# How did Malawi Accumulate External Debt?

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……..a large proportion of external debt resources were not deployed towards productive uses?

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SUMMARY

This paper investigates how Malawi accumulated external debts amounting to $2.7 billion, without a corresponding growth in the economy, exports capability or poverty reduction, and finds that debts contracted during 1973-82 were triggered by balance of payments problems caused by the first and second round of the oil crises. The paper also finds that export commodity price deflation that started in the late 1970s and worsened during the 1980s also contributed to widening gaps in external liquidity.

The paper also finds that Malawi heavy interest burden as a result of the policy of 'real interest rates' adopted in the western world during the 1970's to ensure that interest payable on loans sufficiently compensated lenders for the erosion to the real value of the original loan suffered from inflation. The primary shock to world interest rates started with surging inflation in the US after 1976, pushing with it the world average rates of interest as a result of which interest on Malawi debt rose from only 1.9% in 1976 to more than 9% in 1981.

However, Malawi herself also takes a share of the blame. The government's policy of seeking comprehensive ownership of the means of production and also centralized management of the economy contributed to enhanced external debt accumulation to cover both heavy investment costs and persistent operating losses. The country's industrial policy favouring import substitution also raised appetite for importation while at the same time suppressing expansion of manufactured exports. Much of the debt accumulation is also linked to foreign exchange shortages caused by foreign exchange rules, restrictions on commodity exports and policies of overvalued exchange rates and interest rate repression.

The paper concludes that, while there is ample evidence to support the role of international prices of oil and macroeconomic policies of industrial countries as the precipitators of external debt, domestic economic policies in Malawi itself contributed to worsening the debt problem. The fact that there is a fifty four-fold increase in debt stock while there has only been a less than tenfold expansion in national output exemplifies the fact that a large proportion of the resources were not deployed towards productive uses.

The fact that Malawi's external debt stands at nearly $2.7 billion now - which is fifty four times, more than at the time of independence in 1964 - certainly warrants some examination of the underlying causes. The original rationale for external financing was to overcome domestic shortages of savings and foreign exchange to meet the needs of development in full. However, the fact that there has only been a less than tenfold expansion in national output raises the question of whether indeed external finance was utilized towards development.

Oil Price Factor

For Malawi, the period 1973-82 exhibits the most rapid initial build up of external borrowing, primarily triggered by adverse effects on balance of payments arising from the 1973/74-oil crisis. After settling to a downward trend from the level of $1.50 a barrel in 1960 to $1.30 a barrel in 1970 the price of oil had began to escalate in 1971.

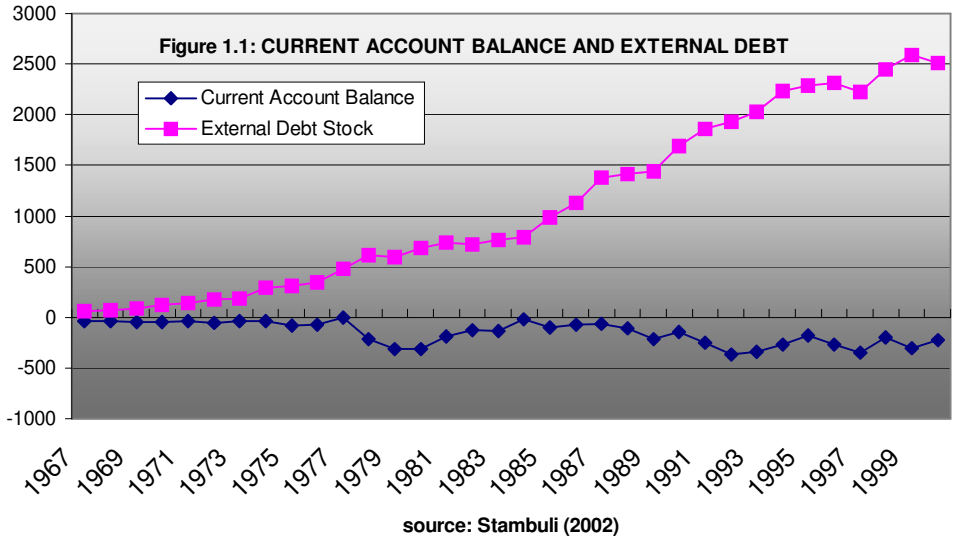
In a matter of only five years Malawi's external debt had risen 2.5 times from $121million in 1970 to $307 million in 1975. The fact that debt to GDP ratios changed from 41% to 53% during this period exemplifies the worsening debt situation. In relation to exports, debt service had also worsened consuming 10.1% of the resource, up from 9.1%.

Much of the rise in Malawi's external borrowing in the 1970s was triggered by a further oil price rises to $2.70 per barrel in 1973 and $10 in 1974. By 1975, Malawi's current account balance had deteriorated to $86 million, representing 14% of GDP.

