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# Financial Liberalization and the Industrial Response: Concentration and Entry in Malawi

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**Summary.** — It has been suggested that financial liberalization may be a key policy to promote industrialization as it removes the credit access constraint on firms, especially small and medium ones. We investigate the effect of credit expansion in the wake of liberalization on the structure of the industrial sectors in Malawi and find that, in contrast to the hypothesis above, it resulted in an increase in industrial concentration and a decrease in net firm entry, especially in sectors that are more finance dependent. The case of Malawi is interesting because financial liberalization has been justified precisely as a means for industrial development and because the implementation of the policy has been regarded as relatively successful.


*Key words* — financial liberalization, industrial concentration, firm entry, external finance dependence, Africa, Malawi

## 1. INTRODUCTION

The importance of developed and stable financial systems for the sustainability of economic growth cannot be overemphasized. Instead, whether financial sector development can be an engine for growth in developing countries and whether policies for financial development should have priority over other policies are still controversial matters. Rather than concentrating on the cross-country aggregate relationship between financial development and economic growth (which on the whole has produced few conclusive results) much of the more recent research investigates the theoretical mechanisms through which financial development may lead to faster growth.

One of these transmission channels centers on the driving role that financial development might have for a country's industrialization as a result of greater firms' access to credit in more developed financial markets. This may be due to the wider availability of finance—a possible consequence of competition among financial institutions—and the adoption—made more likely in financially developed systems—of more transparent accounting and disclosure rules and better corporate governance which help firms overcome adverse selection and moral hazard problems (Levine, 1997). Moreover, since these asymmetric information problems are more severe for new and small firms, financial development should be particularly beneficial to them. [1]

This literature could thus generate powerful policy implications, for financial liberalization may be seen as a crucial policy for the promotion of industrialization. [2] Malawi is a relevant case in point. Its economy is agricultural based and therefore industrialization has been a major policy objective since the country became independent in 1964. However, progress in this area has been rather elusive despite targeted reforms. At the end of the 1980s, the country embarked on a wide-ranging program of financial sector reforms following specific World Bank's advice which identified them as the key to growth and development of the manufacturing sector in the country (World Bank, 1989).

Despite what has been regarded as a generally successful implementation of financial reforms, especially in promoting bank competition and favouring a greater volume of intermediation, the impact of these reforms on the country's industrialization has been disappointing. This could be due to many different factors. In this paper, we investigate specifically the role of financial liberalization and, in particular, whether liberalization led to a relaxation of the credit access constraint facing domestic firms, especially small and medium ones.

Indeed, the outcome of liberalization (i.e., a specific policy input, as opposed to financial development, which is a policy output) is ambiguous on both theoretical and empirical grounds. For example, in a liberalized regime, banks, which during financial repression did not develop their risk assessment and management skills, may concentrate their lending to well-established customers rather than financing new establishments (Caprio, 1994). Banking competition, which always accompanies financial liberalization policies, may not necessarily mitigate this problem since in a competitive environment the importance of relationship lending may increase rather than decrease, because it allows lenders to differentiate themselves from other lenders and gives them a competitive edge (Boot & Thakor, 2000). Moreover, since small and medium firms are more informationally opaque entities, the costs for banks of investing in informational capital to assess the prospects of small and medium enterprises may not be worthwhile (Berger, Klapper, & Udell, 2001). These observations suggest that, even after liberalization, financial institutions may provide credit mostly to larger clients with long-standing

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relationships thus perpetuating entry barriers especially for those firms that are more external finance dependent. According to these arguments, financial liberalization may not relax firms' financing constraints and which industrial sectors stand to gain from liberalization or are more likely to be hurt by it remains to be seen.

Our empirical analysis examines the effect of financial liberalization on concentration and firm entry in the industrial sector. The intuition behind this particular and unusual form of the empirical approach is discussed in Section 4 where we also describe the methodologies used in this paper. [3] This is preceded by background information on the economy of Malawi in Section 2 and a survey of the literature in Section 3. The empirical results are presented and discussed in Section 5. Section 6 concludes.

## 2. THE MANUFACTURING SECTOR AND FINANCIAL LIBERALIZATION IN MALAWI

The economy of Malawi is highly dependent on agricultural commodities. At the time of independence in 1964, the contribution of the manufacturing sector to gross domestic product (GDP) was 8.0%. Thus, the new government made the objective of industrialization a development priority. Industrialization was to transform the country's economic structure from agricultural-based to modern. Moreover, by stimulating production more widely through its forward and backward linkages with other parts of the economy, industrialization was seen as essential to drive strong economic growth. An increased share of industry in GDP would increase employment opportunities, raise incomes, and ultimately translate into improved standards of living for the country's population.

