

Macroeconomic Policy Reforms and Economic Performance in Malawi (1960-2013)

Themba G. CHIRWA
themba.chirwa@mca-m.gov.mw
Department of Economics
University of South Africa

N. M. ODHIAMBO
Department of Economics
University of South Africa

Reformas de política macroeconómica y rendimiento económico en Malawi (1960-2013)

ResumenAbstract

- 1. Introduction**
- 2. Economic Development Policies and Reforms in Malawi**
 - 2.1. The Development Plan of 1971-1980**
 - 2.2. The Medium-Term Plan of 1981-1986**
 - 2.3. The Development Plan of 1987-1996**
 - 2.4. The Malawi Vision 2020**
- 3. The Influence of Government Policy and Reforms on Economic Growth in Malawi**
 - 3.1. Crowding-Out of Private Sector Investments**
 - 3.2. Regulatory Arbitrage**
- 4. Conclusions**
- 5. References**

Macroeconomic Policy Reforms and Economic Performance in Malawi (1960-2013)

Themba G. CHIRWA
themba.chirwa@mca-m.gov.mw
Department of Economics
University of South Africa

N. M. ODHIAMBO
Department of Economics
University of South Africa

Reformas de política macroeconómica y rendimiento económico en Malawi (1960-2013)

Cite as:

Chirwa, T.G., Odhiambo, N.M. (2016). Macroeconomic Policy Reforms and Economic Performance in Malawi (1960-2013). *Iberoamerican Journal of Development Studies*, 5(1):182-203

Abstract

The paper discusses the role that government policies and macroeconomic reforms have played in influencing economic growth in Malawi during the period 1960-2013. The study identifies a State-regulated economic system that dominated the Malawian economy, in which economic growth patterns were influenced mainly by activities financed by the State. Two fundamental challenges are identified that have led to a subdued performance of the economy – the crowding-out effect of State-interventionism affecting private sector-led growth; and regulatory arbitrage that has created an environment for rent-seeking behaviour. The study concludes that policy inconsistencies in implementing economic policies and reforms in Malawi have been instrumental in influencing the suboptimal growth patterns of the Malawian economy.

Keywords: Malawi, Macroeconomic Reforms, Economic Growth.

JEL Classification: E65, O11, O38, P51.

Citar como:

Chirwa, T.G., Odhiambo, N.M. (2016). Macroeconomic Policy Reforms and Economic Performance in Malawi (1960-2013). *Iberoamerican Journal of Development Studies*, 5(1):182-203

Resumen

En el artículo se analiza el papel que las políticas gubernamentales y las reformas macroeconómicas han desempeñado sobre el crecimiento económico en Malawi durante el período 1960-2013. En el estudio se identifica un sistema económico regulado por el Estado, que dominó la economía de Malawi, donde los patrones de crecimiento empresarial estuvieron fuertemente influidos por las actividades financiadas por el Estado. En este sentido, se establecen dos razones fundamentales que han llevado a los malos resultados de la economía: el efecto de exclusión del intervencionismo de Estado, que afecta al crecimiento impulsado por el sector privado, y el arbitraje regulatorio que creó el entorno propicio para la búsqueda de rentas. El estudio concluye que las inconsistencias políticas en la implementación de reformas económicas en Malawi han sido fundamentales para influir en los patrones de crecimiento inestable de su economía.

Palabras clave: Malawi, reformas macroeconómicas, crecimiento económico.

1 Introduction

It is postulated that for a country to benefit from effective economic policies and reforms, one needs to understand the *status quo* of the political economy and the economic policies adopted. The economic growth literature today identifies two main sources of growth: the first of these two relates to what economists call «proximate sources of growth», driven by the accumulation of physical capital and human-capital development, while the second relates to «fundamental sources of growth». These have an important drive to influence a country's ability to attract the proximate factors of production. The fundamental determinants have also a bearing on the stability of the macroeconomic environment; effectiveness of the institutional framework of an economy, related as it is, to governance, incentive structures and the social infrastructure; and setting up the right price mechanism and regulatory environment to clear markets (Corbo *et al.*, 1992; World Bank, 1990, 2002; Snowden and Vane, 2005). It is, therefore, important to study each country in its entirety in order to understand the successes and failures they have faced in attracting the proximate determinants of economic growth.

It has been argued that reforms require austerity measures that promote fiscal discipline, macroeconomic stabilization, free trade, privatization, decontrol of prices, and limited political intervention (World Bank 1990; Lucas 1993; Rodrik 1996). Based on this argument, many economists discuss the role that governments should play in influencing economic performance. The Keynesian school of thought that dominated much of the 1950s and 1960s saw a rapid increase of government involvement that went beyond merely addressing market failures as earlier suggested by Keynes himself; and moved more towards the implementation of interventions expected to be efficiently implemented by private agents. In Keynes view, there were some situations where an economy stuck in recession would not quickly respond to the price mechanism to return to its equilibrium path. Thus, the use of countercyclical fiscal policies was important at this juncture to influence short-run growth while market forces do so in the long-run (Keynes 1936).

The focus, however, changed —especially in the 1980s— when an appropriate mix of both capitalist and state interventionism was introduced that saw many developing countries adopting Structural Adjustment Programmes (SAPs), which were supported by the World Bank and the International Monetary Fund. These programs were aimed at introducing economic policies that corrected market failures created by government such as fiscal austerity, privatization, deregulation and free trade. The traditional role of governments was to intervene in markets —in order to address market failures and public choices (World Bank 1990; Kingston *et al.* 2011)—. A number of Economists have described situations in which govern-

ments intervene and develop the relevant public policies required to address such market failures. Usually, market failures would be associated with situations where there are time-inconsistent interventions (Kydlund and Prescott 1977); externalities, the provision of public goods and regulation (Le Grand 1991); and information asymmetries and market structure (Stiglitz 2000).

Malawi is one of the Sub-Saharan African countries that implemented the Structural Adjustment Programs supported by the World Bank and IMF in 1980. Malawi is also one of the poorest countries in the world, with an average GDP per capita at 2005 constant prices of US\$205 for the period 1960-2013 (World Bank 2015b). Since independence, the country has failed to attract the necessary investment for the economy to grow. The aim of this paper, therefore, is to examine the fundamental determinants of growth in Malawi by examining the various development policies and reforms that the Government has implemented since independence in 1964 and the policy challenges that directly affected the performance of the economy.

