Malawi Economic Monitor

100316

Adjusting in Turbulent Times

October 2015

THE WORLD BANK
IBRD · IDA

MALAWI ECONOMIC MONITOR

OCTOBER 2015

ADJUSTING IN TURBULENT TIMES

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

Acknowledgements

This edition of the Malawi Economic Monitor was prepared by Richard Record (Senior Country Economist), Priscilla Kandoole (Country Economist), Salman Asim (Economist), Efrem Chilima (Senior Private Sector Development Specialist) and Sunganani Kalemba (Consultant). Additional contributions were provided by Esther Naikal (Environmental Economist), Ayaz Parvez (Senior Disaster Risk Management Specialist), Francis Nkoka (Disaster Risk Management Specialist) and Zachary Mills (Governance Specialist).

Overall guidance was provided by Albert Zeufack (Practice Manager, Macroeconomics and Fiscal Management) and Laura Kullenberg (Country Manager for Malawi). The team wishes to thank Yutaka Yoshino (Acting Program Leader), Kevin Carey (Lead Economist) and Yoichiro Ishihara (Senior Economist), as well as peer reviewers Lars Sondergaard (Program Leader) and Tuan Minh Le (Senior Economist), for their constructive input.

This report benefited from fruitful discussions with, and comments and information provided by, representatives of 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. The team 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, design and additional production support. Irfan Kortschak (Consultant) provided editorial assistance.

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 September 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

BOXES

FIGURES

TABLES

OVERVIEW

The Malawi Economic Monitor (MEM) provides an analysis of economic and structural development issues in Malawi. This edition of the MEM was published in October 2015. It follows on from the inaugural edition, which 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 faces in its endeavors to achieve high rates of stable, inclusive and sustainable economic growth.

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

In this edition of the MEM, the focus of the special topic is on the effectiveness of public spending on primary education and the means by which this could be improved. With more than half of Malawi's population under the age of 18, the country faces significant challenges in its efforts to provide quality education to a growing population of students. Malawi also faces ongoing fiscal pressures, so there is a need to find ways to maximize the development impact within the limits of the finite resources available for investment in education.

ECONOMIC DEVELOPMENTS

Malawi's short-term growth prospects have deteriorated markedly in the last few months. This has been due to a combination of weather shocks, increased instability in key macroeconomic variables, and a decline in business confidence. Projections earlier in the year pointed to a continued recovery in the rate of growth in 2015, building on a solid performance in 2014 and incremental efforts to restore macroeconomic balances. However, the full extent of adverse weather conditions has now become apparent, with reductions in the levels of production of both food and non-food crops.

While the impact of the January floods on economic growth was fairly limited, the impact of the late arrival and early cessation of rains on the output of the agricultural sector has been significant. The production of maize was most severely affected, with the third round of the Agriculture Production Estimates Survey indicating a 30.2 percent drop in output. This has significant implications for food security. The performance of other food and cash crops has been mixed, although with a general downward trend.

However, despite expectations of a poor season, aggregate tobacco earnings at the close of the auction season are estimated to have reached figures close to those recorded in 2014. The volume of sales is comparable with that seen last year, suggesting a high degree of resilience in the subsector given the unfavorable climatic conditions. Average prices have declined due to the large existing stock of tobacco on world markets. The net effect has been a 6.7 percent reduction in total tobacco earnings compared to the previous year.

Weak fiscal discipline is the most significant contributor to Malawi's macroeconomic instability, with the prospects for improvement remaining poor. The Government continues to run a large fiscal deficit, with expenditure under pressure due to the rising cost of servicing increased debt, increasing wage demands, the high cost of often inefficient subsidy schemes, and the need to settle outstanding arrears. With limited scope for on-budget foreign financing at levels previously available to the Government, the authorities continue to borrow heavily from domestic sources to close the gap. This creates the risk of pushing up inflation and lending rates, crowding out private sector investment and constraining economic growth.

By the end of the 2014/15 fiscal year, the Government had borrowed four times the amount approved in the budget estimates. While the overall budget deficit for 2014/15 was equivalent to around 5.4 percent of GDP, development expenditure was halved to accommodate increases in recurrent spending and a lower-than-expected value of collected revenues and grants.

The FY15/16 budget was premised on a GDP growth rate of 5.4 percent, an average inflation rate of 16.4 percent, and on an exchange rate of 450 Kwacha to the US dollar. In terms of all three indicators, conditions are likely to be worse than expected, putting the authorities under considerable pressure. With the decline in the GDP growth rate expected over the year, revenue collections are unlikely to meet the targets established in the budget. A higher rate of inflation will increase the cost of domestically procured goods and services and lead to increased wage bill demands from public servants. With some 40 percent of the budget spent on goods and services purchased in foreign currency, a weaker Kwacha increases costs, most notably for fertilizer, drugs and other supplies. It also increases the costs of servicing foreign currency debt.

The fiscal deficit for FY15/16 is projected to reach a value equivalent to 7.0 percent of GDP, significantly

higher than the figure recorded in FY14/15. If, as seems likely, the value of collected revenues is lower than targeted and expenditure is not contained, there is a risk of the deficit increasing. This would contribute to continued macroeconomic stresses and imbalances in Malawi's economy.

The rate of inflation seems set to continue in double digits, with this rate estimated by the World Bank to reach an average of 21.7 percent in 2015, the second highest in Africa. In the earlier months of the year, a gradual easing of price pressures occurred, driven by both falling imported energy prices and lower domestic food prices. The poor maize crop meant that the usual seasonal, post-harvest drop in prices was severely muted. As a result, food prices have risen steadily over recent months due to expectations of shortages. The headline inflation rate for August 2015 stood at 23.0 percent, compared to 24.5 percent at the same period last year (August 2014), and 0.8 percentage points higher than the figure recorded in July 2015. With Malawi being a net importer of oil, low international energy prices have offered some respite. However, this has been more than offset by the depreciation in the value of the Kwacha, which may lead to higher nominal pump prices.

A range of recent changes to monetary policy has exacerbated uncertainty. Changes to the Liquidity Reserve Ratio have been implemented, involving a reduction in the share of total capital that commercial banks needs to leave on deposit at the Reserve Bank of Malawi (RBM) from 15.5 percent to 7.5 percent. This has released some MWK 40 billion into the banking system. While the intention of the policy was to reduce the spread between deposit and lending rates, an indirect effect has been to exacerbate inflationary pressures and increase the demand for foreign currency.

While prime lending rates have declined, these rates continue to be prohibitive for most borrowers. This situation is likely to continue until core inflation is brought back under control. In turn, the control of core inflation is highly dependent on reducing the size of the fiscal deficit and on curbing Government's appetite for borrowing. Similarly, administrative measures to limit exchange rate movements and the spread associated with foreign exchange trading have simply served to stimulate increases in parallel market trading.

Despite the Government having foreign reserves to a value in excess of 3.5 months import cover, the Kwacha depreciated sharply in July. This was largely due to speculation related to the reduced availability of foreign currency and to the low levels of agricultural production. While the exchange rate is usually subject to seasonal variation, these factors resulted in an earlier than usual onset of the seasonal depreciation, which usually takes place at the end of the tobacco season.

Business confidence appears to have declined. Continued fiscal and monetary turbulence, inflationary pressures, high interest rates, the significant extent of the Government's arrears, utility outages, the weakness of the Kwacha and uncertainty regarding the ability of Government to implement key reforms have all served to dampen confidence.

In 2015, Malawi will continue to face significant challenges, as external shocks add pressure to an already weak fiscal position and to poor business confidence. Restoring fiscal balance is critically important to efforts towards reducing inflationary pressures and controlling Government's domestic borrowing requirements. This is the only effective means by which bank lending rates will fall to levels that would make private sector borrowing for investment purposes feasible. Failure to address these imbalances also threatens the outlook for 2016. However, with increased investor confidence and a more benign macroeconomic environment, Malawi can expect to see the increased levels of investment that are necessary to sustain high rates of economic growth, job creation and poverty reduction in the medium term. To achieve these goals, policy makers should implement the following actions:

- **Tight management of public expenditure throughout the 2015/16 fiscal year:** This will involve careful control of expenditure commitments and strict enforcement of budget ceilings across all Ministries, Departments and Agencies to avoid expenditure overruns.
- **Appropriate prioritization of expenditure items if within-year reductions are necessary:** Malawi faces a declining GDP growth rate and consequently lower levels of collected revenues in 2015/16, together with a higher-than-projected rate of inflation and a decline in the value of the Kwacha. With these factors, there is a significant risk that there will be a larger-than-expected gap between available resources and spending commitments. In order to avoid damaging recourse to domestic borrowing, the Government may need to make within-year expenditure cuts. The need to protect key social services safety nets for vulnerable segments of the population will be an important factor in this prioritization process.
- **More intense efforts to improve the efficiency of budget execution, public finance and expenditure management:** A tight fiscal

environment reinforces the need to maximize the efficiency of existing Government expenditure to achieve optimal results and service delivery. Improving efficiency, including through efforts to better manage the wage bill, to intensify reforms to subsidy programs, and to achieve progress with key public financial management and public service reforms, are critically important.

It is expected that Malawi will achieve a GDP growth rate of 2.8 percent in 2015, according to World Bank projections**.** This is a significant downward estimate from that made in February 2015, when the projected rate was 5.1 percent. The downward revision reflects the impact of weather shocks on the production of maize and other key crops, uncertainty to the economic outlook, and a weak fiscal environment. With a more modest rate of economic growth, Malawi is expected to see an increase in the proportion of households living under the international poverty line over the year.

Malawi is facing a twin crisis arising from two separate issues, these being vulnerability to climate shocks and fiscal management challenges. Both issues would be causing macroeconomic instability on their own, but together the impact is amplified. The vulnerability to climate shocks is being manifested in the declining growth rate and deteriorating poverty outcomes. Existing fiscal pressures are being exacerbated by pressure from weather shocks. However, even without these shocks, the fiscal pressures alone would be a significant problem. In particular, the current tendency in fiscal policy towards cutting development expenditure to make space for overruns in recurrent expenditure will cause long-term damage. Thus the two sources of fragility exacerbate each other.

PRIMARY EDUCATION OUTCOMES UNDER FISCAL CONSTRAINTS

Of Malawi's population of 16 million, more than 8 million are below the age of 18. As one of the few countries in the world with a population with a declining average age, Malawi has the opportunity to seize a demographic dividend. However, this will only be possible if young Malawians are equipped with the necessary reading and numeracy skills to participate effectively in the labor market.

Compared to regional comparators, Malawi spends a higher than average proportion of public resources on education, accounting for almost 7 percent of GDP in recent years. Of this, the value of expenditure on primary education is equivalent to approximately 3.3 percent of GDP. This equates to around US$ 25 per pupil per year in on-budget public spending.

However, despite this high level of expenditure, educational outcomes have been disappointing. This special topic examines public expenditure in the primary education sector. It provides an example of the broader fiscal challenges that Malawi is facing, and the need to maximize development outcomes with finite available resources. The analysis draws upon a recent Quality of Service Delivery (QSD) survey examining the reasons for Malawi's poor input-output conversion ratios in the primary education sector and attempts to determine the manner in which systemic challenges in the system can be addressed.

Over 80 percent of Government expenditure on primary education is allocated for the payment of teachers' salaries. The high proportion spent on this item limits the fiscal space for capital expenditure and for procuring critical educational inputs such as the teaching and learning materials necessary for the delivery of quality education. In addition, the absence of mechanisms to accurately assess the performance of teachers results in poor linkages between teacher performance and levels of remuneration and promotion. This leads to a poor conversion of emoluments into teaching time and efforts in the classroom.

The average pupil-teacher-ratio is very high, at 69:1. However, there is a high level of variation in this ratio between schools and across levels within schools. Significant opportunities exist to use the existing stock of primary teachers more efficiently.

While classrooms and textbooks are in short supply, existing resources could be used more efficiently. The actual rate of utilization of textbooks is considerably lower than the pupil-per-textbook ratio, due to a tendency for schools to stockpile these textbooks instead of using them in classrooms. Existing classroom space could see the high level of variation in the average number of students per classroom reduced.

Regression analysis shows that the most significant factor determining progression rates in primary schools in Malawi is the value of non-wage expenditure per pupil. The availability of classrooms is also significant. Additional incremental expenditure on teachers does not contribute significantly to the achievement of higher progression rates in lower primary grades

In a constrained fiscal environment, Malawi can still implement a number of measures to improve educational outcomes. To achieve improved efficiency and productivity gains using available

resources and inputs, policymakers should consider the following measures:

- **To the fullest extent possible, teachers should be relocated from the upper grades, where there is on average a much lower PTR, to lower grades, with the ratio is much higher.** Reallocating teachers within and between schools would be a cost-effective method of improving PTR that mitigates the need to hire additional teachers. The Government should carefully review the marginal impact on learning outcomes derived from the hiring of additional teachers compared to investing in other education expenditures.
- **To improve school management, head teachers in primary schools should be given training to efficiently utilize school inputs.** The current system of training teachers focuses only on pedagogical skills without establishing a strong basis for the effective management of teachers and other teaching resources within schools. The implementation of a well-designed school leadership training program could improve the allocation and distribution of teachers across grades, the use of textbooks in schools, and the management of classroom space.
- **The construction and creation of additional classroom space needs to be targeted with a focus on creating additional space for classes at the lower grades, where classroom shortages are particularly severe.** Schools should be encouraged to use school improvement grants to better manage available space. For example, this could be achieved through the use of partitions to convert one large classroom into two smaller ones.
- **To improve the distribution and use of textbooks, the Government could promote the development of domestic markets for such textbooks, enabling students to purchase them locally.** This could be supplemented by a textbook grant for poor students who cannot afford textbooks. Over time, this system would lead to the development of a secondhand textbook market, reducing the net out-of-pocket expenditure at the household level.
- **School grants should be more effectively linked to school performance, particularly promotion rates in schools.** The current practice of linking school grants to enrolment numbers generates distorted incentives for schools to retain pupils who have virtually dropped out of the system on school rolls. Instead, schools should receive incentives to increase the number of students who complete a full cycle of primary education with the desired level of attainment in the area of reading and numeracy skills.

1. ECONOMIC DEVELOPMENTS

Africa's economic outlook remains positive, but the region faces growing headwinds

1. In 2014, the average rate of growth of GDP throughout Sub-Saharan Africa increased to 4.6 percent, up from 4.2 percent in 2013. However, this is still lower than the average annual rate of 6.4 percent recorded since 2000, with high rates of growth during this period being driven largely by investments in infrastructure and by consumer spending (World Bank 2015a). Overall, rates of growth began to decline at around the turn of the year due to the decline in the price of oil. However, the impact of this decline has been substantially different for oil importers on the one hand and oil exporters on the other. Nearly half of Sub-Saharan Africa's GDP is derived from the export of oil. The decline in the price of oil has had a severe negative impact on the GDP of oil exporters and thus a net negative effect on the GDP of the region as a whole. Between June 2014 and January 2015, oil prices fell by nearly 50 percent, remaining low ever since. This has put substantial pressures on the fiscal and current account balances of oil exporters. Oil exporters in Sub-Saharan Africa are less resilient to the price shock than many other oil-exporting countries because of their much more limited policy buffers.

