AFRICAN DEVELOPMENT BANK GROUP
GROUPE DE LA BANQUE AFRICAINE DE DÉVELOPPEMENT

COUNTRY FOCUS REPORT 2024

MALAWI

Driving Malawi's Transformation

The Reform of the Global Financial Architecture

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The preparation of this report was led by Désiré Vencatachellum, Senior Director, Country Economics Department (ECCE), with Marcellin Ndong Ntah (Lead Economist, ECCE) as the project management Lead, IT support from Abir Bdioui (Consultant, ECCE), and administrative support from Tricia Effe Baidoo (Team Assistant, ECCE). Malawi was prepared by Mr. Albert Mafusire, Principal Country Economist, under the guidance of Mr. George Kararach, Lead Economist for Southern Africa.

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Peer-review comments were received from Anthony Simpasa, Division Manager, Macroeconomics Policy and Debt Sustainability Division and Microeconomic and Institutional Impact Assessment; Vera Oling, Senior Country Economist, from the Country Economics Department; Rumbidzai Rejoice Musakaruka, Senior Fragility and Resilience Officer, Transition States Coordination Office. Dr. Joseph Atta-Mensah, Senior Fellow from Africa Centre for Economic Transformation, acted as an external reviewer.

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ADF	African Development Fund
AEO	African Economic Outlook
AfCFTA	African Continental Free Trade Area
AFSM	African Financial Stability Mechanism
ATM	Agriculture, Tourism and Mining
COP28	Conference of the Parties 28th Meeting
DODMA	Department of Disaster Management Affairs
DRM	Domestic Resource Mobilization
E&S	Environmental and Social
ECF	Extended Credit Facility
FDI	Foreign Direct Investment
GDP	Gross Domestic Product
GHG	Green House Gases
HCD	Human Capital Development
HDI	Human Development Index
HIPC	Heavily Indebted Poor Countries
ICT	Information Communications Technology
IDA	International Development Association
IFI	International Financial Institution
IFPRI	International Food Policy Research Institute
IMF	International Monetary Fund
LDC	Least Developed Country
MDB	Multilateral Development Bank
MIP-1	Malawi Implementation Plan 1
MWK	Malawi Kwacha
NDC	Nationally Determined Contributions
ODA	Official Development Assistance
PFM	Public Finance Management
PPP	Public-Private Partnerships
PPPC	Public-Private Partnerships Commission
SDG	Sustainable Development Goal
TFP	Total Factor Productivity
UN	United Nations
UNDP	United Nations Development Program
US$	United States Dollar
VAT	Value Added Tax
ADF	African Development Fund

EXECUTIVE SUMMARY

Malawi's economic performance has been characterized by increasing macroeconomic instability since 2014, with negative impacts on growth and debt sustainability. Growth has shifted to a lower growth trajectory, inflation has remained elevated, and fiscal and external balances have worsened, resulting in the worst debt crisis the country has ever experienced, with foreign exchange shortages affecting inward investments and modernization of industrial activities.

Multiple shocks have weakened Malawi's economic performance, hence the need for structural and policy reforms. The 2023 approved International Monetary Fund Extended Credit Facility (IMF ECF) aims to address the challenges currently affecting Malawi and ensure a return to macroeconomic stability and medium-term debt sustainability. These efforts include reform of the public finance management framework to ensure sustainable fiscal balances through better budget planning, monitoring, and expenditure controls. The recommended monetary and exchange rate policies aim to rein in inflation by reducing money supply growth, of which monetization of budget financing is one of the causes, while on the exchange rate front, the authorities are encouraged to ensure flexibility of the exchange rate regime and build foreign exchange reserves to reduce the impact of external shocks on the economy.

Structural transformation of the economy is in its infancy. As is the case with other African countries, the country's structural transformation is driven by a growing services sector, while the industrial sector has been on the decline. Moreover, the main labor-absorbing wholesale and retail sub-sector within the services sector is also affected by low productivity. Several factors, particularly institutional and policy elements, limited technological progress due to subdued investments, limited skills, and infrastructure gaps account for the observed structural transformation, hence the limited impact on poverty and lower growth.

Addressing the impediments to structural transformation should include enhanced access to external financing for the country to cope with and mitigate the negative impacts of climate-related shocks, which are not of the country's own making and whose contribution to greenhouse gases are negligible. Increased access to global climate financing, reform of the international financing architecture, as well as enhanced domestic revenue mobilization will go a long way towards addressing financing challenges.

A reform of the international financial architecture is needed urgently as the existing frameworks have been unable to support the mobilization of stable and long-term financing at scale to support investments needed to combat the climate crisis and achieve the sustainable development goals (SDGs) in Malawi in particular, and in Africa in general. Malawi's ambitious climate activities as stated in its nationally determined contribution (NDC) will require significant investments. The combined unconditional and conditional contribution reduction target of greenhouse gas (GHG) emissions is expected to stand at 51% by 2040 as a result of increased investments in clean energy, transport infrastructure, and climate smart agricultural practices.

Additionally, investments in human capital development will be critical for the citizens of Malawi to benefit from jobs created by an improved business environment, as well as from enhanced job opportunities in a growing economy. The international financial architecture therefore needs to be responsive to differentiated needs of African countries. In Malawi, compensating the country for the negative impact of climate shocks will be important.

1

MACROECONOMIC PERFORMANCE AND OUTLOOK

KEY MESSAGES

- **Repeated exogenous and endogenous shocks have significantly impacted economic growth and poverty reduction.** Growth has become more volatile and has shifted to a lower trajectory and only averaged less than 2% in the past four years. Real GDP growth in 2023 is estimated at 1.5%, a moderate recovery from the 0.9% in 2022. The effect has been stagnation in real per capita income. Climate change effects, the COVID-19 pandemic, and geopolitical tensions have compounded the impact of macroeconomic instability on growth.

- **The Reserve Bank of Malawi faces a policy dilemma because of decelerating growth and elevated inflation that has remained above 25% since August 2022 and peaked at 34.5% in December 2023.** A trade-off between supporting growth and reining in inflation was made, with inflation control taking center stage and the policy rate rising by 1,000 basis points to 22% by end 2023 from 12% in April 2022. Nevertheless, inflationary pressures remain.

- **Weaknesses in managing the fiscal deficit have had knock-on effects on debt levels and debt sustainability.** The fiscal deficit was 10.1% of GDP in 2023 against a target of 7.7%, which indicates a wider deficit compared to 9.6% in 2022. The 2022 fiscal deficit also far exceeded the target of 7.0% announced in the budget. In fact, public debt rose sharply to 82.1% of GDP in 2023, up by 5.6% from the previous year. Efforts to address the debt situation are ongoing, but successfully turning around the economy will require a strong commitment to structural and policy reforms to tackle PFM challenges and instill transparency and accountability measures.

- **Malawi has a structural trade imbalance, exceeding USD2.0 billion in 2022 and 2023 that was financed through borrowing, foreign direct investment, and other income inflows.** The current account deficit widened to 7.3% of GDP in 2023 compared to 2.8% of GDP in 2022, against the backdrop of weak export performance and increased import demand. Consequently, international reserves have remained at less than one month of imports.

- **Poverty remains a challenge and has increased during the past five years, possibly reflecting the effect of the pandemic.** The proportion of the population living below the USD 2.15 international poverty line in 2023 stood at 72% compared to 70.1% in 2019. This came despite the marginal decline in the unemployment rate from 6.8% in 2022 to 6.7% in 2023. Given the prevalence of climate shocks and their devastating and long-lasting impacts on the livelihoods of smallholder rural farmers, efforts must be made to foster job creation, resilience building through climate-smart agricultural practices, and support for the entrepreneurial young people.

- **There are several risks to Malawi's economic outlook.** Malawi's projected growth of 3.3% is above Africa's average growth of 3.1% in 2024 but falls below the continental average in 2025. Inflation is projected to remain high due to the poor agricultural season and the attendant spike in food prices, reflecting the effects of the severe drought that has affected whole of Southern Africa region. The forecasted favourable rainfall for 2024/25 season could provide some respite on agricultural production, easing pressure on food prices, with inflation projected to decline to 14.3% in 2025.

“Addressing macroeconomic instability, achieving debt sustainability and closing the infrastructure gaps will improve the overall business environment and help Malawi to lift its medium and long-term growth prospects.”

I. Introduction

Malawi’s development strategy under the country’s Vision 2063 focuses on sustainable wealth creation. Under the Vision, the Government has placed strong emphasis on capacitating the key actors to maximize their economic potential by investing in agriculture commercialization to spur productivity, and in industrialization, and urbanization. Implementation of the new development strategy under the first Ten-Year Implementation Plan (MIP-1) 2021-2030 has coincided with a period of increased prevalence and intensity of climate change shocks and macroeconomic instability, with significant negative impacts on growth and social progress. Efforts to address this situation are ongoing, within the context of the four-year International Monetary Fund’s (IMF) Extended Credit Facility (ECF), but successfully turning around the economy will require a strong commitment to structural and policy reforms. This chapter presents an analysis of Malawi’s economic performance for 2023, including medium-term growth projections over the 2024-2025 period. It will, in particular, assess trends in key macroeconomic indicators, such as fiscal balances and interest rates, changes in domestic and international financial flows, investment, and public debt. The chapter will also discuss the main upside and downside risks to the outlook and provide policy options to foster high and resilient growth, support macroeconomic stability and economic transformation, and deal with shocks that have continued to buffet the country’s economy.

II. Growth performance

Real GDP growth in 2023 was estimated at 1.5%, a moderate recovery from the 0.9% in 2022. Cyclone Freddy reduced agricultural output and disabled a third of the country’s power generation, which also affected industrial activity. While agriculture remains a major economic sector, its contribution to growth has been overtaken by the services sector, which accounts for more than 50% of economic growth since 2018, save for 2020. The importance of the services sector is vividly illustrated in the sharp decline of GDP growth from 5.7% in 2019 to 0.8% in 2020 against the backdrop of the COVID-19 outbreak. Before the economy could fully recover from the effects of Cyclone Ana in 2022, Cyclone Freddy damaged Kapichira Power Station, resulting in intense load shedding that was exacerbated by shortages of petroleum products, which negatively impacted manufacturing activities in 2022 and partly in 2023. As a result, contraction in both utilities and manufacturing dampened growth over the two years, cutting short the strong recovery experienced in 2021. The Government embarked on rebuilding the economy and supporting households affected by the cyclone. Consequently, public sector investments more than doubled from USD 390.1 million in 2022 to USD 981.4 million in 2023. However, falling real incomes due to elevated inflation, monetary tightening, and foreign currency shortages also have had a depressing effect on growth. Despite the macroeconomic instability which gave rise to a restive citizenry in 2022 and 2023, Malawi continues to enjoy political stability, and the current situation bodes well for foreign direct investment. Between 2022 and 2023, Malawi recorded a significant jump in FDI from USD 37.1 million in 2022 to USD 53.2 million in 2023, as well as an increase in public sector investments which more than doubled from USD 390.1 million to USD 981.4 million between 2022 and 2023.

