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STRATEGIES FOR SMALL AND MEDIUM ENTERPRISES IN MALAWI

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2. The macro structural context in which SMEs operate. Some 12% of the Malawi population lives in cities, in towns, and in small urban centers. Another 6% lives on estates. The rest of the population--over 80% of the people--lives on rural holdings whose average size is very small and is decreasing due to population growth. Average income per household on these small holdings is estimated for 1980/81 to be about MK300 per year. Of this amount, about MK110 is in cash, the rest being subsistence food. Of the cash income, about two-thirds comes from sources other than sales of cash crops (i.e. from wage income, from non-agricultural activities and from transfers). The importance of non-farm enterprises in providing cash income for smallholders is obvious.

About a third of this cash income is spent on purchases of food. This means that cash expenditures for non-food purposes by the 80% of the population living on small holdings amounts to only about MK70-80 per household per year. These are national average figures; in poorer regions, the comparable figure seems to be barely MK50 per household per year. In the aggregate, these figures are reported to be growing little if at all. It is clear that there is very little potential for expanding output of SME producers for sale in these small, isolated and slowly-growing markets.

As a rough estimate, there are probably about 30-35,000 SMEs in Malawi with some hired labor. In addition, there are about 110-120,000 self-employed individuals, relying only on their own labor, perhaps with some unpaid family members to help, and another 50-60,000 hired workers in small enterprises. For all of these, the SMEs are their primary activity. In addition, there are probably hundreds of thousands more who engage in some non-farm activity on a part time basis.

Over the past decade, population growth rate has accelerated (compared to the previous decade), growth in employment in larger, formal sector enterprises has declined while the rate of growth of labor on smallholdings has increased. All of these are ominous trends.

3. Major categories of potential growth for SMEs. The structural features of the economy just outlined help define areas of potential growth among small and medium enterprises. Opportunities for these producers arise in three principal areas:

-Through linkages with growing sectors of the economy: urban enterprises (including large, modern producers), estates, and those smallholder farms where cash crops are being introduced. Three categories of linkages are at work here: those arising from increases in demand for consumer goods as incomes rise; backwards production linkages (the provision of inputs); and forward production linkages (processing, transporting and trading the output of other sectors). An important component of SME development strategy should be aimed at seeking out dynamic areas of the economy and then maximizing the capacity of small and medium producers to respond to increases in demand arising from linkages with these "growth engines."

-Through increases in the share of SMEs in existing markets. This could involve import substitution; it might mean capturing a larger share of markets currently served by large-scale enterprises. A third opportunity here concerns sales to the government. Key questions in this process concern product price and quality of products produced by small and medium sized firms.

-Through active participation in an improved distribution system, particularly in rural areas. Transportation and commercial activities provide jobs and incomes to those involved directly in these sectors. Perhaps even more important, they open up improved possibilities for increased output and specialization among a great variety of producers whom they serve. Finally, decreased distribution costs raise real incomes of both producers and consumers, thereby further expanding markets by making it possible for these people to purchase more of other products.

A number of suggestions are made concerning policies, regulations and project-level interventions which could help small and medium producers respond to opportunities in each of these three areas (see pages 11-12).

4. The Gender Issue. It is suggested that the gender issue be approached in the context of the preceding analysis. If the areas just discussed are those with particularly favorable growth prospects, then special efforts should be made to ensure that women enjoy a significant share of the growth in these areas. A number of suggestions are made for ways to do this (see pages 12-13).

5. The text explores in some detail five areas of policy and project intervention: credit and the financial system, foreign exchange controls, taxes, regulations, and project-level assistance. For the purposes of this summary, we limit ourselves to only two, which appear to us to be of particular importance:

-Financial markets: financial institutions are fairly well developed in terms of savings facilities, which is important for SMEs which often rely heavily on own savings for their investment funds; however, the negative real interest rates on all deposits since 1983 is worrisome. The country is less well served on the credit side. There is reason to believe that there are substantial numbers of viable investment projects among SMEs which are constrained by the non-availability of credit. Three approaches are explored for dealing with this problem: seek to expand the flow of credit to SMEs through commercial banks; continue to focus primarily on non-bank financial intermediaries; and promote the creation of new financial institutions. While each has advantages, the first seems particularly worthy of serious consideration. In the discussion of interest rates, particular attention is paid to the problems of oligopolistic markets, leading to suggestions for increasing the degree of competition in the financial market, and to issues arising from the high cost of lending to SMEs. Some interventions may be justified establishing flexible floors for deposit rates and ceilings for loan rates, although with many caveats.

-The regulatory environment: while it is difficult to prove, our impression is that government controls and regulations which restrict economic activity by location, by activity and by individual constitute a serious constraint on growth and development. We are particularly concerned about the tight controls on the transport of people and of products, which inhibits the development of the distribution system. Cumbersome registration procedures for companies are also important since such registration is a precondition for access to various other things such as credit and foreign exchange.

6. Data sources and analyses. It is clear to all that government policy as well as promotional activities suffer from inadequate information concerning the size and structure of the SME sector, its pattern of growth and developmental potential. Four types of surveys or analytical approaches are described which can help remedy this situation. First priority should be given to

comprehensive surveys, which would provide base-line data about the extent and structure of the sector. These provide only a snap-shot picture, however, and need to be supplemented by other studies designed to explore patterns of growth and dynamics in the sector. The goal of this undertaking is to strengthen the ability of the government to establish effective policies for the promotion of SMEs, to feed directly into private investors as well as credit institutions and assistance agencies, enabling each to use their resources more effectively. It can also provide an important base for monitoring changes in this area, both at a policy and at a project level.

7. Institutional questions. It is impossible to exaggerate the importance of establishing an appropriate institutional structure, if one is to deal in a fundamental and sustainable way with issues of policy formulation, regulation and promotion of SMEs. Our suggested guiding principles include the following:

-The government's analytical capacity clearly needs to be strengthened. Good policy in this area must be informed by a better information base and a better understanding of the dimensions and dynamics of the sector. The small enterprise unit in MTIT must interpret the needs of SMEs in all the different forums of government where policies are made which affect these enterprises.

-On the other hand, the core of the promotional activities which are needed in this area must be done outside of government. Civil servants in Malawi as elsewhere have the wrong kinds of motivations and incentives, of training and orientation for this type of work.

-The task of data collection and analysis for the SME sector should be the responsibility of a permanent, autonomous, national institution. This institution needs to have close links to government, to the business community (including the financial institutions) and to the assistance agencies, but should be independent of each. We would propose that the institution be an outgrowth of READI. Whether this or some other configuration is chosen, the establishment of a permanent national institutional structure for data collection and analysis, for SME promotion and for policy formulation should be a high priority concern.

8. On the final question of monitoring and evaluation, the report makes a distinction between monitoring (keeping track of what is going on) and evaluation. For assistance projects such as those channeled through READI, the former is relatively easy, although even that seems to have been done in an incomplete way in some project activities here. The evaluation task is much more complex and can be costly. It requires working with a control group, which is not done in any of the SME activities in Malawi.

For comprehensive activities such as the MED project, monitoring and evaluation could both be approached at a rather simple level based on the measures specified in the conditions precedent (for monitoring) and the policy reform matrix (for evaluation). At a deeper level, however, one would like to be able to monitor the patterns and rates of development in the SME sector, and to evaluate the extent to which the policy and regulatory changes introduced have contributed to that growth, or whether other changes are called for. These tasks require substantially more information than is currently available, and more thorough analysis of the process of change in the economy. This leads to a final plea for the establishment of a permanent, national institutional framework which will be capable of that type of data collection and analysis.

List of Acronyms Used

ADMARC	Agricultural Development and Marketing Corporation
BAS/TAS	Business Advisory Service/Technical Advisory Service
CB	Commercial Banks
CBM	Commercial Bank of Malawi
DEMATT	Development of Malawian Traders Trust
DHS	Deloitte, Haskins and Sells
FX	Foreign Exchange
GDP	Gross Domestic Product
INDEFUND	Industrial Development Fund of Malawi
ITPAK	Industrial and Trade Policy Adjustment Credit (of the World Bank)
K (or MK)	Malawi kwacha. 1 kwacha = approximately US$0.37 (currently, MK2.71 = US$ 1)
LDCs	Less Developed Countries
MED	Malawi Enterprise Development (a USAID Project)
MEDI	Malawi Enterprise Development Institute
MUSCCO	Malawi Union of Savings and Credit Cooperatives
MTIT	Ministry of Trade, Industry and Tourism
NBM	National Bank of Malawi
NBS	New Building Society
PAYE	Pay as you Earn
PCU	Project Coordination Unit
POSB	Post Office Savings Bank
RB	Reserve Bank of Malawi
READI	Rural Enterprises and Agrobusiness Development Institutions
SEDOM	Small Industries Development Organization of Malawi
SME	Small and Medium Enterprise

I. Introduction and background. There is much optimism in the development community about the potential contribution to the development process of small and medium enterprises (SMEs). Small producers in many countries have been found to be efficient in their use of resources, to be effective in creating employment at low costs in terms of capital, and in helping expand economic opportunities in rural areas.

Policy statements of the Malawi government reflect this thinking. The basic document in this regard, Statement of Development Policies, 1987-96 (DevPol), emphasizes that "the next decade will see a particular emphasis on support for small-scale enterprises" (p. 55). This theme is elaborated at considerable length throughout the DevPol document.

At the same time, it may be wise at the outset to express a word of caution. SMEs have an important contribution to make to the development of Malawi; but the growth of the sector also faces serious constraints, and cannot be expected by itself to solve all the problems arising from the slow growth taking place elsewhere in the economy. SMEs are no panacea.

This paper explores the context in which SMEs operate in Malawi; suggests a general approach to the development of SMEs in terms of areas of concentration; explores policy, regulatory and project interventions which may be needed to help move the economy in this direction; and examines the needs in terms of data and its analysis as well as of institutions for the encouragement of small and medium enterprises. Finally, it concludes with a discussion of issues of monitoring and evaluation in this sector.

1.1. The macro policy context in which SME's operate. After fifteen years of impressive if narrowly-focused growth in post-independence Malawi, the economy ran into serious problems in the late 1970's resulting from deteriorating terms of trade, sharp increases in transportation costs for external commerce, and higher interest rates on international loans. Major adjustments were required to deal with these external shocks. The country adopted a series of policy changes, which fall under the general heading of structural adjustments. A number of components of these adjustments are in mid-course; major changes have been introduced, but the final steps remain to be taken, and in some cases the ramifications of the steps already taken are still to show their full effects on the economy.

These adjustments present challenges as well as opportunities for SMEs. In broad outline, the macroeconomic policies adopted by the government should have a generally favorable impact on the development of SMEs over the next five years. Adjustments already made should provide a basis for restoring modestly positive growth of per capita income in Malawi. As of mid-July, Reserve Bank economists are projecting real GDP growth of 3.9% for 1989, only slightly under the World Bank projection in the ITPAC report (May, 1988). The favorable impact on SMEs of rising per capita incomes is self-evident, although the distribution of income gains is important as well.

Potentially even more significant than small improvements in per capita income is the movement towards a more balanced government budget, lower inflation, and a more sustainable balance of payments position. Looking first at the government budget, the latest Monthly Statistical Bulletin shows that the government recurrent account achieved a surplus of K88 million in the twelve months to February, 1989, compared to a deficit of K185 million the previous twelve months. This remarkable turn-around was achieved by a combination of increased tax revenues and spending reductions. Thus government saving swung from very negative (nearly -7% of GDP for 1987) to positive (1.8% for 1988). These changes meant that net domestic credit to the government did not just rise more slowly; it actually declined by 33%. The government completely reversed what had been its voracious appetite for absorbing increments in domestic credit at the expense of the private sector.

The direct impact of these government finance adjustments for SMEs is not of major importance, since bank credit to the SME sector was negligible in any event. The modern sector bore the brunt of the credit squeeze, and will benefit most directly from its relaxation. But indirect effects on SMEs of paring the budget deficit could be quite significant. This can be seen by considering some of the adverse indirect effects of the credit squeeze.

-The most obvious linkage is that the credit squeeze contributed to stagnation of modern sector growth and declining real per capita incomes, to the detriment of SMEs.

-The government's huge appetite for domestic credit was financed in large part by central bank credits, which generated rapid growth of the monetary base, which in turn fueled a rapid growth of the money supply. The ensuing inflation reached 37% (composite retail price index) over the twelve month period to February, 1988. Over the subsequent twelve months to February, 1989, inflation declined to 26%. Reserve Bank economists state that inflation has since ebbed further, and may decline to as low as 12% by the year-end.

The dominant effect of high rates of inflation on SMEs is probably damaging. Given the limited flexibility of nominal interest rates, higher inflation increases the inflation tax on financial savings, whether in the form of cash or deposits. It also lowers the real cost of credit, but SMEs have not had much access to credit. To the extent that wages fail to adjust, inflation erodes consumer purchasing power. Inflation also increases uncertainty, a key concern of SMEs, and encourages inefficient investment in inflation hedges to the detriment of productivity.

-To contain inflationary effects of government borrowing, the Reserve Bank imposed credit ceilings on the commercial banks. With a lid on lending, the banks lacked the incentive to mobilize deposit funds or to offer attractive deposit rates when interest rates were decontrolled. Evidence to this effect is that the banks recently "rationalized" their mobile units, resulting in a cutback in rural depository services. Also, when interest rates were decontrolled, the banks attempted to reduce deposit rates, which were already negative in real terms. This prompted the Reserve Bank to step in with strong "advice" on what the "deregulated" rates should be.

Since retained earnings and private savings are the primary vehicles for financing SME expansion, anything impairing deposit services or reducing real deposit rates hinders SME development. Negative real deposit rates are especially pernicious because they erode savings and undermine attempts to build up capital, sapping domestic savings. Both by fueling inflation and necessitating credit ceilings, the government's appetite for domestic credit contributed to the problem.

-Finally, if commercial banks are unable to service even prime customers as a consequence of the large public sector borrowing requirement, any prospect of engaging their financial infrastructure to service SME demand for credit is lost, unless this is done through sheer compulsion.

Although domestic credit to the government has declined and inflation has ebbed, the task of easing macroeconomic constraints that adversely affect SMEs is not yet complete. Credit ceilings will continue to be needed until the excess monetary base has been absorbed by economic growth or by further reductions in the government's credit position with the central bank. Also, inflation is still quite high relative to most deposit rates.

The external sector remains out of balance, as indicated by the need for continued foreign exchange (FX) licensing. Evidently Malawi is still unable to finance its trade deficit without restricting imports through foreign exchange controls. But these controls impose heavy burdens on SMEs:

-SMEs are generally last in the queue for FX permits to import raw materials, intermediate goods, and spare parts -- if they know how to reach the queue at all.

-Often, essential SME inputs are imported by trading intermediaries who are in a position to charge excessively high prices as a result of scarcity rents created by the licensing system.

-Even when FX licensing is available, the process imposes costly delays on SMEs. Because they operate on a narrow capital base and sell in highly competitive markets where profit margins are slim, many SMEs are very vulnerable to such costs.

-We have been told that FX licenses are issued on a contingent basis that prevents banks from issuing irrevocable letters of credit to facilitate import procurement. Faced with such "soft" l/c's, foreign suppliers may be reluctant to ship orders, or may charge higher prices to cover the substantial risks implied. Again, SMEs are especially vulnerable to these extra costs.

-The regime of FX licensing implicitly protects domestic producers of restricted products, sometimes at very high effective rates of protection. Since consumer goods imports are often restricted through for FX licensing, the corresponding domestic producers are protected. Such supply restrictions increase prices, thereby eroding consumer purchasing power. Also, in highly concentrated industries, these effective import restrictions invite monopoly pricing.

One reason the government is not making faster progress in restoring external balance is that achieving external equilibrium probably requires further devaluations. These in turn would exacerbate inflationary pressures In the face of a decision on the part of the government to give priority to the control of inflation, the benefits to be gained by SMEs from the favorable macroeconomic adjustments are offset by the continuing constraints imposed by import restrictions. As the adjustment process proceeds, it will be possible to liberalize the economy more completely, to the benefit of SMEs.

One further macroeconomic issue relating indirectly to SME development is the depressed level of savings and investment. According to the latest Finance and Economic Review from the Reserve Bank (1988:III), the ratio of gross domestic investment to GDP is 14.3%. This is slightly higher than the poor investment rates of recent years, but still far below the economy's investment performance of a decade ago. Furthermore, foreign capital inflows accounted for over two-thirds of investment, and government investment continued to exceed private sector investment.

In the interest of restoring more rapid economic growth, it is essential for the government to strive for higher domestic savings rates and to shift investment resources to the private sector. Increased savings should not, however, come at the expense of consumer expenditure, which is surely low enough already. The recent move to a positive rate of government saving is one healthy sign. In addition to this, financial deepening policies are called for to stimulate intermediation of funds, to mobilize hoarded saving, and to improve the allocation of available investment funds.

A final component of Malawi's structural adjustment program concerns the reduced role of the government in the domestic marketing system, particularly as this relates to ADMARC. While this is not normally included as an issue of macroeconomic policy, it is of considerable importance to small enterprises in Malawi. Just as the forced removal of Asians from the rural distribution system a decade ago created opportunities but also caused problems, so the withdrawal of the government monopoly from certain areas of commerce opens new possibilities for small traders to step into the fray. But it is by no means clear that they are in a position to take full advantage of this opportunity. The resulting weakness of the rural distribution system not only means missed opportunities for the traders themselves, but also constitutes a significant handicap for rural small producers who rely on a weak distribution system to supply them with inputs and to help market their products. The withdrawal of the government from certain marketing functions creates new opportunities for private traders; but to enable these traders to take advantage of these opportunities, one must ask whether they have access to credit, to foreign exchange (e.g. for imported trucks), to information, and to the necessary management skills.

In sum, it is clear that the changes taking place at a macro policy level have major impacts on the situation in which SMEs find themselves. These structural adjustments open up new opportunities for small producers as for others in the private sector, but also pose new challenges, particularly during the transitional period. It is important for USAID, in its policy dialogue with the Malawi government, to monitor these changes on a continuing basis.

1.2. The macro structural context in which SMEs operate. There are three key dimensions to be considered here: the distribution of the population, the structure of employment, and the structure of income and demand.

1.2.1. Population distribution. The central facts here can be simply stated. The 1987 population census indicates that 8.2% of the population lives in the four major urban areas. An additional 2.1% lives in other urban centers with over 5,000 people, giving a total of 10.3% of the population in all these urban areas taken together. An additional small number (Pryor estimates it at 2.3% of the population) live in small semi-urban centers. It has been estimated that 6.0% of the households of the country are on estates (Pryor, p. 52). The remainder--over 80% of the population--are located on very small plots of land outside of even secondary urban centers. While these people live on very small rural holdings and are often referred to as smallholders, the discussion of following section makes clear that their activities are by no means exclusively agricultural.

1.2.2. Income and expenditure. The goal of this section is to provide an indication of the structure of income and expenditure in the economy, with special attention to the position of smallholders who, as we have seen, account for over 80% of the population of the country. The 1980/81 National Sample Survey of Agriculture gives the following estimates of average cash income per household among smallholders (in kwacha per household per year):

Food crops	31.7
Cash crops & by-products	14.7
Livestock & products	11.4
Subtotal: gross cash income from sale of agricultural products	57.8
Less costs of purchased farm inputs	16.8
Equals net cash income from agriculture	41.0
Business, net of cash business expenses	28.0
Labor (wages received)	21.4
Transfers & others	19.7
Total net cash income per household	110.1

This source does not provide useable estimates of the value of household food production for own consumption. Our approach here is to take the estimate of total agricultural income of smallholders (cash plus subsistence) (World Bank, Malawi Economic Recovery...October 4, 1985, p. 79) and subtract the estimate of net agricultural cash income of smallholders presented above. Such a calculation yields the following pattern of income among different groups in the society, for 1980/81:

	Totals (K millions)	Number of households (000)	Average per household (Kwacha)
GDP at factor cost	900	1,390	650
Smallholders:			
Agriculture: subsistence	222	1,150	190
cash	48		40
Ag., total	270		230
Other income (all cash)	80		70
Smallholder, cash	128		110
Smallholder, total	350		300
Estates	63	90	700
All others	487	150	3,250

These figures should be taken only as indications of orders of magnitude.

The National Sample Survey of Agriculture also gives a breakdown of cash expenditures per household. The figures suggest that the average household spends about MK30 per year on the purchase of food, leaving an average of 70-80 kwacha (U. S. $ 25-30) per household per year for non-food purchases.

These figures are national averages. There are important regional variations around these averages. In a poor area of the South, for example, Peters has estimated the following breakdown of family income, based on detailed data for a sample of 210 households (in kwacha per household per year):[1]

Non-marketed home consumption	28
Marketed farm products	29
Off-farm income	46
Total household income	103

Of this amount, some 45% was used to purchase food, mostly as grains and fish. In this poor area, then, cash purchases of non-food products amount to only somewhat more than 50 kwacha per household per year.

With average smallholder income and expenditure levels this low, it is hardly surprising that household stocks of even simple consumer and producer goods are extremely low. The National Sample Survey of Agriculture (Vol. III, p.

[1] Data reported in Peters' paper are for only 10 months of data collection. We have multiplied the reported totals by 1.2 to place them on an annual basis. Obviously this is a crude adjustment, which will be made unnecessary when the revised analysis is available.

22) reported the following percentages of smallholder families owning at least one of the following items: ploughs, 3.5%; watering cans, 20.4%; chairs, 50.6%; tables, 35.7%; lamps, 33.4%. The slow spread of cash crops among smallholders, combined with declining yields as a result of soil deterioration, has meant that total income among smallholders is growing only very slowly if at all; official statistics show real income from smallholder agriculture in 1987 to be virtually the same as in 1979, although the population living on these holdings has increased substantially in the meantime. When one recognizes that the country's smallholders are spread over rural areas where transport and distribution systems are rudimentary so even the small markets that do exist are dispersed and fragmented, it is clear that the process of selling in these markets is far from easy; any attempt to expand the output of small and medium enterprises for sale in such markets faces formidable obstacles.

