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Chapter 3

The Role of Financial Institutions in the Economic Development of Malawi: Commercial Banks Perspective[a]

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1. INTRODUCTION.

Malawi is a low income country hence economic development is one of the priorities. Economic development encompasses three essential components namely; capacity building, good governance and economic reform. Acquired skills can not be utilised fully and institutions cannot operate efficiently without good governance. Economic reforms cannot be implemented properly without institutions that are functioning well.

A financial system can be described as an organisation that transfers excess funds from individuals and organisations with a surplus to those with deficits. It consists of financial instruments, legal structure and institutions and individuals dealing with the flow of funds. Financial institutions perform a wide range of functions in the system but their primary role is to assist channelling funds from surplus into deficit economic entities. They also guide the flow of scarce financial resources to investments of highest return and interest rate (price of capital) is the essential instrument in fulfilling this function. According to Cube and Senbet (1994), an efficient financial system is critical not only for domestic capital mobilisation but also as a vehicle for gaining competitive advantage in the global markets for capital. For efficiency the system must pay depositors favourable rates of interest and charge borrowers favourable rates of interest on loans.

Capital mobilisation is generally one of the most necessary conditions for development. A World Bank (1997) study emphasises the role played by banking sector in the process of financial integration in developing countries. It further states that the banking system is one of the main channels through which the benefits of integration materialise. The two principal sources of capital are external and domestic and the domestic funds are by far the most important

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[a] Tsutomu Takane, ed., *Agricultural and Rural Development in Malawi: Macro and Micro Perspectives* (Chiba, Japan: Institute of Developing Economies, 2005).

component (Lemo 2002). In the modern world one of the most active sectors in the economy is the financial service which further has big implications on the level and direction of economic growth. The key to economic growth in Malawi[1] relies on the efficient channelling of investment funds to the real sector.

This study focused on the formal financial institutions, specifically commercial banks operating in Malawi. In most developing countries the financial system is most dominated by commercial banks. Literature review was conducted to identify the services offered and geographical coverage of these services. Semi structured interviews were conducted with operations managers and financial managers from all commercial bank head offices and branches, two discount houses, one savings institution and two development banks. Literature review of the institutions (National Bank, Stanbic Bank, Finance Bank, IndeBank, First Merchant Bank, New Building Society Bank, Opportunity International Bank, Nedbank Malawi Savings Bank and First Discount House) various reports pertaining to financial and economic matters was carried out.

A brief discussion on the prevailing economic conditions as they affect the financial system has also been done in this paper. The paper further discusses the opportunities and challenges that are faced by the institutions and their contribution to economic development.

The overall objective is to assess the significance of formal financial institutions in contributing to the economic development of Malawi. Specifically, this paper aimed at:

1. Assessing the size of the financial intermediation in terms of availability and distribution of financial institutions.
2. Assessing the extent to which intermediaries channel resources to the private sector rather than the government.
3. Assessing the extent to which commercial banks rather than the central bank provide the intermediation.
4. Discussing the effect of the prevailing economic environment on the performance of commercial banks.

2. ROLE OF FINANCIAL MARKETS.

In any economy the principal role of financial markets is to channel funds from ultimate lenders to ultimate borrowers. The simplest transaction that takes place is the direct transfer of surplus funds from lenders to borrowers. In a more complex arrangement a middleman matches the needs different borrowers to those of lenders and this middleman is the financial intermediary. A financial intermediary borrows from lenders and lends to borrowers and in the process new instruments in the form of claims on the intermediary are formed. Rojas-Suerez and Weisbrod (1995) reported that in developing countries most household savings are held in the form of bank deposits and bank loans represent the most important source of external finance. In developing economies, like Malawi, of all the types of financial intermediaries, commercial banks are the most important group and they perform several types of intermediation.

Commercial banks transform and distribute uncertainty associated with an event through default risk intermediation which involves offering claims to savers that are protected to losses to some extent.

Financial intermediaries accept deposits in denominations that differ from those of loans they make. They remove the need for a coincidence of wants on the basis of size. In direct markets as economies grow it becomes increasingly difficult and expensive to match size requirements for both lenders and borrowers.

They supply or borrow funds when neither the interest rate nor the period matches. Financial institutions carry out interest rate intermediation. For example a bank borrows at a fixed rate when its lending rate is variable. Along with this service they also conduct term intermediation where funds are provided to borrowers for periods differing from those on commitments. For instance banks offer loans for a longer period than that for which deposits have been attracted. They also offer capital value intermediation by holding claims whose capital value fluctuates with the market rate while issuing obligations that can be redeemed at a fixed money value.

By making funds available for both borrowers through loans and lenders via deposit withdrawals, banks provide liquidity intermediation. This service is especially needed as transactions became larger and payments must be paid over longer distances in an increasingly complex and independent economy.

3. THE FINANCIAL SYSTEM

In any country a financial system is the engine to development hence it is of paramount importance in policy implications. In the 1980's a number of African countries initiated financial policy reforms as part of structural adjustment programmes due to financial liberalization, innovation and computer technology.

Reforms in Malawi, and three other African countries[2], failed to increase credit allocation to the private sector. Central government and public enterprises continued to dominate total credit (Ernest *et al.* 2002). During the same period some improvement was observed in the semi formal [3] financial sector, but due to weak linkages between the formal and the informal/semiformal sectors there has been less measurable impact on financial intermediation.

The reforms were initiated under statement of development policies which were not conducive to competition and discouraged intermediation. New market oriented legal framework was adopted in the new banking system and the Reserve Bank of Malawi Acts of 1989[4]. In 1990 Capital Market Development Act was introduced to man licensing and operation of securities professionals. This development improved intermediation, expansion and competition in financial markets. Malawi was classified as having a basic structure and regulatory system in place. It was further reported that with the exception of Mauritius and Tanzania, the average experience of bank supervisors in Sub-Saharan Africa is between 2 to 5 years. The type of skills needed by supervisors are scarce in Less Developing Countries and because of financial constraints in the public sector, supervisory departments often struggle to retain skilled staff in the face of competition from the private sector (Mehran *et al.* 1998).

