

Malawi
Economic
Monitor

Charting a New Course

June 2019



THE WORLD BANK
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MALAWI ECONOMIC MONITOR

JUNE 2019

CHARTING A NEW COURSE

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Acknowledgements

This edition of the Malawi Economic Monitor was prepared by Priscilla Kandoole (Country Economist); Patrick Hettinger (Senior Country Economist); Angela Zeleza (Consultant); Sunganani Kalemba (Consultant); Efrem Chilima (Senior Private Sector Specialist); Laston Manja (Consultant); and William Mwanza (Consultant). Time Fatch (Senior Agriculture Economist); Habtamu Fuje (Economist); Francis Nkoka (Senior Disaster Risk Management Specialist); Deborah Isser (Lead Governance Specialist); Michael Roscitt (Public Sector Specialist); Innocent Mulindwa (Senior Education Specialist); Salman Asim (Senior Economist); Miriam Schneidman (Lead Health Specialist); Chipso Msowoya (Social Protection Specialist); Kagaba Paul Mukilbi (Energy Specialist); Josses Mugabi (Senior Water Supply and Sanitation Specialist); Colin Andrews (Program Manager); Boban Paul (Young Professional); Ross Hughes (Senior Natural Resource Management Specialist) and Simon Croxton (Consultant) provided additional contributions.

Abebe Adugna (Practice Manager, Macroeconomics, Trade and Investment); Greg Toulmin (Country Manager, Malawi); and Bella Bird (Country Director, Malawi) provided overall guidance. The team wishes to thank Yutaka Yoshino (Program Leader); William Battaille (Lead Economist); and peer reviewers Richard Record (Lead Economist); Samson Kwalingana (Senior Economist); Muna Meky (Program Leader); and Michael Stevens (External Peer Reviewer) for their constructive inputs.

This report benefited from fruitful discussions, comments and information provided by representatives of the Ministry of Finance, Economic Planning and Development; the Reserve Bank of Malawi; the National Statistical Office; the Malawi Revenue Authority; and a number of other Government Ministries, Departments and Agencies. The team would also like to thank representatives of the private sector in Lilongwe and Blantyre for their helpful contributions.

Zeria Banda (Communications Officer); Andrew Massa (Consultant); Gloria Chinguo (Team Assistant); and Tinyade Kumsinda (Team Assistant) provided assistance with external communications, design and additional production support. Irfan Kortschak (Consultant) provided editorial support.

The findings, interpretations, and conclusions expressed in this publication do not necessarily reflect the views of the World Bank's Executive Directors or the countries they represent. The report is based on information current as of May 2019.

The World Bank team welcomes feedback on the structure and content of the Malawi Economic Monitor. Please send comments to Priscilla Kandoole (pkandoole@worldbank.org) and/or Patrick Hettinger (phettinger@worldbank.org).

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OVERVIEW

The Malawi Economic Monitor (MEM) provides an analysis of economic and structural development issues in Malawi. This edition was published in June 2019. It follows eight previous editions of the MEM and is part of an ongoing series, with future editions to follow twice each year.

The aim of the publication is to foster better-informed policy analysis and debate regarding the key challenges that Malawi faces in its endeavor to achieve high rates of stable, inclusive and sustainable economic growth.

The MEM consists of two parts: Part 1 presents a review of recent economic developments and a macroeconomic outlook and risks. Part 2 focuses on a special topic relevant to Malawi's development prospects.

In this edition, the special topic focuses on priority recommendations for an incoming administration to move Malawi towards a vibrant economy and create jobs. Malawi has achieved recent, notable gains in macroeconomic stability, a reduction in ultra-poverty rates, and progress in key demographic outcomes, but the country has yet to see a strong growth response. The call is clear: following elections in May 2019, the next five years provide a generational opportunity to break the cycle of crisis and vulnerability and put the country on a path of inclusive growth and job creation for the growing population. To that end, this report recommends policy directions in four interrelated focus areas, these being: the establishment of stronger economic and institutional foundations; the transformation of the economy; building human capital; and resilience.

ECONOMIC DEVELOPMENTS

Malawi's real Gross Domestic Product (GDP) growth decelerated from 4.0 percent in 2017 to 3.5 percent in 2018. This was due to a decline in agriculture production resulting from a dry spell and Fall Army Worms infestation. This has had a major knock-on impact on agro-processing and households' disposable incomes, which in turn has affected demand for services. The dry spells also adversely impacted electricity generation and its contribution to growth.

Despite a poor maize harvest, the overall inflation rate remained in single digits. As of May 2019, headline inflation stood at 8.9 percent. The decline has been largely aided by a steady deceleration in non-food inflation which reached 5.7 percent, one of the lowest in years. This was supported by the continued stability of the Malawi Kwacha and a

tight monetary policy. A weak maize harvest had significant implications for food inflation with pressure remaining elevated during the lean periods in the agricultural season, particularly for rural households.

On the back of sustained single digit inflation, the Reserve Bank of Malawi (RBM) reduced its policy rate by a cumulative 250 basis points during the first two quarters of 2019. The policy rate was reduced from 16 to 14.5 percent in January, and then to 13.5 percent in May. The Lombard rate was also reduced to 14.9 percent, with the RBM instructing commercial banks to use this as the base lending rate. In May, this instruction was refined, with the base lending rate set to a weighted average of the Lombard rate, the Interbank rate, the 91-day Treasury bill and the Savings rate. The RBM introduced the reference rate with an intention to remove arbitrage in the setting of base lending rates by commercial banks.

At mid-year, the FY2018/19 fiscal deficit target had been exceeded by roughly 1 percent of GDP. Although domestic revenue performance was above target, a shortfall in grants and recurrent expenditure overruns meant that the Government missed its mid-year fiscal deficit target. Recurrent expenditure overruns were largely due to front loading of capital expenditures and an increase in election-related spending. Lower than expected grants were associated with an underperformance in foreign-financed development projects.

In March 2019, Cyclone Idai impacted 17 geographical areas with heavy rains and strong winds, affecting an estimated 975,588 people, displacing over 90,000 people and killing 60 people. While the estimated growth impact from the Post-Disaster Needs Assessment is only -0.1 percentage points, the socio-economic impact is significant and is highest in districts with the poorest populations. Seven of the fifteen affected districts have had more than 10 percent of their population affected, including three districts with about one-quarter of their population affected. The floods are likely to have exacerbated poverty, with significant implications on various aspects of human development, including through the impact on assets such as houses, buildings, livestock, crops, bicycles and farming equipment; on health and education services; and on environmental conditions.

In 2019, Malawi's economic growth rate is projected to reach 4.5 percent, increasing over the medium term to 5.0-5.5 percent. Agriculture is expected to remain resilient. Growth in this sector will be driven by an expected increase in tobacco production, much of which is grown in areas unaffected by the

Cyclone, and by a bumper maize harvest in unaffected districts.

The FY2018/19 fiscal deficit is expected to stand at 5.8 percent of GDP, lower than the previous year (7.8 percent of GDP) but higher than budgeted (3.8 percent of GDP). Despite missing its target, the expected deficit demonstrates progress over FY2017/18, particularly for an election year. The higher than anticipated projected deficit is due to lower than expected revenues and grants (about 0.7 percent of GDP) and higher than expected recurrent expenditure (about 1.3 percent of GDP). The excess in recurrent expenditure is the result of increased spending on election preparations, higher spending on goods and services, and statutory obligations, with the latter particularly involving claims for resolved court cases. Additionally, development expenditure is expected to be over-budget by 0.7 percent of GDP, as project implementation was frontloaded prior to elections. The impact of the natural disaster places further pressure on an already constrained budget, making fiscal consolidation efforts even more difficult.

Most of the fiscal deficit will be financed by domestic debt, which is already unsustainably high. Although domestic treasury bill rates have fallen by about 2 percentage points since January, domestic interest payments remain high at 3.6 percent of GDP, crowding out the space for discretionary spending. The increasing level of domestic debt at high interest rates has resulted in a high overall risk of debt distress. To address this, the Government should diligently pursue policies to reduce fiscal deficits by strengthening expenditure control, undertaking growth enhancing expenditures, and improving domestic revenue mobilization.

On the external front, Cyclone Idai is expected to adversely impact the current account deficit to a projected 10.0 percent of GDP. Before the Cyclone, the current account deficit was expected to narrow from 10.9 percent in 2018 to 9.5 percent of GDP in 2019. There were no major production losses to the key export commodities. Imports, however, are expected to increase due to recovery and reconstruction activities. Increased external financing is expected to finance much of the recovery-related imports. Food imports are unlikely to increase due to an expected strong maize crop in unaffected districts.

Unless Malawi achieves higher levels of economic diversification and greater fiscal restraint, it will remain trapped in a vicious cycle of climatic shocks and weak fiscal management. To break out of this cycle, the authorities need to implement measures to ensure macroeconomic stability; transform the

agriculture sector; and encourage private sector investment to create jobs.

CHARTING A NEW COURSE

The special topic of this economic update lays out policy priorities for the newly elected Government.

The incoming administration faces both daunting challenges and significant opportunities. Malawi has been able to achieve progress on the macroeconomic front, including exchange rate stability and single digit inflation. However, the country continues to face enormous challenges, with uneven and skewed improvements in human development, with much less significant gains for the bottom 40 percent.

Malawi's leadership needs to take bold actions to achieve higher rates of inclusive growth. Strong and decisive leadership is needed to chart a new course to enable the emergence of a vibrant economy that creates productive jobs and delivers quality basic services to its population. In the first year of the new administration, there is an opportunity to lay the foundations to achieve these goals. This report identifies four key areas of policy priorities that the new administration should focus on.

First, Malawi must lay solid foundations for growth by implementing supportive macroeconomic policies and establishing an effective public service. The country has historically suffered from an unstable macroeconomic environment, which has been largely due to weak macroeconomic management and institutions. Together, these factors have undermined growth and failed to facilitate poverty reduction. To address this, the new Government must establish a clear commitment to maintaining fiscal discipline, to improving governance, and to addressing corruption to improve service delivery. In the first year, the new administration should:

- **Maintain low inflation and price stability:** To do this, Malawi needs to sustain central bank independence in order to support monetary policy which will enable lower inflation and interest rates and a stable exchange rate.
- **Instill fiscal discipline:** Strong political commitment is needed for realistic budgeting and staying within budget. This will require discipline to avoid unbudgeted expenditure. Fiscal consolidation is needed to reduce budget deficits which will lead to lower domestic debt. This will increase fiscal space which can be used as a buffer to manage shocks and towards investment spending.
- **Strengthen State Owned Enterprises (SOEs) oversight, financial management, and transparency:** Increased oversight and

strengthened governance of SOEs will improve efficiency, avoid accumulation of arrears and the realization of contingent liabilities, and increase dividend payments. It will also strengthen service delivery.

- **Leadership and culture change:** Unleashing the potential of the public service will require signaling a commitment to integrity and enforcement of rules and procedures particularly at senior management levels. It calls for efforts to:
 - 1) Appoint senior management officials based on merit and performance
 - 2) Hold controlling officers accountable for the management of finances and staffing
 - 3) Sanction those who divert or waste public monies
 - 4) Recognize, encourage and reward staff who perform well
- **Strengthen service delivery through a renewed commitment to effective and accountable decentralization:** Priority actions include strengthening fiscal decentralization through a revised intergovernmental fiscal transfer system, reallocating human resources to core positions in local authorities and tightening oversight over public resource management.

Second, Malawi needs to transform the economy and increase growth to create productive job opportunities, and to ensure food security. Malawi needs to achieve higher levels of economic growth and investment to facilitate structural transformation and to create productive jobs for its rapidly growing population. This will require a concerted, coordinated effort across the Government to change the Government's relationship with the private sector, and to proactively remove blockages to economic transformation within the agricultural and non-agricultural sectors. Specifically, in the first year, the new administration should:

- **Initiate a coordinated, cross-government effort to radically reform the business environment:** The Government needs to develop an investment climate and sectoral regulatory frameworks that can attract higher-quality investors and investments, and facilitate the creation of better jobs in profitable, diverse sectors. This will require coordination at the highest level, across Ministries, Departments and Agencies, to coherently remove blockages along value chains. Malawi needs to reduce the cost of doing business and level the playing field for SMEs that can drive job creation. Promoting predictability, transparency, and market

contestability, particularly for local value addition, is key.

- **Improve trade policies to promote production and exports:** Malawi should remove trade restrictions and establish transparent, predictable trade policies to improve agricultural markets and to also stimulate production and exports.
- **Improve financial and operational efficiency, as well as governance, of energy and water utilities:** This is critical to expand access to reliable energy and water. Government should adopt prepaid meter policies to improve revenue collection. Moreover, strengthened governance frameworks will allow utilities to make autonomous decisions regarding recruitment, procurement, and financial management. This will further support strong public and private investment in the sectors.

Third, Malawi needs to strengthen its human capital by improving education and reducing fertility rates and stunting. To achieve and sustain higher levels of inclusive economic growth, Malawi needs to continue to reduce its high fertility rates, particularly amongst adolescents. This will reduce the rate of incidence of stunting and relieve pressure on limited agricultural land and government services. Additionally, the Government should implement measures to expand equitable access to higher quality education. In the first year, the new administration should:

- **Fast-track implementation of key education policies that enhance efficiency and target remote areas:** This includes automatic promotion in lower primary, targeted deployment and retention of teachers, and provision of low-cost learning shelters.
- **Scale up access to family planning and reproductive health services:** Policies that make family planning services more accessible, less costly, and of higher quality will promote lower fertility. In doing so, it will be critical to scale up approaches to reach, in particular, adolescent girls, especially those in rural areas.
- **Strengthen maternal and child health and nutrition interventions:** Key interventions include: expanding access to four or more antenatal care visits; promoting breastfeeding beyond the current 3.8 months; scaling up access to parenting education, early stimulation, and early learning.

Fourth, Malawi needs to develop systems to increase resilience to shocks. The frequency and severity of weather and climate shocks in Malawi have been

rising, and Malawi's poor are highly vulnerable to shocks. Scaling up social safety nets can provide households with resilience to shocks but increasing and reforming the funding mix is necessary to increase effectiveness. Malawi is facing increasing climate risks, while current growth patterns are causing the massive depletion of natural capital. The Government should actively improve disaster risk management systems and implement measures to address land degradation. This will reduce the vulnerability to shocks and enable higher rates of sustained inclusive growth, while also reducing fiscal risks. In the first year, the new administration should:

- **Commit to safety nets financing:** The Government should commit to a national financing strategy to support an adequate, sustainable social protection system. It will also be important to design social safety nets that can be scaled up during shocks to help households' build resilience.
- **Implement and harmonize policies related to environmental management, climate change, DRM, and land to promote a systematic approach to resilience building:** Recently enacted policies and laws equip Malawi to break the cycle of vulnerability and build environmental and disaster resilience. They encourage immediate actions to change current trends of decline and degradation of the environment and facilitate risk reduction measures that minimize impact of hazards and reduce vulnerabilities.

1. ECONOMIC DEVELOPMENTS

1.1 RECENT DEVELOPMENTS

Sub-Saharan Africa set to recover despite weak global economy

1. In 2018, economic growth across the Sub-Saharan Africa (SSA) region remained subdued, with the average rate standing at 2.7 percent, only a slight increase from 2.6 percent in 2016 (see Table 1). This was largely due to a weak response in the region's biggest oil and metal exporters to rising commodity prices. Growth was particularly low among the three regional giants (Angola, Nigeria and South Africa), which together account for more than half of the region's GDP. The investment and production in these three countries failed to keep pace with changes in global value chains (South Africa) and rising global oil prices (Nigeria and Angola). Growth in the rest of the SSA region was more varied. While metal exporters recorded relatively low rates of growth, smaller oil exporters experienced higher rates, with increases to oil production in response to increasing global oil prices. Non-resource rich SSA countries also recorded relatively high rates of growth due to increased agricultural production following the previous year's drought weather conditions, and to improved consumer demand and declining inflation.

2. The regional growth rate for SSA is forecast to continue to accelerate in 2019, despite a weakening global economy.

Due to the projected slow recovery of global trade and manufacturing, it is forecast that the global economy will contract slightly to 2.9 percent from the 3 percent realized in 2018. Nonetheless, a stronger recovery is projected for SSA with real GDP growth expected to pick up from 2.7 to 3.4 percent in 2019. This is based on anticipated improvements in investment in large economies and continued growth in non-resource intensive countries.

3. The growth rates for the region's strongest economies are expected to remain below the regional average in 2019.

Nigeria's growth is expected to increase modestly from 1.9 percent in 2018 to 2.2 percent in 2019 predicated on a recovery in oil production. However, this growth may be constrained by a slow recovery in private consumption. Similarly, South Africa's growth rate is expected to increase from 0.9 percent in 2018 to 1.3 percent in 2019, with ongoing constraints on domestic demand, limited Government spending and challenges to utility supply. Of the regional giants, Angola is expected to record the highest rate of increase from -1.8 percent in 2018 to 2.9 percent in 2019. This forecast is premised on increased production from new oil fields and ongoing economic reforms that are anticipated to bolster the business environment. Solid growth is expected for the rest of the region, albeit with significant variations across countries. In particular, metal exporters and non-resource rich countries, including Malawi, are expected to record relatively high rates due in part to recovery in agricultural production.

Table 1: Real GDP growth (Percent)

	2016	2017	2018e	2019f	2020f
World	2.4	3.1	3.0	2.9	2.8
Malawi	2.5	4.0	3.5	4.5	4.9
SSA excl. RSA, Angola and Nigeria	4.3	4.7	4.7	5.4	5.4
Nigeria, RSA and Angola	-0.8	0.9	1.1	1.9	2.1
SSA incl. RSA, Angola and Nigeria	1.3	2.6	2.7	3.4	3.6

Source: World Bank Global Economic Prospects

NB: e - estimate, f - forecast

4. These economic forecasts for the SSA remain subject to significant downside external and internal risks. The most significant external risks relate to slower than expected growth in China and the Euro area and to escalating trade tensions between the USA and China both of which pose significant risks to the region's commodity exporters. Continued and increasing reliance on foreign currency dominated loans also heightens the risks associated with currency volatility and debt financing. There are also a number of significant internal risks, including those related to the region's susceptibility to weather shocks, increasing financial sector stress and political uncertainties and weakening economic reforms particularly in countries holding elections in 2019.

Box 1: Impact of Tropical Cyclone Idai on Malawi

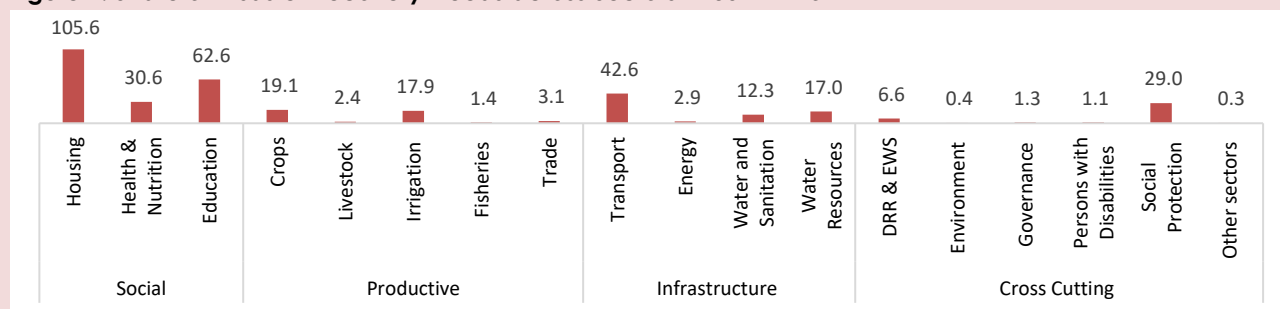
Parts of Malawi were in the path of Tropical Cyclone Idai, from the Mozambican Channel, on and after 4 March 2019. To facilitate a humanitarian response, the Government commissioned a Post Disaster Needs Assessment (PDNA), with support from the World Bank, United Nations, European Union and African Development Bank.¹

Seventeen geographical areas² were impacted, with approximately 975,600 people affected, 90,000 people displaced, and 60 people killed. Total effects amounted to US\$ 220.2 million, of which US\$ 157.7 million (72 percent) was from the total or partial destruction of infrastructure and physical assets, and US\$ 62.5 million (28 percent) was losses due to changes in economic flows arising from the disaster. The effects were mostly concentrated in the social sector (US\$ 130.3 million, 59.2 percent), followed by infrastructure (US\$ 51.5 million, 23.4 percent) and productive activities (US\$ 38.4 million, 17.4 percent). In the social sector, the effects were highest in the housing sub-sector with most houses being private property and not following resilient construction standards. Effects were also evident in infrastructure sector especially in road network; drainage systems; power supply lines; irrigation and water supply equipment and flood control structures. Crops at the maturing stage and livestock were submerged or washed away which reduced returns from crop and animal production.

Production losses are estimated at about US\$ 9.96 million (0.13 percent of GDP). Agriculture, construction, electricity and water supply, wholesale and retail trade, transport and accommodation and food services sectors were affected. The current account deficit is expected to widen slightly, with imports of goods and services for recovery and reconstruction likely to increase after the disaster. It is also expected that expenditures on relief and post floods recovery will exert additional pressure on the fiscal position. However, some of these negative effects could be mitigated by the multiplier effects of recovery efforts through an increase in public investment and foreign aid inflows, which could buffer reserves.

Human and social development aspects have been further constrained. Poverty has deepened as people were made homeless, jobless or without a livelihood with risk and vulnerability to food insecurity and diseases. Learning was disrupted as some school blocks were damaged or used as temporary camps for internally displaced people. Primary health service became inaccessible in some communities. The risk of the spread of non-communicable diseases, such as cholera and malaria, is high due to exposure to contaminated water resources and poor sanitation. Infrastructure damages are estimated at about 288,371 houses, 1,569 schools, 129 bridges and 1,841km of road network. Female-headed households and those headed by vulnerable groups (young, elderly and persons with disability) were disproportionately affected.

Figure 1: Share of Disaster Recovery Needs across Sectors in USD million



Source: Government of Malawi (2019) Malawi Post Disaster Needs Assessment

Post-disaster recovery needs are expected to reach US\$ 368.3 million (see Figure 1). Recovery financing is required to resume production and access to goods and services, restore good governance and decision making process and implement risk reduction measures. Reconstruction resources are required to repair and rebuild destroyed physical assets and infrastructure to disaster-resilient standards and conditions. Going forward, Malawi needs to strengthen its comprehensive disaster risk management strategy that promotes resilience to disaster and fosters inclusive sustainable economic growth and development. The PDNA concludes that the following are of paramount importance: institutional arrangements that clearly define roles and responsibilities; a comprehensive and well-managed data information system; capacity building at the national and local levels; investment in resilient infrastructure; comprehensive hazard mapping and zoning; scaling up the Social Cash Transfer Program; and adoption of resilience agricultural measures and diversification.

