

Chapter 2

Background, Structure and Financial Reforms

“It has been said that figures rule the world; maybe. I am quite sure that it is figures which show whether it is being ruled well or badly”.

(Goethe 1749–1832)

2.1 Introduction

Owing to persistent slowdown in economic growth and failure to achieve significant improvement in the standard of living, the period of early 1980s witnessed, almost worldwide, radical initiatives aimed at safeguarding and intensifying national economic performance in a more competitive world in many developing countries. A number of new programs were aimed at stimulating productivity and improving the economic environment in a national, regional and international context (Himbara, 1994). For African countries, despite this integration of the economic environment of the world and recognition of the need for new social, economic and political strategies, the Sub-Saharan African economic direction remained unaltered. Surprisingly, as noted by Himbara, the region remained engrossed in a crisis that consisted of every conceivable malaise. In total even ‘where population were not threatened by starvation, disease, or war, dissipation of the economic infrastructure amidst astonishingly widespread corruption became the norm’ (p. 2). Due to these reasons and under such circumstances African countries became increasingly marginalized in the 1980s and early 1990s. Clearly by the mid 1980s symptoms of malaise were evident everywhere. The returns on investment projects were relatively much lower in Africa than in other regions and more than a quarter of the existing projects failed to generate a positive rate of return (World Bank, 1994). This resulted in a drastic reduction in the region’s share of international trade and foreign direct investment. In effect, Sub-Saharan African countries (SSA) had the least growth compared to other developing regions (and more so as compared to East Asian Economies) (World Bank). Clearly it was time for Sub-Saharan African countries to begin to adjust and improve their policies to restore economic growth

along with other developing countries including Thailand. Beginning with late 1980s many governments of the region undertook major policy reform programs and restructured their economies to varying extents. Thus this was the beginning of the era of the 'structural adjustment program' with the objective of establishing a market-friendly set of incentives that can encourage the accumulation of capital and more efficient allocation of resources.¹ As part of the structural adjustment program, financial systems (markets) were restructured in most of the countries, with a major emphasis on liberalization measures and reduction or removal of controls and state interventions.

The impacts of these reform measures seem to have had little positive effect in this region so far (Nissanke & Aryeetey, 1998). In particular, despite efforts to improve the macroeconomic environment and strengthen the public and private sectors, savings rates in Sub-Saharan African countries remained low while GDP growth rates show minimal improvement (see Table 2.1). Various studies have attempted to explain Africa's poor performance before and after reforms, mostly employing different quantitative tools to analyse econometrically the factors behind the economic stagnation and decline of the region. This includes some of the recent work such as Oyejide (2000), Hoeffler (1999), and Ghura and Hajimichael (1996). These studies generally conclude that poor policies and some hostile external factors account for the major part of the low economic growth in Africa. However, due to inherent limitations in the use of statistical data for African economies, the quantitative analysis cannot be considered to exhaust the possibilities in explaining African growth. There are a number of reasons as to why econometric analysis does not fully explain Africa's low growth. Firstly, the statistical data used for econometric analysis is either inconsistent or highly subject to errors in measuring the variables (Nyawata & Bird, 2003; Aryeetey & Udry, 2000). Secondly, the easily accessible policy indicators fail to capture the intricacies of policy intervention. It is a clear fact that states in Africa play an active part in setting prices, nationalizing banks, controlling allocation of funds, creating public monopolies for agricultural export, restricting the activities of the private sector through directly or indirectly regulating them, and creating many state enterprises for various economic and non-economic reasons. None of these interventions or their impact is easily quantifiable since the required data are unavailable or unreliable. Lastly, in the 1970s and 1980s there was a widespread deterioration in governance. As states tried to meet the aspirations for quick developments which were promised during independence, the role of the state expanded rapidly, influencing each and every economic activity. More often political interest preceded a country's developmental targets. To such an extent, the government becomes an object of political annexation rather a target of policy. Precisely Jackson (1977) sums this up, by referring to government in Africa as 'neither wholly public nor wholly private' but rather 'para-public'. Realistically then, the cost associated with poor governance extends beyond what

¹These were some of the objectives of the adjustment program according to the World Bank, which could have been different from the point of view individual countries.

Table 2.1 Assessing the impact of structural adjustment program for African countries

Country	GDP growth rate		Gross Dom. savings		Private savings rate		Public savings rate		Investment (% GDP)	
	1981–1986	87–97	1981–1986	87–97	1981–1986	87–97	1981–1986	87–97	1981–1986	87–97
Botswana ^a	5.9	6.7	26.1	38.8	-1.1	16.0	26.8	29.6	31.6	23.6
Burkina Faso ^a	3.9	3.7	-4.3	6.9	-3.2	3.3	-1.1	0.5	20.0	22.5
Burundi ^b	4.2	-0.3	3.1	-1.3	1.7	-2.0	1.4	1.5	16.4	14.1
Cameroon	5.7	-1.6	29.1	19.3	18.5	19.9	10.6	0.3	24.8	17.2
Cote d'Ivoire	0.0	2.2	21.3	15.6	18.1	22.4	3.2	-9.8	17.9	11.0
Gabon	-0.7	3.3	49.2	39.1	33.1	34.2	16.0	-1.0	37.2	25.6
Gambia ^a	3.2	3.1	6.2	6.3	7.6	8.4	-1.4	1.0	19.0	19.8
Ghana ^a	2.7	4.5	5.6	7.7	7.3	2.2	-1.7	2.6	6.3	18.0
Kenya ^b	3.6	3.2	20.7	15.3	20.8	16.4	-0.1	-1.1	23.1	18.1
Madagascar ^b	1.0	1.5	1.9	4.7	1.7	3.2	0.2	1.5	9.1	11.8
Malawi ^b	3.2	3.7	13.3	5.8	16.0	11.0	-2.7	-0.3	17.6	19.2
Mali ^b	2.6	3.3	-2.9	6.3	-0.6	4.2	-2.3	0.8	17.2	22.4
Niger ^b	-3.0	1.5	5.1	4.4	5.4	9.0	-0.3	-2.7	12.9	10.1
Nigeria ^a	-0.1	4.0	14.4	24.1	10.8	25.6	3.6	-1.2	16.5	18.4
Senegal ^b	3.1	2.7	-0.4	8.5	2.9	7.5	-3.3	-0.1	11.2	14.9
Sierra Leone	-0.5	-1.8	7.4	2.6	16.3	21.1	-8.9	-8.0	13.9	8.9
Tanzania ^a	2.6	3.1	9.7	1.5	13.9	2.9	-4.2	-1.6	18.3	22.6
Zimbabwe ^a	1.6	3.7	17.9	17.3	21.6	19.3	-3.7	-2.5	19.6	18.9

^aIndicates that the country showed large improvement in macroeconomic indicators^bIndicates that the country showed little improvement in macroeconomic indicators, while the rest showed some sign of deterioration. Gross domestic, private, public saving rates and investment share are all in percentage of GDP.

Source: World Development Indicators (various issues) and Nisanke and Aryeetey (1998).

is usually captured in policy variables. In this regard, this study intends to assess the impact of the recent financial liberalization in many Sub-Saharan African and Asian countries using a case study approach on a sample of three countries from the region (Kenya, Malawi, and Botswana) and Thailand in Asia in which reforms were implemented.

2.2 The Case of Kenya

Kenya was a British colony and protectorate from as early as 1890 and gained its independence in 1963. Immediately after independence, the country inherited an economic system and infrastructure that made it possible to formulate and administer development plans and other important policies. During the early years of independence, the government had a number of development programs aimed to increase productivity through developing agricultural sectors, and training the people to assume a greater role in the economy. The *Swynnerton plan* for land reform was fully implemented.² This was to ensure that land development occurred and at the same time progressive farmers emerged, who would be able to obtain credit by mortgaging their property rights (Azam & Daubree, 1997). In addition, the *Development Program 1963–1967* outlined priority areas which were to receive a large share of government expenditure. This program included improving education and infrastructure, extending government administration, and training manpower. These sectors were viewed to provide a quick return in a shorter period of time (IBRD, 1963). Through these policies and considering projections from development programs, it can be said that the Kenyan government started from a situation of great advantage in what has been done prior and immediately after, often cited as equal to the best in Africa. The pay-off from these bold steps was immediately observed. In the first 15 years of post independence saw the Kenyan economy grow at an average annual rate of 6.7%, believed to be one of the highest in Africa during this period.

Post-1963 Economic Performance: Table 2.2 shows actual and predicted per worker economic growth decomposition, where an upward surge in the growth rate in the 1964–1980 period is observable. It is clear that the growth in the early years was higher than predicted by the outside academics. There was a substantial improvement in the growth of physical capital as well as the education per worker until the early 1980s. It is necessary then, to look at some of the events that took place during this period, which led to such an improvement. Specifically, if we look at the investment trend (see Table 2.3), the ratio of investment to GDP improved reasonably, reaching an average of 16% for the period of 1960–1964, and further improved to 18.3% in the 1965–1969 period. Following independence, the uncertainties

²This was a plan to intensify the development of the agricultural sector by transforming the economy of the land and extending individual and cooperative ownership. For specific details refer to IBRD (1963).

Table 2.2 Decomposition of Kenya's economic growth (percentage)

Period	Growth in real GDP per worker	Predicted growth in real GDP per worker	Growth in physical capital per worker	Growth in education per worker
1960–1964	0.38	0.31	–2.60	0.03
1965–1969	3.67	1.37	1.05	1.15
1970–1974	4.85	2.46	1.39	1.51
1975–1979	1.62	2.21	0.46	1.14
1980–1984	–0.76	1.45	1.30	0.87
1985–1989	1.99	1.18	–1.90	0.73
1990–1994	–1.83	0.92	–2.60	0.43

Source: Mwega and Ndungu (2002).

Table 2.3 Investment and education indicators

Period	Initial real GDP per capita 1985 prices	Initial average years of education attained population ≥ 15 years	Ratio of investment to GDP at current international prices
1960–1964	659	1.5	16.1
1965–1969	614	1.7	18.3
1970–1974	586	2.2	19.3
1975–1979	837	2.2	15.1
1980–1984	911	3.4	13.7
1985–1989	794	3.4	11.9
1990–1997	911	3.7	7.2

Source: Hoeffler (1999) and *Penn World Tables*, Mark 6.1.

of the transition period diminished and the government began to increase its own development spending while private investment quickly recovered (Mwega & Ndungu, 2002). Investment in human capital development increased as the government enabled schools to expand into rural areas and enrolment rates improved substantially. This raised the average years of schooling for those of at least 15 years of age in the population to 1.7 in 1969 from 1.5 in 1965. Owing to this, Azam and Dubree (1997) report that up until the boom in tropical beverages in the late 1970s, the Kenyan economic growth was driven by accumulation of human capital whereas the physical capital lagged behind.

The trend in gross domestic investment was upward till 1980 in Kenya, while the general downturn experienced afterwards was less immediately drastic. One reason that could explain this is that the country was moderately indebted during this period, and hence was able to allocate enough of its national income to domestic investment (Himbara, 1994). The government also pursued strategies that emphasized economic development over equity and built upon the institutions and policies inherited from the colonial era. Such policies included emphasis on private sector growth, and expanding production of the two principal crops – coffee and tea – for which the country enjoyed a comparative advantage in the world market and which could be grown by small farmers. Further, this attitude also helped increase the

receptivity of foreign private investment (Barkan, 1994). In pursuit of this expansionary phase, the government expenditure increased rapidly during the mid 1960s and early 1970s (Table 2.4).³ A number of reasons necessitated this, first, there was a pressure on the government after independence to expand facilities and harness production from various regions across the country. Second, such expenditure was necessary for the government to consolidate ethnic harmony among diverse tribes in Kenya, and consequently a significant portion of the budgetary expenditure went to rural development and settlement, and administrative expansion. Despite this, there was macroeconomic stability, as inflation generally remained low. The monetary policy was very conservative and the rate of expansion in money supply was low. This was because the public sector was also pre-empting an increased share of total resources to finance its activities (Mwega & Ndungu, 2002). Understandably, Kenya did have a competitive edge over many countries around the region even as the country attained its independence. Having the largest port in East Africa and a railway system that connected a large part of the country, it was well placed to become a manufacturing and service hub for East and Central Africa. The East African Co-operation treaty⁴ which was signed in 1967 enabled expansion of free trade within the Eastern African community and Kenya became a large supplier of manufactured goods and petroleum products within East Africa (Azam & Daubree, 1997). In this regard, the country was already fairly industrialized with significant manufacturing exports in the mid 1960s and it was already a step ahead of a number of today's African economic giants as noted by Himbara. By 1965, Kenya earned US\$14 million from manufacturing exports compared to US\$1 million for the combined total earned by Mauritius and Botswana in the same year (World Bank, 1989).

2.2.1 The Structure of the Financial System

Kenya had an operative financial system as early as 1910 following the British occupation and the construction of the Kenya-Uganda railway. As at 1956, Kenya had 3 large foreign banks which dominated the sector for quite a long period: National and Grindlays Bank, the Standard Bank of South Africa, and the Bank of India, while a number of others were founded a few years later.⁵ At independence, the country shared a monetary institute with Tanzania and Uganda, and therefore had a developed financial sector by African standards. Various problems with the

³With long collection lags and fixed level of expenditures, the money value of taxes deteriorated with prices raising, resulting widening deficit in real terms. On the other hand, foreign loans and aid disbursement declined from 8.15% in 1972 to 4.2% of GDP in 1996 (Mwega & Ndungu, 2002).

⁴This free trade agreement was signed by Kenya, Tanzania and Uganda in 1967, but the East African community had a custom union as early as 1937 (Hazelwood, 1979).

⁵NSE (2001) gives a historical background of the financial system in Kenya, including dates of establishment of numerous today's famous banks.

Table 2.4 Real economic growth rates in various sectors (*annual percentage rate*)

Sector	1960–1964	1965–1969	1970–1974	1975–1979	1980–1984	1985–1989	1990–1994	1995–1999
GDP growth	3.86	7.2	8.9	5.4	2.8	5.7	1.6	2.7
Government	12.0	14.9	17.1	18.4	18.5	18.1	16.7	16.1
Population	3.1	3.3	3.5	3.7	3.7	3.3	2.8	2.5
Agriculture (%GDP)	39.4	35.6	34.1	37.1	33.3	31.9	29.5	27.6
Manufacturing (%GDP)	9.7	11.4	12.1	11.8	12.2	11.7	11.2	10.8
Inflation	1.5	2.1	7.8	14.1	13.6	9.9	28.0	6.0

Source: World Bank, *World Tables* (several editions).

Table 2.5 Important events that had significant economic influence in Kenya

Date	Event
1977	Collapse of East African community
1976–1979	Terms of trade improvement (coffee boom)
1979	Oil price shock
1983–1984	Severe drought across the country
1991	Oil price shock following Gulf war
1991	Financial liberalization following structural adjustment program
1991–1993	Aid suspension
1992	Ethnic clashes (first multiparty elections)
1997–1998	Changes in weather condition (El-Nino rains)
1997–2000	Further aid embargo
1999	Extended drought (power supply shortage in many parts of the country)

Source: Authors' compilation from various publications.

