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ECONOMIC DEVELOPMENT DOCUMENT

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INTERNATIONAL DEVELOPMENT ASSOCIATION

ECONOMIC DEVELOPMENT DOCUMENT FOR THE REPUBLIC OF MALAWI

ASSESSMENT LETTER FOR THE IMF

Approved by Bella Bird (Country Director)
May 29, 2017

I. COUNTRY CONTEXT

1. **Malawi is a small open economy in Sub-Saharan Africa with a per capita GNI of just US$320 in 2016, one of the lowest in the world.** Per capita income has grown at an average of little more than 1.5 percent between 1995 and 2014, below the average of 2.8 percent for non-resource-rich African economies. Malawi remains an outlier even compared to its peers that are geographically and demographically similar and were at a similar stage of development in 1995.

2. **While not strictly a fragile state, Malawi displays many of the characteristics of fragile and conflict affected countries, particularly in terms of the way that its governance institutions function.** The economy is dominated by the agricultural sector, which accounts for about a third of GDP, and drives livelihoods for two thirds of the population.

3. **Over past decades, the country's development progress has been negatively affected by shocks leaving the country in a cycle of vulnerability.** Both climate-related external shocks, and domestic political and governance shocks, have collectively contributed to economic stagnation and a low pace of poverty reduction.

II. POVERTY AND VULNERABILITY

4. **In the last ten years, Malawi has seen some progress in non-monetary indicators of human development, however there have been persistent challenges with respect to progress in reducing poverty in monetary terms**. As a result of the progress accomplished in some health and education aspects, and due to large flows of ODA, Malawi partially or fully achieved 4 of 8 of the Millennium Development Goals (MDGs), the set of 2015 targets to address poverty in its many dimensions.

5. **Gains in access to primary education have been steady and positive.** Between 2004 and 2013, primary school completion rates rose by 17 percentage points to reach 75 percent. The proportion of households with school-aged children attending school also has increased steadily since 2004, reaching 63 percent in 2013.

6. **In addition, child malnutrition has trended downwards, as has under-five mortality.** According to the Malawi Demographic Health Surveys (DHS) between 2004 and 2015, the prevalence of stunting among children under five (a measure of long-term nutritional deprivation in children) fell from 53 percent to 37 percent. Data from the DHS also reveals that the under-five mortality rate declined from 133 deaths per 1,000 live births in 2004 to 64 deaths per 1,000 live births in 2015. A downward trend also was observed in the prevalence, incidence, and deaths associated with HIV/AIDS, malaria, and tuberculosis, particularly since 2000.

7. **Notwithstanding the improvements in non-income dimensions of poverty, monetary poverty in Malawi remains pervasive and largely stagnant, especially in rural areas.** In 2010, using a basic needs basket that cost 37,000 kwachas per person per year, 50 percent of the population were classified as poor. Approximately 25 percent lived in extreme poverty, defined as the inability to satisfy food needs. Between 2004 and 2010, poverty in rural areas (where most Malawians live) increased slightly from 56 percent to 57 percent. Extreme poverty increased at a greater rate from 24 percent to 28 percent. The average consumption of the poor moved farther below the poverty line as well. Using the international poverty line of US$1.90 per person per day (at 2011 international prices), Malawi's poverty rate in 2010 remained high––71 percent—a small increase from 64 percent in 1997.

8. **More recently, poverty likely has increased further, given the large-scale floods of 2015 and the major drought of 2016, which also had a major impact on growth**. No comparable living standards measurement survey has been completed since the Third Integrated Household Survey (IHS3) of 2010/11 (the 2016/17 Fourth Integrated Household Survey is currently in the field), but other sources of data allow for projections of poverty. A World Bank macro-poverty forecast exercise has projected that poverty in Malawi measured by the population living below the international poverty line has not changed between 2010 and 2016 (70.9 percent in 2010 to 69.6 percent in 2016). However, considering that a significant number of the non-poor in rural areas are highly vulnerable to weather shocks, the poverty rate is—if anything—expected to increase due to the impact of recent floods and drought.

9. fallen only marginally from 70.9 percent in 2010 to 69.6 percent in 2016. Using a panel survey to the IHS3, when only household characteristics (number of members, location, and sociodemographic profile) were used to predict the likelihood of falling into poverty, 22 percent of households were expected to become poor in 2013. This proportion almost doubled to 42 percent when expected shocks, particularly rainfall shocks, also were considered.

10. **Food insecurity in Malawi remains widespread, especially among the rural poor.** In 2013, a large 81 percent of poor rural households consumed fewer than 2,100 kilocalories per capita per day (kcal/person/day), considered the benchmark a person needs to lead a healthy life. Not surprisingly, in 2013, 65 percent of all households (and 84 percent of rural households) reported experiencing food insecurity for at least 1 month per year—a 15 percentage point increase since 2010.