Source: Government of Malawi (2019) Malawi Post Disaster Needs Assessment

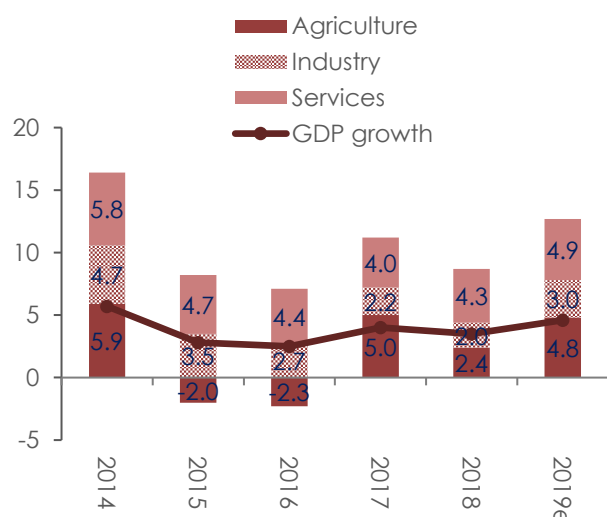
Malawi poised for economic recovery despite destruction from Cyclone Idai

5. Malawi's GDP growth decelerated from 4.0 percent in 2017 to 3.5 percent in 2018 mainly due to a fall in agriculture production. Agriculture remains critically important to Malawi's economy. Although the sector contributes only 30 percent to GDP, it impacts growth in the other sectors by providing key inputs for the manufacturing sector and determining most household incomes levels which drive demand in the service sectors. The performance of the agriculture sector, particularly the maize sub-sector, has significant implications for Malawi's food security and inflation rates, with food contributing a major proportion of the Consumer Price Index (CPI) especially for the rural population. In 2018, agriculture's contribution to GDP declined (see Figure 2) on account of a dry spell and Fall Army Worm (FAW) infestations, with this pest devastating crop production in the region since 2016.

6. There was varied performance across agriculture in 2018. Production declined for maize (28 percent), soya bean (19 percent), groundnuts (12 percent) and pulses (10 percent) (see Figure 3). By contrast, production increased for tubers (4 percent) and tobacco (90 percent). Increased tobacco production resulted in an increase in average household incomes, despite a 16 percent decline in average prices from US\$ 1.99/kg in 2017 to US\$ 1.67/kg in 2018. The total value of tobacco production increased by 59 percent over the year, going up from US\$ 212.5 million in 2017 to an estimated US\$ 337.5 million in 2018.

Figure 2: Stronger growth is anticipated as all sectors recover...

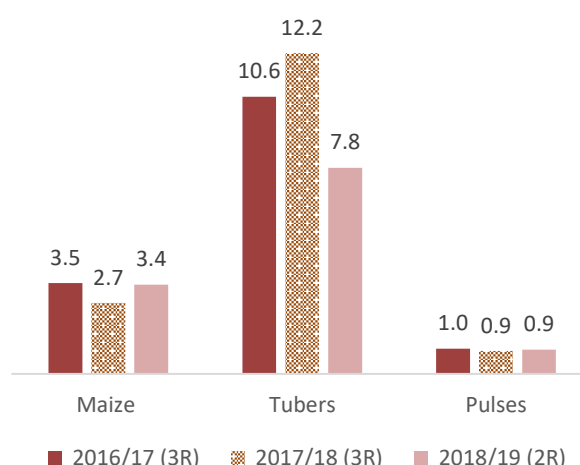
Real GDP growth by sector (percent)



Source: World Bank MFM0d

Figure 3: ... maize production resilient despite the devastation caused by Cyclone Idai

MT (millions), Second and Third round crop estimates



Source: World Bank staff calculations based on Ministry of Agriculture data

NB: Tubers include cassava and all potatoes.

7. Through much of 2018, Malawi's electricity generation capacity faced constraints, with reduced output negatively impacting the industry and service sectors. As with its agriculture sector, Malawi's energy sector is heavily dependent on weather conditions. About 98 percent of Malawi's electricity is generated by hydroelectric power stations. In the past year, electricity generation was negatively impacted by low water levels during drought periods and silting during the rainy season, in addition to ongoing repairs and maintenance works. As a result, hydroelectric power generation dropped to 75 percent with emergency diesel generators supporting about 25 percent of output. In comparison to energy production in 2017, production was about 2 percent lower through July 2018. However, from September to December 2018 energy production was on average, 15 percent higher (due to the introduction of emergency diesel generators) than the same period in 2017, when the country was impacted by significant blackouts. Due to this performance in the last four months of 2018, overall production for the year was 2.8 percent higher than in 2017.

¹ The following DPs, and NGOs participated in the exercise: World Bank, UNDP, UNICEF, UN Women, UNFPA, WFP, FAO, AfDB, Save the Children, Care International, The Federation of Disability Organisations in Malawi (FEDOMA), Youth Net and Counselling (YONECO), The Polytechnic and Arup Consultants.

² These included fifteen districts (Balaka, Blantyre, Chikwawa, Chiradzulu, Dedza, Machinga, Mangochi, Mulanje, Mwanza, Neno, Nsanje, Ntcheu, Phalombe, Thyolo, Zomba) and two cities (Blantyre and Zomba).

8. As a result of this low output and of the subdued performance of the agriculture sector in 2018, the industry and service sectors recorded only modest rates of growth. The industry sector (which is heavily dependent on agricultural inputs) grew by 2.0 percent in 2018 compared to 2.1 percent in 2017 while services (which is heavily reliant on agricultural incomes) grew by 4.3 percent in 2018 from 4.0 percent in 2017 (see Figure 2). However, in 2019, the industry sector is projected to grow by 1.0 percentage points to 3.0 percent while the services sector is projected to grow by 0.6 percentage points to 4.9 percent (see Figure 2). These projections are predicated mainly on a projected recovery in agriculture with the growth rate for the sector projected to increase from 2.4 percent in 2018 to 4.8 percent in 2019.

9. Post-Cyclone Idai, Malawi's real GDP growth in 2019 is projected at 4.5 percent. This is a reduction from an earlier projection of 4.6 percent growth due to the impact of the Cyclone (see Box 1). Despite some crop losses in affected areas due to the Cyclone, Malawi's agriculture sector is broadly expected to rebound after a weak harvest in 2018. Growth in the agriculture sector is expected to increase to 4.8 percent in 2019. Tobacco production is expected to increase by 2.1 percent, driven by increased hectareage, with farmers switching to tobacco because of the 2018 season sales and by improvements in planting technologies. These factors are expected to increase farm incomes and to mitigate specific crop-related risks. While maize production was affected to some extent in the flood-affected districts, production is expected remain resilient, increasing by 24.4 percent from 2.7 million MT in 2017/18 to 3.4 million MT in 2018/19. Other crops whose production is expected to increase include rice (16.9 percent); cassava (5.4 percent); sweet potatoes (13.9 percent); potatoes (23.7 percent); and groundnuts (17.8 percent).

10. Malawi's economic recovery is subject to significant external and internal risks. In recent years, weather and climate related shocks have increased in both severity and frequency, with this trend likely to continue into the foreseeable future. In Malawi, the impact of these shocks on food security is intensified by the dominance of smallholder maize production and investment in FISP³. While FISP does result in increased yields, the proportion of total expenditure allocated for the program reduces space for investment in other more resilient options. These shocks also impact the energy sector due to the dominance of hydroelectric power. Inadequate policy responses and policy induced distortions tend to aggravate the impact of these shocks, exacerbating market failures and frustrating poverty reduction efforts. To avoid instability, structural reforms and the implementation of careful fiscal and macroeconomic management is thus crucial. Policy options to mitigate the impact of these shocks include measures to: diversify and expand sources of energy; improve agricultural markets; target resources and diversify away from maize; encourage value addition and broader economic diversification; and strengthen disaster response and social protection programs. In addition, Malawi is vulnerable to global commodity price volatility, particularly as it affects the key imports of fuel and fertilizers.

Malawi continues to be stuck in a poverty trap

11. Poverty reduction has been slow over the past decade in Malawi.

Since 2016/17, Malawi's poverty rate has remained roughly unchanged, standing in excess of 50 percent of the population. There is a massive disparity in the rates between rural areas (59.5 percent) and urban areas (17.7 percent). There also remains a significant disparity in the rates between rural regions in different areas, with the highest rates in the Rural South, followed by the Rural North. However, while the rate has increased in both the Rural South and Rural Central, it has remained roughly unchanged in the Rural North (see Table 2). The poverty gap, which captures the average shortfall of consumption of the poor as a percentage of the poverty line, decreased slightly in the period from 2010/11 to 2016/17. Nationally, the poverty gap decreased from 18.9 percent to 16.8 percent over this period. The gap declined in both urban and rural areas (NSO, 2018). Malawi's vulnerability to climate-related shocks limit the country's progress in reducing poverty. Considering that a significant number of the non-poor reside in rural areas and are highly vulnerable to weather shocks it comes as no surprise that poverty remains pervasive.

Table 2: Poverty Indexes 2010/11 and 2016/17

	2010/11	2016/17
Poverty Headcount rate		
National	50.7	51.5
Urban	17.3	17.7
Rural	56.6	59.5
Rural North	59.9	59.9
Rural Center	48.7	53.6
Rural South	63.3	65.2
Poverty Gap		
National	18.9	16.8
Urban	4.8	4.5
Rural	21.4	19.7

Source: National Statistical Office (NSO) Fourth Integrated Household Survey (IHS4) 2018

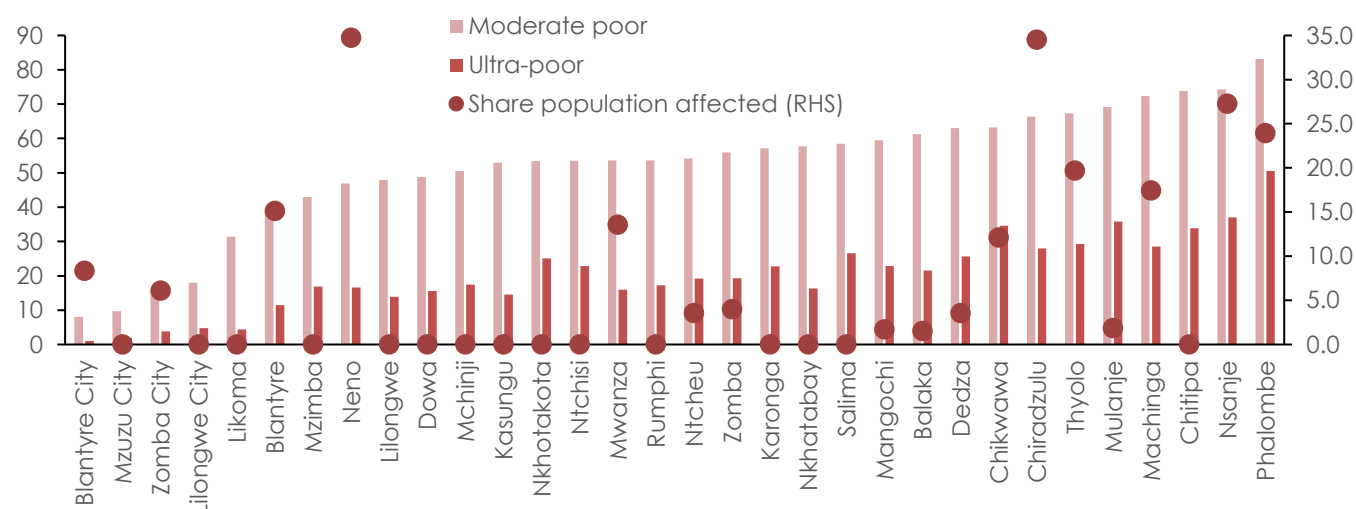
³ See Box 2 on some insights on implementing a Universal Input Subsidy Program

12. While Malawi's youth bulge creates the potential for a demographic dividend, if it is not harnessed appropriately, it also represents a challenge to breaking the poverty cycle. About half of the population under the age of 15 and 60 percent are below the age of 24. With a current population growth of about 3 percent, Malawi's population is projected to reach 30 million by 2030,⁴ while the number of children is expected to double to 16.2 million. At present, about 58 percent of children live below the national poverty line compared to 51.5 percent for the total population. The ultra-poverty rate for children is 24 percent, higher than the estimated overall national rate, which stands at 20 percent. The poverty rate is highest amongst children of 5-14 years, with an estimated 60 percent of those in this group being poor and 25 percent being ultra-poor. The rates are significantly higher in rural areas compared to urban areas, with 22 percent of those in this group in urban areas being poor and 6 percent being ultra-poor, compared to 67 percent and 29 percent respectively for those in rural areas (UNICEF, NSO 2018). Although the rate for multi-dimensional child poverty has declined from 63 percent in 2012/13 to an estimated 61 percent in 2016/17, about 50 percent of children in rural areas continue to be both monetarily and multi-dimensionally poor. This compares sharply to an estimated 13 percent in urban areas. The rural/urban divide is highest in the dimensions of housing (61 percent vs 17 percent); nutrition (36 percent vs 16 percent); education (40 percent vs 26 percent); and information (30 percent vs 8 percent).

13. Vulnerability to climate related natural disasters also contributes to the worsening poverty situation. Over the past two decades, drought and flood events have increased in frequency, intensity, and magnitude with negative consequences for food and water security, and sustainable livelihoods for the rural population. The recent tropical Cyclone Idai (see Box 1) has affected fifteen districts and two cities, in seven of which more than 10 percent of their population was affected, and in three of which about one-quarter of their population was affected. While some higher income areas have been impacted particularly in Blantyre, where an estimated 8.3 percent of the population was affected, the impact has been much higher in poorer districts mostly in the Southern region (see Figure 4).

Figure 4: The impact of Cyclone Idai has been the highest on districts with the poorest populations

Poverty rates & estimated population affected by district, percent



Source: World Bank staff calculations based on data from NSO IHS4 (2018) and GoM PDNA (2019)

14. Crop losses due to Cyclone Idai have significant food security and welfare implications. The floods are likely to have exacerbated poverty due to their significant impact on animal and crop production for the affected households. Various aspects of human development were also affected through the impact on assets such as houses, buildings, livestock, crops, bicycles and farming equipment; on health and education services; and on environmental conditions. In terms of monetary poverty, simulation results show that annual food consumption expenditure is expected to decline by 4 to 5 percent in Nsanje and Phalombe districts and by 2.5 percent in Ntcheu district as a result of lost crop production. The decrease in consumption could exacerbate the already dire welfare conditions in these districts.

⁴ Malawi's population density continues to grow while the land area remains static. The 2018 Population Housing Census finds that Malawi population density stood at 186 persons per square kilometer up from 138 in the 2008 census representing a 35 percent jump. Across the regions, southern region has the highest population density at 244 persons per square kilometer followed by the central region with 211 persons per square kilometer and the northern region with an average of 84 persons per square kilometer (NSO, 2018, Preliminary Malawi Population and Housing Census Report).

15. Without a concerted humanitarian effort, the crop losses would translate into higher moderate and ultra-poverty (see Figure 5). The affected districts already have very high poverty rates. Moderate poverty, for example, is 83 percent and 74 percent in Phalombe and Nsanje districts, respectively. As a result of crops lost due to Cyclone Idai, the moderate poverty rate is expected to increase by as much as 1.2 percentage points in Nsanje district. Five of the affected districts are expected to see an increase in moderate poverty rate by at least 0.5 percentage point. Ultra-poverty is also expected to increase. Phalombe and Nsanje districts, for example, are expected to experience 3.3 and 1.5 percentage points increases ultra-poverty rates, respectively.

Figure 5: Change in Poverty after Cyclone Idai



Source: World Bank staff calculations based on data from NSO IHS4 (2018) and GoM PDNA (2019)

Note: This is a result of a simulation exercise, and not official poverty statistics. The simulation is based on the areas of crop land damaged for 7 major staple crops, the typical total area of land covered by these crops in each district, and the share own production in total household consumption in the affected districts.

16. For the Government to effectively address Malawi's poverty challenges, it cannot adopt a narrow, one-off approach. In addition to improved investments in human capital development, Government must address the cyclical nature of poverty more holistically. Recurrent natural shocks and macroeconomic instability have been compounded by a myriad of factors that significantly limit poverty reduction, including through constraints on the economic productivity of land, labor, and capital. The worst off include those in the rural areas, particularly labor-constrained female-headed households; estate workers or tenants; *ganyu*⁵ and other casual laborers; destitute or disadvantaged children; people with disabilities, including the blind; and resource constrained urban households. To address the needs of these groups, a highly multifaceted and broad-based approach to breaking Malawi's poverty cycle is vital.

The FY2018/19 mid-year fiscal deficit target was missed

17. At mid-year, the FY2018/19 fiscal deficit target was exceeded by roughly 1 percent of GDP. Although domestic revenue collection was above target, a short fall in grants and recurrent expenditure overruns caused the Government to miss its mid-year target. Overruns were largely due to front loading of expenditures and increased election-related spending. Lower than expected grants also led to underperformance in foreign financed development projects.

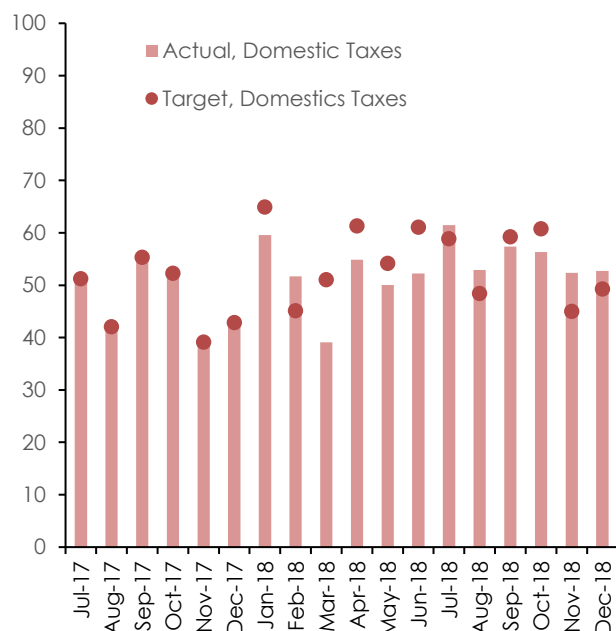
18. Over-performance in total revenues was largely driven by strong performance in domestic taxes. The outturn for domestic revenues at mid-year FY2018/19 was MK 514.8 billion, representing an over-performance of MK 18.6 billion (3.8 percent above target). Tax revenues stood at about MK479 billion, an overperformance of about MK 22 billion (4.8 percent above target). This represents a 19.5 percent tax revenue growth relative to FY2017/18 mid-year (see Figure 6). This was primarily driven by domestic taxes, particularly PAYE, domestic VAT and import duty. Import duty overperformed by about MK 9 billion (23.8 percent above target); withholding tax by MK 7.8 billion (21.2 percent above target); income tax by about MK 10 billion (8 percent above target), and domestic VAT by MK 8.1 billion (10.3 percent

⁵ Common Chichewa term for informal off-farm labour, short-term rural labour/piecework

above target). There was also an increase in import duty, particularly on account of increased imports of cement (supporting on-going construction projects), petroleum products and vehicles.

Figure 6: Revenue collection has mostly met targets

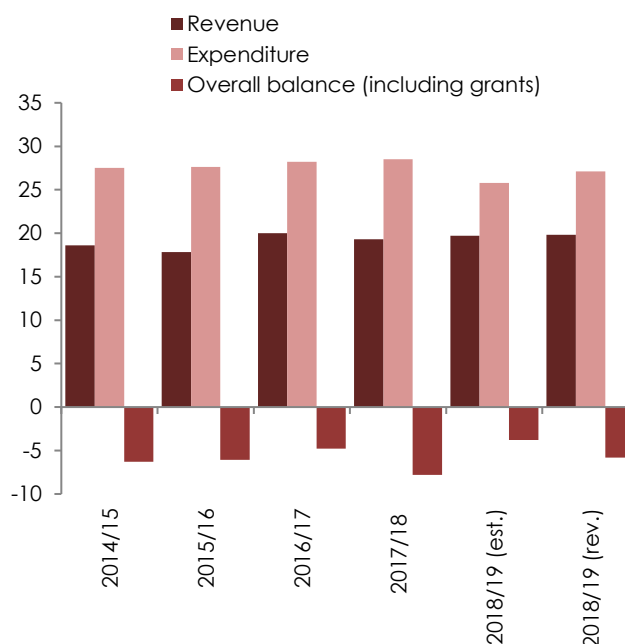
Net actual revenue vs. net target revenue
Malawi Kwacha billion



Source: World Bank staff calculations based on MoFEPD data

Figure 7: The deficit is projected to slightly widen in FY2018/19 compared to the approved budget

Percent of GDP



Source: World Bank staff calculations based on MoFEPD data

19. By contrast, corporate tax collection underperformed by MK10.9 billion (-20.3 percent). This underperformance was primarily due to increased investments by the banking sector in digital software and thus corresponding lower levels of provisional tax. Previously, corporate tax accounted for close to 4.5 percent of GDP. This has declined significantly, to 1.5 percent of GDP. In addition, continued weak demand has led to imports and customs and excises duty remaining mostly flat. Non-tax revenues also under-performed, falling by MK 3.7 billion (9.5 percent) below target, largely due to the non-payment of taxes by some parastatals and the weak performance of dividends, which underperformed by MK 1.3 billion (26.4 percent), and departmental receipts, which underperformed by MK 2.8 billion (18.7 percent).

20. Although domestic revenues exceeded targets, grants were significantly lower than anticipated. Dedicated grants fell by about 50 percent of the target and project grants fell by about 37 percent of the target, largely due to slow project execution. Overall, during the first half, total revenue and grants underperformed by about 11 percent of the mid-year target.

21. Expenditure on goods and services and on subsidies and transfers contributed to over expenditures. Under goods and services, increases largely related to over expenditures on generic goods and services by MK 16.3 billion and other statutory expenditures by MK 4.4 billion. Expenditure on the Farm Input Subsidy Program (FISP) exceeded the budget by MK 4.3 billion to reach MK 19.9 billion, with the mid-year target standing at MK 15.5 billion. This is attributed to an earlier than usual commencement of the FISP exercise. However, maize purchases have been contained in the first half of the financial year, with expenditure standing at MK 10 billion, significantly lower than the mid-year target of MK 20 billion. This is mainly due to sufficient maize production and reserves in the country. In contrast, development expenditure underperformed, largely due to poor rates of execution for both foreign and domestically financed projects. Foreign-financed development expenditure amounted to about MK 46 billion, with the targeted levels standing at about MK 98 billion. Over the year, domestically-financed expenditure amounted to about MK 51 billion, with the targeted levels standing at MK 72 billion.