East African Currency Board and the need for each country to pursue different economic and political policies prompted the establishment of the Central Bank of Kenya in 1966 (see Table 2.5 for other related reasons). From then on, Kenya had an independent monetary policy. Through the Central Bank Act, the Central Bank had supervisory powers over commercial banks and financial institutions. Up until 1991, the Central Bank used four main instruments for conducting its monetary policies (Central Bank, 2000). The minimum liquid asset ratio was first imposed on commercial banks at 12.5% of their deposit liabilities and later (in 1974) extended to cover other deposit taking financial institutions (NBFIs).⁶ The Central Bank also required commercial banks to maintain a cash balance calculated as a percentage of their deposit liabilities.⁷

The objective of this was to reduce banks' free cash reserve and enhance their capacity to give loans. Another instrument that was most consistently used was the quantitative credit guidelines for the growth of bank credit. These guidelines were meant to influence the directions of credit and encourage lending to sectors of high priority.⁸ Finally, the Central Bank also used interest rate structure to direct credit growth and to promote savings. The bank pursued a low interest rate policy during the first 20 years of independence in order to encourage investment and protect small borrowers (Central Bank, 2000).

During this period both the inflation rate and the spread between lending and deposit rates were low (see Fig. 2.1) while the real interest rate remained negative or insignificantly positive. Conventionally, such a low interest rate did not encourage savings, however, it did enable the government to finance its expenditure cheaply (Mwega & Ndungu, 2002). Initially there was a statutory limit to the

⁶The minimum liquid asset ratio for NBFIs was set at 10%.

⁷In particular this was used from late 1971 onwards.

⁸For example the banks were required to extend 17% of their deposit liabilities as credit to agriculture.

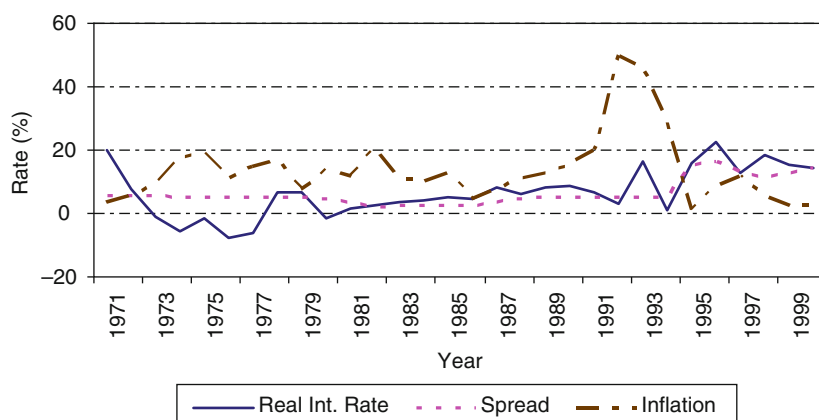


Fig. 2.1 Inflation and interest rate movements

Source: World Bank, *World Tables* and *World Development Indicators*, various issues.

Table 2.6 Government deficit financing (5 years averages)

Indicator	1969–1973	1974–1978	1978–1983	1984–1988
Public saving (%GDP)	1.5	2.3	0.7	–2.0
Budget deficit (%GDP)	–4.9	–7.1	–9.4	–5.0
Bank loans (%GDP)	0.7	1.6	1.5	1.7
Share of private sector (in total domestic credit)	82.0	71.0	65.0	58.0

Note: Bank loans do not include borrowing by public enterprises. Public saving is current account balance/GDP and budget deficit is the overall expenditures in excess of revenues including external grants as a percentage of GDP.

Source: Azam and Dubree (1997).

amount of credit the Central Bank could extend to the government, but that provision was scrapped in 1972, enabling the Central Bank to put ceiling on lending by commercial banks, in particular to the private sector and to impose directives regarding the allocation of credit (Azam & Daubree, 1997). As can be seen from Table 2.6, the government did not keep fiscal discipline, especially from 1970. The budget deficit was 4.9% in 1963–1973, rising to 7.1% and 9.4% in 1974–1978 and 1979–1983 periods respectively. Eventually the government turned to monetary financing of these deficits. In assessing the budget deficit and public savings, we observe that public saving was quite low, quite reasonably indicating that the deficit was mainly due to public investment. Additionally, it can be observed that the share of the private sector gradually decreased as lending to the state and public sector increased, due to budget deficits.

Undoubtedly this is an obvious case of crowding out of the private sector. In this regard, and as noted in Figure 2.1, there are clear signs of financial repression as substantiated by a systematically negative real interest rate from 1972 to 1982. The nominal interest rate also shows clear signs of rigidity as the spread appears to be

constant throughout the period. On average the real interest rate was marginally low, obviously showing excess demand for credit, leading to the rationing of credit by the banking system. Consequently, this gave the government some level of discretionary power over the allocation of investment, power that it did not fail to use to channel funds to the public sector or financing the deficit (Killick & Mwega, 1990). Nevertheless, even though the low interest rate structure did not encourage savings, capital accumulation was enabled since it was indirectly subsidized, resulting in a capital intensive import substitution industrialization strategy.

As noted by Mwega and Ndungu (2002), this was going to affect the economy in three major directions. Firstly, with cheap availability of capital, firms invested in significant capacities assuming that future demand for their goods would not constrain production. Additionally, given the rising rate of population growth in this period and labour abundance in the country, such a trend did not help the labour market, resulting in a production sector that is capital intensive in labour abundant state. Lastly, given the umbrella protection and political patronage, the heavy investment capacities led to low capacity utilization given the size of the market. This led to underutilization in various sub-sectors, raising average overhead cost. Under such a production system, product prices increased further and further damaging profitability. Accordingly, the economic system could not be efficient and the production level was far from optimal. Admittedly, though the GDP growth was still positive, undoubtedly this was going to have a negative impact on the economic performance in the long-run.

In parallel with the above policies, the banking industry expanded rapidly during the 1968–1980 period. This was part of the government policy of nationalizing institutions and allowing greater local participation. In 1968 the government established National Bank of Kenya (NBK) and 3 years later it acquired 60% of the National and Grindlays Bank, renaming it Kenya Commercial Bank (KCB). Both these banks increased their branches across the country and soon KCB was the largest bank in terms of deposits, having 49 branches out of 161 bank branches in the country (Azam & Daubree, 1997). In line with the *Development Plan 1964–1970*, the government had two objectives in doing this. Firstly, it wanted to promote vigorously the African people's participation in every sphere of the national economy, hence giving them greater access to credit, while loosening the domination of the banking structure by a few powerful banks (Grosh, 1990). Secondly, by increasing the government share in the banking sector, it would facilitate expansion of credit to priority sectors and redistribute activity towards less favoured regions. As the government invested heavily in the financial sector, Kenya's financial sector grew steadily in the 1980s as indicated by the growth of the share of the financial sector in GDP from 9.8% in 1974 to 12.4% in 1980.⁹ Subsequently the deposits at the public owned banks and other non-bank financial institutions increased significantly, reaching 37.5% of all deposits of the Kenyan financial sector.

⁹Refer to Mwega and Ndungu (2002) for further discussion on this and for the breakdown of contributions by other important sectors.

However, due to financial repression policies, the nationalized banks were subject to various forms of government pressure that frequently threatened their efficiency (Azam & Daubree, 1997). Such banks were required to extend their services to areas that were disadvantaged, where returns were low. Additionally they were subjected to pressure from specific political groups who channelled funds into projects with returns below par in the name of priority areas. Further, the nationalized banks were quite often called in to help drowned public and parastatal enterprises in different sectors by injecting funds using doubtful justification. Indeed, with time, the financial sector led by national banks grew weaker and weaker. As noted by Mwega and Ndungu (2002), such banks were extensively used to fund state enterprises which were often unable to service their loans due to poor management, ineffective statutory power to raise funds independently and vulnerability to political patronage and abuse. Due to such practices, it is reasonable that the size of non-performing loans increased in this period. By late 1980, it was estimated that bad loans made up at least 15% of the loan books of both NBK and KCB (Grosh, 1990).

2.2.2 Agricultural Sector and Other Policies Framework

Since the British rule, Kenya's rate of economic growth and improvement in the standard of living has depended primarily on development in the agricultural sector. As early as 1950 tea and coffee alone contributed more than 30% of the total export (IBRD, 1963) and in 1961 the two crops contributed 42% of the total value of export. In the early years of independence, economic policies were geared towards expanding agricultural production to increase the prospect for world trade in commodities the country had competitive advantage to produce. Following *Sessional Paper No.1*,¹⁰ a substantial amount of previously European owned land was transferred to local farmers and large resources were devoted to land registration and development (Bigsten & Ndungu, 1991). To increase productivity, high yielding crops were introduced and smallholder farmers were encouraged to increase the share of high value crops. Thus the agricultural sector contribution remained significant even after independence. In 1963, the share of agricultural production in GDP was 38% and on average this share was 35% for the period of 1961–1970 (see Table 2.4). Although in an expansionary phase, the government had overall budget discipline as fiscal and monetary policies were on the whole cautious (Bigsten & Ndungu). In effect agricultural productivity improved in between 1967 and 1969, but the agricultural policies were founded on the principle of equitable income distribution, employment and self efficiency (Mwega & Ndungu, 2002). To achieve this, the state was the sole decision maker, controlling prices and marketing channels of almost all major crops. These policies weakened the agricultural

¹⁰A detailed description of the content of this plan can be found in Kenya (1965).

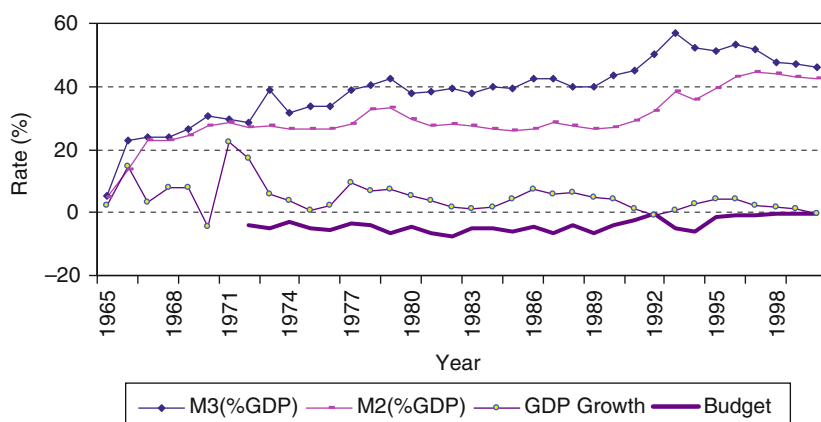


Fig. 2.2 Performance analysis in Kenya

Source: World Bank, World Tables and International Financial Statistics (IFS).

sector as it was not allowed to fully integrate with other sectors and the product market, while there was little incentive left for farmers to apply extra effort. In 1971, Kenya experienced its first balance of payment problems resulting from unfavourable terms of trade coupled with its expansionary budget (Fig. 2.2). This crisis was further worsened by the 1973 oil shock which caused a 30% increase in all other import prices (Bigsten & Ndungu, 1991).

Following this, a number of restrictive budgetary policies were introduced: (1) Import controls were increased, and specific quantitative restrictions were implemented. Import licensing became more restrictive as the government introduced highly protective policies for domestic producers, empowering them to authorize the imports of certain goods through a 'No Objection certificate'. Additionally the government set up a sales tax system which was biased against importers since local producers could do away with their dues benefiting them even further. (2) Domestic credit was restricted. Through the central bank the commercial banks and NBFIs were instructed to reduce their lending, resulting in a reduction in domestic credit to an annual average rate of 12.2% during 1971–1972 compared with 30.2% in 1970 (see also Table 2.6).¹¹ (3) In response to built-in price increase expectation, the government further tightened price controls. Consequently, in 1971–1972 inflation slowed down to an annual average of 4% compared with 7% in the previous year (Fig. 2.1).

With such huge policy intervention during this period, the Kenyan economy was once again on the whole closed after it had appeared relatively open for less than 5 years. Domestic competition and competitiveness reduced and shifted incentives

¹¹See also the behaviour of M2 (% of GDP) and M3 (% of GDP) during this period in Figure 2.2.

against export production (Mwega & Ndungu, 2002). The relatively smaller and weaker¹² manufacturing sector accrued all the incentives at the expense of important sectors such as agriculture and services which undoubtedly contributed most to the economic growth. While various policies were introduced during 1967–1971, the exchange rate was minimally used as an instrument of monetary policy. The Central Bank pursued a fixed exchange rate system between 1966 and 1982. Up to 1974, the Kenya shilling was pegged to the US dollar, but after a number of devaluations the peg was changed to Special Drawing Rights (SDR) (Ndungu, 1999). In an effort to arrest the deteriorating balance of payment (see Fig. 2.2), government borrowing from the banking system was reduced in fiscal years 1973 and 1974 while interest rates for both lending and deposits were raised for the first time (Fig. 2.1). But inflation accelerated again in 1975 to an average of 15.5% while the GDP growth was down to 2.8%, leading the way for investment and imports to fall drastically (see Fig. 2.3). In the wake of slowed economic growth, the government realised something was wrong. Through *Sessional Paper No.4 of 1975* a further strategy of coping with the crisis was spelled out. The Kenya shilling was devalued by 14% while an export subsidy of 10% was instituted, both aimed at improving the level of exports.

Subsequently while a tight credit stance was to be maintained, the government considered it necessary to channel more credit to agriculture in view of its significant contribution to the overall national economy. In this context the commercial banks were required to increase their loans to the agricultural sector from 14% in 1974 to 17% of their deposits in the following year. This is also reflected in the

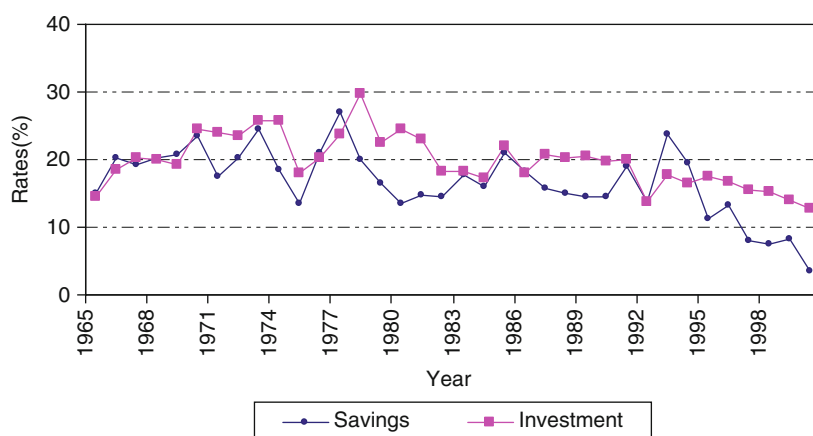


Fig. 2.3 Savings-investment analysis in Kenya

Source: African Development Indicators (various issues).

