

# Malawi Economic Monitor

# Harnessing the Urban Economy

May 2017



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**MALAWI ECONOMIC MONITOR**  
MAY 2017  
**HARNESSING THE URBAN ECONOMY**

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## TABLE OF CONTENTS

Overview .....	1
<b>1. Economic developments .....</b>	<b>5</b>
Economic growth remains subdued across Sub-Saharan Africa .....	5
Malawi's economy is set for recovery after two years of weather-related shocks.....	5
There are signs of improvement in the fiscal performance amidst a humanitarian crisis.....	9
The fiscal outlook envisages a modest degree of consolidation over the medium term .....	11
Debt levels continue to rise, placing a growing burden upon Government.....	13
Inflation has declined faster than expected.....	14
The Kwacha has stabilized, defying seasonal trends and expectations of a depreciation .....	17
Tight liquidity conditions have helped to contain non-food inflation.....	18
Increased tobacco exports have helped to offset weaker performance by other commodities.....	19
An increased import bill is being driven by food imports.....	21
Weak economic performance has affected credit quality .....	23
Investors still remain skeptical of signs of economic recovery .....	24
<b>2. Special topic: urbanization and its potential to drive growth and development .....</b>	<b>28</b>
Separating myth from truth: urbanization trends in Malawi .....	28
Signs of structural change and the role of urbanization .....	30
Reforming Malawi's urban institutions and their financing mechanisms .....	36
What should the Government do? .....	39
<b>Data.....</b>	<b>41</b>
<b>References .....</b>	<b>42</b>

## BOXES

Box 1: Stabilizing maize prices in the midst of a food crisis .....	8
Box 2: Efforts to restore integrity in Malawi's Public Financial Management system after "cashgate" .....	14
Box 3: The evolution of domestic borrowing in Malawi.....	16
Box 4: What factors determine fuel prices in Malawi? .....	22
Box 5: Modelling economic vulnerability and future climate change risks in Malawi .....	26
Box 6: Malawi's rural and urban economies.....	32

## FIGURES

Figure 1: Malawi is expected to see a stronger growth performance compared to regional peers.....	7
Figure 2: ...driven by a recovery in agricultural output.....	7
Figure 3: As a result of policy interventions, maize prices were much more stable during the 2016/17 lean season compared to in 2015/16 .....	8
Figure 4: The drought has made it more difficult to reduce the fiscal deficit.....	10
Figure 5: ...but revenue collection is exceeding targets due to intensification efforts.....	10
Figure 6: Hiring has pushed up recurrent spending in the education sector.....	13
Figure 7: Subsidies and transfers have fallen, while wages and debt service have risen.....	13
Figure 8: Headline inflation has slowed, largely in response to a fall in food inflation.....	15
Figure 9: ...although rebounding crude oil prices may contribute to non-food inflationary pressures .....	15
Figure 10: Malawi's stock of debt, particularly domestic debt, has been rising fast in recent years .....	16
Figure 11: Borrowing from monetary authorities has been the main category of public domestic debt.....	16
Figure 12: Interest payments have significantly increased since 2013.....	17
Figure 13: Expenditure on interest on domestic debt has been consistently underestimated.....	17
Figure 14: The Kwacha has begun to experience greater stability.....	18
Figure 15: ...helped by tight monetary conditions and a more stable interbank rate .....	18
Figure 16: Tobacco and pulses saw export growth in 2016, with other commodity exports falling.....	19
Figure 17: Imports were generally lower in 2016, with the exception of food imports .....	19
Figure 18: Tobacco still dominates Malawi's exports.....	20
Figure 19: Maize prices in Malawi showed a significant premium compared to Zambia during 2016 .....	20
Figure 20: Tobacco production has seen high volatility as farmers chase higher prices over time .....	21
Figure 21: Tobacco production and export numbers differ given lower exportable values .....	21
Figure 22: Illustration of the breakdown of fuel price determinants in Malawi .....	22
Figure 23: Banking sector capital adequacy ratios have slipped, but are above minimum thresholds.....	24
Figure 24: ...but the share of non-performing loans has reached new peaks .....	24
Figure 25: During recent year, Malawi's economy became stuck in a vicious cycle.....	25
Figure 26: ...but needs to shift to a virtuous circle.....	25
Figure 27: Climate change is projected to have a significant negative impact on Malawi's economy .....	26
Figure 28: Malawi is less urban and urbanizing at a slower pace compared to other African countries .....	29
Figure 29: Malawi's urban centers are dominated by Lilongwe and Blantyre .....	30
Figure 30: Malawi is undergoing structural change out of agriculture .....	31
Figure 31: In aggregate terms, Malawi spends more on rural local governments.....	38
Figure 32: ...but per capita spending is higher for urban local governments .....	38

## TABLES

Table 1: Fiscal accounts.....	12
Table 2: Industry and services are growing faster than agriculture, but account for only a small share of GDP .....	31
Table 3: Characteristics of Cities, Towns and Rural Economies .....	32
Table 4: Almost a third of rural jobs are in non-farm activities and one in every six urban jobs are in agriculture .....	33
Table 5: Economic growth under differing urbanization scenarios .....	35
Table 6: Household welfare under differing urbanization scenarios.....	35
Table 7: Summary of urbanization scenarios.....	36
Table 8: Selected macroeconomic indicators.....	41



## OVERVIEW

**The Malawi Economic Monitor (MEM) provides an analysis of economic and structural development issues in Malawi.** This edition of the MEM was published in May 2017. It follows on from the four previous editions of the MEM, and is part of an ongoing series, with future editions to follow twice per year.

**The aim of the publication is to foster better-informed policy analysis and debate** regarding the key challenges that Malawi faces in its endeavors 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. Part 2 focuses in greater depth on a special, selected topic relevant to Malawi's development prospects.

**In this edition of the MEM, the focus of the special topic is on urban development.** Malawi's economy is predominantly based on agriculture and the level of urbanization is low. And urban transformation is taking place at a slow rate. However, Malawi's cities and towns contribute a disproportionately large share of GDP relative to their population size. Similarly, poverty rates are lower in Malawi's urban areas. In the long term, a well-managed process of urbanization will be critical to Malawi's efforts to boost resilience, reduce poverty, and achieve sustainable, inclusive growth.

### ECONOMIC DEVELOPMENTS

**In 2016, Malawi's real GDP grew by 2.5 percent despite a significant contraction in the agriculture sector.** Floods and droughts in early 2015, followed by another major drought in 2016, have had severe consequences on agricultural production, energy generation and poverty reduction. The agriculture sector, which contributes to around 30 percent of GDP, contracted by 2.3 percent in 2016. The production of maize, a vital crop for food security, fell by 14.7 percent in 2016, following a fall of 30.2 percent in the previous year. By contrast, the industrial and services sectors were both estimated to have recorded positive rates of growth of 2.4 percent and 4.4 percent, respectively.

**While the recent food security crisis has been the most significant in over a decade, the Government's policy response helped to mitigate the adverse impact at the household level.** The responses included a well-financed humanitarian program that managed to meet the needs of food insecure households. The Government, through the Agricultural Development and Marketing

Corporation (ADMARC) Limited, also set a maize market intervention price in line with market forces, which ensured stable prices and subsequently a deceleration in the rate of inflation.

**In 2016, the inflation rate stood at an average of 21.7 percent, almost at par with the rate of 21.9 percent recorded in 2015, but the rate is now beginning to decline.** While the inflation rate has remained in double digits for the past five years, it has been declining consistently, falling to 14.6 percent in April 2017. The recent decline was mainly driven by a sustained fall in maize prices and consequently a gradual softening of food price inflation. A continued tight monetary stance has also helped to reduce non-food inflation. However, the rural inflation rate was significantly higher than the national average, standing at 16.2 percent in April 2017, compared to 12.5 percent for urban inflation. This has put disproportionate pressure on Malawi's poor population, most of whom live in rural areas.

**Efforts are being made to address the large fiscal deficits of recent years.** The fiscal deficit remained high in FY 2016, standing at around 6.0 percent of GDP. The FY 2017 budget included a number of measures intended to reduce expenditure pressures, including reforms to the Farm Input Subsidy Program (FISP) to reduce costs and improve efficiency. The food crisis resulted in a dramatic increase in borrowing during the second half of FY 2016, due to the unplanned expenditure on post-harvest maize purchases in anticipation of interventions in food-deficient areas. In the first half of FY 2017, domestic borrowing was more restrained, at MWK 25.1 billion, well below the approved target of MWK 40.0 billion. With a majority of foreign aid continuing to be delivered off-budget, the Government has committed to increasing its efforts to consolidate public spending and improve budget execution and oversight by monitoring the monthly budget outturns for all Ministries, Departments and Agencies.

**Real GDP growth is expected to increase to 4.4 percent in 2017, driven by improved conditions in the agriculture sector.** A favorable weather pattern with increased rainfalls in 2017 is expected to result in higher levels of agricultural output than were recorded in 2015 and 2016. It will also increase the water resources required for electricity generation. The production of maize is projected to increase by 40 percent in 2017, in line with increases of total crop production of a similar magnitude, setting the economy on a recovery course. While agriculture

accounts for about a third of GDP, it indirectly affects a large part of Malawi's services sectors. Similarly, much of Malawi's small manufacturing sector is agro based. However, the production of tobacco, Malawi's key export commodity, is expected to decline by 36 percent as the low prices recorded last season have driven a significant proportion of smallholders to shift towards leguminous crops such as groundnuts and pulses. Nevertheless, improved quality and higher prices have been experienced reflecting better matched domestic supply with respect to the level of international demand for Malawi's crop.

**In 2017, the average inflation rate is projected to decelerate to 15.2 percent**, following improved agricultural production and reduced pressure on food prices.

**With stronger growth and reduced inflation, Malawi's poverty is expected to decline somewhat.** This represents a change from 2015 and 2016, when population growth outpaced GDP growth, meaning that average per capita income saw a decline. The proportion of poor households living under the international poverty line of US \$1.9/day (2011 PPP) is expected to marginally decline from around 69.8 percent in 2016 to 69.4 in 2017.

**With the projected recovery in agriculture and improved domestic revenue mobilization, the fiscal deficit is expected to narrow over the medium term.** Following the large expenditures associated with the Government's response to the humanitarian crisis, projections for the fiscal outlook indicate a modest fiscal consolidation will likely continue into FY 2018. It is expected that most of the financing will be through concessional foreign borrowing (1.8 percent of GDP) helped by a resumption of budget support by multilateral development partners, together with significant domestic borrowing (1.0 percent of GDP). However, as in 2015/16, the fiscal deficit will be amplified by the costs of rolling over a significant stock of maturing zero-coupon bonds (2.1 percent of GDP) into interest bearing securities.

**Exogenous climate-induced shocks are a major source of vulnerability**, especially for agricultural growth, which in turn has implications for the overall growth and poverty reduction in Malawi. Reforms to boost agricultural commercialization can help build resilience and economic diversification over the medium term, but economic performance is expected to remain vulnerable to climate variability for some time.

**In Malawi, recurring shocks have often resulted in fiscal gaps and slippages.** Exogenous shocks could be amplified by possible fiscal slippages and over

borrowing, especially in the run-up to elections in 2019. As recurring weather shocks are expected to have an ongoing impact on Malawi's economy, there is a need to build a system that ensures food insecure households are provided with sufficient and better-directed transfers through safety nets.

**Over the medium term, it is essential for Malawi to build resilience to both internal and external shocks.** Key steps toward building resilience include: (i) deeper policy reforms to reduce distortions in the agriculture sector, boost commercialization and ensure that markets function effectively, including through maize market reforms; (ii) maintaining macroeconomic stability and, in particular, improving fiscal discipline and carefully managing debt sustainability; and (iii) making investments to build resilience against weather shocks and to diversify the economy, while reforming and expanding existing safety nets to enable flexible responses to shocks.

#### **URBANIZATION IN MALAWI**

**In Malawi, policymakers have tended to be wary of urbanization and of its potentially adverse impacts, including the urbanization of poverty.** Malawi is predominantly rural, so naturally, national development policies have focused on the development of rural areas.

**However, contrary to common perceptions, Malawi is still at an early stage of urbanization and is urbanizing at only a moderate rate.** In 2008, only 15.6 percent of the total population (2.8 million people) lived in urban areas. In the period from 1998 to 2008, the annual urbanization rate averaged at around 3.7-3.9 percent, a lower rate than that recorded by many other African countries. While rural to urban migration has been the main driver of urbanization, the number of migrants is small. At the current pace, Malawi's urban population share can be expected to remain below 20 percent until 2040.

**With the low base and the moderate rate of urbanization, Malawi is well-positioned to formulate plans to maximize the benefits of urban agglomeration into the future.** Past economic growth patterns indicate signs of positive structural change, with the share of agriculture to GDP and employment falling and that of more productive sectors, such as industry and services, increasing. While data limitations make it difficult to accurately determine the precise contribution of urban areas to this process, Malawi's cities and towns have clearly played an important role, with their contribution to economic growth disproportionately high relative to their population share.

**Projected urbanization and economic growth rates for the period from 2010 to 2030 show that even a slightly increased rate of urbanization could greatly enhance Malawi's long-term economic prospects.**

A scenario involving a more rapid rate of urbanization is simulated by increasing the rural to urban migration by five percentage points in excess of historical migration rates, so that the urbanization rate reaches 21.2 percent in 2030. Under this scenario, the total GDP growth rate accelerates, with the economy being 14.1 percent larger than it would have been without the more rapid rate of urbanization. Given the strong production and consumption linkages between rural and urban areas, a more rapid rate of urban growth generates an increase in the backward linkages to agriculture, encouraging more meaningful structural change.

**However, a more rapid rate of urbanization may also lead to a phenomenon known as the "urbanization of poverty," unless a higher proportion of public resources are allocated to meet investment needs in urban areas.** With a fixed government budget envelope, increased investment in urban areas could come at the cost of a fall in public expenditure in rural areas and the growth rate of agricultural GDP. Moreover, a reduction in rural investment would also lead to worse outcomes for poor urban households, because the decline in the agricultural growth rate would lead to increases in food prices. However, the urban economy can finance its own development by increasing the urban tax base, without hurting rural areas. Thus, a win-win scenario can be reached through the imposition of more effective taxation on urban enterprises and households.

**In Malawi, the current state of local governments' institutional and financial arrangements raises questions regarding their capacity to manage more rapid urbanization.** While in theory, both urban and rural local governments have a wide range and large number of statutory functions, they are actually only involved in a sub-set of their assigned functions. As a result, infrastructure and service needs remain largely unaddressed. In particular, in urban areas, secondary road networks are often limited in coverage, while feeder roads are generally in poor condition. Similarly, solid waste management in Malawi's towns and cities remains a major challenge.

**Urban local governments' financial and capacity limitations are the most significant constraint on their ability to facilitate infrastructure development and service delivery effectively.** City Councils rely on own-source revenues (OSRs) for 65-80 percent of

their total revenues, an unusually high level compared to other countries in Sub-Saharan Africa. Moreover, the average annual value of OSR per capita is low, standing at less than US\$ 5. This indicates a generally inadequate level of revenues, especially considering that the average per capita value of inter-governmental fiscal transfers (IGFTs) is also well below US\$ 5 per capita. Modes of operation are also suboptimal, with services delivered on a force account basis, relying directly on City Council equipment and labor. As a result, the proportion of recurrent expenditure is very high, with the average ranging from between 70 to 100 percent of total City Council expenditure. Not surprisingly, City Councils' capital expenditures constitute less than 10 percent of the total of all city spending.

**Property tax is the largest contributor to City Councils' OSRs and there is significant potential to increase revenues from this source.** Property tax currently accounts for around 50-65 percent of the total value of City Councils' OSRs and for around 40-50 percent of their total revenue. However, revenue from this source is lower than it could be for a number of reasons. The Blantyre City Council (BCC) introduced a system enabling the direct payment of taxes through commercial banks. The substantial improvements recorded by the BCC demonstrate that even minor improvements in the tax payment system can lead to improved collection rates. Similarly, Mzuzu City Council recorded significant successes from its measures to increase the number of taxable properties. These initiatives show that urban local governments can improve their tax administration and collect a higher level of revenue from property taxes.

**Urbanization creates opportunities for broad-based economic development in Malawi. In order to reap the potential benefits, urban local governments need more funds and greater capacities.** However, given Malawi's limited fiscal space, the following efficiency-enhancing policy measures are recommended:

- **A systematic and focused effort should be made to improve City Councils' OSR systems, with particular emphasis on property tax.** Recommended measures include: amending legal and regulatory provisions to make property valuation methods more up-to-date; modernizing payment systems to facilitate the collection process, to reduce leakage and to encourage tax-payers to settle property rates; implementing sensitization and awareness campaigns for tax-payers; and providing City Council revenue officials with training and



modern taxation tools (such as Geographic Information Systems - GIS).

- **With the expansion of the tax base, City Councils should improve on infrastructure and service delivery by better managing the provision of services and budgets.** They may consider outsourcing some services to the private sector, especially in sectors where private sector involvement has proven to be cost effective, such as waste management and road works. This will also enable City Councils to reduce their payrolls and other recurrent costs and thereby create space to increase capital investment.
- **In the medium term, Government should consider measures to increase the value of IGFTs to City, Municipal and Town Councils.** A system could be developed to incentivize local governments to improve performance in the management of their resources, by linking increased IGFTs to the fulfilment of certain

conditions and to improved performance. For example, local governments could be eligible for increased transfers on the condition that they successfully increase their OSRs, and/or transform their management systems and the structure of their budgets.

**Finally, urbanization has the feature that a few decisions made early on in the process can have a strong effect on its subsequent quality and efficiency.** Collective action is required first to get the public space that allows urban mobility and interconnection, and this is something that will not happen through a solely market-driven process. Once urban development takes place, it is almost impossible to increase or reconfigure public space. For the case of Malawi, this does not mean immediate attention is needed to comprehensive urban planning. But it points to the importance of forward thinking and action in terms of specific decisions for securing rights of way for infrastructure and clarity on the division between public and private space.

# 1. ECONOMIC DEVELOPMENTS

## Economic growth remains subdued across Sub-Saharan Africa

**1. In 2016, the average rate of economic growth for the sub-Saharan African region stood at 1.5 percent, the lowest rate since 1994.** This is the second year in a row in which a declining rate has been recorded, with the rate declining to 3.1 percent in 2015. With this decline, in 2016, the average regional per capita Gross Domestic Product (GDP) is estimated to have contracted by 1.1 percent, compared to the increase of 0.4 percent recorded in 2015. Low commodity prices, weak external demand, drought, and security problems all had a negative impact on economic performance in the region. The average price of crude oil stood at US\$ 43 per barrel in 2016, down 15 percent from 2015. Metal prices increased, but were on average 11 percent lower than in 2015. In addition, agricultural prices remained weak. The net result was a deterioration in the terms-of-trade for the continent as a whole.

**2. In addition to these adverse external factors, in 2016, a number of countries across Sub-Saharan Africa were subject to negative domestic shocks.** In particular, the El Niño-induced drought caused sharp falls in agricultural production and in the production of hydroelectric power across countries in Eastern and Southern Africa. In particular, South Africa and net oil exporting countries recorded poor economic performance, with these countries together accounting for approximately two-thirds of regional output. Other commodity exporters in the region, particularly those dependent on minerals, have also struggled to adjust to lower prices.

**3. While it is expected that the regional economy will begin to recover in 2017, with the growth forecast at 2.9 percent, this is below the estimated population growth rate, implying that per capita incomes would decrease.** The recovery is expected to be moderated by the fact that the region is continuing to adjust to lower commodity prices. Although these prices are expected to increase in the medium term, they are likely to remain significantly below their pre-global-crisis averages. Growth rates will continue to vary widely across the region, with growth in South Africa and amongst net oil exporters expected to be weaker than in the case of metals exporters, with growth in non-resource-intensive countries remaining robust.

**4. A number of downside risks continue to affect the regional outlook.** In terms of external risks, heightened policy uncertainty in the USA and Europe could lead to increased volatility and higher borrowing costs for emerging and frontier markets. Similarly, a sharper-than-expected slowdown in China could weigh on demand for export commodities. In terms of domestic risks, the main risk is that policy makers might fail to make the necessary adjustments to an environment characterized by low commodity prices and weak global demand. In this environment, the countries in the region require sustained measures to contain fiscal deficits and to rebuild buffers. The key medium-term challenge for the region is to develop new sources of growth while at the same time maintaining macroeconomic stability.

## Malawi's economy is set for recovery after two years of weather-related shocks

**5. In 2016, Malawi's rate of economic growth stood at just 2.5 percent.** The late onset of rains and the erratic dry spells associated with the El Niño weather pattern weighed heavily on agricultural production levels. In particular, a prolonged drought resulted in a second successive year of crop failures in the Southern region of the country and parts of the Central region. Maize production declined for the two consecutive years, falling by an additional 14.7 percent in the 2015/16 growing season, following a decline of 30.2 percent recorded in the 2014/15 growing season. This exacerbated the already troubling food insecurity situation. Initially, it was projected that 40 percent of Malawi's citizens would suffer from food insecurity in 2016/17. In September 2016, maize prices set by the Government, through the Agricultural Development and Marketing Corporation (ADMARC) Limited, were in line with market forces. Together with a well-financed humanitarian response, this measure effectively met the needs of food insecure households and reversed an accelerating food price inflation (see Box 1).

**6. Tobacco remains Malawi's most significant cash crop.** With an ongoing decline in global demand for tobacco and with Malawi's tobacco production levels in 2016 in excess of demand, unit prices were on average 19 percent lower than in the previous year. In 2016, there was a 30 percent oversupply of burley tobacco, Malawi's main tobacco product, amounting to 40 million kg. The average price of burley tobacco, which constituted over 80 percent of Malawi's tobacco sales, declined by 22 percent, while the average price of dark fired tobacco declined by 8 percent. By contrast, the average price for flue cured tobacco increased by 8 percent. In 2016, at

the close of the season, the total value of tobacco sales stood at US\$ 276.4 million, 18.1 percent lower than the value realized at the same point in 2015.

