

# Malawi



**ECONOMIC REFORMS AND ECONOMIC  
RECOVERY**

**JANUARY 26, 2013**

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# Outline



- I. Introduction: Why is there a need for economic reforms?
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  - B. The current economic crisis
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- IV. What are the key challenges?
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# I. Introduction: Why is there a need for economic reforms?



## A. To address longer-term structural issues

- Need for economic diversification and sustained growth
- Need for enhanced competitiveness

## B. To stabilize the economy and address the current economic crisis

- Dealing with the effects of previous economic mismanagement
- Responding to challenges posed by external shocks

# A. Long-term Structural Issues



- Malawi's poverty reduction and wealth creation goals (MGDS I & II) are ambitious and will require an outward orientation to achieve the stated objectives. Why?
  - **Rapid population growth** (2.8-3 percent per annum). *Economic transformation* is needed as *economic growth needs to keep pace with Malawi's fast population growth in order to achieve tangible poverty reduction and reach middle income status by 2020.*
  - **Limited domestic market.** As a small, landlocked country, the Malawian market is too small to generate a sufficiently high growth rate on a sustained basis without substantial external linkages. So, achievement of MGDS goals will require an outward orientation with *supportive policies that enhance external competitiveness and diversified, inclusive growth.*
  - **High susceptibility to shocks.** Malawi is vulnerable to a host of shocks—weather-related shocks, aid shocks, and trade shocks (both in terms of exports and imports prices), and therefore needs a diversified productive and export base in order to mitigate its vulnerability.

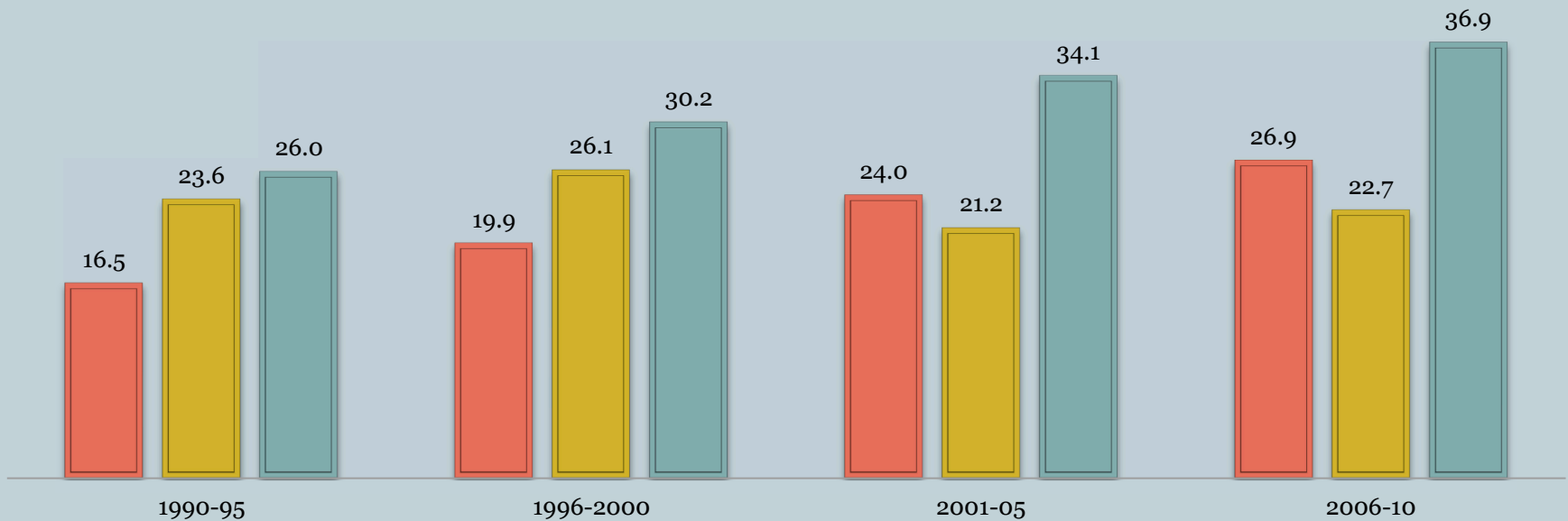
But, while enhanced external competitiveness is needed to transform Malawi from a *net exporter* to a *net importer*, several indicators point to a steady *erosion* in Malawi's international competitiveness overtime...



For e.g. Malawi's export performance has systematically trailed SSA as a whole and began trailing other African LICs since 2001...

