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Macroeconomic policy for employment creation: The case of Malawi

Sonali Deraniyagala and Ben Kaluwa

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**Macroeconomic policy for
employment creation:
The case of Malawi**

Sonali Deraniyagala
Ben Kaluwa

Employment
Policy
Department

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Preface

The primary goal of the ILO is to contribute, with member States, to achieve full and productive employment and decent work for all, including women and young people, a goal embedded in the ILO Declaration 2008 on *Social Justice for a Fair Globalization, and*¹ which has now been widely adopted by the international community.

In order to support member States and the social partners to reach the goal, the ILO pursues a Decent Work Agenda which comprises four interrelated areas: Respect for fundamental worker's rights and international labour standards, employment promotion, social protection and social dialogue. Explanations of this integrated approach and related challenges are contained in a number of key documents: in those explaining and elaborating the concept of decent work², in the Employment Policy Convention, 1964 (No. 122), and in the Global Employment Agenda.

The Global Employment Agenda was developed by the ILO through tripartite consensus of its Governing Body's Employment and Social Policy Committee. Since its adoption in 2003 it has been further articulated and made more operational and today it constitutes the basic framework through which the ILO pursues the objective of placing employment at the centre of economic and social policies.³

The Employment Sector is fully engaged in the implementation of the Global Employment Agenda, and is doing so through a large range of technical support and capacity building activities, advisory services and policy research. As part of its research and publications programme, the Employment Sector promotes knowledge-generation around key policy issues and topics conforming to the core elements of the Global Employment Agenda and the Decent Work Agenda. The Sector's publications consist of books, monographs, working papers, employment reports and policy briefs.⁴

The *Employment Working Papers* series is designed to disseminate the main findings of research initiatives undertaken by the various departments and programmes of the Sector. The working papers are intended to encourage exchange of ideas and to stimulate debate. The views expressed are the responsibility of the author(s) and do not necessarily represent those of the ILO.

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¹ See http://www.ilo.org/public/english/bureau/dgo/download/dg_announce_en.pdf

² See the successive Reports of the Director-General to the International Labour Conference: *Decent work* (1999); *Reducing the decent work deficit: A global challenge* (2001); *Working out of poverty* (2003).

³ See <http://www.ilo.org/gea>. And in particular: *Implementing the Global Employment Agenda: Employment strategies in support of decent work*, "Vision" document, ILO, 2006.

⁴ See <http://www.ilo.org/employment>.

Foreword

At the 99th session of the International Labour Conference, constituents endorsed the need to promote a ‘pro-employment’ macroeconomic framework. It was felt that the current framework, while making an important contribution to the goal of macroeconomic stability, paid insufficient attention to the way in which macroeconomic policy instruments either helped or hindered employment creation and poverty reduction. In the standard framework that has evolved since the days of the structural adjustment programmes of the 1980s and 1990s and that has remained intact during the 2000s, the emphasis is on attaining key nominal targets pertaining to debts, deficits and inflation. The rationale is that attaining such targets in the medium to long run will engender a predictable macroeconomic environment that is crucial for supporting growth and hence employment creation. It now appears that macroeconomic stability is necessary, but by no means sufficient to engender inclusive, job-rich growth.

The ILO/Korea partnership programme has been providing additional support to the Employment Policy Department’s endeavour to identify existing constraints in the macroeconomic policy instruments that may hinder generation of full and productive employment, and to suggest a way forward for job-rich growth. A series of country case studies has been conducted, and the current case study of Malawi represents one result. It analyzes recent macroeconomic performance, shows their relationship with employment outcomes or lack thereof, reviews the existing programmes on employment and social safety nets, and reflects the views of the ILO constituency and other key national stakeholders that were collected through consultations.

Malawi is one of the poorest countries in the world, with poverty widespread at 40 per cent in 2009. Rural subsistence agriculture still dominates as a source of livelihood for the majority of the population. Malawi has experienced a drastic reduction in inflation rate since 2004, but until then, the inflation rate reached double-digit for a long period of time, driven largely by the exchange rate that strongly influenced consumer prices. It reflected the structural weakness of the economy, as well as vulnerable external account situation. In order to generate productive employment opportunities, the economy has to diversify from low-productivity subsistence agriculture and narrow export base, consisting mainly of tobacco, towards other agricultural food and cash crops and non-primary export sectors. In order to do so, the paper concretely recommends adjustments to the monetary, fiscal and external sector policies that would support the much needed diversification process. They include reduction in commercial banks’ excess liquidity, greater expenditure on skills and capability development, improved revenue mobilization, and devaluation of the Malawi Kwacha.

The paper was presented and discussed in a national workshop in November 2010 opened by the Hon. Minister of Labour and attended by the representatives of the Employers’ and Workers’ organizations. The paper reflects the valuable and concrete views that were actively expressed by the participants. We are grateful to the ILO Country Office for the Zambia, Malawi and Mozambique for providing valuable support in organizing and conducting the workshop.

Azita Berar Awad
Director
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Introduction

This paper investigates the links between macroeconomic policy and employment creation in Malawi. It identifies ways in which monetary, fiscal and external sector policies (dealing with the exchange rate and the capital account) can be used to boost employment creation in Malawi.

The prevailing orthodoxy on macroeconomic policy focuses on stabilisation and on maintaining internal and external balance. This is seen as the optimal way to create conditions conducive to rapid economic growth, which in turn boosts employment. This paper departs from the orthodoxy and argues that a developing country such as Malawi can use macroeconomic policies that go beyond narrow stabilisation. We identify a range of macroeconomic policy instruments that can help direct the Malawian economy onto a path of employment-creating economic growth.

Section One presents the thematic background for our study. Section Two deals with the key features of growth, poverty and employment in the Malawian economy.

Section Three outlines the macroeconomic policy environment in the country. Section Four examines monetary policy options for enhancing employment-rich growth. Section Five examines fiscal policy options for job creation. Section Six deals with exchange rate, capital account and other external sector policy options for boosting economic growth and employment. Section Seven summarises the main conclusions of the report.

Section one

Thematic background

The orthodox approach to macroeconomic policy in developing countries focuses on stabilisation. Maintaining internal and external equilibrium is seen as the main aim of macroeconomic policy. This results in policy targets of curbing inflation, containing the fiscal deficit and enabling the emergence of market-clearing exchange rates. This view assumes that a stable macroeconomic environment, together with a non-interventionist state that does not crowd out private investment, will generate faster economic growth.

However, the theoretical underpinnings of this orthodoxy have been questioned extensively (Rodrik 2006, 2009). The positive causal link between macroeconomic stabilisation and economic growth remains ambiguous. Economic growth may not always follow once 'correct' incentives and a stable environment are created. The links between stabilisation and employment growth are even more tenuous. Even in instances where stabilisation is accompanied by faster growth, this growth will not necessarily be employment boosting.

There is also little empirical evidence to support the central hypotheses of the orthodoxy. For instance, the claim that holding inflation below 5 per cent (or even below 10 per cent) promotes growth does not hold up to empirical testing. Therefore, the zeal with which stabilisation policies have dwelt on this target is questionable. Indeed, it has been widely argued that excessive focus on inflation targets has hampered economic growth by restricting the policy space available to use fiscal instruments to boost investment and stabilise output during downturns (Ocampo 2009).

Focusing only on inflation and on deficits also results in too narrow a view of stabilisation. For developing countries beset by structural weaknesses and market

imperfections, stabilisation needs to be defined more broadly to include stability and growth in the real economy. Such stability in the real economy may sometimes require allowing larger fiscal deficits and higher rates of inflation than prescribed by conventional macro policy.

While conventional macroeconomic policy only allows a stabilising role for fiscal policy, fiscal policy can be used as an explicit tool of employment creation and poverty reduction. The MDG agenda highlighted the structure of government expenditure and emphasised the need for pro-poor budgets. This indeed led to a dramatic increase in social sector spending across much of the developing world. However, it sometimes also resulted in an under-allocation of government expenditure for economic sectors. It is important therefore re-emphasise the importance of state expenditure on economic sectors which can generate employment-creating economic growth.

Section two

The economy of Malawi: Key features

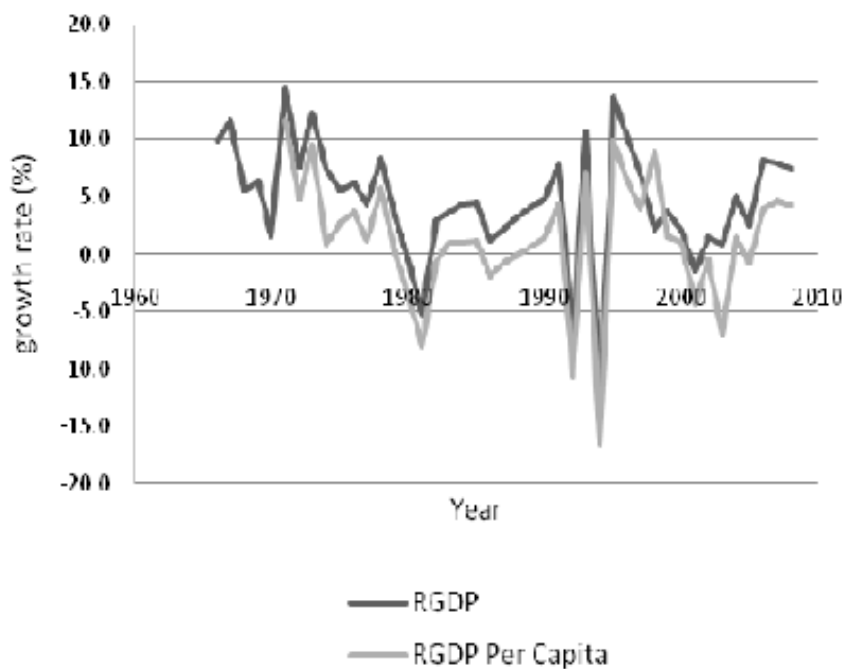
Malawi, a landlocked and densely-populated nation in Southern Africa, is one of the poorest countries in the world. Malawi's GDP per capita in 2009 was US\$ 344 (IMF 2009). Poverty is widespread. In 2009 it was estimated that 40 per cent of Malawi's population lived in poverty (National Statistical Office 2010). The population of Malawi is mainly rural and subsistence agricultural production dominates. Malawi is also highly aid-dependent. Foreign grants made up 44 per cent of the national budget in 2008/2009.

2.1 Trends in Growth and Structural Change

a) Economic growth

After experiencing low economic growth rates for much of the period since the early 1980s, Malawi has shown a growth turnaround in recent years. GDP growth rates averaged around 7 per cent per annum between 2005 and 2009. Although this recent performance is good by any standards, Malawi's growth has a history of volatility (Figure 1 and Table 1).

Figure 1. Growth rates 1960-2010



Source: Mangani (2009).

Table 1. GDP growth rates

Period	Rate of GDP growth
1966-1969	8.4
1970-1974	8.6
1975-1979	5.5
1980-1984	1.0
1985-1989	3.0
1990-1994	0.4
1995-1999	7.4
2000-2004	1.6
2005-2008	6.5
2008-2009	9.7
2009-2010	7.7

Source: World Development Indicators 2010

b) Economic structure

The Malawian economy is predominantly agricultural. While Table 2 shows that agriculture's share in total GDP has declined during the last two decades (accounting for 34 per cent of GDP in 2009, down from 50 per cent in 1988), agriculture still supports around 85 per cent of livelihoods. This sector is also the main source of export earnings.

The contribution of manufacturing to total GDP has declined slightly in past twenty years. Manufacturing in Malawi consists largely of agro-processing. The service sector has greatly expanded its share of GDP, from 26 per cent in 1988 to 45 per cent in 2008. Output in this sector is dominated by wholesaling and retailing.

Table 2. Economic structure

	1988	1998	2007	2009
Agriculture	50	35.6	34.3	34.3
Industry	24	18	20.3	20.4
Manufacturing	15.8	13.6	14.2	14.4
Services	26	46.1	45.1	45.1

Source: World Development Indicators 2010

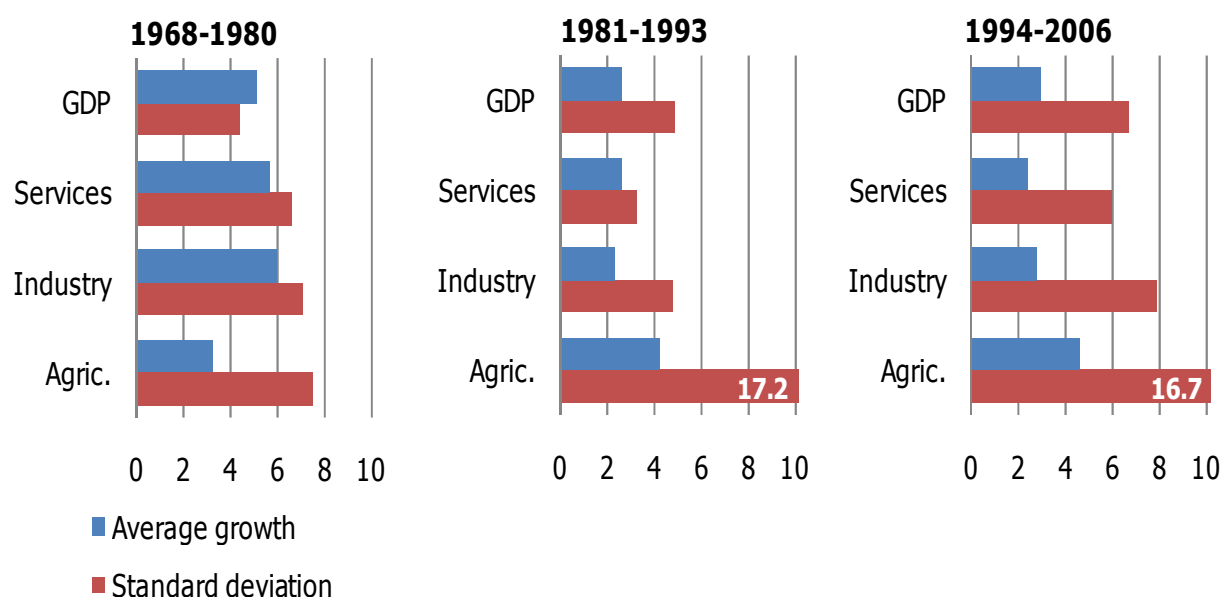
Agricultural growth rates, while averaging only 1.00 for the ten year period 1998–2008, have improved drastically in the past few years. This sector grew by 6 per cent in 2007 and 5.2 per cent in 2008 (Table 3). Manufacturing growth rates have also improved in the period 2007-2009, reflecting increased output in agro-processing. As Figure 2 shows however, there is considerable year-on-year variation in agricultural growth, with the standard deviations for growth in each time period being high. This reflects the weather and imported input dependence of this sector.

Table 3. Sectoral growth rates

	1988-98	1998-08	2007	2008	2009
Agriculture	6.2	1.00	5.9	5.2	
Industry	2.7	3.1	8.5	6.0	
Manufacturing	1.7	1.1	9.3	6.4	
Services	2.3	3.0	4.0	4.9	

Source: World Development Indicators 2010

Figure 2. Sectoral growth rates



Source: Derived from World Bank Country at a Glance Malawi tables.

c) The role of maize in the Malawian economy

Maize is the primary domestic agricultural crop in Malawi. Around 80 per cent of maize cultivation is done by smallholders for subsistence. The Poverty and Vulnerability Assessment (World Bank, 2006) estimates that only 10-15 per cent of the total crop is sold, that around half (52 per cent) of small holders sell *some* of their output on the market, but that only 18 per cent sell more than half of their output.

Maize production is promoted through an extensive input subsidy which is the central plank of the Malawi government's social sector strategy. While agriculture is allocated around 14 per cent of the total national budget, around 80 per cent of the agricultural budget was spent on the input subsidy in 2009.

Several studies have shown that the input subsidy programme is an important determinant of food security in Malawi. (DfiD 2008). Complemented by favourable rainfall conditions, Malawi has registered surplus national maize production since 2006, even managing to export some of the surplus grain in 2007.

