



MALAWI

SELECTED ISSUES

May 2018

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MALAWI

SELECTED ISSUES

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Approved By
Michael Atingi-Ego

Prepared by Luiz Almeida, Mitra Farahbaksh, Werner Keller, Edna Mensah, Malika Pant, Jack Ree (all AFR), Edward Archibald and Bob Muchabaiwa (both UNICEF) with support from Juan Carlos Flores and Shirin Nikaein Towfighian (both AFR). Supervised by Pritha Mitra (AFR).

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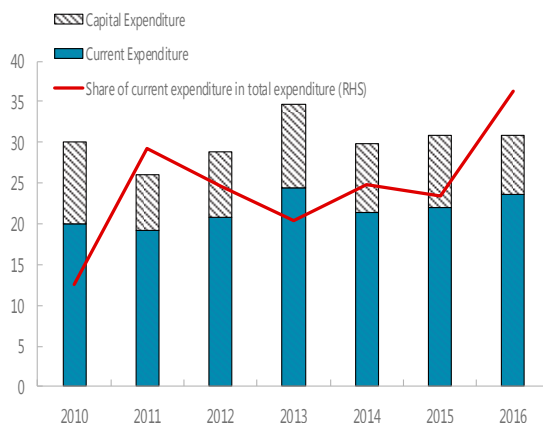
EFFICIENCY OF PUBLIC SPENDING ON HEALTH AND EDUCATION IN MALAWI

A. Background

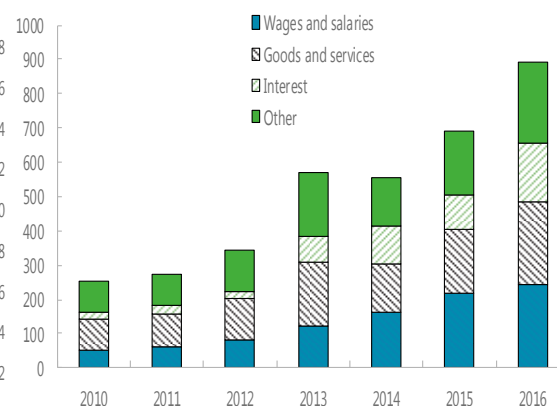
1. **Malawi has large development needs but limited fiscal space.** Fostering inclusive growth, building resilience and alleviating poverty all hinge on substantial improvements to the population's education and health—two key pillars of the Malawi Growth and Development Strategy (MGDS) III. The strategy envisions annual increases of 4 percent of GDP in total education and health spending over the next five years. Absent a surge in revenues or donor assistance, it will be challenging to meet these targets as debt sustainability concerns limit non-concessional borrowing options.
2. **Improving spending efficiency could help create fiscal space.** Increasing spending efficiency allows a country to achieve the same output with fewer resources or achieve higher output with the same resources. In other words, it helps ensure value for money, reduce waste of resources, and maintain fiscal discipline. However, the process of improving efficiency takes time and typically requires deep reforms to secure long-term gains.
3. **This paper benchmarks Malawi's public spending and identifies areas where there is scope to improve expenditure efficiency.** It documents recent public spending trends in Malawi with a focus on healthcare and education spending and compares with low-income countries' (LICs) averages. Applying the data envelopment analysis (DEA) methodology, the paper assesses public spending efficiency and provides policy suggestions for improving efficiency in education and health.

B. Public Spending on Health and Education: Trends and Impact

4. **In recent years, public spending has stagnated as a share of GDP—with interest spending crowding out priority spending.** Averaging 30 percent of GDP during 2010–16, public spending has been increasingly dominated by current spending (whose share rose almost 10 pps) at the detriment of capital spending. While all components of current spending have risen, increased government borrowing and higher borrowing costs have almost doubled the share of interest spending (from 10 to 18 percent of current spending during 2010–16, Figure 1).

Figure 1. Trends and Composition of Public and Current Spending**Figure 1. Malawi: Trends in Public Spending and Composition, 2010-2016**
(Percent of GDP)

Sources: Country authorities; IMF staff estimates.

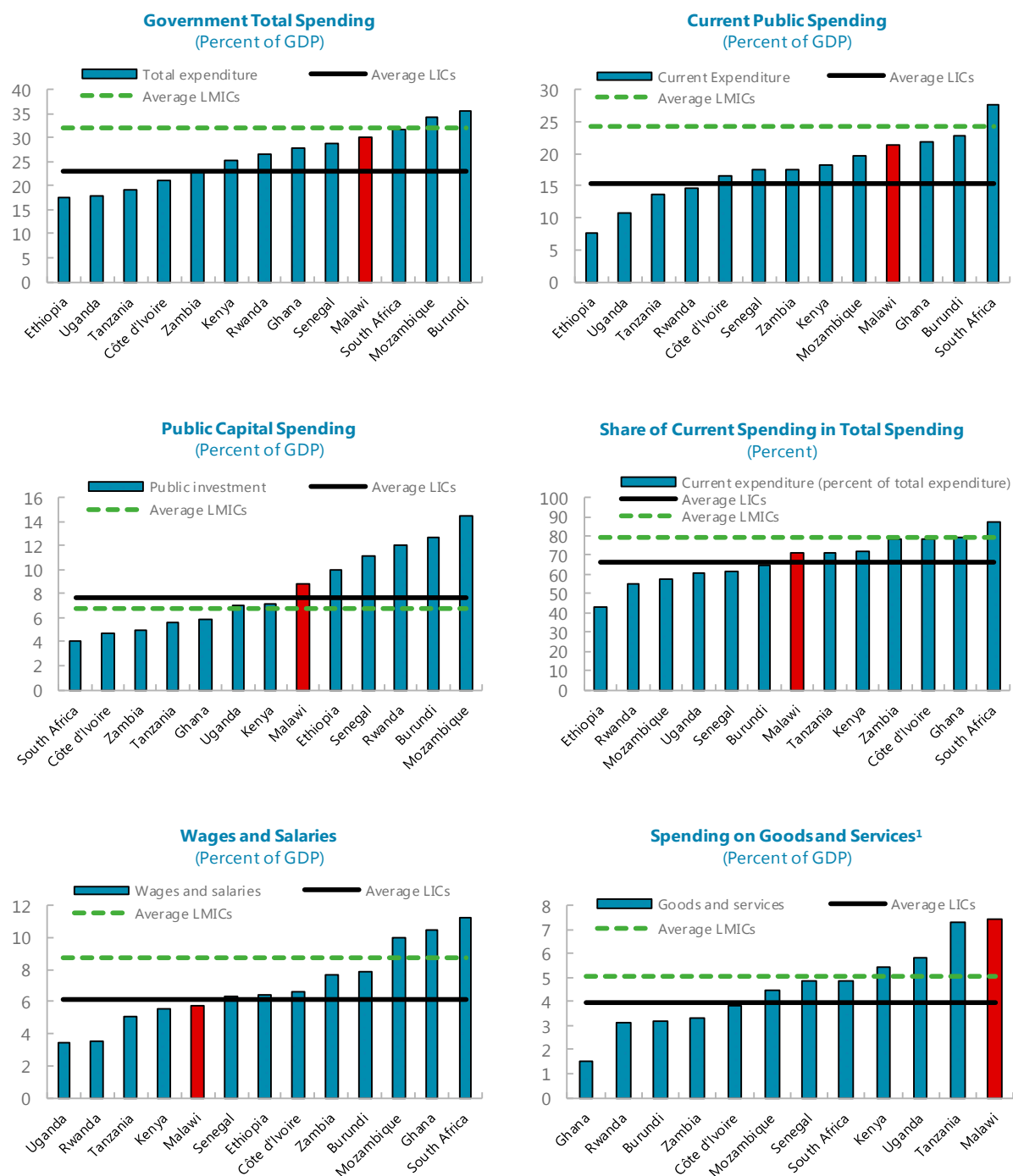
Figure 2. Malawi: Composition of Current Spending, 2010-2016
(Billion kwacha)

Sources: Country authorities; IMF staff estimates.

5. Compared to other LICs, spending (particularly on goods and services) is above average (Figure 2). In 2010-15, Malawi's government spending was well above the LIC average due to high current spending. Despite recent declines in the share of goods and services out of total spending, Malawi's spending in this area as a share of GDP is still one of the highest in Sub-Saharan Africa (SSA). In contrast, wages and salaries is below the LIC average and capital spending is close to the LIC average.

6. Public health spending—spanning goods and services, wages, and capital spending—has declined since 2011 but health outcomes are steadily improving (Figure 3). Public spending on health peaked in 2011 and then fell by more than \$10 per capita between 2011-13. However, at \$15 per capita, it remains just above the average level of the early 2000s. Private health spending (including some off-budget donor financed spending) also decreased since its peak in 2011 but by only one third as much. Despite reduced spending, health outcomes continue to improve. Infant mortality decreased by almost 50 per live birth and life expectancy increased by 15 years since the early 2000s.

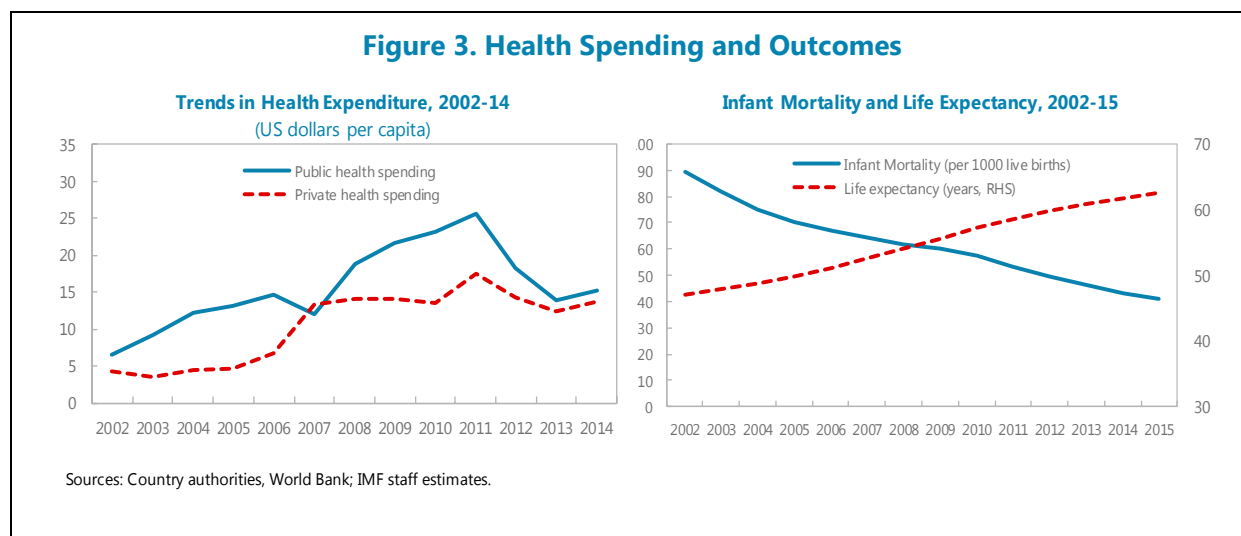
Figure 2. Public Spending in Malawi in a Cross-Country Perspective, 2010–15



Sources: Country authorities; IMF staff estimates.