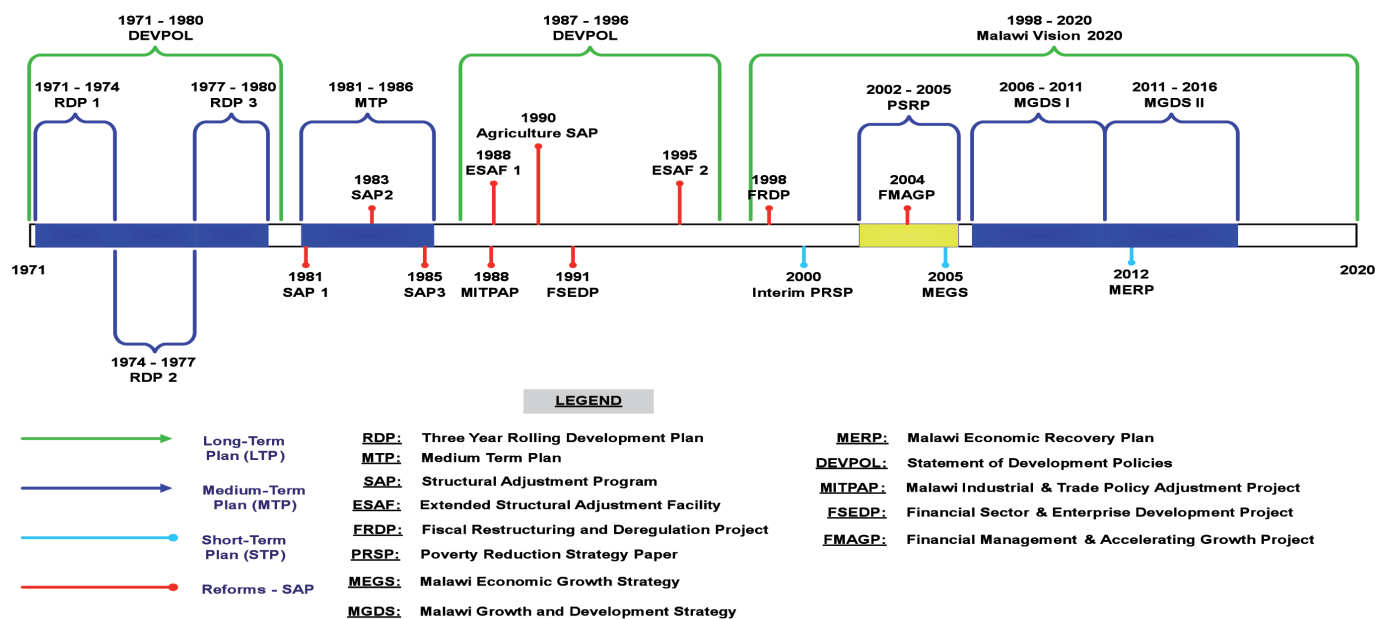
The rest of the paper is organized as follows: the second section examines development plans and reforms that were implemented in Malawi during the period 1970-2010, and their influence on economic growth. The third section discusses the policy challenges that arose from the implementation of the development policies and reforms related to economic growth performance. Lastly, the fourth section concludes the paper.

2 Economic Development Policies and Reforms in Malawi

The nature of Malawi's economic and development policy planning since independence has been guided by the availability of natural resources endowment, driven largely by abundant fertile land and the availability of cheap unskilled labour. The institutional framework and stage of development at independence were the two most important factors that defined the structure and content of future development policies. Although taking different approaches, the institutional framework was characterized by a mixed economic system that defined a national regulated State development planning process highly centralized and driven by State planning (World Bank 1966; Government of Malawi 1971).

As in many mixed economic systems, development planning in Malawi started from the agricultural sector, where the formulation of public investment projects was geared towards supporting agricultural production and productivity. With no existing mining industry, the availability of abundant fertile land and cheap labour

guided the development of economic policy that focused on where Malawi had a comparative advantage in labour-intensive agricultural development (Government of Malawi 1971; World Bank 1975). Figure 1 below is a chronology of Long-Term Plans (LTPs), Medium-Term Plans (MTPs) and Short-Term Plans (STPs) that have been implemented in Malawi since independence to support the Government philosophy. As illustrated in figure 1, the sub-sections 2.1-2.7 below give an overview of the development policies and reforms that were implemented in Malawi during the period 1970-2011.



NB: The chronology of these events was combined by the authors from various Development Policies, Plans and Reforms implemented in Malawi since 1971, from the Statement of Development Policies, 1971-1980; Three-Year Rolling Development Plans, 1971-1980; Medium-Term Plan, 1981-1986; Statement of Development Policies, 1987-1996; Malawi Vision 2010, and a number of Structural Adjustment Reforms, financed by the World Bank and the International Monetary Fund.

Figure 1
Malawi Development Policies and Reforms (1970-2020)

2.1. The Development Plan of 1971-1980

The first long-term development plan to be implemented by the Government of Malawi was the Statement of Development Policies, 1971-1980. The implementation of the development plan was done via three-year rolling development plans for the periods 1971-1974, 1974-1977, and 1977-1980 (World Bank 1975). The central objectives of the development plan were to: (i) achieve an average growth rate of 8% per annum (p.a.); (ii) increase agricultural production and productivity to raise rural incomes and national foreign exchange earnings; (iii) expand geographical distribution of economic activity by opening up new areas in the Central and Northern Regions of the country; (iv) increase local participation in economic activities through management and ownership of enter-

prises; and (v) elimination of the dependence on foreign assistance to cover government's recurrent expenditure (Government of Malawi 1971). The Government of Malawi took up development planning, with little engagement of the private sector as this sector during the 1960s was underdeveloped. According to the World Bank Development Indicators (2015b), Gross Domestic Savings in the 1960s was negative and averaged -0.2% p.a. while economic growth averaged 4.8% p.a.; and as a result the Government's involvement was critical. Parastatals were being created in areas, such as commerce and industry, agricultural production, transport and communications, tourism and social services (Government of Malawi 1971). Economic growth in the 1970s rebounded and the economy grew at an average rate of 6.2% p.a., which was more than twice the growth rate of population averaging 2.9% p.a. during the same period. Furthermore, Gross Domestic Savings as a share of GDP improved from -0.2% p.a. in the 1960s to an average of 14.4% p.a. in the 1970s (World Bank 2015b).

However, towards the end of the decade, there were five major problems that affected the sustainability of Malawi's future economic growth. These included the slow growth and poor quality of traditional exports from smallholder farmers; the declining terms of trade; the continued problem of population growth that increased pressure on the land available for the cultivation of export crops; the low performance of public enterprises; the increasing government budget deficit; and the slow growth in human capital development—resulting in a continued shortage of skilled labour, and reliance on expatriates (World Bank 1981a).

The lack of diversification of cash crops for exports, such as tobacco and tea, which accounted for 90% of all foreign exchange earnings, was facing a significant challenge of unpredictable export prices and price controls by the Government. The low international tobacco and tea prices; taxes on export crops such as cotton, groundnuts and tobacco; and *ad hoc* or arbitrary price controls on agricultural products, such as meat, poultry and dairy products; led to growth stagnation of smallholder agriculture (World Bank 1981a). Figure 2 is an illustration of real price movements for international tobacco and tea prices that affected the Malawian economy during the period 1960-2013.

