

DRAFT

VOLUME 1

MALAWI

INTEGRATED FRAMEWORK

DIAGNOSTIC TRADE INTEGRATION STUDY

FOR CONSULTATION AND DISCUSSION

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ACRONYMS

ACB	Anti-Corruption Bureau
ACP	Africa Caribbean Pacific
ACV	Agreement on Customs Valuation
ADB	African Development Bank
ADMARC	Agricultural Development and Marketing Corporation
AGOA	African Growth and Opportunity Act
AHL	Auction Holdings Ltd.
ARET	Agricultural Research and Extension Trust
ASYCUDA	Automated System for Customs Data
CBI	Cross-Border Initiative
CEAR	Central East African Railways
CET	Common External Tariff
COMESA	Common Market for Eastern and Southern Africa
DFID	Department for International Development
DWM	David Whitehead Malawi
EAC	Commission for East African Cooperation
EBA	Everything But Arms
EPZ	Export Promotion Zones
FTA	Free Trade Agreement
GOM	Government of Malawi
GSP	Generalized System of Preferences
HIPC	Highly Indebted Poor Countries Initiative
HTS	Harmonized Tariff System
ICRISAT	The International Crops Research Institute for the Semi Arid Tropics
IDA	International Development Association
IOC	Indian Ocean Commission
MATECO	Malawi Tea Corporation
MBS	Malawi Bureau of Standards
MCCCI	Malawi Confederation of Chambers of Commerce and Industry
MCI	Ministry of Commerce and Industry
MEPC	Malawi Export Promotion Council
MFN	Most Favored Nation
MIPA	Malawi Investment Promotion Agency
MOAI	Ministry of Agriculture and Irrigation
MOF	Ministry of Finance
MRA	Malawi Revenue Authority
MUB	Manufacturing Under Bound
NAFTA	North American Free Trade Agreement
NAG	National Action Group
NASFAM	National Smallholder Farmers' Association of Malawi
NRA	National Roads Authority
PAMA	Paprika Manufacturers Association
PRSP	Poverty Reduction Strategy Paper
PSI	Pre-Shipment Inspection
REER	Real Effective Exchange Rates
RTOA	Road Transport Operators Association
SACU	Southern African Customs Union
SADC	Southern African Development Community

SDF	Standards Development Forum
SGS	Société Générale de Surveillance
SPS	Sanitary and Phytosanitary Standards
SQAM	Standards, Quality, Accreditation and Metrology
STA	Smallholder Tea Authority
STABEX	Stabilization System for Export Earnings
SUCOMA	Sugar Corporation of Malawi
TAMA	Tobacco Association of Malawi
TBT	Technical Barriers to Trade
TRIPS	Trade-Related Intellectual Property Rights
USAID	United States Agency for International Development
WCO	World Customs Organization
WTO	World Trade Organization

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PREFACE

This is the first draft of the Malawi Diagnostic Trade Integration Study (DTIS) to be circulated to key stakeholders with a view to securing comments. Once comments and suggestions are received, a revised draft will be circulated to the Integrated Framework (IF) Working Group and country focal point for further revisions and improvements.

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The authors would like to express their gratitude to all those in Malawi—in government, non-government organizations and the business community—for their time and insights into Malawi's economic opportunities and challenges.

The focal point in Malawi has been Brian Mtonya from Malawi's Ministry of Commerce and Industry (MCI) who has overseen the activities of the Malawi Integrated Framework National Steering Committee which is comprised of government, private sector, development partners, and other interested stakeholders.

This study is not meant to be exhaustive in nature. Rather, because various aspects of Malawi's trade regime and the institutional capacity and other constraints that Malawi faces in integrating more effectively in the world trading systems have been the subject of recent studies¹, this report is intended to fill the gap between the recent studies and to

¹ The WTO's Trade Policy Review, the World Bank's Country Economic Memorandum and other studies conducted under the auspices of DFID and other development partners.

place increased emphasis on the linkages between trade and poverty, on the prospects for growth among Malawi's major and emerging export sub-sectors, and on the need to further integrate trade policy and capacity within the country's broader development and poverty reduction strategies. The study's main objective is to develop recommendations for programs and policies, which Malawi and the international community can pursue in order to enhance Malawi's integration into world trade in ways that would result in poverty reduction. The diagnostic study is composed of two volumes. Volume 1 is the main report providing the assessment and technical analysis of major issues faced by Malawi as it attempts to take advantage of opportunities offered by the regional and international market environment. Volume 2 presents selected background papers prepared for the diagnostic study.

Events leading up to the Malawi Diagnostic Trade Integration Study (DTIS)

The Integrated Framework (IF) Program commenced in 1997 to promote the integration of least developed countries into the global economy. Participating agencies are the World Trade Organization (WTO), the International Monetary Fund (IMF), the International Trade Centre (ITC), United Nations Development Program (UNDP), United Nations Conference for Trade and Development (UNCTAD) and the World Bank (WB).

In 2000, a Trust Fund was established to increase the benefits that least developed countries derive from trade related Technical Assistance (TA). As of September 2001 pledges to the Trust Fund had been made by the following partners: Canada, United Kingdom, Japan, Switzerland, Norway, Denmark, Sweden, Ireland, United States, the Netherlands, Finland, UNDP, the European Commission, France and the World Bank. Three pilot countries (Cambodia, Madagascar and Mauritania) were identified for a program of work starting with a diagnostic trade integration study covering competitiveness and the impact of increased integration in the world economy on poverty and implied technical assistance needs flowing from these findings.

In late 2001 the Government of Malawi and the Integrated Framework Inter Agency Working Group (IAWG) agreed that Malawi would be one of four countries to participate in the next round of the IF work program.

In November 2001, a preliminary mission to Malawi was conducted by IAWG representatives to establish working arrangements with the government, establish processes for recruiting local IF team members and establish the scope of the Terms of Reference.

In February 2002, the Terms of Reference were reviewed by the Integrated Framework National Steering Committee that was formed in Malawi, consisting of government officials, private sector representatives, development partners, and non-governmental organizations. (The Ministry of Commerce and Industry serves as the focal point for the National Steering Committee).

In April 2002, the National Steering Committee met once again to approve the Terms of Reference. This also coincided with the commencement of the field mission to Malawi, which carried out its work between April 29 and May 10, 2002.

EXECUTIVE SUMMARY

Trade has historically formed a significant dimension of Malawi's economy. For much of the past century, the fostering of trade has been a prominent feature of the Malawian economy. During the colonial period, the Nyasaland economy came to be centrally based upon the production and exports of selected agricultural commodities, primarily on foreign-owned and settler estates, using the indigenous population as labor. This structure remained in place up through and beyond Malawi's independence in 1964, with export-oriented agriculture supplemented by domestic food production by smallholder farmers and the migration of large numbers of Malawians to work in the mineral mines of South Africa.

The historical linkages between trade and growth have been narrow and precarious. During the 1960s and 1970s, export-oriented estate production of tobacco, tea, coffee, and other crops underpinned a relatively rapid (>6% per annum) and seemingly sustainable rate of GDP growth. However, this growth was narrowly based and was associated with a highly skewed distribution of wealth and income. Also, a series of external shocks in the 1980s and early 1990s exposed the fragility of Malawi's economy, resulting in recurring macroeconomic instability, a stagnation in exports, and a decline in per capita income over an extended period.

Poverty is widespread and severe. An enduring legacy of this long-standing dualistic development strategy and the deceleration of economic growth has been the widespread incidence of poverty in Malawi. It is estimated that 63 percent, or more than 6.2 million Malawians are poor. The poor are concentrated in rural areas, where the formal economic sector continues to make little contribution to household incomes and where most of the poor remain focused on subsistence-oriented farming. A declining natural resource base and the spread of HIV/AIDS has weakened the capacity of many poor rural households to even ensure subsistence. Weak rural infrastructure, a declining system for agricultural advise and technology support, and weak or uncertain market institutions in many locations and for many commodities have severely constrained the ability of the rural poor to sustainably participate in commercial and export-oriented production. Providing improved access to markets and reducing the risks that households face remain key challenges for poverty reduction in Malawi.

New opportunities for accelerated economic growth and improved trade performance presented themselves over the past decade. During the early 1990s, Malawi underwent a transition to democracy with the new government putting in place policies to re-establish macroeconomic stability, liberalize the economy and trade regime, and enable much broader participation in higher income potential agricultural and manufacturing activities. Within Southern Africa, there occurred a restoration of peace in neighboring Mozambique, a democratic transition in South Africa, and broader efforts to strengthen regional trade. Malawi was provided with (more extended) preferential access to selected international markets, including those within the European Union and the United States.

Yet, results have fallen short of expectations. Over the past decade Malawi's trade and wider economic performance have lagged behind expectations and behind the performance of many other developing countries. Malawi's trade remains highly dependent upon a limited range of primary commodities, for several of which the country has experienced a decline in its international competitiveness and market share. Between 1990 and 2001, the bulk of the increment in Malawi's export trade was accounted for by tobacco and even in that industry there are serious challenges to sustained growth. Export product diversification has been very limited and the country has only minimally taken advantage of emerging market opportunities within the region or beyond. Certain structural changes—especially in the tobacco sub-sector—did provide for a broader distribution of the benefits of trade during the early to mid-1990s, yet much of these gains have eroded in recent years because of the declining profitability of production. Malawi was adversely affected by downward movements in international commodity prices, yet these trends were exacerbated by supply side weaknesses which prevented or delayed an effective response.

Malawi's trade performance has not been substantially hindered by its trade policies, institutions and agreements. This Diagnostic Trade Integration study has sought to assess the past performance and future prospects for Malawi's international trade, to discern the primary contributing and constraining factors, and to elaborate upon the areas for needed capacity-building and further technical assistance. The analysis suggests that whatever shortcomings there may be in the country's trade policies, trade-related institutions, or market access conditions—and several of these shortcomings are highlighted in this paper—these have not and presently are not the central barriers inhibiting Malawian producers and consumers from better realizing income and welfare gains from international trade.

Macroeconomic instability has been a major constraint upon trade and growth. Malawi has not experienced a sustained period of macroeconomic stability during the 1990s. It is only once the macroeconomic environment has been stabilized, including bringing down both inflation and interest rates, that other policy prescriptions suggested in the scope of this DTIS will have a prospect to succeed. A key area that requires policy reform is with respect to the exchange rate, where volatility has constrained trade and investment.

Addressing supply side issues is fundamental to alleviating constraints on trade. At the forefront of these are both internal and external transport costs. These are exceptionally high, weakening the competitiveness and profitability of Malawian firms and farmers. Malawi's land-locked position is a contributing factor yet this disadvantage is magnified by policy and institutional constraints in relation to road, rail and air transport services. Some transport reforms have already been undertaken. However, another phase of reform and action is necessary to support trade. This will entail challenges to Malawi's influential domestic trucking industry as well as improved transport investment and service coordination with Malawi's neighbors.

Agriculture and related agro-industry lies at the heart of a pro-poor growth strategy. Agricultural and rural development are central to Malawi's broader development. Over the past decade, only limited and uneven progress has been made in realizing Malawi's rural development objectives—achieving broad-based growth, diversifying the structure of production and trade, and improving household and national food security. For the near future, the contribution of exports to growth and poverty reduction will be primarily dependent upon the improved performance of a small number of commodity sub-sectors that currently dominate exports-- tobacco, tea, cotton, and sugar. In the first three of these sub-sectors, low and declining productivity and high market-related transaction costs threaten continued viability for many producers in the face of depressed international commodity prices. Hence, Malawi's "core business" remains at risk and coordinated efforts involving the private and public sectors are needed. At the same time, there are ample opportunities for Malawi to further diversify its exports—especially among products where it has a history of successful trade (i.e. groundnuts, spices, textiles and clothing), yet supply side productivity and other constraints must be effectively addressed.

The Policy Challenge

The objective of public policy in Malawi should be to provide an institutional framework by which economic agents can exploit the main advantages that Malawi has: one of the lowest labor costs in the region, a reputation for a hard-working labor force, a stable political environment, an increasingly open trading environment, and established market linkages through major international companies. The following will be necessary parts of a program to enhance trade, raise growth and reduce poverty in Malawi:

Macro-economic stability, and in particular, a reduction in exchange rate volatility.

The strengthening of a physical and institutional ***infrastructure for the development of markets and the facilitation of exports and growth***, based around the removal of supply side constraints which inhibit productivity improvements, hinder or preclude access to markets within the country, and substantially raise the costs of selling in overseas markets. Paramount amongst these is the transport network and the cost and quality competitiveness of transport services. Other priorities are: using public/private partnerships to enhance productivity and quality in primary agriculture, lowering the market and transaction costs facing small farmers and businesses, improving the provision of utilities and finance, and increasing efficiency and capacity in the provision of customs services.

An ***upgrading of Trade Policy Making Capacity***. Given the importance of trade in Malawi and its potential role in alleviating poverty, there is a need for a clear understanding of trade policy issues and an ability to analyze, identify and then effectively represent Malawi's interests in domestic, regional and multilateral trade discussions and negotiations. Malawi would benefit from a more assertive and

comprehensive trade policy approach to translate participation in these various trade agreements into concrete benefits for the private sector. There is also an evident need to intensify the dialogue between Government, the private sector, and other stakeholders in defining priorities for trade policy and strategies for improving Malawi's competitive position.

To achieve such a program will require raising the political and administrative profile of trade in Malawi and more concretely drawing out the linkages between trade, growth, and poverty reduction in development and public expenditure planning. Certain policy, political and administrative measures will be needed to restore investor and producer confidence and alleviate current constraints. The provision of technical assistance and the strengthening of certain capacities in both the public and private sectors can effectively complement these policy and administrative measures. Some of this would relate to essentially 'trade-related' institutions. However, in the short-term, those areas of institutional strengthening which would likely have the greatest impact on the country's trade (and related income benefits) lie at the level of particular sectors or sub-sectors.

The success of the Integrated Framework will depend on the ability of both donors and Malawian recipients to effectively coordinate the external assistance provided by bilateral and multilateral agencies. The Integrated Framework is predicated on the efforts of a lead donor to serve as the interlocutor between the varied donors and Malawi institutions. NORAD has agreed to take on this task so that the IF process can move forward successfully. The Malawi Integrated Framework National Steering Committee, along with other government and private sector constituencies will also need to play a more active role in the future to help promote the implementation of the IF program

The key recommendations and technical assistance implications are presented in the Action Matrix below. Appendix A contains a matrix of current trade related technical assistance efforts by the donor community in Malawi.

ACTION MATRIX
ACTION PLAN FOR IMPROVING COMPETITIVENESS OF THE MALAWI ECONOMY
AND ITS INTEGRATION INTO THE GLOBAL ECONOMY

Macroeconomic Enabling Environment (Highest Priority—prerequisite for sustainable growth)				
Opportunity or Barrier	Action(s)	Support Measures	Responsible Agencies	Time Frame
Macroeconomic instability and volatile exchange rates inhibit investment and business	<p>1. Adhere more strictly to fiscal targets as a part of a macroeconomic framework.</p> <ul style="list-style-type: none"> • Implement effective expenditure control mechanisms • Improve parastatal finances, accelerate privatization program. • Make explicit budgetary provisions for emergency food relief and institutional reforms to ensure that food security is addressed without unplanned budgetary demands <p>2. Reduce intra year fluctuations in borrowing by establishing a better monitoring mechanism for aid flows, and holding a higher level of reserves.</p> <p>3. Stabilize real exchange rate by consistent adherence to the monetary and fiscal targets set in the macro framework and develop a more active nominal exchange rate policy to avoid sharp short-run fluctuations (this will require a higher level of international reserves).</p>	Technical assistance	<p>Ministry of Finance</p> <p>Central Bank of Malawi</p>	Commence immediately.

Transportation (High Priority—critical for increasing trade value and the incomes of the poor)				
Opportunity or Barrier	Action(s)	Possible Support Measures	Responsible Agencies	Time Frame
High cost of transport remains a major constraint to trade, growth and poverty alleviation.	1. Work with the government of Mozambique to improve the Nacala corridor. Urgently assist in fixing the 77 km stretch that is damaged.		Ministry of Transportation; Transport Operations Association	Commence immediately.
	2. Address the issue of the domestic trucking cartel. Ensure access for foreign truckers to Malawi traffic in order to bring internal transport costs more in line with regional norms.	Assess costs, benefits, and distributional dimensions of a policy change. Ensure reciprocal treatment for Malawian truckers in other regional countries.		Complete analysis by 2 nd quarter of 2003. Implement policy changes by end of 2003.
	3. Re-assess tax structure on transport equipment and services with a view toward lowering costs and increasing competitiveness.	Assess fiscal costs, sectoral benefits, and distributional dimensions of policy changes.		By 3 rd quarter of 2003.
	4. Review existing restrictions on air transport landing rights and existing landing and associated fees with a view toward increasing services and lowering costs.	Comparative country analysis of air transport policies and landing fees and other charges.		By 1 st quarter of 2004.
	5. Explore opportunities for improved freight transport management involving more back-hauling and thus reduced regional freight rates.	Analyze scope of the problem and opportunities and recommend institutional arrangements for improved information sharing and coordination.		By 1 st quarter of 2004.

Export Sector-Specific Measures				
Opportunity or Barrier	Action(s)	Possible Support Measures	Responsible Agencies	Time Frame
Tobacco (High Priority) (Arena with most significant trade-poverty reduction potential in the short-term)				
Lack of collective strategic vision on the prospects and national development role of the industry	Formulation of tobacco sub-sector strategy	Facilitation of public-private collaborative effort	Working party involving major stakeholders	Strategy prepared by June 2003
Weak governance structure inhibits policy formation and effective regulation of the tobacco industry	<p>1. Restructure the board of the TCC to render it autonomous of vested interests</p> <p>2. Strengthen the analytical, industry monitoring, and market intelligence capacities of the TCC</p> <p>3. Restructure TAMA as an association representing and supporting commercial agriculture (not tobacco-specific)</p> <p>4. Revamp the grower registration system to increase transparency and minimize evasion of taxes, levies and loan payments</p>	<p>Short-term technical assistance to advise restructuring, capacity building, and on necessary TCC levy to finance needed capacity</p> <p>Short-term technical assistance to advise on restructuring.</p> <p>Advice on new process and system for tobacco grower registration</p>	MOAI, TCC	<p>2nd quarter of 2003</p> <p>By end of 2003</p> <p>By 1st quarter of 2004</p> <p>2nd quarter of 2003</p>
Opportunity to improve the efficiency and equity of tobacco marketing arrangements	<p>Remove 7 percent withholding tax from smallholder clubs</p> <p>Negotiate reduced AHL auctioning fees</p> <p>Implement a transparent and non-discriminatory 'designated buyer' system</p> <p>Develop a 'code of practice' and performance monitoring system for satellite depots.</p>	<p>No support necessary. MRA and AHL can manage</p> <p>Advise on comparable and appropriate fee structures.</p> <p>Technical assistance to help develop code and monitoring system</p>	<p>MRA, AHL</p> <p>MOAI</p> <p>MOAI, TCC</p> <p>MOAI, TCC, TAMA, NASFAM</p>	<p>Implement prior to 2002/2003 marketing season</p> <p>Same</p> <p>Same</p> <p>Same</p>

Export Sector-Specific Measures (continued) (Medium Priority)				
Opportunity or Barrier	Action(s)	Possible Support Measures	Responsible Agencies	Time Frame
<p><u>Sugar</u></p> <p>Uncertain policy environment constrains further investment in production and processing capacity</p>	Develop a sugar sector policy and strategy	Facilitation of strategy development	MOAI, MOCI, and working group comprising industry, farm, and consumer interests	<p>Compete by August 2003.</p> <p>Draw upon recently completed 'value-chain' analysis</p>
<p><u>Groundnuts and Spices</u></p> <p>Low productivity and inconsistent quality limit the realization of export potential for groundnuts, other legumes, and various spices—all widely produced by smallholders</p>	<p>Improve the availability of quality seed and of technical information to farmers. Direct public sector activity or financing may be needed for foundation seed multiplication for legumes. Farmer advisory services can be coordinated by industry associations in collaboration with MOAI.</p> <p>Apply international standards and develop necessary quality control systems. Develop industry 'code of practice' which incorporates these standards.</p>	Technical support to the industry associations, including Legume Association and PAMA	MOAI, MBS, private companies, and NGOs	On-going activity needs to be intensified perhaps through SADP or various on-going private sector development programs
<p><u>Tea</u></p> <p>Uncertainty regarding the future viability and competitiveness of the tea industry</p>	<p>Review and revise electricity tariffs for tea estates</p> <p>Clarify the land tenure rights of non-Malawians</p> <p>Depoliticize and strengthen the support capacities of the Smallholder Tea Trust</p> <p>Permit and facilitate smallholder tea outgrower arrangements with estates</p>	<p>Assessment of financial implications, costs and benefits</p> <p>Technical assistance for the Smallholder Tea Trust</p>	MOAI, Smallholder Tea Trust, Tea Association	<p>1st quarter of 2003</p> <p>By end of 2003</p>

<p><u>Cotton</u></p> <p>Very low productivity and declining quality, low ginnery capacity utilization, and uncoordinated interventions inhibit growth and income generation</p>	<p>Through the newly-created Cotton Council, create and implement a focused program of cotton R&D, farmer advisory services, farmer group development, and industry quality standards and monitoring.</p>	<p>Financial and technical assistance to the Council to be phased out after two years.</p>	<p>Cotton Council, MOAI, private ginning companies</p>	<p>Mid-2003 to mid-2005</p>
<p><u>Textiles and Clothing</u></p> <p>Generally unrealized opportunity for garment exports to the United States under the AGOA initiative</p>	<p>Intensify efforts to encourage FDI in the garments sector</p> <p>Strengthen the capacities for product design and development among SME garment companies</p>	<p>Investment targeting program</p> <p>Training program or secondment of retired international garment executives</p>	<p>MIPA; MOCI</p> <p>MOCI</p>	<p>Intensify on-going activity</p> <p>2nd quarter of 2003</p>
<p>Weak performance and uncertainty surrounding DWS inhibits textile exports as well as forward and backward linkages</p>	<p>Accelerate the process of privatizing DWS and if necessary during an interim period put in place a management contract</p>	<p>No support necessary</p>	<p>Privatization Commission</p>	<p>Immediately as decision has been made to withhold further GOM financing of DWS</p>
<p><u>Food Products</u></p> <p>Generally unrealized opportunities to penetrate the South African market for higher value-added food products</p>	<p>Encourage joint venture investments and other strategic marketing arrangements</p>	<p>Possible support for investor targeting, match-maker, marketing strategy development</p>	<p>MIPA, MEPC, MOCI. Cooperation with members of the National Action Group (NAG)</p>	<p>2003/2004</p>

Customs Reform (Lesser priority as there are on-going programs)

Opportunity or Barrier	Action(s)	Possible Support Measures	Responsible Agencies	Time Frame
Phase out of PSI procedures and implementation of WTO Customs Valuation Agreement have not received sufficient management attention.	<p>Senior managers workshop to assess the implications of, and plan for, the retirement of PSI services and the full implementation of WTO Valuation.</p> <p>Development of plan for sequencing the retirement of PSI services.</p>	Technical Assistance from Customs Specialist	MRA	<p>On-going as part of CUSP and ASYCUDA programs.</p> <p>Complete by 3rd quarter of 2003</p>
Compliance with Customs regulations is lacking.	<p>Set up Customs Commercial Investigation, Intelligence and Post Clearance Audit Units (to be conjoined with the Tax Audit and Investigation Directorate of MRA):</p> <ul style="list-style-type: none"> • Identify resource requirements • Write position profiles • Recruit/train personnel. • Supervise start-up operations 	Technical Assistance from Customs Specialist	MRA	Complete the process by the end of 2003. Do this under existing TA programs.
Ineffective implementation of duty drawback schemes	Strengthen institutional capacity to administer drawback program.	Technical Assistance from Customs Specialist	MRA/Ministry of Finance	Complete by 3rd quarter of 2003
Lack of confidence in the integrity of the organisation.	<p>WCO workshop on Integrity</p> <p>Develop and implement an integrity strategy following the principles of the WCO's Arusha Declaration</p>	WCO Technical Assistance	MRA	4 th Quarter 2003

Trade Policy (Lesser priority as there are on-going programs)				
Weak analytical capacity for trade policy analysis and implementation. Improve capacity for negotiating at the WTO and in regional and bilateral agreements	1. Strengthen institutional structure for formulation and implementation of trade policy and insure that sufficient human resources are trained and deployed. 2. Improve understanding of the WTO within the government and private sector 3. Improve understanding of SADC and COMESA within the public and private sector 4. Improve negotiating skills 5. Improve inter-ministerial coordination	Technical assistance/training	Ministry of Commerce and Trade and other trade-related Ministries	On-going especially under TPP program
Overlapping regional trade integration efforts create confusion among policymakers and the business community	Conduct economic assessment of the opportunities for increasing the economic benefits from regional integration. Encourage dialog between SADC and COMESA members on a process of rationalization of the integration process.	Technical assistance.	Ministry of Commerce and Trade and other trade-related Ministries	Complete by 3rd Quarter 2003 under existing TA program
Lack of coordination between institutions and stakeholders is hampering progress and creating duplication of effort.	Improve liaison with private sector advisory groups such as the National Action Group and the National Steering Committee on Trade Policy	Support private sector secretariat and workshops to promote dialog between stakeholders.	Ministry of Commerce and Trade and other trade-related Ministries	Immediately

INTRODUCTION

Trade has long been a central feature of Malawi's economy. With the establishment of a British Protectorate in Nyasaland in the 1890s, European companies and individuals established coffee estates. As the world coffee prices collapsed at the turn of the century, the settlers turned their attention to cotton, tea, and tobacco. The Nyasaland economy came to be centrally based upon the production and exports of selected commodities, primarily on estates, using the indigenous population as labor.

This structure remained in place up through and beyond Malawi's independence in 1964, with export-oriented agriculture supplemented by domestic food production by smallholder farmers and the migration of large numbers of Malawians to work in the mineral mines of South Africa. The post-independence leadership embraced the estate-led development strategy, orchestrating a significant increase in production and exports of tobacco, resulting in a 6 percent average annual growth rate in GDP between independence and the late 1970s.

This growth, however, was narrowly based and was associated with a highly skewed distribution of income and wealth. A series of external shocks in the 1980s and early 1990s exposed the fragility of Malawi's economy. Such shocks—including the war in Mozambique, which cut vital transport links and brought a flood of refugees; unstable prices for Malawi's main export commodities, and drought—led to recurring crises and macroeconomic instability. The net result was the slowing of growth and an actual decline in per capita income by some 10 percent during the period from the late 1970s to the early 1990s.

However, by the early 1990s, several developments, both locally and within the region, presented opportunities for Malawi to re-accelerate its economic growth, and, through structural changes, bring about a reduction in the incidence of poverty. At the regional level, there occurred a democratic transition in South Africa, an end to hostilities in Mozambique, and movements to strengthen regional trade and collaboration in various fields. Malawi itself underwent a transition to democracy with the new government putting in place policies to re-establish macroeconomic stability, liberalize the economy and place more emphasis on poverty reduction. The new government liberalized the trade and foreign exchange regimes, by reducing high tariffs and eliminating controls on foreign exchange. It also moved to remove the previous restrictions on the cultivation of major crops, most particularly opening up the opportunities for tobacco production to large numbers of smallholder farmers.

As a small country with a limited domestic market and a very narrowly based economy, trade constitutes a comparatively high proportion of Malawi's GDP. As a result, Malawi's trade performance should have a significant impact on the country's overall rate of economic growth, while its trade regime should significantly affect the competitiveness of specific industries and the economy overall. Furthermore, the

political and economic reforms which occurred domestically, as well as within the Southern African region in the early 1990s, were expected to foster more rapid growth in Malawi as well as a more vibrant and diversified pattern of international trade.

The results of the reform process of the 1990s have yet to realize the anticipated gains for Malawi. Malawi continues to face immense developmental challenges. It is dependent on relatively few primary agricultural commodities, which makes macroeconomic and structural policy reforms crucial in the face of the economy's vulnerability to international conditions. The economy remains rudimentary, and agricultural land resources, the core to future growth, suffer from over intensive use, soil degradation, and deforestation. Government trade-related policies have changed enormously since the mid 1980s from those of post-independence, which centered on import substitution and other interventionist measures, including state ownership, to promote industrialization. Reinforced by subsequent structural adjustment programs, deepening reforms continued from the mid 1990s. These centered on reducing the restrictiveness and complexity of the trade regime and promoting greater integration through bilateral, regional, and multilateral agreements. Wide-reaching structural reforms included trade liberalization, exchange rate flexibility and, albeit currently suspended and subject to review, privatization. Nevertheless, persistent structural problems, compounded at times by inappropriate stabilization policies, especially expansionary fiscal policy, have fueled a volatile appreciating real exchange rate, high inflation, and exorbitant interest rates.

The economy remains precariously poised, facing a weak business environment and uncertain prospects. Sustained overall economic reforms are needed to reduce supply-side constraints and other bottlenecks in the economy, including poor infrastructure. Otherwise, Malawi will be unable to benefit from recent initiatives by major trading partners to enhance its preferential market access, such as the United States' African Growth and Opportunity Act, and the EU's "Everything But Arms" arrangement for least developed countries.

