Chapter 3 - Structural Adjustment and Poverty

Malawi has implemented a series of structural adjustment programmes (SAPs) to address structural weaknesses and adjust the economy to attain sustainable growth and poverty reduction. The major areas of focus of the SAPs included the liberalisation of the agricultural sector, parastatal sector reform, privatisation, trade liberalisation, financial sector reform, exchange rate liberalisation, interest rate liberalisation; and the rationalisation of the Budget. Nonetheless, the adjustment programmes have had limited impact on economic growth and poverty reduction.

This chapter presents an overview of the structural adjustment policies and their impact on economic growth and poverty reduction, and finally outlines the rationale for the new approach to Poverty Reduction Strategies.

3.1 Overview of Structural Adjustment Policies

Between 1981 and 1994, Malawi implemented several structural adjustment programmes supported by the International Monetary Fund (IMF) and the World Bank (WB). From 1995 to date, Malawi has implemented three Fiscal Restructuring and Deregulation Programmes (FRDP), another form of SAP supported by the World Bank. Malawi has also been through a series of Enhanced Structural Adjustment Facilities (ESAF) supported by the International Monetary Fund (IMF). In parallel to the introduction of the PRSP approach internationally, the IMF has adopted Poverty Reduction and Growth Facilities (PRGF) as its main instrument in Malawi.

Given that Malawi is an agro-based economy, many of the reforms were focussed on the agricultural sector. The first key reform was price decontrol, which was aimed at allowing market forces to drive resource allocation in production. Secondly, market liberalisation was intended to foster competition and ensure that smallholder farmers get good input and producer prices. In particular, the repeal of the Special Crops Act in 1995 lifted restrictions on smallholder production of burley tobacco and allowed smallholder farmers to generate more income.

In the financial sector, the Reserve Bank of Malawi (RBM) 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.

The 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 also undertook 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, such as employment and popular ownership, remain unresolved.

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 also undertook civil service reform. The Civil Service Reform programme included a census of civil servants and the retrenchment of 20,000 temporary employees. In addition, strategic and functional reviews of Ministries 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. As noted 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 strengthening the monitoring of expenditure, and creating an integrated fiscal reporting system linking the Treasury with the Reserve Bank of Malawi and line ministries to ensure timely reconciliation of accounts.

3.2 Effects of Structural Adjustment on Poverty

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

3.3 Economic Performance during Adjustment

From independence through to 1979, the Malawi economy registered impressive growth. Real output growth, mainly spurred by the agricultural sector, averaged 6.7 percent during this period. However, the benefits of this growth were poorly distributed, as growth was narrowly based on estate agriculture. Starting from 1979, Malawi suffered from a series of exogenous shocks, including 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. In addition, policy weaknesses and slippages exacerbated the effect of these external shocks.

As a result of these internal and external factors, real GDP growth fluctuated between 1979 and 1987, recovering to a high of 6.8 percent in 1984 following droughts in previous years. The agricultural sector continued to be the main source of growth and domestic saving.

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 through the 1990s, largely as a result of external shocks such as droughts and the reduction of donor financial support between 1992 and 1994. For example, the economy recorded growth rates of -7.9 percent in 1992 and -11.6 percent in 1994, before recovering with a growth rate of 14.5 percent in 1996. Growth has averaged 2.6 percent between 1997 and 2000 and stands at 1.8 percent in 2001.

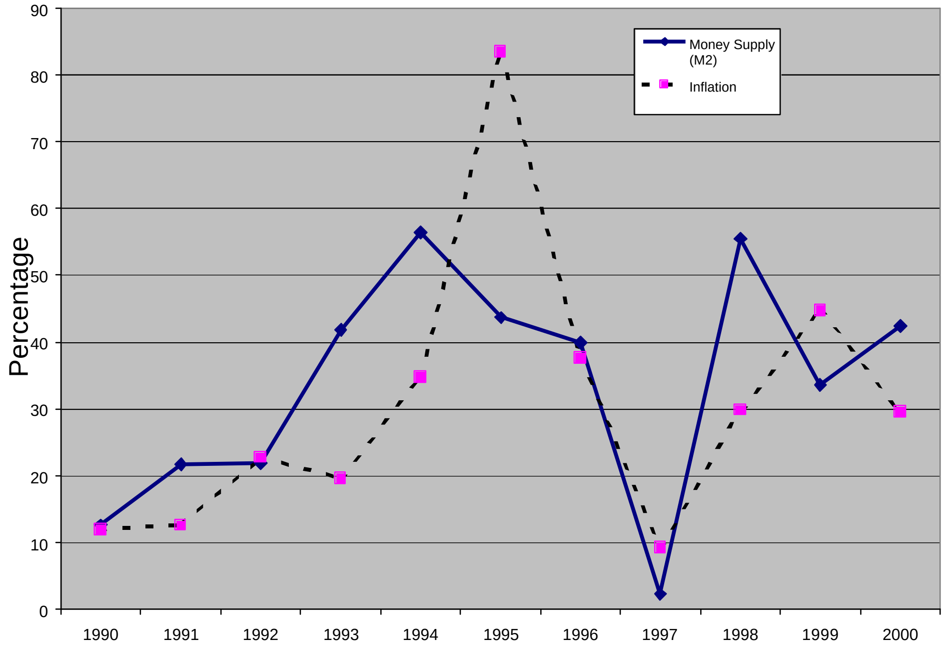
This poor economic growth performance implies that the majority of the population experienced no change in their economic status. The situation was more serious among the poor whose household consumption even in times of relative growth has stagnated. Thus economic performance during the adjustment period from 1981 to date had minimal impact on poverty reduction.

