

Malawi
Economic
Monitor

Emerging Stronger

October 2016



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MALAWI ECONOMIC MONITOR

OCTOBER 2016

EMERGING STRONGER

World Bank Office Malawi

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

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

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OVERVIEW

The Malawi Economic Monitor (MEM) provides an analysis of economic and structural development issues in Malawi. This edition of the MEM was published in October 2016. It follows on from the three previous editions of the MEM, and is part of an ongoing series, with future editions to follow twice per year.

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

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

In this edition of the MEM, the focus of the special topic is on poverty and vulnerability. At a time when Malawi is experiencing a second successive year of food insecurity, the special topic focuses on the key factors that have led to persistently high poverty rates in rural areas, with these factors contributing significantly to vulnerability to the impact of climate shocks. The special topic also identifies and describes potential pathways and reforms that could help Malawi improve its level of resilience to better manage the impact of future shocks.

ECONOMIC DEVELOPMENTS

In 2016, with Malawi facing drought and subsequently poor harvests for a second consecutive year, it is expected to record a GDP growth rate of 2.5 percent. The severe droughts have affected agricultural production, with these droughts following both flooding and drought in the previous year. The start of the 2015/16 agricultural season was delayed, with the advent of the season being followed by erratic and below average rains, with prolonged dry spells resulting in severe crop failures, particularly in the Southern Region and parts of the Central Region. The production of maize, the key food crop, fell by 14.7 percent. This follows the decline of 30.2 percent recorded in the previous year. Thus, growth in the agricultural sector is expected to decline for a second consecutive year, with the rate of decline standing at 2.3 percent in 2016. The rate of growth for industry is expected to stand at 2.4 percent, while the rate for services is expected to stand at 4.4 percent.

Malawi is particularly vulnerable to weather shocks. The impact of shocks has intensified over the years and is likely to continue to worsen with climate

change. Over the past four decades, droughts have become more frequent, widespread, and intense. The effects have been compounded by a number of other factors, including Malawi's high rate of population growth and environmental degradation. On average, these shocks have caused annual losses to a value equivalent to 1 percent of GDP. Most drought episodes have occurred in El Niño years, during which Malawi experiences rainfall deficits.

The humanitarian impact of the drought will be significant, with around 40 percent of Malawi's population likely to experience food insecurity. Estimates indicate that at least 6.5 million people in Malawi's 24 drought-affected districts will not be able to meet their food requirements during the 2016/17 consumption period. The total annual maize deficit is projected to reach 768,687 metric tons, compared to the deficit of 233,000 metric tons recorded in the previous year.

With the GDP growth rate lower than the population growth rate for a second consecutive year, average living standards will fall in 2016. Given Malawi's relatively high population growth rate of 3.1 percent, Malawi's economy needs to expand at a faster rate than is the case for many comparable countries to ensure improvements in average living standards over time.

Malawi's Government has limited fiscal space available to respond to the crisis. Large fiscal deficits over the past three years and high levels of debt mean that the Government has limited scope to respond to the humanitarian crisis unless it receives significant support from development partners. Following a major public financial management scandal in 2013, the level of on-budget development assistance provided by development partners to Malawi has fallen dramatically. Following this withdrawal of support, the Government has run large fiscal deficits over successive years. The Government has come under pressure to increase expenditure as a result of increasing debt service costs; rising public sector wage demands; costly subsidy schemes; and the need to settle outstanding arrears.

To finance fiscal deficits, the authorities have borrowed heavily from domestic sources. This has exerted an upward pressure on inflation and lending rates, crowding out private sector investment. More importantly, the Government has not been able to establish the necessary fiscal buffers that would enable a more robust domestic response to external weather shocks.

The Government's recent efforts to consolidate public expenditure have produced some positive results, but these efforts will be hard to sustain in the context of the current humanitarian crisis. Efforts to consolidate expenditure; to improve budget execution; and to exercise stronger central oversight over public expenditure have enabled greater month-on-month control over spending commitments by ministries, departments and agencies. As a result of these efforts, despite the fact that the value of collected revenues stood at 3.0 percent below targeted levels by the end of the fiscal year in June 2016, the Government was able to contain expenditure growth. However, at the end of the year, domestic borrowing was still in excess of targeted levels, largely because the Government began to purchase maize towards the end of the fiscal year to prepare to implement its humanitarian response.

The FY 2016/17 budget emphasizes the allocation of resources for food purchases and for investments to increase agricultural resilience. Key elements of the budget include reforms to the contentious Farm Input Subsidy Program (FISP), with these reforms including a sizable budget cut; a reduction in the number of beneficiaries; and the significantly increased involvement of the private sector in importation and retailing. Health and education budgets have been ring-fenced, with the allocations for almost all other budget lines being reduced in real terms.

The fiscal deficit for FY 2016/17 is projected to reach a value equivalent to 4.1 percent of GDP, a decline from the figure of 4.3 percent recorded in FY 2015/16. This gap is expected to be met mostly through concessional foreign financing, the value of which is estimated to reach the equivalent of 2.6 percent of GDP, and through domestic borrowing, at 1.4 percent of GDP. However, significant additional resources will be required to meet the food deficit requirement. Unless these resources are provided by development partners, the Government will struggle to remain below its targeted domestic borrowing limit.

While the rate of inflation declined in the period up until April, it accelerated in June and July, mostly due to increased food prices, before stabilizing again. In September 2016, the year-on-year headline inflation rate stood at 21.2 percent, representing a 1.6 percentage point decrease from the previous month. The figure at this point in 2016 compares to that of 24.1 percent recorded at the same point last year. Malawi is a net energy importer, so the decline in global oil prices has provided some respite, exerting downward pressure on non-food inflation and resulting in improved

terms of trade. Prices are expected to remain under upward pressure until the next harvest in early 2017. Thus, in 2016, the overall annual rate is expected to stand at 22.5 percent.

The Reserve Bank of Malawi's tight monetary stance has constrained the pace of credit growth. Active market interventions by the authorities through the issuance of Reserve Bank of Malawi (RBM) securities have helped to mop up liquidity and to ensure continuous positive real interest rates. The RBM continues to maintain its policy rate at 27.0 percent.

A second year of drought conditions and weak economic growth has weighed on business confidence. The agricultural sector dominates Malawi's economy, directly accounting for around a third of GDP. This share is even higher if the contribution of agricultural manufacturing and services is taken into account. However, even before the impact of recent weather shocks, Malawi's private sector was struggling to cope with an extended period of macroeconomic instability. High interest rates and inflation rates have undermined the returns on private investments, as demonstrated by the increasing share of non-performing bank loans. Increasingly frequent power and water supply outages in Malawi's key economic hubs, Lilongwe and Blantyre, and the instability of the exchange rate have also sapped investor confidence.

An economic recovery is possible in 2017, although its achievement would require the implementation of a number of politically challenging reforms. In particular, the Government faces the challenge of managing the humanitarian response effectively while at the same time continuing with efforts to restore fiscal balances and to control inflation. The simultaneous achievement of these goals is not impossible, but it will certainly require prudent management and careful prioritization of expenditure. In 2017, a higher rate of growth could be driven by increased agricultural output. However, growth recovery is dependent on the implementation of a well-managed humanitarian response and careful macroeconomic management to avoid further instability.

A strong El Niño effect in Southern Africa is typically followed by a similarly strong La Niña effect, resulting in higher than average rainfalls in Malawi. This could help support a recovery in the production of key crops, including maize, and the restoration of the water resources upon which Malawi is currently dependent for electricity generation. However, there is also a risk that a La Niña effect could trigger localized flooding that would place already strained disaster response mechanisms under further pressure.

In the medium-term, improved economic performance is dependent on Malawi building its level of resilience to enable it to better withstand the impact of both internal and external shocks. It is highly likely that Malawi will continue to face weather shocks on a recurring basis. Key steps to lay the foundations for a growth recovery include the following:

- **Policy reforms to reduce distortions and to ensure that agricultural markets function more effectively:** Malawi's agricultural sector continues to be dominated by smallholders oriented towards subsistence farming, with only a limited degree of commercialization. The prices for agricultural commodities in Malawi are amongst the most volatile in the region. In many instances, the impact of climate-induced shocks has been amplified by policy-induced distortions that result in market failure.
- **Measures to maintain economic stability and to improve fiscal discipline:** Improved levels of macroeconomic stability and fiscal discipline are essential to the achievement of a medium-term growth recovery in Malawi. Only by breaking the current vicious cycle, characterized by large deficits, over-borrowing and the crowding-out of the private sector, can Malawi effectively control inflation and restore the basic macroeconomic conditions necessary for higher levels of investment and job creation. The Government should also implement measures to increase fiscal buffers to enable the budget to better withstand the impact of external shocks. Improved systems of public financial management and governance could result in increases to ODA flows to on-budget execution, reversing the trend of these flows to off-budget execution.
- **Investments to build resilience to mitigate against climate-induced weather shocks and to diversify Malawi's economy:** These investments should include measures to develop agricultural infrastructure and extension services to facilitate a higher level of crop diversification, to improve yields, and to build resilience through the development of irrigation, market information systems and improved farmer organization.

POVERTY AND VULNERABILITY

Malawi is currently experiencing one of the most significant humanitarian crises in the country's history. In addition to the impact of the droughts, Malawi's predominantly rural population is also suffering from the prolonged effects of sustained macroeconomic instability, with an average annual

inflation rate in excess of 20 percent for more than five years.

While the current food security crisis is undoubtedly a result of changing weather patterns, the impact of the drought has been exacerbated by policies that have made Malawi particularly vulnerable to shocks. Building on recent research, this publication examines the reasons for the persistence of poverty in Malawi, while also identifying policy options to improve the socio-economic circumstances of Malawi's vulnerable population.

In a number of non-income indicators, some encouraging progress has been made in terms of human development over recent years. For example, over the past decade, gains in access to primary education have been steady and positive. Similarly, the incidence of child malnutrition has been declining. The under-five child mortality rate has also declined. As a result of the progress made in health, nutrition and education, Malawi achieved four out of eight of the Millennium Development Goals. The proportion of the poor who are deprived in multiple dimensions has also declined.

However, this progress has been dwarfed by persistent challenges, with monetary poverty in rural Malawi remaining pervasive and largely stagnant. In 2010, measured with reference to a basic needs basket that costs MWK 37,000 per person per year, more than half of the rural population was classified as poor. Approximately one-quarter lived in extreme poverty, defined in terms of the inability to satisfy basic food needs. More worrisome is that in the period from 2004 to 2010, the poverty rate in rural areas remained unchanged at around 56 percent, with the extreme poverty rate actually increasing, from 24 to 28 percent.

Food insecurity and chronic poverty also remain widespread. In 2013, 84 percent of rural poor households reported experiencing food insecurity for at least one month of a year, a 17 percentage point increase since 2010.

Most of Malawi's chronically poor population live in rural areas. Of the 2.6 million people considered chronically poor, 2.4 million of them live in rural areas. Health and weather shocks, combined with a lack of insurance programs and other safety nets, are a major cause of both food insecurity and chronic poverty. Rural households are especially vulnerable to being trapped in poverty due to a high exposure to shocks and a low capacity to cope with them.

To date, the achievement of sustained poverty reduction in the rural areas has been difficult, with reductions over the last decade being both modest and fragile.

The achievement of higher levels of agricultural productivity is essential to improve the welfare of rural households. Agriculture constitutes the backbone of Malawi's economy, contributing to more than 30 percent of its GDP and employing 85 percent of its workforce. Most producers are subsistence farmers who cultivate small plots of land, with limited income diversification opportunities.

Empirical estimates show that, in the period from 2010 to 2013, a 10 percent increase in the level of agricultural productivity improved average per capita consumption levels in agricultural households by 1.3 percent. Poverty also declined in terms of other indicators with increases in agricultural productivity. Evidence shows that at the household level, half of the gains from increased agricultural productivity goes towards increased food consumption, measured in terms of per capita calorie intake. It is projected that if maize yields increased by 50 percent, the poverty rate among rural agricultural households would decline by approximately 7 percentage points, lifting approximately 600,000 people out of poverty.

Unfortunately, increases in productivity of this order have yet to be achieved. In the period from 2010 to 2013, maize yields increased by only a modest 8 percent, with growth in yields being higher for the non-poor. Maize yields for the poor were 31 percent lower than for the non-poor.

Agricultural productivity in Malawi has remained largely stagnant due to the limited adoption of complementary investments in agriculture and access to information. The share of farms with access to complementary inputs (inorganic fertilizer, improved seeds, extension services) was low, despite evidence that the combined use of complementary investments raises the level of productivity more than the use of any single input by itself.

Households in primarily agricultural economies such as Malawi are generally unable to depend on income from a single source such as crops from rain fed agriculture to meet their needs. They often need to diversify sources of income to minimize losses from highly risk-prone agricultural incomes. They may need to use non-farm income to overcome thin credit markets to smooth consumption, to finance farm investments, or start businesses.

In Malawi, participation in non-farm sectors, particularly non-farm self-employment, is associated with improved socio-economic circumstances of the household level. An exercise to account for changes in poverty status in terms of sources of income indicated that, in the period from 2010 to 2013, rising income from non-farm business

activities played a greater role in reducing poverty in rural areas more than the any other source of income. However, the opportunities for non-farm self-employment have remained precarious and limited.

Rural incomes are not only relatively low, they are also characterized by a high level of volatility, with the constant threat of weather and health shocks. In the current context, financial markets do not provide insurance and other similar products at sufficient scale to enable households to manage risk. Therefore, social protection programs that protect basic minimum income and mitigate the impact of income shocks are important tools to address extreme poverty.

The coverage of the Government's main social safety net programs remains limited, despite recent expansions. Public expenditure on social protection in Malawi is low by international standards. In 2014/15, the annual budget for social protection programs accounted for approximately 0.8 percent of GDP, approximately two-thirds of the average level of expenditure by low-income countries in Africa. In addition to limited coverage, social assistance programs in Malawi have experienced high leakage rates. In 2013, six of every 10 beneficiaries of the two largest social programs in terms of budget were not poor.

The current crisis in Malawi creates opportunities to undertake radical reforms that will enable it to emerge stronger and more resilient. Recommended policy measures include:

- **First, to lay the foundation for future growth, it is essential to establish macroeconomic stability.** Stabilizing the macroeconomic environment will encourage investments, growth, and employment generation. It will also bring immediate relief to the poor by reducing the pressure on their household budgets caused by rampant inflation. While it is necessary to bring fiscal deficits under control, measures to reduce public spending or to increase revenue collections could have adverse impacts on the poor. Therefore, policy actions to restore fiscal balances should build in safeguards to protect pro-poor spending.
- **Second, inclusive growth is unlikely to be achieved without improving the level of productivity of agriculture.** To date, agricultural growth has been achieved through factor accumulation, primarily involving the expansion of resources such as land cultivated and labor. However, in a country with one of the highest population densities in Africa and increasingly limited land for new farming, there is little space

to extend such gains into the future. To improve productivity, it is necessary for the Government to improve the composition of its expenditure on agriculture by continuing reforms to the FISP.

- **Third, to achieve higher levels of agricultural productivity and to reduce rural poverty, significant structural reforms must be accelerated.** A major constraint on the growth of non-farm self-employment in rural areas is the lack of demand for the products produced by rural enterprises. The very low level of urbanization (16 percent of the population) and the low average incomes in rural areas limit the opportunities to generate higher incomes from non-farm activities in these areas. To achieve higher levels of prosperity in Malawi's areas, broad structural transformation is required, with this transformation including a more rapid rate of orderly urbanization.
- **Fourth, the Government should implement measures to improve the efficiency and effectiveness of safety net programs.** To improve the impact of its programs, the Government

should consider extending coverage to a greater number of beneficiaries; improve targeting for greater impact and reduce leakages; and ensure clarity in the objectives of program such as FISP, with beneficiaries shifted from this program to programs clearly intended to fulfil a social protection function.

- **Fifth, the Government should implement measures to accelerate the demographic transition to boost poverty reduction.** Given that Malawi is already one of the most densely populated nations in Africa, unchecked population growth will put enormous pressure on limited land resources and on the delivery of services, making poverty reduction harder to achieve. Moreover, the overall youth of Malawi's population means that ratio between dependents and members of the workforce is extremely high, with this ratio generally associated with higher poverty levels.

1. ECONOMIC DEVELOPMENTS

Economic growth has slowed across Sub-Saharan Africa

1. In 2016, Sub-Saharan Africa's average rate of economic growth is projected to decline substantially to a figure of just 1.6 percent, down from the figure of 3.0 percent recorded in the previous year. This will be the region's lowest level of growth in more than two decades. Low commodity prices, rising borrowing costs, tightening global financial conditions and drought in large parts of the region are the major contributing causes for the constrained growth across Africa.

2. With commodities making up a significant proportion of exports in the region, low global commodity prices have had a significant overall negative impact. In particular, oil exporters have experienced a sharp deterioration in their terms of trade. This has strained their fiscal and current account balances. Over the year, improvements to market sentiment and a decline in the value of the US dollar have contributed to a modest rebound in prices. However, global commodity prices are expected to remain low into the medium term future, which will have an ongoing impact.

3. There has been a significant divergence in the impact of the low commodity prices on oil importers and exporters respectively. The low global commodity prices have had their most significant impact on economies most dependent on oil exports, such as Nigeria. To a lesser extent, they have also had a significant negative impact on economies heavily dependent on non-energy mineral exports, such as South Africa, Zambia and Zimbabwe. By contrast, the economies of countries that are net importers of oil and that have a more diverse export base, such as Tanzania and Kenya, have performed relatively well.

4. To achieve economic recovery, commodity exporters must adjust to the likely scenario of a protracted period of low global commodity prices by developing new sources of growth. To achieve this, they need to improve their efforts to mobilize domestic resources and to implement measures to ensure a greater degree of flexibility in exchange rates to cushion the impact of the decline in commodity prices. In the context of increased external risk and higher levels of fiscal vulnerability, there is a significant need for policymakers to intensify their efforts to rebuild policy buffers.

5. Overall, the economies of the region are vulnerable to a number of significant risks. These include the possibility of a sharper-than-expected slowdown in the economic growth of major trading partners, which could further reduce the demand for commodities and lead to lower levels of investment. Growth in the Euro region remains vulnerable to a number of risks, including those related to uncertainties created by the UK's decision to leave the European Union (see Box 1 for a short analysis of the likely impact of Brexit on Malawi). Slower-than-expected growth in China would similarly affect the sub-Saharan African region's exports and official inflows. A further decline in oil prices or a failure by economies in the region to make timely adjustments to the impact of this decline could also create policy uncertainty and dampen investor sentiment. Finally, a continuation or exacerbation of the droughts that have affected Southern African could negatively impact the performance of the agricultural and hydropower generation sectors and exacerbate inflationary pressures.