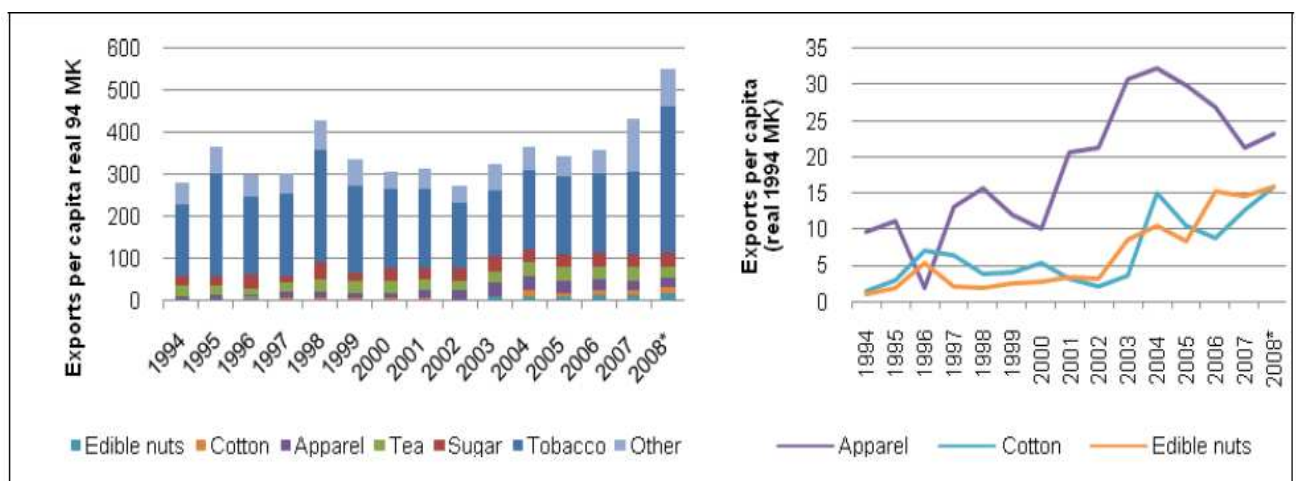
There has been debate in Malawi around the extent to which maize production drives economic growth. Much of the research points to the conclusion that, while central to welfare, maize does not dominate the dynamics of economic growth. One explanation for this limited correlation between maize output and GDP growth is the high proportion of output which is consumed by the producer and which never reaches the market. Hence, although clear that very poor harvests are associated with contractions in output the correlation is weaker in years of good harvest. Maize contributes to GDP – by definition – but strong maize harvests alone do not inevitably create strong overall growth.

d) A narrow concentration of exports

Tobacco which is Malawi's main cash crop is also the country's main export. The share of tobacco in total exports is around 60 per cent. Malawi's export basket therefore is highly concentrated in a few products, leaving the country highly vulnerable to demand changes and terms of trade shocks. Just four crops (Tobacco, tea, sugar and cotton) account for 75 per cent of exports.

The composition of exports has not changed significantly over time. There has been virtually no change in the export basket since 1994, apart from the nascent incursions of apparel, cotton and edible nuts (Figure 3) . These have expanded at an average per capita rate of 11 per cent since 1994 but combined still account for less than one tenth of total revenue.

Figure 3. Export Trends



Source: National Statistical Office (various)

This lack of export diversification is a key weakness of the economy. It puts heavy reliance on the tobacco sector and commits the economy to growth constrained by world

demand for a niche product. While recent economic growth rates can partly be explained by rises in the tobacco price, the economy remains vulnerable to adverse future price shocks. Expansion of tobacco production does not appear to be a viable export strategy for the medium to long term. The majority of Malawi's tobacco crop is burley which is used mainly as a neutral flavoured filler in the market for high-end cigarettes. Although expanding, there is a ceiling on world demand for such tobacco.

The high level of export concentration is further revealed in Table 4. The Herfindahl-Hirschmann index for Malawi is 0.625, compared with an average of 0.40 for developing countries.

Table 4 Malawi Relative Structure of the External Sector (Current Account)

	2000			2009		
	No. of Products Exported/Imported	Diversification Index	Concentration Index	Number of Products Exported/imported	Diversification Index	Concentration Index
Exports						
WORLD	261.000	0.000	0.074	260.000	0.000	0.071
DEVELOPING ECONOMIES	261.000	0.262	0.129	260.000	0.228	0.120
TRANSITION ECONOMIES	261.000	0.568	0.207	260.000	0.560	0.324
DEVELOPED ECONOMIES	260.000	0.132	0.071	260.000	0.174	0.060
Developing Economies Africa	260.000	0.608	0.350	260.000	0.577	0.400
Eastern Africa	243.000	0.730	0.134	260.000	0.668	0.130
MALAWI	70.000	0.805	0.585	111.000	0.809	0.625
Mozambique	214.000	0.788	0.307	236.000	0.734	0.322
South Africa	260.000	0.544	0.141	253.000	0.582	0.145
WORLD	261.000	0.000	0.073	260.000	0.000	0.071
DEVELOPING ECONOMIES	261.000	0.178	0.088	260.000	0.170	0.087
TRANSITION ECONOMIES	259.000	0.310	0.059	259.000	0.243	0.051
DEVELOPED ECONOMIES	260.000	0.074	0.077	260.000	0.103	0.075
Developing Economies Africa	260.000	0.279	0.061	260.000	0.276	0.065
Eastern Africa	259.000	0.411	0.090	260.000	0.391	0.104
MALAWI	183.000	0.533	0.143	252.000	0.490	0.118
Mozambique	256.000	0.440	0.070	257.000	0.490	0.113
South Africa	260.000	0.298	0.132	259.000	0.240	0.142

Source: Reserve Bank of Malawi, Financial and Economic Reviews

Note: Diversification Index is computed in terms of difference of structure of trade from world average, ranging 0-1 with 1 for big difference. Concentration Index is based on the Herfindahl-Hirschmann index and lies between 0 and 1 (highest concentration).

e) A high level of import-dependence

The Malawian economy is also highly import-dependent (Table 5). Imports of consumer goods, food and “other manufactures” account for 40 per cent of the total value of merchandise imports, well in excess of capital goods imports.

Table 5 The structure of imports

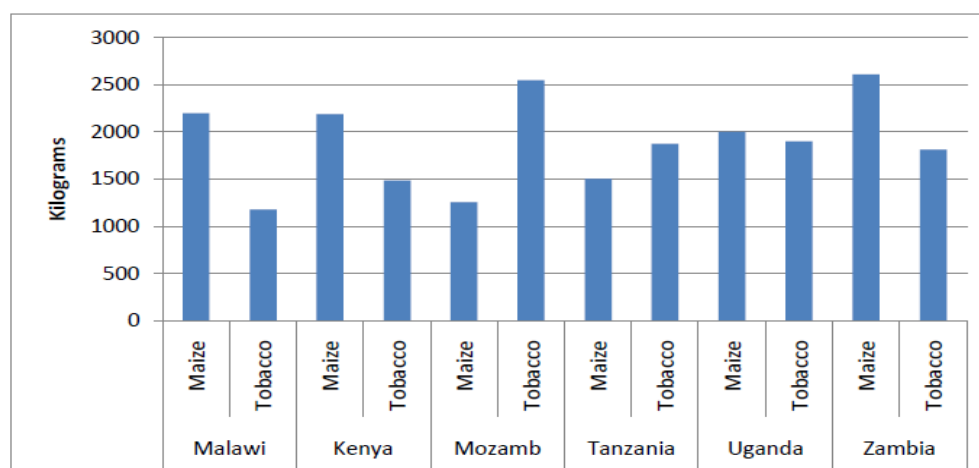
Imports/GDP (2009 %)	42
Food Imports/Total Imports (%)	15
Fuels as % Total Imports	11
Manufactures as % Total Imports	72
Of which	
chemicals	22
machinery	25
other	25

Source: UNCTAD 2010

f) Low productivity in agriculture

Agricultural productivity has shown little improvement in the past decade. Maize production is also marked by low productivity levels, reflecting insufficient irrigation and weak technologies. While potential yields for hybrid maize range from 5 to 8 tons per hectare, average actual yields in Malawi have been around 1.5 tons and rarely reached more than 2.5 tons. Productivity levels in tobacco cultivation are also low. Currently, tobacco yields are around one tonne per hectare, lower than many other African countries (Figure 4).

Figure 4 Average maize and tobacco yields per hectare



Source: FAO Statistics database.

g) Limited Irrigation and Infrastructure

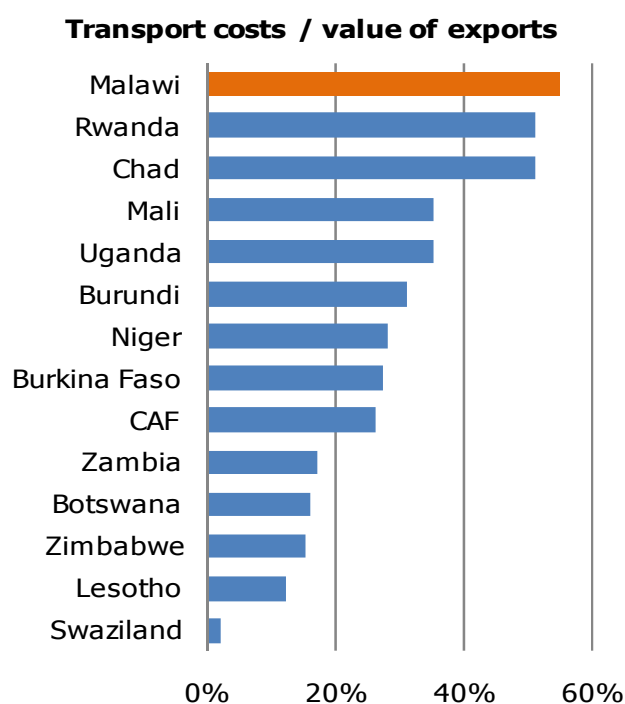
Agricultural production in Malawi is mainly rain-fed. Irrigation in Malawi is scarce and only 27 per cent of potential land is irrigated. The dependence on rain-fed agriculture makes the output performance of this sector highly volatile. Malawi farmers rarely use even low cost, technologically simple means of irrigation, reflecting their inability (due to a lack income, mainly) to undertake even such small investments.

Historically Malawi has experienced serious droughts (1992, 1994, 1997, 2002, 2005) and floods, both of which have impeded agricultural productivity, damaging both agricultural land and crops. This rainfall variability is thought to have intensified risk-averse behaviour by farmers and investors in agricultural industries and services, limiting diversification into other cash crops.

Infrastructure in Malawi is poor. As a landlocked country, Malawi is marked by very high transport costs, amongst the highest in the world (Figure 5). Road conditions have improved significantly since 2004 but are still inadequate. In 2007, 33 per cent of the total road network was in good condition compared to 24 per cent recorded in 2006. Improvement in road infrastructure is the result of active donors' support, notably that of the European Union. Much of this upgrading however has been of main roads. Unpaved roads that serve the majority of the population remain in poor condition, making it difficult for farmers to move their crops for sale and making them dependent on local traders who pay lower than market prices.

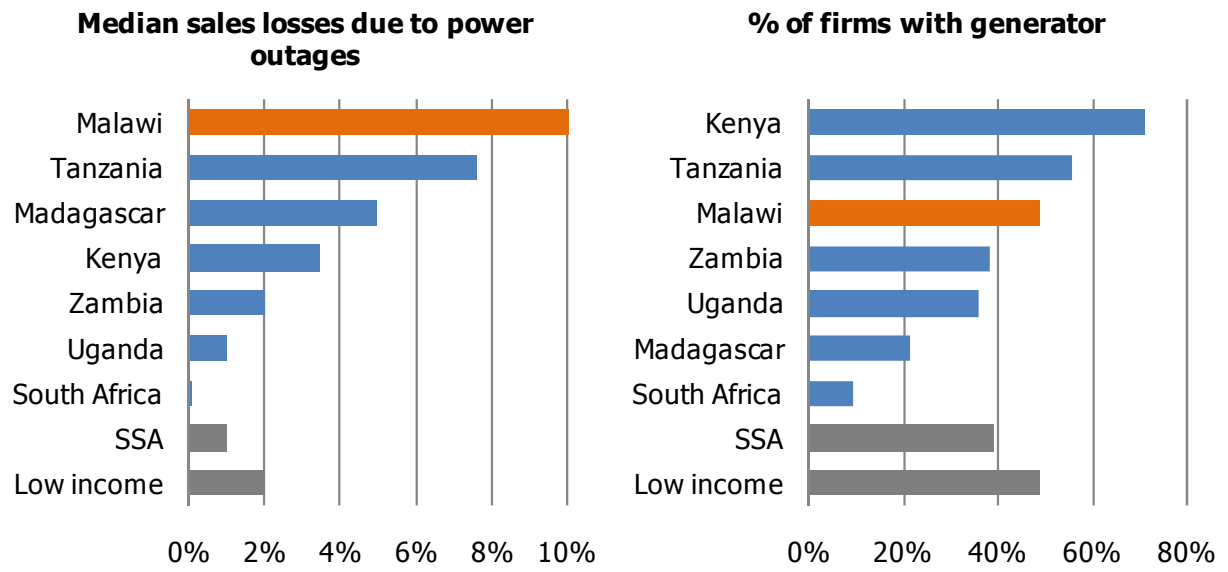
The state of power infrastructure is also poor, impacting on returns to investment and constraining new investment. As Figure 6 indicates Malawi had the highest level of sales losses due to power outages, compared with other sub-Saharan African countries.

Figure 5. Transports Costs



Source: African Development Bank 2009

Figure 6. Electricity Supply Shortfalls



Source: African Development Bank (2009)

2.2 Trends in employment and poverty

a) Widespread poverty and a high incidence of rural poverty

Poverty in Malawi is widespread. In 2009 it was estimated that 40 per cent of Malawi's population lived in poverty. This, however, is an improvement over the 54 per cent poverty rate recorded in 2004 (National Statistical Office NSO 2009).

While the overall incidence of poverty in Malawi is around 40 per cent, rural poverty is significantly higher than urban poverty. The incidence of rural poverty in 2008 was 44 per cent, as compared with a 13 per cent incidence of urban poverty. Urban poverty has fallen more rapidly than rural poverty in recent years. While rural poverty fell from 56 to 44 per cent between 2005 and 2008, urban fell from 25 per cent to 13 per cent in the same period.

Table 7. The Incidence of Poverty in Malawi

Table 19. Poverty headcount ratios

	IHS1 1998	IHS2 2004	WMS 2005	WMS 2006	WMS 2007	WMS 2008
Proportion poor						
Malawi	54	52	50	45	40	40
Urban	19	25	24	25	11	13
Rural	58	56	53	47	44	-
Rural Northern region	56	56	51	46	46	35
Rural Central region	48	47	46	40	36	40
Rural Southern region	68	64	60	55	51	51
Proportion ultra-poor						
Malawi	24	22	21	17	15	15
Urban	5	8	8	6	2	3
Rural	26	24	23	19	17	-
Rural Northern region	25	26	21	17	18	11
Rural Central region	16	16	16	12	11	12
Rural Southern region	35	32	30	25	22	24

Sources: NSO (2000, 2005, 2006, 2007, 2009a).

b) Low levels of human development

Multi-dimensional poverty is also widespread and human development levels in Malawi are low. Malawi's Human Development Index (HDI) value for 2010 is 0.385, which puts it in the low human development category and positions the country at 153 out of 169 countries and areas. Between 1980 and 2010, Malawi's HDI value increased from 0.258 to 0.385, an increase of 49 per cent or average annual increase of about 1.3 per cent. Table reviews Malawi's progress in each of the HDI indicators. Between 1980 and 2010, Malawi's life expectancy at birth increased by about 10 years, mean years of schooling increased by almost 3 years 4 and expected years of schooling increased by about 4 years. Malawi's GNI per capita increased by 21 per cent during the same period.

However, Malawi's 2010 HDI of 0.385 is below the average of 0.389 for countries in Sub-Saharan Africa. It is also below the average of 0.393 for low human development countries.

Table 6. Human Development Malawi

	Life expectancy at birth	Expected years of schooling	Means years of schooling	GNI per capita (PPP US\$)	HDI value
1980	44.8	4.8	1.8	752	0.258
1985	46.6	5.2	2.1	740	0.274
1990	49.3	5.8	2.5	653	0.289
1995	51.9	11.4	2.8	697	0.344
2000	51.0	10.3	3.0	734	0.344
2005	51.1	9.1	3.4	669	0.336
2010	54.6	8.9	4.3	911	0.385

Source: Human Development Report, UNDP, 2010

c) High levels of underemployment

Current data on unemployment and employment in Malawi is largely non-existent. A Labour Force Survey has not been undertaken since 1993. Existing employment data is based on small household surveys that aim to capture welfare and therefore give little indication of the true incidence of underemployment. However, high levels of absolute poverty indicate that large segments of the population lack regular, paid work.

d) The informal sector as key source of jobs

Malawi's workforce is mainly engaged in informal work, again reflecting the prevalence of small holder agriculture. It is estimated that around 90 per cent total working population is engaged in the informal sector. Women are less likely to be engaged in formal sector work than men. Women's share of wage employment is only 20 per cent (ILO 2010). The vast majority (90 per cent) of women work in the 'agriculture, forestry and fisheries' sector.

The only survey that primarily focuses on the informal sector is the Malawi National Gemini Micro and Small Scale Enterprise (MSE) Survey from 2000 (NSO, 2001). It covered firms with less than 50 employees and on-farm agricultural activities as long as 50 per cent of the production was sold and the household earned more than MK 6,000 from the sale of the produce. The survey thus included both mlimi who sell a large part of their harvest, and small firms, capturing small-scale private businesses which mainly is in the informal sector.