This study is designed to examine the prospects for and the barriers facing an expansion of Malawi's external trade and to suggest a range of actions, by both government and private sector, to address current bottlenecks and to best realize the country's trade potential and so help to reduce poverty. The paper is structured as follows: Chapter 1 provides an overview of the economic setting and the nature of poverty in Malawi. Chapter 2 discusses Malawi's trade regime and its recent trade performance. Chapter 3 describes the trade policy-making and implementing institutions whilst Chapter 4 reviews issues related to trade facilitation, focusing on customs and transportation. Chapter 5 examines the competitiveness, near-term growth prospects and constraints pertaining to Malawi's major and emerging merchandise exports as well as those of its tourism industry.

CHAPTER 1

ECONOMIC SETTING

The Republic of Malawi is a landlocked country situated in Southern Africa, comprising an area of almost 118,500 square kilometers. It is adjacent to Zambia, Tanzania and Mozambique. The population of Malawi was estimated at 11 million in 1999. The population of its capital, Lilongwe, is approximately 400,000. Over three quarters of inhabitants live in rural areas. This chapter provides a brief overview of the key economic features of the economy and in particular those that relate to trade and poverty. The main conclusions are:

- Malawi is one of the world's poorest least-developed countries. Between half and two-thirds of the population lives below the poverty line, and severe health problems, especially the HIV/AIDS pandemic, compounds immensely Malawi's development problems. Most social indicators are extremely poor relative to sub-Saharan Africa.
- The poor are found primarily in rural areas and are mainly involved in subsistence farming – reflecting the risks associated with other activities and the lack of linkages to markets.
- Economic growth in Malawi has been constrained by macroeconomic instability. At the forefront of this has been exchange rate volatility, which has adversely affected trading firms and suppressed investment.

1.1 ECONOMIC STRUCTURE AND PERFORMANCE

Agriculture accounts for 33 percent of GDP while manufacturing accounts for only 12 percent. Nearly 22 percent of the GDP comes from the distribution sector and is mainly accounted for by trading and retailing activities most of which are based in or linked to the rural economy. Very little diversification of output took place during the last decade except within agriculture, where the share of small-scale agriculture has increased, while that of medium/large-scale estate agriculture has stagnated.

During most of the 1990s, Malawi's growth performance was modest. Official statistics show that since 1995 GDP has grown on average by about 3.6 percent per annum, which is about 1.4 percentage points above the population growth rate of 2.2 percent. Malawi's growth performance has been somewhat better than the sub-Saharan Africa average and better than other landlocked neighboring countries such as Zambia and Zimbabwe, yet significantly lower than other countries within the region which have been more successful in promoting domestic and foreign direct investment (i.e. Mozambique and Uganda) . However, Malawi's growth

performance has worsened recently (Table 1.1) with average GDP growth of 2.7 during 1998-2001 compared to 4.6 percent between 1995-98.²

TABLE 1.1 KEY ECONOMIC INDICATORS

	1995	1996	1997	1998	1999	2000	2001	1995-98	1998-01
GDP growth (constant, % p.a.)*	16.7	7.3	3.8	3.3	4.0	1.6	2.8	4.6	2.7
Agriculture**	39.6	25.5	0.0	2.7	11.2	5.7	3.7	7.6	6.5
Industry	4.6	8.6	-0.1	1.2	2.5	-0.5	0.6	2.8	0.7
Services	8.9	-0.8	8.3	4.6	2.6	0.6	3.0	4.3	1.9
CPI (end-of-period, %)	74.9	6.7	15.2	53.1	28.2	35.4	22.1	37.5	35.4
Treasury bill rate	46.3	30.8	18.3	33.0	42.9	39.5	41.7	32.1	39.3
Exchange rate (MK/\$, End of period)	15.3	15.3	16.44	31.07	44.08	59.54	72.2	23.9	58.9
Money and quasi money growth (% p.a.)	56.2	39.6	2.1	60.0	26.5	41.4	10.1 ***	39.5	32.0
Current account balance (% of GDP)									
Excluding grants	-12.0	-12.0	-14.2	-12.0	-16.6	-12.6	-13.4	-12.5	-13.7
Including grants	-1.4	-7.6	-10.8	-2.8	-7.9	-3.9	-6.7	-5.7	-5.3
Gross international reserves (months of imports)	2.3	3.6	2.1	4.4	3.8	4.6	4.2	3.1	4.2
Fiscal balance (% of GDP) ****									
Excluding official transfers	-12.7	-8.3	-9.0	-12.8	-11	-15	-15.9	-10.0	-12.6
Including official transfers	-4.7	-2.8	-5.6	-5.1	-5.6	-4.1	-3.3	-4.6	-4.5

Sources: IMF, IFS, and World Bank staff estimates

* Growth rates from 1995-98 and 1998-01 are least squares estimates

** Includes forestry and fishing.

*** First three quarters

**** Fiscal year. 1995 refers to 1995-96

² Even the observed modest growth reported in official statistics is likely to be overstated. Much of the growth during 1995-2001 has been attributed to a reportedly high growth of almost 6.7 percent per annum in agriculture. There are considerable uncertainties associated with Malawi's agricultural statistics and its calculation of agricultural GDP. Given recent trends in crop yields and commodity prices, together with available data on social indicators and household expenditures and consumption, it is most unlikely that Malawi's agricultural GDP has grown by more than a very modest rate over the past three to five years.

Real per capita GDP grew on average by less than 0.5 percent per annum from 1989 to 1999 and, while the disappointing growth performance is largely attributable to episodes of stop-and-go macroeconomic policies and structural impediments, Malawi was also hit by adverse terms of trade trends, major droughts, the HIV/AIDS pandemic, and wars in neighboring countries.

Low growth during the 1990s has been accompanied by a high degree of macroeconomic volatility, with sharp falls in output followed by periods of recovery. There are three main factors behind the observed volatility. First, the economy is highly vulnerable to droughts. The fall in output during 1994 and the low growth in 1998 and 2000 can be traced to droughts. Second, the sharp deterioration in fiscal performance in 1994, and during 1998-2001 has affected growth through high inflation and interest rates. Third, on the positive side, rapid recovery during 1995 and 1996 can be traced to the acceleration in the implementation of reforms especially the liberalization of smallholder agriculture.

TABLE 1.2 MALAWI: SELECTED ECONOMIC INDICATORS, 1999-2005

	1999	2000	2001	2002	2003	2004	2005
Real GDP growth (in percent)	4.0	1.7	-1.5	1.8	4.5	5.2	5.4
Inflation rate (end of period, percent)	28.2	35.4	22.1	5.0	5.0	4.2	4.1
External current account deficit (after grants) (in percent of GDP)	-8.3	-5.3	-7.3	-11.3	-6.7	-5.7	-5.3
Domestic fiscal balance (in percent of GDP) 1/	-2.7	-4.7	-8.1	-5.4	-3.2	-2.6	-2.0
Broad money growth (end of period, percent)	33.6	42.4	12.1	7.9	13.4	13.5	13.4

Sources: Malawian authorities; and Fund staff estimates.

1/ For 1999/2000, 2000/01, 2001/02, and 2002/03 (July/June).

Figures for 2003 to 2005 are projections

1.2 POVERTY

With a per capita Gross National Product of US\$180 in 1999, Malawi ranks among the 6 poorest countries in the world. The country is characterized by widespread poverty, with 95.1 percent (65.1 percent in Purchasing Power Parity dollars) living on less than a dollar a day and 98.6 percent (87.9 percent in PPP dollars) living on less than \$2 a day. The distribution of income in Malawi is highly skewed. Malawi's Gini coefficient is estimated at 0.6, one of the highest in the world. Life expectancy

in 2000 was 39 years and the human capital capacity among the population is conspicuously low.³

**TABLE 1.3 SELECTED SOCIAL AND DEMOGRAPHIC INDICATORS
IN MALAWI AND OTHER COUNTRIES ^{1/}**

	Malawi	Sub-Saharan Africa
Population below the poverty line	65	..
Per capita income (\$US)	167	470
Illiteracy rate (percent of people aged 15 and above)	40	39
Life expectancy at birth (years)	39	47
Infant mortality (per 1,000 live births)	1,120	1,100
HIV/AIDS prevalence rate (percent; ages 15-49)	15	8.4

Sources: World Bank, *World Development Indicators 2001* as of March 31, 2002; and National Statistical Office of Malawi, *2000 Malawi Demographic and Health Survey Report*.

^{1/} Data for most recent year available

Malawi has a series of disadvantages. It has one agricultural season a year; it is one of the most densely populated countries in the region; it is landlocked; and most importantly, the poor have effectively been blocked from joining the economic mainstream during the country's development experience. Agriculture is central to Malawi and almost 70% of agricultural produce comes from smallholder farmers, who, on average, have less than a hectare of land to cultivate.

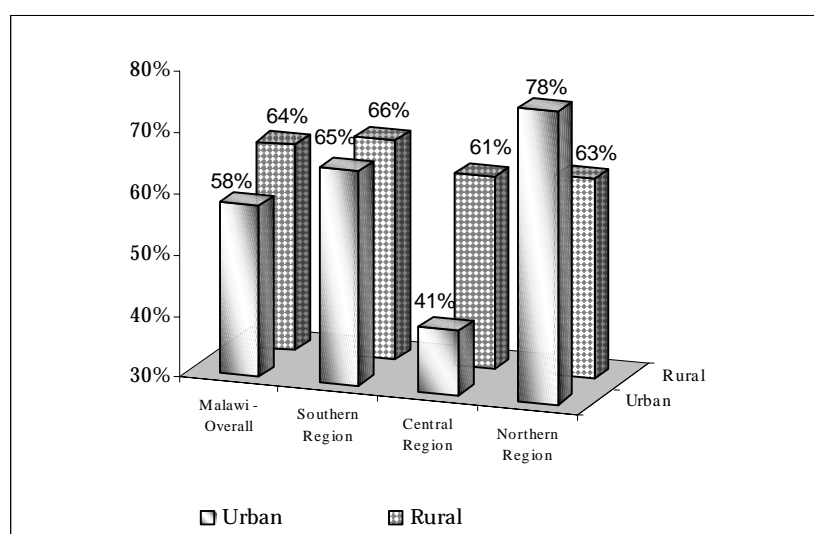
Economic growth and poverty reduction depend heavily on the prospects of households engaged in agricultural production. There are, however, considerable challenges to growth in this realm. First, households face considerable risks in engaging in productive activities. These risks include uncertainty about weather conditions, macro economic instability, and uncertainty about revenues from cultivated cash crops. As a result of the many risks faced by farmers, households, especially the poor ones that are close to falling below minimum food needs or those that consume less than the minimum food needs, steer away from cash crop cultivation and engage in subsistence crop cultivation. Also, the market infrastructure in Malawi is very weak which contributes to high domestic transaction costs. For instance, in rural areas, large numbers of smallholder households live a considerable distance from even small market centers where fertilizer and other agricultural inputs can be purchased and where crops can be sold. Three quarters of all transportation between households and these market centers is by foot, resulting in a situation where many households are more than one and a half hours away from a market center.

³ Only 11.2 percent of the population, over 25 years of age, completes Standard 8. An uneducated person heads almost a third of poor households and only 3 percent of poor household heads has a Malawi School Certificate. The quality of education received is also at issue with the average pupil teacher ratio of 114.

1.2.1 Poverty Profile

Only 34 percent of households meet recommended daily calorie intake levels.⁴ On the basis of four regional poverty lines, 63 percent of the population, or more than 6.2 million Malawians are poor. The poor are regionally concentrated with almost half the poor population living in the Southern region, where the headcount rate is 65.7 percent. Households below the poverty line consume less than half the value of food consumed by households above the poverty line (Kw4.25 per capita daily for households below the poverty line and Kw10.00 per capita for households above the poverty line).

FIGURE 1.1 MEASURES OF POVERTY BY REGION



Three quarters of average household cash and non-cash expenditures are allocated towards food in Malawi, with the poorest households allocating more than 80 percent of total expenditures to food (Figure 1.2). Almost half of all household expenditures are characterized as non-cash expenditures – highlighting the extreme dependence on subsistence agriculture and the underutilization of markets.

Table 1.4 presents the sources of household income. Since decile 2 through 7 and deciles 8 and 9 are similar in structure, they have been grouped together. Imputed values of own production that is consumed, subsistence, makes up half of all household income.⁵ Subsistence income is particularly important for the bottom 7 deciles, with rates of dependence in the 60 to 70 percent range.

⁴ A detailed poverty profile and the determinants of poverty are presented in the National Economic Council (2000) and National Economic Council, et al. (2001).

⁵ It should be noted that incomes are under reported in Malawi. In order to account for this problem, we made the assumption that cash incomes and cash expenditures are the same for all households.

Surprisingly, formal sector employment is the most significant source of cash income. It contributes about 26 percent of total household income. From a distributional standpoint, both wages from the government sector and from the non-government sector play a particularly important roll with increasing incomes. For instance, the richest decile derive about 37 percent of income from non-government wages while the same source only accounts for about 10 percent.

Remittances are also important and account for 4 percent of household income. Remittance income is an especially important source of income in poorer households. 8 percent of household income in the poorest households is from remittances, while the proportion drops to 4 percent for the richest households. It is interesting that the remittances coming into rural areas are almost evenly split between remittances coming in from other rural areas versus those coming in from urban areas.⁶ In urban areas, the proportion of income from remittances is only 5 percent.

TABLE 1.4 SOURCE OF HOUSEHOLD INCOME IN MALAWI ACROSS HOUSEHOLD EXPENDITURE QUINTILES

	Decile 1	Deciles 2 -7	Deciles 8-9	Decile 10	Average
Net income from cash crops sales	6%	4%	5%	4%	4%
Wage income from non-government sector	10%	7%	13%	37%	19%
Net income from food crop sales	4%	2%	1%	0%	1%
Other income (livestock, small enterprises, rent, interest)	13%	9%	12%	22%	15%
Wage income from government sector	0%	3%	7%	12%	7%
Remittances	8%	5%	4%	4%	4%
Subsistence income	61%	70%	58%	22%	49%

1.2.2 Poverty Reduction Strategy

Malawi's poverty reduction strategy aims at reducing the incidence of poverty to 59 percent in 2005 from 65 percent in 1998. The recently completed PRSP clearly recognizes that higher and sustained economic growth is necessary to make a sizable dent in poverty and lays out a four-pronged strategy:

- to promote sustainable pro-poor growth by offering the poor an opportunity to increase their incomes and providing the private sector with an enabling environment for investment;

⁶ However, a slightly larger remittance is received from urban areas.

-
- to develop human capital and reduce income inequality; a healthy and educated population will be more productive and less income inequality promotes the productive potential of the poor.
 - to improve the quality of life for the most vulnerable by strengthening their resilience to shocks through social safety net programs; and
 - to establish good governance, thereby ensuring that public institutions and systems protect and benefit the poor.

This strategy, in turn, forms the basis of Malawi's macroeconomic program. The program aims at restoring and consolidating macroeconomic stability as key to moving onto a higher growth trajectory. At the same time, it includes structural reform elements, including on governance, which had earlier jeopardized the stabilization effort and impeded growth. Moreover, the program makes room for a substantial increase in spending on human capital and the provision of transfers to the poor through social safety net programs.

The engine of the government's pro-poor growth strategy will be the agricultural sector, as most of the poor are engaged in subsistence farming. Broad-based growth in agriculture would address the dual objectives of food security and income enhancement for the poor. The PRSP specifically recognizes that restoring macroeconomic stability is a necessary condition for growth in the agricultural sector, as high interest rates, high inflation, and sharp devaluations have severely reduced investment and productivity growth.

There are, however, risks that could derail the authorities' strategy:

- A lack of spending discipline by the government could result in the reemergence of excessive government borrowing and, therefore, add further pressure to real interest rates. Also, exogenous shocks—such as adverse weather and movements in commodity prices—could complicate macroeconomic management.
- The PRSP does not clearly specify the pro-poor programs that will be protected should shocks require adjustments to the budget. This shortcoming, together with capacity constraints and the weaknesses in public expenditure management, could result in a diversion of funds into non-priority areas.
- The weak implementation and absorption capacity is being exacerbated by the high rate of HIV/AIDS, which is rapidly taking its toll on both the public and private sector. Also, an expected rise in the HIV/AIDS prevalence rate might require a further reallocation of resources into staff recruitment and training.
- The election cycle could also jeopardize implementation of the PRSP. In the run-up to elections in 2004, budgetary pressures could reemerge, the structural reform program could be derailed, and improvements in governance could be reversed.

1.3 MACROECONOMIC TRENDS

Malawi has not had any extended period of macroeconomic stability in the 1990s as its adjustment programs have been derailed by fiscal pressures, amplified by lack of progress in structural reforms. Fiscal pressures arose mostly from parastatal bailouts, delays in adjusting consumption prices of petroleum products, wage increases, and tax cuts, and also from poor governance, including weak expenditure management systems. Monetary policy attempted to limit the inflationary consequences, but, ultimately, had to accommodate the fiscal pressures, resulting in high and volatile inflation. The exchange rate was stable in nominal terms for long periods, but there were sharp depreciations in 1994, 1998, and 2000, which led to pronounced income losses for farmers.⁷ The effective real exchange rate depreciated by over 40 percent during the 1990s

Malawi is receiving debt relief under the enhanced HIPC Initiative. It has been the recipient of substantial foreign financing, leaving it with a stock of external debt at end-1999 equivalent in net present value terms to 82 percent of GDP and 269 percent of exports of goods and nonfactor services. In December 2000, the Boards of the IMF and the World Bank⁸ approved a decision point under the enhanced HIPC Initiative and endorsed an interim poverty reduction strategy paper (PRSP). Moreover, in January 2001, the African Development Bank approved debt relief and the Paris Club agreed to provide debt relief under Cologne terms.⁹

The medium-term macroeconomic framework envisages by 2005 an increase in real growth to over 5 percent, a sustained reduction in inflation to below 5 percent, and a rebuilding of international reserves to about 4½ months of imports (see Table 1.3).¹⁰ The growth target is achievable, based on performance in the past, and necessary to attain the poverty reduction target.¹¹ After a substantial fiscal adjustment in 2002/03, the fiscal balance is expected to improve further, owing mostly to a smaller domestic interest bill, and to make room for a significant increase in private sector credit and investment. Monetary policy will remain geared to achieving the targeted reduction in inflation while there will be some real depreciation of the Kwacha in response to the fiscal adjustment.

⁷ In 1998 alone, the income loss for tobacco farmers, transporters, and sellers is estimated at 4 percent of GDP.

⁸ Sixty percent of nominal debt is owed to IDA.

⁹ In November 1999, the Paris Club creditor countries, in the framework of the initiative for "Heavily Indebted Poor Countries" (HIPC) and in the aftermath of the Cologne Summit, accepted to raise the level of cancellation for the poorest countries up to 90 percent or more if necessary in the framework of the HIPC initiative.

¹⁰ These projections take into account the adverse effect of HIV/AIDS on growth, estimated at 1½ percentage points per annum.

¹¹ To reduce the absolute number of the poor, it is estimated that Malawi will have to grow by at least 5 percent per annum, as the income elasticity of the poor with respect to overall growth is less than one.

The external current account deficit is expected to widen sharply in 2002, owing to the large-scale maize imports in response to the food crisis, before narrowing in the medium term, in line with higher public and private savings (Table 1.3). Malawi will continue to benefit from sizable aid inflows in the medium term. These aid flows have been projected based on existing donor programs, but could be higher. Moreover, it is expected that donors will continue to shift from project to program support¹² with a strengthening in accountability and transparency in the budget and from loans to grant financing. Moderate growth is projected for non-maize imports, and export growth is expected to pick up, as nontraditional exports develop and because prospects for both price developments and demand for traditional exports are favorable. The external current account deficit will be more than covered by grants, concessional financing, foreign direct investment, and debt relief under the enhanced Initiative for Heavily Indebted Poor Countries (HIPC Initiative). This will also allow for a buildup of international reserves. However, the large-scale commercial maize import requirement in 2002 will give rise to a balance of payments gap of US\$60 million in 2003.

Growth is expected to accelerate gradually over the next few years:

- In the short term, the recovery should come from improved macroeconomic stability, a reduction in real interest rates, and a rebound in private sector credit.
- In the medium term, growth should be bolstered by the privatization of parastatals, and the accompanying expansion and enhanced reliability of utility services. At the same time, reforms to government operations should reduce the amount of “red tape” and strengthen the delivery of economic and social services. These measures, together with an improvement in governance, should renew confidence in the public sector and lower the cost of doing business.
- In the long term, growth will be augmented by the benefits of investment in human capital associated with improved health and education.

1.3.1 Exchange Rate Issues

Within the macroeconomic policy framework special attention should be given to the issue of the level and volatility of the exchange rate. There is little hope for expanding and diversifying Malawi's participation in the international trading system unless the country can effectively address the problems associated with exchange rate volatility. The effects of exchange rate overvaluation have been studied extensively. A wide range of economic studies find that exchange rate overvaluation and associated high volatility are negatively correlated with both

¹² Project support is earmarked, while program support finances general budgetary expenditure.

export and GDP growth.¹³ The importance of competitive and stable exchange rates, as economies become more open, has increasingly become recognized.¹⁴

Exchange rate volatility creates a risky business environment in which there are uncertainties about future profits as well as future payments. In poor countries where financial instruments for hedging against foreign exchange rate risks are not developed, liquidity and solvency problems for firms are inevitable when the currency is devalued because of unsustainable balance of payments problems. Exchange rate volatility also makes local banks unwilling to offer credit facilities denominated in a foreign currency because of the foreign exchange risk involved. This denies the market of more affordable foreign denominated credit facilities. A stable currency serves importers and exporters equally, regardless of the exchange rate, as businesses can plan effectively, which is impossible when exchange rates fluctuate unpredictably. Their cost structures are less variable from year to year allowing them to invest with greater certainty regarding returns.

There are several factors contributing to the difficulties that poor countries face in maintaining a competitive exchange system. Some of these countries include exchange rate as a nominal anchor for the stabilization program and exiting the peg is costly. They have thin foreign exchange markets where minor changes in demand or supply can result in significant changes in exchange rates. At the same time, these economies are highly dependent on primary commodity exports that are subject to sharp price changes in the world market, as is the case with Malawi and its dependence on tobacco. The importance of the agriculture sector to these countries makes them vulnerable to weather-related shocks. Other factors include highly volatile capital inflows. As significant quantities of capital, in the form of investment or aid, enter these countries without well-functioning financial sectors, it is extremely difficult to smooth the pressure on the exchange rate to appreciate.

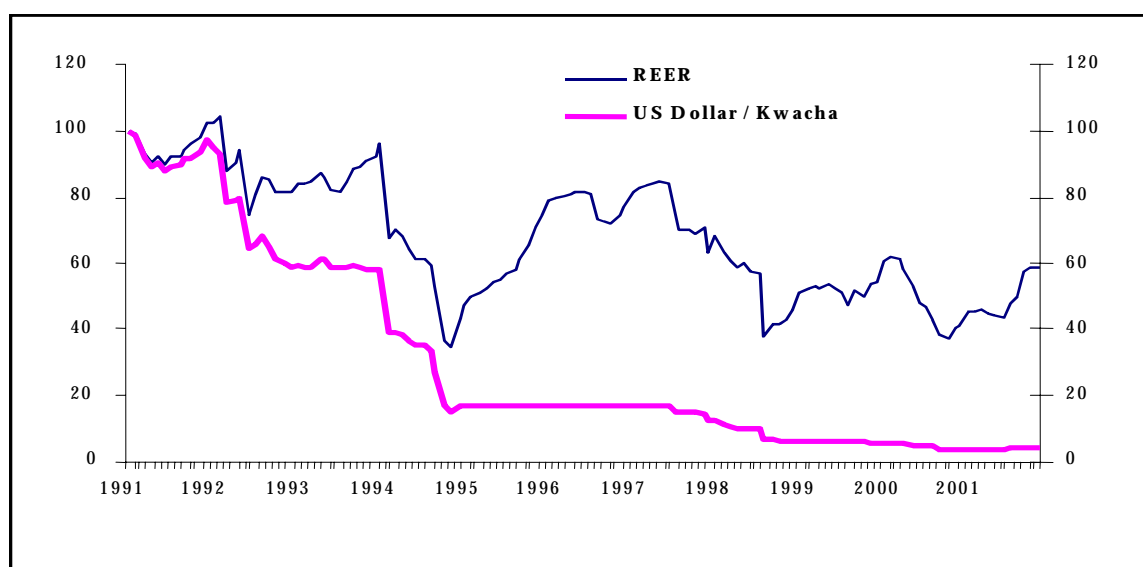
Malawi has experienced periods of overvaluation and high volatility in its real exchange rate during the 1990s (Figure 1.2). Following the formal adoption of a flexible exchange rate regime in 1995, the Kwacha remained broadly stable in nominal terms but the real exchange rate has experienced large fluctuations: it appreciated 40 percent between 1995 and 1996, and then depreciated 40 percent between 1997 and 1998. There is a strong correlation between real exchange and inflation movements, which reflects the importance of imported goods in the consumption basket.

¹³ See Dollar (1992), Hinkle and Montiel (1999) and Sekkat and Varoudakis (2000) amongst others.

¹⁴ Whilst the average exchange rate of developing countries depreciated during the 1990s the average volatility of real exchange rates in small, low-income countries increased. Among poor countries, those that exhibited low exchange rate volatility had over 6 percent export and nearly 2 percent annual growth, which is significantly greater than that of those countries with high exchange rate volatility (Global Economic Prospects, World Bank 2001).

In Malawi, the significant appreciation of the currency in the post 1994 period as the economy was being liberalized probably led to a loss of competitiveness of local firms in domestic and international markets. The Kwacha has also experienced three major depreciations since 1994 when the currency was liberalized. A weaker currency does of course render exports more competitive and can therefore act as a stimulus to export growth. However, a depreciation in the Kwacha can be equally harmful for manufacturers who are heavily dependent on imports for their equipment, machinery, and intermediate inputs. The majority of manufacturing firms in Malawi obtain intermediate inputs from abroad. Some firms import as much as two-thirds of their inputs. There will also be upward pressure on other costs as workers demand higher wages to maintain their purchasing power. Firms that have a high import component in their production and little or no exports will experience a harsher trading environment. On the other hand, firms with low import content in production and high exports will potentially benefit most from a weaker currency. Agro-processing, for example, belongs to the latter group and therefore has good growth potential.

FIGURE 1.2 NOMINAL AND REAL EFFECTIVE EXCHANGE RATES (REER) FOR MALAWI KWACHA IN THE 1990S



(Index: 1991=100).

Source: International Financial Statistics, IMF.

Even for exporters, however, a sharp depreciation can be unfavorable if the firm incurs costs, which it cannot reverse in the short-term. The worst scenario for firms is when the currency moves in both directions within a short period of time as occurred in 2000-2001. Both importers and exporters were affected adversely in this case but especially those firms that had to import inputs during November/December (before the agricultural planting season) and sell their output for less local currency per dollar during the marketing season in June/July. The tobacco industry was affected in such a way as were other industries that depend on the agricultural season.

CHAPTER 2

MALAWI'S TRADE REGIME AND PERFORMANCE¹⁵

This chapter examines the structure and recent performance of Malawi's trade, its current trade regime, and its involvement in WTO, regional and bilateral trading arrangements. The principal conclusions are:

- Malawi's exports remain heavily dependent upon Tobacco, which accounts for around two-thirds of the total, and basic agricultural commodities. Export growth in Malawi during the 1990s was slow compared to other similar developing countries.
- Despite the high ratio of Malawi's trade to GDP, the country's exports were not a major contributor to economic growth in the 1990s. This reflects dependence on agricultural exports and the low linkages to the rest of the economy of some of the main products exported.
- Malawi's trade liberalization program has produced a relatively open regime and its tariff structure is generally comparable to those of other countries in the region. There is perhaps room for further tariff reductions on imported intermediate goods to encourage domestic manufacturing. Despite its reforms, Malawi's economic performance has been modest which suggests that attention should move to supply constraints in the Malawi economy.
- Malawi needs to exploit opportunities for linkages with international markets at both the multilateral and the regional level. In the regional context, Malawi should seek a framework with simple rules of origin and low external barriers.

2.1 STRUCTURE AND PERFORMANCE OF MALAWI'S INTERNATIONAL TRADE

2.1.1 Exports

In 1990, the structure of Malawi's export trade essentially reflected its earlier colonial pattern, but with the addition of an internationally competitive sugar industry during the 1980s and the emergence of a small export trade in textile and clothing products. These developments had been overshadowed by the enormous growth in the country's tobacco exports, which had taken place in the 1970s (nearly 20 percent per annum growth) and 1980s (6.5 percent growth per annum). As a result, by 1990, tobacco accounted for two-thirds of the country's total exports. A decade later, despite increased concerns about the sustainability of international demand for

¹⁵ Supplemental and more detailed information regarding Malawi's trade regime is available in the WTO's Trade Policy Review (WT/TPR/S/96) January 9, 2002.

tobacco products and periodic efforts to promote the diversification of Malawi's economy, the country remains heavily dependent upon tobacco and a few other agricultural commodities for its foreign exchange earnings. Malawi is one of six African countries for which the exports of one commodity account for more than 50 percent of total exports.¹⁶

The expansion of the clothing and apparel sector was primarily due to the bilateral trade agreement that Malawi signed with South Africa in 1990, which granted Malawi exports nonreciprocal duty free access to South Africa's market. As a result of this significant preference in South Africa's market, Malawi firms exported increased volumes of apparel to South Africa during the mid-1990s. However, as a result of changes precipitated by the SADC Trade Protocol, and disputes over Malawi's adherence to rules of origin, Malawi's clothing and apparel exports to South Africa have recently declined dramatically. Some of these exports are being shifted to the United States where some increased trade was recorded in 2000 and 2001, although Malawi's trade remains small especially in comparison with the more successful emerging clothing exporters in the region, such as Mauritius, Lesotho, and Kenya.

