Reserve Bank of Malawi

Curriculum Vitae

Levie Jeremiah Sato

Mr Levie Jeremiah Sato is Senior Economist in the Research and Statistics Department of the Reserve Bank of Malawi, responsible for the analysis of economic developments in the banking system and monetary policy review

Mr Sato was born in 1966 and joined the Reserve Bank of Malawi in July 1990 as a Bank Officer soon after graduating from the University of Malawi with a bachelor's degree in Economics. He joined Williams College, Massachusetts, USA in 1997 and obtained a master's degree in Economics in 1998. He is currently a Macroeconomic and Financial Management Institute (MEFMI) candidate fellow in Macroeconomic Management (specialising in Financial Programming and Economic Stabilisation). Mr Sato is also a member of the Monetary Policy Implementation and the National Economic Management Committees in Malawi.

E-mail: ljeremiah@rbm.malawi.net

Acknowledgements

I am thankful to members of the Economic Affairs Division of the Reserve Bank of Malawi for their wonderful comments and suggestion. In particular, I would like to thank Mr. P W Mamba, Mr. C Msosa, Mr. M Khomba and Mr. R Wiyo. However, the views expressed in this paper are mine and do not necessarily reflect those of the Reserve Bank of Malawi or the people mentioned herein. Any errors and shortfalls, therefore, are my responsibility.

Levie Jeremiah Sato
Monday, 28 May, 2001

MONETARY POLICY FRAMEWORKS IN AFRICA: THE CASE OF MALAWI

Paper presented at an International Conference on Monetary Policy Frameworks in Africa at the South African Reserve Bank, Pretoria, South Africa.

September 17 – 19, 2001

By: Levie Jeremiah Sato
Senior Economist
Reserve Bank of Malawi
P.O Box 30063
Capital City
Lilongwe 3
MALAWI

ljeremiah@rbm.malawi.net

Introduction

Monetary policies are determined by current and prospective economic developments while the manner in which the other functions of the central bank are carried out depend largely on the prevailing stance of monetary policy. Thus, a country's monetary policy framework may well depend on its form of government, its economic and legal systems, its financial institutions and the level of expertise in monetary policy matters that exist both inside and outside the central bank (Bank of England, 1999 and Meulendyke, 1989).

This paper describes the monetary policy framework operating in Malawi. It first outlines a general monetary policy framework as adopted by many central banks before moving to a specifically Malawian case. The first chapter, therefore, provides an overview of monetary policy frameworks operating in the world. It briefly discusses monetary targeting, exchange rate targeting, and inflation targeting as monetary policy frameworks. The second chapter looks at monetary policy in Malawi. It first outlines the legal framework under which the authorities operate and then discusses the monetary policy design and implementation. Attention is paid to policy objectives and instruments. The chapter also discusses the evolution of the exchange rate policy as an anchor of monetary policy. In chapter three, the paper highlights the operations of the Monetary Policy Committee before presenting a conclusion in chapter four.

1. An Overview of Monetary Policy Frameworks[1]

The Bank of England, 1999, quotes Mc Nees, 1987 as defining a monetary policy framework as an institutional arrangement under which monetary policy decisions are made and executed. As a policy tool, therefore, it requires definition of the goal variables (ultimate objectives) that may include defining the level of economic growth (GDP), employment, and general price level. Of late, many central banks have been given a specific mandate to pursue the objective of price stability in the interest of stable and sustainable economic growth.

Any monetary policy framework defines the intermediate targets that will be monitored and used in order to attain the ultimate objective. As a result, it is expected that the intermediate target should have a direct bearing on the ultimate objective and should be more directly influenced by available monetary policy instruments. Generally, intermediate targets can be specified as any of or a combination of the money supply aggregates, exchange rate and nominal gross domestic product (GDP). Since the Phillips curve suggests that there is a trade off between anti-inflationary policies and growth[2] , some central banks do not focus much on growth issues. Instead they focus on the price stability as a requirement for sustainable growth.

To attain the intermediate target and the ultimate objectives of monetary policy, the authorities adopt an operational control framework that specifies the operational variables of monetary policy. One of the ways is through changes in interest rates. Under this framework, interest rates are used as a policy variable and the control of inflation is the ultimate objective while the broad measure of money or exchange rate is the intermediate target. The central bank affects the level of short-term interest rates by its discount policy which is often supplemented by open market operations in order to influence money supply.

---

1 Most of the discussion in this chapter has been adopted from reading material and lecture notes on Central Banking for SADC Countries, South African Reserve Bank Training Institute, June 1996

2 See also A R Bergstom. Et al, *Stability and Inflation* and M J Fry, et al, *Central Banking in Developing Countries: Objectives, Activities & Independence*

Alternatively, monetary policy aims at controlling the monetary base of the banking system rather than interest rates. Under this approach, the monetary aggregates are controlled through making changes to the monetary base of the banks and the interest rate is no longer a policy instrument, but is allowed to fluctuate according to market forces alone. The policy instrument under these conditions is then primarily the banks' reserve assets requirement. This system of control has been criticized on account of the loose relationship between the bank's cash reserves and monetary aggregate. In addition, the system is characterized by volatile exchange rates and interest rates patterns and can, therefore, exert devastating long-term effects on the real sector (SARB Training Institute, 1996).

