Malawi Economic Monitor

# STRENGTHENING FISCAL RESILIENCE AND SERVICE DELIVERY

## ECONOMIC DEVELOPMENTS AND OUTLOOK

JUNE 28, 2022

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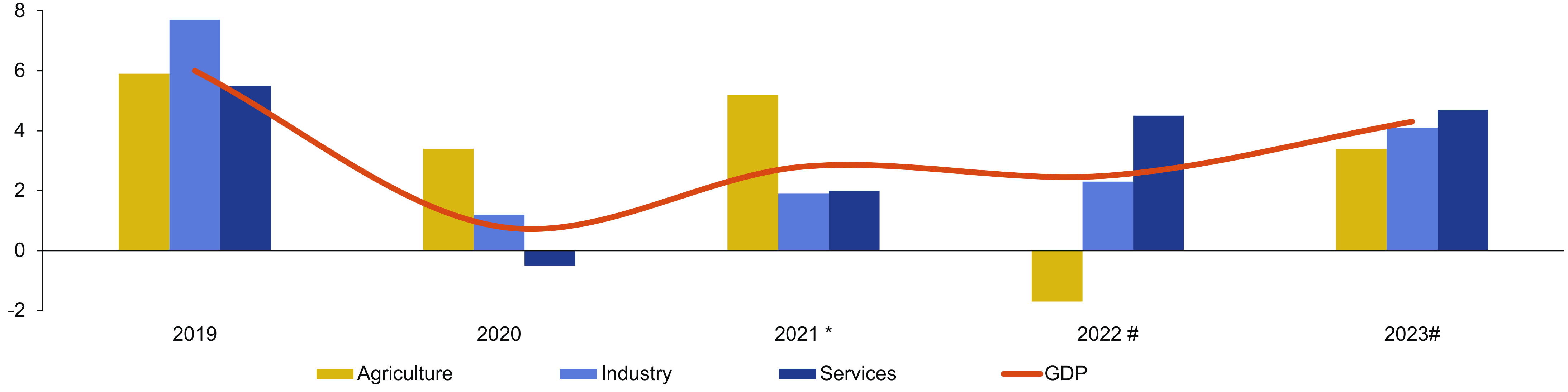
# SECTION 1

# RECENT ECONOMIC DEVELOPMENTS

# AMID SUSTAINED IMBALANCES AND NUMEROUS SHOCKS, THE POST-COVID RECOVERY REMAINS WEAK

**Real GDP growth by sector, percent**



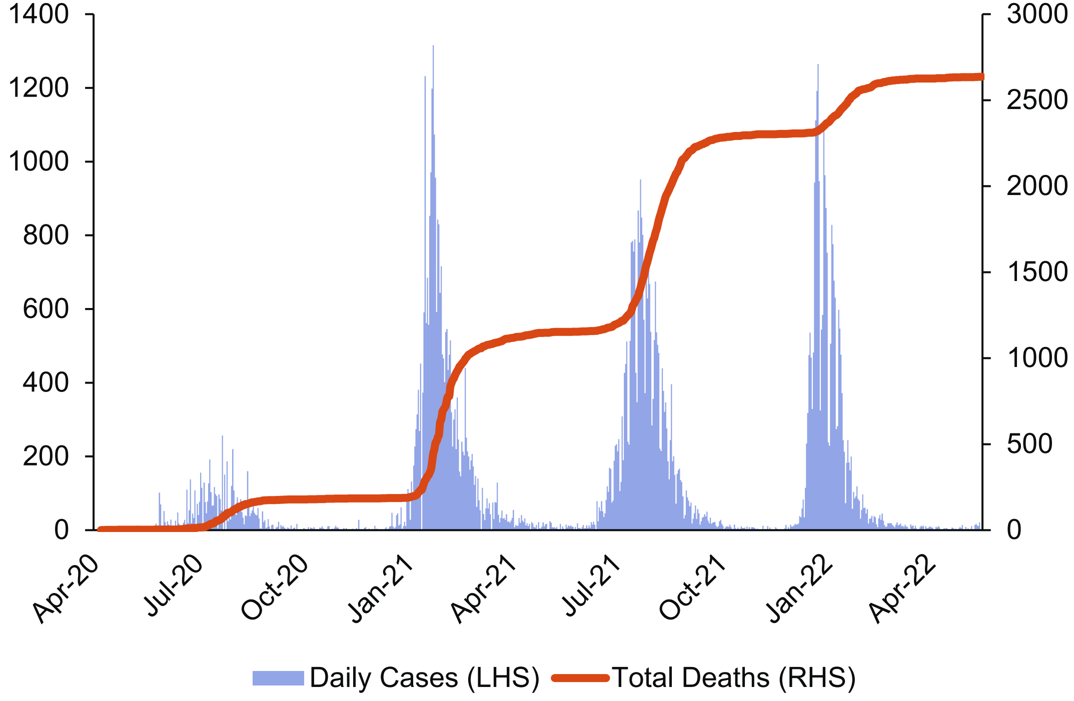

*Note:* * Estimates, # Forecasts. Analysis carried out before May 2022 exchange rate adjustment.
*Source:* World Bank staff calculations.

# COVID IMPACTS ARE DECLINING, BUT LOW VACCINATION RATE REMAINS CONCERNING

Malawi weathered a **4th COVID-19 wave** but public health and economic impacts were less severe than during prior waves.

However, **Malawi remains highly vulnerable to new variants**: at the end of May, only 8% had received their first dose, compared to a regional average of 22%.

**Malawi has experienced four distinct COVID waves**

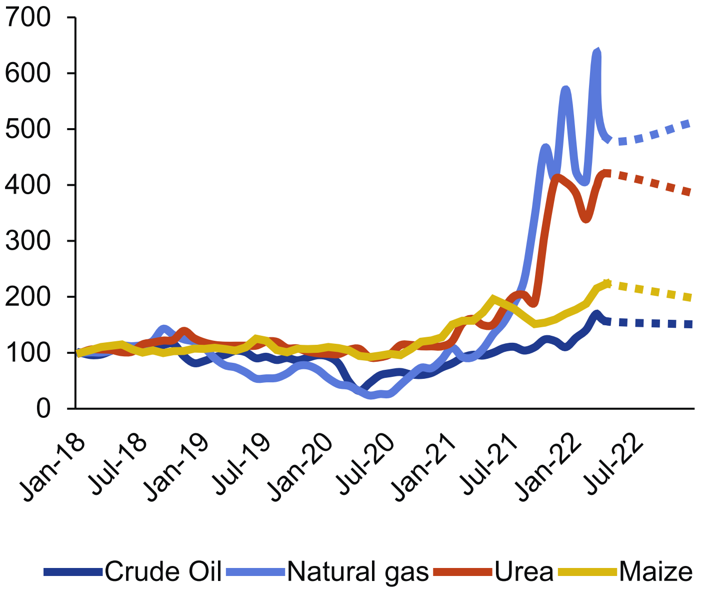



*Source:* World Bank based on Our World in Data

# A BAD CYCLONE SEASON AND THE RUSSIA-URKAINE WAR HAVE EXACERBATED EXISTING CHALLENGES

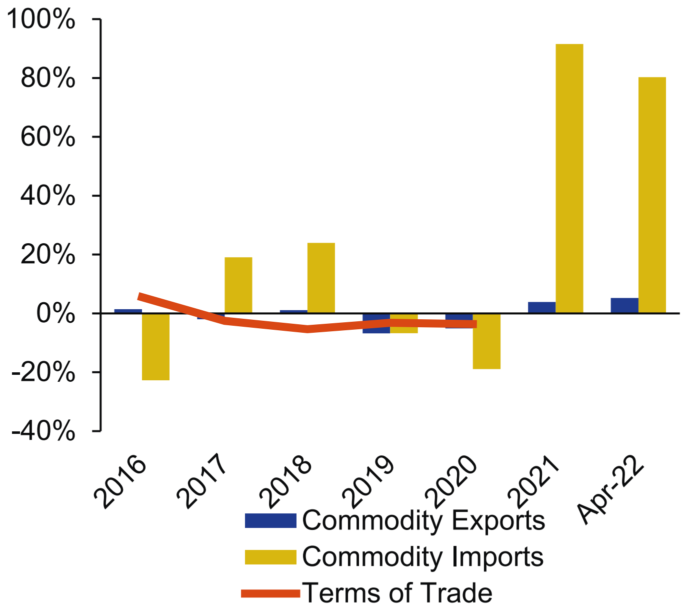
- **Tropical Storm Ana caused severe flooding**, directly impacting about 5% of the population across 18 districts. Direct damage is 1.5-2.7% of GDP, especially in the agriculture and energy sectors.
- **The invasion of Ukraine is impacting the global economy** through numerous channels including i) rising commodity prices, ii) higher production costs, iii) higher borrowing costs, and iv) food shortages.
- **Impacts will be more severe for net commodity importers like Malawi.** World Bank estimates suggest an additional financing need of 1.6-3.2 percent of GDP to sustain current fuel and fertilizer consumption.