As illustrated in figure 2, international prices for tobacco and tea declined sharply in real terms between 1960 and 1970. International tobacco prices fell by almost two-thirds from US\$9,073 per metric ton in 1960 to US\$3,500 per metric ton in 1980. Similarly, international tea prices fell by more than half from an average of US\$5.38 per kg in 1960 to US\$2.54 per kg in 1980 (World Bank 2015a).

Secondly, the continued growth in population as a driver of economic growth became a concern, owing to the fact that available fertile land for cultivation was sharply declining. Between 1966 and

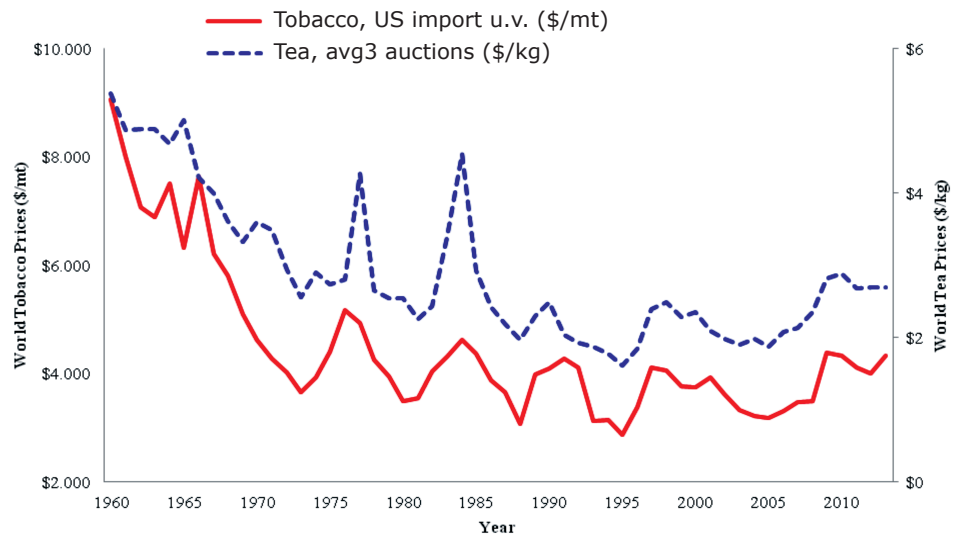


Figure 2
International Commodity Prices for Tobacco and Tea (1960-2013)
Source: World Bank (2015a).

1976, population growth was estimated at 3.3% p.a., declining to 2.9% p.a. between 1977 and 1986 (Government of Malawi 2010). The rising population meant that government had to spend more on social services, such as health and education, which was already constrained; and as a result, the shortage of skilled labour continued to increase in the 1970s. The shortage of skilled labour was also exacerbated by wage controls implemented by the Government that restrained increases in real wages —leading to serious adjustment problems affecting the Malawian economy (Government of Malawi 1987; World Bank 1981a)—. This led to increasing government budget deficits, which crowded out private investment. Although the Government registered surpluses on its recurrent account and modest budget deficits between 1973 and 1979, the situation changed drastically between 1979 and 1981, when the fiscal position deteriorated sharply. Figure 3 illustrates co-movements between government consumption and the accumulation of Gross Domestic Savings during the period 1960-2013. The primary vertical axis on the left represents a scale for government consumption while the secondary vertical axis on the right is a scale for gross domestic savings.

The poor performance of a number of public enterprises registering significant losses had an adverse impact on the government's budget, which increased the subventions to such poor enterprises (Government of Malawi 1987; World Bank 1988). As illustrated in figure 3, government consumption as a share of GDP was on average over the minimal threshold of 10% of GDP. Though Gross Domestic Savings as a share of GDP improved in the 1970s and 1980s, the crowding-out effect of increased government consumption started to be felt in the 1990s where Gross Domestic Savings declined sharply from an average of 14.4% in the 1970s to 2.5% p.a. in the 1990s (World Bank 2015b).

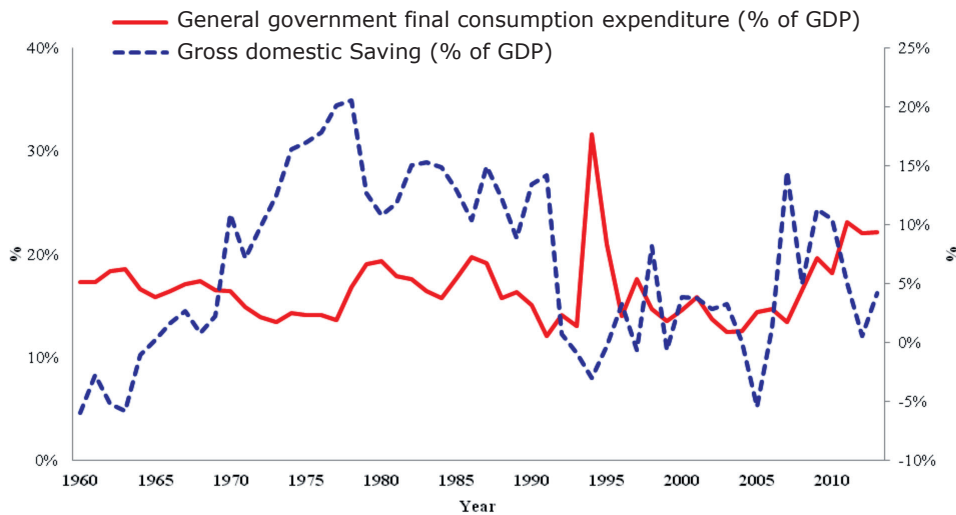


Figure 3

Crowding-out Effect of Government Consumption on Gross Domestic Savings: 1960-2013

Source: World Bank (2015b).

2.2. The Medium-Term Plan of 1981-1986

The advent of Structural Adjustment Programs in Malawi commenced with the development of a five-year Medium-Term Plan covering the Government of Malawi's fiscal years of 1981/1982 to 1985/1986. This was formulated in consultation with the World Bank and International Monetary Fund, in order to tackle the structural problems and economic shocks faced by Malawi during the period 1979-1981. The major objectives of the medium-term plan were threefold: (i) to achieve a real GDP growth rate of 4.8% p.a.; (ii) to increase export diversification through the development of new smallholder and estate crops, livestock and forestry industries, and agro-businesses; and (iii) to improve the financial performance of public enterprises to reduce the burden on domestic borrowing and debt (World Bank 1988; Collier and Gunning 1999).

The Medium-Term Plan was supported by three structural adjustment loans funded by the World Bank in June 1981, November 1983 and November 1985 (World Bank 1981b; 1983; 1985). The key principal objective of these loans was to assist the Government of Malawi in addressing its balance-of-payment problems. The balance-of-payment support had conditions, of which one related to influencing fiscal and monetary policies targeting high fiscal deficits that caused increases in prices (inflation), and exchange rate misalignment. During the period when the structural reforms were implemented, the Government of Malawi managed to contain current account deficits, which fell from 23.5% of GDP in 1979-1980 to an average of 9.5% of GDP during the period of 1981-1985 (World Bank 1988).