III. Recent macroeconomic and social developments

3.1 Monetary policy – Inflation – Exchange rate

Malawi faces a policy dilemma, given decelerating growth and increasing inflation that peaked at 34.5% in December 2023. Inflation averaged 28.7% in 2023 compared to 20.8% the previous year, driven mainly by food prices, especially maize, and the devaluation/depreciation of the domestic currency (Table 1). The Malawi Kwacha remained under pressure due to shortages of foreign currency, despite the two devaluations of 25% in May 2022 and 44% on 9 November 2023. This was exacerbated by monetization of the fiscal deficit, which propelled broad money supply growth. Broad money rose by about 86% (MWK 1.98 trillion to MWK 3.68 trillion) from January 2022 to December 2023. The official foreign exchange reserves of USD 198.8 million represented less than one month of import requirements. Malawi has also experienced increasing parallel foreign exchange market premiums. The exchange rate premium fell from 50% to 4.1% following the currency devaluation in November 2023, but quickly rose to 12.1% by the end of December 2023. The effect of these factors on inflation forced the Reserve Bank of Malawi to tighten monetary policy to curb high inflation. The tightening of monetary policy saw the policy rate rise by 1,000 basis points to 22% by end 2023 from 12% in April 2022.

Macroeconomic imbalances have also been recorded in the financial sector. At 6.6% on 31 December 2022, non-performing loans of commercial banks were above the internationally accepted level of 5%. However, the banking sector has remained stable and profitable. Core and total capital ratios for the banking sector in 2022 were 19.0% and 22.4% respectively, an increase from 17% and 20% in 2021. However, the increasing exposure to the Government poses a threat to financial stability.

3.2 Fiscal policy and public debt

The fiscal deficit was 10.1% of GDP in 2023 against a target of 7.7%, and 9.6% recorded in 2022. The 2022 fiscal deficit also far exceeded the target of 7.0% announced in the budget and presents a risk of macroeconomic instability. The worse-than-expected fiscal outturns were on account of greater than budgeted wage bills and under performance of revenue, as well as weak budget control systems due to partial implementation of the integrated financial management information system (IFMIS). The primary deficit rose sharply between 2019 and 2020, more than doubling to 3.6% of GDP and rose further to 6.3% in 2022. The fiscal deficit was partly financed through a World Bank budget support operation and increased borrowing from the domestic market, including monetization of the deficit. Public debt therefore rose sharply to 82.1% of GDP in 2023, up by 5.6 percentage points from the previous year. Using the 2023 data, the country's total debt stands at USD 7.6 billion. Multilateral and bilateral creditors are owed USD 2.8 billion (37.6%) and USD 382 million (5%) respectively. Malawi's commercial debt amounts to USD 431 million (5.7%), the major creditors being the African Export-Import Bank and Trade and Development Bank. Of the USD 3.9 billion in domestic debt, USD 325 million (4.3%) is collateralized debt.

External public debt service accounted for 46.9% of revenue (excluding grants) and 58.1% of total exports. In the 2023/24 fiscal year (FY), interest payments on total public debt account for 5.6% of total public expenditure compared to 4.9% the previous year. Malawi's current debt ratios are far above the recommended ceilings – debt-to-GDP ratio (30%), external debt-to-revenue ratio (14%), and external debt service-to-exports ratio (10%). Thus, Malawi's external and public debt is in distress.

3.3 External position – External financial flows

The current account deficit widened to 7.3% of GDP in 2023 compared to 2.8% of GDP in 2022 as imports increased while exports performed poorly. Fuel and fertilizers account for 27.1% of the import bill, and the recent increases for these two commodities have reduced the country's capacity to import other essential products, such as pharmaceuticals and other medical supplies. Meanwhile, exports are showing some signs of recovery, rising by about 8% in 2023 over the level achieved in 2022. Tobacco remains a dominant export earner, accounting for about 42.7% of total exports. Thus, agriculture continues to be a dominant export sector, accounting for almost 70% of receipts. Malawi has a structural trade imbalance, exceeding USD 2.0 billion in 2022 and 2023 and financed through borrowing, foreign direct investment, arrears to foreigners and other income inflows. While remittances data for the full 2023 is not available, indications are that there has been a decline. Over the first nine months of 2023, remittances amounted to about USD 115 million compared to USD 300 million in 2022. In contrast, foreign direct investment increased from USD 37.1 million in 2022 to USD 53.2 million in 2023. However, there is data paucity regarding how the country fully finances such a huge trade imbalance. Given the country's limited capacity to generate foreign currency sustainably due to its reliance on primary commodities that are vulnerable to price volatility, foreign reserves have remained below one month of imports since 2022. International reserves stand at less than one month of imports.

Table 1.1 - Macroeconomic Indicators

	2019	2020	2021	2022	2023(e)	2024(p)	2025(p)
Real GDP Growth	5.7	0.8	4.6	0.9	1.5	3.3	3.8
Inflation	9.4	8.6	9.3	20.8	28.7	27.3	14.3
Overall Fiscal Balance, Including Grants (% GDP)*	-4.6	-6.6	-7.4	-9.6	-10.1	-8.7	-7.6
Primary balance (% GDP)	-1.7	-3.6	-3.7	-6.3	-5.2	-3.1	-1.1
Current Account (% GDP)	-12.0	-12.5	-16.7	-2.8	-7.3	-8.2	-9.5
Total Population (Millions)	18.9	19.4	19.9	20.4	20.9		
Life Expectancy at Birth (Years)	64.1	63.7	62.9	62.9	63.7		

Source: Data from Domestic authorities; estimates (e) and prediction (p) based on authors' calculations. AfDB Statistics Department, April 2024 Note: *Data in fiscal year 1 April (n-1)/ 31 March (n)

3.4 Social developments

Poverty remains a challenge, with 72% of the population below the USD 2.15 international poverty line in 2023 compared to 70.1% in 2019, while the unemployment rate fell from 6.8% in 2022 to 6.7% in 2023. Given the prevalence of climate shocks and their devastating and long-lasting impacts on the livelihoods of smallholder rural farmers, efforts must be made to increase economic opportunities, build resilience through climate-smart agricultural practices, and support the entrepreneurial young people. This is particularly important because of the large informal sector where earnings and potential for growth are constrained. Malawi's income inequality, as measured by the Gini coefficient, is estimated at 0.39 in 2023, which is low compared to other countries in the region, such as Zimbabwe (0.50) and South Africa (0.63). To significantly address poverty, Malawi needs to raise growth levels, ensure inclusive development, and reduce vulnerability to climate shocks through climate-smart agricultural practices. Addressing macroeconomic instability, especially reigning in inflation, as well as ensuring food security would go a long way towards improving the poverty situation.

IV. Macroeconomic outlook and risks

4.1 Outlook

Economic growth is projected at 3.3% and 3.8% in 2024 and 2025 respectively, which is lower than the January 2024 projections. The downward revision is due to the negative impact of the drought on agriculture and the uncertainty created by multiple shocks. The projected growth will be driven by the mining, retail, and tourism sectors. The current projected growth rate falls far below the 6% growth target in the First 10-Year Implementation Plan (MIP-1) of the Malawi Vision 2063. Although Malawi's projected growth in 2023 is above the African average growth of 3.1% in 2024, it falls below the continental average in 2025.

Inflation will remain high due to the poor agricultural season, but may start falling in 2024, down to 14.3% in 2025. A key factor in moderating inflationary pressures is likely to be a slowdown in the growth of money supply, as monetization of the fiscal deficit stops. Moreover, Malawi has embarked on a program to reduce food insecurity through increased area under irrigation, thereby lowering supply-side induced inflationary pressures. Efforts towards fiscal consolidation are expected to narrow the fiscal deficit to 8.7% and 7.6% in 2024 and 2025 respectively. In addition, the increased support from external partners is supposed to narrow the financing gap. As the economy recovers, the current account deficit is projected to widen in 2024 and 2025 to 9.5% of GDP. The response of exports to the exchange rate adjustment and ongoing gradual depreciation is slow as investments to increase supply and secure new markets take longer to materialize, whereas import demand response is almost immediate. The Government's focus on diversification through increased production of crops other than tobacco and commercialization of agriculture is expected to sustain growing exports, which will be complemented with mining and tourism receipts. Having secured the IMF Extended Credit Facility in late 2023, opportunities for increased external financing, especially from the multi-lateral creditors, are being realized. In addition, the promising conclusion of the debt restructuring process is expected to increase the fiscal space as debt and debt financing levels fall, making more development financing available.

Box 1.1: Impact of tighter international financial conditions

Malawi's progressive and worsening external and public debt situation since 2016 resulted in the country being in debt distress by end-2022. Over the years, access to external financing became more difficult and the authorities turned to contracting expensive private and domestic debt. The Government's recourse to high-cost domestic borrowing, given the country's limited access to external credit, to meet its financing needs pushed domestic debt upwards. Rising domestic interest costs have not only increased the fiscal burden, but also tightened liquidity on the domestic market. Yields on the domestic market have thus risen. As at 16 February 2024, yields on 91-day and 10-year paper were 15.88% and 35% respectively compared to 9.82% and 22.98% on the same date respectively in 2022. Consequently, the private sector has been crowded out, with negative implications on investment and growth. Servicing external debt has also become a drain and accounts for 46.9% of revenue (excluding grants) and 58.1% of total exports, thereby further reducing fiscal space and the Government's ability to finance development.

4.2 Risks

The projected outlook is marred by several risks. Malawi's economy faces significant headwinds, namely, shortage of foreign currency, macroeconomic instability, and drought. Dependence on rain-fed agriculture, given the increasing vulnerability to climate change, is also a major risk. The huge trade imbalance is making the accumulation of foreign reserves more difficult, as they remain below one month of imports. The tailwinds include Government's focus on increasing the area under irrigation, with the Shire Valley Transformation Program being a potential game changer in the agricultural sector. Ongoing debt restructuring negotiations, if successful, will help reduce debt to sustainable levels. Increased inflows of donor resources following the approval of the IMF Extended Credit Facility in late 2023 are likely to reduce the foreign currency squeeze. Increased external financing is expected to improve foreign currency availability, while debt restructuring is expected to reduce servicing costs.

