

Malawi Economic Monitor

Managing Fiscal Pressures

March 2015



THE WORLD BANK
IBRD • IDA

MALAWI ECONOMIC MONITOR
MARCH 2015
MANAGING FISCAL PRESSURES

World Bank Office Malawi
Mulanje House
Capital City, PO Box 30557
Lilongwe 3, Malawi
+265 (0) 1 770 611
www.worldbank.org/mw

Acknowledgements

The first edition of the Malawi Economic Monitor was prepared by Richard Record (Senior Country Economist) and Priscilla Kandoole (Country Economist), from the World Bank's Macroeconomics and Fiscal Management Global Practice; and Mombert Hoppe (Trade Economist), from the Trade and Competitiveness Global Practice. Additional contributions were provided by Alejandro de la Fuente (Poverty Economist); Efrem Chilima (Senior Private Sector Development Specialist); Olivier Durand (Senior Agricultural Specialist); and Martin Lokanc (Mining Specialist).

Overall guidance was provided by Albert Zeufack (Practice Manager) and Praveen Kumar (Program Leader). The team wishes to thank Laura Kullenberg (Country Manager); Kevin Carey (Lead Economist); Philip Schuler (Senior Economist); Thomas Farole (Senior Trade Economist); Vijay Pillai (Country Program Coordinator); and Appolenia Mbowe (Senior Economist) for their helpful input.

This report benefited from fruitful discussions, comments, and information provided by the Ministry of Finance, Economic Planning and Development; the Reserve Bank of Malawi; the Ministry of Agriculture; the Ministry of Industry and Trade; the Malawi Revenue Authority; and a number of other Government ministries, departments and agencies. We would also like to thank representatives from the private sector in Lilongwe and Blantyre for their helpful contributions.

Zeria Banda (Communications Officer) and Deliwe Ziyendammanja (Team Assistant) provided assistance in external communications, web production, design and additional production support. Editorial assistance was provided by Irfan Kortschak (Consultant).

The findings, interpretations, and conclusions expressed herein do not necessarily reflect the views of the World Bank's Executive Directors or the countries they represent. The report is based on information current as of February 2015.

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

TABLE OF CONTENTS

Executive Summary	1
1. Economic Developments	4
Malawi's growth recovery continues, but faces significant policy headwinds	4
Fiscal policy has been under significant pressure	5
Public sector debt is rising	6
Inflation remains stubbornly high	7
After a period of volatility, the Kwacha has stabilized	8
An accommodative monetary stance has allowed inflationary pressures to remain	9
Export performance is driven by increased tobacco earnings	9
Continued import growth and a large structural deficit on the current account	11
The financial sector shows signs of strain.....	11
Policy uncertainty is undermining business confidence	12
Regional macroeconomic outlook.....	13
Growth prospects for Malawi.....	13
Fiscal policy will need to be tightened.....	14
A tighter monetary stance will be needed to bring down inflation	18
The outlook for the current account is broadly positive, but a significant deficit remains	19
Priority steps to restore macroeconomic stability	19
2. Special Topic: Building Trade Competitiveness	22
Malawi's recent trade performance	22
Key policy challenges Malawi is facing	24
What should the Government do?	29
Data	31
References	32

BOXES

Box 1: Hopes of export diversification through uranium mining appear to have stalled	10
Box 2: What are the latest poverty trends in Malawi?	12
Box 3: The Farm Input Subsidy Program is placing the government's budget under enormous strain	17
Box 4: Estimating the impact of falling oil prices on Malawi	19
Box 5: Using a Trade Portal to improve transparency of regulatory requirements at the border	28

FIGURES

Figure 1: Malawi's rates of growth are close to regional averages.....	4
Figure 2: The most significant sectors are agriculture, forestry and fisheries, and wholesale/retail trade	4
Figure 3: Government's fiscal position is expected to remain under pressure... ..	6
Figure 4: ...leading to rising debt levels.....	6
Figure 5: Inflation has been very high, especially by regional standards	7
Figure 6: Commodities prices, particularly energy prices, are on a declining trend.....	7
Figure 7: Thin reserves and seasonality in export earnings, drives exchange rate instability	8
Figure 8: Interest rates are edging down	8
Figure 9: Malawi runs a large and structural current account deficit	9
Figure 10: ...with sector growth rates showing a mixed picture	9
Figure 11: Boom and bust for global uranium prices.....	10
Figure 12: Consumption shares by quintile	13
Figure 13: Major sectoral allocations in the 2014/15 budget are broadly unchanged	16
Figure 14: Efforts to diversify the export base have had some success	23
Figure 15: Domestic transport costs are many times international transport costs	23

TABLES

Table 1: Incidence of poverty.....	12
Table 2: Poverty transitions	12
Table 3: Location of the poor	13
Table 4: Fiscal accounts.....	15
Table 5: The costs of FISP, 2005/06 to 2014/15.....	17
Table 6: Selected macroeconomic indicators	31

EXECUTIVE SUMMARY

The Malawi Economic Monitor (MEM) is a new publication by the World Bank. This publication is intended to provide an analysis of economic and structural development issues in Malawi. This first edition was published in March 2015, with future editions to follow twice each year.

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

The MEM has two parts: Part 1 presents a review of recent economic developments, followed by a macroeconomic outlook; and Part 2 focuses on a selected special topic key to Malawi's development prospects. Each edition of the Malawi Economic Monitor will include a different special topic for examination in Part 2.

In this edition of the MEM, the focus of the special topic is on building trade competitiveness. As a small, landlocked economy with a large current account deficit and following a period during which the Kwacha has been under pressure, the section focuses on some of the key constraints that are limiting Malawi's ability to benefit more effectively from the opportunities created by international trade.

RECENT ECONOMIC DEVELOPMENTS

Malawi's rate of growth has remained stable. The rate of growth of GDP in 2014 is estimated at 5.7 percent, with this growth largely driven by expansion in the agricultural; information and communication; and wholesale and retail trade sectors.

However, the country faces significant policy headwinds. Uncertainties resulting from inconsistent policies and macroeconomic imbalances are beginning to have an impact on economic outcomes. The withdrawal of budget support by development partners following the 2013 public finance mismanagement scandal (known as "cashgate")¹ placed the Government's fiscal accounts under enormous pressure. This has resulted in a substantially enlarged fiscal deficit and a build-up of significant payment arrears.

¹ In September 2013, revelations arose of misappropriation of significant amounts of public funds through fraudulent transactions carried out in the government's Integrated Financial Management Information System (IFMIS).

While the human costs of the January 2015 floods in Southern Malawi are significant, the economic impact is likely to be more muted. Damage has been estimated at a value equivalent to 5.0 percent of GDP. The floods are also projected to reduce GDP growth in 2015 by 0.56 percent. However, the impact of the floods on growth is likely to be offset by reconstruction efforts financed through increased foreign grants.

The rate of inflation remains stubbornly high, averaging 23.8 percent in 2014. This high rate of inflation continues to adversely affect economic outcomes and business confidence. It also has a significant negative impact on real incomes, particularly for the poor.

In 2014, Malawi recorded broad-based growth in its exports, with the export of tobacco making a particularly significant contribution. The value of merchandise exports grew 6.8 percent over 2014, with the value of tobacco exports increasing by 11.1 percent. Resilient growth across Sub-Saharan Africa, particularly amongst Malawi's immediate neighbors, continued to create a growing demand for Malawi's tradables.

The suspension of uranium production at the Kayelekera mine in early 2014 was a blow to Malawi's efforts to broaden the range of exports. As a result of this suspension, uranium exports slumped. With global demand for uranium set to remain depressed for some time, it is unlikely that prices will increase to the point where restarting operations becomes viable in the immediate future.

With the loss of budget support and reduced confidence in the use of Government systems for foreign aid disbursement since the "cashgate" scandal, Malawi's fiscal position has come under significant pressure. In the 2013/14 fiscal year, the total value of grants received stood at barely a quarter of that expected at the time of the preparation of the budget. In proportion to GDP, the total value of grants declined from 14.5 percent in 2012/13 to 4.4 percent in 2013/14. Reductions in development expenditures were offset by increases in recurrent expenditure over the same period. Better than expected performance in the area of the collection of tax and non-tax revenues partially offset the decline in grant financing, although not to the extent of avoiding the running of a significantly enlarged fiscal deficit.

Thus, the net effect of these various factors was a substantial increase in the size of the budget deficit in the 2013/14 fiscal year. The deficit reached a value equivalent to 8.6 percent of GDP, up from 1.3

percent in 2012/13. In addition, the Government accrued a substantial stock of domestic payment arrears over the year, with the value of these arrears reaching the equivalent of 7.9 percent of GDP. The buildup of these arrears was largely the result of fiscal indiscipline and expenditure overruns.

After a period of volatility, the exchange rate for the Kwacha has stabilized, albeit at lower levels than was previously the case. Speculation in the “lean foreign exchange season” placed the value of the Kwacha under pressure, exacerbated by a lack of confidence created by the widespread misperception that Malawi was operating a “zero aid” budget. After depreciating by some 20 percent, the value of the Kwacha stabilized, following revisions to banking sector liquidity reserve requirements and a debt swap transaction that boosted gross official reserves by USD 250 million.

Malawi's public debt has increased sharply over recent years with servicing costs now close to levels recorded prior to the 2006 debt relief. Total public and publicly guaranteed debt reached an estimated value of USD 2.59 billion by the end of 2014 (equivalent to 69.6 percent of GDP). Increases have been driven by growth in both domestic and external debt. Annual debt service costs are now at a value equivalent to 5.3 percent of GDP.

MACROECONOMIC OUTLOOK

Malawi is at risk of becoming stuck in a low level equilibrium, characterized by a large fiscal deficit, a high rate of inflation, rising debt and recurring public financial management problems. These factors trigger uncertainty in policy formulation, which result in declining business confidence and investment, in turn making the fiscal deficit more difficult to close. The key policy challenge for 2015 is to break out of this cycle and reestablish macroeconomic stability.

The underlying fundamentals for Malawi's medium term growth prospects are improving. Growing regional demand and improved cross-border infrastructure create increased opportunities to maximize the benefits of Malawi's natural endowments. However, poor and uncertain economic policies; the high cost of doing business; and an uncondusive regulatory environment dampen Malawi's growth prospects.

Short-term economic performance is highly dependent on the restoration of macroeconomic balances. In particular, the running of a large fiscal deficit results in increased domestic borrowing and arrears. This has resulted in sharply lower private sector confidence. Similarly, persistently high inflation rates erode incomes and discourage investment.

Therefore, the Government must make increased efforts to achieve fiscal consolidation. In particular, to restore fiscal balances, the Government needs to manage expenditure tightly, with particular focus on containing the public sector wage bill and subsidy programs such as the Farm Input Subsidy Program (FISP), both of which weigh heavily on the budget.

With Malawi's economy heavily dependent on aid, changes in development partner sentiment have a significant impact on the budget. Despite characterizations of a “zero aid” budget, the Government continues to receive a significant amount of foreign aid from development partners. However, un-earmarked budget support is only likely to resume once core public financial management weaknesses have been addressed. Efforts are being made to rebuild controls and integrity in public finance, but tangible progress will be needed in order to rebuild public confidence.

The Government will need to continue to apply a tight monetary stance in order to ensure that inflation remains under control. With increased fiscal discipline and a reduced need to engage in domestic public sector borrowing, year-on-year inflation is expected to begin to decline to an average of 18.1 percent over 2015.

Lower global oil prices will result in a decrease in the cost of oil imports, which may offer some additional and timely relief on inflation. Lower prices in 2015 may result in Malawi's oil import bill falling by up to 19.7 percent. However, so far, the impact of the decline in international oil prices on domestic pump prices has been blunted by exchange rate weakness and high inbound logistics costs.

With Malawi facing significant challenges in 2015, the key priority is to take steps to restore macroeconomic stability and to rebuild confidence in the economy. Priority actions to help break Malawi out of the current low level equilibrium can be summarized as follows:

- **Fiscal consolidation** and a reduction in the size of the budget deficit;
- **The application of a tight monetary policy** and scaled back domestic borrowing to gradually reduce inflationary pressures;
- **The reform of key subsidy programs, particularly FISP**, in order to reduce fiscal pressures and to improve policy effectiveness;
- **Implementation of public financial management reforms in prioritized areas** to rebuild confidence in the integrity of Government accounts.

Malawi is projected to record a rate of growth of GDP of 5.1 percent in 2015. The achievement of this rate is premised on the continued expansion of the agricultural and wholesale and retail trade sectors. It also assumes that the Government will continue to exert efforts to consolidate public expenditure; to strengthen the integrity of public finances; and to restore internal and external balances. The net effect of the January 2015 floods on GDP growth over the year is expected to be neutral as the impact of the floods is offset by recovery and reconstruction work.

BUILDING TRADE COMPETITIVENESS

Over recent years, Malawi has failed to achieve its full potential in terms of export performance. Thus, the export sector currently provides only a limited contribution to growth in per capita income. Similarly, macroeconomic and fiscal management problems have served to undermine trade competitiveness.

Malawi's economy also continues to be affected by a large, structural current account deficit and perennial stress on the Kwacha. The concentration of exports in a limited number of sub-sectors and seasonality of earnings leaves Malawi vulnerable to external shocks and reinforces fiscal pressures.

Contributing to the sub-optimal performance of the export sector is the fact that it continues to be dominated by a very small number of large firms. Regulatory barriers, high transaction costs and non-transparent procedures act as a barrier to new entrants. Because of these and other factors, the success rate of new exporters has been very low.

Terms of trade have moved against Malawi over recent decades, with the unit value of exports falling compared to the unit value of imported

goods. This means that the country has to trade an increasingly large volume of exports to pay for the same volume of imports.

However, a fast growing regional economy and a simplification of trade procedures create opportunities for Malawi to gain greater benefits from international trade. In addition to improved macroeconomic policies and improved stability, three key reforms to build competitiveness through reduced trade costs include the following:

- The **removal of a range of domestic policies that depress the performance of the export sector** such as **removing remaining export bans** and **ensuring that no new ones are introduced; reviewing existing import and export licenses; and streamlining the manner in which remaining licenses are applied.**
- The need to **review and publish existing trade regulations** and their application to reduce costs, delays, and uncertainty;
- The need to consistently and fully implement policy decisions that have been taken to ensure a **more predictable trading environment** for existing firms and potential investors.
- Reforms to **improve border crossing times** and reduce delays by full implementation of Government's decision to reduce the number of agencies present at the border.
- Reforms to **reduce barriers to competition in the transport** sector in order to encourage entry and to reduce transport prices.

1. ECONOMIC DEVELOPMENTS

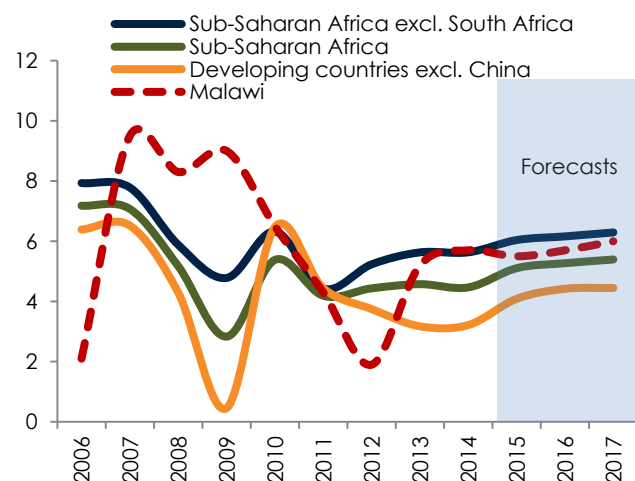
Malawi's growth recovery continues, but faces significant policy headwinds

1. Malawi's economy has continued to grow at a moderate pace. In 2014, the rate of growth of GDP stood at 5.7 percent, a modest increase compared to the rate of 5.2 percent recorded in the previous year. Although the prospects for growth in 2015 and 2016 are generally positive, there are a number of significant downside risks. In particular, the rate of inflation, while beginning to trend downwards, has remained persistently high, at 19.7 percent in February 2015. Lending rates, which have fluctuated above 35 percent, also remain high, while the Government's fiscal position remains weak in an already constrained environment. The limited fiscal space leaves little room for the Government to absorb shocks, such as those resulting from the floods in January 2015, which affected Malawi's southern districts.

