

Pathways to greater efficiency and growth in the Malawi Tobacco Industry

A Poverty and Social Impact Analysis

The setting

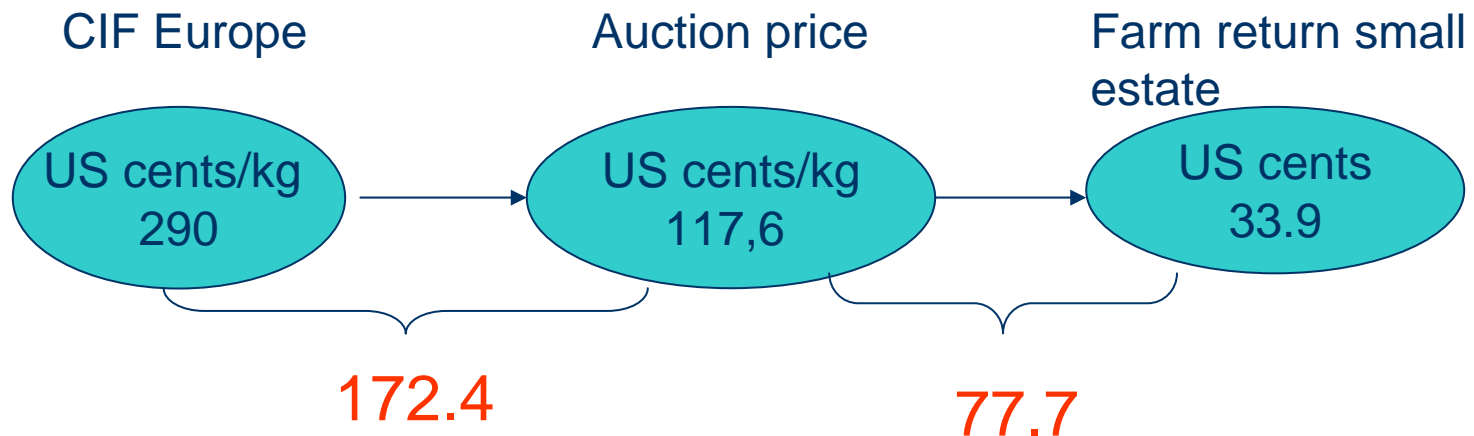
- Major objectives of the Government of Malawi are
 - Accelerate growth
 - Reduce poverty
- The tobacco sector has to play a key role
- However, at the moment the tobacco industry is depressed
 - Low farm productivity
 - Low prices
 - High supply chain margins that do not add value to the grower
 - Absence of actions or incentives to improve production, marketing or investments

Options to improve the situation

- How to capture a higher European price?
- How to reduce the margin between the European price and the auction price?
- How to reduce the margin between the auction price and the farm return?
- How to improve productivity on the farm?

Marketing costs: What matters most

- The margin between the CIF price and the auction price is much higher than the margin between the auction price and the farm price
- Malawi's focus should be on the landed CIF international price



Message 1:

**“There is no demand constraint
for Malawian tobacco”.**

Tobacco expansion Is possible

Malawi's Position on the Tobacco World Market I

- Malawi is a small player on the world market for tobacco.
 - Holds about 2 % of leaf production and
 - 5 % of trade in leaf
- Market power can be created if Malawi offers **high quality tobacco**
- Important: Malawi's main direction of exports are the EU and the US markets
- These two blocs together with China are the big players on the market

Malawi's export potential in spite of shrinking world demand II

- Policy decisions in the US (12% of world tobacco production) will improve Malawi's export potential
 - To the US because domestic production will decline
 - To the EU as US exports to the EU decline
- The major increase in tobacco consumption over the next years will be in China and developing countries

Message 2:

“The world market price can be improved”

An increase of the CIF price in Europe by only **1 percent** could lead to an increase of farm revenue of small estate by about **9 percent**.

Malawi's export potential in spite of shrinking world demand II

- Significant dynamics on EU markets (holds 14% of world tobacco production)
 - Expansion of trade preferences for new member countries should lead to an immediate rise in prices
 - EU tobacco production will drop significantly due to changes in policies in 2007/08
 - Reductions in EU production will more than compensate the projected reductions in tobacco consumption in this region

How to increase the international price?

