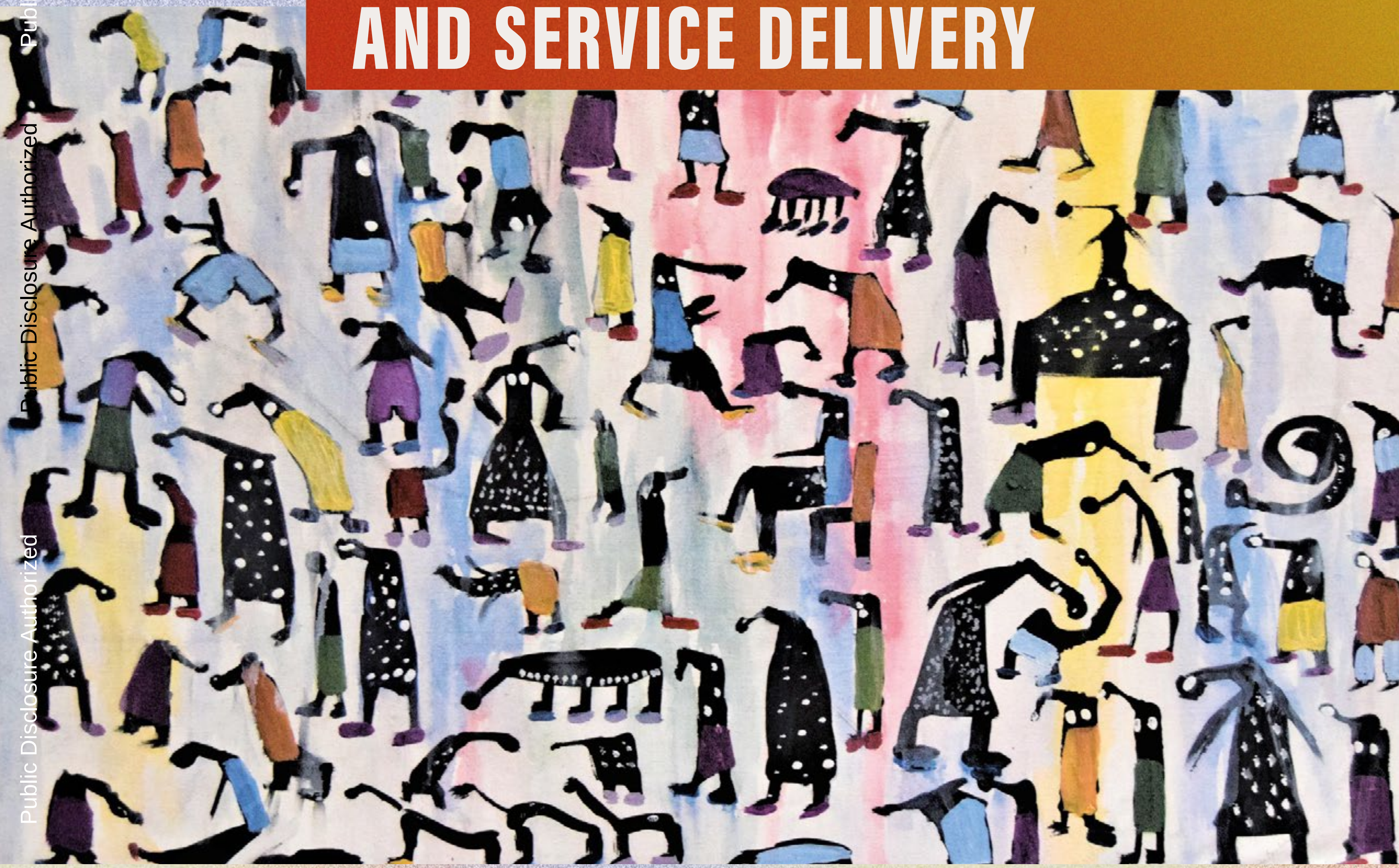
Malawi Economic Monitor

JUNE 2022

STRENGTHENING FISCAL RESILIENCE AND SERVICE DELIVERY



THE WORLD BANK
IBRD • IDA | WORLD BANK GROUP

Malawi
Economic
Monitor

JUNE 2022

STRENGTHENING FISCAL RESILIENCE AND SERVICE DELIVERY

THE WORLD BANK
IBRD • IDA | WORLD BANK GROUP

1818 H Street NW
Washington DC 20433
Telephone: 202-473-1000
Internet: www.worldbank.org

Civer Art Work Credit:
Elson Kambalu

Cover design, interior design & typesetting::
Piotr Ruczynski, London, United Kingdom

CONTENTS

BOXES

FIGURES

TABLES

ACKNOWLEDGEMENTS

The Malawi Economic Monitor (MEM) provides an analysis of economic and structural development issues in Malawi. This 15th edition was published in June 2022 and is part of an ongoing series, with future editions to follow twice each year. The publication intends to foster better-informed policy analysis and debate regarding the key challenges that Malawi faces in its endeavor to achieve inclusive and sustainable economic growth.

This edition of the Malawi Economic Monitor was prepared by Jakob Engel (Senior Country Economist, Task Team Leader), Yumeka Hirano (Economist, co-Task Team Leader), Yalenga Nyirenda (Consultant), Hayaan Nur (Consultant), Efrem Chilima (Senior Private Sector Specialist), Michael Roscitt (Public Sector Specialist), Deborah Isser (Lead Governance Specialist), Musharraf Cyan (Consultant), and Douglas Porter (Consultant). Chapter 2 benefited from collaboration and analysis led by United Nations International Children's Emergency Fund (UNICEF) Malawi, and the Overseas Development Institute (ODI). Contributions were also made by Lina Marcela Cardona (Economist), Francis Samson Nkoka (Senior Disaster Risk Management Specialist), Nicholas James Callender (Disaster Risk Management Specialist), William Mwanza (ET Consultant), and Innocent Njati Banda (ET Consultant).

Vivek Suri (Practice Manager, Macroeconomics, Trade and Investment), Hugh Riddell (Country Manager, Malawi), and Mara Warwick (Country Director, Malawi) provided overall guidance. The team wishes to thank William Battaile (Lead Country Economist) and peer reviewers Miguel Angel Saldarriaga Noel (Economist) and Farah Zahir (Senior Economist) for their constructive inputs.

This report benefited from fruitful discussions, comments and information provided by representatives of the Ministry of Finance and Economic Affairs (MOFEA); the Reserve Bank of Malawi; the National Statistical Office (NSO); and a number of other government ministries, departments and agencies. The team would also like to thank representatives of the private sector in Lilongwe and Blantyre for their helpful contributions.

Henry Chimbali (External Affairs Officer) and Elizabeth Mangani (Team Assistant) provided assistance with external communications, design and additional production support. Peter Kjaer Milne (Consultant) provided editorial support.

The findings, interpretations, and conclusions expressed in this publication do not necessarily reflect the views of the World Bank's Executive Directors or the countries they represent. The report is based on information current as of May 15, 2022.

The World Bank team welcomes feedback on the structure and content of the Malawi Economic Monitor. Please send comments to Jakob Engel (jengel@worldbank.org), Yumeka Hirano (yhirano@worldbank.org) or Yalenga Nyirenda (ynyirenda@worldbank.org).

ABBREVIATIONS

AIP	Affordable Inputs Programme
COGA	Control of Goods Act
CDF	Constituency Development Fund
DDF	District Development Fund
DoDMA	Department of Disaster Management Affairs
DSA	Debt Sustainability Analysis
EMDEs	Emerging Markets and Developing Economies
FEWSNET	Famine Early Warning Systems Network
GDP	Gross Domestic Product
GoM	Government of Malawi
GRF	General Resource Fund
IGFTS	Intergovernmental Fiscal Transfer System
IMF	International Monetary Fund
LAPA	Local Authority Performance Assessment
LAs	Local Authorities
MEM	Malawi Economic Monitor
MDAs	Ministries, Departments, and Authorities
MoFEA	Ministry of Finance and Economic Affairs
MPC	Monetary Policy Committee
MPs	Members of Parliament
NNR	National Net Revenue
NPLs	Non-Performing Loans
NLGFC	National Local Government Finance Committee
NSO	National Statistical Office
ODI	Overseas Development Institute
ORT	Other Recurrent Transactions
OSR	Own-Source Revenues
PAYE	Pay-As-You-Earn
PBG	Performance Based Grant
RBM	Reserve Bank of Malawi
ROA	Return on Assets
ROE	Return on Equity
SDR	Special Drawing Right
SSA	Sub-Saharan Africa
TT	Telegraphic Transfers
UNICEF	United Nations International Children's Emergency Fund
VAT	Value Added Tax
WEO	World Economic Outlook

OVERVIEW

Cyclones, chronic macroeconomic imbalances, and rising commodity prices are impeding Malawi's recovery from the pandemic

Malawi's economic growth remained below population growth in 2021 and is expected to decline further in 2022 due to chronic fiscal and external imbalances, compounded by severe weather events. Malawi's economic recovery from the impacts of the COVID-19 pandemic in 2021 was tepid, with growth increasing to 2.8 percent on the back of a bumper harvest and strong growth in the agriculture sector, and a moderate rebound in industry and services. Tropical storm Ana, which struck the southern parts of Malawi in January 2022, significantly impacted the country's economy and displaced thousands of families. Following damage to the Kapichira hydroelectric power station, it will likely take at least six months to restore full power generation capacity.

Most recently, the war in Ukraine has added a new crisis to what was already a challenging global economic climate. Rising global fertilizer and fuel prices, which have been exacerbated by the war, are exerting additional pressure on external balances. These have resulted in a deterioration in Malawi's terms of trade and are exerting upward pressure on inflation.

Headline inflation rose to 15.7 percent in April 2022, the highest since March 2017. Domestic food prices have been increasing, while surging global oil prices on top of supply constraints induced by the COVID-19 pandemic have contributed to a jump in domestic energy prices. Higher fuel prices have been passed on to consumers after the price was adjusted by 22 percent in April 2022, with further adjustments pending. In light of rising inflation, the Reserve Bank of Malawi (RBM) increased its key policy rate for the first time since November 2020 from 12 to 14 percent. The necessary downward adjustment of the official Malawi kwacha-US dollar exchange rate will add short-term pressure on prices for imports, while medium-term developments depend on a stabilization of global commodity markets, as well as government and RBM policies.

Continued price increases of 15 percent would result in the poverty rate rising by close to 3 percentage points. Rising prices reduce the purchasing power of households and lower the consumption of important items, especially food. This further contributes to the rising incidence of food insecurity, which is expected to increase further in the coming lean season. Poor households will suffer more from food inflation, given the large share of food in their consumption basket. If inflation were to increase to 20 percent, the impact on the poverty rate would be even higher, increasing by around 4 percentage points.

The fiscal deficit increased by 1.6 percentage points of GDP to 8.7 percent of GDP over FY2021/22, the highest in over a decade. Weak performance in tax collection contributed to revenues missing the revised target for the fiscal year. Spending overruns in compensation for government employees, social benefits and interest payments, as well as higher-than-targeted spending on fertilizer payments under the Affordable Input Programme (AIP), exerted additional pressure on expenditures, which totaled 19.4 percent of GDP.

The adjustment of the kwacha can help address external imbalances, while fiscal imbalances and unsustainable debt continue to pose risks

The Government is taking steps toward fiscal consolidation in FY2022/23, but the budgeted deficit still remains high, at 7.7 percent of GDP. The fiscal deficit for FY2022/23 is projected to decline slightly through significant improvements on the revenue side, especially due to increased taxes and a modest increase in grants, as well as planned spending reductions in social benefits driven by AIP reform. Deficit reduction in the coming fiscal year relies on optimistic assumptions that would be difficult to meet under the current trajectory. Deficits will largely be financed by domestic debt.

Following external and fiscal deficits over many years, financed by increased commercial borrowing, Malawi's debt has become unsustainable. The November 2021 International Monetary Fund (IMF)-World Bank Debt Sustainability Analysis (DSA) indicates that Malawi's external debt and public debt are both at high risk of debt distress—a heightened assessment from September 2020, when the external risk was rated as moderate. The primary deficit and non-interest current account deficit continue to be the main drivers of public and external debt, respectively. Interest expense is expected to increase significantly in FY2022/23 to more than 4.6 percent of GDP—more than the Government spends on any individual sector. Domestic interest rates remain high and are still increasing, which could push payments beyond their projected levels.

The RBM adjusted the Malawi kwacha downward by 25 percent, after the spread between the official and the market exchange rates had progressively widened in recent months. In its May 26, 2022, statement, the RBM also announced its intention to buy Malawi kwacha from the market and that this would be supported by appropriate monetary and fiscal policies. This comes after a period during which there had been little change in the official rate, while the spread with the cash exchange rate had increased. The announced change in exchange rate regime, if adequately supported, will help to address external balances by limiting imports in the short term and boosting the export competitiveness of Malawian firms.

Malawi's foreign reserves remain very low, with little room to absorb shocks. Gross reserves decreased to 1.5 months of import coverage in March 2022 and net reserves have been negative for most of the past year. While measures to rebalance the foreign exchange market, such as the mandatory conversion of export proceeds, have not been sufficient to match supply and demand, the recent exchange rate adjustment will assist in boosting Malawi's reserve position. The change in policy will also alleviate foreign exchange shortages, which reportedly led to import payment arrears and impediments to doing business.

The financial sector has been stable, helped by revenues from lending to the Government. Nonperforming loans (NPLs) stood at 4.5 percent in December 2021. A recent RBM stress test shows the banking sector remains mostly resilient to shocks. This is supported by large shares of commercial bank lending going to the Government.

Stepping up bold reforms: Enhancing macroeconomic stability, supporting growth, and protecting the poor against shocks

Amid uncertain global growth prospects, risks to the Malawian economy are decisively tilted to the downside. These risks include weather-related shocks in an economy that has made little progress in limiting its risk exposure. Low crop production and price pressures have resulted in a concerning food security situation, especially for the upcoming lean season. The situation for chronically food-insecure households may worsen. Malawi also remains susceptible to a renewed spread of the COVID-19 pandemic, especially in light of very low vaccination rates.

Spending pressures in response to weather-related shocks and impacts of the Russia–Ukraine conflict mean that resolve and clear prioritization are needed to meet fiscal consolidation targets. The impact of climate-related shocks, as well as higher energy prices and increasing production costs, could further constrain economic activity. This could negatively impact tax revenue performance. The higher cost of fertilizer imports under the AIP also poses a fiscal risk and will require reforms to the program. In turn, Malawi is likely to need additional concessional financing to maintain its current level of imports. Gross foreign reserves are projected to remain very low, increasing the risk to growth, and are inadequate to withstand severe external shocks.

The 15th edition of the Malawi Economic Monitor proposes bold policy actions to address the growing number of challenges and improve the current economic situation. These include addressing macroeconomic imbalances in the near term and enhancing medium-term growth through increased exports and private sector competitiveness, while at the same time protecting the poor and most vulnerable:

i) *Restoring macroeconomic stability.* A coordinated package of reforms is urgently needed, encompassing fiscal consolidation, flexible exchange rate management, restoring debt sustainability, and improved governance.

ii) *Enhancing export competitiveness and market-oriented growth.* Economic diversification and export growth will be essential to increase overall growth. This requires implementing the National Export Strategy, strengthening the institutional framework for private sector development, and focusing on agricultural commercialization and productivity growth.

iii) *Protecting the poor and strengthening resilience.* Vulnerability to external shocks and austerity measures could negatively impact poor and vulnerable households in the short term. Social protection programs must be reinforced to prevent deterioration in consumption and welfare.

Finance must follow function to deliver on Malawi's service delivery ambitions through decentralization

The urgent need to increase fiscal efficiency and protect the vulnerable makes it crucial to assess how high-quality service delivery at the local level can be ensured. Part 2 of this MEM discusses the importance of deepening fiscal decentralization, strengthening the intergovernmental fiscal transfer system, and delivering quality services that reach poor and vulnerable households.

Malawi's decentralization journey to date has been characterized by a blurring of intergovernmental accountability lines and a system of fiscal decentralization where "finance has not followed function." Malawi's national development strategies have consistently identified decentralization as a key vehicle to strengthen local service delivery. Despite these ambitions, the reality of the past three decades has been one of decentralization reforms that have been rolled out in a fractured, uneven and incomplete fashion—and influenced by a political economy where political leaders have a significant incentive to retain control of resources, while simultaneously continuing to make public commitments to the tenets of decentralization. This is further complicated by development partners in Malawi that, in the post-Cashgate environment,[1] have continued to concentrate funding through vertical, off-budget projects that are fragmented at the local level. In sum, this has had the effect of uncoordinated planning and decision-making over service delivery across levels of government, with sector and district processes often occurring in parallel and overlapping ways.

1. The "Cashgate" scandal refers to the discovery in September 2013 of the theft of over US$50 million in public funds through illegal access to the national Integrated Financial Management Information System.

To achieve a meaningful deepening of decentralization, the vicious cycle of low trust → low investment → low accountability in local governments must be broken. Malawi's decentralization journey is currently stuck in a messy middle. Allegations of low local government capacity have historically served as a justification for retaining funds at the center and/or for significantly earmarking funds through deconcentrated, conditional transfers. This means that in many instances local governments are demoted to acting as implementing organs of the central government, rather than governing agents in their own right. At the same time, what at face value is often deemed poor governance or lack of capacity is sometimes the manifestation of coping mechanisms by local government officers who are often required to bend the rules to carry out service delivery responsibilities in the face of underfunded service delivery mandates and an unreliable fiscal transfer system. This makes it difficult to distinguish "coping" from "corruption" and reinforces decisions to maintain the status quo.

The recent introduction of results-based development financing to local governments now presents new pathways to influence the incentives of this cycle. Development transfers are becoming a dynamic arena for political contest at both the national and local levels, headlined by the introduction of the Performance Based Grant (PBG) and the subsequent increase of the Constituency Development Fund (CDF) to MK 100 million per constituency in the FY2022/23 budget. The results-based conditions of the PBG are enhancing the predictable discretionary development financing made available to local governments, but tying the access to transparency, accountability, and the achievement of results with the funds delivered. The incentive effect of the PBG has already begun to display its potential to unlock performance and impact accountability relationships between and within levels of government, and has the potential to influence the delivery of other development funds at the local government level.

The Government of Malawi has the opportunity to establish an architecture that increases confidence to consolidate development expenditure through local government systems. The early results of the PBG are providing the examples of an architecture that can be leveraged to increase public trust in local governments as a vehicle for decentralization, while also embracing the incentives that have historically driven this inherently political reform agenda. If Local Authorities (LAs) continue to improve their performance, it has the potential to build confidence in their ability to manage increasing resources in line with their devolved functions, laying a foundation for a coherent framework for meaningful fiscal decentralization. Given the volume of service delivery funding that is currently delivered off-budget, this also paves the way for streamlining development-partner funding through national and local systems to avoid some of the complexities and distortions that arise from parallel funding streams.

To achieve the potential of improved local governance and deepened fiscal decentralization, the 15th edition of the Malawi Economic Monitor proposes seven policy actions:

i) **Bolster coordinated, high-level leadership of fiscal decentralization agenda.** Leadership from the highest levels of government is necessary for a meaningful fiscal decentralization reform agenda. It should leverage the coordination of the 'decentralization troika' of the Ministry of Finance and Economic Affairs (MOFEA), the Ministry of Local Government, and the National Local Government Finance Committee (NLGFC) to implement results with sector ministries.

ii) **Increase the evidence base around vertical imbalance.** Vertical sharing of resources should be informed by the minimum expenditure levels required for agreed levels of service delivery. The fundamental need to correct the vertical imbalance should be reiterated in national policy.

iii) **Leverage ongoing legislative and policy reviews.** The ongoing review of the Local Government Act and the National Decentralization Policy should be leveraged to introduce a realistic and evidence-based set of guiding principles to guide fiscal decentralization.

iv) **Simplify the inter-governmental fiscal transfer system and increase transparency.** Both the formula and the allocations should be disseminated widely as a prerequisite for greater understanding and agreements on the objectives and operation of the policies and programs for service delivery.

v) **Coordinate development funds, tied to performance.** A sequenced coordination and consolidation of development funds should be embarked upon, including the introduction of associated performance elements. This can begin with the PBG and District Development Fund (DDF) and could be considered for other Government of Malawi and development partner-financed modalities, including the introduction of sector conditional grants.

vi) **Revitalize the general-purpose grant.** The current use of the general resource fund (GRF) and other sector recurrent transactions should be critically reviewed, and the revitalization of a general-purpose grant seriously considered. This should be closely tied to a deepened analysis of tax capacity and tax effort across LAs.

vii) **Strengthen the equalization of transfers.** Equalization should be strengthened through revision of formulas and inclusion of rational expenditure needs and fiscal capacity measures in the formulas.

1

ECONOMIC DEVELOPMENTS

1.1

GLOBAL AND REGIONAL CONTEXT

The war in Ukraine is contributing to a slowdown of the global economy

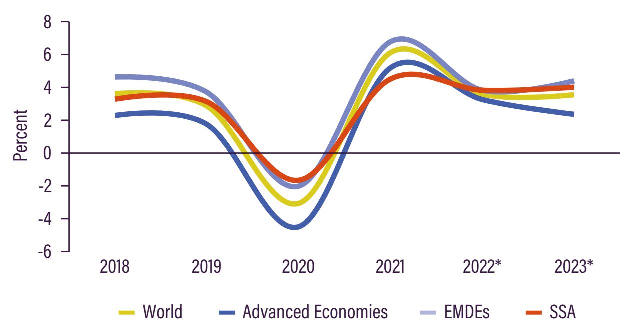
The year 2021 saw a major rebound in global economic growth, but the recovery is already running out of steam. Growth in global real gross domestic product (GDP) stood at 6.1 percent in 2021 (Figure 1.1) and 5.7 percent in emerging markets and developing economies (EMDEs). The Sub-Saharan African (SSA) region recorded 4.5 percent growth in 2021, after a shallower dip in economic performance in 2020. Global real GDP has overtaken its 2019 level, but several factors have slowed the momentum of the global economy: pent-up demand is waning, and countries are unwinding many of the stimulus and supportive policies that they had introduced at the beginning of the COVID-19 pandemic. Other factors constraining the global recovery include declining productivity growth in China, which is seeing both continued COVID-19-induced lockdowns in numerous industrial centers and volatility in the real estate sector following the collapse of the Evergrande property developer. Furthermore, the recovery of consumption in some rich countries is lagging expectations, while fiscal and monetary space to support growth in many EMDEs is reaching its limits.

The war in Ukraine has added a new and unpredictable crisis to what was already a challenging global climate. This is impacting the global economy both directly and indirectly. In addition to the direct human toll in terms of lives lost, individuals displaced and property destroyed, the conflict is impacting global commodity markets, and trade and financial flows, as well as overall market confidence (see Box 1.1). These shocks are having a profound impact in the rest of the developing world.

