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*Full Length Research Paper*

# Interdependency between monetary policy instruments and Indonesian economic growth

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The objective of this study is to analyze the interdependency between monetary policy instruments and Indonesian economic growth for the periods of 2000 to 2011. The monetary policy instruments are open market operation (OPT), reserve requirement (RR), and discount rate. For the analysis, this study employs Structural Vector Autoregression, and Impulse Response Function. The results of the analysis show that Open market Operation (OPT), Reserve Requirement (RR), and discount interest rate (rDiskonto) have some degrees of interdependency on economic growth (GROW) through other intermediary macroeconomic variables. These variables are exchange rate, exports, imports, investment, and balance of payment, unemployment and inflation. Impulse Response Function showing a shock in OPT by one standard deviation has a negative effect on economic growth (for short-, medium, and long-terms) through out. In other words, if OPT increases, economic growth decreases. An increase in Reserve Requirement (RR) has an immediate negative impact on growth. In a slightly longer period, the impact of RR on growth becomes positive. However, in other periods (medium- and long-terms) the impact of RR on growth was negative. The increased rDiskonto can increase growth in the medium term, contrary to other periods.

**Key words:** Interdependency, monetary policy, and economic growth.

## INTRODUCTION

Monetary policy is planned and executed by a central bank to control money supply in order to achieve high employment growth and job vacancy, low inflation, balance of payments, and a desired economic development and growth (Pohan, 2008). The monetary policy instruments are open market operation, reserve requirement and discount rate. The target variable is aggregate demand or GDP. The transmission mechanism of

monetary policy is through intermediate macroeconomic variables such as interest rate and investment, and imports, exports, and balance of payments, among others.

According to Keynes, fiscal policy is an important factor to determine aggregate demand, while monetary policy such as a change in money supply has relatively weak or even insignificant impact under certain condition on the economy. The mechanism of money supply to influence

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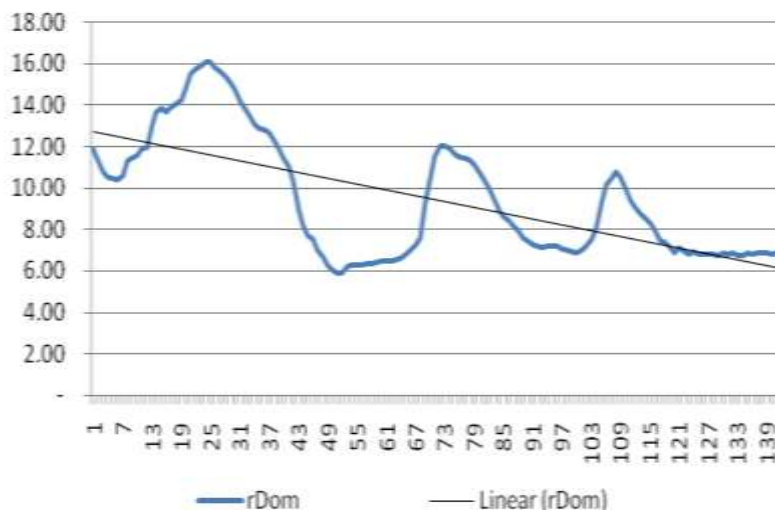


Figure 1. Trend of domestic interest rate 2000-2011.

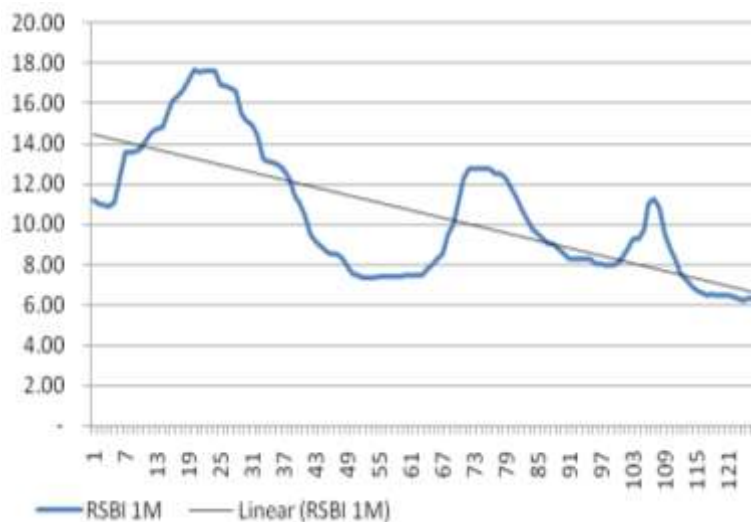


Figure 2. Trend of discount rate of central bank (RSBI) 2000-2010.

aggregate demand is through other intermediate variables, that is, interest rate and investment (Ahuja, 2002). However, the monetarist believes that money supply is really important to influence and enhance economy activity and price level (Sukirno, 2004). According to Mundell-Fleming proposition, the effectiveness of fiscal and monetary policies in impacting aggregate income depends on the exchange rate regime of a particular country (Mankiw, 2000).

Looking at Indonesian data for the last one decade (2000 – 2010), there was an increase in money in circulation and a downward trend in discount rate (RSBI) followed by a decrease in domestic interest rate. At the same time Indonesian Central Bank tended to increase

the reserve requirement (RR). According to Pohan (2008), an increase in RR has a partial impact on money in circulation and total credit offered by the commercial bank. But, for the same time period, money supply showed an increasing trend. The same was true for credit disbursed for investment. But, according to Julaihah (2004), the increase in money in circulation (JUB) in the decade of the study was absorbed by an increase in the reserve requirement (RR) and thus this increase in money supply was not offered to the society (absorbed by increase in the RR). In other words, the increase in money in circulation has no impact on the growth of real sector (Figures 1 – 6).

Theoretically, a decrease in the domestic interest rate

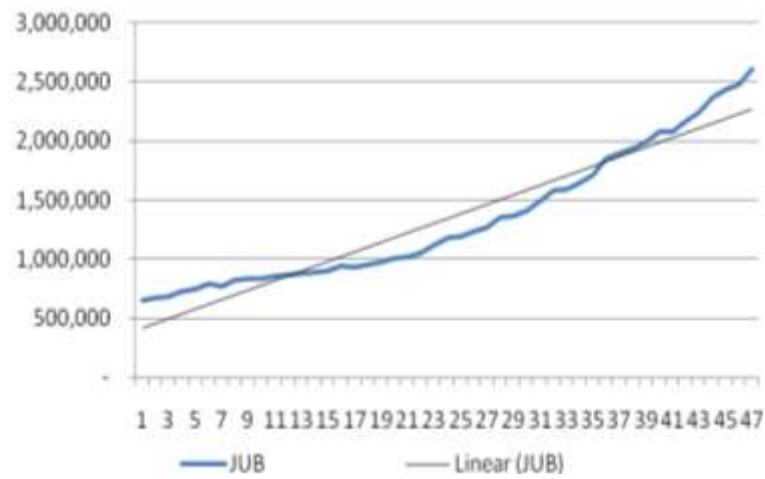


Figure 3. Trend of money in circulation 2000-2011 (Billion Rp).

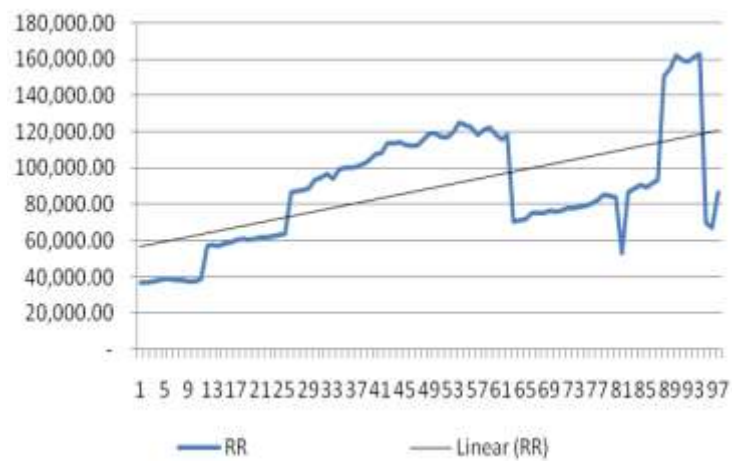


Figure 4. Trend of Reserve Requirement (RR) 2003-2011.

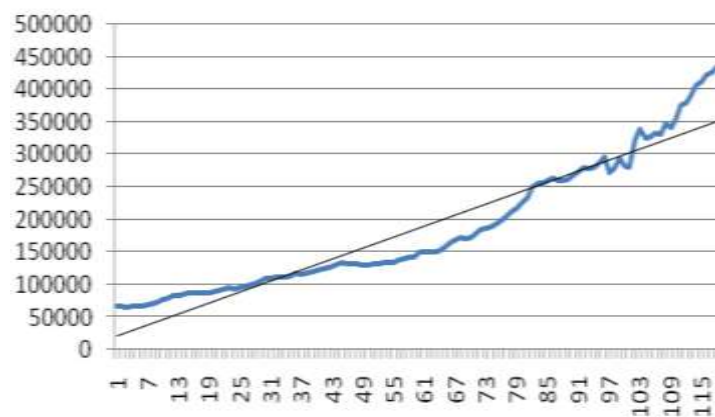


Figure 5. Trend of loans for investment approved by commercial banks 2002-2011.



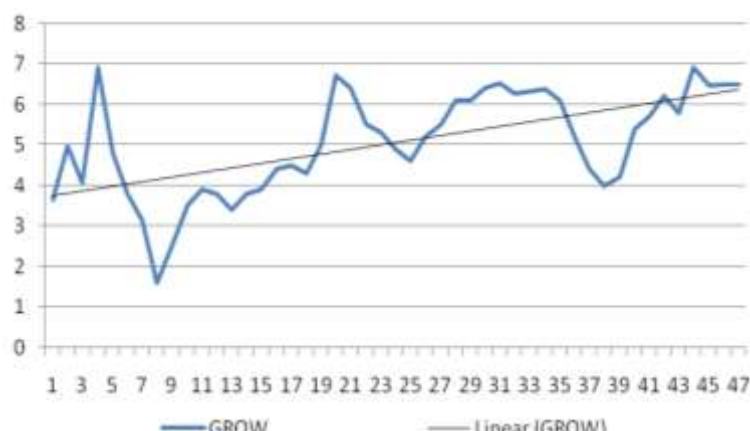


Figure 6. Trend of Economic growth 2000-2011

has a positive impact on investment and this can be translated into an increase in investment and economic growth. Interest, inflation and exchange rates have an impact on export and economic growth. These impacts are parallel to what is predicted by Mundell-Fleming theory (Mankiw, 2000). In a small open economy that has no restriction on capital mobility, a decrease in domestic interest rate triggers capital outflow.

Generally, the objective of this study is to analyze the interdependency of monetary policy instruments comprising open market operation (OPT), reserve requirement (RR) and discount interest rate (*rDiskonto*) on economic growth in Indonesia. The transmission mechanism of these instruments is via the impact on intermediate variables such as money in circulation (JUB), domestic interest rate (JUB), exchange rate (EXC), exports (EXPORT), imports (IMPORT), investment (INVEST), balance of payment (BOP) and inflation (INF). The organization of this paper is as follows; the next section discusses the methodology of the study and this is followed by results and discussions. The last section concludes.