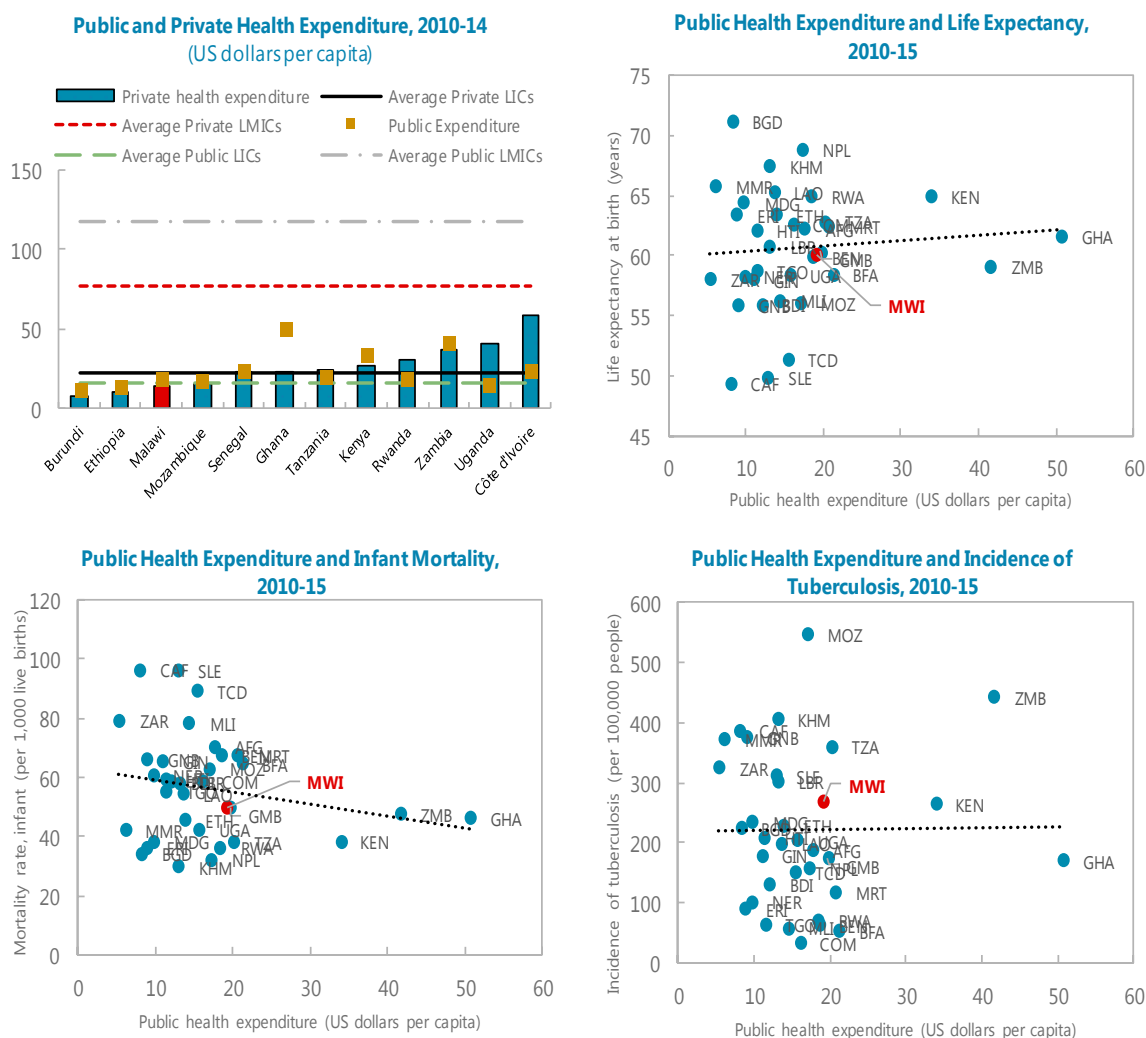
¹Data on expenditure on goods and services is not available for Ethiopia.

7. Malawi's health outcomes are mixed relative to LICs with similar levels of health spending per capita (Figure 4). Public and private health spending per capita are just under the LIC average. Compared to other LICs with similar levels of health spending per capita, Malawi has relatively lower infant mortality and about average life expectancy but the incidence of tuberculosis is higher.



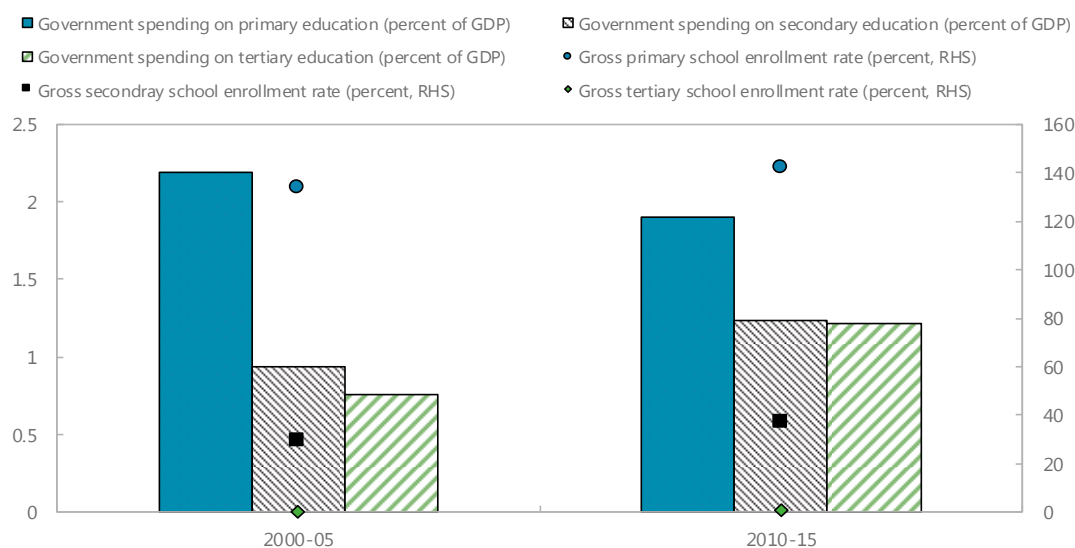
8. Government spending on education,—also spanning goods and services, wages, and capital spending—especially secondary and tertiary, has increased since the early 2000s but performance remains broadly unchanged (Figure 5). Average spending during 2010–15 rose by 0.5 pps to 4.5 percent relative to the average for 2000–05. The largest increases were in secondary and tertiary education spending of 0.3 and 0.5 pps, respectively. However, secondary school enrollment rates only increased by 8 pps and tertiary school enrollment rates did not change. In contrast, primary school spending fell by 0.3 pps but enrollment rates increased slightly by 9 pps.

9. Malawi's education spending is above the LIC average but outcomes are mixed (Figure 6). During 2010–15, Malawi spent about 1 percent of GDP more than the LIC average on public education. Spending more than half its education budget on primary education, Malawi achieved very positive results for primary school enrolment—Malawi had one of the highest enrolment rates among LICs during 2010–15. In contrast, secondary and tertiary school enrolment was much lower than in peers spending similar amounts. Ideally, the analysis should complement these indicators on the quantity of education with ones on the quality of education. Completion rate and standardized test scores (such as the Program for International Student Assessment) are some examples. However, given the scarcity of data in these areas for a large number of LICs, these indicators were not included in this analysis.

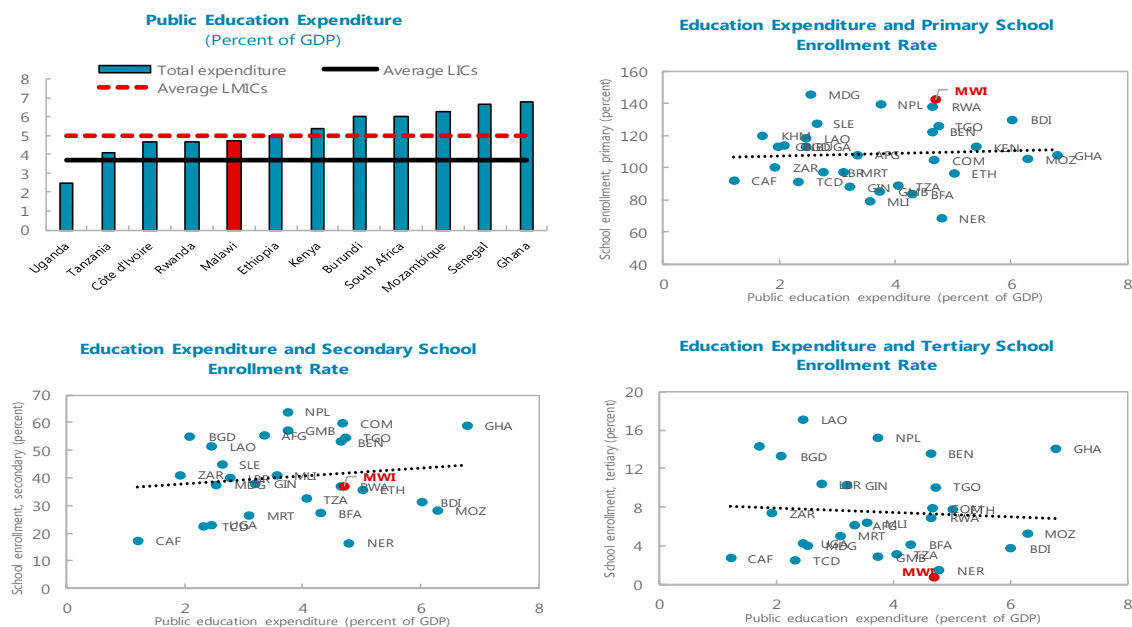
Figure 4. Health Spending and Outcomes in Malawi and Comparator Countries, 2010–15¹

Sources: Country authorities, World Bank; IMF staff estimates.

¹Latest available data in WDI for health expenditure is 2014.

Figure 5. Public Spending on Education and School Enrollment Rate, 2000–15

Sources: Country authorities, World Bank, and IMF staff estimates.

Figure 6. Public Education Spending and Outcomes in Malawi and Comparator Countries, 2010–15

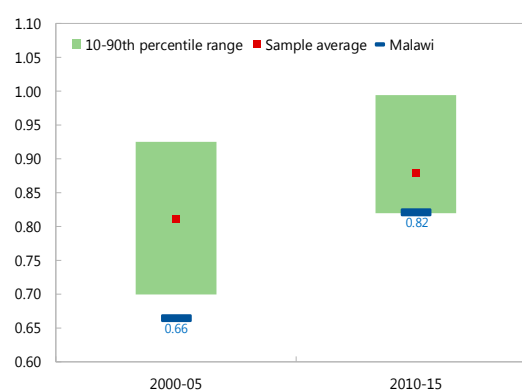
Sources: Country authorities, World Bank; IMF staff estimates.