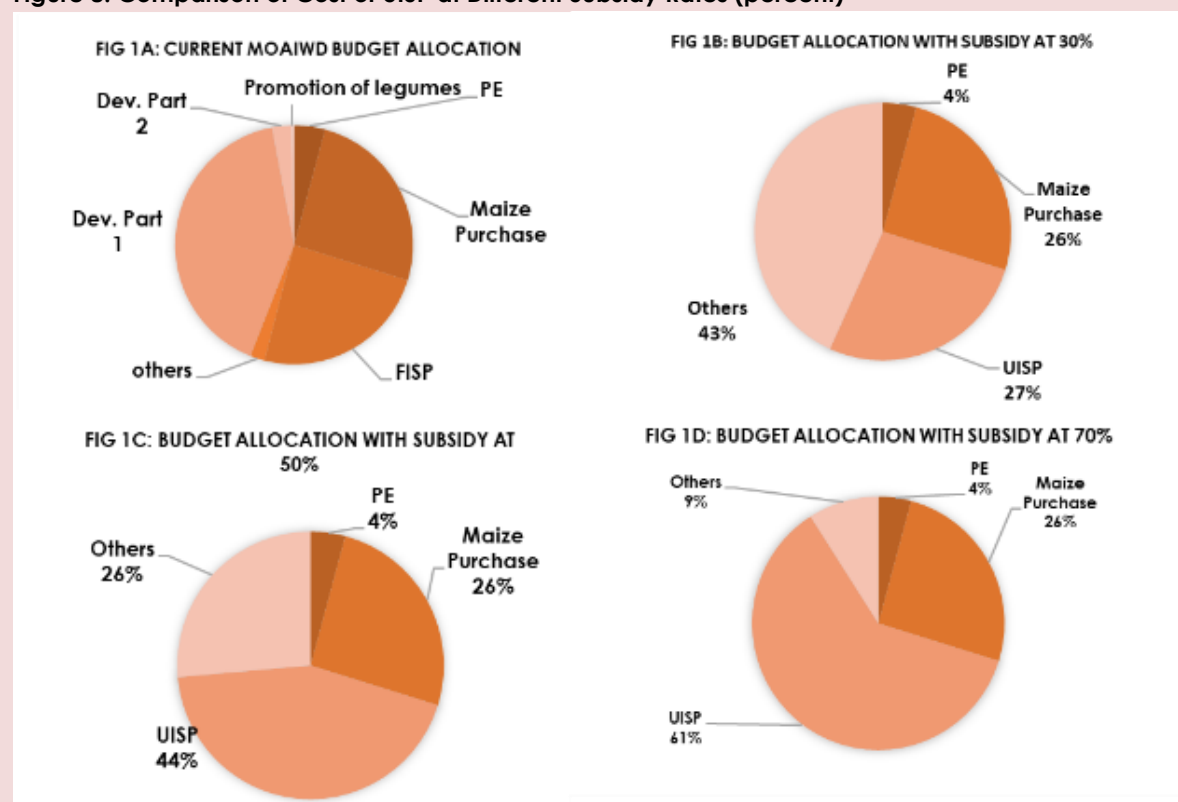
Box 2: Cost Implications of a Universal Fertilizer Subsidy in Malawi

The Farm Input Subsidy Program (FISP) is one of the key agriculture policy interventions that was introduced in 2005 to increase smallholder farmers' access to improved agricultural farm inputs to attain food security at household and national levels. Apart from helping to increase average yields from 0.8MT/ha to around 2.4 MT/ha, the program has also increased consumption of fertilizer in the country from 28kg per hectare to about 45kg per hectare relative to Sub Saharan countries with average fertilizer use of about 7kg per hectare.

Over the years, there has been a growing consensus amongst stakeholders regarding the need for the Government to improve the program's efficiency and sustainability. In FY2013/14, the Government initiated a number of reforms to the FISP, with these reforms currently on-going. These reforms include: increasing private sector participation in direct retailing; increasing farmer contribution (capping the coupon value); promoting diversification; and improving beneficiary targeting (targeting of productive poor smallholder farmers). These reforms have reduced the financial burden on Government and made it easier to monitor budget implementation.

Recently, there has been growing debate amongst political parties as to whether a Universal Input Subsidy Program (UISP) might be possible in Malawi. This box attempts to provide some insights to estimate the cost of implementing a universal subsidy program in Malawi. The analysis has assessed the cost of a universal subsidy at *ad valorem* rates of 30 percent, 50 percent and 70 percent, respectively (see Figure 8). The current FISP subsidy is at about 70 percent. The analysis estimated that for a 30 percent *ad valorem* input subsidy, the Government would spend between MK 26.8 billion (US\$ 35.6 million) and MK 39.2 billion (US\$ 52.3 million) per financial year. This figure compares very well with the cost of MK 41.3 billion (US\$ 55.74 million) for FISP in the 2018/19 financial year. With a 50 percent *ad valorem*, the Government would spend between MK 43.0 billion (US\$ 57.5 million) and MK 63.7 billion (US\$ 85.4 million) while at 70 percent, this would increase to between MK 60.0 billion (US\$ 80.4 million) and MK 88.9 billion (US\$ 119.5 million). With *ad valorem* subsidy rates of 50 percent and 70 percent, this would represent a significant increase relative to the cost of FISP, with a 20 percent and 37 percent increase in the proportion of the agriculture budget respectively. However, it should be noted that the cost of a UISP would increase if the prices of inputs are relatively lower than in the neighbouring countries as this would encourage informal exports of the inputs to neighbouring countries.

Figure 8: Comparison of Cost of UISP at Different Subsidy Rates (percent)



Source: World Bank staff calculations based on Agriculture Joint Sector Review Report (Figure 1a) & IFPRI data (Figures 1b-d)

The cost of subsidies has significant implications for agricultural development. A recent analysis of the Integrated Household Surveys (IHS) shows that the current program disproportionately benefits agricultural households in the middle and upper income brackets, rather than the poor. This implies that moving towards a universal input subsidy at *ad valorem* subsidy rates at 50 percent and 70 percent, improvements to input use will be concentrated among the better off farmers at the expense of the poorest farmers. Generally, this analysis shows that it is possible to implement a Universal Input Subsidy Program in Malawi from a simple fiscal cost perspective, if the *ad valorem* subsidy rate is reduced to 30 percent. However, the opportunity cost of implementing the program would be huge, especially if the subsidy was maintained at the current level of 70 percent.

Universal input subsidies will reinforce overreliance on maize rather than promoting crop diversification. The current agriculture sector budget is dominated by FISP and maize purchases, which together constitute about 50 percent of the sector budget. With the current proportion of the budget allocated to the agriculture sector, a UISP would be feasible at a 25 percent subsidy rate, as this level would maintain the status quo. Implementing 50 percent and 70 percent subsidy rates would result in the substantial erosion of resources allocated to other equally important sub-sectors, such as research, extension and irrigation. This would discourage investment in efforts to diversify the economy, as the focus would be on maize production. This would also impact Malawi's level of resilience to climatic shocks. In addition, increasing investments in the UISP would also significantly affect the implementation of the recently launched National Agriculture Investment Plan (NAIP), which has identified 16 priority intervention areas. It is obvious that implementing a UISP will involve trade-offs between competing policy objectives that the Government would need to balance carefully. This may imply increases to the allocation of resources to the agriculture sector to accommodate the UISP. At the same time, substantially reducing the *ad valorem* subsidy rate (say to 30 percent) would imply restrictions to access to subsidized inputs to the middle and richer households at the expense of the poor productive farmers.

Experience from elsewhere in Africa has shown that UISPs are expensive propositions that are difficult to sustain especially in small economies like Malawi. A recent IFPRI study in Ghana shows that there are huge gains with reductions to leakages by more than 72 percent when targeting is implemented properly. There are opportunities for Malawi to learn from Ghana's experience and to improve and upscale pilots that have been implemented since 2016 to target productive poor smallholder farmers. Malawi should focus on upscaling approaches that promote the targeting of productive poor farmers. This is supported by the results of the pilot study on targeting, which produced promising results regarding the speed of redemption of inputs and productivity gains. This will ensure that adequate resources are available to rebalance investments in the agriculture sector.

Sources: International Food Policy Research Institute (IFPRI) Malawi and World Bank

FY2018/19 budget likely to miss target due to election and Cyclone related spending pressures

22. The Government faces mounting fiscal pressure, with increases to domestic revenues being outweighed by expenditures overruns. At the end of the fiscal year, domestic revenues are projected to stand at 19.8 percent of GDP, a marginal increase from an earlier estimate of 19.7 percent of GDP at the beginning of the fiscal year. The estimated increase in revenues is predicated on the recent easing of power bottlenecks; sustained single digit inflation; stable Malawi Kwacha; and the opening of the tobacco market. In addition, the Malawi Revenue Authority (MRA) will continue to strengthen enforcement and monitor the use of electronic fiscal devices (EFDs) to reduce malpractices and manipulations of the system. However, banking sector profits could remain weak due to a lower interest rate environment, which could weigh in on interest income. Corporate income tax is projected to fall short of the target. In addition, the underperformance and unpredictability of parastatal dividends; a fall in dedicated and project grants; and the revision of program grants to zero are likely to undermine overall revenue growth.

23. The Government should intensify its efforts to contain expenditure within budget ceilings. In the second half of FY2018/19, fiscal pressure on the budget is expected from expenditure on wages and salaries. Expenditure on wages and salaries is estimated to rise to 7.2 percent of GDP in FY2018/19 from 6.5 percent in FY 2017/18, the highest level in recent years. This is mainly attributed to recruitment in the education and health sectors. Additionally, the Government has revised expenditure on goods and services upwards particularly for transfers to public entities, election related expenditures, generic goods and services, and other statutory expenditures. Consequently, the Government's total expenditure in FY2018/19 is likely to be above the estimated budget by about 1.3 percent of GDP.

Table 3: Fiscal accounts

Percentage of GDP

	2014/15	2015/16	2016/17	2017/18	2018/19	
					Estimated	Revised
Revenue and grants	21.4	21.6	23.5	20.8	22.0	21.3
Revenue	18.6	17.8	20.0	19.3	19.7	19.8
Tax Revenue	16.3	16.0	17.6	17.1	17.6	17.9
Nontax revenue	2.4	1.8	2.4	2.2	2.1	1.9
Grants	2.8	3.7	3.5	1.4	2.3	1.5
Budget support grants	0.0	0.5	0.3	0.0	0.0	0.0
Dedicated grants	1.1	1.8	1.5	0.5	1.0	0.6
Project grants	1.7	1.4	1.7	0.9	1.2	0.9
Expenditure and net lending	27.5	27.6	28.2	28.5	25.8	27.1
Recurrent expenditure	22.2	23.5	21.7	23.8	20.7	21.2
Wages and salaries	6.9	6.4	6.2	6.5	7.2	7.2
Interest payments	4.0	4.0	4.3	3.9	3.8	3.8
Foreign	0.3	0.3	0.3	0.3	0.4	0.3
Domestic	3.8	3.7	4.1	3.6	3.5	3.6
Goods and services	5.5	5.8	5.9	6.7	5.6	6.0
Maize purchases	0.2	0.8	0.7	0.7	0.2	0.2
Subsidies and transfers	4.9	4.9	3.8	5.0	4.0	4.1
Fertilizer subsidy	1.9	1.8	0.7	0.7	0.8	0.8
Arrears payments	1.1	2.5	1.4	1.6	0.1	0.1
ZCPN for securitizing arrears ¹	0.7	2.5	1.4	1.5	0.0	0
Development expenditure	5.3	4.0	6.4	4.7	5.0	5.7
Domestically financed	1.0	0.7	0.7	1.6	1.3	2.1
Foreign financed	4.4	3.3	5.8	3.1	3.6	3.6
Overall balance (incl. grants) excl ZCPN ³	(5.7)	(3.1)	(3.4)	(6.2)	(3.8)	(5.8)
Overall balance (incl. grants)²	(6.3)	(6.1)	(4.8)	(7.8)	(3.8)	(5.8)
Financing	5.8	6.1	4.9	8.2	3.8	5.8
Net foreign financing	2.5	1.9	2.5	2.5	0.6	1.3
Gross foreign borrowing	2.9	2.4	3.0	3.1	1.4	2.1
Budget support loans	0.0	0.0	0.0	1.3	0.0	0.0
Project loans	2.2	1.9	2.5	1.7	1.4	1.7
Other loans	0.7	0.5	0.5	0.1	0.0	0.4
Amortization	(0.4)	(0.5)	(0.6)	(0.6)	(0.9)	(0.9)
Net Domestic borrowing	3.3	1.7	0.9	6.2	4.7	6.0
Securitization of domestic arrears	0.0	2.5	1.3	(0.5)	(1.4)	(1.5)
Privatization proceeds	0.0	0.0	0.3	0.0	0.0	0.0
<i>Memorandum items:</i>						
Primary balance including ZCPN ²	(1.7)	(2.1)	(0.5)	(3.8)	(0.0)	(5.8)
Primary balance excluding ZCPN ³	(1.0)	0.9	0.9	(2.3)	(0.0)	(5.8)

Source: World Bank staff calculations based on MoFEPD data

¹ Issuance of zero-coupon promissory notes² Includes promissory notes issued for the repayment of domestic arrears accumulated since FY2012/13³ Excludes promissory notes issued for the repayment of domestic arrears accumulated since FY2012/13

24. In FY2018/19, the fiscal deficit is expected to reach 5.8 percent of GDP, higher than budgeted at the beginning of the year (3.8 percent of GDP) but lower than the outturn in the previous year (7.8 percent of GDP). The fiscal year is projected to close about 2 percent of GDP above its initial deficit target, but this would still demonstrate progress over FY2017/18, particularly for an election year. A higher than anticipated deficit has been due to lower than expected revenues and grants (about 0.7 percent of GDP), and higher than expected recurrent expenditure (about 1.3 percent of GDP). The excess in recurrent expenditure results from increased spending on election preparations, higher spending on goods and services, and statutory obligations, particularly claims for resolved court cases. Additionally, development expenditure is expected to be over-budget by 0.7 percent of GDP, as project implementation was frontloaded prior to

elections in the second half of the fiscal year. The impact of the Cyclone exerts further pressure on an already constrained budget, making fiscal consolidation efforts even more difficult.

25. Domestic borrowing is expected to increase substantially to meet the financing gap. Total expenditure in the FY2018/19 revised budget is projected to increase from the budgeted 25.8 percent of GDP to 27.1 percent of GDP. Total revenue and grants are projected to decrease from 22 percent of GDP to 21.3 percent of GDP largely due to a downward revision of grants from 2.3 to 1.5 percent of GDP, whilst domestic revenues remain broadly the same. Net domestic borrowing has thus been revised upwards to 6.0 percent of GDP, from the previously-estimated level of 4.7 percent. Net foreign borrowing has also increased, from about 0.6 percent of GDP to 1.3 percent of GDP (see Table 3). The recourse to deficit financing raises concern for Malawi’s sustainability of debt.

Domestic debt continues on an upward trend

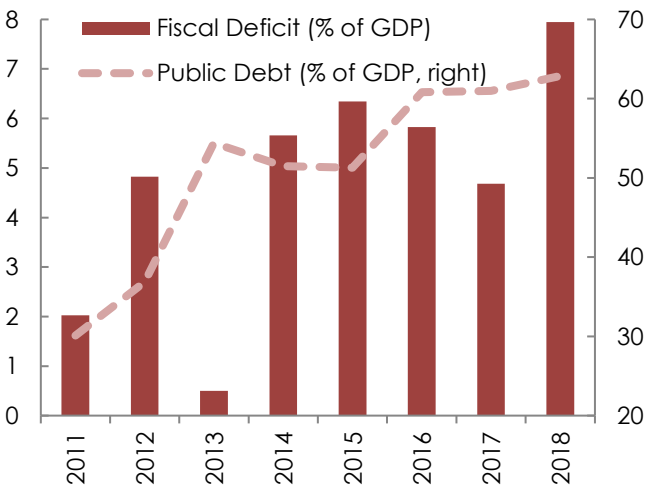
26. Malawi’s debt to GDP ratio has more than doubled since FY2011 to about 60 percent in FY2018. The Government thus faces increasing exposure to high domestic debt (see Figure 9). Accumulation of public debt stems largely from fiscal deficits as the Government has frequently spent over the budget in recent years. This presents a significant risk, as the deficit is expected to be largely financed by high-cost domestic borrowing.

27. While the stock of domestic debt is lower than external debt, the interest burden is substantially greater. Since FY2013/14, the Government has been making high interest payments on domestic debt, reaching 20 percent of Government revenue (see Figure 10). In the last 18 months, the Government’s borrowing has gradually transitioned, with a shift away from the RBM and towards commercial banks and non-banks. Meanwhile, net credit from commercial banks has more than doubled from MK 200 million to MK 403 million in the first three quarters of the fiscal year. Net borrowing from the non-bank sector has increased by 62 percent over this period, from MK 418 million to MK 676 million.

28. With the fiscal deficit expected to widen over initial budget projections, this will increase domestic public debt, undermining fiscal sustainability. Considering the elevated levels of domestic debt, Malawi needs to reduce fiscal deficits to support fiscal and debt sustainability, particularly during years of relative macroeconomic stability. The Government needs to strengthen fiscal discipline to spend within budget, while also budgeting for reduced primary deficits over the medium term. In doing so, it should also strengthen its public financial management systems, possibly enabling it to regain donor confidence, complemented by growth enhancing expenditures, strengthening expenditure controls and improving domestic revenue mobilization.

Figure 9: Malawi’s fiscal deficits and debt levels have deteriorated in recent years.

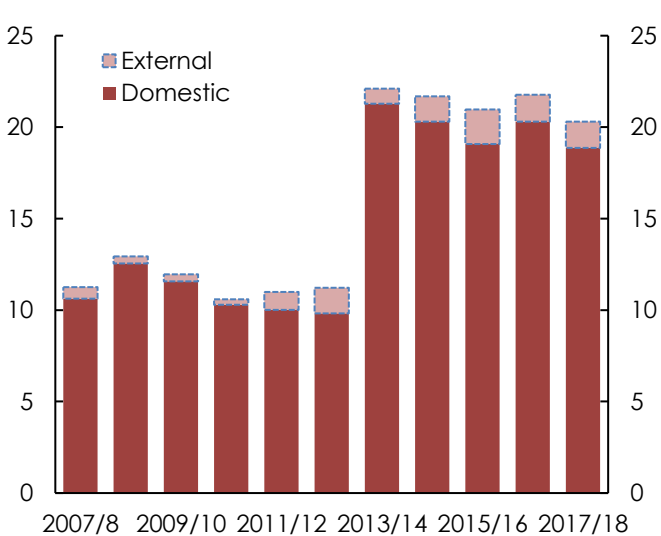
Percent of GDP



Source: World Bank staff calculations based on Ministry of Finance data

Figure 10: Domestic interest costs weigh heavily on expenditure

Percent of Revenue



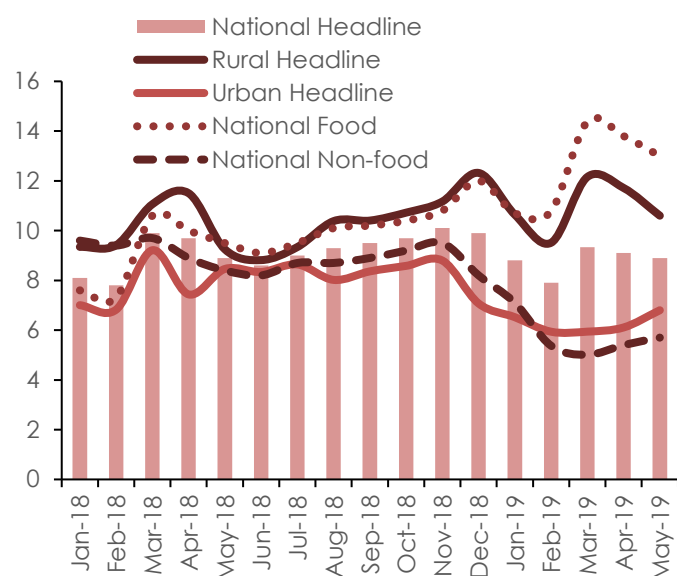
Source: World Bank staff calculations based on Ministry of Finance data

Inflation remained stable aided by a steady exchange rate

29. Headline inflation continued in single digits. Inflation has been in single digits since August 2017 (apart from November 2018 when it reached 10.1 percent). As of May 2019, the year-on-year (yoy) headline inflation rate stood at 8.9 percent. Non-food inflation has steadily declined despite facing upward pressure from electricity and fuel prices revisions between January and November 2018 (see Figure 11). Electricity tariffs were last increased in October 2018, with prices having cumulatively gone up by 53 percent since January 2018. Although fuel prices were reduced in January 2019, the cumulative average increase since January 2018 is about 6 percent (see Figure 12). The movements in food inflation have largely reflected seasonal trends, with a decline during the harvest months of May and June, followed by steady increases and a peak towards the end of the year. Food inflation, which particularly impacts rural areas, has been significantly higher than non-food inflation since mid-2018, due to the aftereffects of the weak maize crop from 2017/18 (see Figure 11).

Figure 11: Headline inflation is holding steady

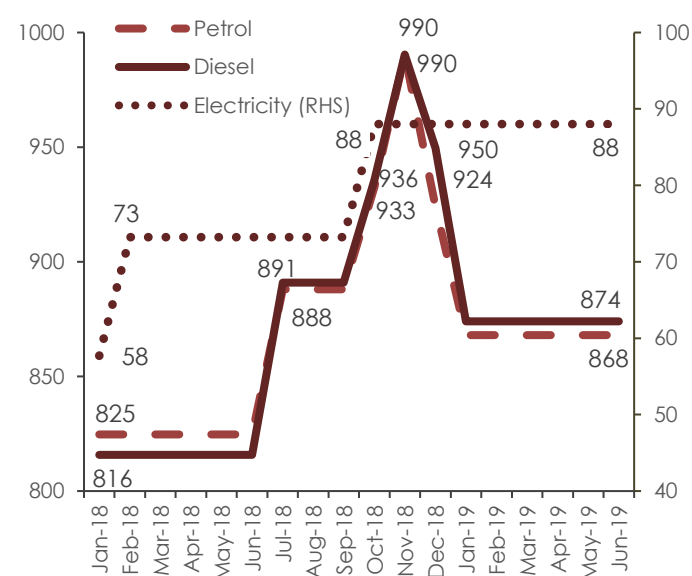
Headline, food and nonfood rural and urban inflation, y-o-y percent (Dec 2017=100)



Source: World Bank staff calculations based on NSO data

Figure 12: Non-food inflation closely trailed by changes in electricity and fuel prices

Electricity (RHS) (MWK/kWh) and Petrol and diesel (MWK/liter)



Source: World Bank calculations based on MERA and ESCOM data

30. Fluctuations in food prices continue to have a significant impact on rural welfare. Food dominates the rural CPI (53.5 percent), significantly higher than for the urban CPI (35.6 percent). Consequently, rural inflation is highly volatile, reflecting the seasonal availability of the staple crop maize. Rural inflation has continued to contribute to a higher national headline inflation rate. The headline inflation rate of 8.9 percent in May is attributed to a rural rate of 10.6 percent and an urban rate of 6.8 percent. The national food inflation rate stood at 13.0 percent, with the rural rate at 14.6 percent and the urban rate at 10.2 percent. The national non-food inflation rate stood at 5.7 percent, with the rural rate at 5.1 percent and the urban rate at 6.3 percent.

31. In 2019, headline inflation rate is expected to hold steady, with a projected annual average rate of 8.9 percent. This is premised on a steady decrease in international commodity prices, particularly key imports of fertilizer and crude oil. Combined with a continued stability of the Kwacha relative to the US Dollar, the risk of imported inflation should remain low. Despite the impact of the Cyclone, a good harvest is expected, which should ease pressure on food inflation.

