

EVOLUTION OF EXCHANGE RATE DETERMINATION IN MALAWI: PAST AND PRESENT

The management of exchange rate in Malawi has been pursued with three major policy objectives in mind. These include:

- i. attainment of growth in real income;
- ii. maintenance of a viable balance of payments position; and
- iii. attainment of stable domestic prices.

These objectives were attained to some extent in the 1970s; but, owing to both external and internal factors, they were difficult to achieve in the 1980s. In this section, we look at the evolution of the exchange rate in Malawi by focusing on periods identified as first the par value peg to the British pound sterling; second, the peg to the trade-weighted basket of the US dollar and the British pound; third, the peg to the SDR; fourth, the peg to a basket of currencies; and finally the floating regime. The analysis of recent developments will follow.

(a) British Pound Sterling/Malawi pound par value system (1965-1973)

The use of the exchange rate as an instrument of monetary policy began as early as 1965 when the Reserve Bank of Malawi became fully operational. Soon after attaining self rule from Britain in 1964, Malawi introduced its own Malawi pound, which later became known as the Malawi kwacha in early 1971. At that time the Malawi currency was pegged at par to the British pound sterling and this continued until November 1973. During this period (1965-1973), the Malawi pound moved in tandem with movements in the British sterling, such that when the latter was devalued by some 14 percent in November 1967, the Malawi pound was also devalued by the same magnitude. During that time the Malawi pound was floating against the US dollar and commercial banks calculated rates for other currencies with reference to London Inter-bank Market rates. During this exchange rate regime, the Malawi economy enjoyed buoyant economic growth and had a healthy balance of payments position.

During this period, many developed countries including the United Kingdom, maintained a fixed exchange rate system with the gold or the US dollar.^{[1] [2]} By 1971 problems arising from limited gold supply^[3] began to surface; and, by 1973 this system completely collapsed as most major countries renounced the par value system. This was followed by the generalized floating of exchange rates by several countries, which caused large volatilities in currency markets. The Malawi currency, as was expected, depreciated along with the depreciation of the British pound to which it was pegged. Authorities, thus, began to think of other ways of managing the exchange rate.

(b) Peg to weighted Basket of British Pound and the US dollar (1973-1975)

From November 19, 1973, Malawi authorities responded to the movements in the international currencies by de-linking the Malawi kwacha from the British pound, and pegging it to a trade-weighted basket of the British pound and the US dollar. In this system, the Reserve Bank determined the exchange rate by setting daily buying and selling rates for the US dollar and the British pound in the light of foreign exchange market developments. During this period, which ended in June 1975, authorities started pursuing an active exchange rate policy, which involved overt (announced) devaluations of the kwacha when a need arose.

(c) The Peg to the IMF SDR (1975-1984)

With effect from 9 June 1975, the Malawi kwacha was pegged to the IMF's Special Drawing Rights (SDR) initially at the rate of MK1.0540 to one SDR. The middle rate for the US dollar was determined on the basis of the IMF's daily calculations of the US dollar-SDR rate; rates for other currencies were determined on the basis of cross rates on the London inter-bank market. This time the US dollar was used as the intervention currency.

For a time, the peg to the SDR seemed to have worked better for the economy as evidenced by the temporary stability achieved with the new peg at a time when major international currencies were experiencing violent movements. These benefits, however, proved to be only short-lived as the SDR began to appreciate in chorus with the US dollar^[4] in the early 1980s. The Malawi kwacha responded by appreciating along with the SDR. This did not go well with Malawi authorities as it constrained export development.

It must also be recalled that at the beginning of the 1980s, Malawi's sound economic performance was seriously disrupted by several shocks, both from external and internal sources. One of the external factors was deterioration in the country's terms of trade, which resulted largely from weak external demand for the country's primary products in world markets. As the SDR continued to appreciate, Malawi authorities had to take active exchange rate actions with the view to restraining the terms of trade from further deterioration. Hence on April 24, 1982 the kwacha was devalued by 15 percent. This was followed by another devaluation of 12 percent on 17 September 1983. These actions, however, failed to redress the situation as the country was also severely affected by a drought, which curtailed agricultural production, thereby adding pressure on the country's balance of payments.

(d) Peg to the Weighted-Basket of Seven Currencies (1984-1994)

Despite the devaluations carried out in 1982 and 1983, the country's external situation continued to deteriorate, which was made even worse by the disruption of the traditional transport routes to the maritime ports of Beira and Nacala due to political conflicts in Mozambique. On 17 January, 1984 authorities de-linked the Malawi kwacha from the SDR and pegged it to a trade weighted-basket of seven currencies^[5] representing the geographical composition of Malawi's trade and the currencies used in settling the country's international transactions. During this regime, the middle rate of the Malawi kwacha exchange rate as quoted by the Reserve Bank was determined on the basis of the daily calculations of the exchange rate of the US dollar in terms of the SDR. Rates of other currencies were quoted by the Reserve Bank on the basis of the appropriate daily cross rates as communicated by the IMF. Frequent adjustments were made with the view to realigning the kwacha with the basket taking into account inflation differentials.