Defying earlier expectations, inflation continues to accelerate globally, compounding pressures on supply chains. While the 2021 rate of 4.7 percent was already historically high, inflation is still accelerating in 2022 (Figure 1.2). The United States reported 8.3 percent and the Euro area 8.1 percent inflation in May 2022. Prices for energy and other commodities have been increasing, not only affecting consumer prices directly, but also compounding pressures on already stretched supply chains. Widespread lockdowns caused many consumers to increase

FIGURE 1.1 The global economic rebound is running out of steam

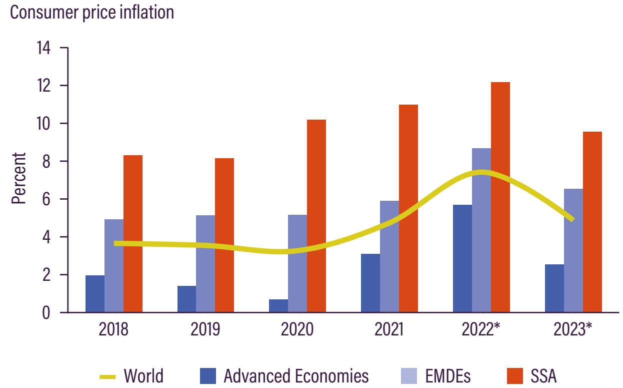
Real GDP growth



Note: *Projections.
Source: IMF World Economic Outlook (WEO) 04/2022.

FIGURE 1.2 Global inflation is expected to exceed last year's levels

Consumer price inflation



Note: *Projections.
Source: IMF WEO 04/2022.

BOX 1.1 Economic ripple effects of the war in Ukraine

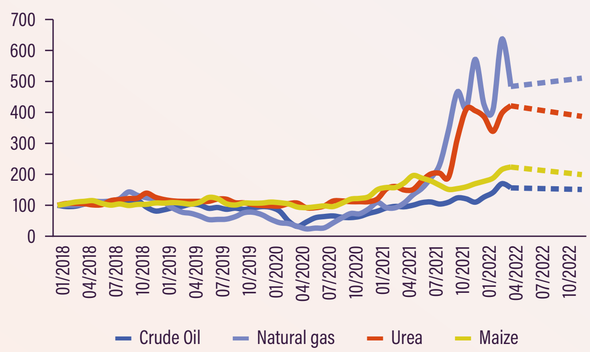
The Russian Federation's invasion of Ukraine is expected to cause significant impacts on the global economy through various transmission channels:

- **Rising commodity prices.** The Russian Federation and Ukraine are among the largest producers of oil, gas, wheat and other commodities. International prices for crude oil and maize (US$110 per bbl and US$345 per mt, respectively, as of May 2022) are now 1.6 and 2.2 times as high as pre-pandemic levels, respectively (Figure B1.1.1). Urea and natural gas on European exchanges (a key ingredient in fertilizer production and other chemical processes) traded at more than four times their 2018 price levels. Impacts have been significant for net energy importers and those that are already experiencing balance-of-payments pressures.
- **Broad-based inflation.** High global commodity prices will further fuel inflation pressures due both to higher production costs, as well as increased transportation costs.
- **Financial conditions.** Sovereign borrowing costs have increased, with rises in 10-year US Government bond yields further tightening global financial conditions. EMDEs with pre-existing financial vulnerabilities, including elevated debt and large foreign currency-denominated debts, and commodity-importing EMDEs with weaker credit ratings are likely to suffer adverse consequences due to higher borrowing costs.
- **Global food shortages.** The upward pressure on global staple food prices (especially wheat and maize) will lead to food shortages, especially in net-importing countries with fewer financial means.
- **Reorganization of global value chains.** While there is only limited evidence of this to date, in the medium term EMDEs may be negatively impacted by advanced economies reshoring production and scaling back economic ties. This could undermine the historical gains from globalization and derail multilateral efforts toward cooperation on issues ranging from trade integration to debt.

The impact of the conflict in Ukraine varies across countries in Africa, depending on the sources of growth and the nature of each country's economic linkages with the Russian Federation and Ukraine. The countries in the Horn of Africa (Somalia, Ethiopia, Sudan), which are highly dependent on imports of wheat and cereals, were already suffering from severe food shortages, and growing current account and budget deficits (World Bank, 2022b). Most other countries in the region will be negatively impacted, significantly in some cases, with estimated negative terms-of-trade shocks as high as 4 percent of GDP, for example, in Burundi, Eswatini, Mauritius and Zimbabwe. In the case of Malawi, World Bank estimates show that the impact of higher global fertilizer prices could be as high as 2 percent of GDP. The exceptions are Nigeria, Angola and South Sudan, which are benefiting from rising oil prices. Exporters of metals and minerals, such as Zambia and South Africa, are also expected to be cushioned from large terms-of-trade shocks.

FIGURE B1.1.1 Already skyrocketing commodity prices are being further fueled by the Russian Federation's invasion of Ukraine

Select commodity prices, indexed, 01/2018=100



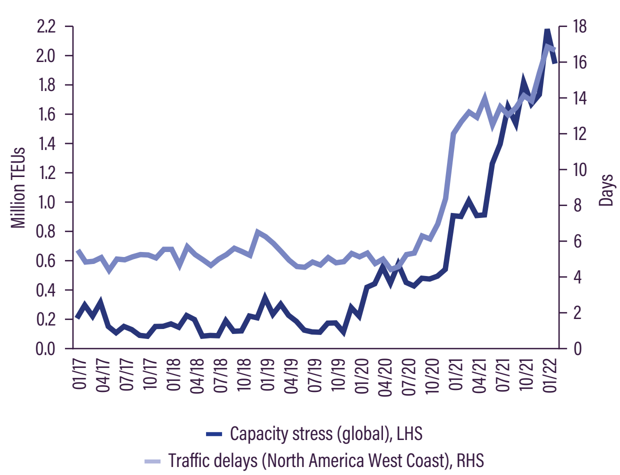
Source: World Bank Pink Sheet and World Bank Commodities Market Outlook, 04/2022.

their consumption of goods, while services declined substantially. The rise in demand, coupled with continued pandemic-related disruptions, has created an unprecedented level of strain on the global transport and logistics industry, causing severe delays in global trade and shipping (Figure 1.3). Despite some reversals in the trend toward goods consumption, depleted inventories and labor shortages mean that supply chain pressures continue to approach record heights. These are being compounded by the conflict in Ukraine, which is disrupting air and rail traffic between Asia and Europe, as well as the COVID-19-induced lockdowns in China (Windward, 2022).

While the toll from the COVID-19 pandemic remains significant, the public health and economic impacts of the pandemic have progressively decreased with rising vaccination rates. On January 19, 2022, during the peak of the Omicron variant wave, a daily global record of 4.21 million new COVID-19 infections was recorded. However, with more than 60 percent of the

FIGURE 1.3 Supply chains disruptions continue

Supply chain capacity stress (million TEUs) and traffic delays (hours), through March 2022



Source: World Bank Trade Watch 04/2022.

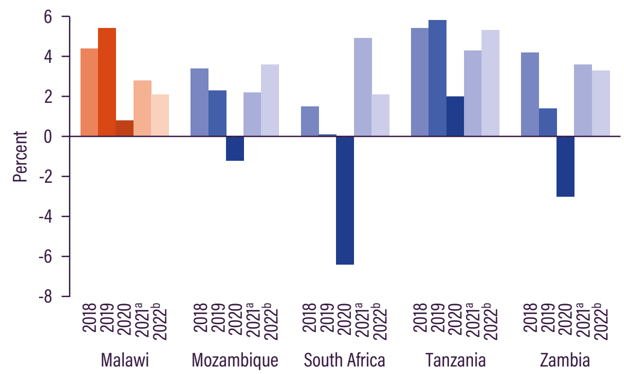
world's population now protected by vaccines and many people having been previously infected, the infection-severity from the Omicron variant has generally been lower than the Delta variant. Governments around the world also re-imposed fewer restrictions, dampening the adverse economic impact. African governments, too, reacted with fewer restrictions, despite the vaccination rate of only 20 percent on the continent trailing global averages. China is the big exception in this regard: it continues to pursue a zero COVID-19 eradication policy domestically. Nearly 400 million people in the country were affected by some form of lockdown between the start of the year and mid-April 2022, including the entire populations of the commercial hubs of Shanghai and Shenzhen.

Growth among Malawi's neighbors and the wider region has recovered from the COVID-19 shock, though progress remains uneven across countries. Mozambique, South Africa, Tanzania and Zambia all registered positive growth in 2021 (Figure 1.4). South Africa continues to struggle with longer-term macroeconomic and social challenges, and its recovery from the severe economic contraction in 2020 remains slow. However, prices for gold and platinum—two of South Africa's key exports—are at record highs, compensating for some of the higher cost of oil imports. Zambia remains in negotiations to unwind its debt following its sovereign default and is undertaking deep fiscal reforms. Tanzania continues to be one of the fastest growing economies in the region, though tourism still lags its 2019 levels. Mozambique has been a beneficiary of the recent commodity boom. However, the northern part of the country, where Mozambique's gas reserves are located, continues to be the site of conflict, and there is evidence of the Islamist insurgency spreading, including to Nyasa province, which neighbors Malawi. Mozambique, similar to Malawi, was also impacted by a severe cyclone season.

Malawi's neighbors successfully countered inflationary pressures throughout 2021 (Figure 1.5). Inflation started rising in many countries in the region in the second half of 2020. However, most countries besides Malawi have managed to stabilize inflation, though all countries have seen prices increase in recent months. Zambia and Mozambique's central banks were among the first in the world to raise their policy rates after the COVID-19 shock of 2020.

FIGURE 1.4 Economic growth remains uneven across the region

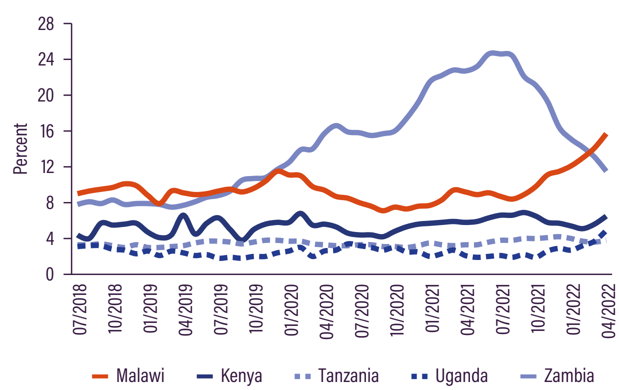
Real GDP growth



Note: a. Estimates, b. Forecasts.
Source: World Bank Macro Poverty Outlook.

FIGURE 1.5 Inflation is largely contained in neighboring countries

Headline inflation, y-o-y



Source: World Bank staff calculations based on data from Food and Agriculture Organization Food Price Monitoring and Analysis tool.

1.2

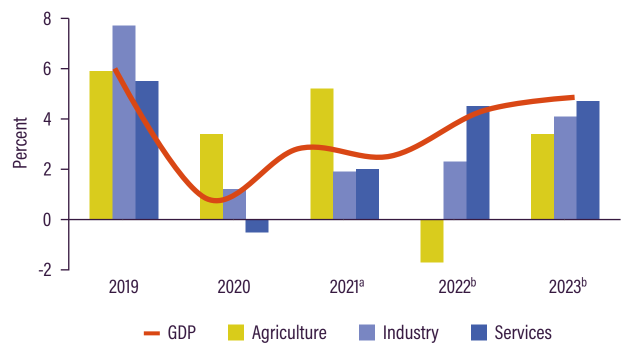
RECENT ECONOMIC DEVELOPMENTS

Multiple shocks are impeding Malawi's recovery from the pandemic

Malawi's economic growth increased to 2.8 percent in 2021, but remained below pre-pandemic levels. Backed by a strong harvest, the agriculture sector was the fastest growing sector in 2021, at 5.2 percent (Figure 1.6). Yields increased the most for soya beans and other pulses, as well as staples such as maize, sorghum and rice. Strong agricultural growth was driven by auspicious weather patterns during the growing season and supported by increased use of inputs such as fertilizers and improved seeds. The industry and services sectors lagged behind, growing at 1.9 and 2.0 percent, respectively.

FIGURE 1.6 Overall economic growth remains weak

Real GDP growth by sector

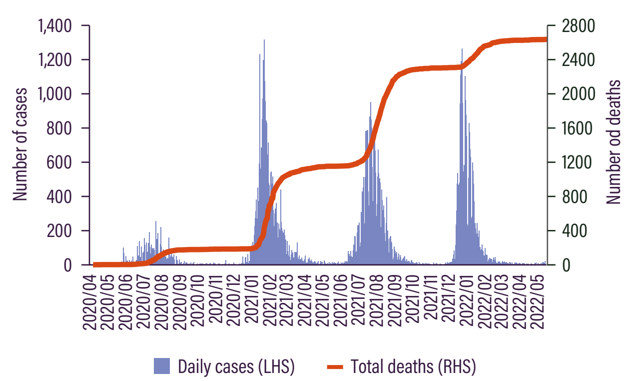


Note: a. Estimates, b. Forecasts.
Source: World Bank staff calculations.

Relatively bright spots in the economy in 2021 included the construction industry, while trading activities and tourism have been slow to recover. COVID-19-related restrictions on movement hampered construction activities during 2020 and the loosening of these restrictions, allowing for the resumption of construction work on schools and roads, gave a moderate boost to the sector. This had positive knock-on effects on activities such as quarrying and real estate. Meanwhile, supply chain disruptions proved to have longer-lasting effects on trading activities and tourism.[2] Many countries had also temporarily reinstated travel restrictions on Malawi in November 2021 with the emergence of the Omicron variant of the COVID-19 virus in Southern Africa.

FIGURE 1.7 Malawi has experienced four distinct COVID-19 waves

Daily confirmed number of cases of COVID-19 in Malawi



Source: World Bank based on Our World in Data.

Malawi has weathered a fourth wave of the COVID-19 pandemic emanating from the Omicron variant, though the incidence of deaths was considerably lower than in previous waves (Figure 1.7). With the Government resorting to fewer restrictions than during previous waves, economic impacts were less severe. However, Malawi's vaccination figures remain low, with just 8.1 percent having received their first vaccine dose (as of May 16, 2022). The country lags behind the regional average (22.4 percent) due to distribution challenges, limited supply, a shortage of qualified staff and few hospitals, and widespread public hesitancy. The February 2022 diagnosis of

2. Tourism has been one of the most adversely affected sectors by the COVID-19 pandemic. In 2020, Malawi received 198,905 international visitors, which is 20 percent lower than the previous year (NSO, 2021).

a case of wild polio virus in Lilongwe has also created a further public health challenge, though there has been a swift public health response.[3]

Climate-related shocks, including a dry spell at the beginning of the planting season and a series of storms, are likely to depress crop production. The Ministry of Agriculture's first-round crop production survey estimates a decline in maize yields by 13 percent on the record yields in the previous season. However, the survey does not take into account prolonged dry spells in December 2021 and January 2022. Data collection also preceded tropical storm Ana, cyclone Batsirai, and cyclone Gombe, all of which impacted Malawi in early 2022. The impact of tropical storm Ana, which struck the southern parts of Malawi, had particularly severe impacts (see Box 1.2). As a result, the Famine Early Warning Network (FEWS NET) (2022) expects crop production to be 15 to 25 percent below average in 2022.

Low crop production and price pressures have resulted in a concerning food security situation, especially for the upcoming lean season. Low yields, high government-mandated farmgate prices, and broader inflationary pressures, including increasing maize prices, have put pressure on households (World Food Programme, 2022). The situation is especially tense in the Lower Shire, where FEWS NET (2022) expects crisis-level acute food security outcomes. UNICEF (2022) recorded a steep increase in the number of children admitted with severe acute malnutrition in February 2022.

Frequent weather shocks, along with the slow pace of structural transformation, have contributed to the high and stagnant rates of poverty over the past decade. More than half of Malawi's population lives in poverty and the national extreme poverty rate increased from 20.1 percent in 2016 to 20.5 percent in FY2019/20 (Figure 1.8).[4] The persistence of high poverty has been driven by slow and uneven economic growth, high inequality, rapid population growth, and substantial barriers to economic transformation, such as low access to formal sources of finance and distance to markets (World Bank, forthcoming). Lack of growth, coupled with high population growth of almost 3 percent per year, has made it difficult to translate any modest GDP gains into significant per capita gains. The lack of significant structural transformation has turned low-productivity agriculture and casual labor (ganyu) into the main income source for poor households. The value added per worker has remained below the regional average and has changed little over the past 15 years. In addition, recurrent shocks increase the vulnerability of poor households because of their impacts on the agriculture sector and the limited savings that they can call on to offset the negative impacts of climate shocks.

BOX 1.2 Impact of tropical storm Ana

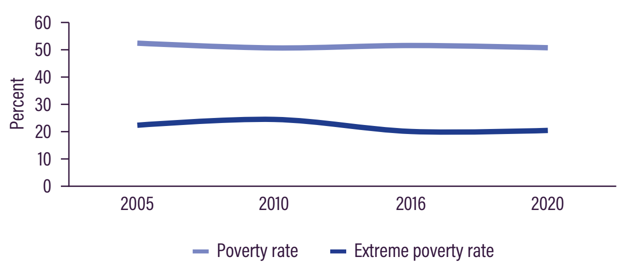
Tropical storm Ana caused severe flooding, affecting over 995,000 people — about 5 percent of the population — in 18 out of 28 districts in Malawi. At least 46 people died and over 190,000 people were displaced and temporarily sheltered in schools, churches, hospitals and other sites. The storm inflicted heavy damage on housing and critical public infrastructure, including roads, bridges, the rail network, electricity and water supply systems, classrooms and health centers. The storm damaged or destroyed at least 476 schools (affecting over 398,000 students), damaged 47 health centers and flooded over 115,000 hectares of crops.

Damages from tropical storm Ana is estimated to total between US$183 million and US$328 million, and particularly impact the energy and agriculture sectors. Direct damage represents between 1.5 and 2.7 percent of Malawi's national GDP (2021). The entire country experienced electric power interruptions, as the 129 MW Kapichira hydroelectric power station — which produces almost one-third of Malawian electricity — was forced into shut down following flashfloods. It is expected to take at least six months to fully restore its capacity, compounding existing electricity shortages. Prolonged electricity shortages may also affect agricultural processing. According to the Department of Disaster Management Affairs (DoDMA), at least 77,000 hectares of crops were either washed away or submerged in six affected districts.

Sources: DoDMA 2022; World Bank 2022e.

FIGURE 1.8 Malawi's poverty rate has not declined in the past 15 years

National poverty headcount rate



Notes: The national poverty rate is the share of the population whose total expenditure is below the cost meeting basic nutritional needs or 2,215 calories per day (food poverty line) and other basic needs (nonfood poverty line). The extreme poverty rate corresponds to the share of the population whose total per capita expenditure is below the cost of acquiring 2,215 calories per day.

Source: World Bank staff calculations based on Integrated Household Survey poverty estimates.

3. The discovery of this case follows the World Health Organization's declaration in August 2020 that the entire continent was officially polio-free. The Government rapidly responded by declaring a national health emergency and commencing a mass vaccination campaign, with 6.9 million doses procured by UNICEF to vaccinate about 2.9 million children under the age of five.

4. Between 2010 and FY2019/20, the international poverty rate (the share of people living below the US$1.90 per day) increased from 72 to 74 percent.

The Government has made progress in scaling shock-sensitive safety nets and social cash transfers to meet the needs of the extreme poor during disasters and crises. Such action signals that the authorities are prioritizing social protection and that they plan to expand the role of social protection to mitigate the negative impacts of shocks on the poor.[5] The Government has designed a scalable mechanism and triggered the first drought response emergency cash transfers in early 2022.

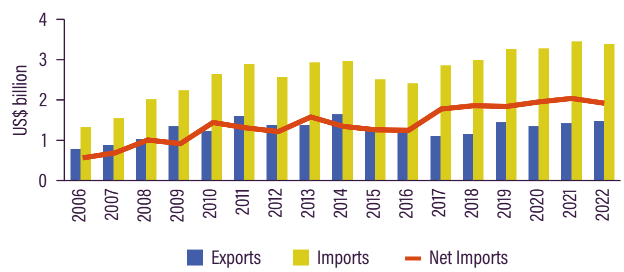
Rising global commodity prices exert pressure on external balances

Malawi's trade and current account imbalances further widened in 2021, as Malawi continues to import more than twice as much as it exports. The trade deficit increased by US$86 million, to more than US$2 billion in 2021 (Figure 1.9). Malawi's current account deficit deteriorated to 13.1 percent of GDP in 2021, up from 12.4 percent in 2020, reflecting a sharp increase in imported commodities and weak export growth (Figure 1.10). Despite rising global prices, 2021 fertilizer imports volumes remained largely stable, while fuel imports volumes only started decreasing in late 2021, as buyers were temporarily shielded from global price dynamics through price controls. While Malawi buys few of the commodities it imports directly from the Russian Federation (0.7 percent of total imports in 2020) or Ukraine (0.1 percent), Malawi remains subject to global supply pressures and escalating price dynamics. According to World Bank estimates, Malawi will likely require financing of between 1.6 and 3.2 percent of GDP to sustain the current consumption pattern of fertilizers, fuels and wheat in 2022.

Malawi's terms of trade have deteriorated, with imported commodities now 92 percent more expensive and exported commodities only appreciating by 4 percent in 2021 (Figure 1.11). Commodities represented 57 percent of exports and 13 percent of imports in 2021. Exported commodities are dominated by tobacco (MK 328 billion in 2021), sugar (MK 60 billion in 2021), and tea (MK 58 billion in 2021). Fertilizers (MK 228 billion in 2021) and fuels (MK 104 billion in 2021) are the most significant imports. Commodity prices have continued to rise in 2022, as the import price index stood at 80 percent above 2021 levels by end-April 2022 due to the escalating Ukraine crisis. Fuel import volumes in the six months to January 2022 were also down by 25 percent on the same period one year earlier, showing the impact of price increases. However, global price increases mean that the value of imported fuel went up. More generally, the significant volatility in commodity markets illustrates the vulnerability of Malawi's economy to such shocks, highlighting the need for further diversification and commercialization (see Box 1.3).

FIGURE 1.9 Malawi's trade imbalance is increasing

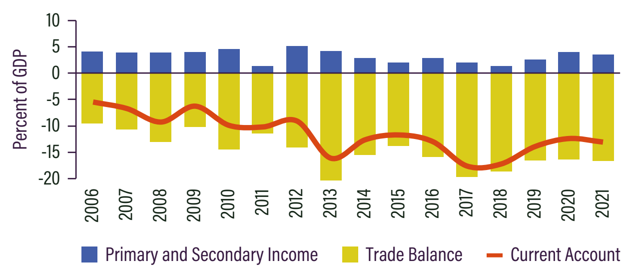
Exports and imports



Source: World Bank staff calculations based on NSO data.