The Malawi financial system is small (Table 1) and can be divided into four markets namely; commercial, corporate, leasing and finance and savings. Financial sectors in most African and other developing countries are generally dominated by commercial banks which account for over 80% of the system's total assets, (Chatterji 1999). Like in a number of developing countries, Malawi's financial system is dominated by commercial banks. It has a total of 9 commercial banks, two of which have been established within the last two years, 5 Finance houses and Merchant banks, 4 development finance institutions and two savings institutions. The sole building society and two other merchant banks transformed themselves into commercial banks in the past three years. A number of other financial institutions operating in most of the rural areas are the informal and the semi formal institutions

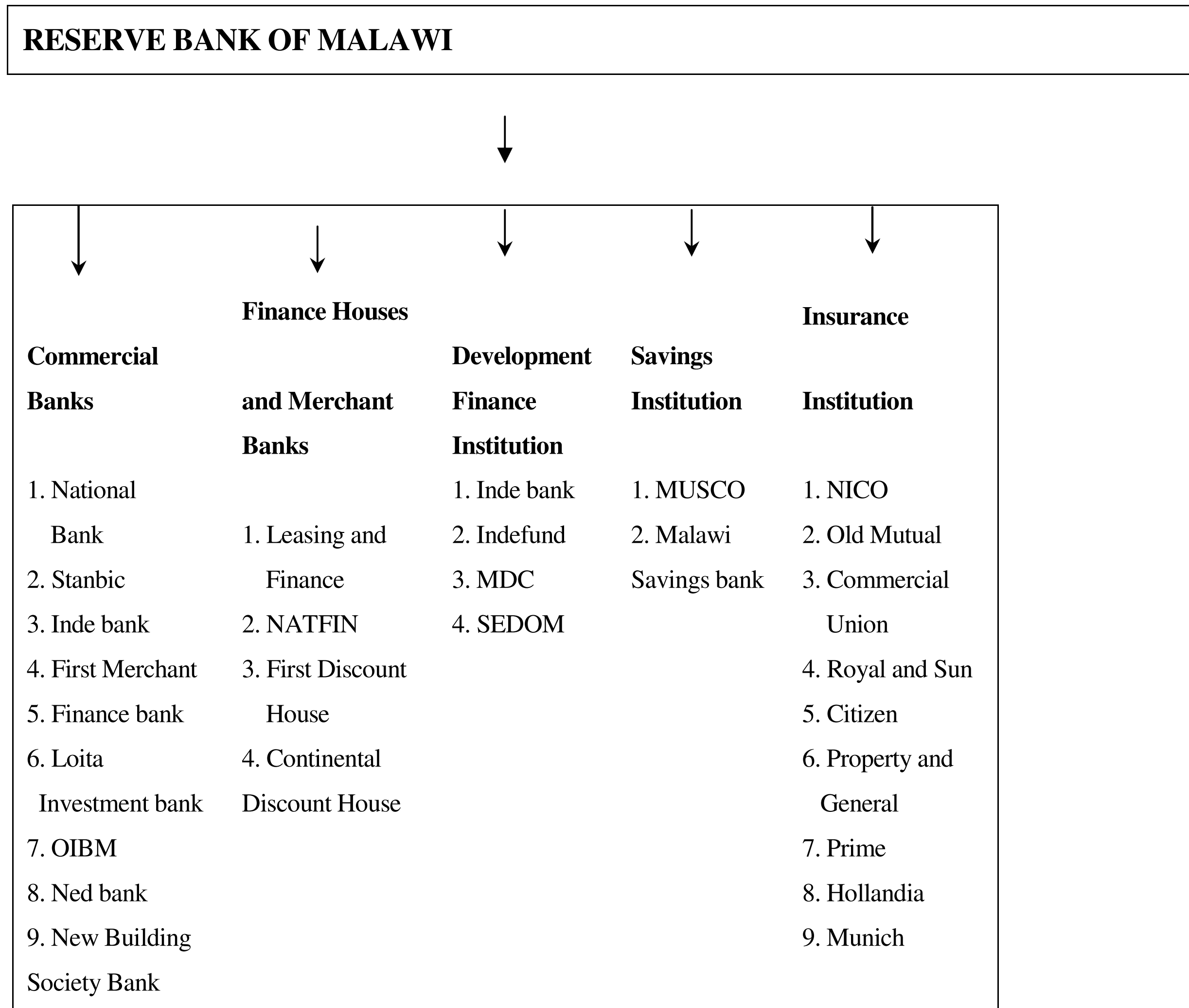
Table 1. Distribution of Commercial Banks Branches and Agencies Across Malawi.

	National	Stanbic	Finance	FMB	INDE	Loita	OIBM	NBS	Nedbank
Balaka		1							
Blantyre	5	4	2	2	3	1		5	1
Chikwawa		1							
Chiradzulu									
Chitipa									
Dedza		1							
Dowa									
Karonga	1							1	
Kasungu	1							1	
Likoma									
Lilongwe	2	2	2	2		1	2	3	1
Machinga									
Mangochi	2	1						1	
Mchinji								1	
Mulanje	1							1	
Mwanza		1							
Mzimba									
Mzuzu	1	1	1	1				1	
Neno									
Nkhatabay									
Nkhotakota		2							
Ntcheu		1							
Ntchisi									
Nsanje									
Phalombe									
Rumphi									
Salima		1							
Thyolo									
Zomba	1	1							

Source: Annual reports of various commercial banks.

Note: The distribution shown does not differentiate between presence of an agency or a branch.

Figure 1. Financial system composition.



Source: Reserve Bank of Malawi reports.

Note: OIBM - Opportunity International Bank of Malawi

FINCOM – Finance Corporation of Malawi

NATFIN – National Finance Company

MDC – Malawi Development Corporation

SEDOM – Smallholder Entrepreneurs Development of Malawi

MUSCO – Malawi Union of Savings and Cooperatives

NICO – National Insurance Company

Inde – Investment and Development

Hollandia and Munich are re-insurance companies.

Table 2: Ownership structure of selected financial institutions.

Name	Shareholder	Share percentage
National Bank	Press Corporation Limited(PCL) Old Mutual AIHC Members of the Public Employees	52 23 13.1 10.9 1
New Building Society Bank	NICO Holdings Limited National Investment Trust Malawi Government	76 14 10
Leasing and Finance Company	First merchant Bank	100
First Merchant Bank	Prime bank Ltd Kenya zambezi	12.5 50
INDE Bank	AIHC Commonwealth Development Corporation Deutsche Investitions und Entwicklungs Geselleshcaft GmbH Nederlandse Financierings-Maatschappij Voor Ontwilkkelingslanden NV European Investment Bank(EIB) Employees Share ownership Scheme Trust	25.67 22.13 22.13 22.13 4.99 2.95
Stanbic Bank	Stanbic Africa Holdings Ltd Malawi Government NICO Public Stanbic Employees Trust	60.18 8 20 10.62 1.2
First Discount House	PCL Old Mutual Kingdom Holdings T. F Mpinganjira Trust	30 20 25.1 24.9
Opportunity International Bank	Trust for Transformation Opportunity Micro Finance Ltd Opportunity Transformation Investment	12 69 19

Source: various Annual reports and survey information.