In general, the choice of a monetary policy framework adopted by a country depends on the economic, financial, and institutional environment within which policy is operating apart from other constraints on policy formulation.

1.1 Targeting Monetary Aggregates

The choice of the money supply target is based on the function of money itself. Since money represents a generalized purchasing power, it should be reasonably well linked to the nominal value of total spending and output of goods and services in an economic system (Meulendyke, 1989). Economic agents opt to hold money balances because with these they are able to meet a substantial volume of economic transactions easily. That notwithstanding, the volume of money held is limited because doing so would entail a cost in the form of foregone opportunities for alternative investments. The amount of money that is consistent with the goals for prices and output will, therefore, depend on the customs, practices, regulations, and political environment of the country (Meulendyke, 1989). If these are stable, the relationship between money and economic activity will be stable too and money growth in excess of the amount needed to support the relationship should translate into an upward adjustment in domestic prices[1] (Meulendyke, 1989). Targeting the money supply, therefore, aims at reducing the excess of money stock to levels required to support the relationship between expected price level and output. Such action is premised on the belief that the cure for inflation is a monetary one, and if the growth rate of money supply is controlled effectively, so will inflation.

Generally, monetary targeting entails the selection of particular monetary aggregate (reserve money, narrow money or a broad measure of money) that best serves as an intermediate policy target. In some cases, several monetary aggregates may be used as a monitoring tool. A particular target range or point must be stated within a time frame. In most cases, the monetary targets are regarded as indicative of the growth in the monetary aggregate that the central bank would like to see realized given the prevailing and expected general economic conditions in the country.

There are various channels through which changes in the money supply can occur, but money is usually created through the extension of credit by the banking institutions. A policy aimed at managing the rate of increase in money supply should therefore concern itself with the rate of growth of claims of the banking sector on the domestic economy. That is, central banks need to be concerned with the amount of total bank credit as part of any policy aimed at targeting the growth in money supply.

Money supply targeting has got some problems: There is no guarantee that the relationship between the supply of money and inflation are in any way stable or predictable. There is no guarantee that low rate of growth in money supply will guarantee zero or low inflation at all times. However, modern monetarists, though recognizing that the relationship is complicated, continue to hold that the quantity theory of money is key to controlling the price level and the level of economic activity in the long run (Bloomsburg, 1993). The decision on monetary policy stance at any given point in time is even complicated because of uncertainties concerning the unavoidable time lags between changes in the money stock and inflation rate.

---

1 See also Milton Friedman, *Studies in Quantity Theory of Money*; John M Keynes, *The General Theory of Employment, Interest and Money*

Instability in the demand for money can also render monetary targeting difficult. The underlying demand function can be very unstable which is also closely related to the problem of instability in the velocity of circulation that can change because of intermediation or disintermediation, hoarding, technological advances, and changes in payment habits (SARB Training Institute, 1996). Finally, as alluded to earlier on, there is the problem of the choice of the monetary measure that has to be targeted.

1.2 Targeting the exchange rate

The targeting of a single exchange rate often means that the spot rate of the domestic currency is linked to that of an anchor currency. This is more easily achieved if the countries linked to the anchor currency have similar economic conditions, are geographically bound, and as long as the anchor country follows prudent macroeconomic policies. A country with a fixed exchange rate should also have enough reserves to defend the exchange rate in case it gets under attack. Otherwise, exchange rate targeting is more difficult if not impossible to sustain. The control framework, in this case, would be to have money supply as the intermediate target while the real effective exchange rate gets closely monitored on a very flexible basis and the spot exchange rate allowed to find its own level with minimal intervention by the central bank to smoothen out temporary swings (SARB Training Institute, 1996). These fundamental forces will however, greatly be influenced by the authorities' success in achieving adequate control over the growth in money supply.

The pursuit of an exchange rate targeting demands credibility. Inspiring and maintaining credibility requires that the authorities leave no doubt as to their ability and preparedness to raise interest rates to the level necessary to stabilize the exchange rate. The weak spot in exchange rate targeting rests on its potential vulnerability to high level of capital mobility (especially in an open economy) which in turn can have major implications for the level of interest rates required to attain the exchange rate target. The link of one currency to the anchor currency also implies that the interest rate has to be used as the operational variable of monetary policy. The central bank, thus, loses control of money supply, which has to be allowed to adjust fully to the fixed exchange rate and the required level of interest rates. Furthermore, if the exchange rate is used as a policy target, with price stability as the ultimate goal, it can no longer be used structurally to promote exports. At the same time, a large and persistent currency depreciation will fuel inflationary pressures. Under exchange targeting framework, therefore, monetary policy is severely limited because it is directed only at the exchange rate, constraining the ability of the central bank to respond to domestic or external shocks unlike in countries that have flexible exchange rate arrangements with monetary aggregate as the intermediate target for monetary policy (Croce and Khan, 2000).

