Malawi Economic Monitor

FEBRUARY 2024

TURNING THE CORNER?

SPECIAL TOPIC:

HEALTHY WATERSHEDS FOR A STRONG ECONOMY

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ACKNOWLEDGEMENTS

The Malawi Economic Monitor (MEM) provides an analysis of economic and structural development issues in Malawi. This 18th edition was published in February 2024 and is part of an ongoing series published twice each year. The publication intends to foster better-informed policy analysis and debate regarding the key challenges that Malawi faces in its endeavor to achieve inclusive and sustainable economic growth.

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

ABBREVIATIONS

ADD	Agricultural Development District
AIP	Affordable Inputs Program
CECF	Community Environmental Conservation Fund
CEM	Country Economic Memorandum
COP	Conference of Parties
CSA	Climate Smart Agriculture
ECF	Extended Credit Facility
EMDEs	Emerging Markets and Developing Economies
FAO	Food and Agriculture Organization
FMDF	Forest Management and Development Fund
FOB	Free on Board
GDP	Gross Domestic Product
IEA	International Energy Agency
IFMIS	Integrated Financial Management Information System
IMF	International Monetary Fund
IPC	Integrated Food Security Phase Classification
LMICs	Low and Low-Middle Income Countries
MDAs	Ministries, Departments and Agencies
MEM	Malawi Economic Monitor
MERA	Malawi Energy Regulatory Authority
MPC	Monetary Policy Committee
MoFEA	Ministry of Finance and Economic Affairs
MWK	Malawi Kwacha
MVAC	Malawi Vulnerability Assessment Committee
NPLs	Non-Performing Loans
NSO	National Statistics Office
OAG	Official Airline Guide
OECD	Organization for Economic Cooperation and Development
PFM	Public Finance Management
RBM	Reserve Bank of Malawi
ROA	Return on Assets
SLA	Sustainable Land Management
SSA	Subs-Saharan Africa
TT	Telegraphic Transfer
UNEP	United Nations Environment Programme
USA	United States of America
US$	United States Dollar
WEO	World Economic Outlook
WMO	World Meteorological Organization
WTTC	World Tourism and Travel Council

OVERVIEW

Malawi has now taken bold steps to stabilize the economy, but 2023 saw low growth, and macroeconomic imbalances continue into 2024

Malawi's economy is estimated to have grown by only 1.6 percent in 2023. The resumption of energy production at the Kapichira hydroelectric power plant has improved access to electricity and supported economic activity, particularly in the industry and services sectors. However, production inputs across sectors were often unavailable throughout 2023 due to foreign exchange shortages, dampening growth. Following Cyclone Freddy, agricultural output in 2023 was only marginally larger than in 2022. Rapid inflation and foreign exchange shortages throughout the year contributed to a weak business environment, further undermining economic growth.

Recent exchange rate reforms are yet to translate into increased liquidity in formal foreign exchange markets. While the 2012 exchange rate liberalization led to an immediate uptick in foreign exchange trading among authorized dealers, liquidity levels have remained stagnant following the November 2023 exchange rate reforms. Uncertainty about the new exchange rate regime and the reemergence of spreads against parallel markets after the depreciation likely reduce the incentive for market actors to formalize foreign exchange transactions.

Rapid price increases and limited employment options have led to a rise in food insecurity and poverty in Malawi. Many Malawians feel the squeeze from the scarcity of available jobs and pressures on real wages. In 2023, approximately 71.7 percent of the population were estimated to be living below the international poverty line. One in five are expected to experience crisis-level food insecurity during the lean season, with profound implications for human development outcomes, including mental health. The food security situation is particularly tense in the southeastern region of the country.

Imports have remained steady despite low foreign exchange liquidity in the formal market. Significant revisions in trade data in 2023 show that imports have remained stable in US$ terms during the period of foreign exchange shortages, which started in mid-2022. Increased support from development partners likely played a significant role in alleviating the impacts of the current crisis. Nevertheless, due to elevated international commodity prices, Malawi still imported fewer liters of fuel and fewer bags of fertilizer than before the crisis. The exchange rate adjustment appears to be contributing to limiting non-essential imports—a necessity for reducing Malawi's trade deficit over the medium term.

The delayed re-alignment of the kwacha contributed to inflationary pressures. In December 2023, headline inflation surged to 34.5 percent, up from 26.9 percent in October 2023, before the devaluation. This marked a reversal of the declining inflation trend observed between August and October 2023. The increase in inflation has been particularly driven by a rise in food inflation, climbing from 34.5 percent in October to 43.5 in December 2023.

The fiscal deficit is narrowing for the first time in six years

Over the past decade, increased government spending has pushed government financing requirements to unsustainable levels, but there is now a notable shift towards fiscal consolidation. Financing of the fiscal deficit has resulted in major debt vulnerabilities and a crowding out of private sector credit. Ongoing government efforts aimed at consolidating public finances are expected to play a role in

curbing borrowing. Reforms in revenue collection, supported by budget support, are expected to reduce the fiscal deficit to 7.4 percent of GDP, the first reduction in six years, though this excludes the statutory RBM recapitalization following the November 2023 devaluation.

Public and publicly guaranteed debt remains in distress and unsustainable, requiring timely and substantial debt restructuring. The stock of public debt is estimated to have increased from 75.7 percent of GDP in 2022 to 81.3 percent in 2023. The government is encountering difficulties in securing financing from the domestic market, with subscriptions falling below requirements in most security auctions. The November 2023 joint World Bank-International Monetary Fund (IMF) Debt Sustainability Analysis reported that both external and overall public debt remain in distress and are unsustainable under current policies. The government is pursuing external debt restructuring, having received financing assurances from China and India in late 2023, which have provided momentum that debt relief can be achieved. Agreement with these official creditors, along with progress in negotiations with Malawi's commercial lenders, will be key for achieving debt sustainability over the medium term.

The Reserve Bank of Malawi (RBM) adjusted the official exchange rate by 44 percent, promised to increase kwacha flexibility, and has further tightened monetary policy

The RBM implemented a 44 percent adjustment to the MWK-US$ exchange rate and introduced additional measures to increase the flexibility of the kwacha. This revision, announced on November 9, 2023, shifted the selling rate from MWK 1,180 to MWK 1,700 per US$, marking a departure from a period of fixed exchange rate management and diminishing foreign exchange reserves. Since the 25 percent adjustment in May 2022, the official rate had remained largely unchanged, while the parallel rate continued to rise. The spread between the official and parallel market exchange rate peaked in August 2023 at 63 percent. The RBM viewed the adjusted US$-kwacha rate as market-clearing, aligning it with market fundamentals and mitigating arbitrage opportunities. Following the devaluation, the RBM announced plans to increase the frequency of foreign exchange auctions and permit intermediaries to trade at freely negotiated rates. However, the implementation of these measures remains limited.

The RBM has tightened monetary policy to contain inflationary pressures. The Monetary Policy Committee responded to high inflation by raising the policy rate twice in 2023, from 18 to 24 percent, and again in early 2024 to 26 percent.[1] While money supply growth remained high, it decelerated from its peak of 38.8 percent in December 2022 to 28.3 percent in October 2023. Subsequently, due to revaluation gains resulting from the exchange rate adjustment, money supply increased to 32.2 percent year-on-year in December 2023. Additionally, the yields of both seven-year and ten-year Treasury Notes increased by 450 basis points over the course of the year.

Malawi's economic recovery requires strong commitment to sustain reforms

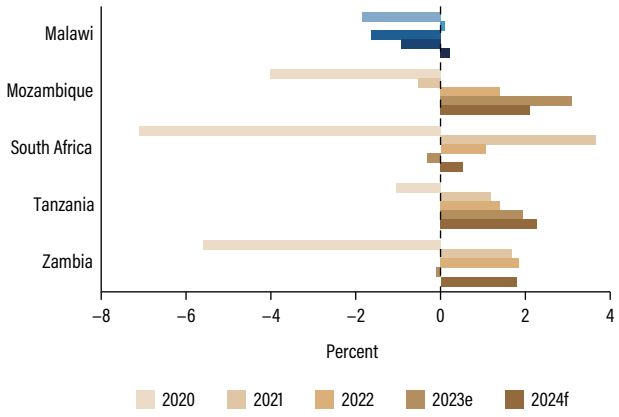
Economic growth is projected to increase, driven by an improved macroeconomic environment and sustained structural reforms. Growth is estimated to reach around 3 percent in 2024, primarily due to a modest easing of global commodity prices, a moderate improvement in agricultural production, and increased output bolstered by improved foreign exchange inflows. Over the medium term, growth is expected to average 4 percent, underpinned by ongoing and announced macroeconomic reforms designed to address external and fiscal imbalances. Fiscal consolidation measures and public financial management reforms, supported by the new IMF Extended Credit Facility program and the new World Bank Development Policy Operation, are critical for regaining long-term macroeconomic stability and fiscal sustainability. The gradual stabilization of the current account deficit, expected to

1. This was preceded by two increases in 2022—from 12 to 14 percent in April, and then to 18 percent in October.

FIGURE O.1 A snapshot of Malawi's economic situation

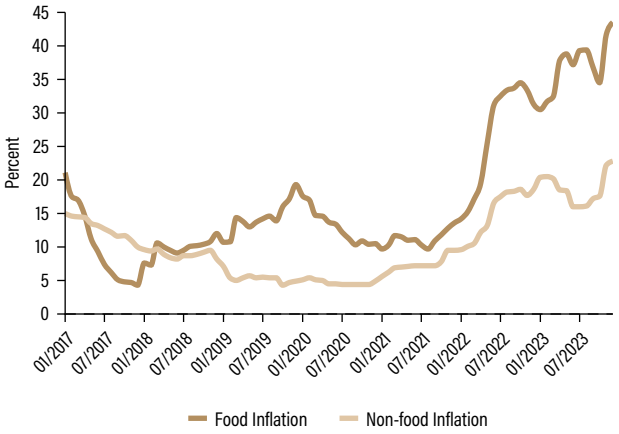
a. Malawi's per-capita growth lags others in the region despite coming from the lowest base

GDP per capita in 2015 real US$ growth



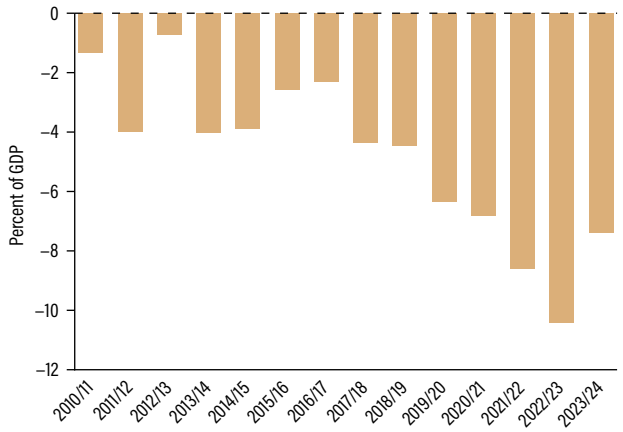
b. Food and non-food inflation remain elevated

Year-on-year growth, percnet



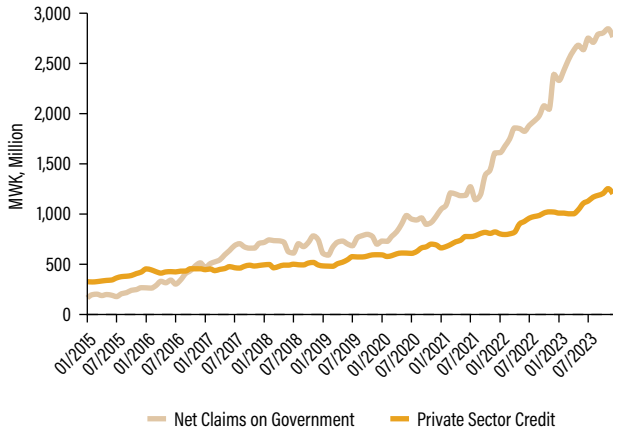
c. Government borrowing is expected to decline in FY2023/24

Net borrowing as a percent of GDP



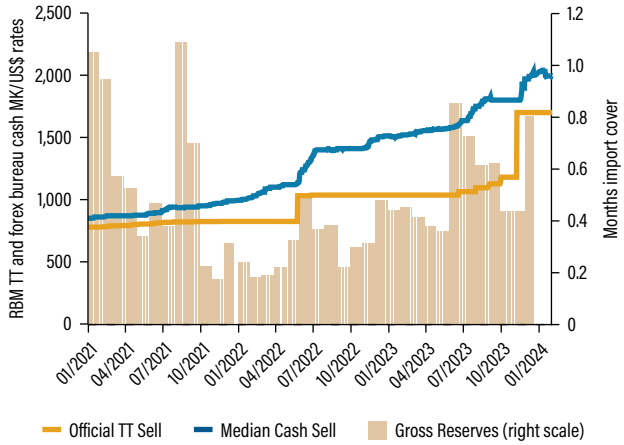
d. Government domestic borrowing is crowding out private sector credit

Net claims on government and private sector credit, in million MWK



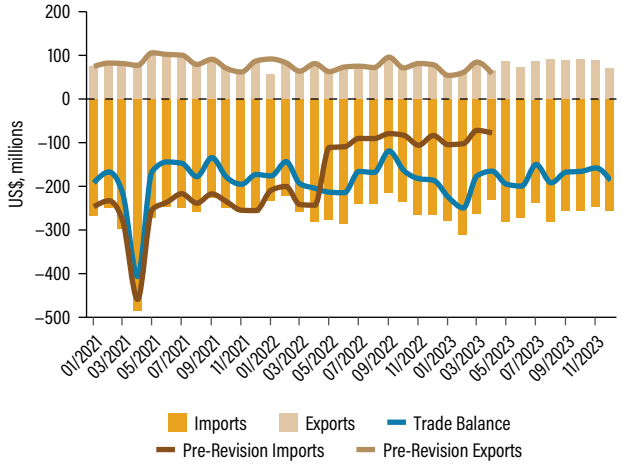
e. While the RBM adjusted the exchange rate by 44 percent, reserves remain low

RBM telegraphic transfer (TT) and forex bureau (FXB) cash MWK/US$ rates and spreads through Jan 4 and months of import cover



f. Malawi imported significantly more than previously assumed

Seasonally adjusted imports, exports, and trade balance



Sources: a. Africa Macro Poverty Outlook 10/2023; b. WB with data from NSO; c. WB with data from MoFEA; d. WB with data from RBM; e. World Bank staff calculations based on RBM data; f. Staff calculations based on National Statistics Office 2023.

be around 9 percent of GDP, is anticipated with the support of an improved policy environment. At the same time, stabilization supports an enhanced business climate and increased investment by private enterprises and in key infrastructure—including for electricity generation and crop diversification.

Inflationary pressures will persist in the short term but are expected to ease toward the end of 2024. This projection is based on both the expected reduction of short-term effects from the exchange rate adjustment and the implementation of supportive macroeconomic and structural policy reforms. Nevertheless, the ongoing El Nino season may lead to lower than expected agricultural production and sustained elevated food prices. Looking ahead, the implementation of prudent monetary and fiscal policies is essential to mitigate the impacts of these factors and lower inflation sustainably.

The 18th edition of the Malawi Economic Monitor (MEM) outlines urgent actions required to consolidate the stabilization of the economy, enhance growth, and safeguard the most vulnerable. Specific recommendations include:

i) ***Bolstering macroeconomic stability:*** Sustain the ongoing macro-fiscal reforms, with a focus on implementing plans to increase the flexibility of the exchange rate, rebuilding foreign reserves, enforcing fiscal discipline, enhancing public financial management, and attaining debt sustainability. The success of planned fiscal tightening, related fiscal governance reforms, and effective external debt restructuring will be critical for regaining debt sustainability.

ii) ***Creating the foundations for export-led growth:*** Stimulate agricultural growth by advancing with reforms of the Affordable Input Program and increased investment in commercialization initiatives. It is critical to encourage exports by reducing non-tariff barriers and supporting the development of an efficient and transparent mining sector.

iii) ***Building resilience and protecting the poor:*** Given the heightened risk of extreme weather events and food insecurity, it is essential to implement expanded social cash transfer and climate-smart public works projects, as well as to strengthen the functioning of agricultural markets. Implementing of the Disaster Risk Management Bill will enhance preparedness for future disasters and contribute to overall resilience.

Special Topic on "Healthy Watersheds for a Strong Economy"

Healthy watersheds can benefit everyone in Malawi, but they need to be cared for and nurtured

Watersheds play a crucial role in sustaining the ecosystem, biodiversity, wildlife, agriculture, and human population by serving as the natural resource base for all forms of life. These natural boundaries of river catchments form a mosaic covering the entire land surface of the earth. Watersheds describe areas of land that feed water to a river, draining through the landscape into tributaries and main river channels. This MEM Special Topic examines the opportunities to redirect funds currently allocated for agricultural and forestry inputs toward a more explicit emphasis on watersheds. It explores why a stronger focus on watersheds is important for Malawi, discusses options for financing interventions aimed at rehabilitating the country's degraded watersheds, and suggests ways to enhance the involvement of the private sector.

The health of Malawi's watersheds is impacted by rising population density. Since 1970, Malawi's population has surged from just over 4.6 million to nearly 21 million at the start of 2024. The majority of the population resides in rural areas and is characterized by poverty and a heavy reliance on natural resources for sustenance. Consequently, rapid population growth exerts substantial pressure on natural ecosystems.

Current livelihood strategies are pushing the natural environment to a critical threshold, where it may soon be incapable of providing the necessary services to safeguard both livelihoods and infrastructure. This jeopardizes the resilience required to address the challenges posed by a changing climate.

Human activities are increasingly detrimental to the health of Malawi's watersheds. The rapid conversion of land for agriculture and widespread deforestation for wood are proceeding at an alarming rate. Forest cover has declined from 47 percent in 1975 to just over 20 percent in 2021. Deforestation, coupled with forest deterioration and the loss of trees on farms, significantly contributes to land and water degradation. In 2017, 'hotspots' of degradation, where multiple indicators of degradation converge, covered over 40 percent of the country. Currently, approximately 75 percent of Malawi's soils are degraded or are threatened by degradation. This degradation has a cascading effect on the quality and quantity of water resources. Runoff from degraded landscapes carries soils and agrochemicals, polluting watercourses and wetlands. This can lead to the loss of soil fertility and diminishes the overall capacity of watersheds to protect, conserve, and nurture embedded natural resources.

This trend is worsened by changing climate patterns. Malawi is already witnessing increased climate variability, characterized by higher temperatures, prolonged dry periods, and more erratic and intense rainfall. These patterns are likely to lead to more frequent droughts and flooding (GoM 2017; World Bank 2022). Such changes exacerbate soil erosion and land degradation, resulting in reduced agricultural productivity, an increase in vector-borne diseases, and an elevated risk of damage to infrastructure. Hydropower plants on the Shire River often struggle to meet peak demand due in part to low flows and sediments resulting from the degradation of upstream catchments—a predicament that climate change will intensify. Recent years have seen flooding alone cost the country 5 percent of its GDP (GoM 2023), and a recent study found that soil loss could increase by three to four times compared to 2010 baseline levels (Asfaw et al., 2020). Cyclone Freddy in 2023, causing losses and damage exceeding US$500 million (approximately 3.8 percent of GDP) and displacing 2.5 million people, serves as a warning of impending shocks. However, analysis in the World Bank's recent "Malawi Climate and Development Report" indicates that acting to reduce soil erosion and improve land management can lead to significant economic gains under a variety of climate scenarios (World Bank 2022).

Addressing land degradation presents economic opportunities with substantial financial returns. Aligned with the *Malawi 2063* vision, investing in watershed restoration activities has the potential to substantially reduce soil erosion rates, improve crop productivity, and enhance water storage. A recent study (Kirui 2016) estimates that every dollar invested in restoring degraded land would return US$4.3 (in net present value) over 30 years. The technologies required for restoration are standard soil and water conservation practices, including terracing, bunding, tree planting, and the utilization of more organic fertilizers. A government assessment indicates that restoring degraded cropland could boost maize production by 40 percent, benefitting smallholders who adopt restoration practices (GoM 2017). Moreover, carbon markets also present financing opportunities: the restoration of Malawi's forests, coupled with policies to reduce biomass dependence, could increase Malawi's carbon stocks by 148 Mt by 2050. This has the potential to generate earnings of between US$24.8 million and US$74.3 million per year (World Bank 2022).

Revitalizing precious natural resources requires putting existing policies into practice

Malawi's policy framework for watersheds is relatively strong, yet government implementation remains poor. The government's vision for watershed management is ambitious and incorporates sensible technical approaches. However, both local and central governments struggle to implement policy and legislation. Cross-sectoral coordination and collaboration is weak, monitoring is limited, and compliance is low.

Successful land restoration interventions across the country offer scalable models. These include effective forest co-management, profitable agroforestry, sustainable agricultural practices, private sector forestry investments, and community-focused payment-for-results schemes. While these interventions have proven successful on a relatively small-scale, they are often linked to donor-funded or NGO-led initiatives. Scaling up these models would require collaboration across government agencies, the enhancement of government staff skills, and a realignment of budget priorities.

Certain existing policies create incentives for farmers to engage in unsustainable land management practices. Government subsidies, like the Affordable Input Program (AIP), place too much emphasis on mono-cropping and the use of inorganic fertilizers. While this approach may lead to short-term yield gains, it contributes to long-term land degradation. An alternative approach would be to redirect these funds to support on-farm conservation practices. Additionally, insecure land tenure creates a situation in which farmers lack the incentive to invest in the long-term health of their land.

A key challenge lies in establishing suitable financing frameworks to attract and support both public and private sector investment. While existing public funding sources like the AIP, the Forest Development and Management Fund, the Climate Fund, and the National Parks and Wildlife Fund could be repurposed or refocused, practical watershed investments will require a blend of public and private investments. Developing suitable business models is essential to incentivize and support investments from both sectors. One effective tool is the use of revolving community funds, which can promote conservation, restoration, and sustainable resource management when linked to larger funds with stringent environmental criteria. Illustrating this principle, a pilot project in the Shire communities for a local 'environmental conservation fund' demonstrated that even small resources can serve as a significant incentive for voluntary community action, as long as the funds are earmarked for agreed conservation activities.

Approaches involving 'results-based payment' offer an alternative method for providing donor finance and encourage the cross-sectoral collaboration required to rehabilitate watersheds at scale. While public funds should be channeled towards watershed rehabilitation, it is crucial to supplement them with private sector investments, especially in areas such as forest plantations, contract farming, and carbon farming, where watershed rehabilitation aligns with profitable investment opportunities. The challenge is not only in implementing technical interventions but also in establishing effective institutional arrangements to manage and support these types of interventions. Experience in Malawi and elsewhere underscores the importance of careful design that includes both technical and institutional support for ensuring the long-term sustainability of watershed rehabilitation efforts.

Watershed rehabilitation is expensive but will have widespread benefits and is critical for Malawi's sustainable future

Enhancing the sustainable management and utilization of watersheds offers opportunities to boost Malawi's economic performance. Healthy watersheds play a crucial role in building resilience to climate risks by providing cover against floods and holding water to mitigate droughts. Moreover, these improvements can contribute significantly to establishing more dependable and sustainable livelihoods, particularly benefiting economically vulnerable households. Any action to halt degradation and support the rehabilitation of Malawi's watersheds will generate benefits for the entire population. It should be considered a priority for the country.