1.2.3. Employment. Information about the structure of employment in different types of enterprises in Malawi is confused by a lack of basic data as well as by a great confusion of concepts. In our view, the clearest way of looking at this question is that suggested in the SORCA-BMB Study of Off-farm Income Generation and Employment in Malawi. That study started from the 1977 population census, updating it on the basis of subsequent information from various sources (particularly, the 1983 survey undertaken by the Center for Social Research) to derive the following estimates for 1987:

	Urban	Rural	Total
Employers	8,205	24,624	32,829
Employees	16,690	36,118	52,808
Self-employed	22,915	94,547	117,462
Total people	47,810	155,289	203,099

Note: urban in these figures refers only to the three main cities.

These figures could be interpreted as follows. In 1987, there were 32,829 (say: between 30,000 and 35,000) small enterprises with paid employees. In addition, there 117,462 individuals whose primary work was in a small enterprise but with no hired workers (although perhaps there were unpaid family workers). There were also something over 50,000 paid emplyees working in the sector (presumably working for the first group). All these are engaged in full-time work (or at least that these were their principal activities). So, finally, there is a large group of others who may have been involved in small enterprise work or informal sector activities as a secondary occupation. Peters says that, among the 210 families she studied in detail in South Zomba, there was not a single household that did not have some source of off-farm income. If one were to include such people in ones measure, the numbers could be immense; but there is really absolutely no data to measure the importance of this phenomenon.

There are other sources of data which can be used to cross-check this information:

-Industrial licenses. In principle, any manufacturing firm with five or more workers must have an industrial license. The list of licensees currently stands at 222, of which 43 are fully Malawian-owned.

-Trade licenses: In principle, all trading firms operating from fixed premises are required to have a trade license. At present, the number of licenses issued is as follows:

	Malawians	Non-Malawians
Retailers	16,700	1,383
Wholesalers	256	302
Others	40	140
Total	16,996	1,825

-Tax returns: The information from the tax rolls is quite limited. The most recent (preliminary) data concerns numbers of taxpaying assessments made for the year ending 31 March 1986. In that year, there were 994 companies assessed for taxes, with the following sectoral breakdown:

Agriculture	139
Manufacturing	128
Transport	27
Wholesale and retail trade	311
Services	127
All others	265
Total	994

Of this total, 955 were incorporated in Malawi. Of those 955, very preliminary figures are available on distribution by taxable income levels, as well as total tax payments. Just 300 of these companies had taxable income of MK10,000 or less.

Enterprises with turnover below MK2,400 per year pay at a much lower rate. While no precise figures are available on the number of taxpayers in this category, we have estimated them at about 2,600.

The DEMATT resource survey, which did a comprehensive enumeration of all enterprises with a fixed location in 169 trading centers of the country. Their survey excluded all the urban areas, and covered 60-65% of other trading centers (but probably the most important non-urban ones were included). They enumerated 8,318 enterprises, distributed as follows:

Producers	2,414
Traders (retail and wholesale)	2,765
Services (including repairs)	3,439
Total	8,318

At last report, SEDOM had received 5,472 loan applications, and had approved 3,338 of these (Chalamanda).

Let us summarize briefly.

-There are currently 222 industrial licenses outstanding, of which 43 for wholly Malawian owned firms.

-There are currently 18,821 trade licenses outstanding, of which 16,996 to Malawian traders.

-About 2,600 returns are filed for the small business tax.

-994 companies pay income tax, of which 955 are incorporated in Malawi.

-DEMATT, covering 60-65% of rural trading centers, counted 8,318 enterprises in fixed locations.

-SEDOM has approved loans for 3,338 enterprises.

These figures suggest that the number of SMEs in the country, leaving aside for a moment one-person establishments with no paid labor, may be in the range 30-35,000. Of this total, perhaps half have trade or industrial licenses (virtually all in trade); probably only about 10% pay taxes, mostly the small business tax. About three-fourths operate in rural areas. These enterprises have an average of about 1.6 paid employees per establishment. About 10% have received SEDOM loans.

In addition to these establishments with paid employees, there were another 120,000 or so individuals engaged more or less full time in non-agricultural pursuits either alone or with only unpaid family workers. Over 80% of these were in rural areas.

Finally, there are a completely unmeasured additional number of people who are engaged in non-farm work on an occasional or part-time basis.

We pass now from a discussion of the structure of enterprises and employment among SMEs to patterns of change. The follwing are the principal features:

--- the labor force's accelerating rate of growth, 3.63% p.a. from 77-87, versus 2.82% from '66-77 [Census, 1987];

--- the formal sector's slowing down, from 7% p.a. during '66-77 to 3.61 from '77-87, with the following components of that slowdown:

*** the modern industrial and service subsector's slowdown (from 6.1 and 5.8% to 5.9 and 4.5% respectively, over the decades 66-77 and 77-87), combined with the excess capacity in modern industry [see also, IBRD, <u>Industrial Sector Memorandum</u>, 11/88];

*** large estate agriculture's very substantial slowdown, from 14% p.a. from '66-77 to 2% for '77-88 [see also, Christiansen, USDA, 5/89]; and

--- smallholder agriculture, desperately poverty-stricken, ominously increasing its rate of growth of employment from 1.8 over the period 1966-77 to 3.1% p.a. between 1977 and 1987.

Sources: USAID, MED PAAD, 8/88, table 7; also in Santiago and Tyson.

These are ominous trends indeed. The accelerating pace of population growth, combined with a slowing rate of employment increase in formal enterprises has led to expanding employment in smallholder agriculture at a pace which is surely not sustainabile, in view of the small average farm size for this group. Some have argued that this reasoning makes clear the urgency for the SME sector to expand to fill the gap. Yet the reasoning of this paper should make one aware of the severe limitations of this reasoning: the fact that rapid growth of employment in SMEs is <u>needed</u> because other sectors are not keeping up with growth of the labor force in no way implies that such growth is <u>feasible</u>.

Other dimensions of the employment picture particularly as it relates to skills and training are discussed further in Annex III.

II. <u>Major categories of potential growth for SMEs</u>. The structural features of the economy described above are of central importance in determining the potential patterns of growth among small and medium enterprises in Malawi. Opportunities for SME development arise in three principal areas:

2.1. <u>Through linkages with growing sectors of the economy</u>. These sectors include urban enterprises (including large, modern producers), estates, and those smallholder farms where cash crops are being introduced. Three familiar categories of linkages are at work here: those arising from increases in demand for consumer goods as incomes rise; backwards production linkages (the provision of intermediate inputs); and forward production linkages (processing, transporting and trading the output of other sectors). Cross-country comparisons make clear that the first of these is by far the most important of the three. An important component of SME development strategy should be aimed at seeking out dynamic areas of the economy and then maximizing the capacity of small and medium producers to respond to increases in demand arising from linkages with these "growth engines." This strategy can be expressed as one of "maximizing the multipliers."

2.2. <u>Through increases in the share of SMEs in existing markets</u>. This could involve import substitution; it might mean capturing a larger share of markets currently served by large-scale enterprises. A third opportunity here concerns sales to the government. Key questions in this process concern the price and quality of products made by small enterprises.

2.3. <u>Through active participation in an improved distribution system, particularly in rural areas</u>. Transportation and commercial activities provide jobs and incomes to those involved directly in these sectors. Perhaps even more important, they open up improved possibilities for increased output and specialization among a great variety of producers whom they serve. Finally, decreased distribution costs raise real incomes of both producers and consumers, thereby further expanding markets by making it possible for these people to purchase more of other products.

The following review seeks to explore the ways in which policies, relaxation of regulations, and project-level interventions might be used to strengthen the capacity of small and medium enterprises to take advantage of these three types of opportunities. These are outlined first in terms of the three target areas just discussed, then by looking across these categories at particular policy domains.

III. Policy, regulatory and project implications, by target. Principal interventions which would help SMEs develop along the lines just described include the following:

3.1. In developing SME linkages with growing markets:

-Seek to raise the income of small-holders through the introduction of cash crops, dry season crops, tree crops, small animal husbandry, etc. as well as expanding estate production, perhaps by bringing more idle estate land under cultivation.

-Undertake studies to identify the geographic locations and categories of goods and services where markets are expanding.

-Provide information to private sector producers concerning these potential markets.

-Focus the provision of technical and managerial skills on strengthening the capacity of producers to respond to these growing demands.

-Deal with problems in the distribution system to ensure an adequate and reasonably priced supply of raw materials and intermediate inputs to producers seeking to supply these growing demands (see 3.3 below).

-Increase the supply of credit available to these producers.

-Coordinate the development of physical infrastructure (rural roads, secondary urban centers, electricity and water, perhaps sites and services units) to take advantage of and reinforce these natural market forces.

3.2. In helping SMEs capture a larger share of existing markets:

-Introduce cost-reducing efforts to make SME products and services more competitive. This includes efforts to make technical information more easily available to small producers. It involves efforts to lower the costs of inputs, particularly imported inputs, through direct access or through increased competition among traders to decrease existing very high mark-ups.

-Examine contracting procedures and ways of improving access to information as to product availability, to promote contract and subcontracting supply by small producers to larger producing and trading enterprises as well as to the government.

-Explore the establishment of appropriate product standards which small producers can achieve and which satisfy the needs of the users.

3.3. <u>In strengthening the distribution system and increasing the participation of SMEs in that system</u>:

-Increase the availability of transport equipment, including imported bicycles and used cars and improved availability of spare parts; provide training to those involved in vehicle repair.

-Explore the possibilities of establishing or expanding local assembly/production of bicycles, tricycles, ox carts, etc.

-Liberalize transportation and commercial regulations to make it easier for people to engage in these activities. Reduce the costs of trading licenses, currently seen as important sources of revenue but causing problems for small traders. Encourage busses to liberalize rules concerning the transport of produce and supplies with the passenger (e.g. on tops of busses).

-Liberalize locational restrictions which prevent small and informal sellers to have access to locations which are more convenient to buyers.

-Provide training for small traders and transporters, perhaps with visits to neighboring countries, to sensitize them to possibilities of playing a more active and aggressive role.

-Expand the availability of credit, particularly trade credit, to producers as well as to merchants.

IV. <u>The Gender Issue</u>. Previous sections have outlined major areas in the economy which appear to have particularly good opportunities for success, in an overall environment which may be characterized as difficult for small and medium enterprises. In our view, this reasoning also provides the appropriate context for dealing with the gender issue. These same areas of concentration provide the most auspicious prospects for women, as they do for men. In fact, one could say that since women face particular disadvantages arising from discrimination, from lower capital stock (including investments in their own skills) and from continuing household responsibilities, it is particularly important to help them seek out productive activities which have above-average chances of success.

This does not mean that one should ignore the gender issue, simply offering undifferentiated assistance to all beneficiaries, male and female alike. It is entirely appropriate to undertake some types of aid specially targeted for women, particularly if this is designed to help them overcome handicaps such as those mentioned above. But it does mean that such assistance should be scrutinized with the same attention to prospects for success, seeking to overcoming the problems of selling in small, dispersed and slowly growing rural markets which are common to enterprises run by males as well as by females. Suggestions along these lines include the following:

-Pay particular attention to product lines and activities where women are represented in significant numbers (e.g. tailoring) to see how these product lines can be tied into growing segments of the market, perhaps through some type of product modification or market diversification. For example, if it is found feasible to expand the role of small producers in the provision of school uniforms, women (particularly low-income women) could be specially targeted in developing this source of supply.

-Pay particular attention to the actual and potential role of women as traders. For any types of interventions in this area such as those suggested above, special care should be taken to open these opportunities to women.

-Continue to support studies which clarify the interactions between farm and non-farm activities at the household level and the complex and diverse ways in which improved access by women to information or to inputs can bring about multiple improvements in household income as well as in nutrition.

-Explore the development and expanded availability of simple implements which will ease the time-consuming tasks imposed on women: gathering wood, fetching water, preparing food etc.

V. <u>Policies, regulatory reform and project interventions for SME promotion</u>. The following discussion focuses on five major areas: financial markets; foreign trade; taxes; other licenses and regulations; and direct assistance through project-type interventions.

5.1. <u>Financial Markets</u>. The financial system of Malawi is examined in considerable detail in Annex IV of this paper. The following are the main points which emerge from that analysis.

-The financial system must be understood in terms of its provision of deposit facilities as well as of credit. Much of the original financing of small enterprises is derived from own savings, supplemented over time by retained earnings. The provision of a safe, accessible means of saving which earns at least a non-negative real rate of return can be very important in facilitating that process. Malawi is relatively well served from this point of view; there are a number of institutions with extensive savings facilities, including the commercial banks, MUSSCO, the Post Office Savings Banks, and the New Building Society. However, since 1983, real interest rates on deposits in all these institutions have been negative, sometimes sharply so (as in 1987, when the inflation rate was 37% while deposit rates were between 0 and 13%).

-The country is much less well served in terms of the provision of credit, particularly for SMEs. It seems likely that there are substantial numbers of viable investment projects among small and medium enterprises which are ruled out by a non-availability of credit.

-Three different approaches are explored in an effort to expand the flow of credit to SMEs. The first of these involves engaging the commercial banks. While some have expressed skepticism about the potential for change here, there are convincing reasons for making a serious effort. The banks already have a fairly widespread network throughout the country, which it would be difficult and costly to duplicate. In a country where bank management skills are extremely scarce, it makes sense to try to build on what exists rather than considering duplication. Finally and perhaps most important, the bankers themselves have expressed a willingness to consider seriously a variety of possible approaches. These would need to be packaged in such a way that some of the early training and associated technical assistance costs are met from outside funds. Beyond this, there may need to be some type of arrangement which would reduce the extent to which the banks risk depositors' money (as well as their own capital) in such loans. A variety of alternative arrangements are outlined. Further movement along these lines would require a donor commitment to work with the commercial banks on exploring the market for financial services to SMEs. With some innovation and a spirit of cooperation between the banks, the government and external donors, it should be possible to move forward in this area without resorting to highly politicized or bureaucratic interventions.

-A second alternative would be to continue to focus USAID's efforts on existing non-bank financial intermediaries, particularly INDEFUND and MUSSCO. These institutions have made useful contributions and are expanding their activities; yet it seems unlikely that they alone will be able to satisfy all the valid credit needs of SMEs in the foreseeable future.

-A third approach involves creating new financial institutions. We start from the premise that the segmentation of capital markets is not an efficient way of promoting SME development and that the duplication of infrastructure can be costly; yet the introduction of increased competition could surely have a salutary effect on the financial system. One approach with interesting possibilities involves the infusion of a savings/credit element into existing grass-roots organizations, experimenting with low-cost "appropriate financial technology." The Malawi Mudzi Fund is forging the way on a pilot basis here; other options may involve similar work with women's groups, with farmers clubs, or with simple market banks.

-A different approach to the credit area involves looking not at different suppliers of credit but at filling gaps in the existing financial system by focusing on unmet credit needs of particular groups of borrowers: women, potential entrepreneurs engaged in starting new enterprises, and the credit needs associated with innovative experiments in new technologies or new products. The special needs of such borrowers are explored.

-A further section of the financial sector Annex explores interest rate policies. The discussion of this question starts from the fact that the banking system in Malawi is made up of only two institutions, with a significant overlap in the ownership of the two. In such an oligopoly situation, the banks have every incentive to pay low interest rates on deposits and charge high rates on loans. The most desirable approach to this problem would be to seek to introduce greater competition in the financial system. Failing that--or until that becomes more effective--it may be appropriate for the government to intervene by establishing flexible minimum rates on deposits and maximum rates on loans. It would be particularly important in such a case to recognize that loans by commercial banks to small borrowers almost inevitably involve higher administrative costs as well as higher risks. If banks are to be enticed to expand their lending to small enterprises, they must be permitted to charge higher interest rates on such loans, to compensate them for these additional costs.

-Finally, as requested in the terms of reference, the Annex examines the major provisions of the new Reserve Bank Act.

5.2. Foreign trade. As discussed in section 1.1 above, despite a strengthening overall balance of payments, the country continues to combine a somewhat overvalued exchange rate with a discretionary system of exchange control which allocates this scarce resource according to priorities determined by the government. As of this writing (July, 1989), exchange control has been eliminated for products accounting for 3/4 of all imports of raw materials and intermediate products, based on 1984 imports. For the remaining categories of raw materials and intermediate products, as well as for all final consumer goods, release of foreign exchange for a particular import is discretionary. While the government has stated its intention of further expanding the number of items for which the release of foreign exchange is automatic, converting the procedure from a positive list ("permits are not required for the following items...") to a shorter negative list ("no permits are required for any imports except the following items..."), it seems likely that this instrument will continue in the foreseeable future to be used to restrict the import of products manufactured within the country, particularly those made by large enterprises.

This partially de-controlled foreign exchange regime disadvantages small and medium enterprises in two major ways: through its impact on the supply of imported inputs used by these enterprises, and through its protective effects on large enterprises.

In general, small, unregistered enterprises are not authorized to undertake imports of needed raw materials and intermediate products. Foreign exchange is released only to registered businesses, an understandable restriction in a situation where scarce foreign currency can command a premium, and the government is determined to allocate this scarce resource according to its own priorities. The result, though, is that import needs of small producers may not be recognized at all by the Reserve Bank authorities; where they are recognized, import permission is granted to larger traders, who must import the needed products on behalf of the smaller users. Three things are wrong with this arrangement:

-Often it is the wrong product that is imported. The larger merchants do not pay sufficient attention to particular product characteristics which may be crucial for the production process, and so may select inappropriately.

-The user is at the mercy of the supplier from a price point of view. Particularly if there are only a few importers of a particular input, there is a risk of oligopolistic manipulation.

-The process is slow and unreliable. The limited capital available to small enterprises and their small profit margins make them particularly vulnerable to delays in input availability.

The exchange regime can also have the disadvantage of providing high levels of protection for large enterprises. Imported inputs are made available to these producers on a priority basis and at a favorable exchange rate; but imports of competing finished products are currently sharply restricted and may even be prohibited. In some cases, small producers may be producing for the same protected markets and hence may benefit from this protection; more often, they find that the protection is not extended to them, and indeed, as we have seen, they are disadvantaged by the difficulties of obtaining the required imported inputs. Small enterprises producing raw materials and intermediate products (including simple machinery and equipment) find that they have to compete against imports freely available at favorable exchange rates, while they must purchase their inputs from high-cost local suppliers (in technical terms, they are receiving negative effective protection). Finally, there is a significant negative indirect effect on the small producers arising from the high protection of large enterprises, which results from the increased price which consumers must pay for these products, thereby reducing their real incomes and the spending margins available for purchases from small enterprises.

5.[illegible]. Taxes. Tax rates in Malawi are high. The 50% corporate tax rate, 50% marginal tax on personal incomes over K22,000 and 35% base rate for the surtax or value added tax are all high levels. Revenues are increasing as the effectiveness of collection becomes more thorough; as this happens, it should be possible to reduce some of the tax rates without sacrificing revenues.

The tax structure affects small and medium enterprises in three principal ways.

-There is a graduated tax on enterprises with turnover of less than K2,400 per year, sometimes called the small business tax. Rates range from 3% to 7% of turnover. While no data are available on the number of enterprises paying the tax, total receipts from this source tax in 1987/88 were only K313,911. If the average enterprise paying the graduated business tax had a turnover of K2,000 and a tax rate of 6%, this would imply that some 2,600 enterprises paid the tax in that year, a tiny number given the likely number of small enterprises in the country. Most small producers clearly don't pay the tax. It is probably true that the cost of collection of this tax is greater than the receipts. Ministry of Finance officials have indicated that they would like to abolish the tax. This would certainly make sense.

-The surtax, converted to operate on a value added principle on May 1, 1989, is levied at a 10% rate on imported raw materials and 35% on most other imports. It is fixed at 35% for domestic sales of most manufactured goods, with higher rates for selected luxury goods (for cars, the tax is 55%). If a manufacturing firm pays the tax on its sales, it can deduct from the amount due any payments made on purchased inputs (which is what gives the tax its value added character).

Enterprises with turnover of K10,000 or more must register and pay the tax; smaller firms are not required to register. This means that smaller firms generally do not pay the tax on their sales. They do, however, have to pay the tax on any inputs purchased from registered firms, as well as on all imported inputs. This can put the small supplier at a disadvantage relative to a larger competitor in selling to another large, registered buyer. If the buyer purchases from a tax-paying supplier, he can deduct any taxes paid by his supplier from his own tax liability. If the supplying firm is not registered and so does not pay the surtax, then the buyer can make no such deductions, even though there may have been substantial tax payments from earlier stages in the production process (e.g. on imported raw materials) incorporated in his purchase price. This provides an incentive for a small producer to register under this system, even though he is not required to; there are provisions in the law for this, although few have chosen to register. If most of his sales are to non-registered buyers, a small producer would be better off not registering, even though this disadvantages him in his sales to registered buyers. Even if he wishes to register, the process may be difficult for him if he has only rudimentary books. In sum, while this arrangement constitutes an effective way of drawing small producers into the tax net without having to collect from each directly (since they pay at the level of their inputs), it does increase the size of the barrier facing small firms seeking to grow by selling to large buyers. The high level of the tax (35% as a minimum, with selected products taxed at 55%, 85%, and even 100%) means that the impact can be significant.

-There are somewhat similar factors at work in relation to the withholding tax for income. The system here works as follows. A number of large firms (about 100 as of this writing) are required to register as withholders. For all purchases which they make, they must withhold a portion of the purchase price from the amount transferred to the seller. This amount is passed directly to the government, with a list of the sellers and amounts withheld. The seller then can credit this amount towards his or her subsequent income tax payments.

Again, this can be seen as an ingenious system for taxing suppliers who would not otherwise be reached by the tax net. But again it has the effect of making small suppliers uninterested in selling to registered buyers, since in that case a portion of the selling price is withheld; the seller can only recoup that loss by moving inside the tax frontier. If most of his sales are to other smaller or non-registered buyers, he is probably better off staying outside. Again, the net effect is to increase the size of the barrier facing a small firm, most of whose sales are to other small buyers but who is considering entering the market of sales to large buyers.

