

Resolving Malawi's Binding Foreign Exchange Constraint

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Executive Summary

This research note diagnoses the causes behind Malawi's foreign exchange constraint and identifies options for addressing the problem. Malawi is currently experiencing a severe and prolonged macroeconomic crisis, characterized by declining per capita income, crippling foreign exchange shortages, high inflation, and a rapidly growing (domestic) debt burden. Multi-faceted macroeconomic reforms are needed (see Growth Lab's previous report, "Malawi's Path out of Poverty and Toward Prosperity"). However, we find that relaxing extreme foreign exchange shortages by achieving a market-clearing rate could be achieved relatively quickly. The gains of this reform would be large, and the risks would be limited if the exchange rate realignment is matched with consistent monetary and fiscal policy. This note explains this path.

Excess money creation is the cause of both the high and increasing parallel market premium for foreign exchange and high inflation in Malawi today. Since 2020, the monetary base has expanded by a factor of four as the government has relied on the Reserve Bank of Malawi (RBM) to finance its large fiscal deficits. This has resulted in an increasing supply of Kwacha "chasing" a limited supply of dollars, which has caused a rising parallel market premium for foreign exchange. Much of the economy has, in practice, already shifted to the parallel rate, which means that the passthrough of a devaluation of the official rate on inflation would be limited. Previous one-off devaluations failed to address the parallel market premium because they did not align the path of the official exchange rate with that of money growth. Meanwhile, cracking down on the parallel market without addressing underlying causes also will not work because actors in the economy desperate for foreign exchange will always try to find workarounds.

This paper discusses options for achieving a market-clearing exchange rate to end inefficient foreign exchange rationing and bring foreign currency back into official channels. This requires an initial sharp devaluation to unify the official and parallel rates, followed by a consistent policy to prevent renewed misalignment. Two operational paths are discussed as options: a *managed float*, where the rate is determined daily by bilateral market transactions, or a *rule-based managed crawl*, which anchors the daily adjustment of the exchange rate to the path of domestic liquidity growth (see Table 1). A full float and an end to capital controls is not advisable in the current context.

Foreign exchange reform is necessary but cannot fully succeed in isolation. Measures aimed at addressing the foreign exchange shortage can work in the short-term to relax this binding constraint on growth. But these measures alone cannot restore other macroeconomic balances. To achieve lower inflation, the Government of Malawi must reduce its primary deficit and limit the need for money printing. Furthermore, policymakers must manage the fiscal impact of devaluation

and the transition of administered prices (such as fuel and fertilizer) from the overvalued official exchange rate. Failure to do so could result in a negative fiscal feedback loop, where devaluation necessitates more money printing. Macprudential policy may also allow for a reduction in the domestic interest burden, and increased donor support would help enable macroeconomic stabilization and growth. In the long term, Malawi must diversify and grow its export sectors to generate more foreign exchange. Analysis discussing these necessary dimensions of overall macroeconomic reform are discussed in the three annexes, while the note focuses on the somewhat independent options that Malawi can use to meaningfully address the binding foreign exchange constraint that the economy currently faces.

Table 1: Post-Unification Exchange Rate Options At-a-Glance

Key consideration	Managed float (single rate)	Rule-based crawl (NDA-anchored)
How rate is set	Daily market transactions determine the rate; RBM publishes a reference rate that is average of these transactions.	RBM sets a pre-announced daily depreciation path linked to NDA growth.
Expectation anchor	Current and expected fiscal and monetary policy	Current and expected fiscal and monetary policy and the crawl rule
Operational demands	Requires deep, competitive FX markets and reserves to smooth volatility.	Requires rule discipline and monitoring of market signals.
Main benefit	Simple and market-driven once conditions are right.	More stable and predictable under fiscal dominance.
Main risk	Volatility and distorted pricing in thin markets.	Greater administrative complexity; political pressure to override rules.
Best suited for Malawi when	If expectations about future fiscal and monetary policy are well anchored and FX markets not thin.	If expectations about fiscal and monetary policy are volatile and FX markets are thin

Note Both options assume an initial exchange rate realignment to unify the official and parallel rates, followed by a consistent mechanism to prevent renewed misalignment.

1. Introduction

Since 2020, Malawi has been mired in a worsening macroeconomic crisis. Annual inflation has been consistently above 25%, and real GDP growth has averaged only 1.7% per year between 2020 and 2025.¹ Population has grown at more than 2.6% per year.² Thus, Malawians have been growing poorer on average every day. Malawi has been plagued by high rates of poverty and periods of food insecurity for a long time. Amidst the current crisis, there are recurrent shortages of fuel, fertilizer, electricity, medicine, and other imported goods. Official reserves have amounted to just days or weeks of import cover in recent months, and Malawi is in debt distress. The current situation has been called “the most severe and prolonged economic crisis since independence”.³

The current crisis has emerged in the context of more than a decade of economic stagnation. As described in

Annex 1: Macro Policy and the Foreign Exchange Constraint, Malawi’s economy has been stuck in an equilibrium of stagnation since at least 2012. After a period of higher growth rates in the mid-2000s, GDP growth was, on average, barely able to keep up with population growth from 2012 to 2019. The current crisis is severe, while policymakers have been forced to navigate challenges of low growth and high vulnerability to shocks for more than a decade.

A lack of foreign exchange is the binding constraint on growth; this is at the heart of the current crisis and longer-term stagnation. Malawi’s economy is held back by a lack of foreign exchange. There is a high and rising parallel premium for foreign exchange, indicating its scarcity. As shown in Annex 1, the growth slowdown since 2012 coincided with a stagnation with sources of foreign exchange, including a decline in exports (such as tobacco, sugar and garments),⁴ and foreign aid. Firms consistently identify a lack of access to foreign exchange as their primary constraint in Malawi and rely on the parallel market, informal credit, forward markets and numerous forms of workarounds to access foreign exchange at high costs.

The purpose of this document is to diagnose the causes behind the foreign exchange constraint and present options for addressing the problem. There have been recent analyses that diagnose Malawi’s macroeconomic and growth crises at length, which include recommendations on reforms for debt, fiscal adjustment, taxes, food security, etc. The focus of

¹ World Bank World Development Indicators

² Ibid.

³ African Development Bank, United Nations & World Bank Group (2025) *No Time to Waste: Policy Priorities for Malawi’s Recovery*. Washington, DC: World Bank Group

⁴ See Atlas of Economic Complexity (<https://bit.ly/48PqjTe>)

this note is more targeted: to identify specific foreign exchange and monetary policy options that can address the worst aspects of the foreign exchange constraint in the short term.

2. Unpacking the Foreign Exchange Constraint

Access to foreign exchange is critical to economic growth and household wellbeing. In every economy, businesses need imports (e.g., imports of raw materials, production inputs, spare parts, and more) to function, and households need access to imported consumption goods. This is especially true in small, landlocked developing economies like Malawi. In fact, an estimated 96% of Malawian exporters rely on imported inputs, compared with 79% in Sub-Saharan Africa on average.⁵ But in Malawi, access to scarce foreign exchange is rationed. Banks and foreign exchange bureaus lack the dollars to meet demand, so a parallel market has emerged.

The high and rising parallel market premium for foreign exchange provides a signal of the unmet demand for foreign exchange in an economy. The more desperate businesses and individuals are to access scarce foreign exchange, the larger the parallel market premium (i.e., parallel market rate for USD/MWK divided by official rate) rises. In the parallel market, businesses and consumers buy and sell these dollars at an informal market-determined price. If it were not for the parallel market, businesses and households would struggle even more in Malawi than they do today. With a parallel market premium at about 150%, Malawi's is one of the highest in the world, and it has been rising quickly. In just four years, the parallel rate premium has gone from 12% (August 2021) to almost 180% (August 2025). Only Iran is known to have a larger premium.⁶

The lack of foreign exchange on the official market has become so severe that much of the economy already operates at the parallel market rate. A wide variety of businesses in Malawi and investors considering Malawi are quick to report foreign exchange as their top constraint. Many businesses have closed or are now closing because they are unable to convert the Kwacha they generate into foreign currency and imports. This includes major anchor businesses with high levels of employment. This process is hollowing out an economy that has seen very low growth and is unable to generate sufficient jobs for the population. The official exchange rate now applies, in practice, to a narrow set of priority transactions, primarily government subsidized fuel and fertilizer. Most of the real economy has been forced by rationing to adjust to the parallel market rate when it comes to the cost of imports. For most imported products found in stores and markets, the premium has already been paid by traders and is priced in for final consumers. In the same

⁵ World Bank Enterprise Surveys (2025)

⁶ African Development Bank, United Nations, & World Bank Group (2025)

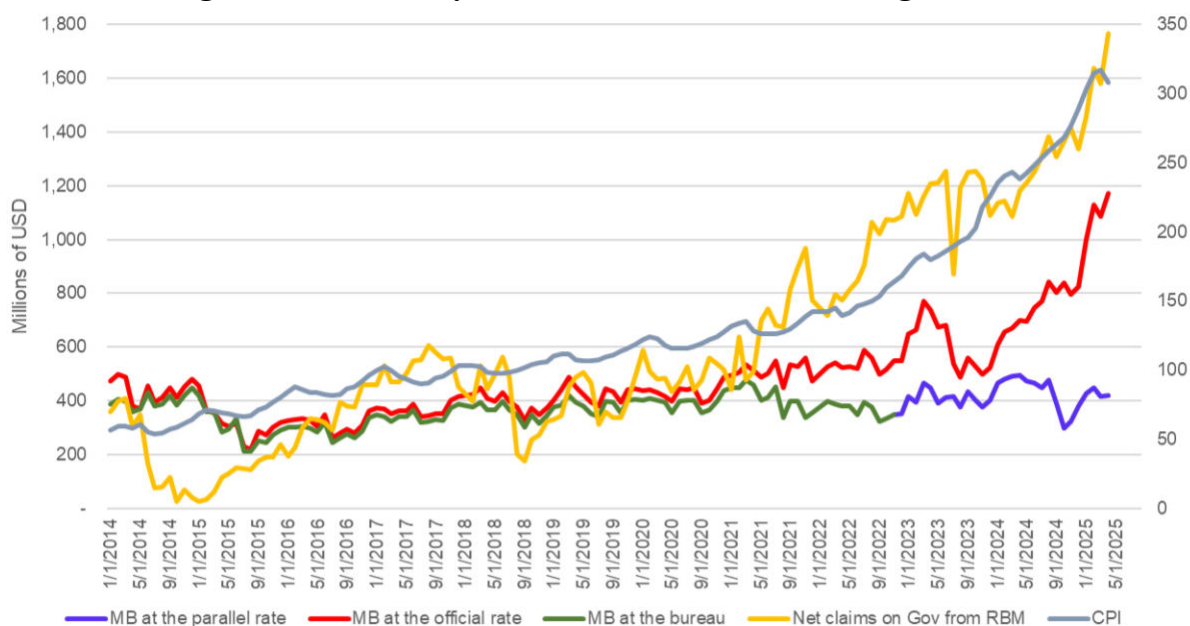
way, businesses pay the premium for foreign exchange by going directly to the parallel market to source foreign currency or by paying fees and premia in the legal banking system.

Economic theory and our empirical analysis show that money creation is the root cause of foreign exchange scarcity and high inflation today. The parallel market rate is determined by the supply and demand for dollars when valued in terms of Kwacha (when measured in Kwacha/USD terms). The supply of Kwacha has grown substantially over recent years, lowering its value. As discussed in Annex 2: What is Causing Inflation in Malawi?, there has been extraordinary growth of the money supply since 2020, which has been far above money demand. Kwacha in circulation has increased by a factor of three. This is main driver of inflation as price increases are the consequence of this increased supply of Kwacha “chasing” the same number of goods and services (or less supply in the case of some products like maize). We estimate that rapid money growth has an almost one-for-one impact on the parallel market rate, which reflects the market-determined price for dollars. Like with broader inflation, the parallel market rate is the result of the increased supply of Kwacha “chasing” the same supply of dollars. The parallel market is effectively devaluing the Kwacha so that the amount of base money when valued in parallel market dollars remains constant (Figure 1). In fact, the parallel market rate has been remarkably predictable based on the growth of money supply. The parallel rate is also impacted by short-term factors. For example, the rate jumped when flows from USAID were frozen in April 2025 and declined after the September election results. However, over the medium-term, the fundamental factors of foreign exchange generation and money supply are driving the parallel market rate.

Malawi’s large, unfunded fiscal deficit is the reason behind rapid money growth. The primary cause of the increase in the monetary base is a large rise in net domestic assets (NDAs) on the RBM’s balance sheet. This rise has been driven by a rise in net claims on government (NCGs) (see Figure 1). Malawi continues to run a very large total fiscal deficit, estimated at 12% of GDP per the November 2025 budget speech. The deficit is financed primarily through domestic borrowing via government bonds purchased by commercial banks and other entities. The RBM buys these bonds on the secondary market (creating NCG assets) with newly printed Kwacha. This growth in the monetary base then translates into growth of money in circulation. The money multiplier in Malawi has been declining over recent years. Therefore, the entirety of the rapid growth of broad money is due to expansion of the monetary base. This drives inflation (see Annex 2 Annex 2: What is Causing Inflation in Malawi?), but this inflation is also what keeps government borrowing costs low in real terms. We estimate that seigniorage is expected to be about 3.8% of GDP in 2025 (Figure 2). This is a significant source of government financing. So long as this dynamic continues,

high inflation is set to continue.⁷ In fact, inflation could be on a path to rise higher if domestic borrowing continues to increase.

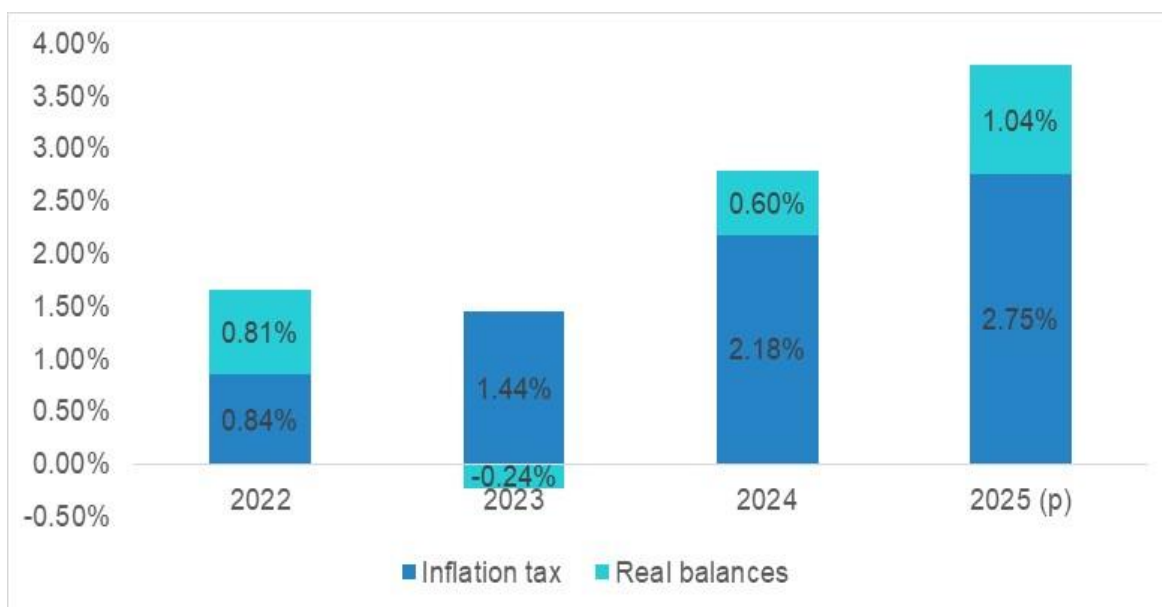
Figure 1: Base Money at Official and Market Exchange Rates



Note: Base money as: Currency in circulation + Bankers deposits + Liabilities to other sectors
Source: Reserve Bank of Malawi; Parallel rate data collected by local organization

Figure 2: Seigniorage as Share of GDP

⁷ The real balance component of seigniorage in Malawi has been positive in line with a fall in the velocity of broad money. This means that despite high inflation, there seems to be stable (and potentially rising) demand for Kwacha and Kwacha deposits. However, this is likely due to capital controls and a lack of other options which is then an unstable equilibrium that could unravel if people flee Kwacha holdings *en masse*.