Adverse weather conditions have affected Malawi's economic growth

6. Malawi's economy has been negatively impacted by severe droughts that have affected the country for two consecutive years. In this context, in 2016, it is expected to record a rate of economic growth of only 2.5 percent (see Figure 1). Adverse weather conditions have had a negative impact on Malawi's agricultural production in both the 2014/15 and 2015/16 growing seasons, with both floods and droughts in the former, and with further droughts in the latter. In terms of the achievement of food security, Malawi's key crop is maize, the production of which has fallen by 14.7 percent this year, following a fall of 30.2 percent in the previous year according to the third-round crop estimates. As a result of this and other factors, in 2016, the overall rate of growth for the Malawi's agricultural sector is expected to decline by 2.3 percent, deepening the declines recorded in the previous year. By contrast, the relatively small industrial and services sectors are both expected to record positive rates of growth, with the industrial sector expected to grow by 2.4 percent and the services sector expected to grow by 4.4 percent.

7. Malawi's economy is particularly vulnerable to weather shocks. The negative impact of drought has become increasingly significant over the years. With the adverse effects of climate change, this trend is likely to continue into the future, with the negative impacts of drought compounded by factors such as population growth and environmental degradation (see Box 2 for a comparative perspective of Malawi's vulnerability to climate shocks

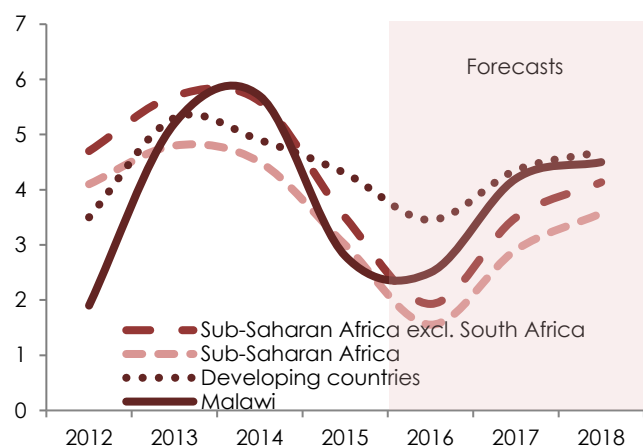
compared to other countries in the region). Data from available records show that over the past 100 years, Malawi has experienced approximately 20 major droughts. On average, droughts and dry spells cause annual losses equivalent to 1 percent of GDP. Most drought episodes have occurred in El Niño years, with Malawi particularly likely to experience rainfall deficits in these years.

8. In the 2015/2016 agricultural season, strong El Niño conditions prevailed, with erratic rains and prolonged dry spells across most parts of the country. As a result of these events, the start of the agricultural season was delayed by two to four weeks, with this being caused by the erratic and lower than average rainfall in November and December 2015. Exacerbating this effect, prolonged dry spells resulted in severe crop failures, particularly in the Southern Region and in parts of the Central Region. In response to these events, the Government declared a state of emergency in April 2016. Shortly following this, it carried out a post disaster needs assessment, as a result of which a food insecurity response plan was developed and put into action in July 2016.

9. The humanitarian impact of the decline in agricultural production will be significant, with around 40 percent of Malawi's population likely to suffer from food insecurity. Estimates from the Malawi Vulnerability Assessment Committee (MVAC) suggest that at least 6.5 million people in Malawi's 24 drought-affected districts will not be able to meet their food requirements in 2016/17. Malawi's total maize output stood at 2,431,313 metric tons, well below the 3,215,135 metric tons required to meet national needs for food consumption, seed, stock feed and industrial use. In terms the gap between production levels and consumption needs, the deficit is estimated to stand at the total of 768,687 metric tons of maize in 2016/17, compared to the deficit of 233,000 metric tons recorded in the previous year (see Figure 2). The cumulative impact of the two years of drought in economic terms is estimated to amount to losses of US\$ 295.2 million, which is equal to 5.6 percent of Malawi's GDP.

Figure 1: Growth rates have fallen in Malawi and across the region...

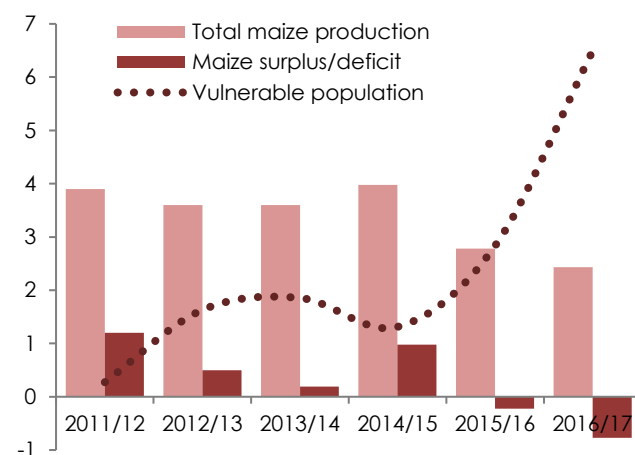
GDP growth adjusted for inflation, annualized, percent



Source: World Bank Global Economic Prospects

Figure 2: ...as the country faces increased food insecurity

Annual maize production/surplus/deficit, millions of tons; Vulnerable population, millions of people



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

10. In addition to its direct negative impact on economic growth, the drought will have a number of other indirect and direct effects. In Malawi's predominantly agricultural economy, lower levels of maize production have driven up food prices and thus have had a significant inflationary impact. The drought is also expected to result in a deterioration in Malawi's trade balance due to both a decline in the export of agricultural products and the need to import food. The Government's fiscal position is also likely to be negatively affected, as the value of collected revenues is expected to decline while expenditures increase as a result of the need to implement the humanitarian response.

11. With Malawi's largely agricultural economic base, a contraction in levels of agricultural production has a significant impact on the overall performance of the economy. In addition to the decline in the production of maize, declines also occurred in the case of other key crops in 2015/16. In particular, the production of rice declined by 21.6 percent; of wheat by 31.1 percent; of sorghum by 27.1 percent; and of millet by 40.9 percent. Of the food crops, increases in levels of production were recorded only in the case of sweet potatoes and potatoes, with the output of cassava remaining roughly unchanged over the year. In the case of cash crops, the output of pulses remained roughly unaffected, as did that of tea and coffee.

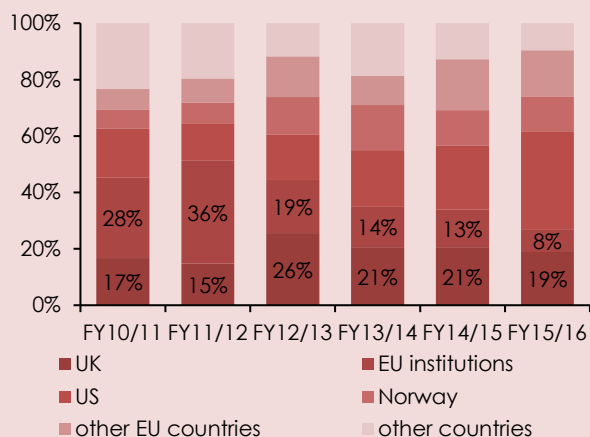
Box 1: What does Brexit mean for Malawi?

On 23 June 2016, the Government of the United Kingdom conducted a referendum in which the electorate voted to leave the European Union (“Brexit”). This has set in motion a chain of economic reactions and adjustments across the world. Malawi’s economy is affected by developments in the UK and the EU in three main ways: official development assistance; foreign direct investment; and, trade. In particular, the volatility in global currency markets resulting from the Brexit vote has affected the Malawi Kwacha. In the period immediately following the referendum, the value of the Pound depreciated by 7.8 percent relative to the Kwacha, based on figures for the average values in the pre-referendum period in June compared to the post referendum period until early September. The value of the Euro relative to the Kwacha also fluctuated significantly in the post-referendum period, although this appears to have been only temporary (see Figure 4).

Both the UK and the EU are major contributors to Malawi in terms of Official Development Assistance (ODA). Britain is the largest bilateral donor to Malawi and the third-largest contributor to the EU Development Fund. With aid being an important financial link between the UK and Malawi, any change in UK ODA spending would have an impact. In addition, a sustained depreciation in the value of Sterling would reduce the value of British aid flows to Malawi when converted into Kwacha.

Figure 3: The UK and EU are major bilateral aid donors to Malawi...

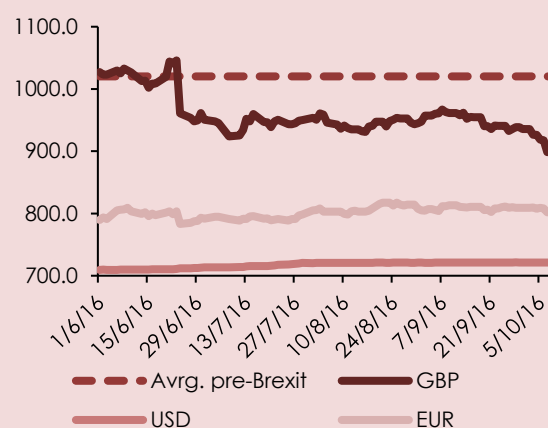
Countries’ share in Malawian bilateral ODA receipts, 2010/11-2015/16



Source: OECD International Development Statistics

Figure 4: ...but Sterling has depreciated, reducing the value of UK aid in Kwacha terms

Malawi Kwacha against major currencies, Middle Rate, Average MWK/GBP from June 1 to October 13, 2016



Source: Reserve Bank of Malawi

The UK and EU are also key partners with Malawi in terms of investment and trade. According to data from the Malawi Investment and Trade Center, the UK and the EU account for a relatively small proportion of the total value of committed FDI (3.6 percent and 1.7 percent respectively). In terms of trade, the UK and the EU account for a somewhat larger proportion of Malawi’s export trade, accounting for 3 percent and 15 percent of Malawian exports respectively (Comtrade 2016 data). The goods exported consist largely of primary products such as sugar, coffee and tea, for which the level of demand is relatively inelastic to prices. However, with Malawi’s thin export base, any reduction in foreign demand may still have a significant impact. Imports from the UK constitute approximately 3 percent of the total value of Malawi’s imports, consisting primarily of cars, pharmaceuticals and other chemical products. While these imports might become less costly in the short term due to the depreciation in the value of the Pound, it seems likely that prices in the UK will increase over the medium term, as many of the inputs for these products are sourced from abroad, mainly from markets in the EU.

12. In 2016, the performance of the tobacco sector, Malawi’s most significant cash crop, has also been poor. The decline in output of this crop was relatively slight compared to the decline in output of maize, standing at only 5.3 percent (for smallholder production). However, with the ongoing decline in global demand, the output was still in excess of demand, and unit prices were consequently lower. In addition, macroeconomic instability in Egypt disrupted sales to one of Malawi’s key markets, with the market still carrying over stocks from last year’s sales season. Despite these unfavorable conditions, tobacco remains Malawi’s most important export product. At mid October, the total value of tobacco sales stood at US\$ 240 million, a decline of 29 percent compared to the value of US\$ 334 million recorded at the same point in 2015. Over the same time periods, the volume of sales declined by 19 percent, while average prices declined by 13 percent. The effects of oversupply were most pronounced in the case of burley tobacco sold at auction, with the prices recorded in 2016 prices being 40 percent lower than in 2015. By contrast,

prices for tobacco produced under the integrated production system, in which farmers are under contract to tobacco buyers, have been much firmer. Similarly, in the case of specialty varieties, particularly flue-cured and dark-fired tobacco, there has been a higher level of demand and higher average prices.

13. With the rate of growth of GDP lower than the rate of population growth for a second consecutive year, it is likely that average living standards will remain roughly stable. The proportion of the population living below the international poverty line (US \$1.9/day in 2011 PPP prices) is expected to remain flat at around 69 percent, with the possibility of a slight decline for the second consecutive year. With Malawi's average annual rate of population growth standing at around 3.1 percent, Malawi needs to record a higher rate of economic growth than do many comparable countries to ensure improvements in average living standards and reductions in poverty.

14. Malawi has limited fiscal space available in which to respond to the crisis. Malawi has experienced significant budget deficits and high levels of debt over the past three years. Under these conditions, it has limited scope to respond to the humanitarian crisis without significant support from development partners. Following a major public financial management scandal in 2013, the level of on-budget development assistance received by Malawi has declined dramatically. In the context of this decline, the Government has run large fiscal deficits over the past three years. It has come under pressure to increase expenditure due to a number of factors, including increasing debt service costs; rising public sector wage demands; costly subsidy schemes; and the need to settle outstanding arrears. To finance fiscal deficits, the Government has borrowed heavily from domestic sources. This has exerted an upward pressure on both inflation and lending rates, crowding out private sector investment. Even more significantly, the Government has not been able to build up the necessary fiscal buffers that might have enabled it to implement a stronger domestic response to weather and other shocks.

15. While it is not impossible for Malawi to achieve economic recovery in 2017, this will require the Government to implement a number of politically challenging reforms. The Government must strive to balance the need to effectively manage a humanitarian response to the food crisis, while continuing with its efforts to restore fiscal balances and to control inflation. While the simultaneous achievement of these goals is not impossible, the implementation of measures to achieve them will certainly require prudent management and careful prioritization. In 2017, it is possible that a higher rate of economic growth will result from a recovery to the performance of the agricultural sector.

16. In Southern Africa, a strong El Niño effect is typically followed by a similarly strong La Niña effect, resulting in higher than average rainfalls. This rainfall could facilitate a recovery in the production of key crops, including maize. It could also restore the water resources in Lake Malawi upon which Malawi relies for hydroelectricity generation. However, any such increased rate of growth will be dependent on the effective implementation of a well-managed humanitarian response to the 2015/16 drought and on careful macroeconomic management to avoid instability. Also, there is a risk that a La Niña effect could trigger localized flooding, which might place already strained disaster response mechanisms under further pressure.

17. In the longer term, Malawi will need to undertake investments and to implement reforms to build resilience and to reduce its degree of vulnerability to climate shocks. The impact of climate shocks on Malawi's economy is already clearly apparent from the declining rate of economic growth and the increasing poverty rate. The Government faces the significant challenge of balancing the need to finance short-term requirements, including measures to prevent and address humanitarian crises, against the need for development expenditure, which is required to build the level of resilience to the impact of climate shocks, and thus to prevent similar crisis from having a similar impact in the future.

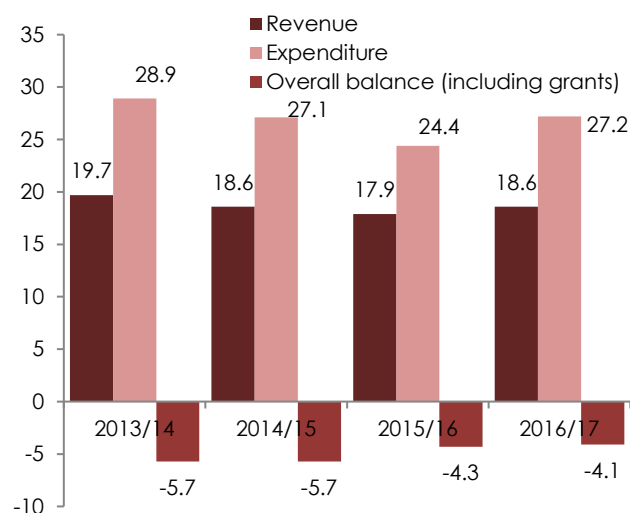
Some improvement to fiscal trends, despite the food crisis

18. In Malawi, fiscal indiscipline has been a recurring cause of instability and volatility. There have been frequent instances of fiscal slippages, in which the value of realized deficits significantly exceeded plans established at the beginning of the fiscal year, with the central bank being required to finance much of the gap. The unpredictable and volatile nature of foreign aid has further compounded this problem, with the share of ODA that is on the budget declining sharply over the past decade. The impact of climatic shocks over the past two consecutive years has further exacerbated macroeconomic instability, making it harder for Malawi to break the cycle of dependency.

19. The execution of the FY 2015/16 budget reveals a modest degree of recovery in terms of the fiscal stance¹. Over the year, the value of both tax and non-tax revenues was lower than the approved estimates, largely due to sluggish revenue collections in the context of the weak economy. Despite the Government's expectations that there would be an increase in the value of grants, with increased disbursements in the second half of the year, the total value of grants was actually lower than the approved estimates. Consequently, the total value of revenue and grants stood at a figure equivalent to 20.2 percent of GDP, compared to the approved estimates of 21.7 percent. In this context, the Government exercised a significant degree of spending restraint, with an overall expenditure outturn of 24.4 percent from an approved 26.2 percent of GDP. As in the past, this was achieved through a reduction in domestically-financed development expenditure, with this reduction offsetting increases in recurrent expenditure.

Figure 5: Weather shocks are slowing the pace of fiscal consolidation

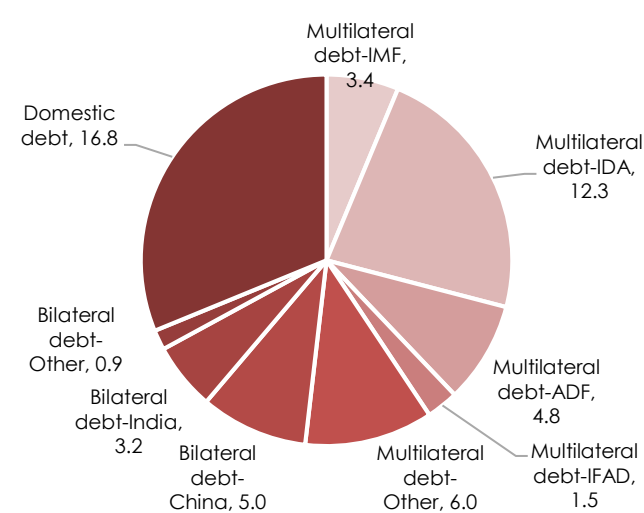
Revenue, expenditure and budget deficit, percent of GDP



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

Figure 6: Most of Malawi's debt is on concessional terms

Outstanding external and domestic debt by source, percent of GDP



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

20. Over the past year, the total value of collected revenues was generally low, with collection performance only improving towards the end of the year. The value of collected domestic revenues was lower than the approved target by about 1.0 percent of GDP, largely due to the lower than expected value of tax and non-tax revenues resulting from the economic deceleration. Towards the end of the fiscal year, a slight improvement in the performance of revenue collections was recorded, with the value of revenues collected in June exceeding the established target. Revenue collections have continued to exceed their targets through the first three months of the 2016/17 fiscal year.