The country clearly needs tax revenues; small producers should pay their "fair share." In the absence of special arrangements such as the ones discussed here, small producers generally escape with relatively low rates. It should be recognized, though, that the current arrangements link the process of drawing them into the tax system with a different transition which the country should be trying to promote, namely, encouraging small producers to increase their linkages with dynamic segments of the market, including larger enterprises.

5.4. Government regulations. An outsider coming for the first time to Malawi is struck by the extent to which the country is neat, clean and organized. It is impressive. Yet it is also true that dynamic development is often disorganized and helter-skelter. Insistence on regularity, on meeting norms of cleanliness and safety can have a stifling effect on initiative and creativity, factors which have to be at the heart of the development process. It is difficult for outsiders to judge the real impact of these controls and regulations. All one can do is to identify specific examples which seem on the basis of a very short time in the country to be of some importance.

-At the head of the list one must put the control of transport, of people as well as of things. There are strict rules as to who may transport passengers over what routes. These rules severely restrict the supply of transport, leaving many areas poorly served in terms of frequency and reliability. While it is entirely appropriate for the government to be concerned about the safety of vehicles carrying people on a paying basis, it is also important that the government be equally concerned about the supply of transport. Rather than simply saying "no" to unsafe vehicles, what is required is an active policy seeking to increase the supply of safe vehicles. As we have suggested above, this is an obvious area where small enterprises could thrive, given a more positive and supportive government attitude.

-A second area of concern relates to the location of economic activity. The decision to restrict many types of production and trade to certain districts certainly makes for a neater and more sightly city; but such restrictions clearly eliminate possibilities for productive employment by offering goods and services at other locations which are more convenient to some consumers. Most people are probably well served by the opportunity to buy in the central market most of the time; but there are enough exceptions to justify the offering of some products in other locations. The fact that these are made illegal prevents some jobs from coming into existence; it also imposes costs on consumers who would otherwise have taken advantage of those services.

-One may ask about rules concerning the hours during which enterprises may be open. One wonders why no petrol station is permitted to stay open after 6:00 PM. There are clearly people who would be happy for a job working on a later shift. The rule does cost jobs, then, as well as inconveniencing consumers. The argument that robbers would take advantage of any station which remains open later seems thoroughly unconvincing.

-It is appropriate and necessary for a country to have procedures for establishing a company, for registering a company name. In this case, questions may be asked not about the fact of registration but about the procedures followed, which--particularly for small and not well established enterprises--are reported to be very time-consuming (it is said to take as long as five years to complete the procedures). Since such registration is a prerequisite for a variety of other things (in particular, for credit and for import permits), it is important that the procedures be kept as simple as possible.

-Complicated procedures for registering new companies add to another significant problem facing the country: that of industrial concentration. The World Bank found that 86% of all firms in the country operate under monopolistic or oligopolistic conditions (Industrial Sector Memorandum, p. 3). The most effective way of fighting against the pernicious effects of this industrial concentration is to promote competition, particularly through the establishment of efficient SMEs. Cumbersome registration procedures impede that process.

Once again, it is difficult for an outsider to judge the real significance of all these regulations. Based on comments received from producers and other knowledgeable individuals, it seems that they impose some significant costs on the nation, seriously impeding the formation and growth of small and medium enterprises.

5.5. Project-level interventions: BAS/TAS. The principal issues relating to technical assistance and business advisory assistance for small and medium enterprises are three:

i) Is any such assistance justified, or are costs so high that one should focus exclusively on work at the policy level?

ii) If any such assistance is to be offered, what is needed? What type of assistance, for what types of enterprises?

iii) What should be the institutional mechanism for providing the assistance? What are appropriate funding mechanisms?

These are complex and difficult questions. Capable and informed people differ in their answers to each one. The three are interrelated; if an activity can be self-financing, at least in part, that can improve its cost-effectiveness, as can institutional mechanisms which make it possible to reach many beneficiaries with carefully targeted assistance. We are not in a position to provide definitive answers to any of these questions for Malawi, but only to offer comments based on impressions gained here and on experience in other countries.

-While we have met with head office staff in each of the three principal organizations providing such assistance in Malawi today (DEMATT, SEDOM and MEDI), we have not undertaken field visits to any nor have we talked to their clients (other than a very few encountered by chance in the course of our field visits). For this reason we are not in a position to render any judgement about the effectiveness of their work.

-Experience in other countries makes clear that BAS/TAS-type assistance is most likely to succeed if it is targeted towards existing enterprises. The most successful projects have focused for each client on one type of intervention, whether it be the introduction of a new product, a new marketing arrangement, improved management skills, etc. Work with new enterprises, by contrast, requires helping with the mastery of a number of new skills, all at the same time. This is always more difficult and more expensive, as DEMATT's new approach is proving. Furthermore, since the majority of new start-ups do not survive more than three years in most places in the world (including the United States), one has a much higher chance of success if the assistance is offered primarily to enterprises that have proven their ability to survive but need help to develop.

-Another key lesson learned from research in a number of countries is that one-person enterprises are a particularly un-promising target group to work with. Careful analysis suggests that economic efficiency is substantially lower in one-person enterprises; that the prospects for growth are substantially higher among such firms, while "mortality rates" - the share of start-ups that go out of business before the end of, say, three years - is much higher among firms which start as one-person firms, compared to those that start at least one notch higher. This is an extremely important finding, since it implies that the appropriate target group for SME assistance in Malawi is made up of some 30-35,000 enterprises, not 150-200,000. Seen in this light, SEDOM's 3,300 approved loans are making a significant contribution.

-The development of pilot projects such as the lime project by the READI PCU seems to be an exception to this rule which deserves to be supported and multiplied. The approach involves applied research on the adaptation of technology in a potentially profitable new undertaking. There can be legitimate external benefits in such cases, where new technologies and new product lines, if successfully proven, may be transferred naturally through the forces of the market to other enterprises without having to duplicate the original teething costs. It is appropriate for donor funds to underwrite the experimental phases of such pilot projects; but for those undertakings which prove to be financially viable, it should be possible to recoup many (not all) of these costs by selling tne activity to a private entrepreneur.

-We are in full agreement with steps under way in SEDOM and MEDI to separate technical assistance from financing. One person made the case to us that it is efficient to combine these functions ("a staff member is going all the way out to see the client; he can just as well provide assistance, monitor the progress of the activity and take loan repayments"). This argument should be rejected for at least two reasons:

i) it is important for management, and therefore for record-keeping, to be able to separate the two functions; otherwise one can never meaningfully work towards the goal of making the financial component self-sufficient, which should be the target.

ii) both for the staff members and for the client, it is important to keep the two functions distinct. One function is to offer advice and training, the other is to offer credit. To provide the two together via the same agent risks weakening the final responsibility of the borrower to repay the loan, to listen to the advice but then to make his or her own decision as to whether to accept the advice.

-We hope that the new focus of DEMATT will not lead to the complete abandonment of its original goal of strengthening rural traders. That task has not yet been completed, and in fact still remains as pressing as ever. DEMATT's lack of success in this area may suggest the need for fresh approaches, such as one built around recognized and legitimized working relationships with Asian wholesalers in the cities, using this as a vehicle for on-the-job training.

-We have not heard of the existence of technology information centers in the country, other than the rudimentary ones being developed by DEMATT, MEDI and the READI PCU. Such capacity can provide useful backstopping for a number of different agencies providing assistance to SMEs. If one were to seek to establish such capacity in the country, one should start by exploring the possibility of strengthening an existing institution, if one exists (perhaps at the University) rather than starting a new one. It appears that little attention has been given to possibilities of exchange and mutual reinforcement among existing assistance agencies which might permit the field staff of DEMATT to turn to technical specialists at MEDI for help with a particular problem, for example.

-We are skeptical of the idea that "entrepreneurial spirit" (whatever that means) can be instilled in someone who does not already have it. On the other hand, if one can identify people who seem to exhibit this spirit, there are useful things that can be taught to strengthen their management skills, enabling them to be more effective entrepreneurs. That could be a central focus of management training.

-In sum, we believe that every effort should be made to look for ways of targeting assistance as carefully as possible, thereby reducing costs per intervention and raising prospects of success. It is also desirable to press the beneficiaries to make a significant contribution towards the cost. But for carefully designed projects, it is entirely appropriate to subsidize the provision of technical and managerial assistance to small producers from donor funds.

VI. Data needs and analytical approaches. It is frequently said that there is a need for more information and better analysis of the small and medium enterprise sector. But what kind of information? And what kind of analysis is needed to provide more effective leadership in the sector? Four types of analyses have been used in this regard. Each has something to contribute to our understanding. The following brief presentation is offered not with any thought that all four should immediately be undertaken in Malawi, but to place in context those which are under way or which are under consideration.

6.1. Census-type surveys of small and medium enterprises. To date, no truly comprehensive survey has been undertaken to measure the dimensions of the SME sector. As a result, noone knows, for example, whether the number of small manufacturing firms in the country is 25,000 or 100,000. In the absence of such information, it is impossible to have more than an impression as to whether the sector is growing, and if so, at what rate, in what industrial sectors, and in what localities. In the same way, information concerning the level of employment in the sector, the extent of involvement of women, the degree to which labor use is part-time or full time, seasonal or year-around, and patterns of income earned is all conjectural. The 1986 READI survey provided important insights into the characteristics of the enterprises covered by the survey; but there is no way of knowing the extent to which that survey was representative of the whole universe of SMEs. The 1988 DEMATT Resource Survey, which purports to enumerate all production, service and distribution enterprises in 169 trading centers throughout the country, provides some important additional information in this regard; but with its enumeration of only 8,600 small and medium enterprises in production, retailing and services in the whole country, one is left wondering about the estimate in the READI New Directions document that there are 182,000 such enterprises (p. 7). Clearly, there is a high priority need to provide a firmer base for understanding the magnitude and structure of the sector.

The most frequently used approach here is one that involves area sampling, which provides important information fairly quickly and at reasonable cost.[1] An ambitious proposal along these lines was developed by NSO and included in the Annex of the READI New Directions, but apparently has elicited no further action. In order to monitor the evolving structure of the economy, it would be important either to undertake the survey on a continuous rolling basis (as the NSO proposed) or at regular intervals (perhaps every three to five years).

6.2. Subsector analysis. Comprehensive surveys are indispensable in delineating the size of the SME sector, its industrial structure and locational patterns as well as some basic characteristics of the enterprises; but they tell very little about the situation and growth potential of different categories of producers. In approaching these latter questions, it has proven helpful to view SMEs in the context of subsectors. This means seeing them as participants in production and distribution systems which extend from primary production to finished products in the hands of final consumers. Frequently, there are alternative channels for such a transformation, which compete for the consumer's kwacha: tailors compete with ready-made garment manufacturers, and each competes with imported used clothes.

This approach has helped to clarify the ways in which policies discriminate against one channel and in favor of another, thereby favoring or dis-favoring small enterprise participants. It has also been helpful in identifying intervention points which make it possible, by reinforcing the effectiveness of one or two firms, to strengthen the competitive position of a whole channel, including large numbers of small producers who participate in the channel. The establishment of a firm providing kiln-dried lumber, for example, can make it possible for hundreds of small carpenters to improve the

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[1] For a description of the approach followed and the results of one such survey, see J. T. Milimo and Y. Fisseha, "Rural Small Scale Enterprises in Zambia: Results of a 1985 Country-Wide Survey," M. S. U. International Working Paper No. 28, East Lansing, Michigan, 1986.

quality of their products, thereby improving their competitive position relative to large manufacturers with their own kilns. In Malawi, an improved supply of parts for one individual who repairs sewing machines can benefit large numbers of tailors. Finally, this approach provides a context for analyzing patterns of change, as one channel gains at the expense of another, often with a significant impact on the position of small enterprises. As AID's recent review of the informal sector in Malawi makes clear, this approach can provide interesting insights even when used with a very short time frame.[1]

6.3. Household survey data. There are a number of important ways in which household surveys can contribute to our understanding of the situation and growth potential of small enterprises. For one thing, such surveys give indications concerning the structure of consumer expenditure for households with different income levels; these cross-section data can be used to estimate income elasticities of demand, indicating how demand is likely to change as incomes grow, thereby pinpointing potentially growing markets. Secondly, they measure the significance and role of non-farm activities in household income. Resources often flow most freely between activities within a household. Labor can be allocated to farming or to beer brewing on an hour-by-hour basis; capital generated in beer brewing can be used to buy fertilizer. In some cases, these interactions are complementary (as in the capital case just mentioned); in others, they are competitive. In some cases, it is only at the household level that one can understand and seek to deal with the constraints which hinder the expansion or modernization of a particular activity. For example, a need to use one's labor resources at a precise point in time for particular agricultural pursuits or household responsibilities may constrain one's availability for non-farm work.

The recent paper by Peters provides a good example of the kinds of insights that can be derived from such household survey data. Working with a sample of 210 households in South Zomba, she found that "there is not a single household in the sample which does not earn income from some off farm source. For most households, their income and food strategies depend on juggling own crop production with self employment, wage work, and receiving transfers from persons working outside the household. For all households, the particular mix of activities and the set of outcomes depend on the level of assets and the structure of opportunities. For the richer, the strategies followed tend to be complementary, reciprocally and positively reinforcing; for the poor, the strategies tend to conflict, producing negative tradeoffs and reducing their overall ability to feed and support themselves." An understanding of the nature of these interrelationships adds considerably to one's ability to promote the growth of rural non-farm activities.

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[1] See F. O'Regan, C. G. Wescott and G. Butler, "Malawi: Informal Sector Assessment," USAID Consultancy Report, July, 1989. For a more extensive discussion of the subsector approach, see J. Boomgard et al, "Subsector Analysis: Its Nature, Conduct and Potential Contribution to Small Enterprise Development," M. S. U. International Development Working Paper No. 26, 1986.

6.4. Analysis of firm dynamics. A final type of information which can help inform the process of enterprise development concerns the pattern of growth in individual firms. As the READI New Directions study makes clear, enterprises generally face different sets of problems at the time of their start-up from those they encounter if they seek to expand after they have been in business for a few years. In fact, very little information is available, in Malawi or elsewhere, concerning patterns of birth, growth, and death of firms. Suppose in a certain year one finds ten small firms and two medium ones in a certain industry and location. Five years later, one may find ten small firms and ten medium ones. Obvious questions include the following: were the extra medium firms originally started as small enterprises which then grew, or did they start larger? Are the ten small firms in the final year the same ones that started there, or did several of the latter go out of business, being replaced by new entrants? Answers to such questions are obviously of great importance in targeting assistance to categories of producers that have better chances of surviving and growing; yet our understanding of these patterns of growth at a firm level is woefully inadequate. There are straightforward survey techniques which can provide important insights here.

These four categories of studies are presented as if they were separate and distinct; but there are important inter-relationships between them. Patterns of firm dynamics may be quite different in different subsectors, or in the same subsector for countries at different stages of development. Household surveys can provide important insights into the evolution of a particular subsector such as the production of simple agricultural implements, and conversely. Once again, this is not to say that one must undertake all these studies for any one of them to be useful, but that each reinforces the amount that can be learned from the others. Finally, it should be emphasized that the goal of this information collection and analysis is not improved understanding per se, but to strengthen the ability of the government to establish effective policies for the promotion of small and medium enterprises, and to feed directly into private investors as well as credit institutions and assistance agencies, enabling each to use their resources more productively. In Malawi, a long succession of consultancy reports and government documents has bemoaned the inadequate information base for formulating good policy, for productive investments and for effective project interventions. These are some the things that can be done--but not by short-term, expatriate consultants--to remedy that situation.

VII. Institutional issues. This leads immediately into the institutional question: what is the best institutional pattern for the analysis, encouragement and promotion of small and medium enterprises? We offer the following suggestions for dealing with this important question.

-The government has a central responsibility here which relates to policy. There are many dimensions of policy which have an important impact on SMEs, each of which is now and will remain under the control of different branches of government: foreign exchange and credit policies (Reserve Bank), taxation (Ministry of Finance), location regulations (Department of Town and Country Planning), labor market regulations (Ministry of Labor), the promotion of entrepreneurship (MEDI), etc. Decisions in each of these areas can have major impacts on SMEs, and the needs of this sector should be taken into account in the decision-making process. At present there is no single unit thinking in comprehensive terms about policies for the development and promotion of small and medium enterprises. The correct place to do this is in the Ministry of Trade, Industry and Tourism. The government's commitment to strengthen the small enterprise unit in that Ministry is a good sign, although little has been done to date to prove that it is serious about that commitment. It seems excessively optimistic to believe that the arrival of an expatriate advisor in the unit will change things in a fundamental way, as has been suggested.

-On the other hand, the core of the promotional activities which are needed in this area must be done outside of the government. Civil servants around the world have the wrong kinds of motivations and incentives, of training and orientation, to be effective in this kind of work. MTIT currently has an industrial promotion unit (two positions), but their tasks are effectively limited to the supervision of foreign assistance in product development, working particularly with the Commonwealth Secretariat. Other institutions are also engaged in one form or another of industrial promotion: DEMATT, SEDOM and READI. All of these operate in ways which are coordinated with the government. But building up a unit within the Ministry with principal responsibilities for industrial promotion is an invitation to a funeral. Promotional activities are essentially entrepreneurial, and that has never been a strong characteristic of civil servants.

-There is a third function to be performed here, which relates to data collection and analysis. This activity forms the basis for each of the other two. Good policy must be informed by a better understanding of the dimensions of the SME sector, the impact on it of existing policies and regulations, the sector's potential for development, and the needed changes in policies and regulations to support a more vigorous growth. But effective promotional work is equally dependent on a similar set of information.

The precise institutional structuring of these three functions is of central importance for the development of the sector. We have presented our reasons above for arguing that the promotional activity should be located outside the civil service. There are also good reasons for suggesting that large-scale, on-going data-collection activities such as household surveys should be primarily the responsibility of the National Statistical Office, although the Center for Social Research at the University is about to embark on a major undertaking in this area. Subsector studies and analyses of firm dynamics, on the other hand, could probably best be done directly in a separate unit with a focused mandate relating to SMEs.

This leads us to our central suggestion in this area: that USAID work towards a situation where there is an autonomous, permanent, national institution with responsibility for analysis and, to a limited extent, the promotion of SMEs. In more specific terms, we think that READI's Project Coordinating Unit should evolve into such a unit as rapidly as possible.

The direct promotional activities of such a unit would be limited. It would not have its own field network like DEMATT and SEDOM. With the exception of experimental pilot projects, it would work primarily through these two organizations as well as with others involved in SME development, promotion and finance: MEDI, MUSSCO, the Malawi Mudzi Fund, etc.

Although we have emphasized autonomy for the unit, it is obvious that links to other institutions would be crucial:

i) to MTIT, since they are the ones with responsibility for policy in this area. One of the tasks of the unit would be to help inform MTIT about issues that need to be addressed at a policy level;

ii) to NSO and the Center for Social Research, to the extent that these organizations are engaged in relevant survey work;

iii) to the assistance agencies, particularly DEMATT, SEDOM and MEDI. A key goal of the undertaking would be to service these organizations, strengthening their ability to provide effective assistance by undertaking broader studies which clarify the sectors, regions and enterprise types which are growing, which enterprises can most effectively use what types of promotion, etc. This means that these institutions should have an active role in defining the studies to be done so that the analysis can respond to the organizations' own needs.

iv) to private enterprises, including commercial banks. This is important partly because the task of assisting businesses requires entering into a business mentality. Beyond this, if the studies and promotional activities undertaken are credible to the business community, these firms have much to offer in the way of counsel and advice as well as through contracts with smaller suppliers.

Such an undertaking would require a long-term staff development plan for the unit, probably including overseas training. The designation and/or recruitment of Malawian staff who can take over the leadership of the undertaking, either immediately or after a period of training, should receive top priority attention. Both the permanence (this should not be thought of as a temporary activity, which will terminate when current sources of funding end) and the national ownership (not in the financial sense) and national staff leadership (at least in the medium term) must be emphasized. It might be wise to invite participation from other donors, so this is not conceived of as USAID's private preserve.

No matter whether this or some other institutional configuration is decided on, it is extremely important that this question be addressed, debated, and a decision taken so serious work can begin on building up a permanent, national institutional structure capable of doing the data collection and analysis, the promotion and the policy formulation which are so badly needed in the sector. As long as this fundamental institutional question is not addressed, the best that can one can hope for is a series of separate and individual projects, each of which may do useful work but which leave all the fundamental issues relating to the future development of the sector untouched.

VIII. Monitoring and Evaluation (M&E). The tasks here are quite different for single-intervention assistance projects, such as the assistance through READI to MUSSCO or DEMATT, compared to comprehensive policy projects like MED. We begin with the single-intervention projects, using MUSSCO as an example.

-Monitoring essentially means keeping track of what is going on. This can be done at any of several different levels. In the MUSSCO example, one might ask: how many loans have been issued? Are they being repaid? For what types of activities are loans being issued? What is the level of employment in the activities funded by the loans? etc. It is surprising that this type of monitoring is not being done on a routine basis in that project.

-Evaluation is a quite different and altogether more complicated task. In the MUSSCO case, one could start with the organization itself: is MUSSCO administering the program according to acceptable standards of management and bookkeeping? The Deloitte, Haskins and Sells reviews are doing an effective job of evaluation at this level. One might also ask, though, about the impact of the program on the ultimate beneficiaries (say, the loan recipients). To do a true evaluation here requires that one ask (and answer!) the question: what is the net effect of the assistance on the beneficiary? This in turn requires two things: first, that one know what is happening to the beneficiary; and secondly, that one has some way of estimating what would have happened to the beneficiary in the absence of the assistance. This is normally handled by using a control group, assumed to be comparable to those who are assisted in all significant dimensions except than that they do not receive assistance. The difference in developments between the two groups then is said to measure the net impact of the assistance on its recipients.