2. The relatively high rate of economic growth recorded in 2014 was primarily driven by the growth of the agricultural; information and communication; and wholesale and retail trade sectors. In the 2014 crop production season, Malawi recorded good harvests, primarily as a result of favorable climatic conditions. The Agriculture Production Estimates Survey shows that the outputs for most crops, including tobacco, maize, rice, pulses and potatoes, increased significantly over the year. In particular, the production of tobacco increased by 14 percent compared to the previous year, with a total volume of 192.0 million metric tons in 2014, compared to 168.6 million metric tons in 2013. This increase in production was largely driven by the increased availability of inputs and by expectations of higher prices. Over the tobacco marketing season, which opened in March and closed in September, the total value of sales of tobacco reached USD 361.6 million, with an average price of USD 1.85 per kg. This compares to a total value of USD 361.7 million during the same period in 2013, when the average price stood at USD 2.15 per kg. Despite this impressive performance, the rate of growth for a number of other traditional crops, including tea, sugar and cotton, was more restrained. Amongst the other sectors, growth in the information and communications sector was driven by activities related to the general elections, while the increased availability of foreign exchange and fuel as well as public spending drove growth in the wholesale and retail trade sectors.

Figure 1: Malawi's rates of growth are close to regional averages

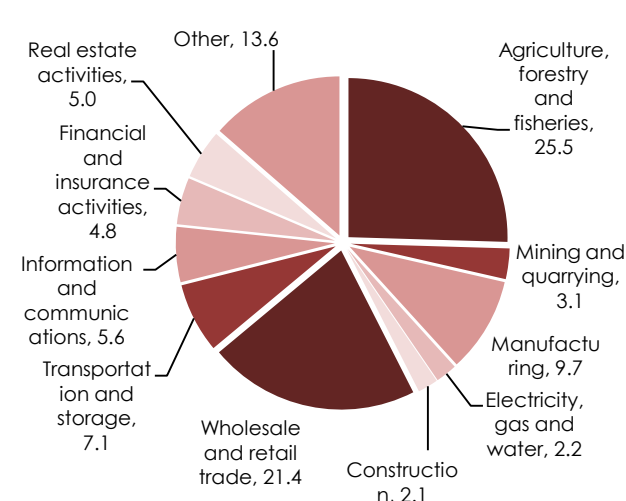
GDP growth adjusted for inflation, annualized (percent)



Source: World Bank Global Economic Prospects

Figure 2: The most significant sectors are agriculture, forestry and fisheries, and wholesale/retail trade

GDP shares (percent of total), 2014



Source: MoFEPD, IMF and World Bank staff calculations

3. Macroeconomic imbalances and uncertainties related to Government policy are beginning to have a negative impact on the economy. Following the "cashgate" public financial management scandal in 2013, the withdrawal of budget support placed the Government's fiscal accounts under enormous pressures. These pressures resulted in a substantial increase to the budget deficit, which reached a value equivalent to 8.6 percent of GDP in the 2013/14 fiscal year, compared to 1.3 percent in 2012/13. In turn, this resulted in a significant expansion in domestic public sector borrowing. During the same period, the Government also recorded substantial payment arrears, with the value of these arrears estimated at MWK 158 billion (equivalent to USD 400 million, or 7.9 percent of GDP). In addition, a number of factors, including a persistently high rate of inflation; high

interest rates; a large structural current account deficit; and pressure on the local currency, all contributed to a decline in the level of confidence of the private sector.

4. Despite the significant human costs of the January 2015 floods in Southern Malawi, the effects on economic growth are likely to be limited. An estimated 89,000 hectares of cropland was destroyed by the floods, representing around 2.4 percent of total agricultural land in Malawi. Estimates from the Post Disaster Needs Assessment put the total value of damage and losses, including to agricultural crops, housing, commerce and public infrastructure at around USD 324 million (equivalent to 5.0 percent of GDP). Production of key cash crops (tobacco, tea and sugar) has not been affected by the floods. Initial fears of disruption to Malawi's key economic infrastructure, particularly its power generating, water supply and transport infrastructure appear to have receded. Very high rates of poverty and vulnerability among the population in the affected areas points to the need to improve resilience and safety nets. It also means that the impact of the floods on GDP growth will be muted. The negative impulse of the floods on GDP growth in 2015 is estimated to be 0.56 percent of GDP. This is likely to be offset by recovery and reconstruction efforts financed via increased foreign grants. As such the net impact of the floods over the course of 2015 is projected to be neutral.

5. Across Sub-Saharan Africa, in 2014, rates of economic growth are projected to increase to an average of approximately 4.5 percent, compared to a rate of 4.0 percent recorded in 2013. Excluding South Africa, the overall rate of growth for Africa was higher than in any other developing region, with the exception of the China (World Bank 2015). In particular, Nigeria, which has the region's largest economy, recorded strong growth, with this growth being driven by a buoyant non-oil sector. In addition, growth rates were high in many of the region's low-income countries, including in Malawi's neighbors, Mozambique and Tanzania. However, a number of countries recorded a less impressive performance. In particular, the rate of economic growth slowed markedly in South Africa, with strikes in the mining sector, electricity shortages, and low levels of investor confidence being significant factors. The rate of growth also declined in Zimbabwe, largely due to a weak mining sector and a precarious external position. Elsewhere, the Ebola outbreak severely disrupted economic activity in Guinea, Liberia and Sierra Leone.

6. Investment in public infrastructure; increased levels of production in the agricultural sector; and an expanding services sector were key drivers of growth across the Africa region. Investments in infrastructure, including ports, electricity generation facilities, and transportation helped to sustain growth. In terms of agriculture, a record maize harvest in Zambia more than offset the decline in levels of copper production. However, the overall value of foreign direct investment flows, an important source of financing of fixed capital formation in the region, declined, reflecting an overall decrease in the rate of growth in emerging markets and soft commodity prices.

Fiscal policy has been under significant pressure

7. In the 2013/14 fiscal year, the value of grants received by the Malawi Government was barely a quarter of that expected at the time of budget preparation. The gap was largely the result of the withdrawal of support by development partners following the "cashgate" scandal². This loss of confidence resulted not only in the almost total loss of budget support (program grants), but also in a sharp decline in the value of dedicated and project grants that are on-budget.³ As a share of GDP, the value of grants declined from 14.5 percent in 2012/13 to 4.4 percent in 2013/14.

8. Reductions in development expenditures were offset by increases in current expenditure over the same period. With a decline in the value of foreign grants, the value of development expenditures declined from the equivalent of 8.6 percent of GDP in 2012/13 to 6.4 percent of GDP in 2013/14. However, the pace of current expenditure accelerated during 2013/14, just at a time when the Government was least able to afford such an expansion. The most significant increase was in the cost of debt service payments, principally involving domestic debt, with the total cost of these payments increasing from the equivalent of 2.4 percent of GDP in 2012/13 to 6.0 percent in 2013/14. The total cost of the public sector wage bill also increased from the equivalent of 8.0 of GDP

² In September 2013, revelations arose of misappropriation of significant amounts of public funds through fraudulent transactions carried out in the government's Integrated Financial Management Information System (IFMIS).

³ In the terminology of the Malawi Government's budget, grants are divided into three classifications: (i) "program grants", which includes grants provided as budget support (similarly, loans provided as budget support are termed "program loans"); (ii) "dedicated grants", which includes grants provided for the financing of sector-wide approaches, pooled arrangements and basket funds; and (iii) "project grants", which includes regular project assistance that is included as part of the budget. Other grants received that are disbursed outside of the budget, through for example non-governmental organizations, are not included in the budget but are listed as a separate annex to the budget document.

in 2012/13 to 8.7 percent 2013/14. Expenditure on goods and services declined somewhat, from 11.9 percent of GDP to 11.2 percent, as the Government attempted to constrain the growing deficit. At the same time, the cost of subsidy programs, particularly the Farm Input Fertilizer Subsidy Program (FISP), continued to weigh heavily on the budget.

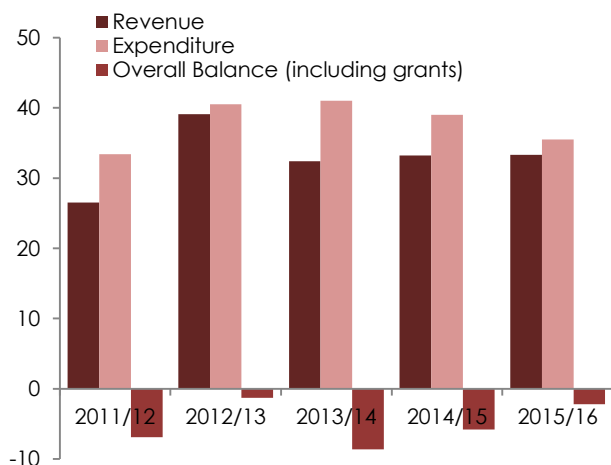
9. In 2013/14, better than expected performance in terms of tax and non-tax revenue collection partially offset the losses resulting from reductions in grant financing. However, this was insufficient to avoid the running of a significantly enlarged fiscal deficit. The value of tax revenues increased from the equivalent of 22.3 percent of GDP in 2012/13 to 24.6 percent in 2013/14, with a strong performance in the collection of all sources of tax, including corporate, personal and value added tax. The strong performance was largely the result of the continued growth recovery of Malawi's private sector. Intensified efforts by the Malawi Revenue Authority (MRA) and the introduction of modernized technology and electronic fiscal devices that allow for the calculation of VAT payments at the point of sale in wholesale and retail outlets also appear to be having a positive impact.

10. The net effect of these various factors was a substantial increase in the budget deficit in 2013/14. Despite improved revenue performance, the sudden loss of grant financing and the continued growth in current expenditure resulted in the fiscal deficit reaching the equivalent of 8.6 percent of GDP in 2013/14, up from 1.3 percent in 2012/13. With dramatically reduced foreign financing, the bulk of the increased deficit was financed by high cost domestic borrowing, requiring increased current expenditure on debt service payments, which in turn exacerbated the increase in the fiscal deficit.

11. In addition, the Government accrued a substantial stock of domestic payment arrears during 2013/14, largely as a result of the breakdown in fiscal discipline. The total value of outstanding arrears, owed mostly to utilities and private creditors (including a significant share to suppliers of fertilizer and seeds procured by the Government under FISP) reached the equivalent of 7.9 percent of GDP, with the value of these arrears standing at MWK 158 billion (equivalent to approximately USD 400 million). These arrears are essentially a form of off-balance sheet domestic borrowing that takes liquidity out of the domestic private sector and undermines future investment. In January 2015, in an effort to regularize the arrears, the Government began to issue zero-coupon bonds to holders of arrears as a means of securitizing the debt and bringing it on-budget.

Figure 3: Government's fiscal position is expected to remain under pressure...

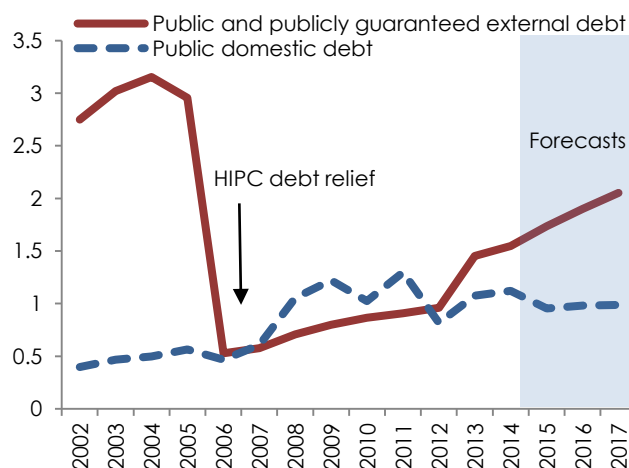
Revenue, expenditure and budget deficit, percent of GDP



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

Figure 4: ...leading to rising debt levels

USD billions



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

Public sector debt is rising

12. The level of Malawi's total public and publicly guaranteed (PPG) debt has increased sharply over the last three years. The total value of PPG debt increased from USD 1.56 billion in 2012 (equivalent to 49.7 percent of GDP); to USD 2.38 billion in 2013; and to an estimated USD 2.59 billion in 2014 (equivalent to 69.6 percent of GDP). These increases, which reflect growth in both domestic and external debt, have been largely driven by increased recourse to domestic financing in the wake of external financing shortfalls resulting from reductions in foreign grants to Government and from the bringing on-budget of significant past domestic payment arrears that had previously been off-budget. As explained previously, the Government has brought many of these arrears on-

budget by issuing zero-coupon bonds. The rate of growth of the total value of external debt, which grew briskly during 2012 and 2013 as a result of donor commitments to Malawi, has been subdued following the 2013 public financial management scandal. However, the sale in late 2014 of existing domestic debt to the COMESA PTA Bank resulted in a transfer of domestic debt to external debt. The transaction provided a USD 250 million cash injection to official resources, resulting in increased levels of confidence in the Kwacha while also reducing the cost of debt service. However, aggregate debt levels are now approaching those seen prior to the implementation of the debt relief initiative implemented under the Highly Indebted Poor Countries (HIPC) program. Similarly, while the bulk of the country's debt is highly concessional, significant values of higher cost, non-concessional debt have been contracted in recent years. Thus, Malawi is exposed to growing risks of debt distress and is particularly vulnerable if the value of the Kwacha depreciates, which would increase the burden of foreign-denominated debt service and repayments.

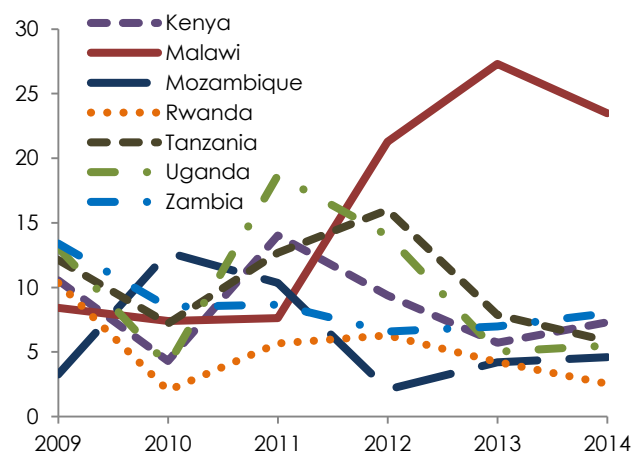
Inflation remains stubbornly high

13. The rate of inflation in Malawi is significantly higher than the regional average, with inflationary pressures continuing to have a negative impact on the Malawian economy. The rate of inflation began to decline in the first quarter of 2014, following significant increases to the prices of both food and non-food items in the fourth quarter of 2013. However, upward pressure increased in the second half of the year, mostly as a result of non-food inflation, which in turn was exacerbated by the weakness of the local currency. With these fluctuations, by the end of 2014, the annual average headline inflation rate stood at 23.8 percent, compared to a rate of 27.3 percent at the same point in 2013. This high rate contrasts with average rates across the sub-Saharan region, where the tendency was towards a decline resulting from a moderation in both oil and non-oil commodity prices; good harvests; and macroprudential tightening.