The progress made was a result of reduced external borrowing by government of commercial loans to concessional loans offered by the World Bank, the African Development Bank and others; the

rescheduling of debt-service payments that were due between 1981 and 1985; and the reduction of public sector consumption on merchandize imports. The Structural Adjustment Programmes also had the arduous task of exploring ways to improve output growth through trade, investment in agriculture and industry, and employment performance in sectoral institutions and government services (World Bank 1981a).

The crowding-out effect of increased Government expenditures was felt when the levels of investments fell sharply by almost 50% during the 1979-1981 period; gross capital formation as a share of GDP fell from 30.2% of GDP in 1979 to 17.6% of GDP in 1981 (World Bank 2015b). The vulnerability of the government's budget continued with a rapid deterioration of the government's budget deficit that rose from 12.3% of GDP during the 1978/1979 fiscal year to 16.5% of GDP in the 1980/1981 fiscal year. Although the government managed to reduce the overall government budget deficit from 16.5% of GDP during the 1980/1981 fiscal year to 8.3% of GDP in the 1985/1986 fiscal year, this was at the expense of a significant reduction in development expenditure (Government of Malawi 1987).

An increase in Government expenditure was also problematic; since it continued to crowd-out private investment, which rose from 20% of GDP in 1986 to 31% of GDP in 1994 (World Bank 2015b). The growth in Government recurrent expenditures was marred by high interest payments, which increased due to the borrowing at commercial interest rates. The increased borrowing was used to support recurrent expenditures and a sharp deterioration of the performance of public enterprises (Government of Malawi 1987; Collier and Gunning 1999). Figure 4 illustrates the co-movement between government consumption share in GDP and real interest rates.

As illustrated in figure 4, high rates of government consumption are associated with high rates of real interest rates revealing a

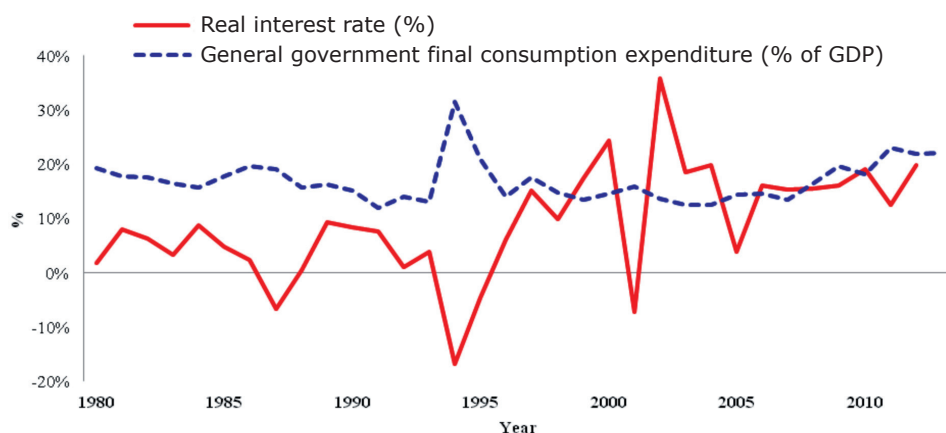


Figure 4
Government Consumption and Real Interest Rates (1980-2013)
Source: World Bank (2015b).

positive co-movement. The real interest rate has grown from an average of 3.8% p.a. in the 1980s to 16.1% during the period 2001-2013 (World Bank 2015b). The economy during the period of implementation of the Medium-Term Plan, however, did not perform as expected. Between 1981 and 1985, the real GDP growth rate for the period averaged 2.2% p.a. versus a target of 4.8% p.a. Although there were some improvements in the balance of payments position—due to foreign capital inflows from the World Bank and the IMF—, the key drivers of economic growth deteriorated sharply. Inflation grew at an average rate of 13.1% p.a., followed by exchange rate devaluations that averaged 9.5% p.a. (World Bank 2015b).

On a more positive note, the structural adjustment programmes supported by the World Bank and the IMF assisted Malawi in improving its balance-of-payments position. The trade balance registered a significant improvement, which reduced from an average of -8.4% of GDP between 1978 and 1980 to a surplus averaging 7.1% of GDP during the period 1981-1985. The current account deficit also declined significantly—from an average of -24% of GDP between 1978 and 1980 to a lower average of -11.5% of GDP during the 1981-1986 period (Reserve Bank of Malawi 1989).

2.3. The Development Plan of 1987-1996

The Medium-Term Plan implemented during the 1981-1986 period did not provide a coherent blueprint for the Government, in terms of prioritizing where investments were to be channelled. A new comprehensive development strategy was formulated in 1987, with a focus on reducing poverty, promoting education and health, improving income distribution and the welfare stability for Malawians. The Statement of Development Policies of 1987-1996 had four critical objectives: (i) to achieve an average real GDP growth of 4.4% p.a. that was expected to exceed the rate of population growth projected to grow at 3.7% p.a.; (ii) to restore fiscal discipline to ease pressure on the balance-of-payments position; (iii) to improve the balance-of-payments position through export diversification; and (iv) to reduce the annual rate of inflation from 26% in 1987 to 5% by 1991 (World Bank 1988).

This was also the first long-term development plan that outlined the structural policy reforms needed to boost the key productive sectors of the economy. The focus was to increase production and productivity by following a more market-oriented approach with increased private sector participation (Government of Malawi 1987). The Government in its statement outlined four critical policies aimed at improving private sector participation and reducing its involvement in the economic growth process. The first policy was to ensure that a favourable climate to attract private sector investment from both domestic and foreign sources was encouraged through the provision of incentives to undertake specific economic activities. This was to

be achieved by ensuring that the Government moved away from direct control and the strict regulation of enterprises —to one of promotion and support.

Secondly, the Government accepted the responsibility of providing essential infrastructural services, such as roads, electricity supply, telecommunication and land. Thirdly, the Government would promote Research and Development (R&D), particularly in the key sectors of agriculture, fisheries, mineral exploration, industrial technology, disease control and the environment. Lastly, the Government assumed the responsibility of developing human capital to ensure the availability of skilled labour. Investments in education focused on expansion and improving the quality of primary and secondary education, enhancing scientific and technical skills and improving teacher training. Health and population growth were also critical investments that the Government planned —in particular increasing resources for maternal and child-care services and increasing the number of primary health clinics in rural areas (Government of Malawi 1987).