C. Public Spending Efficiency in Health and Education

10. Public spending on health and education is assessed using the data envelopment analysis (DEA) approach. This methodology allows capturing of the relative efficiency of a country in translating public spending (inputs) into measurable outcomes (outputs). The frontier is estimated based on best performer countries with similar levels of input—countries that maximize output for a given level of inputs, or minimize the use of inputs for a given level of output—and then countries are ranked according to how far they are from the “efficient frontier”. The resulting efficiency score lies between 0 and 1, with 1 being the score for the most efficient countries. For a given country, the distance to the frontier is the output increase that could be achieved with the same inputs should the country be at the efficiency frontier—or alternatively the reduction in inputs that could be achieved while leaving output unchanged. The DEA approach has the advantage of being simple and easy to implement and of not requiring assumptions regarding the production function. However, it does not control for a large number of variables.¹ To reduce country heterogeneity the analysis is focused on a sample of LICs (34 for the health DEA and 27 for the education DEA) with data available for the period 2010-15.^{2,3} The analysis is replicated for the period 2000-05 to assess whether public spending efficiency has worsened or improved over time. The DEA model adopted is an output-oriented model with variable returns to scale.⁴

11. The DEA model indicates scope to improve efficiency of health spending in Malawi. A one input-one output model is applied with the output indicator being health adjusted life expectancy (HALE)⁵, as this represents a broad measure of the health status of a country, while total health spending per capita is the input.

Figure 7. Efficiency Score of Health Spending per Capita



Sources: IMF staff estimates.

¹ For a discussion on efficiency approaches, see Gupta and Verhoeven (2001), Herrera and Pang (2005), and Grigoli and Kapsoli (2013). In particular, there is significant off-budget donor support in many countries in the sample, including Malawi. If off-budget support in education or health is more (less) efficient than on-budget support then there will be an upwards (downwards) bias in the results.

² The country sample varies with data availability.

³ The DEA data set and underlying analysis applied in this paper is an extension of the work in Kpodar (2016).

⁴ In an output-oriented model, the objective is to assess by how much output could be expanded without altering the quantities of inputs. The assumption of variable returns to scale implies that production technology may exhibit increasing, constant, and decreasing returns to scale. With constant returns to scale, output will change by the same proportion as inputs are changed.

⁵ HALE estimates the number of healthy years an individual is expected to live (at birth) by subtracting the years of ill health, weighted according to severity, from overall life expectancy. Data is sourced from the World Health Organization (WHO).

Malawi's efficiency score is 0.82 in 2010-15, implying the HALE could have been 18 percent higher (from 51 years to 60 years) if there were no inefficiencies and the current health spending level is maintained (Figure 7). Malawi's efficiency score is well-below the sample average (near the bottom 90th percentile). However, it has improved significantly since 2000-05 when it was the second lowest in the sample with a score of 0.66.⁶

12. One source of inefficiency in the health sector is a lack of appropriate human, technical, and financial resources. Since 2013, the Malawian government has been spending less than US\$30 per capita on health, far below the SSA average (US\$98). An implication of the very low per-capita health sector government budget is critical shortages of skilled personnel, drugs, hospital equipment and other supplies. There is one surgeon per 100,000 people, one physician per 5200 people and one nurse per 3500 people.⁷ Doctors and nurses frequently operate without requisite tools and medical supplies. Thus, staff motivation and morale is often low – breeding absenteeism, corruption and underperformance.

13. The composition and misallocation of scarce resources have also created inefficiencies. The majority of health sector resources are for recurrent expenditures, especially salaries and wages. In 2017–18, almost 80 percent of the sector's resources were for recurrent expenditures, mainly salaries and wages. Limited resources are sometimes spent on high cost and low impact programs, usually curative interventions, at the expense of low cost and probably more effective preventative interventions. For example, several cost effective preventative health interventions, according to Disability Adjusted Life Year (DALY), are sometimes not prioritized in government budgets (UNICEF Malawi, 2017). Curative services have absorbed more than 95 percent of other recurrent transactions for the Ministry of Health over the past five years. Most health sector resources from donors are earmarked to responding to specific diseases such as cholera, HIV/AIDS, tuberculosis and malaria; they are less commonly directed to general health systems strengthening. For example, approximately 49 percent of donor contributions were earmarked for HIV and AIDS related interventions between 2011 and 2015 (UNICEF Malawi, 2017).

14. Health budgets are sometimes not spent or disbursed in accordance with projected timelines. In 2016-17, for example, the drugs budget for District Councils was nearly fully exhausted in the first half of the year. Compounding the situation is a lack of robust health monitoring and evaluation systems, which prevents the government from effectively monitoring performance of the health sector to identify inefficiencies and suggest remedial actions (Chirwa, 2013). Delays in disbursement of funds to departments and health facilities is another cause of inefficiency. Several districts have reported between two to five months of delay in transfers of funds from the national level.⁸ Further, when received, the funds are often less than what was requested.

⁶ The generally high efficiency scores in the sample could reflect the fact that in many LICs public health spending is in large part funded by donors through grants and loans. In some cases, direct donor interventions bypass the budget, suggesting that actual public health spending may be higher than observed in the data.

⁷ Calculations based on World Development Indicators data.

⁸ UNICEF Malawi, Staff Field Reports.

15. Waste and corruption also pose significant risks to efficient health spending in Malawi.

Health sector leakages arise from several sources, including inadequate inventory control, poor record keeping, weak public supply management system and inaccurate reporting of receipts, stock levels and other supplies (Government of Malawi, 2006). Drugs and other items are sometimes issued to patients without being properly recorded. Essential medicines are the poorest documented commodities, especially at the health facility level. Where they exist, records are sometimes unreliable and not consolidated nor standardized across commodities and departments. Recent evidence suggests that 94 percent of leakages happen at the health facility level compared to 6 percent at the warehouse level (CHAI, 2013). Leakages within the HIV/AIDS sector alone have been estimated to be at least nine percent of national expenditures on the same (CHAI, 2013). Additionally, the pharmaceutical market in Malawi has sometimes been flooded with fake and substandard medicines (Chirwa, 2013).

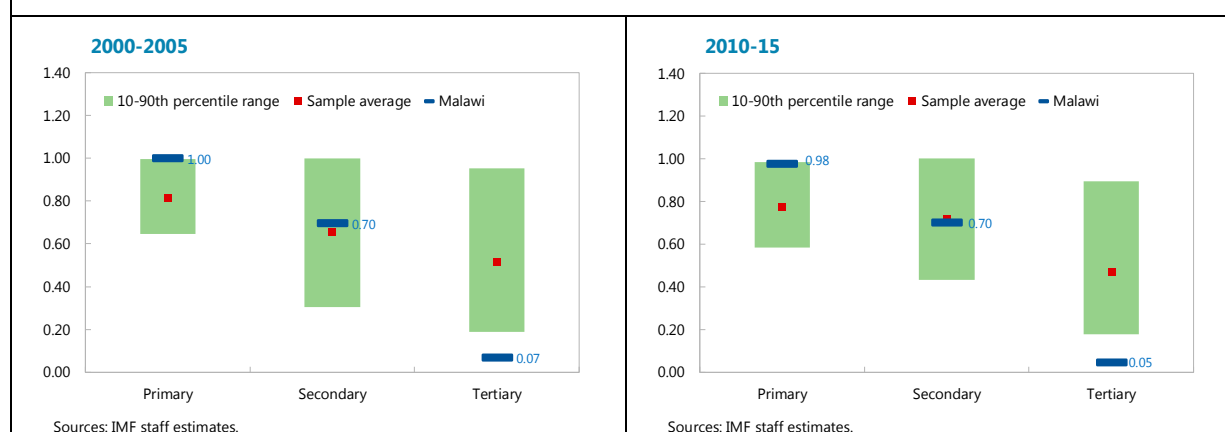
16. The DEA model finds varying results within the different levels of Malawi's education system (primary, secondary and tertiary).

The DEA one input-one output model was applied to evaluate efficiency of spending within the three levels of education. In this model the input is education spending (per capita) per each level with enrollment rate as the output.^{9,10} The results showed high efficiency for primary education, which appears to mirror the very high enrolment rates (Figure 8). Caution is required in interpreting these results. They focus only on enrollment and do not account for other critical factors such as quality of education. In addition, high enrolment rates in primary education are due to numerous factors in addition to public investment in basic education, including increased public awareness of the role of education, targeted social protection programs (such as schools meals, cash transfers and other forms of educational assistance helping poor families in Malawi), and significant financial contribution from development partners to support construction of schools. Malawi's efficiency scores fall substantially in secondary and tertiary education, where inefficiencies cost up to two fifths and almost all of the output, respectively.

17. The mix of education spending influences efficiency where high impact and low cost interventions are not adequately resourced. Although Early Childhood Development (ECD) is one of the highest impact areas, it received just 0.26 percent of the education budget in 2017-18. Secondary education also received significantly less funding (14 percent) compared to tertiary education (25.5 percent).

⁹ Private education spending is not included due to a lack of data. Since education is primarily financed by public funds in LICs, this omission should not significantly affect the results. The model used to measure efficiency in education spending is admittedly simplified. The main weakness of the model is that enrollment does not reflect the full context of education spending. The model tends to mask other key output and education quality indicators such as teacher absenteeism, pupil-teacher ratio, pupil-classroom, and pupil-text-book ratio.

¹⁰ Another version of the model was run, using primary and secondary completion rates as the output. However, due to limited data availability and therefore a low sample size, this model has the risk of not being statistically significant.

Figure 8. Efficiency Score of Education Spending per Capita

18. Insufficient inputs generate inefficiencies and ineffectiveness, as it is extremely challenging to effectively deliver a quality education with inadequate resources. The education sector lacks adequate supply across multiple indicators, including trained teacher-pupil ratios (1:80 for primary and 1:44 for secondary) and student-text book ratio (five students in standard 5 and 6 share one textbook in English, Mathematics, and Chichewa). Low teacher morale, absenteeism, and limited professional development exacerbate existing inefficiencies. Furthermore, the very low supply of public secondary schools (747 public secondary school against 5470 primary schools) is a key factor behind low secondary enrolment, especially for girls. Only 16 percent of children transition from primary to secondary school; of those, only eight percent move on to tertiary education (Government of Malawi, 2017).

19. Inefficiencies also arise from poorly utilized education budgets. The vast majority of education budgets are applied to salaries and wages, leaving very few resources for essential supplies such as books, desks, and other teaching and learning materials. Recurrent costs absorbed an average of 85 percent of the national education budget for the Ministry of Education between financial years 2013-14 and 2017-18 (UNICEF Malawi, 2018). This means only 15 percent of the budget remains for development such as construction of schools. Education sector public expenditure tracking surveys have revealed delays exceeding five months in the disbursement of education resources such as School Improvement Grants (CSEC, 2017). Schools in rural and remote areas are underserved. Centralized procurement of teaching and learning materials also contribute to inefficiencies in education spending. Inadequate systems are also exemplified by poor rates of distribution and repayment of tertiary education loans (World Bank, 2013).

D. Policies

20. Enhancing the level and allocation of health and education budgets. Efficiency would improve with a sub-sectoral rebalancing of the composition of education and health spending and prioritization of human, technical, and financial resources towards these critical sectors. This includes increasing allocative efficiency and equity in budget allocations to primary, secondary, and tertiary health and education services, and prioritizing low-cost but high impact interventions—such as preventative and community health and ECD. Similarly, there is a need to balance infrastructure creation with maintenance. In recent years, budgets for Other Recurrent Transactions (ORT) have been increasing at a significantly slower pace in comparison to Personal Emolument (PE)—as evidenced by ORT budgets to District Councils for education and health.