Source: Own calculations using Reserve Bank of Malawi data

3. Policy Implications for Addressing the Constraint

It is possible for a foreign exchange policy adjustment to achieve a market clearing rate that addresses the worst harms of foreign exchange rationing even before a full fiscal adjustment.

To bring down the rate of money creation, the Government of Malawi will need to achieve a large fiscal adjustment that reduces the need for domestic borrowing and money creation. During a credible adjustment, government may also be able to utilize other forms of financing unavailable today that do not result in money growth. The fiscal adjustment is crucial for macroeconomic success, but Malawi could begin to relax the foreign exchange constraint more immediately. To achieve a market clearing rate (i.e., where the market allocates scarce foreign exchange rather than by government officials through rationing) requires that the exchange rate be aligned with the market equilibrium in the supply and demand for dollars.

There are multiple policy options for achieving a market-clearing exchange rate. A floating exchange rate clears the market automatically. A managed exchange rate can achieve the same outcome if the pace of depreciation keeps up with the pace of money growth and money demand. This could be achieved through an initial devaluation calibrated to unify the exchange rate (i.e. devaluing by the parallel market premium) followed by an exchange rate that continuously adjusts to clear the market. With a market-clearing exchange rate, the more government increases money supply beyond what the economy demands, the more depreciation would occur. Likewise, the faster that money printing is reduced, the less that future depreciation would be needed. This is the path that Ethiopia followed recently (see Box 1).

The parallel rate already adjusts to clear the market, but at great cost to the economy. The current system forces most foreign exchange transactions into informal markets, which ultimately deepens the problem in the official market. As agents in the economy increasingly use informal channels, this reduces foreign exchange in the official market (that which is used for official imports). The system puts an implicit tax on exporters to subsidize official imports.⁸ It also undermines the ability of businesses repatriate earnings from exports and invest in new export sectors. This inevitably reduces exports, slows growth, and weakens government tax revenues. Negative impacts on tax revenues then cause government to print more money to finance its deficit, which deepens the foreign exchange scarcity. An official market-clearing exchange rate would not be painless, but much of the pain is already priced in. As was true in 2012, when Malawi had a freely floating exchange rate, this adjustment would keep overall imports at the level which the

⁸ The World Bank estimates that this implicit subsidy is 4.4% of GDP (see World Bank (2025) *Malawi Public Finance Review: Restoring stability, rebuilding trust*. Washington, DC: World Bank)

economy can afford based on its foreign exchange inflows. Unlike in 2012, there are indications that much of the economy has already absorbed the pain of adjustment. Those who would be poised to lose out the most from a market-clearing exchange rate would be those who profit from the arbitrage activity. This includes those involved in the smuggling of goods as well as those who manipulate the current exemption systems for profit.

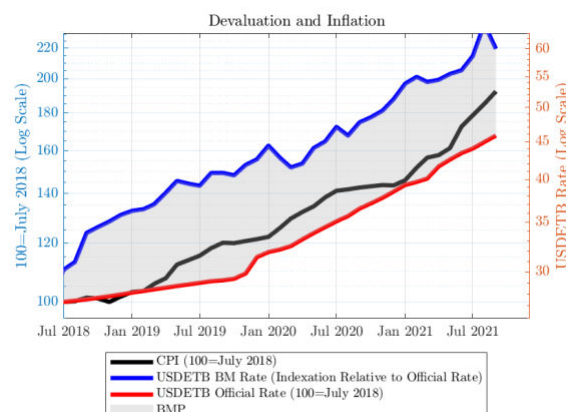
An adjustment would not completely solve the long-term foreign exchange generation challenge, but it is necessary to move Malawi towards a long-term growth path and encourage investment. As argued in Annex 1, Malawi’s longer-term constraint is that its sources of foreign exchange have stagnated and declined while the population has continued to grow rapidly. The Malawian economy has been generating roughly the same amount of foreign exchange (about 3 billion USD) through official channels since 2013 due to stagnant exports, aid receipts, foreign direct investment (FDI), and remittances. Thus, foreign exchange has been declining in per capita terms — from USD 200 per person in 2013 to under USD 150 since 2020.⁹ Over the long-run, Malawi will need to diversify its sources of exports and foreign exchange earnings. However, attracting investment in these sectors requires allowing the market rather than rationing to allocate scarce foreign exchange.

With a clear understanding of the foreign exchange constraint, it is evident why many policies intended to address it are not effective. Policies that try to preserve the current foreign exchange regime by force — by tightening rationing or fixing prices by decrees —can make the constraint worse. Restricting foreign exchange at the official rate does not create more dollars. Rather, it pushes demand into informal channels, widens the parallel premium, and erodes confidence. In addition, the parallel market is supplied, to a significant degree, by illicit cross-border trading activities, often of the items that are made artificially cheap in Malawi due to the overvalued exchange rate. This smuggling creates many inefficiencies, but it also brings foreign currency into Malawi for circulation. If government were to clamp down on smuggling, it would only drive the parallel market by making the dollars scarcer. Likewise, approaches that undermine official foreign exchange generation will also tend to make matters worse. This includes export bans or policies that undermine tourism, such as high visa fees and high administrative costs. Finally, devaluing once without changing fiscal policy or monetary financing would only reset the starting point of the next crisis. As with previous devaluations in 2022 and 2023, inflation would remain high, the parallel rate would adjust, and the foreign exchange constraint would persist.

⁹ Compare this to foreign exchange per capita in Mozambique (~USD 500) and Zambia (USD 650).

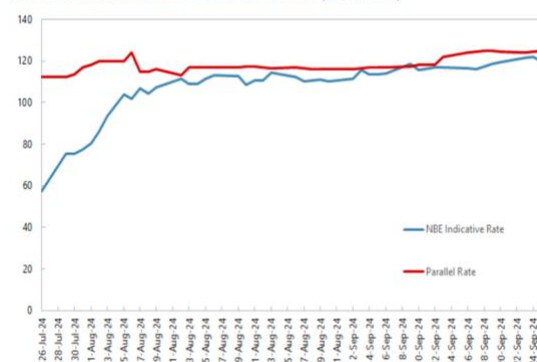
Box 1: Ethiopia's Successful Foreign Exchange Reform

From roughly the years 2015 to 2024, Ethiopia faced a macroeconomic problem much like that of Malawi today. Ethiopia faced slowing growth, high inflation, and a widening parallel market premium that reflected extreme scarcity of foreign exchange in the economy. Foreign exchange was far and away the top constraint limiting growth and job creation (Hausmann et al., 2022). Like Malawi, Ethiopia was printing excess money to finance a large deficit, and the resulting inflation was keeping real interest rates in the banking system.



Source: Growth Lab using NBE data

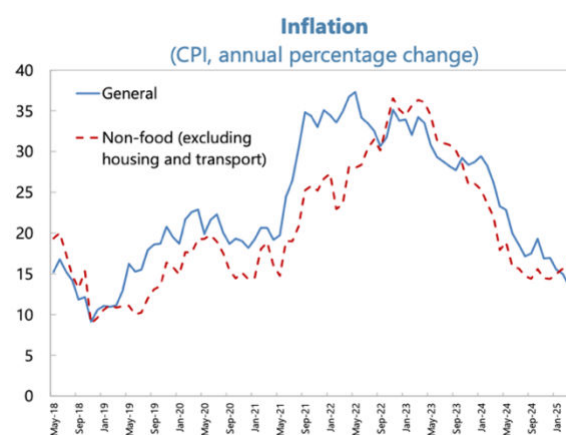
NBE Indicative Rate vs Parallel Rate (ETB/USD)



Source: IMF Article IV, July 2025

By 2023, the problems had intensified. Inflation was over 30% and the parallel market premium had reached 100%. Years of effort to crack down on the parallel market and dozens of foreign exchange directives failed to improve the situation. Ethiopia operated a crawling peg where the official exchange rate was devalued by a planned amount. But, like Malawi, this exchange rate crawl was out of step with the pace of money creation. The National Bank of Ethiopia (NBE) increased the rate of crawl but could not address the premium because these adjustments remained small in comparison to the path of money creation.

In 2024, Ethiopia addressed the FX constraint while also bringing annual inflation down toward target levels (10%). The NBE reduced money creation over a period of a year prior to July 2024, at which point it floated the Ethiopian Birr. The official exchange rate quickly converged to the parallel rate. Inflation continued its downward trajectory with very little one-time passthrough in prices. As of late 2025, the exchange rate continues to depreciate with market forces. Exports and imports have shifted to formal channels, causing rapid growth in tax collection from import duties. Announced foreign investment has increased, especially in mining and energy, as investors are no longer concerned about converting earnings into foreign exchange.



Source: IMF Article IV, July 2025

4. Design Decisions of Foreign Exchange Reform

With wider macroeconomic constraints in place, this note proposes a third-best solution to addressing the binding foreign exchange constraint. The previous sections argued that Malawi's foreign exchange constraint is a consequence of: (1) severe weakness of foreign exchange generation; (2) rapid money creation to finance a large fiscal deficit; and (3) a fixed, overvalued official exchange rate. The ideal solution would be to bring in more dollars and increase the demand for Kwacha through diversification of exports, i.e. address issue (1). If this were achieved at the level of rapidly developing countries like Vietnam or China, foreign exchange would cease to be a problem. This is the long-term solution, but it is not possible in the immediate term. A second-best solution would be to eliminate rapid money creation, issue (2), which would address both inflation and the widening parallel market premium. This is critical over the medium-term and will be challenging. Nevertheless, the worst aspects of the foreign exchange constraint can be relaxed by addressing the third issue — the fixed, overvalued exchange rate. Malawi can move to a market-determined exchange rate to ensure that scarce dollars are allocated efficiently, even if this is the third-best solution to the foreign exchange constraint in the current context.

The goal of the foreign exchange reform should be to re-align the official exchange rate with the market-clearing rate in a sustainable, ongoing manner. A durable realignment implies an initially large adjustment — a devaluation equal to the current parallel market premium — followed by a consistent policy to allow the market to continue to clear. The initial sharp re-alignment serves essential economic functions. First, it would allow for businesses with the willingness to pay for foreign exchange to do so in the official market and at lower transaction costs. If credible, it would quickly bring foreign exchange back from the parallel market into official channels. By adjusting sharply, it would also affect expectations more than a gradual attempt at market alignment. The reset would attract remittances and exports revenue that were previously sent through informal channels or held abroad. It may also signal to donors and external partners that the country is serious about reform, unlocking aid flows. Following the 2012 devaluation, gross official reserves increased from \$215 million in December 2011 to \$279 million in December 2012 and \$403 million by December 2013. The fiscal position improved dramatically at this time, with the deficit falling to 0.8% of GDP in FY 2012/13 compared to 8.4% of GDP in FY 2011/12. In the current context, we estimate that the direct effects of a devaluation will be only mildly positive to neutral to a first order on the fiscal balance (see Box 2). Fiscal gains would only accumulate with time and consistency.

Box 2: Impact of a Devaluation on the Government Fiscal Deficit

What would be the impacts of a devaluation on the fiscal balance? To answer this question, we begin by laying out the fiscal accounts to identify the foreign exchange (FX) denominated accounts.

Fiscal Accounts (2024)

Tax Revenue	2,867,814	Recurrent Expenditure	4,487,289
PAYE	583,143	Wages and Salaries	1,251,526
Other	116,599	Interest payments	1,336,725
Corporate Tax	766,451	Other expenditures	1,176,029
Provisional Tax	283,240	Purchase of goods & services	512,953
Withholding Tax	246,142	Pensions and Gratuities	210,057
Import Duty (Including surcharge)	392,361	Unallocable Expenditures (arrears)	-
Value Added Tax	770,091	Development Expenditure	1,789,683
Miscellaneous Duties	1,196	Domestically Financed	344,740
Excise Duty	354,573	Foreign Financed	1,446,943
Other Taxes	-	Net lending	-
Tax Refunds	(79,867)	Total Expenditure	6,298,973
Other (non-tax) Revenues	73,612		
Total Domestic Revenue	2,941,426		
Grants	1,081,559		
Total Revenues & Grants	4,022,985		

Source: RBM

Based on this breakdown, a devaluation would be expected to be mildly net positive for the fiscal accounts. On the revenue side, two categories — import duties and grants — are entirely denominated in FX and the rest are fully denominated in domestic currency. On the expenditure side, three categories combine Kwacha- and FX-denominated expenses: purchases of goods and services, development expenditures, and other expenditures. There are FX-denominated interest payments, of course, but they are small, so we ignore them for simplicity. In the absence of official data, we assume rough estimates for the share of FX-denominated expenditures in these three categories: 1/4, 1/3 and 1/3, respectively. Using these rough shares, we estimate that in 2024, 37% and 17% of revenues and expenditures, respectively, were FX currency denominated. Therefore, revenues would stand to benefit more than expenses would be expected to expand directly from a devaluation.

Current distribution of FX and domestic denominated revenues and expenditures and simulated distribution under a simulated 100% devaluation

Current distribution	Revenues	Expenditures	Assuming a 100% devaluation	Revenues	Expenditures
Kwacha	2,549,065	5,237,420	Kwacha	2,549,065	5,237,420
US\$	1,473,920	1,061,553	US\$	2,947,840	2,123,106

Source: Own estimations

Government would make fiscal policy decisions that could improve or worsen the fiscal impact.

This simulation assumes no passthrough or *ex post* adjustment from a devaluation into domestic currency denominated accounts. In practice, the cost structure of most Kwacha-denominated goods and services will include FX inputs, particularly in an import dependent country. Furthermore, the experience of the 2023 devaluation, when wages and salaries were increased nearly one-for-one with the devaluation, shows that if there is adjustment in wages and salaries after a devaluation, this can eliminate the fiscal benefits. To minimize the risk of negative fiscal impacts of devaluation, government should implement fiscal policy that does not offset the adjustment through a rise in wage bill.

The exchange rate policy after an initial unification must be clearly defined to allow the market to clear and allow expectations to be credibly anchored. This part of the strategy is critical, and a lack of consistent strategy has caused many attempts at exchange rate unification in other countries to fail. Box 3 explains the fundamental factors that underlie a market-clearing exchange rate. Any feasible reform path, even with external financing and support, will take time to achieve higher exports, a primary surplus, a reduced debt burden, and lower inflation. It will take time for efforts at diversification (e.g., in agriculture, tourism, mining, and manufacturing) to bear results. The most optimistic plans for fiscal consolidation envision Malawi achieving a small primary surplus by 2027 (and even this is optimistic given recent experience). This means that for a period, there will continue to be money printing and inflation which must be accounted for in the new exchange rate policy. Furthermore, Malawi lacks reserves to sustainably intervene in the foreign exchange market. Even if it had reserves, macroeconomic fundamentals mean that it cannot defend an overvalued exchange rate for too long. Any external support, for example through an IMF program and donor support, will be a small portion of the total financing gap required.¹⁰

The market will not clear if the Kwacha is pegged after the initial unification because the nominal exchange rate will face natural pressure to depreciate over time. The sources of foreign exchange in Malawi are currently weak, while the current monetary policy stance is financing the deficit and causing a large inflation differential between Malawi and the United States. So long as these forces are true, the Kwacha will continue to need to depreciate to stay in line with the market-determined equilibrium. If the path of the real exchange rate changes for the better (because of increased investment or exports) or if inflation declines due to reduced money printing to finance the deficit, the amount that the Kwacha will need to depreciate to remain in a market-clearing equilibrium will also be less. Realistically, in any credible reform paths (even the most aggressive in terms of fiscal adjustment), Malawi will face weak fundamentals on exports and investment as well as inflation above the U.S. level. Since Malawi's stated inflation target of 5% is higher than the U.S. target of 2%, even a successful economic reset will retain an inflation differential. This means that the Kwacha will require ongoing (i.e., daily) adjustment and depreciation to make sure that it does not become overvalued and a parallel rate, scarcity, and rationing does not re-emerge. Therefore, it is not possible for Malawi to maintain a pegged rate. This necessity to continue to depreciate was also true in the case of Ethiopia (see Box 1). Even

¹⁰ In the previous IMF ECF, financing was 11% of the total external financing gap (International Monetary Fund, 2023)

with a relatively large fiscal adjustment, Ethiopia moved to a managed float that has continued to depreciate over time.