¹²Refer to my previous analysis for various reasons for inefficiencies in the manufacturing sector.

movement of both money supply (M2 and M3 in Fig. 2.2) and inflation (Fig. 2.1).¹³ Bigsten and Ndungu (1991) argue that following a temporary trade shock (the coffee boom of 1976–1979)¹⁴ the above mentioned economic restructuring was neglected. Due to a temporary external shock, the price Kenya received for its coffee exports significantly increased between 1975 and 1977. Initially the boom directly constituted a 38% improvement in the barter terms of trade, but it further instigated a substantial improvement in the Kenya tea prices and other export items, taking the total terms of trade improvement to 54% (Bevan, Collier, & Gunning, 1999). As the prices of both coffee and tea increased and exports improved, a large part of the gains was to be passed on to the producers, while after a certain period the government revenue and public expenditure both increased remarkably. This income gain redirected the private sector interest in the agricultural sector and the growth in the industrial sector also improved to 14% in 1977. Effectively then, the average real GDP growth for the 3 years of the windfall was 6.8% (Azam & Daubree, 1997). The improvement in income during this period also resulted in changes in savings and investment rates (see Fig. 2.3). Enhancement in the income of peasant coffee and tea farmers triggered significant increases in their savings. It is estimated that in the first year of the windfall, the farmers saved about 45% of their windfall income in bank deposits (Bevan et al., 1999).¹⁵ Following the windfall, the relative size of the government budget increased dramatically beginning with 1977, causing rapid expansion in government spending (Table 2.7). In this regard, over the years what really mattered for the progress of the economy was not only why did government spending increase but where did such expenditure fall

Table 2.7 Fiscal aggregates over 1976–1983 following the coffee boom

Year	Total revenue	Total expenditure	Consumption	Gross fixed Capital formation	Surplus/deficit
1976	4.2	9.5	8.1	1.5	−5.3
1977	36.6	28.9	22.7	6.1	7.7
1978	38.4	48.5	41.7	7.4	0.0
1979	76.8	84.1	63.7	20.2	−7.3
1980	86.7	94.9	67.5	27.4	−8.2
1981	72.9	84.7	85.5	9.3	−21.8
1982	57.6	69.4	77.5	−8.1	−11.8
1983	52.7	49.2	58.2	−9.1	3.4

Note: All figures are in million of Kenya shillings.

Source: Bevan, Collier and Gunning (1999).

¹³For close comparison of money supply, domestic credit and interest rate movement in this period refer to Ndungu (1999).

¹⁴The boom did not actually result from coffee alone; in fact the price of most of the tropical beverages improved in one way or the other, but since coffee accounted for more than 70% of the terms of trade improvement, Bevan, Collier, and Gunning (1999) as well as other researchers termed this as the coffee boom.

¹⁵This trend is also revealed in Figure 2.3 where dramatic upward swings in savings and later investment rates are especially distinguishable.

to. The data indicate that the bulk of the increase in the spending was in form of consumption, though initially there was some level of success in raising the development component of the budget relative to the recurrent component.¹⁶

The gross capital formation did not improve much consistently and was reduced to a very small share of the GDP at the end of the period. Beginning with 1976, rapid increase in government revenue is observable. Bevan et al. (1999) observe that the increase resulted from indirect taxation and foreign borrowing. Both sales taxes and import duties were raised for the purpose of financing the expenditure increase resulting from the boom. However due to a large drought in 1979 and the second oil price hike, the government increased its level of foreign borrowings. In the period of 1978–1981, 15% of the budget was financed by external loans and grants following a fiscal deficit of 1.9% of GDP. Such action did not favour future economic improvement because the policy makers chose to increase future debt-servicing rather than immediately crowding out private domestic capital formation (Bevan et al., 1999). In sum, the evidence from various sources suggests that the government did not create the required regulatory framework to maximize the benefit of the temporary trade shock. The existing financial and monetary policy did not encourage private savings. The unanticipated gain by the private sector induced an investment boom leading to a rise in the demand for non-tradable goods. Therefore the private windfall saving was channelled to the construction industry, causing a surge in imports of consumer durables and a general increase in the price level due to a temporary expansion in disposable income. Inflation accelerated from year to year, reaching the peak in 1982, while the overall budget deficit continued to widen, hitting 10% of the GDP in 1980. This proved hard to reverse largely because the growth rate of the population was quite high, bypassing GDP growth for the first time in 1980. Similarly, the public sector workforce had increased during the boom (Bigsten & Ndungu, 1991). The large fiscal deficit of late 1980s made it extremely difficult for the government to contain its spending, necessitating a new credit negotiation with the IMF. This expensive foreign borrowing to sustain economic growth in the 1980s meant a rise in the debt-service ratio to over 30% at the end of the 1980s from 5% in the mid 1970s.

2.2.3 Liberalization and the Era of Structural Adjustments

For the large part of the late 1970s and early 1980s the government was faced with serious imbalances, increased external debt and a rapidly rising rate of population growth. These factors were eroding the basis for economic growth, and hence they paved the way for structural adjustment programs (SAPs). SAPs actually began in Kenya in the mid 1980s but because of shortcomings in the implementation, it was not until the early 1990s that some serious reform measures were implemented. The

¹⁶A breakdown of the fiscal pattern and analysis of transmission mechanism from private to public has been given by Bevan, Collier, and Gunning (1999, pp. 75–79).

objectives of SAPs in Kenya included initiating: macroeconomic policies that would promote stability, agricultural reforms that would help farmers improve productivity and trade policies that would boost exports and liberalize imports (World Bank, 1994). To a large extent these policies were intended to help markets and market development in Kenya through encouraging competition while minimizing the unnecessary government regulation and involvement. In the long-run this will encourage the accumulation of capital and enhance the efficiency of allocation of resources which are needed to move on to a faster economic growth path and reduction in the level of poverty. To enhance the competitiveness of the Kenyan product in the global market, a number of reform measures were taken. Of these the three most significant were trade liberalization, exchange rate adjustment and financial sector reforms.

As part of the structural adjustment program, prominent features of these stabilization measures included financial liberalization which involved the abolishment of directed credit mechanisms, removal of ceilings on interest rates and importantly, the pursuit of price stabilization through appropriate macro-policies. Meanwhile, there had also been other broad measures of the trade and exchange rate reforms. Improving terms of trade and increasing the level of export has ever been the goal of the Kenyan government, but many of the past policies hampered this target either directly or indirectly. Trade liberalization, both internal and external, received greater attention in various phases of the reform program (Mwega & Ndungu, 2002). Major steps that were taken to accomplish this included abolishing quantitative restriction (quotas), reducing tariff levels and introducing a more flexible exchange rate regime. Import barriers were also significantly reduced through lifting import controls. This enabled many domestic manufacturers, both in private and parastatals, to get access to imported inputs and to cheaper external credit to finance the required capital goods at a more reasonable exchange rate. Mwega and Ndungu report that between 1980 and 1985 alone, the share of items that could be imported without any attached restrictions increased from 24% to 48% of total value of imported items. In 1987–1988 the import licensing system underwent significant improvement while a wave of tariff reductions, which were instigated by World Bank as part of the adjustment program for the industrial sector, took place. Consequently, between 1987 and 1991, the number of goods subject to quotas reduced from 40.3% to 22.1% of the total. This drastic improvement in access to imported goods boosted the manufacturing sector, where quotas covered virtually 100% in 1986, 79% in 1988, 45% in 1990 and 28% in 1991 (Azam & Daubree, 1997). By the end of 1991 imports requiring licensing were largely restricted on health, security and environment reasons only (Mwega & Ndungu). Kenya generally pursued a fixed exchange rate policy for the period prior to 1982. The fixed exchange rate regime was replaced in 1983 by a more flexible regime. A crawling peg system was first introduced, where discrete devaluations were undertaken to account for inflation and external payment conditions. Following structural adjustment and financial reforms, further liberalization of the foreign exchange market was undertaken in 1993. The Foreign Exchange Bearer Certificate (Forex-Cs) was introduced by the Central Bank to curb capital flight and attract

foreign exchange outside the domestic banking system. A floating exchange rate system was adopted to enable reflection of external imbalances in the money market and supply constraint in the economy. Despite this, it immediately turned out that the exchange rate was no longer stable, imposing risks on importers, exporters and those with future contracts (Ndungu, 1999).¹⁷ This led to a significant uncertainty in the market and prices instability, producing a spiral of inflation (see Fig. 2.1).

2.3 The Case of Malawi

Malawi was a British protectorate from 1891 until it gained independence in 1964. Up until shortly before independence, the country had no established economic infrastructure as the level of technological adoption was low, domestic manufacturing was relatively insignificant and means of transportation and communication generally inadequate (Pryor, 1990). In addition to this underdeveloped economic condition, the country is geographically disadvantaged as Malawi is land locked, small and with few rough roads linking it to its neighbours. Given these conditions, Malawi had little chance for economic success following independence. Since the colonial government had relatively few economic policies to develop an economic platform, the new nation had to create plans for economic development and construction of an economic infrastructure. The new government concluded that the country's economic future lay in the export-oriented agricultural sector, and hence provided strong support for the agricultural development path (Channock, 1972). But the country started from such a low level of productivity that the long-term target of achieving an acceptable level of economic development seemed unattainable (Pryor, 1990). Further, the short-term problems were as many as the long-term ones. The government revenue resources were so limited that it could only cover about half of its expenditure,¹⁸ the requirements for investment were rising while domestic savings were clearly quite low (see Fig. 2.4).

Post-Independent Economic Performance: Malawi's GDP growth rates in real terms improved considerably from 1960 until the late 1970s when it started slowing down markedly. Specifically the surge in the real GDP growth was exceptionally significant from 1960 to 1974 (refer to Table 2.8 and Table 2.12). The real GDP grew at an average rate of 5.8% during first 5 years following independence (Pryor, 1990). During the subsequent half a decade, the economy even grew at an impressive rate registering an average annual growth rate above 7% (see Table 2.8). For the period of 1976–1980 the annual average growth rate was 5.1%, only subsequently moderately slowing down before hitting rock bottom in the late 1990s. However, looking at the state of the economy following independence,

¹⁷For example, in 1993 alone the Kenya Shilling was devalued three times losing about 70% of its value.

¹⁸This point is further elaborated by both Pryor (1990) and Channock (1972).

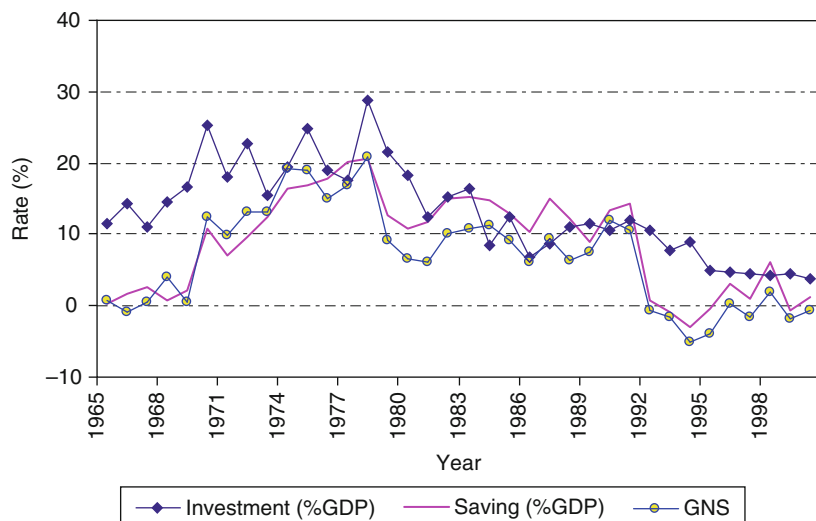


Fig. 2.4 Investment-savings analysis in Malawi

Note: GNS stands for gross national savings.

Source: World Bank, African Development Indicators.

such progress was not visible, and hence, the quick economic growth seemed spectacular. Chipeta and Mkandawire (2002) remark that a considerable level of structural transformation had also occurred during the period of 1964–1979. The share of agriculture in GDP declined on average from 46.1% in 1965–1970 to almost 41% in 1981–1985 while the share of manufacturing in GDP increased from 4.5%¹⁹ to 14% in the same period. Similarly, the share of industry as a whole to GDP increased from 15.7% to 21.2% respectively (refer to Table 2.11) due to an increase in import-substitution manufacturing. This indicates that despite Malawi placing agricultural development on top of the list priority sectors, other important sectors including manufacturing and industry as a whole also experienced satisfactory progress during the same period. Moreover, even though there was a reduction in the contribution of agriculture to the GDP, the locus of agricultural production also changed. Estate production significantly increased from 7% of the total agricultural value added in 1964 to 20% in 1979 (Pryor, 1990).

The above economic growth trend was only possible with the strategic and tactical economic policies undertaken by the government. In the period of 1964–1979 three major development plans were successfully implemented.²⁰ These development plans stressed the highest priority areas intended to increase productivity,

¹⁹This figure is according to Chipeta and Mkandawire (2002) though it is not provided in Table 2.11.

²⁰This includes the long-term development plan of 1965–1969, Gwedo No. 2 plan and DevPol I (Malawi, 1971).

Table 2.8 General macroeconomic indicators of Malawi (*percentage*)

Indicator	1971–1975	1976–1980	1981–1985	1986–1990	1991–1995	1996–2000
Growth rate of real GDP	7.6	5.1	2.2	2.3	3.5	4.0
Growth rate of GDP p/c	4.4	1.5	–1.1	–0.9	1.9	1.7
Current account deficit of BOP/GDP	10.6	15.6	9.3	5.3	20.5	30.4
Budget deficit including grants (% GDP)	1.6	8.9	8.8	5.7	4.2	6.2
Budget deficit excluding grants (% GDP)	2.5	12.1	9.3	7.8	13.5	19.8
Inflation	9.5	9.5	12.9	18.9	31.9	31.8

Source: World Bank, African Development Indicators.

Table 2.9 Total capital flows to Malawi

Period	LTD (US\$M)	Debt service (% of Exports)	Debt service (% of GNP)	FDI (%GDP)	Aid (% GNP)
1971–1975	210.4	n.a	2.5	1.4	8.4
1976–1980	403.7	15.1	3.9	0.5	9.6
1981–1985	711.6	34.4	9.0	0.1	11.8
1986–1990	1189.9	36.4	8.9	0.0	27.4
1991–1995	1,760.2	23.6	6.3	0.5	30.8
1996–2000	2,331.1	13.2	3.9	2.5	22.4

Note: LTD is the Long-Term Debt and FDI is the Foreign Direct Investment net inflows.

Source: World Bank, Global Development Finance.

allocated incentives for private investment and to some extent enhanced foreign trade. These plans constituted an integrated program intended to achieve specific aims (essential for economic progress) (Pryor, 1990). To achieve the objective of the abovementioned strategic plans, the government was able to mobilize the necessary funds, both externally and internally, by raising the level of savings (see the savings trend in Fig. 2.4). At independence, the gross domestic savings were 4% of the GDP while the gross national savings were almost insignificant. Chipeta and Mkandawire (1992) observe that together the gross domestic savings and gross national savings financed only 8% of total investment between 1967 and 1969. But from 1969 savings started catching up with investment. Both public and private sector savings increased rapidly, causing the gross domestic savings to increase to 14.9% in 1979 from 1% in 1965 (World Bank, 1985), financing almost 50% of the total investment. Further, because of the steps taken by the government to revive the private sector as well as expand income, internal sources of funds grew and foreign investment increased, while aid to GNP recorded 8.4% on average for the period of 1971–1975 (see Table 2.9).

As funds were mobilized from both domestic and foreign sources, investment as a share of GDP rose steadily from 8.9% in 1964 to 29.1% in 1974. The five year average of 1971–1975 stood at 23.8% from 16.4% for the period of 1964–1969 (see Fig. 2.4). Pryor (1990) has looked at the effectiveness of such high investment levels in Malawi. Using incremental capital ratio (ICOR) as a measure of investment effectiveness,²¹ he reports ICOR of 3.7 for the period 1964–1979, climbing to 9.9 in 1979–1986. This rate of ICOR was much lower than that of many African countries, indicating high investment effectiveness. Due to the suitable environment (socially and politically) that had been created by the government in the post-independence, the per capita GDP, investment and savings were able to increase remarkably. In particular, the political stability and visionary leadership enhanced the chances of mobilizing funds and providing strategic policies for economic take-off (Table 2.10).

