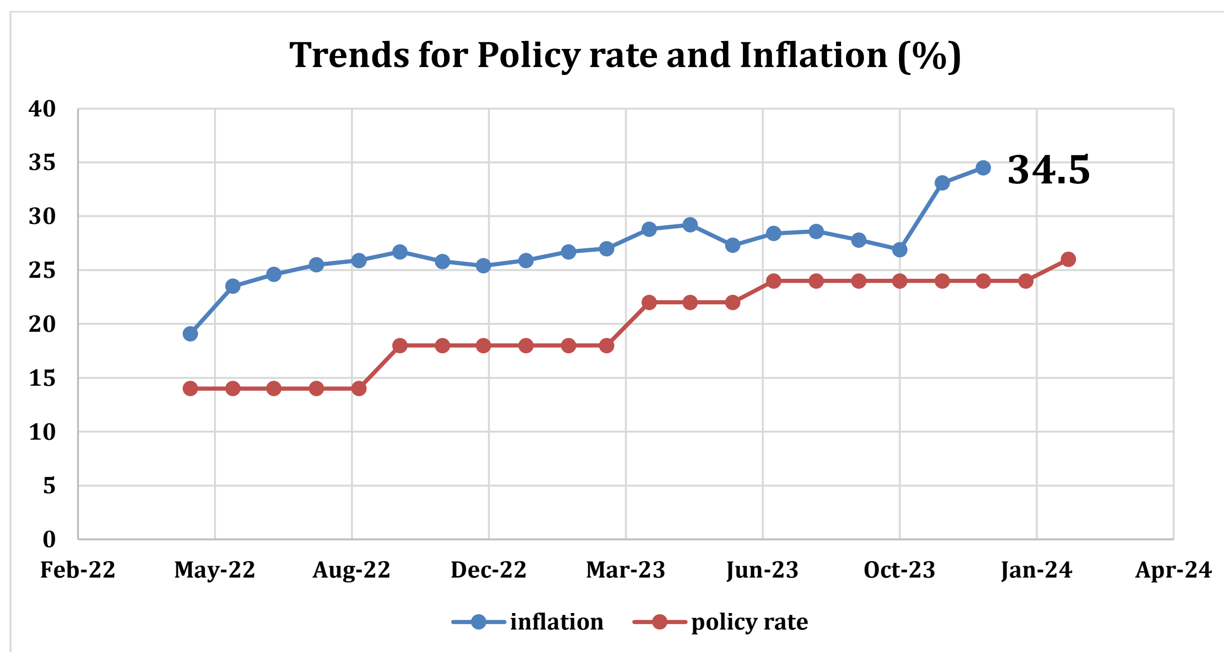
TIGHTENING OF THE MONETARY POLICY



The Monetary Policy Committee (MPC) implemented a significant policy adjustment on February 1st, 2024, raising the policy rate by 200 basis points from 24 percent to 26 percent. This measure aims to address the persistent inflationary pressures, which have surpassed the targeted range of 5 percent.

The MPC convened on January 31 and February 1, 2024, deliberating on maintaining the Lombard rate at 20 basis points above the policy rate and the Liquidity Reserve Requirement (LRR) ratio at 7.75 percent for domestic currency deposits and 3.75 percent for foreign currency deposits. The decision to enact this adjustment reflects the Committee's recognition of intensified inflationary pressures, necessitating immediate action to restore price stability and counter inflation.

The fourth quarter of 2023 witnessed a notable increase in headline inflation, soaring to 31.5 percent from the preceding quarter's 28.2 percent, resulting in an annual average inflation rate of 25.8 percent. This surge was primarily attributed to the effects of a 44.0 percent exchange rate devaluation in November 2023 and subsequent adjustments in energy prices. Concurrently, food inflation rose to an average of 39.9 percent, while non-food inflation increased to an average of 20.9 percent during the same period.

Looking ahead, the MPC anticipates further inflationary pressures driven by the lagged effects of exchange rate adjustments, higher maize prices due to anticipated lower production, and exacerbated inflation expectations. These factors have led to an upward shift in the inflation trajectory.

IMPLICATIONS FOR THE BUSINESS COMMUNITY

In Malawi, the relationship between inflation and policy rates is closely intertwined, with interest rates serving as the primary tool for managing inflation. By raising the policy rate, the central bank aims to reduce the money supply in circulation, subsequently curbing demand for goods and services.

An increase in the policy rate leads to higher commercial bank lending rates, discouraging consumer borrowing for consumption purposes, thereby reducing consumption spending and demand for goods and services. Moreover, higher interest rates impact businesses not only on the consumption side but also influence investment decisions due to increased borrowing costs. This elevated cost of loanable funds constrains businesses from investing in new machinery, inputs, and infrastructure.

POTENTIAL RISKS

While the MPC views raising the policy rate as a key tool to combat inflation, it is necessary that the monetary policy measures complement fiscal policies aimed at enhancing food production and managing exchange rates. Notably, in 2023, despite a 600 basis points increase in the policy rate, headline inflation surged to 34.5 percent by December 2023 from 25.9 percent in January 2023. The predominant drivers of inflation were food inflation throughout the year and the immediate impacts of currency devaluation in the latter quarters.

This underscores the significance of addressing supply-side factors alongside demand-side interventions. Neglecting the supply side risks perpetuating high inflation levels despite monetary tightening until the harvesting season.

Furthermore, the economy should anticipate the cumulative, lagged effects of currency devaluation on inflation. The tightening of monetary policy will inevitably raise borrowing costs, impacting business operations and growth prospects adversely.

Lastly, the efficacy of the policy hinges significantly on the government's fiscal stance in 2024. Given the government's substantial borrowing activity, any increase in expenditure may offset declines in private expenditure, potentially undermining the effectiveness of monetary interventions. Therefore, a coordinated approach between monetary and fiscal policies is imperative for mitigating inflationary pressures and fostering sustainable economic growth.