FIGURE 1.10 The current account deficit remains high

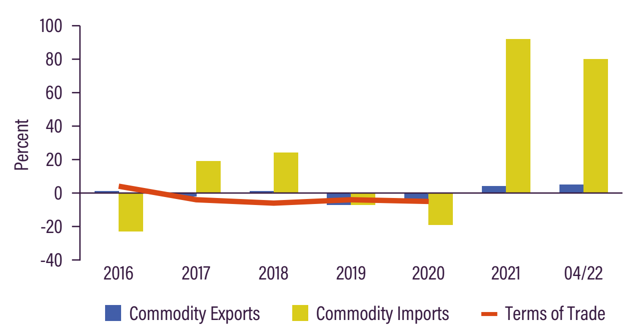
Current account



Note: Indexed price change is calculated as the weighted average price change of reported commodity imports/exports in the preceding year. Weights are assigned according to the preceding year's trade value.
Source: World Bank staff calculations based on IMF WEO 04/2022 and NSO data.

FIGURE 1.11 More expensive imports and stable export prices spell trouble

Export and import commodities price index change



Note: Indexed price change is calculated as the weighted average price change of reported commodity imports/exports in the preceding year. Weights are assigned according to the preceding year's trade value.
Source: World Bank staff calculations based on World Bank Commodity Markets Outlook and NSO data.

5. Shock-sensitive social protection is part of a broader government policy commitment, as embodied in the second Malawi National Social Support Program.

BOX 1.3 Recent trade policy reforms could contribute to commercialization and increased investment in agribusiness, but implementation will be key

Arbitrary export bans have discouraged agricultural commercialization. The previous Control of Goods Act (COGA) provided discretionary powers to the Ministry of Trade and Industry to control the import and export of goods into and from Malawi. This often led to the ad-hoc and non-transparent implementation of import and export controls, resulting in unpredictability in the market, high levels of discretion by officials, and deterring increased investment and trade. Ad-hoc export bans contributed to Malawi having the highest maize price variability in the region (Edelman and Baulch, 2016).

Historically, maize export bans have failed to improve food security or increase production. Bans on maize exports have been in place in most years since 2005, including in years of surplus, and have contributed to the continuation of low-productivity subsistence maize farming, with negative spillover effects on the entire agriculture sector. They have also largely failed to improve food security, while hindering commercial investment, preventing farmers from being able to earn higher prices for maize in export markets, and pushing more traders into informal trade.

The Government of Malawi has taken an important step to revise the COGA to improve predictability. To provide clear and transparent procedures for exports and imports, Parliament passed a new Control of Goods Act on May 15, 2018, and gazetted regulations on July 26, 2020, thereby operationalizing the new Act. The new Act is largely in line with World Trade Organization provisions, which disallow quantitative restrictions, such as bans or licensing measures except on stipulated public interest grounds. The regulations to the Act clarify thresholds that must be met for bans or licensing measures to be permitted, based on specific public interest justifications. Crops that require a license under the Act include maize, rice, sorghum, soya beans, cotton lint and seed, oilseeds, and residues from oilseeds.

With the new COGA, the Government has initiated a data-driven approach to maize trade policy, though there has been some inconsistency in its implementation. The approach relies on comparing the national food balance sheet with national food requirements, and domestic prices with export parity prices, as provided for in the threshold for safeguarding food security in the Act. In December 2021, the Government issued an order allowing for maize exports. The approach has extended to the current issuance of export licenses due to climatic shocks, including tropical storm Ana. So far, export data show that just over 2,000 tons of maize meal has been exported out of a surplus of 700,000 tons reported in December, 2021. Over the same period, informal exports of maize have continued, standing at 24,500 tons, with informal imports estimated at 6,700 tons.

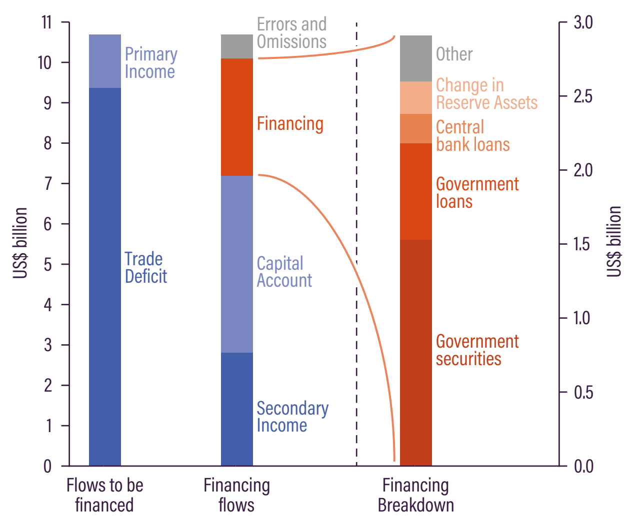
While this represents an important reform to regulate exports based on clearly defined public interest grounds and data, there is still a need for further consolidation of this process. The institutional framework that underpins implementation needs to be strengthened to allow for timely generation of accurate data, mechanisms for coordination and the sharing of data among relevant stakeholders, awareness of the provisions of the new COGA, capacity of staff in the relevant ministries, departments and agencies, and the effective monitoring of informal exports. There is also a need to ensure that public-private dialogue is sustained to support implementation.

Tobacco sales in 2022 have lagged behind the 2021 performance. By May 20, 2022—the eighth week of auctions—only 52 percent of the amount of tobacco sold during the equivalent period[6] in 2021 had been sold. Prices were 22 percent higher, and some farmers may be holding out to bring tobacco to the auction floors, in anticipation of even higher prices. However, following a challenging planting season, it is unlikely that 2021 volumes can be achieved this year.

Historically, Malawi has financed its trade deficit primarily with transfers from abroad and through debt (Figure 1.12). Between 2017 and 2021, Malawi needed US$9.4 billion to finance its trade deficit and US$1.3 billion to fund its negative primary income. During the same period, it received US$2.8 billion in current transfers (secondary income), which helped finance consumption expenditure. Only 14 percent of these transfers were received by the Government, while 29 percent represents remittances, and the rest represents other transfers to non-government enterprises such as NGOs. In addition, Malawi attracted US$4.4 billion in transfers for capital

FIGURE 1.12 How Malawi pays (and borrows) for its imports

Simplified balance of payments and net financing breakdown, 2017–21



Note: Government securities include those held by non-residents.
Source: World Bank calculations based on NSO data.

6. Equivalent period refers to the tobacco sales performance as of May 21, 2021, rather than at the end of the eighth week of auctions, which ended on June 1, 2021.

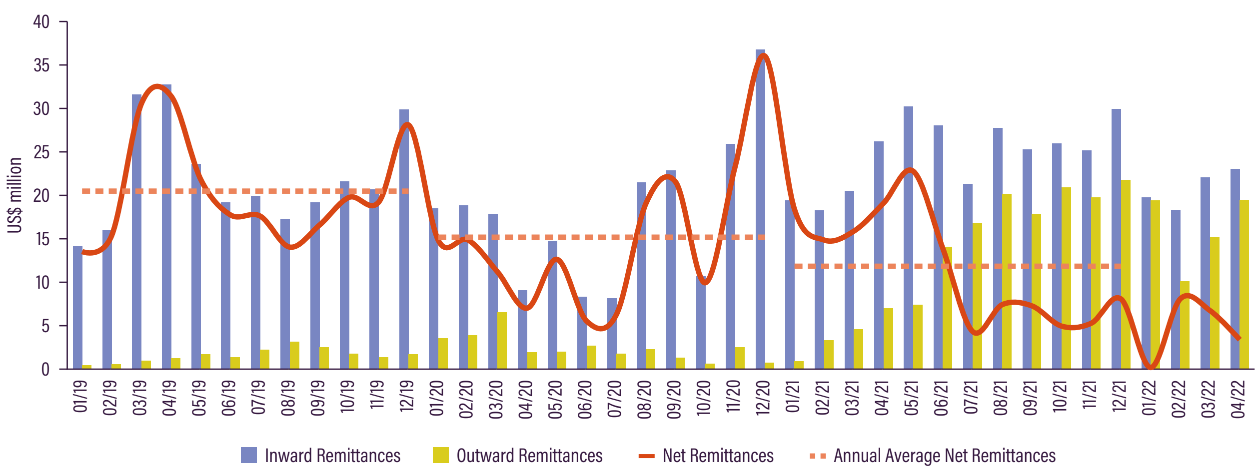
expenditure. Most current transfers (86 percent) and capital transfers (77 percent) went to private enterprises rather than the Government. The remaining US$2.9 billion was largely financed through public sector debt and a decrease in reserve assets.

Financing volatile imports with transfers and debt is risky, especially now given Malawi's low level of reserve assets. Recent swings in commodity prices underline the price risks that small and open economies such as Malawi face. Furthermore, transfers from foreigners can be stopped abruptly and typically are not within the control of government. Conditions on international financial markets are currently highly volatile and could lead to abrupt changes in the feasibility of financing the current account deficit. The RBM moved to buying foreign exchange outright following the May 2022 Malawi kwacha depreciation and this has the potential to bolster Malawi's reserve position providing more room to absorb shocks. The announced actions could decrease the role of external finance.

Net remittances are declining, limiting their roles as a foreign exchange earner. Remittance inflows reached record levels in 2021 at a monthly average of US$25 million (Figure 1.13). However, Malawi is also recording significant remittance outflows for the first time, with a monthly average of US$13 million in 2021. This trend has continued in the first four months of 2022, with monthly inflows of US$21 million being counteracted by US$16 million in outflows. It is unclear what exactly has caused this shift, or what the destination of these outflows is. However, they limit the role of net remittances as a foreign exchange earner.

FIGURE 1.13 A key forex earner in decline

Inward, outward, and net remittances in Malawi



Source: World Bank staff calculations based on RBM data.

The Government is increasingly promoting import substitution to address foreign exchange shortages, but the effectiveness of this approach remains questionable. Import substitution is a broad term for policies that attempt to replace foreign imports with domestic production. One example of this is the "Buy Malawi Strategy", which was officially launched in 2016 and attempts to inspire Malawians to buy more locally produced goods instead of imported products. The Government further proposed supporting the strategy with increased regulation, such as compelling retailers to provide at least 50 percent of shelf space to domestic items. While it remains to be seen whether enforcement follows rhetoric, government officials have recently promised to step up the enforcement of guidelines designed to promote import substitution. It is worth noting, however, that international experience shows that promoting the competitiveness of exporters is typically more effective than pursuing import substitution at increasing productivity growth, especially when the domestic market is small. While such perspectives are reflected in select government documents and initiatives, such as the National Export Strategy II, which was launched in December 2021, as well as in Malawi's participation in the African

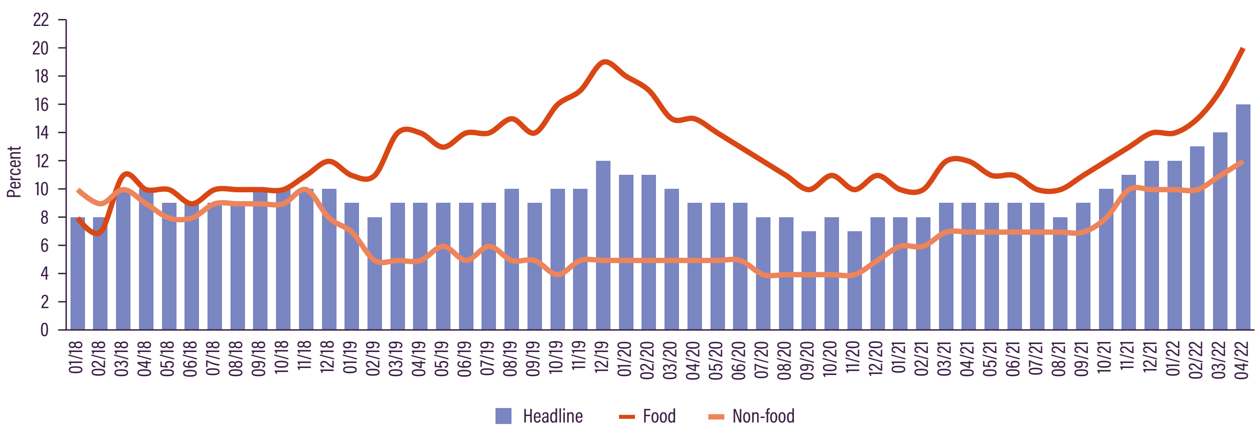
Continental Free Trade Area, there remains some ambiguity as to how determined Malawi is to commit to an export-led growth strategy.

Elevated global commodities prices and a loose monetary stance exert upward pressure on inflation

Headline inflation rose to 15.7 percent in April 2022, the highest level since April 2017, as both food and non-food inflation maintain their upward trajectory. Food inflation reached 19.5 percent in April 2022, the highest level since February 2017 (Figure 1.14). Despite the country recording a bumper harvest during the 2021 agriculture season, domestic food prices for maize, rice, cassava and other staple goods have been increasing, partly because of distribution challenges from surplus to deficit areas caused by a poor transport network and underdeveloped supply chains. Later increases were driven by the anticipation of lower yields in the 2022 harvest, pushing staple prices closer to higher regional average prices. With a consistently low policy interest rate and liquidity-injecting Open Market Operations throughout 2021, the RBM remained accommodative despite accelerating price increases. The Monetary Policy Committee (MPC) decided to lift the policy rate from 12 to 14 percent on April 29, 2022, after inflation had been running in double digits for half a year. The MPC noted that continued inflationary pressures increase production costs, such that an accommodative monetary policy stance may not be consequential in supporting economic recovery.

FIGURE 1.14 Inflation in Malawi is increasing, driven by food inflation

Headline, food and non-food Inflation, y-o-y



Source: World Bank staff calculations based on NSO data.

Global supply constraints induced by the COVID-19 pandemic, surging global oil prices, and the recent exchange rate adjustment contributed to the jump in domestic energy prices. While domestic fuel prices are usually supported by the Price Stabilization Fund, as global prices have increased, so the Price Stabilization Fund was depleted and could no longer cushion domestic prices. Thus, fuel prices were adjusted upward by 22 percent in April 2022, following a 28 percent increase in October 2021. This contributed to the rise in non-food inflation. The Russia–Ukraine crisis has exerted additional pressure on already elevated global fuel prices, pushing crude oil above US$103 per barrel as of April 2022, from just US$63 a year earlier and US$21 two years ago. Increased global prices and the downward adjustment of the Malawi kwacha meant that price changes were outside the range that the significantly depleted Price Stabilization Fund could cushion. Year-on-year non-food inflation reached 12.2 percent in April 2022. Inflationary pressures will continue due to elevated commodity prices driven by global supply constraints, continued depreciation pressures on the Malawi kwacha, and the Russia–Ukraine war, affecting households' ability to maintain their past levels of consumption (see Box 1.4).

BOX 1.4 Poverty impacts of the rising inflation

Public concerns about the rising cost of living have been growing in recent months as inflation, especially for food, has increased. Inflationary pressures are likely to continue throughout 2022, affecting households' consumption. Price rises have been most significant for food products, which make up the majority of households' expenditure, especially for the poor.

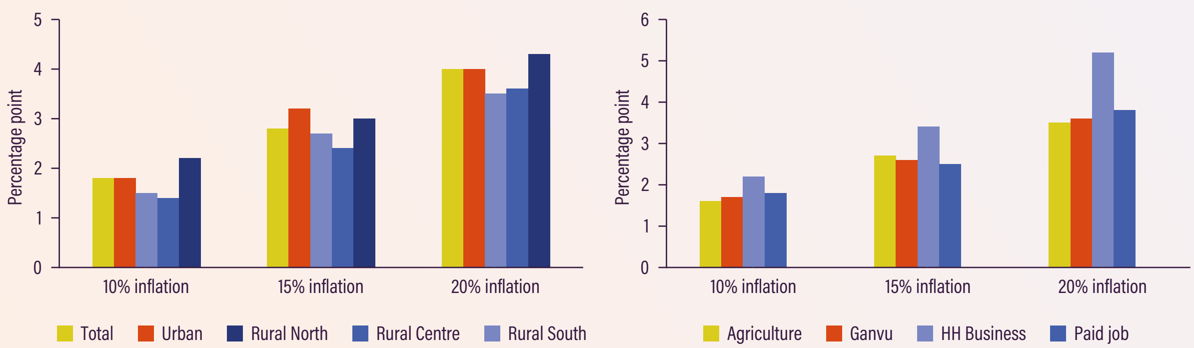
New analysis conducted for this MEM examines the effects of food inflation and shows that price increases of 15 percent would result in the national poverty rate rising by almost 3 percentage points. A further increase to 20 percent, would add another 1 percentage point to the poverty rate. This is because households are forced to reduce consumption, pushing some below the poverty line. The magnitude of the effect depends on whether households are net consumers (i.e., those whose net consumption decreases with higher prices as they consume more than they sell) or net producers (i.e., those whose net consumption increases with higher prices as they sell more than they consume).[a]

The impact of food inflation on poverty differs depending on where people live, with urban dwellers hit the hardest. Although rural people have a higher food budget share, they produce a higher share of their food and are more likely to have an income from agriculture than those in cities. In the case of 15 percent food inflation, urban poverty would increase by 3.2 percentage points, while the rural central region, which has the biggest proportion of households reliant on agricultural incomes, would see a smaller increase (2.4 percentage points) (Figure B1.4.1). A 20 percent increase could increase poverty in the rural south by 4.3 percentage points.

Changes in poverty also depend on the main source of household income. With high levels of food inflation, poverty rises more for people in households with self-employed household members who work on their own-account or own a business. For people with a paid job as their primary source of income, poverty rises less as these households tend to be further from the poverty line and less vulnerable to price shocks.

FIGURE B1.4.1 Rising prices hit the urban population and household businesses the hardest

Percentage point increase in national poverty rate



Source: World Bank staff calculations using data from Integrated Household Survey 5.

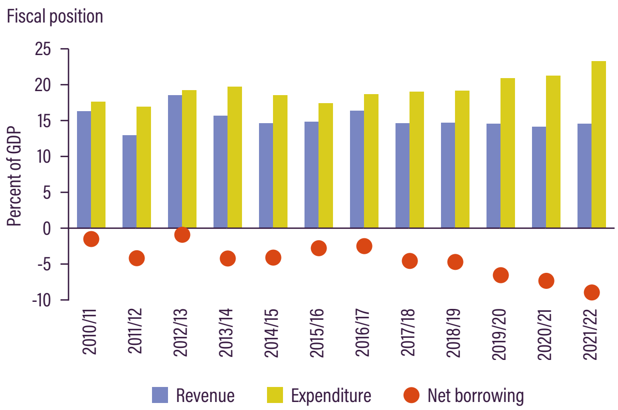
a. *The analysis relies on the following assumptions:* (i) households do not change their consumption patterns; (ii) food inflation affects everyone equally; (iii) changes in food prices do not affect the share of food produced by families to be consumed in house; (iv) the increase in food prices translates into an equivalent reduction of households' consumption; and (v) the increase in agricultural income translates into an equivalent increase in consumption for people in producer households.

Upward revisions in expenditure pushed the fiscal deficit to a record high in FY2021/22

The fiscal deficit increased by 1.6 percent of GDP, to 8.7 percent of GDP over FY2021/22, the highest in over a decade, owing to lower-than-expected revenues and spending overruns (Figure 1.15). The Government missed targets on taxes and grants, widening net borrowing by 0.5 percent of GDP. This was offset by underperformance in the acquisition of non-financial assets by 2.9 percent of GDP, contributing to expenditure performing within the upward revised target for total spending. This underperformance on revenues and under-expenditure on non-financial assets continues a longstanding pattern. While the Government had expected grants to approach pre-pandemic levels of above 2 percent of GDP, in fact disbursements were lower at 1.2 percent of GDP.

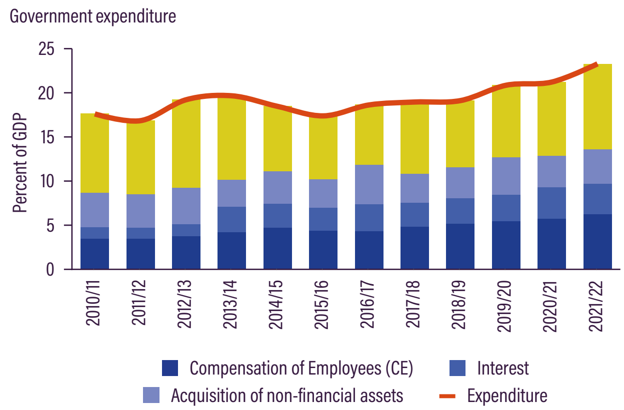
Lower-than-anticipated tax revenues were the main contributor to total revenues missing the revised target for the fiscal year. Revenues totaled 14.6 percent of GDP, underperforming the revised target of 15.7 percent of GDP due to a shortfall in income taxes, profits and capital gains. Tax revenue collections improved in FY2021/22 over the previous fiscal year to 12.7 percent of GDP but fell short of attaining the target of 13.2 percent of GDP, which was significantly higher than historical collections. While revenue mobilization was expected to pick up with the economic recovery, the introduction of certain measures may have contributed to the decline, such as the tax rate reduction in the middle Pay-As-You-Earn (PAYE) bracket (MK 100,000 to MK 1 million per month) from 30 to 25 percent. The Government also implemented other measures, such as the introduction of a duty-free week.[7] Taxes on goods and services attained their target of 5.9 percent of GDP, as business activity picked up with fewer mobility restrictions imposed as a result of the weakening of the pandemic.

FIGURE 1.15 Malawi's fiscal position continues to worsen...



Source: World Bank staff calculations with data from MoFEA.

FIGURE 1.16 ...as expenditure surges



Source: World Bank staff calculations with data from MoFEA.

Spending overruns in compensation for government employees, social benefits and interest payments exerted additional pressure on expenses. Expenses totaled 19.4 percent of GDP. The Government implemented a higher-than-budgeted adjustment (and three times more than the expected inflation rate over the same period) on wages and salaries of 14 percent in FY2021/22 which, together with new hiring, contributed to overruns in wages and salaries. Consequently, the compensation of public employees reached 6.3 percent of GDP, higher than the initial target of 5.7 percent of GDP. This is the highest level of spending for the compensation of public employees in over a decade. Interest expenses totaled 3.4 percent of GDP in FY2021/22 (26 percent of domestic revenue) but remained within the revised target of 3.8 percent of GDP. With public employee compensation and interest payments making up 42 percent of total expenditure (Figure 1.16), fiscal space for other government discretionary policies and its ability to respond to shocks are constrained.