Box 3: Economic Fundamentals of the Exchange Rate

Basic economics tells us that even after a large re-alignment, the Kwacha will need to have ongoing depreciation to stay with fundamentals. From the theory of purchasing power parity (PPP), the real exchange rate (RER) is defined as follows (such that an increase in the RER is a depreciation):

$$RER = \frac{eP_F}{P_D} \quad (1)$$

Where e is the nominal exchange rate (Kwacha per dollars so that an increase is a depreciation), P_D is the domestic price level, P_F is the foreign price level. We can use this to examine what the change in the nominal exchange rate must be to in line with fundamentals:

$$RER = \frac{eP_F}{P_D} \quad (1)$$

$$\% \Delta RER = \% \Delta e + (\pi_F - \pi_D) \quad (2)$$

$$\% \Delta e = \% \Delta RER + (\pi_D - \pi_F) \quad (3)$$

$$E[\% \Delta e] = E[\% \Delta RER] + E[(\pi_D - \pi_F)] \quad (4)$$

Equation 3 says that in order for the nominal exchange rate to be in line with fundamentals it must depreciate in line with factors affecting the real exchange rate (i.e., due to terms of trade, real shocks, productivity, inflows and outflows of foreign exchange) and with the inflation differential between Malawi and the United States (or a basket of countries if managed vs. a basket of foreign currencies). Equation 4, with expectations, says that the expected rate of depreciation will be what the market thinks will happen with the expected path of the real exchange rate and with the path of inflation in Malawi.

The main operational decision for a market-clearing system would be how to manage or anchor the daily adjustment of the exchange rate that will be needed to clear the market. The overhaul of the foreign exchange market also entails the decision of what to do with the current capital controls. One course of action is to remove capital controls and let the exchange rate float. We do not recommend this course of action as the RBM does not have international reserves to smooth short-term fluctuations in the exchange rate. The small size and sparse liquidity of Malawi's foreign exchange market make excess short term exchange rate volatility very likely. We next outline two better options for managing the exchange rate after the initial realignment. One

option is a managed float with a single exchange rate where daily adjustments happen through the market and the RBM publishes a reference rate based on market transactions each day. The second option is a rule-based crawling peg with dual exchange rates and a rule-based adjustment.

Managed Float Option

In a managed float scenario, Malawi would allow banks, firms, forex bureaus to transact bilaterally with one another at any foreign exchange rate they see fit. The RBM would direct all surrendered foreign exchange (from remittances, exports, aid) to the banking sector where banks would buy the foreign exchange at prices negotiated with the individual or firm. In addition, the RBM would develop an interbank market, auctions and provide monitoring of forward and options contracts to facilitate price discovery. All agents would be required to register these transactions with the RBM and the prices at which they transacted. Each day, the RBM would publish a reference rate that is the weighted average of the transactions during the previous day. To the extent that the RBM intervenes in the foreign exchange market, it would only be to smooth out volatility. This is the approach that Ethiopia took to its foreign exchange reforms (see Box 1) which was successfully able to bring the parallel premium down and bring down inflation.

This option has benefits in its simplicity but carries risks of distorted and volatile price discovery. The benefit of this approach is its simplicity where the government does not intervene in the foreign exchange market except to smooth volatility. It essentially legalizes the parallel market and allows the market to discover the right price. The difficulty with this approach is that if exchange markets are thin or dominated by a few players (as could be the case in Malawi), then the reference rate based on the previous day's transactions and auctions may not function well for discovering the right market price. In addition, especially in the early period of this policy, there would be a lot of uncertainty and potentially volatility as the market settles and begins to operate effectively. Finally, being able to smooth volatility requires some supply of international reserves, whereas Malawi has a deeply negative net international reserve position.¹¹

Managed Crawl Option

A managed crawl would create a system where the official exchange rate is determined each day by the RBM following a pre-determined, pre-announced path. With a crawling peg, the RBM would pre-announce a depreciation path for the official Kwacha rate (either to the USD or

¹¹ See International Monetary Fund. African Dept. "Malawi: 2025 Article IV Consultation-Press Release; Staff Report; and Statement by the Executive Director for Malawi", *IMF Staff Country Reports* 2025, 226 (2025) for a discussion on a pure float and managed float for Malawi.

perhaps a basket of currencies) that keeps the official rate as close as possible to the market-clearing rate. Official transactions would be at this official rate and would include all the current account transactions, including fuel and fertilizer, as well as institutional capital account transactions. Foreign aid, external credit to the government, banks and corporations, and direct foreign investment would be settled in this market. Dividends, private and public debt settlements would also be settled in this official market. The expected rate of crawl could be pre-announced for a month or a quarter, based on the government's forecast of its financing needs, to guide inflation expectations. An announced band around the path could be utilized for unexpected volatility and the rate could be adjusted monthly or quarterly.

Numerous countries have utilized a managed crawl approach to effectively align the path of the exchange rate with the path of inflation. Examples of this approach include Chile, Colombia, and Israel, which all used this type of exchange rate regime at times when inflation was high and could not be brought down immediately through inflation targeting measures. These countries used the crawling peg regime as a transition regime to anchor expectations and discipline government finances before adopting a floating rate and inflation targeting. Botswana has also implemented a managed crawl for the last 20 years.¹² In Botswana's case, the rationale is to prevent inflows and commodity booms from over-appreciating the exchange rate and reducing competitiveness (Bank of Botswana, n.d.). In each of these cases, policymakers set the rate of the crawl based on a forecasted inflation differential between the local currency and either the USD or a basket of currencies (for example, Botswana uses a combination of the South African Rand and the IMF's SDR composite) and announce a band around that path that they can use to adjust to short-term deviations from the forecast. In cases of fiscal dominance, like that of Malawi, some countries have set the crawl rate based on the rate of money growth. Nicaragua followed this logic in its managed crawl, which allowed the exchange rate to adjust easily when it needed to accommodate large fiscal deficits. Nicaragua implemented a crawling peg in 1991 after a period of hyperinflation and fiscal dominance had eroded trust in the currency and unanchored expectations. The initial crawl was more than 12% per year before stabilizing to 5% a year, falling further in the 2000s. In 2024, Nicaragua changed the rate of crawl to 0% transitioning to a fixed exchange rate since inflation expectations had now become anchored and the fiscal was on a long-term sustainable path.^[OBJ]

¹² See the Bank of Botswana's explainer page for more information: <https://www.bankofbotswana.bw/content/current-exchange-rate-framework>.

In the case of Malawi, the official exchange rate's rate of crawl could be done through a simple rule of thumb. Forecasting inflation differentials can be difficult, especially before expectations have been well-anchored in a new regime. For Malawi, inflation is driven by money growth, specifically of the monetary base. The growth of base money is driven by the growth in net domestic assets to help finance the fiscal deficit. Given the causal relationship between net domestic asset growth and inflation (see Annex 2), net domestic assets could be used to determine the crawl rate. RBM could let the official exchange rate grow at the same rate of the RBM's net domestic assets (NDAs), thereby keeping NDA constant in dollar terms (see Box 4 for further explanation). Rather than introducing a new anchor, this would effectively formalize the anchoring mechanism that already occurs in the parallel market. Recall, that in Figure 1, the parallel rate has already been adjusting to keep the dollar value of base money constant. It has grown less than the rate of NDAs, because the RBM has negative, decreasing net foreign assets sterilizing some of the NDA growth. However, the growth of NDA as a rule becomes even more clear if Malawi needs to accumulate reserves instead of further bleeding them.

In this managed option, an additional legal, parallel financial market for foreign exchange where private individuals and corporations can change the currency composition of their asset portfolios would also be helpful. This additional market is likely to be more volatile but would have no allocative role for goods and services. The evolution of the exchange rate in this market would be influenced by the current and expected levels of the Kwacha money supply and demand. Its evolution will allow government officials and authorities to 'discover' the Kwacha's value. The purpose of this market is to allow agents to freely change the composition of their portfolios and then provide a signal of whether the government's rate of crawl is consistent with the market-clearing rate. By keeping the gap between the official rate and this parallel rate as small as possible, the system would also have much less room for agents to arbitrage between markets. Signals of an overvalued Kwacha would be a widening gap between the financial and the official exchange rate or a loss of reserves, which could then inform adjustments. For example, the rate of crawl could be accelerated or decelerated if the rate in the financial market deviates by more than 10% on average for a week or two.

The managed crawl option has more complications in implementation but also provides several advantages. The downside of this option is that it is more complicated to administer, though the previous policy requires setting up working and functioning foreign exchange markets for price discovery. One advantage of this option is that it provides a clear pathway for the future growth of the money supply and the exchange rate that can help anchor expectations in the economy *ex ante*. Also, government could decide to embark on a policy of reserve accumulation by accelerating the rate of crawl to a level above the rate of expansion of the RBM's rate of growth

of domestic credit (though this would entail more inflation as the RBM would be buying reserves by issuing money).

Box 4: Targeting the Growth of NDAs

The monetary base (MB) is the key driver of inflation in Malawi. Recall from Box 3, that to keep the Kwacha at its market clearing rate, the official exchange rate needs to devalue in line with the inflation differential between Malawi and the US (for the Kwacha to USD rate). The MB can be decomposed as follows:

$$MB = eNFA + NDA \quad (1)$$

Where MB is the monetary base in Kwachas, NFAs is the RBM's net foreign assets and e is the official exchange rate (so that eNFA is the value of NFAs in Kwachas), and NDA is the RBM's net domestic assets in Kwachas. If we re-arrange this equation and look at changes, we will have:

$$NFA = \frac{MB}{e} + \frac{NDA}{e} \quad (2)$$

$$\Delta NFA = \Delta \left(\frac{MB}{e} \right) - \Delta \left(\frac{NDA}{e} \right) \quad (3)$$

Equation 3 shows that the change in the USD value of NFAs (i.e., reserves) depends on two things: (1) the growth of NDAs and (2) the pace of devaluation. If NDAs grow by 25% and the official exchange rate is devalued by 5%, then the USD value of NDAs will grow by about 20%. If the demand for base money does not increase by 20% based on real GDP growth and the market for Kwachas, then there will be pressure on reserves to decline and for the parallel market rate to depreciate.

Priced at the parallel rate, Figure 1 suggests that the dollar value of MB (the demand for base money) has been flat while GDP growth has been low. This shows then why there has been so much pressure on NFAs and the black market because NDAs have been growing quickly, but the pace of devaluation is not keeping up. This motivates making the rate of crawl equal to the expected growth of NDAs.

Choosing the Most Appropriate Option in Malawi

The most appropriate post-unification exchange rate regime for Malawi should be determined by fiscal credibility, foreign exchange market depth, institutional capacity, and the need to anchor expectations during the transition. If the RBM has the operational capacity to transparently monitor and publish market outcomes, a managed float with a single exchange rate is likely to be the best option. If a fiscal adjustment is sufficiently front-loaded to materially slow the growth of the monetary base, foreign exchange markets could generate enough transaction volume and participant diversity to support reliable daily price discovery. This would also increase the likelihood of success of a managed float. Under these conditions, market-based price formation can allow the exchange rate to settle quickly at its market-clearing level, with central bank intervention limited to smoothing short-term volatility.

Current conditions in Malawi appear to favor the managed crawl approach, particularly if aligned with the path of NDA growth. If fiscal adjustment proceeds more gradually implying continued pressure on domestic liquidity growth, foreign exchange markets remain thin or concentrated, and inflation expectations are fragile, reliance on market price discovery alone risks excessive volatility and renewed misalignment. In this environment, a rule-based managed crawl would be preferable. By explicitly linking the daily adjustment of the official exchange rate to the projected path of domestic liquidity growth, while retaining clear and transparent rules for accelerating or decelerating the crawl in response to persistent market signals, this approach can provide a stronger nominal anchor for expectations and reduce uncertainty during the transition. Although it is administratively more complex, a managed crawl might offer greater macroeconomic stability until fiscal credibility, market depth, and institutional capacity are sufficiently rebuilt to support a managed float. This option might also be a good transitional solution if there is too much resistance to float immediately. If the Government of Malawi can make a large, credible fiscal adjustment, it could reduce the crawl rate potentially to a point that keeps the currency more stable.

5. Necessary Macroeconomic Policy Stance for Overall Success

Foreign exchange policy is only one part of the necessary reform path of Malawi. Strategies across fiscal and monetary policy and beyond, will need to be consistent for the foreign exchange policy adjustment to be effective and for Malawi to restore stability and growth. Although not the focus of this brief note, we summarize the importance of consistent strategies for: (1) on-budget fiscal policy affecting the primary deficit; (2) implicit subsidies and the public sector wage bill; (3) the interest burden on new debt; (4) navigating risks of shocks to foreign exchange supply; and (5) maximizing new sources of foreign exchange. Various macroeconomic policy decisions across these dimensions will be needed for overall success. Although foreign exchange availability can be meaningfully improved in the short-term, these decisions will affect the ultimate path of exchange rate depreciation by affecting real and monetary factors affecting the real equilibrium exchange rate.

Fiscal policy is critical for any reform path because the fiscal deficit is the underlying reason for money creation, inflation, and the widening parallel rate. A strong and credible fiscal adjustment path will reduce the amount of depreciation that will be needed in a market-clearing system. There has been much good analysis provided by international partners on how to achieve this adjustment through a combination of revenue mobilization and expenditure control and reforms to government public financial management systems. See, for example, the World Bank's latest public expenditure review.¹³ While these policies are not a focus of this note, they are critical to making sure that any foreign exchange reforms are successful and sustainable.

Outside of direct budgetary decisions, there are other government policies that will affect the fiscal impact of the foreign exchange policy adjustment. It will be important for overall success to delink fuel, fertilizer, and government wages from an overvalued exchange rate valuation. Following the 2023 devaluation, fuel prices rose more than other prices because they were priced at the overvalued official rate while many other prices had already priced in the parallel rate. In addition, the government raised wages for government employees in line with the devaluation. As noted in Box 2, this impact is very important on the fiscal deficit. This adjustment caused the devaluation to have a negative impact on government finances, which then required more money printing and caused the underlying market rate to depreciate, undermining some of the benefit of the devaluation. To avoid the same pitfall, government should be aware of the pressure to raise public wages when it devalues. Similarly, it should make fuel and fertilizer prices less reliant on

¹³ *Malawi Public Finance Review: Restoring stability, rebuilding trust.* (World Bank, 2025b).

the old, overvalued exchange rate such that there is less pressure to keep these prices lower after an exchange rate re-alignment. With time, these prices and government wages can be adjusted in line with market fundamentals.