Due to lack of well-developed alternative sources of energy, the Malawi economy suffered major losses on the current accounts, compelling further borrowing, the consequences of which became embedded in the economic system.

Figure 1.1, shows that Malawi experienced further external debt accumulation during 1978-82. This result from further balance of payments deterioration caused by the second round of the oil crisis. At a price of $32.50 per barrel in 1981, oil prices had risen ten times across the preceding eight-year horizon.[2]

[2] From only $1.50 in 1960, the price per barrel of oil had dropped to $1.30 in 1970 before picking up again reaching $2.70 in 1973. The price rose further to $10.00, $13.00 and $32.50 in 1974, 1978 and 1981, respectively




**source: Stambuli (2002)**

The consequent rise in external debt stock to $684.56 million in 1980 and $1.7 billion in 1990 and $2.2 billion in 1994 represents a fourfold increase from the level of 1979. In contrast, national output in 1994 had dropped to five percent below the level in 1980, while exports had only risen by 14%. The 1990-95 episode of external debt escalation is largely attributed to maize imports triggered by devastating droughts of 1992 and 1994.

Table 1.1, below shows that debt service alone escalated to claim almost 40% of export revenues in 1985 as a result of Debt to GDP ratio worsening to 87.3%.

| Table 1.1 | MALAWI DEBT INDICATORS | | | | | |
|---|---|---|---|---|---|---|
| | 1970 | 1975 | 1980 | 1985 | 1990 | 1994 |
| Debt stock ($billion) | 121.1 | 307.7 | 684.6 | 987.7 | 1686.6 | 2237.4 |
| Debt service/exports ratio | 9.1% | 10.1% | 23.7% | 39.6% | 30.4% | 27.7% |
| Debt/GDP ratio | 41.7% | 50.2% | 55.3% | 87.3% | 89.7% | 189.3% |
| | Source: African Development Indicators CD-ROM | | | | | |

Notwithstanding implications of oil price inflation on balance of payment, export commodity price deflation towards 1980s also contributed to widening gaps in external liquidity.

As the strong export demand acted as a trigger for oil prices, it is also notable that, due of the supply inelasticity of primary commodities in the short-term commodity prices had also risen by 13% in 1972 and a further 53% in 1973. This appears to have heightened the euphoria in Malawi where exports expanded by 114% between 1972 and 1977.

Some of the debt problem is manifested by the sudden down turn in export fortunes as commodity prices ebbed by 19% in 1975. As the second round of the energy crisis took Saudi crude from $13 a

barrel in 1978 to $32.50 in 1981, manifestly raising the total oil import bill from 5.9% of GDP in 1973 to 21% of GDP in 1981, export revenues were also suffering. Export growth was -9% in 1978 followed by -16.4% and -4.4% in 1982 and 1983. Export revenues declined further by -20% and -1% in 1985 and 1986, respectively.

The interest rate factor

Much as the oil price factor provides a compelling background to the crisis, Malawi debt seems to have suffered from a financial policy of 'real interest rates' introduced in the 1970's. This was intended to ensure that interest payable on loans sufficiently compensated lenders for the erosion to the real value of the original loan suffered from inflation.

This approach meant that new loans contracted to repay maturing loans carried a higher rate of interest, while existing loans were equally affected since the agreements had interest rates defined at a fixed premium above the base rate – for example the London Inter-bank Offer Rate. As a debtor, Malawi found herself facing heavier interest obligation as a result of a mere upward revision to the base-lending rates in Europe and America.

The primary shock to world interest rates started with surging inflation in the US after 1976, pushing with it the average rates of interest worldwide. The choice to countries like Malawi was either to increase debt to keep inflation-adjusted debt stock constant or borrow less to avoid high rates of interest but consequently experience a reduction in the real value of the inward transfer.