## METHODOLOGY

This section discusses methodology and data. The time series data for the period of 2000 - 2011 were retrieved from the Bank of Indonesia and the Statistics Department of Indonesian. These data were tested for stationarity of the variables or unit root test known as stationary stochastic process (Bapepam, 2008) by employing Augmented Dickey Fuller (ADF) test. The next step was to determine the length of the lag using Akaike Information Criterion (AIC), Schwarz Information Criterion (SIC), and Likelihood Ratio (LR) (Thomas, 1997; Greene, 2000; Alfirman and Sutriano, 2006) methods. The objective of these tests is to determine whether the variables used in this study were cointegrated or not as suggested by Bafadal (2005), Bapepam (2008), Engle and Granger (1987) and Ward (2000). The cointegration test was conducted by employing Johansen Criterion. The estimation models used for this study were Vector Autoregression (VAR), Structural Vector Autoregression

(SVAR), and test of Impulse Response Function (IRF). The VAR model was widely used to investigate the impact of monetary policy such as the studies of the dynamic effect of monetary policy and the effectiveness of monetary policy (Gordon dan Leeper, 1994; Rudebusch, 1998; Hakim, 2003). The VAR model assumes all variables are endogenous. Also, VAR model is able to estimate identity equation such as in the Engel-Granger causality equation (Thomas, 1997; Gujarati, 1995, Hakim, 2003). The model specification of the VAR can be expressed as follows:

$$\text{VAR}(k), Z_t = A_1 Z_{t-1} + A_2 Z_{t-2} + \dots + A_k Z_{t-k} + \varepsilon_t$$

where  $Z_t$  is a specified time series variable,  $A_k$  is the parameter of an  $n \times n$  matrix, and  $K$  is the order or lag. The order of the VAR ( $k$ ) is determined by *Akaike Information Criterion* (AIC) test, *Likelihood-Ratio* (LR) test, and *Schwarz Information Criterion* (SIC). If  $k=2$  then the model specification of VAR in this research can be formulated as follows:

$$\begin{aligned} r\text{GROW}_t = & a_{11}OPT_{t-1} + a_{12}GWM_{t-1} + a_{13}r\text{Diskonto}_{t-1} + a_{14}r\text{JUB}_{t-1} + a_{15}r\text{DOM}_{t-1} \\ & + a_{16}EXC_{t-1} + a_{17}EXPORT_{t-1} + a_{18}IMPORT_{t-1} + a_{19}INVEST_{t-1} + a_{1,10}BOP_{t-1} \\ & + a_{11}OPT_{t-2} + a_{12}GWM_{t-2} + a_{13}r\text{Diskonto}_{t-2} + a_{14}r\text{JUB}_{t-2} + a_{15}r\text{DOM}_{t-2} \\ & + a_{1,12}INF_{t-1} + a_{1,13}GROW + a_{16}EXC_{t-2} + a_{17}EXPORT_{t-2} + a_{18}IMPORT_{t-2} + a_{19}INVEST_{t-2} \\ & + a_{1,10}BOP_{t-2} + a_{1,11}INF_{t-2} + a_{1,12}GROW_{t-2} \end{aligned}$$

The SVAR equations for this study are as follow:

$$\begin{aligned} \text{LOG}[OPT] = & u_1; \text{LOG}[GWM] = u_2; \text{LOG}[r\text{Diskonto}] = u_3; \text{LOG}[JUB] = u_4 \\ \text{LOG}[EXC] = & u_5; \text{LOG}[EXPORT] = u_6; \text{LOG}[IMP] = u_7; \text{LOG}[INV] = u_8 \\ \text{LOG}[GROW] - & c_1\text{LOG}[OPT] - c_2\text{LOG}[RR] - c_3\text{LOG}[r\text{Diskonto}] - c_4\text{LOG}[JUB] - c_5\text{LOG}[RDOM] \\ & - c_6\text{LOG}[EXC] - c_7\text{LOG}[EXPORT] - c_8\text{LOG}[IMPORT] - c_9\text{LOG}[INVEST] - c_{10}\text{LOG}[BOP] \\ & - c_{11}\text{LOG}[INF] = u_{12} \end{aligned}$$

## RESULTS AND DISCUSSION

Of the stationary test, all variables have been stationary at the second difference. Table 1 shows the results of the SVAR of the shock in monetary policy variables on economic growth. All of the monetary variables – open market operation (OPT), reserve requirement (RR) and

**Table 1.** SVAR estimation results on economic growth.

Variable	Coefficient	Probability	Variable	Coefficient	Probability
OPT	-1.367774	0.0041	EXPORT	5.636611	0.0000
RR	-1.698417	0.0000	IMPORT	-7.356434	0.0000
rDiskonto	-0.845875	0.0030	INVEST	-0.063818	0.9031
rDOM	1.636008	0.0000	BOP	0.126896	0.4110
EXC	-5.090151	0.0074	INF	-0.148985	0.3123

Source: the result of the research: JUB variable is not cointegrated to the level of second difference so it was excluded from the model.

**Table 2.** The summary of the results of the growth of IRF.

No	Variables	Periods		
		Short	Mmedium	Long
1	ε OPT	-	-	-
2	ε RR	+	-	+
3	ε rDiskonto	-	+	-
4	ε rDOM	-	+	-
5	ε EXC	-	-	-
6	ε EXPORT	+	+	+
7	ε IMPORT	-	+	+
8	ε INVEST	+	+	+
9	ε BOP	+	-	-
10	ε INF	-	+	+

Source: the result of the research.

discount rate (rDiskonto) – have a negative impact on economic growth. An increase in OPT by Rp 1 billion will make the Indonesian economic growth to decrease by 1.378 percent.

A shock in RR has a coefficient of -1.698. This coefficient implies that an increase in reserve requirement by Rp 1 billion, the economic growth will shrink by 1.698 percent. With a shock in discount rate (rDiskonto) by one percent, the economic growth will decrease by 0.846 percent.

The above SVAR results show that monetary policy instruments have interdependency with economic growth. The effect of monetary policy instruments on growth can be explained as follows. When the financial paper (such as T-bill and bond) is recalled through open market operation (OPT) there will be an increase in money supply. An increase in money supply is usually followed by a decrease in reserve requirement (RR) and a decrease in discount rate (rDiskonto). Thus domestic interest rate (rDOM) will increase (?). An increase in domestic interest rate (rDOM) has an impact on exchange rate (EXC). A decrease in exchange rate encourages exports (EXPORT), discourages imports (IMPORT) as well as a decrease in investment (INV). As a result of that, balance of payments (BOP) becomes a deficit and a decrease in inflation

(INF), thus there will be an impact on economic growth.

Intermediate variables – domestic interest rate (rDOM), exchange rate (EXC), exports (EXPORT), and imports (IMPORT) – partially have a significant effect on economic growth with an  $\alpha = 0.05$ . Other intermediate variables – investment (INV), balance of payment (BOP) and inflation (INF) – have no effect on growth. Exports (EXPORT) have the biggest positive coefficient which was 5.6366. The demand for exports was very high during the period of the study, thus the economic growth.

In this study, it was found that investment has no impact or to a certain degree investment was detrimental to growth. However, this finding was parallel to the study done by Erwan (2005). Sollow-Swan's economic growth theory explains that if a country has adopted an efficient and advanced technology, saving and investment that has increased has a positive effect on economic growth, with the assumption that the population and technology are constant. But, let us say population is not constant, then, a high saving and investment as well as high consumption are required to increase economic growth. The finding of this study was at odd to the literature. An expansion to Sollow-Swan's theory highlighted the fact that when the relationship between investment and unemployment is negative then investment is the only source of capital accumulation. Then it is revealed that the growth happens due to the decline of inflation and unemployment which increases purchasing power of the people and obviously the growth itself; this growth does not happen through the growth of investment.

The results of SVAR model estimation can be used to analyse the respond function towards equilibrium path and the response of accumulation function towards equilibrium path and variant proportions. This analysis is known as *impulse response function analysis* (IRF) that can be used to see the effect of a change in one standard deviation of a variable towards the said variable or other variable. For the purpose of this study, the analysis of IRF was divided into 3 terms: short-term (period 1-5), medium-term (period 6-10) and long-term (period 10-20). One period was equal to 2.5 months. The summary of IRF analysis for Indonesian economic growth is presented in Table 2. The shock by one standard deviation of the

**Table 3.** The respond of economic growth variables toward monetary policy variable (OPT, RR, dan rDiskonto).

Period	OPT	RR	rDiskonto	Period	OPT	RR	rDiskonto
1	-0.085983	-0.234694	-0.255708	11	0.029208	-0.113843	-0.062043
2	-0.012841	-0.058139	-0.026794	12	-0.010598	-0.071451	-0.037922
3	-0.178600	0.060360	-0.079235	13	-0.015514	0.007927	-0.013561
4	-0.265863	0.169872	0.011423	14	0.015711	0.040006	-0.052062
5	-0.208985	0.037125	-0.085779	15	0.030243	0.036198	-0.078298
6	-0.116975	0.074845	-0.036691	16	-0.001586	0.021083	-0.053772
7	-0.131852	0.006579	0.013164	17	-0.031534	0.024556	-0.019567
8	-0.095377	-0.037698	0.048646	18	-0.017839	0.038212	-0.011565
9	0.004082	-0.046421	0.045328	19	0.007398	0.023439	-0.028659
10	0.043066	-0.086001	-0.020727	20	-0.000734	-0.011839	-0.035917

Source: the result of the research.

OPT variable has a negative effect on economic growth in all short-, medium- and long-terms. The shock of RR by one standard deviation has a negative impact on growth for medium-term only. While the shock in discount rate (rDiskonto) by one standard deviation affected economic growth for short- and long-terms only.

In other words, the shock in OPT will be responded by economic growth negatively. That means, if OPT increases then economic growth will decrease. The increase in RR in the short- and long-periods has an impact on economic growth in a positive manner, while an increase in rDiskonto has an effect on growth for middle-period only.

For the intermediate variables, the shocks of export and investment by one standard deviation, respectively, have positively affected economic growth in short-, medium- and long-terms. But, a shock on exchange rate variable (EXC) has a negative effect on growth for all three periods. A shock by one standard deviation on imports (IMPORT) and investment (INVEST) has a negative effect on growth in a short-period, but has a positive effect on economic growth in the medium- and long-terms.

The results of the shock by one standard deviation on monetary policy variables on economic growth are shown in Table 3, while the results of the shock on intermediate variables on growth are revealed in Table 4.

Table 3 (Columns 2 and 6) explains the effect of a shock by one standard deviation on open market operation (OPT) toward economic growth (GROW). On the first period, the shock of OPT caused the growth to decrease by 0.09 percent. The decline in economic growth was continuous until the 8<sup>th</sup> period, that is, medium-term. But, at the end of medium-term, that is, the 9<sup>th</sup> and 10<sup>th</sup> periods, the effect became positive (0.0431 percent). This positive effect can be seen in the long-term (11<sup>th</sup> to 20<sup>th</sup> periods).

The shock of reserve requirement (RR) by one standard

deviation has a negative effect on growth initially. For period 1, the effect was -0.2347 percent and for period 2 it was -0.05814 percent. But for the 3<sup>rd</sup> to 7<sup>th</sup> periods the effect of the shock in reserve requirement (RR) by one standard deviation on economic growth was positive. For the 7<sup>th</sup> – 12<sup>th</sup>, the response was negative again and followed by a positive impact for the periods 13<sup>th</sup> – 19<sup>th</sup>.

The impact of a shock by one standard deviation on discount rate (rDiskonto) on economic growth shows mostly in a negative fashion as predicted by the literature (see Columns 4 and 8, Table 3). The results revealed that this negative impact occurred in the periods of 1 – 3 and the periods of 10 – 20.

Tabel 4 explains the effect of the shock of an intermediate variable by one standard deviation on economic growth. On the second column of Table 4 the effect of the shock of domestic interest rate (rDOM) on growth is seen.

It is expected that an increase in domestic interest rate (rDOM) to have a negative impact on growth. This study found that for the first period, a shock in rDOM by one standard deviation caused the economic growth to increase by 0.1515 percent. However, in the second period the growth decreased by -0.3141 percent. This negative relationship lasted until the 6<sup>th</sup> period. For the 7<sup>th</sup> – 10<sup>th</sup> period domestic interest rate and growth interacted in a positive manner. However, this interaction became negative for periods 7 to 20.

The response of economic growth as a result of a change by one standard deviation of the exchange rate (EXC) during the observation periods always showed a negative relationship (see Colum 3, Table 4). In other words, if the value of the Rupiah was stronger compared to those of the USD, it has a negative impact on growth.

The literature predicts that exports promote growth. So does the export led theory on growth. The results of this study revealed that an increase in exports (EXPORT) by one standard deviation has a positive effect on growth as

**Table 4.** The response of economic growth variable toward intermediate variable.

Period	rDOM	EXC	EXPORT	IMPORT	INVEST	BOP	INF
1	0.151493	-0.114832	-0.054465	-0.285395	-0.048689	0.079341	-0.171645
2	-0.314126	-0.227317	0.197824	-0.032649	0.109396	0.203092	-0.140860
3	-0.412368	-0.145038	0.039868	-0.066381	0.176372	0.051081	-0.057399
4	-0.309570	-0.073998	0.153662	0.080863	0.145589	0.092824	-0.078183
5	-0.282505	-0.051077	0.088866	0.082047	0.157562	0.167643	0.042675
6	-0.052148	-0.071419	0.087270	0.026280	0.108187	0.081135	0.115466
7	0.026505	-0.106393	0.126742	0.065270	0.025943	0.019718	0.138278
8	0.074328	-0.036861	0.100386	0.169154	-0.066764	-0.058296	0.122291
9	0.054010	-0.010022	0.090966	0.199816	-0.111204	-0.074695	0.125967
10	0.018522	-0.036748	0.065948	0.120708	-0.104762	-0.027640	0.136385
11	-0.022889	-0.064488	0.085143	0.044524	-0.042252	-0.001256	0.120444
12	-0.065772	-0.055194	0.058171	-0.007573	-0.004656	-0.029431	0.075568
13	-0.077387	-0.017850	0.037805	0.005118	0.007000	-0.023749	0.027426
14	-0.087707	-0.006044	0.030537	0.015723	0.044414	0.031886	0.022369
15	-0.079787	-0.032787	0.035595	-0.032564	0.077278	0.056366	0.034334
16	-0.071017	-0.057459	0.054302	-0.059345	0.076095	0.038714	0.031677
17	-0.056283	-0.038735	0.061166	-0.008305	0.050785	0.014074	0.014690
18	-0.039024	-0.009532	0.059974	0.061402	0.026790	0.016858	0.008942
19	-0.032167	-0.013417	0.062494	0.073456	0.019292	0.038236	0.029139
20	-0.033237	-0.039039	0.074251	0.043432	0.022429	0.039630	0.052728

Source: the result of the research.

shown in Colum 4 of Table 4, except for the 1st period. Column 5 of Table 4 reveals the reaction of growth on imports (IMPORT). It is found that a change in IMPORT by one standard deviation has a mixed effect on growth, although the literature suggests a negative relationship between IMPORT and growth. Imports components of a growing economy, such as in the case of Indonesia, consist of consumer goods and capital goods. The importation of consumer goods increases the production capacity of a country. Thus, the results showed a mixed relationship between imports and growth.