Although the peg to the trade-weighted basket of currencies managed to improve the current account balance from -11.8 percent of GDP in 1983 to a low of -1.7 percent in 1984 (Table 1 appended), problems on the international trading routes intensified when Beira and Nacala routes were completely closed to Malawi traffic in 1984. This forced the country to rely on long overland routes to the ports of Durban in South Africa and Dar-es-Salaam in Tanzania, a change which significantly increased the country's c.i.f. / f.o.b.^[6] margin from only 22 percent in the 1970s to over 40 percent since 1984. This worsened the country's terms of trade. Authorities had to take active exchange rate changes. Thus on April 2, 1985 the kwacha was devalued by 15 percent; it was devalued by 10 percent on August 16, 1986; by 20 percent on February 7, 1987; by 15 percent on 16 January 1988; by 7 percent on 24 March 1990; and twice in 1992, by 15 percent on March 28 and 22 percent July 11.

(e) Floatation of the Malawi kwacha (February, 1994)

In 1988, the Malawi government embarked on a three-year structural adjustment program supported by the IMF's Structural Adjustment Facility (SAF), the World Bank's Industrial and Trade Policy Adjustment Credit (ITPAC) and the Agricultural Sector Adjustment Credit (ASAC). Among other things, this program involved a phased liberalization of imports, that is the removal of restrictions on the approval and availability of foreign exchange for private sector imports, as well as a move towards adoption of a more flexible exchange rate policy.

On February 7, 1994 the foreign exchange market was completely liberalized and the kwacha was allowed to float freely. Several factors led to this change, including: fundamental disequilibrium as revealed by balance of payments pressures emanating from the 1992/93 drought; the withdrawal of non-humanitarian development assistance by the international community on account of "good governance" issues; and by the fact that several member countries of the then Preferential Trade Area (PTA) now COMESA had already adopted various types of market-determined exchange rates.

To support the liberalization, other measures were also implemented in 1994. A foreign exchange retention scheme whereby exporters of non-traditional exports were allowed to retain a major portion of their export earnings was instituted. Furthermore, exporters of traditional exports, i.e. tobacco, tea and sugar were allowed to open interest earning foreign denominated accounts with domestic banks. These measures were meant to encourage production for export. In addition, restrictions on capital movements by non-residents were also removed, and foreigners were permitted to make direct investments and buy market-traded paper and repatriate investment proceeds without any restrictions.

The switch from the fixed regime to the floating one was meant to achieve certain objectives, which can be summed up as:

- (a) improvement of the country's export competitiveness;
- (b) provision of an efficient foreign exchange allocation mechanism;
- (c) dampening speculative attacks on the kwacha; and
- (d) restoration of both investor and donor confidence; among other objectives.

The following features were also put in place to support the foreign exchange market liberalization:

- (a) authorized dealer banks were free to buy and sell foreign exchange at freely determined market exchange rates;
- (b) foreign exchange bureaus were authorized to engage in spot transactions with the general public on the basis of exchange rates arrived at with their clients;
- (c) foreign exchange brokers^[7] were authorized to match orders from buyers and sellers of foreign exchange on agency basis only;
- (d) to determine the exchange rate, the Reserve Bank convened weekly fixing sessions at which offers to buy and sell foreign exchange from authorized participants were matched to arrive at a clearing exchange rate. Thus the type of the free float adopted was the auctioning system; and
- (e) exchange rates of other currencies were determined on the basis of the cross rates of the US dollar for the concerned currencies.

There are many advantages for floating a currency. One is that a floating currency ensures that movements of the exchange rate are in line with the market forces of demand for and supply of foreign exchange. In this case, the foreign exchange value of the domestic currency settles at a price, which equates the quantity of foreign exchange demanded to the quantity supplied. Just like

in any other free market, if the amount of foreign exchange supplied in the foreign exchange market falls short of the amount demanded, the price of the foreign exchange rises until the quantity demanded is equal to the quantity supplied. The reverse occurs when the quantity supplied exceeds the quantity demanded.

(e) Recent Developments in the Malawi Kwacha Exchange Rates

When authorities floated the Malawi kwacha on 7 February 1994, the currency immediately plummeted, from its level of K6.70 per US\$1.0 on Friday, 4 February to K9.88 per US\$1.0 on 28 February 1994, a loss of 32.2 percent within a period of one month. This resulted from a combination of factors, such as the liberalization of the foreign exchange market and the 1992/93 drought. By end-November of that year, the kwacha had depreciated in nominal terms by over 290 percent against the US dollar; 300 percent against the British pound; 279 percent against the South African rand; and 335 percent against the German mark, reflecting spending overruns which led to loss of confidence in the kwacha. Initially, such massive depreciations were viewed as excessive. In fact the general consensus was that the depreciation was more than what was implied by the economic fundamentals.