**7. Despite the drought conditions in 2016, tobacco production proved to be resilient, resulting in an output in excess of demand, which contributed to the significant decline in average prices.** The 2016 tobacco auction sales season was particularly long, lasting 38 weeks as opposed to the usual 20 weeks, with buyers struggling to absorb the excess supply resulting from the over production that year and from carryover stock from the previous year. Lower prices and later sales for smallholders operating outside of contract farming arrangements (the integrated production system) have influenced planting decisions for the 2017 season. A significant proportion of non-contract farmers appear to have switched to the cultivation of legumes in the 2016/17 growing season. The decision of a significant proportion of smallholder farmers to shift away from tobacco production is characteristic of a production cycle that manifests every 3-5 years, with farmers making the decision either to shift into or away from tobacco production on the basis of the prices obtained in the previous season. In the past, tobacco grown through contract farming arrangements has consistently recorded higher prices than in the case of tobacco sold at auction, with production of the latter being harder to regulate and with a tendency towards over supply if prices in the previous season were higher than average. This was the case in the 2016 tobacco season, where the average price for burley, flue cured and dark fired tobacco produced through contract farming arrangements was 47 percent, 32 percent and 29 percent, respectively, higher than tobacco sold on auction. Developments in the sector include the introduction of the Farmers Management System (FMS) in 2017, which is intended to manage production volumes and quality by registering individual tobacco farmers and allocating production quotas based on the farmer's historical production performance. This measure is intended to ensure some level of predictability of supply and price stability in the sector.

**8. Large scale, frequent power cuts and water rationing in the second half of 2016 had a significant negative impact on the productive sectors.** As water levels became critically low due to the drought conditions, Malawi's hydroelectric generation facilities were unable to operate at full capacity. As a result, output fell from 365 MW in the pre-drought period to a low point of 150 MW. This further exacerbated an already existing electricity demand gap of 75 MW in normal conditions, with the limited availability of electric power acting as a key constraint on a number of productive sectors, particularly manufacturing. As a result of increased cost of production, subdued domestic demand, and the weak performance of the agricultural sector, growth in the industrial and service sectors was slower by 1.1 and 0.3 percent respectively from the growth obtained in 2015. However, with the resumption of rains, the output of electric power is expected to increase in 2017, although it will remain below full capacity. Together with the recovery in agricultural production, this will result in a recovery to services and industry in 2017, with respective growth rates of 4.5 percent and 5.6 percent.

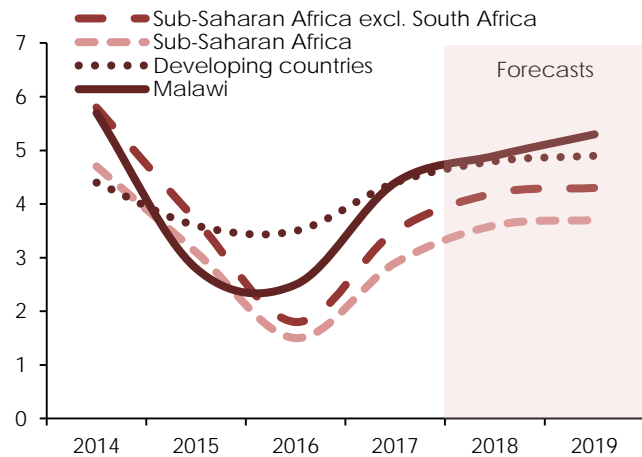
**9. With the recovery to the agriculture, industry and services sectors, Malawi's economic growth is expected to increase to 4.4 percent in 2017** (see Figure 1 and Figure 2). This increase is expected to be driven by above average rainfalls, which will stimulate the growth in all sectors. The agricultural sector contributes about 30 percent of Malawi's GDP, dominating activities in the other sectors of the economy, such as agro-processing and manufacturing. This sector is expected to grow by 4.8 percent in 2017, a recovery from the negative rate of 2.3 percent recorded in 2016. Following two years of contraction, second round national cereal production estimates forecast a 40.6 percent increase in overall crop production, with a 40.2 percent increase in maize production. This should result in improved food security for the majority of the population, higher disposable incomes for farming households, and increased revenue collection. Combined with greater expected macroeconomic stability, this should result in general increases to economic activity, thus driving recovery. Within the agricultural sector, it is expected that there will be significant shifts in the composition of crops in the 2016/17 growing season, with tobacco production expected to decline by 36 percent as more farmers shift towards the production of legumes such as groundnuts and pulses whose production is expected to increase. Despite the fall in production of tobacco, the quality and prices have been better and coupled with the ongoing drought in East Africa, this should result in an increase in realized prices for tea especially, further strengthening the economic position in 2017.

**10. Malawi remains vulnerable to risks associated with pest infestations, including the Fall Army Worm (FAW), which have negatively impacted cereal crop yields in parts of Southern Africa.** This pest which is indigenous to the tropical regions of the western hemisphere has caused significant crop damage across the region. In Malawi, FAW was first detected in maize and sorghum in three Agriculture Development Divisions (ADDs) in December 2016. By February 2017 the infestation had spread to all districts of Malawi. Most of the impact of this pest is expected to occur in Northern Malawi, where the rains came late, creating ideal conditions for FAW infestations. However, the level of crop damage has yet to be ascertained, with Government forecasting a more limited 2 percent reduction in maize yields in the North, despite higher forecasts by the Food and Agriculture Organization.

The Ministry of Agriculture, Irrigation and Water Development has intensified control efforts by conducting monitoring exercises, providing pesticides to farmers in the affected areas, and conducting sensitization campaigns. If the pest causes higher-than-expected levels of damage, the forecasted recovery in maize production in the 2016/17 season will need to be revised downwards, affecting Malawi's economic recovery and raising prospects for food shortages in 2017/18.

**Figure 1: Malawi is expected to see a stronger growth performance compared to regional peers...**

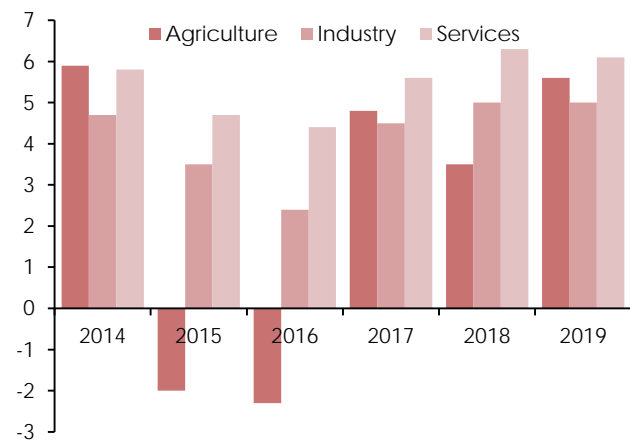
Real GDP growth, annualized, percent



Source: World Bank Global Economic Prospects

**Figure 2: ...driven by a recovery in agricultural output**

Real GDP growth by sector, annualized, percent



Source: World Bank staff estimates based on MFM0d

**11. Weather shocks are expected to have an ongoing cyclic impact on Malawi's economic performance into the medium-term future.** The negative impact of drought and flooding has become increasingly significant over the years. With the adverse effects of climate change, this trend is likely to continue into the future, with the negative impacts of weather shocks compounded by factors such as population growth and environmental degradation. Data from available records show that over the past 100 years, Malawi has experienced approximately 20 major droughts. On average, droughts and dry spells cause annual losses equivalent to 1 percent of GDP (GFDRR, 2009). Most drought episodes have occurred in El Niño years, with Malawi particularly likely to experience rainfall deficits in these years.

**12. The projected growth recovery over the next few years is predicated on improved macroeconomic conditions and on factors favorable to the agricultural sector.** In Southern Africa, a strong El Niño effect is typically followed by a similarly strong La Niña effect, resulting in higher than average rainfalls. This rainfall is expected to facilitate a recovery in the production of key crops, including maize. It is also expected to facilitate an increase to the water resources in Lake Malawi required for the generation of hydroelectric power. However, the achievement of this growth recovery is subject to several risks and will therefore require structural reforms and careful macroeconomic and fiscal management to avoid instability.

**13. While a growth recovery is expected in 2017, economic performance remains subject to significant downside risks.** These risks relate primarily to Malawi's continued vulnerability to external shocks, amplified by the risk of fiscal slippages. Reforms to boost agricultural commercialization will help build medium term resilience, but Malawi is expected to remain vulnerable to climate variability at least into the medium-term future. For example, there is a risk that a La Niña effect could trigger localized flooding, which might place already strained disaster response mechanisms under further pressure. Similarly, despite encouraging efforts to achieve fiscal consolidation, past experience suggests that Malawi has struggled to contain recurrent expenditure over the political-business cycle. Such pressures would be amplified by lower-than-expected grants and concessional financing, putting pressure on domestic borrowing and in turn delaying the implementation of a disinflationary program. The continued decline in the prospects of the tobacco sector, Malawi's primary commodity export, combined with slow diversification and higher crude oil prices, would also put pressure on external balances.

**14. With stronger growth and reduced inflation, Malawi's poverty is expected to decline somewhat.** This represents a change from 2015 and 2016, when population growth outpaced GDP growth, meaning that average per capita incomes saw a decline. The proportion of poor households living under the international poverty line of US \$1.9/day (2011 PPP) is expected to marginally decline from around 69.8 percent in 2016 to 69.4 in 2017.

### Box 1: Stabilizing maize prices in the midst of a food crisis

**Malawi is increasingly susceptible to adverse weather conditions that trigger food shortages.** Its heavy reliance on rain-fed agriculture is often aggravated by poor policy responses in times of food crisis. It has become customary for the Government to intervene in the maize market during food crises through the ADMARC Limited and the National Food Reserve Agency (NFRA) to buy, distribute and sell maize throughout the country. In doing so, the Government often sets a maximum price for all agricultural products, including maize, sold in ADMARC depots. Other public sector interventions intended to address food insecurity include the Farm Input Subsidy Program (FISP), the promulgation of minimum farm gate prices to encourage maize production, and restrictions on maize exports.

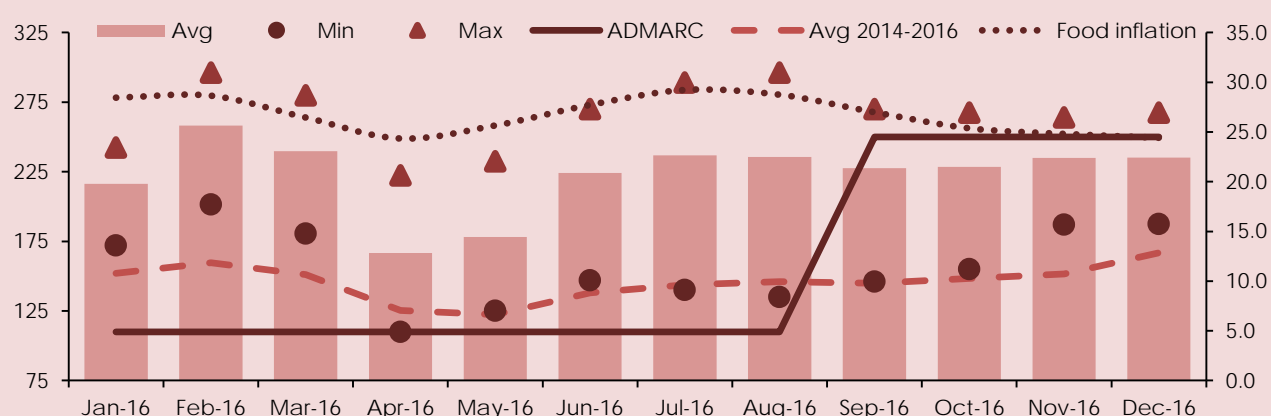
**Despite these interventions, Malawi's maize market remains extremely thin, with few buyers and sellers relative to the number of producers.** Research has revealed that only about 8.5 percent of farmers are outright sellers of maize, 8.9 percent operate as buyers and sellers, and 55.3 percent purchase maize only to supplement their own stocks. When markets are thin, small disruptions and interventions in supply and demand can result in large movements in market prices. Thus, the Government's interventions often have the opposite of the intended effect, undermining its own objective of stabilizing prices and improving food security.

**Recent maize market intervention measures produced very different results.** During the 2015/16 lean season, the Government intervened by setting the price for maize sold through ADMARC facilities at MWK 110 per kg, which was two and half times cheaper than the prevailing market price. This encouraged hoarding and speculative purchases of maize by traders from ADMARC, resulting in unavailability of the commodity at ADMARC depots. This also impeded domestic trade, as market participants were exposed to the risk of ADMARC undercutting them by selling at a price below cost. Much of the subsidized maize sold by ADMARC ended up in the hands of traders, who then sold it at the much higher market prices. Thus, this intervention was largely ineffective in terms of its stated goal of providing relief to the food insecure during this critical period.

**In contrast, during the 2016/17 lean season, there is evidence that the humanitarian crisis triggered some behavioral changes amongst public institutions, with a subsequent positive response by the private sector.** In the face of considerable political pressure, ADMARC committed to a published retail price of MWK 250 per kg of maize. While this was a substantial increase from the price of MWK 110 per kg established in the previous season, it was set at a level which balanced the institution's need to recover costs with the risk that a higher price would drive a greater number of consumers into seeking humanitarian relief. Private trade in maize from neighboring countries, especially Mozambique and Zambia, was very active, in addition to the parallel market that exists throughout Eastern and Southern Africa to circumvent maize export bans.

**Figure 3: As a result of policy interventions, maize prices were much more stable during the 2016/17 lean season compared to in 2015/16**

Maize prices, MWK /kg (LHS); food price inflation, percent (RHS); monthly data during 2016



Source: World Bank staff calculations based on mobile Vulnerability Analysis and Mapping (mVAM) and Agricultural Marketing Information System (AMIS) data

**Thus, breaking with recent historical practice, ADMARC's prices were close to the market rate, which left the wider market uninterrupted.** An analysis of the average price of maize over the past three years shows that ADMARC prices have been consistently set below the three-year average. For the first part of 2016, prices were also set below the minimum price across the various markets (see Figure 3). When Government sets a price that is lower than the prevailing market price and has the stock, vendors tend to buy out the maize from ADMARC



for resale, equalizing the market prices, at the expense of the intended beneficiaries. Similarly, when Government sets a price without appropriate stock levels and when the market is aware of this, the market is unresponsive.

**The market intervention price set by ADMARC during the 2016/17 leans season was in line with market forces, ensuring price stability and subsequently a deceleration in the rate of inflation.** A substantial increase in the ADMARC price to MWK 250 per kg not only brought its price above the average market price, the price was also closer to the maximum price being offered in the various markets. This resulted in a sustained fall in maize prices, which has been a significant factor driving the ongoing declining trend in food inflation since September 2016 and consequently the deceleration in the headline inflation rate.

**Unless Malawi diversifies its crop production, maize production will remain critically important to the achievement of food security.** Therefore, improving the availability of this commodity and the performance of maize markets is crucial to the achievement of food security in the context of rain fed agriculture and natural disasters. Producers need to be encouraged to engage and invest in maize production and marketing. However, this can only be achieved once producers are assured of a reasonable degree of stability and predictability of the maize markets, with the most critically important measure to achieve this being the minimization of distortions to the market.

## **There are signs of improvement in the fiscal performance amidst a humanitarian crisis**

### **16. As a result of both exogenous and endogenous shocks, the fiscal stance has come under increasing pressure.**

From 2013, Malawi has contended with a widening fiscal gap resulting from a sharp decline in on-budget Official Development Assistance (ODA) after the “cashgate” scandal and exacerbated by two consecutive years of drought and floods in 2015 and 2016. Since then, the Government has struggled to adjust to the reduction in the share of ODA that is disbursed through the budget. It has proved to be difficult to consolidate expenditure around lower volumes of grants. In addition, weather-related shocks have contributed to poor macroeconomic performance, which in turn led to sluggish revenue collection.

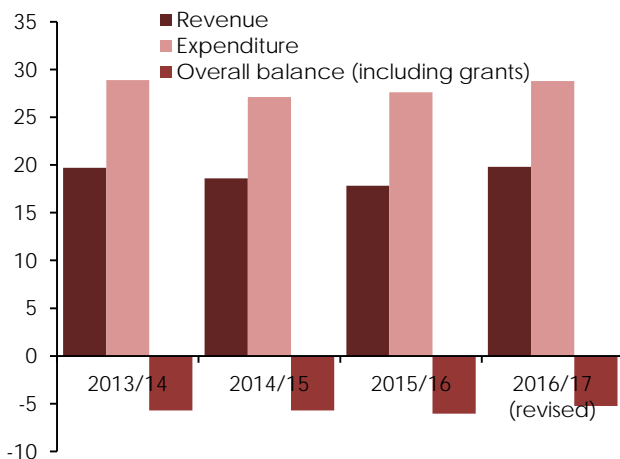
**17. The FY 2016/17 budget was framed to increase allocations for the purchase of food and for investments to improve the level of resilience in the agricultural sector.** Measures prescribed by the budget included radical reforms to the FISP. Health, education and social protection budgets were ring-fenced, with reduced allocations to almost all other budget lines in real terms. Irrigation was prioritized in the development budget, as a significant measure to improve resilience. To meet the overall food deficit requirement, significant additional resources were required from development partners to enable the Government to implement an effective humanitarian response to the food crisis.

**18. Implementation of the reformed FISP Program substantially improved in 2016/17, although some inefficiencies remain and will need to be addressed in future planning and execution.** The 2016/17 FISP Program was substantially reformed with a reduction in the number of beneficiaries from 1.5 million in 2015 to 0.9 million in 2016. In addition, the supply of inputs was made open to private suppliers for the first time in the program's history via a fixed value coupon model, with almost 80 percent of fertilizer being procured and distributed by the private sector as well as 100 percent of seeds. Private sector participation meant that fertilizer inputs were delivered in a timely fashion, as compared to previous years. However, beneficiary selection was delayed, also the case in previous years, as it mostly occurred by the end of November, and was compounded by delays in the production of vouchers. It is also worth noting that this was the first year on record that FISP was completed within the stipulated budget. To ensure that FISP is efficiently run and that inputs are applied to maximize potential production, program design should be cleared well in advance of the start of operations. In addition, further efforts are needed to better target beneficiaries who are cash constrained, but have adequate land and labor to effectively make use of subsidized farms inputs.

**19. Despite the looming food crisis, the Government has managed to contain fiscal pressure, with borrowing remaining within the approved target and below the International Monetary Fund (IMF) program ceiling.** The food crisis resulted in a dramatic increase in borrowing during the first half of FY 2017, due to unplanned expenditure on post-harvest maize purchases in anticipation of interventions in food-deficient areas. Although the fiscal deficit in FY 2016 remains high, at about 6 percent of GDP, some positive results on the fiscal side were recorded in the first half of FY 2017. In particular, by the end of December, domestic borrowing had reached MWK 25.1 billion, well below the approved ceiling under the IMF Extended Credit Facility (ECF) target of MWK 40.0 billion.

**Figure 4: The drought has made it more difficult to reduce the fiscal deficit...**

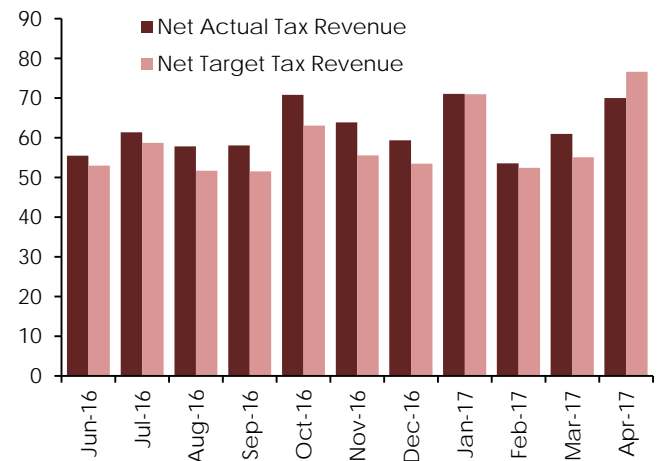
Revenue, expenditure and budget deficit, percent of GDP



Source: World Bank staff calculations and estimates based on MoFEPD data

**Figure 5: ...but revenue collection is exceeding targets due to intensification efforts**

Net actual revenue vs. net target revenue in MWK billions



Source: World Bank staff calculations and estimates based on MoFEPD data

**20. For the semester ending December 2016, the Malawi Revenue Authority (MRA) exceeded its half-year revenue collection target by 11 percent.** For the first half of the fiscal year, the cumulative total revenue collected exceeded the target by MWK 37.9 billion. From the month of June 2016, MRA exceeded its monthly revenue collection targets for every consecutive month (with the exception of April) (see Figure 5). These high levels of collection can be attributed to several factors. Amongst others, the MRA's migration from the ASYCUDA ++ software system to ASYCUDA World has resulted in efficiency gains for both domestic and trade tax collections, with leakages minimized. In addition, collections increased from a windfall capital gains tax from the sale of Carlsberg Breweries Limited; the payment of arrears by the construction industry; tariff hikes in telecommunications and utilities; a review of tariff headings reducing the scope of duty free allowances by introducing Value Added Tax (VAT) on some products which were previously zero rated; significant increases to import and excise duty due to a rise in imports of fuel as well as power backups (generators, solar panels, batteries); the migration by the Electricity Supply Corporation of Malawi (ESCOM) from the use of postpaid billing meters to pre-paid meters; intensified audit and tax investigation activities; and the implementation of whistle blowing systems. All these factors resulted in strong performance across the different tax instruments, including the Pay-As-You-Earn (PAYE), Fringe Benefit Tax, Provisional Tax, Import Duty, VAT and Excise Duty categories. It is expected that for the remainder of the fiscal year, the value of collected revenues will be in excess of the revised tax revenue target of MWK 754.9 billion, which is already MWK 46.1 billion above the initial target.

**21. The proportion of ODA that is provided through off budget mechanisms continues to increase, with the slow disbursement of the total volume of grants reflecting slow absorption by Ministries, Departments and Agencies (MDAs).** By the end of December 2016, the mid-year outturn revealed that only about MWK 30 billion had been disbursed, against the projected figure of MWK 103 billion. As in previous years, the proportion of development assistance provided through off budget mechanisms continues to increase and is now around two thirds of Malawi's approximate US\$ 1 billion annual ODA allocation. At the project level, the rate of absorption of committed funds remains low, reflecting the slow pace of implementation of project activities.