### Exports of Goods and Services (Percent of GDP)

■ Low-income countries ■ Malawi ■ Sub-Saharan Africa



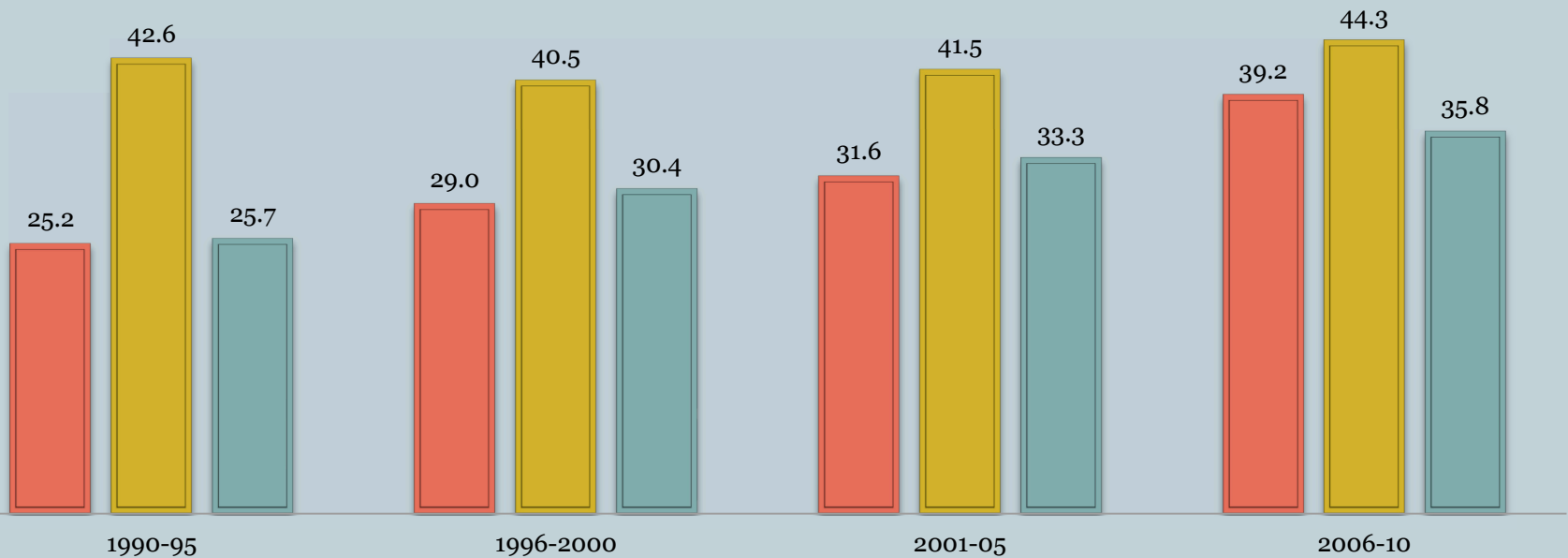
*...While its ratio of imports to GDP has widely exceeded the average for African LICs and SSA*



This is a clear indication of the exchange rate misalignment, with an overvalued Kwacha favoring imports and discouraging export diversification and growth

### Imports of Goods and Services (Percent of GDP)

■ Low-income countries ■ Malawi ■ Sub-Saharan Africa



• Moreover, much of this increase was attributable to imports of consumables rather than imports of intermediate and investment goods.

# Malawi's aid dependency far exceeds that of other African LICs and SSA



## Official Grants (Percent of GDP)

■ Low-income countries ■ Malawi ■ Sub-Saharan Africa

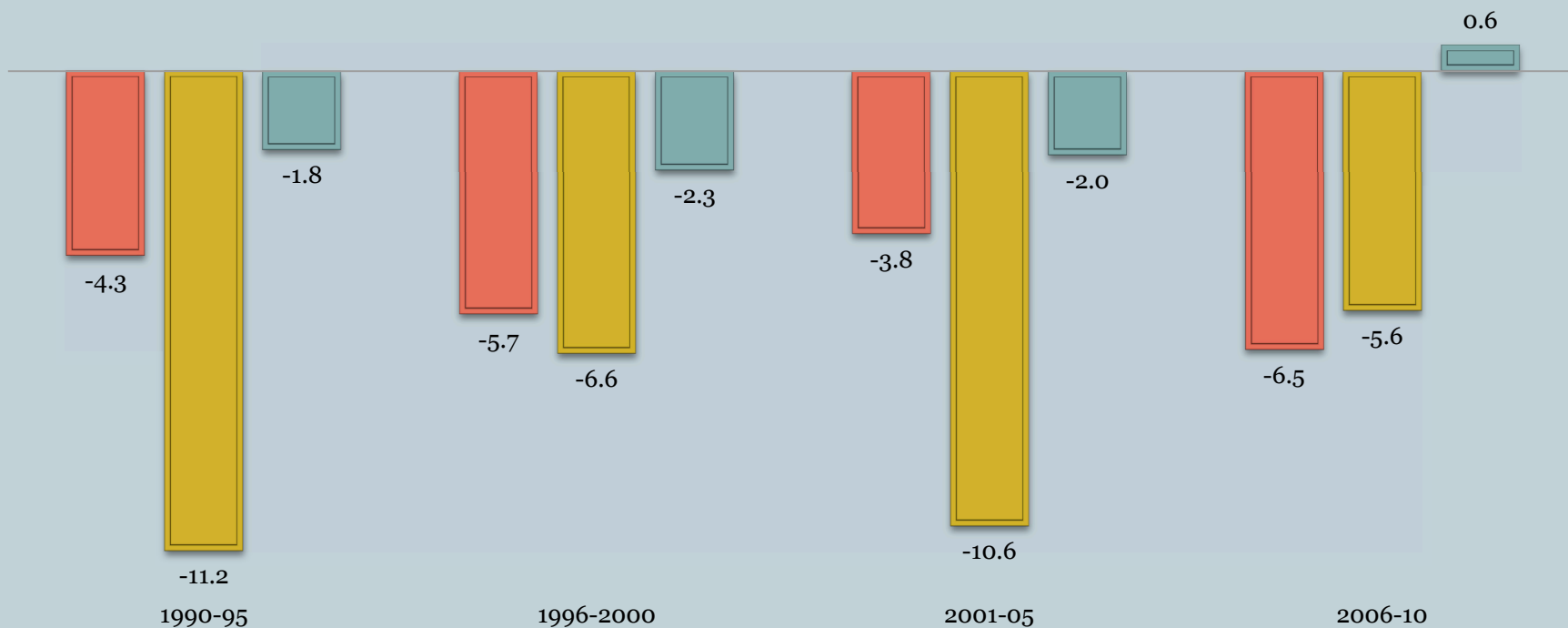


But, despite such sizeable aid inflows, Malawi still faces a pronounced external current account deficit...