A shock in investment (INVEST) by one standard deviation has a positive impact on growth for the periods of 2 to 7 and for the periods of 13 – 20, as predicted in the literature. However, other time periods the response of growth on investment was negative.

The response of economic growth on a shock by one standard deviation of balance of payment (BOP) and inflation (INF), respectively, is shown as mixed results. Balance of payment has a positive effect on growth for the beginning of the periods (period 1 to 7) and at the end of the periods (periods 14 to 20). However, in the middle range (periods 8 to 13), there was a negative relationship between BOP and growth. Inflation has a negative relationship with growth for the beginning of the periods (periods 1 to 4), but has a positive correlation after period 5.

It can be summarized that in a short period of time, the response of growth as a result of a shock by one standard deviation of a certain intermediate variable has an impact as predicted by the theory. An increase in the balance of payment (BOP) caused economic growth. This study adds little to the literature in the case of domestic interest rate (rDOM), in which the correlation between rDOM and growth was mixed. The results of the simulation that is, an increase in one standard deviation of the variable OPT, RR, rDiskonto, EXC, IMPORT, INVEST and INF showed a decrease in growth in a short-term. In short-term, an increase in EXPORT did not show an expected outcome as predicted by the theory. During the period of 2004 – 2010 the highest contributor to Indonesian gross domestic product (PDB) was oil and gas industry (24 – 28 percent), while agriculture, animal husbandry, forestry and fishery sectors contributed 13 – 15 percent of the gross domestic product.

In the medium-term, an increase in OPT, EXPORT, IMPORT, INVEST, BOP, INF has shown an increase in GROWTH. These results were in tandem to what was predicted by the theory. The low level of inflation (below 10 percent) was able to speed up economic growth. An increase in price as a result of low inflation encouraged producers to produce more because they think they made more profit. But, if there was a high level of inflation, many economic activities will be disrupted. The

same situation was true for IMPORT. A high demand for IMPORT has a negative consequence on balance of payment (BOP). An increase in imports sped up economic growth if it was accompanied by an increase in exports. Thus, net export was expected to become a source of foreign exchange to increase the output.

In the long-run, an increase in OPT, EXPORT, IMPORT and INF has a parallel relationship with economic growth. A high consumption of imported good in the long period enabled the economy to expand. The high consumption of the public was considered as a source of national income, even though this condition can possibly cause inflation.

## Conclusion

The results of this study show that the monetary policy instruments in the form of open market operation (OPT), Reserve Requirement (RR), and discount rate (rDisk) have interdependency with economic growth (GROW) through some macroeconomic variables such as intermediate variables. A shock in monetary policy variables (OPT, RR, and rDiskonto) has a negatively significant effect on Indonesia economic growth.

The result of Impulse Response Function shows that an OPT affected negatively growth variable, either in the short-, medium- or long-terms. While RR variable had positive effect on growth in the long-run and rDiskonto variable impacted growth positively in the medium-run. In other words, in general, an increase in OPT impacted economic growth negatively, while an increase in RR impacted growth positively in the short- and long-terms. The increase in rDiskonto has an increased effect on economic growth in medium-term.

A shock in reserve requirement (RR) by one standard deviation has a negative impact on growth at an early stage (the first two periods). But, after the 3<sup>rd</sup> period, the economic growth showed a positive effect as a result of an increase in RR. However in the long-run the impact of an increase in RR on growth became negative again. A shock in discount rate (rDiskonto) variable by one standard deviation, in general, has a negative effect on growth.

To increase the rate of economic growth in the short term, the government must be aware of the swift flow of goods imported into Indonesia, because it can lower domestic production. Expansionary monetary policy needs to be done, because the decline in interest rates can stimulate investors to invest in the country to cause economic growth.

## Conflict of Interests

The author have not declared any conflict of interests.

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*Full Length Research Paper*

## Poverty reduction through the ICT: Global system for mobile communication (GSM) perspective

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Poverty amid plenty is one of the greatest challenges confronting Nigerian economy. Government at all levels had initiated various forms of poverty reduction strategies in an attempt to reduce the incidence of poverty in Nigeria. Using data obtained through the administration of questionnaires on the operators of GSM purposively selected within the study area, the paper examined the extent to which evolution of GSM has been able to reduce poverty in Ilorin metropolis. A research question was raised. A hypothesis was tested at 0.05 level of significance. The data obtained from the field were analyzed using descriptive statistics and chi-square. The findings reveal that GSM has contributed immensely to poverty reduction through income generated because of employment provision. The paper therefore concluded that GSM has the potentials to reduce poverty in the study area if proper policies such as an enabling environment were created for more operators to thrive. Based on this, the paper recommends among others that government should create a technical ICT (GSM) training centre such that the trainee will be based on salaries and wages with the view that they will be able to provide services to GSM operators or users.

**Key words:** Poverty, Global System for Mobile Communication, ICT, poverty alleviation, food and shelter.

### INTRODUCTION

Nigeria is a densely populated country blessed with material and human resources that are pre-requisite to economic growth and development. Ironically, poverty amid plenty is the greatest challenges confronting Nigerian economy. Actually, the case of poverty in Nigeria is not only ridiculous but also embarrassing. Despite the

fact that Nigeria is an oil-producing nation, more than 70 percent of its population live in abject poverty. The high incidence of poverty experienced in Nigeria could be traced back to the period of oil boom in the 1980s that saw an unprecedented rise in poverty profile from 27 to 66 percent in 1996 and to over 70 percent in 1999 (Akudulu,

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2007).

A recent study has shown that unemployment, income inequality, polygamy, sickness and environmental degradation are among the major causes of poverty in Nigeria. The National Bureau of statistics (2012) reported that about 112,519 million Nigerian live in relative poverty and this figure is alarming. Furthermore, the poverty situation in Nigeria is the high prevalence among the youths in the country. Despite the growing rate of Gross Domestic Products (GDP) of 7.75 percent, there is no corresponding increase in the living standard of more than half of the country's population (Ajakaiye and Olomola, 2003).

However, eradicating poverty has become major challenges facing the third world today and Nigeria in particular. Due to the rising rate of poverty and its attendant consequences, government at all levels had initiated various policies and programmes in a bid to reduce or alleviate the high rate of poverty in Nigeria.

These programmes and policies can be categorized into the pre-SAP and post-SAP policies aimed at tackling the poverty level in Nigeria. The pre-SAP poverty reduction strategies include the Green Revolution Programme of 1979 with the mandate of mitigating the effects of food supply. In addition, the establishment of National Directorate of Employment (NDE) in 1987 helped in solving the problem of unemployment to some extent. The Operation Feed the Nation (OFN) was introduced by the Federal Military Government headed by General Olusegun Obasanjo with specific focus on increasing food production on the premise that availability of cheap food would ensure a higher nutrition level and lead to national growth and development.

Other notable policies and programmes aimed at combating poverty are; the Better Life for Rural Women that was founded in 1986, National Poverty Eradication Programme (NAPEP) in 2001, National Economic Empowerment and Development Strategy (NEEDS) of 2004. Aside these, the federal government also seek an effective collaboration with both the state and local government to have an equivalent of NEED, thus brought about the State Economic Empowerment and Development State Strategy (SEEDS) and Local Government Economic Empowerment strategy (LEEDS) respectively. Despite these efforts and the amount of resources committed to the programmes, they seem inefficient to address the problem of poverty in Nigeria. This is because poverty has neither ceased nor abated.

The role of ICTs in combating poverty and contributing to sustainable socio-economic development cannot be ignored. This is because ICT has played a leading role in driving economic growth and development in the industrial and newly industrialized nations. Specifically, the study examined the extent to which evolution of Global System for Mobile Communication (GSM) has helped to sustain income level and consequently reduced poverty in Ilorin metropolis.

The paper is presented in five sections: section one is the introduction which is followed by conceptual clarification, theoretical literature and empirical literature; in section three, we outlined the methodology that was adopted in the study; section four presents and discusses the results of the study and the final section presents the conclusion and recommendations.

## Conceptual clarification

### Poverty

Poverty is a multifaceted phenomenon that means different thing to different people and has no single definition. In essence, it is easier to describe poverty than defining it. World Bank (2001) sees poverty as a situation whereby an individual within the society is deprived of the necessity of life, which includes food, shelter and clothing. However, poverty is more than deprivation of the necessities of food, clothing and shelter but encompasses the individual inability to have access to education, health and social exclusion.

Ajakaiye and Olomola (2003) described poverty as inability to gain access to the basic necessities of life such as food, clothing, and shelter amongst others. Poverty is real and it exists in all economies of the world, even at varying levels.

In another dimension, World Bank (1990) defined poverty as the inability of an individual or section of a society to attain a specified minimum standard of living. The term poverty is not having a universally accepted definition largely because it affects many aspects of the human conditions, including physical, moral and psychological conditions. It is perhaps for this very reason that Agbu (1997) observed that poverty is more easily recognised than defined.

Odejide (1997) conceptualised poverty within the context of both absolute and relative terms. He described absolute poverty as the lack of resources to obtain and consume a certain bundle of goods and services, which contain an objective minimum of necessities such as food, shelter, and clothing among others.

## THEORETICAL LITERATURE

There are divergence opinions about the cause of poverty. The decency theory points that poverty is externally created and can only be eradicated if the developed countries can alter their unfavorable trade relations with the developing countries, while the modernization theory is of the opinion that poverty is externally created in the developing nation and could only be removed through the internal strategies by following the development path of the developed nations. This however supports the views

that poverty is caused by lack of employment opportunities, high population growth rate etc.

Ajakaiye (2001) therefore categorized poverty into three; these are psychological deprivation, social deprivation and human deprivation. The first is concerned with income/consumption factors. The social aspect manifests itself in lack of resources required for participation in customary activities (social exclusion) and the final category related to the denial of right and freedom in the society as well as lack of dignity.

Report from the National Bureau of Statistics indicated that poverty has increased considerable in Nigeria with about 112 million Nigerians living below the poverty line. The report further stressed that despite the country growth rate of real Gross Domestic Product (GDP) of 7.68 percent in 2010 as against 8.60 in 2011, the population of Nigerians living below the poverty line is increasing rapidly.

A report from the Federal Office of Statistics in 2006 indicated that the estimated incidence of poverty in most states in Nigeria is about 0.51%, which by implication it means about 51 percent of the country population are poor. Although, this is not peculiar to Nigeria alone as poverty is stricken in nearly all the entire African countries.

National Bureau of Statistics and World Bank (2013) reported that poverty has increased considerably in Nigeria with about 112 million Nigerians living below the poverty line. The report indicated that the country real gross domestic product (GDP) grew by 7.68 percent in 2011 as against 8.60 percent in 2010; despite this growth rate, the population of Nigerians living below the poverty line was increasing too rapidly.

It is obvious from the above that there is a high level of prevalence of poverty in Nigeria.

## Empirical literature

Many studies have documented the role of global system for mobile communication in reducing poverty especially in highly populated area. There is enough evidence to suggest that Global system for mobile communication can reduce the incidence of poverty in Nigeria. Global system for mobile communication is defined as a globally accepted standard for digital cellular communication. GSM is the name of a standardization group established on 1998 to create a common European mobile telephone standard that would formulate specification for participation in GSM partnership.

For instance, Gold et al. (2012) examines the impact of mobile telecommunication on the Nigeria economy and the growth implications in terms of income and employment opportunities. The study reported that GSM leads to reduction in poverty level and incidence through increase

in income generation capacity and business expansion of the households.

