ILO proposes monetary policies for Malawi's employment creation

By Gregory Gondwe: @Kalipochi

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The International Labour Organisation (ILO) has released a report on Malawi which is trying to establish on how monetary policy instruments can be used to encourage Malawi onto a path of employment-generating growth. The report titled *Macroeconomic policy for employment creation: The Case for Malawi* released last month has identified three policy areas for consideration.

These include the need for Malawi to reduce excess liquidity of commercial banks, which is the quantity of reserves deposited with the central bank by deposit money banks plus cash in vaults and other eligible liquid assets in excess of the required or statutory level.

The other one is to encourage the Reserve Bank of Malawi (RBM) to take on a greater developmental role and to introduce interest rate flexibility which is tuned to seasonality in the agricultural sector in order to promote agricultural growth and job creation.

The report released by the International Labour Office under its employment sector is also called 'Employment Working Paper No. 93' and has been researched by University of Malawi economics lecturer Professor Ben Kaluwa and Dr. Sonali Deraniyagala who teaches in the department of economics at the School of Oriental and African Studies (SOAS) of the University of London.

High levels of liquidity

On reducing commercial bank excess liquidity to encourage employment-rich growth, the two economists have observed in the report that Malawian commercial banks have been characterised by systematically high levels of liquidity.

"The liquidity ratio of banks in 2009 was around 35% which is way above the required reserve ratio of between 15 and 20%," they observed.

The research findings say high levels of commercial bank liquidity have important implications for the use of monetary policy for stimulating employment-rich growth as it indicates scope for channelling credit to productive sectors which need to expand for the economy to undergo structural change.

The two economists however observed that institutional factors may encourage commercial banks to hold precautionary reserves since poorly developed interbank markets, for example, make it difficult for banks to borrow in order to cover contingencies.

Banks encounter difficulties

"It has also been suggested that difficulties encountered by banks in tracking their position at the central bank may require them to hold reserves above the statutory limits. In addition, banks may want to hold precautionary excess reserves due to problems with the payments system," the reports says, which added that remote bank branches may need to hold excess reserves due to transportation problems.

The other observation is that of the importance of agricultural finance for commercial banks which could make both the demand for credit and supply of deposits highly seasonal and not suitably synchronised.

Liquidity trap

"If commercial banks hold more liquidity than they require, why they not expand lending, buy government securities or reduce deposits?" the report queries before attempting one possible explanation which could be that economies are in liquidity trap.

The explanation on a standard liquidity trap is where the rate of return on lending is too low to cover intermediation costs and where bonds and reserves are perfect substitutes; banks have a higher yield on reserves than they do on loans. Hence, a monetary expansion by the central bank just leads to an increase in excess reserves, even beyond banks prudential requirements.

Malawi's case is linked to lack of loan repayment with 11 licensed commercial banks currently in Malawi which reach out to 19% of the adult population banked.

By March 2009, total assets held by the banking system was estimated at about US$1.28 billion, of which more than 65% is concentrated in the country's three largest banks - National Bank of Malawi, Standard Bank and NBS Bank.

Limited interbank market

While there is only a limited interbank market, profitability among commercial banks in Malawi is very high with the average return on equity in the banking sector estimated at 48% at the end of 2008.

"This level of profitability indicates that there is less pressure on commercial banks to diversify their client base and develop new markets for their financial services," says Kaluwa and Deraniyagala.

Malawi's commercial banks intentionally reduce exposure to agricultural lending due to weak loan repayment.

"It appears that already high profitability levels have led banks to hold excess liquidity - they have few incentives to seek out new, more risky borrowers," observed the ILO report.

Monetary policy recommendations

The ILO has since made monetary policy recommendations for Malawi which it calling on the country to "use a 'carrot and stick' approach" to reduce bank liquidity. The economic gurus say since in the present economic reality, it is unlikely that commercial banks in Malawi will increase productive lending and change the risk or return trade-off that exists positive incentives to reduce liquidity or disincentives to maintain high liquidity are required.

"We suggest the Reserve Bank takes an inventive approach to this issue and reduces liquidity in a way that could generate job-rich growth. We propose the following two options," says the economists.

The Reserve Bank, ILO says could link commercial bank reserve requirements to lending for priority sectors.

"Hence it would allow a proportion of their lending, say 0.1%, to these sectors to qualify as banks' eligible reserves. This therefore involves a strategic direction of credit by the state by using the 'carrot' of the reserve ratio as a policy instrument," said says Kaluwa and Deraniyagala.

Priority lending

In order to create employment in Malawi, ILO says there is need for what is known as priority lending by the commercial banks.

Although the 'Integrated Cotton and Textile Sector' is given specific mention but this could apply to all manufacturing and exporting activities which should indeed be key priority for directed commercial bank lending.

ILO says tourism is another sector that could benefit from priority lending especially considering that Malawi has potential for reaching into the higher value end of the tourist market. For instance, ILO says aiming at joint Zambia/Malawi travel could be the way to invest although it may require capital investment.

ILO says Malawi can also use an 'excess liquidity tax' as a 'stick' to discourage commercial banks from inefficient hoarding of cash.

"In other words, commercial banks could be disciplined if liquidity levels are higher than the Reserve Banks stipulated ratio. An alternative way viewing this can be as an inverse standing facility - short-term high-interest lending," say Kaluwa and Deraniyagala.