V. Policy options to foster high and resilient growth: Supporting macroeconomic stability and economic transformation

Attaining macroeconomic stability remains a critical factor in turning around Malawi's short-term economic fortunes. The current monetary stance stifles private sector growth and may have limited success in addressing inflation, which is largely driven by fiscal and supply-side factors. The pursuit of public finance management (PFM) reforms to achieve fiscal and debt sustainability is therefore important. PFM reforms will ensure sustainable fiscal balances and thereby eliminate the need for monetization of the budget deficit. Improving the business environment is critical to ensuring increased investments, and thus supports exports and improves Malawi's foreign currency earnings. In addition, exchange rate pressures may persist until Malawi's export performance improves. The export diversification measures taken by the Government through the ATM strategy will also help in this regard. However, the Government may need to address some of the policy inconsistencies, such as export controls, to ensure that producers make their decisions based on target markets. Apart from enhancing the debt management capacity and PFM-related elements, securing favorable debt treatment under the ongoing restructuring process within the G20 framework is important, but it has turned out to be slow and cumbersome. As regards PFM actions, full implementation of the integrated financial management information system (IFMIS) and its roll out to all government ministries and departments is important. In the medium-to-long term, structural transformation of the economy is expected to enhance economic resilience and social outcomes through increased job creation as the economy diversifies and income earning capacity improves, thereby reducing poverty. While agriculture remains a key sector in Malawi's transformation, opportunities in mining and tourism need to be maximized through investments in infrastructure, especially in

TAKING STOCK OF MALAWI'S STRUCTURAL TRANSFORMATION PROGRESS

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KEY MESSAGES

- **Malawi has since the 1980s achieved moderate GDP growth, but this has not translated into similar gains in terms of real per capita income.** Real GDP growth averaged about 3.2% between 1980 and 2022, while real per capita income improved by a mere 0.32% over the same period. Overall, Malawi ranks 135th out of 166 countries for sustainable development, with a score of 56.3 out of 100 compared to Africa's highest ranked country (Tunisia), 58th and a score of 72.5.

- **Labor productivity in agriculture, wholesale and retail, and public services is much lower compared to financial services, real estate, business services and utilities.** The agricultural sector is the least productive, but accounts for the largest share of total employment at 64.1%, followed by the wholesale and retail sectors at 17.6%. Malawi enjoyed higher levels of structural transformation from 1995 to 1997, and from 2004 to 2009. As from 2010, lower levels of structural transformation were observed, and this period coincides with falling gross fixed capital formation. Overall, structural transformation has occurred slowly, as manufacturing and services sectors' shares in GDP and employment are growing, while that for agriculture is falling.

- **Several factors account for Malawi's performance with respect to structural change.** The factors include institutional and policy factors, technological and investment trends, and the quality of labor resources and infrastructure development. Gaps in productivity-enhancing infrastructure are a major hindrance to structural transformation.

- **The agriculture, tourism, and mining strategy has the potential to transform the economy.** Central in this strategy is a move towards mega farms, commercialization and agro-industrialization, exploitation of minerals associated with the energy transition, and development of cultural and nature-based tourism. Ancillary investments in energy, transport, and the agriculture value chain, both in terms of inputs and outputs, will support agricultural growth while also benefiting from agglomeration.

I. Introduction

This chapter aims to present a comprehensive overview of recent progress in Malawi's economic transformation amid a changing world, identify its key trends, and outline its characteristics as well as estimate the financing needs to fast-track structural transformation. It will take both a historical perspective (what has been done so far) and a forward-looking approach (what can or should be done in the future to fast-track progress) to structural transformation, comparing Malawi's performance to that of Africa and other peer countries and drawing lessons for the future. The chapter will assess the impact of a wide array of socio-economic, financial, governance, and external factors on Malawi's structural transformation, as well the financing needs and gaps, with the objective of highlighting the main pull and push factors and guiding evidence-informed policymaking and investment opportunities.

"Malawi's high urbanization rates, accompanied by a growing informal sector that is characterized with low capital-labor ratios, low productivity levels and low incomes make it difficult for the country to achieve structural transformation and lift millions of its population out of poverty."

II. Taking stock of economic performance and transformation in Malawi

Malawi has since the 1980s achieved moderate GDP growth, but this has not translated into similar gains in terms of real per capita income (Figures 2.1 and 2.2). Real GDP growth averaged about 3.2% between 1980 and 2022, while real per capita income improved by a mere 0.32% over the same period due to a high annual population growth rate of about 2.7%. Overall, Malawi performed worse than its regional low-income peers, and below the African average (Figure 2.1). Over the 1980-1989 decade, Malawi's per capita income fell, and the pattern was replicated more recently in 2020 and 2022. Generally speaking, Malawi's poor economic performance is due to its limited investments to exploit the natural resource base, reliance on rain-fed agriculture, and low levels of social and technical capital. During the 1980s, Malawi experienced an economic downturn due to deteriorating international terms of trade, reduced accessibility to trade routes because of the war in Mozambique which increased its transport costs, rising costs of oil, and poor weather. At the domestic level, a dysfunctional dual economy comprising crowded smallholder and subsistence farmers, juxtaposed with a large-scale plantation-based agriculture sector, excluded most of the population from meaningful economic activities.

The restructuring of public companies at the behest of the Bretton Woods institutions brought limited recovery to the economy in the early 1990s. The situation was compounded by adverse weather shocks, the influx of Mozambican refugees, and suspension of non-humanitarian donor support (Cammack, 2004). Participation of the indigenous population in the production of cash crops following the repeal of the Special Crops Act helped to expand agriculture (World Bank, 2009). In addition, the early 1990s were also characterized by macroeconomic instability, exemplified in runaway inflation, high fiscal deficits, and excessive government domestic borrowing that crowded out the private sector.

Figure 2.1: Malawi's real GDP Growth vs Africa and Peer Countries (%)

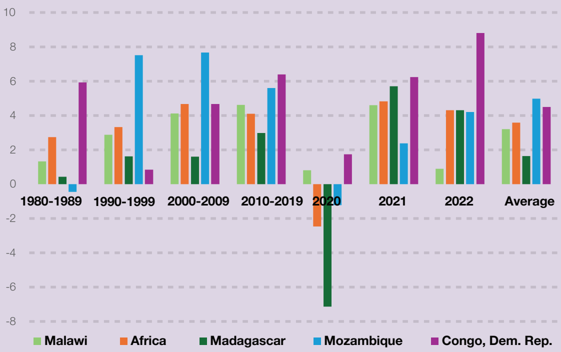
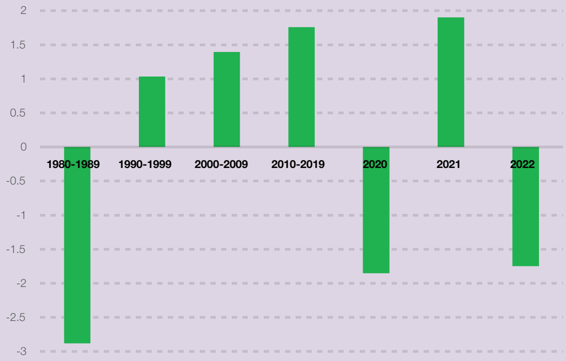


Figure 2.2: Evolution of Malawi's Real GDP Per Capita (%)



Source: African Development Bank statistics and IMF World Economic Outlook database

The opening up of the economy at the dawn of democracy in 1994, restoration of development aid and debt forgiveness under the Heavily Indebted Poor Countries Initiative in 2006, as well as expansion in education and health services sustained growth (Cammack, 2004). New investments in infrastructure and support to smallholder farmers fostered growth until 2014 when donor support collapsed after the Cashgate scandal (Kayuni, 2016). Increased volatility in growth ensued, and the situation worsened due to repeated multiple shocks. In addition, Malawi's internal policy lapses worsened macroeconomic instability, leading to the current debt crisis. Lack of policy consistency and structural transformation are therefore major obstacles to sustained per capita income growth. Using the Rule of 72 and given the current rate of per capita income growth, it will take almost 219 years for Malawi's per capita income to double.[1]

The 2023 Sustainable Development Report ranks Malawi 135th out of 166 countries, with a score of 56.3 out of 100 compared to Africa's highest ranked country (Tunisia), 58th and a score of 72.5. However, Malawi performed better than 27 other African countries (including its regional peers Zimbabwe, Zambia, Mozambique, and Lesotho) where data was available. Out of the 17 sustainable development goals (SDGs), Malawi recorded increasing poverty although income inequality was reduced. Moreover, only slight positive movements were recorded in four SDGs (Good Health and Well-being, Gender Equality, Responsible Consumption and Production, and Climate Action) and the rest showed no change. With only six years left for the SDGs targets, Malawi would have to achieve growth levels that are higher than 6% to achieve the poverty goal, a real challenge given its vulnerability to climate change events and its dependence on agriculture. As regards energy, education, productivity, and infrastructure which are crucial for structural transformation, Malawi scored relatively well for education (52.8) and productivity (67.3), but performed poorly in infrastructure (20.3) and energy (42.0), putting it well below the North African countries and South Africa. To accelerate reforms and attain the targets in 2030, Malawi will need to transform its economy through increased mobilization of external and internal financial resources to invest in infrastructure, industrial facilities, institutional capacity building, and human capital development.

1 https://www.forbes.com/advisor/investing/rule-of-72/

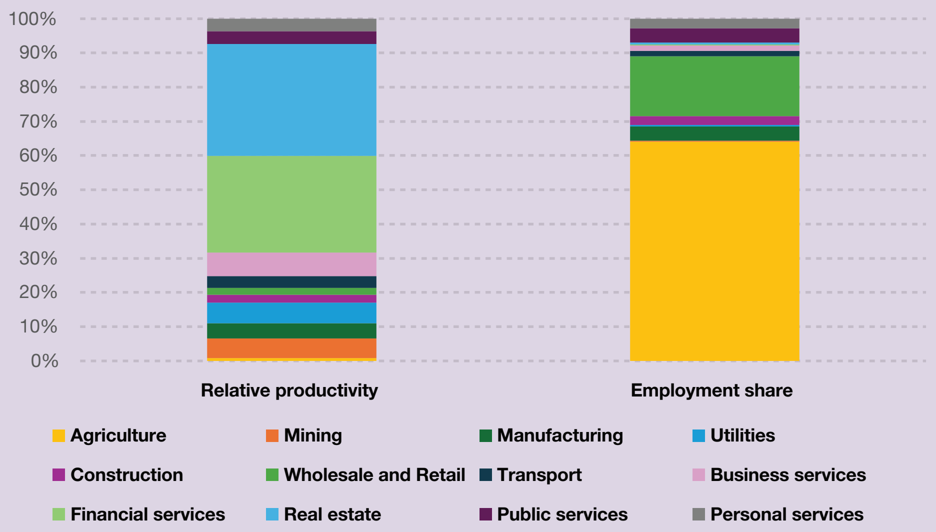
Lorem ipsum

III. Malawi's structural transformation: Drivers, bottlenecks, opportunities

3.1 Structural/economic transformation

Structural transformation is defined as the shift of an economy's structure from low-productivity, labor-intensive activities to higher productivity, capital and skill-intensive activities. As indicated in AEO 2024, "Africa has been transforming without a marked level of industrialization but through a low-skill services sector, mainly because of low manufacturing activity." In the case of Malawi, industrial production has been falling with labor shed from agriculture mainly absorbed in the services sector. Relative labor productivity of the 12 main sectors in Malawi, calculated as the ratio of each sector's labor productivity to the average labor productivity of the economy, highlights significant labor productivity gaps across sectors. Specifically, labor productivity in agriculture, wholesale and retail trade, and public services is much lower than in financial services, real estate, business services, and utilities. However, considering the employment shares, the least productive sector took the lion's share of total employment at 64.1%, followed by wholesale and retail sector at 17.6% (Figure 2.3). As Malawi's authorities seek to grow the economy through diversification and value addition, it is important to also analyze the trend and level of productivity of various sub-sectors under manufacturing. Using data for 2000-2018, it is observed that the food, textiles and wood, paper and print manufacturing sub-sectors employ the largest shares of labor. With respect to relative labor productivity, the wood, paper and print sub-sectors are at the top,followed by food manufacturing and transport equipment. An agriculture-led value chain development strategy points to potentially significant gains to realize structural transformation in Malawi. This outcome is consistent with the finding of Benson and Hartley (2020), which concludes that Malawi would benefit more by transitioning into manufacturing and services sectors. Further analysis of productivity indicates that the upward trend in labor productivity recorded between 2000 and 2012 was reversed in 2013, and continued to fall until 2018. The falling productivity was accompanied by weakening growth in the economy.