21. To an increasing extent, ODA is taking the form of off-budget support, with this being provided at a slower pace as a result of low absorptive capacities at the project level. The value of realized grants stood at the equivalent of 2.3 percent of GDP, about 0.5 percent less than the approved estimate. The value of program grants increased from the equivalent of 0.2 percent of GDP in the approved estimates to 0.5 percent realized. This increase is attributable to a disbursement from the African Development Bank that was planned for the first half of the year but that was actually disbursed in the second half. As a result of exchange rate gains, the value of the disbursement was significantly higher than estimated at the point of budget approval. While the value of dedicated grants has not differed significantly from the approved estimates, the value of project grants has been significantly lower. This reflects a slowdown in the progress of project implementation, which has consequently affected the disbursement of funds for the implementation of project activities.

22. Faced with a lower than expected value of collected revenues and grants, the Government responded through measures to restrain expenditure. For the most part, the Government managed to consolidate expenditure through reductions in development expenditure, which offset moderate increases in recurrent spending. In terms of

¹ Note that the GDP series has been rebased to 2010 so all numbers in this report will differ from previous publications for all statistics presented as a percentage of GDP.

recurrent expenditure, the most significant pressure resulted from the cost of subsidies and transfers resulting from overruns to expenditure on the Farm Input Subsidy Program (FISP). Over the years, cost overruns of this kind have been a frequent occurrence, usually taking place as a result of depreciation in the value of the Kwacha, which makes the import of the required inputs relatively more expensive. On this occasion, overruns were exacerbated by the payment of arrears to suppliers, with these payments being delayed in the first half of the year. Expenditure on goods and services also increased in line with the general increase in price levels, with this increase occurring at a faster rate than anticipated at the time the budget was formulated. Overall, expenditure on wages and salaries and interest on debt was roughly in line with the approved estimates. However, while the cost of interest on foreign debt declined, there was an increase in the cost of interest on domestic debt. This can be explained by the decrease in the level of foreign financing and by the high cost of servicing domestic debt. On average, the interest rates incurred on external debt are much lower than for domestic debt because these loans are mostly contracted on concessional terms.

23. However, overruns on recurrent spending were offset by cuts to development expenditure. With the decline in on-budget donor support, the Government has consistently resorted to domestic borrowing to cover the financing gap. Over the year, a continuation of the trend towards a reduction in development expenditure relative to recurrent expenditure was observed. The realized value of foreign-financed capital expenditure (Part 1) stood at the equivalent of 3.1 percent of GDP, significantly lower than the approved estimate of 4.9 percent. This was largely due to the low absorptive capacity of projects, which lead to a slow rate of disbursement. The realized value of domestically-financed capital expenditure stood at the equivalent of just 0.7 percent of GDP, compared to the approved estimate of 1.4 percent. On the one hand, this partly reflects the general slowdown in the rate of project implementation, which has also affected counterpart funding. On the other hand, as alluded to earlier, it also reflects the tendency of the Government to reduce development expenditure to offset shortfalls in recurrent expenditure.

24. While the financing gap has narrowed somewhat, domestic borrowing increased to a level significantly in excess of targets as a result of the Government's need to finance its response to the food crisis. The Government recorded an overall deficit to a value equivalent to 4.3 percent of GDP, with the approved estimate standing at 4.7 percent. The value of foreign financing was significantly lower than estimated at the point of approval, with this value equivalent to 1.6 percent of GDP, approximately half the value of the approved estimate. As a response to this, the Government resorted to increased domestic borrowing. The value of domestic borrowing increased to MWK 70.7 billion (2.0 percent of GDP), up from MWK 53.1 billion (1.5 percent of GDP). This value is in excess of the International Monetary Fund (IMF) Extended Credit Facility (ECF) target of MWK 25.0 billion (0.7 percent of GDP). Until the mid-year, the Government had successfully contained domestic borrowing to levels lower than the targeted ceiling. However, the food crisis resulted in a dramatic increase in borrowing in the remainder of the fiscal year, with unplanned expenditure on post-harvest maize purchases in anticipation of planned interventions in food-deficient areas.

Managing fiscal pressures will require tight controls and expenditure reprioritization

25. A significant proportion of funding under the FY 2016/17 budget has been allocated for the purchase of food for the Government's humanitarian response to the crisis. It also includes allocations for investments that lay the foundation to improve the resilience of the agricultural sector. Measures prescribed by the budget include radical reforms to the contentious FISP, with these reforms including a significant budget cut; a reduction in the number of beneficiaries; and increased emphasis on private sector involvement in importation and retailing. Health and education budgets have been ring-fenced, with reduced allocations to almost all other budget lines in real terms. In terms of resources allocated for development, irrigation has been prioritized. The budget was formulated in the context of a particularly challenging year for Malawi, with approximately 40 percent of the population expected to experience hunger. To meet the food deficit requirement, significant additional resources will be required from development partners. In the absence of an effective response, the Government will struggle to remain below its targeted domestic borrowing limit, with its domestic debt already disturbingly large. Despite these challenges, if Malawi is to achieve an economic recovery in 2017, the achievement of fiscal balances is essential.

26. The total projected value of revenues and grants is expected to reach the equivalent of 23.2 percent of GDP, with the value of domestic revenues estimated at 18.6 percent and grants at 4.6 percent. In the context of generally poor macroeconomic performance, the MRA was unable to achieve its revenue targets in the early period of 2016. However, it exceeded these targets in June, July and August. To a large extent, good performance in terms of the collection of revenues from goods and services led to the overall strong performance in these months. In particular,

revenues collected from VAT were significantly higher than targeted, due to improved tax administration involving the intensification of enforcement efforts, the extensive use of technology (electronic fiscal devices) and reduced exemptions. The “Lisiti Langa” campaign, which was launched to encourage consumers to demand machine-printed receipts for all purchases, appears to be yielding positive results. The value of import and local excise duties was also in excess of targets in these months. This follows a spike in the volume of fuel imports as a result of increases in the purchase of fuel products following disruptions to the import of petroleum through the Beira route. While the trends apparent in the early period of the year may not continue over the full fiscal year, they are nonetheless an encouraging beginning for the Government at a time when every Kwacha counts. A factor that may reduce the value of collected revenues relates to the increased expenditure on the purchase of maize for relief. There is no tax on maize and a large share of transportation services have become involved in the transportation of this commodity, rather than on commercial activities that generate tax revenues. Thus, if weather conditions improve and the food crisis recedes, the performance of revenue collection can be expected to improve. According to the FY16/17 budget, the value of grants is projected to increase. The value of dedicated grants is expected to remain at roughly similar levels as those in previous years, with the value of program grants remaining close to zero due to the continued lack of general budget support.

Table 1: Fiscal accounts

Percentage of GDP (with rebased GDP)

	2012/13	2013/14	2014/15	2015/16		2016/17
				Budget	Actual	Proj.
Revenue and grants	27.5	23.2	21.4	21.7	20.2	23.2
Revenue	17.3	19.7	18.6	18.9	17.9	18.6
Tax Revenue	15.7	17.3	16.3	16.8	16.1	16.8
Nontax revenue	1.6	2.4	2.4	2.1	1.8	1.8
Grants	10.2	3.5	2.8	2.8	2.3	4.6
Budget support grants	4.5	0.3	0.0	0.2	0.5	0.3
Project grants	3.7	1.4	1.1	1.1	1.0	1.3
Dedicated grants	2.0	1.8	1.7	1.5	0.8	3.0
Expenditure and net lending	28.0	28.9	27.1	26.2	24.4	27.2
Recurrent expenditure	22.0	24.4	21.8	19.8	20.6	19.5
Wages and salaries	5.7	6.2	6.9	6.5	6.4	6.5
Interest payments	1.9	4.4	4.0	3.6	3.5	3.4
Foreign	0.2	0.2	0.3	0.7	0.3	0.3
Domestic	1.7	4.2	3.8	2.9	3.2	3.1
Goods and services	7.9	7.9	5.5	5.3	5.9	5.7
Subsidies and other current transfers	5.7	5.6	4.9	4.5	4.9	3.9
Fertilizer and seed subsidy	3.0	2.7	1.9	1.2	1.8	0.8
Arrears payments	0.0	0.4	0.4	0.0	0.0	0.1
Development expenditure	6.1	4.5	5.3	6.4	3.8	7.6
Domestically financed	1.8	0.9	1.0	1.4	0.7	0.9
Foreign financed	4.2	3.6	4.4	4.9	3.1	6.7
Overall balance (including grants)	(0.5)	(5.7)	(5.7)	(4.7)	(4.3)	(4.1)
Financing	1.8	6.1	5.8	4.7	3.9	4.1
Net foreign financing	1.9	2.0	2.5	3.2	1.6	2.6
Gross foreign borrowing	2.2	2.4	2.9	3.7	2.1	3.2
Budget support loans	0.0	0.6	0.7	0.9	0.4	0.6
Project loans	2.2	1.8	2.2	2.8	1.6	2.7
Amortization	(0.3)	(0.4)	(0.4)	(0.5)	(0.5)	(0.6)
Net domestic borrowing	(0.1)	4.2	3.3	1.5	2.0	1.4
<i>Memorandum items:</i>						
Nominal GDP rebased (MWK billion)	1,717	2,242	2,848	3,521	3,521	4,219

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

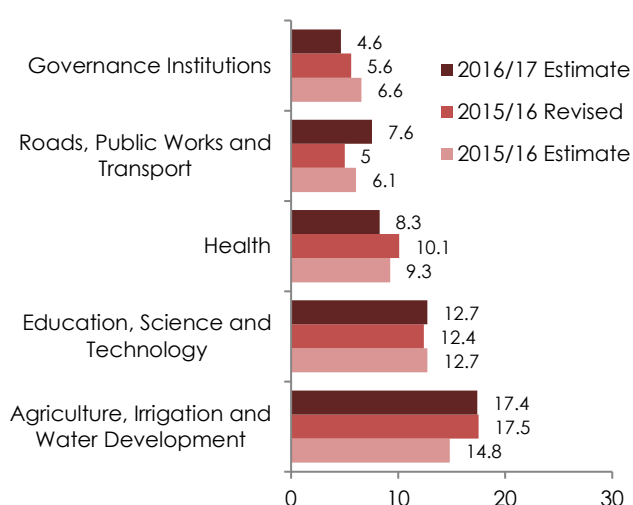
27. A sustained commitment to tight fiscal policies is vital if balances are to be restored, with this being a precondition for economic recovery in 2017. The El Niño-induced economic slowdown is expected to have a negative impact on revenues and to increase expenditure pressures. To address these impacts, the Government has committed to both reductions in expenditure and to changes in its composition. In particular, it has proposed to cut fertilizer subsidies and to contain the wage bill by limiting wage increases and by intensified efforts to remove ghost workers from the payroll. In its FY 2016/17 budget statement, the Government announced additional reforms to FISP, with these reforms being based to a significant extent on lessons learnt from a successful pilot project implemented in the previous fiscal year. Relative to allocations under last year’s budget, the allocation to FISP has

been reduced by about 1 percent of GDP. The proposed reforms include measures to increase the involvement of the private sector in retailing from 23 percent to 60 percent of the total; reducing the number of beneficiaries from 1,500,000 to 900,000; and improving targeting to focus on more productive farmers. In addition, Government will issue fixed-value coupons to beneficiaries valued at MWK 15,000, thus capping Government's fiscal liability and removing a serial source of budgetary overruns. On a positive note, with the slump in commodity prices, international prices for fertilizer have declined steadily throughout the year. If this trend continues, it is likely that the cost of fertilizer in real terms will be lower this year than in the previous year, thereby reducing the import bill and the cost of the scheme.

28. The pattern of the top three allocations to agriculture, education and health, respectively, has generally been sustained over the past three years (see Figure 7). Agriculture continues to receive the highest single portion of allocated funding, with these allocations estimated to reach a value of around 17.4 percent of the total budget in FY16/17. With the proposed reforms to FISP, under the current budget, the allocations for fertilizer and seed subsidies have declined significantly, by 0.8 percent of GDP. The overall proportion of the budget allocated for agriculture, however, remains roughly the same as in the previous fiscal year. The reduced allocations for fertilizer and seed subsidies were offset by the increased allocation for the food purchases necessary in the context of the crisis (also of around 0.8 percent of GDP). The proportions allocated to health and education remain roughly the same as in the previous fiscal year, with a significant proportion of these funds allocated to meet the wage bill resulting from the ongoing recruitment of teachers and health workers. The allocation for roads, public works and transport has increased compared to the previous year, with increased allocations for capital expenditure in the transport sub-sector. The budget includes allocations for two large projects involving the rehabilitation and maintenance of the Kamuzu and Chileka International Airports, and for a trade facilitation project. The fifth largest allocation was for governance, with this prioritized to finance the ongoing public finance management reforms.

Figure 7: Agriculture remains the top most funded sector, particularly in light of the food crisis response

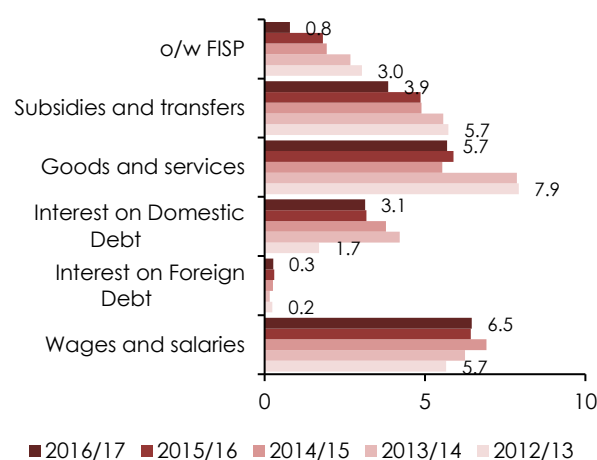
Top five sectoral budget allocations, percentage of total budget, selected years, net of transfers to local councils and subventions



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

Figure 8: Wages and salaries continue to drive recurrent spending, while FISP reforms have reduced the cost of subsidies

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



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

29. In terms of recurrent expenditure, the largest proportion was allocated to meet the cost of wages and salaries, with the value of this expenditure standing at around 6.5 percent of GDP in FY17, up from around 5.7 percent in FY 12/13 (see Figure 8). Wages and salaries account for approximately 33 percent of the total value of recurrent expenditure, while the cost of debt service accounts for around 17.4 percent. While the proportion allocated to service foreign debt has remained roughly unchanged, the cost of servicing domestic debt has increased sharply. This increased cost has been driven by the high interest rates associated with domestic debt and with the dramatically higher level of domestic borrowing over the year to finance the fiscal gap. The proportion of expenditure on goods and services appears to have declined slightly, probably due to the decline in on-budget support, with key bilateral development partners displaying a preference for off-budget financing. The proportion of expenditure on subsidies and transfers has also declined over the past few years, from a value of around 5.7 percent of GDP in FY 12/13 to about 3.9 percent in FY 16/17. This has been mostly driven by the gradual decline in the value of allocations for FISP, with this value now standing at 0.8 percent of GDP.

30. In FY 2016/17, the fiscal deficit is projected to reach a value of 4.1 percent of GDP, compared to the figure of 4.3 percent recorded in FY 2015/16. This deficit is expected to be met mostly through concessional foreign financing, the value of which is estimated to reach 2.6 percent of GDP, and domestic borrowing, the value of which is estimated to reach 1.4 percent of GDP (MWK 60.0 billion). In the context of the need to address the humanitarian crisis, a significant proportion of the Government's purchases of maize will need to be sourced from outside Africa, due to the region wide impact of the adverse weather conditions, with associated higher costs. With the Government's purchase of large amounts of this commodity at relatively high prices, domestic borrowing is expected to exceed the level set under Malawi's IMF program by about 1.1 percent of GDP.

31. The challenge for the Government is to balance its efforts to restore fiscal discipline with its efforts to effectively respond to the need to address Malawi's food security needs. The extent to which the Government succeeds in this endeavor will have a major impact on the economic outlook for 2017 and for the medium-term outlook. With persistently large deficits, Malawi has very limited fiscal space to respond to the crisis. The Government continues to face a number of significant risks, mostly related to a second consecutive year of adverse weather; the threat of yet another climatic shock (La Niña); declining and volatile on-budget ODA flows; persistently high inflation; and weak global demand for Malawi's produce. The impact of policy-induced fiscal risks can be mitigated by containing public expenditure and by conducting concerted efforts to increase domestic revenues. A well-managed response to the food crisis is not necessarily inconsistent with a disinflationary policy, as food will be imported and incremental ODA inflows should not have any inflationary impact. Nonetheless, it will be difficult for the Government to control non-food expenditures at a time of severe stress. With Malawi's relatively undiversified economy and its reliance on a few primary exports, it remains vulnerable to external demand and price shocks.

Increased debt leaves Malawi with limited space to respond to crises

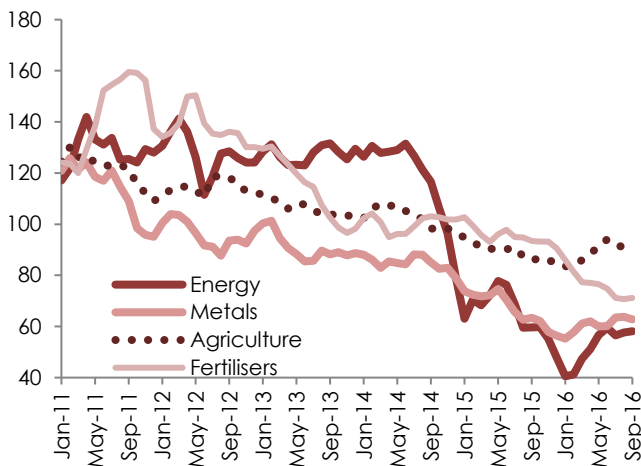
32. Malawi's debt stock has grown significantly over recent years. At the end of 2015, the value of external debt stood at about US\$ 1.78 billion (37.0 percent of GDP), a significant increase from the figure of US\$ 1.45 billion (30.8 percent of GDP) recorded at the end of 2013. Most of Malawi's external debt (around 75 percent) has been contracted with multilateral creditors (principally the World Bank; the International Monetary Fund; and the African Development Bank) on highly concessional terms. However, the proportion consisting of bilateral external debt has been increasing rapidly, with the majority of this debt being contracted with China and India (see Figure 6). At the end of 2015, the total value of domestic debt stood at MWK 538.2 billion (16.8 percent of GDP), a significant increase from the figure of MWK 206.6 billion (13.8 percent of GDP) recorded in 2013. Increases in domestic debt have been driven by large fiscal deficits over the past three years, and by the securitization of arrears and the issuance of promissory notes. While the stock of domestic debt is lower than that of external debt, the principal in the former case needs to be repaid over a much shorter period. Typically, Treasury Bills are issued for durations of up to one year, while most external debt is repayable over a period of 25-40 years. Similarly, the interest charged on domestic loans is on average significantly higher. Thus, in FY 2016/17, the cost of servicing domestic debt is expected to reach 3.1 percent of GDP, compared to the figure of only 0.3 percent for servicing foreign debt. The high cost of servicing domestic debt puts considerable short-term pressure on Malawi's budget.