### External Current Account, *Including* Grants (Percent of GDP)

■ Low-income countries ■ Malawi ■ Sub-Saharan Africa



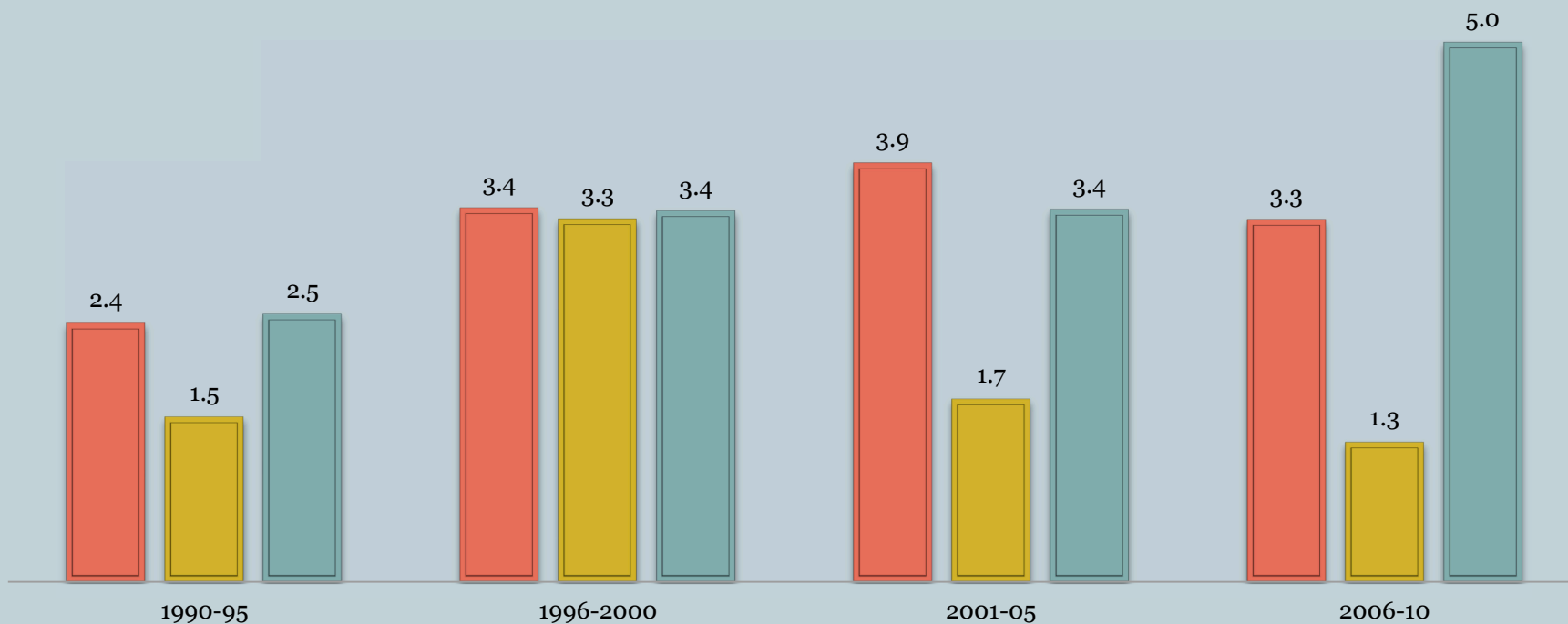


*...Which in the absence of sizeable capital inflows, has contributed to a steady loss of international reserves and chronically low import cover*



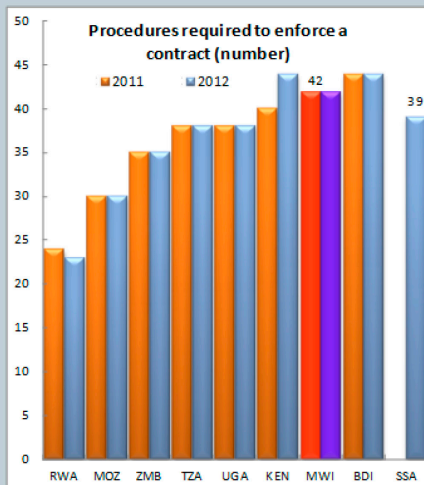
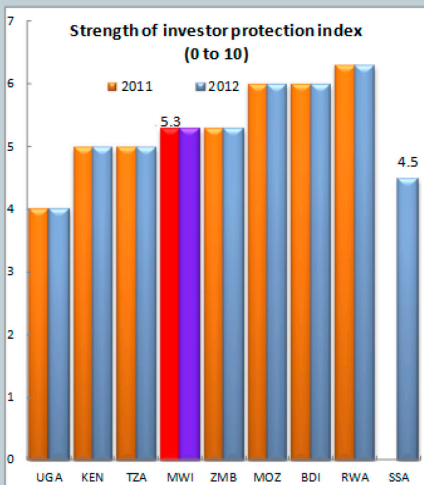
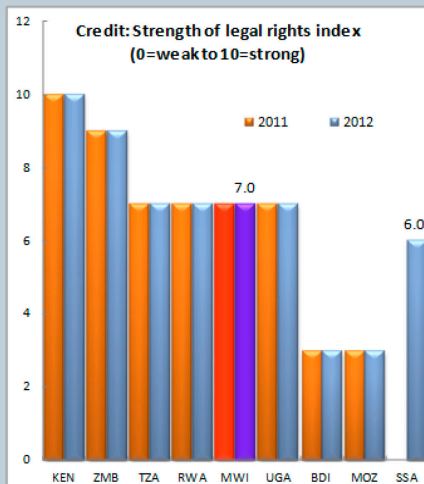
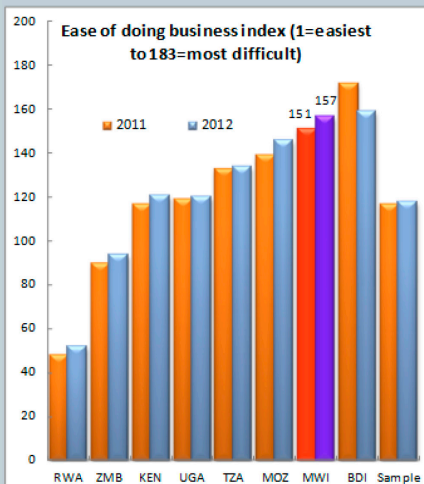
## Reserves (Months of imports of goods and services)