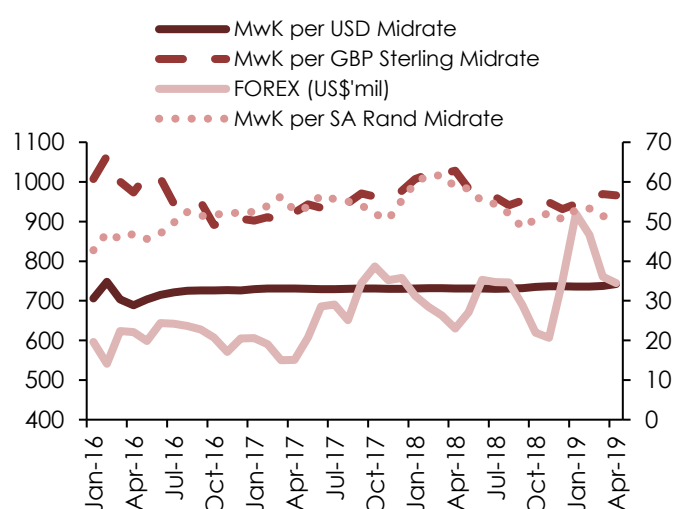
32. This positive outlook is subject to a number of domestic and global risks. In terms of domestic risks, inflation is strongly correlated with energy prices and agricultural output. A good harvest is required to sustain the reduction in food prices. With the limited impact of Cyclone Idai on maize production, there is unlikely to be an increased risk of inflationary pressure on food. On the non-food side, however, the Malawi Energy Regulatory Authority (MERA) approved a 31.8 percent increase in electricity tariffs over the period 2018-2022, which could exert upward pressure. Furthermore, while movements in imported fuel prices are affected by the Automatic Fuel Pricing mechanism, they are ultimately determined by movements in global oil prices.

RBM interventions helped support exchange rate and price stability

33. The Malawi Kwacha has remained fairly stable relative to the US dollar in part due to the tight monetary policy. In May 2019, the Kwacha traded at around MK 751/US\$. This is a marginal depreciation from about MK 731/US\$ over the same period last year (see Figure 13). Compared to other currencies, the Kwacha held ground against the Euro and the British Pound over the same time, probably due to developments related to Brexit. Within the SADC, the Kwacha appreciated slightly against the South African Rand, trading at MK 52/ZAR in May 2019, up from around MK 58/ZAR in May 2018. The Real Effective Exchange Rate (REER) appreciated in 2018, as the inflation more than offset the nominal depreciation against some of the country's trading partners which could reduce competitiveness.

Figure 13: Robust reserve levels have seen continued stability of the Kwacha

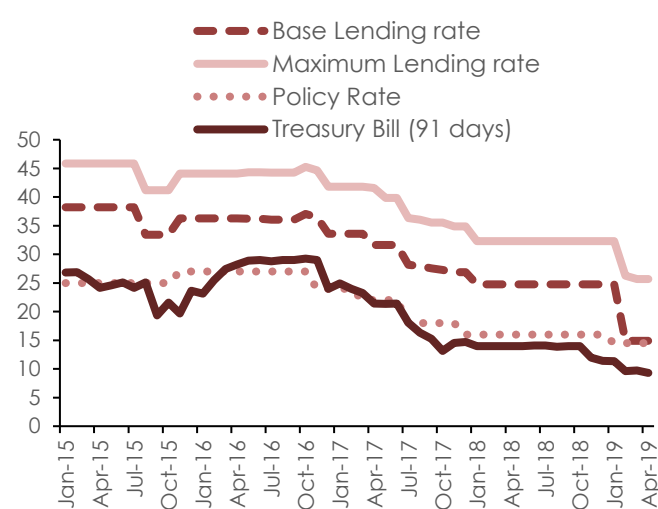
Gross official reserves in US\$ millions, Mid-rate Exchange Rate (MK/US\$), (MK/GBP) and MK/ZAR (RHS)



Source: World Bank staff calculations based on RBM data

Figure 14: Commercial banks' rates remain relatively high despite having a lower policy rate

Percent



Source: World Bank staff calculations based on RBM data

34. The RBM's Open Market Operations helped to stabilize inflation and the exchange rate and supported the building up of foreign reserves. Malawi built up its forex reserves, supported by aid inflows and remittances from the diaspora, traditional exports, and non-traditional export sectors such as oil seeds amongst other channels. As at end-April 2019, gross official foreign exchange reserves stood at US\$ 744.8 million, representing 3.6 months of import cover. This compares favorably to the 3.0 months of import cover during the same period in 2018.

35. Sustained single digit inflation enabled the RBM to reduce its policy rate by a cumulative 250 basis points during the first two quarters of the year. The policy rate currently stands at 13.5 percent, having been reduced from 14.5 percent in May and 16 percent in January. The Monetary Policy Committee (MPC) also reduced the Lombard rate to 14.9 percent and the Liquidity Reserve Ratio on foreign and local currency deposits to 3.75 percent and 5.0 percent respectively. Following the decision in January 2019 for commercial banks to use the Lombard rate as the base lending rate, the MPC refined this decision by introducing other rates in its May 2019 meeting. The reference rate will now be a weighted average of the Lombard rate, the Interbank rate, the 91-day Treasury bill and the Savings rate. These changes aim at ensuring stronger transmission of monetary policy actions to lending rates.

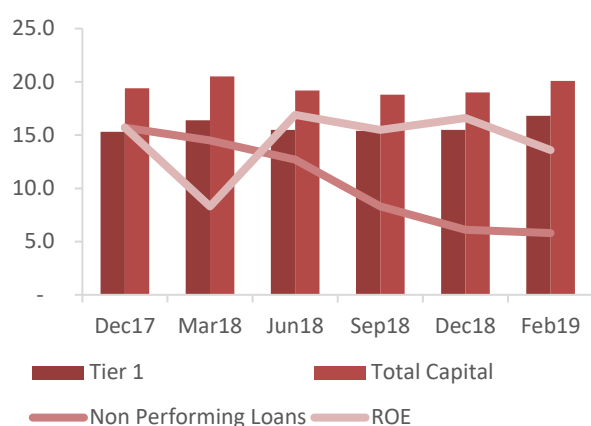
The banking sector is resilient as industry wide capital and liquidity improves

36. Malawi's banking sector remains sufficiently capitalized. The industry-wide total Capital Adequacy Ratio (CAR) increased to 21.0 percent in February 2019 from 8.8 percent in December 2018. Over this period, Tier 1 capital also increased to 16.8 percent from 15.6 percent (see Figure 15). These increases are due to commercial banks continuing to implement an agenda to increase capital to counter the weaknesses that have led to shortfalls in the past. This is also a result of the slowdown in bank provisioning for Non-Performing Loans (NPLs). RBM advised banks to implement measures to reduce NPLs, including cleaning up debt books and strengthening debt recovery.

37. The banking sector's asset quality improved as banks vigorously cleaned their loan books in 2018. The sector-wide average ratio of NPLs to gross loans declined to 7.9 percent in October 2018 and 5.8 percent in February 2019, from 18.8 percent in September 2018. NPLs decreased in the period from July 2018 to December 2018 driven mostly by a decrease in the household and Small and Medium Enterprises (SMEs) sectors. It should be noted that the reduction in NPLs was mostly driven by write-offs by the banks rather than improved recoveries. Meanwhile, commercial banks have lowered their provisioning for loan losses on the back of perceptions of favorable macroeconomic conditions in the near term.

Figure 15: Industry is sufficiently capitalized and NPLs are continuing to decline ...

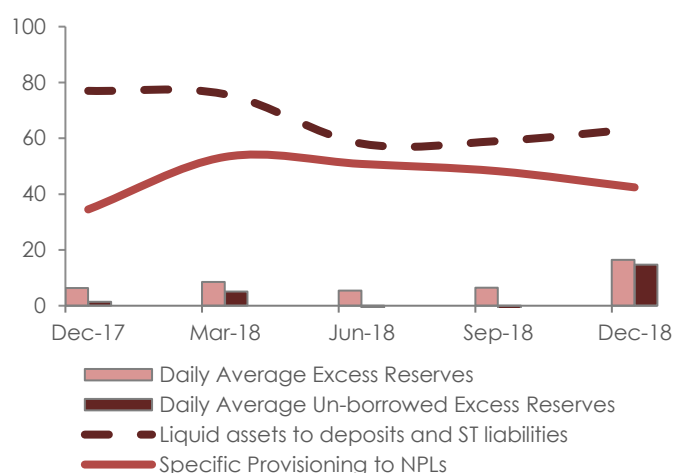
Capital adequacy, NPLs and earnings (percent)



Source: World Bank staff calculations based on RBM data

Figure 16: Average daily un-borrowed excess reserve was positive by the end of the year

Average banking system liquidity, (percent)



Source: World Bank staff calculations based on RBM data

38. Banking sector liquidity remains strong. In December 2018, liquid assets comprised of 63.3 percent of deposits and short-term liabilities, against a 25 percent minimum prudential requirement. This was an increase from about 58 percent in mid-2018. With this improvement, average daily un-borrowed excess reserves grew in the year (see Figure 16). RBM's liquidity stress testing in December 2018 reveals that the banking industry is strong and resilient to liquidity risk.

39. Banking industry profitability remains positive. Overall banking industry profit after tax grew by 17.1 percent in the period from December 2017 and December 2018. This was largely a result of an increase in non-interest income. Non-interest income comprises 32.6 percent of the profit after tax. On the other hand, interest income, which contributed 67.4 percent, deteriorated by 2.3 percent. The Return on Equity (ROE) remained positive but declined to 13.6 percent in February 2019, down from 16.6 percent in December 2018 and 16.9 percent in June 2018. Similarly, the return on assets (ROA), which was at 2.3 percent in June 2018 and 2.2 percent in December 2018, decreased to 1.7 percent in February 2019.

40. Recent investments in the country's digital financial infrastructure serve to further enhance profitability of banks and other financial institutions. This can be achieved through increased operational efficiency, reduced operational costs and increased revenue streams over the short to medium term. Once consolidated and complemented by progress in other areas such as credit reporting and secured lending, these investments, along with the innovative product development that they foster, have the potential to facilitate reductions in the cost of borrowing to consumers and increased financial inclusion (see Box 3).

Government borrowing continues to outpace private sector credit

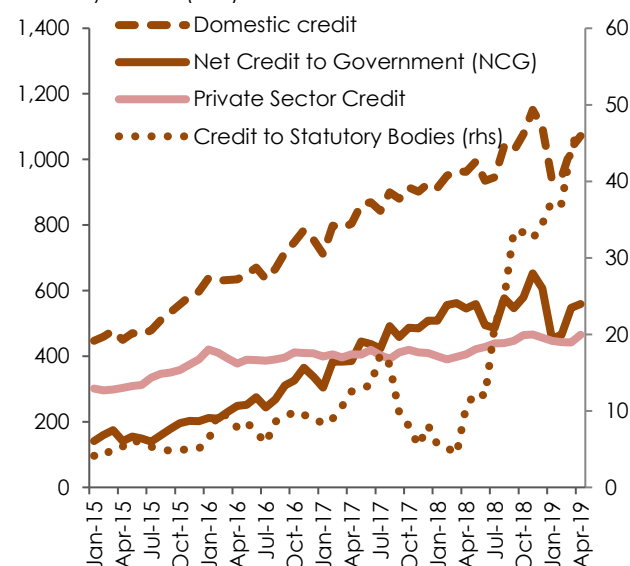
41. Credit to the public sector has increased over the past year. The banking system's domestic credit has increased by 11.3 percent in April 2019 yoy, a slowdown compared to April 2018 when domestic credit grew by 19.8 percent yoy. Of the total amount, about 52.2 percent was net credit to the central government, 43.4 percent was credit to the private sector, while net credit to statutory bodies comprised 4.4 percent (See Figure 17). Credit to statutory bodies, although still at a low level, has grown tenfold from the April 2018 position.

42. Total government borrowing has increased by close to 44 percent over the past year, but largely from the non-banking sources. Government borrowing from RBM declined by 57.3 percent, from MK 353,218.8 billion in April 2018 to

MK 150,798.0 billion in April 2019, in line with the IMF ECF program. On the other hand, government borrowing from commercial banks and non-banking sectors rose by 113.0 percent yoy by April 2019, (112.3 percent from commercial banks and 113.4 from non-banking sector) (See Figure 18). In part, non-bank borrowing supported increased deposits at RBM since early 2019.

Figure 17: Domestic Credit from banking sector

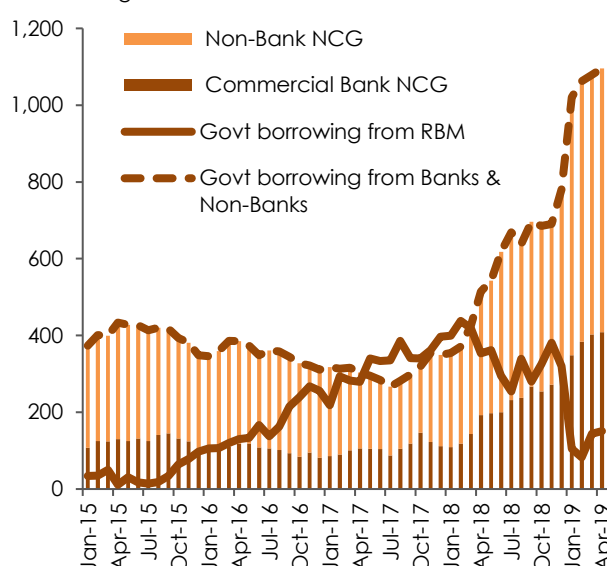
MK, 000 billion
Net Credit to Govt (NCG), Private Sector Credit, Credit to Statutory bodies (RHS)



Source: World Banks staff calculations based on RBM data

Figure 18: Government Borrowing from Banking and non-banking sector

Non-Bank NCG, Commercial Bank NCG, Govt Borrowing from RBM, Govt Borrowing from Banks & Non-banks



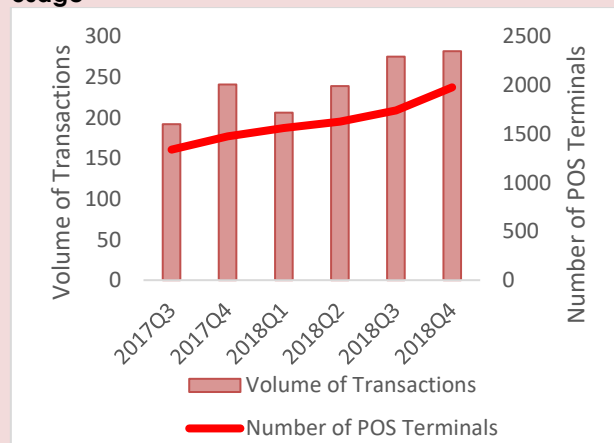
Source: World Banks staff calculations based on RBM data

43. Credit growth to the private sector has picked up since August 2018. It grew by 14.5 percent yoy in April 2019, an increase from only 0.1 percent a year prior, despite a generally weak business environment. The wholesale and retail trade sector represent the largest share of outstanding credit stock, comprising 25.5 percent, followed by agriculture (24.9 per cent) then manufacturing (20.9 per cent).

Box 3: Digital systems in Malawi's financial architecture

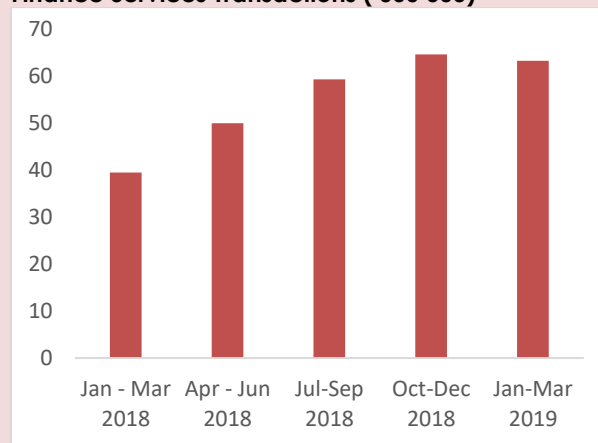
The World Bank is providing support to the Government of Malawi to increase financial inclusion. From 2011 to 2018 support was provided to implement the Financial Sector Technical Assistance Project (FSTAP) with a key objective to enhance the adoption and usage of digital technology to provide solutions, facilitate connections and bridge physical distance, thereby increasing access to finance for the currently unbanked, but bankable, population in Malawi. The project supported, among other areas, improving financial infrastructure and enhancing financial architecture with digital systems that aim to facilitate payments more efficiently.

Figure 19: Trends in Point of Sale Deployment and Usage



Source: World Bank staff calculations based on RBM Data

Figure 20: Estimated Volume of Overall Retail Digital Finance Services Transactions ('000 000)



Source: World Bank staff calculations based on RBM Data

With this support, the Government has improved Malawi's payment infrastructure by implementing the National Switch (Natswitch) project. The Natswitch is an ecosystem of digital retail payment systems that facilitates interoperability between card-based and wallet-based systems. The primary aim was to connect all banks and other payment service providers to a central transaction switching platform, and thus provide customers with access to their money or the ability to make payments through any Auto-Teller Machine (ATM), Point of Sale (POS) device, and mobile and internet payment channels, regardless of which bank or service provider their account is held, or card is issued. To date, 489 ATMs and 2,010 POS devices have been interconnected through the Natswitch (see Figure 19). This has substantially reduced the time and cost that people faced to access an ATM or POS. The Natswitch has also facilitated wallet-to-wallet transactions exchange between Airtel Money and TNM Mpamba, Malawi's two leading mobile money platforms. Malawi has become a global leader in the implementation of this kind of solution since the system went live in November 2018. According to GSMA data, as of 2018, only eighteen other countries apart from Malawi have such interoperability between mobile money platforms. With these integrations, the volume of overall retail digital financial services (DFS) transactions has increased in 2018 (see Figure 20).

Despite this improvement, mobile money services have not been fully utilized in Malawi. In terms of usage, mobile money services continue to be dominated by cash in/out transactions and airtime top ups. However, business to business (B2B) transactions contributed to 23.1 percent of the total value of mobile money payment transactions. This suggests that businesses are slowly adopting mobile money for payment of goods and services. However, further efforts are required to encourage this trend.

While the number of mobile money agents is increasing, most of these are still located in urban areas. By the end of 2018, there was a total of 39,434 agents. However, the distribution of these agents remains heavily skewed towards urban and semi-urban areas. About 77 percent of these agents operate in urban and semi-urban areas while only 23 percent operate in rural areas. Considering that the majority of Malawi's total population is based in rural areas, there is need for concerted efforts by all stakeholders to increase the deployment of access points in rural areas so that a greater proportion of the population have access to secure and affordable payments channels. Further, the usage of mobile money is characterized by high inactivity rates amongst subscribers and sparse availability of agents in rural areas.

The improved payment infrastructure has been extended to microfinance institutions (MFIs) and savings and credit cooperatives (SACCOs), as these play a crucial role in promoting financial inclusion. The microfinance transactions processing hub (or MFI Hub) was implemented to enable MFIs and SACCOs to share a common integrated, interoperable hardware and software platform that meets all their management information system needs. The system helps reduce operational costs; streamline lending processes, thereby reducing cost of borrowing; ease customer service and ability to grow customer base; enhance transparency and integrity; facilitate savings mobilization; and enhance financing to SMEs. The MFI Hub has been integrated with the Natswitch and with the two Mobile Network Operators. Efforts are still underway to integrate with credit reference bureaus, and to enable USSD and debit card facilities. These integrations will further expand the scope for digital transactions across the population, particularly in the rural areas.

The Malawi Stock Exchange Automated Trading System (MSE ATS) went live on 7 June 2018. The ATS has a number of advantages, including increased efficiency by reducing the number of days of settlement from five to three; expanding trading hours from a single one hour session to five hours of continuous trading; eliminating human intervention in determining trade prices; and reducing the time it takes for initial public offerings to be processed and new listings to be made on the MSE. The system also enhances financial inclusion, as the minimum number of shares that can be traded has been reduced from 100 to one. The ATS also enables more people to participate on the MSE more easily and by increasing prospects for investment in listed companies, thereby positively impacting the economy by facilitating the growth of listed companies.

With the recent introduction of these systems, measures are now needed to increase usage, to build trust in the systems, and to protect users. It will be necessary to implement measures to increase financial literacy to generate greater awareness of the benefits of using digital technology, as well as implement consumer protection programs to allay fears related to using the systems.

Malawi's export base remains heavily dependent on tobacco

44. Exports increased in 2018, largely due to an increase in tobacco exports. According to National Statistics Office (NSO) estimates, tobacco export values are estimated to have increased from about US\$532 million in 2017 to US\$688 million in 2018. This coincided with the highest level of tobacco production since 2011. This followed relatively low levels of production in 2017, which led to higher prices, encouraging smallholders to increase production in 2018. Exports were also buoyed by an increase in tea earnings, from about US\$72 million in 2017 to US\$ 87 million in 2018, an increase of 22

percent. The export of groundnuts and macadamia also increased, up from an estimated US\$ 35 million in 2017 to US\$ 53 million in 2018. Sugar and cotton exports continued to perform poorly.

45. In 2018, modest domestic demand continued to weigh on import growth, despite an increase in petroleum-related imports. Petrol and diesel import values increased by almost 50 percent due to higher international oil prices, which increased on average by about 23 percent, as well as a 20 percent increase in volume. The volume of diesel imports increased to 273 million liters from 224 million litres in 2017, an increase of about 22 percent. This was partly due to the use of emergency diesel powered generators which came online in 2018. These generators can require 4.8 million liters per month which represents more than 20 percent of monthly diesel imports. The volume of petrol imports increased from 183 million litres in 2017 to 209 million liters in 2018, an increase of about 14 percent.

46. In 2019, tobacco production and exports are expected to pick up in line with the strong agricultural harvest. A strong tea supply in Eastern Africa is expected to contribute to lower tea prices and slower exports, so that overall tea export values could decline. Imports can be expected to remain level in 2019. Domestic demand is expected to remain subdued, which, combined with lower international oil prices, should reduce the import bill. This may be offset, to some extent, by some potential pickup associated with the humanitarian response to Cyclone Idai, although a strong maize crop in unaffected districts should avert the need for food imports. Moreover, Cyclone Idai impacted transportation corridors in Mozambique leading to the port of Beira, which could have some impact on Malawi's trade. About 47 percent of Malawi's exports and 36 percent of imports flow through Beira, so that for several months, exporters may seek other ports, such as Nacala, Durban, or Dar-es-Salaam. In doing so, some import and export times could increase and possibly result in higher costs, affecting exporters' margins and import prices.

47. The expected decline in global tobacco demand underscores the need for Malawi to intensify its efforts to diversify its exports. As part of Malawi's Integrated Production System (IPS), tobacco smallholders are being encouraged to grow other cash crops. In addition, trade negotiations could help open up markets for products such as pigeon peas, soya, macadamia, and groundnuts, which have shown increased potential in recent years. To optimize its diversification initiatives, Malawi should also strive to move up the value chain into the medium term. However, this will require an improved business environment, with supportive sector regulatory frameworks, improved access to reliable energy, and lower transportation costs.

48. The current account balance is projected to tighten to about 10 percent of GDP in 2019. Cyclone Idai could adversely impact the trade deficit, by up to about 0.5 percent of GDP. Preliminary assessments indicate that there were no major production losses to key export commodities. Imports, however, are expected to pick up due to recovery and reconstruction activities, although food imports should not increase due to a strong harvest. Increased donor support is expected to finance much of the recovery-related imports.