Loan guarantee system

ILO observes that Malawi is currently moving towards a loan guarantee system through the establishment of a Credit Reference Bureau and National Identity system.

"This should ease the risk averseness of commercial bank to lend. With these institutional arrangements in place, the Reserve Bank will be in a better position to use carrot and stick instruments to reduce excess bank liquidity in a way that promotes growth and employment creation," it says.

On the involvement of the central bank in creating jobs, ILO base their argument on the law that guides the bank which was established in 1965.

The current enabling legislation of the RBM, the Reserve Bank of Malawi Act 1989, stipulates the bank's mandate in relation to monetary policy in very broad terms, ILO observes.

The law says RBM will implement measures designed to influence the money supply and the availability of credit, interest rates and exchange rates with the view to promoting economic growth, employment, stability in prices and sustainable balance of payments position.

It also says the bank has to operationalise these broad policy objectives in the short to medium term, besides proclaiming the monetary policy objective of achieving low inflation and low interest rates, and setting an inflation target of 5% by 2011.

"While the RBM clearly sets price stability as its measurable monetary policy objective in the short-term, it remains vague in terms of the uniqueness of its policy instrument," observe Kaluwa and Deraniyagala.

They say this is evident in the pronouncement that says in Malawi the objective of monetary policy is to bring inflation down to a single digit by 2008.

Monetary policy

"To achieve this, reserve money will remain the anchor of monetary policy. The Reserve Bank of Malawi uses a combination of instruments to achieve its objective on monetary policy; These include the bank rate, liquidity reserve requirements, open market operations, and sales and purchases of foreign exchange," say the economists.

They observe that while in recent years the key intermediate target of monetary policy has been the control of growth in broad money, the operating procedure has focused on monitoring growth in reserve money.

"This monitoring process is achieved through reserve money programming within the IMF's monetary programming model for the country, which sets monthly and quarterly reserve money targets based on broad money targets thought to be consistent with the desired levels of economic growth and inflation," explain Kaluwa and Deraniyagala..

Therefore, they say once an estimate of the commercial banks' liquidity requirements is made, the procedure involves RBM's intervention through changes in the amount of reserve money according to the stipulated liquidity reserve ratio (LRR), by manipulating commercial banks' access to credit from the central bank.

In the Malawi case, the LRR is the ration of liquid assets that comprise cash; net balances with the RBM; Treasury Bills; exchange discounted and purchased payable in Malawi; local registered stocks and transit items to commercial banks' liabilities to the public.

ILO observes that the IMF expects progress in monetary policy to be reflected by a shift from direct instruments towards indirect money market operations which for developing countries is limited by underdeveloped capital markets.

However, it observes further that for structural transformation that boosts employment-creating growth this would not be enough.

Loan guarantee programmes

ILO says RBM can play a role in mobilising resources for microfinance institutions (MFIs), small and medium enterprises (SMEs) and key sectors such as manufacturing and exports capable of transforming economies, generating value addition, employment, incomes and export potential.

"Loan guarantee programmes can be used for this end," Kaluwa and Deraniyagala say in the report, "These would guarantee a proportion of commercial banks loans to other financial institutions that have the experience to on-lend to SMEs which create decent jobs and other positive effects."

ILO says loan guarantee programmes are not monetary policy instruments but can achieve allocative outcomes while the narrow focus on inflation and deficits of IMF programmes has itself has been considered not to be development oriented and irrelevant for developing country needs, RBM is mandated to improve the availability of credit and supporting private-sector-led structural change and economic growth to prove it otherwise.

Adjust interest rates

The other ILO monetary policy recommendation is that Malawi needs to adjust interest rates to take account of seasonality in agriculture.

"While interest rates have been falling in recent years, Malawi's real lending rates are in the order of 15% which is by far one of the highest in the world," observe Kaluwa and Deraniyagala.

They also observe that in Malawi interest rate spreads at around 20% - are also the highest in the region though decreasing slowly.

In Malawi, use of the monetary instrument of the interest rate to promote job rich growth calls for a rethinking of the directional relationship between inflation and the rate of interest.

The two economists then called for a delinking of the exiting directional relationship between inflation and interest rate changes since as a poor country food prices contribute highly to the national consumer price index in Malawi, at an estimated 55%.

They said since maize, the main component of food for the majority is grown mainly on a subsistence basis and under uni-modal rain-fed conditions, in typical years its supply is limited and its price on the market display seasonality patterns.

"The price of maize tends to rise around the time when farmers are preparing for the next season's crop. Rising interest rates at this time deters investment and constrains future supply and pushes up prices in the longer term," say Kaluwa and Deraniyagala.

ILO observes that among the major cash crops, sugar is the main one grown under irrigation and its seasonality cycle differs from that of rain-fed crops because of water-management and conditions required for harvesting.

"Food and particularly maize production and availability have implications for inter-seasonal price patterns and food and headline inflation," they say.

ILO says production of other main non-irrigated cash crops; presently tobacco and cotton exports have implications for the current account, where the exports are also seasonal. Harvests of rain-fed crops are delivered after the rainy season which lasts between October and May.

Unless Malawi takes heed to the findings which are in a 70-page book, Malawi's employment market will continue to shrink thereby effecting the industrial development as well as the economy.

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