Munich Personal RePEc Archive

Fiscal policies are more potent to redress acute foreign currency exchange shortage in Malawi

Phiri Kampanje, Brian

15 August 2022

Online at https://mpra.ub.uni-muenchen.de/114421/
MPRA Paper No. 114421, posted 09 Sep 2022 08:15 UTC

FOREX MANAGEMENT POLICY. MALAWI

Fiscal policies are more potent to redress acute foreign currency exchange shortage in Malawi

By

Brian Phiri Kampanje

Abstract

The ultimate guardrail of forex reserves in Malawi should be the National Assembly whose sole existence is to serve the needs of the Malawians. The monetary authorities can intervene in the market forces to stabilise the value of the Malawi Kwacha against major trading currencies but have limited capacity to influence on how forex in Malawi can be externalised or what measures can be done to keep more forex only meant for crucial imports. Parliament through fiscal policies is able to do so and it is now time Malawi must adopt contractionary fiscal policies by spending less on non-essential expenses such as foreign travel, suspend purchase of new fleets of vehicles but above all, use the tax code to discourage importation of non-essential items into Malawi.

Type of Paper: Literature Review

Key words: Fiscal; Malawi; Policies; Shortage; Forex

1.0 Introduction

Malawi has been facing acute foreign exchange currency shortage since 2009 resulting in scarcity of petroleum products which reached its peak in 2011 – Kampanje (2012b). Reserve Bank of Malawi (2016b) vividly narrated the forex issue deficiency situation in 2012 which led Malawi to devalue the local currency as follows:

[The Kwacha was devalued in May 2012 by 49% to K250/US$ and hereafter allowed to be determined by market forces of demand and supply. The main objective was to correct once and for all the exchange rate misalignment and create long-term conditions for a more resilient, productive and exporting country.

As Malawians would recall, the exchange rate misalignment was so serious that the country had very limited forex reserve and accumulated huge external payment arrears (estimated to be in excess of US$600 million) held by both Government and the private sector. This created persistent and widespread shortages of fuel and other critical imports. Indeed, the exchange rate misalignment diverted foreign exchange transactions to the parallel or black market. Prior to the devaluation the official exchange rate was K169/US$ compared to over K250/US$ in the parallel market.

To support the misalignment, exchange controls were intensified and pervasive. With non-bank foreign exchange bureaus closed, access to foreign exchange by the general public was extremely difficult. To cut a long story short, the

economy was in a precarious state and had the exchange rate misalignment continued, the government would have lost the Kwacha as a legal tender currency and the country could have become completely dollarized.

By June 2013, the end of the 2012/2013 fiscal year, the Kwacha had lost a further 32% to K330/US$. The central bank's net foreign exchange position had improved from negative US$161.1 million in June 2012 to US$147.5 million, implying an increase in terms of import cover from 0.6 to 2.4. All external payments arrears had been cleared by September 2013. This improvement in the country's external position was made possible not just by the liberalization of the foreign exchange market but also by the act that government did not borrow from the domestic market that financial year.].

The negative effect of the massive devaluation of the Malawi Kwacha in May 2012 triggered inflation and Kampanje (2012a) stipulated that Malawi actually descended into hyperinflationary economy status and reporting entities were therefore required to reclassify their financial results based on the principles of IAS 29 – Financial Reporting in Hyperinflationary Economies.

Reserve Bank of Malawi (2022) stated that it would allow the exchange rate to adjust to a market clearing position with a view of endorsing a flexible exchange rate "managed float" regime that allows the exchange rate developments to reflect market fundamentals. There appears to be contradiction with the Reserve Bank of Malawi (2016b) which touted free flow exchange rate

regime dictated by demand-supply market conditions. Perhaps the clue regarding possible fixed exchange rate regime silently adopted by the central bank is provided in the Reserve Bank of Malawi (2019:4):

[This plan is being developed at a time the Malawi economy has stabilized. Inflation is in single digit for 14 months running since August 2017, the exchange rate has been stable for 25 months running since August 2016, at 16 percent, the Policy Rate is at its lowest since May 2012 and import cover is at 3.6 months and still growing.].

There are however concerns that economic figures for 2019 and part of 2020 might have been altered to show a better performance than what was actually the case such that exchange rate might have been worse off than reported in the official statistics as noted by International Monetary Fund (2021).