1.3 Inflation Targeting

Inflation targeting is a monetary policy framework that commits the central bank to achieving low inflation . The central bank and government issue a joint public statement indicating an explicit quantitative inflation target to be achieved during a given time period. The central bank ensures that the announced target is achieved. As a result, inflation targeting requires some form of central bank independence in the choice of policy instruments and how they are to be employed (instrument independence).

A typical inflation-targeting central bank sets its instruments, such as interest rates, today at a level that will bring inflation forecasts at the end of the programme period to the inflation target. Inflation forecasts become intermediate targets. The discrepancy between the inflation target and the forecasts determine the kind of policy action to close the gap.

Inflation targeting implies that the money authorities attempt to address inflation directly, usually because the money supply target has proved to a be a fickle guide. This approach however, requires a high degree of co-operation between government, private business, trade unions, and the central bank which can be difficult to obtain.

---

1 See Enzo Croce and Mohsin Khan, *Monetary Regimes and Inflation Targeting* and Guy Debelle, et all, *Inflation targeting as a Framework for Monetary Policy*

2. Monetary Policy in Malawi

2.1 Legal Framework

The Reserve Bank of Malawi (RBM) was established by an Act of Parliament passed in July 1964 (repealed in 1989) and became operational in 1965. The Reserve Bank Act 1989 provides some form of independence to the Bank in the conduct of monetary policy and exchange rate management in addition to issuance of Malawi currency. At his discretion, the Governor of the Reserve Bank of Malawi may inform the authorities about developments in monetary policy.

The Act stipulates that monetary policy, in Malawi, should aim at promoting economic growth, employment, stability in prices, and maintenance of a sustainable balance of payments position. However, in recent years, the role of the Bank has been understood as that of maintaining price stability while promoting overall financial system soundness and monetary stability in the long-term interest of the national economy. Operationally, the Reserve Bank seeks to influence the M2 money aggregate and domestic interest rates to attain its objective. The main instruments available to the Bank include statutory liquidity reserve requirement (LRR), open market operations (OMO), and the Bank rate.

2.2 Monetary Policy Design

Up until late 1980s, monetary policy in Malawi was characterized by repressive procedures such as direct credit, interest rate ceilings, and strict controls on foreign exchange and capital flows. Supported by the International Monetary Fund, Malawi went into structural adjustment programs beginning in the second half of 1988. The programmes comprised reforms aimed at reducing direct government intervention in the economy, and where necessary, developing new mechanisms for indirect market-mediated implementation of policies. These included the development and diversification of financial institutions, elimination of direct controls, replacing them with more indirect techniques for influencing monetary aggregates. Credit ceilings and rationing were abandoned by 1989. Instead the reserve requirement ration was introduced as a monetary policy instrument. Interest rates, which were initially prescribed by the Reserve Bank, were completely deregulated in 1990. Prior foreign exchange approval requirements for about 98 percent of imports were eliminated by the end of 1991. In February 1994, the exchange rate was liberalized and exchange controls were removed except for the capital account

To strengthen the role of the Bank in financial regulations, the function of Bank Supervision, which was in the hands of the Ministry of Finance, was moved to the Reserve Bank in 1989. Prior to that move, the central bank was only responsible for inspection of commercial bank and emphasis was put on whether exchange controls were being adhered to without consideration to prudential bank supervision. With the creation of Bank Supervision, coverage was extended to include other non-bank financial institutions that take funds from the public and issue loans upon the same.

2.3 Monetary Policy Operations

The liberalization of the financial sector, as earlier on indicated, meant that monetary policy had to shift from direct to indirect methods. This facilitated the conduct of monetary policy in line with macroeconomic objectives of maintaining sustainable growth, viable balance of payments position and stable prices. The central bank keeps a close eye on all indicators that would entail price developments including the CPI, growth in GDP, monetary growth and expansion of bank credit.

Table 1: Selected Macroeconomic Indicators

	1994	1995	1996	1997	1998	1999	2000
Real GDP[1]	-11.6	13.8	10.5	6.6	2.6	4.0	3.4
M2 money Supply[2]	56.4	43.7	39.9	2.2	55.5	33.6	42.4
CPI inflation[3]	34.6	83.3	37.6	9.2	29.8	44.7	29.6
MK/USD rate[3]	8.74	15.28	15.28	16.44	31.07	44.09	80.09

Source: Reserve Bank of Malawi Monthly Economic Review, August 2000 and March 2001

1 Annual percentage change

2 Year-on-year rate of inflation

3 Period average

In trying to attain its goal of price stability, the Reserve Bank of Malawi establishes an annual inflation rate target, announced by the Minister of Finance in his Budget Statement to Parliament, and uses control over monetary aggregates as an immediate variable. In order to achieve the price objective, the Bank exerts stricter controls over reserve money, employing for this purpose quarterly growth targets (usually agreed with the Fund under the supported programmes). While more emphasis was initially put on growth in the M2 aggregate, recent developments have indicated that M2 can better be influenced by monitoring growth in reserve money aggregate because the central bank has better control over the latter than the M2 money stock.