**22. The Government has managed to constrain expenditure levels, with spending remaining within the approved limits in the first half of FY 2017, with cuts to key subsidy programs making space for humanitarian spending.** Total expenditure and net lending was about 14 percent lower than approved, with most of the under expenditure on the recurrent side. As has been the case in previous years, there was an underestimation of expenditure on interest on domestic debt (see Figure 13) and wages and salaries, resulting in increasing over expenditure by 6 percent and 8 percent, respectively. The increased expenditure on domestic interest was mainly due to the retirement of maturing zero coupon bonds with interest bearing securities and the replacement of part of the maturing PTA facility with high interest securities. Expenditure on wages and salaries included arrears paid in the first quarter to around 10,500 primary school teachers and 460 secondary school teachers. However, the over spending in these areas was offset by declines in expenditures on subsidies and transfers (25 percent) and good and services (12 percent). In a disturbing ongoing trend, expenditure on the development side fell by 38 percent,

with spending on domestically financed projects (Part II) falling short by 21 percent and on foreign financed projects (Part I) by 40 percent.

**23. Despite the shortfalls in total revenues and grants, the Government managed to meet the financing gap by containing expenditure and by borrowing.** By the end of the first half of the year, the fiscal deficit stood at MWK 75.9 billion, against a projected figure of MWK 104.2 billion. The authorities managed to finance the shortfall within approved ceilings, with foreign financing of about MWK 42.7 billion against an approved MWK 53.1 billion, and domestic financing of MWK 25.1 billion against an approved MWK 40.1 billion. The balance was met by financing from privatization proceeds, the value of which amounted to about MWK 11.3 billion. At the time of the budget's formulation, growth was subdued following two consecutive years of adverse weather conditions which affected agricultural production and put households at risk of food insecurity. The humanitarian response was well-financed by the Government and Development Partners thereby meeting the needs of food insecure households.

### **The fiscal outlook envisages a modest degree of consolidation over the medium term**

**24. The revised fiscal framework aims to sustain the gains achieved in the first half of FY 2016/17.** The overall projections indicate an upward revision of total domestic revenues by 7.3 percent. This is justified in terms of expectations of increased tax and non-tax revenues, based on the assumption that the over performance in collections will continue for the remainder of the year as a result of ongoing efforts to intensify collections and of efficiency gains from the new system. Total expenditure is estimated to go up by 3.5 percent. Most categories in recurrent spending have remained broadly in line with approved estimates except for increases in interest on domestic debt and arrears repayments. These changes have necessitated cuts to the development budget which has been reduced by about 19 percent to offset increases to recurrent expenditure.

**25. While domestic revenue is projected to increase, grants are projected to decline in the short term.** The revised projections are based on estimates that both tax and non-tax revenues will continue to increase for the remainder of the year. Domestic revenues are projected to increase by 7.3 percent to reach a value of MWK 840.5 billion, revised from the figure of MWK 783.3 billion. However, the value of grants is projected to continue to decline, with this value projected to reach MWK 158.7, revised from MWK 194.7 billion in the approved framework. This is mainly on account of project grants, with projects continuing to be affected by low absorption capacities and the slow rate of implementation.

**26. Expenditure projections have been revised upwards risking overruns beyond the available resource envelope and the ceiling for borrowing.** Recurrent expenditure has been revised upwards by 12.5 percent, increasing from MWK 823.3 billion to MWK 925.9 billion. The revisions are mainly due to the provisions for interest payments on securitizing zero coupon bonds and domestic debt. Provisions for goods and services also include an increased allocation for road maintenance and additional resources for maize purchases provided through retroactive financing under a World Bank project (Malawi Drought Recovery and Resilience Project, MDRRP). The provision for FISP has remained unchanged, as the delayed payments are expected to be transacted in the third quarter. The low disbursement of projects grants and the low absorption capacity across MDAs has contributed to shortfalls in foreign-financed development projects. Domestically-financed expenditure is projected to increase, with additional resources earmarked for the construction of Mombera University.

**27. Major sectoral allocations continue to reflect a relatively constant pattern.** In terms of the allocations they receive, the top five sectors are as follows: agriculture at 17.7 percent; education at 15.7 percent; health at 8.4 percent; transport at 7.7 percent and governance at 4.8 percent (see Figure 6). This pattern has remained broadly constant over the past several years. However, more recently, roads, public works and transport has been allocated a greater proportion of resources than governance due to a number of roads and construction works. In particular, major ongoing projects include the rehabilitation and maintenance of the Kamuzu and Chileka International Airports. With the reforms to FISP, the share of fertilizer and seed subsidies has steadily declined from about 3.0 percent of GDP in FY 2013 to around 0.8 percent of GDP in FY 2017. Nonetheless, agriculture continues to receive the most significant share of resources, with its share in proportion to the total budget remaining broadly unchanged. In part, the high proportion of resources this sector receives has been the result of the increased resources allocated to address the humanitarian crisis following two consecutive years of adverse weather conditions. Within the education and health sectors, the most significant expenditures are on the wage bill for teachers and health personnel. Within the governance sector, the most significant expenditures are on the financing of ongoing public finance management reforms.

**28. The main pressure points on the budget relate to expenditure on wages and salaries and on interest on domestic debt, with these expenditures on a rising trend over the years.** Expenditures on wages and salaries are the largest budget item, standing at a value of 6.4 percent of GDP in FY 2016/17, up from 5.7 percent of GDP in FY 2012/13 (see Figure 7). The rapid growth in the wage bill is primarily due to a sustained increase in the number of civil servants, with the total number of people increasing from around 111,000 in 2008 to 186,000 in 2016. This increase raises questions about the sustainability of the overall public sector wage bill. Weaknesses in establishment and personnel controls have prevented the authorities from taking a more strategic view of public sector hiring and have made the payroll vulnerable to fraud. In addition, the absence of an interface between the payroll and the IFMIS exposes the system to vulnerabilities. Policy reforms should aim at improving the payroll management system and at establishing stronger establishment controls. Debt servicing costs are also further compressing the Government's available fiscal space, crowding out private sector investment and contributing to inflationary pressures. The increase in domestic debt has been exacerbated by the widening fiscal gap following the suspension of budget support in 2013 which has led to a surge in interest payments on domestic debt (see Figure 10). This has been compounded by the need to finance the Government's response to the food crisis in the past two years, and by the securitization of arrears and issuance of promissory notes. In this context, it is imperative that the authorities remain committed to increasing efforts to consolidate fiscal spending and to improve budget execution and oversight by monitoring the monthly budget outturns for all MDAs.

**Table 1: Fiscal accounts**

Percentage of GDP (with rebased GDP)

	2012/13	2013/14	2014/15	2015/16	2016/17	
					Approved	Revised
<b>Revenue and grants</b>	<b>27.5</b>	<b>23.2</b>	<b>21.4</b>	<b>21.6</b>	<b>23.1</b>	<b>22.8</b>
<b>Revenue</b>	<b>17.3</b>	<b>19.7</b>	<b>18.6</b>	<b>17.8</b>	<b>18.5</b>	<b>19.8</b>
Tax Revenue	15.7	17.3	16.3	16.0	16.7	17.8
Nontax revenue	1.6	2.4	2.4	1.8	1.8	2.0
<b>Grants</b>	<b>10.2</b>	<b>3.5</b>	<b>2.8</b>	<b>3.7</b>	<b>4.6</b>	<b>3.0</b>
Budget support grants	4.5	0.3	0.0	0.5	0.3	0.3
Dedicated grants	3.7	1.4	1.1	1.8	1.3	1.1
Project grants	2.0	1.8	1.7	1.4	3.0	1.6
<b>Expenditure and net lending</b>	<b>28.0</b>	<b>28.9</b>	<b>27.1</b>	<b>27.6</b>	<b>27.1</b>	<b>28.0</b>
<b>Recurrent expenditure</b>	<b>22.0</b>	<b>24.4</b>	<b>21.8</b>	<b>23.5</b>	<b>19.4</b>	<b>21.8</b>
Wages and salaries	5.7	6.2	6.9	6.4	6.4	6.4
Interest payments	1.9	4.4	4.0	4.0	3.4	4.0
Foreign	0.2	0.2	0.3	0.3	0.3	0.3
Domestic	1.7	4.2	3.8	3.7	3.1	3.7
Goods and services	7.9	7.9	5.5	5.8	5.7	6.0
Maize purchases	0.2	0.3	0.2	0.8	0.8	0.8
Subsidies and transfers	5.7	5.6	4.9	4.9	3.8	4.1
Fertilizer subsidy	3.0	2.7	1.9	1.8	0.8	0.8
Arrears payments	0.7	0.4	0.4	2.5	0.1	1.4
<b>Development expenditure</b>	<b>6.1</b>	<b>4.5</b>	<b>5.3</b>	<b>4.0</b>	<b>7.6</b>	<b>6.1</b>
Domestically financed	1.8	0.9	1.0	0.7	0.9	1.0
Foreign financed	4.2	3.6	4.4	3.3	6.7	5.1
<b>Overall balance (incl. grants)</b>	<b>(0.5)</b>	<b>(5.7)</b>	<b>(5.7)</b>	<b>(6.1)</b>	<b>(4.0)</b>	<b>(5.2)</b>
Financing	1.8	6.1	5.8	6.1	4.0	5.2
Net foreign financing	1.9	2.0	2.5	1.9	2.6	2.6
Gross foreign borrowing	2.2	2.4	2.9	2.4	3.2	3.2
Budget support loans	0.0	0.0	0.0	0.0	0.0	0.0
Project loans	2.2	1.8	2.2	1.9	2.7	2.3
Other loans	0.0	0.6	0.7	0.5	0.6	1.0
Amortization	(0.3)	(0.4)	(0.4)	(0.5)	(0.6)	(0.7)
Net Domestic borrowing	(0.1)	4.2	3.3	1.7	1.4	1.0
Securitization of domestic arrears	0.0	0.0	0.0	2.5	0.8	1.3
Privatization proceeds	0.0	0.0	0.0	0.0	0.0	0.3

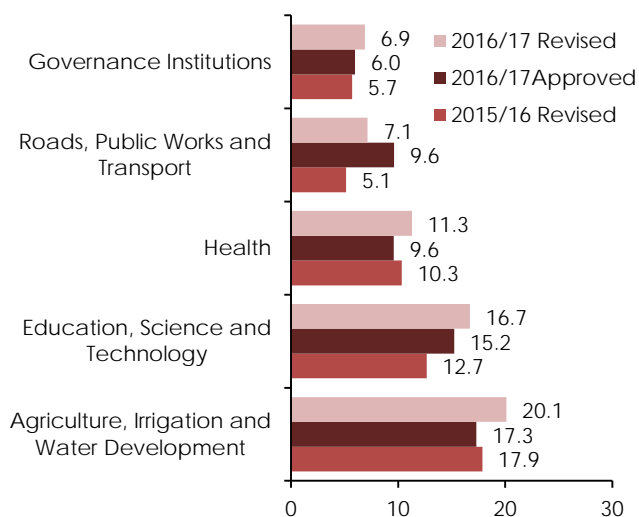
Source: World Bank staff calculations based on MoFE PD data

**29. The fiscal deficit in FY 2016/17 is projected to reach 5.2 percent of GDP, lower than the figure of 6.1 percent recorded in FY 2015/16** (see Figure 4). With a recovery to the agricultural sector and improved domestic revenue mobilization, the fiscal balance is expected to narrow over the medium term. A modest fiscal consolidation is also envisaged, following the high level of expenditure resulting from the Government's response to the humanitarian

crisis, which included maize imports. The underlying deficit is expected to be financed mostly through concessional foreign financing (2.6 percent of GDP) and through domestic borrowing (1.0 percent of GDP). However, as in 2015/16, the deficit is amplified by the costs of converting maturing zero-coupon bonds into interest bearing securities (1.3 percent of GDP). There will also be modest proceeds from privatization (0.3 percent of GDP).

**Figure 6: Hiring has pushed up recurrent spending in the education sector**

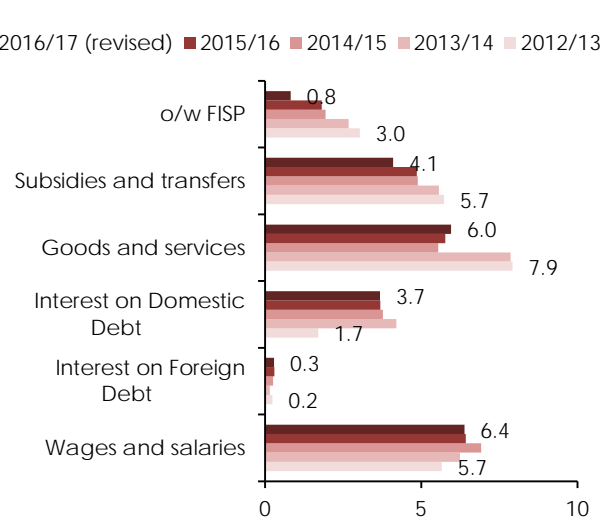
Top five sectoral budget allocations, percentage of total budget, selected years, net of transfers to local councils and subventions



Source: World Bank staff calculations and estimates based on MoFEPS data

**Figure 7: Subsidies and transfers have fallen, while wages and debt service have risen**

Share of estimated recurrent expenditure, percentage of GDP



Source: World Bank staff calculations and estimates based on MoFEPS data

**30. The extent of fiscal consolidation is likely to be limited by pressure on domestic borrowing.** This relates to expenditures on the securitization of zero-coupon bonds and the settlement of outstanding arrears. However, after 2017/18, as the pressure of food insecurity recedes, a faster pace of consolidation may become possible as a result of the intensification of revenue collection; the settlement of all outstanding arrears; the implementation of tight expenditure controls; the reform of key expenditure programs, such as the FISP; and the containment of other spending (including the public sector wage bill). In terms of financing, continued reforms to PFM will help to facilitate a gradual recovery in the share of ODA financing provided to Malawi through the budget as well as a resumed general budget support from multilateral development partners (see Box 2). In turn, the latter could support a reduction in the domestic borrowing requirement and therefore in domestic debt service costs, providing further fiscal reinforcement.

## Debt levels continue to rise, placing a growing burden upon Government

**31. Malawi's current debt burden remains manageable, although the rapid increase in domestic debt (rather than external debt) is beginning to create stresses.** As determined by the most recent Joint World Bank and IMF Debt Sustainability Analysis (DSA), Malawi's total public and publicly guaranteed (PPG) external debt stands at US\$ 1.79 billion (33.1 percent of GDP) at the end of 2016. Gross domestic debt increased from MWK 206.6 billion at the end of 2012 to MWK 865.3 billion (21.1 percent of GDP) at the end of 2016. The pace of growth of external debt has been rather moderate, reflecting the highly concessional nature of the bulk of Malawi's external debt, with limited options for non-concessional borrowing. However, domestic borrowing has increased rapidly, quadrupling over the last four years, mainly as a result of external financing shortfalls arising from the 2013 "cashgate" scandal and the consequent decline in on-budget financing from development partners (see Box 3). Difficulty in undertaking a fiscal adjustment and expenditure overruns (particularly in the area of the public sector wage bill and on subsidy programs), the securitization of a large stock of domestic arrears, and the economic shock of two years of drought, have all contributed to the growth in the stock of domestic debt.



## Box 2: Efforts to restore integrity in Malawi's Public Financial Management system after "cashgate"

The discovery in September 2013 of a massive theft of public resources by a group of individuals, including both from the Government and the private sector, exposed significant underlying weaknesses in Malawi's Public Financial Management (PFM) systems. Dubbed the "cashgate" scandal, some US\$ 50 million in public funds were stolen through illegal access to the national payment system. The repercussions included a major public outcry, the arrest (and subsequent trial and imprisonment) of a number of Government officials, and the dissolution of the Cabinet. Prior to the scandal, budget support had been provided by six development partners under a common approach. This budget support was suspended and there were sharp reductions in the share of Official Development Assistance (ODA) channeled by development partners through national systems. As a consequence, Malawi's fiscal situation deteriorated rapidly, with a significant negative impact on private sector confidence and on Malawi's international reputation.

The newly elected Government in 2014 committed itself to rebuilding trust in public institutions and to correcting macroeconomic imbalances as a means for Malawi to achieve sustainable and inclusive growth. As a means of achieving this, "home grown" PFM and Public Sector Reform (PSR) plans have been launched with high level political support. Nonetheless, fiscal adjustment has proved challenging, particularly in the context of two years of consecutive weather shocks that have dampened growth and created additional fiscal burdens on already strained public resources. Similarly, the majority of aid flows have been shifted to implementation mechanisms outside of Government systems.

Measures to restore basic PFM systems have taken longer than expected to materialize, with progress slower than might have been hoped. This partly reflects the fact that the "cashgate" scandal and its aftermath exposed a financial management and accountability framework that was in fact much weaker than had been previously recognized. A large gap between the form of Malawi's public sector institutions, many of which compare favorably with international norms and standards, and their actual function has become apparent, with many of these institutions characterized by the complete breakdown of basic reporting and control frameworks (Bridges and Woolcock, 2016).

However, after a slow start, a back to basics approach is beginning to restore confidence. Bolstered by the provision of significant technical assistance, and as a response to acute expenditure pressures resulting from external shocks, the Government has rebuilt the framework under which Controlling Officers operate under the supervision of the Secretary to the Treasury and are accountable for day-to-day transactions. This has helped to re-establish centralized monitoring and controls of expenditures and commitments. Similarly, the Government has cleared the backlog in its financial reporting obligations, producing five years of financial statements within a single year, with these financial statements now current for the first time in a decade. More than 10,000 public servants have submitted detailed declarations of their assets. A payroll audit has resulted in significant improvements to an error-strewn wage bill. Information security has been strengthened, with system access regularly subjected to penetration testing as part of efforts to close the loopholes that allowed "cashgate" to happen. The existing Integrated Financial Management Information System (IFMIS) has been reinforced, with a successor system currently in the process of competitive procurement. There is also a broad-based realization that Malawi needs to significantly improve accountability frameworks through a number of means, including the increased independence of the external audit function, if public confidence is to be fully restored.

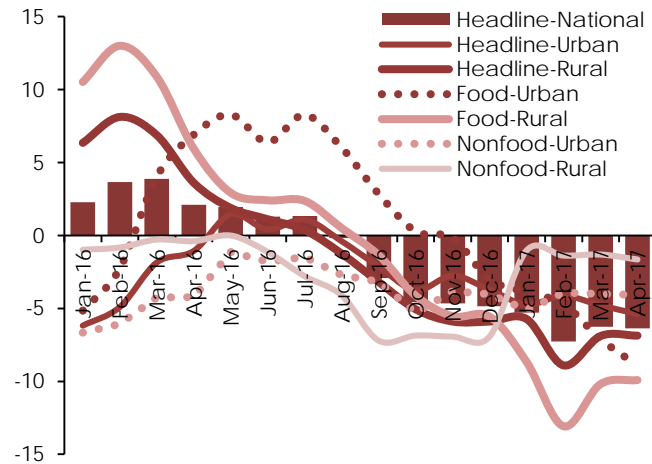
## Inflation has declined faster than expected

33. In April 2017, the headline inflation rate decelerated to 14.6 percent; largely due to the sustained decline in food prices resulting from the increased availability of maize following the importation relief maize for humanitarian purposes during the lean season (see Figure 8). In Malawi, a period of lower inflation usually occurs during and immediately after the harvest season, usually between April and September. In 2016, this period was considerably shorter than usual. Poor yields resulted in a scarcity of maize on the market, which meant that while the headline inflation rate in April declined significantly, it increased rapidly to an annual high of 23.5 percent in July 2016. However, the expectation of the arrival of maize imports in response to the humanitarian crisis during the second half of 2016 resulted in a sustained, gradual decline in the headline inflation rate to an annual low of 19.9 percent in November 2016. Thus, the average rate for the year stood at 21.7 percent, only slightly lower than the rate of 21.9 percent recorded in 2015. The increased availability of maize has resulted in a sustained decline in maize prices, with a consequent downward impact on food price inflation. As a result, while the inflation rate has remained in double digits for the past five years, it has been on a declining path recording a rate of 14.6 percent

in April 2017, 1.2 percentage points lower than the rate recorded in March 2017. This is also significantly lower than the rate of 20.9 percent recorded in April 2016. The rate seen in April 2017 is the lowest since the Kwacha was allowed to float in May 2012.

**Figure 8: Headline inflation has slowed, largely in response to a fall in food inflation...**

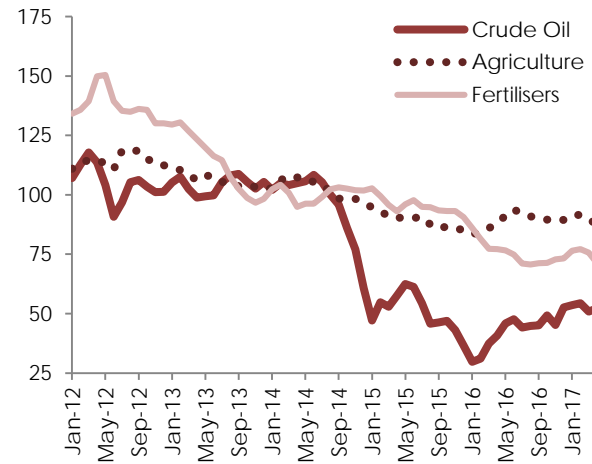
Headline, food and non-food monthly inflation, percent, year-on-year change



Source: World Bank staff calculations based on data from NSO

**Figure 9: ...although rebounding crude oil prices may contribute to non-food inflationary pressures**

International commodity price indices, 2012-2017, 2010= 100



Source: World Bank Development Prospects Group

**34. Food inflation remains the most significant driving factor for headline inflation, constituting about 50.2 percent of the national consumption basket, with this figure rising to 61.7 percent for the rural areas.** By April 2017, national food inflation had fallen by 9.6 percentage points from the figure of 24.3 percent recorded in April 2016. Despite this decline, and that of 9.9 percentage points in rural areas, over the same period, the rural food inflation rate was still 5.8 percentage points higher than the urban rate. Food accounts for a larger share of the consumption basket in rural areas than in urban areas, with maize accounting for a larger share of rural diets, thus leaving the rural population more exposed to price movements of food in general and maize in particular. Therefore, the decline in the national headline inflation masks the uneven burden that inflation has on the country's poor, the majority of whom are based in rural areas and are affected by higher than average rates of inflation.

