

Political Change, Economic Transition
and Catalysis of IMF/World Bank Economic Models
- the case of Malawi

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ABSTRACT

This paper investigates whether or not there is a recognizable pattern of cohesion in economic policy formulation between poor countries (on one hand) and the IMF and World Bank (on the other hand) in the context of change in domestic political dispensation. Malawi provides an appropriate study setting on account of the recent shift from one party dictatorship to multiparty democracy against the background of traditional cooperation with the IMF and World Bank in policy formulation.

The paper finds that World Bank and IMF had persistently opposed the strategy of elite agricultural expansion, inward looking industry and state expansion into the private sector. In their place, the Bretton Woods Institutions had suggested policies seeking to revitalize smallholder agriculture, promote outward looking industry and private enterprise.

As a result intransigence of the previous regime the IMF and World Bank have taken advantage of political change in Malawi to push a reform program. The new regime is keen to bring rural agricultural sectors into the cash market economy, undertake privatization to ease off pressures on fiscal resources, liberalize industry to promote a competitive culture in business and also liberalize trade policies to continually integrate Malawi to the world trading system.

However, thirty years of neglect, dysfunctional markets, weak supply response and fragile fiscal foundations are manifesting themselves in widespread economic stagnation. The enthusiasm of the World Bank and IMF in pushing for continued reform is further hurting the economy and pushing the regime into a crisis of confidence.

The main conclusion of this paper is that liberal political systems have a higher propensity to conform to free market policy reforms, but rather than emphasize on resolve, credibility, and certainty of the reform process, and also allow reasonable time for adjustment, the Bank and Fund is keen to push for reform without shaping business expectations or minimizing the costs of transition for the firms and people affected. Despite commitment to reform, external financing remains a quid pro quo against specific policy actions. Contrary to existing literature on aid and economic policy, external assistance is yet to evolve to become a reinforcing agent or as a means of reducing the cost of reforms.

This paper is a product of ongoing research on interactions between western ideals and economic models (on one hand) and homegrown programs of poor countries (on the other).

TABLE OF CONTENTS

INTRODUCTION

- Early Beginnings**
- IMF Lending to Malawi**
- IMF Conditionality**
- The IMF and World Bank Models**
- Model Specifications**
- Scope for Investigation**
- Observations**

Chapter 1: AGRICULTURAL POLICIES

- 1.2 Agricultural Land Policy**
- 1.3 Agricultural Production Policy**
- 1.4 Agricultural Prices Policy**
- 1.5 Policy Implications: Agriculture**

Chapter 2: PUBLIC SECTOR POLICIES

- 2.1 Growth Implications**
- 2.2 Public sector Reform**
- 2.3 Parastatals Sector**
- 2.4 Privatisation & Divestiture**
- 2.5 Summary**

Chapter 3: INDUSTRIAL, AND TRADE POLICIES

- 3.1 Industrial Ownership**
- 3.2 Industrial Policy Implications**
- 3.3 Trade and Exchange Rate Policies**
- 3.4 Policy Implications**
- 3.5 Interest Rate Policy**

Chapter 4: WORLD BANK AGRICULTURAL MODEL

- 4.1 New Agricultural Policy**
- 4.2 First Bank Agricultural Model – (1980-90)**
- 4.3 Revised First Bank Agricultural Model – (1987-90)**
- 4.4 Revised First Bank Agricultural Model – (1988-90)**
- 4.5 Second Bank Agricultural Model – 1990**
- 4.6 SBAM90 Implementation**

Chapter 5: INDUSTRIAL & TRADE REFORM MODELS

5.1 Trade Liberalisation

Chapter 6: FINANCIAL POLICY REFORM

6.1 Financial Liberalization

6.2 IMF-Bank Model

6.3 Policy Implementation

6.4 Macroeconomic Implications

6.5 Policy Implications

Chapter 7: NEW AGRICULTURAL STRATEGY

7.1 New Govt, New Strategy

7.2 Policy implications

7.3 New Strategy Old Problems

7.4 Bank-Govt Co-operation

Chapter 8: INDUSTRIAL REORIENTATION

8.1 Incomplete Reforms

8.2 Long term concerns

Chapter 9: STRATEGIC REORIENTATION

9.1 Bottom up Development - MASAF

9.2 New Infrastructure Model

9.3 Policy Implications of NRA

Chapter 10: TRANSITIONAL ISSUES

10.1 Agricultural Liberalisation

10.2 Agricultural Marketing

10.3 Input Sectors

10.4 Constraints to Private Involvement

10.5 Land Reform

10.6 Rural Development

10.7 Developing Markets

10.8 Future of Reform

10.9 Donor Co-ordination

INTRODUCTION

Early Beginnings

The rising influence of World Bank and IMF in Malawi is associated with attempts to overcome fiscal and balance of payments problems the country experienced in the 1970's. The Organization of the Petroleum Exporting Countries (OPEC) quadrupled the price of crude oil in 1973-1974, and further increased petroleum prices in 1979 and in 1980.

This resulted in a worldwide energy crisis that transformed the pattern of international flow of funds. The OPEC countries' monetary reserves accumulated rapidly, but oil-exporting countries like Malawi experienced severe balance of payments problems.

In an effort to subdue inflationary pressures caused by oil prices increases industrial countries resorted to increases in interest rates. The policy framework also favoured reduction of imports to accommodate expensive petroleum imports.

These measures worsened the balance of payments deficits for many of the developing countries. In addition to high cost of oil, debtor had to pay higher interest rates on loans obtained from the industrial country banks. Reduced imports from industrial countries also translated into major reduction in foreign exchange revenues for developing country exporters.

Towards 1980, economic conditions in most poor countries were characterised by widening foreign exchange gaps. This was a combined effect of a drop in foreign exchange receipts against a background of high imports bills.

Malawi suffered greatly, because closure of the Nacala route as a result of the war in Mozambique meant that alternative and more expensive routes had to be pursued to the sea via Beira and Durban. This reduced export proceeds reaching the country as well as raising costs of freight and insurance.

On one hand, this meant that external borrowing was imperative to achieve balance of payments stability. On the other hand, financial gains of oil exporting countries were reflected in rapid accumulation of petro-dollars in western private banks. Rising demand for foreign exchange among developing countries and the rising supply of petro-dollars in the west therefore gave way to a cycle of lending and borrowing that characterised international economic relations between north and south.

IMF Lending to Malawi

Although, the IMF was not constituted to lend, it found itself lending to Malawi and other oil importing poor countries through an Oil Facility established in 1974. This was enlarged in

1975 to aid the balance of payments difficulties. IMF also allowed Malawi access to an Oil Facility Subsidy Account established to alleviate the cost of borrowing under the Oil Facility.

The thinking of IMF was that such recycling was necessary to prevent the world economy from experiencing the worst recession. This was however to provide the channels through which the full extent of the oil crisis translated itself into an external debt crisis.

Most oil importing countries had acquired short-term finance from private banks to satisfy balance of payments needs they had perceived to be transitory. As it turned out, repayments became due while export commodity prices were still depressed, thus necessitating further borrowing to finance repayment.

IMF Conditionality

Throughout the 1980s the IMF has moved beyond "lender-of-last-resort," to join the World Bank as mediators with creditor nations and private banks. In due course, both IMF and the World Bank found themselves getting involved in the formulation of macroeconomic and structural reform policy in Malawi.

Compelled by the exigency of the debt crisis, the two institutions have also moved from temporary arrangements to programs for adjustment over longer periods.² This has entailed the attachment of conditionality to their lending operations.

One type of conditionality is the stabilisation program traditionally administered by the IMF. These include quantified targets or ceilings for bank credit, the budget deficit, foreign borrowing, external arrears, and international reserves. The other, administered by the World Bank includes a range of structural policy reforms, which include statements of policies that the member intends to follow e.g. allowing ordinary farmers to grow tobacco in Malawi.

The significance of conditionality is that it defines a program of change that a country is expected to follow based on principles advocated by the IMF and the World Bank. In reality, conditionality has sought to dismantle welfare states in most poor countries, and it has become the basis upon which the two institutions are reviled. The philosophy of the bank and Fund has been criticized as being too oriented to the industrial economies and not adapted to developing economies.

The IMF and World Bank Models

IMF Stabilisation policies traditionally aim to control the demand side of the economy. The principal target is achievement of low inflation and consequently, sustainable balance of payments. This is contextually different from the World Bank's management of the supply

² From short-term arrangements, the IMF has resorted to extended arrangements through the Structural Adjustment Facility (established in 1985) and the Enhanced Structural Adjustment Facility (established in 1986)

side of the economy on the basis of efficiency raising policies is assigned the term 'structural adjustment'.

Corbo and Fischer (1992) characterise the short-term nature of stabilisation policies and their emphasis on inflation control. On the other hand, Khan (1987) creates a contrasting profile of adjustment policies focussing on their precursory role to growth by removing 'market imperfections'. United nations (1992, page 1-2), also describe adjustment as policy changes needed to put the economy on a sustainable growth path.

Mosley, Subasat and Weeks (1995) determine that in terms of assignment of responsibility IMF focuses on stabilisation seeking to achieve external and internal equilibrium, while World Bank focus on structural adjustment to promote long-term growth. However, Williamson (1990) disputes a mutually exclusive classification. He observes that programmes of the two institutions are sometimes sequential, but at other times simultaneous. He also argues that the activities of the Bank and Fund have also been blurred as a result of their involvement in joint programmes.

The views of Williamson have opened scope for presentations of the Fund and bank in the context of the 'Washington policy consensus'. This is because World Bank policies suffer the same stabilisation emphasis as those of the IMF. Most importantly, the view that the policies of these institutions were designed to restore economic viability has been at the centre of the shift in multilateral financing from projects to policy reform (Mosley, Harrigan and Toye, 1991).

Model Specifications

The Bank and Fund efforts to stabilise the macroeconomic environment is premised on a model specification based on explicit choices of fiscal policy and monetary policy giving emphasis to demand management. The model is based on the premise that fiscal deficits are the main cause of inflation, and therefore tax and expenditure instruments are central to the task of controlling inflation.

This, however, poses a number of development policy questions. From the viewpoint of conventional logic that increased social spending is key to achievement of the objective of improving social indicators, the model specification faces the question of whether it is optimal to relegate the role of fiscal policy to short term objective of inflation control.

Mosley & Weeks (1993) question whether this amounts to fiscal policy relinquishing its role in stimulating growth. The IMF-Bank model reassignment of the role of fiscal policy also runs counter to the Harrod-Domar model stipulation that growth in public investment is key to increased capital accumulation as a spur for private investment, job creation and growth.

The IMF-Bank model prediction is, however, that low inflation is key to economic growth. This is on the expectation that low inflation promotes a stable economic environment, which in turn

promotes foreign and domestic private investment. The model therefore defines job creation and per capita growth as spin offs from economic expansion.

Interestingly, Guillaumont & Guillaumont (1994) tests the logic of the trade offs between inflation control and economic growth functions of fiscal policy in the IMF-Bank model. They pose the question of whether low inflation cannot be achieved while fiscal policy remains focussed on its traditional role of promoting growth.

The IMF-Bank model also advocates changes to the setting of interest rates in the economy to levels above international rates. The rationale for such setting is to attract inflows of short-term capital. However, the IMF-Bank model reassignment of the role of monetary policy runs counter to strict stipulations of the neoclassical framework of the Bank analysis that investment is sensitive to the interest rate.

The debate, therefore, rages between the IMF-Bank prediction of resurgence in external inflows and the danger that a policy of setting interest rates so high would depress investment. Even if prediction of a rise in external inflows materialises the model does not seem to identify this as achieving short-term external reserve buoyancy at the expense of a lower rate of economic growth. The IMF-Bank model also appears overly optimistic in the estimation of responses to international interest rate differentials given that financial markets in most poor countries are narrow and under-developed.

A critical examination of the IMF-Bank model also seems to suggest that such a prescription may result in a government-induced distortion of the financial market. The efficient time structure of interest rates stipulates that short-term interest rates should be below long-term rates. A logical extension is also that the later should approximate the social rate of time preference. A policy of interest rates based on the IMF-Bank model may therefore satisfy the short term goal of attracting reserves but distort the task of mobilising savings to meet investment demand in the long term.

In its entirety, the stabilisation formulation of the IMF-Bank model espouses four objectives to be achieved using three instruments. The objectives arise with clarity as price stability, current account sustainability, foreign exchange accumulation and economic growth. The instruments include the fiscal deficit, nominal exchange rate and the interest rate.

The IMF-Bank model also advocates switching policies in favour of the traded (export) goods through periodic devaluations. Wage controls are a regular feature of stabilization policies, as well as privatisation and retrenchment of the public sector workers and removal of subsidies. These aim to cut 'wasteful spending and are indirectly linked to the budget deficit reduction instrument.

The IMF-Bank model also advocates liberalisation of the domestic and foreign markets. The former aims to free up economic activity while the latter promotes integration of the domestic

economy to the international trading system. Both policy measures comes with elimination of domestic price and foreign exchange decontrols

Scope for Investigation

In the context of the transition from one party dictatorship to multi-party democracy this study examines how closely the government of Malawi has adopted Bank-Fund supported policy adjustment operations. In the context of the one party and the multiparty government, this study also examines the respective trends in economic performance.

The search for answers compelled this research to examine the economic logic of each policy prescription and determine whether the position taken by government was appropriate to long-term development. This is in particular reference to policies of agriculture production, marketing and land reform, and also restructuring of the public sector, privatization and private sector development.

This includes investigating whether liberalization has brought rural sectors of the country into the cash market economy, whether privatization has eased off pressures on government finances and whether industrial liberalization has brought a new competitive culture. Has liberal trade opened up Malawi to world trade in such a way that the country is benefiting?

A comparative analysis is also undertaken to evaluate whether the policy outcomes support the economic endeavours put in place. This involves analysis of trends in per capita income, consumption, production, macroeconomic imbalances and social indicators.

The study also examines the sources of the current economic distress in Malawi, both in a short term and long-term context.

Observations

This study observes that after more than 20 years of Bank-Fund supported policy adjustment operations economic performance in Malawi is still disappointing. The fundamental weakness to the country's development efforts is government's belief in a top down strategy that excluded the poor from the means of driving economic growth.

The conversion of nearly 1 million ha of land from customary use to idle leasehold land held by estates and The government's repeated refusal to allow smallholders to grow burley tobacco and obtain full value for export sales are two policy actions that destined the country to the fate of economic distress.

The top down strategy is also manifested in the large public sector established in Malawi from proceeds of tobacco exports and high levels of aid. The parastatal sector has been a major source of drainage to government resources and credit from the banks as a result of poor management and inefficiency. Parastatal domination was supported by the country's

industrial policy restricting industrial ownership to ADMARC, MDC, Press Corporation and licensed entrepreneurs.

During the post-Banda era, there is remarkable commitment to implement economic reforms. Agricultural liberalization is gradually bringing rural sectors of the country into the cash market economy. Privatization is also easing off pressures on government to subvent loss making public enterprises while industrial liberalization has brought a new competitive culture in business. Liberal trade policies are also advancing the process of opening up the country to world trade.

Malawi's real predicament has been the protracted resistance to reform that has left the post-Banda era with a long list of reform actions that were overdue. The bank and Fund have failed to commit themselves to a thoughtfully spaced timetable for implementing reforms in Malawi.

Rather than emphasize the resolve, credibility, and certainty of the reform process, and also allow reasonable time for adjustment, the Bank and Fund is keen to push for reform without shaping business expectations or minimizing the costs of transition for the firms and people affected.

The Bank and Fund do not seem to realise that an export culture needs more time than usually allowed by time bound Bank-Fund reform programs. Bank-Fund models have also underestimated the social impact of economic reorientation. Fiscal discipline has been pursued emphasis on numerical reductions at the expense of social obligations of the poverty alleviation program.