²¹Note that the lower the measure of ICOR the higher the effectiveness, other things being equal.

Table 2.10 Major events that had significant economic influence in Malawi

Year	Event
1964	The country received its independence from British rule.
1971–1975	The country introduced new currency (Malawian Kwacha) to replace the Pound. In 1975 the Malawian Kwacha was pegged to Special Drawing Rights (SDR) of the IMF.
1979	Oil price shock and civil war in Mozambique.
1979	Terms of trade deterioration set in, eventually leading to financial difficulties in various sectors.
1981	Crop prices were adjusted to encourage production by smallholders to boost exports.
1982–1984	Series of devaluations of Kwacha to achieve balance of payments equilibrium. The Kwacha was later pegged to weighted basket of strong currencies.
1988	As part of structural adjustment program, import controls are relaxed and scope of export licensing reduced.
1989	Review of legal framework for financial sector leading into a new and revised legislation.
1990–1992	Interest rates are liberalized, credit controls eliminated and financial markets opened up to allow competition.
1994	Malawian Kwacha is floated for the first time.
1995	Stock market is established to integrate the financial system.
1995–1996	Public sector ‘downsizing’ begins as privatization is introduced.
1996	Introduction of Export Processing Zone (EPZ).

Source: Reserve Bank of Malawi, Financial and Economic Review (various issues), Chipeta and Mkandawire (2002) and UNDP (1999).

Chipeta and Mkandawire (2002) have attempted to decompose the economic growth in Malawi for the period of 1960–1997. They observe that physical capital per worker contributed more to the growth of real GDP per worker than education and total factor productivity. They note that for the period of 1960–1979, where GDP per capita had been high and increasing, the physical capital per worker had remained high. This is not a surprise as the investment rate was gradually increasing, while uncertainties over the political future of the country were over and with a peaceful transition, the government was able to lure foreign funds, either through grants or loans (see Table 2.9).

Beginning in 1979, the GDP per capita started falling as the upward trend in savings and investment reversed (Fig. 2.4).²² The investment share of the GDP fell from 30.2% in 1979 to 12.3% in 1986 while the gross domestic savings fell from 14.9% to 10.1% in the same period. Consequently the growth of real GDP per capita and physical capital per worker both subsequently declined. This led to a large resource gap where an amount equivalent to K30 million in real terms (at constant 1978 prices) were needed each year to meet the country’s total investment requirement

²²This was due to a combination of inconsistent government policy choices and repressive financial operations.

(Malawi, 1986). The economic slowdown of this period set in a widening budget deficit and triggered an upward pressure on inflation (see Table 2.8). As a result, the share of gross fixed capital started to decline while public investment fell on average from 16.3% and 14.4% in 1976–1980 to 10.8% and 9% in 1981–1985 respectively. For the first time, the government's long-term development policies appeared to have lost focus and the economy was generally forced to continue to rely heavily on external sources of finance (Chipeta & Mkandawire, 2002).

2.3.1 Structure of the Financial System

Having a sound financial system has been shown to be necessary for performing critical market functions, such as payment facilitation, savings mobilization, risk diversification, resource allocation and trade integration. An increasing body of literature demonstrates that financial sector development is very closely linked to economic development (see for example, World Bank (1994), King and Levine (1993), Fry (1988) and Goldsmith (1969)). Although Malawi was a British protectorate from 1891, the country did not inherit either a well functioning financial system or a good economic infrastructure at independence. This was partly because the colonial government found no mineral resources and extensive agricultural development (which the country was suitable for) was discouraged due to high transportation costs and lack of sea outlet (Pryor, 1990). Because of these factors, the colonial government had little control over the economy and did not take bold steps to build integrated economic institutions. Up to 1964 Malawi had no central bank although even during the colonial period some foreign interests owned several commercial banks (Chipeta & Mkandawire, 1992). In the post-independence era, as the country moved to realize its own economic philosophy and development ideology the Reserve Bank of Malawi (RBM) was founded. This was necessary to regulate the market as well as ensure the proper functioning of various economic units. The RBM officially started its operation in June 1965 taking over Malawi's share of the assets and liabilities of the Bank of Rhodesia and Nyasaland (Chipeta & Mkandawire).²³ As financial systems in Sub-Saharan African countries have traditionally been characterized by, interest rates were controlled in Malawi, and credits were directed while prices were heavily regulated, particularly for the period of 1964–1979. These severe market interventions which lead to limited competition and groom inefficiencies are behavioural traits of financial institutions under a financially repressive regime (Gibson & Tsakalotos, 1994). Chipeta and Mkandawire (2002) observe that central bank policies in Malawi, specially in the 1960s and 1970s encouraged financial repression, characterized by direct controls of bank credit, interest rates, and free entry into the financial markets. The RBM was passive rather than active in encouraging new entrants in the financial and banking sector. The main function of the bank remained as the regulatory body of the

²³This was an administrative federation to which Malawi belonged from 1954 to 1964.

banking sector and a major lender of the government but it played no major role in non-banking private sector. The banking sector has not been competitive as such, as the players were ever few. From independence, there were two banks (Barclays and Standard) which merged in 1971 to form the National Bank of Malawi (NBM). In 1970 a new commercial bank was established, named the Commercial Bank of Malawi (CBM).

It is surprising that up to the 1980s when the Malawian economy was growing remarkably, these two banks were the only commercial banks competing with few other Non-Bank Financial Institutions (NBFIs). Together for the period of 1964–1979 there were eight financial institutions including six NBFIs, of which only three were newly established (Chipeta & Mkandawire, 2002). Malawi experienced a high degree of financial repression from independence until the early 1980s, with administered interest rates, a credit ceiling, a segmented capital market and high intermediation costs. Apparently until July 1987 the RBM set the prime lending rates, allowing the central government borrow large amounts cheaply. Accordingly, for most of the 1970s and early 1980s the real interest rates were either very low or negative (refer to Table 2.14). Despite setting the prime lending rate, the central bank did not enforce any specific mechanism to mobilize savings beyond its regulative responsibility over the commercial banks (Cromwell, 1992). Commercial banks and other financial institutions determined by themselves what facilities to offer to the public as they created savings deposit instruments deemed profitable (Chirwa, 2001). Due to the passive role by the RBM there were no incentives for entrance by new financial institutions into the financial market as the old institutions consolidated their monopoly power. To some extent, this must have limited the resource mobilization since the Central Bank might have assisted in increasing the level of savings mobilization by playing a more active role in institutional development in the financial sector (Bhatt, 1986).

Despite the lack of competition in the banking sector, the commercial banks provided a large range of deposit instruments and a wider network of savings infrastructure which enabled steady increase of savings, particularly in the private sector. Chipeta and Mkandawire (1992) recognize that the major source of savings in Malawi has been the private sector, which accounted for more than 80% of total during 1972–1984. Interest rates data show that generally up until the end of the 1970s the real bank rates were positive (though quite low) as inflation remained minimal. This environment was favourable for private savings. With regard to this Pryor (1990) reports that for a large part of the 1970s, the time and savings accounts paid 2.5% above the banks' rate, providing depositors with a real positive return at very little risk since the government guaranteed the major banks. By 1983, the GDP growth was clearly slowing down, registering an average growth of 1.5% for the period of 1979–1984. Cromwell (1992) gives three major reasons for this downturn which ultimately triggered the decline in economic development. External factors have had a major influence on this as to begin with, the 1990 terms of trade were barely 59% of the 1970 level due to the relative fall in the world market prices of Malawian exports (mainly agricultural products). Specifically, the substantial reduction in the world prices of tea and tobacco was a major concern (refer to

Table 2.11 Selective economic indicators of Malawi (*annual average*)

Year	Agriculture (% GDP)	Manufacturing (% GDP)	Industry (% GDP)	Services (% GDP)	Export (% GDP)	Import (% GDP)	TOT
1965–1970	46.1	n.a	15.7	38.2	27.3	44.7	120.8
1971–1975	42.0	13.1	17.5	40.5	26.3	39.2	122.7
1976–1980	43.9	13.0	21.0	35.0	26.3	38.9	120.5
1981–1985	41.6	14.0	21.2	37.1	24.3	29.0	105.9
1986–1990	47.0	17.0	25.4	27.6	22.9	30.7	100.3
1991–1995	37.4	17.7	24.8	37.8	24.4	42.6	90.4
1996–2000	37.7	13.9	18.4	44.0	26.2	37.1	90.3

Note: Terms of Trade (TOT) is calculated taking 1987 = 100. Industry includes manufacturing, mining and construction sub-sectors of the economy. Whole GDP is composed of agriculture, industry and services while manufacturing is given since it is the leading sector in industry.

Table 2.11). Exports grew by only 0.6% a year from 1979 through 1985 compared to 5.8%, the average annual growth rate of 1964–1979 (Pryor). Further, the world oil price shock of the 1970s and the escalation of civil war in Mozambique led to an increase in the cost of imports as well as transportation cost.²⁴ Second, although the government's economic policy at post-independence was relatively clear, some of its plans were not spelled out explicitly (Pryor).²⁵ Inevitably, this gave rise to economic mismanagement as the government deficit continued to widen, averaging 10% of GDP in the 1970s. The central government had to sustain its budget through heavy borrowings, from both external and internal sources, consequently crowding out the private sector which largely contributed to economic growth and provided the largest share of the total savings (UNDP, 1999).

Third, Malawi's development plan was biased towards the agricultural sector as the government placed its highest priorities on it, ruling out the promotion of highly capital intensive manufacturing and industry sectors (Pryor, 1988).²⁶ This heavily concentrated strategy had a disastrous impact when Malawi's terms of trade deteriorated due to a shock in international world prices. This triggered serious structural problems as many agricultural estates that were highly geared were forced into bankruptcy. These economic complications led to a balance of payment crisis, debt rescheduling and necessitated frequent but partial restructuring of the economy in the early 1980s (Pryor, 1990). In an attempt to achieve balance of payment equilibrium, the government almost doubled its tariff rate in 1980 while quantitative restriction of inputs increased, a move that signalled government reversal on its former liberal trade policy (Chipeta & Mkandawire, 2002). These

²⁴List of important events that had largely influenced economic performance in Malawi are given in Table 2.10.

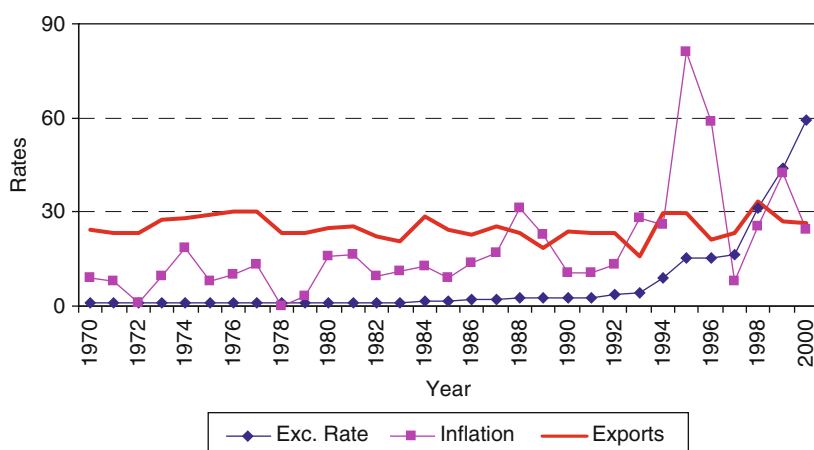
²⁵For example DevPol II and various trade policies were either differently implemented or ambiguously projected.

²⁶Despite these agricultural oriented plans, the contribution of the manufacturing sector to the GDP in particular was significant during the 1970s (see Table 2.11).

Table 2.12 Annual average growth rates of various sectors (*percentage*)

Year	GDP	GDP p/c	Export	Import	Agriculture	Manufacturing
1965–1970	7.7	4.5	13.9	20.4	20.5	n.a
1971–1975	7.6	4.4	5.8	4.6	6.6	20.4
1976–1980	4.9	1.5	8.5	1.8	4.3	16.7
1981–1985	2.2	−1.0	2.7	−1.9	6.4	2.4
1986–1990	2.3	−0.9	1.9	3.2	1.3	3.6
1991–1995	3.5	1.9	1.5	−2.7	8.0	2.1
1996–2000	4.0	1.7	4.4	1.4	10.5	1.1

Source: World Bank, World Development Indicators.

**Fig. 2.5** Trends in selected macroeconomic indicators

Note: Exc. Rate is the official exchange rate, Inflation is CPI (Annual percentage) and Export is a percentage of GDP.

Source: IMF, International Financial Statistics (IFS).

measures somehow managed to discourage imports however, resulting in marginal growth in net exports (Table 2.12). Examination of the economic trend of Malawi from independence to 1979 shows that the country encouraged trade openness and, hence, export growth was sustained, contributing significantly to the GDP (see Table 2.11 and Table 2.12).

On the other hand, the country pursued a managed exchange rate system with the objectives of attaining real income growth, maintaining a viable balance of payment position and stable domestic prices (Malawi, 2000). Subsequently the Malawian Kwacha appeared undervalued for a large part of the 1970s as inflation remained under control (refer to Fig. 2.5). The growth in money supply remained moderate, closely matching the GDP growth (Pryor, 1990). Over time, as terms of trade worsened and the balance of payment problem was seriously exacerbated, the growth rate in money supply (M1) increased at an average annual rate of 27%,

Table 2.13 Measures of financial deepening in Malawi

Year	Deposit/GDP	M2 (%GDP)	M3 (%GDP)	DCP	TLCB
1971–1975	16.2	20.0	24.6	12.0	18.5
1976–1980	17.4	19.5	24.7	17.6	31.3
1981–1985	18.5	20.0	24.0	17.0	41.0
1986–1990	17.7	19.9	24.2	10.9	27.7
1991–1995	15.9	18.7	24.5	13.3	24.4
1996–2000	16.0	13.9	17.4	6.2	9.3

Note: DCP is the ratio of domestic credit to the private sector while TLCB is the total lending by the commercial banks.

Source: World Development Indicators and International Financial Statistics (IFS).

Table 2.14 Trends in various forms of interest rates in Malawi

Period	Lending rates	Deposit rates	T. bills	RIR (Bank)	RIR (T. bills)	RIR (Deposits)
1971–1975	8.5	4.4	5.6	–2.0	–3.3	–4.8
1976–1980	11.0	6.4	6.9	–1.3	–2.5	2.6
1981–1985	14.3	9.9	10.6	–2.5	–2.2	–2.7
1986–1990	18.7	11.6	13.7	–6.0	–4.4	–6.2
1991–1995	29.9	21.2	21.3	–5.0	–5.5	–6.7
1996–2000	43.6	24.4	24.6	10.2	–0.2	–6.0

Note: RIR is real interest rate in banks lending, deposit and treasury bills.

Source: World Development Indicators and International Financial Statistics (IFS).

inflicting an upward trend in inflation (refer to Fig. 2.5). To finance the deficit, the state increased its borrowing from the banking sector, receiving a large share of domestic credit (Table 2.13). This, together with the adverse external shock of 1979–1982, further depressed private income, which led to a fall in domestic savings (Chipeta & Mkandawire, 1992).