21. Strengthening procurement functions, supply management, and other elements of the public expenditure chain. Within the health sector, the focus should be on enhancing the capacity and role of the Central Medical Stores (CMST), given parallel procurement systems in the country and reports of leakages within the CMST supply chain. There is also a need to strengthen national health accounts and improve transparency, forward planning and timeliness of procurements in line with the new Procurement Act (2017). Effective planning, prioritization and timely payment of goods and services purchases is key to improving the efficiency of both health and education expenditures.

22. Enhancing fiscal transparency and accountability at national and sub-national levels throughout the budget cycle. Public spending achieves better health and education outcomes if it is done in a transparent and accountable manner (Swaroop et al., 2002). Financial accountability, including comprehensive financial reporting on allocated budgets to ministries, departments, agencies (MDAs) and district councils, should be enhanced. Enforcement mechanisms and sanctions for non-compliance should be strengthened. It is also essential that key budget documents, including in-year reports, annual financial statements and audit reports, be publicly available for scrutiny, including by legislatures.¹¹ Transparency should also be enhanced when making financing and contracting decisions, especially for big capital projects. Public participation in budgeting and social accountability actions by citizens should also be encouraged.

23. Strengthening Program-Based Budgeting (PBB) and stimulating efficiency in frontline service delivery. The recent introduction of PBB holds great potential to improve efficiency, but stronger links are required between PBB and sector plans, and the monitoring and evaluation of PBBs requires significant attention. Performance and incentive systems for frontline staff should be enhanced. Efficiency of frontline staff could be improved through incentive schemes such as performance-based financing, and encouragement of cost-containment measures by MDAs in addition to reconfiguration and integration of service delivery. MDAs should be supported to use appropriate technology and strengthen their monitoring, evaluation and audit functions, and to periodically publish performance information. The rollout of the national identity registration system

¹¹ The recently released Open Budget Survey results (2017) shows that Malawi's performance with regards to budget transparency has significantly gone down from 65/100 in 2015 to 26/100 in 2017.

is an opportunity for improving data and information systems, including understanding how and whether frontline service delivery is impacting citizens.

E. Conclusions

24. There is significant room to improve public spending efficiency. Malawi performs poorly in health and education spending efficiency. Spending in these areas will need to be stepped up to achieve better living standards and higher, more inclusive growth. Improving spending efficiency (including the composition of spending) would also increase fiscal space for increased spending in these and other growth-enhancing areas.

25. Four key reforms can have an immediate impact. A rebalancing of the composition of education and health spending—including greater prioritization of low cost-high impact spending and balancing maintenance against capital spending—would yield immediate results in both health and education. Strengthening the public expenditure management chain, especially procurement and supply management, will be important. These reforms would go hand in hand with greater fiscal transparency and accountability in these sectors. Similarly, program-based budgeting is critical to better planning. Finally, a strong incentive system would improve the efficiency of staff.

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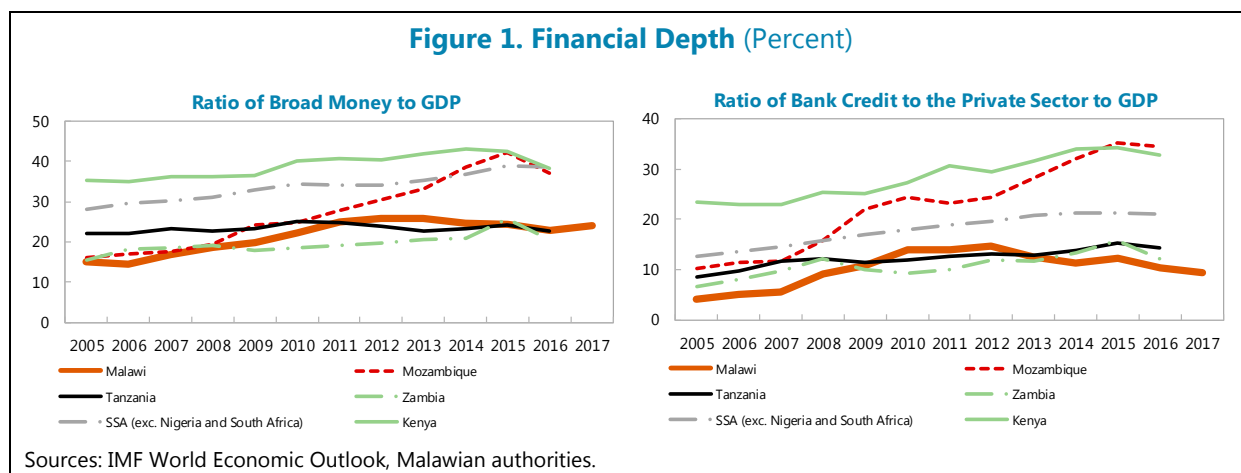
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SUPPORTING GROWTH THROUGH INCREASED CREDIT TO THE PRIVATE SECTOR

A. Background

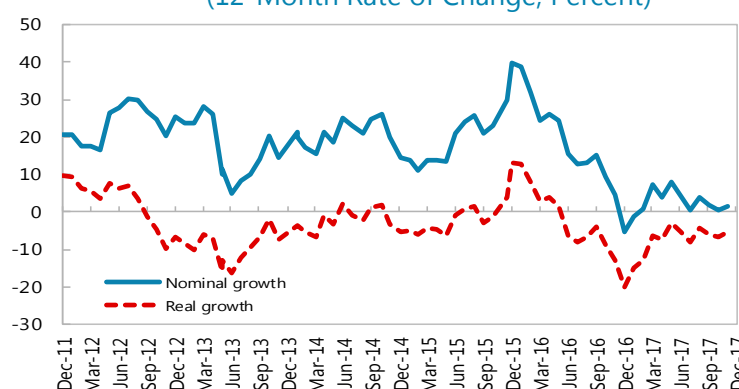
- 1. A sound and inclusive financial system lays the foundation for sustained and broad-based growth.** Financial deepening increases a country's resilience and boosts economic growth by mobilizing savings, promoting information sharing, improving resource allocation, and facilitating diversification and management of risk (Sahay et al., 2015).
- 2. Malawi is one of the least banked countries in the world.** The banking system's credit to the private sector (relative to GDP) is low compared to peers (Figures 1 and 2). Other measures of financial depth, such as the ratio of broad money to GDP exhibit a similar pattern. Only 16 percent of the population have accounts at a financial institution, compared to averages of 29 percent for the Sub-Saharan African (SSA) region and 22 percent for Low Income Countries (LICs).¹



- 3. Raising credit growth across the population will benefit broad-based economic growth.** The next section assesses the extent to which Malawi's recent private sector credit growth falls short of what is implied by fundamentals. The reasons behind weak credit growth are discussed in the following section, then policies to raise it, and conclusions.

¹ Latest data is as of 2014.

Figure 2. Credit to the Private Sector
(12-Month Rate of Change, Percent)

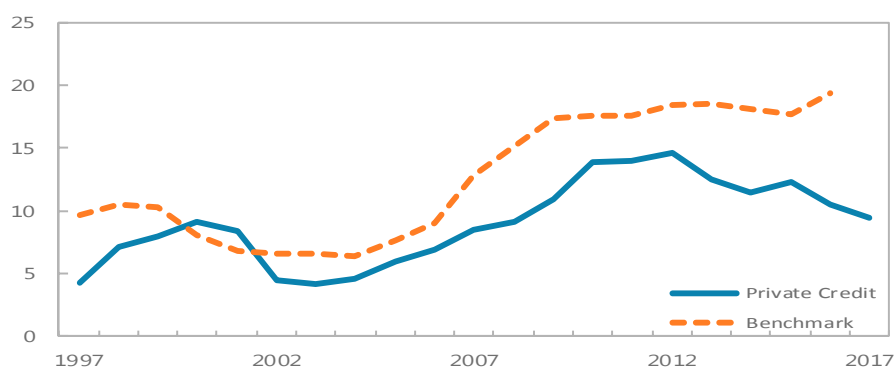


Sources: Malawian authorities; IMF staff estimates.

B. Measuring the Credit Gap

4. The ratio of private sector credit to GDP remains below the level implied by Malawi's fundamentals. Following the methodology in Al Hussainy (2011) and Barajas et al. (2013), this note derives a benchmark ratio of private sector credit to GDP based on several structural factors in a panel of over 120 emerging and developing countries for the period from 1986 to 2016.² The fitted values from these regressions serve as the private sector-to-GDP benchmark. For the case of Malawi, this benchmark level is higher than the actual level by at least 6 percent of GDP, implying that financial depth is lagging the level implied by the country's structural characteristics (Figure 3).

Figure 3. Credit to the Private Sector
(Percent of GDP)



Sources: Malawian authorities; IMF staff estimates.

² It regresses the ratio of private sector credit-to-GDP on: (i) the log of GDP per capita and its square, (ii) the log of the population to proxy for market size, (iii) the log of population density to proxy for the ease of service provision, (iv) the log of the age dependency ratio to account for demographic trends and the related savings behavior, (v) an oil exporters' dummy and time dummies to control for global factors.

Table 1. Determinants of Financial Inclusiveness Gaps, 2004-2016

	(1)	(2)	(3)	(4)	(5)
<u>Economic Environment</u>					
Growth	0.000 (0.77)				0.000 *** (-3.61)
US Federal Funds Rate ¹	-0.002 (-0.69)				0.000 (-0.07)
<u>External Stance</u>					
FDI/GDP		0.000 (0.72)			0.002 ** (2.30)
Trade Openness		0.133 *** (3.04)			0.249 *** (4.02)
Capital Controls		0.051 *** (3.52)			0.106 *** (4.25)
<u>Policies</u>					
Fiscal Balance (cyc. Adjusted)/GDP			-0.147 * (-1.91)		-0.043 (-0.34)
Inflation			0.000 *** (-9.81)		-0.000 *** (-4.60)
FX Regime			0.006 (1)		0.000 (0.02)
Health Spending/GDP			0.004 (1.32)		0.01 ** (2.00)
<u>Institutions and Infrastructure</u>					
Institutions (ICRG)				0.193 *** (2.92)	0.16 ** (2.23)
Telephone Lines				0.000 *** (10.3)	0.00 *** (10.22)
Internet Use				0.000 (0.44)	0.00 (-0.08)
Credit Information Depth				-0.002 (-0.59)	0.00 (0.70)
Constant	-0.014 **	-0.09 ***	-0.0504 **	-0.1285 ***	(0.30) ***
Number of observations	1,436	1,436	1,436	1,436	1,436
R-squared	0.001	0.011	0.0052	0.054	0.104

¹ Proxy for external environment.

Robust t-statistic in parentheses; significance levels at 10 percent (*), 5 percent (**), and 1 percent (***) levels, respectively.