To facilitate the industrialization effort, the government promulgated two related pieces of legislation. The *Industrial Development Act* of 1966 set out the conditions for the licensing of industrial firms. This legislation favoured large firms by providing exclusive monopoly rights to large enterprises with the potential for the exploitation of economies of scale. The other piece of legislation was the *Control of Goods Act* of 1968, which intended to curtail monopolistic pricing behavior but, by setting a statutory limit price for a wide variety of manufactured products, it also effectively protected incumbent firms from new entry.

The state played a catalytic role in the industrialization process as public enterprises were set up to compensate for the scarcity of indigenous capital and the lack of an indigenous entrepreneurial class. Moreover, these enterprises, which started in very specific activities, branched out into many different industries. For example, by 1980, two of such leading state-owned enterprises—ADMARC and MDC—had direct and indirect ownership in 32 other manufacturing enterprises operating in highly oligopolistic markets (Harrigan, 1991). The government also insisted that multinational companies entered domestic industries in joint ventures either with a public enterprise or with a large private business (Seidman, 1986). This industrialization strategy resulted in a strongly dualistic structure of the industrial sector. On the one side there is a small number of relatively large-scale, modern, mainly capital intensive enterprises, whose ownership is mostly concentrated in public enterprises and a few foreign multinational firms. These large firms have access to bank financing: state-owned enterprises have close ownership relations with the country's two commercial banks; joint ventures with a foreign multinational enterprise can access foreign financing through their foreign partners. On the other side of the size distribution there are relatively few small and medium enterprises operating in the formal sector as well as a multitude of informal micro and small enterprises.

Formal small-scale enterprises—defined as those with 20 or fewer workers—are a relatively small segment of the industrial sector, both in absolute terms and in relation to the formal manufacturing sector: in 1985, 40% of industrial establishments were small scale but they employed only 2.0% of the official manufacturing labor force and contributed 2.3% of manufacturing value added. These enterprises are labor intensive and typically depend on local inputs of raw materials, while machinery and spare parts have to be imported. Methods of production and machinery used are directly related to the entrepreneurs' access to finance and technical assistance, rather than reflecting a conscious choice of appropriate production methods (World Bank, 1989). The informal sector, which is estimated by Ettema (1984) to comprise 18,000 firms, employs about 35% of the Malawian secondary sector labor force. Their production is based on very simple technology. Linkages with the modern industrial sector are virtually nonexistent and the shortage of start-up finance is a severe constraint for their operation. The industrial structure is, therefore, characterized by lack of competition as industrial sectors are dominated by monopolies and oligopolies. Based on 1986 data, World Bank (1989) calculates that 86% of firms operated under oligopolistic conditions.

While the weight of manufacturing in GDP rose to only 11.0% by 1978, the economic performance and that of the manufacturing sector were good, as between 1973 and 1978 industrial output and GDP grew by an average of 5.9% per year. However, as the economy was badly affected by the 1979 oil price shock and civil strife in the neighboring Mozambique, Malawi embarked from 1981 on wide-ranging policy reforms with the support of various structural adjustment and sectoral adjustment loans from the World Bank. One of the main objectives of adjustment was to stimulate growth and competition in the manufacturing sector. To this purpose, reforms aimed to develop outward-looking industrial structures; create an enabling policy environment through sound macroeconomic management and reforms of trade policy; downsize inefficient public sector; improve the management and finances of public enterprises; and foster the development of private sector enterprise, especially small and medium-sized enterprises (Mulaga & Weiss, 1996).

However, the industrial response fell short of expectations: between 1980 and 1987 industry grew only by 1.2% per year—about half the rate of growth of the economy. Thus, policies for industrialization were broadly ineffective, as agriculture remained the dominant sector of the economy while the contribution of the manufacturing sector toward real output declined. Not only is the size of the manufacturing sector still small and mostly concentrated in five sub-sectors (food processing, beverages, tobacco processing, textiles, and pharmaceuticals) but its structure remains predominantly oligopolistic.

In its analysis of the industrial sector in Malawi, the World Bank (1989) identified financial sector underdevelopment as a continuing major impediment to the growth and development of the manufacturing sector. Financial liberalization (interest rate liberalization, market-determined credit allocation, deregulation of entry, banking competition, and closer central bank supervision) would raise saving mobilization and increase banking sector intermediation, improve risk assessment and risk management, improve the efficiency of resource allocation and create a more efficient formal financial sector. Accordingly, the government of Malawi undertook systematic