Higher-than-targeted spending on fertilizer payments under AIP, caused by high fertilizer prices and program inefficiencies, were key to expenditure overruns. Expenditure on the AIP reached 2.1 percent of GDP, higher than the target of 1.6 percent of GDP. This is the highest level of spending on fertilizer subsidies on record. The Government increased its contribution per bag of supplied fertilizer by 25 percent after bidding had started and awarded bids without the requirement of performance bonds to suppliers with little experience, some of which underperformed on their obligations. The Government has voiced concern over the fiscal risk and the strain on the external balance that the AIP poses. It has announced that it will present plans to limit expenditure on the AIP to its reduced budget allocation. In addition, the Government overspent in grants to other general government units, driven by higher spending on subventions.

Total development spending was 3.9 percent of GDP and continued to decline relative to recurrent expenditures, as the Government failed to attain its FY2021/22 target. Domestically financed development spending (referred to the acquisition of non-financial assets in the budget) came to 1.8 percent of GDP, underperforming the target by 1.0 percent of GDP. Constrained by lower-than-anticipated disbursements

7. During the "Duty Free Week", from January 23 to 29, 2022, importers were allowed to import goods whose value for duty purposes does not exceed US$3,000 free of any import duty, import excise and import Value Added Tax (VAT).

in development grants and loans, foreign-financed development spending totaled 2.1 percent of GDP, far less than the revised target of 4.0 percent of GDP, indicating slow implementation of development projects.

The uptake of high-cost domestic debt continues. The budget was boosted by a disbursement of IMF Special Drawing Rights (SDR) in August 2021, equivalent to 1.9 percent of GDP. In addition, domestic financing amounting to 5.9 percent of GDP, at the same level as in the previous fiscal year, was required to cover the financing gap.

TABLE 1.1 Fiscal accounts

Percent of GDP

				2021/22		2022/23
	2018/19	2019/20	2020/21	Revised	Projected	Proposed
Revenue	**14.7**	**14.6**	**14.1**	**15.7**	**14.6**	**17.0**
Domestic Revenue	**13.2**	**13.1**	**12.7**	**13.9**	**13.4**	**14.2**
Taxes	**12.8**	**12.3**	**11.9**	**13.2**	**12.7**	**13.4**
Taxes on Income, Profits and Capital Gains	6.0	5.8	5.6	6.3	5.7	6.4
Taxes on Goods and Services	5.7	5.5	5.4	5.9	5.9	5.8
Taxes on International Trade and Transactions	1.1	1.0	0.9	1.1	1.0	1.2
Other Taxes	0.0	0.0	0.0	0.0	0.0	0.0
Grants	**1.4**	**1.5**	**1.5**	**1.8**	**1.2**	**2.8**
From Foreign Governments	-	-	-	0.7	-	0.4
From International Organizations	1.4	1.5	1.5	1.0	1.2	2.4
Other Revenue	**0.5**	**0.8**	**0.7**	**0.7**	**0.7**	**0.9**
Property Income	0.1	0.3	0.4	0.3	0.1	0.5
Sale of Goods and Services	0.4	0.5	0.3	0.3	0.6	0.3
Fines, Penalties and Forfeits	0.0	0.0	0.1	0.1	0.0	0.0
Transfers not elsewhere classified	-	-	-	-	-	-
Expenditure	**19.1**	**20.9**	**21.2**	**26.1**	**23.3**	**24.7**
Expense	**15.6**	**16.6**	**17.7**	**19.3**	**19.4**	**17.6**
Compensation of Employees	5.2	5.5	5.7	6.2	6.3	6.0
Goods and Services	3.4	4.0	3.6	4.0	3.8	3.1
Generic goods and services	2.1	2.5	2.2	2.3	2.3	2.0
Maize purchases	0.1	0.1	0.1	0.2	0.2	0.1
Interest	2.9	3.0	3.6	3.8	3.4	4.6
To non-residents	0.2	0.2	0.2	0.2	0.2	0.2
To residents other than general government	2.7	2.8	3.4	3.6	3.3	4.4
Grants	2.7	2.7	1.9	2.1	2.2	1.9
Social Benefits	1.4	1.4	2.5	2.8	3.2	1.9
Fertilizer payments	0.4	0.3	1.3	1.6	2.1	0.8
Other Expenses	0.1	0.1	0.3	0.4	0.4	0.1
Acquisition of Non-Financial Assets	**3.5**	**4.2**	**3.6**	**6.8**	**3.9**	**7.1**
Foreign financed	2.2	2.4	2.6	4.0	2.1	5.1
Domestically financed	1.4	1.8	1.0	2.8	1.8	2.1
Net borrowing	**(4.5)**	**(6.3)**	**(7.1)**	**(10.4)**	**(8.7)**	**(7.7)**
Primary Balance	**(1.6)**	**(3.3)**	**(3.5)**	**(6.6)**	**(5.3)**	**(3.1)**
Net Incurrence of liabilities	**4.5**	**5.7**	**6.9**	**10.4**	**4.3**	**7.7**
Foreign Liabilities	**0.8**	**0.8**	**1.0**	**1.7**	**2.8**	**2.0**
Monetary Gold and Special Drawing Rights	-	-	-	-	1.9	-
Program Borrowing	0.1	0.0	0.3	-	-	0.4
Project Loans	1.0	1.2	1.1	2.3	0.9	2.3
Amortization	(0.4)	(0.4)	(0.4)	(0.6)	(0.0)	(0.6)
Domestic Liabilities	**3.8**	**4.9**	**5.9**	**8.7**	**5.9**	**5.7**

* FY2021/22 figures as a percent of GDP represent a nine-month fiscal year, to enable comparison with previous FYs.

Note: Figures are a share of rebased GDP figures.

The FY2022/23 budget exhibits tangible steps toward deficit reduction, but fiscal space remains constrained

Fiscal space is expected to remain constrained, despite an increase in revenue and reduced spending. The Government projects that the fiscal deficit for FY2022/23 will decline slightly to 7.7 percent of GDP from an outturn of 8.7 percent of GDP in FY2021/22. Much of this is to be achieved through significant improvements on the revenue side, driven by increased tax collection, as well as a modest increase in grants, which will contribute to improved revenue performance. The Government has also planned significant spending reductions in social benefits driven by AIP reform, with the overall budget of the AIP for FY2022/23 set at MK 109 billion—a 33 percent reduction relative to the FY2021/22 outturn.

Revenues are projected to rise to 17.0 percent of GDP in FY2022/23, with across-the-board increases in all major categories, though this relies on optimistic assumptions. Taxes are expected to increase to 13.4 percent of GDP, supported by an improved performance of taxes on income, profits and capital gains, and taxes on international trade. However, the Government has introduced numerous measures aimed at alleviating the tax burden that are revenue-reducing in nature, including the removal of VAT on cooking oil and tap water, a reduction in the withholding tax on tobacco sales, and the removal of import duty, VAT and excise tax on spare-parts for energy generation and distribution, as well as the removal of import duty and excise tax on tire retreads. In addition, it remains unclear what impact changes to the PAYE brackets benefiting lower earners will have.

Increases in grants is expected to contribute more to revenues, though based on recent experience this could be challenging to achieve. The disbursement of grants is expected to improve significantly to 2.8 percent of GDP, more than doubling the FY2021/22 outturn of 1.2 percent of GDP. Drawing on recent experience, it is likely that a good proportion of these grants may not materialize, especially as disbursement is also dependent on the absorption of resources in development projects, which continues to be slower than planned.

Expenditure is projected to increase to 24.7 percent of GDP in FY2022/23, over an outturn of 23.3 percent of GDP in FY2021/22. This is driven by a projected surge in acquisition of non-financial assets, up to 7.1 percent of GDP from 3.9 percent of GDP in FY2021/22. Other than interest, all other categories of expenses are projected to decline over their outturn in FY2021/22. However, fiscal pressures from elevated global commodity prices, especially on the implementation of the AIP, may exert an upward push on expenditure and thus run counter to fiscal consolidation aims. Materialization of contingent liabilities (e.g., reported MK 64 billion required as a bailout for the Agriculture Development and Marketing Corporation) may add to fiscal pressures.

Expenses are budgeted to decline to 17.6 percent of GDP in FY2022/23, through fiscal consolidation efforts, most notably reforms of the AIP. The Government announced that it will present plans to reform the AIP, including by reducing the overall cost and moving some beneficiaries over to cash transfer programs. Overall, it targets fiscal savings of 0.8 percent of GDP in the FY2022/23 budget. Consequently, social benefits are projected to decline from an outturn of 3.2 percent of GDP in FY2021/22 to 1.9 percent of GDP in FY2022/23. Lower spending in goods and services is also planned, contributing to a decline to 3.1 percent of GDP, from a likely outturn of 4.0 percent of GDP in FY2021/22. The Government is also planning to contain the adjustment in wages and salaries, which are expected to decline to 6.0 percent of GDP. However, interest payments are projected to increase significantly to 4.6 percent of GDP and, as domestic interest rates remain high, debt servicing could exceed expectations. The November 2022 DSA projects interest expenditure at 4.7 percent of GDP, while not taking into account recent budget overruns or an exchange rate adjustment.

The Government is pursuing extensive public financial management (PFM) reforms through the new Public Finance Management Act. The Public Finance Management Act, approved by the National Assembly in March 2022, aims to address systemic weaknesses and support fiscal consolidation, including through the establishment of a Treasury Single Account, emphasizing reporting by state-owned enterprises, and providing clarity on the responsibilities of all public officers, with disciplinary measures and sanctions for misusing government resources. However, the problems that Malawi has encountered in its PFM system have historically not been due to the absence of a legal framework, but rather due to inadequate implementation of the existing rules. As such, the implementation of the new Act will need to be prioritized. Additional effort will be needed to support reforms that are not covered by the Act, such as public investment management—the largest source of contingent liabilities.

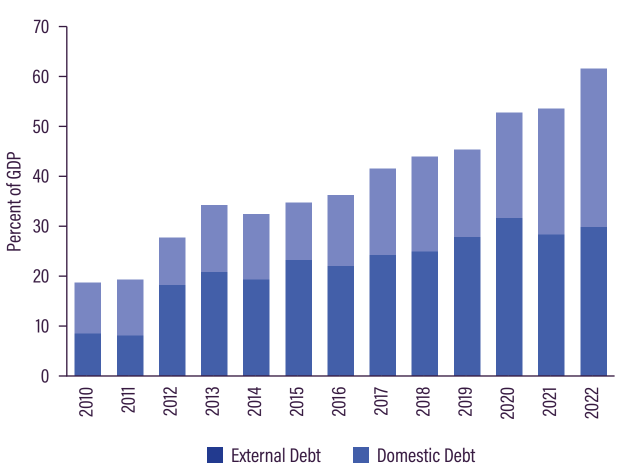
The Government projects a significant pick-up in foreign-financed development spending, from an outturn of 2.1 percent of GDP in FY2021/22 to 5.1 percent of GDP in FY2022/23—the highest level in over a decade. However, this depends on the materialization of anticipated project-related grants and loans, which have to a large extent been underperforming their approved targets, as well as on project execution. Domestically financed development spending is projected to increase to 2.1 percent of GDP, from a likely outturn of 1.8 percent of GDP. Part of this arises from the scaling up of CDF to MK 100 million per constituency, totaling MK 19.3 billion. The Government will need to enhance oversight of the Fund to ensure that resources do in fact benefit the population (see Part 2 on fiscal decentralization). Total development spending is thus projected to increase to 7.1 percent of GDP. The fiscal deficit will still be largely financed through domestic borrowing (5.7 percent of GDP), with foreign financing expected to total 2.0 percent of GDP.

An increase in commercial domestic debt has made Malawian external debt unsustainable

Malawi's debt has become unsustainable. The November 2021 IMF–World Bank DSA indicates that Malawi's external and public debt are both at high risk of debt distress and that debt is unsustainable (IMF and World Bank, 2021). The stock of public and public-guaranteed debt increased to 59 percent of GDP[8] in 2021, up from 55 percent in 2020. This was driven by increased uptake of both domestic and external debt (Figure 1.17). Financing of government fiscal deficits using high-cost domestic borrowing continues to drive domestic debt on an upward trajectory (Figure 1.18). Consequently, this has also been driving domestic debt service upward, increasing the fiscal burden from payments on both interest

FIGURE 1.17 External debt pushes public debt upward...

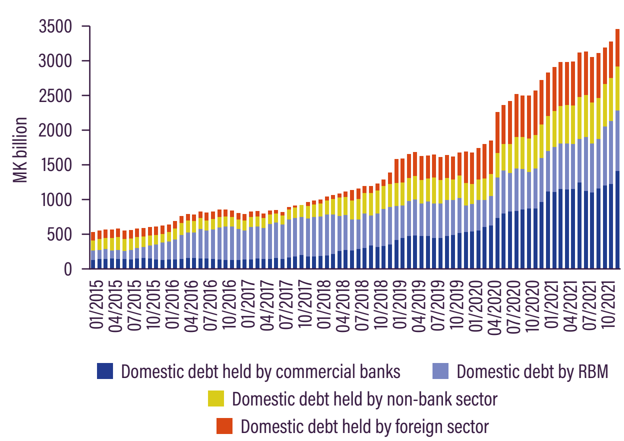
Public debt



Source: World Bank staff calculations with data from the RBM and MoFEA.

FIGURE 1.18 ...and domestic debt from commercial banks is increasing

Domestic debt by holder



Source: World Bank staff calculations with data from the RBM.

8. Rebased GDP at 2017 prices.

and principal. The change in definition of external debt from a currency to a residency basis[9] and the conversion of RBM short-term reserve liabilities to medium-term external debt have seen total external debt increase to 32.9 percent of GDP in 2020—the highest level since debt relief under the Highly-Indebted Poor Countries Initiative in 2006. RBM uptake of medium-term debt on non-concessional terms has also increased the debt-servicing burden from external debt.

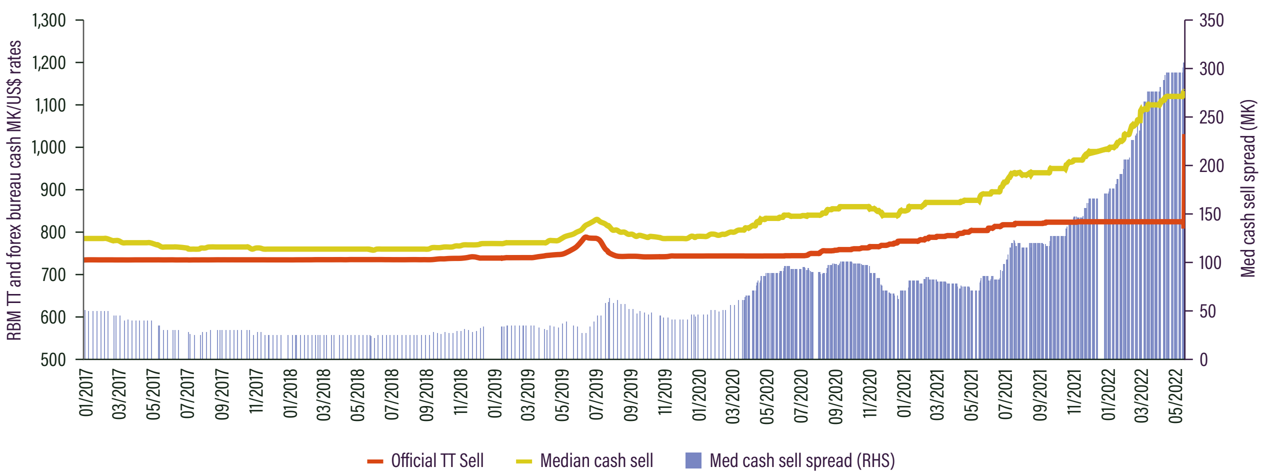
The composition of external debt shifted toward non-concessional debt from regional development banks,[10] while commercial banks remain the highest holder of domestic debt. The share of external debt held by multilaterals on concessional terms at end-2020 has been revised downward to 58.9 percent, from 80 percent reported in the September 2020 IMF–World Bank report (IMF and World Bank, 2020). Regional development banks held 29.5 percent of the external debt in 2020, while the remaining 11.5 percent was held by official bilateral lenders. High interest rates associated with debt from regional development banks have resulted in an increased external debt-servicing burden. Uptake of domestic debt by the RBM has increased, but bank and non-bank private financial institutions remain the largest holders of domestic debt, and were owed 75 percent of the total domestic debt stock as of December 2021.

The RBM increased interest rates and adjusted downward the official Malawi kwacha-US dollar exchange rate by 25 percent

After remaining virtually unchanged between November 2020 and May 2022, the RBM adjusted the Malawi kwacha downward by 25 percent to align official rates with market rates. The official Malawi kwacha exchange rate for telegraphic transfers (TT), through which most foreign exchange transactions are carried out, had only marginally depreciated by 1.4 percent between July 2021 and May 2022, after a gradual depreciation of 9.3 percent from June 2020 to June 2021 (Figure 1.19). Meanwhile, foreign exchange bureau cash exchange rates depreciated by 24.1 percent between July 2021 and May 2022, widening the spread against the TT rate to 28 percent. To rebalance the market, protect official reserves, and to counteract arbitrage opportunities emanating from a spread to cash rates, the RBM decided to cut the official rate by 25 percent in a landmark decision on May 26, 2022.

FIGURE 1.19 Spreads between TT and bureau MK-US$ exchange rates widened until the recent adjustment...

RBM TT and forex bureau cash MK/US$ rates and spreads through May 27



Source: World Bank staff calculations based on RBM data.

9. The previous DSA was based on currency implying debt held in currency other than Malawi kwacha was recorded as external debt. This has been revised to residency basis implying that debt held by non-residents is classified as part of external debt.

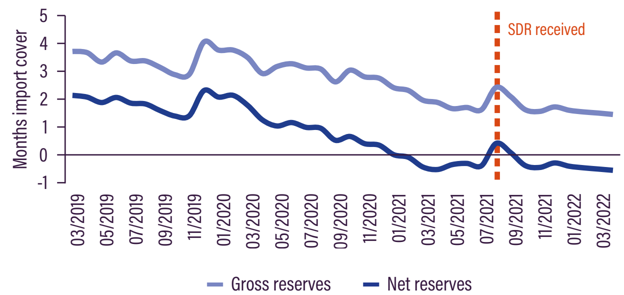
10. Regional development banks exclude the African Development Bank, which falls into the category of multilateral lenders typically providing highly concessional finance.

The RBM expects that this adjustment will prevent the depletion of reserves. While previously the RBM predominantly attempted to balance the market for foreign exchange through measures such as re-introducing the mandatory sale of export proceeds in August 2021 on a temporary basis, it has now resorted to a price mechanism by devaluing the Malawi kwacha. This comes after efforts requiring exporters to liquidate 30 percent of their proceeds held in Foreign Currency Denominated Accounts did not sufficiently support the foreign exchange supply to eradicate imbalances in the interbank market. Before the adjustment, the private sector had reported difficulties and delays in accessing foreign exchange. This resulted in import payment arrears and the interruption of imports, including some medicines. Airline operators announced that they would cease to accept Malawi kwacha, as they were unable to convert local currency into Foreign Currency Denominated Account holdings. If supported by adequate macroeconomic and structural policies, the exchange rate adjustment has the potential to make foreign exchange more widely available by both attracting foreign exchange supply through increased purchasing power and constricting demand for foreign exchange by making it less affordable.

Urgent action was needed to reverse the trend of declining official reserves, which have reached their lowest level in recent years. Gross reserves decreased to less than half, from US$847 million in December 2019 to US$385 million in March 2022, or around just 1.5 months of import coverage (Figure 1.20). This is much lower than the recommended adequacy level (3.9 months of import coverage) for a credit-constrained economy (IMF, 2021). Net reserves have been negative since February 2021, except when Malawi benefited from the IMF's SDR allocation (August–September 2021). The RBM has supported Malawi kwacha stability through substantial foreign exchange swaps (both new and roll-overs) and medium-term borrowing facilities (Figure 1.21) to maintain the reversion to a "stabilized" exchange rate regime, despite a de jure "floating" arrangement (IMF, 2020). While reserves have also been affected by poor export performance and the rising costs of imports, relinquishing some control of the exchange rate has the potential to support the build-up of official reserves. The RBM intends to become a net buyer of foreign exchange in the market and recent announcements commit it to move toward a "managed float" regime.

FIGURE 1.20 ...while reserves have declined further

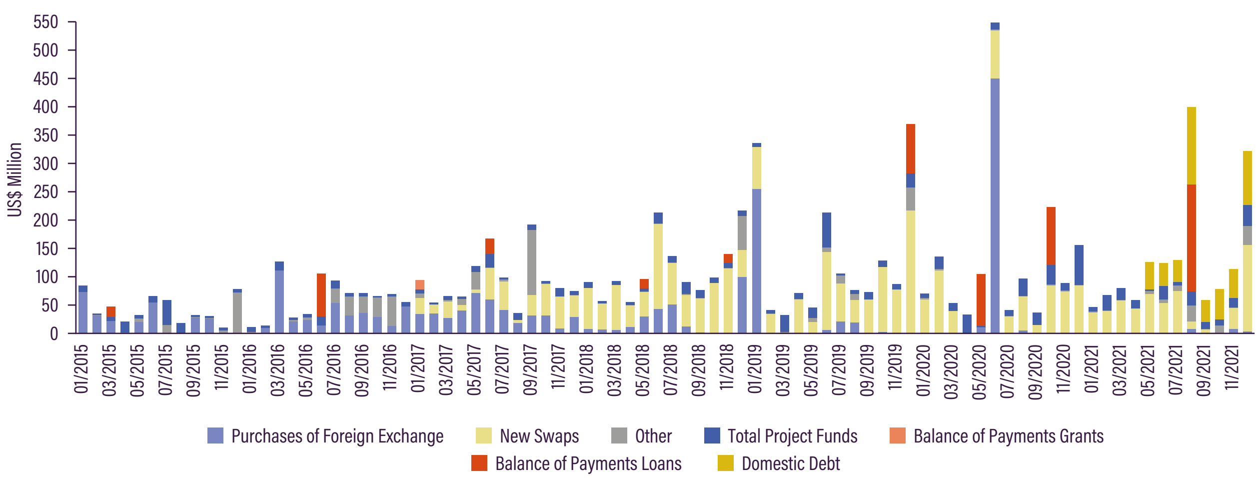
Official/net gross reserves



Notes: Net reserves subtract predetermined short-term drains, such as short-term swaps.
Source: World Bank staff calculations based on RBM data.