**Commodity prices were already skyrocketing before the Russia-Ukraine War**




*Source:* World Bank Pink Sheet and CMO 4/20222

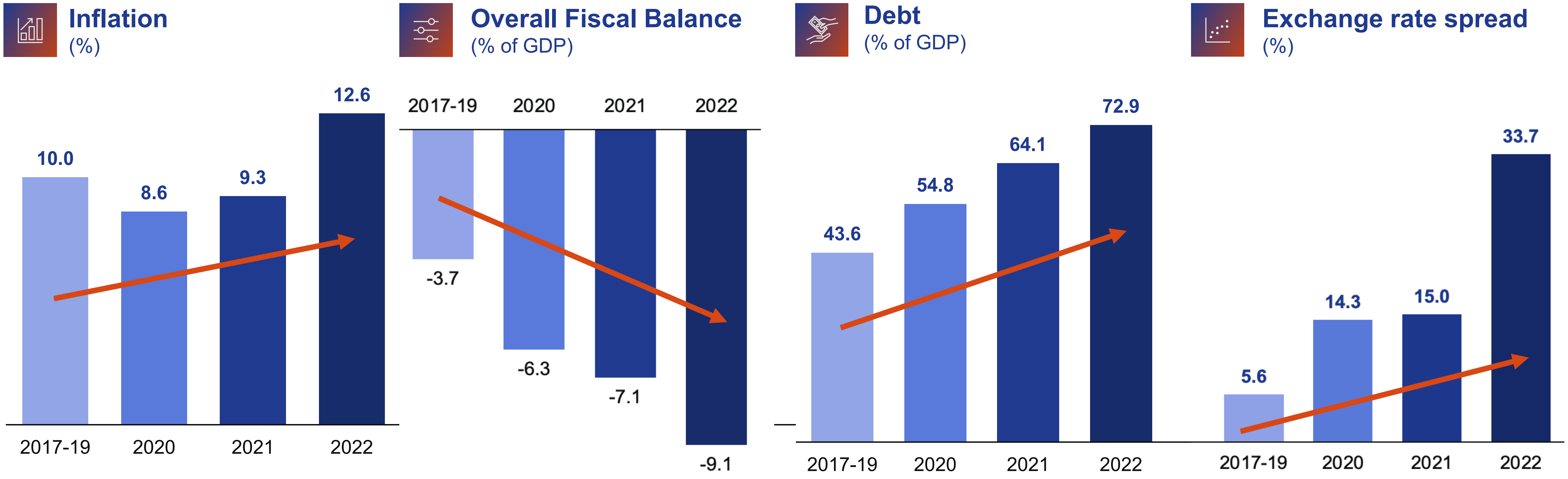
**More expensive imports in light of stable export prices have resulted in a terms-of-trade deterioration**




*Source:* World Bank staff calculations based on World Bank CMO and NSO data

# THESE SHOCKS ARE HITTING AN ECONOMY THAT IS ALREADY HIGHLY VULNERABLE

## Macroeconomic imbalances have amplified the effects of external shocks, reducing buffers and heightening the need for comprehensive reforms.

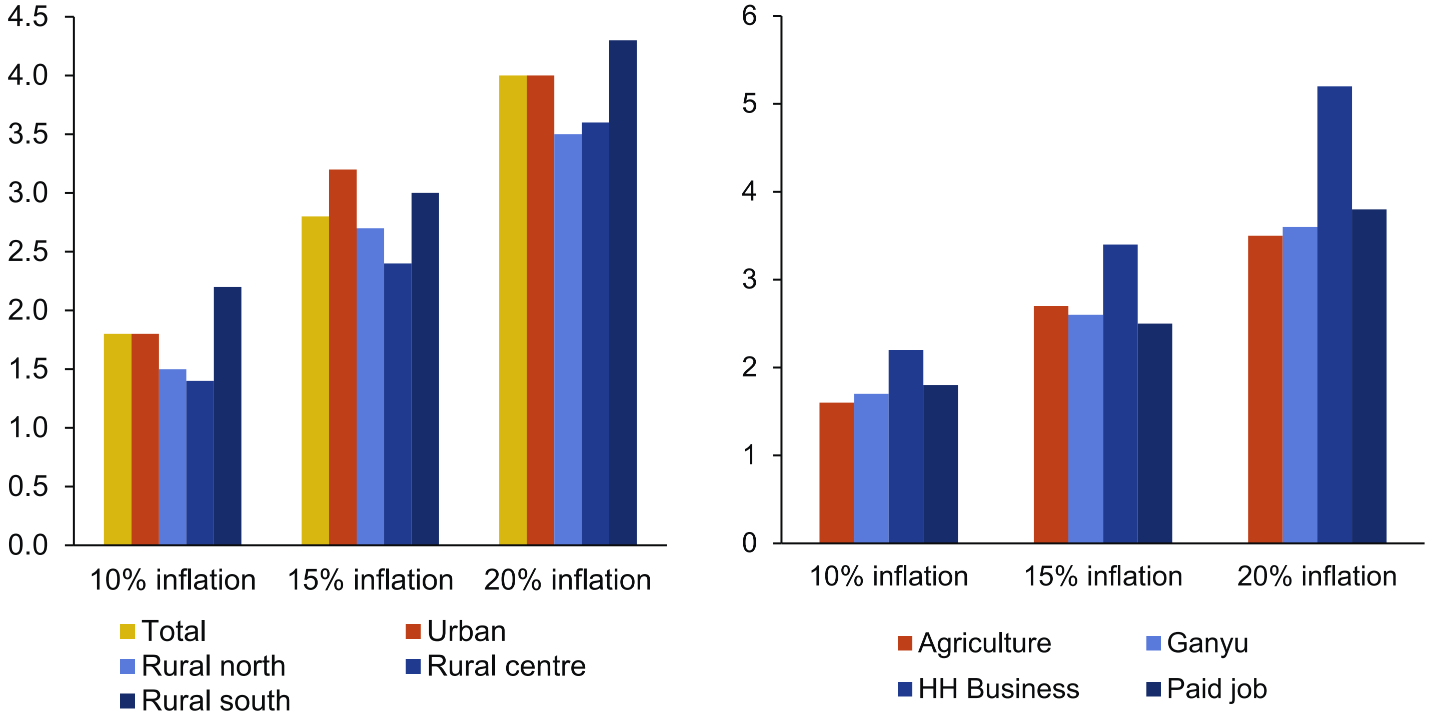



*Source:* World Bank staff calculations based on MoFEA and RBM data

# GLOBAL AND DOMESTIC SUPPLY-SIDE AND POLICY FACTORS HAVE DRIVEN UP INFLATION

- Concern about the rising cost of living has been growing as the inflation rate has increased to almost 20%.
- Causes for inflation vary by sector:
  - Food: distribution challenges, anticipation of lower 2022 yields.
  - Non-food: global supply constraints, surging oil prices, recent exchange rate adjustment.
- New World Bank analysis shows that food price increases of 15% push more than 500,000 Malawians below the poverty line. An increase from 15 to 20% leaves an additional 200,000 in poverty.
- The impact of food inflation differs significantly based on where people live and on their main source of income.