An important structural reform that the Government of Malawi implemented during the period of its second long-term development plan was the Industrial and Trade Policy Structural Adjustment Programme (ITPSAP) signed on May 25, 1988 with the World Bank. The aim of the ITPSAP was to facilitate the creation of an enabling environment for the growth of the manufacturing sector, to increase the efficiency of resource allocation, to create employment, and to promote the growth of exports. The ITPSAP was also implemented to support an existing agreement that the Government had signed with the IMF on its first ESAF in 1988 that aimed at reducing government expenditure from 33% of GDP in 1986 to 24% of GDP in 1991 (Collier and Gunning 1999).

The ITPSAP introduced major trade liberalization policy reforms targeting fiscal spending, exchange rate liberalization by the year 1991, and trade tax reforms. The ITPSAP also provided the needed foreign exchange to finance imports by promoting a market determined allocation of foreign exchange. Furthermore, the ITPSAP aimed at liberalizing the import regime and constituted the removal of import prohibitions, the rationalization of import tariffs, and price decontrol (World Bank 1988).

The market-determined exchange rate regime was, however, short-lived; and it only survived up to November 1994. Policy inconsistencies grossly affected the implementation of a market-determined exchange rate regime. The numerous devaluations and depreciations of the Malawi Kwacha —28.5% in 1992; 22.2% in 1993; and 98.4% in 1994— led the Government to move back to a fixed exchange rate regime. This was implemented between December 1994 and June 1997. From July 1997 to July 2003, the exchange-rate policy moved back to a flexible exchange rate regime (Reserve Bank of Malawi 2005).

Exchange rate policy reversals continued thereafter; and from August 2003 to February 2005, the regime returned to a fixed exchange rate system. In 2005, there were two policy reversals: between March and June 2005, the Reserve Bank of Malawi adopted a flexible exchange rate regime, which was changed to a fixed exchange rate system from July to December 2005. The policy reversal trend continued; and from January 2006 to November 2007, a flexible exchange rate policy was adopted; before being reversed to a fixed managed float with occasional devaluation between December 2007 and April 2012. From May 2012 onwards, the policy moved to a full market-determined (floating) exchange rate regime (Reserve Bank of Malawi 2008; Government of Malawi 2012).

The period of multiparty dispensation in 1994 came with additional reforms that aimed at addressing structural constraints. In April 1996, the new Government signed a Fiscal Restructuring and Deregulation Project with the World Bank to continue supporting the balance-of-payment financial requirements faced by Malawi year after year, on condition that certain policy reforms were implemented to restore macroeconomic stability.

The project also supported the reforms initiated through the second ESAF that was financed by the IMF in 1995 (World Bank 1998). With the first Fiscal Restructuring and Deregulation Credit from the World Bank, the Government removed restrictions on smallholder production of key cash crops, such as burley tobacco. Restrictions were also removed for private traders to freely trade in key agricultural areas, such as seeds and fertilizers, outputs such as burley tobacco, and other cash crops. The Government, on the other hand, reduced the provision of fertilizer subsidies, introduced privatization programs to restructure commercial parastatals that were a significant drain on government resources, and undertook major tax and civil service reforms (World Bank 1998).

A second credit on Fiscal Restructuring and Deregulation was signed in November 1998 with the World Bank —to continue supporting policy reforms aimed at promoting private sector-led growth, accelerating privatization efforts of public parastatals that had been a drain on the government's budget, and supporting public sector reforms aimed at improving the management of public expenditure (World Bank 1998). Despite Malawi implementing all these structural adjustment reforms, high fiscal deficits still continued to be a significant setback in attaining the macroeconomic stability that was crucial for sustainable economic growth.

At the helm of the high fiscal deficits was the continued poor performance and mismanagement of public expenditure, coupled with weak policy and strategic planning. This created a mismatch between planned projects and the availability of resources to fund them —leading the Government to excessively borrow— both from

the local and external financial markets. As a result, fiscal deficits continued to increase from an average of 2.0% of GDP during the fiscal year (FY) 2000/2001; 7.7% of GDP in FY2001/2002; to an average of 12.8% of GDP in FY2002/2003 (Government of Malawi 2004, p. 2).

The decade performance during the implementation of the second long-term development plan was, nevertheless, unsatisfactory. During the period, 1987-1996, the economy grew at an average growth rate that equalled the rate of population growth at 3.7% p.a. versus a projected growth rate of 4.4% p.a. The inflation rate continued to increase, averaging 29.8% p.a. against a target of 5%. The terms-of-trade never improved, as projected, due to the continued declining of international export prices such as tobacco and tea; and the rising import bills, where the current account deficit as a proportion of real GDP rose from an average of -10.7% of real GDP during the 1981-1986 period to an average of -18.1% of real GDP between 1987 and 1996 (Reserve Bank of Malawi 1999; World Bank 2015b).

2.4. The Malawi Vision 2020

Malawi's third long-term strategy, the Malawi Vision 2020, was developed through an extensive consultative and participatory process in 1998 that provided another dimension to long-term strategic development management. The Vision was a collection of aspirations —and not development plans *per se*, as described in the previous long-term development plans. Rather than adopting a project-by-project approach, the Vision adopted a multi-faceted and multi-sectoral approach that involved considering changes in economic, technological, social and political attitudes (Government of Malawi 1998).

The other distinguishing feature of the Malawi Vision 2020 was the coverage period, which covered a period of 20 years, unlike the earlier long-term development plans that had covered a period of 10 years. The overall goal of the Vision was for Malawi to become a middle-income country with a per capita real income of US\$1,000 by the year 2020. This aspiration meant that, given a population growth rate of 2.0% p.a., as projected by the Population and Housing Census (1998), real GDP growth was expected to increase at an average rate of 9% p.a.; while real income per capita was expected to increase at a rate of 7% p.a. from baseline values for the year 1998 (Government of Malawi 1998).

During the period 1998-2013, the Malawi economy experienced a real GDP growth rate of 4.1% p.a. against a target of 9% p.a.; an actual real GDP per capita growth rate of 1.2% p.a. versus a target of 7% p.a.; an unstable inflation rate that grew at a rate of 17.5% p.a., versus a policy of having a single-digit inflation rate with a

target of 5% p.a.; and a local currency that depreciated at an annual rate of 23.5% p.a. (World Bank 2015b).

There were three medium-term strategies that were developed in support, partly or entirely, of the Malawi Vision 2020. These are discussed below, starting with the Malawi Poverty Reduction Strategy Paper of 2002-2005, the Malawi Economic Growth Strategy of 2004, and the Malawi Growth and Development Strategy of 2006-2010.

The Malawi Poverty Reduction Strategy of 2002-2005

The Malawi Poverty Reduction Strategy Paper (MPRSP) was approved by the Government in April 2002 as another statement of medium-term national strategy. The MPRSP was implemented for a period of three years, 2002-2005; and it provided a major policy departure from the previous development plans; and most importantly the Development Policies of the 1970s and 1980s (Government of Malawi 2002, p. 1). The MPRSP focus was on poverty-reduction through addressing socio-economic and political issues that would empower the poor as the underlying philosophy (Government of Malawi 2002).

