

Malawi's Path Out of Poverty and Toward Prosperity

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Executive Summary

The Malawian economy is currently unable to grow despite the immense potential of its people. Per capita income has been declining since 2020, while poverty remains amongst the highest in the world. Equally problematic, Malawi's growth over the preceding decade was wholly insufficient to keep pace with the rest of the global economy. This kept Malawian per capita income at less than 1% of the U.S. level. Unless problems that have been allowed to fester are reversed, most Malawian families will continue to be subjected to poverty and extreme vulnerability, today and potentially for generations to come. Worse, Malawi is in the midst of a slow-moving macroeconomic crisis which could become deeper and more acute if access to foreign exchange collapses further.

Reversing the course of the national economy is ultimately about putting Malawians in a position to pursue opportunities that are currently held back. Even as the nation has faced nearly annual climate-related shocks, Malawians are resilient. It is their access to productive economic networks that holds back opportunity. Other countries such as Rwanda and Ethiopia that are landlocked, face weather shocks, and were recently as poor as Malawi have been able to achieve accelerated growth paths through long-term investment and growth in exports. Malawians are meanwhile brimming with untapped potential, and Malawian businesses are as enterprising as any in the world. There are many potential opportunities for growth in Malawi from agriculture, mining, tourism, and others that are severely held back by macroeconomic circumstances.

Jumpstarting growth is impossible under current macroeconomic constraints. As growth has lagged, and as Malawi has been subjected to shocks, macroeconomic policy has been put in a bind, which has been increasingly tightening. As late 2025, Malawi faces foreign exchange shortages that have played a critical role in undermining the economy for several years. This shortage has come alongside high inflation, which is undermining the hard-earned incomes of Malawians. Recent investment levels have been insufficient for Malawi's current needs and have been reliant on increasingly fickle donor support. Private investment is extremely low in Malawi. It is very difficult for both domestic and foreign investors to invest in Malawi's potential when they cannot import the inputs they need or freely move in and out the dollars their export businesses generate, and when returns are at risk of being inflated away. While solving macroeconomic challenges alone will not create the dynamic export sectors that Malawi needs, it is a necessary condition.

The current macroeconomic environment is causing pain and hardship while putting Malawi in an even more vulnerable position. The government has lost access to external credit, leaving it reliant on a vicious cycle of domestic borrowing from banks at high cost and excess money

creation to support current spending. Foreign exchange availability teeters on the edge of collapse, with import coverage measured in units of days or weeks. Access to foreign exchange and finance from domestic banks provides a tenuous lifeline, but this system will break at some point if the balance sheets of banks increasingly deteriorate. All the while, as macroeconomic policy targets survival rather than a strategy for addressing the core problems, the damage of these distortions on the economy and lives of everyday Malawians is immense. Macroeconomic anchors are currently ineffective, and Malawians are growing poorer each day. With buffers so thin, Malawi is one shock away from potentially being in an even worse crisis.

As a result, Malawi has two economic problems: a medium-term growth challenge and a short-term macroeconomic stabilization crisis. It is important to understand each of these clearly and how they interact. This note points to several key observations on the growth challenge and the path out of the macroeconomic crisis. The report is organized around five key conclusions, which do not neatly align with the stated understanding of the Government of Malawi nor that of international development community in all cases.

- **First, the path to growth will hinge on expanding exports.** Malawi has gotten to this critical point because its traditional sources of foreign exchange (e.g., tobacco and aid) have stagnated or declined while its population grows, and it is hit by increasingly more frequent shocks. Since 2012, this has led to three distinct phases of macroeconomic management to live within lesser means. Growth will require a steady increase in export generation, and strategies should thus pay special attention to what holds back the growth of existing and new exporters. The current macroeconomic regime is clearly untenable but a return to previous regimes is also no longer possible. The regime that allowed for a fixed exchange rate and low inflation over 2017-2020 is no longer possible because it relied on positive net foreign reserves that were available at the time. Policymakers will need to develop a new path that is built on generating exports and foreign investment. Such a path will need to both solve the current macro issues and remove restrictions and barriers in areas like land, access to energy, transport that prevent investors from investing in Malawi in high-potential sectors.
- **Second, the fundamental cause of the short-term macroeconomic crisis is a fiscal deficit that results in excess money creation and, thus, in exchange rate pressure, inflation, and accumulation of domestic debt.** Malawi's government has taken on spending responsibilities it cannot fund with current tax levels and has financed this gap with a combination of expensive debt and printing by the Reserve Bank of Malawi (RBM). These result in exchange rate pressure, inflation, and an unsustainable domestic debt spiral that threatens to turn into a banking crisis. Thus, solving the macro crisis will require a fiscal

adjustment that puts Malawi on a sustainable fiscal path. There are some opportunities on primary expenditure reduction and reducing the high cost of debt services. But there will also need to be a concerted effort on revenue mobilization. With limited available data, it is unclear which tax-related strategies (closing loopholes vs. addressing tax evasion, for example) can have the biggest positive impact, especially in a short-term scenario of an economy under stress. However, international experience and the wider macroeconomic context of Malawi suggest that a bold focus on evasion may be the most important step. If revenue collection can overdeliver, this reduces the need for domestic borrowing and money creation, which makes addressing inflation and the debt path more achievable. Clearer and more transparent fiscal strategies could help to crowd in additional donor budget support. A strong commitment and performance in this realm can also help re-establish credibility for Malawi among the international community.

- **Third, addressing the current macroeconomic crisis and high inflation can only happen if money creation slows.** Food price shocks may have played an important role in price increases experienced in 2011-15, but this is not the driver of Malawi's inflation over the last several years. Inflation is coming overwhelmingly from growth of the monetary base, which is a result of money creation. Money creation has been used to fill a fiscal gap that is occurring at unprecedented levels. Bringing down inflation will be impossible without slowing growth of base money by the RBM, which in turn means slowing government borrowing from the RBM. This suggests that the monetary base or the value of net domestic assets may be viable to use as a policy anchor. Meanwhile, issues in food supply and farmer productivity are an ongoing risk. Malawi has available policy options to increase agricultural productivity and food security that have yet to be mobilized to address food supply risks. Food security will be a key concern in the short run. This note, however, focuses on the underlying economic causes of Malawi's current macroeconomic predicament, long-term lack of growth, and recurring food insecurity.
- **Fourth, domestic debt is a ticking time bomb that risks turning into a banking crisis. Sustainability requires dealing with both the high price of the stock of domestic debt and the flow of new domestic debt.** Any path to growth and any credible fiscal adjustment will require lowering the growing interest rate burden of Malawi's debt and getting back to debt sustainability. However, this will not be achieved through external debt reprofiling or debt forgiveness alone. What most undermines Malawi's current situation is the ballooning path of domestic debt accumulation. High domestic borrowing raises rollover risks, keeps interest costs elevated, and pressures the RBM to finance the deficit, thereby fueling inflation

and eroding policy credibility. A large and growing share of the fiscal deficit is now explained by interest payments on this debt, creating a vicious cycle of borrowing to service past borrowing. Unless this cycle is addressed, there will be little other fiscal space, and fiscal adjustment will not be possible. External debt operations can play a supportive role, but only if pursued alongside credible fiscal consolidation and declining money growth. There is also limited room for such borrowing to continue and if the government cannot use this channel to borrow then it will be forced to either inflate away the debt with hyperinflation or default resulting in a larger banking crisis.

- **Fifth, the current exchange rate system is not working in terms of stated goals as a macroeconomic anchor. Meanwhile, it is disincentivizing exports and investment making the overall macroeconomic challenges worse.** The parallel market has grown as a second-best way for actors in the economy to access foreign exchange. Rather than being a hinderance, it is providing a release valve. At this point, most imports are made at the parallel-market rate, meaning that much of the economy is already off the official rate. Excess money in circulation is leading directly to depreciation of the kwacha in the parallel market and to inflation. Thus, there is more space for policy change than commonly appreciated, especially if there is a clear strategy to deal with the fuel sector which is one of the major sectors to continue to use the official rate. Distortions across the economy from prolonged (and growing) scarcity of officially supplied foreign exchange is a top constraint that holds back the development of new exporters. Rationing of imports at the official exchange rate, and through outright restrictions, not only undermines imported inputs and investment by would-be exporters but also has created an inward-oriented economy that centers on government and donors as markets. Given the consequences on the real economy and the ineffectiveness of the current anchor, the path forward on exchange rate management should be an area of detailed planning and potential experimentation rather than a debate between extremes of a current policy and a free-floating rate.

The goal of this policy note is to provide inputs for Malawian policymakers to develop a truly homegrown reform plan and initial path to growth, which could be leveraged to crowd in short-term support of the IMF and other international institutions. Malawi risks an acute macroeconomic crisis alongside constraints that have undermined growth for decades. History shows that effective approaches in economic circumstances like this cannot be externally driven; they must be homegrown. Malawian leaders need to have a clear understanding of the origins, causes, and consequences of macroeconomic challenges, and the boldness to act on challenges with evidence. Likewise, when governments put forth evidence-based strategies for change and

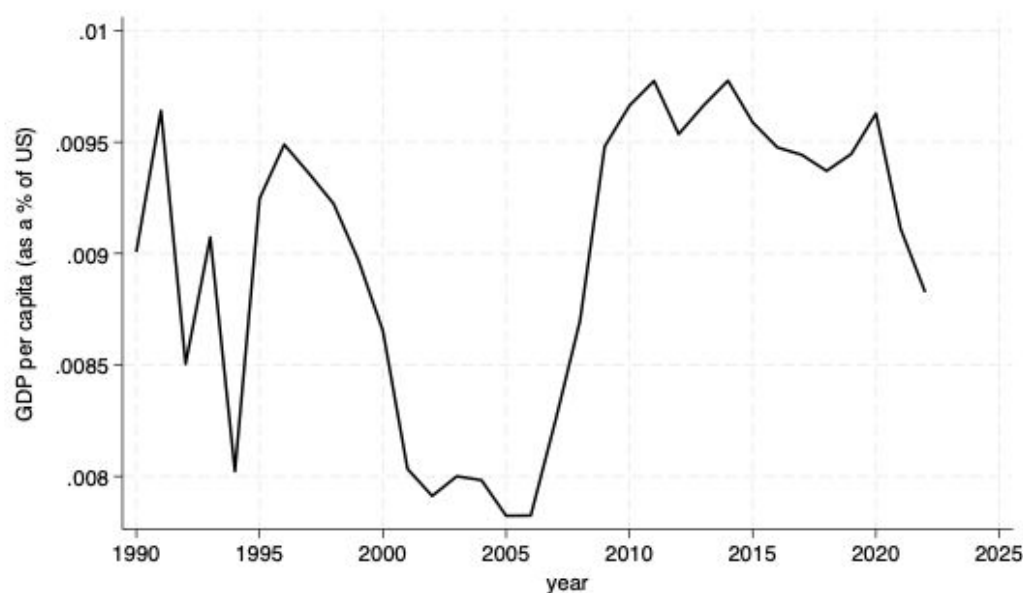
make good faith requests for support, it is the responsibility of international development organizations to help. With these two ingredients, a path out of poverty and toward prosperity is possible.

There may be a window of opportunity to use the current crisis and a potential future IMF program to implement both macroeconomic and investment reforms that could put Malawi on a higher growth path. To replenish buffers and reserves, and regain the confidence of donors and external lenders, Malawi will need external financing from the IMF. This financing will come with its set of conditionalities. Usually, the dynamic is one where these conditions are imposed on a developing country. But there is an opportunity, instead, to proactively approach the IMF with a clear plan. This plan must make difficult choices on issues like the budget and exchange rate. But such a program can also be an opportunity. It can be the moment to make the reforms to both the macroeconomic and investment environment that allows it to grow into the future, credibly showing investors across the world that Malawi is a place where they can thrive. To do so, will require a focused strategy on what reforms are critical and taking advantage of opportunities as they arise.

1. The Missing Growth Path: Exports, FDI, and New Drivers

It is important to see today's macroeconomic challenges in the context of Malawi's long-term inability to grow as an economy. Malawi's economic growth has been one of the lowest in the world over the last two decades. Between 1994 and 2024, Malawi's income per capita has grown on average at about 1.1% per year. This growth rate during this period is ranked 127th among all countries, placing it ahead of few countries in the region like Zimbabwe or Burundi and conflict-affected countries like South Sudan or Afghanistan. As a result, Malawi remains one of the poorest countries in the world with an income per capita that is stuck less than 1% that of the United States (Figure 1). This slow growth means that Malawi has not been able to begin to catch up with middle income and developed countries in income and standard of living. For quality of life to truly improve, Malawi needs higher growth that is sustained over a long period of time.

