Chapter 3 – Structural Adjustment and Poverty

Malawi has implemented a series of Structural Adjustment Programmes (SAPs). The major areas of focus in the SAPs have included the liberalisation of the agricultural sector (which centred on price decontrols, market liberalisation, and the repealing of the Special Crops Act), parastatal sector reform, financial sector reform (which included the liberalisation of the exchange rate, relaxation of exchange controls, and interest rate liberalisation) and the rationalisation of the Budget.

However the adjustment programmes have had limited impact on economic growth and poverty reduction due to a number of factors. This chapter presents an overview of the Structural Adjustment Policies and Economic Performance, and outlines a new approach to Poverty Reduction Strategies.

3.1Overview of Structural Adjustment Policies

Between 1981 and 1994, Malawi implemented six Structural Adjustment Programmes supported by the International Monetary Fund and the World Bank. From 1995 to date, Malawi has implemented three Fiscal Restructuring and Deregulation Programmes (FRDP), another form of SAP supported by the World Bank. The major thrust of these SAPs was to stimulate the economy to achieve sustained economic growth and development.

In the agricultural sector, the reforms centred on price decontrol, market liberalisation, and the repealing of the Special Crops Act. Price decontrol was aimed at allowing market forces to drive resource allocation in production whilst market liberalisation was intended to foster competition and ensure that smallholder farmers get good input and producer prices. The repeal of the Special Crops Act lifted restrictions on smallholder production of burley tobacco.

In the financial sector, the Reserve Bank of Malawi and Banking Acts were reviewed in 1998/99 to allow, among other things, easy entry of new banking institutions into the financial sector and to give the Reserve Bank greater independence in the formulation of monetary policy. The revision of the Acts also strengthened the RBM's powers to supervise the banking industry. The liberalisation of the financial sector also meant that monetary policy had to shift from direct to indirect instruments of monetary policy.

Liberalisation of interest rates began in 1987 when lending rates were freed. Deposit interest rates were deregulated in 1988 together with the abolition of preferential interest rates to the agricultural sector. By May 1990, all interest rates became fully liberalised.

Another notable policy reform undertaken was the liberalisation of the exchange rate system in order to promote the country's competitiveness in international trade. The Kwacha's flotation in February 1994 was meant to enhance flexibility in achieving this goal.

During the same adjustment process, Government has also undertaken the privatisation of public enterprises through the enactment of the Privatisation Act passed in 1995. This was aimed at improving efficiency, fostering competition and establishing a wider base of share ownership. Although privatisation has in general been characterised as a success, a number of social and redistributive issues remain unresolved such as employment and popular ownership.

Major industry and trade reforms were implemented in 1988 through the Industrial and Trade Policy Adjustment Programme. The programme eliminated quantitative restrictions and rationalised trade taxes. Malawi's tariff bands were reduced to four. The foreign exchange market was also liberalised to ensure efficiency in foreign exchange allocation.

Locally produced goods were exempted from surtax in 1992 as a way of offering protection to local producers. The rationalisation of trade taxes ensured that only import duties were used as instruments of protection, while domestic taxes emphasised taxing consumption rather than production.

To promote Public Sector Management the Government has undertaken Civil Service Reform. The Civil Service Reform programme has included a census of Civil Servants and the retrenchment of 20,000 temporary employees. In addition, strategic and functional reviews of

Ministries have formed the basis for rationalisation of Government through contracting out certain functions and removal of operational overlaps.

Government also adopted the Medium Term Expenditure Framework (MTEF) in 1997 to improve the allocation and quality of public expenditure in view of the great need for an efficient public service and the very limited financial resources available. Specifically, efforts were made to strengthen expenditure prioritisation and to increase allocation to priority sectors such as education and health. These reforms were supported by the Fiscal Restructuring and Deregulation Programme, which also sought to reduce domestic financing of deficits and retiring of domestic debt.