3.1 Commercial Banks

Commercial banks in Malawi provide a wide range of services some of which are offering acceptance of deposit in the form of demand, time and savings, provision of short, medium and long term credit facilities, financing of international trade, smart cash (auto teller service) and mortgage finance.

National Bank of Malawi (NB) was founded in 1971 after a merger of the Malawi operations of Standard Bank of South Africa (Limited) and Barclays Bank International. It currently operates 13 branches and 8 static agencies. National Finance Company is a subsidiary of National Bank whose nature of operations is leasing and deposit taking. The bank has 69.8% of control. Another subsidiary is National Bank of Malawi Nominees Limited which holds investments as nominees and is 100% controlled by the Bank. It has 35% of the commercial banking market share.

Stanbic Bank was established in 1970, under the name Commercial Bank of Malawi, as an exclusive Malawian bank. Shareholders have evolved over time and it is now called Stanbic reflecting the majority shareholder (see Table 2). It is the second largest commercial bank in with approximately 26% of the market shares.

Opportunity International Bank of Malawi was established in September 2002 but officially opened to the public on 23rd May, 2003. It currently has two branches in Lilongwe with one branch located in the peri urban area where most of its target customers reside. This is a foreign bank and its target market is the disadvantaged Malawians who have not had access to banking services.

First Merchant Bank started its operations in 1995 and was the first private sector owned commercial bank to be granted a banking license in Malawi. It has grown and now operates five branches (see Table 1). In August 2003 the *banker magazine* selected the bank for Bank of the Year award for two successive years (2002, 2003). First Merchant Bank is the sole owner of Leasing and Finance Company of Malawi (LFC) which specialises in long term lending through the financing of capital equipment such as transportation equipment, earth moving equipment, medical equipment, industrial machinery, farm machinery, and office equipment among many others.

Ned Bank has an average market share of 3%. It was registered in Malawi in 1976 as Finance Corporation of Malawi Limited (FINCOM) as a wholly owned subsidiary of the Agricultural Development and Marketing Corporation (ADMARC). It was established to provide local support to Malawi Finance Company (MFC). In 1999 it was registered as a deposit taking institution and in 2001 it was granted full banking license and the name later changed to Ned Bank to reflect its majority shareholders (Table 2)

Investment and Development Bank of Malawi (INDEBANK) was incorporated in 1972 as a commercial institution providing long-term loans and equity finance for financially viable projects especially those with an agricultural orientation amongst large estates. It had the principal objective of encouraging new and joint commercial and industrial development

ventures between local and foreign partners with preference being given to indigenous Malawians. In 2001 the bank and its merchant banking subsidiary, Inde Bank Financial Services Limited (Underfinanced) merged to create INDE Bank Limited as a fully fledged commercial bank

New Building Society Bank was established in 1964 as a building society. In 2003 it was given a license to operate as a commercial bank. It was officially launched as a commercial bank in November, 2004.

Finance Bank was established in 1995 and is wholly foreign owned. It has four branches and one agency. The Finance Holding Corporation of Dublin, Ireland holds 93% of shares with the remaining 7% held by Finance Bank Zambia Ltd.

Loita Investment Bank was registered as a commercial bank in 1999. It operates from two branches in Blantrye and Lilongwe. Its focus is on corporate banking facilities and corporate liability management services. It successfully launched as, advisor and arranger, the first ever issue of Commercial Paper in Malawi for the largest conglomerate.

Development is stimulated by easy access to financial services. Not all towns in Malawi are serviced by the commercial banks operating in the country. Formal financial services can be made available to rural people under some conditions which have to be satisfied; Institutions have to be adequately staffed with trained personnel, volume of business must sufficiently cover costs and generate returns and availability of reliable security for cash held. Data available shows that such conditions in the rural Malawi have not been met and the rural population are perceived to be poor to use banking services due to lack of assets to use as collateral, there capacity to save is low due to low income and high prevailing interest rates. Poor communication among other things has also contributed to poor development of the formal financial institutions[5] in the rural areas of Malawi. Naameh (2002) reported that the greatest challenge in financial sector development of most developing countries is education and training. There is need to direct resources on financial education targeting schools, Small and Medium Enterprises (SME), journalists, lawyers, politicians and communities in rural areas. It is only when their hearts and minds are won that they can be persuaded to put their money to good use.

The Reserve Bank of Malawi was established in 1965 to ensure monetary stability and maintain good financial system among other responsibilities of the central bank. As stated earlier in the paper, the National and Commercial[6] bank were established in 1970 and 1971 respectively. All the other commercial banks were established after the Capital Market Development Act which was established in 1990. Even though commercial banks have existed since 1970 in Malawi, there is a still insufficient financial service available. Lack of sufficient financial services to individuals is ranked as one of the issues hindering economic growth in less developed countries. According to a report to the World Bank on the ongoing operational, economic and sector work, lack of access to financial services and absence of convenient savings instrument and credit mechanisms is a major constraint limiting the accumulation of assets by the poor and the development of indigenous enterprises. In Malawi formal banks are poorly distributed throughout the country with a concentration in the major cities and towns only[7]. Zeller (1993) reported that because the poor have little or no collateral, required credit amounts

and instalments are small, the transaction costs tend to be high hence formal financial institutions are discouraged to expand their services to rural households. There are certain services that formal institutions offer that could benefit the rural households engaged in small scale enterprises i.e. long term credit, short term credit at reasonable interest rates and savings accounts etc. Providing banking facilities to the rural areas would boost mobilisation of financial deposits which are crucial to the economic development of Malawi because over 50% of the population reside in rural areas. Successful mobilisation of credit on its own would not lead to more investment and growth but also putting more effort into supporting the development of SME's. SME's are crucial for employment, innovation, investment and growth in most developing countries including Malawi but are not served well by the banking sector. The smallholder sector provides almost 80% of food and involves about 1.6 million families operating on smallholdings of 1.8 million hectares (United Nations and Malawi Government 1994). Without accessible banking facilities people tend to hoard their money. Over 40% of money in circulation does not pass through the financial system in Malawi. This contributes to poor mobilization of funds hence poor accumulation of domestic capital. Most small business owners in Malawi do not own bank accounts. An account with most of the formal institutions requires one to have an identity which most Malawians do not have.[8] In addition to that in all the formal branches there is need for a minimum book balance before the account is opened which in most banks is quite high for an average Malawian small business person. There have been some positive developments through the establishment of the Opportunity International Bank of Malawi[9] whose target customers are the economically disadvantaged Malawians who have never had access to financial services.