Figure 1: Malawi's GDP Per Capita as a Share of the United States

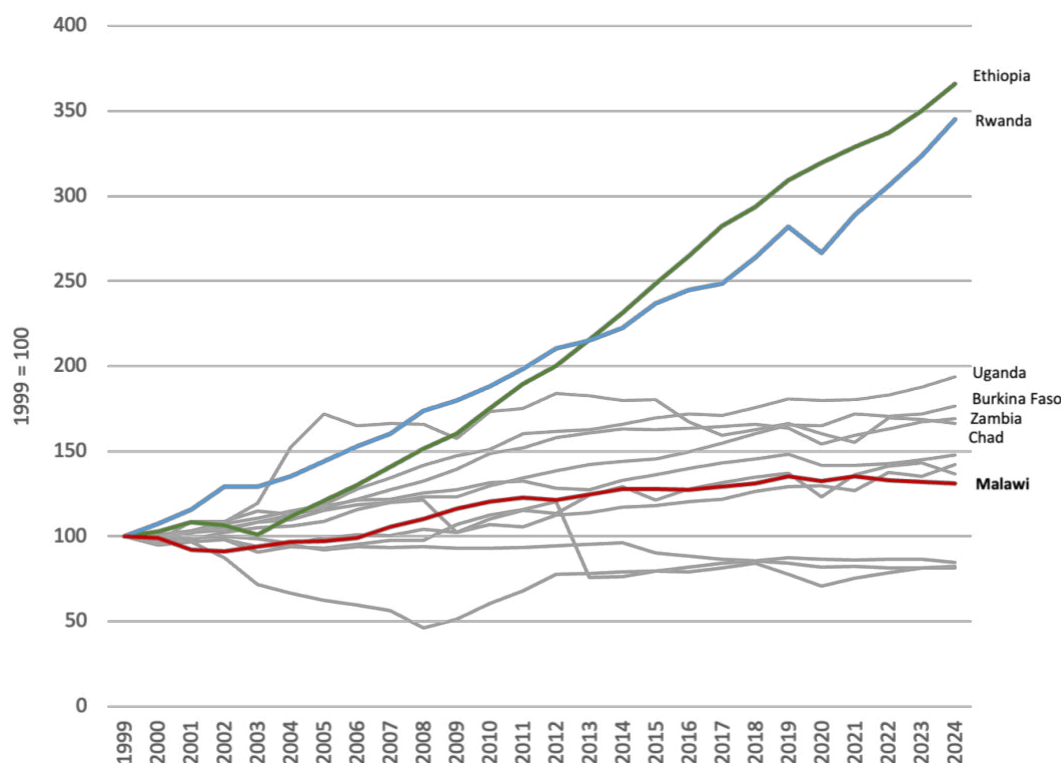


Source: World Bank World Development Indicators

Though Malawi faces headwinds like exposure to weather shocks and being landlocked, the experiences of other countries suggest that it is possible for Malawi to grow. No doubt Malawi's geography in being land-locked and its exposure to so many weather shocks make growth difficult. A current external environment with increasing geopolitical and trade uncertainty also makes growth and development more difficult. However, this does not consign Malawi to low growth forever. In fact, extremely large disparities in economic performance of landlocked Sub-Saharan countries over the past 25 years show that better growth is possible (Figure 2). Even

among landlocked countries, Malawi has been a poor growth performer. Between 1999 and 2024, Ethiopia and Rwanda have been the 9th and 12th fastest growing economies in the world with a compound annual growth rate (CAGR) of 5.3% and 5.1% per year, respectively.

Figure 2: Income Per Capita in Sub-Saharan Landlocked Countries (1999 to 2024)



Source: World Bank World Development Indicators

The fundamental challenge for Malawi, and the reason for its declining growth prospects, is that it does not generate enough foreign exchange. Producing foreign exchange is critical for growth because growing economies need to be able to afford growing imports. These imports include goods for consumption but also capital goods, inputs to production, spare parts, and more. Importing in a land-locked country like Malawi is expensive enough because of transportation cost. However, when a country does not have enough foreign exchange, it becomes almost impossible. Looking back at its growth path (Figure 3), Malawi saw an increase in growth between 2006 and 2010 due to a combination of debt relief, good weather, and a large increase in agricultural productivity that happened after the initial agricultural inputs program. This period was also a one of rising imports (Figure 4) across the board including for both consumption goods as well as inputs for agriculture, manufacturing, and mining. It is no coincidence that growth declined and hit a low in 2012 simultaneously as imports per capita declined. Unfortunately, the economy has not been able to import at the preceding level ever since. For this reason, growth has

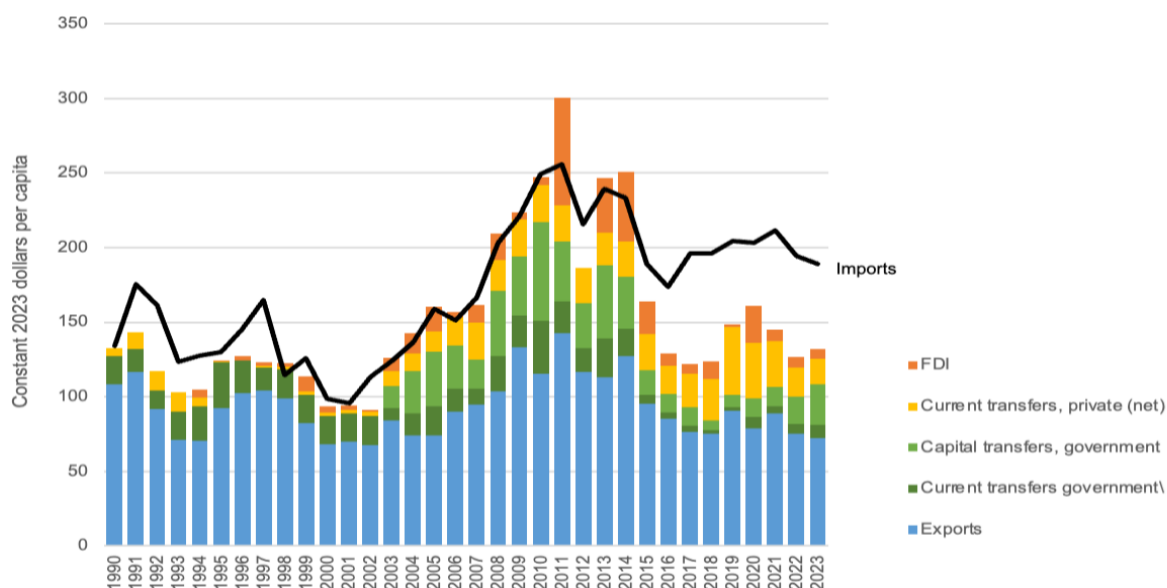
been very low. The average rate of growth since 2020 is the same as it was at the previous low point of 2012, and income per capita is declining year on year. This fundamental constraint at play is that Malawi has been unable to generate enough foreign exchange to pay for imports, and the constraint has been binding for close to 15 years.

Figure 3: Real GDP and Real GDP Per Capita Growth in Malawi



Source: World Bank World Development Indicators

Figure 4: Malawi Imports Per Capita and Broad Sources of Foreign Exchange



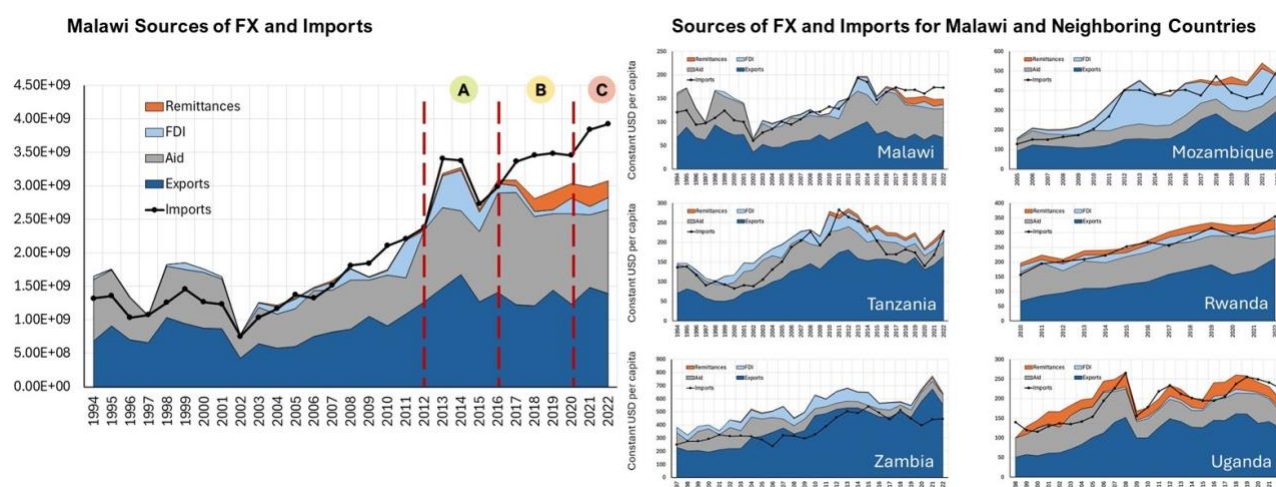
Source: World Bank World Development Indicators

Since 2010, Malawi has seen stagnation and loss of exports along with declining budget assistance (aid) and low foreign direct investment. Alongside external shock, this has been a

recipe for disaster for Malawi's balance of payments. Malawi's population continues to rise by over 2.5% per year. This means that merely maintaining per capita imports would require that foreign exchange (FX) would need to grow by at least that amount. As Figure 4 shows, Malawi's sources of FX have instead stagnated and declined. Tobacco exports have fallen from their peak at over USD 650 million in 2014 and have never reached those highs since. Tobacco currently is a declining industry globally, with global trade essentially flat since 2012. Over that time, Malawi has also lost entire export industries like uranium and textiles which were bringing in smaller amounts of export earnings. FDI has also fallen from previous highs. Looking ahead, there is future uncertainty about foreign aid as foreign governments cut back due to their domestic political dynamics, and Malawi already receives much lower budget assistance than in the past.

Some observers may say that these are just the typical challenges that countries in the region face, but this is not true – the gap in foreign exchange generation for Malawi is bigger than comparator countries. Notably, Malawi faces this foreign exchange generation problem much more intensively than other countries in the region, including Mozambique, Tanzania, Zambia, and Rwanda (Figure 5). Each of these countries has enjoyed recent export growth from sectors including mining, manufacturing, IT/ICT. At times, Malawi's macroeconomic management is compared to some of these countries, but this overlooks an important difference in that these economies are currently able to afford increasing imports while Malawi is not. In most cases, this is through recent export growth in natural resource, including natural gas in Mozambique, copper in Zambia, and gold and copper in Tanzania.

Figure 5: Malawi Sources of FX and Imports (in USD) (left graph) and Sources of FX and Imports Per Capita Terms for Malawi and Select Regional Comparators (right graphs)



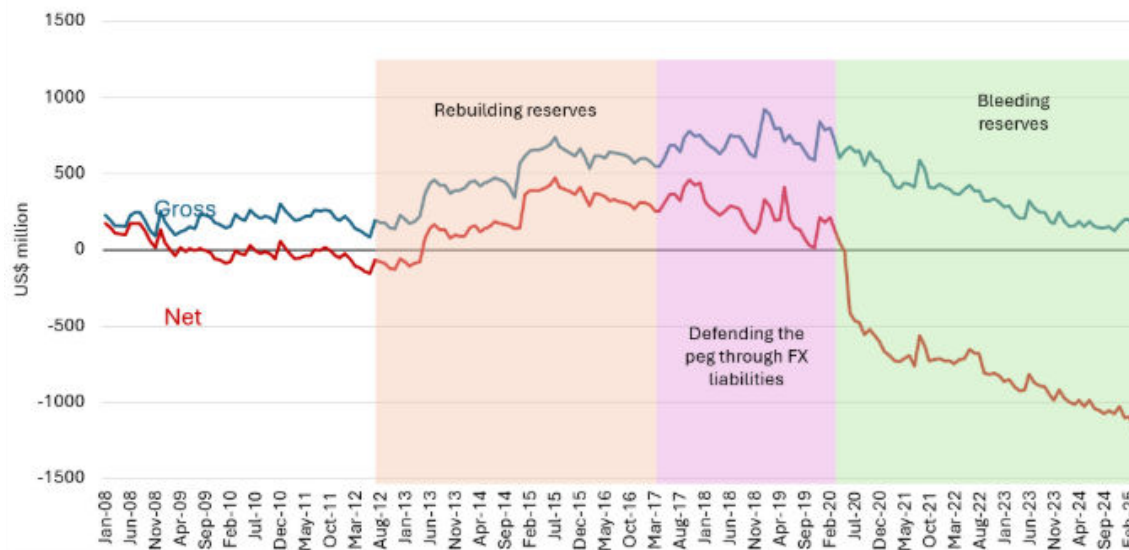
Source: World Bank World Development Indicators

Today's macroeconomic challenge has emerged within this larger and longer-term problem of exports and foreign exchange. Over the last 10-15 years, one can observe three distinct periods of macroeconomic policy. Each of these periods was an attempt to live within declining means (i.e., less capacity for the economy to import) as well as limits created by the previous policy regime. These periods are marked as A, B, and C on the left graph of Figure 5 and shown in terms of growth and net international reserves in Figure 6.