Transforming environmental deterioration into opportunities for economic growth necessitates the complementary protection of land, forest, and water resources. The necessary policies and strategies are already in place. The challenge lies in shifting the focus and priorities to ensure that these existing plans are translated into practice. This MEM Special Topic provides recommendations on how this shift can be achieved. These include:

Land:

i) Redirect existing agricultural practices to increase productivity by protecting and conserving land, rather than degrading it;
ii) Broaden land tenure rights to incentivize sustainable land husbandry;
iii) Explore the potential to use results-based payments such as the successful Community Environment Conservation Funds (CECF).

Forests:

i) Align forestry and energy policies;
ii) Use limited public financing to leverage additional private-sector investment in forest management and restoration;
iii) Ensure prices charged by the Forest Management and Development Fund reflect current market prices;
iv) Scale up forest co-management approach to balance responsibility and authority between communities and government;
v) Promote agroforestry and tree-based systems to reduce pressure on Malawi's natural forests.

Water:

i) Ensure that institutional mandates in the water sector are implemented and enforced to realize the benefits of existing policy reforms (such as Malawi Water Resources act, 2013);
ii) Strengthen systems and capacities for licensing, allocation, and monitoring of water use.

1

ECONOMIC DEVELOPMENTS

1.1

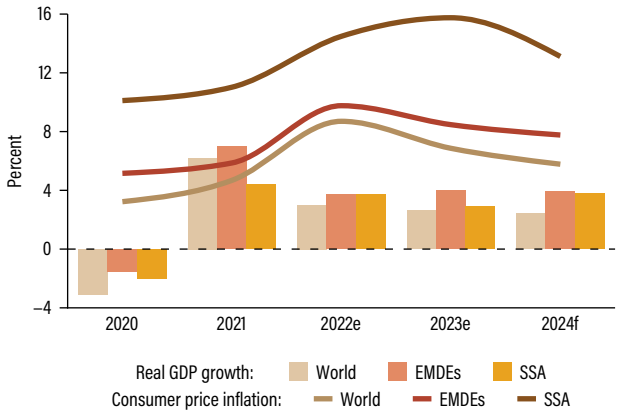
GLOBAL AND REGIONAL CONTEXT

Emerging markets and developing economies have not returned to their pre-pandemic growth path

Global growth remains below its pre-pandemic levels, with emerging markets and developing economies (EMDEs) lagging the robust levels of growth of the previous decade. During the 2010s, global growth averaged 3.7 percent while EMDEs expanded at an average rate of 5.1 percent. Gross domestic product (GDP) growth in 2023 is estimated to have decelerated to 2.6 percent for the world (Figure 1.1). In part, this growth slowdown reflects the impact of monetary tightening to address inflation, which continues to be above target in most countries. Average growth estimated at 4.0 percent for EMDEs in 2023 hides increasing divergence between those countries with solid economic fundamentals and those without. The long-term consequences of the pandemic and the impacts of conflicts continue to weigh on growth. Additionally, increased global fragmentation,[2] the effects of fiscal tightening amidst high debt levels, and increasing climate change impacts have resulted in growth levels trailing those observed in the previous decade.

FIGURE 1.1 Inflationary pressures are decreasing but so is global growth

Real GDP growth and consumer price inflation



Source: World Bank Global Economic Prospects 01/2024 (growth) and IMF World Economic Outlook 10/2023 (inflation).
Note: e indicates estimates and f indicates forecasts.

The growth rate in Sub-Saharan Africa (SSA) is estimated to have decelerated to 2.9 percent in 2023, which is 0.3 percentage points lower than the June projection. In three of the region's largest economies—Nigeria, South Africa, and Angola—growth slowed down to an average of 1.8 percent (World Bank 2024). South Africa's continued energy crisis has contributed to weak levels of growth. Additionally, a significant drop in growth among metal exporters, coupled with reduced global mineral prices, escalating conflict in the Sahel, multiple coups in West Africa, and diminished external demand—particularly from China—have collectively led to a decline in growth across the region. Many African countries were able to reduce headline consumer inflation in 2023, following significant increases in global food and energy prices in 2022. However, the high cost of living persists, exacerbating economic hardship for the poor and contributing to increased food insecurity across the region.

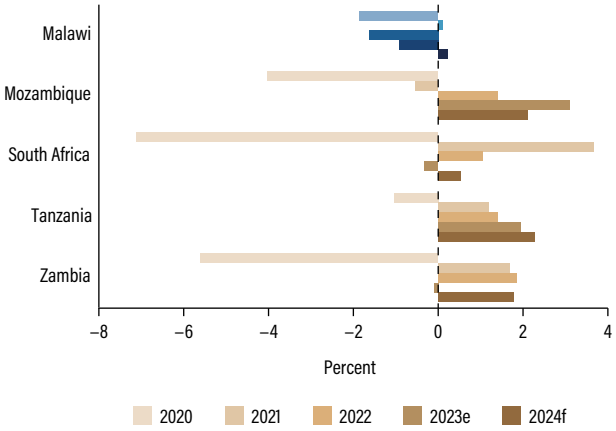
Malawi's neighbors and key trading partners in Southern Africa faced significant economic challenges (Figure 1.2). Economic adjustment and public debt challenges in Zambia, coupled with South Africa's

2. Growing trade restrictions are reversing past economic integration and its associated benefits (see World Bank 2023a on the proliferation of these restrictions). Additionally, cross-border movements of capital, technology, workers, and payments are increasingly curtailed. Recent IMF estimates put the costs of increased geoeconomic fragmentation at up to 7 percent of GDP (Aiyar et al. 2023).

persistent structural growth weaknesses, led to a decline in per capita GDP for both countries in 2023 compared to 2022 (-0.3 percent in South Africa and -0.1 percent in Zambia). Despite these declines, per capita growth in both countries was higher than that of Malawi (-0.9 percent). Countries in Malawi's region are significant mineral exporters and have been impacted by low metals prices. Although global food prices have declined from their peaks in 2022, heightened food insecurity amid elevated food prices remains a major concern across Southern Africa (Figure 1.3).

FIGURE 1.2 Malawi's per-capita growth is the slowest in the region despite coming from the lowest base

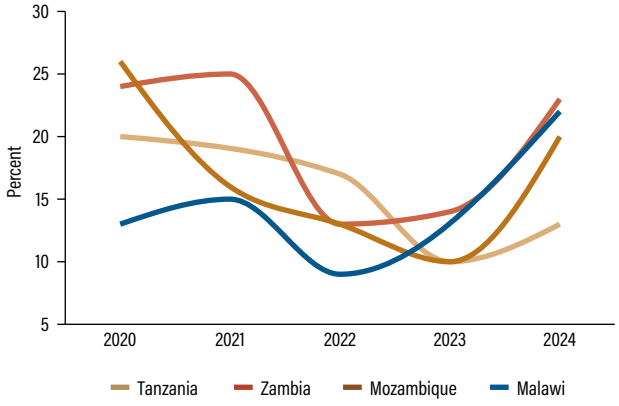
GDP per capita in 2015 real US$ growth



Source: Africa Macro Poverty Outlook 10/2023.

FIGURE 1.3 Malawi and its neighbors have high shares of the population facing food crises

Share of population expected to experience crisis-level food insecurity or above as per maximum IPC forecast for the year

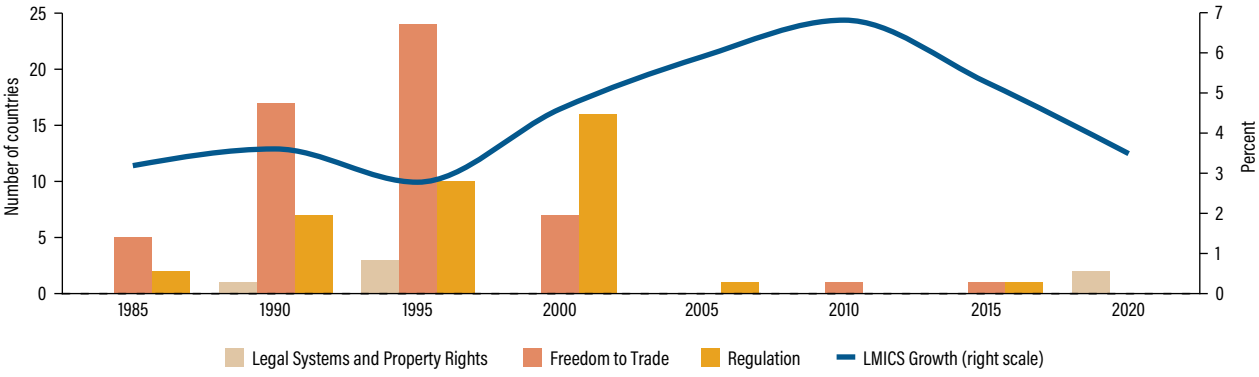


Source: IPC 2023.

Weakened growth momentum and increased vulnerabilities across the continent highlight the importance of resuming structural reforms to reignite growth. The historic growth surge experienced by low- and middle-income countries, including in Africa, beginning in the early 2000s, was underpinned by a wave of decisive reforms in the 1990s, in addition to a favorable external environment (Figure 1.4). Research indicates that actions such as stabilizing the macroeconomy, reducing trade barriers, and embracing foreign investment can each contribute several percentage points to annual growth over the subsequent decade (Chari, Reyes and Henry 2020; Archibong, Coulibaly and Onkonjo-Ileala 2021). Increased vulnerabilities, including those stemming from climate change, highlight the importance of establishing conditions conducive to sustainable, private sector-led long-term growth.

FIGURE 1.4 A wave of determined reform in the 1990s was followed by accelerated economic growth

Number of countries implementing substantial* liberalization of the legal system and property rights, freedom to trade, or regulatory reforms in the preceding five years and average economic growth in LMICS



Source: Fraser Institute Economic Freedom 2023, IMF WEO 10/2023.
Note: *At least one Standard Deviation.

Global leaders convened in Dubai for the 28th Conference of Parties (COP) with the aim of strengthening and realigning efforts to meet the climate goals outlined in the Paris Agreement. The overarching goal of the Paris Agreement is to hold the increase in the global average temperature to well below 2° Celsius above pre-industrial levels and to pursue efforts to limit the temperature increase to 1.5° Celsius. With an average temperature estimated at 1.45° Celsius above pre-industrial levels, 2023 was the warmest year on record by a significant margin (WMO 2024).[3] While current climate policies aim to reduce greenhouse gas emissions, which cause climate change, emissions have increased in 2023 to 57.4 tons of CO_2 equivalent. They need to decline by 28 percent by 2030 for the Paris Agreement 2° Celsius pathway and 42 percent for the 1.5° Celsius pathway (UNEP 2023). In the context of significant climate change already locked in, adaptation efforts and protecting people from the worst effects has increasing relevance. Watershed protection, which is an important tool for climate change adaptation, is gaining prominence in both global and national agendas (see Special Topic Section).

3. 2016 previously held the record with 1.29° Celsius above pre-industrial levels.

1.2

RECENT ECONOMIC DEVELOPMENTS

Growth remained low amidst delayed steps towards macroeconomic stabilization

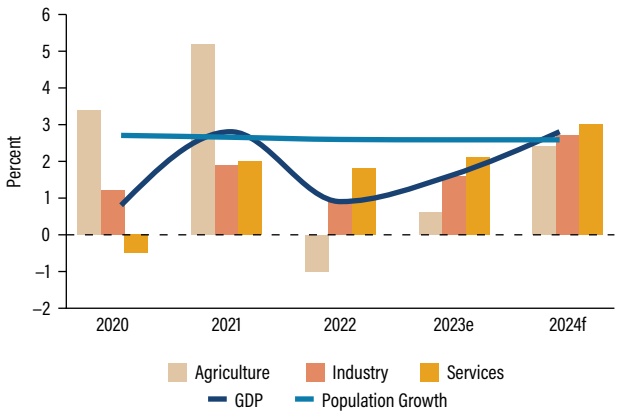
Malawi has taken important steps towards macroeconomic stabilization in recent months. These actions include an adjustment of the exchange rate, the announcement of increased flexibility of the kwacha, the agreement on an Extended Credit Facility (ECF) with the IMF, a reform program supported by World Bank Development Policy Operation (DPO) (see Box B.1), progress on debt relief, and steps towards monetary tightening. These reforms are expected to bring about improvements in the real economy. However, such reforms often do not immediately yield increased growth. For example, the transmission of monetary tightening to the economy is thought to have an average lag of approximately 29 months (Havranek and Rusnak 2013). Subsequently, additional time is required for increased macroeconomic stability to manifest in higher investment, growth, and job creation.

These important macroeconomic reforms came too late to significantly contribute to growth for 2023, though their implementation is expected to support accelerated growth in 2024 and beyond. Malawi's economy is estimated to have grown by only 1.6 percent in 2023 (Figure 1.5). While the resumption of electricity production at the Kapichira hydroelectric power plant supported economic activity, particularly in the industry and services sectors, production inputs have often been unavailable throughout 2023. Following Cyclone Freddy, agricultural output was only marginally higher than in 2022. Rapid inflation and foreign exchange shortages throughout the year contributed to a weak business environment, further undermining economic growth.

Businesses received a significant boost from improvements in the electricity sector. Existing demand was largely met following the recommissioning of the Kapichira hydroelectric power plant in May 2023, ending scheduled load-shedding. At the same time, the expansion of energy access gained momentum in 2023, with over 50,000 new households and businesses being connected to the grid, and numerous others accessing off-grid solutions (World Bank 2023d). Price alleviation for businesses was additionally announced in December 2023, with the electricity price increase following the exchange rate adjustment suspended until April 2024.

FIGURE 1.5 Malawi is expected to emerge from negative per capita growth

Real GDP growth by sector



Source: World Bank Macro Poverty Outlook (World Bank 2023d) and World Population Prospects (2022).

Note: e indicates estimates and f forecasts.

Despite higher costs, normalizing fuel supplies is taking time. The fuel supply situation in Malawi remains challenging as the foreign exchange market has not stabilized yet, and retailers struggle to raise the additional working capital for their now significantly more expensive stock. The average pump price

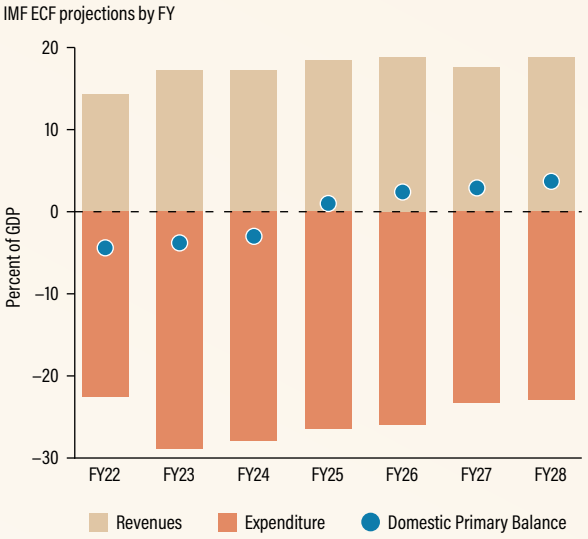
BOX 1.1 What is in the recently approved ECF and DPO programs?

On November 15th, 2023, the Executive Board of the IMF approved an ECF for Malawi, followed by a DPO by the World Bank on December 12th, 2023. The ECF is set to disburse a credit of US$175 million over four years. The DPO, provided as a grant, has already disbursed US$80 million, along with a second tranche of US$80 million upon meeting key triggers. Additionally, US$57 million have been approved to be made available immediately in case of a national emergency, acting as an insurance against further shocks. These disbursements play a direct role in addressing Malawi's severe fiscal and Balance of Payments (BOP) challenges. More importantly, the underlying reforms that these programs support are expected to enable the major adjustments needed for more macroeconomic stability and growth.

The ECF-supported program aims at restoring macroeconomic stability through six reform areas. These reform areas are creating a sustainable fiscal position, achieving price stability and safeguarding financial sector stability, rebuilding international reserves and normalizing the market for foreign exchange, restoring debt sustainability and external viability, addressing weaknesses in governance, sustainable growth and climate resilience, and capacity development. The program contains five Performance Criteria (targets for key economic variables under the government's control, including the domestic primary balance and net international reserves; see Figures B1.1.1 and B1.1.2), six Prior Actions (reforms that had to take place before approving the program), and sixteen Structural Benchmarks (reforms that must take place during the program for it to continue).

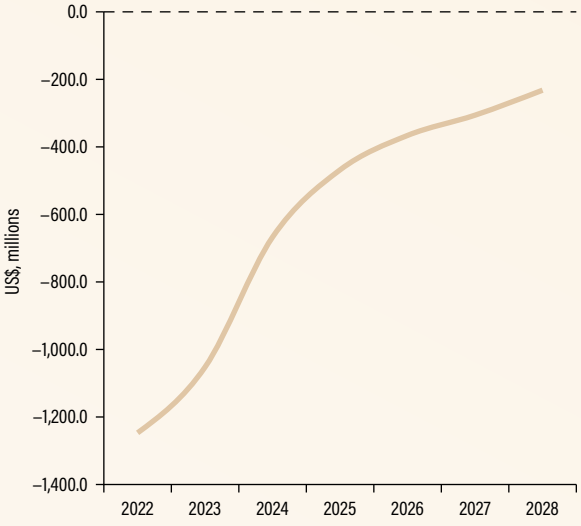
The structural reforms supported by the DPO are designed to bolster the foundations for sustained economic growth. The DPO, the first in a series of two operations, is anchored in a robust government-led structural reform agenda to i) strengthen fiscal sustainability and transparency, ii) stimulate private sector-led growth, and iii) increase resilience to shocks. Key reforms that have unlocked the DPO include measures to strengthen the legal framework for public finance management and public private partnerships, reforms in the digital and energy sectors, increased public procurement transparency, reforms to modernize the Affordable Inputs Program (AIP), fostering financial inclusion and strengthening shock-sensitive social safety nets.

FIGURE B1.1.1 The ECF envisions a rapid fiscal turnaround in FY25 through fewer expenditures and more revenues



Source: IMF 2023.

FIGURE B1.1.2 Rapidly accumulating reserves is a key expectation under the ECF to restore external stability



Source: IMF 2023.

of MWK2,632 lies significantly above the Shadow Price of MWK2,176 as of late January 2024.[4] The imposition of high fees, intended to compensate for losses incurred due to a pump price that remained too low for an extended period, contributes to the high fuel prices following the necessary adjustments. Additionally, fuel importers are currently facing unusually high prices from their suppliers, as much of the sourcing is done on open credit rather than being backed up by adequate trade finance. As a result, while Malawi used to import fuel at internationally competitive prices, importers now pay a 49 percent

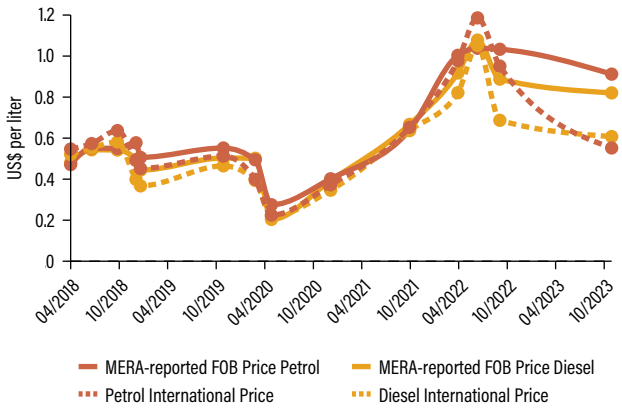
4. The Shadow Price is calculated as international landed costs of fuel at the median Foreign Exchange Bureau selling rate plus the proportional taxes calculated based on the international landed costs plus the fixed taxes and levies contained in the official price build-up. It does not contain financing levies or levies for the Price Stabilisation Fund (see World Bank 2023a).

markup compared to international peers (Figure 1.6). The economic cost of this delayed adjustment in the foreign exchange and fuel sector is significant: consumers and the private sector, which relies on fuel for production, now pay unusually high prices and suffer from uncertain supply.

The *Malawi 2063* priority sectors of tourism and mining continue to hold significant potential but did not take off in 2023. New analysis prepared for the new World Bank Country Economic Memorandum (CEM), *A Narrow Path to Prosperity*, shows that Malawi has a robust pipeline of mining projects, including numerous minerals essential for the global green energy transition (see Box 1.2; World Bank 2023b). Tourism, despite great potential, does not yet operate within an environment conducive for rapid growth (see World Bank 2023e for a more detailed analysis). Consequently, the growth in tourist arrivals in 2023 has fallen behind that observed among many of Malawi's peers (Figure 1.7).

FIGURE 1.6 Malawi used to source fuel at competitive prices, but now pays extra

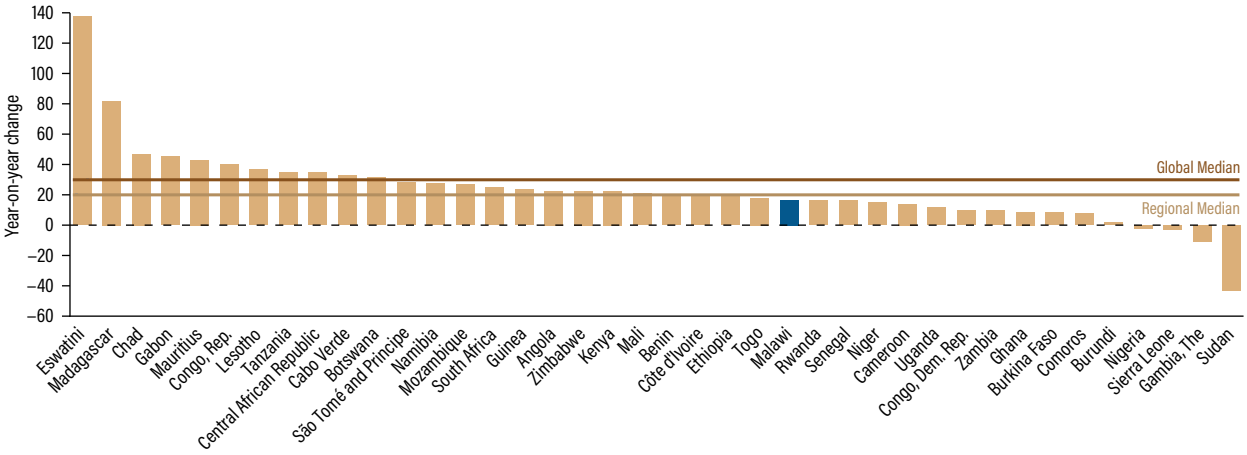
MERA-reported FOB price of fuel and international prices



Source: World Bank staff calculations based on MERA data and State of New York Transportation Fuels Spot Prices data.

FIGURE 1.7 Tourist arrivals to Malawi continue to lag most many other countries in the region

Year-on-year change in estimated aviation passenger arrivals (Q2 2022 – 2023)

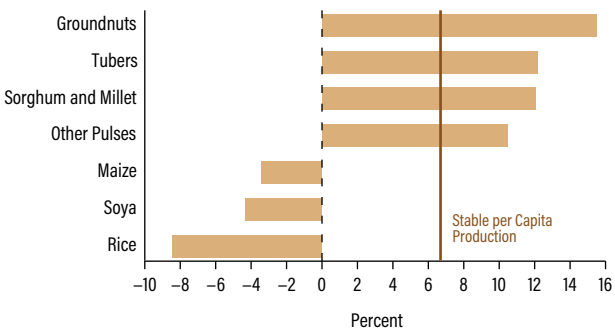


Source: OAG Traffic Analyzer; WTTC in World Bank (2023d).

Groundnuts, tubers, and traditional cereals outperformed maize and soybean production in 2023 (Figure 1.8). To keep per capita production stable given population growth, output for 2023 would have needed to exceed the average for the preceding five years by 6.6 percent (Figure 1.8). Official production estimates show that this has not been the case in 2023 for many of Malawi's most important crops. Maize production lagged 3.4 percent behind the five-year average, with farmers facing challenges in accessing inputs and significant production volumes being destroyed by Cyclone Freddy. Soybean production also lagged the five-year average by 4.3 percent, as the crop was affected by rust as well as climate shocks. Inherently more resilient and less input-reliant crops, however, exceeded their five-year average, with groundnuts, tubers, and traditional cereals outperforming other crops.