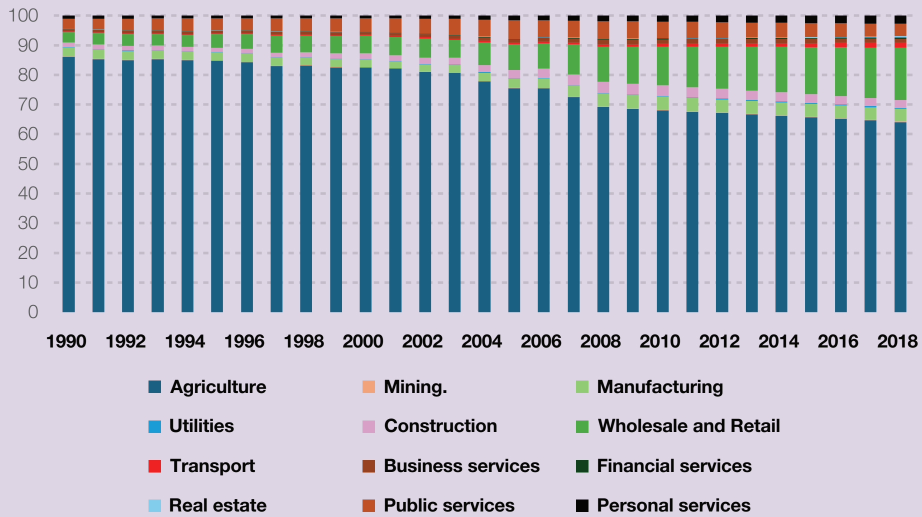
Figure 2.3: Relative Sectoral Productivity and Employment SharesChart Title



Source: Staff calculations using the Economic Transformation Database (Kruse et al. 2023).

Agriculture employs the greatest share of Malawi's total labor (Figure 2.4), but this share declined over the 1990-2018 period, dropping from 86.1% in 1990 to 64.1% in 2018. In contrast, the share of employment in the wholesale and retail sector increased from 3.4% to 17.6% over the same period. In addition, the manufacturing sector's share increased, while that of the public services shrank. As regards the manufacturing sector, the increase in labor share that started in 2006 generally stagnated at about 4.3% over the rest of the period. This suggests that labor moved into less productive sectors, hence the overall falling growth. Another important factor to consider is the increasing importance of the informal sector in urban areas. While data on the informal sector is not readily available, estimates put its contribution to the economy at between 25% and 30% of GDP.[2] Informal sector activities are associated with low levels of investment and do not have access to financing. The result is that the informal sector is marked by low productivity and low incomes, and therefore incapable of pulling Malawians out of poverty. As such, increasing productivity in the agricultural sector through increased mechanization can reduce labor requirements in the sector, but contribute more to growth. Labor has been reallocated to the manufacturing and services sectors, but it should be noted that the wholesale and retail sector which has been absorbing most of the labor also has low productivity, thereby limiting the extent of growth in productivity of the economy and reducing growth rates.

Figure 2.4: Sectoral Employmnt Shares in Malawi, 1990-2018



3.2 Unpacking Malawi's structural transformation through labor productivity decomposition

McMillan and Rodrik's methodology (Box 2.1) has been used to examine the decomposition of labor productivity in Malawi and compare it to the African average over three decades. First, productivity can increase within sectors thanks to capital investments, technological innovations, efficiency gains arising from intra-industry trade, and reduced misallocation within sectors. Second, productivity can grow through the reallocation of labor from low- to high-productivity sectors—the "structural change" component. This section aims to determine the extent to which labor productivi-

[2] The micro, small and Medium-sized enterprises sector's contribution to gross domestic product (GDP) was USD 6.6 billion, with the informal sector contributing USD 3.2 billion in 2022 [World Bank (2022) Malawi Micro, Small and Medium Enterprise Tracker, Background Paper to the Malawi Country Economic Memorandum].

ty growth in the 1990s, 2000s and 2010s can be attributed to structural change. Additionally, we will analyze the pattern of productivity growth within agricultural and non-agricultural sectors. The shift from less productive sectors (e.g. agriculture) to more productive activities (mostly services) will contribute to economic growth even in the absence of within-sector productivity growth. Lastly, this section will assess the outlook of structural change effect based on the possibility that it may cease if non-agriculture sectors do not experience rapid productivity growth.

Box 2.1: Learning from successful experiences in supporting growth and structural transformation

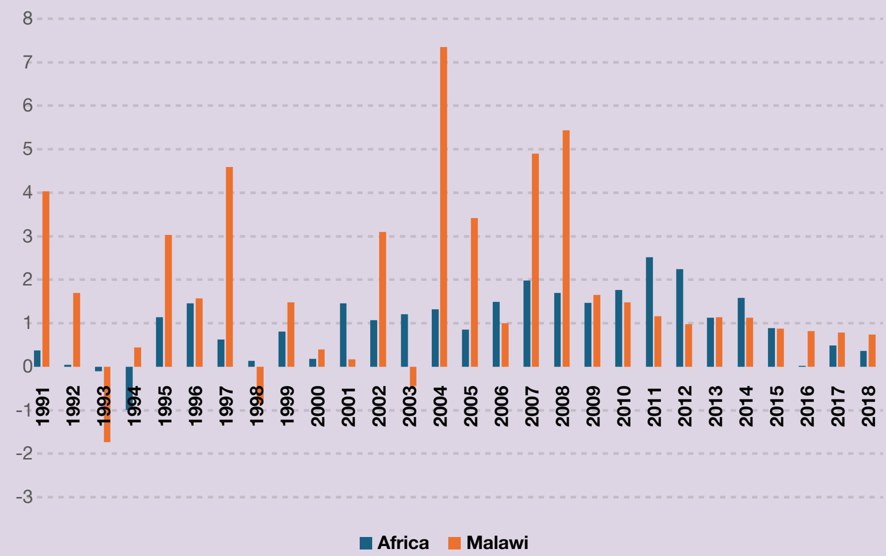
With the services sector showing signs of a driver in structural change in Malawi, there are parallels that can be drawn from other countries within and outside the continent. India's growth performance in the past three decades has been driven by the services rather than manufacturing sector. Critical in this observation is that India has focused more on high-skill tradable services, including digital-based exports such as call centers, data-entry services, software development. In addition, consumer-facing services in India, such as wholesale and retail trade, transport, and other non-tradables have been part of the country's growth story. For Malawi, the latter group of service activities do not show any evidence of having the potential to drive growth and structural change except for transport services.

Côte d'Ivoire's experience with the services and manufacturing sectors indicate that total factor productivity is 7 percent higher on average in services than in manufacturing. It also shows that high-productivity firms in services hire more workers, especially low-skilled workers, than low-productivity firms in services. It concludes that there is evidence consistent with the idea that the services sector is leading structural transformation and growth in Côte d'Ivoire. For a foreign currency-constrained country as Malawi, it would be important to focus on the tradables sector as it will address both the need for job creation and exports revenue generation to service its debt and finance import substitution activities through investments in agriculture-intensive value-adding activities.

Source: Abridged from Chapter 2 of the African Economic Outlook, 2024.

An analysis of Malawi's structural change trend (Figure 2.5) reveals high volatility for the 1991-2009 period although the country performed better than the African average in 14 out of the 20 years. One of the factors that seems to account for periods of structural transformation is higher levels of gross fixed capital formation (GFCF). Malawi enjoyed higher levels of structural transformation from 1995 to 1997 and from 2004 to 2009. As from 2010, lower levels of structural transformation were observed, and this period coincided with the falling GFCF and relatively better performance of the overall African economy. Particularly noticeable is that the 2004-2009 period is associated with the steep fall in the share of employment in agriculture, while the services sector made significant gains in its employment share. Moreover, higher levels of capital formation are likely to be associated with the introduction of new technologies that propel productivity and this is especially true for the financial sector. Comparing productivity in the three broad sectors, while agriculture had a higher productivity level in the 1990s, industry and services became more productive in the successive two decades. This was also accompanied by increasing shares in employment.

Figure 2.5: Structural Change in Malawi and Africa,1991-2018



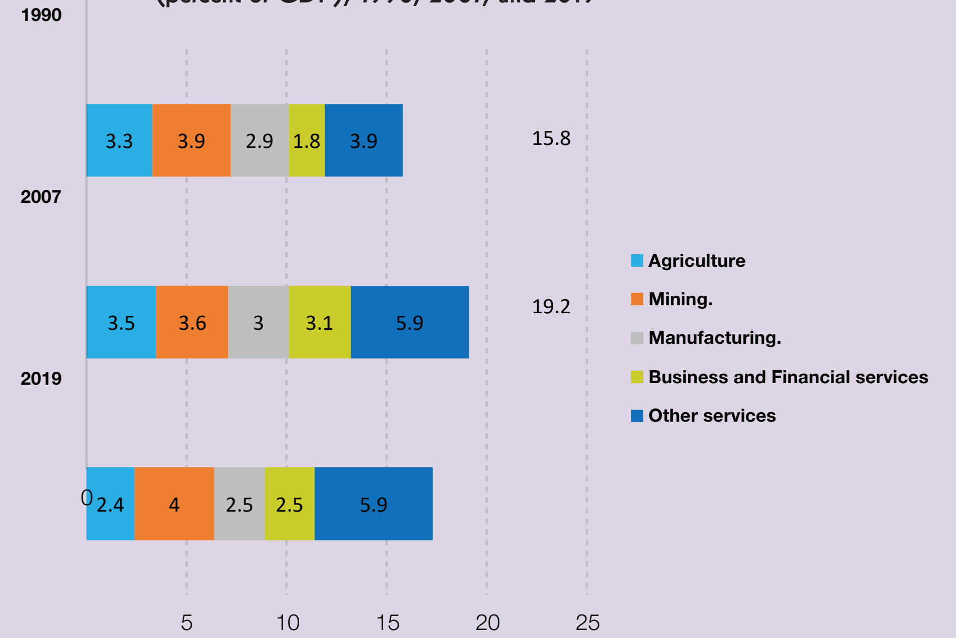
Source: Staff calculations using the Economic Transformation Database (Kruse et al. 2023).