3.2 Ownership structure

The government of Malawi exercises great deal of control over financial system. Ownership of the banking sector is dominated directly or indirectly by the government and Press Corporation Limited (Conglomerate) PCL, in which it holds 49% of shares. It has the majority of shares in National Bank (see Table 2) which has a largest market share of about 35%. As part of efforts to privatise the commercial banking sector, the government sold some of its direct shares in Stanbic Bank while PCL sold all its shares to Stanbic Holdings. Government controls over financial institutions in most developing countries are the principle means of guiding entrepreneurs and the economy. To a certain extent this scenario contributed to much bank lending to the government and parastatals usually on a short term basis and less lending to private individuals. In developing countries state ownership of some or all of the principal banks, ceilings on deposits interest rates and floors on loans rates of interest are ways in which government exerts control on financial systems. The main reasons for such control range from keeping down cost of production, subsidising disadvantaged economic groups and servicing the public sectors debt.

It has been reported that there are difficulties in applying the developing country model of regulation which relies heavily on accurate financial information highly skilled technician and an

impartial bureaucracy in an environment characterised by weak accounting and legal frameworks, acute shortages of skilled personnel and pervasive political interference in public administration (Brownbridge and Kirkpatrick 2000). A number of studies have been done to see the effect of ownership structure of financial institutions on economic growth. There are conflicting views about the impact of government ownership of banks on financial and economic development (Laporta *et al*. 2001). Other theories argue that government ownership of banks facilitate the mobilisation of savings and the allocation of those savings toward strategic projects which will have impacts on the economy. This results because governments have information and sufficient incentives to ensure socially desirable investments. Other researchers (i.e. Gerschenkron, 1962) advocate government ownership of banks to promote economic and financial development especially in underdeveloped countries.

A conflicting view argues that governments do not have sufficient incentives to ensure socially desirable investments (Schleifer and Vishny 1993, 1994). Most governments politicise resource allocation, soften budget constraints. They further facilitate financing of politically attractive projects but not necessarily efficient projects which hinders economic growth.

Malawi's banking sector is relatively underdeveloped. At the other end there is the stock exchange which can be described as illiquid and had only 10 companies listed as of December, 2003. As in many developing countries, few institutions and markets in the financial system coupled with lack of linkages impair the financial sectors ability to allocate resources to their maximum use. Efficiency and effectiveness of the institutions and markets can be influenced by various factors including industry structure, foreign participation in the sector, competition, etc. Subhrendu (1999) reported that the involvement of Government in the financial sector can override the predictability of the various factors hence important to understand the nature and degree of Government influence through measures like ownership of institutions, level of government financing and regulatory and lending and interest rate controls.

4. ECONOMIC ENVIRONMENT

Interest rates play a very important role in the development of financial markets. A discussion of how interest rates are formed in a free market and the effect that ceilings on interest rates has on savings and investment will be carried out before looking at the interest rates in Malawi. The impact that ceilings on interest rates and financial intermediation has on credit will be demonstrated geometrically using the principles of supply and demand (as shown in Figure 2).

In the diagrams shown, the horizontal axis represents the quantity of borrowing or lending per unit of time (x), and the vertical axis the cost of borrowing (r) and the rate of return that lenders will have for postponing immediate consumption. The demand for credit by the economy is shown by the downward sloping curve labelled D. This partly indicates that as the quantity of investments per unit time increases the cost of borrowing declines. The economy's supply of credit is shown by the upward sloping curve, S. This is the amount of credit offered to others either directly or indirectly through intermediaries, i.e., banks. As the share of total saving provided for financial assets increases, the return on real assets or investments abroad decreases.

Assuming that there are no transaction costs or interest rate regulations, the market determined interest rate would be r = 1 and amount of credit per period, x. The equilibrium point where supply equals demand, y.

Figure 2. Geometric presentation of impact of financial intermediation and interest rate ceilings on Supply and Demand of Credit.

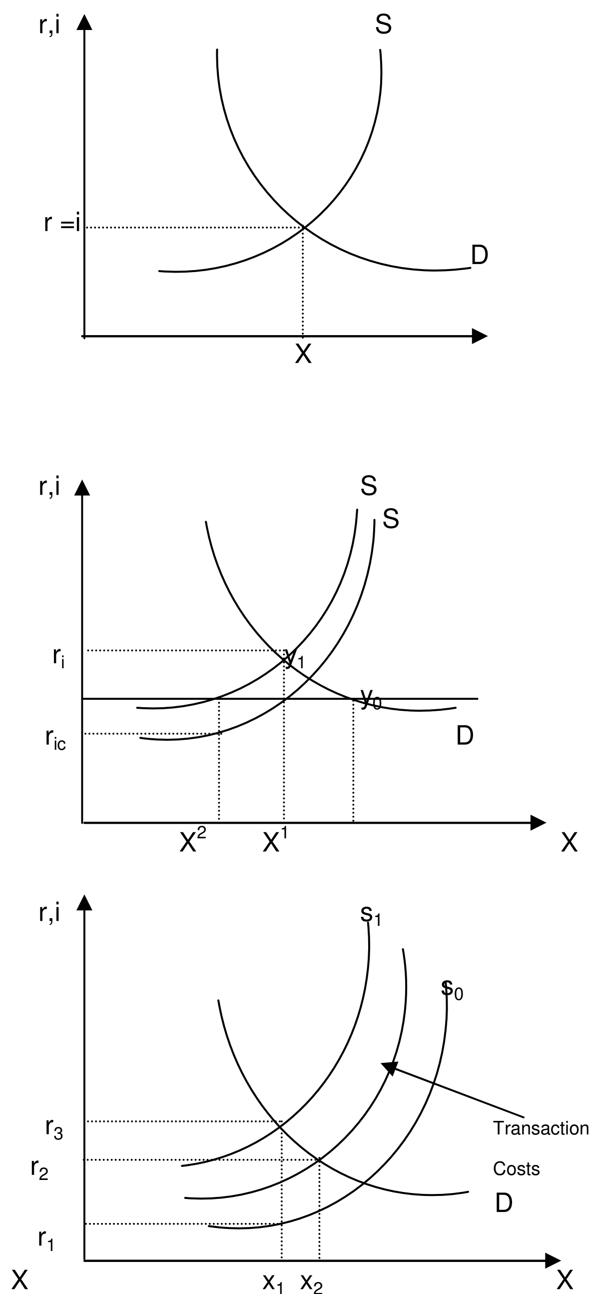


Diagram A shows the effect of interest rate ceiling. The horizontal line represents the interest rate ceiling at r_{ic}. If the ceiling is applied to deposit rates, the cost of borrowers will be raised to $r_{1.}$ and the amount lent will reduce to x_1. Instead if the ceiling rates are applied to lending rates banks will set the deposit rates at r_{ic} deducting transaction costs. The amount deposited and lent (when taken out from reserve requirements) will be x_2. Then the excess demand for credit which cannot be satisfied will be $x_0 - x_2$ and lenders will tend to ration the available supply.