■ Low-income countries ■ Malawi ■ Sub-Saharan Africa

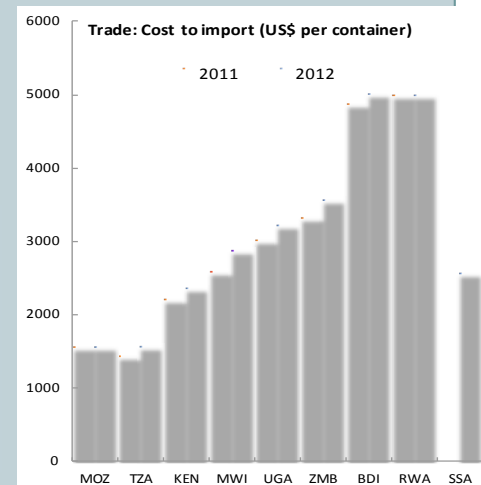
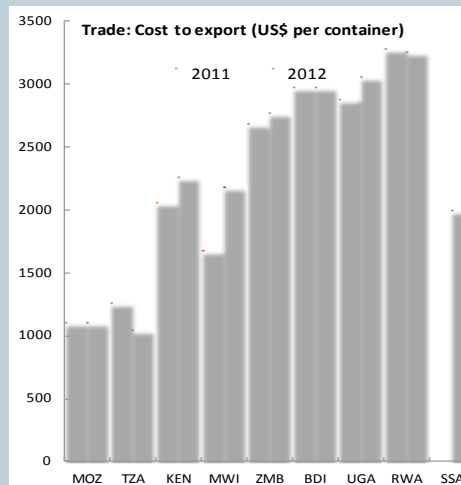
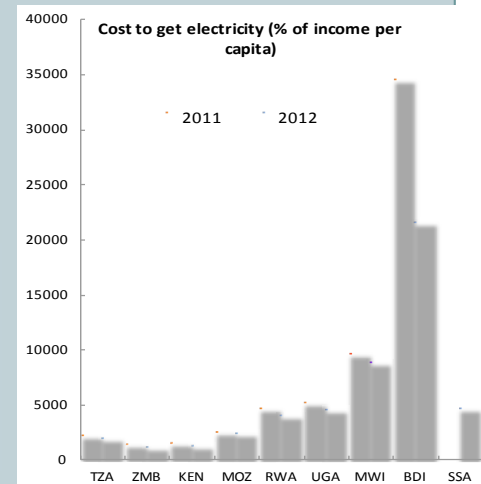
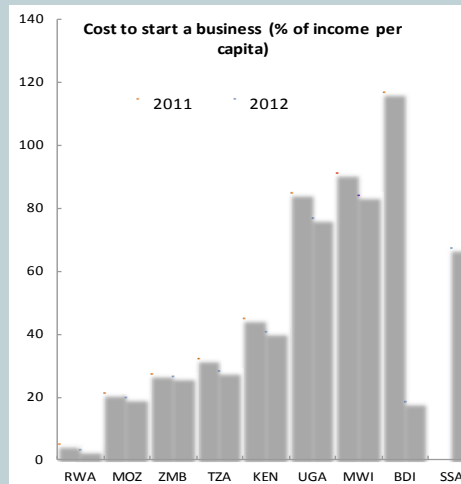


# The World Bank's Doing Business Indicators, also suggest that Malawi is at a competitive disadvantage vis-à-vis business climate conditions and business costs in neighboring countries

Business Climate -- Cross-Country Comparison  
Ease of Doing Business -- Cross-Country Comparison



Business Costs -- Cross-Country Comparison



Source: World Bank Doing Business Data Bank: <http://databank.worldbank.org/ddp/home.do>