3.3.1 Inflation and Money Supply

Between 1980 and 1990, the inflation rate, as indicated by the Consumer Price Index (CPI), remained stable averaging 16.6 percent. During the period of 1990-2000, the annual inflation rate fluctuated. 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[31] resulting in annual inflation rates of 29.8 percent and 44.7 percent in 1998 and 1999, respectively. In recent years inflation averaged 30 percent.

[31] Cost push inflation results from a sudden shock to certain prices, which then has further effects on other prices (including wages). In this case the shock was caused by a depreciation of the Kwacha that increased the price of imports, such as fuel.

Figure 3.1: Trends in Money Supply (M2) and Inflation 1990-2000



Source: Government of Malawi (various years): *Economic Report*

As Figure 3.1 above demonstrates, inflation in Malawi has been caused by high money supply (largely as a result of excessive Government borrowing) and the cost-push effects arising from movements in the nominal exchange rate. Inflation is a regressive and arbitrary tax, which places a heavy burden on the poor who have no other means of countering the associated adverse effects such as interest bearing accounts. In particular, high inflation is damaging to disposable incomes as it erodes purchasing power.

There is a correlation between movements in money supply and in inflation. Usually, increases in the growth of money have been followed by increases in the rate of inflation. The main source of increases in money supply is Government borrowing, from financial and non-financial institutions to finance its operations. It therefore follows that reducing the fiscal deficit will be followed by deceleration in the growth of money, and hence low inflation.

Table 3.1: Basic Macroeconomic Indicators

% unless otherwise indicated	**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
Fiscal deficit/GDP inc. grants – Fiscal Year	15.0	5.7	4.4	5.2	3.4	5.6	5.7
Domestic Saving/GDP	-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
Current Account Deficit/GDP inc. grants	-13.4	-1.7	-7.7	-10.5	-2.5	-8.3	-4.9
Exchange rate (MK:1USD, 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: Government of Malawi (various years): *Economic Report*

3.3.2 Nominal Exchange Rate

During the period of reforms, the exchange rate between the Malawi Kwacha and the United States Dollar moved from MK1.05 to the dollar in 1982 to MK4.4 in 1993. As shown in Table 3.1, the Kwacha exchange rate moved further from MK 8.7 in 1994 to MK59.5 in 2000. By February 2001 the United States Dollar traded at MK80.5 although later in that year, the Kwacha appreciated to MK61.3 to 1US$.

3.3.3 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 17 percent in 1980 to 29.5 percent in 1993. The rate moved further from 31.0 percent in 1994 to 52 percent in 2001. This has led to the crowding out of the private sector. High interest rates act as disincentive to investment as they increase the cost of borrowing and hence retard economic growth. High interest rates have worsened poverty as the poor fail to raise credit resources to maximise agricultural production and other income generating activities.

3.4 Effects of Agricultural Reform

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[32], which stimulated the growth of trading, transport and other income. However, over time, these benefits have been offset by input prices increasing faster than producer prices. The lifting of price controls and elimination of fertiliser subsidies have contributed to increased input costs. Again, during years of bumper crops, farmers have lost out because producer prices have often collapsed without any remedial Government interventions.

The failure to foster competition in both the input and output markets in response to the liberalisation compromised the sector's ability to consolidate and sustain the benefits accruing to the poor.

3.5 Fiscal Policy and Expenditure Allocations

Apart from the poor fiscal and tax policies relating to the size of deficit, the allocation of resources through the budget plays a major role in poverty reduction. 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-1990s, with Education receiving the highest share within this category.

However, despite this positive trend towards increased allocations to priority poverty reducing areas, Table 3.2 also demonstrates that this prioritisation has not been adequate. In particular, General Administration continues to account for a large share of the Budget (averaging around 30 percent over the period). The significant variations in the percentage shares from year to year can partly be explained by changes in the levels and recording of donor funding.

[32] World Bank (2000)

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

percent	1995/6	1996/7	1997/8	1998/9	1999/2000
General Administration	21.8	37.0	35.1	22.9	30.7
General Public Services	15.6	29.3	27.5	16.9	24.3
Defence	3.2	4.0	3.5	2.5	2.8
Public Order and Safety	3.1	3.8	4.1	3.5	3.7
Social and Community Services	40.6	24.3	38.9	40.5	41.7
Education	17.4	11.1	17.5	14.9	15.6
Health	11.1	6.0	9.6	12.2	11.6
Social Security	7.6	4.9	6.7	5.4	7.2
Economic Services	15.6	9.3	9.5	20.0	20.2
Agriculture	9.2	6.2	4.7	12.4	11.0
Unallocable	22.0	29.4	16.5	16.6	7.4
Total	100.0	100.0	100.0	100.0	100.0

Source: Government of Malawi (various years): *Economic Reports*

Although allocations to priority areas, such as social services, have increased, the quality of expenditure has not fully reached the beneficiaries. As the 2000 Public Expenditure Review (PER) clearly demonstrates, resources within the priority sectors of education, health and agriculture have not been used efficiently and effectively. In particular:

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 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.

3.6 New Approach to Poverty Reduction

As noted in the preceding section, the various structural reform programs did not translate 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 projects under the PAP included: Free

Primary Education, Malawi Social Action Fund (MASAF) funded Community Projects, European Union (EU) Micro-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 or long-term. The result was the existence of disjointed initiatives, which lacked proper co-ordination.

It is against this background that Malawian stakeholders, including Government, have 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. It has also been noted that for poverty reduction to be achieved, pro-poor economic growth must be stimulated whilst investing in social sector development and ensuring that Government intervenes to help those who cannot benefit from growth. The strategy must also address a number of cross-cutting issues, such as the HIV/AIDS epidemic, gender equality, the sustainable use of natural resources, and the creation of a science and technology culture.