**Percentage point increase in national poverty rate for food specific inflation rates**

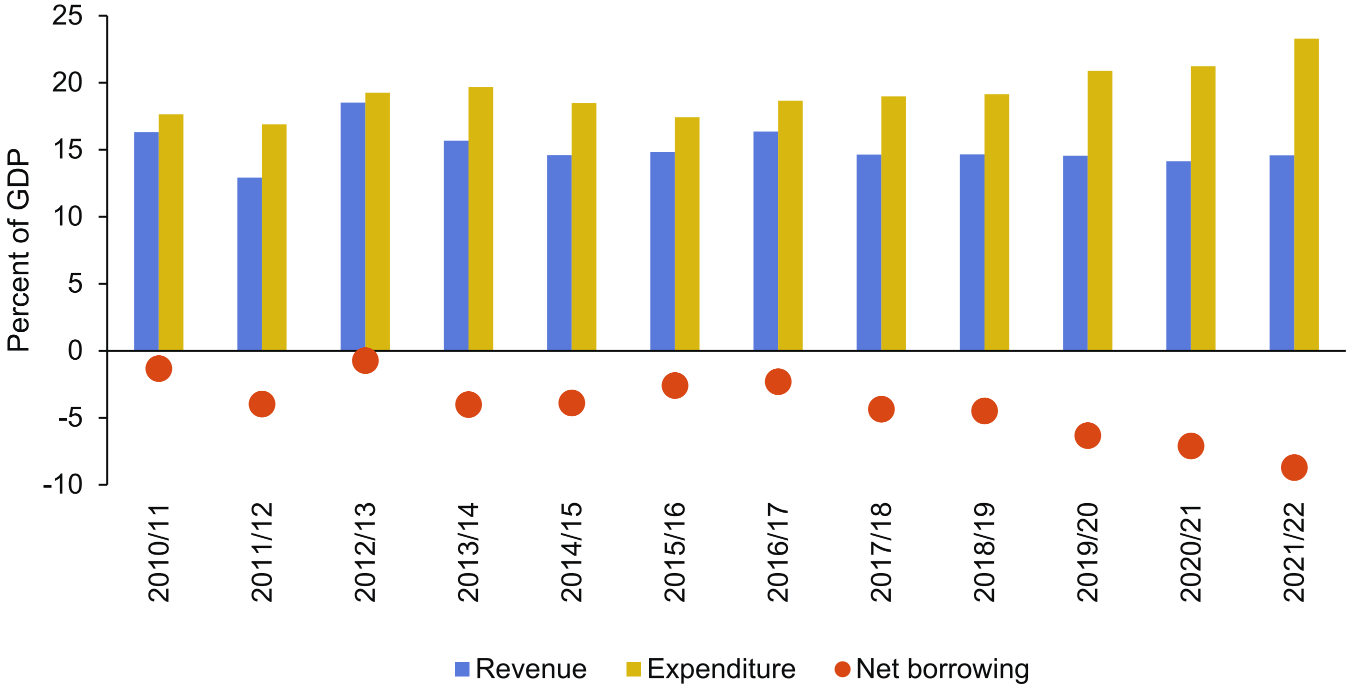



*Source:* World Bank staff calculations based on IHS5 data

# MALAWI'S FISCAL POSITION HAS CONTINUED TO WORSEN

- The fiscal deficit increased to 8.7 percent of GDP in FY2021/22, the highest in over a decade.
  - Weak performance in tax collection contributed to revenues missing the revised target.
  - Expenditure totaled 19.4 percent of GDP following overruns in government employee compensation, social benefits and interest payments, as well as high spending on AIP.
- The FY2022/23 budget exhibits tangible steps toward deficit reduction, but fiscal space remains constrained.

**The fiscal deficit has increased in light of surging government expenditures and stagnant revenues**




*Source:* World Bank staff calculations based on MoFEA data

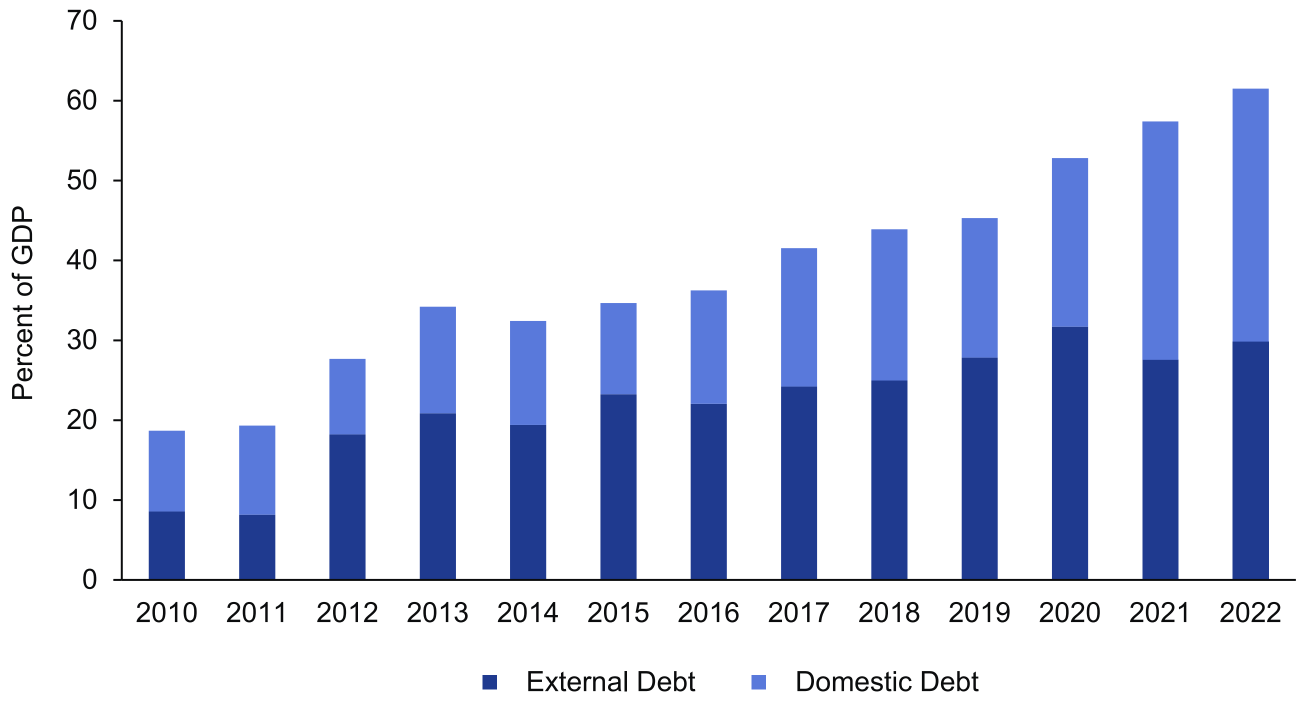
# AN INCREASE IN COMMERCIAL BORROWING HAS MADE MALAWI'S DEBT UNSUSTAINABLE

Following many years external and fiscal deficits financed by increased commercial borrowing, **Malawi's debt has become unsustainable** and rising interest expense is expected to increase significantly in FY2022/23.

There have been several drivers of Malawi's debt problems, including

1. Financing of deficits through high-cost domestic borrowing;
2. Medium-term non-concessional external debt by the RBM;
3. Low GDP growth increasing the debt servicing burden;
4. High interest rates.

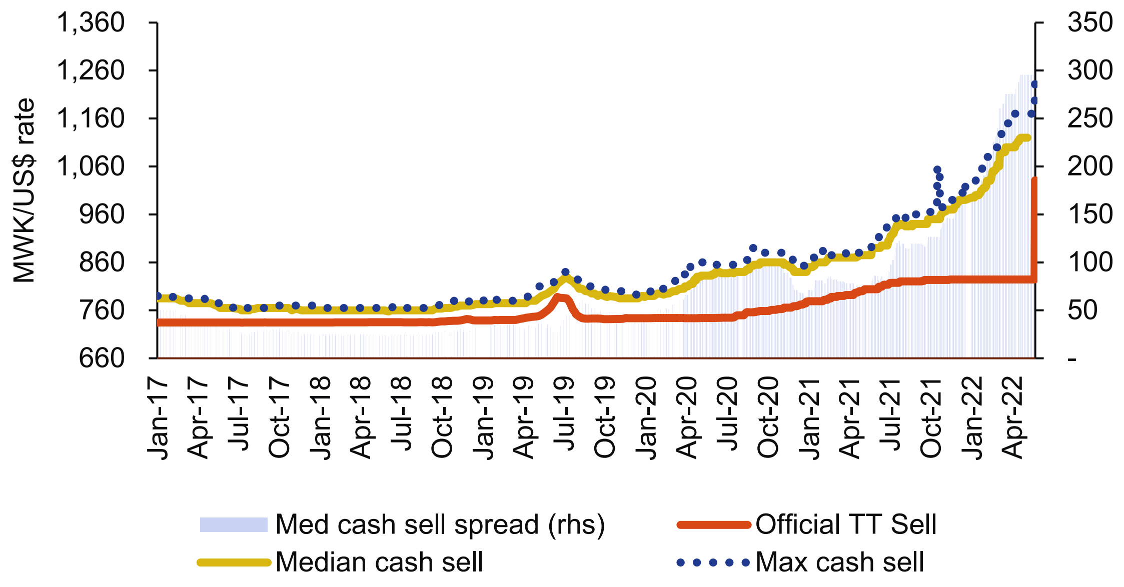
**A steady rise in domestic and external debt**




*Source:* World Bank staff calculations based on RBM and MoFEA data.