1.2 MACROECONOMIC OUTLOOK AND RISKS

Diversify the economy and increase fiscal restraint to reduce vulnerability to shocks

49. Medium term growth is expected to pick up to the range of 5 to 5.5 percent. It is expected that higher rates will be supported by a rebound in the agriculture sector, despite the short-term adverse impact of flooding due to Cyclone Idai. The rebound in the performance of the agriculture sector is also expected to support growth in the manufacturing and services sectors, through the impact of agriculture on agro-processing activities and on farmers' disposable incomes. As rainfall patterns return to normal and power projects come on stream, energy supply is also expected to improve, further supporting medium-term growth. However, the continued vulnerability of agriculture shows the critical importance of sustaining the resilience agenda.

50. Inflation is projected to decline to around 7.5 percent over the medium term. The implementation of a more consistent and prudent set of monetary policies over the past two years has contributed to a steady decline in inflation and to an easing of exchange rate volatility. This is expected to continue over the medium term. In addition, increased availability of food, coupled with improved transparency regarding public sector maize market interventions, is expected to keep inflation in single digits. The IMF Extended Credit Facility (ECF) arrangement will also provide a supportive anchor to macroeconomic management over the next three years.

51. The current account deficit is projected to continue to narrow and remain in the range of 8-10 percent of GDP over the medium term. Exports are expected to grow, supported in part by incremental shifts towards tobacco production.

The import bill could increase due to Cyclone Idai related humanitarian assistance and to recovery and reconstruction work. However, demand for other imports is estimated to continue to be subdued as economic activity is projected to pick up only slightly. The current account deficit, as a percentage of GDP, is therefore estimated to remain in the range of 8-10 percent over the medium term. The current account deficit will continue to be financed by official development assistance, and to a lesser extent, foreign direct investment.

52. The fiscal outlook envisages a fiscal consolidation over the medium term. Although the FY2018/19 budget is expected to miss its ambitious consolidation to a deficit of 3.8 percent of GDP, the projected 5.8 percent outcome is an improvement over FY2017/18. Beyond FY2018/19, further fiscal consolidation is expected, supported by the IMF Extended Credit Facility (ECF) program, after various one-off shocks in FY2017/18 and election-related pressures in FY2018/19. A projected pickup in growth should also support the fiscal transition towards a slightly positive primary balance in FY2019/20. However, Malawi is likely to expect to continue being buffeted by various climactic shocks, which can be expected to derail fiscal deficits.

Risks remain high, as the economy remains vulnerable to external and domestic shocks

53. Although the macroeconomic impact of Cyclone Idai has been limited, vulnerabilities to the economic outlook remain tilted to the downside owing to continued internal and external shocks.

- *Weak fiscal consolidation:* Accelerated fiscal consolidation is key to restore fiscal and debt sustainability for the country, and to support public and private investment. At mid-year, the FY 2018/19 fiscal deficit target was already exceeded by roughly 1 percent of GDP due to front loading of budgeted expenditures and an increase in election related spending. Malawi has faced various one-off shocks in the last two years which have derailed deficits. Moving forward, it is essential both to increase fiscal restraint and to reduce vulnerability to shocks in order to increase fiscal sustainability.
- *Recurrence of adverse weather:* With Malawi's heavy reliance on the agriculture sector, its exposure to weather-related shocks is high. In addition, it has very limited fiscal space to respond quickly and effectively to such shocks. As a result, whenever Malawi is hit by a natural disaster, such as floods or drought, these events have significant potential to disrupt the economy and to undermine fiscal plans. In the case of the impacts from Cyclone Idai, unless external support is provided, they are likely to put further pressure on an already constrained budget, making fiscal consolidation efforts even more difficult.
- *Weak governance:* With elections now concluded, there is a window of opportunity to strengthen commitment to policy and the implementation of reforms. Building reform momentum to address weak governance and corruption is critically important to strengthen economic outcomes and to bolster donor confidence. Without this sustained commitment, delay in reforms related to Public Finance Management, and poor expenditure and commitment controls, will continue to undermine confidence in budgetary processes.

Policy and institutional actions are needed to change the patterns of growth

54. To address vulnerability to climactic shocks, Malawi must diversify its economy, which will only be possible if the Government exerts greater fiscal restraint. Increased fiscal restraint can help reduce high cost domestic-borrowing and increase the fiscal space for development expenditure, to diversify the economy. Reduced Government domestic borrowing will also reduce interest rate pressures, so creating space for increased private sector borrowing and investment. In addition, the Government needs a comprehensive, multisectoral focus on improving the business environment, to achieve this diversification and to create jobs for a rapidly growing population. Once realized, a more diversified economy would be less susceptible to shocks, creating a virtuous cycle to support a more stable fiscal policy.

55. The new political leadership in Malawi needs to move towards "business unusual" to break Malawi's cycle of crisis and vulnerability and put the country on a path towards increased inclusive growth and job creation for a growing population. This edition of the MEM identifies Malawi's key challenges and opportunities and presents priority policy interventions for the country to sustain and build on recent gains towards eliminating extreme poverty and boosting shared prosperity. It argues that Malawi needs to implement bold policies and allocate limited fiscal resources on areas that have the most impact on growth, job creation, and poverty reduction. The Government will need to transform its relationship with the private sector and strengthen its focus on service delivery to break out of recurrent cycles of weak governance and institutions. This will ensure macroeconomic stability as well as sound and efficient policy implementation, to diversify the economy, improve human capital, and develop strategies to improve resilience.

2. SPECIAL TOPIC: CHARTING A NEW COURSE⁶

This economic update presents key considerations for the newly elected Government as it prepares its policy agenda. The incoming administration faces both challenges and opportunities to build on past progress. Malawi has seen recent achievements on the macroeconomic front, including exchange rate stability and reducing inflation to single digits. However, significant challenges remain.

While Malawi has made some progress in terms of human development outcomes, these improvements have been extremely uneven, with the gains much less significant for the poorest 40 percent of the population. In particular, fertility rates remain stubbornly high among the poorest segment of the population, which is also disproportionately affected by stunting. A rapidly expanding population, together with increasingly degraded soil and environment, compound the situation. In addition, while Malawi's rate of ultra poverty has fallen, its rate of moderate poverty has remained above 50 percent. Moreover, a large proportion of the population still depend on the fluctuating fortunes of rainfed subsistence agriculture, and there has been little economic diversification.

Although weather shocks are important in explaining Malawi's macroeconomic instability, evidence suggests that poor economic policies and management have been a greater cause. This means that the most important causes of instability appear to be within Government's control. The new administration should therefore grasp this challenge. To do so will require strong leadership and commitment to maintaining macroeconomic stability, particularly through tighter control of expenditure, even in the face of political pressure. This will involve fundamental changes in approach to economic management, governance and institutions, human development and resilience. To this end, the Government needs to implement bold policies and allocate limited fiscal resources effectively, focusing on areas that have the greatest impact on growth, job creation, and poverty reduction. This will also require transforming its relationship with the private sector and strengthening Government's focus on service delivery.

In the first year of the new administration, there is an opportunity to lay the foundation to achieve these goals through a focus on four areas:

- *Theme 1: Malawi needs to ensure the foundations for growth are in place, with supportive macroeconomic policies and a results-oriented public service.*
- *Theme 2: Malawi needs to transform the economy and increase growth to create jobs and ensure food security.*
- *Theme 3: Malawi needs to strengthen its human capital by improving education and reducing fertility and stunting.*
- *Theme 4: Malawi must actively develop systems to increase resilience to shocks.*

Theme 1: Establish the foundations for growth with supportive macroeconomic policies and a results-oriented public service

56. Across the world, countries that have achieved and sustained high rates of inclusive growth since the 1950s have been characterized by five main factors. These are macroeconomic stability; leadership and governance committed to growth; openness to trade and readiness to exploit global demand; high investment and savings; and market allocation that allows prices to guide resources (Growth Commission, 2008). Sustained commitment to improving performance in each of these areas will be critical for Malawi to sustainably increase growth and incomes.

57. Malawi faces a critical opportunity to demonstrate stronger economic management and service delivery. With exchange rate depreciation and high inflation tamed since early 2017, the Government should move forward to institutionalize commitment mechanisms to counter inevitable political pressures. Stronger fiscal management will be the lynchpin for success. A track record of macroeconomic stability, low inflation, and fiscal discipline will promote investment, which can be crowded in by improving public investment management to deliver needed infrastructure and other public goods. The potential of Malawi's public service (previously among the best in Sub Saharan Africa) must be unleashed through clear signals from the highest level that standards of integrity will be enforced. Additionally,

⁶ This section is a consolidation of nine policy notes that were prepared to inform political debate in the leadup to Malawi's May 2019 presidential elections and the incoming administration's development agenda. The notes provide the World Bank's diagnosis of Malawi's main economic and social development challenges and charts a possible course to address them. The insights offered draw upon a wealth of analysis carried out by the World Bank country team in the past few years, including a Systematic Country Diagnostic and a Country Economic Memorandum.

the new administration should focus on translating achievements at the central level into more effective service delivery through strengthened public finance and human resource management, and re-committing to effective and accountable decentralization.

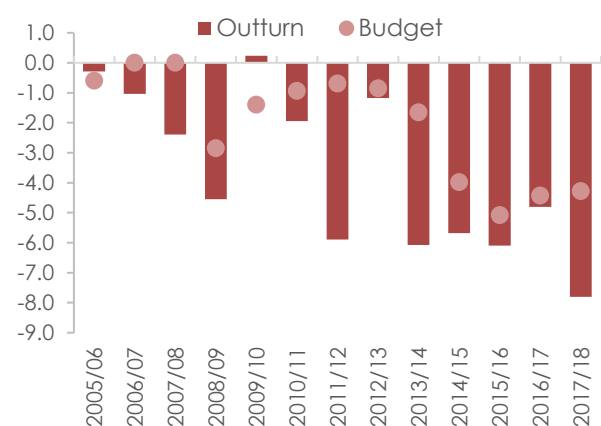
Strengthen macroeconomic and fiscal policies

58. Malawi has experienced repeated episodes of macroeconomic instability, with negative implications for sustained economic growth and poverty reduction. This instability has contributed to persistently high poverty rates and relatively low growth rates compared to regional peers. It has undermined growth and investment, with periods of rapid currency depreciation and high inflation rates, with these rates standing at more than 20 percent in the period from 2011 to 2016. Correspondingly, Malawi has also recorded some of the highest interest rates in the region. However, Malawi has enjoyed a period of stability over the past couple of years. Since early 2017, the exchange rate has remained relatively stable with inflation declining to single digits.

59. Exogenous climate-induced shocks are a major source of vulnerability, with these shocks exacerbating macroeconomic instability and making it harder for Malawi to break the cycle of vulnerability. As a small, open economy with an undiversified production and export base and a heavy dependence on aid, Malawi is vulnerable to weather shocks, particularly droughts and floods. It is also vulnerable to terms-of-trade shocks, particularly related to oil and fertilizer price increases and tobacco price declines; and to sudden and sharp declines in capital inflows, including external aid. Weather shocks are invariably accompanied by declines in agricultural output and associated slowdowns in economic activity. In turn, this leads to declines in domestic revenue and increases in expenditure on relief. Together, these factors have frequently de-stabilized national budgets. The most common response has been to delay adjustment and to strive to manage until the arrival of external aid.

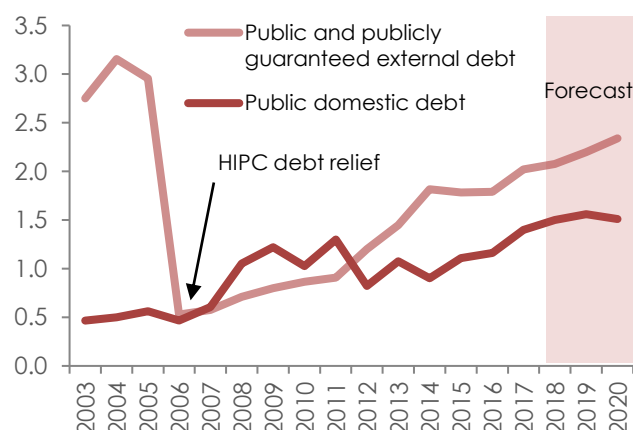
60. Additionally, fiscal risks, particularly relating to State Owned Enterprises (SOEs), have led to expenditure overruns in recent years. Weak financial management of SOEs poses a risk to public finances, causing operational losses and the accumulation of arrears and contingent liabilities. Government guarantees of parastatals' loans also pose fiscal risks. In cases of default, the Government has provided funds to bail out these SOEs on several occasions. For example, in 2017/18, the Government stepped in to bail out ADMARC, resulting in unplanned expenditure to a value of 1 percent of GDP.

Figure 21: Expenditure overruns and revenue shortfalls continue to widen the fiscal gap
Percent of GDP



Source: World Bank staff based on MoFEPD data

Figure 22: ... leading to rising debt levels
USD billions



Source: World Bank staff based on DSA data

61. Regular expenditure overruns and shortfalls in revenues and grants have led to the frequent recurrence of high fiscal deficits (see Figure 21). In recent years, this has led to a substantial buildup of domestic borrowing at high interest rates, with more than 90 percent of interest costs being for domestic debt. This has reduced fiscal space and contributed to the crowding out of private sector lending. Almost all of the fiscal space created as a result of the 2006 debt relief process, implemented under the Highly Indebted Poor Countries Initiative, has now been eroded (see Figure 22).

62. Increasing fiscal restraint is key to support growth. A stronger commitment to reversing recent fiscal slippages would reduce fiscal deficits and reliance on high-cost domestic borrowing. In turn, this would exert downward pressure on interest rates and thus increase access to finance. Key to this will be controlling expenditure pressures. The Government must exert sustained vigilance to control expenditure on the wage bill and to reduce high levels of domestic borrowing in order to decrease the burden of interest payments and to expand fiscal space for development expenditure. It is also important for the Government to avoid the accumulation of arrears, which have undermined past budgets.

63. Strengthening the effectiveness of public investment is also needed to support growth. Historically, Malawi's level of public investment has been low, with poor returns on investment due to suboptimal public investment management. Returns from domestically-funded public investment expenditure are often undermined by weak cost-benefit analysis, unpredictable funding, non-transparent procurement processes, weak project management and implementation, and ineffective monitoring, evaluation, and oversight (Public Investment Management Assessment 2018).

64. Until 2018, the Reserve Bank of Malawi (RBM) funded national budget deficits, which contributed to exchange rate volatility and high inflation. RBM financing of deficits stopped in 2018, providing strong support for macroeconomic stability. In addition, in late 2018, the RBM Act was passed to reinforce and support the institution's independence. Ensuring that this act and other measures are implemented to reinforce this independence will be critical for macro-stability going forward.

65. Despite persistent challenges, Malawi has been able to successfully implement reforms when incentives have been aligned. The Government can continue to restore and build confidence by maintaining a strong commitment to sound economic and public financial management. With the decreased exchange rate volatility and inflation rates since early 2017, the new Government has an opportunity to sustain this stability by institutionalizing commitment mechanisms to counter inevitable political pressures. To achieve this, it will need stronger fiscal management. If the Government consistently maintains macroeconomic stability, low inflation, and fiscal discipline, it will crowd in private sector investment, with improvements to public investment management enhancing the Government's ability to deliver much-needed infrastructure and other public goods.

Strengthening institutions to deliver results

66. Good governance and institutions are necessary to support sustainable economic growth. With weak institutions and limited policy buffers, the adverse consequences of negative shocks tend to accumulate, entrenching low growth. In the past, corruption shocks such as cash-gate have resulted in donor withdrawals and the Government responding with reform efforts that soon lapse. This pattern reinforces a suboptimal cycle, with short bursts of progress being followed by periods of stagnation. This cycle has created a persistent low-level equilibrium that constrains the state's ability to commit to stable fiscal policies, invest in an effective bureaucracy, and coordinate public and private actors to build resilience to prevent, not just react to, food insecurity.

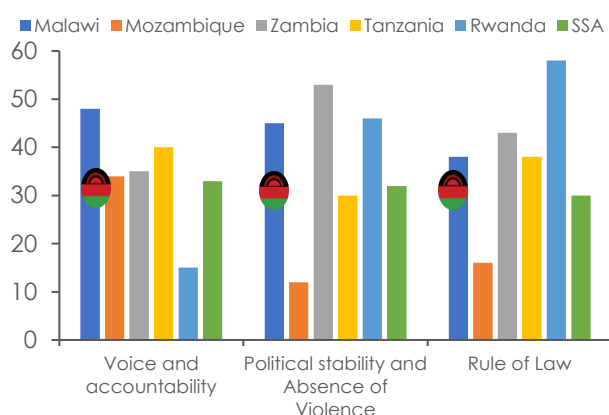
67. Deficits in core public sector functions such as public financial management and bureaucratic effectiveness have been well-documented. The 2013 "cashgate" scandal was a stark reminder that fundamental and deep-rooted governance problems have remained largely impervious to technical reform efforts. When the last administration launched its flagship strategy *Making Malawi Work* in 2015, it acknowledged deep politicization, ineffective performance management, unfair career progression and widespread impunity for wrongdoing in the public service.

68. The poor performance of the public sector has been characterized by the weak enforcement of laws and regulations and a focus on form rather than function. While there is a general outward semblance of a modernized system of economic governance, the underlying political and institutional barriers to change persist. On the surface, Malawi's laws and policies are generally sound, but these are often not accompanied by the necessary commitment mechanisms and incentives to effectively shape behavior. This is partly due to inappropriate technical design of policies, but also to an incentive system that discourages compliance. This results in a wide implementation gap between the formal rules and policies and their implementation in practice (see Figure 23 and Figure 24).

69. These dysfunctions are evident in weak service delivery and human development outcomes. Over the past two decades, Malawi has made significant progress in the areas of maternal and child mortality and primary school enrollment rates, largely due to donor interventions and the free primary school initiative. However, there are significant limitations in the coverage, access, and quality of public services. The very low ratios of medical workers and teachers to the population are exacerbated by inequitable distribution and by poor links between pay and performance.

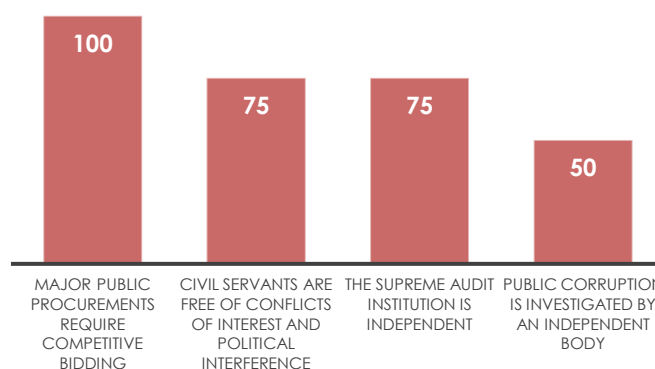
According to Afrobarometer, citizens' perceptions of the Government's handling of basic health and education services and water and sanitation services have been declining for a decade. Over the same period, other key indicators of Government effectiveness, including control of corruption, regulatory quality, and trust, have also fallen.

Figure 23: Malawi scores well relative to neighbors and SSA average on some governance indicators ...



Source: Select Worldwide Governance Indicators

Figure 24: ... but faces a severe implementation gap on key dimensions of integrity.



Source: Africa Integrity Indicators 2017. Nr. represents gap between law & practice; 100=strongest, 0= smallest gap

70. Malawi's public sector reform efforts over the last few decades have shown that reform is ineffective without the highest levels of leadership committing to overhaul incentives and signal willingness to enforce adherence to standards of integrity and performance. While incremental progress has been made, it is often limited to inputs without clear outcomes. Political imperatives lead to backsliding and a gap between the rules on paper and the realities on the ground. Overcoming these pressures, however difficult, is essential to break out of the status quo.

71. Lessons from other countries show that strong and clear leadership can overcome legacies of poor public performance. To do so, it must be ready to reward performance and impose sanctions for abuse. With that commitment and demonstration of 'getting the basics right', a range of public sector modernization reforms can, over time, restore the civil service to the high level of effectiveness it once had. While this can be difficult to achieve across the board, successful countries have invested in 'pockets of effectiveness' to progress priority areas and demonstrate what can be done. The new administration should avoid both sweeping and piecemeal reform plans. Instead it must focus first on demonstrating credible commitment to enforce the basics and restore confidence, and second, on investing in select areas of performance that will yield concrete results.

72. Investing in effective and accountable decentralization can be a critical path to strengthen public resource management for improved service delivery. Introduced in 1998, decentralization was rolled out in a fractured, uneven and incomplete way, which undermined the anticipated gains in responsiveness to local needs. Since 2014, a renewed momentum brought back elected local councilors, introduced a development grant, and devolved human resources to local authorities. Driven by a general sense of public grievance regarding the poor quality and limited availability of basic services, there is a widespread belief that intensified decentralization is the best means to deliver public services and socioeconomic development projects more efficiently and effectively. Local service delivery is thwarted by inadequate fiscal decentralization policies, weak oversight over financial management, and inequitable deployment of critical human resources. Moreover, this encourages fragmentation of service delivery as development partners build parallel systems.

73. Malawi can move forward by renewing its commitment to enhance local service delivery using a results-based approach to reform. Lessons learnt from previous efforts in Malawi and elsewhere suggest that the authorities should shift their focus to target institutions spanning the results chain. These lessons suggest that better results could be achieved through improved cooperation between central and local authorities, with clear links between activities supported and service delivery results. The success of reform efforts will depend on continued investment to strengthen core PFM functions, including planning, budgeting, procurement, and audit. However, with a results-driven approach, it must be recognized that successful outcomes require effective integration of multiple roles, agencies, and functions.

74. Effective citizen engagement can help strengthen reform strategies that meet resistance by vested interests. Malawi has a rich history of positive engagement by civil society, the church, the judiciary, and the media in pushing for reform and preventing abuses of power. Broad-based coalitions of private sector actors can counter pressures associated

with elite capture. Constructive partnerships between civil society and the government can help ensure proper use of resources and innovative solutions to a range of challenges, as has been demonstrated by social accountability initiatives around teacher absenteeism, textbook procurement, and at a larger level public private dialogue for business environment. The new administration would do well to see citizen engagement as a critical pathway to breaking from business as usual and institutionalizing reforms in ways that resist reversal and that begin to change state-citizen relations through a more responsive social contract.

Specific policy actions for the new administration to consider for Theme 1:

In the first year:

- Instill fiscal discipline by strengthening political commitment to realistic budgeting and staying within budget.
- Strengthen SOE oversight, public financial management, and accountability with comprehensive and transparent financial reporting and monitoring.
- Sustaining central bank independence to support lower inflation, reduced interest rates, and a stable exchange rate.
- Get the basics right in public service and signaling a commitment to integrity and enforcement of rules and procedures by:
 - i) Appoint and support merit and performance based senior management officials;
 - ii) Hold controlling officers accountable for the management of public finances and staffing;
 - iii) Sanction those who divert or waste public monies; and
 - iv) Make clear what is expected and recognize, encourage and reward staff who perform well.
- Strengthen service delivery through a renewed commitment to effective and accountable decentralization.

In the medium term:

- Rationalize expenditures to create fiscal space that would allow for responses to shocks without endangering macroeconomic stability.
- Crowd in private investment with smart public investments, while improving public investment management.
- Strengthen public service delivery by investing in effective and accountable national systems of public resource management including improved coordination between central government and local authorities.