- Between 2012 and 2016 (Period A), Malawi let imports decline alongside the decline in FX generation. The kwacha was allowed to float and Malawi kept budget deficits under control. This allowed reserves to be rebuilt and keep debt low. However, in the face of rising weather shocks and declining sources of FX, especially after 2014, this meant that Malawi was forced to contract imports, which meant a sharp adjustment to lower means across the economy. Inflation during this period was uncomfortably high and this experience still looms large in the memory of policymakers today.
- Between 2016 and 2019/2020 (Period B), policymakers chose to fix the exchange rate to try to anchor inflation and drew down on international reserves that had been accumulated to defend the peg. This allowed imports to increase without the underlying FX inflows to support this. The fiscal deficit was kept at a moderate level and inflation was low. This approach was unsustainable, however, because it required Malawi to dramatically draw down reserves. It did so not by selling its gross reserves but through incurring FX liabilities at the RBM, causing the decline in net reserves shown in Figure 6. This was essentially borrowing from the future to fund the present. Once net reserves were exhausted, there were no buffers once hit with COVID-19 and subsequent shocks.
- Finally, between 2020 and the present (Period C), Malawi continues to draw down on net reserves, but additionally gross reserves have fallen to critical levels. In this context, Malawi has tried to maintain a fixed exchange rate through one-off devaluations but has seen no recovery of export and FX growth. At the same time, the fiscal deficit has widened sharply, and government has relied increasingly on borrowing from domestic banks (at high nominal interest rates) and on money creation. This has created large imbalances, rising debt, and high inflation. A large parallel-market premium has emerged as actors in the economy work to access critical foreign exchange through non-official channels. Malawi is now in a precarious position where gross reserves are as low as they were in 2012, but net reserves are much more negative. This is a result of external debt and FX swaps the RBM undertook during COVID-19 and increasingly due to FX swaps and

borrowing from domestic banks. Another shock could force a sharp adjustment in the exchange rate, and now there are much deeper FX liabilities built up in the system.

Figure 6: Malawi's Gross and Net International Reserves



Source: IMF SSA database, Reserve Bank of Malawi

This historical path reveals two important realities: (1) the limits of the most recent macroeconomic policy regime are being reached, and (2) none of the regimes has allowed for sufficient export growth to drive overall economic growth and achieve macroeconomic stability in a sustainable way. As the current macroeconomic system faces critical risks, Malawi will not be able to go back to any of the previous regimes successfully because it does not have the reserve cover. Just as importantly, no macroeconomic adjustment strategy alone will pull Malawi out of this longer-term growth problem. A sudden free float would keep the macroeconomic system more sustainable but, without other measures, would mean resigning the country to accepting lower imports and a lower standard of living much like in 2012. The next section of this briefing will provide a critical look at intersecting macroeconomic issues in a way that could help to inform policy. At the same time, it will be important to view macroeconomic adjustment as one necessary piece — but not the only piece — of the puzzle toward unlocking growth.

In addition to macroeconomic reform, Malawi will need additional strategies to engineer an investment boom in export sectors. Exporters in Malawi today are critically constrained by foreign exchange access and the same system is a major constraint to new investment from foreign companies, including in new growth opportunities. Few investors can invest in Malawi if they

cannot bring their dollars in freely to invest and if they cannot reliably take the dollar value of their export earnings out of the country. Effective macroeconomic reform will help, but an investment boom in export sectors will also require additional action to help alleviate sector-specific constraints in high-potential growth sectors. This report focuses on macroeconomic reform, but future research could focus on steps to mobilize investment opportunities once the foreign exchange constraint is lifted.

Macroeconomic reform in the current moment can appear overwhelming or impossible, but by unpacking the key issues, we find that there are four key needs for success. These are: (1) addressing the core fiscal problem that underlies debt accumulation, inflation, and the parallel market premium; (2) reducing money creation to address inflation; (3) tackling the growing vulnerability of domestic debt; and (4) developing a new anchor given the negative consequences of the current exchange rate regime.

2. Unpacking Today's Macroeconomic Crisis

There is no doubt that the economic crisis was the top issue Malawians had on their minds as they voted in September 2025. According to the March 2025 Afrobarometer Survey, 76% of Malawian voters thought that the country was heading in the wrong direction, and economic issues represent 80% of the most important problems reflected in the responses. According to the same survey, 76% of Malawians believed government was doing a bad or very bad job managing the economy, and 50% said a very bad job. A July 2025 Institute for Policy and Opinion Research survey conveys a similar story, with 87% describing the current economic conditions as bad or worse, and more than half as very bad.

Out of many challenges, the Growth Lab analysis suggests that there are four issues that will be most critical for a successful macroeconomic turnaround. This section provides analysis across each in order: (1) the core fiscal problem; (2) the cause of inflation, (3) the ticking time bomb of domestic debt, (4) the consequences of the current exchange rate regime. Ultimately, the Government of Malawi must develop a coherent vision across these four issues that addresses their causes and intersecting nature. If it does, IMF and donor support should follow that vision. This vision does *not* need to address all problems at the same time, however. Based on the overall analysis, Malawi most critically must restore access to foreign exchange in the economy in the short-term, but to do so, it also needs a credible longer-term path to fiscal sustainability and an exit path from the ticking time bomb of domestic debt. The following sections unpack the issues to the extent that publicly available data allows.

2.1 The Core Fiscal Problem

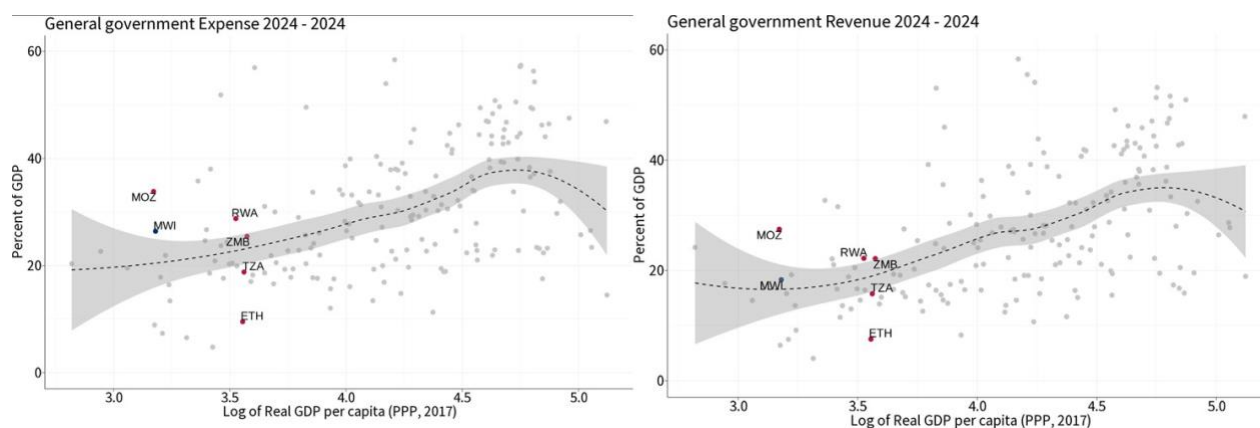
At the core of the current macroeconomic crisis is a fiscal problem. The fiscal problem can be thought of as the reason why a festering balance of payments problem transformed into a multi-faceted macroeconomic crisis. Therefore, a path to fiscal health is needed for any shorter-term macroeconomic measures to have durable success. As this section will discuss, the government of Malawi has taken on spending responsibilities that it cannot fund with current revenues and taxes. This gap causes a revenue gap that the government must finance domestically (since external financing is not possible). This domestic financing comes from domestic borrowing at expensive rates and money printing by the RBM. Money creation by the RBM results in more kwacha chasing fewer dollars and imports. This results in exchange rate misalignments and price pressure. In the context of a fixed official exchange rate, this results in depreciation of the parallel rate and a widening parallel-market premium, which is then reflected in higher domestic prices and inflation. As will be explained, recent inflation is not mainly the result of food shocks or exchange rate movements, but of rapid growth in the money supply driven by the RBM's financing of the government deficit. Unless the fiscal deficit is credibly reduced, the pressure to finance it with money creation will remain, perpetuating the cycle of exchange rate pressure, parallel rate depreciation, inflation, and macroeconomic instability.

The IMF warns that Malawi needs urgent fiscal action (IMF Article IV, August 2025). The fiscal deficit is projected to reach 10.1% of GDP in 2025, financed largely through expensive domestic borrowing and central bank advances. Public debt is expected to be around 80% of GDP, with interest payments alone absorbing close to 6.6% of GDP, which crowds out space for health, education, and infrastructure spending. A large share of the fiscal imbalance comes from the interest burden, which may be eased through debt management tools such as external restructuring, longer maturities, and less reliance on short-term domestic debt. But stabilizing debt requires more than lower interest costs. The IMF estimates Malawi must move the primary deficit of 3.5% of GDP today to a deficit of 1% of GDP in the near term and to a surplus of about 2% of GDP over the medium term to stabilize the debt trajectory. Closing the gap requires revenue mobilization and expenditure rationalization measures, which would also help to ease the interest burden by lowering the cost of borrowing.

Malawi's fiscal challenge lies in spending above its means while collecting only average levels of revenues (Figure 7). On the revenue side, Malawi lies close to the fitted line for its income level, suggesting that overall performance is in line with expectations. Yet comparisons with landlocked peers such as Rwanda and Zambia show that significantly higher revenue collection

levels are possible. On the expenditure side, Malawi sits above the fitted line, spending more than would be expected given its income level and revenue capacity. Together, these trends mean that Malawi is spending like one of its better-performing peers but collecting revenues only at the level predicted by its low income.

Figure 7: General Government Expenses and Revenue and GDP per capita, 2024



Source: Based on World Economic Outlook (April 2025)

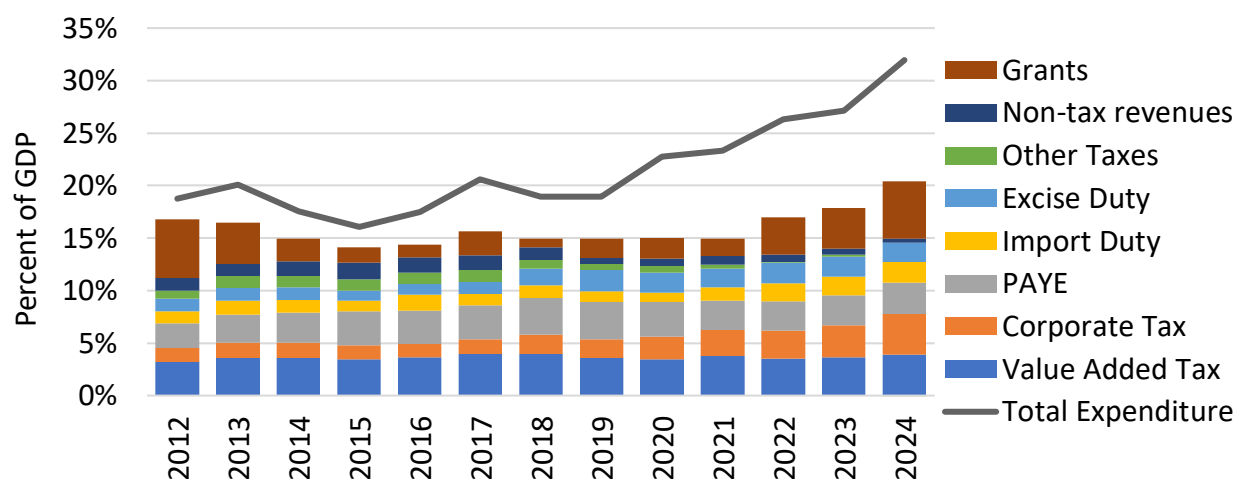
When looking at the evolution of revenue and expenses, revenues have increased since 2022, fueled by higher corporate taxes, import duties, and grants, but this growth has not kept pace with the surge in expenditures (Figure 8). Consolidation must therefore act on both fronts: raising more revenue, as peers have shown possible, and reprioritizing expenditures to ensure scarce resources are directed toward growth-enhancing uses. Closing this gap is not only about balancing the budget, but about building a stronger, more resilient fiscal foundation that reduces reliance on monetary financing and external aid while creating space for investment in growth and social priorities.¹

Raising more revenue is essential, but it must be done in a way that strengthens rather than weakens the economy. There is broad agreement that Malawi has room to improve revenue collection, but the strategy matters. There is a trade-off between raising tax rates and broadening the tax base. While further research is needed, raising rates can deliver quick gains but risks depressing consumption and investment, widening informality, and further discouraging

¹ If made available for research, government data could be utilized to a much greater extent than covered here to better understand the original causes of the unsustainable path as well as to inform effective tax measures and expenditure strategies.

compliance. A more durable and equitable approach is to broaden the base by closing loopholes, rationalizing exemptions, and tightening enforcement to reduce evasion and avoidance. This strategy not only raises more revenue, but also improves fairness, levels the playing field across firms, and makes the system more resilient.