**35. The RBM's maintenance of a tight monetary policy has successfully reduced the pace of credit growth, and consequently had a downward influence on the non-food inflation rate.** RBM implemented a tight monetary policy for the greater part of 2016 to help control non-food inflation rate. Among other measures, this policy involved the mopping up of excess liquidity. The maintenance of this policy and the stable exchange rate have contributed in part to a reduction in non-food inflation rate, which, from a rate of 18.7 percent in August 2016, has been on a declining trend since September 2016 reaching 14.4 percent in April 2017. It has been noted that the rural non-food inflation rate seems to be declining at a slower pace than the national and urban non-food inflation rate. This phenomenon needs to be investigated further, as it may indicate a shift in rural non-food expenditure patterns, with possible implications for overall inflation in the future.

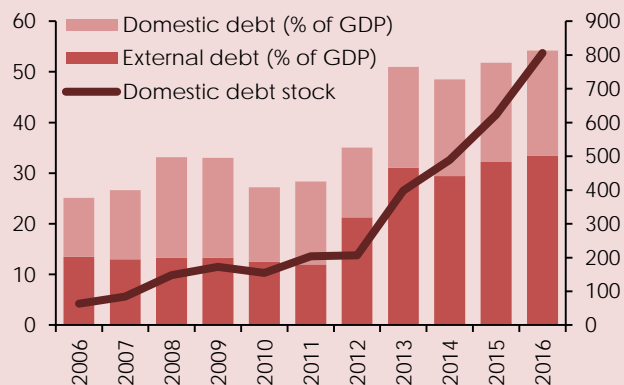
**36. Malawi's headline inflation rate is expected to decline further during the course of 2017, to a projected annual average of 15.2 percent.** However, this outlook remains subject to a number of domestic and global risks and opportunities. Domestically ADMARC plays an important role in setting maize prices, and the alignment of its prices with prevailing market prices is critical in maintaining price stability. In terms of domestic risks, the rate of inflation will be strongly correlated with agricultural output, with a good harvest required to sustain the reduction in food prices. Second round crop estimates project an increase in maize production of 40.2 percent. However, this estimate is subject to considerable downside risks, particularly those related to the impact of an infestation of army worms, which have attacked crops in many countries in Southern Africa, including Malawi. In terms of global risks, the rate of inflation may be impacted by increases in oil prices. As Malawi is a net oil importer with high inland transport costs, a rebound in international oil prices poses a risk. The agreement by the Organization of Petroleum Exporting Countries (OPEC) and non-OPEC nations to cut output by a combined 1.8 million barrels per day (bpd) in the first half of 2017 might put pressure on Malawi's reserves (see Figure 9). OPEC's crude output, which averaged 33.5 million bpd during the third quarter of 2016, is expected to fall to 32.5 million bpd, if and when participating petroleum producers adhere to the agreement. In addition, if prices in the tobacco subsector continues to underperform, this may result in increases to the imported non-food inflation rate, reducing the impact of the disinflation gains made during the beginning of the year.

### Box 3: The evolution of domestic borrowing in Malawi

In the past two decades, domestic debt has been accumulating at an increasingly rapid rate. The total value of gross domestic borrowing stood at MWK 30.3 billion, or 11.3 percent of GDP, in 2002. By December 2016, the value of domestic debt had increased to MWK 865.3 billion, or 21.1 percent of GDP (see Figure 10). Although the stock of domestic debt is lower than that of external debt, its relative proportion has been increasing over time. In addition, the cost of servicing domestic debt is high, due to the high interest rates and the short-term profile associated with government securities. With the high cost of borrowing, an increasingly heavy expenditure burden, the withdrawal of budget support since 2013 and unstable economic growth, a vicious cycle of domestic debt dependency has been created.

**Figure 10: Malawi's stock of debt, particularly domestic debt, has been rising fast in recent years**

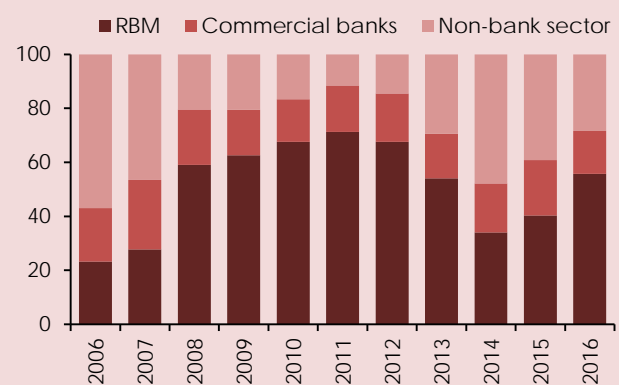
Domestic and external debt as a percentage of GDP (LHS); domestic debt in MWK billions (RHS)



Source: World Bank staff estimates based on MoFEPD and RBM data

**Figure 11: Borrowing from monetary authorities has been the main category of public domestic debt**

Sources of borrowing by category, percentage of total domestic debt



Source: World Bank staff estimates based on MoFEPD and RBM data

Historically, the largest source of domestic borrowing has been from the Reserve Bank, which accounts for an average of almost 50 percent of total domestic borrowing (see Figure 11). The non-bank private sector accounts for the next largest share, holding around a third of domestic debt. In third place are commercial banks, at almost 20 percent. There was a spike in borrowing from the Reserve Bank of Malawi (RBM) in the period from 2007 to 2008, as the share increased from 27.7 to 59.1 percent of total domestic borrowing, with the holding of Treasury Bills by RBM increasing by 151.4 percent. This occurred due to the financing of the fiscal deficit prior to the election in 2009, and to the high level of expenditure on the FISP (IMF, 2010). Borrowing from the monetary authority continued to increase, reaching a peak of 71.3 percent of total domestic borrowing in 2011 equivalent to 11.5 percent of GDP, before falling to an average of around 50 percent in the period from 2012 to 2016. The second spike in borrowing from the RBM during this period was in 2016, with an increase of 78.2 percent compared to the previous year. This was due to a large increase in the holdings of Treasury Notes, from 4.9 percent of GDP in 2015 to 9.6 percent at the end of 2016, in order to finance growing fiscal obligations as a result of the widening fiscal gap following withdrawal of foreign financing on budget.

**Borrowing by the non-bank sector<sup>1</sup> has increased substantially over the past five years driven by the increased financing needs of the Government.** In 2013, there was an almost threefold increase in the value of credit from the non-bank sector through Treasury Bill holdings (3.5 percent of GDP) and through the securitization of domestic arrears (2.2 percent of GDP).<sup>2</sup> The large increase in the holdings of Treasury Bills was also mirrored by commercial banks. During this period, total public debt grew by 92.7 percent, mainly to cover the shortfall created by the withdrawal of budget support in 2013. At the end of 2014, the PTA debt restructuring loan was implemented, with this loan providing a cash injection of US\$ 250 million to official resources to be repaid in Malawi Kwacha. In order to carry out the transaction, RBM advances were converted into Treasury Notes and sold to the COMESA PTA Bank. Thus, the equivalent amount in Malawi Kwacha, valued at MWK 106.6 billion,

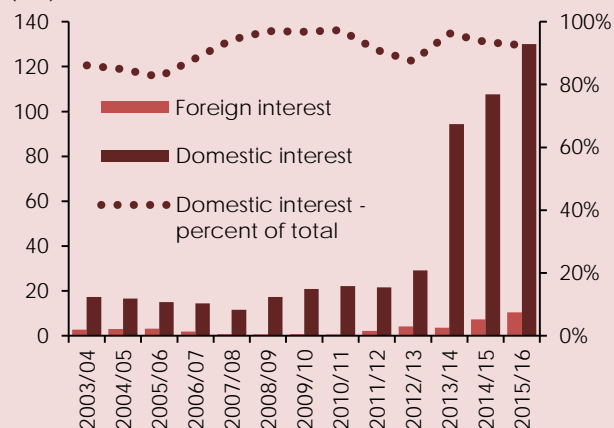
1 The non-bank sector mainly consists of financial institutions other than commercial banks including insurance firms, discount houses and pension funds.

2 The government recognized stock of domestic arrears of MK 157 billion or 7.9 percent of GDP in FY 2013/14. This followed the recognition of domestic arrears of around MK 72 billion in 2012 which were duly paid through cash and securities.

was transferred from monetary authorities to the private sector, explaining the shift in the categories of domestic debt in the period from 2013 to 2014, with an increase in the share held by the private sector relative to the share held by the Reserve Bank. This shifted back by the end of 2016, with RBM becoming the predominant lender, holding a 56 percent of total domestic borrowing, through the issuance of Treasury Notes<sup>3</sup>.

**Figure 12: Interest payments have significantly increased since 2013**

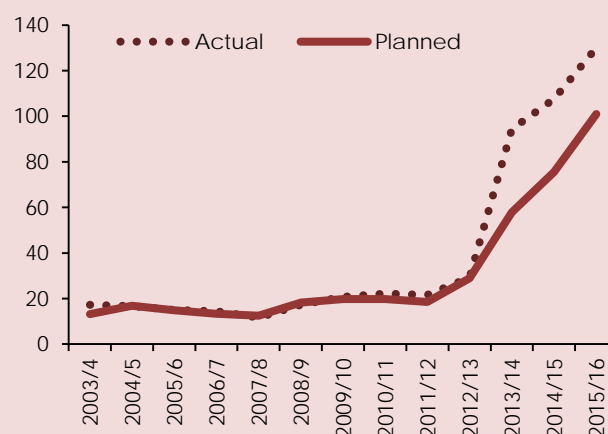
Interest expense, foreign and domestic, in MWK billions (LHS); domestic interest payments as percent of total interest expense (RHS)



Source: World Bank staff estimates based on MoFEPD and RBM data

**Figure 13: Expenditure on interest on domestic debt has been consistently underestimated**

Domestic interest payments, in MWK billions, planned vs. actuals



Source: World Bank staff estimates based on MoFEPD and RBM data

**Despite accounting for less than half of the total debt stock, payments on domestic borrowing constitute over 90 percent of total interest payments.** The high cost of finance and the short-term maturity of domestic debt has meant that an increase in domestic borrowing following “cashgate” has been accompanied by a large increase in the cost of servicing such debt (see Figure 12). In the period from 2011/12 to 2013/14, interest payments on domestic debt increased by 223.0 percent, from 1.7 percent of GDP to 4.1 percent of GDP, and then subsided to 3.7 percent of GDP in 2014/15 and 2015/16. In addition, since 2013/14, planned expenditure on domestic interest has been consistently underestimated with actual expenditure being almost 45 percent higher on average than planned expenditure in the period from 2013/14 to 2015/16 (see Figure 13).

**This high level of expenditure on domestic debt service has implications for Government expenditure on social and productive sectors.** Interest repayments are eroding the national budget, thus measures to reduce domestic debt are key in making the budget sustainable. In 2015/16, expenditure on interest payments was one and a half times greater than expenditure on health and more than 20 percent higher than expenditure on education. Paying down existing debt and reducing the accumulation of new debt will free up resources to enable the Government to increase expenditure on social and productive sectors in the medium to long term.

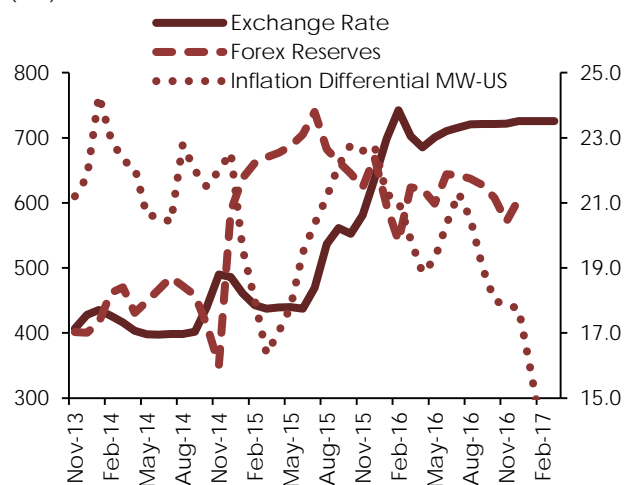
## The Kwacha has stabilized, defying seasonal trends and expectations of a depreciation

**37. The Malawi Kwacha has continued to maintain its value relative to other currencies, despite the usual pressures that occur during the lean foreign exchange season.** The value of the Malawi Kwacha relative to the Dollar has remained broadly stable since September 2016, with an average mid-rate of around MWK 721/US\$, and depreciating by just 0.6 percent to a mid-rate of MWK 726/US\$ in April 2017 (see Figure 14). The stability in the exchange rate has also had a positive impact on the deceleration of the non-food inflation rate, which declined from 15.9 percent to 14.5 percent over the same period. Unsurprisingly, foreign exchange reserves steadily declined towards the end of the year, reaching US\$ 605 million (equivalent to 2.9 months of import cover) in December 2016, down from the figure of US\$ 642 million in June 2016, with a draw down for maize imports in response to the humanitarian crisis. As of April 2017, gross official reserves stood at US\$ 553 million (equivalent to 2.7 months of import cover).

<sup>3</sup> For further detail on the composition of gross domestic debt refer to the Debt Sustainability Analysis (June 2016) prepared jointly by the IMF and the World Bank.

**Figure 14: The Kwacha has begun to experience greater stability...**

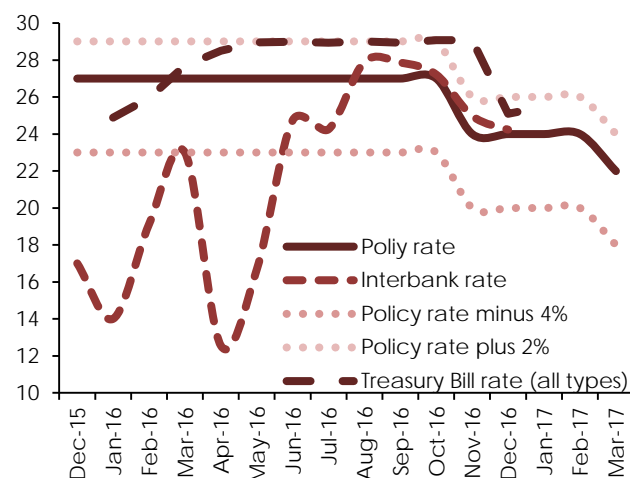
Kwacha/US\$ exchange rate (LHS), gross official resources in US\$ millions (LHS) and difference between Malawi and US inflation rate (RHS)



Source: World Bank staff calculations based on RBM data

**Figure 15: ...helped by tight monetary conditions and a more stable interbank rate**

Policy, interbank and Treasury Bill rates (including +2 and -4 interbank bands)



Source: World Bank staff calculations based on RBM data

## Tight liquidity conditions have helped to contain non-food inflation

**38. The RBM continued to implement a tight monetary policy throughout 2016.** In the second half of 2016, money supply grew by 15 percent, compared to the increase of 30 percent recorded in the first half of the year. This reflects efforts by the RBM to contain liquidity in the economy and is aligned with the nominal GDP growth rate of about 22 percent in 2016. Nonetheless, credit to the Government, in particular, expanded significantly, mainly due to the financing of maturing securities (zero coupon bonds). Although the government credit growth accelerated, the RBM intensified efforts to mop up excess liquidity, thereby reducing the impact of the fiscal injection.

**39. By the end of November 2016, the policy rate was reduced by 3 percentage points, following the sustained fall in the inflation rate over the preceding three months.** The Monetary Policy Committee (MPC) announced a reduction in the policy rate from 27 percent to 24 percent following a deceleration in the headline inflation rate from a peak of 23.5 percent in July to 20.1 percent in October. In the past, upward inflationary pressure has been driven by both food insecurity and a loose fiscal stance. Thus, the reduction in the rate was announced at the point when the economy started showing signs of stabilization, with the economy on a disinflationary path and with a steady exchange rate. The RBM has remained committed to a tight monetary stance maintaining a positive real policy rate to ensure that inflation, particularly non-food inflation, remains on a downward path.

**40. The lower policy rate led to an adjustment of base lending rates by commercial banks, although the banks' rates still remain exorbitantly high.** In response to the reduction in the policy rate, commercial banks revised their base lending rates downwards, as a result of which the average lending rate in 2016 was 1.7 percentage points lower than the average rate in 2015. Despite the decline, the rates are still amongst the highest in the region. This has often led to high rate of default and has created an unfavorable environment for private sector to access finance for investments to boost economic growth.

**41. In March 2017, the MPC reduced the policy rate by an additional 2 percentage points to 22 percent.** The MPC decided to reduce the policy rate only four months after it had reduced the rate from 24 percent adjusted in November 2016 to 22 percent in March 2017. This was based on decelerating inflationary trend and inflation outlook. However, the MPC maintained the Liquidity Reserve Requirement (LRR) at 7.5 percent. A lower policy rate has already triggered a fall in lending rates offered by commercial banks. Although the rates still remain high by regional standards, lower lending rates are likely to ease credit conditions as well as opening up access to finance by the private sector for investment which should have a positive impact on economic growth

**42. The Interbank rate (IBR) has been close to the policy rate since May 2016, ranging from 2 percent above and 4 percent below this rate, reflecting tight liquidity conditions in the banking system** (see Figure 15). In the past, the stability of the IBR has been negatively affected by the high degree of volatility of liquidity levels. The IBR has generally been correlated with unborrowed excess reserves, dropping or rising as excess reserves increase or decrease. According to RBM data, the IBR stood at 24.2 percent at the end of the first half of 2016 and at 26.7



percent at the end of the second half. The IBR increased over this period as a result of the RBM's market interventions, in line with its tight monetary policy stance. It is expected that as long as liquidity remains tight, the IBR will continue to stay high and close to the policy rate. Following the recent reduction in the policy rate, the IBR may trend downward, but is likely to remain stable as long as the RBM intensifies its mop up operations to sterilize any excessive liquidity.

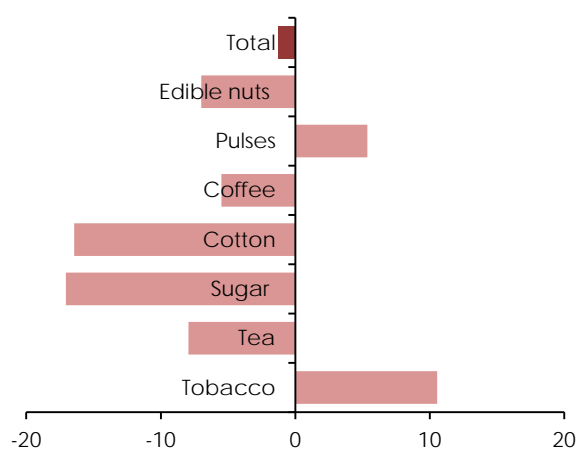
## Increased tobacco exports have helped to offset weaker performance by other commodities

**43. Malawi's exports were strongly affected by the impact of the El-Niño drought, with its major exports being agricultural commodities.** Other factors that contributed to the decline were low commodity prices and a decline in demand by regional trading partners, particularly South Africa. On the other hand, tobacco proved resilient to the effects of the drought, with production in 2016 at 195.1 million kg almost matching the level of 2015 volumes at 192.7 million kg. Agricultural commodities contribute to more than three quarters of Malawi's export earnings, with tobacco alone contributing to almost 50 percent. Hence, movements in tobacco tend to have a significant influence on overall export performance.

**44. An increase in tobacco exports was sufficiently significant to offset the decrease in other major exports.** Total exports are estimated to have decreased by around 1.3 percent in 2016, driven by a decline in most major exports except tobacco and pulses (see Figure 16). Going forward, although tobacco exports are expected to decline due to a fall in tobacco production in 2017, overall export earnings are expected to improve modestly due to the rebound in the agricultural sector following favorable rains and a slight increase in international commodity prices.

**Figure 16: Tobacco and pulses saw export growth in 2016, with other commodity exports falling**

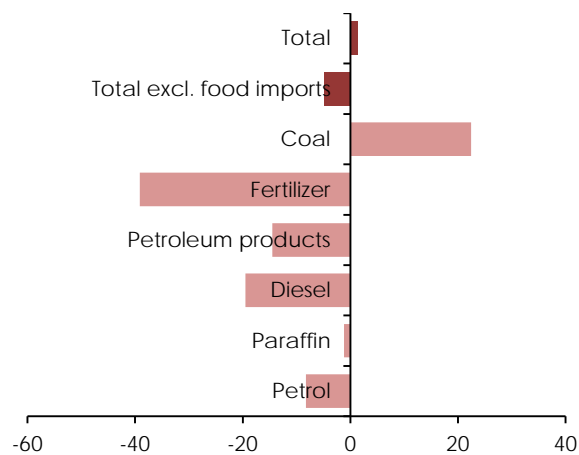
Exports by type, 2016 percentage change from previous year, US dollar terms



Source: World Bank staff calculations and estimates based on NSO data

**Figure 17: Imports were generally lower in 2016, with the exception of food imports**

Imports by type, 2016 percentage change from previous year, US dollar terms



Source: World Bank staff calculations and estimates based on NSO data

Note: Excludes food (maize) imports, which accounted for an estimated 6.5 percent of total imports in 2016, but were of a negligible value in 2015

**45. Tobacco, sugar and tea, in declining order, are Malawi's most significant exports. such that developments in sugar and tea production are also important determinants of the external balance.** However, sugar and tea generate significantly lower export earnings than tobacco, with earnings from tobacco exports valued at US\$600 million, compared to the combined total of US\$ 200 million for tea and sugar in 2014 (National Statistical Office). The main markets for sugar have been the European Union (EU) and the United States of America (USA), although regional exports have contributed to an increasingly large proportion. In addition, the domestic market for sugar remains quite significant. Sugar exports to the EU have been decreasing partly as a result of lower prices, while the impending abolition of EU sugar production quotas on 30 September 2017 is expected to reduce exports from the African region, which previously enjoyed preferential access to the EU market (Rakotoarisoa and Chang 2017)<sup>4</sup>. In

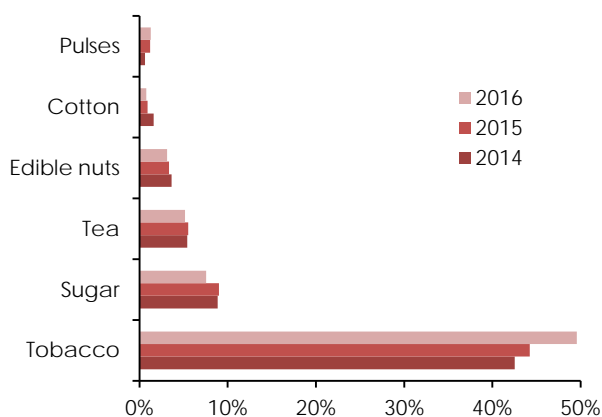
<sup>4</sup> Sugar production quotas control EU sugar supply, such that abolishing them is expected to lead to an increase in EU sugar production and a decrease in imports into the region.

the case of tea, domestic sales have also been on the rise, although these sales constitute a much smaller proportion than in the case of sugar. Malawi is the second largest tea producer in Africa, although it remains far behind Kenya, which produces an average of around 500 million kg annually, compared to Malawi's output of between 40 and 50 million kg. Nevertheless, a drought in Kenya in 2017 is expected to boost the demand for and price of Malawi's tea exports. Malawi appears to be losing some market share in the United Kingdom (UK), the second most significant export market after South Africa, possibly due to a change in consumer preferences towards other beverages and specialty teas.