Over the course of the 1990s, Malawi has had some modest success in developing or re-establishing an export trade in groundnuts and macadamia nuts, rice, and paprika, while the country has largely failed to take advantage of major opportunities to provide South Africa with food and agricultural raw materials¹⁷. The country has also failed to build upon a nascent cut flower industry to improve its international market position.¹⁸

Malawi's export trade has essentially remained stagnant. Note from the table that for most individual commodities or products, Malawi's export values (in US \$) were actually lower in 2000 than in 1990. The exceptions to this are tobacco, clothing, and the 'other' category, the latter consisting of a large number of products, each involving small levels of trade.

The direction of Malawi's export trade has changed significantly with the share of developed countries falling from 68 percent to 58 percent, with a substantial reduction in the share of Malawi's exports going to the countries of the European Union. The share of Malawi's exports going to South Africa and to a range of developing and transition countries has increased, although this is primarily a result of changing trends in international demand for tobacco and the increasing importance of trade with SADC and COMESA countries.

¹⁶ The other countries are Angola, Nigeria, Burundi, Congo, and Guinea Bissau.

¹⁷ South Africa's food and agricultural imports were R 9.64 billion in 2000, approximately double their level in 1994. In 2000, Malawi accounted for only 1.2 percent of SA's food/agricultural imports with 80 percent of that trade being of tobacco, tea, or cotton.

¹⁸ In contrast with the more positive experiences of Kenya, Zimbabwe, Zambia, and Uganda.

**TABLE 2.1 STRUCTURE OF MALAWI'S EXPORT TRADE, 1990 AND 2000
(US\$ MILLIONS)**

Product	1990		2000	
	Value	% Share	Value	% Share
Tobacco	208.7	66	278.3	69
Tea	38.3	12	35.5	9
Clothing	5.3	2	26.3	6
Sugar	25.7	8	22.5	6
Coffee	11.0	3	6.5	2
Textiles	5.9	2	3.8	1
Cotton	4.4	1	3.7	1
Nuts	2.6	1	2.5	1
Other	17.1	5	29.1	7
Total	314.8		404.6	

Source: UN COMTRADE and authors calculations

TABLE 2.2 DIRECTION OF MALAWI'S EXPORTS, 1990 AND 2000 (% SHARES)

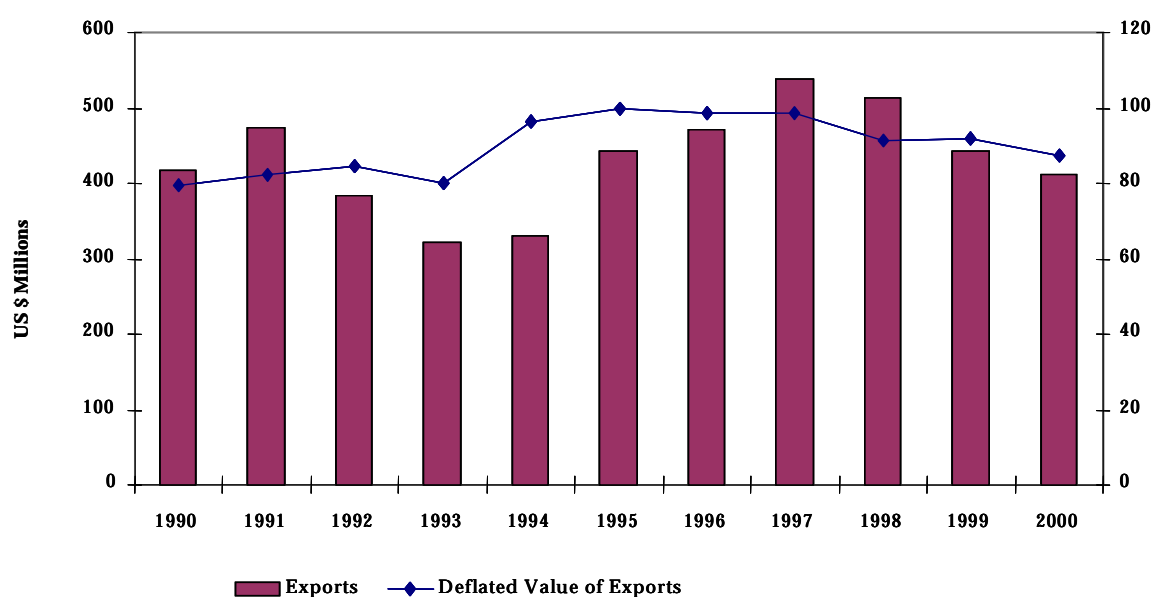
	1990	2000
EU	46	34
USA	17	13
Japan	14	11
South Africa	<1	9
Other	23	34

Source: UNCOMTRADE and authors calculations

Over the course of the past decade, the value of Malawi's aggregate exports has increased on average by 1.8 percent per annum. This rate of growth lags behind that for sub-Saharan Africa's exports (4.8 percent growth per annum) and that for the group of least developed countries (6 percent growth per annum). Most of Malawi's neighbors have also experienced a higher rate of annual growth in export values. As seen in the Figure 2.1, Malawi's exports have fluctuated from year-to-year, having reached their highest levels during the 1996-1998 period, essentially as a result of somewhat higher tobacco exports (and generally higher commodity prices) in those years. The graph also shows the development of Malawi's exports in real terms, deflated by the price index for the country's imports. Deflated exports measure the volume of imports that the country's exports can buy. This indicates that over the course of the past decade, the real value of Malawi's exports have recovered from a period low point in 1993-94, yet by 1999 had essentially the same value as when the decade began.

The decline in Malawi's total exports over the past few years is essentially the result of sharply reduced international commodity prices. Coffee prices in October 2001 were some 75 percent lower than the peak price reached in 1997, as a result of massive oversupply of both arabica and robusta varieties in the world market. World tobacco prices were some 15 percent lower in 2000 than in 1997, again due to an oversupply situation, which emerged in the late 1990s with the build-up of unsold stocks in a number of major, producing countries. World tea prices also declined sharply following the East Asian financial crisis and as a consequence of lower crude oil prices and their impact on purchasing power in the Middle East. Similarly, world cotton prices declined sharply in the late 90s and reached historic low points in late 2001.

FIGURE 2.1 MALAWI'S AGGREGATE EXPORT VALUES AND EXPORTS DEFLATED BY IMPORT PRICE INDEX



Source: IMF

Not only has Malawi failed to achieve any significant degree of export diversification, but its relative position in several major commodity markets has also deteriorated. This decline has been most substantial in the tea and coffee markets, where Malawi faces a range of supply constraints. In tobacco, Malawi has actually increased its share of world trade in burley tobacco varieties, although its trade and its market share has contracted for other varieties, including flue-cured, dark-fired, and oriental. (See Section 5.3) Malawi's sugar industry is one of the most cost competitive producers in the world, yet very high transport and other logistical costs associated with Malawi's exports via Southern African ports substantially weaken

that competitive position and limit the country's exports to sales under special preferential pricing and quota arrangements (i.e. in the European Union).¹⁹

TABLE 2.3 AVERAGE ANNUAL RATES OF GROWTH IN EXPORTS, 1990 - 2000

Category	Malawi	World	LDC's	Sub-Saharan Africa*
Total Merchandise Trade Value	3.98	6.60	6.05	4.77
Total Agricultural Products Value	1.72	4.04	2.79	5.05
Tobacco				
Volume	2.39	3.02	4.33	4.31
Value	1.36	4.21	3.9	3.86
Sugar				
Volume	0.27	4.06	3.27	-0.96
Value	1.06	0.66	0.84	-1.2
Coffee				
Volume	-6.98	0.96	0.37	-1.59
Value	0.94	8.75	7.06	5.41
Tea				
Volume	-1.30	1.88	1.09	3.85
Value	-0.57	2.06	0.64	6.20

*Not including South Africa.

Source: FAO Statistics

2.1.2 Exports and Growth

Despite the high ratio of Malawi's trade to GDP, the country's exports were not a major contributor to economic growth in the 1990s. This is contrary to what has been observed in many successful countries, where exports have been the "engine of growth." Compared to many other countries, Malawi's average GDP growth rate during the decade was higher than those of Least Developed countries. However, its export growth rate was noticeably lower than both groups.

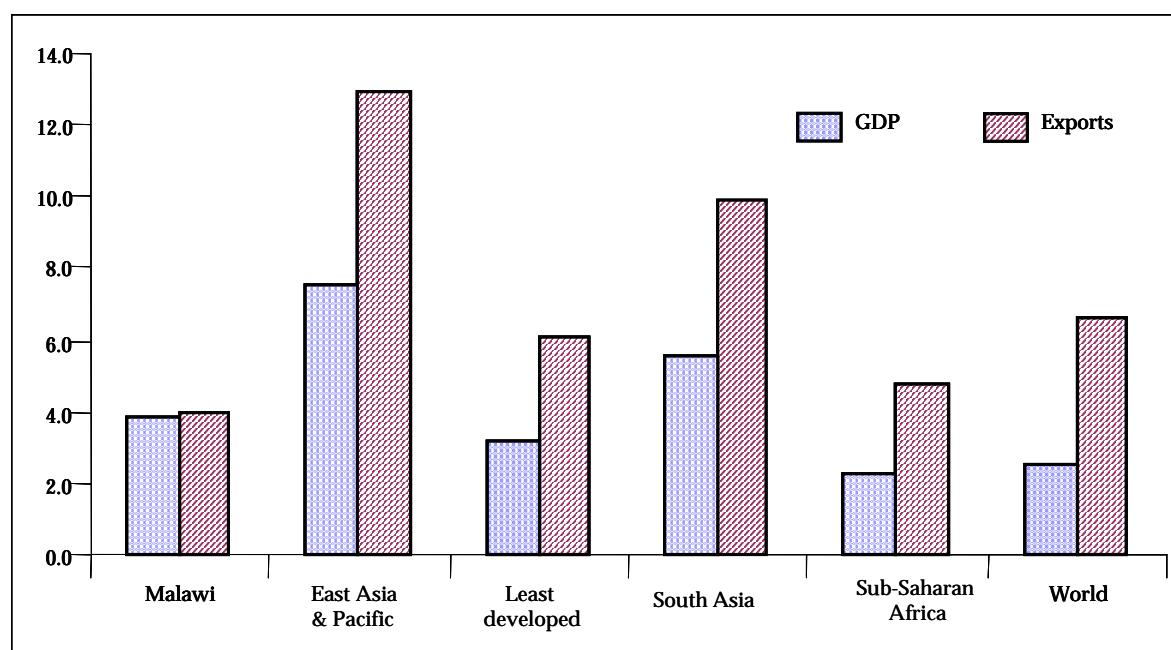
The weak relationship between GDP and exports becomes more apparent when one looks at the weak annual growth rates (Figure 2.3)²⁰, which can be attributed to two factors. First, Malawi's economy is heavily dependent on agricultural products

¹⁹ The overland freight and port charges for Malawi's sugar are about \$60 compared with costs of \$16 and \$30 for similar services for the South African and Swaziland industries, respectively. Ex-mill costs for Malawi are in the order of \$225/ton, indicating the major significance of these regional logistics costs to its overall cost structure.

²⁰ The one-year lag between GDP growth and exports could be caused by the fact that the bulk of income from exports is usually received late in the year and the secondary effects on the economy do not materialize until the following year.

whose output is linked to rainfall. As a result, wide fluctuations in GDP are likely to be far more correlated with rainfall than with export patterns. Second, the structure of the country's primary export sector limits the effects of exports on the rest of the economy. The bulk of Malawi's coffee and tea is produced by a limited number of large-scale estates, with few forward and backward linkages. The same applies to sugar as some 90 percent of production takes place on SUCOMA's estates. However, both the sugar and tea industries do employ large numbers of people. Yet, their level of employment has changed little over the past decade.

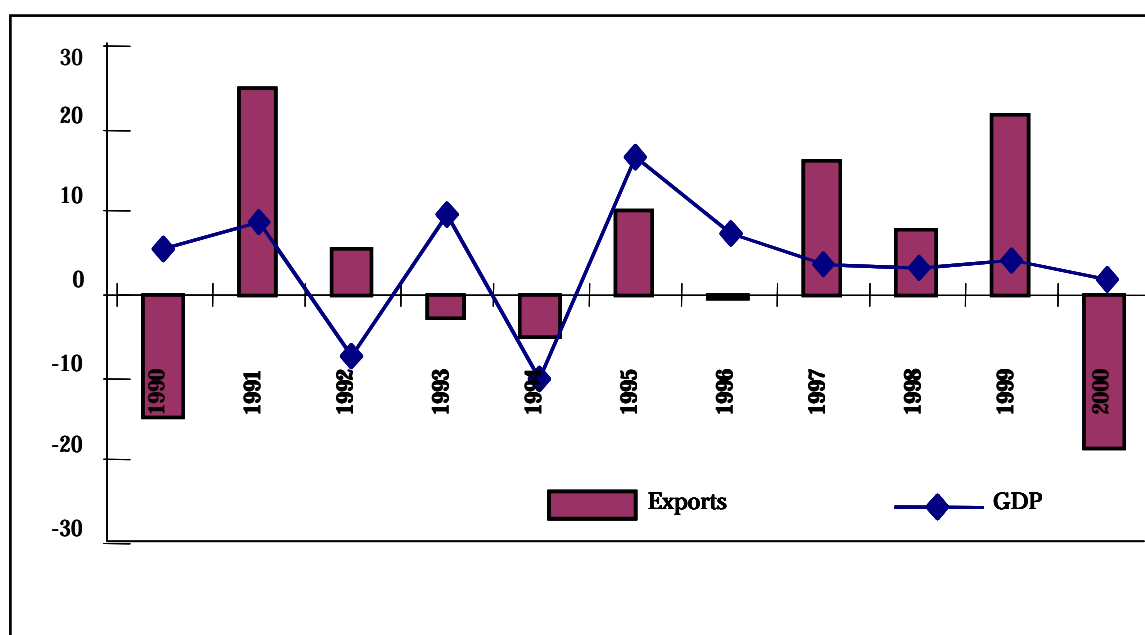
FIGURE 2.2 COMPARATIVE RATES OF GROWTH IN GDP AND EXPORTS 1990-2000



Source: World Bank Data and authors' calculations

Of the major export-oriented industries, only for tobacco would there be an expectation of strong linkages between export performance and a wide set of income and employment multipliers within the country. The liberalization of Malawi's tobacco subsector in the early to mid-1990s resulted in a massive redistribution of income from a small number of estates to a large number of smallholder farmers. This redistribution of income, together with the continued profitability of the crop at that time, undoubtedly contributed to the relatively high rates of GDP growth recorded during the 1995-97 period. However, tobacco prices subsequently declined, substantially eroding the profitability of the crop over the 1999 to 2001 period.

FIGURE 2.3 GROWTH RATES OF MALAWI'S GDP AND LAGGED EXPORTS



Source: IMF

2.1.3 Imports

Malawi's imports have fluctuated widely on a year-by-year basis due to the changing availability of foreign exchange arising from a combination of exports, public sector borrowing and donor transfers. In 1999, imports totaled some \$613 million. The composition of these imports is far less concentrated than Malawi's merchandise exports and no single product category accounts for more than 15 percent of total imports. Malawi's leading imports are vehicles (and parts), petroleum fuels, various types of machinery, and fertilizer. Other prominent imports are pharmaceuticals, iron and steel, wheat flour and cement. This pattern of imports is similar to that observed a decade ago. Whenever there have been shortfalls of maize production, maize imports have featured prominently in the country's trade (as in 1993, 1995, 1998, and 2001/2). In addition, there is a considerable on-going pattern of informal, cross-border trade, much of which involves the movement (and Malawi's importation) of food and other basic consumer goods.

While the composition of Malawi's imports remained static, the shares of the country's main import partners witnessed some change. The share of industrialized countries dropped from 50 percent in 1990 to less than 38 percent at the end of the decade. The share of the EU, the leading source of Malawi's imports, fell by 10 percentage points between 1990 and 1999. Similarly, Japan's share in 1999 was 4.5 percent, down from 7.5 percent nine years earlier. Among Malawi's regional partners, South Africa kept its share of about one third of Malawi's total imports and Zimbabwe more than doubled its share from 4.5 to 10 percent.

TABLE 2.4 LEADING IMPORTS FOR MALAWI, 1999

Item	Value \$ Million	%Share
Vehicles and Parts	76.3	12.4
Petroleum Fuels	69.3	11.3
Machinery, Boilers, and Parts	67.1	10.9
Electrical Machinery	51.7	8.4
Fertilizer	27.7	4.5
Wheat Flour	14.8	2.4
Pharmaceuticals	12.8	2.1
Iron and Steel	11.8	1.9
Sub-Total	255.2	41.6
Total Imports	613.4	100.0

Source: COMTRADE and authors calculations

TABLE 2.5 SOURCES OF MALAWI'S IMPORTS, 1990 AND 1999 (% SHARES)

	1990	1999
EU	40.3	30
South Africa	31.7	32.3
Japan	7.5	4.5
Zimbabwe	4.6	10.4
USA	2.1	2.2
Mozambique	0.2	0.8
Other	13.78	20.52

Source: COMTRADE

2.1.4 Trade Reforms and Current Regime

Throughout the 1990s, Malawi implemented a series of reforms aimed at reducing tariffs and eliminating non-tariff barriers. The government's trade liberalization measures also included consolidation of the tariff structure and liberalization of the export regime and exchange rates. On tariff structures, Malawi eliminated the import duties on raw materials used in manufacturing and reduced the maximum tariff rate on finished products from 40 percent to 35 percent in 1997, and further to 25 percent in 1999.

As part of its effort to eliminate non-tariff barriers, in 1992-93 Malawi authorities eliminated the differential in the surtax rate levied on imports and domestically produced goods. In 1997, authorities abolished all licensing requirements on

imports and exports, apart from those that are granted a special status on grounds of health, security and environmental considerations^{21 22}.

In the export regime, Malawi took a major step in 1994 when it abolished the export surrender requirement, with the exception of tea, sugar and tobacco, which remained taxed at 4 percent until 1998. In 1997, the government increased incentives to exports by canceling corporate tax on firms in export processing zones. Additionally, new simplified processes for registration and incorporation of companies were implemented in order to boost manufactured production.

In the area of exchange rate policies, after some episodes of relevant depreciation in 1994 and 2000, Malawi's Central Bank has reduced its market interventions to smooth the fluctuations in the market for foreign currencies. However, over this period real exchange rates have been extremely volatile. This volatility has undermined the benefits of liberalization and, as a result, supply response to depreciation was very limited.

2.1.5 The Current Trade Regime

Import regime: Malawi has relatively moderate tariffs. Its maximum tariff rate is 25 percent and average MFN tariff is 13.6 percent (15.2 percent for agriculture products and 13.3 percent for manufacturing). There are five bands of tariffs (0, 5, 10, 20 and 25 percent) with 60 percent of the tariff lines at 10 percent or less.²³ Malawi has bound the total of its tariff lines in agriculture at the WTO (at 125 percent), but only 3.9 percent of tariff lines in industrial products (at 47 percent).

High tariffs are concentrated in sectors where local production is large such as coffee, tea, and nuts or, more generally, in consumer goods. Consumer products have an average tariff that is more than three times higher than tariffs on capital goods (19 and 5 percent respectively). Similarly, tariffs on unprocessed products are 30 percent lower than tariffs on fully processed products. These rates do not include the preferential tariffs that Malawi offers to members of COMESA and SADC. Tariffs rates on consumer goods originating from COMESA and SADC members are, on average, 5 and 15 percent respectively.

In addition to tariffs, there are two types of taxes that apply to imported goods — surtax and excise tax. The surtax, which was introduced in 1989, initially applied selectively to goods and services, but it has since been progressively extended to more products and is now applied at a rate of 20 percent to most goods. Many

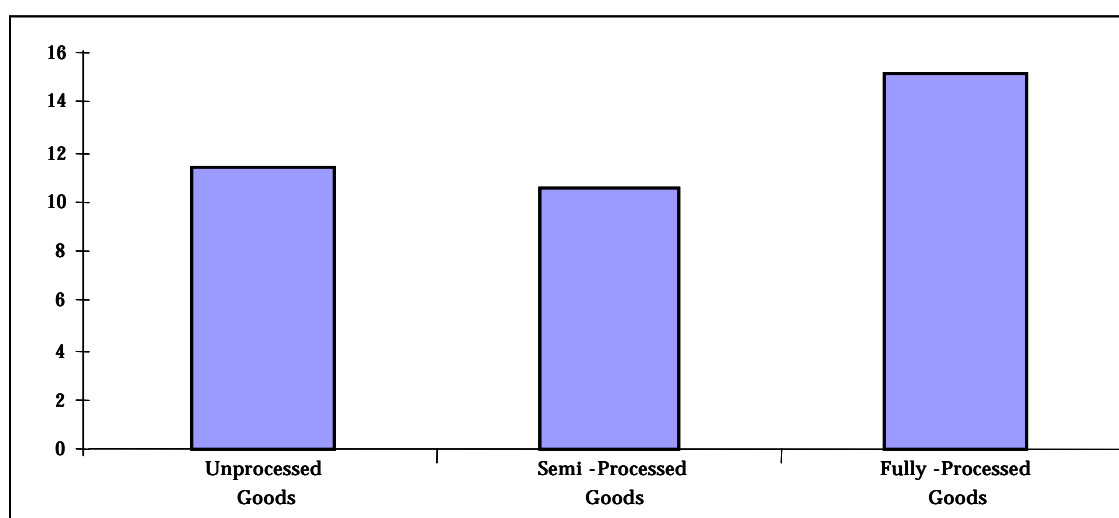
²¹ Only 5 percent of the country's total imports (13 commodities) are currently subject to a license system. The government also began to eliminate exchange controls (though at the price of an increase in the import duty rates), since 1988.

²² Controls on food exports are still in place on food security grounds.

²³ Tariff lines used are at the two-digit level of the Harmonized System.

services, including expenditure on legal services, telecommunications, motor vehicle repairs and satellite as well as cable television are taxed at 20 percent; other services including hotel accommodations, restaurants, and photographic services are taxed at 10 percent.²⁴ The surtax applies (at the same rate) to both domestic and imported products. On imports, the tax base is the duty-inclusive c.i.f. price, while on domestically produced goods it is the normal ex-factory price (including packaging). The government has in place a mechanism that provides producers, including exporters, with tax credits for surtax paid on inputs. The surtax allows the government to broaden the tax base, by including indirect and direct taxes, and reduce its revenue reliance on trade taxes, especially tariffs.

FIGURE 2.4 AVERAGE TARIFF BY LEVEL OF PROCESSING (PERCENTAGE)



Source: Malawi Tariff Code (2000)

Consumer goods are on average subject to 13 percent surtax but health-related goods such as medicines and vaccines as well as some types of fruits and vegetables are exempt. Intermediate and capital goods used in agriculture production or in manufacturing are also exempt from the tax. For instance, fertilizers, cotton yarn and other types of yarn used in the country's growing clothing industry are not taxed. In total, the surtax applies to 4,200 product lines, which implies that 2,200 products items are exempt.

Ad valorem excise duties are also applied to both imported and domestic products, and account for approximately 5 percent of total tax revenue. Even though the coverage of excise duty was expanded to include standard goods and some intermediate goods, the number of goods that are subject to this tax is still limited.²⁵ Additionally, the average excise tax is low; 1 percent for capital and intermediate goods, and 3 percent for consumer goods. Exporters of a wide range of specified

²⁴ Electricity is taxed at either 10 percent or 20 percent, depending upon whether consumed by residential or commercial users, respectively. See Customs Schedule, Third Schedule, Part III, 1999.

²⁵ Of 6,600 goods reviewed, around 900 are subject to excise tax.

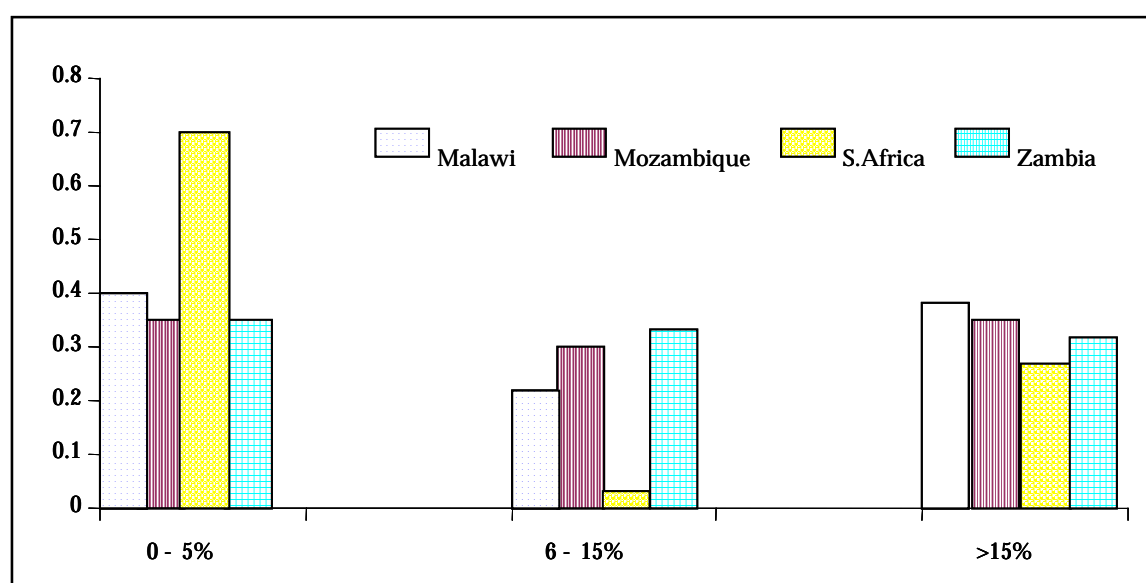
products, such as textile fabric and plastic products as well as those with EPZ status, and a few other manufacturers are exempt from excise duties on direct inputs, excluding petroleum products.

2.1.6 Malawi's Trade Regime Compared to Other Countries

Malawi's trade regime compares favorably to regimes in other Eastern and Southern African Countries. Its average tariff in 2001 is below the average for Sub-Saharan Africa and for the developing countries as a group. Malawi's trade regime was also ranked by the IMF as one of the least restrictive regimes among countries in eastern and southern Africa.

Business and government officials sometimes express the view that Malawi may have liberalized its tariff regime more than other countries in the region, to the detriment of Malawi's competitive position. However, Malawi's tariff rates and structure are rather comparable to those of Zambia, Mozambique and South Africa. Its average tariff of 12 percent is only slightly lower than those of Zambia and Mozambique, which average 14 and 16 percent respectively. Moreover, Malawi's average tariff tops that of its major trading partner in the region, South Africa, whose average tariff rate is 8 percent. In addition, Malawi's structure of cascading tariffs system is also similar to those countries. As a result, Malawi can neither fault its tariff structure for some of the competitive challenges that it faces, nor can it argue that the country has liberalized more than others in the region. As the trend toward further tariff liberalization continues, Malawi can not afford to be complacent about its tariff policies which will require further reforms in order to keep pace with other countries in the region.

**FIGURE 2.5 DISTRIBUTION OF IMPORTS ACCORDING TO TARIFF RATES:
MALAWI COMPARED TO OTHER COUNTRIES IN THE REGION**



Source: Country Tariff Codes

Average Tariff by Function. Malawi has completely eliminated all export taxes, which compares well with the 9.4 percent average export tax in the region.²⁶ However, Malawi's exports are still restricted by mandatory surrenders to the Central Bank of 60 percent of proceeds from exports of tobacco, 8 percent from exports of tea and 6.5 percent from exports of sugar. These funds are in turn used to pay for imports at the official exchange rate and also allow the government to manage the highly seasonal distribution of exports.

Malawi has few export incentive schemes, such as import tariff drawbacks, tariff suspension schemes and export promotion zones (EPZs). Malawi has established export promotion zones where importers are waived from paying tariffs and income taxes for a specified number of years, but their use has been limited. Malawi also has a Manufacturing under bond (MUB) scheme to give incentives to companies that devote only part of their production to exports.²⁷

Malawi's trade liberalization program has produced a relatively open regime and its tariff structure is generally comparable to those of other countries in the region. Still, there is room for external tariff reduction, especially on intermediate goods to encourage domestic manufacturing. The escalatory tariff structure gives some relative protection to the manufacturing sector by applying the highest rates to finished consumer goods. Yet, the fact that intermediate goods are subject to cumulative tariffs and duties that could be as high as 23 percent, provides preferential treatment to manufactures imported from countries that have free trade agreements with Malawi. For instance, Malawi's trade agreement with Zimbabwe provides for duty free entry of goods produced or manufactured in Zimbabwe, which puts domestic manufacturers at disadvantage and results, in some cases, in negative protection rates. (The recent currency collapse in Zimbabwe has further exacerbated bilateral trade in many goods.) As Malawi moves towards greater trade liberalization under COMESA and SADC, it will be important to ensure that its tariff structure does not undermine the competitiveness of its own industries.