Financial institutions charge a certain cost for their service of intermediation. It is very costly for lenders to be looking for credit worthy borrowers for direct transactions. The amount that these lenders charge borrowers to cover this cost is represented by the curve S_1. The vertical distance, d, between supply curve S_1 and S_0 is the transaction costs and they include provisions for expected defaults. If lenders were transacting directly with the borrowers they would be willing to lend x_1 with an expectation of getting a return of r_0. But with the short supply borrowers will be willing to pay r_1. Introduction of transaction costs brings a gap between the cost to borrowers and the return to lenders which reduces the amount of credit lent. Banks exist because they are able to reduce the transaction costs of borrowing and lending. Therefore direct transactions between the lenders and the borrowers are reduced mostly in the formal sector. This is reflected by the supply curve, S_2. The banks spread is the difference between the cost to borrowers and the returns to lenders (difference between the deposit and lending rates). Assuming that this difference is less than the cost of direct lending, the amount lent increases from x_1 to x_2 and the return to lenders increases from r_0 to r_2, and the cost to borrowers drops from r_1 to r_3. The better the banks are at reducing transaction costs the greater the effects. Reduction of taxes on banking, i.e., reserve requirements would have the same effects.

4.1 Interest Rates and Inflation

Cameron (1967), Goldsmith (1969), McKinnon (1973) and Shaw (1973) in their articles argued that well developed financial markets are necessary for the overall economic development of LDC. They further highlight the fact that financial markets affect and are affected by economic growth. Since December 2000, Malawi has been implementing an economic programme under Poverty Reduction and Growth Facility (PRGF) with support from IMF (Malawi Economic Report 2003). Due to lack of fiscal discipline the programme went off track and left the government to rely on domestic financing to finance the budget deficit. Since 1999 the deficits to GDP ratio has been on the increase (see Table 3) even after grants were received. From 2000 to 2001 the ratio declined mainly due to the effect of some aid for drought relief and it further shot up in 2002 as a result of maize importations. Within the same years interest rate increased from 47 %(bank rate) in January 1999 to 50.23% in December 2000 to the highest level 75.53% in February 2001. Government borrowing increased by over 900% from 2000 to 2001. The increase in interest rate had an effect on the money supply which recorded a drop in growth from 47.1% in 2000 to 21.2% in 2001. Bank deposits on the other hand increased

Table 3: Selected Economic Indicators

	1998	1999	2000	2001	2002	2003
GDP at Current Market Prices (Kmn)	54,788.60	79817.8	103,425.20	123080	154,007.50	172468
Real GDP at growth %	1.1	3.5	0.2	-4.1	1.8	4.4
Annual Inflation rate	29.8	44.9	29.3	27.5	14.8	9.6
Deficit/GDP ratio [1] (before grants)	-6.2	-8.8	-11	-5.8	-9.7	-9
Deficit/GDP ratio (after grants)	-0.2	-3.1	-3.2	-1.5	-3.3	-5.7
Net domestic credit[2]	2652	4236.9	7426.9	12173.6	22868.5	28059.9
Government	-464.8	-718.5	567.3	5829	15711.2	18603.1
statutory bodies	-362.1	1238.3	1042	-109.4	-206.2	-351.8
Private(gross)	3478.8	3717.1	5817.5	6454	7663.5	9808.7
Money Supply(M2)	9044.2	12189.3	17924.6	21725.5	27210.4	35182.7
M2 annual growth rate.	52.7	34.8	47.1	21.2	25.2	29.3
Banks Deposits	2078.3	2319.5	1432.3	3174.1	3616.8	4455.2

Year	Month	Interest Rate
1999	January	47%
2000	December	50.23%
2001	January	61.29%
	February	75.53%
	May	61.65%
	June	46.80%
2002	August	43%
	October	40%
2003	June	45%
	November	40%
	December	35%
2004	June	25%

Source: Reserve Bank of Malawi, Monthly Economic reports and other institutions financial and economic reports.

[1] Figures for 2003 are cumulative from January to November and are in calendar year. This applies to both ratios.
[2] This figure and those for M2, its growth rate and banks deposit data for 2003 is for end December. Figures from 2002 are for four commercial banks (National bank of Malawi, Stanbic Bank, First Merchant bank and Finance Bank of Malawi.

Table 4 Commercial banks deposits by main sector[1]

Year	Agriculture	Mining and Quarrying	Manufac-turing	Electricity water and gas	Construction and civil engineering	wholesale and retail trade	Transport storage and communication	Finance insurance, real estate and bus services	Community social and personal services	personal accounts	Total[2]
1998	389.7	8	167.3	10.4	117.1	822.9	205.3	516.7	583.9	2150.4	7201
1999	560.3	20.5	593.1	13.7	256	1276.7	226.7	800.7	1160.6	1092.9	10038.4
2000	220.3	14.6	1329.4	92.8	272.1	1336.4	397.1	1133.8	1851.9	1433.2	14812.9
2001	161.4	3	1173	107.1	331.9	1336.4	335.9	859.8	1828.2	802.4	15709.9
2002	239.7	30.4	1682.9	2718.6	355.2	2718.6	538.1	1034.6	2159.2	1284	20397.9
2003[3]	327.4	2	768.6	151.3	288.4	1778.2	499.9	1017.7	2158.9	2712.2	17720.5

[1] Figures starting from December 1999 include Finance Bank, First Merchant Bank and Malawi Savings Bank. All the figures do not include New Building Society Bank, Opportunity International Bank of Malawi and Inde Bank as they have just been established as commercial banks.
[2] The figure includes time and savings deposits excluding statutory bodies and local authorities.
[3] Figure is for September only and does not include Stanbic Bank.

Table 5. Commercial banks advances by main sector[1]

Year	Agri- culture	Mining and Quarrying	Manufac- turing	Electricity water and gas	Construct- ion and civil enge- neering	wholesale and retail trade	Transport storage and communi- cation	Finance ins- urance, real estate and Business Services	Community social and personal services	personal accounts	Total
1998	552	5.6	573.7	3.2	135.7	719.4	63	332.6	152.7	787.4	3313.5
1999	617.4	6.2	914.3	4	151.4	1259.9	93.2	688.2	848.6	341.7	4229
2000	498.8	9.1	1228.9	195.3	378	1119.8	1192.4	506.9	148.6	632.7	6610.5
2001	565.5	36.6	2206.9	455.9	489.9	939.2	268.7	271.8	148.8	1165.9	6549.2
2002	128.2	8.9	1141	491.1	140.8	858	148.8	111	940.6	2.1	3970.5
2003[2]	343.4	0.6	1320.6	68.8	294.7	1622.4	234.9	383.5	812.2	989.6	6070

Source: Reserve Bank of Malawi Financial and Economic Review, 2003.