- Exploit potential of trade preferences
- Negotiation with EU officials might be needed
- Concerns not only tobacco
- Sugar is also very important

Message 3:

“The margin between the European import price and the Auction price could be reduced”

Reduction of this margin by 1 percent could increase return of small scale farms by 7.6 percent

Improve quality (NTRM!, Reduce transport costs, introduce competition)

How to reduce the margin for international marketing

- Improve leaf quality and yield
- Non-Tobacco-Related-Material increases the margin (affects the conversion rate)
- Can be avoided by
 - Introducing penalties
 - Moving the buyer closer to the farm
- Getting buyers nearer to the farm would also help to improve quality of tobacco

Message 4:

“There is scope to reduce the margin from the Auction price and to the farm gate”

One example: If transport costs were halved - as achieved by NASFAM - farm return could go up by nearly US cents 15 or more than 40 percent

The margin on the domestic market

- Three times of farm return
- Is too high due to
 - Weak institutional framework
 - Disproportionate market power along the supply chain
 - High input and transaction costs and marketing margins

How can it be done?

- Change the institutional setting
- Reduce market power and efficiency by creating competition and regulating the monopolies

Institutional framework

- TCC has to play a key role
 - Change organizational setting
 - Improve capacity and competence to fulfill the present and prospective mandate
- Set up the Competition Commission
 - It has to play a major role

From the Auction Hall to farm gate

- Small estate get about 30 % of the Auction price
- Main components of the chain are
 - **Withholding tax**, which accounted to 24 percent of net return to family of small estate
 - **Transport to AHL**, which amounts to 14 percent
 - **AHL Commission**, which amounts to 12 percent of net return to family of small estate
 - **Bank exchange**, which amounts to 6 percent
 - **Transport to satellite**, which amounts to 5 percent

Two main routes to reduce marketing margins and to increase pass-through

- Contract farming
- Local Commodity Exchanges

Message 5:

“Contract growing offers a great chance for tobacco growers and the economy”

Should be extended for burley production, but needs monitoring!

Contract farming: Expected Benefits I

- Direct contacts between growers and buyers
 - Built up trust, which is main ingredient of any credit system
 - Helps to set up an efficient extension system
 - Helps to improve quality
- Increases choices for farmers and cuts the margin
- Provision of services (extension, credit)

Contract farming: Expected Benefits II

- Higher yields
- Higher income
- Increased efficiency of marketing chain:
Transport costs
- Increase in foreign exchange

Contract farming – Dangers ahead ? I

- Discrimination and marginalization of smallholders? ‘Death’ of smallholders?
NO! Small farmers participate and others are not disadvantaged. **Positive spill-over effects.**
- Negative effects on Auction price and price discovery?
NO! Same amount could go through auction:
No constraint on the world market

Contract farming – Dangers ahead ? II

- Lack of transparency?
Yes, but can be improved
- Market power of buyers?
Yes, but less than before
- Negative effects on credit provision for smallholders?
Not expected! The opposite is more likely