Theme 2: Transform the economy and increase growth to create jobs and ensure food security

75. While it is vital for Malawi to implement measures to improve agricultural productivity, with its rapidly expanding population and limited land base, it is also critical that other sectors absorb an increasing share of the workforce to achieve sustainable growth. Accelerating growth and employment in the private sector would help diversify income sources and improve resilience to shocks in the agriculture sector. Malawi's ability to achieve robust, sustainable growth and poverty reduction will depend to a large extent on developing a thriving private sector. Structural transformation to improve the productivity of the manufacturing and services sectors is critical, with this transformation facilitating the movement of an increased proportion of households from rural to urban areas.

76. The Government needs to increase its efforts to facilitate structural transformation to generate productive work opportunities and higher incomes for its population. To achieve this, it must address a number of significant challenges, including the need to maintain macroeconomic stability to support public and private investment; to improve investment in energy and water; to reduce trade and transport costs; and to improve regulatory and tax transparency and certainty. The Government needs to transform its relationship with the private sector and to adopt a coordinated approach across Government ministries and agencies; to intensify its efforts to level the playing field; to attract high-quality long-term investment; and to create jobs in profitable sectors.

Unlocking the potential of the private sector

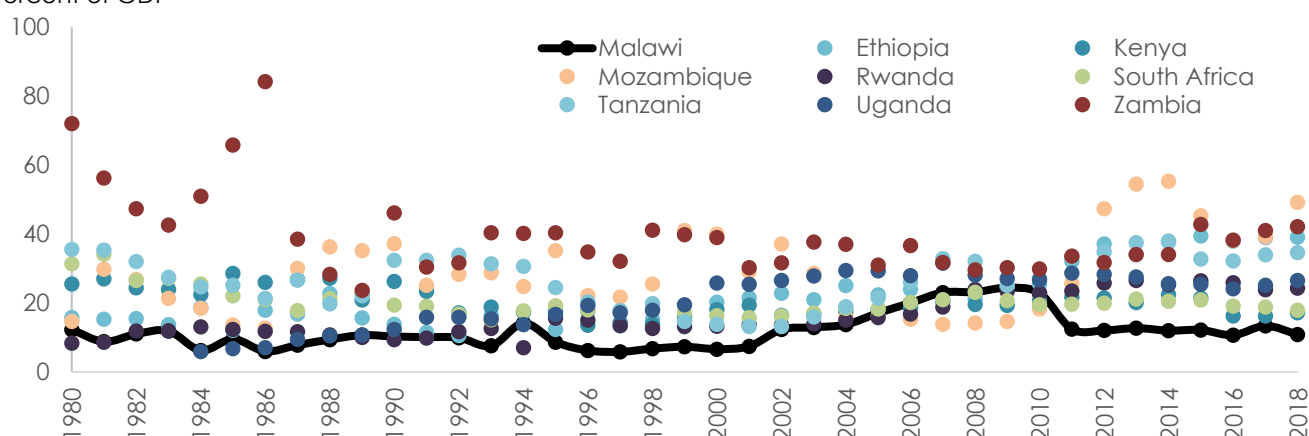
77. With Malawi's high population growth rate, it urgently needs to accelerate economic growth and to create more productive jobs. At current rates, Malawi's population is set to double every 23 years. With environmental and land pressures, it is clear that agriculture sector alone cannot absorb this population growth. At present, Malawi is one of the 15 most agriculture-dependent economies in the world. The proportion of Malawi's citizens that derive their income from agriculture remains stubbornly high at over 85 percent, with the shift to more productive sectors remaining slow. With agriculture likely to remain the backbone of Malawi's economy for the foreseeable future, it must increase

agricultural productivity while at the same time also improving the productivity of other sectors to promote growth, incomes, and job opportunities.

78. The speed of transformation appears to be relatively slow, especially in the context of Malawi's rapidly growing population. Positive yet limited structural transformation appears to be happening in Malawi as labor is shifting towards sectors whose productivity is declining over time. While agriculture is still the dominant source of employment, its share of total employment has gradually fallen. Wholesale and retail trade generated the most jobs for the greater part of the past three decades, followed by government services and construction. These have also been among the least productive sectors, with negative growth in terms of sectoral value added per worker, although their productivity remains higher than that of agriculture. Malawi has experienced limited capital investment, largely towards sectors with lower productivity, such as construction and real estate. Employment growth has thus been the result of 'push factors' out of agriculture, such as increasing population and degradation of soils, rather than 'pull' factors toward services.

Figure 25: Total Investment, Malawi and Select Countries, 1980–2018

Percent of GDP



Source: World Bank staff based on International Monetary Fund (IMF) World Economic Outlook (WEO) April 2019

79. Malawi's low level of investment constrains its ability to achieve high and sustainable economic growth and to create productive jobs. Malawi has one of the lowest rates of total investment in SSA, with the average rate standing at 14.9 percent of GDP in the period from 2000 to 2017, considerably lower than in neighboring Tanzania (24.5 percent) and Zambia (34.7 percent) (IMF WEO) (see Figure 25). This is largely due to low levels of private investment. In the past, both public and private investment have been undermined by macroeconomic instability, which has reduced the certainty needed for investors and driven up interest rates.

80. Economic diversification has been constrained by inadequate investments in agro-processing, resulting in stagnant agricultural productivity and job creation, particularly for the rural population. Malawi's agricultural exports consist predominantly of unprocessed tobacco (about 60 percent of the total), tea, and sugar, with little, if any, value addition. Declining global demand for tobacco amplifies the need for Malawi to achieve higher levels of diversification. To facilitate this, increased private investment in profitable industries that can create employment is needed, and will have to be sustained over decades.

81. Malawi needs to improve transparency and reduce uncertainty to improve its business environment. A non-transparent and uncertain business environment favors companies with long-established networks, with policy biased in favor of larger firms. This is partly due to the enduring legacy of heavy state intervention, which exacerbates barriers to the entry and success of new companies that could play a role in diversifying exports and the economy. Regulatory deficiencies favor established firms with broad networks that enable them to mitigate various risks. Greater efforts will be needed to make regulation—especially tax and licensing requirements—simpler, more accessible, and easier to comply with. It is also essential that sector regulatory frameworks support a level playing field and encourage longer-term investment.

82. Unreliable and limited energy and water supply, as well as high transport and trade costs, further constrain diversification and growth. High transportation and trade costs are a significant impediment, particularly with Malawi's landlocked status and small domestic market. These factors limit investment and FDI, reduce competitiveness, raise the cost to acquire low-cost inputs, and impede the growth of small-scale value addition to agricultural products.

83. Malawi should invest in building skills to diversify and develop a vibrant economy. Low educational standards constrain development and limit employment opportunities for the poor. Almost two-thirds of the labor force have not completed primary education, and another 25 percent have not progressed past primary school. Although firms do not identify the low level of education of workers as a top concern, this reflects the current economic structure, which is a product of these low standards.

84. To develop a vibrant economy and create more jobs, Malawi can leverage a number of opportunities. First, it should support increased value addition, particularly in agriculture. Malawi is potentially competitive in various sectors where it could move from exporting raw and semi-raw commodities to producing higher-value goods and services, thereby creating productive jobs and increasing incomes. In particular, it has opportunities to produce oil seed products, sugar and associated value-added products and manufactured products such as beverages, agro-processing, and packaging.

85. Secondly, increasing regional integration and exports could support economic diversification and more inclusive growth. However, to reap this opportunity, Malawi needs to implement policy reforms to address a range of structural and institutional constraints to reduce trade costs. With Malawi currently relying on low-value agricultural exports with margins too small to overcome high-cost transactions, this is particularly critical. The authorities also need to address nontariff barriers, particularly export bans.

86. Thirdly, Malawi could strive to leverage urbanization and urban-rural linkages. Malawi's urban population has stagnated at around 15 percent since 1999. Even small increases to the urbanization rate and urban investment could enhance economic prospects and facilitate more meaningful structural change. Investments to build dense, connected, and efficient cities would support private sector development, stimulate demand for agricultural products, and increase opportunities for production and trade.

87. Finally, Malawi could more effectively leverage the potential of digital technology. Across the world, digital technology is transforming how people, businesses, and governments communicate, innovate, and transact. It will increasingly drive global economic growth, job creation, and access to services. However, in Malawi, internet services remain expensive, unreliable, and, in many areas, simply unavailable. To improve this, Malawi could encourage greater competition in the sector, review high taxes and regulatory levies on the sector, prioritize broadening internet access, and encourage private investment in the sector.

Increasing agricultural productivity and diversification

88. Agriculture remains the mainstay of Malawi's economy, providing livelihoods for nearly 90 percent of poor households. The sector contributes to around three-quarters of total exports and accounts for 65 percent of total employment in the country. However, the sector contributes to only about 30 percent of GDP, due to the prevalence of low-productivity, subsistence agriculture. Agriculture has strong linkages to other major sectors of the economy, serving as a primary source of food supply, raw materials, incomes, employment, foreign exchange and government revenue. Therefore, improving agricultural performance is critical to reduce extreme poverty and promote shared prosperity. This would require strengthening agricultural markets, diversifying production, and adopting measures to increase resilience to climate change.

89. Malawi's high population growth has intensified pressure on arable land, with people encroaching into marginal areas and employing poor land husbandry practices that undermine soil fertility. Rural population densities in Malawi are significantly higher than in neighboring countries. Agricultural expansion has reached its limits due to population pressures, resulting in more fragile upper catchment areas being opened for cultivation. This has accelerated soil erosion and resulted in the rapid loss of soil fertility. A recent soil-mapping exercise showed that almost 40 percent of agricultural land in Malawi has become highly acidic. Degradation of agricultural land and forests also poses a major threat to productivity and economic development, with annual costs estimated at 5.3 percent of GDP,⁷ with soil degradation identified as one of the main factors driving decreased agricultural yields.

90. Agricultural productivity has fallen far below its potential, particularly among smallholder farmers, with abundant scope for improvement. Most of the growth in production has come from opening uncultivated land, rather than from

⁷ GoM 2011: Ministry of Finance and Development Planning (2011). Economic Valuation of Sustainable Natural Resource Use in Malawi. Poverty and Environment Initiative. UNDP/UNEP.

technological advances. When FISP was introduced in 2005, maize yields initially increased substantially, but have since stagnated between 2.1 and 2.5 tons per ha, far below the potential maximum yield of 6.5 tons per ha. The same is true for other major smallholder crops, including rice, sorghum, millet, common beans, and soya beans. Studies suggest that these yield gaps could be reduced with investment in technology generation, adaptation, and dissemination.⁸

91. Malawi's agricultural sector is vulnerable to production shocks, particularly extreme weather events, which have increased the frequency and intensity of droughts and floods in recent years.⁹ When such shocks reduce crop harvests significantly, many farming households, particularly in the lean period, face hunger and must draw on their assets or turn to short-term coping strategies. Annual losses from production shocks have been estimated to average US\$149 million in the period from 1980 to 2012 (Giertz et al. 2015).¹⁰

92. Increased agricultural diversification could reduce vulnerability to shocks. Malawi's agricultural sector is dominated by maize-based systems, with some 99 percent of smallholders growing maize and relying on a single rainfed season. Consequently, maize production, and the entire sector, suffers from low productivity due to the high risk of climatic shocks. Increasing diversification would reduce risks of income variability, crop failure while supporting farming households to build up savings and productive assets.

93. More predictable and transparent market interventions could reduce price volatility and encourage commercial investment. The Government has used the Control of Goods Act (COGA) to implement export bans to control trade in maize, soy, and other crops. However, the implementation of most export bans has been opaque and idiosyncratic. Various studies, in Malawi and elsewhere, have found that arbitrary and unpredictable licensing and/or bans deter trade, with these practices undermining commercialization.¹¹ Malawi and its neighbors' maize policies, especially related to export bans, have contributed to higher price volatility (see Figure 26 and Figure 27) and decreased private investment. In 2018, Malawi's Parliament passed a new Control of Goods Bill (2018) to create a more predictable trade environment and more transparent regulation of agricultural trade and production. The bill has since been enacted. However, it will be important to expedite the drafting and approval of regulations to guide its implementation.

Figure 26: Variability in Maize Prices, 2005–16, Average

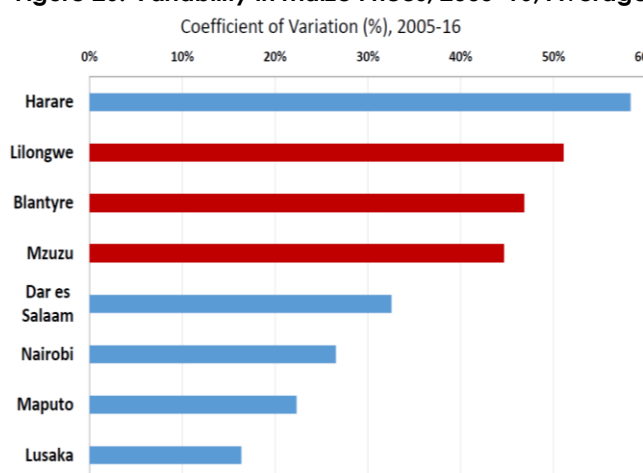
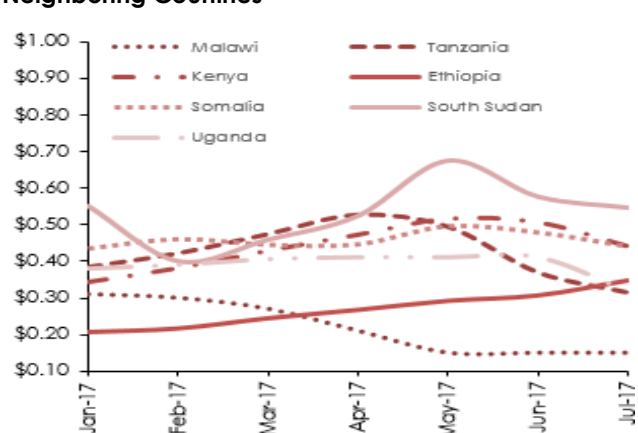


Figure 27: Maize Prices (USD/kg), Malawi and Neighboring Countries



Source: World Bank 2018: Hard Hit by El Nino: Experiences, Responses, and Options for Malawi

94. Reducing market distortions created by the Agricultural Development and Marketing Corporation (ADMARC) and National Food Reserve Agency (NFRA) would also support increased productivity and commercialization. ADMARC and NFRA purchase maize and other crops, theoretically to stabilize prices, to maintain stocks in the Strategic Grain Reserve (SGR), and to serve as a buffer against food shortages. However, these purchases have been inconsistent and unpredictable, while price-setting has not been transparent. These inconsistencies make it difficult for the private sector to plan effectively and may also distort smallholder decisions regarding when and at what price to sell. The Government also sets minimum farm gate prices for purchasing directly from smallholder farmers, although these are also implemented inconsistently. Removing such distortions would support commercialization and investment in agriculture.

⁸ Yield gap is defined as the difference between the actual and potential yields.

⁹ Government of Malawi, National Resilience Strategy (2018-2030)

¹⁰ Giertz et al. 2015.

¹¹ World Bank Systematic Country Diagnostic (SCD) report 2018

95. Government spending on agriculture should shift towards transformational investments, instead of just subsidies for maize inputs and maize procurement. While the Government has consistently met or exceeded the 10 percent budget commitment in the Comprehensive Africa Agriculture Development Programme (CAADP) Compact, agriculture sector growth has failed to attain the Compact's target of 6 percent. The Ministry of Agriculture, Irrigation and Water Development's (MOAIWD) budget continues to focus narrowly on maize production (through the FISP) and on maize consumption (through the SGR and ADMARC). From 2007/08 to 2011/12, expenditure on FISP constituted 73 percent of the MOAIWD budget, and fell to about 50 percent in FY2017/18 following FISP reforms. However, this has not led to increased investment in strategic areas as livestock, extension, irrigation, market development, and research and development, nor has it increased the use of ICT-based extension dissemination methods.

96. To improve the agriculture sector's contribution to poverty reduction, Malawi should adopt a more balanced, cost-effective, and climate-resilient approach. Increasing productivity and resilience to climate change can be achieved through programs to enhance farmers' knowledge of agricultural production and input uses; measures to improve soil fertility; increased use of drought-resistant varieties; crop rotation; irrigation and water development; exploiting the land reform agenda; and addressing gender bias. Measures to commercialize the agricultural sector and to strengthen markets are also critical, including through measures to promote diversification and increased production of cash crops (apart from tobacco and maize); to improve farmers' knowledge and skills in agri-business in terms of pricing, storage, and business negotiation; to reduce inefficient public expenditure; and to limit unpredictable market interventions by the Government.

Improving access and quality of energy & water services

97. Access to energy and water are the top binding constraints to achieving higher rates of growth. Currently, the electrification rate stands at about 11 percent, with huge disparities between urban areas (42 percent) and rural areas (4 percent).¹² The gap between the rich and poor is stark, with the poorest quintile having an access rate of only one percent, while the richest quintile has a rate of 31 percent.¹³ In addition, the annual population growth rate of around 3 percent outstrips the pace of electrification. With Malawi's off-grid sector rather undeveloped, many rural households depend on biomass for their energy needs, which has contributed to severe deforestation.

98. Access to improved water supply and sanitation currently stands at 87 and 44 percent, respectively, although these figures mask the generally poor quality of services. High population growth, dwindling water resources, lagging infrastructure development, and aging water systems create large gaps between supply and demand, leading to unreliable services. Globally, Malawi is ranked fifth amongst the 10 countries (with population greater than one million) with the highest proportion of population at risk of frequent water shortages.¹⁴

99. Malawi's firms are affected by frequent disruptions to electricity and water supply, both of which negatively impact their productivity and competitiveness. The 2014 World Bank Enterprise Survey (WBES) indicated that one-quarter of firms considered electricity outages to be a major constraint on their business activity. In a typical month, firms experienced an average of 6.7 outages lasting about 3.5 hours, with the situation having deteriorated since 2009 (see Figure 28). The frequency of outages is also likely to have increased since the 2014 survey.

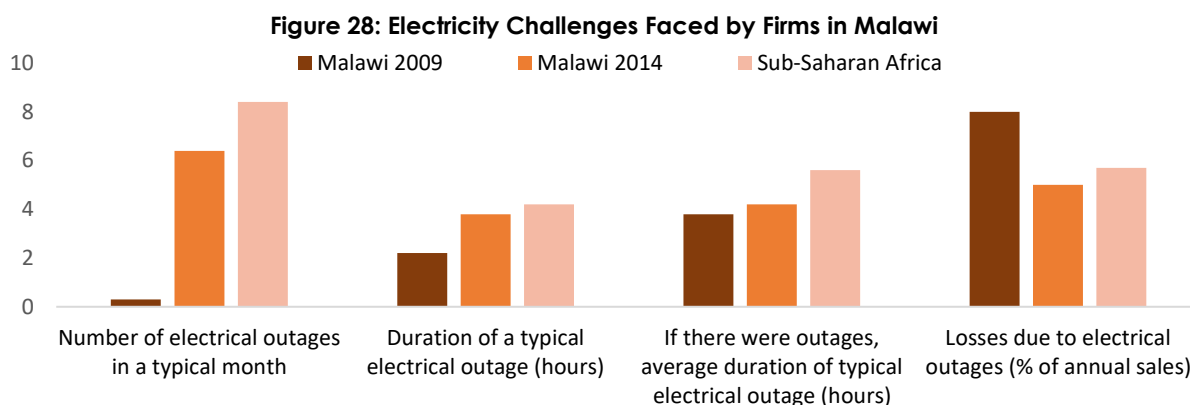
100. The unreliable supply of basic utilities adds to the costs of production and weakens the competitiveness of Malawi's private sector. Although Malawi's grid electricity is reasonably low-cost in terms of tariffs, the large-scale use of back-up systems increases the average cost of electricity to in excess of regional comparators. The low cost of electricity tariffs has also contributed to very limited new capital investment in generation. With respect to water shortages, a recent World Bank global study¹⁵ on the economics of water scarcity suggests that a single water outage in an urban firm can reduce its revenue by more than eight percent, increasing to 35 percent for informal firms.

¹² World Bank (2018). First Order Geospatial Least Cost Electrification Plan.

¹³ Kojima M., Zhou X., Han J., de Wit J., Bacon R. and Trimble C: Who Uses Electricity in Sub-Saharan Africa – Findings from Household Surveys - In each country, people are divided into quintiles based on per capita expenditures, with quintile 1 being the poorest and quintile 5 being the richest.

¹⁴ Sadoff C.W., Hall, J.W., Grey, D., Aerts, J.C.J.H., Ait-Kadi, M., Brown, C., Cox, A., Dadson, S., Garrick, D., Kelman, J., McCormick, P., Ringler, C., Rosegrant, M., Whittington, D. and Wiberg, D. (2015). Securing Water, Sustaining Growth: Report of the GWP/OECD Task Force on Water Security and Sustainable Growth, University of Oxford, UK, 180pp.

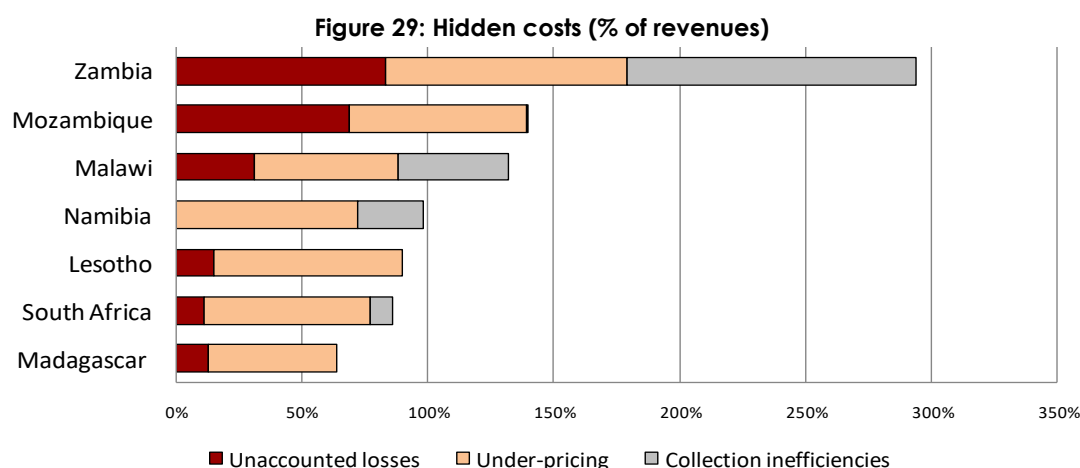
¹⁵ Damania, R. et al (2017). Uncharted Waters: The New Economics of Water Scarcity and Variability. Washington DC, World Bank



Source: World Bank staff calculations based on data from World Bank Enterprise Survey (WBES)

101. Both Malawi's energy and water sectors face two major interrelated challenges, these being (i) lack of investment financing to match needs; and (ii) the inefficiency of service providers. Malawi has a total installed generation capacity of 482 MW. The estimated demand potential currently stands at 440 MW, which is expected to increase to 719 MW in the coming years. Given the heavy reliance on hydropower, with weak rains in recent years, inadequate water levels have resulted in the system operating at less than half the full hydro capacity. This suggests that there is a risk of inadequate hydro generation availability and a need to invest in alternative sources of energy. However, the investment requirements for priority generation and transmission projects are too high to be funded through public sector financing alone. Comprehensive sector reforms are required to encourage private sector participation, especially in generation through Independent Power Producers (IPPs).