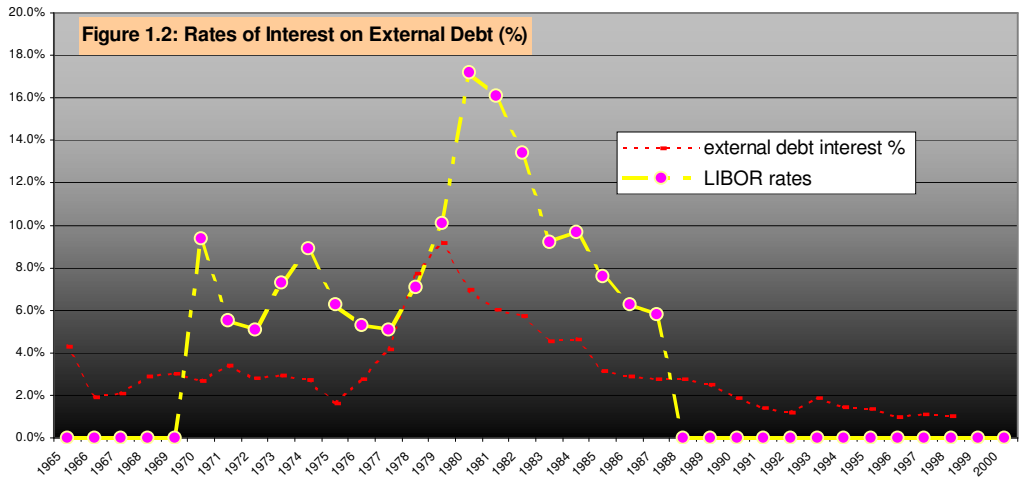



Figure 1.2 demonstrates heavy debt service pressures on the Malawi economy as average interest payable on debt escalated from only 1.9% to more than 9% between in 1976 and 1981. The fact that

this pattern mirrors the upward swing in world interest rates obviously suggests that some of the expansion of external debt in Malawi arose from conditions in industrial countries

Public sector expansion

Malawi herself also takes a share of the blame. The government's policy of seeking comprehensive ownership of the means of production and also centralized management of the economy also contributed to external debt accumulation. Initially, favourable commodity export prices combined with high levels of aid to provide resources to support public enterprise expansion. However, collapse of export commodity prices in the late seventies repositioned the Malawi economy in such a way that resource demands of the large public sector increasingly a predator to public finances.

Initially, the government had resorted to fiscal reallocations giving priority to state subvention, at the expense of public investment, which dropped from 13.6% (1970-80) to 8.2% of GDP (1980-90). However, widening losses in state enterprises and government intransigence to demands for public sector reform forced the treasury into heavy monetisation from the central bank. This method of deficit financing explains the surge in average inflation from 7% (1970-80) to 15% per annum (1980-90) consistent with rising rates of monetary expansion.

The fact that overall import prices rose by 6.4% per annum during 1975-84 while net change in export commodity prices receded from 3.8% per annum in 1975-84 to only 1.4% during 1985-89, exemplifies pressures on Malawi's external liquidity that compelled much of the borrowing. Rising fiscal pressures from state enterprises also coincided with a further rise in import price inflation to 8.4% per annum during 1985-89.

It is clearly evident that state enterprises had increasingly become a major liability to Malawi. From the highs of 9.5% of GDP in 1980 their contribution to national output was to only 3.9% in 1986, and yet, contrary to government rationalization of state enterprises as the engine or promoting industrial development, their share of non-agricultural enterprise had declined to only 6% of GDP in 1991 compared to 11.7% in 1980. However, they maintained an unmitigated role in hemorrhaging financial resources from banks, the budget and external debt.

Their share of bank credit was equivalent to 38% of GDP in 1986, but the share of gross domestic investment attributed to state enterprises had declined to only 10.2% from 49.6% in 1980. In relation

to national output, the share of public enterprises in gross investment also declined from 12.3% of GDP to a mere 2.2%.

Industrial Policy

The fact that industrial development was based on a policy of import substitution (PIS) also shares the indictments for much of the external debt contracted to feed a rising appetite for importation. The aim of PIS was to generate savings in foreign exchange incurred on finished goods imports by producing them locally. Initially, the policy seemed to work as a result of the impetus from agricultural exports expansion and its implications in financing raw material imports and also supporting the growth of domestic aggregate demand.

However, in the absence of established industries manufacturing for the export market, a drop in commodity export prices during the late 1970's opened a foreign exchange gap that afflicted domestic import substitution industry to foreign exchange shortages. It, therefore, became imperative for the state to borrow abroad in order to support raw material imports. The continued drop in export revenues (see above) meant that external borrowing was the only means to sustain industry.