Recent studies on total factor productivity (TFP) in Malawi are scarce. Benson and Hartley (2020) apply a general equilibrium model to analyze Malawi's TFP and conclude that the "transformation of the economy will involve increased economic productivity overall and considerable movement of labor and capital out of agriculture and into manufacturing and services." However, a services-led transformation would result in widening inequalities as the better-off households will benefit more compared to the poor households who would be better served by an agriculture-led transformation although it will result in lower growth and slower transformation. This finding is consistent with data on sector productivity and employment shares where it is observed that the sectors with the least productivity levels (agriculture and wholesale & trade) have the largest employment shares, while those with the highest productivity levels have the least employment shares (see Figure 2.3).

3.3 Rapid growth in income and jobs embodied in services export: New evidence

Evidence from Mensah and de Vries (2024) highlights the relevance of value added embodied in exports for Malawi. Considering five sectors (agriculture, mining, manufacturing, business and financial services and other services), domestic value added in exports is calculated using the hypothetical extraction method introduced by Los et al. (2016). This method considers the ratio of value added to gross output, and the ratio of employment to gross output, to compute value added and the number of jobs embodied in exports respectively. Figure 2.6 indicates that the year 2007 recorded an increase in value added for exports in all sectors except mining, compared to 1990 and 2019. The biggest change in value added embodied in exports occurred in the services category, once again confirming the higher level of structural change during that period. With reference to the broad sectors of agriculture, industry, and services, it is also observed that the services sector recorded the longest sustained period of structural change (2004-2014).

Figure 2.6: Sectoral domestic value added embodied in Malawi's exports (percent of GDP), 1990, 2007, and 2019



Source: Staff calculations using employment and value-added data from ILO and WDI

3.4 Drivers to accelerate structural transformation

Several factors account for Malawi's performance in structural change, ranging from institutional and policy factors to technological advancement, investment trends, the quality of labor resources, and infrastructure development. The first set of factors have a significant influence on the narrower concept of investment climate, while the second and third sets define the broader business environment. Good governance and strong institutions provide a conducive business environment by ensuring macroeconomic stability and predictability, which are essential for medium and long-term business planning. This in turn influences investment decisions and can bring about structural change.

Malawi's access to information and communication technologies (ICT) remains low, with an ICT Index of 31.5 compared to 49.5 for Zambia. However, there have been some improvements in the business and banking sector that have increased productivity and dynamism with positive implications for manufacturing firms, thereby influencing structural transformation. Malawi suffers from significant gaps in productivity-enhancing infrastructure, but there have been some improvements. In 2023, 18% (11.5% in 2020) of the population had access to electricity, 30% (26% in 2020) of roads were paved (1% and 0.1% of tertiary and district road categories are paved, respectively), the internet penetration rate stood at 24.4% (9.9% in 2019) of the total population, and mobile phone penetration was 60% (42.7% in 2021). The infrastructure gaps increase costs for businesses, making the country less competitive. This situation has increased import-based trade, thereby worsening the country's trade imbalance. When combined with institutional weaknesses, inclusive and pro-growth policies lose their attractiveness, thereby reinforcing inefficiencies and misallocation of resources.

Agglomeration enables firms and people to be more productive through proximity (De Weerdt, et al (2023). Malawi has experienced rapid urbanization over the past few years at 5% per annum, (Government of Malawi, 2019), with about 18% of the population living in urban settings in 2022. Urbanization is driven by population growth, rural-urban migration, and immigration. Whether urbanization can contribute to structural transformation in Africa in general has been a point of debate. Compared to other regions of the world, Africa 'has not yet experienced a "green revolution" and urbanization in the continent has proceeded without the development of major industrial sectors,' (Kriticos and Henderson, 2019). De Weerdt, et al (2023) note that in Malawi there is some evidence that agricultural activities close to urban centers have shown higher levels of productivity compared to those far away from urban centers. This observation could be due to farmers shifting to horticulture as opposed to cereals.

The Government of Malawi has adopted a strategy focusing on three sectors – agriculture, tourism, and mining (ATM) – as part of the diversification and transformation of the economy. Central in this strategy is a move towards mega farms, commercialization and agro-industrialization, exploitation of minerals associated with the energy transition, and development of cultural and nature-based tourism. Successful implementation of the ATM strategy requires ancillary investments in energy, transport, and the agriculture value chain, in terms of both inputs and outputs. Under the ATM strategy, Malawi intends to benefit from its several mineral deposits with economic potential, including rare earths, rutile, graphite, uranium, niobium, and tantalum that are energy transition minerals. Malawi's energy mix is dominated by renewable hydro-based energy (94%), and there is still potential for further investments in this sector, which puts the country at the core of a potential green revolution.

According to the United Nations Development Program (UNDP), Malawi has a low Human Development Index (HDI) and was ranked 169th out of the 191 countries in 2021. Its HDI score in 2019 was 0.49 and increased to 0.51 in 2021. The World Bank's Human Capital Index for Malawi increased from 0.36 to 0.41 in 2010 and 2020 respectively. Over the 2016-2018 period, budget expenses for investments in human capital development (education, health, and social protection) averaged 11%. The 2024/25 Financial Statement puts the human capital development (HCD) budget allocation at 33%. The increase in HCD budget is consistent with the efforts under the MIP-1, where HCD is one of the seven drivers of economic transformation.

Box 2.2: Potential and existing opportunities for investment in agriculture

The Government of Malawi's focus on agricultural transformation is three pronged: (i) support increased productivity through mechanization and infrastructural investments to build the sector's resilience; (ii) promote commercialization of the sector through larger farms that will provide advisory services to smallholder farmers; and (iii) support diversification of the sector by broadening the crops base as an anchor for agro-industrial development. For example, the Shire Valley Transformation Program for Malawi aims to increase agricultural productivity and commercialization for targeted households in the Shire Valley; and to improve the sustainable management and utilization of natural resources. On the other hand, the Mega-farm development objective is to ensure the commercial viability of agricultural mechanization through economies of scale and enhanced productivity by promoting efficient extension services to farmers.

3.5 Key bottlenecks to fast-paced structural transformation

Malawi's population structure has barely changed in the past 20 years despite evidence of slowing growth and an increase in the share of the working population from 50% in 2000 to 55% in 2022 (World Bank, 2024). Given that about 80% of the population is under 35 years, there is potential for this age group to contribute positively to a future demographic dividend. Using data for 1987 and 2018 censuses, as well as the Malawi National Statistical Office's projections for 2048, IFPRI (2020) indicates that 'Malawi's demographic transition will have barely begun by 2048', but the youth population is growing. The falling fertility rate, however, points to a potential rapid growth in the working age population thereby reducing the dependency rate. To ensure that Malawi benefits from a demographic dividend in the future, it is important that the country invests in education and skills development, promotes value adding activities fosters appropriate family planning actions to ensure that the high urbanization rate is accompanied with increasing productivity in agriculture, and creates better and higher-productivity jobs in the urban areas. As analyzed in Section 2 above, Malawi will also need to address the challenge of informality due to the low investment and productivity levels in the sector.

The frequency, intensity, and magnitude of extreme weather events in Malawi have increased over the past two decades. Floods, droughts, and strong winds associated with tropical cyclones have increased the country's vulnerability to climate change, putting at risk the lives of the 50.7% of the population that is already in deep poverty. In 2020, Malawi was ranked 163rd out of 182 countries on the Notre Dame Global Adaptation Index (ND-GAIN), which ranks the climate adaptation performance of countries.

The World Bank notes that climate change-induced extreme weather events can raise the country's poverty rate by 8%, which would add another four million poor people by 2040 (World Bank, 2022). Since 2010, Malawi has experienced 16 major floods, two rainfall-related landslides, five storm-related disasters, and two severe droughts. Of these weather-related events, three cyclones - Idai (2019), Gombe (2022) and Freddy (2023) in the southern parts - combined with drought in the north of the country and Tropical Storm Ana (2022), have had devastating effects on people's lives and livelihoods. Building resilience to climate shocks is therefore an important factor in the drive to achieve structural transformation. The Government's ATM strategy partly responds to this challenge.

The World Bank (2018) concludes that 'strengthening and enforcing the foundations of sound and accountable public financial and economic management is essential to restore credibility and confidence, and to create an enabling environment for more effective development performance,' in Malawi. This observation stems from repeated episodes of macroeconomic instability, although exogenous factors contributed to the poor economic performance of the country as reflected in Cammack (2004). Key factors in enhancing governance and institutional quality include a well-motivated civil service whose mandates and responsibilities are well defined. Consequently, civil service reforms, including improvements in the regulatory and policy frameworks to promote efficiency and effectiveness of public service, are crucial in efforts to reduce transaction costs and information asymmetry, and combat corruption.

Although Malawi has some good strategies and plans, these are either not implemented or poorly implemented as there are no incentives for excellence. Relatively weak institutions, combined with foreign exchange constraints due to a structural trade imbalance, have plunged the country into an acute foreign currency shortage, which discourages foreign investors because they will not be able to repatriate their profits or meet foreign currency operational costs. The adoption of a relatively flexible exchange rate system in November 2023 has not eliminated the exchange rate overvaluation, which in itself is an indicator of resource misallocations. Firms are therefore not able to upgrade or invest in cutting-edge technologies that would assist in improving productivity. It will be necessary to enhance structural transformation through quality infrastructure (soft and hard) policy consistency and robust institutions.

In addition, financing constraints have been detailed in Section 2 of Chapter 1, where the current fiscal situation has resulted in high interest rates alongside the dominance of government borrowing from the domestic market that is crowding out the private sector. This challenge is now being addressed within the IMF ECF program, which will also facilitate a return to positive real interest rates to encourage domestic savings.