2. By contrast to its impact on oil exporters, the decline in the price of oil has provided cyclical support to real incomes in net oil-importing countries. In oil importing countries, in the first quarter of 2015, the decline in the cost of fuel had a downward impact on rates of inflation and a positive impact on current accounts. However, with the broad-based strength of the U.S. dollar, even the currencies of oil importing countries showed a tendency to depreciate in value. The rate of growth in South Africa, the region's largest oil importing economy and a major trading partner and source of investment for Malawi, was stronger than expected in the fourth quarter of 2014, with a rebound in the goods-producing sectors following a deceleration earlier in the year. However, this rebound failed to continue into the first quarter of 2015, with growth constrained by energy shortages, a contraction in the output of the agricultural sector, a decline in investor confidence, policy uncertainty, and the anticipated impact of the gradual tightening of monetary and fiscal policy.

3. In 2015, the average rate of growth in Sub-Saharan Africa is projected to slow to 3.7 percent. This is a downward revision, being 0.9 percentage points lower than projections made at the beginning of the year (World Bank 2015a). In 2016, average rates of growth are expected to increase to 4.4 percent, and then to 4.8 percent in 2017. The increase in growth is expected to be driven by strong domestic demand, supported by continuing investment in infrastructure and by increased levels of private consumption resulting from lower oil prices. Consumption dynamics will differ for oil exporters on the one hand and oil importers on the other. Growth in private consumption is expected to slow in the oil exporting nations, with cuts to fuel subsidies implemented to alleviate pressure on the budget resulting in higher costs for consumers. Purchasing power is also expected to decline due to depreciations in the value of local currencies. By contrast, lower fuel prices are expected to contribute to a decline in rates of inflation in the oil importing nations, which should boost consumers' purchasing power and drive increases to the levels of domestic demand.

4. There remains considerable downside risks to the regional outlook, with banking sector weaknesses emerging as a potential contingent liability for governments in the region's oil exporting countries. In terms of exogenous factors, a sharper-than-expected slowdown in the Chinese economy, the potential for further declines in oil prices, a failure of the European bloc to achieve recovery, or a sudden deterioration in global liquidity conditions are the main risks for Africa's growth performance.

Malawi's rate of growth has fallen due to a mix of weather shocks and fiscal slippages

5. In 2015, the rate of economic growth in Malawi is expected to be subdued, as a series of both external and internal shocks take their toll. In 2014, Malawi recorded an impressive rate of growth, standing at 5.7 percent. This high rate of growth was driven by expansion in the agriculture, information and communications, and wholesale and retail trade sectors. However, adverse weather has affected agricultural production and is expected to constrain domestic demand and activities in the manufacturing sector in 2015. Weather-related shocks included flooding in the Southern parts of Malawi, the late onset of rains in most parts of the country, dry spells in the Central and Northern regions, and the early cessation of rain for late planted crops (see Box 1 for fuller details). The third round of the Agriculture Production Estimates Survey estimates that levels of maize production will decline by 30.2 percent, falling from 3,978,123 metric tons in 2014 to an estimated 2,776,277 metric tons in 2015. Erratic rains are the primary cause of the decline in maize production across the smallholder sector. However, inconsistent policies,

including the continued ban on maize exports, also resulted in reduced levels of planting by the commercial sector, which exacerbated the impact of adverse weather conditions.

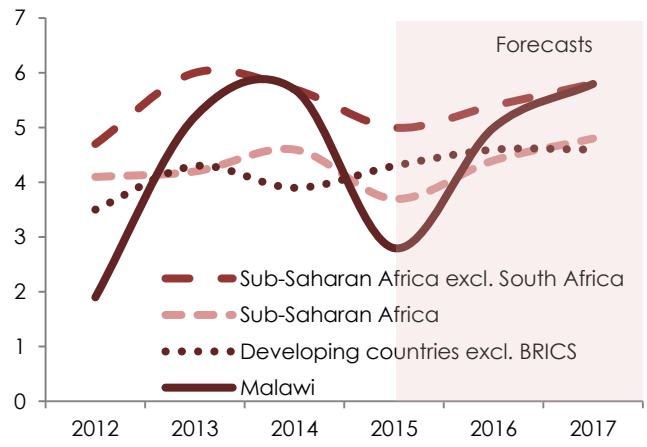
6. In 2015, Malawi's estimated rate of GDP growth has been revised downwards to 2.8 percent,[1] compared to an estimate of 5.1 percent made in February (World Bank 2015b). This significant downward revision recognizes the impact of weather shocks on the production of maize and other key crops, as well as uncertainty to the economic outlook resulting from the resurgent rate of inflation, which reached 23.0 percent in August 2015; continued high-base lending rates, with these rates reaching an average of more than 32 percent in July; and a weak fiscal environment (Figure 1). Failure to contain public spending in the 2014/15 fiscal year, with a much higher than expected level of domestic borrowing, has also played a role in undermining growth. The agriculture sector is expected to contract by 2.0 percent in 2015, while industry is expected to grow by 4.2 percent, and services by 5.1 percent. Both the weather shocks and the macroeconomic imbalances that Malawi is currently experiencing would be causing instability on their own, but together the impact is amplified.

7. Weather-related shocks mean that Malawi is now expected to experience a significant increase in food insecurity, with some 17 percent of the population unable to meet their food requirements. Maize is the country's primary food staple, serving as the main source for the calorific intake of the majority of the population. The volume of maize required to meet Malawi's current consumption needs is estimated at about 3,000,000 metric tons. With the projected decline in levels of production, it is estimated that there will be a shortfall of 223,723 metric tons. As a result, the Malawi Vulnerability Assessment Committee (MVAC) estimates that some 2.8 million people, or 17 percent of Malawi's population, will not be able to meet their requirements for food in 2015/16 (Figure 2).

8. With a slowing rate of GDP growth, the poverty rate is now expected to increase over the course of 2015, before resuming a downwards trend in 2016. With a more modest rate of economic growth projected in 2015, coupled with continued high rates of population growth, the proportion of poor households living under the new international poverty line of US$ 1.9/day (2011 PPP) is expected to increase marginally from 69.7 percent in 2014 to 69.9 percent in 2015[2].

Figure 1: Malawi's economic growth rate is expected to fall below regional averages

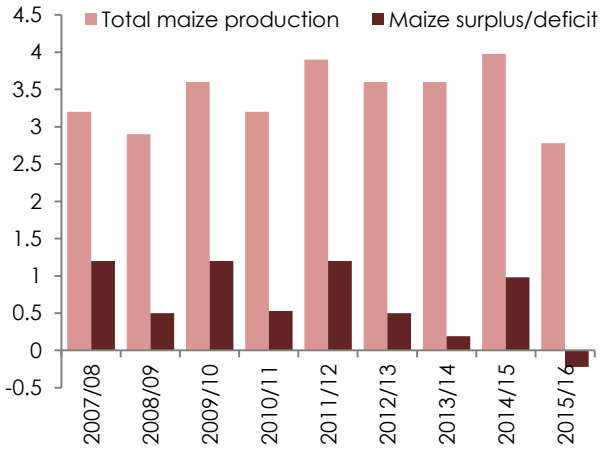
GDP growth adjusted for inflation, annualized (percent)



Source: World Bank Global Economic Prospects

Figure 2: Maize production dropped sharply in the 2015/16 growing season

Annual maize production/surplus/deficit, millions of tons



Source: World Bank staff based on Malawi Vulnerability Assessment Committee data

9. Difficulty in managing public expenditure is a key factor contributing to Malawi's persistent macroeconomic instability. Until the gap between revenue and expenditure is brought under control, the short-term outlook is unlikely to improve. The Government continues to run a large fiscal deficit, with expenditure under pressure as a result of rising debt service costs, increasing wage demands, and the cost of implementing subsidy schemes and

[1] Projection based on the World Bank staff estimates using MFMod.

[2] In October 2015, the World Bank updated the global poverty line used to track progress across countries in reducing extreme poverty. The new poverty line has been revised from US$ 1.25/day (based on 2005 prices) to US$ 1.9/day (based on 2011 prices). A periodic update is needed to account for evolving differences in the cost of living across the world. The updated US$ 1.90/day poverty line expresses, in 2011 prices, the same real value (in poor countries) of the US$ 1.25/day line at 2005 prices. While some countries have seen differences in estimates of the share of the population living below the new international poverty line, the differences for Malawi are very small. In 2010/11, 74.95 percent of Malawi's population was living below the poverty line measured at US$ 1.25/day compared to 73.63 percent at US$ 1.90/day.

addressing arrears. With limited scope for on-budget foreign financing at levels previously available to the Government, the authorities continue to borrow heavily from domestic sources to close the gap. This exacerbates inflationary pressures and drives up lending rates, crowding out private sector investment, constraining economic growth and dampening business confidence.

10. The FY1205/16 budget was prepared by Government assuming a rate of GDP growth of 5.4 percent, an average rate of inflation of 16.4 percent and an exchange rate of 450 Kwacha to the US Dollar. In terms of all three of these indicators, performance is likely to be worse than expected, undermining the ability of the authorities to implement the budget as planned. Lower rates of GDP growth will result in a decline in the value of collected revenues, creating a significant risk that revenue targets may not be achieved. Increases in the rate of inflation will increase the cost of domestically procured goods and services and may lead to increased wage bill demands from public servants. A weaker Kwacha will result in increased actual costs of imported goods and services, with increases to the cost of imported fertilizer, fuel and medicines being particularly significant.

11. Malawi is facing a twin crisis arising from vulnerability to climate shocks, made worse by fiscal management challenges. The impact of the climate shocks is being manifested in the declining growth rate and worsening poverty outcomes. While the negative effect of fiscal pressures are being indirectly exacerbated by the impact of weather shocks, even without this additional factor, they would be a significant cause for concern on their own. In particular, the current tendency of fiscal policy towards cutting development expenditure to make space for overruns in recurrent expenditure will cause long-term damage, particularly given that development expenditure could be leveraged to improve the level of resilience to the impact of climate shocks. Thus the two sources of fragility are negatively reinforcing each other.

12. Malawi's medium-term prospects are positive, if short-term stabilization can be achieved. Malawi is well endowed with agricultural, water and mineral resources. Much of Sub-Saharan Africa is experiencing robust growth. In particular, many of Malawi's neighbors are experiencing sustained high rates of economic growth, with this growth creating an enlarged 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 of Malawi with the regional economy.

13. However, improved economic performance in 2016 and beyond is dependent on the restoration of macroeconomic balances. In particular, it is dependent on the improved management of public expenditure. The running of a large fiscal deficit has resulted in significant increases to the level of domestic borrowing; in poor expenditure discipline; and in the build-up of significant domestic payment arrears. All of these factors have had a significant negative impact on Malawi's economic outlook. Business confidence is only likely to be restored once inflation and interest rates begin to decline. In turn, this is dependent on the achievement of fiscal consolidation 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 towards addressing core public financial management weaknesses that came to light in the wake of the "cashgate" public financial management scandal.

Box 1: What is the economic impact of the 2015 weather shocks on Malawi?

Malawi faces a number of both natural and man-made hazards, with the intensity and frequency of disasters having increased over recent years, largely due to the impacts of climate change, population growth and environmental degradation.

In 2015, a number of weather-related shocks had a negative impact on Malawi's economy, with these shocks resulting in a destruction of assets, a decline in crop production, and disruptions to infrastructure services and economic activities. Unusual patterns of rainfall resulted in both floods and droughts across different parts of the country over an overlapping period of time.

Firstly, very high levels of rainfall in January 2015 resulted in one of the worst floods to have ever hit the country, causing significant damage in the southern region of Malawi. These floods affected some 1.1 million people, displacing 336,000 and killing 104. An estimated 89,000 hectares of cropland was destroyed, representing around 2.4 percent of the total area of agricultural land in Malawi. Estimates from the Post Disaster Needs Assessment (PDNA) put the total value of damage and losses, including to agricultural crops, housing, commerce and public infrastructure, at US$ 335 million (a value equivalent to around 5.0 percent of GDP).

The affected districts are among Malawi's poorest, with as much as 80 percent of the population of these districts living below the national poverty line and with the impact of the floods exacerbating this situation for large numbers of individuals. Poor members of the community have limited ownership of assets, which might otherwise

serve as a buffer against shocks, so their situation is particularly precarious. Since the floods affected some of Malawi's poorest districts, the impact of the disaster has been most significant in terms of human development, with the impact on economic activity somewhat muted.

Compounding the impact of the floods, the delayed onset of rains this year resulted in a shortened growing season across a much larger part of the country. Dry spells in February and March in most central and northern areas and the early cessation of rains at a critical period in crop development resulted in reduced yields for almost all crop types. Maize production in the 2014/15 growing season has been estimated to have fallen by 30.2 percent compared to the previous year, creating significant challenges to the achievement of food security. The yields of cash crops have also seen lower, although to a lesser extent.

In 2015, the floods and the drought had a negative impact on GDP growth. However, the impact of the floods is estimated at only around 0.55 percent of GDP, reflecting both the high levels of poverty (and therefore the low purchasing power) and limited scale of cash crop production in the affected areas. The effect of the floods is also estimated to be partially offset by recovery and reconstruction efforts financed through increases in the value of foreign grants. By comparison, the negative impact of the drought has been estimated at a more significant 2.3 percent of GDP. The more significant impact of the droughts is the result of the impact on maize production across large parts of the country, on levels of production of key cash crops, and on the purchasing power of a significant share of Malawi's population.

It is likely that Malawi will continue to face incidents such as the recent floods and droughts at irregular intervals into the future. To address the impact of such events, a key focus for the future will be on measures to improve resilience. Key recommendations from the PDNA include the implementation of measures to:

- Strengthen institutional arrangements for the management of disasters to ensure effective and well-coordinated implementation of disaster risk management activities;
- Strengthen disaster risk management financing, including through adequate links to disaster preparedness and contingency planning to ensure quick and adequate financing when a disaster occurs;
- Mainstream disaster risk management in all sectors through improved and more resilient designs for key infrastructure, including roads, bridges, schools and health clinics. It is also necessary to ensure that disaster resilience is considered at an early stage in all public investment projects;
- Address the expected decline in levels of agricultural output resulting from weather shocks by introducing inputs-for-assets and cash-for-work programs to provide sustainable livelihood support to affected households;
- Employ a programmatic and integrated approach to disaster recovery planning, with measures to ensure strategic harmonization across public, private and civil society recovery interventions. This will be achieved through the development and institutionalization of a National Disaster Recovery Framework that provides the institutional, policy, financing and implementation arrangements for efficient, effective and sustainable recovery in the context of current and future disasters.

Source: Malawi 2015 Floods Post Disaster Needs Assessment Report

Fiscal performance continues to weaken

14. By the end of the 2014/15 fiscal year, the Government had recorded lower-than-expected levels of revenue and sharply higher recurrent expenditure. The budget deficit for the 2014/15 fiscal year was of a value equivalent to 5.4 percent of GDP[3] (Figure 3). Although this was smaller than the figure of 8.0 percent recorded in 2013/14, the fiscal gap was only closed through a sharp contraction in development expenditures and a quadrupling in the level of domestic borrowing relative to that budgeted for at the beginning of the year. The principal causes of the fiscal pressures experienced during 2014/15 were the significantly higher than anticipated level of recurrent expenditure, particularly expenditure on public sector wages, salaries and pensions; the cost of servicing domestic debt; and the cost of implementing the Farm Input Subsidy Program (FISP). The value of foreign grants was also well below budgeted expectations, while the Government also performed below expectations in the collection of

[3] Malawi's fiscal year runs from July 1 to June 30. Note that Malawi's public expenditure ratios to GDP are large compared to countries with similar characteristics. This is partly due to GDP being very low. Rebasing estimates of GDP would reduce the levels of these indicators, but would not alter the overall pattern of major trends.