Government has also initiated several measures to improve financial management and accountability. Significant progress has been made in the design of a computerised Integrated Financial Management Information System (IFMIS) with a view to strengthen the monitoring of expenditure, and integrated fiscal reporting system linking the Treasury with the Reserve Bank of Malawi and line ministries to ensure timely reconciliation of accounts.

3.2 Economic Performance During Adjustment

The Malawi economy registered impressive growth from independence through to 1979. Real output growth, mainly spurred by the agricultural sector, averaged 6.7 percent during this period. But the fruits of this growth were poorly distributed, and growth itself was narrowly based on estate agriculture. Starting from 1979, Malawi suffered from a series of exogenous shocks, high import costs due to oil price shocks, disruptions in trade routes, the influx of refugees from Mozambique and droughts that disrupted the pattern of growth. Policy weaknesses also exacerbated the effect of these external shocks. External payment arrears rose and this put pressure on foreign exchange. Real GDP growth fell to 1.1 percent and 2.1 percent in 1986 and 1987, respectively.

Following another round of SAPs, Malawi started to experience relatively buoyant economic growth between 1988 and 1991. Real GDP growth rose from 3.3 percent in 1988 to 7.8 percent in 1991. However, the gains arising from this growth were short-lived as growth fluctuated though the 1990s, partly as a result of external shocks such as droughts. For example, the economy recorded negative growth of 7.9 percent in 1992 and 11.6 percent in 1994, before recovering with a growth rate of 14.5 percent in 1996. However, the growth rate has again fallen in recent years, with only 1.8 percent growth recorded in 2000.

3.3Structural Adjustment effects on Poverty

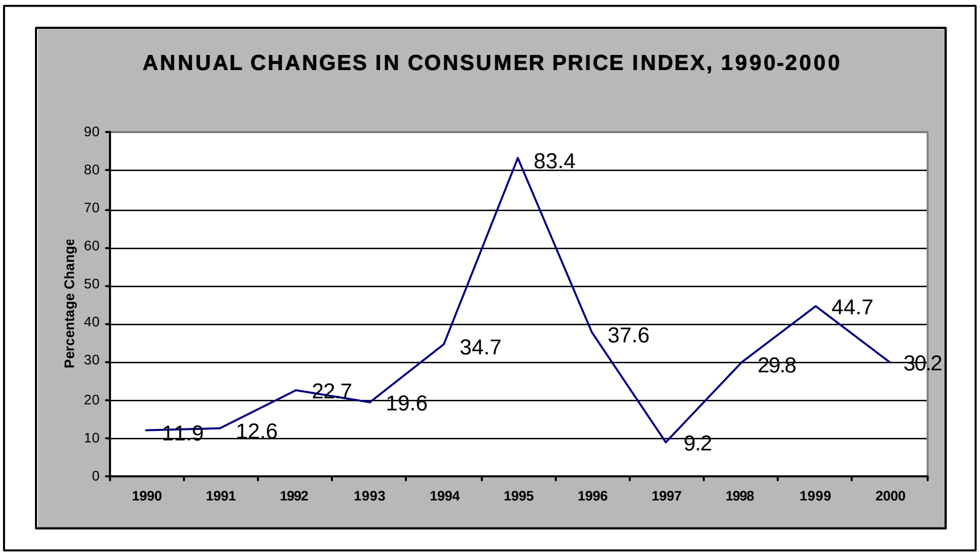
The impact of the wide ranging policy reforms implemented during the adjustment period has been unsatisfactory. Although there have been periods of stability and growth, sustainable growth has proved elusive. The instability arose mainly from external shocks, inconsistent implementation of reforms, fiscal policy slippages and the narrow base of the production capacity. The inability to sustain high rates of growth over a long period undermined any poverty reducing impact of growth. Furthermore, macroeconomic instability actually aggravated the poverty situation as explained below.