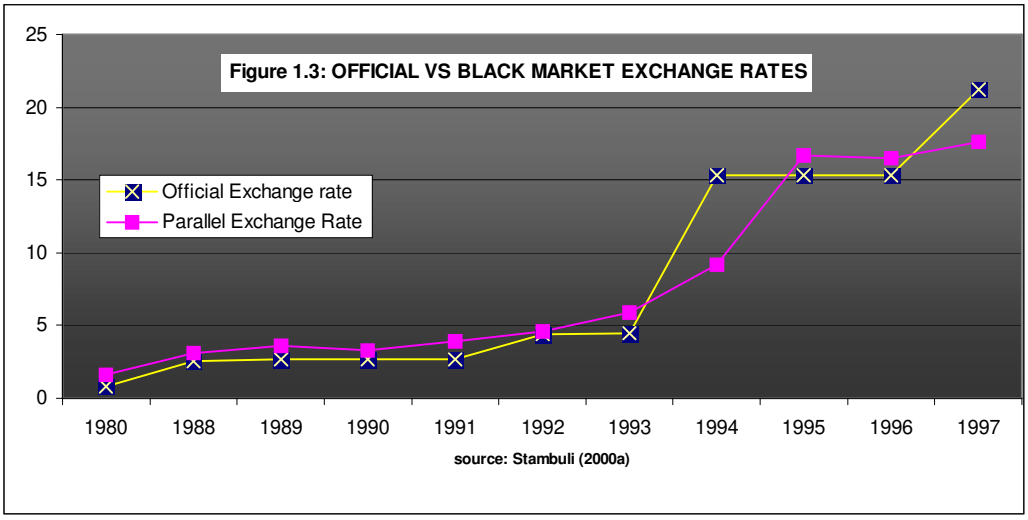
The resulting contraction in the flow of foreign exchange also negatively impacted growth rates for net national income resulting in constrained growth in domestic aggregate demand. This partly contributed to government adopting expansionary policies to prop up the economy with regular fiscal stimuli that depended on external debt finance. This also opened a financing avenue that precipitated foreign borrowing.

Trade and Exchange Policy

In a generalized context, the government's policy of import substitution industry formed part of a wider policy agenda based on restrictive economics that precipitated external debt accumulation. As a complement to protectionist trade rules placing heavy restrictions on imports, the government also imposed restrictions on exports and the use of foreign exchange, thus limiting the openness of the economy to foreign trade.

For a long time exports of groundnuts and cotton were rising sources of export revenue until the government imposed export licensing to guarantee inputs to edible oil production and textiles, respectively. These restrictions were introduced while export prices of these commodities were at their international peak thus denying the country foreign exchange and simultaneously increasing the

propensity for borrowing. The high tariff rates also raised the incentives for smuggling and under-declaration of goods imports thus denying the government significant fiscal revenue, which raised demands for borrowing for the budget.




The rationing of foreign exchange also constrained possible development of a manufacturing export sector in Malawi. Lack of certainty on availability of foreign exchange also raised the incentive for capital flight. Importers inflated invoices to retain foreign exchange abroad while some exporters under invoiced the trade.

Capital flight is also enhanced by a policy of currency overvaluation that gave rise to a black market. The triumph of the black market is exemplified by the fact that its price of foreign exchange remained consistently above the official rate until 1994 when a major corrective devaluation realigned the Kwacha.

Financial Policy

The fact that interest rates had also been maintained at artificially very low levels also contributed to external debt accumulation. Although, the primary purpose may have been to ensure government access to cheap credit, the resulting negative real interest rates served as a disincentive against savings thereby reducing the flow of funds available for onward lending. In the absence of adequate credit resources from the domestic market, the state therefore increased its dependency on foreign borrowing.

Debt Explosion

There is ample evidence to support the role of international prices of oil and macroeconomic policies of industrial countries as the precipitators of external debt accumulation in Malawi. However, it must be conceded that the domestic economic policy regime also contributed to worsening the debt a problem.

A very compelling indictment the country's failure to optimize the presence of debt to engage productive investments capable of generating foreign exchange, and also the presence of policies that gave impetus to debt accumulation. The policy of expanding the public sector at the expense of a vibrant private sector certainly contributed to increased borrowing and its final abuse. Both industrial and trade policies discouraged export production, instead promoting a culture of heavy foreign exchange consumption.

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Interestingly, however, Malawi is experiencing a major turnaround with the problem of external debt. Privatization is not only ameliorating fiscal pressures from the public sector but also generating resources for the budget while promoting free enterprise. The policy of real exchange rate management may have hurt certain importers and import dependent activities, but its role in rationalizing consumption of foreign exchange has greatly contributed to reducing the annual rate of growth of foreign debt. Liberalization is also increasingly integrating Malawi business to the export sector thus raising prospects for further export generation.

As a consequence, the debt service to export ratio was down to 20.8% in 2000, down from 27.7% in 1994. As a result of new resource injections in support of the reform program and consequent restructuring of debt stock, multilateral debt service accounts for 60% of debt service, up from only 40% in 1994, while more costly private commercial debt has receded from 15% of total debt service to only 2%.

Net growth on gross debt is down to 2% per annum since 1995, compared to rates of above 12% from 1971 to 1988. As a result, the debt to GDP ratio is down to 147% from 189% in 1994.

The challenge to Malawi remains the task of re-igniting the private sector to drive the economy while the public sector is consistently rationalized to play the appropriate developmental role in the social sector. Further debt escalation should cause no concern if government role is mere facilitation on behalf of the private sector. Given the current recession, external debt accumulation for such a purpose seems more justified to re-ignite the economy.

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