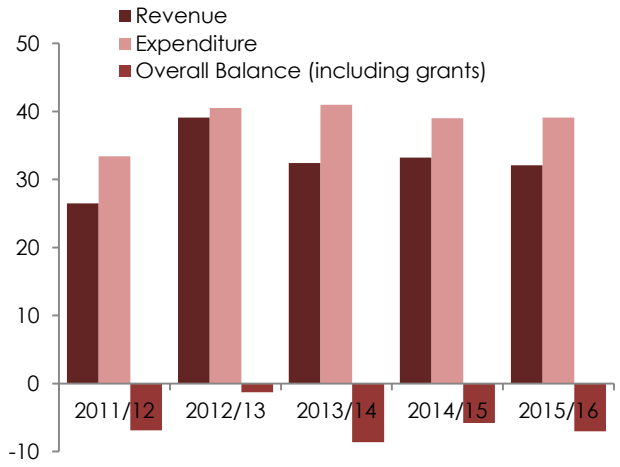
domestic tax revenues. In the absence of foreign sources of deficit financing, the Government bridged the gap by increasing its levels of domestic borrowing.

15. The total value of revenues declined in 2014/15, with foreign development assistance provided on-budget continuing to fall and with the Government recording poor performance in the area of domestic revenue collection. The value of revenue and grants amounted to the equivalent of 30.0 percent of GDP in the final budget outturn for 2014/15, compared to the figure of 33.0 percent recorded in 2013/14 and to that of 32.2 percent projected at the time of the approval of the budget. Revenue collections in all tax categories underperformed in the second half of FY14/15 as a result of a decline in business activity, with the total value of collected revenues falling 4 percent short of targets for the fiscal year as a whole. Weaker consumer demand, the decline in business activity, and disruptions to utility services had an adverse impact on the value of collected VAT, corporate income tax and import duties. The decline in imported energy prices also resulted in a decline in the value of collected trade taxes. The value of collected income tax was higher than expected, partly due to the rapid growth in the civil service payroll. In aggregate terms, the total value of collected tax revenues declined from the equivalent of 24.6 percent of GDP in 2013/14 to 23.2 percent in 2014/15. The value of non-tax revenues increased by the equivalent of 0.2 percent of GDP from the levels recorded in 2013/14. This was the result of the Government's endeavors to increase the costs of services across the board, which partially offset the lower-than-expected value of collected tax revenues.

16. The value of disbursed foreign grants declined as development partners continued to reduce the share of official development assistance channeled through Government systems in response to the 2013 "cashgate" public financial management scandal. The value of grants fell from the equivalent of 5.0 percent of GDP in 2013/14 to 3.7 in 2014/15, against a budgeted figure for 2014/15 of 5.5 percent. This compares to a peak in 2012/13, when Malawi received grants of a value equivalent to 14.5 percent of GDP. No budget support was disbursed during the 2014/15 fiscal year.

Figure 3: Government's fiscal position remains under significant pressure…

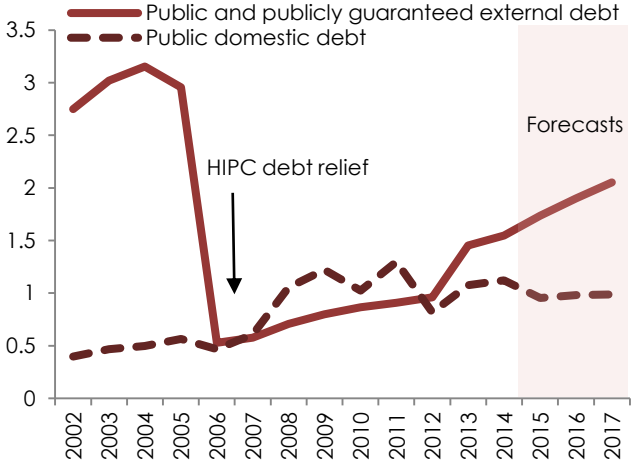
Revenue, expenditure and budget deficit, percent of GDP



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

Figure 4: …leading to continued high rates of borrowing

US$ billions



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

17. Recurrent expenditure expanded at a significant rate, driven by an increase in spending on wages, salaries and pensions, the servicing of domestic debt and subsidy programs. As a share of GDP, recurrent expenditure in the 2014/15 fiscal year reached a value equivalent to 30.9 percent, significantly higher than the figure of 27.6 percent approved in the 2014/15 budget, but less than the figure of 34.7 percent recorded in 2013/14. With the Government struggling to accommodate wage demands across the public sector, expenditure on wages and salaries grew at a rapid pace, reaching a value equivalent to 9.9 percent of GDP, as opposed to an approved estimated value of 8.2 percent of GDP in 2014/15 and 8.9 percent in 2013/14. Following a series of negotiations, the Government granted increases in remuneration in excess of those provided for in the budget. In addition, the size of the payroll grew significantly during the year, primarily due to the recruitment of an additional 11,000 new teachers. It is estimated that an additional 8,000 teachers will be recruited in 2015/16, bringing the total size of the public service to around 186,000 employees (see Box 2 for a detailed discussion on Malawi's public sector wage bill). Another notable area of over-expenditure involved expenditure on fertilizer and seed subsidies under FISP, with the value of this expenditure increasing from the approved figure equivalent to 2.2 percent of GDP to 2.7 percent. This was

largely due to cost overruns resulting from the depreciation in the value of the local currency at the time of purchase and to inefficiencies in procurement, transport and distribution. Heavy recourse to domestic borrowing also resulted in a significant increase in interest payable on Government debt, from an approved value equivalent to 4.0 percent of GDP to 5.8 percent by the end of the fiscal year. The share of expenditure on goods and services declined as the Government attempted to reduce spending. With the additional impact of donor-funded purchases of goods and services increasingly being made off-budget, expenditure on goods and services declined from a value equivalent to 8.1 percent of GDP in the approved estimates to 7.6 percent, as compared to the figure of 11.2 percent recorded in 2013/14. There was no expenditure on the iron sheets subsidy during 2014/15, which resulted in savings to a value equivalent to 0.4 percent of GDP.

18. With the Government simultaneously recording increases in expenditures and decreases in receipts, Malawi's fiscal position came under significant stress during 2014/15, with the deficit covered by heavy cuts to development expenditure and large increases in domestic borrowing. The overall balance ended with an aggregate fiscal deficit broadly in line with that approved at the start of the year, at a value equivalent to 5.4 percent of GDP (see Table 1 for detailed figures). Increased expenditures in the recurrent budget and the lower-than-expected value of collected revenues and grants were offset by cuts to the development budget. Thus, the development budget was more than halved, from a value equivalent to 9.9 percent of GDP in the approved estimates to 4.4 percent at the end of the year. By comparison, in 2013/14, the value of development expenditure stood at the equivalent of 6.4 percent of GDP. Expectations of foreign deficit financing, including expectations of the restoration of some budget support financing during the 2014/15 fiscal year, were not fulfilled. As a result, the Government resorted to domestic borrowing to a greatly more significant extent than expected at the beginning of the fiscal year. The value of net domestic borrowing reached the equivalent of 4.8 percent of GDP in 2014/15, compared to 1.8 percent in the approved estimates. By comparison, in 2013/14, the figure stood at 5.9 percent of GDP. These high rates of domestic borrowing had a number of negative impacts on the broader economy, with the continued large-scale volume of Treasury Bill sales and borrowing from the central bank having an upward impact on the rate of inflation, crowding out private sector investment and dampening economic growth. By the end of 2013/14, the Government had accumulated arrears to a value equivalent to 7.9 percent of GDP. It was planned that the stock of arrears would be cleared by issuing zero coupon promissory notes, with maturity periods ranging from one, two to three years. However, the process of verifying arrears claims and the actual process of issuing bonds has been slow, with notes to a value of only around 14 percent of the total estimated stock of outstanding arrears having been issued by the end of FY2013/14. This has pushed the repayment period backwards, providing some savings to the Government in terms of the repayment of the bonds, at the expense of arrears holders.

Restoring fiscal discipline is a prerequisite for stronger investment and growth

19. Given the deterioration in the short-term macroeconomic outlook, the Government will continue to face tight budgetary constraints over the course of the 2015/16 fiscal year. Since the time of budget preparation, expectations of GDP growth have fallen significantly. Similarly, expectations for annual inflation have risen and the Kwacha has weakened. These effects have cumulatively placed the authorities under heightened pressure from the outset of the new fiscal year.

20. In the context of a challenging macroeconomic environment, bullish estimates for revenues and grants in 2015/16 may prove to be overly ambitious. The total value of revenues and grants is estimated to reach the equivalent of 32.1 percent of GDP, with the value of domestic revenues at 28.0 percent and that of grants at 4.1 percent. This represents real growth over the 2014/15 outturns. The value of domestic revenues met the July target only because government paid two months (June and July) of the public sector wage bill in one month, with the high value of collected payroll taxes compensating for weak performance in other areas. Going forward, as prospects for economic growth remain subdued due to rising food inflation, disruptions in electricity supply, and weak business and consumer confidence, the value of collected domestic revenue is likely to be lower than the projected levels. However, higher-than-expected rates of inflation and a depreciation in the value of the Kwacha should offer some partial respite in terms of the nominal value of collected VAT and trade taxes.

21. At the same time, early indications point to an expansionary budget, with consequent upward pressure on public expenditure. The Government's initial budget presentation outlined an expenditure framework for 2015/16 of MWK 901.6 billion (a value equivalent to 37.9 percent of GDP), which already represented an increase in real terms compared to expenditure in 2014/15. However, by the time of parliamentary approval, the budget had been upwardly revised to MWK 930.0 billion (a value equivalent to 39.1 percent of GDP and higher than the 2014/15 outturn, which stood at the equivalent of 35.4 percent of GDP). This included supplemental increases to the allocations for education (MWK 5 billion), public universities (MWK 3 billion), health (MWK 6 billion), home affairs

(MWK 1.5 billion), the police (MWK 2.8 billion) and the judiciary (MWK 1 billion). The budget for the Local Development Fund was reduced by MK 0.6 billion in order to facilitate increases to expenditure on the Constituency Development Fund, from MWK 9 million to MWK 12 million per constituency. The increase in expenditure is contingent upon the availability of additional financing, in the absence of which the Government may once again resort to increased domestic borrowing.

22. With approximately 40 percent of the budget involving expenditure on items that are priced in foreign currency, depreciations in the value of the Kwacha will automatically compress the fiscal space in which the Government operates. The 2015/16 budget was prepared on the assumption of an average exchange rate of MWK 450 to the US dollar. With the Kwacha losing close to 30 percent of its value against the Dollar within the first two months of the fiscal year, purchasing power will decline for that share of the budget used to procure goods and services in foreign currency. This includes fertilizer, medicines, fuel and the cost of servicing foreign borrowing debts. Similarly, a higher than projected rate of inflation will increase the cost of domestically procured goods and services and lead to higher wage bill demands from public servants.

Table 1: Fiscal accounts

Percentage of GDP

	2012/13	2013/14	2014/15		2015/16
			Budget	Actual	Budget[4]
Revenue and grants	**39.1**	**33.0**	**32.2**	**30.0**	**32.1**
Revenue	**24.5**	**28.0**	**26.7**	**26.3**	**28.0**
Tax Revenue	22.3	24.6	23.9	23.2	24.9
Nontax revenue	2.3	3.3	2.8	3.1	3.1
Grants	**14.5**	**5.0**	**5.5**	**3.7**	**4.1**
Budget support grants	6.4	0.4	0.0	0.0	0.3
Project grants	2.9	2.6	3.6	2.2	2.2
Dedicated grants	5.3	2.0	1.9	1.4	1.6
Expenditure and net lending	**40.5**	**41.0**	**37.6**	**35.4**	**39.1**
Recurrent expenditure	**31.9**	**34.7**	**27.6**	**30.9**	**29.6**
Wages and salaries	8.0	8.9	8.2	9.9	9.6
Interest payments	2.8	6.2	4.0	5.8	5.3
Domestic	2.4	6.0	4.0	5.8	4.2
Foreign	0.3	0.2	0.3	0.4	1.0
Goods and services	11.9	11.2	8.1	7.6	8.1
Subsidies and other current transfers	8.1	7.9	6.8	7.0	6.6
Fertilizer and seed subsidy	4.3	3.8	2.2	2.7	1.7
Arrears payments	1.0	0.5	0.5	0.0	0.0
Development expenditure	**8.6**	**6.4**	**9.9**	**4.4**	**9.4**
Foreign financed	6.0	5.1	7.4	3.1	7.3
Domestically financed	2.6	1.2	2.4	1.4	2.1
Overall balance (including grants)	**-1.3**	**-8.0**	**-5.4**	**-5.4**	**-7.0**
Financing	2.5	8.7	5.0	5.0	7.0
Net foreign financing	2.7	2.8	4.2	0.2	4.8
Gross foreign borrowing	3.1	3.4	4.8	0.8	5.5
Budget support loans	0.0	0.9	1.5	0.0	1.4
Project loans	3.1	2.5	3.3	0.8	4.2
Amortization	-0.4	-0.6	-0.5	-0.6	-0.7
Net domestic borrowing	-0.2	5.9	1.8	4.8	2.2
Memorandum items:					
Nominal GDP (MWK billion)	1,208	1,578	1,991	1,991	2,377
Securitization of domestic payment arrears	0.0	2.5	7.9	1.1	6.8

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

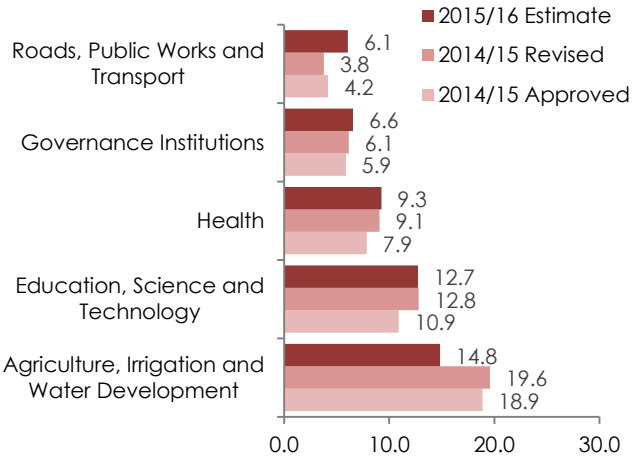
23. The distribution of budgetary allocations among major sectors in FY2015/16 remains roughly unchanged from the previous year. However, the proportion of capital expenditure declined relative to that of recurrent expenditure. Within a resource-constrained environment, there have been some modifications to sectoral allocations. The most significant proportion of expenditure was on the agricultural sector,[5] although in 2015/16, the proportion of the

[4] Revised budget, reflecting adjustments made after approval by parliament.
[5] Including Agriculture, Water Development and Irrigation.

budget allocated to this sector is expected to decline to 14.8 percent, down from approximately 19.6 percent of total expenditure in 2014/15 (Figure 5). This is in line with the proposed rationalization of expenditure related to the implementation of the FISP. The major social sectors, health[6] and education, are expected to receive a share approximately similar to that received in the preceding year. It is expected that the allocations for transport[7] and governance-related agencies will be increased. In terms of the former, the budget emphasizes investment in roads, while in terms of the latter, the increased allocation reflects the Government's commitment to restoring confidence in public finance and economic management systems.