In addition to a strong adjustment affecting the primary deficit, Malawi should also explore tools for lowering the nominal interest burden of debt it issues moving forward. Inflation has helped to keep the domestic debt manageable in real terms but the interest burden competes for other government spending needs. Malawi's domestic debt has exploded to more than 50% of GDP and nominal interest costs are more than 6% of GDP. This has been kept manageable because inflation is high and real interest rates on much of the debt are negative. However, there has been an increasing issuance of longer domestic bonds at high nominal rates (greater than 30%) for which cost could explode if real rates turn positive. In addition, even in aggressive fiscal adjustment scenarios, a positive real interest rate environment will still leave domestic debt expensive and taking up a large share of GDP (at least 6%) and revenues (see Annex 3: Malawi's Debt Dynamics). There has been recent public discussion on the need to restructure and reprofile Malawi's domestic debt. This, however, needs to be weighed against the harm that it can do to the financial system and the fact that the government may end up needing to spend money to recapitalize banks after any reprofiling.¹⁴ One potential policy option would be voluntary a swap of expensive long-term debt issued at fixed interest rates (especially the longer debt recently issued at rates more than 30%) with floating interest rate bonds linked to a short-term market rate.¹⁵

Malawi remains highly vulnerable to shocks to foreign exchange, including weather and climate events, additional reduction in aid, and any global price increases for commodities. Weather shocks and shocks to donor support were factors that influenced the 2012 attempt at exchange rate reform, which was ultimately unsuccessful in achieving macroeconomic balance and economic growth. Malawi has been experiencing increased frequency of weather shocks that have hurt yields and food security. To deal with these, Malawi should pursue adequate buffers (of food, fuel, etc.), strong commitment from donors for support through grants and insurance-like instruments to respond to shocks, and more robust social safety nets (ideally funded with large donor support). In short, there is a need to get as much external support through the IMF, donors,

¹⁴ Grigorian, D.A. (2025) *Toward a common methodology for restructuring sovereign domestic debt*. CGD Working Paper No. 720. Washington, DC: Center for Global Development.

¹⁵ See Grigorian, David A., and Lili Vessereau. 2024. "Ghana: A Case Study of Sovereign Debt Restructuring Under the G20 Common Framework." CGD Working Paper 710.

and others as possible to help build up (real and foreign exchange) buffers. This is necessary to cushion the costs of adjustment and lower longstanding vulnerability faced by many Malawians.

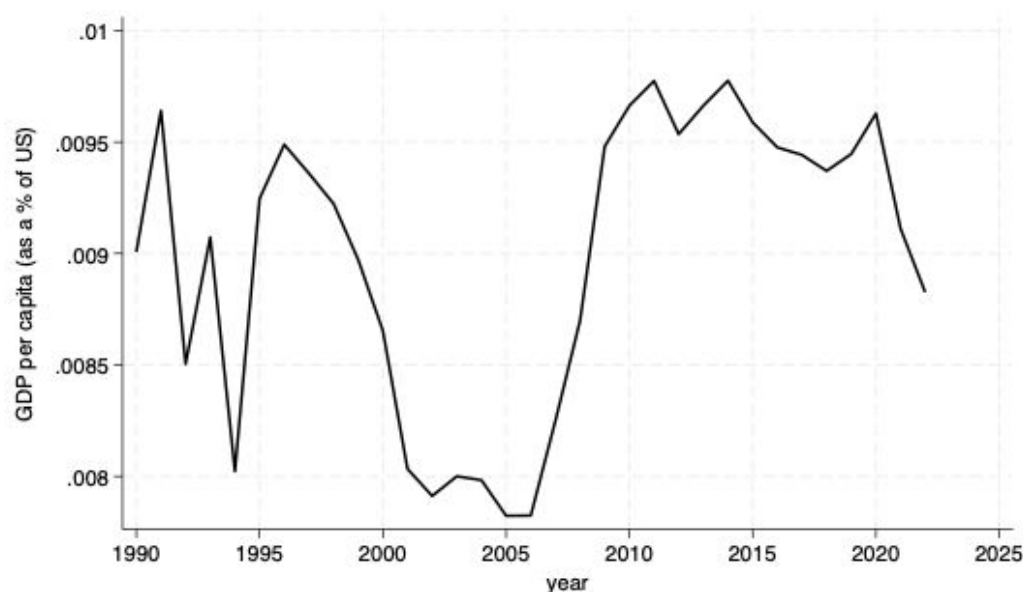
The foreign exchange adjustment will allow for a renewed focus on export growth. If the foreign exchange policy adjustment is successful, it will relax the most binding constraint on foreign exchange inflows through official channels. One longer-term goal of realigning the foreign exchange system to the market is to facilitate exports and investment, which can spur growth, foreign exchange inflows, and additional revenue. However, there are numerous constraints in competitiveness that will need to be addressed with time for Malawi to achieve a stronger path of growth. The adjustment is merely the first and most binding step. With less of a concern for controlling the parallel market following an exchange rate policy adjustment, government would be able to pursue bolder strategies for agriculture, tourism, and mining growth.

Annex 1: Macro Policy and the Foreign Exchange Constraint

This section is extracted from a previous Growth Lab report, “Malawi’s Path Out of Poverty and Toward Prosperity” written in October 2025.

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 3). 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 3: Malawi’s GDP Per Capita as a Share of the US

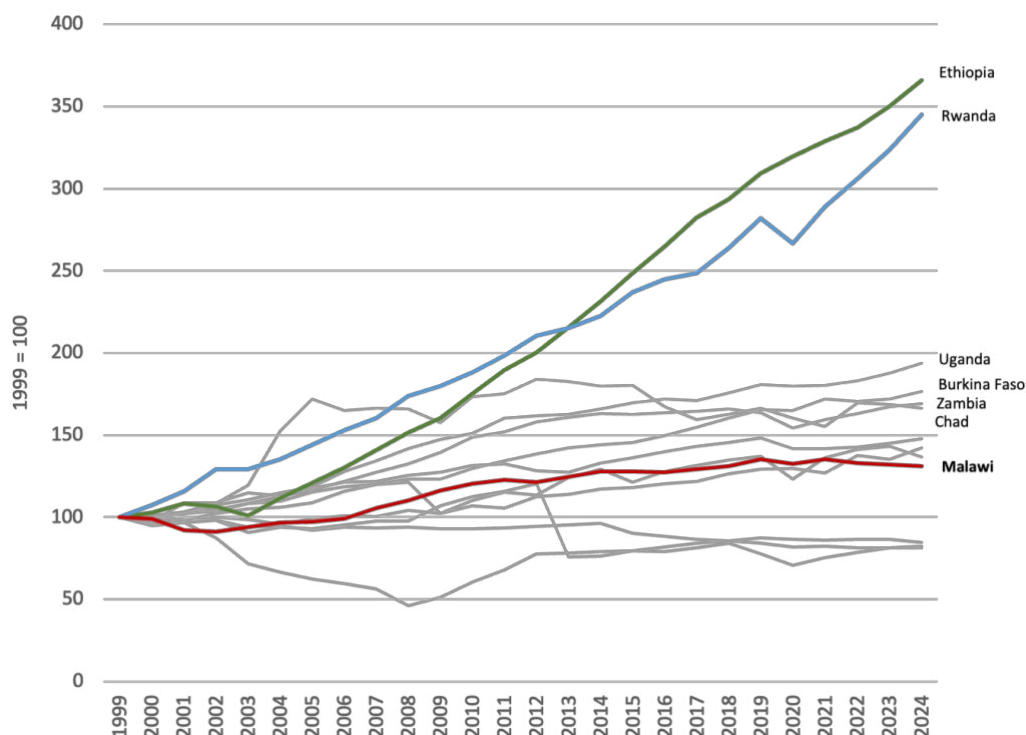


Source: World Bank World Development Indicators

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 4). 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 4: Income Per Capita in Sub-Saharan Landlocked Countries (1999-2024)

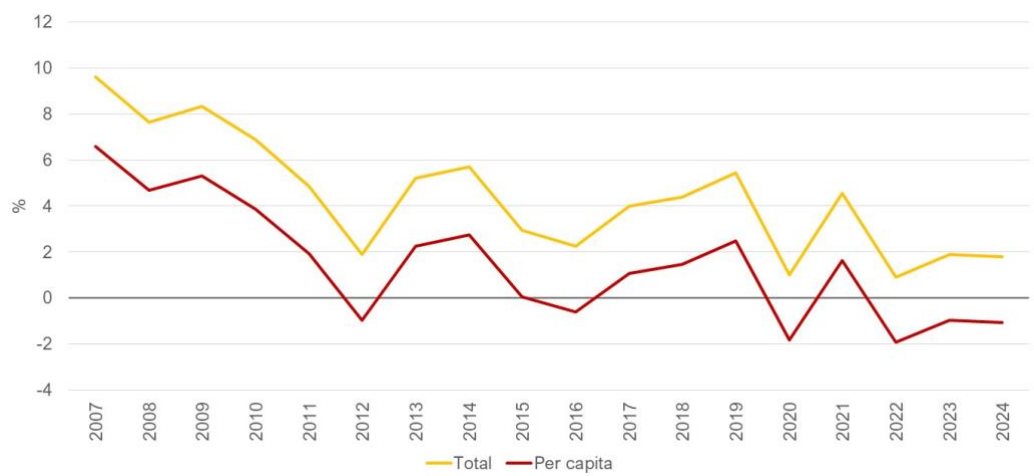


Source: World Bank World Development Indicators

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 5), 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 6) across the board including for both consumption goods as well as inputs for agriculture, manufacturing, and mining. It is no coincidence that growth

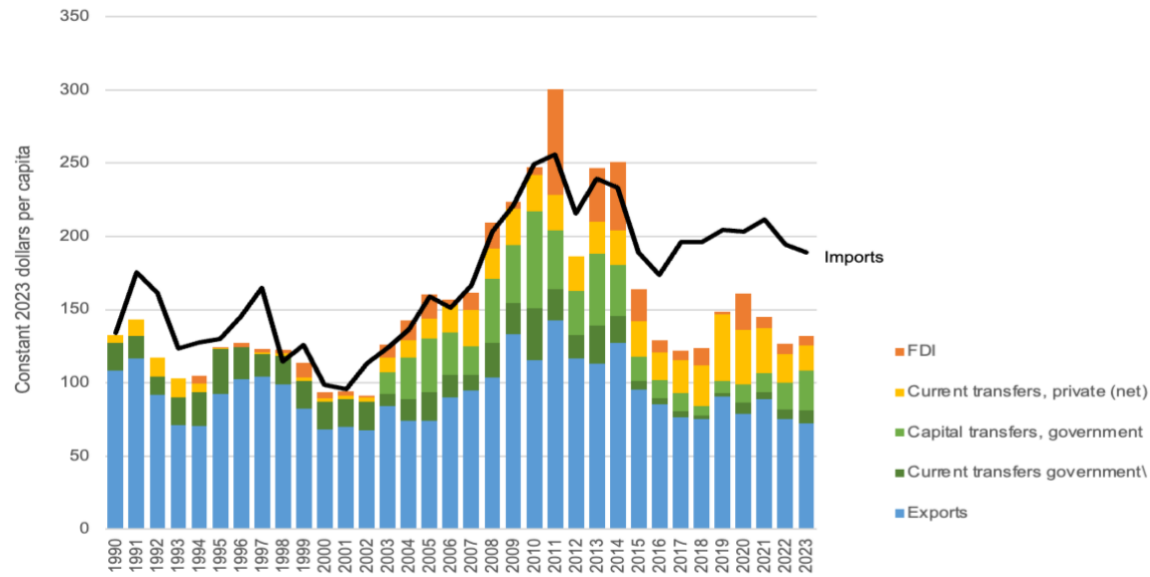
declined and hit a low in 2012 simultaneously as imports per capita declined. Unfortunately, the economy has not been able to import at the preceding level ever since. For this reason, growth has been very low. The average rate of growth since 2020 is the same as it was at the previous low point of 2012, 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 5: Real GDP and Real GDP Per Capita Growth in Malawi



Source: World Bank World Development Indicators

Figure 6: Malawi Imports Per Capita and Broad Sources of Foreign Exchange

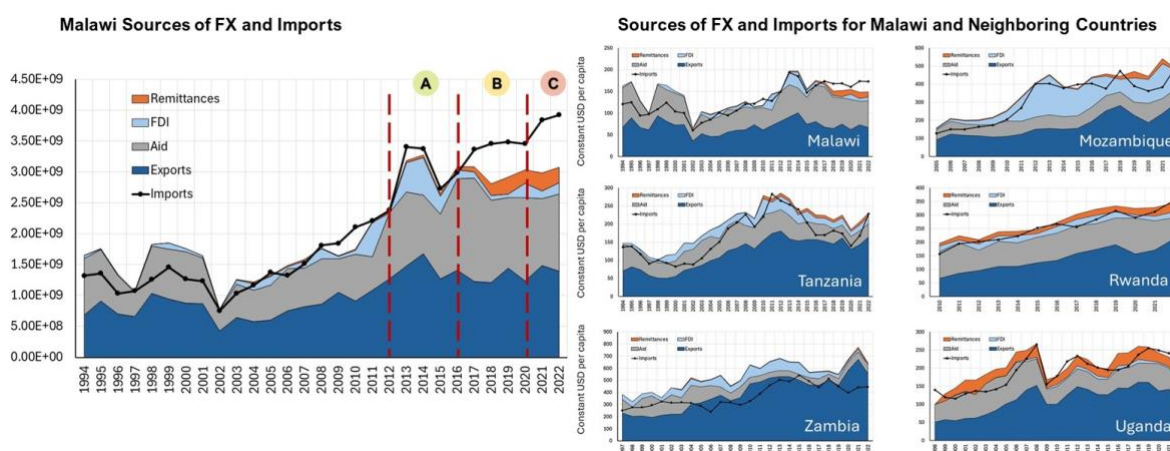


Source: World Bank World Development Indicators

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 7 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 7). 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 7: Malawi Sources of FX and Imports (in USD) (LHS) and Sources of FX and Imports Per Capita Terms for Malawi and Select Regional Comparators (RHS)



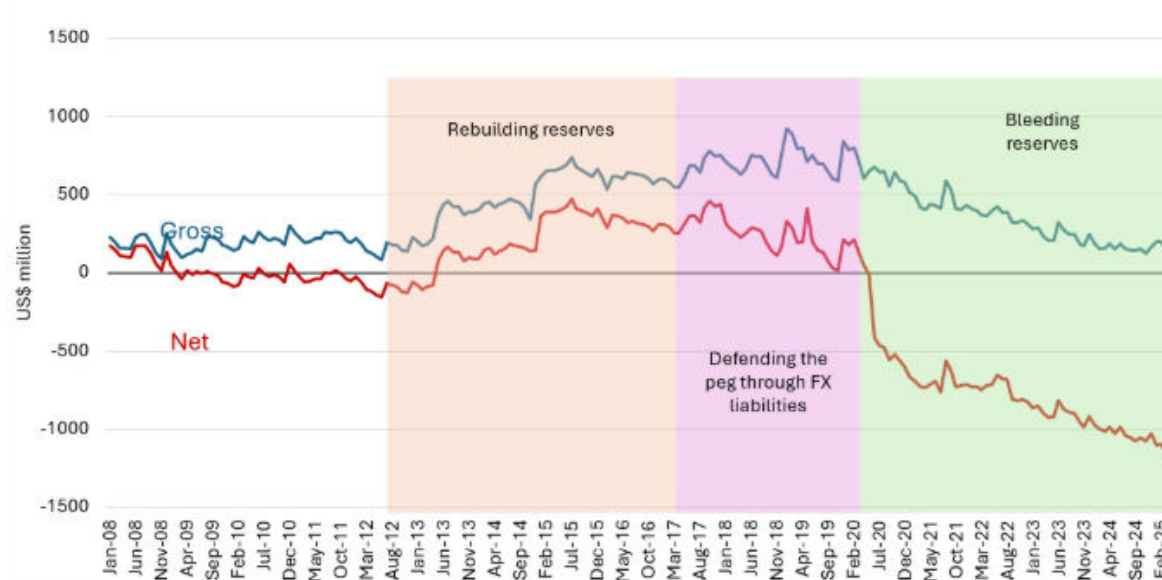
Source: World Bank World Development Indicators

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 7 and shown in terms of growth and net international reserves in Figure 8.

- 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. 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, since 2020 (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 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 8: 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 for Malawi 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 and if they cannot reliably take the dollar value of their export earnings out. Effective macroeconomic reform will help, but an investment boom in export sectors will also require action to help alleviate sector-specific constraints in high-potential growth sectors. 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 processes. They will require investment and time to come to fruition. Even mining, which has generated a lot of attention in the country, will in the best-case scenarios only return higher earnings with a lag from initial investment. The amount that Malawi will benefit in terms of foreign exchange is also uncertain and highly reliant on global prices and on the type of contracts that Malawi enters with mining companies. Foreign investment that can bring in dollars, knowhow, and market access can help accelerate the process while also providing needed foreign exchange. Since any effective macroeconomic reform path is going to require a fiscal contraction, simultaneously expanding foreign investment is of paramount importance.