External financing has been a major disappointment for a government that is committed to reform. Foreign finance remains a quid pro quo against specific policy actions, in a manner that would have been relevant when the Banda regime resisted reform. External assistance has not evolved to become a reinforcing agent and as a means of reducing the cost of reforms to which policymakers in Malawi are already

Reduction of public sector employment and expenditures has caused suffering for the poor. Liberalisation of foreign trade has equally undermined industries providing employment in the private sector. The removal of subsidies on basic consumption goods have resulted in deteriorating standards of living. The fall in quantity and quality of public services in health and education resulting from expenditure cuts have also worsened the situation. Escalating demands for more education spending as a result of high school enrolment have also intensified pressures on the budget.

Chapter 1:

AGRICULTURAL POLICIES

Agricultural Land Policy

At independence in 1964, Malawi inherited an agriculture system consisting of a few large, foreign-owned, export-oriented estates and a smallholder sector of mostly poor, subsistence farmers. Colonial laws allowed estates to obtain the full value of export sales but prevented smallholders from producing burley tobacco, the most lucrative export crop, and forced smallholders to sell through the Agricultural Development and Marketing Corporation (ADMARC).

Despite the 1960 Manifesto of Malawi Congress Party and the 1962-65 Development Plan assigning very high priority to developing smallholder production, the government pursued the colonial agricultural policy through the 1970s and 1980s. The Land Acquisition Act of 1965 enacted to encourage the transfer of smallholder lands to the estate sector heightened the estate bias. As a result, leasehold landholdings rose from 79,000 hectares to 759,400 hectares from 1970 to 1989 (Ng'ong'ola et al., 1997a).³ The number of estates also rose from 229 to over 14, 000 during the same period. (see Table 1.1).

Table 1.1: Number of estates and hectarage, 1970-89

Year	No of estates	Cumulative area ('000 ha)	Mean size of estates (ha)
1970	229	79.0	345
1970-79	1,105	255.8	231
1980	1,321	273.1	207
1981	2,086	320.0	153
1982	3,806	386.0	101
1983	4,806	435.2	91
1984	5,292	460.1	87
1985	5,655	491.5	87
1986	6,247	517.9	83
1987	8,114	588.1	72
1988	11,953	695.8	58
1989	14,355	759.4	53

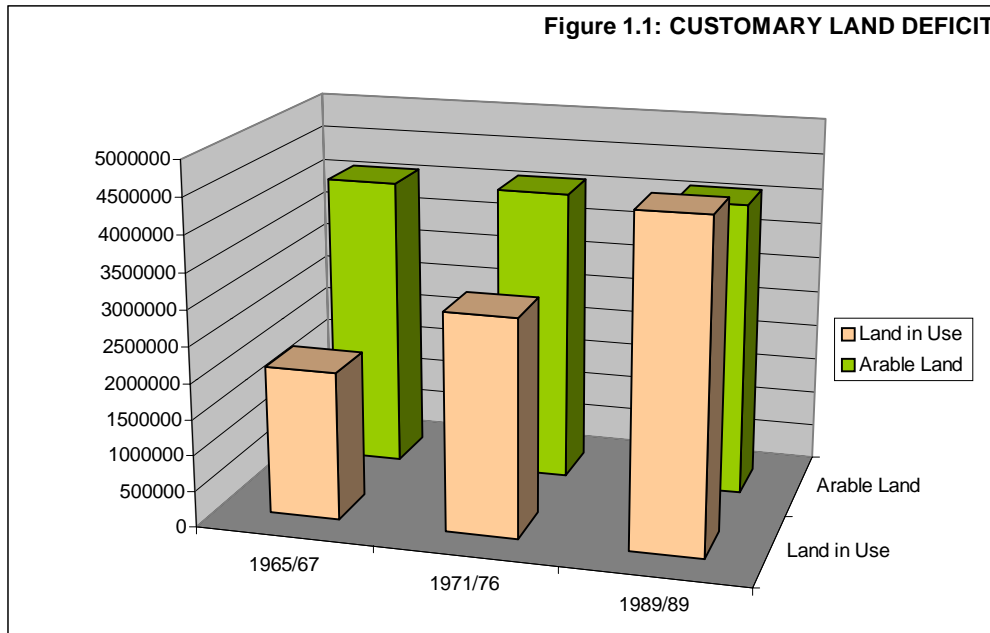
Source: Mkandawire et al. (1990)

Land losses were particularly significant in arable customary land required for food production. The doubling of Malawi population from 4.4 million to 8.2 million therefore raised food demands beyond the country's production capacity. This has had permanent adverse implications on the country's food security.⁴

The phenomenal increase in land under agriculture from 2,064,600 ha in 1965/67 to 3,026,400 ha in 1971/76 is symptomatic of a vicious build up of population pressure. Most

³ It is also estimated that estate land rose to 1,000,000 hectares by 1997, comprising more than 10 per cent of total land

glaring is the further increase to 4,540,000 ha in 1989/90 reflecting the spillage into deforestation pressures. This was in excess of the upper threshold of 4,100,000 hectares suitable farming land.⁵



UNICEF (1993) established that land pressures had forced smallholders to undertake continuous cropping, often of cereal monocultures dominated by maize (grown on 75% of total land area) without rotations or fallow.⁶

DREA (1994) also observes the rising incidence of bad land use practices causing several forms of land degradation, of which soil erosion ranks as the most serious environmental threat.

Bunderson and Hayes (1995) established that by 1987/88, 56% of all smallholders in Malawi cultivated less than one hectare of land, 31 % had 1 to 2 hectares, and only 13% had more than 2 hectares. BDPA (1997) later established that in 1996/97 cultivated land was 0.86 ha per holding a further decrease of about 22% over the previous ten-year period.

Agricultural Production Policy

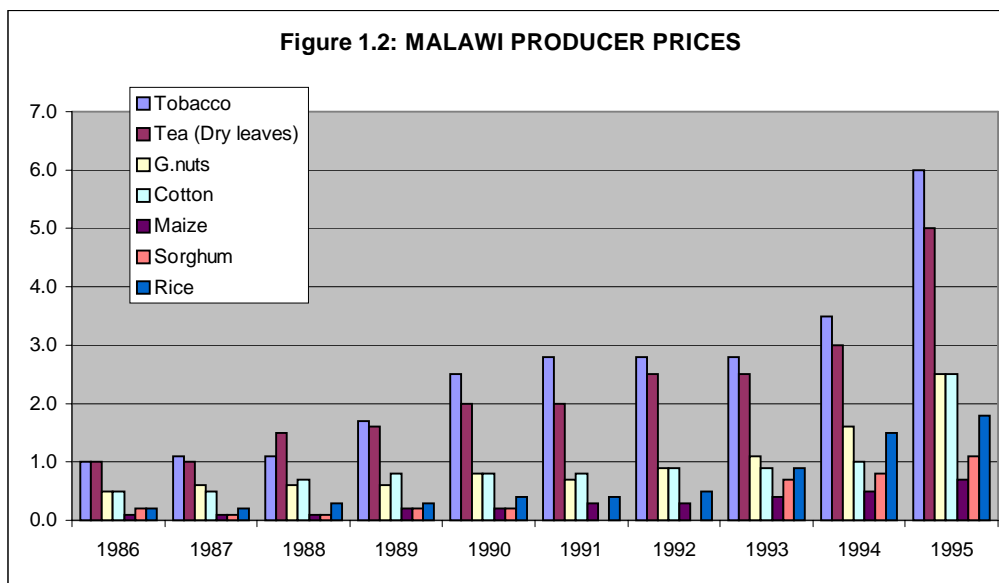
⁴ Meanwhile customary land shrunk from 8.1 million ha to 7.1 million hectares and pressures have worsened with population expansion to 10.4 million

⁵ Commission inquiry on Land established in 1997 established that of the 6.2 million ha of customary land, only 4,100,000 were suitable arable land while 2,100,000 was not

⁶ Bunderson and Hayes (1995) established that by 1987/88, 56% of all smallholders in Malawi cultivated less than one hectare of land, 31 % had 1 to 2 hectares, and only 13% had more than 2 hectares. BDPA (1997) later established that in 1996/97 cultivated land was 0.86 ha per holding a further decrease of about 22% over the previous ten-year period.

The government also enacted the tobacco Act, defining tobacco as a commercial crop to be grown only on leasehold or freehold land in the confines of registered estates. That practically excluded smallholder farmers from producing the crop, which has remained the most profitable throughout the 1960's to the 1990's.

That left a limited range of cash crops available for production by the farmer. The list included maize, groundnuts, rice, sorghum and millet. Most sugar estates had established their own irrigation sugarcane plantations thus eliminating the scope for out-grower sugarcane schemes. Citrus production existed throughout the South-western part of Malawi but in the absence of secondary beneficiation industry, the fruit has ended up in local markets, with little value added.



The government's view of agricultural development was based on the belief by Dr Banda that promotion of estates would provide employment to Malawians. The former President had believed in a trickle down economic model in which workers employed by the estates would acquire technological knowledge to apply to their own farms. The strategies were also based on the expectation that farmers would produce their own food and depend on employment income from estates.

Agricultural Prices Policy

A central plank of the agricultural marketing policy in Malawi was to restrict sales of maize and smallholder produce to ADMARC on the basis of pre-announced and controlled prices. Meanwhile, tobacco-producing estates enjoyed access to lucrative international markets via the auction floors.

The high level of taxation awarded the smallholder an average of less than 50 percent of smallholders' gross prices. In the face of diminishing land holdings, restrictions on cash crop

production and reduced incomes from ADMARC, these government's policies practically excluded 72 percent of its population from development.

Table 1.2: MAIZE PRODUCER AND CONSUMER

PRICES	1987	1988	1989	1990	1991	1992	1993	1994	1995
Maize Producer Prices/kg	0.10	0.10	0.20	0.20	0.30	0.30	0.40	0.50	0.70
Maize Consumer Prices/kg	0.24	0.24	0.37	0.37	0.64	0.64	0.89	1.11	1.22
ADMARC Gross margin/kg	144%	144%	87%	87%	113%	113%	122%	122%	75%

Source: African Development Indicators

In turn, ADMARC used its high profits to subsidize the consumer prices for maize consumers mostly on urban areas and also undertake investments in unproductive parts of the economy (see Table 1.2). However, reduced incomes of smallholders ensured the success of the estate sector, which depended on an ample supply of cheap tenant labour and low prices for the products of smallholders.

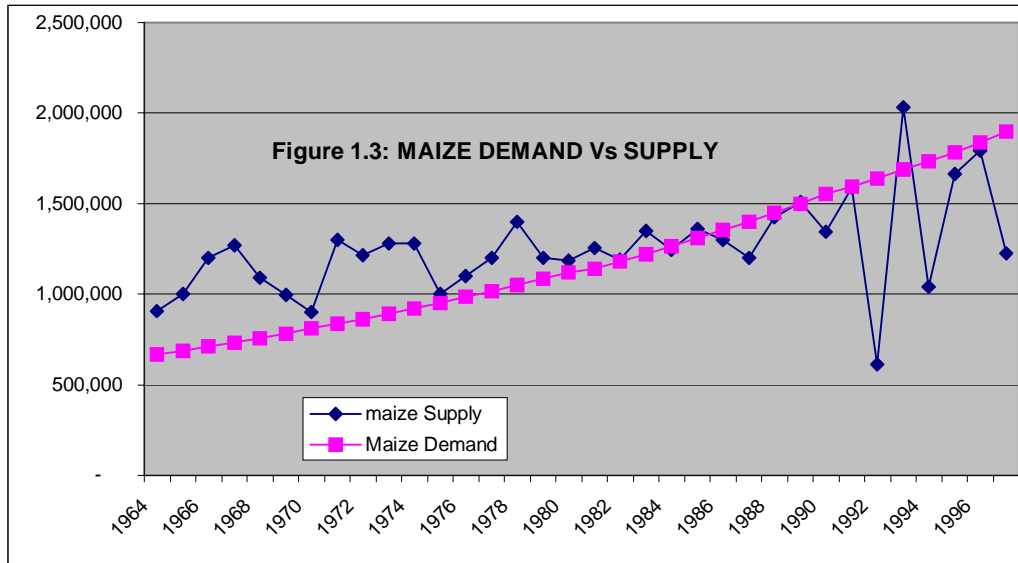
Policy Implications: Agriculture

The strategy of generating an agricultural surplus as the prime support for development was generally accepted as working well for the country, The Malawi economy maintained above average rates of growth in response to growth in agriculture, especially the development of new tobacco estates. Industry and service sector also registered impressive growth.

However, the top down strategy failed miserably. The predicted trickle down of income failed because estate incomes were too low. Technological cross fertilisation did not materialise, either. A majority of tobacco producers were glorified smallholders or civil servants; as such the estates were not well equipped nor well managed to set the desired examples.⁷ The dichotomy between estates and smallholder was a breeding ground for conflicts over land, labour and even markets and the Banda model failed to spark the agrarian revolution that had been anticipated.

The anticipated rise in cash crop production by smallholders did not materialise and the remaining land among smallholder was not enough to meet the country's food requirement (see: Figure 1.3, below). Poor farmers could hardly realise a food surplus to sell to ADMARC. The few who got a surplus it was never a regular trend and they remained inside the income deficiency trap as ADMARC paid less than 40% of the international prices.

⁷ A majority of tobacco producers were also mostly glorified smallholders or civil servants



The adverse price movements, especially for oil in 1979, delivered the final verdict on Malawi. This was a turning point in the fortunes of the country. High import prices and low export values caused a sharp decline in the terms of trade. The estate sector would no longer anchor the Malawi economy as the sole engine for growth.

This was followed by the civil war in Mozambique, which closed Malawi's direct outlets to the sea (and sharply increased transport costs) and resulted in a mass influx in refugees later in the decade. Agricultural growth also fell to about 2.5 percent per annum in the 1980s-less than the population growth rate-with particularly poor performance in the smallholder sector.⁸

Mkandawire (1999) attributes the overall stagnation in smallholder production to reduced access to key productive inputs such as land and low incomes. Production stagnated because the smallholders could not adopt land productivity enhancing technologies such as hybrid maize and fertilisers, which required resources or at least availability of credit. Their high concentrated in maize production, was largely for internal self-consumption while the scope for international tradability.

The most critical concerns arise from increased exports of tobacco, tea, and sugar, simultaneously as food production was declining. Low prices that ADMARC paid to maize producers did not encourage estate production of maize, either. Since estates were not eligible to receive subsidized fertiliser, maize production was unprofitable within the price range paid by ADMARC.

⁸ The economic outcome was worsened by the fact that the smallholder sector, comprising nearly 2 million farm families had been marginalized. This was a sector tasked to produce 80 per cent of the country's food production, but only 10 per cent of total exports so it could provide 60 per cent of the country's workforce

Evidently, a government decision to increase maize prices resulted in some years of bumper crops because of estate production. Sometime in the 1980's Malawi exported maize to surrounding nations, a development that fuelled the image of the country as one of the economic miracles of Africa.

Tobacco production under quota system allowed tobacco farmers to use only part of their leasehold land. The remaining land would have been used to produce maize. However, further declines in the maize-tobacco price ratio and escalating fertiliser prices [following periodic devaluations] made estate maize production absolutely and relatively unprofitable. The fact that land rents had remained economically too low, had also lower the opportunity costs of idle land. Most farmers therefore kept their land idle. In Kasungu alone, estates used only 45% of their land.

These practices persisted while agricultural surveys revealed high levels of malnutrition and child mortality. These findings suggested that the economic growth model of the 1970s and early 1980s had benefited only a few, while the majority of smallholder farmers had not seen their circumstances improve.

The government sustained its resistance to agricultural reform and Estates emerged the winners as they acquired the best land. They also had access to collateralised finance secured by the same land acquired from smallholders. Government policy of repressed interest rates literally subsidised the cost of estate finances. Estates also enjoyed a favourable tax regime with a land tax of only 10 Kwacha per hectare although it was later raised to 30 Kwacha per hectare. This all worked at the expense of alleviating poverty (Mkandawire, 1999)

Chapter 2: PUBLIC SECTOR POLICIES

Growth Implications

The success of post independence Malawi is exemplified in unbroken growth during 1964-1978. Using vast quantities of available land, estates responded to export price improvements averaging 7.1% per annum (1967-73) and very high by any previous standards.