Figure 5: Major sectoral allocations in the 2015/16 budget reflect the dominance of recurrent over development expenditures

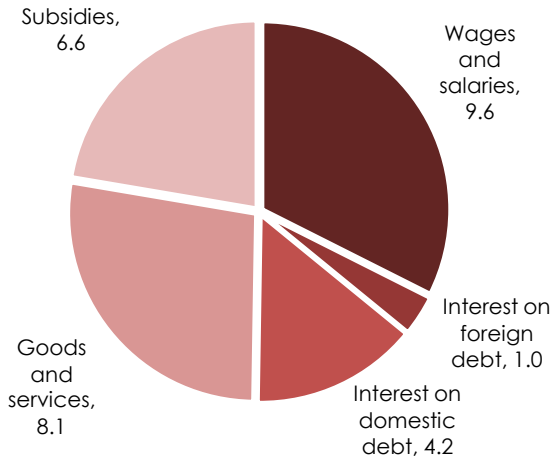
Top five sectoral budget allocations, percentage of total budget, selected years, net of transfers to local councils and subventions



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

Figure 6: Half of recurrent expenditure goes on public sector wages and debt service costs

Share of estimated 2015/16 recurrent expenditure, percentage of GDP



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

24. For the 2015/16 agricultural season, the Government has introduced two key reforms to the Farm Input Subsidy Program, with this program continuing to be targeted to reach 1.5 million beneficiaries. After ten years of implementation, FISP has been credited with having made a contribution to the achievement of improved food security in Malawi. At the same time, the scheme is widely considered to be inefficiently managed and a heavy burden on the national budget. The way the scheme is currently implemented, the associated exchange rate risk is borne exclusively by the Government. Together with inefficient procurement and distribution, this has led to repeated expenditure overruns and poor value for money. In 2014/15, expenditure on FISP accounted for 10 percent of all expenditures under the national budget and 70 percent of the Ministry of Agriculture's expenditures, exceeding initial budget allocations by 26 percent. Even with these investments in FISP, in 2015, Malawi recorded one of the worst harvests on record due to erratic rainfall. Reforms introduced to the scheme in 2015/16 included a reduction in the level of subsidy from 97 percent to 77 percent of the retail price, with farmer contributions increasing from MWK 500 per bag of fertilizer to MWK 3,500 per bag. The reforms also involved a pilot scheme permitting the importation, distribution and retailing of fertilizer by the private sector. The involvement of private suppliers in the supply chain, with private suppliers managing 27 percent of the 150,000 metric tons of fertilizer (up from zero) is a modest but important first step towards the implementation of a more transparent and efficient scheme. The reduction in the level of subsidy provides an increase in fiscal space for the Government, while ensuring that the scheme naturally reaches farmers that have the resources to utilize subsidized fertilizer. Many of the poorest farmers to receive coupons under FISP have in the past sold these coupons, which means that the scheme has effectively served as an extremely expensive, inefficient cash transfer program. The poorest households, such as those that have insufficient land or labor to utilize fertilizer effectively, would be best served through the implementation of alternative social safety programs specifically tailored to meet their needs effectively.

25. Net financing requirements are expected to be met predominantly through long-term and highly concessional foreign project loans. However, in this area, estimates in the budget may prove to be excessively optimistic. The total need for financing is estimated to reach a value equivalent to 7.0 percent of GDP. Of this, foreign financing is projected to reach a value equivalent to 4.8 percent of GDP, with domestic financing at 2.2 percent of GDP. The

[6] Including Nutrition, HIV/AIDS and National AIDS Commission.
[7] Including Transport and Public Works, National Roads Authority and Road Fund Administration.

value of program loans (budget support), which has declined steadily over the recent past, is projected to increase from the equivalent of 0.9 percent of GDP to 1.4 percent. This may prove to be excessively optimistic. The availability of budget support is unlikely to return to levels recorded in the recent past, with even partial restoration being heavily dependent on the Government recording significant progress in implementing its public financial management reforms to rebuild confidence among external partners in the integrity of the Government's fiscal accounts. With Malawi's economy highly dependent on foreign aid, changes in development partner sentiment have an extremely significant impact on budget performance and are a significant source of resource volatility. The net domestic borrowing requirement for 2015/16 is projected to reach a value equivalent to 2.2 percent of GDP. However, there is a risk that this proportion will increase if the value of foreign financing is lower levels than the budget estimates.

Box 2: How much is Malawi spending on the public sector wage bill?

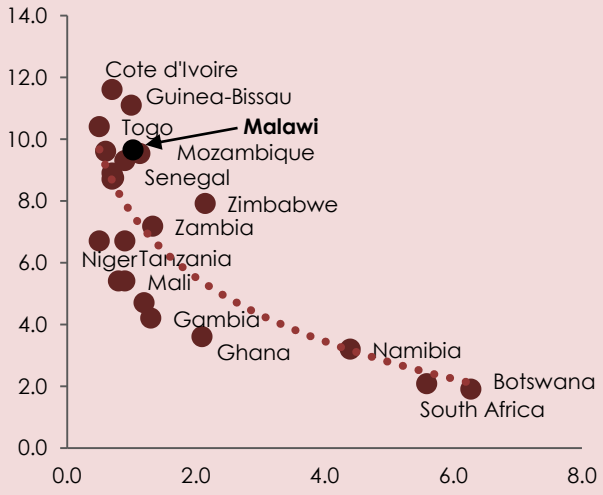
Malawi's public sector wage bill has grown rapidly in recent years. Improving efficiency in the management of spending on wages, salaries and pensions is a key step towards restoring fiscal management. The total value of the public sector wage bill reached a peak at the equivalent of 9.9 percent of GDP in the 2014/15 fiscal year and now accounts for around a third of recurrent expenditure. With such a large share of Government expenditure allocated on wages and salaries, this leaves limited space for non-wage expenditure on items such as teaching materials in schools, medicines in hospitals and health centers or the maintenance of existing capital investments. In all of these areas, the marginal impact of additional spending on social outcomes is likely to be much higher (the breakdown of wage and non-wage expenditure in the primary education subsector is explored in detail as the special topic in Part 2 of this edition of the MEM).

The rapid growth of the wage bill is primarily due to sustained increases in the size of the public service. The number of public servants has grown from around 110,000 persons in 2008, to 178,000 in 2015 and is expected to reach 186,000 persons in 2016. This raises questions about the sustainability of the overall public sector wage bill.

However, despite increases in the aggregate wage bill, the median public sector wage generally falls below comparators in the private sector (although this is not the case at all grades within the civil service). This puts pressure on other areas of Government spending, particularly the large travel budget (at a value equivalent to approximately 2 percent of GDP), which often acts as a supplemental source of income for civil servants. Similarly, significant inefficiencies in the administration of the public sector payroll inflate total costs.

Figure 7: While the size of Malawi's civil service is small compared to other countries in Africa, the cost is high relative to per capita income

Average public sector wage rate as a share of GDP (y axis) plotted against the size of the public service as a share of the total population (x axis), selected countries, 2014 or most recent year available



Source: World Bank staff calculations and estimates

Table 2: Growth in the size of the wage bill has been driven primarily by an expansion in the number of civil servants

Share of estimated 2015/16 recurrent expenditure, percentage of GDP

	No. of civil servants	Wage bill / GDP	Civil servants / population
2009	114,157	6.2 %	0.75
2010	116,258	6.7 %	0.74
2011	129,814	7.2 %	0.80
2012	131,588	8.1 %	0.79
2013	167,300	6.7 %	0.98
2014	173,000	9.9 %	1.02
2015*	177,870	9.6 %	1.05

**Estimate*

Source: World Bank staff calculations and estimates

The Government's new public service reforms, announced in early 2015, offer an opportunity to address the longstanding challenges that prevent the delivery of better quality public services with available resources. Going forward, policymakers should consider the following policy steps:

- *Immediate measures to stem the growth of the public service*: Employment freezes are typically difficult to enforce. However, Malawi has considerable scope to improve employment and wage controls, such as by enforcing strict limits on new hiring.
- *Abolishing unfilled posts*: The Government should consider abolishing posts that have remained unfilled for long periods of time, or for which the relevant agencies cannot provide a reasonable justification.
- *Targets for controlling the wage bill:* The Government could establish medium-term targets for controlling the wage bill as a share of GDP and as a share of public expenditures and adopt policies to advance these objectives.
- *Eliminating discrepancies in the civil service payroll*: The Government should undertake a thorough audit and diagnostic of the administration of the civil service payroll and pension system in order to eliminate discrepancies including "ghost workers".
- *Improving public sector productivity:* The Government could adopt measures to improve performance and enhance public sector productivity. Recent efforts to introduce results-based budgeting techniques should help to provide a stronger analytical basis for the allocation of staff and serve as an important tool for monitoring their impact on public service productivity over time. A thorough review of civil service pay, grading and incentives would be an important part of this process. A number of African countries with relatively small public administrations have been able to provide quality public services with fewer staff by adopting modern management techniques.

26. Careful management of expenditure will be critically important, with the Government facing another challenging year, with a constrained resource envelope. With a poor outlook for growth and revenue collection, rising inflationary pressures, a weak Kwacha, and increased expenditure estimates, it will be a challenge for Malawi to avoid fiscal instability. With very limited budgetary cushions, the risk relates to excessive recourse to domestic borrowing. The 2015/16 budget makes a provision for the doubling of domestic borrowing, from the equivalent of approximately 1.1 percent of GDP in the initial framework to 2.2 percent of GDP in the approved budget. The cost of debt service, the public wage bill, and the cost of subsidies will continue to weigh heavily on the budget (Figure 6). The Government continues to implement a predominantly consumption-oriented budget, with scarce resources consistently being allocated to preserve recurrent expenditure, at the cost of cuts to development expenditure. This is of particular concern given the impact of recent climate shocks and the clear need for Malawi to invest in increased resilience.

27. An aggregate budget deficit of a value equivalent to 7.0 percent of GDP is anticipated in the approved FY2015/16 budget. This is significantly higher than the deficit recorded in FY2014/15, when the figure stood at 5.4 percent. It is also premised on significant increases in foreign financing, which may or may not be realized. If these sources do not materialize, or indeed if any of the risks described above manifest to a significant extent, within-year cuts to expenditure may be necessary to avoid excessive recourse to domestic borrowing. This will require careful prioritization to ensure that key services and safety nets are protected.

The burden of public sector debt remains heavy

28. Malawi's level of debt has increased significantly over recent years, with the costs of debt servicing close to those recorded before debt relief was granted in 2006. The total value of public and publicly-guaranteed debt has increased from a value of US$ 1.56 billion in 2012 (equivalent to 49.7 percent of GDP) to that of an estimated US$ 2.59 billion at the end of 2014 (equivalent to 69.6 percent of GDP). Malawi is now spending the equivalent of 5.3 percent of GDP on debt service, one the highest levels in the region. Almost all of the fiscal space made available as a result of the 2006 debt relief that Malawi received under the Highly Indebted Poor Countries Initiative has now been eroded (Figure 3). The increase in the level of debt has been predominantly driven by domestic borrowing, with domestic borrowing being conducted to make up for external financing shortfalls due to lower-than-expected foreign grants. The securitization of arrears owed by the Government to the private sector through the issuance of zero coupon bonds in early 2015 has also played a role. External debt has also expanded, although with most foreign borrowing contracted on highly concessional terms, the burden is considerably lighter. The sale in late 2014 of US$ 250 million in existing domestic debt to the COMESA PTA Bank also provided a significant input of foreign

currency to official resources. Revisions to the Reserve Bank of Malawi (RBM) Act (approved by Parliament, but not yet promulgated) involve a limit to Government borrowing directly from the Central Bank through conversion of ways and means advances to no more than 10 percent of the previous year's revenues. This is an encouraging policy move.

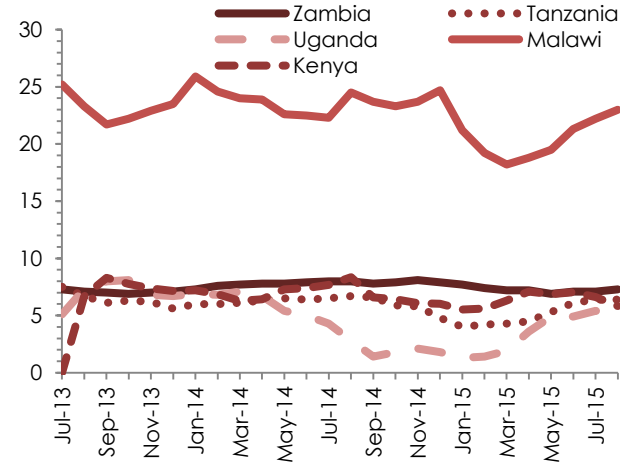
29. Careful budget execution is necessary to restore fiscal discipline. With debt levels rising dramatically, a persistently high rate of inflation, a large fiscal gap, high lending rates and recurring public finance management challenges, the Government has very little available fiscal space. With expenditures growing at a more rapid than expected rate; domestic revenue collection below targets; and foreign financing falling short of expectations, the Government will continually be under pressure to increase domestic borrowing and to accumulate additional arrears. Thus, fiscal instability limits the effectiveness of monetary policy, which consequently culminates in the macroeconomic stresses that the economy is now experiencing.

Malawi continues to battle double digit inflation

30. Malawi's rate of inflation remains stubbornly high. Despite showing signs of declining for several months, it has now resumed an upward trajectory. In the first quarter of the year, the year-on-year headline inflation rate declined slightly, from 21.2 percent in January to 18.2 percent in March. This decline was a result of both lower food prices and, in particular, lower imported energy costs resulting from the global slump in oil prices. However, by April, this downward trend was reversed, with the headline inflation rate increasing to 18.8 percent. This represented a 0.6 percentage point increase from the rate recorded in the preceding month, although it was lower than the rate of 23.9 percent recorded in the same month in the preceding year. The increase in the rate of inflation was mostly driven by an increase in maize prices, which exerted upward pressure on food inflation. The rate of price increases has continued to rise steadily during the second and third quarters. This is somewhat unusual, given that food price pressures usually decline during this period of the year, in the period immediately following the harvest season for key staple foods, particularly maize. With a sharp decline in levels of production of maize in 2015, reduced supply, exacerbated by traders hoarding in anticipation of public relief purchases, resulted in no significant fall in food prices in the post-harvest period, with prices continuing to rise into the third quarter.

Figure 8: Inflation has returned to an upward pathway, and remains well above regional comparators

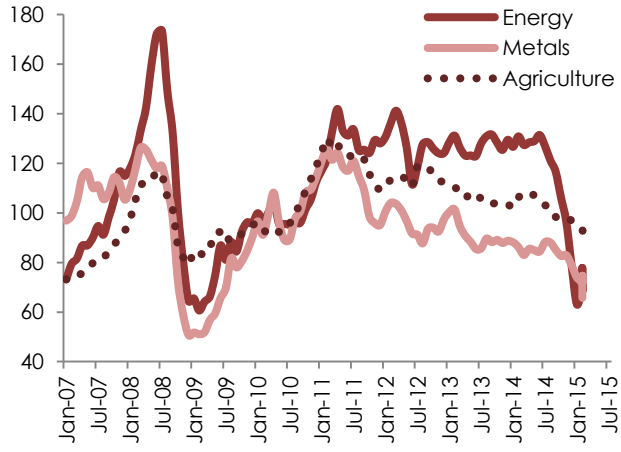
Headline annual inflation, percent, year-on-year, selected countries



Source: World Bank staff based on data from national statistics offices in Malawi, Uganda, Tanzania, Kenya and Zambia

Figure 9: International commodity prices, particularly energy prices, have stabilized at a new lower level

International commodity price indices, 2007-2015, 2010= 100



Source: World Bank Development Prospects Group

31. The headline year-on-year inflation rate reached 23.0 percent in August 2015, one of the highest in Africa (Figure 8). Food accounts for a larger share in the inflation basket in rural areas than in urban areas, constituting 61.7 percent in the former, compared to 33.9 percent in the latter, with the national average standing at 50.2. Thus, higher rates of food inflation erode purchasing power to the greatest extent in the case of net food buyers amongst Malawi's rural population. Malawi's rate of inflation for 2015 is expected to be the second highest in Africa, after Sudan.