The current macroeconomic environment must be stabilized to allow for investors to act on opportunities, but non-macro 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 targets the sector specific constraints that hold back promising sectors. Mining investors need a clearer mechanism for signing Mining Development Agreements (MDAs) and moving 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 substantial financial resources from government and the budget, 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, and/or creating an empowered unit to actively work with investors in export sectors to find and alleviate constraints. Such actions cannot offset the need for macroeconomic reform, but they could accelerate the benefits to the economy of doing so.

Annex 2: What is Causing Inflation in Malawi?

This brief analysis identifies the main cause of Malawi’s recent high inflation, beginning in 2021, as excess growth in money supply. Malawi has experienced distinct episodes of high inflation over the last 25 years under different external and domestic conditions. Inflation has remained high throughout 2025, at close to 30% as an annualized rate, causing pain to households and businesses. Traditional explanations of global food prices, domestic supply shocks, and exchange-rate adjustments do not explain the dynamics of recent inflation. Rather, unprecedented expansion of the money supply, which has been well above money demand, does explain the recent phenomena of inflation. The Reserve Bank of Malawi (RBM) has increasingly accumulated net claims on government and issued money, even as it has consistently shed net foreign assets. This has expanded the broad money supply of Kwacha. We find that both price increases on goods and services and the parallel market price for foreign exchange have been driven by this increase in Kwacha “chasing” the same amount of supply. The deeper reasons behind this problem are ultimately fiscal in nature. Malawi has increasingly relied on printed money to finance a large fiscal deficit. The resulting inflation has partially offset the real cost of rapid buildup of domestic debt. With this year’s overall deficit projected around 12% of GDP, this problem of inflation is set to continue. If the process continues, inflation could be driven up to dangerous levels. The annex concludes with resulting policy implications to bring down inflation.

Introduction and Existing Literature

Malawi has experienced recurring instances of high inflation, and the current battle with inflation is the most severe since at least the turn of the century. Looking at Figure 9, which shows overall inflation and the components of food and non-food inflation, one can see three episodes since the year 2000 when inflation ran well above 10% for a sustained period. Between 2001 and 2007 overall inflation ran high. While food price inflation fell for several years in the middle of this period, non-food inflation remained high throughout. Over 2012-17, inflation was high once again — spiking at close to 40% in 2013 and hovering at around 25% for the next four years. Since 2021, high inflation has re-emerged as a problem. Annual inflation was over 30% throughout 2024 and has held at just under 30% throughout 2025. Apart from the spike in 2013, inflation has been highest in these recent years, and food price increases have significantly outpaced non-food price increases over this time.

Figure 9: Annual Inflation in Malawi, 2001-2025



Source: Reserve Bank of Malawi

Our question of interest is what is driving the current inflation episode, and our goal is to determine policy actions that would be effective in bringing inflation down. The academic and policy literature on Malawi highlights three main drivers of past episodes of inflation: (i) exchange-rate passthrough from devaluations to domestic prices; (ii) persistent growth of broad money (often M2); and (iii) supply shocks, especially food, fuel, and administered prices. This note will explore the evidence of these and potential other causes for the current episode of inflation. Drivers of inflation today may be the same as previous episodes or may differ. This note does not seek to explain inflation in general but rather to understand the current episode and inform actions to address the problem.

Academic literature on inflation in Malawi reaches a broad consensus that previous episodes of inflation cannot be understood without looking at money growth and its fiscal underpinnings, while a more common viewpoint has emphasized (domestic and international) price shocks and exchange rate movements.

- Simwaka et al. (2012) document that, since the mid-1990s, episodes of high inflation have typically coincided with periods of rapid broad money (M2) growth and exchange-rate depreciation. They show that inflation tracks money growth closely until about 2001, after which the simple correlation weakens because the velocity of money shifts downward as financial deepening raises the structural demand for money. Once this is controlled for, money growth continues to play an important role in explaining inflation. Their interpretation is that

monetary policy based on reserve-money targets can deliver low inflation only if fiscal policy is consistent and government does not routinely draw on central bank credit

- Chavula (2016) builds a New Keynesian model for 2002–2015 and uses it to simulate the impact of changes in the policy rate and reserve money on inflation, output, the exchange rate and money supply. The paper finds that inflation at the time was associated with donor suspensions, higher domestic financing needs, and increases in liquidity and money growth as the government borrowed more from the banking system. Fiscal slippages forced the central bank to accommodate, undermining the effectiveness of interest-rate-based tightening.
- Yiheyis and Cleeve (2016) focus on the joint dynamics of the real exchange rate, inflation, output growth, money growth and foreign-exchange reserves over 1980–2011 using autoregressive distributed lag (ARDL) bounds tests and Granger causality. They find a long-run relationship between the real exchange rate (as the dependent variable) driven by output growth and monetary and external conditions. The money supply (M2) does not appear to cause inflation directly once the exchange rate is controlled for, suggesting that the inflationary impact of monetary expansion operates primarily through pressure on the exchange rate and reserve losses.
- Beyond the academic literature, there is a wider recognition that Malawi's inflation has tended to move with three key impulse variables: the exchange rate, money growth, and commodity shocks. Devaluations of the official exchange rate have, at times, coincided with inflation jumps, and earlier work on Malawi emphasized exchange rate pass-through and external food prices as primary drivers. Other contributions have highlighted the role of excess money growth, particularly broad money (M2), in sustaining high inflation, while a third strand stressed domestic supply shocks: harvest outcomes, fuel prices, and administered tariffs.

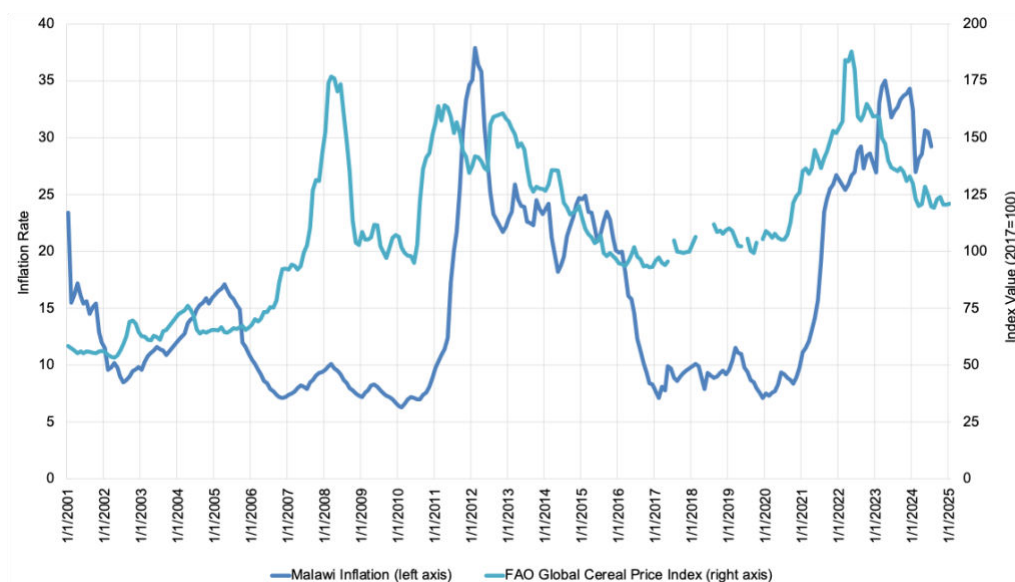
What is driving Malawi's current high inflation?

Movements in the official exchange rate cannot explain the current pattern of inflation.

Unlike the period of 2012-17 when the Kwacha was floating, the exchange rate has been fixed during the recent period. The fixed exchange rate was adjusted through two devaluations, in May 2022 and November 2023, whereas inflation has been high over the whole period. One can see an uptick in inflation around these two dates, which we will investigate later in this note. However, the exchange rate has been fixed at ~1,700 Kwacha per USD since November 2023 and inflation persists. If the official exchange rate devaluation were the driving force behind inflation, there would have been a much larger decline in inflation in 2025 than has been experienced.

Global food prices also cannot explain the current episode of inflation. Inflation is high today, particularly food inflation, even as global food prices have fallen recently (Figure 10). If global food prices were the main cause of recent inflation, we would have expected to see inflation fall since early 2022, but the opposite is true. The recent trend contrasts with the period of 2012-17 when a decline in global cereal prices coincided with a decrease of inflation in Malawi. Malawi's food supply is dominated by maize.

Figure 10: FAO Global Cereals Price Index and Inflation in Malawi

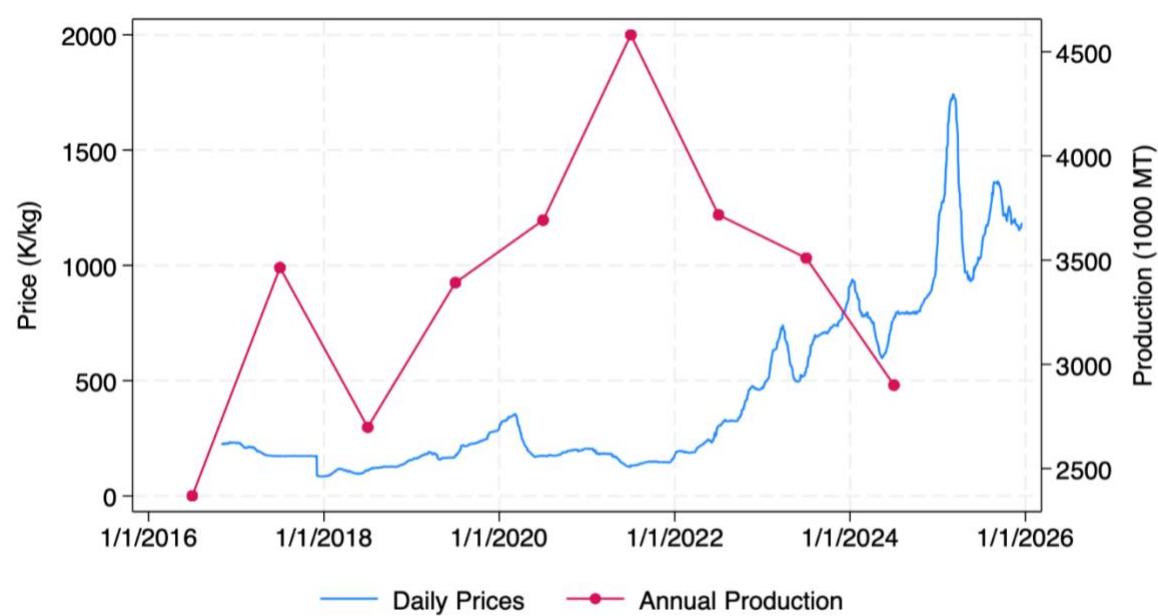


Source: FAO and Reserve Bank of Malawi

Weak domestic maize production has contributed to recent maize price increases but explains only a small part of overall inflation. Malawi's food supply is dominated by maize. Recent national maize production peaked in 2021 and has been weaker in years since due to weather shocks (Figure 11). Maize prices have increased drastically over this same period. Maize prices in Malawi experience spikes before the harvest following low production years. The trend line shows an overall increase in the maize price by a factor of close to five (400% growth) over the period of 2021 to 2025. Over this same period, national maize production has fallen by about 1/3 from its peak in 2021, though net imports of maize over these years mean that maize supply did not fall by as much. (Note: production levels in 2025 have been reported to be close to the level of 2024 at 3,000 MT.) Multiple global studies find that cereal prices have an elasticity to supply over the medium term of multiple cropping cycles of 0.7-1.4. This means that at the high end of price impacts, a decline in supply of 33% would be expected to lead to price increases on the order of 50%. Since the actual price increases of maize was around 400%, this is clearly a

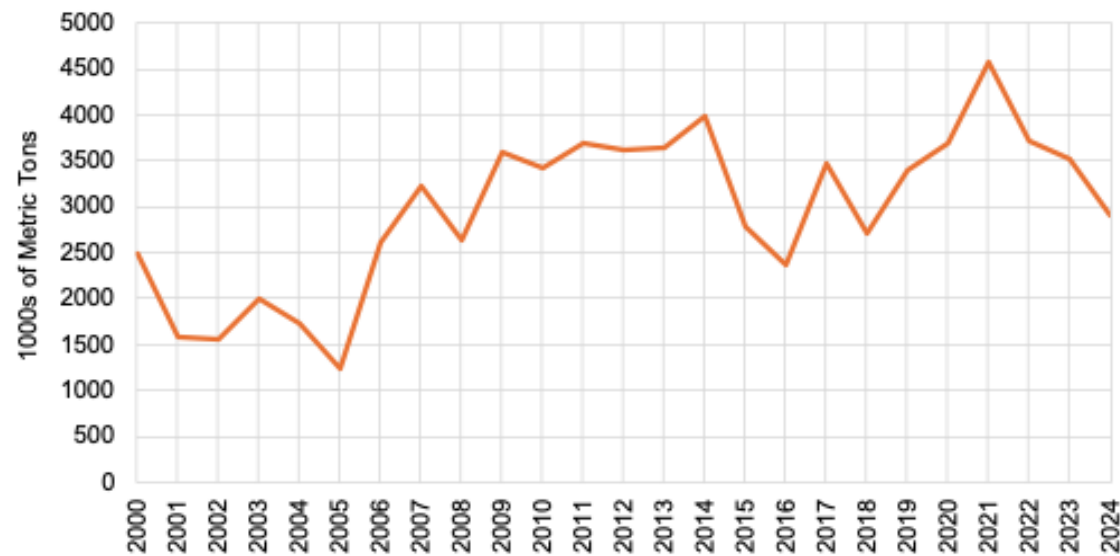
secondary factor. Taking a longer view of production data, Malawi’s maize production in recent years — apart from 2024 — also remains close to historic highs (Figure 12). Given population growth, Malawi needs to achieve production growth (or import growth) food security. Thus, recent production has been highly problematic. However, it is not the main cause of recent inflation.

Figure 11: Maize Prices and Production, 2019-2025



Source: IFPRI and U.S. Department of Agriculture

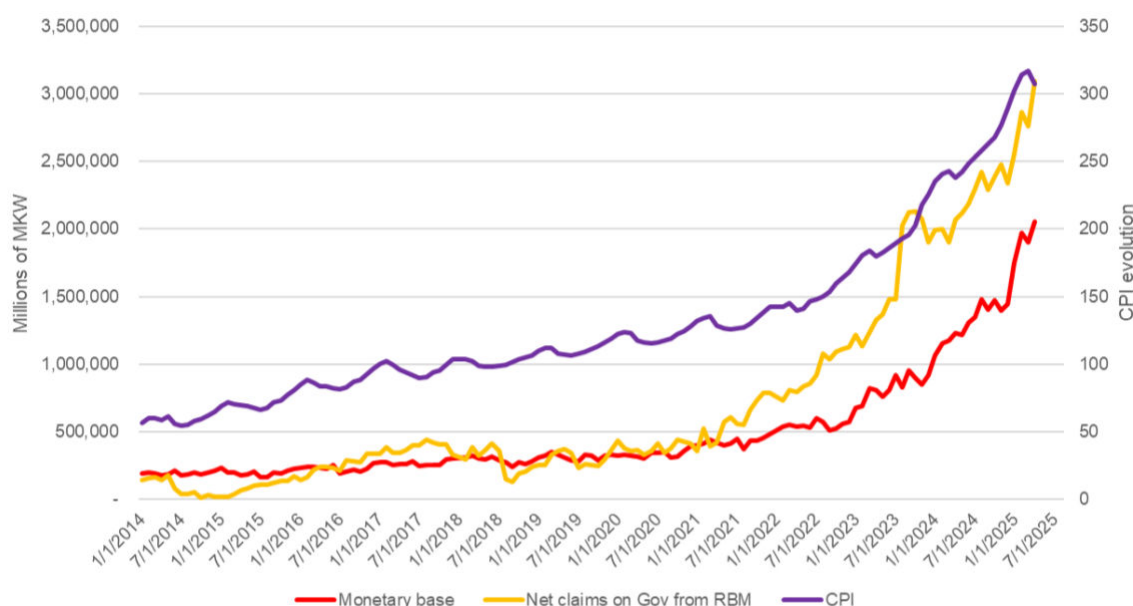
Figure 12: Maize Production in Malawi



Source: U.S. Department of Agriculture

Money supply, meanwhile, has undergone an unprecedented expansion during the current episode of inflation. In recent years, money supply has grown substantially with a pattern that aligns closely with recent inflation. Since 2021, money growth has been on an accelerating path (Figure 13). The Reserve Bank of Malawi (RBM) has expanded its net claims on government (i.e. its holding of government debt) rapidly since 2021. This has translated, with a time lag, into an increase base money at an unprecedented rate — by a factor of more than four in just four years. This pattern aligns closely with that of inflation. The timing is not coincidental. Increases in base money growth appear to precede the acceleration in inflation by three-to-six months, a pattern consistent with standard monetary theory.

