

DRAFT

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***Chapter 1***  
***Regional Trade***

***MALAWI***

***Diagnostic Trade Integration Study***

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## ACRONYMS

ACP	Africa Caribbean Pacific
BLNS	Botswana, Lesotho, Namibia, Swaziland
CET	Common External Tariff
CIF	Customs Insurance and Freight
COMESA	Common Market for Eastern and Southern Africa
DOT	Direction of Trade
EAC	East African Community
EBA	Everything But Arms
EPA	Economic Partnership Agreement
EU	European Union
FTA	Free Trade Agreement
IMF	International Monetary Fund
LCD	Least Developed Country
MFN	Most Favored Nation
OECD	Organization for Economic Cooperation and Development
SACU	South Africa Customs Union
SADC	South Africa Development Community
SPS	Sanitary and Phytosanitary Standards
UNCTAD	United Nations Committee on Trade and Development
WTO	World Trade Organization

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# **CHAPTER 1**

## **REGIONAL TRADE**

### **1.1 INTRODUCTION**

Malawi is a small land locked LDC separated from the markets of OECD countries by some of the largest transport costs in the world<sup>1</sup>, dependent on a single commodity, tobacco, for more than 60 percent of its stagnant export earnings.<sup>2</sup> Given the very small size of its domestic market, international trade has to play an important role in its strategy to stimulate growth and alleviate poverty.

Expanding international trade means developing a more diversified export structure and markets for new export products. In light of Malawi's location and huge transport costs, nearby regional markets need to be given priority in any strategy which involves using international trade as an instrument to achieve long-term development and poverty alleviation objectives. Actually, Malawi already depends on regional sources for more than three quarters of its imports; but only about a quarter of its exports go to markets in the region.

Since Malawi is landlocked, regional relationships are important both in determining trade with regional partners and, because of the importance of transit, in conditioning market access to and imports from the rest of the world. Malawi has recognized the great importance of the regional dimension on its overall ability to trade and has concluded a significant number of trade agreements with countries in the region. The most important of these are the Common Market for Eastern and Southern Africa (COMESA) and the Southern Africa Development Community (SADC). These agreements create significant trade opportunities for the future but also pose a number of challenges for trade policy design and implementation.

The purpose of this chapter is to analyze Malawi's regional trade patterns and agreements in order to identify policy options that the government may consider in formulating a global and regional trade strategy. The chapter is organized as follows: the section following this introduction examines regional trade patterns by country and main product category. The next section reviews and analyzes the implications of the trade agreements which Malawi has concluded or is in the process of negotiating. The last section presents the main conclusions and policy options for the government.

### **1.2 REGIONAL TRADE PATTERNS**

For a landlocked country like Malawi, there are significant problems in identifying the precise destination of its exports and source of its imports. Sometimes data reflect only proximate destination or source ( South Africa, Mozambique) and sometimes, as in the case of tobacco sold at auction, a best guess by the exporter. Nevertheless there are indications that while developed countries continue to be Malawi's main markets for its exports, in particular tobacco, their share has declined substantially in the last decade (Table 1.1). On the import side, the shift towards developing countries and regional sources is even more pronounced. The EU share in particular

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<sup>1</sup> UNCTAD, 2001.

<sup>2</sup> According to the IMF DOT, total exports in 2000 were \$442 million, compared to \$419 million in 1990. Total imports were \$622 million in 2000 and \$627 million in 1990.

has shrunk a great deal, from about a third of total in 1995 to less than 10 percent in 2000. Regional sources accounted for more than 75 percent of total imports in 2000 with South Africa having the lion's share of the total. However it is important to emphasize that these major shifts in the direction of trade have been occurring within a stagnant total both for exports and imports.

In reviewing regional trade patterns, it is first necessary to define the 'region'. For the purpose of this analysis, the region consists of all the twenty five countries in the two regional trading groups, COMESA and SADC to which Malawi belongs. COMESA countries accounted for 10 percent of Malawi's exports and about the same percentage of Malawi's imports in 2000; and SADC for about 17 percent of its exports and almost 53 percent of its imports (Table 1.2). As there are eight countries which are members of both groups (e.g. Zimbabwe, Zambia) countries in the two groups together account for 23 percent of Malawi's total exports and a little more than 53 percent of exports<sup>3</sup>. Trade with African countries other than those in COMESA and SADC is small; but trade, especially imports from developing countries outside Africa, such as India, is substantial and rising.

COMESA's share of Malawi's imports has been declining while its share of Malawi's exports has been rising. This is primarily because imports from Zimbabwe have declined drastically in recent periods<sup>4</sup>, and Malawi imports vary little from other COMESA countries. On the other hand, Malawi's exports to COMESA countries such as Egypt, Kenya and Zambia have been increasing rapidly in the last three years.

South Africa, a member of SADC but not of COMESA, is Malawi's main trading partner, holding a rather large (more than forty percent) share of its total imports. However, its share of Malawi's exports has dropped substantially in recent years, to less than 10 percent of the total. Even so, it continues to be by far the largest regional destination of Malawi's exports (Table 1.2). The main reason for the decline has been reduced exports of textiles and clothing. South Africa is also important because it is the main transit country for Malawi's key export of tobacco.<sup>5</sup>

In addition, there appears to be substantial cross-border trade with Tanzania, Zambia and Mozambique. According to one estimate,<sup>6</sup> in 1995-96 informal trade with the first three countries actually exceeded formal recorded trade. Distortions in Zimbabwe's economy in recent periods have stimulated increases in 'informal' transactions. There is increasing cross-border activity with Tanzania and Mozambique as there are incentives in both countries to avoid import controls and border taxes.

In terms of trade composition, Malawi has recently made some important gains in the Egyptian tobacco market as well as in Kenya's sugar market. By contrast a decomposition of Malawi's exports to the SADC market shows that they tend to consist of a higher proportion of manufactured goods, with textiles and clothing exports to South Africa being the most important

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<sup>3</sup> Imports from COMESA countries other than Zambia and Zimbabwe, which are also members of SADC, are very small.

<sup>4</sup> That is, at least the officially reported imports have declined. There is anecdotal evidence that a lot of the imports from Zimbabwe have gone underground and are not reported because traders are taking advantage of the dual exchange rate regime prevailing in Zimbabwe in recent periods. The situation has led Malawi to impose selective controls on imports from Zimbabwe.