MSE's employed over 1.7 million people in 2000, which was 38 per cent of the total labour force. Many of these were of course smallholder farmers, but the off-farm enterprises employed as many as 22 per cent of the labour force. This reflects the low commercialization rate among smallholders; most of them sell much less than 50 per cent of their produce. Women made up over 40 per cent of the employees, and 80 per cent of the MSEs were located in the rural areas (NSO 2001).

e) Widespread employment in micro and small enterprises

Micro and small enterprises (MSEs) employed around 38 per cent of the labour force in 2008 (ILO 2009). Nearly 80 per cent of micro and small enterprises are in rural areas, many of them farms. However, off-farm MSEs accounted for around 22 per cent of rural employment.

The size distribution of enterprises in Malawi shows a duality – with concentration in micro/small size ranges and in the larger ranges. Employment in medium-sized enterprises is limited, partly indicating that MSEs rarely graduate into medium-sized

firms. Expanding this ‘missing middle’ in the enterprise size distribution could have positive implications for employment creation.

f) Low wage levels and low levels of labour productivity

Wages in Malawi are low. For instance, the monthly wage of a farm worker in Malawi is half that of a farm worker in Mozambique (ILO 2009). In addition, wage differentials across economic sectors are very high. An agricultural worker earns only about 4 per cent of the monthly average wage in the banking sector.

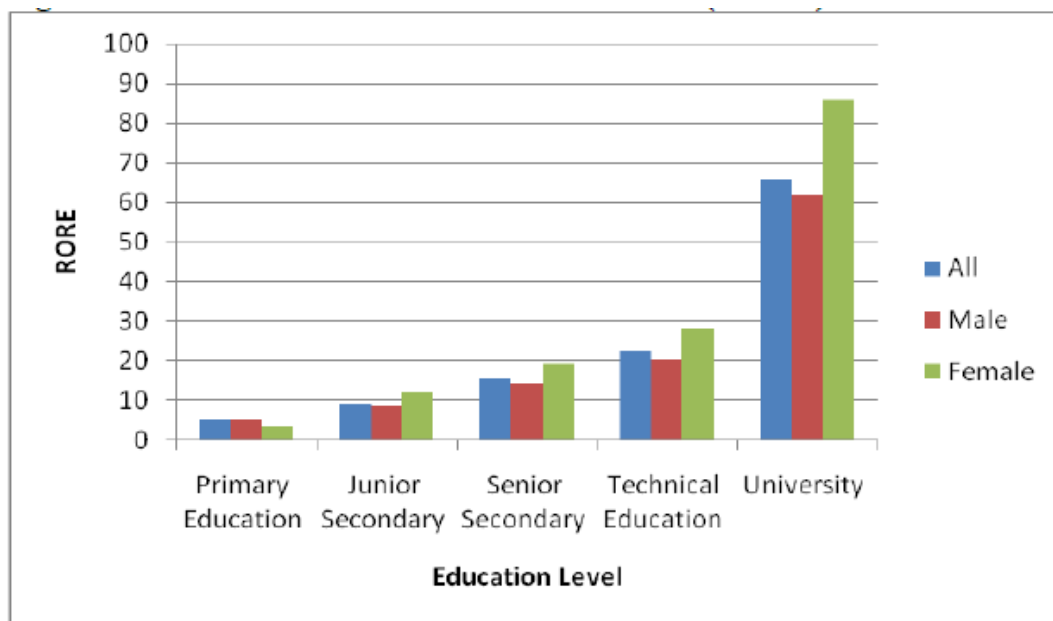
The productivity of Malawi’s workforce is low. Labour productivity growth was negative between the years 2000 and 2004 and showed a positive increase of 4.6 per cent during 2005-2008.

g) Large gaps in education attainment

There is a wide gap in education attainment in Malawi. The primary school attendance rate reasonably high -88 per cent for girls and 82 per cent for boys. Secondary school attendance, however, is very low - 22 per cent rate for girls and 25 per cent rate for boys (NSO 2009).

Private rates of return to higher education are very high due to the scarcity of highly skilled workers (Figure 7). Chirwa and Matita (2009) found that an additional year of university education in Malawi leads to a 62 and 86 per cent wage increase for employed males and females respectively. One more year of TEVET education leads to 20 and 28 per cent wage increase for males and females respectively.

Figure 7 Rates of Return to Education



Source: Chirwa and Matita, 2009.

The supply of vocational and technical skills in Malawi is very limited. Available data shows that at 35 TEVET students per 100,000 inhabitants, Malawi has the lowest number of technical and vocational students relative to comparator countries. This is reflected in the high proportion of unskilled workers in sectors such as manufacturing which we noted above.

This serious dearth of secondary education and technical skills in Malawi indicates a ‘missing middle’ in the distribution of skill levels.

h) Limited access to finance for the poor

The rural economy in Malawi is characterized by missing markets, in particular for credit. Most smallholders farmers lack access to formal lending sources.

As Table 8 shows commercial bank lending to the agricultural sector as a proportion of total bank lending fell from 26.5 per cent in 1990 to 10.8 per cent in 2009. The dramatic increase in credit to ‘community, social and personal services’ (from 1.9 per cent of total credit in 1990 to 30 per cent in 2009), partly reflects lending for private consumption, a big chunk of which is import oriented.

Table 8. Commercial Bank Lending to Key Sectors (as a percentage of total commercial bank advances)

	Agriculture	Manufacturing	Community, Social and Personal Services	Wholesale and retail Trade
1990	26.5	22.6	1.9	33.7
1995	28.5	25.6	4.3	19.4
2000	7.5	18.5	2.1	16.9
2005	9.8	13.3	14.5	14.9
2009	10.8	13.8	30.0	11.8

Source: Computed from Reserve Bank of Malawi, Financial and Economic Review 2010

2.3 Structural change to create more and better jobs in Malawi

Economic growth that brings with it sustained employment creation requires structural change. We identify five types of structural change that are required for generating job-rich growth in Malawi.

1. Diversification within agriculture by reducing the importance of maize in total agricultural output and increasing the importance of other food crops and cash crops.
2. Diversification away from agriculture by reducing the share of agriculture in total GDP and increasing the share of rural and urban non-farm sectors.
3. Diversification of the export sector by reducing dependence on a single product, namely tobacco, and by encouraging export sectors with higher value added and greater downstream and upstream linkages to the domestic economy – for instance, an integrated cotton and textile industry. It is important that Malawi steps onto the first rungs of the ladder of international comparative advantage in non-primary commodities.
4. Reducing the duality in the size distribution of farm and non-farm enterprises, thereby addressing the problem of the ‘missing enterprise middle’.
5. Changing the distribution of skills across the population so as to rectify the existing duality of a small number of highly skilled workers and a large number of workers with basic skills by increasing middle level skills.

In this paper we argue that the five types of structural change highlighted above require an integrated policy approach that links growth, job creation, skill development and technological change. A market-based approach that relies on the price mechanism

alone for resource allocation will not deliver this in the short or medium term. Neither will fiscal and monetary policy that strives only for stabilization.

What is necessary is strategic and selective intervention by the state to pull and push productive resources into new employment generating sectors. And contrary to the orthodox belief, there is scope for the government to use macroeconomic policies for the strategic direction of productive resources. Such behaviour need not be distortionary or have negative growth and welfare effects as orthodoxy predicts. Indeed, as the experience of high performing economies (South Korea, China, India) has shown, developing countries do have a mix of macro policy instruments at hand which can be used to generate job-rich growth

Section three

The macroeconomic policy environment in Malawi

3.1 Malawi's recent programme with the IMF

Malawi reached a completion point under the Heavily Indebted Poor Countries (HIPC) Initiative of the International Monetary Fund (IMF) in 2006. This led to a relief of \$646 million worth of debt (in net present value terms) under both HIPC and Multilateral Debt Relief Initiatives (MDRI), as well as a topping up assistance worth \$411 million in NPV terms. It is estimated that this would reduce the country's annual debt service expenses to \$5 million between 2006 and 2025, and increase average annual debt service savings from \$39 million to \$110 million within the same period (see Benson & Mangani, 2008).

As a spill-over effect of the IMF decision, some donor countries also cancelled Malawi's bilateral debt obligations. Importantly, reaching the HIPC completion point sent strong signals regarding macroeconomic management, and increased both the country's sovereign credit rating and investor confidence. In addition, following a satisfactory final review of the Poverty Reduction and Growth Facility (PRGF) programme in July 2008, Malawi recently became the first recipient of a one-year US\$77 million IMF Exogenous Shock Facility, (ESF) in the wake of high world prices for fertilizer and oil (CABS Group, 2009a). However, only US\$52 million the total ESF value was actually paid out, and the programme was prematurely abandoned because the Government of Malawi could not meet some programme targets. A new three-year programme with the IMF was approved in February 2010.

Malawi came through the global crisis with high growth rates but with a weak external position. The crisis led to a terms of trade shock in 2008 and, to a lesser extent, 2009. The increase in fuel and fertilizer prices in 2008 resulted in an estimated deterioration in the balance of trade of about 7 per cent of GDP. The increase in 2008 fertilizer prices alone was estimated to have contributed to an increase in import costs of almost 3 per cent of GDP, given the government's commitment to maintain the size of the input subsidy program in 2008 and expand it in 2009.

While current account deficits in Malawi are persistent, the deterioration in 2008 and 2009 was particularly severe. The current account deficit worsened from 1.6 per cent of GDP in 2007 to 6.4 per cent and 8.6 per cent in 2008 and 2009, respectively. This was driven in 2008 mainly by worsening terms of trade, while in 2009 this was partly the result of the spillover impact of higher prices from 2008 as well as a growing import bill and moderate growth in exports and net transfers.

In the face of this, in 2008 Malawi became a recipient of US\$77 million from the IMF's Exogenous Shock Facility. Following the expiration of this program in December 2009, the authorities negotiated a new medium-term macroeconomic program with the IMF.

The stated objectives of the IMF programme are:

1. Restoring external equilibrium by liberalizing the foreign exchange regime for current account transactions and by attaining foreign reserves to cover three months of imports
2. To maintain internal equilibrium by prudent fiscal and monetary policies that contain aggregate demand and inflation

3. Sustaining poverty reduction by creating room in the budget for more pro-poor spending and by creating safety nets to protect the poor from exogenous shocks
4. Building competitiveness by encouraging public financial management, tax administration and the efficiency of public enterprises

3.2 The Malawi growth and development strategy (MGDS)

The Malawi Growth and Development Strategy (MGDS) is the overarching development strategy for Malawi for the five years from 2006/2007 to 2010/2011 fiscal years. The MGDS sets out development priorities and proposed outcomes and budgetary allocations. The overall goal of the MGDS is to transform the country from a predominantly consuming and importing country to a producing and exporting country

The main thrust of the MGDS is to create wealth through sustainable economic growth and infrastructure development as a means of achieving poverty reduction. It presents a policy framework that articulates issues related to both economic growth and social development. The policy mix of the MGDS is aimed at achieving the medium-term development objectives of sustainable economic growth and infrastructure development

3.3 The MGDS and strategic interventions in the economy

The MGDS emphasises six key priority areas. These are agriculture and food security; irrigation and water development; transport infrastructure development; energy generation and supply; integrated rural development; and prevention and management of nutrition disorders, HIV and AIDS. These six key priority areas are also expected to accelerate the attainment of the Millennium Development Goals (MDGs) in the areas of health, education, gender, environment, and governance.

These six key priority areas have been selected from the broad MGDS framework of five thematic areas namely; sustainable economic growth; social protection; social development; infrastructure development and improving governance.

The MGDS picks out specific sectors to promote. For instance in terms of rural development, it details the need to build a strong integrated cotton-textile sector which will promote rural incomes through backward and forward linkages. The potential for export earnings from this industry is also emphasized.

In this sense the MGDS sets out a strategic interventions in the economy which are designed to generate growth-enhancing structural change.

3.4 The MGDS and budget priorities

In terms of budget prioritisation of the key target areas, transport infrastructure development takes the largest share of resources estimated at 54.1 per cent over the five years period. This is mainly a reflection of the high costs of proposed infrastructure projects, such as the development of the Shire Zambezi waterway. This is followed by agriculture and food security at 12.2 per cent. The combination of agriculture and food security, and irrigation and water development yields a total allocation of 21.0 per cent. This indicates recognition of the need to increase agricultural productivity.

The prevention and management of nutrition disorders, HIV and AIDS takes 11.2 per cent of the resources. Integrated rural development and energy generation and supply are estimated to be allocated 10.1 per cent and 3.6 per cent respectively.

3.5 Limitations of the MGDS

There are many commendable aspects to the MGDS. It identifies structural weaknesses in the economy and picks out strategic interventions to deal with them. However, several limitations of the MGDS can be noted. Most relevant for our analysis is the fact that the MGDS does not set any employment targets for its priority areas. Many officials who we interviewed for this study recognized this shortcoming. It is intended that the MGDS2, which is currently being prepared, will have more explicit consideration of employment.

Further, while the MGDS, contains explicit elements of a selective industrial strategy – for instance by picking sectors such as the cotton-textile sector for promotion – there is limited discussion of specific measures that can be used to attract private investment into this sector. The role of public spending in building up such a sector is also not adequately addressed.

In addition, while the MGDS sets out expenditure targets, it is based on the assumption that containing the fiscal deficit is central to stabilization. It does not therefore consider possibilities of expanding deficits in the medium term to increase state expenditure in the priority areas.

Section four

Monetary policies for employment creation in Malawi

4.1 The conduct of monetary policy in Malawi

The conduct of monetary policy in Malawi since independence can be outlined in three broadly distinct monetary policy regimes –a) the period of financial repression (1964-86), b) the period of financial reforms (1987-1994) and c) the period of financial liberalisation (post-1994).

Financial repression 1964-1986

At independence in 1964, the formal banking system which the country adopted from the colonial government was perceived to be primarily interested in serving the needs of an expatriate community, to have little interest in direct lending to local entrepreneurs, and to impose unreasonably high charges on routine banking services (Gondwe, 2001). To get rid of these distortions, direct controls on credit and interest rates were imposed. The agricultural sector, in particular, was accorded preferential lending rates and quota credit allocations in line with government policy to promote agricultural production. A fixed exchange rate regime was also adopted and the limited price-controls on selected commodities which had been inherited at independence were extended to protect the internal terms of trade for rural relative to urban dwellers.

In the late 1970s, a hostile external environment forced the economy into a deep recession, which persisted through the 1980s. Intensifications of civil war in neighbouring Mozambique, a consequent flooding of refugees into the country and disruption of a cost effective route to the sea ports of Beira and Nacala, the 1979 oil crisis and drought in 1980 were some of the factors that triggered the recession. In response, a phased financial liberalisation program targeted at enhancing competition and efficiency in the financial sector was adopted.

Financial reforms 1987-1994

The reforms commenced with partial deregulation of lending rates in July 1987 and deposit rates in April 1988. The partial deregulation allowed commercial banks to determine their own lending and deposit rates but not to effect any adjustment without prior consultation with the central bank. Credit ceilings were abolished in 1988. In January 1990, the authorities announced the abolition of preferential lending rates to the agricultural sector. Complete deregulation of the interest rates occurred in May 1990.

The reform program also overhauled the legal and regulatory framework of the banking system, which involved revision of the Reserve Bank of Malawi Act of 1964 and Banking Act of 1965 in May 1989 and December 1989, respectively. While the central bank was previously supervising commercial banks only, the revised Banking Act extended its coverage to include non-bank financial institutions (NBFIs), a function that was previously in the hands of the Treasury. In addition, inspection of the financial institutions was broadened to include adherence to prudential requirements besides compliance to exchange control regulations.

Financial liberalisation –post 1994

Malawi's financial reforms reached near-completion with the floatation of the Malawi Kwacha on February 7, 1994. Subsequently, the monetary authorities removed exchange control regulations, allowed for the establishment of foreign exchange bureaux, introduced foreign currency denominated accounts, established a forward foreign exchange market and started the trading of foreign exchange options and currency swaps. Eight new commercial banks (one of which has since been liquidated) entered the commercial banking sector since 1994, changing the structure of the market from a duopoly to a fairly competitive sector.

4.2 The Reserve Bank of Malawi – Monetary targets and instruments

The Reserve Bank of Malawi (RBM) has been operational since 1965. The current enabling legislation of the RBM, the Reserve Bank of Malawi Act 1989, stipulates the bank's mandate in relation to monetary policy in very broad terms, as follows:

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

To operationalize these broad policy objectives in the short to medium term, the RBM proclaims the monetary policy objective of achieving low inflation and low interest rates, and sets an inflation target of 5 per cent by 2011. While the RBM clearly sets price stability as its measurable monetary policy objective in the short-term, it remains vague in terms of the uniqueness of its policy instrument, as is evident in the following pronouncement:

In Malawi the objective of monetary policy is to bring inflation down to a single digit by 2008. To achieve this, reserve money will remain the anchor of monetary policy. The Reserve Bank of Malawi uses a combination of instruments to achieve its objective on monetary policy. These include the bank rate, liquidity reserve requirements, open market operations, and sales and purchases of foreign exchange.