The establishment of a system of monitoring which permits this type of evaluation is best handled at the design stage of a project. Unfortunately, it is neither very simple nor very cheap to do. For minor projects, one may be satisfied with a simple monitoring system, with evaluation of the organizational effectiveness of implementation of the type DHS has been performing. For larger projects, a more systematic monitoring and deeper evaluation seem called for. If this is not done at the design stage, the approach has to rely on a later identification of a control group, with retrospective data to test the idea that the two are really similar except for the assistance given.

In the absence of a control group, one is left with a much weaker evaluation, namely, one based on a comparison of before and after the assistance rather than with and without the assistance. This approach often exaggerates the impact of the assistance, since it attributes all change to the assistance itself, while some evolution would probably have taken place even without the assistance. The control group is designed precisely to give some idea of the nature and magnitude of these "natural, unassisted changes," providing a basis of comparison for dealing with the question: what difference has the assistance made?

All of this is still focused on the impact of the assistance on the individual beneficiary firm. It has not dealt with possible spread effects ("positive externalities"). Nor has it dealt with the difficult question as to whether the growth in assisted firm A was at the expense of non-assisted firm B (e.g. because the total market is fixed, so the improved management of A simply enabled it to steal some of the market from B). If this were the case, then one might find a significant difference between assisted and non-assisted firms, but the net benefit to the society of the assistance could be zero. This sticky question is normally ignored in discussions of evaluation procedures.

Still focusing on project-level interventions, the final stage of an evaluation could be thought of in cost-benefit terms: are the net benefits substantial enough to justify the costs? This final stage is rarely done for individual projects; it is more often undertaken in multi-country reviews of a number of projects. Doing it in a meaningful way requires measurement of the net benefits of the assistance as outlined above, then measuring the costs, then comparing the two.

Moving on to the case of MED, monitoring could mean determining whether the country has met the conditions precedent specified in the grant agreement. Most of those conditions are laid out in sufficiently precise terms so that monitoring should be a straight-forward task, although some of them will be subject to dispute (have import and export licensing procedures really been streamlined enough to satisfy the conditions? Without precise measures, that would be a judgement call, and hence subject to dispute).

Turning to issues of evaluation, for comprehensive, policy-level projects like MED, the program could well be evaluated relative to the objectives established for it. The policy reform matrix in the PAAD does an effective job of specifying indicators of the extent to which those objectives are being achieved. What remains is to specify detailed measures of each of those indicators, then collect the required data.

Questions of monitoring and evaluation could also be approached at a deeper level. In particular, one would like to monitor the extent to which SMEs are really growing, and if so, what types and in what locations. One would like to evaluate whether the changes adopted have been sufficient to generate the desired pattern of growth, or whether some other constraints have prevented such developments. Addressing these types of questions obviously requires data and analysis. At another level, an evaluation might ask whether an appropriate institutional structure has been put in place which would make it possible for these questions to be examined on a routine basis by the citizens of the country. With this in mind, we would suggest that substantial attention be given in the MED monitoring and evaluation process to the following question:

> **What progress is being made in establishing an institutional context such that the required information is being collected and analyzed to form a basis for improved policy and more effective promotional activities?**

This formulation links the establishment of an appropriate institutional structure with the collection and analysis of data that will be useful both in policy formulation and in promotional activities. It leaves open the precise institutional structure to be adopted as well as the precise set of data to be collected and the analyses to be undertaken (although suggestions on both these questions were presented earlier in this document); but it does elevate to a central position the questions of institutions and of information, which seem to us to be central to progress in this area. Without advances on these two fronts, Malawi may well find itself ten years from now in the same situation as today, with no coherent policy and an inadequate information base on which to formulate such a policy, dependent on expatriates of various persuasions coming through to sell their latest ideas. Malawi desperately needs and surely deserves better than that.

ANNEX I

LIST OF PEOPLE CONTACTED

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ANNEX II

PRINCIPAL DOCUMENTS CONSULTED

The team consulted more studies and documents than they would care to remember. It seems that consultants had done studies on virtually any subject imaginable, and a few that are not. The following were those which we found particularly useful to our work, or which are referenced in the texts.

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Annex III

Small and Medium Enterprises in Malawi:

Their Labor Market

THE HISTORIC CONTEXT

The labor market for today's small and medium enterprises (SMEs) in Malawi has evolved out of a colonial and early independence history of fluctuating biases between the modern urban and estate agriculture sectors, on the one hand, and smallholder agriculture on the other.

The early colony was based on plantation coffee, with an output greater than that of the settler farms of Kenya or Southern Rhodesia. A hut tax forced Africans to seek wage employment on the plantations. The collapse of coffee prices in 1902 forced a shift to cotton, tobacco and tea, while cotton and tobacco prices themselves subsequently plummeted in the early 1930s. Reliance on labor-intensive techniques, with little technological development, resulted in exceptionally low plantation wages and a poor peasant society.

As opposed to the early colonial emphasis on plantations, during the first four decades of the twentieth century the colonial administration developed widespread peasant production. By the late 1920s, peasant export production was a lead factor in economic growth. Nevertheless, although peasant support was important to Dr. Banda and the independence movement, after independence political and economic pressures on the new government again reoriented policy toward the estates. Between 1964 and 1984, estate agriculture's share of GNP rose from four to seven percent, while the smallholder's share fell from 51 to 32 percent. The taxing of smallholder cash crop production provided much of the financing of the tobacco estate expansion and became the principal source of conflict between the two sectors [Christiansen, USDA, 5/89]. Apart from the poverty stricken smallholder agricultural sector, the agricultural estate sector is the largest employer of Malawi's labor force [table one].

After independence, the modern industrial sector also grew rapidly in percentage terms, although from a very small base. During Malawi's first 15 years, value added in manufacturing grew at an annual rate of 10%, while the sector's share of GDP grew from about 9 to nearly 12%. Little is known about the off-farm and small scale industry sector, although the IBRD has reported that its slow growth has been limited primarily by entrepreneurial experience and inadequate access to capital, of which virtually none came from the commercial banking sector [IBRD, Industrial Sector Memorandum, 1988].

THE RECENT LABOR MARKET CONTEXT FOR SMALL AND MEDIUM BUSINESSES

There are two principal dimensions that will be dealt with in the present discussion of today's labor market: employment per se, and the most important measure of the quality of that employment, the income it generates. After highlighting the most important of the patterns relating to those dimensions, employment in SMEs themselves will be considered. Before starting that discussion, however, we make a detour which may help clear up some major statistical inconsistencies.

A digression on employment and small enterprises.

The analysis of employment in Malawi is severely handicapped by inadequate data. One finds a confusing variety of estimates of the size of the SME sector. In part, this is based on a confusion in the data between the number of enterprises and the level of employment in the sector. READI's New Directions study refers to Ettema's 1984 article as the basis for its estimate of 182,000 SME businesses.[1] The report to the European Development Fund by SORCA-BMB cites a different paper by Ettema, published in the same year, as the basis for an estimate of the number of workers in the sector, which they place at "about 180,000." Based on these figures and some assumptions about growth rates, the authors of the SORCA-BMB study estimate the total number of workers in the small-scale enterprise sector at 203,099 in 1987, of which 117,000 are self-employed, 32,800 are employers and 52,800 are employees. These figures could be expressed differently as suggesting that, in 1987, there were 32,800 small enterprises with hired workers; 117,000 self-employed people without hired labor; and 52,800 employees. How many SMEs are there then? It depends on one's definition (should self-employed people without hired labor be counted as a small enterprise? Surely employees should not!). For some purposes, 32,800 may be more appropriate estimate than 182,000. At most, the SORCA-BMB figures would justify a number of 149,800 enterprises (self-employed plus employers).

Let us check these figures with other sources of information concerning the numbers of enterprises which are known in one way or another to the government. There are several sources of information from this point of view:

-Industrial licenses. In principle, any manufacturing firm with five or more workers must have an industrial license. The list of licensees currently stands at 222, of which 43 are fully Malawian-owned.

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[1] Ettema's only estimate in the referenced article is for manufacturing activities (excluding commerce and other services). Following this definition, Ettema estimates that there were only about 18,000 small and medium enterprises in the country.

-Trade licenses: In principle, all trading firms operating from fixed premises are required to have a trade license. At present, the number of licenses issued is as follows:

	Malawians	Non-Malawians
Retailers	16,700	1,383
Wholesalers	256	302
Others	40	140
Total	16,996	1,825

-Tax returns: The information from the tax rolls is quite limited. The most recent (preliminary) data concerns numbers of taxpaying assessments made for the year ending 31 March 1986. In that year, there were 994 companies assessed for taxes, with the following sectoral breakdown:

Agriculture	139
Manufacturing	128
Transport	27
Wholesale and retail trade	311
Services	127
All others	265
Total	994

Of this total, 955 were incorporated in Malawi. Of those 955, very preliminary figures are available on distribution by taxable income levels, as well as total tax payments. Just 300 of these companies had taxable income of MK10,000 or less.

Enterprises with turnover below MK2,400 per year pay at a much lower rate. While no precise figures are available on the number of taxpayers in this category, we have estimated them at about 2,600.

Let us summarize briefly.

-READI New Directions has estimated the number of small and medium businesses at 182,000.

-SORCA-BMB has estimated that there are 32,800 small enterprises with employees; 117,000 self-employed individuals without employees; and 53,000 employees of small firms.

-There are currently 222 industrial licenses outstanding, of which 43 for wholly Malawian owned firms.

-There are currently 18,821 trade licenses outstanding, of which 16,996 to Malawian traders.

-About 2,600 returns are filed for the small business tax.

-994 companies pay income tax, of which 955 are incorporated in Malawi.

These figures suggest that, of the small enterprises with paid employees, perhaps half have trade or industrial licenses (virtually all in trade); probably only about 10% pay taxes, mostly the small business tax. Of course these are all the roughest of figures, among other things, because there is no information on the size distribution of those with trade or industrial licenses. Accepting that limitation, the figures could be taken to imply that somewhat over half the people in the SME sector are self-employed; of the remainder, just under 40% are employers, the other 62% employees. With that background, we turn to the employment data.

Employment per se

In our own approach to the data, we have started with the only available comprehensive set of information on this topic, the 1977 population census. We have compiled the data from that source as follows:

SME employment Estimates for 1977
(000s)

Total economically active population:	2,288 (a)	Census, 1977
Minus those engaged in agriculture, hunting, fishing, & forestry:	(-)1,932 (b)	Census, 1977
Equals: Economically active, non-primary sector primary occupation:	356 (c = a-b)	
Formal sector employment: (NSO, "Reported Employment and Earnings Report", 1976)	276 (d)	
Minus: Formal sector, primary subsector (already deducted in step (b) above):	(-) 134 (e)	
Equals: Formal sector, non-primary:	142 (f = d-e)	
Residual: non-formal, non-primary economically active population:	214 (g = c-f)	

Note: this total includes those who may be in firms with less than 20 workers that are registered but do not report in the NSO series.

If one assumes that the non-formal, non-primary economically active population stayed at a constant share of the labor force, this would lead to an estimate of this figure for 1987 of 289,000.

Statistical note: While the above 1987 figure is approximately 172,000 more than the MED PAAD estimate for informal sector employment, the difference is presumably due to the fact that employment in firms of less than 20 workers is included in the estimate above. Regrettably, none of the SME surveys to date have used a sound sampling frame that would provide a sound estimate of total or disaggregated employment in the small scale sector.

That the diverse estimates of SME employment may be reconcilable derives from the constant problem of defining the sector. If one includes in the sector those that are part-time workers, who may list as their primary occupation for census or industrial reporting purposes agriculture or a job in the formal sector, then there is an overlap of the data categories. A substantial number of people counted as smallholders or as formal sector workers may also be active in the informal sector. When one takes account of this fact, then one despairs of giving any meaningful estimate of the size of the sector.

Past employment trends

Even if one cannot give precise estimates of the total breakdown in employment by type, there are important things one can say about trends in some major categories if employment. The broad trends in the labor market, about which we have relatively good information, are the following (see table one [USAID, MED PAAD, 8/88, table 7; also in Santiago and Tyson, table one, seminar on demography and development, 1989]):

---the labor force's accelerating rate of growth, 3.63% p.a. from 77-87, versus 2.82% from '66-77 [Census, 1987];

---the formal sector's slowing down, from 7% p.a. during '66-77 to 3.61 from '77-87, with the following components of that slowdown:

*** the modern industrial and service subsector's slowdown (from 6.1 and 5.8% to 5.9 and 4.5% respectively, over the decades 66-77 and 77-87), combined with the excess capacity in modern industry [see also, IBRD, Industrial Sector Memorandum, 11/88];

*** large estate agriculture's very substantial slowdown, from 14% p.a. from '66-77 to 2% for '77-88 [see also, Christiansen, USDA, 5/89]; and

---smallholder agriculture, desperately poverty-stricken, ominously increasing its rate of growth of employment from 1.8 over the period 1966-77 to 3.1% p.a. between 1977 and 1987.

Future Employment Trends:

Although the precise magnitude of the sector depends on the definition, it is necessary to consider the general direction and magnitude of the different employment projections which exist.

For example, the MED PAAD states (p. 18) that if, for the next five years, labor force participation rates remain the same, 130,000 new jobs will be needed to avoid increases in labor underutilization. The PAAD goes on, "Unfortunately, if total employment continues to grow as it has over the last 10 years, the economy will experience a shortfall in jobs for approximately 30,000 to 36,000 workers per year over the next five years."

There are, however, as implied above, reasons for questioning the employment trends and forecasts encountered by the Team. Some grounds for skepticism are discussed sector by sector.

<u>The smallholder agriculture sector</u>: In spite of the near doubling of the growth rate of its employment over the last decade, this largest sector (over 80% of the labor force) cannot continue to absorb similar large numbers or expand at the recent rate without an ominous further deterioration in incomes, labor utilization, and social pressures. The very high rate, incidentally, clearly reflects a residual spillover of frustrated job seekers into their last economic refuge. There are several reasons for the limited absorptive capacity of this sector:

---intense population pressure on the land -- less than 25% of the smallholders had access to more than one hectare in 1979/80 [Christiansen, USDA, 5/89, p. 21], the pressure being particularly great in the South;

---the near exhaustion of unutilized arable land; and

---among the lowest per capita incomes in the world.

While ADMARC increased its purchases from smallholders by 119% between 1982 and 1986, as opposed to the previous four years, the benefits were far from uniform, partially due to the fact that smallholders with less than one hectare market insignificant portions of their output. Furthermore, although one of the purposes of IBRD's program of Structural Adjustment Loans ("SALs") for Malawi is to achieve increases in output and incomes for smallholder agriculture (Christiansen, p. 20-1), whether the related policy reforms and credit yields more jobs, in addition to the targeted increases in agricultural output and incomes, remains to be seen. While continued rapid employment growth among smallholders in the South appears extremely unlikely without further immiseration in view of the unusually severe land pressures there, some increase in employment in the North may be possible. However, cultural barriers to migration and the fragility of the land there may limit that growth as well. The GoM and donors now recognize the political, economic, and moral imperatives of redirecting resources to smallholders, either through enhanced technologies for their own plots or through employment either on the estates or in off-farm SMEs.

<u>The larger modern enterprise sector</u>: This sector, including manufacturing, agricultural estates, and large service enterprises, with its employment growth rate having fallen by

nearly half over the past decade, is not likely to increase rapidly in the near future. Among its constraints are problems of infrastructure, debt, entrepreneurial, managerial, domestic demand (weak agricultural growth-driven consumer purchasing power), and foreign exchange constraints. Substantial uncertainty about the ability of the GoM, donors, and the private sector to break these constraints leaves similar questions about any optimistic employment forecasts for the sector. The agricultural estates, included in the formal sector, are particularly unlikely to recover the boom posture they held in the 1960s and '7os, unless a means is found to increase their efficiency and expand their absorption of labor through wage employment.

The SME sector: Although definitional and data problems make it impossible to know the exact dimensions of this sector with any confidence, what does seem clear is that the sector will have to grow if demographic and economic pressure on the land and smallholder sector is not to take disastrous proportions. The constraints discussed above on expansion in employment in the smallholder and formal sectors are not likely to be broken in the near future, so any hope for broad-based growth resides primarily in the small, and to a lesser extent, medium-scale sector.

Labor incomes: On wages and minimum wages:

In 1985, the average wage in formal sector manufacturing was about MK 100 per month (US$40), while the minimum was below MK 1 per day. Both are among the world's lowest (see appendix table 4). Accordingly, Malawi's substantial advantage in labor costs has given it considerable potential to export, particularly within its own region, assuming it breaks serious policy constraints discussed elsewhere in this report. Malawi's labor markets have been relatively competitive, and while there are minimum wages, the government has been generally restrained in its industrial relations policies [IBRD, Industrial Sector Memorandum, 11/88].

On the new minimum: Minimum wages are widely feared by those seeking a labor-intensive development strategy, lest they be raised to such a level that employers adopt capital-intensive and labor-displacing technology, move their operations to lower-wage countries, and/or go out of business due to unbearably high costs in the face of constrained demand.

Malawi has recently raised its minimum wage by 98% in the cities, by 107% in the municipalities, and 126% in the rural areas, the differences apparently intended to minimize earlier regional differences in the minimum. This increase raises the level to MK2.17 per day for the modern industrial sector.

The Policy Team has read and heard mixed impressions about the reasons for and the actual and probable impact of the increase.

As much of the modern sector is reported to be already paying significantly more than the minimum, its impact there is expected to be relatively modest. On the other had, the team heard reports that some of the estates have already begun laying off workers as a result of these increases in their costs. This reaction is in sharp contrast with other reports that it was the estate sector that was pleading with the government to raise the minimum, surely an exceptional case in the history of minimum wages. The reported explanation was that for the estates, the minimum is actually their de facto maximum, and that their workers were so badly off that they felt they needed a higher minimum to maintain order in their labor force. Another astute observer of the Malawian economy believes that in most cases, where estates have displaced labor following the increase, that they will soon rehire their labor because the capital-intensive techniques are still more expensive than their current labor-intensive ones.

Among small producers, it was reported by someone who has reviewed the records of several such enterprises that actual payments were often less than the minimum. This was confirmed by others in subsequent conversations.

On balance, the Team believes that the overall impact on employment of the recent increase in the minimum wage is likely to be minimal. It may even be, given the excess capacity and substantial profit margins reported among formal sector producers, that the increase will sufficiently stimulate demand to produce a net positive employment effect. In that case, there may be an argument for further increasing the minimum.

NET ASSESSMENT OF THE EMPLOYMENT PROBLEM:

All of the above evidence concerning employment and incomes in the Malawian labor market converges in one conclusion: the desperate need for an aggressive policy and program in support of employment and income generation. A continued bias toward the modern and capital-intensive industrial and estates sectors will simply compound the disaster already permeating the smallholder and informal sectors. Substantial labor underutilization, unemployment among graduates from secondary and higher education (in spite of very low levels of educational attainment), extremely low incomes among smallholders and "informals", and excess capacity in the modern industrial and estate sectors all suggest that substantial benefits may flow from a more labor-intensive and broadly-based development strategy. The employment and poverty gaps are so great that no conceivably feasible mobilization of resources in the foreseeable future is likely to close either of them.

The Gender Dimension: Malawian women, as is often true elsewhere, bear a particularly heavy portion of the burden of development. Often they are the primary income earners, particularly, of course, in the numerous households headed by women. Twenty-eight percent of Malawian households were headed by women, and a majority of these were among the poorest. Another study showed that 72% of female-headed smallholder households had less than one hectare of land. As a final example, the correlation of rural seasonal wage employment with the peak of the agricultural season means that women have difficulties taking advantage of such opportunities or do so only by risking not only their own food production (which is true also for men) but also their household's welfare [Sebstad;7].

This burden carries over into their ability to deal effectively in the small and medium scale enterprise sector. As an example, only three of MEDI's participants have been women (out of 213 total graduates between 1985-88) [UNDP/ILO, MEDI evaluation, 2/89]. The READI survey of enterprises found that females accounted for only 19% of employees and 7% of the entrepreneurs. Women also appear to suffer discrimination in financial markets. The SME Policy Team heard anecdotal evidence of women being required to have their husband's approve their loan requests. One woman reported that when she applied for a loan, the financial agency was soon negotiating directly with her husband!

Yet the evidence about the problems women encounter in small enterprise development is not all negative. Regarding their commitments to their businesses, READI reported ["New Directions...", 6/87] that they work full-time (85%) just as often as men (80% for the whole sample). Some evidence, at least on the surface, suggests their relative success in some dimensions of SME-related activities. For example, whereas only 32% of SEDOM's credit applicants were women (68% male), only 66% of the male applications were approved while females were successful in 83% of their cases. The women's success in this case, however, may well lie in both the relatively high socio-economic status of SEDOM's client women and SEDOM's apparent use of a network of informants in their loan approval process. Such a process may screen in the more fortunate and screen out those less so. READI notes that they "arguably enjoy a number of distinct advantages vis-a-vis their rural and less educated counterparts" [New Directions...;54].

SEDOM's female client entrepreneurs did have less experience than males, 34% of the males having six or more years, versus only 18% for females, while 46% of the females had less than one year, versus 34% for the males. This may reflect the women's family responsibilities combined with the facts that SEDOM does not make very small loans, and women are often obliged to engage in activities characterized by low capital outlays and complementing their domestic obligations [Chipande et al, in Sebstad, p. 6].

Women generally have been less successful in educational attainment in Malawi's economically active population, among whom only 1% of the women attended secondary or higher education in 1977, as opposed to four times that many men [Census]. Among SEDOM's female entrepreneurs, however, a larger proportion of attended secondary education (32%) than was true for males (22%), again indicating that those who benefit from SEDOM loans are a highly select group. On the other hand, slightly more female entrepreneurs had never been to school (12% versus 10% for men). Yet it is difficult to say how education affected their performance. Although a relatively low number of females indicated their sales levels, and the number responding was small, the evidence is mixed; on the one hand, approximately a tenth of the male and a fifth of the female-owned enterprises had sales of over MK3,000 or more per month, whereas for turnovers of MK50 or less, males were doing so one-fifth of the time, whereas a quarter of the females were [READI, 28-9].

Entrepreneurship:

A number of times during the course of the Policy Team's discussion of issues and constraints facing micro, small, and medium scale enterprises, the topic of entrepreneurship training has come up, usually with very strong support. This has given the Team some pause.