Figure 8: Revenue Sources and Total Expenditure



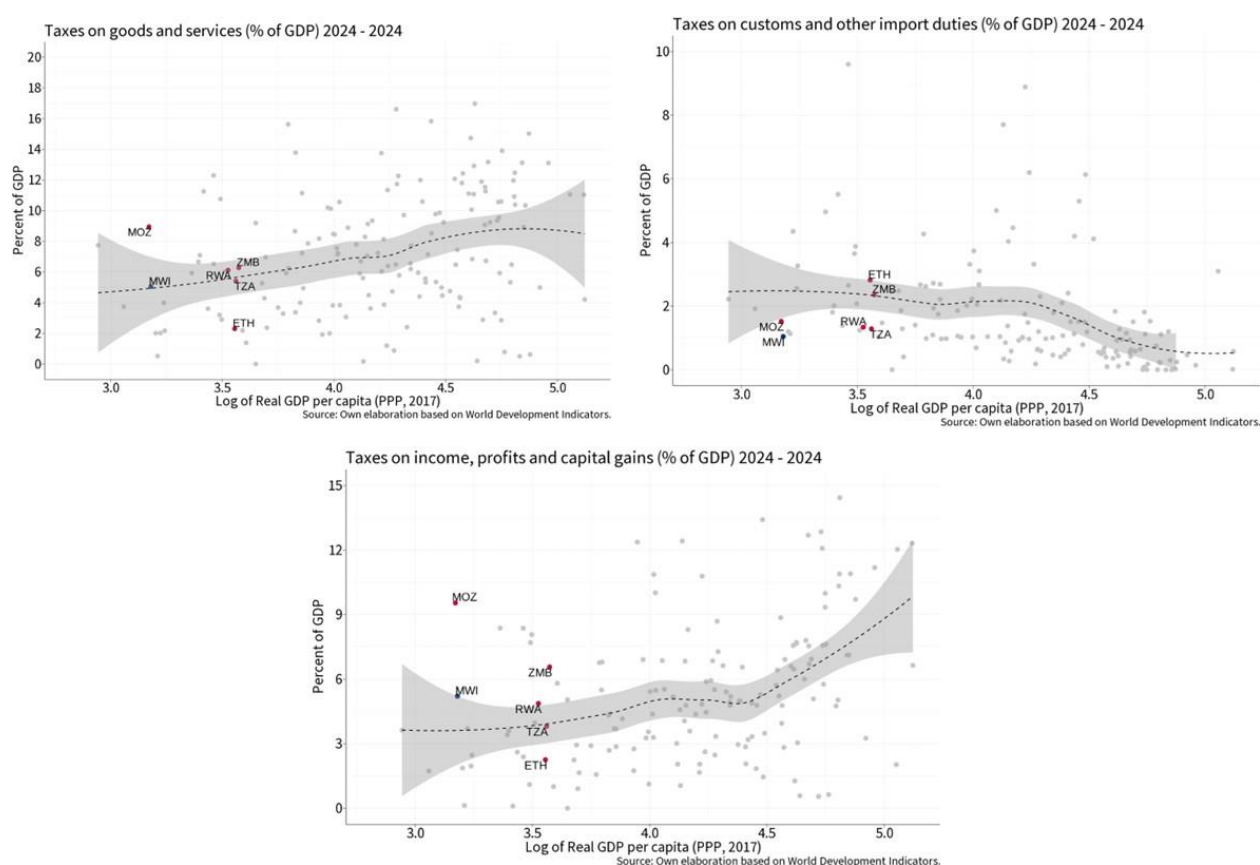
Source: Reserve Bank of Malawi

Peer comparisons show that Malawi’s revenue effort lags in key areas, while others perform more strongly. On taxes on goods and services (incl. VAT and excises), Malawi collects around 5% of GDP, broadly in line with its income level, but below peers like Rwanda and Zambia, which collect closer to 6–7% (Figure 9). This highlights potential for Malawi to raise more from consumption taxes by improving compliance and coverage. On trade taxes, despite the increasing trend since 2022, Malawi collects less than 2% of GDP from customs duties, below the fitted line and below most peers (Figure 9). Weak customs enforcement, exemptions, and under-invoicing all contribute to this gap, suggesting there is significant scope to raise revenues without raising tariff rates. By contrast, on income and corporate taxes, Malawi performs relatively well, collecting around 6% of GDP, above the fitted line and higher than some peers (Figure 9). Malawi’s revenue problem lies on an underperformance in VAT, excise taxes, and customs.

Peer experience shows that revenue reform is possible and effective. Both Zambia and Rwanda raised revenues not by sharply increasing rates but by broadening the base, cutting exemptions, expanding VAT coverage, and investing in digital tools such as electronic invoicing, e-filing, and customs modernization (Salvadori, 2025; IMF, 2023; Aguirre Unceta, 2021; Zambia Revenue

Authority, 2025; Nose and Mengistu, 2023). Malawi could follow a similar path. The IMF's Article IV highlights the urgency of phasing out costly exemptions and incentives that drain revenue without spurring growth. At the same time, the Malawi Revenue Authority can expand e-filing and e-payment platforms, strengthen enforcement of electronic fiscal devices, and improve compliance through systematic audits and the use of third-party data. These reforms would make existing taxes more effective and more fairly distributed. While many of these reforms are in the Domestic Revenue Mobilization Strategy (DRMS) (2021-2026) that was prepared with support from IMF CD, implementation has been slow.

Figure 9: Selected Tax Sources and GDP per capita, 2024



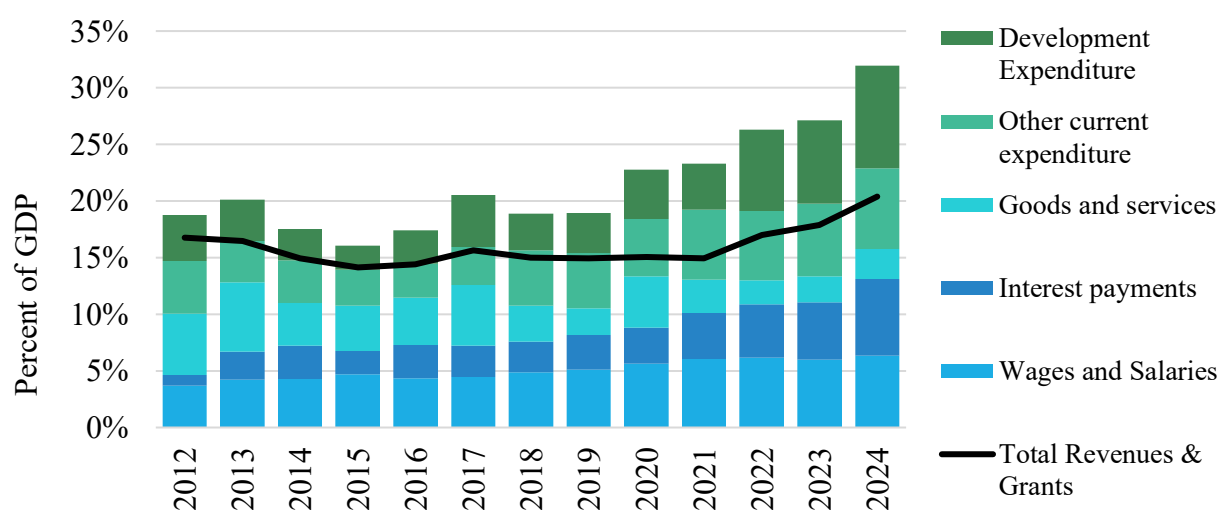
Source: Based on World Development Indicators and World Economic Outlook

Revenue mobilization should not be seen as austerity, but as an investment in Malawi's future. By broadening the base and strengthening compliance, Malawi could gradually reduce reliance on costly domestic borrowing and central bank financing, which would help to lower interest costs, curb inflationary pressures, and restore confidence. At the same time, a more predictable and transparent tax system can improve the business climate, level the playing field

for formal firms, and crowd in private investment. To sustain public support, the government should link revenue gains to visible improvements in health, education, and infrastructure, reinforcing the social contract. In this way, revenue reform can become the cornerstone of a virtuous cycle: stabilizing the macroeconomy, creating fiscal space, and unlocking the resources needed for inclusive growth.

On the expenditure side, the challenge is less about the overall size of the budget than about its efficiency and composition. While spending is only slightly above what would be expected for its income level, the structure is dominated by recurrent pressures (wages, subsidies, and a rising interest bill) alongside capital expenditures whose efficiency is often limited. As shown in Figure 10, expenditures have risen steadily since 2020, driven by wages, subsidies, interest payments, and (especially) development spending, which have all grown faster than revenues. Based on available data, there is not one dominant factor contributing to ballooning expenditures. Instead, there are four key factors that a comprehensive strategy would address.

Figure 10: Expenditure Sources and Total Revenue



Source: Reserve Bank of Malawi

First, while the wage bill is not excessive by international standards, it has been rising quickly and requires stronger payroll controls and allowance reforms. Conversations with analysts highlight that allowances and per diems have become a significant hidden wage-related cost. These payments are often poorly monitored, subject to abuse, and disconnected from performance or service delivery needs. Per diems for workshops, travel, or routine meetings are widely viewed as a form of income supplementation rather than reimbursement, distorting incentives and creating

fiscal leakages. Tackling this issue would not only help contain the wage bill but also improve equity within the civil service and free up resources for frontline delivery.

Second, the Affordable Inputs Program remains costly and poorly targeted, absorbing fiscal space without delivering commensurate productivity gains nor poverty alleviation. Between 2016/17 and 2021/22, around two-thirds of Malawi's agricultural budget went to subsidies, while less than 11% supported irrigation, research, or extension (World Bank, 2025). Studies show that subsidies deliver modest and uneven productivity gains, often benefiting better-off farmers and crowding out private input markets (MwAPATA, 2023; Chirwa and Dorward, 2013). Recent evidence also finds that non-poor farmers achieve higher fertilizer efficiency, raising maize yields by 3-4 kg per kilogram of nitrogen applied, even after accounting for crowding-out (Darko, 2024). These findings highlight a trade-off: Malawi's subsidy program cannot maximize both productivity and poverty reduction at the same time. Better targeting subsidies to more efficient farmers could raise productivity, while freeing fiscal space for poverty-focused transfers. Gradually reducing untargeted fertilizer support would liberate resources for public goods, such as rural roads, irrigation, and extension, that deliver broader growth dividends. In this way, smarter subsidy design could support both poverty alleviation and long-term growth by reallocating resources toward more effective uses. However, with food insecurity looming and a lack of short-term solutions, the political constraints to needed change in the program are significant.

Third, capital expenditure has expanded in recent years, placing Malawi above many peers in the region, but there are weaknesses in public investment management, with many projects fragmented, underfinanced, or poorly sequenced. The IMF also stresses that infrastructure gaps remain severe. Malawi lags behind or far behind regional peers on key indicators such as access to electricity and broadband penetration, which limits private sector competitiveness and raises production costs. Fiscal dominance and foreign exchange shortages have compounded these issues, crowding out private investment in energy and transport and discouraging long-term financing. Without better project selection and oversight, high levels of development expenditure will continue to deliver a limited growth impact.

Finally, Malawi's fiscal position is further undermined by hidden liabilities from fuel imports and state-owned enterprises. The suspension of the automatic fuel pricing mechanism has meant that domestic pump prices are kept well below cost recovery, currently estimated at 32% below import parity for petrol and 19% for diesel (IMF, August 2025). This policy has created arrears of nearly MK1 trillion owed by Malawi Energy Regulatory Authority (MERA) to Petroleum Importers Limited and the National Oil Company of Malawi, while another MK450 billion in unpaid fuel levies has eroded financing for road maintenance and rural electrification

programs. These arrears represent a direct fiscal risk: if cleared abruptly, they could wipe out the space for priority spending. At the same time, contingent liabilities from SOEs, particularly in fuel, energy, and water, are mounting. Many SOEs operate with weak governance, off-budget borrowing, and quasi-fiscal activities that accumulate “below the line,” masking the true size of the deficit and distorting the government’s fiscal accounts. This not only obscures the scale of Malawi’s fiscal problem but also creates the risk of sudden crystallization onto the public balance sheet, further worsening debt sustainability. Addressing these risks will require stronger oversight, greater transparency, and reforms that prevent hidden liabilities from undermining fiscal stability.

Improving the efficiency of spending is therefore an opportunity as well as a necessity. By reducing untargeted subsidies, managing the wage bill more effectively, and strengthening investment quality, Malawi can reorient fiscal policy away from consumption and toward growth-enhancing public goods. These reforms involve trade-offs. Subsidy reform will face political resistance, containing the wage bill may be unpopular with public servants, and reprioritizing capital projects could delay some investments. Yet the dividends are greater. Fiscal space for health and education, higher agricultural productivity through rural infrastructure and irrigation, and stronger trade capacity through better logistics and energy. In this way, expenditure reform can support fiscal consolidation while also laying the foundations for growth and resilience.