While in recent years the key intermediate target of monetary policy has been the control of growth in broad money (M2), the operating procedure has focused on monitoring growth in reserve money (M0). This monitoring process is achieved through reserve money programming within the IMF's monetary programming model for the country, which sets monthly and quarterly reserve money targets based on broad money targets thought to be consistent with the desired levels of economic growth and inflation (Kwalingana, 2007). Therefore, once an estimate of the commercial banks' liquidity requirements is made, the procedure involves RBM's intervention through changes in the amount of reserve money according to the stipulated liquidity reserve ratio (LRR), by manipulating commercial banks' access to credit from the central bank.

The present definition of the LRR is the ration of liquid assets (comprising cash, net balances with the RBM, Treasury Bills, exchange discounted and purchased payable in Malawi, Local Registered Stocks and transit items) to commercial banks' liabilities to the public. (Reserve Bank of Malawi, 2010)

4.3 Inflation trends in Malawi

Malawi has experienced double-digit inflation for long periods since independence. Inflation worsened after the financial reforms of the late 1980s, averaging around 25 per cent during 1995-2004. After the interest rates were decontrolled in 1990 and the exchange rate was freed in 1994, there was severe upward pressure on prices. This was

largely due to the high cost of borrowing (the Bank rate increased to 50 per cent by 1995) and to the sharp rise in import costs following the depreciation of the kwacha in 1994. Annual inflation exceeded 60 per cent in 1995.

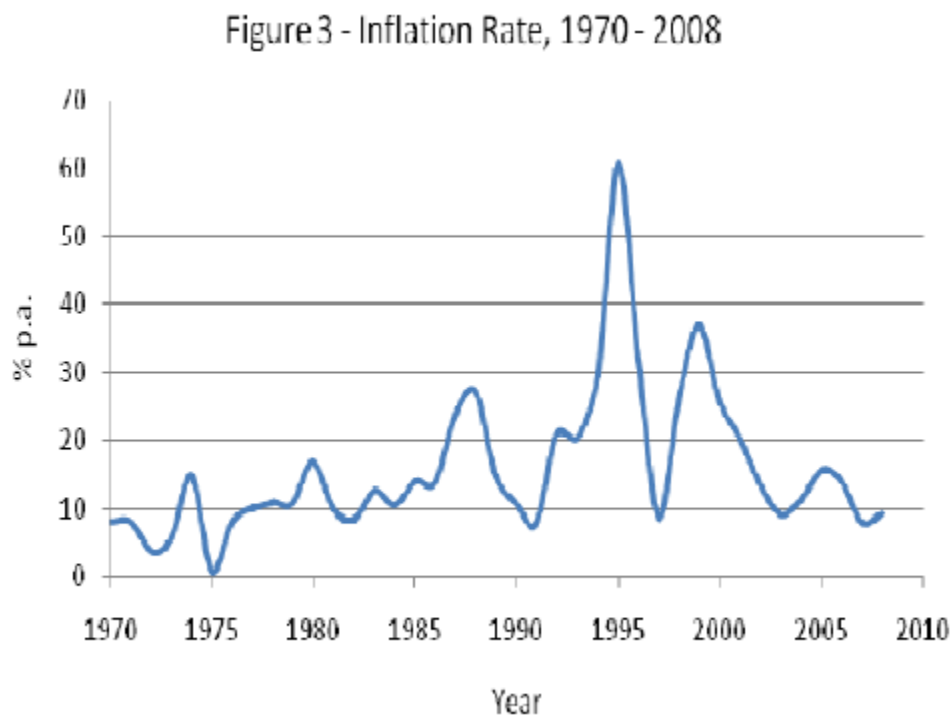
Since 2004, however, there has been a drastic fall in inflation. In recent years inflation has remained moderate. After rising in late 2008, in response to food and fuel price shocks, consumer price inflation decreased steadily to 7.5 per cent in the 12 months to October 2009 (Table 9 and Figure 8).

Table 9 Inflation rates

Year	Inflation Rate
2005	15.4
2006	13.9
2007	8.0
2008	8.7
2009	7.5

Source: Reserve Bank of Malawi –Financial and Economic Reviews

Figure 8 Inflation in Malawi



Source : Mangani (2009)

4.4 The causes of inflation in Malawi

Several recent econometric studies have examined the relationship between the money supply and price levels in Malawi using vector autoregressive models (Mangani 2009; Ngalawa 2009). These studies conclude that the conventional monetary theory of inflation, where an increase in money supply leads to an increase in price levels, does not hold in the case of Malawi. In fact periods with falling inflation (such as the current period) were associated with an increase in the money supply (Ngalawa 2009).

In addition, these econometric studies show that while the lending rate instantaneously responded to bank rate adjustments and although the lending rate somewhat influenced money supply, the effects were hardly ever transmitted to prices. So the Keynesian interest rate view of the monetary policy transmission mechanism also does not apply to Malawi. Interest rates affect inflation via a cost of production effect rather than through money supply effects.

These studies find that the exchange rate that has the most powerful effect on price levels in Malawi. Therefore the exchange rate between the Malawi kwacha and the US dollar appears to be the nominal anchor of stabilisation in economy. The strong influence of the exchange rate on consumer prices reflects the country's high level of openness and import dependence (with imports amounting to 34 per cent of GDP) and a highly vulnerable foreign reserve situation due to a reliance on a narrow range of sources, most notably foreign aid and tobacco exports.

The de facto peg of the Malawi Kwacha to the US dollar has been associated with the moderation of the inflation since 2006 but of course this has led to the appreciation of the real effective exchange rate . In order to restore some external competitiveness and external reserve levels and conform with the IMF ECF programme this stance would have to be corrected, which could upset the inflation performance. This finding that the exchange rate is the most important variable in explaining prices is consistent with analytical results documented for Egypt (see Al-Mashat & Billmeier, 2007), Kenya (Rotich, Kathanje & Maana, 2007), and Ghana (Ocran, 2007).

Aid flows finance about 40 per cent of total expenditure and unpredictability affects the inflation process through the need to borrow in order to finance expenditures whose budgeting was conditioned on the aid. The borrowing could lead to a rise in interest rates and cost-push inflation.

4.5 Can monetary policy instruments be used to encourage Malawi onto a path of employment-generating growth?

Monetary policy can be 'ineffectual' in the context of a low-income country with virtually no domestic bond market (McKinley 2010). Moreover, the types of structural change required in the Malawian economy to promote job-rich growth calls for a re-channelling of resources from one sector to another, or from one industry to another. While macroeconomic policies (especially those that affect general liquidity levels) do not typically perform such a function, we have identified three policy areas for consideration. They are:

1. Reducing Excess Liquidity of Commercial Banks
2. Encouraging the Reserve Bank of Malawi to take on a Greater Developmental Role
3. Introducing interest rate flexibility which is tuned to seasonality in the agricultural sector in order to promote agricultural growth and job creation.

4.5.1 Reducing commercial bank excess liquidity to encourage employment-rich growth

Malawian commercial banks have been characterised by systematically high levels of liquidity (Table 10). As Table shows the liquidity ratio of banks in 2009 was around 35 per cent which is way above the required reserve ratio of between 15 and 20 per cent.

High levels of commercial bank liquidity have important implications for the use of monetary policy for stimulating employment-rich growth. It indicates scope for channelling credit to productive sectors which need to expand for the economy to undergo structural change.

Table 10 Commercial Banks Liquidity Ratios

Year	Liquidity Ratio
2002	51.5
2004	52.5
2006	42.0
2008	39.2
2009	36.5

Source: Computed from Reserve bank of Malawi Financial and Economic Review 2010

Excess liquidity: The literature

Excess liquidity is typically equated to the quantity of reserves deposited with the central bank by deposit money banks plus cash in vaults and other eligible liquid assets in excess of the required or statutory level. There is a large literature that notes the existence of excess liquidity among commercial banks in developing countries and investigates the reasons for this (Khemraj 2007).

Excess liquidity may simply sometimes reflect the holding of liquidity for precautionary purposes. In other words, the accumulation of non-remunerated reserves may be a result of commercial banks optimizing behaviour. Agénor, Aizenman, and Hoffmaister (2004), for example, argue that the accumulation of reserves in excess of requirements in Thailand during the Asian crisis was a result of a supply-side consideration, contraction in the supply of credit by banks, and not due to a reduction in the demand for credit. Hence, their results suggest that the build-up of reserves in Thailand during the Asian crisis was not excessive in the sense that it exceeded commercial banks desired level of reserve holdings.

Agénor, Aizenman, and Hoffmaister (2004) also highlight the role of increased uncertainty or risk of default or rising marginal cost of extending as a rationale for commercial banks' excess liquidity. Institutional factors may also encourage commercial banks to hold precautionary reserves. Poorly developed interbank markets, for example, make it difficult for banks to borrow in order to cover contingencies. It has also been suggested that difficulties encountered by banks in tracking their position at the central bank may require them to hold reserves above the statutory limits. In addition, banks may want to hold precautionary excess reserves due to problems with the payments

system. Also, remote bank branches may need to hold excess reserves due to transportation problems. Finally, the importance of agricultural finance for commercial banks could make both the demand for credit and supply of deposits highly seasonal and not suitably synchronised. The resulting seasonal volatility of deposits and credit demand is likely to increase demand for excess liquidity during certain seasons to cover contingencies.

However, not all excess liquidity may be voluntary. Some authors, for example Dollard and Hallward-Driemeier (1999) argue that, the build-up of excess liquidity in East-Asian countries during the crisis was a result of the reduction in the demand for credit, which itself was a result of the contraction in aggregate demand that accompanied the crisis..

If commercial banks hold more liquidity than they require, why do they not expand lending, buy government securities or reduce deposits?

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

In most Sub-Saharan African economies nominal interest rates are quite high and inconsistent with the presence of a liquidity trap. However, there may be impediments to the efficient functioning of financial markets that lead commercial banks to hold reserves in excess of that required for statutory and prudential purposes. In terms of the loan market, commercial banks may be (a) unable or (b) unwilling to expand lending to reduce involuntary reserves even if interest rates are positive. If governments are concerned about promoting financial deepening in the economy, they may therefore use moral suasion to make commercial banks accept deposits even where these lead to excess liquidity.

Even if banks are able to expand lending, however, asymmetric information and lack of competition suggest that they may not be willing to do so. In SSA, the financial sector is often dominated by a few commercial banks that essentially act as an oligopoly provider of private sector loans and purchaser of government securities. Thus, the benefit of expanding lending at the margin, which is the same as the opportunity cost of involuntary excess reserves, may be much lower than the interest rate and sufficiently low for commercial banks to be willing to accumulate involuntary reserves even when the interest rate is positive.

Also, even if commercial banks are unwilling to expand lending, one would still expect banks to reduce involuntary excess reserves by buying government bonds as these carry a higher yield than reserves. As commercial banks buy bonds, the spread between the return on bonds and reserves should fall until commercial banks are at a point of indifference where the prudential return on reserves equals the return on bonds. In this setting, involuntary excess reserves should only arise if bond yields went to zero so that the economy was in a liquidity trap.

This should be the case even if the non-bank public does not hold bonds. If banks are the only holders of bonds, then the central bank can effectively control the amount of bonds held by the banking sector. However, in this case, competition for bonds among banks should ensure that bond rates eventually fall as bonds are rolled over until a point of indifference between reserves and bonds. Hence, the existence of involuntary excess

liquidity in equilibrium is inconsistent with the existence of a liquid and competitive bond market.

In SSA, however, bond markets tend to be characterized by lack of competition between banks and a lack of a secondary market. Hence, there is no guarantee that the bond market will be able to perform the equilibrating role referred to above and thus enable commercial banks to run down involuntary excess liquidity.

Excess Liquidity in Malawi

There are 11 licensed commercial banks currently in Malawi with 19 per cent of the adult population banked (FinScope Malawi 2009). Total assets held by the banking system as of March 2009 was estimated at about US\$1.28 billion, of which more than 65 per cent is concentrated in the country's three largest banks (Ministry of Finance, 2010, Financial Sector Development Strategy, 2010-2015). There is only a limited interbank market.

Profitability among commercial banks in Malawi is very high. The average return on equity in the banking sector was estimated at 48 per cent at the end of 2008 (Malawi Financial Sector Development Strategy 2010). This level of profitability indicates that there is less pressure on commercial banks to diversify their client base and develop new markets for their financial services. As Table 8 on the sectoral composition of commercial bank lending showed, loans to the agricultural sector as a proportion of total loans has fallen over time. As noted in the Malawi Financial Sector Development Strategy 2010, this reflects banks intentionally reducing exposure to agricultural lending due to weak loan repayment. It appears that already high profitability levels have led banks to hold excess liquidity – they have few incentives to seek out new, more risky borrowers.

In addition, recent financial reform linked to the IMF programme has meant that the Reserve Bank has moved out of the foreign exchange market as the intermediary between the public and commercial banks. Commercial banks now buy and sell foreign exchange directly from those who generate it. They derive around 25 per cent of their total income from foreign exchange markets, with the authorities effectively subsidising banks by supporting market mechanisms that maintain high spreads (Financial Sector Development Strategy 2010).

The official spread is 2 per cent and Foreign Exchange Trading Guidelines do not allow banks to exceed the mid-rate when buying. Consequently banks have a spread of around 1 per cent which significantly boosts their profitability. This source of profits also allows banks to maintain high levels of liquidity but the direct access by commercial banks to tobacco proceeds has since been rescinded in February 2011.

Monetary policy recommendation one – Use a 'carrot and stick' approach to reducing bank liquidity

In the present economic reality, it is unlikely that commercial banks in Malawi will increase productive lending and change the risk/return trade-off that exists. Positive incentives to reduce liquidity or disincentives to maintain high liquidity are required.

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

The Carrot

The Reserve Bank could link commercial bank reserve requirements to lending for priority sectors. Hence it would allow a proportion of their lending, say 0.1 per cent, to these sectors to qualify as banks' eligible reserves. This therefore involves a strategic direction of credit by the state by using the 'carrot' of the reserve ratio as a policy instrument.

What are these priority sectors?

As we discussed in Section...priority sectors are those with strong backward and forward linkages that have potential for enhanced employment generation. For example, the MGDS emphasises the transformation of the economy to a producing (value-adding) and exporting one. The 'Integrated Cotton and Textile Sector' is given specific mention but this could apply to all manufacturing and exporting activities which should indeed be key priority for directed commercial bank lending. Tourism is another sector that will benefit from priority lending. Malawi has potential for reaching into the higher value end of the tourist market (for instance, aiming at joint Zambia/Malawi travel) but this requires capital investment.

In addition, wholesale lending to microfinance institutions can ease credit constraints for micro enterprises. This can go some way in helping these enterprises graduate into small medium-sized firms, thus addressing the issue of 'the missing middle' we identified in Section 3. This would come under sub-theme 1.2, "Enabling environment for business" and is addressed under the new, dedicated Financial Sector Development Strategy, 2010–2015.

The Stick

An 'excess liquidity tax' could be used as a 'stick' to discourage commercial banks from inefficient hoarding of cash. In other words, commercial banks could be disciplined if liquidity levels are higher than the Reserve Banks stipulated ratio. An alternative way viewing this can be as an inverse standing facility (short-term high-interest lending). Commercial banks have been at liberty in introducing "new products", which have included charges for making deposits (use of banking halls), charges on current account balances and pushing costs of faulty or malfunctioning software to customers. Also, from a policy design perspective it can be argued that this instruments is price-based and non-coercive.

Malawi is currently is moving towards a loan guarantee system through the establishment of a Credit Reference Bureau and National Identity system. This should ease the risk averseness of commercial bank to lend. With these institutional arrangements in place the Reserve Bank will be in a better position to use carrot and stick instruments to reduce excess bank liquidity in a way that promotes growth and employment creation.

4.5.2 Monetary policy recommendation two – A greater developmental role for the reserve bank of Malawi

The IMF expects progress in monetary policy to be reflected by a shift from direct instruments towards indirect money market operations which for developing countries is limited by underdeveloped capital markets. However, for structural transformation that boosts employment-creating growth this would not be enough. There is a need for discretionary measures with a stronger allocative stance. Epstein (Feb., 2009) building on the works of others shows that historically present day developed countries and those that

have registered recent success such as India and China were beneficiaries of central banks that played a developmental role.

In Malawi the Reserve Bank can play a role in mobilising resources for micro-finance institutions (MFIs), small and medium enterprises (SMEs) and key sectors such as manufacturing and exports capable of transforming economies, generating value addition, employment, incomes and export potential.