Another distinguishing feature of the MPRSP was its focus on an integrated development strategy that aimed at moving away from centralized planning and towards decentralized planning and implementation. The Central Government's role was, therefore, expected to be reduced to one of national policy planning and development, and the enforcement of standards and regulations (Government of Malawi 2002). The MPRSP objectives were threefold. The first objective was to achieve an average real GDP growth rate of 4.3% p.a. between the period 2002 and 2005. This was expected to increase gradually from 3% in the fiscal year 2002/2003, to 4.5% in the fiscal year 2003/2004, and to 5.2% in the fiscal year 2004/2005.

The second objective was to reduce the rate of inflation from 27.6% in the fiscal year of 2001/2002 to 4.4% in the fiscal year of 2004/2005. The third objective was to ensure a stable exchange rate that depreciated at an annual rate of 2.7% p.a. —from MK71 in the fiscal year of 2002/2003 to MK78 in the fiscal year of 2004/2005 (Government of Malawi 2002).

The macroeconomic instability conditions, however, continued to worsen the domestic investment climate. Between 2002 and 2005, the actual average real GDP growth rate achieved was 3.7% p.a. The inflation rate averaged 12.8% p.a., despite falling from 22.7% in 2001 versus a target of 11.5%, and which then declined further to 11.4% in 2004. The exchange rate depreciated at an average rate of 13.4% p.a., rising from MK72.2 to the dollar in 2001, to MK118.9 to the dollar in 2005 (World Bank 2015b). Though investments (gross capital formation) as a proportion of GDP increased from 13.5% of GDP in 1998 to 22.7% in 2005; gross

domestic savings declined further from 8.1% of GDP in 1998 to -5.5% of GDP in 2005. Foreign capital inflows (foreign aid) thus dominated the contribution towards total investments in the country averaging 25.7% of GDP p.a. during the period 1998-2005 (World Bank 2015b). The MPRSP macroeconomic objectives were, thus, contrary to the Malawi Vision 2020 target of achieving an annual growth rate of 9% p.a.

The Malawi Economic Growth Strategy of 2004-2008

In July 2004, the Government of Malawi —after realizing the deficiencies brought in by the MPRSP— launched a short-term plan, the Malawi Economic Growth Strategy (MEGS). This was a complementary strategy to strengthen the first pillar of the MPRSP, sustainable pro-poor growth. The MEGS was developed on the philosophy that a high rate of economic growth is achievable, if an economy stimulates trade and investment, as well as restoring macroeconomic stability (Government of Malawi 2004). Government realized that the strategies and actions proposed in the MEGS, if implemented effectively, aimed at achieving a minimum and sustained annual economic growth of 6% p.a.

Under this pillar of the MPRSP these changes were ineffective. The evidence was supported by the MPRSP Progress Report of 2003 that identified a lack of proper prioritization of strategies under the pillar that would eliminate impediments to economic growth and the absence of a strategy that articulated the role of the private sector in the growth process (International Monetary Fund 2003). The MEGS thus focused on stimulating trade and investment in key sectors of the economy (Government of Malawi 2004).

The implementation of the MEGS was, however, short-lived, as Government realized the need for the strategy to cover other equally important development aspects, such as human capital development, safety nets, good governance, and the achievement of the Millennium Development Goals. A comprehensive strategy was, therefore, developed by the Government in 2005: the Malawi Growth and Development Strategy (MGDS) to account for both growth and social development (Government of Malawi 2006).

The Malawi Growth and Development Strategy of 2006-2010

The Malawi Growth and Development Strategy (MGDS) was another five-year medium-term strategy covering the period from 2006 to 2011; it was directly linked to four themes under the Malawi Vision 2020 on sustainable economic growth, social development, infrastructural development, and improved governance. The goal of the strategy was to create wealth through sustainable economic growth by first building Malawi's key infrastructure as the main catalyst for reducing poverty. The main objective was to address the balance-of-payments problems; as the performance of the external sector portrayed Malawi as a predominantly consuming,

rather than a producing and export-oriented nation (Government of Malawi 2006).

The main underlying assumptions of the MGDS was to achieve a minimum growth in real GDP of 6% p.a. during its implementation period, a conservative estimate that was lower than the projected growth rate stipulated in the Malawi Vision 2020. The MGDS also recognized the importance of key macroeconomic stabilizing variables of the inflation rate, the interest rate and the exchange rate as critical variables that had affected the sustainability of economic growth in the previous regimes and years.

The Government's target was, therefore, to achieve stability in these macroeconomic variables during its implementation period. The target for inflation was set at 5% by the year 2011; per capita income was expected to grow from US\$242 to US\$450 by the year 2011; and the exchange rate policy was expected to remain market determined within a managed float (Government of Malawi 2006).

The macro-economic performance during the MGDS period was impressive, with high economic growth rates registered in the first four years of implementation, at an average growth rate of 7.2% between 2006 and 2009. The highest growth rate was achieved in 2007 at 9.5%, followed by 8.3% in 2008, and 9% in 2009. However, the performance was disturbed in 2010, when real GDP growth declined to a rate of 6.5%. Real per capita income also rose at an average rate of 4.1% p.a., versus a population growth rate of 3% p.a. (World Bank 2015b). The highest rise in per capita income was recorded in 2007 at a rate of 6.2%. The performance of stabilizing macro-economic variables was also impressive with the inflation rate registering an average growth rate of 9.3% during the MGDS implementation period —with the lowest value achieved in 2010 at 7.4% (World Bank 2015b).

The exchange rate also remained relatively stable due to Government policy to move away from a market determined exchange rate to a managed floating exchange rate regime. This policy reversal saw the exchange rate depreciating within a band at an average rate of 5% p.a. during the MGDS implementation period, and reduced to 1.3% p.a. between 2007 and 2010 (World Bank 2015b).

The balance-of-payments position, however, did not perform well; and Malawi continued to register significant trade deficits averaging -17.4% of real GDP p.a. during the MGDS implementation period. Gross domestic savings almost tripled from an average of -5.5% of GDP in 2005 to 10.4% of GDP in 2010. This facilitated the increase in gross capital formation that grew from 22.7% of GDP in 2005 to 26.0% of GDP in 2010 (World Bank 2015b).

The source of total investments, however, continued to be from foreign capital inflows financed mainly by concessionary loans from the World Bank, IMF and foreign aid through bilateral agreements

with Malawi's major donors. During the MGDS implementation period, foreign aid averaged 26.5% p.a. It was for this reason that Malawi's economic growth was disturbed in 2010 —when most of its major donors pulled out— due to poor macroeconomic governance —leading to a sharp deterioration of economic growth from a buoyant growth rate in 2009 of 9% to 6.5% in 2010 (World Bank 2015b).