14. The high rate of inflation in Malawi is largely driven by non-food inflation, although the decline in the global price of oil may offer some respite. The high rates of non-food inflation generally reflected movements in the exchange rate, with the overall tendency being towards a decline in the value of the local currency. By contrast, the rate of food inflation began to decline at the beginning of the year as the retail price of maize edged downwards. However, there was a seasonal rise in this rate as maize became scarce. The average annual rate in urban areas stood at 32.5 percent, compared to an average rate of 30.0 percent in rural areas, with the difference attributable to the upward pressure on urban inflation that resulted from the relatively greater significance of the non-food element.

Figure 5: Inflation has been very high, especially by regional standards

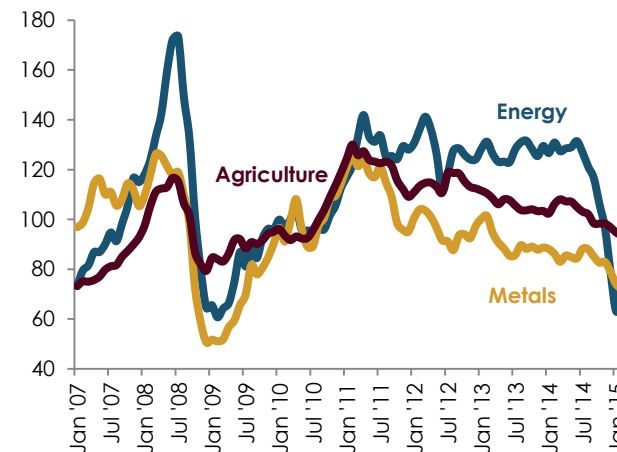
Headline annual inflation, percent, year-on-year



Source: IMF World Economic Outlook

Figure 6: Commodities prices, particularly energy prices, are on a declining trend

Commodity price indices, 2007-2014, 2010= 100



Source: World Bank Development Prospects Group

Note: Data as of February 2015

15. Sustained high rates of inflation may have a significant negative impact on economic outcomes and rates of poverty. Most significantly, inflation may result in declines in real income at the household level. Given that household incomes rarely rise as rapidly as costs, a persistently high rate of inflation erodes purchasing power and discourages saving, with the burden felt most keenly by the poor (see Box 2). In addition, a high rate of inflation has exacerbated uncertainty amongst investors and in the operation of debt markets, and increased the cost of public borrowing.

After a period of volatility, the Kwacha has stabilized

16. The value of the Kwacha depreciated by 20 percent against the US Dollar in late 2014 during the traditional “lean foreign exchange” season. Malawi experiences significant seasonal volatility in its foreign exchange inflows, with earnings from the key tobacco export crop concentrated during the March to August period. In contrast, key import requirements, such as fertilizer procured for the FISP, are sourced during October-December. This leads to a cyclical pattern of upward pressure on the Kwacha during the tobacco earnings season, followed by downward pressure during the “lean” season. Normal cyclical patterns, combined with limited foreign currency reserves, resulted in early pressure on the Kwacha from October 2014. This pattern appears to have been exacerbated by negative perceptions in foreign exchange markets regarding the economic outlook for Malawi, with these perceptions perhaps resulting from a misunderstanding regarding Malawi’s “zero aid” budget.

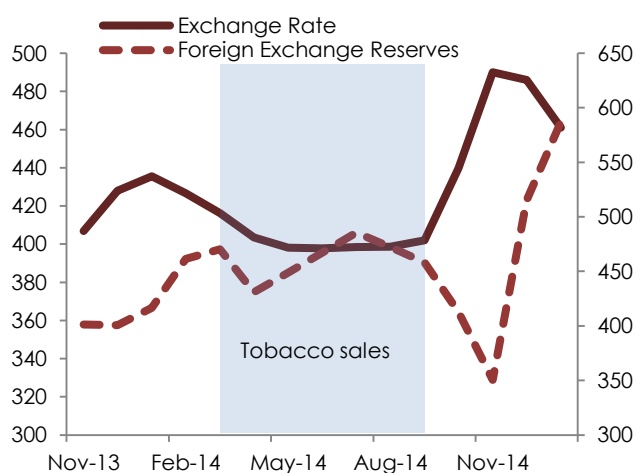
17. While the level of foreign aid flowing through Government systems has fallen considerably in the 2014/15 budget, the value of net official development assistance inflows into the country remains broadly unchanged, at an estimated USD 1 billion per year. However, a greater proportion of these financial resources are currently channeled outside the budget. Despite this, throughout much of the private sector, there has been a widely shared belief regarding the potential negative impact of the “zero-aid” budget, with many parallels drawn with the painful “zero deficit” budget of 2011.

18. The decline in the value of the Kwacha in the third and fourth quarters exacerbated inflationary pressures and resulted in a widening of the 2014/15 fiscal deficit. Key budgetary outlays, in particular the costs of the FISP program, through which the purchase of all fertilizer and seeds is contracted in US dollars, placed the entire exchange rate risk on the Government. The budget was prepared on the assumption of an exchange rate of MWK 400 : USD 1, while the actual expenditure on imported fertilizer involved exchange rates closer to MWK 500 : USD 1.

19. The value of the Kwacha stabilized in December, due to improved levels of confidence and an increase in foreign exchange reserves. The increase in the value of the Kwacha and the stabilization of the exchange rate was largely the result of debt sold to the COMESA PTA Bank, with a total value of USD 250 million; a directive to commercial banks to meet liquidity reserves on foreign exchange in the local currency; and the effect of guidelines that mandated a daily minimum trade amount of USD 250,000 to justify movements to the exchange rate by foreign exchange dealers.

Figure 7: Thin reserves and seasonality in export earnings, drives exchange rate instability

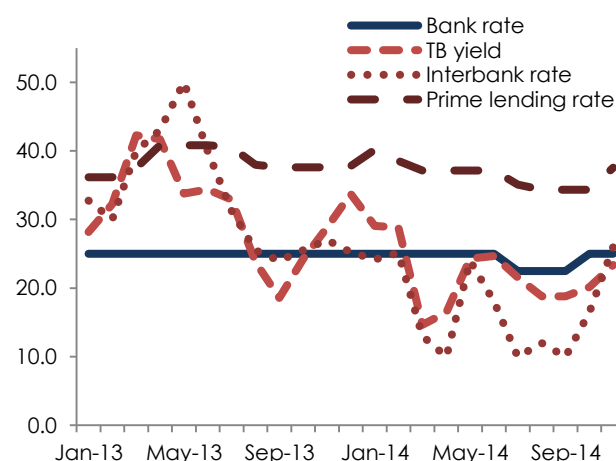
USD/Kwacha exchange rate (LHS) and gross official resources in USD millions (RHS)



Source: World Bank staff based on Reserve Bank of Malawi data

Figure 8: Interest rates are edging down

Policy interest rate, treasury bill rate, interbank rate and average prime lending rate, percent



Source: World Bank staff based on Reserve Bank of Malawi data

20. Efforts to rebuild reserves achieved positive results in the final months of the year, with import cover rising to 2.4 months at the end of 2014. Gross official resources rose to a value of USD 515.5 million (equivalent to 2.4 months of import cover) by the end of December 2014, compared to the level at the end of 2013, when the value of these resources stood at USD 397.0 million (2.0 months of import cover).

An accommodative monetary stance has allowed inflationary pressures to remain

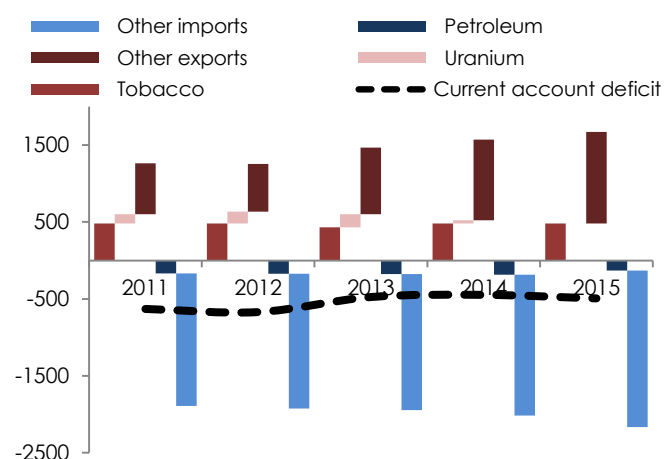
21. The Government has maintained a tight monetary policy, despite a temporary reduction in the policy rate by the Reserve Bank of Malawi (RBM). The lowering of the policy rate in July 2014, from 25.0 percent to 22.5 percent, appears to have been enacted prematurely, as shown by the later decision by the Monetary Policy Committee to reverse the rate reduction in October 2014. Inconsistent macroeconomic policy has sent mixed signals to the public and dampens confidence in the credibility of Government policy. Nonetheless, the RBM has remained committed to the implementation of a flexible exchange rate regime to align the nominal exchange rate to domestic and international fundamentals, despite significant pressure to intervene in foreign exchange markets. This maintains a key policy commitment adopted in the aftermath of the 2011/12 economic and governance crisis.

Export performance is driven by increased tobacco earnings

22. Demand conditions in Malawi's key export markets have remained benign, with a slow growth in developed markets being offset by stronger growth in Sub-Saharan Africa. As indicated above, global commodity prices have been on a broadly downward trend, with prices for Malawi's key agricultural commodities recording a corresponding decline over the year. However, the decline in the price of global commodities has had some positive impacts on the external account, given that Malawi is a net oil importing nation. The decline in oil prices, particularly during the final quarter of 2014, when international oil prices fell below USD 60 per barrel, offered some respite to Malawi at a time when the country was experiencing a decline in the purchasing power of the Kwacha.

Figure 9: Malawi runs a large and structural current account deficit

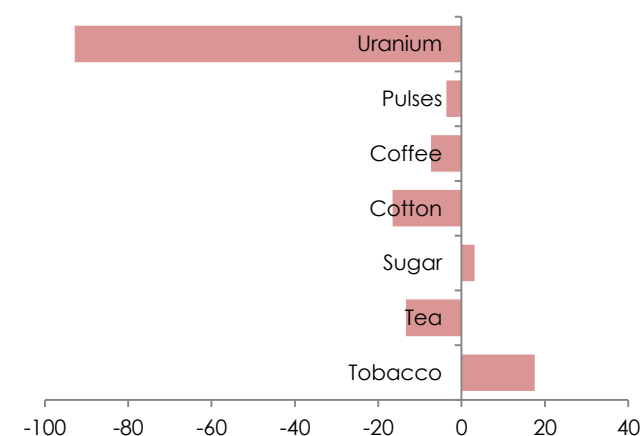
Exports and imports, USD million



Source: World Bank staff based on MoFEPD and IMF data

Figure 10: ...with sector growth rates showing a mixed picture

Exports by type, 2014 change from the previous year, US dollar terms, percent



Source: World Bank staff based on MoFEPD and IMF data

23. The strong performance of the export sector in 2014 was largely due to the high level of tobacco revenues and broad based growth across the smaller export sub-sectors, with these factors helping to offset a sharp decline in uranium exports. The total value of Malawi's merchandise exports grew by 6.8 percent over the year, with a figure of USD 1.57 billion in 2014 compared to USD 1.47 billion in 2013. Over the year, there was a significant rise in the volume of tobacco exports, a key export commodity, with the total value of these exports being partially offset by a decline in prices on global markets. By contrast, both the volume and value of exports of a range of other commodities, including uranium, tea, cotton and pulses, declined, with the fall in prices on global markets being a partial factor. In particular, the volume of the export of uranium declined drastically, largely due to the suspension of uranium production at the Kayelekera uranium mine, with this suspension resulting from sustained low global prices, which rendered the operation non-viable.

24. Over the year, tobacco exports accounted for approximately a third of the total value of Malawi's exports. The total value of processed tobacco exports is estimated to reach USD 480.7 million in 2014, up from USD 432.8 million in 2013, which represents a growth of 11.1 percent. The increase in the volume was largely due to increased levels of production in 2014 and the large carry-over of stocks from the preceding year. The performance of other

commodities was more mixed, with year-on-year declines for pulses, coffee, cotton and tea. There was a modest increase in the value of sugar exports.

25. The suspension of uranium mining at the Kayelekera mine in early 2014 was a blow to Malawi's efforts to broaden the composition of its export basket. Mine operations ceased in February 2014, with processing ending in May. This resulted in the gross value of uranium exports amounting to a total of just USD 40.4 million in 2014, a dramatic decrease from the figure of USD 169.9 million recorded in the previous year. The performance of this sub-sector suffered from weakening international demand for uranium ore, exacerbated by the lack of low cost and reliable grid electricity at Kayelekera, which resulted in production becoming uneconomical. The global slump in uranium prices means that production is unlikely to resume in the immediate future (see Box 1).

Box 1: Hopes of export diversification through uranium mining appear to have stalled

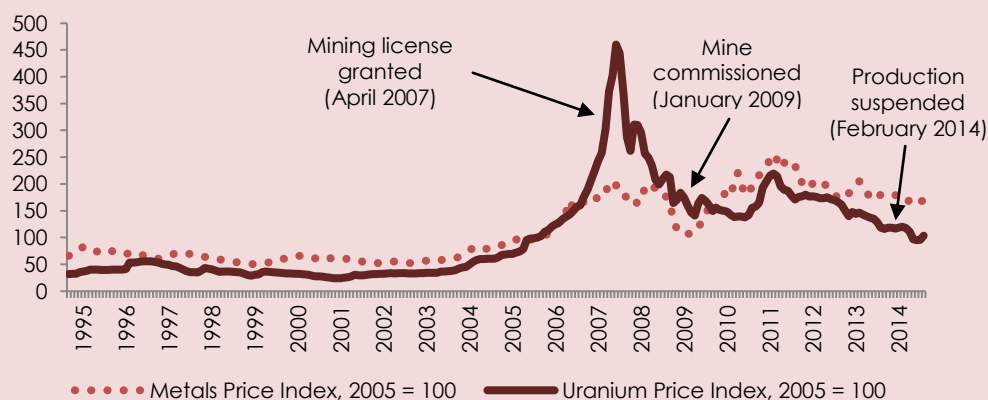
Malawi's export basket is one of the least diversified among developing countries, leaving the country vulnerable to sector-specific shocks. Numerous strategies and action plans have been formulated to facilitate the development of a broader range of export products, thereby reducing dependency on the export of tobacco, Malawi's so-called "green gold."

The award of a mining license in April 2007 to an Australian mining firm to exploit uranium deposits at the Kayelekera site in northern Malawi raised hopes that mining might facilitate the process of diversification. In addition, the project was considered to be a test case of Malawi's ability to attract and absorb large-scale foreign direct investment into a greenfield site.

The volume of production from the mine reached 1,134 tons in 2013, with the annual value of exports of uranium ore peaking at USD 170 million in 2013, at which point it accounted for 11.6 percent of the total value of exports. However, in February 2014, mining operations at Kayelekera ceased, with production ending in May and with its operators placing the facility on care and maintenance. With this move, it seems that the hopes for uranium to become a key export commodity for Malawi must be put on hold.

Figure 11: Boom and bust for global uranium prices

Minerals and uranium commodity price indices



Source: World Bank staff based on IMF data

A number of reasons have been cited for the decision to suspend the mine's operations. Firstly, mining at Kayelekera is highly sensitive to movements in global uranium prices. In addition, the lack of access to cost effective and reliable grid sources of electricity and the resultant dependency on diesel generators reduced economic rates of return. High inbound and outbound transport costs also eroded competitiveness.