Increased government expenditures following the 1994 general elections triggered a rapid acceleration in inflation which reached critical levels in 1995 and 1996. During this period exchange rate policy focused on reducing price increases. Although authorities managed to curb inflationary pressures during the last half of 1996, there were indications that the real exchange rate was appreciating, which was not in the best interest of the country's long term growth prospective. Besides the fact that foreign exchange was readily available during most of 1996, the appreciation of the real exchange rate was caused by domestic developments in the South African economy that saw the rand nose-diving against the US dollar. This affected the Malawi kwacha since Malawi has strong trade links with South Africa.

Despite these developments, the nominal value of the kwacha remained relatively stable, especially vis-à-vis the US dollar during most of 1996 and the first half of 1997. However, this stability also meant that the real exchange rate strengthened over the same period and became excessively overvalued, mainly reflecting huge inflation differentials between Malawi and its trading partners. This, combined with pressures on the currency arising from huge fiscal deficits in the second half of 1997, led to the devaluation of the kwacha in July 1997. At the same time, authorized dealers (except bureaux) were now required to maintain the by-sell spread of not more than 2 percent.

The devaluation of the kwacha in July of 1997 had the effect of improving its competitiveness vis-à-vis currencies of the country's regional trading partners, but this was only temporary. The currency began to appreciate in real terms against the Zimbabwe dollar and the South African rand. This trend continued into the second half of 1998.

South Africa and Zimbabwe account for a considerable proportion (about 60 percent) of Malawi's trade (mainly imports); hence the fall in value of the rand and the Zimbabwe dollar in 1997 and 1998 rendered the kwacha uncompetitive. Furthermore, pressures on the kwacha intensified at the beginning of the second half of 1998 as indicators revealed that tobacco exports and donor-related inflows were going to be much lower than expected at the beginning of the year. As a result the reserves target could hardly be attained. To make matters worse, demand on official reserves which normally emerges in October, began as early as August and this was a clear indication that reserves management thereafter would become increasingly difficult.

It was against this background that authorities decided to take appropriate exchange rate action. Consequently, the kwacha was devalued by 28 percent and 23 percent on 21 and 24 August, respectively. This action resulted in a real depreciation of the kwacha and the demand on official reserves appreciably decreased.

Towards the end of August 1998, the kwacha was allowed to be market determined again and intervention by the Bank was only guided by preset reserves target. However, over this period, the exchange rate system was more of a managed float with banks trading with few limitations. The Reserve Bank remained the main dealer.

From August 1998 to December 1999, the nominal exchange value of the kwacha ranged between K42 to a US dollar and K46.

In the final analysis, it must be mentioned that the maintenance of a stable exchange rate in the short-term requires many things, including first the maintenance of adequate foreign reserves for currency stabilization. Second, fiscal discipline is critical in order to avoid domestically financed deficits. Third a steady inflow of donor support or other capital flows is also fundamental in maintaining a stable exchange rate. Finally, interest rates must be managed flexibly with a view to maintaining demand for local currency. In the long-term, the diversification of the export base, increased investment to meet domestic demand for consumption goods, reduction of external debt and maintenance of a realistic exchange rate will be critical.

During this Bretton Woods System, member states were asked to state the par values for their currencies in line with the Bretton Woods rules. They intervened in the foreign exchange market in order to keep the market exchange rate within one percent of the par value, by adding or reducing their foreign Reserves (Hallwood, P., and MacDonald, R. (1989): International Money: Theory, Evidence and Institutions; Basil Blackwell, Oxford.

[2] Up to the late 1930s, countries were operating under the 'Gold Standard'. This entailed the requirement that domestic currencies be fully backed by gold reserves. This system ended in the 1930s and between 1971 and 1973 countries were operating under the Bretton Woods System in which domestic currencies had an adjustable peg to the US dollar or other currency such as the pound sterling or French franc.

[3] The United States was mandated to maintain gold reserves which were to be exchanged for national currencies of member states in the case of intervention to realign their currencies.

From 1974 the SDR was calculated in reference to a basket made up of major international currencies with the US dollar having the largest weight of over 40 percent in 1981. Other currencies composing the SDR in 1981 were Deutsche Mark (19%); Japanese Yen (13%); French franc (13%); and the British Pound Sterling (13%).

Currencies in the basket and their weights were as follows: US dollar (27 %); Pound Sterling (27 %); South Africa rand (18 %); German Deutsche mark (7 %); Japanese yen (7 %); French franc (7 %); and the Netherlands Guilder (7 %).

[6] c.i.f. / f.o.b. in full is cost, insurance and freight and free on board, respectively, of cost of transportation.

[7] Foreign exchange Brokers were suspended in November, 1994.