2.2 REGIONAL PARTICIPATION

In light of Malawi's location and significant transportation costs, nearby regional markets need to be given more priority in any strategy which involves using international trade as an instrument to achieve long term economic growth and poverty alleviation. Malawi already depends on regional sources for over 75 percent of its imports; although only about 25 percent of its exports go to markets in the region. South Africa, a member of Southern Africa Development Community (SADC) but not of the Common Market for Eastern and Southern Africa (COMESA), is Malawi's main trading partner. South Africa's share of Malawi's exports has

²⁶Hinkle and Herrou-Aragon, 2001.

²⁷ IMF Country Report, *op.cit.*

dropped substantially in recent years, to less than 10 percent of the total. Nonetheless, it continues to be the largest regional destination of Malawi's exports, and considerations about the South African market must continue to drive, to a large extent, the direction of Malawi's regional initiatives.

FIGURE 2.6 SOUTHERN AND EASTERN AFRICA OVERLAPPING REGIONAL ARRANGEMENTS

The government's strategy to pursue these agreements is laudable, as such accords create significant trade opportunities for the future. Nonetheless, they also pose a number of challenges for trade policy design and implementation and place

substantial demands on limited human resources and institutional capabilities. The WTO, in its recent Trade Policy Review of Malawi highlighted the concerns about Malawi's regional strategy by stating that "Malawi's cross membership of overlapping regional and bilateral arrangements (see Figure 2.6) with different trade liberalization agendas and trading rules makes its trade regime more complex. It may distort Malawi's trade and incentive patterns and entail undertaking inconsistent obligations."

The two major regional accords that garner attention from Malawi are COMESA and SADC. COMESA came into force in 1994. Its twenty member states aim to establish a common external tariff (CET) and become a customs union by November 2004. Simultaneously, the members have established a number of preferential trading arrangements with each other, including a Free Trade Agreement (FTA) currently in operation among nine countries including Malawi.

The SADC Treaty was signed in 1992 with the objective of creating a development community that would achieve broad economic and development integration objectives. Membership covers the five countries of the Southern African Customs Union (SACU) and nine other countries, including Malawi, Zambia and Zimbabwe. The Trade Protocol, signed in 1996, entered into force in 2000. It aims to establish a FTA by 2012. Because of the different levels of development of its members, trade liberalization is asymmetric. For example, South Africa is liberalizing its market faster than the other members. Malawi will not begin to liberalize towards South Africa until 2005, although Malawi's liberalization towards the other countries will begin in 2003.

In addition to COMESA and SADC, it is important to note that Malawi, as a member of the ACP countries, which have recently concluded the Cotonou agreement with the EU, faces further complications in its pursuit of regional integration. Under Cotonou's terms, the preferential treatment Malawi receives in EU markets at present will be modified starting in 2008. At that point, Malawi will have the option of either continuing to receive preferential treatment for its products in EU markets under the Everything But Arms (EBA) initiative for all LDCs or it could participate in a yet to be determined regional trading group which would conclude a reciprocal but asymmetric preferential trade agreement with the EU. What will require further study and analysis (on the part of both Malawi and the EU) is whether such a regional agreement would be more appropriately negotiated with either COMESA or SADC. This issue will once again raise essential and complex issues of how Malawi's regional strategy is being designed and implemented.

So far, Malawi's regional agreements do not seem to have caused considerable trade diversion. Its main importing partners benefit from limited preferences as in the case of South Africa or no preferences (e.g. EU, Japan). Even if SADC were to be fully implemented, the fact that South Africa is already the main source of imports and that import duties are relatively low, make trade diversion an unlikely result of the agreement. However, the high dependence on imports from South Africa may

raise some concern for customs revenue once SADC is fully implemented.

As a small open LDC with weak administrative capacity Malawi's trade policy options are limited. To maximize its involvement in international markets Malawi should seek a simple and free external trading environment in which to sell its products. Given its inability, through small size, to effectively initiate international initiatives alone, effective involvement in regional agreements will be important. Given the above objective this will entail minimizing the costs of trade diversion associated by keeping external tariffs as low as possible and seeking simple rules of origin and at the lowest threshold of value added as possible.

To ensure that it fully exploits the advantages that are available from participation in both regional and multilateral institutions, Malawi needs to develop a more comprehensive capability for monitoring and evaluating its own national interests through the process of analysis, policymaking, and the negotiation of agreements that directly benefit Malawi. Unfortunately, a small LDC like Malawi, faces limitations, not only in advocating on behalf of itself, but also in what it can do to provide leadership in rationalizing regional trade groupings. Hence, for the time being, the government needs to work within the existing structures in trying to take advantage of what they offer and in working with other small countries with relatively liberal trade regimes to help shape them, to the extent possible, to meet their needs. Currently, this would involve actions to lobby together with other small LDCs for simplified, uniform and low threshold rules of origin in all preferences and align, within COMESA, with those countries that have low tariffs so that they can reduce the external tariff over time. Continuing participation of Malawi in COMESA seems to be worthwhile since there seems to be scope for expanding some of its exports to this area. Since South Africa decided not join COMESA, Malawi must participate in SADC in order to protect, to the extent it can, its access to the South African market, its biggest market in the region.

Finally, the actions of the WTO may also significantly affect Malawi's regional trade policy, as it will other countries in Southern and Eastern Africa. Because the debate about the relative merits of regionalism versus multilateralism are unlikely to subside, it will be incumbent on countries like Malawi to catalog and highlight the benefits of regional integration as a stepping stone and as a means of fulfilling the further goal of full integration into the international trading system.

The regional and bilateral trade arrangements in which Malawi is participating and the negotiations on the Cotonou agreement are presenting the government of Malawi with a number of important challenges. Some of these challenges are short term in nature and need to be addressed on an urgent basis; others are more for the medium and longer term, and require the development of a strategy that would be implemented over time. In order to deal with these challenges and develop a longer-term strategy, Malawi needs to identify and address its human resource and institutional shortcomings.

In practice and for various reasons, there will be a need for a co-operative approach between the various regional groups that have been formed in Eastern and Southern Africa and especially between COMESA, SADC and the EAC (Kenya, Uganda, and Tanzania). Given the limited capacities within many of the member countries, the responsibility to reconcile the various inconsistencies in the commitments of countries with joint membership in more than one group, will fall to these regional organizations.

More pressing, in the short term, is for the Malawi government to effectively implement the complex set of agreements in which it is participating and to translate participation in these various agreements into concrete benefits for its private sector. To do so will require the strengthening of the capacity of its customs service and its trade related institutions in order to implement the complex intertwined agreements. At the government level, this is an administrative challenge for the customs authorities, which have to scrutinize imports from a variety of sources, each with a different tariff rate and each subject to different rules of origin. It will also require policy decisions that create the appropriate regulatory and business environment that promotes further participation in the opportunities afforded by the agreements. However, government must also undertake significant efforts to build understanding and support for these regional agreements. Not only is this essential in order to reap the economic benefits of regional integration, but without such efforts, the constituencies that have been supportive of reform and trade liberalization will lose the impelling force that can encourage the process to move further.

2.3 THE AGOA AND EBA INITIATIVES

Prior to the EBA and AGOA initiatives, exports of tobacco, sugar and apparel to the US and the EU were subject to quotas. AGOA, which was enacted in May 2000, extends the Generalized System of Preferences (GSP) for eligible countries in sub-Saharan Africa until September 30th 2008 or seven years longer than in other developing countries, and offers duty free access to many products of eligible African countries. While maintaining quotas on sugar and tobacco, the Act provides for duty-free and quota-free access to the US market for apparel made in eligible Sub-Saharan African countries from US fabric. It also provides for substantial growth of duty-free and quota-free apparel imports made from fabric produced in beneficiary countries in Sub-Saharan Africa.

In comparison, “The Everything But Arms” initiative, which came into effect in March 2001, removes all tariffs and quotas on all imports from Least Developed countries other than those classified as armaments. This will be achieved by amending the current GSP except for sugar, rice and bananas, for which the removal of restrictions will be undertaken in three annual stages, leading to full elimination by January 1, 2009.

AGOA and EBA provide Malawi with a window of opportunity to increase its exports to its main trading partners. However, the extent to which Malawi will expand its exports and capture a larger share of the US and the EU markets depend on the following factors:

- The extent to which AGOA and EBA represent an improvement on current terms of access for Malawi's exports to the US and the EU markets, including the ability to satisfy rules of origin and the impact of the costs of proving origin.
- The state of demand in the US and the EU markets for Malawi's exports.
- The supply capacity of Malawi's export sector and its ability to respond to increasing demand.
- The competitiveness of Malawi's products in terms of prices and quality.

2.3.1 The Potential Impact of AGOA

The United States has been Malawi's second largest trade partner after the European Union, buying an average of 15 percent of Malawi's total exports during the 1990s. The simple average Most Favored Nation (MFN) tariff faced by Malawi exporters in the United States in 2000 was 10 percent. Tariff revenue of US \$4 million collected on Malawi's exports in the US, which amounted to US \$68 million in 2000, implies an average tariff of almost 6 percent. Of these revenues, \$2.8 million were collected on tobacco exports and the rest mainly on apparel and clothing (\$306 thousand). About 45 percent of Malawi's tobacco exports to the US entered the market duty free as part of the 12,000-ton annual quota that the US grants to Malawi. The rest of Malawi's tobacco exports were, on average, subject to 10 percent tariff. Despite the fact that AGOA covers some of the tobacco categories that Malawi exports to the US, it is unlikely that Malawi's tobacco exports will increase as a result of the improved market access conditions. Even if tariff reduction was translated to a decrease in prices, it will not offset declining demand for tobacco in the US. Malawi's tobacco exports to the US have dropped by 27 percent in 2000 and by 23 percent 2001 respectively.^{28,29} At the same time, tea, Malawi's second largest export to the United States, was not previously subject to any tariffs or duties.

²⁸ US based cigarettes manufacturers are increasingly shifting their production to countries where demand is still growing.

²⁹ The decline in tobacco exports in 2001 came after Malawi became eligible under AGOA.

With the exception of apparel and clothing, AGOA does not offer any of Malawi's exports meaningful improved access to the US market.³⁰ Many agricultural products that are covered by AGOA already enjoyed duty free access under the GSP system. Furthermore, products that was not included in the GSP system and are of interest to Malawi such as, sugar, cotton and certain types of nuts are not covered by AGOA either.

Hence, the overall outlook is that AGOA is likely to provide stimulus only to exports in the apparel and clothing sector. The US is the largest single market for clothing and apparel and demand is rising. Moreover, US imports of both groups are subject to quotas and to average import-weighted MFN tariff of 11.6 percent.³¹ Last year, Malawi's exports of apparel and clothing to the US increased by almost 80 percent compared to 2000 reaching US \$21.6 million.

Nonetheless, Malawi's apparel and clothing manufactures need to overcome supply constraints caused by the absence of a sufficiently enabling legal and regulatory environment, and increase the competitiveness of their products if they are to maximize their gains under AGOA. Malawi's difficulties with its apparel exports to South Africa underlines the supply constraints of Malawi producers and Malawi's limited ability to compete without preferential treatment.

2.3.2 The Potential Impact of EBA

Malawi already received highly preferential access to the EU market under the Cotonou Agreement. Therefore, the impact of the European Union's EBA will mostly take place in the sugar sector. (See discussion starting on Section 5.5). However, there is the important issue of the extent to which Malawi can take advantage of the trade preferences that are available and how important those preferences are to export expansion. The main factor, which constrains the taking-up of these preferences, is probably the nature of the rules of origin that the EU imposes and the costs of providing the relevant documentation to prove conformity with these rules.

³⁰ Apparel imports made with regional (African) fabric and yarn are subject to a cap of 1.5 percent of overall US apparel imports, growing to 3.5 percent of overall imports over an 8-year period. Under a Special Rule for Lesser Developed Beneficiary Countries, those with a per capita GNP under \$1,500 in 1998 will enjoy duty-free access for apparel made from fabric originating anywhere in the world until September 30, 2004. Apparel imported under the Special Rule is counted against the cap.

³¹ The US will remove quotas on clothing and apparel in 2004, in line with the Uruguay agreements but tariffs will remain.

CHAPTER 3

TRADE-RELATED INSTITUTIONS³²

Malawi's trade policies have undergone significant liberalization over the course of the past decade, as Malawi has increased efforts to integrate itself into both regional and international markets. These liberalizations have placed pressures not only on domestic institutions such as those responsible for customs administration, and export promotion, but also on the entire policy-making apparatus encompassing the various elements of government, particularly including the Ministries of Finance and Commerce. This chapter reviews the main trade policy making and implementing institutions in Malawi, the key conclusions are:

- To be able to fully participate, and effectively achieve its objectives, in regional and multilateral fora, Malawi needs to
 - increase its capacity for trade policy awareness, analysis, and understanding;
 - develop effective interagency structures to support trade policy development;
 - provide for the more effective participation of all stakeholders, including the private sector, in the process of analysis and policy formulation.

3.1 INSTITUTIONAL CONSTRAINTS

In general, the primary institutional restraints on Malawi's trade-related capabilities include:

- lack of sufficient or appropriately trained human resources
- management of relevant institutions
- lack of financial and material resources
- inadequate communication with both internal and external stakeholders

Private sector observers agree that government institutions are under financed, but few believe that more money alone would solve the problems. A complete overhaul would be needed, which might include reduced staffing levels, competitive salaries, professional top management, and greater involvement by the private sector in the

³² This section draws on "Study To Identify Malawi's Institutional Needs In The Area Of Trade Development" by Oxford Policy Management and Management Solutions Consulting and supported by DFID. Other reports have also focused extensively on the institutional needs of Malawi in the trade-related areas.

appointment and staffing of various consultative bodies and boards. (This private sector involvement should be controlled by the private sector- i.e. not favored private sector people appointed by the Government of Malawi.)

As in other LDCs, institutional capacity among trade-related institutions in Malawi is weak. The Ministry of Commerce and Industry (MCI), which has primary responsibility for trade policy analysis, formulation and implementation does not have sufficient resources to carry out its functions, and has customarily been viewed as a "second tier" entity within the context of government policy making. This second-class status inevitably results in its lack of political clout within the decision-making apparatus, as well as less resources being devoted to its mission.

The weaknesses within the trade-policy-making processes are evident at multiple levels of the policy and implementation process. Ever since its adoption of economic reforms, Malawi has staked much of its economic growth aspirations on improved export performance. In similar fashion, the recently completed PRSP states that development and promotion of domestic and international trade should include the provision of supportive infrastructure, the expansion of export market share and the negotiation of preferential arrangements.

Despite this emphasis on trade as a mechanism for poverty alleviation and economic growth, the institutions with responsibility for analyzing, designing, and implementing trade policies do not have the resources to carry out this expanding mandate.

Increasingly, Malawi is making efforts to take part in regional, bilateral and multilateral trading arrangements as a means of enhancing its role in the international trading system. Yet, despite its membership in these various entities, Malawi's ability to influence the direction of these groupings is circumscribed because of the absence of resources and capacity. The environment in which such trade occurs is determined by regional agreements such as the SADC and COMESA processes and multilaterally by the WTO. Yet, Malawi finds itself unable to affect these organizations in any substantial way because of a number of factors. Malawi has a poor capacity of determining what its national interests are in the trade area. In the absence of an effective means of consultation with its private sector, the government cannot gather the information it needs to develop an understanding of the risks and opportunities that would come from expanded international trade.

Even if there is an exchange of information between the government and Malawi's private sector - which is increasingly true with the recent creation of a number of consultative entities such as the National Working Group on Trade Policy - the government lacks the analytical resources to synthesize a trade policy that balances the risks and opportunities to various constituencies within the national economy. As a result, the pursuit of trade policy tends to be reactive in nature, decisions being precipitated by external developments such as consultative meetings called under the auspices of SADC or COMESA on a particular issue.

As it stands, there is a significant need within the Malawi government for capacity building on a broad scale. This need has been recognized by the recent launch by the World Bank of a national capacity building effort, which is currently focusing on agriculture, health, and education. While distinct, the fact that such a capacity building initiative is proceeding offers the opportunity for a mutually supportive environment for a capacity building effort that focuses primarily on the trade-related needs of Malawi under the auspices of the Integrated Framework.

3.1.1 Ministry of Commerce and Industry

The Ministry of Commerce and Industry is given primary responsibility for trade policy development and implementation. The Ministry has received technical assistance from development partners, but still lacks the ability to successfully carry out its myriad functions.

The constraints identified in terms of bilateral, regional and multilateral trading agreements are as follows:

- Lack of capacity in negotiating skills and support structures.
- Lack of in-depth knowledge of the legal and policy issues surrounding the trade agreements and their application to Malawi. The knowledge level in all ministries regarding the constraints and requirements of various trade agreements is also limited.
- Malawi does not fully participate in WTO negotiations. To a large extent this is due to Malawi's lack of representation in Geneva and general lack of capacity to attend and participate in meetings. Lack of funding is a significant cause of this inadequate participation.
- The committee on WTO issues and structures operating in Malawi lacks the required strength and needs review. An awareness program needs to be instituted.
- The interagency mechanisms and structures in each ministry required to support trade policy development are lacking. In many ministries, they do not exist at all and their development is urgently required. The linkages between trade policy and other policy issues are inadequately understood.³³
- The private sector is inadequately involved in the development of trade policy. Although the National Working Group on Trade Policy is in principle a very useful private-public sector forum, it is constrained in its capacity to analyze issues, disseminate information and help in policy formulation. Furthermore, until recently it has only handled the SADC Trade Protocol. As such, it has

³³ The minimal attention to trade policy issues during the recent PRSP exercise is an illustration of the need to improve linkages among various policy initiatives.

inadequate knowledge of and experience with the other trade policy issues, including the WTO, EU-ACP, COMESA and the bilateral agreements. More recently, the creation of the National Action Group (NAG) has brought with it the involvement of Malawi's most active companies, but the need for effective interaction and meaningful consultations between the government and the private sector is evident.

- Lack of awareness among all stakeholders on the implications of the WTO agreements.

3.1.2 Malawi Export Promotion Council and the Malawi Investment Promotion Agency

The Malawi Export Promotion Council (MEPC) was established in 1971 and its primary function is to promote exports of agriculture and manufactured goods from Malawi. MEPC organizes occasional trade shows and "Malawi Days" to promote domestic products. The mission statement for MEPC is in line with the Government's export diversification policy that is aimed at reducing the country's excessive dependence on a few traditional export products. MEPC uses an integrated approach covering five key areas which include product development, market development, export trade facilitation, exporter extension service and trade information service.

Unfortunately, utilizing MEPC's data is difficult as much of the information that is available is out of date. MEPC has some information about the products produced by domestic firms but suffers from a significant gap of information about other markets where such products might be sold. This dearth of information has recently been partially addressed through the creation of an Information Center, partially funded by USAID, but there is still further improvement needed in the development of market information. There is also a shortage of export and import management skills both within MEPC and more broadly in the business community. Finally, but perhaps most notably, Malawi's international trade representatives are resident in only two countries of the region, significantly limiting the opportunity for further export development.

The Malawi Investment Promotion Agency is a statutory body whose main objective is to facilitate all aspects of the investment process, both domestic and international. MIPA is responsible for providing relevant services to investors to promote inward investment. The most serious problem facing MIPA is that it has suffered from inadequate funding, and this has to some extent affected the Agency's ability to carry out some of its core functions.

MIPA is not currently a "one-stop shop" in that they do not have representatives of all the relevant agencies involved in investment approval resident in-house. Rather MIPA sees itself as a one-stop facilitating agency - the investor comes to them, and

they do the running around to the various government agencies and departments whose approvals are required. There is currently no consistent monitoring of new investors to ensure that their investment and local employment levels are in line with what they undertook in their initial investment proposal.

A decision has been taken to merge MIPA and MEPC into one institution. This new institution should focus more on assisting businesses through providing regular marketing information, outlining the implication of trade agreements, and working to simplify the procedures for establishing new businesses rather than administering incentives. Experience elsewhere, however, suggests that the merging of investment promotion and export development is not a panacea. Both merged entities or separate entities encompassing these functions can work effectively, but their success has more to do with the competence of management and whether sufficient resources are made available to carry out their functional responsibilities.

3.1.3 Malawi Bureau of Standards

The Malawi Bureau of Standards (MBS) was established in 1972. It is the national enquiry point that is required by the WTO under the Agreement on Technical Barriers to Trade. MBS sets and implements standards and conducts conformity tests on selected imports and exports. An increasing proportion of its funding over the years has come from revenues generated by its quality assurance and testing activities. There are three technical divisions operating within MBS: (i) chemical and textile; (ii) engineering and materials; and (iii) food and agriculture. For food products, MBS usually uses CODEX standards, yet in some circumstances it has used Indian or South African standards as a reference to a local standard. The bureau has set standards for some of the country's major exports including tea, tobacco and sugar yet it does not conduct any testing of these commodities. Altogether, by the end of 2001, the MBS had established 256 standards, 39 percent of which are related to food and agricultural products. MBS is working closely with its counterpart agencies in other SADC countries to harmonize their standards under the Standard, Quality, Accreditation and Metrology program (SQAM). Since the beginning of the year, members have harmonized ten standards and developed a program to assist industries to comply with the harmonized standards.

In terms of equipment and personnel, the MBS's capacity is relatively limited. At the end of 2001, the Bureau had only 25 lab technicians and 6 enforcement specialists. Similarly, testing equipment is very limited allowing for only one testing line during the high export season. Rapid staff turn over and the threat of brain drain due to uncompetitive remuneration packages are recurring problems. Moreover, due to budgetary restraints, MBS officials are limited in the outreach efforts that they can undertake with a view to improving the competitiveness of Malawi businesses.

MBS is currently seeking funding for five proposals to enhance the capacities of its various divisions. The proposed projects relate to implementation of ISO 9000, the strengthening of standards development and information services; improving

petrochemicals laboratory testing facilities and establishing a national metrology laboratory.

For Malawi's leading agricultural exports, compliance with international sanitary and phytosanitary requirements has not proven to be a problem for the large international companies, which dominate these sectors. Malawi's tobacco is amongst the cleanest in the world, given the very limited use of pesticides in its production. The industry is not encountering major problems in phasing out the use of methyl bromide, as required under the Montreal Protocol. With regard to tea, the concerns for Malawi relate more to improving product quality rather than to SPS issues per se. In addition, the industry is faced with a challenge to meet the social welfare and environmental management standards stipulated by a group of private international tea distributors through their Tea Sourcing Council. For sugar, SUCOMA has not had difficulty meeting international standards related to the presence of contaminants or chemical residues.

It is in relation to some of Malawi's less substantial agricultural exports that some problems of compliance with international SPS standards have arisen. Examples include aflatoxin contamination of some samples of groundnuts and paprika and the presence of aflatoxin and/or peroxide residues in exported macadamia nuts. Over the years, Malawi producers have had difficulty exporting their cashew nuts, in part due to poor processing methods, which resulted in the contamination of nuts by the cashew shell liquid. For the most part, individual industries have had to address their own quality and/or SPS challenges, with some additional support provided by the Ministry of Agriculture and/or MBS.

3.2 PRIVATE SECTOR/PUBLIC SECTOR CONSULTATIVE MECHANISMS

In order to improve public/private collaboration, the Government needs to build a high-level consultation forum comprising of a wide spectrum of business leaders and key government agencies. This broad-based consultative group should meet on a regular basis to tackle areas of mutual concern. Importantly, this forum should be action-oriented in nature as opposed to the frequent workshops that typically fail to advance specific actions. Such a forum will also help to rebuild trust between the government and the private sector and to increase understanding of their respective objectives.

CHAPTER 4

TRADE FACILITATION

As a landlocked country, Malawi is dependent on overland movement of exports and imports. Its transport network and its connections to neighboring countries are, therefore, of utmost economic importance. In turn, the efficiency of the transport network is significantly reliant on the customs operations. Transportation and customs are therefore the primary focus of the following sections, the main conclusions of which are:

- Whilst the operation of customs has become better since the creation of the MRA in 1998, there are still widespread criticisms of its activities, which suggest substantial scope for further improvements. Overall, efficiency remains frustrated by outmoded procedures and management practices, lack of incentive and a relatively weak position in the Government's administrative framework.
- The implementation of the ongoing automation process offers considerable opportunities to improve the efficiency of customs and transit clearance and data and revenue collection tasks and makes possible the development of a system of compliance management.
- There are the beginnings of the MRA becoming a modern externally focused and business-like entity. This development needs to be substantially enhanced with an effort to adopt the best practices found in modern Customs administrations. This will be facilitated by having well-trained and well-respected officials, up to date systems and technology, flexibility to anticipate and react to changes in the environment, and transparent decision-making processes with accessible rights of appeal.
- Inefficient and inadequate transport systems are a major economic constraint in Malawi. Trade is severely hampered by the high cost and unreliability of moving goods in and out of the country whilst rural development and the alleviation of poverty is constrained by the lack of transport infrastructure which acts to delink the rural population from markets.
- To facilitate external trade there is a need to address the problems in accessing the port of Nacala in Mozambique and the unreliability of using this route. Within the domestic economy, liberalization of trucking routes to allow foreign competition would act to depress transport rates.

4.1 CUSTOMS³⁴

The Malawi Revenue Authority (MRA), created in 1998 is a self-financing regulatory parastatal, responsible to the Ministry of Finance. Originally, it was managed by a Board consisting of the Secretaries of Treasury and Commerce and Industry, the Accountant General, the Governor of the Reserve Bank, representatives of the Society of Accountants and Chamber of Commerce, and two private sector representatives appointed by the Minister of Finance. The Board was empowered to appoint a Commissioner General of the Authority for a four-year term. The Board's mandate lapsed at the end of 2001 and a new board had not been appointed at the time of the mission. It is understood that a new board was appointed in June, 2002. The MRA budget is based on a rebate of 2.5 percent of revenues collected and paid to Treasury.

The MRA was established as the main body “responsible for assessment and collection, on behalf of the Government, of specified revenue; for the administration and enforcement of laws relating to such revenue; and to provide for matters incidental thereto or connected therewith.” Customs itself has not had a more specific mission since the inception of the MRA. However, in 1996, as part of an IMF/DFID study, it was agreed that the mission statement for the Malawi Customs and Excise Department would be to efficiently and effectively: (i) collect revenue through customs and excise duties and surtax, (ii) facilitate legitimate trade and travelers, (iii) protect society through the enforcement of the law relating to import and export prohibitions and restrictions, (iv) advise government on customs, excise and surtax matters, and (v) collect and provide import, export and surtax statistics. This mission aligns closely with those of most Customs organizations internationally, whereas the MRA mission is focused only on revenue related matters. As a result, emphasis on non-revenue issues has diminished to a very low level.

The absence of non-revenue performance standards coincides with Customs falling behind in facilitation measures. Even though Malawi compares favorably in this regard with some other countries in the region, traders, transport operators and the Malawi Confederation of Chambers of Commerce and Industry (MCCCI) point to inconsistency and slowness in Customs processing and decision making as an inhibiting factor in conducting competitive business. References were also made to Customs' lack of effectiveness in protecting industries from low standard imports and those on which the correct duties and taxes have not been paid. Nevertheless, it

³⁴ Much of the information obtained in the course of the study is anecdotal and based on the perceptions of the interviewees rather than statistical facts. This study would have benefited from more data being available to support or refute the anecdotal information provided by those interviewed. This is particularly so in assessing the progress of Customs in recent years, especially since the inception of the MRA.

was acknowledged by many that Customs management and efficiency had improved under the MRA.

Except for revenue collections, performance measurement and management statistical information is extremely limited. At present, for example, there are no data available on:

- The volume of declarations processed at the various entry points;
- processing times;
- the allocation of resources;
- detections of breaches of the law;
- breaches by particular individuals or companies; and
- extra revenue collected as a consequence of Customs intervention.

When the ASYCUDA processing system becomes fully operational at the end of 2002, more detailed and timely information can be expected. However, a variation in management focus so as to include non-revenue collection goals will be needed to ensure the routine production of comprehensive management and performance data for use by Customs and external entities alike.

Plans are underway for a major review of the Customs and Excise Act. Proposals for the amendment of some provisions of the Act have been submitted to the current session of parliament. In general, the legislation appears to be dated (e.g., no WTO valuation provisions, inconsistency with international and regional agreements, references to amounts in Kwachas are too low to be meaningful). A full review of legislation during the mission was not envisaged under the terms of reference, but such a review could identify areas requiring attention and recommend changes to ensure that legislation is aligned with international standards including valuation regimes, delegations of authority, administrative penalties and effective and transparent appeal mechanisms.

4.1.1 Customs Valuation

Malawi is an original member of the WTO and consequently is obliged to conduct Customs business within all WTO multilateral agreements that are binding on Malawi. The Agreement on Customs Valuation (ACV) sets international rules for Customs valuation that are designed to be fair, uniform and neutral, and it precludes the use of arbitrary and fictitious Customs values. Through its precise methodology, it assists the trading community and Customs authorities to determine the Customs values and the amount of duties payable with more certainty, and therefore contributes to the facilitation of trade.

Even though Malawi has adopted ACV and it is a requirement of the current PSI

contract to value goods in this way, in practice the provisions are not always applied. In fact, the current legislation related to valuation is not compliant with ACV requirements. The administration acknowledges that the ACV is not applied consistently, but cites difficulties with widespread non-compliance and a high volume of informal trade as reasons for applying arbitrary values. There is a proposed review of legislation to be undertaken in the near future which should pay particular attention to ACV issues.

It is reported that in some instances, values can be “negotiated” by importers or their agents. Apart from falling outside the ACV rules, this practice lends itself to corruption through coercion and should be abolished eventually, but, in the meantime, should be controlled carefully and transparently.