**46. Other key exports include edible nuts, cotton and pulses** (see Figure 18). Cotton exports have declined significantly over recent years, with production falling by 40 percent in 2015 and by 60 percent in 2016, and with international prices declining by 10.7 percent in the period from 2014 to 2016. The significant fall in production volumes was the result of both adverse weather conditions and of the failure of contract farming in 2015. Many of the farmers who were provided with inputs by cotton companies either defaulted or sold their production elsewhere, thus discouraging ginners from providing inputs in 2016. This situation is expected to persist in 2017. The export of pulses, however, increased in 2016, with production rising by 1.7 percent, despite the drought, combined with an increase in average export prices of 3.7 percent. Edible nuts continue to be the fourth largest export, driven by the export of high-value macadamia nuts, although there was a modest decline in production in 2016 due to the drought.<sup>5</sup>

**Figure 18: Tobacco still dominates Malawi's exports**

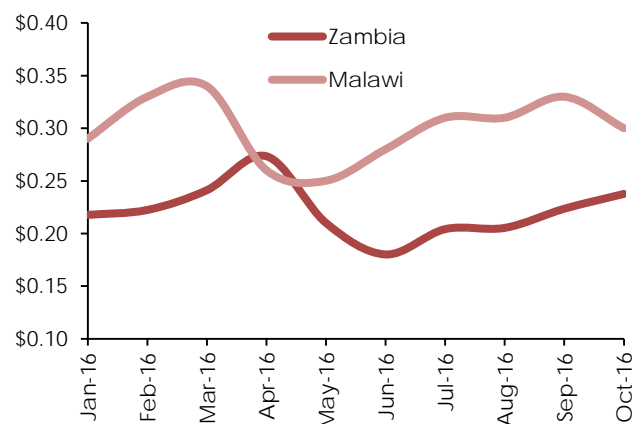
Top exports, percentage of total export earnings, selected years



Source: World Bank staff calculations based on NSO data

**Figure 19: Maize prices in Malawi showed a significant premium compared to Zambia during 2016**

Average maize prices in Malawi and Zambia in US\$ per kg



Source: World Bank staff calculations based on FAO data

**47. With the overproduction of tobacco leading to lower prices in 2016, it is expected that demand will exceed supply in 2017 as a result of dissatisfied farmers shifting away from the cash crop.** The oversupply of burley tobacco, Malawi's main tobacco product, experienced in 2016, occurred due to high prices recorded in 2015 which encouraged farmers to shift towards the crop. The excess supply was sold at a lower price on auction floors, fetching an average price of US\$ 0.98, considerably lower than the average price for tobacco sold under the contract system, which stood at US\$ 1.44. As a result, in 2017 farmers producing tobacco for sale under the auction system, which accounted for around 30 percent of total burley production in 2016, are substituting away from the crop. Thus, it is expected that there will be a supply shortage of almost 20 million kg. In turn, this will lead to higher prices on auction floors, which is likely to motivate farmers to grow the crop in the subsequent year. With farmers basing their decision to engage in the cultivation of this crop on the previous year's prices, this partly explains the high variability in annual tobacco production over time (see Figure 20). Thus, crop size management remains a significant challenge. The implementation of the Farmers Management System in 2017 is anticipated to stabilize supply over the next few years.

**48. Together with more effective crop size management, an amendment to the Tobacco Act is intended to address inefficiencies in the market.** The Tobacco Control Commission (TCC) is currently in the process of amending the Tobacco Act, which has remained unchanged since 1938. Some of the proposed amendments include modifying the penalties for overproduction to reflect current economic conditions. A transfer of 50 percent of proceeds from overproduced tobacco to the Government has also been proposed. These measures are intended to motivate farmers to adhere to their assigned quotas and to control the supply of tobacco

<sup>5</sup> See World Bank (2016b) for further analysis on the emergence of edible nuts as a key export.

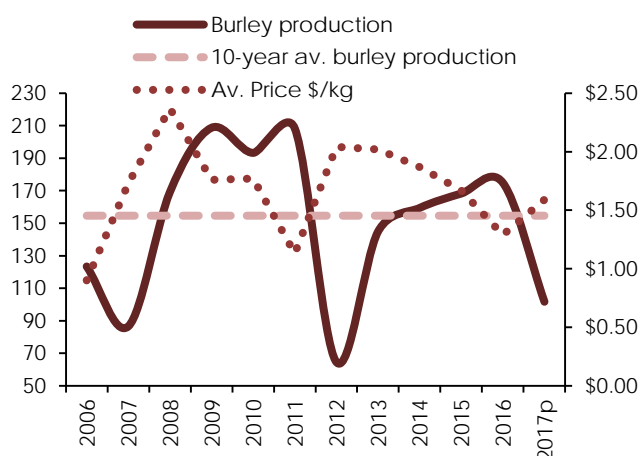
according to the demand. The draft Tobacco Bill is currently with the Government and awaiting discussion in Parliament.

**49. Despite only a marginal increase in supply, the high volume of carry-over stock meant that there was a significant increase in tobacco exports in 2016.** The TCC has estimated a 24.5 percent growth in export volumes between 2015 and 2016. Although export prices fell by an estimated 7.2 percent, the large increase in volumes lead to an increase in the earnings from tobacco exports. Exporting is normally conducted over a three-year period. On average, around 75 percent of burley production is exported during the year in which it is produced, with 20 percent being exported in the subsequent year, and 5 percent exported in the two years following production. In addition, only around 60 percent of burley, 75 percent of flue-cured and 85 percent of dark-fired tobacco produced are actually exportable. This leads to a significant difference between export and production numbers, while export prices have a premium of at least double the local sales price (see Figure 21).

**50. In 2017, although an overall decline in tobacco production is expected, the decline in exports is projected to be less pronounced.** Tobacco exports are projected to decline by around 27.6 percent, while overall production is projected to decline by 36 percent. Although prices are expected to improve due to the undersupply and to the increase in international prices, the fall in the volume of exports is expected to more than balance the impact of this, thus leading to an overall decrease in the value of tobacco exported.

**Figure 20: Tobacco production has seen high volatility as farmers chase higher prices over time**

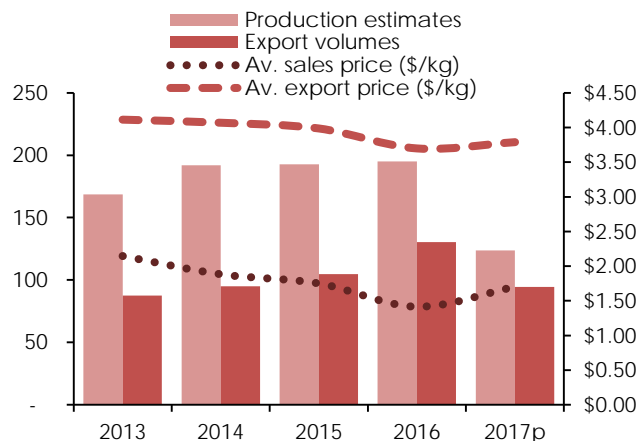
Annual burley production in million kg (LHS) and average prices in US dollars per kg (RHS)



Source: World Bank staff calculations based on TCC data

**Figure 21: Tobacco production and export numbers differ given lower exportable values**

Annual tobacco production and export volumes in million kg (LHS), average sales prices and export price in US\$ per kg (RHS)



Source: World Bank staff calculations based on TCC data

## An increased import bill is being driven by food imports

**51. The import bill is estimated to have increased in 2016, mainly due to the high volume of food imports.** Over the year, the total value of imports is estimated to have increased by 1.4 percent. When food imports are excluded, the total value of imports declined by 4.8 percent, mainly due to the decline in the value of the import of petroleum products and fertilizer (see Figure 17). Although the volume of fuel imported increased by an estimated 12.8 percent, mainly as a result of the increased use of generators to manage persistent power cuts, the fall in the dollar unit price was quite significant, ranging from a drop of 24.5 percent for petrol to 32.6 percent for paraffin (see Box 4). The effect of the decline in prices more than counteracted the increased volumes, meaning that the total value of imports declined. In addition, the value of imported fertilizer decreased by almost 40 percent, with the average unit price remaining stable but with the quantities imported falling significantly due to the scaling down of the FISP, with a reduction in the number of beneficiaries from 1.5 million in 2015 to 0.9 million in 2016.

**52. The maize shortage resulted in the import of foods by both the Government, and the private sector on an unprecedented scale.** Official estimates indicate that in 2016, a total of 284,000 metric tons of maize was imported, with the value of these imports standing at almost US\$127 million, or 5.5 percent of the total value of all imports.<sup>6</sup> In addition, a number of other commodities, such as other cereals, pulses and vegetable oil, were imported to facilitate the Government's humanitarian response to the food crisis in 2016. Apart from imports from

<sup>6</sup> For comparison, petroleum products accounted for an estimated 8.0 percent of imports and fertilizer for 5.8 percent of imports in 2016.

development partners and the private sector, there was also a significant volume of informal imports from across the border in Zambia, where maize fetched significantly lower prices (see Figure 19). However, quantifying the volume and value of these informal imports would be extremely challenging, given the nature of these transactions.

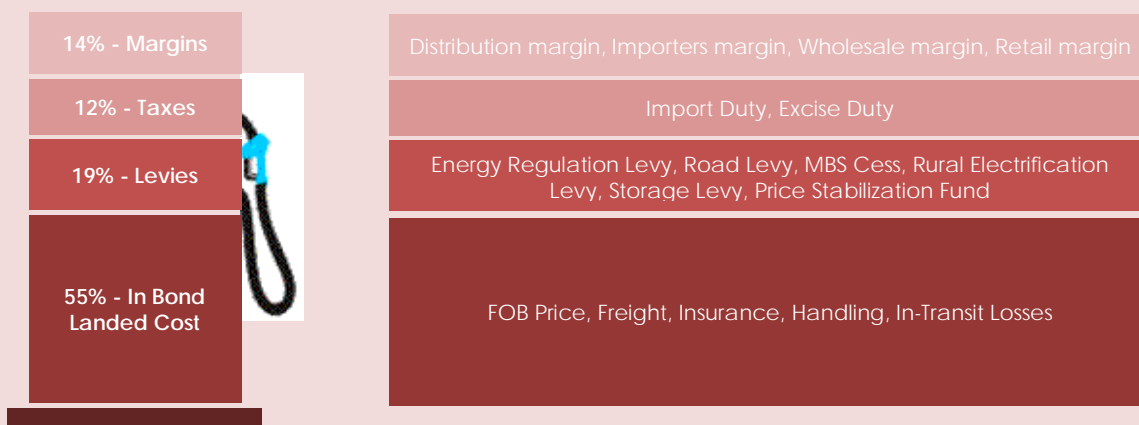
**53. In 2016, the trade deficit is estimated to have deteriorated as a result of the combined impact of the decrease in exports and the increase in imports.** The merchandise trade deficit is expected to deteriorate from 11.5 percent of GDP in 2015 to 19.0 percent of GDP in 2016. In 2017, the trade position will most likely improve as a result of the increase in exports following a favorable agricultural season, with this more than counteracting the expected increase in imports. Without food imports, the import bill is likely to grow only modestly due to a recovery in economic activity, higher fuel prices and increased fuel imports.

#### Box 4: What factors determine fuel prices in Malawi?

**The Government began to implement the Automatic Fuel Pricing Mechanism (APM) in 2012.** This measure was intended to ensure that local fuel prices reflect the movements of Free on Board (FOB) oil prices on the international market and the exchange rate of the Kwacha relative to the United States Dollar. Thus, the APM was implemented to ensure that importers fully recover their importation costs in order to sustain the importation of fuel into the country. The introduction of the APM was part of a package of reforms introduced in 2012 to facilitate Malawi's recovery from a policy-induced recession, during which the country experienced severe shortages of imported goods, including fuel.

**The pricing of fuel in Malawi has four components.** These are (i) In Bond Landed Cost (IBLC), the importation cost made up of FOB oil prices, transport costs, fuel handling costs, insurance and a provision for in-transit losses; (ii) Levies, consisting of government levies on fuel price build up; (iii) Taxes imposed on petroleum products; and (iv) Trading Margins (distribution margin, importers margin, wholesale margin and retail margin).

**Figure 22: Illustration of the breakdown of fuel price determinants in Malawi**



Source: World Bank staff calculations based on MERA data

**Under the APM, prices of petroleum products are revised when the IBLC changes beyond a ±5 percent threshold.** If all other factors remain constant, this means that when the landed cost falls by above or below 5 percent, prices are adjusted upwards or downwards, respectively. The major determinant of IBLC movement is FOB and exchange rate movements. The 5 percent threshold is set through the Price Stabilization Fund (PSF) and compensates importers on any IBLC changes above zero (0) percent but within + 5 percent. The PSF collects revenue to cushion pump prices for changes between zero (0) and - 5 percent. In some instances, where the PSF is deemed to have funds adequate to cushion losses beyond the ±5 percent band, prices may be maintained or increased partially. This is justifiable because the PSF was instituted to eliminate local price volatility in the most prudent manner possible. The summation of the IBLC and other components of the pricing structure (levies, government taxes and industry margins) determine the final pump price. Since the major determinant in the pricing of fuel is the IBLC, does this mean that the other components in the pricing structure are stationary or fixed?

**In order to understand fuel pricing in Malawi, in addition to understanding the APM principle, it is also necessary to understand the other components of the pricing structure.** Levies represent funds that the Malawi Energy Regulatory Authority (MERA) collects on behalf of itself and other institutions for a range of purposes. It is important to note that the Treasury authorizes the values of the levies, with MERA's role being to implement

these levies as directed. Taxes include import duty and excise duty. The rates are determined by the Government with import duty as a percentage of IBLC and excise duty as a percentage of the sum of the IBLC and import duty. Trading margins are the gross margins that the various dealers in the industry receive on their business. These are distribution margins which compensate for the internal distribution of fuel from oil company depots to service stations beyond a 10km radius; importers margin, which allows importers to cover their overheads and administrative costs; wholesale margin, which is a gross profit margin for the wholesaler; and retail margin, which is a gross profit margin for the retailer.

**The price build-up of petroleum products includes various levies.** These are as follows: (i) the Energy Regulation Levy, which supports MERA's operations; (ii) the Road Levy, which is remitted to the Roads Fund Administration for road construction and maintenance; (iii) the Malawi Bureau of Standards (MBS) Cess, which supports the development of standards for petroleum products; (iv) the Rural Electrification Levy, which is remitted to the Department of Energy for rural electrification projects; (v) the Storage Levy, which supports the construction and maintenance of storage facilities, including strategic fuel reserves; and (vi) the PSF, which is used to compensate importers when there is a positive differential between the actual and the deemed landed cost of petroleum products. Among these levies, the MBS Cess, the Road Levy and the PSF are linked to the IBLC and hence they adjust automatically to the changes of the IBLC. Authorized revisions in the other levies may therefore trigger a price change, even when the changes in IBLC are within the  $\pm 5$  percent band.

**The rates of duty and excise taxes are linked to the IBLC.** Hence, any upward or downward movements also change the tax payable per liter of the petroleum product. As a result, if the Government decides to revise the rates, this may impact the prices of petroleum products, even if the change in IBLC is within the  $\pm 5$  percent band.

**Major players in the supply of petroleum products in the country include importers, transporters, oil marketing companies (OMCs) and retailers (filling station dealers).** All these players need to be adequately compensated through a reasonable return on their investment in order to sustain the flow of petroleum products into Malawi. Industry margins which are set by MERA and represent compensation to these players, form the final component of the pricing structure. Importers, OMCs and retailers are allocated trading margins to sustain their operations and to earn returns on their investments. OMCs and retailer margins are determined through models that take into account changes in economic fundamentals, which include inflation, the exchange rate, industry investment, operating costs and revenues. Therefore, adverse changes in the operating environment trigger a revision of margins, which may have an impact on the pump prices, regardless of changes to the IBLC.

Source: MERA

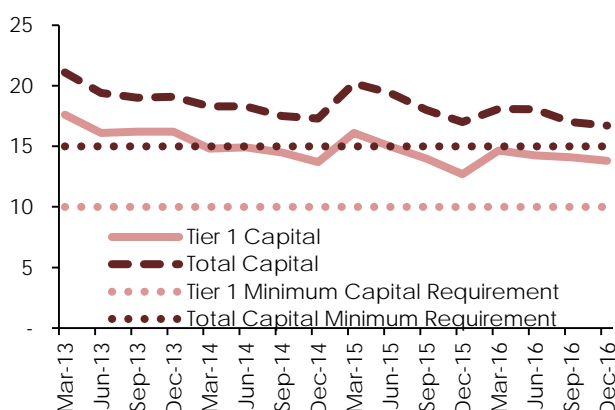
## Weak economic performance has affected credit quality

**54. In terms of a number of significant indicators, Malawi's banking sector's capital adequacy ratios remain under pressure, reflecting a sustained period of weak economic activity.** While the state of the banking sector as a whole remains sound, a significant proportion of smaller banks have become increasingly stressed and will require additional capital injections from existing or new shareholders. Despite this stress, the overall capital adequacy ratios for the banking sector remain above the prudential minimum regulatory requirements, although they have deteriorated over the course of the year (see Figure 23). The Tier 1 capital ratio declined steadily over 2016, from 14.7 percent in March to 13.8 percent in December, with the minimum requirement standing at 10.0 percent. The total capital to assets ratio also declined over the year, from 18.1 percent in March to 16.7 percent in December, with the minimum requirement standing at 15.0 percent. This deterioration has been accompanied by sharp declines in levels of return on equity and on assets for the overall banking sector, reflecting the challenges the sector faced in 2016, particularly in the case of smaller banks. However, all banks retained adequate and increasing levels of liquidity in the year. Ratio of gross loans to deposits remained steady but on a declining trend.



**Figure 23: Banking sector capital adequacy ratios have slipped, but are above minimum thresholds...**

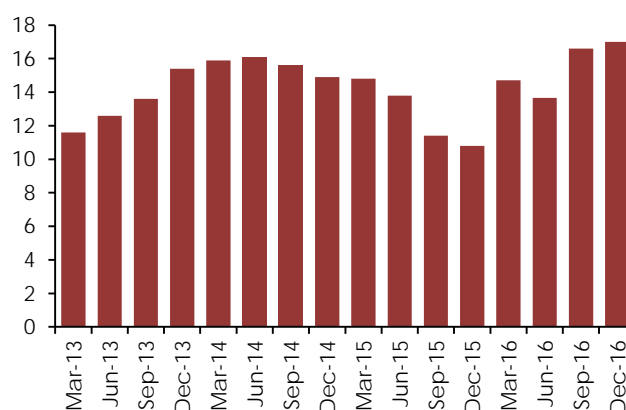
Capital adequacy, ratio of Tier 1 and total capital to risk weighted assets, percentage



Source: World Bank staff calculations based on RBM data

**Figure 24: ...but the share of non-performing loans has reached new peaks**

Ratio of non-performing loans to gross loans, percentage



Source: World Bank staff calculations based on RBM data

**55. The proportion of non-performing loans (NPLs) increased throughout 2016, further reflecting the decline in the quality of credit.** As measured by the level of NPLs, overall asset quality continued to deteriorate in 2016 (see Figure 24). The overall average ratio of total NPLs to gross loans increased from 10.8 percent in December 2015 to 17.1 percent in December 2016. This suggests that Malawi’s poor economic performance for two consecutive years has had a negative impact on the quality of credit across the economy, with borrowers struggling to service high cost loans. However, a closer analysis shows that a significant share of the NPLs are concentrated within a few of the smaller banks, most of which are highly exposed to retail, mortgage and agricultural lending. Overall, the share of NPLs remain within the defined prudential limits. The ratio would significantly lower if reported in risk-weighted terms rather than as a simple average across all of Malawi’s commercial banks.

### Investors still remain skeptical of signs of economic recovery

**56. Business confidence remains subdued following two years of drought conditions and weak economic growth.**

Cumulative weather shocks and reduced disposable incomes have negatively affected output across the agriculture, services and manufacturing sectors. The resultant weak economic growth and the associated low level of confidence has been exacerbated by severe power outages experienced throughout 2016, with these outages disrupting production and increasing the cost of business activities. High interest and inflation rates have eroded the returns on private investments, as demonstrated by the increasing share of NPLs. The slow pace of settlement of Government arrears has also had an effect on private sector liquidity. Finally, efforts towards fiscal consolidation by the public sector have had an impact on business activity, with the Government reducing discretionary public spending and deferring capital investment. Thus, much of the private sector has continued to adopt a “wait and see” approach, deferring activity until expectations for a recovery in 2017 become manifest through actual and sustained increased demand for goods and services.