FIGURE 1. 8 More resilient crops that require fewer inputs had a strong 2023

Change in production relative to average output for 2018 – 2022



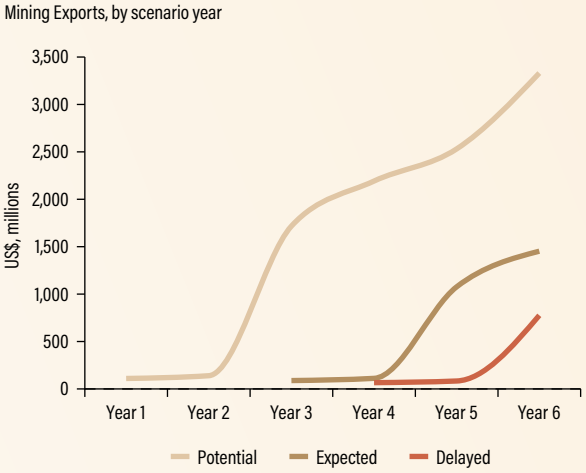
Source: Ministry of Agriculture.

BOX 1.2 The Promise and Risks in Malawi's Mining Sector

Mining exports have the potential to transform Malawi's economy in the medium-term. New World Bank research (Malunga et al. 2024) shows the promise of Malawi's mining sector to catalyze economic development. It thus validates the importance accorded to mining in the *Malawi 2063*, which positions the sector as a central driver of growth and industrialization. The report analyses six major mining projects spread across the country for their fiscal and export implications. Even in the most conservative scenario, mining exports replace tobacco as Malawi's top export in the span of six years following the start of production. Potential fiscal revenues could then also contribute to more than 10 percent of total public revenues. The analysis also shows that the promise of mining will take some years to fully materialize and hinges on adequate policy. The pace and progression of mine development in Malawi relies not only on the technical aspects of the projects but equally on the governance of the sector. Factors such as an adequate fiscal regime, streamlined permitting, strong community engagement, and sufficient infrastructure play key roles in shaping the trajectory of the mining sector.

Translating proven resources in the ground into wealth for ordinary Malawians is a critical challenge for policy going forward. A first step is an effective fiscal regime. However, how such revenues are then used to further national development also plays a critical role. Mining is highly capital-intensive and potential employment in the researched projects only totals 26,000 jobs. Therefore, the government must exercise caution to avoid neglecting other sectors that are more employment-intensive. With continued risks in the pipeline, evidenced by the large gap between the "potential" and "delayed" scenarios (Figure B.1.2.1), the government also needs to avoid falling victim to the "pre-source curse," by spending mining revenues which may never materialize (Cust and Zeufack 2023).

FIGURE B1.2.1 Mining has great potential, but the scale of revenue gains is highly uncertain

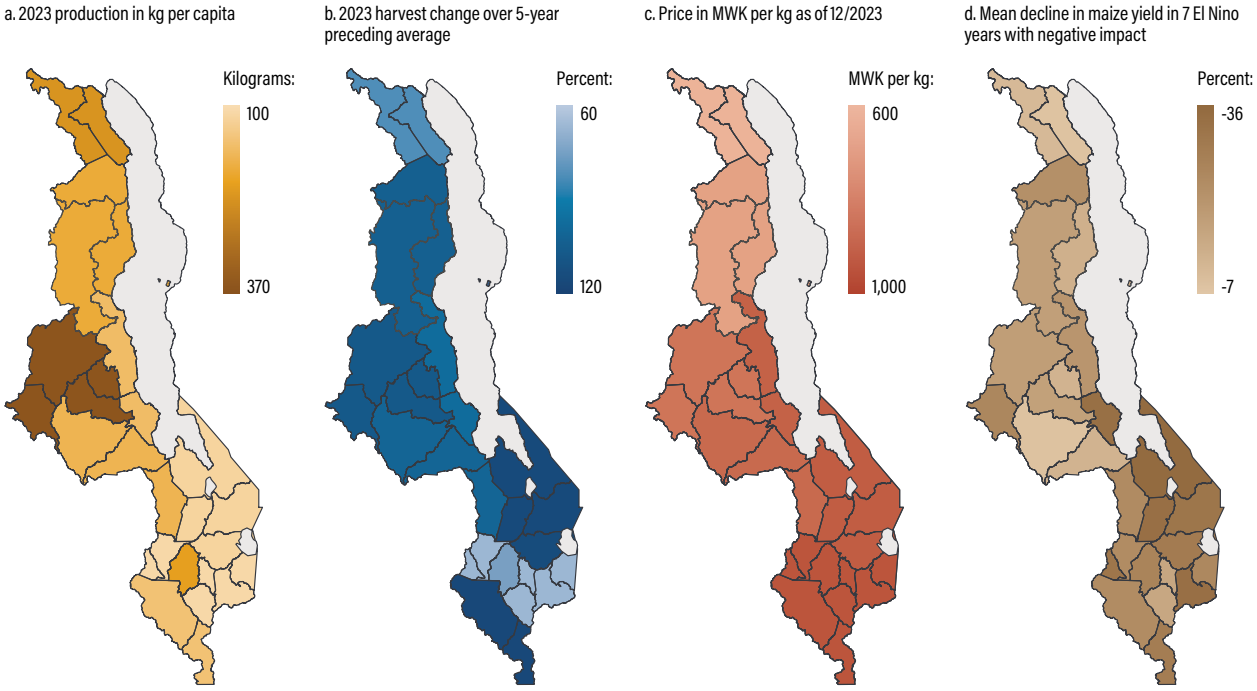


Source: Malunga, Ostensson, Anderson and Aguilar (2024).

Malawi's maize farmers face the quadruple challenge of low per capita production, sparse harvests in 2023, high prices, and high susceptibility to El Nino impacts (see Figure 1.9). Although maize serves as the primary source of calories across much of Malawi, significant variations in maize cultivation and markets exist despite the relatively small geographic scale of the country. For instance, the most productive Kasungu Agricultural Development District (ADD) is estimated to have produced more than three times as much per capita as the least productive ADD, Blantyre. With a per capita production of only 107 kg, the Blantyre ADD, covering 4.1 million residents in Neno, Mwanza, Blantyre, Chiradzulu, Phalombe, Mulanje, and Thyolo, had the lowest maize production levels in the country. In 2023, the Blantyre ADD also produced the sparsest maize crop compared to recent averages, falling 34.4 percent behind the 5-year norm. Maize was also 63 percent more expensive in December 2023 in the far-Southern Chikwawa market than in the far-Northern Karonga market (IFPRI 2023). This arises from the limited integration of national maize markets, posing a particular problem as the Blantyre ADD and the neighboring Shire Valley ADD also record the highest prices. Additionally, the south-eastern region of Malawi faces particularly poor prospects for recovery in 2024, given the anticipated impact of the El Nino phenomenon on the growing season. Historically, the Machinga, Salima, Shire Valley, and Blantyre ADDs have suffered disproportionate crop losses during El Nino years. Maize yields in these areas have typically decreased by a quarter to a third in an average year affected by El Nino (Anderson et al. 2023).

At the start of the 2023/24 farming season, ambiguity remains regarding the targeting of productive farmers under the Affordable Inputs Program (AIP), which may further constrain agricultural output. The 2023/24 AIP was launched in October 2023, intending to target 1.5 million of the more productive farming households, based on continued efforts to streamline and reform the AIP. The government indicates that the program is on track, having reached 84 percent of beneficiaries as of early January 2024 (Mkwanda 2024). However, the AIP Implementation Guidelines leave some ambiguity on how these beneficiaries were selected, citing a variety of selection methods (Duchoslav and De Weerdt 2023). Additionally, uncertainty remains about how fiscal shortfalls in the program would be addressed.

FIGURE 1.9 Malawi's south-east faces low per capita production, sparse 2023 harvests, high prices, and high susceptibility to En Nino



Source: Staff calculations based on Ministry of Agriculture 2023, IFPRI 2023, and Anderson et al. 2023.

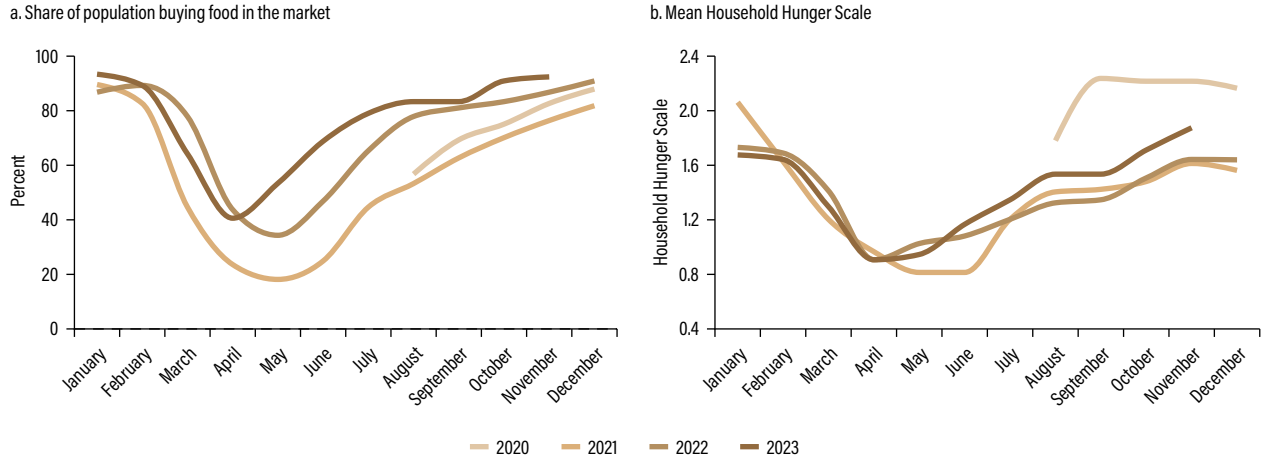
Beneficiary contributions (MWK 30,000), the total number of beneficiaries (1.5 million), and the budget (MWK 110 billion) have been defined in advance, without clarifying which of these parameters would be adjusted in light of higher than anticipated fertilizer prices. In turn, it is possible that not all beneficiaries can be supplied at the subsidized price and within the planned budget ceiling.

Recent growth challenges are impacting human development outcomes

Due to weak harvests on their own land, many Malawians are turning to markets for food purchases earlier, driving prices up and resulting in escalating food insecurity. With low personal stocks, Malawians had to start buying maize from markets earlier after harvests than in recent years. Among the respondents of the Rapid Feedback Monitoring System (RFMS) survey of rural southern Malawians[5], more than half bought their maize from the market in May (Figure 1.10). In 2021, it took until August to reach this level. Maize prices have doubled for the second consecutive year, driving up food insecurity. Ahead of the lean season, the Malawi Vulnerability Assessment Committee (MVAC) estimated that one in five Malawians would experience crisis-level food insecurity or worse (IPC 2023). Since the assessment was published in August 2023, the minimum amount of money Malawians need for survival has increased dramatically, by 10 percent in November 2023 alone. This has intensified pressure on Malawians already prone to food insecurity (WFP 2023). Nevertheless, households in the RFMS only report to be marginally more food insecure than in previous years as of November 2023, with 38.3 percent of households classified as food insecure or worse.

5. Estimations are based on the Rapid Feedback Monitoring System (RFMS) which is representative for Zomba Rural, Mangochi Rural, Chiradzulu, Phalombe, Chikwawa, and Balaka throughout the survey period. Thyolo, Nsanje, Machinga, and Mulanje are represented from July 2021. The urban districts Blantyre and Zomba, as well as the northern districts Karonga have also been added to the RFMS but have been omitted from estimation to ensure intertemporal comparability.

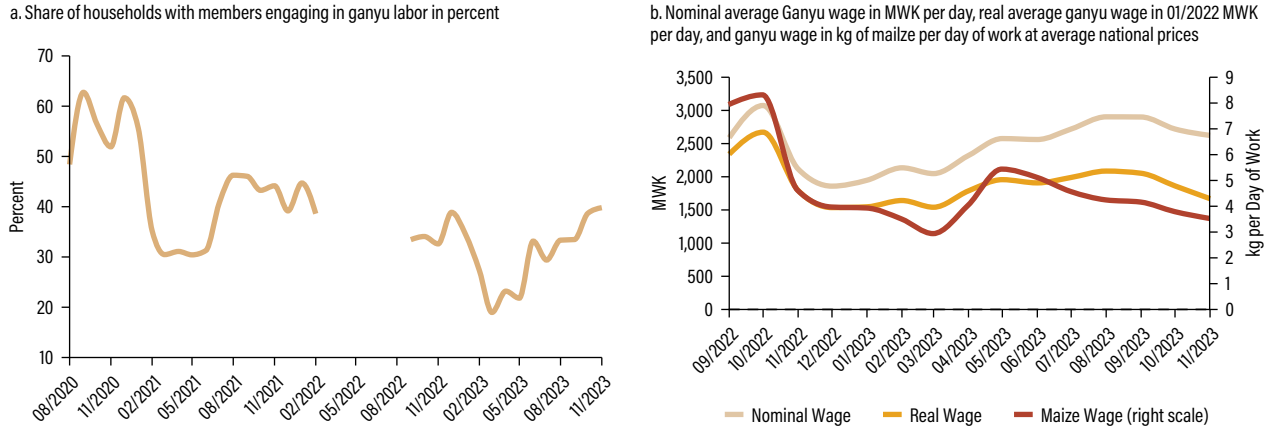
FIGURE 1.10 More southern rural Malawians are buying maize from markets and food insecurity is more widespread



Source: Staff calculations based on Rapid Feedback Monitoring System 2023.

Ganyu labor, the mainstay especially of poorer households, both pays less and has become scarcer, driving up poverty. Ganyu, a term for casual labor in Malawi, is the main source of income, especially for vulnerable households (Benson and De Weerdt 2023). While in November 2022, 11.9 percent of households in rural southern Malawi reported challenges in finding ganyu during the previous week, that share increased to 20.0 percent in November 2023. Along with seasonality in the share of households engaging in ganyu across the season, the type of work performed changes. More than 4 in 5 ganyu laborers were working on farms in January 2023, while almost half of ganyu laborers were pursuing typically more profitable non-farm jobs in July 2023. This leads to fluctuations in wages. However, ganyu wages, while stable in nominal terms, have been trending down in real terms recently (Figure 1.11). In November 2023 a typical full days' worth of labor brought in only MWK2,623 or just enough to buy 3.5 kg of maize at national average prices. Whether the hike in the minimum wage from MWK50,000 per month (MWK1,923 per day) to MWK90,000 (MWK3,462 per day) announced in January 2024 will make a noticeable difference in typical pay remains unclear. While many public and formally employed workers will almost certainly benefit, even before the minimum wage hike ganyu wages were below the minimum wage for 44.1 percent of RFMS survey respondents. Only 19.1 percent of ganyu laborers received a wage that exceeds the new minimum wage. Consequently, poverty levels are rising in Malawi, and are estimated to have reached 71.7 percent in 2023 at the international extreme poverty line of US$ 2.15 per person per day (approximately MWK 920 in 2022).

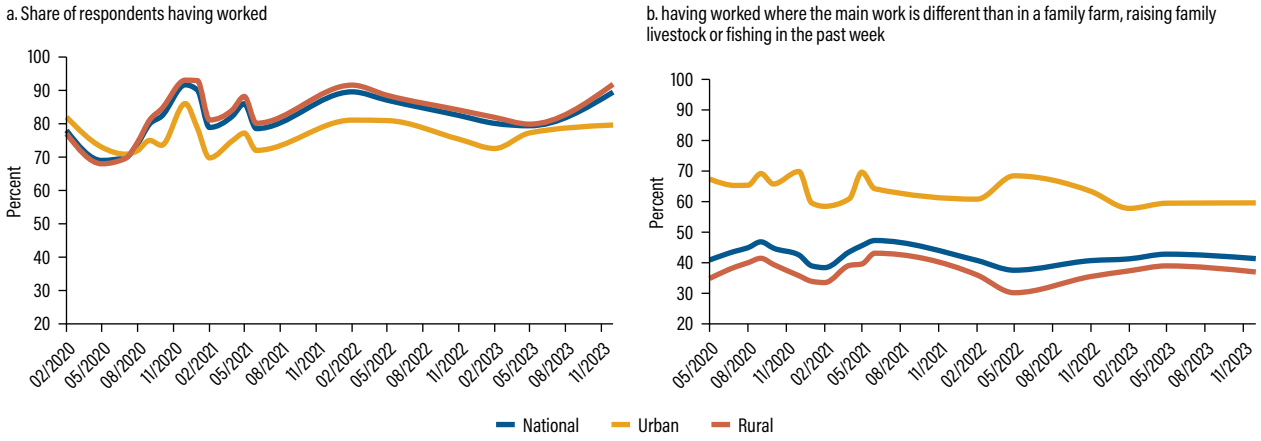
FIGURE 1.11 Fewer Malawians surveyed in the RFMS are finding ganyu labor despite declining pay



Sources: Staff calculations based on Rapid Feedback Monitoring System 2023, Reserve Bank of Malawi 2023, and IFPRI 2023.

The share of Malawians working increased for the first time in nearly two years, driven primarily by an increased reliance on family farming. In the last nationally representative High Frequency Phone Survey carried out in December 2023, nine in ten respondents reported to have worked during the previous week (Figure 1.12). This is up from 78.4 percent in May 2022 and similar to the peaks recorded during the 2020/21 and 2021/22 farming season (the 2022/23 farming season did not record the expected boost in employment). However, the recent boost in employment came entirely from family farming. Employment off family farms continues to stagnate and lag behind pre-pandemic levels in urban areas.

FIGURE 1.12 While the share of Malawians working has increased between May and December 2023, employment off family farms has stagnated

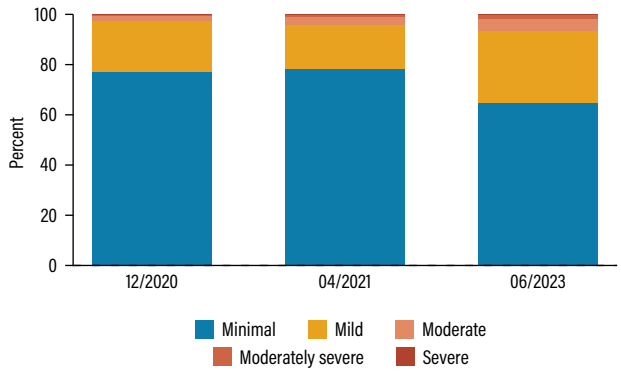


Source: Staff calculations based on High-Frequency Phone Survey 2024.

Concerns about employment prospects and physical safety as well as food insecurity are also associated with the deteriorating mental health of many Malawians. While only one in five Malawians reported symptoms of at least mild depression on the Personal Health Questionnaire Depression Scale in April 2021, that share has increased to more than one in three by June 2023. Half of respondents in June 2023 were assessed to be severely food insecure on the FAO Food Insecurity Experience Scale. Among those facing food insecurity, half of the respondents exhibited symptoms of depression, whereas among those who were more food secure, only one in five showed similar signs. Other shocks associated with depression symptoms were the experience of illness, injury or death of an income earning member of the household, the theft or looting of cash and other property, or the experience of job loss among household members.

FIGURE 1.13 Increasing shares of Malawians are experiencing depression

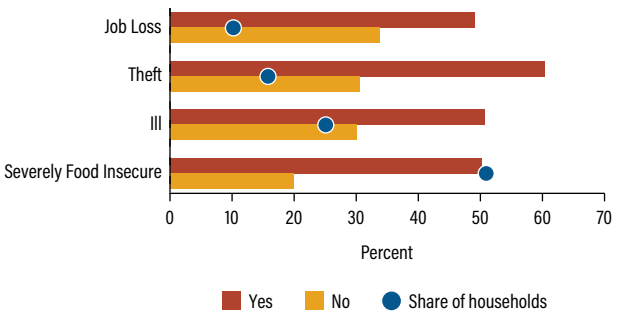
Share of respondents scoring on Personal Health Questionnaire Depression Scale categories



Source: Staff calculations based on High Frequency Phone Survey 2023.

FIGURE 1.14 Hunger, illness, crime, and job loss are risk factors for depression

Share of respondents experiencing potentially traumatic circumstances, and share of these households reporting at least minimal depression



Source: Staff calculations based on High Frequency Phone Survey 2023.

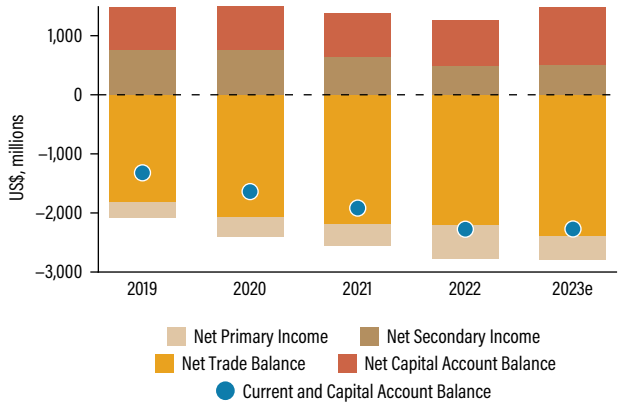
Note: Assessment of food insecurity based on FAO Food Insecurity Experience Scale. Illness includes illness, injury or death of an income earning household member. Theft includes experiencing theft or looting of cash or other property.

Imports have remained steady despite low foreign exchange liquidity in the formal market

Estimates indicate that the country is starting to recover from the economic crisis that started in early 2022 (Figure 1.15). The government and firms have faced significant difficulties to pay for imports due to a large, persistent, and increasing trade imbalance as well as low foreign exchange reserves. Interest payments on existing foreign debts make up the bulk of Malawi's primary income deficit.[6] Large transfers for both current expenditures, called secondary income, and for investment, called capital account transfers, are not able to make up for this imbalance. This imbalance, however, is estimated to have decreased from US$1.5 billion in 2022 to US$1.3 billion in 2023, attributed to larger transfers and reduced interest payments on external debt. The means by which Malawi managed to sustain persistent shortfalls is not clear. The country reports large investment inflows, mostly composed of new debt and arrears payable to foreigners. However, nearly one third of the shortfall remains unexplained, and is classified under "errors and omissions" (see Figure 1.16).

FIGURE 1.15 More transfers and frozen debt payments are estimated to have made up for a continuedly large trade imbalance in 2023

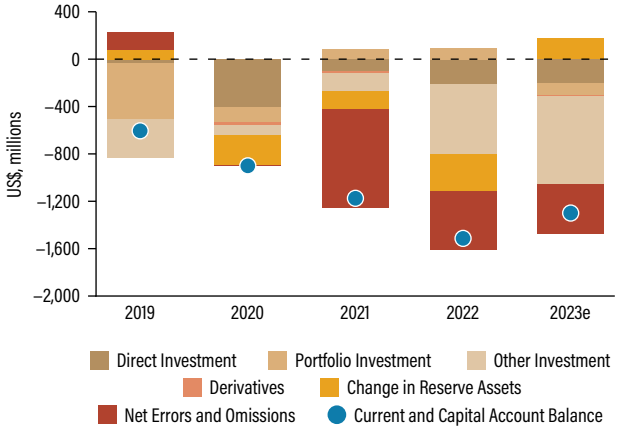
Malawi's current and capital account by component and year



Source: Staff estimates based on National Statistics Office data.
Note: e indicates estimates.