III. MALAWI'S DEVELOPMENT PLAN

11. **The Malawi Growth and Development Strategy (MGDS) is the country's overarching medium term development tool** designed to lead the country towards attainment of the MDGs and the nation's long term aspirations as spelt out in its Vision 2020. The first MGDS (MGDS I) was in operation from 2006-2011. It built on consolidated lessons from the Malawi Economic Growth Strategy of 2004 and drew its focus areas from the country's first medium-term development strategy, the Malawi Poverty Reduction Strategy that was in operation from 2002-2005. The second MGDS (MGDS II) aimed to guide Malawi's development and growth path during 2012– 2016.

12. **Both the MGDS I and II shared the same objective of reducing poverty through sustainable economic growth and infrastructure development.** However, the key priority areas of the MGDS have been changed over the years to reflect lessons learnt from previous development strategies. Weaknesses in the planning and implementation of MGDS I, necessitated rethinking of its successor, MGDS II, to give emphasis to the need to diversify the economy, improve governance and promote human capital development.

13. **Implementation of MGDS II saw major challenges, with very limited progress towards the attainment of the strategy's targets and goals.** Major governance shocks, including a policy-induced recession in 2012 accompanied by fuel and foreign exchange shortages, followed by the "cashgate" corruption scandal of 2013 where a large amount of resources were stolen from government accounts, not only undermined growth but also dented Malawi's international reputation. Since 2013, Malawi has struggled to restore macroeconomic stability, as fiscal imbalances and weaknesses in public finance management, compounded by a shift of a significant share of donor aid to off-budget mechanisms, have resulted in a vicious cycle of rising debt, high inflation, high interest rates and poor business confidence.

14. **Malawi's Economic Development Document presents an interim picture of the country's medium-term development plan, as the successor strategy—likely to be called MGDS III—is prepared.** Disappointing results with respect to implementation of MGDS II have triggered a qualified rethink in Malawi's development planning process. There is a growing recognition that Malawi needs a more realistic development plan, in terms of both the underlying assumptions and resource availability, as well as with fewer priorities and a greater emphasis on implementation. Climate change has also become a major new factor in this process. The recent formation of a quasi-independent National Development and Planning Commission will also help to improve the independence of the planning process in Malawi.

IV. KEY POLICY PRIORITIES FOR POVERTY REDUCTION

15. **As articulated in the Economic Development Document, the overarching policy objective of the Government of Malawi is to improve national economic development and reduce poverty among the Malawian population**. Five priority areas have been identified through a consultative process, including: agriculture and climate change management; education and skills development; energy and industrial development; transport and ICT infrastructure development; and health and population management. These priorities correspond well to Malawi's underlying development challenges of reducing poverty and various forms of inequality, boosting agricultural performance, and achieving structural transformation coupled with demographic transition—while necessitating an additional focus on macroeconomic stability. The following paragraphs set out a summary assessment of the key associated challenges as Malawi seeks to achieve sustainable reductions in the level of poverty.

16. **Achieving robust agricultural growth**. Agriculture constitutes the backbone of the Malawian economy and agricultural performance has more significant implications for economic growth and poverty reduction, especially in rural areas, than any other sector. However, agricultural sector growth has been volatile and frequently surpassed by population growth. To date, agricultural growth has been achieved through factor accumulation—primarily through inputs such as land cultivated and labor. However, given one of the highest population densities in Africa and shrinking farm sizes, the gains from continuing such practices are approaching their limit. In addition, most farmers in Malawi rely on rain-fed agriculture, which is highly risk prone, particularly to price and weather shocks, and suffers from low productivity. And many of Malawi's agricultural institutions and past policy choices have served to exacerbate price volatility and undermine incentives for investment in commercial agriculture. ***Boosting agricultural productivity will require the reallocation of resources to provide more comprehensive and targeted support to the rural poor, including efforts through introducing climate-smart agriculture, investing in irrigation and water management, and transitioning subsistence agriculture to more diversified, commercial agriculture.***

17. **Managing rising climate risks**. The impact of flooding and drought in Malawi has intensified over recent years and is likely to worsen with climate change. In the past four decades, droughts have become more frequent, widespread, and intense. As a result of the most recent drought in 2015/16, around 40 percent of the population experienced food insecurity. This calls for further interventions to ***increase resilience to***

climate related shocks focused on modernizing institutions and policies, expanding social safety nets and investing in resilient infrastructure**.**

18. **Facilitating structural transformation**. Although urbanization has been an important catalyst for growth and poverty reduction in many countries in sub-Saharan Africa, Malawi has seen a very slow pace of urbanization in recent years. Within rural areas, the labor force has started to move from the agricultural sector to the non-farm sector, contributing to poverty reduction. But, the opportunities for the non-farm sector are volatile and the life-span of the non-farm businesses is very short. Furthermore, the business environment for the non-farm sector is challenging in that access to finance, access to markets, and access to electricity are all highly restricted in rural areas and the human capital of the rural labor force remains low. ***Stimulating growth in the non-farm sector will require investment in education and skills, complementary investments in critical infrastructure (such as power, connectivity and access to finance) and smarter policies to facilitate faster, but sustainable, urbanization.***