### Measures required to sustain a growth recovery

**57. As Malawi exits a two-year period of economic and humanitarian stress, it is important that appropriate lessons are learned—both to build a sustained economic recovery, and to improve resilience against future shocks.**

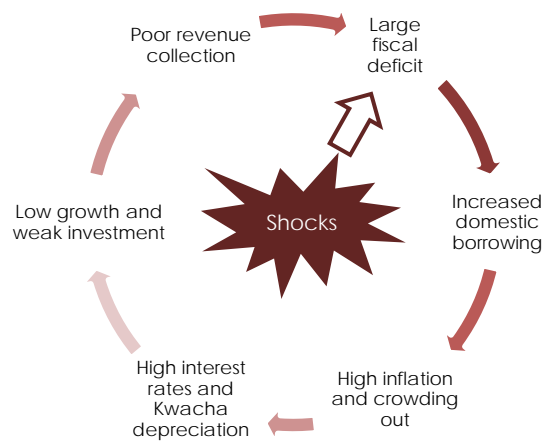
Two years of drought conditions have exacerbated pressures on an already weak economy, which even prior to these adverse weather conditions was struggling to adjust to the impact of the “cashgate” scandal, which resulted in a drastic reduction in on-budget development assistance. As a result, Malawi’s economy has become stuck in a vicious cycle characterized by large fiscal deficits, excessive borrowing, and high inflation and interest rates. In turn, these factors depress investment and growth, which then lead to weak revenue collection performance, which has further exacerbated fiscal pressures (see Figure 25).

**58. Malawi will only record significantly improved medium-term economic performance if it develops higher levels of resilience to both internal and external shocks.**

It is likely that Malawi will continue to face recurring weather shocks into the future, so it is essential for it to develop the systems and mechanisms required to manage these shocks effectively. To build resilience, it is critical that policy makers implement policy and institutional reforms to eliminate the policy-induced distortions that exacerbate agricultural and climate vulnerability. They

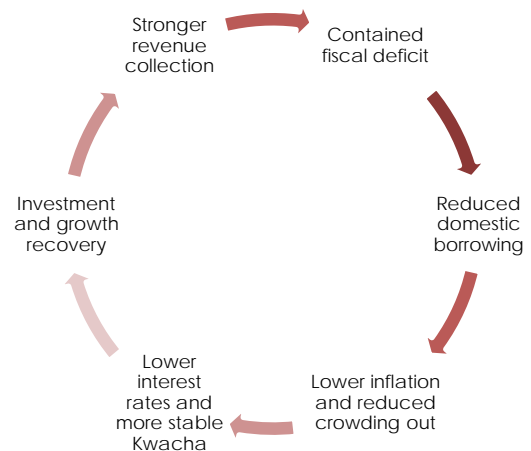
should also implement measures to improve macroeconomic governance to increase fiscal buffers and to restore the confidence of development partners. Finally, investments are required to develop the resilience of the agricultural sector in the long term.

**Figure 25: During recent year, Malawi's economy became stuck in a vicious cycle...**



Source: World Bank staff

**Figure 26: ...but needs to shift to a virtuous circle**



Source: World Bank staff

**59. Malawi's prospects for sustaining a growth recovery are also dependent on deepening of reform efforts and avoiding a repetition of past mistakes.** Recommended measures to help sustain a recovery in economic growth include the following:

- *Policy reforms to reduce distortions and to ensure that agricultural markets function more effectively:* Malawi's smallholder-driven agricultural sector continues to be characterized by a strong subsistence orientation, with limited levels of commercialization. In addition, the prices of its agricultural commodities are amongst the region's most volatile. In many instances, the negative impact of climate-induced shocks has been exacerbated by policy-induced distortions that contribute to market failures. Issues include a lack of transparency and predictability in the market interventions implemented by key public sector institutions involved in the management of commodity markets, such as ADMARC and NFRA.
- *Measures to reduce deficits, over-borrowing, and the crowding out of the private sector:* Improved levels of macroeconomic stability and fiscal discipline, as well as the careful maintenance of debt sustainability, are essential to the achievement of a medium-term growth recovery in Malawi. Only by breaking the current vicious cycle of large deficits, over-borrowing and crowding out can Malawi effectively control inflation and restore the basic macroeconomic conditions necessary for higher levels of investment and job creation (see Figure 26). Moreover, Malawi is reaching the upper limits at which its stock of domestic debt can be sustainably managed, calling for prudence with respect to new borrowing commitments. The Government should also implement measures to increase fiscal buffers to enable the budget to withstand the impact of external shocks, possibly including the adoption of fiscal rules. Deeper efforts to improve systems of public financial management and governance could result in increases to ODA flows to on-budget execution, reversing the trend of these flows to off-budget execution.
- *Investments to build resilience to mitigate against climate-induced weather shocks and to diversify Malawi's economy:* These investments should include measures to develop agricultural infrastructure and extension services to facilitate a higher level of crop diversification, to improve yields, and to build resilience through the development of irrigation, market information systems and improved farmer organization.

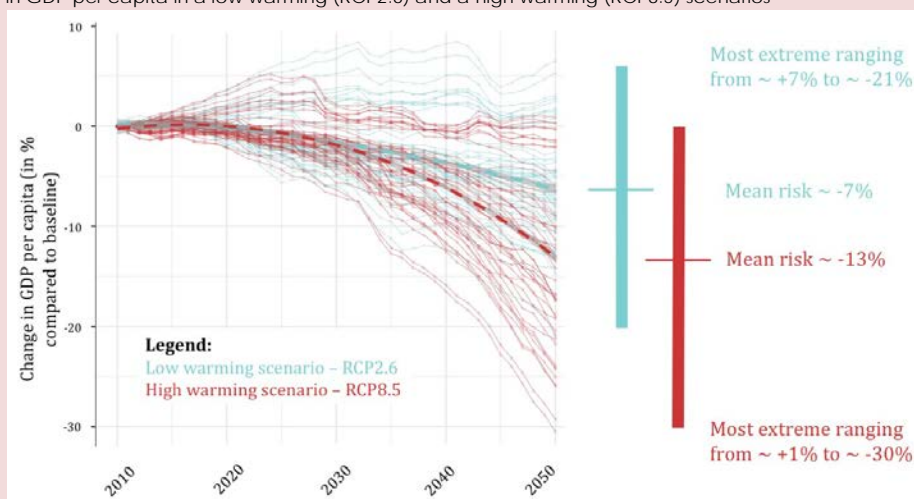
### Box 5: Modelling economic vulnerability and future climate change risks in Malawi

In recent years, Malawi has been repeatedly affected by the negative consequences of climate-related disasters, particularly floods and droughts. With the progressively mounting consequences of climate change, Malawi's economy could be negatively impacted by weather shocks to an even greater extent in the future. Building on the analyses conducted for the Multi-Sectoral Investment Plan (MSIP) under the seventeenth replenishment of the International Development Association (IDA17),<sup>7</sup> this box discusses Malawi's vulnerability to weather changes and evaluates the extent to which the economy could be affected under future climate change.

In Malawi, floods and droughts have had a significant negative impact on per capita GDP. According to the Post Disaster Needs Assessment (PDNA) conducted in 2015, the floods resulted in damages and losses to a value of around US\$ 335.0 million, or approximately 5.2 per cent of GDP. As a consequence, they caused a loss in overall GDP growth of an estimated 0.6 percent. Another PDNA conducted in 2016 revealed that the consequent drought resulted in damages and losses to a value of US\$ 365.9 million, or approximately 5.6 percent of GDP, with a loss in agricultural growth of an estimated 7.3 percent. To further understand the interaction between climatic conditions and economic development, the vulnerability of the economy to the consequences of precipitation and temperature changes and extremes was identified for the period from 1980 to 2014 using a non-linear econometric model. The econometric analysis shows that Malawi has a higher level of sensitivity to extreme dry events than almost any other African country.<sup>8</sup> The predominance of the contribution of the agricultural sector to GDP, combined with Malawi's significant social dependency on this sector, mean that Malawi is highly vulnerable to rainfall patterns, with drought having potentially catastrophic economic and social consequences.

**Figure 27: Climate change is projected to have a significant negative impact on Malawi's economy**

Projected change in GDP per capita in a low warming (RCP2.6) and a high warming (RCP8.5) scenarios



Source: Baarsch et. al. (forthcoming)

Note. Estimates do not account for the lagged effect of extreme dry and wet events on GDP per capita. Their integration would increase the estimated changes.

With an increasing frequency of extreme wet and dry events and with increasing temperatures, Malawi's economy could be severely affected by climate change into the future. For this analysis, projections for the future economic risks to GDP per capita are calculated by using high temporal and geographical resolution projections of precipitation and temperature for the period from 2010 to 2050. The projections are realized in two warming scenarios developed for the Fifth Assessment Report by the Intergovernmental Panel for Climate Change (IPCC). The high warming scenario (IPCC RCP8.5) and the low warming scenario (IPCC RCP2.6) are based on the highest and lowest increases in temperature projected in the IPCC report, respectively. These

<sup>7</sup> The MSIP project of the World Bank's International Development Association (IDA) is a project across five African countries (Cameroon, Ghana, Malawi, Mali and Senegal), with the objective to develop multi-sectoral investment plans to increase the countries' resilience to the adverse consequences of climate-related disasters and climate change.

<sup>8</sup> Extreme dry events were defined as droughts measured in terms of low precipitation using the Standardised Precipitation Index (SPI).

scenarios compare the range of risks for the period up to 2050 compared to the current risks, although different warming levels at lower or higher ranges cannot be ruled out.

**The projections show that in both scenarios, climate change will have a negative impact on per capita GDP** (see Figure 27). The change in per capita GDP is compared to a baseline scenario that assumes no further climate change.<sup>9</sup> At the mean, and within a broad range of uncertainty, the central estimates show that in the low warming scenario, GDP per capita could decrease by 7 percent by 2050 relative to the baseline, while in the high warming scenario, it could decrease by as much as 13 percent relative to the baseline. For risk management, mean estimates of damages are insufficient. At the high end of the uncertainty in damage estimates, the decrease in GDP per capita by 2050 ranges from 21 percent in the low warming scenario to up to 30 percent in the high warming scenario. If such decreases were to materialize, they would have serious implications on poverty reduction and social and human development in Malawi.

**The findings from the ongoing World Bank research demonstrate the strong interconnection between climate change and economic development in Malawi.** Climate change has potentially significant consequences for development stemming from extreme weather events and from associated long-term changes in weather patterns. In order to address these risks, measures to develop resilience to the impact of climatic conditions need to be effectively integrated in policy and development planning processes, from the local to the national level.

Sources: Baarsch et. al. (forthcoming) and World Bank (forthcoming)

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<sup>9</sup> The change in GDP per capita induced by future climate change is estimated against a baseline projection from the Organization for Economic Co-operation and Development (OECD) that assumes 'business as usual' hence no further climate change (Dellink et al. 2015). More details on the modeling framework can be found in Baarsch et al. (forthcoming).

## 2. SPECIAL TOPIC: URBANIZATION AND ITS POTENTIAL TO DRIVE GROWTH AND DEVELOPMENT

*During two years of successive weather shocks, attention in Malawi has been focused on addressing short term needs—particularly with regard to food insecurity. As Malawi now looks beyond the recent crisis and towards a growth recovery, it is opportune to pay greater attention to structural issues affecting the medium term growth and development trajectory of the country.*

*In Malawi, to this point, issues associated with urbanization have only received limited attention in policy discussions. Despite common perceptions that Malawi is urbanizing rapidly, the country is still at an early stage of urbanization. In 2010, less than 16 percent of the total population lived in urban areas, with Malawi urbanizing at the moderate average annual rate of 3.7-3.9 percent in the period from 1998 to 2008. At the current rate and with the current base, Malawi is well-positioned to formulate effective plans to maximize the benefits of urban agglomeration, while minimizing the negative impact of congestion.*

*This special topic examines the extent to which Malawi's cities and towns might contribute to national development, by analyzing Malawi's past patterns of economic growth, then projecting the role of urbanization to the country's future growth. This role is discussed in the context of the current institutional and financial capacities of local governments to manage urbanization. The analysis finds that even small increases in the pace of urbanization could greatly enhance Malawi's long-term economic prospects by facilitating accelerated growth and beneficial structural change. However, these benefits will only be achieved if there is a commensurate increase in investments to address infrastructure and service delivery needs in urban areas. At present, it is clear that these needs are not being met. Given current fiscal pressures, it is important to focus on how the impact of finite public sector investment can be maximized to leverage the potential of urbanization.*

### Separating myth from truth: urbanization trends in Malawi

**60. In Malawi, policymakers have tended to be wary of urbanization and of its potentially adverse impacts, including the urbanization of poverty.** Malawi is predominantly rural, with on average just over 16 percent of the total population (2.8 million) living in urban areas in the period from 1998 to 2008. Naturally, national development policies have focused on the development of rural areas. The policies mandated by the Second Malawi Growth and Development Strategy (MGDS II), which is soon to be superseded by a successor Strategy, reflect these priorities, as they are primarily orientated towards increasing agricultural productivity and value-addition and towards creating markets and employment opportunities in rural areas (Government of Malawi 2011). However, rural development is seen not only as being an end in itself, but as a means to curtail and contain the process of urbanization and its perceived negative impacts. For example, MDGS-II mandates the establishment of a Green Belt, a specific intention of which is to “reduce rural-urban migration.” It also contains population policies that aimed to address “the vulnerabilities caused by... migration and rapid urbanization” (Government of Malawi 2011).

**61. Some of the policymakers' concerns regarding the process of urbanization appear to be driven by alarmist interpretations of Malawi's urbanization rate.** In fact, some of the estimates of Malawi's urbanization rate appear to be excessively high. It has been stated that Malawi is “one of the most rapidly urbanizing countries in the world,” with claims that the mean urban annual growth rate stood at 4.7 percent in 2008 and with dire warnings of the potential urbanization of poverty and proliferation of slums accompanying this process (UN-HABITAT 2012). The *Situation of Urbanization in Malawi Report* (Manda 2013), prepared for the Ministry of Lands, Housing and Urban Development, puts the average annual urbanization rate (the increase in the proportion of urban residents relative to the total population) at 5.2 percent, on the basis of which it is projected that 50 percent of Malawi's population will live in urban areas by 2050<sup>10</sup>.

**62. In fact, a careful investigation of the data shows that Malawi's population is growing at a more moderate rate, and that it is still at the early stages of urbanization.** The data shows that Malawi's actual average rate of urbanization in the period from 1998 to 2008 stood at around 3.7-3.9 percent, a lower rate than that recorded by many other African countries (see Figure 28). The horizontal axis of Figure 28 shows the proportion of the total population in urban areas, while the vertical axis shows the percentage point gap between urban and rural

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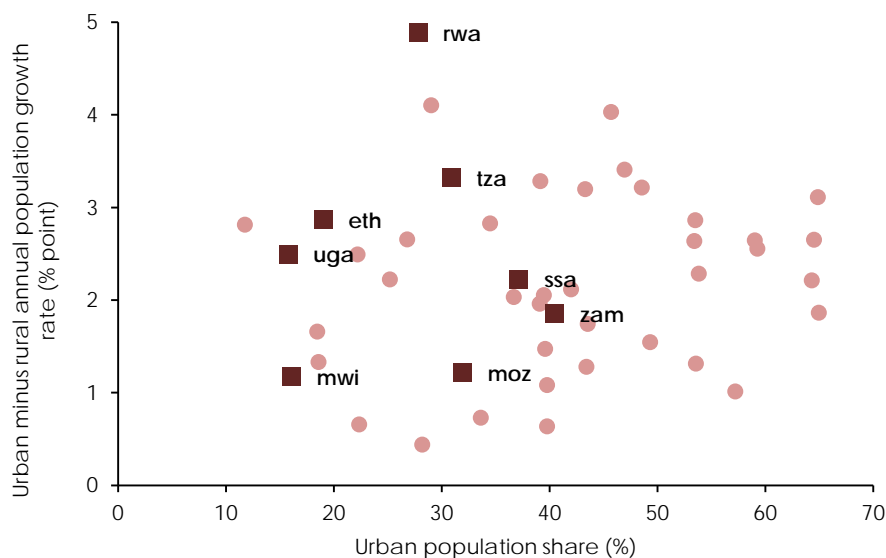
<sup>10</sup> Both are citing the 2008 Population Census by the National Statistics Office (NSO), which reports that Malawi's urban population growth rate was 5.3 percent per year during 1987-1998 but only 3.7 percent per year during 1998-2008 (NSO 2008, pp. 26). However, summing the reported populations of individual urban centers yields an urban population growth rate of 3.9 percent per year.



population growth rates in 2014, with a higher value suggesting a more rapid rate of urbanization. Malawi (MWI) lies towards the lower left-hand side of the figure, because a relatively small proportion of its population lives in urban areas and its urban population growth rate is only about one percentage point higher than its rural population growth rate. This is half the average urbanization rate for countries in the Sub-Saharan Africa (SSA) region, and lower than in other agrarian countries at similar levels of urbanization, such as Ethiopia (ETH), Rwanda (RWA) and Uganda (UGA).

**Figure 28: Malawi is less urban and urbanizing at a slower pace compared to other African countries**

Urbanization rates in Sub-Saharan Africa, 2014



Source: World Bank (2016d)

Notes: MWI is Malawi; RWA is Rwanda; ZAM is Zambia; MOZ is Mozambique; UGA is Uganda; ETH is Ethiopia; TZA is Tanzania; and SSA is Sub-Saharan Africa.

**63. With its current population growth rates, the proportion of Malawians living in urban areas can be projected to remain below 20 percent until 2040.** Assuming that current annual growth rates for cities (3.7 percent); towns (4.2 percent); and rural areas (2.6 percent) remain constant, a simple projection of population levels for 2040 suggests that Malawi's total population could reach 32 million people by 2040. The urban population share increases from 15.6 percent in 2008 to 19.9 percent in 2040. This suggests that Malawi's towns and cities will contain an additional three million people by 2040, a threefold increase relative to 2008 population levels.

**64. Malawi's urbanization pattern is defined primarily by the patterns of its four main cities, which together account for the majority of the urban population.** Malawi's urban population lives in 31 urban settlements, which are classified into three categories: Primary, Secondary and Other settlements (NSO 2010). This classification is not based solely on population size, but rather on a number of factors, including the extent of the settlement's orientation towards non-agricultural activities, its population density, and levels of access to a range of services. As such, the ranking of settlements in terms of population size does not neatly correlate with a breakdown in terms of the three categories<sup>11</sup>. This is evident from Figure 29, which shows the size distribution of urban centers in 2008. For example, Luchenza, with a population of 11,000 people, is categorized as a secondary town. By contrast, Nkhotokota has a population of 25,000, but is not thus categorized. Figure 29 also indicates the dominance of Malawi's primary urban settlements, Lilongwe, Blantyre, Mzuzu and Zomba, in terms of their contribution to the total urban population. While they may be considerably smaller than the primary settlements of other countries and demonstrate relatively low population densities, they are home to more than 75 percent of Malawi's urban population. Lilongwe and Blantyre, even though not necessarily growing at the fastest rate as compared to some secondary towns, will contribute to almost three quarters of the increase in the total urban population by 2040.

**65. Rural to urban migration has been the main driver of urbanization in Malawi, although the number of migrants is small.** Counting the migrants who had moved to or left the urban centers in the 12-year period since 1998, 7.9 percent of the urban population consisted of migrants from rural to urban areas<sup>12</sup>. This inflow was offset by a 2.4 percent outflow of urban residents moving to rural areas. The net effect is that 5.5 percent of the total urban population in 2011 consisted of migrants who had moved to towns or cities in the period from 1998 to 2010. In

<sup>11</sup> Considering this, urban areas in this report are grouped into "primary cities" and "secondary towns", where the latter includes all of the "other centers."

<sup>12</sup> The Third Integrated Household Survey (IHS3) conducted in 2010/11 includes questions such as if households had always resided in their current location and, if not, where they had previously resided and which year they had migrated. This provides information on internal migration flows between and within rural and urban areas.

terms of numbers, the net annual migration inflow to cities and towns stands only at 14,000 people (2006-2010), which explains the moderate pace of urban population growth<sup>13</sup>.

**Figure 29: Malawi's urban centers are dominated by Lilongwe and Blantyre**

Size distribution of urban centers, log scale, 2008



Source: World Bank (2016d)

## Signs of structural change and the role of urbanization

**66. With the low base and moderate rate of urbanization, Malawi is well-positioned to formulate plans to maximize the benefits of urban agglomeration into the future.** To examine these potential benefits, this special topic starts by focusing on the past and future role of urbanization in Malawi's national growth and development, before discussing its challenges. This investigation proposes that unlike the conventional view, urbanization can play an important role in the achievement of economic and social development in Malawi. Past growth trajectories do indeed indicate signs of economic structural change over a period of time. It is difficult to identify the precise contribution of urban areas to this process due to data limitations, as not all data can be disaggregated at the urban and rural geographical levels. Nonetheless, it is clear that Malawi's cities and towns have played an important role, making a disproportionately large contribution to economic growth relative to their population share. Emerging evidence also suggests that strong rural-urban linkages exist. These linkages emphasize that it is necessary to formulate strategies that promote comprehensive, integrated growth, rather than viewing rural and urban growth in competition with each other.

*Malawi's economy grew at an annual rate of 3.9 percent during 1998-2013, with movement of workers out of agriculture and into non-agricultural sectors*

**67. In the period from 1998 to 2013, Malawi recorded modest rates of economic growth, with the average annual increase in GDP standing at 3.9 percent** (NSO 2015). Although this rate is lower than average for the Sub-Saharan Africa as a whole, Malawi still performed well relative to its own historical record. At 3.9 percent, the average annual rate of growth of GDP exceeded the average annual rate of population growth, which stood at 3.0 percent. As a result, GDP *per capita* increased from US\$ 416 in 1998 to US\$ 472 in 2013, a rate of approximately 1 percent per year. As Table 2 shows, the industrial sector has been the major driver of economic growth, growing at an average annual rate of 5.4 percent over the period in question, mainly due to the expansion of manufacturing and construction. By contrast, the rate of growth of the agricultural sector was lower than the average annual rate of growth of GDP, standing at only 3.0 percent. Thus, in terms of its contribution to total GDP, its share fell from 36.1 percent in 1998 to 31.8 percent in 2013. In 2013, services accounted for 51.2 percent of GDP, while agriculture only accounted for less than one third of value added.

<sup>13</sup> Considering that the urban residents' income level is much higher than that of rural ones (see Box 6), further explanation is required as to why rural residents are not migrating to urban areas. While the lack of data on migration does not allow this special topic to investigate this question, understanding the constraints to rural-to-urban migration will be important in order to estimate the potential increase in welfare anticipated for migrants.