The resulting surge is reflected in sustained growth in agriculture averaging 4.1% per annum (1965-80). Output of tobacco alone rose from 20,600 tonnes in 1967-71 to 54,580 tonnes in 1980, annual growth of some 18.3%.

This translated into GDP growth averaging 5.5%, and annual growth in industry and service sectors averaging 6.4% and 6.7%, respectively (World Development Report, 1992). The changing pattern of Malawi's economic fortunes is reflected in strong export growth and a major boost in fiscal revenues that combined with high levels of aid/GDP ratios to support high levels of public investment.

Initially, public investment was significant, accounting for two-thirds of total investment. However, the government failed to translate these investment outlays into social welfare improvements. Health and education expenditure remained below 6 percent of GDP in the late 1960s, and despite continued growth social expenditures fell to about 5 percent by the mid 1970s (Prior, 1990: 173).

Much of the public resource was deployed towards public sector expansion. This was a program of creating parastatal organization to undertake various private sector activities in industry, trade, finance, and farming and property development. At the time the strategy was to extend the scope for state driven development to other sector outside agriculture.

Short of being construed a nationalization program; the program of parastatal development brought much of the private sector under government control. Most such investments were made through government ministries. These efforts were complimented by MDC involvement in industrial development alongside ADMARC and Press Corporation owned by Dr Banda.

This was to replicate the agricultural optimism that had seen the government place too much emphasis on estate agriculture at the expense of the smallholder farmers.

Changing Fortunes

The end of Malawi's fortunes did not come abruptly. Although export prices remained favorable, averaging 3.8% per annum during 1975-84, agriculture expansion had receded to an annual average of 2.2% during this period. This translated into lower rates of GDP growth

averaging 3.2%, and retarded growth in industry and service sectors, at 2.7% and 3.7% per annum, respectively (see: Table 2.1).

The period from 1970-76 saw inflation rising to 9.8% from only 2.3% in 1960-70 period. During 1980-90 annual inflation surged further to an average 15%. Over a period of fourteen years (1975-1989) per capita GDP remained stagnant at \$164, and the Kwacha showed signs of fatigue, losing 1% of its value every year (1975-84) and losing a further 2.2% per annum during 1985-89.

Table 2.1: ECONOMIC AGGREGATES (annual average growth)

	1965-80	1975-84	1985-89
GDP (annual growth)	5.50	3.20	1.90
Agriculture	4.10	2.20	1.20
Industry	6.40	2.70	3.70
Services	6.70	3.70	3.70

source: UN Statistical Yearbooks, 1978, 1985 and 1992

From a high of 25.3% of GDP (1975-84) gross investment dropped to 17.3% (1985-89), the biggest drop being registered in public investment from 13.6% to 8.2% of GDP during the same period. The build up of uncertainty, stagnation in confidence and rising interest rates also resulted in a drop in private investment from 7% to 6% of GDP.

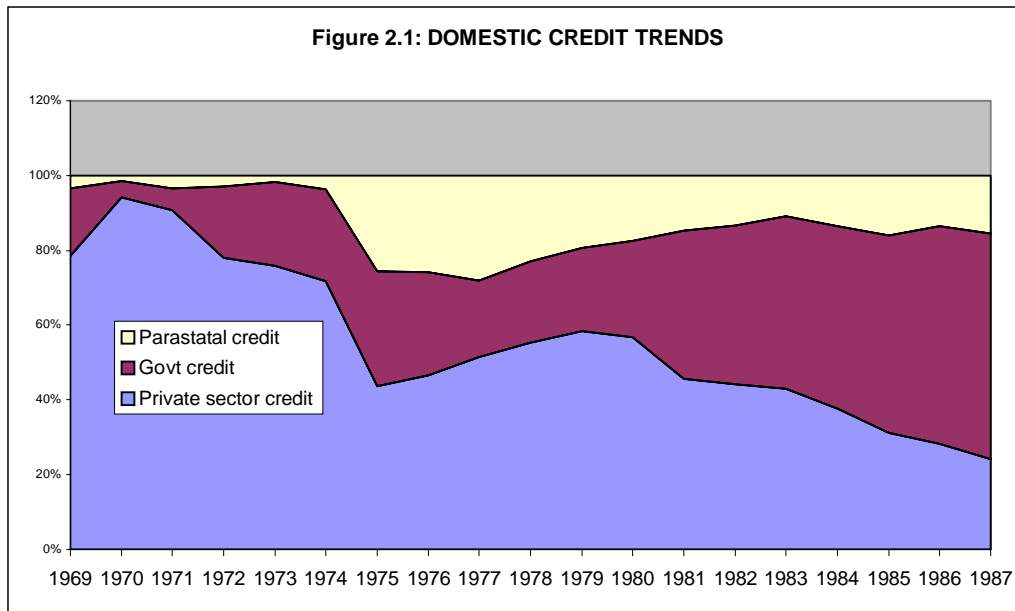
These adverse developments arose from retarded annual growth in export prices from 3.8% in 1975-84 to only 1.4% during 1985-89, which worsened to 0.2% during 1990-98. At the same time costs of imports continued to rise under the influence of high costs of petroleum products.⁹

The subsequent period of 1980-94, saw the economy and the public sector enter a period of serious imbalance. There were severe shocks, including increases in oil prices and transport costs related to external trade, as routes through Mozambique were disrupted by civil war. The war in the neighboring country forced up to 750,000 refugees into Malawi, at a time when it was experiencing severe drought.

Investments dropped sharply and foreign reserves dwindled. Growth for the period 1980-94 was only 1.6 percent. The budget deficit, rising to 15 percent in 1980 alone, averaged above 10 percent during 1981-87, and escalating back to 15 percent in 1994.

Pressures arising from deteriorating economy and rapid expansion of the parastatal sector obviously weighted heavily upon the fiscal budget. Persistent losses by parastatals had resulted in government providing the resources to keep them running, at least until 1974.

⁹ import prices rose by 6.4% per annum during 1975-84 and escalated to 8.4% per annum during 1985-89



Government persisted in skirting around the question of reforming the sector to make it more independent, market orientated, efficient and competitive. Instead, priority was given to reduction of parastatal drainage of public resources, a strategy that saw a mere redirection of the financial haemorrhage from the fiscal budget to the banking sector.

From only 2% in 1973, the share of bank credit consumed by parastatals rose to 26% in 1978. The crowding out effects resulted in private sector access to credit declining from 76% to only 51%, during the same period.

Figure 2.1 above shows that despite fiscal relief from redirection of parastatal financing, government used existing privileges of credit from the Central bank to sustain its appetite for more spending. As parastatal share of credit was soaring, government share of credit remained between 22% and 23% through out the period.

During the remaining part of the 1983-87 period, total government and parastatal borrowing soared to account for 76% of domestic credit. Private sector borrowing which was reduced to only 24% reflects much the working capital deficiencies that characterized the private sector.¹⁰

Public sector Reform

¹⁰ In the early 1990s donors withdrew their balance of payments support to Malawi to demonstrate their increasing concern with both the poor fiscal discipline of the government and its human rights violations. The donor community also hoped that aid retrenchment would force the government to hold multiparty elections and pave the way for reform of the economy

The government clearly recognized the need to reform the public sector, but its own view that State Enterprises were founded out of the best of intentions stood in contrast to glaring losses which resulted in reduced social spending. The view of the government was that state enterprises were created to ensure that citizens had access to goods and services that the private sector might not have been willing or able to provide.

The government also argued that some enterprises required high levels of investment and in some cases a foreign technical partner had to be brought in. The latter demanded government involvement not only to inspire confidence, but as protectionist guarantee for recovery of initial investments without competition, given the fact that the market was small and any competition would have been fatal.

The apprehensions of the government to reforming the public sector are not without cause. Early efforts at public sector reform in Malawi had sparked what turned out to be a cabinet crisis. Concerns over the management of the transition from an expatriate-based civil service to one dominated by Africans has resulted in The Skinner Commission, established in 1964. The report recommended lower salaries and job reclassification for African employees taking over the civil service.

These recommendations were adopted and the salary scales were compressed accordingly. However, very little effort was allotted the more important task of creating incentives in the public sector in order to ensure the efficient provision of basic services in, for example, education, agriculture, healthcare and communications.

Resistance to public sector reform was apparent in response to a study commissioned by The Economic Commission for Africa in 1966(Msosa 1998). This had recommended measures aimed at increasing public sector efficiency and improving administrative capacities in state institutions. Very few of its recommendations were adopted.

Equally ineffective was the Herbecq Review Commission of 1985 whose recommendations on staff structure, career development and job grading were not fully implemented. The proposals were meant to improve the quality of the civil service, while putting a cap on employment. On the contrary, the number of civil servants continued to grow rapidly during the 1980s.

Parastatals Sector

The lack of commitment to reform persisted while the parastatals sector increasingly became a major liability to Malawi. Over the period 1985-92 the World Bank had urged Malawi to rethink her system of economic patronage and downsize a patently inefficient public sector. The Bank proposal suggested a combination of measures to improve the management of parastatal finances, while fostering development of private industry, in a transition towards making capitalism more significant.

Declining significance of the public sector is evident from a decline in parastatal contribution to national output from 9.5% of GDP in 1980 to only 3.9% in 1986. Contrary to government's justification of the role of parastatals in industrial development, the share of public enterprises in non-agricultural activity was only 6% of GDP in 1991 compared to 11.7% in 1980.

Their share of gross domestic investment also 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 only 2.2%.

Invariably, Gross domestic credit to public enterprises accounted for 38% of GDP in 1986. Apart from covering operational losses, most such credit went to payroll demand of bloated employee registers, which consistently accounted for 12% of formal sector employment in the country. The deleterious effects of parastatal borrowing is manifested by the fact that the share of public enterprises in domestic credit 'outstanding' was as high as 20.4% of GDP in 1991. This was inspite of state subventions averaging 1% of GDP from 1985-89.¹¹

Privatisation & Divestiture

Adoption of privatisation by the resistant government poses a number of interesting areas of examination in public sector reform. Admittedly, the main obstacles to privatisation in Malawi have been distrust, institutional impediments and poor planning. The notion of "privatisation" seemed to arouse tenacious bureaucratic resistance.

These are sentiments embodied in the philosophies that prevailed within the Department of Statutory Bodies that had demonstrated lack of authority and political support to oversee improvements in parastatal financial management. Was it then feasible for Malawi to undertake privatisation under the same institution?

This, of course, is in addition to the restrictive political environment, sensitivity to foreign influences and distrust of the motives of foreign investors. Moreover, there was unease about the social repercussions of displacing massive numbers of skilled workers.

The outcome is that privatisation resulted in only 35 transactions between 1980 and 1993. This is an average of only 3 per year and does not compare with the fact that the new government concluded 9 privatisations in 1996 alone. In a period of five years (1996-2001), the new government had concluded 44 privatisations, raising a total of \$1.2 billion.

Summary

A very outstanding feature of Malawi's economic structure appears to be state involvement, crafted along the lines of patronage. Public sector expansion follows the same trajectory as

¹¹ Quantification of the precise degree of resource haemorrhage by parastatals is a trick exercise is a complex task because it would include Indirect transfers including the absorption of losses, exemptions or non-payment of duties and taxes which remain a major drain on public budgets

estate domination in the agricultural sector. The established culture seem to have been reinforced by the fact that the prime beneficiaries subsisted in a climate of influence and were therefore not amenable to any gospel preaching the advantages of change.

Early attempts at privatisation appear to have suffered serious institutional impediments that mirror the lack of political will. To the extent that the public sector provided job openings for employees introduced by politicians, it was essentially part of a political utility function. State enterprises undertook inappropriate investments, which entailed huge unjustified capital outlays to generate outcomes that were politically desirable.

The fact that the quality and coverage of products and services offered was poor, but sold at artificially low prices served the government pursuit for political triumphalism. Weak financial performance resulting in losses was anticipated and the huge bailouts that persisted served the regime.

Implementation of the restructuring/divestiture programs, clearly demanded requisite skills to set goals, priorities, sequencing of the privatisation program. Given that the Department of Statutory Bodies suffered persistent lack of skills to undertake adequate preparatory work, government acceptance of privatisation did not reflect a change of policy stance.¹² Most parastatals had weak and cumbersome organizational structures and requiring them to reform them selves was a clear sign of unwillingness to reform.¹³

Three decades of centralized investment planning, extensive government control and regulation of economic activities also created mistrust for the privatisation program. This is in addition to the fact that private sector initiative had been suppressed by a pervasive disincentive regime.¹⁴ Persistence of an atmosphere of partial economic liberalization also signalled government reluctance to liberalise private activity.

Privatisation itself had serious afflictions from bureaucratic discretion in the application of controls and arbitrary administration. The poor financial condition of industrial parastatals and their inability to service their debt had also undermined their marketability as a firm. The use of licensing and other regulations to curb non-indigenous entrepreneurs has also undermined confidence among the Asian and expatriates to invest in privatised enterprises.

¹² The government itself adopted a number of ad hoc approaches, leaving most of the work up to the parastatals themselves--hardly disinterested parties

¹³ The establishment of the Privatisation Commission only came under the reign of the new government in 1996, almost twelve years after privatisation had started.

¹⁴ To some degree, the relatively large informal sector in Malawi would suggest that business was already attempting to escape extensive state intrusion by early 1990's

Chapter 3:

INDUSTRIAL, AND TRADE POLICIES

Industrial Ownership

Since independence in 1964, Malawi industry has been directed by government policy of seeking comprehensive ownership of the means of production and centralised management of the economy. Ownership has been pursued through a strategy of setting up industrial development institutions extending from the mainstay of government. This has been accomplished in three ways.

Firstly, government created MDC as a specialised development bank to establish new industries. MDC was instrumental in providing long-term financing for investment at early stages of development. Its key industries included the Portland Cement Company of Malawi, packaging Industries, as well as investment in Commercial Bank of Malawi.¹⁵

Secondly, government compelled ADMARC to establish ADMARC Investments Company to recycle profits made from produce trading into ownership of industry. ADMARC was sole investor in Finance Corporation of Malawi exclusively providing import export finance. ADMARC also joined Barclays and Standard Bank in the localisation of National Bank of Malawi.¹⁶

Thirdly, Press Corporation owned by Banda undertook a number of acquisitions in the key strategic areas of the economy. Press joined ADMARC as co-investor in National Bank. Press also joined MDC as investors in National Insurance Company, and undertook joint investments with Carlsberg Denmark in Carlsberg Malawi.

Press Corporation also owned a large number of tobacco estates under Press Agriculture, General Farming. This was in addition to Khasu, Mudi , Kasonjola and other estates owned personally by Dr Banda. Meanwhile, Blantyre Print owned privately by Dr Banda also acquired shares in Limbe Leaf tobacco that in turn took up shares in Auction Holdings Ltd, jointly with ADMARC.

In the 1970's, Dr Banda's directive removing all Asians from the rural areas paved the way for expansion of PTC shops under press Corporation and also Chipiku stores owned by Lonrho.

Finally, government itself invested in various enterprises that would have elicited private sector participation. Through the Treasury, government acquired shares in the New Building

¹⁵ MDC also owned Cold Storage Company, Agrimal, Plastic products Ltd

Society, as a co-investor with Lonrho. Government shareholding in Commercial Bank of Malawi also supplemented MDC investment.¹⁷

These ownership structures clearly have implications in private sector development. Government's intrusive hand coupled with personal business interests of the President practically limited Malawian entrepreneurship to the informal sector. Foreign investment materialised only if undertaken in partnership with government and its agencies.