Asheeta (2008) examines the role of mobile telephone in sustainable poverty reduction among the rural poor. The finding reveals that economic and social benefits of mobile telephone are higher in rural areas and consequently have a multi-dimensional positive impact on sustainable poverty reduction.

Kadir (2013) had studied the impact of deregulated telecommunication sector on employment generation in Ilorin metropolis. The author used both primary and secondary data to obtain relevant information from the respondents through the administration of questionnaires. The results showed that GSM has considerably generated employment opportunities for youths in the study area.

Okogun and Abang (2013) reported that the GSM business has contributed to the economy in the area of GSM recharge card and printing. This has the effect of saving the country about \$150 million monthly while providing employment and new skills to the dealers.

In the same manner, using Human Development index (HDI) and Gini coefficient, Okogun and Abang (2013) evaluated information and communication technology as a means of reducing poverty in Nigeria. The study reveals that country HDI is low which signifies that about 70 percent of the population live below the poverty line, and a growing inequality between the poor and rich was also identified through the Gini coefficient.

On the role of SSEs in poverty reduction, Yauri et al. (2008) studied 36 Small Scale Entrepreneurs in Sokoto and found out that there is a strong relationship between SSEs and poverty reduction in Sokoto metropolis. Specifically, the study established that SSEs is playing significant roles in creation of employment and serving as sources of disposable income to the entrepreneurs. The review of empirical studies suggests that not much work has been done on the relationship between Global System for mobile communication and poverty reduction particularly in Ilorin metropolis. This research intends to fill this gap identified in the literature

## METHODOLOGY

In order to find answer to the question raised above, a hypothesis was tested to establish if there is any significant relationship between global system for mobile communication and poverty reduction. Thus, the hypothesis is stated as follows;

$H_0$ : There is no significant relationship between GSM and poverty reduction.

The study is a descriptive survey type. The respondents were drawn from the operators of global system for mobile communication. One hundred (100) respondents were selected for the study. Data were collected through the administration of questionnaires on the respondent selected through purposive sampling procedures. The questionnaire was divided into two sections; section A



**Table 1.** Profiles of operators of GSM business in the study area.

Variables	Respondents' opinion	F	%
<b>Age Structure</b>	15-25	07	20
	26-35	35	41.2
	36-45	30	35.3
	46-55	13	18.8
<b>Respondent Status</b>	Married	65	76.5
	Single	20	23.5
<b>Level of Education</b>	Primary	17	20
	Secondary	45	52.9
	Tertiary	20	23.5
	No formal education	03	3.5
<b>Gender Attribute</b>	Male	50	58.8
	Female	35	41.2
<b>Ethnic Group</b>	Yoruba	53	62.4
	Hausa	15	17.6
	Igbo	17	20

Source: Author's Field Survey, July 2014.

**Table 2.** Areas affected by the use of GSM.

Variables	Responses		Total
	Yes	No	
Shelter	50	25	78
Feeding	60	10	71
Rent	48	20	74
<b>TOTAL</b>	<b>158</b>	<b>53</b>	<b>255</b>

Source: Author's Computation, 2014

**Table 3.** Relationship between GSM and poverty reduction.

R/C	fo	Fe	fo - fe	(fo-fe) <sup>2</sup>	(FO-FE) <sup>2</sup> /fe
1-1	50	48.33	1.67	2.79	0.058
1-2	25	16.21	8.79	77.26	4.766
1-3	2	12.85	-1085	117.72	9.161
1-1	60	43.99	16.01	256.32	5.827
1-2	10	14.76	-4.76	22.66	1.535
1-3	1	11.69	-10.69	114.28	9.776
1-1	48	45.85	2.15	4.62	0.100
1-2	20	15.38	4.62	21.34	1.388
1-3	6	12.19	-619	38.31	3.142

Source: Author's computation, 2014.

describes the demographic data of the respondents while the other section contains questions that are relevant to GSM as it is related to poverty reduction in the study area.

The data obtained from the study were analysed using descriptive statistics and chi-square. The descriptive statistics inform of frequency table and percentage was used to analyse the demographic data of the respondents while the chi-square was employed to analyse data on GSM poverty reduction ability. Three important variables were used to determine the extent to which GSM has helped in reducing poverty in the study area. These variables serve as a yardstick to measure the extent to which an individual who engages in GSM business was able to provide for his or her daily needs which invariably improved their living standard.

## RESULTS AND DISCUSSION

This section presents the results from the data obtained from the respondents. Initially, 100 respondents were selected for the purpose of questionnaire administration; 85 were returned. Out of the 85 respondents that returned the questionnaires, 50 of them were males, while the remaining 35 were female.

Table 1 shows the distribution of the respondents according to their sex, age, mental status, education level and ethnic group.

Another characteristic of the respondents is that 20 of them (23.5%) acquired tertiary education either in the form of first degree, OND, HND or NCE. 45 of the respondents (slightly over 50%) possessed 'O' level and another group 17 respondents (20%) obtained primary school leaving certificate. Only 3.5% of the respondents claimed that they did not have any formal education. This implies that although majority of the respondents have acquired a reasonable level of education, they could not secure formal employment that could get them out of poverty in the study area.

This result further reveals that majority of the operators of GSM business in the study area are male. As can be seen in the table, 50 respondents (58.8%) are males and the remaining (41.21%) are females. Finally, the results indicated that majority of the respondents are Yorubas, totalling 35 or 62.4% of the sample. 17 respondents are Igbos; Hausas has the least, totalling 15 in the sample.

### Hypothesis testing: there is no significant relationship between GSM and poverty reduction

$$\Sigma = 35.753$$

$$X^2 \Sigma \frac{(fo - fe)^2}{f} = 35.75$$

Decision Rule: - Since the calculated X<sup>2</sup> value i.e. 35.75 is greater than the X<sup>2</sup> critical value i.e. 14. 86 we reject the null hypothesis, which state, there is no significant relationship between GSM and poverty reduction, and accept the alternative hypothesis, which states that there is a significant relationship between GSM and poverty reduction (Tables 2 and 3). The finding from this study corroborates those of Gold et al. (2012), Yauri et al.

(2008) and Kadir (2013) who reported that GSM has contributed significantly to poverty reduction in Nigeria through employment creation and income generation.

## CONCLUSION AND RECOMMENDATIONS

The paper examined the extent to which information and communication technology has been able to reduce poverty in the study area with particular emphasis on one aspect of ICT .i.e. GSM. The findings from the study reveal that global system for mobile communications has been able to reduce poverty in the study area based on the calculated X value that is greater than the critical X value. Based on the findings above, the paper recommended as follows;

- i. Government should create a technical ICT (GSM) training centres such that the trainees will be based on salaries and wages with the view that they will be able to provide services to GSM operators or users.
- ii. Government and corporate bodies should partner GSM operators by giving them financial and logistic aids so as to reduce the financial burden needed to operate a successful GSM business centre.

## Conflict of Interests

The authors have not declared any conflict of interests.

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*Full Length Research Paper*

# The effects of financial reforms on consumption behaviour in Malawi

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**The objective of the paper is to assess whether financial reforms have a statistically significant effect on Malawi consumption behaviour. More specifically, the paper examines the existence of Permanent Income Hypothesis (PIH) and assesses whether the reforms have affected consumption behaviour by reducing liquidity constraints using Instrumental Variable and Two Stage Least Squares (IV-TSLS) approach. The paper finds that the PIH does not hold in Malawi and most consumers are current income consumers. They consume from “hand to mouth” and very little is left to smooth consumption in their life time. Empirical evidence from the thesis shows that the main failure of the PIH hypothesis is due to liquidity constraint which is manifested in the under development of the financial market and unstable macroeconomic conditions in Malawi. Weak financial institutions, both structural and operational have impacted negatively on the accessibility of financial resources for most Malawians despite the reforms. This is a bigger lesson for policy makers to consider in the preparation of future broad based financial reforms.**

**Key words:** Financial liberalisation, permanent income hypothesis, linear spline function, principal component analysis, rule-of-thumb.

## INTRODUCTION

Although, Malawi implemented financial reforms starting from 1987 under the structural adjustment programmes supported by the International Monetary Fund (IMF) and the World Bank, empirical work testing the effect of these reforms on aggregate consumption which forms 90% of gross domestic product (GDP) has not been investigated. The only studies well documented in the literature include the effects of financial liberalisation on savings; on the banking industry; other industries and firms; monetary

policy and formal and informal financial markets (Chirwa and Mlachila, 2004; Kabango and Paloni, 2010; Ngalawa and Viegli, 2010).

In most of the studies outlined above, the reform measures were expected to affect mobilisation of savings and investment through their effect on availability and allocation of credit. However, these studies demonstrate that savings as percent of GDP and private credit as percent of GDP declined while aggregate household

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consumption increased during the liberalisation period. In principal, liberalisation would have increased competition in the formal credit market and eased restrictions on borrowers. This would have expanded liquidity options of households who have the ability to smooth consumption. Hence relaxing the liquidity constraints on borrowers that used to be rationed out of the market may allow consumers to borrow to cover shortfalls in income and enhance the ability to consume wealth at the same time (Qi and Prime, 2009). These researchers conclude that credit will increase leading to increase in aggregate consumption and a decline in aggregate savings. Instead, the country experienced a decline in credit during liberalisation and shows very limited relationship with consumption pattern in Malawi. Therefore, these patterns of consumption and private credit provide motivation for further investigations of behavioural changes in aggregate consumption in Malawi.

Mankiw (2006) argues that if consumption forms a large share of GDP then little disturbances in this component will yield comprehensive effects on the country's aggregate demand. Hence, establishing the type of consumption pattern that exists in Malawi will provide clear indications to understand the formulation of sound fiscal and financial policies. For instance, if this study will show that a significant proportion of consumers are unable to smooth consumption effectively because of liquidity constraints, then movements in current income may be an additional determinant of consumption. This would imply that changes in aggregate consumption expenditure will be more responsive to income changes induced by policy. Thus, government actions could be destabilising if consumption patterns are closer to liquidity constrained consumers (also called 'rule-of-thumb' consumers) than to those who can smooth their consumption overtime following the permanent income hypothesis.

In addition, large composition of aggregate consumption plays an important role in a country's welfare and business fluctuations. Therefore, a large body of literature continues to model how households decide how much to consume, respond to uncertainty over future incomes, movements in interest rates, and expectations of future shifts in taxes and wages, which are key determinants of the impact of government policies. Advanced econometric models such as dynamic stochastic general equilibrium models (DSGE) frequently use the assumption of household consumption behaviour in modelling the effects of fiscal and monetary policies on economic activities. The country is still reforming the financial sector and for instance, the capital account has not been fully deregulated and the sector still remains shallow. Hence, continued empirical investigations about the past performance of the financial sector and having past knowledge about consumption behaviour are crucial in the current on-going reform process.

Studies on the effect of financial liberalisation on consumption behaviour have mainly followed the seminal

work of Hall (1978) on the Permanent Income Hypothesis (PIH). The hypothesis based on the representative agent consumption model proposes that aggregate consumption patterns respond to changes in permanent income. However, empirical work done by Campbell and Mankiw (1989) found that apart from responding to permanent income, aggregate consumption also responds to changes in current income. Thus consumers can be categorised as either permanent income consumers or current income consumers. They argue that consumption expenditures seem to respond to predictable changes in income because some consumers encounter binding liquidity constraints in some period. Specifically, the liquidity constrained consumers are unable or unwilling to use financial markets to smooth consumption.

Barrell and Davis (2007) have explained the link between excess sensitivity of current consumption to current income and liberalisation. They observed that liberalisation makes excess sensitivity (liquidity constraints) to decline and enhance consumption to track current income closely. However, in a situation of continued credit market imperfection despite liberalisation, the excess sensitivity of consumption to income may not decline and consumers will be forced to consume entirely out of current income. That is, consumers will be unable to borrow against future income and hence affect the consumption of significant fraction of consumers. Another reason why excess sensitivity may remain high during liberalisation is through rational expectation arguments. For instance, uncertainty about future income can induce consumers engaging in precautionary savings and increasing this uncertainty will increase savings and reduce consumption relative to income (Blundell-Wignall et al., 1991). Most of these arguments are based on the empirical findings from industrialised and emerging economies and very limited country specific studies have been conducted in sub-Saharan Africa. Hence, one of the contributions of this paper is an empirical extension of Campbell and Mankiw's (1989) model on Malawi data and findings add to the empirical literature in Africa.

Attempts have also been made to explore factors behind the rejection of the PIH (Gomes and Paz, 2010). They have found that myopia, liquidity constraints and perverse asymmetry are important factors behind the failure of PIH. For instance, Shea (1995) explains that under myopia, aggregate consumption behaviour tracks current income and consequently consumption should increase and decrease in response to increases and decreases in the expected income, respectively. While under liquidity constraint, consumers are prevented from borrowing when income is temporarily very low.