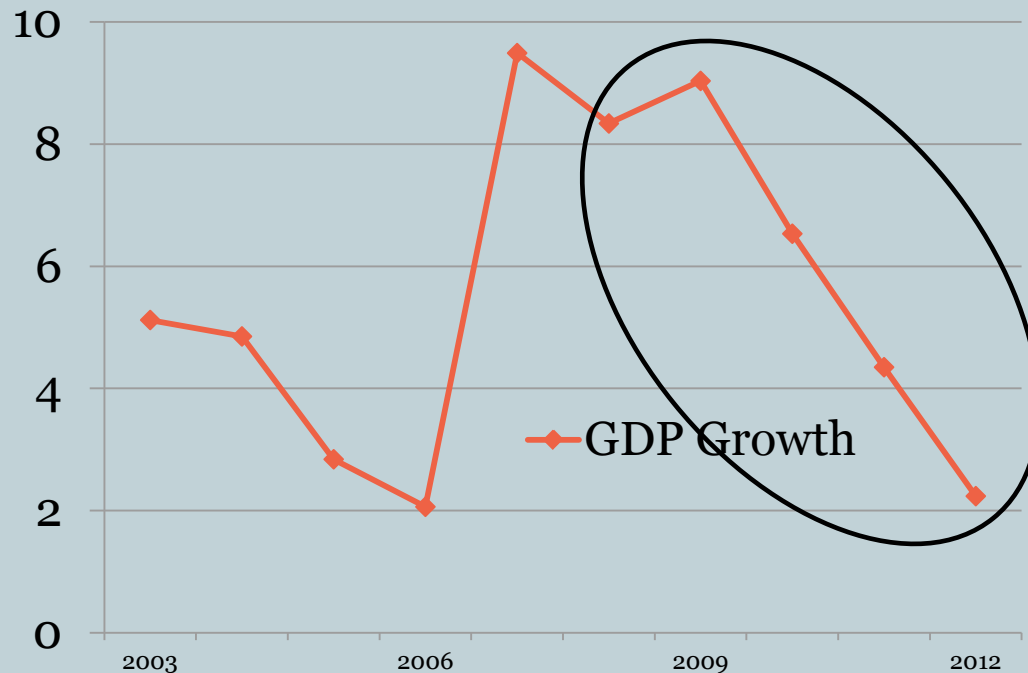
Source: World Bank Doing Business Indicators Database.

## B. The origins of the current economic crisis pre-date the current administration's policies



*Despite an earlier impressive upward growth trend, Malawi's growth rate has been sharply declining since 2010, and its social indicators suggest not much progress on poverty reduction.*

### Malawi – Real GDP Growth



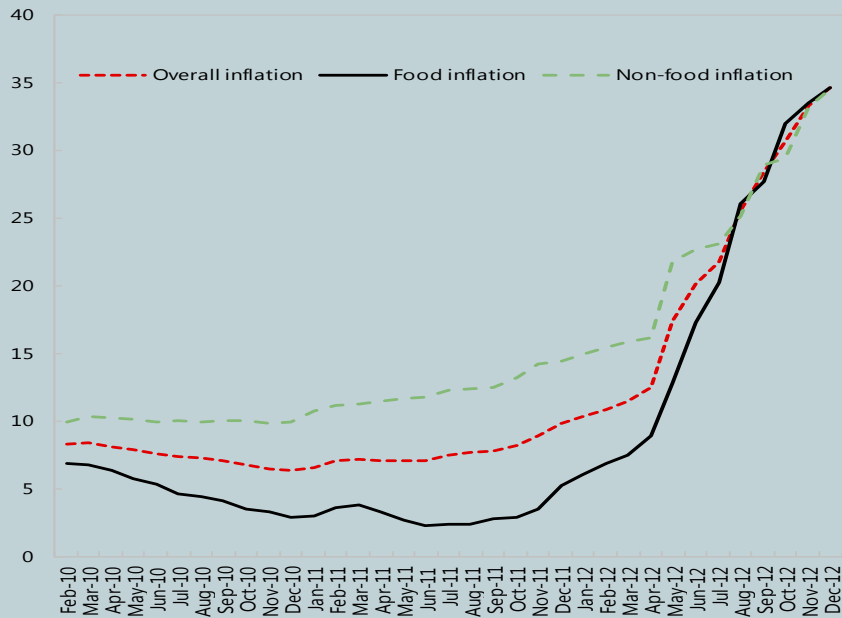
Malawi – Poverty Characteristics	IHS2	IHS3
	2004/2005	2010/2011
Poverty rate National	52.40%	50.70%
Poverty rate Urban	25.40%	17.30%
Poverty rate Rural	55.90%	56.60%
Ultra poor National	22.30%	24.50%
Ultra poor Urban	7.50%	4.30%
Ultra poor Rural	24.20%	28.10%

# The steady deterioration in key macro indicators was already evident after December 2010 when the First ECF began going off-track