Technical training on ACV has been provided since March 2001 under the Pre Shipment Inspection contract with Société Générale de Surveillance and so there is little need for more technical training. However, the lack of accompanying organizational and procedural changes leaves the administration with little capacity to apply valuation methods that fall within the ACV rules. The administration would benefit from a high-level seminar or workshop, provided by WCO or a Customs administration that has fully implemented WTO valuation, and that is aimed at developing a strategy for full implementation.

Given the current low level of acceptance and experience in the areas of post clearance audit and risk management, Customs would benefit from a period of professional advice in these areas. Technical assistance leading up to implementation could be provided through a short-term (three to six months) technical advisor appointment.

Pre Shipment Inspection (PSI)

PSI is used by governments to assist in establishing the nature and value of goods in the country of export and is widely used by countries to combat revenue leakage caused by inefficient Customs administration, valuation fraud and corruption. PSI was first introduced in Malawi in 1992. The current PSI contract (with Société Générale de Surveillance - SGS) began in March 2001 with a two-year sunset clause to phase out PSI as a trade-off for higher salaries in the MRA and increased revenues. Under the contract, SGS undertakes to verify valuation, tariff classification and origin data for imports valued at greater than US\$2000 CIF. SGS also provides technical training and management development through a sub-contract arrangement with Crown Agents.

WCO policy recommends against PSI, stating that its use reduces the capacity of Customs to carry out its proper functions. Many administrations report that the use of PSI to determine classifications and values has had a severe adverse impact on the skills of Customs officials. Some companies provide for training of Customs officials under the terms of their contract, often in conjunction with a “sunset” clause that is meant to restore their functions to Customs.

Another consideration is the cost of PSI relative to the investment that would be necessary to bring the Customs administration to a fully effective state. The cost of these services in Malawi is said to be equivalent to 1.5 percent of the value of the goods subject to inspection. Based on that rate, the annual cost of PSI services in Malawi is estimated to be in excess of Kw750 million, or 150 percent of the budget of the MRA.

Based on the information provided, there is little to suggest that the management at Customs is preparing itself for post-PSI responsibilities, either in terms of technical capacity or systems. For example, Customs will need to implement a system, prior to March 2003, that will ensure that data currently obtained through PSI will be both presented and valid.

4.1.2 Development of a System of Compliance Management

The principle behind compliance management is to provide the necessary information, support and incentives to maximize the number of declarants that will voluntarily comply with all requirements. If Customs clients know clearly what they are required to do, they are given the support necessary to do it, and there are commercial or other benefits in choosing to comply, then there is a high chance that they will do so. Benefits should include discriminatory treatment such that compliant traders would gain from streamlined processes, reduced likelihood of inspections and special considerations such as inspections at premises and periodic payment.

With a higher proportion of compliant (and therefore “low risk”) clients, Customs is able to divert more attention and resources to the non-compliant clients. In principle, they will be subjected to a greater degree of scrutiny and therefore, more inconvenience, costs and risks. Clearly, the tendency would be for more declarants to comply.

This concept was discussed with some of the high volume importers and transport operators, and they welcomed the opportunity to participate in such a program with Customs. The EPZ program is another area that could be included, even though not a large user of Customs resources. Essential supporting mechanisms such as an intelligence database and risk profiles need to be developed and disincentives for non-compliance need to be applied. Assistance in the form of technical expertise from a donor administration or specialist consultant will be required to implement such an effort.

4.1.3 Automation

At the time of the mission, Customs was in the process of installation of ASYCUDA at the main border crossing, Mwanza. Together with Blantyre, which is already operating, this will bring over 70 percent of import transactions under automated processing. Other posts are coming on line in the near future. Once bedded down, presently forecast for December 2002, the current version (2.7) will be upgraded to

ASYCUDA ++ (version 3.1).

In principle, this will provide an effective platform to support compliance and risk management principles. However, there is some resistance amongst technical staff to accept ASYCUDA. This is a common problem in countries where substantial corruption is present and where capacity to cope with modern and accountable Customs practices is limited.

The reasons for the resistance observed in Malawi were not investigated. Logically following the experiences in other countries, it is likely to stem from a number of fears, rational or not, that new technology will threaten jobs; and that individuals might see themselves losing relevance and opportunities to exercise discretionary power (legitimately or otherwise). It also stems from a reluctance to trust technology instead of the knowledge and experience of “the old hands.”

There was an indication that the technical assistance currently being provided by DFID is to be reviewed. Any reduction to the support for implementation of ASYCUDA ++ will have obvious negative consequences. If this were the case, it would be vital for Customs to find an alternative form of technical assistance.

4.1.4 Transit

Most clearances of cargo are made inland at Blantyre or Lilongwe. As nearly all cargo arrives by road, there is a heavy dependence on the secure transit of goods. A computerized system for transit has been operating for some years but is not working effectively. Set up under an assistance program by the Harvard Institute, the system, introduced as a trial, was never fully implemented. Poor communications infrastructure and vulnerable software have contributed to incomplete transactions and fraudulent abuse. It was estimated that over 400 containers have been lost in transit, causing significant losses in revenue.

The Transit Module of ASYCUDA++ will support a more rigorous control of transit goods when introduced late in 2002. Customs also plans to clear all goods at the border posts at which ASYCUDA is operating, lowering the demand on resources needed to service the inland temporary stores, reducing the overall volume of transit transactions and therefore also the associated risks.

A new solution for transit security in the form of an electronic seal has recently been developed and has attracted attention in regions with high dependency on international transit trade. NAFTA and SADC countries have expressed interest in this technology and Malawi should monitor developments in this area. This would present a simple, practical and useful form of technical assistance in the medium term.

4.1.5 Revenue Leakage

As a poor country, Malawi relies heavily on Customs revenues and taxes to fund government programs. It can ill-afford to ignore revenue shortfalls that come as a result of leakage. Currently there are neither data nor estimates available that give an indication of the amount of revenue that is lost because of breaches of customs and tax laws. Stakeholders and Customs officials have reported that duty and tax evasion is widespread. Add to this the difficulties presented by Malawi's porous borders, and the high incidence of corruption that has been reported, and there is a high likelihood of substantial revenue leakage. Based on the experiences of other African countries, leakage through under valuation, origin fraud, misclassification and smuggling in Malawi could be many billions of Kwachas annually.

4.1.6 Corruption

There is very little direct evidence of corruption in Customs although the Malawi Anti Corruption Bureau (ACB) has reported several cases. When asked, senior management said that there had been only one or two isolated cases of corruption involving Customs officials in the past two years. Although reporting mechanisms are available to traders and the public to report instances of corruption, few reports were received. Several stakeholders indicated that experience had taught them that it is safer not to make reports, citing examples of no action being taken on the allegations and then being subjected to retribution by the alleged offenders on future transactions.

Anecdotally, corruption is endemic in Customs at all levels. These allegations come from the private sector, other ministries and from within the MRA itself. Corruption is said to vary from minor cases of "speed money" paid to cut through bureaucracy (often deliberately manufactured by the perpetrators), to very large amounts paid to avoid the proper payment of revenue due by misrepresenting values, tariff classifications and origin of goods. Large-scale corruption is said to involve politicians and senior management of the MRA. Stakeholders have alleged that the ACB is also subject to political influence.

If the allegations mentioned above are true, then it is difficult to see how any external intervention can have a direct impact. *Political will and determined top-level management are needed to underpin any strategy for fighting corruption.* If that support became evident, then an integrity strategy could be developed following the principles of the WCO's Arusha Declaration. A Code of Conduct was issued in 1996 and each officer was required to sign a statement that he/she had read and understood it and would abide by it. It was re-launched under the MRA in 2001.

Malawi would not be the only Customs organization with corruption problems. Customs anywhere must deal with the combination of power, opportunity and incentive. Few administrations could say that they are completely free of the problem. If quick fixes were available, this would not be the case. Much has been written on the subject and if there was a consensus, it would be that simple solutions

do not have an impact. A multi-faceted approach is needed, comprising reforms across the full range of administration, from legislation and procedures, to personnel policies and incentives/sanctions.

4.1.7 Reward System

Reward systems are common in many developing countries. Typically, they are based on financial rewards to individuals who are responsible for uncovering underpayments of duties and taxes and, in size, are often linked to the amount of revenue involved. They are usually designed to meet two objectives, to compensate officials for relatively low pay, and to encourage officials to find and report infractions. In this way, they may offer a legitimate alternative to indulging in corruption.

A serious disadvantage with systems that reward individuals is that the tendency is for them to act individually to maximize personal reward. This causes them to resist sharing information and to find ways to intervene in the process to increase their opportunities to receive rewards. During interviews with the private sector, complaints were made about over-zealousness of some officials who appeared to be trying to create offenses from innocent situations.

Customs had a reward system before the beginning of the MRA, but none has been operational since that time. The old system is presently under review with the intention of introducing a new system. The issues raised above should be carefully considered during this process.

4.1.8 Stakeholder Perceptions

Customs policies and procedures have an impact on other agencies, the private sector and the public at large, so it is important to recognize the needs and views of those affected by Customs. Interviews were conducted during the IF mission but many were made confidentially to avoid the possibility of any future adverse treatment or retribution. This alone tells part of the story. While there appears to be a significant involvement by the private sector in Customs business through membership of MRA Board, those interviewed from both the public and private, are somewhat critical of the state of Customs/stakeholder relationships.

Generally, there is a perception within the private sector that despite Customs becoming a more progressive organization since the inception of the MRA, there are many lasting inefficiencies that need to be addressed. Many industrialists would welcome a more open partnership with Customs to meet mutual interests and ultimately to contribute to the economic development of Malawi.

Government stakeholders interviewed pointed to a lack of coordination and understanding between MCI, Ministry of Finance and MRA (Customs). Border posts, particularly Mwanza, by far the largest, are seen as weak and are not enforcing policies and legislation. Customs officials are seen as reasonably

competent, but often expressed is the need for additional training and financial resources to be properly effective. Training is conducted through the Institute of Tax Administration. All officials are given a 2 - 3 week induction course followed by specialist courses depending on the assigned work area. Advanced specialized courses are provided for more senior officials but there is a need for more such efforts.

Customs decision-making is seen as heavily influenced by political factors. Examples given ranged from nepotism in staff appointments to decisions about valuation of goods and concessions granted. Decisions are seen to be pushed upwards. This occurs because of a fear among officials that in making decisions, they are exposed to criticism from above for not making “correct” decisions, or being accused of corruption if they make decisions that (legitimately) favor declarants. There is also a tendency in management to locate much of the operational decision-making at the top. It might be because there is a perhaps justified lack of confidence in the judgment of more junior officials. There are also allegations, inside and outside MRA, that top-level interventions in decision-making involve political interference and corruption.³⁵

Both private and public sector stakeholders are keen to participate in regular dialogue with Customs, not only to receive information, but also to raise matters of concern and to pro-actively contribute to policy development and strategic initiatives of Customs. This would also assist in improving communication generally and helping to overcome any misperceptions that are held. While there is currently a regular forum for stakeholders to meet with the Commissioner, these meetings tend to be informational with very little opportunity given for, or interest in, hearing or acting on private sector viewpoints. Many of the larger players choose not to attend for this reason. Consideration could be given to widening the role of the Board to meet with stakeholder groups regularly. A further functional role could be to act as the first point of contact for complaints related to corruption and officer behavior.

4.1.9 The Need for Further Reform and External Assistance

Customs has benefited from many diverse external assistance inputs. However, there does not appear to have been any formal evaluation of the impact of this assistance on the organization. For example, a DFID funded diagnostic study conducted in 1996 generated a detailed strategic plan, but six years later, there is no evidence of any assessment having been carried out.

³⁵ One industry source estimated that the cost overheads of delays and inconveniences caused by Customs amount to 20 percent of total costs. Another estimated the cost at half a million dollars. While these appear to be arbitrary and perhaps therefore not in any way accurate, they are perhaps indicative of the dimension of the problem as perceived by those close to the Customs system.

Currently, DFID funds a number of long-term expatriate technical support staff that provide guidance in development and implementation of ASYCUDA, investigation and training. At the time of writing, DFID was planning to withdraw the long-term position in favor of short-term ad hoc assistance. SGS, under its current contract, delivers some technical training under a sub-contract arrangement with Crown Agents. Other assistance is provided from time to time by the WTO (valuation) and the WCO, but details were not available.

Currently there appears to be a widespread lack of confidence in the integrity of Customs among those who must deal with the organization and little trust in the mechanisms that exist to make representations. Overall, efficiency is frustrated by outmoded procedures and management practices, lack of incentive and a relatively weak position in the Government's administrative framework. In short, Customs does not yet have the capacity to effectively carry out its mandate. Further, it is criticized for lacking strategy and relying heavily on the personality of the Commissioner General. The external perception of Customs is that it is slow, inefficient, corrupt, poorly managed and lacking technical expertise.

Nevertheless, there are senior staff, recruited since the inception of the MRA, who appear to be both capable and motivated to drive positive change in Customs. There are the beginnings of a new outlook; the MRA, as a modern, externally focused and business-like entity. In order to improve the situation further, Malawi Customs must look to model itself on the best practices found in modern Customs administrations in other parts of the world, including adhering to widely accepted international standards and conventions, so as to ultimately provide a responsive and timely service to clients. This will be facilitated by having well-trained and well-respected officials, up to date systems and technology, flexibility to anticipate and react to changes in the environment, and transparent decision-making processes with accessible rights of appeal.

4.2 TRANSPORT

Being an open economy, the transport sector in Malawi plays an important role in the national economy. The efficiency of the transport sector is a key factor in determining the cost of imports, the competitiveness and profitability of exports, and the domestic price of staple foods for consumers. Being landlocked, Malawi also relies on its neighbors to maintain land based transport links with the outside world. The nearest port is Nacala in Mozambique located approximately 610km away from the country's eastern boundary. The vast majority of Malawi's exports and imports are transported by rail to and from Nacala or by road to and from Beira in Mozambique, Dar-es-Salaam in Tanzania or Durban in South Africa. Transport costs to and from Malawi are high and while the rail and road links serving Malawi are adequate, there is substantial room for improvement to reduce these high costs.

While a complete quantitative analysis of the transport cost factor in Malawi's trade

and market development is not available, some selected figures illustrate the scope of the problem as well as the opportunity to achieve overall welfare gains by adopting measures which can bring down transport costs. The high cost and non-affordability of fertilizer has contributed to its reduced use by Malawian farmers, with subsequent adverse effects on yields and soil fertility. Transport costs are by far the single largest factor in the (relatively) high costs paid by Malawian farmers. In 2002, transport costs accounted for 46% of the landed CIF landed cost for urea into Lilongwe and approximately one-third of the retail price paid by farmers. Transport costs are also a huge factor in the costs for other bulk commodities. Nearly one-third of the pump price for fuel in Malawi can be attributed to transport costs. While Malawi is an efficient producer of sugar, domestic transport costs account for 15% or more of local consumer prices. For exports, regional and international transport costs add nearly 50% to the ex-mill production costs for Malawian sugar.

Transport costs comprise a much lower proportion of the cost structure for Malawi's higher unit value exports, such as tobacco, tea, and garments, yet these relatively high costs are a contributing factor in the low and declining profitability and viability of some producers. In the case of tobacco, transport bottlenecks and rising farm to auction transport and handling costs have been a major problem facing large numbers of smallholder growers. Logistical bottlenecks along the Nacala and Beira rail routes have resulted in nearly 60% of Malawi's tobacco exports being sent overland to the more distant port of Durban. The estimated potential savings from more fully utilizing the closer ports, when combined with possible savings from more competitive and efficient farm-to-market transport services, could increase the net (cash) income by smallholder tobacco growers by some 35 –50% .

The Malawi Poverty Reduction Strategy accords great importance to the transport sector, although not specifically in the context of trade. Particular attention is given to the deficiencies and opportunities in rural infrastructure and transport services. The vast majority of the population is rural yet this sector of the population is the least accessible and the least mobile. There have been several attempts by various government departments and aid agencies to initiate motorized transport in the rural areas. Future initiatives will have to confront the poor condition of the rural road network that results in high operating costs, low residential densities that result in long travel distances with low patronage, and a low disposable income.³⁶

³⁶ There have also been attempts to improve accessibility and mobility of the rural community by constructing footpaths, cycle ways and narrow river crossings, and by using alternative non-motorized transport. Most of these initiatives have also proved to be unsuccessful. Where they have succeeded, funds have not been available for any expansion.

TABLE 4.1: COMPARATIVE LOGISTICS COSTS FOR MALAWI'S TOBACCO EXPORTS

ALL COSTS RELATED TO A 40' CONTAINER MOVING FROM LILONGWE TO HAMBURG

From Lilongwe:	Via Beira	Via Nacala	Via Durban
Transport:	Road	Rail	Road & Rail
Approx. charge by agent in US \$:	\$1650	\$1685	\$2500
Breakdown:	Lilongwe to Mozambique Border +/- \$400 Mozambique Border to Beira +/- \$800 Port Charges, Commission etc. +/- \$450 Local clearing charges \$15	Lilongwe to Nacala rails \$1400 Lift/cross haul +/- \$150 Local clearing charges \$15	Lilongwe to Johannesburg by road +/- \$1400 Cross haul & rail to Durban +/- \$900 Commissions +/- \$200
Other Charges:	Mozambique Container handling fee \$100	Mozambique Container handling fee \$100	
Transit Time:	2 Days	3 Days	5 Days
Borders to cross:	Malawi/Mozambique	Malawi/Mozambique	Malawi/Mozambique Mozambique/Zimbabwe Zimbabwe/South Africa
Variables:	Availability of containers for line requested (limited choice)		
	Availability of Trucks	Availability of Rail Wagons	Availability of Trucks
	Container terminal breakdowns/congestion		
	Rain damage to roads	De-railments Wash-aways	Date stack opens in Durban
	Weather delays in ports particularly Durban		
	Road blocks		Port congestion Port strikes
	Via Beira	Via Nacala	Via Durban
Ocean freight to Hamburg :	+/- \$2100*	+/- \$2100*	+/- \$1700
Other Charges BAF-8.38%	\$176	\$176	\$143
Terminal handling charges Hamburg:	+/- \$180	+/- \$180	+/- \$180
TOTAL COSTS:	\$4206	\$4241	\$4523

*Would decline if there were more regular and larger freight traffic as trans-shipments would not be necessary

4.2.1 Road Transport

The current direction of policies in the road transport sector seek to promote competition and to enable operators to set their own freight and passenger rates in accordance with market conditions. While new entry into the domestic market is

relatively free, foreign registered vehicles are not permitted to carry goods from origination to destination points within Malawi or to conduct business along the secondary routes of the country. Foreign operators importing goods into Malawi are only allowed to deliver goods in specified warehouses along the Blantyre-Lilongwe-Mzuzu route. Hence, certain types of trade-related road haulage services (i.e. farm to market/processor transport of tobacco and other commodities; domestic sugar distribution; domestic fertilizer distribution) are reserved for Malawian registered vehicles.

While this policy helps to ensure business opportunities for Malawian transport companies, it, when combined with other policies, contributes to domestic road haulage costs which are well above regional norms. Domestic transport rates in Malawi are equivalent to about US\$0.065 to US\$0.075 per ton/km. Comparable rates in South Africa and Zimbabwe are much lower at about US\$0.02 on trunk roads and US\$0.035 on rural roads on secondary routes. With freight rates being set or 'recommended' by the Road Transport Operators Association, the full benefits from a more liberalized market have failed to reach Malawian producers and consumers.

In addition to the restrictions on competition (from international haulers), there are other reasons why domestic transport costs in Malawi are especially high. One is transport-related taxes, with imported trucks, tires, and other spare parts facing import duties as well as a 20% surtax. Transport services themselves are subjected to a surtax of 20%.³⁷ A second factor is the quality of Malawi's roads. While the core road network is adequate, the condition of rural roads is considered below average within Southern Africa. The high cost of locally borrowed capital is another contributing factor. Diesel fuel costs in Malawi are substantially higher than in South Africa (in part due to transportation costs), yet in line with those of other regional countries.

The relatively high operating costs of Malawian haulers (and their greater difficulty in organizing back-loads) makes it difficult for them to compete regionally and thus re-enforces their motivation to protect major aspects of the domestic market.³⁸ International transport operators have an edge logistically over their Malawian counterparts because the rates are dictated by inbound cargo, which is the basis on which rates are calculated. Malawi is a net importer of bulky products. Thus, the international operator is already assured of covering its margins and loads negotiated from Malawi are a bonus. The scenario is quite different for the local operator. Their outbound trip generally carries cargo of a lesser value, which reduces their profitability. Malawian haulers are not well placed to market themselves in

³⁷ Imported trucks not having the SGS inspection have been required to pay the Pre Shipment Inspection (PSI) tax.

³⁸ The main cross-border business run by Malawian haulers is that of fuel cartage. Competitive price has generally not been the main factor in awarding the contracts for this business. The only time foreign firms carry fuel into Malawi is when there is a shortage of haulage capacity within the country.

South Africa to obtain return loads. Malawian operators without depots in Zimbabwe or South Africa also face problems managing breakdowns, difficulties at border posts, etc.. RTOA estimates that about 65% of Malawi's international trade by road is carried by international operators.³⁹

4.2.2 Rail Transport

Malawi's rail network is not very extensive with only the southern half of the country effectively served by two rail lines. Malawi has a total of 797km of single-track public railway line within the country's borders, of which 717km is operational. The rail network extends in a North – South direction from near the Mozambique border in the south through Blantyre up to Salima in the north from where it changes direction to the west and continues through Lilongwe to Mchinji and the Zambian border. The Nacala Corridor line extends from the Indian Ocean port of Nacala (Mozambique) in the east through the Malawi border town of Nayuchi and links up with the North - South line at Nkaya. There is also a privately owned 25km long spur off the North – South line from Namatunu to Chingale. The operational rail line in Malawi is generally in good condition although substantial portions of the track are programmed to be re-ballasted and the track will be resurfaced where required.

Rail was the main mode of transport for Malawi's foreign trade before the lines to Beira and Nacala were severely damaged in 1984-85. Road transport took over Malawi's foreign trade from 1984-85 onwards, and rail has struggled to regain traffic. Nacala, the cheapest route for Malawi's trade, continues to be beset with structural problems. Since the recent privatization of the (Malawi part of the) Nacala corridor and the formation of the Central East African Railways (CEAR), service on the line has improved. However, the operations on the Mozambican part of the railway/port continue to be in the public sector⁴⁰ and continue to suffer from security problems including losses of cargo during transit, unpredictability and inefficiency of the port authority, excessive bureaucracy in processing customs documents in Nacala, lack of flexibility in scheduling shipments, and occasional derailments during bad weather. In addition, a 77km section of track between Cuamba and Entrelagos damaged in floods in 2001 has not yet been repaired. Finally, Nacala port remains off the standard international shipping routes. Unless the shipment is large enough to justify the cost of making an extraordinary port of call at Nacala, the goods must often disembark at Durban or Maputo from large, internationally competitively priced ships and transship to expensive coastal vessels. Thus, most of the problems confronting rail transport are external.

³⁹ Because of the long distances involved, road transport to or from regional ports and market centers is high. For example, the road costs to Lilongwe from Beira, Johannesburg, and Durban are \$61/ton, \$96/ton, and \$110/ton, respectively

⁴⁰ The concession agreement has been signed in September 2000 but the takeover has yet to take place.

Few goods that face tight delivery schedules are routed through Nacala. In recent months, the Nacala route has lost its traditional 20 percent volume of fuel imports into Malawi due to poor safety standards at the port. Despite the substantially higher overland costs incurred, the bulk of Malawi's tobacco exports are transported by road to South Africa because of the unreliability of the rail service through Nacala and the non-availability of rail container during parts of the year. Malawi's sugar exports are mostly conducted via rail through Mozambican ports, yet during the rainy season (November to April) there are frequent delays, plus there are constant problems with the utilization and availability of freight wagons. On several occasions, Malawi's sugar exporter has needed to move cargo by breakbulk (road) to Beira and then load containers at the port, raising its overland transport costs by some 50%.

4.2.3 Civil Aviation

Civil aviation in Malawi is a comparatively small industry; however, air transport is both strategically important, as Malawi is a landlocked country, and economically sensitive due to trade globalization and the adoption of an open skies policies in COMESA. During the past 10 to 20 years, the Malawi government has invested heavily in civil aviation infrastructure, equipment and aircraft in order to be able to provide international standard air travel over Malawi skies.

Malawi has four international airports; two major airports at Lilongwe and Chileka (Blantyre) and two minor airports at Mzuzu and Karongo. In addition to these international airports there are a further 19 registered airfields in Malawi of which 4 are privately owned. There are also at least 10 known unregistered airfields throughout Malawi.

A total of six national airlines operate 37 scheduled international flights per week from Lilongwe and Chileka international airports: Air Malawi, Air Zimbabwe, South African Airways, Ethiopian Airlines, Kenya Airways and British Airways. These airlines serve 6 regional destinations outside Malawi and one inter-continental destination. Air Malawi also operates 60 scheduled domestic flights per week between Lilongwe, Blantyre, Mzuzu, Karongo and Makokola.

Malawi needs to ensure that international standards in aviation are maintained in order to be able to protect existing investment in aviation infrastructure, provide a safe air travel environment and encourage private sector involvement in civil aviation. As such, the Malawi Government has a National Transport Policy for Civil Aviation that has specific objectives and strategies with regard to aviation infrastructure, safe, efficient and cost effective air travel and compliance with international standards and policies. Action Plans have been developed to satisfy the requirements of the National Transport Policy.

Air transport is the main mode for international business and government travel. The two international airports have adequate capacity to handle demand, which in fact has been declining. Passenger and airfreight flight schedules and services have

been cut as a consequence, and more use is now made of regional hub airports for international flight links. Low levels of demand and high costs ensure that air transport is not a major domestic mode, but it could become more important if smaller airfields around the lake, national parks and game reserves were upgraded in order to develop the tourist industry.

Malawi is considered to be one of the highest cost countries in the world to fly into. All private and cargo flights are considered by the aviation authorities to be commercial flights. A variety of fees—landing fees, temporary service permits, fees to charge batteries and pump tires—as well as the costs of aviation fuel are generally higher in Malawi than elsewhere. The average charges for a small aircraft to travel in and out of Malawi is estimated to be \$370. In comparison, Mozambican charges have recently been lowered to an average of \$85 for a similar aircraft.

The decline of international commercial flights into and out of Malawi, together with restrictions on landing rights (minimum 48 hours prior notice), the high landing and service fees, and a requirement to pay Air Malawi a royalty of 4% on all air cargo, has contributed to the relatively poor availability and very high cost of airfreight services out of Malawi. Malawi's struggling cut flower exporters have had to pay upwards of \$2.20/kg. for airfreight to Western Europe, compared with rates of between \$1.60 and \$1.85/kg. for their Kenyan, Zimbabwean, and Zambian competitors.

4.2.4 Improving the Transport Situation in Malawi

The actions taken by the Government have created the preconditions for a competitive transport industry. The next phase of reforms is more difficult requiring actions, which are in the international arena, and actions, which will hurt the influential domestic trucking industry. These include the following:

- The Government of Malawi needs to work closely with the Government of Mozambique to increase the efficiency of the (Mozambican part of the) Nacala railway and the efficiency of the port to provide Malawi with the cheapest route to the ocean. The 77 km of the damaged track between Cuamba and Entrelagos needs to be urgently repaired.
- The Government must be proactive in creating competition on the trucking routes, both internally and externally. Given the influential trucking lobby it would be crucial to lift restrictions excluding foreign operators from the market. There should also be a re-assessment of the current tax structure on road transport equipment and services.
- A number of specific actions could be taken to improve the rural road network. These include:
 - Raising more resources for road maintenance by raising the fuel levy, other road user charges (e.g. vehicle licenses, transit tolls, parking charges), and

allocating some of HIPC resources especially for the rehabilitation and construction of rural feeder roads. (While such a policy would also raise transport costs, the benefits of improved infrastructure might easily outweigh the costs.)

- NRA could improve the prioritization of rural feeder roads by transferring the responsibility for the planning and management of rural roads to the District Assemblies. These District Assemblies could work with MASAF and the communities to jointly prioritize rural roads.
- In order to provide an appropriate legal framework for private sector participation in road concessioning, the Government should amend the Road Act, as a part of which, a concession agreed during a term of office would not be revoked with a change in regime.

CHAPTER 5

SELECTED SECTORAL ISSUES

Malawi's exports are currently dominated by a narrow range of agricultural products. The performance of these sectors will in large part determine overall developments in exports and the impact of exports on growth and poverty in Malawi. This chapter briefly reviews the prospects for and problems facing the tobacco, tea, sugar and cotton sectors. At the same time, export diversification will be an important element in reducing vulnerability to external shocks and in exploiting available resources. The main conclusions are:

- In recent years, stagnant or declining yields together with declining commodity prices have reduced profitability and incomes in agriculture. Investment in sectors such as tea and sugar has been constrained.
- Substantial changes have occurred in the tobacco sector with a large shift towards smallholder cultivation. Improvements to the auction and marketing system for tobacco, which reduce costs, would have particular benefits for such small producers.
- In 2001, tobacco, sugar, and tea collectively accounted for more than 90 percent of Malawi's agricultural exports. Within each of these industries, only a few firms account for the bulk of exports. Five multinational companies account for more than 85 percent of Malawi's total agricultural exports. Malawi's agricultural exports have undergone little diversification during the 1990s.
- There are prospects for export expansion in the major sectors of tobacco, tea, sugar and cotton. The extent to which these are exploited will be fundamental to future growth in Malawi. Nevertheless, there are also prospects for some diversification into other sectors such as groundnuts and paprika; and also textiles and clothing; and tourism.
- In all agricultural sectors, there is a need to raise yields and quality, and increase the spread of knowledge concerning cultivation. This would be assisted by a strengthening agribusiness-smallholder linkages as well as producer associations.
- In the textiles sector there is a need to privatize the main producer to realize the available potential for production and trade. For clothing, the key issue is the stability of current market access conditions in the major industrial markets. Exploitation of tourism faces the constraints of poor transport and communications infrastructure, limited and unreliable power supplies, high levies and taxes and concerns over security and health. A detailed economic analysis of the potential of the Malawi tourist industry is required.