Accordingly, consumption is more correlated with predictable income increases than declines. Gomes and Paz (2010), in their study on Brazil, have demonstrated that both factors can coexist. On the extreme side, Paz (2006) found that neither liquidity constraints nor myopia contributes to the failure of PIH but consumption is

sensitive only to expected income declines which Shea (1995) called 'perverse asymmetry'.

Ang (2011) has argued further that liberalisation can reduce the response of current consumption to changes in current income in a country with stable macroeconomic background and good financial institutions. However, the current study only explains why liquidity constraints and myopic tendencies remain high despite implementing liberalisation in Malawi. Findings by Malawi Financial Sector Assessment Programme (2007) show that Malawi experienced macroeconomic instability and weak financial institutions during the liberalisation period. They further elaborate that the financial sector is characterised by weak imperfect financial information, lack of proper legal financial systems and supervision, undeveloped credit markets and reliance on collateral requirements which exclude many participants in the formal financial systems. Hence, the formal financial sector may have not changed credit availability which may have impacted negatively on liquidity constraints in Malawi during liberalisation.

Various measures have been deployed to model the direct and interactive effects of financial reforms on economic activities. However, single country empirical studies on the impact of financial liberalisation provide mixed evidence (Barrell and Davis, 2007). The disparities in results partly may also be attributed to differences in the methodological innovations in the measurement of the proxy defining liberalisation indices. Recently, common approaches employed are the principal component analysis (Shrestha and Chwdhury, 2006) and the linear spline function (Aron and Muellbauer, 2000). Thus, another contribution of this study is an attempt to construct the financial reform index for Malawi using the principal component analysis and the linear spline function. Most studies in Malawi use single proxies such as the ratio of private credit to GDP and dummy variables prior and post period of liberalisation. Therefore, constructed indices may help to address issues of comprehensive representation and accommodate the sequential institutional changes due to changes in financial sector policy reforms.

Henceforth, the purpose of this chapter is to investigate the existence of Permanent Income Hypothesis (PIH) based on Campbell and Mankiw (1989) following the implementation of financial reforms in Malawi in the 1980s and 1990s. More specifically, the study questions whether financial reforms contributed to the promotion of the financial system that is capable of influencing households to use the financial markets to smooth their consumption pattern in time of need. If it happens that PIH exists in Malawi, the chapter continues to explore further whether the failure is due to liquidity constraints or myopia as done by Gomez and Paz (2010) on Brazil. The study further attempts to examine whether the degree of excess sensitivity (liquidity constraint) of consumption declines during financial reforms by simply controlling financial reforms represented by indicators of financial

reforms. Explanations as to why liquidity constraint remains high despite implementing reform in Malawi are also provided. This chapter is unique from the rest in the sense that new constructed time series of financial reform indices based on Aron and Muellbauer (2000) are used. To the best of our knowledge, this is the first study to investigate these questions for a small country like Malawi.

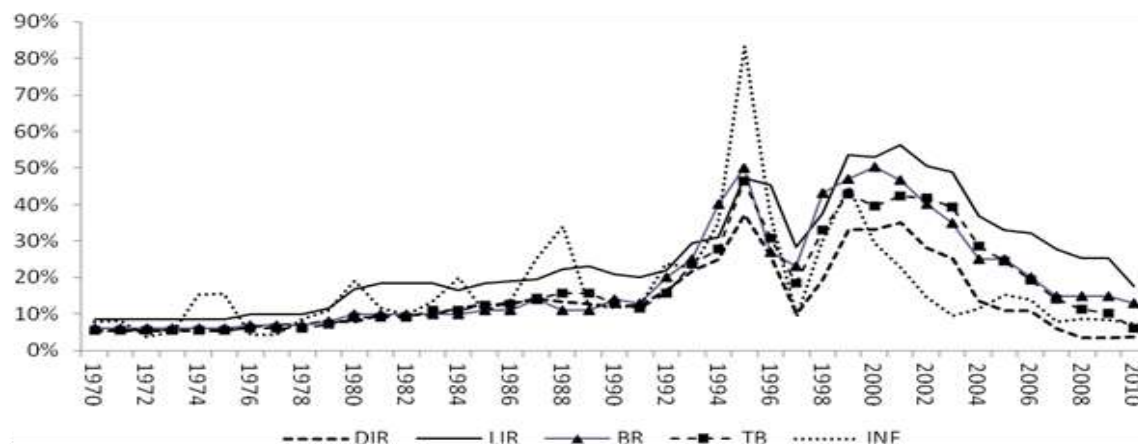
## **BRIEF OVERVIEW OF FINANCIAL LIBERALISATION IN MALAWI**

### **Financial reforms**

In Malawi, liberalisation of the financial sector started during the structural adjustment programmes supported by International Monetary Fund (IMF) and the World Bank (WB) in the 1980s. Liberalisation aimed at reducing direct government intervention while at the same time increasing the competition and efficiency in the operations of the financial sector. Measures of liberalisation included decontrolling interest rates, eliminating credit limits, reforming financial institutions, deregulating the financial sector, and adoption of indirect instruments of monetary policy (Chirwa and Mlachila, 2004). Accordingly, Malawi implemented many policy measures under liberalisation and we concentrate on those related to the study. For more information a brief historical aspect of financial reform is outlined in annex 1<sup>ii</sup>.

Liberalisation of the financial sector started with the deregulation of interest rates in July 1987. Prior to that the basic structure of interest rates was directly administered by the Reserve Bank of Malawi (RBM) with an aim of keeping the interest rates low in order to reduce government expenditures and promote private investment. In particular, commercial banks in Malawi were given the freedom to set their own lending interest rates starting in 1987. This was followed by the deregulation of the deposits rates in April 1988. By August 1988, preferential interest rates to the agriculture sector were abolished and full interest decontrol was done in May 1990. The significant objective of interest rate liberalisation was to influence and encourage borrowing and raise the cost of funds to all financial institutions. Consequently, as shown in Figure 1, there were upward trends of various nominal interest rates after the liberalisation but this happened on the background of high inflation and high income growth volatility. In addition, high interest rates in Malawi have generally been due to high levels of government borrowing of funds on the money market. The money market comprised of a high oligopolistic structure with only two banks which accounted for 90% of bank credit in the economy during the liberalisation period.

Malawi removed credit ceilings and rationing in 1989 (Chipeta and Mkandawire, 1991). By elimination of credit



**Figure 1.** Trend of Various Interest Rates and Inflation. Note: Data obtained from IMF-IFS, World Bank Indicators and RBM Financial and Economic Reports. INF, DIR, LIR, BR and TB stand for inflation, deposit interest rate, lending interest rate, bank rate and Treasury bill, respectively.

control, it was envisaged that further increase in private sector credit will be achieved. The removal of credit controls which constitute a liquidity constraint may imply that excess sensitivity will be reduced during liberalisation. Henceforth, the pattern of Malawi consumption will be smoothed during the liberalisation period and thereafter. However, RBM introduced the liquidity reserve requirement (LRR) ratio as the major monetary policy instrument in June 1989. RBM started with 10 percent of LRR and thereafter it trended upwards until 2003. As in Chirwa and Mlachila (2001), banks in Malawi reacted to these high LRR by widening the interest rate spread and hence shifting the cost of refinancing requirements to the customers. Thus, the introduction of LRR can be seen as counter-productive as it might have restricted consumer credit absorption as the cost of borrowing increased. Simultaneously, government implemented open market operations (OMO) and the bank rate with Treasury bills, RBM bills, Local registered stock and repurchase agreements (repos) as main instruments of monetary policy, due to inherently limited flexibility of the LRR. Despite some of these efforts, Figure 2 shows that private credit declined during the liberalisation period, but started improving in 2004.

Other reform policies involved the amendment of the RBM Act and Banking Act which were completed in 1989. After the revision of the Acts, privatisation and restructuring of banks and other financial institutions followed starting from 1990. This resulted in the expansion of banks from two in 1994 to nine in 2008 (Lea and Hanmer, 2009). In the foreign exchange market, Malawi adopted a floating exchange rate regime and removed exchange rate controls except for the capital account in 1994. Due to potential volatility of foreign exchange experienced during the floating regime, Malawi adopted a managed floating exchange rate regime in 1995. The RBM was

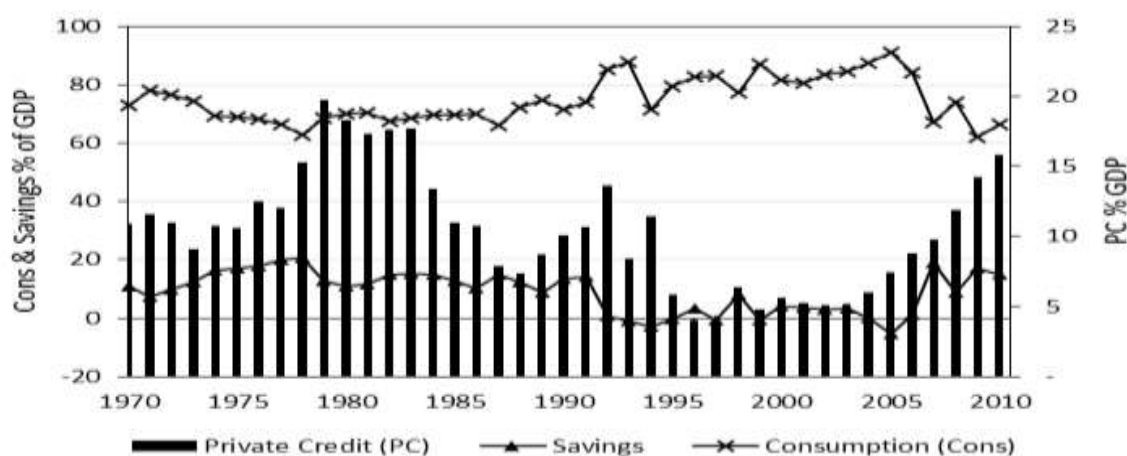
allowed to intervene to influence the exchange rate through sales and purchases of foreign currency, hence managing the exchange rate within a limited band. The band was removed later in 1998 in favour of a floating exchange rate regime (Mangani, 2011). The stock exchange officially opened in 1995 and listing of the first company took place in 1996. Despite this, capital markets are not fully developed and activities on the Malawi stock exchange remain limited.

The important feature of financial reform on financial markets is the promotion of savings. Reinhart and Tokatlidis (2003) argue that the effect of real interest rates on consumption and savings depends upon the level of permanent income or wealth of the country. They contend that households first have to achieve subsistence consumption before other inter-temporal consumption choices are made. Hence, countries having high composition of subsistence consumption, consumption and savings will be insensitive to changes in real interest rates, consumption will decline and savings increase after an increase in real interest rates. From Figure 3, savings and consumption as a percentage of GDP instead declined and increased, respectively during liberalisation period in Malawi. The decline in savings as proportion of GDP was largely experienced in the 1990s and reached negative 3 percent in 1994 from 14 percent in 1991; consumption on the other hand dropped in the 1980s and started increasing in the 1990s and thereafter.

Furthermore, liberalisation of the credit controls and ceilings indicate that not all households have access to credit. Hence, some consumers are not able to smooth their consumption overtime because they cannot afford to borrow from the formal financial sector. These liquidity constrained consumers from determining their consumption and savings based on current income. Therefore, relaxing credit controls and improving credit availability



**Figure 2.** Economic growth and private credit as % GDP. Source: Data used from IMF-IFS, World Bank Development Indicators and RBM Economic and Financial Review. Private credit is calculated as percentage of GDP and economic growth is percentage changes of real GDP.



**Figure 3.** Savings, private credit and consumption as % of GDP. Source: Data used from IMF-IFS, World Bank Development Indicators and RBM Economic and Financial Review.

may lead to consumption increases after the financial reforms (Reinhart and Tokatlidis, 2003). Accordingly, Figure 3 portrays that Malawi experienced an increase in consumption as percent of GDP and a decline in savings as a percent of GDP which according to Bayoumi's (1993) arguments may be attributed to increased liquidity coming from increased credit as a result of liberalisation. Private credit as percent of GDP, however, declined during liberalisation. One important feature in Figures 1, 2 and 3 is the turnaround of the pattern of macroeconomic variables after 2006. In particular, we observe that inflation declined, private credit increased, economic growth increased, savings increased and consumption declined. It would be interesting to investigate what caused the turnaround of economic events after 2006.