In addition to government controlling the massive parastatals sector, government also obtained a means control management in the mainstream of the private sector.¹⁸ This was in addition to marshalling of financing from financial institutions to specific companies and also the practice of preferential treatment in favour of certain borrowers.¹⁹

The government's protectionist strategy was also legitimised through a requirement for an industrial licence to be obtained before commencement of any industry. This was a provision of the Industrial Development Act of 1966. Prior to applying for a licence, it was also a precondition that an investor proves source of funds for the business. The industrial licence application forms also required indication that a company has been registered and that land has been acquired to implement the project.

Industrialists ended up in a Catch 22 situation because funding agencies also demanded an industrial licence before loan applications would be processed. The land department also needed assurance that licence had been obtained before land was allotted. At the time, company registration took a minimum of six months as applicants' details were vetted by the intelligence agencies.

The final issuance of a licence also depended upon existing industries agreeing to competition. A common excuse was that the market was small and that existing operators had adequate capacity to meet demand. Some licences were granted on condition that the new operator does not sell locally. In most cases disputes protracted over a period of two years, during which prices of capital equipment changed affecting project viability.

¹⁶ ADMARC also owned Malawi Insurance Brokers Ltd, Grain & Milling Co Limited

¹⁷ Government also owned Leopard Match Company, Malawi Catering Services, Malawi Dairy Industries, Malawi Property investment Company, Malawi Rural Finance Company,

¹⁸ By virtue of public control of New Building Society and Commercial bank of Malawi, John Tembo was Chairman in both. As chairman of Blantyre Print, John Tembo was automatically Chairman of Limbe leaf Co and Auction Holdings. As lead local shareholder in National Bank, Press had their managing director as Chairman and he came right under John Tembo as Chairman of Press Corporation

¹⁹ Bad debts of Press to Commercial Bank of Malawi amounting to \$39 million was replaced by govt bonds in 1984 Debt recovery. Six million shares of Press held in loss making Dwangwa Sugar Corporation were transferred to government.

For many years after independence Malawi industry has also been based on import substitution, heavy protection, and anti-export bias. Through the MDC, ADMARC and Press Corporation the government pursued a deliberate strategy to produce imported goods locally in order to save foreign exchange. The government also promulgated heavy tariffs and duties on imported products some of which were also subject to licensing, quotas or complete embargo.

The implications of import substitution have been largely adverse for Malawi. The limited size of the local market has meant that capacity utilisation in most industries depended on high rates of growth in consumption. The inward looking strategy also deprived the industry the opportunity to explore export markets from which increased capacity utilisation would translate into further employment creation.

Industrial Policy Implications

In the early years after independence, Malawi industry grew at very high rates averaging 6.4% per annum (1965-80). This was attributed to expansion in industries processing agricultural products (especially tobacco, tea and sugar) and growth of import substitution industries producing consumer goods.

This was reflected in the doubling of the index of manufacturing employment from 91.0 in 1969 to 184.0 in 1978 (1970=100, UN Statistical Yearbook, 1979/80, page 89). The index of industrial production also rose sharply from 56 in 1970 to 122.0 in 1978 (1975=100). As at 1969, the number registered unemployed was only 1,200.

The downturn in the industrial sector that started towards the end of the 1980's has much to do with events emanating from the foreign sector that undermined the growth rate of aggregate demand within Malawi. A drop in export prices had reduced the flow of foreign exchange and therefore slowed the growth of incomes. Slow growth in domestic demand largely accounted for the drop in industrial expansion to an annual average of only 2.2% 1975-84.

Much of the independent private industrial sector was also constrained as government and parastatal monopoly of credit limited their access to credit from 76% in 1973 to only 24% in 1987. The drop in parastatal share of non-agricultural GDP from 11.1% in 1980 to 6.1% in 1985 is not consistent with the fact that the share of bank credit to the public sector rose from 44% to 69% during the same period.

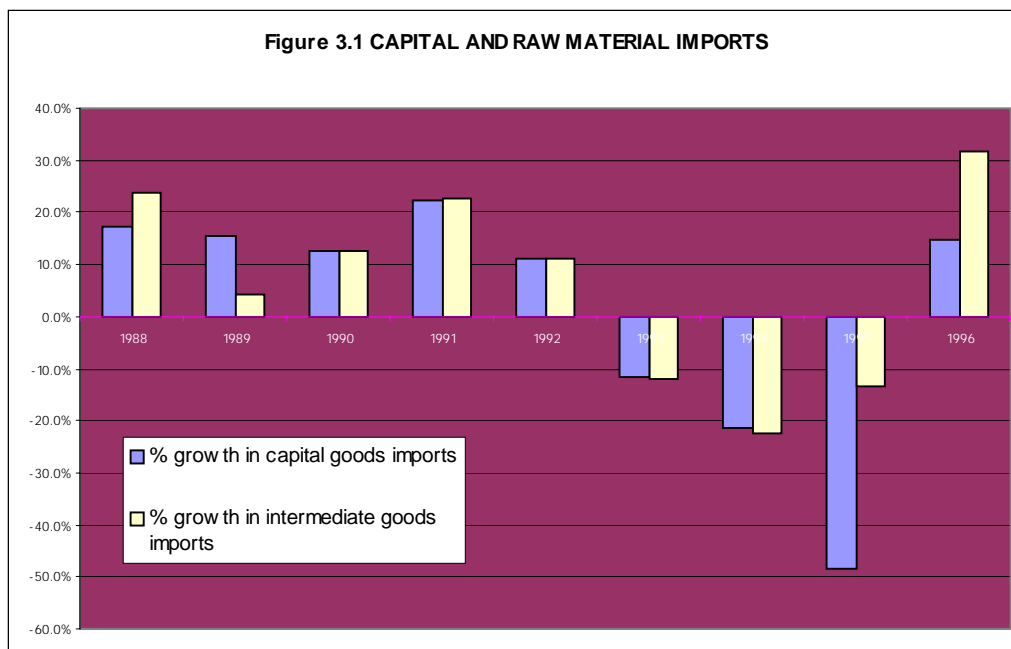


Figure 3.1 above shows that the rate of growth of industrial raw material imports declined in response to a drop in domestic demand. Subsequently, firms suspended long term investment decisions and reduced capital imports as well. After 1993, firms undertook major reduction in investment and capacity utilisation.

These developments would have been attributed to import liberalisation but this period is accompanied by massive reductions in the rate of growth of imports of consumer goods.

The deteriorating private sector investment initiative is also evidenced by the fact that annual average gross private investment declined from 7% during 1975-84 to 6% during 1985-89. The downward trend is more apparent in private savings which declined from 15.6% 1974-85 to only 10% 1985-89. Gross domestic savings dropped further to 5.1% during 1990-96 period.

The downturn in the economy is reflected more widely by declining wages, the highest of which was in the manufacturing sector from \$75 in 1980 to only \$13.00 in 1995. Wages declined in every sector of the economy as shown in Table 3.1.

Table 3.1: WAGES IN ECONOMIC SECTORS OF MALAWI (CURRENT \$ PER MONTH)

	1980	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995
Agriculture sector	20.00	14.00	13.00	12.00	13.00	15.00	16.00				
Industrial Sector	75.00	54.00	57.00	53.00	53.00	65.00	55.00	47.00	40.00	21.00	13.00

Mining & Quarry	36.00	29.00	20.00	17.00	17.00	20.00	30.00	23.00	59.00	30.00	18.00
Construction	60.00	31.00	29.00	29.00	29.00	30.00	31.00	34.00	33.00	22.00	17.00
Trans, storage & Comm.	99.00	50.00	47.00	49.00	62.00	63.00	70.00	66.00	63.00	37.00	25.00
Community, social & personal								59.00	50.00	43.00	24.00 12.00

source: African Development Indicators
1998/99

Deterioration of Malawi industry is closely associated with the deterioration of the state enterprise sector because parastatals supplied most of the industrial output. Their performance was dismal, due to poor management, political interference, and organisational inefficiencies. Despite unlimited access to resources, their investments were poorly conceived, the design and quality of their products/ services was poor and pricing was sub-optimal.

Industrial capacity among the parastatals industries also remained too low following episodes of foreign exchange shortage, which affected imports of raw materials. The fact that sub-optimal product pricing resulted in payment of sub-market prices to households supplying raw materials also extends the indictment of ADMARC taxation policies to the industrial sector.

Malawi greatly needed to minimise effects of export price deflation that affected much of commodity prices. Promotion of non traditional exports provided a possible avenue. However, the government's emphasis on an inward industrial strategy destroyed incentives for development of non-traditional exports. This forced the government to rely heavily on foreign borrowing to finance imports. Thus, apart from threatened domestic bank liquidity parastatals became a source of external debt accumulation.

Trade and Exchange Rate Policies

The government's Import Substitution Industrialisation (ISI) strategy also had strong backing from a protectionist trade regime placing heavy restrictions on imports. The government imposed administrative controls on imports, requiring licences to import certain commodities. Government also introduced a number of Physical controls. They included quota restrictions, and in some cases, a complete embargo against specified imports or imports from certain countries.

Through the Reserve Bank of Malawi, the government also administered financial controls in rationing of foreign exchange for payment of imports. Additionally, the Malawi government introduced a range of tariff barriers to imports. They involved selective rates of duty being applied to imported commodities and arbitrary rates of surtaxes, excise duties and levies.

More than the fiscal motives of raising revenues these tariffs served to discriminate against certain imports, with the principal objective of discouraging consumption and, most importantly, to protect certain local industries.

The authorities seem to have deliberately introduced a cumbersome process of acquiring foreign exchange to dissuade potential importers. Initially, merchants had to obtain an import licence administered by the Ministry of Trade, before submitting an application for foreign exchange at the Reserve Bank. Consideration of import approval was also conditional upon the importer depositing the equivalent amount of the value of imports with their bank.

The Reserve Bank would decline the application if it were deemed that the import had less justification or they would approve only part of the application. Foreign exchange rationing had in some cases resulted in the Reserve Bank approving finished products while declining importation of raw material to make the same product.

In the event that exchange control approval was obtained, importation had to take place within 90 days. Any change either in price of the suppliers or the cost of insurance and freight required a fresh submission of a revised set of certified invoices.

These arrangements clearly stifled Malawi's ability to participate effectively as a trading partner in the international economy. Most significant was the negative impact of these arrangements on industries using imported raw materials. Even more contradictory was the fact that such regulations persisted while government advocated an import substitution industrialisation.

Trade restrictions also reigned against exports. For a long time export of groundnuts and cotton required licences. Most commodity exports were also subject to inspection by Malawi Bureau of standards and authorities required that proceeds from reach their account within 90 days from the date of export.

Policy Implications

The requirement for import licences clearly slowed down the entire pace of business. The process itself became a breeding ground for corruption among government officials. The system also distorted incentives for competition as licence holders exploited the market both in terms of over pricing, demands for prepayment before imports were made and the hoarding of goods. In some cases traders denied licences resorted to smuggling which denied the government much needed revenue.

High import tariffs also reflected negatively on private sector development. At high tariff rates the incentives for smuggling or under-declaration of goods were very high. As a result government lost large amounts of revenue. Customs officers also found themselves frequently caught up in a cycle of bribery and corruption. Given the magnitude of potential savings from duty evasion, traders were more inclined to collude with customs officers.

High rates of tariff almost always resulted in the extra cost being passed on to the consumer, in the case of consumer products. In the case of raw materials high tariffs frequently resulted in crowding out resources meant to finance raw materials for production operations. Consequently, stock outs were frequent and these resulted in low capacity utilisation and in worse situations work stoppages and an inherently low propensity to expand employment.

Apart from constraining the operation of business Government's policy of discriminatory tariffs adversely affected industries seeking to merely process goods for export to other countries. The practical implication of import tariffs was to raise the cost of production and therefore dictate prices at which non traditional exports would be made. This worked against the country's export endeavours.

Discriminatory tariffs also provoked retaliation in a form of similar measure imposed against export from Malawi. This frequently resulted in loss of export markets.

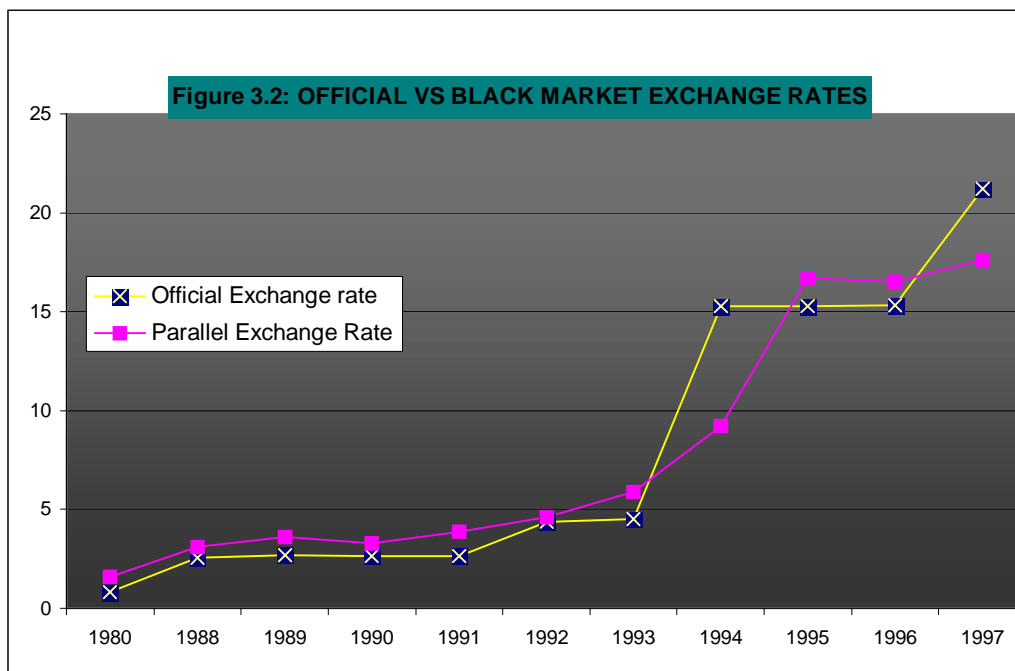


Figure 3.2 above suggests that rationing of foreign exchange and other restrictions promoted the rise of a black market. Throughout the 1980's, the black market price remains above the official rate, except 1994 when the Kwacha experienced a major devaluation.

Theoretically, this can be construed to imply that shortage of goods caused by licensing and shortages of foreign exchange may have placed a price premium on certain goods. Given the high profit margin, the purchase of foreign exchange at higher parallel market prices was within the limits of rational business.

On the supply side, government exchange controls implied that exporters who earned dollars face the trade off between queuing up to regain access to their own foreign exchange or

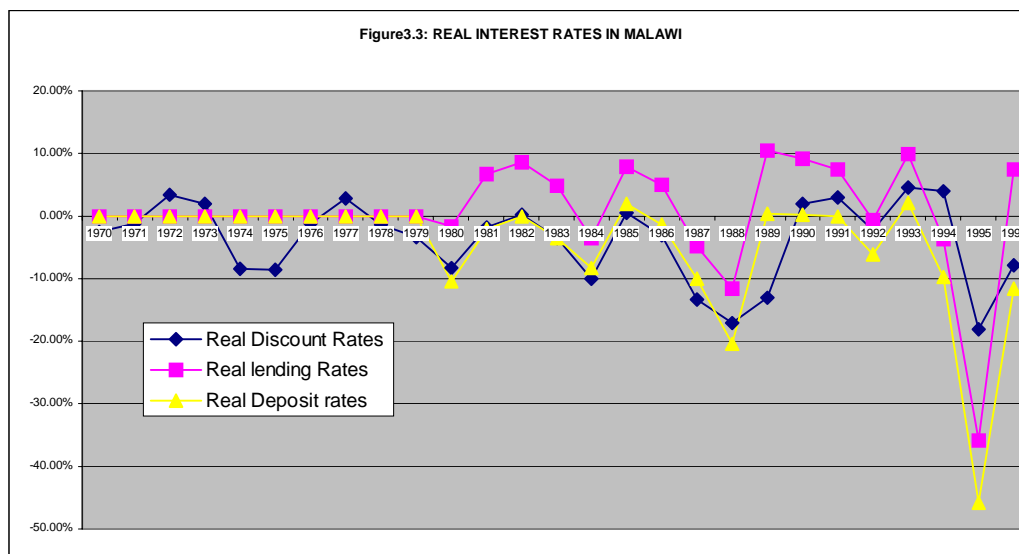
retaining for own use or profitable gain. On the stipulations of the liquidity preference theory, the latter prevailed.