Perhaps most significantly, uranium was trading at USD 110 per pound when the mining license to develop the Kayelekera site was granted. The feasibility study assumed a minimum price of USD 60 per pound throughout the productive life of the mine. As it turned out, the top of the uranium commodity price cycle appears to have occurred in 2007. By the time the mine was commissioned in January 2009, prices had already halved to USD 51 per pound, with global supply exceeding the weakening level of demand. Next, the Tohoku earthquake in Japan and the meltdown at the Fukushima Nuclear Power Plant in March 2011 triggered changes in the level of demand for uranium for civil nuclear power generation across the developed world, which exacerbated the decline in prices. By the time mining ceased at Kayelekera in February 2014, uranium was trading at just USD 36

per pound.

According to company sources, prices would need to be in the USD 65-70 per pound range for production to resume. The mine has an estimated six years of ore remaining in proven/probable reserves, although the developer is conducting exploratory work in order to extend the life of the mine to a minimum of ten years.

Whether or not the mine at Kayelekera eventually resumes operations will depend primarily on future prospects for global uranium prices, for which the immediate outlook is uncertain. Similarly, without an improved energy infrastructure and a more predictable and consistent regulatory framework for mining operations, it will be challenging to attract significant amounts of new investment to develop mining in Malawi.

Continued import growth and a large structural deficit on the current account

26. The easing of foreign exchange challenges and an increase in disposable incomes, largely as a result of good harvests, drove an increase in the rate of growth of imports. In 2014, the total value of merchandise imports reached USD 2.02 billion, representing an increase of approximately 3.8 percent compared to 2013. The value of imports of petroleum products also rose modestly, to USD 183.0 million.

27. Malawi's current account deficit widened in 2014. The value of this current account deficit increased from the equivalent of 1.8 percent of GDP in 2013 to 5.1 percent of GDP in 2014, primarily due to the large decline in grants resulting from the suspension of donor support following the public financial management scandal. Excluding grants, the merchandise trade balance decreased slightly from the equivalent of 12.4 percent of GDP in 2013 to 10.5 percent in 2014.

28. As a net oil importer, Malawi stands to benefit from the decline in global oil prices, as a result of lower import costs and lower rates of inflation. In the second half of 2014, the impact of falling global oil prices was largely offset by a depreciation in the value of the Kwacha relative to the US Dollar. With a stabilization in the value of the domestic currency towards the end of 2014, lower global oil prices have begun to result in lower fuel prices in Malawi. So far, around 46 percent of the decline in global oil prices have "passed through" to lower fuel pump prices in Malawi (see Box 4).

The financial sector shows signs of strain

29. A volatile exchange rate and the resulting high interest and inflation rates continue to pose challenges in the financial sector. Of the eleven commercial banks operating in Malawi, the financial sector is dominated by two privately owned banks. In terms of capital adequacy, the Tier 1 capital ratio for the sector as a whole stood at 13.7 percent in December 2014, compared to the new prudential benchmark of 10.0 percent. This was helped by the recapitalization of a number of banks in 2014. The banking sector continued to see a high level of profitability, with the rate of return on equity (ROE) at 30.8 percent as of September, 2014. The rate of return on assets (ROA) is also comparatively high (standing at 4.6 percent in September, 2014, up slightly from the figure of 4.5 percent recorded in March, 2014), partly reflecting high risk in the market.

30. However, asset quality is under pressure, with problems concentrated in Government-owned financial institutions. This is reflected by an increase in the proportion of non-performing loans (NPL) relative to the total value of outstanding loans. The NPL ratio has increased from 11.6 percent in March 2013 to 14.9 percent in December 2014, with a significant proportion of these NPLs being concentrated in state-owned banks.

31. Financial services are becoming more widely available. In 2013/14, financial institutions gradually increased the use of branchless financial delivery mechanisms by issuing smart or debit cards and by implementing point-of-sale or mobile branches, mobile banking and agent banking systems. As a result, the rate of penetration of mobile money has been increasing steadily. The findings of the 2014 FinScope Survey show that there has been an increase in the proportion of the population using formal banking services, from 19 percent (about 1.2 million) in 2008 to 33 percent (2.4 million) in 2013. This has been largely driven by the increased availability and use of transactional products/services facilitated by new innovations such as e-money in the rural areas and by the increased usage of credit and debit cards. Despite these increases, Malawi is still characterized by low levels of outreach. The nonbank microfinance industry remains nascent, with most institutions constrained by limited financial resources; poor physical infrastructure; and a lack of financial literacy.

Policy uncertainty is undermining business confidence

32. The net effect of current Government fiscal and monetary policies, together with perceptions that all foreign aid is being and will continue to be withheld, is undermining private sector confidence. Businesses are confused regarding the direction of Government policy. In particular, having seen the impact of a “zero deficit” budget in recent years, the private sector is concerned about the impact of a so-called “zero aid” budget. It is also skeptical regarding the technical ability of the Government to implement its stated policies. With bank prime lending rates standing at close to 40 percent at the end of 2014, there are few private sector investments that can result in a positive rate of return if financed through commercial loans. Malawi is at risk of becoming stuck in a low equilibrium cycle, characterized by a high level of fiscal deficit; a high rate of inflation; and public financial management problems. These factors trigger uncertainty regarding policy formulation, which results in a decline in the level of business confidence, which in turn leads to a decline in the level of investment and in sluggish growth, which makes the fiscal deficit more difficult to close. The key policy challenge in 2015 will be to break this cycle and to re-establish macroeconomic stability.

Box 2: What are the latest poverty trends in Malawi?

Newly available data from the 2013 Integrated Household Panel Survey (IHPS) provides an opportunity to take stock of poverty trends in Malawi over recent years. The IHPS is a panel survey that follows over time the people living in the households that were interviewed as part of the Third Integrated Household Survey (IHS3) undertaken in 2010/11. The IHPS is designed to be *complementary* to the official poverty analyses based on the IHS, which is typically conducted every five years. Unlike the cross-sectional IHS, the IHPS also allows for understanding movements in and out of poverty for the same group of individuals over time.

The poverty lines used in the IHPS analysis are the same constant real poverty lines used in the analysis of the IHS2 2004/05 and the IHS3 2010/11. The poverty line can be defined as the monetary cost to a given person, at a given place and time, of a reference level of welfare. The total poverty line comprises two principal components: food and non-food. The food poverty line represents the cost of a food bundle that provides the necessary energy requirements per person per day (estimated to be 2,400 kilocalories per person). The non-food poverty line represents an allowance for basic non-food needs. In 2013, the population whose total consumption falls below MK 85,852 are considered to be poor.

Analysis of the IHPS data shows that the rate of incidence of poverty has fallen slightly from 40.2 percent in 2010 to 38.7 percent in 2013.⁴ Urban areas recorded an increase in poverty, while rural areas experienced a decline in the share of those who are poor (although the overall rate of poverty remains much higher in rural areas). The proportion of the population considered poor has declined in the north and the southern region, but risen in the center.

Table 1: Incidence of poverty

Percentage of the population, 2010 and 2013

	2010		2013	
	Estimate	Standard error	Estimate	Standard error
Malawi	40.2	1.8	38.7	1.8
Urban	17.9	4.9	26.2	5.3
Rural	44.0	2.0	40.9	1.9
North	50.2	3.8	43.3	3.9
Center	33.5	2.8	39.0	2.7
South	45.0	2.8	37.3	2.7

Source: NSO and World Bank IHPS

Table 2: Poverty transitions

Percentage of the population, categories are based on original 2010

Location, 2010 and 2013

	Stay non-poor	Become non-poor	Become poor	Stay poor	Total
Malawi	44	17	15	23	100
Urban	67	6	15	12	100
Rural	41	19	15	25	100
North	36	21	14	29	100
Center	48	13	19	20	100
South	43	20	12	25	100

Source: NSO and World Bank IHPS

⁴ Note that due to differences in seasonality, poverty lines estimated with the IHPS data are not directly comparable with those in the IHS. IHS data remains the primary source of official poverty estimates in Malawi. However, the IHPS data provides a snapshot of emerging trends and poverty dynamics ahead of availability of the fourth round of the IHS in 2016. The most recent official poverty estimate, using the national poverty line, is from the IHS3 2010/11 where 50.7 percent of the population were classified as poor. Similarly an estimated 72.2 percent of Malawi's population falls below the international poverty line of USD 1.25 per day.

One of the useful features of a panel survey is that it enables an analysis of the poverty transitions experienced by the population across time. Some two thirds of people remain in their respective poverty status: 44 percent stay out of poverty; and 23 percent stay poor. The remaining third of the population is almost evenly split between the 17 percent that escapes poverty and the 15 percent that become poor. Residents of urban areas experience less mobility across the poverty line than do those in rural areas. Across regions, the degree of upward mobility is considerably higher than downward mobility in both the north and the south, while the opposite is true in the center.

Inequality refers to the distribution of income or, more precisely in this case, levels of consumption among the entire population. One indicator used to assess the evolution of inequality is the share of national consumption held by each quintile. The shares of consumption of the bottom four quintiles increased modestly from 2010 to 2013, while the share of the 20 percent of the population with the highest consumption declined. This finding suggests that inequality is somewhat lower in 2013 than in 2010.

Figure 12: Consumption shares by quintile

Consumption share (percentage) by quintile, 2010 and 2013



Source: NSO and World Bank IHPS

Table 3: Location of the poor

Rates of poverty and percentage of the population, 2010 and 2013

	2010			2013		
	Pover ty (%) pop)	Pop (%)	Poor (%)	Pover ty (%) pop)	Pop (%)	Poor (%)
Malawi	40.2	100.0	100.0	38.7	100.0	100.0
Urban	17.9	14.5	6.5	26.2	14.8	10.0
Rural	44.0	85.5	93.6	40.9	85.2	90.0
North	50.2	9.8	12.3	43.3	9.9	11.1
Center	33.5	46.3	38.5	39.0	46.6	47.0
South	45.0	43.9	49.2	37.3	43.5	41.9

Source: NSO and World Bank IHPS

Regional macroeconomic outlook

33. In general, the medium-term growth prospects for Sub-Saharan Africa are favorable. However, they are also subject to significant downside risks. Regional GDP growth is projected to increase to a rate of 5.1 percent in 2015 from that of 4.5 percent in 2014 before rising steadily to 5.4 percent in 2017. This increase will be supported by sustained investment in infrastructure; increased levels of agricultural production; and the ongoing expansion of service sectors (World Bank 2015). Although commodity prices and capital inflows are expected to provide less support and although the level of demand and economic activity in emerging markets is expected to remain subdued, Sub-Saharan Africa is nevertheless expected to remain one of the fastest growing regions in the world. South Africa, a key investor and source of demand for Malawi, is expected to experience a slow but steady rate of economic growth, helped by improving labor relations; gradually increasing net exports; and reforms to alleviate bottlenecks in the energy sector.

34. In 2015, the global prices of oil, metal and agricultural commodities are expected to continue to decline. The slowdown of the construction sector in China, the world's largest metal consumer, is expected to exert significant downward pressure on the demand for and on the prices of metals. The supply of oil and metals is projected to increase through 2015-17, with producers increasing output despite the decline in prices. This increased supply is expected to be absorbed by growing demand as the global recovery gathers momentum. As a result, commodity prices are expected to recover somewhat in 2016-17.

35. A lower rate of growth in emerging economy export markets is the main external risk to the regional outlook. In particular, a worse-than-expected slowdown in China would reduce the level of demand for commodities, exerting further downward pressure on prices, especially considering that supply is abundant. On the whole, a sharper-than-expected decline in the price of oil would have an adverse impact on the Sub-Saharan Africa region, even though net oil importers such as Malawi would gain. In a simulation involving a decline in the price of oil by 15 percent from the baseline, Sub-Saharan Africa would experience a deterioration in its trade balance by an average of nearly two percent of GDP (World Bank 2015).

Growth prospects for Malawi

36. Based on economic fundamentals, the medium term prospects for Malawi's growth are gradually improving. The country is well endowed with agricultural, water and mineral resources. The risks of food security challenges,

which periodically dogged growth performance during the 1990s and 2000s, have declined. Similarly, Malawi is moving past the worst of its health-related challenges, particularly those created by the HIV/AIDS epidemic, which undermined human capital development to a significant extent. Much of Sub-Saharan Africa is experiencing robust growth. In particular, Malawi's neighbors, including Mozambique, Zambia and Tanzania, are all experiencing sustained high rates of economic growth, with this growth creating a growing regional base of demand for Malawi's produce. Major new infrastructure projects, such as the Nacala Rail Line and the proposed Malawi-Mozambique interconnector, have the potential to result in a higher level of integration between Malawi and the regional economy.

37. However, Malawi's medium term economic performance in 2015 and 2016 is dependent on the restoration of macroeconomic balances and, in particular, on improved fiscal management. The running of a large fiscal deficit has resulted in significant increases to the level of domestic borrowing; poor expenditure discipline; and the build-up of significant domestic payment arrears. All of these have done significant damage to Malawi's economic outlook. Business confidence is only likely to rebound once inflation and interest rates begin to decline. In turn, this is dependent on fiscal consolidation; a further intensification of revenue collection; and improved expenditure discipline. The restoration of external budget support would aid efforts to consolidate the budget and reduce the high costs associated with domestic borrowing. However, this restoration is only likely once the Government has made credible progress in addressing core public financial management weaknesses. Early steps, including the fixing of urgent security weaknesses in the Integrated Financial Management Information System, the preparation of a PFM reform program, as well as the identification of broader reforms by the newly established Public Service Reforms Commission, all point in the right direction. However, the extent of the challenges will require focused implementation of difficult reforms over a sustained period of time. Broader skepticism on the declining effectiveness of Malawi's public sector also serves to dampen investor confidence.

38. On a year-on-year basis, Malawi is projected to record a real rate of growth in GDP of 5.1 percent in 2015.⁵ These projected rates of growth are based on the premise that the agricultural, wholesale and retail trade, and the construction sectors will continue to expand and that the regional demand for Malawi's products will continue to increase. Agricultural growth is expected to be weaker in 2015 compared to 2014 on account of the late and heavy onset of rainfall. Similarly the negative impulse resulting from the January 2015 floods projected to be offset by reconstruction. The economic growth outlook is conditional on continued efforts to consolidate current expenditure and to restore internal and external balances. It is also dependent on efforts to strengthen public financial management to the point where a gradual increase in foreign aid provided through Government systems becomes possible.

Fiscal policy will need to be tightened

39. A key focus of the 2014/15 budget will be to consolidate expenditures and to restore stability to fiscal policy. The 2014/15 fiscal stance provides for a modest degree of fiscal consolidation, with a projected fiscal deficit equivalent to 5.9 percent of GDP, with this figure revised upwards at the mid-year budget review from a level equivalent to 5.4 percent of GDP.

40. Despite media characterizations of a "zero aid budget", the 2014/15 budget estimates include foreign grants to a value equivalent to 6.1 percent of GDP. This is substantially less than the peak level of 14.5 percent in 2012/13, but it certainly cannot be described as "zero." Rather, it represents a projected increase over the level received in 2013/14, with 15.6 percent of the 2014/15 budget to be financed by foreign grants. Grants for budget support are estimated to be close to zero in the 2014/15 budget,⁶ while a modest recovery in dedicated grants is expected, although these will remain below previously recorded levels. This reflects a degree of realism on the Government's part regarding the likelihood of development partners taking the decision to disburse grants through Government systems in the wake of the exposure of public financial mismanagement and control weaknesses. The total aggregate value of project grants is expected to rebound, with the Government having requested development partners to channel development assistance through alternative mechanisms including through projects with parallel fiduciary systems.

41. Performance in the area of revenue collection is expected to remain robust, following last year's strong performance. The total combined value of tax and non-tax revenues is estimated to reach the equivalent of 27.0

⁵ Projection based on the World Bank staff estimates using MFMMod, with baseline data incorporated from IMF staff projections.