Moreover, empirical findings in Malawi generally indicate that liberalisation has little effect on improving credit availability in Malawi. More specifically, the study found that the demand for bank credit was adversely affected by unfavourable economic environment of high budget deficits, large government demands for bank credit, high rates of inflation, high nominal rate of interest rate and a depreciating currency. In addition, low credit has been attributed to structural issues which include unreliable power and water supplies, unsatisfactory state of internal road networks, and high transport costs. Other institutional set up problems observed include the fact that 90 percent of the Malawi population still remain unbanked and 85 percent of households are predominantly rural and employed in the agricultural sector (Malawi

Financial Sector Assessment Programme, 2007). The banking system which forms a large share of the formal financial sector is still fragmented and repressed, mainly situated in urban areas and provide credit mostly to large-scale enterprises (Chipeta and Mkandawire 1991). Even where financial institutions have sufficient resources, lending to small-scale households is seen to be costly and considered a risky credit business.

The Malawi Financial Sector Assessment Programme (2007) has also provided additional factors that led to many Malawians having limited access to formal financial systems. Some of the operational factors include high cost of maintaining bank accounts because many Malawians cannot afford minimum balances due to low income levels, cash based payment systems and delays in loan processing and high cost of banking transfers. Other factors include the higher amount of securities that the banking system imposes on borrowers depending on their perception of risks; weak microfinance sectors; limited export finance; existence of large informal sector and limited primary capital markets; and limited legal and regulatory frameworks. These factors have deprived many Malawians accessibility to formal financial systems and cause most household consumers to remain liquidity constrained even after financial reforms in the 1980s and 1990s.

This section has provided a few explanations as to why liquidity constrained consumers exist in Malawi. It is clear from existing literature that the liquidity constraint situation of consumers in Malawi did not improve during the liberalisation era. As discussed above, liberalisation is a process and cannot be specifically defined. Therefore, the study attempts to construct proxies for liberalisation in order to quantify the true picture of financial reforms in Malawi as discussed below.

### Financial liberalisation index

In practice, single indicators of financial reforms such as ratio of liquidity liability (M2) to nominal GDP, ratio of debt to GDP and ratio of domestic private credit to nominal GDP have been used (Beck et al., 2000). However, these indicators are not comprehensive representations of financial sector development and constructing a financial liberalisation measure with various aspects of the deregulatory and the institution-building process of financial development is very difficult. In addition, others have used dummy variables to represent financial reforms but this has been found to be mostly subjective and difficult in assigning arbitrary dummies (Groenewold et al., 2008). Recently, studies have suggested the use of a financial liberalisation index constructed from principal component analysis. However, Aron and Muellbauer (2000) have argued that the principal component technique does not link institutional information with behavioural responses. Therefore, a paper by Aron and Muellbauer has constructed a financial reform index

using a linear spline function accommodating the sequential institutional changes that occur due to changes in the financial sector policy reforms.

Given these considerations, this study attempts to construct a financial reform index for Malawi employing both the principal component and the linear spline function using quarterly data from 1980q1 to 2009q4. The indices are specifically helpful in monitoring the pace of liberalisation and evaluating the impact of the policy on various aspects of the economy. After constructing the two financial liberalisation indices, the study also attempts to estimate the impact of financial liberalisation on consumption behaviour using the constructed indicators of financial liberalisation. Apart from estimating a consumption function with financial liberalisation indices obtained from principal component analysis and the linear spline function, the study will also estimate the consumption function using the ratio of private domestic credit to nominal GDP as an index.

### Financial liberalisation index from principal component analysis

Shrestha and Chowdhury (2006) have attempted to construct financial liberalisation indices using the principal component analysis. Specifically, their approaches were based on assigning arbitrary dummies between 0 and 1 to construct a single index of liberalisation depending on the implementation status to each financial liberalisation policy variables. However, Groenewold et al. (2008) have argued that the process of choosing dummies will be plagued by certain arbitrariness in the assignment of numbers to events. Therefore, we depart from this practice and compute the weighted average of the principal components directly from the three standard measures of financial depth which include the ratio of liquidity liabilities (M2) to GDP, the ratio of domestic private credit (PC) to GDP, and ratio of commercial bank assets (CBA) to commercial bank assets plus central bank assets.<sup>iii</sup>

Following Shrestha and Chowdhury (2006) but using indicators of financial depth as discussed above, the composition of financial liberalisation ( $FLI_t^{PC}$ ) based on the principal component method can be expressed as follows:

$$FLI_t^{PC} = w_1 PC_t + w_2 M2_t + w_3 CBA_t \quad (1)$$

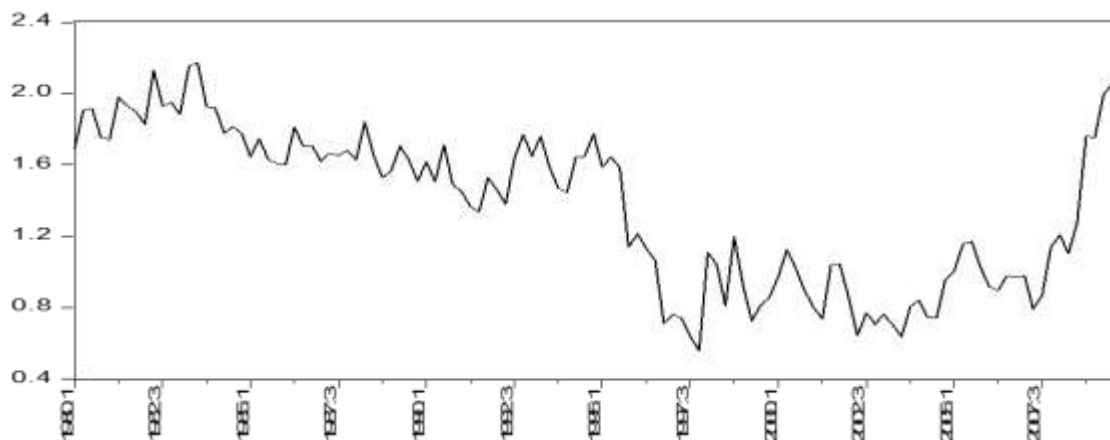
where  $w_i$  is the weight of the component given by the respective eigenvector of the selected principal components. These three standard measures are translated into natural logarithms. After computations, Table 1 reports the eigenvalues of the three possible components as well as the proportion and cumulative proportion of the variation in variables explained by each. The first principle component explains over 65 percent of total variation and



**Table 1.** Eigenvalue and scores of principal components.

Component/v variable	Eigenvalue	% of Variance explained	Cumulative % of variance explained	Score principal component 1	Score principal component 2
1	1.939	65	65	0.633	0.329
2	0.777	26	91	0.638	0.291
3	0.284	9	100	-0.438	0.899

Note: variables in chronological order are 1) PC, 2) M2, and 3) CBA.

**Figure 4.** Financial Reform Index Using Principal Component Analysis

the second principal component explains over 26 percent of total variation. Hence, the first financial liberalisation index ( $FLI_t^{PC}$ ) is estimated using the eigenvectors of principal component 1.

The series are graphed in Figure 4 and it is evident that financial sector development deteriorated starting from 1980 and became slightly stable during the implementation of financial reforms in 1987. Although, interest rates were decontrolled and credit rationing was removed, episodes of ups and downs were observed during the reform period. Some policy measures introduced such as the introduction of liquidity reserve ratio and limited initial conditions of institutional environment were counterproductive to the reform programme. Other factors contributing to unsuccessful financial reform programmes included political change regime in 1992 and 1994, withdrawal of donor funding, fiscal indiscipline and drought during the reform period (Mangani, 2011). Financial reforms showed signs of positive contribution starting from 2005 coinciding with the new government in power.

#### Financial liberalisation index from linear spline function

Financial reform is also proxied by a linear spline function

as done in Aron and Muellbauer (2000)'s study. To define the linear spline function, its coefficients are first estimated jointly from the consumption function. Theoretically and empirically, a macro-econometric consumption function would include an income term, a wealth term and a real interest rate term (Cappelen et al., 2006). However, the wealth term is excluded because data were not available for Malawi. In addition, Musila (2002) found insignificant impact of wealth and interest rate in describing consumption pattern in Malawi. Hence, the national disposable income is used as income in the household sector adjusted for inflation.

The estimated consumption function is as follows:

$$\Delta c_t = \mu + \lambda \Delta y_t + \alpha(y_{t-1} - c_{t-1}) + \omega_i d_{it} + \varepsilon_t, \quad (2)$$

where  $c_t$  is the natural logarithm of consumption and  $y_t$  is the natural logarithm of income.  $\alpha$  is speed of adjustment,  $\omega_i$  denotes a group of coefficients obtained from a group of dummy variables ( $d_{it}$ ) at different time period of liberalisation that will be used to construct the index and  $\varepsilon_t$  is the white noise.

As observed from the review of financial reforms in Malawi, the financial liberalisation process has progressed in many stages and involved many policy reform

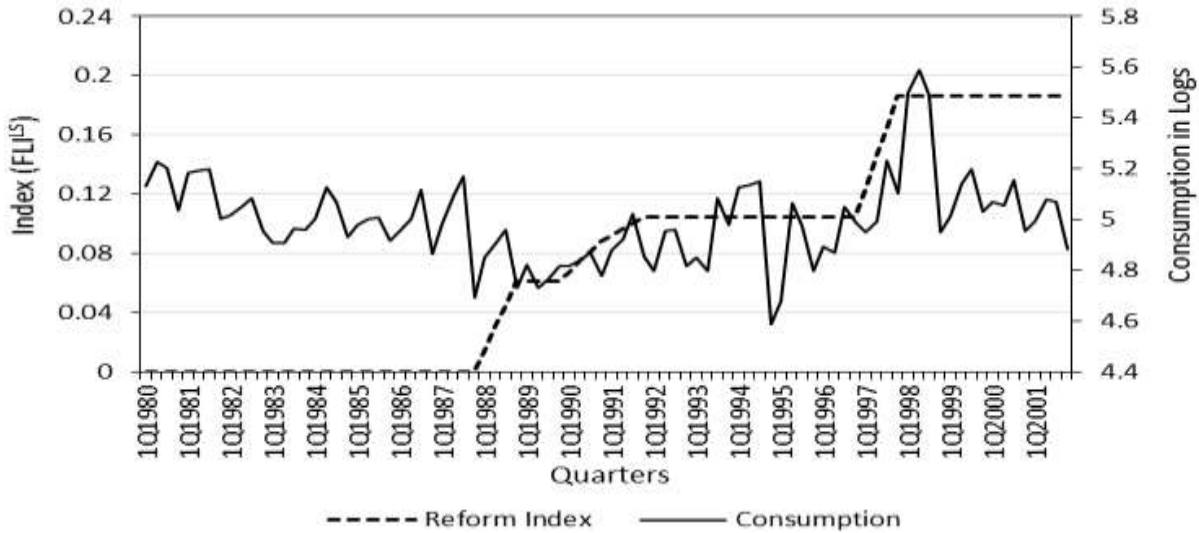


Figure 5. Consumption and Financial Liberalisation Index

measures<sup>iv</sup>. Malawi implemented financial reforms sequentially between 1987 and 1998 and the set of reform measures were introduced at different time period starting with the liberalisation of lending rates in 1987 and then deposit rates in 1988. Other reform measures in the area of credit controls, financial institutions, monetary policy, exchange rate and current and capital account followed in the later years as highlighted in Annex 1. Based on this history of financial reform in Malawi, dummies for the linear spline function are generated as follows. Financial reform started in 1987 and 0 is assigned prior to the liberalisation and 1 thereafter. By use of the quarterly data series, a 4 quarter moving average is created with predetermined moving average of dummies in 1987.  $d_{87}$  is defined as 0 prior to 1987 and 0.25 in the first quarter of 1987, 0.5 in the second quarter, 0.75 in the third quarter and 1 starting from fourth quarter and thereafter.  $d_{88}$  is defined as the 4 quarter lag of  $d_{1987}$ ,  $d_{89}$  is the 8 quarter lag of  $d_{1987}$ ; this continues until we obtain  $d_{98}$  which will be 44 quarter lag of  $d_{1987}$ . Then the linear spline function ( $FLI_t^{LS}$ ) is defined as follows:

$$FLI_t^{LS} = w_1 * d_{87} + w_2 * d_{88} + w_3 * d_{89} + w_4 * d_{90} + w_5 * d_{91} + w_6 * d_{92} + w_7 * d_{93} + w_8 * d_{94} + w_9 * d_{95} + w_{10} * d_{96} + w_{11} * d_{97} + w_{12} * d_{98} \tag{3}$$

The coefficients ( $w_i$ ) in equation 3 are estimated from equation 2. Based on Aron and Muellbauer's (2000) arguments, only positive coefficients are used in the estimation of equation 3. They argue that negative coefficients indicate policy reversal in the implementation of financial liberalisation. Positive effects of liberalisation are not realised in economies practicing policy reversal because most households and firms lose trust and

coherence in adopting government policies. After estimations, 5 positive coefficients of dummies out of 12 were used in estimating  $FLI_t^{LS}$  in equation 3. The estimated  $FLI_t^{LS}$  is plotted together with consumption function as shown in Figure 5. The results show that consumption has moved along with financial reform index except in 1994 at the time of political change regime. It will be interesting to see how the coefficients will behave in a more sophisticated consumption function with wealth variables and interest rates variables. Additionally, joint estimation with household debt function should also be considered in future after obtaining reliable data on domestic debt. This is work in progress to improve on the formulation of the consumption function and debt function that can be jointly estimated to obtain reliable coefficients that can be used to construct a formal financial reform index for Malawi.