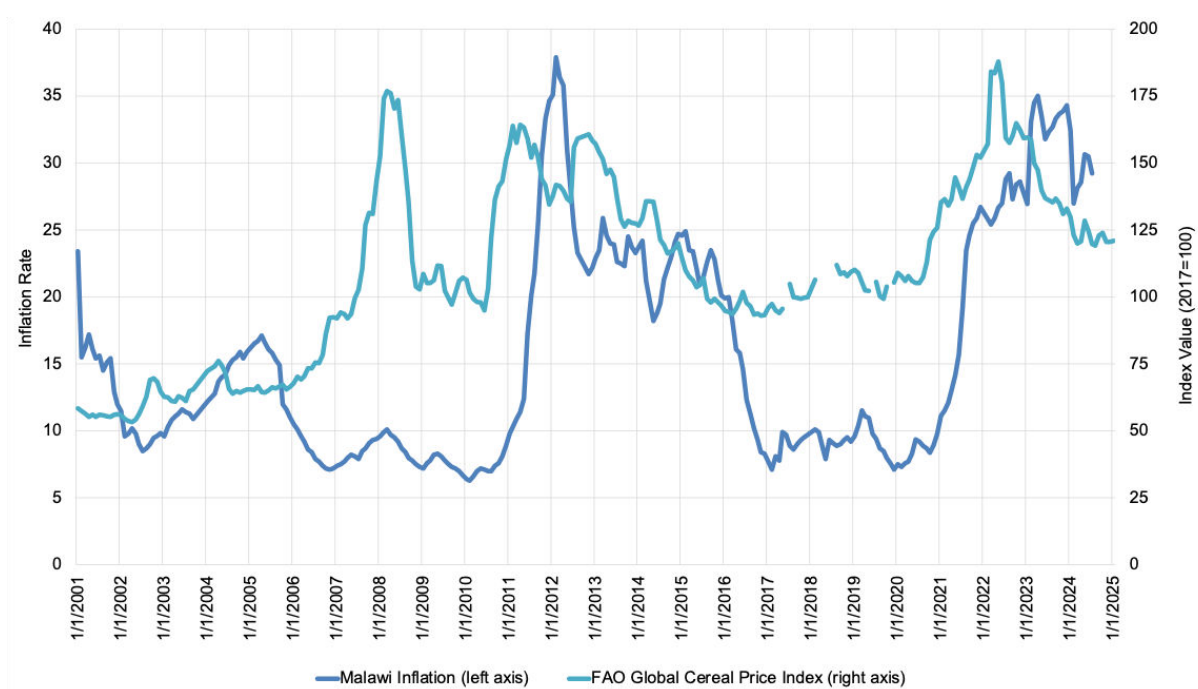
2.2 What is Causing Inflation?

Inflation has been a serious and persistent challenge in Malawi over the last several years. Year-on-year inflation has remained at above 25% throughout all months of 2025. This is a reduction from throughout 2024, when it was over 30%, but this rate is far too high for Malawian families to retain the value of their income and for businesses to operate efficiently. Malawi has experienced recurring battles with inflation. In 2012, inflation peaked at 40% and remained elevated until 2016. Inflation was, notably, brought down to below 10% from mid-2017 until the final months of 2021. So, what has caused inflation to grow and persist since then and what will it take to bring inflation back under control?

Food shocks have contributed to previous inflationary episodes in Malawi, but this is not the cause of inflation today. Malawian analysts often point to global food prices, domestic maize production, and exchange rate passthrough as the central drivers of inflation. These channels are consequential, but they are not always the main causes. Figure 11 shows the Food and Agriculture Organization of the United Nations (FAO)’s global cereal price index alongside inflation in Malawi. The global cereal price captures a sharp rise in cereal prices in 2007-08, which put pressure on prices but did not cause a large inflationary event, and global increases in 2011 and

2021 that do coincide with the start of inflationary episodes in Malawi. Malawi has also experienced localized weather shocks (droughts, floods, cyclones) that have impacted local food production and food security in other periods, most notably 2004-05, 2015-18, and 2023-today. Over 2012-15, Malawi faced persistently high global food prices at the same time as it lost purchasing power on the global markets as the kwacha depreciated during a floating exchange rate regime. This appears to be a substantial driver of inflation during that period, even as the relative price of food versus non-food items during that period did not rise according to official data as one would expect if food supply shocks were the main cause.

Figure 11: FAO Global Cereals Price Index and Malawi's Overall Inflation

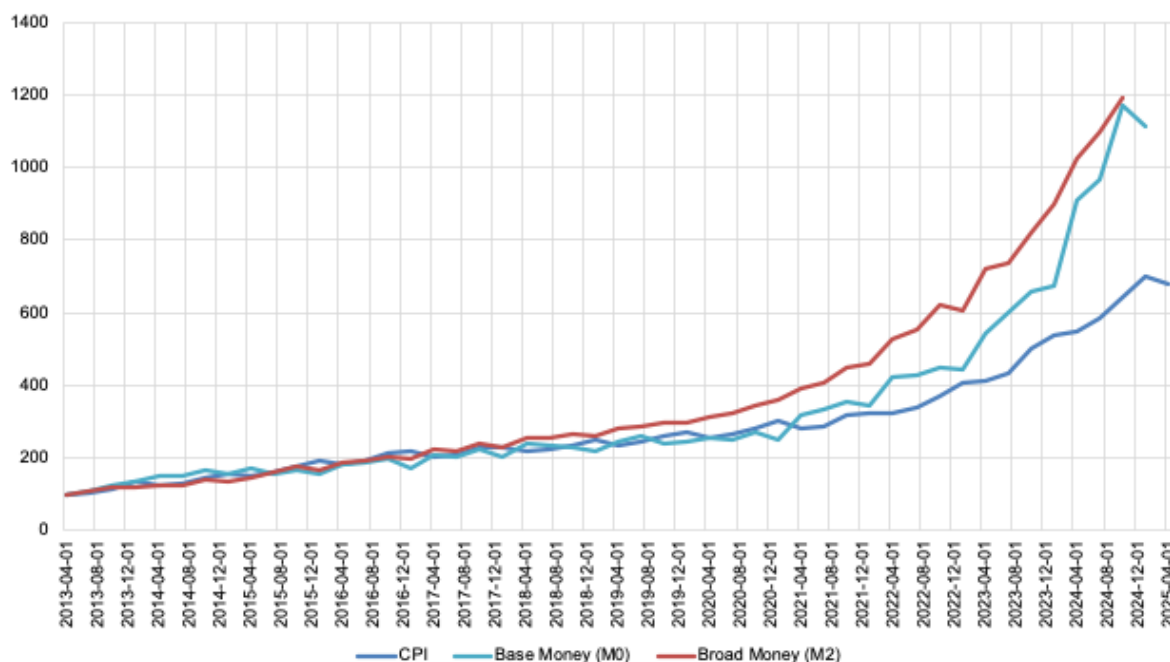


Source: FAO and Reserve Bank of Malawi

Today's inflation reflects a different profile and is subject to a substantial new driver: growth of the money supply. Current inflation remains elevated even as global prices have come down and as the exchange rate has been very close to fixed at close to 1700 kwacha/USD since November 2023. Starting in 2021 and increasing since 2023, the RBM was expanding base money unlike ever before. As shown in Figure 12, base money has been expanded rapidly over this period by a factor of more than four. This expansion has accelerated the growth of broad money, which has put immense upward pressure on inflation (the rate of change of CPI). The acceleration in base money growth in early 2021 precedes an acceleration in CPI growth (higher inflation) by 3-6 months. This occurs again in 2023. Based on Figure 12, a recent decrease in base money at the end

of 2024 may be having a lagged impact on inflation in 2025, however there are also signs of seasonality. More recent indicators will show if the preceding trend continued into 2025. Unlike 2012-15, this recent period of high inflation has come with increasing relative prices of food even as global food prices have declined. This suggests that a consequence of the fixed exchange rate and current foreign exchange scarcity is an inability of the economy to import food on the global market and benefit from lower prices.

Figure 12: CPI, Base Money and Broad Money Indexed Values (April 2013 = 100)

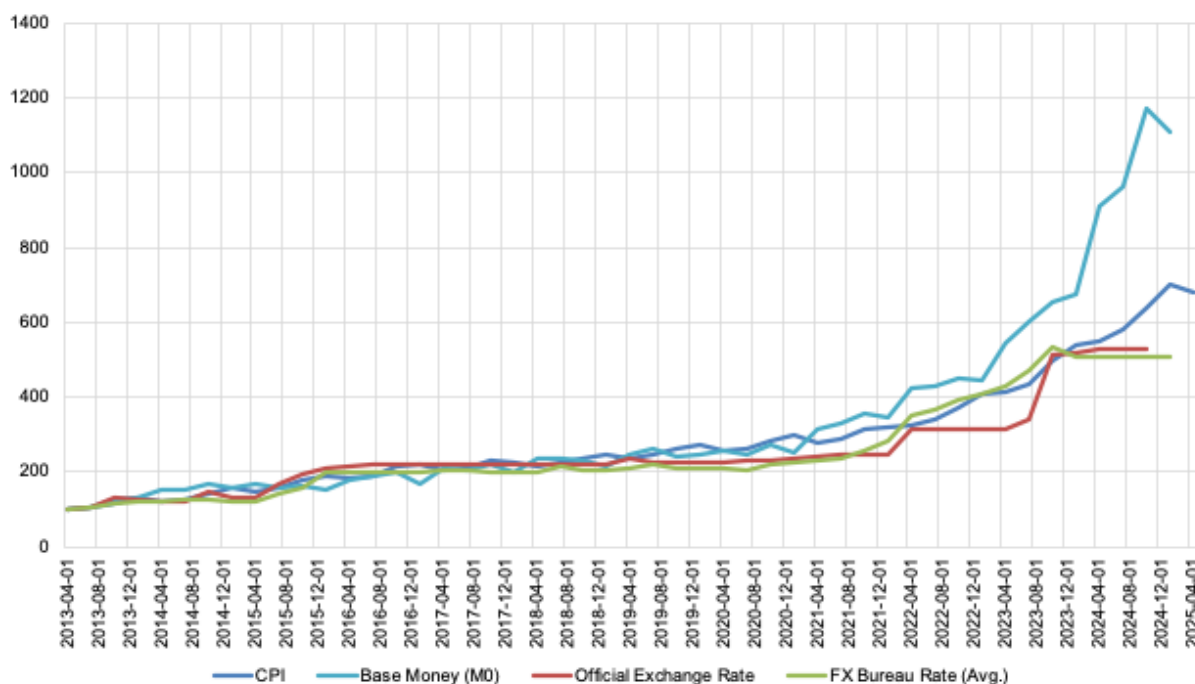


Source: Reserve Bank of Malawi

The official exchange rate channel is another widely acknowledged source of inflation in Malawi, but recent patterns show that causation runs differently: money creation is causing inflation and depreciation in the parallel market, which then forces an official rate adjustment eventually. Depreciation raises the cost of imported goods, which passes directly into the consumer price index. For one-time devaluations, these impacts are generally short-lived as prices adjust. Meanwhile, continued inflation can effectively force a devaluation, which appears to be the more striking pattern in Malawi. Figure 13 once again shows base money benchmarked to 2013 along with CPI (same as previous graph) but this time the graph also shows the official exchange rate and the average rate at regulated foreign exchange bureaus. As inflation accelerated since 2021, the more market-determined price of foreign exchange at FX bureaus also accelerated. The devaluation at the official rate in 2023 can be seen as an adjustment to catch up with these fundamentals, but base money growth and inflation continued thereafter. At this point, the

allowable rate at FX bureaus was capped and these ceased to be market clearing. Recently published estimates of the parallel market rate by the IMF put it at 2-3 times the FX bureau rate in 2025 (IMF Article IV Report, August 2025). These patterns are a clear indication that inflation should not be seen as a symptom of depreciation in Malawi; it is more accurate to treat devaluations as a delayed consequence of a monetary imbalance. Likewise, the parallel market for foreign exchange is not the cause of inflation, but rather a symptom of this same imbalance.

Figure 13: CPI, Base Money, and Exchange Rates Indexed Values (April 2013 = 100)



Source: Reserve Bank of Malawi

The evidence is clear that current inflation cannot be brought down to desirable levels without lowering the rate of money creation. This can be viewed as good news because it means that the power to control inflation is within the power of government much more than if the main cause were food related or external shocks that are outside of government's control. The proximate cause of this recent monetary expansion has been partial financing of the large fiscal deficit by the RBM through its net claims on government (NCG). More specifically, the RBM is re-purchasing a share of the government securities initially purchased by domestic commercial banks on the secondary market by expanding the money supply. Slowing this growth is clearly more easily said than done. With a rising primary deficit and declining aid flows, government is left with few options to finance critical spending. We estimate that the inflation tax helps generate more than 2% of GDP per year in financing for the government. But this reliance has created a vicious cycle.

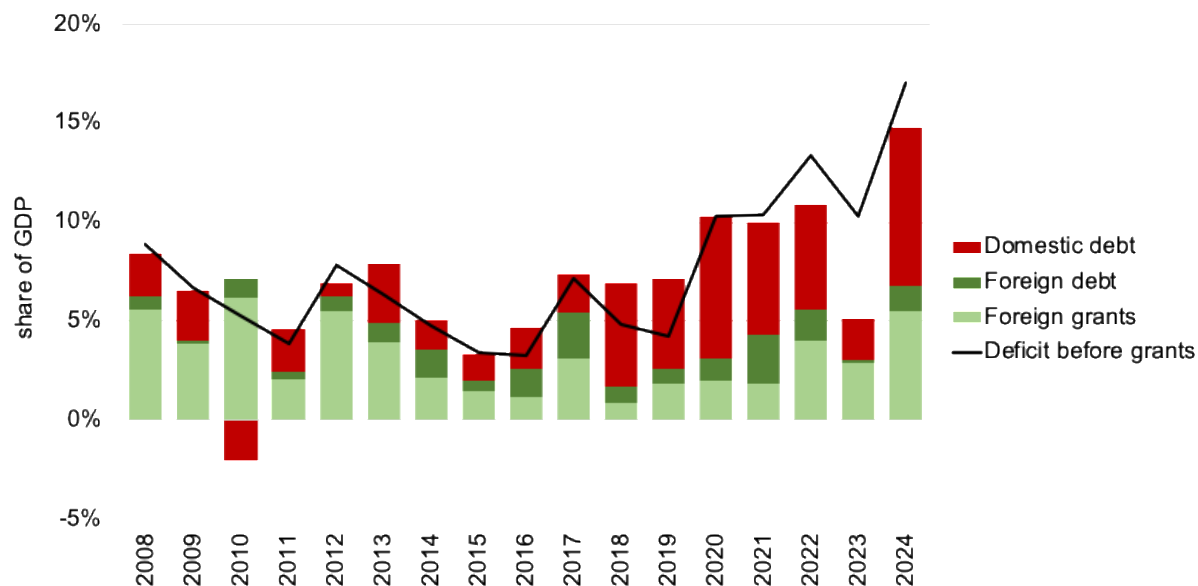
Fiscal deficits lead to money creation, which fuels inflation and depreciation pressure, which in turn raises expenditure needs and deepens the deficit. Solutions are not easy but without addressing this root cause, inflation would continue even after a large devaluation if this source of excess money creation is not slowed down.