Entrepreneurship training is not well defined. Nor is its value well documented. The Team is skeptical as to whether one can train people to be entrepreneurs, if they have not developed something of that undefinable spirit and talent in the course of their earlier lives.

S&T/RD/EED let a research contract to assess those personal entrepreneurial characteristics which such a training program might target as objectives. The identification of such traits was fraught with conceptual and statistical difficulties, finally concluding with less than dramatic results. In spite of these inconclusive findings, a field trial based partially on those research findings was undertaken in Malawi, by MSI. A draft final report by MSI evaluating MSI's own training program has been submitted, with findings that are moderately positive in terms of the impact of the training on employment generation and the firm's income. However, the report has not yet been subjected to final review.

MEDI -- which evolved from a vocational training institute and has tried unsuccessfully to blend entrepreneurship with vocational training -- is often referred to as a source of the sort of entrepreneurial training that would help stimulate Malawi's SME sector by filling the oft report entrepreneurial gap. [Yes, another gap!] The Policy Team has heard mixed stories about the quality of MEDI's program and suggests that before USAID/M provides and support to MEDI or indeed to entrepreneurship training in general, the mission give serious attention to the matter. One commentator suggested that the only reason students enroll in the MEDI program is because they are assured they will receive credit for tools, equipment, and/or working capital when they finish. Such credit is apparently even used to spice up MEDI's advertisements for openings.

UNDP and ILO have a recent evaluation report that suggests some problems in MEDI's current operations, including its current cost-effectiveness and curricular mix, of skill training and entrepreneurship. The report goes on to recommend extension of the program with substantially more focus on entrepreneurship. UNDP will be receiving a set of consultant reports on the institution in the near future, before the mission supports any new GoM activity in this area, the Team suggests USAID/M review those reports and the full set of entrepreneurship and vocational training issues.

Unemployment, Training, Education and Income:

Like most developing countries, Malawi does not at the present time appear to have a significant open aggregate unemployment problem. Most people and their families are apparently too near the margin of economic survival to afford to be able not work. This was true in the 1977 census, when only 2% reported themselves unoccupied and seeking work, and it is very likely true now, as confirmed by numerous individuals interviewed by the Team. While the pattern of employment and income pressures discussed above may have raised the rate somewhat, it is not believed to have reached the levels of 10, 20, or 30% that have alarmed a few countries.

Nevertheless, this is not to say that there are no important unemployment problems. In addition to the underemployment or poverty problem, which the ILO has stressed predominates in most developing countries, a portion of the current social stress may be traced to the unemployment problem which exists among secondary school leavers and graduates from higher education. The team heard reports, for example, of very bright students waiting five years for jobs, of hundreds of applicants for single white collar positions, and even degree holders having similar difficulties.

Although precise and current statistics are not available on this topic, an ILO report on Malawi's youth employment problem is helpful. Livingston has noted 1977's 8.1% urban unemployment rate for youth 10-24 years of age (a 3.2% rural rate; 9% for urban girls), and, in view of education's correlation with urbanization, these relatively high rates in the urban areas support the anecdotal evidence. With placement apparently becoming increasingly difficult in the formal sector since that time, it is unlikely that these rates have fallen. A 1983 tracer/follow-up study by the Ministry of Labor of those who took their secondary school exams in 1976 reported unemployment rates of 15 to 35% for the "Malawi Certificate of Education" leavers and 49-62% for the "Junior Certificate of Education" leavers. While the methodology and implementation of the survey leave doubts about accuracy, even allowing for substantial error, the evidence is strong enough to support the argument that an important education and manpower problem does exist [ILO/JASPA (Livingston), 1986].

Among the responses proposed for this problem by experts contacted by the Team were:

---first, to hold the line on formal secondary and higher education, in spite of the relatively low enrolment ratios;

---second, to enhance the quality of business management training, rather than general education; and,

---third, to enhance the quantity and quality of relatively low cost basic skill development programs.

One might voice strong reservations about the first of these ideas; surely in a country as poor and as poorly educated as Malawi, further expansion of higher education is part of the solution, not part of the problem. The other two proposals make good sense to the Team. More will be said below about business and management training.

Concerning relatively efficient technical or skill training, USAID may wish to tune in to the findings of the OECD/ILO/IBRD study of training in Sub-Saharan Africa, currently underway in a variety of countries, and to which AFR/DP was considering a contribution. A variety of other donors have contributed to support the million dollar effort.

On the value of skill training in Malawi, suggestive evidence on income by occupation in appendix table 2. The value of general education to the entrepreneur, and a hint concerning return to specific vocational training, are also reported in appendix tables 3 and 4. Appendix table five [READI, "New Directions..." 6/87), p. 61] gives further support for the clear relationship between education and the performance of small enterprises. The causal relationship, however, is not as straightforward as it appears, for there are undoubtedly also correlations between turnover, capital investments, socio-economic background, and education. Thus, some of the correlation between education and small firm income is due, in all probability, to the effects of these other factors.

The Urban/Rural Distribution of Small Enterprises

The distribution of small enterprises between the urban and rural areas is important not merely for reasons of geographic equity but also because of the efficiency of the enterprise. In research completed in a variety of countries by Michigan State University [Liedholm and Mead], a positive correlation was found between the returns to labor of the enterprise and the extent to which it is urbanized. This, of course, has strong implications for plans to strengthen Malawi's small enterprise system. Assuming there are no reasons to believe the generalized relation is not true for Malawi, allocating large shares of small enterprise support resources for firms in remote rural areas would seem likely to cast a shadow over the efficiency of the program. To do so would mean that the small firms would lose the advantages of the economies of agglomeration as a result of having better access to input and output markets, suppliers, replacement parts, servicing technicians, credit, communications, and sales markets.

Some notion of the geographic distribution of small enterprises may be found in 1977 census data, such as that found in appendix table 6. The table also indicates that, in rural areas, in addition to those who were principally subsistence farmers, there were nearly 100,000 people who were principally engaged in non-farm activities or family business workers (6,000), self-employed (88,000) and employers (1,000). In addition, some share of the rural employers are undoubtedly employed in non-farm activities off the estates.

Monitoring Progress of SMEs for the MED Program

USAID has asked that the SME Policy Team comment on techniques for monitoring the progress of SMEs following the implementation of the MED program. This note relates particularly to monitoring procedures for the labor market. For such a purpose, a variety of options are open to the USAID mission.

Internal Project Monitoring Information: This would be the least costly of the alternatives and would have to be built into the internal functioning of the MED program. Included could be the collection of data on the internal costs, employment generated, number of enterprises assisted, repayment rates for program related loans (e.g., the possible extension of credit to SEDOM, INDEFUND, and DEMATT), and feedback to the mission from the enterprises affected directly by the program. The latter, for clarification, might include a simple post-card or one-page questionnaire to be filled out by the firms and returned by mail either directly to USAID or, to simplify mission administration, to the formal project auditor for compilation and analysis. This data would not be adequate to monitor any external effects or the context of program implementation.

Key informant surveys: This is a technique formalized and tested for labor market surveys by the ILO to generate manpower planning and analysis information without using costly sample survey techniques. Basically, it uses less costly non-random sample surveys of carefully selected "key informants" -- local officials, academics, PVO/NGO spokespersons, and/or business representatives -- to generate data necessary for program development and modification. A similar technique might be developed to monitor MED, based on using a different sort of panel of experts, one more familiar with the operation of MED related programs and their impacts. The sorts of questions which might be asked of the informants could be those pertaining to business conditions and trends in their area or the country as a whole (depending on their expertise), growth of the private sector, the general level of profits, the availability of credit or other critical inputs such as communications or transportation, employment expansion/contraction, wages/incomes, labor supply, other business problems, including those of small enterprises in particular, and educational or training problems.

Formal sample surveys by NSO: These might be supplementary probability-based household and/or establishment sample surveys to be run by the National Statistical Organization. The advantage of these is that they would give sound information on the aggregate prosperity of those involved in enterprises, classified by the scale of their employer. Analyzed in conjunction with information on the implementation of policy and program reforms, such data would be most valuable in charting both the impact of MED and related activities, as well as the need for further reforms and program action. The advantage of this information over the internal project data is that it would give a perspective that would incorporate impacts, whether positive or negative, external to the project participants (e.g., including the loss of jobs by firms competing with those which receive credit through MED-related funding). The advantage of the household approach is that income and employment data could be related to changes in expenditure and basic human needs indices (e.g., education and health), while being able to get a handle on the extent to which small and informal enterprise employment may reflect a second or third job for the individual concerned. The advantage of the enterprise approach would be that the employment and income data for the worker could be related to data characterizing the enterprise that would not be available through the household approach. AID might wish to offer its support for a collection process, similar to that already made to NSO (see READI, "New Directions..." Statistical Appendix, p. 48, 11/87), in collaboration with IBRD or other donors.

Table 1.

Population, Labor Force, and Employment in Malawi

selected years

(in thousands)

	1966	1977	1987	Average Annual Growth Rate (%) 1966-77	1977-87
Total Population (all ages)	4,039.6	5,547.5	7,982.6	2.88	3.64
Urban	203.3	470.6	878.1	7.63	6.24
Rural	3,836.3	5,076.8	7,104.5	2.55	3.36
	1968	1977	1986	1968-77	1977-86
Labor Force [a]	1,775.5	2,288.3	3,171.5	2.82	3.63
Formal Sector Employment [b]	164.6	309.0	427.8	7.00	3.61
Agriculture, Forestry and Fishing	44.2	155.1	185.1	13.95	1.96
Industry [c]	34.5	59.8	101.8	6.11	5.91
Services [d]	55.9	94.1	140.9	5.79	4.48
Unallocated	30.0	0.0	0.0	-	-
Informal Sector Employment [e]	44.9	84.3	116.7	7.00	3.61
Smallholder Agriculture and Residual	1,566.6	1,848.4	2,435.4	1.84	3.06
Unemployed		46.6	191.6	-	15.71

Source: Data obtained from various publications of the National Statistical Office as well as published and unpublished documents of the World Bank. See World Bank, Employment Aspects of Economic Development in Malawi, May 8, 1981.

a Labor force estimate for population ten years of age and older. Estimated by applying 1977 ratio of labor force ten years of age and older to total population, all ages, to population census estimates.

a

b Formal sector figures are primarily from NSO, Reported Employment and Earnings. The unallocated are based on an estimate of 30,000 employees working in small establishments (those with less than 20 employees) not covered in figures for 1968.

c Includes mining and quarrying, manufacturing, electricity and water, and building and construction.

d Includes wholesale and retail trade, hotels and restaurants, transport, storage and communications, financing, insurance and business services, and community, social and personal services.

e Figures based on constant 1977 ratio of formal to informal sector employment. Excludes self-employed in agriculture, forestry, and fishing.

TABLE TWO

1977 CENUSUS

ECONOMIC ACTIVE POP 10 AND OLDER (000s)

BY INDUSTRY	BOTH	MALE	FEMALE
ALL IND GPS	2288	1232	2288
AGR HUNTING FOREST FISHING	1932	936	1969
MINING & QUARRYING	2	2	
MFG	82	68	15
ELECT, GAS, WATER	4	4	
CONSTRUCTION	47	45	2
TRADE, RESTR, AND HOTELS	63	50	12
TRNSPT, STORAGE, + COMMC	23	23	1
FIN, INS, R. EST, & BUS. SER.	4	4	1
COMMUNITY, SOC, & PER SERV	83	67	15
OTHER	47	33	14

*: LESS THAN .5

BY ACTIVITY STATUS			
TOTAL	2288	1232	1056
SUBSISTANCE FARMER	1724	742	982
EMPLOYEE	407	368	38
FAMILY BUSINESS WORKERS	7	4	4
SELF EMPLOYEE	103	83	20
EMPLOYERS	2	1	*
UNEMPLOYEE	46	34	12

APPENDIX TABLE 1

MALAWI: EMPLOYMENT AND WAGES

	1973	1974	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986
Minimum wage (kwachas per day)														
BLANTYRE		0.40	0.40	0.40	0.40	0.40	0.40	0.45	0.70	0.81	0.81	0.81	1.00	1.00
LILONGWE		0.35	0.35	0.35	0.35	0.35	0.35	0.44	0.70	0.81	0.81	0.81	1.00	1.00
ZOMBA		0.35	0.35	0.35	0.35	0.35	0.35	0.40	0.60	0.69	0.69	0.69	0.85	0.85
MZUZU		0.35	0.35	0.35	0.35	0.35	0.35	0.40	0.60	0.69	0.69	0.69	1.00	1.00
OTHER		0.25	0.25	0.25	0.25	0.25	0.25	0.30	0.50	0.58	0.58	0.58	0.70	0.70
WAGES -NOMINAL AND REAL-														
Nominal (kwachas per year)														
From Annual Report on Employment and Earnings														
Total	n.a.	n.a.	n.a.	n.a.	366	427	443	524	592	691	651	711	755	n.a.
Manufacturing	n.a.	n.a.	n.a.	n.a.	519	563	610	728	816	1072	956	870	844	n.a.
Manufacturing/Total (in %)	n.a.	n.a.	n.a.	n.a.	142	132	138	139	138	155	147	122	112	n.a.
From Annual Economic Survey														
Total	345	394	438	456	486	564	612	762	761	893	956	n.a.	n.a.	n.a.
Manufacturing	421	473	544	593	626	697	791	834	1056	1107	1229	n.a.	n.a.	n.a.
Manufacturing/Total (in %)	122	120	124	130	129	124	129	109	139	124	128	n.a.	n.a.	n.a.
Real (1978=100)														
From Annual Report on Employment and Earnings														
Total	n.a.	n.a.	n.a.	n.a.	87	100	99	102	99	106	90	87	81	n.a.
Manunfacturing	n.a.	n.a.	n.a.	n.a.	94	100	104	108	104	125	100	81	69	n.a.
From Annual Economic Survey														
Total	99	96	96	94	88	100	104	113	97	104	100	n.a.	n.a.	n.a.
Manufacturing	97	92	96	97	90	100	111	101	110	105	105	n.a.	n.a.	n.a.
Real Minimum Wage Index (1978=100) -Deflated by GDP deflator at factor cost-														
BLANTYRE	n.a.	137	126	116	102	100	96	94	126	133	119	106	115	101
LILONGWE	n.a.	137	126	116	102	100	96	106	143	151	136	121	131	116
ZOMBA	n.a.	137	126	116	102	100	96	95	123	129	116	103	112	98
MZUZU	n.a.	137	126	116	102	100	96	95	123	129	116	103	131	116
OTHER	n.a.	137	126	116	102	100	96	100	143	152	136	121	129	113
	n.a.	137	126	118	102	100								

SOURCE: IBRD "INDUSTRY SECTOR MEMORANDUM", 11/88

APPENDIX TABLE 2

Earnings in informal sector enterprise, by activity, 1983

	Mean monthly gross earnings (K)[1]				Employees per business	Monthly wage excluding apprentices(K)
weighted	Dry average[2]	Wet season	season			
Welding	329.2	350	300	-	3.00	27
Brick-maker	327.1	500	85	38	2.38	23
Garage	286.2	312	250	13	2.81	31
Maize-mill	140.3	162	110	11	1.34	15
Builder	89.6	100	75	75	0.29	40
Carpenter	69.4	79	56	47	1.04	30
Bakery	41.2	47	33	68	0.48	9
Radio repair	38.0	43	31	33	0.23	19
Tinsmith	34.7	38	30	61	0.72	17
Watch repair	30.1	33	26	93	0.09	-
Tailor	29.4	34	23	79	0.32	21
Bicycle repair	21.7	25	17	82	0.18	-
Shoe repair	20.2	21	19	89	0.13	20
Beer brewing	19.8	19	21	96	0.05	-
Basket-maker	15.5	18	12	98	0.04	-
Mat-maker	12.7	16	8	98	0.02	-
Pottery	9.5	12	6	100	0.00	-
Blacksmith	9.4	9	10	67	0.40	-
All trades	26.3	30	21	78	0.38	21
Minimum wage rural/urban 1983						13/17

[1] Median values for all business units

[2] Weighted average of dry season and wet season earnings assuming ratio of 7:5 months.

SOURCE : IBRD "INDUSTRY SECTOR MEMORANDUM", 11/88

APPENDIX TABLE 3

Table 19 Factors affecting the income-earning capacity of informal small-scale industry in Malawi

	Gross monthly earnings(kwacha per month)	Mean numbers employed per establishment
Initial outlay (K)		
0-	24	0.190
50-	40	0.410
100-	44	0.550
500 or more	171	1.475
		0.365
Education of owner		
no education	19	0.180
Std I - IV	29	0.255
Std V - VIII	36	0.455
Higher	100	1.010
		0.34
Location of enterprise		
village	18	0.175
trading centre	30	0.380
town/city	35	0.415
		0.34

(Source:

SOURCE: W.ETTEMA, "SMALL SCALE INDUSTRY IN MALAWI- JOFAFR-STUD 12/84

APPENDIX TABLE 4

Monthly income of urban households by education of household head, 1979/80

	% earning below 40K	% earning over 100K	Median income(K)	% increase over previous educational level
Never went to school	55.6	9.6	37.40	-
Std 1 - 4	47.0	16.1	43.56	16.5
Std 5 - 8	35.8	23.2	56.26	29.2
Sec. School failed JCE	17.8	41.9	87.54	55.6
Sec. school JC, failed MCE	5.7	35.7	109.90	25.5
Sec. School passed MCE	0.6	42.1	155.70	41.7
Trade test, nursing certif., or at least 2 "A" levels	-	92.1	411.56	134.3
University	-	100	more than 600	-

Source: Urban household expenditure survey, 1979/80, National Statistical Office, 1983.

APPENDIX TABLE 5

LEVELS OF EDUCATION OF ENTREPRENEURS BY NORMAL MONTHLY TURNOVER OF BUSINESS

Level of education	Normal monthly turnover: Less than K50	K51-100	K101-200	K201-1,000	K1001-3,000	K3001+	Total
None	26	13	14	31	11	5	100
Primary	23	19	14	27	12	6	100
Jr. Secondary	11	15	13	34	16	11	100
Up. Secondary	3	4	11	28	25	29	100

SOURCE : READI, "NEW DIRECTIONS...."

APPENDIX TABLE 6

1977 CENSUS

EC ACTIVE (10 YRS + OLD)

	URBAN (THOUSAND)				RURAL
	LILONGWE & BLANTYRE CITIES	OTHER URBAN	TOTAL URBAN		
TOTAL	107	47	154		2134
MLIMI	7	15	27		1702
EMPLOYEES	84	26	110		297
FAMILY BUSINESS WORKERS	1	*	1		6
SELF-EMPLOYER	10	5	15		88
UNEMPLOYEE	*	*	*		1
	5	2	7		40

APPENDIX TABLE 7

Employment
Average Number of Persons Engaged, by Sex, 1976-77 1/

Industry Group	1976				1977[e]			
	Male		Female		Male		Female	
	Number	Percentage	Number	Percentage	Number	Percentage	Number	Percentage
Agriculture, Forestry and Fishing	90,907	85.3	15,658	14.7	115,614	86.3	18,330	13.7
Mining and Quarrying	1,09[illegible]	99.7	3	0.3	508	99.8	1	0.2
Manufacturing	34,437	95.5	1,610	4.5	30,023	95.5	1,426	4.5
Electricity and Water	2,824	93.3	203	6.7	2,566	93.3	185	6.0
Building and Construction	21,076	99.4	118	0.6	22,227	99.5	113	0.5
Wholesale and Retail Trade, Hotels and Restaurants 2/	18,262	88.0	2,491	12.0	17,100	93.3	1,221	6.7
Transport, Storage and Communications	12,549	97.0	391	3.0	15,139	96.4	558	3.6
Financial Institutions, Real Estate and Business Services 3/	2,956	86.7	455	13.3	5,497	91.0	542	9.0
Community, Social and Personal Services	55,737	89.6	6,454	10.4	38,108	84.5	6,968	15.5
All Industries	239,843	89.8	27,383	10.2	246,782	89.4	29,344	10.6

1/ Quarterly average of number of people employed in establishments employing 20 and more people.

2/ Does not include Government sector employees.

3/ Includes Government sector employees.

E : ESTIMATE

SOURCE : NSO REGISTERED EMPLOYMENT AND EARNINGS REPORT, 1976

Annex IV:

Strategies for the Promotion of SME Activities in Malawi: Financial Sector Analysis

I. Introduction: Is There a Case for Policy Interventions?

Economists never fully resolved an old debate about the desirability of nurturing financial institutions ahead of demand for their services. But the debate did result in a firm consensus that underdeveloped financial markets impair economic development. Provision of financial services is not simply a matter of satisfying market demands; rather, it is fundamental to mobilizing savings and facilitating the efficient allocation of investment resources among competing uses. For this reason, the structure of the financial system and the financ al policies of the government play major roles -- for better or for worse -- in determining the rate of growth and the evolving structure of the economy.

To justify policy interventions in financial markets it is not enough to say that these markets are important. One must also believe that private market forces are not performing intermediation tasks effectively or efficently, and that the government has tools for improving on the outcome. One must be convinced that the patient is ill, and at the doctor's presecription will work without undue adverse side effects. On this score, no firm consensus yet exists. Some specialists contend that government interventions, as a rule, are worse than the illness itself. Others are equally convinced that financial markets in most LDCs operate very imperfectly and that well-chosen and well-executed policy interventions can be enormously helpful. Too often, however, policy interventions are ill-chosen or badly-executed, with the result that the patient is not much helped and the financial system itself suffers. Such remedies are to be avoided. The efficacy of potential policy interventions, then, is the heart of the matter.

As in most LDCs financial markets (especially formal sector institutions) in Malawi bear little resemblance to perfect markets. Bank and non-bank financial markets are highly concentrated and segmented. Other financial market imperfections can be observed as well. Bankers, for example, are unfamiliar with or untrained in technologies for delivering financial services to smaller and less sophisticated groups of customers. Lending to non-prime customers is also inhibited by the underdeveloped state of complementary markets for insurance and property. Furthermore, the provision of banking services to small-holder agriculture and to non-agricultual

SMEs is linked closely to fundamental problems of food insecurity, underemployment, and poverty. It is often said that such externality arguments are difficult to confirm, but in Malawi they are even more difficult to dismiss.

