# Imports and trade balance in malawi economics essay

ASSIGN BUSTER

Malawi experiences chronic trade deficit since 1980; imports are more than exports which implies that the economy spends more than it earns. As such, the country depends on assistance from the IMF, the World Bank, and other bilateral donors to finance the gap.[1]The assistance is through both commercial and concessional loans as well as grants. These financing options have not only made the country accumulate debts but also have exposed it to economic shocks. For instance, in 2009, most donors were unable to commit their support due to the global financial crisis, and in 2010, IMF also stopped financing the country because of worsening human rights conditions in the country. These made the country to experience a deep recession between 2009 and 2011. The country was unable to finance its necessary import such as oil, machinery spare parts and fertilizer among others, hence production was negatively affected.[2]

IMF argues that devaluation of the Malawi currency, the Kwacha, and floating it should be emphasized in order to increase exports or reduce imports or both so as to improve the balance of trade situation in the country. IMF says that " over the years, persistent overvaluation of the Kwacha has contributed to growth in imports outpacing growth in exports."[3]Therefore, they recommend that an exchange rate policy that makes the Kwacha lose value relative to other currencies will improve the balance of trade condition in the long-term. This is because volume of exports is increased as they are made cheaper in foreign money and volume of imports is reduced as they are made expensive in local money. In fact, Malawi has implemented this advice several times since 1980, but its benefits are yet to be observed.

Should Malawi concentrate on this policy to improve the trade balance? On the one hand, some policy makers are arguing that it will indeed assist the country, while on the other hand, others think that the policy is of less significance to the economy. This controversy is arising because the policy is based on a theoretical relationship between the exchange rate and the balance of trade, which depends on assumptions called Marshall-Lerner conditions. These assumptions are the source of the disagreements. Marshal and Lerner establish that if devaluation is to lead to improvement of the balance of trade, firstly, the increase in the price of imports should be able to incentivise the economy to significantly substitute the imports for local commodities and, secondly, the decline in price of exports should also be able to incentivise the trading partners to significantly increase demand. [4]One group of policy makers suggests that these conditions will not hold because of the nature and composition of Malawi's exports and imports, while the other group believes that the assumptions hold in the long-term.

## 1. 2 Thesis Statement

This study, however, argues that devaluation will not incentivise foreigners to demand more of Malawi products or make the country reduce importation; hence the trade balance will not improve in the long run. This is because the country's main exports are primary products, and main imports are products that the country cannot produce, but needs them. As such, this policy should be emphasised alone as a solution to the trade deficits but rather it should be implemented along other policies that will alter the export basket composition and domestic consumption needs.

On the nature of exports, over 80 percent of them are primary products, which include tobacco, tea, coffee and cotton.[5]These products have a unique characteristic that their demand does not increase much when their prices go down. For instance, Todaro and Smith indicate that “ demand for primary products is not very responsive to price changes.”[6]In other words, international demand of these products is inelastic; it cannot be increased merely by price cuts. In addition, the authors say that empirical evidence indicate that prices of primary products are declining over time when compared to prices of manufactured products. Therefore, the expected increase in exports revenue as a result of increase in volume is offset by the decline in international prices for primary products relative to manufactured products. Such being the case, emphasis should be on promoting value addition and changing the nature of these exports, other than devaluation alone.

On the composition of imports, trade statistics show that the country’s major imports include petroleum products, fertilizer, other semi-manufactured products, and machinery and spare parts.[7]The statistics reveal that since 1980, Malawi has failed to substitute these imports despite the fact that their prices have been increasing in local money. In other words, it can be inferred that the demand for these imports is inelastic in the country; they cannot be reduced simply by price increments. This is because they are necessities for the survival of the economy. In fact, the value of imports just increases with effect from devaluation. Thus a strategy that keeps the prices of imports low is better to the economy’s growth than a policy that increases them.

Since exports are not likely to increase much and imports increase due to devaluation as explained above, therefore, there is high probability that trade balance situation will not improve in Malawi due to devaluation. Such being the case, strategies that aim at promoting quality and value addition on exports should be prioritised. Moreover, policies that will assist the impoverished nation to come up with efficient ways of producing these products, such as improved technology, can be the best alternatives. On important note, devaluation tends to be inflationary when it does not lead to decline in imports and increase in exports. James Chad (2012), for instance, argues that devaluation has instantaneous effect of increasing prices of imports; hence cost of production also increases. If imports cannot be reduced over time, high domestic prices are set to prevail. In this situation, employees also ask for higher wages to maintain their living standards, which further increase the production costs. This " wage-price spiral" is then set into action.[8]Thus a new set of challenges is introduced in the economy.

## 1. 3 Purpose of Study

This study intends to generate empirical evidence on the effects of devaluation of the Malawi currency. Specifically, the study will estimate the impact of devaluation on exports; impact of devaluation on imports; and impact of devaluation on trade balance (the difference between exports and imports values). This is because identification of these relationships will assist in solving the current controversy on whether this policy will assist in improving the trade deficit or not in the long term and within this, to what extent are imports and exports being affected. Thus policy makers will have evidence to implement policies that maximises social welfare of the nation.

In addition, if the study proves that indeed devaluation does not improve trade balance in the country, it will be suspected of inducing rapid inflation, which is also troubling the country. But this study will not investigate this relationship as it needs a separate study.

## 1. 4 Research Questions

With the above purposes in mind, the study will address the following questions:

To what extent does devaluation affect imports in Malawi?

To what extent does devaluation affect exports in Malawi? and

To what extent is the trade balance affected by devaluation in Malawi?

## 1. 5 Organisation of the Study

The remaining part of the study is organised as follows: Chapter 2 explains the background analysis of the trade balance situation in Malawi and the policies implemented so far to improve the situation. Chapter 3 provides the theoretical relationship between devaluation and exports, imports and balance of trade. It also provides empirical evidence from studies on these relationships. In addition, the chapter states the significance of this study. Chapter 4 deals with methodology of the study which is a summary of workable definitions and measurements of balance of trade, exports, imports and devaluation. Chapter 5 is a discussion of the statistical results obtained based on the methodology. Finally, chapter 6 is a summary of the main findings of the study. It also outlines the areas that will need further research and the major weaknesses of the study.