In order to influence growth in the money stock, the central bank increases or decreases the amount of reserve money by managing both the domestic and foreign sources of reserve money (credit from the central bank, and acquisition of foreign exchange by the Bank that has impact on local money creation). The central banks' daily monetary management involves making estimates of banking system's liquidity situations. Based on the outcome, the central bank decides how to intervene, i.e. inject or withdraw liquidity from the system. Outlined below are major monetary policy instruments and how they are utilized.

2.4 Liquidity Reserve Requirement (LRR)

Liquidity Reserve Requirement (LRR) refers to the proportion of deposit liabilities a financial institution holds (in the form of readily acceptable means of payments) with a central bank principally for the purpose of implementing monetary policy objectives and second for prudential purposes so as to safe guard depositor's interest.

In Malawi, the LRR was first applied in June 1989 following the revision of both the Banking Act and Reserve Bank of Malawi Act. Section 38 of the Banking Act (1989) and Sections 30, 36 and 48 of the Reserve Bank of Malawi Act of 1989 authorize the Reserve Bank to prescribe a minimum cash reserve balance which other banks are required to maintain in the form of deposits with the Reserve Bank. The LRR is justified on the need by the Bank to provide uniform mechanism where the central bank may implement monetary policy objectives to protect the external value of the national currency and maintain a monetary equilibrium and also assure adherence to prudential liquidity standards by individual institutions.

The Bank sets minimum Liquidity Reserve Requirements that are supposed to be met by all eligible institutions. Each eligible depository institution is required to maintain required reserves, expressed as a percentage of total deposit liabilities equivalent to a given percent of total applicable deposit liabilities, whether domestic or foreign. The reserves so required are maintained in the same currency as the underlying deposit liability. Currently, eligible assets for the LRR requirement include cash on had and in the vaults; balances on deposit with the Reserve Bank and proportion of balances with the discount house.

The basis for computing the required reserves amount is the monthly averages of the applicable deposit liabilities specified above. Such averages are computed using totals as of close of busi-

ness for each working day of the month immediately preceding the month for which the reserve requirement must be maintained. Each depository institution is required to ensure that it has eligible liquid assets in an amount at least equal to the required reserve amount on the first business day of each month to the end of the month. Failure to meet the liquidity reserve requirement by the deadline may result in the assessment of penalty or other regulatory sanctions as circumstances may warrant.

Table 2: Malawi: Interest rates (1994 - 2000)[1]

	1994	1995	1996	1997	1998	1999	2000
Bank Rate	40.00	50.00	27.00	23.00	43.00	47.00	50.23
LRR rate	20.00	35.00	35.00	35.00	35.00	35.00	30.00
Prime Rate[2]	31.00	47.33	45.33	28.25	37.67	53.58	52.00
Deposit rate[2]	25.00	37.27	26.33	10.21	19.06	32.21	34.50
91-days TB rate	27.68	46.30	30.83	13.31	32.98	42.85	67.46

Source: Reserve Bank of Malawi Monthly Economic Review, various issues

1 End of period

2 End period average

When the LRR was first introduced in 1989, the rate was set at 20 per cent of commercial banks' deposit liabilities. It was increased to 35 percent in 1995 and remained there until in the second half of 2000 when the rate was adjusted down to 30 percent. Even at a lower level of 30 percent when compared to the 35 percent that ruled between 1995 and mid 2000, the ratio is significantly high. Furthermore, maintaining the ratio at such high levels has many adverse implications for the efficiency of financial intermediation in Malawi and for the efficiency of monetary policy as well.

Requiring depository institutions to maintain non-remunerated balances is in effect a tax on these institutions equivalent to the interest they could have earned on those balances in the absence of reserve requirements. The implicit tax on reserves, when added to all other costs of intermediation that may be borne by banks, is reflected in a wide spread between deposit and lending rates (interest rate spread).

The high level at which requirements have been maintained is also an obstacle to the Reserve Bank's efforts to employ market-based instruments of policy in a more active way, especially when monetary restraint is required. The amount of leverage that the RBM can exert on money supply through changes in reserve money is constrained by the high reserve requirement. The high reserve ratio tends to cause the money multiplier to be relatively low , and therefore, requires a correspondingly large amount of security sales to absorb a given amount of liquidity and to effect changes in the rate of money growth (Iden and Barret, 1999).

While appreciating the need to, therefore, lower the LRR rate, there are other considerations that have to be made. For example, a reduction in the reserve ratio could exacerbate inflationary pressures unless it is offset with other monetary instruments. Otherwise, the resultant increase in free reserves would renew inflationary pressures. Ideally, that could be achieved through more aggressive sales of government securities or issue of the Bank's own paper of a combination of both. However, in the case of Malawi, the amount of money that was created by way of interest on open market operations, by end 2000, was already enormous and defeating the cause for which they were issued.