FIGURE 1.21 Rather than outright purchases, repayable swaps were the main source of foreign exchange that the RBM used to support the exchange rate

RBM gross foreign exchange reserve boosting transactions by type

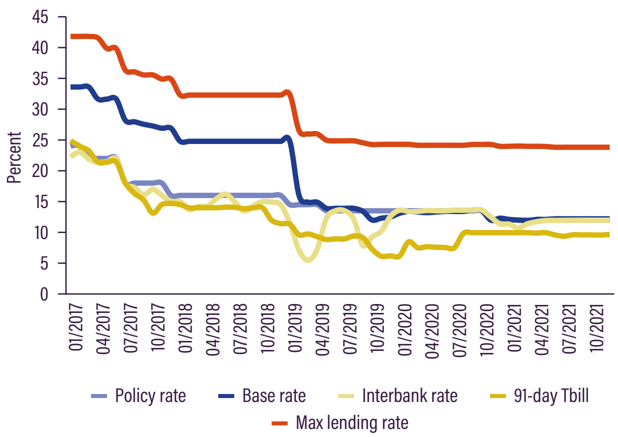


Source: World Bank staff calculations based on RBM data.

In April 2022, the MPC increased its key policy rate for the first time since November 2020. On April 29, 2022, the policy rate was increased from 12 to 14 percent, after the RBM had remained accommodative throughout 2021 (Figure 1.22). Yields on Treasury Bills and Treasury Notes have increased slightly in response, after already having been elevated by tight market liquidity and strong government demand for credit (Figure 1.23). Inter-bank rates closely tracked the monetary policy rate in response.

FIGURE 1.22 The RBM maintained an accommodative stance in 2021

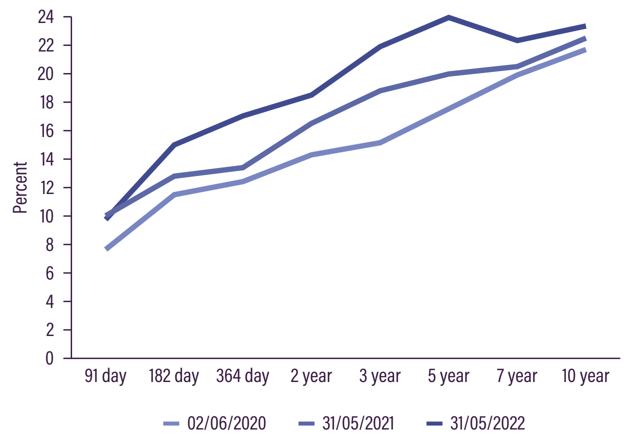
Interest rates



Source: World Bank staff calculations based on RBM data.

FIGURE 1.23 Government borrowing yields have increased in response to the policy rate increase in April 2022.

T-Bill and T-Note interest rates



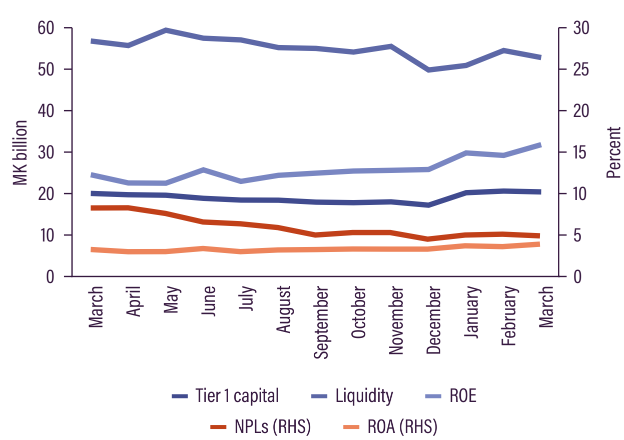
Source: World Bank staff calculations based on RBM data.

Despite economic challenges, the financial sector has remained stable

Despite the scarcity of foreign exchange, increasing inflation and the slowdown in economic activities, the financial sector has been resilient, supported by high levels of government borrowing. Banks maintained adequate capital and liquidity positions throughout 2021 and continued along that path in the first quarter of 2022 (Figure 1.24). The banking sector's return on equity (ROE) was at 31.8 percent in March 2022, compared with 21.2 in January 2021 and 25.8 percent in December 2021. Return on assets (ROA) grew steadily from 2.8 percent in January 2021 to 3.3 percent in December 2021 and 3.9 percent in March 2022. The liquidity coverage ratio remained above the prudential benchmark of 25 percent but declined from 55.9 percent in January 2021 to 49.8 percent in December 2021 and 52.8 percent in March 2022. The commercial banking sector maintained an adequate capital buffer, with the tier 1 capital ratio standing at 20.4 percent in March 2022, compared with 20.5 and 17.2 percent in January and December 2021, respectively. NPLs to gross loans and advances remained healthy and on a broadly downward trend, standing at 4.9 percent in March 2022, down from a peak at 8.3 percent in April 2021. The recent RBM stress test shows that the banking sector is able to withstand moderate shocks, despite some risks (see Box 1.5). These results are backed by increasingly profitable lending to the Government which, starting in 2021, established the Government as the majority borrower of commercial banks. The Government was the borrower for 59 percent of outstanding commercial bank credit as of December 2021, up from 50 percent in December 2020 and 26 percent at the start of 2017.

FIGURE 1.24 NPLs have declined since May 2021

Selected banking soundness indicators



Source: World Bank staff calculations based on RBM data.

BOX 1.5 Is the banking industry resilient to shocks?

The RBM conducted stress tests for the banking industry in December 2021, based on data from all eight commercial banks in Malawi. In this exercise, the banks were subjected to various shocks to assess the resilience and vulnerabilities of the industry to potential credit, liquidity, income, and interest rate risks.

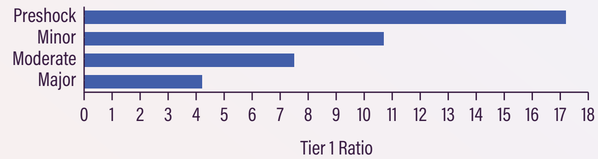
The banking industry is resilient to interest rate risk and income risk shocks, while it performs worse on credit risks (concentration and single name credit concentration). Liquidity risk test results were mixed, as the sector was resilient to shocks after applying haircuts* on liquid assets, while being vulnerable to deposit runs. The Credit Risk Test showed that a significant increase of NPLs could result in undercapitalization of the industry, deteriorating the core capital ratio below the prudential requirement of 10 percent for the banks (Figure B1.5.1). Under a minor shock, the core capital ratio remained marginally above the 10 percent mark, at 10.7 percent.

The banking industry is also vulnerable to default by large borrowers, which could result in undercapitalization. In a scenario where the top five borrowers default, the industry core capital ratio dropped below the prudential requirement, to 7.6 percent after the successive default of the top five large borrowers at each of the eight banks (Figure B1.5.2). An individual bank assessment also revealed that only one bank would register a core capital ratio above 10 percent after default of top five borrowers.

In all shock scenarios, the liquidity ratio remains at 58.9 percent, significantly above the prudential requirement of 25.0 percent. Applying haircuts on liquid assets did not significantly affect the liquid ratio position. On an individual bank basis, six out of eight banks withstood the liquidity shocks, as evidenced by liquidity ratios remaining well above the prudential benchmark.

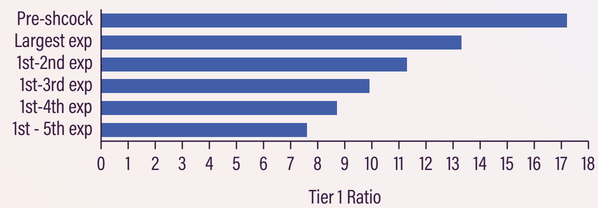
The stress test also showed that the sector is able to withstand a mild to moderate run on deposits. This scenario tested the sector's ability to withstand the withdrawal of customer deposits (survival period: five days, and a daily deposit run of 10, 20, and 30 percent on full liquid assets). The result shows that the sector remained resilient in the minor case scenario for both system-wide and bank-specific shocks. The sector became vulnerable in the moderate case scenario at the system-wide level, and in the major case scenario for both the system-wide and bank-specific shocks. At the individual level, five of the eight banks were able to meet customer demand for deposits in the minor system-wide and bank-specific shock scenarios.

FIGURE B1.5.1 Capita ratios decline with a major deterioration of asset quality



Source: World Bank estimates based on RBM data.

FIGURE B1.5.2 Capital ratios deteriorating with successive default of top five borrowers



Source: World Bank estimates based on RBM data.

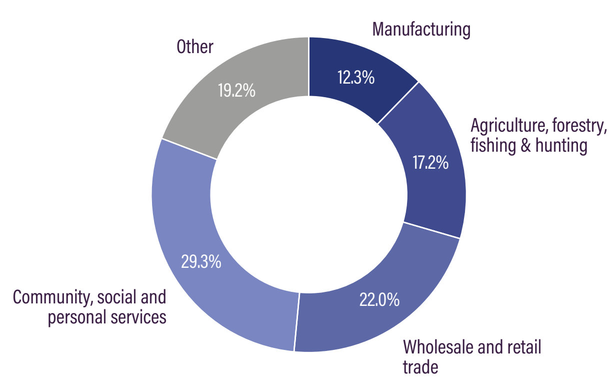
Exposures beyond single obligor limits by granting temporary waivers have created credit risk in the banking industry. The waivers are mostly granted by the RBM on exposures to borrowers in the country's strategic sectors, such as for the importation of fuel and fertilizer, but with increased credit risks.

Note: * When a bank takes a 'haircut', this means that it accepts less than the sum that was due in a particular loan account.
Source: RBM, December 2021: Financial Stability Report.

Private sector lending continues to grow, though sectoral concentration remains high. Private sector lending increased from a monthly average of MK 450 billion in 2019, to MK 616 billion in 2020 and MK 746 billion in 2021. It averaged MK 847 billion per month between January and March 2022. In terms of the distribution of credit by sector in 2021, gross loans and leases remained concentrated in three sectors, namely: (i) community, social and personal services, which for 2021 accounted on average for 29.3 percent; (ii) wholesale and retail trade, accounting for 22.0 percent; and (iii) the agriculture, forestry, fishing and hunting sector, at 17.2 percent, while the manufacturing sector accounted for only 12.3 percent and the remaining sectors accounted for a total of only 19.2 percent (Figure 1.25). At the end of December 2021, the top three sectors collectively accounted for 68.5 percent of the total loan portfolio. Similarly, over 60 percent of NPLs were concentrated in these three sectors: wholesale and retail trade (34.7 percent); community, social and personal services (16.4 percent); and agriculture, forestry, fishing and hunting (10.9 percent).

FIGURE 1.25 Private sector credit growth has continued

Average of monthly share to total lending in 2021



Source: World Bank staff calculations based on RBM data.

1.3

MEDIUM-TERM ECONOMIC OUTLOOK

Risks to the Malawian economy are decisively tilted to the downside. Under baseline assumptions, Malawi's economic growth is expected to decline in 2022.[11] Rather than driving the economic recovery as in 2021, the agriculture sector is expected to contract in 2022, caused by weather-related shocks. Likewise, industry and services will suffer from the damaged infrastructure caused by the recent cyclone, particularly for electricity generation. This baseline scenario assumes adequate action by the authorities to tackle current macroeconomic challenges. While there remains scope for decisive measures to lead the economy to outperform baseline projections, adverse risks still prevail. These risks include unaddressed macroeconomic imbalances weighing down the economy, a further deterioration of the international economic context, and potential additional COVID-19 variant waves further impacting economic activity.

The downward adjustment of the Malawi kwacha and a move toward a floating exchange rate will help rebalance Malawi's external position. A more flexible Malawi kwacha means that the price mechanism is reintroduced to balance Malawi's external trade. While many prices already reflected market-clearing rates prior to the exchange rate adjustment, rising prices for Malawi's critical imports and wider availability of foreign exchange could expand the trade deficit in the short term, though higher import prices will likely result in a decline of imports. In the medium term, a weaker Malawi kwacha will boost the competitiveness of Malawian enterprises in both domestic and international markets, improving Malawi's external position.

Malawian businesses and consumers will likely have to expect higher Malawi kwacha prices for fuel and electricity. The exchange rate adjustment will also likely trigger a change in tariffs by Malawi Energy Regulatory Authority under the Automatic Pricing Mechanisms. Whether these steep price rises are one-time events will depend on the decisiveness of action by the authorities. Prudent monetary policy, as announced by the RBM, together with a more constrained fiscal policy, will better support exchange rate management than has been the case in the past, and thus support price stability. However, such policies may imply further adjustments to the policy rate in response to inflationary pressures, RBM open-market operations to neutralize foreign exchange purchases, tight liquidity and rising interest rates in financial markets and, crucially, decisive further reductions to the fiscal deficit.

Rising food prices will exacerbate an already tense food security situation. Poverty, frequent climate-related shocks, and implementation challenges in key areas of agricultural policy mean that one-third of Malawians are already chronically food insecure (IPC Global Support Unit, 2022). In an environment in which food-related commodity prices are escalating, outside support and government spending will need to make up for potential shortfalls. While historically Malawi has imported close to half its wheat from Ukraine and the Russian Federation, indirect effects of the conflict are more likely to aggravate the already tense food security situation. Global price pressures on edible fats and fertilizers are

11. In light of the exchange rate adjustment announced on May 26, 2022, the World Bank's macroeconomic projections are being revised and new forecasts will be published in the coming months.

already influencing domestic markets, pressuring low-income households. While nationally sufficient quantities of staples will be available, access by the most vulnerable remains difficult.[12]

Spending pressures in response to weather-related shocks and the unpredictable impacts of the Russia–Ukraine conflict will test deficit reduction efforts. The impact of climate-related shocks, as well as higher energy prices and the increasing costs of production driven by the Russia–Ukraine war, could further constrain domestic activity. This will likely trickle down into reduced tax revenue performance, while regaining foreign exchange availability might have more delayed positive impacts. Higher fertilizer payments under the AIP, driven by both program inefficiencies and high fertilizer prices, also pose a fiscal risk. In addition, elevated domestic prices could lead to increased government spending in goods and services, and thus result in expenditure overruns. Whether these pressures will lead to fiscal slippage will depend on the Government's ability to reprioritize and adjust other less-pressing expenditures.

Public debt will remain elevated in the medium term. Government borrowing to finance deficits will contribute to additional uptake of domestic debt, further crowding out private sector investment (IMF, 2018). Depending on how much currency risk is held by the Government, the 25 percent adjustment of the Malawi kwacha could significantly increase debt stock as a share of GDP, from 59 percent to between 64.6 and 66 percent.[13] Interest rates on domestic and external debt are also increasing and may further worsen the debt-servicing burden.

Rebuilding foreign reserves could take several years, exposing Malawi's economy to risks in the meantime. The low level of foreign reserves is inadequate to mitigate external shocks, especially given increased global fuel and fertilizer prices. It will take several years of determined action by the RBM to rebuild an adequate cushion of foreign exchange reserves. In addition, increasing commercial borrowing to stabilize the exchange rate and maintain the reserve position increases the risks of an external financing interruption, which would have potentially severe implications on growth and macroeconomic stability.

Policy Options: Reducing macroeconomic imbalances, supporting the recovery of growth, and protecting the poor against shocks

In 2022, the Government has begun implementing critical policy reforms to address macroeconomic imbalances, but further action is needed to ensure a rapid stabilization and a return to higher levels of growth. Following limited progress in 2021, the Government has taken important steps in 2022 to address macroeconomic imbalances, including the adjustment of the official exchange rate, advancing the implementation of the revised COGA, moving to reform the AIP, and approving the 2022 Public Finance Management Act. In parallel, support to the poorest is being expanded significantly through an expansion of cash transfer programs. Moving forward on announced policy reforms and implementing agreed strategies have become more important than ever to address economic distortions and support sound economic management. Several critical reforms are still being finalized, including supporting more flexible exchange-rate management with appropriate monetary and fiscal policies, debt restructuring and key PFM reforms.

The 15th edition of the Malawi Economic Monitor proposes a policy agenda to address macroeconomic imbalances in the short term and enhance private sector-led growth in the medium term, while protecting the poor and most vulnerable:

12. Current projections indicate a 2022 maize harvest of 3.8 million tons against a need of 3.5 million tons. While post-harvest losses typically consume 10 percent, Agricultural Development and Marketing Corporation and Strategic Grain Reserve stockpiles of up to 0.3 million tons in addition to those owned by private traders are likely to be nationally sufficient.

13. In an extreme case, where all currency risk and Malawi's external debt is held by the borrower, external debt stock as a share of GDP would increase from 31.9to 39.9 percent.

i) *Restoring macroeconomic stability.* A coordinated package of reforms is needed, encompassing fiscal consolidation, a debt workout, the institutionalization of a flexible, well-supported exchange rate regime, and improved governance.

ii) *Enhance competitiveness and market-oriented growth.* Economic diversification and export growth will be essential to increase overall growth.[14] This requires taking advantage of the increased competitiveness of Malawi's exporters following the exchange rate adjustment, including by focusing on agricultural commercialization and productivity growth, implementing the new National Export Strategy, and strengthening the institutional framework for private sector development.

iii) *Protecting the poor and strengthening resilience.* Vulnerability to external shocks and austerity measures could negatively impact poor and vulnerable households in the short term. Social protection programs must be reinforced to prevent deterioration in consumption and welfare.

Fiscal management pressures and the need to protect the vulnerable make it critical to ensure increased efficiency of expenditure and high-quality service delivery at the local level. In this context, Part 2 discusses the importance of deepening fiscal decentralization, strengthening the intergovernmental fiscal transfer system, and delivering quality services that reach poor and vulnerable households.

TABLE 1.2 Priority policy areas and key actions

1. Restoring macroeconomic stability			
Addressing fiscal pressures	Continue fiscal consolidation efforts, starting with the implementation of reforms to improve targeting under the AIP.	short*	
	Strengthen budget planning and prioritize expenditures in a sustainable medium-term fiscal framework.	medium	
	Undertake a rigorous cost-benefit analysis and screening to manage public investment projects efficiently.	medium	
Addressing public debt vulnerabilities	Enhance public debt transparency by expanding the coverage of public debt reports to include comprehensive information on contingent liabilities and outstanding payments.	short	
	Develop a new medium-term debt strategy with a focus on bringing debt down to prudent levels.	medium	
	Explore approaches with creditors to revert currently unsustainable debt levels back to viable quantities.	short	
Improving public finance management	End overspending on budget allocations by implementing commitment controls and implementing a framework for cash management that supports more efficient service delivery and catalyzes development partners' and public trust.	short	
	Implement the Public Finance Management Act in a way that fulfills the legislators' intention.	medium	
Improving exchange rate management	Institutionalize an exchange rate regime that sustainably provides foreign exchange to buyers.	medium	
	Support new exchange rate flexibility and RBM foreign exchange purchases with tighter monetary policy, including through RBM balance sheet operations.	short	
	Soften and eventually abolish measures such as mandatory conversions.	medium	
Mitigating credit risks to ensuring banking stability	The RBM should consider conducting more frequent horizontal reviews of concentration risk to detect any vulnerabilities across the system.	short	
	Phase out single exposure limit waivers altogether, which are a major cause of credit concentration risks in the banking system.	medium	

14. Export promotion is a time-consuming and strenuous process that will require comprehensive action across all Malawian authorities. However, it nevertheless makes sense to pursue a market of about US$28.5 trillion, the volume of global trade in 2021, rather than a US$14 billion domestic market.

2. Enhancing country's production base, competitiveness and export market-oriented growth		
Strengthen the institutional framework that underpins implementation of the COGA, including on the generation of accurate data, coordination and sharing of data among relevant stakeholders.	short	Sustain
Clarify objectives and adjust medium-term strategy of AIP, by developing and publicizing a clear roadmap for farmers to maximize the program for productivity while ensuring value for money.	medium	Initiate
Implement the country's new National Export Strategy, promoting access to key regional and global markets, such as the African Continental Free Trade Area.	medium	Initiate
Increase access to reliable power by strengthening the governance of the sector and providing adequate conditions for energy projects.	medium	Strengthen
Promote longer-term and more affordable financing options for the private sector, particularly smaller enterprises, by fostering conducive aggregate financing conditions and stimulating a competitive financial sector	medium	Strengthen
3. Protecting the poor and strengthening resilience		
Scale up low-cost, high-impact health interventions, and especially vaccines, to protect people from the COVID-19 pandemic and polio.	short	Sustain
Expand cash transfers to help vulnerable households afford food and other necessities from local markets.	medium	Sustain
Expand public works programs.	medium	Strengthen
To enhance long-term food security, support improved nutritional practices and strengthen agricultural policy by focusing on more nutrient-dense foods than maize, and agricultural productivity bolstering measures.	Medium	Strengthen

Initiate Phase out Sustain Strengthen

Note: *short term—actions for the next 3 to 6 months; medium term—actions for the next 6 to 18 months.

2

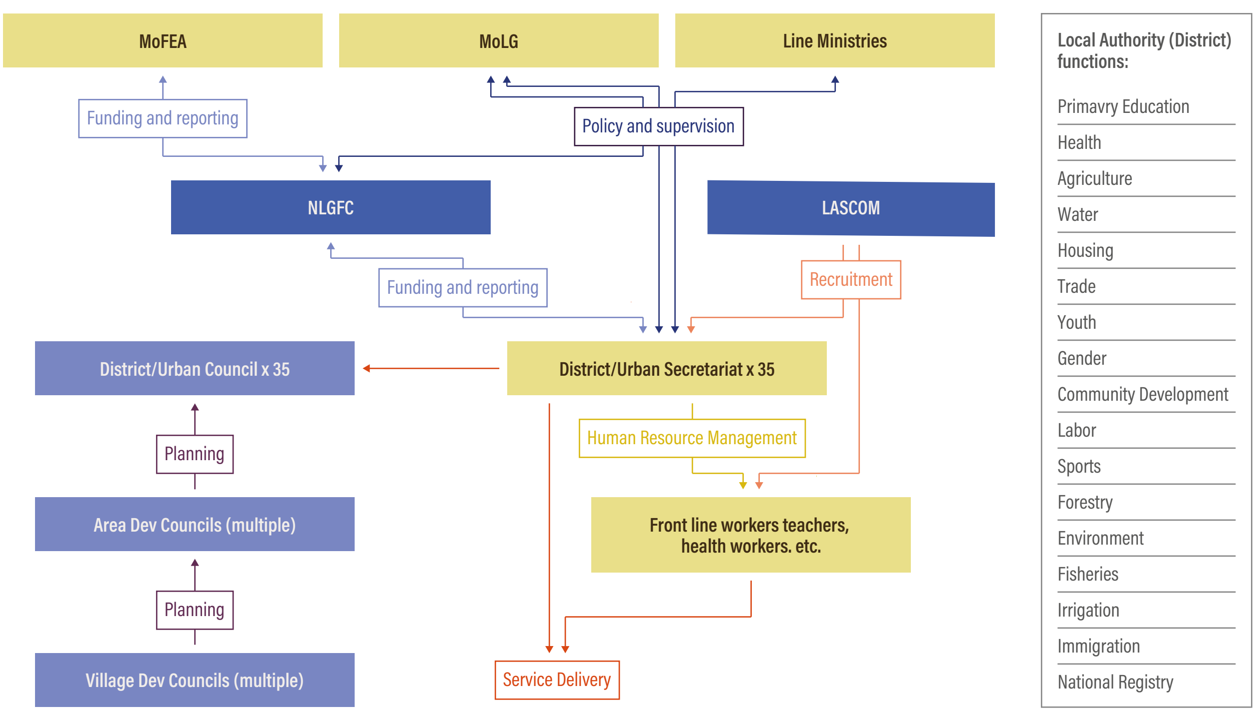
DEEPENING FISCAL DECENTRALIZATION FOR ENHANCED SERVICE DELIVERY

Deepening fiscal decentralization is a key vehicle for enhancing service delivery in Malawi. This agenda has become even more important with fiscal space now severely constrained, as a result of multiple recent shocks aggravating poverty and disparities across regions. This chapter examines the status of financing of decentralized local service delivery in Malawi and the opportunities that exist moving forward. Malawi's intergovernmental fiscal transfer system (IGFTS) is the primary mechanism through which decentralized local service delivery responsibilities are financed, but it has persistently failed to establish a match between policy commitments and fiscal outlays. This chapter presents an analysis of the performance of the IGFTS across five criteria, while also capturing the "coping mechanisms" that Local Authorities (LAs) have developed and utilize amid an historically unreliable system of local government financing. It also presents the early results of new results-based financing mechanisms that have been recently introduced to LAs, together with the opportunities these present to increase the level of confidence of both the Government of Malawi and development partners in the consolidation of development expenditures throughout local government systems.

