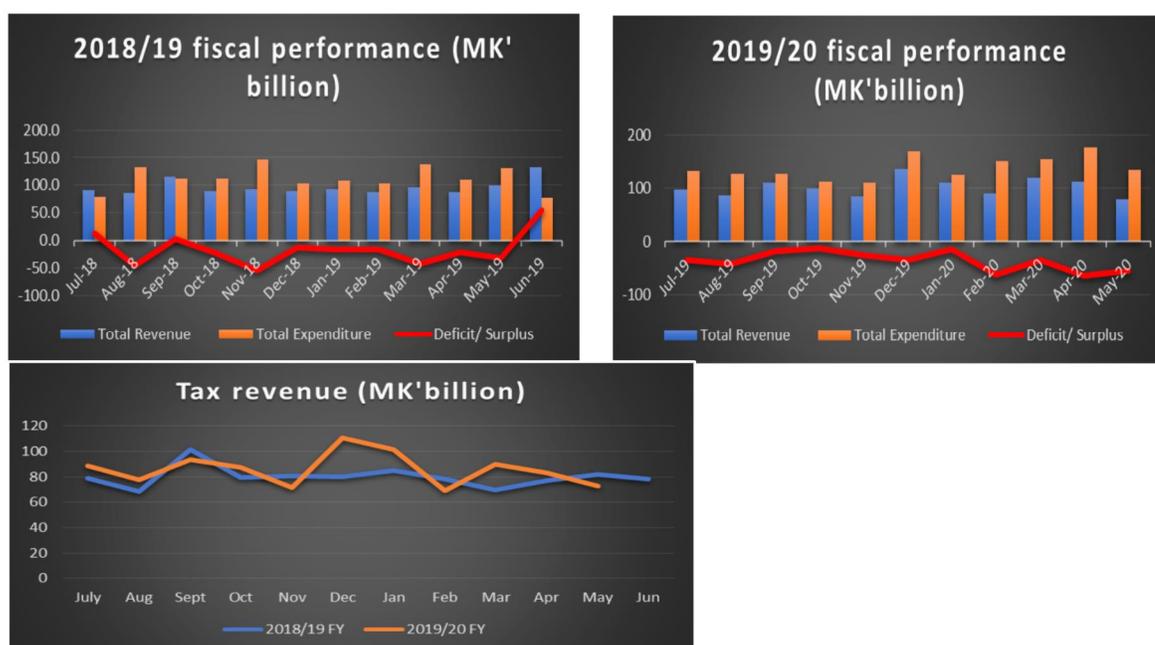
- Increased fiscal expenditures due to increased cost of health care and social transfers. According to the IMF COVID-19 fiscal policy response tracker, the Government of Malawi's response plan includes; a US\$20 million (0.25 percent of GDP) in spending on health care and targeted social assistance programs; this includes hiring 2000 additional health care workers. As well as, an Emergency Cash Transfer Program of about \$50 million (0.6 percent of GDP), mostly financed by development partners, to support small businesses in major urban areas which runs from May-November 2020.

These two developments have contributed to the widening of the fiscal deficit, with the 2019/20 fiscal year closing with a deficit of MK 555.6 billion. Furthermore, due to the continued impact of the pandemic on the fiscus, the overall fiscal balance for 2020/21 fiscal year is projected to increase to K754.8 billion.

In regards to the impact of the external sector imbalances on the fiscal sector, developments in the external sector have influenced this sector as follows, ceteris paribus:

- The shock to the supply of foreign currency in the economy, has presented challenges to the fiscal sector in terms of its ability to settle obligatory foreign currency debt which is mostly in the form of amortization payments. The continued shortage of foreign currency increases the risk of Government defaulting on its external debt obligations.

Figure 2: Evolution of fiscal performance in 2018/19 and 2019/20 fiscal years.