FIGURE 1.16 Large errors and omissions mean that we do not know how Malawi affords its current account imbalance

Malawi's financial account by component and year

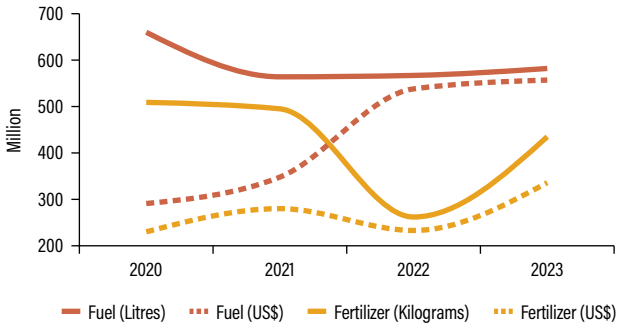


Source: Staff estimates based on National Statistics Office data.
Note: e indicates estimates.

Malawi imports less fuel and fertilizer than before the onset of the crisis, although the share of these commodities in the total value of imports has been increasing (Figure 1.17). Reducing the amounts of non-essential imports is critical to shrinking Malawi's unsustainable trade imbalance. The recent adjustment of the exchange rate is a key policy tool to achieve this by making imports less affordable and exports more competitive. Recent revisions of Malawi's trade data (Box 1.3) show that fertilizer and fuel accounted for 27.1 percent of imported value since the start of 2022, compared to 18.8 percent two years earlier. However, this still represents 6.1 percent fewer liters of fuel and 30.6 percent fewer bags of fertilizer, reflecting the substantial increase in the cost of both commodities over the past two years. However, fuel and fertilizer imports started increasing again recently: Malawi has imported 2.7 percent

FIGURE 1.17 Fuel and fertilizer imports have increased more in value than volumes

Official fuel and fertilizer imports per year



Source: Staff calculations based on National Statistics Office 2023.

6. Primary income is earned income paid to non-residents. Large components are interest payments on debt and the compensation of non-resident employees.

more fuel and 66.3 percent more fertilizer by volume in 2023 than in 2022. Other essential imports, such as medical supplies and pharmaceutical imports continue to experience reductions in import values.

BOX 1.3 Revised trade figures show a more nuanced picture of Malawi's BOP crisis

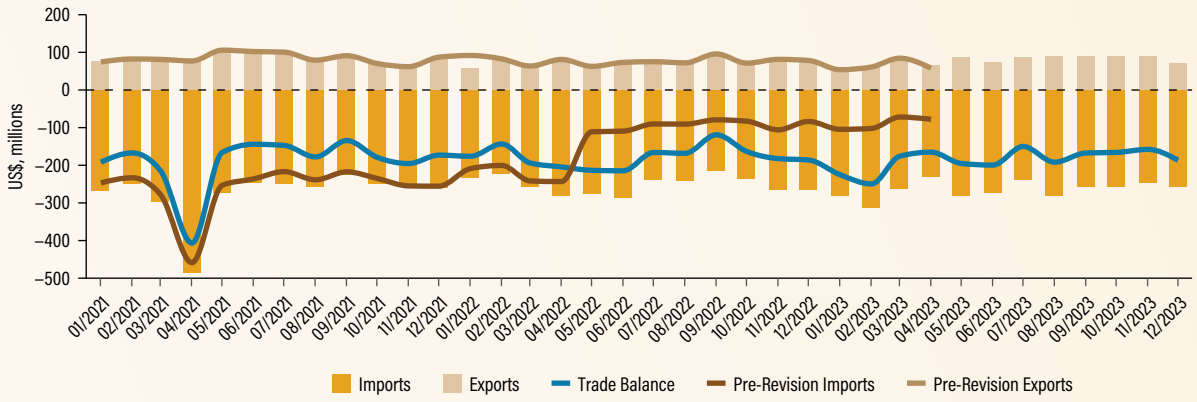
The National Statistics Office (NSO) published revised trade figures after working with the IMF to enhance the quality of reporting (see Figure B.1.3.1). According to the NSO, previously published figures had missed imports recorded at inland examination centers, though customs revenue data suggests that imports have nevertheless been taxed throughout. Where third-party sources of import data exist, such as for fuel (through MERA) and fertilizer (through the Fertilizer Association of Malawi), the revised figures now match these more closely. Nominal imports were adjusted upward by 37.5 percent for the period January 2020 to April 2023 with the majority of increases in the year from May 2022 to April 2023 (178.8 percent adjustment). Nominal exports remained at similar levels (-1.1 percent adjustment for the entire period). Underreporting was concentrated in fuel (23 percent), plastics, paper, printing products and textiles (17 percent), and fats, cereals, and soap (15 percent).

The revised data shows a more nuanced picture of Malawi's balance of payments, suggesting that the crisis-induced import compression was less severe than had been assumed in previous analyses (including past MEMs). The US$ value of official imports since 2022—i.e., since onset of the acute phase of the economic crisis—had been 0.5 percent higher than the two years prior. This contrasts with Malawi's balance of payments crises in 1992–1994 and 2012–2015 which required a marked narrowing of the trade deficit by restricting imports. Among Malawi's four major BOP crises in the past 30 years, it was only during the 1997–2003 crisis that imports expanded during the second half of the crisis (Nur 2024 forthcoming). However, due to rising prices, Malawians can still afford fewer imports of some key commodities (see above) and due to distortions in trade and foreign exchange markets, imports often do not reach those who need them most.

These data revisions suggest there are significant weaknesses in Malawi's core statistical capacities. Accurate economic data are critical for good decision-making by both the government and other actors. This is especially the case for generally straight-forward and trusted data sources like official trade figures. A new regional World Bank project that includes Malawi will particularly support the strengthening of statistical capacity in the NSO to help address some of these weaknesses.

FIGURE B1.3.1 Malawi's imported significantly more than previously assumed

Seasonally adjusted imports, exports, and trade balance



Source: Staff calculations based on National Statistics Office 2023.

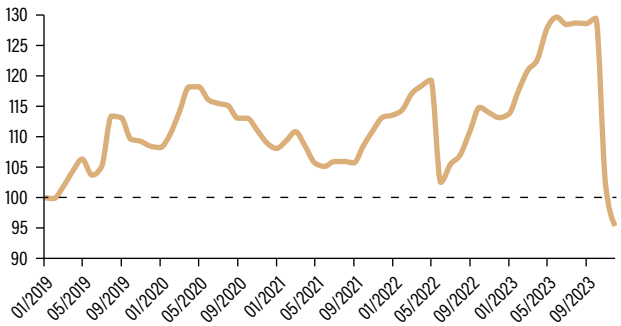
Exports in US$ terms in 2023 were 8.3 percent higher than in 2022. During 2023, Malawi's export basket continued to be dominated by tobacco (42.7 percent of total exports), followed by pulses (7.5 percent), and tea (7.3 percent). Especially sugar and pulses have recorded a particularly strong 2023 export season with both higher prices and volumes. Meanwhile, macadamia exporters, despite again achieving a double-digit increase in volumes exported, suffered from a sharp global reduction in prices, bringing 2023 export values down relative to 2022. Smaller quantities of groundnuts have been exported officially in 2023 than in 2022, following last year's 99 percent growth in volumes.

The export competitiveness boost from the depreciation relies on the continued flexibility of the exchange rate. Due to relatively stable nominal exchange rates and considerably higher inflation in Malawi compared to its trading partners, Malawian exporters experienced a loss of competitiveness in the year through October 2023 (Figure 1.18). However, the 44 percent adjustment announced on

November 8 has significantly depreciated Malawi's real exchange rate, bringing it closer to the parallel market rate. New World Bank research shows that exports fall rapidly following real exchange rate appreciations but increase only gradually in response to depreciations (World Bank 2023a). While exporters benefit from a boost in their competitiveness, they need time to identify markets for their newly competitive products, secure the necessary capital for increased production, and access trade finance. Moreover, this competitiveness boost for exporters will be eroded within months if the inflation differential between Malawi and key export markets (and especially between Malawi and the US) continues and the exchange rate remains inflexible.

FIGURE 1.18 A sharp drop in the real effective exchange rate is likely to boost exports

Real effective exchange rate index, 01/2019 = 100



Source: IMF International Financial Statistics 2023.

Malawi's terms of trade are stabilizing close to their pre-pandemic level (Figure 1.19). Early in the pandemic, very low oil and fertilizer prices meant that Malawi could afford more imports from its export proceeds. However, a spike in fuel and fertilizer prices in 2021 resulted in an adverse terms of trade shock for Malawi. With oil and fertilizer prices moderating and many of Malawi's main exports maintaining high prices internationally, Malawi's commodity terms of trade are stabilizing near their 2019 level.

Unprecedented support by development partners likely alleviated the impacts of macroeconomic instability fueled by the currency crisis. From 2018–2022, the World Bank, the United States of America (USA), and the IMF have disbursed 44.5 percent of all Official Development Assistance to Malawi according to the Organization for Economic Cooperation and Development (OECD) Creditor Reporting System. While direct budget support had a diminished role until recently, other on-budget development assistance (including front-loading of quickly disbursing operations) has been significantly scaled up since the onset of the pandemic (Figure 1.20). Because a large share of these funds are converted into Malawi kwacha (such as disbursements for social cash transfers) or replace public foreign exchange expenditures (such as disbursements for imported machinery to restore the Kapichira dam), they have helped alleviate the severity of Malawi's balance of payments crisis.

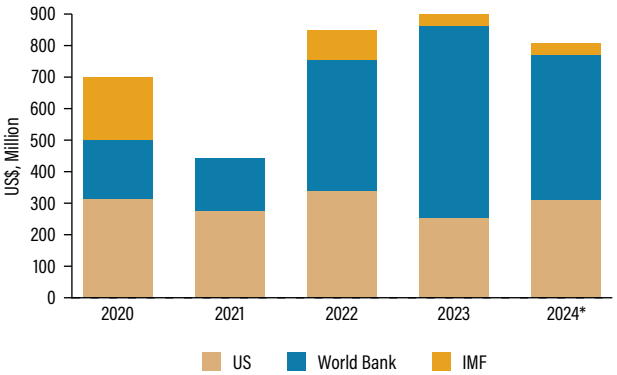
FIGURE 1.19 Malawi's commodity terms of trade are stabilizing at pre-pandemic levels

Commodity terms of trade, index with 01/2019 = 100

Source: Staff calculations based on IMF Commodity Terms of Trade 2023 and World Bank Commodity Markets Outlook 2023.

FIGURE 1.20 Development partners have stepped up support

Gross disbursements by source



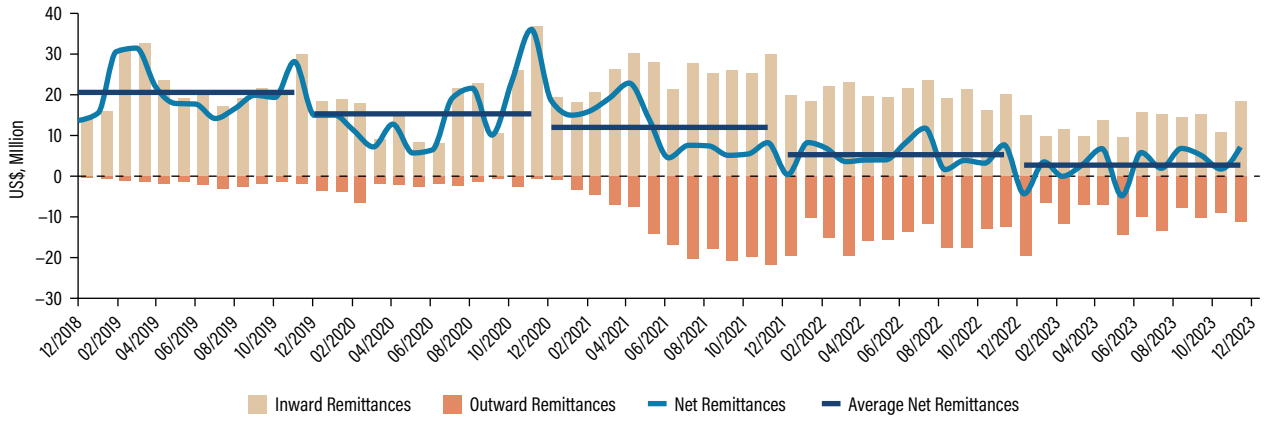
Source: US Department of State 2023, IMF 2023, and World Bank 2023.
Note: *budgets and commitments.

Officially recorded remittances continued to decline throughout 2023, as many transactions likely moved to the parallel market (Figure 1.21). According to the 2019/20 Integrated Household Survey, 4.6 percent of Malawian households received international remittances. The median amount received was

MWK 50,000 a year while the mean was MWK 154,000. This implies a national total of approximately US$38 million. The RBM estimate of US$213 million in 2020 for official remittances likely includes other transfers mislabeled as remittances. However, remittances increasingly migrated to the parallel market as the spread between the exchange rates offered by official remittance providers and the parallel market rate widened.

FIGURE 1.21 Significantly less money is coming in through official remittance channels

Inward and outward remittances, by month

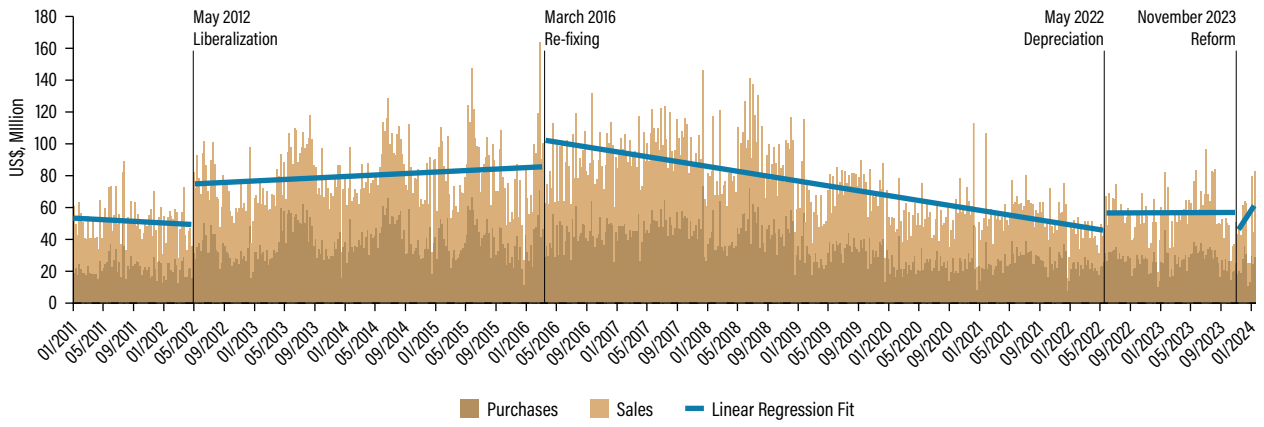


Source: Reserve Bank of Malawi 2023.

The depreciation of the Malawi kwacha has not yet resulted in a significant increase in foreign exchange availability. This contrasts with the liberalization of foreign exchange markets in May 2012, which led to an immediate boost to liquidity in Authorized Dealer Bank (ADB) foreign exchange markets (Figure 1.22). Traded volumes continued to increase despite economic hardship as market participants gained trust in the new system. While the reintroduction of an exchange rate peg in March 2016 initially boosted foreign exchange trade, driven primarily by increased ADB foreign exchange purchases, the overvalued exchange rate led to decreasing trading volumes over time. Following the May 2022 depreciation, the market stabilized. However, no immediate uptick in foreign exchange liquidity was observed in the weeks following the exchange rate reforms announced in November 2023. Although the more competitive exchange rate and the threat of additional enforcement of penalties for parallel market transactions serve as incentives to shift transactions into the formal market, continued spreads and uncertainty about the credibility of the newly announced exchange rate regime discourage the formalization of foreign exchange transactions.

FIGURE 1.22 Foreign exchange liquidity in the official system is yet to benefit from recent reforms

Authorized Dealer Bank foreign exchange purchases and sales per week



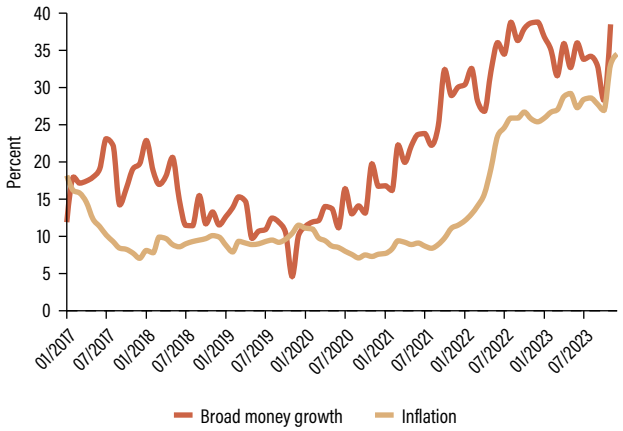
Source: Reserve Bank of Malawi 2023.

The delayed devaluation of the Kwacha has pushed inflation upwards

After a decrease in the preceding months, the 44 percent adjustment of the kwacha in November 2023 elevated inflationary pressures (Figure 1.23). This was primarily fueled by price increases for commodities that had previously been purchased at the official rate. As a result, food inflation rose and peaked at 43.5 percent in December 2023 (Figure 1.24). Previously, the easing of global pressures and the moderation of domestic food prices had contributed to food inflation declining to 34.5 percent in October 2023.

FIGURE 1.23 Inflation is rising, and broad money growth has picked up again

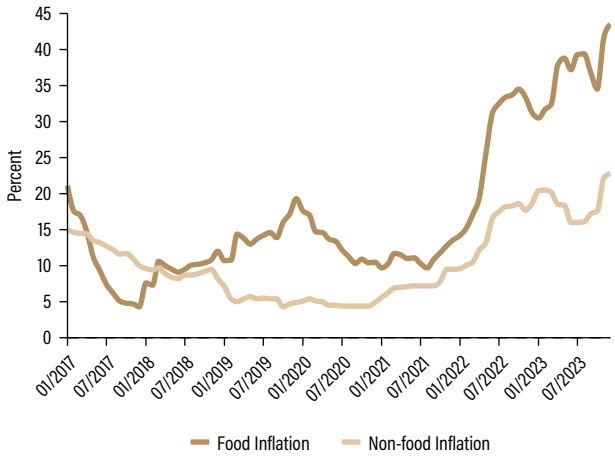
Inflation and broad money growth (year-on-year), in percent



Source: WB with data from NSO.

FIGURE 1.24 Food and non-food inflation remain elevated

Year-on-year growth, in percent



Source: WB with data from NSO.

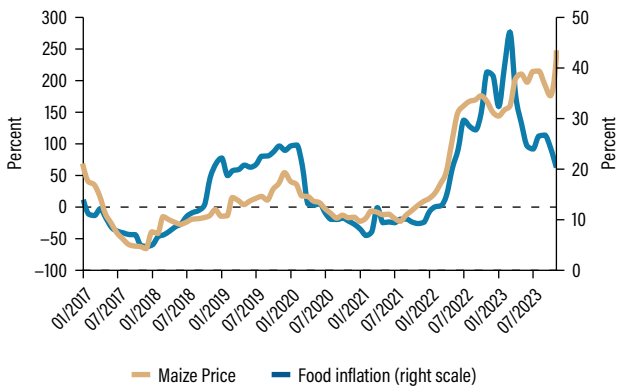
Although year-on-year headline inflation had slightly slowed down to 26.9 percent in October 2023 from its peak of 29.2 percent in May 2023, it subsequently resumed an upward trend reaching 34.5 percent in December 2023. The previous slowing was in part driven by the government's effort to tackle mounting inflationary pressures by tightening monetary policy, both through increases in the policy rate and decelerating money supply growth. Money supply growth had peaked at 38.8 percent in December 2022, mainly due to a monetization of the fiscal deficit, though this had declined somewhat to 28.3 percent in October 2023. Driven by revaluation benefits on foreign currency denominated deposits associated with the 44 percent adjustment, money supply growth increased to 38.5 percent in November 2023.

Supply constraints and high minimum farmgate prices have contributed to domestic food prices maintaining their upward trend. The price of maize continued to rise, increasing by over 60 percent year-on-year to MWK 744 per kilogram in November 2023 (Figure 1.25). The highest maize prices, exceeding MWK 800 per kilogram, were reported in the Southern region. Given the high share of maize in the food basket, this contributed to food inflation remaining above 30 percent throughout the year. Prices of other food commodities also increased, driven by both domestic supply constraints, and imported inflation.

The November 8 2023 adjustment of the kwacha also exerted upward pressures on non-food inflation. Non-food inflation had decreased from its peak of 20.5 percent in February 2023 but has since resumed an upward trend, reaching 22.8 percent

FIGURE 1.25 Maize prices are driving up food inflation

Year-on-year growth, in percent



Source: WB with data from NSO.

in December 2023. Due to pricing controls, tariffs for most utilities, including fuel, did not adjust to the depreciation of the parallel rate and to inflation. Consequently, this contained inflationary pressure and helped non-food inflation remain steady between June and August 2023. Recent increases in tariffs for water and electricity, as well as for rentals, exerted upward pressure and contributed to non-food inflation rising to 18 percent in October 2023. The 44 percent adjustment of the Kwacha in November 2023 exerted additional upward pressure, especially on transportation and other categories that heavily rely on imports, and pushed non-food inflation beyond 20 percent in December 2023.

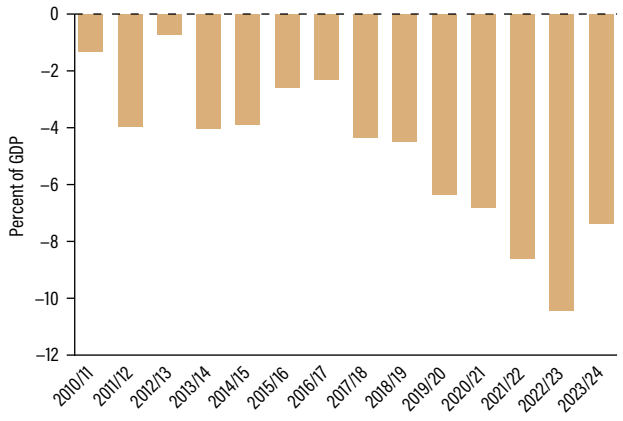
The fiscal deficit is narrowing for the first time in six years

In the last decade, government spending has risen substantially, pushing financing requirements to unsustainable levels. Growth in government expenditure has mostly exceeded growth in revenue (see Figure 1.27). Consequently, the fiscal deficit (net borrowing) has steadily increased over the last decade and exceeded 10 percent of GDP in FY2022/23 (Figure 1.26). This has predominantly been financed by the incurrence of domestic liabilities, mostly from the banking sector (see next section). This has been inflationary and crowded out resources to spur private sector growth. Continuous rising financing needs have made it difficult for the government to source enough resources to finance the deficit, especially in FY2023/24, where resources from the domestic market have mostly fallen short of the required amounts.

Net borrowing appears to be moderating in FY2023/24, in line with the government's efforts to reform public finances. The government expects that the performance during the first half of the fiscal year will continue throughout the remainder of the year, mainly supported by resumption of budget support and exchange rate gains. Net borrowing is estimated at 7.4 percent of GDP in FY2023/24, an improvement from 10.4 percent of GDP in FY2022/23 (Figure 1.26). This is the first time that the net borrowing is expected to decline in six years. However, this excludes the expenditures required for the statutory recapitalization of the RBM following the November devaluation. This performance will be supported by a marginal decline in expenditure by 0.7 percent of GDP and an increase of 2.4 percent of GDP in revenue (see Figure 1.27).