Finance must follow function to deliver on Malawi's service delivery ambitions through decentralization

Malawi's national development strategies have consistently identified decentralization as a key vehicle for strengthening local service delivery. Decentralization is at the center of the policy reform agenda around the world, and is positioned as a mechanism to increase the voice of citizens and strengthen incentives for public officials to deliver services (Hart, T. and Welham, B., 2016; Faguet, J.P. and Pöschl, C., 2015). Decentralized service delivery was formally enshrined in the 1994 Constitution, as part of Malawi's transition to multi-party democracy. Decentralization ambitions were framed as the mechanism through which to diffuse political, administrative and fiscal responsibilities to newly established local governments, while also bringing services closer to citizens. Implementation was directed by the 1998 Local Government Act and the National Decentralization Policy, which empowered local governments to assume the planning, budgeting, implementation and management of service delivery for 17 devolved sectors. The Ministry of Local Government is the lead agency in coordination and implementation of the decentralization policy, the NLGFC guides the implementation of the IGFTS and financial management in LAS, while central sectoral ministries are meant to retain responsibility over policy formation, inspectorates, monitoring, training/curriculum, and the establishment of standards (Figure 2.1). These delivery ambitions, in turn, have been reflected in Malawi's recent medium-term development strategies, including Malawi Vision 2063 and the Malawi Development Growth Strategy III, both of which call for full devolution to allow local governments to play a more effective role in delivering on these priorities and investing in secondary cities in their localities to drive Malawi's growth agenda.

FIGURE 2.1 Decentralized roles and functions



Note: LASCOM = Local Government, Ministry Of, Local Government Service Commission; MoFEPD = Ministry of Finance and Economic Affairs, Economic Planning and Development; MoLG =Ministry of Local Government.
Source: World Bank (2020b).

Malawi's decentralization pathways should be analyzed with attention to their underlying political economy drivers and cannot be solely analyzed from a technical perspective. In countries across the world, the decision to embark on a decentralization reform agenda rarely happens solely because politicians simply want to improve service delivery, but is more often driven by broader and more complex political factors (Hart, T. and Welham, B., 2016). Malawi's economy is marked by the relative absence of private sector rents (Said, J. and Singini, K., 2014), which attracts political competition for control of the aid-dependent capital budget. In practice, this means that decisions surrounding the decentralization of funds are often the result of strong incentives for political leaders and central ministries to retain control of resources for capital expenditure, while also retaining attribution for delivering tangible development outputs to citizens (Chingaipe, H. et al., 2015; Chiweza, A., 2016; Chiweza, A., 2015; United States Agency for International Development, 2016; O'Neil, T. et al., 2014; Tambulasi, R. and Chasukwa, M., 2014). This is notably illustrated by the two most devolved sectors—education and health—which still see central government continuing to manage capital investment and expenditure, procurement and the distribution of materials (medication, textbooks, etc.), and even many small-scale public works. This is mirrored at the local level where those funds that are decentralized become victim to excessive fragmentation, although this does also allow for the costs and benefits of development spending to be spread out across many actors. This all contributes to an incomplete and uneven implementation of decentralization, in which the center is selective and slow in transferring functions and funds to local governments, while continuing to make public commitments to the principles of decentralization, such as in the Malawi Vision 2063.

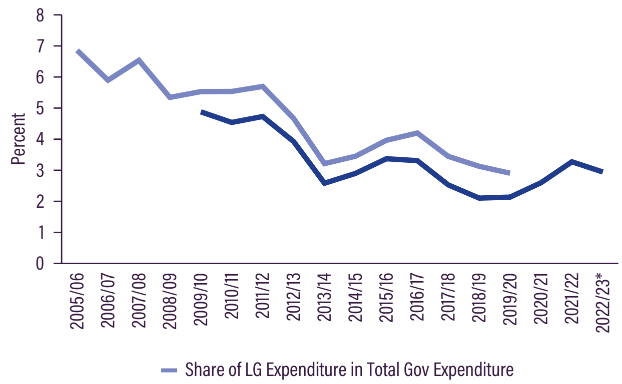
The reality of decentralized service delivery in Malawi to date has therefore been characterized by overlapping mandates/responsibilities, both between and within each level of government. On paper, sector policies reflect elaborate norms and ambitious standards on equity, affordability and access. These policies are supposed to be matched by expenditure allocations that support the functions for which local government is responsible, the corresponding costed budgets for service delivery, and the degree of discretion that local governments have to make decisions on how to deliver services. In practice, however, decentralization reforms have been rolled out in a fragmented, uneven and incomplete fashion, given that: (i) central ministries, departments, and authorities (MDAs) continue to retain control over expenditure responsibility for a high percentage of development and capital investments; (ii) service delivery standards are not being costed to give a sense of the minimum cost implications of providing the mandated local government services; and (iii) for those funds that are transferred to LAs, central MDAs have rarely developed sector guidelines that indicate basic information regarding the specific transfers (e.g., objectives/purpose, allocation formulas) or guidance on how the funds should be used (eligible/ineligible activities) (UNICEF and ODI, forthcoming). This is further complicated by the fact that the many sectors are funded by, and significantly dependent on, development-partner support provided off-budget. This has manifested in a reality where Malawi is more functionally exhibiting a highly deconcentrated model of fiscal decentralization (Chinsinga, B., 2009).[15]This results in service delivery mandates/responsibilities that are co-occupied, where the functions to plan/prioritize, budget, procure and deliver the services are carried out by both central MDAs and LAs in the same arena. In sum, this has had the effect of uncoordinated planning and decision-making over service delivery across levels of government, with sector and district processes often occurring in parallel and overlapping ways (O'Neil, T. et al., 2014).

The cumulative effect of these dynamics is a system of fiscal decentralization in which finance has not followed function. Malawi has never had a comprehensive fiscal decentralization policy that guides the allocation of fiscal resources from central government to local governments in line with their administrative responsibilities, public finance management rules, and institutional arrangements. Instead, the primary drivers of large-scale shifts in the decentralization of resources over the past two decades have been decisions made in by Parliament, often in response to expedient, political

15. Deconcentration is often considered to be the weakest form of decentralization and is used most frequently in unitary states, where it is characterized by a shift in responsibilities of from central government officials in the capital city to those working in regions, provinces or districts, or the creation of field administration or local administrative capacity under the supervision of central government ministries (World Bank, 1999).

pressures.[16] Outside of these events, the broader implicit policy appears to mean staying close to the nominal value of the previous year's budgets and transfers which, in a cash-based public finance system, are aligned far more toward revenue consequences of macro-fiscal volatility than to service delivery principles. Despite the fact that the principles of the National Decentralization Policy have been consistently reiterated in the majority of sector strategic plans since 1998, the share of local government expenditure has more than halved as a percentage of total government spending over the past 17 years (Figure 2.2). In turn, this has reinforced and deepened the capacity constraints facing local government officials, who are tasked with carrying out their service delivery responsibilities in the face of an often unreliable system of fiscal decentralization.

FIGURE 2.2 Local government expenditure as a share of total government expenditure (FY2005/06 – FY2022/23)



Note: *Budget estimates.
Source: GoM Budget Execution Data.

Despite these challenges, there have been a number of meaningful policy choices in favor of decentralization over the past few years that present an opportunity to incentivize the improved delivery of services to citizens. These reforms have been driven by the need to respond to widespread public discontent regarding the quality of service delivery, while also addressing pressures from political fragmentation. This renewed momentum for decentralization has led to reforms that include the following:

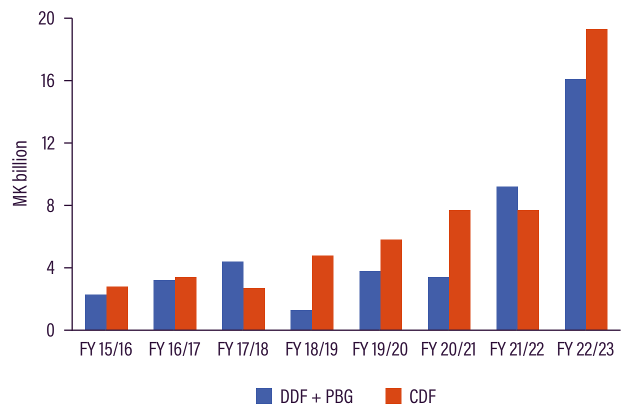
- In 2014, the re-introduction of elected Local Councilors (the first elections in 10 years);
- In 2016, the introduction of the DDF, for the first time providing discretionary development resources for councils to address local priorities;
- In 2017, the long-planned devolution of human resources shifted tens of thousands of personnel from central ministries to district administrations with recruitment managed by the Local Authority Service Commission;
- In 2018, the merger of the National Local Government Finance Committee (responsible for intergovernmental fiscal transfers) and the Local Development Fund (responsible for managing local development funds and institutional capacity building) into a single entity;
- In 2021, the introduction of the PBG to the 28 rural District Councils, providing local governments with the opportunity to significantly increase their access to discretionary development funds (to complement the DDF), but tied to performance and results as measured by the Local Authority Performance Assessment (LAPA); and
- In 2022, the legislative and regulatory reviews of the Local Government Act and the National Decentralization Policy are being conducted for the first time in 20+ years.

Development transfers have increased in volume and as a percentage of the transfer pool in recent years, presenting both an opportunity and a risk. Development transfers have become a dynamic arena for political contest at both the national and local levels, with Members of Parliament (MPs) and Local Councilors each contesting for the credit of delivering development projects to their constituents. Until

16. This includes the introduction of the Boreholes Fund, which provides equal, earmarked funding for boreholes in every constituency, the Community Social Economic Projects, which was introduced in FY2017/18 and viewed as a reward for voting down electoral reforms legislation in November 2017, and the systematic increases in the CDF, which started at 6 million inhabitants per constituency in 2006 and increased to 100 million inhabitants per constituency in the most recent FY2022/23 budget.

2015, the only transfer for development purposes was the CDF—an amount allocated to each MP for development projects in their respective constituencies and initially introduced at MK 7 million per constituency. In FY2015/16, the Government of Malawi introduced the DDF which, for the first time, provided a broadly discretionary development fund for LAs, to be used for capital investments in any of their devolved functions.[17] Since that point in time, while the DDF has stayed relatively constant, the CDF has steadily grown, driven by the demands of parliamentarians and, most notably, was increased by 2.5 times in the FY2022/23 budget, to MK 100 million per constituency. The introduction of the PBG in FY2021/22 now serves as a significant supplement to the DDF (but one that is tied to performance) for District Councils. In sum, this has resulted in a notable increase in the development funds devolved in the name of decentralized development and service delivery, but with each of these aligning with the interests of different political leaders located in different levels of the state (Figure 2.3).

FIGURE 2.3 "Discretionary" development funds for LAs (FY2016/17 – FY2022/23)



Source: GoM Budget Data and World Bank.

For a meaningful deepening of decentralization to continue, the vicious cycle of low trust → low investment → low accountability in local governments needs to be broken. Malawi's decentralization journey is currently stuck in a messy middle. Allegations of low local government capacity have historically served as a justification for retaining funds at the center and/or for significantly earmarking funds through conditional transfers (which means that, in many instances, local governments are demoted to the role of implementing organs of the central government, rather than governing agents in their own right). At the same time, what at face value is often deemed poor governance or a lack of capacity is sometimes the manifestation of coping mechanisms by local government officers, who are required to bend the rules to carry out service delivery responsibilities in the face of underfunded service delivery mandates and an unreliable fiscal transfer system. As a result, this makes it difficult to distinguish "coping" from "corruption", and helps to reinforce the status quo.

The recent introduction of results-based financing to local government presents a new opportunity to influence the incentives driving this cycle, with the objective of establishing an architecture that increases confidence to consolidate development expenditures through local government systems. The significant increase in discretionary development funds that has been recently made available to District Councils—headlined by the introduction of the PBG—presents a significant opportunity to influence this dysfunctional cycle. This significantly boosts the predictable discretionary development financing made available to local governments, but at the same time by tying access to these additional funds to transparency, accountability and the achievement of results. The PBG alone cannot and will not shift Malawi's decentralization pathways, particularly given the significant increases in the CDF in the recent budget, which is meant to deliver similar development outcomes but with differing accountability pathways to MPs. However, if capitalized upon, the PBG has the potential to lay the foundation for a more coherent framework for performance-based national service delivery systems across multiple financing streams by serving as a proof-of-concept to demonstrate the potential for streamlining the Government's and development partners' funding through local government systems.

17. Urban LAs have received an Infrastructure Development Fund since 2005.

Malawi's Intergovernmental Fiscal Transfer System — Parameters, Coping Mechanisms and Service Delivery

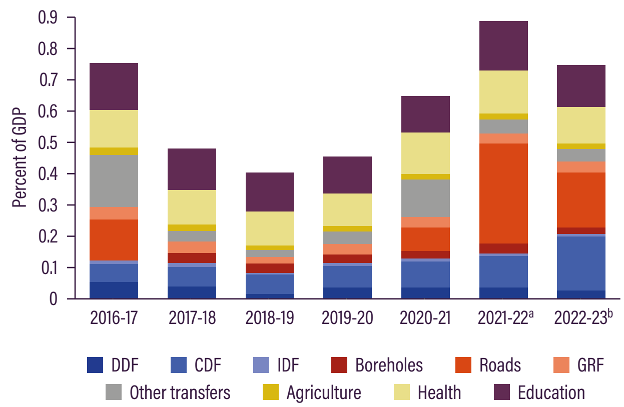
Malawi's IGFTS is the primary mechanism by which decentralized local service delivery responsibilities in Malawi's 28 rural District Councils are financed. In FY2019/20, fiscal transfers represented 88 percent of on-budget financing for Malawi's 28 rural District Councils, with the balance primarily funded through own-source revenues (OSR). City Councils and Municipal/Town Councils, on the other hand, fund 75–80 percent of their budgets through OSR (UNICEF and ODI, forthcoming). Since OSR is not tied to any specific services, cities and towns have significantly more financial autonomy vis-à-vis the national government and, as a consequence, their expenditure allocations vary significantly from their rural peers. This Special Theme primarily focuses on the performance of the IGFTS and its role in fiscal decentralization, since it is the primary source of service delivery funding for rural District Councils, in whose districts over 85 percent of Malawians and over 90 percent of poor Malawians live. The financing of local service delivery in urban areas (i.e., City and Municipal/Town Councils) is becoming increasingly critical, however.

The IGFTS is characterized by a large number of fragmented transfers that are primarily earmarked or conditioned by the center. The system comprises 33 different transfers, which can be broadly broken into three categories: (i) development transfers reserved for capital investments; (ii) the GRF, originally designed as flexible funding for LAs (development or recurrent spending), but that is now only sufficient for District Councils to fund basic administrative and policy functions; and (iii) non-wage other recurrent transactions (ORTs), earmarked for specific sectors (Figure 2.4). Across these three categories, only 8 percent of the total transfers in FY2021/22 were "discretionary", such that local governments control how the funds are used and for which they are directly accountable to their local citizens. The bulk of the transfers are represented by ORT transfers to 17 sectors earmarked for activities and in effect undertaken by local governments on behalf of higher-level entities. Although personal emoluments account for 75–80 percent of all budgeted funds at the local level, these funds are not part of the transfer formulas and are never actually transferred to local council accounts.

Any system of intergovernmental fiscal transfers can be described and evaluated according to five parameters. These are adequacy, timeliness, predictability, transparency, and equalization (World Bank, 2020a) (see Box 2.1). In line with this approach, each sub-section below defines the parameter and explains why it is important in terms of governance and service delivery. It then presents a brief analysis of its performance in Malawi and, in turn, examines how its performance influences the "trust-investment-accountability" cycle, and the ways in which LAs have evolved in practice to carry out their service delivery responsibilities through "coping mechanisms".

FIGURE 2.4 IGFTS transfers by category as a share of GDP

Fiscal Transfers



Note: Red shade areas designate development expenditure.
a. Preliminary, b. Budget.
Source: Staff calculations based on data from UNICEF and ODI (forthcoming), MoFEA, and IMF WEO 10/2021.

BOX 2.1 Parameters of intergovernmental fiscal transfer systems

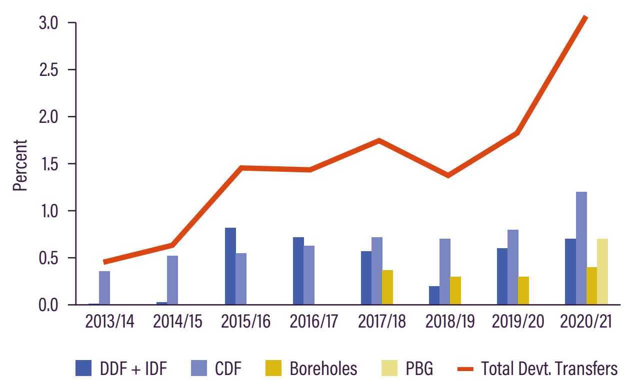
1. **Adequacy:** The extent to which transfers made to subnational authorities match the expenditure needs they face in meeting the governance and service delivery obligations assigned to them as a result of national policies or laws.
2. **Predictability**: The degree to which end-of-year receipts match budgets approved at the beginning of the year.
3. **Timeliness:** The congruence between the administratively stipulated dates of transfers and the actual dates when transfers are received.
4. **Transparency:** The degree to which the transfer formula is known and is adhered to, and budgeted shares and actual receipts are reported on and published.
5. **Equalization:** The extent to which transfers are pro-poor and aim to provide equitable access to services regardless of endowment, fiscal capacity and cost of delivery.

Adequacy

Revenue adequacy refers to a central normative principle underlying decentralization, namely, that finance should follow function. Technically, revenue adequacy is a measure of the extent to which transfers made to subnational authorities match the expenditure needs they face in meeting the governance and service delivery obligations assigned to them as a result of national policies or laws. Correcting the vertical imbalance that results from differences between the revenues assigned to local governments and their statutory obligations is a necessary condition for achieving the full benefits of decentralization. While full adequacy is elusive in any system, the legitimacy of a system of decentralized governance is signaled by the responsiveness and trends of budget outlays made by central government and transferred so that local governments can credibly discharge their responsibilities.

Overall, there are no meaningful, evidence-based standards in place to measure the adequacy of Malawi's IGFTS. Due to the lack of costed service delivery standards, no meaningful estimates can be made of the vertical imbalance arising out of the decentralized expenditure and revenue assignments in Malawi,[18] nor is there a clear policy on the extent to which the vertical imbalance is to be corrected. The only normative target that exists is the 1998 National Decentralization Policy, which stipulates that no less than 5 percent of National Net Revenue (NNR) should be "set aside for LGAS' development". However, the definition of how this is measured remains unclear and no commitment has been made in recent years to meet this target. Using conservative estimates, the GRF only constituted 0.3 percent of NNR in FY2021/22 and the combined value of all development funds to LAS only exceeded 2 percent of NNR for the first time in FY2021/22 with the addition of the PBG (UNICEF and ODI, forthcoming). (Figure 2.5).

FIGURE 2.5 Development transfers as a share of NNR (FY2015/16 – FY2020/21)



Source: GoM Budget Data.

Recurrent financing to District Councils has failed to keep pace with this increase in development funding. In FY2021/22, ORT represented 44 percent of the transfer pool to District Councils compared with an average of 90 percent per year of the pool in the period 2009–2015. At the same time, a systematic analysis of transfers across sectors reveals a consistent decrease in real, per-capita terms over the past six years, declining by between 25 and 45 percent in almost all LAS from 2014 to 2021 (World Bank, 2020a; UNICEF and ODI, forthcoming).This decline is most notable for the key decentralized sectors, such as health and education, which have declined in real terms by 24 and 17 percent, respectively, over the past four years, despite the continued deconcentration of service delivery responsibilities and increase in development expenditure to manage (UNICEF and ODI, forthcoming). Equally, the GRF has declined by 20 percent in real terms over the same period. While the GRF was originally designed with the expectation that it would serve as an unconditional transfer for both development and recurrent expenditure, it is now effectively used as ORT for district administrative functions and councilors' allowances.

The effects of this persistent vertical imbalance risk neutralizing the development objectives of decentralization. While policy on the decentralization of service delivery obligations appears to have been revitalized over the past five years, there is no evidence that efforts have been made to correct the vertical imbalance. First, in the primary service delivery sectors of health and education, transfers have not grown (and have decreased in real, per-capita terms) despite the continued deconcentration of functions, such as the shift of all human resource management of front-line service providers (teachers, nurses/nurse-aides) to local government. Second, while development transfers have been increasing,

18. A costing of service delivery obligations in the social sectors and agriculture is currently being undertaken by the NLGFC and Ministry of Local Government with the support of UNICEF.

they are increasingly fragmented and growing at the expense of the DDF, which represents the only pool of truly "discretionary" development funds for LAs to implement their District Development Plans/ Annual Investment Plans, and that respond to local needs. Finally, this comes in the context of the lack of an overall vertical allocation strategy, leaving no policy lever or target to determine the true shortfalls in overall and sectoral transfer amounts, and their effects on service delivery. This has all contributed toward local governments arguing persuasively that they are being set up against impossible targets with sector ORT failing to grow in line with increased responsibilities, while the availability of funds is increasingly constrained.