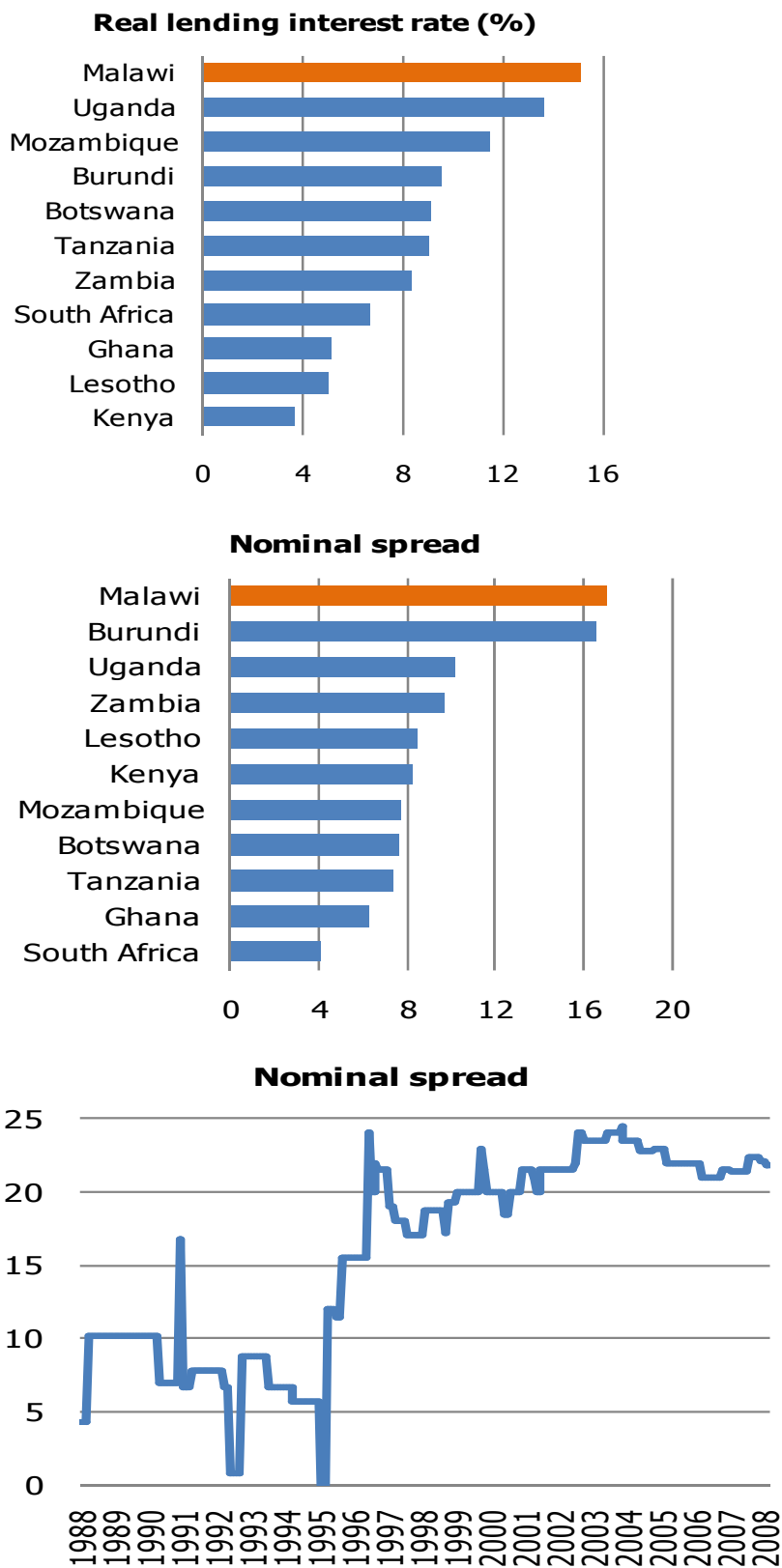
Loan guarantee programmes can be used for this end. These would guarantee a proportion of commercial banks loans to other financial institutions that have the experience to on-lend to SMEs which create decent jobs and other positive effects. The guarantees lower commercial bank risk, the need for collateral and also the final interest rate charges (or raise the risk-weighted price for the commercial banks).

Loan guarantee programmes are not monetary policy instruments but can achieve allocative outcomes while the narrow focus on inflation and deficits of IMF programmes has itself has been considered not to be development oriented and irrelevant for developing country needs (UNCTAD, 21 June, 2010). The Reserve Bank is mandated to improve the availability of credit and supporting private-sector-led structural change and economic growth. Moreover, the Malawi Growth and Development Strategy (1996–2011) and all the IMF programmes for more than a decade and including the current ECF have required policies that have a strong focus on poverty reduction. Currently the RBM oversees the development and articulation of the financial sector with the rest of the economy to improve the Government's ability to conduct macroeconomic policy through improved transmission channels. A host of bills have been prepared and some already passed by Parliament. These, include the Financial Services Bill, Banking Bill, Insurance Bill, Microfinance Bill, Credit Referencing Bureau Bill, the Financial Cooperatives Bill, the Reserve Bank of Malawi Bill, the Retirement Funds Bill, the Companies Bill, the Bankruptcy Bill and the Payments, Clearing and Settlement Bill. In addition a first stage Financial Sector Development Strategy 2010–2015 has been prepared.

4.5.3 Monetary policy recommendation three – Adjust interest rates to take account of seasonality in agriculture

While interest rates have been falling in recent years, Malawi's real lending rates are in the order of 15 per cent which is by far one of the highest in the world. Interest rate spreads at around 20 per cent- are also the highest in the region though decreasing slowly

Figure 9. Real Lending Interest Rates and Nominal Spread in sub-Saharan Africa



Source: IMF (2002)

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

This rationale for this recommendation can be elaborated as follows.

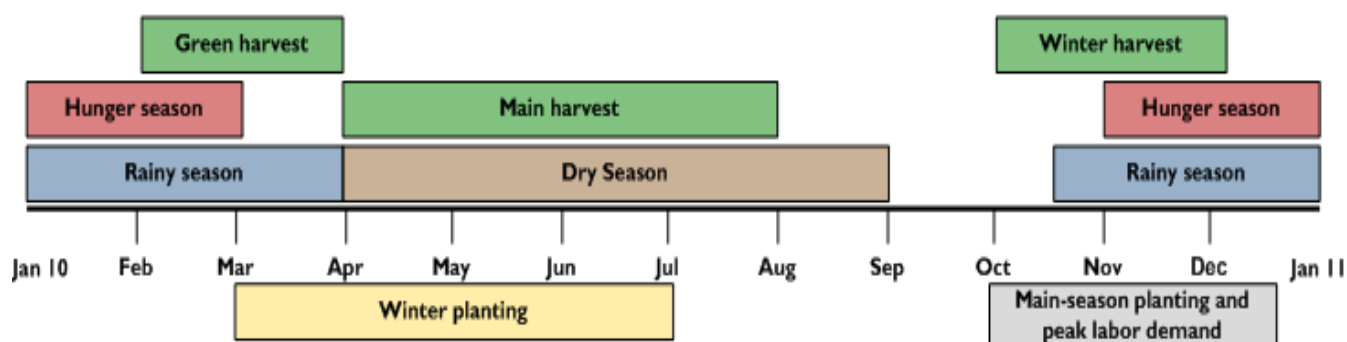
This paper calls for a delinking of the exiting directional relationship between inflation and interest rate changes. As a poor country food prices contribute highly to the national consumer price index in Malawi, an estimated 55 per cent (World Bank, 2004). Since maize, the main component of food for the majority is grown mainly on a subsistence basis and under uni-modal rain-fed conditions, in typical years its supply is limited and its price on the market display seasonality patterns. The price of maize tends to rise around the time when farmers are preparing for the next season's crop. Rising interest rates at this time deters investment and constrains future supply and pushes up prices in the longer term. Current policy thinking does not allow for falling interest rates at a time of rising prices. However, we suggest that it is important to recognise the seasonality of price movements and create flexibility in short-term interest rate movements. This argument extends to the whole agriculture sector including export and other cash crops whose supply needs to be strengthened for rural incomes and domestic value addition such as the integrated cotton and textile sector.

Interest rate manoeuvres of this sort are contingent on several factors. One, the willingness of commercial banks to lend (and the effectiveness of our proposed policies to deal with this). Two, the creation on new lending sources such as micro-finance institutions which are still in their infancy in Malawi. Such institutions should be encouraged to understand the seasonality of the demand for rural credit and manipulate interest rates accordingly.

Seasonality and Monetary Policy

Figure 10 below sets out Malawi's seasonality timeline and its links to rain-fed agriculture activity for food and cash crops as well as consumption. Among the major cash crops, sugar is the main one grown under irrigation and its seasonality cycle differs from that of rain-fed crops because of water-management and conditions required for harvesting. Food and particularly maize production and availability have implications for inter-seasonal price patterns and food and headline inflation. Production of other main non-irrigated cash crops, presently tobacco and cotton exports have implications for the current account, where the exports are also seasonal. Harvests of rain-fed crops are delivered after the rainy season which lasts between October and May.

Figure 10 Malawi Agriculture Seasonality Timeline



Source: USAID, Famine Early Warning System Network (FEWS NET)

In Malawi the growing of maize is under rain-fed conditions. Apart from exceptionally good harvest years, the seasonal patterns of price are similar and reflect relative scarcity the further away from harvest.

The Food Price-Inflation Nexus

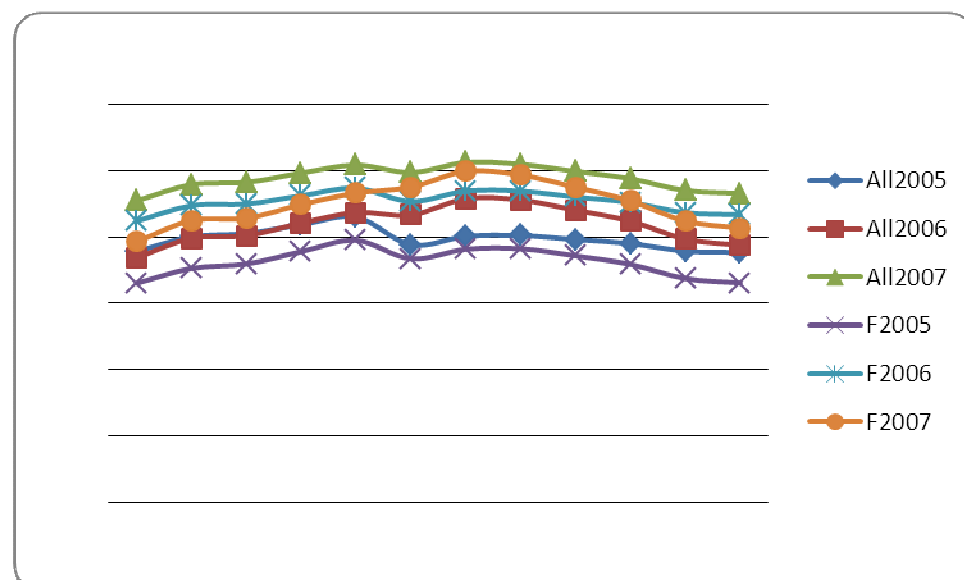
Table 11 presents Malawi's food costs and the All-items Consumer Price Index aligned to start at the end of the harvest season, which during August for the three-year period 2005-2007. Figure 11 shows, visually a high degree of correlation in all the series indicating that the seasonality and the food price-CPI link is fairly stable across years. The food price-CPI correlation coefficients for the three years, 2005, 2006 and 2007 are respectively, 0.849, 0.923 and 0.955.

Table 11 Malawi: Seasonal Food Costs and the All Items CPI

Month	All Items CPI			Food Costs		
	All2005	All2006	All2007	F2005	F2006	F2007
Aug	189.0	184.2	227.1	165.1	211.8	196.3
Sept	200.1	199.0	239.3	176.3	223.5	212.3
Oct	202.5	200.9	241.0	179.6	224.7	214.0
Nov	209.1	210.3	248.0	188.9	230.9	224.3
Dec	214.8	218.3	254.0	197.4	236.6	232.9
Jan	194.1	216.4	248.4	183.5	226.6	237.4
Feb	200.4	228.7	256.0	190.7	234.5	249.4
Mar	201.0	227.7	254.6	191.1	234.4	246.5
April	198.0	220.0	249.2	185.7	229.9	237.3
May	195.0	211.8	243.7	179.3	225.8	227.0
Jun	189.3	198.3	234.9	168.7	218.2	211.8
Jul	188.4	193.7	232.6	165.3	216.6	206.6

Source: National Statistical Office, Statistical Yearbook, 2010.

Figure 11 Malawi Food Costs/CPI Seasonality and Correlation



Source: FAO 2010

Implications of Seasonality for the Conduct of Monetary Policy

Legislatively monetary policy in Malawi, in the area of interest rate setting, is a mandate of the central bank. But institutionally and operationally the central bank has had as much autonomy as the authorities who determine Treasury Bill and other yields as well as the necessity for IMF programme allows it, which is none.

Under the IMF's Article VIII the common understanding by both the IMF and the demand side, the Ministry of Finance is that interest rates benchmarked on the bank rate cannot, even and especially in the short-term, be seen to be going in the opposite direction as that the inflation rates: in fact the IMF's position has been that if the basis of bank rate reduction is a fall in the inflation rate the opposite should also apply. When Treasury Bill yields are not in contention, as has been the case recently, the bank rate reductions can only be contemplated from about March to July. The seasonality issue related to rain-fed agriculture means that the barometric bank rate should actually be rising thereafter during the season when all other farmers apart from irrigation production are preparing for the next growing season in terms of borrowing between August and September of each year.

The implied (short-term) seasonality in the cost of borrowing which affects the levels of practically all output including food and cash crops (for domestic value addition and exports) as well as food prices and export earnings is in this context seasonally pro-cyclical and locally (domestically) destabilising. The link does not lend itself to supporting domestic livelihoods, including the sustenance of employment and consumption.

The foregoing is an observation which is generalizable beyond the Malawian context and applies to similarly placed economies with high dependence on the agriculture sector and nature for agricultural production. Recently, Malawi has been able to reduce the bank rate at the back of the agricultural input programme and favourable rains which have brought food prices and the inflation rate down to single-digit levels for a prolonged period of time.

In the light of the above discussion this study recommends that a wide band of interest rates are used strategically to incentivise seasonal operation decisions and to promote long-term crop diversification.

Section five

Fiscal policy and employment growth

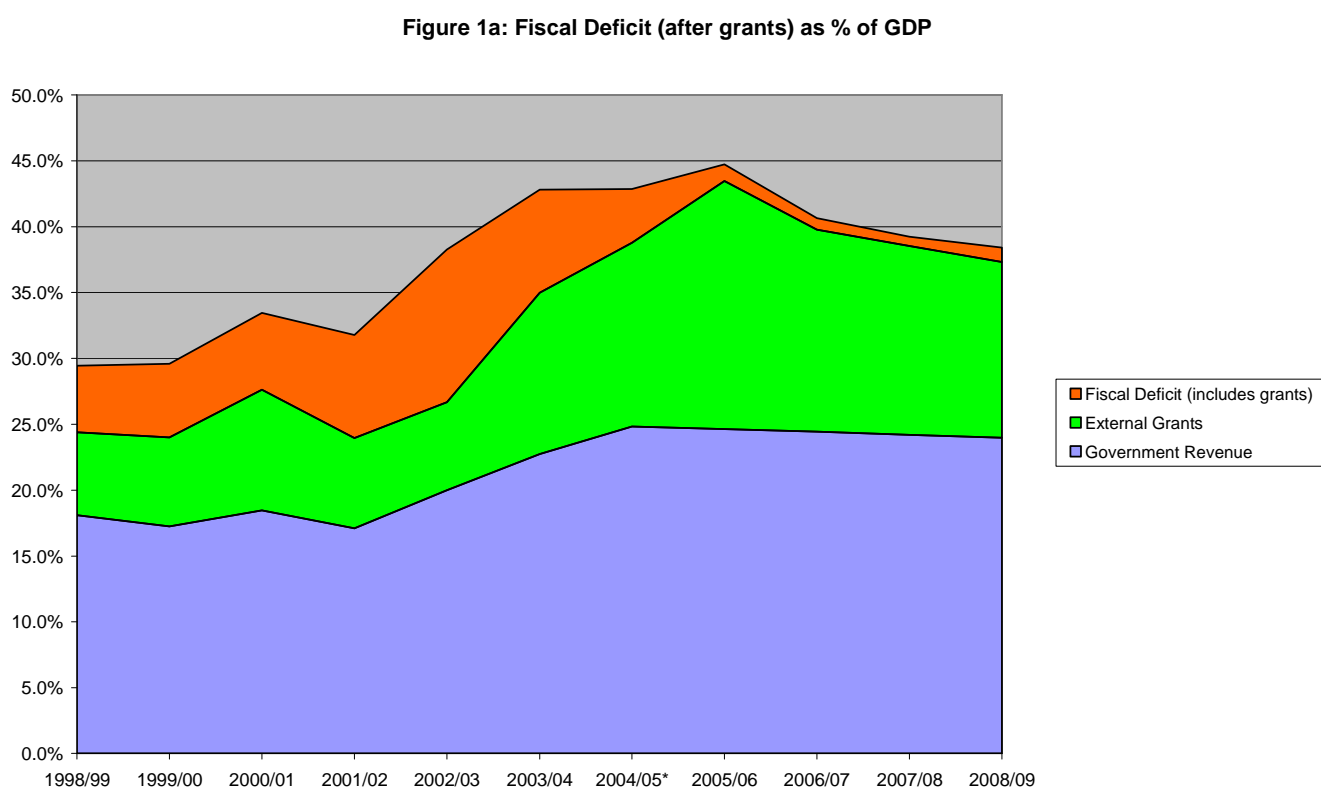
5.1 Trends in fiscal performance

Fiscal policy in Malawi over the last 5 years has emphasised the need to shrink deficits.

