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A Narrow Path **to Prosperity**

MALAWI
COUNTRY ECONOMIC MEMORANDUM

WORLD BANK GROUP

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8 KEY FINDINGS FROM THE COUNTRY ECONOMIC MEMORANDUM

1 **Over the past 30 years, Malawi's per capita gross domestic product (GDP) has increased by over 50 percent, a growth trajectory comparable to that of other countries in the region but insufficient to significantly raise living standards and close the gap to its neighbors.** Some peer countries have managed to triple their per capita GDP over this time resulting in dramatically reduced poverty rates. Analysis using the World Bank's "Long-Term Growth Model" shows that there is no single solution to reaching the *Malawi 2063* growth targets. Rather, reaching upper middle-income status in the next 40 years will require simultaneously increasing the effectiveness and efficiency of public investment, catalyzing private investment and enhancing economy-wide efficiency.

2 **Malawi's disappointing economic growth outcomes can be attributed to policy choices that have worsened an already unfavorable external environment and resulted in significant fiscal and external imbalances.** Weak fiscal planning and implementation make budgets an ineffective guide to resource allocation. Unsustainable debt, driven by high fiscal deficits, is a drain on economic growth. Inadequate management of external balances promotes costly balance-of-payments crises. Each of these is determined by policy choices. Macroeconomic policy reforms, including those currently under implementation, hold the key for Malawi to move from a vicious cycle to a virtuous one.

3 **Government policies over many decades have aimed to promote food self-sufficiency rather than commercial farming, leaving most Malawians in an underperforming agricultural sector.** Farming for themselves provides only a third of the typical rural household's income. Even farming much more productively, in current systems, presents no route out of poverty for the majority. Untapped potential for further growth and job creation in agriculture primarily comes from scaling up agricultural commercialization. With the right policies commercial farmers create increased local demand, stimulating rural off-farm labor markets. Transforming the rural economy also requires a more market-driven approach and more efficient and targeted support.

4 **Malawi was among the countries hardest hit by the COVID-19 pandemic.** Eighty-five percent of firms lost sales, the fifth-highest incidence among 48 countries in the Business Pulse Survey. However, it was the series of shocks since 2020 that have been particularly damaging, as sales have continued to decline through 2022. Two-thirds of businesses surveyed in 2022 believe that increased non-labor input costs (such as for energy and fuel) negatively affected their profits, while foreign exchange unavailability undermined profitability for more than three-quarters of firms.

5 **Market distortions and a lack of firms' competitiveness result in low dynamism and unrealized productivity gains.** Low overall productivity levels and large gaps between productive and unproductive firms suggest that many firms are not using their resources efficiently to compete and grow. Firms face significant barriers, including in accessing finance, information, and international markets. The private sector would also benefit from better access to electricity, lower levels of corruption, and a more stable policy environment. This would in turn bolster growth.

6 **For exports to drive growth, Malawi needs to depart from a pattern where chronic trade imbalances and restrictive trade policies reinforce each other.** Significant policy barriers and foreign exchange rationing not only reduce access to inputs but also act as a tax on exports, creating disincentives for firms to trade. These distortions hinder diversification into non-traditional exports with higher value added. They also drive informal trade and smuggling. This is further exacerbated by imports (and scarce forex) primarily being directed toward consumption goods rather than intermediate goods necessary for participation in global and regional value chains.

7 **Malawi has high potential to significantly increase non-traditional agricultural exports and mining.** The soybean, macadamia and groundnut value chains have developed industrial-scale production and processing capacities capable of servicing regional and global markets. Recent discoveries of energy transition minerals present transformative opportunities for increased exports, and in turn foreign exchange generation, fiscal revenues, and growth if these are managed responsibly. Benefiting from this significant economic potential requires sustained implementation of policies geared toward export-led growth, rather than creating additional barriers to trade and investment.

8 **Unlocking economic growth in Malawi requires the alignment of political incentives with development goals.** Eleven case studies of recent Malawian successes highlight growing non-traditional agricultural value chains, well-executed public sector reforms, and Government strategies that were effectively implemented. These successes required institutional changes through empowered and committed leadership, effective management, the aligning of financial incentives with performance, and fostering strategic public-private dialogue. A feedback loop between more conducive sectoral governance and macroeconomic reform can bring Malawi closer to the growth ambitions stated in the *Malawi 2063*.

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Acknowledgements

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The full list of background papers can be found in Appendix A.

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The World Bank team welcomes feedback on the Country Economic Memorandum. Please send comments to Jakob Engel (jengel@worldbank.org).

Abbreviations

ADMARC	Agricultural Development and Marketing Corporation
AfCFTA	African Continental Free Trade Area
AgDiv	Feed the Future Malawi Ag Diversification Activity
AIDS	Acquired Immunodeficiency Syndrome
AIP	Affordable Inputs Program
BEC	Broad Economic Categories (product nomenclature)
BMGF	Bill and Melinda Gates Foundation
BoP	Balance of Payments
BPS	Business Pulse Survey
CAGR	Compound Annual Growth Rate
CC	City Council
CCDR	Country Climate and Development Report
CD1	Currency Declaration Form
CEM	Country Economic Memorandum
CEO	Chief Executive Officer
CET	Common External Tariff
CFTA	Competition and Fair Trading Act
CFTC	Competition and Fair Trading Commission
CHAI	Clinton Health Access Initiative
CI	Confidence Interval
COGA	Control of Goods Act
COMESA	Common Market for Eastern and Southern Africa
COVID-19	Coronavirus Disease 2019
DARS	Ministry of Agriculture Department for Agricultural Services
DRG	Department of the Registrar General
DSA	Debt Sustainability Analysis
EGPAF	Elizabeth Glaser Pediatric AIDS Foundation
EITI	Extractives Industry Transparency Initiative
EIU	The Economist Intelligence Unit
EnDev	Energizing Development Program
ESCOM	Electricity Supply Corporation of Malawi
EU	European Union
FAO	Food and Agriculture Organization
FDI	Foreign Direct Investment
FISP	Farm Input Subsidy Program
FS	Funneling Survey
FY	Financial Year
GATS	General Agreement on Trade in Services
GDP	Gross Domestic Product
GESD	World Bank Malawi Governance to Enable Service Delivery Project
GVCs	Global Value Chains
ha	Hectares
HIPC	Highly Indebted Poor Country
HIV	Human Immunodeficiency Virus
HS	Harmonized System (multipurpose international product nomenclature)
ICT	Information and Communcation Technology
ID	Identification
IFMIS	Integrated Financial Management Information System
IFPRI	International Food Policy Research Institute
IFS	International Financial Statistics
IHS	Integrated Household Survey
ILO	International Labour Organization
ILOSTAT	International Labour Organization Department of Satistics
IMF	International Monetary Fund
LAPA	Local Authority Performance Assessment
LGFC	Local Government Finance Council
LTGM	Long-Term Growth Model
LWB	Lilongwe Water Board
LWSP	Lilongwe Water and Sanitation Project
MACRO	Malawi AIDS Counselling and Resource Organization
MDAs	Ministries, Departments, and Agencies
MERA	Malawi Energy Regulatory Authority
MFMod	Macro-Fiscal Model
MoA	Ministry of Agriculture
MoE	Ministry of Natural Resources, Energy, and Mining
MoFEA	Ministry of Finance and Economic Affairs
MoH	Ministry of Health
MoLG	Ministry of Local Government
MoTI	Ministry of Trade and Industry
MPO	Macro-Poverty Outlook
MRA	Malawi Revenue Authority
MSME	Micro, Small, and Medium-Sized Enterprises
MT	Metric Tons
MTDS	Medium-Term Debt Management Strategy
MWI	Malawi
MWK	Malawi Kwacha
NES II	National Export Strategy II
NES	National Export Strategy
NGOs	Non-Governmental Organizations
NOCMA	National Oil Company of Malawi
NPC	National Planning Commission
NSO	National Statistical Office
NTB	Non-Tariff Barrier

ODA	Official Development Assistance
OECD	Organization for Economic Co-operation and Development
PBG	Performance-Based Grant
PEPFAR	President's Emergency Plan for AIDS Relief
PFM	Public Financial Management
PO	Producer Organization
PPP	Purchasing Power Parity
PSIP	Public Sector Investment Program
PTA	Preferential Trade Agreement
Q4	Fourth Quarter of a Year
RBM	Reserve Bank of Malawi
REER	Real Effective Exchange Rate
RER	Real Exchange Rate
RFA	Road Fund Administration
RHS	Right-Hand Scale
RIAPA	Rural Investment and Policy Analysis (data and modelling system)
RISE	Regulatory Indicators for Sustainable Energy
ROA	Returns on Assets
ROE	Returns on Equity
SADC	Southern African Development Community
SCTP	Social Cash Transfer Program
SME	Small and Medium-Sized Enterprises
SOE	State-Owned Enterprise
SSA	Sub-Sahara Africa
STRI	Services Trade Restrictiveness Index
TEU	Twenty-Foot Container Equivalent Unit
TFP	Total Factor Productivity
ToT	Terms-of-trade
TRIST	Tariff Reform Impact Simulation Tool
UNDP	United Nations Development Program
UNESCAP	United Nations Economic and Social Commission for Asia and the Pacific
US	United States of America
US$	United States Dollar
USAID	United States Agency for International Development
WBES	World Bank Enterprise Survey
WBG	World Bank Group
WDI	World Development Indicators
WEF	World Economic Forum
WEO	World Economic Outlook
WGI	Worldwide Governance Indicators
WITS	World International Trade Solution
WTO	World Trade Organization

OVERVIEW

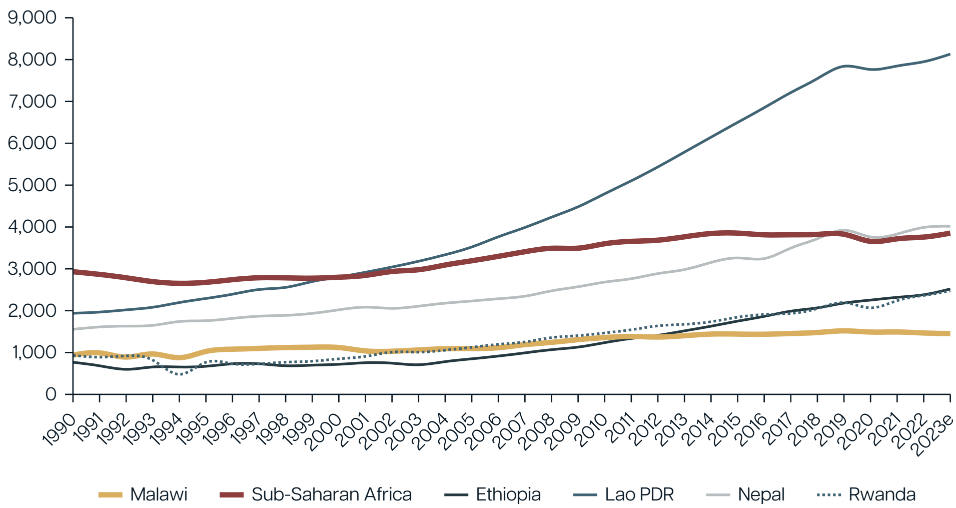
Malawi urgently needs a new development model to alter its current economic trajectory

As Malawi enters its seventh decade since independence, the country is at a critical juncture in its development journey. The "poly-crisis" facing the country between 2020 – 2023 has negatively affected lives and livelihoods. Per capita gross domestic product (GDP) growth has been negative during this period, resulting in an increase in poverty levels from an already high baseline. At the start of the 2023/24 lean season, more than one in five Malawians were estimated to be experiencing acute and severe food insecurity. A series of shocks worsened large fiscal and external imbalances, leading to the necessity of external debt restructuring, fiscal consolidation and sustained shortages of essential commodities, including pharmaceuticals, food, fertilizer, and fuel. The scarcity of foreign exchange in the official market has undermined businesses, fostered illicit trade and smuggling, suppressed imports, and led to the withdrawal of trade finance. While economic reforms are starting to take shape, they have yet to decisively propel the country onto a more rapid development trajectory.

Higher levels of sustained growth are urgently needed. Over the past 30 years, Malawi's per capita gross domestic product (GDP) has increased by over 50 percent, a growth trajectory comparable to that of other countries in the region (Figure O.1). However, some peer countries have managed to triple their per capita GDP over this time, leading to substantial reductions in poverty rates. Additionally, given its significantly lower baseline, this has meant Malawi has not been able to catch up to its more prosperous neighbors. In turn, growth has been insufficient to significantly raise living standards. There have been periods

Figure O.1 Malawi's economic trajectory lags that of top growth performers

Real GDP per capita in 2017 constant US$ purchasing power parity



Source: World Bank WDI (1990 – 2021) and staff calculations based on World Bank Macro-Poverty Outlook (2023).

in Malawi's post-independence history when annual per capita GDP growth exceeded 4 percent, most notably in the 15 years following independence (1964 – 1979) and during the boom following debt relief in the context of the Heavily Indebted Poor Countries (HIPC) initiative (2006 – 2011). Unfortunately, these periods were interrupted by stretches of very sluggish growth, resulting in modest overall economic gains and largely stagnant poverty rates.

Malawi has, however, made significant strides in many areas of human development. Since 1990, life expectancy has increased by more than 20 years, driven in part by significant progress in reducing infant and child mortality and successful efforts against communicable diseases. According to the Human Capital Index, Malawi is ranked between Iraq and Botswana, both upper middle-income countries. Malawi's Government recognizes the importance of economic growth as a catalyst of socio-economic progress and has set clear targets in its development vision, the *Malawi 2063*. These objectives include achieving lower middle-income status by 2030 and upper middle-income status by 2063. However, Malawi remains off track to reach these goals and has been unable to sustain an inclusive economic expansion sufficient to significantly reduce poverty and improve the wellbeing of the average Malawian citizen.

The Malawian Government has recently made several difficult decisions to address this crisis, acknowledging the need for tough but important reforms to stabilize and bolster the macroeconomic foundations for growth. This includes significant movement towards aligning official and parallel exchange rates and increasing the flexibility of the kwacha. Additionally, progress has been made in debt restructuring. Fiscal consolidation measures have been announced, including reforms to improve the efficiency and sustainability of the Affordable Inputs Programme, the country's fertilizer subsidy. Collectively, these steps indicate an acknowledgement of the need for difficult but important decisions to stabilize the macroeconomy and help create foundations for inclusive, sustained growth, and they are supported by Malawi's economic history. Previous growth episodes were characterized by temporary macroeconomic stability, fiscal solvency, and a relatively favorable business environment. However, the question remains: will this prove to be just another crisis or a genuine turning point in Malawi's economic journey?

Four core challenges: declining exports, low savings and investment, a slow shift of workers out of subsistence agriculture, and high climate vulnerability

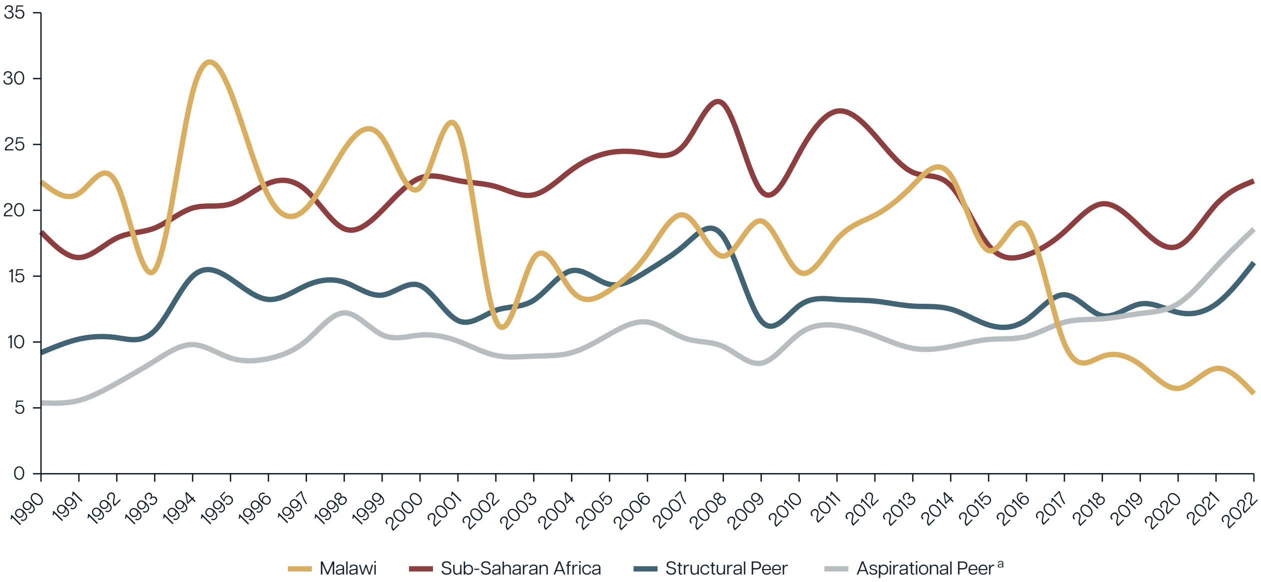
Malawi's export performance has weakened in recent decades from an already low base, in contrast to most other peers (Figure O.2). The integration into global and regional value chains has proven highly beneficial for countries in East and South Asia, as well as some high-growth African nations like Ethiopia and Rwanda. For countries with small domestic markets on a global scale, such as Malawi, leveraging trade makes sense. Driven by strong commodity exports, Malawian exports (as a share of GDP) during the 1990s were ahead of regional averages and those of structural and aspirational peers.[1] This trend has

1. Peer countries were selected for facing similar structural economic challenges to Malawi, including a geography that makes trade inherently costly, an economy dominated by agriculture, high vulnerability to shocks and similar policy challenges, such as fiscal, monetary, and external imbalances. We selected nine countries grouped into "structural peers" and "aspirational peers". Structural peers, including Burundi, Madagascar, Niger, Uganda, and Zimbabwe, fulfil the characteristics above and have similar growth outcomes as Malawi. Aspirational peers share many of the same structural characteristics. However, Ethiopia, Lao PDR, Nepal, and Rwanda, which were selected as aspirational peers, have embarked on much more comprehensive economic transformation over the past three decades.

reversed, with Malawi now exporting less than 40 percent of the output typical for an African country. The low level of exports paired with high import demand has significant macroeconomic consequences, perpetuating foreign exchange shortages and causing microeconomic impacts as firms miss out on the productivity gains associated with exporting.

Figure O.2 **In contrast to higher achievers, Malawi's exports are in decline**

Merchandise exports as a share of GDP, percent



Source: World Bank staff calculations based on World Bank WDI based on World Trade Organization, World Bank WDI based on World Bank National Accounts, and World Bank MPO.

a. Excluding Lao PDR.

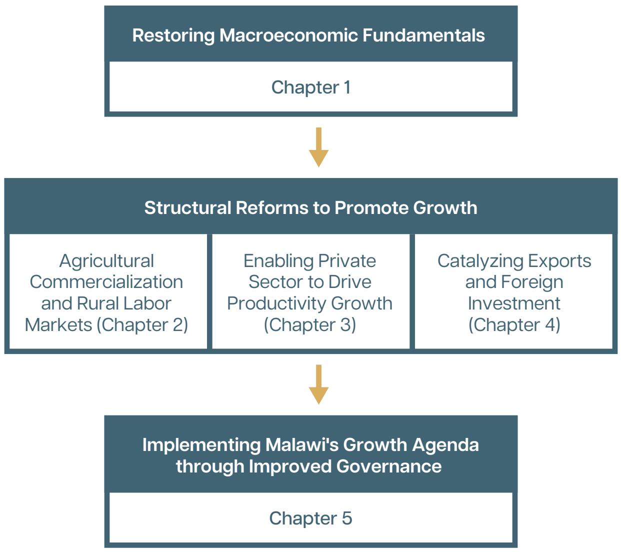
Malawi exhibits one of the lowest savings rates in the world, driven by high levels of government consumption, and limited household and commercial saving. Malawian savings amounted to 11.0 percent of GDP in 2019.[2] At the time, only seven out of 161 countries with available data reported lower figures, and this rate is expected to have declined further since then. The investment rate stood at just 12.3 percent in 2019, barely half of the regional norm of 22.2 percent. This made Malawi the country with the seventh-lowest investment rate globally. Aspirational peers invested more than 2.5 times as much of their output as Malawi, supporting considerably stronger growth.

The sluggish movement of workers out of agriculture and into industry and services has contributed to these disappointing outcomes. The process of structural transformation, marked by workers seeking and securing opportunities beyond agriculture, can spur the commercialization and professionalization of the economy and underpins productivity growth in the medium term. Furthermore, it can make scarce resources such as land and water available to the most productive farmers. So far, these shifts have proceeded slowly in Malawi, though the change since the 1990s has been comparable to that of the region. The share of workers in agriculture has decreased by 14 percentage points, compared with 12 percentage points in Sub-Saharan Africa, albeit from a lower baseline.

2. Malawi has not published a national accounts expenditure series, which includes savings and investment rates, since it rebased its GDP in 2020. The 2020 rebasing led to a 38 percent upward revision. Savings and investment figures presented here are based on pre-rebasing national accounts.

Malawi is also one of the countries most prone to climate change, and how the country addresses these risks will increasingly define its economic trajectory. According to the World Bank's *Country Climate and Development Report* (CCDR, World Bank 2022a), climate change is anticipated to impose large costs on the economy, with disproportionately impact on already vulnerable households. These impacts on GDP are estimated to range from 3 to 9 percent by 2030. Beyond the broader economic effects, climate shocks directly contribute to increased poverty. Agriculture, the mainstay of most vulnerable Malawian households, is more exposed to climate shocks than other economic sectors, and housing and living conditions suffer in the aftermath of floods and droughts.

Figure O.3 **Structure of the Country Economic Memorandum**



This Country Economic Memorandum (CEM) argues for a significant shift in policy to enable a virtuous cycle of sustained and inclusive economic growth, outlined in five building blocks (Figure O.3). Chapter 1 identifies policy priorities to restore the macroeconomic fundamentals for growth through fiscal reform, debt sustainability, external rebalancing, and monetary stability. The following three chapters address three core structural constraints to growth and propose key reforms to accelerate agricultural commercialization and improve rural labor markets (Chapter 2), enable the private sector to drive productivity growth (Chapter 3), and catalyze exports and foreign investment (Chapter 4). Acknowledging that implementing key growth-enhancing policies — be they macroeconomic or structural — are the result of complex political economy and governance arrangements, Chapter 5 focuses on how past Malawian successes can inform future sectoral policies, reforms, and strategies to achieve the goals outlined in the *Malawi 2063*.

CHAPTER 1: Restoring macroeconomic stability is a precondition for higher and sustained rates of growth that can significantly reduce poverty

Improved fiscal, debt, external, and monetary policy can be instrumental in setting Malawi up for more rapid economic growth. The disappointing growth and development outcomes of recent years stem from sustained macroeconomic imbalances that have worsened an already unfavorable external environment. Malawi is exceptionally vulnerable to climate change, terms-of-trade shocks, and other natural and human disasters. As a landlocked country, it relies on neighboring nations to access commercial ports. While Malawi's government has limited control over these structural dynamics, it can shape macroeconomic policy to establish foundations for either absorbing or exacerbating these shocks. Unfortunately, past macroeconomic policies have often increased the country's structural vulnerability, incurring a significant opportunity cost in terms of foregone growth.

For the past decade, Malawi's fiscal position has continued to deteriorate, with weak fiscal planning and implementation rendering budgets ineffective as guides to resource allocation. While significant budget deficits have been planned for, budget overruns have exacerbated negative budget outturns. Easily predictable expenditure items have repeatedly exceeded their allocation, pointing to institutional rather than technical causes of budget overruns. Financial management systems have proven ineffective in containing expenditure to budget ceilings. Non-adherence to public financial management (PFM) laws and procedures has led to frequent reports of expenditure overruns and contractual commitments surpassing approved ceilings. Without effective budgeting, prioritizing the most growth-effective expenditures becomes impossible.

Malawi is currently grappling with a public debt crisis driven by the accumulation of high-interest external debt and expensive domestic borrowing used for financing fiscal and current account deficits, rather than investments. External debt contracted on commercial terms with plurilateral development banks starting in 2018 was initially not disclosed. High interest payments put pressure on fiscal space for critical public spending. The speed and manner in which Malawi resolves its public debt crisis will have significant implications on its economic growth trajectory. It is therefore critical for the country to minimize the time during which it bears the costs of being in restructuring, such as increased bond yields and financial disruption, without yet receiving the benefits of decreased debt stocks. Initial financing assurances from the main official creditors represent an important step in this process.

Mismanagement of external balances have resulted in a costly Balance of Payments (BoP) crisis in Malawi, the fourth such crisis in 30 years. Outside of Malawi's four BoP crises since 1990, Malawi recorded an average GDP growth of 6.1 percent a year, but growth was only 1.6 percent a year during these crises. A large and increasing trade imbalance, exacerbated by periodic terms-of-trade shocks, has been the primary driver of BoP imbalances. These shocks have been exacerbated by Malawi's narrow import and export baskets, leading to rising trade imbalances. The adequate management of Malawi's external balances is critical to sustained economic growth. Exchange rates can serve the critical function of absorbing trade and other BoP shocks. However, Malawian authorities have tended to mute this balancing channel by attempting to maintain unsustainable currency pegs. This has led to a scarcity of foreign reserves and the allocation of foreign exchange through administrative measures, along with frequent shortages of essential imports. Repeatedly, exchange rate misalignment has been associated with the dualization of the exchange rate, opening arbitrage opportunities and providing incentives for informal trade.

To break away from old growth patterns, Malawi must abandon old ways. Analysis using the World Bank's "Long-Term Growth Model" shows that there is no single solution to reaching current growth targets. Rather, getting back on track and reaching upper middle-income status in the next 40 years will require simultaneously increasing the effectiveness and efficiency of public investment, catalyzing private investment and enhancing economy-wide efficiency. Getting macroeconomic policy right is foundational in this regard. This requires achieving debt sustainability and improved debt management, sustained fiscal reforms, increasing the efficiency of public investment, and ensuring a more resilient external balance. Stabilizing the macroeconomy will in turn attract increased private investment, enabling the country to leverage its growing and competent workforce.

CHAPTER 2: Agricultural commercialization can drive structural transformation and support the transformation of the rural economy

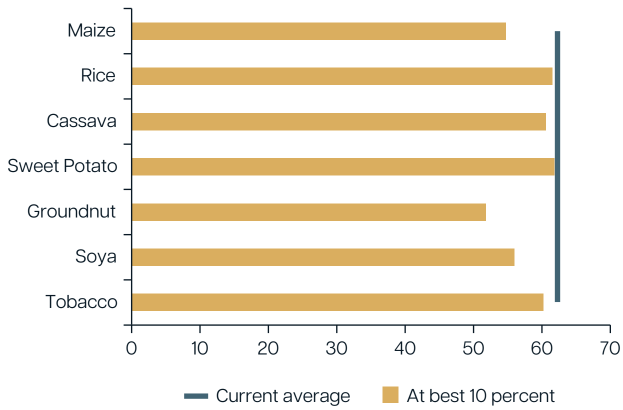
Malawi's economy remains highly dependent on agriculture, with the sector playing a critical role in the country's overall economic performance. In 2021, it is estimated that over three-quarters of all adults derived their livelihoods from agriculture, contributing approximately 23 percent to the total GDP. The sector is also critically important to the food security of households and the nation as a whole. Given these factors, agriculture will remain central to Malawi's development for years to come.

However, rural households in Malawi have had few opportunities to increase their incomes. Ninety-four percent of all poor households in Malawi are in rural communities, and the rural poverty headcount ratio at the national poverty line (57 percent) is almost three times that found in urban areas (19 percent). Fewer than 7 percent of households can generate enough income from their farming to meet their basic needs, contributing, on average, 30 percent of the total income of the typical farming household. The median farming household surveyed in the most recent Integrated Household Survey (2019/20) derived MWK 16,190 (about US$20 in nominal terms) in value per capita annually from their efforts.

Even with significantly higher levels of productivity, a farmer with extremely small landholdings is likely to remain in poverty and struggle to meet basic needs. New analysis in this CEM (Benson and De Weerdt, 2023) shows that if all farming households were to attain the agricultural productivity levels of the top 10 percent most productive farming households, the poverty rate would not significantly reduce (Figure O.4). Consequently, most farming households turn to other forms of employment off their own farms to avoid or escape poverty including through *ganyu* labor, by operating a household enterprise and through other longer-term employment (Figure O.5). However, under current conditions, non-farm rural employment does not provide sufficiently high incomes to lift households out of poverty either.

Figure O.4 **Even major productivity improvements could not reduce poverty sufficiently**

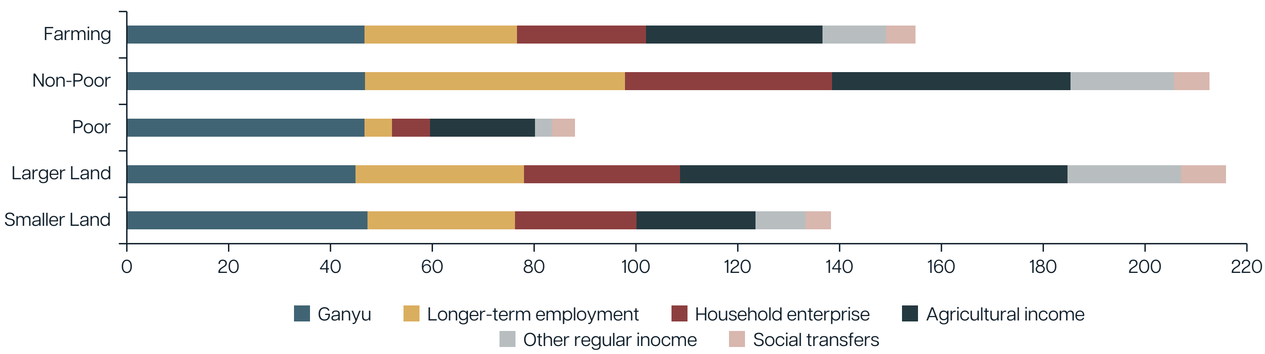
Income poverty rate at current average levels of productivity and productivity of most productive 10 percent, percent



Source: World Bank staff calculations based on IHS (2019/20) analysis in Benson and De Weerdt (2023).

Figure O.5 **Agricultural income is typically a small share of total income**

Average per capita annual income, in current MWK ('000)



Source: World Bank staff calculations based on IHS (2019/20) analysis in Benson and De Weerdt (2023).

In this context, a shift in the rural economy is needed to sustainably reduce poverty. Successful commercial farming creates demand for labor, contributing significantly to rural markets. While this transformation is not yet happening at scale across Malawi, there are pockets of agricultural commercialization. The share of commercially oriented farming households among all Malawian households has remained low but relatively steady over time, despite challenges such as shrinking landholdings with, at best, limited improvements in levels of agricultural productivity. However, with effective market development and increased agricultural productivity, the share of Malawian households that are commercially oriented farming households can be expected to grow.

Productive alliances, characterized by strong farmer organizations, links to offtake markets, improved access to finance, and an enabling environment, can help make markets work for commercializing smallholders. The productive alliance model starts with strengthening or building producer organizations to allow smallholders to seize market opportunities and have their voices heard, receive more information, reduce costs, and reap the rewards that come from selling in volume. Productive alliances' efforts to improve the enabling environment, including reforms to land tenure security, standards, and certifications, are all geared toward improving agricultural commercialization. Productive alliances can therefore promote greater inclusion, especially for women.

The Government of Malawi has recently intensified efforts to promote and develop large-scale farms in the country through its "mega-farms" initiative. This marks a potentially significant shift in the Government's approach to economic development and the transformation of the agriculture sector, towards a greater emphasis on supporting land access and consolidation, along with the rehabilitation of idle or underutilized land on a larger scale.

However, there are critical binding constraints to the realization of the agricultural growth and rural transformation vision, including an inefficient use of agricultural expenditures and trade restrictions. While Malawi's agriculture sector requires significant investments to boost resilience and productivity, a conducive policy framework is paramount for unlocking the commercialization potential of Malawian farmers — and ultimately for sustained growth. A central challenge in this regard is the dominance of fertilizer subsidy schemes in policymaking. Despite consuming about 40 percent of scarce agriculture budget resources in recent years, the Affordable Inputs Program has done little to stimulate the process of agricultural transformation necessary for Malawi to generate higher economic growth and create more jobs. Existing constraints also stem from the legacy of past policy interventions, including prevailing trade restrictions, that dampen incentives for greater commercialization. These factors continue to impact how Malawi's key agriculture sector institutions function, despite numerous attempts at reform.

Malawi's agriculture sector has largely been shaped by policies that have promoted food self-sufficiency rather than commercial farming. As a result, the sector harbors untapped potential for further growth and job creation. Presently, only a small minority of the population engages in commercial farming, hindered by an unfavorable policy environment that fails to incentivize broader employment creation. This policy environment, paired with the inability of its public sector institutions to implement reforms, are key challenges to realizing the country's vision for agricultural growth and rural economic transformation. Addressing these challenges requires a comprehensive agenda focused on effective coordination, sequencing, and targeting of policies and investments, structured around three pillars:

- **Pillar 1: Remove barriers to stimulate private sector engagement in the agri-food sector,** such that private investments can complement scarce public resources.

- **Pillar 2: Repurpose existing policies and support programs** such as input subsidies to foster efficiency and equity in the rural agricultural market and better serve the expansion of rural employment and growth.

- **Pillar 3: Foster commercially oriented agricultural production and marketing systems** that can expand opportunities for and participation of farmers in productive agricultural value chains and lead to broader rural economic transformation in Malawi.

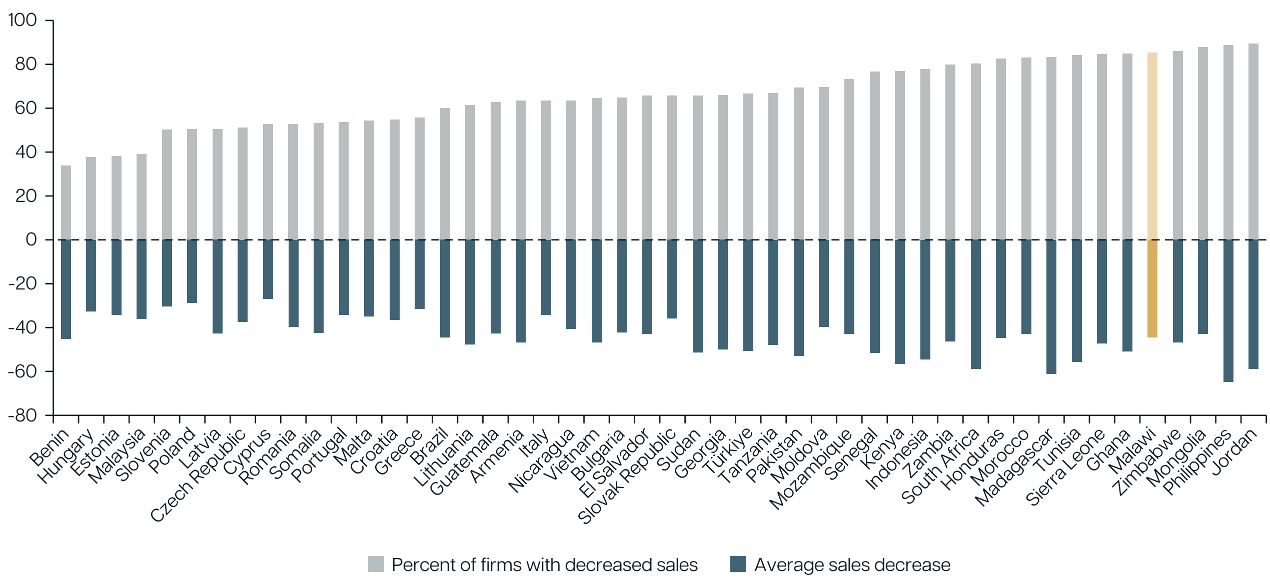
CHAPTER 3: Supporting private sector growth by addressing core constraints to firms' productivity

Malawi is facing numerous escalating challenges that make a focus on job creation and private sector–led growth a necessity. With the population growing at about 2.5 percent per year, the economy is not growing at a sufficient pace to provide decent jobs for the roughly 400,000 young Malawians entering the labor market annually (International Finance Corporation 2021). Nine out of ten Malawian firms are either small or micro-enterprises and operate within the informal sector (FinMark Trust, Imani Development, and AESA 2019). Productivity is low for most firms in Malawi, with the majority producing little surplus to invest and grow. Large productivity gaps between firms ae indicative of significant barriers, including in firms' ability to access finance, information, and international markets.

The ongoing crisis has further exacerbated the challenges faced by firms and heightened the country's urgent jobs challenge. The impact of the COVID-19 pandemic, leading to weakened demand, combined with electricity, fuel and forex shortages, have had a particularly detrimental impact on the private sector. Many firms find themselves with few buffers and limited access to finance to cushion successive strains. Between 2019 and 2020, 84 percent of firms reported a decline in sales. Among the 48 countries captured by the Business Pulse Surveys, only four suffered more widespread sales losses (Figure O.6). The contraction in sales was also severe, with an average loss in sales of 44 percent.

Figure O.6 **Malawian firms experienced some of the most widespread sales losses globally**

Share of firms reporting a decrease in sales and average sales decreases relative to one year earlier as of Q4 2020, percent



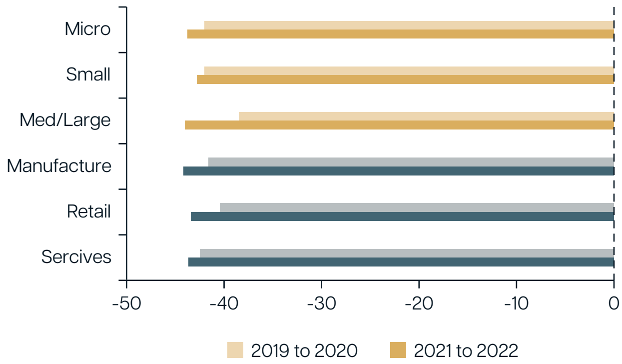
Source: Business Pulse Survey.

Rather than rebounding, sales for most firms continued to drop into late 2022 (Figure O.7). Two-thirds of businesses surveyed in October 2022 reported that increased energy and fuel costs had negatively affected their profits, while forex unavailability was seen as a threat to profitability by more than three-quarters of firms. Larger enterprises were less likely to have a continued decline in sales. However, these firms nonetheless recorded the largest average decreases in sales. Manufacturing firms exhibiting the highest likelihood of substantial declines relative to retail and services firms.

Market distortions and a lack of competitiveness in the private sector contribute to the absence of a dynamic cycle wherein unproductive firms are replaced by more efficient new firms. Large productivity gaps between productive and unproductive firms suggest that firms are not using their resources efficiently to compete and grow. A productive firm in the 90th percentile is 37 times more productive than a firm in the 10th percentile. Moreover, young firms, on average, are significantly less productive than older firms, suggesting that new entrants are not spurred by competition to replace stagnant unproductive firms.

Figure O.7 Rather than rebounding, sales for most firms continued to drop into 2022.

Average change in sales relative to one year earlier in Q4 2020 and Q4 2022 by sector, percent



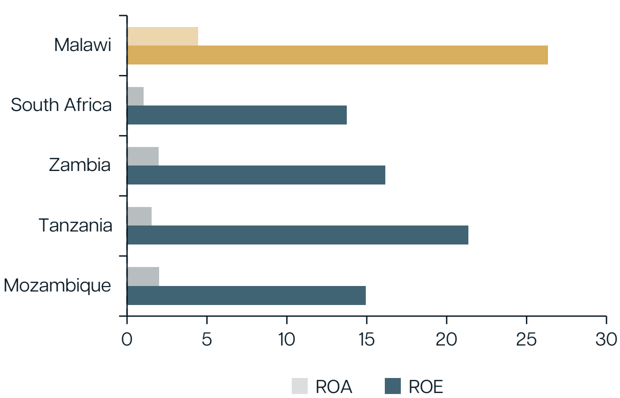
Source: Business Pulse Survey.

Firms' capabilities are key to productivity growth, but managerial systems are inefficient, and there is a notable deficiency in the level of digitization among firms. While Malawian enterprises are aware of good basic managerial practices, this often does not necessarily translate into how businesses are operated. For instance, while managers maintain financial records, the methods employed are often rudimentary, relying on paper-based systems. This limits their ability to analyze data and translate financial insights into improved business processes. Despite the general availability of digital options and an RBM order that all businesses must offer digital payment, eighty-four percent of businesses primarily receive payments in cash.

With limited access to finance, firms are unable to withstand shocks and grow. Ninety-five percent of firms express difficulties in accessing financing, citing high interest rates and repayment risks as their main concerns. Paradoxically, while the financial sector has remained stable and profitable amid recent crises, outperforming regional comparators (Figure O.8), this success is largely attributed to extensive lending to the government, crowding out credit available to the private sector (Figure O.9). Due to low-risk appetite, financial institutions provide limited supply of credit to the private sector and charge high rates to private sector borrowers. Key factors constraining lending to smaller and informal firms include lack of collateral and proper credit referencing, ID card challenges, and the informality of most firms.

Figure O.8 Malawian banks have higher returns on assets (ROA) and equity (ROE) than those in neighboring countries (2011–21)

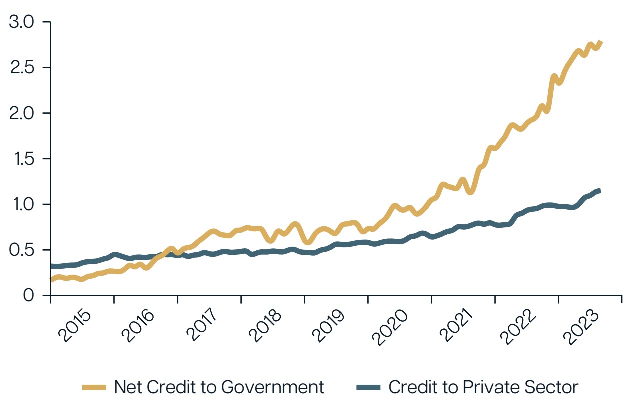
ROA and ROE in percent for Malawi and regional comparators



Source: Chilima and Gondwe (2023) based on World Bank and RBM data.

Figure O.9 Lending to Government has increased dramatically in recent years, crowding in out private sector credit

Credit to Government and the Private Sector, in MWK billion



Source: World Bank with data from RBM.

Malawian firms face considerable barriers to formalization, entry, and growth, partially due to significant distortions that constrain competition in many sectors. Entrenched corruption, uncompetitive practices, cumbersome tax administration, and an unpredictable regulatory environment favor incumbents and stifle growth of existing businesses. Many sectors, including construction, telecommunications, retail, insurance, and agro-processing, have a high degree of market concentration, creating risks for collusion. State-owned enterprises (SOEs) often compete with the private sector, enjoying significant regulatory, financial, or other advantages. The existing legal and regulatory apparatus limits the Competition and Fair Trading Commission's (CFTC) capabilities to address anti-competitive behavior effectively.

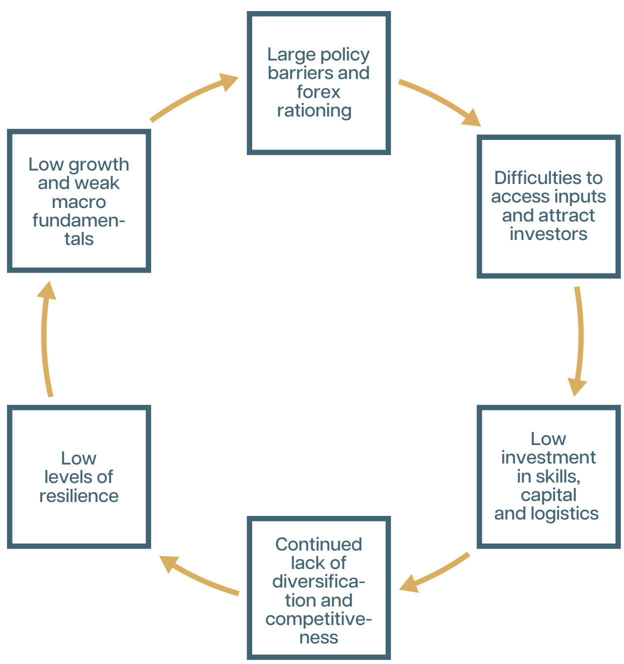
For Malawi's private sector to drive growth, significant reforms are needed. Strengthening firms' capabilities requires improved management training and support services. Considering the energy and forex constraints faced by firms, the Government may also want to consider prioritizing key industries in terms of access to essential services and forex allocations. To improve access to finance, and in the context of wider debt sustainability reforms, there is an urgent need for the public sector to reduce borrowing demands. Simultaneously, banks must reduce operating costs through cost-sharing of technology investments, automated service provision, efficient credit referencing, and timely resolution of court cases. Finally, it is critical to improve the legal and operational capacity of the CFTC for more robust competition enforcement and advocacy.

CHAPTER 4: Increasing trade can help restore macroeconomic stability and drive industrialization

Malawi's continued lack of economic diversification has been central to its macroeconomic challenges. The country has faced persistent difficulties in enhancing export performance, relying heavily on tobacco exports, with diversification efforts proceeding only slowly and exports declining. Increasing exports would generate more forex, addressing pervasive shortages in the economy. This underscores the importance of Malawi developing and implementing a robust strategy to integrate into global markets while improving its macroeconomic stability.

Malawi must break the vicious cycle in which structural factors and restrictive trade policies reinforce each other, perpetuating a low-level equilibrium (Figure O.10). Large policy distortions and forex rationing not only reduce access to inputs but also to essential goods like health and food products. The economy also suffers from a lack of investment and high trade costs due to poor logistics and infrastructure. These issues, compounded by the structural barriers of being a small, landlocked country, reduce overall economic resilience and negatively impact Malawi's macroeconomic environment through low levels of foreign exchange earnings resulting from low export levels. Consequently, Malawi requires an export-oriented strategy to stimulate economic development and overcome the country's structural challenges. By diversifying the economy, capitalizing on opportunities in key sectors, and addressing long-standing issues, Malawi can unlock its full potential and position itself for sustainable and inclusive growth.

Figure O.10 A vicious cycle of restrictive trade policies and weak outcomes



Source: World Bank staff.

Six stylized facts characterize Malawi's trade performance:

1. *Malawi's exports have declined significantly in the past decade, resulting in low forex earnings and driving Malawi's macroeconomic imbalances.* The decline in exports has resulted in a worsening current account balance and dwindling reserves. Double-digit current account imbalances (in terms of percentage of GDP) between 2013 and 2021 have led to the accumulation of substantial external liabilities (Figure O.11). This has resulted in a gradual deterioration in net reserves, especially in the post-COVID-19 years.

2. *Malawi's overall export performance has been worsening, largely due to the dominant role of only one declining crop — tobacco — in its export basket* (Figure O.12). This double burden of over-reliance on a single commodity and the volatility of its other exports not only exposes the country to fluctuations in global commodity prices and demand dynamics, but also results in inadequate and unstable foreign exchange earnings. This has resulted in limited diversification. The number of products exported by Malawi declined by 24.3 percent between 2015 and 2020. Malawi has also experienced a reduction in the number of markets reached.

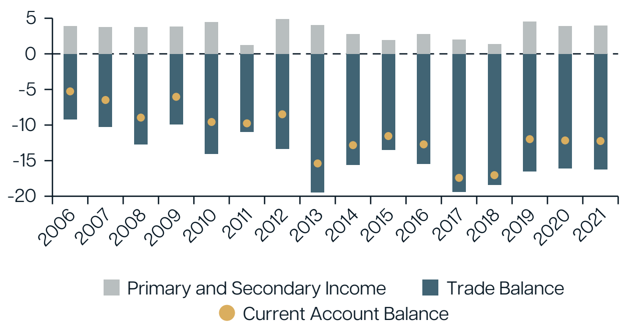
3. *Exports and exporters exhibit low survival rates.* The overall number of exporters has dropped over the past decade, mainly due to the stronger decline in entry rates than exit rates, resulting in higher concentration. Moreover, the survival rate of new entrants is relatively low. On average, only 20 percent of new exporters manage to survive into the subsequent year over the period from 2006 to 2022, and 5.7 percent survive past the third year.

4. *Malawian exporters lose more from exchange rate appreciations than they gain from depreciations.* A declining real exchange rate is generally expected to improve export competitiveness. However, Malawian exports do not increase quickly during real exchange rate depreciations but fall rapidly during appreciations. There are several causes for this differentiated response. First, supply constraints reduce exporters' capacity to scale up. Second, finding new clients can be difficult and expensive for firms. Third, during periods of overvaluation, exporters face additional constraints as spreads between official and parallel market exchange rates emerge, acting as a de facto tax on official exports. This implies that an exchange rate policy that is good for exporters minimizes periods of appreciations (like during fixed exchange rate episodes). Depreciations provide exporters with a boost, but this takes time to fully materialise.

5. *Malawi "under-imports" intermediate goods necessary for GVC participation, while consumption goods use up an increasing share of forex.* Countries that import intermediates tend to be better performers in terms of exports, as they contribute to technology transfer and

Figure O.11 The current account deficit has deteriorated in recent years

Current account, percent of GDP

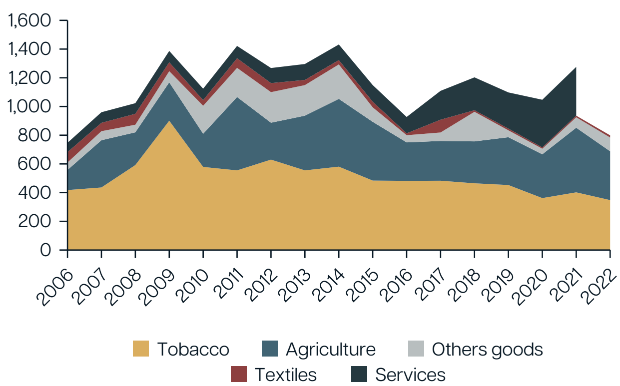


Source: World bank staff calculations based on IMF WEO 04/2022 and NSO data.

Note: Indexed price change is calculated as the weighted average price change of reported commodity imports/exports in the preceding year. Weights are assigned according to the preceding year's trade value.

Figure O.12 Malawi's exports composition is dominated by tobacco and services

Exports by sector, in US$ ('000,000)



Source: World Bank staff calculations based on MRA transactions data for goods exports and WDI data for services.

Note: Services exports do not include the category "maintenance and repair."

productivity enhancement. However, Malawi imports fewer intermediate goods than peer countries, indicating a weaker integration of intermediate products into the production process. In recent years, the growth rate of consumption goods has surpassed that of intermediates.

6. *Foreign investment, a key ingredient for export growth, has declined from an already low base.* Malawi's FDI inflows to GDP ratio in 2021 was less than 0.36 percent, significantly lower than the regional average of 2 percent or more. More generally, the importance of FDI as an external finance source has steadily diminished over the past decade, while remittances and ODA have emerged as the primary sources of external financing.

Malawi's trade and industrial policy is central to its weak trade performance. The prevalence of non-tariff barriers (NTBs) constitutes a major constraint to export growth, resulting in Malawi having particularly "thick" borders (Figure O.13). Thicker borders indicate greater price differences between producer and consumer prices, implying higher trade costs and potential barriers to trade for Malawi. Many of these policies yield unintended consequences that are at odds with the Government's goals of improving economic diversification and resilience. Examples include administratively burdensome import and export licenses for numerous goods, export permits, mandatory conversion of export proceeds, and an onerous regime of mandatory standards. The presence of further NTBs at the border and in neighboring transit countries such as Mozambique, Tanzania, and Zambia add to the costs of trade for Malawian exporters and importers. Central to this is the lack of coordination between Malawi and its neighbors to address barriers encountered by traders. Such policies are likely to reduce both the number of firms exporting and the total value of exported goods.

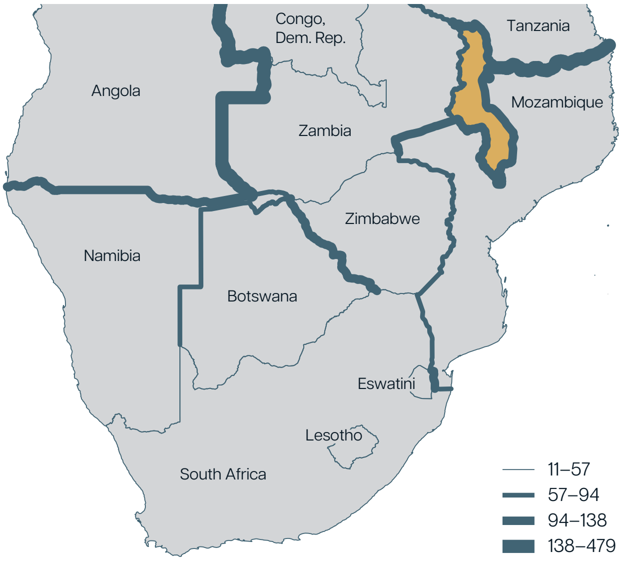
Malawi's challenge in attracting FDI is correlated with its relatively high legal barriers to FDI. When compared to its regional peers in the Southern African Development Community (SADC), Malawi falls within the lowest quartile on the SADC Investment Climate Scorecard, which is based on the OECD FDI Regulatory Restrictiveness Index. Furthermore, in comparison to global standards, Malawi's level of FDI restrictiveness is more than three times higher than the global average according to the same OECD methodology.

The African Continental Free Trade Area (AfCFTA) presents a timely opportunity for Malawi to expand its trade beyond its proximate markets. To reap the benefits of AfCFTA, Malawi must focus on trade facilitation and the rationalization of NTBs. The anticipated real income gains in 2035 are estimated to be as high as 1.8 percent relative to the baseline. Malawi stands to realize significant benefits in several sectors, including processed food, agriculture, and trade services, balancing out losses in manufacturing. Importantly, the implementation of the AfCFTA agreement in Malawi is expected to have minimal impact on customs tax revenues.

New agriculture export crops have shown significant potential as drivers of exports and for increasing upstream and downstream value addition. Soybeans represent a particularly notable example of this diversification

Figure O.13 Malawi's borders are "thicker" than those of many other countries in the region

Bilateral Border Thickness (percent ad valorem), 2015–2018 averages



Source: Arvis et al. (2020) based on World Bank-UNESCAP database (2015–18 averages).

process, emerging as the second-largest export and the most advanced value-adding sector in Malawi. Notably, investment in the soybean value chain means that it is now capable of fostering a downstream industry for the viable in-country production of multiple products. Macadamia has also emerged as a dynamic export growth sector, with Malawi currently ranking as the eighth-largest exporter globally. Malawian groundnuts are also increasingly processed for international markets, building on production arrangements from the tobacco value chain. Sustaining the prosperity of these burgeoning export sectors will necessitate the creation of an enabling environment that supports export growth and attracts increased investment.