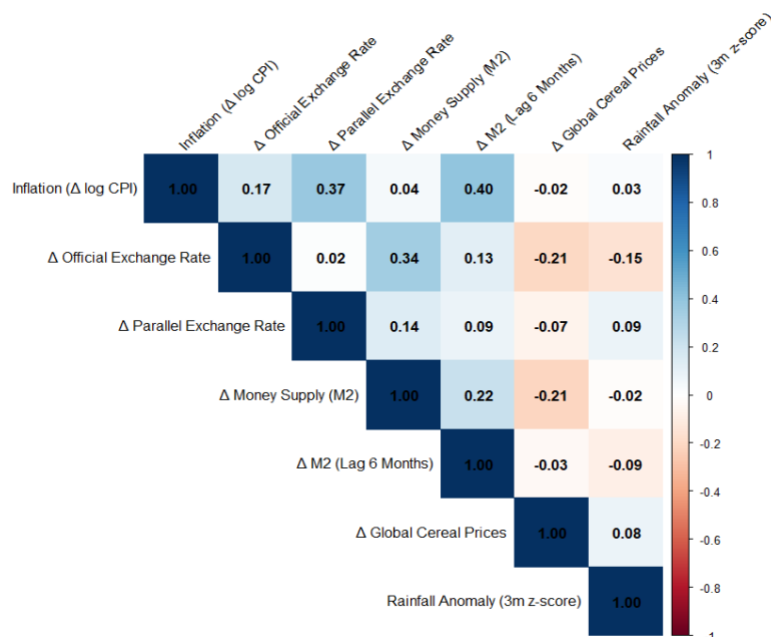
Figure 13: Evolution of the Monetary Base, Net Claims on Government, and CPI



Source: Reserve Bank of Malawi

A look at monthly correlations in variables confirms the tight relationship between money supply expansion and inflation. Figure 14 provides simple correlations between the inflation and changes in several other variables of interest (the official exchange rate, the parallel exchange rate, broad money supply (M2), broad money supply lagged by six months, global cereal prices, and a measure of rainfall anomaly), using monthly data from June 2019 through August 2025 to isolate the current episode of inflation. Monthly inflation over this period is most correlated with the change in M2 six months prior and the current parallel market premium for foreign exchange. There is a lower positive correlation with the official exchange rate and essentially no correlation with global cereal prices and rainfall anomalies. Correlation does not mean causation, however. Thus, we will investigate causation later in this note.

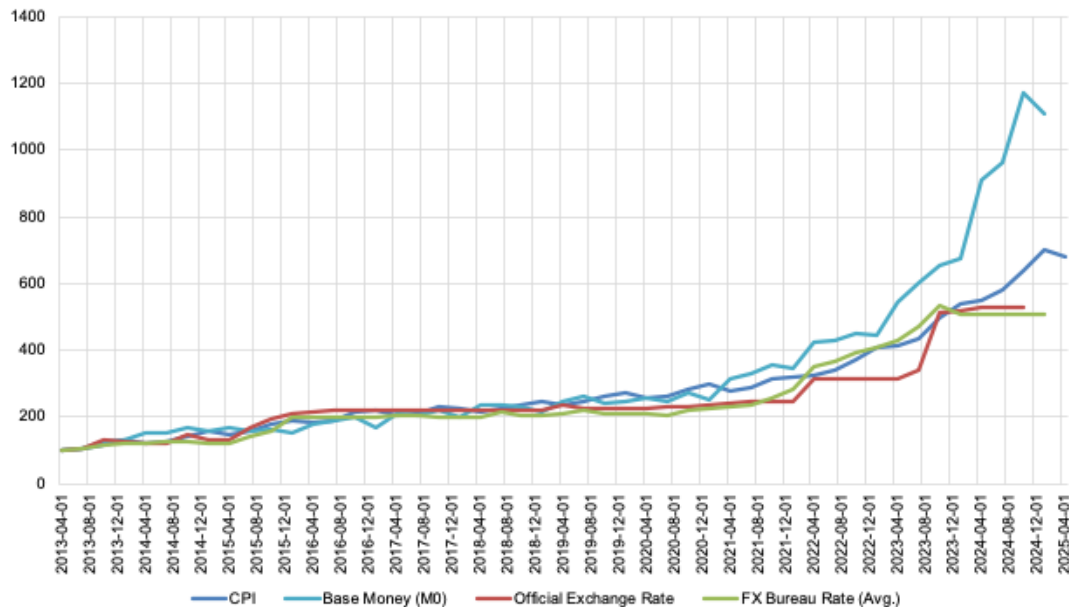
Figure 14: Correlation of Inflation and Other Relevant Variables Since June 2019



Source: Own analysis using data from the Reserve Bank of Malawi, FAO, and IFPRI

A closer look at movements in the official exchange rate alongside monetary variables reveals a clear pattern of the official exchange rate “catching up” with inflation rather than driving it. Common wisdom in Malawi often treats official exchange rate depreciation as a cause of inflation, but the evidence suggests the causation largely runs in the opposite direction. Monetary expansion causes inflation, which creates a pressure on the exchange rate to depreciate. Since there is an active parallel market in Malawi, the adjustment happens quickly in the parallel market rate for dollars. Official devaluations eventually follow as belated adjustments to this underlying reality. This sequence is visible in the data. Figure 15 shows CPI, base money, the official exchange rate, and the average FX bureau rate all benchmarked to their 2013 values to observe changes over time. As inflation accelerated since 2020, the more market-determined price of foreign exchange at FX bureaus also accelerated. The devaluations of the official rate in 2022 and 2023 can be seen as an adjustment to catch up with these fundamentals, but base money growth and inflation continued thereafter. In late 2023, the allowable rate at FX bureaus was capped and these ceased to be market clearing. 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 15: CPI, Base Money, and Exchange Rates Indexed Values (April 2013=100)



Source: Reserve Bank of Malawi

This causal chain where money growth causes inflation and a parallel market premium for foreign exchange, which the official exchange rate must eventually catch up with, also matches regression results using established methods. To explore these relationships more carefully, we replicated the approach of the RBM’s 2011 study (Simwaka et al., 2012), “Money Supply and Inflation in Malawi: An Econometric Investigation,” which used an error-correction model (ECM), using data covering the current episode of inflation. Using this approach, we estimate monthly inflation as a function of the official and parallel FX rates, M2 growth lagged by six months, a rainy-season dummy variable, and a global cereal price index. As done in the 2011 study, we also include inflation in the previous month in the regression specification. The lagged ECM term captures the long-run relationship between prices, money and foreign exchange. Table 2 shows the results of three different regressions that include either the official exchange rate, parallel market exchange rate, or both influences. Across all specifications, lagged inflation is highly significant with a large coefficient, reflecting persistence in price dynamics. The official exchange rate is never statistically significant, while the parallel market rate coefficient is positive and significant. M2 growth lagged by six months is a robust and economically important driver in all three models. When this model is run without one-month lagged inflation, the coefficients and significance of lagged M2 growth and the parallel market rate all increase.

Table 2: Regression Results of an ECM Model of Recent Inflation

Inflation Drivers in Malawi: FX, Money Supply, Rain Season & Global Cereal Prices			
	Model 1	Model 2	Model 3
Constant	-0.206 (0.161)	-0.208 (0.191)	0.025 (0.390)
Lagged inflation	0.502*** (0.141)	0.508*** (0.117)	0.593*** (0.128)
Official FX Rate	-0.003 (0.059)		0.012 (0.058)
Log-difference Money Supply (M2, 6-month)	0.256** (0.094)	0.244** (0.082)	0.284** (0.086)
Rainy-season dummy	-0.011+ (0.006)	-0.009+ (0.005)	-0.012* (0.005)
Log-difference FAO Cereal Price Index	0.102 (0.065)	0.121* (0.057)	0.112+ (0.061)
Parallel FX Rate		0.087** (0.032)	
FX Premium (Parallel - Official)			0.018+ (0.010)
Num.Obs.	66	64	64
R2	0.392	0.512	0.460
R2 Adj.	0.330	0.461	0.393
RMSE	0.02	0.02	0.02

+ p < 0.1, * p < 0.05, ** p < 0.01, *** p < 0.001

+ p < 0.1, * p < 0.05, ** p < 0.01, *** p < 0.001

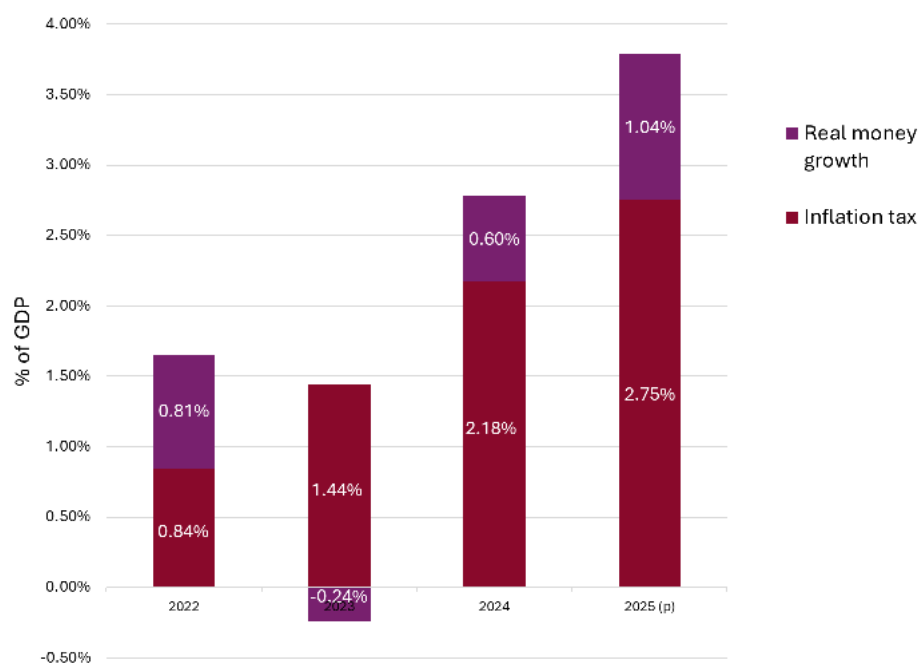
Standard OLS standard errors in parentheses.

Changes in FX measures are calculated as monthly log-differences.

The evidence points to excess money supply growth as the overwhelming cause of inflation today, which begs the question of why money growth is so high. The answer is out of fiscal necessity. Facing a rising primary deficit and declining aid flows, the government has increasingly relied on money growth to finance expenditures. The Government of Malawi now issues a large amount of domestic debt each year, which is held primarily by commercial banks and other financial institutions. The RBM purchases government securities on the secondary market, paying for them by expanding the monetary base. This process effectively monetizes the fiscal deficit. The RBM is creating much more money than the economy is demanding, resulting in seigniorage. Figure 16 decomposes seigniorage into its two components — the inflation tax and real money

growth — each as a share of GDP.¹⁶ Total seigniorage was about 1.6% of GDP in 2022 and 1.2% in 2023, before rising sharply to almost 2.8% of GDP in 2024 and a projected 3.8% in 2025. Over time, the composition has shifted toward the inflation tax component, which expands from 0.8% of GDP in 2022 to an estimated 2.8% in 2025, indicating that today’s high inflation is itself a major source of budgetary financing. Since the government is financing a non-trivial share of its needs by creating money, bringing inflation down will require replacing this implicit tax with other, non-inflationary sources of public sector funding.

Figure 16: Inflation Tax and Real Money Growth Contributions to Seigniorage



Source: Own calculations using Ministry of Finance data

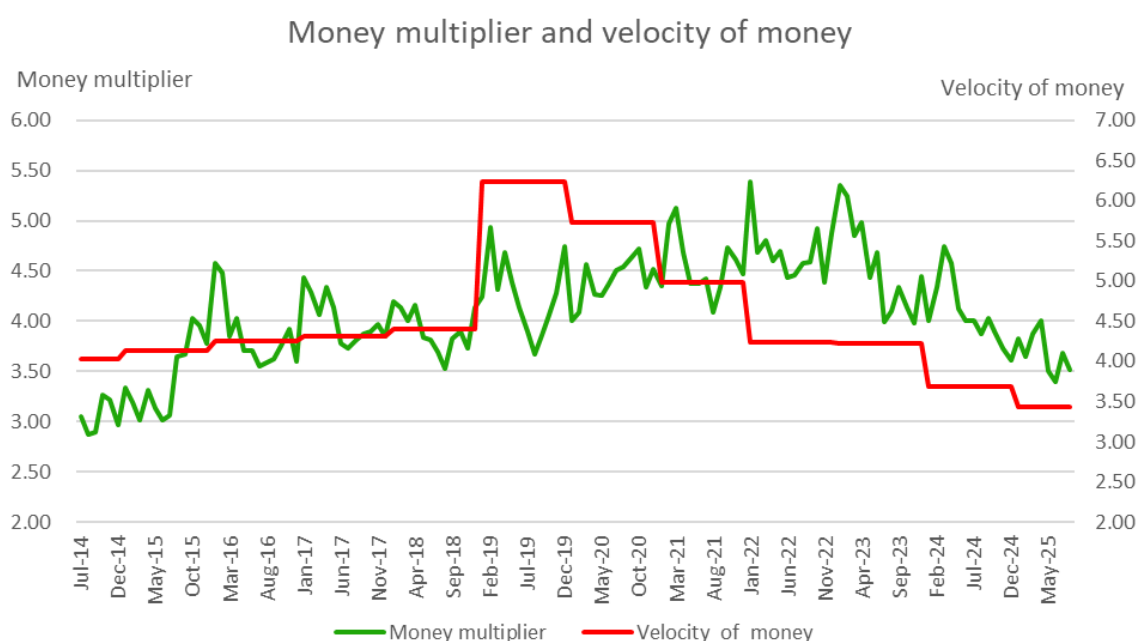
Decomposition of Money Growth

Decomposing the process of money growth is important for targeting effective solutions. The following decomposition of money growth — first of base money changes and then broad money changes — shows that reserve money, not the money multiplier or velocity, is the main driver of recent change. On the RBM balance sheet, the monetary base has grown primarily through increases in net claims on government and through liquidity provided to banks, which is often

¹⁶ Seigniorage is calculated as $\Delta MB / GDP$; the inflation tax as $\pi \times (MB / GDP)$. Their difference represents real money growth—the non-inflationary component of money creation.

recycled into additional government debt holdings. Meanwhile, M2 has expanded rapidly, while both velocity and the money multiplier have declined (Figure 17). Households and firms are holding larger nominal balances relative to income, and banks are creating fewer deposits per Kwacha of reserves. This configuration implies that M2 growth is clearly being driven by the expansion of the monetary base, rather than by faster circulation of money or aggressive bank credit creation. This is consistent with RBM reporting that shows that banks are not expanding bank branches or ATM networks, even as money supply is growing and bank profitability is increasing.