FIGURE 1. 26 Net borrowing is expected to decline in FY2023/24

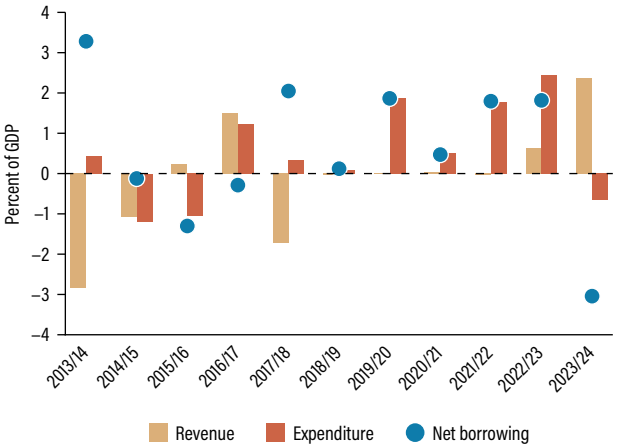
Net borrowing, in percent of GDP



Source: WB with data from MoFEA.

FIGURE 1. 27 ...supported by higher revenue collection

Change in revenue, expenditure and fiscal deficit relative to previous FY, in percent of GDP



Source: WB with data from MoFEA.

However, recent government actions raise concerns about the veracity of announced fiscal governance reforms. The planned Lilongwe-Salima Water Project raises governance concerns from the modality of its implementation (especially related to a lack of transparency around the borrowing of resources for government equity). It also poses challenges for public finance management reforms, and also elevates fiscal

risks that could potentially reduce gains from the ongoing fiscal consolidation process. Recent revelations related to the procurement of defense equipment from a company linked to a businessman facing numerous corruption charges highlight the importance of the comprehensive roll-out and real-time utilization of the Integrated Financial Management Information System (IFMIS) across all ministries, departments and agencies (MDAs) and ensuring that transparent procedures for procurement processes are followed.

Bolstered by increased disbursement of grants, revenue is estimated to continue increasing throughout FY2023/24. Taxes are expected to reach 12.7 percent of GDP, supported by improved collection across categories. The 44 percent adjustment of the kwacha is expected to have a positive impact on international trade and transactions taxes. Aided by the anticipated budget support and exchange rate gains, the disbursement of grants is expected to surpass the approved target of 1.8 percent of GDP, reaching 3.7 percent of GDP by the end of the fiscal year. Other revenue is also expected to improve and reach 1.2 percent of GDP, from an approved target of 0.7 percent of GDP.

Increased spending across all expenditure categories is expected to surpass the approved target. All categories of expenses and acquisition of non-financial assets (development spending) are estimated to exceed their approved levels, contributing to an upward revision of expenditure. Expenditure is estimated to reach 25.0 percent of GDP in FY2023/24, higher than the approved target of 21.9 percent of GDP. Compensation of employees is expected to reach 5.9 percent of GDP, driven by new transport allowances and an upward adjustment of salaries to cushion civil servants from the rising cost of living. The devaluation of the kwacha and consequent rising inflation is expected to push government spending on goods and services upwards to 3.5 percent of GDP, from an approved target of 3.2 percent of GDP. Moreover, anticipated recapitalization of the Reserve Bank of Malawi to carter for losses incurred from the devaluation may likely push expenses further beyond the approved target. Similarly, rising interest rates and government borrowing exert upward pressure on interest expense, which is expected to reach 5.4 percent of GDP. Development spending is expected to increase to 6.2 percent of GDP, with increases in both the domestically and foreign financed components. Foreign financed development spending is expected to reach 4.6 percent of GDP driven by exchange rate gains and increased allocations for project spending. Similarly, the domestically financed component is expected to increase and reach 1.6 percent of GDP from an approved target of 1.3 percent of GDP.

As part of efforts to contain growth of high-cost domestic debt, the government intends to incur more foreign liabilities on concessional terms to finance the deficit. Incurrence of foreign liabilities is expected to increase to 1.1 percent of GDP from an approved target of 0.8 percent of GDP, driven by both increased volumes of concessional borrowing and MWK disbursements becoming larger for a given amount of US$ following the exchange rate adjustment. In turn, a slight reduction in the incurrence of domestic liabilities from an approved target of 6.4 percent of GDP to 6.3 percent of GDP is expected. However, additional borrowing to finance RBM recapitalization may result in incurrence of domestic liabilities even beyond the original approved target.

Through the first three quarters of the fiscal year, the fiscal deficit reached 6.1 percent of GDP.[7] Bolstered by good performance in all the categories, revenue reached 16.4 percent of GDP. Disbursement of budget support and exchange rate gains contributed to grants reaching 3.2 percent of GDP, the highest in the past decade. Income, profits, and capital gains taxes made up 5.8 percent of GDP and contributed to the tax intake totaling 12.0 percent of GDP. Government expenditure reached 22.5 percent of GDP, driven by both expenses (17.5 percent of GDP) and development spending (5.0 percent of GDP).

Statutory expenditures continue to erode fiscal space. Through the third quarter, compensation of employees and interest expenses reached 5.0 and 4.6 percent of GDP, respectively. Development spending reached 5.0 percent of GDP (3.5 percent of GDP foreign financed and 1.5 percent of GDP domestically

7. Shares of GDP are relative to 75 percent of 2023 GDP.

financed). If the same momentum can be maintained in the last quarter of the fiscal year, government will likely attain the targets in the revised budget, though in the past fiscal slippages often were most severe in the fourth quarter. Downside risks emanate from the recapitalization of losses incurred by the RBM from the devaluation of the kwacha. This could potentially widen the fiscal deficit.

TABLE 1.1 Fiscal accounts

Percent of GDP

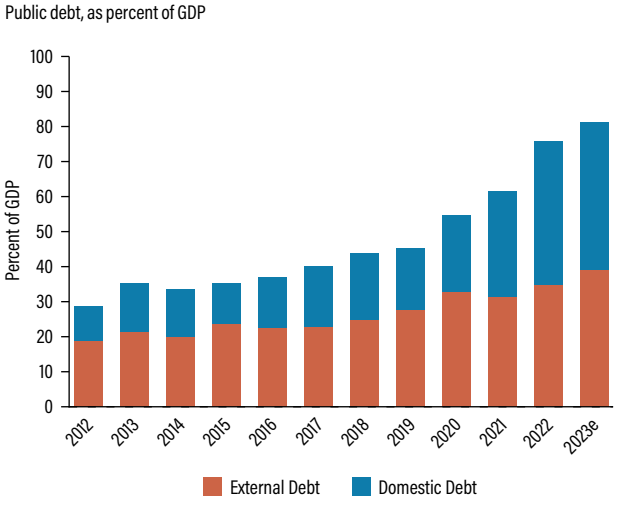
				23/24	
	20/21	21/22	22/23	Approved Budget	Revised Budget
Revenue	14.7	14.6	15.2	14.7	17.6
Domestic Revenue	12.8	12.8	12.1	12.9	13.9
Taxes	12.0	12.1	11.6	12.3	12.7
Taxes on Income, Profits and Capital Gains	5.6	5.5	5.5	5.7	5.9
Taxes on Goods and Services	5.4	5.6	5.0	5.2	5.4
Taxes on International Trade and Transactions	1.0	1.0	1.1	1.4	1.4
Other Taxes	0.0	0.0	0.0	0.0	0.0
Grants	1.9	1.8	3.1	1.8	3.7
From Foreign Governments	0.0	0.0	0.2	0.1	0.1
From International Organizations	1.9	1.8	2.9	1.7	3.6
Other Revenue	0.7	0.7	0.5	0.7	1.2
Property Income	0.4	0.1	0.1	0.3	0.8
Sale of Goods and Services	0.3	0.6	0.4	0.4	0.4
Fines, Penalties and Forfeits	0.1	0.0	0.0	0.0	0.0
Expenditure	21.5	23.2	25.7	21.9	25.0
Expense	17.8	18.5	18.6	17.1	18.8
Compensation of Employees	5.8	6.0	5.6	5.4	5.9
Goods and Services	3.6	3.8	3.1	3.2	3.5
Generic goods and services	2.2	2.2	1.9	1.9	2.1
Interest	3.6	3.3	4.6	5.3	5.4
To non-residents	0.2	0.2	0.3	0.0	0.5
To residents other than general government	3.4	3.1	4.3	0.0	4.8
Grants	1.9	2.1	3.3	1.7	1.9
Social Benefits	2.5	3.0	1.9	1.4	1.7
Fertilizer payments	1.3	1.9	1.1	0.6	0.6
Other Expenses	0.3	0.4	0.1	0.1	0.3
Acquisition of Non-Financial Assets	3.7	4.7	7.0	4.8	6.2
Foreign financed	2.7	3.0	5.4	3.5	4.6
Domestically financed	1.0	1.7	1.7	1.3	1.6
Net borrowing	-6.8	-8.6	-10.4	-7.1	-7.4
Primary Balance	-3.2	-5.3	-5.9	-1.8	-2.0
Net Incurrence of Liabilities	6.9	10.3	7.0	7.1	7.4
Foreign Liabilities	1.0	2.6	1.9	0.8	1.1
Borrowing	1.0	0.7	1.9	1.7	2.1
Amortization	-0.4	-0.4	-0.6	-0.9	-1.0
Domestic Liabilities	5.9	7.7	5.1	6.4	6.3

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

Debt accumulation is slowing but timely and successful debt restructuring remains urgent

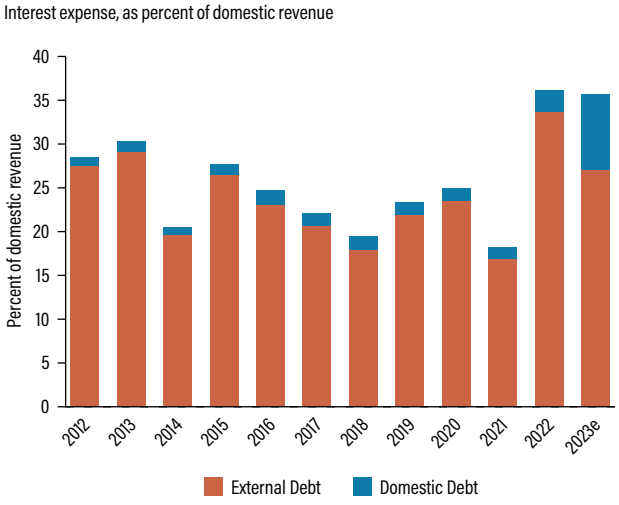
Government uptake of domestic and external debt is slowing but remains high. The stock of public and publicly guaranteed debt continues to rise, driven by increased uptake of both domestic and external debt. The stock of public debt is estimated to have increased from 75.7 percent of GDP in 2022 to 81.3 percent in 2023. Rising fiscal deficits and subsequent financing through high-cost domestic debt has resulted in domestic debt increasing, rising from 30 percent of GDP in 2021 to 42 percent of GDP in 2023 (Figure 1.28). External debt also rose and is estimated at 39.3 percent of GDP in 2023. The necessity of tightening monetary policy and the consequent raising of interest rates on treasury securities have not only contributed to a rising fiscal burden resulting in interest expense absorbing over 30 percent of the domestic resource envelope (Figure 1.29), but have also increased debt refinancing risks. With tightened liquidity conditions, the government has mostly struggled to source financing from the domestic market, with subscription amounts falling below requirements in most security auctions.

FIGURE 1.28 Public debt still rising



Source: WB with data from MoFEA.
Note: e indicates estimates.

FIGURE 1.29 ...and interest expense is eroding fiscal room



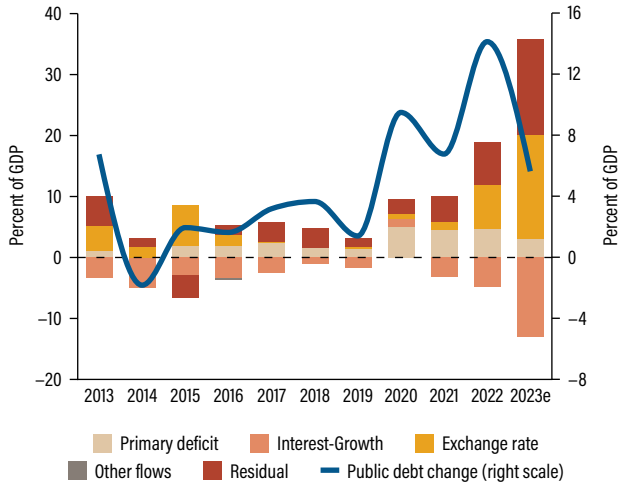
Source: WB with data from MoFEA.
Note: e indicates estimates.

Public and publicly guaranteed debt remains in distress and unsustainable. The November 2023 joint World Bank-IMF Debt Sustainability Analysis reported that external and total public debt is still in distress and unsustainable under current policies. The recent surge in public debt has been primarily driven by escalating fiscal deficits and the depreciation of the kwacha. Figure 1.30 also shows that rising unidentified debt flows (the residual) are pushing public debt upwards. For external debt, the accumulation of commercial external debt through conversion of medium-term swaps into medium term debt in 2020 contributed to a high debt servicing burden. Under the new program with the IMF, as well as the World Bank's Sustainable Development Finance Policy, the Government will remain committed to refraining from non-concessional borrowing, with most external financing either grants (as is the case for funding from the World Bank and most development partners) or concessional loans. This has already contributed to a slight shift in external debt towards concessional debt held by multilaterals (Figure 1.31). In 2022, multilaterals held 64 percent of total external debt.

The authorities are continuing to pursue external debt restructuring. Financing assurances from China and India were received in November 2023, and these will assist the debt restructuring process. Timely and successful implementation will be key for external debt to be considered sustainable on a forward-looking basis.

FIGURE 1.30 Deficits and the exchange rate depreciation are driving public debt accumulation

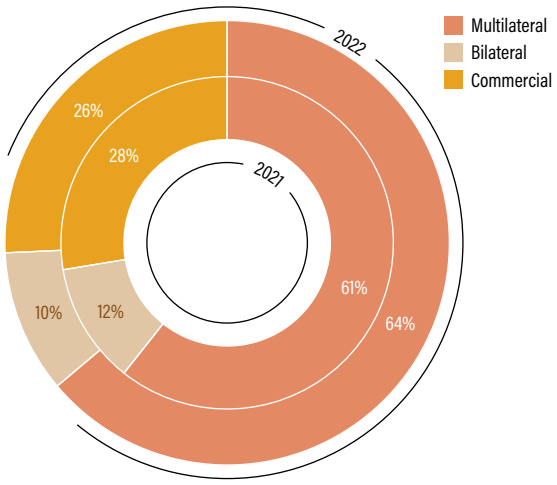
Public debt and change in public debt, as a percent of GDP



Source: WB with data from MoFEA.

FIGURE 1.31 Multilateral institutions hold the highest share of external debt

External debt by creditor, as share of total public debt

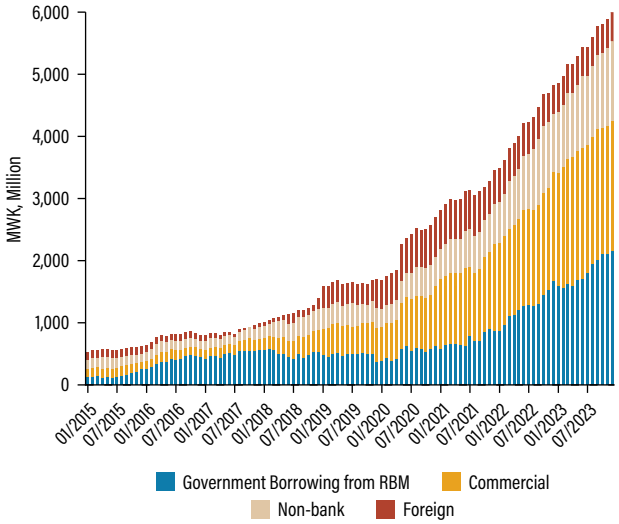


Source: WB with data from MoFEA.

Government borrowing from the banking sector continues to crowd out private sector credit. The share of government domestic debt held by the RBM and commercial banks has increased to 70.1 percent of total government domestic debt as of November 2023 (Figure 1.32). This has limited the amount of credit available for private sector borrowing (Figure 1.33), which is essential for stimulating economic activity. By June 2023, exposure of the banking sector to government debt had reached 38.6 percent. Central banking financing alone increased to 35.4 percent of total domestic debt in November 2023, mainly from trading on the secondary market. The resulting increase in the money supply has resulted in inflationary pressures. The RBM financing limit under the new ECF may moderate borrowing from the RBM, potentially leading to increased private sector credit, reduced money supply, and alleviated inflationary pressures.

FIGURE 1.32 Domestic debt is still shifting towards the banking sector

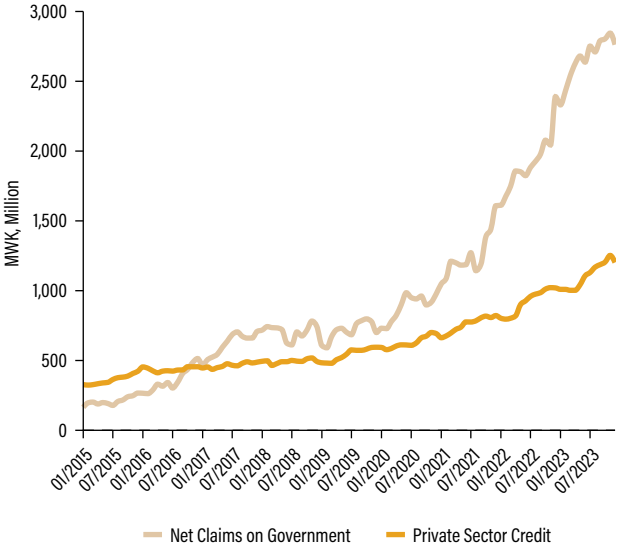
Domestic debt, in MWK million



Source: WB with data from RBM.

FIGURE 1.33 ...crowding out private sector credit

Lending to Government and private sector credit, in MWK million



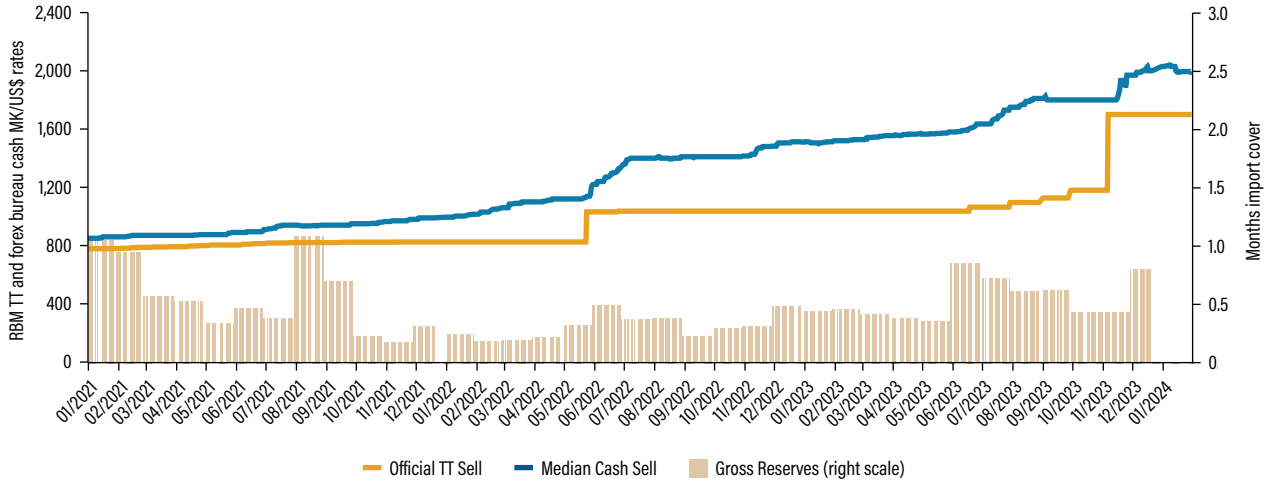
Source: WB with data from RBM.

The RBM adjusted the exchange rate by 44 percent, announced measures to increase kwacha flexibility, and maintained a tightened monetary policy

The Reserve Bank of Malawi (RBM) adjusted the exchange rate to the US$ by 44 percent. The rate was revised from a selling rate of MWK 1,180 to MWK 1,700 per US$ on November 9, 2023. This follows a period of rigid exchange rate management. The official exchange rate had hardly moved since May 2022, while the parallel rate[8] continued to rise. The spread between the official and parallel market exchange rate peaked in August 2023 at 63 percent, then stabilized at around 50 percent by October 2023. This highlighted the need to align the exchange rate with market fundamentals and prevent arbitrage opportunities (Figure 1.34).[9] The new US$-kwacha rate was seen as market-clearing by the RBM.

FIGURE 1.34 While the RBM adjusted the exchange rate by 44 percent, reserves remain low

RBM telegraphic transfer (TT) and forex bureau (FXB) cash MWK/US$ rates through Feb 2 and months of import cover



Source: World Bank staff calculations based on RBM data.

The spread between the official and market exchange rates has widened since the devaluation. After the devaluation in November 2023, the spread between the official and median bureau rates initially narrowed to 6 percent but has subsequently widened to over 17 percent in January 2024. The RBM had been conducting monthly forex auctions since June 2023, leading to a 14 percent depreciation against the US dollar from June to October 2023. More recently, it announced plans to increase the frequency of foreign exchange auctions and permit intermediaries to trade at freely negotiated rates. The devaluation has helped reduce demand for non-essential imports. Moving forward with more flexible exchange rate management will be key for improving external sector competitiveness and building up official reserves.

Official foreign exchange reserves have only improved slightly in 2023, despite efforts to rebuild these. Gross official reserves were recorded at US$201.3 million (0.8 month of import cover) in December 2023, an increase from the level at the end of 2022 when reserves were US$120.2 million (0.5 months of import cover). Despite various measures, including conducting foreign exchange auctions, the RBM has rebuilt its official reserves only slowly. Auction purchases have had a very minor role in this regard, contributing only US$700 thousand (less than 1 day import cover) between November 2023 and January 2024.

8. The parallel rate is proxied by the median rate for cash purchases at foreign exchange bureaus, which tend to be less strictly controlled rates.

9. The official exchange rate remained fixed at MWK 1,036 per US$ throughout June 2022 to June 2023 after the official kwacha-US dollar exchange rate was adjusted downward by 25 percent in May 2022. Similarly, the official exchange rate hardly moved throughout 2021 and early 2022, resulting in spread at 37 percent in May 2022.

BOX 1.4 Lessons from successful exchange rate reforms

Malawi is one of several countries that have recently attempted to reform an overvalued and overly rigid exchange rate. Burundi, Egypt, and Nigeria are three other regional examples of countries that recently took steps to move towards the parallel market rate. In all these countries, the overvalued exchange rate had resulted in lack of access to imported production inputs and consumption goods, as well as the proliferation of corruption around buying foreign exchange at official rates and reselling it with a profit in the parallel market.

An overnight change in the rate is only the first step in successful exchange rate reforms. As many factors that undergird the emergence of a parallel market, such as restrictive capital control policies, often do not disappear immediately, the adjustment process can take several months (Gray 2021). An initial overshoot, where the exchange rate at first depreciates beyond the market-clearing rate as foreign exchange sellers factor in the risk arising from the uncertain situation, is almost inevitable. Many countries also experience a decline in trust in the effectiveness of the depreciation, as liquidity takes time to be restored. In turn, some countries opt for a peg at a different level or transition to another managed regime.