3.4Macroeconomic Trends

3.4.1 Inflation

During the period of 1900-2000, the annual inflation rate as indicated by the Consumer Price Index (CPI) has remained relatively high. As figure 3.1 below indicates, inflation moved from 11.9 percent in 1990, to 34.7 percent in 1994, and 83.4 percent in 1995, mainly due to fiscal slippages and external shocks. Prudent fiscal policies introduced in 1995 reduced inflation to 37.6 percent in 1996 and to 9.2 percent in 1997. The depreciation of the Kwacha in August 1998 led to cost-push inflationary pressure resulting in annual inflation rates of 29.8 percent and 44.7 percent in 1998 and 1999, respectively. In the recent years inflation has averaged 30 percent.

Figure 3.1: Trends in Inflation 1990-2000



Source: Malawi Government, Economic Report (various Issues)

Inflation is a regressive and arbitrary tax, which places a heavy burden on the poor who have no any other means of countering the associated adverse effect such as interest bearing accounts. In particular high inflation is damaging to growth as it erodes purchasing power most seriously on the poor.

Table 3.1: Basic Macroeconomic Indicators

	1994	**1995**	**1996**	**1997**	**1998**	**1999**	**2000**
GDP growth rate	-10.2	9.6	8.2	4.9	2.0	4.0	1.7
Average Annual Inflation	34.7	83.1	37.7	9.1	29.8	44.8	29.6
Domestic Saving/DGP	-3.0	-3.0	3.0	0.9	6.0	3.1	3.1
Investment/GDP	29.1	17.0	11.6	12.2	13.3	14.8	15.9
Interest rate (Lending)	31.0	47.3	45.3	28.3	37.7	53.6	53.6
Current Account Deficit/GDP (inc grant)	-13.4	-1.7	-7.7	-10.5	-2.5	-8.3	-4.9
Exchange rate (MK1US$, average	8.7	15.3	15.3	16.4	31.1	44.1	59.5
External Debts/GDP	150.6	139.1	88.6	90.8	142.7	144.0	150.3

Source: IMF

3.4.2 Nominal Exchange Rate

During the period of reforms, as shown in Table 3.1 above, the Kwacha exchange rate has moved from MK 8.7 to the 1 US$ in 1994 to MK59.5 to 1 US$ 2000. By February 2001 the United States Dollar traded at 80.5 Malawi Kwacha although the Kwacha has of late appreciated to MK61.3 to 1US$. During the same period a depreciating exchange rate has also eroded incomes and the purchasing power of the poor through inflationary effects.

3.4.3 Interest Rates

High fiscal deficits as shown in Table 3.1 above have during the Structural Adjustment period necessitated excessive Government borrowing, which in turn has led to high interest rates. Interest rates (lending) moved from 31.0 percent in 1994 to 53.6 percent. This led to the crowding out of the private sector. High interest rates act as disincentive to investment and therefore retard economic growth and worsen poverty as the poor fail to raise credit resources to participate in production.

3.5Agricultural Effects of Adjustment

The initial impact of the reforms implemented in the agricultural sector led to a substantial increase in the production of tobacco as well as private sector participation in marketing of agricultural produce. The liberalisation of burley tobacco production alone generated around US$185 million of revenues for the rural sector, which stimulated the growth of trading, transport and other income. However, over time, these benefits have been offset by inputs prices increasing faster than producer prices. The lifting of price controls, elimination of fertiliser subsidies have all contributed to increased input costs. Again, during years of bumper crops, farmers have lost out because producers prices have often collapsed without any remedial Government interventions.

3.6 Fiscal Policy and Expenditure Allocations

In addition to general fiscal policies relating to the size of the deficit and tax policies, the ways in which Government allocates resources through the Budget plays a large role in poverty reduction. Since the mid-1990s the Government has reallocated its expenditures towards the social sectors.

As indicated in Table 3.2 below, Government has allocated the largest share of the total budget to Social and Community Services from the mid-1990's, with Education receiving the highest share within this category.