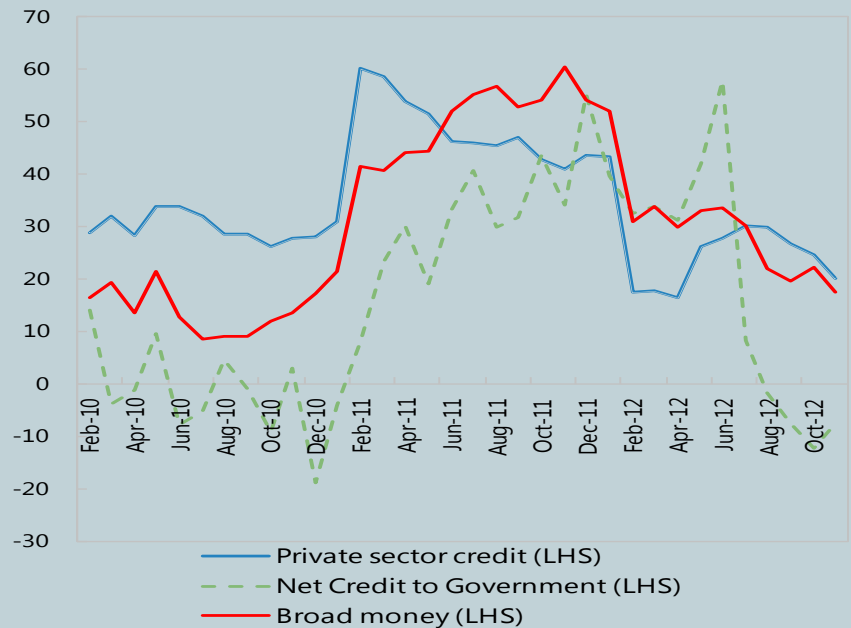


**Figure. Malawi: Monthly Macro Statistics**

**Malawi: Inflation -- 12-Month Changes**  
(In Percent)



**Monetary Aggregates and Overall Inflation**  
(12-Month Change, Percent)



- The upward trend in Inflation was already noticeable by February 2011, and stemmed from aggregate demand pressure due to expansionary fiscal and monetary policies. This in turn put pressure on the parallel market exchange rate, which further fueled primarily non-food inflation. Food inflation was low and tempered by good weather.
- After the May reforms, the exchange rate has been unified with the parallel market premium less than 5%.
- Tight fiscal policies after passage of the FY2012/13 budget (effective July 2012) have helped contain money growth, but monetary accommodation of banks' liquidity needs has proved expansionary & further fueled nonfood inflation.
- The humanitarian crisis in the South has led to a steady rise in food inflation since October 2011, which requires increased supply of additional maize in drought-stricken areas. Containing inflation will require concrete actions on both the food and nonfood fronts.

Malawi was clearly on an unsustainable path, as there were several worrisome signs that pressures on Malawi's FX market had intensified and become untenable...



- Rapid growth of domestic incomes and a broadly fixed exchange rate created an imbalance between the growth of imports and exports, and led to widened current account and balance of payments deficits.
- Perennially low import cover (at about 1.1 months, the third lowest in SSA)
- A large and widening parallel market premium (peaking at 80 percent)
- Key supply-side bottlenecks stemming from a chronic shortage of foreign exchange (including fuel, power and water shortages; diminished access to external credit lines; and unavailability of intermediate inputs)
- Intensification of FX rationing, closure of some FX bureaus and imposition of restrictions on the foreign exchange bureau rate, forcing more transactions into the illicit foreign exchange black market
- Widespread firm closures, downsizing, and retrenchment of employees.

## ...And, the **Economic Outlook** was also bleak in the wake of unchanged policies



- **Official FX market was shrinking**, as economic activity was increasingly being conducted in a thriving black market. Loss of tobacco and other export proceeds through smuggling across borders and hence loss of FX in the official market.
- **The outlook for growth was dismal** as firms continued to shut down and retrench workers given persistent FX, fuel and other supply-side constraints, including an inability to purchase intermediate inputs; and over the medium term growth was expected to stall. Slower growth led to an erosion of tax base. External credit lines remained blocked.
- **Inflationary pressures were expected to keep intensifying** in the wake of increased domestic financing of the fiscal deficit and continued excess demand for FX. Inability to shield the poor from rising prices given reduced aid flows.
- **The fiscal deficit was expected to persist and widen**, owing to: (a) the shrinking tax base and exchange rate overvaluation, which resulted in reduced tax revenues; (b) the failure to adequately scale back fiscal expenditures (due to growing wage demands and other spending pressures); and (c) absence of budget support.
- **Net Domestic Borrowing would increase sharply**. The fiscal deficit was increasingly financed by domestic borrowing, including from the central bank through monetization (which was directly inflationary) and the issuance of government securities. But, in an inflationary environment, government must pay much higher interest rates to successfully place its securities. Higher interest rates raise the opportunity cost of funds and feed into producer costs, which are then passed on to consumers and further fuels inflation, in part through the emergence of a price-wage spiral.
- **International reserves would remain perilously low**. Excess demand for foreign exchange was expected to intensify as exchange rate overvaluation persisted, and continued to exert pressure on FX reserves, with reserve adequacy ratios continuing on a downward slide toward eventual depletion. Lack of budget support would further compound an already difficult FX situation.

The government's options were *limited*, and essentially two-fold—(1) Maintain **Unchanged policies** with disorderly adjustment; or (2) Effect an **Orderly Adjustment** to restructure the economy and put it on a sustainable growth path through implementation comprehensive reforms



Recognition within government that neither option was going to be painless, but that the second option was preferred as it constituted ***controlled pain with gain*** and entailed prospects of a brighter future after a temporary period of adjustment:

- ***Unchanged policies*** would have led to total economic disarray (akin to Zimbabwe during the “lost decade”—e.g. eventual hyperinflation, soaring interest rates, economic stagnation and contraction, capital flight!!!)
- By contrast, with the ***Orderly Adjustment approach***, the Malawian government has attempted to:
  - Mitigate the impact of the adjustment on the poor and vulnerable,
  - Cushion the severity of the adjustment by unlocking donor assistance
  - Restore confidence to domestic and foreign investors and help encourage private remittances
  - Boost FX inflows into the official FX market, and thereby facilitating a significant reduction in private foreign liabilities,
  - Unlock private external credit lines so that fuel and other imported inputs can resume and facilitate production
  - Stimulate exports while curbing the growth of non-essential imports