Malawi's mining sector, while currently insignificant, can play a transformational role in driving export growth and addressing foreign exchange constraints. Recent discoveries of energy transition minerals such as rare earths, niobium, rutile, and graphite, were spurred by global demand driven by climate change and geopolitical events. They offer opportunities for growth in exports, revenues, and sustainable social and economic development. Seven priority mining projects, including those for "green minerals" essential for the sustainable energy transition, are progressing, indicating a likely increase in the sector's contribution to GDP. However, the scale of its contribution to Malawi's economy remains uncertain given potential delays and the uncertainty of global commodity price dynamics.

Several challenges must be navigated to transform Malawi's mining potential into tangible economic and social benefits. Critical issues include the scaling up of infrastructure, refining the fiscal regime, reducing the time required for mining permits and licenses effectively, and addressing environmental and social challenges. Infrastructure limitations, particular access to sufficient and reliable energy and adequate transport links through roads, ports, and railways, will also prove challenging. It will also be important to ensure the fiscal regime can balance the dual priorities of maximizing revenues over many years and maintaining the necessary production incentive for industry actors. How these issues are addressed influences the sector's contribution to the economy and the benefits for ordinary Malawians. Transparent contract negotiations, recourse to sufficient expertise, and a fiscal regime that supports stability are key for maximizing the mining sector's potential.

Benefiting from this potential requires sustained implementation of policies geared toward export-led growth, rather than creating ever more barriers to trade. This includes addressing the significant policy distortions that create uncertainty for investors and raise costs for exporters and importers, as well as leveraging the AfCFTA to develop value chains for growing sectors, such as agro-processing, mining, and tourism. Finally, it will be important to increase the competitiveness of Malawi's key corridors jointly with neighbors, including through the implementation of trade facilitation and coordinated border management reforms.

CHAPTER 5: Malawi's path to prosperity is as much about the "how" as the "what": the governance and implementation agenda

To address the macroeconomic and structural constraints that have resulted in Malawi's low-growth equilibrium, it is important to also understand the political economy underlying these constraints, including instances when these dynamics have been thwarted. While Malawi is a peaceful, democratic, and lawful nation compared with its peers, political dynamics create strong incentives for policies that address short-term needs, while undermining the ability to credibly commit to long-term structural reforms, and a macro-fiscal trajectory needed to spur inclusive growth and structural transformation.

Past analyses of the political economy of core governance constraints impeding Malawi's growth focus on three interlinked issues: (i) fraught state-business relationships; (ii) decentralized short-term rent seeking; and (iii) isomorphism. Mistrust between the state and business interests is rooted in Malawi's history and deals-based political arrangement. It leads to a disinterest in creating opportunities for private sector growth, in a lack of state capability for economic development, and is reflected in overbearing regulation. At the same time, political elites are focused on the extraction of rents in the short term, rather than enabling growth of available rents. This is reflected in pervasive corruption. In addition, while committed to making processes look legitimate and in line with international best practices, this often only happens at surface level with underlying informal arrangements remain unchanged — a dynamic referred to as "isomorphism". This is reinforced by development partners that have expended significant effort to improve governance arrangements but have often provided pre-formulated fixes without sufficient attention to local dynamics.

Among all these governance and institutional challenges, genuine achievements can go unnoticed. Chronicling success can be a key element of accountability. Most critically, cases of success hold valuable lessons that are integral to continue positive outcomes and to scale success. In turn, this CEM identifies 11 "success stories" where generally adverse conditions were overcome to attain positive outcomes through the effective governance and reform of: (i) value chains; (ii) public entities and SOEs; and (iii) public programs. Selection was based on a nomination process among the CEM team, with input from external advisors. This resulted in the following selection (Table O.1):

(i) *Three agricultural value chains:* groundnuts, macadamia, and soybeans;

(ii) *Four episodes of public institutions that were successfully reformed:* Lilongwe Water Board, Phalombe District Council, Press Corporation, and Road Fund Administration; and

(iii) *Four public programs:* Malawi's response to the AIDS epidemic, the widespread distribution of stoves to achieve clean cooking goals, results-based financing of local government development efforts, and the early years of the Farm Input Subsidy Program.

Table O.1 Overview of eleven Malawian success stories

Category	Case	Positive Outcomes Achieved
Value Chains	Groundnuts	Tobacco companies, assisted by a partnership with USAID, laid the groundwork to build a vertically integrated groundnut value chain. Three improved varieties were released and are now produced at scale. Two large companies have contracted about 7,000 farmers to produce locally processed groundnuts.
	Macadamia	With 10,000 hectares planted, Malawi became the eight-largest macadamia exporter globally. Eight major producers with over 2,000 permanent employees grow and market macadamia alongside 4,000 smallholders.
	Soybeans	Soybeans have emerged as the second-largest export and the most advanced value-adding sector in Malawi. Over 300,000 tons of production, exporting US$133 million worth in 2021 and 700,000 tons of industrial level processing capacity represent a fivefold increase over a decade.
Public Entity Reforms	Lilongwe Water Board	With World Bank support, the Lilongwe Water Board (LWB) launched its "Pathway to Success Program" to address capacity gaps. Through this, LWB increased access to water supply services, continuity of supply, revenue, cost recovery, customer service delivery, and reduced wastage.
	Phalombe District Council	In the 2021 Local Authority Performance Assessment (LAPA), Phalombe achieved an education sector score of 60 percent, almost double the national average. It evidenced "home-grown" innovations, like partnerships with local businesses, and high levels of accountability.

Category	Case	Positive Outcomes Achieved
Public Entity Reforms (cont.)	Press Corporation	In 1995, the National Assembly passed the Press Trust Reconstruction Act, which redefined Press Trust's charitable objectives and Press Corporation's privately organized corporate governance. The transformation enabled joint ventures with local and foreign partners and made the company profitable.
	Road Fund Administration	The Road Fund Administration (RFA) has established a track record of sound financial performance and good governance. It has enhanced and diversified revenues through initiatives like the Road Toll Program and become the most creditworthy SOE with 10 years of clean audits. It has successfully placed bonds in local capital markets.
Public Programs	HIV/AIDS response	Malawi has achieved a reduced number of HIV infections (from 28,000 to 20,000), increased awareness of those who are HIV positive (88 percent), a high linkage rate to HIV treatment (98 percent), and a high success rate among those treated (97 percent) between 2016 and 2021.
	Clean cooking stove distribution	In 2020, Malawi officially achieved its goal of migrating 2 million households to cleaner cooking alternatives. This success was driven by outstanding sectoral governance, placing Malawi a joint fourth among 53 countries evaluated by the "Regulatory Indicators for Sustainable Energy". Under government leadership, with development partner support and aligned private sector involvement, millions of households now use more efficient and less polluting cookstoves.
	Local government results-based financing	Supported by a World Bank grant, the Government has increased the transfer of district development funds for the 28 rural District Councils in 2020. The amount districts receive is based on the annual LAPA score and districts that do not fulfil minimum access conditions are not eligible. Having entered the second LAPA round in 2021, districts have produced across-the-board improvements with the largest increases among previously least performing districts.
	Early years of FISP	FISP succeeded in raising awareness among Malawian farmers of the value of inorganic fertilizer. In the years after FISP was introduced in 2004/05, Malawi significantly increased maize production and achieved national food sovereignty in most years.

Government facilitation rather than control have led to groundnuts, macadamia, and soyabeans becoming the primary cash crops for many farmers, with upstream and downstream industries emerging. While not yet reaching the scale of tobacco, all three value chains have seen significant growth in recent years. In all three cases, successful coordination and alignment among a diverse set of stakeholders was achieved. To achieve scale, value chains often needed both the know-how and marketing capacity of major commercial firms and the production scale that only smallholders can achieve. However, the Government and development partners also played important roles in the scale-up of all three value chains. This shows the importance of three main ingredients: strong market demand, government support rather than control, and a long-term vision. Malawi is a small market that cannot be isolated from global forces. However, the three profiled value chains are indicative of the large welfare gains that further growth can provide for average Malawians. Finally, they show that successful support is rooted in active dialogue between public stakeholders, private companies, smallholder interests, and development partners.

The cases of Lilongwe Water Board, Phalombe District Council, Press Corporation, and Road Fund Administration show that public entities are reformable and can deliver on their mandates across sectors. Public enterprises do not tend to turn around by themselves; the Government and development partners have been key facilitators in these cases. Lilongwe Water Board's transformation process was led by the Corporate Management Team, which was supported by the World Bank in its "Pathway to Success Program". The RFA board, which guided its transformation, also seats members from the private sector, public office holders, and civil society, all appointed by the Ministry of Finance. The formula for successful public enterprise reform includes dedicated and empowered leaders finding adapted operational solutions, building on a conducive financial environment.

Finally, the four cases of successfully implemented strategies provide tangible evidence that public policy goals can be both ambitious and achievable, with positive impacts on millions of Malawian citizens. All four cases deviate from the common belief that Malawi produces high-quality strategies but typically fails to implement them. Malawi's response to the AIDS epidemic, the widespread distribution of cooking stoves to achieve clean cooking goals, results-based financing of local government development efforts, and the early years of the Farm Input Subsidy Program (FISP) all involved the central government and international support, while the private sector was actively leveraged for clean cooking and FISP. Overcoming the most pressing problems also requires financial prioritization, either by finding adequate development partner finance or by prioritizing interventions in Malawian budgets. All successes gained traction with the Government communicating ambitious but achievable targets rooted in a clear public agenda, such as the target of 2 million cleaner cooking alternatives to households.

These 11 successful cases have not been immune to the typical challenges affecting Malawian governance. What sets these cases apart is their ability to overcome or work around these challenges. Leadership and effective management are a cornerstone of virtually all 11 cases. While in most cases such leadership was provided by the Government, some success stories were at points coordinated by other entities when given the space. Having access to suitable finance is another commonality among successful cases. Value chains demand patient debt and equity finance for producers, public entities require the right financial incentives to perform, and ambitious government programs need sufficient financial backing.

Scaling these successes has the potential to enable a virtuous feedback loop with wider macroeconomic and sectoral governance. Strengthened productive sectors will empower the Malawian private sector. In turn, an empowered private sector will have stronger leverage to insist on better macroeconomic policy or on more open trade policies. At the same time, the private sector will be a key beneficiary of enhanced macroeconomic governance. Low inflation, the ability to trade, and a solvent public sector will lift critical constraints to their business expansion. Similarly, better performing public enterprises will mean that they become less of a drain and potentially even a contributor to the treasury. This will help enable necessary fiscal reforms. At the same time, enhanced macroeconomic stewardship will make targets for public enterprises both better defined and more achievable. Meanwhile, demonstrated public success through the achievement of sectoral targets will nurture the public trust and accountability necessary to improve macroeconomic governance and even at times take difficult and initially unpopular decisions.

Governance and institutional reforms are inherently difficult and past advice and reform support has failed often. The analysis of case studies shows the importance of leadership to any reform process, and emphasizes the need to promote it in more targeted ways. The choice of leaders is likely to be deeply engrained in the political economy of the wider system. However, existing leaders can be made more effective by promoting their missions and providing them support. For example, for state-owned enterprises (SOEs), public signing ceremony of Shareholders Letters of Expectations between the Ministry of Finance and SOE leaders is an encouraging sign of the promotion of effective leadership. Results-based financing has demonstrated its potential to align financial incentives with performance and should be considered as an approach more widely. Fostering coalitions for change and strategic public-private dialogue can help overcome fraught state-business relationships. A number of initiatives already evidence this approach, including the Presidential Delivery Unit's "Private Sector Labs", the Presidential Private Sector Council, and the Public Service Reforms Agenda. Strengthened secretariats are key ingredients to continue their momentum into implementation.

Going Forward: What are the Priority Actions needed to start a virtuous cycle of macro stability and growth?

The current crisis offers an opportunity to rebalance and transform the economy, but this will require doing things differently. Over the past decades, many opportunities have been squandered and large amounts of domestic and external resources have been poorly used as Malawi has fallen behind many of its peers. In addition, the changing external environment, with declining aid flows, rising geo-economic fragmentation, and the increasing frequency of climate-related disasters creates significant new challenges. These will make catching up more difficult. The cost of further delays to much-needed reforms could be devastating for the country and its people. However, the building blocks to achieve this transformation are well understood among Malawian policymakers and the wider society, even if there is disagreement on the details of specific policy solutions.

To support this process, the CEM identifies the top 10 priority reforms, emerging from the five chapters. These aim to support a successful shift from "business as usual" by strengthening the necessary macroeconomic fundamentals, supporting a bold structural reform agenda, and learning from past successes to improve policy implementation and economic governance. The implementation of these reforms would not only mark a departure from growth patterns since independence but can also have transformative effects on the standard of living of Malawians, helping to reduce persistently high poverty levels and creating new opportunities. This can provide the foundation for Malawi to achieve its vision and become an inclusively wealthy and self-reliant nation.

Table O.2 Top policy priorities by chapter

Sector	Policy issue	Short-Term Actions *(the next 3–6 months)*	Medium-Term Implementation *(before the end of 2025)*
Creating the macroeconomic fundamentals (Chapter 1)	*Ending the current BOP crises and strengthening foundations to prevent future crises*	Create a sustainable and well-supported exchange rate regime, by institutionalizing a market-based and -clearing foreign exchange pricing mechanism.	Maintain a market-determined exchange rate and strategically use official reserves, external public debt, and financial openness to manage external balances.
	Proceeding with robust fiscal reforms	Demonstrate that Malawi can operate within its budget in FY 2023/24 by implementing fiscal consolidation measures, increasing domestic revenue, and improving forecasts of pre-determined expenditure.	Enhance legislative accountability to budget estimates and fully implement IFMIS across Government.
Agricultural Commercialization and Rural Labor Markets (Chapter 2)	*Fostering agricultural markets and appropriate market institutions*	Consistently implement COGA, promote public-private partnerships for commercialization, and increase transparency for government interventions in the market.	Minimize discretionary interventions in agricultural markets and ensure predictability for domestic and foreign investors.
	Reforming agricultural expenditures to foster efficiency and equity in the rural agricultural market	Proceed with AIP 2.0 reform process to reduce the fiscal burden, maximize fertilizer use efficiency through better targeting by using a finalized beneficiary registry, and improve the timeliness of input procurement and distribution.	Repurpose agricultural expenditures by reducing subsidies and investing in growth-enhancing areas, including climate adaptation.
Enabling the Private Sector to Drive Productivity Growth (Chapter 3)	*Improving access to finance, especially for smaller firms*	Address the crowding out of the private sector from commercial borrowing, including by setting clear and credible targets for the reduction of Government domestic borrowing.	Reduce the operational costs of commercial and development banks through de-risking, cost-sharing of technology investments, automated service provision, efficient credit referencing, and timely resolution of court cases.

Sector	Policy issue	Short-Term Actions (the next 3 – 6 months)	Medium-Term Implementation (before the end of 2025)
Enabling the Private Sector to Drive Productivity Growth (Chapter 3) *cont.*	*Strengthening the ability of the CFTC to enforce the competition regulatory and legal framework to enhance the welfare of consumers and foster competitive enterprises.*	Expedite the enactment of the Competition and Fair Trading Bill and corresponding regulations.	Invest in the capacity of CFTC and associated judiciary institutions, support the outreach and enforcement systems associated with the amended Competition and Fair Trading Act, and embed competition principles in broader public policies.
Catalyzing Exports and Foreign Investment (Chapter 4)	*Incentivizing exports by reducing non-tariff barriers*	The Ministry of Trade and Industry reviews existing NTBs and develops strategy for phasing these out, especially in sectors where Malawi has a comparative advantage (agriculture, agro-processing, mining, tourism)	The government together with the legislature ensures through enhanced internal review and external consultations that all future trade policy measures are developed jointly with industry and focus on maximizing export growth, attracting investment, and incentivizing exports to use official channels.
	Enhancing the attractiveness of Malawi to export-oriented and import-substituting FDI in sectors where the country has a potential comparative advantage	The government together with the legislature ensures that any legislation under discussion such as the Crops Bill, and export licensing procedures, create a conducive and predictable policy environment that supports domestic and foreign investment and are aligned with the implementation of the COGA.	The Ministry of Lands, Housing and Urban Development together with the legislature and the Ministry of Trade and Industry aligns foreign ownership and lease structures of land to international standards and streamlines the process for obtaining licenses and permits.
Implementing Malawi's Growth Agenda through Improved Governance (Chapter 5)	*Promoting and enabling effective leadership*	Publicize and reward strong public sector performance and the leaders behind it	Focus the implementation of public service legislation currently undergoing revision on incentivizing improved performance among senior public servants and executives.
	Creating appropriate financial incentives to strengthen leadership and program implementation	Scale up results-based financing within government systems, with a focus on harmonization of financing across government and development partners within common platforms.	Create concerted action among public, private, and international stakeholders around results-based financing architectures in line with clear sectoral targets and with high-level political backing.

From Stagnant to Thriving: Overcoming Macroeconomic Constraints to Malawi's Growth

KEY FINDINGS

1 Over the past 30 years, Malawi's per capita gross domestic product (GDP) has increased by over 50 percent, a growth trajectory comparable to that of other countries in the region. However, Malawi's growth has been insufficient to significantly raise living standards and close the gap to its neighbors. Some peer countries have managed to triple their per capita GDP over this time. Tepid growth outcomes have been due to the slow movement of workers out of agriculture and into industry and services, very weak export growth, and low levels of savings and investment.

2 Malawi is off-track relative to the growth ambitions stated in the *Malawi 2063* and requires comprehensive reforms to put them back within reach. Analysis using the World Bank's "Long-Term Growth Model" shows that there is no single solution to reaching current growth targets. Rather, getting back on track and reaching upper middle-income status in the next 40 years will require simultaneously increasing the effectiveness and efficiency of public investment, catalyzing private investment and enhancing economy-wide efficiency.

3 Malawi's disappointing economic growth outcomes can be attributed to policy choices that have worsened an already unfavorable external environment and resulted in significant fiscal and external imbalances. Malawi is exceptionally vulnerable to climate change and terms-of-trade shocks, and as a land-locked country, it depends on its neighbors to access commercial ports. While the Government has limited control over these structural dynamics, its macroeconomic policy can create foundations for either absorbing or exacerbating these shocks. Malawi's recent history shows that this is decisive: past growth episodes were marked by temporary macroeconomic stability, fiscal solvency, and a relatively favorable business environment.

4 Weak fiscal planning and implementation have made budgets an ineffective foundation for resource allocation. Unsustainable debt, driven by fiscal deficits, external balance shortfalls, and governance challenges, are a drain on economic growth. Inadequate management of the external sector promotes costly balance-of-payments crises. These dynamics have had mutually reinforcing impacts that have resulted in a vicious cycle of macroeconomic underperformance and deepening crises.

5 The current crisis presents an opportunity for a change from "business as usual". Focusing macroeconomic policy on long-term sustainable growth, starting with improved fiscal, debt and external balance management, is central to transforming this cycle of crises into one of opportunities. This requires achieving debt sustainability and improving debt management, implementing robust fiscal reforms, increasing the efficiency of public investment, and strengthening external resilience. In addition, Malawi needs a surge in private investment to capitalize on its growing and highly competent workforce.

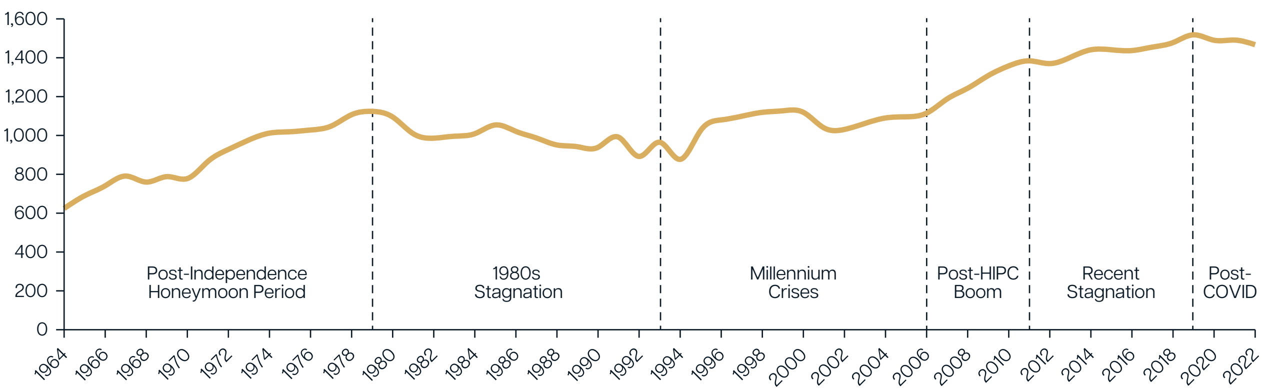
SLOW GROWTH IS AT THE ROOT OF MALAWI'S HIGH POVERTY RATE

The *Malawi 2063* (NPC 2020) development strategy recognizes that the development and prosperity of Malawi depend on the achievement of sustained economic growth. While Malawi has made strides in improving key human development outcomes, such as life expectancy, access to education, and health over the years[3], poverty reduction aims remain significantly off-track. The *Malawi 2063* recognizes the importance of economic growth as a catalyst of socio-economic progress and sets a clear target: achieving upper middle-income status by the year 2063. This Country Economic Memorandum (CEM) analyzes what it would take to achieve higher and sustained growth. Special attention is given to what can be done in both the short term (3 – 6 months) and the medium term (the next two years) to get Malawi's economy back on track. This, in turn, can help improve and refine current and future policies and interventions, including those in the *Malawi 2063* "Multi-Year Implementation Plan, 2021 – 2030" (NPC 2021).

Economic growth in Malawi since independence has been too slow to substantially improve the economic welfare of the average Malawian (Figure 1.1). The quality of statistical records has changed over time. Nevertheless, most sources agree that Malawi's economy has grown only slightly more quickly than its population since Malawi's independence in 1964. Per capita production has roughly doubled from a low base since independence, translating into an annual real per capita growth of only 1 percent.[4]

Figure 1.1 Despite periods of acceleration, Malawi's economic growth has not been transformational

GDP per capita in 2017 constant US$ purchasing power parity



Source: World Bank World Development Indicators (1990 – 2021), staff calculations based on World Bank Macro-Poverty Outlook (10/2023), and staff calculations based on Maddison Project Database 2020 (1964 – 1989).

3. Life expectancy at birth increased by 20 years to 63 years between 1990 and 2021. It now exceeds the regional average of 60 years. Meanwhile, in 2021, 87 percent of the relevant age group completed primary education, outperforming the regional average of 71 percent. This is up from just 30 percent in 1990. Access to health services improved, too. For instance, the World Health Organization estimates that 93 percent of all one-year-olds in 2021 have been immunized against diphtheria, tetanus, and pertussis, up from 87 percent in 1990 and ahead of the Africa region average of 71 percent.

4. When available, this report uses growth estimates from the World Bank's World Development Indicators (WDI). Tracking production and incomes over a long period is challenging, as production and consumption patterns are not static. Using different schemes for benchmarking makes production figures sensitive to different price changes. Looking at the Maddison Project Database, World Bank National Accounts Data, the IMF World Economic Outlook database, the Penn World Table 10.0 and the World Bank WDI, we find that depending on the source, real per capita GDP is between 30 and 220 percent higher today than at independence and has grown between -4 and 70 percent since democratization in 1994.

Per capita growth has been negative since 2020 due to a severe macroeconomic crisis. Malawi is experiencing the effects of longstanding balance of payments (BoP), fiscal, and monetary imbalances. Many of these have been noted in previous CEMs (and other reports). This CEM primarily documents the increased acuteness of these imbalances, and the rising cost of inaction. Macroeconomic imbalances come on top of recurrent external shocks, to which Malawi is exceptionally susceptible, in part due to the weakness of the economy. The increasingly severe climate-related disasters that Malawi faces put additional stress on public spending, the trade balance, and pressures for monetary financing, creating additional challenges for macroeconomic adjustment.

Slow economic growth is at the heart of persistently high poverty rates. Economic growth reduces poverty because it tends to lift income levels across the income distribution, lifting those living close to poverty lines out of poverty (Adams 2003). The relationship is strong enough that most other factors are secondary when modeling monetary poverty: a 1-percentage-point increase in economic growth is generally found to be associated with a 2–3 percent decrease in the proportion of people living in poverty (Bourguignon 2003; World Bank 2001).[5]

Due to slow economic growth, Malawi defies a global and regional trend of decreasing poverty levels. At the national poverty line, 50.7 percent of Malawians remained in poverty as of 2019, virtually unchanged over the past decade. Despite being home to only 0.24 percent of the world's population, Malawi is home to 2.0 percent of the world's extreme poor. The recent World Bank "Malawi Poverty Assessment" (World Bank 2022d) highlights slow structural transformation as a driving force of stagnating poverty levels since 2010, as non-farm sectors were unable to absorb the surplus of labor resulting from population growth.

In addition to their effects on the overall economy, climate shocks directly affect poverty. The probability of a household being poor increases by 14 percentage points after experiencing a climate shock (World Bank 2022d). Agriculture, the mainstay of most vulnerable Malawian households, is more exposed to climate shocks than other economic sectors. Housing and living conditions suffer in the aftermath of floods and droughts. Most households have few options to mitigate the negative impacts of shocks, with limited help available from the Government or non-governmental organizations (NGOs), closely circumscribed savings, and almost non-existent access to credit.

This chapter argues that these disappointing growth and development outcomes are the result of policy choices that have exacerbated an already unfavorable external environment and geography. Malawi is exceptionally vulnerable to climate change, terms-of-trade (ToT) shocks, and other natural and human disasters. Moreover, as a land-locked country, it depends on its neighbors to access commercial ports. While the Government of Malawi has limited agency over these structural dynamics, it can direct macroeconomic policy to create foundations for either absorbing or exacerbating shocks. Improved fiscal, debt, external, and monetary policy choices can be instrumental in setting Malawi up for more rapid economic growth. For example, while Malawi is structurally dependent on imports of price-volatile commodities such as chemical fertilizers and fuel, a rigid exchange rate long prohibited adaptation to import price shocks through this channel. Similarly, Malawi's low fiscal revenues are a genuine challenge in meeting developmental needs. As such, policy choices have done little to address and mitigate the country's structural vulnerability, and have had a significant opportunity cost in terms of foregone growth.

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5. Often lower elasticities are estimated for African countries. This is primarily a mechanical phenomenon, as high poverty levels mean that similar elasticities imply a larger absolute reduction in poverty at the same poverty line. This does not negate the centrality of growth to poverty reduction (Christiaensen and Hill 2019, 43).

This chapter provides a comprehensive analysis of the country's economic trajectory and explains what is needed to achieve higher levels of growth over the coming years and decades. The second section delves deeper into Malawi's economic history, identifying both periods of higher growth and benchmarking Malawi's performance against that of a selection of peer countries. It then examines two salient economic aspects present in almost every rapidly growing country, namely structural change and export growth, to create the foundations for a more detailed discussion of these issues in later chapters. The third section presents the results from a long-term growth modeling exercise benchmarking Malawi's current trajectory and various alternative scenarios against the ambitions expressed in the *Malawi 2063*. This is followed by an analysis of how policy choices related to public debt management, fiscal policy, and the external balance have resulted in, and mutually reinforced, Malawi's current macroeconomic crisis. The chapter concludes by proposing priority macroeconomic policy reforms to put the *Malawi 2063* back on track.

MALAWI'S ECONOMIC HISTORY SINCE INDEPENDENCE HAS BEEN DEFINED BY STAGNATION, SHOCKS AND BRIEF GROWTH BURSTS

Malawi's post-independence growth history can be divided into six periods. These periods are characterized by structural departures from the economy's previous overall trajectory. During a post-independence "honeymoon" (1964 – 1979), Malawi's economy was on an upward trajectory. At 4.1 percent, per capita economic growth was robust and comparable to many other countries recently freed from colonial rule. However, this was followed by a period of stagnation from 1980 to 1994. In a typical year during this period, per capita GDP declined by 1.0 percent. Unfortunately, the advent of multiparty democracy in 1994 did not coincide with a change in the country's economic fortunes, as Malawians experienced various crises amid political transition until 2005. More stability ensued after the write-down of the majority of Malawi's external debt in the context of the Highly Indebted Poor Country (HIPC) Initiative in 2006, enabling real per capita growth of 4.0 percent until 2011. However, by 2012, Malawi's economy had again begun to stagnate. This was driven by increased macroeconomic volatility following the "Cashgate" scandal and the withdrawal of budget support, as well as increasingly frequent external shocks. Per capita GDP growth slowed to just 1.2 percent. Since 2020, Malawi has entered a period of economic decline, with per capita growth shrinking as the country has struggled to recover from the impacts of the COVID-19 pandemic amid acute macroeconomic imbalances.

Two periods stand out in terms of growth performance: the post-independence honeymoon (1964 – 1979) and the post-HIPC boom (2006 – 2011). During these periods, per capita growth exceeded 4 percent, while it averaged just 0.2 percent during the remaining years. Growth episodes were marked by temporary macroeconomic stability, fiscal solvency, and a relatively favorable business environment. Both the post-independence honeymoon and the post-HIPC boom were not without major external shocks. Between 2006 and 2008, international fertilizer prices more than doubled, constituting a major terms-of-trade (ToT) shock for Malawi. During the 1964 – 1979 honeymoon, Malawi also experienced its first post-independence recession in 1968 but the economy quickly rebounded.

Key to absorbing external shocks has been relative macroeconomic stability. For instance, in the post-HIPC era, inflation was kept mostly in single digits through, among other measures, an unsustainable peg of the Malawi kwacha. Consequently, while Malawi made some improvements in terms of total factor productivity during the time, Malawi's economy primarily grew on the extensive margin. Initially robust donor support, high growth rates throughout the region driven by a commodity boom and relatively abundant liquidity following the 2006 debt relief helped to sustain investment until macroeconomic imbalances became binding towards the end of the period. Once Malawi's government was able to borrow again, budgets grew by a third in terms of their share of GDP and the share of public resources having to be expended on interest decreased. This allowed some reallocation to public investment resulting in a state-led investment boom. Economic success in the post-independence and post-HIPC eras can also be linked to political developments, such as a relatively disciplined bureaucracy leading to rent-seeking structured around longer time horizons (Cammack and Kelsall 2011). When bureaucrats claim benefits over the medium term rather than seeking immediate rents, they gain a stake in the performance of the economy (see Chapter 5).

Periods of unsustainable expansion also set Malawi up for subsequent economic problems. Both the post-independence honeymoon period and the post-HIPC era started the process of unsustainable public debt accumulation that would weigh the economy down many years into the future. This was driven in part by structural budgetary indiscipline. Both episodes are also times when the current account was starkly negative, driven by an overvalued exchange rate. This brought with it shortages of strategic imports such as fuel. Such pegs not only necessitated external financing to keep foreign exchange available but also enabled monetary policy — including monetary financing — that was too accommodative, creating imbalances that would lead to surging inflation when market-based exchange rates fed through into the real economy. Periods of economic expansion did not result in the accumulation of sufficient buffers, with many structural growth constraints remaining unaddressed.

The Malawian government has attempted to steer its economic development through numerous plans since independence. Malawi's first development plan, the *Nyasaland Development Plan* (1962 – 1965), focused on creating functional state institutions. Subsequent plans were dominated by President Hastings Kamuzu Banda's economic ambitions before the structural adjustment agenda took hold in the 1980s. While previous plans included growth targets, the *Vision 2020*, launched in 1998, was the first to strive for middle income status. The *Malawi 2063* that was launched in 2021 seeks to make Malawi "an inclusively wealthy and self-reliant industrialized upper middle-income country" by 2063.

Stronger linkages to budgets, political economy improvements, and stronger alignment of development partners are needed to make the *Malawi 2063* more relevant for Malawi's economic trajectory than previous plans. As the comprehensive analysis of Malawi's history in development planning shows, a disconnect between development plans and outcomes stems from a failure to translate strategic plans into national and sectoral priorities, as well as resource allocation (Masanjala 2023). Underlying macroeconomic frameworks were often overly optimistic and not based on the economy's capacity. Other factors that derailed plans include a political order characterized by clientelism (see Chapter 5), and a failure to incentivize the private sector to work towards the vision (see Chapters 3 and 4). Development partners, whose funds account for most development spending, often contribute to the ineffectiveness of development planning by bypassing central planning ministries. Their plans and ambitions not only strongly influence the national agenda but can take precedence over national aspirations.

The legacy of the current decade, whether as a time when macroeconomic fundamentals were created for long-term growth or as the start of another period of economic decline comparable to the 1980s, will largely hinge on the direction of macroeconomic

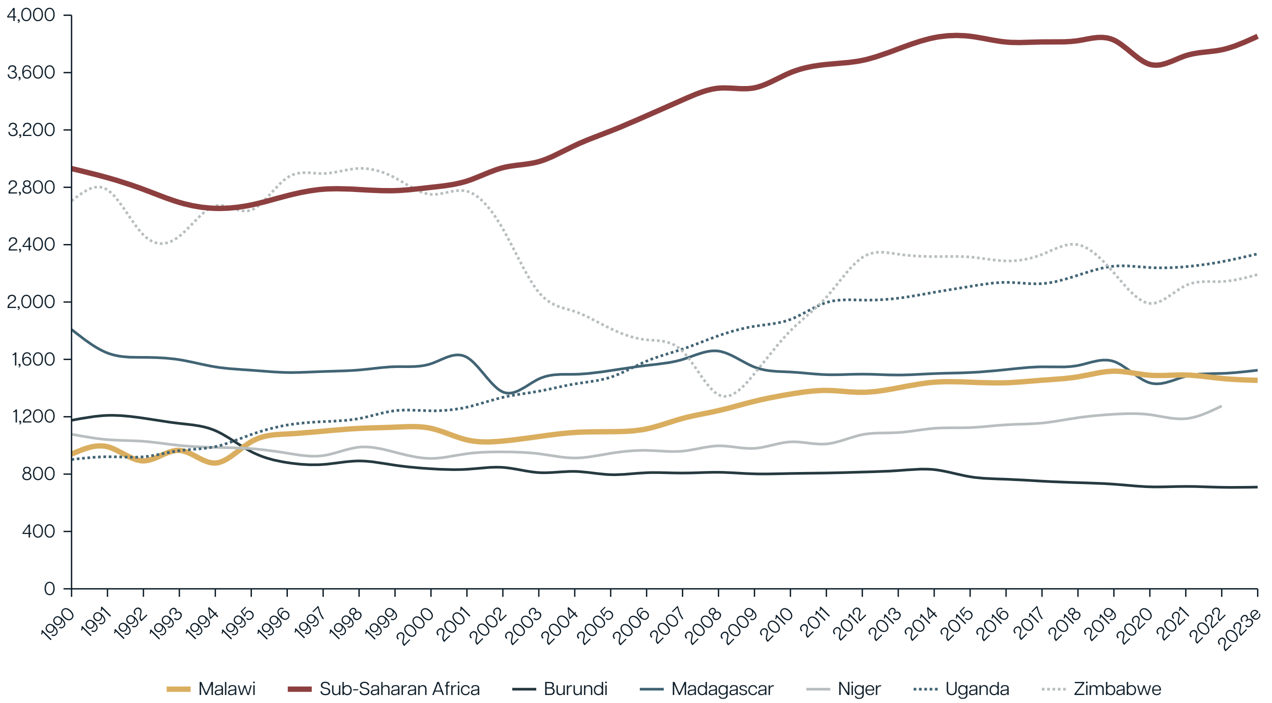
policy. Malawi's economy has been in crisis since 2020. While external events bear some responsibility, sustained macroeconomic imbalances and persistent microeconomic challenges have exerted a more significant impact on Malawi. Most importantly, the current crisis could present an opportunity for reform and for a departure from "business as usual." However, many aspects mirror those of the 1980s, including escalating public solvency and balance of payment challenges, along with persistently high inflation.

Malawi's economy is on a trajectory that is comparable to structurally similar countries, but growth is too low to significantly improve welfare

Malawi's per capita real economic growth between 1990 and 2022 has been insufficient to catch up on regional averages (Figure 1.2). At the end of 2022, Malawians produced 56 percent more per capita than they did in 1990, while the average African produced just 32 percent more. However, given Malawi's significantly lower baseline — average African incomes in 1990 were more than three times larger than in Malawi — this did not result in significant economic convergence. The literature on convergence shows that it tends to be easier for lower-income countries to achieve rapid economic growth (Islam 2003).

Figure 1.2 Malawi's economic trajectory is on a par with that of many structurally similar countries

Real GDP per capita in 2017 constant US$ purchasing power parity



Source: World Bank WDI (1990 – 2021) and staff calculations based on World Bank Macro-Poverty Outlook (2022).

A group of peer countries — Burundi, Madagascar, Niger, Uganda, and Zimbabwe — was picked for their structural similarity to Malawi (see Box 1.1). Burundi, Madagascar, and Zimbabwe are poorer today than they were in 1990, but of these only Burundi has a lower per capita GDP than Malawi. Niger's economy has seen limited expansion since 1990 (18 percent increase in per capita GDP) while Uganda, starting from an even lower baseline than Malawi, expanded its output by 253 percent.

Box 1.1 Selection of comparator countries

Peer countries were selected for facing similar structural economic challenges to Malawi. First, this includes a geography that makes trade inherently costly through large distances to major trading routes, such as being landlocked or, in the case of Madagascar, an island. Second, the economies of peer countries, as of 1990, were to a similar degree dominated by agriculture, with the exception of Zimbabwe where agriculture dominated employment but was a minor share of production in the 1990s. Third, a high vulnerability to shocks is a defining feature of Malawi's economy that peers share. Malawi is one of the countries that is most vulnerable to climate change. How the country addresses these risks will increasingly define Malawi's economic trajectory (World Bank 2022a). Peer countries also exhibit many of the policy challenges, such as fiscal, monetary, and external imbalances, that define Malawi's recent economic developments. Lastly, socio-economic similarities, such as being on the same continent and largely spared from violent conflicts, were considered salient characteristics.

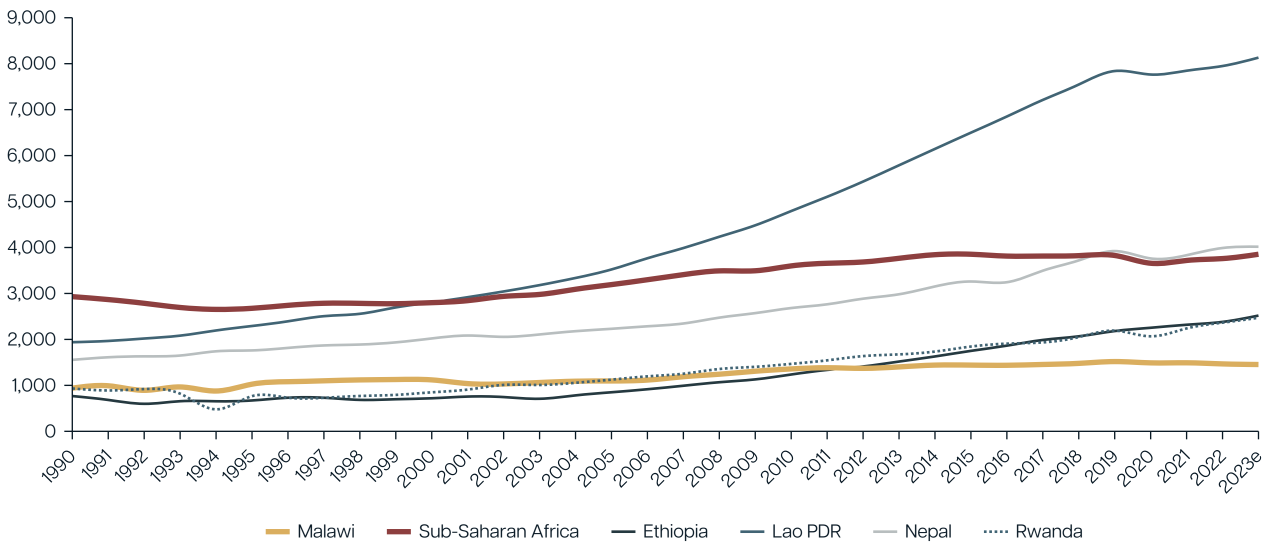
For this CEM, we selected nine countries grouped into "structural peers" and "aspirational peers." Structural peers meet the criteria outlined above and exhibit similar growth outcomes as Malawi. Aspirational peers share many of the same structural characteristics. However, Ethiopia, Lao PDR, Nepal, and Rwanda, which were selected as aspirational peers, have undergone a much more comprehensive economic transformation over the past three decades. They had a comparable starting point in 1990 as Malawi but were better able to decrease their reliance on subsistence agriculture through a focus on macroeconomic stability and export-led growth. Consequently, real per capita production among aspirational peers is on average 3.1 times higher today than it was in 1990. While several aspirational peers have less democratic governance system than Malawi, most existing evidence indicates a long-term link between democratic governance and growth given greater investment in human capital, more stability, and greater economic freedom (Acemoglu et al. 2019; Doucouliagos and Ulubaşoğlu 2008).

A few countries were able to achieve much higher growth despite similarly challenging circumstances

While Malawi's per capita GDP has increased by half since 1990, some otherwise structurally similar countries have grown by at least 150 percent during the same time (Figure 1.3). Lao PDR is the top performer in the group, quadrupling per capita GDP since 1990. Ethiopia started its period of high growth later but was the world's fastest growing country during the 2010s, more than tripling its per capita economic output in the process.

Figure 1.3 Malawi's economic trajectory lags behind that of top growth performers

Real GDP per capita in 2017 constant US$ purchasing power parity



Source: World Bank WDI (1990 – 2021) and staff calculations based on World Bank Macro-Poverty Outlook (2022).

Nepal and Rwanda are stories of rapid turnaround. Both were involved in conflicts during the 1990s and among the smallest economies in their respective regions. None of their growth experiences were without setbacks and the cases illustrate that countries do not need to get everything right to embark on rapid economic growth. Some of these setbacks were caused by external shocks, such as the Gorkha earthquake in Nepal in 2015 that killed nearly 9,000 people. Moreover, even though they managed to significantly improve average incomes, some of these countries now face comparable macroeconomic challenges as Malawi, such as Ethiopia's ongoing BoP crisis or Lao PDR's increasing debt burden.

Aspirational peers illustrate that long-term growth often requires a clear growth vision and the alignment of macroeconomic and sectoral economic policy design and implementation with that vision. These countries were able to attract the investment necessary for the rapid expansion of their productive capacities based on clear targets that motivated significant policy reforms. Their growth experiences were often also marked by deliberate planning to prioritize growth and the determined implementation of these plans. In contrast, policies in Malawi have often been reactive and have not addressed root causes of the country's economic stagnation despite the articulation of well-designed growth and development strategies (Masanjala 2023). The high-level Growth Commission, looking at a wider set of countries, found that while all governments "are sometimes clumsy and sometimes errant," leadership and effective government are a necessary requirement for high economic growth (Commission on Growth and Development 2008, p. 6).

Each country's growth story also has its idiosyncratic components that may provide valuable lessons for Malawi. Lao PDR has leveraged its proximity to Thailand and China to advance its own success, while Rwanda transformed an otherwise difficult starting point — a small, land-locked country with a history of conflict — through strong economic governance. Ethiopia shows how a country can achieve moderate levels of industrial growth despite a challenging geography (being landlocked in a conflict-affected region) and possessing its own complex political economy, and Nepal illustrates how to bounce back from frequent natural disasters.

Growth requires investment, which has not been forthcoming for Malawi

The majority of investment typically comes from domestic savings, which have been low in Malawi. Malawian savings amounted to 11.0 percent of GDP in 2019[6] (Figure 1.4). At the time, only seven out of 161 countries with available data reported lower figures. This came after a rebound in savings rates from a low of 3.6 percent in 2016. Structural peers tended to save more than Malawi, which experienced a rapid deceleration of savings since the onset of the COVID-19 pandemic. This is driven by high levels of government consumption and limited household and commercial saving. The expansion of social safety net coverage is unlikely to have driven decreases in savings since much of the underlying expenditure is internationally funded, meaning it does not replace national savings. Moreover, available evidence, including from Malawi, suggests that recipient households increase rather than reduce their savings in response (Bastagli et al. 2016).

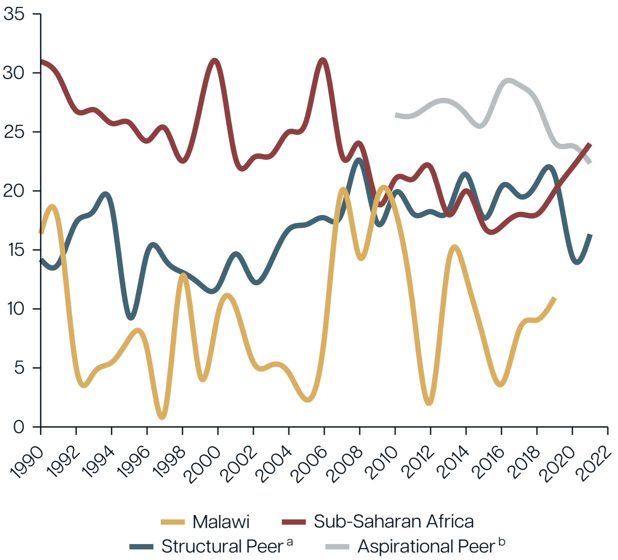
Malawi's investment rates have been chronically low with the exception of two brief investment booms immediately following democratization and in the post-HIPC years. Gross fixed capital formation as a share of GDP stood at just 12.3 percent in 2019, barely half

6. Malawi has not published a national accounts expenditure series, which includes savings and investment rates, since it rebased its GDP in 2020. The 2020 rebasing led to a 38 percent upward revision. Savings and investment figures presented here are based on pre-rebasing national accounts.

the regional norm of 22.2 percent (Figure 1.5). That made Malawi the country with the seventh-lowest investment rate among 171 economies globally, only ahead of Zimbabwe among its peers (which was battling an episode of hyperinflation). Aspirational peers invested more than 2.5 times as much of their production as Malawi, supporting strong growth. Averages hide the diversity in financing strategies that aspirational peers have for their investment. While Ethiopia and Rwanda attract significant foreign financing, Nepal's unusually high savings rates mean that even its robust rate of domestic investment does not completely absorb them. Malawi has in the recent past made some steps towards closing legal and regulatory gaps to enhance the investment environment, including ratifying the New York Convention on Recognition and Enforcement of Foreign Arbitral Awards. However, major hurdles, especially for prospective foreign investors remain, such as limited access to land and comprehensive capital controls (see Chapter 4). Additionally, the misapplication of official policy and law, whether due to weak institutional capacity, rent-seeking or the government's fiscal interests, has negatively influenced perceptions of Malawi's investment environment (International Finance Corporation 2021).

Figure 1.4 Malawi's savings rate is volatile but generally below its peers

Gross national savings as a percentage of GDP

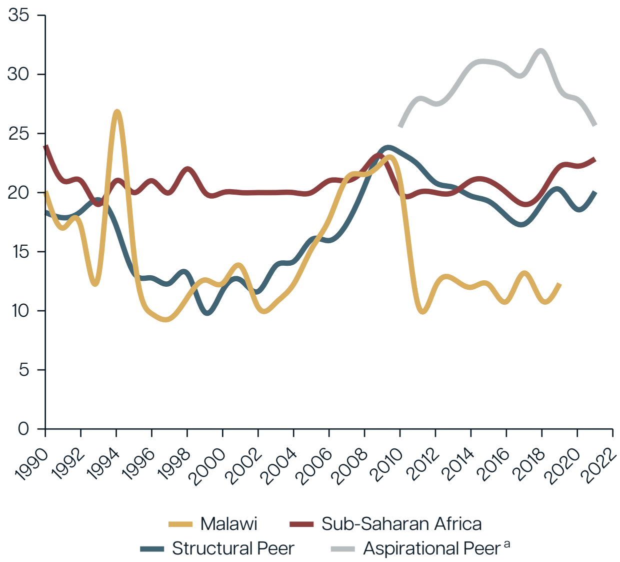


Source: World Development Indicators. April 2021 release for Malawi, latest for peer countries.

a. Excluding Burundi and Zimbabwe; b. Excluding Lao PDR.

Figure 1.5 Two short-lived investment booms only brought Malawi to the regional average

Gross fixed capital formation as a percentage of GDP



Source: World Development Indicators. April 2021 release for Malawi, latest for peer countries.

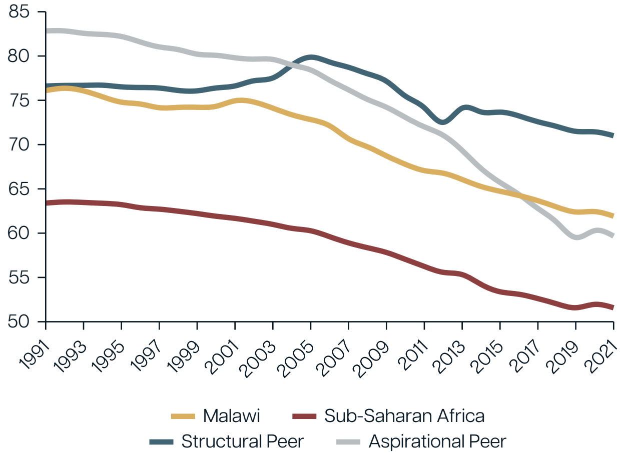
a. Excluding Lao PDR.

Structural transformation – a hallmark of rapidly developing economies – has been slow in Malawi

So far, shifts associated with structural transformation have only proceeded slowly in Malawi. Low-income countries tend to have the vast majority of their population working in agriculture (Herrendorf, Rogerson, and Valentinyi 2013). This is also where a large share of production takes place. The main type of enterprise is the smallholder farm with self-employment dominating (Kuznets 1973). All episodes of significant economic development have included structural transformation, marked by a migration of a large share of workers from agriculture to jobs in the industrial and services sectors, typically within private enterprises. This signifies a shift in the focus of the economy toward more productive industrial and services sector activities and is often accompanied by a move toward more productive firms within the same sector. Internationally comparable International Labor Organization (ILO) estimates indicate that 62 percent of Malawian workers continue to be employed in agriculture (Figure 1.6). This is more than the average for the region (52 percent) and the average for low-income countries (60 percent).

Figure 1.6 Structural transformation reduces agricultural employment

Employment in agriculture as a share of total employment, percent

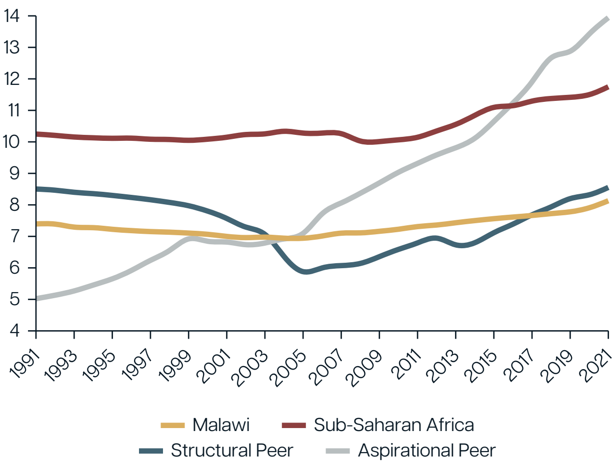


Source: World Bank WDI, based on International Labor Organization ILOSTAT ILO modeled estimates database.

Countries with similar growth outcomes to Malawi maintain an even higher share of their workforce in agriculture, while rapidly growing countries have seen workers move into industrial jobs. Burundi (86 percent), Madagascar (74 percent), and Niger (71 percent) still have higher shares of their population working in agriculture. Rapidly growing economies have especially distinguished themselves by creating jobs in industry (Figure 1.7). Stagnant or declining industry employment shares globally, as is the case for Malawi and its structural peers, have given rise to debates around premature deindustrialization (Rodrik 2016). However, aspirational peers show that countries can diverge from these trends. Services sector jobs have been on an upward trajectory across the region, among aspirational peers and, to a lesser extent, structural peers (Figure 1.8), absorbing the majority of labor freed up in agriculture.

Figure 1.7 Quickly growing countries industrialize much faster than peers

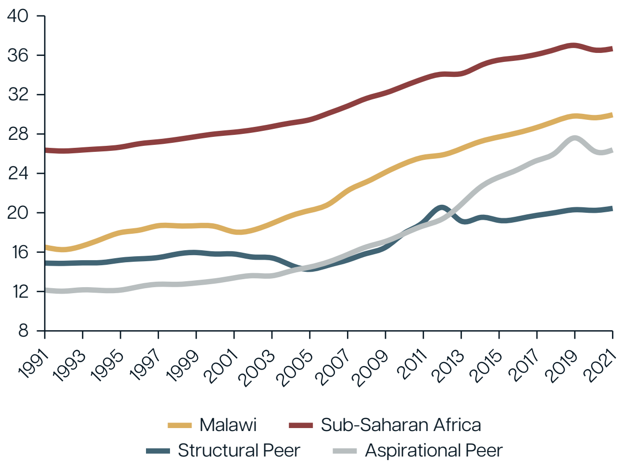
Employment in industry as a share of total employment, percent



Source: World Bank WDI, based on International Labor Organization ILOSTAT ILO modeled estimates database.

Figure 1.8 Services play an increasing role in most economies

Employment in services as a share of total employment, percent

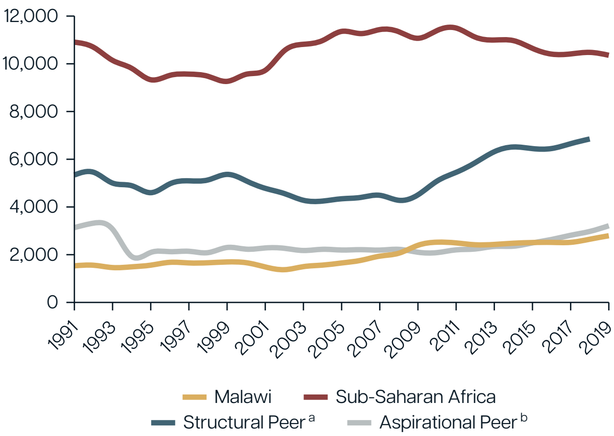


Source: World Bank WDI, based on International Labor Organization ILOSTAT ILO modeled estimates database.

The shift in employment patterns out of agriculture has lifted people into jobs that tend to be an order of magnitude more productive. The value created per worker in industry and services among aspirational peers is roughly in line with the levels observed in Malawi (Figure 1.9 and Figure 1.10). Thus, their faster progress in increasing economy-wide productivity has been driven more by moving workers into the sectors where they are most productive than by more rapid advances in within-sector productivity. Conversely, structural peers show that their higher levels of industrial and services productivity are no guarantee for structural transformation when other obstacles exist in reallocating workers to new sectors (see Chapter 2 for a more in-depth discussion of Malawi's rural employment patterns).