C. Reasons Behind Weak Private Sector Credit

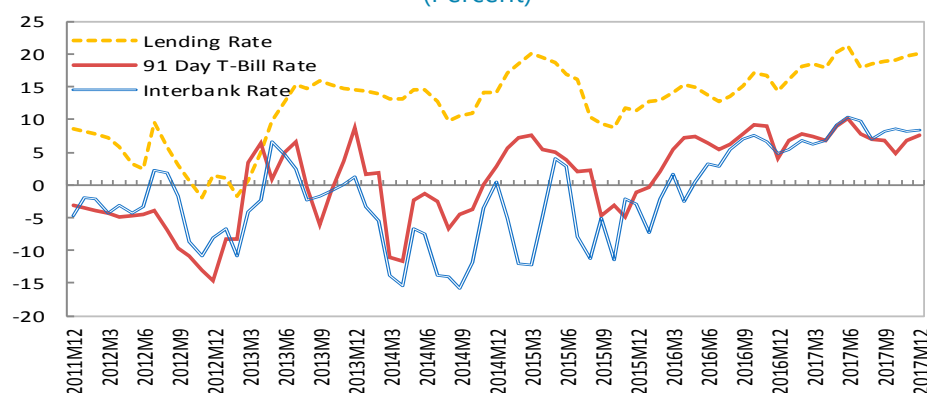
Demand-Side factors

5. Weak macro environment. Since 2013, a series of shocks (cashgate, El-Nino induced drought), high-inflation, insufficient structural reforms, and weak infrastructure weighed on economic activity. The adverse effects on credit demand were exacerbated by domestic payment arrears (about 5 percent of GDP) arising from insufficient fiscal adjustment.

6. High interest rates. Interest rate spreads—around 22 percent at end-2017—are high by regional standards (Figures 4-7). An RBM study found banks' operating costs have the highest statistical significance in explaining the high spread, followed by liquidity. Wages and employee benefits account for about 50 percent of the operating expense, while all other costs accounted for another 30 percent. In particular, costs of evaluation, monitoring, and enforcement are elevated by a lack of shared credit information on borrowers, fraud, dysfunctional land and company registries, and deficiencies in the insolvency laws and their administration.

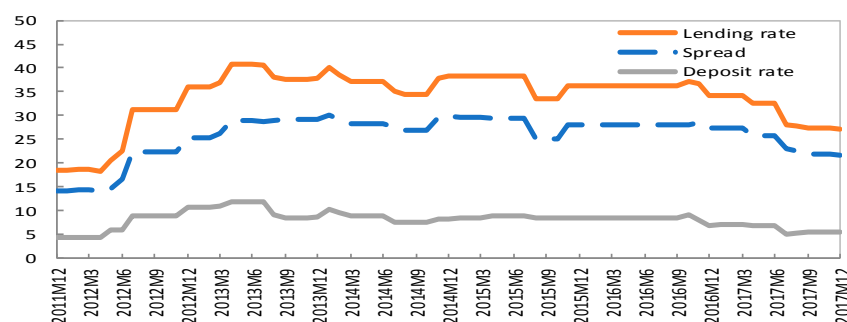
7. Under-developed mobile banking. Access to finance for a rurally dispersed population is best served by mobile banking. However, the poor quality and high cost of mobile subscriptions is holding back mobile banking. Since the two mobile network operators introduced mobile money facilities in 2012 and 2013 and the development of a non-e-wallet mobile money transfer platform, the value and volume of mobile money transactions has increased dramatically. Over this period, the number of transactions has increased from 1,700 transactions, with a total value of MK 3.5 million, in March 2012 to 11.4 million transactions, with a total value of MK 760 million, in August 2017. Mobile phone ownership also increased exponentially from 382 in 1995 to more than 7 million in 2016. However, the number of mobile subscriptions and the rate of use of mobile phones for financial transactions is still lower than the SSA and LIC averages. Only 40 percent of Malawians have mobile subscriptions. Of those, 4 percent have mobile money accounts (vs. 16 percent of the population having bank accounts) even though mobile money accounts are cheaper than maintaining a bank account. Limited access to mobile money transfers may be explained by non-e-wallet agents' preference for urban markets—where the RBM recently found that only 5.5 percent of non-e-wallet agents were located in rural areas.

Figure 4. Real Interest Rates
(Percent)



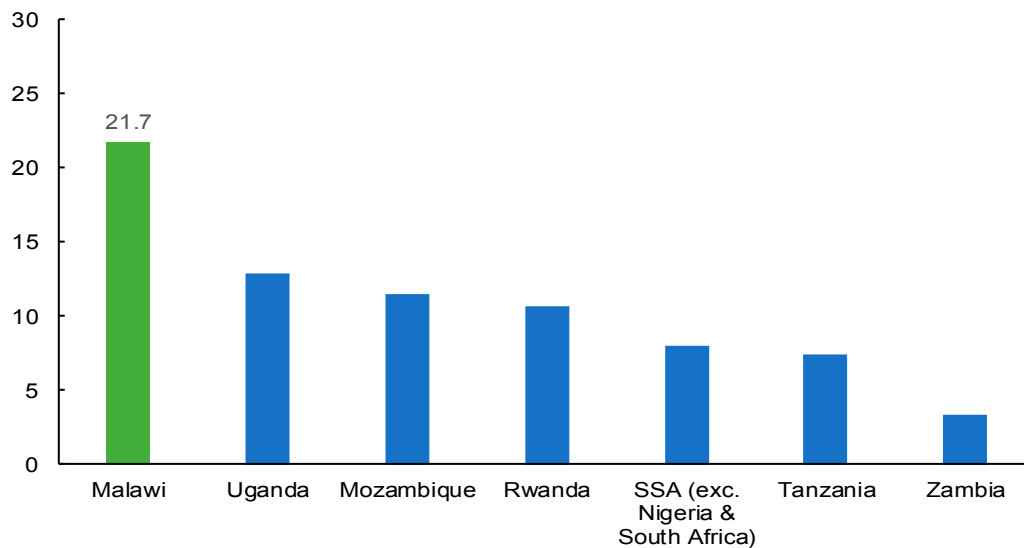
Sources: Malawian authorities; IMF staff estimates.

Figure 5. Spread Between Deposit and Lending Rates, 2011–17
(Percent)



Sources: Malawian authorities; IMF staff estimates.

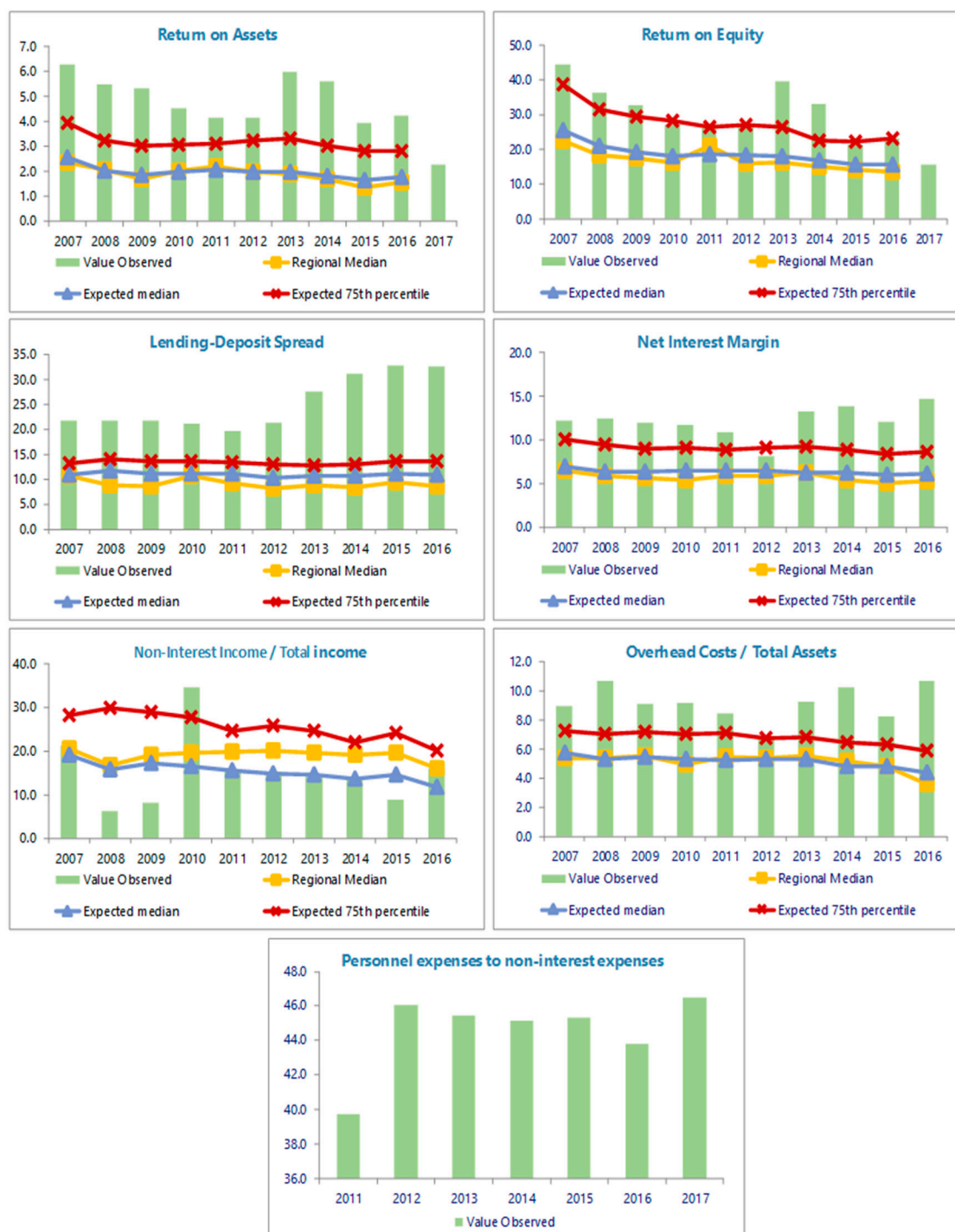
Figure 6. Spread Between Deposit and Lending Rates, 2017¹
(Percent)



Sources: World Bank World Development Indicators Database, Malawian authorities; IMF staff estimates.

1/ SSA (ex. Nigeria and South Africa): 2016.

Figure 7. Financial Efficiency (Percent)



Sources: Finstats 2018 database, Malawian authorities.

Supply-Side Factors

8. Loan concentration. The two largest commercial banks hold nearly 90 percent of deposits but lend to a limited number of companies. Overall, banks' credit exposure is more than 25 percent each to their first and second largest borrowers. Banks tend to favor large enterprises and government assets to minimize risk. Their business model is not well-suited to SMEs and micro-agents. Lending to smaller businesses is costly due to the lack of information on creditors and perceived default risk. As a result, the financial system is fragmented with a large part of the population lacking access to formal financial institutions.

9. Crowding out. Banks' balance sheets large exposure to the government is crowding out lending to the economy (Figures 8-9). As of end-2017, the government provided about 9 percent of the banking system's deposits, and held about 23 percent of outstanding credit (compared with 2 percent and 11 percent in 2012). During 2012-17, banks doubled holdings of government securities to about 30 percent of their total assets. Government securities are more profitable than lending to the private sector because of (i) their high yield (average of 20 percent in the first 9 months of 2017 on 91-day treasury bill, versus an average inflation of about 13 percent during the same period), which is tax exempt; (ii) the ease with which these securities can be refinanced at the RBM's discount window; and (iii) "zero weighting" of government sovereign risk in the computation of bank solvency—implying no capital provisioning and providing a high leverage effect on profitability.