## II. The Reform Agenda is Multifaceted and Phased



- In the near term, it aims to achieve macroeconomic stabilization through implementation of the **ECF arrangement** so as to create an enabling environment for sustained investment and inclusive growth.
- But, it complements economic stabilization efforts with the implementation of the **Economic Recovery Plan (ERP)**, which lays out a short- and medium-term implementation plan for achieving poverty eradication. It does so by identifying and implementing projects in five key areas that can lead growth and achieve quick results. These areas include: *commercial agriculture (including value addition), tourism, energy, mining and infrastructure development*.
- The ERP is also supplemented by the **National Export Promotion Strategy (NES)**, which provides a prioritised road map for developing Malawi's productive base and improving the country's export competitiveness. NES emphasizes four areas: export clusters, conducive business environment, supportive economic institutions to build the productive base of the economy, and competencies, skills and knowledge development. Implementation of the NES will be supported by pooling government and donor resources under the Trade, Industry and Private Sector Development Sector Wide Approach (TIPSD SWAp).



**A. The ECF.** Recent policy reforms, supported by the ECF, were designed to promote external competitiveness and correct Malawi's chronic external imbalance (MEFP pp.42-43)

Key Commitments	Key Objectives	Specific Actions Taken
<b>Exchange rate flexibility</b>	Adoption of a market-clearing rate so as to <i>incentivize exports, compress non-essential imports, and encourage FX flows into the official FX market (as opposed to the black market).</i>	-- Devalued the exchange rate by 49 percent in kwacha terms and 33 percent in US dollar terms --Maintenance of a market-clearing rate through ongoing exchange rate flexibility. Exchange rate can appreciate and depreciate depending on market conditions.
<b>Liberalization of the foreign exchange regime</b>	Unification of the FX market by eliminating the incentive to operate in the black market,  --Commercial banks and bureau rates determined by supply and demand, and allocation of FX is made on a market basis as opposed to by rationing.	--FX surrender requirement reverted to commercial banks in May 2012, <i>in order to inject FX into, and help reactivate, the interbank FX market.</i> --Removal of restrictions on FX transactions by banks and FX bureaus. --Elimination of RBM prescreening of FX requests exceeding US\$50,000.
<b>Elimination of current account restrictions under Article VIII</b>	Compliance with IMF Article VIII, so as to allow for full current account convertibility.	--Revising and updating laws and regulations to remove restrictions that impede access to FX for current account transactions.
<b>Supportive fiscal and monetary policies to help achieve macroeconomic stability and accumulate reserves.</b>	Adoption of a prudent fiscal and monetary stance in support of exchange rate flexibility:  -- Adherence to program targets for NDA, NIR, and Net Domestic Repayment in order to help contain aggregate demand and reduce pressure on international reserves. --Strengthening public financial management to improve fiscal transparency and public sector efficiency.	--Approval of FY 2012/13 budget, which keeps expenditures in line with available resources. --Increase in retail fuel prices to reflect inbound landed cost and adoption of <b>an automatic fuel price adjustment mechanism</b> to pass-through changes in import prices (budgetary savings of 2% of GDP/US\$120 million/K36 billion). --Provision for social safety nets for the poor and vulnerable, with the assistance of the World Bank and other Development Partners. --Central Bank's policy rate raised from 13% to 16% in May, 21% in June, and 25% in November. --Closure of the uncollateralized discount window at end-November 2012.
<b>Reforms to remove structural bottlenecks, improve the investment climate and promote sustained and inclusive growth.</b>	Create an enabling environment for private investment, economic diversification and growth through enhanced external competitiveness . --Includes licensing and regulatory reforms and efforts to strengthen creditor rights.	--Adjustment of electricity tariffs to cost recovery levels in order reduce subsidy and better attract PPP investment. --Restoration of MCC Energy Compact --Resumption of talks on Mozambican and Zambian interconnectors --Reactivating talks on Blantyre-Beira railway link.

### III. Results: What has been achieved to *date vis-à-vis macro stabilization—just 8.5 months into the reforms?* Are the reforms bearing fruit?



#### **Real Sector**

- Near elimination of fuel queues due to significant increase in fuel availability
- Pickup in production and hiring of workers
- Acreage under cultivation of cash crops up in response to liberalized exchange rate and movement to contract farming in the tobacco industry
- Agricultural production expected to benefit from scaled up FISP and the return of favorable rainfall

#### **External Sector**

- **Exchange rate unification**—parallel market premium now negligible (around 5 percent)
- **Enhanced FX availability**. Increased bank access to FX—still not perfect, but greatly improved and still improving...
- **Restoration of external credit lines**. Reduction in private foreign liabilities has led to a restoration of external credit lines and generated expressions of interest by foreign investors
- Rate of depreciation of the kwacha has significantly slowed

# Progress to Date (Continued)



## Fiscal Sector

- Passage of a budget in line with available resource envelope, so no increase in government net borrowing from domestic banking system.
- Successful implementation of the Automatic Fuel Price Adjustment Mechanism is already producing budgetary savings that are being deployed to targeted social protection programs.
- Resumption of **budget support** and significant **scaling up of aid**— Grants are expected to go from just **4.4% of GDP in FY2011/12 to 14.4% in FY2012/13!!!** This has facilitated a sizeable scaling up of social spending (FISP, public works programs, work for assets programs, cash transfers, school bursary and feeding programs, and other social protection programs) to help cushion the poor and vulnerable.
  - This point is worth emphasizing because **austerity** usually connotes a **reduction** in the ratio of government spending to GDP, but in Malawi's case with added aid flows total spending is budgeted to **rise** as a percentage of GDP from 35% to 39.7%. In the absence of these flows the impact of the adjustment would have been much more severe.