As the discussion above suggests, the debate about financial market efficiency pertains directly to SME development. Clearly, the effective demand for financial services by SMEs is not well-served. Every piece of evidence the team has encountered points to serious gaps in the menu of financial services available to groups other than prime, conventional bank customers. In READI's SME survey, lack of credit was by far the most serious constraint cited by entrepreneurs, and often the only problem mentioned (READI, 1987). Another example is a recent anthropological study of smallholder agriculture in South Zomba, where poor farm households earn 38% of their income from off-farm activities, including informal sector production and trade. Yet they lack liquidity even to service their "desparately" felt need for obtaining fertilizer, let alone other income generating activities. It is quite clear, too, that informal markets are not providing adequate financial services either. This will be discussed in more detail below.

Accordingly, this report takes as given the existence of important unsatisfied demands for financial services for SMEs. The crucial question is whether constructive interventions can be designed. Equally to the point, if the government is determined to intervene in the financial markets to promote SME development, what policy options should donors support?

The next section (II) rounds out the introductory material by establishing some basic premises underlying the subsequent analysis. This is followed by a discussion of how macroeconomic financial policies affect SMEs, as a guide to policy dialogue with GoM (III). Two sections (IV and V) then deal with the financial market structure and the structure of interest rates. This material constitutes the heart of the report. Next (VI) some special categories of financial needs are discussed. Section VII reviews the new Reserve Bank Act in the context of its implications for SME financing, followed (VIII) by brief concluding remarks about directions for A.I.D. strategy.

II. Basic Premises

Three fundamental premises of the report have already been discussed:

-Currently, the financial system falls far short of satisfying the effective demand for financial services in the SME sector.

-This lack of financial services seriously constrains the expansion and development of SMEs.

-This lack of financial services for SMEs represents a serious financial market imperfection, not an optimal allocation of scarce resources to other clearly superior investments.

None of these premises has been established with rigor, but all three have to be accepted if the question of policy interventions is to be interesting. If A.I.D. chooses to reject any one of the three, it would follow that the proper financial market policy is laissez-faire -- apart from the macroeconomic considerations. For present purposes we proceed on the assumption that the do-nothing option is rejected.

Six additional premises (in no order of importance) can be stated here with a minimum of discussion.

-The objective is not simply to deliver financial services to SMEs, but to do so in the course of developing a sound and competitive financial system.

-There is a danger of pursuing superficially promising policy interventions that are damaging to the financial system, costly to the economy, and perhaps even ineffective in achieving their stated purpose. One must guard against adopting policy remedies that are worse than the market "disease."

-The demand for financial services by SMEs includes access to both deposit services and credit; over time the demand for checking services and other banking services will grow in importance as well, especially for the more advanced SMEs.

-Credit technologies exist for providing viable and cost-effective financial services to many SMEs, though not necessarily through formal institutions in all cases.

-The goverment of Malawi cannot afford recurrent subsidies for financial services, and will not soon have the capability to administer heavily bureaucratic interventions (which in any case are generally undesirable).

-SME activities have a key economic role to play in the long run as well as the short run, though the mix of SME activities will be quite different over these two time frames. There is a need for financial markets to facilitate SME development, as well as servicing current needs.

III. Macroeconomic Financial Policies Linked to SME Development

Business conditions faced by SMEs are predicated on the economy's aggregate performance. Consequently, the success of any structural interventions in the financial markets requires consistent macroeconomic policies. For this reason some key links between SMEs and the macroeconomics of development finance will be addressed before proceeding to analyze the structure of the financial system.

The links in question involve complex general equilibrium interactions which may affect different SMEs in different ways. Hence there are exceptions to almost any generalization. Even a phenomenon as fundamental as strong economic growth is not uniformally favorable for all SMEs. Some, for example, produce inferior goods that may sell better when earnings are weak. Also, rapid growth accelerates structural changes that can hasten the demise of certain classes of SMEs that would not in any case survive modernization in the long run. These are exceptions, though, to the rule that macroeconomic health fosters healthier SMEs and LEs alike. For the sake of brevity, the focus here will be on the rules rather than the exceptions.

In the context of Malawi's structural adjustment program the government has adopted macroeconomic policies that should have a generally salutary impact on the development of SMEs over the next five years. Adjustments already in place should provide a basis for restoring modestly positive **growth** of per capita income in Malawi. As of mid-July, Reserve Bank economists are projecting real GDP growth of 3.9% for 1989, only slightly under the World Bank projection in the ITPAC report (May, 1988). Faster growth is anticipated in future years, barring unforeseen setback. The favorable impact on SMEs of rising per capita incomes is self-evident, although the distribution of income gains is important as well.

Potentially even more significant than small improvements in per capita income is the movement towards a more balanced government budget, lower inflation, and a more sustainable balance of payments position. Looking first at the government budget, the latest Monthly Statistical Bulletin (MSB) shows that the government recurrent account achieved a surplus of K88 million in the twelve months to February, 1989, compared to a deficit of K185 million the previous twelve months. This remarkable turn around was achieved by a combination of increased tax revenues and spending reductions (even in nominal terms). Thus **government saving** swung from very negative (nearly -7% of GDP for 1987) to positive (1.8% for 1988) (see Table 1). From CY 1987 to CY 1988 development account expenditures were cut to the bone, declining 23% in nominal terms.

Together these changes meant that **net domestic credit to the government** did not just rise more slowly; it actually declined by 33%. The government completely reversed what had been its voracious appetite for absorbing increments in domestic credit at the expense of the private sector. The latter rose over this period by 38% in nominal terms (nearly 10% in real terms) from its depressed level in 1987. As of February, 1989 domestic credit to the private sector accounted for 49% of total domestic credit, up from only 29% a year earlier. These numbers reveal that much progress has been made in restoring credit flows to the private sector, though much more remains to be done.

The <u>direct</u> impact of these government finance adjustments for SMEs is not of major importance since bank credit to the SME sector was negligible in any event. The modern sector bore the brunt of the credit squeeze, and will benefit most directly from its relaxation. But <u>indirect</u> effects on SMEs of paring the budget deficit could be quite significant. This can be seen by considering some of the adverse indirect effects of the credit squeeze.

-The most obvious linkage is that the credit squeeze contributed to stagnation of modern sector growth and declining real per capita incomes, to the detriment of SMEs.

-The government's huge appetite for domestic credit was financed in a large part by central bank credits, which generated rapid growth of the monetary base, which in turn fueled rapid growth of the money supply. Initially the monetary expansion simply accomodated inflationary pressures originating from external shocks. Further rapid monetary growth, however, would only entrench **inflation**, which reached 37% (composite retail price index) over the twelve months period to February, 1988. Over the subsequent twelve months to February, 1989, inflation declined to 26%. Reserve Bank economists state that inflation has since ebbed to less than 20% and may decline to as low as 12% by the year-end.
The dominant effect of high inflation on SMEs is probably damaging. Given the insufficient flexibility of nominal interest rates, higher inflation rates increase the inflation tax on financial savings, whether in the form of cash or deposits. (It also lowers the real cost of credit, but SMEs have not had much access to credit.) To the extent that wages fail to adjust fully and promptly, inflation erodes consumer purchasing power. Inflation also increases uncertainty, a key concern of SMEs, and encourages inefficient investment in inflation hedges to the detriment of productivity.

-To contain inflationary effects of the the government's appetite for domestic credit, the Reserve Bank imposed **credit**

ceilings on the commercial banks. With a lid on lending, the banks lacked the incentive to mobilize deposit funds or to offer attractive deposit rates when interest rates were decontrolled. Evidence to this effect is that the banks recently "rationalized" their mobile units, resulting in a cutback of rural depository services. Also, when interest rates were decontrolled the banks attempted to reduce deposit rates, which were already negative in real terms. This prompted the Reserve Bank to step in with strong "advice" on what the "deregulated" rates should be. (Even so, they remain negative in real terms, contrary to DevPol.)

Since retained earnings and private savings are primary vehicles for financing SME expansion, anything impairing deposit services or reducing real deposit rates hinders SME development. (Assuming that at least some SMEs use or would wish to use formal sector deposit services.) Negative real deposit rates are especially pernicious because they erode savings, undermine attempts to build up capital, and encourage capital flight, sapping domestic savings. Both by fueling inflation and necessitating credit ceilings, the government's appetite for domestic credit was detrimental to SMEs.

-Finally, if commercial banks are unable to service even prime customers as a consequence of the large public sector borrowing requirement, any prospect of engaging their financial infrastructure to service SME effective demand for credit is lost, except through sheer compulsion. (Prospects for engaging the commercial banks are discussed in section IV.)

Although domestic credit to the government has declined and inflation has ebbed, the task of easing macroeconomic constraints that adversely affect SMEs is not yet complete. Credit ceilings will continue to be needed until the excess monetary base has been largely absorbed by economic growth or further reductions in the government's credit position with the central bank. Also, inflation is still quite high relative to most deposit rates. (See Table 2).

In addition, the external sector remains far from balanced, as indicated by the need for continued **foreign exchange (FX) licensing**. Evidently Malawi is still unable to finance its trade deficit without restricting imports. But FX licensing imposes heavy burdens on many SMEs:

-SMEs are generally last in the queue for FX licenses to import raw materials, intermediate goods, and spare parts -- if they know how to reach the queue at all.

-Often, essential SME inputs are imported by trading intermediaries who are in a position to charge excessively high prices as a result of scarcity rents created by the licensing system.

-Even when FX licensing is available, the process imposes costly delays on SMEs. Because they operate on a narrow capital base and sell in highly competitive markets where profit margins are slim, many SMEs are very vulnerable to such costs.

-We have been told that FX permits are issued on a contingent basis that prevents banks from writing irrevocable letters of credit to facilitate import procurement. Faced with such "soft" l/c's, foreign suppliers may be reluctant to ship orders, or may charge higher prices to cover the substantial risks implied. Again, SMEs are especially vulnerable to any such extra costs.

-The regime of FX licensing implicitly protects domestic producers of restricted products, often at very high effective rates of protection. Since consumer goods imports are often restricted in this manner, the corresponding domestic markets are protected. Such supply restrictions increase prices, and thereby erode consumer purchasing power. Also, in highly concentrated industries these effective import restrictions invite monopoly pricing.

-In highly competitive SME-dominated markets, ease of entry will drive out monopoly profits that would otherwise result from protection (assuming inputs are available). Unfortunately, this entry of new producers will be matched by a mass exit if and when the FX licensing is ended. In less formal terms this means that many inefficient SME jobs can be engendered by the temporary and artificial market incentives created by effective protection -- and then lost, traumatically, when FX controls are no longer needed.

-Finally, the economy as a whole is much more vulnerable to external shocks when external balance is achieved superficially through FX controls. The trade deficit may be held to a sustainable level, but all available foreign exchange earnings are required for debt service payments and for <u>essential</u> imports. If external trade conditions deteriorate, there is no room for the economy to maneuver; essential imports will have to be cut. And SMEs will be first in line to suffer from the cutbacks.

One reason the government is not making faster progress in restoring external balance is that achieving external equilibrium probably requires further devaluations. These in turn would exacerbate inflationary pressures. This is indeed a hard trade-off. In effect, the government seems to be accepting microeconomic distortions imposed by the FX controls in return for progress in controlling inflation. To its credit, the government has also sharply reduced the share of available FX it claims for itself. Still, the benefits gained by SMEs from the favorable macroeconomic adjustments are offset to an unmeasurable extent by the continued constraints imposed by the effective import restrictions. Only when the adjustment process is further along will it be possible to liberalize the economy more completely, to the benefit of SMEs.

One final macroeconomic finance issue relating indirectly to SME development is the depressed level of **savings and investment.** The structural adjustment program is increasing economic growth primarily by easing constraints on the use of existing capacity. But in the long run capacity itself must grow more quickly. According to the latest Finance and Economic Review from the Reserve Bank (1988:III) the ratio of gross domestic investment to GDP is 14.3%. This is slightly higher than the poor investment rates of recent years, but still far below the economy's investment performance of a decade ago. Furthermore, foreign capital inflows accounted for over two-thirds of investment, and government investment continued to exceed private sector investment.

In the interests of restoring more rapid economic growth, it is essential for the government to pursue policies that stimulate higher domestic savings rates, and to continue shifting investment resources to the private sector. Increased savings should not, however, come at the expense of consumer expenditure, which is quite low enough already. The recent move to a positive rate of government saving (recurrent budget surplus) has been a healthy sign. But the primary need now is for financial deepening policies that stimulate intermediation, mobilize hoarded saving, and improve the allocation of investment resources.

IV. Financial Market Structure and SME Development

Overview of present conditions

Although most discussions of SME financial needs focus on credit, deposit services are at least equally important. Only a subset of SMEs are likely to be credit-worthy, even with appropriate credit technologies. But virtually all SMEs can benefit greatly from convenient, safe, and remunerative deposit facilities for storing liquidity and accumulating capital.

In institutional terms, Malawi is already unusually well served with **deposit facilities:**

-The Post Office Savings Bank (POSB) accepts savings deposits at offices throughout the country, which are open six days a week. These accounts pay an interest rate of 10.75%, presently tax free. They are subject to a minimum balance of MK 5, and a maximum withdrawal of MK 150. In practice people often have difficulty withdrawing amounts well below that ceiling. Also, it is usually necessary to have proper identification, such as a receipt for the poll tax (levied only on men) or a school certificate. One informant told the team that in his village one must show an ID bearing a photo, which very few people have. Those without a photo ID one must bring along a witness who either has one or is well known to the post office. According to this informant, witnesses sometimes charge a fee that can be as large as MK 5 on a MK 20 withdrawal. As a consequence, in his village most people simply keep their money at home. "Then you have no problem." This seems to be an exceptional case, however.

-In addition to branch offices in urban centers, the two commercial banks maintain a network of agency offices and mobile-unit stopping points in the rural areas. The agencies are open at least once a week, while the rural stopping points are visited at least once a fortnight. The range of bank deposit rates is shown in Table 2. These rates have been decontrolled, but are now being set through negotiations between the two banks and the Reserve Bank. So far this amounts to the same thing as controls. The value of bank deposit services to SMEs is limited by the intermittent nature of the rural network, by service charges, by the zero interest rate on demand deposits, and by a K20 minimum balance for savings accounts. Also, the banks seem to have a poor reputation for catering to the needs of the "small people." According to the banks, the itinerate deposit services are substantial money-losers.

-In the urban areas the New Building Society is a popular institution for savings and time deposits. NBS pays the same deposit interest rates as the commercial banks, but unlike the banks (at present) the NBS also makes small loans against deposit balances. In addition, we have been told that "small people" are treated well at NBS offices.

-MUSSCO oversees 90 registered Credit Union Societies around the country. These societies pay 5% interest on share deposits; in addition 20 of the societies are now in a position to pay dividends. Share deposits qualify savers for loans. They also bear automatic life insurance coverage paying double the balance in the event of the member's death. Coverage is underwritten by CUNA Mutual in Madison, Wisconsin; premiums of 65 tambala per K1000 are borne by the credit society out of income from loans. It is questionable whether funds entering the CUs are net new savings, or rather diverted from other types of deposits in order to qualify for loans and insurance benefits. The CUs would surely stimulate more net new saving if their deposit interest rates were more competitive.

-The Leasing and Finance Company accepts deposits by mail, and pays up to 19% on five-year accounts. These LFC accounts offer both the highest rates and the longest maturities available in the country, but this new organization is not yet widely known.

-In the near future, the Mudzi Fund of Malawi, a derivative of the Grameen Bank in Bangladesh, should begin pilot operations in the districts of Mangochi and Chirazu. The organization has the potential to offer very convenient deposit services to very small rural depositors. But it will be many years before the Mudzi can be replicated on a broad scale, even if it proves to work well in Malawian conditions.

-We have found no evidence of any widespread informal sector deposit services. Indeed some informants told us that rural savers were known to bury their money in the ground before the financial institutions arrived. Probably some still do.

The existing institutional network is impressive for such a poor country. But the fact remains that the (ex post) real interest rate on nearly every category of deposits has been negative since 1983, and very negative the past two years. This means that savers have been losing wealth to the inflation tax, rather than accumulating wealth. Not surprisingly, the ratio of quasi-money (which includes savings and time deposit balances) to narrow money dropped from 1.65 to 1.02 over the period 1984 to 1988. The policy issues relating to interest rates are discussed in more detail in section V.

In addition, SMEs outside the major urban centers lack access to fully liquid deposits. The POSB is the most convenient institution, but it can be rather difficult for rural depositors to withdraw anything other than small amounts. Credit union deposit shares can be withdrawn on demand unless they are backing loans, but this condition is usually binding. Also, some societies are said to discourage the withdrawal of shares.

Turning to credit facilities, the picture is far less satisfactory. Generally speaking, no reasonable credit services were available to SMEs until quite recently, apart from intra-family arrangements. As discussed above, all available evidence indicates that the lack of credit has been a severe constraint for many (but surely not all) SMEs.

It has to be recognized, however, that credit can be a burden to SMEs, rather than an opoportunity for growth. In thin markets where effective demand is a severe constraint on sales, credit can create added costs while generating very little new revenue. Similarly, for activities operating on a very narrow markup, the return on leveraging the business may be less than the cost of borrowing. Just as a knife can be a tool or a threat, so may be credit. The lesson here is not to restrict credit, but to use it carefully.

With this in mind we can turn to a review of credit institutions serving SMEs in Malawi. The following thumb-nail sketches are not intended to be complete, since most of these institutions have been described in many of the referenced reports (see especially World Bank, Industry Sector, 1988, and ARIES, An Evaluation of the Malawi READI Project, 1989.) Lending rates are summarized in Table 2, and will be discussed in detail later.

-The commercial banks have a well-deserved reputation for catering to prime customers, while screening out less well-established clients with heavy security requirements. Recently, however, both banks have instituted lending schemes for small tobacco farmers. These schemes require a sizable contribution on the part of the farmer, and are secured by direct payment out of auction proceeds. Even so, this lending activity is a step in the direction of servicing smaller borrowers with less than blue-chip balance sheets.

-On the other end of the scale, the informal credit markets are all but absent insofar as servicing business needs. Supplier trade credit is "extremely difficult" for SMEs to get, according to available evidence. In the few instances where this is available it must be secured with a post-dated check, and the equivalent of 60% interest rate (relative to cash discounts) is charged. In dealing with their low-income consumers, though, SMEs frequently need to sell on credit, placing a double squeeze on cash flows.

Traditional money-lenders (katapila) are to be found in both the cities and the villages. According to the katapila we interviewed, the interest rate charged is from 40% to 50% per loan, usually over one month duration. Occasionally these loans are used for business purposes, according this informant. But at an effective annual interest rate of 600% katapila credit can only be used in emergency situations, not to finance normal business operations.

-The most active SME credit institution is the Small

Enterprise Development Organization of Malawi (SEDOM), which began operating in 1983. Its portfolio consists of mini-loans ranging from MK 100 to MK 5000 and terms loans that can be as large as MK 75 million. As of year-end, 1988 SEDOM had 2300 loans outstanding, with an outstanding balance of MK 6.3 million. The average loan size of approvals has been MK 4,100. This is to be contrasted to the break-even size of a first loan, which has recently been calculated at MK 12,000. Even this calculation excludes the opportunity cost of equity capital, the market price of borrowed funds, and the cost of expatriate staff financed by technical assistance grants. Also, the arrears rate is high enough to warrant concern. As of the end of 1988 arrears totalled 13.9% of the outstanding portfolio balance. This works out to 19% of gross repayments due. In the course of its lending SEDOM also provides other important forms of assistance to its customers, including management advice, procurement help, and contract solicitation (such as orders for tin buckets, or tables for Red Cross refugee camps).

-INDEFUND, a (largely) private development bank that began operating in 1982, serves somewhat larger businesses than does SEDOM. Its lends for projects in the range of MK 30,000 to MK 220,000. As of the end of March, 1989, a cumulative total of only 97 loans had been approved, with an average loan size of MK 50,000. The portfolio totalled MK 3.8 million. INDEFUND operated at a slight accounting profit for 1988, and has run at a small loss for the first four months of 1989. During the first quarter of this year, INDEFUND's operating expenses amounted to a remarkably low 4% of loans outstanding. As with SEDOM, INDEFUND's accounts benefit from the availability of very soft funds. Total finance charges hardly amounted to 1% of total assets. Arrears, though, amounted to 8% of the outstanding loan balance. This works out to over 30% of repayments due (the total of repayments due to date is much smaller than the balance outstanding). Overall, INDEFUND is providing important credit services to a small number of clients at the upper end of the SME scale.

-The credit union system offers short term loans geared to each members' share deposit balance, as well as longer term loans funded and screened by the apex organization, MUSSCO. By repaying small initial loans (of perhaps 80% of their share balance) an individual can work up to a loan as large as ten times his/her share balance, if s/he qualifies for a MUSSCO term loan. To date only 39 term loans have been approved, averaging MK 15,000 -- which also happens to be the maximum loan size allowed! Based on observing application forms in the field, MUSSCO officials estimate that 75% of credit union loans are used for productive purposes, particularly fertilizer purchases. Although a number of credit unions appear to be solidly on their feet, MUSSCO itself will cover only 34% of its costs this year, and hopes to be only 50% self-sufficient by 1995.

-MEDI, the Malawi Entrepreneurial Development Institute, also provides credit to graduates of its training courses. Most loans are in kind, in the form of equipment and supplies, and have a five-year term. According to departing Peace Corp volunteers, most MEDI students enroll in the course primarily for the loan. The team has been told that steps are being taken to shift the loan function from MEDI to SEDOM.

-The Leasing Finance Company packages loans in the form of leases that are generally converted into purchases at the end of the contract. The leases can be quite attractive because the equipment being financed is the primary collateral, the full payment is tax deductible rather than just the interest, payment terms can be designed to suit the lessee's seasonal cash flow, and approvals can be turned around in just one week. Any equipment bearing a serial number, so as to permit repossession, can be financed through a lease, including small equipment like a typewriter or a sewing machine.