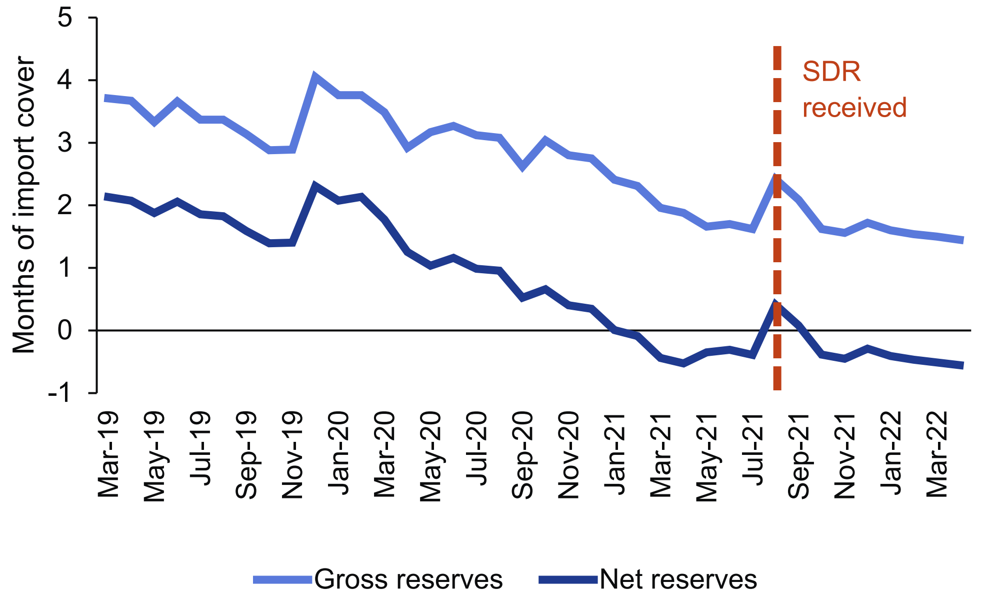
# TO PREVENT THE DEPLETION OF RESERVES, THE RBM ADJUSTED THE KWACHA-US$ EXCHANGE RATE BY 25%

**Spreads between official and bureau MK-US$ exchange rate widened until the recent adjustment…**




*Source:* World Bank staff calculations based on RBM data.

**… while reserves have declined further**




*Source:* World Bank staff calculations based on RBM data.

# SECTION 2

# OUTLOOK

# AND POLICY PRIORITIES

# DESPITE SEVERAL DOWNSIDE RISKS, THERE IS INCREASED MOMENTUM TO STABILIZE THE ECONOMY

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It will be important to maintain and accelerate this momentum over the coming months. Key challenges include:

1. **Downward adjustment of the Kwacha** and move towards floating exchange rate is now leading to higher prices but will likely bolster reserves and increase the external competitiveness of firms.
2. **Rising prices** will exacerbate a tense food security situation and may require additional government and external spending to make up for shortfalls.
3. **Spending pressures** will test deficit reduction efforts. This will require the Government's ability to reprioritize and adjust quickly to new demands.
4. **Public debt will remain elevated** with the recent adjustment impacting total debt stock and rising interest rates likely to further create debt challenges.
5. **Low levels of reserves** could expose the economy to further shocks, with determined action required over several years to rebuild an adequate cushion.

# PRIORITY POLICY REFORMS

## The Government has begun implementing critical policy reforms to address macroeconomic imbalances, but further action is needed in three areas

### RESTORE MACROECONOMIC STABILITY

- **Address fiscal pressures** by continuing fiscal consolidation reforms, strengthen budget planning and improving the screening of investment projects.
- **Address debt vulnerabilities** by enhancing transparency and explore options with creditors to bring debt to sustainable levels.
- **Improve exchange rate management** by maintaining exchange rate flexibility and soften mandatory conversions.
- **Improve public financial management** through PFM Act implementation.

### ENHANCE COMPETITIVENESS AND EXPORT-DRIVEN GROWTH

- **Advance the implementation of COGA and reform AIP** to support agricultural diversification and exports.
- **Implement the new National Export Strategy** to access key regional and global markets (including the AfCFTA)
- **Increase access to reliable power** by strengthening the governance of the sector.
- **Promote more affordable private sector financing.**

### PROTECT THE POOR AND STRENGTHEN RESILIENCE

- **Expand cash transfers and public works** to help vulnerable households afford food and other necessities from local markets.
- **Enhance long-term food security** by focusing on more nutrient-dense foods than maize, and agricultural productivity bolstering measures.
- **Scale up health interventions**, including vaccines related to polio and COVID-19.

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28/06/2022

# STRENGTHENING FISCAL RESILIENCE AND SERVICE DELIVERY

## SPECIAL THEME:

## DEEPENING FISCAL DECENTRALIZATION FOR ENHANCED SERVICED DELIVERY

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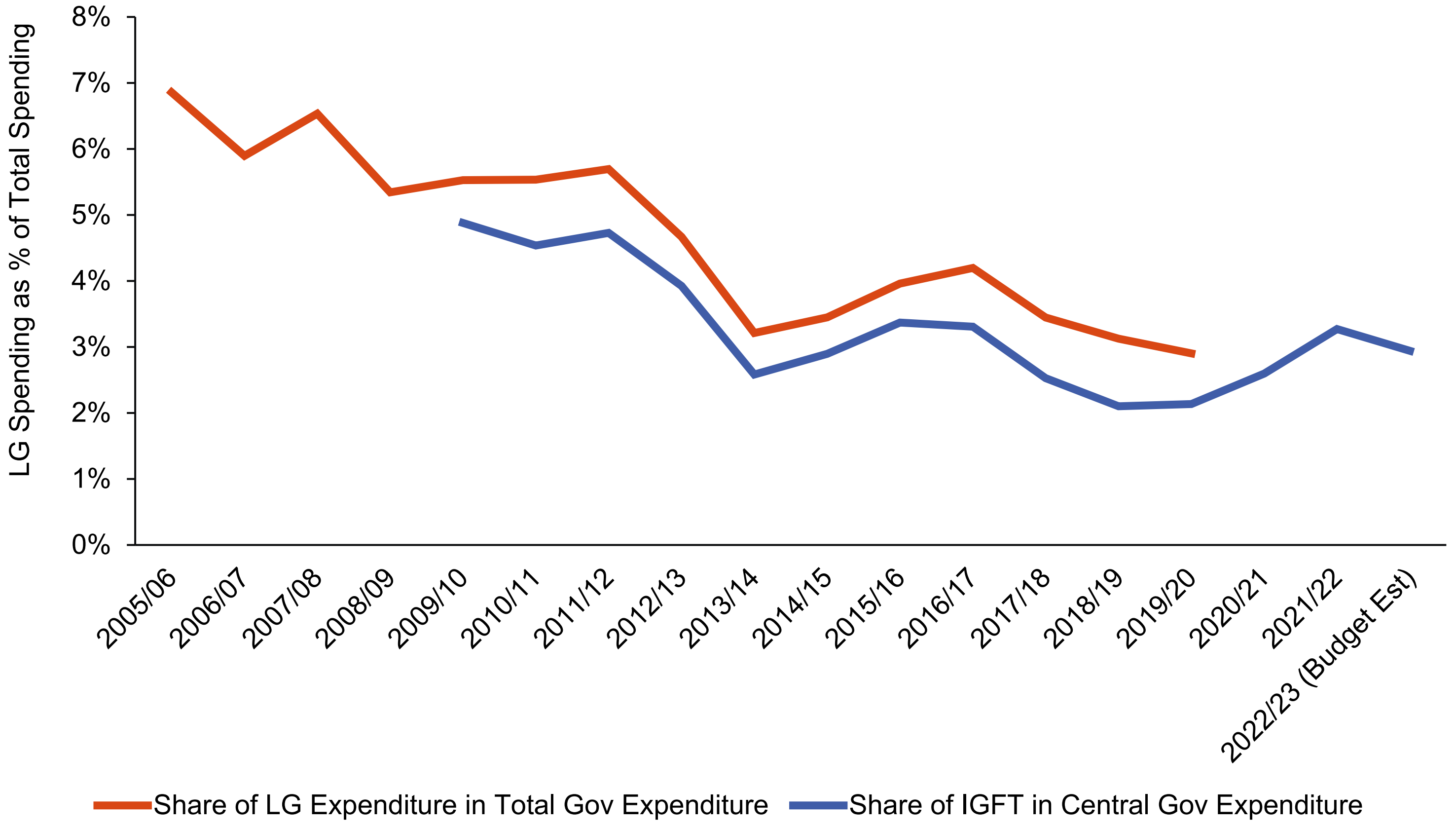
# PROMISE VS. REALITY: FINANCE HAS NOT FOLLOWED FUNCTION