<sup>5</sup> Indeed there is some question as to whether some of Malawi's tobacco exports to South Africa are truly intended for that country's market or are simply goods in transit. If South Africa is shown as the country of destination in the exporter's declaration then it is considered the country of final destination even in cases where the goods are re-exported. See Imani-Capricorn, 2001.

<sup>6</sup> Imani-Capricorn, 2001.

item. However, exports of these products to the South African market have stagnated in recent periods for reasons discussed below. So have exports of other products, such as vegetables, sugar and tobacco to both South Africa and other SACU countries such as Botswana.

On the import side South Africa is the main source for a large variety of final goods products, machinery and equipment as well as inputs such as oil, fertilizers and pharmaceuticals. In addition, maize has been imported in substantial quantities from regional sources during recent drought periods.

### **1.3 REGIONAL TRADE AGREEMENTS**

These regional trade patterns have to some extent been affected by regional trade agreements in which Malawi is already participating. However, many of these agreements, while formally signed some time ago, have become operational only recently. Thus, their impact is likely to be felt more strongly in the future. At the same time, some of the existing bilateral trade arrangements ( e.g with South Africa) will be affected by the new arrangements being put in place under SADC.

All of the agreements have been motivated to a significant extent by political considerations. The economic and trade implications of their implementation have not been fully analyzed by participating countries. As a consequence, many countries have found it difficult to implement the agreements after they have signed them. Their participation in multiple and overlapping agreements introduces a great deal of complexity in incentives to the trading community and presents a challenge for the customs authorities to implement. The multilateral and bilateral agreements to which Malawi belongs are discussed below. The descriptions focus at some length on implementation aspects such as the determination of the rules of origin, which are essential for the operation of these preferential trade arrangements.

#### **1.3.1 COMESA**

The Common Market for Eastern and Southern Africa (COMESA) came into force in 1994. Its twenty member states ( see Box 1.1 for a listing) aim to establish a common external tariff (CET), and thus become a customs union, by November 2004. In the meantime, the members have established a number of preferential trading arrangements with each other. First, there is a Free Trade Agreement (FTA) currently in operation among nine countries ( see Box 1.1) including Malawi. Trade among these countries is at zero tariffs for all products. Second, there are several countries which offer preferential treatment to each other's exports. In some cases<sup>7</sup> the preferences amount to 80 percent of the MFN tariff, in others<sup>8</sup>, 60 percent. Trade between the countries which are members of the FTA and the others takes place at the latter's preferential rates. During 2001 a number of the countries presently offering only preferential treatment indicated their intention to join the full fledged FTA.

When COMESA becomes a customs union in 2004, the future participation in COMESA of at least four countries, Namibia, Swaziland, Kenya and Uganda, will be problematic. The first two countries are already members of the South Africa Customs Union (SACU). They cannot continue to be members of the SACU customs union and a different one in COMESA. They can only have one common external tariff, either that of SACU or that of COMESA. Similarly, Kenya and Uganda have signed an agreement with Tanzania to establish a customs union under the East African Community (EAC) by 2004. They cannot have a common external tariff under the AC and a different one under COMESA.<sup>9</sup>

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<sup>7</sup> Comoros, Eritrea, Uganda.

<sup>8</sup> Burundi, Rwanda.

<sup>9</sup>It has been argued that the EAC and COMESA could be made compatible if their CET is the same. This would be correct, except that under the EAC, Tanzania and Uganda expect to undertake an asymmetric liberalization vis a vis Kenya, i.e. Kenya's trade barriers will come down faster vis a vis the other two countries than vice versa. Thus, the two agreements are incompatible, even if the CET is the same, as Uganda and Kenya under the COMESA customs union are expected to liberalize symmetrically (COMESA, 2002).

**BOX 1.1 MEMBERSHIP IN REGIONAL ECONOMIC ORGANIZATIONS**

Country	COMESA	SADC	SACU	EAC
Angola	X	X		
Botswana		X	X	
Burundi	X			
Comores	X			
Congo	X			
Djibouti*	X			
Egypt*	X			
Eritrea	X			
Ethiopia	X			
Kenya*	X			X
Lesotho		X	X	
Madagascar*	X			
Malawi*	X	X		
Mauritius*	X	X		
Mozambique		X		
Namibia	X	X	X	
Rwanda	X			
Seychelles	X	X		
South Africa		X	X	
Sudan*	X			
Swaziland	X	X	X	
Tanzania		X		X
Uganda	X			X
Zambia*	X	X		
Zimbabwe	X	X		

\*Member of COMESA FTA

In addition to the preferential trade arrangements, there are other COMESA institutions aimed at promoting regional trade, for example, an export credit facility in which several COMESA members, including Malawi, participate.

In all cases, the preferential treatment accorded to participating country exports is based on rules of origin. In determining origin in the current COMESA agreement, four alternatives can be used at the option of the importer:

- the value added principle is employed with a minimum threshold of 35 percent value added in the exporting country (with the threshold reduced to 25 percent for certain products which are considered 'developmentally important');
- change of tariff classification following in-country transformation;
- totally produced in country (no imported inputs);
- imported content no more than 60 percent of total CIF value.

Of course, once a full fledged customs union is in place, no rules of origin would apply to trade among its members.

### **1.3.2 SADC**

The SADC Treaty was signed in 1992 with the objective of creating a development community that would achieve broad economic and development integration objectives. Membership covers the five countries of the Southern African Customs Union (SACU) and nine other countries, including Malawi, Zambia and Zimbabwe (see list in Box 1.1). The Trade Protocol, signed in 1996, and entered into force in 2000, aims at establishing an FTA by 2012. Because of the different levels of development of its membership, trade liberalization is asymmetric, with South Africa liberalizing its market faster than the other members, and with differences also in the pace of liberalization between the countries classified as 'developing' (Zimbabwe and Mauritius) and the others, including Malawi, which are Least Developed (LDCs). Malawi will not begin to liberalize towards South Africa until 2005, while liberalization towards the other countries will begin in 2003.