68. In terms of the sectoral composition of employment, the proportion of the workforce employed in agriculture has declined, indicating that Malawi's economy is undergoing a structural change. The proportion of the workforce employed in the service sectors increased at an average annual rate of 7.7 percent in the period from 1998 to 2013, increasing by 17 percentage points. By contrast, the proportion employed in agriculture declined in absolute terms, despite rural population growth (see Table 2)<sup>14</sup>. The fact that agricultural GDP has increased while the proportion of the workforce employed in that sector has declined shows that there has been an increase in agricultural value-added per worker. In addition, labor productivity is low in the agricultural sector, so the migration of workers to more productive sectors has the potential to further increase national average GDP per worker. This movement from low to high productivity sectors is referred to as positive structural change, which is strongly correlated with long-term economic development<sup>15</sup>.

**Table 2: Industry and services are growing faster than agriculture, but account for only a small share of GDP**

Selected economic indicators and annual rate of change, 1998-2013

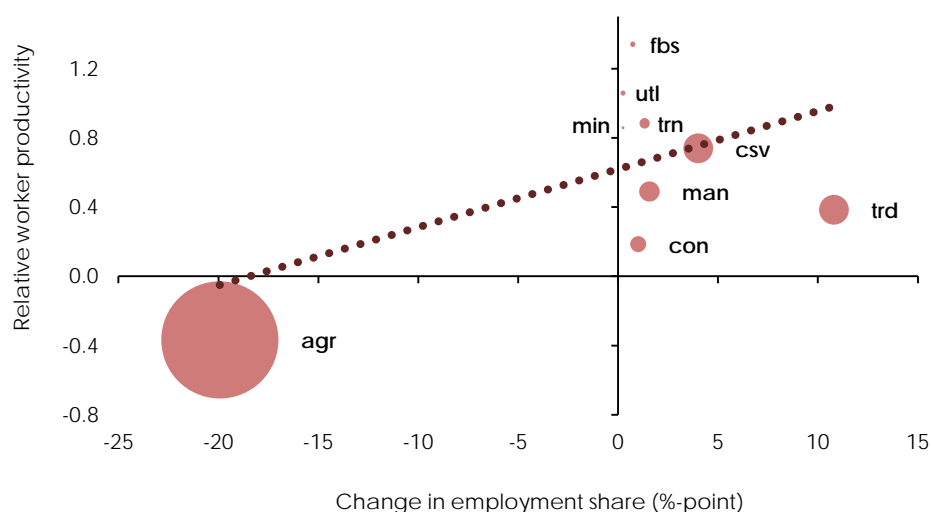
	1998	2013	Annual growth, 1998-2013
<b>GDP (\$ million)</b>	4,133	7,287	3.9
Agriculture	1,491	2,315	3.0
Industry	512	1,135	5.4
Services	2,130	3,837	4.0
<b>Employment (1000s)</b>	4,446	5,547	1.5
Agriculture	3,736	3,556	-0.3
Industry	193	411	5.2
Services	517	1,581	7.7
<b>GDP per worker (\$)</b>	929	1,314	3.2
Agriculture	399	651	4.5
Industry	2,658	2,764	0.4
Services	4,116	2,427	-4.7

Source: World Bank (2016d)

69. While agriculture is still the dominant source of employment, its share of total employment has fallen by almost 20 percentage points. Figure 30 contextualizes Malawi's process of structural change. The vertical axis shows sectoral productivity relative to economy-wide productivity. A positive value means that a sector generated above-average value-added per worker in 1998. The horizontal axis shows the percentage point change in employment shares in the period from 1998 to 2013. A negative value indicates that a sector's share of total employment

**Figure 30: Malawi is undergoing structural change out of agriculture**

Structural change, 1998-2013



Source: World Bank (2016d)

Note: Size of circle equals initial employment share. AGR is agriculture; MIN is mining; MAN is manufacturing; UTL is utilities (electricity and water); CON is construction; TRD is trade services; TRN is transport and communication; FBS is financial and business services; and CSV is public and community services

<sup>14</sup> Agriculture's falling employment share in Malawi is supported by various surveys and censuses. The share was estimated at 87 percent in 1987 (NSO 1989); 84 percent in 1998 (NSO 2000a); 73 percent in 2008 (NSO 2010); and 64 percent in 2013 (NSO 2014b). The downward trend is consistent with the reanalysis of historical data conducted by the Groningen Growth and Development Centre (see de Vries et al. 2015).

<sup>15</sup> Whereas such change is typically characterized by a decline in the relative importance of agriculture and with increased migration to urban centers, it may not be the case in Malawi where rural-to-urban migration is rather limited and transformation in terms of a move out of agriculture to non-agricultural sectors has taken place largely in rural areas, as discussed below. In addition, it is noteworthy that while the overall productivity of the country has increased, productivity in the service sector has dropped significantly, which may indicate weak competitiveness of the non-farm sector.

fell, even though the number of people employed in that sector may have grown in absolute terms. Finally, the size of the circles represents a sector's initial contribution to total employment. In 1998, 84 percent of Malawi's workers identified themselves as farmers, thus the circle representing agriculture is the largest (see AGR in Figure 30). However, its position below the horizontal axis indicates that its share has declined over the period from 1998 to 2013.

**70. Overall, the trade and community services sectors generated half of the new jobs created in Malawi over the past 15 years and were responsible for three-quarters of the positive structural change.** With the exception of agriculture, all other sectors included in the figure recorded an increase in their employment share. The most significant increase occurred in the case of trade services (TRD), followed by community services (CSV). Community services include both high-productivity services such as health and education services and low-productivity services such as paid domestic work. Most of the observed increase was driven by increases in the share of lower-productivity community services.

#### Box 6: Malawi's rural and urban economies

**Rural-urban linkages in Malawi are complex because there is no clear distinction between sectoral activities occurring in rural and urban areas.** As demonstrated by employment shares, similar activities exist across a continuum of areas that are more or less urban. It is plausible that linkages to rural areas are stronger for smaller

towns than for major cities, given the former's proximity to rural areas. Given this, Malawi's urban centers are separated into towns and cities in order to better reflect the country's rural-urban continuum and to enable an estimate of the extent and manner to which economic structures and linkages vary across and between cities, towns and rural areas. Table 3 reports key statistics describing the city, town and rural economies in 2010.

**Rural-urban production linkages are characterized by a heavy concentration of agriculture in rural areas and of services in urban areas.** Agricultural GDP is heavily concentrated in rural areas (93.8 percent), with services underrepresented in these areas, with 35.3 percent from rural areas compared to the national total of 51.2 percent. Rural households also spend almost two-thirds of their income on agricultural products (49.3 percent) and processed foods (14.3 percent), including

**Table 3: Characteristics of Cities, Towns and Rural Economies**  
2010

	Rural	Towns	Cities	All
Population (millions)	11.9	0.4	1.8	14.1
Share (%)	84.6	2.7	12.7	100
Poor population (millions)	5.4	0.1	0.2	5.6
Share (%)	95.8	1.2	3.0	100
Consumption per capita (\$)	341	940	1,136	458
Poverty headcount rate (%)	45.3	18.4	9.4	40.0
Sector GDP shares (%)	100	100	100	100
Agriculture	49.2	9.5	4.5	32.3
Industry	15.5	20.0	17.7	16.5
Services	35.3	70.5	77.8	51.2
Regional GDP shares (%)	61.6	5.9	32.5	100
Agriculture	93.8	1.7	4.5	100
Industry	57.9	7.2	34.9	100
Services	42.5	8.1	49.4	100
Total consumption shares (%)	100	100	100	100
Agriculture	49.3	28.7	22.1	39.6
Processed foods	14.3	13.7	12.8	13.8
Industrial goods	9.2	18.8	12.9	10.9
Services	27.3	38.8	52.1	35.7
Product consumption shares (%)	63.0	5.5	31.5	100
Agriculture	78.4	4.0	17.6	100
Processed foods	65.2	5.5	29.3	100
Industrial goods	53.1	9.5	37.4	100
Services	48.1	6.0	45.9	100

Source: NSO, using a range of data, including data derived from Malawi's 2010 Social Accounting Matrix (SAM),<sup>16</sup> which was formulated on the basis of national accounts and agricultural and economic surveys from the National Statistical Office; revenue and expenditure data from the Ministry of Finance; and balance of payments data from the Reserve Bank of Malawi. Information related to labor and households (incomes and expenditures) was derived from the IHS3 (NSO 2012) and the 2010 and 2011 Economic Surveys (NSO 2014c).

meals purchased away from the home. Although some agricultural production occurs within town boundaries, it is the industrial and service sectors that are most important for towns. Formal services are overwhelmingly concentrated in cities. This is reflected in city households' consumption patterns, which consist of a higher proportion of industrial products and services than in rural areas, with the proportion in cities being higher than

<sup>16</sup> A SAM is a consistent accounting framework that captures all income and expenditures flows in Malawi during a given year. It is an economy-wide database because it includes all sectors and households as well as the government and the economy's interactions with the rest of the world.

the national average.

**Rural-urban consumption linkages exist, notably in the case of the consumption of agricultural products in urban areas and of banking and financial services in rural areas.** For example, city households are responsible for the consumption of 18 percent of all agricultural products consumed in Malawi, although only five percent of agricultural output is produced in cities. Cities are therefore *net importers* of agricultural products from rural areas, although they are also more likely to consume foods imported from abroad. Similar rural-to-urban trade flows exist for industrial goods and for services. Electricity, for example, is generated in rural areas but consumed by urban producers and households. By contrast, rural producers and households are net importers of banking and financial services from urban centers, including small towns.

Source: World Bank (2016d)

*Most non-farm jobs in Malawi are created in rural areas, where most of Malawi's structural change has occurred. However, urban employment is growing faster than the national average*

**71. How does this economic shift away from agriculture relate to urbanization? While positive structural change is often assumed to be synonymous with urbanization, this has not been the case in Malawi.** Malawi has a large non-farm economy in rural areas. Thus, non-agricultural growth and job creation cannot be simply equated with an expansion of the urban economy. In fact, most of the expansion of Malawi's non-agricultural sector has occurred in rural areas, rather than in towns and cities. This is somewhat consistent with Malawi's small urban population share and slow process of urbanization relative to other developing countries. That is, *sectoral* patterns of growth, across agriculture, industry and services, do not neatly overlap with *spatial* patterns of growth, across rural and urban areas. As a result, GDP data alone is not sufficient to infer the contribution of urban centers to national economic development. Instead, household survey and population census data are used to compare employment levels in rural and urban areas. Table 4 shows rural and urban employment shares using data from the 2013 Labor Force Survey. The table also reports each sector and region's contribution to total job creation in the period from 1998 to 2013 using data from the 1998 Population Census.

**72. Agricultural and non-agricultural sectors can operate in both rural and urban areas, although the characteristics of the two sectors will differ in each of these areas.** The first three columns of the table show that neither the rural nor urban economy corresponds exactly to agriculture or non-agriculture respectively. Almost a third of rural jobs (29.7 percent) are in non-farm activities, including industry and services. Similarly, around one in every six urban jobs (16.4 percent) is in agriculture. However, the characteristics of agricultural activities vary between rural and urban areas. Urban agriculture mainly involves the production of food crops, such as maize and horticulture, which are non-tradable goods and tend to be locally consumed. By contrast, rural agriculture is more diverse and involves export-oriented, tradable crops such as tobacco and cotton to a much greater extent. Most agricultural jobs in Malawi involve smallholder farmers operating on small plots of land. However, in rural areas, there are also large-scale estate farms, which primarily produce maize and sugarcane.

**Table 4: Almost a third of rural jobs are in non-farm activities and one in every six urban jobs are in agriculture**

Share of employment by sector/urban/rural and rate of change, 1998-2013

	Share of total regional employment, 2013			Share of total sector employment, 2013			Share of total national change in employment, 1998-2013 (%)		
	National	Urban	Rural	National	Urban	Rural	National	Urban	Rural
<b>All sectors</b>	100	100	100	100	11.6	88.4	100	17.3	82.7
<b>Agriculture</b>	64.1	16.4	70.4	100	3.0	97.0	-16.4	1.6	-18.0
<b>Industry</b>	7.4	16.7	6.2	100	26.2	73.8	19.8	2.3	17.5
Mining	0.3	1.1	0.2	100	41.9	58.1	1.3	0.6	0.7
Manufacturing	4.1	7.7	3.6	100	21.7	78.3	10.4	0.8	9.7
Utilities	0.4	0.8	0.4	100	22.3	77.7	1.4	0.0	1.4
Construction	2.6	7.2	2.0	100	32.0	68.0	6.7	1.0	5.7
<b>Services</b>	28.5	66.9	23.5	100	27.2	72.8	96.6	13.4	83.2
Trade services	16.9	34.8	14.6	100	23.2	76.8	62.1	8.8	53.3
Transport, communication	2.0	5.4	1.6	100	31.4	68.6	7.4	1.2	6.2
Financial, business services	0.9	3.9	0.5	100	49.9	50.1	3.9	1.7	2.2
Community, public services	8.7	22.8	6.8	100	31.0	69.0	23.3	1.8	21.5

Source: World Bank (2016d)



**73. Non-farm employment in Malawi is dominated by services, with most of the expansion of the sector occurring in rural areas rather than urban centers.** Services account for 28.5 percent of total national employment, with most service jobs in the locally traded sector (16.9 percent), which includes wholesale and retail trade and restaurants. These activities are particularly important in rural areas, where they account for more than half of all non-farm jobs (14.6 percent out of 23.5 percent). By contrast, a greater proportion of urban non-farm jobs is in sectors such as finance and business services (3.9 percent) and public administration (22.8 percent). The final three columns of Table 4 describe contributions to national job creation. The absolute majority of the new jobs was created in rural areas (82.7 percent). In addition, all rural employment growth was driven by the creation of jobs in non-farm sectors, with rural agricultural employment declining over this period (thus indicated in negative terms) suggesting that structural transformation occurred mainly in rural areas. As was shown in Figure 30, most of the shift in employment out of agriculture was into the trade and community services sectors.

**74. Nonetheless, the urban economy is an important source of job creation in Malawi, with urban employment growing at a faster rate than the national average over the past 15 years.** Urban employment growth accounted for 17.3 percent of all new jobs created in Malawi in the period from 1998 to 2013. This is higher than its 11.6 percent share of national employment in 2013. Similar trends are observed in the contribution of the urban sector to national GDP. Malawi's four cities form the economic core of the national economy, with their contribution to national GDP (33 percent) far in excess of their population share (13 percent). By contrast, while rural areas are home to 85 percent of Malawi's population, these areas account for only 62 percent of national GDP. Secondary towns are home to about three percent of the population, but contribute to six percent of national GDP. Although data constraints make it hard to gauge the precise contribution of cities and towns to structural transformation, it is clear that complex linkages exist between rural and urban areas across sectors (see Box 6).

*A more rapid rate of migration will facilitate economic growth and reduce poverty if public investment in urban areas is self-financed through more effective taxation in these areas*

**75. Harnessing the urban economy will require the development of a comprehensive, integrated strategy to benefit both rural and urban areas.** As a step towards this, this special topic simulates the potential impacts of a more rapid rate of urbanization on Malawi's growth and welfare over the longer term. Drawing on a recent study by the World Bank (2016d), the *Malawi Urbanization Review*, four scenarios of urbanization and economic growth are developed for the period from 2010 to 2030, with each of these scenarios involving different public investment options. The key underlying assumption is that rural to urban migration generates positive agglomeration effects, including increased productivity. However, a higher level of urbanization also reduces the amount of public capital available to each urban resident and can create congestion effects, which can occur when urbanization outpaces public investment in urban infrastructure and services, leading to overstretched transport systems, inadequate housing, and other negative effects. These negative effects may undermine the potential benefits to be derived from urbanization. For example, congestion effects may reduce worker productivity by increasing the time taken to get to work on crowded roads, or increasing morbidity (sick days) because of inadequate water and sanitation infrastructure.

**76. In the baseline scenario, Malawi continues to see the same rates of economic, population and urbanization growth as in the period from 2010 to 2030, reaching a 16.2 percent urbanization rate in 2030 and with an average annual GDP growth rate of 3.96 percent.** The baseline scenario is developed on the assumption of a "business-as-usual" growth path or a continuation of the historical trends observed in the period from 1998 to 2013. This provides a counterfactual against which the three alternative growth scenarios can be compared. The structural change in this scenario reflects the patterns observed in the period from 1998 to 2013, with agriculture recording a relatively low rate of growth compared to industry and services, with a corresponding decline in its proportionate contribution to national GDP. Welfare (see Table 6) increases at the rate of 0.13 percent per year for poor households (those in the bottom two national per capita consumption quantiles), leading to a small decline in poverty, while the gap between poor and non-poor households grows, with the circumstances of the latter group improving at a much faster rate than those of the former (at the projected rate of 1.16 percent per year).

**77. Under a scenario involving a more rapid rate of urbanization (21.2 percent in 2030), the pace of economic growth and structural change accelerates, albeit with increased congestion effects in urban areas.** The faster urbanization scenario is simulated by increasing the rate of rural to urban migration by five percentage points relative to historical migration rates, to reach the urbanization rate of 21.2 percent in 2030. Under this scenario, the total GDP growth rate is increased by 0.7 percentage points per year, leading to a cumulative effect according to which the economy is 14.1 percent larger than it would have been without the higher level of urbanization. All additional growth resulting from the more rapid rate of urbanization occurs in cities and towns, whose economies are 37.4 and 27.7 percent larger respectively in 2030 than in the baseline. A more rapid pace of urban growth

also generates stronger backward linkages to agriculture, mainly because rising urban incomes create greater demand for agricultural products, which in turn results in an increased agricultural GDP growth rate. Urbanization also encourages a positive transformation within the agricultural sector, facilitating a shift towards higher-value activities, including a higher level of production of export crops, such as tobacco and cotton, and of food crops that are hard to substitute with imports, such as livestock and fish. Despite increased agricultural output, almost all of which is produced in rural areas, the rural economy contracts relative to the baseline due to a deceleration in the growth of rural non-farm activities.

**Table 5: Economic growth under differing urbanization scenarios**

Malawi CGE model results, 2010-2030

	Total GDP share, 2010 (%)	Baseline annual growth rate (%)	Urbanization scenarios (%-point deviation from baseline)		
			Faster migration	Urban investment	Win-win investment
Annual GDP growth	100	3.96	0.66	0.68	0.82
Agriculture	32.3	2.81	0.17	-0.03	0.14
Industry	16.5	4.69	0.83	0.95	1.10
Manufacturing	10.6	4.60	0.89	1.01	1.10
Agro-processing	6.0	4.10	0.79	0.81	0.93
Other manufacturing	4.6	5.19	0.99	1.22	1.29
Other industry	4.7	4.90	0.90	1.00	1.32
Services	51.2	4.35	0.83	0.90	1.03
Rural areas	61.6	3.04	-0.29	-0.52	-0.33
Towns	5.9	4.91	1.23	1.22	1.54
Cities	32.5	5.22	1.60	1.83	1.91

Source: World Bank (2016d)

**78. It is recognized that a more rapid rate of urbanization might lead to an “urbanization of poverty” phenomenon due to urban infrastructure deficits and other factors. In the urban investment scenario, a higher proportion of public resources is allocated to the development of urban areas, offset by reduced investment in rural areas.**

Under the rapid urbanization scenario, the rate of increase in the urban population exceeds the rate of increase in urban GDP, resulting in lower urban per capita GDP and welfare relative to the baseline, with this having its most severe impact on urban poor households. In order to prevent this urbanization of poverty, a simulation is conducted under which the level of public resources allocated to the development of cities and towns is increased to the point where urban public capital per capita remains unchanged from baseline levels and where there are no negative congestion effects to offset the positive urban agglomeration effects. However, this scenario involves a reduction in the growth rate of rural public expenditure and agricultural GDP. Also, reallocating investment away from rural agriculture does not achieve the goal of preventing an increase in urban poverty. Rather, a reduction in rural investment actually leads to worse outcomes for poor urban households, because the slower rate of agricultural growth leads to increased real food prices, on which poor urban households spend most of their income.

**Table 6: Household welfare under differing urbanization scenarios**

Malawi CGE model results, 2010-2030

	Average per capita consumption, 2010 (\$)	Baseline annual growth rate (%)	Urbanization scenarios (Annual growth rate, %)		
			Faster migration	Urban investment	Win-win investment
National welfare	458	1.01	1.52	1.48	1.36
Poor	147	0.13	0.25	0.14	0.25
Non-poor	665	1.16	1.73	1.70	1.56
Urban welfare	1,102	1.74	1.54	1.58	1.29
Poor	174	0.95	-0.07	-0.16	0.00
Non-poor	1,217	1.90	1.88	1.92	1.63
Rural welfare	341	0.35	0.61	0.49	0.50
Poor	146	0.06	0.23	0.12	0.22
Non-poor	502	0.45	0.82	0.71	0.70

Source: World Bank (2016d)

Note: Welfare is measured using equivalent variation, which is a consumption-based measure that controls for price changes.

**79. It is possible to envision a win-win solution, in which a more rapid rate of urbanization is accompanied with the financing of the increased investment needs by increasing the urban tax base.** This win-win scenario assumes that

the overall government budget envelope can be increased to finance more rapid urban development. Increased government expenditure is made possible by increasing direct taxes on urban enterprises and households, enabling the level of public investment in rural areas to be maintained at the baseline level. If the urban economy finances its own development through the implementation of an effective taxation regime, the urbanization of poverty and the negative impact on the welfare of urban poor households could be prevented. At the same time, continued agricultural transformation could facilitate a reduction in rural poverty, contrasting with the outcome under the previous two scenarios, in which agricultural GDP growth declines. In this way, a more rapid rate of economic growth, positive structural change, and improved national welfare could all be achieved. Only non-poor urban households would be worse off if taxes were raised to finance urban investments. However, even with higher taxes, they would still be the main beneficiaries from more rapid urbanization, with their per capita welfare being 38.1 percent higher in 2030 than the figure of 46.4 percent if they had not had to finance urban investments.