Figure 1.9 **Malawian industry workers are as productive as those among aspirational peers; there are just fewer of them**

Industry (incl. construction), value added per worker in constant 2015 US$

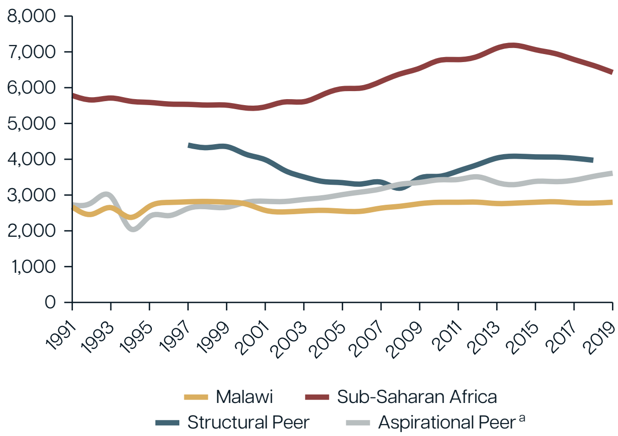


Source: World Bank WDI, based on World Bank National Accounts and International Labor Organization ILOSTAT database.

a. Excluding Madagascar; b. Excluding Lao PDR.

Figure 1.10 **Services workers are much more productive than those in agriculture but Malawian services workers still lag peers**

Services, value added per worker in constant 2015 US$



Source: World Bank WDI, based on World Bank National Accounts and International Labor Organization ILOSTAT database.

a. Excluding Lao PDR.

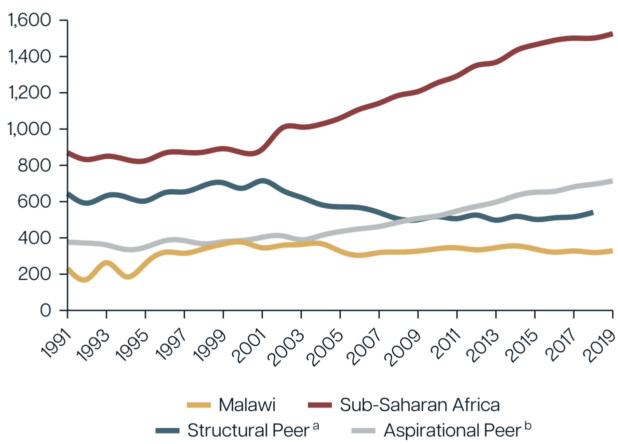
Shifting employment out of agriculture has contributed to making the sector much more productive among aspirational peers on a per-worker basis. Meanwhile, increased population pressures depress agricultural productivity in Malawi relative to its peers (Figure 1.11). Opportunities outside of agriculture can spur the commercialization and professionalization of agriculture as farmers serve expanded local markets and underpins productivity growth over the medium term. Additionally, non-agricultural opportunities can make scarce resources such as land and water available to the most productive farmers. However, in the absence of such employment opportunities, as in the case of structural peers, labor productivity in agriculture can suffer despite the availability of enhanced technical inputs.

While rapid developers leverage trade, Malawi's export performance has been declining

Increased global trade has been a key ingredient for all rapidly growing countries, and Malawi's aspirational peers more than tripled the role of exports in their economies (Figure 1.12). In particular, the integration into global value chains (GVCs) has been a boon to countries experiencing strong catch-up growth. For example, in Ethiopia, firms participating in GVCs are more than twice as productive as similar firms that participate in regular, non-GVC trade (World Bank 2020). However, the global trading environment

Figure 1.11 **African farmers have become much more productive recently but not in Malawi**

Agriculture, forestry, and fishing, value added per worker in constant 2015 US$



Source: World Bank WDI, based on World Bank National Accounts and International Labor Organization ILOSTAT database.

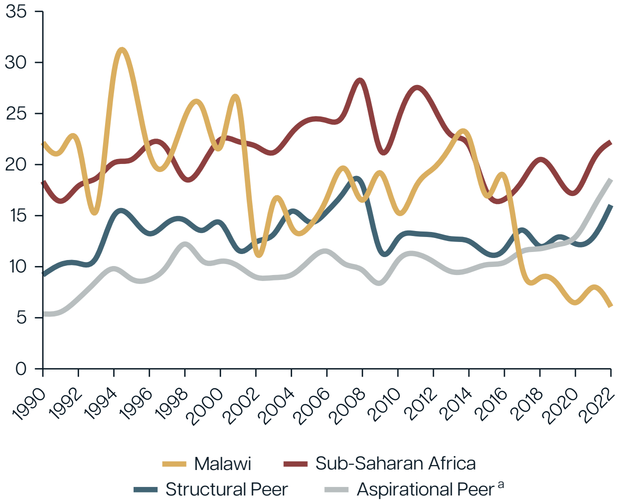
a. Excluding Madagascar; b. Excluding Lao PDR.

is becoming increasingly challenging, with global growth in trade sluggish since the global financial crisis of 2008 and new threats emerging, including trade conflicts among large economies and the arrival of new labor-saving technologies.

Leveraging trade makes particular sense for countries with small domestic markets in global terms. Malawians earn only 0.01 percent of global income, which is insufficient to support most modern value chains. At US$25 trillion, the global market for merchandise exports is more than 2,000 times larger than Malawi's domestic market. Thus, the potential gains for Malawian firms from targeting international markets and for all Malawians obtaining the best inputs and goods available globally are especially high.

Figure 1.12 In contrast to higher achievers, Malawi's exports are in decline

Merchandise exports as a share of GDP, percent



Source: World Bank staff calculations based on World Bank WDI based on World Trade Organization, World Bank WDI based on World Bank National Accounts, and World Bank MPO.

a. Excluding Lao PDR.

Malawi's export performance has nevertheless been declining over recent decades. With strong commodity exports, Malawian exports as a share of GDP in the 1990s were ahead of regional averages and those of structural and aspirational peers. This relationship was reversed, with Malawi exporting less than 40 percent of the output that is typical for an African country. This has immediate macroeconomic consequences, including external balance and foreign exchange challenges, as well as microeconomic impacts. Exporting firms tend to become more productive over time, while firms relegated to the domestic market have fewer incentives to increase their competitiveness. These issues are discussed in more detail in Chapters 3 and 4.

MALAWI'S LONG-TERM GROWTH OUTLOOK

Economic models can help in understanding the potential impact of different growth drivers that could be affected by economic policy. This CEM uses the World Bank "Long-Term Growth Model" (LTGM), which depicts a baseline scenario showing the most likely outcome if growth fundamentals are carried forward into the future (Loayza and Pennings 2023). In addition, we present four additional scenarios that represent fundamental shifts in government policy (Figure 1.13). The model sets itself apart from other economic modeling exercises in the forecasting of long-term average growth rates to be expected given growth fundamentals (see Annex 1.1 for a more detailed discussion of the technical formulation and input variables).[7] This also distinguishes the LTGM from the National Planning Commission's "Foresighting Project" (NPC forthcoming).[8]

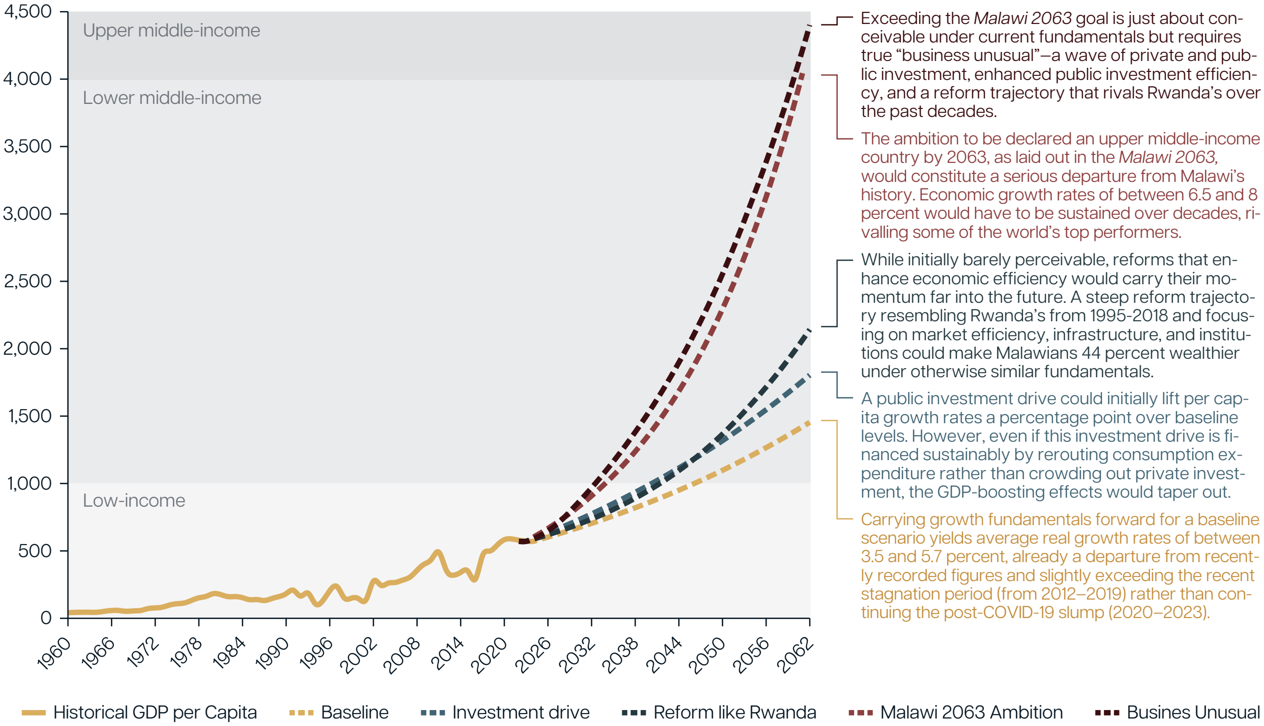
The LTGM concurs with modeling under the National Planning Commission's "Foresighting Project" that, under current fundamentals, the *Malawi 2063* goals are likely to be missed by a significant margin. The Foresighting model expects lower middle-income

7. The World Bank conducts other economic modeling exercises, including through its Macro-Fiscal Model (MFMod), which informs the biannual Macro-Poverty Outlook (MPO) for each country. MFMod provides a comprehensive macroeconomic forecast without scenario elements. An adaptation of MFMod to take into account climate change dynamics is presented in the Malawi Country Climate and Development Report (CCDR, World Bank 2022a).

8. The NPC's model integrates an economic module that already is significantly more complex than the LTGM into a much larger model aimed at giving a comprehensive account of Malawi's development trajectory.

Figure 1.13 The LTGM illustrates scenarios of Malawi's potential future

Real 2018 US$ per capita



Source: World Bank analysis using the LTGM.

status to be achieved by 2048, with income levels significantly below the upper middle-income target by 2063. Similarly, the LTGM model presented here sees lower middle-income status achieved by 2046 under baseline assumptions, with income levels slightly more than one-third of the envisioned value by 2063.

Required growth levels to reach the 2063 goal are very ambitious but not without international historical precedent. To achieve the 2063 goal, Malawian per capita incomes would have to increase by 5.1 percent between 2024 and 2063. Some aspirational peers have achieved this over extended periods. For example, Ethiopia's per capita GDP expanded by 5.6 percent on average between 2000 and 2022, despite this period including a civil war and the impacts from the COVID-19 pandemic. The "2063 Goal Scenario" assumes that, while other fundamentals remain the same, investment is increased to the level where the 2063 goal is achieved. While initially ramping up investment to slightly above 20 percent of GDP (a figure in line with regional norms) would be enough to achieve the desired growth levels, toward the end of the modeling period Malawi would have to reinvest more than half of its GDP to achieve its production goals — a figure that is clearly unattainable.

The "Investment Drive Scenario" shows that while increasing public investment at the expense of reduced consumption is important, growth effects fade when not backed by a private investment surge. For this scenario, a permanent increase in public investment to 7.3 percent of GDP was assumed, while private investment remained unaffected. This entails financing investment by reducing government consumption and redirecting external grants to avoid crowding the private sector out of the limited available funds. Historically, the vast majority of public investment has been financed through development assistance.

However, mobilizing assistance at the necessary scale for this scenario may pose challenges. A surge in public investment can lift growth by 1 percentage point over baseline levels in the short and medium term. However, the growth effects would diminish over time, as increased funds are needed merely to maintain the existing public capital stock, and the scenario does not assume complementary accelerated private sector development. Nonetheless, per capita production would be 21 percent higher than at baseline, assuming a 20 percent reduction in government consumption.

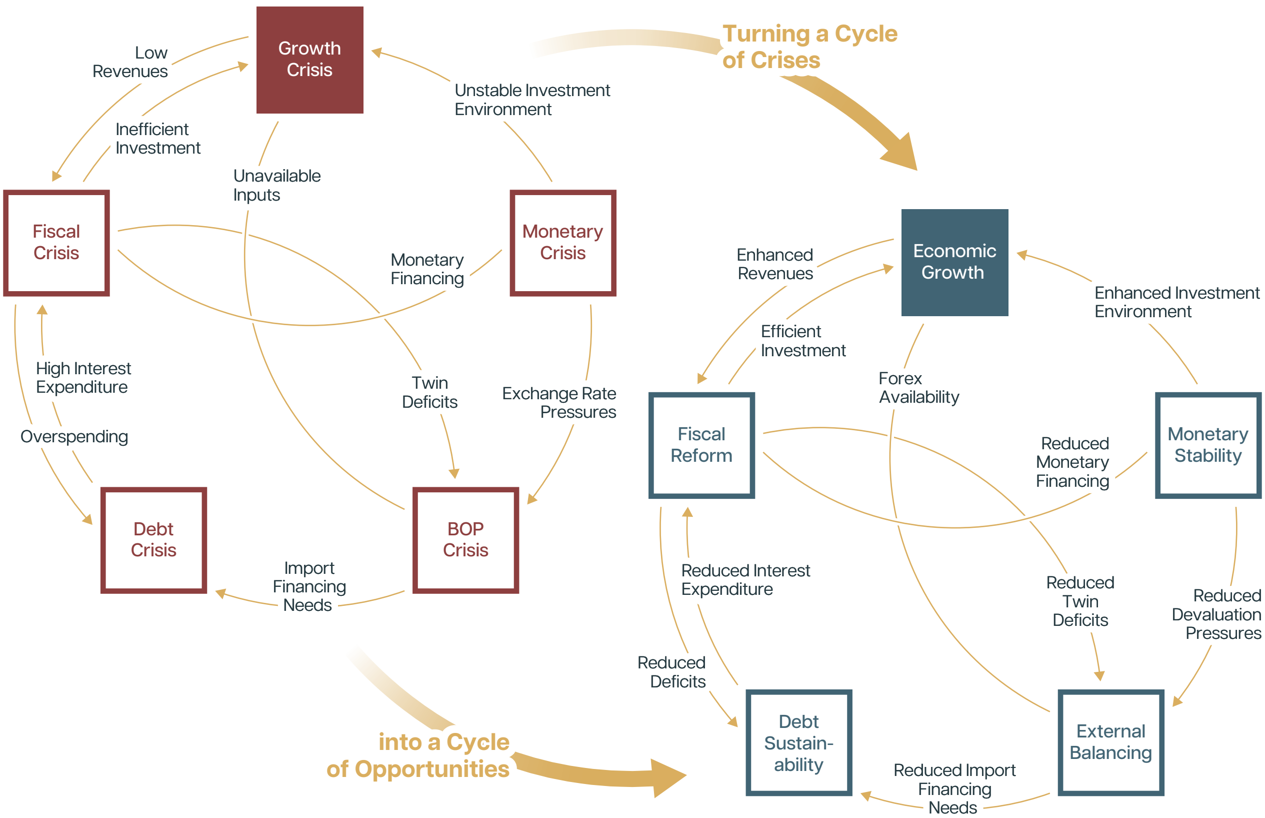
Embarking on reforms that enhance the efficiency of the economy would yield long-term benefits. According to the literature and empirical analysis, five reform domains affect total factor productivity (TFP) growth (Kim and Loayza 2019): innovation, education, efficiency, infrastructure, and institutions. Malawi has made significant strides in several of these domains, although Rwanda has demonstrated even more reform momentum. The "Reform Like Rwanda" scenario is based on the assumption that Malawi embarks on a TFP-boosting reform path that resembles Rwanda's trajectory from 1995 to 2018. This involves, notably, providing adequate electricity, controlling corruption, and improving regulatory quality to enhance economy-wide efficiency. While these reforms would take time to generate growth effects, they are projected to lift income levels by 44 percent over baseline by 2063.

The "Business Unusual" scenario assumes the reorientation of all economic policy toward increasing economic growth, demonstrating that a determined multi-pronged approach can put the *Malawi 2063* goals just within reach. In addition to the ambitious efficiency-enhancing reforms described in the "Reform Like Rwanda" scenario, the "Business Unusual" scenario assumes a focused prioritization of productive investments. On the public side, this entails embarking on an investment trajectory akin to the one outlined in the "Investment Drive" scenario, while also rigorously prioritizing essential infrastructure over less productive investments. This, in turn, is expected to boost the efficiency of public investment by 30 percent. A critical aspect of the "Business Unusual" scenario is ensuring that public investment crowds in, rather than crowds out, private investment. Private investment is assumed to surge to 17.3 percent, a rate not uncommon, as Uganda, a structural peer, achieves similar levels. However, achieving this from Malawi's current status, would require a realignment of macroeconomic and sectoral policy to prioritize the promotion of investment. It requires the promotion of domestic savings funneled efficiently to productive firms operating in a vibrant business environment through a well-functioning financial sector (see Chapter 3). Foreign investors will also need to play a pivotal role due to scarce domestic resources and efficiency constraints (see Chapter 4). However, based on the LTGM simulations, such a comprehensive turnaround is the only scenario that puts the *Malawi 2063* growth goals within reach.

MACROECONOMIC POLICY AND INSTITUTIONS DRIVE GROWTH OUTCOMES

Getting macroeconomic policy right is essential to move Malawi from a cycle of crises to sustained and rapid economic growth. On top of slow growth, Malawi is experiencing a monetary crisis with inflation close to 30 percent and diminished trust in central bank targets. In addition, Malawi's public and external debt is in distress (International Monetary Fund and International Development Association 2023). Malawi's unsustainable debt is rooted in an unsustainable fiscal trajectory, evidenced by a fiscal deficit of 11.8 percent of GDP in FY 2022/23, as well as an acute BoP crisis. These crises reinforce each other and keep Malawi in a cycle of macroeconomic underperformance. Fiscal reform, debt sustainability, external rebalancing, and monetary stability are key components of promoting economic growth (Figure 1.14). Each of these aspects is primarily determined by policy choices. In turn, a substantial shift in policy is critical for Malawi to move from a cycle of crises to one of opportunities.

Figure 1.14 Malawi's macroeconomic policy challenges are all interconnected.



Source: World Bank staff.

The current crisis presents an opportunity to consistently implement improved macroeconomic policy. This section provides details on policy drivers in three critical areas: the management of public debt, the management of fiscal balances, and the management of external balances. Each problem is individually introduced, describing the evolution of the policy issue, its connection to economic growth, and policy options for resolution. Subsequently, an examination explores how implementing policy in a coordinated and consistent manner across these (as well as related policy areas) can generate additional synergies.

Unsustainable debt, driven by fiscal deficits, external balance shortfalls, and governance failures, is a drain on economic growth.

Malawi is in the midst of a public debt crisis. Malawi's latest IMF-World Bank Debt Sustainability Analysis (DSA) shows both Malawi's external debt and overall debt as being in distress (International Monetary Fund and International Development Association 2023) in light of ongoing restructuring negotiations. Furthermore, Malawi's external debt is assessed as being unsustainable. Breaches of sustainability thresholds occur both on liquidity and solvency indicators,[9] with the headline figure of total public sector debt estimated at 75.2 percent of GDP at the end of 2022.

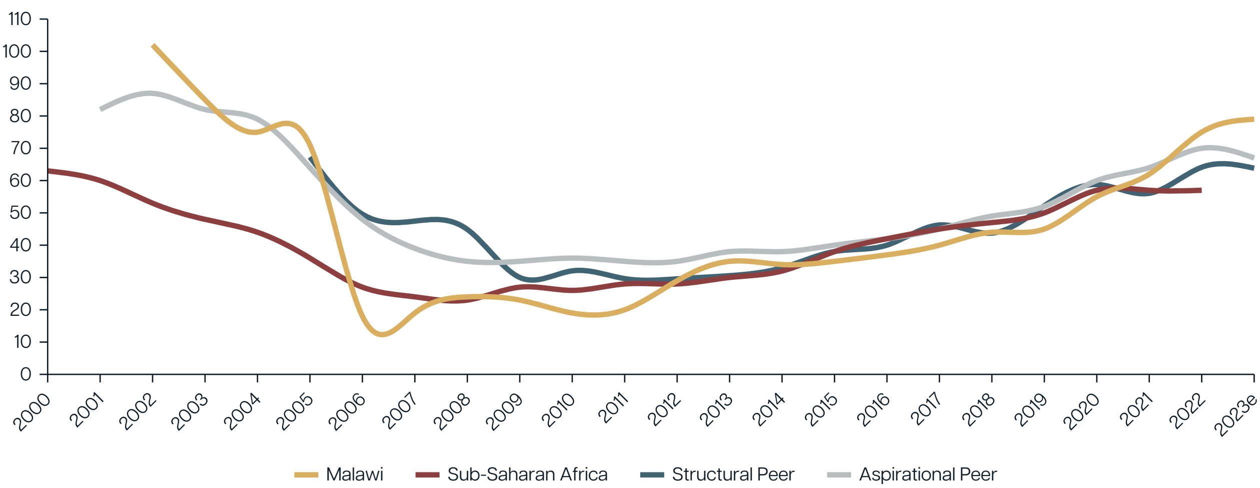
Malawi's debt crisis is driven by the accumulation of high-interest external debt and expensive domestic borrowing. These were used to finance continued fiscal and current account deficits, which drove the sharp rise in public debt. Domestic debt covers the residual budget deficits that are not covered by concessional external financing. Nominal interest rates of up to 33.0 percent on 10-year Treasury notes indicate the high costs of this strategy, despite significant efforts to suppress rates through monetary financing. External debt contracted on commercial terms with plurilateral development banks starting in 2018, which was initially concealed, temporarily covered external balance shortfalls. However, at this stage external debt has reached a level of unsustainability such that it points to governance weaknesses. At contracted terms, the DSA projects that a majority of export revenues would have to be used to repay external loans in the near term.

Costly debt reduces discretionary fiscal expenditure. The high levels of debt require large debt servicing costs, putting pressures on fiscal space for critical public spending. Interest expenses in FY2022/23 account for 39 percent of domestic revenue. Interest payments have become a larger expense than any single sector, including education, agriculture, and health, and the share is expected to increase further in the absence of any significant restructuring. High interest payments leave little room for discretionary investment spending, while low public solvency makes raising finance even for financially viable investment projects challenging.

Ultimately, the extent to which government borrowing contributes to long-term growth largely depends on its strategic use. Figure 1.15 shows that Malawi's debt accumulation patterns, with debt relief around the turn of the century and rapid re-accumulation since

Figure 1.15 Malawi's debt trajectory was not uncommon among peers over many years, but growth in high-cost borrowing over recent years has led to debt distress

Gross public debt as a percentage of GDP



Source: World Bank staff calculations based on IMF WEO 10/2023.

9. DSA liquidity indicators refer to the present value of the debt service-to-exports ratio and of the debt service-to-revenue ratio. The two primary solvency indicators are the present value of the debt-to-GDP ratio and of the debt-to-exports ratio.

the 2010s, are broadly in line with regional trends and those observed among peers. When public borrowing is directed toward growth-enhancing initiatives where the benefits significantly outweigh the financing costs, public debt can be a net gain. In many cases, however, accumulated debt has predominantly become a drain. This explains a complex and idiosyncratic relationship between public debt and long-term economic performance (Eberhardt and Presbitero 2015).

The speed and manner in which Malawi resolves its current public debt crisis has significant implications for its economic growth trajectory. Given Malawi's current debt levels, there is a consensus that debt restructuring is needed to revert to debt sustainability. Economic performance of debtor countries typically improves significantly after debt relief operations, but only if these involve debt write-offs (Reinhart and Trebesch 2016). The speed of restructuring is critical as a country tries to minimize the duration of bearing the costs of being in restructuring, such as increased bond yields and financial disruption, while not yet reaping the benefits of decreased debt stocks. Simultaneously, formulating the appropriate reform package, including measures to support fiscal consolidation and enhance growth, is critical to avoid a serial default (Kose et al. 2022).

Weak fiscal planning and implementation make budgets an ineffective guide to resource allocation

Weak fiscal planning and implementation contribute to continued deficits. Over the last decade, Malawi's fiscal position has deteriorated, culminating in the current fiscal crisis. Despite the stated intentions of successive governments to reform fiscal policy, there has been insufficient action to curb shortfalls. While significant budget deficits have been planned for, budget overruns have exacerbated negative budget outturns (Box 1.2).

Box 1.2 How deficit budgets, weak implementation, and underreported deficits drive public debt

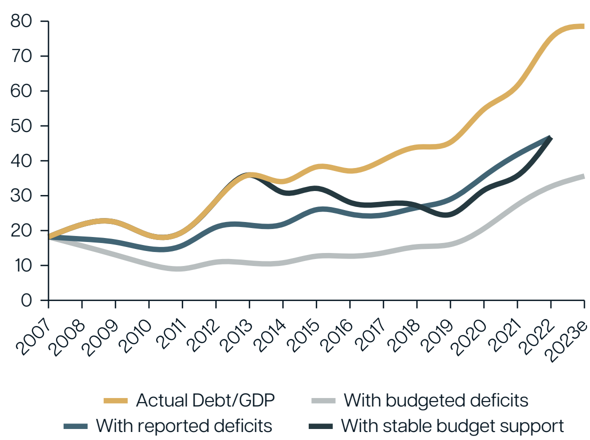
Debt levels can be predicted based on budgeted deficits, reported deficits, and continued budget support. . In the previous CEM (Record, Kumar, and Kandoole 2018), the authors analyzed whether reported debt levels are explained by reported budget deficits. We extend this analysis to also predict debt levels under budgeted deficits and without the withdrawal of budget support after the 2013 "Cashgate" scandal under otherwise equal fundamentals such as GDP growth and exchange rates.

Rapidly increasing debt levels in all scenarios after 2019 are an indication of poor budget planning, while a spread between the scenarios under budgeted and reported deficits are a sign of budget implementation shortcomings. Recent approved and released budget deficits were too high to contain the accumulation of public debt. Additionally, budgeting has not sufficiently taken account the withdrawal of budget support in the wake of the "Cashgate" scandal. Had budget support been maintained at 5.3 percent of GDP – the norm between 2007 and 2013 – debt levels would have decreased until 2019 with the same expenditure levels.

A large and increasing spread between reported debt levels and those implied by reported deficits are an indication of weaknesses in fiscal governance. These increases cannot be explained with reported fundamentals, pointing to the additional unreported use of fiscal resources.

Figure B.1.2.1 Where does debt come from?

Predicted and actual debt levels as a share of GDP



Source: World Bank staff calculation based on MoFEA data.

Easily predictable expenditure items have repeatedly exceeded their allocation, pointing to institutional rather than technical causes of budget overruns. On the revenue side, the Malawian authorities frequently applied significant optimism in the prediction of grant inflows. Expenditure overruns were driven by interest expenditure and compensation of employees, which are largely predetermined and therefore should be easily forecastable at the start of the financial year.

Low trust in budget institutions prompted development partners to establish parallel systems to deliver assistance. Since the 2013 "Cashgate" scandal, external budget support and grants have been significantly reduced, with adverse effects on the funding level of government operations. Despite the prospect of resumed budget support and significant technical assistance from development partners, the authorities have not been able to re-establish a system where most development partners have confidence that contributions effectively lead to development impacts.

Financial management systems have not been effective in containing expenditure to budget ceilings. The Government's Integrated Financial Management Information System (IFMIS) should play a key role in containing expenditure. Ministries, departments, and agencies (MDAs) are required to conduct all processes pertaining to the implementation of the state budget in the IFMIS. However, non-compliance with IFMIS procedures has resulted in frequently reported expenditure overruns and contractual commitments to expenditure in excess of their approved ceilings. Aggregate overruns and the accumulation of arrears are the direct consequences of such procedural shortfalls.

Despite elaborate budgeting institutions, these have proven ineffective in ensuring that budgets serve as a useful guide to actual resource allocation in Malawi. The Ministry of Finance (MoF), MDAs, and the legislature all have designated roles in the budgeting process.[10] Non-compliance with these processes undermines the entire system. For instance, limited scrutiny of budget outturns and the resultant lack of any disciplinary action by the legislature removes incentives for MDAs and the MoF to adhere to ceilings agreed upon with the legislature. This, in turn, hampers the ability to prioritize and rationalize expenditure, including on potentially substantial implicit subsidies currently delivered through budgetary mechanisms, as much as through the state-owned enterprise and other parastatal sectors.

Without effective budgeting it is impossible to prioritize the most growth-enhancing expenditures. Certain government expenditures have significantly greater impacts on raising growth and the standard of living of Malawians than others. Governments equipped with effective mechanisms to prioritize the most efficient expenditure items are more adept at promoting growth. The various stakeholders involved in the budgeting process offer potential entry points for improvement. While any substantive reform typically includes improved performance by the MoF, the legislature or civil society could potentially contribute to a virtuous cycle through increased pressure on policymakers. However, institutionalizing enhanced accountability is a medium-term endeavor, and rebuilding trust in systems requires a demonstration period.

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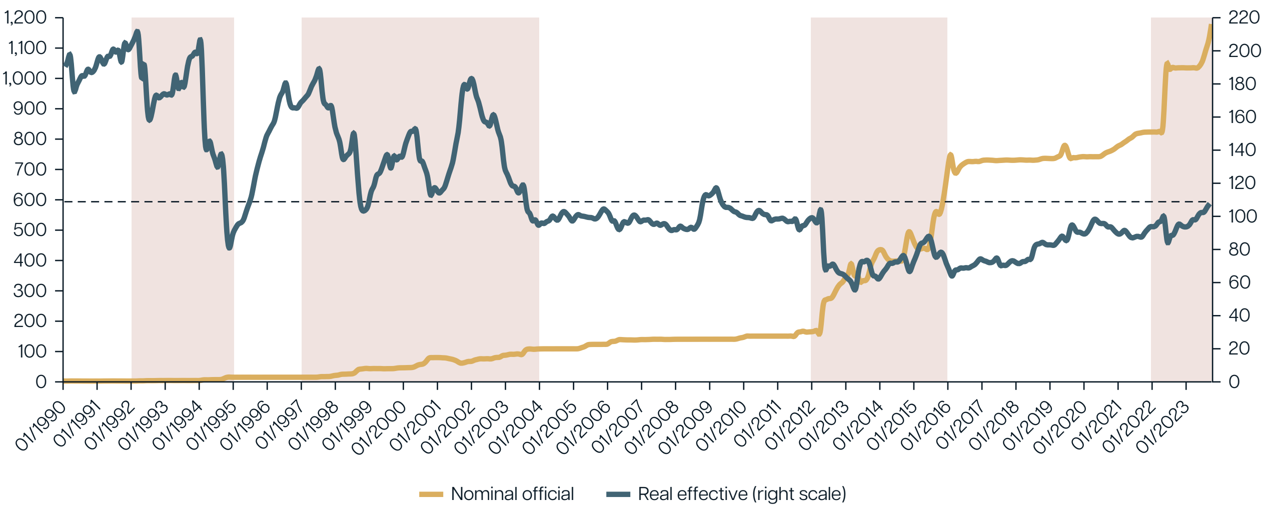
10. In principle, the MoF prepares a fiscal framework, prioritizes MDA demands for resources, and then oversees budget implementation. MDAs prepare credible cash flows and spend funds under MoF guidance. The legislature scrutinizes both budget estimates and outturns.

Inadequate management of external balances promotes costly BoP crises

Malawi's BoP crises have been correlated with phases of weak economic growth. There have been four acute BoP crisis periods starting in 1992, 1997, 2012, and 2022 (Nur 2023; Figure 1.16). These crisis periods are marked by a shortage of foreign currency reserves to pay for imports or to service foreign liabilities, leading to a forced depreciation of the Malawi kwacha.

Figure 1.16 Malawi has entered its fourth acute BoP crisis in as many decades

Nominal official exchange rate in MWK per US$, real effective exchange rate indexed (2010 = 100, RHS), BoP crisis periods indicated in grey



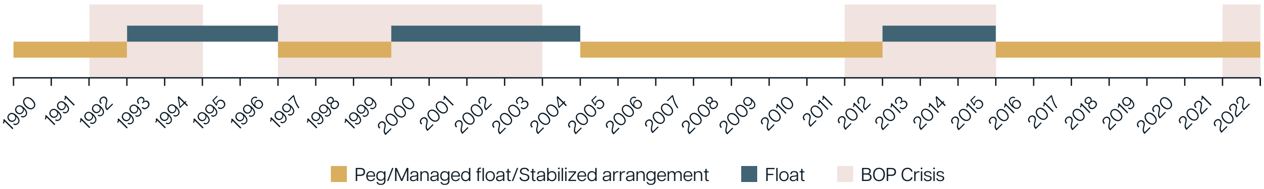
Source: World Bank staff calculations based on IMF IFS.

A large and increasing trade imbalance, intensified by periodic ToT shocks, has been the primary driver of BoP imbalances. With a trend of rising imports and decreasing exports, Malawi's trade imbalance has been rising. Recurring ToT shocks, exacerbated by Malawi's narrow import and export baskets, lead to spikes in the trade imbalance, such as when oil and fertilizer prices quickly rose after the COVID-19 pandemic and with the onset of Russia's invasion of Ukraine. The money that Malawi earned (primary income) and received (secondary income) from abroad, along with one-time transfers for investment (capital transfers), was not enough to make up for the fact that Malawi purchased more imports than it sold in exports to other countries. To deal with this issue, Malawi had to rely on financial solutions (its financial account), such as by increasing borrowing.

Malawi went into each BoP crisis with a managed exchange rate and only overcame these crises after floating the kwacha. Exchange rates can serve the critical function of absorbing trade and other BoP shocks. By making imports more expensive, they limit import demand, while also incentivizing the retention of foreign exchange in Malawi. Exchange rate speculation can assist price discovery in a well-developed system, balancing current transactions over a longer time horizon (Hayward 2018). In a floating exchange rate regime with developed markets this leads to exchange rates closely approximating random walks. In turn, the current foreign exchange rate becomes the most reliable predictor of future exchange rates, incorporating all available information on the underlying international value of a currency (Rossi 2013). It also makes the generation of additional foreign exchange more attractive by increasing the domestic purchasing power of exports. However, the Malawian authorities have tended to not take advantage this balancing channel (Figure 1.17). The consequence is the scarcity of foreign exchange at any price and the

Figure 1.17 A history of policy reversal

The evolution of Malawi's exchange rate regime



Source: World Bank staff calculations based on data from IMF Annual Reports on Exchange Arrangements and Exchange Restrictions.

allocation of foreign exchange through administrative measures, as well as frequent scarcity of essential imports (see Box 1.3). Exchange rate misalignment also repeatedly coincided with the dualization of the exchange rate, creating arbitrage opportunities and providing incentives for informal trade (see Chapter 4).

Box 1.3 Weak external balance management combined with inadequate sectoral governance leads to Malawi's periodic fuel crises

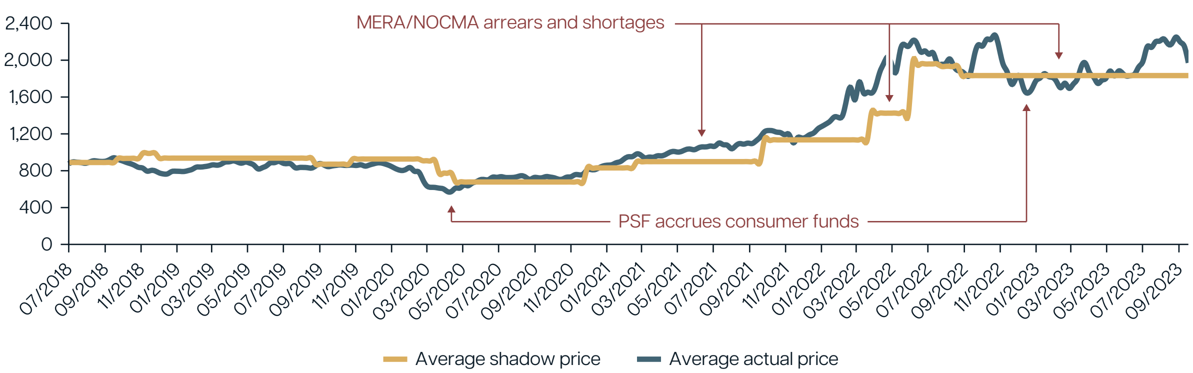
One of the most prevalent symptoms of Malawi's BoP crises is the unavailability of fuel. The unavailability of foreign exchange has wide-ranging effects across the Malawian economy, including challenges in importing essential medical supplies. However, one of the most visible symptoms is the scarcity of fuel, evident in empty fuel pumps. Most recently, fuel pumps ran dry across the country starting in April 2022, with stocks repeatedly running out since. Industry customers report unfulfilled demand since the second half of 2021.

Unavailability of foreign exchange combines with weak sectoral governance to cause these shortages. Since Malawi imports the vast majority of motor fuels, a severe scarcity of foreign exchange means that motor fuels also become unavailable. The sector receives some official financing support, but since official international liquidity tends to be low during crises, such support is circumscribed. Since the price of fuel is closely regulated, financing can also not be profitably obtained on parallel markets. The Automatic Fuel Price Mechanism, which was developed in response to the 2011 fuel crisis, operates under the assumption of a unified, market-determined exchange rate. Furthermore, adjustment to changes in international prices can be slow, indicating policy implementation shortcomings.

Intervention leads to shortages with limited cushioning of consumers from price shocks. World Bank analysis shows that, with some delay, administered fuel prices closely track the economic costs of fuel. This means that the stated policy goal of interventions, such as cushioning consumers from price shocks through the Price Stabilisation Fund, is not achieved. In addition, when the administered price of fuels is below economic costs of fuel, public entities such as MERA and NOCMA in the fuel sector tend to accumulate debts.

Figure B.1.3.1 Small mismatches with major effects

Economic costs of fuel and pump prices



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

Note: Averages are taken between diesel and petrol. 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.

The adequate management of Malawi's external balances is critical to sustained economic growth. While Malawi recorded average GDP growth of 6.1 percent in years outside crises since 1990, growth during BoP crisis years was only 1.6 percent. At the same time, Malawi never fully experienced the benefits associated with trust in the long-term viability of external balances or the institutionalization of growth-enhancing external sector policies, such as openness to foreign direct investment (FDI) and a highly liquid foreign exchange market.

There is scope to improve the management of official reserves, external debt, and financial openness to promote external resilience. Official foreign exchange reserves have historically been low in Malawi and tend to be accumulated during BoP crises rather than providing a crisis buffer. Malawi has also decreased its foreign exchange holdings *after* making its exchange rate less flexible — a deviation from the conventional paradigm suggesting that more flexible exchange rate regimes require fewer reserves than fixed rates (Choi and Baek 2004). Similarly, public external debt incurrence is largely unaffected by crises, indicating that this channel does not actively cushion BoP shocks. Financial openness is chronically below regional and global norms, with the stance not softened as a policy tool to attract transfers during BoP crisis periods. Being dependent on foreign aid, Malawi has also struggled to smooth transfers through Official Development Assistance (ODA) with dips in the run-up to several of Malawi's BoP crises. World Bank and IMF programs have not succeeded in institutionalizing more sustainable external balance management practices. Despite nine International Monetary Fund (IMF) programs since 1994 with external stability as a program goal,[11] there have been frequent reversals on targeted policy impacts.[12]

Macroeconomic policy requires support from sectoral policies. For instance, enhanced price stability enables the mobilization of greater domestic savings for investment. However, private investment will crucially depend on the prospects that businesses see for higher returns, requiring an improved business environment to translate into economic growth. At the same time, increased monetary stability would also allow more Malawians to rely on markets rather than their own agricultural plots for their livelihoods, in turn supporting structural transformation and agricultural commercialization. Similarly, external balancing will alleviate critical foreign exchange constraints on exporting firms, contributing to a virtuous feedback loop between macroeconomic reform and export-led growth. All these examples highlight the importance of integrating macroeconomic, sectoral, and microeconomic policies into a comprehensive reform agenda.

Many of Malawi's macroeconomic policy challenges stem from governance issues as much as from technical problems. Many principles of macroeconomic policy enjoy broad consensus among economists and policy makers and often the wider public, both in Malawi and abroad. For instance, fundamental ingredients of monetary stability such as central bank independence and abstaining from monetary financing are enshrined in Malawian law. The failure to achieve monetary stability in Malawi therefore points to implementation challenges rather than ambiguity on the technical level. Therefore, a dedicated chapter in this CEM addresses overcoming these types of implementation challenges (see Chapter 5).

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11. This has been explicitly the case since the introduction of explicit program goal recording, and implicitly through Quantitative Performance Criteria and Structural Benchmarks on reserves and exchange systems before that.

12. Likewise, there have been 10 World Bank Development Policy Operations (DPOs) in the same time frame, some of which have attempted to incentivize external stability.

MACROECONOMIC POLICY REFORMS TO GET MALAWI BACK ON TRACK

Malawi has the human capital required to achieve its growth ambitions, but what it currently lacks is the investment to enhance productivity. Malawi's population is expected to continue growing, with the share of working age Malawians growing at one percent per year, presenting a potentially strong demographic dividend. Moreover, Malawians are well-positioned to be productive, benefitting from relatively good health and education outcomes, as evidenced by the Human Capital Index, where Malawi ranks between Botswana and Iraq, two much wealthier countries. The main finding from the long-term growth modeling exercise is that the scarcity of capital is the limiting factor for Malawi to achieve higher growth levels. While initiating reforms that promote efficiency across the economy is crucial to sustain a long-term growth momentum, immediate and substantial growth can be attained by removing obstacles that constrain investment. This aligns with the chapter's analysis of structural transformation dynamics, which shows that to thrive economically Malawians need to move from fields into factories, workshops, and offices — all of which require investment.

Getting Malawi back on track will require determined macroeconomic reforms. This chapter delves into specific macroeconomic policy drivers of growth, while Chapter 5 provides details on systemic governance reforms that can serve as the foundation for accelerated change. The analysis in this chapter showed that Malawi's policy environment is not yet aligned with the requirements for rapid economic growth. To embark on the "Business Unusual" scenario, which is the only one compatible with envisioned growth targets, decisive reforms are essential. These reforms would not only mark a departure from growth patterns since independence but also have transformative effects on the standard of living of Malawians, helping reduce persistently high poverty levels.

A successful departure rests on two principles that give rise to five priority actions each in the short and medium term (Table 1.1):

1. **Prioritize growth within government:** Prioritizing growth within government starts with making growth-enhancing public investment possible at scale. To accomplish this, government debt must be sustainable. In the short term, the only way to achieve this is by restructuring external debt, which should be achieved rapidly to minimize the period during which the Malawian economy would suffer from low investment, while not yet benefiting from the growth-boost of debt relief. Given the experiences with two periods of high debt, such restructuring should be accompanied by reforms to make debt sustainability last. This entails reforming debt management. It also requires enhanced fiscal credibility, which demands determined fiscal reform. A crucial first step toward fiscal reform is to demonstrate budget credibility in the current budget by adhering to what was approved. To make this more than a one-off achievement, Malawi will need to invigorate its budgeting institutions and rely on modern systems such as the IFMIS. However, the created fiscal space will only yield positive outcomes if the funds are invested productively. Prioritizing efficient investments means eliminating weak projects by removing them from the Public Sector Investment Program (PSIP), which, in turn, requires robust screening and monitoring. Malawi will not have the means to implement all projects currently in the PSIP, even in the longer term. Allocations to less important projects mean that critical ones are neglected. Expenditure within projects that are known to be growth-enhancing also needs to focus on the capital investment itself rather than compliance with standards.

The increasing impacts of climate change means that addressing key infrastructure constraints must consider new climate-related risk factors. To achieve this, climate change adaptation needs to be mainstreamed in government systems. As a large share of public investment is supported by development partners, aligning their activities more closely to national priorities is essential to ensure rapid progress on growth targets. The focus of public expenditure on growth-effective investment presents both a political and technical agenda. While analyses, including previous and the forthcoming Public Expenditure Reviews, can offer technical insights, it is the responsibility of leaders to set investment targets, display less tolerance for inefficient expenditure (including untargeted subsidies), and demand that public expenditure aligns with national economic development priorities.

2. **Enable the private sector to prioritize growth:** Since the Government alone cannot generate the necessary investments to accelerate growth, it is vital to facilitate private sector investment — as was demonstrated in the LTGM analysis in this Chapter. Following a 44 percent devaluation of the Malawi kwacha, coupled with the announcement of reforms to increase exchange rate flexibility in November 2023, Malawi should strive to maximize the economic benefits from exchange rate reform by institutionally anchoring a market-determined and unified exchange rate. To crowd foreign exchange into official systems, the authorities need to credibly commit to a transparent mechanism that ensures holders of foreign exchange, like prospective investors, receive market-level rates. To sustainably relegate costly BoP crises to the past and foster trust in the new system, the strategic employment of key external balance management tools will be necessary. Unlocking rapid private sector growth from a macroeconomic perspective requires the comprehensive prioritization of growth, including a strategic focus on the business environment that Malawi offers potential foreign investors. Therefore, strategically increasing financial openness is important to increasing productivity and alleviating foreign exchange scarcities. In the medium term, all proposed macroeconomic policy changes should foster an investment climate that encourages foreign as much as domestic investment. This assurance is essential for investors to perceive Malawi as the vibrant and attractive market that it aspires to be.

Table 1. 1 Top five macro-fiscal policy priorities

Policy Issue	Short-Term Actions *(the next 3 – 6 months)*	Medium-Term Implementation *(before the end of 2025)*
1. Achieving debt sustainability and improving debt management	Rapidly conclude negotiations with creditors to achieve sufficient reductions in external debt levels and proceed with implementation of the country's Debt Strategy.	Enhance public debt transparency through increased coverage, adhere to an annual borrowing plan and contain debt levels to pre-defined targets.
2. Proceeding with robust fiscal reforms	Demonstrate that Malawi can operate within its budget in FY 2023/24 by implementing fiscal consolidation measures, increasing domestic revenue, and improving forecasts of pre-determined expenditure.	Enhance legislative accountability to budget estimates and fully implement IFMIS across Government.
3. Enhancing efficiency in public investment	Strengthen public investment management by phasing out investment projects without evidenced impact from the PSIP and not entering any new projects into the PSIP in the FY2024/25 budget that have not been screened and validated in line with PSIP procedures.	Reallocate Government expenditure and development partner resources towards investments that best alleviate key economic constraints and promote resilience to climate change.

Policy Issue	Short-Term Actions *(the next 3 – 6 months)*	Medium-Term Implementation *(before the end of 2025)*
4. Ending the current BOP crises and strengthening foundations to prevent future crises	Support reserve accumulation and create a sustainable and well-supported exchange rate regime, by institutionalizing a market-based and -clearing foreign exchange pricing mechanism.	Maintain a market-determined exchange rate and strategically use official reserves, external public debt, and financial openness to manage external balances.
5. Prioritizing the promotion of productive private investment	Evaluate all proposed major policy changes for their implication on Malawi's attractiveness for investment.	Increase financial and trade openness to make Malawi a more attractive destination for international investors.

ANNEX 1.1

Specification for the Long-Term Growth Model analysis

The LTGM's Technical Formulation

The LTGM attempts to provide the simplest possible forecast of long-term average growth rates to be expected given growth fundamentals. The model is an adaptation of the Solow-Swan model for analyzing future growth paths. The LTGM is based on a single Cobb-Douglas production function and avoids multiple sectors as well as market balancing — issues relevant to shorter-term forecasts. Investment rates are exogenous, as are TFP and demographics. However, some refinements of the LTGM concern demographics, which allow accounting for the demographic dividend, and human capital — two factors that become increasingly important the longer the modelling horizon. Overall, the model remains simple enough to be summarized in three formulas (see below) and for the model to be solved in an excel spreadsheet. All materials needed to replicate this growth modelling exercise can be found on the LTGM website: https://www.worldbank.org/en/research/brief/LTGM

The LTGM can be summarized in three equations:

1. Production function

$$Y_t = A_t K_t^{1-\beta} (h_t L_t)^{\beta}$$

2. Capital Accumulation

$$K_{t+1} = (1 - \delta) K_t + I_t$$

3. Demographics and Labor Market

$$y_t^{PC} = \frac{Y_t}{N_t} = \frac{Y_t}{L_t} \frac{L_t}{W_t} \frac{W_t}{N_t} = [L_t k_t^{1-\beta} h_t^{\beta}] \rho_t \omega_t$$

Where: A_t: TFP; K_t: capital stock , h_t: human capital per worker; L_t: number of workers; I_t: investment; W_t: working-age population; N_t: total population; ρ_t: labour participation rate; ω_t: working-age-population to population ratio; k_t: capital/worker

Baseline assumptions were carefully selected (see Table A1.1). While a focus of the LTGM was to keep data inputs parsimonious to enable estimation for almost every country, including those with limited statistical capacity, economic judgement had to be exercised to select the most robust estimate among contradictory ones.

The UN population projections show that across the *Malawi 2063,* Malawi will enjoy the once-off growth-boosting benefits of the demographic transition. Additionally, Malawi has impressive levels of human capital. Among structural and aspirational peers only Lao PDR, Nepal, and Zimbabwe, countries that were significantly wealthier than Malawi for several decades, outperform Malawi on the Human Capital Index. The recent *Human Capital Review* highlights progress on infant and child mortality and nutrition as a key contributor to this success (World Bank 2023). It sees decreasing fertility, maternal and neonatal mortality, chronic malnutrition, and improving education as well as elevating the women's empowerment agenda as key priorities to continue recent successes. Already realized fertility decreases that started in the 1980s also mean that this generation will likely constitute an increasing share of the total population until the 2060s. This demographic dividend and comparatively high human capital are key growth opportunities for Malawi.

However, climate change will mean that achieving projected baseline growth levels will be challenging. The CCDR modelling shows that climate change could reduce GDP by 8 – 16 percent by 2050 (World Bank 2022a). This notwithstanding, building greater climate resilience to climate change can minimize impacts significantly. If Malawi prioritizes resilience given the stark warnings that recent shocks have delivered, such impacts are within the margin of error for this modelling exercise.

Table A1.1.1 LTGM Input Variables

Variable	Baseline Assumption	Source	Justification
Labour share (β)	47.7%	Penn World Table 10	Sources agree that Malawi's labor share is close to 50 percent. As a reliable and comprehensive source, the Penn World Table was chosen.
Capital Depreciation	6.7%	Penn World Table 10	The Penn World Table is the only major source that calculates capital depreciation for Malawi. 6.7 percent is within the expected range between 5 and 10 percent calculated for peers.
Initial Capital	127% of GDP	MFMoD 2019	Sources diverge in their estimates of initial capital. MFMOD was chosen as this is a source where quality is regularly assured specifically for Malawi by a World Bank team. At only 17 percentage points lower, Penn World Table estimates are similar.
Human Capital Growth	2.0% sloping down to 1.2% by 2040	CEM team estimates	Initial human capital growth is estimated to be the average over the last five years. However, such high growth rates were not sustained over the long term by any country. Thus, a reduction to 1.2 percent growth, a value achieved by some of the historic top performers, was assumed for the medium term.
TFP Growth	0.23%	Penn World Table 10	TFP growth in the LTGM excludes human capital growth making it not directly comparable to more common calculations of TFP. TFP growth has been unstable over recent decades. TFP growth has been estimated to be very high in the early 2000s, but has likely been negative in recent years. The authors chose the 2010 – 2014 average estimated based on the Penn World Table 10 as this has the same order of magnitude as the regional norm (0.5 percent) and is likely to be reflective of long-term trends.
Demographics	UN Projections	UN Population Division	The authors used the UN Population Division central estimates for all models as this represents the premier source on population dynamics.
Investment	14.3% of GDP	World Bank National Accounts	This is the long-term average statistic for when Malawi still reported an expenditure series (2010). This is the only major available source despite some uncertainty surrounding the estimate as it predates the latest rebasing of national accounts.

CHAPTER 2

Commercializing Agriculture and Improving the Prospects for Rural Employment

KEY FINDINGS

1 Two thirds of all Malawian adults work in agriculture and the sector contributes significantly to GDP. However, high poverty rates show that there have been few opportunities to increase rural incomes. Ninety-four percent of all poor households in Malawi are in rural communities and the rural poverty headcount ratio at the national poverty line (57 percent) is almost three times that found in urban areas (19 percent).

2 Although Malawi's economy remains among the world's most dependent on agriculture, the current structure of household agricultural production does not facilitate sustained poverty reduction for most farming households. Due to small landholdings, even if all farming households were able to achieve the agricultural productivity levels of the top 10 percent most productive households, the poverty rate would not see a significant reduction.

3 Farming contributes only 30 percent to the total income of the typical farming household, with these households only deriving about US$20 (in nominal terms) in value per capita annually from their endeavors. Other significant sources of income include casual, short-term *ganyu* employment, more formal, longer-term wage employment, and commercial enterprises.

4 Commercial agriculture is a driver of growth and job creation. While comprising only 7 percent of Malawian households, commercial farmers possess the potential to boost local demand for products and services, thereby stimulating rural off-farm labor markets.

5 Malawi's agriculture sector has largely been shaped by policies emphasizing food self-sufficiency rather than commercial farming. Consequently, the sector has untapped potential for increased growth and job creation. However, commercial farmers have faced obstacles such as unpredictable government interventions in input and output markets, land tenure uncertainty, and an unattractive external trade regime. Addressing these policy barriers and improving institutional capacity to implement planned reforms are crucial steps for achieving agricultural growth and rural economic transformation.

INTRODUCTION

Malawi's economy remains highly dependent on agriculture with the sector playing a critical role in the country's overall macroeconomic performance. Estimates indicate that in 2021, two in three adults derived their livelihoods from agriculture and the sector contributed about 23 percent to the country's total GDP (Malawi Government 2022; see chapter 1). The agriculture sector will remain of central importance for Malawi to achieve its economic and human development objectives for years to come.

The agriculture sector is critical both for household and national food security. Subsistence considerations continue to influence cropping patterns and shape households' engagement with agricultural markets. Since ensuring food and nutrition security through the market is challenging, most farming households rely on their own production to meet the majority of their caloric needs (Benson and Edelman 2016).[13] This situation, coupled with limited access to credit, creates incentives for poor Malawian households to underinvest in productive capital.