Liberalization will occur progressively in different products:

- Category A products, mostly capital goods and raw materials with very low or zero tariffs already, comprising about 47 percent of SADC trade, will be liberalized upon each country's accession.
- Category B goods, a mixed group of products accounting for another 40 percent of the total will be liberalized at a different pace for the various country groups over 8 years, with South Africa's liberalization being the fastest and Malawi's and other LDCs the slowest.
- Category C products, characterized as 'sensitive' will start being liberalized 5 years after accession and will reach zero tariffs in 2012. Sensitive products for Malawi are sugar, confectionery, beer, textiles, matches and motor vehicles.<sup>10</sup>

In addition to these rules regarding tariffs, there is a separate agreement involving sugar; and there are separate quantitative restrictions involving textiles in the SACU markets, both of which would affect Malawi's exports.

SADC has also adopted rules of origin for the FTA which are based solely on the principle of product transformation (single or double) but which vary by product group; an approach which is different from the one currently used in COMESA and the bilateral preferential agreements that Malawi has signed.<sup>11</sup>

The SADC agreement on textiles and clothing is between the SACU countries and Mozambique, Malawi, Tanzania and Zambia and covers exports from the latter four countries to the SACU market. Under this agreement, Malawi textile companies can export to SACU duty free and with no quota, as long as there has been a two-tariff heading transformation of the article in question. If there is only a one-tariff heading transformation, there is a quota for imports into SACU (in practice the quotas seem to be solely with respect to South Africa) with different quotas per country per tariff line. Apparently, SACU has also agreed, in principle, to the possibility of transferring unused quotas among the exporting countries.

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<sup>10</sup> It is unclear why motor vehicles was put in the 'sensitive' list for Malawi as there is no domestic production or assembly. Perhaps it was because of customs revenue implications of eliminating the tariff. The products excluded from the FTA primarily involve items typically excluded for health, safety and similar reasons.

<sup>11</sup> This essentially means that the product is judged eligible for preferential treatment when the transformation that has occurred in the exporting country results in a change in its category of tariff classification, at least once, e.g from raw material to semi-processed, or twice, to final good.

### **1.3.3 Bilateral Agreements**

**South Africa.** An asymmetric trade agreement with South Africa has been in place since 1990. Under this agreement, Malawi exports are admitted into South Africa duty free provided they have 25 percent local value added, while South African exports to Malawi are only accorded MFN treatment. Also, agricultural and agro-industrial goods enter South Africa under authority of an import permit. In this respect there are two lists: the first includes a wide range of products while the second consists of coffee, tea and sugar. There are quantitative restrictions on some products, and there is a *minimum* volume for permits issued for tobacco and groundnuts<sup>12</sup>. The agreement is supposed to lapse in 2008 and superseded by SADC arrangements regarding tariffs. In the meantime, as noted above, quantitative restrictions on certain Malawi exports to South Africa and other SACU countries have been put in place as part of the SADC agreement.

**Zimbabwe.** There is a reciprocal bilateral preferential trade agreement which came into effect in 1995. The agreement provides for reciprocal free trade in all products, provided there is 25 percent local value added and the product conforms to the required national standards in the importing country. At present, this agreement is virtually identical to the FTA in place among COMESA members, except that the rules of origin are slightly more lenient. The agreement will be superseded when the two countries become members of the COMESA customs union in 2004.<sup>13</sup>

**Potential Bilaterals.** The government has been considering the conclusion of bilateral free trade arrangements with Zambia, Tanzania, and Mozambique. In Zambia's case the intention is to negotiate an agreement in the COMESA context which however, involves a less demanding threshold in the rules of origin of 25 percent of value added—ie. the same as with the agreement with Zimbabwe. In the case of the other two countries Malawi exporters are finding it difficult to access their markets. In Tanzania's case, which previously had been a member of COMESA but withdrew, the problem is that the MFN tariffs are too high. In Mozambique, the concern is with administrative procedures and barriers. In both cases the objective would be to move faster in liberalizing trade than the SADC agreements make possible. Of the three agreements, the one with Mozambique appears closest to being concluded.

### **1.3.4 Preferential Arrangements with the European Union**

While this chapter is focusing on regional trade arrangements, it is necessary to make an important aside regarding trade relationships with the European Union (EU). Malawi is a member of the ACP countries which have concluded the Cotonou agreement with the EU. Under the terms of this agreement, the preferential treatment Malawi receives in EU markets at present will be modified starting in 2008. At that point, Malawi, an LDC will have an option: it could either continue to receive preferential treatment for its products in EU markets under the latter's Everything But Arms (EBA) initiative for all LDCs; or it could participate in a yet to be determined regional trading group which would conclude a reciprocal but asymmetric preferential trade agreement with the EU. Actually, the decision on this would have to be made much sooner, as the EU is already starting to discuss with different groups of ACP countries,

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<sup>12</sup>Imani-Capricorn 2001, COMESA, 2002.

<sup>13</sup> There is also an old bilateral 'customs' agreement with Botswana which covers manufactures and under which Malawi exported some sugar to that country. Presumably this agreement will be (or already has been) subsumed under the SADC arrangements.

especially in West Africa and the Caribbean, the conclusion of these so called Economic Partnership Agreements (EPAs)<sup>14</sup>.

Given that there are at least two regional agreements (COMESA and SADC) to which countries in Eastern and Southern Africa, including Malawi belong,<sup>15</sup> the question is which of the arrangements will be the one with which the EU negotiates an EPA. At present, the ACP countries are envisaging a two stage process. During the first stage, which is to last until the Fall of 2003, the ACP countries will negotiate as a group on the overall principles and conditions of the EPAs including such items as the rules of origin and the fate of the existing commodity protocols on sugar, rice and bananas ( although these would be progressively phased out under the EBA). In the second stage the details of the regional arrangements will be decided.

In practice and for various reasons, there will be a need for a cooperative approach between the various regional groups that have been formed in Eastern and Southern Africa and especially between COMESA, SADC and EAC. First, these groups will have in any case to reconcile the various inconsistencies in the legal commitments of countries with joint membership in more than one group (see above). Second, it would be problematic for the EU to negotiate with either SADC or COMESA as such, since the former contains South Africa, which is not an ACP member and with which the EU has a separate agreement. Similarly, COMESA contains Egypt, also a non-ACP country with which the EU has a different preferential agreement<sup>16</sup>. The point is that both the need to reconcile the differences resulting from the overlapping memberships and the pressure of the EU to find a suitable regional grouping with which to negotiate an EPA may lead to yet another reshuffle of the existing preferential arrangements in which Malawi is participating.