Interest Rate Policy

The absence of functioning capital markets at the time of independence, clearly presented a difficult choice to government plans to develop agriculture and industry. One choice was for government to engage in a protracted task of laying institutional foundations of bond and equity markets. This was to culminate in to a capital market to support both agriculture and industry. One alternative presented government with the choice to use public funding to develop parastatal organisations, However, yet another alternative presented government with the choice to compel banks to lend to specific sectors.

Given the pressures to deliver a new economy consistent with aspirations of the poor, government chose the second alternative as a matter of expediency. However, the third alternative kicked in when it became apparent that the government's industrial development agenda would not be accomplished without recourse to resources of the banking system.

In addition to directing credit, the government also adopted a policy of keeping interest rates down to allow parastatals to obtain cheap finance via government guarantees.²⁰ Figure 3.3 below shows that for much of the 1970's and 1980's, government held interest rates below market-clearing levels. Nonetheless, high rates of output growth raised the aggregate level of financial savings.



By keeping real interest rates on deposits and loans low the government engineered a massive transfer of wealth from savers (mostly households) to parastatal borrowers.

²⁰ Commercial bank once provided lending to tobacco farmers buying off estates from ADMARC only if Peat Marwick was the auditor

Moreover, because strict foreign exchange controls prevented households from converting their savings into foreign assets, households were forced to accept negative real interest rates. Real deposit rates have not been positive in Malawi until 1990.

Agenor and Montiel (1996) define financial repression as a phenomenon associated with negative interest rates caused by government interventions. McKinnon (1988) identifies financial repression in the context of reductions in the flow of loanable funds associated with discretionary bank lending. He also identifies financial repression as a source of retardation in investment, which occurs by punishing liquid assets and encouraging inflation hedges. He also argues that financial repression also undermines monetary stability required to support robust open markets in stocks and bonds.

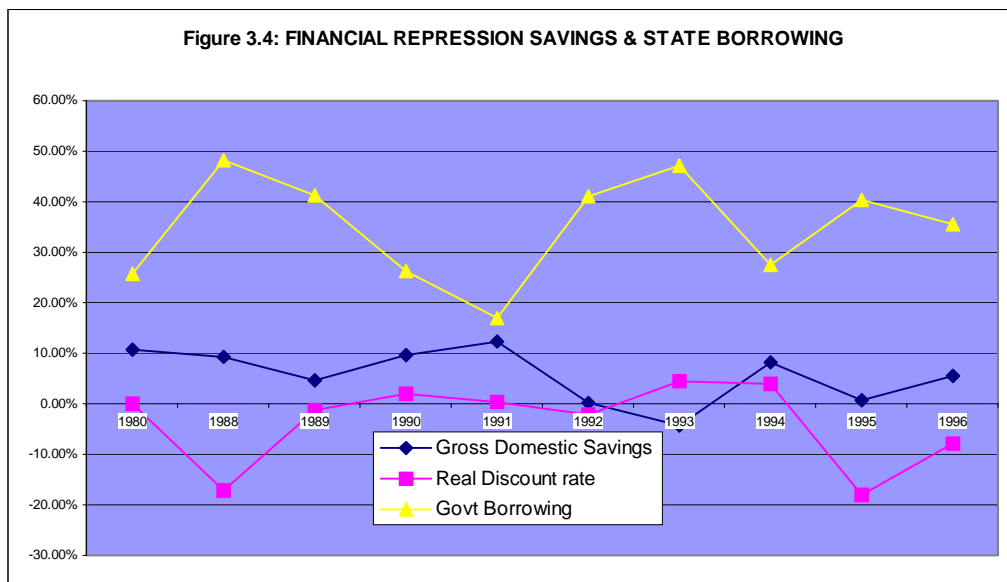


Figure 3.4 above shows that the real discount rate has had a propulsive influence on the rate of savings lagged by one year. However, the economy seems to save more when the government is borrowing less and vice versa. This would suggest that financial repression is also consistent with government desire to secure resources to finance the budget or resource transfers to selected industries in the parastatal sector at a very low cost.

However, in assessing whether selective interventions were good for growth, the government did not set prerequisites for success. Policymakers concentrated on propping up industries without engaging in restructuring to avert failure. The governments also neglected to develop institutional mechanisms to establish clear performance criteria for selective interventions and also to monitor performance.

Chapter 4:

WORLD BANK AGRICULTURAL MODEL

New Agricultural Policy

IMF and World Bank involvement become significant at the onset of external economic shocks that had undermined the estate sector as a singular engine for the growth and economic security of Malawi. Given government's obsession with the estate sector the attention of World Bank in supporting smallholder production, exemplifies the contradiction between government's model and the Bank Agricultural model.

On its own the Bank focused on area-based, integrated rural development projects in the late 1960s and later switching to a less capital-intensive approach, under the umbrella of the National Rural Development Program, in 1970's which placed greater emphasis on agricultural extension. The World Bank later moved towards sectoral operations in extension, agricultural research, and smallholder credit. The role of the World Bank was later defined by a series of structural adjustment credits with significant agriculture-related conditionality that were made following the balance of payments crisis in the late 1970s.

The 1980s saw five Bank-supported policy adjustment operations with a total value of \$200 million. The first set of strategies focussed on the last five years from 1981-85. In large part, these changes resulted from the conditions attached to structural adjustment loans (SALs) made to the government by the World Bank and the International Monetary Fund (IMF), hence the generic reference to the strategies as the Bank-Fund Model.

The SALs were to address Malawi's deteriorating terms of trade and balance of payment problems by promoting new agricultural pricing policies, state divestiture of agricultural marketing functions, growth of the private sector, removal of fertiliser and other subsidies, and increased production of food and export crops.

First Bank Agricultural Model – (1980-90)

The basis of the Bank Agricultural Model (BAM) for recovery of the agricultural sector was relaxation of the price setting system and improvements to the efficiency and fiscal position of the major marketing parastatal, ADMARC. The Bank Agricultural Model (BAM) was extended to include the provision of tobacco production licenses to smallholders. The principal objective of the investment operations was to increase smallholder production, especially for the export market.

The main constraint to the Bank Model is always that Dr Banda had placed top priority in the smallholder sector on self-sufficiency through maize production as opposed to income generation. His overall development strategy was to develop an agricultural surplus. He

dominated the economy, and shaped the direction of external assistance and there was nothing they could do to surpass the Minister of Agriculture.

Low prices for smallholder products were an element of this flawed strategy. In particular low maize prices dissuaded estates from using idle land to produce commercial maize. There was increasing disquiet about continued support of the regime, but the World Bank's involvement was strongly influenced by the troubled regional situation and its devastating effect on Malawi.

Throughout the 1980's the World Bank was forced to accept the dualism in the agricultural sector as given. Despite the broader constraints on small-scale enterprises and the distortions the agricultural economy was causing in labour and product markets, it persisted. This policy held down the value of smallholder output and real wages and impoverished the smallholder sector and also reduced the scope for expansion in small and medium enterprises.

The Bank's ended up with two approaches, focusing on adjustment to improve production incentives, and directing efforts toward the poor by improving food security through extension-based efforts. The latter paradigm could have been abandoned if there had been progress on the former. There was clearly no effective linkage between these two efforts.

The institutional structure on the Malawian side reinforced this effect. In addition, on the technical side, the Bank placed great emphasis on yield increases as the basis for intensification, particularly on maize. This tied in with the government view of the smallholders as subsistence-based and led to more than 70 percent of the smallholder area being planted to maize. Given the limited income potential of this approach, smallholder response was tepid, which was the main cause of the poor results of early adjustment.

Revised First Bank Agricultural Model – (1987-90)

For long-time, repressive policies of the Banda regime concealed the effects of low food production on the country's nutritional standards. By the late 1980s, the refugee influx exposed the country's nutritional problems and the regime's willingness to consider policy changes increased. The Bank and other donors supported a major collaborative exercise with government to investigate sectoral conditions.

Throughout the 1980's ADMARC had remained the main marketing channel and storage facility of agricultural produce and inputs. The Bank Model sought to diminish this role significantly and promote greater private sector involvement. Heightened ADMARC activity also meant a heavy fiscal burden.

The revised model focused on closure of ADMARC markets to permit the entry of private traders, a reform strategy to involve privatization/liquidation of the loss making subsidiaries of

ADMARC investments and the auctioning part of ADMARC's marketing and storage infrastructure.

The reform program was dodged with doubts over unwillingness of private traders to operate in markets from which ADMARC had closed. The government was particularly reluctant on account of the role of ADMARC as a source of supply in times of scarcity. There was concern that ADMARC withdrawal would give rise to considerable resentment and lead to political fallout in the affected areas.

The initial reforms produced very little in the form of private response because traders still had to be licensed to operate in designated areas. Private trading was restricted to markets from which ADMARC had pulled out and most such markets did not meet standards for profitable participation.

Government had also persisted with requirements for export licensing for agriculture commodities especially for the main staple maize and groundnuts. Private participation in the tobacco market was also limited because smallholder production, which was still subject to quota arrangements, produced very little; while estate producers had ready access to export markets via the auction floors.

The absence of liberal pre-export financing in an environment of highly collateralised lending also meant that produce trading was a preserve of businesses with a strong asset base. In effect, that inhibited rural based private traders, who were perceived to have local knowledge of the markets, and were expected to promote reticulation of produce among the fragmented markets.

Progress on private trading was limited as ADMARC still absorbed a lion share of the official maize market. Private traders found themselves competing with a giant that dominates in terms of distribution networks, storage and transportation infrastructure and financial facilities, but is not prepared to offer a better price to the farmer.

The government remained reluctant to relinquish control over fertilizers; seeds and agro-chemicals. The responsibility was however taken out of government through establishment of the EU supported SFFRFM as the main importer of fertilizer into the country. Official seed distribution also remained heavily controlled by the State despite the usual complaints about low quality of seed. The legal framework for producing and distributing certified seeds also remained unchanged to allow seed production.

Revised First Bank Agricultural Model – (1988-90)

A subsequent Bank Modelled intervention into the agricultural sector involved establishment of a Smallholder Agricultural Credit Administration to manage a system for the extension and control of loans to farmers and village groups. SACA turned out to be an extremely effective credit system was established with the best record of pay back in Malawi.

This coincided with establishment of the Smallholder Fertiliser Revolving Fund to centralise fertiliser procurement and distribution outside government

Second Bank Agricultural Model – 1990

Ten years after the first attempt at giving smallholders an opportunity to participate in the country's development, Malawi's poor were still handicapped by high taxes. The smallholder sector was effectively excluded from export production and had to rely on subsistence farming while it was used as a source of cheap labour by the estates.

Through the Second Bank Agricultural Model – 1990 (SBAM90) the World Bank sought to push for change through the Agricultural Sector Adjustment Credit, approved in 1990. This program was designed to give smallholders direct and untaxed access to export markets, particularly for tobacco.

SBAM90 was designed to mobilize a vast reservoir of potential export capacity and remove one of the leading causes of rural poverty in Malawi by changing the role of ADMARC and establishing new rules for the production and marketing of tobacco. The project envisaged a "new deal" for smallholders, who would obtain a substantial portion of market revenues from all tobacco sales and gain access, on a pilot basis, to the right to produce burley tobacco. Since burley tobacco yielded 10 times the income per hectare of hybrid maize (the leading subsistence crop), the reforms promised a strong attack on rural poverty.

SBAM90 also continued to support macroeconomic adjustments in line with earlier operations, and added steps to improve the efficiency of land use on estates; divest ADMARC of its non-commercial functions (or ensure their proper budgetary support); revise the Ministry of Agriculture's budget; and redirect maize breeding towards high-yielding flint hybrids.

SBAM90 Implementation

Although the tobacco and ADMARC reforms were preconditions for release of the second tranche of the credit, originally scheduled for December 1990 the government was unwilling to implement the new tobacco deal and reduce ADMARC's monopoly as promised. The government's argument was that this would undermine the estates by forcing them to pay higher labour costs. The government was clearly reluctant to dismantle the system that allowed estates to exploit smallholders.

The Bank also rejected the alternatives proposed by the government, and the release of the second tranche was suspended. The Bank held its ground for 10 months, but it eventually released the second tranche after the government renewed its promise to implement the agreed reforms. The negotiations coincided with a sharp decline in bilateral aid, as donors became increasingly supportive of the opposition's demands for free and fair elections.

The Bank's action at the time may have been influenced by its awareness that USAID, the donor of a follow-up project (then under preparation) would demand full implementation of reforms as a precondition for disbursements. Another view is that the Bank, thanks to its patient negotiation, achieved a slight relaxation of constraints on the smallholder sector, opening the way for the bilateral donor to insist, in the follow-up project, on full deregulation. By keeping communications with the government open, Bank staff believes they paved the way for a smooth transition to a more democratic regime.

Actual achievements under the project were modest. Macroeconomic policy reforms were carried out without significant problems, but major sectoral reforms were still on hold when the project closed in 1992.

Chapter 5:

INDUSTRIAL & TRADE REFORM MODELS

Industrial Liberalisation

The industry policy Model offered by the World Bank placed greater reliance on deregulation and the power of market forces in determining who goes into business. The financial haemorrhage of fiscal resources arising from parastatals suggested the need for parastatal reform as well as export orientation of Malawi industry, and promotion of domestic and external competition to increase efficiency.

The Bank Model also summons improvements in macroeconomic management and a realistic exchange rate policy as the cornerstone of the reorientation efforts. Overvaluation of the Malawi kwacha meant that parastatals enjoyed an implicit subsidy on the price of imported raw materials. Instead of pursuing tight demand management to redress external imbalances and keep exchange rates in line with domestic macro fundamentals, governments tended to borrow abroad to feed raw material imports. The industrial and trade policy reform packages proposed by the Bank were practicable, but government's reluctance remained a binding constraints affecting the speed of supply response.

Under the Industrial & Trade Policy Adjustment Credit (ITPAC) approved in 1987 the bank Model advocates removal of industrial licensing requirement to pave way for free entry of industrialists in any sector without restriction. The model also recognises abolition of licence as a means to promote quick diversification of industries and also to promote competition in sectors otherwise held as monopolies.

The Model also supported creation of Chirimba, Kanengo and Luwina industrial sites in the three regions of the country. To facilitate these developments the Bank provided a Sites and service credit to finance development of power supply, in roads, and industrial effluent standard sewage. Through the Malawi Development Corporation, the Bank also provided funding for construction of factory shells.

Under ITPAC the Bank model also proposed establishment of the Malawi Investment promotion agency, as a one stop window to promote investments in Malawi. These measures were also accompanied by restructuring of the Malawi Export Promotion Council (MEPC) to promote Malawi exports. The program also contained measures to promote non traditional exports from Malawi.

Despite tangible achievements in implementing many of these programs, the effort resulted in partial transformation and removal of constraints fell short of potential of free enterprise. Industrial initiative remained constrained by lack of venture capital finance. Despite foreign exchange liberalisation a number of constraints remained which raised uncertainty in availability of foreign exchange to import raw materials.

Establishment of the Malawi Investment Promotion Agency, which took two years kept Malawi behind other countries with functioning investment agencies. The range of incentives at implementation were still far below the standard for international competitiveness and the agency remained constrained by red tape and bureaucracy as approvals had to be sought from Reserve Bank and the government.

The slow pace of parastatal sector reform also curtailed the interest of potential investors in Malawi. As reflected in the budget, parastatal losses continued to weigh down government raising public sector borrowing requirements to cover their losses while operating efficiency remained in a tail spin. As economic stability remained fragile, the prospect of policy reversals could not be ruled out, and the sustainability of the industrial reform effort was still dodged by a cloud of uncertainty.

