Essays on Fiscal and Monetary Policies in Malawi

Summary of dissertation

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by

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This dissertation comprises of two studies on fiscal and monetary policies in Malawi. These studies cover a range of issues concerning the implementation, effectiveness, relevance, and interaction of the policies.

In the first study, designated as ***chapter 3*** of the dissertation, Malawi's fiscal and monetary policy rules are estimated and their effects and influence on key macroeconomic variables analyzed in a New Keynesian DSGE framework. The Bayesian technique is used to estimate the model using data on consumption, investment, inflation, nominal interest rate, government spending, consumption tax revenue, and income tax revenue. It is found that monetary policy in Malawi follows a Taylor type interest rate rule in which interest rates respond strongly to changes in inflation, in accordance with the "Taylor principle", and only mildly to output fluctuations. Fiscal policy too reacts to output fluctuations in a modest fashion. With regards to the main drivers of output fluctuations, it is shown that although fiscal and monetary policy shocks play a significant role, it is actually productivity shocks and to a lesser extent cost-push shocks that are the main determinants of business cycles.

The second study is presented in ***chapter 4*** of the dissertation and in it we analyze the interaction between fiscal and monetary policies in Malawi using a structural VAR framework with sign restrictions. The key question addressed is whether macroeconomic policy environment in Malawi is characterized by fiscal dominance or monetary dominance. The model that we derive is used to identify government spending shocks, government revenue shocks, and monetary policy shocks so as to observe their respective effects on the conduct of fiscal and monetary policy. The results show that policy making in Malawi leans towards a monetary dominant regime rather than a fiscal dominant one. This is manifested by a counteractive reaction of monetary policy to loose fiscal policy on one hand and a cooperative reaction of fiscal policy to tight monetary policy stance on the other hand. The results also show that spending shocks are not financed by tax revenues which, coupled with the non-cooperative nature of monetary policy, is consistent the high public debt accumulation observed in the data.

The two studies are supplemented by an introductory chapter (***chapter 1***), a summary of some stylized facts about the Malawi economy that are relevant to our two studies (***chapter 2***), and a summary of our main conclusions and recommendations (***chapter 5)***.