Despite this, fewer than 7 percent of households can generate sufficient income from farming to meet their basic needs. On average, farming contributes only 30 percent to the total income of the median farming household, typically MWK 16,190 (about US$20 in nominal terms), in value per capita annually from their efforts (IHS 2019/20). Female-headed households face additional hurdles, experiencing limited access to agricultural resources and services, thereby exacerbating gender gaps in agricultural productivity and the ability to meet basic needs through agriculture (Fisher and Kandiwa 2014).

Malawian agriculture has consistently been characterized by low and stagnant productivity. Approximately 80 percent of farming households operate on the basis of just one rain-fed crop per year, leading to significant year-to-year variability in production. This is further exacerbated by factors such as limited use of improved agricultural technologies, inputs, and practices; poor access to credit and markets; extremely small farmer landholdings compared to regional counterparts; and, increasingly, the impacts of climate change and variability. The average Malawian farm size is only 0.7 hectares (ha), significantly smaller than farms in neighboring countries. The agriculture sector is highly susceptible to climate shocks, with recurrent extreme weather events, including dry spells and devastating tropical cyclones,[14] impacting lives, livelihoods, and the country's socio-economic infrastructure (Government of Malawi 2023). Notably, the second-biggest impact of climate change on the Malawian economy is through shocks to labor productivity (World Bank 2022a). Over the past 15 years, the value added per worker has not only remained below the regional average but shown minimal change (World Bank 2022c). This, in turn, affects Malawians' livelihoods, food security, and resilience, particularly in rural areas. Even with adaptation measures in place, the negative impacts on labor productivity will persist, underscoring the need to shift labor away from agriculture by creating job opportunities in other sectors.

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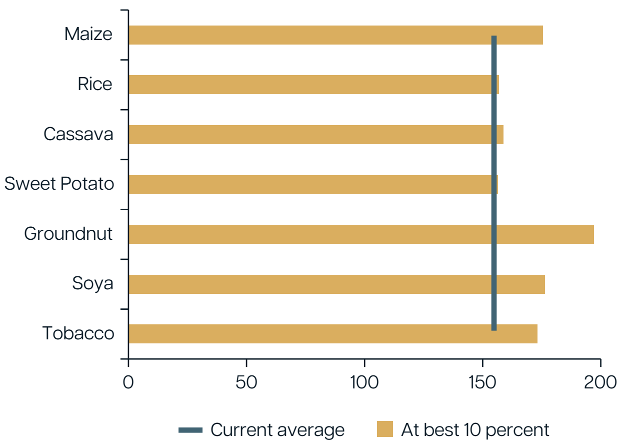
13. As discussed in Benson and Edelman (2016), food security for Malawian households depends to a large extent on own production of food.

14. The effects of Tropical Cyclone Idai in 2019 placed Malawi in the top five countries most affected by extreme weather events, according to the Global Climate Risk Index. Tropical Storm Ana and Tropical Cyclone Gombe (both in 2022) resulted in 64 fatalities and 945,934 people affected; Tropical Cyclone Freddy in 2023 impacted more than 2,267,458 people, including more than 659,278 displaced, and 679 deaths.

Additionally, new analysis presented in this CEM shows that the welfare gains from increased productivity are indeed important, but they are limited for households with small cropland holdings (Benson and De Weerdt 2023). This indicates that even with significantly higher levels of productivity, a farmer with extremely small landholdings is likely to remain in poverty and struggle to meet basic needs. Benson and De Weerdt (2023) demonstrate that if all farming households could attain the agricultural productivity levels of the top 10 percent most productive households, household incomes would increase (Figure 2.1) and the poverty rate would be reduced. However, the impacts would not be transformative, ranging from 1.9 to 9.7 percentage points, depending on the main crop planted (Figure 2.2). Furthermore, the volatility of crop prices means that even farmers with larger holdings cannot be confident that they will always generate sufficient income from their crop production. To meet the basic needs of their members, most farming households, whether poor or non-poor, need to pursue additional economic activities alongside farming. Thus, while agriculture is set to remain Malawi's largest employer over the next decade, it is insufficient to provide a viable pathway out of poverty for most rural Malawians.

Figure 2.1 Significant productivity improvements would not raise incomes by much

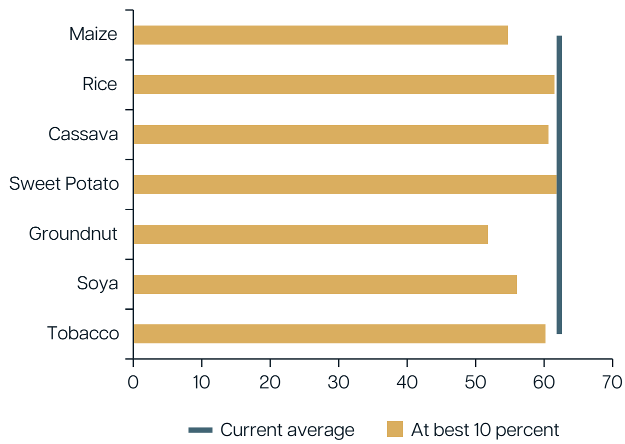
Average annual income (MWK) and income of the 10 percent most productive farmers, percent



Source: World Bank staff calculations based on IHS analysis in Benson and De Weerdt (2023).

Figure 2.2 Even substantial productivity improvements only lead to modest poverty gains

Income poverty rate at current average levels of productivity and productivity of most productive 10 percent, percent



Source: World Bank staff calculations based on IHS analysis in Benson and De Weerdt (2023).

To achieve meaningful advances in human and economic development, it is imperative to address critical constraints to growth in the agriculture sector and support the expansion of broader rural employment opportunities. Poverty predominantly persists in rural Malawi, where the vast majority of the country's population (84 percent) resides, and 94 percent of all poor households are found (World Bank 2022d). The past 15 years of poverty stagnation have resulted in a significant increase in the absolute number of poor Malawians.[15] Prioritizing improvements in rural labor market outcomes to foster a more robust and vibrant rural economy holds the key to reducing poverty in Malawi.

15. However, this masks progress against poverty in the Rural North, where the poverty rate reduced 24 percentage points between 2016 and 2019. It also conceals notable falls in urban poverty between 2004 and 2010 (World Bank 2022d).

Most farming households are already turning to alternative employment opportunities beyond their own farms to mitigate or escape poverty. Rural Malawian households adopt various diversified livelihood strategies, including engaging in casual labor, securing longer-term wage employment, managing household enterprises, and, to a lesser degree, receiving regular income payments such as pensions and social protection transfers. Additionally, the overvaluation of the kwacha (see Chapter 1) has skewed producer incentives in recent years, discouraging exports and pushing smallholders into subsistence farming and/or seeking off-farm opportunities for income generation. This has also hindered downstream job creation, such as through processing and value addition activities. Further analysis is needed to better understand the restrictions that are dampening producer incentives and the factors driving them.[16] Moreover, many of these households lack the resources or skills necessary to create or secure employment that provides sufficient income. Under current conditions, non-farm rural employment does not yield incomes high enough to lift households out of poverty. Nonetheless, income from off own-farm activities constitutes most of the income of most rural households, with 73 percent of farming households deriving more than half of their annual income from off-farm sources.

A small but growing share of commercially oriented farmers is uniquely positioned to support the transformation of rural markets and drive economic growth within rural communities. Presently, this group currently comprises only 7 percent of all Malawian households. However, these households can contribute to sharp and permanent reductions in rural poverty facilitated by: (i) a much smaller but significantly more productive share of rural households engaged in farming, achieving much higher incomes than currently observed; and (ii) a larger group of workers, particularly in rural communities, gaining access to substantially expanded options for generating income to meet the basic needs of their households, especially outside of agriculture.

Given Malawi's current situation, there is no single magic bullet for sustained growth and prosperity. Instead, a comprehensive agenda is needed, emphasizing effective coordination and sequencing of policies and investments. In this context, policies promoting market-led growth, land tenure security, and deepened financial markets in rural areas are critical for realizing the envisioned transformation of food systems in Malawi. No other sector holds the same potential to meet the country's job creation challenge (International Finance Corporation 2021).

This chapter outlines a future vision of a diversified, more commercially oriented agriculture sector as a source of growth, development, and job creation in Malawi. The following section highlights employment opportunities and challenges for rural households in Malawi, providing insights into why the agriculture sector is currently underperforming. The following section discusses viable pathways out of poverty, propelled by an emerging cohort of commercial farmers who are predominantly youthful, productive, and entrepreneurial. These farmers are creating increased demand for innovation, capital investment, and service provision in the agrifood sector. This section is followed by a discussion of the drivers and constraints shaping rural economic development. The chapter concludes with recommendations aimed at informing policy reforms and transcending business-as-usual in Malawi's agrifood sector.

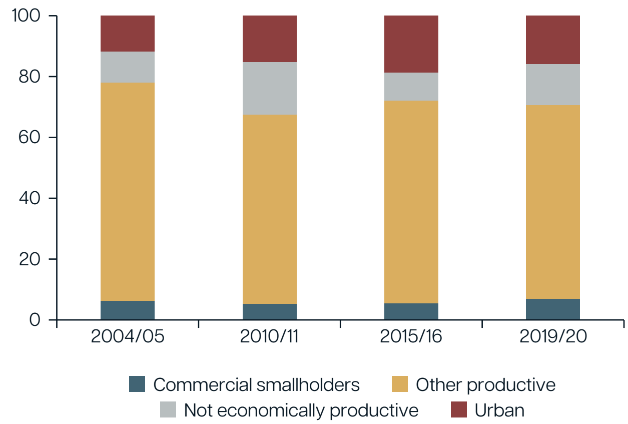
16. For example, based on FAO MAFAP data until 2018, the negative market price support (i.e., implicit taxation) was significantly larger in absolute terms than the public expenditures support provided (subsidies and other public goods) to promote productivity and production, with the overall producer support being negative.

UNDERSTANDING RURAL ECONOMY DYNAMICS IN MALAWI: EMPLOYMENT OPPORTUNITIES AND CHALLENGES FOR RURAL HOUSEHOLDS

Understanding the full diversity of income-generating activities that rural Malawians engage in is crucial to developing viable strategies to enhance incomes and reduce poverty. Households across the rural-urban divide can be categorized into four groups based on economic, residential, and demographic characteristics. These are: (i) commercially oriented smallholder farmers;[17] (ii) other productive rural households; (iii) households that are not economically productive; and (iv) productive urban households (Figure 2.3). Each of these types of households plays a dedicated role in rural economies and impacts how agricultural and non-agricultural labor markets interact. Interactions between local and national economies is also important in shaping rural labor market dynamics, as is the level of skill required for higher returns. To develop viable strategies to boost rural incomes, it is essential to understand the appropriate policy options that can enhance what households reap from farming and to focus on increasing the returns that these households receive from their non-farm work.

Figure 2.3 Share of household types by IHS wave

Percentage share of households



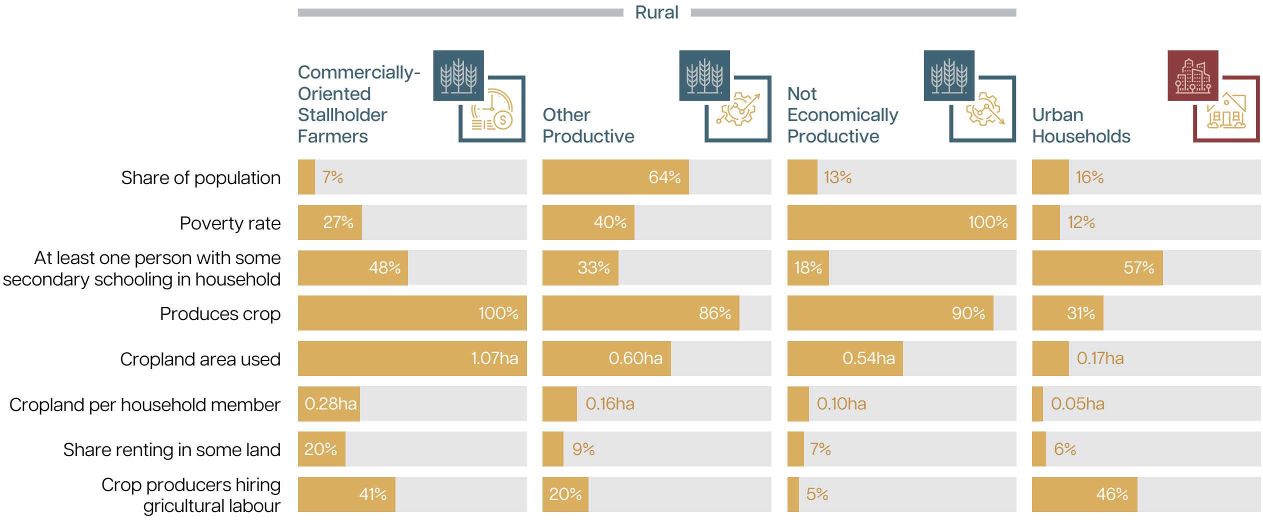
Source: World Bank staff compilation based on Benson and De Weerdt (2023).

Furthermore, Malawians engage in a wide range of livelihoods and economic activities. First, it is necessary to revise the common assumption that agriculture is the central livelihoods for rural households across Malawi, and that their welfare is primarily dependent upon the quality of their household annual crop production. While crop production remains central to their welfare, the ability to secure sufficiently remunerative off-farm employment often holds greater significance. Poor farming households, despite their efforts, are still unable to consistently meet their basic needs by combining these income streams. Second, in developing strategies for rural economic and human development in Malawi, accelerating agricultural production growth, particularly through increased productivity, and increasing the returns to farming is a necessary but incomplete solution. Equal emphasis should be placed on enabling workers in rural households to qualify for and secure good off-farm jobs. Without an increase in the number and quality of such employment opportunities, the economies of most rural communities across Malawi are likely to stagnate, and poverty will deepen among households living in them.

17. A smallholder commercial farmer is broadly engaged in agricultural production for the market. These farmers are typically net sellers, i.e., able to meet food consumption needs while also producing a surplus to sell. For the purposes of this report, households are categorized as commercially oriented if their consumption level is above the food poverty line and reported selling more than one-quarter of their harvested maize annually. Although the total value of crop production that was sold could have been used to define households in this category, maize was used for analytical simplicity. Eighty-eight percent of farming household in Malawi produce maize and the crop is planted on over 70 percent of the cropland of farming households. In addition, gross sales as a share of maize harvested was used, given that information on food crop sales and consumption is not sufficiently harmonized in the IHS to determine annually whether a household is a net maize seller or a net maize purchaser. Information on crop sales is collected on a seasonal basis, while information on food purchases is based on food consumption recall over the previous seven days.

Figure 2.4 Typology of Malawian households

Shares calculated as percentage of overall population covered in the 2019/20 IHS 5 survey. Poverty rate is defined as the share of households falling under the national per-capita basic needs poverty line.



Source: World Bank staff compilation based on IHS analysis in Benson and De Weerdt (2023).

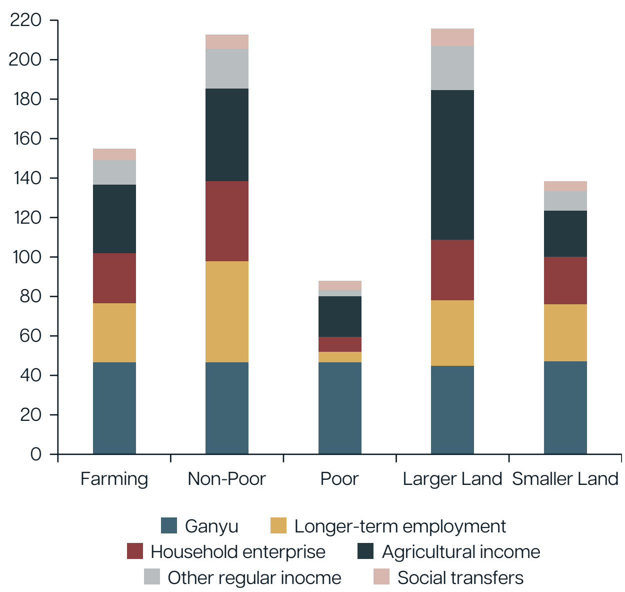
Note: Commercial Smallholders are defined as those households that are not ultra-poor (i.e., consumption below the food poverty line) and that sell more than one-quarter of the maize they harvested. Not Economically Productive Households are ultra-poor and more than half of their members are not working age (aged 15 to 64). Urban Households are residents of urban centers and rural towns. Other Productive Households are rural households that do not fall into the Commercial Smallholder or the Not Economically Productive Household categories.

The average farming household in Malawi is already heavily dependent on off-farm employment, which provides around two-thirds of their income (Figure 2.5). Workers in farming households have three principal sources for off-farm employment, each with its own advantages and challenges:

- **Casual, short-term "ganyu" employment is the basic component of the income of most farming households.** *Ganyu* employment allows workers in farming households to focus on farming during the rainy season and then pick up temporary work or reengage in a household enterprise after the harvest. During the dry season, *ganyu* labor is the main coping strategy used by poor Malawian households to meet their food security needs (Whiteside 2000). Poor farming households are almost 40 percent more likely to engage in *ganyu* labor than members of non-poor farming households, while those with smaller landholdings are 20 percent more likely to do so than those with larger cropland holdings. Although non-farming households engage in *ganyu* labor while they seek to secure more remunerative longer-term wage employment, farming households primarily rely on this income source to meet their food security needs, especially during the dry season when there is a labor surplus. Most *ganyu* labor is linked directly or indirectly to agriculture, both on-farm and off-farm, such as working on other people's fields, engaging

Figure 2.5 Agricultural income is typically a small share of total income.

In current MWK ('000) per capita per year



Source: World Bank staff calculations based on IHS analysis in Benson and De Weerdt (2023).

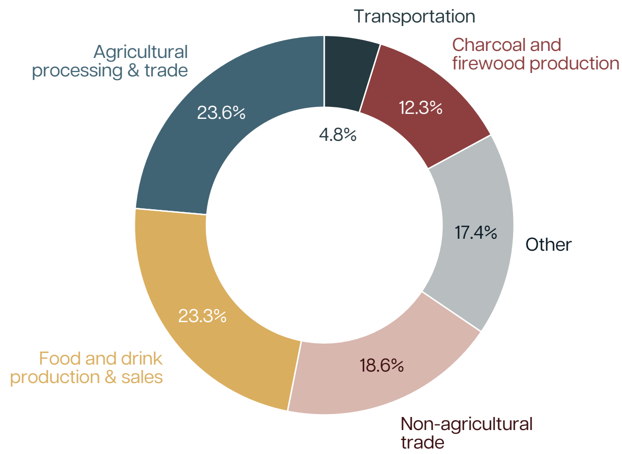
in processing and trade, and working in the rural retail sector. Smallholder farmers engaged in *ganyu* labor might sacrifice productivity on their own farm while working on other people's fields, because this is when the demand for labor is at its highest. Furthermore, demand for *ganyu* labor in farming communities in the dry season is lower than during the cropping season, while the supply of workers competing for *ganyu* labor opportunities at that time of year is large, suppressing wages. Despite this, *ganyu* labor is occupying an increasing share in household incomes, rising from 18 to 37 percent between 2010 and 2019.

- **More formal, longer-term wage employment can provide a steady income stream for households, but relatively few farming households have members engaged in wage employment.** This is noteworthy, given that only 10 percent of all working-age individuals in Malawi receive a salary, and the overall share of working-age individuals with wage employment has declined over time. This indicates significant obstacles to expanding formal labor markets across the country, particularly for members of farming households. While 24 percent of those working-age individuals in non-farming households have wage employment, only 7 percent of those in farming households do. Surprisingly, despite most agricultural production occurring at the smallholder farmer level, the most common type of wage employment is found in the agri-food sector, encompassing everything from on-farm production to trade, processing, and marketing. Longer-term salaried work opportunities are rare, and there is a surplus of potential workers for employers offering wage employment in the sector, leading to strong downward pressure on rural wage levels. Despite this, the overall share of income from household businesses and wage jobs has increased from 3 to 11 percent since 2010, although it remains low.

- **Commercial household enterprises offer off-farm opportunities to a significant subset of farming and non-farming households in Malawi.** In part because wage employment opportunities are so rare, more than one-third of farming households have members that operate at least one commercial enterprise, such as charcoal or firewood production or traditional straw or wood products, while 45 percent of non-farming households have some form of household enterprise. Enterprises centered on processing, sales, trade of agricultural products, and/or selling their own production are the most reported type (Figure 2.6). Farming households with relatively small cropland holdings are more likely to operate enterprises. The enterprises that members of farming households operate are often only available during the dry season, reflecting the strong seasonality of agricultural production. For instance, less than one-third of household enterprises operate 12 months a year. However, many households do not have the capital or skillsets needed to create enterprises that can generate returns to labor that provide sufficient income to cover the basic needs of their households. Moreover, enterprises with higher remuneration may need to be situated in areas with adequate demand and purchasing power for their products or services. often near urban centers. Additionally, these enterprises might rely on public services, such as electricity, transportation, communication, and information services, for commercial success. Household enterprises requiring significant capital to launch will be constrained by Malawian households' poor access to credit (see also Chapter 3).

Figure 2.6 Processing, sales, and trade of agricultural products are the most commonly reported enterprises

Percentage share of all household enterprises



Source: World Bank staff calculations based on IHS analysis in Benson and De Weerdt (2023).

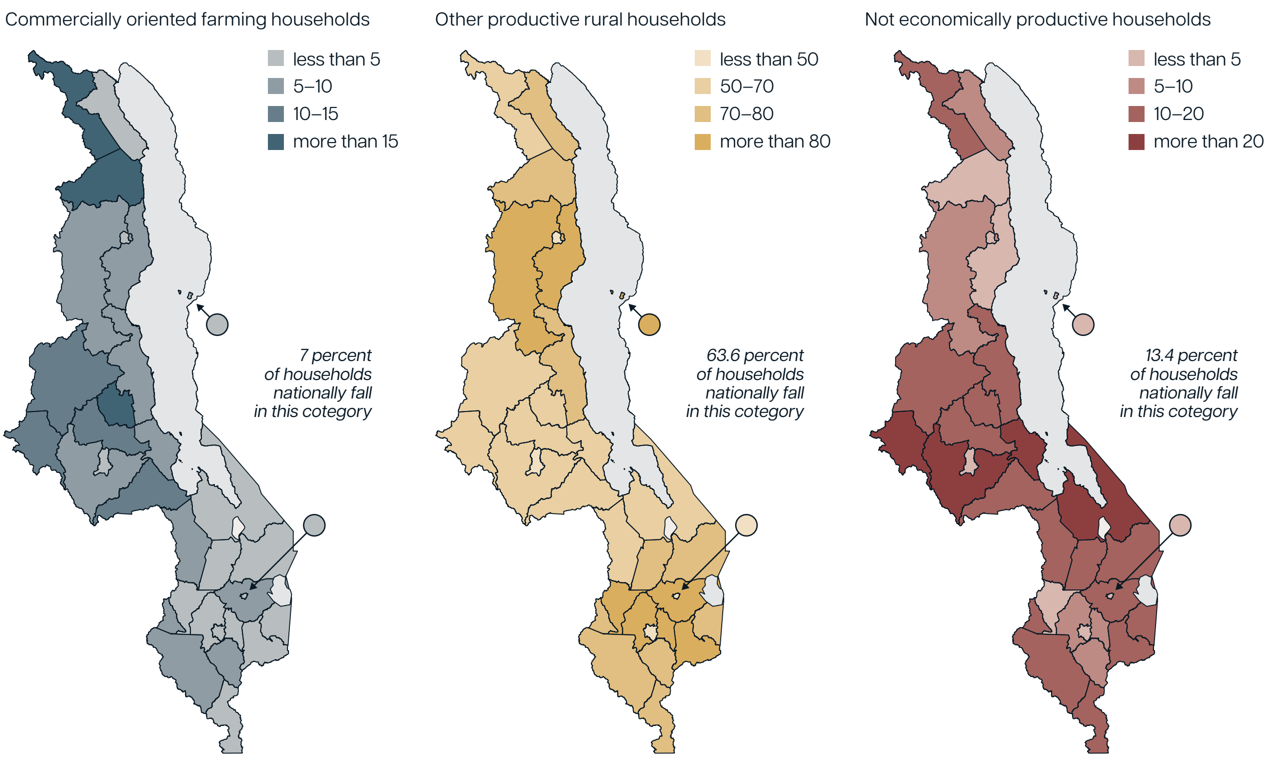
Poorer households are more likely to engage in off-farm employment, especially relying on types of off-farm work with lower entry barriers such as temporary *ganyu* employment and household enterprises. While these opportunities supplement their farming income, they often yield lower earnings compared to employment requiring specialized skills. Many households equipped with sufficient labor are still unable to meet their basic needs, as current rural labor market conditions do not offer the off-farm employment opportunities needed to reliably provide the required income to meet basic needs. Malawi has the third-highest working poverty rate globally according to International Labour Organization estimates, and as the share of households that will need to find off-farm employment to supplement their incomes and escape poverty increases, pressures on rural labor markets will increase. To accommodate this supply increase, fundamental shifts in the functioning of rural labor markets need to occur.

AGRICULTURAL COMMERCIALIZATION CAN BE A SOURCE OF GROWTH AND A PATHWAY OUT OF POVERTY

There are emerging geographic pockets of agricultural commercialization in Malawi. Despite an agriculture sector experiencing reduced landholdings and limited productivity improvements, the share of commercially oriented farming households has remained relatively stable over time. Nationally, the share of commercializing smallholders is low at 7 percent, showing little change since 2004/05 (Figure 2.7). However, there are significant

Figure 2.7 **Commercial farming households are heavily concentrated in the North and Central Regions**

Maps by district, and major urban centres of households that fall into rural households, percent



Source: World Bank staff calculations based on IHS analysis in Benson and De Weerdt (2023).

spatial disparities indicating localized commercialization in Malawi. For instance, while the rural Central Region has a similar number of households compared with the rural Southern Region, the share of commercially oriented households in 2019/20 was almost three times higher in the Central Region (11.8 percent) than in the Southern Region (4.6 percent). The share of commercially oriented farmers is also higher than the national average in the Northern Region (10.6 percent). Importantly, the share of commercially oriented farmers in the Central Region increased steadily from 8.2 percent in 2004/05 to 11.8 percent in 2019/20. Similarly, this share rose from 7.5 to 10.6 percent in the Northern Region over the same period. However, in the Southern Region, the share of commercializing farmers declined from 6.1 to 4.6 percent between 2004/05 and 2019/20. These trends highlight that agricultural commercialization exists in localized pockets in Malawi, even though these pockets may be too small to be evident in nationally representative data. This is likely to occur in areas with better access to land and irrigation, closer proximity to urban markets, and major trade routes. Select commercialized farmers produce much of Malawi's main exports: tobacco, sugar, tea, and soybeans. With effective market development and increased agricultural productivity, the share of Malawian households engaged in commercially oriented farming can be expected to grow.

In this context, promoting agricultural commercialization necessitates targeted support programs for those farming households and organizations capable of significantly increasing productivity and hence production. These include the subset of farmers with relatively larger cropland holdings concentrated in the mid-altitude plateau areas of the Central and Northern Regions, those living near large irrigation and anchor farm schemes, particularly in the Southern Region, or those seeking economies of scale by joining farmer organizations. Out of a total of 1.1 million businesses classified as micro, small and medium enterprises (MSMEs) in the country, an estimated 188,000 are in agriculture, and 15,000 are in agro-processing, with most relying on agricultural inputs or producing food products (International Finance Corporation 2021).

The model of rural economic development in which a vibrant commercial farming sector animates rural non-farm economic activities operates as follows: As the productivity of commercial farming households rises, their farm production expands, leading to higher incomes. With increased income, they demand more goods and services produced by their less agriculture-focused neighbors. These goods and services are typically labor-intensive, require limited capital, and are usually not marketed outside of the local community. They include construction and building repair services, transport, education, health, social services, furniture and handicraft-making, and food and beverage processing, among others. This, in turn, stimulates rural off-farm downstream labor markets for a wide range of input suppliers, transporters, agro-processors, domestic food manufacturers, and other related service providers, already central to most rural economic activity. Successful commercial farming creates demand for labor, playing a pivotal role in rural markets. This consumption linkage also diffuses many of the economic gains from more productive farming to other rural households, deepening local markets, accelerating local economic activities, and improving access to food for economically active households in these communities, including the poor.

As this pattern of rural economic development unfolds, non-farming households increasingly derive higher returns from their non-farm activities compared to their low-productivity farming. Many households producing goods and services for the local market expand their activities to serve wider markets, driving some specialization in local rural employment patterns and boosting their income. In so doing, many will transition from being poor, subsistence-oriented households engaged in some farming to becoming non-farming households specializing in livelihoods outside of agricultural production. Moreover, large shares of the cropland currently used by these less agriculture-focused rural households, could increasingly become available for more productive use by commercial smallholder farming households, further accelerating agricultural and rural economic growth. Land tenure security will be crucial to realize this potential, as commercial agriculture requires farmers to have the right incentives for longer term investments in their land. However, the driving force behind this potential phenomenon — commercially oriented smallholder farmers — must be central to any policies and programs that seek to foster rural economic transformation and assure food security for Malawi (Benson 2021).

Several factors present challenges to this model of rural economic development in Malawi. The ongoing prevalence of subsistence-oriented agriculture raises questions about the feasibility of such a development approach for communities without significant changes to policy and market functioning. This is pertinent as the broader political and economic context, along with the local structure of agricultural production, are important determinants of the impact of this improved agricultural productivity on poverty (Benson 2021). In Malawi, this is limited by:

(i) Access to land and the dominance of customary communal land tenure systems that constrain the ability of commercially oriented farming households to significantly expand the areas they farm;

(ii) Significant labor bottlenecks for commercially oriented smallholder farming households operating at scales that require labor (especially short term, seasonal labor) beyond what is available in their household, given that rainfed and largely unmechanized farming systems demand labor at specific points in the cropping season — and community members who might supply that labor may have a strong economic preference to work on their own crops (Benson 2021);

(iii) Limited markets that provide reliable commercial incentives for farming households for inputs, outputs, and consumption goods. Stability in seasonal price patterns is a critical component in establishing reliable commercial incentives for farming households (Timmer 2015).

Despite these challenges, there are several complementary pathways to achieve agricultural commercialization in Malawi. The three primary avenues analyzed in this chapter are: (i) medium-sized family farms, as evidenced in neighboring countries; (ii) the development of appropriate farmer organizations and strengthening their access to markets through productive partnership models; and (iii) the development of anchor farm models where large commercial farms will partner with smallholders to provide them with access to agricultural inputs, training, and markets.

Agricultural commercialization through medium-sized family farms

There is growing evidence from the region that emerging commercially oriented, small- and medium-size farmers can become a significant source of demand for innovation, capital investment, and service provision, which together can drive productivity growth and job creation. For example, medium-scale commercializing farms (5 – 100 ha) now control roughly 20 percent of total farmland in Kenya, 32 percent in Ghana, 39 percent in Tanzania, and over 50 percent in Zambia. In Tanzania, medium-sized farms generated 13 million labor days per year. This trend often indicates increased interest in land by urban-based professionals or well-off rural people. Approximately half of these farmers obtained their land later in life, financed by non-farm income. A greater share of savings in urban areas is being re-invested in farming and agribusiness (Jayne et al. 2019). Commercially oriented households are more likely to be headed by men and by younger individuals than are other productive rural households. While there has been a large increase in the share of female-headed households in the general population, such households are significantly underrepresented in the commercially oriented farming household category. Commercially oriented farming households, in turn, scale up and specialize in farming, while less productive farming households increasingly rely on off-farm employment for their livelihoods.

Current trends indicate that in Malawi there is little evidence of a restructuring of employment patterns is occurring at scale (Benson and De Weerdt 2023). To successfully transition from primarily agricultural to non-agricultural livelihoods, such households will need to obtain sufficient income from non-agricultural employment, so that rainfed farming conducted on their cropland holdings increasingly is seen as a poor economic choice for workers in the households. Thus far, only a relatively small share of Malawian households has successfully made this transition out of agriculture. While such transitions in household economies will be difficult for many, the current trend of declining average agricultural landholdings, low crop productivity, and a rising prevalence of food insecurity makes such changes increasingly necessary.

Over time, the share of commercially oriented farming households in Malawi has shown slow but steady growth. The slow pace of this growth underscores the need for more concerted efforts to build the capacity of these households for engaging in higher-productivity commercial agricultural production and to improve the enabling environment, especially through improved markets. There are certain policy components to strengthening agricultural markets in Malawi that can provide reliable commercial incentives for farming households. These include ensuring predictable government engagement in agricultural marketing and trade, providing public services to enable markets to operate more efficiently, adopting policy stances that are supportive of agricultural market traders, and expanding participation in regional markets by farmers and other actors in Malawi's agricultural commodity value chains. Despite the challenges outlined above, commercially oriented smallholder farming households are not diminishing. Instead, there remains an open window of opportunity for this model of rural economic development to establish itself in Malawi.

Smallholder commercialization through the development of farmer organizations and productive partnership models

Productive alliances, characterized by strong farmer organizations, links to offtake markets, improved access to finance, and an enabling environment, can help make markets work for commercializing smallholders. The productive alliance model starts with strengthening or building Producer Organizations (POs) to allow smallholders to seize market opportunities and have their voices heard, receive more information, reduce costs, and reap the rewards that come from selling at scale. Productive alliances link POs with off-takers to assure access to markets and partnerships. "Off-takers" — companies that buy produce and refine it, such as commercial-scale oil mills and the dairy industry — are operating at low capacity largely because of inconsistent supply.[18] If farmer POs orientate their production to meet this demand, it would result in a mutually beneficial, commercial relationship between farmers and buyers. Productive alliances empower farmers to respond to competitive calls for funding proposals (for example, where POs are awarded matching grants based on farmer contributions). This boosts production levels and promotes ownership by the farmers.

Productive alliances connect farmers to finance to boost the production capacity of farmer producer organizations. Their efforts to improve the enabling environment, including reforms, land tenure security, standards, and certifications, are all geared toward improving agricultural commercialization. Productive alliances can promote greater inclusion, especially for women. The most vulnerable members of the farmer POs are the ones profiting most from commercial partnerships with buyers. Ideally, such collaborative partnerships provide an opportunity for women to compete on levels of productivity with men by providing them with access to inputs, technologies, and markets (Davis et al. 2023). Such efforts have increased the volume and value of sales commercialized with improved farmer access to finance and markets. The types of value chains also spur the hopes for a virtuous cycle of economic transformation: while some value chains are in traditional export goods, others predominantly serve a local market, creating local economic feedback effects.

Large scale agricultural commercialization through anchor farm or megafarm models: making large-scale agriculture work for smallholder farmers

Recent debates have focused on the value of large-scale commercialization through anchor farms[19] or "megafarms" to accelerate local agricultural development for neighboring smallholder farming households. Estates are believed to cover 1.35 million hectares, constituting about 25 percent of the country's arable land (Deininger and Xia 2018). In this model of rural economic development, large commercial farms partner with neighboring smallholder farming households to provide them with access to agricultural inputs, training, and more lucrative markets (Gondwe et al. 2022). Thus, whether an anchor farm approach will foster rural development is entirely dependent on the design and extent of their engagement with neighboring households. Productive megafarms that fail to both directly and indirectly expand employment opportunities for workers in neighboring rural communities and do not contribute to increased economic activity within those communities will not propel Malawi toward its development vision.

Empirical evidence on the impact of Malawi's estates[20] on local communities and smallholders is scarce and largely inconclusive, reflecting the variety of outcomes possible across projects, locations, and times. Existing literature suggests that 70 percent of estate leases have expired, reducing government revenue by up to US$35 million (Deininger and

18. In some cases, off-takers have been found to reduce operations to artificially manipulate the prices of processed products. For example, there is research that points to soybean crushers operating below capacity to keep factory-gate prices of soya low and retails prices of cooking oil high. Therefore, there may be more to low utilization of processing capacity than unreliable supply.

19. Large-scale farms in Malawi are generally between 500 to 5,000 hectares.

20. The agricultural sector in Malawi, while dominated by household-level production, includes a significant footprint of commercial estates involving relatively larger areas of land obtained through freehold ownership or through long-term leasehold arrangements. Recent studies estimate that estates in Malawi occupy 1.35 million ha (Deininger and Xia 2017), while IHS5 analysis suggests that farming households cultivated a little under 2.5 million ha; it is estimated that only about 40 percent of estate land is currently being cultivated (Deininger and Xia 2018).

Xia 2018). Recent studies on the performance of large farms and their impacts on surrounding communities and smallholder farmers in both Malawi and across the region reveal mixed impacts.[21]

The Government of Malawi has recently intensified efforts to promote and develop large-scale farms in the country.[22] This signals a potentially significant shift in the Government's approach to economic development and the transformation of the agriculture sector — from a focus on input subsidies to support more productive smallholders to greater support for land access and consolidation, as well as the rehabilitation of idle or underutilized land at scale. The further development of stronger domestic agri-food value chains will create opportunities for small, medium, and large players across the sector.

Recommendations from recent analysis suggest several actions that the Government of Malawi can take to support both smallholders and large farms. Currently, unpredictable government interventions in output markets and insufficient incentives to support large-scale production are negatively impacting the performance of large farms (Gondwe et al. 2022). Other studies point to the need for greater public investment in transportation infrastructure, which could help farmers of all sizes by improving access to inputs and input markets (Julien, Bravo-Ureta, and Rada 2019) . Programs to support managerial skills and foster diversification are also commonly recommended (Joseph, van Dijk, and Krisztin 2023). Importantly, the private sector is likely best suited to lead the operations and management of megafarms, with the Government fostering a conducive environment for investors. When assessing megafarm-centered strategies, close consideration must be given to the degree of inclusive consumption linkages and positive spillovers to neighboring communities. The stronger these linkages, the greater the potential for poverty reduction and enhancement of rural employment through a partnership between the larger farm and the local community.

Box 2.1 International best practice for large scale commercialization to inform Malawi's Mega-Farm initiative

Anchor farms control a significant share of cropland in Malawi and therefore agricultural support programs in Malawi could be better designed to help build stronger linkages between the larger farms, nearby farmers, and local communities. The constraints that anchor farms face are not so different from those of commercializing farming households. The conceptual framework of commercialization presented here suggests that the anchor farm model could energize local economic activity if its design is based on close engagement with nearby communities.

Analysis of the determinants of large-scale land investment globally highlights the need for both natural endowments and an enabling environment. Availability of arable land and sufficient water, and strong institutions and systems to manage and protect land and water rights, are paramount. Investors also prefer a country where governments support trade openness, and where farmers already have relatively high agricultural productivity (Mazzocchi et al. 2018). Other positively correlated factors include the economic size of the investors' countries, institutional capacity, good governance, and security and safety in the destination country (Kareem 2018).

Secure property rights and land governance have proven to be essential in supporting legal land consolidation and the endogenous transformation of rural economies from smallholder systems to large-scale commercial farming.

21. While some suggest significant negative impacts on the absolute value of agricultural output of smallholders located in proximity to estates, others find that the yields of most food crops are generally higher on small-scale farms than on large-scale farms in Malawi (Gondwe et al. 2022). Similar studies conducted in neighboring countries have found varying and occasionally conflicting results, highlighting the limited transferability of results from one country to another and further motivating more data collection and analysis in the Malawian context (Joseph, van Dijk, and Krisztin 2023). The local context and supporting policies play a key role in enabling positive spillovers for smallholders in proximity to estates.

22. In December 2022, Greenbelt Authority CEO, Eric Chizungu, reported the Government had helped to establish five megafarms — one each in Karonga, Nkhata Bay, Nkhotakota, Mangochi, and Chikwawa. The Greenbelt Authority is believed to be managing the development and operations of each site.

When these systems are in place, smallholders can voluntarily supply the large farms with land and labor. Analysis by the Food and Agriculture Organization (FAO) also suggests that investments that involve local farmers as equal business partners, leaving them in control of their land, have the most positive and sustainable effects on local economies and social development (Liu 2014). In such cases, local communities and individual farmers may need strong external support to facilitate and conclude investment deals. Attention should also be paid to women's contracting opportunities and future access to employment; otherwise, inequality may be exacerbated (Fitawek et al. 2020).

Governments will also need to adapt social protection programs. The often-seasonal nature of large-scale production and labor demand, and low wages paid to surplus labor, may not facilitate savings and sufficient investments in other economic activities to significantly improve welfare and food security in some households in local communities (Fitawek and Hendriks 2021). Proactive government policies can offset the potential income losses by protecting rural households from welfare losses through social safety net programs and income transfers (Ma, Lin, and Sexton 2022). Subsidy programs, generally speaking, should be (re)assessed to ensure that they are producing the desired impacts (Ma, Lin, and Sexton 2022). For example, programs to support mechanization may be best at improving productivity of medium farms, rather than small or large farms (Qiu, Choy, and Luo 2022).

Lastly, prospective investors need to be able to access patient capital, as financial returns to investment are unlikely to materialize in the first years. While some projects may be commercially viable for multinational companies to able to access finance, other investors may need assistance in identifying funding mechanisms and structuring potential deals. Financial institutions, development partners, NGOs, and research organizations can play important roles in this process. Building relationships, sharing market intelligence, and facilitating investment (concessional and blended finance) can all be catalytic to large-scale investment in agriculture.

DRIVERS AND CONSTRAINTS TO RURAL ECONOMIC DEVELOPMENT

The policy environment is the binding constraint to the realization of the agricultural growth and rural transformation vision laid out in the section above. While Malawi's agriculture sector needs deep investments to boost resilience and productivity, a conducive policy framework is central to the realization of the commercialization potential of Malawian farmers — and ultimately for sustained growth. Existing constraints also pertain to the legacy of past policy interventions that reduce incentives toward greater commercialization and continue to impact how Malawi's key agriculture sector institutions function despite numerous attempts at reform. Central to this is the dominance of fertilizer subsidy schemes in policymaking (see Box 2.2).

Given Malawi's fiscal pressures, necessary policy adjustments cannot incur additional costs. Repurposing current policies therefore presents an opportunity with marginal financial consequences. In particular, there is a need to rethink subsidy programs, for these to incentivize farmers to adopt good practices (e.g., climate-smart agricultural practices and those that can improve soil health). Such steps could further unlock a range of financing options that government support programs could leverage, such as those related to harnessing carbon markets (BioCarbon Fund 2022).

Key constraints to creating rural transformation through market integration and increased commercialization pertain largely to market access. These include the high transaction costs that farmers face (particularly for transportation) and the high risk that traders may not be around when the produce is ready to be sold. On the other hand, traders cannot be sure whether there will be enough suppliers in a given market to justify the high costs of traveling to farms. Potential traders can also be deterred by government intervention, which prioritizes controlling the actions of existing traders often without acknowledging the efficiency that their profit orientation brings. As a result, few farmers can profit from seasonally high demand for their produce, and trade is less effective in reducing price differentials both within the country and over time.

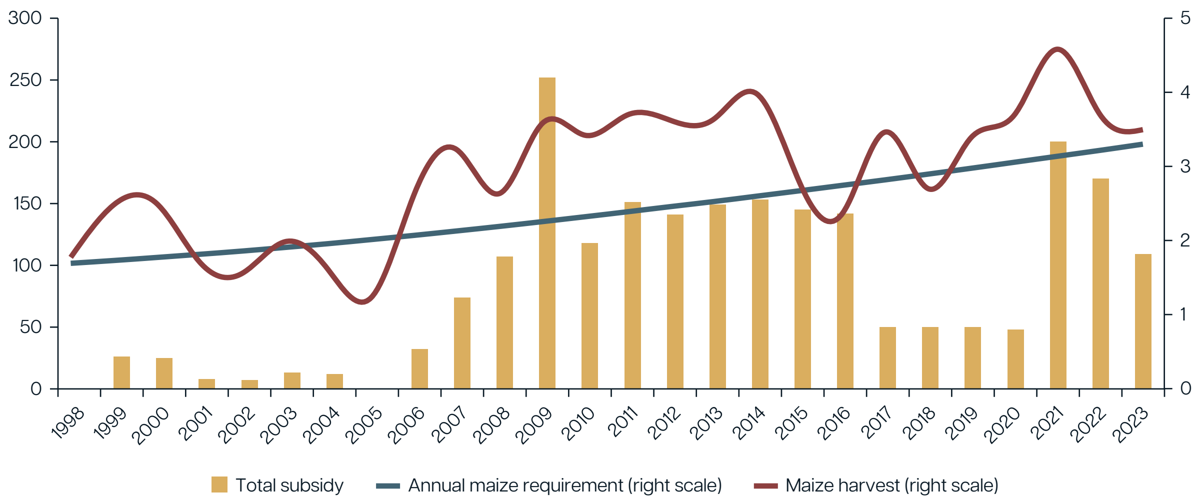
Box 2.2 **Reforming the Affordable Inputs Program (AIP) can unlock significant resources for more productive uses**

Malawi's agriculture sector has been shaped by policies that have often failed to incentivize employment creation and greater commercialization and instead perpetuated the country's continued slow pace of economic transformation. The Affordable Inputs Programme, the current version of Malawi's input subsidy, is a classic example of how misguided policy programs can cause more harm than good. The AIP has consumed around 40 percent of scarce agriculture budget resources on average in recent years. Yet it has done little to stimulate the agricultural transformation that Malawi needs to generate higher economic growth and create more jobs, with AIP expenditure only weakly correlated to total maize production (Figure B.2.2.1). In fact, if anything, it has contributed to the status quo of the current low-return maize-based farming systems that have trapped many rural households in poverty and contributed to poor nutrition and soil health outcomes. Furthermore, it crowds out productive investments and consumes a significant share of available foreign exchange resources.

Recognizing this, the Government of Malawi has begun implementing reforms to the AIP. These include: (i) reducing the overall budget and the number of beneficiaries; and (ii) improving targeting by focusing on productive farmers, thus link the poorest segment (with limited land and labor) to scaled up social protection programs and commercial oriented one to other programs. It will be important to reduce the number of beneficiaries by focusing on farmers and regions that have the most potential in terms of productivity gains, while supporting those that fall short through social protection programs. Further efforts to promote private sector participation in fertilizer procurement and distribution would also likely improve the implementation of the program.

Figure B.2.2. 1 **Expenditure on fertilizer subsidies has had only a weak relationship with maize production**

Subsidy in US$ million, maize in million metric tons (MT)



Source: IFPRI 2022.

The necessary policy and institutional conditions to support market-based competition in the agriculture sector in Malawi are not in place. Parastatals such as the Agricultural Development and Marketing Corporation (ADMARC) have been characterized by poor governance, financial mismanagement, and distortion of markets. Furthermore, the private sector in Malawi has increasingly been disincentivized from engaging in (both local and export) agricultural input and output markets, including through government price intervention policies and trade restrictions in key commodities such as maize. Additionally, rather than smoothing prices, control measures have contributed to price volatility in Malawian markets being among the highest in the region (Benson 2021).

Incentivizing select crops has led to low crop diversification, exposing smallholders to significant market risks, along with reduced resilience and income prospects (Ada Ignaciuk, Maggio, and Sitko 2018). Malawian farmers who practice crop diversification are more likely to have a diverse diet, along with a more stable food supplies and income (Mango et al. 2018). In Malawi, aside from maize, entire communities continue to depend on tobacco earnings, and this dependence exposes them to large risks related to price swings. The ever-decreasing size of land and the frequency of land fragmentation are also instilling a serious bottleneck to promote any sort of commercialization. Land laws and policy, characterized by tenure insecurity and usufruct claims, incentivizes increased fragmentation.

Rural development policy that historically focused on reducing rural to urban migration hindered the switch to market-based off-farm livelihoods at scale, which has left Malawians working in less-productive agricultural jobs, with adverse effects on poverty levels (World Bank 2016, World Bank 2022d). The relatively slow urbanization process and slow structural transformation in Malawi compared with other African countries has been accompanied by sluggish growth of jobs in the manufacturing and service sectors (see Chapter 1).

Malawi has high and urgent investment needs for resilience and support for vulnerable households coping with climate change impacts. The recent "Malawi Country Climate and Development Report" (World Bank 2022a) shows that climate change induced reductions in the value of crops is as much as 25 percent without adequate adaptation measures. Changes in the availability of water for rain-fed cropping is the main factor. Climate change will invariably make it harder for the country to transition from low-productivity, subsistence agriculture to a more productive and commercially oriented sector.

To foster agricultural growth, buyers and sellers alike must be able to rely on the market to support their livelihoods. Progress on agricultural commercialization and growth requires the integration of household risks and vulnerability issues — including breaking the cycle of household food insecurity. This requires holistic solutions to make markets more reliable, efficient, and equitable for buyers and sellers alike. Low-productivity subsistence farming will continue to be dominant in smallholder farming systems across Malawi if farming households perceive that they cannot rely on the market to supply adequate food for their families.

There are several potential *drivers of change* that may foster the emergence of commercially oriented farmers, particularly those that may help promote more efficient and equitable markets. Increasing market participation is an important first step in determining the degree of smallholder commercialization and, in this regard, Malawi's growing contingent of commercializing farmers, though small, is a key driver of change. Further supporting the engagement of farming households in market-oriented agriculture is critical, and while historically market liberalization policy agendas aimed at stimulating and enhancing agricultural commercialization have been widely promoted in the region, they have not necessarily served as drivers of change in Malawi. To date, many smallholder producers are unable to benefit from commercialization opportunities presented by liberalized markets (Wollverton and Neven 2014). Engendering a more open market therefore needs to be complemented by other policies that enable the engagement of the most vulnerable groups, such as strategic support programs and social protection measures for resource-poor farming households. A more vibrant rural economy will be of little help for those who do not have the capacity to participate in it.

Recent evidence suggests that the agrifood system in Malawi of late is largely being driven by the domestic market. Domestic-market-oriented value chains, import-substitutable and less-traded value chains together contributed to 79 percent of growth in the agriculture sector from 2009 to 2019. Less-traded value chains dominate agrifood systems with the largest initial size and high growth rate, and exportable value chains have had the lowest growth rate (2.4 percent). Domestic consumption and dietary change are therefore crucial drivers of this transformation. In turn, promoting specific markets for subsectors or commodities such as horticulture, cattle and milk and fishery value chains, in addition to maize, can help achieve broad and more inclusive development outcomes.[23] In tandem, urbanization anchored in the modernization of locally relevant value chains should be considered as a pathway for inclusive development of both urban and rural areas, as it can serve to simultaneously raise farm incomes, create off-farm income-earning opportunities, and create specialized urban hubs that can boost economic growth (Benson and De Weerdt 2023).

Just as critical is capitalizing on Malawi's core comparative advantage: its large, youthful, and capable population. The relatively high level of entrepreneurship in the context of limited wage employment options and seasonal agricultural production can be an important resource to draw upon as the Malawian economy continues to develop. Placing Malawi's young, entrepreneurial farmers at the center of policies and strategic programs by prioritizing investments in labor-complementing technologies is key. Related to this is capitalizing on the use of digital technologies among youth, which can serve as a key driver for structural transformation, with great potential to address challenges pertaining to accessing inputs and technology, financial services, and markets for farmers as they transit to commercial value chains. Furthermore, in contrast to perceptions, which depict rural households as a relatively undifferentiated mass, Malawian farming households are highly heterogenous. Understanding the variation among smallholder farmers — a subset that is uniquely positioned within rural communities to serve as an engine of local economic growth — can help better target strategies (Benson 2021). This would also help design support programs that can capitalize on the strengths of such an evolving workforce to sustainably improve the welfare of rural communities and promote longer-term rural economic development.

POLICY REFORMS TO ADVANCE AGRICULTURAL COMMERCIALIZATION AND SUPPORT RURAL LABOR MARKETS

There are narrow but viable pathways for sustained growth and prosperity, which are best capitalized upon through a comprehensive agenda that focuses on the effective coordination, sequencing, and targeting of policies and investments. However, Malawi's current policy environment paired with insufficient implementation capacity and a general lack of transparency and accountability in its governance are key challenges to realizing the vision for agricultural growth and rural economic transformation laid out in this chapter. Based on the analysis in the chapter, several considerations stand out as critical for the Government of Malawi to help guide prioritization to foster and sustain a vibrant and more commercially oriented agriculture sector that can serve as a source of growth and job creation in Malawi. These opportunities for agricultural growth are organized around three pillars.

23. This is evidenced by comparing sources of future growth using an IFPRI-RIAPA model.

Pillar 1: *Stimulate private sector engagement in the agri-food space by removing barriers* and drawing in private investment and financing to the sector. In the longer term, productive and stable agri-food markets are most likely to be achieved through solutions that include private sector engagement to promote higher productivity and production of commercially oriented farmers, coupled with increased purchasing power of consumers through more remunerative off-farm employment. This includes enhanced private sector engagement in agricultural research and the provision of agricultural advisory services. Priorities in this regard include steps to propel needed adaptations in the structure of the economy, including measures to:

- **Foster private sector–led markets and market institutions,** particularly to expand on the recent achievements of agribusiness investments in agricultural commercialization and improving the relative cost-competitiveness of smallholder production systems in Malawi. This would require reducing the uncertainty of the government policy-making process, including Government's commitment to the full implementation of the Control of Goods Act (COGA), along with a careful, inclusive review and revision of the draft Crops Bill. Discretionary interventions, such as through attempts at price controls or selective enforcement of existing regulation should be minimized to facilitate a crowding in of market participants to foster competition.

- **Improve access to agricultural inputs through private sector mechanisms.** An expanded network of agricultural input suppliers ensures the availability of the inputs necessary to raise the crop productivity of farming households. For example, private seed multiplication and rapid variety approval could help in a context of limited public funds and the weak ability to administer efficient outreach and extension services.

Pillar 2: *Repurpose existing policies and support programs* such as input subsidies — without major fiscal repercussions — to foster efficiency and equity in the rural agricultural market and better serve the expansion of rural employment and growth. This will entail fostering a conducive policy framework through coordinated reforms to existing sectoral, multi-sectoral, and macroeconomic policies, given that broader investment climate issues are relevant in the agri-food sector as well. Opportunities exist for sectoral policy interventions for agri-food systems that come at no cost or a relatively low cost and have potentially significant impacts and high returns. This includes measures to:

- **Target agricultural investments, policies, and programs** to the subset of farming households and neighboring agricultural enterprises that can generate significantly more production through higher productivity, even if this will be politically challenging to implement.

- **Establish social safety nets and cash transfers, including for enhancing food security,** to allow less productive households that do not generate sufficient returns from agricultural growth-focused investments and programs — generally those with smaller landholdings — to ensure that they can access what they need for a dignified life, and enabling them to also add resources to the local economy.

- **Establish well-designed climate-smart agricultural support programs** that not only offer social protection and a way for vulnerable households to make a living when opportunities for *ganyu* are scarce, but also strengthen the natural resource base and enhance resilience against the increasing threats from climate change. Climate action is a critical part of the solution to put Malawi on a path toward sustainable and inclusive growth.