This private company was established less than three years ago by the IFC and DEG, from Germany. Already the organization has MK 56 million outstanding. (This in itself bespeaks an economy starved for credit services.) At present, due to the enormous market response, the company is only dealing with businesses having audited books. According to the IFC officer interviewed, the firm's Zimbabwean prototype, UDC, has expanded into leases for SMEs. We were told that LFC is likely to do so as well. LFC is presently involved in an A.I.D. transportation project providing trucks to Malawian businesses, including some small enterprises that own only two or three trucks.

-In-kind agricultural loans are provided to "farmers clubs" through the NRDP arm of the Ministry of Agriculture. These lending services have been severely criticized for reaching only the wealthier echelon of small farmers, but serious efforts appear to be in the works to broaden the coverage of farmers and crops (See DevPol, and World Bank "Aide Memoire," 1989). These farm loans are relevant to non-farm SME development because any form of credit, even when issued in-kind, is ultimately fungible. Many, if not most, small farmers are engaged in off-farm income generating activities. It is to be expected that these side enterprises will benefit when the farmers' liquidity constraints are eased. Quite simply, after receiving the NRDP loans farmers can spend less of their own scarce cash on farm inputs, and reallocate those funds to other productive off-farm activities.

-The New Building Society lends against deposits, in effect taking cash assets as collateral. The vast bulk of its lending, though, consists of commercial mortgages and mortgages to developers.

-The POSB at present makes no loans. All deposit funds are invested in government securities. Preliminary discussions have been taking place between GoM and the World Bank about broadening the organization's role to include lending functions, possibly by spinning off the POSB in the form of a new commercial bank.

-Finally, the nascent Mudzi Fund will be making rural loans to poor farmers on the Grameen model, which involves dealing with groups of five very poor individuals. Initially loans are given to the two neediest members, as identified by the group. The group also agrees on the projects to be undertaken. After these initial loan recipients demonstrate good repayment behavior and the group has begun a regular saving plan, the other members become eligible for loans. As mentioned earlier, the Fund expects to begin a three-year pilot test in two districts within the year.

One other notable feature of Malawi's credit markets is that collateral is required by nearly all the lenders, including SEDOM and INDEFUND. Unlike the situation in many other LDCs, collateral here is serious business. Loan contracts are enforceable in both the traditional courts and the modern courts. And they are in fact enforced. The team has been told by nearly every credit institution that arrears problems do not generally lead to bad debt losses because lenders routinely foreclose on collateral or collect from co-signers. Even katapilas go to court to dun debtors. Of course this doesn't mean that arrears are not a problem. Arrears still absorb a great deal of management time and necessitate considerable collection costs. Moreover, having to foreclose on collateral means that bad loans have been made and productive opportunities have been wasted.

As can be seen, there is life in the SME end of the credit market. But the task of providing credit services is far from complete. It is still that case that established SMEs with eminently sensible and productive credit needs -- a tinsmith who wishes to buy tools or tin sheets in larger lots to reduce the need for frequent trips to the supplier; a tailor who wants to buy a second-hand sewing machine or a bolt of cloth to prepare an inventory of ready-made clothes; a rural trader who wants to buy a small pick-up truck or even a bicycle; a farmer who wants to buy a small tractor, or more fertilizer -- too often have no place to turn for business loans. Moreover, those who are fortunate enough to gain access to SEDOM, MEDI, INDEFUND, or even the credit unions are benefitting from donor support rather than obtaining services that stand up to the market test.

The question at hand, then, is what strategic opportunities exist for improving financial services for SMEs, if any. The analysis will begin in an unlikely corner of the market, the commercial banks.

Option #1: Engaging the commercial banks?

In the minds of many people, including a number of recent consultants, the commercial banks (CBs) are largely irrelevant to SMEs. There is certainly ample evidence to this effect in the form of portfolio statistics, anecdotes of small entrepreneurs being snubbed, and even statements by CB management that they "cannot risk their depositors' money" on risky or poorly secured loans. Attempts have been made in the past to engage the commercial banks in SME lending. For example SEDOM signed a contract a few years ago with CBM to guarantee 80% on CBM loans to established businessmen graduating from the SEDOM program. When the first two customers approached their local branches for loans under the arrangement, one was refused a loan and the second was asked to tie his house as collateral. According to the former GM of SEDOM, no further attempts were made to implement this early guarantee scheme.

Nonetheless, there are substantive reasons to consider a strategy of developing a program of SME lending through the CBs.

-The banks already have a nationwide infrastructure on the ground in terms of facilities and skilled (wo)manpower. Moreover they are sound, self-sustaining institutions with the capacity to deliver a full range of financial services efficiently to large numbers of clients. Duplicating this infrastructure, especially in a manner that segments the credit markets, should be a last resort.

-Quite possibly it is in the long-run interest of the banks themselves (as well as the rest of the country's economic elites) to broaden their markets and penetrate the economy more deeply.

-In any event, the government is clearly considering moving in this direction. Its intentions are spelled out quite explicitly in DevPol, as well as the ITPAC agreement. Even the MED project paper identifies as one progress indicator the "...formulation of a policy proposal to enhance the flow of commercial bank resources to SMEs." If there is to be government intervention, it is essential that the intervention be constructive -- i.e. it must help to promote sound and competitive banking, and not undermine the autonomy and financial integrity of these institutions.

-Perhaps in response to the above, CB management have been making a low-key show of a willingness, if not eagerness, to get more involved in SME lending. This was confirmed by every senior banker we spoke to, as well as a number of independent observers. One banker told us that his bank "categorically rejects" the conjecture that CBs will continue avoiding SME lending. A second banker told the team that "indeed the commercial banks can do more." He went on to say that his bank was considering setting up a risk capital fund for SMEs such as SEDOM graduates. (But don't hold your breath on this.) A third senior banker stated that his bank "would be quite prepared to play their part" if appropriate mechanisms could be developed.

-In many other countries CBs are actively involved in a substantial amount of SME lending. For the most part, special programs and subsidies were adopted to mobilize the CBs to serve the SME sector. But this is not always the case. As one example, a number of agressive and profitable private banks in Indonesia were a step ahead of recalcitrant government-owned banks in lending to SMEs, even though only the state banks benefitted from subsidies.

Considering the central role banks play in most LDC financial systems, the long run payoff from a successful program involving CBs is potentially enormous. (As is the potential damage from poorly designed interventions.) Therefore the CB option merits serious consideration.

The team believes strongly that programs involving compulsory participation, or edicts about specific lending activities, or programs amounting to handouts are counter-productive and dangerous to the integrity of the financial system. Moreover, there is no easy fix that will convince the banks to jump head first into this unfamiliar business. A gainful program will require a sustained effort on the part of the banks to understand the novel market, to train personnel to deal with SMEs, and to develop procedures for reducing lending costs and providing appropriate incentives to branch managers. It will require experimentation to see what, if anything, works in Malawi. In short it requires a <u>learning process</u> -- on the part of potential SME clients as well as the banks. In this light, it is not surprising that banks have been reluctant to embrace SME business. But by the same token, there are opportunities for donors to play a catalytic role by helping to underwrite development costs and by working with the banks on the design and implementation of programs to facilitate SME lending.

A realistic starting point for considering how to engage the CBs is to accept that the banks cannot risk their depositors' funds, and are not in business to lose money. Given these constraints, any non-compulsory program to develop SME lending through the CBs must include three essential elements:

-Seed funds. It will be necessary to provide a pool of seed funds so that banks need not "risk their depositors' money." The terms on which such funds are made available to the banks should incorporate performance incentives. Also, the terms should be concessionary at the outset, to reduce the cost to the banks (and to the SMEs) of exploring this new territory. It is critical, too, that funds are made available to the CBs in such a way that they do not bear a large foreign exchange risk from possible devaluations.

Can donors be reasonably sure that funds for SME loans reach their intended target group? Probably so, if the interest rate is not set too low, and if the target recipient group is defined realistically. (The smallest of SMEs, for example, are probably not bankable.) The fact is that in Malawi there is no great risk that SME loan customers would have been financed anyway!

-Though seed funding is necessary, this alone will not lure commercial banks into diverting considerable resources to SME lending. A complete program also requires a complementary package of what might be called systems assistance. This includes financial and technical assistance to help the banks through the difficult task of training, staff development, and development of appropriate lending procedures and personnel incentives. A shortfall in any one of these categories is enough to condemn the effort.

-Above all, a donor program must be accompanied by a serious commitment by top management of the CBs, and this commitment must be communicated effectively down the ranks.

What about a credit guarantee scheme? This idea was a frequent subject of comment in our interviews. Every banker we spoke to suggested it as a promising escape from the no-security trap. DevPol also mentions that a credit guarantee is under consideration. Guarantee schemes have been a great fad worldwide in programs to encourage CB lending to SMEs. But a recent World Bank survey of guarantee schemes worldwide (Levitsky, 1988) reveals that the simple concept is extremely difficult to implement smoothly. Many guarantee programs turn into costly bureacratic traps that fail ultimately to protect the lenders. Others work more smoothly but are used mostly to double up security on loans that probably would have been made anyway. Yet others are very expensive, with premium incomes falling far short of costs. Some are too tight-fisted and don't do much to stimulate lending; some are too lenient and leave the banks with too little exposure to worry about supervising the loan portfolio.

The World Bank study does not mean that Malawi should discard the credit guarantee option, but it certainly counsels proceeding with great caution, keeping Malawian circumstances in mind. Malawi cannot afford a costly money-losing scheme, especially one that is intended as a means of convincing the banks that SME lending is a viable extension of their customary market. Nor can Malawi afford a large bureacracy for administering a guarantee scheme.

In the longer run, an essential element of any program to deliver commercial banking services services to SMEs is to increase competition in the financial markets, and especially in the banking industry itself. Under the pressure of competition, the banks would almost certainly find it worthwhile to explore new markets, including catering to SME clientel. The team has learned that a number of applications for bank charters have been received by the government. Dealing with these applications should be a high priority. Another possibility would be to recharter an existing non-bank organization, such as SEDOM or the POSB, as a commercial bank. This would obviously require major organizational changes. This mechanism for increasing CB competition would be far less likely to create long-term problems if the institutions were privatized and allowed to operate fully free of political intrusions.

If donor support is provided to the CBs in the form of seed capital and systems assistance, how might the prog. - proceed to channel loan funds to SMEs? One or more of the following options might be considered for discussion with the banks.

-Prime-plus lending. The statement that banks cannot take risks with depositors' money is not strictly accurate. Banks always take risks in return for commensurate rewards. If SME loans are more risky, there can be some prime-plus interest rate which would reward the banks for accepting the extra risk. The same goes if SME lending is unusually costly to administer. If the required interest spread on prime loans is 3%, say, then SME lending may be attractive at an 8% spread. The experience with SME lending programs in Asia suggests that a spread of 8% should be more than adequate in the long run to cover lending costs plus risk, especially in a country like Malawi where lenders are able effectively to foreclose on collateral.

It may be, however, that the required interest rate is so high as to prohibit SMEs from financing productive investments, apart from highly speculative ventures. If this is so in the long run, after the development efforts have run their course, then the lending is not viable. The problem is most likely to arise, though, only in the short run when the banks are still riding the learning curve. The purpose of donor seed funds and systems assistance is precisely to help banks underwrite these development costs without having to pass the full burden onto the SMEs in the short run.

-Small-scale overdrafts. Every member of the study team has an unsecured line of credit of one sort or another, yet not one of us is a blue-chip corporation. With external support, perhaps including a simple, temporary guarantee, banks in Malawi might be willing to undertake a trial overdraft program for standing SME customers.

To this end, the banks might adopt a modified credit union approach to overdrafts. To qualify, a small-scale entrepreneur would first have to maintain a deposit for a specified duration, such as one year. Then, perhaps for another year, the SME owner would be eligible to borrow up to the amount of his/her deposit, with very simple application procedures. In effect the first loan would be secured with cash. If the initial overdraft is handled smoothly, the customer would become eligible for an overdraft up to, say, twice the deposit balance. And so forth. In this way SMEs could build up to larger overdrafts and gain access to a liquid source of working capital. Currently, branch managers are extremely reluctant to approve overdraft facilities. Again,it will require training, appropriate incentives, and a salient commitment by top management if any such experiment is to succeed.

-Indirect lending. It is almost axiomatic that formal financial institutions cannot cover costs on loans to the smallest of the SMEs, even with the best repayment rates. Without large, permanent subsidies, commercial bank credit can penetrate to smaller SMEs only if channelled through a grass-roots intermediary acting as an agent. One remote possibility is for commercial banks to lend through SEDOM or MUSSCO.

Another remote but intriguing possibility is suggested by the case of an Indian commercial bank that serviced even the smallest artisans using traditional money-lenders as agents. This approach greatly expanded the supply of credit in the informal market, and therefore reduced borrowing costs for the SMEs. Also, it tapped into the valuable store of local knowledge possessed by the 'moneylenders, who were rewarded with prestige and leverage of their own capital. Finally, the program eased the customers' repayment burden, as moneylenders collected very small sums each day rather than larger amounts at less frequent intervals. The team is not at all sanguine about this approach working in Malawi, but it is worth pointing out. It is relevent to note that the katapila we interviewed was able to press debtors through the traditional court system. Hence moneylending is not an illegal activity here.

-Project identification support. The READI project has tested these waters in its project promotion studies for INDEFUND (READI, March, 1989). A similar activity for the commercial banks might be underwritten with donor support. Indeed the READI project selection committee included two bankers, and the committe chose to pass some projects directly to the commercial banks rather than INDEFUND (though the outcomes remain to be seen.)

This approach has a high cost per successful project, if the studies focus on individual businesses. A less costly alternative is to study categories of lending opportunities for clusters or types of SMEs, rather than individual entrepreneurs. Feeding such information to the banks (or to SEDOM) and also to the potential clients might lubricate the gears of the lending mechanism in support of highly replicable projects.

-Procurement-based lending. The government has recently announced a new policy of targetting 6% (initially) of its procurements to SMEs. Assuming that the program goes forward effectively, such procurement contracts can provide a basis for securing bank loans, in a fashion parallel to recent lending to small tobacco farmers. In discussing this possibility, one banker suggested that a key difference here is that tobacco sales result in immediate cash payments, whereas the government cannot be relied on to pay promptly. This is indeed a legitimate concern, especially since the profits for the small business(wo)man could easily be eaten up by finance costs during the delay in the government payment. If the government is serious about procurement from SMEs it may have to establish a payment mechanism that guarantees timely disbursement. For example, a pre-deposit toward payment placed in one of the banks would greatly facilitate lending. Similar arrangements might also be used to support the development of subcontracting linkages between large enterprises and SME suppliers.

-Mobile rural lending units. At present the rural mobile units of the CBs are money losers. This is not surprising considering that these units make no loans. The absence of loan services not only cuts revenues, but it also creates an image that the banks are not friends of the "small people." This image, in turn, probably cuts deeply into the potential for mobilizing deposits through the rural units.

A pilot project might be designed to test the potential for turning these operations into profit centers by sending loan officers rather than tellers into the rural areas, armed with a set of simplified procedures that could support a volume of small loans. The lending might be based on the credit union principle, discussed above, or on endorsements from the village headman.

All of the program concepts presented here involve a donor commitment to work with the commercial banks on exploring the market for financial services to SMEs. With some innovation and a spirit of cooperation between the banks, the government, and external donors, it should not be necessary to resort to highly politicized or bureacratic interventions.

Three closing remarks will round out the discussion of the commercial bank strategy. First, although the program options outlined above emphasize providing credit, this is not meant to suggest that credit services are more important than deposit services. The credit services simply need more attention because they are much harder to develop. Second, any bank credit program will be enhanced considerably if business extension services are available to the borrowers. An expansion of BAS/TAS activities can be a very important supporting element of financial market programs. Finally, the macro policy framework must be re-emphasized. When macroeconomic constraints are pinching severely, the impact of efforts to develop financial services for SMEs will be limited.

Option #2: Nurturing non-bank financial intermediaries

The commercial banks, of course, are not the only game in town. They have been emphasized because of their potential importance and because to date they have been relatively neglected by donors. In sharp contrast, the donor community has been heavily involved in developing the capacity of non-bank financial intermediaries (NBFI's) to assist SMEs. These institutions are quite familiar to A.I.D., so the discussion here will be confined to presenting the team's observations.

At the outset it should be made clear that the team has no reason to doubt that the financial services provided by SEDOM, INDEFUND, MUSSCO and MEDI are genuinely aiding many of the recipient SMEs. It is unfortunate, though, that we have to rely on impressions and anecdotal observations for even this mild endorsement. There is a pressing need for monitoring statistics on the condition of the client enterprises, and for programming a careful quantitative impact study of A.I.D.-supported institutions very early in the new CDSS period.

Furthermore, these institutions should not be judged simply on whether they are generating benefits. Doing good is easy. The real issue is whether the institutions are doing good <u>well</u>. Are the long term benefits worth the costs? Are there better ways to intervene to promote SME activities? To these questions our answers are less positive, though again based on impressions rather than solid analysis. Too, the performance of the NBFI's depends in part on interest rate policies, which will be discussed below.

<u>SEDOM</u>. If SEDOM continues to serve primarily as a promotional institution -- catering extensively to small borrowers and incurring high supervision costs by virtue of providing business assistance -- there is no prospect of achieving self sufficiency. But this should not be a condemnation of the organization. SEDOM plays an important developmental role, and reaches a relatively large number of clients. Given the nature of the activity, it is not clear that SEDOM should be pushed to cover costs. Even so, its lending operations should not require continued subsidies. To move toward self-sufficiency in its lending, SEDOM must achieve a better balance between mini loans and terms loans, greatly reduce arrears (preferably through improved project design and selection), and somehow develop separate accounts for the extension component of its supervision activities.

If SEDOM can demonstrate a track record of self-supporting lending operations, with complementary extension services funded separately, it may eventually be in a position to be upgraded into a commercial bank. This development would permit SEDOM to mobilize its considerable understanding of the SME sector to provide a full range of financial services. It would also increase competition in the banking industry. For such a move to be feasible, though, SEDOM would have to be fully free of political intrusions.

<u>INDEFUND</u>. Of the four institutions, only INDEFUND has any prospect of becoming self-supporting over the AID CDSS time period. INDEFUND has a favored position in that it deals with fewer, larger loans and bears less of an extension service burden. By the same token, INDEFUND is not about to become a major player in servicing the SME market. Also, it must be recognized that financial self-sufficiency does not imply

economic efficiency, given that the organization is financed with a large pool of soft funds. To stand fully on its own feet INDEFUND would have to cover its explicit costs and generate a net return equal to the opportunity cost of capital. Until then INDEFUND will continue to operate on a subsidized basis.

MUSSCO. The team began its mission with great doubts about the viability of MUSSCO, based on skeptically reading between the lines of the recent evaluation study. After learning more about the organization first hand our opinion swung strongly in a positive direction. The MUSSCO organization appears to be making considerable progress in creating a solid base of self-sustainable credit societies providing low-cost, grass-roots deposit and loan services. The organization has instituted an effective incentive structure whereby individual societies must demonstrate good performance (including loan collection) in order to qualify for more services and higher status. Although credit union loans are not restricted to income generating activities, casual evidence suggests that most loans are so used. It would be far better, though, to see monitoring statistics. For one thing, with negative real interest rates on CU loans even hoarding unproductive inventories can be profitable, but this is not an activity that donors wish to be funding.

MUSSCO has begun generating more income for itself as a consequence of the fact that 20 of its 90 registered societies have achieved Class A status. This enables their members to apply for term loans from the central office. Still, the apex organization is nowhere near achieving self-sufficiency, even with its soft funding. Furthermore, the costs of supervising and collecting these term loans remain to be established. Overall, the team concludes that the credit union movement can evolve into a very important source of grass-roots financial services. The long-run benefits of supporting MUSSCO will probably be considerable. But implementation of an effective monitoring and evaluation system should be a precondition for continued support.

MEDI. To be brief, MEDI is on the right track in considering termination of its loan program. MEDI does not have any comparative advantage in lending, and assuring graduates of loans the organization distorts its training program.

POSB. As mentioned earlier, the government is currently studying the possibility of upgrading the POSB to handle credit facilities as well as deposits, perhaps becoming a full commercial bank in its own right. Obviously such an enormous transformation would have to be implemented very carefully, since from top to bottom POSB personnel have no experience at all in any banking activities other than accepting savings deposits. Nonetheless the team is intrigued by the concept of grafting a more complete range of financial services onto the one current financial institution with the most pervasive presence throughout the countryside.

Option #3: Creating New Financial Institutions

Apart from permitting new entrants into the major financial markets for the sake of increasing competition, new institutions might be supported to cover major gaps in the network of financial at the lower end of the market. Credit unions and Mudzi fund units might eventually be able to blanket the country side. But the spread of rudimentary financial services could be accelerated by fusing a savings/credit element onto existing grass-roots institutions, without requiring a major investment in organizational bureacracy. Three interesting possibilities have been suggested to the team in the course of our interviews:

-Upgrading women's groups. Some local CCAM goups are presumably well organized and functioning at a high level, while others are less well run. Groups in the first category are capable of taking on additional functions, which might include financial services. One way to introduce such services would be for a donor to make available small challenge grants tied to savings mobilization, for use as a revolving pool of loan funds.

Upgrading farmers clubs. The same remarks apply to well organized and well functioning farmers clubs.

Establishing market banks. In many countries, very small informal banks are common in market places. These informal banks do not require a large amount of start-up capital. Their premises can be a modest storefront or even a stall. Loans to familiar small traders and artisans can be made on a daily or weekly basis on terms that are manageable by even very small traders. For example, a trader might borrow K50 and repay K52 at the end of the day. Annualized, this is an astronomical interest rate, yet a trader only has to earn K3 on the K50 loan to end up ahead for the day.