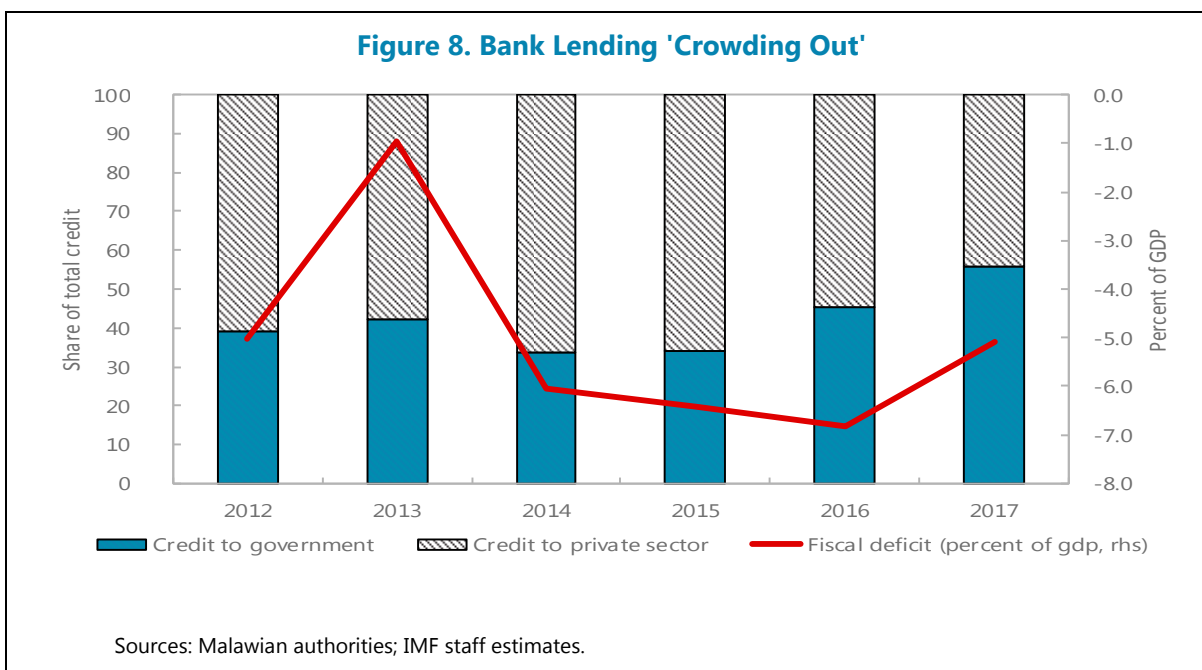
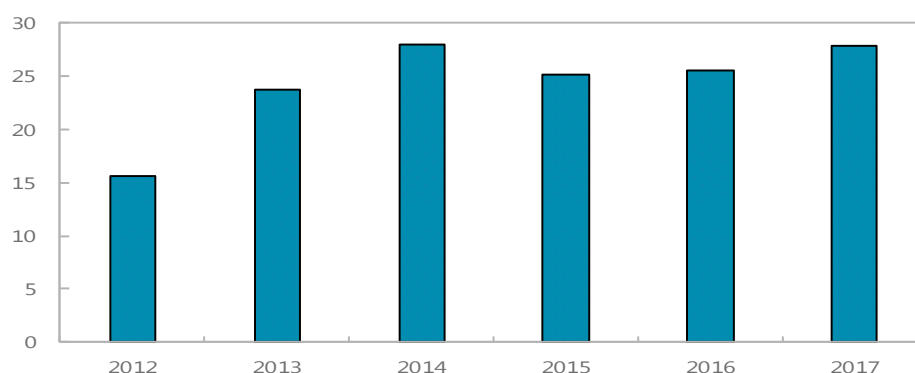


Figure 9. Credit to the Government as Share of Net Domestic Assets
(Percent)



Sources: Malawian authorities; IMF staff estimates.

10. Rising banking sector vulnerabilities:

- **Nonperforming loans (NPLs)** rose from 10.6 percent at end-2015 to about 16 percent at end-2017. This reflects weak economic activity, the accumulation of past domestic payment arrears (about 5 percent of GDP) to government suppliers, lack of proper risk management systems within the commercial banks, weak enforcement of collateral collection, and banks' increased risk aversion in a high inflation environment.
- **Concentration risk** arising from exposure to a few large borrowers susceptible to financial difficulties represents the largest source of credit risk and underscores the need for consolidated supervision. The RBM continued to grant waivers for prudential norms related to a single borrower for large imports such as fertilizer and petroleum products.
- **Intensified interconnections between banks and the government** are raising vulnerabilities in several ways. Large government exposure of banks' balance sheets is creating sovereign-financial links that risk a negative feedback loop if fiscal challenges emerge or liquidity conditions tighten. Government arrears to private contractors have aggravated credit risks and consequently increased provisioning needs. Banks' portfolios are strongly correlated due to their common exposure to the government.

Financial infrastructure

11. Gaps in financial market infrastructure have contributed to low credit provision. Lack of collateral, information asymmetries, and a slow judicial system narrow the number of individuals and companies qualified for bank credit. This, in turn, limits access to credit for the private sector and increases concentration risks for banks.

- **Challenges in using land for collateral**, mostly affecting the rural borrowers, are related to an inadequate legal framework and weak institutional capacity. Land tenure insecurity among smallholder farmers is high. The 2016/17 Integrated Household Survey finds that one

third of households are not confident that they would still possess their land in ten years' time.

- **Information asymmetries** whose resolution could have a significant impact on credit growth, include the lack of high quality centralized credit reports and weak financial literacy. Financial literacy training and transparency in fee charges tend to provide effective consumer protection.
- The **judicial system's** lack of understanding of financial sector regulations, inability to arbitrate quickly, and weak contract enforcement mechanisms result in banks' lending only to lenders that offer robust and enforceable safeguards. Excessive procedural delays also weaken the protection of creditor rights.

D. Role of Public Policy in Facilitating Deepening

12. Promoting higher credit growth and financial inclusion requires a detailed Financial Sector Development Strategy. Key elements of this strategy are outlined below.

13. Fostering macroeconomic stability. Continued disinflation would support macroeconomic stability, in turn, lowering uncertainty and the cost of funds, reducing the costs of opening and maintaining an account in financial institutions, and expanding demand for financial services. Reducing crowding out—through better fiscal and government debt management—would help credit growth, reduce risks to financial stability, and increase competition across banks for new lending opportunities.

14. Addressing information gaps. Strengthening collaboration across banks, the RBM, and the government to offer financial literacy education and training would facilitate better targeting these efforts and expanding them to those at the bottom of the income pyramid.

15. Enabling legislation for microfinance and savings and credit cooperatives (SACCOs). Enabling these institutions that traditionally serve lower-scale operations could spur access to financial services. The benefits of greater microcredit penetration should be balanced with concerns over the lack of regulatory oversight, potential distortions from extensive government support (e.g., discouraging private incentives to mobilize savings), and directed lending.

16. Promoting mobile technology. Supporting technological innovation by promoting the role of the private sector and creating infrastructure to encourage participation would reduce the cost of providing financial services and broaden access of payment services to under-served segments of the population (e.g., in rural areas). Introduction of digital identification (ID) can enhance the reach of mobile banking and deepen financial inclusion. Applying biometric technologies (fingerprinting, for instance, already practiced by two microfinance institutions) to credit approval helps build financial transaction history, allows banks to identify good borrowers, and increases overall efficiency. With adequate coverage, the low transaction costs of the mobile platform could facilitate payments for state benefits such as the FISP and social cash transfers.

17. Managing risks. Proactive oversight, continuous risk monitoring, and mitigating of systemic risks will be critical to supporting a healthy process of financial deepening. For example, regulatory and supervisory frameworks should keep up with market deepening to avoid creating new sources of risk and instability. Stronger regulation and enforcement of connected and insider lending and encouragement of micro-credit would also reduce risks.

18. Strengthening financial frameworks. Improving informational and contractual frameworks would lower financial transactions costs. For example, building or upgrading credit registries. Well-targeted partial credit guarantee schemes could address market failures and promote access in environments with weak credit information and creditor rights. The effectiveness of commercial courts and insolvency regimes could be improved with a commercial courts arbitration mechanism and training for judges to professionalize financial and economic justice systems. Reducing high overhead, personnel, and loan loss provisioning costs would also contribute to lower borrowing costs.

19. Improving property rights. Better titling, registration, and security of land tenure would broaden the use of land as collateral. Responding to the challenges in this area, the government passed 10 new Land Laws in 2016 that strengthen smallholders' tenure security and gender equity by registering customary estates in participatory and low-cost ways. Initial steps have also been taken towards better land administration service delivery, establishing a fully electronic land information system, and modernizing estate leasehold management and ground rent collection. Effective implementation of these laws together with registration and documentation of land rights will facilitate the emergence of functional land markets and the use of land for collateral.

E. Conclusions

20. Malawi has made progress toward financial deepening but considerable efforts are still needed to promote entrepreneurship development by addressing the structural challenges constraining SMEs. Alleviating the various structural barriers to financial deepening, both in terms of depth and access to financial services, will bring substantial benefits for the economy in terms of growth, poverty alleviation, resilience to shocks, and effectiveness of monetary and fiscal policies.

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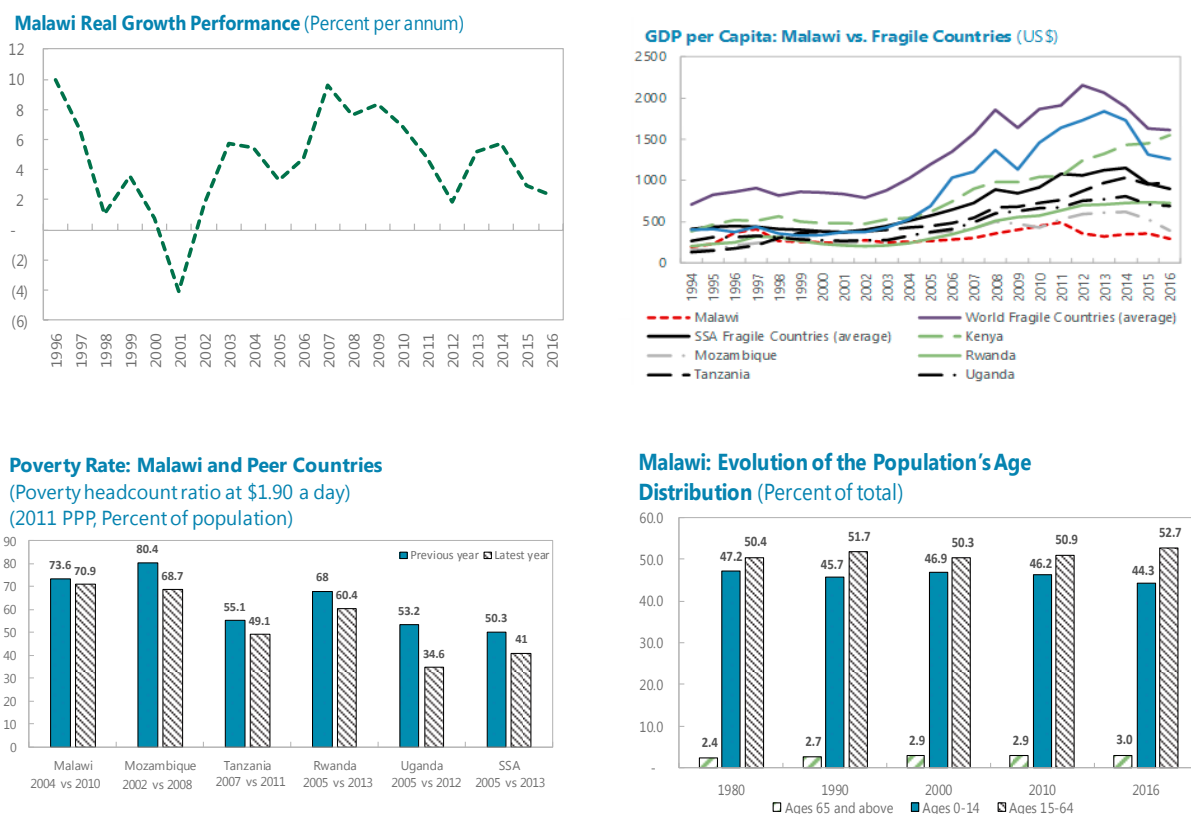
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A PATH TOWARD HIGHER AND MORE INCLUSIVE GROWTH

A. Background

1. Over the past decade, Malawi's economic growth has been weak and not as inclusive as in peers. Malawi's real GDP growth dropped from 7.5 percent in 2007-11 to 3.6 percent in 2012-16 (Figure 1). As a result, per capita GDP is far below that of regional peers and other fragile states. The average poverty rate was around 70 percent in 2016 (the World Bank's World Development Indicators (WDI) estimates based on international poverty line of US\$1.90 per day) and rural poverty is on the rise due to high population growth (3 percent) and density. These pressures will only continue to build with nearly half the population below the age of 15.