## Malawi is characterized by a system of fiscal decentralization in which finance has not followed function

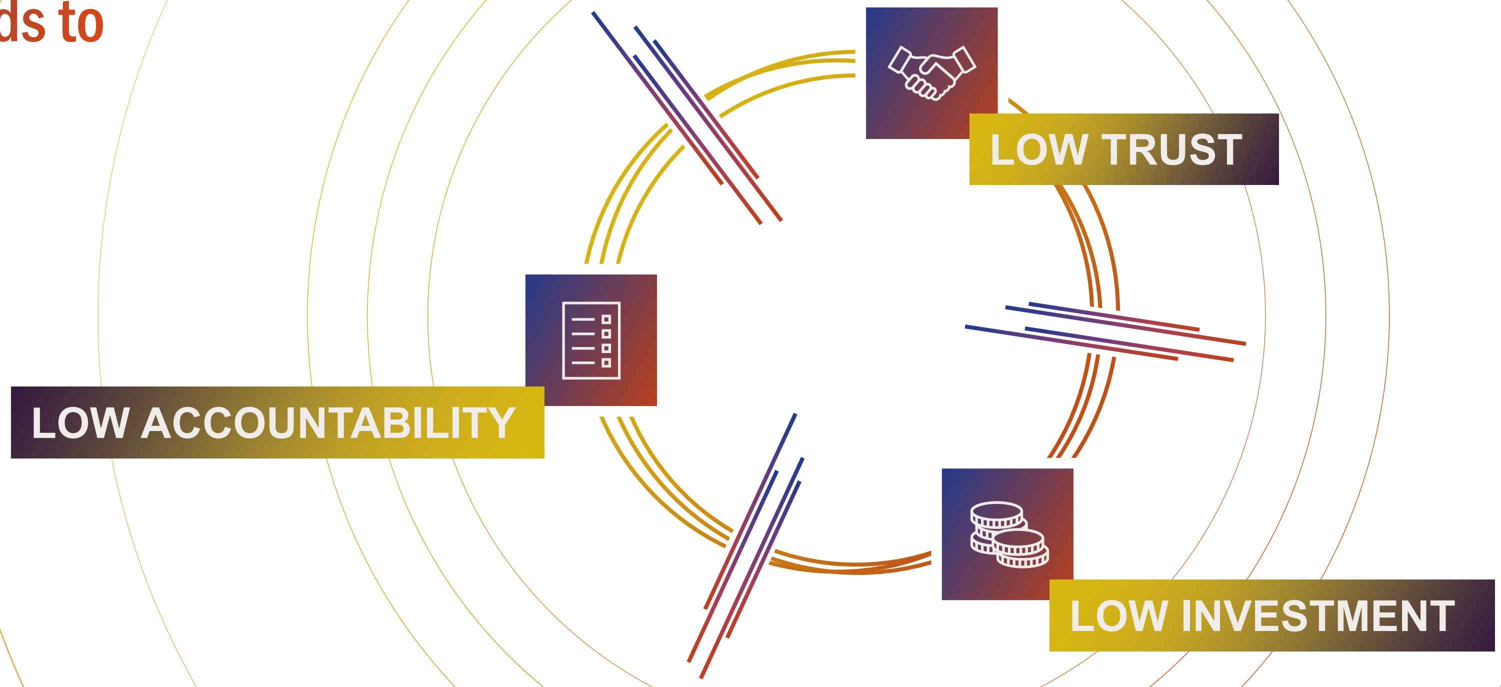
**Local Authority (District) functions:**

- Primary Education
- Health
- Agriculture
- Water
- Housing
- Trade
- Youth
- Gender
- Community Development
- Labor
- Sports
- Forestry
- Environment
- Fisheries
- Irrigation
- Immigration
- National Registry



# BREAKING THE CYCLE OF LOW TRUST IN LOCAL GOVERNMENTS

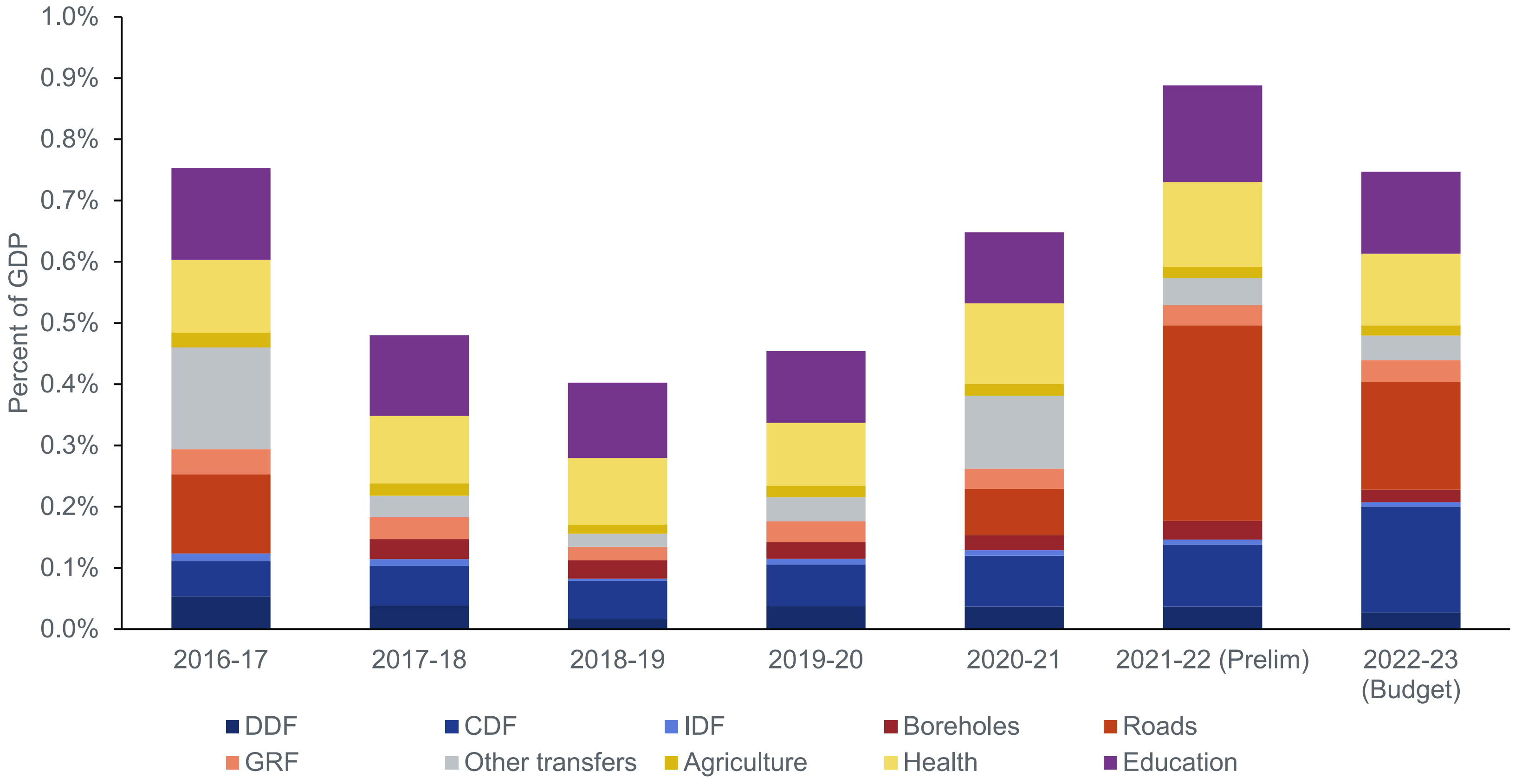
For a meaningful deepening of decentralization to continue, the vicious cycle of low trust in local governments needs to be broken



# FISCAL TRANSFERS FOR SERVICE DELIVERY

Malawi's intergovernmental fiscal transfer system (IGFTS) is the primary mechanism by which decentralized local service delivery responsibilities in Malawi's 28 rural District Councils are financed

**IGFTS transfers by category as a share of GDP**



# IGFTS PARAMETERS

## Parameters of intergovernmental fiscal transfer systems

### ADEQUACY

The extent to which transfers made to subnational authorities match the expenditure needs they face in meeting the governance and service delivery obligations assigned to them as a result of national policies or laws.