32. Increases in both food and non-food inflation create a risk to the general price outlook. It will be challenging to curb upward pressures. It is estimated that levels of maize production will contract by 30.2 percent during the main 2015 growing season. This will create upward pressure on the rate of inflation, with maize prices going up as a result of the gap between supply and demand. Additionally, non-food inflation has also started to increase in reaction

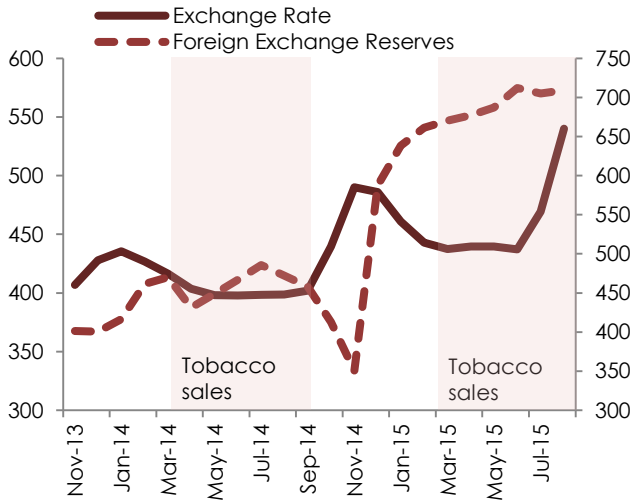
to a sharp depreciation in the value of the Kwacha, with this depreciation pushing up the cost of imports. Large, ongoing fiscal deficits are also expected to exert an additional upward pressure on the rate of inflation during 2015 and 2016. As a result of these factors, the rate of headline inflation is significantly higher than regional comparators in Africa, with Malawi's annual average rate of inflation projected to reach 21.7 percent in 2015.

The Kwacha has experienced a sharp depreciation

33. Malawi's level of foreign exchange reserves has risen steadily over the first half of 2015, providing the country with increased levels of import cover. In December 2014, the debt swap transaction with the COMESA PTA Bank provided Malawi with an injection of foreign reserves to a value of US$ 250 million. In addition, while tobacco sales have declined marginally during the 2015 export season, this sector has still provided a significant seasonal boost to foreign exchange earnings. The value of total gross official reserves has risen steadily through the first half of 2015 to reach US$ 712.0 million (equivalent to 3.4 months of import cover) by the end of June 2015, compared to the figure of US$ 467.0 million (2.4 months of import cover) by the end of June 2014 (Figure 10). In the early part of the second half of the year, reserves have drifted down due to high demand for foreign currency, to US$ 682.5 million (3.3 months of import cover) by August 2015.

Figure 10: Reserves have increased, but the exchange rate remains volatile and under pressure

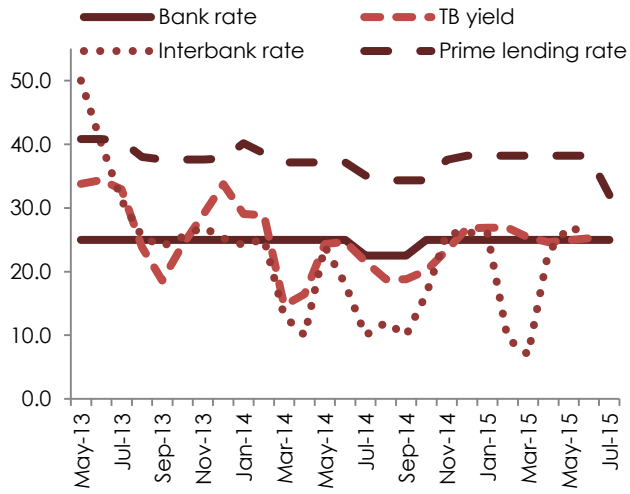
US$/Kwacha exchange rate (LHS) and gross official resources in US$ millions (RHS)



Source: World Bank staff based on RBM data

Figure 11: Interest rates have remained high, driven by persistently high inflation rates

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



Source: World Bank staff based on RBM data

34. However, despite the increase in the value of reserves, the Kwacha has come under sustained speculative pressure. During the first half of the year, the Kwacha experienced a modest appreciation in value against major trading currencies, with the rate of exchange increasing from MWK 462 to the US dollar in January to MWK 437 in June. This appreciation was largely due to a stabilization of foreign exchange markets, boosted by seasonal expectations of significant inflows resulting from the sale of tobacco from February onwards. However, during July and August, the domestic currency experienced a sustained downward trend, depreciating by more than 30 percent. Thus, in September 2015, the Kwacha was trading at MWK 555 to the US dollar. This sharp decline in the value of the domestic currency is due to a number of factors. Since its floatation in 2012, the Kwacha has tended to be subject to significant seasonal fluctuations, appreciating in value during the early months of the year prior to and during the early stages of the tobacco marketing season. It tends to depreciate in value from September onwards after the end of this season, when the supply of foreign exchange declines, and when large-scale fertilizer imports are sourced under the Government's FISP, with consequent increases in the demand for foreign currency. In addition, as confidence in the US economy has grown, the value of the US dollar has also increased on average against all major currencies. This has placed additional pressure on the Kwacha. Most significantly, Malawi has experienced a significant decline in business confidence as a result of the weather shocks and the Government's ongoing fiscal challenges. This has undermined confidence in the domestic currency, encouraging speculation and bringing forward the seasonal depreciation in the Kwacha, as importers sought to source foreign exchange for imports early in the year.

35. Until inflation can be brought under control, and in turn the size of the fiscal deficit, then the Kwacha will remain under pressure. With the rate of inflation in Malawi currently standing at 23 percent, compared to a rate of close to

zero in the United States, basic economic theory suggests that in simple purchasing power terms—meaning for relative prices to remain the same in the two currencies—then the Kwacha can be expected to depreciate against the US Dollar by around 23 percent over a year. Compared to other key reference currencies, such as the South Africa Rand, which has also depreciating in recent months, the fall in value of the Kwacha is somewhat less significant. The high rate of inflation is primarily driven by the Government's high level of fiscal deficits. Thus, reducing the rate of inflation' would be the most effective way to ensure the stabilization of the Kwacha. In the long run, the challenge will be to improve Malawi's competitiveness so that the country can generate additional sources of export earnings. To achieve this, it is vitally necessary to improve economic infrastructure, in particular power, water and transport services. It is also essential to build human capital through the provision of effective education and skills training, and to simplify Malawi's often complex and burdensome regulatory environment for business.

Monetary policy appears to be losing effectiveness

36. In an attempt to arrest the depreciation in the value of the Kwacha, the Government has implemented a number of administrative measures to regulate foreign exchange trading by authorized dealer banks. However, so far, these measures have had only a limited effect. In June 2015, the RBM issued revised guidelines for foreign exchange trading, with these guidelines including new instructions that banks' opening foreign exchange rates should not exceed plus/minus 0.25 percent of the previous day's market average closing prices; that intraday market changes should not cumulatively exceed plus/minus 0.5 percent of opening rates; that rates can only change when a transaction to a value of US$ 250,000 (or equivalent) has been executed; and that the spread between buying and selling exchange rates should not exceed MWK 5 for all trading currencies at any point in time. The last measure was revised in September 2015, with the limit on the maximum spread increased to 2.5 percent. While the intention of these administrative measures was to curb speculation and to smoothen patterns of foreign exchange transactions, the measures resulted in an increase in the volume of foreign exchange trading through forex bureaus (which are not constrained by the same regulations that apply to banks) and an increase in activity on the parallel market. The RBM's measures also reduced foreign currency exposure limits from plus/minus 35 percent to plus/minus 10 percent of commercial banks' core capital, restricting foreign exchange liquidity in the banking sector. This follows regulations introduced in late 2014 that required authorized dealer banks to maintain their liquidity reserve requirement balances for foreign currency deposits in Kwacha, calculated according to the banks' own selling rates, whereas previously reserve requirements were met in foreign currency. Until Malawi addresses the fundamental issues that are driving depreciations in the value of the Kwacha, these being the consistently high rate of inflation compounded by a large fiscal deficit, weak business sentiment, and import requirements that are in excess of export earnings, then such measures will at best have only a marginal impact. In the meantime, they are likely to encourage the further development of parallel foreign exchange trading outside of the commercial banking sector.

37. Bank lending rates remain prohibitive for most borrowers. With the policy rate remaining set at 25 percent, a reduction in the Liquidity Reserve Requirement (LRR) ratio has enabled banks to lower the spread between the prime lending rate and deposit rates (Figure 11). Changes to the LRR ratio through a reduction in the share of total capital that commercial banks need to leave on deposit at the RBM from 15.5 to 7.5 percent have also released some MWK 40 billion into the banking system. While the intention of this policy was to reduce the spread between deposit and lending rates, it has indirectly contributed to upward inflationary pressures and the demand for foreign exchange. Efforts to mop up the excess liquidity through the issuance of RBM securities would reduce the profits made by the RBM, reducing any surpluses paid by the Central Bank to the Treasury in the 2015/16 fiscal year. There has been a drop in prime lending rates (from around 38 percent to 32 percent) and a reduction in the spread between lending and deposit rates. However, lending rates will continue to remain prohibitively high for most borrowers until the core rate of inflation is brought back under control. In turn, this is highly dependent on reducing the size of the fiscal deficit and on curbing the Government's own appetite for borrowing. By the end of June 2015, approximately one third of total banking sector assets were held in Treasury Bills, with average yields of 25.2 percent, reflecting the dominance of fiscal policy over monetary policy in Malawi.

38. With the rate of inflation remaining high, a tight monetary stance will need to be maintained throughout 2015 until the rate of price increases can be curbed on a sustainable basis. The implementation of this stance will involve the maintenance of positive real interest rates for a sustained period of time and the avoidance of premature cuts in the policy rate. In the past, exchange rate volatility has played a key role in imported inflation in Malawi. The rapid depreciation in the value of the Kwacha in mid 2015 will further exacerbate inflationary pressures throughout the remainder of the year.

39. Short-term inflationary expectations are also likely to remain high, putting pressure on wage demands. A 24.8 percent increase in the minimum wage in September 2015, from MWK 551.0 per day to MWK 687.7, will also act as an anchor for the magnitude of wage increase expectations in the economy. This includes expectations amongst the public sector, where it is likely that the Government will come under increased pressure to contain the public sector wage bill.

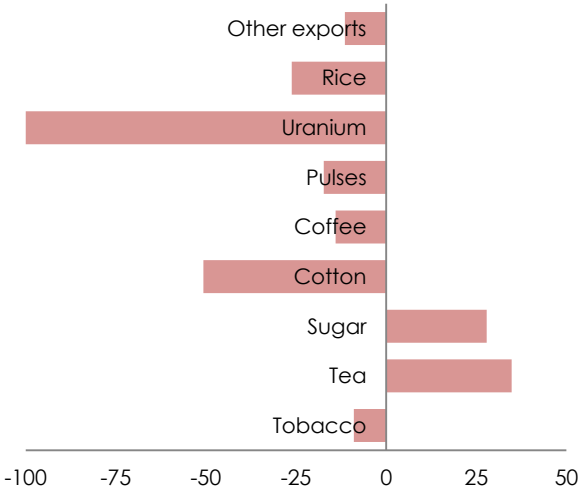
Sluggish export performance due to weaker demand and reduced agricultural output

40. Demand for Malawi's key exports has deteriorated somewhat due to slow growth in developed markets and an economic downturn in Sub-Saharan Africa. In 2014, relatively weak demand from Europe and the US was offset by strong growth in Africa. However, the decline in commodity prices has resulted in a decline in growth among oil exporting economies, depressing the region's overall outlook. Recession in South Africa, Malawi's largest trading partner, has also dampened the prospects for Malawi's exports. In aggregate terms, the decline in global commodity prices has had some positive effects on Malawi's external account, given that it is a net oil importing nation. Oil prices continued to decline in the first and second quarters of 2015, falling to below US$ 50 per barrel. This has offered a degree of respite to Malawi at a time when the country was experiencing a decline in the purchasing power of the Kwacha. While almost all commodity prices have fallen during the past 12 months, the drop in the prices of agricultural commodities (where Malawi does have an export interest) has been considerably less significant than the drop in prices for minerals and energy (Figure 9).

41. Erratic rainfall patterns during the 2014/15 growing season have also had an impact on key cash crop exports. Not only has poor rainfall had a negative impact on the production of maize for domestic consumption, it has also had a negative impact on the production of other crops, including key cash crops for export. This is expected to have a corresponding impact on export earnings in 2015 (Figure 12). However, declines in the yields of cash crops have generally been less significant than the decline in the yield of maize.

Figure 12: Most of Malawi's exports are expected to show a decline in 2015…

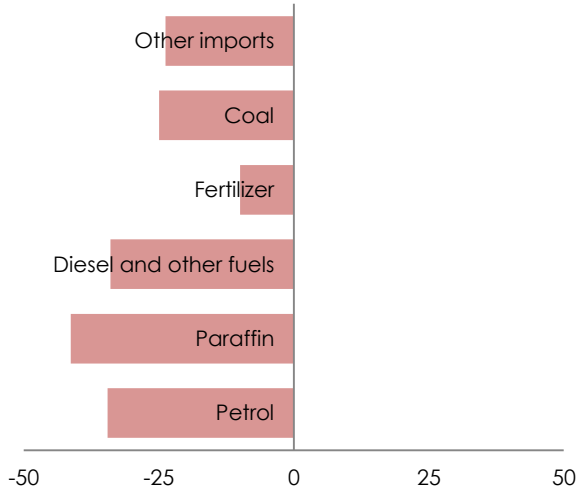
Exports by type, 2015 projected change from the previous year, US dollar terms, percent



Source: World Bank staff based on MoFEPD data

Figure 13: …with imports also expected to register annualized reductions

Imports by type, 2015 projected change from the previous year, US dollar terms, percent



Source: World Bank staff based on MoFEPD data

42. Despite concerns regarding the impact of poor rains on Malawi's tobacco crop, the sector is expected to record a robust performance in 2015. The tobacco marketing season closed in early October 2015 with total sales of 192,690 tons, a small increase of 0.4 percent above the volume of sales recorded in 2014. However, prices fell by 6.9 percent compared to the previous year, with the average price over the year standing at US$ 1.75 per kg. Thus, the total value of sales over the season amounted to US$ 337.4 million, compared to the figure of US$ 361.6 million recorded in 2014, which represents a decline of 6.7 percent. Prices weakened gradually over the course of the season and are mostly attributed to existing large stocks on global markets. Sales of the dominant burley variety were broadly stable over the year, with reduced sales mainly affecting the flu-cured variety. The shift towards production of tobacco under contract farming arrangements through the "integrated production system" continued in the 2015. With this shift, more than 85 percent of all tobacco is now sold on contract, leaving just a small portion sold at open auction. This also leads to a faster sales process than in the past, with foreign exchange

inflows earned over a shorter period of time than under the traditional auction system. The sale of tobacco under contract also enables increased access to inputs for farmers and improves quality standards, with rejection rates of less than 5 percent, compared to a rate of around 50 percent for tobacco sold at auction. In 2015, in the case of burley tobacco, produce sold under contract attracted an average price premium of 13 percent compared to that sold at auction.

43. Following the suspension of mining at Kayelekera in 2014, Malawi's export of uranium has now completely ceased. The mine's operations ceased in February 2014, with processing and export flows ending shortly afterwards. The facility remains under care and maintenance, with a restoration of production only viable if uranium prices rise significantly from current levels. The global outlook is unlikely to improve in the short term, with lower fossil fuel prices reducing the attractiveness of nuclear power.