Trade Liberalisation

Malawi's trade liberalisation started with a program of reforms that started in 1987. The World Bank & IMF provided aid to Malawi under the Industrial and Trade Policy Adjustment Credit (ITPAC), which was to be used to compensate fiscal losses incurred on tariff reduction. The credit also helped to bolster Malawi's foreign reserves because reduced cost of imports was expected to spur demand for imports. However, the donors and Government of Malawi determined that despite low tariff rates a rise in import volumes was likely to boost fiscal revenues from trade tariffs.

Under this program government was committed to a program of phased tariff reduction while the number of items requiring import licensing was continually reduced. Quota and certain embargoes were also lifted. However, for a long time government remained unwilling to give up foreign exchange controls until February 1994 when it was agreed that the Malawi currency was to float and therefore automatically find its own value based on the demand and supply of foreign exchange.

Trade liberalization also had to be accompanied by budgetary reforms and reform public enterprises as well as the civil service. This is because trade liberalisation had the potential to result in reduced fiscal revenue. A program of privatisation was put in place to dispose off loss making companies so that government generates savings from monies otherwise required to meet those losses.

In that way government would be taking care of the expenditure side of the budget so that a drop in fiscal revenues does not result in transfer of resources from essential spending in education and health. Privatisation was also one way to prevent reforms from backsliding. It was a sure way of ensuring that Malawi government did not return to high tariffs as a means of raising revenue.

However, design of privatisation was flawed. Rather than just privatise Malawi needed a law to recognise the conversion of public enterprises into private companies. Some reforms were rushed, under pressure from the Bank, even though the government lacked commitment and wanted more time to consolidate the reforms. In particular, liberalisation of foreign exchange which only came in 1994 should have come earlier than liberalisation of imports. Between 1987 and 1994, administrative constraints to imports had been removed but there was still the constraint of access to foreign exchange.

It was not until 1996 that Malawi had a Privatisation Act passed in Parliament. Previously conditions and targets for privatisation were poorly defined, so it was difficult to determine whether the government was actually privatising the right enterprises and not just paper firms. The government apparently viewed the agreement to "rationalize the public enterprise sector" as an agreement to divest itself of non-performing public enterprises. It was never convinced of the need to privatise the seemingly successful enterprises.

At the time of change of government in 1994, more than 100 commercial and financial enterprises remained under state ownership, burdening the economy. Yet this was many years after government had begun experienced losses in fiscal revenue as a result of low tariffs.

Despite the banking sector reforms, the reluctance of government, MDC and ADMARC to sell shares in the two main commercial banks continued to send mixed signals. Economic liberalization also led to a demand for political liberalization and the period from 1991 to 1993 was a period of such political upheaval that some policies adopted earlier were reversed and adjustment was disrupted.

Most project funding cancelled during the aid withdrawal in 1992, after a new government failed to resolve some fundamental political issues resulted in disruption to the reforms program and government literally suspended public enterprise reforms, and actually adopted a new civil service statute that was to make retrenchment very difficult.

As of today it can be said that trade liberalization succeeded in making Malawi a more significant player on global trade, but this would have been achieved faster had budgetary reform, public enterprises reform and the civil service reform enjoyed the continued commitment from government.

Chapter 6:

FINANCIAL POLICY REFORM

Financial Liberalization

Since the mid-1980s, Malawi has attempted to reforming financial systems to promote competition in the financial sector. Financial liberalization has also aimed to develop the scope for financial intermediation with a view to mobilizing savings. High Inflation has been a regular feature in Malawi, often resulting in negative real interest rates. Consequently savings growth has been suppressed, while government developed a growing appetite for borrowing. Much of the slow growth of employment, hence incomes is associated with the declining ratio of credit to private Sector in relation to GDP.

Government borrowing has also resulted in the "excess liquidity syndrome" a very recurrent feature arising from regular participation of the Reserve bank in financing government borrowing. Excess liquidity is also commensurate with high inflationary expectations and heightened exchange rate risk that gave way to pernicious speculation. The common policy contradiction in Malawi has also been government pursuit of expansionary fiscal policy while Reserve Bank maintained a contractionary stance, thus resulting in wrong monetary/ fiscal policy that caused financial sector malfunctioning.

While the economy has been plagued by regular episodes of macroeconomic instability, an underlying climate of fragility has persisted, thus producing inadequate results for reforms in the real sectors. This impeded investment and growth in many sectors of the economy.

IMF-Bank Model

The IMF-bank model of financial policy reform aimed at dismantling government's control over interest rates and intervention in activities of the banks. The bank model advocated determination of interest rates based on demand and supply for capital and also access to credit on the basis of financial merit.

The Bank model is based on a delicate sequence of liberalizing interest rates before the capital account and liberalization of the current account before the capital account. The bank model also advocates depreciation of the exchange rate while addressing inter-temporal concerns of credibility, especially ensuring that the fiscal situation is in order. Only after these conditions are in place is overall interest rate liberalization acceptable.

The IMF-Bank Model stipulation is highly cautious of persistent macroeconomic instability in the form of high public sector deficits during financial liberalization, as it is almost certain to result in run away of domestic currency or the alternative of high real interest rates which hurt investment. In the Bank Fund Model, the role of excessive government borrowing is to

increase crowding out the private sector, impedes financial deepening and increase vulnerability of the financial system.

Overall, the Bank model presents financial liberalization as a good thing in a sense that it can ignite economic growth, and that crisis can be avoided if you get the initial conditions and the sequencing right. The Bank-Fund model also emphasizes the health of the banking sector, requiring strong bank supervision. The models also highlight dangers of a credibility gap arising from delayed fiscal and structural reforms which may complicate macroeconomic management substantially if the financial environment is liberalized.

The tricky question facing countries like Malawi is the “Optimum Order” of financial liberalization. Foremost the model demands the balancing of the central government’s finances, followed by the opening of the domestic capital market. The Bank-Fund model also highlights the more important stages of liberalization of the foreign exchanges and subsequent freeing foreign exchange convertibility on capital account.

Policy Implementation

The financial Liberalization Program in Malawi started with removal of interest rate ceilings in April 1988, followed by initiation of steps to set up discounting and financing facilities in May 1989 and introduction of a statutory reserve requirement of 10 percent of total bank deposits in June.

In 1990 provision was made for the Investment and Development Bank of Malawi, previously not a deposit-taking institution, to now accept corporate deposits. In May, the Reserve Bank introduced a Bank rate, linked to an official auction rate of treasury bills followed by the granting of permission to Parastatals to switch their deposits from the Reserve Bank of Malawi to commercial banks in October 1990.

In November the Central Bank introduced the monthly auction of reserve Bank of Malawi bills, open for commercial banks, and the final removal of credit ceilings in January 1991.

For some time Malawi remained partially liberalized in terms of current account convertibility. Significant steps were made toward liberalizing external trade-related transactions in the 1990s but some forms of indirect controls to other current transactions (invisibles not related to trade) and controls on the surrender of foreign exchange proceeds and on the opening of foreign exchange bank accounts

At the precinct of the 1994 general elections, Malawi joined Madagascar, Rwanda, and Tanzania in upholding market determined exchange rates floating independently. Malawi also joined participation in the CBI (Cross-Border Initiative) countries abolishing the requirement for licensing in either export or import trade. Government also abolished requirements for authorization in the event that residents and nonresidents wished to establish foreign exchange denominated bank accounts.

However, in Malawi like in Ghana, a requirement was retained for partial surrender of foreign exchange proceeds for certain commodities. Malawi also joined Ghana and Madagascar to uphold a requirement for indirect control on payments on non-trade invisibles through authorized dealers.

The highest degree of external current account liberalization is recorded for Kenya, Mauritius, Uganda, and Zambia at the exclusion of Malawi. In these countries exchange rates are market-determined and independently floating, there is also unlimited market openness and participation in the CBI. However, shortcomings in the payments system affect the smooth settlement of external transactions.

From the above profile, implementation of financial reforms in Malawi has had a few pitfalls. Contrary to the ideal pattern of preceding domestic financial liberalization by domestic real liberalization, Malawi was the opposite. The entry of smallholder farmers, for example, dates back to mid 1990's more than four years after the financial sector had started opening up.

Domestic financial liberalization also came after external real liberalization, thus plunging the economy into crisis of disorder. Import liberalization in Malawi started several years before merchants were allowed less restricted access to foreign exchange.

Given the economic fragilities that pervade Malawi, feasible financial liberalization in Malawi would have been undertaken with a package that emphasized adherence to macroeconomic stability. Development of indirect monetary instruments and strengthening of the regulatory environment and bank supervision would also be the necessary pre-requisites.

Subsequently, the process would have required enhancement of competition among banks and development of the payment system, followed by development of secondary market for government securities, removal of direct controls and establishment of central bank autonomy.

Financial liberalization and Sequencing of Reforms would ideally have started with interest rates liberalization, abolition of credit ceilings and the end to directed credit programs, and development of Indirect Monetary Instruments. The program should have aimed to strengthen the regulatory framework from which increased competition in the financial sector would develop thereby increasing the efficiency of credit allocation in the economy

Malawi belongs to a group of countries with partially liberalized capital account convertibility, maintaining direct and restrictive control over most outward capital account transactions. Malawi also suffers the consequences of very small financial markets with no significant opportunities to foreign investors. This is unlike full capital account convertibility in Kenya, Mauritius, Uganda, and Zambia.

Macroeconomic Implications

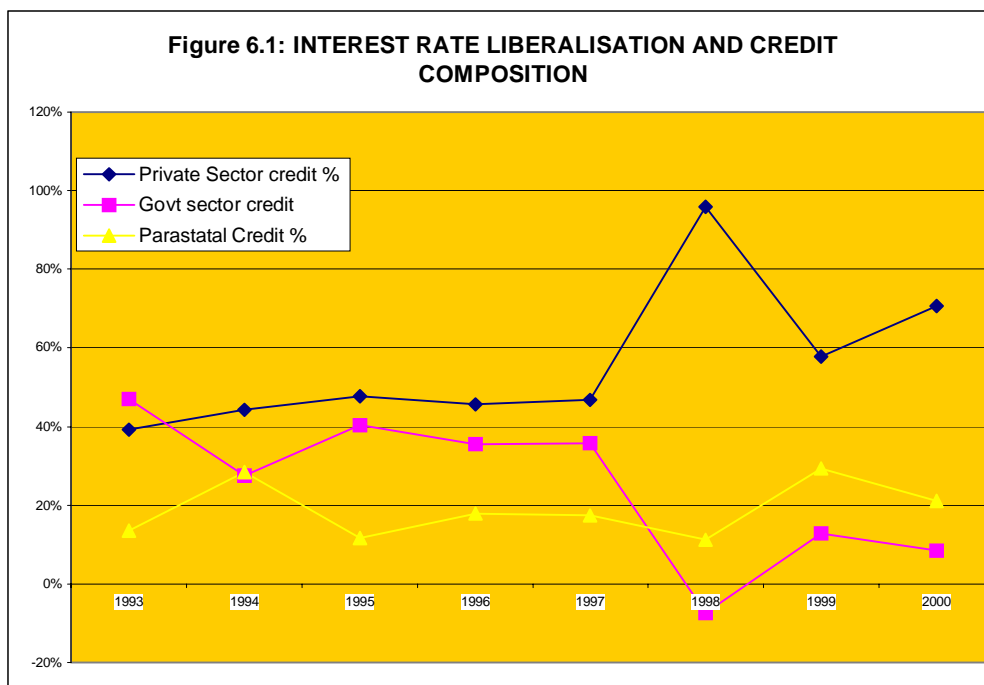
As a conventional measures of the extent of financial deepening (Fry, 1994), Broad Money to GDP ratio (M2/GDP) has decelerated since 1994 from over 20% to around 15% (Table 6.1, below)

Table 6.1:	MONEY SUPPLY AND NATIONAL OUTPUT						
	1994	1995	1996	1997	1998	1999	2000
GDP - market Prices	10324	21556	35138	42244	54769	82168	93471
Money Supply (M2)	2417	3885	5434	5555	8641	11545	14836
M2/GDP ratio	23.4%	18.0%	15.5%	13.1%	15.8%	14.1%	15.9%

MK million
RBM Monthly Economic Review, July 2000

Using real interest rates to measure the degree of repression (Gelb, 1989), Figure 3.3 showed that for much of the 1970's and 1980's, government held interest rates below market-clearing levels. The high aggregate level of financial savings arose from high rates of output growth and the fact that households were restricted from converting their incomes into foreign exchange.

Figure 3.4 also showed that the real discount rate has had a propulsive influence on the rate of savings lagged by one year. The economies saved more when the government was borrowing less and vice versa. This would suggest that financial repression was consistent with government desire to secure resources to finance the budget or resource transfers to selected industries in the parastatal sector at a very low cost.



Using credit to Private Sector Ratio to determine the intensity of crowding out (Pill and Pradhan, 1995) figure 6.1 above shows that the private sector has increased its share of credit since the beginning of interest liberalization. The share of government sector credit has declines as well as that of the Parastatals.

Financial Deepening “ in Malawi seems to have improved a little when we refer to the first two indicators (M2/GDP and Quasi-Money/GDP). The private sector also appears to have benefited from the financial liberalization process: credit to private sector in Malawi is growing, at least during 1994-2000.

The level of financial intermediation is yet to develop. The smaller private sector in Malawi remains the main problem. The inefficient payments system, a high required level of unremunerated reserves, the historically poor experience with default on credit altogether result in the holding of excess reserves.

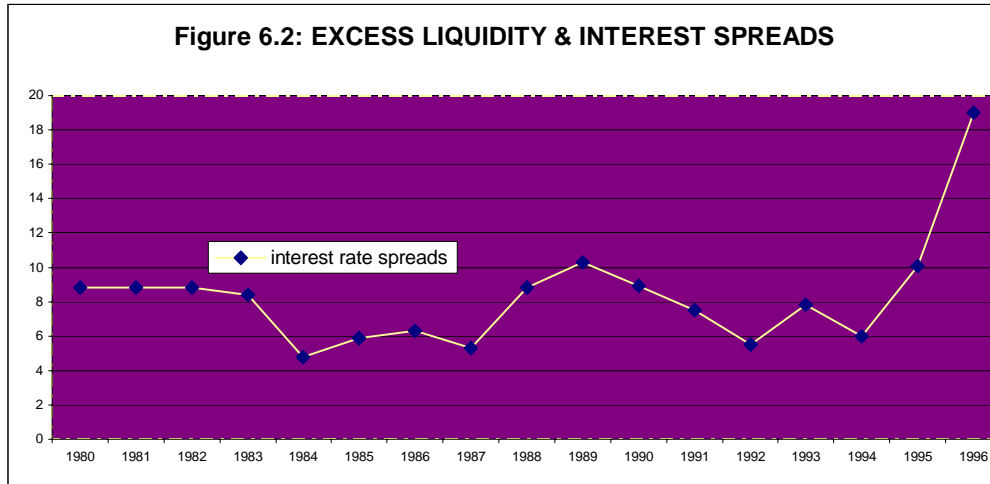
In examining the “excess liquidity syndrome” in Malawi, defined as the ratio of the difference between liquid asset holdings and required holdings over total deposit liabilities

Excess Reserves in the Banking System (In Percent

Table 6.2

	1983	1984	1985	1986	1987	1988	1989
Excess Liquidity	2.2	13.6	19.2	35.2	42.6	32.8	8.3

The principal reason for the “Excess Liquidity Syndrome” is the lack of investment opportunities in the private sector, the high cost of financial intermediation, which is not accompanied by a normal spread between deposit and lending interest rates and that leads to passive behavior by commercial banks (Figure 6.2).



The “Excess Liquidity Syndrome” can also be attributed to external shocks and delays in the repatriation of funds placed in foreign banks in speculating about the likelihood of devaluation. The turbulent economic conditions have also triggered a marked slowdown of banking sector activity in the domestic economy to protect against a high default risk.