IV. Finance to fast-track Malawi's structural transformation: How much is at stake?

4.1 Malawi's commitments to structural change

This section assesses Malawi's structural transformation agenda, especially through the ATM Strategy that is part of the MIP-1. As discussed in Section 2 of this Chapter, the Government of Malawi has adopted a strategy focusing on three sectors – agriculture, tourism, and mining – in efforts to diversify and transform the economy. This strategy aims to create opportunities for investment in high productivity sectors that are also labor intensive to ensure the creation of more jobs. The ATM Strategy is derived from the seven enablers of MIP-1.[3] Efforts to make agriculture resilient to climate shocks and improve food security are being made through the implementation of the Shire Valley Transformation Program, and increased surface water harvesting projects across the country. Moreover, the Government is making efforts to improve its agricultural extension services and promote better animal husbandry and agronomic practices. As the tourism sector, the policies seek to

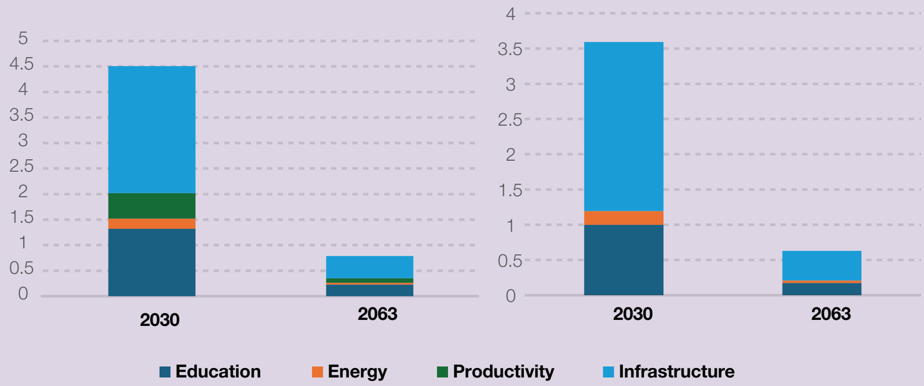
3 Seven enablers of the Malawi Vision 2063: Mindset Change, Effective Governance Systems and Institutions, Enhanced Public Sector Performance, Private Sector Dynamism, Human Capital Development, Economic Infrastructure, and Environmental Sustainability.

support the private sector to invest in culture and nature-based tourism. In the process, the Government has also waived visa requirements for 79 countries worldwide. In the mining sector, a public company, Malawi Mining Company, has been established to spearhead investments in the sector and the incentive regime for the extractive industry has been revised to make it more attractive to investors.

4.2 Financing needs and financing gap

Estimates of the financing needs and gap for the 2030 Agenda for Sustainable Development and the African Union's Agenda 2063 have been made based on the median input levels and controlling for other factors such as projected demographics and the level of GDP per capita. The approach focuses on how much African countries need to spend-and the financing gap to be filled-if they target the same level of performance as other developing countries in sectors critical for structural transformation. Based on this approach, it is estimated that Malawi will need about USD 4.5 billion to finance investments in education, energy, productivity, and infrastructure annually until 2030 or about USD 0.79 billion annually until 2063. Given the current inflows of financing, Malawi faces a gap of about USD 3.59 billion or USD 0.63 billion annually to fast-track structural transformation by 2030 or 2063 respectively (Figure 2.7). The largest financing needs are in infrastructure (55% of total), followed by education (30% of total).

Figure 2.7: Estimated annual financing needs and financing gap to fast-track structural transformation in Malawi by 2030 and 2063 (USD Billion)

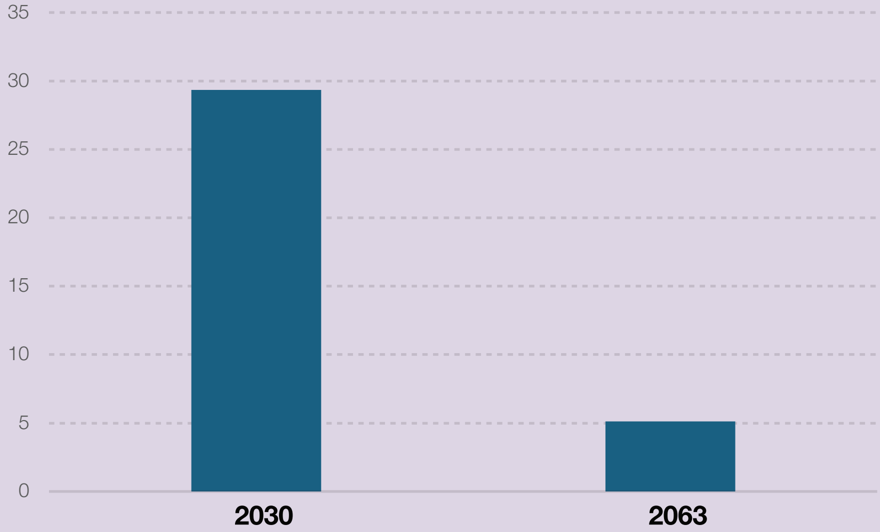


Source: Staff calculations based on the methodology described in Annex 2.2 and database from Sachs et al. (2023), UNESCO, CIA, EIA, NASA, IMF, and World Bank.

4.3 Closing the financing gap through domestic resource mobilization

Both external and domestic financing are critical to fast-track structural transformation. Enhanced mobilization of domestic financing through higher tax revenue could help close the estimated financing gaps. Considering the current tax-to-GDP ratios, for Malawi to close its financing gap by 2030 or 2063, the annual tax-to-GDP ratios would need to increase to 29.3 and 5.1 respectively (Figure 2.8). Given that the 2023/2024 level of the tax-to-GDP ratio was only 12.9, Malawi would need to more than

Figure 2.8: Required increase in Tax-to-GDP ratio to close annual financing gap in 2030 and 2063



Source: Staff calculations based on the methodology described in Annex 2.2 and database from Sachs et al. (2023), UNESCO, CIA, EIA, NASA, IMF, and World Bank.

double its tax revenue collection rate, a challenging feat indeed. While data on Malawi's potential to increase tax revenue collection is not available, increasing domestic financing alone will not enable the country to fast-track structural transformation by 2030 or 2063. For example, over the 2011-2021 period, Malawi's value-added tax (VAT) efficiency has ranged between 16% and 21%. To that end, significant external financing would be required if Malawi were to fast-track structural transformation by either 2030 or 2063. While the importance of public resources to finance structural transformation cannot be underestimated, mobilization of domestic private finance is important.

Key in this process is the need to reduce the cost of capital to investors and increase access. The Malawi financial sector has not been able to play an optimal role in financial resource allocation as about 60% of credit is channeled to the Government and only 30% is available for the private sector. Of this amount, 70% is allocated to non-productive sectors such as trading activities and on short-term basis. Malawi has been making efforts to strengthen its development financing capacity with the establishment of the Malawi Agricultural and Industrial Investment Corporation to provide cheaper and long-term credit to the productive sector.

Box 2.3: Bank's support to economic transformation in Malawi

Through its strategies for Malawi, the Bank has focused on investments targeted at enhancing productivity, competitiveness, and inclusive development. These investments are mainly in infrastructure development (transport, energy, and water). Among such investments are the Shire Valley Transformation program through co-financing arrangements with other donors, the Nacala Corridor, and trade facilitation investments in One-Stop Border Posts with Mozambique and Zambia. The projects address both hard and soft infrastructure issues. Building on the ICT developments in the country, the Bank is also supporting the digitization of revenue collection as part of the broader objective of enhancing domestic revenue mobilization. In skills development, the Bank helped in developing infrastructure for technical skills development focused on agriculture, water, and minerals beneficiation.

4.4 Concluding remarks and policy recommendations

The analysis in this chapter has identified key elements regarding structural transformation in Malawi. First, we observe that Malawi's economic growth performance has been below that of Africa and its peers in the region except for Madagascar. Despite averaging 3.2% growth for the past four decades, per capita income growth was only 0.32% over the same period. Therefore, growth has not been accompanied by poverty reduction. This could be due to the fact that the largest employers in the country, agriculture and wholesale and retail sectors, are associated with the least productivity levels. Moreover, Malawi is experiencing high urbanization rates without noticeable structural transformation due to the preponderance of the informal sector, a sector that has low capital-labor ratios, hence the low productivity levels. To fast-track structural transformation, the following recommendations are proposed:

4.4.1 Establish and institutionalize development plans and policies tailored to areas of comparative advantage as priorities and implement them consistently, while avoiding policy reversals that tend to disrupt progress.

Since independence, Malawi has enjoyed political stability, but its institutions have remained weak. Repeated cycles of macroeconomic instability have negatively impacted growth and structural transformation. The periods of poor economic growth have been associated with high inflation, large fiscal deficits, perennial structural external account imbalances, and exchange rate pressures. Of note is that Malawi has developed some good policies and strategies, but their implementation has been partial, and marked by policy reversals, which is primarily due to weak institutions, lack of ownership of the plans, and limited political commitment.

4.4.2 Create targeted and streamlined incentives to catalyze mobilization of private capital flows and build DRM capacity to support Malawi's development plans in key sectors for structural transformation.

To fast-track structural transformation, Malawi needs to create opportunities for private investment in high productivity areas like the financial and manufacturing sectors. The ATM strategy that the Government has adopted promises to provide impetus to growth and structural transformation that is anchored on driving higher productivity in agriculture and related agriculture value adding activities based on exploiting the country's natural endowments – labor and natural resources, including land. Critical to enhancing productivity will be the investments in human capital development to ensure the availability of highly skilled labor. However, investments in ancillary sectors like infrastructure, especially transport, energy and water, will be critical to building resilience in the agricultural sector and ensuring competitiveness of the country's exports. This process, when accompanied by macroeconomic stability, will enhance the country's attractiveness for external investments and the associated technological advances that would drive productivity growth.

The 2014 Malawi National Industry Policy identified the key action points to a competitive and structurally transforming industrial sector that would support livelihoods in an environmentally and socially sustainable manner. While the focus of the policy was on manufacturing, the ATM strategy provides a broader focus that takes advantage of the country's natural endowments, with potential early wins. The private sector, on the other hand, will support structural transformation given its potential in mobilizing additional resources, especially as the public sector encounter difficulties in investing in development.

4.4.3 Build and deepen markets at national and regional levels.

Given the existence of the African Continental Free Trade Area (AfCFTA), the participation of regional and continental financial sector stakeholders in the country will enhance productivity and facilitate the opening of new opportunities for investment. Such opportunities include increased financial integration, movement of labor, and better specialization, and thereby foster structural transformation. Regional institutions could also play a critical role by establishing frameworks for regional integration, including the setting of standards. For small open economies like Malawi, the regional bodies provide the primary conditions for regional trade. Development financial institutions (DFIs) and multilateral development banks (MDBs) also have a role to play as they provide access to cheaper and tailor-made financial solutions. As regards the MDBs, their convening power and financial muscle will help in providing regional public goods, including advisory services. Consequently, to benefit from available opportunities, Malawi needs to strengthen its legal, policy and institutional framework for the management of environmental and social (E&S) risks and impacts since this is one of the key requirements of MDBs.

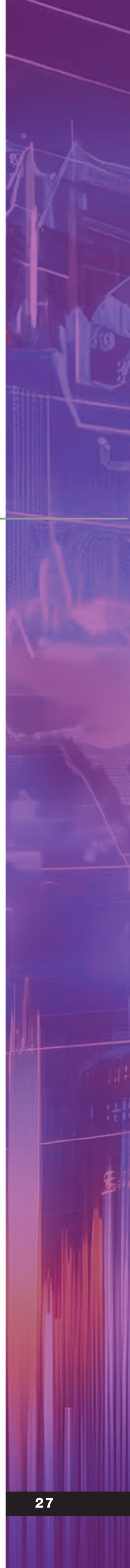
4.4.4 Prioritize public service delivery and prudence in public finance management.