Source: Data from RBM

As the diagram indicates, between March and May, 2020, Government registered a wider fiscal deficit compared to 2019 over the same period. This is due to the decline in tax revenue owing to pandemic related restrictions (both domestic & international) as well as the increased expenditure outlay to fight the pandemic and to finance the fresh elections that took place in June, 2020.

iv. Covid-19 shock and the financial sector

Many times when an economy is hit by a shock that threatens the stability of the financial sector, the monetary authorities react swiftly by effecting necessary monetary policy instruments to mitigate the financial risks and thus bring stability to the income flow. With this thought in mind, in April, 2020, the Reserve Bank of Malawi effected a number of measures to support the economy in response to the effects of the shock. The measures which included: reduction of the Lombard rate as well as the Liquid Reserves Requirement Ratio for domestic deposits were aimed at increasing the money supply in the economy amid the tightening financial conditions at the time.

Specifically, the shock has affected financial sector developments by weakening the quality of assets in the banking sector, *ceteris paribus*. The impact of the COVID-19 shock on the real sector has adversely affected the balance sheet for most private businesses thereby undermining their capacity to services loans owed to banks and thus affecting the quality of commercial banks loan book through increases in Non-Performing Loans (NPL).

According to the June, 2020 RBM Financial Stability Report, asset quality for the banking sector decreased slightly as measured by the increasing NPL ratio above the acceptable limit of 5.0 percent. As at end June 2020, the industry registered an NPL ratio of 6.6 percent, an increase from 6.3 percent reported in December 2019. The increase in the ratio was attributed to growth in level of NPLs by 6.9 percent to K43.0 billion while gross loans and leases only grew by 3.0 percent to K653.5 billion in June 2020. Notably, restaurants and hotels sector reported the highest growth in NPLs by 254.9 percent to K1, 853.9 million in June 2020.

In regards to the impact of the external sector imbalances on the financial sector, developments in the external sector have influenced this sector as follows, *ceteris paribus*:

- The decline in external inflows in the financial account as well as the decline in credit inflows in the current account has affected the balance sheet of the central bank by undermining the stock of Net Foreign Assets. Consequently, if we are to go by the tautology of macroeconomics which states that a positive change in Net Foreign Assets (NFA) results to a positive change in the monetary base and vice versa, *ceteris paribus*. The decline in net foreign assets over the first two quarters of 2020, (**as shown in figure 3**) most likely caused a decline in the monetary base, *ceteris paribus*. In an effort to maintain the domestic economy at desired level of the monetary base, the monetary authorities most likely reacted with counteractive measures aimed at increasing the stock of Net Domestic Assets (NDA). Measures such as reduction of the Lombard rate, helped increase the central bank's claims

on commercial banks and thus the subsequent increase in Net Domestic Assets (NDA). RBM statistics indicate that during the second quarter of 2020, NDA grew by K147.6 billion to K1.1 trillion. The source of this growth being the increase in central bank net domestic claims which surged by K237.3 billion to K1.6 trillion while NFA dropped by K37.0 billion (US\$50.9 million) to K260.3 billion (US\$350.3 million), over the same period.

In a nutshell, external sector imbalances in the domestic economy have spilled over to the other three accounts of the economy. Due to the interrelation that exists among the accounts, policy action aimed at implementing counteractive measures in the other accounts can help ease the current external sector imbalances. For instance, targeted measures to reduce demand for imports in the real sector can help ease foreign currency demand, while the fiscus can reduce its appetite for external debt and generally control its outflow spending.

3.2 The COVID-19 Shock and the external sector developments vis-à-vis Malawi's economy

The recovery period for the global economy largely remains uncertain due to the general lack of clarity in regards to the pathway and intensity of the impact of the pandemic. As already pointed out, due to the global impact of the shock, Malawi is facing external sector imbalances caused by suppressed external inflows, thus making it difficult for the country to finance its external sector obligations.

Specifically, Balance of Payment of pressures are emanating from the following two channels:

- I. Import payments for imported goods and services that the domestic heavily relies on.
- II. Obligatory Government amortization payments that are paid in foreign currency.

Therefore, based on the structure of Malawi's economy, this section will assess the evolution of BOP pressures in the domestic economy over the period of the COVID-19 pandemic. Furthermore, this section will speculate on the possible areas in the economy that are the source of the increasing BOP financing pressures and how the BOP pressures are in turn influencing foreign exchange market operations.