---

1 Reserves (R) equal required reserves (RR) plus excess reserves (ER). The multiplier (m) equal (M2/R. Therefore, an increase in reserve ratio (r) increases RR and hence R making m smaller.

Theoretically, reserve requirements aim at controlling money growth through a lower bank multiplier, which offsets the effects of an expansion in base money. Although the LRR is still considered one of the major policy tools, its importance has been declining in recent years. Instead more emphasis has been placed on the use of open market operations. Use of LRR is limited by the fact that it cannot be adjusted often to take into account daily fluctuations in liquidity estimates for fear of disrupting the financial planning process in the banking system.

2.4.1 RBM Open Market Operations

Treasury bills (TBs) auctions, as a major indirect monetary policy instrument, were introduced in 1992. However, the purposes for the issuance of such bills were two-fold: first, for fiscal budgetary purposes and, second for liquidity management purposes. Originally Treasury bill tenors were of 30 days, 60 days and 91 days. The 30 days and 60 days maturities have since been abolished and replaced with 183 days and 271 days tenors, respectively. Before 1995, Treasury bill auctions were held once a month. Currently they are held every week to ensure a smooth monetary policy implementation.

In 1998 the Bank acquired some TBs to be used solely for monetary purposes. The two issues however, did not carry different rates of interest because it made no difference in the participating agents as to whether one was monetary or budgetary. A distinction was, nonetheless, made in the accounting sense. The central bank assumed responsibility over the monetary bills while government was responsible for honouring obligations arising from issuance of budgetary bills. Proceeds of monetary policy issues were fully frozen in the Bank until maturity. In a bid to remain more transparent in its monetary operations, the RBM began issuing its own bill (RBM bill) in August 2000 to supplement the existing, and replace, monetary Treasury bills gotten in 1998.

Table 3: Open Market Operations and Reserve Money[1]

	1994	1995	1996	1997	1998	1999	2000
Total Bills	520.3	2,332.8	3,144.1	3,324.3	4,140.1	7,7731.8	11,567.9
Budgetary Treasury bills	520.3	2,332.8	3,144.1	3,224.3	3,336.5	4,918.8	9,172.7
Monetary Policy Bills[2]	-	-	-	-	803.6	2,813.0	2,395.2
Reserve Money	1,231.9	2,355.0	3,268.8	3,276.2	4,308.1	5,929.6	6,230.5
Money multiplier	2.2	1.7	1.7	1.7	2.0	1.9	2.6

Source: Reserve Bank of Malawi Financial and Economic Review and other staff report

1 End period balances

2 Includes monetary Treasury bills and RBM bills

2.4.2 Repurchase and Discount Window Facilities

Repurchase facilities are collateralised loans where a borrower, mostly a commercial bank, undertakes to buy back the underlying or lodged securities at the same face value or price on a specific further date. Therefore, the ownership of the securities does not change hands. A discount facility, on the other hand, is a sale of a security at a discount to its face value whereby the seller forfeits or the buyer assumes ownership of the security in question. In a situation where the discounted negotiable security is being discounted then such a transaction is referred to as a rediscount.

In Malawi, the discount facilities are intended to assist commercial banks meet unanticipated shortages of funds, and thus ensuring smooth payments and clearing system. Shortages of funds that are likely to be protracted are addressed through other means such as portfolio adjustments. In order to discourage frequent or continuous recourse to the window, the central bank takes action including charging of a punitive premium on top of the prevailing charge for the usage of either the LRR, repurchase or discount facility. A commercial bank may borrow on repo basis from the Reserve Bank for a period of up to seven days.

2.5 The Inter-Bank Market

An inter-bank market was instituted in February 1997. Since then the financial sector has experienced a substantial growth in the level of transactions. The volume of transactions passing through the market rose from K966.7million in April 1997 to K35,045.5 million by the end of 2000. The introduction of the market assisted the financial institutions in their liquidity management thereby creating some flexibility in serving their customers while reducing commercial bank recourse to the central bank window. At the same time, the market provided an arena for promoting a market-based monetary policy. As Slok, 2000 noted, a market based monetary policy depends of the existence of a market for money and foreign exchange. If the institutional framework for monetary policy and specific monetary instruments are lacking or malfunctioning, the conduct and effectiveness of monetary policy will be impeded.

2.6 Exchange Rate Policy
2.6.1 Exchange Rate Determination Before 1994

From independence in 1964 to January 1971 Malawi operated within the Sterling zone with the Malawi pound pegged at par to the British pound sterling. The Malawi kwacha was introduced in February 1971 and it was pegged to the Pound sterling at two to one. In November 1973, the currency was pegged to a weighted average of the Pound and the US dollar. However, due to heavy fluctuations of the two currencies (Argy, 1982), the kwacha was pegged to the SDR in June 1975. This allowed the kwacha some measure of stability until early 1980s when the SDR started appreciating rapidly, forcing the authorities to devalue the local currency against the SDR by 15 and 12 percent in April 1982 and September 1983, respectively.