The IMF programme in Malawi calls for fiscal tightening, with a floor on social spending. The government has therefore committed to cut lower priority expenditures while protecting social expenditures while fiscal deficits ranged between 6 per cent and 11 per cent of GDP in the period 1995–2004, they have declined thereafter. The deficit was 5.8 per cent of GDP in 2008/2009 and 4.2 per cent in 2009/2010 (Figure 12). The loosening of fiscal policy early 2009 was the result of sizeable budget overruns on fertilizer and general expenditures in goods and services. The overrun on fertilizer expenditures reflected in part high prices in international markets.

Domestic debt in Malawi rose sharply between 2000 and 2004 (reaching 20 per cent of GDP in 2004) but has been falling since (Figure 13).

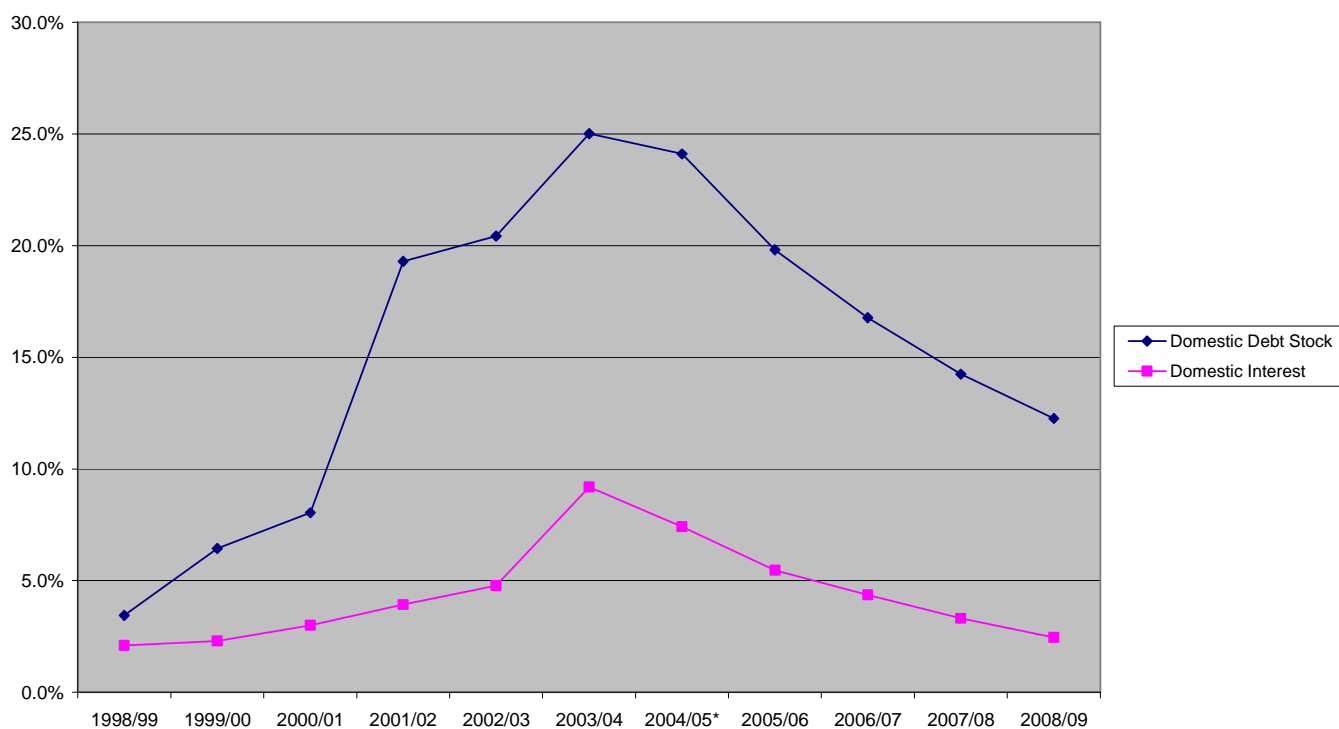
Figure 12. Revenue, grants and deficits as a percentage of GDP



Source: African Development Bank (2009)

Figure 13. Domestic debt

Figure 2a: Domestic Debt as % of GDP



Source: African Development Bank (2009)

a) Falling development expenditure

Development expenditure as a proportion of total expenditure has fallen over time. While development expenditure accounted for 41 per cent of total expenditure in 2006, it had fallen to 26.5 by 2010 (Table 12). This partly reflects increased social sector expenditure, in particular the wage costs in education and health. The decline in Development Expenditure also reflects increased outlays on the input subsidy for maize.

Table 12 Recurrent and development expenditure as a percentage of total expenditure

	2006/07	2007/08	2008/09	2009/2010
Recurrent expenditure	58.6	58.4	77.0	74.0
Development expenditure	41.4	41.8	23.7	26.5

Source: Computed from Reserve bank of Malawi Financial and Economic Review 2010

b) The challenges of protecting social sector expenditure

Gains have been made in social sector expenditure and these need to be protected. However, problems remain. The education sector faces a financing gap of over US\$200 million to implement its education sector plan over the three years, the 2009/10 budget has been reduced from 4.3 per cent of GDP to 4.2 per cent.

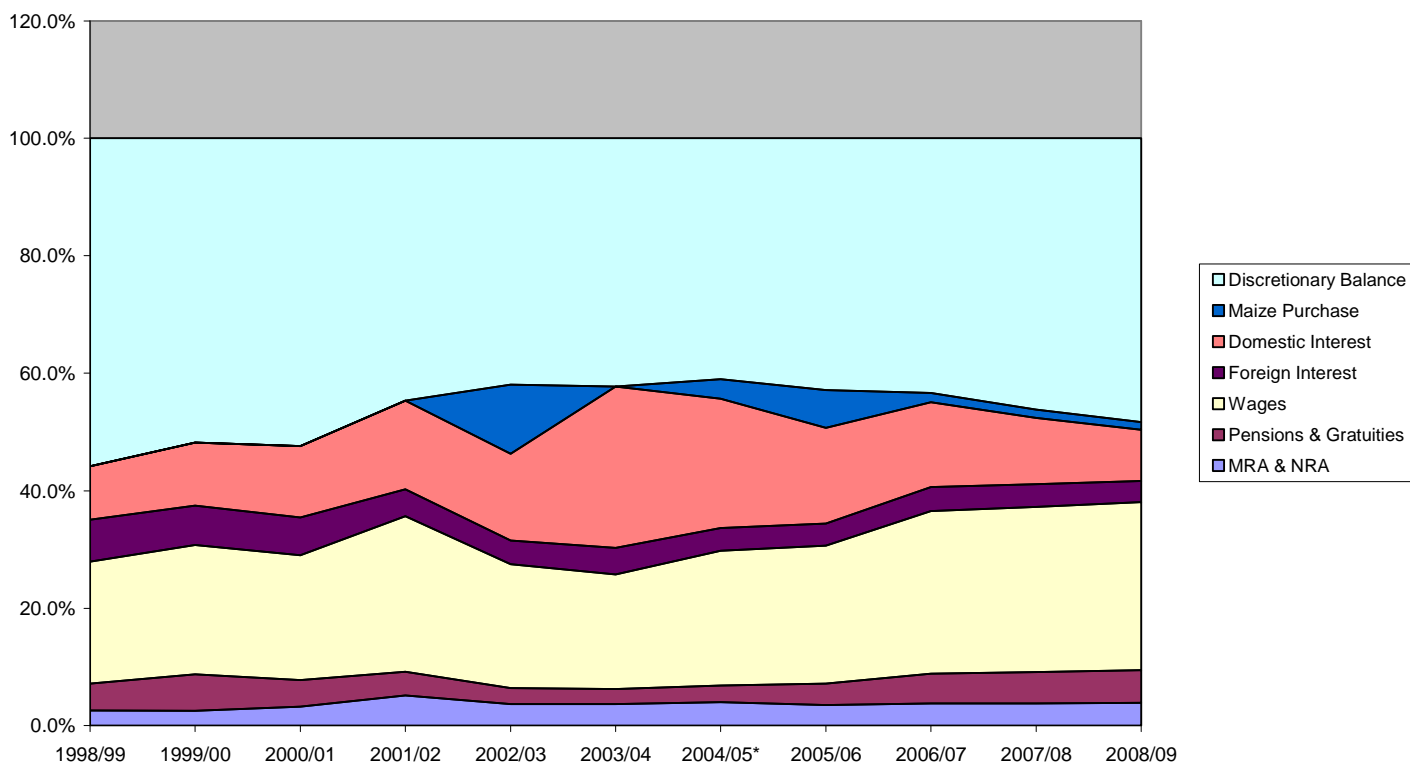
Similarly, allocation to the health sector has been cut from 6.2 per cent of GDP to 4.8 per cent. Government has sought to minimize the negative impact of these spending cuts to high priority social sectors. For instance, the 2009/10 revised budget has increased Nutrition and HIV/AIDS spending by 0.24 per cent of GDP to offset some of the cuts in the original budget.

c) The maize input subsidy

The main plank of social sector spending is the input subsidy program (Figure 7). Expenditure on fertilizers amounts to 80 per cent of the combined expenditures on education and health. Until 2009, the cost of the program was rapidly increasing. When it started in 2005/06, the program cost just \$70 million, or 1.7 per cent of GDP. However during the 2008/09 agricultural season, the program cost rose to \$279 million or 5.8 per cent of GDP, partly as a result of the sharp increase in world fertilizer prices. As this level of spending on the programme was not sustainable, the Government's response was to re-target the program towards maize production in 2009/10.

Figure 14 The importance of maize in public expenditure

Figure 3a: Breakdown of Domestic Expenditure (%)



Source: African Development Bank (2009)

d) Aid dependency of the budget

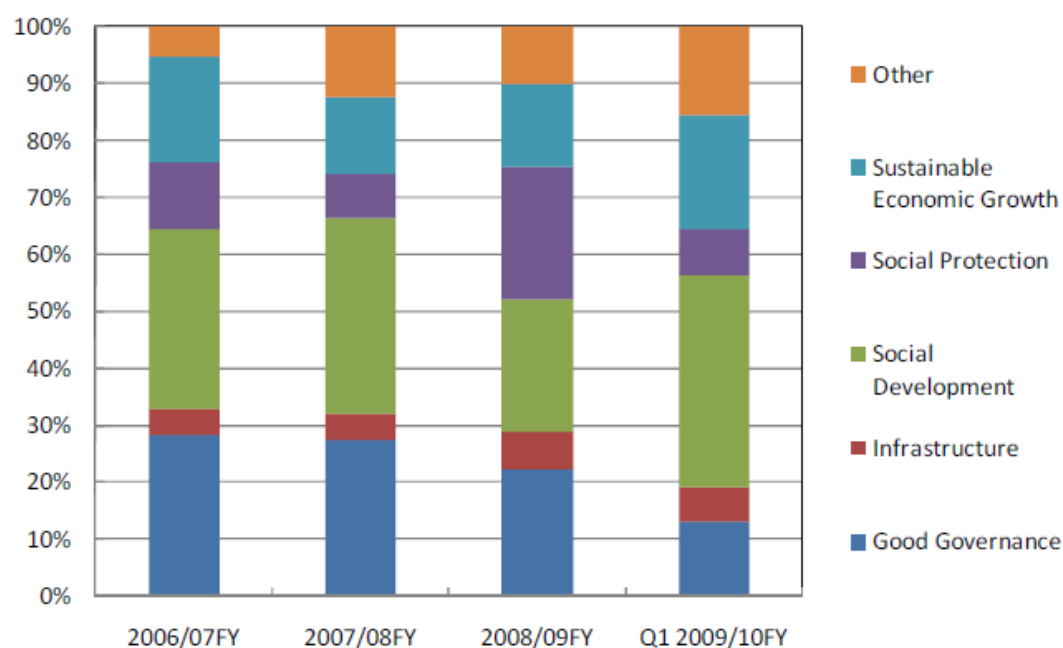
Malawi's budget relies heavily on foreign aid. In the 2009/10 budget, aid accounted for 33 per cent of the total financing. Grants as a proportion of GDP have been steadily declining as domestic revenue performance has strengthened overtime. As a share of GDP, grants are estimated at 11.4 per cent in 2009/10, a slight decline from 11.7 per cent in 2008. This decline from 2008/09 is attributed to budget support disbursement delays over macroeconomic and fiscal concerns. Direct budget support in fiscal year 2009/10 represents 25 per cent of all grant inflows and 9 per cent of the total budget. Predictability remains an issue as most budget support donors tie their support to government's performance on the IMF-monitored programme. Government partially attributes domestic debt increases to unpredictability of budget support disbursements.

Importantly 80 per cent of the annual development budget is financed by foreign grants and loans.

As Figure 15 shows aid disbursements have broadly been in line with the Malawi Growth and Development Strategy priorities.

Figure 15

: Total Aid Disbursements by MGDS Priority (2008/09FY vs. 2009/10FY to Date)



Source: Ministry of Finance 2010

e) Restructuring loss making of parastatals

The Malawi government has taken steps to privatize some parastatals – including the Agricultural Development and Marketing Corporation (ADMARC), ESCOM (electricity) and the Water Boards. The process has, however, stalled due to concerns about the social welfare role of these parastatals. Public private partnerships have now been emphasized as a way of moving forward the privatisation agenda and improving efficiency of public enterprises. The Privatisation Commission is being transformed into Public Private Partnership (PPP) Unit.

f) Improvements in revenue mobilisation

Tax revenue mobilisation improved in the past five years, averaging 17 per cent of GDP.. The establishment of the semi-autonomous Malawi Revenue Authority (MRA) in 1998 has helped to expand the tax base and improve compliance. The MRA Act is the overall legal framework for revenue collection in Malawi. The Taxation Act provides for collection of income tax which includes Pay As You Earn (PAYE) and related fringe benefits. The VAT Act and the Customs and Excise Act provide the legal framework for the collection of VAT and various trade taxes respectively. Work to review the Tax Code of 1971 is under way with 2010 as a target date for approval

In 2009 2516 new tax payers were registered. At MWK 75.36 billion, the total tax revenue in the 2008/09 tax year represented a 32 per cent increase over the 2007/08 level.

As a proportion of total revenues, tax revenues have increased from 53 per cent in 2005/06 to 60 per cent in 2008/98 while non-tax revenues have declined from 47 per cent to 40 during the same period.

Indirect taxes contribute the most to total government tax revenues. In the 2008/09 tax year, 47 per cent of the total tax revenue came from indirect taxes with direct taxes and import duties contributing 37 per cent and 11 per cent respectively..

The VAT and corporate tax rates stand at 16.5 per cent and 30 per cent respectively. Tax rates for individuals are on a graduated basis, the first MWK 120 000 being taxed at 0 per cent, the next MWK 36 000 at 15 per cent and anything above that, at 30 per cent. There is a 10 per cent withholding tax on dividends as well as a 15 per cent income tax on non-residents who were originally from Malawi. The law provides for various degrees of tax exemptions to the presidency, government ministers, parliamentarians, members of the diplomatic corps and donor-funded programmes.

5.2 Fiscal policy options for employment-boosting growth

5.2.1 *Focusing on the structure of fiscal deficits*

The orthodox approach to fiscal policy focuses mainly on its magnitude, and aims to keep this magnitude within non-inflationary levels. The structure of the fiscal deficit is examined mainly to identify wasteful expenditures that can be eliminated for fiscal prudence.

This paper argues that the structure of the fiscal deficit can have a significant impact on employment-generating growth. We focus in particular on the economic/social sector divide in government spending.