## Monetary Sector

- Elimination of the government's domestic borrowing requirement facilitates slowdown in monetary expansion.
- Higher bank rate signals RBM's intent to tighten monetary policy

## IV. What are the key challenges?



- **More public outreach** is needed by government—As suggested by some there's a need for a more proactive communication strategy explaining the rationale underlying the reform agenda and the fact that the reforms are working. This is needed to help diffuse growing impatience with the reform agenda and mounting pressure for policy reversals (especially with respect to rising wage demands and abandonment of the flexible exchange rate policy).
- **Sharper containment of liquidity** growth is needed in order to reduce pressure on the exchange rate and help reduce inflation. This will likely restrict credit growth in the short term, but it is seen as a temporary measure.
- **The effectiveness of the humanitarian response** in distributing grain to food deficit areas in the south will also impact the rate at which food prices decline nationally.

# V. Critics of the reform agenda have posed the following questions



- *“Is inflation being caused by the devaluation and exchange rate flexibility? And, would a fixed exchange rate be more appropriate for Malawi?”*. This argument is based on the wrong counterfactual. Remember, the choices were not *whether* to adjust, but *how*—orderly or disorderly—as the day of reckoning was going to come. Having a fixed exchange rate is fine if there are adequate reserves to defend the rate—i.e. the central bank has to have enough FX to sell to the market when clients demand FX at the set fixed price. But, this is not the case in Malawi—since reserves are perilously low.
- *“Wouldn’t more donor funds solve the problem?”*—Recall that Malawi is already the beneficiary of sizeable donor flows (three times that of other African LICs relative to GDP) and that aid flows were also significantly scaled up in FY2012/13. We are probably approaching the limits to which this can be further increased because the external environment is now more difficult even for donors, where even they (e.g. the U.K. and Ireland) have been hard hit by the global financial crisis and have faced significant retrenchment. Moreover, the reform agenda is designed to address the root causes of Malawi’s external imbalance so that its aid dependency and vulnerability can be reduced.
- *“Can a devaluation work in Malawi since the export supply response is relatively weak?”* – It is true that the export supply response is not instantaneous in an agrarian economy, but other countries with similar productive structures have successfully diversified their export base over time by pursuing consistent policies (e.g. these include many of Malawi’s neighbors, such as Zambia, Mozambique, Tanzania, Uganda).
  - In addition, the restoration of macroeconomic stability restores confidence and boosts other potential sources of FX, such as private remittances, FDI, and portfolio investment, so its not just boosting exports that is important.

# More questions



- *“Since Malawi is a net importer, doesn’t devaluation and depreciation just make imports more expensive and only further fuel inflation?”* This argument is counter-intuitive, as it presupposes that there is no FX constraint. The exchange rate, which is just the price of FX needs to be market-determined in order to equilibrate FX demand with the available supply and curb non-essential imports.
- *“When will inflation be brought back under control and the exchange rate stop depreciating?”* The answer to this question will depend on several things, including: (a) policy consistency—fiscal and monetary restraint, the latter prioritized over other competing objectives; (b) the degree of investor confidence and magnitude of FX inflows ; (c) the effectiveness of the food humanitarian response; and (d) the size and quality of this year’s harvest.

Malawi's recent move to exchange rate flexibility is not unique – Many other countries in the region have successfully stabilized and diversified their productive and export base...and mostly 20-30 years ago



*Malawi's neighbors with flexible exchange rates have achieved higher reserve coverage, while achieving similar growth and inflationary outcomes, but Malawi's high growth has been declining and is not sustainable*

Country	Real GDP 2003-11	CPI --12- month increase 2003-11	Reserves (in months of imports at 2003-2011)
Malawi	6.1	10.1	1.3
Mauritius	4.3	5.9	4.0
Mozambique	7.3	10.1	4.4
Tanzania	7.0	6.9	5.3
Uganda	7.5	7.7	6.0
Zambia	6.1	13.4	2.6

Malawi has successfully devalued in the past and international reserves rose within the context of complementary fiscal, monetary, and wage policies...But these reform efforts were not sustained



August 1998 –MK devalued 47 percent and allowed to float

- ❑ REER depreciated by 31 percent by November 1998
- ❑ International reserves rose from 2.6 months at end-1997 to **4 months of imports** by end-1998 and **4.5 months** at end-1999

September 2001 to July 2003—57 percent nominal depreciation, 35 percent REER depreciation.

February to July 2005—13.5 percent depreciation, and 12.4 percent from January to May 2006

- ❑ Underlying inflation continued to decline
- ❑ Continued high real interest rates to anchor inflationary expectations.



## VI. Conclusion: *Expectations Must be Managed*

Malawi is very much at a cross-roads:

- But, the economic outlook is favorable, and downside risks can be managed, if recent policy reforms are sustained and future policy choices are consistent with MGDS-II objectives. The reforms are already bearing fruit and the cost of policy reversals could be irreparable.
- Malawi must reestablish a good track record—investors dread uncertainty and honoring commitments is important for boosting investor confidence and maintaining development partners' trust and goodwill. The potential pool of FDI into Africa is large (an estimated US\$82 billion in 2011 and potentially US\$150 billion by 2015) and recent policy reforms are designed to help Malawi attract some of these FDI flows.
- The authorities' reform agenda is a comprehensive one, and is designed to **transform** Malawi's economy and help it attain the national goals outlined in the MGDS-II.

Thank you