2.3.2 *Agricultural Sector and Other Policies Framework*

Since independence, agriculture has remained the largest economic sector in Malawi by serving as the major source of income and provision of employment. A typically small landlocked country with rich soil, agricultural production was suitable and further enhanced by abundance of labour force.²⁷ In both the 1970s and 1980s exports were largely agricultural oriented, accounting for more than 95% of raw and manufactured exports. Likewise in this regard it was estimated that 80–85%

²⁷With difficulties in the capacity to create wage employment and uncertainties in wage policies, elasticity of employment in industrial sector was weak compared to the agricultural sector.

of the total population were employed in this sector during the same period (Cromwell, 1992). In the first two decades post-independence, the government's development policy initially centred on the agricultural sector. Land allocation, credit extension, and wage and other general government policies favoured agricultural development relative to other economic units (Pryor, 1990). Through government involvement, the agricultural sector was sub-divided into large scale commercial estate firms and smallholding farmers, most of them privately growing diverse crops in small and customary held lands as opposed to leasehold or freehold lands in the estate sector. These distinctions were particularly visible in tobacco, tea and sugar plantations (Chipeta & Mkandawire, 2002). Estate farmers enjoyed multiple privileges including cheap access to domestic credit, better infrastructure, reliable market information and competitive prices. Due to this, the agricultural sector enjoyed a higher annual average growth rate of 20.5% in the 1965–1970 period (see Table 2.12), causing estate sector's contribution to export to increase by 13% per annum over the period of 1973–1983 (Chipeta & Mkandawire). In this respect, agriculture played a leading role in the growth of the country's GDP and exports as it accounted for 46.1% and 42% of the GDP in 1965–1970 and 1971–1975 respectively, enabling real GDP growth of 7.7% and 7.6% in the same periods (see Table 2.11). The sector's role was further boosted by the temporary positive trade shock Malawi experienced, despite it being short lived (1977–1979)²⁸ before severe deteriorations terms of trade. Improvement in prices of tea (57% increase) which accounted for over one-fifth of Malawi's export, and a rise in tobacco prices (estimated to be 18.8%) which accounted for over 50% of the total export, led to a 19% total increase in terms of trade (Harrigan, 1999). The above trade improvement had an obvious impact on the disposable income level, government expenditure and tax policies. Since initially the windfall income accrued to the private sector, the government implemented revenue collection measures intended to raise government revenue (Harrigan). Likewise, because of the expansion in income base and the low level of inflation, the demand for industrial product increased (World Bank, 1988). Thus, the estate agricultural production expanded further and the industrial base broadened, facilitating import-substitution manufacturing enterprises to a considerable extent (Chipeta & Mkandawire, 2002).²⁹ As noted by Cromwell (1992), although the shock was temporary the public expenditure skyrocketed, continuously exceeding the total revenue before finally resulting in a consistent overall deficit increase from 7.7% of GDP in 1976 to 10.1% in 1979 to a further 15.5% in 1980 (see also Table 2.8).³⁰

Drastic deceleration of GDP growth set in around 1980, when the average annual growth rate of GDP fell from 4.9% to 2.2% in the periods of 1976–1980 and 1981–1985

²⁸Refer to Harrigan (1999) for an examination of Malawi's temporary positive trade shock.

²⁹Both Table 2.11 and Table 2.12 give the trend in contribution and average annual growth of the manufacturing sector, indicating that the sector's contribution to GDP was improving up to 1991–1995 although the average annual growth rates were only particularly high in 1971–1975 and 1976–1980.

³⁰An extensive coverage of the fiscal pattern of 1970 to 1983 is also given by Harrigan (1999).

respectively (see Table 2.11) while the current account deficit increased sharply on average from 10.6% in 1971–1975 to 15.6% in 1976–1980. This dramatic downturn in growth was caused by many factors, of both an internal and external nature. Ballooning public parastatals, poor weather conditions, bad public management, deteriorating terms of trade, civil war in Mozambique and increased transport and utility cost are among the many factors that are believed to have contributed to such poor performance (Chipeta, 1993). Following this, the country embarked upon a number of stabilization measures aimed to restore macroeconomic stability and economic growth. Since the agricultural sector was the leading economic sector, the principal objectives of structural adjustment programmes focused on correcting the price determination policy and improving fiscal and monetary mechanisms (Chipeta). Three consecutive structural adjustment loans were made with the specific purpose of expanding the role of the private sector, by removing pricing and marketing constraints on smallholder agriculture and gradually increasing efficiency of land use and productivity, and enhancing the income of smallholder farmers (Cromwell, 1992). The above early reforms were implemented to rationalize domestic agricultural prices, liberalize marketing strategies – which were predominantly given to the Agricultural Development and Marketing Corporation (ADMARC) – and remove agricultural subsidies while granting smallholding farmers the choice to grow what was desirable to them (UNDP, 1999). The impact of the above reforms on the general economy was positive, though not significant. The real growth rate slightly improved on average from 2.2% to 2.3% from 1981–1985 to 1986–1990 respectively (Table 2.12). In the same period, the contribution of the agricultural sector to the GDP improved from 41.6% to 47%. This improvement had seemingly been enabled by the availability of imported inputs and more discretion by smallholder farmers to grow profitable product such as burley tobacco and other cash crops (Chipeta). However, UNDP (1999) notes that the growth of the smallholder sub-sector after reforms was hampered by higher and continually rising input costs. On the other hand, other macroeconomic instability (such as higher inflation, frequent devaluations and inadequate credit facilities) coupled with unfavourable internal terms of trade have cancelled out the effectiveness of the above corrective measures (see Fig. 2.5). Meanwhile, the structural reforms brought with them new public and quasi-public institutions such as the National Rural Development Programme and the Agricultural Sector Adjustment Credit, which was created in the late 1980s to improve the general standard of living in the rural areas and to help in expansion of smallholder farming while ADMARC was restructured (Cromwell). This did not bring about much improvement in the smallholder sub-sector since other market imperfections such as lack of market information and limited capabilities for marketing channels prevailed (Chipeta & Mkandawire, 2002). With the introduction of financial liberalization and improvement in the level of competition, the share of the agricultural sector's contribution to the GDP has been decreasing on average, from 47% in 1985–1990 to 37.7% in 1996–2000, while total exports have also seen downward moving trends (see Table 2.11 and Fig. 2.5).

During the reform period and even after financial sector liberalization, exports marginally improved; hence, it is observable from Table 2.11 that the economic liberalization overall did not feed to a remarkable expansion in trade. Both agriculture and exports were subsequently troubled by a series of currency depreciations which directly induced higher inflation (Fig. 2.5). In support this of argument, Chipeta and Mkandawire (2002) report a one-to-one relationship between elasticity of domestic inflation and currency devaluation. Since the post-independence policies were agriculture biased, the manufacturing sector was not considered for long-term transformation and contribution to the economy. Although the Malawi government did not have deliberate policies to expand the manufacturing sector, the general economic development of the 1960s and 1970s was favourable to this sector (Pryor, 1990). Initially, as savings improved and public investment expanded due to improvement in GDP in the early decades, venture into manufacturing was facilitated by the availability of capital as well as improvement in the level of infrastructure, indirect tax incentive and enhancement in the local demand (Chipeta & Mkandawire). But due to heavy price regulation and lack of qualified human resource, the sector could not flourish. As prices could not adjust upward, while input cost increased frequently due to a diminishing transport network and communication system, further burdened by frequent changing of government regulation, profitability in the sector was a major concern (Pryor). During the reform period, the contribution of the manufacturing sector slightly improved from 13% on average in 1976–1980 to 17% in 1986–1990 (see Table 2.11). As the budget deficit widened in the 1980s and external sources of funds drastically reduced (refer to Table 2.9), government borrowing crowded out the private sector's credit expansion. Partly this also limited the growth of the manufacturing industry in Malawi in post-structural reforms. But gradually with implementation of the reforms programme, prices were decontrolled and until recently, petrol and motor vehicle spare parts were the only major items covered by the price regulation scheme (UNDP, 1999). In the recent years and especially after 1990, the share of the manufacturing sector to GDP decreased from 17% on average in 1986–1990 to 13.9% in 1996–2000, which is barely different from the sector's contribution in the early 1970s.

Despite reforms in various dimensions, the gradual transformation of the manufacturing sector to the mainstream economy has not been possible, although the level of competition has improved. This scenario has been created by a number of factors. First, internal factors which include poor state of utilities and high transport cost have killed the growth of the sector. It is reported that Malawi has one of the highest internal transportation costs in Africa, estimated to account for almost 47% of imports as at 1997 (Chipeta & Mkandawire, 2002).³¹ Second, an overvalued exchange rate in the 1970s and 1980s made it difficult to export and compete with foreign firm. Then, the unstable exchange regime in the 1990s, which directly induced high inflation during the structural adjustment programme, has

³¹Likewise Kayanula and Quartey (2000) estimate that cost, insurance and freight (CIF) margins increased from an average of 15% in early 1970s to about 40% during 1980s.

also not helped manufacturing. Thus, although devaluation may have increased the volume of exports in the short-term, in the long-run this jeopardizes the whole economy as it does not promote diversification.

Financial Reforms and Structural Adjustments: As discussed above, until the late 1990s Malawi's financial sector was generally repressed and inefficient (see Table 2.14). Although the government did not directly or fully own all assets in the banking sector, the ownership in the banking industry was highly concentrated (Chirwa, 2001). Other visible characteristics of financial repression included controlled interest rates, a ceiling on commercial banks credit expansion and relatively subsidized and directed fund flows (Chipeta & Mkandawire, 2002; UNDP, 1999; Cromwell, 1992; Pryor, 1990). As part of the World Bank and IMF recovery program proposed to most of the SSA countries, Malawi embarked on economy-wide structural reforms from the mid-1980s, which included reorganization of the country's financial system.

Financial reforms in Malawi took off in 1987 where lending interest rates were initially liberalized and subsequently deposit rates were also deregulated in 1988, while formally the government was geared towards abolishing the credit ceiling and rationing (Chirwa, 2001). The objectives of taking these determined steps in the financial sector were to facilitate competitiveness, enhance financial services offered and enable institutions to increase and introduce new financial products (UNDP, 1999). To accommodate the new changes and enlist ways to deal with any post-era ambiguities, new financial legislation was introduced.³² These new legal frameworks significantly empowered the RBM and gave it the mandate to supervise, regulate and monitor effective running of the financial system. It was also given the powers to introduce indirect monetary instruments and amend entry regulations of new banks and other financial institutions into the financial system (Mlachila & Chirwa, 2002). Prior to the recent financial reform progress, there was modest development of the financial sector in Malawi. For many decades after independence, the formal financial system was dominated by RBM and two other large commercial banks (Nissanke & Aryeetey, 1998). The government heavily directed resource flows while the central bank had no direct role in promoting savings and investment beyond setting the level of interest rates (Chipeta & Mkandawire, 1992). As given in Table 2.15 and also discussed by Mlachila and Chirwa (2002) and Gelbard and Leite (1999), as at 1987 all the six indicators of financial development were ranked either minimally developed or underdeveloped. Overall, in 1987 the level of financial development in Malawi was generally underdeveloped. Subsequently, we can also assess the transformation of the financial system over a decade which coincided with the era of structural reforms that had begun in 1987. In total, there has been an improvement in all the indicators of financial development over the period. Among all other indices, market structure and competitiveness of the financial system were ranked highest in both 1997 and

³²In this aspect the government amended the Reserve Bank Act 1965 and the Bank Act 1965 and enacted the Reserve Bank Act 1989 and the Bank Act 1989.

Table 2.15 Financial market transformation in Malawi

Indicator	Quartile 1987 index	Quartile 1997 index	Improvement (%)
Financial liberalization	20	43	115
Financial product	6	56	833
Financial openness	31	45	45
Monetary policy instruments	0	43	n.a
Market structure	56	62	11
Institutional environment	29	43	48
Overall	24 (Underdeveloped)	47 (Minimally Developed)	96

Source: Gelbard and Leite (1999).

1987, while over the period, indices of financial liberalization and financial products have seen the highest improvement, both recording more than 100% improvement. Similarly financial openness, institutional environment and monetary policy instrument indices have also seen remarkable changes over the decade. However, even though the financial sector in Malawi has seen 96% improvement in the overall index, it still largely remains minimally developed and far from being fully competitive and at par with the rest of the world.

2.4 The Case of Botswana

The post-independence period's economic performance of Botswana has shown it to be one of the fastest growing economies in the world, surprisingly when the economic stagnation and deterioration was widespread in the African continent. Extensive literature on the economic development of Botswana points out that the State of Botswana is a unique African institution, and the economic progress achieved within the short period of three decades has been described as 'impressive', 'exceptional', 'unusual', and 'a miracle' (see for example, Samatar (1999), Leith (1997), and Harvey (1992)). For the past two and half decades the country's growth has been one of the fastest in the world. More or less, during 1960–1990 Botswana was the fastest growing country in the world, with an average annual increase in GDP of 13.9% from 1965 to 1980 and 11.3% from 1980 to 1990 (Good, 1992). Overall, the average real GDP growth has been almost 10% for the period of 1960–2000, while real GDP per capita growth was above 7%. These rates are well above the average for Sub-Saharan Africa. Being a member of the African continent that has been characterized by economic mismanagement, complex economic and political instability and continuous ethnic conflict and tension, Botswana managed to achieve political stability and sustained economic development. In this perspective, the country has earned the reputation of having some of the most effective institutions and technocrats, the most efficient public sector management

and sound and liberal democratic political system in Africa and indeed among developing countries in general (Sharma & Mhlauli, 1994). Botswana achieved its independence in 1966 and was geographically disadvantaged in the sense that the country is landlocked and predominantly tropical.³³ Additionally, it was classified as one of the poorest countries in the world and has since been transformed into one of the richest economies in Africa and is now grouped by the World Bank and the United Nations as an upper middle income country (Hope, 1997). When the country attained its independence, the GDP per capita stood at US\$236 and, like many other less developed countries, was heavily dependent on foreign aid for all its recurrent and development spending. Since then, the economy has been moving positively and the average annual growth of the GDP per capita has been 5.6%, 11.2% and 6.4% for the decades of 1961–1970, 1971–1980 and 1981–1990 respectively. Similarly the share of investment to GDP has been increasing from 4.3% in 1960 to nearly 20% on average for the period of 1981–1990, recording the highest level of above 24% in the 1971–1980 period. This trend was necessary as the country had no infrastructure worthy of mention, no real telecommunication or power supply network and only had unreliable water and electricity supply when it achieved full independence. These all required urgent attention from the new independent state (Harland-Thunberg, 1978).

At independence, the economy was heavily dependent primarily on subsistence agriculture and the cattle industry, as the agricultural sector contributed 40.6% of the GDP in 1960 and 31.8% in 1965. The industry sector contributed only 13.6% and 19.7% respectively in the same periods (see Table 2.16). The country had a number of acute problems in the years after independence: a highly unskilled labour force,³⁴ shallow financial base, and hostile and racist neighbours (Samatar, 1999). This required an aggressive development plan capable of promoting economic development and at the same time reducing the political, institutional and economic problems. Samatar discusses that the government used a dual strategy to overcome

Table 2.16 Annual growth rate of various sectors (*annual percentage*)

Sector	1961–1970	1971–1980	1981–1990	1991–2000
GDP growth	8.7	15.2	10.1	4.8
GDP per capita	5.6	11.2	6.4	2.4
Agriculture	5.1	8.3	3.2	1.4
Manufacturing	1.1	19.7	9.7	4.4
Industry	10.8	17.4	10.7	2.8
Inflation	2.8	10.8	10.6	10.5
Population	4.0	4.0	3.0	2.5

Source: World Bank, World Development Indicators.