To enable us to do this, the analysis will look at the following:

- a) Analyze developments overtime in the evolution of the stock of external assets relative to the stock of external liabilities (**International Investment Position**) as well as analyze the evolution of the goods and services account balance (**trade balance**).
- b) Analyze developments overtime in Malawi's stock of gross foreign reserves and if the country has enough liquid foreign reserves to finance its external financial obligations.

3.1 Malawi's external sector balances

The initial sharp tightening in global financial conditions and large terms-of-trade fluctuations caused by the COVID-19 pandemic, have led to lower net capital and financial inflows as well as reduced exports receipts for Malawi's economy. Consequently, these have adversely affected the evolution of the stock of external assets and liabilities-the components of the International Investment Position (IIP) as well as the credit and debit transactions in the goods and services account. Therefore, this section will analyze how the COVID-19 shock has affected changes in the Net IIP balance as well as the trade balance for Malawi's economy.

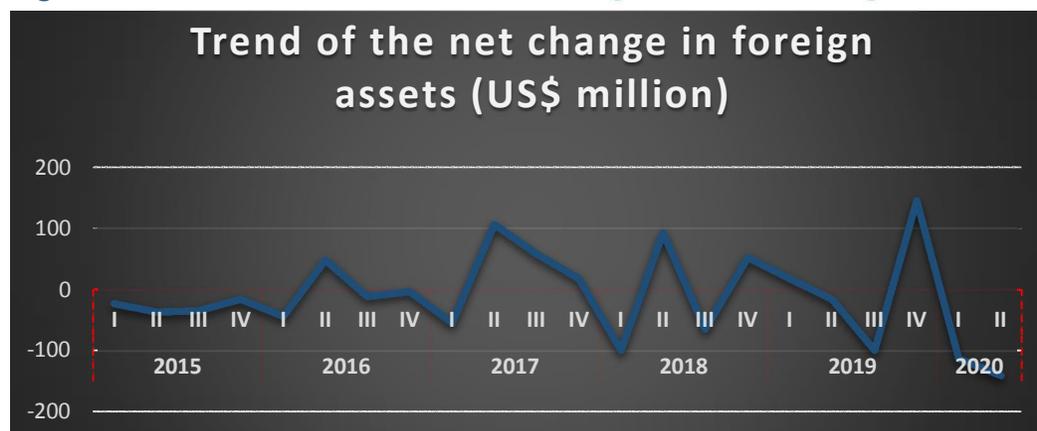
3.1.1 The International Investment Position (IIP) for Malawi

Over the last five years, the evolution of the stock of external assets and liabilities in the domestic economy has been quite volatile, with the IIP balance registering significant peaks and troughs throughout this period (**figure 3 below**). As **section 2** of this paper already pointed out, the COVID-19 shock has led to reversals to external capital inflows as well as export receipts, creating challenges for the economy to balance its payments owed to the external sector. Consequently, in order to mitigate the rising BOP financing pressures, the monetary authorities most likely resorted to drawing down on the country's external assets as well as obtaining external loans specifically for BOP support such as those obtained from the IMF which ultimately increased the country's external liabilities. In light of this, it is safe to conclude that the reversals to external financial inflows have contributed to the evolution of the stock of external assets and liabilities in the domestic economy.

According to data from the Reserve Bank of Malawi (RBM), over the second quarter of 2020, the economy recorded an increasing negative net foreign assets balance of -139.8 US\$ million compared to -112.0 US\$ million recorded in the first quarter of 2020. The statistics clearly indicate increasing foreign liabilities relative to foreign assets in the domestic economy over this period of the COVID-19 shock. Furthermore, the net IIP position of -139.8 US\$ million is a record high over the last five years (beginning 2015).

Figure 3 below shows the trend in the evolution of the stock of foreign assets vs. foreign liabilities from 2015 to the second quarter of 2020.