### PREDICTABILITY

The degree to which end-of-year receipts match budgets approved at the beginning of the year.

### TIMELINESS

The congruence between the administratively stipulated dates of transfers and the actual dates when transfers are received.

### TRANSPARENCY

The degree to which the transfer formula is known and is adhered to, and budgeted shares and actual receipts are reported on and published.

### EQUALIZATION

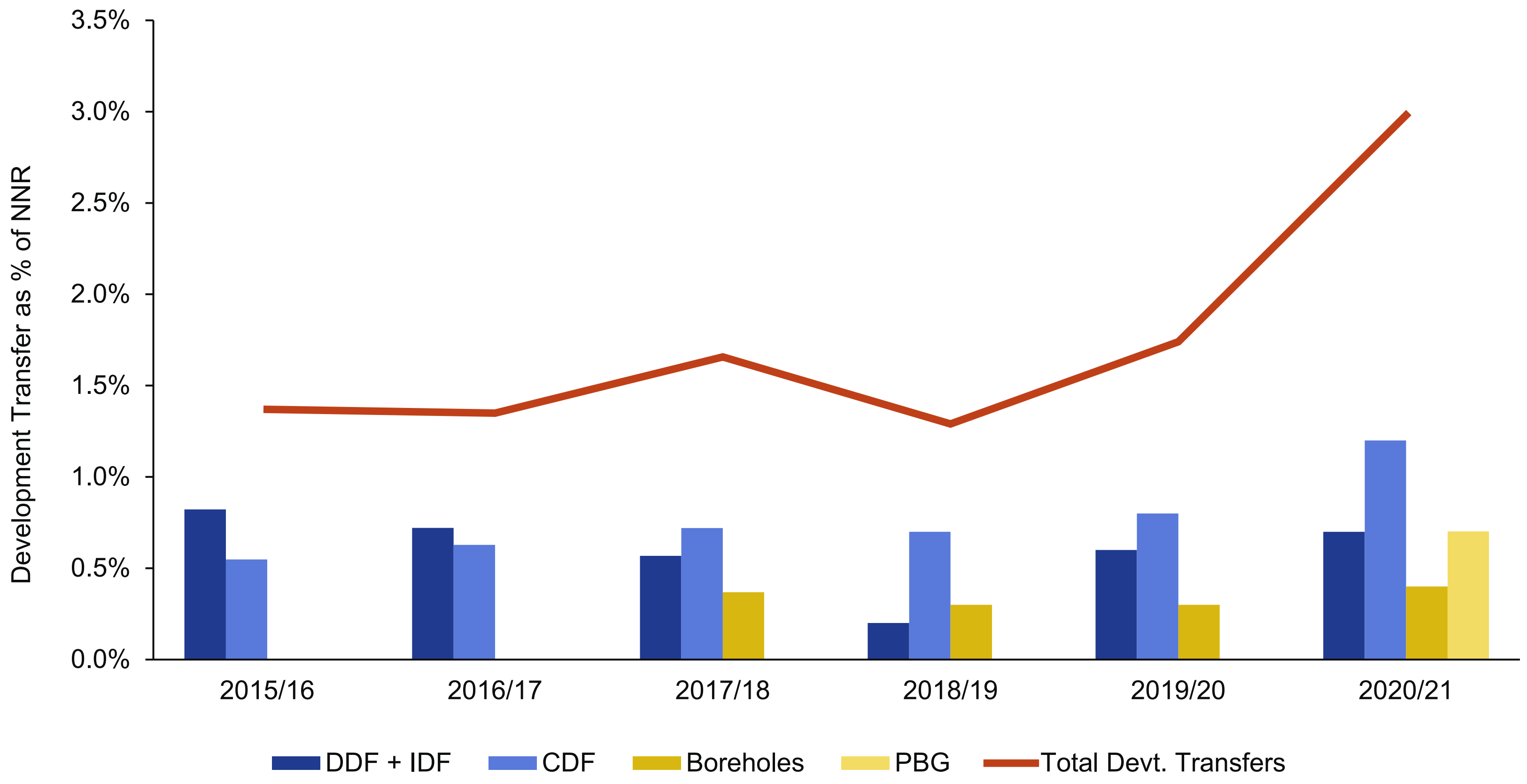
The extent to which transfers are pro-poor and aim to provide equitable access to services regardless of endowment, fiscal capacity and cost of delivery.

# ADEQUACY

Overall, there are currently no meaningful, evidence-based standards in place to measure the adequacy of Malawi's IGFTS...

...although a persistent vertical imbalance remains well recognized.

**Development transfers as a share of NNR (FY2015/16 – FY2020/21)**

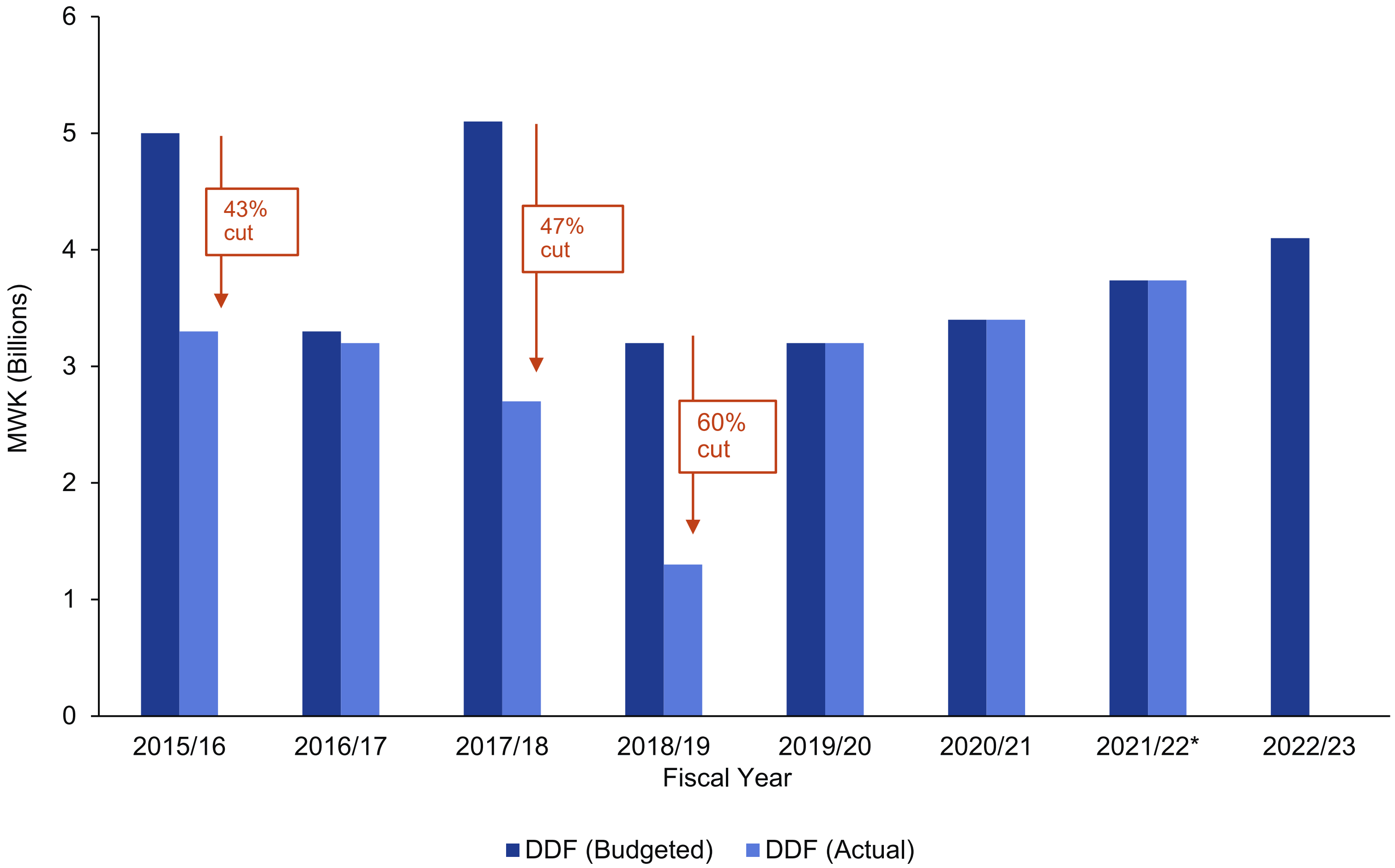


# PREDICTABILITY

Development transfers have been the most un-predictable for Local Authorities over the past several years...