3

The Influence of Government Policy and Reforms on Economic Growth in Malawi

The evidence provided in the literature review on development plans and reforms implemented in Malawi during the study period show a high degree of State-intervention leading the growth process. This was in sharp contrast to the principles leading the Structural Adjustment Programmes that aimed at promoting a market-oriented economy with increased private sector involvement in the economy (Bird and Rowlands 2000). The aim of structural adjustment loans was to enforce a market-oriented economy and a significant move away from a State-regulated economy with a focus on privatization of state-owned industries, liberalization of capital markets, and market-based pricing (Easterly 2005).

Government interventions are expected to address market failures; and from the viewpoint of a classical economist, the Government is expected to limit its activities to creating an enabling environment for private sector-led growth (Snowdon and Vane 2005). The first market reforms to address this concern commenced in the 1980s, with the advent of Structural Adjustment Programmes financed by the World Bank and the IMF. However, these reforms did not achieve their stated objectives in many African countries including Malawi (Easterly 2005). Comparable studies conducted in Africa, show a similar trend where structural adjustment programs failed; not entirely a blame on the principles governing the structural adjustment process, but rather policy inconsistencies that most governments adopted. In a study by Kingston *et al.* (2011), structural adjustment programs failed to transform economies such as Ivory Coast, Senegal, Uganda and Zimbabwe. A common feature of these countries, including Malawi, is that their economies continue to be largely driven by agriculture.

The literature review for Malawi conducted in this study supports the inability of the structural adjustment loans to influence government in creating an enabling environment for private sector led growth, improving the level of public savings, restructuring the agricultural sector with a focus on implementation of programs with high returns, the efficient use of public resource, the adoption of rational prices and world market conditions to guide investment and production

decisions, and the restructuring of public enterprises (Easterly 2005). These results also support the empirical analysis found in Gebregziabher (2015, p. 179) where Malawi experienced a sharp decline in economic growth rates even after structural adjustment reforms were implemented. However, based on the literature review, it is clear that the economic woes experienced in Malawi during the study period were not necessarily a problem of the structural adjustment programs; but rather a failure to adjust towards a more market-driven economy led by private sector development.

The period of implementing the Structural Adjustment Programmes in Malawi was characterized by macroeconomic instability mainly influenced by policy inconsistencies in implementing the reforms and declining productivity (Government of Malawi 2004, p. 12). The economic system that dominated and was promoted by the Government during the study period was, therefore, more of a State-regulated economic system that created two main challenges for the Malawian economy: the crowding-out of private sector investment, and regulatory arbitrage that created an environment characterized by rent-seeking behaviour. The following sections discuss these challenges in more detail.

3.1. Crowding-Out of Private Sector Investments

Since independence, the Government of Malawi has implemented development policies and reforms that were inconsistent with regard to the objectives they set out to achieve. Since 1964, the Government of Malawi created public institutions and parastatals in areas that were expected to be efficiently delivered by private sector agents. These policies eventually crowded-out private sector investment, destroyed incentives for increasing production and productivity, as well as entrepreneurial growth; and they promoted unnecessary bureaucracies, rent-seeking behaviour and corruption (World Bank 1998, p. 11; Government of Malawi 2004, pp. 16 and 69-70).

Increased government budget deficits have been manifested throughout the study period; and some of the factors it affected include the low accumulation of physical capital that declined sharply, averaging 27.0% of GDP p.a. during the period 1971-1980, 19% during the 1981-1990 period, 17% between 1991 and 2000, and an average of 21% of GDP p.a. during the period 2001-2013. Further deterioration was experienced in the failure of Malawi to attract foreign direct investment that averaged 1.3% of GDP at 2005 constant prices p.a.; low gross domestic savings that averaged 6.5% of GDP at 2005 constant prices p.a. during the period 1960-2013; and high real interest rates that rose from an average of 3.8% during the period 1981-1980 to 16.1% during the period 2001-2013 (World Bank 2015b).

By international standards, the level of gross domestic savings which is a key source of investment in any economy, averaged 6.5%

of GDP during the period 1960-2013. This was significantly below the minimum levels required for an economy to grow which is expected to be not less than 20% of GDP (Bassanini *et al.* 2001). As a result, the policies and institutions that the Government of Malawi had established and implemented failed to generate the necessary savings and investments required for the economy to grow. The level of government failure in this case was insurmountable; and it is recommended that the Government of Malawi sustainably reduces its involvement in the market, as well as facilitating the process to create a conducive environment for private sector-led growth.

3.2. Regulatory Arbitrage

One of the major challenges that the Malawian economy has faced is related to regulatory arbitrage that resulted from the inefficient implementation of Government-led interventions — leading to price and exchange rate misalignments, commodity subsidies and subventions to parastatals that have been a significant drain on public resources (Government of Malawi 2006).

Le Grand (1991) argued that through the operations of markets, the price mechanism is crucial; as it links the production costs of an intervention to the income that it generates. Similar arguments have been propounded in the literature whereby a stable macroeconomic environment supported by an efficient price mechanism and regulatory environment; as well as efficient public institutions is conducive for economic growth (World Bank 1990). However, State-run interventions do not go through such processes; as almost all of the government activities are financed through the collection of government revenues, whose main sources are taxes, donations or grants. Since the price mechanism is not usually used when the Government selects which public interventions to implement, there is no guarantee that the public policy choices made will be optimal. This missing link, therefore, increases the likelihood of misallocating public resources which promote interventions that are implemented sub-optimally.

The public interventions that the Government of Malawi implemented during the study period were, therefore, no exception to this rule. Throughout our study period, the evidence provided shows that price and exchange-rate controls, commodity subsidies and subventions to poorly performing parastatals were supported by the Government budget (World Bank 1998, p. 11; Government of Malawi 2006, p. 79). In addition, government did not utilize price signals from trends in international commodity prices for its major cash crops such as tobacco and tea where their prices fell significantly during the study period. For instance, tobacco prices declined by two-thirds, while tea prices fell by almost half during the period 1960-2013 (World Bank 2015a). With the likelihood that government revenues support interventions with unrelated costs of production,

the Government of Malawi is not able to be in a position to know whether more or less resources are being used to support any given public intervention optimally. Implementing activities that would lead to reducing allocative inefficiencies is, therefore, recommended if Malawi is to attract the necessary investments needed for the economy to grow.

4 Conclusions

The paper has examined the role that the State in Malawi played in influencing economic growth trajectories over the period 1960-2013. The analysis provides a linkage of the role that development policies and reforms played as fundamental drivers of economic growth to attract the necessary investments and in the accumulation of physical capital in Malawi. The study reveals that the level of State-intervention has been high; and created a macroeconomic environment that was not conducive for growth. This led to two main challenges that affected the Malawian economy. These include the crowding-out of private sector investment, and regulatory arbitrage.

