Malawi Country Economic Memorandum

Seizing Opportunities For Growth Through Regional Integration and Trade

Key Messages

i. Malawi needs to focus on exports to maintain and broaden its current inspiring levels of economic growth. Consequently, the focus of future policy should be on reforms that improve competitiveness in global and regional markets. This does not require a fundamental shift in direction, but it does require a rebalancing of policy and expenditures to support an outward oriented development framework.

ii. Until the onset of the global financial crisis, the promise of this approach was becoming self-evident. Rapid economic growth, strong donor support, increases in foreign direct investment, the concrete potential to upgrade regional infrastructure, and the gradual dismantling of barriers within the Region through the COMESA and SADC Free Trade areas were all working in a direction that holds much promise for Malawi. Despite recent global developments, this report makes the case that for a small landlocked economy like Malawi, integration into a dynamic and more open Southern Africa region will continue to hold much of the key for improving prosperity and livelihoods.

What drives growth?

iii. Malawi's growth is export led. Despite changes in the structure of agricultural production from estate to smallholder farming and liberalization of prices and finance, a longstanding relationship exists and persists between exports and overall GDP. More specifically between GDP and export revenues expressed in real domestic currency. A central driver of the economy has been the positive multiplier effect of exports, which creates demand for local services and to a limited extent domestic manufacturing.

iv. The real exchange rate determines the strength of the multiplier effect from exports by translating US$ export revenues into local purchasing power. There are clear signs that the exchange rate is currently overvalued and an adjustment is warranted. These include a limited response to growth from import substituting sectors, a lack of export diversification and chronic shortages of foreign exchange combined with a widening gap in the parallel exchange market.

v. Although maize consumption is central to the welfare of Malawi's population, maize has contributed only additively to GDP and has actually been a driver of economic volatility due to its dependence on rainfall. The weak link between maize and economic growth is due mainly to the limited multiplier or spill-over effects of maize, due to the low proportion of production sold.

vi. The export of non-traditional products to regional markets is becoming increasingly important to export growth and diversification. Progress in regional cooperation through SADC, COMESA and bilaterally with South Africa will be key to expanding market access and the flow of inward investment to support diversified exports and economic growth.

Agriculture

vii. A dynamic smallholder farming sector has driven growth in agriculture. Smallholders have responded impressively when offered favourable opportunities and prices. Higher international agricultural prices and relatively strong regional growth are creating new opportunities for commercial crops in Malawi, even though theses prospects are clouded by the global economic crisis in the short term. However, if as many expect, world food prices will eventually rebound to levels that exceed those of the 1990s, agriculture can continue to be a significant driver of for growth, both through regional exports as well as through import substitution.

viii. Regional cooperation in agriculture is central to Malawi's market access, product quality and technological capability. Malawi depends on regional collaboration to upgrade infrastructure to regional and international markets; the harmonization of standards and sanitary measures; protection against plant and animal disease epidemics; and the generation of new technology.

ix. The potential for regional trade is impeded by the risk of government intervention, and differences in rules of origin, quality and product standards. Trade in food staples has long been discouraged by national policies that place a high priority on food self-sufficiency. In 2008, Malawi banned all exports of maize, and other SADC and COMESA countries have also intervened in these markets. Consequently, one of the biggest impediments to large-scale investment in regional trading capability remains the unpredictable behaviour of governments in imposing export bans whenever they fear shortages in their own markets.

x. Recent macroeconomic and agricultural policy decisions, however, have risked deteriorating agricultural incentives in Malawi. These include the maintenance of an overvalued exchange rate, restriction on private trade in maize and the setting of minimum prices for several crops, which puts recent gains at risk and potentially undermines investment in productivity improvements.

xi. Malawi's competitiveness is undermined by low productivity, high cost of inputs, high cost of transport, and high costs along the value chain. Inorganic fertilizer and other agricultural inputs are expensive mainly due to high international and domestic transport costs as well as high trader margins because of transaction risks associated with agricultural input trading. The high cost of inputs further leads to lower than optimal uptake of fertilizer and improved seed. Overtime, low uptake of improved technology results in under-capitalization in the sector, which tends to arrest any more technological and institutional innovations.

xii. Much of the competitive advantage of agribusiness, which Malawi enjoys, is due to the regulatory regimes and market institutions, which have developed for specific subsectors. However, in some subsectors, the regulatory environment has degraded and the government has exercised arbitrary intervention in price and trade controls. A new legislative compact is needed in many sub-sectors that commit the government to rule based regulation, which is systematic, predicable and based on facts and market intelligence. The key objective should be the adoption of just enough regulation to assure that each sector is able to enhance its response time to competitive challenges.

xiii. Food security has improved in Malawi due to widespread use of fertilizer and improved seed made possible by the input subsidy program. However, it will be important to rebalance agricultural expenditures by allocating resources to programs that deal with crop diversification, small-stock production, commodity risk management and other productivity enhancing investments. Expenditure on the fertilizer and seed program should be contained by better targeting toward food deficit households as well as more timely procurement.

xiv. Policy should shift away from unilateral minimum price management toward productivity promotion as a means to increase the income of farmers. Maize prices would be better stabilized through the consistent application of market risk management strategies rather than internal trade and price controls. Agricultural productivity could be improved through a targeted reduction of fuel levies, a reduction in the cost of finance, improved information about credit history and the linking of crop lending with weather insurance.