It is evident that “excess liquidity” is impeding the effectiveness of the monetary policy based on the use of indirect instruments of monetary control. “Excess Liquidity” means that reserves of the banks are higher than reserve requirement ratios. In practice, the money market is “out of bank”; i.e. banks do not depend on the Central Bank for their refinancing operations. An increase of the reserve requirement ratio means that indirect instruments of monetary control have no effect on the monetary regulation.

In Malawi, Treasury bills or central bank bills have also come to be viewed as better sources of investment and revenue despite the existence of excess liquidity in the financial sector, only a relatively modest share of loanable funds is made available for private sector development.

Policy Implications

Interest rates are defined as being high if they are positive by three or more percentage points in real terms (See: Vicente Galbis, IMF, Working Paper, 93/7, p.14). The persistence of high inflationary expectations has forced the Reserve Bank to raise interest rates to restrain monetary expansion in an attempt to stabilize prices.

Interest rate hikes have also been aimed at minimizing the risk of rapid Exchange Rate Depreciation. This is to avert the risk of reducing the external value of domestic money balances. There are also instances of wrong macroeconomic Policy mix; for instance, simultaneous existence of fiscal expansion and monetary restraint.

High real interest rates can also be explained by the oligopolistic behavior of financial institutions in a concentrated financial market²¹ characterized by predatory competition and also "Distress Borrowing" by non financial enterprises resulting in an interest rate inelastic demand for funds. High real interest rates can also be explained by moral hazard. This may result from the existence of explicit or implicit deposit insurance, without adequate bank supervision and a very high genuine demand for investment funds not caused by distress borrowing.

Malawi has made progress in liberalizing the financial domestic sector and the external current and capital account. However, movements in real interest rates are generally determined by the changes in inflation. Furthermore, the macroeconomic environment was also poor in Malawi when financial liberalization took place..

The Macroeconomic Stance the Three Years Preceding Financial Liberalization

	1985	1986	1987
Inflation Rate	10.5	14.0	25 (34.6 in 1994)
Current Account/GDP	-11.2	-7.2	-5.2 (-34.9 in 94)
Overall Budget/GDP	-8.4	-9.9	-8.8

The high, volatile, and rampant inflation, current Account Deficits, budget Deficits and overvaluation of local currency could partly explain the reasons why the results of financial liberalization in Malawi has resulted in chaos. A stable macroeconomic is therefore an important variable in the success of financial liberalization.

²¹ See the Herfindahl-Hirschman Index, called H index : a measure of bank concentration : it takes account both the number of institutions and their relative size. It varies from 0 (no concentration) to 1 (full concentration, with only one bank)

Chapter 7:

NEW AGRICULTURAL STRATEGY

New Govt, New Strategy

The new government in Malawi took over power against the background of the government's unwillingness to implement the new tobacco deal to allow poor smallholders or reduce ADMARC's monopoly. While the government's had argued that this would undermine the estates by forcing them to pay higher labour costs the new government was more willing to dismantle the system that allowed estates to exploit smallholders.

The government adopted the Bank Model that had been transferred to the USAID, and co-operated to full implementation of reforms. In fact the new deal open up the environment for full deregulation. The bank rejoined the deregulation process under a subsequent Fiscal Restructuring and Deregulation Program (FRDP) one of whose conditions was the final abolition of tobacco quotas, liberalisation of almost all agricultural input and product markets, and the creation of a land commission.

By 1996, agricultural policy in Malawi cotton and tobacco marketing had been completely liberalised. The cap on estate payments to tenants had also been removed and a floating exchange rate was in place as well as the limits on tobacco licensing and private maize trading.

Two output variables highlight the benefits of policy changes initiated by the Bank's project and implemented by the follow-up project. From the viewpoint of poverty, for the first time in 1995-96, the estate sector had difficulty in finding tenants. Demand for tenants has increased their wages, indicating increased prosperity and reduced poverty in the smallholder sector.

From the viewpoint of national output, a total of 110,000 tons of burley tobacco were sold at the auction in 1995, compared with the initial target of 99,000 tons. The 1996 target was raised to 120,000 tons—a 20 percent increase in Malawi's most important export within one year.

Policy implications

The new deal experienced showed that smallholders had to be treated as well as the large estates if poverty was to be reduced and food security strengthened. It had become clear that Malawi could not achieve its full development potential as long as the smallholder sector was so heavily taxed. The move also showed that the key to food security was to allow smallholders to earn enough income either to use high-yield maize varieties and fertiliser or to buy maize for food. The experience also showed that maintaining two systems of land tenure could not be used to justify limitations in the crops that could be grown or the marketing channels that could be used.

The experience also showed that although the IMF and Bank were impotent in the context of forcing a country to undertake economic reforms, their position was defined by two options. The Bank could choose to continue dialogue with a reluctant government, in the hope that the borrower will take "ownership" of the reforms, or it could insist that reforms be the preconditions for lending.

The Bank's decided to fund a minimal lending program in order to maintain policy dialogue. It might be argued that the bank's soft attitude precluded significant progress towards policy reform. However, the fact that the Bank opted to keep lines of communication open, means it maintained its role of an honest broker between the government, the donor community, and the political opposition to pave the way for future reform.

New Strategy Old Problems

The success the new strategy showed that the policy of low prices for smallholder products had been a key element of Dr Banda's flawed strategy. Notwithstanding increased climatic variability, agriculture sector growth rebounded to over 5 percent per year and there had been a significant shift to tobacco and from maize to other food crops, particularly roots and legumes. Cross-border trade has also been increasing, especially with Mozambique, where the population/land ratios sharply contrast that in Malawi.

However, there is considerable debate over the extent and implications of these changes, which current data sources do not clarify. For example, there is considerable disagreement over why farmers are shifting to root crops and whether they are desirable from the soil - fertility and nutritional points of view, even though they do reduce climatic risk and spread labour requirements.

It is also paradoxical that while value added per hectare has increased, poverty remains pervasive and malnutrition is more widespread. It is also apparent that agricultural programs are having limited impact on the rural poor, especially female-headed households, which comprise about 30 percent of the total.

Bank-Govt Co-operation

However, there is a higher degree of consistency between the current government and programs of the Bank and Fund. World Bank operations support the mutually agreed agricultural strategy, with major emphasis on improving and broadening the research and extension effort and also strengthening financial services to small-scale producers and related businesses and on attempting to target a range of efforts toward the poor (Starter pack). There is also a high degree of donor co-ordination as the World Bank is assisting in work on land and soil fertility issues with other donors and in other activities particularly targeting the rural poor and female headed households.

Further development of the sector is outline in a new approach exemplified in the new Country Assistance Strategy drawn out by the Government and the World Bank. The follow up strategy recognises that the key to overall growth in the economy will be the expansion of smallholder agriculture. The strategy also takes into account-related activities in transport, marketing, and other off-farm processing and services.

A Sectoral Investment Program will be the basis for future approach to Agricultural development, supported by a range of flexible lending instruments, such as Learning and Innovation Loans. These are envisaged for operations addressing the natural resource management and land problems affecting development of the sector.

Chapter 8:

INDUSTRIAL REORIENTATION

Incomplete Reforms

Since coming to power in 1994 the new government has moved swiftly to complete remaining reforms. Import licensing has been curtailed significantly, and foreign exchange allocation has become more transparent, efficient, and equitable. The government has also accelerated the process of privatisation including liquidations of loss making state enterprises.

Public sector divestiture also means that direct resource transfers have been curtailed, and indirect transfers (absorption of losses, exemptions or non-payment of duties and taxes) are only an exception and not the rule. The impact of parastatal drainage on the budget has also been significantly mitigated. The most serious effort has been the establishment of a privatisation commission to prepare, implement, and co-ordinate restructuring/privatisation programs.

Further trade and exchange liberalisation, supported by bilateral and multilateral assistance, has increased the availability of imported industrial inputs. As a result, industrial capacity use has risen to 50-60 percent on average, compared with 25-30 percent in the mid-1980s.

Businesses no longer have to apply for exchange control approval. They merely have to lodge their import documents with their bank, which in turn attends to Reserve Bank auctions to obtain foreign exchange to liquidate import bills.

As a bonus to exporters, government introduced Foreign Currency Denominated Accounts (FCDA). This relaxes pressure on exporters to bring into Malawi their export receipts within 90 days and also ensures that exporters no longer queue up for foreign exchange to pay for imports.²²

The ITPAC reforms of 1987 did not therefore yield results until further deregulation introduced by the new government. The government reformed the exchange rate regime further and

²² Under the FCDA system exporters would keep their export receipts abroad and instead be allocated the equivalent amount of money in Kwacha in Malawi, which they could draw to pay local costs. In that case the RBM would reclaim the equivalent amount against their foreign exchange accounts. The more the exporter utilised in Malawi the more of his foreign exchange was reclaimed by the RBM. In the event that RBM wanted dollars they would negotiate with the exporters through their banks and agree on a rate of exchange for each transaction. The FCDA system provided to two tier system where the private sector was guaranteed its own foreign exchange while government had ready access to IMF Funds, donor aid or use private sector foreign exchange at a price.

reduced and rationalised import tariffs progressively to an mean tariff of 25.6% by end 1997. The government also lifted quantitative restrictions, removed most controls on prices and profits, and took steps to improve the public investment program and the condition of the financial sector.

By 1995 Malawi saw the first private participation in banking. The rising volume of liberal trade to which they provided financing was a major incentive. Investment and Development Bank of Malawi established Indefinance a special window to deal with trade, while government also experienced an increase in fiscal revenues earned from customs duties on imports.

Long term concerns

Despite these developments, it will be an exaggeration to suggest that these reforms have achieved the desired results. Industrial reorientation efforts are only beginning to create a "level playing field". Parastatals continue to pre-empt credit and also blunt competition. The goal of balancing the public/private enterprise mix by downsizing the parastatal sector will remain elusive as long as divestiture of the Parastatals remains slow and the many impediments to the private sector remain in place.

Very little progress has also been made in fostering the growth of export-oriented or efficient import-substituting manufacturing. In general, the private sector response to pro-export policies has been slower than expected.

The reform programs also fail to address social safety concerns. When the programs were begun, any hardships caused by the reforms were expected to be short-lived. In practice, the suffering of a large part of the population, particularly in urban areas, began quickly and was difficult to bear. This seems to have been sustained and therefore increased resistance to the reform programs and forced government to slow down on policy implementation.

If the expected structural transformation and growth in industry had been achieved, there is no doubt that living standards would have fallen less and therefore encouraged further reforms.

It is only recently that, in the context of follow-on restructuring and privatisation exercises, the government has begun to seriously examine elements of a safety net. Given the government's commitment to reform, It does appear that the Bank and Fund were assured that they no longer face the dilemma of supporting adjustment to prevent policy reversal as was the case under Banda. Instability of financial support has been frequent and high enough to cause policy reversals in Malawi.

Chapter 9:

STRATEGIC REORIENTATION

Bottom Up Development - MASAF

One of the lessons from the agricultural strategies of the Banda regime has been the marginalisation of poorer families from excessive emphasis on a trickle down strategy for which no mechanism existed to transfer resources to the poor. Banda's equally top heavy industrial strategy, favoured high-level entrepreneurship development through Parastatals at the expense of the country's potential for small and medium enterprises.

The plight of low level communities in Malawi also worsened by many years of sluggish social spending as a results of cuts imposed by structural adjustment programmes that started in 1979. Marginalized communities also experienced price increases as a result of subsidy removals and deliberate reductions in pro-poor allocations in the budget in favour of preserving expenditure preferences of the status quo.

Based on these background facts, the new government set out a programme through which efforts to reduce poverty would be mobilised from among the poor. Instead of relying on central planning authorities and Ministries at capital hill, the government sought to reorient efforts to reduce poverty in a targeted manner while attempting to reintegrate destitute Malawian groups into the mainstream of the economy.

Unlike the prescriptive style of project selection through government ministries the government sought a demand-driven initiative reflecting the needs expressed felt by the people themselves. The proposal was that government funding would be a mere response and not the starting point.

Structural Adjustment had clearly created a gap between government structures, and the local communities, and government's idea was to fill that gap and widen the scope for carrying out participatory development activities.

The Government's other concern was that spiralling overheads in development organisations consumed resources that would be more effectively used to provide assistance to the poor. The concept of a rural based development initiative was more attractive on the rationale that low management costs would permit more resources to be directly deployed towards poverty reduction.

A further concern was that projects that were planned and executed by central authorities almost always discriminated against small-scale construction companies based in the rural areas. Rural and people driven project development was therefore one idea of the government building a true partnership through local people to include organisations working at the local level.

Government therefore established the Malawi Social Action Fund to overcome was the problem of long delays before a project is implemented. MASAF was the mechanism that would have projects implemented relatively rapidly and to the design and specification of the poor themselves.

The concept of MASAF represents a key element of economic reform transforming the project development machinery from central government to the people them selves. For many years Malawians had undertaken self-help projects in their own areas, which contributed to the process of addressing the lack of social amenities required in their areas.

However, these self-help projects were initiated and organised by political leaders. They undertook the project in full, but at no time did they have an effective voice in deciding what was to be done. At no time did they have control over decisions that affected their lives. MASAF served to bring universal suffrage within the proximity of economic activity.

New Infrastructure Model

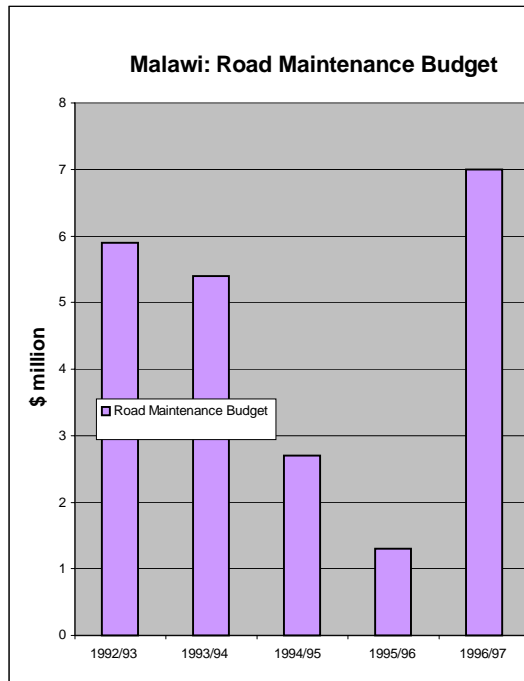
The government has also developed a new policy framework that redefines its position from the traditional role of leading development to that of creating an enabling environment for efficient implementation of transport goals. This is exemplified in the establishment of the Road Maintenance Initiative (RMI) in 1995 in response to deteriorating conditions of the road network and its adverse impact on economic growth.

The government initially developed a Road Sector Policy, which formed the basis of preparation and implementation of a five year (1999-2004) Road Maintenance and Rehabilitation Program (ROMARP).

This arrangement is a complete contrast to previous years, when effectively, Ministry Of Works & Supplies was managing (since the early 1980s) all public roads (DRIMP, etc) as district authorities did not exist. As part of the reform program, functions performed by National Economic Council have been moved to the Ministry Of Transport whereas those performed by the Ministry of Works and Supplies have been transferred to the National Roads Authority.

The focus of attention has therefore moved from mere budgeting to increasing the capacity of MOT to undertake analytical work in the functional area of transport policy formulation. As such, the staff in Ministry Of Works & Supplies has been reduced from almost 1,200 in 1997 to about 300 in 2001, and the Government is committed to further reducing the staff to about 100 in a few years, as NRA is fully established and functional.