2.3 Domestic Debt: A Ticking Time Bomb

Debt accumulation is on an unsustainable path and the main risk moving forward is heavy reliance on domestic banks at high nominal interest rates. By the end of 2024, Malawi's public debt stock reached USD 10.3 billion (83 percent of GDP). Of this, 42 percent was external (and largely in foreign currency) while 58 percent was domestic, mostly denominated in kwacha. Looking only at the stock of debt may suggest that external debt is a larger cause for concern than domestic. Malawi's external public debt stood at USD 4.4 billion (37 percent of GDP) at the end of 2024, with arrears already USD 669 million. Since external debt is denominated in foreign currency, this stock of debt is problematic in relation to Malawi's low foreign exchange generation, and arrears at such a level clearly require negotiated solutions. However, the actual debt service burden on external debt is relatively low. Around USD 3.1 billion (70 percent) of Malawi's external liabilities are owed to multilaterals such as the World Bank and African Development Bank, which typically do not restructure. The remainder is owed to bilateral and commercial creditors. This last group includes African Export-Import (Exim) Bank and the Eastern and Southern African Trade and Development Bank (TDB), which are now involved in ongoing debt restructuring negotiations with government.

The most striking feature of Malawi's debt is the degree to which it has increasingly relied on domestic borrowing to finance a larger and larger fiscal deficit over the last five years (Figure 14). By 2024, the fiscal deficit before foreign grants had tripled as a share of GDP versus the norm prior to 2020. As can be seen in the figure, government borrowing had earlier transitioned to heavy reliance on domestic borrowing as of 2018 as the macroeconomic policy regime evolved at the time. As the fiscal gap demanded a sharp increase in financing, public borrowing from domestic commercial banks increased further. In 2024, domestic debt issuance amounted to 8 percent of GDP. Commercial banks have thus far been happy to lend government money, which has resulted in high bank profitability, but this is not guaranteed into the future. The practice increasingly distorts the financial system and may undermine the sustainability of the asset base of banks' balance sheets. Furthermore, the interest burden of this debt is growing (to more than 6% of GDP) and crowding out fiscal space.

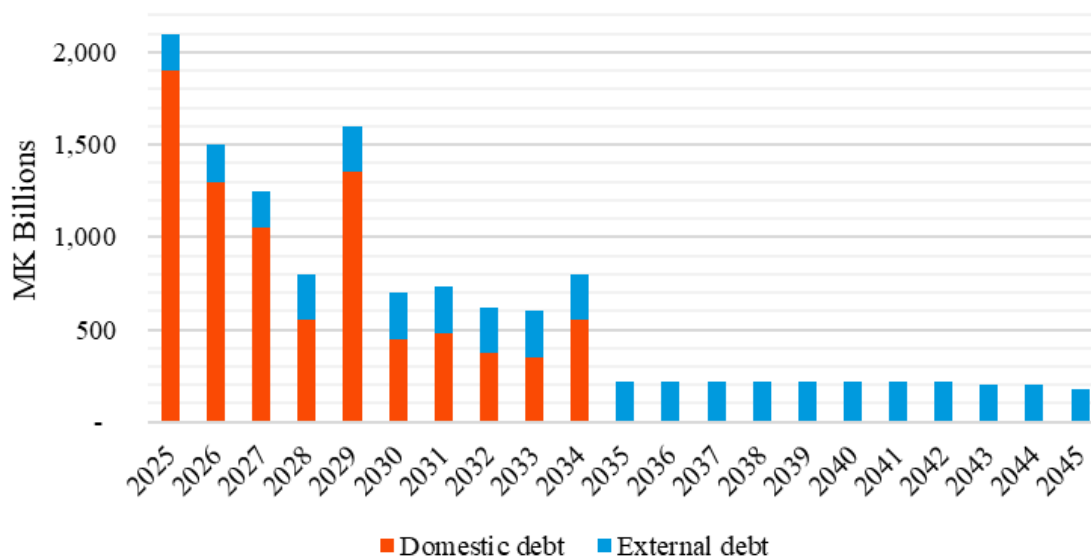
Figure 14: Fiscal Deficit Before Grants and Sources of Grants and Financing



Source: Reserve Bank of Malawi

The scale of domestic borrowing is rapidly increasing — at high costs for government and high profits for domestic banks — and the scale would become much higher if inflation is lowered. Domestic borrowing has been heavily skewed toward short-term maturities at high nominal interest rates. As a result, debt payments due each year are overwhelmingly on domestic loans (Figure 15). Short-term treasury bills pay between 16–26% interest, and longer-term notes pay 29–35%. With inflation running at close to 30%, this cost is effectively passed along to society to pay as an inflation tax. Reliance and costs are increasing. In 2024, the government spent MK 1.2 trillion on interest alone — 62% more than the year before. In practice, this means the government is already using about 4–5% of GDP every year just to cover interest, and that burden will only grow heavier if inflation falls as we would want it to. The IMF’s latest Article IV report (August 2025) projects a rise in the interest bill to 8 percent of GDP in FY2025/26 and anticipates that the interest bill alone will exceed 40 percent of total government revenue (including grants) in 2026. This puts into perspective the extreme degree to which other public spending priorities are increasingly crowded out due to the cost of past borrowing. This dynamic is set to worsen. Domestic debt is projected to climb from 50 percent of GDP in 2024 to 66 percent in 2030, even as total public debt falls. With external debt access largely closed, domestic financing needs will continue to be necessary. With maturities largely short-term, this does provide space for future (nominal) interest rates to adjust downward if inflation does decline.

Figure 15: Debt Maturity Profile by Domestic and External Debt



Source: RBM, IMF

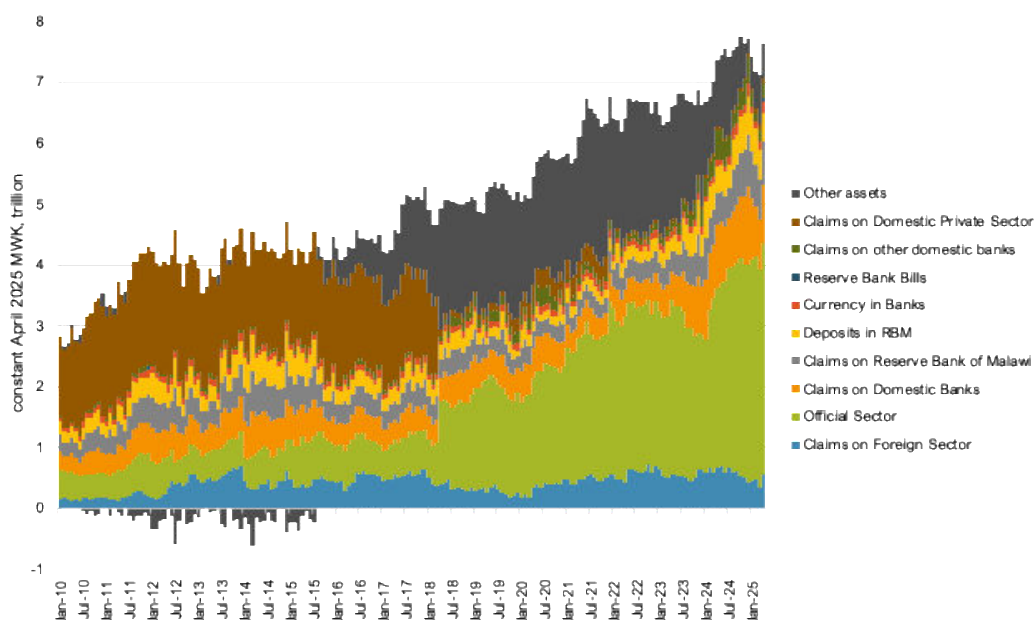
As this reliance on government domestic borrowing continues, the credit market becomes increasingly distorted to an extent that may lead to an abrupt end in bank willingness to finance the government. Currently, domestic banks are profiting immensely from these loans. These profits stand out as an anomaly among large businesses in Malawi and banks in Malawi also stand out among businesses across all of Africa.² Inflation is high, and real interest rates are negative, but banks are profiting on the spread between the loans they issue (largely to government) and the deposits they hold. The RBM is also repurchasing government debt in substantial volumes and expanding money supply. Domestic banks profit from this exchange. As can be seen in Figure 16, government treasuries (the green segment of the graph) are driving up bank's asset base, but there is very little lending to the non-banking private sector or "other assets". Continuing this path could be a critical risk for bank balance sheets, which may cause a pullback in official lending.

This distorted credit market also undermines growth and export generation. Currently, the financial system's increasing exposure to government debt is, to some extent, limiting credit to productive sectors, including export-oriented industries that could generate foreign exchange and strengthen Malawi's debt-servicing capacity. The private sector faces other challenges — especially foreign exchange availability and imports — that are decreasing demand for credit (in Malawian kwacha), but some amount of crowding out is inevitable. Provided there is demand for

² See: <https://african.business/2025/05/trade-investment/southern-africas-top-companies-25-the-rise-of-malawi>

credit, redirecting even 10% of current government borrowing (about MK 200 billion) toward private sector lending could double credit to energy and mining projects; sectors that could generate exports needed to ease FX shortages. Other countries provide examples of how consequential crowding out can be even in the presence of other constraints on the private sector.³

Figure 16: Asset Composition of Commercial Banks in Malawi



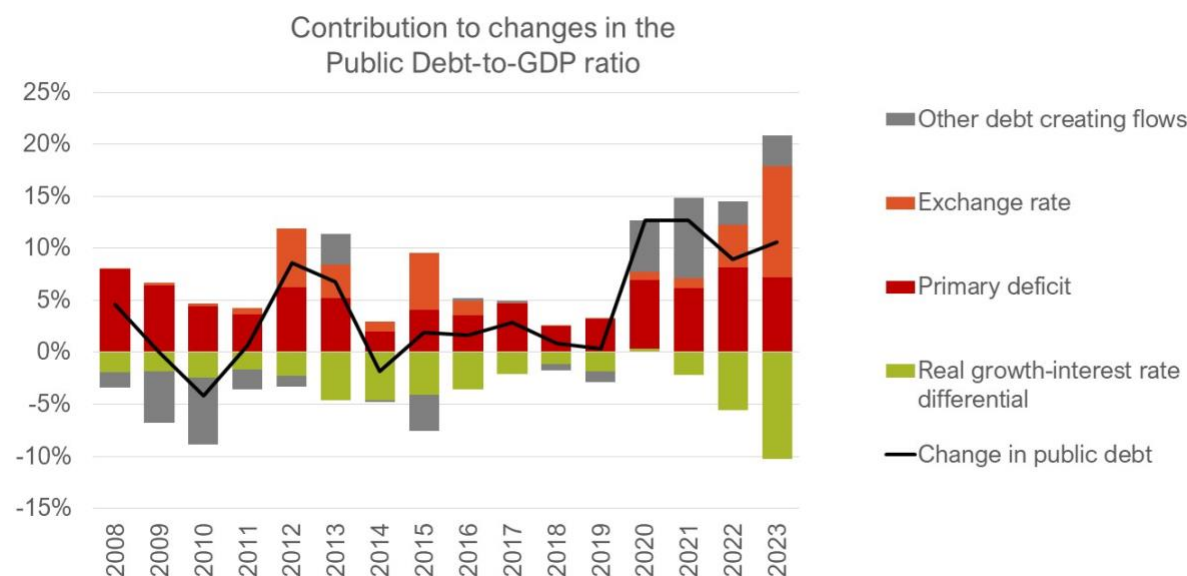
Source: Reserve Bank of Malawi

While negotiations to restructure external debt are important and ongoing, a more aggressive strategy for reducing the reliance and costs of domestic debt may be needed. Government and the IMF have both emphasized the need for external debt restructuring. Malawi has made some progress on its debt negotiations, but the sticking point remains the debt with Afri-Exim Bank and TDB. These negotiations have remained difficult and will need to continue their course for Malawi to regain debt sustainability and regain access to external borrowing in the future. However, the growing problem of domestic debt and its costs for the budget are increasingly important and threaten to cause problems for government and the banking sector if not addressed. This is not a problem that will be solved overnight. Figure 17 shows a

³ Ethiopia provides an example of scale. In Ethiopia, compulsory bank purchases of government securities diverted nearly 30% of banking assets into the public sector, constraining private lending. When the requirement was reduced in 2019, credit to private firms grew by 20% year-on-year even while firms continued to be severely impacted by foreign exchange scarcity.

decomposition of the debt dynamics for Malawi. The primary driver of increased debt, which itself is increasingly domestic, are primary deficits and other debt creating inflows. Dealing with the domestic debt issue will mean eventually transitioning the primary deficit to a primary surplus to end new issuance and better control of other flows which might have their origin in contingent liabilities. Government may also need to change how it rolls over its debt in the future as it matures or implement other strategies to retire its expensive domestic debt.