#### **1.4 IMPLICATIONS OF THE REGIONAL ARRANGEMENTS FOR MALAWI**

The regional trade arrangements in which Malawi is participating and the negotiations on the Cotonou agreement are presenting the government of Malawi with a number of important challenges. Some of these challenges are short-term in nature and need to be addressed on an urgent basis; others are more for the medium- to longer-term, and require the development of a strategy that would be implemented over time. In dealing with these challenges and developing a longer-term strategy, Malawi needs to keep in mind some of the main lessons about regional integration among developing countries and apply them to the realities it faces at present.

A key lesson about South—South integration is that preferential trade arrangements among developing countries tend, as a rule, to result in unequal benefits, favoring the largest and more advanced.<sup>17</sup> This issue has been explicitly recognized in SADC and an effort has been made to deal with it through asymmetric liberalization. While it is too early to judge the success of this approach in this case, the government needs to be alert to the potential problems stemming from it, especially as there is little evidence that asymmetric liberalization has succeeded in avoiding polarization of benefits in other regional groupings of developing countries, that have tried it, for example in Central America.

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<sup>14</sup> These arrangements originally were referred to as 'Regional Economic Partnership Agreements' (REPAs).

<sup>15</sup> And a third one as well, the East African Community, with membership by Kenya, Tanzania and Uganda.

<sup>16</sup> SADC, 2002; COMESA, 2002.

<sup>17</sup> World Bank, 2000.

Another key lesson is that all regional groupings tend to yield greater benefits to their participants when the overall trade regime is liberal rather than when the trade regime is closed to the rest of the world. North—South regional preferential arrangements such as those proposed in the context of Cotonou, can be particularly beneficial to developing countries. Their main benefits are dynamic and long-term and result from the additional investment and technology flows that may be expected to occur from the stronger integration of the economies. Their costs, like those of all preferential arrangements, result from the trade diversion that they generate, i.e when the preference margins result in shifting from a low cost producer outside the preferential area to a high cost one inside. However these costs would tend to be lower, the greater the existing trade links between the countries *without preferences* and the lower the degree of overall protection against third country imports. This implies that Malawi should maintain low overall protection towards the rest of the world even as it engages in preferential trade arrangements with regional partners or the EU.

And a final lesson, is that the benefits from economic integration derive less from trade preferences as such but from 'deep integration' in which countries align a variety of economic policies to create a single market or a common economic space. It is only then that the benefits from the economies of scale, which are so important in stimulating productivity and growth, appear to materialize.

### **1.4.1 Short-Term Challenges**

**Implementation.** The first challenge faced by the Malawi government is the sheer problem of implementing the complex set of agreements in which it is participating. This is a challenge primarily for the customs authorities which have to scrutinize imports from a variety of sources each with a different tariff rate and each subject to different rules of origin. To be precise, Malawi's tariff schedule has to have six rates for each product line<sup>18</sup>: (a) the basic, non- MFN rate ; (b) the MFN rate, (c) the rate applied to various COMESA members with which a full FTA is not in force ( which could be 40 percent or 20 percent of the MFN rate for different countries; (d) the rate to be applied to imports from South Africa ( as part of the SADC agreement); (e)-(f) the rates applied to non -COMESA SADC – one for Botswana, Lesotho, Namibia, Swaziland-BLNS and one for the rest of SADC (as the rate of Malawi's import liberalization towards the BLNS countries and the rest of SADC is different). Note also, that imports from COMESA are not supposed to pay the surcharge of 20 percent. However the surcharge is actually paid and has to be reclaimed later. An important issue for regional trade, in this context, is how quickly the refunds are being made.

In addition, having determined the source of the imported merchandise, a determination has to be made as to whether it meets the rules of origin requirements so that it can be extended a preferential rate. Recall, in this context, that the two regional arrangements (COMESA and SADC) to which Malawi belongs have alternative ways of determining origin, as do the bilaterals. Thus, for a single product coming from Zimbabwe, there could be three different tariff rates that would potentially apply: zero under COMESA or the bilateral, the SADC rate—in the unlikely circumstance that the good does not qualify under the COMESA or the bilateral—or the MFN rate, if the product does not qualify for any of the preferences, and three rules of origin, the bilateral, COMESA and SADC.

The basic rule that is supposed to be applied is that the good would enter under the provisions and rules most favorable to the importer. Thus, in principle there should be no problem. Having determined under which agreement the good will be entering Malawi, the certificate of origin would be checked. While the customs officers are well trained, the situation is so complex that issues of interpretation will inevitably arise. The opportunities for both confusion and corruption will multiply and could undermine the whole purpose of setting up a trade agreement.

On the exporting side, there are different issues. Some of the multinationals which operate in several of the countries in the region have segmented the regional markets; thus, one company with producing plants in both Malawi and South Africa may use the Malawi plant to supply COMESA markets in Zambia, but the South Africa plant to supply SACU or Mozambique. Thus, the opening up of markets through the provision of additional preferences may not influence the direction of trade. On the other hand, for small or new potential exporters, the multiplicity of markets and rules creates considerable confusion and makes it more difficult to trade.

As a general rule, the COMESA arrangements are being viewed by exporters as being simpler and more beneficial, while the SADC provisions have appeared to be more complex and to involve uncertainties regarding which rules will apply in particular products. The tobacco exports to Egypt and sugar exports to Kenya have been noted; but it appears that Egypt is viewed as a market for a wider range of products, including vegetables and other agricultural products.

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<sup>18</sup> An additional line would be needed if Malawi joins a preferential agreement with the EU.

The SADC arrangements on textiles and several other products are likely to be less advantageous to Malawi's exporters than the situation prevailing under the Malawi—South Africa bilateral up to recently. At the same time, South Africa had been concerned about the influx of textiles and clothing from Malawi for some time and had already taken steps in the form of anti-dumping actions to limit them even under the existing agreement. As noted earlier, these exports have stagnated in recent periods.

There is little that Malawi can do to change the SADC arrangements at present. Participation in the SADC agreement became necessary when South Africa decided to create another free trade area and not join COMESA. Malawi had to participate in SADC in order to protect, to the extent it could, the preferences it was receiving in South Africa, its biggest market in the region.