The 2006 Public Expenditure Review for Malawi posited two alternative expenditure strategies which were seen to generate varying results. On the one hand, a strategy that focuses on increased spending on economic sectors was seen as leading primarily to higher growth and its effect on poverty reduction was claimed to be less significant. On the other hand a strategy that increased social sector spending was seen as having a larger, more direct positive impact on poverty reduction.

Our report calls for new thinking on this social/economic divide in state spending. While indeed we agree that social expenditure is crucial for reducing many aspects of poverty – especially non-income aspects – the ways in which spending on economic sectors impact upon poverty and employment require further analysis. Strategic and efficient expenditures by the state in economic sectors can bring about a sustained

reduction in poverty than comes about through the poor gaining access to regular, paid work.

We highlight several fiscal policy options for boosting job-creating growth in Malawi.

5.2.2. Fiscal policy recommendation one – Target fiscal policy to boosting priority sectors

Expenditure on priority economic sectors that enable structural change and diversification should increase if Malawi is to embark on a path of job-rich growth.

As noted in Section Four, export-oriented and vertically integrated sectors such as cotton and textiles should be developed in Malawi. This sector should be targeted by appropriate expenditure and tax incentives. Tourism is another sector that should be targeted.

5.2.3 Fiscal policy recommendation two - Facilitate increased private investment through fiscal incentives and by complementary public investments that ‘crowd in’ private investment.

State investment in priority sectors should aim at facilitating increased private sector participation. There are some areas of economic infrastructure provision into which the private sector can be encouraged to enter, for instance private-public partnerships could be considered in electricity generation. The government needs to provide fiscal incentives for this and to regulate the private sector (in particular through competition policy) so that the objective of easing this infrastructure constraint is met.

5.2.4 Fiscal policy recommendation three – Increase public expenditure on skill development

Skill development should be a focus on government expenditure. This is an area where private sector involvement is likely to be unsuitable for meeting national objectives. In particular, the ‘missing middle’ of skills in Malawi should be targeted. Skill development should be closely integrated into overall policy for structural change and diversification. Hence expenditure should focus on skills needed by priority sectors. Again, the integrated cotton-textile industry should be targeted.

There should be a re-alignment of public expenditure away from tertiary education and into the vocational and technical sector (TVET). A primarily state financed training institute for the clothing industry (with tax incentives to encourage private sector participation) , would fill a large skill gap in this priority sector.

5.2.5 Fiscal policy recommendation four – Design an exit strategy from the maize subsidy and increase public investment in irrigation

It is time to also think of an exit strategy from expenditure on maize. This has to be gradual and sequential, for instance by a gradual reduction of the subsidy for maize and an increase in subsidy for other cash crops. Our recommendation of an exit strategy from maize does not have the objective of deficit reduction. Instead, we see this as part of an overall strategy to improve diversification within agriculture so that the sector grows in a way that generates a significant increase in decent jobs and in incomes.

Given high levels of rural poverty, investment in irrigation remains beyond the reach of poor farmers. 'Irrigation and Water Development' is a priority of the MGDS and 21 per cent of MGDS expenditure is allocated to the food security, agriculture and irrigation sector. However, high expenditure on maize input subsidies constrains public irrigation investment. A gradual exit strategy from maize can release funds that should be directed towards irrigation.

5.2.6 Fiscal policy recommendation five – Increase the efficiency of public expenditure

Boosting employment-rich growth also requires improving the efficiency of public expenditure. The 2006 Public Expenditure Review notes that the efficiency of education expenditure is low. Efficiency gains are crucial if Malawi is to reach the goal of universal primary education by 2015. Reaching this goal requires a 40 per cent increase in recurrent expenditure in education.

As noted above, the Malawi government is also taking steps to establish public-private partnerships when restructuring loss making parastatals. It is important that reducing fiscal losses is not the only guiding objective of this process. In particular, improving service delivery, especially in key areas such as electricity, must be integral to this restructure process.

5.2.7 Fiscal policy recommendation six - Improve Revenue Mobilisation

As we noted earlier several recent steps have been taken to enhance tax revenue mobilisation. The Malawi Revenue Authority was established to improve the efficiency and effectiveness of tax revenue mobilisation. In 2006 the authorities removed the Minister of Finance's discretionary powers to waive duty – considered non-transparent and prone to abuse. The authorities further abolished the cumbersome and costly pre-shipment inspection, and replaced it with the post-clearance auditing function in 2009. Latest reforms include extending VAT in 2004 to manufacturing, wholesale and retail to expand the tax base.

Still, challenges remain to further increase revenue mobilisation.

About 70 per cent of Malawians are smallholder subsistence farmers whose annual earnings cannot easily be assessed, captured and taxed. The informal sector is large, estimated at about 70 per cent of the urban labour force. The majority of operators in the agriculture and informal sectors are self-employed. Operating mostly on cash-based transactions, taxpayer registration and compliance in the informal sector are problematic. MRA also observes that some formal sector entities operate in the informal sector through third parties to avoid tax. It is necessary therefore to better target the informal sector in revenue mobilisation efforts.

Section six

External sector policies and employment creation

6.1 The external sector in Malawi

Section Two showed that Malawi has a weak external sector characterised by narrowly concentrated primary commodity exports and a high level of import dependence. Due to a strong kwacha, import growth at 5.04 per cent has outpaced the growth in exports. Extension of high-priced fertiliser contracts and extra budgetary imports contributed to the high import bill. Nevertheless, the trade balance has continued to improve from -10.1 per cent of GDP in 2008 to -8.8 per cent in 2009. Foreign Direct Investment fell from USD 215 million in 2008 to USD 110 million in 2009. Consequently, the current account deficit has expanded from -6.8 per cent of GDP in 2008 to -8.1 per cent.

6.1.1 Exchange Rate Policy

Various exchange rate regimes have been pursued in Malawi during its history.

The Malawi kwacha (MK) was pegged to the British pound sterling (GBP) at one-to-one between 1964, and at MK2.00 = GBP1.00 between 1967 and 1973. Following the collapse of the Bretton Woods' fixed exchange rate system, the kwacha was pegged to a trade-weighted average of the pound sterling and US dollar between November 1973 and June 1975, and to the Special Drawing Rights (SDR) at almost one-to-one between July 1975 and January 1984. In response to an expansion in Malawi's trade volume and trading partners, the kwacha was eventually pegged to a trade-weighted basket of seven currencies. This period was characterised by frequent devaluations of the kwacha, implemented in the context of the IMF's SAPs, in an attempt to improve the country's export competitiveness and BOP position. Devaluations of 10 per cent, 20 per cent, 7 per cent, 15 per cent, and 22 per cent were effected in 1986, 1987, 1988, March 1990, March 1992 and August 1992, respectively.

In February 1994, the kwacha was finally floated, and an interbank foreign exchange market was introduced to determine the exchange rate through market forces. The current account was effectively liberalised consequently, although the capital account remains un-liberalised and some exchange controls (e.g., limitations on foreign exchange allowances for travel, remittances, repatriations and importation of consumer goods) remain in place. The immediate effect of the flotation was a 220.9 per cent depreciation of the domestic currency by December 1994 (Kayira, 2006)

To operationalize the flexible regime, an auctioning system was introduced at the time of currency floatation, allowing the highest bidder to purchase the available foreign exchange from the RBM. This system was, however, abandoned within 1994. Instead, the government adopted a managed floating system in 1995, under which the authorities intervened to artificially influence the exchange rate through sales and purchases of foreign currency, hence managing it within a limited band. However, the band was removed later in 1998 in favour of a free float, only to be reinstated in mid-2004.

From May 2006, the government of Malawi pursued a fixed pegged exchange rate policy, holding the nominal value of the Malawi Kwacha steady at MWK 141:1 USD up to October 2009. The authorities used the exchange rate as an anchor to stabilise the price of imports. The strong kwacha however meant that imports became implicitly cheap while the real kwacha price of tobacco stagnated. A fixed peg against the US

dollar resulted in a sharp appreciation of the real and nominal effective exchange rate on the back of the strengthening of the US dollar in the first half of the year. This meant other currencies such as the British Pound (GBP) and the Euro (EUR) weakened against the dollar, leading to an implicit appreciation of the MWK.

The government of Malawi has moved to address the problem of foreign exchange shortages and low reserves by adopting a more flexible exchange rate. In October 2009, they introduced a flexible exchange rate for the MWK against the USD with the objective of creating a better balance between supply and demand of foreign exchange.

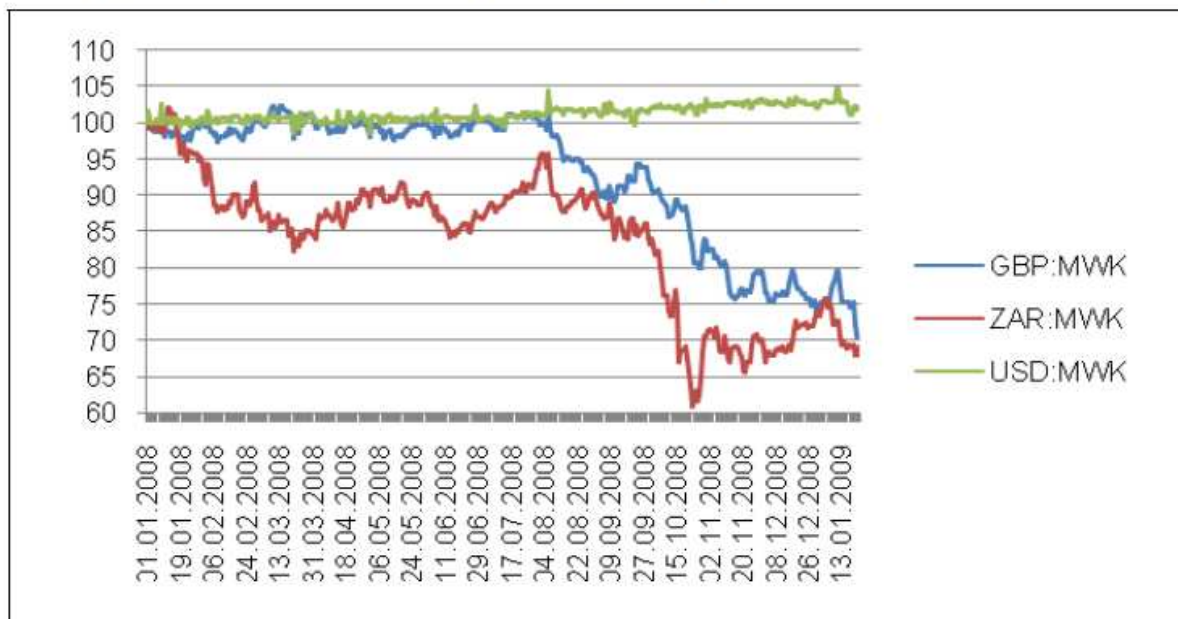
6.1.2 *The Present Overvaluation of the Malawi Kwacha*

The sharp devaluation of most global currencies against the dollar since August 2008 has resulted in a very significant appreciation of the Malawian kwacha against its main trading counterparts.

The Malawi government has resisted devaluation, viewing a viewed a depreciating currency as being perceived by their detractors as a sign of failure in economic management. So the Kwacha has been kept overvalued with the preference being to allocate foreign reserves administratively. Shortages of foreign reserves have been blamed on transfer pricing in sectors such as tobacco and on the smuggling of foreign currency.

Exchange rate liberalisation is a main theme of the IMF program and the disadvantages of an overvalued currency are emphasised by the Fund.

Figure 11: Recent nominal exchange rates (rebased to 1 Jan 08 = 100)

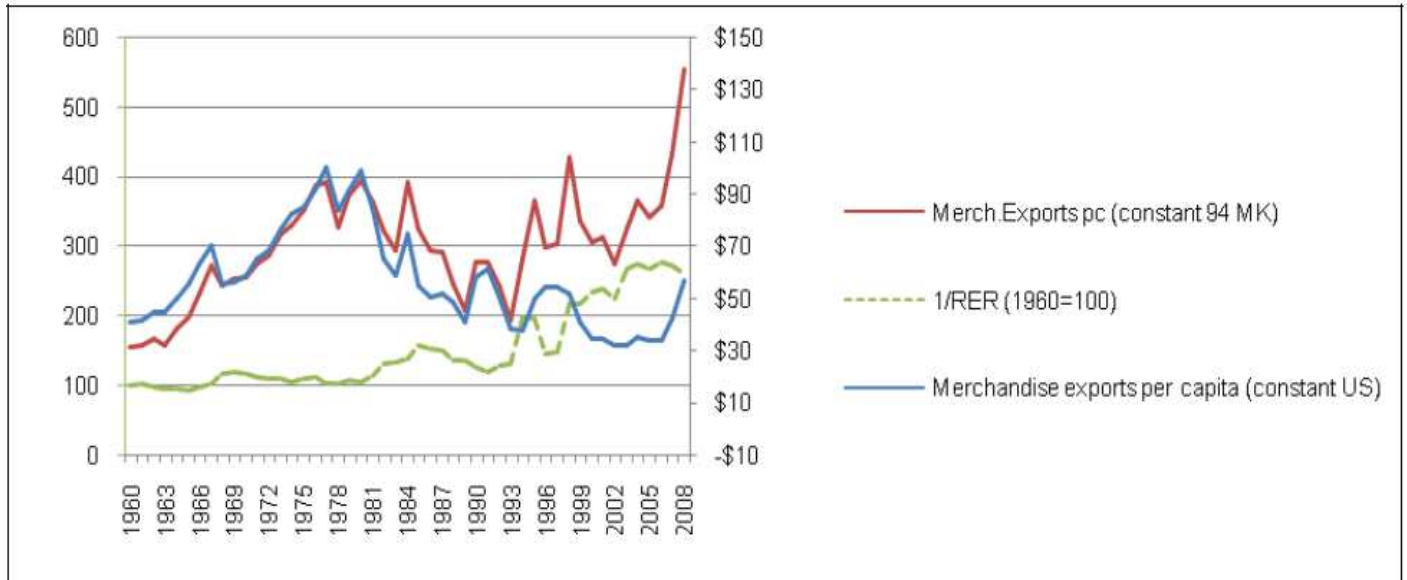


Source: Reserve Bank of Malawi 2010

6.1.3 *The Role of the Real Exchange Rate in Economic Growth in Malawi*

Many commentators have noted the role played by exchange rates in the Malawian economy, both as an anchor of stabilisation and in promoting growth (Mangani 2010).

The importance of exports expressed in real kwacha rather than real dollars highlights the importance of the real exchange rate in Malawi's growth story (Lea and Hanmer 2009). Thus a devaluation of the real exchange rate increases the real domestic value of exports relative to the real dollar value. To illustrate quite how important this variable has been for growth, Figure 10 plots per capita exports in both real dollars and real kwacha.



Source: Reserve Bank of Malawi 2010

The two series track each other reasonably well until 1994 when kwacha exports sharply depart from the dollar series. The improvement is due to a steady depreciation of the real exchange rate – shown on the graph by the rise in its reciprocal. This depreciation has increased the real kwacha value of exports by about 2.5 times since the exchange rate levels of the 1970s. Because GDP is highly sensitive to export revenues in real kwacha, this management of the exchange rate is very likely to have had a large beneficial effect on incomes, and more than any other policy instrument, enabled Malawi to grow in a hostile terms-of-trade environment.

The data also implies that prior to liberalization in 1994, the formal exchange rate was greatly overvalued, and Malawi could only have experienced such high growth in the seventies due to exceptionally favourable export prices. It is also clear that although the long-term trend has been positive, the management of the rate has been volatile. Sharp step devaluations have rapidly transmitted into domestic prices causing the real exchange rate to depreciate and then re-appreciate, and this instability is likely to have disrupted growth by increasing uncertainty in real export prices. Partly as a result of this, the government has used the nominal exchange rate as a stabilization instrument, implementing a slow crawling peg to the US dollar since 2006.

Overvaluation has resulted in an import boom. Imports have doubled over the last five years in nominal dollar terms (NSO). How was such an import boom financed? Principally it was through the foreign exchange generated by exports and aid. The depletion of foreign exchange reserves has also contributed falling to 1.3 months of import cover by the end of 2008.

The rise in imports since 2004 has been accompanied by a change in composition skewed towards consumption. In real dollar terms consumption imports have increased by 86 per cent, intermediate imports by 50 per cent (mainly on account of fuel and fertilizer) and investment imports by only 29 per cent.

Further, consumption demand which has *not* created a response from domestic industry. Taken together with the trade deficit and run down of reserves, this emphasizes again that the exchange rate remains overvalued.

6.2 External sector policies for employment generation

6.2.1. *External sector recommendation one – This report argues for a devaluation of the Malawi Kwacha.*

Devaluation is necessary to ease the current very serious foreign exchange shortage which disrupts supplies of imported inputs and stalls production and also raises import costs due to interest charges by foreign suppliers and buyers. This foreign exchange constraint needs to be eased as part of a macroeconomic policy package aimed at creating employment-rich growth.