Table 4: Official Devaluations in Malawi

	Devaluation (percent)
April 1982	15
September 1983	12
April 1985	15
August 1986	10
February 1987	20
January 1988	15
March 1990	7
March 1992	15
June 1992	22

Source: National Statistical Office: Malawi, Monthly Statistical Bulletin; December 1997.

Because of continued appreciation of the SDR and the fact that the SDR did not properly represent the currencies of Malawi's trading partners, the authorities decided to add the South African rand to the SDR basket in January 1984. following this peg, the main thrust was to maintain external competitiveness by ensuring that the real effective exchange rate (REER) was not appreciating. This was achieved by periodic devaluations of the kwacha, especially that the rate of inflation in Malawi remained higher than that of the trading partners. Towards the end of 1991, the kwacha appreciated rapidly in real terms because of sharp devaluations in some of the trading partners' currencies such as South Africa, Zimbabwe and Zambia and also due to unfavourable movements in relative prices. That led to two devaluations in June 1992.

Progressively, it became apparent that the exchange rate was becoming heavily politicised with each devaluation-becoming subject of intense speculation within the private sector. That led to lack of confidence in the exchange system, of which a major consequence was a marked slowdown in repatriating of export proceeds. The situation was worsened by the cut in non-humanitarian assistance by bilateral donors in 1992 because of governance issues. As a result, the foreign exchange situation became critical and external arrears began to accumulate. Following the above scenario,

the authorities decided to have a far-reaching overhaul of the exchange rate system by floating the kwacha against other currencies on February 7, 1994. Thus, just like Gambia (Fry, et al, 1996) Malawi floated the exchange rate on grounds of payments disequilibria unlike Uganda and Zambia where the choice was purely liberalization.

2.6.2 Exchange Rate Determination after Kwacha Floatation

As a step towards market determination of the exchange rate, the Malawi authorities created a foreign exchange market administered by the central bank where weekly auctions of foreign exchange would take place. Buyers of foreign exchange would bid through the commercial banks the price at which they wanted to buy a certain amount of foreign exchange. In the same way, sellers would determine their selling price and amounts. Successful bidders would then pay their bidding prices and not the clearing rate. This is what is sometimes referred to as the Dutch auctioning system and was practiced in Ghana, Zambia and Bolivia (Quirk, 1987). The central bank only intervened by adjusting the amount of foreign exchange supplied to the auction. Prior to the auctioning system, the central bank had to selectively allocate foreign exchange to the various sectors of the economy, which undoubtedly led to inefficient allocation of the scarce foreign reserves though no specific case has been cited in the available literature. Together with the exchange rate liberalization, all foreign exchange transactions were liberalized except for the capital account which remained under exchange control regulations.

Opening the capital account in the initial stages of a liberalization process over-exposes a country to external volatility. Opening the capital account at a period when the domestic capital market is still repressed or underdeveloped may lead to massive capital outflows (Bruno, 1988) and complicate the conduct of monetary policy.

In order to support the foreign exchange liberalization effectively, the authorities encouraged new entrants into the foreign exchange market by licensing other authorized foreign exchange dealers (Bureau de Changes) in addition to the two commercial banks that existed then. Investment in the banking sector was encouraged so much so that by the end of 1995 two new commercial banks had become operational. Reflecting the scarcity of foreign exchange reserves and the overvaluation of the Kwacha before the flotation, the Kwacha depreciated from about MK4.5 to the US Dollar (USD) in January 1994 to MK7.3 to the Dollar by the end June 1994 when the weekly auctions were abandoned. The Kwacha continued to depreciate and stabilized at around MK15.3 to the Dollar by the end of 1994.

Following the abandonment of the auction system, all foreign exchange transactions to do with the private sector are dealt with by the dealer institutions at exchange rates privately determined. As a result, the official exchange rate is determined by averaging the rates offered by the Authorized Dealer Banks (ADBs) . Rates offered by the bureaus act as signals to the developments in the parallel markets. The central bank however continues to intervene on the foreign exchange market by seasonally buying or selling foreign exchange to control fluctuations in foreign exchange supplies. The flow of foreign exchange in Malawi is seasonal because of its dependence on agriculture (mainly tobacco) as the main foreign exchange earner.

The ADBs are free to work out their own opening rate for the USD based on available information. Ideally, the ADBs are supposed to be guided by demand and supply conditions in the market, their own trading positions that mainly constitutes the safeguarding of their profit margins, positions of competitors, and the general outlook of the economy. The obvious advantage of the system is that it is transparent and easy, simply requiring the collection of the rates from the banks and calculating the simple average.