5.1 AGRICULTURE, AGRO-INDUSTRY AND TRADE: ISSUES AND OPPORTUNITIES

Some 85 percent of Malawi's people work in agriculture. Primary agricultural production accounts for an estimated 33 percent of GDP, while agro-industry and other agro-related services (including food distribution) accounts for perhaps another 24 percent of GDP.⁴¹ Agricultural products account for more than 85 percent of Malawi's merchandise trade. For the foreseeable future, Malawi's economy and external trade is expected to remain heavily dependent upon its agricultural performance.⁴² This section provides a brief overview of the general structure and recent performance of Malawi agriculture and then reviews the particular experiences and opportunities for broad-based growth in selected sub-sectors — those which have either dominated Malawi's exports over an extended period or are considered to have the potential for near-term export-oriented growth.

The analysis here does not directly address issues associated with national and household food security. Malawi faces large and long-standing challenges in relation to food security yet these are well beyond the scope of the Integrated Framework. There are certainly some trade-related dimensions to food security—especially the cross-border and wider regional trade in maize. However, there are many other dimensions, including the restoration of soil fertility, the implementation of safety net programs, the maintenance of a national food and financial reserve, other government interventions in the maize market, etc. These and other dimensions of food security are addressed in the recent Country Economic Memorandum and in other policy papers.

Given the very limited purchasing power within Malawi, most of the potential for income and value-added growth in agriculture lies in export markets, to some extent within the Southern African region but more prominently outside of the region. It is recognized, however, that the sustainability of current agricultural exports, let alone their prospects for future growth is impaired by on-going problems in achieving food security in the country. To a significant extent, the two are intertwined. Income from production and employment related to export crops can, and has recently been, an important basis for food security among a large number of rural households. However, disruptions in food production and/or wide variability in the domestic prices for staple foods greatly inhibit the capacity of smallholder farmers to devote their limited land and other resources to commercial, export-oriented activities.

⁴¹ Approximately half of manufacturing value-added is accounted for by agro-processing or wood processing. All manufacturing accounts for 13 percent of GDP. The distribution sector accounts for 22 percent. We estimate that 80 percent of this is related to food and other agricultural product distribution.

⁴² Keep in mind that 30 percent of Malawi's GDP is public expenditures on schools, health care, etc. Putting such expenditures aside, agriculture and agribusiness account for 81 percent of the balance of the economy.

5.2 GENERAL OVERVIEW

Historically, there has been a strong link between agriculture and trade. During the colonial period and in the first quarter century following Malawi's independence in 1964, the focus and source of economic growth was on commercial medium/large-scale agriculture, centered on the production of tobacco, tea, and other crops for export. So-called 'estates' were provided with preferential access to land, finance, and labor. The bulk of the country's population was active as smallholder farm households, their primary functions being to feed the nation and to provide a ready and inexpensive pool of labor for the estates. Smallholder cash crop opportunities were officially constrained or the returns to these activities substantially reduced by inequitable pricing arrangements. This dualistic economic structure resulted in growth (at least through the 1970s), but also a highly skewed distribution of income and opportunities for advancement.

Dualism remains a prominent feature of Malawi's rural economy and export-oriented supply chains, although there are now some intermediate forms of agriculture. The bulk of agricultural value-added and land under cultivation is done by some two million smallholder farm households whose average landholding is only one hectare. These farmers cultivate maize and other food crops and approximately one-third of smallholders also grow industrial or other (primarily) cash crops. At the other end of the spectrum lie a few hundred large estates, owned or leased by corporations or individuals. These typically have several hundred hectares or more under cash crops and, in some cases, large animal herds. In between these two segments in the Malawi agrarian structure lie some 25,000 medium-scale farms (although referred to as 'estates' because of their leasehold land tenure status), the bulk of which being of a size between 10 and 20 hectares and combining commercial crop and livestock production and (extended) household food production.

Malawi has one of the highest population densities in sub-Saharan Africa and the amount of arable land per rural inhabitant is lower than in most other countries in the region. In contrast to other densely populated developing countries, high population density in Malawi has not led to agricultural intensification, but rather to continued depletion of soil nutrients as well as deforestation. Malawi's dualistic agricultural structure and constraints on the development of a land market have resulted in a situation where there is both substantial over-utilization of arable land (i.e. among many smallholders) and substantial under-utilization of arable land (i.e. among some segments of the 'estate' sector). Malawi agriculture largely depends upon a four-month rainy season, with only 57,000 hectares (i.e. 2 percent of the cultivated area) being under formal irrigation. As discussed in the previous chapter one of the difficulties facing the country and the agricultural sector relates to the lack of an adequate transportation infrastructure. For the majority of the country's rural population the only means of transport is walking, head loading, bicycles and animal-drawn carts. Motorized private and public transport in the rural areas is virtually non-existent mainly due to the poor condition of the rural road network,

particularly during the wet season. This hinders the movement of the cash crop economy and the informal trade sectors of Malawi.

Malawi's primary food crop is maize, with this crop covering upwards of 60 percent of the total cultivated area of the country. Other major food crops are sweet potatoes, cassava, beans, and groundnuts. Tobacco (Burley and Virginia Flue-Cured varieties) is the country's leading cash crop and export earner, followed by sugarcane, tea, cotton, coffee, and several crops used for spices or colorants (i.e. birds-eye chilies, paprika). Table 5.1 below provides a rough indication of the relative shares of different categories of farmers in the production of the major exported (or exportable) cash crops.

Smallholder farmers are now the dominant producers of burley tobacco, cotton, and paprika, while large estate companies account for most of the country's production of flue-cured tobacco, sugarcane, tea, and coffee. Taking into account the relative proportions of different product exports, we estimate that smallholder farmers and large commercial estates each contribute to 45 percent of the country's agricultural exports, with medium-scale farms (i.e. 'small estates') accounting for the remaining 10 percent. This represents a major shift from Malawi's long-standing historical pattern of commercial farm dominance of export-oriented agriculture.

TABLE 5.1 PRODUCTION STRUCTURE FOR SELECTED AGRICULTURAL EXPORT CROPS

				Share of Production (%)*		
	2001 Production (000 Tons)	Total Number of Growers**	Total # of Persons Reliant Upon Income (Millions)***	Smallholder Farmers	Medium- Scale Farms	Large Commercial Farms
Burley Tobacco	125.0	325,000	1.75	70	16	14
Flue-Cured Tobacco	8.3	850	0.01	15	0	85
Sugarcane	1845.0	550	0.06	0	10	90
Tea	41.9	7,000	0.25	7	0	93
Cotton	37.0	80,000	0.40	94	5	1
Coffee	3.5	4,000	0.02	10	0	90
Paprika	1.6	60,000	0.30	85	10	5

#Other estimates or based on data provided by industry sources.

**Including smallholders and estates.

***Includes growers and employees in production and processing operations. Assumes that average household is five persons.

Source: Industry interviews and staff estimates.

Agricultural and rural developments are central to Malawi's broader development strategy as represented in the Poverty Reduction Strategy Paper (2002) and previous

strategy documents. In the wake of policy reforms in the early to mid-1990s, the core objectives in Malawi agriculture were to foster broad-based growth, facilitate a diversification of production and trade, and improve food security, both at a household and national level. Results have been mixed with regard to the first two objectives. And, thus far, Malawi has been unable to achieve sustained improvements in food security, either at the national level or among large numbers of rural households.⁴³

There is considerable uncertainty regarding the performance of Malawi agriculture in recent years. Seemingly unreliable estimates for production of secondary food crops (especially root crops) have substantially skewed official statistics resulting in a huge over-estimate of agricultural GDP growth. Official statistics suggest an average annual growth rate of 6.5 percent in agricultural value-added over the 1998 to 2001 period and a similar rate of growth over a more extended period dating back to 1995. Other measurements of agricultural performance—including trends in agricultural exports, food and cash crop profitability, productivity and results from nutritional studies—suggest a different pattern. Specifically, while Malawi agriculture most likely did experience relatively rapid and broad-based growth during the mid-1990s—following earlier sectoral reforms—this growth decelerated sharply after 1997 and it is entirely possible that the sector has actually experienced some decline in value-added in recent years as a result of declining commodity prices and shifts from higher to lower value crop production.^{44 45}

On a variety of fronts the performance of the sector has been mixed and generally below expectations and the requirements for contributing to rural poverty reduction. For example, the available evidence suggests that average national yields for the lead food crop (maize) have been stagnant while those for the leading cash crop (tobacco) have declined over the past five to seven years. There are no noticeable improvements in yields during this period for any of the other major cash crops.⁴⁶ Declining soil fertility, reduced use of fertilizer and improved seeds, and the adverse effects of HIV/AIDS on labor availability and health have been contributing factors.

Stagnant or declining yields, together with declining commodity prices have contributed to the reduced profitability of many crop enterprises in Malawi. An indication of this for smallholder farmers is provided in Figure 5.1. Estate agriculture has also experienced sharply reduced profitability, especially for tobacco, tea, and

⁴³ See the Country Economic Memorandum.

⁴⁴ Official statistics suggest that there has occurred a large expansion in the area under cultivation over the past five years. This seems implausible given the land pressures in smallholder communal areas and the limited conversion of estate land back into communal tenure.

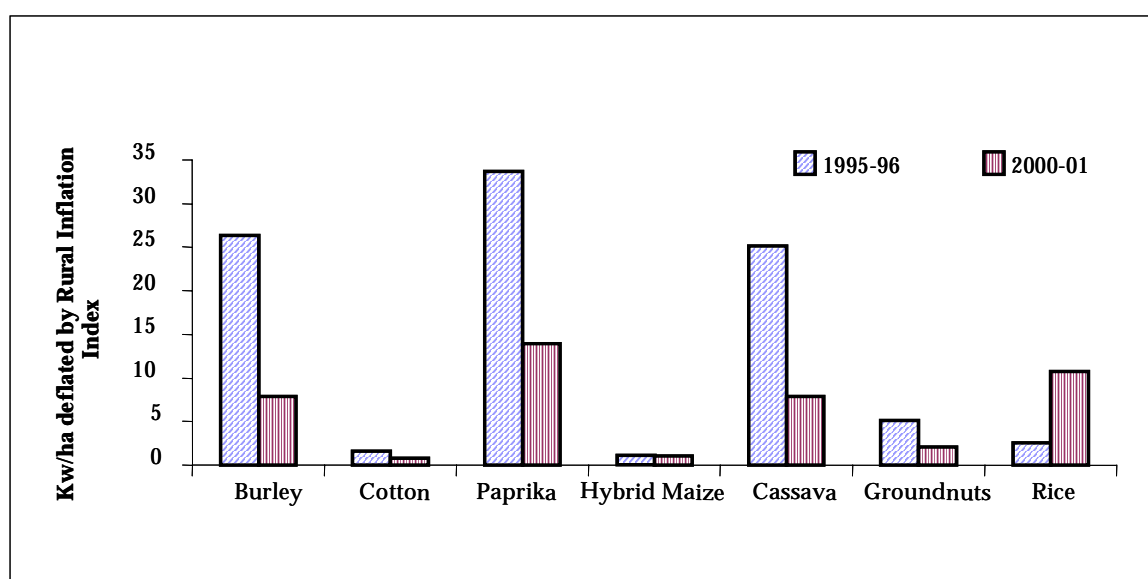
⁴⁵ National accounts estimates do not fully reflect changing commodity prices. Thus, the sharp downward movement in international tobacco, coffee, tea, and cotton prices since 1997 has not been fully factored in, suggesting a further upward bias of official statistics on agricultural value-added (growth) in recent years.

⁴⁶ Some gains have apparently been made in yields for selected root crops due to the increased availability and distribution of improved planting materials.

coffee, leading to widespread exit from the former (see below) and curtailment of investment in the latter two. Some estates have successfully diversified into other activities (i.e. macadamia nuts; poultry production; seed multiplication), but most have not due to financial and/or managerial constraints. As a result, there has been an overall reduction in employment within the estate sub-sector, with the sharpest reductions being on tobacco-centered estates.

There has occurred some diversification and increased commercialization of smallholder agriculture in the period since 1995. Part of this has occurred in the patterns of food crop cultivation with a partial shift from maize to cassava, sweet potatoes and potatoes. There has occurred some diversification in the diets of rural (and other) households, yet the country does still remain heavily dependent upon its variable maize crop. With regard to cash crops, there occurred a massive movement of smallholder farmers into burley tobacco production in the mid-to-late 1990s, following the relaxation of controls in this market. This development resulted in perhaps the most significant and broadly dispersed flow of cash income into rural Malawi in its entire history. That income flow, however, has not been sustained in recent years as will be discussed below. For other traditional cash crops grown by smallholders—including tea, cotton, and groundnuts—there has been little dynamism in recent years and, for many farmers, reductions in income. Although still on a modest scale, there has been some recent success in reviving or developing smallholder production of spices and paprika.

FIGURE 5.1 SMALLHOLDER AVERAGE GROSS MARGINS



Source: Estimates based on Keyser (1996) and NASFAM (2001)

In 2001, tobacco, sugar, and tea collectively accounted for more than 90 percent of Malawi's agricultural exports. Within each of these industries only a few firms account for the bulk of exports. In the case of tobacco, three international companies purchase more than 90 percent of the crop at local auctions and have a similar share of the country's exports. In the case of sugar, one joint-venture company (with a

majority ownership share for an international company) accounts for all of the exports. Five firms account for the bulk of Malawi's tea exports with one firm alone accounting for upwards of 70 percent of the purchases of tea at the Limbe auction.

Hence, more than 85 percent of Malawi's total agricultural exports are accounted for by five multinational companies. An additional proportion is accounted for by other multinational or foreign-owned companies, with the balance being undertaken by a variety of small-to-medium scale Malawi-owned enterprises. At least for the currently dominant export subsectors—tobacco, sugar, and tea—this pattern is not expected to change very much in the near future and has implications for the approach and focus of possible capacity-building or technical assistance support. Malawi's agricultural exports have undergone little diversification during the 1990s. Tobacco exports have become predominantly centered on burley tobacco because of a continuous and large decline in exports of other types of tobacco. There are a variety of other agricultural products exported—including paprika, chilies, cut flowers, etc.—yet their aggregate value was less than \$5 million in 2001.

The sections which follow highlight recent developments, major constraints, growth opportunities and possible support requirements in an array of subsectors. In the consultations associated with the preparation of this paper, there was a widespread perception among Malawi officials and agricultural/agribusiness representatives that the country should focus on its 'core business'—essentially raising productivity and quality and reducing costs in its leading export sectors, while reviving selected supply chains for which Malawi has had some past success, plus obvious near-term opportunities. The sentiment was decidedly against seeking trade and development solutions by diverting attention to more exotic products and niche markets for which the country has little comparative advantage and for which there is limited scope for broad participation. This guidance is reflected in the sub-sectoral foci below.

5.3 ISSUES AND OPPORTUNITIES IN THE TOBACCO SUB-SECTOR⁴⁷

Trends in Level and Structure of Tobacco Production. Tobacco accounts for about 60 percent of Malawi's merchandise exports, 23 percent of its total tax base, and about 13 percent of its GDP. As seen in Table 5.2 below, tobacco production grew rapidly in the early 1990s but has since leveled off with large year-to-year fluctuations. The leveling off of production has been accompanied by major structural changes in the tobacco industry during the 1990s, with a sharp decline in production by medium and large-scale farms (i.e. 'estates') and a concomitant increase in the production by smallholder farmers. In 2001, smallholders accounted for an estimated 70 percent of national burley tobacco production, approximately double their share in 1996. Tobacco is cultivated by nearly one in five smallholder households-- amounting to

⁴⁷ See Volume II for a fuller analysis of Malawi's tobacco sub-sector and its wider international market context.

perhaps 350,000 households. Another trend has been the growing dominance of burley tobacco within the country's overall tobacco production, essentially due to the large and steady decline in production in Virginia Flue-cured tobacco (by estates) and a range of sun-dried tobacco varieties (by smallholders).

TABLE 5.2 MALAWI TOBACCO PRODUCTION TRENDS (000s TONS)

Year	Burley	Flue-Cured	Western Types	Total
1990-93 Ave.	85.3	27.3	11.9	124.5
1994	71.3	20.7	5.5	97.5
1995	101.4	19.9	8.8	130.1
1996	117.9	15.4	8.3	141.6
1997	133.9	14.9	9.3	158.1
1998	113.8	13.9	6.7	134.4
1999	111.4	14.3	8.8	134.5
2000	142.2	10.7	6.8	159.7
2001	115.3*	8.3	1.0	124.6*

* Does not include crop diverted across the borders and then re-imported, estimated at 5,000 to 10,000 tons.

Source: Tobacco Control Commission

The contraction of estate tobacco production stems from long-standing financial, managerial, and labor-related problems, all of which were exacerbated by the liberalization of the sector and by a post-1997 sharp decline in tobacco prices. In recent years, the tenancy system which had been the backbone of 'estate' burley production has more or less broken down because smallholders have had the option to grow the crop on their own land, and also because of opportunistic behavior by estate managers and the remaining tenants in diverting the harvested crop to traders (rather than to the tobacco auctions in the name of the estate owners). Shortages of wood for curing have been another factor undercutting the viability of estate flue-cured tobacco. Upwards of 40-50 percent of estates which had previously relied heavily on income from tobacco have substantially reduced or altogether ceased production over the past five years, although some remain active in the sector as intermediate buyers between other growers and the auctions.

In sharp contrast, during the mid-to-late 1990s several factors facilitated the entry of smallholder farmers into the sector. One of these was strong economic incentives. At least during this period, tobacco cultivation was more remunerative than most other crops grown by smallholders. Plus, the marketing system for this crop was comparatively far more developed. A second important factor was the broad spread of technical knowledge of (at least aspects of) tobacco cultivation. Hundreds of thousands of rural Malawians had prior experience with tobacco—as laborers or tenants on estates, growing specialty varieties of tobacco, or cultivating burley tobacco illegally prior to the early 90s reforms. Further facilitating the spread of smallholder burley production were three areas of institutional development:

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- *Producer organization*—the formation of ‘burley clubs’ both with the support of the Ministry of Agriculture and under the auspices of a USAID-supported Smallholder Agribusiness Development Project. Many of these clubs matured and undertook joint input purchases and crop transport. The SADP has given rise to the formation of a National Association of Smallholder Farmers of Malawi (NASFAM);
 - *Additional market intermediation*—in areas where ‘burley clubs’ were not well developed, a number of so-called ‘intermediate buyers’ emerged and were licensed. These buyers paid immediate cash for the cured crop, albeit at discounted prices. They also provided a logistical link for farmers who otherwise were not able to bring their tobacco to the auction floors in the major cities;
 - *Agricultural credit*—prior to the mid-1990s, credit from financial institutions was not generally availed to smallholders and the credit which was available—from a government agency—was essentially for inputs for maize production. The Malawi Rural Finance Company was established in 1994 as an autonomous (though government-owned) financial institution and was supported under a World Bank project. Although not originally anticipated, the company came to serve as the leading source of finance for smallholder tobacco growers in the late 1990s with those accessing credit generally outperforming other farmers in terms of crop yield and quality;

Prospects for Tobacco. Malawi is now a very minor producer of Virginia Flue-cured tobacco, yet it is a major player in the burley tobacco market, accounting for some 19 percent of world production and as much as 30 percent of world exports.⁴⁸ Malawi is the world’s leading exporter of burley tobacco leaf. Despite on-going efforts by the World Health Organization and others to reduce cigarette use because of its adverse health effects, world demand for Malawi’s tobacco should remain robust for the next decade and probably well beyond. Recent analysis by the FAO suggests that total demand for tobacco products will increase at an average of 2 percent per annum between 1998 and 2010, with the bulk of the growth occurring in developing countries and especially China.

According to industry sources, Malawi is still relatively well positioned in the world tobacco market. The country produces a relatively low-cost burley tobacco with excellent filler properties. It is amongst the cleanest tobaccos in the world due to the very limited local use of agro-chemicals. Malawi’s tobacco also has a relatively low nicotine content, this being a valuable attribute for a filler-type product. Even if Malawi were to only maintain its share in the world market for burley (30 percent), it should be possible for Malawi to export the equivalent of between 120,000 to 135,000 tons of green leaf tobacco – matching the peak levels achieved in the late 1990s. In addition, it should also be possible for Malawi to achieve a partial recovery in its

⁴⁸ China accounts for nearly 25 percent of the world production of burley but all of it is domestically consumed.

production of flue-cured tobacco to about 20,000 tons from the present levels (2002) of just over 10,000 tons⁴⁹. The current instabilities in Zimbabwe and the sharp decline in Virginia tobacco production represent an opportunity for Malawi to improve its own market share.

In the period from 1997 to 2000, there was a sharp decline in international tobacco leaf prices due to an imbalance in global supply and demand. More recently, prices have leveled off and then recovered somewhat. Over the medium term, there is some uncertainty about the likely direction of international prices, although these are most unlikely to return to the relatively high levels of the mid-1990s. Given that the bulk of incremental demand is likely to come from developing countries—where the overall cost structure for both tobacco leaf and cigarettes is lower than in Europe or North America—the more likely price scenario is one of stagnancy or slow declines. This could change, however, if production support measures are fully removed in the United States and the EU and if tobacco production in Zimbabwe does not recover.

The tobacco industry should therefore not be regarded as a ‘sunset industry’ for Malawi, as some analysts and policy-makers have argued. The 1997 – 2000 sharp price decline is less a result of the effectiveness of tobacco use reduction efforts than of oversupply and general economic downturns in Asia and elsewhere. For the foreseeable future, Malawi is most unlikely to be demand constrained. However, there will likely remain downward pressures on price. This necessitates that Malawi achieve both productivity gains and cost efficiencies in its production and export supply chain. Otherwise, the country will be unable to sustain let alone increase its tobacco exports because of the declining profitability of the crop for large numbers of growers. As will be emphasized below, this will require a reversal of recent trends.

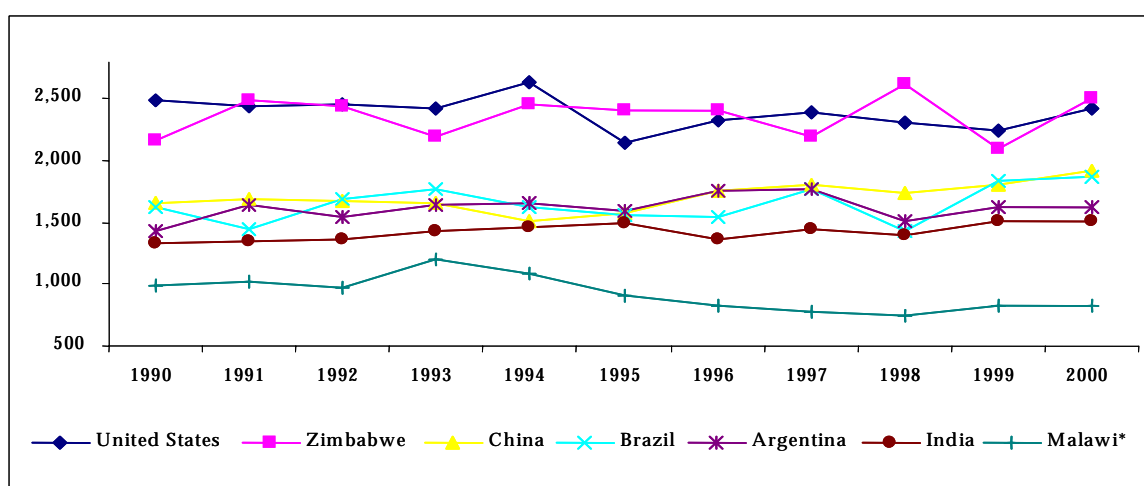
Productivity and Profitability. In Malawi, average yields for burley tobacco production have fallen, more or less steadily, from 1150 kilograms per hectare in 1990 to 922 kg per ha in 2001. Average yields have also fallen for flue-cured production from 1760 kg/ha in 1990 to 973 kg/ha in 2001. For these varieties of tobacco, such yields are extremely low by international standards, and, in recent years, approximately one half or less than the yields obtained in each of the major tobacco-producing countries with whom Malawi competes (Figure 5.2).

Low and declining yields can be attributed to a range of factors including declining soil fertility, low and declining use of fertilizers, the widespread use of low quality own saved seed, the declining availability of technical advice from the official extension service, an increased incidence of disease and pests due to inadequate crop rotation and significant post-harvest losses due to inadequate curing barn infrastructure. These factors can be addressed and the trend in declining productivity reversed.

⁴⁹ Although way below the early nineties level of about 40,000 tons.

The decline in yields has been accompanied by a decline in prices at the auction floors, which determine the returns to farmers. For both burley and flue cured tobacco, prices (in US\$/kg nominal terms) peaked in 1996 but have declined steadily since then. For burley, despite some recovery in 2001, the auction prices in the past two seasons are nearly one third lower than those that prevailed in 1996/97. The decline in prices at the auction floors mirrors the general trend in world prices exacerbated by some decline in quality of Malawi's burley crop.

FIGURE 5.2 COMPARATIVE TOBACCO YIELDS (KG/HA)



Source: FAO, Tobacco Control Commission

Further exacerbating these price trends has been adverse movements in the Kwacha exchange rate.⁵⁰ The combined effects of productivity losses, price declines, and exchange rate instability have had a dramatic adverse effect on the profitability of tobacco in Malawi, substantially curtailing the flow of money into rural areas. For example, an analysis of crop budgets for an 'average member' of NASFAM shows that the returns per kilogram for burley tobacco fell by 50 percent in 2000 and then again, by almost half, in 2001 (see Table 5.3). For burley and flue-cured tobacco combined, gross revenues per hectare have fallen from just over \$1600 in the mid-1990s to about \$1000 in recent years. On a more macro level, we estimate that over the 1997-99 period, the aggregated net profit for smallholder tobacco growers remained between \$25.8 and \$27 million each year. In 2000, this fell to \$16 million, while in 2001 it fell further to \$8 million. Hence, the net flow of income to rural areas from smallholder tobacco cultivation has fallen by some two-thirds. Therefore, as a result of declining yields and prices, *over the past five years Malawi has devoted more of*

⁵⁰ For example, during the 2000/01 seasons, the Kwacha appreciated between the time when farmers purchased inputs and when they sold their tobacco. In the prior two years, a major depreciation of the Kwacha did take place, yet tobacco growers did not benefit as this devaluation occurred only after the crop-selling period, and auction prices (in US\$) had been converted in Kwacha. The devaluation immediately hurt tobacco growers as it was priced into their leading purchased input—fertilizer—which is entirely imported.

its relatively scarce fertile land to tobacco, yet has derived lower incomes and export earnings from this production. It is essential that this trend be reversed.

TABLE 5.3 NET RETURNS FOR (NASFAM) SMALLHOLDER BURLEY GROWERS

	1997	1998	1999	2000	2001
Ave. Sales Price (\$/kg)	1.56	1.30	1.42	1.05	1.10
Net Returns/Kg (\$)	0.36	0.37	0.34	0.17	0.09
Net Returns Per Farmer (\$; Output =300 kg)	108	111	102	51	26
Net Returns Per Hectare	540	555	510	255	130
Net Returns as % of Ave. Price	23	28	24	16	8

Source: NASFAM

The decline in profitability is also due to inefficiencies in the current marketing system for tobacco and in this respect there are also opportunities for improvement. According to current regulations (i.e., the Tobacco Act), all tobacco exported from Malawi must be sold over the auction floors. There is currently only one auctioning company, Auction Holdings Ltd. (AHL), the largest shareholder being the parastatal ADMARC. While AHL is professionally run and operates a relatively advanced auctioning system, its structure of fees is quite high and the supply chain leading up to the auctions is beset with major problems and inefficiencies. AHL's auctioning fee is 3.95 percent of the gross revenue of the crop, which compares with a fee of only 2.4 percent in Zimbabwe.⁵¹

Malawi's auction system was originally designed to cater to several hundred and later several thousand growers. It was not designed to coordinate the logistics and sale of tobacco by more than 300,000 smallholder farmers, many of whom live in remote areas. Presently, growers have three means of bringing their tobacco to the auction floors:⁵²

- Larger growers deliver their tobacco straight to the auction floors, using their own or hired vehicles.
- Some 20 percent of smallholder tobacco growers belong to well organized clubs under the umbrella of NASFAM. They can effectively negotiate and hire transport services to bring their tobacco to the auctions and have a specific line of entry into the auction facilities.

⁵¹ The fees charged by AHL to apply a stop order for a financial institution are also extremely high, being 3 percent of the loan amount, as compared with the fee of only 0.14 percent of the loan amount charged under similar circumstances in Zimbabwe.