[1] Figures starting from Dec 1999 include Finance Bank, First Merchant Bank and Malawi Savings Bank. All the figures do not include New Building Society Bank, Opportunity International Bank of Malawi and Inde Bank as they have just been established as commercial banks.
[2] Figure is for September only and does not include Stanbic Bank.

by about 120%, Total advances by the Commercial banks to the main sectors declined very slightly (Table 5).

Over the past few years Malawi has experienced an unstable economic environment. This affected the way banks and non bank financial institutions conducted their business. Apart from fluctuations in interest rates, the inflation rate has not been encouraging. Inflation rate has been declining from 44.9% in 1999 to 9.6% in 2003. The high increase in inflation rate in 1999 was due to the elections which were conducted in the year. There have been some fluctuations due to rising costs of maize, rise in price of fuel and status of donor aid to the country[10]. Boycotting of the donors to Malawi resulted in government turning to the domestic market to finance budget deficits[11]. Credit to government increased by K982.1 million in the third quarter of 2003. With the high interest rates commercial banks and other financial institutions advanced huge amounts of credit to the government through money market with the major participant being New Building Society Bank (Reserve Bank of Malawi 2003).

Malawi is the second country after Zimbabwe with the highest interest rates on Treasury Bills, according to the South African based Standard Bank Group in a brief analysis of 12 African capital markets from august 2001 to August 2004 (*The Nation*, 20th September 2004).

Before liberalisation, deposit rates were set by the Reserve Bank. Lending rates were liberalised in 1987 followed by deregulation of deposit rates in 1988 (Mamba 1996). According to Chirwa (2001), the Reserve Bank sets discount rates which influence the direction of changes in the interest rate structure. Financial institutions set their own prices guided by the discount rate. High interest rates which have been experienced since 2000 till early 2004 affected trends in deposits and also crowding out of the private sector. Investors are not able to borrow from the financial system as it is expensive. Funds mobilised by the formal institutions were mostly invested in the treasury bills since they provided almost risk free high returns than investing money in other projects. According to a local newspaper article commentators argued that 'in an economy where other sectors are struggling to survive there should be something wrong with the scenario where only banks and other players in the financial sector are making huge profits at the expense of the private sector which keeps them in business'(*The Nation*, 16th August 2004). Table 4 and 5 show the trend in the amounts of deposits in the commercial banks versus the total advances to the different sectors of the economy. A high percentage of credit goes to the manufacturing sector as opposed to agriculture which is the backbone of economy of Malawi. In 2000 there was a high increase in the percentage of advances to the transport, storage and communications sector and in 2001 personal accounts recorded an increase as well. Credit to agricultural sector is associated with low bank profitability and credit to manufacturing and distribution sectors is associated with high profitability. There is a high correlation between bank profitability and credit creation (Chirwa 2001). This explains why share to agricultural sector is decreasing in favour of the share of credit to manufacturing sector.

In June, 2004 the Reserve Bank of Malawi announced a cut in base interest rate from 35% to 25%. Due to this cut investors have shifted from investing on the money market to capital market due to the prospects of an improvement in the economy hence growth is anticipated. Confidence in the economy is coming back and investors are anticipating companies to perform well.

Investor confidence on the capital market soured since the Reserve Bank of Malawi announced a 10% point cut in the bank rate from 35%. Investors see stock market yields of 30% being superior to money markets rate that dropped to 24%.

All commercial banks are required to give a certain percentage of there total deposit balances and savings to the Reserve Bank of Malawi as a reserve requirement. The percentage has always been 30% but has recently[12] been adjusted downwards to 27.5%. Such high liquidity reserve requirements encourage crowding out of the private sector and provide the government with a buffer of resources to finance deficits (Gibson and Tsakalotos 1994).

Annual inflation rate has been dropping from 44.9% in 1999 to 9.6% in 2003 (see Table 3). Empirical evidence suggests that savers are reluctant to purchase financial assets in an inflationary environment. When inflation is high the public do not have enough savings as more is spent on consumption. Deposits in the banks have been increasing slowly since 2001 when there was a huge increase, from K1,432.3 million to K3,174.1 million (see Table 4). Fluctuations in inflation rates were fuelled due to rises in fuel, uncertainties surrounding donor aid and also a growth in the money supply. Money supply has been increasing at a very high rate (from MK9, 044.2 million in 1998 to MK35, 182.7 million in 2003) due to the government adoption of expansionary fiscal policies. This drop has been above targeted inflation in the Malawi Poverty Reduction Strategy (MPRS)[13]. Financial intermediaries tend to favour short term credit as opposed to long term credit in inflationary conditions. These transactions favour inventory accumulation and not capital loans hence naturally inhibit the development of the financial sector. As a result self-financing and establishment of traditional credit sectors is enhanced.

A foreign presence in the financial sector of Malawi is allowed. Banks are considered to be foreign when 50% or more shares belong to foreigners. All banks are subject to periodic inspections by the Reserve Bank. Claessens et al. (2001) found out that foreign banks improve domestic efficiency and that they may also make the system stable. But this allowance results in competition, as is the case currently in Malawi, hence reduced profits which hurt the domestic banks resulting in a system being fragile. In theory there are conflicting views on the need for and the effect of regulations on entry into banking sector.

5. EFFICIENCY INDICATORS

The total banks demand deposits plus time savings deposits have been increasing at an increasing rate since1999 except for years between 2000 and 2001 when deposits increased from MK14812.9 million to MK15709.9 million. Interest rates were high during this time and savers preferred to invest their money in the money market by buying treasury bills as opposed to keeping their money in the savings accounts where it would have earned little interest.

As indicated earlier in the paper, banks primarily exist to channel funds from savers to investors. Two potential measures, overhead costs and net interest margin can be used to determine the efficiency of the commercial banks in performing this function.

Net interest margin is calculated as the accounting value of net interest revenue that a bank makes divided by the total assets. Table 6 shows the calculated interest margins of some of the

commercial banks in Malawi. The higher the ratio the more efficient the bank is. National Bank is the biggest market share holder and by 2003 its net interest margin ratio was 12%. It has been increasing since 2000 indicating slight improvements in efficiency. The same goes for Stanbic Bank which is the second market share holder in the industry.

Table 6. Net Interest Margin Ratio for Selected Commercial Banks.

	2003	2002	2001	2000
National Bank	0.125364	0.106137	-	-
Finance Bank	0.084036	0.127122	-	-
Stanbic Bank	0.110432	0.102618	0.109974	0.097022
First Merchant Bank	0.085543	0.089659	0.088193	0.104702

Source: calculated using figures from balance sheets and income statements of the various commercial banks.
Note: Information for other banks was not readily available because they started operating as commercial banks recently.