³³It is estimated that only about 4% of all the land can easily be cultivated while the rest is either desert or barely suitable for grazing land (Acemoglu, Johnson & Robinson, 2001).

³⁴Acemoglu, Johnson and Robinson (2001) remark that at independence there were only 22 Batswanans who were university graduates and 100 others from secondary school.

these problems. First, it kept very close ties with its former colonial power and other donors for financial support to run its annual budget and establish effective public administration. It further decided to remain within the Southern African Custom Union (SACU)³⁵ and renegotiate for a new formula of revenue distribution which enabled the country to receive a stream flows of revenue which were needed to implement various developmental plans. Second, it moved to retain any expatriate former protectorate officers willing to stay, while approving an immediate program of establishing institutional capacity to train Batswanans in significant numbers. This strategy not only enabled a smooth transition but allowed the government to have the necessary human resources for high level policy making and professional services, and effective implementation of the government plans. Effectively during the first decade of independence, growth in the GDP relied heavily on donors' aid which to a large extent financed whole of the development budget and almost half of the recurrent expenditure (Maipose & Matsheka, 2002). Two other events later boosted the pace of economic growth. Most importantly, the government's continued effort to exploit the country's natural resources paid off with the successful discovery and exploitation of a number of mineral resources, notably nickel, copper and later diamonds in the early 1970s. Secondly, the end of the drought and the modernization of the livestock industry which eventually resulted in Botswana gaining access to the EEC for beef export at prices above the world market was particularly a big boost for the agricultural sector and the economy as a whole (Maipose & Matsheka). In post-independence eight National Development Plans (NDP) were formulated and implemented. The eighth NDP (1997–2002) was launched in 1998. Each of these development plans were aimed to achieve four overall national development objectives of rapid economic growth, social justice, economic independence and sustained development.³⁶ In pursuing these objectives, Botswana needed to keep close ties with the outside world for budget financing before self sufficiency and afterwards for marketing its natural resources. Hence the country kept a very open economy, with both exports and imports accounting for a substantial ratio of the GDP (above 50%) and as the expansion of the diamond industry increased the export earnings, these ratios grew even higher during the period of 1981–1991 (refer to Table 2.19).

Looking at the savings and investment trends, it is obvious that savings were lower than investment before the mineral exploitation in late 1970s (Ahmed, 2006).^{37,38} During this period, the foreign savings contributed significantly to the capital stock. Hence for the period of 1966–1989, the economic growth was to a considerable degree dependent on funds from abroad (Maipose & Matsheka, 2002). The productions of copper, nickel and diamond for export has increased the

³⁵This union was founded in 1910 and Botswana has been a member since then.

³⁶For further discussion on the specifics of these national development plans see Maipose and Matsheka (2002).

³⁷This section is heavily based on facts, issues and analyses provided in Ahmed (2006)

³⁸The analysis of savings and investment trends is depicted in Figure 2.6.

government revenue tremendously by virtue of its large shareholding and royalty payments. Due to this, the government revenue increased from US\$540 million in 1985 to US\$1.6 billion in 1994 (Hope, 1997). This large windfall for the state, particularly from diamonds, was managed effectively unlike in other African countries such as Nigeria, Angola, Zaire and Sierra Leone where abundance of such natural resources appeared to be a curse rather than a blessing. The increase in the government revenue in parallel with diamonds' income resulted in complementary avenues of employment creation and rural development, as the expenditure on infrastructure, education, health services and other social aspects increased proportionately.³⁹ Likewise the structure of institutions in Botswana limited domestic political instability and conflict over control of resources, something quite common in other Sub-Saharan African countries. Obviously, good institutions are not nature-given but something that evolves over time, and hence a plausible question that many have asked is how Botswana did acquire these institutions from the beginning. Unfortunately, a comprehensive answer to this question can only be given by looking at political and historical trends in the country even prior to the colonial era, something which is beyond the scope of this study. But generally there are two important factors that enabled the establishment of relatively 'good institutions' in Botswana. First, the existence of a strong tribal institution, particularly tribal chiefs, has encouraged broad participation in political and economic affairs (Acemoglu, Johnson, & Robinson, 2001). Moreover the *Tswana* customs of *kgotla* (town meeting) induced a strong tradition of participation and broad consultation at all levels of public life from village to central government (Maipose & Matsheka). Additionally, although there is a significant amount of ethnical diversity, the highly accommodating culture of *Tswana* (the largest tribe) coupled with the small size of the country configured a population that is largely homogenous. Second, the class of leadership during post-independence, particularly Khama and Masire,⁴⁰ set high ethical standards. This led to the establishment and continuity of a strong, independent, and accountable political elite and a civil service which remained committed to economic development within the framework of a largely democratic, liberal and competitive system.⁴¹

The rapid progress attained by Botswana has also brought about the sectoral transformation during the last three and half decades. The share of the industrial sector contribution to the GDP grew from 13.6% in 1960 to 54.6% in 1990. The sharp increase is largely due to the increasing level of mining activities in the period. The manufacturing sector's relative share remained almost unchanged as it accounted for 6% in 1960, 4.9% in 1990 and 5.3% in 1997 (Table 2.17). Maipose and Matsheka (2002) attribute the sluggishness in the growth of this sector to the small size of the domestic market, lack of skilled labour, free trade with SACU and

³⁹A fairly detailed analysis on this can be found in Sharma and Mhlau (1994).

⁴⁰These are the first and second presidents of the country.

⁴¹Samatar (1999) devotes a whole chapter for the purpose of discussing the class of leadership in Botswana.

Table 2.17 Components of the GDP, 1966-2000 (*percentage share*)

Year	Agriculture	Manufacturing	Mining	Industry
1966	39.0	8.0	0.0	17.3
1975	25.4	6.9	12.5	32.5
1977	21.3	5.8	15.2	34.6
1979	13.1	3.7	31.2	44.0
1982	8.9	6.7	32.0	43.9
1985	5.5	5.2	47.2	56.1
1987	7.2	5.1	45.5	57.2
1989	4.8	5.0	51.2	61.1
1991	4.4	5.0	37.7	53.2
1993	4.4	4.6	35.7	47.8
2000	4.2	6.0	33.7	44.3

Source: World Bank, World Tables and Bank of Botswana annual reports.

high utility cost especially of electricity and water rates. On the other hand the contribution of the agricultural sector to the GDP has been declining over time. The share of the agricultural sector has shrunk from 40.6% in 1960 to 4.6% in 1990 while mining looks to have moved in the opposite direction in a similar magnitude (Table 2.17). Despite having some signs of mono-economy where diamond revenue constitutes more than 50% of the total government revenue, Botswana looks to have avoided 'Dutch disease' by investing a large share of these resources in physical and social infrastructure and other non-mining productive areas of the economy. Through its prudent management system, the government managed to channel surpluses away from the recurrent budget to be used in other areas prioritized to be beneficial for the country. Like other small open economies, the Botswana economy is exposed to a variety of external shocks which can have an immediate impact on its local economic affairs. The government revenue is highly dependent on mineral rent which is directly related to the foreign sector (Hope, 1997). Additionally foreign reserve earnings and customs revenue are highly externally influenced while the agricultural sector, especially the beef industry, is also directly affected by fluctuations in the world prices and environmental changes (Maipose & Matsheka). While subjected to all the above income vulnerability, Botswana has kept inflation relatively low and even recently it has been on a declining trend. The average annual rate of inflation was 10.8% in 1995 compared to 11.4% in 1990 and 12.7% in 1993.⁴² Seemingly, by instituting a policy making process that develops the budget and monitors program implementation, Botswana was able to continuously keep a budget surplus and enforce a fiscal discipline which remained free from any serious political influence. On this point Maipose and Matsheka remark that the economic progress of Botswana was based on institutional quality and highlight four significant interrelated institutional factors. First, the institutionalization of a stable and largely less corrupt and more democratic system of government

⁴²This depicted trend in the inflation seems to be very closely linked to the rates in South Africa, reflecting declining prices in both countries as discussed by Hope (1997).

that set exemplary leadership has helped to create public accountability, responsibility and transparency. Second, the establishment of national development planning and its integration with the annual budget process have avoided the many planning and budgetary conflicts that are common in other developing countries. Third, realistic and strategic state intervention in financing development plans and distributing wealth fairly has loosened physical and manpower constraints for successful economic transformation. Lastly, prudent macroeconomic management ensured economic and political stability while successfully avoiding ad hoc economic problems.

2.4.1 Structural Developments of the Financial System

At independence in 1966, Botswana was one of the poorest African countries, heavily dependent on foreign aid and colonial grants.⁴³ The country did not only have any independent financial structure but also infrastructure and communication system to support and promote economic development. From 1895, Botswana used various South African currencies as legal tender and did not regard it necessary to establish its own currency and monetary system until a decade after independence. Up to 1976, Botswana had been a member of the Rand Monetary Area (RMA) where all the monetary, foreign exchange policies and other economic policy instruments were directly determined by South African authorities.⁴⁴ Interest rates, foreign exchange rates and even exchange controls were all regulated by South Africa, without required consultation with the small member countries (Harvey, 1997). This gave Botswana little room for the necessary monetary and macroeconomic reforms during this period (Dahl, 1981). Additionally, because of the absence of a national central bank, almost all operating financial institutions were foreign subsidiaries with their headquarters in South Africa.

Despite lacking the flexibility necessary for conducting its own economic affairs and policy options to combat various internal and external shocks, Botswana continued to be part of the Rand Monetary Area for two major reasons. Firstly, the newly independent government of Botswana was indebted and relied heavily on grants for its expenditure due to its limited resources. For this reason, it was necessary to stay in the RMA to increase government income earned from custom's revenue. Under the South African Customs Union Agreement, withdrawing from the union would have drastically reduced the share of revenue due to Botswana. Secondly, having a serious shortage of skilled and educated labour, Botswana did not have the capacity to effectively run such an institution (Samatar, 1999).

⁴³See Table 2.18 and further discussions later.

⁴⁴With Botswana, the other two countries who used Rand currency issued by South Africa were Lesotho and Swaziland.

Moreover, hiring expatriates and professional services from abroad was clearly not an affordable alternative at that point. The country also could not afford the cost of creating new financial institutions for this purpose, as there were other important national projects such as infrastructure establishment and educational enhancement that the country needed urgently (Harvey, 1985). Instead, the government renegotiated the Customs Union Agreement in 1969 and signed a new formula where Botswana's share of customs union revenue was proportionately linked to growth in imports.⁴⁵ In this respect, despite achieving political independence, the Botswana government did not rush for economic independence for justifiable reasons. However other attempts were made to enable a liberal economic environment for the sake of attracting foreign investment as well as maintaining an open economy (Maipose & Matsheka, 2002). Commercial banks were free to allocate credit while individuals and institutions were able to freely invest their liquid funds in the Johannesburg money market (Harvey). Thus, the government's role was not to control but rather to 'assist the private sector in every way' in pursuance of the attainment of social and economic development goals (Harvey, 1996).⁴⁶

Botswana's economy grew rapidly in the early 1970s due to expansion in mineral and other agricultural industry (cattle ranching). As a result the GDP (at constant 1974 prices) rose by 13% a year in the 10 years to 1977–1978 (Makgetla, 1982). Investment in infrastructure and other economic areas also increased significantly during this period (see Table 2.18 (a)). Increase in the mining activities (the share of mining as a percentage of GDP increased from 0% to 12% in 1975) and subsequent expansion in trade (exports) enabled the government to balance the recurrent budget expenditure by 1973 without grants-in-aid from the British government (Harvey and Lewis, 1990, p. 189).⁴⁷ As observable from Table 2.18 (b), the building up of foreign reserves together with a consistent increase in the government's share of the revenue transformed Botswana's finances. To an extent, this was a necessary condition for building an independent financial system. In 1976 Botswana took the alternative of setting up its own monetary institution to manage and direct its financial macroeconomic policies and hence withdrew from RMA. After the creation of the Bank of Botswana, which started operating in January 1976, a national currency 'Pula' was introduced (Dahl, 1981).

Looking at the banking sector, Botswana only had two foreign owned commercial banks in operation since independence: Standard and Barclays. Following the adoption of independent financial regulation, these two commercial banks were required to incorporate locally, even though the government maintained its former policy of non-interference in the affairs of these institutions. Unlike other African countries, there have been no changes in the ownership and control of these commercial banks despite their increasing dominance in the financial sector. To

⁴⁵For an extended discussion of the renegotiation of the new Customs Union Agreement, see Harvey and Lewis (1990, pp. 189–192).

⁴⁶This was outlined in the Transitional Plan for Social and Economic Development, 1966.

⁴⁷See also Table 2.19.

Table 2.18 GDP per capita, investment, aid and foreign exchange reserves

(a) GDP per capita, investment and aid							
Indicator	1966	1961–1970	1970	1971–1980	1980	1981–1990	1991–2000
GDP per capita	236	284	413	1062	1984	3,430	5,909
Investment (ratio of GDP)	12.5	11.1	23.6	24.1	20.7	18.4	16.0
Aid (ratio of GDI)	30.9	19.2	14.1	12.5	9.7	7.6	2.1
(b) Debt and foreign exchange reserves							
Year	Foreign exchange (US\$)		Import cover (No. Months)		Long-term debts (US\$)		
1976	75		4		169.1		
1979	267		6		123.4		
1983	396		7		230.1		
1987	2,013		24		545.5		
1991	3,719		24		613.2		
1995	4,696		23		693.2		
1999	6,240		29		454.7		
2000	6,658		34		397.6		

Note: The GDP per capita is at constant 1996 US\$.

Source: Bank of Botswana Annual Reports, Penn World Table and Harvey and Lewis (1990).

instil business confidence and maintain an open economic system, the authorities opted for the use of indirect policy instruments rather than a direct market intervention policy widely used in other parts of Africa at that time, despite there being some concern and political pressure (Harvey & Lewis, 1990).⁴⁸ However, the creation of the Bank of Botswana and the introduction of the local currency 'Pula' decreased the power of the local banks to dictate interest rates and transfer funds abroad (Makgetla, 1982). Partly due to this, growth in credit by the commercial banks decreased from 46% in 1976 to 5% in 1979. On the other hand, to encourage foreign capital inflows and make more credit available to local borrowers, selective exchange controls (controls on capital account) with South Africa were introduced. In this regard, while residents were obliged to sell their portfolios in Rand, large corporations were also required to hold their liquid balances in Pula bank deposits (Harvey, 1996) under the new requirements.⁴⁹ These amendments and a continuous increase in mineral exports led to a steady increase in foreign exchange reserves from US\$75 million in 1976 to US\$267 million in 1979 (see also Table 2.19), while the government had on deposit at the Bank of Botswana between 30% and 50% of a year's current revenue for the period (Harvey, 1985).

However, it became obvious that the changes in the financial environment did not lead to a growth in the bank's lending activities. This was observable from the fact that commercial banks were making minimal advances to developmental sectors, such as manufacturing and other industrial activities, at a time when their liquid assets were more than the amount required for precautionary purposes (Makgetla, 1982). For this reason, the government claimed that there was a lack of long-term and project financing while domestic savings grew faster but were not utilized to accelerate economic development. Although the commercial banking sector argued that this was due to the lack of parallel long-term deposits, some evidence appear to supports the government's claim: (1) FDI inflows continued despite a significant

Table 2.19 Balances in various sectors (*as a percentage of GDP*)

Indicator	1971–1975	1976–1980	1981–1985	1986–1990	1991–1995	1996–2000
Budget balance	–7	–1	7	14	7	8
Current revenue	23	25	38	49	45	44
Expenditure	25	29	31	32	36	35
Exports	36	44	55	64	49	40
Imports	49	49	49	43	39	35
FDI	–2	7	4	3	–1	1

Note: Budget balances include grants while FDI means foreign direct investment.