An efficient and disciplined public service, free from corruption, will enhance resource mobilization and allocations in support of more productive and transformational investments. Malawi's tax-to-GDP ratio of 12.9% is below the African average and limits the capacity of the Government to deliver basic public services. Moreover, the current fiscal challenges facing the country are partly due to limited capacity to mobilize tax revenue and efficiently apply those resources for the maximum benefit of its citizenry and the private sector. An active and dynamic private sector will support tax revenue generation, promote inclusive growth through job creation, and provide access to a variety of goods and basic services.

Malawi's PFM systems should not only incorporate efficient revenue mobilization, but also include efficient allocation of the resources and ensure value for money in their utilization. Strong political commitment will be needed to develop expertise in core departments and fiscal units in charge of PFM activities. This process includes developing clear guidelines and built-in regulatory systems to ensure an efficient tax and non-tax revenue structure that fosters private sector development and innovation. As many of the African countries, Malawi needs to improve tax compliance by enhancing the social contract with its citizens. Strengthening supreme audit and public accountability systems will go a long way towards ensuring transparency and confidence in the PF system. The burgeoning informal sector in Malawi can only start to contribute meaningfully to the fiscus if its operators see value in formalizing their activities. For example, the registration of the informal sector players could be attractive if it is also regarded as enhancing the protection their rights, entitlements, and assets. Malawi can benefit from the Bank's virtual and interactive collaborative environment, virtual knowledge repositories, policy lab unit, and a virtual campus on PFM for real-time support to public officers.

3

FINANCING STRUCTURAL TRANSFORMATION IN MALAWI: THE NEED FOR REFORMS OF THE INTEERNATIONAL FINANCIAL ARCHITECTURE



KEY MESSAGES

- **As in many other African countries, Malawi needs large investments to fast-track structural transformation, while dealing with the threats of climate change, and global shocks.** To achieve the investments level required, reform of the international financial architecture is needed for an equitable and inclusive global financial system that works for both the rich and poor countries.

- **During Malawi's Chairmanship of the LDCs group of countries that ended in 2023, the Government made an impassioned plea for debt cancellation.** Debt has had a disproportionate effect in shrinking the LDCs' fiscal space and consequently reducing their ability to invest for development.

- **The six areas needing urgent attention are: global economic governance, debt relief and the cost of sovereign borrowing, international public finance, the global financial safety nets, lengthening the loans terms, and addressing the global tax architecture for equitable and inclusive sustainable development.** The UN justifies the need for reforms in these areas as they help to remedy the absence of a mechanism to ensure availability of stable and adequate long-term financing for investments needed to combat the climate crisis and achieve the sustainable development goals (SDGs) for the eight billion people in the world today.

- **Reform of the global financial architecture is not a silver bullet for Malawi to fast-track structural transformation.** However, without the reform, Malawi will not be able to implement its commitment to green growth and realize its ambitions for climate actions as detailed in its nationally determined contribution (NDC), as they will require significant investments. The combined unconditional and conditional contribution reduction target of GHG emissions will be 51% by 2040.

I. Introduction

As in many other African countries, Malawi needs significant investments to meet the challenge of achieving structural transformation, while dealing with the threats of climate change, and global shocks that have negative spillover effects on the country. To fast-track structural transformation by 2030, while dealing with the threat of climate change, Malawi's financing requirements will amount to USD 4.5 billion per year. If the period is extended to 2063, the annual financing needs will be USD 0.79 billion. Considering the current inflows of financing, Malawi faces a gap of about USD 3.59 billion or USD 0.63 billion per year to fast-track structural transformation by 2030 or 2063 respectively. These estimates of financing needs and gaps to fast-track structural transformation are provided in the 2024 African Economic Outlook (AEO 2024) and data on the financing of climate actions (AEO 2022 and 2023). While domestic resource mobilization will be key to meeting the country's development needs, it is observed that such resources will not cover the financing gaps, hence the need for increased external financing. Reforms to the international financial architecture are therefore needed to ensure an equitable and inclusive global financial system that works for both the rich and poor countries.

"Enhancing domestic resources mobilization is important for Malawi to realize development aspirations, but will not cover the financing gaps, hence reforms to the international financial architecture to ensure an equitable and inclusive global financial system that works for both the rich and poor countries are needed."

II. Malawi's stand on the need to reform the international financial architecture

The amount of development financing that Malawi needs to transform its economy is far much higher than what it currently receives (see Chapter 2). Climate-related emergencies that impact the livelihoods of the population, given Malawi's current debt distress situation, have amplified calls for reforms to the international financial architecture to enable countries in similar situations to access external financing in a timely and sustainable manner. Current challenges in the international financial architecture include difficulties in the governance system and technical deficiencies that tend to increase the cost of accessing available resources. Thus, Malawi and other similar African countries face the daunting task of financing their development needs at higher costs, yet they are the least prepared to do so, leading to the recurring debt challenges on the continent. For instance," developing countries' average interest cost on external borrowing is three times higher than that of developed countries" (Ulrich and Aitken, 2022). Overall, developed countries owe the largest amount of debt, but only spend 3.5% of their domestic revenue to pay for external debt compared to 14% for the least developed countries (LDCs).

During Malawi's Chairmanship of the LDCs group of countries, Malawi made an impassioned plea for debt cancellation due to its disproportionate effect of shrinking the LDCs' fiscal space and consequently reducing their ability to invest for development. In addition, Malawi called for enhanced access to low-cost, long-term and predictable flows of aid. In 2023/2024, Malawi's external public debt service accounted for 46.9% of revenue (excluding grants) and 58.1% of total export earnings. During the COVID-19 pandemic, access to emergency financing flows for developed countries largely skewed towards the developed economies, with Africa receiving only 4.5% of the USD 650 billion in Special Drawing Rights (SDRs) issued by the International Monetary Fund (IMF) in 2021 (see Chapter 2). In addition, out of the USD 17 trillion (or 19% of global GDP) rolled out as total fiscal measures to fight the COVID-19 pandemic in 2020-2021, Africa accounted for just USD 89.5 billion or 0.5% of the global value for pandemic emergency response.

Malawi has also underscored its ambitious plans to reduce GHG emissions by 51% as an expression of its contribution from green growth focusing on energy, agriculture, environment, and transport actions. Over 90% of Malawi's energy generation is from renewable sources. As regards the transport sector, investments in better roads and rail systems are meant to reduce the country's carbon footprint. At the policy level, Malawi also banned the production and use of charcoal to preserve forests, although this policy has hardly been implemented as the country lacks alternatives for its poor population. To lessen the burden of financing for development and structural change, the United Nations (2023) identifies six main areas needing urgent attention, namely global economic governance, debt relief and the cost of sovereign borrowing, international public finance, the global financial safety net, lengthening the loan terms, and addressing the global tax architecture for equitable and inclusive sustainable development. Details on the reforms in these areas are provided in AEO 2024. In the case of Malawi, while changes to all these elements will bring some positive results, greater benefits will flow from the following:

i. Given its debt distress situation, Malawi would greatly benefit from a debt restructuring process that would lengthen the term structure of its debt, reduce the debt cost, and cancel its debt, all of which would reduce its debt burden and increase fiscal space.

ii. Reform of the international public finance landscape, focusing on multilateral development banks (MDBs), international financial institutions (IFIs), and official development assistance (ODA) to increase financial flows to needy countries, reduce the cost of finance, and improve predictability of such flows to developing nations. The World Bank's International Development Assistance (IDA) and the African Development Bank's African Development Fund (ADF) instruments have inbuilt mechanisms to reduce the debt burden faced by African countries by shifting towards grant financing once a country is at high risk of debt distress.

iii. International financial safety nets can support Africa's structural transformation if they are tailored to sustain resilience building by focusing on the productive capacity and diversification of Malawi's production base, and thereby reduce its vulnerability to shocks, such as the current geopolitical tensions and climate change events. Given the underdeveloped nature of African financial markets and the tendency for external portfolio flows to exit the continent in time of potential challenges, current international financial safety nets are ill-designed to be of benefit to Africa. In the case of Malawi, the exchange rate pressures on the Malawi Kwacha also hamper inflows of foreign currency.

iv. There are currently a few big multinational or foreign firms operating in Malawi. However, as the country continues to improve the business environment, more of such firms are likely to invest in the domestic economy, and issues around international tax arrangements will be amplified.

v. Closely linked to cuts in MDB and IFI financing is the credit rating methodology used by credit rating agencies. As noted in AEO 2024, reforming credit rating agencies could reduce debt service costs by up to USD 74 billion per annum in interest payments. A fairer credit rating methodology should lay emphasis on basic economic fundamentals. Such savings are significant to meet part of the financing needs to fast track Africa's structural transformation.

The UN (2023) argues that 'the existing architecture has been unable to support the mobilization of stable and long-term financing at scale for investments needed to com¬bat the climate crisis and achieve the Sustainable Development Goals for the 8 billion people in the world today.' Maintaining the existing global financial architecture would therefore imply failure to achieve the 2030 SDGs. Indications are that many developing countries will miss their targets unless financing is scaled up sufficiently.

III. Mobilizing additional resources for Africa's structural transformation

Current inflows of financing to Malawi and Africa, in general, fall far short of the requirements to fast-track structural transformation by 2030 0r 2063. In 2022, the total inflows from FDI, ODA, remittances, and net portfolio investments to Africa were only USD 174.9 billion, down 19.4% from USD 217.1 billion recorded in 2021. Moreover, out of the USD 652.6 billion of global climate finance mobilized in 2019/20, Africa received only USD 29.5 billion (or 4.5%), 86% from public sources and 14% from private sources. For Malawi, these flows amounted to USD 926.1 million in 2021. Net portfolio investments were negative since 2019 when the debt crisis worsened, and foreign reserves dwindled to less than one month of imports cover. Compared to the annual financing needs to fast-track structural transformation by 2030, current inflows represent 21% of needs. Moreover, the unpredictability of such flows makes it difficult for the Government to plan for development.