Figure 3: The evolution in the stock of foreign assets vs. foreign liabilities



Source: Data from RBM

As figure 3 indicates, during the second quarter of 2020, the domestic economy recorded a rise in the IIP imbalance, an all-time high over the period between 2015 and 2020. This rising stock of foreign liabilities coupled with the diminishing capital inflows and export receipts in the economy if not reversed, could exacerbate already existing external vulnerabilities in the domestic economy. Furthermore, this could have serious short run implications on inflation emanating from negative pressures on the exchange rate caused by the IIP imbalance. Negative pressures on the exchange rate have already been witnessed, as there is currently an imbalance in the demand and supply for foreign currency leading to an acute shortage of foreign currency supply in the domestic economy.

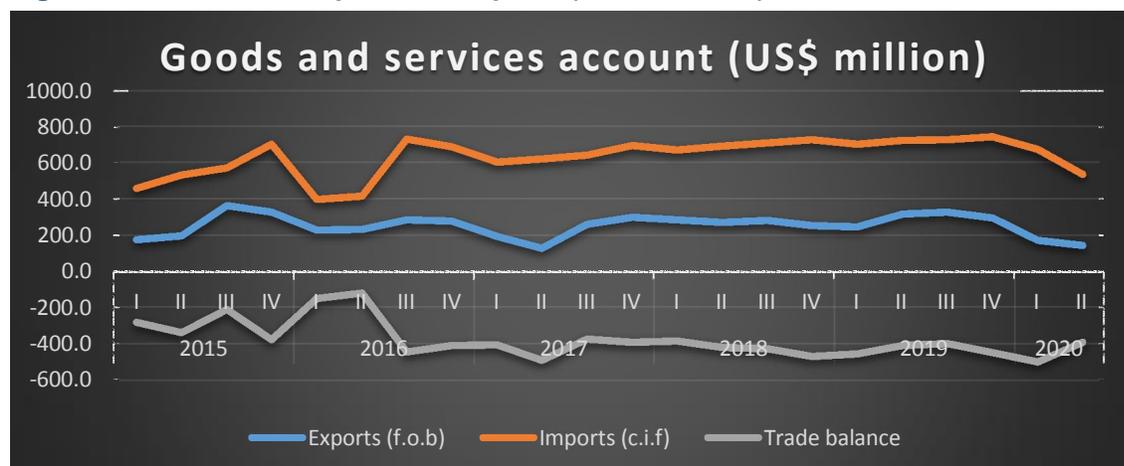
3.1.2 The Goods and Services account

According to the IMF 2020 external sector report, in the first five months of 2020, the global volume of goods trade was about 20 percent lower than in 2019 while for services trade, the expected contraction in 2020 is more severe than could be expected based on the prospective fall in aggregate demand. The global trade shock has consequently affected Malawi with the domestic economy being hit hard by external shocks since March 2020 (both demand and supply side) and these have adversely affected the country's trade balance position.

The impact of fluctuations in global trade on the domestic economy is on account of Malawi being part of the global economy through the globally connected value chain and supply chain. As a result, the domestic economy recorded reduced values of exports and imports in the first two quarters of 2020 relative to the years 2018 and 2019 respectively, over the same period. Even though, fluctuations occurred both in the credit and debit transactions of the goods and services account, the first quarter of 2020, recorded a worse trade balance of -498.9 US\$ million, indicating that the impact of external demand side shocks has been more severe compared to supply side shocks. The trade balance recorded in the first quarter of 2020, is a record high over the period between 2015 and 2020.

Figure 4 below shows the trend of exports, imports and the overall trade balance.

Figure 4: The trend of exports vs. imports (trade balance)



Source: Data from RBM

As per figure 4, between the fourth quarter of 2020 and the first quarter 2020, RBM statistics show that the value of exports contracted by 42 percent while the value of imports contracted by 10 percent. Furthermore, between the first quarter of 2020 and the second quarter of 2020, RBM statistics show that the value of exports contracted by 17 percent while the value of imports contracted by 20 percent.