Source: World Bank, World Development Indicators.

⁴⁸Of specific concern was the behaviour of the commercial banks where, despite taking deposits from Botswana, they invested more than 50% of their funds outside the country when these funds were seriously needed to finance many development projects in the country.

⁴⁹Additionally, to discourage large capital expatriation, foreign companies were not allowed to borrow more than they brought into the country.

build up in the country's reserves in the late 1970s and 1980s (see Table 2.19). Since FDI comes with technical, management and necessary market links, foreigners must have observed that there were good investment projects, which local investors did not take up. (2) Because commercial banks' excess liquidity build up increased from 32% in 1976 to nearly 60% in 1981 (Harvey, 1996), it appeared these institutions were not taking the initiatives to expand their investment horizons.

Concerned with the size of the long-term lending by the commercial banking sector, the government tried to remedy the situation by giving a number of incentives to compel the investment of resources in productive activities. The margin between prime lending rate and the return on additional liquid assets was allowed to increase from 3.5% to 6.5% points between 1975 and 1979, with the aim of giving more incentive to lending (Harvey, 1996). Additionally, Botswana's interest rates were lowered in the hope that more businesses would be established in the country, since interest rate differentials were significant, and lending terms made easier (see Fig. 2.6). Further, to increase long-term deposits available to the banks (since they claimed it was not possible to make project lending out of short-term deposits) the government also deposited some of its surpluses for a long term, while enabling the commercial banks to take cattle as security against loans (Harvey, 1985). However, these incentives were ineffective. As noted by Harvey and Lewis (1990), there are two reasons as to why these measures did not work. First, commercial banks were making enormous profits from their existing business (short term loans and foreign exchange transactions). Therefore, there was little need for banks to take the considerable effort to invest their resources into new and unconventional projects. Second, these commercial banks did not have the staff with the necessary experience and skills to evaluate and nominate long-term projects. With the higher risk of undertaking new investment initiatives, banks were reluctant to pursue business lines in which they were neither supported for nor technically equipped to adopt.

The problem of over-liquidity became even more serious in 1978 when the Bank of Botswana had to act as the deposit taker of last resort (Harvey & Lewis, 1990, p. 223). Primarily, this was created by the mining and government sectors which had large savings deposits but little need for any loans, while in the other sectors of the economy, there were few investment projects matching the requirements for the commercial banks. With these problems, there was an increasingly need for a new set of financial institutions, to identify and support a new range of borrowers. A number of financial parastatals came into existence for this purpose. The National Development Bank (NDB) and the Botswana Development Corporation (BDC) were formed with the main aim of extending credit to parastatals and other productive agencies as a mechanism to handle extra liquidity (Makgetla, 1982). Furthermore, these institutions were also meant to ease the availability and provision of finance on terms better adapted to local circumstances. With these changes and the gradual institutional and financial market development, including the establishment of the Botswana Stock Market (BSM), the financial system in Botswana overall improved from being minimally developed in 1987 (with an index of 49 compared to 33 for SSA average) to somewhat developed in 1997

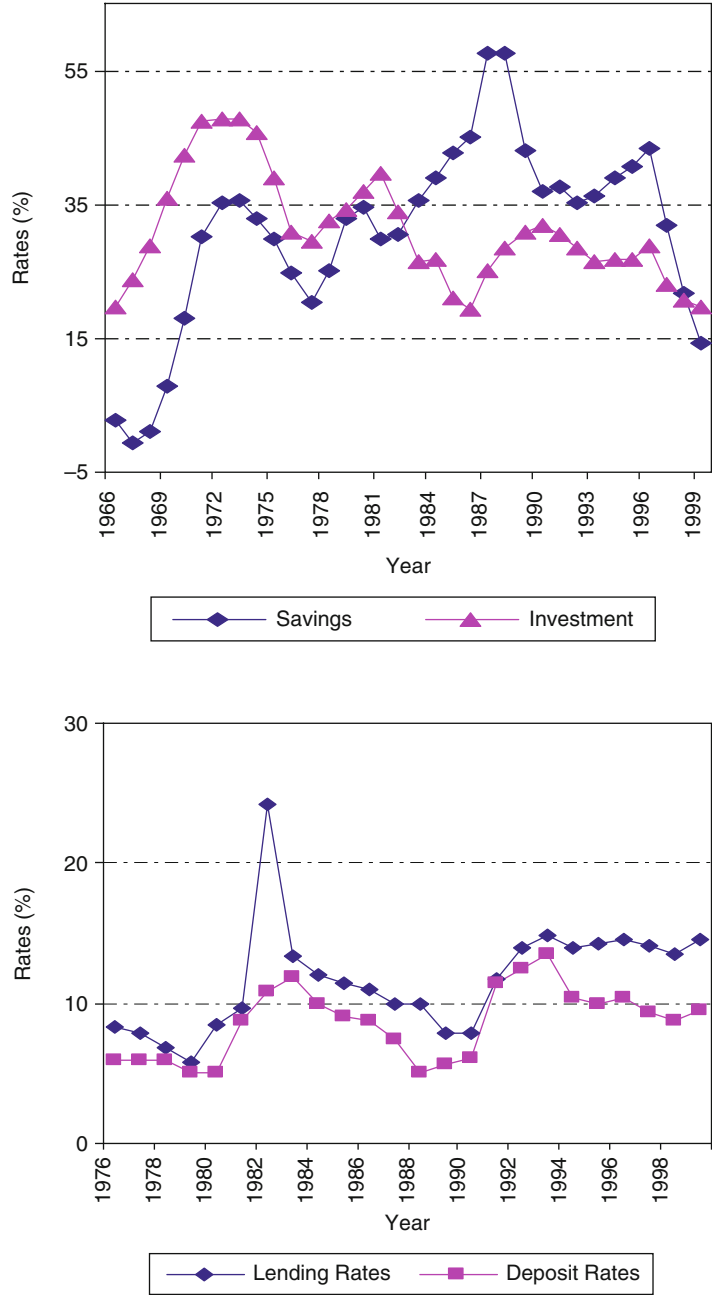


Fig. 2.6 Interest rate, savings and investment trends in Botswana
Source: IMF, International Financial Statistics, IFS (various issues).

Table 2.20 Financial development index in Botswana

Indicator	1987 Level	Index	1997 Level	Index
Market structure	Largely developed	76	Largely developed	92
Financial product	Underdeveloped	17	Somewhat developed	51
Financial liberalization	Repressed	20	Somewhat liberalized	65
Institutional environment	Somewhat supportive	71	Somewhat supportive	71
Financial openness	Somewhat open	54	Minimally open	46
Monetary policy	Minimally developed	29	Somewhat developed	71
Overall development	Minimally developed	49	Somewhat developed	62
Highest – Overall development	Largely developed	77	Largely developed	87
SSA – Overall development	Minimally developed	33	Somewhat developed	56

Source: Gelbard and Leite (1999).

(with an index of 62 compared to 56 for SSA average). Botswana's financial system index scores above the SSA in both 1987 and 1997 although the level of improvement is marginal, just 27% over the decade (see Table 2.20). In support of this process, there was an increase in the accumulation of financial assets and liabilities in the economic system, reflecting growth in the monetarization process (see the trend and behaviour of M2 and M3 in Figure 2.9).

2.4.2 Supplementing Role of Foreign Aid in Botswana: The Two-Gap Model

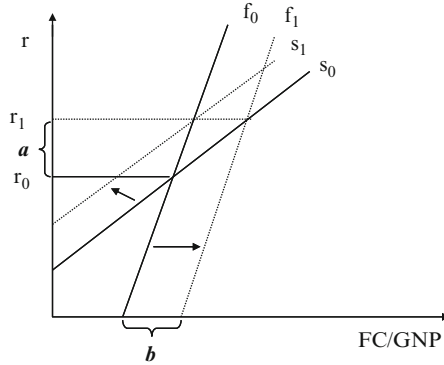
In a small open economy, such as is the case in most of developing countries, there are generally two major constraints; lower level of savings which ultimately limits investment and foreign exchange constraint which also limits the ability of importing skill intensive capital goods. Imports, particularly of capital goods and machineries play an important role in international transfer technology and enhance local technological innovation. This has formally been discussed by Williamson (1983) as two-gap model (referring to saving and foreign exchange constraints). Taking the case of a developing economy where two goods are produced, capital intensive good K_c is always imported while labour intensive good K_l is exported.

Let us denote α and β as fixed input coefficients per unit of both labour and capital intensive goods and assuming full employment,⁵⁰ then:

$$S = (\alpha + \beta)\Delta Y \quad (2.1)$$

where S is the savings necessary to finance change in output and ΔY is change in output. Further in an open economy imports affect level of savings and hence:

⁵⁰Here we are considering savings necessary to finance both goods K_c and K_l .

Fig. 2.7 Savings and Foreign exchange constraint

$$S_d = s(1 - m)Y \quad (2.2)$$

where S_d is the total domestic savings. When domestic savings can be supplemented by foreign savings (either through aid or private capital inflows) to finance growth in output then:

$$\Delta Y = \left\{ \frac{s(1 - m) + \eta}{\alpha + \beta} \right\} Y \quad (2.3)$$

Here η denotes the portion of foreign capital inflows. Deriving growth equation from the above we get:

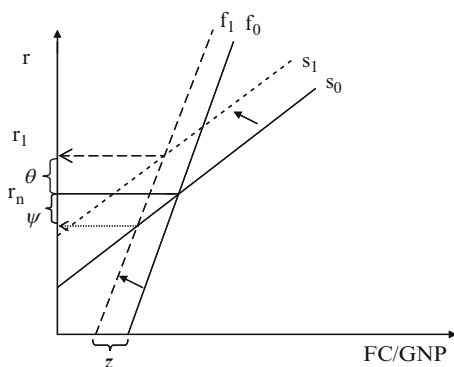
$$r = \Delta Y/Y = \frac{s(1 - m) + \eta}{c} \quad (2.4)$$

where r is the growth in the national income and c is the incremental capital output ratio ($\alpha + \beta$). The above growth equation indicates that growth is positively related to rate of savings and foreign capital inflow while it is negatively related to the incremental capital output ratio. Figure 2.7 shows diagrammatical representation of the two-gap model.

Growth in the national income is shown in the y-axis denoted by r . S_0 shows savings constraint which increases with an increase in marginal propensity to save out of domestic income, s , and decreases with the marginal propensity to import. Foreign capital-GNP ratio is shown on x-axis denoted by FC while line f_0 shows foreign exchange constraint, determined negatively by export-GNP ratio and positively by marginal propensity to import.

As also noted by Frimpong-Ansah and Ingham (1992) and indicated by the diagram, the national growth rate can either be raised by an increase in the domestic savings rate or an increase in foreign capital inflow (i.e. either by change a or b). Typically Botswana's rapid economic growth highly depended on foreign capital (aid and private inflows). Aid constituted almost 31% of gross domestic investment

Fig. 2.8 Aid decline as savings rate increases in Botswana



in 1966 and reached an average of 17.2% for the period 1961–1970 (see Table 2.18) while foreign direct investment has been improving though marginally (Table 2.19). On the other hand, domestic savings as a percentage of GDP was negative in the early years after independence improving continuously to reach its peak in 1990s with an average of 42% between 1986 and 1990 (refer to Table 2.19 and Fig. 2.6). In parallel the country's debt increased from US\$169.1 million 1976 to US\$545.5 million in 1987 while foreign exchange reserves continued to rise from US\$75 million to US\$2013 million in the same period (Table 2.18).⁵¹

Initially, Botswana relied almost entirely on aid to finance its budget and hence attracted grants from an increasing number of donors through efficient management of aid-finance projects (Harvey & Lewis, 1990). Indeed Botswana has had the highest per capita aid in sub-Saharan Africa and foreign capital in the form of grants which continued to flow even after the country attained middle-income status (Maipose & Matsheka, 2002). In Figure 2.8 we denote Botswana's move from aid-dependent to self-sustained growth path.

The country initially depended on foreign capital inflows to supplement domestic savings. Botswana effectively managed its aid resources and was able to sustain the economic growth with decreasing dependence on aid. In Figure 2.8, national income growth increases from r_0 to r_1 as a result of increases in savings rate. Hence savings constraint line shifts from s_0 to s_1 whereas foreign constraint line shifts from f_0 to f_1 . This demonstrate that decline in aid is exactly compensated for by an increase in domestic saving equivalent to ψ . The portion θ represents the net additional growth after fully compensating for reduction in aid-foreign capital inflows, which further stimulate more savings.

Typically as income grew, domestic savings increased continuously, whereas the marginal rate of savings was higher than the marginal rate of investment, the savings gap declined overtime. Similarly the foreign exchange gap became gradually less restrictive as exports increased faster than the increase in imports.

⁵¹Good (1992) notes that external debt stood at US\$14million in 1970.

2.4.3 Trends and Policies in Agriculture and other Sectors

Botswana is situated in the centre of the Southern African Plateau and is totally landlocked. It is not an ideal country for arable farming as the soil is of poor fertility and the rainfall is low (Jones, 1981). Prior to independence, and even up to the late 1960s, Botswana depended heavily on agriculture (see Table 2.17). The sector contributed about one-third of the GDP although since 1970s its importance has been diminishing. According to the 1964 census, almost 90% of the economically active population was engaged in agriculture and as at 1971 the rate was as high as 86% (Harvey & Lewis, 1990). In 1966, agriculture contributed about 39% of the GDP. Effectively, cattle raising remained the major agricultural activity, accounting for about 80% of the marketed agricultural output in 1966 (Harland-Thunberg, 1978). As crop agriculture has never been a major source of income in rural Botswana, important government policies have been biased towards the livestock sector which was a major export earning source before mineral exploitation. Immediately after independence the government took direct action to improve the management of the national herd to improve its quality and value as an economic resource. A livestock diseases control program was launched where steps were taken to enhance animal health, and a Tribal Grazing Land programme was implemented to provide adequate grazing space (Harvey & Lewis). The impact of this was immediately realized as Botswana gained access to the European Economic Community (EEC) for beef export at prices above the world market. The cattle population increased by 8% during the years 1970–1975 as a result of these encouraging policies. Hence, from 1966 to 1977, the net sales of the Botswana Meat Commission (BMC) which had exclusive export rights of beef and cattle increased from P7 million to P42 million (Hubbard, 1981). In recent years, the contribution of the agricultural sector to the GDP has been reducing. As noted in Table 2.17, the share of the sector in GDP has shrunk from 39% in 1966 to 4.2% in 2000, compared with the mining sector that rose from zero to almost 34% in the same period. But this does not mean that the sector is no longer important. The magnitude of public investment has been quite high although increase in agricultural productivity and output has been low. The government's planned development spending in various NDP plans⁵² for the agricultural sector has been large relative to revenue from the sector in the post-independence period. The government generously supported the industry with revenue from diamond exports, as it has stepped in on many occasions to pay BMC's tax liabilities when the institution had not performed well (Samatar, 1999). In the recent past, the government has shown commitment to economic diversification including ways to improve agricultural contributions as this has been the main focus of NDP8 (1997–2001). Ultimately, the state intends to achieve structural transformation where large revenue from the diamond sector can be used to boost the growth of non-mineral sectors to reduce the

⁵²Harvey and Lewis (1990) give a breakdown of planned development spending on agriculture. This spending has been significantly increasing from NDP2 (1970–1974) to NDP5 (1980–1984).

degree of dependency on the vulnerable mining sector only for growth (BoB, 2000). In spite of various initiatives to spur growth in the sector, such as the restructuring of the Botswana Agricultural Marketing Board and easing of financial assistance, the sector's contribution continues to fall. Such a progressive decline in agriculture in the 1980s and 1990s has to a great extent been caused by natural phenomena such as unfavourable weather conditions and persistent drought combined with a number of structural problems (BoB).