Trade Logistics

xv. Malawi’s geography is a challenge – given its distance from markets including gateway ports in Mozambique and South Africa. The current transportation costs measured as unit costs per kilometre travelled are not especially high. However, distances are relatively large and ultimately the total cost of export transport to final destination probably amounts to less than 15 percent of trade value while cost of import transport is approximately 12.5 percent of the value of imports.

xvi. While there is probably limited scope to alter the fundamental issues of international transport costs, the *reliability* of trade transport is a constraint to growth and is a policy variable, which could receive more attention. Malawian trade suffers extensive delays at ports (with the exception of Durban) and is subject to a high number of procedures and transit arrangements creating extremely fragmented supply chains.

xvii. Policy makers and donors have over-emphasized road infrastructure at the expense of concession efficiency, trade facilitation and regional cooperation. The focus of policy should shift towards the maintenance (roads) and rehabilitation (rail) of current infrastructure, the creation of a single regional transit regime, improvements in regional trade facilitation, and to promote through regional organizations, an increased operational efficiency of ports.

xviii. Regional trade facilitation could be improved through the establishment of a regional door-to-door transit regime, through the creation of a consistent SADC/COMESA transit regime in the form of regional carnet-bond system and the harmonization of road charges within SADC. Although Mozambique may not be able to be among the first countries to join the system, practical improvements could be negotiated between Malawi, Mozambique, and Zambia for the Beira and Nacala corridors.

xix. The efficiency of domestic trade facilitation could be improved by allowing custom declarations to be filled in and processed online; introducing an authorized operator regime for large importers, introducing tighter regulation of customs brokers; and improving transparency and response time of the issuance of trade licenses.

Spatial Dimension of growth

xx. Malawi's manufacturing industry is concentrated in Blantyre and Lilongwe. Industry in Blantyre is higher-tech and more externally orientated. Blantyre is physically closer to international markets and hence firms specialize in activities benefiting from access to international markets. Lilongwe is located in the agriculture belt and hence firms are more linked to domestic markets through agro-processing. Consequently, reliable power provision and international transport as well trade facilitation is relatively more important to firms located near Blantyre than firms located near Lilongwe are. It is important to recognize these differences when prioritizing public investments in power, transport and trade logistics.

xxi. Spatial analysis also reveals that the production of cash crops is concentrated in areas of good agronomic potential with relatively low transport times to major cities. While Malawi's current transport strategy focuses on tarmac roads, a higher economic return could be gained from prioritizing feeder roads in areas of high agronomic potential as farmers transport costs are significantly affected by the quality of feeder roads.

xxii. The domestic trucking industry is artificially protected from international competition on domestic routes, which contributes to significantly higher domestic transport costs and lower farm-gate prices. Even though international fleets would not be able to enter rural sections of the market because of load sizes and road quality, domestic routes should be opened to international competition.

Energy

xxiii. The undersupply and poor quality of electricity in Malawi is a binding constraint on economic growth, and energy generation is near totally dependent on the Shire river. The government needs to invest urgently in additional generating capacity.

xxiv. The regulatory framework of the industry requires clarification and reform. Electricity tariffs need to be substantially raised to fund additional investment; and the commercial framework needs to provide sufficient incentives to attract long-term investment from Independent Power Producers.

xxv. The industry should investigate ways of prioritizing uninterrupted supply to growth-critical industries, and of creating a tariff, which reflects the true cost of prioritization. Spatial analysis indicates that the highest demand for reliable use of electricity is most likely around Blantyre as most manufacturing and export oriented firms are located there.

Macro economic management

xxvi. Recent macro economic policy in Malawi, in particular fiscal discipline, have significantly contributed to Malawi's growth momentum and have also improved its growth prospects. However, this has not led to a sufficient large domestic supply response for GDP growth to match growth of aggregate demand. Consequently, macroeconomic management should therefore emphasize its role in supporting economic growth.

xxvii. In the short run, macroeconomic policy needs to contain growth in aggregate demand as it has outpaced increases in GDP, partly through an adjustment of the real exchange rate and a reduction of public expenditures. This will also assist in restraining the demand for imports of consumables. In addition, macroeconomic policy also needs to address the accumulation of foreign reserves and as such a re-evaluation of the use of foreign aid.

xxviii. For macroeconomic policy to have the desired impact on Malawi's productive capacity and supply potential, policy will need to be complemented by public investments to alleviate the supply side constraints identified in the areas of energy supply, and (cross-border) transport and trade facilitation. This will require a further switching of public expenditures in favour of infrastructural programs that improve productivity while at the same time reducing overall public expenditures, as the size of government has grown large compared to its comparators.