The underwhelming performance of export receipts if prolonged would most likely worsen BOP financing pressures in the economy, as demand for some imports like petrol and fertilizer tends to be inelastic. This then creates the need for the domestic economy to find alternative BOP financing means in the short-run, which might include; external borrowing as well as drawing down on the external assets of the domestic economy. However, as pointed out in [section 3.1.1](#), over the two quarters of 2020, Malawi's economy has registered increasing external liabilities relative to assets, as such increasing the liabilities abruptly through more external borrowing could exacerbate the external stress the domestic economy is already under. Unless Malawi can agree debt restructuring with its external creditors or continue to get IMF-supported financial assistance, increasing its external liabilities could have serious macroeconomic implications with the list not limited to national output losses caused by prolonged external stress periods of the economy.

Alternatively, this brings us to the exports-imports angle to addressing the BOP financing pressures. For this, the following considerations have to be made first:

- a) Whether and how possible it is at least in the short-run, to increase the export of goods and services?
- b) How easy and how possible it is at least in the short-run, to compress the expenditures made on the goods and services that the domestic economy imports?

In trying to answer the two questions above, it is important to point out that the current global economic outlook as well as the structure of Malawi's economy presents fundamental challenges to effecting either of the two alternative strategies highlighted above. This is due to the following reasons:

- I. The level of export receipts of an economy depends on external demand, as such with global economic activity still largely suppressed, it is difficult to imagine how Malawi can leverage gains from increasing its export volumes under the current global economic scenario.
- II. Secondly, with the export base for Malawi lacking diversification as it is largely composed of agricultural commodities whose production is seasonal. It is difficult to imagine how export receipts can improve during this time which is the off season in the agriculture sector.
- III. On the other hand, in regards to imports of goods and services, an important point to note is that consumer demand for imports is particularly rigid over the short-run, mainly because of habit persistence. For instance, in Malawi most consumers believe that foreign products are superior to local products as such it would be very difficult for the consumers to modify their consumption choices very quickly.
- IV. Furthermore, since the agriculture sector is the main GDP growth driver for the country, imports like fertilizer are so crucial to the economy that any slight shock to their availability has serious macroeconomic implications on the economy. On top of this, due to the domestic economy's need for imports like pharmaceutical and petroleum products as well as raw materials for production, demand for imports tends to be inelastic. Therefore, considering that the production and consumption behaviour of economic agents in Malawi are highly import dependent, reducing imports in the short-run would prove very challenging.

In this regard, any export-import strategy to be developed would have to consider the short-run factors highlighted above.

In a nutshell, the COVID-19 shock has adversely affected developments in the goods and services account through dampening effects mainly on export receipts. Even though imports have also deteriorated relative to other years, demand for certain imports is particularly rigid in the short-run due to consumer behavior persistence and due to their importance to the economy. As such, though subdued at the moment, demand for imports will most probably start to gradually pick up in the near term. However, the situation for Malawi's exports is not so promising, as our exports base is dominated by agricultural commodities that are seasonal and often suffer from price shocks, thus, making the task of boosting export receipts in the short-run more challenging.

Having said this, the urgent need for Malawi to find a way to offset this trade imbalance remains. As such, both the fiscal and monetary authorities must respectively consider coming up with a set of policy interventions that would facilitate structural changes in the economy to reduce the imbalance in the short run as the country is waiting to find long term solutions to the problem.

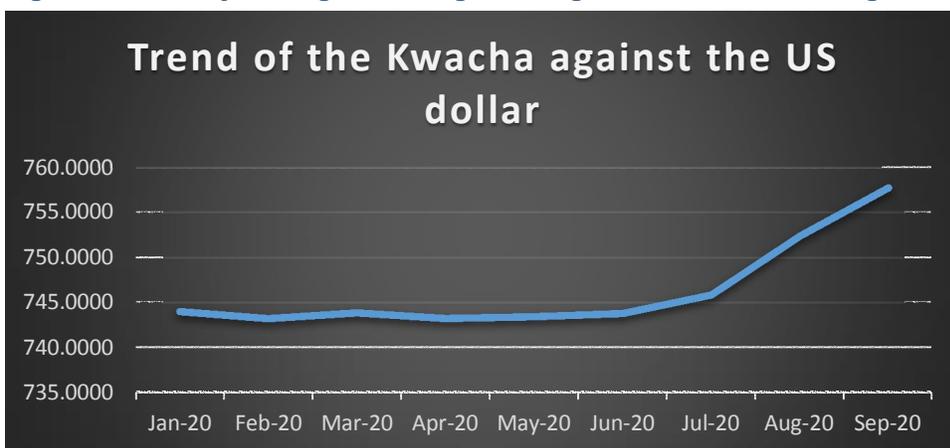
3.2 Developments in the stock of gross foreign reserves