⁶ Initial expectations of zero budget support ("program grants") in the 2014/15 budget were revised at the mid-year review after confirmation of a planned disbursement by the African Development Bank.

percent of GDP in 2014/15, a figure that compares very favorably with regional comparators. At the mid-year point, the level of collection of domestic revenues was lower than the approved budget estimates, which provided for continued revenue outperformance. The under-collection was attributed to under-collection in the area of taxes on goods and services and on international trade largely owing to the sharp depreciation in the value of the local currency in the first half of the financial year. Non-tax revenues also fell as a result of reduced fuel consumption (lower fuel levies) and the inability of Government Ministries, Departments and Agencies (MDAs) to collect fees and other payments (lower departmental receipts). The value of dedicated and project grants was also below agreed upon targets. Despite these setbacks, the outlook for the revenue projections to the end of the financial year is positive, bearing in mind the impact of the onset of the tobacco season and of the appreciation in the value of the Kwacha and its increased stability.

42. Expenditure is projected to decline as the Government adjusts to the reduced availability of financial resources. However, the degree of consolidation is less than that expected at the time of the approval of the budget. Total expenditure for 2014/15 is projected to reach a level equivalent to 39.0 percent of GDP, higher than the figure of 37.7 percent projected at the time of budget approval, but lower than the level of 41.0 percent recorded in 2013/14. Significant expenditure overruns are expected due to the costs of debt service, salary increments and subsidies, with these overruns to be offset by reductions in domestically financed development expenditures. The public wage bill also weighs heavily on the Government's fiscal accounts, with wages and salaries now reaching a value equivalent to 8.2 percent of GDP. So far, most of the efforts to consolidate the budget have focused on cuts to the development budget rather than on recurrent expenditures, resulting in a heavy short-term, consumption-oriented budget.

Table 4: Fiscal accounts

Percent of GDP

	2012/13	2013/14	2014/15	
			Budget	Proj.
Revenue and Grants	39.1	32.4	32.3	33.1
Revenue	24.5	28.0	26.7	27.0
Tax Revenue	22.3	24.6	23.9	24.1
Nontax revenue	2.3	3.3	2.8	2.9
Grants	14.5	4.4	5.6	6.1
Budget support grants	6.4	0.4	0.0	0.4
Project grants	2.9	2.6	3.6	3.6
Dedicated grants	5.3	1.4	1.9	2.1
Expenditure and net lending	40.5	41.0	37.7	39.0
Recurrent expenditure	31.9	34.7	27.7	29.3
Wages and salaries	8.0	8.9	8.2	8.2
Interest payments	2.8	6.2	4.0	5.3
Domestic	2.4	6.0	3.8	4.6
Foreign	0.3	0.2	0.3	0.7
Goods and services	11.9	11.2	8.1	8.0
Subsidies and other current transfers	8.1	7.9	6.8	7.3
Fertilizer and seed subsidy	4.3	3.8	2.5	3.0
Arrears payments	1.0	0.5	0.5	0.5
Development expenditure	8.6	6.4	9.9	9.6
Foreign financed	6.0	5.1	7.4	7.7
Domestically financed	2.6	1.2	2.5	1.9
Overall balance (including grants)	-1.3	-8.6	-5.4	-5.9
Financing	2.5	8.7	5.4	5.9
Net foreign financing	2.7	2.8	4.6	4.0
Gross foreign borrowing	3.1	3.4	5.2	5.0
Budget support loans	0.0	0.9	1.9	0.0
Project loans	3.1	2.5	3.3	4.1
Other external loans	0.0	0.0	0.0	0.9
Amortization	-0.4	-0.6	-0.6	-1.0
Net domestic borrowing	-0.2	5.9	0.8	1.9

Memorandum items:

Nominal GDP (MWK billion)	1,208	1,578	1,986
Securitization of domestic payment arrears	0.0	2.5	7.9

Source: Malawian authorities and IMF staff estimates

43. The public sector interest bill is now close to the levels recorded prior to Malawi's debt relief under the Highly Indebted Poor Countries (HIPC) initiative. Debt service costs are projected to reach the equivalent of 5.3 percent of GDP in 2014/15, constituting approximately 13.6 percent of the budget. The cost of both domestic and foreign financing is higher than projected at the time of budget approval due to both continued high interest rates (on domestic debt service) and the depreciation in the value of the Kwacha in late 2014 (on foreign debt service).

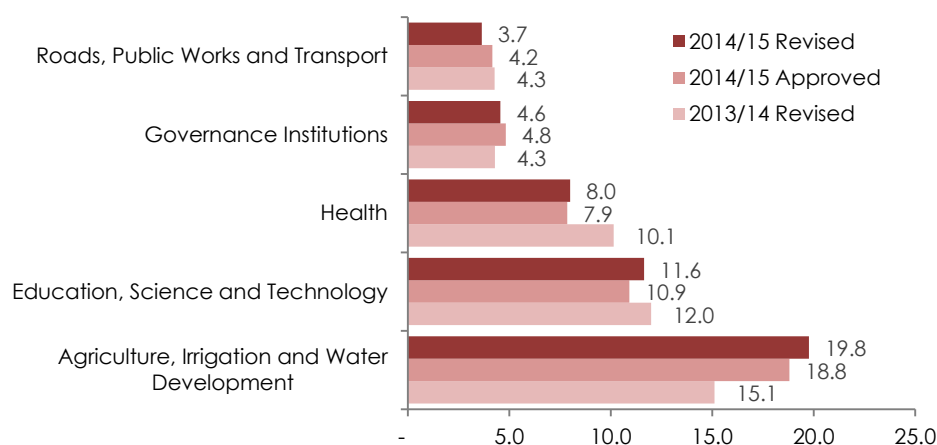
44. The cost of subsidies continues to represent a significant proportion of the recurrent expenditure budget, with cost overruns exposing Government accounts to a high degree of risk. Early attempts to trim expenditures in 2014/15 on the key, politically sensitive fertilizer and seed subsidies through anticipated efficiency gains appear not to have produced the expected results. As a result of a mixture of losses and liabilities carried forward from previous years; procurement and distribution challenges; and a depreciation in the value of the Kwacha (with the entire exchange rate risk carried by the Government, since supplies are contracted in US dollars), the FISP is expected to experience significant overruns, with total costs rising from a projected 2.5 percent of GDP to 3.0 percent (see Box 3 for a more complete discussion). Without major reform, costs associated with the FISP program will continue to impose increasing fiscal pressures on the Government. New subsidy programs, including those involving subsidies for iron sheets and cement (announced as part of the President's general election campaign), will only add to budget pressures during a challenging period in which fiscal consolidation is vitally necessary.

45. This year, approximately two-thirds of Malawi's net financing requirements are expected to be met through long-term and highly concessional foreign project loans. Initial expectations of foreign program loans (budget support) have been sharply revised down. Given the limited available remaining fiscal space to increase domestic borrowing, the net domestic borrowing requirement for 2014/15, at the equivalent of 1.9 percent of GDP, is significantly lower than in 2013/14 (5.9 percent of GDP).

46. In terms of the distribution of expenditure, given the limited fiscal space available to the Government, there are few significant modifications to sectoral allocations in the 2014/15 budget. However, major social sectors, including health and education, will receive reduced allocations as a share of the total budget, in line with a more modest development budget.

Figure 13: Major sectoral allocations in the 2014/15 budget are broadly unchanged

Top five sectoral budget allocations, percentage of total budget, selected years



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

47. Given the longstanding importance attached to the achievement of food self-sufficiency, agriculture, irrigation and water development will receive the largest share of the revised 2014/15 budget, at 18.8 in the approved budget compared to 19.8 percent in the revised estimates. Expenditure on the FISP program is estimated to account for 44 percent of the total budget for the agricultural sector in this financial year. This is followed by the education sector (11.6 percent from 10.9 percent in the approved budget) and health⁷ (8.0 percent from 7.9 percent in the approved budget). Previously, it was expected that development partners would channel on-budget foreign grants into the social delivery sectors through off-budget means to compensate for reduced public expenditure. In a bid to boost performance in the area of public financial management, there

⁷ Includes allocations to the Ministry, Department of Nutrition, HIV and AIDS, and the National AIDS Commission.

are increased commitments to governance institutions.⁸ Allocations for the roads, public works and transport sector⁹ for the remainder of the year will contract from 4.2 percent in the approved budget to 3.7 percent in the revised estimates, with a cut in development expenditure for locally financed projects (see Figure 13).

48. With Malawi's economy highly dependent on aid, changes in development partner sentiment have an immediate and far-reaching impact on the budget. In recent years, fluctuating volumes of foreign aid have become a significant source of volatility. It will take some time before development partners' confidence in the integrity of Malawi's public financial management systems is restored to a level sufficient for the restoration of significant development finance channeled through Government systems, including general budget support (through either program grants or program loans).

49. With the 2014/15 budget, the Government has very little breathing space. If the deficit is significantly larger than anticipated or if estimated foreign sources of deficit financing do not materialize, it will be difficult to maintain macroeconomic stability. There is a risk that the Government will be forced to resort yet again to either increased domestic borrowing or an increase in the value of arrears, either of which would have damaging side effects and continue to exert upward pressure on the rate of inflation, crowding out private sector investment and putting economic growth at risk. Therefore, close and careful monitoring of expenditure will be required throughout the remainder of the financial year. If further within-year cuts to the budget are necessary, some prioritization of Government expenditures may need to be applied to protect priority public services. Major reform efforts will be needed to rebuild confidence in the integrity of the Government's public financial management systems, both to improve the efficiency of public expenditure and to facilitate the restoration of budget support and increased on-budget development assistance.

Box 3: The Farm Input Subsidy Program is placing the government's budget under enormous strain

The provision of subsidies for modern inputs for smallholders has been a part of Malawi's agricultural development strategy for decades, with the current Farm Input Subsidy Program (FISP) being justified on the basis that soil nutrients, particularly nitrogen, are essential for maize production. These nutrients are in short supply, and inorganic fertilizer is the most effective short-term method for farmers to add nutrients to the soil. Furthermore, most smallholders in Malawi lack the cash resources or access to credit that would enable them to purchase inorganic fertilizer at commercial market prices.

The FISP has multiple stated objectives, including: (i) increasing smallholder maize yields and overall levels of production; (ii) achieving reductions in poverty levels; (iii) promoting food security; and (iv) enhancing rural incomes. While the stated objectives are admirable, the weight of the evidence suggests that the households who should be targeted to increase maize productivity are likely not the same households who should be targeted to reduce rural poverty.

National production estimates from the Ministry of Agriculture, Irrigation and Water Development suggest that maize production outputs in Malawi have increased dramatically since the FISP was scaled up in 2005/06. During that year, the total level of maize production was estimated to be more than double that recorded in 2004/05. Official estimates in the subsequent years also indicate that Malawi has generated substantial maize surpluses. However, maize prices have remained high over this period and there is some evidence to suggest that production figures may have been overestimated. Evidence from Malawi and elsewhere also suggests that resource-constrained farmers tend to receive a lower rate of return from the use of inorganic fertilizer than do somewhat better off-households. In addition, recent research also raises questions about the degree to which the FISP has contributed to poverty reduction in Malawi, despite its large financial outlay.

In financial terms, since its introduction in 2005/06, FISP has come to completely dominate Malawi's agricultural budget. In 2014/15, the program is estimated to account for approximately 70 percent of public expenditure on agriculture and up to 10 percent of the entire national budget. This has crowded out investment in other agricultural programs that might have resulted in longer term productivity gains or facilitated greater crop diversification.

Table 5: The costs of FISP, 2005/06 to 2014/15

Cropping year	05/06	06/07	07/08	08/09	09/10	10/11	11/12	12/13	13/14	14/15
---------------	-------	-------	-------	-------	-------	-------	-------	-------	-------	-------

⁸ Among others these include Anti-Corruption Bureau, Director of Public Prosecutions, Judiciary and the Police.

⁹ Comprises allocations to the Ministry, Road Funds Administration and National Roads Authority.

Total fertilizer subsidized (MT 000s)	131	175	217	197	160	161	140	154	150	150
Fertilizer subsidy (percent)	64	72	79	91	88	91	93	97	97	97
Total budgeted cost (USD million)	36.4	53.6	82.1	139.1	155.0	130.0	129.5	131.8	140.0	126.5
Total cost as % agriculture budget	-	47	57	68	53	60	49	62	69	75
Total cost as % of national budget	-	7	8	16	7	8	7	8	10	7
Total cost as % of GDP	-	3	3	7	3	3	3	4	3	3
Actual cost (net of farmer contributions and including cost overruns) (USD million)	32.0	73.9	107.3	241.7	108.5	143.6	134.1	137.9	146.2	160.0

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

The FISP is also widely considered to be inefficiently implemented and has been a major source of budget overruns in recent years. In 2014/15, a combination of factors, including the need to clear unpaid arrears for the purchase of fertilizer and seeds from the previous season; the clearance of unused fertilizer from the Farm Input Loan Program; an inefficient tonnage allocation formula that raises average purchase costs for the Government; and (most significantly) the depreciation in the value of the Kwacha are expected to result in a large overrun. The total cost of FISP in 2014/15 is now expected to reach MWK 70 billion, compared to an allocated budget of MWK 50.8 billion. This figure accounts for a sizable proportion of Malawi's budget deficit this year.

One reason for the high costs of FISP is the extremely high subsidy rate, with farmers paying as little as three percent of the "market" price of fertilizer. Lowering the rate of subsidy by increasing farmers' required contribution would reduce Government costs, and also induce less productive farmers (who would sell FISP fertilizer) to self-select out of the program.

As a land-locked country with no readily available domestic or regional source of fossil fuels, Malawi does not produce its own fertilizer. Therefore, all fertilizer used in the country must be procured from abroad. Given the size of the FISP, the program has consumed a significant portion of the country's foreign exchange reserves. The policy of formulating the budget in June/July, when the Kwacha tends to be at its strongest, and purchasing imported fertilizer in October/November during the lean forex season when the Kwacha is under pressure, continually exposes the Government to foreign exchange risk. In addition, as currently implemented, the program creates considerable private sector distortions and undermines the incentives for private providers of farm inputs to serve rural areas. A number of steps should be taken to improve the effectiveness of FISP to lower the program's costs, including the following:

- Gradual shifting resources from FISP to fund other developmental programs and working towards building an agricultural credit system;
- Improving FISP targeting criteria to focus on relatively productive farmers and providing social safety net programs for poor households who cannot use fertilizer effectively;
- Reducing logistical costs by involving private suppliers in the retail distribution of fertilizer, as is currently done for seeds;
- Increasing farmers' required contribution to purchase FISP fertilizer to a minimum of 30 percent of the market price;
- Improving agricultural statistics to properly monitor production and productivity to fine-tune the level of subsidy. Backspace;
- Moving the fiscal calendar so that the year begins in January, or including next year's FISP budget in the current year. This would lower procurement costs and help to ensure that FISP fertilizer is available to farmers in a timely manner.

Source: Adapted from World Bank (2013) Malawi Agricultural Public Expenditure Review

A tighter monetary stance will be needed to bring down inflation

50. With continued efforts to bring fiscal balances under control, the rate of inflation is expected to gradually decline. The large fiscal deficits of recent years and the resulting increases in the level of domestic borrowing have driven the rate of inflation upwards and served to undermine an otherwise tight monetary stance. Based on the premise that fiscal balances can be gradually brought under control, the rate of inflation is projected to decline to an annual average of 18.1 percent in 2015, compared to the average annual rate of 23.8 percent in 2014.

51. Lower imported energy prices may exert some additional and timely downward pressure on the rate of inflation. A decline in the internationally traded prices for oil offer some respite for Malawi, which is a net fuel importer. So far, the pass-through effects have been muted by the depreciation in the value of the Kwacha in the last quarter of 2014; long lead times in fuel procurement; and a series of levies, margins and taxes (see Box 4). However, as a result of the fall in global fuel prices, Malawi's aggregate oil import bill for 2015 is projected to be 19.7 percent lower than if prices had remained at their 2014 levels.