The Malawi Kwacha was devalued by 25 percent at the end of May 2022. The Monetary Policy Report July (2022:v) averred:

[The persistent merchandise trade deficits have resulted in domestic supply of foreign exchange being perpetually lower than its demand. As the supply-demand imbalances continued to deepen, a number of problems emerged, including the widening of the spread between the ADBs TT rates and the Bureau cash exchange rates. As a corrective measure, the RBM adjusted the exchange rate by 25.0 percent effective 27th May

2022. Cumulatively, the kwacha lost 25.5 percent (K209.76) against the US dollar; 6.2 percent (K74.04) against the pound; and 7.5 percent (K77.14) against the euro in 2022Q2. However, the local currency strengthened by 2.8 percent (K1.88) against the South African rand during the same period.

Inflation pressures continued to intensify in 2022Q2 such that headline inflation accelerated to an average of 19.4 percent, from 13.1 percent in 2022Q1 and compared to 9.1 percent in 2021Q2. The increase represented the combined effect of rising costs of domestic fuel prices, pass-through of exchange rate depreciation, price mark-up shocks on domestically-produced agricultural food commodities induced by the high costs of fertilizers, rising global food prices and speculation of low food production following unfavourable weather patterns during the 2021/22 agricultural season.].

2.0 Deficiencies of monetary policies in forex matters

The Reserve Bank of Malawi as a monetary authority in the local macroeconomic environment touted the floating exchange rate regime as highlighted in Reserve Bank of Malawi (2016a) in which it stipulated that during the fixed exchange rate era up to 2010/2011, there were no exchange rate gains for exporters, tobacco farmers inclusive (where early planning and early purchase of inputs maximises exchange rate gains for tobacco farmers). While the argument above holds true, the impact of the exchange rate gains were overshadowed by high inflationary factors as Malawi is a predominantly importing country as evidenced by the huge trade deficit –

National Export Strategy (2013). The country is still battling with significant trade imbalances and has recently once again formulated strategy to achieve export-led growth through the rolling out of the National Export Strategy II (2021). The devaluation of the local currency therefore led more citizens into poverty with little cushion (social package programmes) despite the country rolling out the Malawi Economic Recovery Plan (2012) because there was unprecedented movement in the exchange rate between 2012 and 2017.

The monetary authorities also undertook some measures as debt swaps with Preferential Trade Area (PTA) Bank at the end of 2014, reviewed guidelines for foreign exchange trading activities and revision of the Liquidity Requirement Directive - Financial Stability Report (2015).

What is certainly clear is that the monetary authorities dealt with the effects of acute shortage of forex in Malawi and not the causality. Could fiscal policies been the suitable measures to deal with scarcity of forex in the past in Malawi, now and the future? Rubi (2009) noted that regular behaviour of a system can only be determined when there is adequate information. It is therefore imperative to evaluate some of the fiscal policies which could have exacerbated the forex shortage and what needs to be done now and going forward.

3.0 Malawian fiscal policies and forex shortage

Congressional Research Service (2021:1) briefly describes fiscal policies as follows:

[Fiscal policy describes changes to government spending and revenue behavior in an effort to influence economic outcomes. The government can impact the level of economic activity (often measured by gross domestic product [GDP]) in the short term by changing its level of spending and tax revenue. Expansionary fiscal policy—an increase in government spending, a decrease in tax revenue, or a combination of the two—is expected to spur economic activity, whereas contractionary fiscal policy—a decrease in government spending, an increase in tax revenue, or a combination of the two—is expected to slow economic activity. When the government's budget is running a deficit (when spending exceeds revenues), fiscal policy is said to be expansionary.].

The Malawi Government has for a greater part since multiparty dispensation in 1994 operated on a deficit which as per observation of Congressional Research Service (2021) qualifies as expansionary fiscal policies. Malawi was receiving donor aid for budgetary support up to forty percent of the national budget as highlighted by Butty (2015):

[Malawi lost up to 40 percent of the budget support aid it was receiving from foreign donors when the European Union, the World Bank, and the United Kingdom suspended aid last year because of the corruption scandal, known as "Cashgate," which diverted about $32 million from government accounts].

Malawi tried to achieve zero deficit budgets albeit with little success as noted by Chinsinga (2014):

[The critical question is why the government … not moving with speed on cashgate even as it holds the key to the restoration of budgetary support? Instead, his government has opted for the "zero–aid budget" as a strategy to cope with the withdrawal of donor support.

The zero-aid budget is pegged at MK742 billion, with a deficit of about MK 107 billion. It is therefore projected that the national revenue authority will rake in about MK 535 billion. While the 2014/15 budget has desisted from raising taxes, it does not explain how the deficit will be financed, apart from saying that the government will continue engaging with donors, and should they decide to support it, a supplementary budget will be prepared accordingly.