...with weak predictability immediately felt in local governance and service delivery

**DDF budgeted vs actual (FY2015/16 – FY2022/23)**

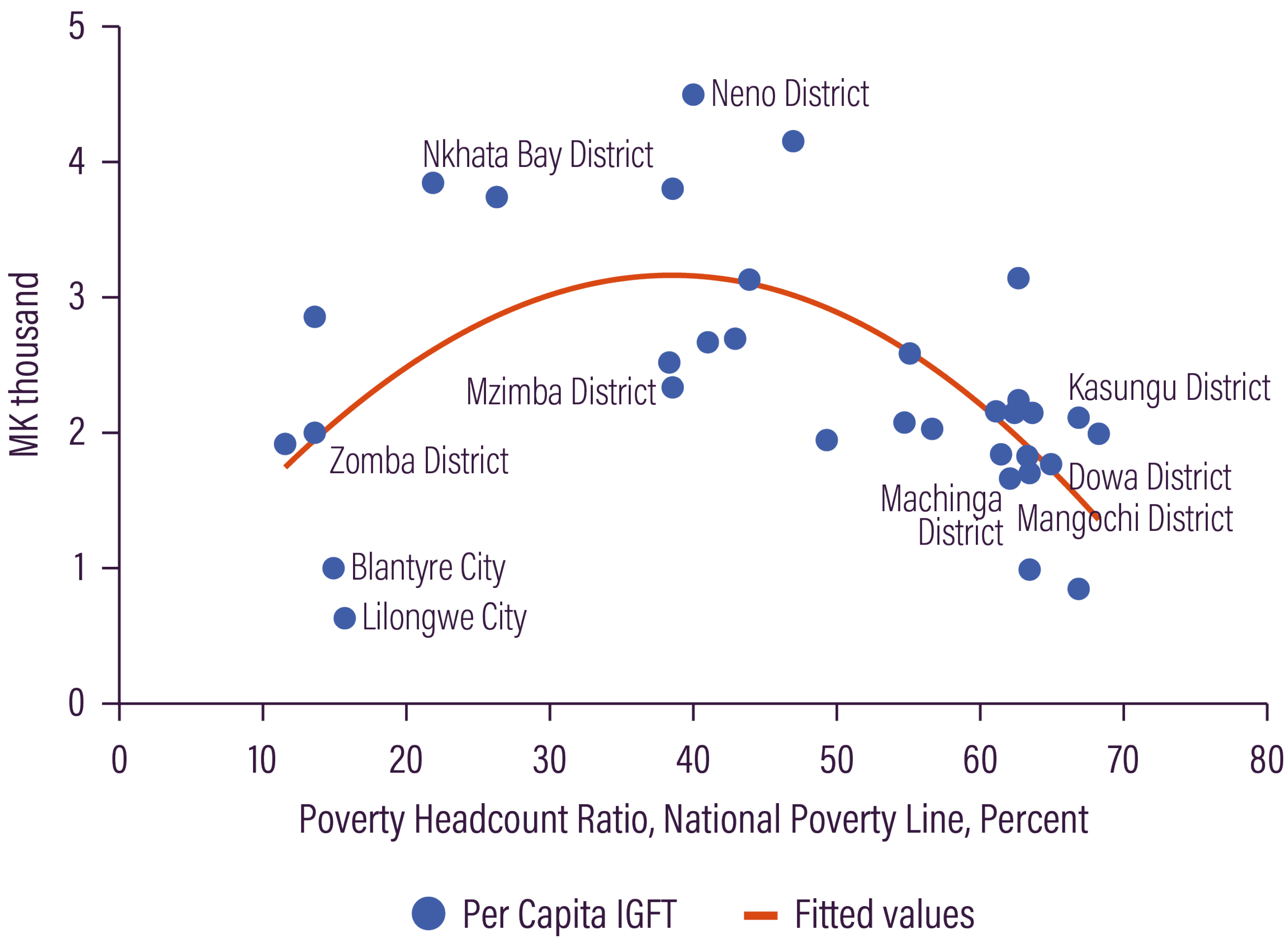


# EQUALIZATION

Overall the equalization effects of fiscal transfers in Malawi are weak...

...with the large gaps in per-capita transfers suggesting historical trends are exacerbating existing inequalities

Total IGFT per capita by 2020 poverty headcount



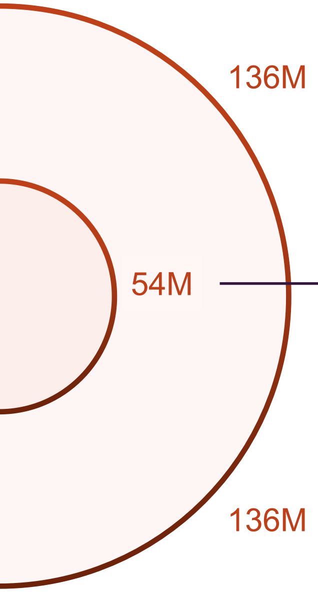
# EMERGING PATHWAYS TO INCREASE TRUST IN LOCAL GOVERNMENT SYSTEMS

The historical performance of the fiscal transfer system has reinforced the vicious cycle of trust...

...but new pathways are emerging to break out of it

# PERFORMANCE BASED GRANT: TYING RESOURCES TO RESULTS

## DDF Historical Trends




In FY18/19 – Chikwawa District was budgeted a DDF allocation of **MWK 136 million**

In FY18/19, Chikwawa district actually received **DDF total of MWK 54 million**

In FY20/21, GoM has committed to maintain and disburse at least the FY19/20 DDF Budgeted Total of **MWK 136 million**

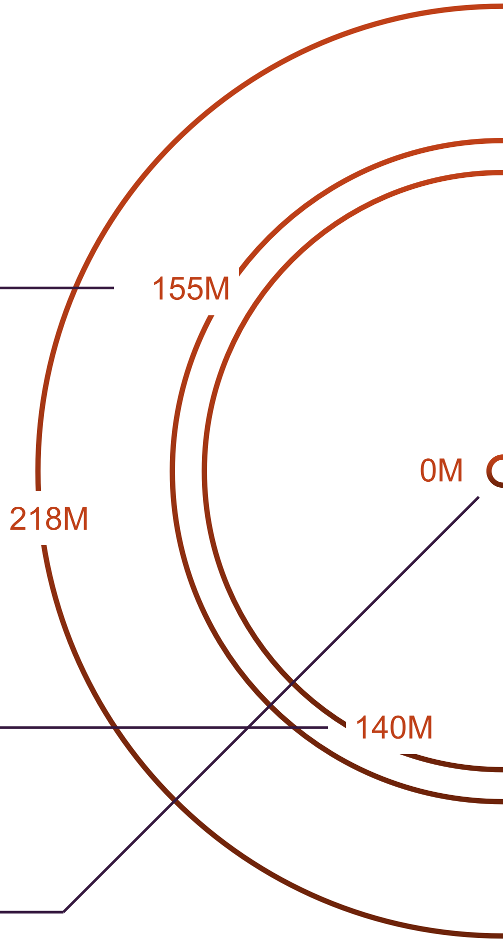
## PBG in FY21/22

In 2021 –Chikwawa met their MACs and was the 21st ranked District (out of 28) – resulting in a PBG allocation of **MWK 155 million**

If Chikwawa was the **top performing** LAPA district, they would have received an **additional MWK 63 million** – for a total of **MWK 218 million**

If Chikwawa was the **lowest performing** LAPA district, they would have received **MWK 15 million LESS** – for a total of **MWK 140 million**

If Chikwawa didn't meet any of their MACs or Triggers – they would have received **0 PBG**