---

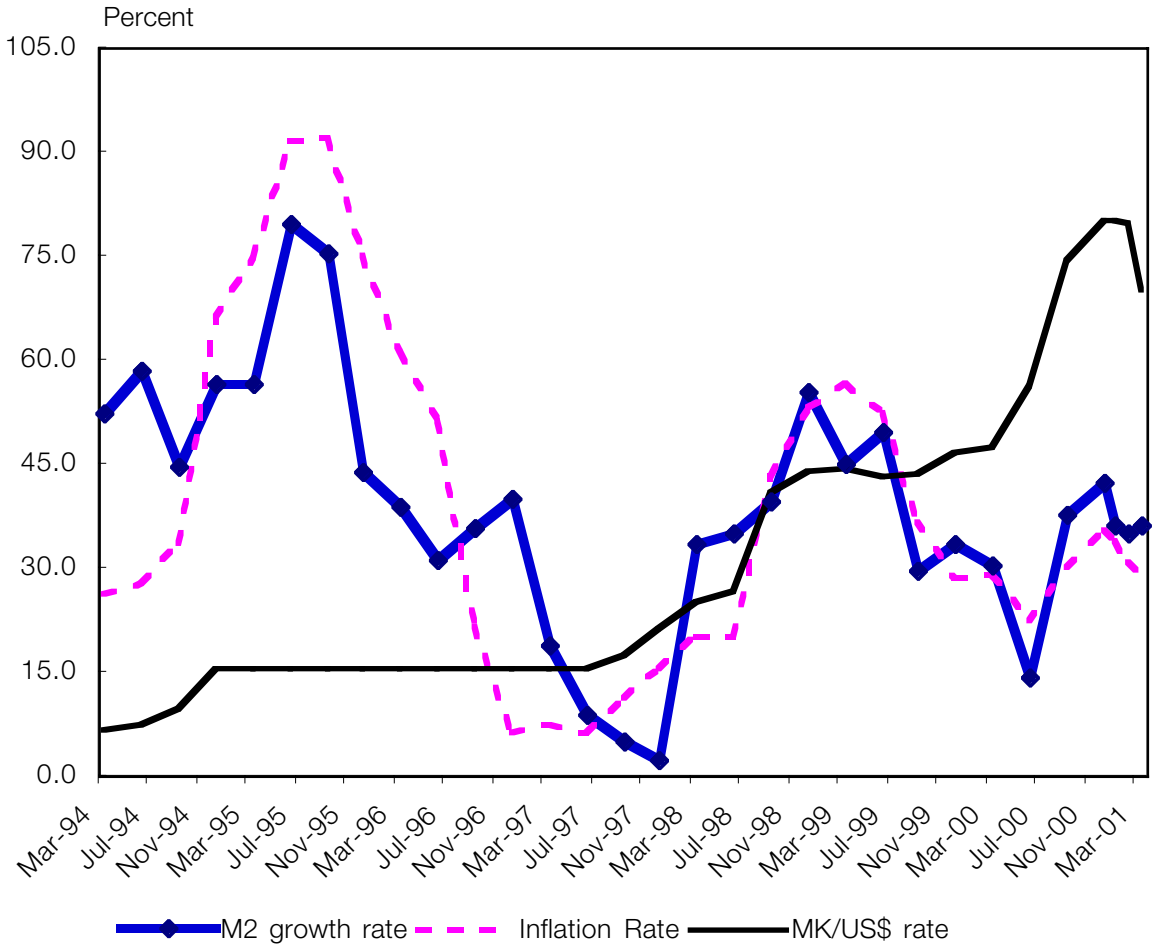
1 National Bank of Malawi, Commercial Bank of Malawi, Finance Corporation of Malawi, Indebank Financial Services, Finance Bank of Malawi, First Merchant Bank and Loita Investment Bank of Malawi

The system, however, assumes that ADBs are able to assess the market correctly. In the course of operating this system, it has been noted that capacity to interpret information is lacking in most ADBs. Notably, smaller ADBs always ask for rates from the big ADBs before working out their rates. This is obviously a "follow-the-leader" market behaviour and therefore reduces competition that is essential in ensuring that the Kwacha is set at the right price.

2.6.3 Exchange Rate Policy and Price Stability

In Malawi, demand for foreign exchange has been documented to be seasonal and sometimes speculative. Empirically, it has been observed that the growth of money supply determines the depreciation rate of the local currency and at the same time fluctuations in the nominal exchange rate trigger inflationary expectations and hence demand for money. Monetarists believe that growth of money supply determines the inflation rate in the long run. The rate of inflation, on the other hand, affects growth of output and employment. It is in this vain that Malawian authorities have adopted a broader approach, interlinking fiscal and monetary policies in macroeconomic management, where the exchange rate is one of the variables.

Chart 1 : Malawi Money Supply, Exchange Rate, and the Price Level



Source : Reserve Bank of Malawi, Financial Economic Review

3. Role of Monetary Policy Committee (MPC)

A Monetary Policy Committee (MPC) was formally instituted in February 2000. The MPC aims at promoting efficiency, transparency and ensuring a well-organised decision-making process in the formulation and conduct of monetary policy. The MPC meets every month and it consists of the Governor, Deputy Governor, and General Managers as voting members and several Heads of Department in the Bank as non-voting members of the committee.