We observe different performances between the principal component analysis and the spline function. The principal component shows that the actual implementation of liberalisation policies had negative effects on financial sector development which by implication may have led to non-effects of financial reforms on consumption. In section 2, we observed that some policy measures implemented were counter-productive to the reform programme. In addition, the financial reform programme was implemented under the background of unstable macroeconomic fundamentals such as high inflation, erratic economic growth and change in political regimes. However, we observe different scenario under the spline function. The changes in aggregate consumption pattern moved along with financial reforms. Consumption is trending at the lower level than before liberalisation. But episodes of upward movements in consumption when financial reform improved contradict the permanent

income hypothesis and liquidity constraint. This may imply that changes in consumption pattern arose during liberalisation following changes in the current income.

Nevertheless, in both methodologies, the outcomes after financial liberalisation beginning 2007 show that financial sector development improved. From Figure 3, private credit increased, savings rejuvenated and consumption decreased in line with the theoretical expectations. Several questions can be asked from this. Is this an element of reduction in liquidity constraints? Is this an element of reduction in myopic tendencies of consumers? Did Malawi introduce other policies such as institutional policies apart from financial policies which had positive effects on changing consumption pattern during this period? For instance, government may have implemented policies in agriculture, education and health that likely may have influenced household consumption behaviour. In order to answer such questions, there is need for a more dynamic macroeconomic model which will be an important topic for the next study.

## EMPIRICAL SPECIFICATION OF THE MODEL

In this study, we adopt the Euler-equation approach based on the work of Hall (1978) to analyse the development of aggregate consumption function. The model follows the solved-out consumption function set out in Campbell and Mankiw (1989) in which we allow for the presence of liquidity constraints as follows:

$$\Delta c_t = \mu + \lambda \Delta y_t + \theta rlr_t + \varepsilon_t, \quad (4)$$

where  $\Delta c_t$  represents the change of the log of aggregate consumption,  $\Delta y_t$  is the change of the log of aggregate income while  $\mu$  and  $\varepsilon_t$  represent the drift and the error term, respectively.  $\theta$  is the elasticity of substitution parameter and  $rlr_t$  is the real lending rate. The parameter  $\lambda$  represents the degree of excess sensitivity. This equation simply states that the change in consumption is a weighted average of the change in current income and the unpredicted changes in permanent income. Hence, the analysis of changes in consumption pattern will be based on the degree of excess sensitivity. Therefore, we test the hypothesis that  $\lambda = 0$ . If  $\lambda$  is significant and positive, it entails rejection of the permanent income hypothesis, that is consumption behaviour in Malawi follows a rule-of-thumb.

In theory, real interest rates ( $rlr_t$ ) would also be expected to influence savings, and therefore consumption, with lower interest rates leading to increased consumption. However, actual trends of savings declined during liberalisation in Malawi. The interest rate structure is still non-market determined due to high official oligopolistic

financial structure and high government credit uptake. Hence, interest rate structure is likely to be controlled and consumer credits are likely to be low and lenders continue to use different criteria in credit rationing. Therefore, we assume constant elasticity of substitution but include it in our estimations to testify non-impact of interest rates on consumption in Malawi.

After examining the level of excess sensitivity, it is found that PIH did not exist in Malawi despite implementing financial reforms. We then extend our investigation to test whether this level of sensitivity declined during liberalisation period. We use indices of financial liberalisation constructed because liberalisation involves many policy measures. On the understanding that we can obtain different outcomes using different indices, we allow for up to three separate parameters on the liberalisation indices to access different aspects of the evolution of consumption behaviour following liberalisation. In this context, we modify equation 4 to allow for liquidity constraints and financial liberalisation as follows:<sup>v</sup>

$$\Delta c_t = \mu + \lambda \Delta y_t + \delta FLI_t + \varepsilon_t \quad (5)$$

where  $FLI_t$  is a proxy for financial liberalisation. Three proxies are used which include the ratio of private credit to GDP ( $FLI_t^C$ ), constructed series of financial liberalisation from the principal component ( $FLI_t^{PC}$ ) and constructed series from the linear spline function ( $FLI_t^{LS}$ ). It is anticipated that the size of excess sensitivity  $\lambda$  for Malawi will decline during the liberalisation period. As explained in the introduction, one reason for excess sensitivity is the existence of liquidity constraints. Therefore, a significant and reduced  $\lambda$  during the liberalisation period would show that financial liberalisation improved liquidity situation and hence changed the pattern of consumption in Malawi.

The hypothesis that excess sensitivity  $\lambda = 0$  may be rejected and may not decline during the liberalisation period has prompted us to explore further factors behind the negative outcomes. Building from the work of Shea (1995) and others, we modify equation 4 further to isolate liquidity constraints effects in Malawi:

$$\Delta c_t = \mu + \lambda_1 DUM1 \Delta y_t + \lambda_2 DUM2 \Delta y_t + \varepsilon_t, \quad (6)$$

where  $DUM1$  is a dummy variable for periods in which  $\Delta y_t > 0$  and  $DUM2$  is a dummy variable for periods in which  $\Delta y_t < 0$ . Under liquidity constraint  $\lambda_1$  should be positive, significant and greater than  $\lambda_t$  while under myopia  $\lambda_1$  and  $\lambda_2$  should be positive, significant and greater than zero.

However, estimating excess sensitivity  $\lambda$  using ordinary

**Table 2.** Test for serial correlation.

	M1	Income	Consumption	IIP
M1	1.000			
Income	0.993	1.000		
Consumption	0.954	0.956	1.000	
IIP	0.434	0.438	0.401	1.000

Note: Test for serial correlation so that M1 can be used to calibrate the quarterly series of household consumption and national disposable income.

least squares (OLS) in all the models will yield biased and inconsistent coefficient because we are using expected variables in the equations. More specifically, permanent income hypothesis involves predictable components of income growth and real interest rates which are unobservable quantities (Wooldridge, 2009). Such simultaneous and error specifications can bring about the problem of endogeneity. Thus the explanatory variable  $\Delta y_t$  in equation 4 maybe correlated with  $\varepsilon_t$ . To address such endogeneity problem, the current study uses instrumental variables technique and two-stage least squares (IV –TSLS) employed by Campbell and Mankiw (1989).

In the IV-TSLS, we use the predetermined variables as instruments. Specifically, the lagged values of  $\Delta y_t$  are usually considered in the literature because the lagged variables are likely to be correlated with their current variables but not with the error term, since they were generated at an earlier point in time. In addition, instrumental variables are used to control for the possibility that changes in current income might signal changes in permanent income. The first lags are not used in this study because consumption and income data are time averaging and may induce serial correlation between the variable and its first lag (Campbell and Mankiw, 1989). Instead, we use lags starting from the second lag period in order to circumvent this problem. The only problem is that the degree of predictability is somehow lost in the first stage of regression (Agell and Berg, 1996).

### Data and description statistics

The study uses quarterly data for the period 1987:1 to 2009:4 which were collected from International Financial Statistics (IFS) of IMF. Missing data were filled and consolidated from various in-country publications of the RBM, National Statistics Office (NSO) and from the Ministry of Development Planning and Cooperation (MDPC). Data series include real per capita national disposable income (total domestic consumption plus total national savings), real per capita household consumption, and bank lending interest rate. Real interest rates are calculated according to the formula  $1+r_t = (1+i_t)/(1+\pi_t)$ ,

where  $r_t$  is real interest rate,  $i_t$  is nominal interest rate and  $\pi_t$  is inflation (Paz and Gomes, 2010). Household consumption (consumption) and national disposable income (income) are collected annually with monetary aggregates (M1) in Malawi (Table 2). According to Denton (1971) approach, indices of industrial production (IIP) as related series would have been appropriate data to interpolate the quarterly GDP but IIP was not correlated with consumption and income. In this regard, the series were interpolated using annual data to obtain quarterly series estimated using indices of seasonally adjusted money series (M1). In particular, we calculated quarterly changes of M1 and use these changes to interpolate the annual consumption and income into quarterly series as done in Denton (1971).

Consumption and income variables were converted into natural logarithms. This makes the model estimated as the log-linear approximation to the true model. As shown in Table 3, consumption and income series were tested using the Augmented Dickey-Fuller test for stationarity and the Johansen procedure for cointegration. The series were not stationary in levels and became stationary at first difference, that is they are integrated of order one I (1).

Using Johansen procedure, the series are not cointegrated at the 5% critical value; hence the null hypothesis of non-cointegration cannot be rejected. Thus the model is proven to be properly specified and can model the series in difference without losing important information in the estimated equation. It is also observed that estimations should use consumption data of non-durables and services and total disposable income or disposable labour income but Campbell and Mankiw (1990) found that the distinction is not very important. They obtained similar results empirically.

### EMPIRICAL ANALYSIS

The estimated model on whether permanent income hypothesis exists in Malawi is represented in Table 4. First, we tested the quality of the instruments used in our estimations and results are reported in the first stage regressions. The test results show that each set of

**Table 3.** Testing for stationarity and cointegration.

Testing for stationarity		Testing for Cointegration – Johansen Procedure		
<b>Variables</b>	Dickey-Fuller Test	Null hypothesis	Trace test	p-value
$c_t$	-1.197 (0.673)	$r=0.v$ $r=1$	10.712	(0.230)
$\Delta c_t$	-6.133 (0.000)	$r=1.v$ $r=2$	1.881	(0.170)
$y_t$	-0.907 (0.782)	Null hypothesis	Max-Eigen test	p-value
$\Delta y_t$	-4.957 (0.000)	$r=0.v$ $r=1$	8.831	(0.301)
		$r=1.v$ $r=2$	1.881	(0.170)

Note: The testing null hypothesis is that the variable has a unit root I (1). The figures in parenthesis are p-values. In terms of cointegration,  $r$  is the number of cointegrating vector. Number of lags used is 1 in both cases.

**Table 4.** Estimate of  $\lambda$  model for Malawi 1987Q1 – 2009Q4.

First Stage Regressions				
Instrument	$\Delta c_t$ equation	$\Delta y_t$ equation	$\lambda$ estimate (s.e.)	Test of restrictions
Model 1 (OLS)			0.922*** (0.066)	
Model 2 (IV)	0.182 (0.001)	0.227 (0.000)	0.870*** (0.170)	-0.025 (0.855)
Model 3 (IV)	0.199 (0.000)	0.262 (0.000)	0.815*** (0.120)	-0.030 (0.942)
Model 4 (IV)	0.222 (0.000)	0.187 (0.000)	1.125*** (0.158)	-0.033 (0.996)
Model 5 (IV)	0.180 (0.001)	0.247 (0.000)	0.914*** (0.098)	-0.040 (0.830)
Model 6 (IV)	0.278 (0.000)	0.280 (0.006)	0.983*** (0.110)	0.008 (0.428)

Notes: Three asterisks indicate 1% significance level and the figures in brackets are standard errors.

instruments has strong predicting power for both income growth and consumption changes. One noticing feature is that the absolute  $R^2$  for consumption are smaller than  $R^2$  for income, except when real interest rate is used as instrument. This provides evidence against the permanent income hypothesis in Malawi. Campbell and Mankiw (1990) have argued that such result is sometimes obtained because of the error in the measurement of the income growth. However, obtaining uncorrelated measurement error will not bias the IV estimates of  $\lambda$  but will reduce the predictability of income growth.

Second, we tested the validity of the instruments using the over-identifying restriction tests of the instruments and this method is equivalent to the Sargan test. The test is conducted across all models. The adjusted  $R^2$  for a

regression of IV residual on the instruments with p-values in brackets for a Wald test that all the coefficients are zero are reported in the last column of Table 4. In all the models, the test results show that there is no evidence against the restrictions in the models used for estimations. Hence, we can argue that the models are well specified.

Third, attempts have been made to address the issues of heteroskedasticity, serial correlation, stability of parameters, and testing for restriction in the use of instrumental variables to address the issue of over-identification in Tables 5 and 6. Most of these tests show that all the standard errors and test statistics are heteroskedasticity, autocorrelation, and stability consistent.