This is not the first time that Malawi experiments with an innovative budgetary framework. In the 2011/12 fiscal year, …, rolled out the so-called zero-deficit budget. Likewise, the zero-deficit budget was minted in response to donors' withdrawal of budgetary support, prompted by a worrisome economic management and governance track record. The consequences were disastrous: Malawi was headed for almost complete political, economic and social meltdown.].

Malawi Government reverted to deficit budget as noted in the 2021/2022 National Budget Statement:

[61. Madam Speaker, the 2021/2022 overall balance is

estimated at a deficit of K718.3 billion, which is 7.0 percent of the rebased GDP, and markedly lower compared to 8.8 percent of GDP during the 2020/2021 fiscal year. This deficit will be financed through foreign borrowing amounting to K134.8 billion and domestic borrowing amounting to K583.5 billion, or 5.7 percent of the rebased GDP.].

The 2022/2023 National Budget Statement stipulated the following regarding the deficit:

[64. Madam Speaker, the 2022/2023 overall fiscal balance is estimated at a deficit of K884.0 billion, which is 7.7 percent of GDP. Effectively the 2022/2023 deficit as a percent of GDP is lower than the projected likely outturn in the 2021/2022 fiscal year although the 2021/2022 fiscal year was only for 9 months. Government has taken a decision to level and flatten this line from this financial year onwards. Government, Madam Speaker, intends to stabilize the debt creation processes and embark on a downward debt trajectory in the subsequent national budgets. The deficit Madam Speaker will be financed through foreign borrowing amounting to K230.07 billion and domestic borrowing amounting to K653.98 billion.].

The foreign borrowings brought in some forex in the country but this was overshadowed by the huge local borrowings which the Government used to purchase goods and services mainly imported and therefore send more forex abroad. In fact, it appears the National Assembly does not consider matters of improving the foreign currency exchange rate but rather leave this in the hands of the monetary authorities as noted in the Economic and

Fiscal Policy Statement (2019:11) as follows:

[Exchange rate policy

24. Since 2012, the Reserve Bank of Malawi (RBM) has implemented a floating exchange rate system and remains committed to this regime. This is aimed at allowing the kwacha to adjust to domestic and international developments. Nevertheless, the Bank will continue to monitor the foreign exchange market and intervene in case of excessive volatility which pose risk to financial stability. In such circumstances, the RBM will take necessary measures in order to make sure that the foreign exchange market operates efficiently.]

Economic and Fiscal Policy Statement (2021:12) averred:

[Exchange rate policy

28. Government through the Reserve Bank of Malawi will continue to pursue a flexible exchange rate regime that is market-determined while managing excessive exchange rate fluctuations. The exchange rate remained relatively stable over the past year despite adverse developments in our external accounts, amidst Covid-19 pandemic. The country's trade balance remains weak and fragile. In 2020/21 FY, on the one hand, exports performed dismally due to reduced global demand, border closures, and heightened trade transit costs resulting from economic disruptions in neighboring countries. On the other hand, imports remained elevated. This heightened demand for foreign exchange amidst significantly lower supply.].

This is a clear understanding that Parliament does not take any measures to influence the exchange rate and this is a substantial anomaly since cost push inflation in Malawi is triggered by adverse movement of price of products such as petroleum and inorganic fertilisers as these are imported. Parliament ought to provide oversight function on the effectiveness of measures undertaken by the monetary authorities on the stability of the exchange rate and further explore ways utilising the tax code to discourage importation of less important and undesirable products into the country. It is more desirable to control import of certain products than making the Kwacha less affordable as suggested by World Bank (2022:30):

[If supported by adequate macroeconomic and structural policies, the exchange rate adjustment has the potential to make foreign exchange more widely available by both attracting foreign exchange supply through increased purchasing power and constricting demand for foreign exchange by making it less affordable.].

The view by World Bank (2022) above is fundamentally flawed because Malawi should limit what it can import by instituting appropriate tax regimes to achieve a set number of objectives including promoting local industry championed under “Buy Malawi Strategy”, discourage tying forex to non-productive assets, limit consumption of undesirable products particularly those considered health hazards etc.

Kampanje (2012b) recommended that Government of Malawi should adopt austerity measures such as reducing offshore trainings for few individuals and instead invite renowned trainers to impart knowledge and skills amongst a large group of the locals. It was also recommended that government projects should utilise local resources and imports only permitted where it is absolutely necessary. Furthermore, expenditures in the diplomatic missions should be prioritised to those bringing tangible benefits to the Malawian economy.