This lack of adequacy is simultaneously weakening accountability at the local-government level. The effects of suboptimal adequacy on local governance and service delivery will manifest not only through underfinanced local mandates, but also through weakened accountability functions and fiduciary practices, as staff and councilors scramble to meet competing demands on a day-to-day basis (see Box 2.2). If adequacy is chronically suboptimal, service delivery is weakened. This undermines the legitimacy of local political processes (such as making plans and budgets, or reporting on expenditures and results), and results in citizen disaffection with local authority, thus over time corroding the basis of local political accountability.

BOX 2.2 LA coping mechanism — Internal borrowing

LAs are reported to sometimes resort to "internal borrowing" to fund priority expenditures. In this practice, insufficient budgets in a specific sector are ameliorated with funds dedicated to another sector. This can be done to alleviate cash-flow constraints (then the other sector receives funds from the priority sector later on), to circumnavigate red tape associated with specific budgets, or to boost overall expenditure in especially under-resourced sectors.

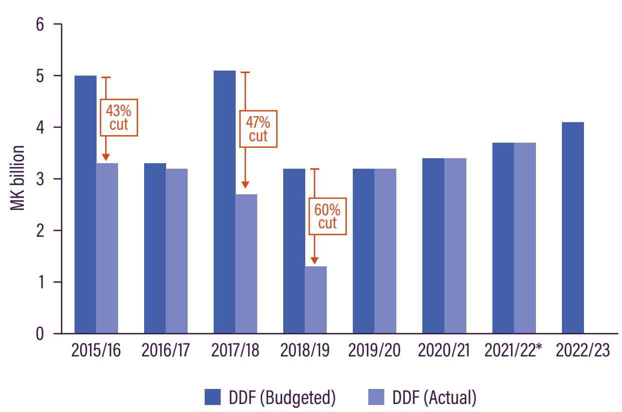
This practice, albeit emanating from understandable pressures, is illegal and corrupts accounting. Ultimately, it is accountability that suffers when the reported expenditure does not correlate with the delivered services. While additional sensitization to the gravity of the offence may be needed, more flexible budgets and budgets that are commensurate with the expected service delivery may be the primary solution.

Predictability

The degree of certainty associated with the amounts to be received in transfers by local government, as against the amounts denominated at the beginning of the year, is referred to as predictability. In other words, predictability is defined as the variation between amounts received over amounts appropriated in budgets in any given year. This is distinguished from timeliness, which measures the difference between the planned and actual dates of the transfers.

Predictability of the IGFTs in Malawi varies across transfers, but has been most variable for development transfers. For the largest transfers of sectoral ORT in health and education, there has been consistent predictability, both in the annual budgeted figures that have never decreased from the previous year, and in end-of-year receipts that have always been greater than 90 percent of the amounts budgeted. The GRF had historically exhibited consistency, but in FY2018/19 it only received 62.3 percent of the originally budgeted sum for that year. Development transfers display a divergent trend, with the CDF growing and receiving over 99 percent of the budgeted totals every year, while the DDF has been extremely volatile, both in budgeted figures and year-end receipts. This was evident in an average DDF cut of 38 percent per year in the mid-term between FY2015/16 and FY2018/19 (Figure 2.6) and variation across districts.[19] These cuts also led to intra-year

FIGURE 2.6 DDF budgeted vs actual (FY2015/16 – FY2022/23)



Note: *FY2021/22 prorated for shorter period nine-month fiscal year.
Source: World Bank staff calculations based on NLGFC and MoFEA data.

19. The Financing Agreement for the World Bank Governance to Enable Service Delivery project has contributed to reducing the mid-year volatility of the DDF since FY2020/21. Disbursement of the aggregate funds for the PBG for a coming fiscal year is conditional on the DDF: (i) Being budgeted at least at the previous year's amount, adjusted by Consumer Price Index; (ii) being funded in full at the amount budgeted; and (iii) 100 percent disbursement by the end of the first month of the fourth quarter of the fiscal year.

variability and the incentive to front-load expenditure, given that districts were only able to spend 10 percent of their budget allocations in the second half of the year.

Weak predictability of transfers is immediately felt in local governance and service delivery. Local-level planning and budgeting requires a reasonable degree of certainty in the flow of resources from the center. Where transfers are chronically unpredictable, common patterns emerge: local governments undervalue their plans and budgets; their support and supervision of service facilities becomes unreliable; they fail to meet contractual obligations with vendors and contractors (see Box 2.3); and they can absent themselves from their obligations to co-produce, together with communities, new civil infrastructure assets and maintain basic services. As local governments are compelled to push and pull available cash between competing payment demands, maintenance and service commitments suffer, and new investments take longer and cost more to complete. Again, the credibility of local councils is undermined, citizens refuse to take council business seriously, politicians become more likely to behave opportunistically, and the accountability of administrators becomes blurred by a myriad of ad-hoc arrangements and undocumented decisions.

BOX 2.3 LA coping mechanism — Contract splitting

In the face of increasingly unpredictable development transfers, many LAs resort to “contract splitting” to allow work to continue, while dealing with cash flow uncertainties. Under contract splitting, the project scope is split into more than one contract to allow for local contracting, cost minimization and better cash flow management.

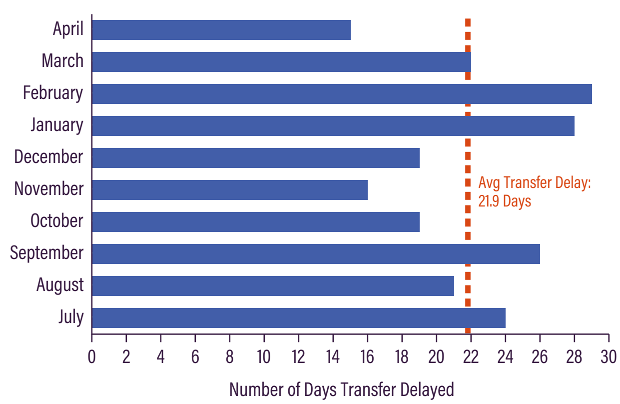
Despite these short-term benefits, local contracting often compromises on quality and is prone to local political influences. It also complicates project management with the Project Management Committee or the project supervisor assuming the role of project management, often coordinating between different contracts on a project. Supply contracts are often prone to weak supervision. On paper, the supply contractors are selected and given a schedule of prices. In practice, it is reported that, while agreed prices may be applied, verification of the quantity of goods delivered is not possible in all cases.

Timeliness

Timeliness refers to the correspondence between the administratively stipulated dates of transfers and the actual dates when transfers are received by local governments. Timeliness, therefore, is assessed by the lag between the two dates. The timeliness of transfers is crucially important where, as is the case in Malawi, LAs operate in a tight and precarious fiscal space with numerous expenditure responsibilities on which multiple service facilities depend for continuity.

Little hard data are available on the timeliness of transfers, but they often appear to be delayed. Data unavailability makes it hard to verify claims of chronic delays. The limited data from FY2018/19 that are available are presented in Figure 2.7. Regulations stipulate that all transfers should occur on the tenth day of each month. However, LAs received transfers, on average, only after 21.9 days, or the 22nd day of the month.

FIGURE 2.7 Average IGFT transfer delays during (FY2019/20)



Source: World Bank staff calculations based on NLGFC data.

Lack of timeliness affects local governance and service delivery in several ways. It results in delays in the payment of salaries of those staff on district payrolls, the delayed supply of essential materials to schools, clinics and other services, and the rescheduling of work on infrastructure projects, with potential cost overruns and imposts arising from grievance redress with vendors and contractors. When delays become a recurring feature of the IGFTs, the authorities may create standard operating procedures in the way local budgets are executed, such as by increasing debt and arrears (see Box 2.4). While these ad-hoc mechanisms may creatively mitigate the disruptions caused by untimely transfers, they can also have perverse effects on the quality of accounting, including the integrity of Integrated Financial Management Information System as an instrument for real-time transaction management and on the reliability of financial reports.

BOX 2.4 LA coping mechanism — Running up debt

LAs are entitled to create debt and other liabilities to finance service delivery, but districts make different use of this tool. The Public Finance Management Act of 2003 explicitly allows LAs to take out debt. However, many LA liabilities are arrears rather than planned debts.

LA liabilities are generally limited, especially compared with central government liabilities, only a subset of which is presented here (MK 4 billion for LAs vs MK 4.1 trillion nationally). However, this hides the issues that some District Councils face. Mzuzu City Council stands out, having had liabilities that were the equivalent to1.6 times its annual revenues on the books at the end of FY2019/20.

The framework for such borrowing is weak. There are no clear purposes for borrowing, nor does national law provide a framework for proceedings in the case of LA debt distress. Furthermore, without regular comprehensive reporting, the true scale of LA liabilities may be underestimated. LAs can access overdrafts and loans from local financial institutions such as banks. There is the Development Fund for Local Authorities, which was established as a Trust Fund in 1993, and which can provide debt and grant finance. However, between 2014 and 2021, the average annual loan was just MK 158 million, a relatively insignificant amount considering the large scope of LAs' financial responsibilities.

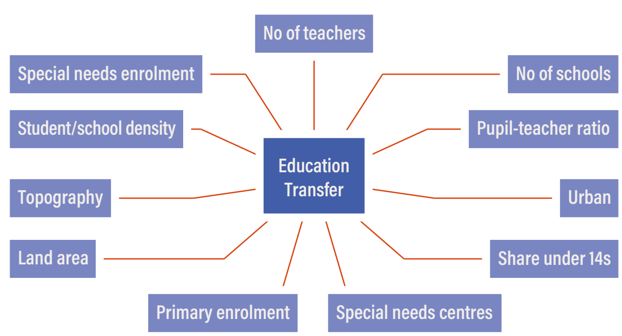
Transparency

A transparent transfer is one where officials and citizens know in advance how much funding they should receive based on clear formula criteria, and where actual receipts match those expected amounts. In contrast, opaque systems are characterized by stakeholders being uncertain as to how much funding they should receive. In addition, actual allocation may largely depend on discretionary decisions, which are hard to comprehend for many stakeholders.

Attempts to create transparent transfers in Malawi have focused on creating formulas. These formulas were formulated for each transfer category separately and have varying levels of complexity. They range from a fixed sum per constituency in the case of the CDF to a formula based on a dozen variables with different weights in the case of the education transfer (Figure 2.8).

Overly complex formulas mean that local officials and their constituents do not know how much money they are entitled to. While most officials and many Malawian citizens are aware that in FY2022/23 each constituency should receive MK 100 million for their CDF, it is almost impossible to understand how large their education transfer should be due to both the complexity of the formula and failures to publish the relevant budget data in a timely and publicly accessible way. Too many variables in an overly complex formula based on sometimes outdated or otherwise questionable data mean that few local officials or citizens know how much their district should receive.

FIGURE 2.8 Factors influencing the IGFTS for education as per the FY2019/20 formula



Source: World Bank staff illustration based on World Bank Malawi Public Expenditure Review2020.

In addition, the Government often does not adhere to the allocation formulas, giving rise to opaque transfers. For instance, the formula for DDF allocations dictates that it should be based on a split between 30 percent on equal shares and 70 percent based on a formula comprising population, land area, illiteracy and infant mortality. An overly weighted equal shares component is inherently problematic, as four LAs have to serve more than one million inhabitants from the same funds, while four LAs have to serve fewer than 100,000 inhabitants. Furthermore, before reforms to the DDF, actual allocations were made on an ad-hoc basis and even more equal shares, leading to per capita allocations in FY2017/18 ranging from MK 51 to MK 474. Ad-hoc decisions can also lead to a vicious cycle where lower-capacity LAs have less clout to lobby for funds, leading to even lower financial capacity.

Development partner-funded programs are often similarly opaque. With little coordination on the national level, development partners often select LAs for collaboration themselves. Even data-sharing on collaboration efforts is limited with the cessation of the national Aid Coordination Platform. Some LAs complain that the conditions for accessing development-partner funds are often unclear, sometimes to the degree that personal relationships are cited as a major driver in accessing grants. This makes it even harder for LA officials to understand how much funding they can access and can also lead them to becoming dependent on development-partner funds.

Equalization

To combat existing inequalities, intergovernmental fiscal transfers can be defined as a development instrument in two ways: (i) in a basic fashion, as being "pro-poor", with poorer districts receiving more resources; or (ii) in a more complex fashion, providing "equitable access to services" for all citizens, regardless of their place of residence, incorporating relative revenue-based endowment and fiscal capacity, as well as differentials in the cost of delivery. Therefore, the goal of equalization is to bring per capita revenues for service delivery expenditure to within a relatively narrow range across jurisdictions, while keeping local tax efforts comparable and based on the needs/costs of providing public goods and services.

Overall, the equalization effects of IGFTs in Malawi are weak. Because comparatively wealthy cities can raise more OSR, total revenues are higher in richer LAs (Figure 2.9). IGFTs account for this issue to a degree, such that these richer cities should receive smaller amounts from this transfer. However, the downward sloping line in Figure 2.10 shows that, outside of the cities, richer districts receive significantly more per-capita IGFTs. Little can be said regarding how equal service levels are across districts without the intensive triangulation of data. While single districts report certain achievements, there is no overall stock-taking on how well service delivery performs across districts. After all, more wealthy districts tend to also face higher costs and thus the money that districts spend may be an imperfect proxy for the amount and quality of services that citizens receive. Applying additional sectoral standards agreed upon by the Government can help clarify how well the money is translated into services, such as comparing some key education ratios across districts against normalized transfer amounts (Table 2.1). While this is imperfect and cumbersome, it could be used as a first step toward realistically operationalizing government standards across districts, to monitor and use the results to inform sectoral allocations through the IGFTs.

FIGURE 2.9 Total revenue per capita by 2020 poverty headcount

MK, National poverty headcount rate

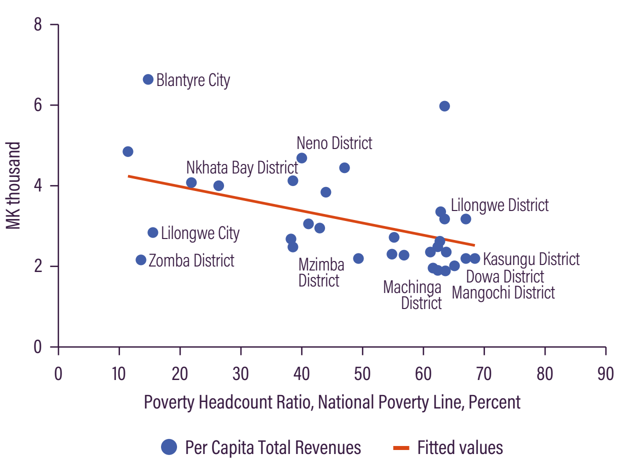
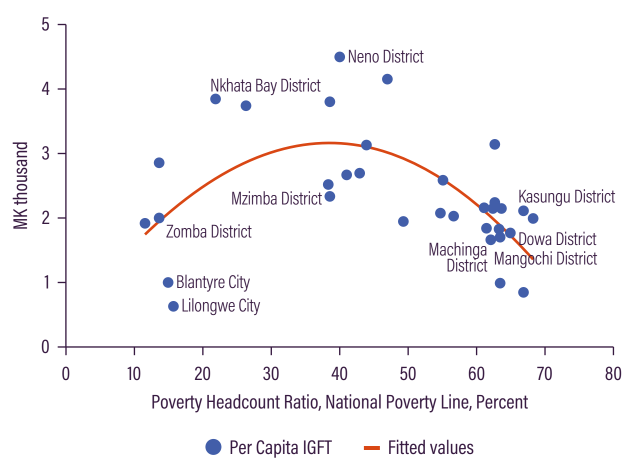


FIGURE 2.10 Total IGFT per capita by 2020 poverty headcount

MK, National poverty headcount rate



Source: World Bank staff calculations based on data from UNICEF and ODI (forthcoming) and World Bank Malawi Poverty Assessment (World Bank, forthcoming).

TABLE 2.1 Education service delivery standards vs. sample district outcomes

	Government Standard	Mangochi	Lilongwe	Mwanza
Teacher-pupil ratio	1:60	1:118	1:76	1:63
Pupil classroom ratio	60:1	151:1	149:1	114:1
Pupil/latrine ration	25:1 for boys and 15:1 for girls	106:1	100:1	70:1
Pupil/textbook ratio	1:1		3:1	11:1
Pupil desk ratio	2:1	15:1	10:1	6:1

Sources: UNICEF and ODI (forthcoming) and GoM LA socioeconomic profiles.

The large gaps in per capita transfers and limited awareness suggest that historical transfers may be exacerbating existing inequalities. For instance, in FY2019/20, Likoma District received IGFTs totaling MK 17,406 per inhabitant, while Neno District received MK 4,522 per inhabitant. Meanwhile, Machinga District only received MK 1,693 per inhabitant, or 10 percent of Likoma's allocation per capita. While services may be more expensive to deliver on an isolated island, this cannot fully account for such stark differences. Rather, many allocations appear to be driven by more equitable overall allocations originally made several years ago and subsequently follow a path whereby formulas are not applied on an annual basis, but rather are simply adjusted based off the previous year's figures. Reticence to embark on comprehensive formula review is often driven by political pressure to ensure no local governments "lose" in the short-term due to the changes, and any major changes in the formula should therefore be accompanied by hold harmless or grandfathering provisions to smooth equalization (Boadway, R. and Shah, A., 2007).

Weak equalization is further exacerbated as development-partner funds enter local jurisdictions. Due to the amount of development-partner support that is provided off-budget, little is known about the volume or sectoral breakdown of funds that are flowing to specific districts via fragmented channels. Aggregate data are not available to compare the size and effects of these programs, but anecdotal evidence suggests that there are wide variations across districts. This is therefore assumed to exacerbate the effects of weak equalization.

Results-based financing is triggering local government performance and accountability

The historical performance of the IGFTs as documented has reinforced the vicious circle of low trust → low investment → low accountability in local governments, but has also encouraged new pathways to potentially breakout of this cycle in Malawi. While it is widely recognized that decentralized service delivery can lead to greater efficiencies/equity/responsiveness of service delivery, the commitment to follow through by matching resources to functional responsibilities has been held back by a lack of trust in the capacities of local government systems by central government and development partners alike. This reticence, however, has further weakened the system of intergovernmental fiscal and accountability relations between central and local governments, which has further debilitated service delivery performance. The experience of decentralization across the continent (and globally) has highlighted that it is always a deeply politically contested process, but if strategically approached it can also present an opportunity to incentivize a results-oriented pathway toward deepening decentralization.

The Government of Malawi introduced a new PBG in FY2021/22 as a new funding mechanism to give District Councils the opportunity to significantly increase their access to discretionary development resources, but tied to the achievement of results. Over the past two decades, PBGs have become an increasingly utilized tool targeted at incentivizing institutional and service delivery performance in the region. Several useful lessons learned have been garnered in this period based on the opportunities and risks that the tool presents (see Box 2.5). In Malawi, the PBG is responding directly to the lack of discretionary development funds at the local-government level, serving as a de facto top-up to the

DDF for the 28 rural District Councils. This means that it is providing District Councils with increased funding and choice in the selection of priority projects in their District Development Plans in areas such as education (new primary schools, teachers' housing, etc.), health (rehabilitation and construction of health units, etc.), and transport (bridges and community roads, etc.). It is changing the traditional rules of the game, however, as districts' access to the PBG and the size of allocation that they receive are linked to their score on the annual LAPA (see Box 2.6). The incentive to perform is significant. In FY2021/22, the total PBG envelope was almost three times that of the DDF (PBG of MK 7.8 billion, vs DDF of MK 2.8 billion). The scale of these resources, in turn, has the potential to attract the increased attention of citizens and civil society to increase the demand-side pressure on local governments to deliver.

BOX 2.5 PBG risks and opportunities—Lessons learned on design and implementation

PBGs are a specific type of IGFT mechanism targeting local and subnational governments. They are typically designed to improve the institutional and service delivery performance of targeted subnational/local governments through a set of financial incentives, often in support of decentralization and devolution objectives of national governments across countries.

Over at least the past two decades, the World Bank has established an extensive portfolio of PBG financing programs supporting governments across several regions, and especially in low- and lower middle-income countries. These programs are generally characterized by a design that focuses on improving the institutional and infrastructure service delivery performance of targeted (grant-receiving) local/subnational governments through a set of financial incentives.

The success of a PBG program is ultimately dependent on the adaptation/responsiveness to the local institutional incentives, the policy enabling environment, and the broader macro-fiscal situation that the country is facing. A recent review of urban PBG programs globally highlighted the following key lessons learned:

i. *Design the PBG to ensure strong incentives:* Ensuring a substantial size of PBG is critical to adequately incentivizing local governments to achieve performance targets and give infrastructure investments a real impact.

ii. *Develop a credible, transparent assessment process:* It is essential to develop a performance measurement and assessment process that is rigorous, credible and objective enough to build trust among stakeholders and to adequately incentivize local governments.

iii. *Complement with targeted, fit-for-purpose capacity building:* Well-designed capacity-building support targeting specific performance areas that are institutional barriers for local governments to improve their performances, as well as assisting low-performing local governments to climb up the performance ladder.

A key consideration for PBG programs is how to sustain their impacts beyond the period of program financing provided by development partners such as the World Bank, and to embed the grant systems into the intergovernmental fiscal framework. This is fundamental to a successful decentralization process, and the institutional improvement and empowerment of local governments in the long run. In the early stages of programs such as Malawi, this is supported by: (i) focusing on improving existing government systems; and (ii) ensuring strong inter-governmental coordination and incentives for all stakeholders involved in the programs.

BOX 2.6 The LAPA and PBG cycle

Eligibility for the PBG and the amount of the performance element will be determined by the annual LAPA. While all 28 District Councils will be entitled to access the PBG on an annual basis, eligibility to do so will be determined through two sets of prior conditions in the performance assessment.

The first, called **Minimum Access Conditions**, are assessed against District Council performance in the previous fiscal year on two basic indicators, namely: (i) the submission of annual financial statements; and (ii) 100 percent compliance with the investment menu.

The second, called **Triggers**, are designed to ensure that District Councils have basic fiduciary safeguards in place to manage the coming fiscal year's grant. Each District Council must meet all Minimum Access Conditions and Triggers before any grant transfer is made.

Under the LAPA, District Councils are scored against three clusters of performance measures, designed to incentivize improvements on: (i) the delivery of quality investments that respond to community priorities; (ii) the efficient and accountable management of resources; and (iii) supporting frontline service delivery.