The expansion of Malawi's Social Cash Transfer Program (SCTP) may offer a potential starting point, given the Government's demonstrated capacity to implement the program.

Pillar 3: ***Foster commercially oriented agricultural production and marketing systems*** on small, medium, as well as large farms that can expand opportunities for and participation of farmers in productive agricultural value chains and lead to broader rural economic transformation in Malawi, regardless of the specific commercialization pathway. Specific recommendations under this pillar include the following:

- **Support and strengthen farmer organizations,** which are critical for the emergence of productive partnership arrangements, as it makes smallholders more attractive business partners for agri-businesses and off-takers.

- **Fast-track farmer-relevant macroeconomic adjustments.** Of the macroeconomic adjustments recommended in Chapter 1, some have special relevance for the ability of current smallholding households to move to a market-based livelihood. The flexibility of the exchange rate is necessary for price signals from international markets to reach farmers so that they can produce the most profitable crops. Monetary and fiscal adjustments are needed to reduce the price risks farmers face when switching to more market-based livelihoods. Currency that maintains its value and the provision of essential public infrastructure and services that are relevant to commercial farmers are needed for farmers to rely on their sales proceeds.

- **Promote regional market integration** by alleviating barriers to trade as outlined in Chapter 4, paired with more efficient logistics and trade corridors to bring produce to regional and global markets. This would enable commercialization of agriculture in both directions: farmers can be reached through the local network and their produce can access expanded markets through regional corridors, incentivized through regional market integration measures.

- **Revitalize commercial farming enterprises or estates that are operating under long-term leasehold land tenure arrangements.** Policies are needed to incentivize estate owners to either use their land or to release it to others who can better do so. Furthermore, better and up-to-date knowledge of the characteristics, productivity, and financial performance of estates is needed to ensure that the agricultural resources of the country controlled by estate holders are being used effectively.

- **Increase farm-level productivity** by promoting effective soil, irrigation and water management, along with the adoption of innovative farming technologies that also improve resilience against climate-related shocks, and related risk management practices.

- **Invest in critical physical infrastructure,** including storage facilities and cold chains, transport and road infrastructure, as well as energy.

Key recommendations are summarized in Table 2.1.

Table 2.1 Top five agricultural policy priorities

Policy Issue	Short-Term Actions *(next 3–6 months)*	Medium-Term Implementation *(before the end of 2025)*
1. Fostering markets and appropriate market institutions	Consistently implement COGA, promote public-private partnerships for commercialization, and increase transparency for government interventions in the market.	Minimize discretionary interventions in agricultural markets and ensure predictability for domestic and foreign investors.
2. Reforming agricultural expenditures to foster efficiency and equity in the rural agricultural market	Proceed with AIP 2.0 reform process to reduce the fiscal burden, maximize fertilizer use efficiency through better targeting by using a finalized beneficiary registry, and improve the timeliness of input procurement and distribution.	Repurpose agricultural expenditures by reducing subsidies and investing in growth-enhancing areas, including climate adaptation.
3. Strengthening farmer organizations	Proceed with review of Cooperatives Act and promotion of electronic cooperative registry.	Review regulation and information systems to support the crowding in of domestic and international traders to purchase farmer cooperative outputs though improved information systems on cooperatives and fewer restrictions on commercial practices of cooperatives.
4. Improving access to agricultural inputs through private sector mechanisms	Finalize fertilizer and seed regulations to improve productivity and catalyze private sector and identify innovation in delivery to promote input use efficiency and private sector participation.	Implement new fertilizer and seed laws, that will: (i) improve the steady and reliable distribution and accessibility of fertilizers and seeds through engagement with the private sector, (ii) encourage market-oriented approaches that can ensure better prices, quality, and availability of inputs in the market, and (iii) facilitate collaboration with the private sector in research and development to develop and introduce climate-resilient inputs and practices.
5. 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.	Focus land reforms on increasing land tenure security and enabling the renting of land to the most productive farmers.

Unlocking Core Constraints to Private Sector Productivity Growth

KEY FINDINGS

1 Market distortions and a lack of private sector competitiveness result in the absence of a dynamic cycle of where unproductive firms are replaced by more efficient new firms. Low overall productivity levels and large gaps between the most and least efficient firms suggest that many firms are not using their resources efficiently to compete and grow. Significant bottlenecks, including in accessing finance, information, and international markets, are compounded by problems of electricity access, corruption, and political instability.

2 The COVID-19 pandemic and the series of shocks since 2020 have had a devastating impact on the private sector. Eighty-five percent of firms lost sales, the fifth-highest incidence among 48 countries in the World Bank Business Pulse Survey. However, it was the subsequent shocks since 2020 that have been particularly damaging, as sales have continued to decline through 2022. Two-thirds of businesses surveyed in late 2022 believe that increased non-labor input costs negatively affected their profits, while foreign exchange unavailability was seen as a threat to profitability by more than three-quarters of firms.

3 With limited access to finance, firms are unable to weather shocks and grow. This is reported as the leading constraint faced by firms, with high interest rates and repayment risks cited as the main concerns. Due to a low-risk appetite, financial institutions provide limited credit to the private sector and charge high rates, in excess of 30 percent, to borrowers. Instead, credit to government has soared, resulting in a highly profitable and well-capitalized financial sector.

4 Increasing firms' capabilities is key to productivity growth, but an implementation gap constrains efficient management. While Malawian enterprises are aware of and often use good basic managerial practices, this frequently does not translate into how businesses are in fact operated.

5 Significant reforms are needed for Malawi's private sector to drive growth. Management training and support services are essential, including strengthening digital access. To improve access to finance, there is an urgent need for the public sector to reduce borrowing demands. Banks will need to reduce operating costs, as well as improve identification systems and develop a credible credit referencing system. Finally, it is critical to improve government capacity to strengthen competition enforcement and advocacy.

IMPROVING PRIVATE SECTOR PERFORMANCE IS CENTRAL TO ADDRESSING MALAWI'S JOBS CHALLENGE

The ongoing crisis has further exacerbated the difficulties faced by firms, and heightened the need to focus on private sector-led growth. The 2019 Malawi FinScope MSME Survey estimated that there were almost 1.6 million enterprises in the country, employing about 1.8 million people, with nine out of ten Malawian firms either small or micro-enterprises and operating in the informal sector (FinMark Trust, Imani Development, and AESA 2019). The majority operate in the wholesale and retail trade, as well as various agriculture-related services. Productivity is low for most firms in Malawi, with the majority producing little surplus to invest and grow. The combined impact of the supply- and demand-side shock following the COVID-19 pandemic, followed by electricity, fuel and foreign exchange shortages from 2022 onward, have had a particularly detrimental impact on the private sector. Most firms have few buffers and limited access to finance to bridge successive strains.

The private sector is central to addressing Malawi's urgent jobs challenge. With the population increasing at about 2.5 percent per year, the economy is not growing fast enough to provide decent jobs for over 400,000 young Malawians entering the labor market annually (International Finance Corporation 2021). Only one in ten Malawians over the age of 15 has a wage- or salary-paying job. Women, especially, struggle to find decent jobs, in part due to their relative under-enrolment in secondary and tertiary education, with most ending up at less productive, informal MSMEs.

Malawian firms face considerable constraints to growth. Macro-fiscal fundamentals, access to reliable power, and access to markets, have been identified as critical bottlenecks for Malawi's private sector, which in turn would drive structural transformation (International Finance Corporation 2021). Malawian businesses report many issues typical for low-income countries as their top concerns, including access to finance. However, problems of electricity access, corruption, and political instability stand out in their reported severity, even among peers. With such impediments to growth, most businesses remain either micro or small enterprises.

To help accelerate growth and support the country's structural transformation, a better enabling environment for firms' growth and entrepreneurship is needed. To this end, this chapter addresses four questions:

1. What are the salient characteristics of Malawi's private sector?

2. How have the series of recent shocks beginning with the COVID-19 pandemic impacted firms?

3. What is the role of two key determinants of firms' performance, the access to finance and competition dynamics (Section 3.6), in constraining the productivity growth of firms?

4. How can these constraints be addressed to strengthen private sector-led growth?

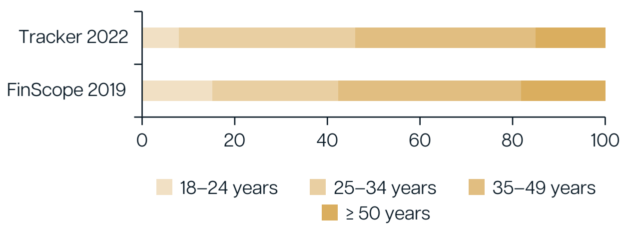
This analysis draws on the analysis of three main sources of survey data (Aterido 2023; FinMark Trust 2023). These are the World Bank Business Pulse Surveys (BPS 2020 and 2022), the "Funneling Survey" (FS), a pilot survey implemented in 2022 to test various methods of measuring firms' capabilities, such as knowledge of technical skills, business practices, and entrepreneurs' personal and psychological traits, and the FinScope survey of 2019 with a follow-up MSME Tracker Survey in 2022 (see Annex 3.1 for an overview of data sources). This is complemented by comparisons with the 2014 World Bank Enterprise Survey. All four of these datasets have slightly different samples, and the BPS, FS and FinScope surveys are all not fully representative of Malawians firms, though the FinScope survey is representative of MSMEs. They nonetheless provide both novel and recent insights into key issues related to firms' performance.

UNPACKING THE PERFORMANCE OF MALAWI'S FIRMS

Most Malawian entrepreneurs are young and resilient. About two in five business owners are classified as youths, being aged 35 years or younger (FinMark Trust 2023, Figure 3.1). The vast majority of entrepreneurs operate a micro or small business that they have started as one of the scarce opportunities available to improve their livelihood (Figure 3.2). Especially women are entering entrepreneurship, with the primary aim of providing for their family and for a lack of better opportunities. The inheritance of businesses plays virtually no role in motivating entrepreneurship.

Figure 3.1 Malawian entrepreneurs tend to be young

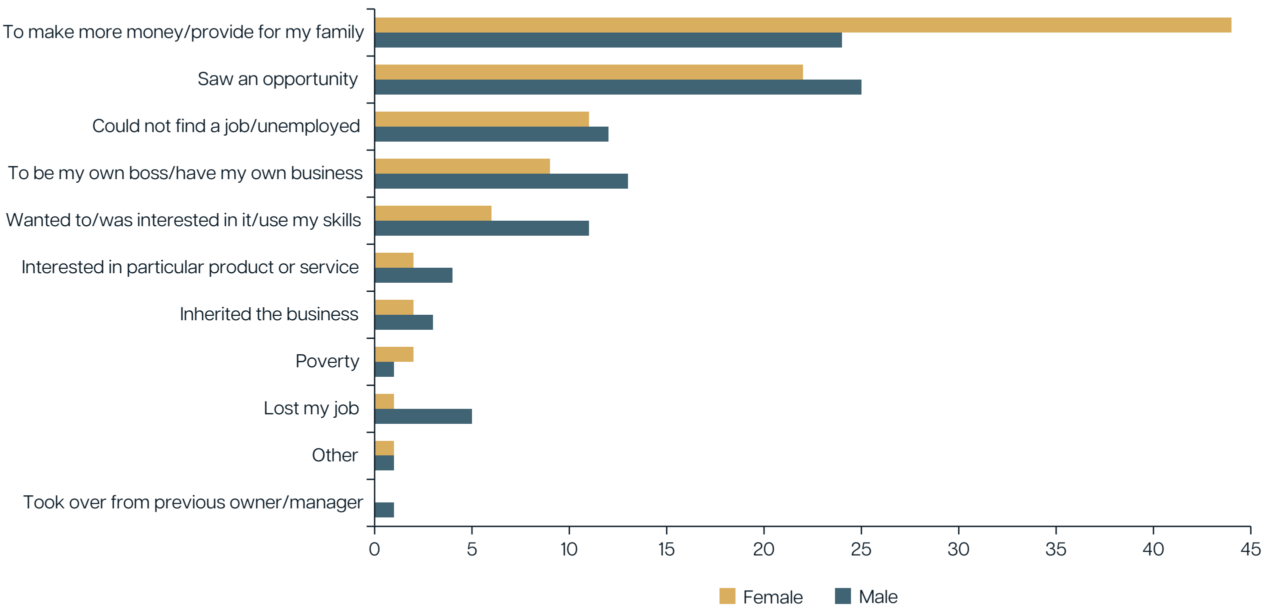
Age categories of business owner, percent



Source: FinScpoe 2019 and MSME Tracker Survey 2022.

Figure 3.2 Becoming an entrepreneur is a necessity rather than a choice

Main motivation to start a business by gender, percent



Source: MSME Tracker Survey 2022.

Malawi's firms are, for the most part, relatively unproductive. Growth occurs when productive firms access adequate inputs, labor, and capital. If productive firms thrive, wages rise, and consumption increases, creating more demand, and in turn generating a virtuous cycle. To calculate firms' performance, a proxy of labor productivity, sales per worker, is used.[24] Annual sales per worker among surveyed firms ranged from US$4,600 (BPS) to US$12,200 (FS). Even among the larger enterprises in the 2014 Enterprise Survey, firms earned only US$20,200 per worker. These levels are insufficient to ensure that quality inputs can be purchased, profits are generated, and workers are compensated adequately.

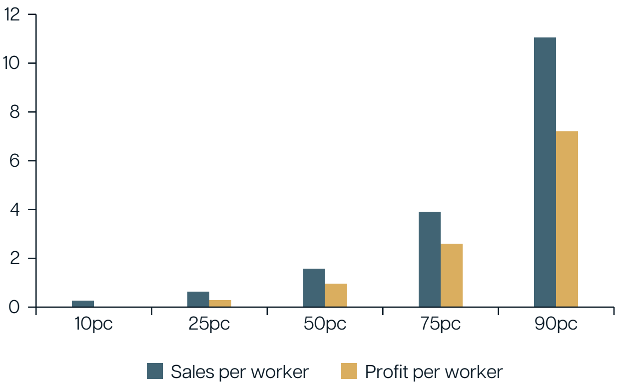
Small Malawian firms concentrate on services and larger ones generally are in retail, while manufacturing firms are a small minority. At least 74 percent of firms captured by the surveys of smaller firms specialize in retail or services, with the majority operating small-scale service businesses. Even among the larger firms in the 2014 Enterprise Survey, only 29 percent manufacture products.

Market distortions and a lack of firms' competitiveness result in the absence of a robust cycle of creative destruction. Large productivity gaps between productive and unproductive firms suggest that firms are not using their resources efficiently to compete and grow. Although productivity is low for most firms in Malawi, a firm in the 90th percentile is 37 times more productive, in terms of sales per worker, than a firm in the 10th percentile (Figure 3.3). The median of firms' sales per worker in the BPS is just three times the annual minimum wage of MWK 600,000 and its profit per worker is double the minimum wage. In contrast, the 90th percentile firms' sales and profit per worker are 22 and 14 times, respectively, the annual minimum wage. High levels of dispersion are also recorded for profits per worker. This can be a sign of misallocation within an economy, suggesting that resources do not flow to the enterprises that can make the most of them. Moreover, the gap between the most productive and least productive firms widens when firms are older. Finally, young firms on average are less productive than older firms, suggesting that new entrants are not spurred by competition and do not replace stagnant, unproductive firms.

The dispersion of productivity can also be seen within industries, and especially in services. A manufacturing firm in the 80th percentile is between seven (BPS) and eight (FS) times more productive than another in the 20th percentile (Figure 3.4). The difference is between 13 (BPS) and 17 times (FS) for wholesale and retail firms, and 9 (BPS) and 20 times (FS) in services. High dispersion in a sector can signal the existence of frictions that prevent the efficient

Figure 3.3 The gap between the most and least productive and profitable Malawian firms is significant

Measures of labor productivity in US$ ('000)



Source: Business Pulse Survey, Funneling Survey.

Figure 3.4 The productivity gap is greatest for retail and services firms

Gap between firms at the 80th and 20th percentile according to labor productivity measures, percent

Source: Business Pulse Survey, Funneling Survey.

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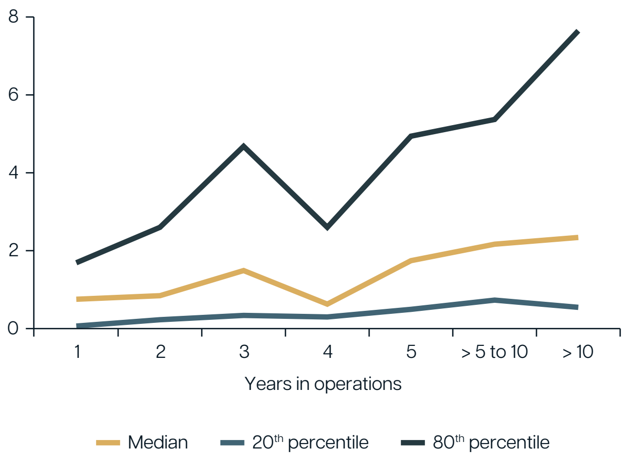
24. Labor productivity is typically defined as the value added per unit of labor (worker or hours worked). Using revenues, instead of value added, does not capture *efficiency* in the use of intermediary inputs. Certain industries, especially services, do not use as many intermediate inputs and may appear less productive. Furthermore, labor productivity does not capture the role of capital. Capital-intensive industries employ less workers and exude higher labor productivity. However, past surveys have shown that the correlation between sales per worker and value added per worker has historically been very high in Malawi.

allocation of resources between firms in the same industry. For comparison, in the United States, firms in the 90th percentile are only twice as productive as firms in the 10th percentile (Hsieh and Klenow 2009).[25]

A process of creative destruction does not seem to be particularly strong in Malawi, as low productivity firms remain, and young firms tend to be significantly less productive than established ones. The productivity dispersion widens along the age spectrum: the productivity of the 80th percentile of firms is higher for older firms relative to younger firms in the 80th percentile. In contrast, the productivity of the bottom 20th percentile is flat regardless the age. In the case of sales per worker, the 20 percent most productive older firms have 3.3 times higher sales per worker than the 20 percent most productive young firms. The bottom 20 percent of old firms are only 0.3 times more productive that the bottom 20 percent of young firms (Figure 3.5). Profits per worker follow the same pattern and have a similar order of magnitude. In fact, half of firms improve little over time. The results of productivity linear regression reporting margins on age shows that younger firms are less productive than older firms by a significant gap (Figure 3.6). This finding, together with the evidence of non-productive firms remaining in the economy, indicates that the dynamic of entry and exit is not leading to significant aggregate productivity gains.

Figure 3.5 The gap between the most and least productive firms increases with age

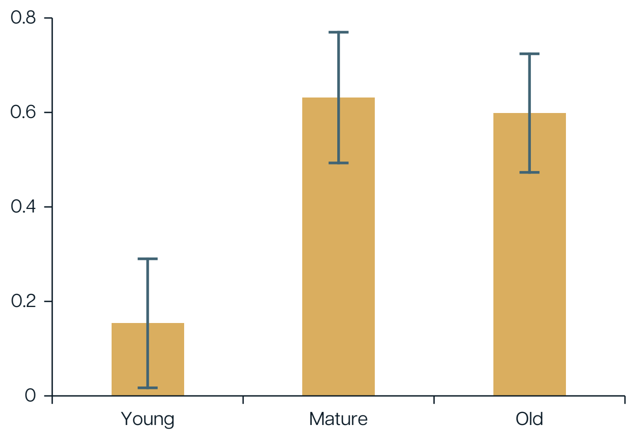
Sales per worker distribution by age, labor productivity in US$ ('000)



Source: Business Pulse Survey.

Figure 3.6 Younger firms are significantly less productive than older firms

Prediction of sales per worker by firms' age, log of sales per workers in 2019 in US$ ('000)



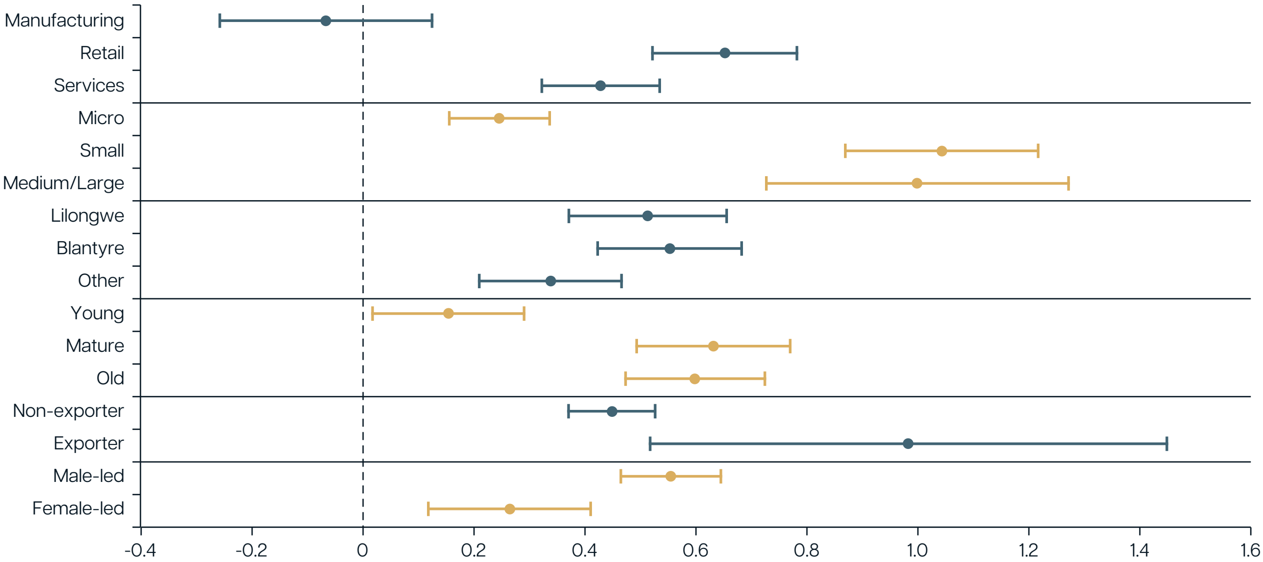
Source: Business Pulse Survey.

Retail enterprises, as well as medium and large firms and exporters, are most productive while manufacturers, micro-enterprises and young firms are least productive (Figure 3.7). When controlling for firm size, the manufacturing sector is underperforming, both as measured by sales per worker, as in the BPS, or by profit per worker in the FS. Retail firms are more productive. In both datasets, the magnitude of the coefficient is large, and results are significant at the 1 percent level. A firm in retail is likely to be 8.1 (BPS) or 7.6 (FS) percent more productive than a firm in manufacturing. Moreover, male-led firms tend to be more productive (see Box 3.1).

25. However, other factors can contribute to this dispersion as well. Bloom, Sadun, and Van Reenen (2012) show how management practices contribute to larger productivity differences, and Foster, Haltiwanger, and Syverson (2008), just to cite a few, show similar effects due to technology adoption.

Figure 3.7 Medium and large firms and exporters are most productive

Predictors of productivity



Source: Business Pulse Survey.

Note: Margins reported. All coefficients are significant at 1 or 5% level except for location.

Box 3.1 Reducing gender gaps between entrepreneurs has the potential to boost firms' productivity

Female entrepreneurs' sales and profits in Malawi are much lower than those of their male peers. Recent analysis of household data shows that women constitute about half of entrepreneurs in Malawi but their sales and profits are lower by 46 and 31 percent, respectively (World Bank 2022c). This mirrors a pattern found across the continent (World Bank 2019b).

Less than one-third of this gap is due to differences in endowments. Malawian women are constrained in the resources that they can bring into their businesses. For example, in agriculture men tend to be more productive farmers, meaning they can invest more savings from their agricultural production in their businesses, while women are more reliant on smaller gifts for start-up capital. Women also tend to be less endowed with skills and experience, evidenced by lower education and younger age, on average.

Two-thirds of the gender gap in sales is driven by constraints on how women can conduct their businesses. Women spend more on raw materials and earn higher returns on raw material expenditures than male entrepreneurs do. While more productive use of raw materials narrows gender gaps, differences in the labor that women have access to more than outweighs this. Women tend to put less time into their enterprises themselves, often being disproportionally burdened with domestic responsibilities. While their own time is just as productive as that of their male peers, the workers that women tend to be able to hire generate lower sales. Men tend to hire a larger number of male workers from outside their own household and pay them higher wages, widening the gender gap in sales. Men also tend to be more mobile with their business, having to be less concerned about their safety and about cultural norms, further exacerbating disparities.

Malawian women have lower levels of financial inclusion than men. Women are less likely to own bank accounts, use a mobile phone for financial transactions less often, and save and borrow less often from a financial institution. This also provides them with less scope to invest and grow their businesses. The assets that women do possess are often less secure, especially land on which tenure is uncertain, with women less likely to have their names on land titles and less decision-making control over their land.

There are several potential reasons why micro-enterprises lag behind. The small size of the vast majority of firms could be explained by entrepreneurs' lack of desire to expand, or by their insufficient capability to do so. But external factors, such as market failures, to which small firms are likely to be more vulnerable, matter as well, especially in Malawi. Market frictions impede appropriate access to the resources needed for production and micro-enterprises are less capable of overcoming obstacles to access them. If the allocation of the factors of production is costly, the flow of resources to more productive firms is inefficient. As a result, productive firms fail to thrive and pressure to compete weakens. When competition is weak, less productive micro-enterprises are not incentivized to either grow or exit.

The picture emerging of Malawian firms as primarily small, unproductive, and service-oriented corroborates that many dynamics associated with structural transformation have not yet started. In addition to people moving out of agriculture, structural transformation and growth take-off are characterized by a move into larger and impersonal enterprises oriented toward international markets (see Chapter 1). However, the average Malawian enterprise tends to still be operated by one person with at most a few employees, providing a locally consumed service.

A MANAGEMENT IMPLEMENTATION GAP HOLDS MALAWIAN FIRMS BACK

Better management improves firms' performance. Controlling for sector size, location, age, exporter, and gender, firms with better management practices are likely to have higher sales per worker. An increase by one standard deviation in a firm's management score (an indicator that combines measures of keeping business records, monitoring business performance, and setting business targets) is associated with nearly 30 percent higher sales per worker. It is notable that, almost across the board, Malawian enterprises use good basic managerial practices. Regardless of size or sector, at least 79 percent of firms have performance indicators, short- or long-term goals and keep records of finances. It has been shown that such basic managerial practices can enhance business performance, putting the locus of control over the performance of businesses to managers (Mano et al. 2012).

However, awareness of these sound managerial practices often does not translate into processes on the ground (Table 3.1). While managers record their finances, this often happens in relatively rudimentary ways on paper. This limits their ability to analyze the data and translate financial insights into improved business processes. At the same time, while managers tend to formulate performance indicators, the minority uses them strategically to make human resource decisions. While enterprises tend to have defined goals, the process to achieve them can also face challenges. The processes of solving problems, learning, and improving after a problem emerged is only a standard procedure for one in five Malawian firms.

Table 3.1 Malawian firms use good basic managerial practices but do not widely implement many professional solutions

Share of companies reporting the practice by size and sector, percent

	All	Micro	Non-Micro	Services	Manufacturing
Has performance indicators	81	79	86	84	79
Has short- or long-term goals	82	80	89	84	81
Keeps records of finances	88	81	99	88	88
Fixes a production problem and improves	20	12	31	23	17
Promotes only on performance and ability	27	14	53	34	21
Manages finances by hand	59	85	25	49	69
Manages finances w/ standard computer	39	15	70	47	30
Manages finances w/ platform or sp. software	3	1	5	4	1

	All	Micro	Non-Micro	Services	Manufacturing
Management score	38	31	54	42	35
Uses internet, social media platforms	40	40	70	50	40
Invests in digital technology	20	10	20	20	20
Adjusted digital technology	30	30	40	40	30
Updated digital functions	70	60	90	70	70
Share of sales using digital platforms	14	9	19	17	11
Most frequent payment method is digital	0	0	0	0	0
Most frequent sales method is digital	10	0	10	10	0
Digital score	20	20	20	20	20

Source: Business Pulse Survey, merged across waves.

Due to limited access to digital services, Malawian businesses largely stay offline. Even during the pandemic, only 11.7 percent of sales were made online. Only some firms adjusted their business models during the pandemic, with 18 percent investing in digital technologies. Less than half of firms use the internet or social media at all, with online marketing (27 percent of firms), sales and payments (21 percent), and business administration (11 percent) the most popular technologies. A full 84 percent of businesses primarily receive payments in cash, despite the general availability of digital technologies and an RBM order that all businesses must offer digital payment (Kondowe 2018). Moreover, the use of digital technologies, such as digital payments or the use of digital communication and marketing techniques, was not associated with higher sales per worker. This is in contrast to the global picture where firms' productivity and the adoption of digital technologies are closely correlated (Cirera et al. 2021).

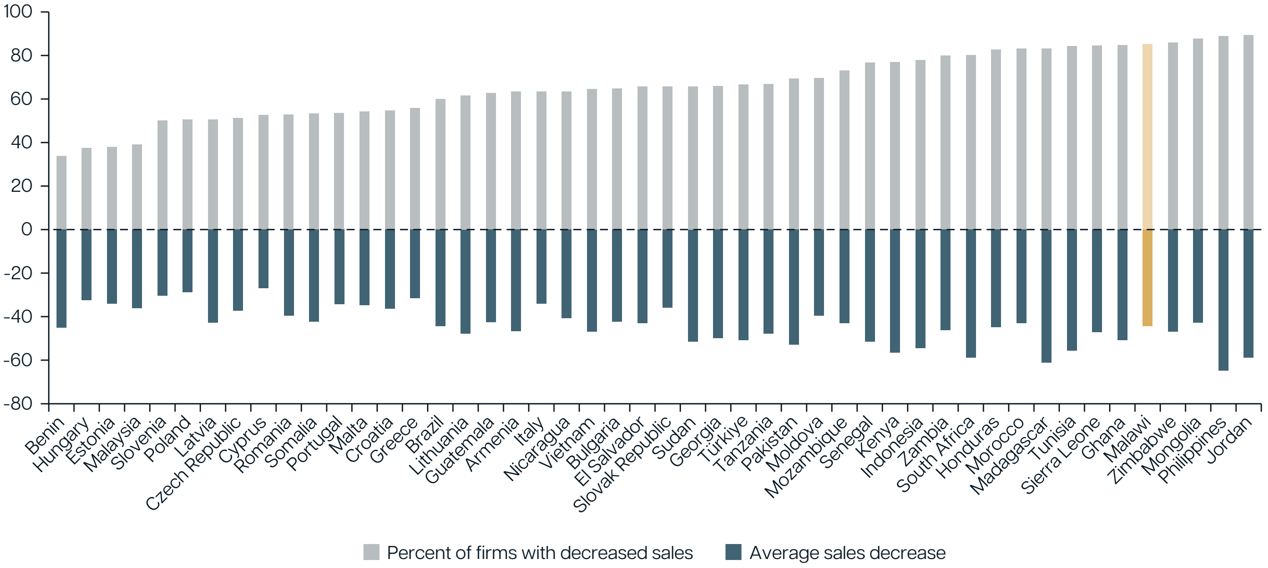
A SERIES OF SHOCKS SINCE 2020 EXACERBATED EXISTING STRUCTURAL WEAKNESSES AND HAS DEVASTATED MALAWI'S PRIVATE SECTOR

In light of many of the structural challenges and constraints discussed above, Malawian firms were among the most severely impacted globally during the initial COVID-19 shock (Figure 3.8). Between 2019 and 2020, 84 percent of firms reported a decrease in sales. Among 48 countries captured by the Business Pulse Surveys, only four countries suffered more widespread sales losses. The compression in sales was also severe, with an average loss in sales of 44 percent. However, the stringency of COVID-19 controls is unlikely to be the only factor leading to this decline. Among 180 counties where the "Lockdown Stringency Index" measured the severity of control measures, Malawi ranked 120th at the end of 2020, before many measures were lifted throughout 2021 and 2022 (Hale et al. 2021). Sales decreases were also most prevalent among manufacturing firms and the smallest enterprises, sectors where COVID-19 control measures are typically assumed to be least relevant and least strictly enforced. The depth of sales decreases was most severe in services and small enterprises, which is more in line with global patterns (Olczyk and Kuc-Czarnecka 2021).

Sales for most firms continued to drop into late 2022. By the end of 2021, real per capita production globally had rebounded past the levels recorded before the pandemic. While employment levels lagged behind, firms' sales even in countries that had significant macroeconomic difficulties, such as Zambia, had surpassed pre-pandemic levels by the middle of

Figure 3.8 Malawian firms experienced some of the most widespread sales losses globally

Share of firms reporting a decrease in sales and average sales decreases relative to one year earlier as of Q4 2020, percent



Source: Business Pulse Survey.

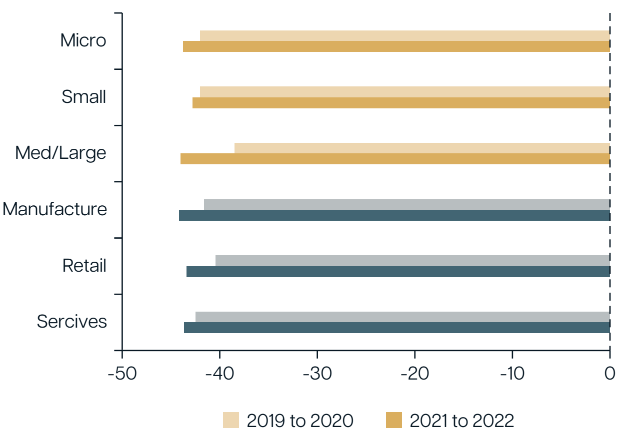
the year (Hoy et al. 2022). However, this was not the case in Malawi. By late 2022, 68 percent of Malawian firms had still not recovered in terms of sales. Firms across sectors recorded large sales decreases, with the likelihood being the highest among manufacturing firms.

The severe macroeconomic crisis lies at the heart of Malawian business challenges. Escalating foreign exchange shortages and rising input costs put pressure on already strained enterprises. Two-thirds of businesses surveyed in 2022 believed that increased non-labor input costs negatively affected their profits, while foreign exchange unavailability was seen as a threat to profitability by more than three-quarters of firms. Three-quarters of firms also reported difficulties in accessing finance, which could be used to overcome such crises (World Bank 2022b). All three are at least in part a result of macroeconomic policy (see Chapter 1).

While Malawian managers are generally optimistic, they are losing hope of an imminent rebound. Asked for a baseline scenario, managers expected a 22 percent increase in sales over the next six months in November 2020. However, this was followed by widespread decreases in sales through 2022 (Figure 3.9). This is reflected in the more recent expectations that Malawian businesses have for future sales growth, which declined to 7 percent in the October 2022 BPS. Even in an optimistic scenario, many firms do not expect to recover past their pre-COVID-19 sales levels within half a year anymore, with a reported expected sales growth of 36 percent. Such a decline in the outlook of businesses is an adverse indication for Malawi's economic future, as managers who do not expect growth will be risk-averse and delay investment or hiring decisions.

Figure 3.9 Rather than rebounding, sales for most firms continued to decline into 2022

Average change in sales relative to one year earlier in Q4 2020 and Q4 2022 by sector, percent



Source: Business Pulse Survey.

THE FINANCIAL SECTOR CURRENTLY DOES NOT SUFFICIENTLY SUPPORT PRIVATE SECTOR GROWTH

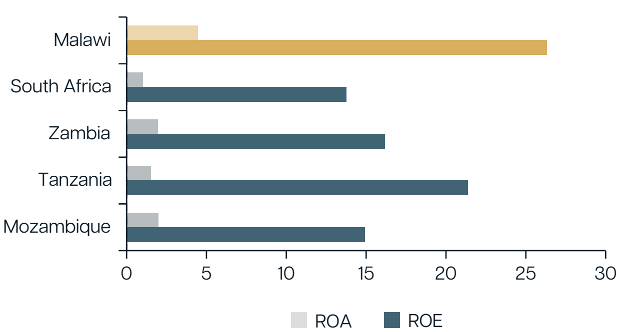
With limited credit available, firms are unable to weather shocks and grow, and the difficulty of accessing finance at affordable rates is generally the most prominent constraint listed by firms across surveys. Access to capital is one of the channels that allows firms to invest, acquire better technology, and become more productive. On the one hand, firms lack capacity: only 61 percent of firms in the BPS had a bank account, and 37 percent of these use the same account for business and personal transactions. At the height of the pandemic, in late 2020, 95 percent of firms complained about having difficulties in accessing financing with high interest rates and repayment risks the main concerns. With the cash available, 84 percent of firms could not cover costs for more than one month, with liquidity concerns greatest for small firms. Sixty-five percent had outstanding liabilities, and 40 percent of businesses were already in arrears or expected to be in the next 6 months. By 2022, financial conditions had improved slightly: 69 percent of firms still lacked financial access and fewer firms expected to fall in arrears. However, the percentage of firms with outstanding liabilities increased from 65 to 68 percent.

This is in part because access to credit for the private sector is crowded out by high levels of government borrowing, reducing firms' ability to cushion recent shocks. Only 10 percent of medium enterprises, 5 percent of small enterprises, and 3 percent of micro-enterprises have credit from a commercial bank (FinMark Trust, Imani Development, and AESA 2019). Commercial banks' financial intermediation is low, with a high degree of concentration: an estimated 90 percent of loans are channeled to a handful of large firms (International Finance Corporation 2021). Due to a low-risk appetite, financial institutions provide limited supply of credit to the private sector and charge high rates: banks' net interest margins averaged 11.5 percent over the past decade to private sector borrowers (Chilima, Banda, and Gondwe 2023).

Overall, the financial sector has managed to remain stable and profitable throughout recent crises, performing better than its regional comparators (Figure 3.10). Overall, banks are also well capitalized, with Malawian banks having the highest bank-to-asset ratio among countries in the region (Chilima, Banda, and Gondwe 2023). However, this has been driven by high levels of lending to the Government, crowding out private sector credit (Figure 3.11). Increased credit demand from the Government because of sustained and growing government deficits has reduced the probability of firms being able to access credit at competitive rates. As

Figure 3.10 Malawian banks have higher returns on assets (ROA) and equity (ROE) than those in neighboring countries (2011–21)

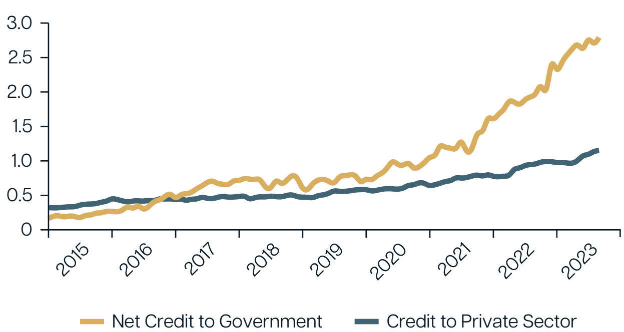
ROA and ROE as a percent



Source: Chilima and Gondwe (2023) based on World Bank and RBM data.

Figure 3.11 Lending to government has increased dramatically in recent years, crowding out private sector credit

Credit in MWK billion



Source: World Bank with data from RBM.

a result, commercial banks are discouraged from lending to the private sector due to their reliable access to government paper. In addition, this discourages them from seeking new lending opportunities. Key factors constraining lending to smaller and informal firms include lack of collateral and proper credit referencing, ID card challenges and the informality of most firms.

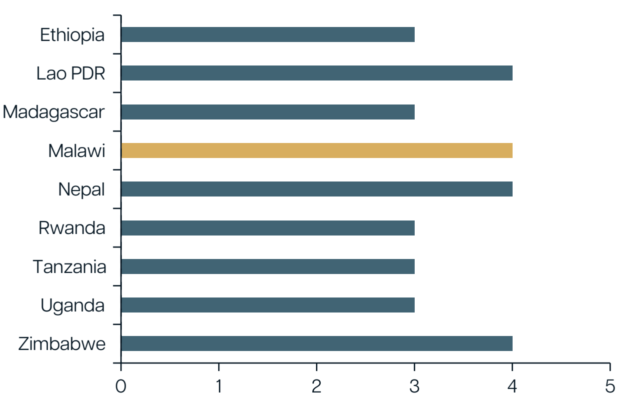
MORE NEEDS TO BE DONE TO EVEN THE PLAYING FIELD AND ADDRESS ANTI-COMPETITIVE BEHAVIOR

Improving the competitive environment for firms can result in lower prices for consumers, higher quality goods and services, productivity growth and, in turn, GDP and wage growth. It can motivate within-firm growth by driving companies to expand their capabilities (Aghion and Howitt 1992; Bloom, Sadun, and Van Reenen 2012) and can drive between-firm growth as more productive firms leverage their competitive advantage to gain market share (Bartelsman and Dhrymes 1998; Olley and Pakes 1996). Finally, it can support market dynamism by strengthening entry and exit dynamics (Eslava et al. 2013; Hopenhayn 1992).

Malawian firms face considerable barriers to entry and growth in part due to significant distortions that constrain competition in many sectors. As discussed earlier, the expected cycle of creative destruction that helps drive productivity growth does not operate effectively in Malawi. This is supported by some indicators of competition dynamics. According to Economist Intelligence Unit measures of the role of vested interests and cronyism in distorting decision-making, Malawi (along with Lao PDR, Nepal and Zimbabwe among its peers) has the worst possible score (Figure 3.12). However, in other areas its performance is in the middle range among comparators: for example, in terms of the extent of market dominance, Malawi's score, while declining between 2012–13 and 2017–18, is similar to most of its peers (Figure 3.13).

Figure 3.12 Vested interests and cronyism are seen as central to policy

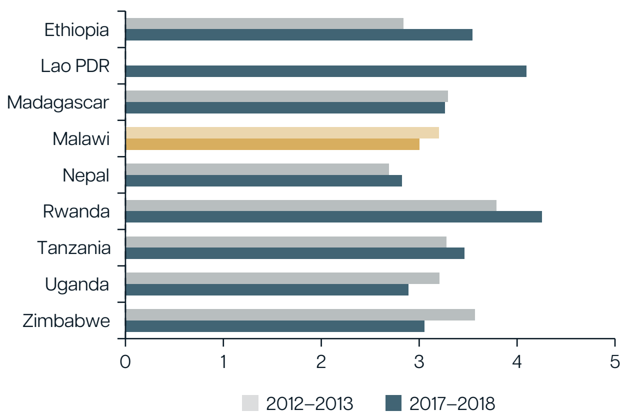
Degree to which vested interests and cronyism distort decision-making, 0–4 (worst)



Source: Economist Intelligence Unit.

Figure 3.13 Malawi is similar to comparators in terms of the degree of market dominance

Extent of market dominance, 1–7 (best)



Source: World Economic Forum Global Competitiveness Index.

While competition appears to be quite robust at the level of micro- and small enterprise, many sectors have a high degree of market concentration, creating greater risk of collusion. For example, in the financial sector, just three pension companies control 62.9 percent of the total assets of the industry, and two insurers account for 97.6 percent of gross premiums written for life insurance, while the two largest banks held 46.2 percent of the total assets and 50.1 percent of the loans in 2021 (Chilima, Banda, and Gondwe 2023). Just two mobile network operators dominate the market, creating significant risks for anti-competitive behavior.

Beyond market structure, government interventions impact competition in numerous sectors (International Finance Corporation 2021). Interventions in the agro-processing, fertilizer, road construction and freight transport industries protect incumbents and discourage involvement by investors, especially from abroad. Furthermore, state-owned enterprises (SOEs) often compete with the private sector while having significant regulatory, financial, or other advantages over competitors.

The existing legal and regulatory apparatus gives the Competition and Fair Trading Commission (CFTC) only limited capabilities to develop and implement pro-competitive regulatory reforms and address anti-competitive behavior. Other sector regulators, such as the Malawi Energy Regulatory Authority or Malawi Communications Regulation Authority, frequently have concurrent jurisdiction over competition and consumer protection matters. To address this, the CFTC has entered into Memorandum of Understandings with various sector regulators. However, not all cases that should be handled jointly are so. Lack of human and financial resources can additionally hold the CFTC back from comprehensively fulfilling its mandate. There is a lack of a unified vision for the role of government-owned commercial activities in Malawi's competition framework and no clear national agenda to use competition to address the market power of large and often politically connected firms. This comes in addition to challenges with the Competition and Fair Trading Act (CFTA). When fines are imposed these tend to be so low as to be ineffective in deterring anti-competitive behavior (MK500,000 or financial gain if greater). A bill to amend the CFTA has been drafted. Political economy and competition dynamics, including how they have thwarted private sector growth, are discussed in more detail in Chapter 5.

POLICY REFORMS TO INCREASE FIRMS' PRODUCTIVITY AND STRENGTHEN CAPABILITIES

To achieve its economic growth ambitions outlined in the *Malawi 2063,* Malawi must energize its private sector. Chapter 1 illustrated that Malawi needs strong private sector growth to unlock its economic growth ambitions under the *Malawi 2063*. Small, unproductive, service-, and domestically oriented firms are unlikely to be the driver of such rapid growth, thus requiring a transformation of how Malawi's private sector runs. While the potential for more private sector dynamism exists, the Malawian authorities need to create a conducive environment for the private sector to achieve growth (Table 3.2).

Malawian entrepreneurs require access to the tools they need to enable them to succeed. These tools include digital technologies and production inputs, whether they are imports such as fuel or locally produced services such as electricity. Many producers will also require secure access to land, which is not always granted by the Land Act. With a young and dynamic population, the reasons that Malawi is still largely at the sidelines of digital transformation are likely rooted in structural issues, including insufficient teaching of digital skills and the large costs of reliable mobile and internet services in Malawi. The unavailability of imported inputs is rooted in Malawi's macroeconomic challenges, which Chapter 1 discusses in detail. To enhance the provision of public services, Malawi needs to undertake comprehensive reforms of its public entities, as detailed in Chapter 5, to improve their efficiency and effectiveness.

Giving Malawian women entrepreneurs the same opportunities as their male counterparts would benefit everyone. In a difficult operating environment, Malawi will need to draw from the full pool of entrepreneurial talent that it has available. Management processes have been shown to be a key determinant of financial success and are likely to become even more so in an improved operating environment. Thus, providing all talent regardless of gender the same opportunities to improve is likely to pay off. However, to scale their businesses, Malawian entrepreneurs will also need access to capital, which only better functioning financial markets can provide. Given the current situation where most entrepreneurs, and especially women entrepreneurs, can only provide limited collateral, innovative solutions are needed to ensure they can still access loans that enable them to scale up.

Rapid growth of Malawi's private sector hinges on efficient financial intermediation. Shifting financing from the Government to the most productive private enterprises is a complex policy process that demands determination and meticulous planning. The more efficiently this process works, the lower the financing costs for borrowing enterprises. Thus, efficiency-enhancing reforms in the financial sector will benefit the wider public. Preparing more enterprises to be ready to absorb prospectively higher private sector financing volumes, such as through incubation and information programs, can play a role to make the reorientation of financial intermediation successful.

Promoting competition in Malawi benefits both consumers and businesses. Competition stimulates enterprises to deliver the best goods and services at competitive prices, enhancing the welfare of Malawian consumers. Moreover, businesses that emerge in a competitive environment tend to be more productive and internationally competitive. Achieving this level of competition requires robust legal support and an empowered competition watchdog.

Table 3.2 Top five private sector policy priorities

Policy Issue	Short-Term Actions *(next 3 – 6 months)*	Medium-Term Implementation *(before the end of 2025)*
1. Ensuring that those firms that can make the most productive use of fuel, forex, and energy can access it	Publish a transparent allocation and prioritization process for foreign exchange, fuel and power that enables the most productive firms to access sufficient inputs.	Address underlying infrastructure and macroeconomic constraints that result in frequent scarcity of key inputs.
2. Improving entrepreneurship outcomes, especially for women	Update financial regulations to promote more opportunities for non-collateral dependent loans, efficient collateral registries, and reliable ID systems to offer larger volume loans necessary for transformational business growth.	Support business incubation through training in financial management, financial reporting, and developing business plans and strategies with a focus on implementation capacity.
3. Increasing access to digital technologies	Reduce the cost of mobile phone ownership and broadband services by rationalizing tax and levy policies, and by promoting infrastructure sharing to encourage wider access for low-income citizens.	Strengthen education and worker training programs focused on digital literacy (for all users) and digital skills (for more specialized careers).
4. Improving access to finance, especially for smaller firms	Address the crowding out of the private sector from commercial borrowing, including by setting clear and credible targets for the reduction of Government domestic borrowing.	Reduce the operational costs of commercial and development banks through de-risking, cost-sharing of technology investments, automated service provision, efficient credit referencing, and timely resolution of court cases.
5. Strengthening the ability of the CFTC to enforce the competition regulatory and legal framework to enhance the welfare of consumers and foster competitive enterprises	Expedite the enactment of the Competition and Fair Trading Bill and corresponding regulations.	Invest in the capacity of CFTC and associated judiciary institutions, support the outreach and enforcement systems associated with the amended Competition and Fair Trading Act, and embed competition principles in broader public policies.

ANNEX 3.1

Data Sources Used for Firm-level Analysis

There are four main sources of data informing the analysis in this chapter. Business Pulse Survey (BPS) data are used to provide evidence on the impact of the COVID-19 pandemic and to assess the capacity of firms to cope with and adjust to the series of recent crises. The data from the first round of the BPS (wave 1) were collected in the 4th quarter of 2020, when the impacts of the shock were already clearly evident. A state of emergency had been declared in March 2020 and, although a lockdown was not enforced, in April 2020 gatherings were prohibited, schools were closed, and a curfew was compulsory. Following the economic downturn due to the health crisis, Malawi's economy briefly rebounded but in 2022 a series of external shocks and a BoP crisis severely weakened the economy again. Consequently, firms continue to suffer setbacks just as the COVID-19 pandemic was receding. A follow-up survey (wave 5) took place between the end of October and mid-November 2022 when restrictions had been lifted and supply chains were largely restored, but the country was suffering from other external shocks.

The BPS are an excellent resource to understand firms' resilience and firms' capacity to adjust. A particular strength of the data is the comprehensive information regarding finance, firms' capabilities, and technology adoption. But there are limitations. First and foremost is the lack of representability of the surveys. The survey was designed to monitor the impact, adjustment, and recovery of firms. To this end, there is a question asking the total value of sales in 2019 (before the COVID-19 pandemic). To assess impact and recovery, the survey asks the percentage of decrease (or increase) in sales with respect to the same period in 2019 and with respect to 2022.

The Funneling Survey (FS) was a pilot survey implemented in 2022 to test various methods of measuring firm capabilities such as knowledge of technical skills, business practices, and entrepreneur's personal and psychological traits. In addition, the data have information on sales, total expenditures, profits, and financial access. The FS does not include firms smaller than four employees or firms larger than 100 but does include informal firms. There are three independent necessary processes for registering a business: (i) registration at the Department of the Registrar's General (DRG); (ii) tax registration at the Malawian Revenue Authority (MRA); and (iii) registration at the local City Council (CC) to obtain a business license. Enforcement is very limited, but registration with DRG or MRA are necessary to access formal credit. Thus, the definition of formality is whether the firm is registered with DRG or MRA. The FS analysis exploits the richness of firms' capabilities data to look at the correlation of firms' performance with their capabilities.

Although neither the BPS nor the FS are representative, they provide novel information on topics not covered by the World Bank Enterprise Survey (WBES). The analysis builds on previous work, including Record et Al. (2016), using the 2009 and 2014 WBES. In the BPS there are 61 percent of micro firms (one to five employees, including the owner) in wave 2 and 79 percent in wave 5. The FS incudes only firms with four or more employees (but no larger than 100) and it has 33 percent of micro firms. More than half of the firms in WBES and FS are small (six to 20 employees), while only 26 percent in the BPS wave 2 and 15 percent wave 5 are small firms. Both datasets have a smaller share of medium firms compared with the WBES. Finally, the BPS has 2 percent large firms (55 establishments). Thus, micro firms are overrepresented in the BPS in comparison to the FS, while the opposite is true for small firms. The share of manufacturing is higher in the WBES compared with both the BPS and FS, while retail firms are lower and services higher in the FS in relation to both the WBES and BPS. Finally, the share of women-led establishments is around 30 percent in the BPS and FS, but only 16 percent in the WBES.

The FinScope survey was instituted to generate representative data on Malawi's MSME. The survey focusses on MSME owners and their financial service needs. The objectives of the survey were to (i) assess the size and scope of MSME in Malawi, (ii) describe the levels and landscape of access to financial products and services, (iii) identify the drivers and barriers to financial access, (iv) identify binding constraints to MSME development and growth, and (v) structure the MSME sector into market segments and identify the needs of each. The MSME Tracker Survey was instated as a follow-up to the FinScope Survey in 2019. While the data is more recent, it loses its representativeness of MSMEs in Malawi, with especially urban enterprises overrepresent. Methodological details can be found in the accompanying reports (FinMark Trust, Imani Development, and AESA 2019; FinMark Trust 2023).

Table A.3.1.1 Overview of sample for each data source

	WB Enterprise Survey		Business Pulse Survey, Wave 2		Business Pulse Survey, Wave 5		Funneling Survey		FinScope Survey, 2019			MSME Tracker Survey, 2022	
	(n)	Share	(n)	Share	(n)	Share	(n)	Share	(n)	Share (unweighted)	Share (weighted)	(n)	Share
Manufacturing	197	40%	205	10%	278	15%	46	12%	423	14%	22%	264	26%
Retail	212	43%	793	40%	942	50%	112	28%	2,208	74%	69%	514	50%
Services	84	17%	993	50%	678	36%	240	60%	362	12%	9%	248	24%
Micro	n/a	n/a	1,209	61%	1,509	79%	167	33%	1,607	54%	74%	916	89%
Small	289	55%	508	26%	282	15%	291	58%	1,203	40%	23%	106	10%
Medium	141	27%	218	11%	96	5%	47	9%	183	6%	3%	4	1%
Large	93	18%	52	3%	23	1%	n/a	n/a	0	0%	0%	0	0%
Woman-owned	83	16%	548	29%	646	34%	145	29%	1,225	41%	49%	328	32%
Formal	n/a	n/a	n/a	n/a	n/a	n/a	414	82%	735	25%	11%	385	38%
Total	523	100%	1,990	100%	1,910	100%	505	100%	2,993	100%	100%	1,026	100%

CHAPTER 4

Increased Trade Can Help Stabilize the Economy and Drive Industrialization

KEY FINDINGS

1 Malawi's chronic trade imbalance has worsened significantly in recent years, resulting in a consistent foreign exchange shortfall. Low levels of investment and high trade costs due to policy barriers, inefficient logistics and poor infrastructure, compounded by the structural challenges of being a small, landlocked country reduce overall economic resilience and negatively impact Malawi's economy.

2 Malawi's export performance has been worsening, largely due to its heavy reliance on one declining crop – tobacco. The double burden of being overly dependent on a single commodity and the volatility of its other exports not only exposes the country to fluctuations in global commodity prices and demand dynamics, but also results in inadequate and unstable foreign exchange earnings.