Inflation has resumed an upward path, driven by concerns about food availability

33. While the rate of inflation declined in the period up until April, it began to rise again from June, with the acceleration driven mostly by increases in food prices, with non-food prices increasing to a lesser extent, before later stabilizing again. The rate of inflation reached a highpoint of 24.9 percent recorded in December 2015. With the low output of maize in the 2015/16 planting season, harvests resulted in only a short-lived reduction in the rate of food inflation, which reached the figure of 29.2 percent in July. This was an increase from the low point of 24.3 percent recorded in April and 3.9 percentage points higher than the rate recorded in July 2015. At the end of July, the annualized rate for 2016 already stood higher than all yearly rates recorded since 2013. The rate of increase for the non-food component stood at around 18.0 percent until June, before experiencing an increase in July, when it reached 18.7 percent. Prior to this, a deceleration in consumer demand and a decline in the rate of growth in public sector borrowing had exerted downward pressure on the non-food inflation rate, while the recent acceleration seems to have been partially caused by the clearing of arrears from the fiscal year that ended in June 2016. In September 2016, the year-on-year headline inflation rate stood at 21.2 percent, compared to the figure of 24.1 percent recorded at the same point last year. This indicates some moderation in price increases, possibly due to weakening purchasing power as the effects of Malawi's drought on rural incomes become more pronounced.

Figure 9: The decline in energy prices seems to have stalled, while food prices are increasing globally

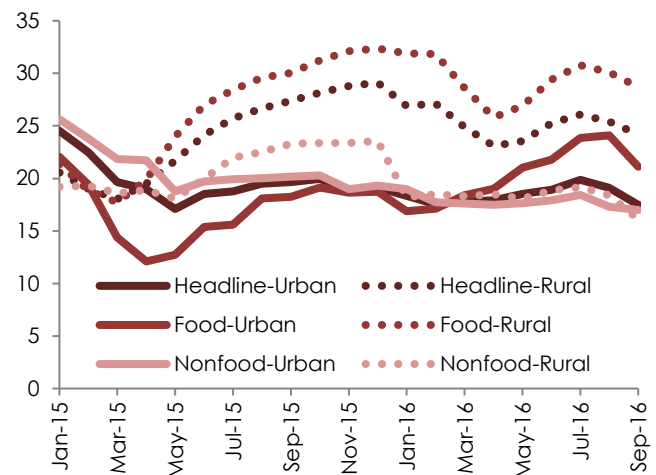
International commodity price indices, 2007-2015, 2010= 100



Source: World Bank Development Prospects Group

Figure 10: This is mirrored in Malawi, where food inflation is the main driver of an overall acceleration of prices

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



Source: World Bank staff based on data from NSO

34. As Malawi is a net energy importer, the decline in oil prices provides some respite in terms of non-food inflation.

In particular, the decline in these prices has led to improved terms of trade and lower imported energy costs. In recent months though, there has been a steady depreciation in the value of the Kwacha relative to the US dollar, compounded by an increase in the landed cost of petroleum products due to a decline in the level of global oil production. So, while increased transportation costs have not been the only reason for the recent acceleration in the rate of non-food inflation, the recent increase in petroleum product prices, as announced by Malawi Energy Regulatory Authority (MERA) in June, is likely to contribute to a further increase in this rate. On the other hand, fertilizer prices have declined steadily throughout the year. Depending on future price developments and on the timing of imports, this may help to contain the cost of purchases during the 2016 import season. However, market imperfections and high transaction costs tend to limit the extent to which lower prices are transmitted to Malawi, which may reduce this effect. Furthermore, the El Niño weather phenomenon has affected agricultural production worldwide, contributing to a recent increase in agricultural prices. This is especially pronounced in the Southern African region, so the food imports required for the humanitarian response will also come at a relatively high cost.

35. The poor harvest has resulted in increasing food prices across Malawi, particularly in rural areas. A comparison of food prices in urban and rural areas shows that food prices in rural areas were 7.5 percentage points higher than in urban areas in September, standing at 28.7 percent. This partially reflects the larger share of imported and processed food in urban consumption baskets, with the rapidly increasing prices for domestically produced maize having a greater impact in rural areas. At the same time, it also reveals a low level of market integration between rural areas, with the impact of cross-country trade of agricultural produce in terms of mitigating price rises being quite limited.

36. The rate of inflation is expected to continue to increase until at least the end of the year, with the overall annual rate for 2016 expected to reach 22.5 percent. In early 2017, the advent of the next harvest season and the finalization of fertilizer procurements should contribute to a deceleration in the rate of inflation, with food prices declining and forex reserves stabilizing. Until then, the rate of food inflation will be largely determined by the scope and speed of the response to the food crisis and by the level of output from winter cropping. Amongst other factors, the non-food inflation rate may be affected by rising water and electricity costs, given that the capacity for electrical power generation has been reduced by the drought.

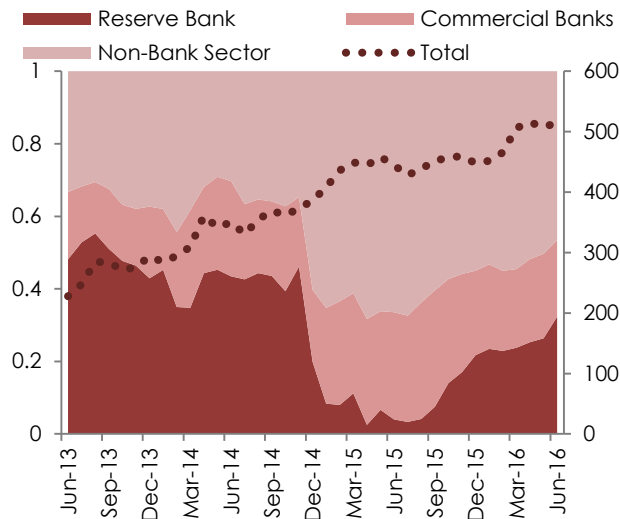
The Kwacha has depreciated earlier and more sharply than usual, with inflationary pressures persisting

37. The value of the Kwacha relative to most major currencies traditionally follows seasonal trends. This year, in February, it experienced an unusually steep depreciation in its value relative to the US dollar. Following this, its value appreciated only temporarily, before again beginning to decline. According to normal seasonal trends, the Kwacha gains value during the tobacco sales season in the period from March to September, with a subsequent depreciation when demand for foreign exchange is high, particularly during the period when fertilizer is imported, in advance of the following planting season. In mid-2015, the depreciation was unusually strong and prolonged,

with the lowest midmarket exchange rate recorded in February, when the exchange rate stood at 742 MWK/US\$. A consequent appreciation, with the mid-rate standing at 685 MWK/US\$ in April, probably reflects seasonal expectations of inflows from tobacco earnings, though indications of a further appreciation in the value of the Kwacha have so far been limited.

Figure 11: Continued high domestic borrowing contributes to persistent inflation...

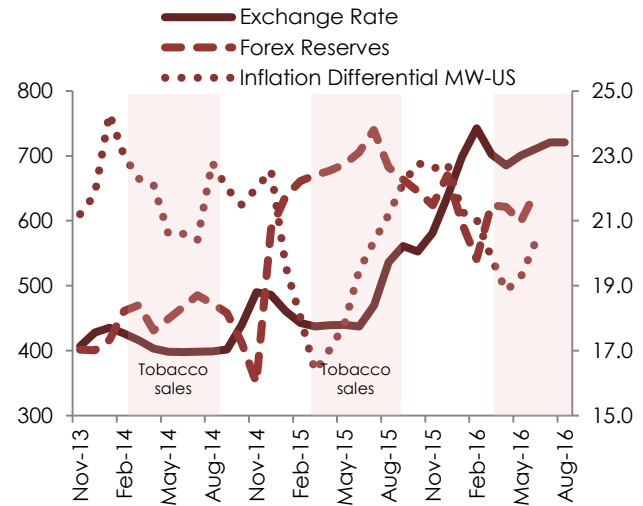
Total domestic borrowing, billion Kwacha (RHS); shares of various sectors in total domestic borrowing (LHS)



Source: World Bank staff based on RBM data

Figure 12: ...leading to depreciation of the Kwacha against a much more stable US dollar

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



Source: World Bank staff based on RBM, US Bureau of Labor data

38. While the overall trend towards a depreciation in the value of the Kwacha reflects uncertainties regarding Malawi's macroeconomic outlook, it has also been driven by a general strengthening of the US dollar relative to emerging and developing country currencies. This is reflected by the Kwacha's relatively lower rate of depreciation against regional currencies such as the South African Rand and the Zambian Kwacha. The strengthening of the US dollar has been largely driven by expectations of an increase in the US Federal Reserve Bank's reference lending rate; by concerns regarding the sustainability of resource-fueled growth in developing economies led by Chinese demand; and by pressure on the Euro and British Pound after the Brexit vote in June (see Box 1). A decline in the value of the Kwacha results in an increased import bill for strategic commodities such as fuel, fertilizer and pharmaceuticals. Import cover in August stood at 4.1 months, unchanged from the same point in the previous year. This is an increase from the figure of 3.6 months recorded in May 2016, though this may partially reflect the impact of IMF disbursements. A drawing-down on reserves is likely to occur in coming months as the lean foreign exchange season approaches, particularly in the context of the high level of demand for food imports necessary to implement the humanitarian response to the drought.

39. A disappointing tobacco sales season and currency speculation have contributed to a shorter-than-usual period of moderated appreciation, with the average mid-exchange rate stabilizing at 720 Kwacha to the US dollar in August. A relatively good tobacco harvest resulted in an over-supply on the market. Together with a low level of global demand, this has led to both unit prices and volumes traded being below expectations during the first few months of the marketing season. The value of US dollar earnings from this sector has thus been below average.

40. The value of the Kwacha is likely to continue to depreciate relative to the US dollar for some time to come, as long as Malawi's rate of inflation remains higher than that of the US. With a continuation of a relatively low reserve rate in the United States, the spread between the US and Malawi's inflation rates is likely to be driven by changes in the latter, with these changes contributing significantly to fluctuations in the exchange rate (see Figure 12). Periods in which the Kwacha appreciates are associated with a decreasing differential. In keeping with this trend, the high level of depreciation in the second half of 2015 followed a significant increase in the differential. Therefore, to prevent further dramatic depreciations, the control of domestic inflation is essential. In addition, the strong demand for food and fertilizer imports is expected to put pressure on the exchange rate and on foreign reserves, with proceeds from the export of tobacco being of critical importance.

A tight monetary policy stance has helped to contain non-food inflation

41. The Reserve Bank of Malawi (RBM) continues to maintain its policy rate at 27 percent. The temporary decrease in the rate of inflation did not provide sufficient room for a reduction in the policy rate, with the medium-term risks remaining high, especially in terms of uncertainties related to the projected increase in food prices resulting from the drought. While the RBM has played a key role in controlling non-food inflation since the fuel crisis in 2012, the range of instruments available to it to control food inflation are much more limited, with food inflation currently being the main driver of increases to the overall consumer price index. Thus, with the rate of inflation expected to accelerate, further adjustments to the policy rate may be required in the future to maintain positive real interest rates and to maintain incentives for saving and holding Kwacha.

42. The tight monetary stance has resulted in a deceleration in the pace of growth of credit. The RBM's active market interventions, involving the issuance of RBM securities, has helped to absorb liquidity and to ensure the maintenance of positive real interest rates. The sharp and early depreciation in the value of the Kwacha in the period from July to August 2015 was attributed in part to excess market liquidity following the reduction in the liquidity reserve ratio requirement, with currency speculation also playing a role. Reduced liquidity has helped to contain these pressures and to reduce the short-term demand for foreign currency, while also resulting in a deceleration in the pace of credit growth. This has helped to ensure a more orderly depreciation in the value of the Kwacha.

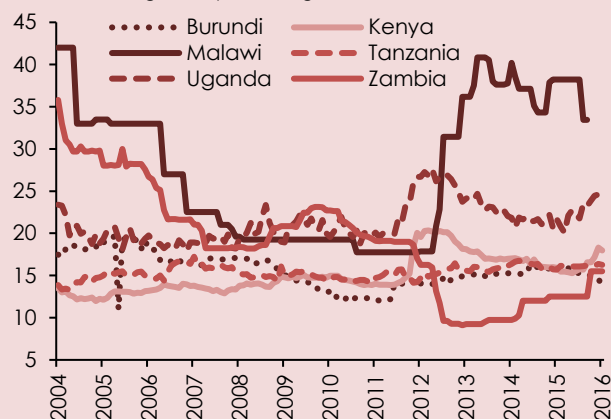
43. The rates for Treasury Bills have risen as a result of expectations of an acceleration in the rate of inflation. With inflation now accelerating, yields on Treasury Bills have also risen to an average of 28.99 percent for the three available periods of maturity. With Government debt accounting for 20.3 percent of commercial banks' domestic lending in August 2016, the Treasury Bill rate is a key determining factor for market interest rates in Malawi. As such, banks have little incentive to lower the interest rate for private loans (see Box 4 below).

Box 2: Why are interest rates and spreads so high in Malawi?

Compared to its peers, Malawi's lending rates and interest rate spreads are structurally high. Since the end of 2012, nominal lending rates and interest rate spreads (the differential between lending rates and deposit rates) have surged to place Malawi in the 90th percentile across the world. As a result, Malawi compares poorly with key country comparators and with other countries in the Sub-Saharan Africa region.

Figure 13: In recent years, nominal lending rates in Malawi have been well above comparators...

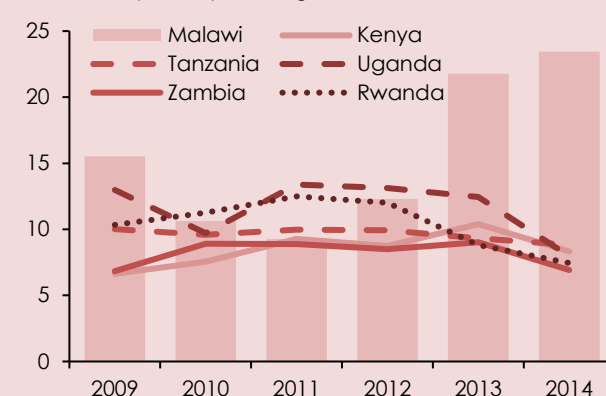
Nominal lending rates, percentages, selected countries



Source: World Bank staff calculations based on RBM and IMF International Finance Statistics data

Figure 14: ...and the spread between deposit and lending rates has also widened

Interest rates spreads, percentages, selected countries



Source: World Bank staff calculations based on Bankscope Bureau van Dijk data

High lending rates restrict private sector access to finance, while high interest rate spreads are often a sign of low and inefficient financial sector development. Both can have an adverse impact on economic growth. The 2014 Malawi Enterprise Survey found that limited access to finance and its high cost were the most significant constraints to private investment. Research shows that financing constraints, particularly in the form of high interest rates, are more binding than most other constraints on growth.² While high interest rate spreads may serve to increase banks' capital, which increases their financial soundness, they are typically reflective of low levels of competitiveness and operational inefficiencies within the banking sector. Cross-country empirical evidence also

² Ayyagari et al. (2008).

indicates that high interest rate spreads are correlated with low levels of financial development, which can have a strong negative impact on economic growth over long-term periods.³

Recent analysis of Malawi's banking sector has found that high lending rates and interest rate spreads are primarily the result of macroeconomic factors, particularly high rates of inflation. A high rate of inflation lowers real income in nominal terms, so banks increase their lending rates to avoid a decline in their revenues. Further, a persistently high rate of inflation increases economic uncertainties, increasing banks' credit risk. Since mid-2012, Malawi's rate of inflation has been persistently high, reaching an average annual level in excess of 20 percent. As a result, banks add a substantial premium to their interest rate spreads to mitigate the impact of the decrease in the real value of income and of increasing credit risks.

In addition, a number of other key variables have contributed to upward pressure on spreads and lending rates, including the following:

- *The cost of funding (or deposits):* These costs vary, depending on the source of funding. Funds from large depositors tend to be expensive, as they demand and secure deposit rates that are close to or above Treasury bill rates. In contrast, retail deposits tend to be a relatively cheap source of funds.
- *Operating costs:* These costs are generally the largest component of spreads in Sub-Saharan Africa. Operating costs tend to be high in Malawi given the limited supply of banking skills and the relatively high cost of doing business due to various infrastructure constraints. These costs have also increased as Malawi's banks invest in developing and expanding their outreach.
- *Borrower credit risk:* The difficulty of assessing and monitoring borrower creditworthiness and low levels of collateralization lead to a high proportion of non-performing loans and, ultimately, to losses for banks. Unfavorable macroeconomic conditions also increase this risk.
- *Regulatory costs:* While a well-designed regulatory regime has the potential to improve banks' resilience to sudden shocks and financial crises, the opportunity cost of these buffers is passed on to customers.

Lastly, Malawian banks have a high level of exposure to the public sector, which not only crowds out the private sector but also exerts upward pressure on interest rates. In 2014, the Government held about 20 percent of outstanding credit from banks while Government securities comprised about 24 percent of total banking assets. Bank investments in Government securities can be more profitable than lending operations that inherently incur a higher level of expense and involve a higher degree of risk. Therefore, lending rates move upwards to compensate for the opportunity cost of investing in lower risk Government securities. Large-scale Government borrowing in Malawi has led to a surge in Treasury Bill yields, which increases the attractiveness of these government securities. In addition, short-term Treasury Bill rates tend to set the marginal cost of funds faced by banks. Consequently, changes in these rates affect interest rate spreads.

Reducing lending rates and spreads in an effective manner requires a sustained effort to overcome structural challenges. Low levels of economic development and low average per capita incomes have led to a limited supply of savings, contributing to high level of competition for deposits and to higher funding costs and lending rates. Addressing these challenges requires long-term investment and reforms that reduce the cost of doing business in Malawi and change the structure of the economy and the banking system.

Nonetheless, policy measures that target the factors contributing to high lending rates and spreads can help in the medium term. Such measures should aim to increase the financial soundness of the banking sector; to increase banking sector efficiency; to lower operational costs; to increase the availability of information on borrowers; to promote banking sector competition; to strengthen collateral frameworks; and to expand the implementation of financial literacy and education programs. To be effective, these measures need to be combined with complementary efforts on other fronts, including efforts to improve the business environment more broadly. Ensuring macroeconomic stability and fiscal discipline is a fundamental prerequisite for lowering lending rates and interest rate spreads, so measures to achieve these goals should be a top priority.