In addition, at the higher end of the financial system, there is a need for the country to develop money and capital markets, including markets for government securities, commercial paper, and equities. The evolution of such markets will provide savers and borrowers alike more choices, and therefore increase competitive pressures on exisiting financial intermediaries in both the deposit market and the lending market. As noted above, SMEs are likely to benefit from an increase in competition in the financial markets.

In conclusion, this section has probed three broad strategies that A.I.D. might pursue to promote better financial services for SMEs: (1) a strategy of engaging the commercial banks; (2) a strategy of working with specialized financial intermediaries that cater primarily to SMEs; and (3) a strategy of developing new institutions to cover gaps in the present network of financial services. It must be kept in mind, however, that the goal is not simply to inject credit into the sector. Rather, the goal is to develop a sound and competitive financial system that effectively and efficiently serves the various financial needs of the community.

V. Interest rates on SME financial services

Interest rates represent the price of funds in financial market transactions. Like other prices, interest rates serve both as an incentive for suppliers and as a rationing device for allocating the available supply among competing users. In particular, interest rates provide an incentive for savers to store liquidity or wealth in the form of financial assets, while rationing out less efficient uses of available funds. In addition, interest rates determine the cost of funds to borrowers and the income earned by lenders.

In well-developed and competitive markets, supply and demand interactions perform the basic incentive/rationing functions efficiently -- given the technology and information available to market participants. Government interventions in such markets only impair their efficient operation and create distortions that lead to costly resource misallocation.

If this familiar story were fully applicable to financial markets in Malawi, interest rate policy would be trivially simple: hands off. Unhappily, the real world is more complicated. Financial markets in Malawi are neither well-developed nor competitive. The banking industry, the core of the financial system, is effectively a cartel. If left entirely free to determine prices, the banks could exercise their market power by setting deposit rates too low and lending rates too high, relative to what would be efficient for the economy. The absence of alternative financial markets only enhances the banks' market power.

On top of this, the present technology of finance in Malawi is largely limited to conventional, traditional banking practices. This traditional technology in banking is reinforced by the bankers' very limited understanding of the true risks and returns of non-conventional lending to labor-intensive SMEs. These constraints would tend to push the "free-market" interest rate on SME loans well above the level that would promote an efficient allocation of resources to the sector.

Hence, there is justification for the government to be watching and perhaps intervening to influence the level of deposit rates and lending rates, including rates on SME loans. Does government know better, though, about what interest rates should be? Not with any precision, certainly. Therefore, any interventions must be conservative in nature. Otherwise government intervention in setting interest rates can be quite counterproductive. Holding lending rates too low, for example, can create severe problems of excess demand, with all the attendent distortions. It can also undermine efforts by financial institutions to become self-supporting -- as is currently the case in Malawi.

Interest rate policy, then, is highly non-trivial. A hands-off policy is inefficient because the financial markets are not very deep yet. But a hands-on policy can be very clumsy, and even more inefficient if poorly designed.

So what policy conclusions follow? The team recommends limited interventions to prevent banks from exercising their market power by setting deposit rates too low or SME lending rates too high. But such interventions must avoid the trap of administering a cure that is worse than the disease. This means that interest rate regulations must adhere to certain basic rules.

First, interest rate policy must be flexible, and reviewed on a regular basis. This is an important point since the government has established a track record of insufficient flexibility in administering interest rates. Nominal rates have remained fixed for lengthy periods of time, even as real interest rates have swung wildly. Despite a firm DevPol commitment "to assure a positive real return for savers," regulated deposit rates have been negative in real terms since 1983.

Second, all interest rate restrictions should be phased out as the financial markets become deeper and more competitive.

Finally, interventions should not take the form of setting interest rates. Rather, the policy should only involve setting boundary conditions within which market forces can operate freely. A discussion of these boundary conditions follows.

Deposit rate rules

As a guiding principal it is often maintained that deposit rates must be positive in real terms. This is a bit oversimplified, for the following reasons.

First, it is expected returns that motivate economic decisions. Suppose a burst of inflation is expected to recede quickly due to a credible government policy response. The expected real interest rate may then be attractive even if nominal deposit rate is currently below the inflation rate most recently observed.

Second, the reward from holding financial assets does not consist solely of interest income. Bank deposits, for example, provide "peace of mind" as well. Demand deposits also provide liquidity and transactions services. For this reason it is commonplace around the world for demand deposits to continue growing even though the real interest rate on such balances is decidedly negative -- as long as it is not so negative as to undercut the service value of these deposit accounts. By the same token, slightly negative real interest rates on time and savings deposits are no cause for panic, though obviously positive real rates would do a better job of mobilizing new deposits.

Third, adjusting nominal interest rates fully to inflation is itself not costless. This is especially true when a spurt of inflation is caused by an external shock. In this case maintaining a constant difference between nominal interest rates and inflation actually causes a sharp and traumatic increase in the real cost of credit to domestic borrowers. When inflation is caused by domestic policy errors, increasing the nominal interest rate can still be highly disruptive of financial market stability. The reason is that high inflation is usually unstable inflation, giving rise to the risk of "inflation surprises," as farmers in the US midwest recently learned to their dismay.

To illustrate, note that with 2% inflation, a nominal interest rate of 5% translates into a <u>real</u> interest rate of 3%. The real interest rate is also 3% (approximately) with 32% inflation and a 35% nominal interest rate. But in the latter case, the <u>future</u> inflation rate is much more uncertain. So is the effective real interest rate. Hence there is a high probability that lenders will get burned by unexpected increases in inflation. Ironically, there is also a high probability that borrowers will get burned by unexpectedly low inflation. This heightened risk reduces both the supply and the demand for financial resources, stifling financial market operations. Medium to long term transactions may virtually disappear.

Finally, high nominal interest rates can be a major cost factor. If businesses pass on this higher cost the result is to sustain the inflationary spiral. If they can't do so, many may be forced into bankruptcy.

From this analysis we reach the following conclusion to guide any government interventions in determining deposit rates:

- The goverment should let the market determine deposit rates as long as there is no indication that an exercise of market power is artifically holding the rates too low to mobilize domestic savings.

-In the face of changing conditions, deposit rate rigidity is undesireable; but mechanically adjusting the nominal deposit rate to every observed change in the inflation rate is inappropriate.

-Slightly negative real interest rates are no cause for panic, especially when firm and credible anti-inflationary policies are being instituted.

-When high inflation is a lingering problem, the financial risks associated with inflation surprises are best dealt with by introducing indexed financial contracts, not by simply increasing nominal interest rates to inflation plus a few percent. The mechanism here is a contract stipulating an interest rate of, say, 3% plus ex post realized inflation, not ex ante expected inflation.

Lending rate rules.

Loan markets in Malawi are less competitive and more segmented than deposit markets, and techniques for lending to SMEs are especially underdeveloped. Hence policy on lending rates for SME borrowers should be somewhat more aggressive than policy on deposit rates or interest rates on more conventional loans. The problem is to prevent either the exercise of market power or the underdeveloped lending technology from pushing lending rates too high for the market to develop -- while assuring that policy interventions do not set lending rates too low.

In particular, the policy on lending rates must adhere to all of the following conditions:

-The cost of borrowing (inclusive of transactions costs) must emphatically be positive in real terms.

To violate this condition is to invite severe excess demand problems. Note that the real cost of borrowing includes not only the interest cost, but also transactions costs, the opportunity cost of compensating balances, legal costs of securing collateral, and risk costs to the borrower. The point is that loans most certainly cannot be priced as free goods. To do so is to invite insatiable excess demand problems.

-Moreover, lending rates must be high enough to cover the full costs of lending, apart from the development costs associated with learning the SME market. (The development costs can properly be supported by donors.) Otherwise the lending program is not financially viable.

This condition actually involves more than meets the eye. First, there are great dangers that cost-plus pricing will reward highly inefficient operations. Careful monitoring can mitigate this problem to a degree. But only the eventual emergence of more competitive markets will solve the problem. Note also that for the lending to be viable in economic terms it is the opportunity cost of funds, not the financial cost of funds, that ultimately must be covered by the lending rates.

-To the extent that SME loans are more risky and/or more costly to administer (per kwacha of lending) they must bear correspondingly higher interest rates than traditional loans.

One reason, obviously, is to sustain the interest of private-sector lenders. An equally important consideration is that setting SME interest rates too low relative to other lending rates invites widespread diversion of program funds to borrowers who would otherwise qualify for normal bank loans.

The free market, if left to itself, would automatically satisfy every one of these conditions. Hence the conditions are relevant only when government interventions are being imposed. Such interventions are called for only because interest rates on SME loans could be too high and lending volume too low (perhaps near zero) if left to Malawi's underdeveloped financial markets to determine. Once the market becomes more competitive, these interventions would no longer be appropriate.

One additional consideration must be understood. Setting lending rates too low also impairs the development of competing financial institutions. For example, if bank loans are relatively cheap, incentives for establishing money and capital markets are diluted. More to the point, if lending rates at specialized development institutions such as SEDOM are artificially low, many borrowers will prefer to queue for SEDOM loans rather than apply for bank loans. Also, those who do receive bank loans will feel that they are being treated unfairly. Both effects undermine efforts by the commercial banks to enter the SME market.

To reiterate: there is justification for the government to place a ceiling on SME lending rates, but if this ceiling is set too low (as at present), the intervention will create more problems than it solves. A.I.D. should bear this in mind in its policy dialogue with the GoM, and in the context of any financial market programs it pursues.

VI. Special financial needs

Women.

Women face a number of special problems in obtaining financial services in Malawi. One problem is a traditional cultural attitude that wives are subservient to husbands in financial dealings. On this basis, financial institutions are known to require women to obtain their husband's written consent before undertaking legal transactions. We have also heard of cases where financial institutions did not require such consent, and then had to deal with irate husbands who felt their authority had been challenged. With modernization and a strong assist from indigenous women's groups these attitudes are slowly changing, but they certainly have not disappeared.

Non-discriminatory procedures and fair treatment of women must be an essential condition built into any financial market program supported by A.I.D. In addition, financial service programs should incorporate <u>pro-active efforts to overcome traditional biasses</u> through targetted advertising, public service messages on radio, and other outreach activities.

Another effective barrier some women face in dealing with financial institutions is the <u>lack of identification papers</u>. All men pay a poll tax, and receive a tax reciept that can be used as identification in many circumstances. Women do not pay this tax and therefore do not receive the receipts. Women are also less likely than men to possess school certificates, because female enrollment rates are lower than those for males. And obviously, drivers' licenses and passports are not widely held. This particular problem is troublesome, but easy to resolve if only there is a will to do so. Attention to the issue on the part of a donor agency might be the catalyst needed to stimulate action in providing identification papers for all who wish to have them.

The most severe financial problem faced by women is that they comprise <u>disproportionately the poorest</u> of the smallholders in Malawi. They therefore lack effective access to resources of all kinds, including food as well as finance. Most of these women are forced by poverty to engage in simple, low-return secondary activities to generate income. There is no way that such poor individuals will qualify for any formal credit, and even a modest fee or minimum balance requirement is enough to preclude their use of deposit services to store liquidity and accumulate small sums of savings. The only financial institutions that can possibly assist these impoverished women in a cost-effective manner, if at all, are grass-roots organizations such as the Mudzi Fund. Another option mentioned in section IV is to channel funds through local women's groups. It is quite likely, though, that the benefits from this latter type of program would be captured by somewhat higher status women, who probably dominate most local women's groups.

Somewhat ironically, while facing discrimination women seem also to have gained a reputation as being better credit risks than men. Women are said to have better saving habits and less wasteful expenditure patterns. Women also face fewer social obligations that divert scarce cash away from business uses. If these images have substance, experience should itself help to break down the cultural and logistical sources of discrimination against women in the financial markets.

Start-ups.

The major source of equity capital for starting new SMEs is personal savings. The single most important intervention on behalf of start ups, therefore, is to assure that remunerative deposit facilities are available throughout the country.

For the very poor, saving enough to start anything more than a rudimentary business is largely out of the question. Grass-roots financial organizations such as credit unions and the Mudzi Fund will probably help to ease this constraint. Other households may have access to substantial pools of savings for start-ups through high wage jobs outside Malawi, jobs in the modern sector (especially when these jobs include training), or civil service retirement gratuities.

Although many potential entrepreneurs are held back by lack of start-up capital, this type of SME lending is by far the hardest to evaluate. Also, the risks are multiplied because there is uncertainty about both the enterprise and the entrepreneur. An exception would be where a business(wo)man of proven ability wants to start a new venture, in which case (s)he should have a sizable amount of equity to contribute to the project. As development institutions, non-bank intermediaries like INDEFUND and SEDOM may be involved in start up lending to a limited extent. But in general start up funding is not going to be an important activity for formal financial institutions. For A.I.D. this should be a lower priority concern than helping proven entrepreneurs to expand and develop their business.

SME modernization.

Another major point of financial intervention in developing the SME sector in Malawi is underwriting the cost of experiments with innovative appropriate technologies (AT) and products. The READI project is doing a bit of this, much to its credit. Such innovations often have an economic payoff that is far larger than the returns to the individual entrepreneur, because the individual cannot capture the benefits of replicability nor the potential increase in consumer surplus. Such projects are also extremely risky when undertaken singly, but far less so when a portfolio of innovative projects are being financed. In addition, pilot projects require access to information and organizational skills that are not readily available to an individual entrepreneur.

All of these factors inhibit the flow of finance for AT pilot projects through ordinary financial markets, despite their potentially high payoff to the economy as a whole. Consequently, funding for such efforts might be a high priority in A.I.D.'s SME strategy for Malawi, along with technical assistance.

VII. The new Reserve Bank Act and Banking Act

The team's scope of work includes a request for comments on the consequences of the new Reserve Bank Act for SME development in Malawi. Three problems arise in responding to this charge. First, we did not obtain a copy of the old banking act (although it was summarized in a 1986 Price Waterhouse report on business conditions in Malawi, prepared for A.I.D.). Hence the comments here deal with the new law itself, rather than the changes relative to the old law. Second, the interpretation of the law is at least as important as its literal contents. Obviously the team can say nothing meaningful about how the legislation will be put into practice. Third, none of us is a lawyer; we can only comment as economists.

In general outline, the new Reserve Bank Act of Malawi contains no surprises. Its main parts establish:

- a reasonable set of objectives for an LDC central bank;
- the capital structure;
- the organizational structure;
- regulation of the currency;
- the Reserve Bank's role in managing foreign exchange reserves and the exchange rate;
- the powers and functions, including a standard set of monetary instruments;
- supervisory functions (audits and prudent regulations) over both bank and non-bank financial institutions;
- stipulations on Reserve Bank accounting;
- miscellaneous provisions, including a clause on promoting development, to be discussed below.

Comments on more detailed provisions of the Reserve Bank Act follow. Identifying numbers refer to section and subsection of the Act.

2. The term financial institution refers to a "person" other than a bank who is registered as a financial institution. We have been told that this excludes organizations such as SEDOM and MEDI, which are registered as promotional rather than financial institutions.

4. Notable among the objectives of the bank are,

    (d) to implement measures to influence the money supply and the availability of credit, interest rates and exchange

rates with the view to promoting economic growth, employment, stability in prices and a sustainable balance of payments position;
(e) to promote a sound financial structure, including... adequate financial services;
(f) to promote a money and capital market in Malawi;
(j) to promote development in Malawi.

These provisions seem to give the Reserve Bank a great deal of latitude in dealing with both macro policy and the structural development of the financial system. Implicitly the development functions could involve actions affecting SMEs. But it must be kept in mind that this section is dealing with objectives, not powers as such.

6.2. The five-person Board of directors may include the Secretary to the Treasury, the Secretary for Economic Planning and Development, and the Accountant General. This leaves the Reserve Bank open to potential political interference, with unknown consequences for SMEs.

6.5. The potential for political influence is enhanced by setting two-year terms for the directors, who are appointed by the President. The Governor and Deputy Governor, however, have five-year terms.

28.c. The Reserve Bank is to serve as the banker for state-controlled corporations, as well as the government itself. This could in the future place state enterprises first in line for credit, even ahead of the commercial banks.

28.j. The RB can hold equity investments in corporations "facilitating economic development" that are set up "under the authority of government." This is an unusual power, with unforeseeable implications.

30. This section empowers the RB to regulate not only exchange rates, but also interest rates.

36-7. Reserve requirements and cash requirements apply to non-bank financial institutions such as INDEFUND as well as banks.

47. "The Bank shall promote close co-operation with the banks and financial institutions in Malawi...." This section, under the Powers and Functions article, is perhaps the most interesting in the Act. The reader can make almost anything of it.

49. This section returns to the capital and money market objective, but in a very limited context. First, it falls under the article governing Supervision, not Powers. Second,

the bank "shall promote" these markets only "by establishing and monitoring the regulatory framework...;" with no pro-active role being specified.

60. Under Miscellaneous, the RB is directed to "promote further development of trade, industry, agriculture, transport, financial and other sectors of Malawi." This sweeping section is limited only in that the RB must act "within the framework of its powers, functions and objectives... and within the limitations of its position as a central bank." In conjunction with section 47 this is potentially mischievous. On the other hand it could well be called into play to promote SME lending as a form of "co-operation."

In conclusion, it should be noted that in interviews the team received very mixed reactions about the significance of this new law. One economist expected the law to create a wave of strong controls. Another official seemed to welcome the law because it would permit the RB to direct bank credit. Yet another said that the principal result would be to give the RB better monetary tools so that it could move <u>away</u> from credit controls. The bankers, in turn, did not seem the least bit alarmed by the new act. It might be that they expect the government to be leaning on the them to lend to SMEs whether or not the new law empowers the RB to intervene in credit allocations. It should be noted that a new Banking Act is also in the works at the present time.

VIII. Conclusion: Mapping A financial market strategy

The purpose of this report has been to assist A.I.D. in formulating its Malawi country strategy for the next five years. The specific context herein is the potential range of financial market policies, programs, and projects that might be undertaken in support of SME development of Malawi. Since the principal elements of the report will be summarized in our team's main report, only brief concluding remarks will be presented here.

First, although it may seem that macroeconomic policy is a sphere entirely distinct from SME promotion, in fact the two are tightly linked. Macroeconomic policy has pervasive effects on the health of the SME sector. In particular, the success of structural interventions in support of SME development depend critically on the prevailing macroeconomic framework. Hence a macroeconomic policy dialogue needs to be integrated with structural interventions to develop SME financial market services.

Second, this report has presented and discussed a wide variety of potential financial market interventions on behalf of SME development. These include: (1) assisting commercial banks to explore this unfamiliar market, with the expectation of engaging their active involvement over the long run; (2) continuing to build the capacity of specialized institutions providing financial services benefitting SMEs; (3) working to create new institutions for covering gaps in the emerging network financial services for SMEs. Another option (4) is to focus on special financial needs, rather than on a particular class of institutions. The team suggests that the commercial bank option be accorded serious attention, both because of its enormous potential and its relative neglect to date. Moreover, donor support can play a critical role in developing the banks' capacity to service SMEs.

Third, although not emphasized in the report, financial interventions will be all the more effective if accompanied by support of complementary institutions. This support includes strengthing the government ministries, widening the net of non-financial assistance to SMEs, and creating a systematic and regular information base on SME activities, income-expenditure patterns, and manpower-earnings trends.

Finally, the team is aware that donors other than A.I.D. are keenly interested in similar issues. Donor coordination must be an important component of A.I.D.'s strategic analysis.

TABLE I. SELECTED MACROECONOMIC INDICATORS

		CALENDAR YEAR	
	1980	1980	1980
Per Capital GDP. at 1978 factor cost (K)	126.5	115.4	116.0
Gross dom. investment /GDP (%)	37.8	14.0	14.3
Net foreign finance /GPD (%)	22.0	7.1	10.0
Gross national saving /GDP (%)	9.8	7.0	4.2
Govt. Revenue Account balance /GDP (%)	+2.2	-6.7	+1:8
Dom. credit to govt and stat. bodies/total dom.cr (%)	41.3	71.4	45.1
m2/GDP (%)	17.7	21.6	19.3
Quase-money/m2 (%)	47.9	58.2	50.6
Currency /Bank deposits (%)	24.8	22.5	24.0
Composite retail price index (year end)	100	297.5	375.4

Source:

Calculated from data in February, 1989, Monthly Statistical Bullet; and 1988 III financial and Economic Review

Note:

(1) preliminary Estimates

TABLE 2. SELECTED INTEREST RATES, JULY, 1989

	DEPOSIT RATES 1	LENDING RATES 2
COMMECIAL BANK	10.75% SAVINGS ACCT 12.75% 3-MONTH TD 13.00% 6-MONTH TD 13.25% 12-MONTH TD	17% AGRCI 22% MAXIMUM, OTHER LOANS
INDEFUND	- NA -	16.5% AGRIC 18.5% MFG 20.5% WORKING CAPITAL
SEDOM	- NA - 5% + DIVIDENDS (IF ANY)	18% MINI LOANS 18% TERM LOANS 18% REGULAR LOANS 16% TERMS LOANS
MEDI	- NA -	15%
POSB	10.75% TAX FARE	- NA -
NEW BUILDING SOCIETY	10.75 SAVINGS ACCOUNT 13.25 6-12 MONTH TD 13.75 12-24 MONTH TD	13.75% OWNER OCC. HOUSING 19.00% RENTAL HOUSING 20.00% COMMERCIAL PROPERTY
LFC	(IFC INTEREST RATES) 13% 3 months 14% 6-11 months 15.5% 12 months 16% 18 month 16.5% 24 months 17% 30 months 18.5% 36 months 19% 60 months	25% "ON DECLINING BALANCE"
GOVERNMENT TREASURY BILLS	15.75%	

1,2 To approximate real interest rate, use formula r= i-p, where r = real interest rate, i =naminal interest rate, and p= inflation ate If, for example, p- 20% for 1989, then on a 121-month commercial bank TD, r= - 6.75%

3 The dedining balance method gives an accurate measure of the effective interest rate. Contrast this with discount method sometimes used by bakns: on a K1000 loan at 20%, K20 would be paid up fron. Effectively, K20 is being paid only K80 of actual loan funds available, so the effective interest rate is 25%, not the advertised 20%