The Ministry of Finance (The Treasury), and the National Economic Council (NEC), have a right to be represented in a non-voting capacity. However, their representation is restricted to the level of the Secretary to the Treasury (ST), Principal Secretary for Economic Affairs in the Ministry of Finance, and Principal Secretary for NEC.

Decisions made during these meetings are made public through newspapers.

4. Conclusion

Monetary policy in Malawi focuses on prices and financial sector stability. The policy regime has evolved from fixed exchange rates, which had with it some form of foreign exchange rationing, administration of interest rates, credit ceilings and preferential credit to certain sectors, in particular, agriculture. Beginning 1987, the country went into several reforms. As a result, the country saw the liberalization of interest rates; abolition of preferential rates while the bank rate was actively administered. In 1989, the liquidity reserve requirement was introduced together with the discount window. In the early 1990s Malawi saw the introduction of Treasury bill auctioning and complete abolition of credit ceilings. By 1994 the kwacha was liberalised while interest rates became more market determined. Broad money became the anchor of monetary policy with reserve money as the operating target.

As Slok, 2000 noted in his paper "*Can Monetary Policy be Effective During Transition, Lessons From Mongolia*", a key challenge in the formulation and implementation of monetary policy for Malawi has been that inflation is not (or perceived not to be) only a monetary phenomenon. There are other structural issues that cannot be left unconsidered though delving into them would entail diverting from the core responsibility of the central bank. Apart from the usual demand pull and cost push pressures, there are other additional factors that influence the direction of prices. We have things like the seasonal pattern of food inflation, which follows the agricultural cycle and cannot be influenced by monetary policy. Other things include price liberalisation which at the beginning of transition results in an initial price level adjustment and substantial changes in relative prices and hence inflation. In addition, there is monetary financing of fiscal deficits, (as seen during the dry up of donor support in the early 1990s) which generated inflationary pressures. Furthermore, there is a downward rigidity in the goods and labour market, which together with price indexation (though not very pronounced) generate some form of inflation. In Malawi, most prices are indexed to the exchange rate, especially the US Dollar rate against the Malawi Kwacha.

Monetary policy formulation and implementation in Malawi has, thus, generally taken the path of learning by doing and the process still continues. The Monetary Policy Committee so created has a major task which may seem straightforward and yet it is not. Given the above considerations, determining the appropriate policy stance and balancing long run and short-run objectives in the execution of policy have proved to be very challenging and not so straightforward. Decisions have to be made as events unfold and the policy actions themselves become part of a dynamic economic process whose effects may extend over a considerable time period.

Selected References

Alexander, William E, Barlino, Tomas J T, and Enoch, Charles et al, The Adoption of Indirect Instruments of Monetary Policy, IMF Occasional Paper No. 126; International Monetary Fund, Washington DC, 1995

Argy, Victor: Exchange Rate Management in Theory and Practice, Princeton University, 1982

Bank for International Settlements, Monetary Policy Operating procedures in Emerging Markets, BIS Policy Paper No. 5, Basle, Switzerland, 1999

Bank of England, Monetary Policy Frameworks in a Global Context: Summary Prepared For the Central Bank Governor's Symposium at the Bank of England for June 4, 1999, Bank of England, 1999

Bergstrom, A.R., Catt A.J.L., Peston M.H, and Silverstone, B.D.J. (Editors), Stability and Inflation:

A volume of essays to honour the memory of A.WH. Phillips, John Wiley & Sons, Chichester, 1978

Croce, E and Khan, Mohsin S, Monetary Regimes and Inflation Targeting in Finance & Development: Economies in Transition, International Monetary Fund, Washington DC September 2000

Debelle, G., Masson, P., Savastano, M., and Sharma, S, Inflation Targeting as a Framework for Monetary Policy, International Monetary Fund, Washington ,Dc 1998.

Fischer, Stanley, Devaluation and Inflation in The Open Economy, Tools for Policy Makers Developing Countries, Oxford University Press, New York 1995

Fry, Maxwell J, Goodhart, Charles A.E. and Almeida, Alvaro, Central Banking in Developing Countries: Objectives, Activities and Independence, Routledge, London, 1999

Meulendyke, Annie-Marie, U.S Monetary Policy and Financial Markets, Federal Reserve Bank of New York, New York City, 1989

Quirk, Peter, Floating Exchange Rates in Developing Countries, Experience with Auction And Interbank Markets, IMF, 1987

Ritter, Lawrence S and Shilber, William L, Principles of Money and Banking, and Financial Markets, Basic Books, Inc., publishers, New York, 1986

Slok, Torsten, Can Monetary Policy be Effective During Transition? Lessons from Mongolia, in Finance and Developments, Transition Economies, IMF, September 2000