Source: Kibuuka and Vicente (2016)

The decline in exports mirrors the fall in tobacco sales

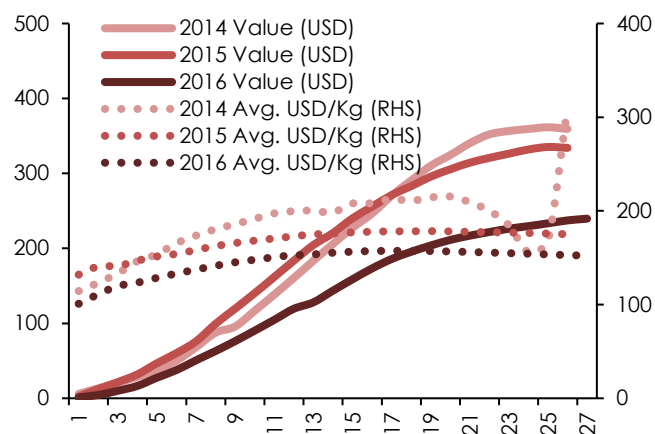
44. The impact of the drought, low global commodity prices, and the poor economic performance of Malawi's key trade partners, especially within the Sub-Saharan African region, continue to constrain the performance of Malawi's

³ Demirgüç-Kunt and Levine (2008).

external sector. In particular, the low rates of growth recorded by key trading partners such as South Africa have decreased the demand for Malawi's exports. In addition, Malawi's limited degree of product diversification renders it exposed to the decline in global commodity prices. The slow recovery of global commodity prices, especially for agricultural commodities, offsets the benefits derived from the decline in the price of oil and fertilizer, while the depreciation in the value of the Kwacha drives up the cost of the import bill for essential products.

Figure 15: Both tobacco sales and average prices are lower in 2016 compared to the last two years

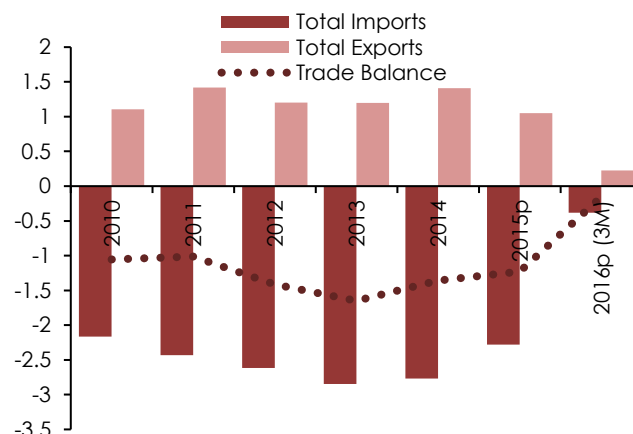
Cumulative value of sales/ week in US\$ millions (LHS) and average price in US cents/kilo (RHS), by week of sales from start of season, 2014-2016



Source: World Bank staff based on TCC data

Figure 16: The deficit on the current account balance has seen a modest contraction

Exports, imports and trade balance in US\$ billions, 2010-2015, first three months for 2016



Source: World Bank staff based on NSO data

45. Tobacco remains Malawi's most significant export, despite the decrease in global demand and declining prices for this commodity.

Over the past decade, tobacco has contributed to an average level of 50 percent of all Malawi's exports earnings. Despite the recent draught, tobacco production has remained relatively high, while prices have fallen, further limiting the value of sales realized each subsequent season (see Figure 15). During the most recent tobacco selling season, which commenced in April 2016, there has been a sustained decline in the price of tobacco. This decline has been particularly significant for auctioned tobacco, rather than for tobacco grown on contract. At present, tobacco grown on contract accounts for around 90 percent of all tobacco sold in Malawi. Low prices on the auction floors are at least partially driven by over-production in the sector, in addition to the decline in average global commodity prices. The situation is exacerbated by the high level of carryover stocks from the previous season. Similarly, the export value of tea fell by US\$ 10.3 million (40 percent) and of coffee by US\$ 176,000 (19 percent). By contrast, some other sectors made gains, with the export value of sugar in the first quarter increasing by US\$ 8.0 million (70 percent) and of cotton by US\$ 82,000 (19 percent).

Improved terms of trade have helped to reduce the cost of imports

46. The total merchandise import bill continues to decline, largely due to low energy prices and low levels of demand that result from Malawi's low rate of economic growth.

First quarter projections for 2016 indicate that the year-on-year merchandise imports bill will have declined by 47 percent compared to the same period in 2015. Despite the frequent blackouts, the value of diesel imports in this period has declined by US\$ 16.8 million (48 percent) compared to the figure recorded for the same period in 2015. This is largely due to the fact that transporters prefer to purchase fuel in neighboring countries, as its cost in Malawi is relatively high. On the other hand, the value of petrol imports has increased, due to increased demand as motorists purchased buffer reserves in response to the increased insecurity along the Beira corridor.

47. The value of fertilizer imports is expected to decline, with reductions in the number of FISP beneficiaries and with ongoing declines in the global price of fertilizers.

The cost of imported fertilizers in the first quarter of 2016 declined by US\$ 20.7 million (61 percent) compared to the same period in the previous year. This is mainly due to the sustained fall in global fertilizer prices, with these prices falling to below US\$ 75 per ton for the first time since January 2007. In addition, the number of FISP beneficiaries declined from 1.5 million to 0.95 million over the same period.

48. In 2015, Malawi achieved reductions in the trade deficit, with the deficit declining by US\$ 130.5 million compared to the figure recorded in the previous year. However, the value of the deficit is expected to increase in 2016.

The total value of the import bill is expected to increase in the latter part of 2016 due to Malawi's need to import maize

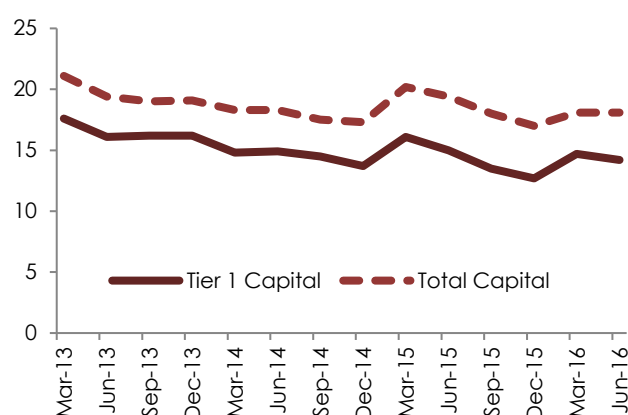
for humanitarian relief. This should increase the current account to a level higher than the figure of 8.2 percent of GDP recorded in 2015.

Weak economic performance has affected credit quality

49. Indicators suggest that while Malawi's banking sector's capital adequacy ratios are under pressure, they continue to meet minimum prudential requirements. In June 2016, Malawi's Tier 1 capital ratio stood at 14.2 percent, with the minimum prudential requirement standing at 10 percent. At the same point, its total capital ratio stood at 18.1 percent, with the minimum level standing at 15 percent (see Figure 17). The banking sector consistently records high returns on equity, reflecting a strong asset base of deposits. However, after a number of years of low rates of economic growth and of a tight monetary stance, lending to the private sector has inevitably been depressed. In the first half of 2016, the value of credit provided to the private sector remained flat in nominal terms, representing a decline in real terms.

Figure 17: Banking sector capital adequacy ratios remain above minimum thresholds...

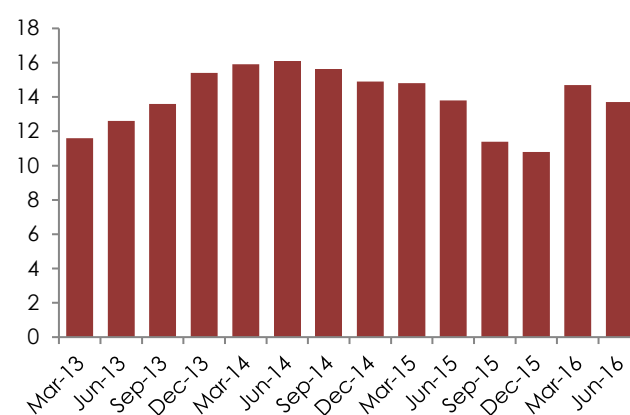
Capital adequacy, ratio of Tier 1 and total capital to risk weighted assets, percentage



Source: World Bank staff based on RBM data

Figure 18: ...but the share of non-performing loans has begun to rise again

Ratio of non-performing loans to gross loans, percentage



Source: World Bank staff based on RBM data

50. Following a period of two years in which the proportion of non-performing loans declined, this proportion has again begun to increase. In June 2016, the proportion of non-performing loans (NPLs) increased to 13.7 percent of the total value of gross loans, up from a low point of 10.8 percent recorded in December 2015 (see Figure 18). Prior to this increase, the proportion of NPLs had been on a declining trend since mid-2014. These figures suggest that Malawi's poor economic performance for two consecutive years is having a negative impact on credit quality across the economy.

Investor confidence remains subdued

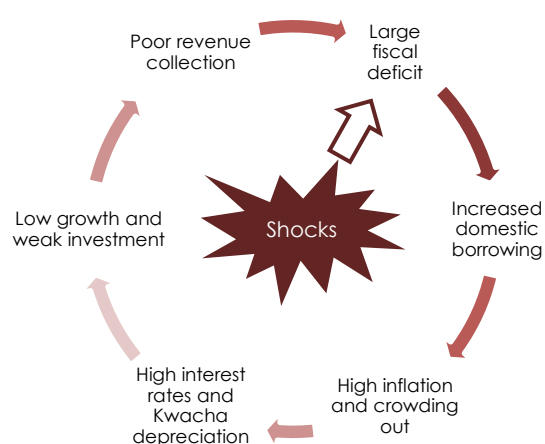
51. A second year of drought conditions and weak economic growth has had a negative impact on business confidence. Malawi's agricultural sector is the most significant contributor to the economy, directly accounting for around a third of GDP, with this proportion increasing if agricultural manufacturing and services are taken into account. Thus, weather shocks, including drought or floods, have a significant impact on levels of business confidence in the country. However, even prior to the impact of recent flooding and droughts, Malawi's private sector was struggling with an extended period of macroeconomic instability. High interest and inflation rates have eroded the returns on private investments, as demonstrated by the increasing share of non-performing bank loans. Increasingly frequent power and water supply shortages in Lilongwe and Blantyre, Malawi's key economic hubs, and the high exchange rate volatility have also sapped investor confidence (See Box 3 for a more complete discussion of Malawi's investment climate constraints).

Measures to build a more resilient economy

52. During recent years, Malawi's economy has been destabilized by the impact of a number of internal and external shocks. Two years of drought conditions across the country and localized flooding have increased the pressure on an already weak economy, which even prior to these adverse events was struggling to adjust to the impact of the "cashgate" scandal, which involved the misappropriation of a high value of public funds and a subsequent drastic reduction in on-budget development assistance. As a result, Malawi's economy has become

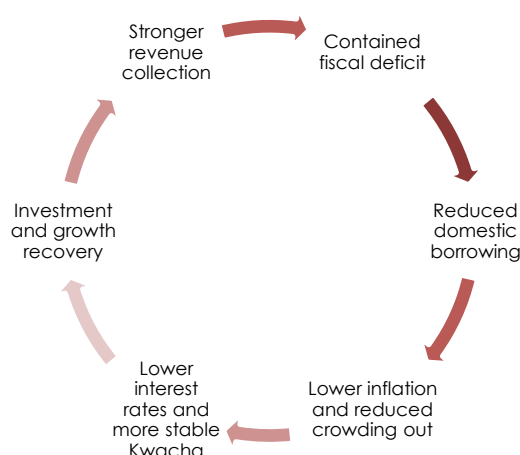
stuck in a vicious cycle characterized by large fiscal deficits, excessive borrowing, and high inflation and interest rates. In turn, these factors have depressed investment and growth, which then lead to weak revenue collection performance, which further exacerbates fiscal pressures (see Figure 19).

Figure 19: Malawi's economy has become stuck in a vicious cycle...



Source: World Bank staff

Figure 20: ...but needs to shift to a virtuous circle



Source: World Bank staff

53. Malawi's short-term challenge is to effectively manage the looming humanitarian crisis while at the same time safeguarding macroeconomic balances, and ensuring a smooth transition to medium term drought recovery and resilience building. The achievement of these dual goals requires the following:

- *Careful management of the humanitarian response and its transition to medium term drought response:* Amongst other key measures, this will require the following: (a) a review of existing interventions and programs in each of the assessed areas to determine the optimal utilization of existing resources and the identification of financing gaps; (b) coordination of drought recovery programming to ensure harmonization between the agencies involved in needs planning and execution; and (c) prioritization of needs between and across sectors and districts based on objective impact proportionate criteria in the context of a comprehensive drought recovery framework. Attention should be given to not only to facilitating a recovery from the impact of the current drought, but also to encouraging the adoption of mitigation measures to reduce the impact of future drought events.
- *Prudent expenditure management and commitment control to avoid loss of macroeconomic instability:* In the context of the current pressing humanitarian prices, the Government will naturally prioritize expenditure for the response to this crisis. However, given the Government's limited available fiscal space, it is critical that its expenditure remains below targeted limits and that it strives to expand its fiscal space through a reprioritization of expenditures. It must strive to avoid overruns through excessive expenditure on costly short-term arrangements. Economic recovery in 2017 will only be possible if Malawi emerges from the crisis with stable macroeconomic balances.

54. Improved economic performance in the medium-term future will only be possible if Malawi improves its levels of resilience to both internal and external shocks. It is likely that Malawi will continue to face recurring weather shocks into the future, so it is essential for it to develop the systems and mechanisms required to manage these shocks effectively. To build resilience, policy and institutional reforms will be required to eliminate the policy-induced distortions that exacerbate agricultural and climate vulnerability. It is also necessary to improve macroeconomic governance to increase fiscal buffers and to restore the confidence of development partners. Finally, investments are required to develop the resilience of the agricultural sector in the long term. Thus, the measures required to facilitate a recovery in economic growth include the following:

- *Policy reforms to reduce distortions and to ensure that agricultural markets function more effectively:* Malawi's smallholder-driven agricultural sector retains a strong subsistence orientation, with limited levels of commercialization. In addition, the prices of its agricultural commodities are amongst the region's most volatile. In many instances, the negative impact of climate-induced shocks has been exacerbated by policy-induced distortions that contribute to market failures. Issues include a lack of transparency and predictability in the market interventions implemented by key public sector institutions involved in the management of commodity

markets, such as Agricultural Development Marketing Corporation (ADMARC) and National Food Reserve Agency (NFRA).

- *Measures to reduce deficits, over-borrowing, and the crowding out of the private sector:* Improved levels of macroeconomic stability and fiscal discipline are essential to the achievement of medium-term growth recovery in Malawi. Only by breaking the current vicious cycle of large deficits, over-borrowing and crowding out can Malawi effectively control inflation and restore the basic macroeconomic conditions necessary for higher levels of investment and job creation. Moreover, Malawi is reaching the upper limits at which its stock of domestic debt can be sustainably managed. The Government should also implement measures to increase fiscal buffers to enable the budget to withstand the impact of external shocks. Improved systems of public financial management and governance could result in increases to ODA flows to on-budget execution, reversing the trend of these flows to off-budget execution.
- *Investments to build resilience to mitigate against climate-induced weather shocks and to diversify Malawi's economy:* These investments should include measures to develop agricultural infrastructure and extension services facilitate a higher level of crop diversification, to improve yields, and to build resilience through the development of irrigation, market information systems and improved farmer organization.

Box 3: What constraints are holding back Malawi's private sector?

Private enterprises play a key economic role as providers of goods and services, as importers and exporters, and as employers and tax payers. While business cycles and fluctuations in global demand affect private enterprises in the short term, there may be systemic constraints holding back their development over the longer term. In the case of Malawi, the business structure has been characterized as one of a 'missing middle.' On the one end of the spectrum, there is a sizeable group of larger firms, a large proportion of which are involved in agricultural processing, trading, and retail. On the other end of the spectrum, there is a vast number of household and micro-enterprises engaged in sales and small-scale manufacturing. The absence of a large group of middle-sized companies may suggest that a non-conducive business environment constrains growth opportunities for small-sized companies and favors those with established networks.

Figure 21: Access to finance is the main obstacle to investment in Malawi as well as in comparator countries

Percentage of firms reporting their most significant investment climate constraint



Source: World Bank Enterprise Surveys

The formal private sector continues to be constrained by a number of factors that affect its earnings and employment potential. In two nationally representative enterprise surveys, conducted respectively in 2008 and 2014, limited access to finance; the unreliability of electricity supply; and the country's tax system are consistently identified as the most significant constraints, with corruption also being identified as increasingly significant.

Capacity utilization is low, suggesting that the private sector is operating at below its potential. As a result of the challenging business environment, manufacturing firms in Malawi state that they are only able to realize 68 percent of the output they would be capable of producing given their equipment and manpower, a figure equal to that of Zambia, but far lower than for firms in Tanzania (82 percent). This figure will have almost certainly declined since the time of the survey, due to increasingly frequent power interruptions.

The most significant identified investment constraint is access to finance, with this being especially so in the case of small firms. High interest rates, collateral requirements and complex application procedures are cited as the main reasons for businesses not contracting loans. While 79 percent of large firms (more than 100 employees) had contracted loans in the year prior to the survey, only 63 percent of businesses with 10-49 employees and 33 percent of businesses with less than five employees had done so. Therefore, smaller enterprises mostly source their working capital from within their business, or utilize their private assets as collateral when taking up credit. On the other hand, larger and more successful companies, especially those in the manufacturing sector, borrow money more frequently to finance both investment and current expenditure, as they can pledge land or buildings as collateral. While measures to reduce interest rates should be prioritized to ensure broader access to finance (see Box 2), these findings also suggest that measures to improve financial literacy and to develop financial products tailored to the needs of small businesses may also play an important role.

Corruption is increasingly identified as a constraint to business activity. In 2014, 24 percent of companies reported having been asked for bribes by public officials over the previous year, while only 13.7 percent reported having

been asked in 2008. Overall, one in five interactions with public sector institutions was reported to have involved bribes.