3 For exports to drive growth, Malawi must break the vicious cycle in which chronic trade imbalances and restrictive trade policies reinforce each other. Large policy distortions and foreign exchange rationing not only reduce access to inputs, but also act as a tax on exports, creating incentives for smuggling and informal trade, and hindering diversification into non-traditional exports with higher value added. This is further worsened by scarce foreign exchange primarily supporting the import of consumption goods rather than the inputs necessary for participation in global and regional value chains.

4 Malawi has high potential to increase exports in non-traditional agricultural exports such as soybeans, macadamia, and groundnuts, as well as in mining. Recent discoveries of energy transition minerals, including rare earths, niobium, rutile, and graphite, present opportunities for increased exports, and in turn foreign exchange generation, fiscal revenues, and growth – if these are managed responsibly.

5 Given its dependence on its neighbors both as export markets and to reach ports, reducing trade and transport costs will be essential for Malawi to leverage trade for growth. Central to this will be advancing trade facilitation and customs reforms, and especially the removal of non-tariff barriers especially along key corridors. Integration through the African Continental Free Trade Area could bring significant benefits to Malawi, particularly in the processed food, agriculture, and trade sectors.

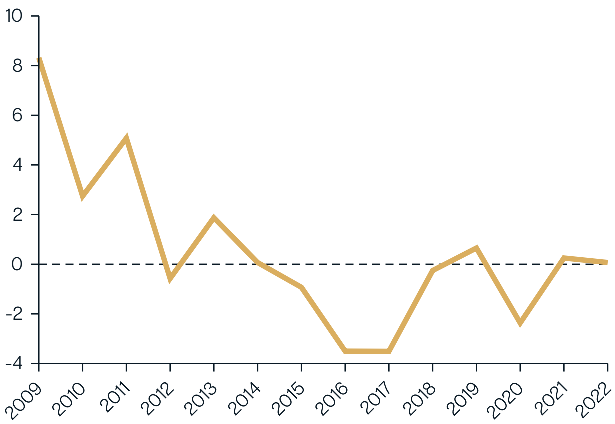
IMPROVING TRADE PERFORMANCE CAN UNLOCK MALAWI'S ECONOMIC POTENTIAL

Malawi's weak trade performance is central to its broader macroeconomic challenges. Chapter 1 shows how Malawi outperformed its peers in exports during the 1990s and early 2000s, but has since fallen behind. It also shows that improvements to Malawi's external performance, paired with broader macroeconomics reforms, can help transform a self-reinforcing cycle of crises into a cycle of opportunities.

The country's lack of economic diversification presents a significant obstacle to unlocking Malawi's full economic potential. The economy faces numerous structural constraints. Malawi is a landlocked country with large distances to ports, a small domestic market, and few natural resources. The country has faced persistent challenges in enhancing export performance, relying heavily on tobacco exports, with diversification efforts proceeding only slowly and exports declining (Figure 4.1). While the 2013 – 2018 National Export Strategy (NES) achieved some of its intermediate targets, such as launching the "Buy Malawi" Initiative and accession to the World Trade Organization (WTO) Trade Facilitation Agreement, it failed to attain its core aim of building Malawi's productive base and export capacity through the development of export clusters, building a conducive environment for competitiveness, strengthening supportive institutions, and investing in competencies, skills and knowledge relevant to exporting (Ministry of Trade and Industry 2013). The NES set a target of increasing export values by 13 percent between 2013 and 2017. However, the average annual growth rates during this period were -9.0 percent for goods, 16 percent for services, and -6.2 percent overall (Figure 4.2).

Figure 4.1 Malawi's goods exports have been in decline

Annual export growth, 3-year rolling average, percent



Source: World Bank staff calculations based on MRA transactions data for goods exports.

Figure 4.2 Malawi's NES export growth targets were not achieved

Compound annual growth rate (CAGR), percent

Source: World Bank staff calculations based on MRA transactions data for goods exports and WDI data for services.

Malawi's Government has set ambitious targets for export growth with its new National Export Strategy II (NES II, Ministry of Trade 2021) **and the importance of increasing exports is also central to the *Malawi 2063*** (Box 4.1). As foreign currency shortages continue to constrain the economy, increased exports have the potential to become a vital source of foreign exchange. This underscores the importance of Malawi developing and implementing a robust strategy to increase export competitiveness, integrate into global markets, and stabilize its macroeconomy. To achieve the aims of the NES II, Malawi needs to adapt its domestic policies and create an enabling environment that fosters and incentivizes export growth.

Box 4.1 Can Malawi's new National Export Strategy achieve its ambitious targets?

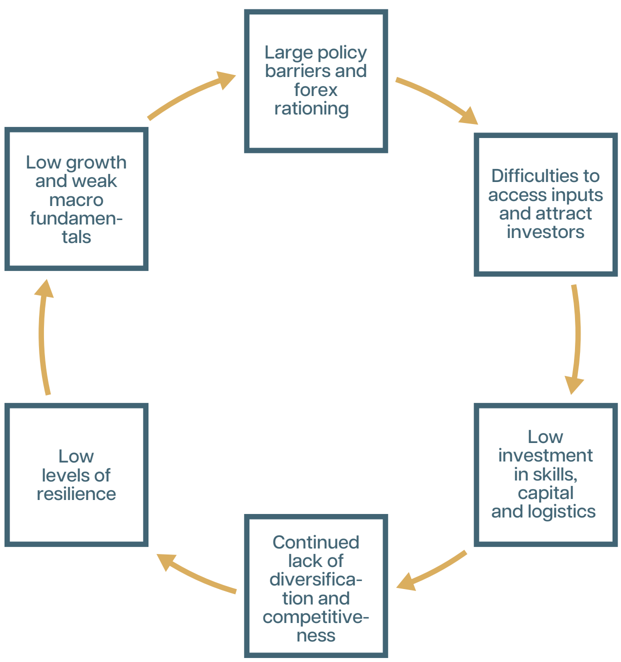
Malawi's new National Export Strategy (NES II) was announced as a successor strategy to the previous NES, which for the most part missed its targets. It focuses on promoting export competitiveness and expanding exports from 14.6 to 20 percent of GDP by 2026. The strategy has four goals: (i) increasing exports of "made in Malawi" products; (ii) reinforcing export readiness and competitiveness of Malawian firms; (iii) enhancing domestic investment and the business environment; and (iv) improving implementation. The priority sectors are agriculture (including forestry and fishing), manufacturing, mining and services.

The NES II sets ambitious targets. Overall, the NES II aims to improve Malawi's export competitiveness, expand its export markets, and promote sustainable and inclusive economic growth.The NES II has several more specific objectives, including increasing traditional exports by 25 percent and non-traditional exports by 50 percent, expanding the volume of exports by 10 percent, reaching 125 markets, and attracting 20 new firms to enter the export market annually. The strategy also aims to strengthen trade agreements by negotiating eight new trade agreements, increasing the total from 32 to 40 agreements.

In recent years, the decline in exports and lack of diversification has been caused in part by restrictive policies that have yielded few positive impacts. In addition, persistent foreign exchange shortages have made it difficult and often impossible for producers to access necessary intermediate inputs (see also Chapter 1). Policy has often focused excessively on increasing administrative regulations which contribute to non-tariff barriers (NTBs),[26] impacting importers and exporters, as well as the promotion of import substitution over export-led growth. These amplify existing constraints and prevent the private sector from growing and becoming more competitive.

To achieve its development aspirations, Malawi must break the vicious cycle in which structural factors and restrictive trade policies reinforce each other, perpetuating a low-level equilibrium (Figure 4.3). Large policy barriers and foreign exchange rationing not only reduces access to inputs, but also to essential goods such as health and food products, putting the poorest at risk. In addition, these barriers act as a tax on exports, as official exports face a price disadvantage in foreign markets, affecting their competitiveness. This reduces income from exports and creates disincentives for firms to trade, hindering improvements in export diversification and complexity. The economy also suffers from a lack of investment and high trade costs due to poor logistics and infrastructure. These issues, compounded by the structural barriers of being a small, landlocked country, reduce overall economic resilience and negatively impact Malawi's macroeconomy through insufficient foreign exchange earnings resulting from low exports. This chapter argues for an export-oriented strategy to stimulate economic development and overcome these structural challenges. By diversifying the economy, leveraging opportunities in key sectors, and addressing long standing issues, Malawi can unlock its full potential and position itself for sustainable and inclusive growth.

Figure 4.3 A vicious cycle of restrictive trade policies and weak outcomes



Source: World Bank staff.

26. NTBs describe all measures that restrict imports or exports of goods or services through mechanisms other than the simple imposition of tariffs.

This restrictive environment prevents growth in emerging sectors such as agri-business, mining, and tourism. Recognizing that Malawi cannot achieve complete domestic self-sufficiency in all sectors, it is imperative to strategically target and allocate scare resources towards areas where growth can realistically occur. By adopting a step-by-step approach toward developing more complex exports and attracting investments in key industries, Malawi can capitalize on its comparative advantage in agro-processing, mining and tourism, and gradually expand its economic potential. Over time, these efforts will generate spillover effects within the domestic economy, fostering stronger linkages with local businesses and providing them with significant benefits through access to regional and global markets.

The chapter addresses how Malawi can create a more diversified and resilient economy through trade, while strengthening its macroeconomic environment. The next section summarizes key stylized facts on Malawi's trade performance. The third section then addresses the underlying policy causes of its sluggish trade performance. It then explores potential ways Malawi can enhance its trade performance to fulfill the Government's objectives of diversifying the economy and increasing exports. The final section presents policy recommendations derived from the analysis.

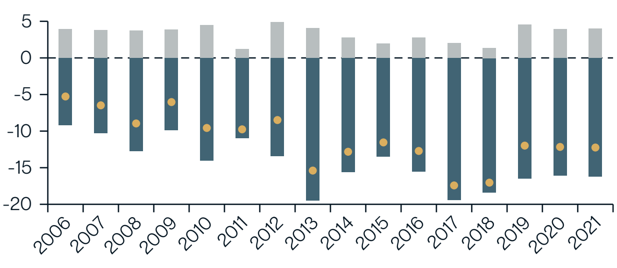
AN OVERVIEW OF MALAWI'S TRADE PERFORMANCE IN SIX FACTS

1. Malawi's exports have declined significantly in the past decade, resulting in low foreign exchange earnings and driving Malawi's macroeconomic imbalances

The decline in exports has resulted in a worsening current account balance and dwindling reserves. Double-digit current account imbalances (in terms of percentage of GDP) between 2013 and 2021 have led to the accumulation of substantial external liabilities (Figure 4.4). This has resulted in a gradual deterioration in net reserves, especially in the post-COVID-19 years (Figure 4.5).

Figure 4.4 The current account deficit has deteriorated in recent years...

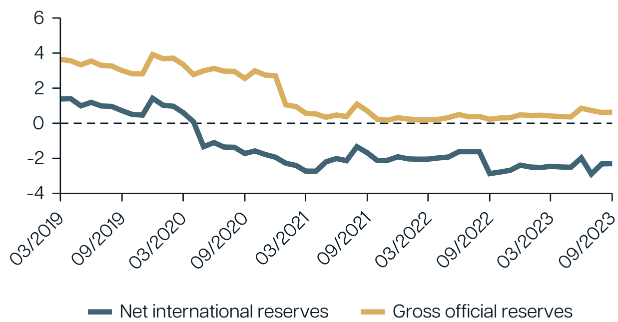
Current account, percent of GDP



Source: World bank staff calculations based on World Development Indicators (2023)

Figure 4.5 ...resulting in dangerously low reserves

Official gross and net reserves, months of import cover



Source: World Bank staff calculations based on RBM data.

Note: Net reserves subtract predetermined short-term drains, such as short-term swaps.

The decline in exports stems from decreasing volumes along established trade links while volumes for new export relationships stagnated. Incumbent firms exported fewer existing products to previously established markets (also called the intensive margin) between 2009 and 2022 (Edwards, Engel, and Stojanov 2023). Similarly, net entry of firms and expansion by incumbent exporters into new markets (also called the extensive margin) failed to continue the previous growth into the post-2009 period.

These dynamics are also reflected in Malawi's level of trade openness, as measured by the overall share of exports relative to GDP. Openness has declined over the past two decades, reflecting the worsening of its export performance (Figure 4.6). This decline indicates that Malawi's goods exports have underperformed, relative to the country's level of economic development. However, this decline in goods exports has been partially offset by growth in the services sector, as well as a small increase in agricultural exports. Growth in the services sector,[27] and especially transport services, has been strong, with an annual average growth rate of 20.0 percent since 2016, making it the primary source of export growth and helping balance out the decline in goods exports (Figure 4.7).

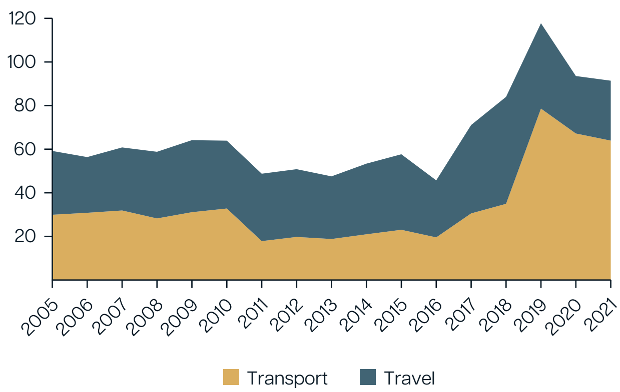
Figure 4.6 Malawi's historical trend in trade openness from 1990 to 2020

Share of GDP, percent

Source: World Development Indicators.

Figure 4.7 Malawi's services exports have spiked since 2016

US$ ('000,000)



Source: WTO services data.

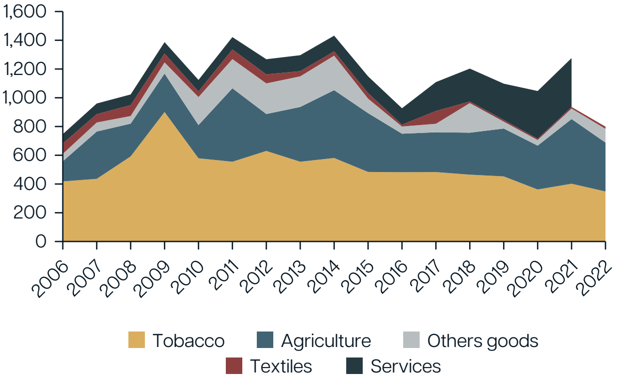
2. Malawi's exports are highly concentrated, with little progress achieved toward diversification

Malawi's overall export performance has been worsening, largely due to its heavy reliance on one declining crop — tobacco. Despite the Government's efforts to promote diversification, tobacco exports account for between 30 and 45 percent of the country's total goods and services exports in recent years (Figure 4.8). Other non-tobacco agricultural exports, while showing significant overall growth, also demonstrate high volatility. This double burden of over-reliance on a single commodity and the volatility of its other exports not only exposes Malawi to fluctuations in global commodity prices and demand dynamics, but also results in inadequate and unstable foreign exchange earnings (Figure 4.9).

27. Service exports in this study exclude the category "Maintenance and repair services" due to limitations in the available data. The data for this category was only captured in the Balance of Payments (BoP) survey conducted in 2021, covering 2019 – 2021, without normalizing the previous years' estimates. Consequently, a kink is observed in the data for 2019. Prior to the survey, data collection relied on administrative sources and estimations, and the normalization of estimates based on the survey results was not carried out, resulting in a discrepancy in the data for 2019. "Maintenance and repair services" encompass the maintenance and repair work carried out by residents on goods owned by non-residents, as well as vice versa. This includes activities such as the maintenance and repair of ships, aircraft, and other transportation equipment.

Figure 4.8 Malawi's exports composition is dominated by tobacco and services

US$ ('000,000)

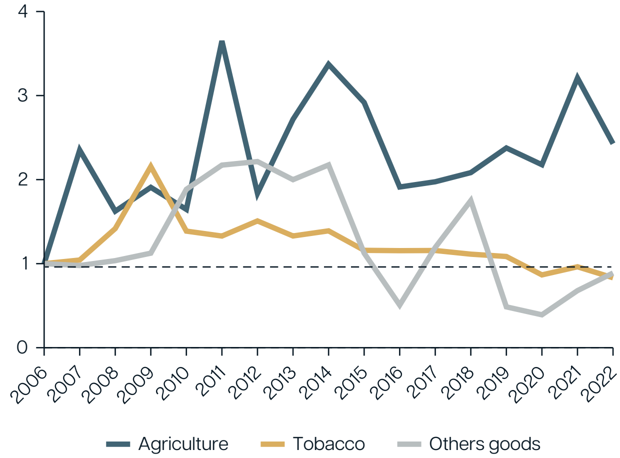


Source: World Bank staff calculations based on MRA transactions data for goods exports and WDI data for services. Note: services exports do not include the category "maintenance and repair".

Note: Services exports do not include the category "maintenance and repair".

Figure 4.9 Malawi's declining export performance and volatility in other exports

2006=1



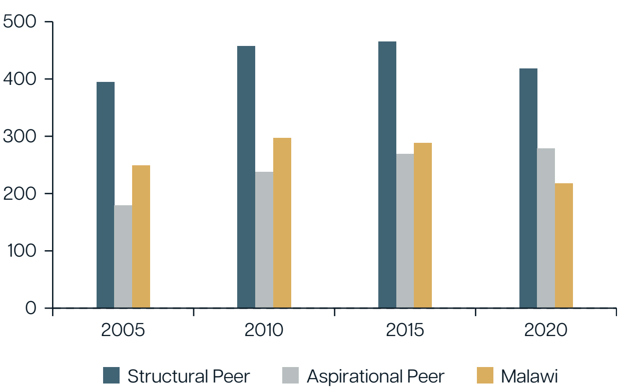
Source: World Bank staff calculations based on MRA transactions data for goods exports.

Malawi's heavy reliance on tobacco as its main export commodity has resulted in limited diversification. Out of over 5,000 existing products in the Harmonized System (HS) classification, Malawi exported 218 products in 2020. This represents a marked reduction of exported products by 24.3 percent compared with 2015, when the country exported 288 products (Figure 4.10). This places it above some peers, such as Niger and Rwanda, but far behind Lao PDR, Madagascar and Uganda.

While Malawi reached fewer markets, African markets proved the most resilient. Most Malawian exports, but especially tobacco, have experienced a decline in the number of markets that they access (Figure 4.11). These patterns suggest challenges in accessing new markets and imply high exit rates for firms operating in those sectors. The share of Malawi's exports destined for African countries rose from 37 to 45 percent between 2006 and 2022, driven by food and manufactured goods exports.

Figure 4.10 Malawi's number of differentiated exports is diminishing

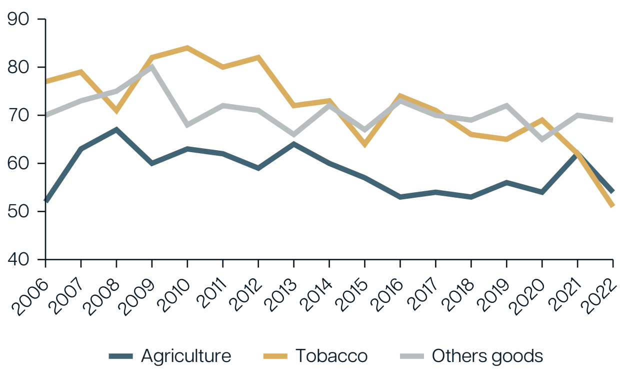
Number of product HS 6 digits, 2005–2020



Source: World Bank staff calculations based on WITS-Comtrade data.

Figure 4.11 Malawi's number of markets reached declined for most of its exports sectors in recent years

Number of markets, 2006–2022



Source: World Bank staff calculations based on MRA transactions data for goods exports.

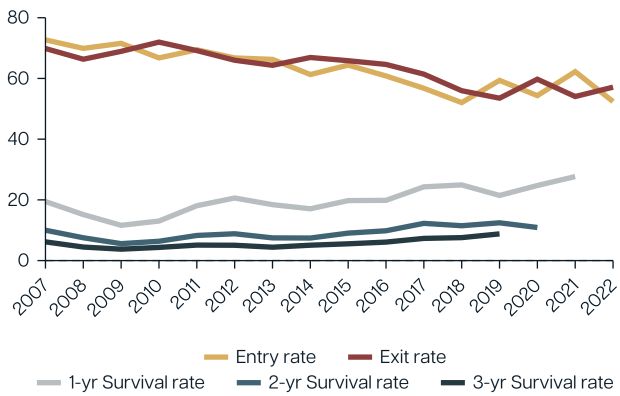
3. Exports and exporters exhibit low survival rates

To achieve and sustain export-led growth, Malawian firms will need to not only successfully enter new export markets and products, but also survive and grow as exporters. Export diversification can be driven by the entry of new firms into exporting or by firms exporting into new markets and selling new products. However, often export survival, i.e., maintaining these trade relationships, is a key challenge for exporting firms (Carrère and Strauss-Kahn 2017).

The overall number of exporters has dropped over the past decade, mainly due to the stronger decline in entry rates than exit rates, resulting in higher concentration. The decline in the number of exporters can be attributed to diminishing entry rates, although exit rates have also decreased. Moreover, the survival rates of new entrants are relatively low. On average, only 20 percent of new exporters manage to survive into the subsequent year over the period 2006–2022, and 5.7 percent survived past the third year (Figure 4.12). Global value chain (GVC) firms, i.e., firms that both export and import, tend to be larger and export more diversified goods than their peers that only export. They also show more stability (Figure 4.13). Over the 2006–2022 period, the one-year survival rate of GVC firms was 35 percent compared with 11 percent for non-GVC firms. The three-year survival rate was 13 percent for GVC firms, whereas only 2 percent of non-GVC entrants continued to export for three successive years (Figure 4.14).

Figure 4.12 Export survival rates are low and stagnant

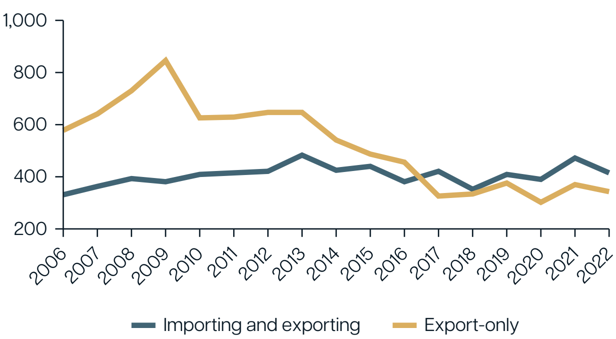
Percent



Source: World Bank staff calculations based on MRA transactions data for goods exports.

Figure 4.13 Malawian exporters have been declining, while GVC firms show more stability

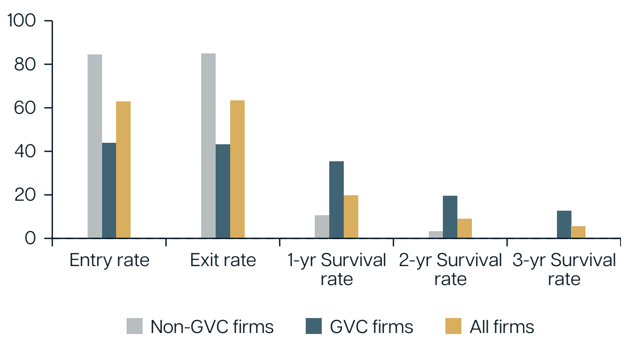
Number of exporting firms



Source: World Bank staff calculations based on MRA transactions data for goods exports.

Figure 4.14 Firms that are linked to GVCs build stronger export relationships

Annual average, percent



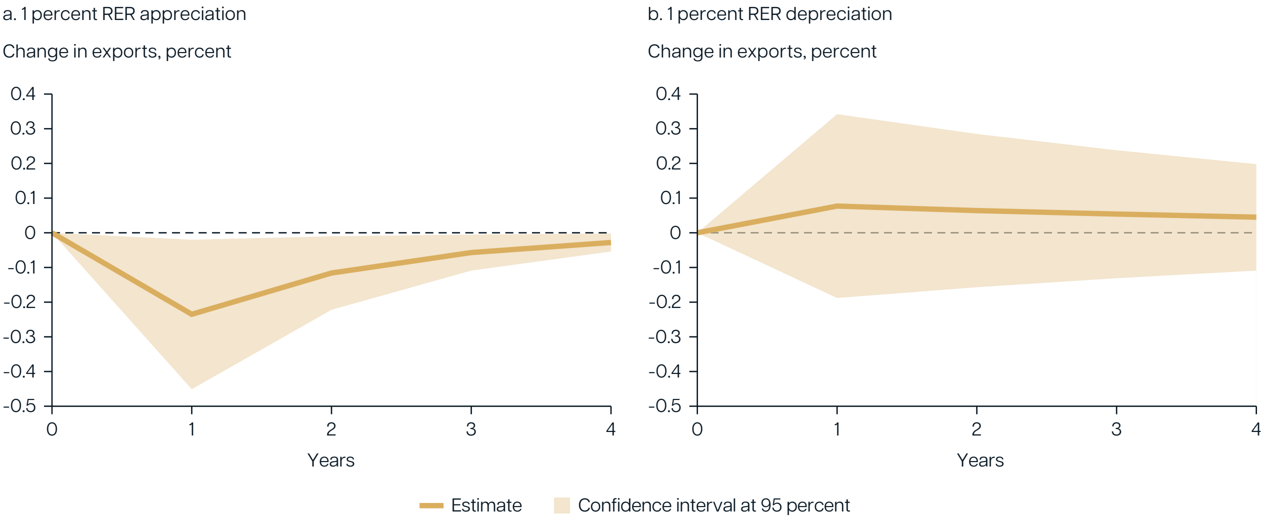
Source: World Bank staff calculations based on MRA transactions data for goods exports.

4. Malawian exporters lose more from exchange rate appreciations than they gain from depreciations

Though a declining real exchange rate can have strong negative macroeconomic and societal impacts, it is generally expected to improve export competitiveness. When the real exchange rate (RER) depreciates, production costs for domestic firms fall relative to foreign competitors. This enables local firms to become more competitive in other markets and increase their likelihood of exporting. In fact, having a 'competitive currency' to encourage export success is a common policy recommendation and often demanded by exporting firms (Frieden 2015), but the literature is not conclusive on its outcomes. Developing countries have often experienced delayed realizations of the maximum effects of depreciations (Bayoumi 1996; Colacelli 2009; Hooper and Marquez 1993; Pirzada 2019).[28]

Historically, Malawian exports increased gradually following RER depreciations but fell rapidly during appreciations, hindering the country from taking advantage of this mechanism for increasing its competitiveness. During most periods in its history, Malawi has maintained a fixed nominal exchange rate, which has resulted in an appreciation of the RER in real terms (see Chapter 1). While these gradual appreciations reduce exports by undermining competitiveness, new econometric research conducted for this CEM (Brun, Stojanov, and Engel 2023) indicates that export recovery is slower when the depreciation eventually occurs. In Malawi, the reaction to an appreciation is fast (Figure 4.15): more than 50 percent of the correction occurs in the first year. A depreciation makes Malawian exports more competitive, resulting in an increase in exports. However, the reaction is slower: it takes four years to process 50 percent of the long-term correction. By the end of the first year, only 16 percent of the long-term increase happened. This implies that an exchange rate policy that is good for exporters minimises periods of appreciations (like during fixed exchange rate episodes). Depreciations provide exporters with a boost, but this takes time to fully materialise.

Figure 4.15 Export response to RER movements: slow to increase but fast to fall



Source: World Bank staff calculations based on MRA transactions data for goods exports.

Note: These figures report estimates for short-run export responses to RER appreciations and depreciations. Exports are deflated by US GDP implicit price deflator. RER is constructed with geometrically weighted averages of nominal exchange rates and price indices of Malawi's trading partners. Figure (a) depicts response after a 1% real effective exchange rate appreciation. Figure (b) depicts response after a 1% real effective exchange rate depreciation. Confidence intervals at 95% are reported as shaded area.

Export responsiveness to RER depreciations exhibits greater strength in those sectors characterized by undifferentiated products, higher labor intensity, and reduced dependence on private capital. The elasticities of exports with respect to real exchange rates during depreciations highlight that undifferentiated products and sectors with higher

28. Recent studies have delved into this by exploring asymmetric reaction to exchange rate changes (Bahmani-Oskooee and Harvey 2022; Brun, Gambetta, and Varela 2022; Cheung and Sengupta 2013; Demian and di Mauro 2018; Šimáková 2018).

labor intensity are more likely to experience significant increases in exports than other sectors. In addition, sectors that rely less on credit react more strongly in response to real exchange rate changes, whereas sectors with greater reliance on credit demonstrate a slower response, suggesting an inadequacy of access to finance. In addition, the elasticity of exports to changes in the real exchange rate is influenced by various factors, including export destination, product, and firm characteristics. Notably, the export response to bilateral exchange rate movements is lower for exports to African countries and neighboring nations, as well as for smaller firms, non-GVC firms, and manufactured goods.

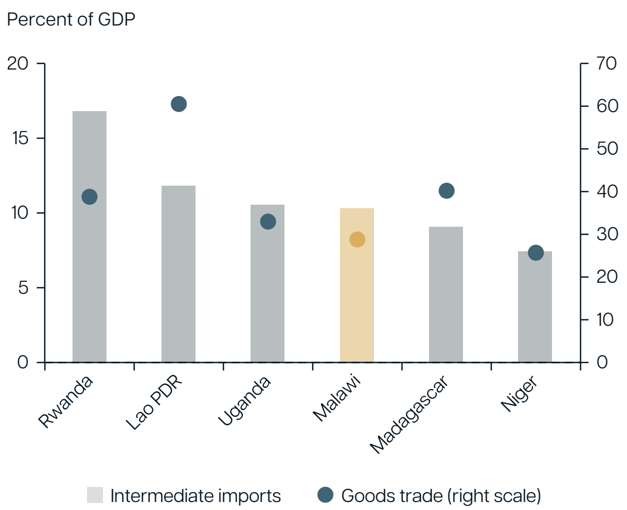
There are several causes for this differentiated response. First, supply constraints reduce exporters' capacity to scale up. Second, finding new clients can be difficult and expensive for firms, especially for those with a narrow potential customer base. Furthermore, during periods of overvaluation, exporters face additional constraints as spreads between official and parallel market exchange rates emerge, acting as a de facto tax on official exports. This is in line with a growing literature that shows that there is a significant heterogeneity in export response following depreciations.[29]

5. Malawi "under-imports" intermediate goods necessary for GVC participation, while consumption goods use up an increasing share of foreign exchange

As for any small economy dependent on agricultural exports, access to imports plays an important role in Malawi's trade competitiveness. In general, smaller developing countries tend to import more as domestic firms seek to gain access to intermediate inputs or capital goods that cannot be produced domestically or for which domestic quality is lower. To foster sustainable export-led growth, importing intermediate inputs and capital goods plays a crucial role, as they contribute to technology transfer and productivity growth (World Bank 2020c). The import basket is therefore a good reflection of domestic production capacity and competitiveness for a small economy like Malawi, as firms often do not have access to inputs from the domestic market (unlike firms in larger economies). Moreover, firms in low-income countries that use intermediate inputs in their production tend to be more productive and efficient than those that source only from the domestic market *(ibid.)*.

Malawi imports fewer intermediate imports than peer countries due to both foreign exchange constraints and other barriers to accessing imports. Only Madagascar and Niger exhibit a similar or lower level of reliance on intermediate (Figure 4.16). Countries that import intermediates tend to be better performers in terms of exports, as they are able to generate higher export values on average. Therefore, improving access to intermediate imports for producers may be a potential avenue for improving Malawi's export competitiveness and economic performance.

Figure 4.16 **Intermediate imports as percent of GDP is relatively lower for Malawi compared with its peers**



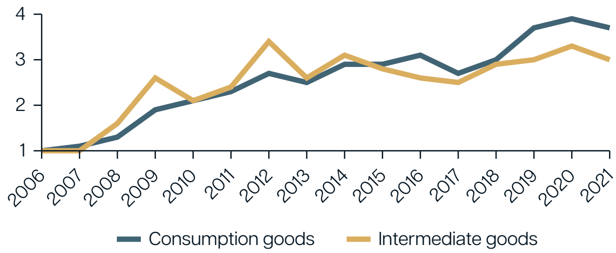
Source: World Bank staff calculations based on WITS reported imports data using BEC classification for intermediates.

29. Structural attributes of the products, conditions under which they are produced, or firms' characteristics may affect responses to similar contexts, and can explain the capacity to yield the benefits from better price-competitiveness (Brun, Stojanov, and Engel 2023; Demian and di Mauro 2018; Dhasmana 2015).

Malawi's imports consist primarily of intermediates and consumption goods. These imports are essential for food security, health, transport, and overall economic competitiveness. However, the growth rate of consumption goods surpasses that of intermediates (Figure 4.17), indicating that productivity may not be improving as desired, as exports are stagnating. Given that consumption goods also comprise critical items such as pharmaceuticals and food products, the Government must manage its import expenditures carefully and ensure sufficient foreign exchange is available for firms that need inputs for production. This highlights the importance of nurturing a private sector that can generate export revenues to purchase imported goods.

Figure 4.17 **The level of intermediate goods imports has been slowing down, while that for consumption goods has been increasing**

Evolution of intermediate and consumption good imports, 2006=1



Source: World Bank staff calculations based on MRA transactions data for goods exports based on WITS reported imports data using BEC classification.

6. Foreign investment — a key ingredient for export growth — has declined from an already low base

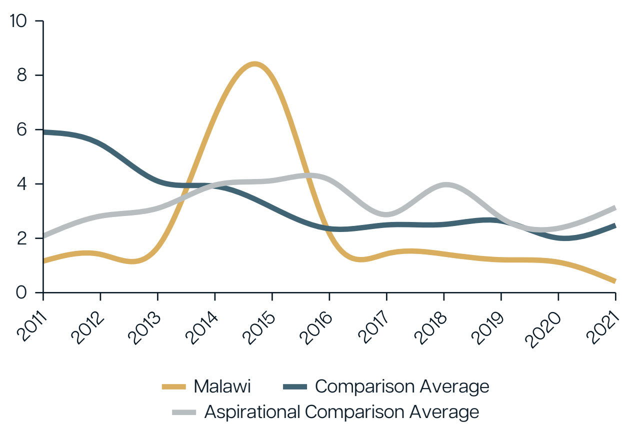
Foreign direct investment (FDI) is a crucial factor in economic growth, as it contributes to increased productivity, innovation, and technology transfer, in turn creating better jobs. In addition to supporting economic diversification, FDI also helps domestic firms become more competitive and expand their export capabilities. By enabling access to intermediate goods and attracting further strategic FDI, countries can increase their participation in regional and global value chains, which in turn can drive industrialization and support the structural transformation of economies. As discussed in Chapter 1, increasing FDI will be an essential ingredient for the capital formation needed to achieve higher and sustained growth rates.

Malawi's inward FDI flows and stocks are below its peers. Inward FDI flows to Malawi, as a share of GDP, experienced a spike in 2014, but have been smaller those of than its peers' since 2016 (Figure 4.18). Compared with peer countries, Malawi's FDI inflows-to-GDP ratio in 2021 was less than 0.36 percent, significantly lower than the regional average of 2 percent or more. Overall, FDI in smaller countries such as Malawi tends to exhibit volatility and scarcity, whereby the realization of even a single investment can have a significant impact.

The importance of FDI as an external finance source has steadily diminished over the past decade, while remittances and ODA have emerged as the primary sources of finance. In 2021, the bulk of financial inflows into the country consisted of ODA and remittances, overshadowing the significance of FDI inflows (Figure 4.19). The decline in inward FDI flows can be attributed to a decrease in intra-company loans, leaving equity (excluding reinvested earnings) as the only substantial inflow in recent years (Figure 4.20).

Figure 4.18 **Inward FDI flows for Malawi and comparison countries, 2011–2021**

Share of GDP, percent

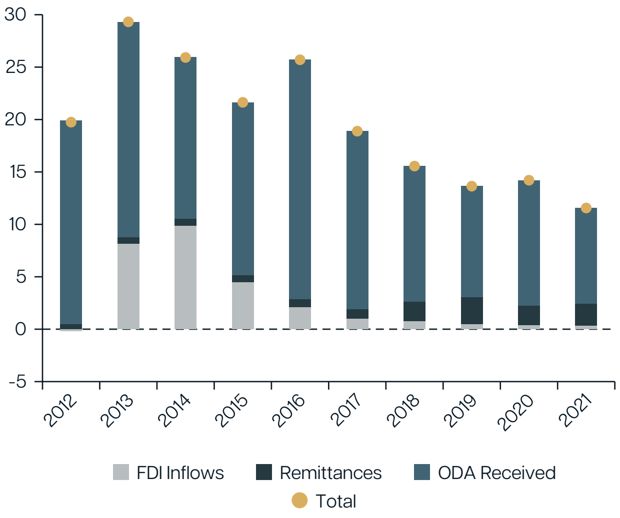


Source: Harmonized Bilateral FDI Database, WBG.

Note: FDI flows are on a net basis (capital transactions' credits less debits between director investors and their foreign affiliates). The "comparison average" group includes Burundi, Madagascar, Niger, and Uganda. The "aspirational comparison average" group includes Ethiopia, Lao PDR, Nepal, and Rwanda.
The spike in the early 2010s includes the investment from Vale under the Nacala Rail Project.

Figure 4.19 Malawi's FDI vs. other sources of external finance (2011 – 2021)

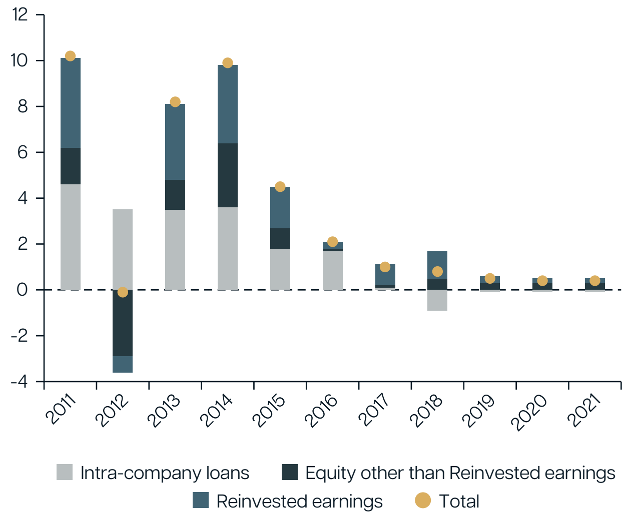
Share of GDP, percent



Source: World Development Indicators.

Figure 4.20 Malawi 's composition of inward FDI flows (2011 – 2021)

Share of GDP, percent

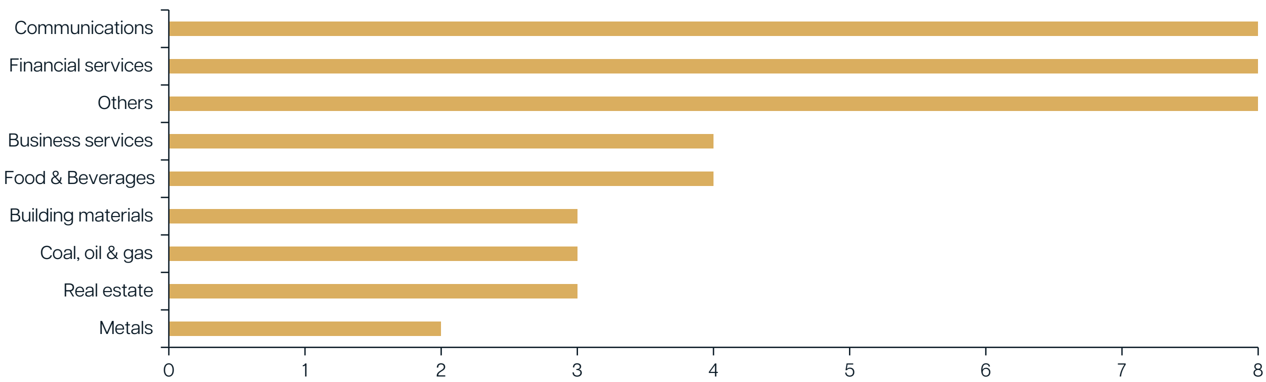


Source: International Monetary Fund, BoP.

This is also reflected in a declining number of FDI projects. Between 2008 and 2022, a total of 52 greenfield FDI projects in Malawi were announced, according to the FDI markets database, meaning that the average year only saw the announcement of 3.5 projects. The dominant sector among these investment announcements was communications and financial services (Figure 4.21). The largest number of projects came from India (7), followed by the United Arab Emirates (6), South Africa (5) and China (4).

Figure 4.21 Most FDI projects have been in services sectors

Number of FDI projects, 2008–2022



Source: fDi Markets data.

Note: The "Others" group includes one project each in the following sectors: Chemicals, Consumer products, Healthcare, Industrial equipment, Pharmaceuticals, Renewable energy, Software & IT services, Transportation & Warehousing.

TRADE AND INDUSTRIAL POLICY CHOICES ARE CENTRAL TO MALAWI'S WEAK TRADE PERFORMANCE

Malawi's geography and its economic structure already pose significant challenges to the country's trade competitiveness. Being a small, landlocked nation with limited resources, the development of a competitive private sector is inherently challenging. These challenges are further amplified by the lack of strong domestic demand, low production capacity, inadequate human capital, and a labor force with comparatively low wages. Several additional policy measures compound this. These include numerous NTBs, thick borders, and the slow pace of trade and transport facilitation reforms, and significant investment and services trade restrictions.

The high cost of trade restrictions

The persistence of trade restrictions and, in particular, the persistence of numerous NTBs, only compounds the structural challenges. While tariffs have declined significantly in recent years and are comparable to those of most peers, the proliferation of NTBs constitutes a key constraint to export growth. Many of these policies have unintended consequences that are inconsistent with the Government's goals of improving the diversification and resilience of the economy. Creating a domestic policy environment that facilitates export growth and improved exporter competitiveness requires reducing barriers that impede the ability to reach foreign markets.

This includes a number of measures, including the following:

- **Malawi has imposed import restrictions on 24 product categories, necessitating import licenses.** In addition, a complete ban on all meat products, with a few exceptions, has been implemented.[30] These restrictions can affect the affordability of essential goods for the poor. They also reduce access to crucial inputs for the private sector, exacerbating the challenges faced by businesses, while domestic procurement for inputs remains limited and insufficient for meeting the demands of the market.

- **Exports licenses also create more cumbersome procedures for exporters.** Malawi has officially imposed export restrictions and requires export licenses for the following group categories: hides and skins, maize, wood timbers, poultry, gems, and petroleum, among others. Such restrictions can reduce the incentives for firms to export through official channels, creating an illegal parallel market.

- **Currently, export permits are required for many crops.** This creates some challenges towards aligning with the initial objective of the revised Control of Goods Act (2018), which aimed to improve the predictability of export restrictions related to food commodities. The Act was designed to regulate exports based on different public interest thresholds, only allowing intervention when public interest in a restriction was established through national food balance sheets. However, the Ministry of Trade and Industry often lacks the necessary information to make timely decisions based on Food Balance Sheets,

30. The restricted import list includes items such as clothing, sugar, gold, live fish, bees, beans (excluding tinned beans and bags weighing less than 90kg), compound products containing flour, eggs, groundnuts, maize, oil seeds, potatoes, rice, rupoko, bananas, and meat.

which moreover only include select grains. This hinders the effectiveness of these important reforms. As a result, licensing requirements persist, undermining the goal of creating a more efficient and transparent system for export restrictions in the agriculture sector.

- **Furthermore, in 2021, the Reserve Bank of Malawi (RBM) reinstated the mandatory conversion of 30 percent of export proceeds as a means to maintain an adequate supply of foreign exchange within the country.** However, this policy has significant implications for the economy as it restricts the private sector's ability to strategically allocate resources. Moreover, this policy sends a negative signal to international investors, who value flexibility and autonomy in managing foreign currency earnings. It is crucial for policy makers to strike a balance between ensuring foreign exchange availability and fostering a favorable investment climate.

- **In addition, the RBM has recently implemented a new directive mandating the declaration of exports using a reintroduced CD1 form.** This form had been discontinued in the past but has now been reinstated through a new directive. According to the law, it is now compulsory for exporters to declare their exports using this form.

- **Another significant development pertains to the introduction of a new directive by the Malawi Revenue Authority (MRA), announced in the 2023 budget and now gazetted in regulations.** This directive requires all exporters to obtain a certificate confirming their use of a bonded export warehouse for their shipments. However, the establishment and licensing of these warehouses, as well as ensuring their widespread availability, entails a complex process that is likely to result in delays and increased costs for the private sector. Such procedures often have unintended consequences, such as driving more firms toward informality and smuggling, and facilitating the emergence of illicit trade flows.

While often intended to bolster Malawi's trade balance, these measures frequently create direct and indirect negative impacts for exporters. Expanded licensing and enforcement regimes were justified with the need to reduce food insecurity and promote the repatriation of export proceeds. However, the lack of clarity surrounding the implementation of these policies, combined with an existing onerous export licensing system, creates further hurdles and uncertainty for exporters. In a context where each additional day that a product is delayed prior to being shipped reduces trade by more than 1 percent (Djankov, Freund, and Pham 2010), such policies are likely to reduce the number of firms exporting, as well as the total value of goods exported.

The negative impact on agricultural trade is particularly high. In Malawi, the persistence of ad-hoc export restrictions and export licensing procedures results in significant underinvestment by the private sector in agro-processing and deters new investors. The complexity of the export licensing process is illustrated in Figure 4.22, as reported by one medium-sized agricultural exporter. On average, assuming no delays on the part of the exporter, this process takes a minimum of four weeks, but often longer. This is due both to the large number of administrative requirements and to the lack of coordination across government ministries. During these delays, goods planned for export may perish (especially agricultural goods), or importers could change their mind and select a producer who can deliver sooner. While the envisioned Malawi National Single Window[31] has the poten-

31. The National Single Window (NSW) is an electronic platform system interconnected with international trade and transport stakeholders to fulfil all imports, exports, and transit border control procedures. Government border control agencies are linked to the NSW platform to process transactions but operate in the background, with workflow management of their organizations integrated into the NSW.

tial to accelerate some steps, the administrative requirements are likely to remain burdensome for exporters as many of these measures are likely to remain.

Figure 4.22 The long journey to an export license for a Malawian agricultural exporter

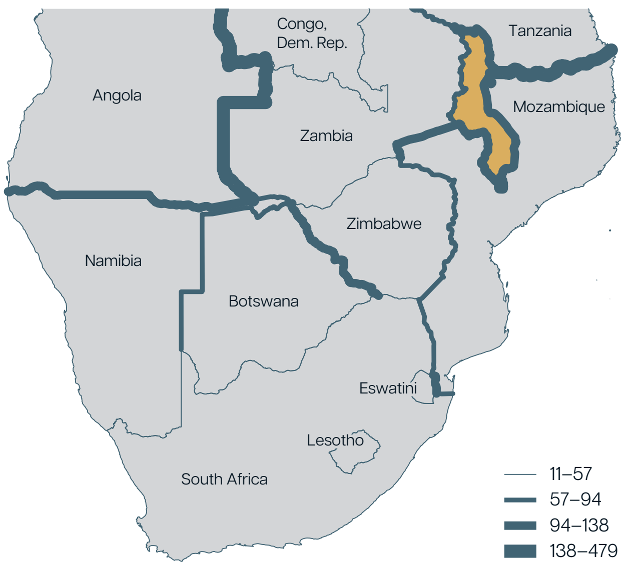
Source: CEM consultations with private sector.

"Thick" borders and the slow pace of regional trade and transport facilitation and integration

Malawi's borders are relatively "thick", leading to higher transport costs compared with peer countries such as Zambia, Zimbabwe, Botswana, and Namibia (Figure 4.23). Thicker borders indicate greater differences between producer and consumer prices, implying higher trade costs and potential barriers to trade for Malawi. An underdeveloped inter-modal transport network and poor logistics infrastructure are hindering service delivery, performance, and economic integration, with transport costs in Malawi among the highest in the region.

Figure 4.23 Malawi's borders are "thicker" than those of many other countries in the region

Bilateral Border Thickness (percent ad valorem), 2015–2018 averages



Source: Arvis et al. (2020) based on World Bank-UNESCAP database (2015 – 18 averages).

While the behind-the-border NTBs discussed in the previous section contribute to these thick borders, and the presence of further NTBs at the border and in neighboring transit countries such as Mozambique and Tanzania, adds to the costs of trade for Malawian exporters and importers. This significantly constrains their opportunities to access regional markets. Due to the country's landlocked position, Malawian exporters and importers are heavily reliant on road transport, with roads used for 99 percent of passenger services, 70 percent of domestic freight and 90 percent of international freight (World Bank 2023). Imports and exports tend to come via the ports of Beira, Nacala, Durban and Dar es Salaam, with most cargo transported by road. Beira and Durban together handle 75 percent of all import and 80 percent of all export traffic. Rail connections, including the railway to Nacala, remain underutilized despite their cost-effectiveness (Table 4.1). This may, however, change following significant investment along the Nacala corridor to improve the port at Nacala, as well as to streamline cross-border coordination on policy and regulatory issues.

Coordination between Malawi, Mozambique and other countries in the region is improving gradually but the lack of common approaches in many areas still contributes the prevalence of NTBs. While the core corridor infrastructure has been built, its condition varies significantly across countries and is impacted by the effects of overloading, the

Table 4.1 Costs by corridor to and from Lilongwe

US$/TEU

Corridor	Imports 2018	Imports 2021	Exports 2018	Exports 2021
Gateway (Port) Costs (US$/TEU)				
Beira – Lilongwe	514	557	414	463
Dar es Salaam – Lilongwe	595	595	395	395
Durban – Lilongwe	624	553	435	394
Nacala – Lilongwe	595	557	586	514
Way (Road and Rail) Costs (US$/TEU)				
Beira – Lilongwe	2,700	2,325	1,500	1,325
Dar es Salaam – Lilongwe	4,700	3,305	4,055	2,575
Durban – Lilongwe	4,965	4,450	3,800	2,900
Nacala – Lilongwe (Road)	2,976	2,795	2,587	1,395
Nacala – Lilongwe (Rail)	1,760	2,897	2,349	1,340
Total (Gateway + Way + Logistics) Costs (US$/TEU)				
Beira – Lilongwe	3,214	3,497	1,914	2,003
Dar es Salaam – Lilongwe	5,295	3,900	4,450	2,970
Durban – Lilongwe	5,589	8,788	4,235	4,449
Nacala – Lilongwe (Road)	3,571	3,912	3,173	2,699
Nacala – Lilongwe (Rail)	2,867	3,492	2,935	2,369

Source: TradeMark East Africa (2022).

Note: TEU = Twenty-foot equivalent unit, based on the volume of a 20-foot-long intermodal container

lack of a sustainable asset management strategy for road repair, and the effects of climate change (World Bank 2023). Transport policies and standards are often not harmonized. These include road-user charges, third-party (cross-border) motor insurance schemes, and vehicle overland control systems, standards, and cross-border road permits. Lack of enforcement of rules (e.g. overloading) and 'informal' road fees, all increase the cost of trade. This is further exacerbated by significant border delays, a lack of backhaul loads (i.e. trucks deliver goods without necessarily finding a load of freight to carry on their return, causing importers to pay a premium), high fuel costs and inadequate infrastructure investment (International Finance Corporation 2021).

Ideally, the introduction of streamlined and harmonized procedures, risk management principles to reduce inspections, and automation would accompany infrastructure improvements to create modern borders. However, where border posts are being rehabilitated often as one-stop border posts, the infrastructure is developed in advance leading to mismatches that reduce operational efficiency and particularly impact agricultural trade. Recent analysis of key obstacles along the Nacala Corridor connecting Malawi and Mozambique highlight the following barriers (Smith 2020):

- **Customs documentation and administrative procedures:** These include non-standardized systems for declaring imports and paying applicable duty rates; incorrect tariff classification; limited and uncoordinated customs working hours; different interpretations of the Rules of Origin; non-acceptance of certificates of origin; application of discriminatory taxes and other charges on imports originating from member states; and cumbersome procedures for verifying originating imports whose origin status is disputed.

- **Immigration procedures:** Such as non-standardized visa fees and cumbersome and duplicated immigration procedures.

- **Quality inspection procedures:** These include delays in the inspection of commercial vehicles; cumbersome and costly quality inspection procedures; unnecessary quality inspections (also of products certified by internationally accredited laboratories); non-standardized procedures for quality inspection and testing; and varying procedures for issuing certification marks.

- **Transiting procedures:** These involve non-harmonized transport policies, laws, regulations and standards, including road-user charges, third-party (cross-border) motor insurance schemes, vehicle overland control systems, vehicle regulations and standards, and cross-border road permits, as well as prohibitive transit charges.

- **Roadblocks:** In particular, this refers to the practice of stopping commercial vehicles at various intra-country roadblocks, even when there is no evidence that the transported goods are illegal or being smuggled.

Finally, small-scale traders are often significantly impacted by current systems and procedures. Cross-border traders, especially women, often lack awareness and knowledge about border procedures and are frequently harassed or subjected to requests for bribes. These smaller informal traders handle a significant volume of trade but generally fall outside official trade statistics. Experience in the region suggests that in this context of ambiguous rules, traders provided with information opt to minimize risk by making behavioral changes, including to adjust border crossing times (World Bank 2020a). Reducing potential risk faced by small-scale traders may require multiple types of interventions, including displaying key information at a visible place at customs offices, increasing safety measures at the border (including cameras, help lines, and better access to information), and implementing a simplified trade regime for low-volume shipments.

Services trade and investment restrictions

Trade in services in Malawi faces significant restrictions that may be hindering growth of the high-productivity services sector and of FDI. Compared with other African countries, Malawi is among the most restrictive countries, according to data from the OECD's Services Trade Restrictiveness Index (STRI). The STRI indicates that Malawi is relatively more protectionist in most sectors, with the exception of transport and finance. This suggests potential for reform, particularly in sectors such as telecommunications and professional services.

The STRI shows that Malawi has among the lowest scores, particularly in terms of ICT, professionals, health, distribution, and tourism. It also ranks below most of its peers in terms of finance, transport, and communications. Out of the broad set of regulations and measures available in the database, around 150 of them were selected to compute the index. The STRI provides comparable information on services trade policies under three out of the four modes of supply in the General Agreement on Trade in Services (GATS), namely cross-border supply (mode 1), commercial presence (mode 3), and presence of natural persons (mode 4). In addition, consumption abroad (mode 2) is available for health services.