44. In 2015, Malawi's exports are exported to fall by 9.9 percent compared to the previous year. The total value of exports in 2015 is expected to amount to US$ 1.58 billion, compared to US$ 1.75 billion in 2014. In general, production of most export crops has proved to be relatively resilient (particularly in the case of tobacco) compared to food crops. However, even where output has been relatively stable, softer global agricultural commodity prices have resulted in a deterioration in the value of total earnings. While a weaker Kwacha may help to boost export earnings in nominal terms, the depreciation seen in July and August 2015 comes late in the agricultural season, and therefore the impact is likely to be somewhat limited.

Imports remain significantly larger than exports

45. As a net oil importer, Malawi continues to benefit from lower global prices for fuels and refined products, including fertilizer. Since the oil price slump that began at the end of 2014, Malawi's monthly energy bill has declined by around 30 percent (Figure 13), offering some relief from non-food inflationary pressures. However, in the domestic market, the impact of further declines in international oil prices in July and August 2015 has been offset by a depreciation in the value of the Kwacha.

46. Malawi's current account deficit is expected to narrow in 2015. Total imports in 2015 are expected to fall by some 11.9 percent on an annual basis, with imports dropping from US$ 2.39 billion in 2014 to US$ 2.10 billion in 2015. Malawi continues to operate a large, structural deficit on the current account. However, in 2015, the deficit is projected to shrink as imports fall at a more rapid pace than exports. In 2015, the value of this current account deficit is expected to decline to the equivalent to 4.1 percent of GDP, compared to 5.0 percent of GDP in 2014.

Key soundness indicators are improving, but the financial sector faces growing pressures

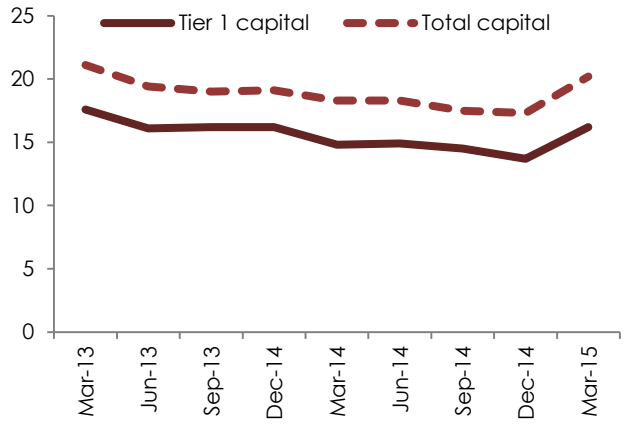
47. During the first half of 2015, despite a challenging macroeconomic environment, core financial soundness indicators showed some improvement. The Tier 1 ratio for Malawi's banking sector increased from 13.7 percent in December 2014, to 16.2 percent in March 2015. Over the same two points in time, the total capital ratio increased from 17.3 percent to 20.2 percent (Figure 14). This reversal of a previously downward trend occurred as banks sought to increase buffers, with growth in core and total capital (38.5 percent and 40.0 percent respectively) outpacing growth in risk weighted assets (21.5 percent growth) over the same period. The sector continued to record high returns on equity, albeit on a declining trend, at 28.1 percent in March 2015.

48. Credit risk remains a major challenge. An unstable macroeconomic environment, characterized by high rates of inflation and a significant depreciation in the value of the Kwacha, together with poor lending practices by banks, has resulted in a high credit risk in the system. These challenges have been exacerbated by a lack of predictability regarding the enforcement of bad debts in the courts and by the large stock of arrears owed by the Government to the private sector. As a result, the proportion of non-performing assets remained high, reaching more than 15 percent of total loans for most of 2014. However, this trend started to reverse in early 2015, with the Non-Performing Loan (NPL) ratio falling to 14.7 percent by March 2015 (Figure 15).

49. Consolidation among Malawi's banks is expected to improve credit quality. Over 2015, the share of NPLs in Malawi's banking system is expected to decline significantly following the completion of the Government's sale of its majority stake in the Malawi Savings Bank and Indebank to other commercial banks. The two transactions will reduce the number of commercial banks operating in Malawi from eleven to nine. It will also mark the Government's complete departure from majority ownership of any financial institution. Both banks have been struggling to meet the minimum prudential capital adequacy requirements (10.0 percent Tier 1 capital and 15.0 percent total capital). Together, they have accounted for a large share of Malawi's banking sector's NPLs. However, in the second half of 2015, a decline in the rate of economic growth is likely to result in increased downward pressure on credit quality.

Figure 14: After a declining trend, banking sector capital adequacy is improving…

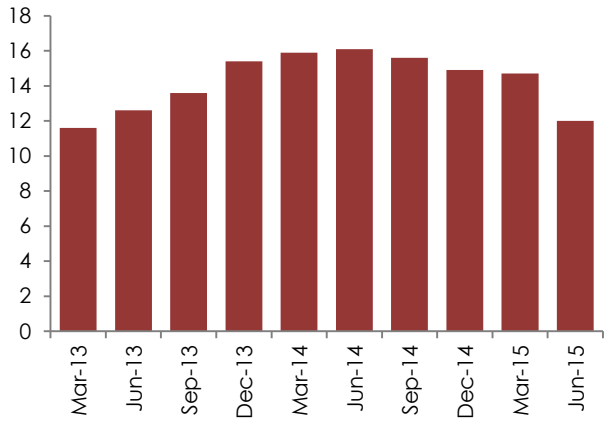
Capital adequacy, ratio of Tier 1 and total capital to risk weighted assets, percentage



Source: World Bank staff based on RBM data

Figure 15: …and the share of non-performing loans is falling

Ratio of non-performing loans to gross loans, percentage



Source: World Bank staff based on RBM data

An uncertain policy environment continues to dampen business confidence

50. Investor confidence remains subdued as a result of an uncertain policy outlook, negative sentiment due to weather shocks and misperceptions regarding Malawi's so-called "zero aid" budget. Despite reductions in prime lending rates offered by commercial banks in response to the LRR policy changes, the cost of borrowing in Kwacha still remains in excess of 30 percent per annum in nominal terms. At that rate, few private sector investments can yield a positive rate of return if financed through commercial loans, with internal financing now the most common source of funds for investment. The weather shocks experienced in the first half of 2015 have dampened business confidence even further, adding to significant skepticism in the private sector regarding the Government's ability to reduce public sector borrowing requirements and the size of the fiscal deficit. Recurring utility supply problems resulting from lower water intake levels and declining efficiency at Malawi's key hydropower generating facilities on the Shire River also create challenges for business, particularly in the manufacturing hub of Blantyre. The slow pace of issuance of zero coupon bonds to the Government's private sector creditors for the settlement of arrears, together with high discount rates offered by commercial banks for bond holders that have cash flow needs, has also had an impact. Finally, the continued misperception that the so-called "zero aid" budget means that no foreign aid is flowing into Malawi is likely to have encouraged speculative attacks against the Kwacha. While the share of foreign aid within the budget has declined in recent years, it still accounts for a significant share of expenditure. Moreover, foreign aid continues to flow into the economy, although with a larger share now disbursed outside Government systems. Malawi is at risk of remaining 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 to sluggish growth, which makes the fiscal deficit more difficult to close. The slow pace of key investment climate reforms, and in particular the gap between stated policy measures and on-the-ground implementation has also served to dampen private sector confidence.

Priority steps to restore fiscal balances

51. With external shocks adding pressure to an already weak fiscal position and poor business sentiment, Malawi will face significant challenges through the remainder of 2015. Restoring fiscal balances remains central to efforts to reduce inflationary pressures and stem the Government's domestic borrowing requirements. This is the only effective way to ensure that bank lending rates fall to levels that would make private sector borrowing for investment purposes feasible. With increased investor confidence and a more benign macroeconomic environment, Malawi can expect to see the increased levels of investment that are necessary to sustain high rates of economic growth, job creation and poverty reduction. Priority actions include the following:

a. **Tight management of public expenditure throughout the 2015/16 fiscal year:** This will involve careful control of expenditure commitments and strict enforcement of budget ceilings across all Ministries, Departments and Agencies (MDAs). In previous years, commitments and spending in excess of budgeted allocations by a number of MDAs have placed fiscal accounts under increased pressure. Given the very limited fiscal space in

2015/16, it is imperative that budget ceilings are strictly managed, with sanctions applied to Controlling Officers that over-commit.

b. **Appropriate prioritization of expenditure items, if within-year reductions in public spending are necessary:** With the decline in the GDP growth rate, it can be expected that the value of the Government's collection of revenues will be lower than that projected in the 2015/16 budget. Coupled with a higher-than-projected rate of inflation and a decline in the value of the Kwacha, there is a significant risk that there will be a larger-than-expected gap between the Government's available resources and its planned spending commitments. In order to avoid intensified domestic borrowing, the Government may need to prepare to make within-year expenditure cuts. The need to protect key social services safety nets for vulnerable segments of the population will be an important factor in this prioritization process.

c. **Intensified efforts to improve efficiency in the areas of budget execution, public finance and expenditure management:** A tight fiscal environment reinforces the need to maximize the efficiency of existing Government expenditure. Improving efficiency, including through the rational management of the wage bill (including non-wage expenditure such as travel), intensified reforms to costly subsidy programs, and increased efforts to progress with key public financial management and public service reforms, are critically important at this point in time.

Box 3: How wealthy is Malawi?

Accumulation of wealth is at the heart of the issue of determining whether development in a country is sustainable. It is wealth—broadly defined to include produced capital, natural capital, and human and social capital—that underlies the generation of national income. Gross domestic product (GDP) has been conventionally used to assess economic performance, measuring economic growth from one year to the next. But GDP does not take into account the depreciation and depletion of a nation's assets. An economy could appear to be growing in the near term by running down assets, such as its non-renewable resources. Therefore, assessments of economic performance need to be based on both measures of annual growth (such as GDP) and measures of the comprehensive wealth of a country, with the latter indicating whether that growth is sustainable in the long term.

Conventional estimates of GDP put the size of Malawi's economy at US$ 4.3 billion, or around US$ 253 per capita, among the world's lowest in 2015. At the same time, World Bank estimates of wealth—including not just produced capital, but also natural and intangible capital—suggest that Malawi's total wealth is US$ 88.9 billion and per capita wealth is US$ 5,750 (Table 3). This clearly puts per capita wealth at a much higher level than conventional estimates, although it is still below the average for low income countries, with the average standing at US$ 9,000. As in the case of many low income nations, natural capital is an important asset for Malawi, comprising more than 50 percent of its total wealth. Natural capital is dominated by agricultural land (primarily crop land), with forest resources, protected areas and subsoil assets making up much of this capital. Produced capital comprises about 15 percent of total wealth, while intangible capital (particularly human and social capital) comprises 35 percent of the nation's wealth.

Table 3: Estimates of Malawi's total wealth

US$ billion and US$ per capita

US$	Total (bn)	Per Capita
Total Wealth	88.9	5,750
Produced Capital	12.7	823
Natural Capital	46.4	3,000
Intangible Capital	31.5	2,036
Net Foreign Assets	-1.7	-109

Source: World Bank staff estimates

Wealth changes through the process of savings and investment. Therefore, it is instructive to consider how national savings have changed over this period. First appearing in the 1999 edition of the World Development Indicators, the World Bank's adjusted net savings (ANS) indicator was created to give national-level decision makers a clear, relatively simple measure of how sustainable their' country's growth policies are.

While standard national accounts only consider the value of a limited set of manufactured capital and assets, ANS offers a more inclusive picture of changes in terms of a comprehensive set of capital assets that constitute a nation's wealth base, including a knowledgeable and skilled workforce and natural resources such as forests, fossil energy, metals, and minerals. The indicator also captures changes in the value of these assets due to pollution and climate change.

Positive saving indicates an investment in the future—it indicates that a nation is accumulating the assets needed to build up its wealth and ensure its economic growth over the longer term. Years of negative saving, on the other hand, suggests that a country is running down its capital stock and is on an unsustainable growth path.

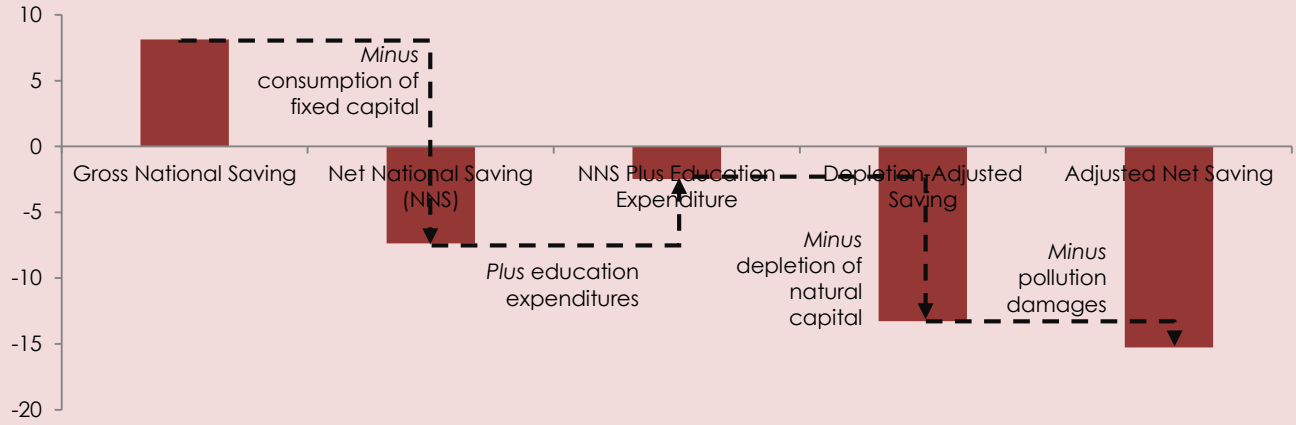
Adjusted net saving is derived from the standard national accounting measure of gross national saving, with four adjustments:

1. Deductions for the depreciation of produced capital, measured by the consumption of fixed capital, which equals net national saving;
2. Addition of investments in human capital, measured by current public expenditures on education;
3. Deductions for the depletion of natural capital, including minerals, energy, land and forest resources; and
4. Deductions for damages from pollution, including carbon emissions.

It is important to note that these estimates are indicative and provide a big picture overview, as they are based on publically-available global databases. The benefit of the ANS dataset is the ability to facilitate cross-country comparisons and to enable the calculation of time trends in a consistent framework. Figure 16 shows the calculation of ANS for Malawi in 2012, where gross national saving is 8 percent of GNI. After adjusting for the consumption of fixed capital (minus 15.5 percent), education expenditures (plus 5 percent), depletion of natural resources (minus 11 percent), and pollution damages (minus 2 percent), Malawi's adjusted net saving is around -15.5 percent of GNI.