Instances of successful and sustained unifications of official and parallel market exchange rates offer valuable lessons. Accomplishing successful exchange rate reform can be challenging both from a technical and political perspective. However, cases such as Uzbekistan in 2017, where the parallel market was practically eliminated in a matter of days, highlight key ingredients for success:

- **A supportive monetary and fiscal context is essential.** High inflation caused by monetary and fiscal misalignments will lead to a continuously depreciating rate. Successful exchange rate reforms generally involve coordinated fiscal and monetary tightening.
- **Overshoot now rather than undershoot later.** The ideal time for adjustment never comes and the new rate will inevitably be perceived as too low by many stakeholders. However, to reap the benefits and unify the exchange rate, the adjustment often needs to be swift and reward those switching into official markets with an attractive rate.
- **Communication is important.** Potential foreign exchange sellers will want to know the exchange rate policy going forward before they trade in the official system. This generally takes longer in contexts where there is a history of mistrust between central banks and market actors.
- **Refraining from moral suasion.** Attempts to coerce market participants into selling foreign exchange at a given rate will clearly signal to them that the new rate is not freely available or fair. In turn, they will be reluctant to bring foreign exchange into official markets.

Monetary policy has been tightened further, showing some results

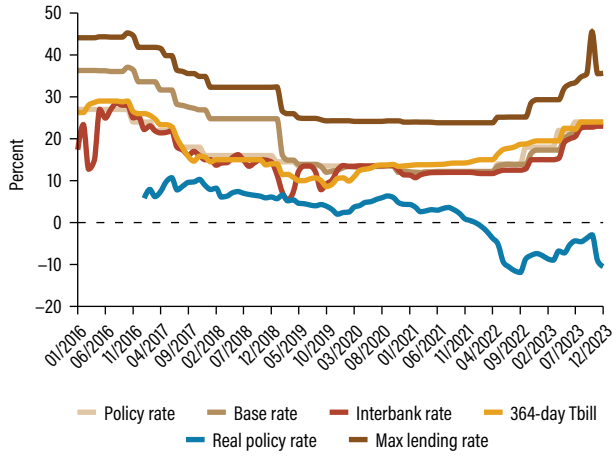
The RBM has tightened monetary policy to contain inflationary pressures. To address high inflation, the Monetary Policy Committee (MPC) increased the policy rate twice in 2023, from 18 to 24 percent (Figure 1.35).[10] With inflation pressures still elevated and intensified, the MPC further raised the policy rate by 200 basis points to 26 percent in February 2024. The MPC also increased the Liquidity Reserve Requirement by 200 basis points to 7.75 percent in July 2023 to curb the expansion of the money supply, and this has been maintained since. The policy rate increase and strong government demand led to a rise in monthly average Treasury Bill and Treasury Note yields across all tenors (Figure 1.36). The yields of both seven-year and ten-year Treasury Notes increased by 450 basis points over the year. This, however, has exerted additional pressure on an already difficult domestic public debt situation by increasing interest payments.

Due to monetary tightening, the growth in money supply had decelerated though the recent exchange rate adjustment has pushed it up once again. Money supply growth reached 38.8 percent year-on-year in December 2022, mainly driven by government borrowing to finance fiscal deficits. However, government borrowing has decelerated which contributed to a slower expansion in the money supply to 28.3 percent in October 2023 (Figure 1.23). Revaluation effects stemming from the 44 percent devaluation of the kwacha and the subsequent rise in foreign currency-denominated deposits have led to a surge in money supply growth, reaching 38.5 percent in November 2023.

10. This was preceded by two increases in 2022—from 12 to 14 percent in April, and then to 18 percent in October.

FIGURE 1.35 While the real Policy Rate continues to be negative....

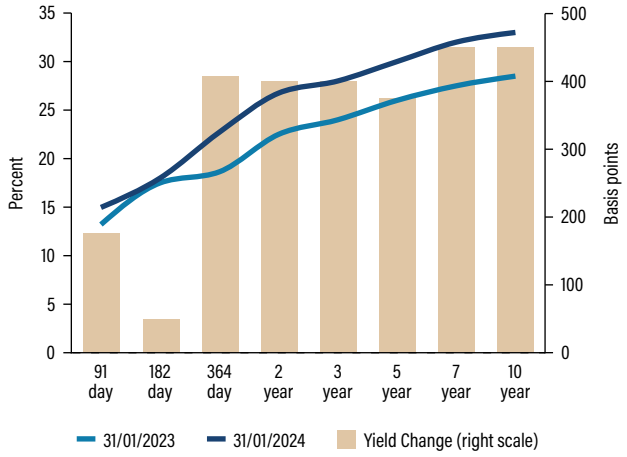
Interest rates, in percent



Source: World Bank staff calculations based on RBM data.

FIGURE 1.36 ...the yield of seven and ten-years notes climbed over the year

Treasury Bill and Treasury Note interest rates, in percent



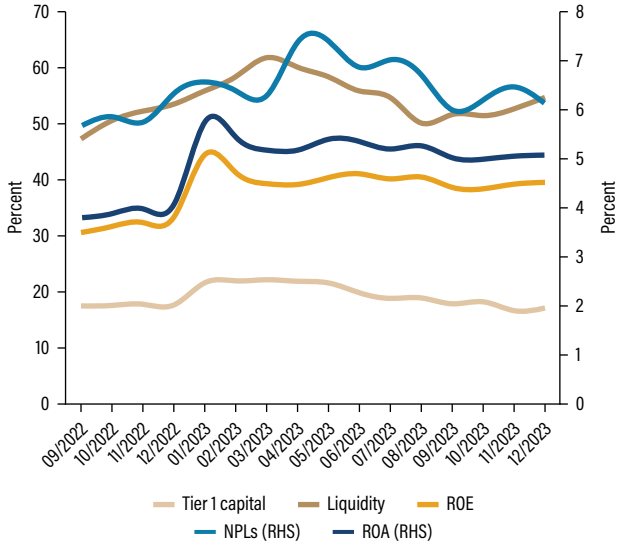
Source: World Bank staff calculations based on RBM data.

The banking sector remains well capitalized, liquid and profitable, and non-performing loans have started to decline

While Malawi faces economic challenges, capital adequacy and banking sector liquidity have continued to perform well. By December 2023, Malawi's banks had a total capital adequacy ratio of 20.1 percent, and a tier 1 capital adequacy ratio of 17.1 percent (Figure 1.37). This compares to regulatory minimums of 10.0 percent and 15.0 percent, respectively. These ratios were slightly higher at 20.9 percent and 17.7 percent, respectively, in December 2022. Liquid assets to deposits and short-term liabilities stood at 54.7 percent in December 2023.

FIGURE 1.37 The banking sector shows resilience

Financial stability indicators, in percent



Source: World Bank staff calculations based on RBM data.

The banking sector continued to post healthy profits in 2023. As of December 2023, commercial banks' return on assets (ROA) increased by 24.4 percent, from 4.1 percent in December 2022 to 5.1 percent in December 2023. Similarly, return on equity (ROE) increased by 18.6 percent from 33.3 percent to 39.5 percent. Overall profit after tax increased by 50.2 percent to MWK 256.7 billion, compared with MWK 170.8 billion recorded in December 2022. High profitability was a result of a 55.1 percent increase in interest income while non-interest income grew by 52.3 percent. This reflects high margins on foreign exchange transactions in an environment of acute foreign exchange scarcity.

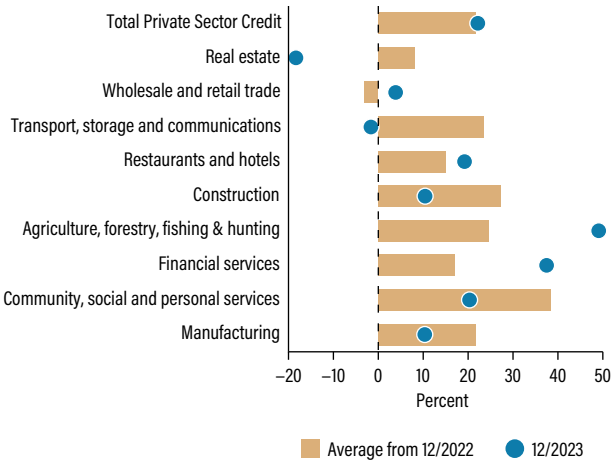
In the second half of 2023, non-performing loans (NPLs) slowed down after growing steadily at the beginning of the year. NPLs decreased slightly from 6.3 percent of gross loans in December 2022 to 6.1 percent in December 2023. Despite this drop, the level of NPLs is still higher than the RBM's benchmark of 5.0 percent, and signals potential risks in the near future. In addition, the continued rise in interest rates may impact the capability of borrowers to service debts, a situation that may be worsened by exchange rate losses incurred by large corporations with foreign currency denominated liabilities following the exchange rate realignment. These challenges

pose further risks to financial stability, especially with regard to NPLs, in a sector that has thus far shown remarkable resilience in the face of economic challenges.

Private sector lending increased in 2023. Credit to firms increased by 22.2 percent from December 2022 to December 2023 compared to the same period in the previous year. In the year up to December 2023, lending to the manufacturing sector grew by 10.3 percent (Figure 1.38). Lending to community, social, and personal services grew by 20.3 percent during the 12 months period ending in December 2023 while lending to the agricultural, forestry, and fishing sector significantly increased by 49.1 percent in December 2023, and lending to the financial services sector by 37.5 percent. The growth in the lending sector reflects a recovery from challenges associated with COVID-19 and cyclones in 2022 and 2023. Lending to real estate shrank while lending to wholesale and retail sector grew by only 3.9 percent.

FIGURE 1.38 Private sector lending is growing, led by the manufacturing sector

Share to total lending in selected sectors, in percent



Source: World Bank staff calculations based on RBM data.

1.3

MEDIUM-TERM ECONOMIC OUTLOOK

Economic growth is projected to increase over the medium term, supported by an improved macroeconomic environment and ongoing structural reforms. Growth is projected to increase to around 3 percent in 2024, mainly driven by a slight easing of global commodity prices, a moderate improvement in agricultural production, and increased output supported by improved foreign exchange inflows. The outlook assumes increased budget support from development partners and that the new IMF program remains on-track. Growth is expected to average 4 percent in the medium term, supported by ongoing and announced macroeconomic reforms aimed at addressing external and fiscal imbalances.

The current account deficit is expected to stabilize in the coming years from the high deficit of recent years. Bolstered by exchange rate reforms and the anticipated accumulation of reserves partly supported by foreign exchange purchases via auctions, exports are projected to gradually improve, contributing to a moderating current account deficit. Broader external sector reforms supported under the recently agreed ECF will help boost reserves.

Inflation pressures will persist in the next year but are expected to subside as announced reforms are implemented. The recent 44 percent adjustment of the kwacha and increased fuel and utility prices are exerting pressures on inflation. In addition, the upcoming El Nino season may result in lower than anticipated agricultural production and higher food prices. Going forward, prudent monetary and fiscal policies are essential to arrest the effects of these transitory factors and lower inflation sustainably.

The fiscal deficit is expected to continue narrowing if fiscal consolidation efforts are sustained. Under the ECF-supported program, the government has committed to consolidate public finances by 1.3 percent per year over the next four years, excluding the recapitalization of the RBM. This will be supported by revenue enhancement measures, including automation of tax administration, VAT tax reforms and streamlining of tax incentives. In addition, the ECF program has catalyzed increased budget support by the World Bank, as well as planned support by the European Union and the African Development Bank. The government will also need to rationalize and prioritize expenditures, including those related to AIP and the wage bill. This will boost available resources and remain critical for regaining macroeconomic stability and fiscal sustainability.

The ongoing implementation of public finance management (PFM) reforms is expected to support improved expenditure management and fiscal consolidation. This includes continued progress in the roll-out and real-time use of the IFMIS to support fiscal reforms, including the implementation of sound commitment control and cash management measures. These efforts are expected to contribute to containing the variance between approved budget and outcomes, leading to a reduced fiscal deficit. Furthermore, the government has developed its first PFM Strategy to establish a framework for implementing reforms in PFM and to align government finances with national development planning. However, governance and transparency issues associated with defense procurement contracts and the Lilongwe-Salima Water Project risk undermining PFM reforms and efforts to restore debt sustainability.

Numerous downside risks to the Malawian economy persist. Vulnerability to natural disasters and unpredictable weather patterns add uncertainty to the outlook. Delays in PFM reforms could hinder fiscal consolidation and the control of spending arrears, as would fiscal slippages in the final quarter of the current fiscal year. Delayed debt restructuring could further exacerbate debt sustainability. Volatile commodity prices could exert pressure on inflation and the external sector. Exchange rate reforms would need to be adequately supported by sound fiscal and monetary policies to facilitate the accumulation of foreign reserves and prevent the re-emergence of a large exchange rate premium. Upside risks include higher-than-expected exports in the agriculture sector, mining production proceeding faster than anticipated, and increased grants.

Policy Priorities: Bolstering macroeconomic stability, creating the foundations for export-led growth, and protecting the poor against shocks

The government has implemented various measures to mitigate the ongoing economic crisis. Notably, this includes i) strengthening debt management, through initiation of debt restructuring with external creditors and restricting new non-concessional borrowing, ii) progressively lowering allocations for fertilizer and seed subsidies through the AIP between FY2021/22 and FY2023/24, iii) conducting foreign exchange auctions and increasing exchange rate flexibility to facilitate price discovery, iv) improving fiscal governance through the implementation of the new PFM Act, and v) most recently, moving forward with efforts to align the exchange rate.

The 18th edition of the Malawi Economic Monitor (MEM) outlines urgent actions and sustained reforms required to consolidate the stabilization of the economy, enhance growth, and protect the most vulnerable. It specifically recommends:

i) *Bolstering macroeconomic stability:* Ongoing macro-fiscal reforms need to be sustained and fully implemented, focusing on rebuilding foreign reserves, enforcing fiscal discipline, enhancing public financial management, improving debt management, and increasing flexibility in exchange rate management. The planned fiscal tightening and related fiscal governance reforms, and successful external debt restructuring will be integral to regaining debt sustainability.

ii) *Creating the foundations for export-led growth:* Key measures include stimulating growth of the agriculture sector by advancing with reforms of the AIP and commercialization initiatives, incentivizing exports by reducing non-tariff barriers, and supporting development of an efficient and transparent mining sector.

iii) *Building resilience and protecting the poor:* With the heightened risk of extreme weather events and food insecurity, it will be essential to move forward with the implementation of the expanded social cash transfer and climate-smart public works programs, as well as to strengthen the functioning of agricultural markets. Implementation of the Disaster Risk Management Bill will be key to enhance preparedness for future disasters and strengthen resilience .

TABLE 1.2 Priority policy areas and key actions

1. Bolstering macroeconomic stability			
Building foreign reserves	Support reserves accumulation, liquidity in the forex market, and the credibility of announced exchange rate reforms (including freely negotiated exchange rates between ADBs and clients, and fortnightly auctions).	Short	
Balancing the budget	Implement fiscal consolidation measures, increase domestic revenue, and improve forecasts of pre-determined expenditure to demonstrate that Malawi can operate within its budget.	Short	
Improving public financial management	Adhere to quarterly allotment ceilings in IFMIS to reduce growing spending arrears that arise from overspending and committing outside the system.	Medium	
Achieving debt sustainability	Rapidly conclude negotiations with creditors to achieve sufficient reductions in external debt levels and contain domestic debt levels to pre-defined targets.	Short	
2. Creating the foundations for export-led growth			
Support development of an efficient and transparent mining sector that can drive growth	Accelerate the development of mining projects under negotiation by identifying critical bottlenecks, streamline and expedite permitting processes, and improve government coordination and capacity to effectively negotiate multiple agreements concurrently.	Medium	
Stimulate agricultural growth	Proceed with the AIP 2.0 reform process to reduce the fiscal burden, maximize fertilizer use efficiency through better targeting, and improve the timeliness of input procurement and distribution.	Short	
Incentivizing exports by reducing non-tariff barriers	Review existing NTBs and develop a strategy for phasing these out, especially in sectors where Malawi has a comparative advantage (agriculture, agro-processing, mining, tourism).	Short	
3. Building resilience and protecting the poor			
Facilitate the move to off-farm livelihood strategies	Continue the rollout and scaling up of cash transfer and climate-smart public works projects to address current livelihoods needs while encouraging the development of a local off-farm economy.	Medium	
Strengthen the functioning and integration of agricultural markets	Minimize interventions in agricultural markets to bolster increased domestic and regional food trade, incentivize increased participation by traders in markets and reduce grain price differentials throughout the country.	Medium	
Preparing for the next disaster	Implement the DRM Bill and Post Disaster Needs Assessment (PDNA) lessons to ensure improved disaster preparedness	Short	

Initiate Strengthen Sustain

2

HEALTHY WATERSHEDS FOR A STRONG ECONOMY

Introduction

This edition of the Malawi Economic Monitor examines the relationship between Malawi's natural capital, in the form of watersheds, and its economy. Currently, the country's watersheds are severely degraded. Improving how watersheds are managed and used can open opportunities to improve the country's economic performance, build resilience to climate risks, and support more reliable and sustainable livelihoods for many households, including the poorest. Box 2.1 explains what a watershed is and the characteristics of a healthy one.

The pressures on Malawi's watersheds are complex, interrelated, and longstanding but are magnified by two underlying drivers: rapid population growth and climate change. Rapid population growth places massive demands on natural ecosystems. Marginal land is converted to agriculture, while forests are harvested for wood or cleared for agriculture. The quality and quantity of water resources decline as soils and agrochemicals run off degraded landscapes and pollute watercourses and wetlands. The resulting degradation leads to the loss of soil fertility and diminished watershed protection. Climate change magnifies existing environmental vulnerabilities and accelerates the decline. This results in reduced incomes and resilience for rural households and, at the national level, reduced economic output and national income. Figure 2.1 illustrates this complex web of environmental decline.

Severe land degradation in the country's most important watersheds significantly impacts water security (including access to drinking water, sanitation, and health), agricultural productivity, and hydropower generation. Recent studies suggest that land degradation hotspots (locations where multiple indicators of degradation combine) cover nearly half (41 percent) of Malawi's land area (Kirui et al. 2021). Around 75 percent of Malawi's soils are degraded or threatened by degradation (Omuto and Vargas 2019). The average annual national soil loss rate in 2014 was 29 tons per hectare (Vargus and Omuto 2016), with other assessments suggesting the rate may be higher in some locations (Asfaw et al., 2018). Chemical land degradation, including soil pollution and salinization or alkalization, was estimated to have led to the loss of 15 percent of Malawi's arable land (FAO, 2013). Projections for future land degradation and soil loss under different climate and population growth scenarios suggest that land degradation will become increasingly severe (World Bank, 2022a), with one study indicating that overall rates of soil loss will increase three- to four-fold relative to 2010 baseline levels (Asfaw et al. 2020). Box 2.2 explains the characteristics of degraded soils.

The Shire River Basin remains the most prominent hotspot of land degradation. High sediment load deposited in riverbeds, reservoirs, and floodplain wetlands affect irrigation canals, fisheries, and hydropower generation. Existing hydropower plants on the Shire River often need help to meet peak demand, partly due to low flows and sediments in the river caused by the degradation of catchments upstream of the plants.

BOX 2.1 What is a Watershed, and what is a 'Healthy' Watershed?

A watershed is an area of land that feeds water to a river, draining through the landscape into tributaries and main river channels. Watersheds are also called 'catchments' or 'river basins.' In most cases, these three terms are used interchangeably. However, to differentiate in terms of scale, 'river basin' is used to describe a watershed covering a large area of land that drains into a major river (e.g., Shire River Basin), while 'sub-catchments' or 'micro-catchments' or 'micro-watersheds' are much smaller parts of a basin that drain into a tributary stream.

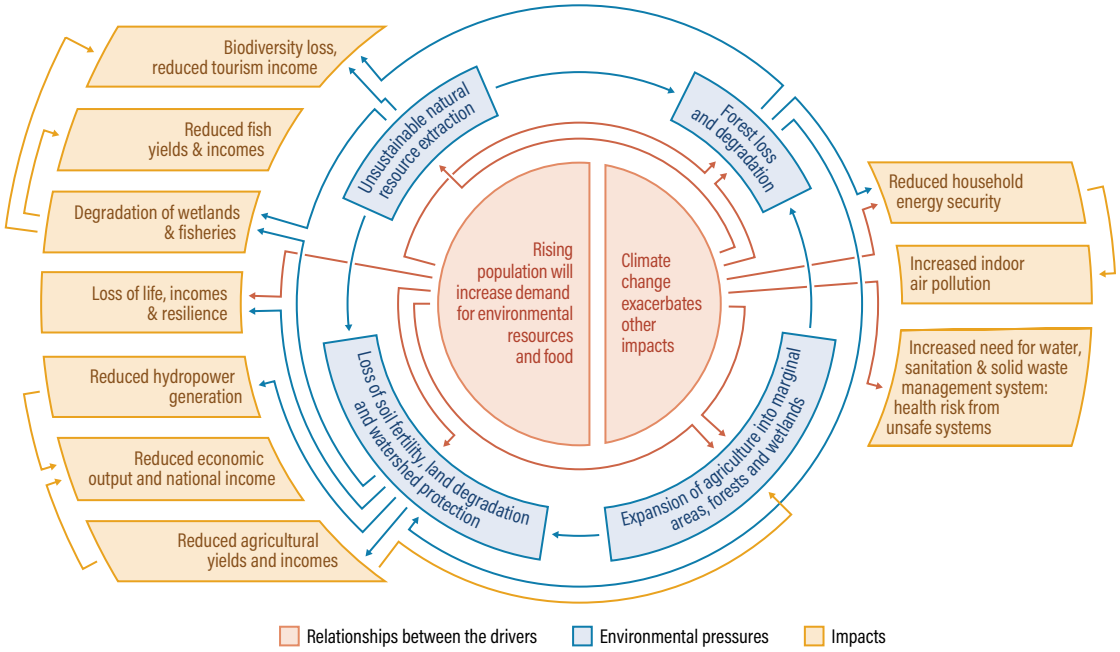
Malawi's watersheds are dynamic areas that become wet and dry depending upon the season or even the effects of an individual storm. Within a watershed, activities on the land interact with the natural hydrologic cycle. Essential nutrients and chemicals are circulated throughout the watershed's system and supply nutritional sources for plant, terrestrial (birds, small mammals, etc.), and aquatic (fish, aquatic insects, etc.) species. People use watersheds to grow food, harvest forests, build homes and businesses, and travel. Human activities significantly impact water movement, water quality, soil conditions, and nutrient availability.

A healthy watershed can support healthy biological communities. A habitat with sufficient size and connectivity to support native plant, terrestrial, and aquatic species is the critical characteristic of a healthy watershed. A healthy watershed protects and renews valuable natural assets, and provides multiple economic and social benefits for a country's population.

Source: Adapted from IUCN 2009.

FIGURE 2.1 Environmental Drivers, Pressures, and Impacts

The relationships between the drivers, the environmental pressures and impacts that work together to create the decline in the health of Malawi's watersheds



Source: World Bank 2019.

BOX 2.2 What are degraded soils?

Soil degradation refers to losing land's physical, chemical, biological, and ecological qualities due to natural or human-caused disturbances. Examples of soil degradation processes are the exhaustion of nutrients and organic matter, soil erosion, acidification, desertification, and pollution.

Four main factors contribute to soil degradation:

- **Biological:** Decreased microbial activity due to destructive biochemical reactions, especially in bare/unprotected earth, reduces yields and makes land less amenable to crop cultivation.
- **Chemical:** Unfavourable changes in soil chemistry (caused, particularly, by synthetic fertilizers and pesticides) diminish plant nutrition: beneficial microbes and humus content decline; and the pH of the ground shifts.
- **Ecological:** Decreased land productivity due to environmental factors, mainly climate change (increasing temperatures, altered precipitation patterns, extreme weather events). Deforestation and the loss of ground cover contribute to the ecological degradation of soil by exposing it to erosion and causing disruptions in ecosystems.
- **Physical:** Loss and depletion of fertile topsoil due to physical impacts (floods, surface runoff, landslides, winds and storms, intensive tillage, heavy machinery use). Long-term physical degradation harms soil fertility, composition, and structure.