Like many other African countries in the region, Botswana had minimal industrial development at the time of independence, as indicated in Table 2.17. The contribution of the industrial sector in 1966 was 17%. A large part of this was due to the cattle industry, led by the BMC which exported meat after minimal processing including tinning and freezing. This accounted for a large proportion of manufacturing activities estimated to be more than one-third (Makgetla, 1982). Other forms of manufacturing or production were almost entirely non-existent as the country lacked adequate power supply, infrastructure and communication facilities. Meanwhile, the share of the mining sector rose from almost zero to nearly 34%, reaching its peak of 51% in 1989. The opening and exploration of three diamond mines⁵³ (Orapa, Letlhakane and Jwaneng) in the 1980s and copper-nickel mines at Selebi-Phikwe in the 1970s provided much of the stimulus to growth in other sectors such as government and infrastructure. Hence the Botswanan economy expanded rapidly from a moderate average GDP growth rate of 8.7% in 1961–1970 to 15.2% in 1971–1980. In the same period the average annual growth rate in the industry increased from 10.8% to a record of 17.4% in a decade. These changes had an impact on the rest of the economy. Total fixed capital formation, exports and government revenue increased significantly, and resulted in two investment booms in 1969–1974 and 1977–1981 (Fig. 2.6).⁵⁴ These booms were led by heavy investment in the mining sector as both Letlhakane and Jwaneng mines were underway. Despite Botswana's rapid rate of economic growth and high level of foreign reserves, the structure of the manufacturing sector did not change. The share of the manufacturing sector has remained almost constant, contributing 6% of the GDP in 2000 compared to 8% in 1966. Due to this, the new economic development strategy issued by the government in NDP8 (1997–2002) stresses the importance of transforming mineral endowment into an endowment of physical and human capital (Maipose & Matsheka, 2002). In this regard, the government initiated a number of Financial Assistance Programs (FAPs) to encourage labour intensive operations and to provide capital grants to small-to-medium sized industries while extending subsidies to infant industries (Harvey & Lewis, 1990). There are a number of reasons why the growth of the manufacturing sector has been modest. First, Botswana still remains a member of SACU where South Africa plays a dominant

⁵³Note that the Orapa mine was opened in 1971 and expanded in 1978, the Letlhakane mine was opened in 1976 and the Jwaneng mine was opened in 1976 and expanded in 1983 (Hill & Knight, 1999).

⁵⁴Harvey and Lewis (1990) analyse the impact of these two booms on the whole economy and on the mining and non-mining sectors.

role. Although Botswana receives a good share of the customs union revenue, such membership is detrimental to the rate of industrialization as citizens and businesses have complete access to inexpensive and indirectly subsidized South African products (Maipose & Matsheka). Hence young and small local industries will find it hard to compete with such well-established foreign industries. Second, even though capital is generally available in Botswana, other constraints such as the shortage of skilled labour – particularly in technological, professional and managerial positions – still exist. Likewise the cost of production is high, as water and electricity rates are higher relative to Zimbabwe and South Africa (Harvey & Lewis). This partially explains why the manufacturing sector has not provided the expected impetus to the economy and, therefore, under such circumstances, the ability of producers to export and significantly compete with imports from internationally competitive firms is hindered without some level of protection. In the immediate years after independence, the country was dependent on foreign support for all its development expenditure and more than half of its recurrent expenditure. Savings had been negative or marginally low (see Fig. 2.6). Domestic savings as a share of GDP was negative in the mid 1960s, low in the late 1960s before reaching 17% in 1970. During this period, the ratio of investment to GDP had been increasing. This difference was largely financed by capital from abroad. Aid as a percentage of GDP stood at 31% in 1966 and, on average, recorded more than 19% between 1961 and 1970 (refer to Table 2.18). Similarly, foreign direct investment (as a percentage of GDP) was increasing and remained positive on average until the late 1990s (see Table 2.19). Between 1966 and 1970 investment ratios were high in Botswana recording 30% on average, while in the next half decade they reached the peak of 45%. These high levels of investment were necessary due to the expansion in infrastructure and exploration in copper/nickel and diamonds which were underway during the period.

Because of expansion in mining exports and a rise in imports, public revenue almost quadrupled in 1976–1980 (Oden, 1981). Between 1971 and 1975, the savings ratio improved to almost 33%. Hence, the rapidly increasing revenue enabled the government to finance its entire current budget and a substantial share of the capital budget with locally generated funds.⁵⁵ The discovery of mineral resources further enhanced the country's image in attracting foreign capital. As its source of revenue expanded, the government saved an increasing share of its income. In the period 1971–1975, public savings was 15% compared to 6% in the private sector. It is not surprising that the real development expenditure in 1967–1987 grew at an average annual real rate of 12.6%, and, in spite of this, the revenue growth was consistently more than the growth in expenditure (Hill & Knight, 1999). The continuous increase in exports over imports enhanced foreign exchange accumulation and the growth of government cash balances at the central bank. Resultantly, the savings pace increased more than investment over time and finally outmatched investment levels in 1986 (Fig. 2.6), and until recently, saving rates in Botswana

⁵⁵A detailed statistical breakdown for the period of 1976–1980 is given by Oden (1981).

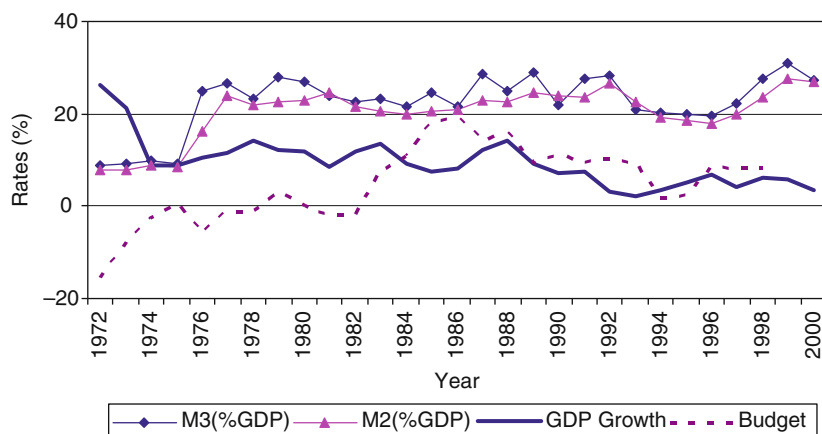


Fig. 2.9 Performance analysis in Botswana

Source: African Development Indicators and International Financial Statistics (IFS)

remained higher than investments. Ultimately, domestic savings financed almost all of the government finance capital formation for the first time in 1984 while foreign capital inflow still remained positive. With constant increases in mineral exports, Botswana's balance of payment has also transformed. Overall, the country had a balance of payment surplus by 1980, and, except for the 3 years of the diamond depression period (1980–1982), where Botswana's terms of trade fell significantly due to a rapid rise in import prices and a significant fall in diamond exports, the balance of payments was mainly surplus (Fig. 2.9).⁵⁶ As the positive diamond shock gradually improved the balance of payments position, exports also increased rapidly. This gradually resulted in an appreciation in the exchange rate (the famous Dutch disease effect) which, in turn, would have harmed the non-booming tradable sector (Hill & Knight). The government realized this effect and intervened in time, introducing necessary policies to prevent the contraction of non-boom tradables through controlling real appreciation in the exchange rate. Furthermore, real appreciation would have reduced export diversification by making manufacturing exports unprofitable. More than this, however, it would have decreased the import-substitution process in both manufacturing and agricultural sectors by making imports cheaper relative to domestic production (Harvey & Lewis, 1990). Likewise, both the recurrent and development expenditure grew faster over the period of 1966–1987, and hence, such excessive spending by the government would have caused rising trends in costs in Botswana compared to its major trading partners. This is reflected in inflation which had been consistently increasing in the same period.

To moderate the abovementioned effects, the government used an exchange rate policy. The main objectives of the exchange rate policy in Botswana were to

⁵⁶For a complete discussion of the nature, causes and impact of the diamond boom and shock in Botswana, see Hill and Knight (1999).

achieve international competitiveness in pricing and to manage inflation, particularly by avoiding imported inflation from main trading partners as much as possible through import prices (Harvey & Lewis, 1990). Oden (1981) observed that, on average, more than 70% of significant increases in inflation during the period of 1976–1981 were imported, especially from South Africa. This was not untypical as the Botswana economy remained extremely open which is reflected by, among other things, high imports of goods and services which, on average, corresponded to close to 50% of the GDP in 1976–1980 (as given in Table 2.19). To curb inflation, the Pula was revalued upwards consistently by 5% in 1977, 1979 and 1980.⁵⁷ These revaluations were expected to have a favourable effect also on income distribution. This is because, in Botswana, poor people have a higher import propensity (more than 70%) relative to the rich (almost 40%) since the poor spend largely on imported basic foodstuffs, whereas the rich spend significant amounts on locally produced products and services (Hill & Knight, 1999). It was also estimated that reductions in inflation would feed back into lower wage increases, and hence, the net effect of exchange rate and income policy would not be, in total, to make the country uncompetitive (Harvey & Lewis).

From the 1970s, government revenue was transformed from being heavily dependent on beef and customs revenue to being almost entirely dependent on mineral income. Before 1976, the revenue growth was led equally by customs revenue and mineral revenue. In contrast, after the 1976 mineral revenues accounted for more than 60% of government revenue, and as at 1986 they reached 72%, whereas tax and customs revenues accounted for only 16% (Hill & Knight, 1999). Thus, when the demand for higher quality gems fell sharply in 1980–1982 – due to a serious recession in the diamond market especially in industrialized countries – Botswana was hit hard. With the opening and expansion of the Orapa mine in 1979 diamond production increased rapidly. But the country was not able to sell, and effectively from August 1981 onwards, diamond exports stopped (Hill & Knight).⁵⁸ As depicted in Fig. 2.9, this caused a serious balance of payments problem. In 1982, the government implemented a package of measures aimed to adjust the economy to the fall in the diamond revenue which included 10% devaluation in the Pula (Harvey, 1985). Other measures which were indeed undertaken included a wage freeze, restrictions in credit and increases in interest rates. Although these measures worked to control the shock, the Pula was again devalued by 15% in 1985 in order to avoid a loss of international competitiveness, and to correct an upward drift of the Pula against the Rand (Harvey). The policy objectives of the exchange rate in recent years remained to maintain a stable environment for the export sector as the government geared towards achieving economic diversification. Unlike previous instances where the main concerns were either curbing inflation or

⁵⁷While most of the African countries had a fixed exchange rate during the 1970s and 1980s, Botswana adopted flexible exchange regimes earlier and more frequently relative to other SSA. Probably this positioned the country more competitively and helped it face booms and slumps.

⁵⁸Formally this only continued for 3 months before exports returned to their normal level.

widening income distribution, the recent trend has been leaning towards promoting economic diversification by enhancing non-traditional manufacturing in both production and exports.⁵⁹ Hence the Bank of Botswana has focused on maintaining stable and competitive real effective exchange rates for the Pula.

2.5 The Thai Financial System

Financial sector reforms in Thailand started back in 1987 to achieve and sustain high rates of economic growth. Thus from late 1980s to mid 1990s Thai economy has witnessed various forms of market liberalization and globalization, resulting a more open and an integrated financial system. This market reforms and relaxation led to massive investment in Thailand's stock market and inflow of foreign capital and investment into the domestic economy. Thailand's financial system and stock market is made up of eight major financial institutions, performing different and specialized financial roles. This includes commercial banks; specialized banks; development finance corporations; the stock exchange; finance, securities, and credit companies; saving cooperatives; insurance companies; and other mortgage institutions (Islam & Wanapalachaikul, 2005, p. 13). Although commercial banks account for 71% of the financial assets, other specialized financial institutions (such as Government Saving Bank, the Industrial Finance Corporation of Thailand, the Bank for Agriculture and Agricultural Cooperatives) also play a major role in financial mobilization (Warr & Nidhiprabha, 1996) and, together with a well-developed foreign exchange market, aid domestic banking business and investment (Ho, 1991).

Similar to the African countries we have discussed above, reforms priorities in Thailand mainly included a comprehensive financial deregulation to enhance foreign trade, promote greater financial intermediation, encourage financial deepening and improve productivity of investment. Thus interest rate deregulation and relaxation of exchange rate and capital controls was the core of Thailand's reform policies and financial liberalization programme. Supported by a further improvement of supervision and examination of financial institutions, these changes have led to the development of better financial instruments, services and the payments system (Islam & Wanapalachaikul, 2005, p. 17). The country achieved a high private investment growth, became a leading destination for international foreign capital and recorded rapid and sustained economic growth during this period, although the financial system became vulnerable to shocks and unstable as evidenced in the fact that the Asian financial crisis in 1999 (Hansanti, Islam & Sheehan, 2008) started in Thailand.

⁵⁹The recent exchange rate objectives are as stated in the Bank of Botswana Annual Report 2000.

2.6 Conclusion

This chapter aimed to give background and status of the four countries of our sample before and during the era of the structural adjustment program. It turns out that the success of economic stabilization and liberalization aimed at improving efficiency and increasing investment and productivity depends on underlying economic foundations as well as commitments of the individual country. Kenya and Malawi have taken similar development strategies where even though reforms were market-oriented, government expenditure and fiscal indiscipline have often limited private sector activities. These countries had pervasive economic intervention and imposed controls which skewed resource allocation and discouraged financial and institutional development. This, to a large extent, must have negated the traditional economic role played by the private sector and hence limited the effective contribution to the economic development. These high level interventions discouraged savings mobilization. Contrastingly, markets in Botswana faced modest intervention in the pre-stabilization period. In most cases those interventions were intended to foster financial intermediation (to induce allocational efficiency) and encourage the general level of lending in the economy.

In all the four countries, financial liberalization was undertaken to integrate the financial system and strengthen the regulatory framework. Accordingly, reforms encouraged financial sector development and enhanced private agents' involvement in all the three countries. However, governments financing requirements and increased macroeconomic uncertainties have reportedly rendered the contribution of such market-based economic transformation to be at best negligible in emerging economies especially in Kenya and Malawi.

Given the mixed experience of financial reform in African and Asian (Thailand) countries, it is essential to evaluate the specific and quantitative impact of financial liberalization in terms of allocative efficiency, savings, financial intermediation and risk-sharing, fiscal condition and social welfare in these countries. Further, it is important to assess the monetary and non-monetary gains to the society and to consider and capture all direct and indirect benefits and costs in an attempt to sum all the impact for financial liberalization and globalization in each period before using appropriate technique (cost-benefit analysis model) to calculate its net social welfare impact.

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