Table 3.2Functional Analysis of Total Government Expenditures: Estimates 1995/96-1999/2000

	1995/96	**1996/97**	**1997/98**	**1998/99**	**1999/00**
General Administration	21.80%	37.02%	35.10%	22.93%	30.73%
General Public Services	15.56%	29.31%	27.50%	16.87%	24.30%
Defence	3.15%	3.96%	3.46%	2.53%	2.77%
Public Order and Safety	3.08%	3.75%	4.14%	3.53%	3.66%
Social and Community Services	40.64%	24.27%	38.89%	40.46%	41.68%
Education	17.38%	11.09%	17.49%	14.90%	15.55%
Health	11.08%	6.00%	9.59%	12.20%	11.58%
Social Security	7.64%	4.89%	6.74%	5.35%	7.16%
Economic	15.56%	9.33%	9.49%	20.04%	20.17%
Agriculture	9.17%	6.17%	4.73%	12.37%	10.95%
Unallocable	22.01%	29.38%	16.53%	16.57%	7.43%
Total	**100.00%**	**100.00%**	**100.00%**	**100.00%**	**100.00%**

Source: Economic Reports

This would imply that resources have been allocated to one of the poverty reducing areas, however as the Table 3.2.above highlights the second largest share of the Budget has been allocated to General Administration, with General Public Services, i.e. the general functions of Government, receiving the highest share within this category. At the same time the percentage share of the agriculture budget increased over this period. Allocations to social services have increased but the quality of expenditure has not fully reached the beneficiaries.

Another point of interest is the significant change in the percentage shares from year to year, partly explained by changes in the levels of donor funding. Within specific sectors the following trends were noted in the Public Expenditure Review prepared by the Malawi Government in 2000:

1. **Education**: the share of the Recurrent Budget for primary education has risen from 50 percent in 1993/94 to around 60 percent in 1999/00, with the poorest sections of the population benefiting from an increasing share of primary education expenditures. However expenditures per pupil are 8 times higher in secondary education than in primary education, and 202 times higher in tertiary education.

2. **Health:** only 18 percent of the Health Budget is spent at on primary health services, which most directly benefit the poor, with tertiary health services receiving the highest share of the budget.

3. **Agriculture:** the highest share of the Agriculture Budget is spent on administration, with Headquarters receiving a significant proportion of this, partly because all donor funds are channelled through Headquarters and because of the centralised structure of the Ministry. Expenditures on agricultural research and extension as a percentage of GDP have fallen, with extension spending declining from 0.6 percent in 1995/96 to 0.3 percent in 2000/01.

Thus the detailed analysis in the PER highlights the fact that although Government has reallocated funds to those Ministries that have direct impact on poverty reduction, these funds were not always directed within the Ministries to those particular sub-sectors and activities that directly benefit the poor. This would explain why the overall reallocations in expenditures have had a limited impact on poverty reduction in the 1990s.

3.7 New Approach to Poverty Reduction

As noted before, the various structural reform programs have not translated into poverty reduction. To address this situation the Poverty Alleviation Program (PAP) was instituted in 1994 as the main strategy for addressing poverty in Malawi. The PAP emphasised the need to raise national productivity through sustainable broad-based economic growth and socio-cultural development. Some of the notable programs under the PAP included: Free Primary Education, Malawi Social Action Fund (MASAF) funded Community Projects, European Union (EU) Macro-Projects and the Bakili Muluzi Health Initiative.

However, the main constraint of the PAP was the absence of a well-articulated action plan to ensure a holistic approach during implementation. In addition, the PAP Policy Framework was silent in terms of setting poverty targets that needed to be achieved either in the medium long-term. The result was the existence of disjointed initiatives, which lacked proper co-ordination.

It is against this background that Government recognised the need to do a balancing act between measures to promote medium and long-term growth and policies to reduce the short to medium term plight of the majority of the population. Government also noted that for poverty reduction to be achieved, there would be need to stimulate pro-poor economic growth whilst investing in social sector development and ensuring that Government intervene to help those who cannot benefit from growth. The strategy would have also to address a number of crosscutting issues, such as the HIV/AIDS epidemic and gender equality. It is against this background that PRSP was initiated.