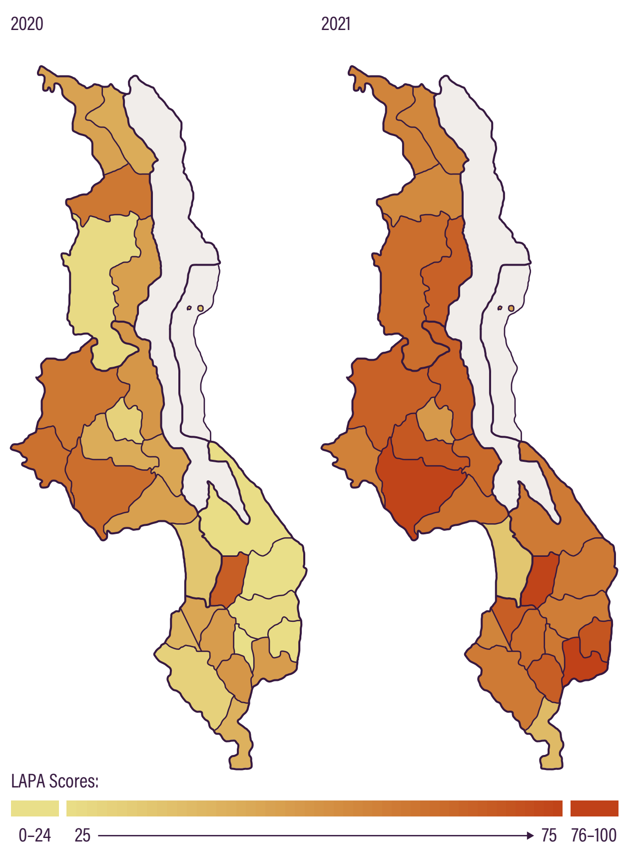
Performance measures are designed with the following principles in mind:

- Supporting compliance with existing regulations (laws, official guidelines, instructions);
- Addressing key blockages on district performance and service delivery;
- Objectively verifiable and measurable without ambiguity;
- Realistically under the control of, and attributable to, actions by the District Council;
- Potentially able to be improved upon within the annual inter-assessment period; and
- Prioritized and limited in number to maximize the incentive effect.

The incentive effect of the PBG has already begun to display its potential to unlock performance and impact accountability relationships between and within levels of government. Even in its first year, early evidence is showing that the PBG is triggering a revitalization of local government systems and procedures, including engagement by locally elected representatives, and further stimulating citizen demand. In the first cycle of the PBG in FY2020/21, 24 out of 28 District Councils qualified to access the grant, with only four districts missing out on the full year of resources as a result of obtaining an adverse opinion on their FY2019/20 audits. This outcome sparked multiple levels of contestation across accountability relationships in government, including: (i) District Councils challenging the National Audit Office on the consistency of their audit results; (ii) the Public Accounts Committee in Parliament and specific MPs contesting the performance of District Commissioners to understand why development funds were being withheld from their constituents; and (iii) local civil society organizations and the media demanding explanations from their elected councilors on why neighboring districts had received an injection of development funds that they had missed out on. While just one example, the PBG's injection of results-based development funds into the heart of local governance—the politics of setting budget priorities, allocating resources and converting them into small scale assets—has triggered accountability and performance into the aforementioned vicious cycle of trust.

Districts Councils have followed this with significant across-the-board improvements in their LAPA 2021 scores, exhibiting an unlocking of "capability" and challenging the narrative of persistent "capacity gaps" in local governments. The results of the LAPA 2021 exercise—the first assessment undertaken after the PBG resources were disbursed to qualifying LAs in FY2020/21—displayed a significant and widespread increase in scores. LAPA scores increased for 26 out of 28 District Councils, with an average increase of 20 points (out of 100) across all districts (Figure 2.11). Notably, the biggest leaps forward also came from the "poorest performing" districts in 2021, debunking concerns of a "capacity trap" in districts that could be reinforced by the PBG architecture. Analyzing the areas where the biggest performance gains were made, the results shows that in Year 1 it appears to have primarily unlocked ***capability*** (i.e., providing an incentive to execute on functions for which LAs have had the previous capacity to perform), such an incentivizing adherence to District Development Plans in the project planning/prioritization process for DDF and PBG projects, and supporting the production of systemic access to information on district DDF and PBG projects to citizens through multiple media channels. This lays to rest the opposing hypothesis that district performance can only be increased through an injection of ***capacity*** (where a lagged effect on results would be expected, irrespective). The PBG system is still in its infancy and, while encouraging, global lessons have proven that it will take several years of a combination of financial and institutional commitment from the highest levels of government for the architecture to take hold within government systems, and without which it can be vulnerable to political manipulation and/or fiscal shocks. Taking these risks into consideration, however, the early results are displaying new pathways in breaking the trust/investment/accountability vicious cycle that has been used as a justification for the lack of momentum in fiscal decentralization.

FIGURE 2.11 LAPA scores 2020 vs 2021



Source: GoM LAPA Task Force.

By increasing the confidence of both central government and development partners in consolidating development expenditures through local government systems, the PBG is serving as a proof-of-concept that has the potential to trigger fiscal decentralization reform. The early results of the PBG are providing examples of an architecture that can be leveraged to increase public trust in local governments as a vehicle for decentralization, while also embracing the incentives that have historically driven this inherently political reform agenda. If continued, the improved performance of LAs has the potential to build confidence in their ability to manage increasing resources in line with their devolved functions, laying the foundation for a coherent framework for national service delivery systems. Given the volume of service delivery funding that is currently delivered off-budget, this also paves the way for streamlining development-partner funding through national and local systems, thereby avoiding some of the complexities and distortions that arise from parallel development-partner funding streams, while also presenting a pathway forward for deepened decentralization.

Pathways are emerging to drive meaningful fiscal decentralization

Malawi's IGFTS is in need of reform. The present system reduces local governments, de facto, to spending units of the national government and, as such, it does not generate any of the putative benefits of decentralized governance in terms of allocative efficiency, or strengthened accountability, be this between citizens and the state, between local government sector managers and staff at the facility level responsible for delivering services, or between elected leaders and administrators. Put differently, the current system provides little basis for local discretion and, as a result, local resource allocation and service delivery remain suboptimal. It is simply not possible for services to be "expressed, defined, and delivered locally," in line with the subsidiarity principle that underpins successful devolutions. Local governments in Malawi operate as extensions of delegated or deconcentrated mandates of central ministries.

At the same time, pathways are emerging to break through the vicious cycle of "low trust → low investment → low accountability" that have held back meaningful fiscal decentralization in Malawi. The underperformance of the IGFTS in Malawi has manifested in a diverse set of mechanisms at the local-government level to continue to deliver services. These mechanisms make it difficult to distinguish "coping" from "corruption" and reinforce the current low-level equilibrium of the messy middle of fiscal decentralization. The significant increase in discretionary development funds that has been recently made available to District Councils—headlined by the introduction of the PBG—presents a significant opportunity to shift the incentives driving this dysfunctional cycle. The improved performance of LAs has the potential to build confidence in their ability to manage increasing resources in line with their devolved functions, laying a foundation for a coherent framework for meaningful fiscal decentralization—one where finally "finance follows function."

The 15th edition of the Malawi Economic Monitor proposes policy actions to deepen fiscal decentralization in the near term, taking into the consideration the volatility of macro-fiscal situations and the nature of the vertical imbalance. Malawi is continuing to face significant macro-fiscal constraints, and any recommendations need to take the volatility of this environment into consideration. Malawi's vertical imbalance is chronic and structural and, as such, short-term measures need to "work with the grain" and build on recent developments to drive incremental improvements. Taking these factors into consideration, the following are areas that should be prioritized for reform:

i) ***Lead together, from the front to drive meaningful fiscal decentralization:*** Deeping fiscal decentralization is an inherently political process, but the underlying objective of improving service delivery for the citizens for whom funds are targeted is a common target by which to coordinate and cooperate. Leadership from the highest levels of government is necessary for a meaningful fiscal decentralization reform agenda. This should leverage the coordination of the 'decentralization troika' of the MOFEA, the Ministry of Local Government, and the NLGFC to implement results with sector ministries.

ii) ***Measure the gap to introduce an evidence-based debate around the vertical imbalance:*** There is no debate over the inadequacy of resources for local governments to meet their service delivery functions. Funds will never be "sufficient", but no evidence-based targets nor credible legislative/policy mechanisms exist to help guide a correction of the current vertical imbalance.

Beyond the general budget constraint, the vertical sharing should be informed by the minimum expenditure levels required for agreed levels of service delivery. The minimum service delivery standards for all decentralized sectors should be costed and this, in turn, should serve as the foundation for policy and regulatory reform to guide correction of the vertical imbalance (see next point). This does not mean that more funds should be requested in an increasingly constrained fiscal environment, but rather that this can inform a roadmap regarding how the current envelope of funds are allocated, both between sectors and across levels of government.

iii) ***Leverage the review of the decentralization legislative and policy architecture to guide implementation:*** Decentralization is a process, not a one-time act and, to date, it has been guided by the Local Government Act and the National Decentralization Policy, which have not been revised since their original inception in 1998. Within these current frameworks, fiscal decentralization is mandated that "at least 5 percent of NNR should be transferred to local governments for development financing", but it is widely acknowledged that this target is neglected and disregarded in practice and does not influence budgetary actions.

With both the Local Government Act and the National Decentralization Policy in the process of being reviewed and revised for the first time in 25 years, this presents a once-in-a-generation opportunity to leverage this process to guide a meaningful and realistic architecture for fiscal decentralization. Passing new legislation and policies will not solve the problem (as it is implementation that ultimately matters) but, if meaningfully leveraged, they could strongly influence the institutional framework to deepen decentralization.

iv) ***Shed light on the IGFTS by simplifying and increasing transparency:*** Low transparency of the IGFTS arises from the complexity of the formulas, non-adherence to formulas and the absence of well-developed reporting mechanisms. The complexity of the formulas and the absence of reporting on transfers and their various parameters reduce the transparency of the system. Lack of predictability remains an issue, given that the formula-based shares do not determine the actual transfers.

Both the formulas and the allocations should be disseminated widely as a prerequisite for greater understanding and agreements on the objectives and operation of the policies and programs for service delivery. They should be made public to citizens through regular and accessible forums.

The formulas require full review, as part of a fiscal decentralization strategy, which may be tasked to assist the transition toward a general-purpose grant (see below), along with the simplification and drastic reduction in the number of grants/transfers. In this context, new formulas should be adopted that have the merits of: (i) communicating national policy to local governments; and (ii) being understandable by elected local government officials and the public at large.

v) ***Order from a common menu—Coordinate development funds tied to performance:*** The notable increase in development funds at the district level over the past few years has come at the expense of fragmentation. This has resulted in multiple silos of different funds with a common development function that are at risk of resulting in "a sum-of-the-parts" that is far less than "the-sum-of-the-whole".

The introduction of the PBG has displayed the impact of the incentive effect of results-based financing, with lessons learned showing that its volume/scale has been critical in moving the needle. A sequenced policy of coordinating and consolidating development funds should be embarked upon, starting with the formal merging of the DDF and PBG, together with the current Boreholes Fund.

With the significant increase in the size of the CDF and its shift to the development account, the PBG and DDF should closely coordinate and begin to introduce associated performance elements.

This should start with a common master District/Constituency Development Plan for all sources of discretionary funds, requirements for transparency and reporting, and the potential harmonization of results-based conditions.

This can also be further extended to development-partner funding in key service delivery sectors, such as health and education, where the "basic package" of LA-delivered services can be costed to inform the introduction of sector conditional grants that build off the results-based architecture.

vi) ***Provide flexibility in how to operate—Revitalization of a General Purpose Grant:*** The mainstay of many fiscal transfer systems is a General Purpose Grant, which local governments use based on their identified operational needs. This was the original idea of the GRF, but this fund has shrunk in size, while ORT has fragmented across its 17 sector-specific transfers.

A current use of GRF and sectoral ORT should be critically reviewed and the revitalization of a General Purpose Grant seriously considered. This should be closely tied to a deepened analysis of tax capacity and tax effort across LAs, to also ensure that a GPG does not disincentivize continued OSR reform efforts.

vii) ***Make it work for everyone—Strengthening the equalization of transfers:*** Finally, Malawi's transfers system has weak equalization effects. This has several implications for decentralized service delivery, including a weakening yardstick for competition and accountability, and the dilution of the potential of services, their mix and level, as expressed, defined, and delivered in accordance with the subsidiary principle.

Equalization should be strengthened through a revision of the formulas and the inclusion of rational expenditure needs and fiscal capacity measures in those formulas. This should be achievable over time, starting with an explicit policy on equalization, with a clear strategy for implementation. Reticence to embark on comprehensive formula review is often driven by political pressure to ensure no local governments "lose" in the short term due to the changes, and any major changes in the formula should therefore be accompanied by hold harmless or grandfathering provisions to smooth equalization.

TABLE 2.2 Priority fiscal decentralization policy areas and key actions

Category	Action	Timeframe	Direction
Bolster coordinated, high-level leadership of the fiscal decentralization agenda	Bolster the guidance from highest levels of government and leverage the coordination of the decentralization troika of the MoFEA, the Ministry of Local Government, and the NLGFC to drive results with sector ministries	Short*	
Introduce evidence-based debate of vertical imbalances	Utilize ongoing costing of minimum service delivery standards for all decentralized sectors to inform how current envelope of decentralized funds are allocated vertically between levels of government	Short	
Leverage ongoing legislative and policy reviews	Leverage the ongoing review of the Local Government Act and the National Decentralization Policy to introduce a realistic and evidence-based set of guiding principles to guide fiscal decentralization	Short	
Increase transparency and simplicity of the transfer system	Undertake a full review of fiscal transfer formulas and allocations with an objective of moving toward a simplification and reduction in the number of grants and transfers	Medium	
Coordinate development funds tied to performance	Embark on the coordination and consolidation of development funds tied to performance measures, starting with the formal merging of the DDF and PBG, together with the current Boreholes Fund. This can also be extended to service delivery sectors to inform the introduction of sector condition grants.	Medium	
Revitalize General Purpose Grant	Review the current utilization of the GRF and sectoral ORT to inform the revitalization of a General Purpose Grant	Medium	
Strengthen equalization of transfers	Equalization should be strengthened through a revision of the formulas and the inclusion of rational expenditure needs and fiscal capacity measures in those formulas	Medium	

Initiate Phase out Sustain Strengthen

Note: *short term—actions for the next 3 to 6 months; medium term—actions for the next 6 to 18 months

TABLE 2.3 Macroeconomic indicators

	2018	2019	2020	2021 (Est.)	2022 (Proj)	2023 (Proj.)
National Accounts and Prices						
GDP at constant market prices (% change)	4.4	5.4	0.8	2.8	2.1	4.3
Agriculture	0.3	5.9	3.4	5.2	-3.0	3.4
Industry	7.2	7.7	1.2	1.9	2.0	4.1
Services	4.5	5.5	-0.5	2.0	4.4	4.7
Consumer prices (annual average)	9.2	9.4	8.6	9.3	12.6	11.5
Central Government (FY % of GDP)						
Revenue and grants	14.6	14.7	14.6	14.1	14.6	17.0
Domestic revenue (tax and non-tax)	13.6	13.2	13.1	12.7	13.4	14.2
Grants	1.0	1.4	1.5	1.5	1.2	2.8
Expenditure and net lending	19.0	19.1	20.9	21.2	23.3	24.7
Overall balance (excluding grants)	-5.4	-5.9	-7.8	-8.6	-9.9	-10.5
Overall balance (including grants)	-4.4	-4.5	-6.3	-7.1	-8.7	-7.7
Foreign financing	1.8	0.8	0.8	1.0	0.9	2.0
Domestic financing	3.0	3.8	4.9	5.9	5.9	5.7
Money and Credit						
Money and quasi-money (% change)	11.4	8.1	10.2	14.4	13.9	11.8
Credit to the private sector (% change)	11.5	21.3	30.1	14.2	12.6	10.1
External Sector (US$ million)						
Exports (goods and services)	1,112	1,238	1,202	1,270	1,303	1,491
Imports (goods and services)	2,927	3,031	3,088	3,299	3,538	3,808
Gross official reserves	750.1	815	566	394	402	415
(months of imports)	3.6	3.9	2.1	1.4	1.5	1.5
Current account (percent of GDP)	-17.0	-13.8	-11.7	-13.0	-14.4	-13.6
Exchange rate (MK per US$ average)	732.33	745.93	780.81	826.97	-	-
Debt Stock						
External debt (public sector, % of GDP)	25.0	27.8	32.9	31.9	34.7	36.3
Domestic public debt (percentage of GDP)	18.9	17.5	21.9	27.1	29.6	32.6
Total public debt (percentage of GDP)	43.9	45.3	54.8	59.0	64.3	68.9
Poverty						
Poverty rate (US$ 1.9 in 2011 PPP terms)		73.5	74.3	74.3	74.4	74.0
Poverty rate (US$ 3.2 in 2011 PPP terms)		90.4	90.7	90.7	90.8	90.5
Poverty rate (US$ 5.5 in 2011 PPP terms)		97.1	97.2	97.2	97.2	97.1

Note: Projections for 2022 and 2023 were carried out in March 2022, and do not reflect the recent exchange rate adjustment.

REFERENCES

Boadway, R. and Shah, A. 2007. Intergovernmental Fiscal Transfers: Principals and Practice. *World Bank Public Sector Governance and Accountability Series.*

Chingaipe, H., White, R. and Thombozi, J. 2015. Political Economy Analysis of Local Government Accountability in Malawi. *Institute for Policy Research & Social Empowerment.*

Chinsinga, B. 2009. Democracy, Decentralisation, and Poverty Reduction in Malawi. *African Studies Review 52(1).*

Chiweza, A. 2015. Political Economy Analysis of Accountability for Resources and Results in Local Government Councils. *Tilitonse Fund.*

Chiweza, A. 2016. The political economy of fiscal decentralization: Implications on local governance and public service delivery. In *Political Transition and Inclusive Development in Malawi* (pp. 95–111). Routledge.

DODMA. 2022. Moderate Tropical Storm Ana Snapshot. DODMA, Lilongwe.

Edelman and Baulch. 2016. Are Malawi's maize and soya trade restrictions causing more harm than good? A summary of evidence and practical alternatives. [Online]. Available at: https://www.ifpri.org/publication/are-malawis-maize-and-soya-trade-restrictions-causing-more-harm-good-summary-evidence

Faguet, J.P. and Pöschl, C. 2015. Is Decentralization Good for Development? Perspectives from Academics and Policy Makers. *Oxford: Oxford University Press.*

FEWS NET. 2022. Malawi Food Security Outlook Update. April 2022. Famine Early Warning Systems Network.

Hart, T. and Welham, B. 2016. Fiscal Decentralization: A public financial management introductory guide. *Overseas Development Institute.*

IMF. 2018. IMF Staff Country Reports 2018, 116. International Monetary Fund, Washington, DC.

IMF. 2020. Annual Report on Exchange Arrangements and Exchange Restrictions. International Monetary Fund, Washington, DC. https://www.elibrary.imf.org/downloadpdf/books/012/29310-9781513556567-en/29310-9781513556567-en-book.pdf

IMF. 2022. World Economic Outlook April 2022: War Sets Back the Global Recovery. IMF, Washington, DC.

IMF and World Bank. 2020. Malawi: Debt Sustainability Analysis. IMF and World Bank, Washington, DC.

IMF and World Bank. 2021. Malawi: Debt Sustainability Analysis. IMF and World Bank, Washington, DC.

IPC Global Support Unit. 2022. Malawi IPC Chronic Food Insecurity Report. Integrated Food Security Phase Classification Global Support Unit, Rome. https://www.ipcinfo.org/fileadmin/user_upload/ipcinfo/docs/IPC_Malawi_ChronicFoodInsec_2022May_report.pdf

NAO. 2021. Malawi Tourism Report (2020). NAO, Lilongwe.

O'Neil, T., Cammack, D., Kanyongolo, E., Mkandawire, M., Mwalyambwere, T., Welham. B., Wild, L. 2014. Fragmented governance and local service delivery in Malawi. *London: Overseas Development Institute.*

RBM. 2021. Financial Stability Report. RBM, Lilongwe.

Said, J. and Singini, K. 2014.The Political Economy Determinants of Economic Growth in Malawi. *ESID Working Paper No. 40.*

Tambulasi, R. and Chasukwa, M. 2014. Substitute is gonna put you down: An analysis of effectiveness of emerging actors as substitutes of local councilors in Malawi's decentralized system. *Journal of Development Effectiveness.*

UNICEF. 2022. *Nutrition Updates. Vol. 1 March 2022.* New York, United Nations Children's Fund.

UNICEF and ODI (forthcoming). Fiscal Decentralization in Malawi: Situational Analysis. *London: ODI.*

United States Agency for International Development. 2016. Political Economy of Decentralization and Local Governance Reforms. *USAID Local Government, Accountability and Performance Program.*

Windward. 2022. *Chinese Port Congestion Stalls Container Vessels Worldwide.* Windward Blog, London. https://windward.ai/blog/chinese-port-congestion-stalls-container-vessels-worldwide/

World Bank. 2004. Decentralization Briefing Notes. World Bank Institute Working Papers Series. World Bank, Washington, DC.

World Bank. 2020a. Malawi Public Expenditure Review 2020: Strengthening Expenditure for Human Capital. World Bank, Washington, DC.

World Bank. 2020b. Project Appraisal Document: Governance to Enable Service Delivery Project. World Bank, Washington, DC.

World Bank. 2022a. Africa: The Economic Impact of Ukraine War and Operational Response. World Bank, Washington, DC.

World Bank. 2022b. Commodity Markets Outlook April 2022. World Bank, Washington, DC.

World Bank. 2022c. Macro Poverty Outlook (April 2022). World Bank, Washington, DC.

World Bank. 2022d. Trade Watch April 2022. World Bank, Washington, DC.

World Bank. 2022e. Tropical Storm Ana, January 2022, Malawi: Global Rapid Damage Estimation (GRADE) Report. World Bank, Washington, DC.

World Bank (forthcoming). Poverty Stagnation and Regional Disparities in Malawi. A Poverty Assessment. World Bank, Washington DC.

World Food Programme. 2022. Minimum Expenditure Basket in Malawi. A look at food and non-food prices and availability in times of COVID-19. Rome, World Food Programme.

The World Bank Malawi Office
Plot 13/59 Off Presidential Way
Mulanje House, City Centre
PO. Box 30557
Lilongwe
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
Wahington, D.C. 20433
USA
Tel: +1 202 473 1000
Fax: +1 202 477 6391
www.worldbank.org

WORLD BANK GROUP