The external sector imbalances that Malawi's economy is currently facing have caused short-run implications on exchange rate fluctuations which have ultimately affected the country's stock of foreign reserves. As already highlighted in [section 3.1](#), reversals to credit inflows in the current account and capital inflows have adversely affected the trade balance and IIP balance, respectively, for Malawi's economy. Consequently, imbalances in these two external sector accounts have affected the domestic foreign exchange market by causing a reduction of foreign currency supply relative to the demand, *ceteris paribus*.

Therefore, in order to maintain stability of the Kwacha, the monetary authorities were most likely forced to provide a cushion to the local foreign exchange market to cover for the deficit in the supply of foreign currency. This would explain why the kwacha remained stable between March

and June, 2020 (**figure 5**), a period over which the domestic economy registered deteriorating external inflows (export receipts) as well as increasing foreign liabilities, both of which have dampening effects on the local currency.

Figure 5: Monthly average exchange rate figures of the Kwacha against the US dollar.

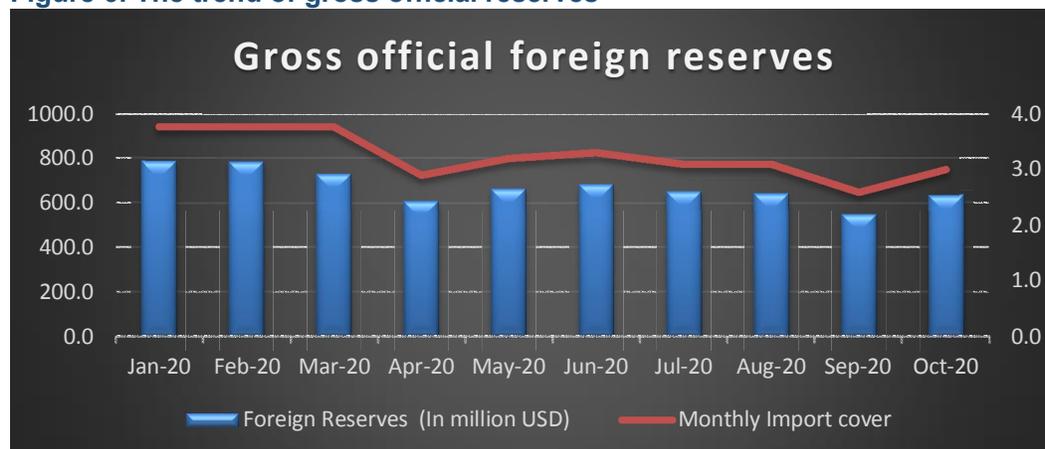


Source: Data from RBM

Figure 5 shows the trend of the Kwacha against the US dollar in terms of monthly average figures. As per the figure, the Kwacha remained stable against the US dollar between March and June, 2020, most likely on account of market interventions from the monetary authorities. However, such interventions have come at a cost in the form of a depletion of Malawi's official foreign reserves. In addition, the depreciation of the local currency between July and September, 2020 would mean that the monetary authorities have most likely reduced the magnitude of their interventions on account of the deteriorating official foreign reserves.

As **figure 6** below indicates, Malawi's gross official reserves have been steadily decreasing since March, 2020 and as at the close of September 2020, Malawi had a total of 546.9 US\$ million foreign reserves covering 2.6 months of imports. The trend has slightly improved in October 2020, with Gross official reserves slightly increasing to US\$635.1 million (3.0 months of import coverage). The increase in gross official reserves is on account of BOP support provided by the IMF under Rapid Credit Facility (REF) rather than improving export receipts. The shortage of foreign currency inflows in the economy has made it impossible for the monetary authorities to adequately replenish the country's stock of foreign reserves as such continued interventions in the local foreign exchange market have led to a continued depletion of the foreign reserves.