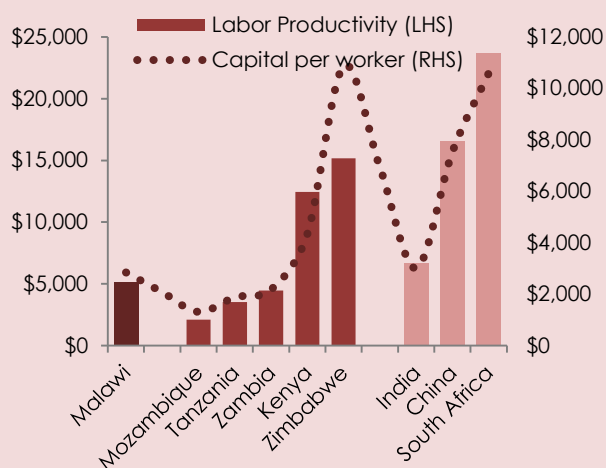
Electricity and water shortages result in high costs for firms, with the situation seeming to have deteriorated since 2008. On average, firms report losing 5.1 percent of their annual sales due to electricity outages, with 40.9 percent of firms reporting that they own a generator to provide backup supplies. Issues with utilities mostly affect medium and larger enterprises, especially in the manufacturing sector. On the other hand, theft and crime are identified as major constraints to a greater extent by smaller (20.0 percent) and medium-sized enterprises (29.1 percent) than by larger ones (9.2 percent). Larger enterprises spend a higher proportion of their resources on security (4.3 percent of annual sales).

Interestingly, labor-related constraints, including those related to the educational attainment of workers and labor costs, are not identified as a major constraint by most businesses. While 40.8 percent of firms in Tanzania identify the low level of educational attainment of the workforce as a major constraint, only 11.9 percent do so in Malawi. Similarly, labor regulations are identified as a constraint by only 4.6 percent of firms in Malawi, compared to 31.7 percent in Tanzania. These figures reflect the relatively high capital intensity of Malawi's businesses, with only a small proportion engaged in labor-intensive sectors.

The prevalence and persistence of the constraints described above may also explain Malawi's puzzlingly high productivity performance. Labor productivity in Malawi, as measured in terms of value added per worker, stands at more than US\$ 5,000. This is higher than in all of its neighboring countries. However, this does not necessarily demonstrate the high level of efficiency of Malawian workers, as Malawi's businesses also utilize a comparatively high level of capital per worker in the region. Estimates of Total Factor Productivity (TFP), a measure of how efficiently firms utilize their combined inputs of capital and labor inputs, rank Malawi favorably relative to its comparators. While the previously observed gap between Malawi and its neighbors narrows when using this aggregate measure, productivity remains higher than would be suggested by the low average income level and the slow growth performance over recent years.

Figure 22: Labor productivity is relatively high, partly explained by high capital intensity...

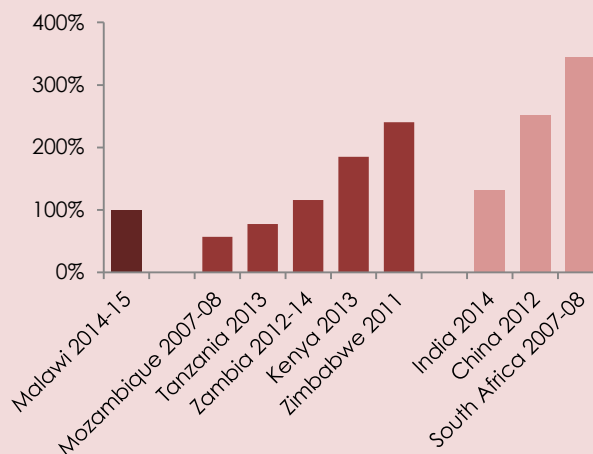
Value added per worker and capital per worker, constant 2009 US dollars, selected countries



Source: World Bank Enterprise Surveys

Figure 23: ...while total factor productivity is lower than for some comparators, but still high given Malawi's level of income

Median total factor productivity relative to Malawi, selected countries



Source: World Bank Enterprise Surveys

While the high level of measured productivity partially reflects the significance of estate farming and of associated processing in the manufacturing sector, it also points to the low degree of competition. This is evident from the pricing power of incumbents and from the existence of significant barriers to entry by new firms. Indeed, access to finance and capital are more challenging for smaller and growing firms than for long-established, larger firms. In addition, the unstable macroeconomic environment and regulatory deficiencies that constrain private sector activity favor established firms with broad networks, enabling them to mitigate the many risks to doing business in Malawi.

Source: Record et al. (2016)

2. SPECIAL TOPIC: PERSISTING POVERTY AND VULNERABILITY

Droughts and other adverse weather incidents have had a devastating impact on Malawi's agricultural sector for two consecutive years, with the most serious effect being the decline in the output of maize, which forms a large part of the staple diet of the majority of the population. As a result, Malawi is currently experiencing one of the most significant humanitarian crises its history, with an estimated 40 percent of the population experiencing food shortages. In addition to the impact of the droughts on the agricultural sector in general and on maize production in particular, Malawi's predominantly rural population is also suffering as a result of the country's prolonged period of macroeconomic instability, the effects of which can be seen from a number of indicators. In particular, the average annual inflation rate has stood at more than 20 percent for at least the last five years, with this having a disproportionate impact on the poorest members of the community. While the current food security crisis is clearly the result of adverse climatic conditions driven by changing weather patterns, the impact of the drought has been exacerbated by past failures to formulate and implement policies to develop the Malawi's resilience to shocks. This special topic draws upon a number of recent analytical works to determine the reasons and causes for the persistence of poverty in Malawi. It also seeks to identify the means by which these policy issues could be addressed and the measures by which Malawi's poor and vulnerable population could achieve higher standards of living.⁴ Although Malawi is currently passing through a particularly challenging period, the crisis presents opportunities to implement radical reforms that could ensure that the country emerges stronger and more resilient, enabling it to achieve equitable, sustainable, inclusive growth into the future.

There have been encouraging elements of progress in terms of human development

55. Over the past decade, the economic performance of Malawi's rural sector has lacked dynamism. With highly unstable macroeconomic fundamentals, the rate of growth has been volatile, inflation and interest rates have been high, and fiscal deficits have widened. Malawi's rate of poverty remains high, with this rate declining at a much slower pace than that of many other countries in the Sub-Saharan African region, including Ethiopia, Ghana, Rwanda, and Uganda. Malawi's rural poor often face significant challenges in achieving food security at the household level. However, despite this generally poor state of affairs, there have been some areas in which significant progress has been made, as described below.

56. The rate of enrolment in primary education has increased steadily. Since 2004, both the proportion of school-aged children attending primary school and the proportion of households with a member who had completed primary school have increased significantly. The proportion of school-aged children attending primary school increased from 53 percent in 2004 to 61 percent in 2013, while the proportion of households with a member who had completed school at this level increased from 41 percent in 2004, to 49 percent in 2010, and to 52 percent in 2013.

57. Over the same period, the rate of childhood malnutrition has declined steadily. According to data from the Demographic and Health Surveys (DHS), the rate of incidence of stunting (a measure of long term nutritional deprivation in children) in rural Malawi declined from 54 percent in 2004 to 39 percent in 2015. Over the same time period, the proportion of underweight children (in terms of ratio of weight to age, which measures short term changes in child nutrition) declined from 18 percent to 12 percent. Data from the second and third Integrated Household Surveys (IHS2 and IHS3) and the Integrated Household Panel Survey in 2013 (IHSP 2013) suggest that the decline in both these rates may have been even more significant.

58. The rate of under-five infant mortality has also declined. According to data from the DHS, this rate of mortality declined from 133 deaths per 1000 live births in 2004, to 112 deaths in 2010, and then to 64 deaths in 2015. In the period from 2004 to 2010, the most significant reduction was recorded in rural areas, with the rate declining from 164 to 130 deaths per 1000 live births in these areas between these two points in time.

59. With these positive achievements in the areas of health, nutrition and education, Malawi has achieved four out of eight of the Millennium Development Goals (MDGs), which set specific targets in terms of addressing multiple dimensions of poverty by 2015. The goals that have been achieved in Malawi are MDG1c (reducing undernourishment); MDG3 (eliminating gender disparity in education); MDG4 (reducing child mortality); and MDG6 (combating HIV/AIDS and other diseases).

⁴ These include the new *Malawi Poverty Assessment* (forthcoming World Bank, 2016e), the *Pathways to Prosperity in Rural Malawi* policy report (forthcoming Dabalen et al. 2016), an analysis of the economic impact of the El Nino drought in SADC, and preliminary analysis of the results of the floods impact assessment survey.

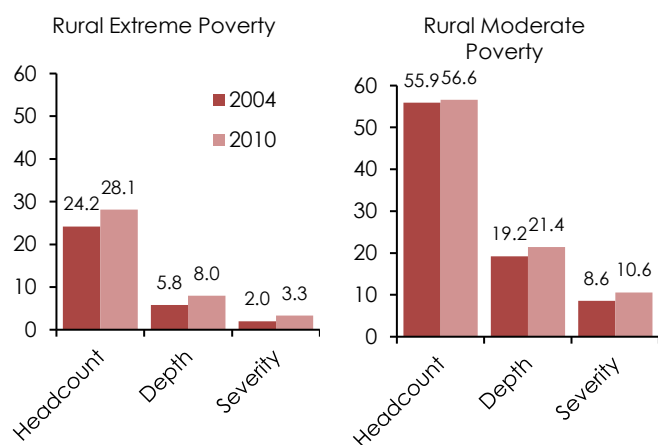
60. The proportion of the population afflicted by poverty in multiple dimensions has declined. The share of the population deprived in multiple dimensions, including education (completion of primary education); health (child under 5 mortality and under-nutrition); access to key services (electricity, improved sanitation, safe drinking water); and ownership of assets (ownership of radio, television, bicycle) fell from 38 percent in 2004 to 32 percent in 2010. The indicator used to track multiple deprivations is usually calculated on the basis of both the proportion of the population deprived in more than one dimension and the average number of dimensions in which the deprivation is experienced (referred as the “intensity of the deprivation”). In the case of rural Malawi, the intensity of the deprivation did not change significantly between the two points in time. Rather, the decline was due to the fact that the proportion of the population deprived in more than one dimension fell by 8 percentage points (from 75 percent to 67 percent).

But these have been dwarfed by persistent challenges

61. While there have been significant reductions in the proportion of the population experiencing deprivation in terms of the non-income dimensions of poverty, the proportion of the population experiencing poverty in monetary terms has remained almost unchanged. In 2010, calculated on the basis of a basic needs basket that costs MWK 37,000 per person per year, more than half of the rural population could be classified as poor. In addition, approximately one quarter could be classified as extremely poor, defined in terms of being unable to satisfy basic food needs (see Figure 24). Even more disturbingly, in the period from 2004 to 2010, the rate of poverty in rural areas remained broadly unchanged at around 56 percent, and with the rate of extreme poverty actually increasing, from 24 to 28 percent. The poverty gap, which measures the consumption shortfall of the poor, was also relatively high. Over the two points in time, the depth of poverty and its severity (measured by the poverty gap squared) remained unchanged (see Figure 24). Finally, based on the international poverty line of US\$1.90 per person per day, in 2010, Malawi’s poverty rate in 2010 stood at 71 percent.

Figure 24: Rural poverty remains high and stagnant...

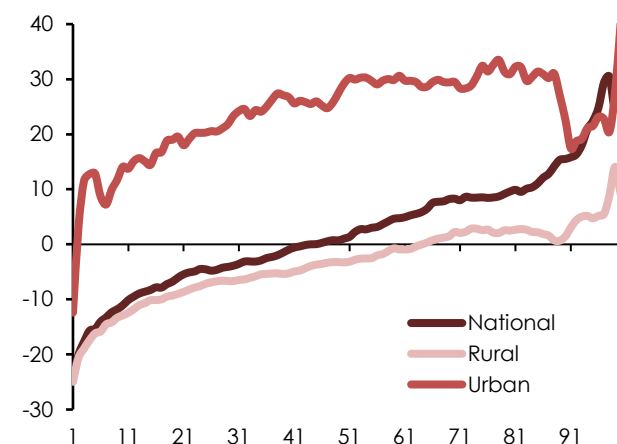
Share of population defined as living in either poverty or extreme poverty, 2004-10



Source: World Bank staff estimates using cross-sectional IHS2 and IHS3 survey data.

Figure 25: ...and the proceeds of economic growth have not been shared

Growth in per capita expenditure, by population decile, 2004-10



Source: World Bank staff estimates using cross-sectional IHS2 and IHS3 survey data.

62. Food insecurity and chronic poverty also remain widespread, with the incidence rate having increased in recent years. In 2010, 67 percent of poor households in rural areas reported experiencing food insecurity for at least one month of the year. By 2013, this figure had increased to 84 percent. A large proportion of poor households failed to consume enough calories each day to meet the benchmark for the average person to lead a healthy life, with 81 percent consuming less than 2,100 kilocalories per capita per day (kcal/person/day).

63. The vast majority of Malawi’s poor population live in rural areas. Of the 2.6 million people categorized as chronically poor, 2.4 million live in rural areas. Household and community level shocks, combined with a lack of insurance schemes and other safety nets, are the major cause of both food insecurity and chronic poverty. Rural households are particularly vulnerable to becoming trapped in a cycle of poverty, due to their high exposure to shocks and their low level of capacity to manage these shocks.

64. Inequality is rising. For most periods up until 2004, Malawi was characterized by low levels of inequality. However, in the period from 2004 to 2010, in terms of the Gini consumption index, the level of inequality in Malawi’s rural areas

increased from 34 to 38. Over the same period, the share of consumption of the poorest 40 percent of the rural population declined from 20 percent to 18 percent. Over this period, the share of consumption of the richest 60 percent of the population increased by 17 percent, while the share of the poorest 40 percent declined by 17 percent. In addition, the inequality gap between urban and rural areas increased. In urban areas, average consumption levels increased for all income groups, with the increases for the poorest groups relatively low compared to the richer groups, but still positive. However, in rural areas, approximately two-thirds of the population experienced real declines in their levels of consumption, with only the richest 5-10 percent experiencing significant increases (see Figure 25). Thus, Malawi's volatile and tepid growth has done little or nothing facilitate increased levels of consumption amongst the country's rural poor.

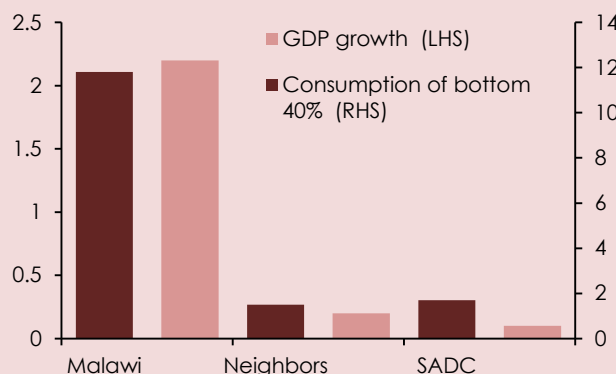
Box 4: Malawi is more vulnerable to climate shocks than other countries in the region

Results from a Computable General Equilibrium analysis place Malawi among the countries most significantly impacted by the current spell of El Niño-induced droughts. On average, this phenomenon is expected to result in an average decrease in the rate of GDP growth of 0.1 percentage points amongst the member states of the Southern Africa Development Community (SADC). However, the level of loss experienced by Malawi is expected to be significantly higher than this average, reaching 2.2 percentage points, or 8 months' worth of GDP growth. This extreme impact is largely due to the level of Malawi's dependence on maize and rain-fed agriculture (World Bank 2016b). With Malawi's already high rate of poverty, the impact of the drought on the poorest 40 percent of the population will also be most significant in Malawi. The average annual level of consumption of the bottom 40 percent will decline by 11.8 percent in Malawi, compared to an average decline of 1.7 percent across the SADC (see Figure 26 below **Error! Reference source not found.**). The annual maize production output is expected to decline year-on-year by 14.7 percent. This follows a decline of 30.2 percent in the previous year. As a consequence of the gap between supply and demand, Malawi has recorded the most significant rise in the price of maize, with this price increasing by 152 percent in nominal terms in the 12-month period prior to March 2016.

While climate shocks continue to affect the entire region, a number of factors aggravate their effects in Malawi. In terms of a headcount ratio, Malawi's poverty rate is significantly higher than that of neighboring countries. In addition, Malawi has the highest poverty gap ratio, indicating that a large share of the population is barely able to cover their food needs, even in normal years. Finally, the situation is exacerbated by Malawi's high population density, with 238 people/km² of agricultural land, compared to the average level of 53 people/km² in neighboring countries (World Bank 2017). Agriculture remains focused on the cultivation of a small number of crops, with 49 percent of agricultural land being utilized for the cultivation of maize. It is estimated that only 0.5 percent of crop plots are under irrigation, rendering production levels and smallholder incomes particularly vulnerable to changing rainfall patterns and associated price swings.

Figure 26: Malawi's GDP will be reduced significantly by the drought, and the poor will be hit hardest...

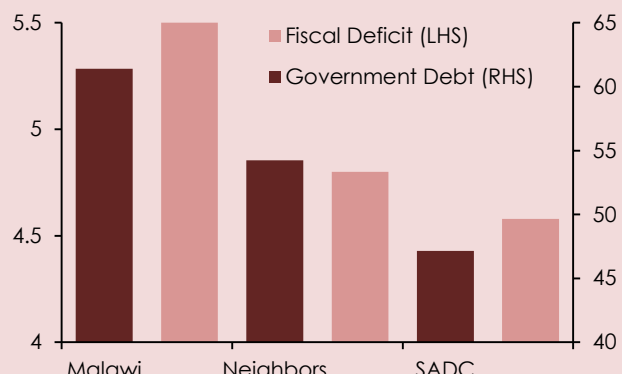
Negative impact on GDP growth and consumption of the bottom 40 percent, annual percentage change, selected countries



Source: World Bank staff estimates based on LINKAGE model

Figure 27: ...with limited fiscal space for Government to respond

Size of fiscal deficit for most recent year and stock of public debt, percentage of GDP, selected countries



Source: World Bank staff calculations

Malawi's vulnerability to climate change is exacerbated by the Government's limited fiscal space. This constrains Government's ability to implement effective responses. In order to finance the shortfalls in the budget, the Government resorts to domestic borrowing, worsening the deteriorating debt situation. Malawi's debt levels are already among the highest in the region, and it is struggling to close a large fiscal deficit (see Figure 27).

Climate change is predicted to increase both the frequency and intensity of extreme weather events throughout the region. In this context, it is vital to improve Malawi's levels of resilience at all levels. Effective measures to improve resilience should address household vulnerabilities related to food security. They should also involve significant investment in the development of human capital and include the implementation of risk management measures for the agriculture sector. Finally, they should include measures to improve the Government's capacity to respond to crises in a comprehensive and sustainable manner (World Bank 2016a).

Source: World Bank (2016b)

Why does rural poverty persist?