In any single location, the importance of each of these factors will vary, depending on the land's starting condition, the nature and severity of the stresses put on it, the land's reactions to those stresses, and the feedback from those reactions on the natural assets.

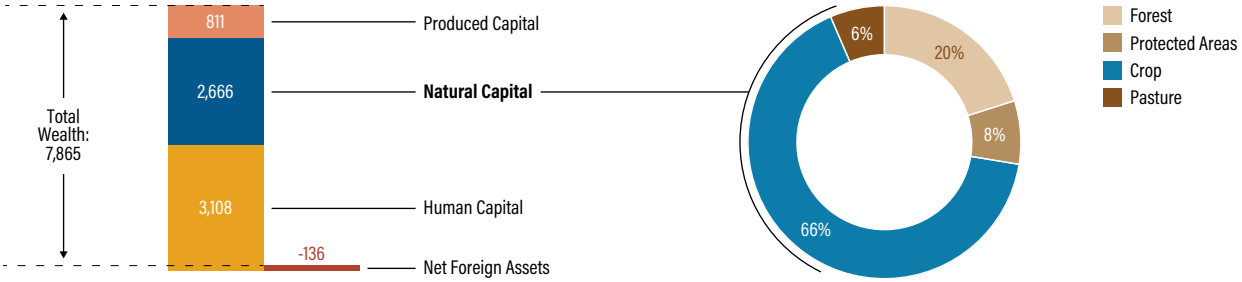
Source: Based on Kogut 2022.

Malawi's watersheds are the key to understanding the challenges currently threatening the country's important and valuable assets: land, forests, and water. Together, these resources are often referred to as 'natural capital' and are essential to the country's overall wealth, although quantifying their monetary value is challenging. Figure 2.2 shows the composition of Malawi's natural capital and its importance to Malawi's total wealth.[11]

11. Natural capital covers the following assets: Nonrenewable resources: 14 types of minerals and fossil fuels; Renewable resources: cropland, pastureland, forest timber, forest services (an estimate of non-timber forest products), watershed services, recreation values), protected areas (value estimated as the opportunity cost of converting to agriculture). The measurement used here does not yet include the value of carbon retention or sequestration services as part of wealth embedded in biological ecosystems (for example, forests and soils), mor does it subtract the social cost of carbon from fossil fuels.

FIGURE 2.2 Where is Malawi's Wealth?—Malawi's Natural Capital

Assets measured in market prices and converted to 2018 US$ using market exchange rates



Source: World Bank 2021.

In combination with other types of capital, natural capital forms part of a country's wealth. It underpins a country's capacity to produce current or potential goods and services in the future to enhance the wellbeing of its citizens. When a country exploits its land, forest resources, and the associated water resources, it may generate income but deplete its natural capital.

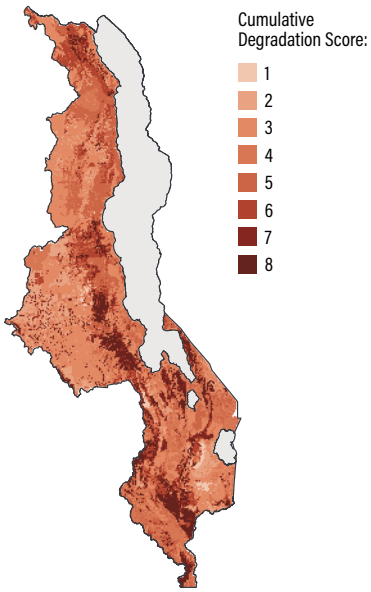
Healthy watersheds can benefit all Malawians, but they need to be nurtured and cared for

Malawi's watersheds support the country's natural resources like land, forests, and water. They help crops, trees, livestock, and fish thrive. Healthy watersheds boost land and water productivity and make communities more resilient to floods and droughts. This resilience ensures a steady source of income, food, water, and power, forming the foundation for developing other valuable assets. Conversely, when watersheds are degraded, they struggle to provide these essential resources. Without intervention, their ability to support the environment declines, leading to increasingly severe problems over time. Given the significance of natural capital as an asset for Malawi (Figure 2.2), it is crucial that it is utilized efficiently and managed in a sustainable manner. Failure to act to protect and enhance Malawi's watersheds may result in a decline in their value, with the associated economic benefits going unrealized.

Around 80 percent of Malawi's land is degraded, impacting the livelihoods of millions (World Bank, 2022a; MoNREM, 2017). This compares with 51 percent in Tanzania, 23 percent in Ethiopia, and 22 percent in Kenya (Kirui et al., 2021). Land degradation 'hotspots' cover about 41 percent of the land area in the country (Figure 2.3), with the Shire River basin the most affected (MoNREM, 2017). Two of Malawi's three prominent soil types are suited to agriculture but also highly susceptible to erosion. The average annual national soil loss rate in 2014 was 29 tons per hectare (Vargus & Omuto, 2016). The negative effects of this rate of loss, if the causes are not addressed, could range up to 20 percent of national agricultural production and 3 percent of GDP, with an additional 10 percent in soil loss leading to more than 270,000 additional individuals in poverty (Asfaw et al., 2020).

FIGURE 2.3 Land degradation across Malawi now covers 41 percent of total land area

Extent and Scale of Degradation



Source: Based on Alliance for Restoration of Forest Landscapes and Ecosystems in Africa 2023.

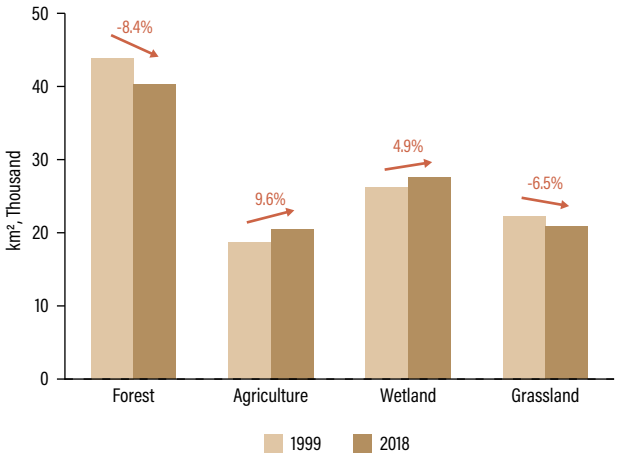
Note: This map shows cumulative degree to which an ecosystem's physical condition, composition, structure, and function have been adversely affected by anthropogenic factors. The higher the score, the more severe the degradation.

This extensive degradation is fueled by limited livelihood options, high population density, and a growing demand for charcoal and firewood. These factors compel people to expand cropping into forests and wetlands, cultivating steep slopes and highly degradable, shallow soils. The scarcity of energy alternatives to charcoal further contributes to ongoing deforestation. Land degradation also significantly impacts other sectors—particularly water resources, energy generation, agriculture, and fisheries. Over recent decades, agricultural land has progressively expanded into forest areas, albeit at a slower pace since 2000. This expansion has led to the cultivation of fragile upper catchments (Figure 2.4). This degrades natural habitats, exacerbates downstream flooding, and increases exposure to weather shocks. Cropping on unsuitable land is seldom productive, and although short-term gains may be achievable with inorganic fertilizer, the yields are not sustainable. This practice inevitably results in increased soil loss and accelerated degradation (Asfaw et al., 2018). Degraded watersheds also impact the availability of clean water in Malawi, as environmental degradation and changes in land use/land cover are major causes of clean water scarcity. This problem is particularly severe in and around urban areas, such as Lilongwe (Nkwanda et al., 2021)

Projections under different climate and population growth rate scenarios suggest that land degradation will become increasingly severe. Climate change can accelerate soil degradation as a result of altered weather patterns, increasing temperatures and extreme weather events. Land degradation could increase the damage to Malawi's infrastructure from inland flooding by as much as 25 percent by 2050. (World Bank 2022a). Increased flooding alters local landscapes, is closely tied to the loss of woodland areas, and constitutes the primary cause of the expansion in wetland areas (Gondwe et al. 2019).

FIGURE 2.4 Forest and grassland is being replaced by agricultural land and wetland

Change in land use and cover from 1999 – 2018, in km²



Source: Based on Gondwe et al. 2019.

TABLE 2.1 The significant drivers of watershed degradation in Malawi

Proximate drivers	Underlying drivers
▪ Charcoal and wood fuel (for domestic and commercial use) ▪ Timber production ▪ Unsustainable agricultural methods (slash and burn with shorter rotations) ▪ Mining	▪ Development processes in energy, forestry, agriculture and water sectors ▪ Poverty ▪ Lack of alternative energy sources ▪ Weak policy environment and lack of planning ▪ Insecure land tenure ▪ Lack of/uneven policy enforcement

Source: Adapted from Kirui 2015.

Chemical land degradation, including soil pollution and salinization/alkalization, has led to a 15 percent loss in the arable land in Malawi in the last decade alone. Land degradation also significantly impacts other sectors—particularly water resources, energy generation, agriculture, and fisheries. Increasingly, agricultural land has expanded into forest areas over recent decades, albeit more slowly since 2000, resulting in the cultivation of fragile upper catchments (see Figure 2.4). This degrades natural habitats, exacerbates downstream flooding, and increases exposure to weather shocks. Projections under different climate and population growth rate scenarios suggest that land degradation will become increasingly severe. For example, land degradation could increase the damage to infrastructure from inland flooding by as much as 25 percent by 2050. (World Bank 2022a).

Effective management of Malawi's watersheds is necessary to reduce Malawi's high poverty levels. 71.7 percent of Malawians live on less than US$2.15 a day, the third-highest rate in Sub-Saharan Africa. The country remains predominantly rural, with nearly 85 percent of the population residing in rural areas. Rural poor households make up approximately 94 percent of all poor households (World Bank, 2022b). Most rural households depend on farming for a significant share of their livelihoods. Alternative sources of income in rural areas, such as wage labor or small-scale enterprises, also depend on local natural resources in some way (World Bank. 2022b). Degraded and degrading watersheds directly limit poor households' ability to improve their incomes and livelihood opportunities.

Malawi is highly vulnerable to the impacts of climate change

Climate change projections indicate that floods, droughts, and heatwaves will increase in severity and frequency. This is expected to accelerate land degradation, contribute to forest loss, and elevate the likelihood of more frequent natural disasters. Future climate change scenarios suggest that Malawi will see increasing climatic variability, higher temperatures, longer dry periods, more erratic and intense rainfall, and associated droughts and flooding (GoM, 2017; World Bank, 2022a). These adverse impacts of changes in weather patterns will have nationwide repercussions, threatening local and national food security, undermining livelihoods, damaging critical infrastructure, and reducing economic activity and output. For example, weather shocks have caused more Malawians to fall back into poverty than those who moved out of it between 2010 and 2019 (World Bank, 2022b). In March 2023, when Tropical Cyclone Freddy struck the country, causing loss and damage of well over US$500 million, more than 2.5 million people were affected, over half of these women and girls of reproductive age, including more than 100,000 pregnant women (GoM, 2023).

Climate shocks will increase the vulnerability of the poorest households, whose livelihoods often depend on natural resources. Many households have very few other resources to fall back on if their core livelihood strategy fails. Poor rural households are particularly exposed to this type of risk because their livelihood security relies on natural resources. Rehabilitating watersheds is key to mitigating these climate risks to livelihood security.

Rehabilitating watersheds will mitigate the impacts of floods and droughts. Healthy watersheds contribute to better runoff control after storms, mitigate soil loss from erosion, and prevent or reverse the degradation of productive land. Reducing soil loss plays a crucial role in minimizing sedimentation in watercourses, leading to improved river/stream flows and decreasing the likelihood of rivers bursting their banks. As a result, heavy storms do less damage to farmland, property, critical infrastructure, and other assets. Improvements in soil water retention and groundwater recharge mitigate the impact of droughts on crops.

Degraded watersheds increase Malawi's vulnerability to disasters

Population growth, and consequently, water demand is surpassing water availability in Malawi. The country has the lowest water availability per capita relative to its neighboring countries. The country's total renewable water resource is ± 927 cubic meters per capita per year. This is very close to water scarcity (UNICEF, 2022). Due to population growth, watershed degradation, and climate change, per capita water availability has declined by 44 percent in the last 20 years (World Bank, 2020). Restoring watershed health at scale would make a significant contribution to addressing water scarcity.

Malawi's lakes, wetlands, aquifers, and river systems constitute its most vital natural resources; however, the country is on the verge of experiencing water stress and scarcity. The likely impacts of climate change and insufficient water infrastructure and management systems add to the risk of widespread water stress (World Bank, 2022a). The compounded economic impact of degraded water resources in Malawi is hard to estimate collectively. However, just one aspect of degraded water resources, poor sanitation, alone costs the country US$ 57 million annually, around 1.1 percent of GDP (UNICEF, 2022). Severe Floods in 2015, 2019 and 2023 have cumulatively cost the country 1.18 percent of its GDP (GoM. 2015; 2019; and 2023)—a financial burden exacerbated by the absence of water-regulating infrastructures, reduced natural floodwater regulation because of forest loss, and encroachment for both farming and construction into high-risk flood zones (GoM, 2023).

The impacts of droughts and floods are exacerbated by the degraded state of Malawi's watersheds. Extreme weather events, beyond Malawi's control, become 'disasters', where mitigation measures are within the country's control. Insufficiently protected soil surfaces in degraded watersheds amplify the

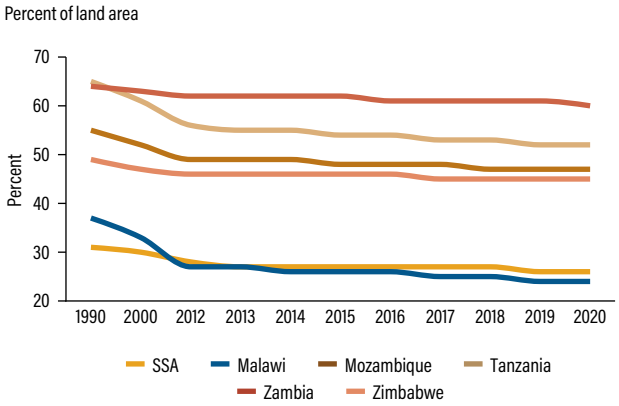
adverse impacts of floods and droughts by increasing runoff, decreasing infiltration, and increasing soil water loss through evaporation. One of the reasons that recent floods have had such devastating consequences is that degraded watersheds were unable to absorb and hold back runoff to protect valuable assets.

Frequent and ongoing disaster responses associated with degraded watersheds displace productive investments. The persistent need for disaster responses ties up human and financial resources that could otherwise be allocated to a diverse array of national development priorities. This includes investments that can mitigate disaster risk, such as rehabilitating watersheds. Reducing the resources required to respond to disasters would free up resources for a wide range of productive investments that could improve Malawi's development trajectory.

Malawi's forests are being lost at an alarming rate

Over half the country's forests and woodlands have vanished in the last 40 years. Those that remain are being thinned through over-extraction and frequent forest fires. In 1975, around 47 percent of Malawi was forested land (Mauambeta et al., 2010). More than half of these forests were lost between 1972 and 1992, at a rate of 2.5 percent per year. Since 1992, the rapid rate of decline has slowed, and deforestation is currently estimated at between 0.63 and 0.76 percent annually, with the scarcity of remaining forest being the primary constraining factor (MoNREM, 2019 and 2020). Regional analysis indicates that Malawi's forested land area share is now lower than the sub-Saharan average and considerably lower than that of its neighbors (Figure 2.5). Forests substantially and directly contribute to livelihoods and the economy and protect vital ecosystem services.

FIGURE 2.5 Comparing Malawi's forested area with that of its neighbors



Source: World Bank data portal.

Forests provide essential environmental and economic benefits, and their decline results in negative environmental and economic consequences. Forests and woodlands contribute to 7 percent of Malawi's total wealth and represent 20 percent of its natural capital (World Bank, 2021). However, these values are expected to decline steadily as forest resources are depleted. Forests and trees make substantial contributions to livelihoods, jobs, and the economy by supplying biomass fuels as sources of soil fertility, preventing land degradation, protecting watersheds, and providing habitats for biodiversity and wildlife. Forests also provide the bulk of Malawi's energy supply through charcoal and firewood, estimated to be worth US$ 352 million in 2017—the equivalent of 4.7 percent of GDP. (World Bank, 2019). Many of the ecosystem services forests provide are not easily quantified and tend to be overlooked in economic planning. The loss of forest and associated habitats and biodiversity significantly impacts the resilience of the surrounding communities dependent on the resources.

Forest loss is closely linked to Malawi's broader problems of land and water degradation. Deforestation, forest degradation, and the loss of on-farm trees are significant contributors to Malawi's land and water degradation problems. Forests and other natural vegetation help buffer the impacts of rainfall, preventing water runoff and soil erosion. As forest cover is lost, increased runoff carries soil from both the previously forested areas and open land downstream. This reduces the productivity of downstream agriculture and erodes stream banks. When soil flows into water courses, it clogs water intakes for irrigation, drinking water supply, and hydropower generation, imposing a broad range of economic costs. This issue has received particular attention in the Shire River basin in Malawi, partly because all of the country's hydroelectricity generation plants are on the Shire River, and the economic consequences of power plant closures are severe.

Expanding agriculture, driven by an increasing rural population with few alternatives to farming, is a key driver of degraded watersheds

Land degradation is a significant threat to agricultural development in Malawi and impacts overall economic growth. The extensive impacts of degradation include a loss in agricultural productivity, heightened expenditure on fertilizers (as degraded soils do not respond optimally to fertilizer treatments), and a general decline in the profitability of crop production. Soil loss removes fertile soils from farmlands and reduces the cultivable soil depth. Due to the size of Malawi's agricultural sector, degraded land significantly constrains the country's overall economic development.

Crop production is facing challenges due to the overall reduction in cropland productivity and an increase in soil erosion in recent years. A rapid expansion in cropland between 1999 and 2018 (an increase of 9.6 percent of the proportion of land area under crops) was characterized by an expansion of crop farming into upland areas, indicating increased land scarcity in Malawi. There is now limited potential for future expansion, as approximately only 5 percent of the total land remains as potentially available cropland—corresponding to 4,671,000 ha. (Chengxiu Li et al, 2021).

Rehabilitating watersheds will protect the livelihoods of poor rural communities. Rehabilitated watersheds will be more productive, potentially increasing food and livelihood security (at local and national levels). Each dollar spent on addressing land degradation in Malawi is estimated to yield about US$ 4.3 over 30 years by restoring the productivity of crop land and forest resources (Kirui, 2016). The technologies required to do this are standard soil and water conservation practices such as terracing and bunding, tree planting, using more organic fertilizers, and planting trees. The government's 2017 Forest Landscape Restoration Opportunities Assessment estimated that restoring 2.4 million hectares of degraded cropland would increase maize production by 1.55 million metric tons per year, an increase of 40 percent (MoNREM 2017). The World Bank's recent "Malawi Climate and Development Report" showed that reducing soil erosion and improving land management can translate into significant economic gains under all climate scenarios (World Bank, 2022a).

While the estimated returns to sustainable land management practices appear to be high, achieving them presents challenges. Experience elsewhere in Southern and East Africa indicates that poorer farm households (the majority of Malawi's rural households) often need more resources to fully benefit from investments, and there are high de-adoption rates for techniques such as conservation agriculture and agroforestry. This is usually because labor requirements are high and/or subsidies have ended. In Malawi, high levels of interventions in the markets for key crops may also play a role.

Insecure land tenure also impacts land degradation because it limits farmers' incentive to invest in improving their land. Improving and protecting degraded land requires time and labor, and most benefits are not seen immediately. Insecure land tenure reduces incentives to invest in higher-value crops or soil conservation measures, resulting in lower productivity levels and land degradation. In a 2016 study, around 33 percent of households told researchers that they felt their rights to their plots were insecure (Lovo, 2016). The recent introduction of new land policies, including those for customary land, reflects a recognition that the lack of tenure security on customary land limits incentives for smallholders and businesses to invest in sustainable land management (SLM) practices.

Agriculture policies play an essential role in shaping natural resource management. Agriculture policies and accompanying state interventions have encouraged mono-cropping, particularly of maize. These policies, such as the current Affordable Input Programme and its predecessor, the Farm Input Subsidy Programme, have worked against crop diversification and sustainable agricultural development in various ways, such as promoting monocultures and the intensive use of inorganic fertilizers. This has contributed to land degradation and reduced resilience, with farmers continually searching for new land for cultivation, often at the expense of forests or opening up poor-quality land that rapidly degrades (see also World Bank 2022d).

Unsustainable agricultural practices can be turned around by incentivizing farmers to manage their land sustainably

Creating incentives for the farm-level scaling up of sustainable land management practices can be achieved by strengthening land tenure security and reforming input subsidies. Two policy priorities are central to this: implementing land tenure reforms at scale and reforms to subsidy regimes. Land tenure reforms at scale will increase tenure security and incentivize landholders to invest in sustainable land management. This will reduce land degradation and increase productivity. Unfortunately, poorly targeted input subsidies currently work in the opposite direction and directly contribute to land degradation (e.g., by constraining crop diversification and encouraging practices that deplete soil fertility) and indirectly (e.g., crowding out fiscal space for investments in extension services). Therefore, subsidy regime reforms are also needed to effectively target limited public resources and create incentives that encourage better land stewardship.

Redirecting existing agricultural subsidies is a practical way to support and ease the transitions to sustainable land and water management practices. More informed expenditure decisions on agricultural inputs are required, focusing on encouraging production systems more oriented towards regenerative practices that tightly recycle nutrients. Extension approaches should steer clear of prioritizing production solely through modern inputs and prescriptive agricultural practices. Instead, they should aim to collaborate directly with communities to address environmental decline and ensure that alternative approaches are introduced and widely shared. One effective strategy is to promote proven soil and water conservation practices integrated with climate-smart agriculture. This involves diversified cropping combined with soil and water management techniques tailored to both the local agro-ecological context and projected changes in climate and weather patterns. These ideas have long been called for by the Agriculture Sector Wide Approach (see https://aswap.mw) and successive Economic Recovery Plans. This is not a simple task because Malawi's extension services struggle to provide effective management and delivery of extension to smallholders (MoAIWD 2018; Ragasa et al. 2019, see Box 2.3).

BOX 2.3 Impacts on Smallholders' Production and Incomes of Investing in Agricultural Extension and Irrigation

A recent modelled cost-benefit study indicates substantial positive benefits are possible through increased investments in agricultural extension and irrigation in Malawi (FAO, ILO, UNICEF, 2019). These are the sort of investments that support better land husbandry and reduce incentives to open up marginal land for cropping. This study examined different household types (non-poor, moderately poor and ultra-poor) in two categories: those with more than 1.5 ha of land and those with less than 1.5 ha. The study assessed the economy-wide impacts (i.e. not just the direct costs and benefits) of increasing these services. For extension, the study looked at doubling access to extension services from 4 percent to 8 percent of rural households with over 1.5 ha of land. The study also examined increasing irrigation access from 17 percent to 34 percent of households with land above 1.5 ha. The National Agricultural Investment Plan targets doubling the agricultural land under irrigation, which implies doubling the proportion of households with access to irrigation (MoAIWD 2018).