Figure 1. Growth, Population, and Poverty



Sources: Malawian authorities, IMF WEO, World Bank's WDI.

2. Malawi's growth trends reflect a lack of both economic diversification and resilience—raising Malawi's vulnerability to external and weather-related shocks. Two thirds of the population are employed in agriculture (primarily maize farming). However, this sector's share of GDP has declined from 40 to 30 percent of GDP over the past decade due to its low productivity and vulnerability to weather-related shocks—reflecting low coverage of engineered irrigation systems,

high transport costs, insufficient services, and limited access to credit. The two-year El-Niño-induced drought (2015-16), for example, dented maize production and adversely affected parts of manufacturing and retail trade closely linked to agriculture. It also reduced hydroelectricity generation (Malawi's main source of electricity), which increased operating costs and lowered capacity utilization in manufacturing and trade. In addition, Malawi is vulnerable to shocks in global tobacco, tea, and sugar prices—altogether about 80 percent of Malawi's exports. Over the past decade, policy uncertainty, governance challenges and high inflation have also taken a toll on confidence and economic activity.

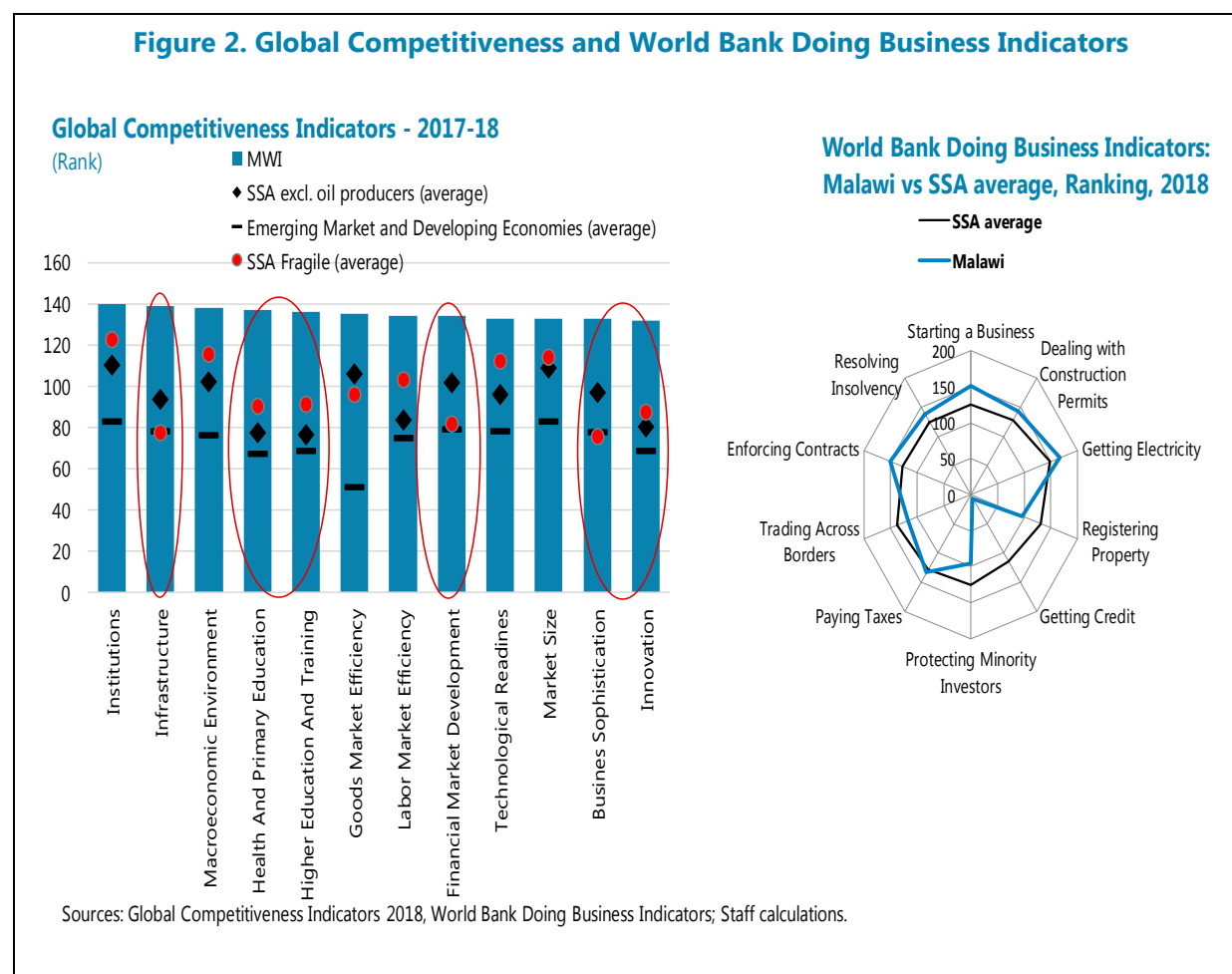
3. This paper examines these challenges and policies to overcome them and, ultimately, achieve higher and more inclusive growth. Critical structural impediments to private sector-driven economic diversification and greater resilience are described in the next section. The last section discusses policies to address these challenges and leverage Malawi's growing population.

B. Challenges to Diversification and Resilience

4. Recent reforms are starting to bear fruit but the reform momentum needs to be stepped up. Against the backdrop of increasing macroeconomic stability, critical reforms supporting a market-based economy have progressed in recent years—including the introduction of a flexible exchange rate regime, reduction of trade barriers, and partial liberalization of energy prices. Improvements in getting credit, protecting investors, resolving insolvency, and facilitating trade have raised Malawi's ranking in the World Bank Doing Business (WBDB) report from 133 in 2017 to 110 in 2018. Despite this improvement, Malawi is still in the bottom half of the 190 countries in the WBDB and has one of the lowest rankings (132 out of 135 countries) in the 2018 Global Competitiveness Indicators (GCI).

5. Comparisons with peers point to large gaps in infrastructure, worker talent, financial market development, and the business environment (Figure 2). This paper applies an array of Third-Party Indicators (TPIs) from independent sources. The TPIs were chosen based on those with the most information on Malawi and its peers. Rankings are influenced by the methodologies applied. The indicators are not produced by a member country's statistical agency, staff was not able in all cases to obtain full access to complete information on sources and methods. Surveys and comparative socio-economic indicators applied are perception based. The TPIs do not replace—but rather supplement—an open, candid, robust and well-documented discussion with the authorities. During the Article IV discussions, the authorities agreed with the findings based on these TPIs. In particular, compared to average fragile states and Sub-Saharan Africa (SSA, excluding oil producers), the GCI ranks Malawi substantially lower in the areas of infrastructure, worker talent, financial market development, and the business environment. Worker talent is reflected in the quality and quantity of education, vocational training, and healthcare. The latest WBDB indicators, though less

comprehensive, support these findings.¹ Malawi's Medium-Term Growth and Development Strategy (MGDS) III also identifies these four structural reform areas as crucial.²



6. Infrastructure challenges—especially in electricity, irrigation, transport, and telecommunications—weigh on economic activity (Figure 3).³

- Frequent and lengthy electricity shortages—due to weak capacity and dependence on drought-vulnerable hydroelectricity generation—increases operating costs for firms, farmers, schools,

¹ The GCI and WBDB indicators usefully highlight key reform areas but do not cover all structural reform areas. The GCI indicators are based on official data and a survey of perceptions of business executives. The WBDB indicators are based on a survey of hard data from experts and analysts.

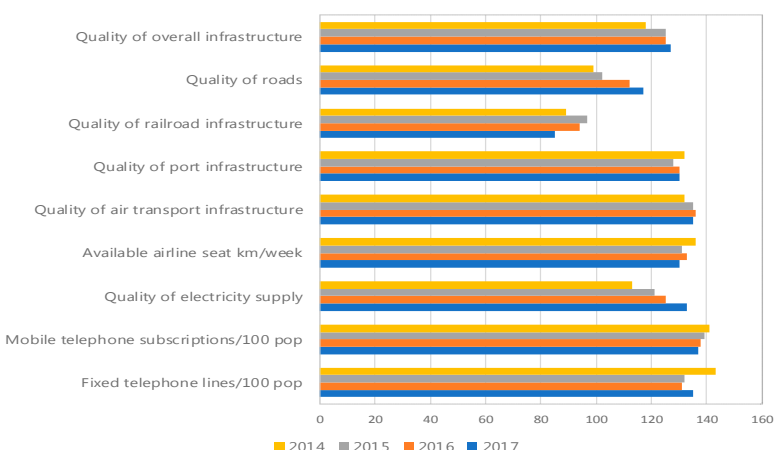
² The MGDS III pillars are (i) Agriculture, Water Development and Climate Change Management, (ii) Education and Skills Development, (iii) Transport and ICT infrastructure, (iv) Energy, Industry and Tourism Development, and (v) Health and Population.

³ The total number of countries in the published rankings vary across years – 2017: out of 137 countries; 2016: out of 138 countries; 2015: out of 140 countries; and 2014: out of 144 countries.

hospitals, and households. That is, when electricity is available. Less than 5 percent of the rural population and below 50 percent of the urban population have access to electricity (WDI, 2018).

- Poor coverage of engineered irrigation (less than 3 percent as of 2015, WBDB, 2017) weighs on farmers' productivity—leaving them vulnerable to weather shocks. Alternatives to engineered irrigation, such as water harvesting and on-farm practices supplemented by small-scale irrigation structures, are insufficiently used. Inadequate water sourcing and management in urban areas creates shortages for households.