52. However, a tight monetary stance will need to be maintained throughout 2015 in order to ensure that inflation is controlled. The maintenance of positive real interest rates for a continued period of time will be necessary in order to bring the rate of inflation down to lower levels. Measures to achieve this will include the avoidance of premature cuts in the policy rate, as occurred in 2014. In the past, exchange rate volatility has played a key role in imported inflation in Malawi. As such, increased reserves and a stabilized exchange rate should also play a positive role in controlling the rate of inflation in 2015.

The outlook for the current account is broadly positive, but a significant deficit remains

53. In terms of the current account, the deficit is expected to decline from the equivalent of 5.1 percent of GDP in 2014 to 4.0 percent in 2015. However, a reduction in the deficit to this order of magnitude is premised on continued strong regional demand for Malawi's tradables and on incremental progress in efforts to restore macroeconomic balances and to rebuild domestic business confidence. Continued robust demand for Malawi's tobacco crops and reasonably good performance by the other agricultural sub-sectors, together with the reduced cost of imported oil, are all expected to play a role.

Priority steps to restore macroeconomic stability

54. With Malawi facing significant challenges in 2015, the top priority is to implement the necessary corrective measures to restore macroeconomic stability as a means to rebuild confidence in the Malawi economy. Priority actions include the following:

- a. **Fiscal consolidation and a reduction in the size of budget deficits in order to reduce costly domestic borrowing costs:** This will require strengthened planning and budgeting, with much more disciplined budget execution and far greater degree of adherence to budgeted expenditure ceilings across ministries, departments and agencies. It will also require close expenditure management;
- b. **Tighter monetary policy and lower levels of domestic borrowing to gradually reduce inflationary pressures:** Once inflation is on a downward trajectory, a more expansive monetary stance will become feasible in the medium term;
- c. **Reform of key subsidy programs, particularly FISP, in order to reduce fiscal pressures and to improve policy effectiveness:** This would include the scaling back of FISP, with a narrowed set of policy goals associated principally with boosting agricultural productivity among farmers that are able to effectively utilize fertilizer, but are unable to afford inputs at market prices. Social protection objectives could be much more effectively achieved through targeted cash transfer programs. Reforms to the budget calendar of any public procurement of farm inputs would be necessary to improve efficiency and to reduce the Government's fiscal risks;
- d. **Implementation of measures to improve public financial management and integrity in prioritized areas:** This should be a first step towards rebuilding domestic confidence in the integrity of Government financial systems and ensuring that donors are willing to resume channeling aid, including budget support, through Government accounts.

Box 4: Estimating the impact of falling oil prices on Malawi

As a net oil importer, Malawi stands to gain from lower international oil prices, principally as a result of the lower cost of energy imports. However, the impact of lower international oil prices has so far been partially offset by exchange rate weakness. There are also likely to be small benefits in terms of a lower rate of inflation and increased economic growth.

Globally, the price of Brent Crude oil fell sharply from a three-year high of USD 115 per barrel in mid-June 2014 to USD 48 in January 2015. The steep, steady fall in oil prices has been attributed to a sluggish global demand and

an increase in production by non-OPEC¹⁰ oil producers, most notably the United States; to the appreciation in the value of the US dollar against major global currencies; and to receding geopolitical concerns regarding supply disruptions in the Middle East.

Malawi has operated an Automatic Pricing Mechanism (APM) since 2012. This system was implemented in an effort to ensure the availability of fuel in the country, following persistent fuel shortages during the economic and governance crisis of 2011/2012. Under this system, the pricing of petroleum products is based on three components, namely the In Bond Landed Cost (IBLC); taxes and levies; and industry margins. Of these components, prices are determined by changes in the IBLC, which consists of the Free on Board (FOB) price of petroleum, railage, road freight, insurance, handling and transit losses. The IBLC value is mainly driven by FOB and exchange rate movements. Under the APM, fuel pump prices are adjusted to reflect changes in the value of the IBLC, allowing for fluctuations in the value of the Kwacha against the US dollar. Thus, to a large extent, the impact of the global decline in oil prices in late 2014 was offset by the simultaneous depreciation in the value of the local currency. Furthermore, the various costs that are added on to the FOB price of petroleum to reach the IBLC to some extent dulls the transmission of changes in global oil prices to the local economy.

To minimize the impact of frequent fuel price fluctuations on the international market, the APM is set to operate within a threshold of ± 5 percent of the IBLC, which is also the trigger limit. The Price Stabilization Fund was established as a hedge fund that absorbs all cost increases within the ± 5 percent threshold and collects revenue for cushioning within the 5 percent band. Thus, a trigger of the threshold as a result of any price changes that occur on the world market may not immediately translated into an adjustment in domestic fuel prices.

Balance of Payments: Empirical evidence suggests that the price elasticity of demand for oil is generally more responsive in the long run than it is in the short run, with consumers having more time to adjust their expectations and shift between energy sources in line with changes in fuel prices. With the expectation that global prices will revert to USD 100 per barrel in two to three years, this estimate is based on the short-run elasticity forecast. On the assumption that the country will not experience any foreign exchange volatilities in the short run, the benefits accrued from the reduced prices will lead to a fall in the oil import bill by USD 32.9 million (19.7 percent), which constitutes 1.5 percent of the total value of merchandise imports.

Inflation: The impact of a fall in oil prices on inflation can be measured through the transport component in the CPI basket. With the transportation component constituting only a small proportion (6.6 percent) of the CPI basket, the expectation is that lower oil prices may not directly translate into a significant decline in the rate of headline inflation. Inflation is more responsive to food prices, which account for 50.2 percent of the weighted CPI.

Pass-through effect: An assessment of the pass-through rate resulting from the decline in the price of oil in the period from January 2014 to February 2015 shows a coefficient of 0.46. This implies that around 46 percent of the global price change was transferred to consumers in the Malawian economy through changes in domestic pump prices. The lag in response to changes in global prices can be understood as the result from standing commitments, as fuel is procured in advance, which results in a lag to adjustments in domestic fuel prices. Secondly, to some extent, the weakness of the Kwacha offset the impact of the decline in fuel prices in Malawi when measured in USD terms in late 2014. Thirdly, significant transport, handling and distribution costs along Malawi's landlocked supply chains have not declined.

Growth: The real effects of the decline in global oil prices depends on the energy intensity of a country, with highly energy intensive economies benefiting to a significantly greater extent. The level of Malawi's average oil intensity has been on a downward trend since 1994. Additionally, there is a wide gap between energy and oil intensity, which implies a reliance on other sources of energy, such as electricity, coal and firewood. The effect of the falling oil price on GDP is therefore expected to be minimal in Malawi.

Public finance: The fiscal effects of a change in global oil prices are significant if a country provides oil subsidies. However, Malawi does not provide such subsidies, which limits the fiscal impact of a global fall in oil prices. Lower prices may have an impact where the Government procures specific goods that have high energy intensity, such as fertilizer, as in the case of Malawi's FISP. Lower oil prices may in turn have an impact on global prices for fertilizer in the medium term, but the specific impact on Malawi, while likely to be positive, is hard to disentangle from broader movements in the exchange rate and in the market price of fertilizer. In terms of the

¹⁰ Organization of the Petroleum Exporting Countries.

collection of tax revenues, import and export duties are levied at 10 percent each for petrol and diesel and at five percent for paraffin of the IBLC, including government levies. Thus, lower inbound oil prices resulted in somewhat lower Government revenues, at around USD 3.5 million less than would have otherwise been the case if oil prices in 2015 had remained at 2014 levels.

Source: World Bank staff estimates based on data provided by the Malawi Energy Regulatory Authority

2. SPECIAL TOPIC: BUILDING TRADE COMPETITIVENESS

What are the key constraints that limit Malawi's ability to benefit from the opportunities created by international trade? As a small, landlocked economy with a large current account deficit, and with its currency under sustained pressure, Malawi should strive to reduce trade costs as a means to achieve sustained, increased economic growth and to facilitate the creation of productive jobs for a greater proportion of its citizens. This special section explores the nature of the constraints that Malawi faces and the means by which these constraints could be addressed.

Malawi's recent trade performance

55. In Malawi, average per capita incomes have increased only slowly over the last 30 years. One reason for this is that over the decades, the rate of increase in the volume of Malawi's trade has barely kept up with population growth. However, Malawi's performance in this area is not immutable. Rather, it depends on a number of factors, including the policy choices that have been made or that have failed to be made in the past. In fact, it is true that Malawi suffers from a number of disadvantages. Malawi is a landlocked country that does not have abundant natural resources; it is poor; and it is densely populated. However, many other countries that have faced similar disadvantages have successfully developed their economies, while Malawi has not. In their endeavors to facilitate the development of the country, policy makers can learn from the experiences of these countries.

56. Accelerating growth in per capita incomes is in turn ultimately a matter of generating sustained productivity growth across multiple sectors of the economy. As the economist Dani Rodrik has pointed out, the fact that labor productivity in Malawi's mining sector is at the same level of that of the US economy as a whole does not mean that Malawi can grow by shifting all its labor to mining. Instead, it points to the need to understand why other sectors of the economy do not experience the productivity-enhancing effect of access to global markets (McMillan and Rodrik 2011). In many African countries, the pattern of growth has confronted policymakers with a very narrowly based formal private sector—narrow in terms of number of workers, firms, and products. For such countries, including Malawi, finding ways to give more local firms, especially smaller firms, access to the opportunities of international trade will be critical for sustainable exit from its low-level equilibrium.

57. A number of recent works of research have argued that Malawi's poor performance is the result of poorly designed, poorly implemented policies in a number of areas, including policies related to macroeconomics, trade, regulation, administrative procedures at border crossings, and the use of infrastructure. Both the Malawi Diagnostic Trade Integration Study (DTIS) (World Bank 2014) and Hoppe and Newfarmer (2014) present evidence to show that the policies in these areas make it difficult for Malawian firms to gain access to low cost imported inputs and to take advantage of export opportunities, particularly within the region. The policy issues outlined in the first section of this report also put a burden on the trade environment, as high uncertainty in the policy environment, inflation, and exchange rate volatility negatively affect investment and export growth.

58. Over the past three decades, the average annual volume of exports from Malawi has grown by only 2.9 percent, not nearly enough to keep pace with population growth, let alone to facilitate increases in per capita incomes (Hoppe and Newfarmer 2014). More significantly, export performance has been highly volatile, as has the economy in general. While global economic growth and the emergence of global supply chains have enabled many African countries to reduce poverty, Malawi's exports grew less rapidly than those of nearly all of its neighbors during the period from 1990 to 2012. Even compared to other land-locked, resource poor countries, such as Uganda, Rwanda, or Burkina Faso, Malawi's export performance is poor.

59. Malawi has a large current account deficit, which in the past was mostly financed by aid inflows. Reforms aimed at reducing high trade costs, which in turn would help boost competitiveness, could result in higher export volumes and reduce pressures on the currency. A more diversified export base could also reduce the cyclical currency movements related to the imports of agricultural inputs and result in an increase in exports during the harvest season.

60. Malawi faces significant vulnerabilities to external shocks because exports remain highly concentrated and under-diversified. The agricultural sector contributes to approximately 80 percent of export earnings, with agricultural exports consisting of only a small number of products, particularly tobacco. Because the level of productivity of the agricultural sector has grown only slowly and because diversification within the agricultural sector has been limited, it has not so far been the driver in exports that it could have been. In 2000, the five most significant commodity exports accounted for almost 90 percent of the total value of all exports. By 2011, the same

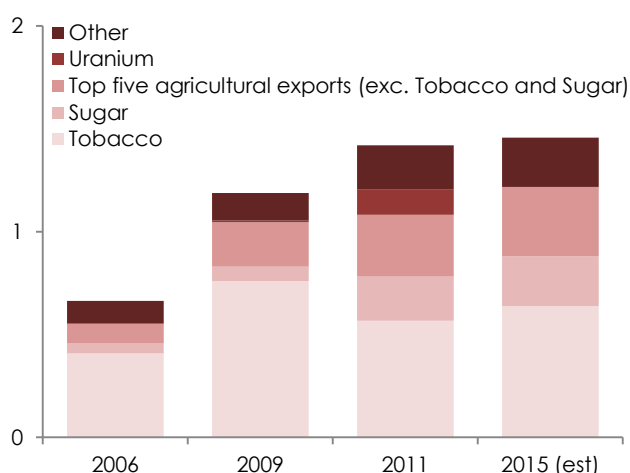
commodities still accounted for 77 percent of the total (Figure 14).¹¹ Thus, Malawi has a high export concentration index, even compared to other countries in Africa.

61. A major contributing factor to this situation is that exports in Malawi continue to be dominated by a very small number of large firms. In 2012, the five largest business enterprises accounted for 62 percent of total exports, while the 20 largest business enterprises accounted for 81 percent. In aggregate terms, the vast majority of exporters are small, with more than 65 percent of firms exporting goods to a value of less than USD 50,000 per year. Thus, there is a “missing middle,” with very few medium sized firms in between the large and the small. As described in greater detail below, recent research indicates that the policy environment in Malawi is biased towards larger firms, which exacerbates the limited entry and success rate of new companies that would contribute to the diversification of exports and of the economy (World Bank 2014).

62. While a large number of new exporters have emerged since 2006, their success rate has been low. In addition, the majority of exporters continue to be very small. The average number of exporters increased from 365 in the period from 2006 to 2008 to 585 in the period from 2009 to 2012. However, in any given year in the period from 2009 to 2012, half of these businesses had not exported the previous year, suggesting that there are significant dynamics related to the entry and exit of these businesses. New exporters appear to have had major difficulties in sustaining export operations, as indicated by the low survival rates, even compared to other Sub-Saharan African countries. Only one third of new entrants in any of the years were able to continue exporting for a second year, (meaning two thirds of new exporters did not export in the following year), and less than a quarter of new exporters continued to export for another year. The exception to this rule was in the tobacco sector, where the survival rate is higher (Fernandes 2013 and World Bank 2014).

Figure 14: Efforts to diversify the export base have had some success

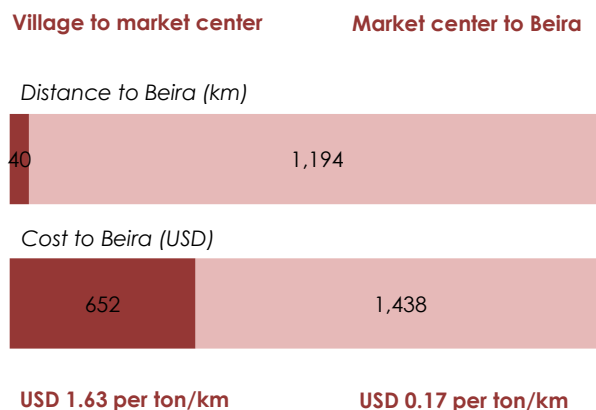
Exports, USD billion



Source: World Bank staff calculations and estimates

Figure 15: Domestic transport costs are many times international transport costs

Comparative costs in USD per ton/km



Source: World Bank DTIS

63. In addition, the value of the goods Malawi exports has fallen in relation to the value of its imports, resulting in a deterioration in the terms of trade. The purchasing power of Malawi's exports has fallen by two-thirds relative to the early 1980s. At least until the mid 2000s, similar declines were recorded by most commodity exporting nations. However, those countries reliant on tobacco have had to cope with a special problem: the long term global decline in the acceptability of smoking and tobacco usage. This factor has resulted in depressed global demand and a consequent reduction in tobacco export prices. To illustrate the declining purchasing power of its main export, World Bank staff estimates show that in 1960, Malawi could buy one barrel of oil for the price of a single kilogram of tobacco. By the early 1980s, this had increased to 10 kilograms, while currently the figure stands at 17 kilograms.