65. In Malawi, reductions in the rate of rural poverty have been difficult to achieve. This has been the case because in rural areas of Malawi, the primary means of deriving a livelihood are the production of crops and employment in the farm labor market (*ganyu*). However, a large proportion of households are unable to rely solely on rain-fed agriculture, which is highly prone to price and weather shocks. Therefore, as a household-level measure to mitigate against the impact of these shocks, households often diversify into non-farm activities, particularly self-employment in household micro-enterprises or off-farm wage labor in rural or urban areas. Finally, many households rely on remittances, pensions, and other public transfers/benefits (nutritional interventions and cash transfers) to meet their most basic needs and to invest in health and education.

66. The potential to utilize household assets to generate income is determined by the contexts in which the households operate. Important contextual issues include the Government's provision of socioeconomic infrastructure, access to markets, and public services to the population; a sound economic environment for investment and employment generation; and the ability to manage risks. From these perspectives, Malawi's broader macroeconomic context has not been conducive to the achievement of poverty reduction. In particular, for most of the past decade, in the period from 2006 to 2015, Malawi's annual average GDP per capita growth rate was a respectable 2.6 percent, which is even better than the average rate for sub-Saharan Africa at 2.0 percent.

67. However, Malawi's GDP was significantly more volatile than the regional average. In some instances, this was not driven by agriculture, the sector in which most of the rural population is employed. For instance, in the period from 2004 to 2010, real agricultural GDP grew at a slower rate than did services (wholesale and retail trade, real estate, information and communications, transport and storage, and professional and other services) and industry (including mining and quarrying, construction, and manufacturing). Volatility in patterns of GDP growth was partly due to macroeconomic instability, characterized by high rates of inflation, the high cost capital, burgeoning fiscal deficits, and a high level of exchange rate volatility. Another significant factor was the negative impact of weather shocks. In addition to the difficult macroeconomic environment, structural impediments to sustained and inclusive growth have created conditions constraining the growth of agricultural incomes; limiting the growth of non-farm opportunities; and rendering safety nets ineffective.

Lack of robust growth in agricultural productivity

68. To improve the socio-economic conditions of rural households, it is necessary to achieve higher levels of agricultural productivity. Agriculture is the backbone of Malawi's economy, contributing to more than 30 percent of its GDP and providing employment for more than 85 percent of its workforce. Most agricultural producers are subsistence farmers who cultivate small plots of land, with limited opportunities to diversify their incomes. Given Malawi's predominantly rural nature and the importance of agriculture for rural livelihoods, especially for the poor, the level of productivity of the agricultural sector has direct implications for economic growth and poverty reduction in Malawi.

69. In the period from 2010 to 2013, empirical evidence show that a 10 percent increase in agricultural productivity is correlated with increases of 1.3 percent to the average per capita level of consumption in rural agricultural households. With increases in agricultural productivity, poverty also declines in terms of measures such as the poverty gap and the severity of poverty. At the household level, half of the gains derived from increased agricultural productivity were utilized to increase food consumption, measured in terms of per capita calorie intake. Projections indicate that if maize yields increased by 50 percent, the poverty rate among rural agricultural households would decline by approximately 7 percentage points, lifting approximately 600,000 people out of poverty.

70. Unfortunately, increases to agricultural productivity of this order have yet to be achieved. In the period from 2010 to 2013, average maize yields increased by only a modest 8 percent. The rate of increase was higher for non-poor farmers than for the poor, with maize yields for poor farmers being 31 percent lower than for the non-poor. There were also substantial variations according to poverty status in the level of productivity of all other major crops

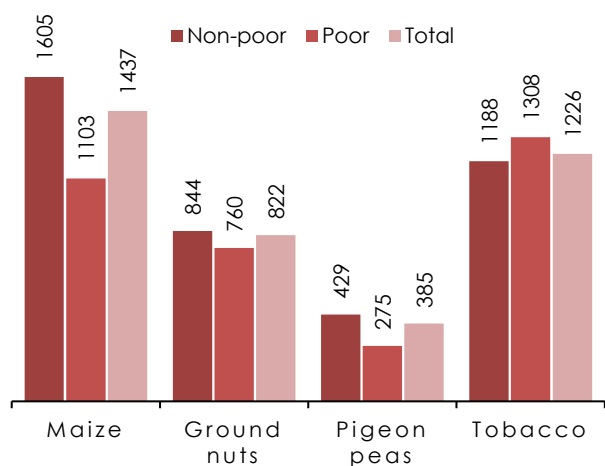
(see Figure 28). In general, average maize yields remained relatively low compared to those of other African countries, such as Rwanda and Uganda, and countries outside the region, at 1.4 tons/ha.⁵ Based on its agronomic potential, it has recently been estimated that Malawi could eventually achieve an average maize yield of approximately 4.5 tons/ha (Benson and Edelman 2016).

71. The level of agricultural productivity in Malawi has remained largely stagnant due to the lack of complementary investments in agriculture and to limited access to information. The proportion of farms with access to complementary inputs (inorganic fertilizer, improved seeds, extension) remains low, despite evidence that the combined use of these various inputs results in a significantly greater increase to yields and productivity levels than do the use of each input alone, with the sum being greater than the parts. Furthermore, in the period from 2010 to 2013, more than half (53 percent) of the maize yield differential between those who remained poor and those who rose out of poverty is explained by changes in the returns on the application of organic fertilizer; the utilization of family labor; access to extension services; and the application of the right type of basal fertilizer. Access to high-quality information and its appropriate use could increase these returns. This is suggested by the fact that households who remained in poverty in both periods had lower levels of education and lived in more remote villages than those who escaped from poverty, with low levels of education and remote location making access to information more difficult.

72. Inefficient patterns of public expenditure on agriculture are a highly significant contributing factor to Malawi's low levels of agricultural productivity. Malawi spends a disproportionately high share of its resources on agriculture relative to other nations in Africa, with these expenditures amounting to a value of 4.2 percent of the total GDP in 2012, compared to the regional average of 1.3 percent. However, the composition of this expenditure is unbalanced and does not achieve a good rate of return on the investment. In particular, expenditure on the FISP has consistently accounted for more than half of the total value of public expenditure on agriculture in Malawi. The disproportionately high expenditure on this program reduces the space for complementary public investments to strengthen markets, to develop irrigation, and to introduce and diffuse new technologies, all of which have significant potential to an increased rate of agricultural productivity growth.

Figure 28: Crop yields of poor households are lower than yields of non-poor households...

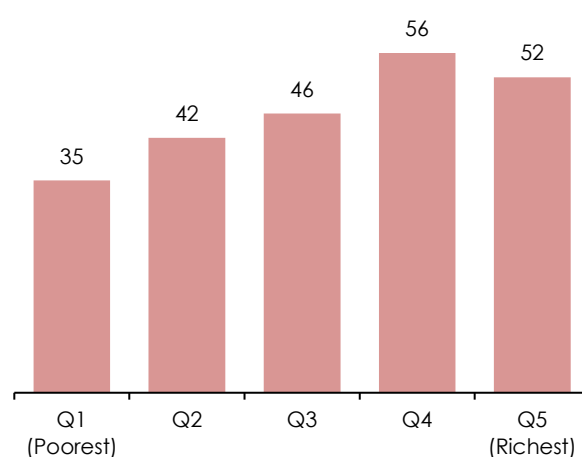
Crop yield in Kg/ha by poverty incidence, 2013



Source: World Bank staff estimates from IHPS survey data

Figure 29: ...and the poor have not been well targeted by fertilizer subsidies

Household participation in FISP by household consumption quintile



Source: World Bank staff estimates from IHPS survey data

73. The FISP program is intended to subsidize the use of inorganic fertilizer, particularly by smallholder, resource-poor farmers. However, the evidence clearly shows that with good weather conditions, increased access to inorganic fertilizer results in only modest increases to the level of maize production. In addition, despite the fact that the stated aim of FISP was to make inorganic fertilizer available to smallholder and resource-poor farmers, the targeting of the program is poor. In 2013, only around one-third of rural households in the bottom quintile obtained subsidized inorganic fertilizer, while half of those in the top two quintiles obtained this fertilizer (see Figure 29). This poor targeting reflects the lack of clarity regarding the objectives of the program. It is not really clear whether the

⁵ Although national production estimates suggested important increases in maize production and productivity from 2005 to 2010, several farm-level studies found relatively modest increases in maize production and yields over the same period (Chibwana and others 2011; Holden and Lunduka 2010; Ricker-Gilbert and others 2011).

program is actually being implemented as a program to reduce poverty or whether the goal is rather to boost maize production at the national level. Whatever the objectives, an increasing body of empirical evidence shows that the impact of FISP on both the reduction of poverty and the achievement of food security at the national level have been unimpressive, with yields not having improved significantly since the initial boost following the launch of the program. The failure to achieve increased yields, despite the high level of participation of a large proportion of non-poor farmers, is cause for concern. This failure also partially explains the modest growth in crop income amongst the poorest rural households and the limited impact of the program in terms of containing real maize prices.

Limited opportunities to move into non-farm activities

74. As is the case in many other primarily agricultural economies, Malawi's poor rural households are generally unable to depend on income from a single source such as crops from rain-fed agriculture. These households are often compelled to diversify their sources of income to reduce their dependence on highly risk-prone agricultural incomes. They may need to use non-farm income to address the constraints created by thin credit markets to smooth consumption, to finance farm investments, or to establish businesses. Recent evidence suggests that Malawi's economy is gradually shifting from agriculture into non-farm sectors. In the period from 1998 to 2013, more than four-fifths (82.7 percent) of Malawi's new jobs were created in rural areas. Over the same time period, the share of rural agricultural employment declined, with all the employment growth in rural areas taking place within the non-farm sectors.

75. At the household level, participation in employment in the non-farm sectors, particularly in non-farm self-employment, is associated with improved socio-economic circumstances. In the period from 2010 to 2013, a breakdown of changes in poverty status by sources of income indicates that increased incomes from non-farm business activities played a greater role in reducing poverty in rural areas than did any other source of income.

76. Despite the positive impact of non-farm self-employment, the opportunities for such employment have remained precarious and limited. While the rate of rural households' participation in non-farm self-employment increased from 20 percent in 2010 to 28 percent in 2013, this rate remains low compared to that of many other low income countries. In addition, the growth potential of these activities appears to be limited. Many rural household enterprises are operated informally from home by young uneducated males. Three out of every four business-owners have no formal education and no access to capital services to enhance productivity. In 2010, the average business had been running for approximately 12 years. By 2013, this had declined to 9 years. This decline may suggest that, while many enterprises were created in the period from 2010 to 2013, a significant proportion of more established businesses have ceased to operate, thus reducing the average age of the enterprises. Thus, household enterprises appear to have relatively short lifespans. In addition, in 2013, only 8 percent of household enterprises were formally registered, possibly because of the short lifespan of these enterprises, with owners thus unwilling to invest time and resources in registration and, more importantly, in enhancing their productivity.

77. The level of productivity of rural non-farm activities is low. If changes to overall productivity are disaggregated into changes within and across economic sectors ("structural change"), two patterns emerge. Labor productivity within the agriculture sector declined over time, but the shift from low to higher productivity sectors was slow. This slow shift suggests that most of the labor leaving the agriculture sector was absorbed into low-productivity activities in other sectors.

78. The level of productivity of non-farm activities is higher in urban areas than in rural areas. Revenues from household enterprises and non-farm wages across all industry groups were considerably higher in urban than in rural areas. In 2010, the average profit from participation in self-employment was MWK 23,400 per month in urban areas, a figure MWK 18,000 higher than the average return in rural areas in the same year. On average, workers in urban areas also consistently earned higher wages in all job categories than did workers in rural areas.

Imperfect safety nets within a context of high economic insecurity

79. Not only are rural incomes relatively low, they are also more highly volatile, with a high level of risk associated with weather and health shocks. At present, financial markets do not provide credit, insurance, or savings products at sufficient scale to enable households to effectively manage risk through measures to protect themselves from changes in incomes, to start businesses, or to purchase inputs. Although private transfers, usually in the form of remittances from household members or benefits from mutual insurance schemes play a useful role, they do not necessarily benefit poor households, nor are they effective as measures to mitigate large-scale, community-wide shocks. Therefore, social protection measures to guarantee basic minimum income levels and protect households from income shocks are essential tools to address extreme poverty and rising inequality.

80. Despite recent expansions, the coverage of the Government's main social safety net programs remains limited.

Public expenditure on social protection in Malawi is relatively low by international standards. In 2014/15, the annual budget for social protection programs accounted for approximately 0.8 percent of GDP, approximately two-thirds of the average level for low-income countries in Africa. In 2013, each of Malawi's main social safety net programs covered less than 10 percent of the poor population, except in the case of the School Feeding Program and the Malawi Social Action Fund-Public Works Program (MASAF-PWP), which reached less than a quarter of the poor population.

81. In addition to limited coverage, the effectiveness of Malawi's social assistance programs has been impacted by high leakage rates.

In 2013, around 60 percent of beneficiaries of MASAF-PWP and/or of direct cash transfers from Government, the two largest social programs in terms of budget, were not poor. While existing mechanisms for redistribution within communities may reduce the impact of this leakage, evidence to support this claim remains anecdotal and unconvincing. Given the low rates of coverage, the poor targeting, and the high rates of leakage, Malawi's social assistance programs are unlikely to facilitate significant reductions in poverty or to protect the vulnerable unless they are subject to major reform.

Box 5: The impact of climate shocks on consumption, assets and social safety nets at the household level

Over the past few years, Malawi's households have been affected by a number of adverse weather events, including droughts and floods, which are occurring with increased frequency.

The impact of these shocks on key macroeconomic variables such as agricultural output, food price inflation and economic growth has been covered in previous editions of the *Malawi Economic Monitor*. However, the Malawi Flood Impact Assessment Survey (FIAS) implemented after the floods in 2014/15 provides unique insights at the microeconomic level, showing not only the impact of the floods on food consumption patterns, consumption expenditures and assets at the household-level, but also the household coping strategies and the factors that underlie resilience to adverse impacts on livelihoods. The FIAS 2015 was a follow up survey of approximately 600 households that had been interviewed twice prior to the 2014/15 floods, in 2013 as part of the Integrated Household Panel Survey (IHPS), and in 2010 as part of the third Integrated Household Survey (IHS3). The FIAS 2015 sample was selected from the IHPS 2013 household sample in Southern and Central region districts and in a manner that allowed for variation in potential household exposure to flood-related shocks.

Due to a combination of lower real food prices and increased earnings through paid labor and cash-transfers, households were able to maintain their calorie consumption during the study period (see Figure 30).

This was mainly driven by a shift towards a less diversified but more calorie dense diet, including unrefined maize, other grains and fruits. Importantly, food was increasingly sourced from the market (70 percent of calories in 2015, compared to 43 percent in 2013), while consumption of own produce decreased. This trend was particularly apparent amongst the worst affected households. This may have been partially facilitated by the sale of assets by these households, but it was also the result of Government-provided cash-transfers that reached a small but increasing proportion of the population. In terms of expenditure on non-food items, households decreased their expenditure on alcohol, tobacco and clothing, while they increased expenditure for health purposes.

While the single most significant impact of the floods was the loss of human life, the first order impacts of floods among FIAS households included a 43 percent decline in average maize yields in the period from 2013 to 2015.

In 2015, the lowest average maize yields were found among households most affected by floods, as expected. Nearly one-third of all FIAS households reported damage to their dwellings, with the incidence highest among those most affected by floods. Similarly, 17 percent of households most affected by floods reported loss of assets. The data also shows a significant decrease in the level of ownership of agricultural implements, and of small livestock, largely due to post-flood sales.

Changes in consumption and dietary patterns are among the most prominent responses to the flood impact.

Given the negative impact of the floods on agricultural production, the share of consumption originating from purchases increased in the period from 2013 to 2015 across the board, particularly among the most affected households. While the real price of key commodities, such as maize flour derivatives, was shown to decline over the survey period, in 2015, the households, particularly those most affected, were able to source a higher share of their calories from cheaper and lower quality maize and from other sources, such as fruit (especially mangoes). The combination of lower real food prices and the shift towards cheaper but relatively calorie dense food options allowed for the co-existence of a decrease in real food consumption expenditures and an increased calorie consumption.

The level of participation in paid labor (ganyu) and the value of earnings derived thereby increased significantly during the study period, which resulted in increases to overall levels of food consumption.

Income derived from

paid labor contributed to 13 percent of households' expenditure on consumption in 2015, up from only 5.4 percent in 2013. The most significant increase in participation in paid labor was observed among the households least affected by floods, which may indicate a stronger demand for agricultural labor in areas benefiting from relatively favorable amounts of rainfall.

Figure 30: Households managed to avoid reduction in calorie acquisition, facilitated by lower real food prices, shifting to cheaper calorie sources...

Calorie consumption per capita per day, by flood affectedness status 2015

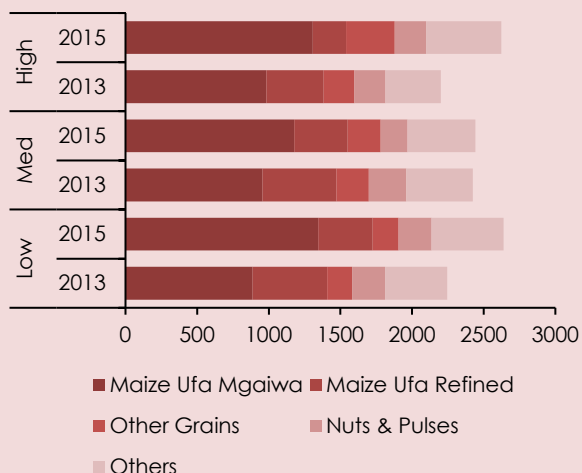
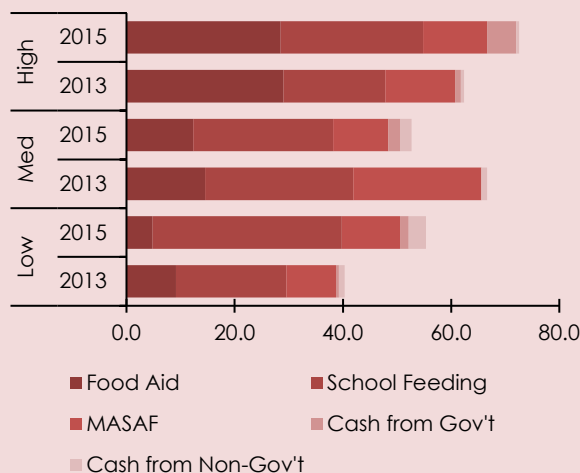


Figure 31: ...and in part through participation in social safety nets and transfers

Receipt of social safety net measures, by flood affectedness status 2015



Source: World Bank / NSO Flood Impact Assessment Survey

Source: World Bank / NSO Flood Impact Assessment Survey

There is scope for improving the targeting of social safety net measures. Food aid reached a constant 30 percent of highly affected households in the period from 2013 to 2015, while the proportion of households receiving direct government cash transfers increased from 1.1 percent to 5.4 percent over the same period. However, public works and schooling feeding programs were less well targeted in those areas where destruction by the floods was most severe.