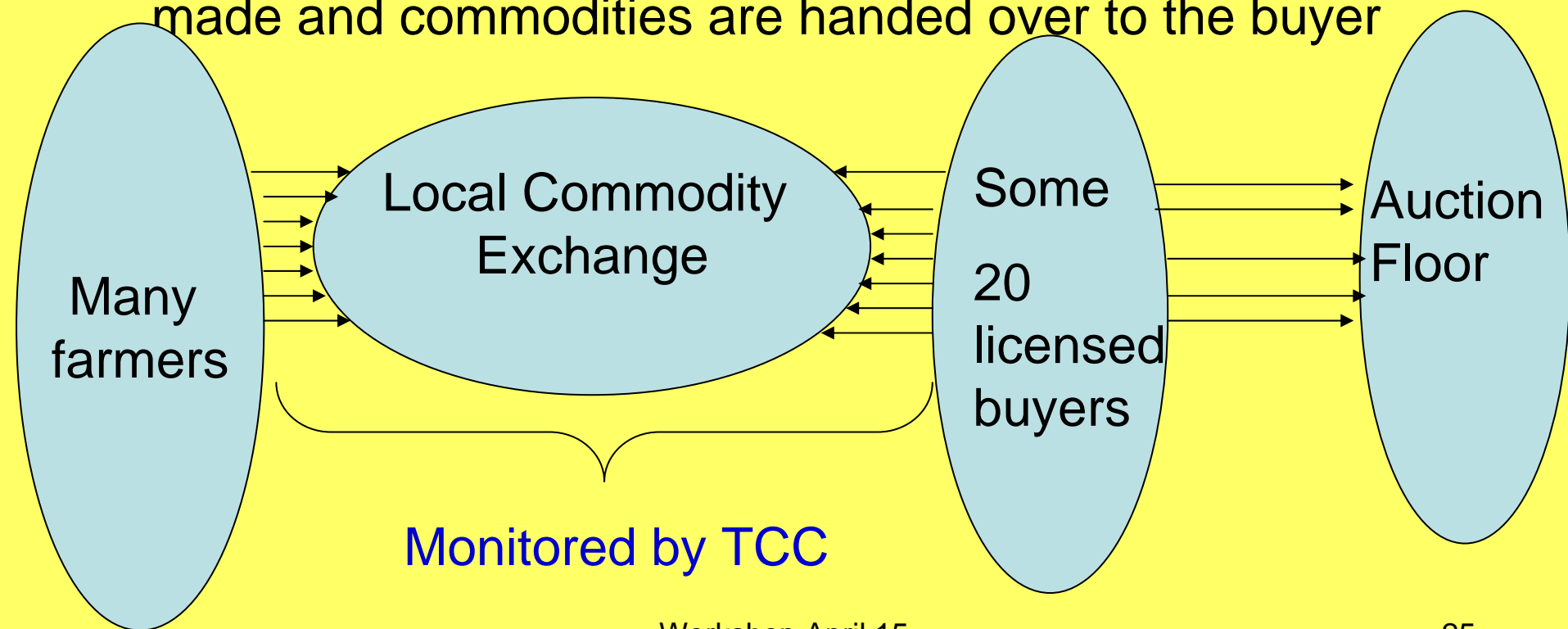
Message 6:

“Birth of Local Commodity Exchanges will most likely improve the marketing system for tobacco and other commodities. Farm return will most likely go up.”

Reduction in the domestic marketing chain

- Set up Local Commodity Exchanges:

Functioning: Prices are set at LCEs, payments are made and commodities are handed over to the buyer



LCE Benefits: Makes life Harder for IBs

- Difficult to control IBs
- Take advantage of poorer farmers
- However, these poor farmers are in high need
- An alternative is needed to help them
- LCE would help to create a decentralized trading system which offers farmers choices

LCE Benefits: Decentralization of markets and increase in competition

- Faster payments to farmers
- Competition among buyers leads to higher prices
- Reduction in transport costs
- Less likely congestions
- Reduction in waste
- Improvement in quality
- Building up trust
- Contributes to an emerging rural finance system

LCE: Problems

- **Bad experience with IBs**

However, the system is different. Can be controlled much better.

- **Higher marketing costs because there are more agents**

However, competition lowers prices if there are not significant economies of scale

- **All buyers will pay the same price as they get the same price at the auction**

No, transport and financial costs differ among buyers

Expectations about prices received at the Auction Hall differ

Gains: Some conservative guesstimates

Action	Impact: Increase in farmers' return
10% increase in CIF price	85%
10% reduction in marketing costs: Auction to Europe	50%
30% reduction of domestic transport costs	20%
20% reduction in AHL fees	2.4%

Summing up: Messages

Message 1: There is no demand constraint for Malawian tobacco

Message 2: The world market price can be improved

Message 3: The margin between the European import price and the Auction price could be reduced

Message 4: There is scope to reduce the margin from the Auction price and to the farm gate

Message 5: Contract growing offers a great chance for tobacco growers and the economy.

Message 6: Birth of Local Commodity Exchanges will likely improve marketing system for tobacco and other commodities.

The prospects for Malawi of the reform

- Contribute toward poverty alleviation
- Improve foreign exchange earnings potential
- Improved farmer returns and rural investment

- Requirements:
- Consider the options, weigh the merits, priritize actions based on farmer benefits.
- **The time for change cannot be better than NOW!**