During the period 1960-2013, the crowding-out effect of government interventions led to a decline in gross domestic savings that averaged 6.5% of GDP at 2005 constant prices p.a., which was significantly below the recommended minimum levels of at least 20% and above. Regulatory arbitrage, on the other hand, led to macro-economic instability as increased government budget deficits and inappropriate resource allocation destabilized the economy through the growth of inflation that averaged 17.9% p.a., exchange rate depreciations that grew at an average rate of 14% p.a. during the period 1981-2013; and inefficient utilization of the price mechanism to inform resource allocation.

The evidence points out that, if the Malawian authorities had focused on ensuring macroeconomic stability, the use of an efficient price mechanism and regulatory environment to inform decisions; a conducive environment for economic growth would have been created and dominated by private sector-led growth. The study, therefore, concludes that policies and reforms have an important role to play and are fundamental drivers of economic growth in Malawi if implemented effectively.

5 References

- BASSANINI A, SCARPETTA S, HEMMINGS P. (2001). Economic Growth: The role of policies and institutions. Panel data evidence from OECD countries. Economics Department Working Papers 283.
- BIRD G, ROWLAND D (2000). The catalysing Role of Policy-Based Lending by the IMF and the World Bank: Fact or fiction? *Journal of International Development* Vol. 12, No. 7:951-973.
- COLLIER P, GUNNING JW (1999). The IMF's Role in Structural Adjustment. WPS/99-18 (June).
- CORBO V, FISCHER S, WEBB SB (1992). Adjustment Lending Revisited: Policies to restore growth. A World Bank Symposium. The World Bank, Washington D. C. (eds).
- EASTERLY W (2005). What did Structural Adjustment Adjust? The association of policies and growth with repeated IMF and World Bank adjustment loans. *Journal of Development Economics* Vol. 76, No. 1:1-22.
- GEBREGZIABHER F (2015). Adjustment and Long-Run Economic Performance in 18 African Countries. *Journal of International Development* Vol. 27, No. 2:170-196.
- GOVERNMENT OF MALAWI (1971). Statement of Development Policies, 1971-1980. Office of the President and Cabinet, Economic Planning Division: Zomba (December).
- GOVERNMENT OF MALAWI (1987). Statement of Development Policies, 1987-1996. Office of the President and Cabinet, Economic Planning and Development Department: Lilongwe.
- GOVERNMENT OF MALAWI (1998). Vision 2020: The National long-term development perspective for Malawi. National Economic Council: Lilongwe (March).
- GOVERNMENT OF MALAWI (2002). Malawi Poverty Reduction Strategy Paper: Final draft. Ministry of Economic Planning and Development: Lilongwe (April).
- GOVERNMENT OF MALAWI (2004). Malawi Economic Growth Strategy Volume II: Main Report. Ministry of Economic Planning and Development: Lilongwe (July).
- GOVERNMENT OF MALAWI (2006). Malawi Growth and Development Strategy: From poverty to prosperity 2006-2011. Ministry of Finance: Lilongwe (July).
- GOVERNMENT OF MALAWI (2012). Malawi Economic Recovery Plan, 2010-2020. Ministry of Economic Planning and Development.
- INTERNATIONAL MONETARY FUND (2003). The Annual Review of the Malawi Poverty Reduction Strategy 2002/03. IMF Country Report No. 03/329 (October).
- KEYNES JM (1936). *The General Theory of Employment, Interest and Money*. London: Macmillan.
- KINGSTON CS, IRIKANA G, DIENYE V, KINGSTON KG (2011). The Impacts of the World Bank and IMF Structural Adjustment Programmes on Africa: The case study of Cote D'Ivoire, Senegal, Uganda, and Zimbabwe. *Sacha Journal of Policy and Strategic Studies* Vol. 1, No. 2:110-130.
- KYDLAND FE, PRESCOTT EC (1977). Rules Rather Than Discretion: The Inconsistency of Optimal Plans. *Journal of Political Economy* Vol. 85, No. 3 (June):473-492.
- LE GRAND J (1991). The Theory of Government Failure. *British Journal of Political Science* Vol. 21, No. 4 (October):423-442.
- LUCAS RE JR. (1993). Making a Miracle. *Econometrica* Vol. 61, No. 2 (March):251-272.
- RESERVE BANK OF MALAWI (1989). *Financial and Economic Review* Vol. XXI, No. 2. Blantyre: Blantyre Print and Packaging.
- RESERVE BANK OF MALAWI (1999). *Financial and Economic Review* Vol. XXXI, No. 2. Blantyre: Blantyre Print and Packaging.
- RESERVE BANK OF MALAWI (2005). *Financial and Economic Review* Vol. 37, No. 1. Blantyre: Blantyre Print and Packaging.
- RESERVE BANK OF MALAWI (2008). *Financial and Economic Review* Vol. 40, No. 3. Blantyre: Blantyre Print and Packaging.
- RODRIG D (1996). Understanding Economic Policy Reform. *Journal of Economic Literature* Vol. 34, No. 1:9-41.
- SNOWDON B, VANE HR (2005). *Modern Macroeconomics: Its origins, development and current state*. Edward Elgar, Northampton: Massachusetts.

- STIGLITZ JE (2000). The Contribution of the New Economics of Information to Twentieth Century Economics. *Quarterly Journal of Economics* Vol. 115, No. 4 (November):1441-1478.
- WORLD BANK (1966). The Economy of Malawi. Africa Department, September 14, retrieved from www.worldbank.org on August 20, 2014.
- WORLD BANK (1975). Recent Economic Development Prospects of Malawi. Country Programs Department II, Eastern African Region, January 14, retrieved from www.worldbank.org on August 20, 2014.
- WORLD BANK (1981a). Malawi Basic Needs. Eastern African Regional Office. May 8, retrieved from www.worldbank.org on August 20, 2014.
- WORLD BANK (1981b). Malawi: Structural Adjustment Loan to the Republic of Malawi. June 4, retrieved from www.worldbank.org on August 20, 2014.
- WORLD BANK (1983). Malawi: Second Structural Adjustment Project. November 29, retrieved from www.worldbank.org on August 20, 2014.
- WORLD BANK (1985). Malawi: Third Structural Adjustment Operation. November 25, retrieved from www.worldbank.org on August 20, 2014.
- WORLD BANK (1988). Malawi: Industrial and Trade Policy Adjustment Program. May 25, retrieved from www.worldbank.org on August 20, 2014.
- WORLD BANK (1990). Adjustment Lending Policies for Sustainable Growth. Policy and Research Series, Washington D. C., World Bank.
- WORLD BANK (1998). Malawi: Second Fiscal Restructuring and Deregulation Program Technical Assistance Project. November 10, retrieved from www.worldbank.org on August 20, 2014.
- WORLD BANK (2002). Building Institutions for Markets. Oxford: Oxford University Press, retrieved from www.worldbank.org on October 17, 2014.
- WORLD BANK (2015a). Commodity Price Data (Pink Sheet). Retrieved from www.worldbank.org on May 5, 2015.
- WORLD BANK (2015b). World Development Indicators 2015. Retrieved from www.worldbank.org on May 5, 2015.