To ensure that these reforms are irreversible, an Act of Parliament was passed in 1997



creating the National Roads Authority (NRA), which is mandated to manage the road sector on behalf of Government with resources generated from a Road Fund (RF), for which the NRA Board has full responsibility. The legislation establishing the NRA and a RF was passed in April 1997.²³

The specific functions of the Board are to (a) manage and direct the utilization of the Road Fund; (b) monitor the maintenance and development of the public road network of Malawi; (c) raise the required funds for adequate maintenance and rehabilitation of public roads; and (d) prioritize annual road program submitted to

the authority by the various central and local road agencies.²⁴

Policy Implications of NRA

Prior to the introduction of the road sector reforms, budget management and allocation of resources to the road sector were not conducive to proper planning and management of the road works. MOWS typically prepared estimates based on the initial proposals of the Roads Department, which were then “approved” by the Ministry of Finance, after revision. The final allocation to MOWS often bore no relation to initial proposals.

The budgetary allocation for road maintenance was therefore vulnerable to fluctuations in fiscal revenues (see Figure). Up until 1995/96, resources allocated to road maintenance expenditure were well below what was needed to assure the quality of the network, e.g. in

²³ NRA is managed by a private sector dominated board

²⁴ The majority members are from the private sector and are the nominees of the Road Transport Operations Association (Vice Chairman), Mini Bus & Taxi Operators, Association, Chamber of Commerce and Industry, National Construction Industry Council (NCIC) and National Road Safety Council (NRSC), which are both statutory bodies set up under their own Acts

1994/95, US\$2.7million was budgeted, less than 15% of the requirements (for details, see Public Expenditure Review, Government of Malawi, June 2000).

During the period 1993-97, budgeted expenditure on roads through MOWS was in the range of 1.3% to 2.9% of the Government recurrent expenditure. Estimated capital spending in 1996/97 was MK320 million (US\$21.5 million) and the ratio of capital to maintenance had declined to about 3:1 from above 21:1 in the early part of the 1990s (Public Expenditure Review, Republic of Malawi, June 2000).

The Road fund, established in April 1998, has therefore lived up to the objective of developing a dedicated and sustainable funding source for road maintenance. The funding is derived from incremental user fees and managed by users and stakeholders.

At the present time, the primary resource base is the fuel levy, which was initially set at MK 1/liter for petrol and MK0.99/liter for diesel. This is an incremental road user charge, which is specifically identified element of the wholesale fuel price structure. The levy has been progressively increased to MK1.25/liter in October 1998 to MK1.75/liter (about US\$0.038/liter) in July 1999 for both petrol and diesel.²⁵

Up to February 2000, a total of MK 614 million (US\$14 million) was received in the RF. This amount should have been sufficient to meet routine maintenance requirements (of roads in maintainable condition), but in the event an appreciable sum is being spent on "holding" maintenance (preserving a road awaiting maintenance in a fair or good condition) and on urban road rehabilitation.

Analytical work suggests that the fuel levy would have to increase by a factor of about 56%, in real terms, over the next five years, if it were to be the only source of funding for road maintenance.

²⁵ The only other source of funding identified for routine maintenance is an extraordinary contribution from EU (MK250 million equivalent) for two years (1999/2000 and 2000/2001) to help address the backlog of work.

Chapter 9:

TRANSITIONAL ISSUES

Agricultural Liberalisation

Malawi's agricultural reform policy may have provided an opportunity for smallholder farmers to enter directly into Malawi's lucrative cash crop export sector, but it is noteworthy that input price liberalisation and devaluation of the local currency have resulted in significant escalation in the pricing of fertiliser.

However, the prohibitive costs of fertiliser have eroded the entrenched belief that fertilisers are the answer to soil fertility problems. More and more farmers are turning to organic soil fertility measures such as burying crop residues, composting, and animal manure that are essential for the regeneration of soil structures. This is a positive outcome of market liberalisation.

A more significant problem in Malawi is that there is no more land available for development of smallholder farming. As such, contrary to established trends world-wide where market liberalisation contributes to agricultural expansion, the experience in Malawi is that farmers are merely switching from food production into cash crops. This is on account of the fact that most of the land suitable for agriculture was allocated in the 1970's and 1980's during the estate centralisation policies of the Banda government.

In addition, these lands have been sub-divided for family members, ruling out following as a soil fertility management strategy. Further, the same lands, under the same crops (maize, groundnuts, millet, beans, and cassava) have been more or less under continuous cultivation for close to four decades. The absence of winter crop farming as a result of low irrigation development has minimised the impact of agricultural liberalisation on the reduction in the lengths of the fallow vis-à-vis agricultural production.

Farmers also acknowledge that market liberalisation has contributed to deforestation through the opening up of markets for wood and wood by-products. Construction of tobacco sheds has also contributed to deforestation; although this is not a robust argument as most tobacco farmers build semi-permanent structures that last up to three years.

There is anecdotal evidence of increased rural income from market liberalisation. However, this does not appear to have led to adoption of soil and water conservation practices because of a conflict of interest between investing in soil and water conservation works and the demands of expensive fertiliser for the next season. Pressures from consumption spending in food, which has become expensive, consume a large part of the incomes earned from the sale of tobacco.

The failure to invest in soil and water conservation works is partly due to the fact that most of the tobacco farmers belong to tobacco clubs and obtain fertiliser through credit. Thus entrenching the view that soil fertility problems can be solved through the use of fertilisers. Where an investment is made, it is in the form of hiring labour to make and/or repair ridges – an activity that is tantamount to land preparation under any other land use system. Thus investments in soil and water conservation works are hardly noticeable.

It is also observed that market liberalisation has also negative and positive impacts on the environment. Agricultural expansion into marginal and unsuitable areas is a major cause of concern. The reasons for the such changes lay in increasing family demands for land, fuel wood, and the allocation of fallow lands and not due to market liberalisation.

While market liberalisation was not directly responsible for any cover changes it was directly responsible for changes in land use, cropping practices, and crops switches. Significant in this regard was that market liberalisation did induce change in the cultivation of dambos and riverbeds for horticultural crops.

A related but somewhat contradictory outcome of market liberalisation policy is that farmers are being forced to form maize clubs for purposes of buying fertiliser. Although this may lead to the return of fertiliser as the soil fertility management approach, the groups may also provide a nucleus for group based activities that may be a springboard for community action.

Agricultural Marketing

Agricultural marketing in Malawi also presents a paradox that will need government resolution as a matter of urgency. ADMARC has become financially constrained to be able to undertake its produce marketing activities with the same vigour as before. This is on account of fiscal limitations on the part of government and prudential lending limits imposed on commercial banks.

In Malawi private trading remains an informal activity, while the marketing board, ADMARC still absorbs a lion share of the official maize market. Private traders find themselves competing with a giant that dominates in terms of distribution networks, storage and transportation infrastructure and financial facilities, but is not prepared to offer a better price to the farmer.

The experience in Malawi is in contrast to countries like Ghana and Benin where marketing boards for cereals still exist, but their share of the market is very minimal because the private sector has taken over most of the marketing activities of cereals. The marketing boards in these countries have reduced their activities to holding buffer stocks or strategic reserves and insuring food security in periods of shortage.

Input Sectors

Historically, fertilisers, seeds and agro-chemicals were more heavily controlled by Malawi government Parastatals than cereal trading and distribution. However, input markets were liberalised after many years of heavy subsidisation by the state. The SFFRFM is the main importer of fertiliser into the country.²⁶

Official seed distribution is also heavily controlled by State Enterprises, although a parallel private sector seed market has emerged. There are usual complaints about low quality of seed and inadequate development of the legal framework for producing and distributing certified seeds.

Thus, although a lot of private traders have entered agricultural input and output markets, expansion of area coverage and quantity traded has been very limited. Traders are not able to go much beyond entry into large-scale trading either in terms of geographical or volume expansion. Traders are often limited by unavailability of credit, limited storage and transportation facilities, and various restrictions by existing organizations or parastatals.

Constraints to Private Involvement

Malawi specifically suffers very poorly developed transportation and communication infrastructure, which limits long-distance trading, movement of information, and overall market efficiency. Many remote areas and regions remain isolated from the rest of the country and become almost self-sustaining entities. Transport costs in most parts of the country constitute up to 50 percent of total operating costs and need to be reduced to promote inter and intra-country trade and better integration of markets. More investments in roads, rail, port infrastructure, and telecommunications networks (telephone and fax networks, internet access, etc.) are needed between and within countries to facilitate trade and access to market information.

Use of storage facilities is not very common and traders store very small quantities. The limited propensity to store stems from the uncertainties regarding movement of prices and government interference, unavailability of storage infrastructure, lack of access to credit, inefficient knowledge about storage technologies, limited area coverage, etc.

Access to formal credit remains a pervasive in Malawi. Not many rural credit and financial organizations have emerged to replace previously subsidized credit from the Smallholder Agricultural Credit Administration (SACA) run by the government. Credit availability is biased to large export producers and trading companies and is not readily available to small-scale farmers or traders.

²⁶ The same as SENCHIM is the major player in fertilizer production and distribution Senegal. In Benin, the marketing board, SONAPRA still regulates the entry and activities of private fertilizer companies

Additionally, access to credit is limited due to high interest rates, lack of collateral, complex administrative procedures, and the short-term nature of the loans. Most traders that use credit obtain it from relatives, friends or moneylenders.

The maize price band operated in Malawi also seems to have features of a fixed price. The price band is a disincentive for private traders to conduct trading over longer distances or to store maize for later sale in leaner periods. Similarly, the ban of export trade in maize poses a constraint to traders seeking to adjust more quickly to changes in prices and supply and demand conditions within and between countries.

The task of developing a market information system that traders can use for their business is still in its infancy and not well targeted to the business sector. It is currently serving the needs of donor organizations and government statistical offices for data analysis and compilation of consumer price indices. Malawi needs to invest more towards developing market information networks that are accessible to the business community.

It is plausible to expect that the extent to which private traders may be expected to respond with their own investment would rise with the quality of infrastructure provided by government. This is a very important guarantee for more integration across local markets considering the thinness of localised markets, which is an obstacle to the transition process.

Land Reform

These factors suggest that future emphasis would be more appropriately placed on land reform to increase land available to farming households. Mixed cropping (rather than sole cropping in maize) should be the norm, with food and cash crops either mixed on expanded land or interspaced within two seasons of the same year including a winter crop driven by irrigation.

However, prior to land reform, it is possible to improve the viability of smallholdings through development of off-farm activities at the village level. Beef and milk production as well as poultry and production of mutton and goat meat have a proven profitability in Malawi where protein intake largely depends upon fish consumption.

The end of subsidization of fertilizer is still recalled as the "golden years" with fondness, but current prices of fertiliser should not cause concern if farmers become more productive than before. Availability of more land should enable farmers to engage in both food and cash cropping and internally generate resources they can invest in fertilisers and other inputs.

Rural Development

Rather than focus on agricultural development, it is appropriate that government adopts a broad approach towards rural development from which a more facilitating environment for agricultural production would emerge. Improving the efficiency of markets and access to

them through improvements in roads and reductions in operational cost of vehicles and greater access to financial services is key to these developments.

It is advisable that support for programs such as the MASAF, which increase resources available in rural areas should be increased to upgrade social and physical capital. This would enable the current agricultural changes to work themselves through and indicate priorities for technical support from the public sector as change continues and would imply working with several ministries besides Agriculture, such as Local Government, Commerce, Transport, and perhaps Education and Health.

The rural public works component of MASAF, especially of a labour-intensive kind should be seen as integral to the rural development strategy. The pervasiveness of rural poverty is at the root of the food security problem. Therefore a program that supports dispersed, small-scale public works, preferably of a labour-intensive kind and targeted at poor households, would serve the twin objectives of increasing the incomes of the rural poor and upgrading rural infrastructure and increasing accessibility to markets and employment opportunities especially in the dry season.

However, such efforts should be integrated into an overall safety net strategy, which has been absent in the past. While MASAF could have a significant role in such a program, it would be desirable to look to other means of managing works so as to avoid overwhelming MASAF's capacity.

Developing Markets

The success of the marketing system obviously depends upon successful linkages to the market economy. This depends upon major improvements in road connections and market infrastructure. It will also take novelty of connecting villages to towns and the ubiquitous flow of information.

Farmers will have become more market-oriented and less risk averse, and farm households should rely on markets more for their daily requirements while directing more of their production toward the market. It will take a lot of technological innovation to simplifying cropping practices to release labour for other more productive tasks at critical periods of the cropping year.

Even if labour bottlenecks emerge farmers should be able to resort to oxenization if returns from farming can provide the needed capital. This should overcome the problem of late land preparation as a result of the usual constraints with family labour.

Continued market oriented diversification will also require the development of export markets. The participation of private sector organizations with links or an established presence in external markets will be essential if significant growth is to be achieved. In addition there may

be prospects for additional processing in Malawi but if such investment is to be attracted, improvement of industrial infrastructure must be a short-term priority.

Future of Reform

The challenge lies squarely upon the Bank and Fund to recognise good reform behaviour by providing Malawi unconditional access to external resources. This should make it easier for the government to stick to agreed reforms. Delays in disbursement of money have more often resulted in fiscal recourse to central bank borrowing. The sustainability of some of the reforms initiated in Malawi, therefore, remains uncertain.

It will be an exaggeration to suggest that interactions between Malawi Government and the Bank/Fund have been fully productive. The net benefit of the Bank's financial and technical assistance remains to be seen. Malawi remains vulnerable to changes in external factors. Since measurable growth in export earnings will take time to achieve, inflows of quick-disbursing external funds will still be needed to sustain import liberalization and policy reform.

The government's willingness to commit itself to a new set of adjustment-related conditions under follow-on operations is, invariably, encouraging because it enhances the prospects of sustaining the process of change. Decisive government action to achieve macroeconomic stability and accelerate the pace of privatisation remain important preconditions in the process of industrial reorientation. However, the process requires donor support.

Donor Coordination

Although signs of new entry and growth in existing private enterprises in recent years are encouraging, private sector growth has yet to become a catalytic force in altering the industrial structure. It is more desirable that the Bank should target its support towards expanding the private sector alongside parastatal privatisation, but aiming at reduction of investor uncertainty.

The task of ensuring adherence to a macroeconomic policy framework that achieves low and stable inflation and a sustainable balance of payments position is a shared one. Donors must meet their own commitments to provide resources to fill the financing gap, so that government does not resort to deficit monetisation.

The deteriorating economic situation in Malawi requires comprehensive reforms to eliminate remaining controls and promote external and domestic competition. However, getting supply response requires improvement in incentives. The main policy instruments revolve around

trade, pricing, and exchange rate management. These require bank-Fund financing and support.

Bank-Fund assistance is also needed in rehabilitation and expansion of existing infrastructure. More investment is needed to implement policies that enhance domestic competition and flexibility in labour markets. Strengthening business laws and the capacity of the judiciary to implement them requires funding.

Bank and Fund must also realise that hasty liberalization has resulted in competition between non-essential imports and domestic industry. The dangers of policy reversals reign high when non essential pose a threat to domestic industry. The Bank and Fund must recognise that further removal of trade barriers requires significant improvement in export competitiveness.

Given the changes brought by globalisation, Bank and Fund also need to support regulatory and institutional measures to improve access to information on technologies and foreign markets. Overall support should be oriented towards private export marketing and service organizations, promotion of "export catalysts" (foreign firms with technical and marketing expertise) to assist firms with export potential in Malawi, and "buyer-seller" links with international marketing firms.

Reform of the financial sector, especially the divestiture of government and parastatals from state-owned banks have paved the way for managerial autonomy. Furthermore, liberalization of entry to the financial sector through licensing of domestic and foreign private banks and strengthening prudential regulation and banking supervision capabilities of central banks have helped to promote developments in the financial sector in Malawi.

On this note, Bank and Fund role should be directed at promoting entry of more private banks to enhance the new corporate culture of managerial independence, sound banking principles, and adaptability to changing economic and financial conditions.

Bank-Fund assistance would also be more appropriately tailored towards development of private sector institutions that could become part of the technological and business know-how base providing information, continuing education, applied research, and private sector dialogue with the government.

Malawi's divestiture program testifies the political commitment of current leaders. However, there are legitimate concerns about how a government can widen ownership of divested enterprises in countries where financial markets are underdeveloped and income inequalities are great.

Bank-Fund conduct in facilitating disbursements remains crucial to economic development in Malawi.

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