64. Malawi's export of services has also grown more modestly than that of neighboring countries, with services representing less than eight percent of the total value of exports in 2012. In addition, Malawi has also not yet

¹¹ A new uranium mine offered brief new hope of diversification and accounted for almost 12 per cent of exports in 2013. However, the mine was placed on 'care and maintenance' in February 2014 because of the fall in global uranium prices. See Box 1 for more detail.

managed to diversify its services exports. Malawi's services exports remain concentrated in transportation and travel services. In 2012, travel services accounted for more than 40 percent of total services exports, followed by transportation services, at 33 percent. This situation is in sharp contrast with that found in neighboring countries, where exports of both traditional services (such as travel and transport services) and non-traditional services (such as communication, financial and business services) are beginning to make a significant contribution to the total value of exports. Only the tourism sector in Malawi is emerging as a new export sector, with receipts from tourism rising some six fold, from a small base of under about USD 10 million in the early 1990s to close to USD 60 million by 2012. Even so, Malawi lags behind other countries in the region in terms of its ability to attract tourists (Hoppe and Newfarmer 2014).

Key policy challenges Malawi is facing

65. Four priority trade policy issues affect the competitiveness of Malawi's enterprises and hold the country back.¹²

These constraints could be addressed with relatively simple and low-cost reforms that could have a large positive impact. Besides the importance of improved macroeconomic policies, which was covered in the previous sections of this publication, recent studies identify three areas for reforms that could have a significant benefit, as follows:

- a. The removal of a range of policies that depress exports;
- b. The need to review and publish existing regulations and their application to reduce costs and delays; and,
- c. Reforms in the transport sector to reduce transport prices.

Policies depress exports and stifle competition

66. The tariff system is non-transparent and complex, and could be simplified in line with existing commitments.

Average tariffs are comparable to those in neighboring countries, with tariffs for agricultural imports generally higher than those for industrial products. The simple average of tariffs in 2013 was 12.4 percent, while the trade weighted applied tariff average was 7.4 percent. But the tariff structure is complex and lacks transparency. While Malawi applies 24 different tariff rates, depending on the type of product involved and where it comes from, 98.5 percent of all products enter under just three tariff rates (zero, ten, and twenty-five percent). Two-thirds of these tariff rates result from the gradual implementation of regional commitments to reduce tariffs under the COMESA and SADC treaties, and many of these are nuisance tariffs of below 5 per cent.¹³ Malawi could implement its commitments differently, thereby reducing the number of tariff lines in place.

67. Malawi collects tariff revenues primarily from only a limited number of import flows. More than half of all imports enter at zero rates of duty, with a further 32 percent entering under tariff lines, with a statutory duty of 10 percent. Malawi implements regional and bilateral preferential trade arrangements under COMESA and SADC, and grants exceptions for imports for Government and military use; international organizations; diplomats; and returning migrant workers; and end-user specific rebates or duty remission schemes. As a result of wide-spread tariff exemptions, effective import duty collection by the Malawi Revenue Authority (MRA) only amounted to 3.4 percent, compared to the trade-weighted tariff average of 6.9 percent in 2012.

68. Due to the complex structure of the tariff system, with many possible duty rates, there is a significant degree of uncertainty in the case of many import transactions as to which tariff rates should apply. Duty rates depend on the precise nature of the product and therefore under which tariff line it will be classified, and where it is considered to originate.¹⁴ In an environment with limited controls, a complex tariff system enables corrupt

¹² Other critical challenges according to the 2009 Enterprise Survey data such as for example access to finance, electricity, tax rates, or the qualification of the labor force, are also important but will not be discussed here in more detail.

¹³ There are another 16 tariff rates that can apply, depending on whether goods originate from within SADC, COMESA, South Africa. While Malawi has reduced tariffs for most imports from SADC countries, largely in line with its commitments, South Africa continues to be treated differently from other SADC countries. Malawi has committed to remove duties on nearly all imports from South Africa by 2012, but continues to apply tariffs on roughly 35 percent of imports from South Africa.

¹⁴ In customs terms, "rules of origin" are used to determine where a product was made and therefore which tariffs will apply if tariffs differ depending on where the product is coming from. For example, imports for products from most COMESA countries are duty free, while they might have to pay duties when being imported from Europe. The importer would have to demonstrate that the good was indeed produced in a COMESA country, to benefit from these lower (preferential) import duties. These rules usually demand that a specific share of the final value was produced in a given country, that the product was transformed sufficiently in a given country.

practices, with informal payments being made to classify goods in a way that allows for the payment of lower import duties. Generally, larger and better connected companies are better able to manage a complex tariff system and to negotiate preferential treatment, granting them a competitive advantage by enabling them to avoid or reduce the payment of duties and thereby to out-price their competitors on the national market.

69. This problem is compounded by discretionary duty exemptions, with the benefits of these exemptions being highly concentrated, which creates barriers to entry for new firms (World Bank 2014). In the period from 2009 to 2012, an average of 139 companies benefitted from preferences under a scheme accessible to specific end-users only, known as Schedule 8. In each year, the ten largest beneficiaries collected two-thirds of the total value of preferences granted under the scheme. In 2012, companies benefitting from preferences under this scheme paid on average 21 percent less for their imported inputs than did competitors who did not benefit from these preferences. Such a high margin provides a significant competitive advantage to established companies, who are the main users of the scheme, while placing other, often new, companies at a comparative disadvantage. This creates very strong barriers to entry. For a new company to compete with those well-established companies, it would have to be significantly more productive to offset the higher input costs. Because this mitigates against new entry, innovation, and efficiency gains from competition, the overall cost of the program is likely to be significantly higher than the nominal costs outlined above.

70. The widespread and non-transparent use of import and export licenses represents a major deterrent for Malawian producers to increase their productivity and to engage in exporting. Obtaining export and import licenses takes time, generates costs, and is marred by uncertainties, negatively affecting investment decisions and competitiveness. There is no simple way for traders to determine which import and export licenses are required at any given point in time. Licensing requirements have not generally been published in a central location, with notice regarding revisions to policies often being issued through ad hoc communications channels.¹⁵

71. The costs and time required to obtain licenses are significant. For example, in the case of agricultural exports, there are eight agencies that issue permits or licenses to import and/or export goods, with these permits or licenses usually only obtainable in the capital, Lilongwe. This requirement results in the imposition of high time and direct costs to trade, as each permit or license requires one or more trips to Lilongwe to visit each relevant agency. Given that there may be more than one license or permit required per consignment, this represents a significant burden. While most traders state that it is "possible" to obtain all of the documentation in a day, it can take four to six weeks for a permit to be approved if no follow-up is provided (World Bank 2014). Absent officials or complications with documentation increase the risk of delays and add to the cost of trade. Such factors can result in delayed shipments and create the risk of being unable to meet delivery deadlines. As a result, farmers and producers need to send shipments earlier than in a predictable trading environment. This results in significant increases to inventory costs and related financing costs.

72. The uncertainty related to the granting of such licenses also impacts investment behavior and the decision to export more generally. Export permits are valid for three months from the date of issue, while import permits are valid for six months. Both cover only one specific type of commodity and specify the total quantity and value that can be traded from the date of issue. This results in a number of difficulties. For example, because of the uncertainty as to whether large farmers will be able to export agricultural produce at international prices, the use of farm machinery lags, which in turn results in a lost opportunity to increase productivity. The rate of usage of tractors in Malawi is roughly half that of Zambia, where mechanization also lags. There have also been reports that companies have been unable to obtain bank financing for investments because banks were not sure that the increased production could be exported if an export ban were to be introduced. There have even been reports that financing for export operations was unobtainable due to the uncertainty of acquiring an export license in time.

73. Export bans, or the threat of an imposition of a ban, have also affected key sectors of the economy. However, these practices have become less frequent in recent years and may thus represent a less significant problem than the problems associated with the import and export licenses. In the short term, export bans may appear to be a smart, politically attractive means of addressing food shortages or ensuring that the prices of affected products remain low. However, these policies tend to undermine food security objectives over the medium term.

¹⁵There have been reports that traders have requested the issuance of export licenses many months after they had been removed, because they had been requested at borders to present such documentation (even though the requirement did no longer exist).

Studies have shown that the most important determinant of total annual crop output is the price level from the previous season. Therefore, while bans may result in lower prices for consumers in any given year, they diminish the incentives for farmers to plant the affected crops in the following year.¹⁶ As a result, export bans have had a negative impact on investment decisions, production levels, and the number of jobs created in the agricultural and agro-processing sectors. Export bans and the threat of bans affect investment in various sectors. For example, they may discourage new entry into commercial farming by potential producers of exports, despite the fact that the activities of these producers might contribute to higher food production levels and improved food security overall. In addition, they may also affect the agro-industrial sector.

Border delays and burdensome procedures increase the cost of imports and make exporters less competitive in foreign markets

74. Exports from Malawi to neighboring countries suffer from long delays. On average, these delays are 10 percent longer than at border crossings across Sub-Saharan Africa. Delays at border crossings are not untypical in Africa, with the time taken to cross a border being nearly two times the average between Latin American countries and nearly three times the average between OECD countries. In 2015, Malawi ranked 170 among 189 countries in the World Bank's Trading Across Borders Index in the Doing Business Survey. These delays drive up the costs of importing consumption goods, unnecessarily taxing Malawian wage earners. They also drive up the costs of imported inputs for Malawian producers, increasing production costs. Because the delays also impact goods leaving the country, border delays and costs place upward pressure on the landed costs of Malawian exports in regional and global markets by increasing input costs and by increasing the costs associated with exporting final goods. Global estimates indicate that, on average, a single additional day's delay in transit drives up the price of exports by nearly one percent (Hummels 2001). Other estimates show that a one day delay has the same effect as adding 70 kilometers to the distance of a journey, with the consequence of reducing export volumes by an average of one percent (Djankov et al 2010). If international averages are an adequate guide, reducing border crossing times by 10 days would decrease the price of imports by approximately 10 percent and expand the value of exports by about the same proportion.

75. Delays result from the lack of coordination between up to 14 agencies at borders; a multitude of bureaucratic requirements; and a lack of transparency. While Customs has made significant improvements and has made information available on their website, access to similar information from approximately 13 other agencies remains limited. Customs has also improved its risk management system for trade transactions, while other agencies' selectivity criteria for the inspection of shipments are not part of the system. Across all agencies, the proportion of goods that are physically inspected at borders remains extremely high. Often, a single shipment is inspected multiple times, as joint inspections are the exception rather than the rule. Customs and Freight Forwarding Agents (CFAs) are often not adequately qualified, reducing the quality of customs declarations; impacting the limited use of risk management system; and leading to additional delays.¹⁷ Attempts to only license qualified CFAs failed in 2012 due to political pressure and it is rare for the MRA to sanction a CFA with suspensions or bans. If implemented appropriately, such measures could improve the quality of data entry and create a virtuous circle (Hoppe and Newfarmer 2014).

76. The level of transparency regarding policies and procedures at borders is very limited. This leads to complex and lengthy import and export transactions, often without creating additional value for the Government. Reports of harassment are frequent. The Government is planning to reduce the number of agencies from 14 to five, possibly by delegating functions when possible. The Government has taken an initial decision that the Malawi Revenue Authority, through its Customs and Excise Division, should take the lead in deciding which agencies should remain at borders. However, so far, only the Malawi Roads Authority has handed over its border responsibilities to Customs.

77. Border delays are exacerbated by the imposition of non-tariff measures (NTMs). These measures impose a substantial cost on potential traders, affecting the input prices of imports and driving up the costs of production and exports. NTMs are non-transparent and may also have a differential impact on producers, depending on their size or the products with which they are involved. Developing transparent NTMs that minimize restrictions on

¹⁶ Moreover, many of the maize producers are small holders and depressing the price of maize undermines poverty reduction objectives.

¹⁷ Border agencies do not trust data entry by CFAs, and a large share of consignments is said to be physically inspected and have their value adjusted. As a result, traders and CFAs under-declare values in the expectation of a later revaluation, leading to a vicious circle.

trade requires countries to pursue a best practice approach to regulation, with an emphasis on achieving transparency and promoting dialogue. A recent study noted that exporters in Malawi reported significantly more cases of domestic NTMs that affected their exports than cases of NTMs in destination markets (International Trade Centre 2012). Among the domestic NTMs they reported facing, the most frequently cited related to licenses or permits to export (some of which have since been removed), followed by foreign exchange regulations (since removed). The exporters also stated that they frequently had problems due to delays in administrative procedures. While foreign exchange regulations have been removed, the volatility of the exchange rate (though not strictly a NTM) has emerged as a new challenge to producers as they evaluate the price of inputs and the competitiveness of their final products on export markets.

78. In terms of NTMs related to importing, the most frequently reported problems relate to import inspections by the Malawi Bureau of Standards (MBS). MBS inspections are meant to ensure that goods sold in Malawi adhere to domestic mandatory standards and are safe for consumption, but the current system seems to mainly generate costs to consumers and users of intermediate inputs, without allowing the MBS to achieve its policy objectives. Recent research shows that MBS' import inspection often generate significant delays and costs for importers because it does not accept certificates of conformity issued by internationally accredited laboratories and certification bodies, effectively duplicating tests. The failure to accept these certificates is clearly contrary to international best practice (International Trade Centre 2012 and World Bank 2014). The MBS tests all consignments before allowing their importation, producing results that have little if any scientific value and that require the payment of fees for a service that creates little or no added value. Such barriers not only increase the final cost of goods for consumers, they also increase the costs of intermediate inputs that are further processed to produce final goods, thereby increasing the final costs of goods produced in Malawi. Where such products are (or could be) exported, these costs directly reduce the level of Malawi's competitiveness in the area of exports to third country markets.

79. The current situation restricts access to critical inputs, including access to improved seeds and fertilizer that could increase the levels of productivity of farmers. The Farm Input Subsidy Program (FISP) has provided access to hybrid maize seed and fertilizer, with this access contributing to a steady increase in the production of maize, cassava, and rice, among other crops. However, fertilizer blends are custom made at high cost and suffer from long delays in tender procedures. As a result, fertilizer prices are roughly 50 percent higher than in Zimbabwe and more than twice as expensive as in South Africa. Seed registration is also costly, usually taking seven to eight years before their release (World Bank 2014). As a result, seed companies only register a few varieties, rather than making available a full spectrum of seeds, some of which might be useful in the range of different conditions across the country. Due to the high costs of implementing FISP, resources have also been diverted away from other important services, such as extension services, resulting in these services being underfunded.¹⁸

80. In the current environment, small-scale producers and traders suffer disproportionately, as overall trade costs are highly regressive on a per-ton basis. Due to the economies of scale, the multitude of specific fees per transaction results in significantly higher trade costs for small traders and firms than for larger ones. Closer inspection of the various fees applied shows that the per ton costs of exporting a ton of rice to Zambia were six times larger for a trader using a 2-ton truck than for a trader using a 30-ton truck (World Bank 2014).¹⁹ For a small trader, the costs, which amount to more than USD 80 per ton of rice, represent more than 14 percent of the farm gate price in Malawi. These high costs are driving small traders to use informal trade channels to enable them to make profits. At the same time, the lack of transparency is likely to result in increased costs for first time exporters, as these exporters need to determine the correct procedures. Together with high specific costs per transaction, this make it more difficult for small exporters to enter export markets, as they have to apportion trade costs among a smaller volume of goods sold on export markets.

High transport costs erode competitiveness

81. High trade costs result from both long supply routes and from high domestic transport prices. As a landlocked country, Malawi is distant from major ports, with freight having to cross neighboring countries. Distances from Lilongwe are 2,678 km to Durban; 1,667 km to Dar-es-Salaam; and 1,194 km to Beira. Despite the fact that international freight rates (on a per ton/km basis) are roughly comparable to freight rates along other corridors in the region, the total costs of bringing goods to the nearest port remain higher than along the most competitive

¹⁸ See Box 3 for more detail on FISP.