There are different measures of financial intermediation that many studies have centered around, although most of them have concentrated on only three. Liquid liabilities are calculated as currency plus demand plus interest bearing liabilities of banks divided by GDP. It has been used by a number of researchers (Goldsmith1969; Mckinnon 1973). It measures the financial depth hence overall size of financial intermediary sector (King and Levine 1993a). This measure may not be widely used on its own because it may not measure the effectiveness of the financial sector in easing informational asymmetries and transaction costs. The figures include deposits by one institution in another hence there is double counting assuming the size of the intermediary sector is positively correlated with the provision and quality of the services. It gives evidence of importance of the financial services performed by the commercial banks relative to size of the economy.

The second ratio is the commercial banks assets divided by the commercial banks plus central banks assets. It measures the degree to which commercial banks versus central bank allocate society's savings. However it does not directly measure the effectiveness of banks in researching firms, exerting corporate control and mobilising savings. It is assumed that banks are likely to be

able to identify more profitable investments, monitor managers mobilise savings and facilitate risk management than central banks (King and Levine 1993a, 1993b).

The final method isolates credit issued to the private sectors opposed to credit issued to the government and public enterprises. Private credit is calculated as the value of credits by financial intermediaries to the private sector divided by GDP. This measure is preferred since it improves on the other measures of financial development. King and Levine (1993a, 1993b) used a measure of gross claims on private sector divided by GDP but this includes credits issued by the monetary authority and government agencies. Figures have been calculated using figures for credit advanced by commercial banks to the private sector and presented in Table 5. Although private credit does not measure directly easiness of information and transaction costs higher levels of private credit are interpreted as indicating higher levels of financial services offered to the community.

Calculation of the ratios described uses flow variables which are defined relative to a period which presents problems in terms of timing and deflating correctly. To solve these problems, end of year figures are deflated by end of year Consumer Price Index (CPI) and GDP by annual CPI. Then the average of the figures from the balance sheet (BS) is computed in year t and t-1. The average is then divided by real GDP measured in year t. Therefore all the calculation follows the following formulae:

$$\frac{[0.5 * \{ BS_t/CPI_{et} + BS_{t-1}/CPI_{et-1}}{GDP/CPI_{at}}$$

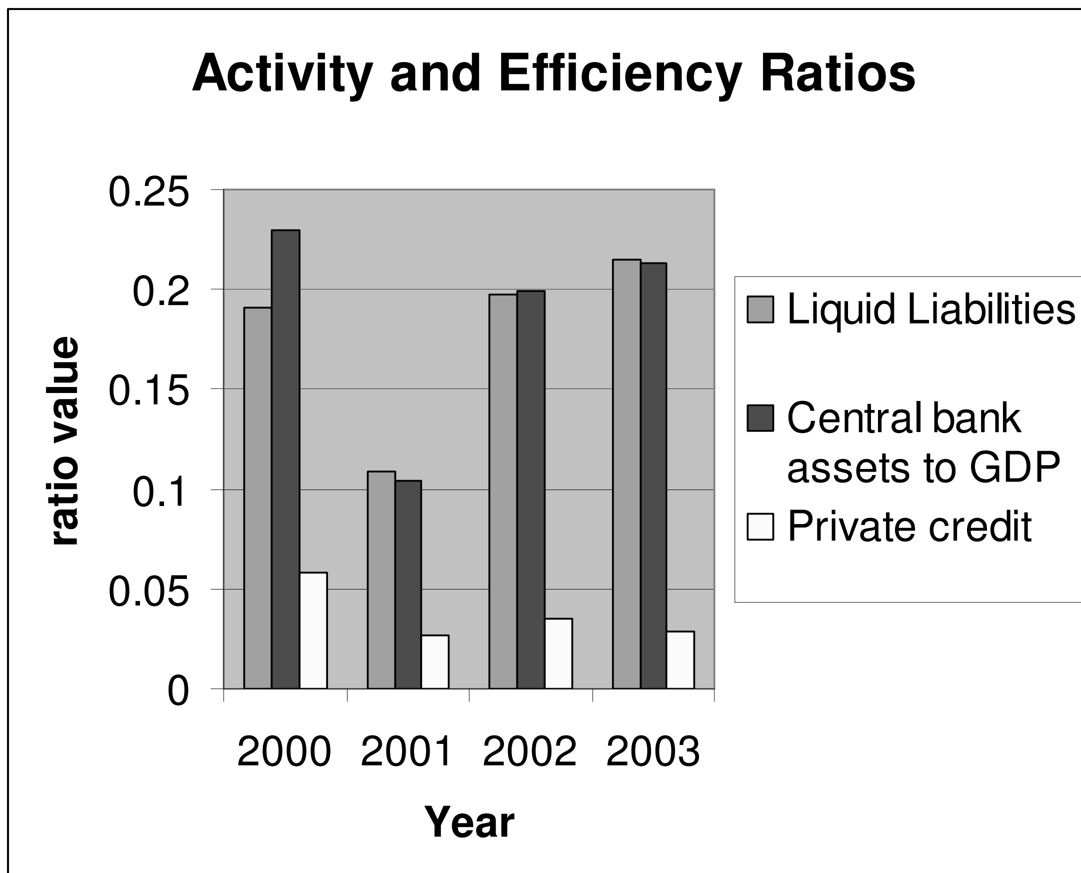
Where e is the end of period and a is the annual figure.

Malawi had a liquid liability of 19% in 2000 which dropped to about 10% in 2001 mainly due to high interest rates that prevailed. Since 2002 it has been increasing indicating that the size of the intermediation provided by the commercial banks is on the increase. An increase in size can indicate also an increase in depth of the sector.

The commercial banks assets to central banks assets ratio shows the commercial banks allocate quite a reasonably high amount of society's savings versus the central bank (see Figure 3). The allocation started increasing rapidly from 2001 this is because of the huge amount of credit that the commercial banks were advancing to the government (Table 5).

The value for private credit has been less than 5% of GDP since 2000. This is indicating low levels of financial services offered by the commercial banks and therefore less financial intermediary development. The average private credit for Ghana and Zaire for the years from 1960 – 1995 was less than 10% and that for Japan and USA was greater than 85% (Beck et al. 2001). There was found to be correlation between income per capita and financial development. Other studies (Beck et al. 1999) found out that commercial banks are more efficient in high and upper-middle income countries and Malawi falls into the low income country groups.

Figure 3. Graph Showing Activity and Efficiency Ratios



Figures for calculations were taken from Reserve Bank reports.