⁵² Many smallholder farmers sell their crop to intermediate buyers, including neighboring estates because of logistics and/or cash flow problems.

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- For all other farmers who do not first sell their crop to intermediate buyers, they bring their tobacco to the satellite depots that are located at 88 sites around the country. Farmers or clubs bring tobacco there, where it is temporarily stored and then transported to the auctions. The Tobacco Association of Malawi (TAMA) negotiates the transport rates.

It is this latter category of growers—which represent the large majority of growers and just under half of the total tobacco crop—which face the most significant logistics and transaction costs. The management of some of the satellite depots has been poor with the not infrequent practice of ‘first in, last out’ for tobacco bales. A not inconsiderable number of bales have ‘gone missing’ or been damaged in some way, either at the depots or in transit. The depots are managed by individual members or counselors of TAMA on a profitable or otherwise basis. TAMA has frequently not negotiated the most favorable transport rates on behalf of farmers, with there sometimes being conflicts of interest in these negotiations. These transaction costs are then magnified when tobacco from the satellite depots is delivered to the auction facilities where, in the middle of the season, there is severe congestion (at least at the Lilongwe auction), which results in up to several weeks delay in sales and payments and, upon occasion, damage or theft of tobacco bales. This delivery system lacks transparency and accountability.

There are further problems which raise the costs associated with the current system of marketing. Firstly, the grower registration system which provides the basis for allocating crop delivery schedules to farmers, for recording statistics and for developing arrangements for the recovery of bank credit through the auction stop-order system has been overwhelmed by the massive new entry of growers into the sector and by its abuse by some to avoid the payment of levies, taxes, and/or financial debts. Hence, an important vehicle for governing and monitoring the sector is largely ineffective.

Secondly, the current practice of deducting 7 percent of the gross revenues of tobacco growers as an installment payment for income tax hits smallholders hard. Virtually all smallholders have incomes below the threshold for income tax and are therefore entitled to claim back these withheld payments. In practice, it is difficult for smallholders to make these claims, and so, although not the intention, this represents a very high tax on smallholder tobacco incomes.

Thirdly, there are various institutional levies, for research, for associations, for a tobacco classification system, and for other purposes which are automatically deducted from the gross revenues of the farmers. This is probably the most convenient way to charge farmers for a variety of services, although the overall levy structure is considerably higher than that applied elsewhere and some of these services are either unnecessary or not effectively provided to the majority of smallholder farmers.

The combination of auction fees, the withholding tax, and the various institutional

levies results in a deduction of nearly 16 percent of the auctioned value of the farmer's crop. When combined with the high logistics and other transaction costs which many smallholders face, it is no wonder that one of the recent coping mechanisms of farmers in the face of reduced prices has been to smuggle their tobacco across neighboring country borders in order to sell their crop and avoid the wide array of deductions.⁵³

In recent years, Malawi's tobacco industry has experienced something of a policy paralysis as various stakeholders have sought to protect their interests, as the governance structure for the industry has incrementally eroded, and as the Government of Malawi has taken its commitment to liberalize the sector to such an extent that it no longer even plays the role of referee among competing interests. Ad hoc measures⁵⁴ and political jawboning for higher market prices have not effectively filled the void and *have left Malawi's largest industry without a coherent vision for future development and without an agreed strategy to raise productivity and reduce costs* and thereby revitalize the profitability of the crop to growers.

A Capacity-Building Agenda. Some of the problems facing tobacco growers include an unstable and unpredictable exchange rate, a high cost of finance, and relatively high transport costs from Malawi to external markets, which require measures well beyond the sector. Within the sector itself the capacity-building needs and possible requirements for technical assistance center around the following:

- *Revamping the grower registration system* and putting in place an annual auditing and performance review system for the tobacco supply chain and each of its constituent parts (including farmer clubs, satellite depots, intermediate buyers, the auctions, and export operations). Part of this effort will require strengthening the statistical and monitoring capacities of the Tobacco Control Commission.
- Moving away from 'policy paralysis' within the sector by *converting the Tobacco Control Commission into an autonomous agency*—rather than one which is presently captured by strong interested parties—with strong regulatory and policy development functions. The TCC's capacity for market intelligence should also be enhanced in order to strengthen the quality of the dialogue between growers, policy-makers, and the tobacco merchant companies regarding price formation and the international demand for Malawi tobacco.
- *Strengthening of producer associations*, including additional support for the expansion or replication of the NASFAM system and the possible restructuring of TAMA and its merger with other associations to bring about a commercial farmer producer organization.

⁵³ During the past two seasons there have been significant volumes of burley tobacco sold in neighboring Zambia and Mozambique, only to be re-imported into Malawi for processing as 'Zambian' or 'Mozambican' tobacco. The tobacco merchant companies, which dominate the purchase of Malawian tobacco, are also active in these neighboring countries.

⁵⁴ Including temporary bans or tariffs on tobacco imports.

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- *Reversing the environmental degradation*, which threatens the sustainability of production, perhaps by undertaking joint investments (by local communities, the tobacco companies, NGOs, the GOM, and donors) in social forestry, soil fertility improvement, and water management in areas of concentrated tobacco production.
 - Providing managerial and financial support to *expand the scope and reach of the research and advisory program* of the Agricultural Research and Extension Trust (ARET). ARET will need to further identify and better communicate ways in which smallholder growers can improve their productivity, raise the quality of their crop, reduce their production costs, and better integrate or rotate other crops along with tobacco and maize. The organization has already outlined a “Back to Basics” program. There remain major uncertainties about how ARET can effectively reach large numbers of smallholder farmers with its production and post-harvest recommendations.
 - *Supporting the emergence of a more effective and competitive satellite depot system*. Existing transporters currently offer a single non-diversified service to deliver tobacco to the auction floors on behalf of their clients. Other enterprises that offer specialized agribusiness services to tobacco farmers include rural input retailers. The potential exists to facilitate the development of existing transporters, retailers and some of the large farms to expand and develop a diversified and integrated set of business services, that would include providing the functions of a satellite depot, required by smallholder tobacco farmers in rural areas. Alternatively, as long as the tobacco auctions remain the dominant (or exclusive) sales channel, there would be benefits from better integrating the satellite depot and auction systems, with AHL taking responsibility for the crop delivered at the satellite depots and arranging for the management of these depots and the transportation logistics to the auctions.
 - *Permitting and indeed facilitating the emergence of contract farming* in the tobacco sub-sector, initially as a supplement to the dominant marketing channel through the auctions. Contract farming could relieve some of the congestion being experienced at the auctions, increase the available financing for the tobacco crop, reduce grower price uncertainty and facilitate more technical support to growers to improve their yields and/or natural resource management capabilities. This should initially be supported for flue-cured tobacco, yet subsequently piloted for burley tobacco.
 - *Re-examining the current policy of permitting the direct export of unprocessed tobacco leaf*, in light of the potential loss of value-added income, and the risks of widespread smuggling, decline in the integrity and reputation of the Malawi crop, and backlash from major tobacco companies. Malawi should not be stimulating the development of competing tobacco leaf processing activity elsewhere in the region, but should maximize the returns to having state-of-the-art facilities within the country.

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- *Policy actions by the GOM to directly reduce the cost burden on smallholder farmers.* This includes negotiating a reduction in the auctioning fees of AHL (and otherwise treating it as a regulated monopoly), directing a time-bound re-assessment of the existing level of statutory levies being applied with a view to reducing these⁵⁵, and developing a modality by which the withholding (income) tax is assigned only to those estate growers who meet the income thresholds. Unless substantially more net income can flow to smallholder burley tobacco growers, Malawi's dominant export industry cannot be sustained.

5.4 ISSUES AND OPPORTUNITIES IN THE TEA SUB-SECTOR⁵⁶

Background and Structure. Tea has been grown commercially in Malawi since the 1880s. The country is the twelfth largest tea producer in the world⁵⁷ and the second largest producer in Africa (behind Kenya). Malawi is the seventh largest exporter of tea in the world, accounting for just under 3 percent of this trade.⁵⁸ Historically, tea has been the second most important export earner for Malawi, although in the past few years it has been overtaken by sugar.

Tea is grown in medium and higher altitude areas in Malawi, which generally obtain rainfall exceeding 1200mm. per year. Production is centered in Mulanje and Thyolo Districts in Southern Province.⁵⁹ Some 85 percent of the tea planted area and 93 percent of production is carried out on some forty large-scale family or corporate owned estates, which generally combine tea, coffee, tobacco and other specialty crops. Many of these have their own tea factories. In recent years, there has been some consolidation of ownership of tea estates such that there are now about ten main groups of estate operations. A Tea Association represents the interests of the tea estates and coordinates the determination of wages and other work conditions within the sector. Approximately 42,000 people are employed on the 'tea' estates, with many being housed (with their families) on the estates and provided with health, educational, and other services.

A small proportion of Malawi tea is produced by some 7,000 smallholder farmers. For many years, smallholders have been registered with and variably supported by a Smallholder Tea Authority and have sold their tea through a state-owned tea processing company called MATECO. Both of these organizations have experienced managerial and financial problems in recent years, resulting in intermittent factory

⁵⁵ A possible exception might be the ARET levy, depending upon there being in place an agreed work program for research and advisory services.

⁵⁶ See Volume Two for a fuller examination of some of the issues ranged here.

⁵⁷ Although its share of world production is only 1.4 percent. Four countries—India, China, Sri Lanka, and Kenya—collectively account for 70 percent of world tea production.

⁵⁸ Unlike the situation in many of the large producing countries in Asia, Malawi exports virtually all of its tea production.

⁵⁹ Although there is one estate in the Nkata Bay area producing tea.

operations and extended delays in payments to farmers. In some areas, smallholders have been permitted to supply or sell their leaf to neighboring estates.

The area planted with tea in Malawi has changed little over the past twenty years, generally remaining within the range of 18,500 to 19,000 hectares. Annual production has generally remained within the range of 35,000 to 45,000 tons per year, with year-to-year fluctuations based upon rainfall patterns. The vast majority of Malawi tea is dependent upon a four-month rainy season, although in the past decade some estates have invested in irrigation which has enabled them to both increase yields and to bring about a more even yielding pattern throughout the year, thereby making more full use of tea factory capacities.

Performance Indicators. Tea yields in Malawi are relatively high in comparison with those in India, China, and Sri Lanka, yet lag behind those of Kenya—Africa’s leading producer.⁶⁰ In recent years, average estate yields in Malawi have been around 2500 kg/ha, compared with about 2900 kg/ha in Kenya. There is a much larger yield gap with regard to smallholders, with Malawi growers obtaining yields, which are about one-half those of their Kenyan counterparts (i.e. 1000 kg/ha vs. 2100 kg/ha). Kenya has better natural conditions—helped by two rainy seasons—than Malawi for tea, but a major additional factor has been the far better support and marketing services provided to Kenyan smallholders than those provided by the Smallholder Tea Authority and MATECO.

Another important determinant of yield and quality is the type of tea planting material used. Most of Malawi tea plantings are of seedling varieties, despite the major advantages of so-called clonal varieties. Malawi had a head start on Kenya in the shift over to clonal varieties, yet has fallen behind over the past decade, despite the availability of STABEX funds to support replanting. Currently, only about 25 percent of estate tea in Malawi is under clonal varieties, while the bulk of smallholder tea is under somewhat improved polyclonal varieties. General financial difficulties faced by some of the estate companies has deterred replanting since this requires them to forego three to four years of income while the tea bushes mature.

Because of its agro-ecological conditions and types of tea varieties used, Malawi produces a low to medium quality tea, which is used as a filler product, blended with other more flavorful teas from other countries. This lower quality is reflected in the discounted price, which much of the Malawi tea obtains. An illustration of this price discount is provided in Table 5.4 below which compares the prices fetched for Malawi tea at the Mombassa Auction with that for Kenyan and other origins of tea.⁶¹

⁶⁰ The year to year fluctuations in Malawi tea production mask over general trends in yields, although there does appear to have been a modest yield increase in recent years over and above the typical results in the prior decade.

⁶¹ The Mombassa auction is the largest in Africa and one of the largest in the world. Prices at that auction are one of the indicators for ‘international prices’ in tea. While only a small proportion of Malawi tea is sold at Mombassa, this is the only place where direct comparisons can be made with other tea suppliers.

TABLE 5.4 AVERAGE PRICES AT THE MOMBASA AUCTION BY COUNTRY OF ORIGIN

	Tanzania	Kenya	Uganda	Malawi	Burundi	Rwanda	Average
	----- US \$/KG -----						
1996	1.10	1.45	1.16	1.27	1.36	1.35	1.28
1997	1.70	2.03	1.80	1.63	—	1.96	1.82
1998	1.22	1.97	1.36	1.28	—	1.39	1.44
1999	1.18	1.86	1.29	1.06	1.65	1.52	1.43
2000	1.58	2.11	1.59	1.17	1.93	1.86	1.71
2001	1.23	1.64	1.14	1.06	1.30	1.48	1.31

Notes: “—” implies tea for this particular origin was not sold at the auction. The average refers to the arithmetic average.

The 2001 figures are as of November 05, 2001.

Source: ITC and Tea Market Report.

The table points to a downward movement in international tea prices since 1997. This has also been the trend for tea sold at the Limbe Auction in Malawi, where approximately 35 - 40 percent of Malawi tea is sold. The average prices in that auction fell from \$1.19/kg in 1997 to \$0.80/kg in 2001. This has contributed to an erosion in profitability of many of Malawi's tea estates, which have simultaneously been adversely affected by very high costs of finance, fluctuating exchange rates for the Kwacha, and escalating electricity costs⁶². For those estates which have not shifted a substantial proportion of their production to clonal teas—which obtain significantly higher prices than other tea varieties⁶³—recent tea prices have fallen below their production costs.⁶⁴ One tea estate has gone into bankruptcy while several others are in a precarious financial situation.

Constraints and Opportunities. There is occurring little new investment in the tea sector despite the needs for further varietal re-planting, the rehabilitation of tea factories, and adding facilities for supplemental irrigation. It is precisely at this time, when international prices are relatively depressed and thus the foregone income is reduced, that estates should be replanting and upgrading the quality of their product. The lack of investment is not only because of the profitability squeeze in the industry, but also due to wider uncertainty, associated with macroeconomic

⁶² Electricity costs for Malawian commercial entities rise in accordance with their use at peak levels. Tea estates are forced to pay throughout the year the equivalent of 80 percent of their peak use rate even though their electricity use is concentrated in a few months when their factories are running.

⁶³ In the first five months of 2002, clonal teas earned an average of \$1.16/kg versus \$0.92/kg for seedling varieties. Other varieties—which account for nearly one-third of the overall crop—fetched only \$0.55/kg. One Malawian estate uses a solvent extraction method to produce decaffeinated tea, earning substantial premiums for this product.

⁶⁴ Generally varying between \$0.75 and \$0.90/kg which includes overhead costs but not depreciation on long-term investments.

instability and with changes in Malawi land tenure provisions—to be implemented under the new Land Policy—which prevent non-Malawians from owning land on a freehold basis. There is perception among some tea estate operators that the GOM is unconcerned about the viability challenges facing the sector.

There are also emerging challenges in relation to smallholder tea. The quality of services provided by the STA has declined, the infrastructure at MATECO has deteriorated, and late payments to farmers have become a regular feature. Some farmers have been selling their crop to nearby estates; others have resorted to selling their tea along the roadside. A Smallholder Trust has now been established with the merger of the STA and MATECO and with plans to enable smallholders to acquire shares in the joint company. It is not clear whether this entity will be able to provide the necessary technical services and commercial wherewithal to maintain the competitiveness of Malawi smallholder tea and to improve the incomes of farmers. Progress with the Smallholder Trust should be monitored carefully and further structural changes made, if necessary. Regardless, farmers should have the opportunity to pursue alternative arrangements for marketing their crop and/or obtaining technical/financial support. This might include contract farming or other arrangements with tea estates. Technical assistance may be helpful in fostering such relationships and perhaps in designing certain types of joint venture models.

There is a range of opportunities available to the sector to expand exports and returns to producers. There is little scope to expand the area under production given the land pressures in the south of the country. Hence, improvements in yields and quality will require in-filling and replanting—based on new clonal varieties, plus investments in irrigation. The cost and availability of finance is a constraint, although there are some loan funds available from the European Investment Bank for these purposes. There are some opportunities for re-directing exports, including channeling more of the crop through the Mombassa auction where there remains a premium over the local auction and continuing to diversify sales toward markets (i.e. Pakistan, Former Soviet Union) where the growth in consumption surpasses that of the United Kingdom—the primary outlet for Malawi tea. More generally, technical assistance could be beneficial in helping the tea industry design and implement a ‘code of practice’ to enable it to comply with the technical and social standards being set by the Tea Sourcing Partnership.

5.5 ISSUES AND OPPORTUNITIES IN THE SUGAR SUB-SECTOR

Background and Status. In recent years, sugar has surpassed tea as Malawi’s second largest merchandise export in value terms. Throughout the 1980s and first half of the 1990s, Malawi’s sugar exports were relatively steady at between twenty and thirty million dollars. In the past few years, there has been some expansion, in part due to the diversification of export sales beyond international preferential quota markets to also include regional markets.

The sugar industry is dominated by the Sugar Corporation of Malawi (SUCOMA) with production estate and factory operations at Nchalo and Dwangwa. There are also outgrower systems associated with each of these operations. SUCOMA was primarily state-owned until 1998 when the Illovo Corporation of South Africa⁶⁵ acquired a 60 percent share. The parastatal ADMARC retains a 25 percent shareholding while the balance of shares is held by public and institutional investors through SUCOMA's listing on the Malawi Stock Exchange.

Sugar presently accounts for about 11 percent of Malawi's agricultural exports. SUCOMA has just over 8500 permanent employees in its agricultural and industrial operations, plus it employs an additional 5,400 persons on a seasonal basis. Thousands of other people are involved in the transport and domestic distribution of sugar. Each of the outgrower operations involves some 270 households. The 20 percent surtax on sugar is an important source of government revenue. SUCOMA's operations are a prominent feature of sub-regional economies. This is most evident in the Shire Valley where the company is the dominant employer and contractor of services.

Malawi's sugar industry is among the world's leading performers in terms of cost efficiency, production yields, factory output ratios and product quality. In 2000, SUCOMA's operations ranked seventh in the world with regard to costs of production. Production yields are also amongst the highest in the world, exceeding 100 tons of sugarcane per hectare. Malawi sugar also has a relatively high sucrose content and its quality meets some of the highest standards in the world set by food and beverage manufacturers. The company is an accredited supplier to Coca-Cola and the Nchalo estate is ISO 9001/2000 listed for Quality Management Systems.

Despite the difficult macroeconomic environment and changes in climate, the performance of SUCOMA has been remarkably consistent since the mid-90s (Table 5.5). In 2000/2001, the company completed a cane expansion and factory rehabilitation program. Nevertheless, the company has not pursued the level of expansion—i.e. a doubling of capacity—which had been considered at the time of Illovo's initial entry. The continued high cost of capital, Malawi's unstable and seemingly unpredictable exchange rate, logistical bottlenecks on export expansion, and the recent influx of cross-border imports from Zimbabwe have resulted in a scaling back of the original investment plans.⁶⁶ With 50 percent of the 2002/3 crop already harvested, prospects for the season are very good, with a return to normal cane yields predicted and a record sugar production of 235,000 tons forecast.

⁶⁵ Illovo is one of the leading global sugar producers plus is a significant manufacturer of downstream products, with interests in six southern African countries and in the United States.

⁶⁶ In 2000, Illovo invested in the Zambia Sugar Company in order to service that market as well as Central Africa.

TABLE 5.5 SUCOMA: SELECTED PERFORMANCE INDICATORS

	Area Harvested (000 Ha.)	Average Yield (Tons Cane Per Ha.)	Sugar Produced (000 Tons)	Sucrose Content (%)	Employees	Return on Net Assets (%)
1996	16.9	106	224	13.7	11,315	67.1
1997	17.2	104	218	13.7	11,282	42.9
1998	16.8	95	195	13.9	11,637	46.8
1999	16.7	101	210	14.1	11,607	60.5
2000	16.0	101	187	13.8	12,278	42.6
2001	17.3	95	208	13.7	11,545	34.5
2002	18.0	92	215	13.9	11,313	34.5

Source: Sucoma, Annual Financial Statements 2002

Markets. World and regional sugar markets are highly protected and otherwise greatly distorted by governmental interventions. Nearly three-quarters of global sugar production (from sugar cane or beet sugar) is sold in the countries of origin at protected prices. The bulk of world trade in sugar is conducted under bilateral and multilateral preferential access agreements, typically stipulating both quantities and prices. The residual ‘free market’ trade in sugar is relatively small (i.e. about 10 percent of world production) and is associated with wide swings in both supply and demand. The so-called ‘world price’ for sugar—that is the average price in the ‘free market’ (or ‘dump’ market) has generally remained below the average cost of producing sugar in most countries.

Historically, the domestic market was the primary focus of SUCOMA. In 1995, some 80 percent of production was directed to the domestic market, with the balance exported to the European Union and the United States under preferential quota arrangements.⁶⁷ The domestic market continues to be the largest single market, although its share has somewhat declined in recent years. During the past two years, the domestic market has taken an average of 52 percent of the volume of production.

Part of this can be attributed to reduced purchasing power within the domestic market. Another factor has been the influx of sugar from Zimbabwe as the sugar industry there has struggled with its own contracting domestic market and with its reduced access to international markets. Much of the inflow of Zimbabwe sugar has taken place on an informal basis with anomalies arising in the collection of the sugar surtax.⁶⁸ Another factor has been the success of SUCOMA in penetrating regional markets, most particularly in servicing the Kenyan market under the COMESA Free Trade Agreement. The company has had more difficulty accessing other regional

⁶⁷ In that year, only 3000 tons of a total production of 178,000 tons was directed to the African regional market.

⁶⁸ Zimbabwe sugar enters Malawi on a duty free basis as part of the COMESA Free Trade Agreement. However, all sugar sold in Malawi should carry the 20 percent surtax.

markets as various governments are seeking to foster the growth and/or rehabilitation of their own sugar industries.⁶⁹

Malawi presently is availed of three distinct preferential quotas into the EU market, each associated with different contract or agreed prices. These are a 21000 ton preferential quota, a 10000 ton 'special' preferential quota, and an 8,000 ton quota under the Everything But Arms agreement. The 'special preferential' system is presently under review and will likely be phased out by 2010 and replaced with an agreement which provides duty free access into Europe for the so-called 'least developed countries' in which Malawi is included. The EBA quota will be increased by 15 percent per year until 2009 when all quotas and duties will be removed for an LDC exporting to Europe. In addition, Malawi has a 10,000 ton preferential quota into the US market and a small (i.e. 5,800 ton) duty-free quota into the SACU market.

Both logistical costs and exchange rate movements are important factors in the relative attractiveness of these different markets. The Malawi domestic market provides SUCOMA with relatively high ex-factory prices because of the relatively small distribution costs involved. In 2001/02, the average proceeds on domestic sales were \$407 per ton, compared with average export revenues (ex-factory) of \$343 per ton. However, SUCOMA needs to undertake exports since nearly three-quarters of its production costs entail expenditures in foreign exchange and the company needs to manage its foreign exchange risks. The company faces significant logistics burdens and costs on its export sales. For example, for shipments to the United States, the transport/logistics burden is equivalent to 34 percent of the CIF value and to 67 percent of SUCOMA's unit production costs for the sugar itself. For sale to the EU under the EBA initiative, transport and logistics costs likewise consume 34 percent of the CIF value. The costs to move the sugar overland and through regional ports are substantially higher than the international shipping and handling costs.

During the 1999 to 2001 period, the adverse movement of European currencies (and subsequently the EURO) against the US dollar reduced the profitability of SUCOMA's sales to Europe. In parallel, the sharp drop of the Rand against the dollar (and the appreciation of the Malawi Kwacha against the Rand) has rendered the South African market less attractive for SUCOMA. Other regional market sales (i.e. to Kenya) provide a useful diversification of markets, yet generally result in ex-factory revenues below those associated with other market outlets (i.e. the domestic market or extra-regional sales under preferential arrangements), in large part due to the very high costs of moving sugar within the region.

Under ideal circumstances, Malawi would continue to expand its exports to preferential markets and to move to import a larger proportion of its domestic needs at the relatively low 'free market' world price. However, major reforms in developed country market protection are unlikely in the near future and a significant proportion of SUCOMA's output will still need to be sold domestically. Some

⁶⁹ Including in some countries where Illovo is involved—i.e. Tanzania and Mozambique.

expansion of trade can occur through the incremental increases in the EBA quota, and if Malawi can negotiate to increase other quotas in the face of shortfalls from other suppliers. The Kenyan market will continue to be attractive, although COMESA-approved safeguards have been put in place to limit duty-free imports into that market.

SUCOMA also has some opportunities to differentiate its products, gaining a premium for the supply of certain specialty products to the food manufacturing industry. The company's strategic direction is to differentiate itself from other producers by offering a range of sugars for the direct consumption market and to progressively move towards packing of the final products in their final European retail packs. Recent developments have seen the geographic risk of exports being spread as new markets in the Baltic, Netherlands, Spain and Italy are opened. Even with expanded overseas market opportunities, SUCOMA would have to overcome logistical bottlenecks. The company has sought to send bulk shipments via both Beira and Nacala, yet has experienced problems of service reliability, theft, etc.

SUCOMA faces several other challenges. One relates to the continued viability of its smallholder outgrower scheme. Smallholder outgrowers have achieved good technical results and earn a good income as long as their repayment of loans (associated with land development and irrigation investments) is frozen. The structuring of these loans, together with the devaluation of the Kwacha since the late 1990s has rendered it impossible for these growers to repay the loans provided by SUCOMA. The smallholder scheme at Dwangwa, which is a privatized area now handed over by Government, is undergoing expansion with financing from the African Development Bank. Unfortunately, the new smallholder scheme at the Nchalo mill, which was funded from commercially borrowed capital, is in dire financial difficulty due to devaluation and high interest rates. SUCOMA indicates that unless a once-off injection of low interest funds can be sourced to restructure the debt burden, the scheme will be forced to close down early in 2003.

Another potential issue, which SUCOMA may face, is the required addition of vitamin A to its sugar (through addition of peanut oil). This initiative comes at the prompting of the NGO community, which has focused on sugar as a means of addressing nutritional concerns. This has been done in Zambia and is mentioned in the Malawi PRSP. If mandated by the GOM, this measure would add substantially to SUCOMA's operating costs, create shelf life and consumer preference problems and create broader problems given the range of products, which SUCOMA produces for different markets.

There is no apparent need for technical assistance in the sugar sector. However, what is needed is the development of an agreed Sugar Policy which defines the vision and objectives for the sector and the position of the government vis-à-vis the domestic market, trade, taxation, etc. Presently, SUCOMA operates in an uncertain policy environment and this provides a hold on any considerations for new investment to expand the company's production capacity. A task force, consisting of

representatives from government (i.e. MOF, MCI, and MOAI), from SUCOMA and sugar distributors, outgrower farmers, and consumers, could be formed to develop a sugar sector strategy and policy paper.

5.6 ISSUES AND OPPORTUNITIES IN THE COTTON SUB-SECTOR

Cotton has traditionally been an important cash crop in Malawi, especially in the lakeshore districts and in other low-lying areas where the climate and soils are not suitable for tobacco. Between 80,000 and 100,000 smallholder households cultivate the crop, typically together with maize and drought-tolerant small grains. A limited number of larger commercial farms previously cultivated cotton; yet its declining profitability, in the face of sharply reduced international prices over the past five years, has led most of these growers to move away from this crop. Historically, a major proportion of the ginned Malawi cotton was sold to domestic garment or textile companies, with the balance of the crop exported as lint within and outside of the region. The downsizing of the garment and textile industries since the early 1990s has resulted in a pattern whereby the bulk of seed cotton is ginned and then exported as lint.

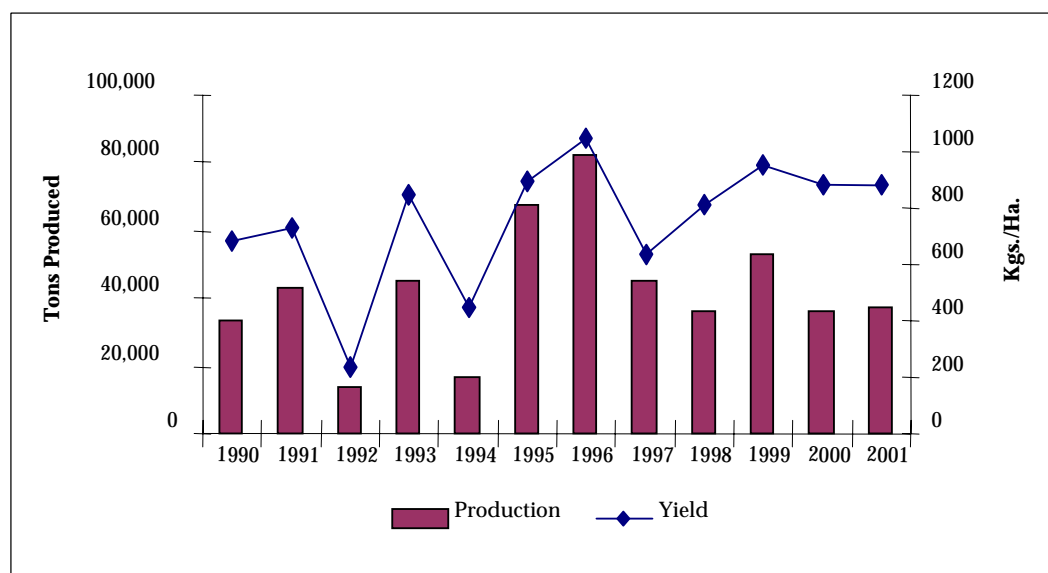
Seed cotton production in Malawi is lower today than it was in the mid-1980s. As Figure 5.3 illustrates, production levels have been highly uneven over the past decade, reaching a peak in 1995 and 1996 and declining sharply since then. The 2002 crop is estimated at less than 20,000 tons. This decline in production has resulted in the mothballing of two of the country's six cotton gins with the others operating at 40 - 50 percent of their capacity. Not only is production down, but so is quality. Malawi used to have the reputation for producing a well-graded middle-level quality of cottonseed. This is no longer the case. The varieties grown locally have deteriorated and there has been a large increase in polypropylene contamination. The out-turn of Malawi's gins are well below those of regional and international standards. Average yields are lower today than in the mid-1990s.