Figure 6: The trend of gross official reserves



Source: Data from RBM

In a nutshell, Malawi's economy is currently experiencing increasing BOP pressures due to the impact of external sector imbalances. The shocks to the external sector are exerting short-run pressures on the local exchange rate market, which ultimately has affected the country's stock of foreign reserves through the exchange market intervention route. Prior to the BOP support from the IMF, the country's stock of foreign reserves were deteriorating steadily and fast, a situation that posed serious threats to the economy. Therefore, there is a need to ensure that the necessary adjustments being made in the economy to offset the impact of external sector imbalances, do not cause reserves to fall to inadequate levels as determined by appropriate metrics.

4. Conclusion and policy recommendations

The outlook for global trade and financial conditions remains highly uncertain and with significant risks due to the pandemic. If the fall in economic activity, global trade, and commodity prices is more persistent than currently assumed, the associated effects on Malawi's current account balance, including through the effects on tourism, commodity balances, and remittances, could be larger. Furthermore, a more persistent tightening in global financial conditions would hinder the recovery in capital inflows in the domestic economy and thus, constrain the financing of current account deficits. Therefore, prolonged external sector imbalances have the following macroeconomic implications in the near term, *ceteris paribus*:

- a) Acute foreign currency shortages could persist as the monetary authorities try to manage the trade-off between cushioning the supply of foreign currency and maintaining their stock of foreign reserves.
- b) Continued depletion of foreign reserves means that Malawi would have limited liquid external assets that can be used to meet its external financial obligations, as such BOP pressures would persist if not get worse.
- c) Continued depletion of foreign reserves means that the magnitude of foreign currency supplied to the local foreign exchange market by monetary authorities to serve as a cushion

would ultimately decline and this could lead to weakening of the local currency further. Historically exchange rate fluctuations in Malawi's economy tend to be inflationary as such this could have dampening effects on inflation.

In the near term, in order to offset the impact of external sector imbalances on the domestic economy, Malawi should consider using capital flow management measures on outflows as part of a broad package, provided this is not substituted for warranted macroeconomic and structural policy actions. Therefore, the policy makers ought to consider the following policy recommendations:

1) Exchange rate to act as a shock absorber

To adjust to the effects of external shocks, such as the fall in export receipts and capital inflows, on the supply of foreign currency, the monetary authorities must at least in the short-run limit their management of Malawi's flexible exchange rate. To some extent RBM must ease control of the exchange and allow it to be market oriented, so that the exchange rate is able to automatically adjust to the shortage of foreign currency supply thereby acting as a shock absorber. Flexible exchange rates serve as an equilibrating mechanism in response to shocks. This only has to be short-term and the RBM can adjust its control as the situation improves. For economies with adequate reserves, exchange rate intervention can be appropriate to alleviate disorderly market conditions and limit financial stress. However, for an economy like Malawi - with limited foreign reserves - the continued depletion of foreign reserves without adequate replenishing of the stock of foreign reserves could force the economy into external stress - a situation whereby the economy pretty much fails to meet its external sector obligations.

2) Providing relief to local producers

So far, the Government of Malawi's response to the impact of COVID-19 on the economy has been limited to policy interventions in the form of tax measures as opposed to effecting an economic recovery to cushion businesses from the impact as many other economies have done. As **section 2** highlighted, the Government is facing increased fiscal pressures which have ultimately led to the widening of fiscal deficit and this could be the reason that has caused the limited interventions. However, since the impact of external imbalances on the supply of foreign currency ultimately affects the domestic economy's ability to meet its external financial obligations which include imports, there is a need for the economy to be more inward looking in terms of consumption. Government must support local businesses which use a large percentage of local resources in their production, so that they are able to increase their capacity and meet the consumption demands of the economy. Government, must go beyond mere rhetoric in promoting consumption of local products but it must go a step further and provide financial support to the local producers most of which are struggling at the moment due to the impact COVID-19.