Figure 17: Decomposition of Malawi Debt Dynamics



Source: IMF and SSA

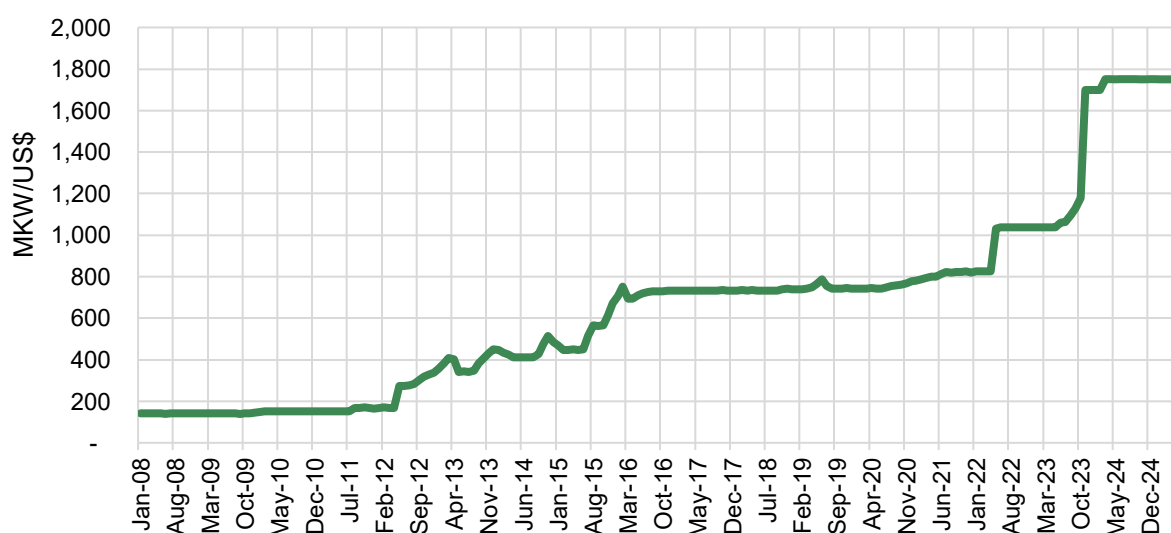
Domestic debt represents a major risk. It is unlikely that Malawi can continue to borrow from the domestic financial sector indefinitely. Government debt already makes up more than 75% of bank assets and, by definition, cannot go higher than 100%. Furthermore, interest expenses are already taking up more than 40% of revenues. At a certain point, the government will be increasingly unable to borrow more domestically. At this point, it will either be forced to finance its deficit through greater money printing leading to hyperinflation or to default on its domestic debt creating an even worse banking crisis. Careful sequencing is required to make sure that reforms do not result in such a crisis.

2.4 Consequences of the Distorted Exchange Rate Regime

The exchange rate is considered an anchor for the macroeconomy of Malawi, but it is not an effective anchor in the current macroeconomic context. In Malawi, policymakers have consistently favored exchange rate stability as a tool for ensuring price predictability, especially

given the large share of imported goods in the CPI basket. However, rather than serving as a reliable anchor for inflation, the *de facto* fixed exchange rate policy in the current environment since 2020 has coexisted with high inflation, recurring episodes of foreign exchange shortages, and need for sharp depreciation to partially adjust in 2022 and 2023 (Figure 18). As the previous section documented, depreciations are more of a response to try to catch up with inflation than a cause of inflation. The fact that inflation has stayed high despite access to essential imports at subsidized official rates suggests that the exchange rate policy and associated foreign exchange rationing have not succeeded in anchoring inflation expectations or providing Malawians with affordable imported goods. In fact, most imports and economic activity appear to have switched over to operating at the parallel market rate, which has been reported at levels 200-300% higher than the official rate this year.

Figure 18: Official Exchange Rate

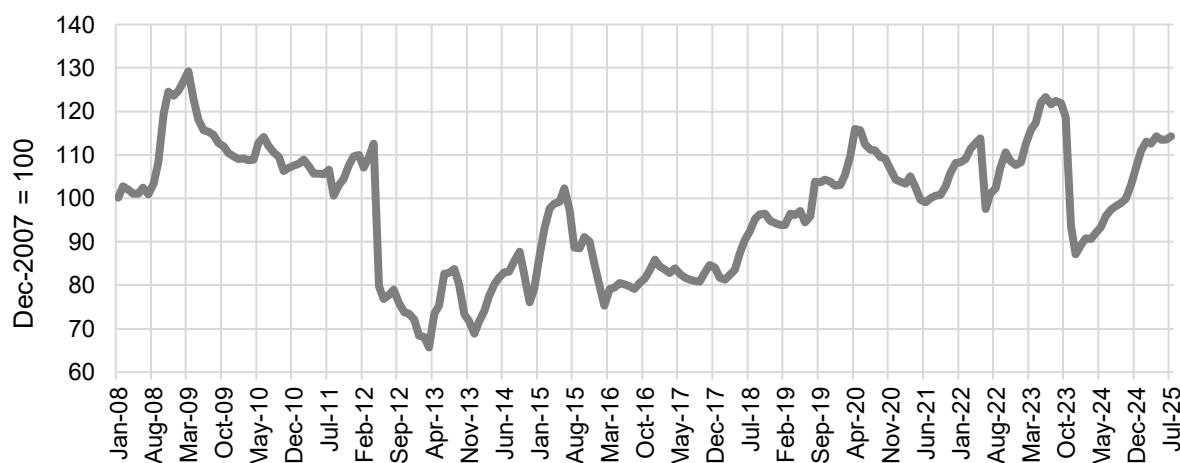


Source: RBM

Inflation and depreciation in the parallel market have prevented the official exchange rate from serving as an effective anchor. Over the past two decades, inflation in Malawi has consistently exceeded not only that of the U.S. — relevant because the kwacha is fixed to the U.S. dollar — but that of its trading partners as well. As a result, even when the nominal exchange rate remains fixed, the real effective exchange rate appreciates (Figure 19). This misalignment builds pressure for depreciation. When external shocks occur, such as a fall in export earnings or decline in aid (which have become common occurrences for Malawi), the overvaluation becomes unsustainable, and sharp corrections eventually follow. This was the case in 2012, when years of

fixing under high inflation culminated in a near 50% devaluation once donor flows were suspended and reserves were exhausted. A similar pattern unfolded in 2015 and 2023; this is the risk today.

Figure 19: Real Effective Exchange Rate



Source: Bruegel

Another sharp adjustment without solving the underlying imbalance is a clear and present danger today. Between 2019 and 2024, the RBM sold over USD 1.1 billion at the official exchange rate, a figure equivalent to 9 times the gross reserves of USD 116 million as of February 2025. This drain directly weakens the ratio of net foreign assets to money supply in the economy. This ratio represents the ratio of dollars to kwacha in the system. As the ratio decreases, pressure on kwacha increases, fueling expectations of future depreciation and encouraging speculative demand in the parallel market. The situation is further exacerbated by a sustained decline in official FX inflows, particularly due to reduced aid and concessional financing. Despite an extremely low reserve-to-import cover, a large exchange rate adjustment may not be forced in the immediate term at the time of writing (early September 2025), but Malawi may be one negative shock away from having no other choice if government purchases of critical imports become impossible.

While sharp adjustment is a concern, today's overvalued exchange rate that leads to foreign exchange scarcity is already having profoundly negative consequences on the Malawian economy — undermining long-term growth and causing short-term pain to everyday Malawians. The exchange rate tends to serve as a barometer for public sentiment about the economy's performance. This political sensitivity is not unique to Malawi. In many developing countries, especially those dependent on imports for food, fuel, and medicine, exchange rate movements translate quickly into social and political consequences. The result is delayed

adjustments, where imbalances are allowed to build up under the surface until a shock forces a sharp, and often painful, adjustment. However, not adjusting the price of foreign exchange to align supply and demand causes several severe negative consequences on people and the economy. These impact channels — several of which are summarized below — are not as obvious to the public but current indications are that these impacts are highly negative in Malawi today.

- For products where imports are rationed, including medicine, the costs are directly felt by people. These impacts are perhaps the most obvious to everyday Malawians. For products where importers who are unable to access dollars through official channels have turned to the parallel market, which raises consumer prices.
- Smuggling and arbitrage between official and parallel markets take activity out of formal channels and undermines revenue generation, which deepens the challenge of inflation discussed above. In the absence of this unavoidable response to FX scarcity, gains from ongoing fiscal reforms could be substantially larger.
- Perhaps more importantly, the system is severely undermining job creation and economic growth. Across the country, businesses who are unable to access imported inputs reliably and predictably are forced to downsize or close. Over time, as government restrictions on imports — including import bans — are utilized, businesses that rely on those imports for production are harmed. In a survey of 1,200 small businesses in October 2022, three quarters of those surveyed reported that unavailability of foreign exchange was a threat to their profitability.⁴ This aligns with overwhelming impacts of foreign exchange scarcity in a similar case, that of Ethiopia prior to a comprehensive homegrown reform program 2024.⁵
- The inability to import makes foreign investment nearly impossible in many cases. This is especially important as Malawi has lacked investment in the type of industries that have transformed job opportunities and driven growth in other developing countries. Growth Lab calculations find that Malawi has lost its foothold in 40 export products over the last decade, including garment and plastic products that have supported long-term transformation in other countries. Over time, measures that restrict certain imports (for example, cotton for garments) can wipe out entire sectors that would otherwise provide export income and jobs.

⁴ More businesses reported that FX availability was causing a strain on business (~80% of businesses) and of that a catastrophic decrease prompting a discontinuation of some business activity (20% of businesses) than the rise in import costs. About 15% of businesses saw rising input costs as causing an increase in business (see [World Bank, 2023](#)), as businesses generally prefer reliable imports at a higher price over no imports at all.

⁵ See a survey of importers conducted at the time ([Growth Lab, 2022](#))

The current system also has highly uneven benefits and costs across society and creates incentives that deepen these problems. The underlying scarcity of foreign exchange forces government to establish rules and systems that prioritize essential goods. This is necessary under the conditions, but each special system intended to direct foreign exchange creates incentives for private actors to manipulate the system. For example, while the system is intended to make fuel affordable for Malawians, in practice, the benefits are highly uneven. Importers often gain privileged access to subsidized fuel at the official rate, only to divert it for resale across borders at a profit. As a result, citizens in neighboring countries benefit from artificially cheap fuel, while ordinary Malawians find themselves long queues at fuel stations. These types of side selling and use of personal networks to access foreign exchange are ubiquitous, even under the best design of special foreign exchange windows. This means that policies for channeling FX are constantly in need of updating, akin to running to stay in the same place. Exporters, especially, face distorted incentives. By surrendering dollars at the overvalued official rate, they are effectively taxed, which reduces incentives to export and lowers official FX inflows. The widening premium, in turn, encourages remittance senders to bypass the formal banking system and sell their dollars in the parallel market, further shrinking official FX inflows.

Given the many unintended negative consequences of the current foreign exchange system, change is urgent. There are many strategies that exist between the two extremes of a fixed peg and a floating rate. The current approach to the exchange is not serving as an anchor and has deep negative impacts. Much of the economy has already adjusted to the parallel market rate, which provides some space for change without large impacts on inflation. The exact strategies for adjustment require careful design and government leadership. Approaches such as setting a rate of crawl of the exchange rate rather than a fixed peg may allow for a more gradual adjustment to begin and reveal information about impact channels that could be used to determine next steps. One example, if a full float is not possible, is to have a large devaluation and then set the crawl to offset the rate of money creation. Such adjustments may only catalyze a small improvement in the real economy but could pave the way for a longer-term adjustment strategy to reach a market-clearing equilibrium. In addition, there is a need to think critically about how to disentangle markets for critical goods like fuel, fertilizer, and medicine from the overall FX system so that they are not causing undue distortions and costs to the rest of the economy. Ultimately, Malawi will need to achieve an acceleration in exports, foreign investment, and/or other sources of foreign exchange (remittances, grants, external loans) to achieve higher levels of overall import spending and sustained economic growth.

3. Implications for the Path Forward

The current macroeconomic crisis and the longer-term export and growth challenge mutually reinforce each other; addressing the former is critical to solving the latter. The current macroeconomic environment with high inflation, foreign exchange shortages, and low bank lending to the private sector make investment in new job-creating industries difficult or impossible for some sectors. It also reduces fiscal resources available for the government to make investments that spur growth. It is important for Malawi to overcome the current crisis so that it can respond to the needs of its population and have the chance to ultimately prosper.