We recognise that devaluation will hugely increase government expenditure on the maize subsidy as fertiliser is imported. In the short- term this will reduce fiscal space. To deal with this to some extent at least, there is an urgent need to enhance domestic tax mobilisation efforts as discussed above. In addition, as mentioned earlier policy debate in Malawi need to consider an exit strategy from the maize subsidy.

By changing the relative prices between tradeables and non-tradeables devaluation can encourage expenditure switching into the non-tradeable sector (e.g. domestic input production) which can promote export competitiveness and diversification in the medium term. If sectors such as an export oriented integrated cotton-textile industry is to take off in Malawi, it is important that a competitive exchange rate be maintained. A competitive exchange rate should be part of a policy package that targets structural change in the economy and generates employment-enhancing growth.

It is also necessary to develop the supply side to respond future exchange rate movements. Exchange rate movements require a domestic response capacity if they are to boost employment-rich growth. Currently, it is unlikely that the domestic private sector in Malawi will respond quickly to the change in relative prices arising from devaluation by investing in production for import substitution or export. A combination of industrial policies directed at specific sectors such as textiles, apparel and agribusiness in required for this. While the MGDS identify the need for this, a range of policy measures to encourage and enable private investment into these sectors needs to be worked out.

6.2.2 *External sector recommendation two – Increase competitiveness of the export sector*

We have shown earlier that Malawi's exports are very limited in scope although there has been some improvement during the past decade (2000–2009). The degree of export diversification is very low. Increasing the labour absorption capacity of the Malawian economy call for growth and structural change in the export sector.

Devaluation will help boost export competitiveness in the short run, to a certain extent.

There is also the need to diversify the export bases by increasing the number of products. This would broaden the front for domestic economic integration through value addition and import-substitution. This in turn would reduce the high import-dependence as well as raise the profile of non-traditional exports for broader-based and stable export earnings from products with higher income elasticity of demand. These require a suitable relative incentive environment that favours or at least one which is not tilted against the tradables sectors or activities. The speed and quality of Malawi's effective responses to the incentive environment will be determined by supply-side constraints but in some instances the demand side also needs to be effectively managed through trade relations.

Export responses from the primary, plantation-based products will likely be locked into long gestation periods as will that requiring domestic value-addition to seasonal crops like cotton which depends on domestic linkage capacity.

Below we identify some markets in which export opportunities have not been fully exploited.

a) Duty free access to developed country markets

Under the United States government's African Growth and Opportunity Act (AGOA) Malawi was a beneficiary of preferential duty and quota free access to the US market for 1,800 product lines. Owing to poor economic and export diversification the economy has only been able to benefit in terms of only two product lines, namely textiles and apparel and macadamia nuts, which in any case are minor exports. Moreover for the textiles and apparel market access was higher in the earlier years (2000-2005) and have since dropped after the expiry of the Multi-Fibre Agreement (MFA) which had protected Malawi and other African bigger South Asian exporters.

Under the European Union's Everything But Arms (EBA) initiative, Malawi has benefitted in the form of higher sugar prices than the world prices, despite quotas applying. But this arrangement is short-lived and scheduled to end in 2015. Yet sugar exports by one firm, Illovo, are easily the second largest export product with Illovo being the largest firm in the economy in terms of turnover, employment and contribution to tax revenue.

b) Trade agreements within southern Africa

Another trade arrangement where Malawi could have under-performed is in the Southern Africa Development Community (SADC) with a scheduled but missed eventual progression to a Customs Union in 2010.

This had negative implications for the textile and apparel sector with Malawi losing out in terms of domestic economic integration and export diversification. Within SADC the Malawi, Mozambique, Tanzania and Zambia (MMTZ) Protocol allowed these countries quota-bound duty-free market access to the Southern Africa Customs Union (SACU) group of countries comprising South Africa, Botswana, Lesotho, Swaziland and Namibia. Malawi benefitted from this through the relocation of garment firms from South Africa to take advantage of this as well as Malawi's export incentives under the Export Process Zones initiative. As result over 4,000 manufacturing jobs which were created almost overnight by the footloose firms in this sector have been in danger of being lost just as quickly.

The MMTZ quota protocol expired in December 2009¹ and Malawi failed to honour its obligation to implement the phase down of its tariffs in line with its offer and the SADC Free Trade Area trade protocol. Under these conditions SACU countries threatened to rescind the quota that MMTZ countries enjoyed.

Given the importance of the integrated cotton sector in the Malawi Growth and Development Strategy and given the sectors' potential for employment generation which we discussed above, losing quota access to export markets has long term negative development effects.

The source of problems with the SACU arrangement has been Malawi's fears of trade revenue losses from the tariff phase down. But a recent study commissioned by the ministry of finance indicates that Malawi's applied tariffs are lower than announced and closer to the those offered and that while the revenue losses would be incurred they are not significant enough for the economy to forego important advantages lost through retaliation, such as alternative revenues sources such as corporate income tax, economic integration and employment, and foreign exchange (Kaluwa and Jung, 2009).

New export sectors – Wood products

The recent export performance of wooden products and furniture though still relatively minor illustrate how Malawi can diversify its production and export bases. Developments taking place in the cotton and textiles sector involve foreign players in supporting growers and the subsequent processing stages. The wooden products and furniture exports too involve Raiply a subsidiary of a Kenyan corporation. The exports involve taking strategic advantage of much lower return freight rates offered by foreign transporters of import into Malawi. A Zimbabwe based road haulier of imports suggested they could offer up to a third of the rates applying to Malawi's imports instead of the trucks returning without a pay-load or loading up with ballast. The same could be negotiated for exports of furniture to the Middle-east via the Tanzania route.

6.3 Capital account policies

Capital account liberalisation

While the current account in Malawi was liberalised in 1994, the capital account remains relatively un-liberalised. Liberalising the capital account is not a pressing issue for the IMF program in Malawi. Given Malawi's commitments under the WTO the capital account management measures have been limited to a relatively small number of controls. These are detailed in the table below.

Table 13. Malawi: Controls on the capital account

Type of Control	Limits/Control
Inflows	
Foreign exchange exposure	Commercial banks 35% of core capital
Foreign participation in TBs (foreign reserves protection)	10% of total stocks
Foreign borrowing	Financial soundness (ability to pay and cost)
FDI	Exchange Control (RBM) registration and evidence of inflows
Portfolio	-Do-
Outflows	
Outward investments	RBM permission required
Dividends (FDI & Portfolio)	Evidence re: registration, declaration of and payment of dividends, taxation

Source: Reserve Bank of Malawi authorities.

Inflows – Among the notable measures are controls regulating foreign exchange exposure related to foreign investor participation in commercial banks. These inflows are portfolio investments in a sector that is highly profitable but does not lend itself directly to the structural change that the economy requires as compared to FDI. This also potentially raises outflows through dividends.

There are also limits on foreign participation in the treasury bill market. For the same reasons as foreign exchange exposure, this restriction is especially important considering government borrowing has pulled the TB rates to above 30 per cent between 1995 and 2001, and often above 40 per cent. The table below suggests that there had slippages on limits to foreign participation in the TB markets. But more importantly it also suggests that falling yields may have an impact on the inflows during the financial and economic crisis.

Table 14. Levels of foreign participation in treasury bills, TB yields, pre-and post-crisis

Date	Participation (% of Total)	Yields (91 Days)
Pre-Crisis	16	33.6 (2000-2007), 13.9 (2007)
2007, Nov	10.5	10.04
2008, April	5	10.16
2008, Nov-March, 2011	<1	7.23 (June 2010)

Source: Reserve Bank of Malawi authorities, Financial and Economic Reviews

Outflow – Just as inflows are linked to potential outflows through dividends so are investment outflows linked to eventual dividends inflows. In 2009 Southern Africa had an outward FDI stock of US\$ 69 billion dominated by South Africa (US\$ 64 billion) followed by Angola (US\$4 billion) (UNCTAD, 2010). Malawi’s outward FDI stock was a modest US\$ 22 million. In Malawi the two sectors that have been that have been particularly active are the wholesale/retail led by a South Africa/Malawi consortium, Metro Cash & Carry and the insurance sector led by National Insurance Company (NICO) going into Zambia and Tanzania respectively. Lately Malawi’s largest commercial bank, National Bank of Malawi has also expressed similar

6.3.1 External sector recommendation three – This report argues that Malawi should continue to maintain controls on short term capital inflows.

The literature provides reasoning for this. Helleiner (2003) argues that following the Second World War nearly all industrialised countries managed their capital accounts. During their periods of take-off in growth, many emerging economies managed portfolio and other capital flows. These include Brazil, Chile, China, Colombia, India, Malaysia, the Republic of Korea and Taiwan Province of China (UNCTAD, 2009 p87).

During periods of crisis such as the Asian crisis of the late 1990s and the recent global financial and economic crisis of 2007–2009 some countries and regions of the world can become relatively attractive as destinations of foreign investment flows because of high returns to investment or they can become relatively riskier. International capital flows tend to be pro-cyclical with excess inflows during booms and capital flight at the hint of instability, deepening economic downturns. Moreover capital inflows by appreciating a country’s real exchange rate hurt structural change and growth by making tradeables sectors uncompetitive and discouraging investment. Hence capital controls can offer stability by countering short-term and volatile flows and stabilising real exchange rates.

The G-20 Ministerial Meeting of 23 October, 2010 stressed the need for the IMF and member countries to work towards external sustainability by among other measures limiting excessive risk. Since the Asian crisis experience with unregulated capital flows the IMF and other institutions have become more receptive to capital management though their preference would be for temporary market based techniques (UNCTAD, 2009, p88).

6.3.2. External sector recommendation four – Attract FDI into strategic economic sectors which have potential for export growth, productivity growth and labour absorption.

As Table 14 shows FDI inflows into Malawi are small compared with many countries in southern Africa.

Table 14 Foreign direct investment in southern Africa.

	FDI Inflows			FDI Outflows		
	(Millions of dollars)					
	2007	2008	2009	2007	2008	2009
Southern Africa	18 764	28 742	21 623	3 998	- 633	1 590
Angola	9 796	16 581	13 101	912	2 570	8
Botswana	495	521	234 *	51	- 91	3 *
Lesotho	97	56	48	-	-	-
Malawi	92	170	60	1	1 *	1 *
Mozambique	427	592	881	-	-	3
Namibia	733	720	516	3	5	- 3
South Africa	5 695	9 006	5 696	2 966	-3 134	1 584
Swaziland	37	106	66	- 23	8	- 7
Zambia	1 324	939	959 *	86	-	-

Source- World Investment Report 2010

According to the World Investment Report 2010, Malawi received low inflows of foreign direct investment and also ‘underperforms’ in its existing capacity to attract foreign investment. This is due to several reasons including its landlocked position, poor infrastructure, high import costs as well as an ineffective regulatory framework (Ministry of Industry, Trade and Private Sector Development 2007).

Foreign investment can generate employment-enhancing growth in specific sectors by filling in existing capital and skills gaps, by transferring new technologies and by enhancing export competitiveness. There are a range of incentives in place to attract foreign investment into Malawi. Further policy efforts to attract foreign investment should explicitly target sectors with employment creation potential – the integrated textile and cotton sector being an obvious candidate for this.

Section seven

A summary of recommendations

1. **Monetary policy recommendation one – Reduce commercial bank excess liquidity.**

This report argues for a ‘carrot and stick’ approach to reduce commercial bank liquidity and to channel excess liquidity into priority productive sectors. We suggest the Reserve Bank takes an inventive approach to this issue and reduces liquidity in a way that could generate job-rich growth. We propose the following two options.

a) The Reserve Bank could link commercial bank reserve requirements to lending for priority sectors, which include sectors with high employment generating potential. Hence it would allow a proportion of lending to these sectors to qualify as banks’ eligible reserves. This therefore involves a strategic direction of credit by the state by using the ‘carrot’ of the reserve ratio as a policy instrument.

b) An ‘excess liquidity tax’ could be used as a ‘stick’ to discourage commercial banks from inefficient hoarding of cash. In other words, commercial banks will be disciplined as they can be if liquidity levels fall below the Reserve Banks stipulated ratio.

2. **Monetary policy recommendation two – A greater developmental role for the reserve bank of Malawi**

The Reserve Bank can play a role in mobilising resources for micro-finance institutions (MFIs), small and medium enterprises (SMEs) and priority sectors that have a high potential for creating new jobs. Instruments such as concessional loans and loan guarantee programs can be used for this.

3. **Monetary policy recommendation three – The paper recommends adjusting interest rates to take account of seasonality in agriculture.**

We propose that a wide band of interest rates are used strategically to incentivise seasonal operation decisions and to promote long-term crop diversification. This can boost agricultural productivity as well as increase employment and incomes in the rural sector.

4. **Fiscal Policy Recommendation One – Target Fiscal Policy to Boosting Priority Sectors**

Expenditure on priority economic sectors that enable structural change and diversification should increase if Malawi is to embark on a path of job-rich growth. Such sectors include export-oriented and vertically integrated sectors such as cotton and textiles should be developed in Malawi.

5. **Fiscal policy recommendation two – Facilitate increased private investment through fiscal incentives and by complementary public investments that ‘crowd in’ private investment.**

State investment in priority sectors should aim at facilitating increased private sector participation. There are some areas of economic infrastructure provision into which the private sector can be encouraged to enter, for instance private-public partnerships could be considered in electricity generation. The government needs to

provide fiscal incentives for this and to regulate the private sector (in particular through competition policy) so that the objective of easing this infrastructure constraint is met.

6. Fiscal policy recommendation three – Increase government expenditure on skill and capability creation

Skill development should be undertaken through government expenditure. This is an area where private sector involvement is likely to be unsuitable for meeting national objectives. In particular, the ‘missing middle’ of skills in Malawi should be targeted. Skill development should be closely integrated into overall policy for structural change and diversification. Hence expenditure should focus on skills needed by priority sectors.

7. Fiscal policy recommendation four – Design an exit strategy from the maize subsidy and increase public investment in irrigation.

It is time to also think of an exit strategy from expenditure on maize. This has to be gradual and sequential, for instance by a gradual reduction of the subsidy for maize and an increase in subsidy for other cash crops. Our recommendation of an exit strategy from maize does not have the objective of deficit reduction. Instead, we see this as part of an overall strategy to improve diversification within agriculture so that the sector grows in a way that generates a significant increase in decent jobs and in incomes.

8. Fiscal policy recommendation five – Increase the efficiency of public expenditure

Boosting employment-rich growth also requires improving the efficiency of public expenditure. The 2006 Public Expenditure Review notes that the efficiency of education expenditure is low. Efficiency gains are crucial if Malawi is to reach the goal of universal primary education by 2015. Reaching this goal requires a 40 per cent increase in recurrent expenditure in education.

9. Fiscal policy recommendation six – Improve efforts at revenue mobilisation.

While gains have been made in revenue mobilization in recent years, increased efforts are necessary to expand the tax base and to improve tax collection. The informal sector as well as formal sector enterprises that often operate in informal sector can be targeted.

10. External sector recommendation one – This report argues for a devaluation of the Malawi Kwacha

Devaluation is necessary to ease the current very serious foreign exchange shortage which disrupts supplies of imported inputs and stalls production and also raises import costs due to interest charges by foreign suppliers and buyers. This foreign exchange constraints need to be eased as part of a macroeconomic policy package aimed at creating employment-rich growth.

11. External sector recommendation two – Increase competitiveness of the export sector

Malawi’s exports are very limited in scope and the degree of export diversification is very low. Increasing the labour absorption capacity of the Malawian economy call for growth and structural change in the export sector. The creation of a diversified and competitive export sector that generates decent jobs must be targeted using a range

exchange rate and supply side policy instruments. Macroeconomic policies alone are insufficient for this.

12. External sector recommendation three - This report argues that Malawi should continue to maintain controls on short term capital inflows

International capital flows tend to be pro-cyclical with excess inflows during booms and capital flight at the hint of instability, deepening economic downturns. Moreover capital inflows by appreciating a country's real exchange rate hurt structural change and growth. In this context capital controls can counter short-term and volatile flows and stabilising real exchange rates. Controls can give policy makers additional instruments for effective and less costly macroeconomic stabilisation measures, while promoting efficiency and growth.

13. External sector recommendation four – Attract foreign direct investment into strategic economic sectors which have potential for export growth, productivity growth and labour absorption

Malawi attracts low inflows of foreign direct investment due to several reasons including its landlocked position, poor infrastructure, high import costs as well as an ineffective regulatory framework. Foreign investment can generate employment-enhancing growth in specific sectors by filling in existing capital and skills gaps, by transferring new technologies and by enhancing export competitiveness. There are a range of incentives in place to attract foreign investment into Malawi. Further policy efforts to attract foreign investment should explicitly target sectors with employment creation potential – the integrated textile and cotton sector being an obvious candidate for this.

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