A variety of factors have contributed to these adverse developments in the sector. One has been the deteriorating quality of available planting seeds, arising from the mixture of different varieties by ginners and their distribution into non-suitable areas and the limited introduction (or approval) of newer varieties. A second factor relates to the general decline of the official extension service and the resultant decline in cotton husbandry, including pest management. A third factor has been price incentives with both the decline in international prices and the inefficiencies in marketing arrangements being translated into substantially lower prices for farmers in recent years.⁷⁰ A fourth factor has been weak competition and instability in the ownership structure of gins. ADMARC has remained in the ginning business yet

⁷⁰ For example, in 1997, the average price for seed cotton delivered to the gin was \$0.30/kg. In 2001, this was 40 percent lower at \$0.18/kg

ownership of the competing gins has changed twice since 1998. Yet another factor has been the weakness of producer organizations in this sub-sector, limiting farmer access to credit and their abilities to achieve economies through joint purchases of inputs and/or transport of seed cotton.

FIGURE 5.3 MALAWI SEED COTTON PRODUCTION AND YIELDS



Source: Ministry of Agriculture and Irrigation

Even without a recovery in Malawi's textile industry (see Section 5.10), there are ample market opportunities for the sale of increased volumes of cotton lint within the region, especially in South Africa and in other countries, which are seeking to take advantage of the opportunities presented by the AGOA initiative by expanding their exports of textiles and garments.⁷¹ Malawi cotton lint can be used by these suppliers as a raw material. This opportunity for regional exports has been the primary stimulus for a recently formed joint venture between ADMARC and the South African company Clark Cotton. This joint venture firm intends to re-invigorate cotton production in the lakeshore area through support to smallholder and other farmers there.

Another promising development has been the creation of a Cotton Council in which a variety of stakeholders are represented. This Council will be undertaking a systematic review of the supply-side factors constraining cotton production, productivity, and profitability and designing strategies to address these. These strategies will likely relate to cotton research and extension, seed multiplication and

⁷¹ Cotton is one of the few agricultural commodities for which SADC countries have increased their share of the South African market since the mid-1990s. Zimbabwe had been the most successful country in servicing this market, although Zimbabwe is not AGOA certified and hence those South African textile and garment companies, which seek to service the US market, will require cotton (or other intermediate products) from sources other than Zimbabwe.

distribution, inputs marketing, and quality management. The Council would likely benefit from financial and technical assistance in the development and subsequent implementation of these strategies.⁷² Assistance would also be beneficial in the formation or strengthening of farmer groups and associations in the main cotton-growing areas. NASFAM has made some in-roads in this area, yet there is considerable scope for further work.

5.7 SELECTED OTHER OPPORTUNITIES FOR DIVERSIFICATION IN EXPORTS

Malawi's merchandise trade remains highly concentrated and a general consensus exists that the country must move to diversify its productive base and its exports. This indeed is an important challenge, although this diversification process must be built upon a solid foundation and at least some recovery of incomes in the traditional dominant sectors. Otherwise, the available domestic resources are too limited to mount a successful pattern of investment, which diversifies the economy. Foreign direct investment will need to play a significant role in any diversification process, yet there still should be domestic partners who are able to invest and local agricultural producers who have the flexibility and resources to redirect their production.

The discussion here focuses on three areas where there appears to be near-term opportunities for broad-based growth involving a diversification of exports, namely:

- (i) groundnuts and other grain legumes as this was traditionally a successful export for Malawi and there remains potential to revitalize this trade geared toward regional and international markets;
- (ii) paprika with Malawi recently emerging as a player in an expanding world market and having opportunities to increase its market share; and
- (iii) textiles/garments for which both AGOA and regional trade agreements present market opportunities yet measures are needed to reverse the recent declining fortunes of these industries.

5.8 GROUNDNUTS

Groundnuts have long been an important part of smallholder production systems in Malawi, both as a source of food and as a contributor to improved soil fertility.

⁷² The focus of the Cotton Council appears to extend well beyond the cotton sub-sector itself and also include the more extended supply chain which involves weaving, spinning, garment manufacturing, etc. It is not necessary for Malawi's cotton industry to be forward integrated with its textile and garment industries for one or both to succeed.

During the 1960s and 1970s, groundnuts were also one of the most important sources of income for smallholder farmers. During that period, some 15 – 25 percent of production was exported, as Malawi's Chalimbana variety was valued as a confectionary nut for both its relatively large size kernels and excellent flavor. Most of the exports were taken to Europe and were largely undertaken by the parastatal ADMARC.

Exports were as high as 51,000 tons in 1967, yet the largest value of exports was recorded in 1980 at nearly \$20 million. Both production and trade were uneven during the 1980s, yet subsequently collapsed, the former due to reduced price incentives and the latter due to a deterioration in product quality and problems with controlling aflatoxin. During the 1990s, Malawi lost its position in the European groundnut market to China and other suppliers and has struggled to revitalize production. Groundnuts are now largely a subsistence crop with only a small share of production (less than 10 per cent) entering into formal markets, whether locally or within the region.

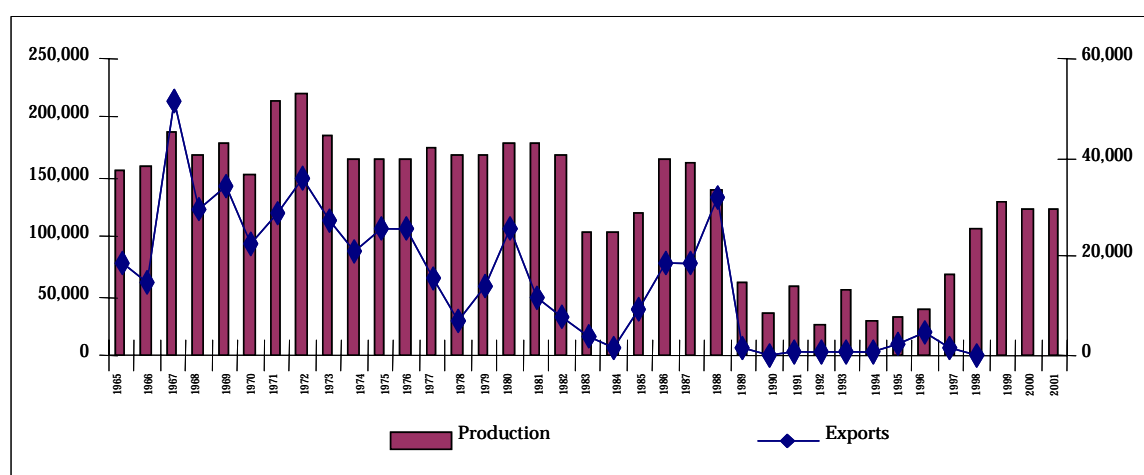
While inadequate price incentives for farmers weakened the commercial market for groundnuts, the large decline in production from the mid-1980s through to the mid-1990s can be attributed to the use of deteriorating quality seed, the absence of an organized system for seed production and delivery and the increased incidence of plant diseases. Farmer yields plummeted to levels amongst the lowest in the world. Research advances were made in developing a better yielding and more disease-tolerant variety (CG7), yet this variety results in a crop with smaller sized kernels and higher oil content—for which there is not a distinctive demand either in the regional or international markets. Less progress has been made in reviving the quality of seed for the Chalimbana variety.

In recent years, several private companies have entered the market for groundnuts and have sought to revive interest—within the region and beyond—for the Malawi product. These and other firms have formed a Legume Association and have been backing efforts, also involving ICRISAT and local researchers, to revive the seed multiplication and delivery system and to increase the awareness of farmers regarding quality specifications, and practices to reduce the incidence of plant diseases and aflatoxin infestation. In a small way, Malawi has begun to return to the international market through a combination of informal sales into Zimbabwe and formal exports to South Africa. Expanding this trade and raising the prospects for renewing trade with Europe will require that (i) production become more reliable and consistent so that exporters can make pre-commitments to perspective buyers; (ii) aflatoxin infestation be managed through adoption of improved post-harvest and storage practices; and (iii) overall quality and productivity is improved—substantially through increased availability and uptake of improved seeds of the market-preferred Chalimbana variety.

However, groundnuts face numerous entry barriers to overseas markets, especially in Quad countries. In addition to product standards, groundnuts exports face

exceptionally high tariffs in the US market even under preferential terms of access such as those offered by AGOA. Even though AGOA grants duty free access to certain types of groundnuts, the act falls short of liberalizing the kinds that are subject to the highest tariff rates. Of about 35 categories of groundnuts defined by the HS code, AGOA grants free access to only nine categories. The average MFN ad valorem tariff on categories not covered by AGOA is 30 percent (which is calculated as a percentage of the value of imports) with a maximum rate of 163.8. In comparison, the nine categories covered by the act have an average MFN tariff of zero percent.

FIGURE 5.4 MALAWI GROUNDNUT PRODUCTION AND EXPORT VOLUMES (TONS)



Source: FAO

In recent years prices in the domestic market have been very attractive to farmers and have even exceeded prices which farmers could realize as part of an export supply system. Resuscitating production for export will thus require a package of support to farmers, which serves to enhance their productivity plus provide more assured market outlets to induce more of a commercial orientation toward the crop. Private exporters are of the view that Malawi could regenerate groundnut exports exceeding 50,000 tons within the next decade, plus also achieve similar levels of exports for other grain legumes—such as pigeon pea, chick peas, and sugar beans—for which Malawi products possess a reputation for quality and for which there are large markets in India, Egypt, and South Africa. They estimate that the combined exports of groundnuts and other grain legumes would well exceed \$50 million within the next five to seven years provided that the seed and overall quality management problems are effectively addressed through a cooperative effort involving both the public and private sector.

Earlier this year a non-governmental organization called Legume Tech International was launched to promote the production and use of grain legumes as a vehicle for poverty reduction and improved food security in Malawi. The planned efforts would likely have spillover effects, simultaneously increasing opportunities for

expanding export-oriented production and sales. These initiatives should be supported by the GOM and by donor agencies.

5.9 PAPRIKA

In recent years, Malawi has emerged as a player in the expanding world market for paprika, which is used as both a spice and a colorant. Production has been built up slowly over the past five years with Malawi now accounting for about 2 percent of world production and perhaps 5 percent of world trade in dried paprika. Five companies are now involved in the collection and sale of the crop, although only two have been actively involved in promoting the crop via the provision of seed and/or extension services. The number of smallholder growers of paprika has increased exponentially in recent years due to favorable prices (at least through 1999), the efforts by private companies in promoting the crop, and the declining profitability of tobacco. For the 2001/2002 season there were an estimated 60,000 farmers growing paprika up from only 10,000 in 1999. Many of these farmers have shifted, at least in part, away from tobacco production, finding paprika more profitable to grow, requiring less labor (especially at the post-harvest stages) and entailing less marketing difficulties. Paprika's agronomic properties are very close to those of tobacco so the learning curve for farmers of this crop has been very quick.

There is considered to be substantial growth potential for Malawi paprika whose export is primarily in dried form to Spain and elsewhere. Malawi is considered the lowest cost producer in the region. The leading producers within the region are either encountering problems of reduced profitability (i.e. in South Africa) or are facing more general threats to their viability (i.e. commercial farmers in Zimbabwe). There is considered to be potential for Malawi to increase its production from a current level of 2000 tons to upwards of 10,000 tons, the latter representing an estimated 10 percent of total world production.

However, important challenges remain. At present, production yields in Malawi are very low at less than 300 kg/ha, compared with yields of nearly 800 kgs/ha among smallholders in Zambia. The quality of Malawi's paprika is also relatively low or variable, although most of the output meets the ASTA standards for the product's use as a colorant. Periodically, problems of aflatoxin contamination are encountered. The number of (private) extension agents advising farmers on paprika cultivation has been overtaken by the rapidly increased number of growers.

For this young industry there is a need to greatly intensify the availability of advisory services, to organize farmers into groups, to undertake a program of applied research to better understand the constraints and opportunities of local farmers, and to build capacities in quality management and the monitoring and testing for aflatoxin contamination. A Paprika Association of Malawi has been

formed with external financial support to better address the non-commercial dimensions of the industry's development.⁷³

Additional technical and financial support to the industry could be provided to or through PAMA to strengthen these capacities and thereby increase productivity and incomes within this industry with evident growth potential. PAMA could organize programs to train farmer groups with a commercial orientation, to develop and implement a code of practice and set of quality and other standards within the industry, to facilitate the provision of credit to growers (via developing a registry and 'black list' of growers), and overseeing applied research activity.

5.10 TEXTILES AND CLOTHING⁷⁴

In 2000, textile and clothing production accounted for 34 percent of manufacturing GDP in Malawi and represented by far the largest source of manufactured product exports. In that year textile and garment exports totaled \$26.7 million and total employment in the industry was estimated at 29,000⁷⁵. The major products of the industry are cotton yarn and fabric, linens, apparel, and clothing accessories. It draws upon both domestic and imported raw materials, including cotton lint and yarn, and polyester.

Malawi's textile and clothing industries date to the 1950s and 1960s. Each was largely focused on the domestic market with some regional sales. Each was afforded protection from competing products by high import tariffs. The liberalization of imports in the early 1990s virtually wiped out the domestic garment industry as large imports occurred of less expensive goods from Asia plus large quantities of second-hand clothes. The garment industry is now primarily oriented to exports as new investors were attracted during the mid-1990s with the establishment of export processing zones. The textile industry has also undergone a transformation and is now dominated by one ailing parastatal company called David Whitehead Malawi (DWM).

Recent years' production and trade has been uneven, reflecting financial and other difficulties faced by DWM, effects of downward international price pressures, high costs of finance and exchange rate instability. An illustration of this is provided in Table 5.6 below. Results for 2001 would indicate some further reduction in exports.

⁷³ There is also a Horticultural Exporters Association. There may be justification for merging these two organizations so as to economize on their administrative overhead and available managerial talent. However, a plausible argument can also be made that the promotion of growth in the paprika industry would be best served by a dedicated (privately managed) support agency.

⁷⁴ This discussion is based upon a background paper on the cotton and garments industry prepared by consultant John Cockcroft, together with a recent paper prepared for the International Trade Centre by the Malawi Confederation of Chambers of Commerce and Industry.

⁷⁵ Of which some 11,000 were employed by SMEs with less than fifty employees each.

Over the past five years, the number of garments manufacturers has declined from about thirty to ten. South Africa has been the single largest market for Malawi textiles and garments, with its relative importance increasing in the late 1990s due to a decline in sales to other SADC countries. Small levels of exports have been undertaken to the EU and very small sales have been made, up to 2000, to the United States. During the past eighteen months there has been increased interest to service the US market and opportunities have been realized since the signing of the AGOA declaration for apparel provision by Malawi in August 2001.

**TABLE 5.6 MALAWI: PRODUCTION AND EXPORTS OF
SELECTED TEXTILE AND GARMENT PRODUCTS**

	HS		Units	1996	1997	1998	1999	2000
Cotton Fabric	5208	Prod. Export	Tons US\$ 000	5396 3149	5680 3107	3291 1498	2929 1504	3075 1322
Linens	6302	Prod. Exports	Mill.Unit US\$000	1.08 2774	1.55 5922	1.49 11108	3.01 9970	2.41 7456
Knitted Apparel and Accessories	61	Prod Exports	Mill.Unit US\$000	8.38 6959	12.08 10532	17.62 9485	15.17 9264	11.37 6379
Non-knitted Apparel and Accessories	62	Prod. Exports	Mill.Unit US\$000	5.81 8643	8.37 13375	9.17 7455	9.59 8275	9.32 6250

Source: Malawi Confederation of Chambers of Commerce and Industry (2002)

Until the early 1990s, DWM had enjoyed financial success as its domestic market was protected by high tariffs and as it obtained local cotton at preferential prices. The enterprise was (and is) the only integrated textile mill in the country with the ability to take on cotton lint for spinning, weaving and printing, dyeing, and several specialized finishing operations. It employed up to 4300 people (1991) and had an annual production of some 30 million linear meters of fabric. The liberalization of textile imports and of the cotton market disrupted the company's domestic market and raised its costs of production. Although DWM was able to expand its exports, this was insufficient to compensate for a collapsing domestic market. DWM's overall output fell sharply as did its financial position. In 1996, the majority foreign owner (Lornho) sold its equity stake to the Government of Malawi for one dollar and since then the company has been entirely owned by the government (in part through ADMARC and the Malawi Development Corporation).

In recent years, DWM has experienced declining production and has built up accumulated arrears of nearly Kw 1 billion. It is operating at less than 20 percent of its capacity producing only about 230,000 linear meters per month. The company is currently carrying a payroll of about 1800 persons, of whom over 1000 are surplus to actual requirements. The retrenchment costs for this number of people would be considerable. The accumulated arrears of the company now approach \$30 million.

DWM retains a solid technological core of over 170 modern looms plus an additional 140 older model looms, which are used primarily for the domestic fabric market. The

company continues to export two product lines into the competitive South African market. Excluding finance servicing costs and those for excess labor, the company would obtain a positive net margin on these sales, yet this is not the case under present circumstances. The company's current financial problems not only result in the under-utilization of its relatively sophisticated capacity and an inability to rehabilitate equipment, but also detract from product development and marketing efforts.

The privatization of DWM appears to be necessary to realize the production and trade potential for textiles, both within the region and potentially beyond. The feasibility of privatization will likely require the GOM (perhaps together with donor agencies) to absorb the financial responsibilities of the company, both in terms of servicing its arrears and in addressing possible retrenchment requirements. Both to aid the privatization process and to achieve more immediate results, support might also be provided in the form of 'turn-around management' and related technical assistance to increase productivity, reduce production costs, diversify the company's product range and improve international marketing.

With regard to garments, a handful of foreign-owned, relatively large companies now account for the bulk of Malawi's exports. These firms have been able to access less expensive finance from offshore sources, plus have been able to draw upon technical expertise from their parent or other affiliated companies. The two largest companies are subsidiaries of Taiwanese companies who operate in Malawi on a Cut, Make and Trim basis. Both are in export processing zones and import virtually all of their garment components (and product designs) from East Asia. Both employ about 3000 people and maintain relatively high standards of production. Both have re-oriented their production to service the United States market, taking advantage of the market access provisions under AGOA. Such firms do not require assistance other than via an improvement in Malawi's overall macroeconomic conditions and negotiations to extend the current AGOA provisions beyond 2004.

Other garment exporters have encountered problems in maintaining their access to the South African market because of a dispute over the interpretation of local content provisions of the Bilateral Agreement. This dispute needs to be resolved. Some of the remaining small and medium-scale garment manufacturers would benefit from technical assistance in garment design and/or international marketing, perhaps organized through the Garment and Textile Manufacturers Association and involving either short-term consultancies or the posting of retired garment industry technical specialists. To further strengthen Malawi's capacity to be a competitive exporter of garments (and textiles) there is a need to increase the availability of training courses/facilities in this field, perhaps under the auspices of the University of Malawi or another institution for technical or higher learning. The design and initial support of such a training program might benefit from external assistance.

5.11 TOURISM⁷⁶

Tourism is one of the sectors identified by the Malawi Government for upgrading and expansion. Growth in the industry is relatively steady, though still low in absolute volume terms. Between 1990 and 1999, the number of international visitors to Malawi almost doubled, from 129,912 in 1990 to an estimated 254,352 in 1999. Just over a quarter of these came on vacation. Receipts from tourism increased from Kw44 million (US\$16.1 million) in 1990 to an estimated Kw1,416 million (US\$30.5 million) in 1999⁷⁷. The World Travel & Tourism Council⁷⁸ estimates that in 2000, the tourism industry in Malawi will contribute approximately Kw2,395 million (US\$29.9 million) directly to GDP, and almost Kw5,380 million (US\$67.2 million) indirectly through upstream and downstream linkages to the broader economy. Reliable statistics on tourism, particularly on expenditures and their multiplier effects, are notoriously difficult to obtain, however. Most such figures are pure estimates. Setting up and maintaining an efficient, reliable, and up-to-date system for acquiring, analyzing and disseminating data on tourism in Malawi must be considered a priority. Without adequate data, planning for an expansion of the industry and a growth in foreign exchange earnings will be difficult to achieve.

A striking trend in recent years has been the apparent fall in the percentage of all international visitors who stayed in hotels, down from 50 percent in 1994 to only 10 percent in 1999. This reflects, in part, the high price of hotels, as well as the rise in the number of smaller, less expensive lodges and somewhat more expensive safari camps. It illustrates one of the difficulties facing the expansion of the tourism industry, namely the high capital cost of investment. Despite the increase in the number of visitors to Malawi, bed occupancy rates have remained relatively static at 38 - 40 percent (no data are readily available on changes in the number of beds available during this period). With such relatively low occupancy rates, hoteliers are forced to charge high prices to recoup the cost of investment and cover operational costs, particularly those at the higher end of the market. One consequence of this may be reluctance by new investors to incur additional costs associated with mitigating the environmental impacts of their developments.

Tourism in Malawi is concentrated on Lake Malawi and the country's main national parks (Liwonde, Kasungu and Nyika). With the high human population density in rural Malawi, there are few remaining prime sites for tourism development, other than along the more isolated sections of the lakeshore. A UNDP-funded Tourism Master Plan Study⁷⁹ has recently been completed, focusing on the further development of the tourism sector.

⁷⁶ The section on tourism is excerpted from "Trade- Environment Linkages and Issues" (2001).

⁷⁷ Department of Tourism (2000). *Tourism statistics summary*. Department of Tourism, Lilongwe, Malawi, 1 pp. (Typescript).

⁷⁸ WTTC (2000). World Travel & Tourism Council Year 2000 TSA Research Summary and Highlights – Malawi. World Travel & Tourism Council, Brussels.

⁷⁹ Strategic Tourism Development Plan (MLW/99/A/08/49).

At present, there is almost no community-based tourism in Malawi, though such initiatives, similar to those being promoted in Tanzania, might be possible. They could provide one way of disbursing economic benefits from tourism direct to local communities, as well as being a powerful incentive for the conservation of culture, historical artifacts, and local environments. A thorough assessment of the opportunities for and constraints on similar developments in Malawi is warranted, including their economic, social and environmental costs and benefits, and the supportive measures that need to be taken by government.

Some of the main constraints facing the tourism industry generally include: long and costly transport links to the major tourist markets in Europe and North America; poor infrastructure servicing the main tourist areas; poor communications; limited and unreliable power supplies; high levies and taxes, coming on top of high costs of accommodation, at least in hotels; concerns about security; and health risks, principally malaria and schistosomiasis (bilharzia) around resorts on Lake Malawi. These will need to be overcome if tourism is to undergo its hoped-for expansion.

A detailed economic analysis of the Malawi tourist industry is needed, to evaluate the real costs and benefits of the industry and its linkages to other parts of the economy. The economic and employment multipliers of tourism are not known and should be estimated. The foreign exchange cost of servicing the visitors should be calculated, particularly the cost of importing goods for the industry and the repatriation of profits by international operators. The impact of the various taxes and levies imposed on the tourism industry, and on visitors directly (visa fees, departure taxes), should also be assessed, as these may be among the factors constraining expansion of the industry.

The Tourism Master Plan Study provides some insights into these issues, and provides for a 5-year plan of action that can help toward improving the tourism sector in Malawi. The plan highlights the range of initiatives, which must be undertaken. These include: (i) the promulgation of a comprehensive Tourism law to act as the foundation for the sector, (ii) the improvement of human resources through training efforts, and (iii) the undertaking of a tourism awareness effort along with improved data collection through the creation of a 'tourism information data base'.

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APPENDIX A
CURRENT TRADE RELATED PROJECTS

Status of current projects by Donor, Government and Private Sector⁸⁰

DfID			
Project	Description	Status	Area of Support
Malawi Exports - TEEM	Expansion of market led local business & exports	Current	Poverty Alleviation
CUSP	Develop Customs and Excise service	Current	Development / Capacity Building
Support to National Statistics Office	Improvement of service	Current	Development / Capacity Building
CRIMp	Develop / refine systems for sustainable and cost effective rural feeder roads maintenance	Current	Transport
TPP	Trade Policy Development and rationalization of approach to funding	Currently in progress	Trade and policy development/ Capacity Building
Private Sector (PSMP)	Promotion private sector growth and development	Current	Private Sector Development
EU			
Project	Description	Status	Area of Support
EBAS	Private Sector development through trade and business development support. This can be in terms of consulting, technology or like assistance. Implemented in the region and accessible to Malawi	Current	Trade and business development
ASYCUDA (Automated systems for Customs Data)	Enhancing of Customs efficiency, effectiveness and quality of import and export data available to the Treasury and to National Statistics Office. Improved revenue collection is anticipated as a direct result.	First Phase completed Second phase under way	Institutional support

⁸⁰ Information in this table drawn from the DFID Malawi Trade Policy project “A Study To Redesign, Translate And Update Malawi’s Needs Assessment Into A Fully Integrated Framework (IF)”

Road Management Support Program	Assistance in achieving good and sustainable management of roads and establishment of road infrastructure through : <ul style="list-style-type: none"> - revise organizational structures and reform road management institutions - improved private sector capacity and participation - improve axle load control and road safety - assist in clearance of backlog of road maintenance work 	Initial three year program commenced 1998 Extended to 31-03-2003	Transport / infrastructure
GTZ			
Project	Description	Status	Area of Support
Economic Development and Employment Promotion Program (EDEP) Ministry of Labor and Vocational Training	Capacity building	Current	Institutional Support
EDEP Malawi Chamber	Small business associations support	Current	Private Sector Development
EDEP Public and selected private technical training providers	Training of trainers, program development,	Current	Training and HR Development
EDEP Promotion of selected small and medium enterprises	Advisory services	Current	SME Development – Private sector
EDEP MSMEP	Micro,small and medium Enterprise Promotion	Current	Private Sector / SME development
NORAD			
Project	Description	Status	Area of Support
Private Sector Development support includes mining	Support aimed at the development of private sector / increased investment into the sector	Mission in preparation	Private Sector
NASFAM – micro credit, irrigation and crop diversification	Program of support to NASFAM	Current-New 5 year support	Agriculture/Private Sector
Banda College of Agriculture	Link with Norwegian University of Agriculture	Current	Institutional Support
UNDP			
Project	Description	Status	Area of Support
Regional Program on Trade	Trade promotion assistance	Not yet implemented in Malawi	Trade development

Enterprise Development Employment Project (EDEP)	<ul style="list-style-type: none"> – training for business sector on international agreements – policy and regulatory framework development – business and technical training support – finance and micro credit – development of competition policy – skills training – essential services such as Marketing (support to MEPC) – SME capacity building (DMET and MIPA) Direct grant scheme through Ministry of Commerce and Industry	Currently in place	Private Sector Development
Investment Forum Support	Support for attending seminars and forums	Current	Trade development
USAID			
Project	Description	Status	Area of Support
Ministry of Transport training program	Training in	Current	Transport
Technical Assistance – crop diversification	Identification of crops available to diversify into and training in these crops	Current	Agriculture
Export diversification to South Africa and Zimbabwe	Promotion of exports into Zimbabwe and South Africa	Current	Agriculture
Dhall project – diversification	Development of Dhall as an alternative crop	Current	Agriculture
Private Sector development projects on small business development, AGOA, Garment and Textile development, Quality management,	Development projects for private sector	Current	Private Sector Development
Malawi Revenue Authority 2 visa program	Development of a rationalized import and export documentation system	Current	Institutional Support
SEDOM – financing arrangement	Financing for the SEDOM program	Still to be finalized	Micro enterprise development
Malawi Trade and Investment Program	<ul style="list-style-type: none"> – Investor Road Map revision IP3 Public sector / Private Sector Partnership in infrastructure development Support to Malawi Chamber of Commerce 	To be implemented	Trade development

WORLD BANK			
Project	Description	Status	Area of Support
Privatization and Utility reform project	Project includes privatization support to Privatization Commission, in relation to MPTC, MACRA, ESCOM, Water Sector, ADMARC, Commercial Bank of Malawi, Air Malawi, Malawi Rural Finance Corporation, Tourism Investment and Development Corporation, Malawi Housing Corporation, Malawi Savings Bank,	Current	Institutional support / private sector development
Road Maintenance and Rehabilitation Project (ROMARP)	Assistance in achieving good and sustainable management of roads and establishment of roads infrastructure	Current	Transport / infrastructure
Malawi Private Sector development Project	Support to private sector growth	Project in design stage	Private Sector Development
Africa Guarantee Facility	Financing facility for exports to encourage growth and investment in private sector	Current	Private Sector Development