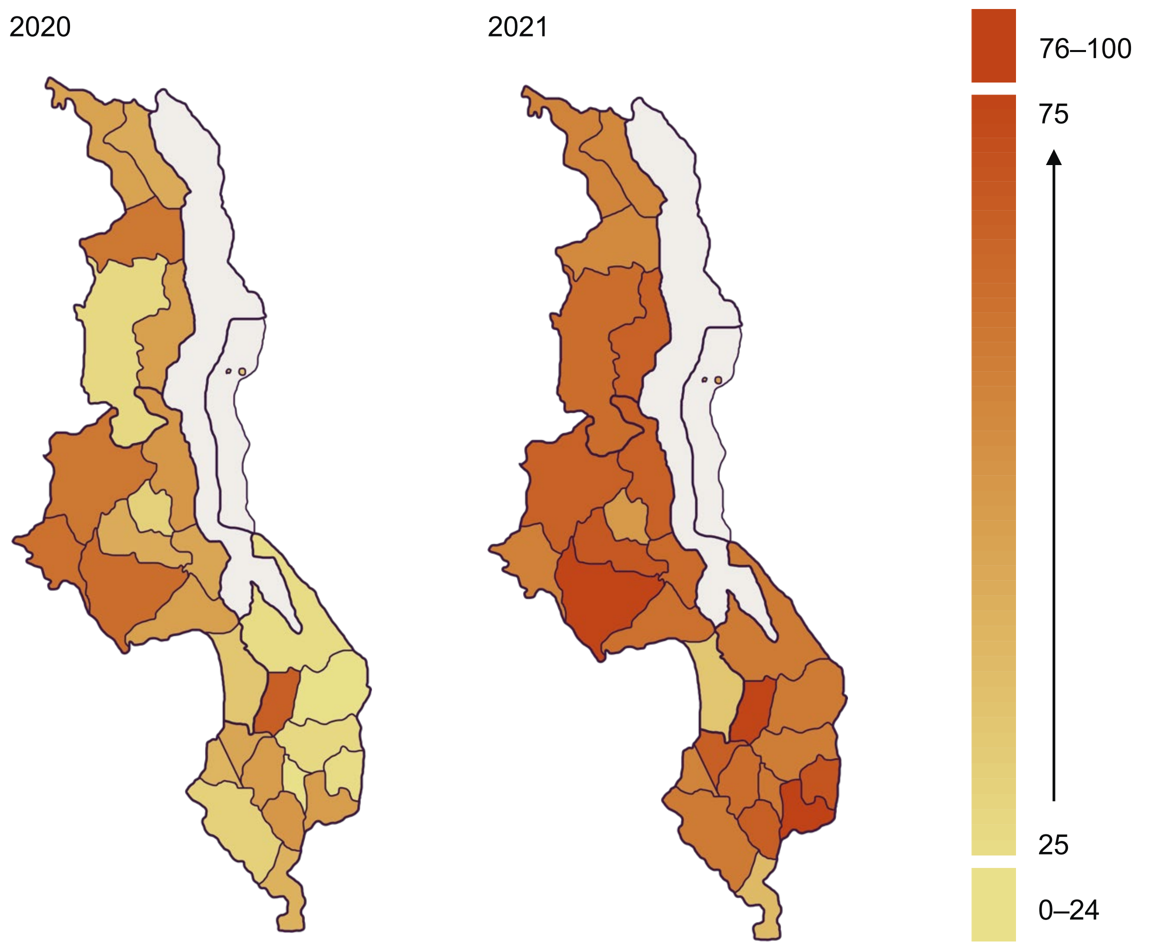


# LOCAL AUTHORITY PERFORMANCE: UNLOCKING CAPABILITY

The incentive effect of the PBG has taken hold, with an average increase in score of 20 points across Districts and biggest leaps from 'poorest performers'...

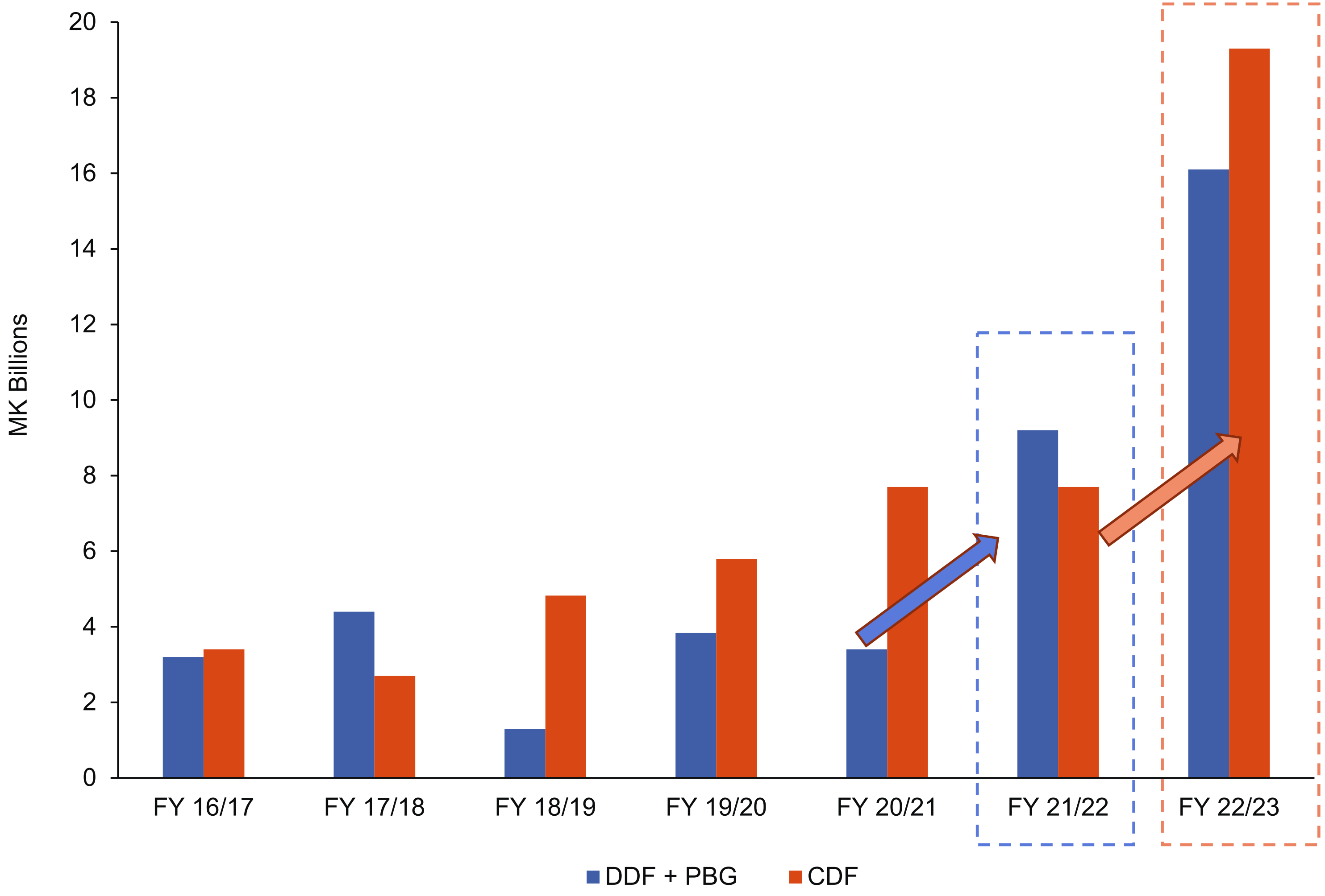
...with results displaying the PBG has unlocked 'capability' in addition to injections in 'capacity'

**LAPA scores 2020 vs 2021**



# A DYNAMIC ARENA: DISCRETIONARY DEVELOPMENT FUNDS

Discretionary development transfers to Local Authorities have increased in volume and as a percentage of the transfer pool in recent years, presenting both an opportunity and risk



# MEM 15 SPECIAL THEME: RECOMMENDATIONS

## Priority fiscal decentralization policy areas and key actions

| Category | Action | Timeframe | Direction |
|---|---|---|---|
| Bolster coordinated, high-level leadership of the fiscal decentralization agenda | Bolster the guidance from highest levels of government and leverage the coordination of the decentralization troika of the MoFEA, the Ministry of Local Government, and the NLGFC to drive results with sector ministries | Short* | |
| Introduce evidence-based debate of vertical imbalances | Utilize ongoing costing of minimum service delivery standards for all decentralized sectors to inform how current envelope of decentralized funds are allocated vertically between levels of government | Short | |
| Leverage ongoing legislative and policy reviews | Leverage the ongoing review of the Local Government Act and the National Decentralization Policy to introduce a realistic and evidence-based set of guiding principles to guide fiscal decentralization | Short | |
| Increase transparency and simplicity of the transfer system | Undertake a full review of fiscal transfer formulas and allocations with an objective of moving toward a simplification and reduction in the number of grants and transfers | Medium | |
| Coordinate development funds tied to performance | Embark on the coordination and consolidation of development funds tied to performance measures, starting with the formal merging of the DDF and PBG, together with the current Boreholes Fund. This can also be extended to service delivery sectors to inform the introduction of sector condition grants. | Medium | |
| Revitalize General Purpose Grant | Review the current utilization of the GRF and sectoral ORT to inform the revitalization of a General Purpose Grant | Medium | |
| Strengthen equalization of transfers | Equalization should be strengthened through a revision of the formulas and the inclusion of rational expenditure needs and fiscal capacity measures in those formulas | Medium | |

Initiate Sustain Strengthen