102. The lack of investment financing has also been a challenge for the water sector. Much of the existing water supply infrastructure was built in the 1970s. However, major investments in ever more expensive water sources, have not translated into improved services, mainly due to the weak institutional capacity of service providers. To reach 100 percent coverage of improved and reliable water supply and 90 percent sanitation coverage by 2030, funding of around US\$ 2 to \$3 billion is needed. However, Government investment in the sector remains extremely low, with this unlikely to increase.



Source: Authors' Calculation based on data from the International Benchmarking Network (IBNET)

103. The inefficiencies of Malawi's energy and water utilities create a hidden fiscal burden. In the energy sector, transmission and distribution losses are estimated at about 18 percent. In the water sector, these losses (non-revenue water) average about 35 percent. Water bill collection rates average around 80 percent, with Government agencies/departments owing utilities large sums of money. Malawi's water utilities lose over an estimated 125 percent of revenues due to these inefficiencies (see Figure 29). Typically, utilities compensate for these losses by reducing maintenance, which further increases losses. This then increases repair costs, thereby reducing financing available for investment. The weak financial position of utilities also hampers their ability to expand access and to ensure reliable service delivery.

104. Strengthening corporate governance and addressing gaps in sector institutional frameworks could alleviate challenges in these sectors. Both the water and electricity sectors are burdened with excessive state representation in

sector institutions, which limits independent decision-making in areas such as recruitment, procurement and financial management. Further, long-standing gaps in the institutional frameworks for both sectors remain unresolved. The Government should support a reform process to allow autonomy and accountability of Malawi's utilities.

105. Urgent policy action is needed in five areas. First, the Government should mandate prepaid services for all Government agencies and departments, which will minimize the accumulation of unpaid utility bills. Second, the Government should provide incentives to service providers to reduce operational inefficiencies by linking public financing for capital expenditure to verifiable improvements in efficiency. Third, the Government should prioritize and fast-track investments that result in rapid improvements in the reliability of services (e.g. reduction in water losses). Finally, the Government should adopt a national electrification strategy that is in line with the National Energy Policy and that is underpinned by sound analytics to drive the sector. These measures must be complemented by medium-term institutional reforms, many of which were initiated years ago, but which have since stalled.

Specific policy actions for the new administration to consider for Theme 2:

In the first year:

- Initiate a cross-Government effort to radically reform the business environment. This should aim to develop an investment climate and sectoral regulatory frameworks that can attract higher-quality investors and investments, and facilitate the creation of better jobs in profitable, diverse sectors.
- Remove restrictions and establish transparent, predictable trade policies to improve agricultural markets, stimulate production and exports.
- Release successful technologies and enforce seed policy regulations.
- Improve financial and operational performance of utilities by linking financing to verifiable improvements in efficiency.
- Strengthen corporate governance and institutional framework of utilities by establishing autonomy and accountability.

In the medium term:

- Address key constraints in the quality and access to backbone services, by:
 - i. Increasing access to finance,
 - ii. Enhancing access and reliability of energy and water supply; and increasing public and private investment in generation and transmission projects
 - iii. Reducing transport and trade costs, and
 - iv. Optimizing the potential of ICT.
- Initiate efforts to better leverage urbanization and urban-rural linkages.
- Accelerate reforms to FISP and increase public spending on priority areas such as extension services, sustainable irrigation, market systems and access to markets.
- Embrace and disseminate other technologies through extension services, particularly ICT.
- Improve the skills of the workforce by enhancing education quality and private sector linkages.

Theme 3: Strengthening human capital

106. Malawi's population growth rate of more than 3 percent is one of the single greatest challenges to improving human capital development and economic prosperity. While Malawi has made good progress in human development outcomes in the last two decades, further progress on reducing fertility rates, particularly amongst adolescent girls, is critical to support improvements in human capital development and inclusive economic growth. Reducing the fertility rate will also help reduce stunting and relieve population pressures on limited agricultural land and Government services. Additionally, while Malawi's education system has expanded rapidly in recent years, its capacity has not increased proportionately. Malawi needs to expand equitable access to good quality education across the education system, particularly for girls. Lower levels of population growth will alleviate pressures on the government to keep up with the increased demand for education, health care and other social services. According to Schneidman et al. (2018), reducing Malawi's fertility rates could lift over 8 million people out of poverty. However, to harness a potential demographic dividend, Malawi needs to accelerate its investment in human capital. Moving towards multisectoral collaboration, that integrates a unified approach to education, health, and nutrition interventions is likely to be more effective. Reforming Malawi's safety nets can also play a role in this.

107. Malawi, as one of the early adopters for the Human Capital Project (HCP)¹⁶, can ensure that its people have the skills and capacities to take advantage of economic opportunities and be productive. Malawi, like most countries in Africa, has a very youthful population, which makes its people the greatest source of wealth. Malawi's HCI score is 0.41, compared to a global average of 0.57. This means that, under current conditions, children born in Malawi will be only 41 percent as productive when they grow up as they could be if they had complete education and full health (as defined by the index). Developing human capital by developing the education, skills, and health of people will therefore play a pivotal role in the transformation of the economy. This will require a massive and coordinated effort to strengthen the quantity, efficiency, and impact of investments in people.

Improving Education Access, Quality, and Equity

108. Malawi's education system has expanded rapidly in recent years, outstretching system capacity. The expansion has resulted in an impressive increase in the number of students enrolling in primary school and, to a lesser extent, in secondary and higher education. However, this rapid expansion has stretched existing resources, including classrooms and infrastructure, staffing, and teaching and learning materials.

109. The limited education resources are poorly distributed, leading to inequities and disparities in conditions and practices. Evidence from the Malawi Longitudinal Schools Survey (MLSS) finds that staff, infrastructure and learning materials are concentrated in schools near to trading centers (towns and large settlements), while schools in remote areas face significant shortages. Remote schools' students are typically poorer and less likely to have literate parents, meaning that schools which face the largest pedagogical challenge are those with the least resources (Asim et al., 2018). Furthermore, high repetition rates perpetuate large class sizes, commonly above 100 at the lower primary level, decreasing system efficiency and the learning impact of available resources. Thus, learning outcomes are improving only slowly, and from a very low base.

110. Learning outcomes are inequitable at both primary and secondary school levels. The average performance of students in learning assessments varies significantly both between and within districts, according to learning assessments conducted with Standard 4 students as part of MLSS. Students in disadvantaged districts,¹⁷ as well as those in more remote schools within districts, achieve lower scores. Girls also perform significantly less well than boys, across subjects and particularly in Math (ibid.). At Secondary level, about 60 percent of students are concentrated in Community Day Secondary Schools (CDSSs) and Open Secondary Schools (OSS). Results from the 2016 Malawi School Certificate of Education (MSCE) show that the CDSS and OSS register lower learning outcomes than other types of public schools (see Figure 30). Furthermore, across all subjects, girls achieve lower learning outcomes than boys.

111. Each year, around 740,000 children enroll in Standard 1. By 2017, Malawi had 5 million registered primary school students and about 350,000 registered secondary school students. However, only three of every 10 children who enroll in Standard 1 reach the end of the primary cycle (Standard 8), and only one completes secondary education. On average, children in Malawi can expect to complete 9.4 years of education by age 18. Adjusted for learning quality, this is equivalent to only 5.4 years, a learning gap of 4 years, which compounds the wastage of resources. The low human capital base continues to provide a weak foundation for Malawi's economic growth and development.

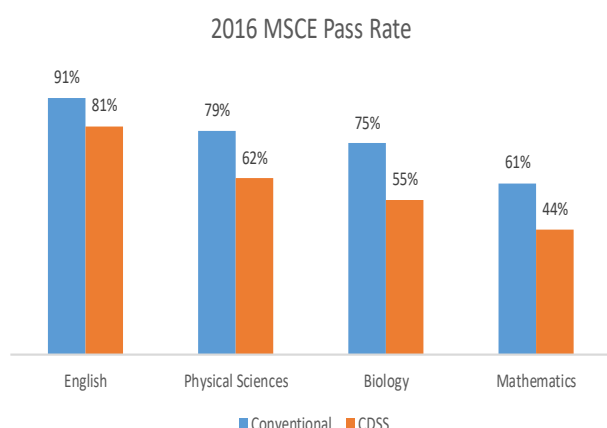
112. However, the Government has demonstrated strong commitment to investing in the education sector. Malawi is among the early adopters of the Human Capital Project (HCP), with a functional multi-sectoral team to champion this agenda convened by the Ministry of Finance. In addition, Government expenditure on education as a percentage of GDP (5.4 percent) is considerably higher than the average for SSA (4.8 percent).¹⁸ Education is the highest funded sector, with 21.5 percent of the total Government budget. Of this, close to 80 percent goes to personnel emoluments, with 75 percent of this proportion going to teachers (see Figure 31). Public expenditure per primary education student has increased to US\$ 115, and to US\$ 318 per secondary student.

¹⁶ The World Bank's new Human Capital Project is a global effort to drive more and better investments in people. It uses the Human Capital Index (HCI) to measure the potential productivity of the next generation. The index uses three main building blocks, namely: (a) Survival – will kids born today survive to school age? (b) School – how much school will they complete and how much will they learn? and (c) Health – will kids leave school in good health and be ready for further learning and/or work?

¹⁷ Disadvantaged districts selected by Government on basis of key education variables including low number of qualified teachers, low retention rates, and lack of classrooms and physical infrastructure. For details, see World Bank, 2016c.

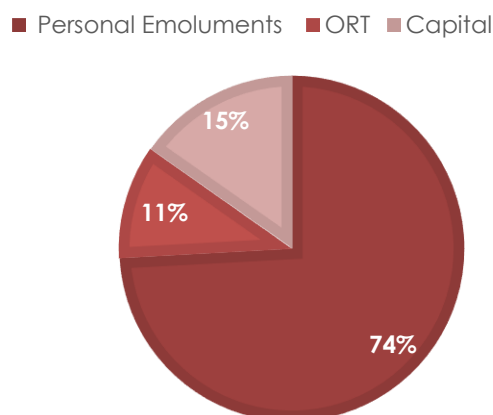
¹⁸ Bashir, S., Lockheed, M., Ninan, E., and Tan J.P., (2018). Facing Forward. Schooling for Learning in Africa. Africa Development Forum. World Bank Group.

Figure 30: MSCE Pass Rate in Selected Subjects and School Type
Percent



Source: Malawi National Examinations Board

Figure 31: PE dominates sector budget leaving little for teaching resources and sector capitalization.
Percentage of total



Source: World Bank staff based on MoFEPD data

113. For Malawi to achieve better and more equitable learning outcomes with limited resources, it urgently needs to better target resources to the schools and students with greatest need. Recent policy reforms and projects suggest an encouraging move in this direction: the Malawi Education Sector Improvement Project (MESIP), supported by the Global Partnership for Education (GPE), targets key activities to the most disadvantaged districts, supporting improvements in staffing and the construction of low-cost learning shelters to reduce the use of open-air classrooms. In addition, through recent reforms to the allocation of newly deployed teachers, the Government has begun to tackle the concentration of teachers in urban schools (Asim et al., 2019).

114. Government, community leaders and parents have a responsibility to ensure that all children who enroll in school complete primary and secondary education. Improving educational access and quality will ensure that these children attain the level of knowledge and skills commensurate with the years spent at school. Low cost alternatives to the current system of secondary education service delivery should also be explored, including through Public-Private Partnerships (PPPs) and Open Distance Learning (ODL) programs to equip the labor force with the basic level of knowledge and skills required to form a solid foundation for future growth and development.

Addressing an unfinished fertility and stunting agenda

115. To eliminate extreme poverty and ensure shared prosperity, Malawi must effectively address the high levels of fertility and stunting. Malawi has experienced a steep drop in mortality and an important but slower decline in fertility, which implies a continued high rate of population growth. In the period from 1990 to 2015, under-5 mortality declined by nearly 75 percent, with life expectancy increasing by 20 years. At the same time, total fertility declined by about 2.3 children per woman. Reductions in childhood stunting have been relatively modest since early 1990s but have accelerated since 2010. While these improvements in child survival and childbearing are impressive, serious challenges persist.

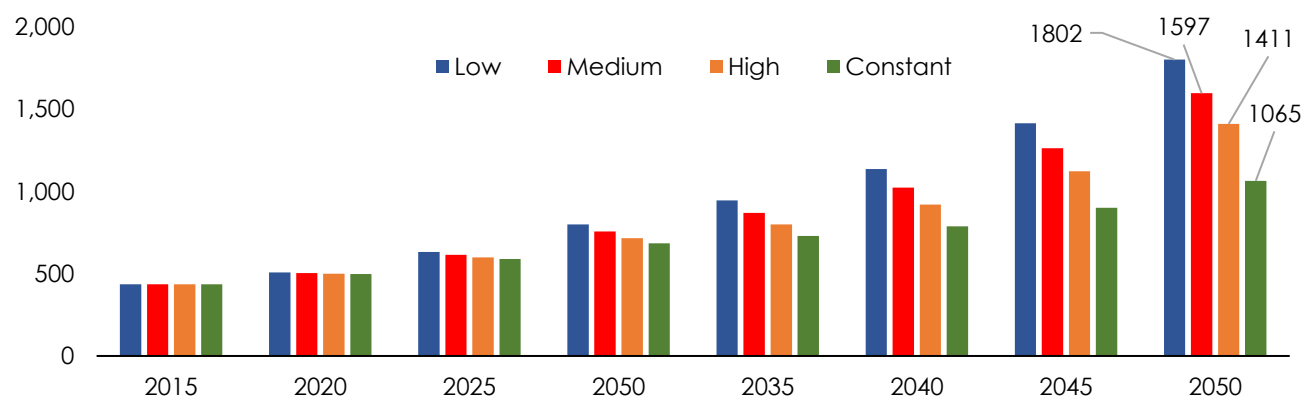
116. High fertility rates perpetuate Malawi's vicious cycle of poverty. The least educated women and those from the poorest communities have the highest fertility rates, which limits their economic prospects and keeps them trapped in poverty. Malawi has one of the highest adolescent childbearing rates in the world, reflecting the prevalence of early marriage and childbearing, which constrain the educational opportunities and lifetime earnings of Malawi's girls. In addition, high fertility rates and shorter intervals between births are associated with higher levels of stunting, which also has a negative impact on levels of educational attainment and lifetime earnings.

117. Fertility rates in Malawi mask wide socioeconomic and educational disparities. Women from the three lowest wealth quintiles have substantially higher fertility rates (4.5–6.0) than those in the top quintile (3.0). There is also a large gap between girls with no education (5.5) and those with secondary or higher education (2.3). This underscores the importance of education for girls, with greater educational attainment raising the value of women's time and increasing the opportunity cost of having children. Education also reduces fertility and stunting by improving children's health and reducing child mortality, with educated women having fewer babies to yield the same desired family size. Educated women are also significantly more likely to adopt more appropriate child-feeding and care practices.

118. Adolescent childbearing declined modestly over the period from 1990 to 2015, from 35 to 29 percent. This decrease has been driven by declines in fertility among urban and wealthier quintiles, while fertility rates for adolescents from the two lowest wealth quintiles have actually increased. The proportion of adolescent women who bear children is still very high, prolonging their reproductive years and contributing to high rates of fertility and stunting. Adolescent women are more likely to experience adverse pregnancy outcomes and are less able to pursue educational opportunities than young women who delay childbearing. Until very recently, the legal age for marriage was only 15 years. While over the past 25 years, the percentage of girls who marry by 15 has declined slightly, from 15 to 9 percent, the percentage who are married by 18 remains stubbornly high, at about 46 percent.

119. Wanted fertility is consistently lower than actual fertility in Malawi, highlighting the need to address the unmet demand for contraception. Utilization of modern contraceptives by married women in Malawi has surged, but there are persistent concerns about consistent use and the quality of services. Contraceptive use increased from 7 percent in 1990 to 58 percent in 2015. However, some women may be using modern contraceptives only sporadically, which can lead to over-reporting, and/or may be using contraception to space rather than to limit births. Most of the constraints to increasing contraceptive use cited by women relate to concerns regarding side effects; personal opposition to contraception by the woman or her husband; or religious or cultural beliefs. As family planning services expand rapidly, more attention needs to be paid to improving the quality of the services, so that women have access to methods that are culturally acceptable, convenient, and provided confidentially.

Figure 32: Real GDP per Capita by Fertility Scenario
Constant 2011 US\$



Source: Schneidman et al. (2018)

120. The maternal mortality ratio (MMR) remains relatively high. In the seven years before the 2000 and 2015-16 DHS Surveys, the MMR dropped steeply, from 1,123 (1993) to 497 (2008-2009) deaths per 100,000 live births. The steady progress reflects better access to antenatal care (now 95 percent) and an increase to institutional deliveries (91 percent), coupled with the expansion of family planning services. Nevertheless, only 51 percent of pregnant women completed four or more antenatal visits and only 42 percent received a postnatal check, with these both being serious gaps that need to be addressed, along with improved utilization of modern contraception. According to the 2015-2016 DHS, at current fertility and mortality rates, during their reproductive lifetime 2 percent of Malawian women will die from maternity-related causes. Clearly it is vital to expand access to a full range of reproductive, family planning, and maternal health services.

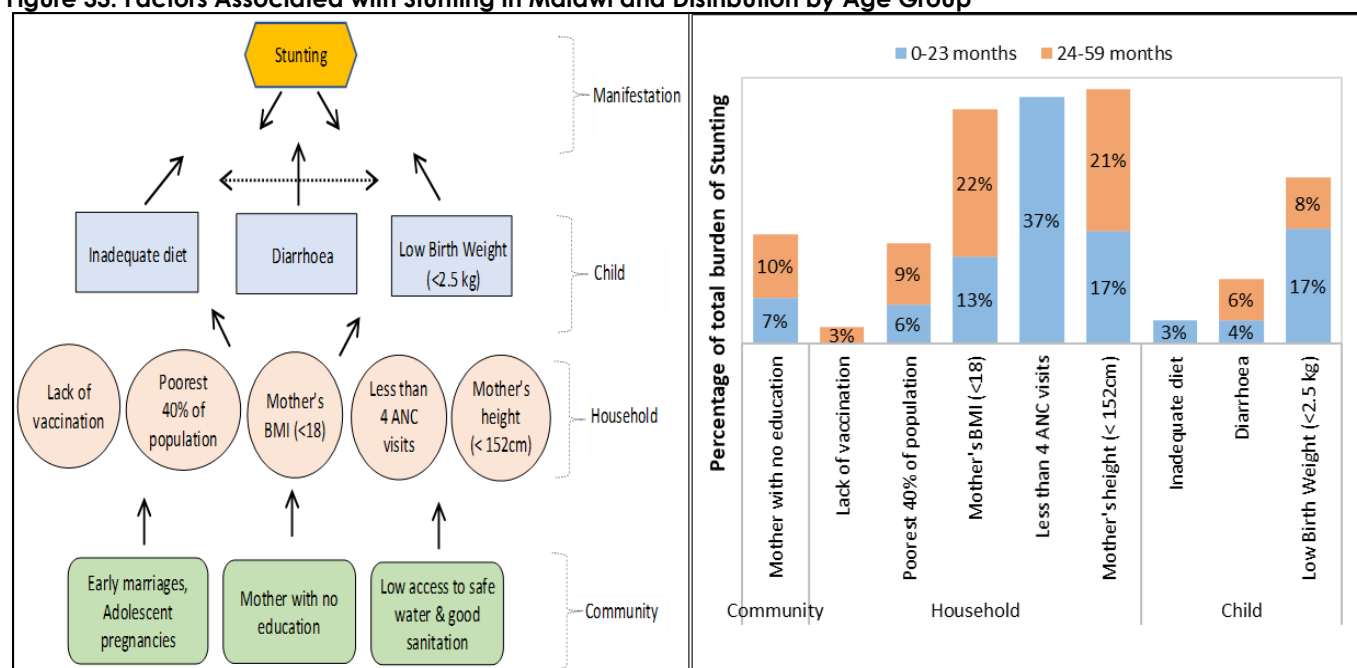
121. Accelerating the demographic transition in Malawi could bring about powerful shifts in the age structure, which would promote economic growth and poverty reduction. Simulation modeling suggests that a one-child difference in Malawi's fertility rates by 2050 can lead to a 28 percent difference in real GDP per capita (see Figure 32). Therefore, going forward, investments in family planning (FP) are key to creating a positive virtuous cycle: helping couples to attain their desired family size; ensuring that women are healthy, educated, and empowered; and allowing their children to survive and thrive. Similarly, nutritional interventions contribute not only to an improved child survival rate, but also to better cognitive development, educational performance and ultimately, economic growth.

122. Stunting tends to be positively associated with fertility, with each negatively impacting the other. On one hand, high fertility and short birth intervals contribute to the high levels of stunting because households find it difficult to meet

the nutritional needs of a growing number of closely spaced children. On the other hand, the high rate of child stunting contributes to high levels of childhood mortality, which in turn affects family formation decisions and thus fertility.

123. While stunting rates have declined very slowly since the early 1990s, this decline has accelerated since 2010. Stunting dropped from about 55 percent in 1992 to 47 percent in 2010, representing an average annual rate of decline (AARR) of only 1.6 percent. However, in the period from 2010 to 2016, the rate of decline increased, with an average annual rate of 3.9 percent, with stunting at 37 percent at the end of this period. This recent rapid decline occurred during a time of significant policy and programmatic focus with rigorous implementation of the Multi-sectoral National Nutrition Policy and Strategic Plan (2007–11). Malawi became one of the first countries to join the Scaling Up Nutrition movement in 2011. With the support of donors, UN agencies, and civil society organizations, it has since given priority to preventive and nutrition-sensitive interventions, with promising results.

Figure 33: Factors Associated with Stunting in Malawi and Distribution by Age Group



Source: Malawi Demographic and Health Surveys 2010 and 2015/16

124. Despite these recent successes, more than 1 million Malawian children are still stunted, with significant disparities between income levels and geographic area. Stunting is higher among children from the poorest households (40.4 percent) than among the wealthiest households (24.3 percent) with only modest declines for the poorest children since the early 1990s. Children in rural households are also much more likely to be stunted than urban children. In the period from 2010 to 2016 stunting declined much faster among urban children (AARR of 7.8 percent) than among rural children (AARR of only 3.5 percent).

125. A healthy, well-nourished, well-educated, and skilled labor force enables national economies to grow faster and be more competitive in the dynamic, technology-led global economy. Malawi has made good progress in terms of many aspects of human capital development, particularly in terms of addressing the high rates of stunting and fertility. However, it needs to intensify and accelerate these efforts. Its prospects for higher levels of inclusive growth and poverty reduction will be substantially enhanced by policies and investments that promote healthy families, gender equality, and an increase in the availability of productive employment for the working-age population.

Specific policy actions for the new administration to consider for Theme 3:

In the first year:

- Fast-track implementation of education policies including on automatic promotion in lower primary, targeted deployment and retention of teachers, and provision of low-cost learning shelters.
- Scale up access to high-quality, affordable family planning and reproductive health services particularly to reach adolescents. This can be done by providing postpartum programs; ramping up the social marketing program; and expanding the menu of contraceptives.

- Improve child survival and child development through expanded access to four or more antenatal care visits; promotion of breastfeeding beyond the current 3.8 months; scaled up access to parenting education, early stimulation, and early learning.