Empirical results represented in Table 4 show that predictable movements in real income growth do exhibit significant explanatory power over consumption growth,

**Table 5.** Estimated results of  $\Delta c_t = \mu + \lambda \Delta y_t + \delta FLI_t^i + \varepsilon_t$ .

	Model 1 OLS	Model 2: IV	Model 2: IV - $FLI_t^{PC}$	Model 3: IV - $FLI_t^{PC}$	Model 4: IV - $FLI_t^{LS}$
$\mu$	-0.003 (0.008)	0.003 (0.008)	-0.037 (0.065)	-0.029 (0.045)	0.039 (0.058)
$\lambda$	0.933*** (0.067)	0.918*** (0.100)	0.932*** (0.097)	0.937*** (0.098)	0.927*** (0.104)
$\delta$			0.018 (0.034)	0.020 (0.036)	-0.307 (0.425)
$\bar{R}^2$	0.795	0.794	0.786	0.787	0.786
D.W.	1.856	1.860	1.822	1.827	1.809
LM(1)	0.001 (0.970)	0.003 (0.957)	0.007 (0.933)	0.002 (0.963)	0.091 (0.763)
ARCH (1)	0.0314 (0.575)	0.312 (0.596)	0.315 (0.575)	0.314 (0.580)	0.329 (0.566)
Ramsey's RESET	0.108 (0.915)	0.025 (0.980)	0.063 (0.950)	0.087 (0.931)	0.151 (0.881)
Test of Restriction	-	-0.040 (0.273)	-0.045 (0.878)	0.046 (0.886)	-0.053 (0.933)

Note: Three (two) asterisks indicate 1% (5%) significance level and the figures in brackets of  $\lambda$  and  $\delta$  are t-statistics. LM (1) test for serial correlation and ARCH (1) test for heteroskedasticity coefficients are observed R-squared and in brackets are p-values. .  
 $H_0: \lambda = 0; H_a: \lambda \neq 0$ .

evidence against the PIH in Malawi. That is, the excess sensitivity is much higher than what is generally observed in industrial countries as well as other less developed countries (Paz and Gomes, 2010). These findings show that almost 90% of households in Malawi are associated with liquidity constraints and cannot smooth their consumption pattern over time. Specifically, it implies that consumers in Malawi depend on current income for their current consumption. The strong effects of current income are consistent with how the economic system prevailed in Malawi. As observed in the literature, the country experienced low liquidity options such as credit unavailability and low savings and most Malawians were unable to use savings and borrowing to smooth the path of consumption.

In the first column of the table, model 1 is estimated using OLS while models 2 to 6 are estimated using two stage least squares. Model 2 uses three lags of income growth as instruments and model 3 uses three lags of consumption growth as instruments. Model 4 instruments are three lags of real interest rate. Model 5 instruments are three lags of income growth, consumption growth and error correction model for consumption and income. Model 6 instruments are three lags of income growth, consumption growth, real interest rate and error correction model for consumption and income. In the first stage

regression, we report the adjusted  $R^2$  statistics for the OLS regression of change in consumption and change in income on the instruments with p-values in brackets for the Wald test of the hypothesis that all coefficients are zero except the intercept.

The inter-temporal substitution of consumption with respect to the real interest rate has also been estimated and the results have not been included in Table 4. The coefficients found were very small and insignificant in all models. We also found that when using lagged real interest rate as instruments, the estimated coefficient  $\lambda$  is greater than 1 but significant. This may imply that model 4 suffers from specification problems. Thus, the predictive power of interest rates on consumption growth or income growth is not clear in Malawi. This confirms the explanation provided in the model specification in section 4.

The results in Table 5 show that the coefficients of the excess sensitivity remained high under all cases of financial liberalisation. In addition, the estimated coefficients under the three liberalisation proxies are insignificant, indicating that there has been very little contribution from financial liberalisation on the consumption behaviour in Malawi. The failure to find any evidence of financial market liberalisation in Malawi is also in keeping with prior expectations. Despite liberalising interest rates and removing credit controls, financial

**Table 6.** Estimated Results of  $\Delta C_t = \mu + \lambda_1 DUM1_t \Delta y_t + \lambda_2 DUM2_t \Delta y_t + \varepsilon_t$ .

	Model 1 (OLS)	Model 2 (IV)	Model 3 (IV)	Model 4 (IV)	Model 5 (IV)
$\mu$	-0.009 (0.013)	-0.030 (0.113)	-0.018 (0.020)	-0.017 (0.018)	-0.030 (0.023)
$\lambda_1$	0.999*** (0.106)	1.302 (1.488)	1.115*** (0.258)	1.105*** (0.243)	1.343*** (0.292)
$\lambda_2$	0.892*** (0.121)	0.850* (0.469)	0.861*** (0.167)	0.867*** (0.167)	0.0.897*** (0.158)
$\bar{R}^2$	0.793	0.774	0.791	0.791	0.765
D.W.	1.870	1.932	1.891	1.888	1.941
LM(2)	0.006 (0.938)	0.058 (0.810)	0.018 (0.894)	0.016 (0.901)	0.070 (0.792)
ARCH (1)	0.325 (0.569)	0.503 (0.478)	0.367 (0.545)	0.362 (0.548)	0.550 (0.458)
Ramsey's RESET	1.623 (0.108)	0.108 (0.914)	0.807 (0.422)	0.675 (0.501)	0.035 (0.972)
Test of Restriction	-	-0.142 (0.631)	0.002 (0.149)	-0.039 (0.361)	-0.015 (0.281)
F-Statistics $H_0: \lambda_1 = \lambda_2$	0.309 (0.580)	0.054 (0.817)	0.437 (0.510)	0.401 (0.528)	0.377 (0.244)

Note: One, two, and three asterisks indicate 10%, 5%, and 1% significance level, respectively and the figures in brackets alongside the coefficients are t-statistics. In the diagnostic part, the figures in brackets are p-values. Other diagnostic estimates were conducted as included in the table. Under myopia,  $H_0: \lambda_1 = \lambda_2$  and  $\lambda_1 > 0, \lambda_2 > 0$  while under liquidity constraint  $H_0: \lambda_1 > \lambda_2$  and  $\lambda_1 > 0$ .

regulation concerning the authorisation of various financial activities was not fully implemented. This can partly be seen in the oligopolistic tendencies that banks practice in Malawi and the high participation of government in credit uptake. In addition, financial reforms could not work in isolation with unstable macroeconomic environment and weak financial institutions. Therefore, the case of liquidity constraints remained strong despite efforts to decontrol interest rates and abolish credit allocations.

Test for parameter stability was done using Ramsey's RESET test and in testing for over-identification restrictions the adjusted  $R^2$  for a regression of IV residual on the instruments with p-values in brackets for a Wald test that all the coefficients are zero was also conducted. Instruments for models 2 to 6 are lagged variables of consumption, lagged variables of income, and an error correction model.

Following the rejection of permanent income hypothesis even during the liberalisation period, we estimated equation 6 in an attempt to clarify the sources of this rejection. The results in Table 6 show that both liquidity constraints and myopic tendencies are important factors behind the rejection of the PIH in Malawi. One possible reason for existence of liquidity constraints is non-effect of significant structural changes in the formal financial sector (particularly on the banking sector) which failed to

improve on making credit available to most households. As explained in section 2.1, the financial sector was characterised by limited presence in rural areas and high cost of financial intermediation. In addition, apart from government taking up a lion's share of credit, the monetary authority implemented counter-productive monetary policy instruments such as the liquidity reserve requirement which controlled the accessibility of liquidity in the economy. This may have possibly hindered accessibility of finance for those household consumers capable of smoothing consumption. Malawians are also myopic in nature because they depend on current income for their daily living. A large population is located in the rural areas and characterised with low savings, very limited non-human assets and low income. This is the first time the estimation of such nature is found on Malawi though similar to what has been found by Gomes and Paz (2010) on Brazil. It is now evident that the reason for the failure of PIH in Malawi is either liquidity constraint or myopia.

In summary, a closer look at our data reveals drastic changes in some macroeconomic variables starting especially from 2005. The years after 2006 dramatically changed in the economic variables with persistent high increase in economic growth, credit resurgence and decrease in aggregate consumption. Hence, it is quite

conceivable that there were other uncertainties or factors that affected consumption apart from financial policy measures implemented during liberalisation. Following the new political dispensation in 2004, Malawi may have implemented other institutional policies apart from financial reforms. For instance, Malawi introduced the fertiliser subsidy programme which on record has contributed to bumper crop harvest in agriculture leading to high economic growth. Therefore, the households in Malawi may have responded to increased uncertainty or other factors which may have increased precautionary savings and hence reduced the level of current consumption in the economy and increased future consumption later. It would be interesting to analyse all these relationships using a dynamic macroeconomic model.

## Conclusion

The study has found that PIH of aggregate consumption behaviour does not exist in Malawi. Most consumers are current income consumers (rule-of-thumb). They consume from “hand to mouth” and very little is left to smooth consumption in their life time. The magnitude of 90% of excess sensitivity implies that most consumers in Malawi are current income consumers and is much higher than what was found in US and UK but even higher than what was found in other less-developed countries like Fiji. Despite Malawi implementing financial reforms in the 1980s and 1990s, households in Malawi seem to link consumption to current income. It is further observed that there was no shift between the current income consumers and permanent income consumers. The excess sensitivity still remains high during the liberalisation period. The empirical findings have further argued that the main reason for the failure of the PIH is due to liquidity constraint which is manifested in the under development of the financial market and unstable macroeconomic conditions in Malawi. Weak financial institutions, both structural and operational have impacted negatively on the accessibility of financial resources for most Malawians. This is a bigger lesson for policy makers to consider in the preparation of the broad based financial reforms in future.

As reviewed in the literature, further research would be more interesting to investigate the turnaround of economic events after 2006. We have observed dramatic changes in the economic variables with persistent high increase in economic growth, credit resurgence, decrease in aggregate consumption and increase in savings. It would be interesting to model what uncertainties or factors that affected consumption and savings apart from failed financial liberalisation. In addition, it would be interesting to investigate if the established high level of liquidity constrained consumers (rule-of-thumb) in Malawi is included in the small macroeconomic dynamic model (sticky price)

for Malawi. As reiterated in the literature, government action could be destabilising if consumption patterns are closer to the rule-of-thumb than permanent income hypothesis. In particular, it will be informative to investigate the impact of monetary policy or fiscal policy on current income consumers who do not borrow or save but follow a simple rule-of-thumb in Malawi using advanced econometric methodologies.

## Conflict of Interests

The author has not declared any conflict of interests.

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## Annex 1. Financial Liberalisation in Malawi 1987-1998.

Period	Policy Measures
July 1987 April 1988 August 1988 May 1990	<b>1. Liberalisation of Interest Rates</b> Commercial banks started setting their own lending interest rates Deposit rates were deregulated Preferential interest rates to the agricultural sector were abolished All interest rates became fully liberalised
1988 1990	<b>2. Directed credit</b> Credit ceilings and credit rationing were removed Preferential lending to Ministry of Agriculture was abolished
June 1989  December 1990 1997  August 1998	<b>3. Cash Reserves and Liquid Assets Requirements</b> LRR ratio introduced at 10% of commercial bank liabilities with commercial banks earning interest rates on reserves LRR ceased to earn interest rates LRR was changed from daily to monthly average and RBM started paying interest rate on reserves LRR changed back to daily observance by commercial banks and RBM ceased to paying interest rates on reserves
1989  March 1998	<b>4. Competition in the financial markets</b> Review of RBM Act and Bank Act leading to deregulation of entry into the banking sector Entry and incorporation of continental discount house and introduction of interbank market lending among commercial banks
1991 1990	<b>5. Open Market Operations</b> Treasury bills introduced RBM bills introduced
January 1971 February 1971 November 1973 June 1975 January 1984 1990 February 1994	<b>6. Exchange Rate Liberalisation</b> British pound/Malawi pound par value system Malawi Kwacha introduced and pegged to the pound at two to one Peg to a weighted average of the pound and the US Dollar Peg to the SDR Peg to a weighted basket of seven currencies Complete liberalisation of foreign exchange allocation Free floating (with intervals of managed float)
February 1995	<b>7. Liberalisation of capital account</b> Malawi stock exchange established (limited liberalisation of capital markets)

<sup>i</sup>Financial liberalization, financial reforms and financial deregulation mean the same in this study and are used interchangeably.

<sup>ii</sup>Full details of financial liberalization in Malawi are documented by Chirwa and Mlachila, 2004.

<sup>iii</sup>The choice of these ratios was done based on the availability data and the level of development of the financial sector in Malawi. For instance, the stock market is still in infancy stage hence we could not include it to represents financial liberalization

<sup>iv</sup>A list of reform measures were summarized from Chirwa and Mlachila (2004) and these are included in Table 1 of chapter 1.

<sup>v</sup>This formulation will require further improvements to allow the coefficient of indicators of financial reforms to vary with the excess sensitivity as done in Bayoumi (2000).

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