¹⁹ The costs are regressive on a per ton basis, even though cost paid to cross the border for a 30 ton truck exporting Malawi rice to Zambia (just over USD 400 per load) are higher than those for a 2 ton truck (about USD 130).

corridors, and long distances further increase total costs. Domestic transport prices also remain high. Even though prices for inter-city transport and regional transport prices have recently converged to around MWK 33 per ton/km, transport prices between farms and cities remain especially high relative to international prices (Gondwe and Kirk, 2014). The convergence of inter-city prices with regional transport prices is partially the result of increased competition from third-country truckers, with this competition possible as a result of poor enforcement of regulations that prohibit competition along domestic routes by third-country truckers (called cabotage). The fact that prices are converging, with significant benefits to domestic producers and other users of transport services, indicates that a relaxation of such restrictions could lead to lower transport prices, including for short-distance transport services.

82. Despite short distances in Malawi, domestic transport costs can represent a significant share of the total cost of transportation from farm to port. The reason for this is that transport prices (on a per ton/km basis) between farms and market centers remain 10 to 20 times higher than transport costs from such centers to ports in Mozambique. Figure 15 illustrates the relative importance of local transportation costs. The local transportation costs for goods transported 40 km from village to market center in Malawi are nearly half the costs for transporting these goods over nearly 1200 km from the market centre in Malawi to the port of Beira. Regional inland transportation costs from Malawi to Mozambique (Tete), Lusaka, and Bulawayo are also 20 to 50 times more expensive per ton/km than the costs incurred for inbound traffic from Durban and Johannesburg.

Box 5: Using a Trade Portal to improve transparency of regulatory requirements at the border

Lack of transparency and predictability surrounding the regulatory requirements for importing and exporting have been identified as a key investment climate constraint in many developing countries. A number of countries, particularly landlocked countries where high trade facilitation costs restrict the opportunities created by international trade, have established trade information portals as a means to reduce compliance costs at the border. The World Trade Organisation (WTO) has given these efforts additional momentum through the Agreement on Trade Facilitation, negotiated in December 2013 in Bali, with this agreement including specific requirements for WTO members to establish trade information portals.

Two useful examples for Malawi include similarly landlocked Laos and Lesotho. In June 2012, Laos was one of the first countries to launch a trade portal as part of the country's WTO accession efforts. The Lao Trade Portal (www.laotradeportal.gov.la) enables traders to cut down the number of trips needed to get information or the length of time to carry out transactions when trading across borders. In a developing economy such as Laos, newly established firms often find it difficult to access information on regulatory processes. This lack of transparency can act as a barrier to entry and create rent seeking opportunities for government officials. The Lao Trade Portal also served as the first step towards the establishment of a National Single Window to allow traders to discharge all import/export obligations through a single electronic channel.

Using the same underlying intellectual property and database system, the Lesotho Trade Portal (<http://www.lesothotradeportal.org.ls>) was launched in March 2014.

Both Trade Portals provide traders with access to:

- All trade-related laws, regulations, measures, restrictions and licensing requirements and tariffs, with all these instruments indexed, cross-referenced, and searchable by commodity code;
- Detailed process maps of business procedures for importing and exporting;
- Full listings of national standards for products;
- Procedures for clearing goods at the border;
- Downloadable forms; and,
- E-alerts which traders can customize to receive information on specific commodities.

Source: Adapted from World Bank (2013) Developing a Trade Information Portal

83. Transport costs along rural roads are mainly high because the poor quality of rural roads increases operating costs. However, limited competition in the area of transportation services along those routes is also an important factor. Farmers at the end of the road are dependent on only one or two trucking services, who also usually fulfill a function as intermediary buyers. This limited competition, together with farmers' lack of knowledge of market prices in urban markets, means that small holder farmers cannot bargain effectively with intermediaries. While a system of minimum farm gate prices was previously implemented, this system was badly designed and largely

ineffective. As a result, it is often alleged that intermediaries buy below minimum prices at the farm gate and sell at minimum prices at factory gates, keeping prices low for farmers and high for buyers.²⁰

Political economy challenges make reform difficult

84. Past reform initiatives in the area of trade policy have stalled or faced outright opposition. While the Government has declared reforms, it has often failed to implement them. This creates the impression of activity, while preserving the status quo. Reforms have often been met by outright opposition or been marred by weak inter-institutional collaboration that has resulted in a failure to implement reforms which often require collaboration between a large number of actors and stakeholders. In some cases, government bodies, mostly parastatals, selectively implement their own policies, substituting organizational goals related to revenue generation for public goals, such as public and consumer safety. A weak central capacity for the formulation and coordination of policy and inefficient and ineffective delivery systems further undermine trade policy reform processes. Weak management and a low level of skills and capacity in many relevant Ministries seem to create further obstacles to the implementation of trade reforms. As a result, policy makers have not seen the benefits of their decisions, as these decisions have not been fully implemented and therefore have not achieved a positive policy impact. Considering the political economy in the design of policy interventions is therefore essential, as recent research has shown.

What should the Government do?

85. Malawi has untapped potential sources to stimulate new growth. To enable Malawi to tap its potential and to achieve an acceleration in economic growth and job creation, the Government will have to implement a number of vitally necessary reforms in a consistent and transparent manner. Reducing trade costs and delays will enable Malawian companies to achieve integration with regional and global production networks, particularly if doing so removes the disproportionate regulatory costs that currently affect small businesses and small farmers. These measures would promote greater competition, which in turn would result in higher levels of productivity across a broad swath of the economy. Raising agricultural yields and introducing new crops could result in a significant growth in productivity and diversification.

86. Export bans undermine long-term food security. These bans should be replaced with better policies to achieve food security, with these policies perhaps involving an expansion to long-term supply and the accumulation of food reserves. This, together with improved agricultural extension and seed policies to encourage drought resistant varieties, could enable the complete eradication of the periodic food scarcities that afflict Malawi.

87. The Government should also review all import and export licensing requirements and strive to eliminate all licenses that do not fulfill a valid purpose. Following a simplification and streamlining of licensing requirements, efforts should be made to improve transparency by socializing these requirements and others online, ideally through the establishment of an up-to-date Trade Information Portal that could function as a legal repository of all regulations in place (see Box 4). All new licenses should be centrally coordinated rather than being issued by individual ministries. The portal should also contain information related to all tariff rates and exemption regimes, making it easier for firms, especially smaller ones, to monitor changes. This would level the playing field between large established incumbents and small potential entrants, thus increasing competition.

88. These reforms should be coupled with effective measures to improve border crossing times. Implementing the Government's decision to reduce the number of agencies at borders from 14 to five and simplifying border crossing procedures by delegating functions in cases where this is possible would be an important first step. Coordinating paperwork, opening hours, data sharing at borders, and other processes, including inspections and risk management between border agencies would contribute to reductions in border crossing times and trade

²⁰ The government had established *minimum farmgate* prices with the objective of assisting farmers to "make informed business decisions" when dealing with buyers, particularly truckers in isolated rural markets. These were legally binding until recently but inconsistently enforced. One of the reasons for the inconsistent enforcement was that the parastatal marketing company does not have the funds to buy the crops at the pre-set prices. Moreover, in practice, the prices set at the beginning of the season may not be relevant by the time of harvest. During the mid-2000s, producer prices for cotton, maize and to some extent rice were higher than regional averages. While these prices do benefit local producers, they reduce competitiveness and effectively discourage production for export (Binswanger-Mkhize et al 2009). In 2009, Cargill, the country's largest ginner and provider of credit, closed its operations in Malawi because it could not economically pay the distorted prices. Regional variations in production and local marketing also mean that one uniform mandatory minimum price will create distortions (World Bank 2014). By 2014, the government reported that minimum prices were no longer binding, but they remained in place mainly for signaling purposes to small holders. It was unclear whether this is widely known in the market.

costs for both imports and exports. A key component of such a reform program would include improving the procedures of the MBS, including through measures to ensure that the Bureau accepts certificates of conformity from internationally accredited certification bodies.

89. To reduce rural transportation prices and to increase incomes at the farm level, the Government could also formulate a program to encourage entry along selected domestic transport routes. This could include a review of Government procurement practices for key commodities, and the reduction of existing barriers to competition. It is often alleged that current practices benefit well-connected truckers and prevent the effective entry of new operators, who often find it difficult to gain access to such contracts.²¹ Complementing these measures with measures to enable farmers to sell their produce at current market prices could also improve farmers' bargaining position, with monopsony buyers visiting their farms, thereby increasing farm-gate prices.

90. A critical element in this transformation relates to the need to actually implement reforms that have been decided upon. It is vitally important to maintain a consistent commitment to reform, without frequent reversals and foot dragging. It is clear from experience in other countries that a set of meaningful and consistent reforms can go a long way towards facilitating an acceleration in economic growth and enabling economic transformation. However, in Malawi, policy makers have failed to implement such a consistent approach in the past. For example, Malawi maintains a stated commitment to fostering export-led growth and diversification through a range of strategies. However, actual policies too often contradict these strategic objectives. For example, export licensing requirements and the fear of export bans prevent the export of value-added produce, while high trade costs effectively penalize domestic producers who find it more difficult to export.

91. Addressing these challenges through the reforms outlined above would increase competitiveness; facilitate increased exports; and generate higher foreign exchange earnings, thereby reducing pressure on the exchange rate. It will be essential to review a wide range of policies and to make a wholehearted commitment to the consistent implementation of these policies to increase investment and to promote stronger growth and job creation. However, trade reforms alone will not be enough. These reforms will need to be complemented by other reforms aimed at improving infrastructure, skills, and political accountability.

92. Not all reforms will have an immediate impact on exports. In addition, reforms are likely to create winners and losers, which will test the Government's political will to implement them. While some reforms will result in immediate trade responses by established companies, others will take time to generate confidence in a more stable and predictable economic environment. Because of this lag between implementation and impact, corresponding investments might take time to materialize. This is likely to create challenges, particularly where politically well-connected losers argue for policy reversal, on the basis that they have seen no immediate positive economic effects. Embarking on and remaining on a consistent, sustained path of reform will be essential for Malawi to tap into her growth potential. It is only by doing so that the country will enact the transformation required to achieve sustained economic growth and job creation, for the benefit of all its citizens.

²¹ Transport prices for these government issued contracts seem to be very attractive too. In 2011 the transport costs for the World Food Program were 30 per cent lower than equivalent transport contracts through by the government for distributing subsidized agricultural inputs (fertilizer) (World Bank 2014).

Data

Table 6: Selected macroeconomic indicators

	2011	2012	2013	2014 Est.	2015 Proj.
National accounts and prices					
GDP at constant market prices (percentage change)	4.3	1.9	5.2	5.7	5.1
Agriculture	6.9	-1.2	5.9	6.1	3.5
Industry	0.9	1.8	5.5	5.1	5.4
Services	3.9	3.8	4.7	5.7	6.0
Consumer prices (annual average)	7.6	21.3	27.3	23.8	18.1
Investment and savings (percent of GDP)					
National savings	9.4	13.2	14.1	10.2	11.2
Gross investment	15.3	16.9	16.0	15.4	15.2
Central government (percent of GDP on a fiscal year basis)					
Revenue	32.1	26.5	39.1	32.4	33.1
Tax and nontax revenue	24.5	22.1	24.5	28.0	27.0
Grants	7.6	4.4	14.5	4.4	6.1
Expenditure and net lending	35.0	33.4	40.5	41.0	39.0
Overall balance (excluding grants)	-10.5	-11.3	-15.9	-13.1	-12.0
Overall balance (including grants)	-2.9	-6.9	-1.4	-8.6	-5.9
Foreign financing	1.3	1.6	2.7	2.8	4.0
Domestic financing	1.7	6.7	-0.2	5.9	1.9
Money and credit					
Money and quasi money (percentage change)	35.7	22.9	35.1	8.8	29.6
Credit to the private sector (percent change)	20.5	25.4	14.4	15.6	19.8
External sector (USD millions, unless otherwise indicated)					
Exports (goods and services)	1,408.7	1,404.1	1,624.3	1,745.1	1,856.8
Imports (goods and services)	2,236.2	2,275.7	2,314.1	2,383.7	2,565.5
Gross official reserves	190.2	215.4	397.0	515.8	557.5
(months of imports)	1.0	1.2	2.0	2.4	2.4
Current account (percent of GDP)	-5.9	-3.7	-1.8	-5.1	-4.0
Debt stock and service					
External debt (public sector, percentage of GDP)	16.9	30.2	44.0	40.3	36.0
Domestic public debt (percentage of GDP)	23.1	19.5	28.1	29.4	25.9
Total public debt (percentage of GDP)	40.0	49.7	72.1	69.6	61.9

Source: Malawian authorities, IMF and World Bank staff estimates

References

- Binswager-Mkhize, P. J. Keyser, D. Rohrbach, H. Tchale (2009) "Agricultural Growth and Diversification", background paper for the Country Economic Memorandum, The World Bank.
- Djankov, S., Freund, C. and S. Pham Cong (2010) "Trading on Time", *Review of Economics and Statistics*, 92:1 February.
- Fernandes, A. (2013) "Characterization of Exporters in Malawi over the 2006-2012 Period", background note prepared for the Diagnostic Trade Integration Study, The World Bank.
- Gondwe, T. and R. Kirk (2014) "Connectivity in Malawi", background paper prepared for the Urbanization Review, The World Bank.
- Government of Malawi (2014) *Annual Economic Report 2014*, Budget Document No.2, Lilongwe: Ministry of Finance, Economic Planning and Development.
- Government of Malawi (2015) "Malawi Floods Post Disaster Needs Assessment", draft manuscript, Department of Disaster Management Affairs, Office of the President and Cabinet.
- Hanmer, L., and N. Lea (2009) "Constraints to Growth in Malawi", Policy Research Working Paper No. 5097 Washington, DC: The World Bank.
- Hoppe, M., and R. Newfarmer (2014) "Using Trade to Raise Incomes for the Next Generation", Malawi Policy Notes Series, Lilongwe: The World Bank.
- Hummels, D. (2001) "Time as a Trade Barrier", GTAP Working Paper No. 18, Purdue University.
- International Monetary Fund (2014) *World Economic Outlook*, October 2014, Washington, DC: IMF.
- International Trade Centre (2012) *Malawi: Company Perspectives*, Series on Non-Tariff Measures, Technical Paper, Geneva: International Trade Centre.
- McMillan, M. S. and D. Rodrik (2011) "Globalization, Structural Change and Productivity Growth", NBER Working Paper No.17143, National Bureau of Economic Research.
- World Bank (2013) *Malawi Agricultural Public Expenditure Review*, Lilongwe: The World Bank
- World Bank (2013) *Developing a Trade Information Portal*, Trade Department, Washington, DC: The World Bank.
- World Bank (2014) *Malawi: Reducing Trade Costs to Promote Competitiveness and Inclusive Growth*, Diagnostic Trade Integration Study, Washington, DC: The World Bank.
- World Bank (2015) *Global Economic Prospects*, Volume 10, January 2015, Washington, DC: The World Bank.

The World Bank Malawi Office
Plot 13/59 Off Presidential Way
Mulanje House, City Centre
P.O. Box 30557
Lilongwe 3
Malawi

Tel: +265 1 770 611
Fax: +265 1 770 158

Email: infomalawi@worldbank.org
www.worldbank.org/malawi

The World Bank
1818 H Street, NW
Washington, D.C. 20433
USA

Tel: +1 202 473 1000
Fax: +1 202 477 6391
www.worldbank.org



WORLD BANK GROUP

www.worldbank.org