In the medium term:

- Expand access to secondary education for poorer girls; and develop targeted policy tools to reduce disparities in school conditions & staffing.
- Adopt low cost options to deliver secondary education - such as public-private partnerships (PPPs) and Open-Distance Learning (ODL).
- Support social and behavior change communications to continue shifting cultural norms on childbearing in a culturally sensitive fashion, with a view to reducing child marriage, early childbearing and family size.
- Pilot alternative approaches for reaching adolescents through expanded access to youth-friendly family planning and reproductive health services combined with life skills training, and income-generating activities.
- Strengthen inter-linkages among health, nutrition, education and social protection programs to deliver on human capital related outcomes

Theme 4: Developing systems to increase resilience to shocks

126. Building human capital will also require measures to increase resilience to shocks, as the poorest are often the most impacted by these shocks. The frequency and severity of weather and climate shocks in Malawi have been rising, with the poor particularly vulnerable to these shocks, which exacerbate food insecurity and impede progress towards reducing stunting. Floods and drought in 2015 and 2016 have contributed to stagnating poverty since 2010/11, undoing advances in the first half of this period. On a positive note, the number of people living in ultra-poverty has declined in absolute terms for the first time since 2004/5. This reduction appears to be associated with the recent expansion of social protection programs, especially the Social Cash Transfer (SCT) program. However, the current level of expenditure on the program is roughly half of the regional average and significantly lower than prior poverty reduction and relief programs. There is, however, fiscal space to devise a sustainable financing strategy for Malawi's safety net program into the future. The Government should also actively improve disaster risk management systems and implement measures to address land degradation. This will reduce the vulnerability to shocks and enable higher rates of sustained inclusive growth, while also reducing fiscal risks.

Realizing the potential of safety nets in Malawi

127. The recently approved second Malawi National Social Support Program (MNSSP II) has created an opportunity to transform the country's social safety net by 2023.¹⁹ MNSSP II shifts the focus from individual social safety net programs to ensuring coherence, integration, and harmonization between systems of interrelated interventions. The MNSSP II prioritizes five areas of support: (i) consumption support; (ii) support for resilient livelihoods; (iii) shock-sensitive social protection; (iv) links between safety nets and other programs; and (v) strengthening all safety net systems.

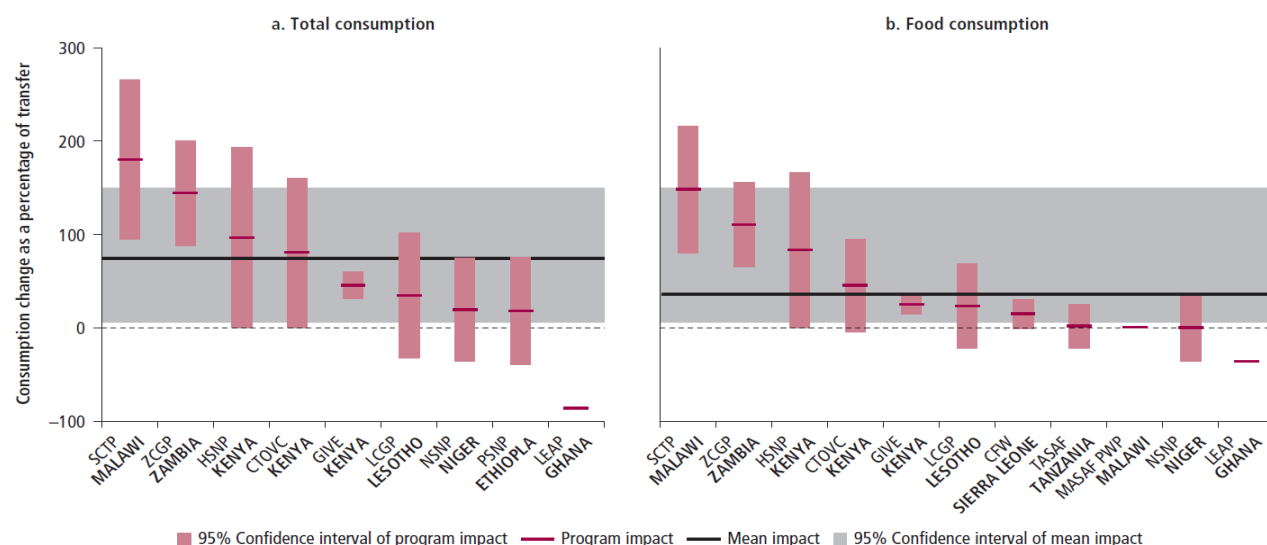
128. There is strong evidence from Malawi showing that safety net programs effectively target the poorest households, providing them with income support to smooth consumption patterns and to enhance household-level investments in human capital development. This is particularly clear when comparing the impact of these programs to other priority poverty and relief response mechanisms, such as the FISP, ADMARC's maize purchases, and humanitarian aid. Recent investments in safety net program delivery mechanisms, such as social registries (Malawi Unified Beneficiary Registry - UBR), e-payments, and citizen engagement, are also making these safety net programs more effective. These programs also complement service delivery in other sectors, such as education and health. In addition, innovation and advances in technology are enabling Malawi to overcome capacity constraints and to strengthen such delivery systems.

129. There is robust evidence that safety nets in Malawi, especially social cash transfers, are an effective investment. Malawi's SCTP has had the strongest and most consistently positive impact of any such program in SSA (Raston et al 2017). Overall, SCT beneficiaries increased their total consumption by 24 percent and food consumption by 23 percent (see Figure 34). Households were also able to build up resilience to economic shocks by investing more in productive assets, particularly livestock, durable assets, and fertilizer. SCTP was also found to encourage the development of human capital by incorporating soft conditions and top-up benefits which encourage households to invest in increased

¹⁹The MNSSP II defines social safety nets ("social support") as "providing income and consumption transfers to the poor and food-insecure, protecting the vulnerable against livelihood risks, and enhancing the social status and rights of the marginalized, with the overall objective of reducing ultra-poverty [and] the economic and social vulnerability of poor and marginalized groups."

educational attainment. Furthermore, contrary to misperceptions that beneficiary households spend cash transfers on alcohol or tobacco, these beneficiaries did not do so. Critically, these impacts were achieved with very modest transfer amounts, estimated at 18 percent of average household spending on consumption.

Figure 34: Estimated Total and Food Consumption



Source: Malawi Economic Monitor (2018) Realizing Safety Nets' Potential

130. Expenditure on social protection programs is overshadowed by expenditure on regressive and less effective programs. In the period from 2011 to 2016, close to 2.6 percent of GDP was spent on MVAC and 2.2 percent on FISP, while only 0.6 percent was spent on social safety net programs. Consequently, only 25 percent of the population has access to these programs, compared to the 33 percent that receive benefits from MVAC and to 37 percent from FISP. Additionally, with the current benefit levels in the flagship Social Cash Transfer Program (SCTP) covering less than a fifth of total household consumption, there is a less significant impact on poverty and inequality.

131. Given Malawi's overwhelming dependence on development partner support, the financing of safety nets at current levels is not sustainable. The Government currently finances only 6 percent of all Malawi's safety net spending. Furthermore, the average expenditure on safety net programs from 2011 to 2016 was 0.6 percent of GDP, considerably lower than the 1.2 percent average for SSA. However, experience across the region (particularly in Senegal and Kenya) suggests that it is possible to: (i) increase the level and strengthen the sustainability of financial resources; (ii) identify the most appropriate mix of domestic, foreign, public, and nonpublic funding sources; and (iii) deploy a flexible financing strategy to respond promptly to shocks and crises (Beegle et al. 2018).

132. Strengthening core delivery systems offers a huge opportunity to improve the safety net system, positioning it as a major contributor to human capital development. For instance, Malawi's social registry, the UBR has excellent potential to boost the Government's capacity to provide stronger delivery systems and institutional mechanisms within the social protection sector. E-payments and a grievance redress system are also being piloted. Even beyond the social protection sector, these improved and harmonized delivery systems offer opportunities to improve the effectiveness of other human capital development interventions, including in sectors such as education, nutrition and health, by facilitating better targeting, streamlined delivery, and accountability.

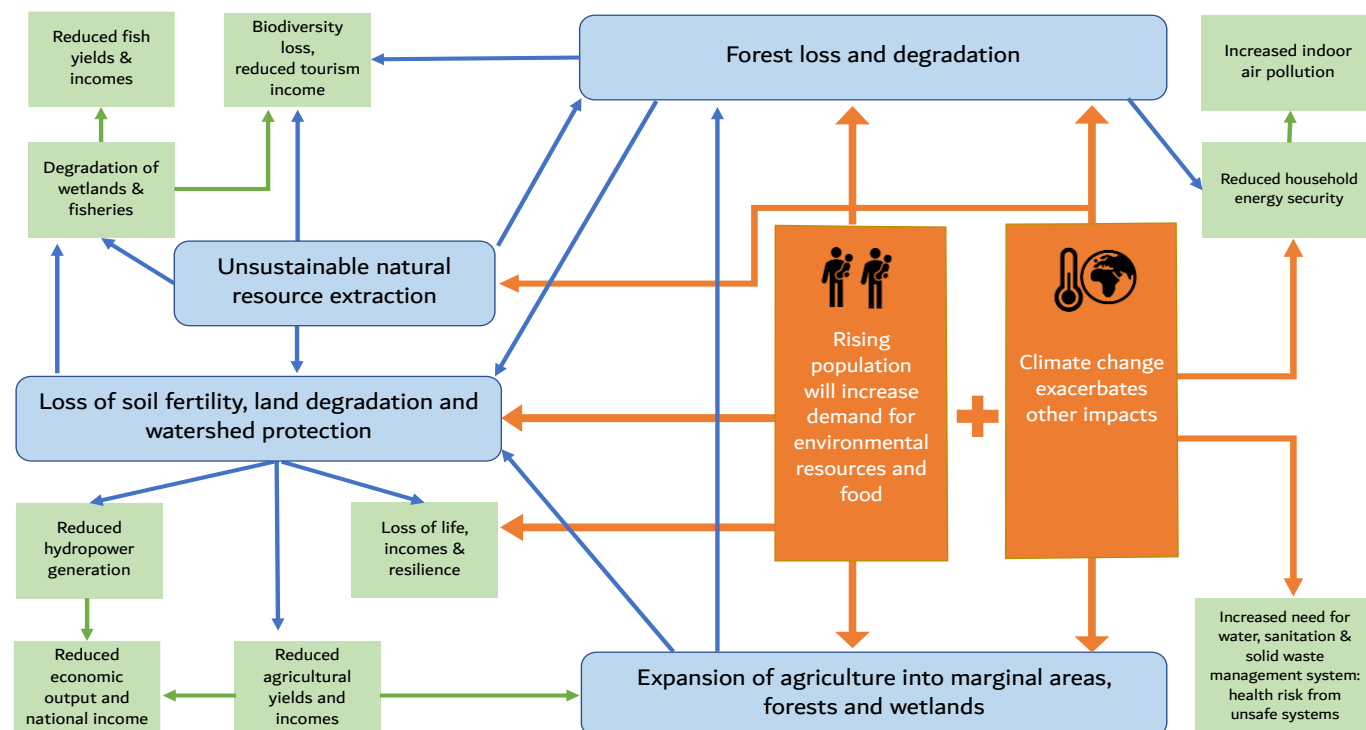
133. Malawi also has the fiscal space to devise a sustainable financing strategy to ensure the effectiveness of its safety net program into the future. There are several options by which a more sustainable financing strategy could be established in the sector. First, there is scope to reallocate resources away from less effective poverty reduction initiatives, particularly the FISP. Second, there is scope to redirect humanitarian financing towards safety net initiatives. Third, contingency or reserve financing mechanisms could be explored to ensure that the safety net system are more resilient and sensitive to shocks.

Breaking the cycle of environmental degradation and increasing resilience

134. Malawi's environment is deteriorating with climate change and the increasingly frequent and severe weather-related natural disasters. Half of the country's forests have disappeared as a result of the widespread land degradation.

Fish stocks and biodiversity are declining. Key drivers are climate change and a high population growth rate, made worse by a vicious cycle of natural resource degradation (see Figure 35). The additional burden of shocks and stresses from climate change and other natural disasters also undermine the country's ability to cope. Malawi does not have the resilience it needs to deal with this situation. Institutional capacity is weak and its economic resources at national and household level are limited.

Figure 35: Drivers, Pressures, and Impacts of Environmental Degradation



Source: Malawi Country Environmental Analysis (2019)

135. Malawi is at high risk from natural disasters. After the 2015 floods, Malawi was categorized by the Climate Change Index as the third most vulnerable country to climate change (Kreft et al, 2017). INFORM's Global Risk Index 2017 ranks it as 16th most vulnerable to humanitarian crisis and disasters. In the period from 1980 to 2017, Malawi has experienced eight major droughts and 33 floods (EM-DAT 2018), with more than 600 disaster events recorded since 1946. The floods of 2015, the worst in 50 years, were followed by a drought in 2016/2017 that affected 6.5 million people, over a third of the total population. Flooding in recent years has cost the country the equivalent of 5 percent of GDP (GoM, 2015b), a financial burden made worse by poor watershed management, the absence of water regulating infrastructure, and human encroachment into high-risk flood zones. These disaster events have a significant impact on people's lives, livelihoods and socioeconomic infrastructure in the affected areas, pushing a large number of people into poverty and food insecurity (PDNA 2019).

136. With a single rainy season and an overreliance on rain-fed agriculture, Malawi's farming population is highly exposed to weather risks, with these risks increasing with the impact of climate change. Drought is the most severe risk with more than 28 million people affected in the past 50 years and average annual losses estimated at 1.7 percent of GDP (equivalent to US\$117 million). The high losses resulting from droughts and other agricultural production risks are a threat to the livelihood of the rural population and place a high burden on public expenditure for disaster relief.

137. The considerable physical and economic costs from natural disasters can adversely impact fiscal and external balances. With the regular recurrence of extreme weather events, fiscal risks arising from weather-related shocks are reflective of failure to plan for these shocks and the lack of a systematic mitigation strategy. Although exogenous shocks, especially extreme weather events, have often precipitated fiscal imbalances, the Government needs to strengthen its fiscal planning and to implement resilience and Disaster Risk Management (DRM) strategies, to address these foreseeable risks.

138. Malawi's road to resilience faces numerous challenges including uncoordinated policy frameworks, delays in policy implementation and inadequate climate and weather information systems. Building resilience to environmental pressures, climate change and natural disasters requires strong legal and institutional frameworks to implement

initiatives that are complementary, coordinated and implemented on time. While a number of such frameworks are in place, there is limited operationalization, weak technical support, inadequate financing and a lack of a systematic approach to holistic resilience building. In addition, climate and weather information systems are not comprehensive, outdated, unsystematic and poorly managed, leading to unreliable, irrelevant and untimely weather forecasting. Improving the delivery, accuracy, quality, and timing of forecasts would improve the ability of stakeholders to respond and adapt effectively to changes in Malawi's climate.

139. Weak institutional capacity further frustrates the implementation process. The slow pace of decentralization at the local level, and a lack of funding, also limits the ability of district councils and extension services to introduce and support interventions that could build resilience. Economic planning also fails to account for natural capital. Institutions, therefore, lack the evidence they need to prioritize the management of this crucial wealth asset.

140. Other challenges include poorly-designed farm subsidies and limited access to private sector funding. The FISP has been in place since 2005. It has been expensive and has failed to encourage Sustainable Land Management (SLM) practices. These are urgently needed to reduce land degradation and other environmental challenges. In addition, improving environmental and DRM is expensive, and the Government has not allocated the resources to address this. Public-private sector partnerships could bring much needed private sector investment into environmental management.

141. Public private Partnerships (PPPs) could enable farmers to gain access to affordable, consumer-oriented agricultural insurance. Since 2005, while the insurance sector has started to offer agricultural insurance for smallholder farmers but the agricultural production that is currently covered is less than 1 percent of the agricultural GDP. However, there are significant opportunities to scale up agricultural insurance which could be linked to commercial agriculture, input subsidy and/or social protection programs, and agricultural credit.

142. Malawi has the opportunity to respond to environmental challenges and natural disasters to reduce poverty and support economic development. Action taken today can turn this situation around. Malawi can fast-track implementation of recent progressive policies for environmental and disaster risk management; strengthen climate information systems; scale up sustainable land management (SLM) approaches nationally; and promote private sector investment in environmental management efforts. Forward-looking fiscal strategies can also plan for these shocks.

Specific policy actions for the new administration to consider for Theme 4:

In the first year:

- Commit to a national financing strategy to support an adequate, sustainable social protection system.
- Design social safety nets that can be scaled up during shocks to help households' build resilience.
- Implement and harmonize policies related to environmental management, climate change, DRM, and land to promote a systematic approach to resilience building.
- Strengthen weather and climate information services. This includes collecting weather and production data, improving flood and drought forecasting, and building effective early warning systems.
- Prepare and publish a fiscal risk statement with built in buffers to enable a flexible response to fiscal costs of natural disasters.
- Raise awareness at the community level of the available strategies and standards for resilience building.

In the medium term:

- Improve the mix of safety net programs to increase efficiency and inter-linkages and gradually reducing Malawi's dependence on humanitarian aid.
- Devolve greater responsibility for environmental management at local level.
- Attract more private sector investment to address priority environmental challenges.
- Develop a comprehensive policy strategy to identify, quantify, manage and mitigate fiscal risks
- Enhance budget and planning processes to incorporate resilience activities.

What will it take to chart a new course towards a vibrant economy and jobs?

143. Malawi can chart a new course towards a future where the population has higher incomes and opportunities, in a vibrant, more diversified economy, that no longer faces hunger and dependency with every weather shock, but instead can harness and benefit from global economic trends.

144. Staying the course on macroeconomic stability and sustaining high growth is key. Across the world, countries that have sustained high growth since the 1950s have had five characteristics in common²⁰: (i) macroeconomic stability; (ii) leadership and governance committed to growth; (iii) openness to trade and readiness to exploit global demand; (iv) high investment and savings; and (v) market allocation that allows prices to guide resources.

145. Malawi has key advantages. The country has been politically stable and conflict-free, with peaceful transitions. It is endowed with a youthful population as well as agricultural, water and mineral resources. These are key ingredients to closing the per capita growth performance gap of 1.5 percent over two decades against 3.1 percent for other non-resource rich SSA economies.

146. Malawi can join the high performers and catch up and even surpass progress seen in the region. For Malawi to achieve higher levels of inclusive economic growth and productive job opportunities, it needs to focus on four themes, with measures to: (i) ensure stronger economic and institutional foundations, with supportive macroeconomic policies and an effective public service; (ii) transform the economy and increase growth to create productive jobs and ensure food security; (iii) strengthen human capital by improving education and reducing the fertility rate and stunting; and (iv) actively develop systems to build resilience to shocks. Some key actions for the first year are summarized below.

Table 4: Summary of First Year Key Priority Actions

Economic and institutional foundations	Instill fiscal discipline by strengthening political commitment to realistic budgeting and staying within budget. This will also support the central bank in maintaining independence to enable lower inflation, interest rates and a stable exchange rate
	Strengthen SOE oversight, financial management, and accountability with comprehensive and transparent governance structures and financial reporting and monitoring
	Get the basics right in public service by (i) appointing senior management officials based on merit and performance; (ii) holding controlling officers accountable for the management of public finances and staffing; (iii) sanctioning those who divert or waste public monies; and (iv) making clear what is expected and recognizing, encouraging and rewarding staff who perform well
Transforming the economy	Initiate a coordinated, cross-Government effort to radically reform the business environment. This should aim to develop an investment climate and sectoral regulatory frameworks that can attract higher-quality investors and investments to facilitate the creation of better jobs in profitable, diverse sectors
	Remove trade restrictions and establish transparent, predictable trade policies to improve agricultural markets, stimulate production and exports
	Improve financial and operational efficiency, as well as governance, of energy and water utilities
Building human capital	Fast-track implementation of education policies including on automatic promotion in lower primary, targeted deployment and retention of teachers, and provision of low-cost learning shelters
	Scale up access to quality, affordable family planning and reproductive health services, particularly to reach adolescents
	Strengthen maternal and child health, nutrition, and early learning interventions to improve child survival and development
Resilience to shocks	Commit to a national financing strategy to support an adequate, sustainable social protection system
	Implement and harmonize policies related to environmental management, climate change, DRM, and land to promote a systematic approach to resilience building
	Prepare and publish a fiscal risk statement with built in buffers to enable a flexible response to fiscal costs of natural disasters

²⁰ Commission on Growth and Development (2008)

DATA

Table 5: Selected Macroeconomic Indicators

	2015	2016	2017	2018	2019 Proj.
National Accounts and Prices					
GDP at constant market prices (percentage change)	2.8	2.5	4.0	3.5	4.5
Agriculture	-2.0	-2.3	5.0	2.4	4.8
Industry	3.5	2.4	2.2	2.0	3.0
Services	4.7	4.4	4.0	4.3	4.9
Consumer prices (annual average)	21.9	21.7	11.5	9.2	8.9
Central Government (percent of GDP on a fiscal year basis)					
Revenue and grants	21.4	21.6	23.5	20.8	21.3
Domestic revenue (tax and nontax)	18.6	17.8	20.0	19.3	19.8
Grants	2.8	3.7	3.5	1.4	1.5
Expenditure and net lending	27.1	27.6	28.2	28.5	27.1
Overall balance (excluding grants)	-8.5	-9.8	-8.2	-9.2	-7.3
Overall balance (including grants)	-5.7	-6.1	-4.8	-7.8	-5.8
Foreign financing	2.5	1.9	2.5	2.5	1.3
Domestic financing	3.3	1.7	0.9	6.2	6.0
Amortization (zero coupon bonds)	0.8	2.5	1.3	-0.5	-1.5
Privatization Proceeds	0.0	0.0	0.3	0.0	0.0
Money and Credit					
Money and quasi money (percentage change)	23.7	15.2	19.7	11.4	12.9
Credit to the private sector (percent change)	29.9	4.6	0.4	11.5	39.4
External Sector (US\$ millions, unless otherwise indicated)					
Exports (goods and services)	1,616	1,502	1,675	1,852	1,993
Imports (goods and services)	2,346	2,569	2,606	2,709	2,771
Gross official reserves	670	605	757	790	699
(months of imports)	3.4	2.9	3.2	3.3	3.0
Current account (percent of GDP)	-9.2	-14.7	-11.3	-10.9	-10.0
Exchange rate (MWK per US\$ average)	499.6	718.0	730.3	732.3	-
Debt Stock					
External debt (public sector, percentage of GDP)	33.5	32.0	33.2	31.2	31.4
Domestic public debt (percentage of GDP)	20.9	23.6	24.5	26.1	24.8
Total public debt (percentage of GDP)	54.4	55.6	57.7	57.3	56.2
Poverty					
International Poverty rate (US\$ 1.9 in 2011 PPP terms)	69.4	69.6	69.4	69.1	68.8
Lower middle-income poverty rate (US\$ 3.2 in PPP terms)	87.5	87.3	87.7	87.6	87.3
Upper middle-income poverty rate (US\$ 5.5 in PPP terms)	95.6	95.7	95.8	95.8	95.7

Source: World Bank staff calculations based on MMod, MoFEPD, RBM and IMF data

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