Malawi's relatively poor performance in attracting FDI is correlated with its relatively high degree of legal barriers to FDI. Compared with its regional peers in the Southern African Development Community (SADC), Malawi ranks in the lowest quartile on the SADC Investment Climate Scorecard, which is based on the OECD FDI Regulatory Restrictiveness Index. Malawi's level of FDI restrictiveness is over three times higher than the global average on the same OECD methodology. Some of Malawi's regulatory barriers to FDI driving these results include limitations on commercial land ownership and leasing, and limits on foreign equity ownership in several sectors including telecommunications, pharmacies, domestic water transport, and radio and TV broadcasting.

The domestic capacity for many higher-skill services is weak in Malawi and requires the importing of expertise from abroad. By facilitating the importing of services, Malawi can enhance the productivity and competitiveness of domestic firms. This approach will not only bridge the gap in services availability but also empower domestic firms to leverage the expertise and resources offered by foreign service providers, thereby boosting their overall performance. The increase in the importance of services means that sectoral linkages between services and goods production will grow stronger. This is particularly important in the case of Malawi, where services play an important role in the economy in terms of their value added to GDP and their employment shares (van de Marel and Shepherd 2020).

HOW MALAWI CAN ACHIEVE ITS EXPORT POTENTIAL

Malawi can leverage the AfCFTA to bring significant benefits

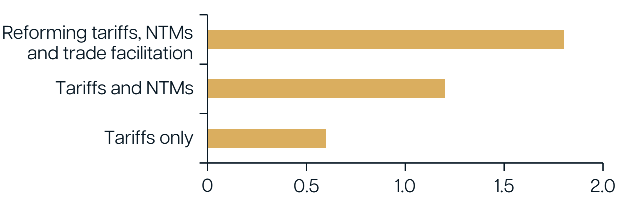
The benefits of joining the AfCFTA can be significant for Malawi. Intra-AfCFTA trade is predicted to increase with the full implementation of the trade agreement (World Bank 2020b). This offers an opportunity for Malawi to expand its trade beyond its proximate markets. African countries have identified regional trade integration as a key driver of economic development and this can be an important building block for the overall economic development of the continent. Malawi is a member of several regional trade agreements, including the SADC and the COMESA, two partially overlapping regional agreements that have a Common External Tariff (CET). The country also became a member of the AfCFTA in 2021.

To reap the welfare benefits of the AfCFTA, trade facilitation and elimination of NTBs will be important for Malawi. Specifically, for Malawi, the removal of NTBs is projected to yield a positive impact on real incomes of 1.2 percent by the year 2035, while the adjustment of AfCFTA tariffs is expected to result in a welfare impact of 0.6 percent, compared with a baseline without an AfCFTA (Figure 4.24). In addition, the implementation of the AfCFTA is expected to result in a 3.7 percent reduction in moderate poverty rates (at PPP US$5.50/day) and a 1.6 percent decrease in extreme poverty rates (at PPP US$1.90/day) over the same time frame.

More specifically, Malawi stands to reap significant benefits in several sectors — in particular processed food, agriculture, and trade services. By 2035, the cumulative change in output compared with the baseline scenario is

Figure 4.24 Real income (welfare) implications from AfCFTA implementation for Malawi in 2035

Change relative to the baseline, percent

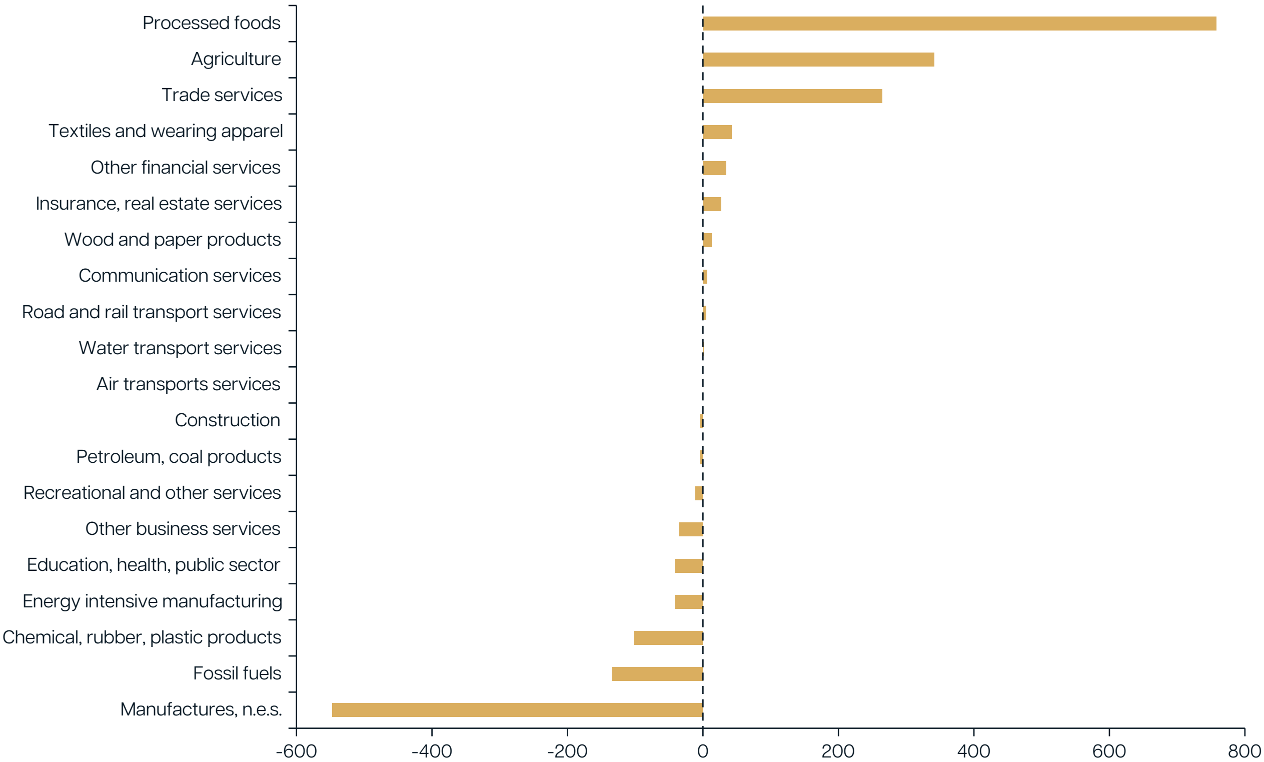


Source: World Bank, 2020.

projected to reach US$758 million (Figure 4.25), with particular gains for the agro-processing and trading sectors, as well as for textile and apparel producers. However, continental integration through the AfCFTA could significantly hurt certain manufacturing sub-sectors. In turn, ensuring that appropriate trade adjustment mechanisms are in place to cushion those losing out from continental integration will be particularly important.

Figure 4.25 Output changes due to the AfCFTA in 2035

By economic activity, cumulative difference with respect to baseline scenario, US$ ('000,000)



Source: World Bank 2022.

An analysis using the Tariff Reform Impact Simulation Tool (TRIST) [32] **shows that the implementation of the AfCFTA agreement in Malawi is expected to have minimal impact, if any, on import flows and customs tax revenues** (Jammes 2023). This outcome can be attributed to two factors: first, the low proportion of imports originating from African countries, excluding South Africa, which constrains the potential for significant import growth from AfCFTA member countries. Second, Malawi already maintains a low level of effective tariff protection, leaving little room for further tariff reduction and subsequently limiting the impact on customs tax revenues. In turn, the fiscal revenue impact of AfCFTA implementation on Malawi is relatively low, with a 7 percent loss in tariff revenues (Table 4.2). In the absence of South Africa, this impact decreases to a mere 0.1 percent decline. The overall change in revenues is less than 1.5 percent.

32. TRIST is an Excel-based tool that can be used by policy makers to analyze the adjustment implications of trade reform (Brenton et al. 2009). It is free and easy to use, transparent, with a simple underlying trade model, and flexible, in that it can quickly address different trade policy scenarios. While TRIST was developed to simulate the short term implications of trade reform on fiscal revenue, TRIST can be extended to estimate the initial impact of trade reform on domestic production and employment in import competing sectors, as well as on poverty.

Table 4.2 Expected impact of full AfCFTA implementation on Malawi's imports, revenues and tariff rate

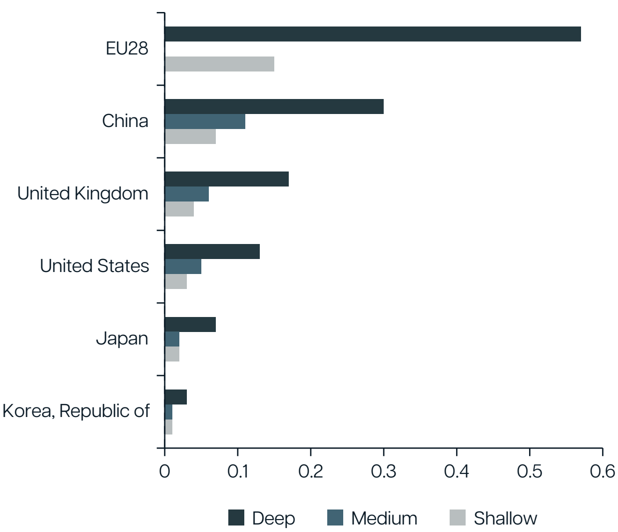
Impact on imports		Collected Tariff rate	
Percent change in imports	0.1	Collected applied tariff rate pre	2.9
Percent change in tariff revenue	-7.0	Collected applied tariff rate post	2.9
Percent change in Total revenue	-1.5	Percent change in collected applied tariff rate	-0.1

Source: Jammes (2023).

In addition, Malawi has the potential to broaden its network of Preferential Trade Agreements (PTAs), which can lead to substantial benefits, especially when these agreements are deeper. Notably, the EU, China, the United States, and the Republic of Korea, among other developed nations, exhibit similar demand and supply patterns in relation to the Malawian market. Strengthening trade ties with these countries (and particularly with the EU, China, and the United Kingdom), can have a significant impact on both GDP and exports (Figure 4.26 and Figure 4.27). Positive but smaller effects can also be expected from stronger trade linkages with the United States, Japan, and the Republic of Korea. Currently, for example, 30 percent of Malawi's export value does not enter the United States tariff-free, and across major export destinations Malawi faces an applied weighted tariff of over 5 percent on its products, whereas Mozambique, Tanzania, and Zambia have rates closer to zero (International Finance Corporation 2021).

Figure 4.26 Deeper trade agreements could lead to GDP gains

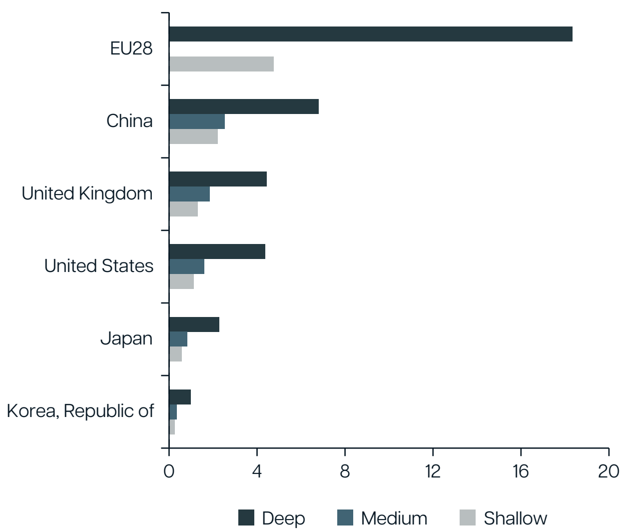
Change in GDP, percent



Source: Calculation based on World Bank Deep Trade Agreements Toolkit and Database 2023.

Figure 4.27 Malawi could increase exports significantly through deeper trade agreements, especially with the EU

Change in exports, percent



Source: Calculation based on World Bank Deep Trade Agreements Toolkit and Database 2023.

Deeper forms of trade integration can reduce trade costs and NTBs as they go beyond traditional trade policy. Such agreements would enable institutional and policy reforms required to facilitate operations fragmented across borders. Deep trade agreements cover legal and regulatory frameworks, harmonize customs procedures, and establish the rules related to intellectual property rights. These would contribute to reducing the risks associated with GVC investment and facilitate the establishment of flexible networks of firms required for GVCs to thrive.

Supporting the development of emerging agro-processing value chains

In recent years, new agricultural export crops have shown significant potential to support increased and more diversified exports, as well as to increase upstream and downstream value addition. This has been driven by a number of lead firms involved in the tobacco, tea and sugar subsectors investing in macadamia, legumes, and groundnuts and developing improved seed varieties to commercialize. These firms can build on their long-term relationships with contract famers, as well as their existing buyer relationships and access to new technologies (see Chapter 5). In line with existing efforts to further commercialize agriculture and move away from a dependence on smallholder production (see Chapter 2), these recent efforts could significantly boost exports while also developing up- and downstream value chains. Considering the current dominance of tobacco, any growth in these other value chains would make an important contribution to diversify Malawi's export basket.

Soybeans represent a particularly notable example of this diversification process, emerging as the second-largest export in 2021 and the most advanced value-adding sector in Malawi (see also Chapter 5). In 2013, only US$0.5 million worth of soybean was exported, equivalent to just 0.1 percent of tobacco exports. Nationwide production stood at just 80,000 tons. This was mostly consumed at the household level, as an additional ingredient for porridge, and purchased by the three small processors at that time, which only had a capacity for 40,000 tons of raw beans. These processors were mainly producing cooking oil, cake as a by-product for chicken feed, and small amounts of soya chunks. In 2023, however, soybean production is estimated by the Government to stand at 380,000 tons.[33] This level of production would equate to a 17-percent compound annual growth rate over the past 10 years. Meanwhile, exports surged to US$133 million in 2021, equivalent to 30 percent of tobacco exports. By comparison, sugar and tea only accounted for 17 and 16 percent of tobacco exports, respectively. It is estimated that by the end of 2023, Malawi will have installed processing capacity at the industrial level (excluding cooperative-level and household-level processing) of 700,000 tons of raw beans per year, an 18-fold increase compared with 10 years ago. There are now seven major processors, and an eighth contemplating entry. Products being produced on an industrial scale are soy chunks, soy lecithin, corn-soy blend, chicken feed, fish feed, and cooking oil. Soya milk production has started at the household and cooperative levels and is being assessed for its potential for production on an industrial scale.

Soybean is arguably the only value chain at present that has the potential for multiple downstream products to be viably produced in-country. This has created the foundation for Malawi's first mature industry that includes extensive processing by multiple players, and not just raw or semi-raw commodities (as is the case with sugar, tea, coffee and many other crops). While it is now the most advanced industry to catalyze a wider broad-based economic transformation, the soybean industry cannot drive this industrialization process alone and other sectors, such as groundnuts, food processing and the services sector, will need to develop similar capacities.

Macadamia and groundnuts have also become a dynamic export growth sectors. By the end of 2023, Malawi will have 10,000 hectares of planted macadamia trees, positioning it to be one of the top global producers. The latest figures place Malawi as the eighth-largest macadamia exporter globally. Currently, macadamia nuts are husked and exported in their

33. Production is hard to estimate accurately because of extensive rust disease on the downside and an increase in cultivated land on the upside.

shells for cracking in South Africa. However, at least one producer, Gala, is exploring investing in a local cracking facility, a US$20 million investment that would increase value added in country. Production and exports are expected to grow in the coming years, as additional trees mature and yields improve. This will require continued support for cracking nuts and related infrastructure, livelihood alternatives for households around estates to deter theft and conflict, and a stable macroeconomic policy environment that enables continued importing of materials needed for investment. This will help to ensure the ability of key value chain actors to engage with smallholder farmers. Malawian groundnuts are also increasingly processed for international markets, building on production arrangements from the tobacco value chain. Newly released varieties have been released and commercial production of inputs is commencing in conjunction with quality assurance processes along the value chain that ensure that Malawian groundnuts meet stringent international standards.

To ensure the continued thriving of these new export sectors, it will be important to create an enabling environment for export growth. This includes the development of a common, long-term vision and roadmap, and frequent dialogue between industry and the Government as well as among the main industry actors, focused on achieving export growth and (where feasible) replacing existing imports. The Government also needs to strengthen consultations and collaboration with industry experts so that the policies it imposes do not have consequences that constrain production and export growth. Furthermore, policy uncertainty around emerging bills and regulations that fail to take into account the needs of the industry could undermine investment. This includes, among others, recent legislative initiatives around the Foreign Exchange Bill, the Tobacco Control Act, the Land Act, the Crops Bill, and export mandate regulations. It will also require the continued implementation of the Control of Goods Act (COGA) and its application to a wider range of crops (see Box 4.2). As Chapter 5 shows, such reforms in the governance of productive agricultural sectors have the potential to galvanize broader macroeconomic improvements and could be replicated in further agro-processing sectors.

Box 4. 2 Recent trade policy reforms could contribute to commercialization and increased investment in agribusiness, but have been partially implemented

In part, the recent dynamism in the agribusiness sector is also the result of policy changes to remove arbitrary export bans. In the past, these discouraged agricultural commercialization but the Government has taken an important step to revise the Control of Goods Act (COGA) to improve predictability. The previous COGA provided discretionary powers to the Ministry of Trade and Industry to control the import and export of goods into and from Malawi. This often led to the ad-hoc and untransparent implementation of import and export controls, resulting in unpredictability in the market, high levels of discretion by officials, and deterring increased investment and trade. Ad-hoc export bans contributed to Malawi having the highest maize price variability in the region (Edelman and Baulch 2016). To provide clear and transparent procedures for exports and imports, Parliament passed an amended COGA on May 15, 2018, and gazetted regulations on July 26, 2020, thereby operationalizing the new Act. The regulations to the Act clarify thresholds that must be met for bans or licensing measures to be permitted, based on specific public interest justifications.

With the amended COGA, the Government has initiated a data-driven approach to maize trade policy, though there has been some inconsistency in its implementation, as well as continued evidence of ad-hoc measures. The approach relies on comparing the national food balance sheet with national food requirements, and domestic prices with export parity prices, as provided for in the threshold for safeguarding food security in the Act. In December 2021, the Government issued an order allowing for maize exports. While this represents an important reform to regulate exports based on clearly defined public interest grounds and data, there is still a need for further consolidation of this process. The institutional framework that underpins implementation needs to be strengthened to allow for timely generation of accurate data, mechanisms for coordination and the sharing of data among relevant stakeholders, awareness of the provisions of the amended COGA, capacity of staff in the relevant ministries, departments and agencies, and the effective monitoring of informal exports. There is also a need to ensure that public-private dialogue is sustained to support implementation. Of particular concern has been the continued incidence of ad-hoc measures, such as the recent revocation of export licenses.

Creating the foundations for mining to generate exports and revenues

Malawi's mining sector can play a key role in driving export growth and addressing fiscal and foreign exchange constraints. This is recognized in the *Malawi 2063,* which sees mining as a central driver of industrialization, especially if sufficient levels of investment in domestic value addition can be achieved. However, currently the sector still plays a relatively minor role, accounting for less than 1 percent of GDP, and with exports averaging between US$100 million and US$158 million in recent years.

In the coming years, Malawi's mining sector holds promise as a crucial catalyst for economic and social development. Recent discoveries of energy transition minerals, including rare earths, niobium, rutile, and graphite, present opportunities for increased exports (and in turn foreign exchange generation), revenues and growth (Malunga 2023). Demand for these minerals has been significantly increased by the energy transition requirements driven by climate change. In addition, demand for uranium has surged due to Europe's energy shortages, which have reshaped the outlook for nuclear power. Demand for these minerals is expected to continue growing, thus aligning with Malawi's mining potential, resources, and project profiles.

Currently, seven projects are moving ahead, with many of these likely to produce the so-called "green minerals" necessary to support the energy transition (Figure 4.28). This includes the following projects:

- *Feasibility study completed:* Rutile in Kasiya, rare earths in Songwe, niobium in Kanyika;
- *Feasibility study ongoing or at advanced exploration:* Graphite in Malingunde, heavy mineral sands in Makanjira and rare earths in Kangankunde.

Finally, the Kayelkera uranium mine may be recommissioned in light of renewed investor interest.

The nation's robust mining portfolio is likely to at least partially materialize. There are proven, declared, and reviewed reserves, with investment decisions nearing and all projects progressing. Furthermore, most of these projects are characterized by relatively low technological complexity and require well-known and standardized processes in terms of extraction, processing, and metallurgy. They are also of manageable scale, without the complexities associated with mega projects.

The current mining projects have the potential to attract a large increase national industrial investment. There is a strong potential for increasing the annual mining contribution to GDP substantially, including through indirect contributions to other sectors and through the supply of rural infrastructure. Minerals produced from across these projects has the potential to gradually replace tobacco as Malawi's dominant export over the medium term. Mining company estimates

Figure 4.28 Seven priority mining projects

Source: Mulunga (2023).

indicate that Kayelekera could resume production as early as 2025, and other projects could come online from 2027 onward. However, past mining projects in Malawi and elsewhere in the region have often failed to deliver on their promise and it will be important to ensure that Malawi does not fall victim to the "presource curse".[34] While projections from mining firms indicate that the sector could play a significant role in the economy, these projections need to be treated with caution at this stage, given the many variables that could influence the materialization of these benefits.

Several factors could impede the transformation of this potential into tangible benefits for Malawi's economy, and its contribution to the economic and social development of the country. The region provides plentiful examples of countries that had limited success in converting subsoil wealth into above ground sustainable prosperity (Cust and Zeufack 2023). Salient factors for Malawi include a lack of adequate infrastructure needed for project development, a tax regime that does not sufficiently align mining company interests with a public interest in maximizing resource revenue, and long processes for obtaining mining permits, licenses, and agreements, as well as environmental and social challenges associated with certain projects. As revenues start to materialize Malawi will also have to decide how to manage them, as the link between mining rents and long-term growth and prosperity can be vary.

The fiscal regime can become a contentious issue within Mining Development Agreements, leading to prolonged negotiations. The design of an appropriate fiscal regime that incentivizes production while maximizing the financial benefit for the public is challenging and most countries in Sub-Sahara Africa fail to capture the full share of resource rents (Cust and Zeufack 2023). Often there are design trade-offs between inflexible fixed-rate royalties which are relatively easy to administer and more progressive profit- or cash flow-based taxes which in theory are better able to calibrate the tax rate to the extracted rents but which are difficult to enforce (Fleming, Manley, and Lassourd 2022). Malawi's current tax regime is likely to yield very different effective taxes on the profits of different mining projects. Additionally, projects are often delayed as elements of the fiscal regime, rather than being a transparent and fixed proposition by the law, become a negotiation issue. The review and approval process of environmental and social impact studies and obtaining mining licenses can also be extended.

Access to infrastructure also poses challenges for project development in Malawi, particularly regarding roads, ports, and energy (Malunga 2023). This aspect is critical for at least three projects: Kayelekera Uranium (requiring power infrastructure), Kanyika Graphite (requiring power and road infrastructure), and Makanjira Heavy Mineral Sands (requiring power and road infrastructure). A further risk factor relates to social and environmental management requirements. Three projects (Kanyika Niobium, Kasiya Rutile, and Malingunde Graphite) need resettlement processes, which involve significant risks and potential impacts that need to be carefully managed, and consequently might impact project schedules and expected costs. In addition, part of the Malingunde Graphite project area is located in wetlands, further complicating environmental management.

Moving ahead it will be important to ensure that these assets belonging to the country are not squandered, and that this opportunity is seized. Production delays are common and price fluctuations can create significant uncertainty around likely revenue and export

34. The "presource curse" refers to lower growth and debt crises following resource discoveries due to elevated expectations which can generate pressure to borrow and spend (Cust and Zeufack 2023). Subsequently, delayed production, falling commodity prices, or less than expected taxes can all lead to fiscal disappointments. The risk of fiscal challenges is compounded in countries with weak institutions.

outcomes. This means incentivizing investment, ensuring that the country maximizes the fiscal gains from these resources over many years, and that these resources are spent effectively to benefit the population. This will require a stable fiscal regime, as well as careful assessments of the potential impact of different incentives. The Government is currently reforming the legal and institutional structure to support the mining sector. In this context, it will be important to ensure that expertise is sought to support negotiations and that all contracts are made public. Malawi's participation in the Extractives Industry Transparency Initiative (EITI) can create an important institutional framework in this regard.

Eliminating trade restrictions and addressing logistics and trade facilitation constraints along key corridors

Given its dependence on its neighbors both as export markets and to reach ports, reducing trade and transport costs will be essential for Malawi to leverage trade for growth. This will require accelerating and deepening many ongoing trade facilitation and connectivity reforms. Given the large number of ministries, departments and agencies (MDAs) involved, it will also require strong cross-government cooperation and working closely with the private sector to better understand the core constraints that firms face when importing and exporting, as well as strengthening cooperation with neighboring countries, in particular Mozambique.

The large prevalence of NTBs both behind and at the border make taking advantage of export opportunities particularly challenging and constrains the development of regional value chains. Moreover, the process around new policies and measures, which impact firms and producers that would like to export, strongly discourages the domestic and foreign investment necessary to develop new areas of comparative advantage. Better understanding the impact of these barriers on different sectors and types of firms is essential. The significant prevalence of smuggling is often used as a justification for imposing increased regulation and further procedures for exporting firms (see Box 4.3). However, these often have the unintended consequence of deterring law-abiding firms from exporting while shifting more trade into the informal sector.

Central to increasing trade this will be advancing on trade facilitation reforms. Key priorities that have been identified include the implementation of the Malawi National Single Window, the simplification of trade documentation (especially for smaller traders), stronger risk management systems so the Malawi Revenue Authority (MRA) can focus limited resources on the riskiest imports (for example, through expanding the Malawi Authorised Economic Operator Program), and the implementation of regional transit procedures. Automation of trade documentation and procedures is needed to lower transaction costs by enabling data sharing. For Malawi, sharing data with Mozambique would bring significant benefits, as data would be captured in the port and transmitted to the point of final clearance. These reforms would contribute to ensuring that the significant investment that has been made in recent years to develop and operationalize One-Stop Border Posts can in fact lead to reductions in trade time and cost.

Finally, the ongoing modernization of the Nacala Corridor has the potential to significantly reduce trade and transport costs. These efforts will increase the reliability and operational efficiency of the corridor and the port, to provide increased comfort for firms to rely on this service and shift from road to rail, especially for transporting the country's agricultural exports, as well as potentially mined resources, and reduce the costs of bulk imports such as fertilizer, fuel, and consumer goods. The recently established Nacala Development Corridor Management Committee can support progress in these areas, including

Box 4.3 The Drivers of Smuggling at Malawi's Borders

Measuring illicit trade is difficult, but there are indications that it plays a significant role in Malawi. Methodologies to estimate illicit trade include looking at mirror trade statistics (differences in the reported exports of the exporting country and the reported imports of the importing country), abnormal pricing, and studying associated illicit financial flows (Cobham and Janský 2020). These methodologies are also sensitive to mis-invoicing, which is also likely to be prevalent in Malawi's trade. Anecdotal evidence such as reported convictions and mismatching mirror trade statistics point at the significance of smuggling in Malawi.

Traders tend to resort to smuggling when the benefits of trading through official channels do not outweigh the costs. Typically, smuggling predominantly affects imports, where traders attempt to avoid taxes and tariffs. Smuggling exports is often a specific response to policy interventions, such as subsidies, implicit or explicit export tariffs, and costly non-tariff barriers. These need to be significant enough to outweigh the benefits of trading officially. These benefits include the creation of stable, longer-term trade relationships between companies, the provision of documents that certify the origin and specification of goods, avoiding the costs of money laundering, avoiding the costs of bribes, and avoiding the potential costs of punishment and customs enforcement.

While the to smuggle imports is typical for the region, Malawian exporters are also incentivized to resort to illicit trade. With a weighted mean tariff rate on imported goods of 6.2 percent in 2020, Malawi is roughly in line with regional norms (5.7 percent in Sub-Sahara Africa in 2017). However, exporters face multiple incentives to smuggle exports, including (i) until recently, an implicit export tax exerted through the exchange rate regime, especially in combination with mandatory conversions at the official exchange rate, (ii) high and therefore costly non-tariff barriers, (iii) below-market-price price controls and subsidies on key commodities including maize, fertilizer and increasingly fuel, and (vi) stringent capital controls. Enforcement measures can deter some smuggling, but many are willing to continue to take legal risks and pay bribes when the financial and time savings of remaining outside the formal trading system are large. At the same time, care must be taken to not make exporting even more costly by increasing onerous compliance measures that further increase the incentive to revert to illicit trade. Scaling up risk-based approaches to trade, where much of the enforcement action is focused on transactions most prone to fraud, is one way to minimize costs for compliant firms.

by facilitating agreement through a framework for monitoring corridor performance, developing corridor improvement initiatives and fostering economic development along the corridor (World Bank 2023). Lastly, the revitalization of the Sena line to the port of Beira could strengthen this corridor, improving multi-modal network connectivity and increasing corridor competition.

POLICY REFORMS TO INCREASE EXPORTS AND BRING IN FOREIGN INVESTMENT

As shown in this chapter, there is potential to significantly grow exports, if the right policy choices are taken to encourage investment and facilitate trade. This will require the sustained implementation of policies geared toward export-led growth, rather than creating ever more barriers to trade. To ensure the effectiveness of such policies, it is essential to focus on the needs of the private sector to drive this agenda. It is recommended that national trade and industrial policies currently under review incorporate these principles. Key recommendations to strengthen the role of trade as a drive of growth are summarized in Table 4.4.

Table 4.4 Top five trade policy priorities

Policy Issue	Short-Term Actions *(the next 3 – 6 months)*	Medium-Term Implementation *(before the end of 2025)*
1. Addressing low foreign exchange availability and high rates of illicit trade and smuggling	The RBM continues the progression toward a sustainable, well-supported, and market-based exchange rate regime, and phases out mandatory conversion requirements.	The RBM publishes its foreign exchange allocation process and makes use of official systems attractive for all foreign exchange transactions by ensuring access at a transparent and competitive rate, while minimizing direct and indirect costs and enforcing sanctions against violations.

Policy Issue	Short-Term Actions *(the next 3 – 6 months)*	Medium-Term Implementation *(before the end of 2025)*
2. Incentivizing exports by reducing non-tariff barriers	The Ministry of Trade and Industry reviews existing NTBs and develops a strategy for phasing these out, especially in sectors where Malawi has a comparative advantage (agriculture, agro-processing, mining, tourism)	The government together with the legislature ensures through enhanced internal review and external consultations that all future trade policy measures are developed jointly with industry and focus on maximizing export growth, attracting investment, and incentivizing exporters to use official channels.
3. Enhancing the attractiveness of Malawi to export-oriented and import-substituting FDI in sectors where the country has a comparative advantage	The government together with the legislature ensures that any legislation under discussion such as the Crops Bill, and export licensing procedures, create a conducive and predictable policy environment that supports domestic and foreign investment and are aligned with the implementation of the COGA.	The Ministry of Lands, Housing and Urban Development together with the legislature and the Ministry of Trade and Industry aligns foreign ownership and lease structures of land to international standards and streamlines the process for obtaining licenses and permits.
4. Strengthening the foundations for the development of an efficient and transparent mining sector that can drive growth and address fiscal and foreign exchange constraints.	Accelerate the development of mining projects under negotiation by identifying critical bottlenecks, streamlining and expediting permitting processes, and improving government coordination and capacity to effectively negotiate multiple agreements concurrently.	Ensure the fiscal regime, revenue management instruments, environmental and social management standards, and community development agreements support quick and transparent contract negotiations that result in enduring and fair agreements for Malawi and facilitate the attraction of new investments.
5. Supporting regional integration to facilitate the development of regional value chains in priority and comparative advantage sectors and improving trade facilitation systems to reduce trade costs, strengthen compliance, and increase revenues	The Ministry of Trade and Industry implements the National Single Window and Coordinated Border Management at key border crossings, cross-border transit and data-sharing agreements, as well as risk management measures such as the use of Inland Examination Centers, Authorized Economic Operators, and Post Clearance Audit at key border agencies.	The Ministry of Trade and Industry adopts and implements agreed AfCFTA protocols with a time-bound plan, facilitates digital trade, and explores the negotiation of new trade agreements with priority trade partners.

CHAPTER 5

Can This Time Be Different? Building on Past Successes to Kickstart Growth

KEY FINDINGS:

1. Unlocking economic growth and developing state capacity requires the alignment of political incentives with development goals. While Malawi has comparatively high levels of voice and accountability, political stability, and rule of law, there is room for improvement in regulatory quality and implementation, control of corruption and rent-seeking, and the effectiveness of government to set an enabling environment for private sector-led growth.

2. The state has a central role in creating the conditions for inclusive growth and job creation. However, in recent decades, decentralized short-horizon rent-seeking and an imperative to maintain deals-based support have perpetuated high levels of corruption and governance outcomes that are unconducive for growth. In addition, isomorphism hinders government effectiveness by prioritizing the appearance of good practice over underlying arrangements on how government decisions are made and implemented.

3. Eleven case studies highlighted in this chapter show significant improvements in governance arrangements in Malawi's recent history. These improvements relate to supporting the growth of agricultural value chains, managing public entities, and delivering public programs. Achieving these outcomes required a change from business as usual, including through empowered and committed leadership, effective institutional management, aligning financial incentives with performance, and fostering strategic public-private dialogue.

4. Scaling success by building on these existing cases and applying lessons to other sectors and programs can directly promote more rapid economic growth. Strengthened productive sectors will empower the Malawian private sector. This private sector in turn can hold macroeconomic policy-making to account, while being a key beneficiary of enhanced macroeconomic governance. Similarly, better performing public enterprises will mean that they become less of a drain, while some can become increased contributors to the country's public finances. This will help enable necessary fiscal reforms.

5. Accelerating Malawi's growth will require a better business environment and policy predictability that incentivize the private sector to invest. Improved management of public resources will need to be anchored by restored macroeconomic stability and debt sustainability. Enhancing the investment readiness of state-owned enterprises through targeted governance improvements can make them sustainably deliver better on their mandates.

FOCUSING ON THE "HOW" OF ENABLING GROWTH THROUGH REFORMS

Central to the premise of this CEM is the understanding that aligning political incentives with developmental ends is key to unlocking rapid and sustained growth (World Bank 2017). The previous four chapters have shown the urgency of comprehensive macroeconomic and structural reforms, and laid out a comprehensive set of policy recommendations. That effective governance and institutional arrangements are central to economic development is one of the most consistent findings in development economics and political science. While at times different names have been attached to this, such as "inclusive institutions" in Acemoglu and Robinson (2012) or "inclusive elite bargains" in Dercon (2022), there is near unanimity that the traditions and institutions by which authority in a country is exercised constitute the root cause of differential economic development. The governance of a country is shaped by structural conditions, historical legacies, and the evolution of its political settlement. Malawi's political settlement is characterized by competition among a small elite ensuring the stable flow of rents, fragmentation along co-ethnic, regional, and traditional authority lines, high dependence on development partners, and a narrow social contract structured around food security, and maize in particular (World Bank 2018).

According to the World Bank's Worldwide Governance Indicators (WGI), Malawi is a peaceful, democratic, and lawful nation compared to its regional peers (Figure 5.1).[35] Malawi scores well on the Voice and Accountability, Political Stability and No Violence, and Rule of Law dimensions. Based on a definition of governance as "the process through which state and nonstate actors interact to design and implement policies within a given set of formal and informal rules that shape and are shaped by power" Malawi has solid foundational characteristics on those three dimensions (World Bank 2017, 41).

However, Malawi fails to translate these advantageous overarching arrangements into other governance dimensions that directly affect the economy. Malawi's current political settlement creates strong incentives for policies that address short-term popular needs, while undermining the ability to credibly commit to long-term structural reforms and a fiscal trajectory needed to spur productive structural transformation. This is expressed through scores on the Government Effectiveness, Regulatory Quality, and Control of Corruption dimensions, which have been largely on a par with regional peers over the past few decades. Government Effectiveness and Regulatory Quality have also declined rather than caught up with those of higher performers, while the Control of Corruption dimension oscillates strongly, driven by the revelation of major corruption scandals and political promises to address graft. As Chapter 1 shows, this governance performance is associated with growth outcomes that are in line with that of many structural peers, but insufficient to reduce poverty levels.

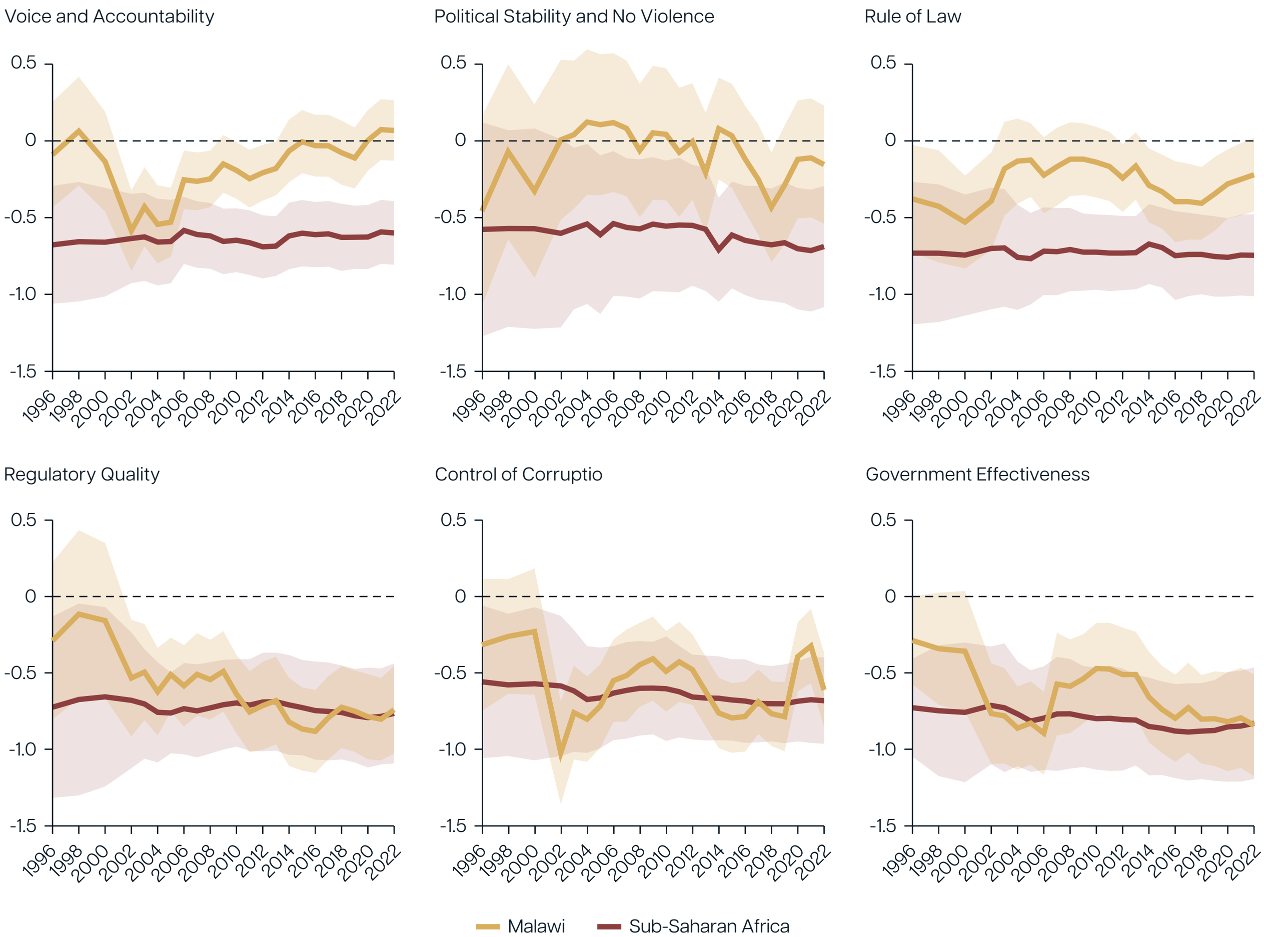
To advance from a difficult starting point, Malawi needs to align governance arrangements with the aim of accelerating economic growth in strategic areas. As a landlocked, resource-scarce country, Malawi needs to efficiently and productively organize its main resource: its people. To excel economically, Malawi will need to explore governance strategies that enable it to make more of its endowments, such as being "a Haven for the Region"

35. The WGI are a set of six aggregate indicators that measure the quality of governance in countries worldwide (Kaufmann, Kraay, and Mastruzzi 2010). The indicators cover over 30 data sources on the perceptions of citizens, experts, and professionals. These include insights from the Afrobarometer, expert judgements from organizations such as Freedom House, and professional opinions such as those expressed in the World Bank's and African Development Bank's Country Policy and Institutional Assessments. The indicators are reported in standard normal units ranging from approximately -2.5 to 2.5 and explicitly account for margins of errors by providing confidence intervals.

or creating "a Transparent and Investor-Friendly Environment for Resource Prospecting" as Paul Collier (2007, 60 – 62) describes options to become wealthier for countries such as Malawi.[36] Among aspirational peers discussed throughout this CEM, Rwanda probably best exemplifies commitment to these strategies. While leaving much to be desired, especially on the Voice and Accountability dimension, it an extremely difficult starting position following the 1994 genocide with strong Regulatory Quality, Control of Corruption, and Government Effectiveness, outperforming Malawi and the region by some margin on these dimensions.

Figure 5.1 While excelling over its peers on some dimensions, on others Malawi's governance arrangements are just average

Worldwide Governance Indicator scores with 90% confidence interval



Source: Staff calculations based on World Governance Indicators, 2022.

This chapter focuses more on the "how" than the "what" of enabling growth through reforms. It addresses the question of how and why Malawi sustains governance arrangements promoting a low-growth equilibrium despite strong performance on some key indicators, and explores how such constraints can be overcome on the basis of past growth and

36. These strategies are intended to imply, in the case of the former, setting policies clearly superior to those of neighboring countries, in turn attracting regionally traded services and exporting them in the region. In the case of the latter, it suggests establishing an adequate governance framework to not fall victim to the resource curse for low-income countries that have significant amounts of undiscovered resources.

reform successes. The next section looks at explanations for Malawi's regulatory shortcomings, corruption, and lacking government effectiveness, drawing on the academic and policy literature. It identifies fraught state-business relationships, decentralized short-horizon rent-seeking, and isomorphism as key drivers. The third section covers 11 cases of success where these constraints were overcome in growing agricultural value chains, the reform of public entities, and in effectively implementing sectoral strategies. The fourth section outlines a framework for how enhanced sectoral performance interacts with macroeconomic governance to promote more rapid economic growth. Because of ample evidence that financial incentives matter for effective governance, the fifth section discusses how to finance Malawi's growth ambitions in a context of very limited fiscal space. The final section translates these findings into an actionable pathway for enhanced governance to drive economic growth.

The scholarly literature acknowledges that Malawi can deliver growth when incentives are aligned.[37] Malawi has had periods of growth (as discussed in Chapter 1), and there are economic sectors that have been and continue to be conducive to growth. The 11 case studies in the following section discuss such areas of effectiveness.

REGULATORY WEAKNESSES, CORRUPTION, AND THE LACK OF GOVERNMENT EFFECTIVENESS HAVE STRUCTURAL CAUSES

Three interlinked issues have been identified in the literature on Malawi's political economy of growth as central governance constraints: (i) fraught state-business relationships; (ii) decentralized short-horizon rent-seeking; and (iii) isomorphism. Mistrust between the state and business interests is rooted in Malawi's history and political arrangement based on narrow patronage deals. This leads to a disinterest in creating opportunities for private sector-led growth, a lack of state capability for economic growth, and is reflected in overbearing regulation. At the same time, political elites are focused on the extraction of rents in the short term, rather than enabling the growth of available rents. This is reflected in endemic and inefficient types of corruption. In addition, while committed to making processes look legitimate and in line with international best practices, this often only happens at a surface level with underlying informal arrangements unchanged. The literature calls this "isomorphism" and identifies it as a driver of government ineffectiveness. Development partners have expended significant effort to improve governance arrangements, but these have often provided pre-formulated fixes without sufficiently adapting these to Malawian dynamics. Such approaches have often driven isomorphic institutions that don't fulfill their function, enable corruption, and shield the Government from pressures to improve.

Fraught State-Business Relationships Lead to Bad Regulation

Between independence and the 1990s, Malawi's economy was characterized by a dominance of the state in the conduct of business (Chingaipe and Leftwich, 2007). Key export sectors — the drivers of short periods of growth take-off — were closely regulated by the Government or had strong involvement by state-owned enterprises (SOEs). Press Holdings, a company formed to run the Malawi Congress Party newspaper, became a sprawling conglomerate

37. Cammack and Kelsall (2011), for example, find that a disciplined technocracy and the centralization of rents drove economic development between 1965 and 1979 (post-independence) and between 2004 and 2009 (Bingu wa Mutharika's first term).

with interests in 17 subsidiaries and 23 associated companies by the 1980s (Cammack and Kelsall 2011). At times, Press Holdings alone had a gross turnover of about one-third of GDP (Makuyana and Odhiambo 2014, 26). Agricultural trading was largely monopolized by ADMARC until reforms in the context of Structural Adjustment Programs reduced direct state involvement. However, despite official liberalization, much of this legacy remains. The markets for the key export commodities tobacco and tea remain structured markets[38] and Malawi's 71 public enterprises continue to play an important role in key sectors of the economy (U.S. Department of State 2022).

Since political liberalization, rents have been decentralized but are tied to a "powerbroker" business elite with little interest in investing in state capacity and growth (Said and Singini 2014). Such powerbroker business elites often operate in import trading and agricultural industries, and regularly win government contracts. Chinsinga (2012) argues that inadequate targeting and intransparent procurement procedures for agricultural input subsidies enable political patronage (see Chapter 2). The powerbrokers use their connections to shape policy to their advantage. Policy makers often oblige as they need powerbroker rents to sustain their political machinery and for personal gains. Many perceive economic policy as a zero-sum game to distribute domestic market surpluses, in turn over-extracting rents rather than growing what is available. Opening up opportunities to unaffiliated businesses through export-oriented reforms or promoting market entry would threaten these established interests. Meanwhile, regardless of the party in power, "the state is used to offer jobs, deals, and contracts to those in business and society on whom it depends for retaining power" (Dercon 2022, 157). Selectively enforced price controls and export bans are often used to settle scores with private traders (Dercon 2022).

The result of this "powerbroker" relationship is an atmosphere of mistrust that prompts overbearing regulation. The dependence of policy makers on powerbroker business actors gives them a motive for distrust. Arrangements with powerbrokers are based on narrow patronage deals rather than being organized by an innate common interest informed by political ideology or long-term party policy. The offer of a more attractive deal can easily lead to a shift from agreed terms. Leftwich (2009) contrasts this with collaborative institutional arrangements where two-way transparency and reciprocity in relations leads to intentions and commitments that are held to be credible. This political economy is exacerbated by many within the business elite being perceived as ethnically distinct. At the same time, with a long history of suppressed private sector growth, there are scant successes to point to where enhanced private sector competitiveness led to increased wealth. The result is often the popular diagnosis of overbearing regulation (The Economist 2022). Policy makers preserve wide-ranging and discretionary powers over business that would be better served by a more stable and parsimonious set of rules, as this provides leverage over powerbrokers who are otherwise presumed to defect from deals.

Decentralized Short-Horizon Rent-Seeking Leads to the Most Inefficient Types of Corruption

International evidence suggests that the direct costs imposed by corruption creates only part of the damaging effects of corruption — it is uncertainty about the level of costs that can make corrupt practices especially inefficient (Olken and Pande 2012). In other regions, high levels of corruption are not necessarily incompatible with rapid economic growth (Banerjee, Mullainathan, and Hanna 2012). India, Indonesia, and Vietnam

38. Structured markets are organized and formal places where market participants enter into regulated trading and financial arrangements. Examples are commodity exchanges. Structured markets often coincide with export mandates, where no commodity can be exported unless it is sold through a structured market.

show that rapid economic growth can take place in contexts with high regulatory hurdles and comparatively high levels of corruption that, however, are highly predictable. While corruption can be perceived as an opportune tool to evade red tape, decentralized and unpredictable arrangements can make returns uncertain. Investors, both domestic and international, tend to shun such arrangements.

In Malawi, both grand and petty corruption is widespread. There is no shortage of grand corruption scandals. Among the most prominent probably is the scandal termed "Cashgate" in 2013, in which around US$50 million was misappropriated through procurement scams. However, there are many other examples.[39] At the same time, petty and every-day corruption is a significant and widely recognized problem. For instance, in the 2019 Afrobarometer Survey, 30.4 percent of respondents stated that they had bribed the police to avoid a problem during an encounter.

Reforms at the turn of the century had little effect on underlying systems. Anti-corruption measures approved in the 1990s, such as the establishment of the Anti-Corruption Bureau, led to high scores in the WGI Control of Corruption dimension into the early 2000s (Kukutschka 2014). However, it turned out that such efforts had little effect on the underlying logic of the system, as they represented institutional changes satisfying external pressures rather than being based on a genuine shift in political interests (Bridges 2016).

Inefficient types of corruption often result from a political settlement characterized by short-horizon decentralized rent-seeking.[40] The most effective path to power, which is concentrated in a strong presidency, is co-opting elites that represent competing factions organized by identity, such as ethnicity and religion, rather than ideology. Factions centered on a big man or woman from a small "bwana class" impervious to formal institutional change find that the way to power is paying rents to maintain their deals-based support. These dispersed power configuration drive weak inclusive growth outcomes compared with peers such as Rwanda (Chinsinga et al. 2022). Nurturing growth of sources of rents, i.e., growing productive industries, is prevented by immediate imperatives exerted through the system.

Isomorphism Leads to Low Government Effectiveness

In addition to outright corruption, state resources often do not translate into developmental gains due to insufficient government effectiveness.[41] This is in part because presenting the impression of commitment, coordination, and cooperation, rather than

39. For instance, in 2001, many development partners suspended aid to Malawi at least partially on corruption grounds. Hidden debts that started to be accumulated in 2018 facilitated Malawi's current BoP crisis. While arrests were made and audits conducted, few high-ranking officers received punishments representing lasting deterrents, a finding consistent with evidence across low-capacity environments (Cuneo, Jetson, and Vannutelli 2023).

40. Cammack and Kelsall (2011) and Roscitt (2013) track Malawian regimes across a centralization-time horizon space. They describe short-horizon decentralized rent-seeking as it gained prominence in Malawi's competitive-clientelist political landscape after the democratic transition as a free-for-all situation that is especially damaging to economic growth. On the other end of the spectrum, highly centralized, longer-horizon rent seeking can promote the developmental utilization of rents. Cammack (2017) connects Malawi being stuck at the short-horizon decentralized end of the spectrum to its competitive clientelist political settlement

41. Government effectiveness describes the quality of public services, the quality of the civil service and the degree of its independence from political pressures, the quality of policy formulation and implementation, and the credibility of the government's commitment to such policies. Such commitment, in addition to effective coordination in shaping expectations to enable complementary action and cooperation, defined as limiting opportunistic behavior to prevent free-riding, are also the "three Cs" of effective governance driving economic development according to the 2017 World Development Report (World Bank 2017).

its reality, is strongly incentivized. Prima facie evidence of this is the large number of high-quality planning documents that Malawian government institutions produce. Performance incentives often center around visible and formal elements of reform (Bridges and Woolcock 2017). This is the case in the competition for external funds, where norms and operational imperatives often lead to a focus on the formal adoption of policies rather than their implementation. With limited transparency and less developed civil society mechanisms for accountability, local stakeholders also often have to focus on what is presented rather than on results.

However, many deeper analyses find a different set of rules at play below a layer of best practice guidelines, something they call *isomorphism.* Especially government financial management has been described in this way.[42] The Systematic Country Diagnostic (World Bank 2018) highlights the appearance of "good practice" financial management coinciding with widespread fraud and limited control. Similarly, the analysis presented in Chapter 1 identifies limited fiscal credibility as a key constraint.

Beneath a veneer of accountability and good governance practices often lies an ineffective bureaucracy. In contrast, aspirational peer countries show that actual commitment to economic development is not primarily expressed through elaborate policy documents. For example, Rwanda's post-1994 development plans were supported by a fundamental shift in the political settlement. Ethiopia's development plans expressed a significant change in the interest of political elites that coincided with systems aimed to effectively project state power for centuries (Dercon 2022).

Poorly formulated development assistance can promote isomorphism and have other corrosive effects on Malawian governance arrangements. While foreign aid is linked to enhanced immediate outcomes in Malawi and elsewhere (De and Becker 2015), it may have differential effects on local governance arrangements. Moreover, institutional reform approaches can incentivize ineffective arrangements (Bridges and Woolcock 2017). Attention should be paid to positively influencing underlying functionality rather than formulating reform initiatives that yield institutions that resemble those found in higher-performing peers. Bridges and Woolcock (2017) in turn advocate for a problem-driven approach, i.e., a process whereby problems are conceived by local stakeholders, including their contextual complexities, and reforms are elaborated through iterative feedback. Genuine local ownership also has the potential to alleviate issues of fragmentation in the delivery of development assistance.

A flight of donors from government systems after the "Cashgate" scandal had little effect on isomorphism, while introducing many governance challenges. Several development partners ended budget support to Malawi after the discovery of widespread fraud during the "Cashgate" scandal in 2013. Others suspended budget support operations and only the World Bank and IMF resumed budget support in the ten years following the scandal.[43] This flight from official systems has had adverse effects, particularly in terms of fragmentation of the financing landscape and a weakening of the policy dialogue (DEval 2018). As development partners shifted off budget, they often ended up working in isolation with a reduced focus on directly strengthening government systems. At the same time, no fundamental shift in the level of isomorphism has occurred, including for public financial

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42. Rakner et al. (2004) describe the budget process as a theatre that masks the real distribution and spending of Government resources. Bridges (2016) speaks about how institutional public financial management reform efforts in Malawi have encouraged Malawi to shape the form rather than the substance of effective governance institutions.

43. The European Union and African Development Bank are considering the resumption of budget support in 2024.

management (PFM). Challenges, such as inadequate commitment controls, difficulties to implement effective cash management, improper use of IFMIS, and large variances from budgets have persisted into the post-Cashgate era (Bridges and Woolcock 2017).

MALAWIAN SUCCESSES OVERCAME GOVERNANCE AND INSTITUTIONAL CONSTRAINTS

Among all these governance challenges, real achievements can go unnoticed. Especially in a region where negative narratives dominate, it is important to balance this with examples where progress has been achieved.[44] While governance successes in other countries have received dedicated volumes (see, for example, Alam, Mokate, and Plangemann 2016 on South Africa), this chapter provides the first such collection dedicated exclusively to Malawian governance achievements.[45]

Chronicling success provides more than uplifting stories in times of crisis; they provide valuable lessons to continue and scale success. Narratives of accomplishment are critical to boost morale in an environment where meeting targets can go unnoticed. They are also a key element of accountability. Positive framing can provide guidance and support to demoralized decision makers (Sheffer and Loewen 2019). Most critically, cases of success hold valuable lessons that are critical to achieving further positive outcomes and to scale these successes.