Figure 16: Estimates indicate that Malawi's Adjusted Net Saving is currently negative…

Percentage of Gross National Income, 2014

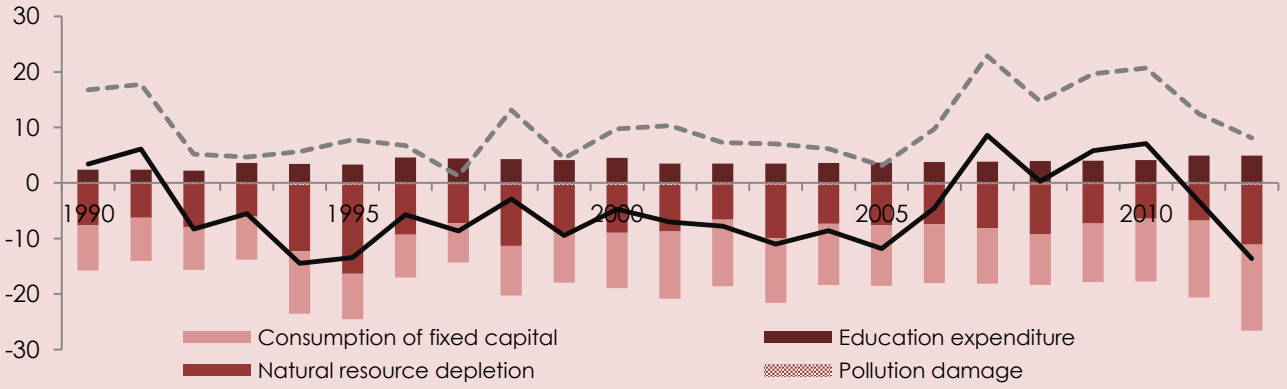


Source: World Bank staff calculations based on World Development Indicators 2015

Malawi's savings trend over the past two decades is shown below in Figure 17, where the line graphs compare the country's gross national saving to its adjusted net saving from 1990 to 2012. Looking first at the trend in GNS, Malawi's total resources available for investment remained low, at around 7 percent from the mid 1990s to 2005, increasing to around 20 percent in the late 2000s, and then falling to 8 percent in 2012. Though ANS generally tracked the movement of GNS, it remained below zero for most of this period, including the last couple of years. This prolonged period of negative ANS suggests that Malawi has not been saving enough (both in gross national savings and in the formation of human capital) to offset the depletion of its assets, mainly the depletion of its physical capital and natural resources.

Figure 17: …and Malawi's Adjusted Net Saving has been negative for most of the last few decades

Percentage of Gross National Income, time series



Source: World Bank staff calculations based on World Development Indicators 2015

The depletion of natural resources is a particularly important measure in the ANS framework to assess sustainable economic growth. While the standard measures for estimating GDP treat the gradual using up of produced capital as a cost of production, they do not regard the using up (or depletion) of natural capital as a cost of production. Therefore, for a resource-rich country, income generated from exploiting natural resources may appear high in the short term, but may not be sustainable in the long run. For Malawi, depletion of natural resources includes the depletion of net timber resources (indicating that annual timber harvested has been beyond the natural re-growth of productive forests), as well as land degradation. This trend serves as a clear warning signal that Malawi is not saving enough each year to offset the depreciation and depletion of its assets.

Estimates of Malawi's natural wealth provide an alternative means of estimated the wealth of the country. The key challenge for the future will be ensuring that Malawi's natural wealth is effectively transformed into human and social capital.

2. SPECIAL TOPIC: PRIMARY EDUCATION OUTCOMES UNDER FISCAL CONSTRAINTS

At a time of macroeconomic instability, the core challenge for Malawi is to restore balance to the country's fiscal accounts. With very limited fiscal space available to Government, and with a slowing economy, it is critical that Malawi gets the most out of available resources that are invested in human capital formation. Similarly, rapid increases in the public sector wage bill have contributed to the current fiscal pressures and macroeconomic instability that Malawi is experiencing. This special topic examines the public education system, where Malawi is spending on average a figure equivalent to 7 percent of GDP. In addition, private out-of-pocket expenditures are estimated to reach a value equivalent to 2-3 percent of GDP. Of this expenditure, 50 percent is utilized for primary education. However, despite this high level of expenditure, educational outcomes have been alarmingly disappointing. Why is this the case? Drawing upon a recent Quality of Service Delivery (QSD) survey, this special section examines the reasons for Malawi's poor input-output conversion ratios in the primary education sector and attempts to determine the manner in which systemic challenges in the system can be addressed. In particular, it concludes that in a fiscally challenged and resource constrained environment, Malawi should strive to improve the efficiency of education expenditures and to ensure that the money spent on education improves the quality of human capital in the country to the maximum possible extent. This may mean revisiting spending patterns in the years ahead.

Eighty-one percent of public spending on education is on teacher salaries

52. Malawi has a total population of 16 million, out of which more than 8 million individuals are under the age of 18. Given Malawi's high birth rate, the proportion of the population consisting of young people will continue to rise for the remainder of the 21st century. While elsewhere in the world, the demographic trends are towards increasingly elderly populations, Malawi will be one of the few countries with an increasingly young population. This demographic trend creates opportunities for Malawi, but it will only be possible to realize these opportunities if young Malawians are equipped with the necessary reading and numeracy skills to participate effectively in the labor market and to raise the productive potential of Malawi's economy. Without a good education system, this goal will not be achieved.

53. Educational outcomes in Malawi are generally poor. Current statistics indicate that just one in three students who enter primary school will complete all eight years of primary education. Approximately 25 percent of grade 1 pupils, and 20 percent of students in grade 2, are required to repeat these grades. This contributes to a situation in which only 19 percent of students progress to grade 8 without repeating a year[8]. A significant proportion of enrolled students remain chronically absent and many drop out of system altogether. Challenges associated with low levels of progression are compounded by the poor quality of education services delivered. The results of two recent national learning achievement studies demonstrate low levels of learning achievement with regard to language and numeracy, with almost 95 percent of pupils assessed in grade 7 demonstrating "*no achievement*" or "*partial achievement*" in mathematics in 2012. According to the Southern and Eastern African Consortium Measuring Education Quality (SEACMEQ), Malawi ranks last in the region for grade 6 english reading, and second from last in mathematics.

54. Malawi's political leaders, government officials, and civil society activists all acknowledge that the state education system needs to be overhauled to impart the necessary skills to the young population in Malawi. The high level of awareness of all stakeholders regarding the state of education is quite evident from higher-than-regional public expenditure on education, with this expenditure reaching an average value equivalent to 7 percent of GDP over the past five years. Expenditure on primary education amounts to a value equivalent to 3.3 percent of GDP and is progressive in nature. Though these high level of expenditures have enabled Malawi to achieve universal access to primary education, the challenge still remains to ensure that the system is able to retain students and equip them with reading and numeracy skills to successfully transition to the secondary and post-secondary levels.

55. The vast majority of government expenditure on primary education is allocated for the payment of teachers' salaries. This limits the fiscal space for capital expenditure and for the procurement of critical, non-recurrent educational inputs. School teachers' salaries have risen faster than average incomes and are relatively high by African standards. Teachers' salaries account for 81 percent of the total value of recurrent expenditure on primary

[8] All figures based on authors' calculations using EMIS data on grade-specific enrolment and repetition.

education, with much of the remaining 19 percent being utilized for the payment of hardship and travel allowances to teachers (Table 4). There is very little room for financing other inputs necessary for delivering quality education.

Table 4: Personnel emoluments account for the majority of public expenditure on primary education

Composition of primary education expenditure

	06/07	11/12	12/13	13/14	14/15
Recurrent expenditure (MWK billions)	11.1	24.4	38.5	42.1	55.6
Personnel emoluments	8.8	19.9	29.5	35.2	45.0
Of which teacher salaries	8.1	18.4	27.1	32.4	41.4
Other recurrent transactions (ORT)	2.3	4.5	9.0	6.9	10.6
Memorandum Items					
Enrolment in Standard 1 to 8 (thousands)	3,281	4,034	4,189	4,498	4,603
Recurrent expenditure per student (MWK at current prices)	3,400	6,051	9,184	9,356	12,061
Recurrent expenditure per student (MWK at 10/11 prices)	4,646	5,622	7,037	5,694	6052
Non-salary expenditure per student (MWK at current prices)	714	1,107	2,153	1,532	2,296
Non-salary expenditure per student (MWK at 10/11 prices)	975	1,028	1,650	932	1152
Salary share of recurrent expenditure	79%	82%	77%	84%	81%

Source: World Bank staff calculations based on MoFEPD and EMIS data.

56. Public on-budget expenditure on primary education reached a value equivalent to approximately MWK 12,061 (US$ 25) per pupil in 2014/15. As a proportion of all expenditure on primary education, the share of expenditure utilized for the remuneration of staff amounted to 81 percent of the total in 2014/15. The salary bill has grown faster than any other recurrent expenditure item, crowding out fiscal space for the procurement of teaching and learning materials and for expenditure on maintenance and other recurring inputs (Table 5).

Table 5: Malawi's wage bill for teachers has grown at a rapid pace

Sources of growth in the wage bill for primary teachers

	2004/05	2012/13	Average annual growth
Wage bill for primary teachers	7,072	27,135	18.3%
Number of teachers (Standards 1-8)	43,952	56,534	3.2%
Average wage per teacher (current prices)	160,902	479,981	14.6%
Average wage per teacher (at 2010/11 prices)	250,638	367,757	4.9%
Consumer price index	64.2	130.5	9.3%

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

57. Upon examination of the drivers of growth in the teachers' wage bill, it is revealed that this is largely driven by increases in per-teacher salaries rather than teacher numbers. It is clear that the basic salary for entry-level teachers is relatively high compared to neighboring countries. In Malawi, the ratio between entry-level teacher salaries and per capita national income is also relatively high, although this is not unusual for countries with low levels of income. Disaggregation of growth in the salary bill demonstrates that: (i) consumer price inflation accounts for 53 percent of the growth in the salary bill over the past eight years; (ii) average real wage increases account for 28 percent; and (iii) growth in the number of teachers account for 18 percent. Thus, the growth in the salary bill is predominantly driven by increases in per-teacher salaries, rather than by increases in teacher numbers.

Existing teachers could be managed more efficiently

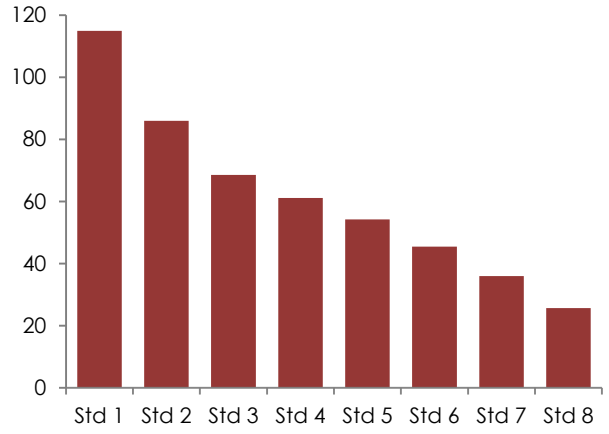
58. Teacher distribution in Malawi is highly uneven between schools and across grades within schools. The average pupil-teacher ratio (PTR) in Malawi is 69:1,[9] significantly higher than the national target of 60:1. High PTRs are repeatedly cited as justification for the hiring of additional primary teachers. However, analysis indicates that the PTR varies greatly between grades. In particular, the ratio is highest in the lowest grades of primary schools, where it averages in excess of 100:1. By contrast, in Standards 7 and 8, the average PTR stands at 50:1. Across levels, there is also considerable variation in PTR *between* schools, with a World Bank Quality of Service Delivery (QSD) survey

[9] An average PTR of 69 is estimated based on current enrolment of 4.5 million. Current enrolment includes a large number of over-age pupils. This burden of over-age pupils on the education system is bound to decline over time. As teacher recruitment has long term cost implications, the basis for hiring new teachers should be the population of 6-13 year olds (3.5 million) instead of current enrolments.

finding that the average PTR for Standards 1-8 is above 70:1 in one out of three schools; and lower than 50:1 in two out of five schools (Figure 18).

Figure 18: Pupil teacher ratios are highest at the lower grades

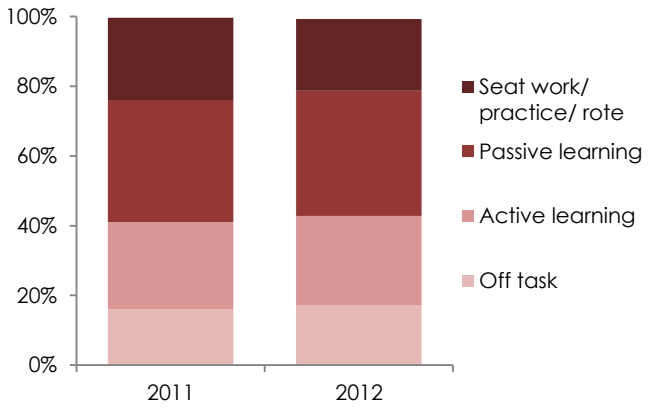
PTR by Standard (grade), 2013



Source: World Bank QSD Survey

Figure 19: Time on task in classrooms is low

Percentage distribution



Source: World Bank QSD Survey

59. In the lowest grades, teachers typically struggle to manage large classes of between 80 to 100 pupils, with these classes being conducted in overcrowded classrooms or even outdoors. Teachers in Standards 4 to 8 typically have a much lighter teaching burden due to smaller class sizes and to the fact that subject specialist teachers enjoy considerable spare time during school hours. Extending school hours by an hour for the lower grades will not address the problems associated with the inequitable distribution of teaching workloads. Rather, further interventions will be required to mandate and/or incentivize teachers of Standards 4 to 8 to contribute to the alleviation of the burden borne by teachers in the lower grades.

60. These findings indicate that significant space exists to use the existing stock of primary teachers more efficiently, without additional expenditure on hiring extra teachers. However, current financial projections by the Ministry of Education, Science and Technology (MoEST) indicate that the share of expenditure dedicated to the servicing of the wage bill is expected to rise further by hiring additional teachers. This will exacerbate the tendency to crowd out investments on other non-salary inputs.

61. Malawi's primary education system is characterized by a general absence of mechanisms to facilitate an accurate assessment of teacher performance. This results in poor linkages between teacher performance and levels of remuneration and promotion, which contributes to the demoralization of the teaching workforce. In addition, the poor targeting of hardship allowances for rural teachers results in low levels of teacher satisfaction with their placement. The QSD survey found that only 40 percent of interviewed teachers were happy with their work location. Of the 60 percent of unhappy teachers, a majority cited long distances between their homes and place of employment as the primary reason for their dissatisfaction. Monthly allowances intended to compensate teachers placed in remote locations are poorly targeted, adding to low levels of motivation and job satisfaction.

62. The poor conversion of expenditure on emoluments into teaching time and effort in the classroom is a matter of concern for Malawi's education system. The average teacher spends less than a total of four hours per day in class. Classroom observations conducted as part of the QSD survey found that on average, teachers were off-task for 20 percent of average class time. In addition, on average, 55 percent of classroom time was spent on passive learning or copying information from the blackboard. Only 25 percent of observed teaching periods involved active teaching and learning activities such as discussions, group work, activities and answering questions (Figure 19). Quality of teaching plays a central role in pupils' learning but weaknesses in governance and accountability have resulted in the limited transmission of expenditure into educational outcomes in Malawi.

63. School Leadership Training Programs could improve the management of resources at the school level. The QSD survey shows that there is considerable variation in school performance across schools. One plausible explanation for the variation in performance across schools is the quality of leadership of the head teacher, particularly his or her ability to leverage resources effectively and to direct them to improve teacher-learner interactions at the school level. Informed by this analysis, the new Global Partnership on Education project purports to develop a "School

Leadership Training Program" for head teachers to train them to better manage schools in resource-constrained environments.