Figure 3. Infrastructure Global Competitiveness Indicators, 2014–17 (Rankings)



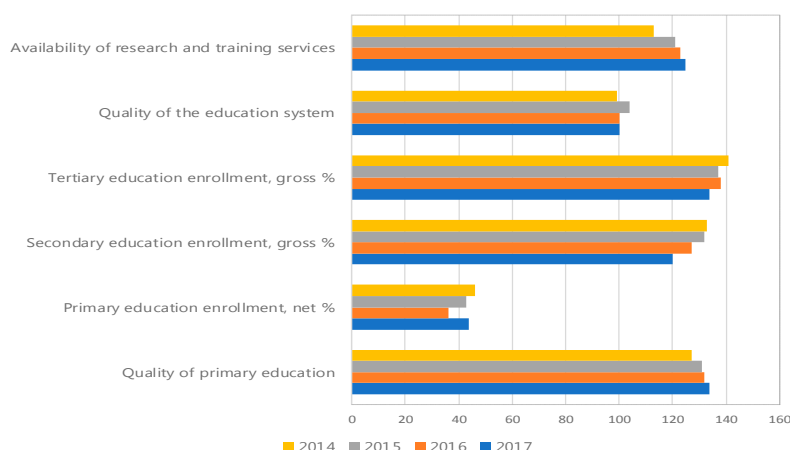
Source: The Global Competitiveness Report, World Economic Forum.

- Limited transport infrastructure and trade logistics pose significant challenges for this landlocked country. Maintenance of poorly constructed and heavily used roads crowds out government spending on other infrastructure. In contrast, poor links to other transport have left the railroad and some ports heavily underutilized.
- Weak telecommunication infrastructure increases business costs, limits domestic and international trade, and reduces access to finance (e.g., hindering mobile banking). However, upgrade and expansion of the infrastructure is constrained by limited market size and sophistication.

7. Productivity is hampered by poor health and education of workers. Very little can be produced without a healthy population. Indicators on child mortality, HIV, malaria, and achieving gender parity in primary education are improving (Table 1). However, more needs to be done. Malawi fell short of the 2015 MDG targets in poverty, universal education, gender equality and maternal health. GCI and WDI indicators point to areas for improving the quality and quantity of education, especially low secondary and tertiary enrollment rates and availability of research and trainings services (Figure 4).⁴

⁴ The total number of countries in the published rankings vary across years – 2017: out of 137 countries; 2016: out of 138 countries; 2015: out of 140 countries; and 2014: out of 144 countries.

Figure 4. Education Global Competitiveness Indicators, 2014–17
(Rankings)



Source: The Global Competitiveness Report, World Economic Forum.

Text Table. Development Indicators, 2006-Latest

		2006	Malawi latest observation	Year of latest observation
Health	Prevalence of HIV, female (% ages 15-24)	6.8	4.5	2016
	Prevalence of HIV, male (% ages 15-24)	2.2	2.2	2016
	Prevalence of HIV, total (% of population ages 15-49)	12.3	9.2	2016
	Incidence of malaria (per 1,000 population at risk)	321.2	188.8	2015
	Children with fever receiving antimalarial drugs (% of children under age 5 with fever)	25.0	39.1	2014
	Child Mortality rate, under-5 (per 1,000)	109.9	64.0	2015
Educatio	School enrollment, primary (gross), gender parity index (GPI)	1.0	1.0	2015
	School enrollment, primary, female (% gross)	128.3	147.0	2015
	School enrollment, primary, male (% gross)	125.3	144.0	2015

Source: World Bank's World Development Indicators.

8. Productivity is hampered by poor health and education of workers. Very little can be produced without a healthy population. Indicators on child mortality, HIV, malaria, and achieving gender parity in primary education are improving (Table 1). However, more needs to be done. Malawi fell short of the 2015 MDG targets in poverty, universal education, gender equality and maternal health. GCI and WDI indicators point to areas for improving the quality and quantity of education, especially low secondary and tertiary enrollment rates and availability of research and trainings services (Figure 4).⁵

⁵ The total number of countries in the published rankings vary across years – 2017: out of 137 countries; 2016: out of 138 countries; 2015: out of 140 countries; and 2014: out of 144 countries.

9. Weakness in financial markets hinders access to finance, which plays a critical role in economic development. For example, it would allow farmers' cooperatives to invest in badly needed irrigation infrastructure. GCI indicators point to Malawi's limited access to affordable credit. Only 40 percent of the population had access to formal sources of credit in 2014—among the lowest financial inclusion rates in the world. Women, accounting for about 83 percent of those who are unbanked, face greater constraints when it comes to accessing affordable finance. Account penetration (the percentage of adults with an account in a financial institution) has stagnated at 16 percent since 2011 and is below the SSA average. Key challenges include prohibitive interest rates on loans reflecting the high cost of opening and maintaining a bank account; weak telecommunications infrastructure (substantially less mobile banking than in peers); and low literacy rates. Financial intermediation is also constrained by institutional obstacles such as unreliable mechanisms to protect creditor rights and recover collateral (elaborated in the accompanying paper on increasing private sector credit).

10. Governance challenges and excessive regulations hurt the business environment. Corruption raises the cost of doing business and reduces business opportunities. In Malawi, the authorities and stakeholders all recognize that highly publicized corruption scandals such as cashgate and maizegate point to serious governance challenges. In addition, many business surveys identify corruption as the most problematic factor for doing business (e.g., the World Economic Forum's executive opinion survey (2017-18)). Despite recent progress in simplifying procedures to start a business, the number of days needed to start a business is still substantially higher than the SSA average (37 days vs. 24 days). Similarly, the costs involved in enforcing contracts, in resolving insolvency, and dealing with construction permits are higher in Malawi compared to the SSA average (Figure 2).

C. Policies

11. Urgent infrastructure needs are challenged by limited fiscal space, debt sustainability considerations, and capacity constraints. Navigating this challenge, requires careful sequencing and prioritization of projects (founded on cost-benefit analysis and multi-year budgeting) as well as enhancing the quality and efficiency of public infrastructure spending to create fiscal space. Responsible fiscal policies and better public financial management combined with increased fiscal transparency and better accounting as well as legal and institutional frameworks could catalyze grants from donors and facilitate private sector participation.

12. Strategic health and education spending would be critical to fostering worker talent. A healthy and well-educated population fosters innovation and productivity, and ultimately, economic diversification and private-sector driven growth. Aware of the government's challenges from limited fiscal space and debt sustainability, donors provide project support of over US\$500 million per year, mainly focused on health and education. However, these projects are not always aligned with each other or with the government's spending in these areas—resulting in substantial inefficiencies. Better planning, prioritization, and coordination between the government and donors can help. Enhanced spending efficiency would also create fiscal space. Recommendations in this

area are detailed in the accompanying paper on efficiency of public spending on health and education. Reforms in education should not only focus on the quantity of education but also on its quality. For example, aligning the design of the education curriculum, apprenticeships, and internships with private sector needs will provide workers with the skills they need to find jobs.

13. Improvements in financial infrastructure, against a backdrop of macroeconomic stability, would support greater access to finance. Increased access to finance is essential for the creation and expansion of businesses across all sectors of the economy, especially for job-creating micro, small, and medium size enterprises (MSMEs). Macroeconomic stability, especially disinflation leading to lower interest rates, is important for financial deepening and inclusion by reducing uncertainty and the cost of funds, lowering the cost of opening and maintaining bank accounts, and expanding the demand of financial services. Addressing information and technology gaps is also critical for reducing the cost of financing. For example, better quality and coverage of roads, public transport, and telecommunications networks would facilitate access to financial institutions and mobile banking. Improving property rights would allow broader use of collateral. Access to finance can also be improved through a strengthened regulatory framework, better risk management, and enabling legislation for microfinance and related institutions.

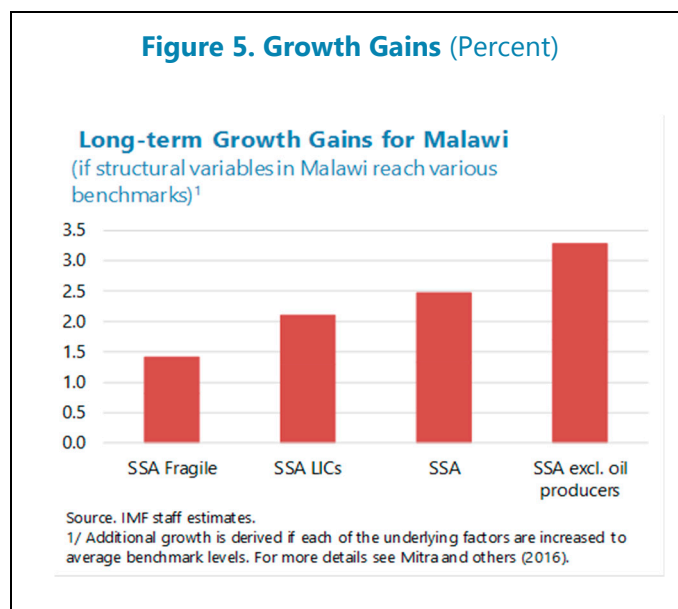
14. A variety of reforms, including in PFM and procurement, would increase the competitiveness of the business environment. A competitive business environment fosters the creation and expansion of businesses and supports the transition of business from the informal to the formal sector. To this end, governance challenges must be addressed—in addition to improving infrastructure, worker talent, and access to finance. This includes reducing avenues for corruption with simpler and more transparent procurement and public financial management practices as well as streamlining of business regulations, eliminating bureaucratic red tape, strengthening contract enforcement, and enhancing insolvency processes. Supporting market-based systems through elimination of export bans and of regulations favoring specific businesses will encourage business competition and entrepreneurial development. Other trade policies include encouraging private sector-driven agricultural commodity marketing and export efforts. Facilitating a greater role for women in economic activities could foster innovation and job-creation. The growth of MSMEs could be enhanced through better business support services and creating stronger market links.⁶

15. Overcoming these obstacles to diversification and resilience could substantially raise long-term growth. Applying policies to close structural gaps with peers in infrastructure, worker talent, financial market development, and the business environment could add 2.5 percentage points to long-term growth (Figure 5) – estimates derived by applying the regression results of Mitra et al. (2016) to the estimated structural gaps between Malawi and the SSA average.⁷ This

⁶ African Development Bank, 2017 AEO.

⁷ These results should be viewed with some caution as there may be other aspects that need equal or more importance which may not be fully captured by these indicators.

translates into an increase in GDP per capita from US\$327 in 2017 to around US\$1,110 over the next 20-30 years.⁸



D. Conclusions

16. In Malawi, achieving higher and more inclusive growth involves overcoming critical structural impediments to private sector-driven economic diversification and greater resilience. Targeting reform efforts around enhancing infrastructure, worker talent, access to finance, and the business environment could triple per capita GDP over the next 20-30 years. Careful prioritization of projects and increased efficiency will be key in making use of limited fiscal space for scaling up spending in support of improving infrastructure (especially in electricity, irrigation, transport, and telecommunications), health, and education. Responsible fiscal policies, better public financial management and procurement practices could catalyze more donor financing while improving the business environment. Increased access to finance, essential for the creation and expansion of businesses across all sectors of the economy, hinges on lowering the cost of financing and better financial and physical infrastructure.

⁸ These calculations assume reforms are implemented from 2021 (adding 2.5 percentage points to GDP growth in each year) and that the current long-term GDP per capita is US\$779.

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