19. **Strengthening macroeconomic stability and the improving the allocation of scarce public resources**. Macroeconomic instability, driven mostly by fiscal slippages and governance failures, has been a persistent challenge for Malawi, undermining growth and investment. High inflation hits the poor disproportionately by reducing their purchasing power and ability to maintain food security. It also contributes to high costs of finance and exchange rate instability, making it harder for businesses to invest and create jobs. Furthermore, to bring fiscal deficits and debt under control the government has frequently needed to undertake measures to reduce public spending and increase revenue collections, which can have adverse impacts on the poor. Making this challenge worse, is the fact that evidence increasingly points to very little impact on growth or poverty from Malawi's major public expenditure programs such as the FISP (Farm Input Subsidy Program). ***Stronger macroeconomic and fiscal management is a necessary pre-requisite for sustainable growth, job creation and poverty reduction in Malawi. Improving the effectiveness of key public expenditure programs will also be necessary to maximize the impact on the poor of the country's finite resource envelope.***

20. **Addressing social inequality, especially gender inequality**. Female headed households face unfavorable conditions in both agricultural production and the non-farm sector businesses compared with male headed households. In the agricultural sector, women tend to have smaller land lots, deploy fewer inputs, benefit from less extension and investment, resulting in significantly lower productivity (by 28 percent on average) compared to their male counterparts. Also, in the nonfarm sector, they tend to have less access to finance, capital and new technology. ***Closing the gender gap will improve agricultural productivity and growth opportunities, and investing in girls' education is a pathway to both higher long-term growth and a lower fertility rate.***

21. **Addressing population growth**. Malawi's fertility rate has remained persistently high and the country's population is expected to double in approximately two decades. For a country that is already one of the most densely populated in Africa, existing levels of population growth will put enormous pressure on limited land resources, service delivery, and make poverty reduction that much harder. Furthermore, the high fertility rate lowers productivity because it impairs women's ability to engage in more productive farming or nonfarm work. ***Addressing rapid population growth and building productive human capacity requires increased investments in the education and skills of the youth so that Malawi can benefit from a demographic dividend.***

V. CONCLUSIONS

22. **Exogenous climate induced shocks have become a major source of volatility in Malawi, exacerbating macroeconomic instability, and making it harder for the country to "break the cycle"**

of vulnerability. Extensive reliance on basic farming methods and reliance on rain-fed agriculture, together with a growing population, has made food security a recurrent challenge as well as adding to pressures on land use, soil fertility and forest resources. In recent years Malawi has suffered from weather shocks at an increasing frequency. Weak public financial management has tended to transmit recurring shocks into fiscal indiscipline, in turn exacerbating macroeconomic instability. Malawi is thus confronted with twin pressures arising from vulnerability to climate shocks and weak fiscal management, both of which contribute to macroeconomic instability.

23. **However, the recent food security crisis has added urgency to difficult and politically challenging reforms** that the Government of Malawi is undertaking to reduce distortions in, and improve the performance of, the agricultural sector; and to rebuild basic public financial management and accountability systems. These measures represent a first, but critical, step towards the building of a more resilient economy. Coupled with an anticipated scale-up of development finance, including under IDA 18, there is a potential pathway open to Malawi as the country attempts to begin making meaningful progress to address the severe and chronic poverty that has characterized the country for the last two decades.

24. **The Economic Development Document presents an appropriate outline of the challenges that Malawi faces with respect to achieving sustainable economic growth and poverty reduction**. The document rightly acknowledges the challenges of past inconsistency of economic policies, the impact of both domestic (governance related) and external (climate related) shocks, and the need to carefully prioritize finite resources towards a more limited set of priority areas.

25. **Yet, as with past plans, the central challenge that Malawi faces is with respect to the actual implementation of stated policy objectives**. This calls for an emphasis on the functional strengthening of the country's public sector institutions so that Malawi is really able to "break the cycle" of vulnerability, better absorb the impact of future shocks and maximize the impact of available domestic and foreign resources. Moreover, while meaningful steps have been taken to reduce the risk of a "cashgate" type event from reoccurring, gaps in oversight do remain—particularly with regard to public procurement—that will require continued efforts to strengthen governance and accountability frameworks.

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FOREWORD

Malawi faces various economic challenges including: low productivity; narrow and raw export base with high reliance on few commodities; lack of alternative energy sources; and poor transport network and ICT facilities. This, in addition to natural disasters that hit the country in 2015 and 2016, affected implementation of the Malawi Growth Development Strategy (MGDS) II- the medium-term development strategy guiding development policies from 2012 to 2016. This affected the achievement of the goals proposed in the strategy document. A review of MGDS revealed that most of the targets that were achieved were linked to Millennium Development Goals. The review identified 9 gaps that need to be addressed in successor development strategies.

In order to address these gaps, there is need to identify game changers which will accelerate the pace of economic growth and development. This will call for a properly sequenced development plan that addresses the most binding constraints first. The Economic Development Document (EDD), whose goal is to highlight the development areas that Malawi will emphasise over the planning period in order to promote economic performance and attain the GDP growth rates of over 7.2 percent, is a reflection of the intervention areas for the national development strategy in the next five years.

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