This CEM identifies 11 success stories (or *"positive deviants"*) where generally adverse conditions were overcome to attain positive outcomes through the governance and reform of: (i) value chains; (ii) public entities and SOEs; and (iii) public programs. To qualify as a success story in this CEM, cases had to demonstrate a tangible impact on the lives of average Malawians. For instance, for agricultural value chains to be included in the selection, they had to show substantial growth, far in excess of traditional value chains, over numerous years. A boom solely based on international prices or outside intervention was not eligible. Selection was based on a nomination process among the project team, with input from external advisors, and resulted in the following selection: (i) three agricultural value chains: groundnuts, macadamia, and soybean; (ii) four turnaround episodes of public institutions: Lilongwe Water Board, Phalombe District, Press Corporation, and Road Fund Administration; and (iii) four public programs: Malawi's response to the AIDS epidemic, the widespread distribution of cooking stoves to achieve clean cooking goals, results-based financing of local government development efforts, and the early years of the Farm Input Subsidy Program.

Each case was analyzed by a recognized expert. Experts were provided with a five-item questionnaire to guide the analysis: (i) the positive outcomes achieved; (ii) the actors involved; (iii) the challenges that were overcome and that remain; (iv) the future outlook; and (v) key lessons. Based on these five questions, case study authors from within and outside the World Bank summarized publicly available material, and generated insights from their own experience and that of key participants. These are summarized in Annex 5.1.

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44. This has given rise to an entire library of case studies that tracks developmental successes on the continent and beyond, though none of these focus on Malawian successes (Princeton University 2023).

45. In 1989, the World Bank reviewed seven cases of success, including well-known instances such as the macroeconomic management of commodity booms in Botswana, as well as less recognized ones, such a program to organize gravity-fed water schemes in rural Malawi (EDI 1989). Malawi also featured in a later such volume through a case study of the successes of the initial years of the Farm Input Subsidy Program (FISP) (Chuhan-Pole and Angwafo 2011).

How to kickstart a new value chain – lessons from the groundnut, macadamia, and soybean value chain

Name	Positive Outcomes	Catalysts	Success Ingredients	Challenges
Groundnut Value Chain	Tobacco companies, assisted by a partnership with USAID, successfully laid the groundwork to build a vertically integrated groundnut value chain. Three improved varieties were released and are now produced at scale. Two large companies have contracted about 7,000 farmers who produce locally processed groundnuts.	• Recognition of global demand weakening for Malawian tobacco led the tobacco industry to diversify into groundnuts. • USAID support and exploration of legume value chains facilitated the process.	• **Local Leadership:** Tobacco industry supported by USAID. • **Market Understanding:** How the regional and global groundnut market works and how to acquire financing for groundnut ventures. • **Partnership:** Strategic partnership and technical assistance from development partners. • **Technological advances:** Focus on high quality seed production and managing risks including aflatoxin.	Exports are dominated by one company while international demand implies space for many more. Access to financing amidst high costs of market entry, unpredictable regulation, and aflatoxin risks remain key challenges.
Macadamia Value Chain	With 10,000 hectares planted by 2023, Malawi has become the sixth-largest macadamia exporter globally in 2021. Eight major producers with over 2,000 permanent employees grow and market macadamia alongside 4,000 smallholders. Local macadamia processing is being explored.	• A shift away from traditional crops such as tobacco. • Long-term investment and interest in community engagement, support from various institutional investors and organizations such as USAID.	• **Patient Capital:** Long-term investments from various sources, ensuring continuity in growth. • **Community Engagement:** Efforts like a community beekeeping project and collaboration with smallholder farmers fostered more inclusive value chains. • **Strategic Partnerships:** Collaborations with investors, development organizations, and local communities allowed for technology transfer, financial support, and problem-solving.	Conflict with local communities and theft have been a hurdle for macadamia estates. Uncertainty over land tenure is problematic considering the long-term nature of macadamia growing, as is the unstable macroeconomic environment.
Soybean Value Chain	Soybeans have emerged as the second largest export and the most advanced value-adding sector in Malawi. Over 300,000 tons of production, exporting US$133 million in 2021 and 700,000 tons of industrial level processing capacity represent a fivefold increase over a decade.	• Rapidly growing global, regional, and local demand for soybeans, and high prices for farmers. • Input providers, anchor farms, processors, and international support	• **Local Leadership:** Input providers, anchor farms, and processors drove the establishment of markets and know-how smaller producers could rely on. • **Demand-Side Oversight:** Global and local demand for diverse soybean products. • **Public-Private Partnerships:** Alignment between private sector, NGOs, and public actors such as USAID. • **Holistic approach:** A comprehensive understanding of the political economy, prioritizing the value chain and engaging public sector partners.	Risks like potential policy uncertainty, a global price decline, illicit exports, and unutilized processing capacity need to be managed. The engagement of Malawian industrial investors and SMEs, and a stronger common vision between the industry and government are needed to sustain growth.

Groundnuts, macadamia, and soybeans have not only become the primary cash crops for many farmers, but they now also have upstream and downstream industries emerging. While not yet reaching the scale of tobacco, all three value chains have seen significant growth in recent years (see also Chapter 4). Groundnuts have been primarily commercialized by major tobacco firms, leveraging more than 7,000 smallholders in their networks to produce high-quality, traceable, and exportable produce. Malawi has become the sixth-largest macadamia exporter globally in 2021, supporting eight commercial firms alongside 4,000 smallholder producers. Soybeans, which were marginal exports a decade ago, have swiftly become Malawi's second-largest export.

All three value chains have upstream and downstream value addition emerging. Malawi now has an installed industrial soybean processing capacity of 700,000 tons, with seven major processors producing various products including soy chunks, soy lecithin, corn-soy blend, chicken feed, fish feed, and cooking oil. The groundnut segment is becoming a vertically integrated value chain, with downstream linkages such as the production of seeds and other inputs, and upstream linkages such as shelling and testing to unlock major export destinations. Macadamia are currently husked and exported in shell, but a major investment in local cracking capacity is underway. Successful value chains spark adjacent activity, such as the poultry and fish feed industry for which soybeans are a major input, honey and paprika which are being intercropped with macadamia, and the agro-input segment, where groundnuts and soybeans are enabling new companies to emerge in inputs such as seed and inoculant.

All three value chain successes coordinated and aligned the interests of a diverse set of stakeholders. To achieve scale, value chains often needed both the know-how and marketing capacity of major commercial firms, and the production scale that in Malawi only smallholders can achieve. However, the Government and development partners also played important roles in the scaling up of all three value chains. The Ministry of Agriculture's Department for Agricultural Services (DARS) constitutes a key linkage in the production of soybean and groundnut seed. Development partners providing financing in all three value chains at important points in time, while also at times playing a critical value chain coordination role.

Generating the required expertise and finding the right role for the Government are important challenges that needed to be overcome. For instance, groundnut machine-shelling requires the updating of seed standards, which requires new expertise. At the same time, finding the right level of Government involvement in each segment is key to their success. Overregulation, such as the setting of minimum farmgate price above market rates, can damage emerging value chains (see also Chapter 2). Policy support is needed, especially when value chains are still in their infancy. Most of all, however, policy coherence and predictability are needed to unlock investments. Unpredictable interventions such as export bans undermine the successful model of value chain development shown by these three value chains.

The three cases show that value chain governance successes have three main ingredients: strong market demand, government support rather than control, and a long-term vision. Malawi is a small market that cannot be isolated from global forces. However, the three value chains introduced here also show the opportunity that this situation can provide for average Malawians. High global prices for soybean and its derivative products created the biggest surge in commercial opportunity for Malawian smallholders in a generation in 2022/23, with global markets absorbing any domestic excess production — as long as the Government continues to play a supportive role.

All three cases also show that successful support is rooted in active dialogue between public stakeholders, private companies, smallholder interests, and development partners. To achieve success at scale, it is imperative that each can play its dedicated role. Among the key support areas where the Government can make a tangible difference is to provide a credible vision for the sector. Real coordination challenges exist between the players in a value chain. For instance, expanding processing capacity only makes sense when local production is adequate, which in turn depends on production inputs. Centrally providing an evidenced and committed signal when it makes sense to expand production capacity can help overcome such coordination challenges.

All three cases also show that value chain growth does not happen overnight. This is most evident in the macadamia value chain where a tree takes the better part of a decade to bear fruit. The soybean value chain also took a decade to emerge from a fringe industry to becoming the major industrial crop it is today. Such long timelines require commitment, even in the face of adversity, as well as patient private capital. For these value chains, it was a long-term strategy of the private sector — primarily the diversification efforts of the tobacco industry and of Malawian and regional food processing companies — and of the public sector, primarily through the coordination efforts and market-building approach of two development partner projects that provided this sustained support.

How to turn around a public entity – lessons from Lilongwe Water Board, Phalombe District Council, Press Corporation, and Road Fund Administration

Name	Positive Outcomes	Catalysts	Success Ingredients	Challenges
Lilongwe Water Board	Under the Lilongwe Water and Sanitation Project, the Lilongwe Water Board (LWB) launched its "Pathway to Success Program" to address capacity gaps. Over its course, LWB increased access to water supply services, continuity of supply, revenue, cost recovery, customer service delivery, and reduced wastage.	The World Bank-financed utility modernization program (Lilongwe Water and Sanitation Project) and LWB's "Pathway to Success Program" acted as catalysts, addressing capacity gaps, standard operating procedures, water safety, and business continuity plans. Organizational change management was vital.	• **Local Leadership:** Transformation led by the LWB Corporate Management Team, with involvement of engineers. • **Demand-side Oversight:** Focus on customer needs and satisfaction, efficiency, and cost recovery. • **Change Management and Training:** Implementing new work culture, training, and leadership development. • **Strategic Partnerships and Financing:** Collaboration with the World Bank and integration of consultancies.	• Changing the existing work culture was a significant challenge that was gradually overcome. • The presence of high levels of non-revenue water still presents an ongoing challenge. • Political instability and short-term contracts created uncertainty at the top level of the LWB. • The ongoing need for an improved regulatory framework and a continued focus on results to maintain progress after project completion in 2024.
Phalombe District Council	In the 2021 Local Authority Performance Assessment (LAPA), Phalombe achieved an education sector score of 60 percent, almost double the national average. It evidenced "home-grown" innovations, like partnerships with local businesses, and high levels of accountability.	The LAPA process and the Performance-Based Grant (PBG) mechanism were major drivers behind the success achieved in Phalombe. The decentralized education system also played a role, allowing Phalombe to innovate despite overarching challenges.	• **Local leadership:** Especially the District Commissioner and Local Councilors drove positive change. • **Collective ownership and accountability:** Emphasis on both were notable. • **High-level commitment:** Resource allocation for education was present, ensuring that even in the face of financial challenges, education remained a priority. • **Performance and inspection reports:** These were effectively used and shared.	• Coordination challenges with the central government continue. • General financial constraints remain severe. • While often addressed comparatively well, policy inconsistencies and oversight issues periodically surface.

Name	Positive Outcomes	Catalysts	Success Ingredients	Challenges
Press Corporation	In 1995, the National Assembly passed the Press Trust Reconstruction Act, which redefined Press Trust's charitable objectives and Press Corporation's privately organized corporate governance. The transformation enabled joint ventures with local and foreign partners and made the company profitable.	Political leadership exerted by the head of the executive, in partnership with international organizations, as well as legal certainty through the Press Trust Reconstruction Act.	• **Separation of political and economic dimensions:** this enabled the restructuring into a commercial operation. • **Strategic collaboration:** this included joint ventures and international collaborations. • **Focused management:** separation of roles between owners and management and adherence to corporate governance principles. • **Focused leadership:** key figures included the president, the board, trustees, development partners and other strategic partners.	• A generally unfavorable business environment including the regulatory regime and lacking infrastructure affect Press Corporation. • A lack of clear policy direction saps confidence. • Policies were implemented without sufficient contextualization during transformation.
Road Fund Administration	The Road Fund Administration (RFA) has established a track record of sound financial performance and good governance. It has enhanced and diversified revenues through initiatives such as the Road Toll Program and become the most creditworthy SOE with 10 years of clean audits. It has successfully placed bonds in local capital markets.	The leadership's emphasis on integrity and teamwork coincided with strategic external support for sustained reform.	• **Integrity and Teamwork:** Fostered within the organization, supported by management. • **High Compliance:** Enforcement of standards and respecting governance requirements and laws. • **Support from the Board of Directors:** Ensures all major decisions align with organizational objectives. • **Private Institution Mindset:** Focus on operating as a financial institution with ISO certification and emphasis on leadership and integrity.	• Potential political influence on public procurement and contract management in the road sector. • Over-commitments, arrears, and Roads Authority debt present contingent liabilities. • Growing concerns about value for money create a need to enhance specialized, technical capacity within the road industry. • Industry-wide practice of underbidding on tenders leads to fiscal risks and increased project costs.

The cases of the Lilongwe Water Board, the Phalombe District Council, Press Corporation, and the Road Fund Administration demonstrate that public entities are reformable and can deliver on their mandates across sectors. Over the past five years, the Lilongwe Water Board has increased its service coverage, reaching more people (89 percent in 2022 from 70 percent in 2017) more often (continuity of supply at 22 hours in 2022 from 16 hours in 2017), while at the same time increasing financial sustainability by enhancing revenue. Phalombe's District Council showed that even Malawi's fourth-poorest district can deliver high-quality services for its citizens by scoring far ahead of national averages in education sector performance. The example of Press Corporation shows that, with the right governance arrangements, commercial public enterprises can be transformed from fiscal burdens into profitable pillars of the economy. Malawi's Road Fund Administration shows that SOEs can be responsible guardians of public funds delivering critical services to the public.

Public enterprises do not tend to turn around by themselves; the Government and development partners are key facilitators in these cases. Lilongwe Water Board's transformation process was led by the Corporate Management Team, which was supported by the World Bank in its "Pathway to Success Program". Similarly, the initiative from Phalombe's District Commissioner was complemented by incentives exerted by the performance-based grants provided through the Governance to Enable Service Delivery Project (GESD), which intentionally leverages existing government systems to bring together national government entities (Ministry of Finance, Ministry of Local Government, National Audit Office) with local representatives (District Commissioner, District Council, Local Government Finance Council). The transformation of Press Corporation after the advent of democracy in 1994 resulted from pressure by the IMF and World Bank to reform, national political contention over the future of the enterprise, attention from the highest levels of national government, and guidance from the board of directors, representing private sector, government, and civil society interests. The RFA board, which guided its transformation, also seats members from the private sector, public office holders, and civil society, appointed by the Ministry of Finance.

Public enterprises are a magnet for rent-seeking, and can suffer from a lack of vision, while also facing unreasonable demands. As public enterprises steer large amounts of public funds, insulating them from adverse political economy pressures can be a challenge. For instance, RFA experienced pressures on public procurement and contract management to sidestep regulation, compromising its financial position. At the same time, inflated expectations of what a public enterprise can deliver from political stakeholders can stand in the way of public enterprises delivering on their core mandates. The ambition to rapidly expand Press Corporation fueled by short-term borrowing in the 1970s brought the company to the brink of financial collapse, necessitating the comprehensive overhaul that started in the 1980s and culminated in its transformation in the 1990s. Off-budget and unfunded road development project mandates that exceeded available financial resources also compromised RFA's financial position during its transition period. Both issues are aggravated if a public enterprise lacks a defined vision, shared by its employees, management, and public stakeholders. Overcoming collective action problems between various stakeholders, enabling a productive work culture, and crafting a reliable policy environment were key challenges in the transformation process of all studied public enterprises. Bringing donors on board for this vision was not always easy. As the experience of Press Corporation shows, the leadership at times did not agree with IMF-led reforms.

The formula for successful public enterprise reform includes dedicated and empowered leaders finding adapted operational solutions, building on a conducive financial environment. Effective leadership has been a key part of the successful turnaround of Malawian public enterprises. When systems are not yet developed to ensure performance, the right people at the top can matter all the more. To enable leaders to make a difference, they need to be empowered by a clear mandate and by political conditions. The right leaders can make a difference in more socially oriented enterprises, as in Phalombe where the District Commissioner created a system of collective ownership and accountability, and public enterprises that provide services on a commercial basis, such as Lilongwe Water Board where a change management program included the training of technical skills and leadership development, promoting rapid improvements in the SOE's professionalism. Often leaders will also need to be persistent to achieve overarching objectives, as was the case of the Minister of Finance insisting on GESD grants being performance-based, and withholding funds from underperforming districts.

However, change programs are not one-size-fits all and each enterprise has its own specific problems, including technical and governance challenges. A case in point is Press Corporation, where an intense dispute over its future in the 1990s was likely necessary to work out the idiosyncratic operational model that it runs today. Industry-specific issues require specialized knowledge and adapted solutions, as is the case with the industry-wide practice of underbidding in road sector tenders that leads to price variations during contract execution. Lastly, transformation processes are as much financial as they are operational. For success to be maintained, financial incentives need to reflect operational priorities and implementing turnaround processes can come at an initial cost. Financial incentives from World Bank project financing played a key role in enforcing disciplined work toward performance goals in several projects.

How to achieve policy goals – lessons from clean cooking, the HIV/AIDS response, the initial years of FISP, and local government finance

Name	Positive Outcomes	Catalysts	Success Ingredients	Challenges
AIDS Response	Malawi has achieved a reduced number of HIV infections (20,000 from 28,000), increased awareness of those who are HIV positive (88 percent), a high rate of HIV treatment (98 percent), and a high success rate (i.e., virally suppressed) among those treated (97 percent) between 2016 and 2021.	The acute HIV/AIDS crisis situation at the start of the 21st century coincided with the availability of technical and financial support from international entities such as the Global Fund, the U.S. President's Emergency Plan for AIDS Relief (PEPFAR), Bill and Melinda Gates Foundation (BMGF), Clinton Health Access Initiative (CHAI), and others.	• **Local Leadership:** The initiative was led by the Malawi Ministry of Health and other local organizations. • **Demand-Side Oversight:** Implementation of various strategies targeting different populations, including prisoners, and mechanisms for locating and re-engaging individuals who have stopped adhering to their HIV treatment regimen. • **Multi-Sector Collaboration:** The HIV response involved various sectors such as Health, Education, Youth, Sports, and Culture, contributing to a broad and effective response. • **Comprehensive Strategies:** Integrating HIV service delivery with Tuberculosis, Sexual and Reproductive Health Rights, Mental Health, and Nutrition promoted efficiency and improved health outcomes.	• Continued infrastructure challenges and human resource shortages. • Commodity management issues continue. • Cases of activity duplication among implementing partners occur despite coordination meetings.
Clean Cooking	In 2020, Malawi officially achieved its goal of disseminating 2 million cleaner cooking alternatives to households. This success was driven by very strong sectoral governance, placing Malawi a joint fourth among 53 countries evaluated by the Regulatory Indicators for Sustainable Energy (RISE). Under Government leadership, with development partner support, and aligned private sector interest (particularly among smaller companies), millions of households were able to use more efficient and less polluting cookstoves such as the portable Chitetezo Mbaula that is commercially sold.	The confluence of government leadership, private sector interest, donor support, and NGO implementation capacity were pivotal.	• **Local Leadership:** The Ministry of Energy provided strong leadership, and the National Cookstove Steering Committee was instrumental in leading policy dialogue. • **Demand-Side Oversight:** Coordinated action, involvement of smaller companies, and alignment of different stakeholders helped drive the change. • **Locally Adapted Solutions:** The use of locally designed Chitetezo Mbaula stoves enabled local production, creating a solution adapted to Malawi's environment. • **Innovative Financing and Implementation:** Programs like Energizing Development (EnDev) brought together various development assistance funds, and innovative approaches like results-based financing were used.	• While the outcomes are promising, there are concerns regarding sustainability and the complexity of future challenges. The ability to shift toward even cleaner cooking solutions like gas and electricity remains restricted, and modelling suggests that there is a need for continued incentives and subsidies to continue achieving goals. • Program focus must also extend to related areas such as sustainable forestry.

Name	Positive Outcomes	Catalysts	Success Ingredients	Challenges
Local Government Results-based Financing	Supported by a World Bank grant, the government has increased the transfer of district development funds for the 28 rural District Councils in 2020. The amount districts receive is based on the annual LAPA and districts that do not fulfil minimum access conditions are excluded. Having entered the second round of LAPA assessments in 2021, districts have followed this with across-the-board improvements with the largest increases among previously least performing districts.	The introduction of the PBG system has served as a significant driver of change, focusing on a results-based approach and aligning with Malawi's decentralization ambitions. This was aided by high-level political commitment.	• **Early, high-level commitment:** Leadership from key ministries ensured momentum, protection, and alignment with accountability measures. • **Innovative Incentive Structure:** Sparked local innovation, peer learning, and adherence to development plans. • **Financial Support and Strategic Partnerships:** World Bank support and cross-ministerial collaboration reduced fragmentation and provided substantial backing. • **Institutionalizing Within Government Systems:** Built within existing structures, strengthening accountability and ensuring alignment with national strategies. • **Embracing Accountability and Transparency:** Fostered transparency at all levels, utilizing tools such as LAPA scores, and reinforced through public commitments.	• The nascent nature of the system means it is still susceptible to various challenges, including political interference and potential fiscal constraints. • The ongoing momentum and alignment among various stakeholders need to be effectively managed to ensure long-term success.
Early Farm Input Subsidy Programme (FISP)	FISP succeeded in raising awareness among Malawian farmers of the value of inorganic fertilizer. In the years after FISP was introduced, Malawi significantly increased maize production and achieved national food sovereignty in most years.	Strong political leadership mobilized domestic funding, only partially supplemented by development partners many of which were in opposition.	• **Local leadership:** Vigorous political support. • **Financing strategy:** Mix of domestic and international funding. • **Logistical efficiency:** Acknowledging private companies' capacity for timely delivery.	• Failure to achieve the government policy goal of household-level food self-sufficiency. • The program quickly became fiscally unsustainable, requiring better targeting and management. • The inability to make fertilizer use profitable at market prices prevented the gradual withdrawal of the subsidy.

The four instances presented in this sub-section provide tangible evidence that public policy goals can be both ambitious *and* achievable, with positive impacts on Malawians. All four cases deviate from the commonly held belief that Malawi produces high-quality strategies but typically fails to implement them. In 2020, Malawi achieved its goal of disseminating 2 million cleaner cooking alternatives to households with positive effects on the health of Malawians and the environment they inhabit, making it a global leader in this area. Due to effective and available treatment, contracting AIDS is not typically a death sentence for Malawians anymore. The continued reduction of infections by 29 percent in the five years through 2021 is a gain in the quality of life of tens of thousands of Malawians. The provision of modern antiretroviral therapy not only underlies reductions in infections but also means that 97 percent of those in treatment have suppressed viral loads, enabling them to lead full lives. In the early years, FISP was a key instrument to achieve national food sovereignty, coming from a situation where Malawi relied on food aid. While having since become an inefficient and unaffordable drain on fiscal space and foreign exchange (see Chapter 2), in the early years FISP addressed acute problems with innovative solutions. The reform of local government finance through Performance-Based Grants (PBGs) revitalized local governance, supporting Malawi's decentralization agenda (World Bank 2022b).

The central government and international supporters were integral to all these successes, while the private sector was actively leveraged for clean cooking and FISP. All public policy goals were achieved under the leadership of the central government pursuing a clear agenda and leveraging international support. Different support was procured from different development partners, each playing to their various strengths. Clean cooking received significant resources from various bilateral development partners, the AIDS response leveraged international and local NGOs, while local government finance was reformed with assistance from the World Bank. FISP was controversial among many development partners from the outset, resulting in it being primarily locally financed, but the Government found some support for select components from bilateral development partners. As a second generation "smart subsidy", promoting private sector fertilizer markets was an explicit policy goal of the FISP. Private sector interests were also actively leveraged to achieve clean cooking goals.

Overcoming coordination problems was as central to success as was adequate resourcing. Initial coordination challenges are reported in all instances. These include the duplication of activities by implementing partners in the AIDS response, while clean cooking is increasingly transforming from a problem of supplying sufficient cleaner burning wood stoves to a problem spanning many sectors, including sustainable forestry and electricity supply. Overcoming the most pressing problems also requires financial prioritization, either by finding adequate donor finance or by prioritizing interventions in Malawian budgets.

Achieving sectoral targets starts with a commitment, and requires bringing diverse stakeholders together, as well as financially prioritizing the most pressing problems. All successes gained traction with the Government communicating ambitious but achievable targets rooted in a clear public agenda, such as the 2 million target for cleaner cooking stoves, the 95-95-95 target in the AIDS response (95 percent of HIV positive Malawians knowing their status, of which 95 percent are on treatment, of which 95 percent have suppressed viral loads), national food sovereignty for FISP, and the delivery of fiscal decentralization for local government finance. Especially in the case of FISP and the AIDS response, the political stakes were high.

These targets were backed up with workable agendas of how to achieve these targets and a credible signal that the Government was serious about them. This aided the coordination of the diverse set of stakeholders involved in each success, each of which has their own objectives. Aligning these objectives with the policy target meant allocating a dedicated role to each stakeholder. Chitetezo Mbaula (cleaner-burning woodstoves) were produced by local manufacturers, giving them a financial incentive to market and scale them as an often-subsidized cleaner cooking alternative. While financial prioritization is no guarantee for success — technically unrefined and badly governed programs can underperform even with ample resources — it is often a necessary ingredient. For instance, providing many additional years of life to millions of HIV-positive Malawians does not come cheap, with typical annual treatment costs of around US$140 even in Malawi's efficient health system (Tagar et al. 2014). To achieve targets, it should be clear where such resources come from, whether this is from the prioritization within limited government budgets, finding development partners that support the achievement of the target, or the resources that Malawians are willing to pay at point of service.

SCALING SUCCESS HAS THE POTENTIAL TO CHANGE THE GREATER PICTURE

These successful cases have not been immune to the typical challenges plaguing Malawian governance. For instance, the groundnut value chain suffers from bad regulation that is induced by fraught state-business relationships, as evidenced by minimum farmgate prices that are often uncompetitive. Meanwhile, the RFA's procurement challenges may be indicative of decentralized short-horizon rent-seeking. Initial challenges facing DARS to provide sufficient basic seeds point to the choice of an operating model not sufficiently adapted to Malawian circumstances and thus low government effectiveness induced by isomorphic replication of unsuitable institutions. Current challenges with the Agricultural Inputs Program, a descendent of the FISP, which increasingly became affected by fraught state-business relationships, decentralized short-term rent-seeking (numerous documented cases of mis-procurement), and isomorphism (inability to keep the program within ostensibly binding budget ceilings), show that initial success requires continued effort and commitment to be sustained.

What sets these cases apart is their ability to overcome challenges. The outlined successes were not achieved because these value chains are exposed to a fundamentally different policy environment than other sectors but rather because actors found effective ways to thrive despite it. While there are some commonalities on how different sectors have achieved success, they all developed their own strategies. However, there are also many commonalities. Leadership and effective management are a cornerstone of virtually all of these cases. While in most cases such leadership was provided by the Government, some success stories were at points coordinated by other entities, such as the role of the AgDiv program in the development of the soybean and groundnut value chains.

Having access to suitable finance is another commonality among successful cases. Value chains demand patient debt and equity finance for producers, public entities require the right financial incentives to perform, while policy goals need sufficient financial backing. Value chains work best in a context of high international demand, public entities require consistent demand for the services they provide, while civil society needs to demand change in how policy is formulated. The central Government remains integral to any national governance success, highlighting the need to operate in a way that is informed by its agenda and interests, to synergize efforts, and to build on its systems and capabilities. The recipe for success is nevertheless not universal. For instance, unlocking productive value chains requires the Government to play a supportive and coordinating role rather than exerting outright control. Achieving policy goals requires Government to set a more strategic agenda. This comes on top of each case displaying its own characteristics.

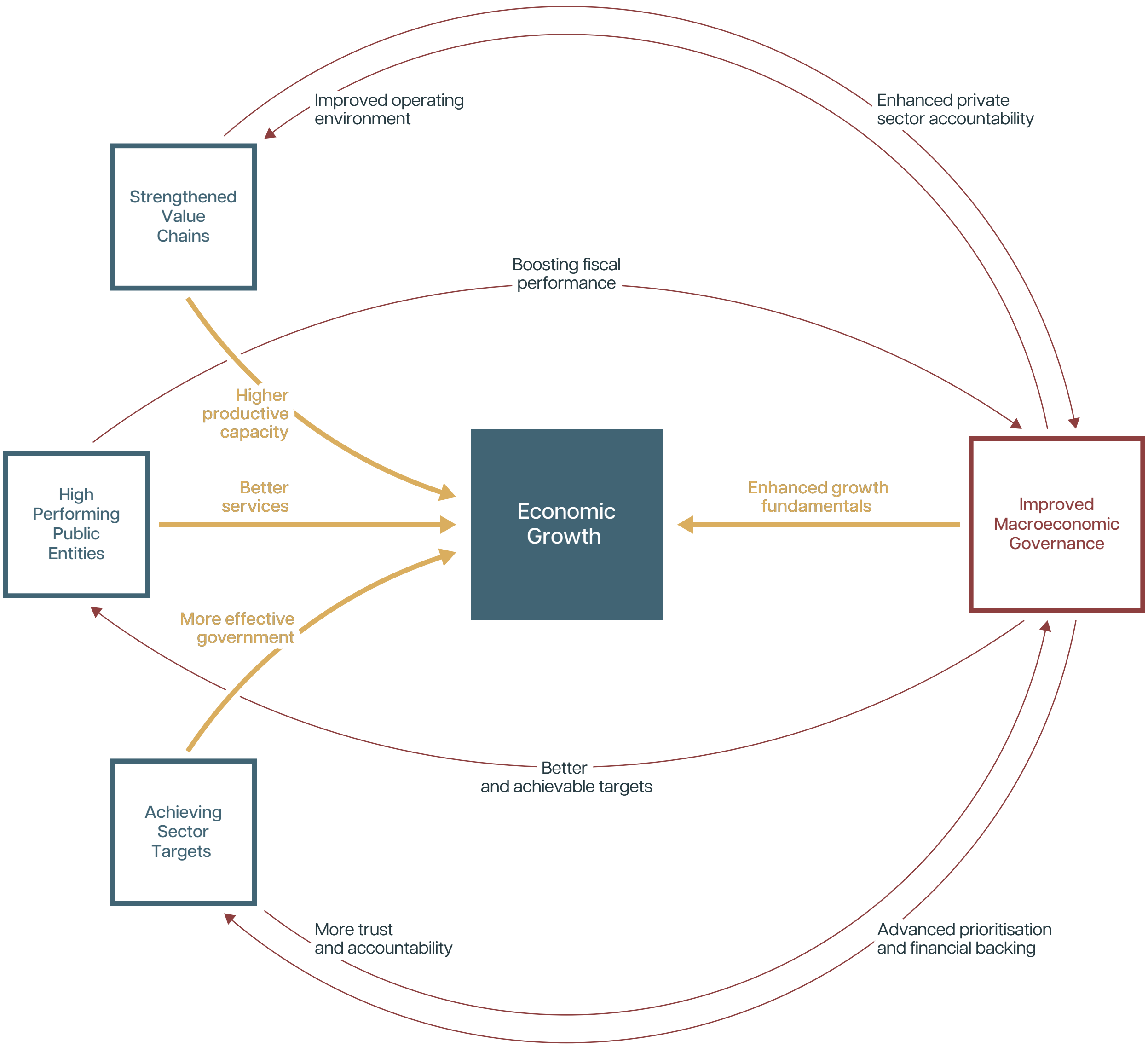
Building on the success of the 11 profiled value chains, public entities, and public programs has a direct bearing on Malawi's growth trajectory. Growth of productive value chains requires market opportunities to be exploited, public sector coordination and support for sustainable market systems, and a long-term and patient approach. This demonstrates that fraught state-business relationships can be managed. Overcoming them can directly enhance Malawi's productive capacity. The analyzed value chains have significant spillovers due to their labor intensity, their large scope for achieving national-level scale, and low barriers to entry. This creates opportunities for farmers to improve their income, supports MSME development and increases the tax base. They also catalyze the expansion of adjacent sectors and thus directly influence economic growth. Making more SOEs meet their targets demonstrates that short horizon rent-seeking is not an innate characteristic of the public sector but an issue that can be addressed with the right leadership, the right operational solutions, and with a conducive financial environment. The sustainable provision of essential services by reformed SOEs will contribute to economic growth and enable the private sector to produce more, relying on these services, also leading to accelerated growth. Meanwhile, the Government performing on its sectoral targets exhibits that, with commitment, bringing relevant stakeholders together and through effective financial prioritization, Malawi can craft its own adapted solutions exemplifying government effectiveness. A more effective government identifying and addressing key societal and economic problems will lay some of the foundations for economic growth.

Enhanced macroeconomic governance is another necessary ingredient to achieve growth targets. As laid out in detail in Chapter 1, getting macroeconomic policy right is indispensable to enter a higher growth trajectory. Having only a few growing productive value chains, some better-run public entities, and the achievement of a few policy targets is not enough for Malawi to experience the economic transformation that it strives for when the general environment for investment and growth remains inadequate. Many of Malawi's most challenging macroeconomic policy issues are as much a matter of governance as of technical capacity. They are also a result of not directly anchoring macroeconomic policy-making in explicit efforts to grow the private sector. This reflects weaknesses in economic decision-making that have, for example, resulted in the contracting of unsustainable debt, repeatedly straying from carefully elaborated and negotiated budgetary targets, or insisting on an exchange rate that has little relevance for most voluntary transactions.

Scaling these 11 successes has the potential to enable a virtuous feedback loop with macroeconomic governance (Figure 5.2). Strengthened productive sectors will empower the Malawian private sector. This private sector in turn can hold macroeconomic policy-making to account. For instance, an empowered private sector will have stronger leverage to insist on a more open and efficient trade environment. At the same time, the private sector will be a key beneficiary of enhanced macroeconomic governance. Kwachas that maintain their value, the ability to trade, and a solvent public sector will lift critical constraints to business expansion. Similarly, better performing public enterprises will mean that they become less of a drain, while some can become increased contributors to the country's public finances. This will help enable necessary fiscal reforms. Enhanced macroeconomic stewardship will make targets for public enterprises both better defined and more achievable. For example, a conducive financial environment in which public entities need to excel will be significantly aided when macroeconomic stability ensues. Meanwhile, demonstrated public success through the achievement of sectoral targets will nurture the trust and accountability fundamentals necessary to improve macroeconomic governance. In turn, enhanced macroeconomic governance will deliver the necessary prioritization and financial backing for sectoral targets to be achieved.

Incremental governance improvements can reinforce much-needed macroeconomic reforms, anchoring them in governance arrangements that deter reversion. Chapter 1 argues that in order to attain a more rapid growth trajectory, the Malawian authorities should embark on a decisive macroeconomic reform agenda. This will in turn create the foundations for improvements in sectoral governance that further bolster macroeconomic reforms and increase their growth-enhancing impacts. The implication of the sectoral governance improvements chronicled in the 11 case studies is that their can be maximized in an improved macroeconomic environment. This would help sustainably anchor improved macroeconomic policy in a more conducive political economy.

Figure 5.2 Feedback loop between enhanced sectoral and macroeconomic governance



Source: World Bank staff.

FINANCING MALAWI'S GROWTH AND ECONOMIC DEVELOPMENT NEEDS TO TAKE MALAWI'S GOVERNANCE DYNAMICS INTO ACCOUNT

Financing Malawi's economic growth will require significant resources to be spent effectively. The *Malawi 2063* multi-year implementation plan, published in 2021, puts the price tag of key interventions for the achievement of targets at MWK 3.0 trillion, or 4.7 times public development expenditure in 2023 and 2024 alone (NPC 2021). The "Business Unusual" scenario in the "Long-Term Growth Model" introduced in Chapter 1 — the only one compatible with *Malawi 2063* growth targets — sees economy-wide public investment increasing to 7.2 percent of GDP and private investment to 17.3 percent. In 2023 Malawi kwacha this equates to about MWK 4.0 trillion, of which more than MKW 1.2 trillion would come from public funds. However, even such large investments will only translate into growth when they are spent effectively, which depends on governance. With the "Integrated National Financing Strategy", Malawi has a comprehensive framework on how to govern the financing of Malawi's developmental ambitions (UNDP 2023).

Facilitating private sector investment

Chapter 1 has highlighted the importance of private investment to achieve growth targets, which is a function of improved state-business relationships. The value chain success stories show that overcoming governance constraints can attract significant investment. Soybean and groundnut processing facilities cost billions of kwacha and, when well run, represent productive investments boosting the Malawian economy. While both value chains overcame governance constraints in their own ways, scaling such investments across more sectors of Malawi's economy will require a general improvement of state-business relationships, sparking an improvement in the regulatory environment.

Given Malawi's limited fiscal space, almost all commercially viable investment will have to be done privately, incentivized by private returns. Malawi already is in debt distress and thus the Government has limited scope to embark on new public investments. Even if dedicated reforms of public entities enable these to deliver, maximizing growth demands a division of labor where the private sector conducts effectively all commercially viable investment. However, this requires private entities to expect to profit from their investments. This in turn requires implementing lessons from the three value chain success stories, given that investors will want assurance that the Government will play a supportive role. Such an assurance would need to be integrated with policy coherence and predictability to foster trust that the envisioned returns are likely to materialize.

Financial sector governance matters for the availability of finance. Pension reform led to the rapid accumulation of pension assets, which stand at MWK 1.7 trillion at the end of 2022 (Reserve Bank of Malawi 2022), illustrating the difference that regulation makes on the supply side. The macadamia value chain was one of the segments that leveraged this source for productive investment.

Facilitating Government investment

Chapter 1 shows that, to achieve growth targets, Malawi needs to increase the scope and quality of its public investment. Increasing the scope of public investment requires raising income, reallocating public expenditure, and attracting additional external resources. Malawi's recent "Domestic Resource Mobilisation Strategy, 2021 – 2026" presents a framework on how to increase revenues. At the same time, there is scope to reallocate public expenditure from less productive efforts to those enabling growth. For instance, the most recent "Public Expenditure Review" chronicles growth of the wage bill from an average of 2.5 percent of GDP between FY2008 and FY2013 to above 6 percent in more recent years (World Bank 2019). Reverting to previous levels of expenditure on compensation of employees alone can free up resources in excess of the previously discussed public investment levels. Reform of agricultural support programs promises additional significant savings (see Chapter 2), while social sector spending can be made more efficient while still delivering improved services (World Bank, Government of Malawi, and Global Financing Facility 2020).

Attracting additional external resources starts with making Malawi's PFM systems trustworthy. After the 2013 "Cashgate" scandal, development partners lost trust in Malawi's PFM systems, withdrawing budget support. Analysis presented in Chapter 1 shows that this significantly weakened Malawi's fiscal position. Because there has been no credible improvement of systems at the scale needed to engender trust, development partners have established elaborate parallel delivery systems over the past decade, making it even harder to bring these back on budget. However, as the PBG success story shows, bringing development partner resources on budget in a transparent and effective way is feasible. Overcoming corruption issues rooted in short-horizon rent-seeking requires dedicated leadership, finding operational solutions that work in the given context, and financially incentivizing change. Migrating to digitized government-to-people payment modes, as targeted by the "Government Payments Roadmap" of 2017, can constitute a technical element of this process (Mwingu and Chilima 2022).

Making the best financial choices requires prioritization within fixed budget ceilings. Chapter 1 and World Bank (2021) demonstrate the need to effectively prioritize the Public Sector Investment Program (PSIP). This includes abandoning spending on low-priority, low-impact projects. From a political economy perspective, this is a difficult process as it requires strategic re-contracting based on a shared vision that the timely implementation of a few projects is preferable to underachievement across many. However, success stories on the achievement of policy goals show that such challenges can be overcome with high-level commitment and bringing stakeholders on board for effective financial prioritization.

Financing Malawi's growth hinges on filling the implementation gap on the Medium-Term Debt Management Strategy (MTDS). Malawi's new MTDS sees nominal public debt sloping down to below 50 percent of GDP by 2026 (Ministry of Finance and Economic Affairs 2022). While requiring fiscal discipline, boosted by increased revenue through the Domestic Resource Mobilization Strategy, in the near term, it will contribute significantly to Malawi's resource envelope, which is constrained by public debt interest being the largest expenditure item (see Chapter 1). This will require a shift in the approach from the previous 2018–2022 MTDS during which public debt rapidly increased instead of declining as planned. Examples of success in the achievement of sectoral goals show that the attainment of ambitious targets is possible, but that this requires deliberate action and doing things differently from a governance perspective.

Facilitating public enterprise investment

To date, RFA is the only SOE that is ready to attract market investment (World Bank 2021). Dedicated leadership fostered an enterprise that has both the balance sheet and the transparency to attract investors. This required enhancing its autonomy and insulating the enterprise from political pressures. The board contains skilled members of the private sector who are focused on the mission of making RFA high-performing.

Accessing private sector capital by SOEs can bring with it a host of stringent but beneficial requirements. Commercial investors can change the governance of an enterprise by expecting higher levels of accuracy, timeliness, and transparency in financial operations (World Bank 2021). Operational capacity is in investors' interest, as it is necessary to maintain financial flows. Initiated by a move to make SOEs investable, this can create an alignment of internal incentives with external ones. SOEs that perform on their mandates while remaining investable demands financial and operational performance to maintain revenue.

HOW TO SYSTEMATICALLY SCALE GOVERNANCE AND IMPLEMENTATION SUCCESSES FOR ECONOMIC GROWTH

The 11 success stories present evidence that, with the right approach, current governance constraints can be overcome, stimulating economic growth. Achieving institutional arrangements that align political incentives with developmental ends is critical to promote growth. This achievement is feasible across 11 cases of high-performing agricultural value chains, public entities, and public programs. By applying similar principles, this success can be scaled. Scaling success is especially urgent in: (i) economic sectors that are pivotal to economic growth, including other agricultural value chains, manufacturing, and the mining industry; (ii) public entities without which growth is unlikely to take off, including ESCOM and water boards; and (iii) in the achievement of strategic goals on which Malawi's economic advancement hinges, and especially the *Malawi 2063*, as well as sectoral strategies such as Malawi's Debt Strategy and the National Export Strategy II. In addition to directly contributing to growth, further successes have the potential to catalyze a positive feedback loop with enhanced macroeconomic governance, further promoting economic growth.

By virtue of being positive outliers, the 11 success stories in this chapter are yet to become the norm. The preponderance of examples where significant reform is urgently needed illustrate that Malawi's overall institutional arrangements are not yet at a place where they systematically promote success at scale. This is also reflected in Malawi's tepid long-term growth performance (see Chapter 1). Governance and institutional reforms are inherently difficult and past efforts to support these reforms has often failed. The second section of this chapter showed that Malawi's governance challenges are deeply rooted in Malawi's history, and its societal and economic structure. However, as a selection of peer countries in Chapter 1 shows, growth take-offs can be sudden and sustained. In the case of Malawi, however, this requires doing things differently.

The presented recommendations (Table 5.1) **aim to provide an actionable approach on how economic governance could be done differently to foster more conducive conditions.** Rather than prescribing specific policy actions, the recommendations attempt to foster a governance environment from which more growth-enhancing policy choices can emerge. They attempt to balance feasibility with the ambition needed to lift Malawi to a higher growth trajectory, and specificity with the need to change implicit governance arrangements. Because the Malawian authorities have often received recommendations from domestic and external stakeholder on what to do differently, often with limited traction, the set of recommendations resulting from the findings in this chapter attempts to capture actionable ways on how to do things differently. Proposed changes focus on: (i) how to invest in peer learning; (ii) how to promote and enable effective leadership; (iii) how to institutionalize examples of 'positive deviance' within government systems; (iv) how to create appropriate financial incentives to strengthen leadership and program implementation; and (v) how to facilitate strategic public-private dialogue and coalitions.

Two sets of recommendations focus on how to institutionally anchor and employ peers to scale success. Institutionalizing examples of success increases the likelihood of thus far limited success to scale, both within the discussed areas and to sectors where veritable success is yet to take hold. Systematically investing in learning exchanges between high-performing and lagging institutions, as a demonstrated method to achieve success, should be a priority. Learning exchanges can both be initiated between peers or facilitated by institutions such as the National Planning Commission, but should be systematized. This can both provide tailwinds to those contributing to the success and be a guide to those looking for inspiration.

In the medium term, the authorities can institutionalize success by isolating the mechanisms and institutional arrangements that drove high performance and embedding these targets within performance management. While peer learning exchanges can provide implementers with details, narratives of success such as the ones presented here can provide general guidance. Rigorously identifying institutional success factors can then lead to their integration into government systems. While institutionally anchoring reforms, Government can also garner increased support by more widely recognizing the contribution that peers can make in backstopping endeavors. Managing relations with institutions such as the National Assembly, the Anti-Corruption Bureau, or the National Audit Office can consume resources and draw attention to potential gaps, but filling these gaps will be rewarded by the trust and resources that the public sector needs to be an effective facilitator of economic growth.

The presented analysis shows the importance of leadership in any reform process, pointing to the need to promote it in targeted ways. The choice of leaders is likely to be deeply engrained in the political economy of the wider system. However, existing leaders can be made more effective by promoting their missions, and providing backing and support, including by prioritizing platforms that visibly promote those who have been the driving forces behind high-performing institutions. In the SOE space, the public signing ceremony of Shareholders Letters of Expectations between the Ministry of Finance and SOE leaders is an encouraging sign of the promotion of effective leadership. Leaders such as the CEO of Lilongwe Water Board were given an opportunity to provide evidence of their leadership to the wider public, while those from less financially sound SOEs were requested to exercise stronger leadership. This promising approach should be continued, expanded, and strengthened. At the same time, the legal framework to incentivize the performance of leaders has been under revision for some time. While formally approving strengthened public service legislation is an important milestone, it is during implementation that additional care must be taken that laws sufficiently incentivize performance among senior public servants and executives.

Creating appropriate financial incentives to strengthen leadership and program implementation was key to each of the 11 case studies, while aligning financial incentives with performance was also crucial. Prioritizing public expenditure is rarely easy or straightforward from a political economy perspective. However, as demonstrated throughout this CEM, effective prioritization is essential for Malawi to have a chance to achieve its growth ambitions. For instance, Chapter 1 recommends enhanced prioritization of the PSIP, while Chapter 2 calls for the increased prioritization of agricultural expenditure. Providing high-level guidance on the available resource envelope, and thus where priorities lie financially, can promote this process. At the same time, results-based financing has demonstrated its potential to align financial incentives with performance and should be considered as an approach more widely. For instance, calls to apply similar disbursement rules to the Constituency Development Fund, as already apply to the majority of district development financing, should be considered. Given the significant role of development partners in Malawi's public financing structure, aligning their financing mechanisms with enhanced common platforms is essential.

Overcoming fraught state-business relationships requires fostering coalitions, which can be facilitated through strategic public-private dialogue. Several initiatives already evidence this approach, including the Presidential Private Sector Council, the Presidential Delivery Unit's "Private Sector Labs", and the Public Service Reforms Agenda. Strengthened secretariats are key ingredients to continue their momentum into implementation. At the same time, more opportunities for co-production[46] between the public sector, the private sector, and civil society should be explored. This can include the organization of key stakeholders of value chains into working groups, or the leveraging of the third sector (voluntary, independent, and civic organizations) to deliver public services. Giving every stakeholder a purpose (such as regulation, implementation, or information provision) can enhance such co-production. In the medium term, such an approach should also give rise to stronger review processes for new regulations and policies. Given the ambitions for economic growth voiced in the *Malawi 2063*, such processes needs to focus on how growth can be advanced.

Table 5.1 Top five governance and implementation priorities

Area	Short-Term Action (3 – 6 months)	Medium-Term Implementation (before the end of 2025)
1. Investing in peer learning	Systematically invest in learning exchanges between high-performing and lagging institutions (SOEs, local governments, MDAs).	Embed success factors identified in performance management.
2. Promoting and enabling effective leadership	Publicize and reward strong performance and the leaders behind it.	Focus the implementation of public service legislation currently undergoing revision on incentivizing performance among senior public servants and executives.
3. Institutionalizing examples of 'positive deviance' within government systems	Rigorously identify the institutional factors supporting 'examples of success to find entry points for integration within government systems (i.e. on budget and using Malawian PFM and accountability systems)	Enable the scaling up of identified examples of success and success factors within government systems, including via the *Malawi 2063* process, though prioritization, programming, and budgets.
4. Creating appropriate financial incentives to strengthen leadership and program implementation	Scale up results-based financing within government systems, with a focus on harmonization of financing across government and development partners within common platforms.	Create concerted action among public, private, and international stakeholders around results-based financing architectures in line with clear sectoral targets with high level political backing.
5. Facilitating strategic public-private dialogue and coalitions	Strengthen the ability of forums such as the Presidential Private Sector Council, the Private Sector Labs and other Public-Private Dialogue mechanisms to influence policy.	Institutionalize a robust review process within the Government for all new regulations and policies as to their economic impact on achieving growth objectives.

46. While cooperation is about working together towards a common goal, co-production is a deeper, more integrated form of collaboration that involves shared decision-making, responsibility, and benefits.

ANNEX 5.1

Summary of Successful Cases

Case	Positive Outcomes Achieved	Key Actors
	Value Chains	
Groundnuts	Tobacco companies, assisted through a partnership with USAID, successfully laid the groundwork to build a vertically integrated groundnut value chain. Three improved varieties were released and are now produced at scale. Two large companies have contracted about 7,000 farmers who produce locally processed groundnuts.	Central government (Ministry of Agriculture) Private companies (Pyxus and Global Ventures) Smallholder farmers Development partners (including USAID)
Macadamia	With 10,000 hectares planted, Malawi became the sixth-largest macadamia exporter globally. Eight major producers with over 2,000 permanent employees grow and market macadamia alongside 4,000 smallholders. Local macadamia processing is being explored.	Private companies (eight major producers) Smallholder Farmers Development partners (including USAID, British International Investment) Local financiers (including Old Mutual)
Soybeans	Soybeans have emerged as the second-largest export and the most advanced value-adding sector in Malawi. Over 300,000 tons of production, and exports worth US$133 million in 2021 and 700,000 tons of industrial level processing capacity are more than five-fold increases over a decade.	Private companies (various input producers, processors, and output buyers) Smallholder framers Development partners (including USAID and UNDP) Central government (MoA, MoIT)
	Public Entity Reforms	
Lilongwe Water Board	Under the World Bank Lilongwe Water and Sanitation Project, the Lilongwe Water Board (LWB) launched its "Pathway to Success Program" to address capacity gaps. Over the course of this program, LWB increased access to water supply services, continuity of supply, revenue, cost recovery, customer service delivery, and reduced wastage.	Parastatal (LWB) Development partners (World Bank)
Phalombe District Council	In the 2021 Local Authority Performance Assessment (LAPA), Phalombe achieved an education sector score of 60 percent, almost double the national average. It evidenced "home-grown" innovations, like partnerships with local businesses, and high levels of accountability.	Local government (Phalombe District Council) Central government (MoF, MoLG) Development partners (World Bank)
Press Corporation	In 1995, the National Assembly passed the Press Trust Reconstruction Act, which redefined Press Trust's charitable objectives and Press Corporation's privately organized corporate governance. The transformation enabled joint ventures with local and foreign partners and made the company a profitable contributor to Malawi's economy.	Parastatal (Press Corporation) Central government (the President, National Assembly) Development partners (IMF, World Bank) Private companies (international strategic partners)
Road Fund Administration	The Road Fund Administration (RFA) has established a track record of sound financial performance and good governance. It has enhanced and diversified revenues through initiatives like the Road Toll Program and become the most creditworthy SOE with 10 years of clean audits. It has successfully placed bonds in local capital markets.	Parastatal (RFA) Central government (MoF) Private companies (private sector board members)
	Public Programs	
AIDS Response	Malawi has achieved a reduced number of HIV infections (20,000 from 28,000), increased awareness of those who are HIV positive (88 percent), a high linkage rate to HIV treatment (98 percent), and a high success rate among those treated (97 percent) between 2016 and 2021.	Central government (MoH, National AIDS Commission) Development partners (including PEPFAR, BMGF, CHAI) NGOs (including EGPAF, Lighthouse Trust, Baylor College, Jhpiego, Partners in Hope, MACRO)

Case	Positive Outcomes Achieved	Key Actors
Clean Cooking	In 2020, Malawi officially achieved its goal of disseminating 2 million cleaner cooking alternatives to households. This success was driven by outstanding sectoral governance, placing Malawi a joint fourth among 53 countries evaluated by the Regulatory Indicators for Sustainable Energy. Under government leadership, with development partner support, and aligned private sector interest, particularly smaller companies, millions of households were brought to use more efficient and less polluting cookstoves such as the Chitetezo Mbaula.	Central government (MoE) Private companies (SMEs such as Mbaula producers) Development partners (EnDev) NGOs (including Concern Worldwide, Maeve Project)
Local Government Results-based Financing	Supported by a World Bank grant, the Government has increased the transfer of district development funds for the 28 rural District Councils in 2020. The amount districts receive is based on the annual LAPA and districts that do not fulfil minimum access conditions are excluded. In the second round of LAPA assessments in 2021, districts have followed this with across-the-board improvements with the largest increases among previously least performing districts.	Central government (MoF, LGFC) Local government (28 rural district councils) Development partner (World Bank)
Early FISP	FISP succeeded in raising awareness among Malawian farmers of the value of inorganic fertilizer. In the five years after FISP was introduced Malawi significantly increased maize production and achieved national food sovereignty in most years.	Central government (MoA)

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APPENDIX A
List of CEM Background Papers

Aterido, Reyes. “Performance, Resilience, and Capabilities of Firms in Malawi: Are Firms Capable of Boosting Growth?”

Benson, Todd, and Joachim De Weerdt. “Employment Options and Challenges for Rural Households in Malawi: An Agriculture and Rural Employment Analysis of the Fifth Malawi Integrated Household Survey, 2019/20.”

Brun, Martin, Aleksandar Stojanov, and Jakob Engel. “Sensitivity of Malawian Exports to Real Effective Exchange Rate Fluctuations.”

Chilima, Efrem, Innocent Njati Banda, and Anderson Gondwe. “Why Lending Rates Are High in Malawi.”

Edward, Lawrence, Jakob Engel, and Aleksandar Stojanov. “Understanding Malawi’s Export Decline.”

FinMark Trust. “Malawi Micro, Small and Medium Enterprise Tracker Survey 2022. Findings Report.”

Jammes, Oliver. “Assessing the Impact of the AfCFTA on Malawi’s Import Values and Fiscal Revenues Using TRIST.”

Malunga, Grain. “Mining Sector Pipeline Rapid Assessment Malawi.”

Masanjala, Winford. “The Evolution of Development Planning in Malawi.”

Nur, Hayaan. “Mastering the Balancing Act: How Malawi Can Emerge from Its Perpetual Balance of Payments Challenges.”

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