**Table 7: Summary of urbanization scenarios**

Scenarios of Urbanization and Public Investment Allocation for 2010-2030

Model scenarios	Relative to historical trend: maintain (→), increase (↑) or decrease (↓)			
	Rural-to-urban migration rate	Urban investment shares	Rural investment shares	Urban tax rates
Baseline	→	→	→	→
1 Faster Urbanization	↑	→	→	→
2 Urban Investment	↑	↑	↓	→
3 Win-win Investment	↑	↑	→	↑

**80. These scenarios suggest that even a slightly more rapid rate of urbanization would make a significant contribution towards facilitating accelerated growth and more meaningful structural change in Malawi.** Each of the scenarios has its pros and cons, with different winners and losers under each. It is important to understand the relative merits and potential trade-offs when prioritizing the allocation of public investments across rural areas, towns and cities. The comparative analysis of the urbanization and public investment scenarios suggests that it would not be beneficial to reduce investments in rural agriculture in order to finance urban development, because this may lead to increased food prices and therefore to increased urban poverty. Fears regarding this outcome have underpinned many of the concerns related to urban migration in Malawi. Rather than reducing investments in rural agriculture, it is recommended that urbanization should be financed by increasing the urban tax base to the level where higher-income urban households still benefit significantly from urban development. To materialize this desired scenario, it is imperative to examine the extent to which urban local governments' current institutional and financing arrangements are fit for purpose and to explore ways to reshape these arrangements so that they serve to leverage the potential of urbanization.

## Reforming Malawi's urban institutions and their financing mechanisms

*Despite decentralization policies that assign a large number of statutory functions to local governments, Malawi's urban local governments are involved in a limited set of functions, leaving infrastructure and services needs unmet*

**81. Measured in terms of total expenditure and revenues, Malawi's local government sector constitutes a relatively small part of the overall public sector.** The principles of decentralization have been enshrined in the new constitution promulgated in 1994. However, the actual implementation of these principles has been very slow, being postponed for nearly two decades until the policy environment for decentralization was reinvigorated through the elections in May 2014. Partly as a result, local government own-source revenues account for only about 0.3 percent of GDP and less than two percent of central government revenues in the period from 2011 to 2014. The total value of local governments' expenditure is considerably less than two percent of GDP. Furthermore, the proportion of both revenues and expenditure has declined over the period. This belies the far-reaching and ambitious intent of decentralization, as mandated by a number of national policy statements and frameworks.

**82. Nonetheless, a wide range and large number of statutory functions are assigned to local governments, which apply uniformly to both urban and rural local governments.** Functions stipulated in the Local Government Act (1998) and National Decentralization Policy (1998) include security, regulation of public areas and general public goods, vital registration, infrastructure provision, social and economic services, and other orthodox local government activities. They overlap extensively with those of line departments and other national institutions. For instance, important functions, such as electricity and water supply, are assigned to the Electricity Supply Corporation of Malawi (de jure) or parastatal Water Boards (de facto), respectively. In addition, there is no

distinction between the functions of local governments in urban and rural areas, despite significant differences in the challenges that they face and the manner in which they are structured and operate. With this ambitious scope of functional assignments and a high degree of ambiguity, accountability can become weak and inefficient duplication may take place.

**83. In practice, local governments are only involved in a sub-set of their assigned functions, and as a result, many urban infrastructure and service needs remain unaddressed.** Notably, urban and secondary road networks are often limited in coverage and feeder roads are in poor condition, discouraging public transport and increasing the cost of intra-urban travel. In Malawi's towns and cities, solid waste management, for which urban local governments have a near exclusive mandate, is also a major challenge. Regular waste collection, whether by public authorities or by the private sector, is generally limited to industrial, commercial and middle income housing areas. Low income housing areas, in which the majority of the urban population lives, are poorly served, if at all. Waste disposal is carried out at municipal landfill sites, where, for the most part, waste is simply dumped rather than disposed of appropriately, with many of these sites rapidly approaching saturation.

**84. Challenges related to infrastructure and service delivery are mainly the result of urban local Governments' financial and capacity limitations.** As will be discussed in the following section, the overall revenues of urban local governments are relatively small, with their capital budgets particularly limited due to the large share of recurrent expenditures. For the provision of primary education services, City Councils only have a nominal responsibility, playing an almost completely passive role in reality. Rather, the Ministry of Education exercises near complete control over most decisions related to primary education, including the payment of all primary school teachers' salaries, with some school management decisions devolved to school management committees consisting of teachers and community representatives. Likewise, City Councils do not receive health sector grants that District Councils receive and thus play a very limited role in the provision of primary health services.

**85. The same challenges apply to planning and coordination, critical functions of urban local governments to manage urbanization in an efficient and productive manner.** Urban local governments, especially City Councils, engage actively in planning (land use or physical planning, investment planning, strategic planning) and produce a plethora of plans (master plans that project spatial and infrastructure intentions, strategic plans that outline the broad ways in which thematic issues are to be addressed, investment plans that list priority infrastructure). However, local government planning in urban jurisdictions is conducted with little coordination and lacks "teeth" for implementation or execution. Mainly due to limited resources, City Councils neither exercise control over key sectors nor have the authority to make other agencies align their plans to city-wide coordination, and thus are unable to facilitate city-wide and cross-sectoral planning.

**86. Modes of operation are also suboptimal as services are delivered relying directly on City Council equipment and labor.** In the case of roads, City Councils are generally poorly equipped while having a large number of available road workers. Demonstrating this, Blantyre, Lilongwe and Mzuzu each have one functioning grader/bulldozer, while their respective public works departments employ around 200, 350 and 110 staff, respectively. Thus, maintenance is generally limited to intermittent labor-intensive work. Likewise, City Councils rely on their own in-house health departments to provide SWM services. In 2015, Lilongwe City Council's SWM operations are conducted by around 600 sweepers and garbage collectors, with only four out of eight garbage trucks currently in operation. Similarly, in 2015, Blantyre City Council's SWM operations deployed around 250 sweepers and cleaners, with only seven out of 11 garbage trucks currently in operation.

*High payroll costs and heavy reliance on limited own-source revenues place urban local governments under severe fiscal pressure*

**87. The fiscal pressures experienced by local governments is reflected by the composition of City Council expenditures, which consist mostly of expenditure on recurrent items and with a considerably larger proportion of payroll-related costs than is the case with District Councils.**<sup>17</sup> Urban local governments account for only approximately 20 percent of total local government expenditure, although this expenditure is considerably greater in per capita terms than in the case of rural local governments (see Figure 31 and Figure 32). In the case of all local governments, a large and increasing proportion of total expenditure consists of recurrent expenditure, with this portion increasing from approximately 87 percent in 2011/12 to more than 92 percent in 2013/14. In all four cities, over the past three years, recurrent expenditure has constituted from between 70 percent to 100 percent of total expenditure. Payroll-related costs have consistently accounted for between 40 percent to 50

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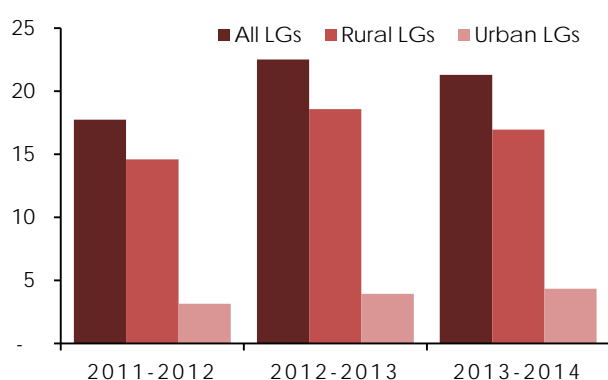
<sup>17</sup> Urban local government in Malawi consists of four City Councils, two Municipal Councils and one Town Council. Among the seven urban local governments, the four City Councils account for around 95 percent of all expenditures—the following discussion concentrates on the spending patterns of City Councils and does not consider municipal or township expenditure.

percent of recurrent expenditures and for between 32 percent to 47 percent of total expenditures. This is much higher than in the case of District Councils, where payroll costs account for less than 7 percent of total expenditure. This can be partially explained by the extent to which many of District Councils' payroll-related costs, particularly sector department staff salaries, are paid for out of the Central Government's budget.

**88. Not surprisingly, City Councils' capital expenditure has accounted for less than 10 percent of their total expenditure, with this portion declining.** In per capita terms, City Councils' capital expenditure has also been low and declining. On average, for all four Cities, per capita capital expenditure stood at about MWK 230 (or US\$ 1.46) in 2011/12; MWK 240 (or US\$ 1.29) in 2012/13; and MWK 180 (or US\$ 0.76) in 2013/14. Nonetheless, it accounts for a greater proportion than in the case of District Councils, where on average capital expenditure accounts for only around 5 percent of total expenditure. The low level of capital expenditure is clearly insufficient to fund the vast amount of capital investment needed to improve infrastructure and service delivery (although it must be stated that by no means all of the required improvements are under the direct mandate of local government).

**Figure 31: In aggregate terms, Malawi spends more on rural local governments...**

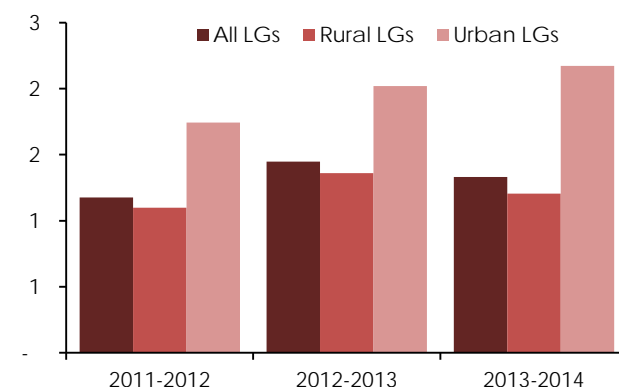
Aggregate expenditure on local government, in billions of Malawi Kwacha, selected years



Source: World Bank (2016d)

**Figure 32: ...but per capita spending is higher for urban local governments**

Per capita expenditure on local government, in thousands of Malawi Kwacha, selected years



Source: World Bank (2016d)

**89. In Malawi, local government expenditure is financed almost entirely from inter-governmental fiscal transfers (IGFTs) and own-source revenues (OSRs), known as locally generated revenues.** However, Districts and Cities are near mirror opposites in terms of their relative dependence on IGFTs/OSRs. While District Councils derive over 90 percent of their total revenues from IGFTs and less than 10 percent from OSRs, City Councils derive only about 20 percent of their total revenues from IGFTs and around 65-80 percent from OSRs. While the Local Government Act allows for sub-national borrowing, in practice, local governments borrow very rarely, particularly for the purpose of financing infrastructure investments. This makes sense, given that the low level of revenues they generate are insufficient to finance borrowing and given that municipal lending institutions and bond markets are absent.

**90. While City Councils rely on OSRs for 65-80 percent of their total revenues, the average value of OSR per capita is less than US\$ 5 annually. The level of dependence on OSRs is unusual, with the overall value of revenues being inadequate.** In Southern Africa, only cities in Zambia and Namibia demonstrate comparable rates of dependence on OSRs. The relative importance of OSRs for City Councils in Malawi is largely due to the very limited value of transfers from central government.

**91. IGFTs consist of sector or conditional grants and unconditional block grants, with the total average per capita value of these grants amounting to US\$ 5 across all local governments.** On the whole, the largest grants are for the health and education sectors. However, there are important differences between District and City Councils in terms of the nature of IGFTs. The only significant sector conditional grant allocated to City Councils is for education. City Councils are also provided with earmarked grants for roads rehabilitation and maintenance, unlike rural local governments. Each sector allocation is based on a specific formula, with local governments' discretion over the use of such sector conditional grants being very limited. Another type of conditional grant is derived from the Constituency Development Fund (CDF), with these grants being earmarked for specific constituencies to finance a range of small-scale community-based projects or investments. Unconditional block grants are allocated from the General Resource Fund (GRF), a central government funding pool. Both CDF and GRF grants account for less than five percent of the total value of all local government grants.

**92. The most important source of revenue for City Councils is property tax, which accounts for between 50-65 percent of total OSRs and for between 40-50 percent of all revenues.** Other sources of revenue include a wide



range of fees and service charges, including market fees, fees for billboards and advertising, parking fees, land allocation and development fees, building permits, etc. According to the Local Government Act, property taxes can be levied on all properties within a local government's jurisdiction, with a few exceptions, such as roads, parks and cemeteries. In practice, most City Councils limit themselves to levying taxes on properties within ratable areas. Although the criteria for ratable areas are not clearly defined, the observed tendency is for commercial/industrial, administrative and formal low density, high value residential areas to be designated as such. By contrast, informal and high density residential areas tend not to be designated as ratable. In theory, local governments also enjoy very wide discretion in terms of establishing the level of property tax rates, which can vary depending on the type of property (commercial, residential, etc.).

**93. Property tax revenues are lower than they could be, due to a number of reasons, including the following:**

- Property tax rolls are generally underestimates of real properties in urban jurisdictions, partly due to City Councils' apparent reluctance to assess property values outside of officially designated ratable areas;
- The institutional and legal framework regulating property taxation has yet to be streamlined and made realistic. The Local Government Act states that the preparation and updating of valuation rolls can only be conducted by registered valuers, of whom there are currently very few in Malawi. Property valuation methods are also cumbersome, relying on individual rather than mass valuations;
- Enforcement and compliance are major constraints on the mobilization of property taxes. There is also a high risk of collected taxes being misplaced or misappropriated by local government revenue collectors, often in collusion with tax-payers;
- Tax-payers are reluctant to pay, given the poor services provided by City Councils. Paying property tax is rightly perceived by Malawian city-dwellers as something for which they should receive services in return.

**94. The potential clearly exists to increase the revenues collected from City Council property and thereby to increase City Councils' OSRs.** For example, in Blantyre, minor improvements were implemented to the tax payment system, with the introduction of facilities for the payment of property taxes directly to a commercial bank. This led to improved collection rates, which increased from less than 50 percent of the amounts billed in 2011/12 to almost 60 percent in 2013/14. The case of Mzuzu, where a major reform and rejuvenation of property tax administration and collection was recently implemented, also demonstrates the potential for improvement. The reforms and the new approach piloted in Mzuzu show that there is significant potential for improvements in other cities to increase the number of taxable properties; to improve tax collection and administration; and to increase the value of collected property tax revenues. Scaling up the measures implemented in Mzuzu would require some regulatory changes, including changes to valuation methods and procedures. They would also require a reassessment of the definition of ratable areas; basic improvements to tax collection processes; and greater local government engagement with residents and property owners.

## **What should the Government do?**

**95. Urbanization creates opportunities for broad-based economic development in Malawi. To leverage this potential, it is vital to invest to a greater extent in urban development, without damaging rural areas.** Over the past 15 years, urban centers have made a disproportionately large contribution to national economic growth relative to their population share. Projections of future growth patterns indicate that a more rapid process of urbanization may facilitate greater economic growth, by increasing the demand of urban businesses and consumers for agricultural products, which in turn can contribute to poverty reduction in rural areas. Following this special topic, which is focused on uncovering the potential of urbanization in Malawi's development, further research is needed to identify optimal location and type of investments that can unlock such potential. And careful attention will also need to be paid to unblocking the policy barriers that constrain the development of urban-rural value chains.

**96. In order to meet the significant and increasing needs of cities for infrastructure and services, urban local governments need increased funds and greater capacities.** The benefits of urban agglomeration could be undermined by congestion effects, which should be counteracted with increased investment in urban infrastructure and services. For this, a systematic, focused effort should be made to improve urban local governments' OSR systems. Measures to achieve this could include amending legal and regulatory provisions to make prescribed property valuation methods and practices more up-to-date; modernizing payment systems to facilitate the collection process, to reduce leakage and to encourage tax-payers to settle property rates; implementing more sensitization and awareness campaigns for tax-payers; and providing City Council revenue

officials with training and modern taxation tools (such as GIS systems). Initiatives with promising outcomes, such as the Mzuzu City Council's initiative to update its tax rolls, need to be studied and, where appropriate, scaled up.

**97. The expansion of the tax base should be accompanied by measures to improve infrastructure and service delivery. This requires City Councils to change the manner in which they manage the provision of services and budgets.** Increasing City Council OSRs may provide them with a basis to make immediate improvements in infrastructure and services delivery. This would go a very long way towards making taxpayers more willing to meet their fiscal obligations. However, the current modalities of city management, which rely on in-house arrangements that draw on city-owned equipment and city-employed labor, are suboptimal and unsustainable. If nothing else, these modalities are associated with the high staffing levels in City Councils, which are reflected in the high share of recurrent costs to total expenditure.<sup>18</sup> Consideration should be given to outsourcing some services to the private sector, especially in sectors where private sector involvement has proven to be cost effective, such as waste collection and road works. This will also enable urban local governments to reduce their payrolls and other recurrent costs and thereby to create space to increase capital investment.

**98. If local government is to effectively contribute to urban development, the Central Government should consider the development of an incentivized system to increase the value of IGFs to City, Municipal and Town Councils.** A system could be developed to incentivize local governments to achieve improved performance in the management of their resources, by linking increased transfers to improved performance and making increases conditional on the fulfilment of certain conditions. For example, increased transfers could be provided to local governments on the condition that they successfully increase their OSRs, and/or transform their management systems and budget structure to achieve higher levels of efficiency and effectiveness. Two models that could be investigated include performance-based grant systems and municipal contracts between central and local governments under which the former provides additional grants and other assistance if the local government implements a defined range of reforms. Both these models have been widely and effectively used in the sub-Saharan African region and elsewhere to achieve better local government management.

**99. In the long term, the role of City Councils in urban development needs to be streamlined to focus on the development of efficient systems for cross-sectoral planning and coordination.** The Constitution provides a mandate for the empowerment of local governments in cities and towns to play a major role in urban infrastructure and service delivery and as forums of democratic governance at the local level. This vision must be revisited in view of how services are actually managed in Malawi, where there is currently substantial duplication of functions across the levels of governments and/or between institutions and where local governments have limited capacity to efficiently fulfil their mandates. Some functions, particularly in the areas of primary education and health services, are probably best left to decentralized line departments, which have already developed extensive systems to provide these services to urban areas. Other existing institutions, such as City Water Boards, may be best suited for the delivery of utilities and other urban public goods and services. City Councils could rather focus on planning and coordination of urban areas, including economic and strategic planning, by strengthening an institutional architecture that facilitates citizen participation and improves downward accountability. In this manner, City Councils will be able to play a vital coordinating role in providing the infrastructure and services necessary for Malawi to mitigate the negative impacts and harness the positive impacts of the process of urbanization.

**100. Finally, the government can make important decisions regarding institutions, infrastructure and interventions that will have a lasting effect on the quality and efficiency of urbanization.** Establishing the institutional groundwork should inform spatial policy and interventions. The government can focus its initial investments on naturally growing urban areas, such as Blantyre as a thriving border town and Lilongwe as a capital town, while other towns can serve as local service providers. Urban planning would be critical for guiding effective infrastructure investments and targeted interventions. Collective action is required first to get the public space that allows urban mobility and interconnection, and this is something that will not happen through a solely market-driven process. Once urban development takes place, it is almost impossible to increase or reconfigure public space. For the case of Malawi, this does not necessarily mean that immediate attention is needed with regard to comprehensive urban planning. But it points to the importance of forward thinking and action in terms of specific decisions for securing rights of way for infrastructure and clarity on the division between public and private space.

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<sup>18</sup> Lilongwe City Council, for example, currently employs about 2,000 staff (roughly one employee for every 350 city residents); Mzuzu employs about 520 staff (one employee for every 300 city residents); and Blantyre about 1,400 staff (one employee for every 500 city residents). Many such staff are unskilled (employed as laborers for public works activities, street sweepers, gardeners) and semi-skilled (employed in clerical/administrative positions, for market management, for revenue collection).

## Data

Table 8: Selected macroeconomic indicators

	2013	2014	2015	2016	2017 Proj.
<b>National Accounts and Prices</b>					
GDP at constant market prices (percentage change)	5.2	5.7	2.8	2.5	4.4
Agriculture	6.6	5.9	-2.0	-2.3	4.8
Industry	3.5	4.7	3.5	2.4	4.5
Services	6.3	5.8	4.7	4.4	5.6
Consumer prices (annual average)	27.3	23.8	21.9	21.7	15.2
<b>Central Government</b> (percent of GDP on a fiscal year basis)					
Revenue and grants	27.5	23.2	21.4	21.6	22.8
Domestic revenue (tax and nontax)	17.3	19.7	18.6	17.8	19.8
Grants	10.2	3.5	2.8	3.7	3.0
Expenditure and net lending	28.0	28.9	27.1	27.6	28.0
Overall balance (excluding grants)	-10.7	-9.2	-8.5	-9.8	-8.2
Overall balance (including grants)	-0.5	-5.7	-5.7	-6.1	-5.2
Foreign financing	1.9	2.0	2.5	1.9	2.6
Domestic financing	0.1	4.2	3.3	1.7	1.0
Amortization (zero coupon bonds)	0.0	0.0	0.8	2.5	1.3
Privatization Proceeds	0.0	0.0	0.0	0.0	0.3
<b>Money and Credit</b>					
Money and quasi money (percentage change)	35.1	20.7	23.7	21.1	22.0
Credit to the private sector (percent change)	14.4	20.0	29.9	24.3	20.1
<b>External Sector</b> (US\$ millions, unless otherwise indicated)					
Exports (goods and services)	1,657	1,737	1,616	1,527	1,701
Imports (goods and services)	2,315	2,399	2,346	2,563	2,627
Gross official reserves	397	588	670	620	640
(months of imports)	2.0	3.1	3.4	2.9	3.0
Current account (percent of GDP)	-8.7	-8.5	-9.2	-16.2	-11.8
Exchange rate (MWK per US\$ average)	369.2	424.4	499.6	713.8	-
<b>Debt Stock and Service</b>					
External debt (public sector, percentage of GDP)	30.8	33.1	37.0	35.4	32.3
Domestic public debt (percentage of GDP)	19.8	14.9	16.8	18.9	17.8
Total public debt (percentage of GDP)	50.6	48.0	53.8	54.2	50.1
<b>Poverty</b>					
Poverty rate (US\$1.9/day in PPP terms)	70.1	69.5	69.6	69.8	69.4
Poverty rate (US\$3.1/day in PPP terms)	87.2	86.8	86.8	87.0	-

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

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