Figure 17: M2 Money Multiplier and Velocity

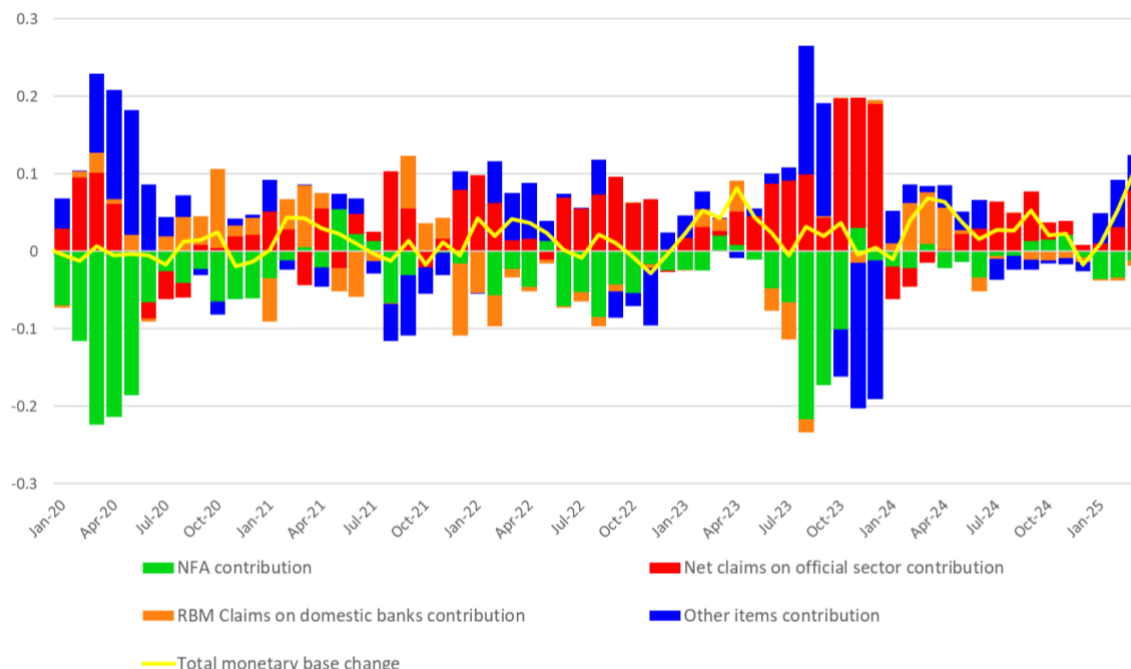


Source: World Bank World Development Indicators and RBM

Decomposing base money growth into its components reveals that net claims on the official sector (i.e. the RBM's financing of government) has been the dominant source of monetary expansion since mid-2023 (Figure 18). Monthly contributions from this channel have routinely reached 15–20% of total base money changes during peak periods in late 2023 and early 2024. The RBM has consistently lost net foreign assets over this same period. The central bank has been losing foreign exchange reserves — selling dollars to defend the exchange rate or meet import demand. All other things equal, this would have decreased money supply. Instead, overall base money has expanded dramatically. The RBM is simultaneously hemorrhaging foreign exchange and printing money to finance the deficit. This combination appears highly unsustainable. Data

from 2024 showed some moderation in both the pace of fiscal financing and overall base money growth. If sustained, this could have translated into lower inflation with a lag of several months. However, money growth accelerated in early 2025, and the structural pressures that created this situation (large fiscal deficits, limited external financing, and weak revenue mobilization) remain unresolved.

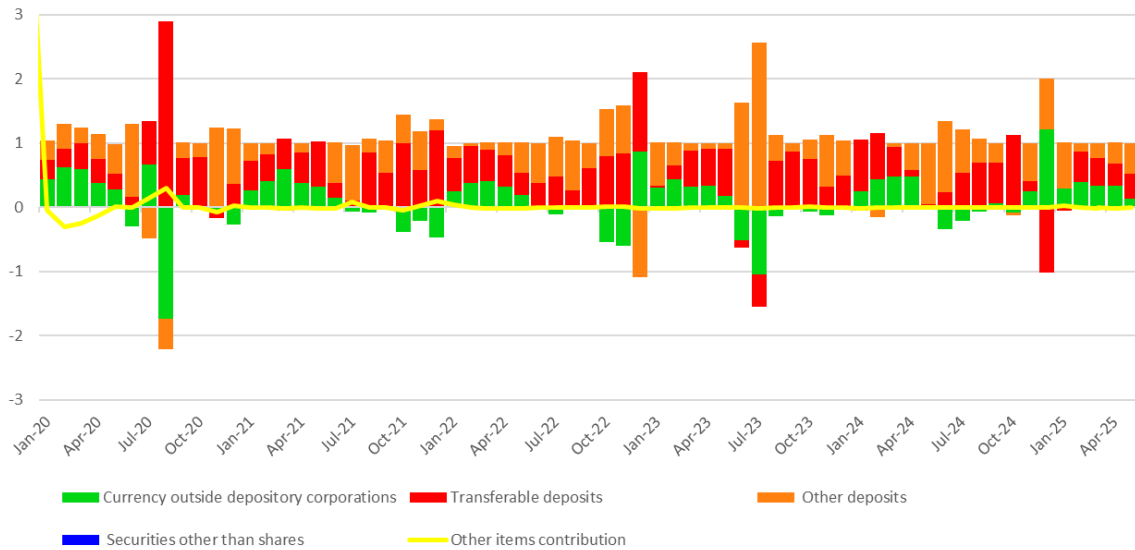
Figure 18: Monetary Base Changes by Component (Monthly)



Source: Reserve Bank of Malawi

The transmission from base money to broad money has been remarkably complete. Decomposing broad money growth (Figure 19) reveals persistent expansion across all deposit categories (transferable deposits, other deposits, and currency in circulation). Unlike base money, where reserve losses partially offset fiscal financing, broad money shows no such counterweight. Other deposits, which include savings and time deposits, have been the steadiest driver, growing in nearly every quarter since 2020. Currency in circulation has also grown consistently as households require ever more banknotes to conduct daily transactions at inflated prices. This is both a symptom and an accelerator, as rising prices increase the demand for nominal money balances, which validates the expansion that caused the price increases in the first place. The damage compounds over time. As inflation persists, expectations become entrenched. Breaking this cycle may require not only slowing money creation but also rebuilding credibility.

Figure 19: Broad Money Change/ Change in Base Money (Quarterly)



Source: Reserve Bank of Malawi

What is needed to bring down inflation?

The evidence that we have shown here shows that the following dilemma is behind inflation experienced in Malawi today:

- The Government of Malawi faces persistent fiscal deficits and limited access to external and domestic non-monetary financing.
- The RBM partially fills this gap by expanding the monetary base, which finances part of the deficit directly and lowers the real interest burden of domestic debt.
- Inflation is the result of the increased supply of Kwacha chasing the same supply of goods and services.
- In the foreign exchange market, the parallel market premium is widening in line with inflation, as more Kwachas chase the same amount of dollars.
- The fixed official exchange rate eventually must adjust to realign with these fundamentals, but without a reduction in money supply growth, inflation and pressure on the parallel market for foreign exchange continues.

- Since access to foreign exchange is constrained, Malawi is unable to take advantage of lower global food prices through imports and remains highly exposed to domestic supply shocks in food production.
- This equilibrium harms households and businesses. Households see the value of their savings and the purchasing power of their income erode month after month. Meanwhile, high and unpredictable inflation discourages investment.
- The scarcity of foreign exchange in the economy worsens and more of the economy moves to informal channels, which widens the fiscal deficit and incentivizes more money printing.

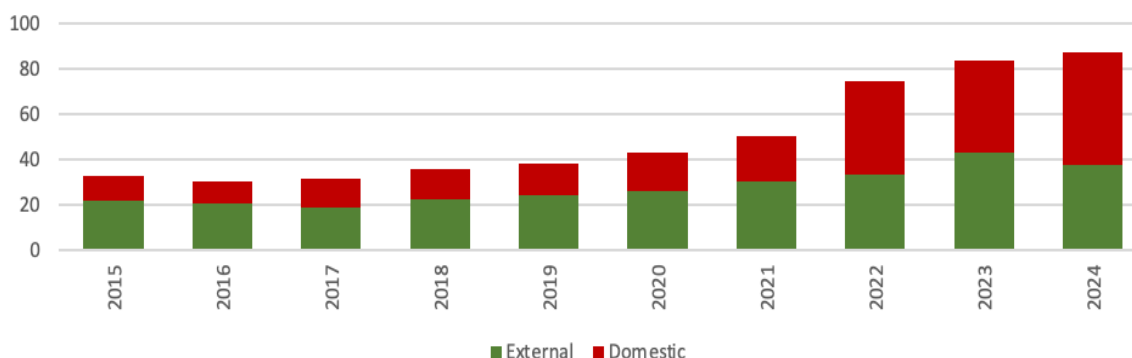
Based on this analysis, the following steps would be needed to bring down inflation:

- To reduce inflation, the growth of the monetary base must slow. This requires limiting monetary financing of the fiscal deficit and accepting lower seigniorage revenues.
- Fiscal policy must be put on a more sustainable path (through a combination of revenue measures, expenditure rationalization, and, ideally, greater access on concessional external financing) to reduce need for domestic debt and money growth.
- Clear operational guidance for the RBM is needed to anchor expectations and break the automatic link between fiscal deficits and money creation. One concrete option is to target the dollar value of domestic assets on the RBM balance sheet:
 - Cap domestic assets (claims on government and banks) in U.S. dollar terms, limiting how much the monetary base can be expanded.
 - Allow significant growth of the monetary base only when net foreign assets increase, thereby tying money creation to genuine improvements in the external position rather than to fiscal pressures.
 - Such a framework would help break the causal chain (fiscal deficit → monetary base expansion → high inflation) and provide a clearer nominal anchor. This would not be a stand-alone solution. Rather, success would depend on accompanying fiscal measures and consistent communication, but it would directly target the mechanism that currently sustains high inflation in Malawi.

Annex 3: Malawi's Debt Dynamics

Malawi is on unsustainable debt accumulation path. Between 2019 and 2024, Malawi's public debt grew from 43% to 88% of GDP (Figure 20), fueled by extraordinarily large fiscal deficits averaging 9.3% of GDP. Interest payments more than doubled during this period, from 3% to 7% of GDP. And to add even more fuel to the fire, the 2025/26 fiscal deficit is projected to close somewhere in the vicinity of 11% to 12% of GDP.

Figure 20: External and Domestic Debt (% of GDP)



Source: Data from World Bank World Development Indicators

This annex explores Malawi's debt dynamics with a focus on understanding relevant issues that will affect the debt trajectory and future money growth. Recent debt sustainability analyses have clearly shown that Malawi has a debt sustainability problem. The most recent WB/IMF Debt Sustainability Analysis (DSA) (International Monetary Fund, 2025a) finds that Malawi's external and public debt are in distress and that the public debt dynamics are unsustainable under current policies. The goal of this annex is to deepen understanding of the dynamics of the interest burden, which has become a significant part of the deficit and the need to print money.

The first section goes over the external debt showing that under current spending, the external debt burden is not high (while Malawi is in arrears for its most expensive creditors) as most of this debt is concessional. Thus, financing the external debt is not (as of yet) a major drain on foreign exchange nor is it a major driver of the deficit. However, external sustainability does depend on robust export growth.

The second section covers the dynamics of domestic debt which has grown rapidly especially in recent years. Because this debt is expensive, the interest burden is high and growing. If Malawi

aims to reduce its fiscal deficit enough to stem money supply growth so that it can implement foreign exchange and macro reforms, the domestic debt poses two challenges First, the high cost of the domestic debt is a major cause of the fiscal deficit that needs to be financed. Second, if Malawi is successful in bringing down inflation, then the burden of this debt (especially the long-term bonds) will increase as real rates rise further. This means that even as the stock of debt stabilizes or declines, the ongoing debt service burden can still be very high.

External Debt

At 37% of GDP by end-2024, the external debt is not particularly high and largely concessional (Table 3). Debt service costs are therefore low, with the exception of those related to the commercial debt, on which it is now in arrears and in ongoing debt restructuring negotiations.

Table 3: Debt and Debt Service Composition

	Debt stock			Debt service 2025
	(million US\$)	% total debt	%GDP	% total debt service
Total	10,328	100%	88%	100%
External	4,385	42%	37%	28%
Multilateral creditors	3,068	30%	26%	3%
IMF	412	4%	3%	0%
World Bank	1,718	17%	15%	3%
AfDB	463	4%	4%	0%
Other Multilaterals	475	5%	4%	0%
o/w: IFAD	144	1%	1%	0%
OFID	86	1%	1%	0%
Bilateral Creditors	362	4%	3%	0%
Paris Club	1	0%	0%	0%
Non-Paris Club	361	3%	3%	0%
o/w: EXIM China	193	2%	2%	0%
EXIM India	92	1%	1%	0%
Local debt with non-residents	31	0%	0%	0%
Commercial creditors	903	9%	8%	22%
o/w: AFREXIM	439	4%	4%	9%
TDB	464	4%	4%	13%
FX Swaps with non-residents	21	0%	0%	0%
Domestic	5,944	58%	50%	72%
Held by residents, total	5,769	56%	49%	72%
FX Swaps with resident	175	2%	1%	0%
Memo items:		0%	0%	0%
Collateralized debt	439	4%	4%	0%

Source: World Bank / IMF DSA

The law of motion of the external debt is determined by the balance of payments identity. Expressed in local currency, the law of motion is captured by equation (1). All values are expressed in domestic currency. D_t^e represents the external debt stock at time t , E_t the exchange rate vis-à-vis the dollar, $D_t^{e,fc}$ the stock of foreign-currency denominated external debt, i_t^e the average interest rate on the foreign-currency denominated external debt, $D_t^{e,dc}$ the stock of domestic-currency denominated external debt, i_t^d the average interest rate on the domestic-currency denominated external debt, $NICD_t$ the non-interest current account deficit, and $NCDF_t$ the non-debt creating flows.

$$(1) \quad D_t^e = E_t D_{t-1}^{e,fc} (1 + i_t^e) + D_{t-1}^{e,dc} (1 + i_t^d) + NICAD_t - NCDF_t$$

If we divide both sides of (1) by GDP, rearrange and simplify terms, we obtain:

$$(2) \quad \Delta d_t^e = i_t^a \sigma_t - g_t \sigma_t - \pi_t^{d,us} (1 + g_t) \sigma_t + \alpha_{t-1} (1 + i_{t-1}^d) \varepsilon_t \sigma_t + nicad_t - ndcf_t$$

where $\alpha_t = \frac{D_t^{e,dc}}{D_t^e}$; $i_t^a = (1 - \alpha_{t-1})i_t^e + \alpha_{t-1}i_t^d$; $\varepsilon_t = \frac{E_t}{E_{t-1}} - 1$; and $\sigma_t = \frac{d_{t-1}^e}{(1+g_t)(1+\pi_t^{d,us})} \cdot \pi_t^{d,us}$ represents the growth of the GDP deflator in US dollar terms.

Equation (2) shows that the change in external debt as a share of can be decomposed into several clear components. The first term in (2) is the contribution of interest payments, the second term the contribution of real GDP growth, the sum of the third and fourth terms the contribution from price and exchange rate changes, and the fifth and sixth term the contributions of the current account balance (excluding interest payments) and nondebt creating flows, respectively. Malawi is entering a phase where there are limited means to finance further increases in the current account deficit (in nominal US dollars). Looking forward, the non-debt creating flows, the trade deficit, and the external debt) are expected to remain near their current nominal levels (Figure 21). The WB/IMF baseline scenario assumes relatively high growth in nominal GDP (in US dollars) as well, and therefore a significant decline in these three accounts as shares of GDP (Figure 22).