Looking ahead, Malawi faces a number of longer-term challenges in the SACU market which will be addressed below. However, in the short term, its participation in both SADC and COMESA will require strengthening of the capacity of its customs service and its trade-related institutions in order to implement the complex intertwined agreements, as well as informing exporters of the new rules affecting access to regional markets, so that the private sector can take advantage of new opportunities that may arise from the agreements. There are also questions as to how the government will implement specific aspects of the agreements, for example what mechanism would be used to allocate and administer the textile and clothing quotas in SADC equitably and efficiently. In principle, auctioning of these quotas is the most efficient solution, which also produces some revenues to the government. There is international experience with auctioning of such quotas for example, by developing countries which are implementing the WTO Agreement on Textiles and Clothing, which would be useful in implementing this SADC arrangement by Malawi.<sup>19</sup>

There may be a few things that could be done also to improve the operation of the South Africa bilateral, as long as it lasts. For example, there should be no reason to impose a *minimum* value on contracts on tobacco or groundnuts shipped to South Africa. Such a limitation would tend to result in discrimination against small producers and traders, the very groups that Malawi would like to help under its poverty reduction strategy.

***The Compatibility between SADC and a COMESA Customs Union.*** As noted above, it is possible for Malawi to be a member of several different preferential arrangements at once. The main difficulties, and they are formidable, relate to the implementation of these agreements at the border, and the opportunities for smuggling and corruption they create. However when COMESA becomes a customs union, as it plans to do in 2004, additional problems are created which could be sufficiently serious as to require a rethinking of the whole architecture of trade agreements in the region. These issues are complex and attention to them is needed immediately in order to reach an understanding of how to deal with them by 2004, otherwise the implementation of the customs union will be delayed.

For Malawi, the first step in implementing the COMESA customs union agreement would be to align its external tariff to the common external tariff (CET) of the customs union. The CET has been agreed to have four tariff bands, 0 percent on capital goods, 5 percent on raw materials, 15 percent on intermediates and 30 percent of final goods. At present such a tariff structure is pretty close to Malawi's, except that Malawi's tariffs on final goods are lower than 30 percent. Acceptance of the 30 percent tariff on final goods will not significantly affect the overall level of protection in Malawi. However, in keeping with the general principle discussed earlier that

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<sup>19</sup> There were also uncertainties regarding the SACU treatment of a number of other products such motor vehicles and wheat and flour, whose resolution at this time is unclear.

Malawi should maintain low protection towards third countries while participating in preferential arrangements, the government could work in COMESA with countries like Uganda and Zambia which have similarly low tariff protection, to reduce the CET on final goods to below 30 percent.

Dealing with Malawi's complex system of surcharges and excises may present a different set of problems. There appears to be no provision in COMESA under which countries would harmonize their policies on surcharges or excises imposed by its members that apply to imports from outside the customs union. If for example Malawi imposes a 20 percent surcharge on all imports and Zimbabwe does not, products intended for Malawi would be shipped to Zimbabwe and then transhipped, in order to avoid paying the surtax. Similar problems will arise when excise rates are very different. Unless there is an understanding on these issues, disputes will arise later on, as there would be significant opportunities for trade deflection and revenue loss.

Trade deflection is again the essence of the problem of establishing a COMESA customs union, when some of its members are also members of SADC and some are not. Take for example a South African product on which the COMESA tariff is 30 percent. Malawi as a member of SADC may impose no tariffs on this South African product. However under COMESA, it would have to levy a tariff of 30 percent. As both regimes are legally binding, neither takes precedence over the other. If Malawi ignores the COMESA commitment, the product could enter Malawi and from there be shipped to Kenya duty free because both Kenya and Malawi belong to the COMESA customs union; although there is no free trade agreement between Kenya and South Africa. In a sense, this would present more problems for Kenya, the non-SADC member, than Malawi. However the problem would need to be addressed by the COMESA members as a group and not solely by Malawi or the other members of COMESA which are also members of SADC. If Malawi imposes a duty of 30 percent in keeping with its COMESA commitment, it will go contrary to its commitment in SADC and the South African exporters would complain.

There are various ways of dealing with the problem. One way is to explicitly choose to ignore it and accept some deflection. The problem may not be that serious because there are few common borders between countries that are in both groups, and countries that are only members of COMESA. Thus, the opportunity of transshipment between two countries which, as members of the customs union would have no border controls, is limited. In such cases, COMESA members could accept the maintenance of border controls even after the customs union is in place<sup>20</sup>.

For non-contiguous COMESA members, for example, for imports into Kenya from Malawi a certificate of origin would be needed in any case at the Kenyan border or port of entry, to ensure that the goods are truly from Malawi, rather than South Africa. Of course, such an arrangement would continue to give rise to opportunities for mislabeling and corruption, but these are endemic in all preferential arrangements without scrupulous and effective administration of rules of origin.

Another way is to establish a full, formal free trade arrangement between all countries in COMESA and SADC. This would enlarge the scope of free trade and reduce the incidence of corruption and smuggling. Yet another arrangement would be to establish two customs unions, one based on COMESA membership and one on SACU, which may be expanded to include more members from the SADC countries, and establish free trade relationships between the two customs unions. However, given the difficulties encountered in negotiating the SADC and

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<sup>20</sup> The problem of incompatibility is even more acute between COMESA and EAC where the countries share several borders.

COMESA agreements in the first place, it is likely that this should be viewed as a long term challenge for the region rather than one that could be negotiated in the short run.

#### **1.4.2 Medium-Term Challenges in Regional Trade**

***The emerging competitive challenges in the region.*** The regional arrangements that are taking shape will present serious challenges to the competitive position of Malawi's producers and exporters. The pressure of competition in the domestic markets will not increase significantly for some time, as under the SADC agreement preferences to South African firms will not start being implemented until 2005. If Malawi participates in an EPA with the EU, preferences to the EU are likely to be delayed for some time. However both South Africa and, to a lesser extent, the EU already offer substantial competition to domestic producers and have significant shares of the Malawi market even without any preferential arrangements.<sup>21</sup> Over time, additional competition will come from these and other countries in the region. It should be noted that precisely because South Africa and the EU already enjoy such a large position in the Malawi market, there is a presumption that extending trade preferences to them may not result in significant trade diversion.

Unlike the domestic market, the situation facing Malawi's exporters in South Africa, their main regional market, will become more challenging very quickly. This is because Malawi will no longer be alone in enjoying preferences in South Africa's markets, as it did under the bilateral agreement it had with it during the last decade. It would face competition from other regional suppliers which are members of SADC. Similarly, Malawi can expect increased competition from other SADC countries in Zimbabwe, a market in which it previously faced competition only from COMESA members.