Unsurprisingly, increasing access to irrigation leads to significant income increases for households with over 1.5 ha of land. However, there are also significant spill-over effects on the incomes of households with less land. As the cost of establishing irrigation schemes is high and spread over 20 years, the study examined the total cost of developing irrigation and the annualized cost of maintaining and operating irrigation once it is fully completed. Doubling the share of households (with land above 1.5 acres) with access to irrigation results in crop production increases of 9.55 percent (full cost annualized) and 15.58 percent (annual cost once operational), as well as a 5.87 percent (full cost annualized) and 11.3 percent (annual cost once operational) increase in total real incomes.

While households that gain access to irrigation benefit directly, as increased production drives down the price of crops, this can cause some non-beneficiaries to decrease their crop production. Nevertheless, real incomes rise across households because food costs decrease due to the larger crop output. In addition, the multiplier effect of increased production and incomes generates spill over into retail, services and non-agricultural production, which benefit all households. Even ultra-poor households saw income gains ranging from 2.45 percent to 34 percent. Increasing extension coverage has real income and production multipliers above 2 MWK for every 1 MWK spent. Total real income rises by 2.48 percent, and they rise by as much as 7 percent for the ultra-poor. Small spillovers exist in other production sectors, but the gains from expanding irrigation are smaller. The additional extension agents required also contribute to the local economy by spending their wages on local products and services.

On the other hand, irrigation has smaller multipliers in the local economy, with cost-benefit ratios for both real income and production lower than one. This is due to the high capital cost of irrigation infrastructure. However, local multipliers do not capture the benefits of lower crop prices for urban consumers or the resulting increase in food security and exports, which may be sizeable given the significant crop production increases resulting from increased irrigation access. Smallholder irrigation schemes are also rising in Malawi (Chafuwa 2017). Although these schemes were not examined in this study, they may be a more cost-effective approach to expanding irrigation and increasing cost-benefit ratios.

Experience in Malawi illustrates that a well-thought-out and comprehensive approach to watershed restoration can be implemented effectively at scale. Although not enough to solve the problem entirely, the government of Malawi, with support from the World Bank and other partners, has ongoing operations supporting vital investments in water infrastructure, agricultural development, natural resources management, and disaster risk management.[12] These programs are building capacity at the national and local level. They are promoting actions such as participatory watershed management, climate-smart public works, reforestation, integrated basin planning, flood risk management, and constructing small- and large-scale irrigation infrastructure. They are also increasing livelihood options and providing work opportunities for rural communities.

One lesson emerging from these interventions is that multisectoral and multiagency endeavors can suffer from a lack of coordination. Different agencies use differing approaches to implementation, targeting, and monitoring, but serious capacity and financing constraints sometimes limit scale-up. A detailed analysis of lessons learned from previous and ongoing interventions is needed to ensure future programming that can contribute to protecting and restoring watersheds is responsive to current and future needs and suited to emerging climate change challenges.

Policies related to watershed management and their implementation often undermine progress

Malawi has a range of policies and institutional arrangements covering all important aspects of watershed management. The country's policy environment is relatively strong, with numerous policies and strategies relevant to managing watersheds. Most of these, especially more recent ones, reflect ambitious aspirations and sensible technical approaches. The National Landscape Restoration Strategy (2017), the Forest Landscape Restoration Opportunities Assessment (2017), and the *Malawi 2063* are good examples of identifying practical opportunities for restoring the productivity and ecological function of degraded watersheds. Effectively implementing, at a national scale, the approaches to watershed protection and rehabilitation proposed in these documents could significantly improve the health of the country's watersheds. The recent introduction of new land policies clarifies and strengthens individual land rights, including those for customary land. This reflects a recognition that the lack of tenure security on customary land limits incentives for smallholders and businesses to invest in sustainable land management practices.

Despite references in major policy statements, in practice, key government stakeholders are inadequately focused on the challenges of cross-sectoral cooperation required to address watershed degradation. This is demonstrated by a marked lack of finance as government spends almost nothing on watershed rehabilitation. In part, these financing constraints reflect how recurrent demands for disaster and emergency financing crowd out development financing, which would reduce disaster risk if used for watershed rehabilitation activities.

The government's ability to implement policies and legislation that effectively rehabilitate degraded land or reforest and protect denuded hillsides is weak at national and local levels. Both local and central government struggle to manage significant technical, managerial, and financial capacity constraints. In addition, as in many countries, government planning and implementation systems are more geared to sectoral, project-based interventions and less experienced at managing the coordinated, cross-sectoral interventions required for effective watershed rehabilitation (Chazdon et al. 2021; Ramponi et al. 2022). As a result of these combined constraints, and despite good intentions, monitoring is often limited, and

12. These include the Shire River Basin Management Program—Phase I, the Malawi Resilience and Disaster Risk Management Project, Shire Valley Transformation Programs 1&2, the Malawi Social Support for Resilient Livelihoods Project, the Malawi Watershed Services Improvement Project, Agricultural Commercialization Projects 1&2 and Agriculture Sector Wide Approach Support Projects 1&2.

the necessary procedures and guidance to deliver policy outcomes cannot be implemented effectively. For example, a recent analysis of flood management in the Shire basin has highlighted gaps in inter-agency communication and coordination around monitoring, data sharing, and planning (World Bank 2023c).

Conflicting policies in various implementation areas have often confused local stakeholders. For example, agricultural policies promote crop cultivation along riverbanks or marginal lands, contradicting forestry and water policies that aim to enhance watershed management through increased vegetative cover. This misalignment prioritizes short-term gains over long-term sustainability, leading to the overexploitation of crucial forest and water resources. Similarly, policy implementation in the energy sector lacks coordination with the forestry sector, resulting in unsustainable overreliance on biofuels. For instance, load shedding in electrical power provided through the national grid spurs the continued exploitation of forests for charcoal. Water resource management is often hampered by a lack of detailed procedures and protocols, combined with the weak capacity of key staff (World Bank 2019).

Attempts to decentralize and bring government services closer to citizens have been slow to deliver results. The decentralization process has been undermined by a slow and fragmented assignment of functions and resources to local authorities. With insufficient financial resources, weak capacity, and incentives to perform, local government has been unable to play an effective role in environmental management (World Bank 2022c).

There are two related reasons for weak institutional capacity for natural resource management at district and local levels. Firstly, the slow pace of implementation of the government's decentralization policies constrains the extent to which district councils and extension services can support farmers in introducing sustainable land management practices or assist Village Natural Resources Management Committees in protecting and restoring forest resources. Secondly, severe under-resourcing constrains the effective functioning of institutions at district and local levels, limiting their ability to implement policy. Malawi allocates less than 1 percent of its annual GDP to environment-related expenditures, and a very small proportion of this is decentralized to the district level. (World Bank 2022c; World Bank 2020).

There needs to be more ownership and coordination both in and between key government agencies. Implementing actions to reverse watershed degradation requires multi-agency coordination, which is not happening effectively. There is often a need for more clarity between key government agencies on relevant roles, responsibilities, and mandates to work together effectively to address degraded watersheds.

Revitalizing precious natural resources requires putting policies into practice

Rehabilitating degraded watersheds by adopting extensive soil and water conservation practices and restoring degraded forests is both time- and labor-intensive. Most of these time and labor costs inevitably fall on individual smallholders. In addition to direct restoration costs, there are additional opportunity costs as land under production is managed differently by, for example, reducing tillage, utilizing crop residues, planting trees, or shifting grazing and cropping patterns—changes that often reduce returns in the short term. Economic benefits from restoration may only be realized at some future date, while people's lives and livelihoods have immediate and urgent requirements.

Productivity gains and protecting and enhancing land and water resources are not mutually exclusive. Substantial positive benefits are possible through increased investments in agricultural extension and irrigation, although adequate and effective systems need to also be in place to manage these investments. Investments that improve access to critical technologies such as irrigation and providing farmers with more information through extension will likely add value to natural capital assets. Well-maintained land is productive year after year; degraded land is not. Managing water resources to reduce wastage and pollution makes better-quality water available to more people. The cost-benefit analysis undertaken to prepare government's 2017 Forest Landscape Restoration Strategy shows

that smallholders who adopt restoration activities would likely be better off in the long run than those who did not (MoNREM 2017). Continuing with a 'business as usual approach' to land and water management will draw down on land, forest, and water resources to such a degree that valuable ecosystem services will be lost. Immediate gains are possible by revising existing watershed management guidelines to prioritize an ecosystem services-based approach to land restoration activities, focusing on increasing soil retention, water flow regulation, and carbon sequestration (World Bank, 2022a). Without these, opportunities to utilize Malawi's valuable natural capital endowments to build a more diverse and profitable economy will disappear.

Nevertheless, there are trade-offs between policies and investments that focus solely on increasing productivity, improving environmental husbandry, and arresting the degradation of natural capital assets. Returning degraded land and water resources to health takes time, money, and skills. In the short term, there is often the challenge that investments focused on addressing degradation have lower returns than alternatives that provide short-term gains from agriculture or forestry.

There are well-known and practical technical approaches to watershed rehabilitation, although they require significant investment. A recent study on watershed restoration options in southern Malawi looked at known restoration technologies selected following consultation with local smallholders, government officials, and potential investors (World Bank, 2023f). These options were: agroforestry systems combined with climate smart agriculture practices (i.e. diversified cropping combined with soil and water management techniques suited to both the local agro-ecological context and projected changes in climate and weather patterns); river and streambank restoration; and buffer zone management. The study calculated that it would cost around US$1,000 / ha. to completely restore just 500,000 hectares of degraded land in the lower Shire River basin. While it is not necessary to restore one million hectares in one intervention, benefits are likely to be limited in smaller intervention that are scattered over a large area. Watershed rehabilitation is most effective when contiguous areas are treated, with a focus on working through neighboring micro-watersheds that together form a substantive part of a larger major watershed.

Despite the substantive costs, rehabilitation investments provide viable financial and environmental returns. The same study included a financial cost-benefit analysis conducted from a private perspective (investor or smallholder) and an economic analysis from a public perspective. These make a solid case for investing in watershed rehabilitation. For example, the results show that afforestation (especially in buffer zones) and agroforestry with climate smart agriculture (CSA) are economically and financially attractive from the public, private, and smallholder perspectives. Including potential carbon market returns makes the financial picture even more attractive for public and larger private sector investors. In addition, the economic benefit for society in terms of biodiversity conservation, reduced erosion and siltation, and clean water supply for downstream users is highly significant. The study illustrates a clear positive economic case for a substantive investment in watershed rehabilitation in Malawi. This study is not alone in identifying strong returns to investments of this nature. As discussed earlier, the potential return on investing in watershed rehabilitation is over 400 percent over 30 years. Box 2.3, above, highlights other research on how the benefits of increasing investments in agricultural extension outweigh costs and provide a practical route to rehabilitating watersheds. The basic financial case is strong, but including ecosystem service values and potential carbon revenues makes the case even stronger.

Financing mechanisms that support investments in watershed rehabilitation need to be refined and extended. Limited public finance is a major constraint on watershed restoration activities, so it is vital to encourage private sector investment to supplement this. Private sector engagement holds strong potential for increased investment in forest restoration, crop diversification, CSA measures, afforestation, and value chain development. Payments for environmental services (such as clean water and flood protection) and carbon farming (where there is the potential to earn between US$24.8 million and US$74.3 million per year (World Bank, 2022a)) offer additional funding opportunities, but developing these mechanisms requires further support, despite existing pilot examples. Existing funding

sources, such as the Affordable Inputs Program (AIP), the Forest Management and Development Fund (FMDF), the Climate Fund, and the National Parks and Wildlife Fund, could be upgraded, redirected, or used more efficiently. For example, the AIP, which already provides direct subsidies to smallholders, could be redirected to provide tapered support to compensate for any yield losses in the initial seasons of converting to more sustainable cultivation practices. The FMDF could easily increase its revenues by simply reflecting current market prices to set the prices it charges for forest products, penalties, and licensing charges. Currently, fuelwood from government plantations is sold for 700 MWK/m^3 (equivalent to US$0.6), whereas the recent market prices have rarely fallen below 20,000 MWK/m^3 (2,850 percent higher).

Business models must be developed further to incentivize and support public and private investments in watershed rehabilitation. In practice, watershed investments will be a blend of public and private investments. On their own, no single set of stakeholders will provide sufficient finance and focus. Public sector investment is essential for capacity building and extension services, particularly since the private sector cannot cover all smallholder farmers. Public sector investment is most suitable in agroforestry and CSA with smallholders and buffer zone management with afforestation. Public investments are crucial for natural forest management in protected areas and riverbank restoration, as these activities rarely provide direct financial benefits even though they deliver significant economic benefits to society. Public investment is also necessary to establish carbon projects for natural forest restoration, provide capacity building, establish monitoring and verification systems, and increase policymakers' awareness of the benefits of carbon sequestration (World Bank 2022a). Agroforestry restoration offers financial benefits for smallholders and the private sector through improved crop and timber production while reducing erosion, capturing carbon, and stimulating local development. There is also potential for carbon farming projects involving smallholders utilizing agroforestry and CSA techniques. However, models suited to Malawi for pooling carbon sequestration from numerous small plots and sharing the revenues equitably will need to be developed.

Existing funds can be redirected to watershed rehabilitation, but they will need augmenting with private sector investments to be effective. Private sector engagement holds strong potential for increased investment in forest restoration and afforestation (particularly for plantation crops), crop diversification, CSA measures, and value chain development. Payments for environmental services and carbon farming offer additional funding opportunities and there are a handful of existing pilot examples. Developing these mechanisms requires further support, particularly in ensuring that policies and regulations assist investment rather than hinder it. In addition, given the scale of the challenge, existing funds can only meet some of the financing requirements and require additional funding to enhance their effectiveness—a key reason to attract private sector investors rather than simply looking to donor funding to fill the gap.

Revolving community funds can effectively promote conservation, restoration, and sustainable resource management when connected to larger funds with strict environmental criteria. For example, the Community Environmental Conservation Fund (CECF) was established under an earlier World Bank-supported program to encourage community engagement in landscape restoration in the Shire River basin and now continues under another World Bank-supported initiative, the Malawi Watershed Services Improvement Project. The CECF provided financial support to communities that collectively committed to implementing environmental management plans at the community level. Micro-credits were extended to community members adopting these practices, with no usage restrictions, but access to the fund hinged on achieving specific conservation-targeted results. These funds aimed to establish a self-sustaining resource pool managed by the community, accessible to all members even after the project's conclusion. Some communities have seen growth in the small CECF funds, increasing from the initial grant of MWK1.1 million to between MWK1.5 million and MWK2.8 million, as borrowers repaid small loans with interest. Although the buying power of these funds has now been eroded by Malawi's high level of inflation, they illustrate the principle that even small resources can provide a significant incentive for voluntary community action.

Results-based financing may be suitable to finance watershed rehabilitation in Malawi. This is an innovative financing approach where, instead of providing finance for inputs, payment is linked to achieving specific targets, with achievements verified by an independent third party. The focus on achieving results rather than procuring inputs can both support and encourage the cross-sectoral coordination required for effective watershed rehabilitation. In Ethiopia, the World Bank is using this approach successfully to support the Ministry of Agriculture in rehabilitating over 2.5 million hectares of severely degraded land in the highlands (World Bank 2023b).

Recommendations

The following recommendations are all reasonably straightforward to implement, as the necessary policies and strategies are in place. The challenge is to shift focus and priorities to ensure these existing policies and strategies are translated into practice.

Land:

i) **Redirect existing agricultural practices** to increase productivity by protecting and conserving land rather than degrading it. This can be a quick win, as it is already happening in some locations, encouraged by government priorities and through programs including the roll-out of climate smart public works to transition out of AIP. This can be supported and encouraged by revising existing watershed management guidelines to prioritize an ecosystem services-based approach to land restoration activities.

ii) **Strengthen land tenure rights to incentivize sustainable land husbandry.** Ensuring security of tenure will provide smallholders with the security to invest in their land for longer-term returns.

iii) **Explore the potential to use results-based payments for watershed rehabilitation.** This financing method may be suited to support rehabilitation activities that are, by necessity, cross-sectoral. It could support community-based initiatives, such as the successful Community Environment Conservation Funds, to incentivize rehabilitation activities directly. It could also be linked to payments to government agencies for achieving specific targets that support watershed rehabilitation.

Forests:

i) **Align forestry and energy policies.** Energy policies must explicitly support forestry policies aimed at managing the charcoal trade in ways that do not lead to widespread deforestation. These aspirations are already embedded in policies, but coordination and implementation are less clear.

ii) **Use limited public financing to leverage additional private-sector investment in forest management and restoration.** The private sector is critical to providing additional finance for rehabilitation. Effective financing mechanisms need to be in place to attract private-sector investors.

iii) **Ensure prices charged by the Forest Management and Development Fund reflect current market prices.** This will significantly increase revenues available for forest rehabilitation.

iv) **Scale up forest co-management** to balance responsibility and authority between communities and government.

v) **Promote agroforestry and tree-based systems** to reduce pressure on Malawi's natural forests. The potential financial and economic returns to this activity are excellent and should be prioritized.

Water:

i) **Ensure that institutional mandates in the water sector are implemented** and enforced to realize the benefits of existing policy reforms (such as Malawi Water Resources Act, 2013). Overlapping functions across the various regulatory and institutional structures responsible for water and sanitation leads to weak policy implementation.

ii) **Strengthen systems and capacities for licensing, allocating, and monitoring water use.** A lack of detailed procedures and protocols, combined with the weak capacity of key staff, results in ineffective water management.

TABLE 2.2 Key Recommendations

Priority recommendations	Opportunities and Challenges	Lead agencies
Land degradation		
1. **Redirect existing agricultural practices** to increase productivity by protecting and conserving land, rather than degrading it. • Reform AIP from an input subsidy program focused only on inputs (fertilizer and mainly maize seed) to a sustainable land stewardship program that promotes agroforestry, forest restoration and sustainable land management practices. • Revise existing watershed management guidelines to prioritize an ecosystem services-based approach to land restoration activities.	• Redirecting existing agricultural practices can be a quick win, as this is already happening in some locations, encouraged by government priorities. • There are inadequate incentives for cross-sectoral coordination by government agencies around watershed management. • At present, the high cost of the Affordable Inputs Programme (AIP) crowds out finance available to the Ministry of Agriculture and hence limits opportunities to support watershed regeneration efforts. • Some rehabilitation practices have longer payback periods, which discourages poor households from adopting them.	**MoAIWD, MoNRCC**
2. **Broaden land tenure rights** to incentivize sustainable land husbandry.	• Tenure security assist the take a longer-term view of restoration benefits. • Ensuring security of tenure will provide smallholders with the security to invest in their land for longer-term returns.	
3. **Explore the potential for results-based payments** to directly incentivize cross-sectoral rehabilitation activities. • Build on positive experiences with the 'Community Environment Conservation Fund' in the Shire basin. • Include payments to government agencies, at national and district level, to support rehabilitation	• Requires effective monitoring and reporting for verification that allows payments to be disbursed.	
Forest and woodlands		
1. **Harmonize forestry and energy policies** to invest in Malawi's energy transition and take pressure off forest resources.	• Energy and Forestry policies are not currently aligned effectively, so, neither are effectively reducing pressures on forests as a source of energy. • Energy transition is complex and requires large investments.	**MoNRCC, MoEA, DoF**
2. **Use limited public financing to leverage additional private sector investment in forest management and restoration.** • Provide clear guidelines on land access and opportunities for forest certification. • Developing institutional and licensing frameworks for legal and sustainable charcoal value chains. • Establish financial framework for forest carbon management.	• Forest and Woodland restoration is an urgent but massive task, with formidable financial and implementation requirements.	
3. **Ensure prices charged by the Forest Management and Development Fund reflect current market prices.**	• Currently FMDF revenues are based on outdated prices for forest products. Using current market prices will significantly increase FMDF revenues available for forest rehabilitation.	
4. **Scale up forest co-management approach to balance responsibility and authority between communities and government.**	• SME's have potential roles in both plantation forestry and value addition to forest products but face regulatory hurdles and barriers to new revenue streams such as payments for ecosystem services.	
5. **Promote agroforestry and tree-based systems to reduce pressure on Malawi's natural forests.**	• Tree planting projects are sometimes unsuccessful as the returns do not justify the land or other resources that farmers must invest. Careful selection of tree species and markets is required. • Lack of data on land cover and the production and use of forest products, limits understanding of the country's forest resources and their contribution to the economy.	
Water resources		
1. **Ensure that institutional mandates in the water sector are implemented and enforced to realize the benefits of existing reforms.**	• Overlapping functions across the various regulatory and institutional structures responsible for water and sanitation leads to weak policy implementation.	**MoWS**
2. **Strengthen systems and capacities for licensing, allocation and monitoring of water use.**	• A lack of detailed procedures and protocols, combined with weak capacity of key staff, results in ineffective water management.	**MoWS and NWRA**

APPENDIX A

Macroeconomic Indicators

	2019	2020	2021	2022e	2023p	2024p
National Accounts and Prices						
GDP at constant market prices (% change)	5.4	0.8	2.8	0.9	1.6	2.8
Agriculture	5.9	3.4	5.2	-1.0	0.6	2.4
Industry	7.7	1.2	1.9	0.9	1.6	2.7
Services	5.5	-0.5	2.0	1.8	2.1	3.0
Consumer prices (annual average)	9.4	8.6	9.3	21.8	28.4	22.1
Central Government (FY % of GDP)						
Revenue and grants	14.6	14.6	14.7	14.0	15.2	17.6
Domestic revenue (tax and non-tax)	13.2	13.1	12.8	12.9	12.1	13.9
Grants	1.4	1.5	1.9	1.1	3.1	3.7
Expenditure and net lending	19.1	20.9	21.5	22.3	25.7	25.0
Overall balance (excluding grants)	-5.9	-7.8	-8.7	-9.4	-13.5	-11.1
Overall balance (including grants)	-4.5	-6.3	-6.8	-8.3	-10.4	-7.4
Foreign financing	0.8	0.8	1.0	2.7	1.9	1.1
Domestic financing	3.8	4.9	5.9	7.7	5.1	6.3
Money and Credit						
Money and quasi-money (% change)	10.2	16.7	30.0	38.8	30.5	29.3
Credit to the private sector (% change)	27.3	16.1	17.8	23.2	19.6	11.2
External Sector (US$ millions)						
Exports (goods and services)	1,446.7	1,308.3	1,587.3	1.486-8	1,559.6	—
Imports (goods and services)	3,265.7	3,373.3	3,767.9	3,706.0	3,944.2	—
Gross official reserves	815	565	79	120	201	714
(months of imports)	3.9	2.7	0.3	0.5	0.8	2.9
Current account (percent of GDP)	-11.9	-13.6	-15.2	-16.9	-15.9	—
Exchange rate (MWK per US$ average)	745.9	749.5	805.9	949.0	—	—
Debt Stock						
External debt (public sector, % of GDP)	27.8	32.9	31.5	34.8	39.3	35.2
Domestic public debt (percentage of GDP)	17.5	21.9	30.0	40.8	42.0	39.8
Total public debt (percentage of GDP)	5.3	54.8	61.5	75.7	81.3	75.0
Poverty						
Poverty rate (US$ 2.15 in 2017 PPP terms)	70.1	70.7	70.6	71.3	71.7	71.5
Poverty rate (US$ 3.65 in 2017 PPP terms)	89.1	89.4	89.4	89.5	89.7	89.6
Poverty rate (US$ 6.85 in 2017 PPP terms)	97.3	97.4	97.4	97.5	97.5	97.5

Sources: World Bank staff calculations based on MFMod, MoFEA, RBM, NSO, and IMF data.

Note: Forecast from October 2023 "Macro-Poverty Outlook" and does not incorporate data and events after September 2023.
e indicates estimates and p indicates projections.

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