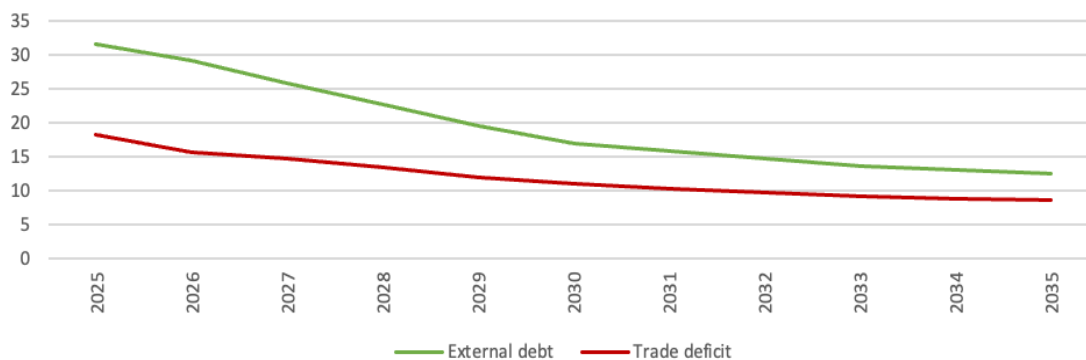
The WB/IMF baseline scenario is highly dependent on export growth (6.4% per CAGR between 2026 and 2035) as a source of FX for growing imports (3.0% CAGR) and as an engine for real GDP growth (3.4% per year over the medium term). Assuming lower exports and GDP growth would result in a larger external financing gap. This would then therefore make the external debt even less sustainable. In other words, if export growth and GDP growth underperform — as we would expect with reducing FX scarcity — external debt sustainability will worsen. This is not because of high external borrowing but rather because of low FX generation.

Figure 21: Trade in Goods and Services (USD Billions)



Source: IMF/WB DSA (October 2025)

Figure 22: External Debt and the Trade Deficit (% of GDP)



Source: IMF/WB DSA (October 2025)

Domestic Debt

The domestic debt is even more problematic and consequential. It is larger, growing much faster, and costlier. As seen in Figure 21, since 2019 the domestic debt has been growing much faster than the external component. Moreover, the domestic debt is not concessional. Interest payments on the domestic debt represented 94.7% of total interest payments in 2024, grew from 2.9% to 6.9% of GDP and from 23% to 46% of domestic revenues between 2019 and 2024. In 2024, the domestic interest burden overtook *wages and salaries* to become the largest spending category in the budget (30% and 23% of current and total expenditures, respectively). Over the past few years, foreign aid has almost entirely migrated from budget support to project financing, the primary deficit has been almost entirely financed domestically, and the primary and domestic

primary deficits have become one and the same. As a result, the simplified dynamic equation for the domestic debt is now (1):

(1) $D_t^d = D_{t-1}^d(1 + i_t^d) + PD_t$; where D^d is the debt stock, t is a time subscript (indicating years in this case), i^d the average interest rate on the domestic debt; and PD the primary deficit. Equation (1) can also be expressed as shares of GDP:

$$(2) \quad d_t = d_{t-1} \frac{(1+i_t^d)}{(1+G_t)} + pd_t \quad ; \text{ with } G \text{ representing the growth rate of Nominal GDP}$$

Alternatively,

$$(2') \quad d_t - d_{t-1} = d_{t-1} \frac{(i_t^d - G_t)}{(1+G_t)} + pd_t$$

Malawi's domestic debt dynamics have been favorable since 2022 (i.e. $i_t^d < G_t$), but marginal interest rate-growth differentials have been largely negative and are expected to remain so (Figure 23 and Figure 24). Except for the year 2023, marginal interest rates on the domestic debt were higher than nominal growth rates. Average effective rates, however, were lower and this resulted in a negative contribution from the growth-interest rate differential throughout this period. The projected decline in inflation and the rise in real interest rates resulting from a higher risk premium on the domestic debt would translate into a reversal of this trend.

Figure 23: Marginal i-G Differentials (%)

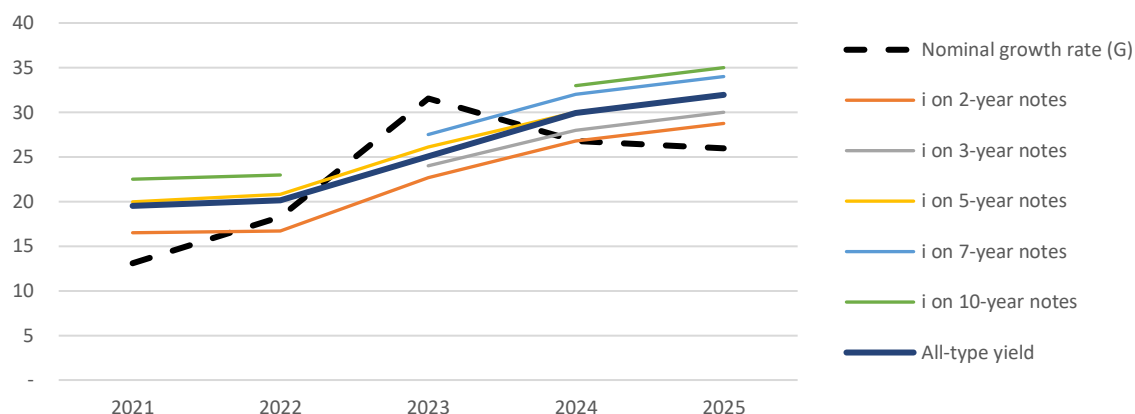
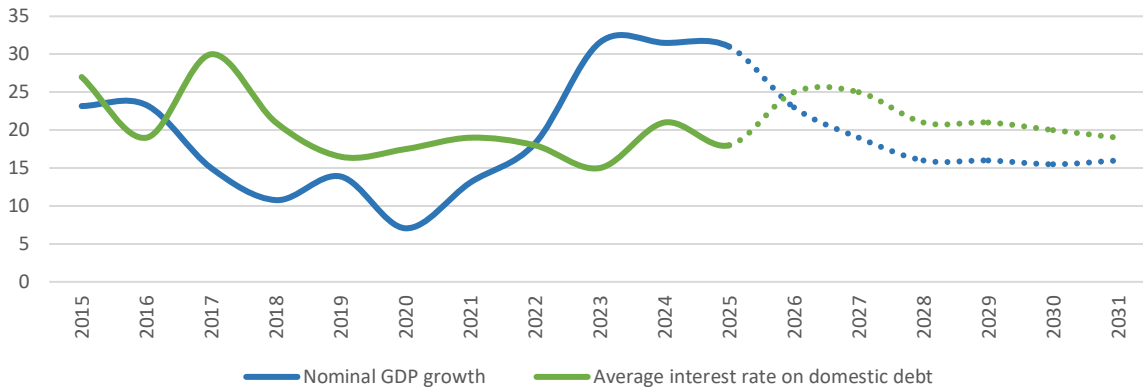


Figure 24: Nominal GDP Growth and Average Interest Rate on Domestic Debt (%)



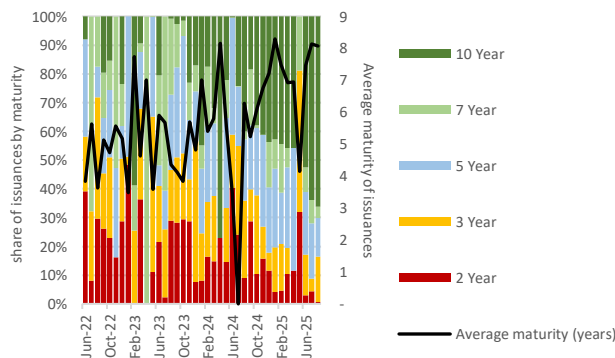
Source: World Bank

A decline in inflation would leave nominal interest payments on this debt unchanged until maturity but sharply increase their real value and their burden relative to government revenues. A sizeable and growing share of Malawi's domestic government debt consists of Treasury notes with maturities of 3, 5, 7, and 10 years and fixed nominal coupon rates of 30–35 percent (see

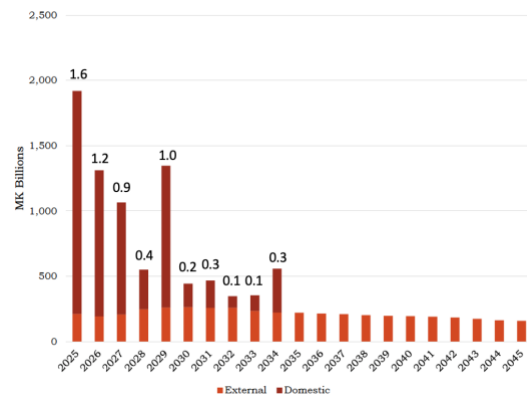
Figure 25). This creates a fiscal obstacle to disinflation: the resulting increase in the real debt-service burden could widen financing needs and induce further monetization, reinforcing a high-inflation equilibrium.

Figure 25: T-Note Issuance and Maturity

A. T-notes issuance by maturity



B. Maturity up to 2045



Sources: RBM

The government could address this problem through a negotiated swap into medium- and long-term floating-rate notes whose nominal principal remains fixed, but whose coupons reset every three or six months based on a clearly specified benchmark deposit rate plus a fixed spread. As inflation and deposit rates decline, the government's interest bill would then adjust downward, supporting rather than undermining disinflation. Retaining long maturities would limit rollover risk, while linking coupons to deposit rates would better match the interest-rate sensitivity of banks' government securities with that of their deposit liabilities.

A reversal of the domestic debt dynamics would imply a rising debt stock due to the carrying cost of previously issued debt, even if the authorities are able to engineer a successful debt swap and a primary balance. Five simulated scenarios can be used to illustrate the challenge as well as the trade-offs that the authorities would face as they tackle this issue. The common governing assumptions for these scenarios are summarized in Table 4. The different scenarios also vary in terms of their primary balance trajectory and growth of GDP. In Scenario 5, we explore the impact of a theoretical haircut on the debt burden, i.e., a reduction in the principal.

Table 4: Basic Parameter Assumptions for Scenarios

Variables	Scenarios	
	1, 2, and 3	4 and 5
G	16%	14%
i	18%	18%
g	3.2%	1.5%
r	5.0%	5.0%

Table 5 provides the results of these five simulations based on the following assumptions:

1. **Scenario 1 assumes a two-year path to a permanent primary deficit of 1% of GDP.** This scenario seeks to illustrate what would happen under current policies. Climbing domestic debt-to-GDP and debt-service to GDP ratios that reach 69.6% and 10.5% by 2035 and 93.4% and 14.1% by 2045, respectively, underscoring the conclusion that emerged from the WB/IMF that the public debt is unsustainable under current policies.
2. **Scenario 2 assumes a three-year path to a permanent primary deficit of 0% of GDP.** This scenario seeks to illustrate what would happen under more stringent fiscal policies. Even with a primary balance, the domestic debt-to-GDP and debt-service to GDP ratios keep rising due to the unfavorable debt dynamics, reaching 61.1% and 9.3% by 2035 and 72.5% and 11.1% by 2045, respectively.

3. **Scenario 3 assumes a four-year path to a permanent primary surplus of 1.5% of GDP.**

This scenario seeks to illustrate what would happen under even more stringent fiscal policies. The domestic debt-to-GDP and debt-service to GDP ratios now decline as the primary surplus more than compensates for the unfavorable debt dynamics, reaching 50.1% and 7.9% by 2035 and 43.2% and 6.8% by 2045, respectively.

4. **Scenario 4 is equivalent to Scenario 3 but with a lower growth rate ($G = 14\%$ instead of 18%).** Scenario 4 seeks to illustrate the impact of a lower growth rate. The domestic debt-to-GDP and debt-service to GDP ratios now rise as the primary surplus is not able to compensate for more unfavorable debt dynamics, reaching 40.0% and 6.3% by 2035 and 38.6% and 6.1% by 2045, respectively.

Scenario 5 is equivalent to Scenario 4 but with a debt restructuring equivalent to an initial 30% haircut on the domestic debt stock lower growth rate. This scenario seeks to explore the impact of a sizeable reduction in the principal. The domestic debt-to-GDP and debt-service to GDP ratios now decline as the lower debt stock allows for the primary surplus to once again more than compensate for the unfavorable debt dynamics, but interest costs as a share of GDP remain high.

Table 5: Scenario Results

Scenario 1: A two-year path a permanent primary deficit of 1% of GDP												
	2025	2026	2027	2028	2029	2030	2031	2032	2033	2034	2035	2045
Debt stock	48.6%	51.4%	53.3%	55.2%	57.2%	59.2%	61.2%	63.3%	65.3%	67.5%	69.6%	93.4%
Debt service	6.6%	7.5%	8.0%	8.3%	8.6%	8.9%	9.2%	9.5%	9.8%	10.1%	10.5%	14.2%
Primary deficit	5.0%	2.0%	1.0%	1.0%	1.0%	1.0%	1.0%	1.0%	1.0%	1.0%	1.0%	1.0%
Scenario 2: A 3-year path to a permanent primary balance (0% of GDP)												
	2025	2026	2027	2028	2029	2030	2031	2032	2033	2034	2035	2045
Debt stock	48.6%	51.4%	53.3%	54.2%	55.2%	56.1%	57.1%	58.1%	59.1%	60.1%	61.1%	72.5%
Debt service	6.6%	7.5%	8.0%	8.3%	8.4%	8.6%	8.7%	8.9%	9.0%	9.2%	9.3%	11.1%
Primary deficit	5.0%	2.0%	1.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
Scenario 3: A 4-year path to a primary surplus of 1.5% of GDP												
	2025	2026	2027	2028	2029	2030	2031	2032	2033	2034	2035	2045
Debt stock	48.6%	51.4%	53.3%	54.2%	53.7%	53.1%	52.5%	51.9%	51.3%	50.7%	50.1%	43.20%
Debt service	6.6%	7.5%	8.0%	8.3%	8.4%	8.3%	8.2%	8.1%	8.1%	8.0%	7.9%	6.8%
Primary deficit	5.0%	2.0%	1.0%	0.0%	-1.5%	-1.5%	-1.5%	-1.5%	-1.5%	-1.5%	-1.5%	-1.5%
Scenario 4: Same as Scenario 3 but with lower growth ($g=1.5\%$; $G=14\%$)												
	2025	2026	2027	2028	2029	2030	2031	2032	2033	2034	2035	2045
Debt stock	48.6%	52.3%	55.1%	56.9%	57.4%	57.9%	58.4%	58.9%	59.4%	59.9%	60.5%	67.2%
Debt service	6.6%	8.7%	9.4%	9.9%	10.3%	10.3%	10.4%	10.5%	10.6%	10.7%	10.8%	10.5%
Primary deficit	5.0%	2.0%	1.0%	0.0%	-1.5%	-1.5%	-1.5%	-1.5%	-1.5%	-1.5%	-1.5%	-1.5%
Scenario 5: Same as Scenario 3 but with an initial 30% haircut on the domestic debt stock												
	2025	2026	2027	2028	2029	2030	2031	2032	2033	2034	2035	2045
Debt stock	34.0%	37.2%	39.5%	40.8%	40.7%	40.6%	40.5%	40.4%	40.3%	40.2%	40.0%	38.6%
Debt service	6.6%	5.3%	5.8%	6.1%	6.3%	6.3%	6.3%	6.3%	6.3%	6.3%	6.2%	6.1%
Primary deficit	5.0%	2.0%	1.0%	0.0%	-1.5%	-1.5%	-1.5%	-1.5%	-1.5%	-1.5%	-1.5%	-1.5%

The simulations highlight the need to tackle the fiscal deficit through a two-pronged strategy aimed at: (1) bringing down the primary deficit and achieving a positive primary balance as quickly as possible; and (2) exploring ways to restructure the domestic debt in a way that leads to significant reductions in debt service payments. The road to price and exchange rate stabilization depends on easing monetary financing of the fiscal deficit. The simulations presented convey the idea that this will be tough and that even under the best of circumstances it will take years to achieve. It is therefore crucial that this process is managed in a way that distributes the sacrifices fairly along the road, and this general principle applies both to the revenue mobilization and expenditure reduction strategies aimed at reducing the primary deficit, as well as to those aimed at reducing debt service costs.

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