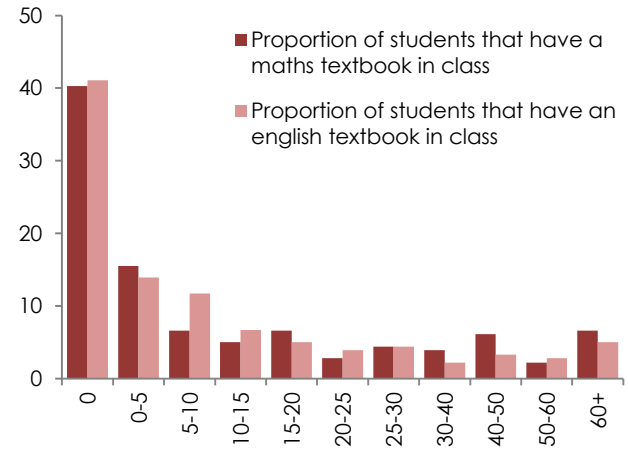
Classroom and textbook shortages contribute to poor outcomes

64. Malawi's primary schools lack a number of critical education inputs. In particular, the most significant challenge involves the distribution and use of textbooks. Education Management Information System (EMIS) data shows that on average, a single textbook is shared by 4 to 12 students, with the most acute shortages experienced by pupils in grades 5 and 6. Moreover, the QSD survey found that the actual utilization of textbooks by students in classrooms is lower than the EMIS pupil-per-textbook ratio. While EMIS data is established on the basis of the number of enrolled pupils divided by the number of textbooks available within a school, the QSD Survey collected data on the actual number of books observed in the students' possession in the classroom (Figure 20). No pupil enrolled in Standard 5 was observed to be using a maths textbook in maths classes in 40.3 percent of schools surveyed, while in the case of english classes, the figure stood at 41.1.

65. The poor utilization rate of available textbooks is observed in a large number of countries dependent on the externally-funded international procurement of school textbooks. It is commonly observed that when schools are not assured of a regular and timely supply of textbooks, a portion of available materials are kept in store for future use. Moreover, when official policies mandate that textbooks are provided free of charge and that schools are required to ensure that each textbook is used for a minimum defined period (three years in Malawi's case) by successive cohorts, pupils are often forbidden from taking textbooks home, limiting the utility of textbooks for student learning.

Figure 20: 40 percent of students in Standard 5 have no maths or english textbooks

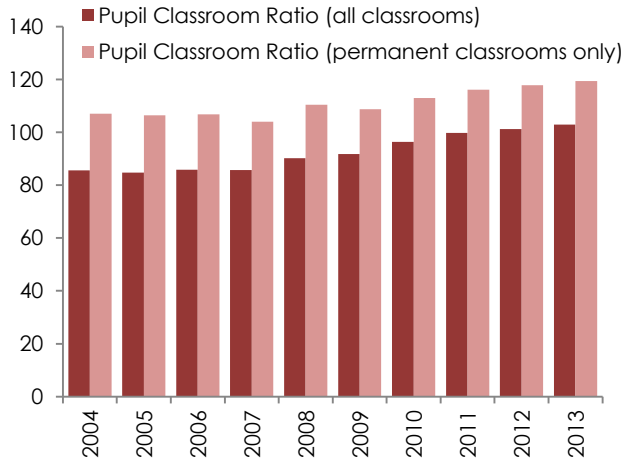
Proportion of students with textbooks in Standard 5



Source: World Bank QSD Survey

Figure 21: The number of students per classroom is very high

Students per classroom, average of Standard 1 to 8



Source: World Bank QSD Survey

66. Classrooms are also in short supply, particularly at the lower primary grades, with construction failing to keep pace with increases in enrolment (Figure 21)**.** EMIS data shows that the stock of primary school classrooms increased from 37,000 to 41,500 in the period from 2004 to 2013, representing a real increase of 12 percent. However, over the same period, the number of enrolled primary students increased by 45 percent. In roughly 33 percent of primary schools, all Standard 3 pupils are taught in open air gatherings, with the figure for pupils in Standard 4 only marginally better at 30 percent. A major disadvantage of outdoor teaching is that classes are regularly cancelled due to bad weather.

67. Despite these disadvantages, the existing stock of classrooms could be utilized more efficiently. Classes at Standards 7 and 8, with smaller cohorts and lower PTRs than the lower levels, are generally taught in classrooms, many of which were built to accommodate 100 pupils or more. These practices indicate inefficient use of existing classroom space, with fewer than 50 pupils occupying a room that could easily accommodate twice that number. A 2014 USAID study identified the poor supply of classroom infrastructure as one of the primary factors contributing to high rates of student absenteeism, repetition and dropouts. While the Government has repeatedly set ambitious targets for classroom construction, financing has been inadequate to address the back-log in school infrastructure. Thus, the average ratio of pupils-to-classrooms has deteriorated over the past decade. As is the case with teacher supply, the constraint is more binding in the lower grades.

68. Expenditure analysis shows that Malawi's primary education system is characterized by acute shortages of key inputs and the mismanagement of resources. This is a typical situation in poor countries with weak governance and accountability systems. A significant question that arises from this analysis is the extent to which variation in school performance can be explained by the uneven distribution of resources across schools. Simple regression analysis shows that there is a statistically significant correlation between classroom provision and non-salary funds and the rates of promotion from Standard 1 to 2 between schools. The level of inputs available per pupil (textbooks, teachers and classrooms) explain less than 15 percent of the variation in progression rates across schools.

69. While classroom availability has a significant impact, neither the number of teachers nor textbooks matter in explaining variations in progression rates between schools. The limited availability and usage of textbooks across the sampled schools might be the reason for the absence of any significant association. Suppose that an additional classroom improves pupils-per-section in Standard 1 from 120 to 60. Other factors remaining constant, this would improve the promotion rate by 2.34 percentage points, which is a modest increase in a country where an average of 25 percent of new entrants repeat their first grade.

70. The average rate of repetition in the first six grades is in excess of 20 percent, significantly higher than the African average of 15 percent. The rate of grade repetition has remained persistently high, increasing slightly over the past decade, in spite of government efforts to mandate automatic promotions for selected classes. The authorities recognize that the "high current repetition rate in primary education is not effective at improving students' learning achievement, is wasteful and ultimately financially unsustainable." A 2011 government circular stated that repetition rates should be reduced through the capping of the repetition rate at 10 percent of pupils per class. Data suggests that this circular had limited practical impact at the level of implementation, and the objective of the circular has been restated as a priority for the new education sector plan. Persistently high rates of repetition are associated with several factors at the household, community and school levels (Box 4).

Table 6: Determinants of Standard 1 progression rate

Ordinary Least Squares regression

	Progression rate Standard 1
Primary student-teacher ratio	0.037
	(0.05)
Student-English textbook ratio	0.155
	(0.18)
Student-Chichewa textbook ratio	-0.095
	(0.25)
Student-Maths textbook ratio	-0.066
	(0.13)
Student-Classroom ratio	-0.039***
	(0.01)
Government funds per student other than salaries	0.012***
	(0.00)
Constant	57.750***
	(4.35)
Observations	170
R^2	0.144

Source: World Bank staff calculations based on QSED data for 2013-14

Standard errors are in parentheses: * p<0.1, ** p<0.05, *** p<0.01

71. The Education Sector Implementation Plan aims to address the challenges related to the poor rate of progression. In an effort to address challenges including the high repetition rates; the low completion rates (particularly for girls); the poor rates of transition from primary to post-primary levels of education; and the steadily worsening examination results, the MoEST has prepared an Education Sector Implementation Plan for 2013-18 (ESIP-II). The plan emphasizes improving learning outcomes at the lower-primary levels, with efforts to expand access to secondary education. The strategy for improving learning outcomes at the lower-primary levels relies heavily on channeling resources to schools through the School Improvement Grants Program, and on the increased provision of incentives for schools to focus on ensuring that students complete the full primary school cycle with the desired levels of numeracy and literacy skills. A key finding of a recent impact evaluation of the Primary School Improvement Program is that non-staff inputs acquired by schools under the program play a critical role in improving the internal efficiency of primary schools by reducing repetition and dropout rates. By directly linking the payment of grants to improvements in school progression rates, schools will be encouraged to spend money on

teaching and learning materials and other non-staff inputs that are critical for pupils to learn and acquire the desired proficiency to progress through standards.

72. While the ESIP-II is sound from a policy perspective, the proposed interventions will not be sufficient to address deep-rooted and systemic problems, such as low levels of teacher motivation and poor learning outcomes. Moreover, the allocation of financial resources is not fully aligned with the needs of the system. The need for additional classrooms receives too little attention and financial support in comparison to the recruitment of additional teachers, even though the former is a more significant factor in improving efficiency. Salaries and allowances are absorbing too large a share of available resources, squeezing the funds available for capital investments and for scaling up school grants as an effective instrument to improve service delivery.

Box 4: Factors leading to high student repetition and attrition rates

Household level

- Subsistence livelihoods in which children are expected to contribute to household chores and wage earning work;
- Children miss classes on market days;
- Low levels of educational attainment on the part of parents.

Community Level

- Cultural practices, including initiation ceremonies that can disrupt two to three weeks of a school term;
- Community video centers, which contribute to truancy as children leave school to watch films;
- Concerns relating to the safety of children, specifically girls, during their commute to school, linked to distance from the school.

School Level

- Lack of learning in school, with 75 percent of student repeaters feeling they did not learn much in class;
- Teacher absenteeism, with students enrolled in early grades receiving only 2-3 hours of teaching per day;
- High student-teacher ratio, combined with absenteeism and low teaching time by those present;
- Ineffective teaching, with 37 percent of teachers admitting that poor teaching was responsible for repetition; and 43 percent of repeater students stating that they did not understand lessons in class;
- Poor school access, with long distance preventing attendance during rainy and cold seasons.

Source: USAID (2014)

What should the Government do?

73. The constrained resource environment in which the Government operates is likely to negatively impact efforts to improve the provision of primary education in Malawi in the medium term. Therefore, these recommendations focus on improving efficiency and achieving productivity gains using available resources and inputs. Priority recommended actions are as follows:

74. Teachers should be relocated from the upper grades, where there is on average a much lower PTR ratio, to lower grades, where the ratio is much higher. Reallocating teachers within and between schools is a cost-effective method of improving PTR that mitigates the need to hire additional teachers. For example, subject specialist teachers in Standards 4 to 8 could assist in teaching Standards 1 and 2. In order to address particularly high PTRs in remote schools, the MoEST could maintain a pool of trained teachers for deployment to schools where needs are most acute. In addition, MoEST should make better use of hardship allowances for rural schools to improve the deployment and retention of teachers in under-served schools. The Government should carefully review the marginal impact on learning outcomes from hiring more teachers compared to investing in other education expenditures.

75. Head Teachers/Principals should be trained in managing schools in resource-constrained environments. The current system of training focuses only on pedagogical skills and the head teachers are not given the necessary know-how to manage schools in a challenging environment. This leads to considerable variation in school performance, with some talented head teachers able to leverage resources more effectively than others. The implementation of a well-designed school leadership training program could improve the allocation of teachers across grades, the use of textbooks in schools, and the management of classroom space.

76. The construction and creation of additional classroom space needs to be targeted at the lower grades, where classroom shortages are particularly severe. Schools should be encouraged to use school improvement grants to

better manage available space. For example, this could be achieved through the use of partitions to convert one large classroom into two smaller spaces. Additional resources could be mobilized from external donors to support the construction of classrooms at schools that need them the most.

77. To improve the distribution and use of textbooks, the Government could promote the development of local markets for such textbooks, enabling students to purchase them locally. This could be supplemented by a textbook grant for poor students who are unable to afford textbooks. Over time, this system would allow for the development of a secondhand market for textbooks, reducing the net out-of-pocket expenditure at the household level.

78. School grants should be more effectively linked to school performance, in particular with promotion rates in lower grades. The current practice of linking school grants to enrolment numbers generates perverse incentives for schools to maintain pupils who have dropped out of the system on school rolls. Instead, schools should receive incentives to increase the number of students who complete a full cycle of primary education with the desired levels of attainment in the area of numeracy and reading skills. The current proposal to link school grants to pupil-teacher ratios runs the risk of perpetuating or worsening incentives for schools to misreport enrolment numbers. Moreover, measures must be taken to reduce delays in the disbursement of school grants and to improve communication between districts and schools. The Government's plan to make the release of district grants conditional on the distribution of school grants will help reduce delays.

Data

Table 7: Selected macroeconomic indicators

	2011	2012	2013	2014	2015 Est.
National Accounts and Prices					
GDP at constant market prices (percentage change)	4.3	1.9	5.2	5.7	2.8
Agriculture	6.9	-1.2	5.9	6.1	-2.0
Industry	0.9	1.8	5.5	5.1	4.2
Services	3.9	3.8	4.7	5.7	5.1
Consumer prices (annual average)	7.6	21.3	27.3	23.8	21.7
Central Government (percent of GDP on a fiscal year basis)					
Revenue	26.5	39.1	33.0	30.0	32.1
Tax and nontax revenue	22.1	24.5	28.0	26.3	28.0
Grants	4.4	14.5	5.0	3.7	4.1
Expenditure and net lending	33.4	40.5	41.0	35.4	39.1
Overall balance (excluding grants)	-11.3	-15.9	-13.0	-9.1	-11.1
Overall balance (including grants)	-6.9	-1.4	-8.0	-5.4	-7.0
Foreign financing	1.6	2.7	2.8	0.2	4.8
Domestic financing	6.7	-0.2	5.9	4.8	2.2
Money and Credit					
Money and quasi money (percentage change)	35.7	22.9	35.1	20.1	18.8
Credit to the private sector (percent change)	20.5	25.4	14.4	20.0	16.2
External Sector (US$ millions, unless otherwise indicated)					
Exports (goods and services)	1,409	1,421	1,657	1,751	1,578
Imports (goods and services)	2,236	2,282	2,315	2,388	2,103
Gross official reserves	190	236	397	595	673
(months of imports)	1.0	1.2	2.0	3.4	3.0
Current account (percent of GDP)	-5.9	-3.5	-1.8	-5.0	-4.1
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
Poverty					
Poverty rate (US$1.9/day in PPP terms)		71.0	70.5	69.7	69.9
Poverty rate (US$3.1/day in PPP terms)		87.7	87.3	86.9	87.1

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

References

Government of Malawi (2015) *Annual Economic Report 2015*, Budget Document No.2, Lilongwe: Ministry of Finance, Economic Planning and Development.

Government of Malawi (2015) *Malawi Floods Post Disaster Needs Assessment*, Lilongwe: Department of Disaster Management Affairs, Office of the President and Cabinet.

IMF (2015) 'Fifth and Sixth Reviews under the Extended Credit Facility Arrangement', March, Staff Report, Washington, DC: International Monetary Fund.

Malawi Vulnerability Assessment Committee (2015) 'National Food Security Forecast, April 2015 to March 2016', Lilongwe: Department of Economic Planning and Development, Ministry of Finance, Economic Planning and Development.

RBM (2015) *Financial Stability Report – June 2015*, Lilongwe: Reserve Bank of Malawi.

USAID (2014) 'Report for a Study on Student Repetition and Attrition in Primary Education in Malawi', Lilongwe: United States Agency for International Development.

World Bank (2013) *Malawi Public Expenditure Review*, Africa Poverty Reduction and Economic Management Unit, Washington, DC: The World Bank.

World Bank (2015a) *Global Economic Prospects – The Global Economy in Transition*, June 2015, Development Economics Vice-Presidency, Washington, DC: The World Bank.

World Bank (2015b) *Malawi Economic Monitor – Managing Fiscal Pressures,* Macroeconomics and Fiscal Management Global Practice, Washington, DC: The World Bank.

World Bank (2015c) *Primary Education in Malawi: Expenditure, Service Delivery and Outcomes*, Education Global Practice, 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
Macroeconomics & Fiscal Management

www.worldbank.org