While these findings are derived from an assessment of the impact of floods, they provide useful insights into the current drought and the manner in which its impacts might be managed. In particular, the findings highlight the importance of maintaining food price stability. Without a real food price decline, the increased level of caloric consumption would not have been possible. Importantly, while the impact of floods was relatively localized, the current drought affects a much larger proportion of the country, resulting in more significant upward pressure on prices. Furthermore, it seems unlikely that the increased demand for *ganyu* labor will be sustained during drought conditions, as agricultural production is interrupted on a larger scale, thus making this source of income less available. To address these issues, the targeting of social safety net programs should be improved and expanded to reach a greater proportion of the population.

Source: World Bank / NSO (2016)

Towards shared prosperity in rural Malawi

82. To summarize, in Malawi, despite some progress in terms of a range of indicators related to the non-income dimensions of poverty, the rate of rural poverty has remained stubbornly high for more than a decade, affecting more than half the rural population. The accumulated evidence suggests three proximate causes. First, the level of agricultural productivity remains low, considerably lower than that of other low income countries in the region, especially among the poor. Second, opportunities for non-farm self-employment in rural areas are limited and the returns on such activities are relatively low, especially for the poor. Third, the Government's major safety net programs have had only a limited impact in terms of poverty reduction, mainly due to limited coverage rates and poor targeting. To address these obstacles, a number of policy actions are recommended. To ensure that these actions lay the foundation for a more dynamic and prosperous rural economy, they should be implemented in a complementary manner, with each reform supporting the others. At their core, these proposed reforms are intended to facilitate the achievement of equitable, inclusive, sustainable growth by increasing economic

productivity in the agricultural sector, facilitating dynamic structural transformation, and establishing better targeted, more inclusive safety nets.

83. First, to lay the foundation for sustained economic growth, it is vital to establish macroeconomic stability. In particular, it is essential to bring the rate of inflation under control over the long-term. This would create relief for the poor at the household level, while also creating a more conducive environment for investment, growth, and employment generation. While it is essential to bringing deficits under control, the achievement of this goal by reducing public spending or increasing revenue could have adverse impacts on the poor. Therefore, policy actions to deficits should build in safeguards to protect pro-poor expenditure, with complementary measures to improve the effectiveness of this expenditure.

84. Second, to facilitate the achievement of higher rates of inclusive growth, it is vital to improve the level of productivity of the agricultural sector. To date, agricultural growth has been achieved through factor accumulation, primarily through the expansion of resources such as land cultivated and labor. However, with one of the highest population densities in Africa and with a decline in the availability of new land for farming, Malawi has limited space to achieve further gains from the continuation of such practices. In all likelihood, in the future, the growth of the agricultural sector will only be possible through increases to the level of agricultural productivity. Four actions are recommended to improve agricultural productivity.

- a. **More balanced expenditure on the agricultural sector:** The single most important measure to improve the composition of expenditure in this sector is to continue reforms to the FISP. Scaling back FISP would significantly improve the Government's fiscal position, freeing up resources for reallocation to complementary investments that could generate higher returns in terms of improving agricultural productivity. In the period from 2004 to 2009, research was conducted into the contribution of specific investments to the value of agricultural revenue, with this study involving a nationally representative sample of smallholder households interviewed three times in the study period, this analysis found that the use of improved maize seed generated the highest returns at the national and regional levels (Lunduka, Ricker-Gilbert and Fisher 2016). The national benefit-to-cost ratio on improved seeds is 2.48, meaning that for every kwacha spent on extension, MWK 1.48 is gained in additional benefits. This shows the potential value of investment in improved higher yielding maize varieties that are resistant to droughts and floods.
- b. **Clear objectives for the FISP:** To ensure that the program fulfils its objectives, it is first necessary to ensure that there is clarity regarding what these objectives actually are. The safety net function of the program, which is intended to facilitate the achievement of food security at the household level, should be separated from the function to increase the overall productivity of maize to achieve food security at the national level. For clarity, it is recommended that a reformed FISP focus on facilitating increased productivity and crop diversification, with other programs fulfilling safety net functions.
- c. **The provision of flexible, short-term support:** In the short term, the Government should provide all rural households with vouchers that can be redeemed at stores selling agricultural inputs operated by the private sector. Farmers should be able to utilize these vouchers for any combination of inputs that they desire.
- d. **The replacement of fertilizer subsidies with cash subsidies and the provision of supplementary services:** In the medium term, the Government should consider transitioning to cash transfers under FISP, combined with provision of supplementary services such as training and information related to new technologies or seeds. Such a bundle is likely to have a higher level of positive impact in terms of improving productivity and reducing poverty than those the current subsidy program. To illustrate this, in 2013, the gap in maize yields between the chronically poor and those who escaped poverty was 320 kg/ha. Approximately half of this can be explained by differences in the returns to family labor utilization and to the extension services obtained. Recent work with the National Smallholder Farmers Association of Malawi Farmers shows that providing transfers and intensive agricultural extension support could alleviate capital and information constraints affecting farmers and boost their productivity (Ambler and others 2016). The Government could consider implementing a cash transfer system on a pilot basis prior to its broader implementation as a learning experience.

85. Third, to achieve higher levels of agricultural productivity growth and rural poverty reduction, measures to implement significant structural change should be accelerated. A major constraint on the growth of non-farm self-employment in rural areas is the lack of demand for the products produced by rural enterprises. The very low level of urbanization (16 percent of the population) and the low average incomes in rural areas limit the opportunities to generate higher incomes from non-farm activities in these areas. A more productive and dynamic agricultural

sector is a vital precondition for increasing rural incomes, enabling workers to move from agriculture to higher productivity sectors and supporting the growth of the rural non-farm sector. However, it will not be possible to sustain this growth unless there are improvements of the level of productivity and dynamism the non-farm sectors, especially in urban areas. To achieve higher levels of prosperity in Malawi's areas, broad structural transformation is required, with this transformation including a more rapid rate of orderly urbanization.

86. International experience shows that a well-managed process of urbanization is often the catalyst for inclusive structural transformation. This process drives an increase in the level of demand for agricultural and other rural products. It improves the accumulation of skills, facilitates occupational specialization, and results in higher levels of labor productivity. It results in a higher level of integration of labor markets and fosters creativity and innovation. In short, urbanization builds human capital in the economy in a manner that cannot usually be achieved solely through formal education. Urban growth has been associated with increases in the level of prosperity for billions of people around the world. Similarly, urban growth could result in higher levels of prosperity for the people of Malawi in both rural and urban areas. A projection shows that an increase in Malawi's level of urbanization, with an increase in the proportion of its population living in urban areas from the current level of 16 percent to 21 percent by 2030 could result in increases of 0.7 percentage points to average annual GDP growth rates. According to this projection, this increased level of urbanization would result in Malawi being 14 percent richer in 2030, without any growth in the country's overall population or the size of its labor force, just through the relocation of 5 percent of rural population to urban areas (Dorosh, Pauw and Thurlow, 2016).

87. To be sure, urbanization and the associated restructuring of the economy involve complex forces and processes that require careful management. The process demands a new set of business and other skills, an environment that encourages and incentivizes the private sector to flourish, a trade policy that facilitates the adoption of technological innovations, a high level of connectivity to facilitate communication and trade, and a balance between large and secondary towns. First and foremost, it demands a high level of macroeconomic stability to anchor sustainable growth. These factors must be present to ensure that urbanization and structural change facilitate sustained, equitable economic growth. Policymakers should consider a number of actions to facilitate the process of urbanization and to ensure that it has a positive impact:

- a. **Removing policy biases against urbanization:** Malawi's development strategy currently prioritizes the achievement of household-level food self-sufficiency in rural areas. This bias explains the long tradition of providing input subsidies for maize and for the export bands on the same crop. By contrast, existing policy does not empower local governments in urban areas. To create smarter and more vibrant urban areas, local governments in urban areas need a higher level of capacity and greater financial resources. Improving the capacities of these governments will include a systematic, focused effort to improve their own-source revenues, especially from property taxes, with these taxes having significant unrealized potential to finance urban development.
- b. **The promotion of "smarter" urbanization:** Whether actions to promote urbanization involve measures to increase the size and density of existing cities or to create new cities, policymakers need to develop a conscious, planned approach to efficiently manage urban land. This includes the explicit mapping of urban land usages and measures to improve the quality and reliability of services. Well-managed urban land will encourage mobility and connectivity; the clustering of economic activities; the protection of the space for public goods (infrastructure, environmental amenities); and the efficient provision of services to the residents of large, intermediate, and small towns.
- c. **The promotion of urban job creation:** In addition to encouraging food self-sufficiency, government policy also prioritizes value addition and job creation in rural areas. One of the unintended consequences of measures to keep households on the land (the "agriculture first" policy) is to discourage migration and urbanization. For positive transformation to occur, it is important to facilitate changes in what people do and where they do it. Therefore, greater emphasis should be placed on the creation of jobs in urban areas by reassessing and reforming the regulatory barriers to the entry of firms, on upgrading skills and promoting entrepreneurship, on raising productivity of small and medium enterprises, on integrating value chains and on reducing the costs of logistics.

88. Fourth, the Government should implement measures to improve the efficiency and effectiveness of safety net programs. In the period from 2013 to 2015, both the MASAF-PWP and Social Cash Transfers Program (SCTP) covered approximately 650,000 households per year. Overall, both programs are characterized by high leakage rates, with a large number of non-poor people receiving cash transfers from the programs. To enhance the impact of these programs, the following policy reforms are proposed:

- a. **Provide transfers of greater value to a greater total number of beneficiaries:** While the coverage of the current social protection scheme has recently been expanded, this coverage is still limited relative to the coverage of programs elsewhere around the world, with a relatively low level of government expenditure. Both the MASAF-PWP and SCTP cover approximately 650,000 households per year in the period from 2013 to 2015. In addition, compared to public work programs in other developing countries, the total value of transfers under the MASAF-PWP is relatively small. Although the daily wage from the MASAF-PWP is comparable to wages provided by other programs, the maximum permitted number of working days per beneficiary per year is much lower, resulting in a comparatively low total transfer value to individual beneficiaries. Scaling back FISP will provide the Government with greater financial space to extend coverage the of its social protection programs. In the medium-to-long term, these programs could be consolidated, with a common registry of beneficiaries and with the programs under a single administration. Such a reform is likely to result in reduced costs and a higher level of effectivity.
- b. **Improve targeting for greater impact:** At present, household survey data suggests that the targeting of existing social protection programs has been ineffective, reducing their pro-poor impact. In the case of MASAF-PWP, one way to improve targeting would be to verify the existing community-based targeting system through proxy means testing. Alternatively, the program could explore the possibility of a self-targeting system, commencing with a pilot study to test this approach. Self-targeting would require lowering the wages provided through the program substantially so that only those with a low opportunity cost of time would be motivated to participate, particularly members of very poor households. However, to ensure that the total value of the transfers received by an individual beneficiary are sufficient to improve socio-economic circumstances at the household level, the number of days in which an individual may participate in the program should not be limited. Recent reforms to enable participation in public works during the lean season when individual beneficiaries may participate for a greater number of days (currently 48 days), and over multiple work cycles should be continued and evaluated.
- c. **Evaluate the value of assets produced under MASAF-PWP:** To date there has been no evaluation of the assets produced by these programs. Therefore, a proper and thorough evaluation of the assets should be undertaken. If the assets are found to have very low value, and the conditions to work are still built into the program design, then the program could alternatively focus on a narrow set of assets that create value to communities (for example, conservation of water-catchment areas). The alternative is to remove the condition to work and convert the MASAF-PWP to a cash program.
- d. **Redefine the target population for the SCTP:** This action should be intended to benefit households that no longer receive benefits under a reformed FISP through their absorption into SCTP. It would also mean expanding the eligibility criteria to include not just those categorized as extremely poor (defined as those unable to meet their basic food consumption needs), but also those categorized as poor (defined in terms of the national poverty line or a close proxy).

89. Fifth, the Government should implement measures to accelerate the demographic transition to boost poverty reduction. Malawi's fertility rate has remained persistently high, with the rate standing at 6.1 births per woman among rural poor women. Malawi's population is projected to double in approximately two decades (22.8 years), with a projected increase from 17.2 million in 2015 to 34.4 million in 2038. Given that Malawi is already one of the most densely populated nations in Africa, unchecked population growth will put enormous pressure on limited land resources and on the delivery of services, making poverty reduction harder to achieve. The high fertility rate also lowers productivity, impairing women's ability to engage in more productive farming or non-farm work, given that women spend a large proportion of their prime years pregnant, lactating, and otherwise engaged in raising children. Moreover, the overall youth of Malawi's population means that ratio between dependents and members of the workforce is extremely high, with this ratio generally associated with higher poverty levels.

90. If Malawi is to achieve significant reductions to its poverty rate and improvements to its level of human development, it needs to implement measures that facilitate a reduced fertility rate. Malawi will only reap the benefits of demographic transition if women are empowered through the implementation of three interrelated policies. First, ongoing measures to improve children's health and to reduce the child mortality rate will reduce demand for more children. At the same time, smaller family sizes will result in improvements to maternal health, which in turn will improve the overall health of children, thus facilitating the emergence of a virtuous circle (Canning, Raja and Yazbeck, 2015). Second, investments in girls' education will reduce the tendency towards early child marriage and early child bearing, prolonging girls' stay in school and delaying the average child bearing age. Continued progress towards the elimination of the gender disparity gap in secondary education could also play a role in reducing the fertility rate, with higher levels of secondary education associated with a reduction in the

proportion of young women deciding to bear children. Third, improving access to family planning services and contraception would reduce the number of pregnancies and encourage women to wait for longer between bearing successive children, with greater spacing associated with better maternal health outcomes. With high fertility rates closely linked to poverty, reducing these rates in Malawi could change improve the ratio between dependents and working adults. In addition, providing a higher quality of education and health services to women and promoting the participation of women in the labor market, particularly in the formal sector and in better paying jobs, with further empower women and complete the establishment of another virtuous circle.

Box 6: Malawi's past experience with call options offers lessons for building climate resilience

Call options can be a useful way to ensure the supply of food imports. During a food crisis in 2005, the Government purchased call options for maize as a result of concerns not only regarding potential price increases, but also regarding logistics and delivery constraints. The call option contract was customized as an over-the-counter physical option which provided more flexibility than a standard financial instrument. Price protection was provided on a "delivered" basis, thus combining the price for white maize on the South Africa Futures Exchange with transport costs to Malawi. The contract also specified terms including flexible delivery locations for physical settlement so that it could be used as a contingency import strategy if needed. Uncertainty regarding the extent of the food shortage, levels of commercial imports, transportation constraints, the performance of local traders, the humanitarian response, and the efficiency of procurement processes made the contingent import aspect of the contract attractive to the Government.

The arrangement also helped to cap the cost of the humanitarian response. In late 2005, as prices increased and food shortages grew, the Government exercised the call option, electing for physical settlement and allocating the majority of imported maize for humanitarian operations. The maize purchased through the option contract was characterized by a better delivery performance than most other procurement procedures. During the delivery period, Malawi recorded considerable costs savings, with spot prices rising by around US\$ 50-90/MT in excess of the ceiling price of the contract.

The contract represented one of the first-ever instances of macro-level hedging by an African government. It covered imports of 60,000 MT of white maize and had a total value of approximately US\$ 17 million, with a premium payment of US\$ 1.53 million. The World Bank provided technical assistance, while the UK Government provided budget support for the purchase of the contract.

Within the region, traders and banks have been supportive of this approach, believing it has a number of indirect advantages in addition to the hedging benefits. Contingent import strategies based on call options help planning because they can be put in place well ahead of eventual crises, then triggered or "called" on an as-needed basis. The approach showed the benefits of using customized risk management solutions to reduce the risk of increasing commodity prices and supply uncertainty. It also demonstrated that market-based strategies can be less costly and more efficient than non-market based attempts to stabilize prices. For the Government of Malawi, which spent an estimated US\$ 110 million on the 2005/06 humanitarian response, the call option was a success, with important lessons learned for the country in its ongoing endeavors to build resilience in the face of likely future climate shocks.

Data

Table 2: Selected macroeconomic indicators

	2012	2013	2014	2015	2016 Est.
National Accounts and Prices					
GDP at constant market prices (percentage change)	1.9	5.2	5.7	2.8	2.5
Agriculture	-0.1	6.6	5.9	-2.0	-2.3
Industry	-0.5	3.5	4.7	3.5	2.4
Services	4.7	6.3	5.8	4.7	4.4
Consumer prices (annual average)	21.3	27.3	23.8	21.9	22.5
GDP per capita (current US\$)	384.0	340.9	362.3	381.3	-
Central Government (percent of GDP on a fiscal year basis)					
Revenue and grants	27.5	23.2	21.4	20.2	23.2
Domestic revenue (tax and nontax)	17.3	19.7	18.6	17.9	18.6
Grants	10.2	3.5	2.8	2.3	4.6
Expenditure and net lending	28.0	28.9	27.1	24.4	27.2
Overall balance (excluding grants)	-10.7	-9.2	-8.5	-6.6	-8.7
Overall balance (including grants)	-0.5	-5.7	-5.7	-4.3	-4.1
Foreign financing	1.9	2.0	2.5	1.6	2.6
Domestic financing	0.1	4.2	3.3	2.0	1.4
Money and Credit					
Money and quasi money (percentage change)	22.9	35.1	20.7	23.7	16.7
Credit to the private sector (percent change)	25.4	14.4	20.0	29.9	20.3
External Sector (US\$ millions, unless otherwise indicated)					
Exports (goods and services)	1,421	1,657	1,737	1,616	1,670
Imports (goods and services)	2,281	2,315	2,399	2,284	2,604
Gross official reserves	236	397	588	670	660
(months of imports)	1.2	2.0	3.1	3.4	3.2
Current account (percent of GDP)	-9.3	-8.7	-8.5	-8.2	-13.9
Debt Stock and Service					
External debt (public sector, percentage of GDP)	26.5	30.8	33.1	37.0	33.2
Domestic public debt (percentage of GDP)	13.8	19.8	14.9	16.8	18.9
Total public debt (percentage of GDP)	40.2	50.6	48.0	53.8	52.1
Poverty					
Poverty rate (US\$1.9/day in PPP terms)	-	70.1	69.3	69.4	69.6
Poverty rate (US\$3.1/day in PPP terms)	-	87.2	86.7	86.8	86.8

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

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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



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