Regional markets are the most important markets on which to focus an export strategy for Malawi. It is far more difficult to market and compete in distant markets in the US and the EU than in regional markets, where there is already some familiarity and local business contacts. The emerging competitive challenges in regional markets imply that Malawi producers and exporters have to redouble their efforts to increase their productivity and keep their competitive edge even to maintain their existing market shares. There is also a need to systematically analyze regional market trends and opportunities in relationship to Malawi's strengths and develop strategies for expanding penetration in regional markets. Imani-Capricorn (2001) provides the example that Malawian rice has a certain flavor that is popular in Zimbabwe; but it needs to be given a brand name in order to differentiate the product.

It is also very important for the government to consider what it can do to assist regional exports. Some measures which are of general importance in stimulating exports may be of particular importance in a regional context. For example, measures to reduce administrative approvals and clearances could be simplified for regional exports (i.e. to countries which are members of the COMESA customs union or SADC); transport costs to regional markets could also be reduced by increasing competition and reducing costs in the trucking industry.

***Government revenue issues.*** Customs and excise duties together account for 60 percent of the tax base, with the surcharges and excises being more important than the tariffs. The preferential arrangements that Malawi has concluded will not have a significant effect in the short-term, but will have an effect in the medium-term.

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<sup>21</sup> Though EU's share is shrinking, and may be part of the reason why the EU is seeking preferential access to Malawi's and other ACP markets through the EPAs.

As Malawi already provided very large preferences on COMESA imports at the time the COMESA FTA was established, the loss in revenue resulting from the tariff reductions was minimal, close to 0.5 percent of total budgetary revenue. The same is likely to be the case when a customs union is established. Indeed the reduction in revenue was small because, as has been noted before, a large portion of the government revenue results from the imposition of excises and surtaxes, not tariffs. Furthermore, excises were not affected by COMESA while the surtaxes were already being waived.

When economic integration takes the form of a free trade area, there is no presumption that the participating countries will do much to align their policies on taxation. However in a customs union, unless there is some harmonization, especially on excises, there is likely to be trade deflection and smuggling to avoid paying the taxes. In principle, COMESA should move in the direction of trying to harmonize both the surtaxes and the excise tax rates of its members. If it does, then Malawi needs to examine the implications of changing these rates on its revenue, as part of a longer-term effort to diversify its revenue sources.

While the revenue effects of COMESA are likely to be small even in the medium-term<sup>22</sup>, this is not the case for SADC. It is estimated that when import taxes on South Africa drop to zero, this will result in a 60 – 70 percent reduction of trade tax revenue and a decline of 7.3 percent in total government revenue<sup>23</sup>. However this effect will not take place for a while, since Malawi's imports from South Africa, which is the main SADC source, will be liberalized only very little in the first four years, until 2005. However there will be an effect in the later part of the liberalization period, i.e. in years 2005-2012. At the same time, if the volume of trade increases, this for a while would offset the reductions in the tariff rates. Even so, at the end of the day, Malawi will have to replace some revenue lost because of trade liberalization with South Africa and SADC and perhaps some more later on, if it gets involved in an EPA with the EU (see below). This means that it has to start thinking now about what alternative measures of taxation it can employ to replace the lost revenue. As new tax systems and approaches take time to design and implement, and even longer to yield any revenue, it cannot afford to wait until the revenue losses start occurring to start thinking about what to do.

***The EU EPAs and EBA.*** Under the terms of the Cotonou agreement, an LDC like Malawi does not have to enter into a EPA with the EU. It can choose to maintain access to the EU markets through the generous preferences (duty and quota free access for all products, after 2008) the EU is committed to provide for LDCs. However the EU is already exerting pressure for all ACP members to participate in EPAs. Malawi does not need to make an immediate decision whether or not to participate in an EPA. It could continue to participate in the first phase of general discussions with the EU, until 2003, while it analyses what is advantageous for it to do.

EPAs would involve certain costs in additional trade diversion. The preferences that would ultimately have to be extended to EU suppliers would mean that these suppliers could displace a low cost supplier from a third country which does not enjoy preferential treatment into Malawi, thus imposing a higher cost to the Malawi consumer—whether an individual or a firm. It could be argued that association with the EU is not going to result in significant trade diversion costs as the EU is already a least cost supplier in a range of products marketed in

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<sup>22</sup> As long as they are limited to tariffs and surcharges.

<sup>23</sup> Imani- Capricorn, 2001.

Malawi. However, the volume of EU imports into Malawi is shrinking, i.e it is not the competitive supplier it once was. Thus, some trade diversion costs, however small, will remain. There would also be some costs in lost tariff revenue. There is also a fear that increased EU competition would hurt domestic producers<sup>24</sup>. At the same time, the EPAs are not, in principle, likely to provide greater access to the EU market than the EBA initiative as the latter is supposed to provide totally free access to all LDC products after 2008, the time when the EPAs themselves are starting to operate. Thus, if the EPAs offer no better access to EU markets and they entail some, however small, costs, why should an LDC like Malawi join the proposed EPAs?

There are a number of possible reasons, which the Malawi authorities need to evaluate carefully, before reaching a decision. First, the EBA involves a unilateral, autonomous offer of preferences from the EU. It can be unilaterally withdrawn, for example, under pressure from domestic EU interests adversely affected by the preferences provided. The EPAs involve a contractual treaty arrangement with the preferences not as easily withdrawn. Of course, if there are serious pressures from domestic EU producers, even the 'contractual' EPA arrangement may be modified; but EPAs probably involve some additional security of access.

Another issue has to do with what happens when and if the EU modifies the market access regimes for products of importance to Malawi such as sugar.<sup>25</sup> Malawi, as an LDC, will be obtaining an increase in its quota in the EU market of 15 percent per annum until the EU sugar market is liberalized in 2008. Malawi and some other existing ACP sugar producers with quotas in the EU appear concerned as to what will happen to the EU market if the ACP sugar protocol is permitted to expire, and are lobbying for its continuation. The fundamental question is how Malawi, would fare under a 'free' sugar regime. Much would depend on what happens in the EU sugar market and what is the supply response in Malawi and other ACP producers. A serious analysis of the sugar situation needs to be made before a decision on the broader EPA issue is taken.