3.1 The Importance of Being Homegrown

Reform priorities must truly be owned, developed, and implemented by the elected Government of Malawi and the people that serve in that government. There is no substitution (including this document) for a plan that is developed by Malawians and for Malawians. This often means that the plan and path forward will look different from what external best practices or conventional wisdom say. Looking like standard reform programs is not a signal of good design. Rather, a strategy that matches evidence of the causes and interactions between macroeconomic problems is the relevant test of good reform design. A first step to developing a homegrown program is having a solid understanding of the causes of the problems Malawi faces. This policy note is meant to serve as one input to increasing understanding. The conclusions presented in this note are intended to be useful as a starting point for policymakers to review and build upon. While some of the findings in this report are not new, others cast the challenge in new ways.

3.2 Role of IMF Programmatic Support

The support of donors will be critical to any effective reform path due to the fiscal gap that that Malawi now faces as well as the balance of payments gap of foreign currency. An IMF program is likely necessary to help rebuild reserves and mitigate short-term risks from reform actions. The IMF instrument that applies in this case is the Extended Credit Facility (ECF). But rather than approach the program as a return the ECF that has just lapsed, this program should be centered on the homegrown strategy that Malawi itself develops. Development of a government-led program will take a period of time, but dialogue could begin immediately to set expectations. Malawi could initiate a set of prior actions, and there likely would need to be an initial Staff-Monitored Program (SMP) developed. IMF fiscal resources, and other donor resources that becomes available based on the credibility that the IMF program provides, are important but should not be allowed to become the drivers for reform actions. Rather, reform actions, which may be

painful in the short-term, should be prioritized based on the longer-term benefits for Malawian society. If an external shock were to strike before a program is developed (e.g., a spike in oil prices or a weather shock this year), Malawi would likely qualify for the IMF's Rapid Credit Facility exogenous shock window. This would allow Malawi to access up to USD 91 million.

An IMF program would come with conditionality, but if Malawi approaches with a truly homegrown plan of its own then this can be an opportunity rather than a problem. Having a homegrown plan that Malawi itself develops and takes to the IMF would be a more sustainable and credible course of action. This also allows Malawi to use the IMF program as a way of implementing structural reforms that might be otherwise difficult to implement for political reasons. For example, steps to remove distortions in the fuel market, reductions in the use of allowances for civil servants, or tax collection strategies that would face political opposition. In this way, conditionality can be used to the country's advantage. Such an approach was instrumental for India. In 1991, India was faced with a severe balance of payments crisis with only a few weeks of reserves left. At this time, India approached the IMF with its own plan for reforms that included important reforms to liberalizing the entire economy which along with macroeconomic reforms, laid the groundwork for India's subsequent growth take-off.

Neither a comprehensive reform plan nor an IMF program needs to be in place to take initial reform actions. In the more immediate term, the government of Malawi can take independent actions that are good for the economy and serve as a signal of credibility that reforms are government-led (if the actions represent a clear break from the past). This could include actions to further open land access for foreign investment and initial steps in fiscal, monetary, or exchange rate policy that are low risk but in line with long-term needs. Such actions could begin to cause early benefits before a more complete, homegrown strategy is developed. With all reforms, clear communication with the public on the reason behind the actions taken will be important.

3.3 Increasing Focus on Investment for Exports

To overcome the problem of low foreign exchange capacity, Malawi will have to build export capacity over the medium to long-term. This will require Malawi to engineer a (foreign) investment boom. The fundamental challenge for growth will be to develop new, dynamic exporting sectors. Thankfully, there are several sectors that could have high potential in Malawi. These include mining, commercial farming (e.g., macadamia, tea, coffee, cocoa, mangoes, etc.), cannabis, tourism, IT/ICT, and plastics manufacturing. There are also short-term opportunities for increasing remittances through increased labor migration. All these opportunities must be thought of as medium or longer-term plays. They will require investment and time to come to fruition.

Even mining, which has generated a lot of attention in the country, will only return higher earnings with a lag from initial investment in the best-case scenarios. Even then, the amount that Malawi will benefit in terms of foreign exchange is uncertain and highly reliant on global prices and on the type of deals Malawi has been able to negotiate. Foreign investment that can bring in dollars, knowhow, and market access in mining and other sectors can help accelerate the growth process while also providing needed foreign exchange. Since any effective macroeconomic reform path is going to require a fiscal contraction, simultaneously expanding foreign investment into the country is of paramount importance.

The current macroeconomic environment must be stabilized to allow for investors to act on opportunities, but non-macroeconomic constraints also hold back several high-potential sectors. The primary factor preventing foreign (and domestic) investment in the country is the unstable macroeconomic and foreign exchange environment. As this environment improves, success will be more rapid if government also relaxes the sector-specific constraints that hold back promising sectors. Mining investors need a clearer mechanism for signing Mining Development Agreements (MDAs) to move forward with projects. Commercial farming must have easy access to land and credit and investments in cold-chain and cheaper transport. Sectors like cannabis rely heavily on standards and certification. These constraints do not necessarily require a lot of financial resources, but they require focused attention and support.

A focus on unlocking foreign investment and export growth may lead to early reforms that would show that Malawi is open for business and signal credibility. Some possible steps include opening more land access for foreign and joint-venture investment from the holdings in Press-Agri, streamlining and standardizing tax incentives and access to special economic zones for any foreign investor that produces exports or creating an empowered unit to actively work with investors in export sectors to prioritize and alleviate constraints. Such actions cannot offset the need for macroeconomic reform, but they could accelerate the benefits of reforms.

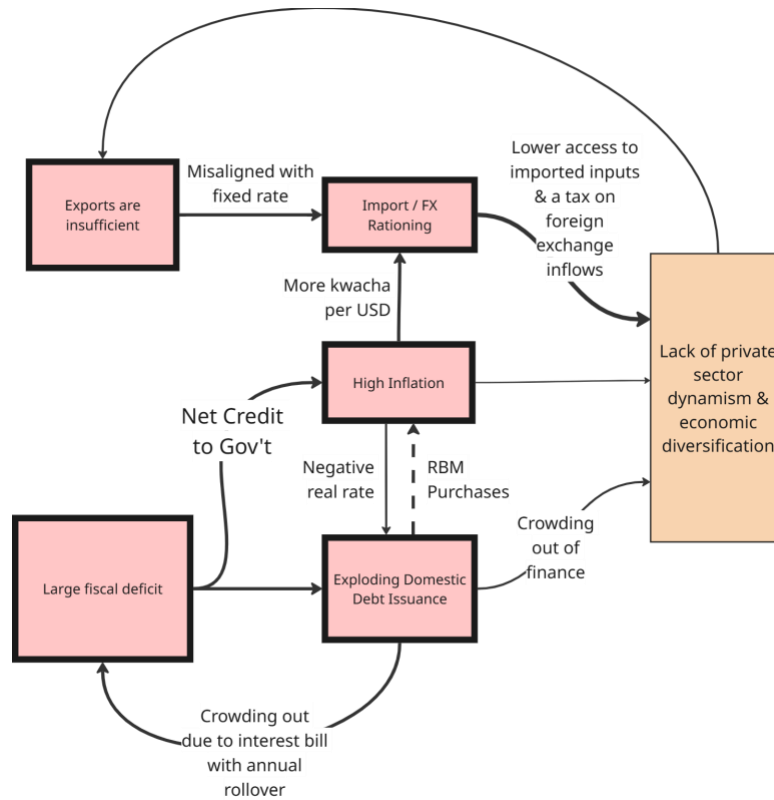
3.4 Action Points to Address the Macroeconomic Syndrome

The long-term challenge for Malawi is its widening gap between its export capacity, and the import needs of a growing population. Macroeconomic policies have tried to manage this widening gap but have made the problem worse. Figure 20 captures the macroeconomic syndrome that Malawi finds itself in. Many challenges map to the large fiscal deficit, which has grown substantially since 2020. The deficit causes government to borrow more each year from domestic banks, with short maturities and high nominal interest rates due to the absence of other viable lenders. This is allowing for high bank profitability but also increasing concentration and

risk in the financial system. The deficit also results in high and increasing net credit to government from the Reserve Bank of Malawi, which backed through treasury assets that the RBM buys in the secondary market. The resulting money creation is the driving cause of high inflation. This is a burden on society but has become a necessary means of financing the deficit. As local money supply grows, this builds up pressure foreign exchange market, which is misaligned with a fixed exchange rate. One-off devaluations that are followed by a fixed rate do not address this misalignment. Exports are struggling and other sources of foreign exchange are also lagging, forcing official access to foreign exchange to be rationed and leading to widespread, severe distortions across the economy. This foreign exchange scarcity undermines private sector activity, including that of exporters and new sources of foreign investment, which deepens the long-term export problem.

To break the cycle, reforms must: (1) Reduce the need for money creation and domestic borrowing that comes from the large fiscal deficit; (2) Allow the price system rather than rationing to clear the foreign exchange market; (3) Resolve the domestic debt issue in a careful way, and (4) Bring in investment into productive sectors that can generate exports.

Figure 20: The Current Macroeconomic Syndrome



Source: Growth Lab construction

Reducing the fiscal deficit to bring down the need for money creation and runaway debt issuance will not happen overnight, but the process must begin. Money creation by the RBM and the inflation it generates creates fiscal resources, so ending this requires finding those fiscal resources from elsewhere (by raising more tax revenues) or through reducing the financing need (by reducing expenditure). The IMF estimates that certain reforms to the VAT and other tax measures could mobilize about 3% of GDP in additional revenue. Reducing recurrent expenditure will be more difficult but a credible commitment to slowing expenditure growth is possible through freezing salaries and hiring of non-essential staff, reducing allowances, and finding other inefficiencies. Additionally, there might be room to mobilize more resources from the banking sector, which remains highly profitable, in a way that also reduces the high cost of interest from the debt held by the domestic banking sector. For example, Malawi might be able to raise reserve requirements such that less money printing is needed to raise the same amount of revenue. Additionally, Malawi may be able to retire its high-priced domestic debt lowering the interest costs which take up a larger share of its budget. Another set of policies would be to reform government debt auctions to introduce more competition among banks or to introduce retail savings products

that could compete with banks for cheap deposits. These would help the government effectively borrow at cheaper costs and reduce the unsustainable interest costs of current domestic debt.

Even as it takes time to achieve a fiscal adjustment, policymakers can change the exchange rate system to one that results in less foreign exchange scarcity. Malawi will need to achieve a market-clearing exchange rate. A full devaluation (to close the parallel market rate) followed by a floating regime may be the best option at this point. Given the size of the parallel market, arrears in the fuel system, and potential IMF and donor support for social transfers, the costs and risks of such a dramatic devaluation may not be as high as feared. Inflation impacts would be limited. In a more ideal scenario, Malawi would significantly lower money printing prior to the exchange rate adjustment such that inflation would be on the downswing. At the same time, there are technical issues with current backlogs for official FX that may take time to unwind before full floating is possible. However, if Malawi has not been able to make a large enough fiscal adjustment at the time of devaluation (or if the costs and risks of floating are considered too high in the short-term), then policymakers can still adjust the exchange rate regime to reduce shortages. One policy option would be to devalue over time to close the parallel-market premium through a crawling peg. For example, the rate of the crawling peg's adjustment could be calibrated initially to close the parallel-market premium over a 3-to-6-month period. Another strategy could be to target the crawling rate to maintain the dollar value of base money. As the market begins to clear, Malawi can then remove administrative barriers and surrender requirements which act like a tax on exporters. Understanding these options is the focus of ongoing Growth Lab research.

Domestic debt will require careful sequencing and a combination of solutions. Malawi will need to find viable solutions for its domestic debt challenge both to reduce interest costs to improve the fiscal deficit and to prevent a future hyperinflation or a banking crisis. This might include policies like raising reserve requirements, voluntary swap auctions, and other ways of engaging with the domestic banks to reprofile domestic debt. At the same time, these measures that deal with the stock of domestic debt need to be done in coordination with a fiscal adjustment that reduces the need to finance more debt domestically.

Lastly, Malawi will need private investment in productive export sectors so that the economy can sustain higher levels of growth. Malawi currently does not have the fiscal space or domestic resources to make widespread investments in infrastructure or incentivize high-potential sectors. Foreign investors bring in their own finance and foreign exchange, as well as critical productive knowhow. But getting these investors in must not be at odds with raising revenue. Instead of an overreliance on tax holidays and incentives, the focus should be on reducing the cost of business. For example, easier and longer-term visas for foreign staff, making land available for foreign

investment, funding bulk transport rates with donor support, developing SEZs with access to electricity, etc. Each investor and industry will have a different set of needs. The Malawi Investment and Trade Center (MITC) has the mandate to lead on such issues but would need to be re-oriented to successfully attract investors into the country. There may also be space for a team or unit that works to accelerate high potential investment opportunities for the country. If successful, most high return opportunities, whether they be in commercial farming, mining, tourism, or manufacturing, will take time (at least 3 to 5 years after investment) to materialize. Tourism growth may also be possible if supportive strategies are prioritized.

The specifics on many of these policies need more careful research and consideration, which must be owned by Malawians for Malawians for it to be truly homegrown. This report is *not* intended to provide specific recommendations on macroeconomic policies or other reform measures. Instead, it aims to inform a more complete understanding of the economic challenge Malawi currently faces and inform policy sequencing decisions.

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