Considering that most of the investment goes into the agriculture sector which attracts FDI from South Africa, USA, UK and India, the potential for the sector to expand exports is growing. However, without commensurate investments infrastructure, especially energy and transport, net earnings may remain low and thus have a limited impact on the trade imbalance. At the policy level, the Government needs to focus on enhancing innovation to boost productivity. The challenge, however, is to ensure increased fiscal space to invest in infrastructure. The role of the private sector to contribute to such investments requires an improved public-private partnership (PPP) framework. Currently, the number and scale of PPP initiatives in Malawi are relatively low compared to other countries in the region. Key challenges in making increased PPP investments include:

i. Limited stakeholder participation, transparency, and disclosure to help build trust and ownership in the PPP process.

ii. The Public Private Partnership Act was enacted in 2022 to provide a legal basis for PPP projects, but further clarity and consistency in regulations and guidelines is needed to ensure clear provisions for project procurement, risk allocation, contract negotiation, and dispute resolution.

iii. Institutional capacity for PPP implementation is limited. Established in 2011 by an Act of Parliament, the PPP Commission (PPPC) is the implementation Agency for PPPs and is responsible for developing guidelines on best practices, yet its capacity in terms of skilled personnel and resources is relatively low. Building the necessary expertise in project appraisal, financial structuring, risk assessment, and contract management is crucial to ensure effective PPP implementation.

iv. Access to finance for PPP projects in Malawi is a significant challenge. The country's financial market infrastructure is still developing, with limited domestic and international financiers interested in funding PPP initiatives. Strengthening partnerships with development finance institutions, exploring credit enhancement mechanisms, and improving the investment climate will help enhance access to finance for PPP projects.

v. Transparency and disclosure practices in Malawi's PPP environment need improvement. Currently, there is limited public access to project information, procurement processes, and contract terms. Enhancing transparency and disclosure mechanisms, such as publishing project information and conducting public consultations, will promote accountability and public scrutiny.

vi. The exchange control regime, especially the export retention, and limitations on profit remittance provisions need further tweaking to ensure that they do not discourage exports or inward investments respectively.

IV. Dealing with Malawi's debt

Malawi is facing its worst debt crisis since 2005. At the Heavily Indebted Poor Countries (HIPC) Initiative completion point in 2006, Malawi's debt-to-GDP ratio dropped from 70.93% to less than 18% and remained below 20% until 2011 before recording a huge increase to 28.46% in 2012. Several low-income debt sustainability thresholds were breached in 2016. Since 2019, Malawi's debt-to-GDP ratio has doubled from about 41% to the current 82.1% in 2023. Total public debt in Malawi stood at 82.1% of GDP in 2023. Compared to 2022, public debt rose by 5.6%. External public debt service accounted for 46.9% of revenues (excluding grants) and 58.1% of total exports. In the 2023/24 fiscal year (FY), interest payments on total public debt account for 5.6% of total public expenditure compared to 4.9% the previous year. Malawi's current debt ratios are far above the recommended ceilings – debt-to-GDP ratio (30%), external debt-to-revenue ratio (14%), and external debt service-to-exports ratio (10%). Thus, Malawi's external and public debt is in distress.

Exogenous and endogenous shocks, including the 2008 global financial crisis and the 2012 Cashgate[4] scandal, are associated with periods of large debt increases. Since 2016, successive adverse climate-related shock and the COVID-19 pandemic have buffeted Malawi. Weather-related events - drought, floods, and landslides - have increased in frequency and intensity, and affect millions of people each year. In addition, declining terms of trade, shortages of foreign currency and elevated inflation negatively impacted economic growth, thereby affecting the country's capacity to generate revenue at a time when expenditures were increasing. Notably, Malawi's dependence on agriculture, given the climate shocks, increases its vulnerability to weather and trade shocks. About 80% of export earnings are agro-based, of which tobacco generates 60% of total exports receipts. Moreover, the 2022 and 2023 devaluations of the Malawi Kwacha contributed to large increases in debt. Over the past five years, the major changes in debt have been driven by the primary deficit, real GDP growth, exchange rate depreciation, and interest rates. The residual, comprising of the unidentified debt creating flows, is also a major determinant of

[4] The Cashgate scandal involved looting, theft and corruption by government officials and was discovered in 2013.

debt.

The Government's recourse to high-cost private external and domestic borrowing, given the country's limited access to external concessional financing, has pushed the cost of debt. Rising debt costs have not only increased the fiscal burden, but also tightened liquidity on the domestic market. As at 16 February 2024, yields on 91-day and 10-year paper were 15.88% and 35% respectively, compared to 9.82% and 22.98% respectively on the same date in 2022.

Malawi is going through debt restructuring negotiations under the G20 Common Framework, as part of the efforts to bring its debt to sustainable levels. Currently, the focus is on increasing the tenure and cost of existing debt, but the process has long delays that put pressure on public finances and create liquidity challenges. Given that non-debt creating external flows are limited, Malawi's ability to finance development and structural transformation has been curtailed.

V. Financing climate action

Floods, droughts, and strong winds associated with tropical cyclones have elevated the country's vulnerability to climate change, putting at risk the lives of 50.7% of the population that is already in deep poverty. In 2021, Malawi was ranked 161st out of 182 countries on the Notre Dame Global Adaptation Index (ND-GAIN), which ranks the climate adaptation performance of countries. Its vulnerability to climate change was scored 0.54, making it 28th most vulnerable country and 25th least prepared country to deal with such shocks. The World Bank notes that climate change-induced extreme weather events can raise the country's poverty rate by 8%, which would add another four million poor people by 2040 (World Bank, 2022). Implementing actions for the country to transition to green growth and fast-track structural transformation have become more difficult than ever. As an illustration, GDP growth averaged 2.8% during the 2018-2022 period, lower than the 3.9% registered over the previous decade, thereby slowing the pace of poverty reduction.

Since 2010, Malawi has experienced 16 major floods, two rainfall-related landslides, five storm-related disasters, and two severe droughts. Of these weather-related events, three cyclones - Idai (2019), Gombe (2022) and Freddy (2023) in the southern parts - combined with drought in the north of the country, and Tropical Storm Ana (2022), have had devastating effects on people's lives and livelihoods. Given Malawi's heavy reliance on agriculture, climate change-related events have exacerbated their effects on the country. Environmental degradation caused by climate change and the increasing human and livestock population pressures are impacting agricultural productivity as more and more marginal areas are being used. Moreover, most smallholder farmers in Malawi are resource-poor, with very limited capacity to respond to more frequent and intense shocks arising from climate change. With seasons getting shorter, yields are falling and causing food shortages with negative implications for nutrition. Poverty, coupled with overdependence on traditional biomass (wood, charcoal) and other fossil fuels to meet the country's growing energy needs, are also contributing to climate change as forest resources are being depleted. As with many other developing countries, the country's structural transformation is threatened by climate change, especially as both agricultural productivity and employment have fallen.

Malawi has shown commitment to green growth by setting ambitious climate actions in its nationally determined contribution (NDC) that will require significant investments. The combined unconditional and conditional contribution reduction target of GHG emissions is 51% by 2040. To achieve this target, the Government of Malawi ratified the Disaster Preparedness and Relief Act of 1991 that established the Department of Disaster Management Affairs (DODMA), an agency which is responsible for coordinating and directing the implementation of disaster risk management programs. These programs aim to improve and safeguard the quality of life of vulnerable Malawians. A series of sector legislative frameworks and strategies to integrate environment and climate change management in socio-economic development activities have been put in place.

Both the public and private sector stakeholders are expected to play key roles in that process. The average climate finance flows for the 2019-2020 period was USD 512 million and that for 2020 alone USD 583.8 million (AEO2023). USD 453 million came from public financing of which 61% was foreign public financing and 27% came from the -Government (AEO2023). Thus, the domestic private sector's 12% contribution to the total financing suggests latent potential that must be tapped, especially as the commercial banks and other financial institutions contributed nothing.

As indicated in Section 3 of this Chapter, external financing flows to Malawi amounted to USD 926.1 million in 2021, against a gap of USD 3.59 billion or USD 0.63 billion annually to fast-track structural transformation by 2030 or 2063 respectively. Similarly, climate financing gaps of more than 50% have been identified. These observations highlight the need for urgent reforms to the global financial architecture, including expanding the mandates of MDBs to finance global public goods.

Given these huge financial needs, Malawi faces challenges in accessing climate finance due to lack of accredited national entities, limited institutional and technical capacity to develop bankable project proposals, difficulties in crowding in private sector financing for climate action, lack of data to monitor both public and private sector investments, and low awareness of available climate funds that the country can use. A National Climate Change Fund is still to be established as a first step towards creating a national mechanism to leverage climate funds.

VI. Policy recommendations

Malawi's status as an ADF and IDA-only grant recipient under the African Development Bank and World Bank respectively, is of benefit to the country as resources from these two institutions do not contribute to the debt crisis. This is beneficial to Malawi, especially at a time when private flows are also depressed due to the perceived high risk of the country and the current global financial architecture that does not provide a solution to the elevated financial needs of the country. If the goal for an inclusive global economy, where no one is left behind, is to be achieved, countries like Malawi or developing countries in general will need preferential access to financing as follows:

i. For a country like Malawi, whose overall credit rating cannot be separated from the climate change impacts, it would be important to have a better understanding of the relative contribution of climate change to the financial health of the country. Better credit rating frameworks that are transparent and consider the natural capital of countries would be important.

ii. Through enhanced and innovative ADF and IDA funding to enable them to have access to larger financing resources targeted at financing transformative investments in developing countries.

iii. A combination of the debt crisis and perceived poor performance of Malawi's governance performance has had the effect of raising the debt cost and reduced access to credit. Malawi therefore needs to address those aspects that are under its control to improve its governance ratings to maximize its access to concessional and bilateral aid. Developed countries should also consider a dedicated fund that would enable Malawi to implement specific governance reforms to ensure a comprehensive, predictable, and adequately funded reform program unlike the current scenario in which the various donors pick and choose what reforms they like to support. Such a program will reduce the need for debt financing of some of the institutional and capacity building reforms.

iv. Malawi is currently going through a debt restructuring process and the supplementary loan agreement it had with China, which increased the tenure of the country's debt by 78 months is likely to influence other bilateral creditors. At this point, Malawi would benefit from an outright debt reduction for the country to be able to channel the debt savings into long-term infrastructural financing to improve its business environment and the competitiveness of its exports. In addition, the current approach that seeks to bring together countries with different interests to resolve debt crises is long and cumbersome. For a country like Malawi that has been facing unprecedented shocks, its capacity to recover will be prolonged. In 2023, the United Nations Conference on Climate Change (COP28) emphasized the need for developing countries to increase investments in climate mitigation and adaptation to fast-track development. Debt relief, together with large increases in aid, grants, and affordable finance from MDBs and official creditors would support the development aspirations of developing countries.

v. As in many other African countries, Malawi has embarked on reforms to deepen its financial sector and boost its capacity to contribute to development financing, including for emergencies. The establishment of an African Financial Stability Mechanism (AFSM) with the sole mandate of debt refinancing is important to ensure that African countries have access to enhanced and affordable financing, particularly during times of crises. The AFSM would alleviate countries' short-term liquidity constraints by enhancing credit and augmenting liquidity on domestic and international debt markets.

vi. Data from Global Financial Integrity indicates that USD 4.7 billion in illicit financial flows left Malawi between 2001 and 2010, about USD 469 million per year. In 2021, Global Financial Integrity indicates an increase of illicit financial flows to USD 650 million per year. Strengthening Malawi's detection of such flows through the establishment of international tax norms, and greater tax transparency and international information sharing could save the country a lot of resources. Such actions will also stem base erosion and profit shifting by multinational corporations, thereby boosting domestic revenues.

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