It is clear that while an EPA with the EU will increase competition and hurt certain producers in the short term, increased competition from abroad can be a stimulus to domestic productivity and efficiency. In this respect, an EPA with the EU is likely to create benefits and not only costs.<sup>26</sup> The issue for Malawi here is not whether to liberalize or not, but whether to do so by providing preferential treatment to EU exporters as opposed to liberalizing multilaterally.

Regarding the important matter of the rules of origin, Malawi combined with other ACP states may be able to negotiate a more favorable treatment than that accorded by the EU under the EBA. This is an important issue because only a small proportion of potential EU imports ( less than half) are actually extended preferential treatment because they do not meet the rules of origin criteria.<sup>27</sup>

The EU is not suggesting that countries joining EPAs would be getting more EU assistance than countries that do not. The aid component of the Cotonou agreement is not conditioned on participation in the EPAs, and the assistance resources available to the agreement appear to be

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<sup>24</sup> Malawi, 2002.

<sup>25</sup> Page, 2001.

<sup>26</sup> COMESA, 2002.

<sup>27</sup> Brenton and Manchin, 2002.

fixed. At the same time, an EPA offers the opportunity, but not the certainty, of further deeper integration through alignment of other policies with the EU which may have a lot of potential benefits for a small country like Malawi and which could exceed the costs associated with the extension of trade preferences. One of the questions that Malawi (and other LDCs) need to be asking the EU is what additional benefits would participation in an EPA provide to it. Would, for example, the EU be prepared, as part of the establishment of a EPA, to exempt products from a country participating in an EPA from anti-dumping actions? Would it be prepared to commit in advance to provide help to a developing country exporter to meet any new sanitary and phyto-sanitary standards the EU imposes?

A final consideration, which is not something that Malawi itself can influence, but which could be useful to Malawi, is whether the EU finds it convenient to exert pressure for some rationalization of the existing preferential trade agreements among Eastern and Southern Africa as part of the process of creating an EPA. One way the EU could do this would be by helping to forge an explicit link between all members of the COMESA customs union as a group (except Egypt) and SADC (except South Africa). There may be other possible arrangements, keeping in mind that the EU as part of the Cotonou agreement has committed itself not only to establish EPAs but also 'alternative equivalent arrangements' that maintain ACP members' access to EU markets.

In sum, Malawi, over the next year or two would have to make a decision with regard to joining an EPA or not. There are three basic options: (a) to jointly negotiate an EPA with a group of other Eastern and Southern Africa countries; (b) to negotiate an EPA individually with the EU; (c) to stay out of the EPA and enjoy the benefits of access to the EU market through the EBA, as well as the other aid benefits it would rightfully enjoy as a member of the ACP and a signatory of the Cotonou agreement.

#### **1.4.3 Regional Institutional Capacity**

A great deal of attention has been devoted to trade preferences as a vehicle for expanding regional trade and much less to other cooperative efforts among the countries in the region. Yet both COMESA and SADC have created the framework for regional cooperation in trade related policies and capacity building which is much needed in the countries in the region.

The COMESA export financing facility has been noted. However there is little evidence of its use and what can be done to make it more effective as a vehicle of trade expansion. It was also noted that countries which have formed a customs union should start thinking about how to integrate their economies more fully, including through cooperation on broader tax policies and other measures to facilitate trade.

Cooperation among the customs authorities of the SADC countries is especially important in making a Free Trade area work effectively. Cooperation is especially needed in reducing the transaction costs for transit through neighboring countries such as Mozambique, Tanzania and South Africa. And cooperation is needed in strengthening competition and breaking up regional monopolist structures such as those that exist in the trucking industry, and in influencing the policies of multinationals which control production and distribution in various sectors and countries in the region.

Meeting WTO requirements through regional cooperative efforts is yet another area which could be explored in the context of SADC or COMESA. Many of the African countries, including Malawi have indicated that they have very limited capacity in meeting their WTO commitments in areas such as Sanitary and Phyto-sanitary Standards (SPS), technical standards, intellectual

property rights, customs valuation etc. Given the enormous needs faced by all the countries in the region, it makes little sense for each one to set up the technical facilities needed to implement their WTO commitments. Should there really be twenty laboratory testing facilities for SPS in the COMESA region? And similarly for technical standards? Why cannot the countries in the region under either the COMESA or SADC groupings agree to set up one common set of policies and institutions on intellectual property rights? Can the EU proposed REPAs help in this respect?

## 1.5 CONCLUSIONS AND RECOMMENDATIONS

Expanding regional trade has to be seen as a key objective in Malawi's efforts to integrate more effectively into the world economy and as part of a long-term strategy to alleviate poverty. The complex, spaghetti-bowl like regional arrangements that have evolved in Eastern and Southern Africa present obvious and daunting implementation challenges for the participating countries, all of whom have weak trade institutions. These arrangements need to be rationalized in order to reduce the opportunities for distortions, corruption and smuggling. Malawi, a landlocked country with a small internal market would benefit from a liberal and transparent trade environment both for itself and for its trading partners in the region.

However, for a small LDC like Malawi, there are limits to what it can do to provide leadership in rationalizing regional trade groupings. Hence, the government should be prepared to work within the existing structures in trying to take advantage of what they offer and in working with other small countries with relatively liberal trade regimes to help shape them, to the extent possible, to meet their needs. In concrete terms this means the following:

- First, Malawi has to continue to participate in both the COMESA and SADC regional groupings. It cannot afford to leave either. Leaving SADC will mean facing even larger problems in competing in South Africa, the largest regional market. Leaving COMESA will mean abandoning an area which has shown promise for expanding some of its exports in recent periods.
- Second, from Malawi's perspective it needs free trade access to both the COMESA markets and South Africa, still its largest market in the region. This is the overall objective towards which the government should be working in the longer-term. There are various options and groupings through which this long-term objective can be achieved such as: (a) through an FTA between all of the members of the COMESA customs union and SADC; (b) through the establishment of two customs unions, one around an expanded SACU and one around COMESA, combined with an FTA between the two customs unions; (c) through a larger FTA or customs union that contains countries from both SADC and COMESA but maintains an FTA with South Africa. Any of these arrangements will be very difficult to negotiate or for Malawi itself to promote. Thus, in the short-term, the key objective should be to strengthen collaboration between the COMESA and SADC groups while keeping free market access for Malawi's products in both.
- Third, because of the importance of South Africa's market to Malawi's exports, Malawi needs to make sure that it continues to have as free access to that market for as long as possible. This means that it should continue to exploit the opportunities currently offered by the South African bilateral as long as possible.<sup>28</sup>

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<sup>28</sup> And similarly, of course, for the bilateral with Zimbabwe.