3.1 Malawian austerity measures in 2022

Government of Malawi through the incumbent regime has announced austerity measures from 1st June 2022 as observed by Nyasatimes (2022):

[The measures include restrictions on foreign trips for all government officials for the period between June and December this year.

They are a result of the current situation following the devaluation of the Kwacha which was meant to improve inflow of forex.

Some of the notable measures include slashing by 20 percent of fuel allocated to ministers, reduction to three international trips by government officials and restricting four meetings per year for all boards of government institution.].

The success of the austerity measures adopted by Government of Malawi will be known in due course but surely doing something is much better than none since the learning process can provide better ways of improving in the future.

3.2 Possible ways of reducing public debt

Government of Malawi (2021:2) annotated the following:

[3. Total Public Debt Stock
As at end-December 2020, Total Public Debt (TPD) stock amounted to MK4.76 trillion or 54 percent of rebased Gross Domestic Product (GDP1), up from MK4.13 trillion or 47 percent of rebased GDP, in June 2020. This translates into an increase of 15 percent or 7 percentage points of GDP between the two periods.

The end-December 2020 TPD stock comprised MK2.04 trillion2 (23 percent of GDP) external debt and MK2.72 trillion3 (31 percent of GDP) domestic debt.].

Government of Malawi (2021:2/3) further averred:

[4. External Public Debt
As at end December 2020, at 83.87 percent (US$2,214.78 million) of total external debt, multilateral creditors continued to account for the largest proportion of Malawi's external debt. This is compared with US$1,981.36 million (82.97 percent of total external debt) reported in June 2020.

Bilateral creditors accounted for 16.13 percent of all external debt (US$426.00 million). This is an increase from June 2020 position which was US$406.82 million representing 17.03 percent of total external debt. As of end December 2020, Central Government owed no debt to commercial creditors.].

World Bank (2022:21) states that historically, Malawi has financed its trade deficit primarily with transfers from abroad and through debt. The debt results in increase in money supply in the economy which in turn increase demand for forex thereby causing forex shortage and adverse movement in the exchange rate but more importantly, the cost of the debt has a substantial impact in the economy as noted by World Bank (2022:28) which projects that interest on debt will be 4.6 percent of Malawi's Gross Domestic Product but this can be higher in view of the recent devaluation of the local currency. Interest expense on external debt is projected to soar as noted by World Bank (2022:28):

[The Government projects a significant pick-up in foreign-financed development spending, from an outturn of 2.1 percent of GDP in FY2021/22 to 5.1 percent of GDP in FY2022/23 — the highest level in over a decade.].

It is important for National Assembly to slow down the expansionary fiscal policies by debt because it is unsustainable in the long-term. There are so many cost-cutting measures which can be explored without compromising public service delivery. Purchase of

expensive motor vehicles for officials and other benefits could reduce public expenditures as part of the fiscal contractionary policies which are not an option in current scenario.

3.3 Proposed additional fiscal measures

Parliament should evaluate all activities which likely deplete the forex and use the tax code as was proposed by Kampanje (2012b) as follows:

a) Increase tax vis-à-vis import duty by 100 percent on second-hand vehicles on any importer who has already imported at least two vehicles in any four year cycle. This is to discourage piling up of motor vehicles without buyers and therefore tie forex. No vehicle should enter Malawi if there is no evidence that it was imported through bank transfers and importer cleared of money laundering suspicions.
b) Income tax for expatriates must be increased by 200 percent for those without verifiable special skills which locals can ably do.
c) Introduce at least 16.5 percent VAT on foreign holiday trip allowance and business allowance. The tax on business allowance can be treated as allowable deduction if export proceeds can be verified from the business trip.
d) Introduce 200 percent excise duty on all inferior and substandard imported products. These should be destroyed to protect the consumers (these include

illegal scales and other measurement instruments for duping local agricultural producers and consumers in the markets).

e) Reintroduce pre-shipment inspection and upfront payment of duty and other taxes wherever possible.
f) Evaluate the tax code on the imported printed materials to discourage huge importation and promote recycling of paper. Imported printed materials are currently in the top five imports for Malawi.
g) Evaluate the tax code for imported plastics and introduce more Excise Duties to discourage use and importation of thin and non-reusable plastic. This can substantially reduce demand for plastic products whose import bill is in the top ten of Malawi's imports value.

4.0 Conclusion and recommendations

The monetary policies do not follow the causality principle. They simply look at the data to determine the demand-supply scenario and simply decide whether the local currency is overvalued or not. Devaluing the local currency or allowing it to depreciate simply increases prospects for cost-push inflation which ultimately hurts the local poor masses even more.