1. Figure used for calculating private credit for 2003 is for September only and does not include Stanbic bank.
2. Figures for 2000 and 2001 were calculated using annual CPI because there was no data for end of year 1999 and 2000.
3. Liquid Liabilities calculation included all claims on commercial banks.
4. Private Credit calculation included advances to the private sector by commercial banks only.
5. GDP value used was the GDP at current market value in local currency(MK = Malawi Kwacha)

6. CHALLENGES AND OPPORTUNITIES.

A number of challenges are being faced by the financial institutions, commercial banks in particular. Competition is one of the major challenges that all financial institutions have to deal with. The economy of Malawi has not been growing very well for the past few years and yet there has been an increase in the number of new commercial banks that have been established.

The other major challenges of the bank can best be explained in two fold; the deposit side and the lending side. On the deposit side the bank would want to see their deposits grow. Encouraging savers to keep long-term deposits is a difficult task especially when the economic conditions are not very encouraging. High inflation rates coupled with high interest rates decreased the people's marginal propensity to save. Many people were operating bank accounts with an average low balance. The level of income and income growth, financial depth combined with fiscal and other incentives are some of the factors that affect willingness to save and hold financial assets. If the financial institutions are to mobilise domestic savings they have to look at what makes people even the poorest to save for both short and long term, how they can reach them and develop the right products to attract them.

The system in Malawi is such that one requires identification such as passport or driving licenses or one should be employed to have a bank account which most Malawians do not have hence denying the banking system of potential deposits.

On the lending side banks face the challenge of investing in potential business ventures. Since 2000 a number of companies have been forced to liquidate due to financial distress which was fuelled by increasing interest rates hence banks turned to investing in the money market and reducing their core business function of channelling funds for real investments. Since most loans are collateral-based most small scale producers and traders do not have enough assets to secure their loans with. Most business people are small scale traders hence the banks tend to lose out.

The reserve requirement that is in place only applies to commercial banks and not any other financial institution and it does not earn any interest hence it is like a huge tax on the commercial banks. If this money was left with the banks it might be invested in other potential projects.

There are huge opportunities for commercial banks to grow and operate profitably. The recent boom of banks in Malawi has brought about competition which has benefited Malawians as they have a wide choice and consequently the banks themselves have improved their services and products offered. Many low to medium income earners do not have access to banking facilities hence an opportunity for banks to expand their coverage.

As the economy is showing signs of improvement with the new government regime and an expected positive participation of the donors, the commercial banks and other players in the financial system will be challenged to operate efficiently as this will be their opportunity to expand on their services.

7. CONCLUDING REMARKS

The distribution of formal banking institutions in Malawi is concentrated in the cities with few agencies in the surrounding towns due to security, communication and perceived ideas that rural people do not have a lot of savings hence transaction costs tend to be high compared to the volume of transactions conducted. The establishment of New Building Society Bank and the Opportunity International Bank of Malawi will in the future improve the distribution as these banks are targeting low to medium income groups of people in Malawi. New Building Society Bank already has a number of established branches in different towns across the country. The findings to, a certain extent, contradict with Beck et al. (2000) conclusion that there is a higher degree of foreign bank penetration in low and lower middle income countries both in terms of number and assets. Foreign banks in Malawi are increasing in number but in terms of the assets National Bank of Malawi is the leading market share holder both in terms of assets and customer numbers. Even in the foreign banks there are shares owned by Malawian companies.

High interest rates, inflation rates, net domestic credit to government and fluctuating currency that have prevailed in the last four years affected the amount of real investments in the country as indicated by a very low private credit as a share of GDP. Savings have been growing at a decreasing rate as people preferred to invest in the money markets. Financial intermediation development as carried out by the commercial banks improved at a snail pace mainly due to a hostile economic environment that prevailed in the past four years. Since May, 2004 there has been some changes which are showing good prospects for economic growth, i.e., a decrease in the interest rates by 10% and tough stand on fiscal discipline which would see donors support resuming hence fewer advances to the government by the commercial banks. This would in the long run result into an increase in real investments as credit will be channelled to the private sector hence improvement in the commercial banks efficiency in providing financial services.

Literature suggests that the financial sector can be viewed as a sort of a building with the financial sector's infrastructure and its environment as the foundation. The other pillars being governance and operations and regulation, and supervision which support financial structure and government involvement. At the top are the various macroeconomic indicators prevailing in the economy. Having this view in mind, there is a need to do more research on the Malawi financial system as a whole so as to come up with policy recommendations to improve the systems efficiency and effectiveness. Therefore, an improvement in the Malawi economy will not only depend on development of financial intermediaries but also government commitment to maintaining a stable and encouraging economic environment.

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ENDNOTES

[1] Agriculture accounts for about 38.6% of the Gross Domestic Product, according to 2003 estimates. Agricultural sector accounts for 80% of the labour force and 80% of farmers are smallholder.

[2] Tanzania, Ghana and Nigeria.

[3] Formal finance refers to all transactions, loans and deposits taking place outside the regulation of a central monetary or financial authority (Adams and Fitchett 1992). Semi formal has characteristics of both formal and informal sectors.

[4] The Malawi economy and its financial system, Reserve Bank report.

[5] National Bank and Stanbic used to operate large numbers of bank mobile agencies prior to 1997. They withdrew there services in some rural locations because of poor communication structures and an outbreak of armed robberies that took place.

[6] This is currently known as Stanbic Bank following change of ownership in 2003.

[7] See Table 1 which highlights the different formal financial institutions available throughout the country.

[8] Only a few Malawians possess a passport or a driving licence for ID. Most Malawian small business owners do not have bank accounts due to not having these identities hence hoard there money which negatively affects the growth of the economy.

[9] It was established in 2002 but operations started in 2003. At the moment it is operating in Lilongwe, with only two branches. It is the only bank so far to take finger prints as an ID for

opening an account. The minimum amount for opening an account is about \$4.70 (at \$1: MK107) just like it is with New Building Society Bank.

[10] IMF suspended donor aid to Malawi in 2000 due to non compliance to the fiscal discipline guidelines.

[11] Data from African Development Bank (ADB) indicate that government expenditure was 31.7% and 28.9% of GDP in 2000 and 2002 respectively.

[12] 0n 1st June, 2004 the Reserve Bank announced the new liquidity reserve requirement for commercial banks to be 27.5% from 30%. Seck and el Nil (1993) argued that high spreads between lending and deposit rates can be viewed as an implicit tax through high reserve requirements on the banking sector by the monetary authorities.

[13] The average annual inflation rate was targeted to be 5% according to MPRS, 2002 with an assumption of prudent fiscal and monetary policies. In December, 2003 the average annual inflation rate was 9.6 %.