- Fourth, within COMESA, Malawi should be working with other members with relatively liberal trading regimes, such as Uganda and perhaps Zambia towards establishing and keeping a low external tariff. The grouping as a whole has been a liberalizing force in the region. All its members, and Malawi in particular, would benefit from a continued liberal trade policy vis a vis the rest of the world.
- Fifth, in a similar vein, Malawi should lobby together with other small LDCs for simplified uniform and low threshold rules of origin in all preferential schemes in which they participate as well as in multilateral fora, so as to get the most benefit from the limited industrial transformation they may be able to achieve. This should be done both within COMESA and SADC, in the relevant group of the WTO where the rules of origin issue will be discussed as part of the ongoing multilateral negotiations, and, last but not least, in the ACP discussions with the EU over EPAs.
- Sixth, a small country like Malawi may not be able to forge regional arrangements to its liking and may be faced with some difficult options. A choice may actually be forced on it if the Eastern and Southern Africa states organize themselves into two customs unions, one around SACU and one around COMESA without a link between the two.<sup>29</sup> This will not be a good situation for Malawi because it needs to have good access to both sets of markets. If such a situation develops, a very detailed analysis of the implications of moving to the SACU or staying with COMESA would be needed. The COMESA tariff structure appears simpler. Moving to the SACU would tend to help specific industries, such as textile and clothing whose access to the South African market is currently constrained by quotas. On the other hand, looking at the overall pattern of protection, SACU's tariff and trade policies seem to serve the interests of the South African economy, which may not be the same as those of Malawi.
- Seventh, caution is urged with respect to concluding additional bilateral agreements. The burden of administering them may be higher than the benefits derived from further preferential arrangements.
- Eighth, it is unclear at this time whether it is in the interest of Malawi to participate in an EPA proposed by the EU. A lot would depend on whether the EU can make a convincing case about it. Malawi needs to participate in the ongoing discussions and try to determine what, if any benefits, would accrue to it from such participation, and whether the EPA can help it meet some of its trade related institutional needs. A key issue will be what happens to sugar, an important export to the EU that has benefited from previous ACP preferences. A study is urgently needed to address the sugar sector under the emerging EU regime. In any case, whatever Malawi does, it has to do together with other countries in the region. Given its institutional weakness, it has no capacity and will obtain no advantages in trying to negotiate and EPA with the EU by itself, i.e option (b) above, is not viable. At the same time it should be alert to the implications of any reshuffling of regional trade arrangements as a consequence of these discussions. It is important that Malawi as well as other small countries in the region maintain their liberal access to each others' markets, as well as to South Africa's and that they do not participate in any preferential arrangement that results in high protection towards third countries.
- Ninth, whatever the opportunities that are offered by regional markets, they will not be realized without an effective macro-economic policy and strengthened trade related institutions. The latter are especially important because of the complexity of the regional

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<sup>29</sup> Obviously, as noted earlier it **cannot** do both.

arrangements that have been put in place. Attention needs to be paid to strengthening the customs authority, reducing paperwork and approvals, and improving regional infrastructure, especially roads. Attention also is needed to developing alternative sources of government revenue to substitute for reduction in tariff revenues resulting from trade liberalization.

- Tenth, while some trade-related policies and institutional development can be pursued by Malawi itself, there are many opportunities for regional policy cooperation beyond trade and in the development of trade institutions. Malawi should place high priority in the development of regional economic cooperation outside of trade preferences. Cooperation in customs and transit are especially important for its overall trade. Similarly, together with others, it needs to explore the possibilities of developing regional institutions to help meet WTO obligations, in such areas as standards and intellectual property.

**TABLE 1.1 MALAWI DIRECTION OF EXPORTS /IMPORTS  
AS PERCENT OF TOTAL EXPORTS/IMPORTS**

<b>Country/Region</b>		<b>1980</b>	<b>1990</b>	<b>1995</b>	<b>1998</b>	<b>1999</b>	<b>2000</b>
<b>Exports</b>							
Industrial Countries		73	74	69	58	59	53
EU		52	48	49	35	39	29
US		16	12	14	12	14	12
Other		5	14	7	10	6	12
Developing Countries and other		27	26	31	42	41	47
Memo: Total Exports In US\$ million		295	419	421	479	482	442
<b>Imports</b>							
Industrial Countries		48	47	42	22	21	15
EU		35	38	32	13	16	9
US		4	2	3	3	1	2
Other		9	8	7	7	4	3
Developing Countries and other		52	53	58	78	79	85
Memo: Total Imports In US \$ million		439	627	500	566	632	622

*Source:* IMF Direction of Trade

**TABLE 1.2 MALAWI'S REGIONAL TRADE  
AS PERCENT OF TOTAL EXPORTS/IMPORTS**

<b>Country/Region</b>		<b>1998</b>	<b>1999</b>	<b>2000</b>
<b>COMESA</b>				
	Exports	4.0	8.3	10.4
	Imports	18.9	14.4	10.2
Egypt	X	1.3	4.7	3.5
	M	0.0	0.1	0.0
Kenya	X	0.7	0.6	2.6
	M	1.6	1.3	0.5
Zambia*	X	0.3	0.8	2.1
	M	1.7	1.7	1.8
Zimbabwe*	X	1.6	1.9	1.8
	M	14.0	10.4	6.8
<b>SADC</b>				
	Exports	16.9	16.5	16.9
	Imports	58.3	47.7	52.9
Mozambique	X	0.4	1.5	2.5
	M	1.7	0.8	1.1
S. Africa	X	13.6	10.8	8.5
	M	37.5	32.3	40.1
Tanzania	X	0.8	1.0	1.4
	M	1.3	0.9	1.4
<b>TOTAL (COMESA+SADC)**</b>				
	Exports	18.9	21.9	23.2
	Imports	59.8	49.0	53.4

\*Also members of SADC and included in its totals

\*\*Totals adjusted for countries with dual memberships

Note : Exports and Imports by value in kwacha, excluding duties, surtaxes and excises

Source: Imani-Capricorn, 2001

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