The ultimate guardrail of forex reserves in Malawi should be the National Assembly whose sole existence is to serve the needs of the Malawians. The monetary authorities can

intervene in the market forces to stabilise the value of the Malawi Kwacha against major trading currencies but have limited capacity to influence on how forex in Malawi can be externalised or what measures can be done to keep more forex only meant for crucial imports. Parliament through fiscal policies is able to do so and it is now time Malawi must adopt contractionary fiscal policies by spending less on non-essential expenses such as foreign travel, suspend purchase of new fleets of vehicles but above, use the tax code to discourage importation of non-essential items into Malawi.

References

2021/2022 National Budget Statement, Delivered in the National Assembly of the Republic of Malawi by Minister of Finance, Honourable Felix Mlusu at the Parliament Building, Lilongwe on Friday, 28th May 2021.

2022/2023 National Budget Statement, Delivered in the National Assembly of the Republic of Malawi by Minister of Finance, Honourable Sosten Alfred Gwengwe, MP at the Parliament Building, Lilongwe on Friday, 18th February 2022.

Butty, James. (2015) "Malawi Donors Want New, Tougher Conditions Before Resuming Aid", Voice of America, 25th November 2015 accessed at https://www.voanews.com/a/malawi-donors-want-new-tougher-conditions-before-resuming-aid/3072937.html

Chinsinga, Blessings. (2014) "The reality of the zero-aid budget in Malawi", Effective States and Inclusive Development Blog, accessed at https://www.effective-states.org/the-reality-of-the-zero-aid-budget-in-malawi/?cn-reloaded

Congressional Research Service (2021) *Fiscal Policy: Economic Effects,* R45723

Economic and Fiscal Policy Statement (2019), Republic of Malawi, Issued by the Honourable Minister of Finance, Economic Planning and Development In Terms of Section 14 of the Public Finance Management Act No 7 of 2003

Economic and Fiscal Policy Statement (2021), Republic of Malawi, Issued by the Honourable Minister of Finance, Economic Planning and Development In Terms of Section 14 of the Public Finance Management Act No 7 of 2003

Financial Stability Report (2015) – Reserve Bank of Malawi. June 2015

Government of Malawi (2021) *Mid Year Public Debt Report for 2020/2021 Financial Year*

International Monetary Fund (2021) "Malawi 2021 Article IV Consultation—Press Release; Staff Report; and Statement by the Executive Director for Malawi" IMF Country Report No 21/269, Statement by Ms. Mannathoko and Ms. Nainda on Malawi December 13, 2021.

Kampanje, Brian. Phiri. (2012) "Multinational Banks operating in Hyperinflationary Economies", *SSRN Applied Accounting Practitioner eJournal,* Vol. 4, No. 38. Also available at http://ssrn.com/abstract=2099831

Kampanje, Brian. Phiri. (2012b) "Resolving fuel shortage in Malawi", *SSRN Public Economics: National Government Expenditures & Related Policies eJournal,* Vol. 7, No. 19. Also available at http://ssrn.com/abstract=2038110.

Malawi Economic Recovery Plan (2012)

Monetary Policy Report July (2022), Reserve Bank of Malawi

National Export Strategy (2013)

National Export Strategy II (2021)

Nyasatimes (2022) "Government implements Chakwera austerity measures as lakeshore meetings are banned", Nyasatimes, 8th June 2022, accessed at https://www.nyasatimes.com/government-implements-chakwera-austerity-measures-as-lakeshore-meetings-are-banned/

Reserve Bank of Malawi (2019) *2019-2021 Strategic Plan*

Reserve Bank of Malawi (2022) *Foreign Exchange Situation in the Country,* Press Release, 26th May 2022.

Reserve Bank of Malawi (2016a) *Impact of Kwacha Exchange Rate Movement on Exporters,* Press Statement, 11th March 2016.

Reserve Bank of Malawi (2016b) *Malawi Kwacha Depreciation and Near Term Prospects,* Press Statement, 28th January 2016.

Rubi, Miguel. (2009) "The Causality Principle: Complexity is the limit", *In Confluence: Interdisciplinary communications 2007/2008,* Edited by Osberg, W. 199-122. Oslo.; Norway: Centre for Advanced Study, Norwegian Academy of Science and Letters.

World Bank (2022) "Strengthening Fiscal Resilience and Service Delivery", *Malawi Economic Monitor,* 15th Edition, 15th June 2002.