December 2004
IMF Country Report No. 04/389

Malawi: Ex Post Assessment of Longer-Term Program Engagement

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International Monetary Fund
Washington, D.C.

INTERNATIONAL MONETARY FUND

MALAWI

Ex Post Assessment of Longer-Term Program Engagement

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Policy Development and Review Departments[1]

Authorized for Distribution by African and
Policy Development and Review Departments

September 16, 2004

I. Introduction

1. **Malawi's economic performance since the late-1970s has been diverse with repeated attempts at macroeconomic stabilization and adjustment, interrupted by policy slippages and exogenous shocks**. Important structural reforms have included improving opportunities for smallholder farmers and reducing the oligopolistic nature of the economy. Moreover, the country underwent a significant political reform in 1994 when the first multi-party elections were held. But putting the public finances on a durable footing and tackling both domestic and external imbalances has proved elusive. Much of the country is mired in poverty, social indicators are amongst the lowest in sub-Saharan Africa, and food security is yet to be attained.

2. **The Fund has remained engaged with Malawi through much of this period, with a series of financial arrangements and staff-monitored programs**. These included three Stand-by Arrangements (SBA), 1979–83; an Extended Fund Facility (EFF), 1983–86; an Enhanced Structural Adjustment Facility (ESAF), 1988–94; a Standby Arrangement (1994); an Enhanced Structural Adjustment Facility (1996–1999); and a Poverty Reduction and Growth Facility (PRGF), 2000–2004 (Table 1).

3. **This report presents an ex-post assessment of Malawi's longer-term program engagement with the Fund.** Given the length of the engagement, and the important political change that took place in the mid-1990s, much of this report focuses on performance during

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the programs supported by the 1995 ESAF and 2000 PRGF arrangements. Section II provides an overview of economic developments. Section III reviews achievements and shortcomings

Table 1. Malawi: IMF Arrangements, 1979-2004

Arrangement	Approval date	Scheduled end date	Actual end date	Approved (SDR, millions)	Disbursed (SDR, millions)
SBA	10/31/79	12/31/81	5/8/80	26.3	5.4
SBA	5/9/80	3/31/82	3/31/82	49.9	40.0
SBA	8/6/82	8/5/83	8/5/83	22.0	22.0
EFF	9/19/83	9/18/86	8/5/86	81.0	57.0
SBA	3/2/88	5/30/89	5/30/89	13.0	9.3
ESAF	7/15/88	9/29/92	3/31/94	67.0	67.0
SBA	11/16/94	6/30/95	6/30/95	15.0	12.7
ESAF	10/18/95	12/16/99	12/16/99	51.0	51.0
PRGF	12/21/00	12/20/03	12/20/03	45.1	12.9

Source: International Monetary Fund

in some key macroeconomic and structural areas. Section IV discusses the role of the Fund in this process, including program design, conditionality, and collaboration with the World Bank. The report concludes in Section V with the main lessons and implications for possible future Fund engagement.

II. Overview of Economic Developments

4. **Malawi's strongest post-independence growth performance came during the period 1970–78, which also coincided with fiscal and monetary policies that were prudent at least in comparison to subsequent periods**. During this period, the government also used credit allocation schemes and direct access to export markets to encourage parastatals to engage in large-scale agricultural production. Smallholder farmers were obliged to sell crops to parastatals, mainly the Agricultural Development and Marketing Corporation (ADMARC), which typically paid less than half the export price and controlled much of storage and distribution facilities. The structure of the economy was highly oligopolistic with an extensive web of interlocking ownership and control of substantial economic resources—including the agricultural, manufacturing, and financial sectors—by a few powerful public and private companies.

5. **The second phase started around 1979 when a number of shocks created serious macroeconomic imbalances which, in the absence of adequate adjustment, resulted in rising inflation and the emergence of an external debt problem**. Over the following

decade, Malawi entered into several financial programs supported by the Fund. During this period, the authorities succeeded in significantly reducing the fiscal deficit. The financial condition of several of the large parastatals improved, but they also used the opportunity to further consolidate their monopoly/monopsony powers, impeding competition. The lack of competition in the financial sector meant that credit allocation tended to favor entrenched interests.

6. **Shocks in the early 1990s, including a severe drought in 1991/92, a cut-off of all nonhumanitarian balance of payments support in 1992/93 due to donors' concerns about governance, and a marked deterioration in the terms of trade, resulted in a major downturn in 1992. The situation was exacerbated by significant fiscal and monetary policy slippages**. A weather-assisted recovery in 1993 formed the basis of a strengthened macroeconomic framework for 1993/94.

7. **During the first half of 1994, Malawi's financial position deteriorated again due to excessive budgetary expenditures in the run-up to the country's first multiparty elections**. The resulting massive recourse to bank financing contributed to a resurgence of inflation, exacerbated by another drought and depreciation of the kwacha following the introduction of a market-based exchange system. The government entered an eight-month SBA, though, in the event, the adjustment was not sustained resulting in a deficit (including grants) of more than 15 percent of GDP and inflation running at 66 percent by end-1994.

8. **Against this background of a mixed record during almost 15 years of adjustment and stabilization efforts (1979–1994), the three-year ESAF arrangement approved in October 1995 listed four main objectives**: (i) raising real GDP growth to an average of 4½ percent per year; (ii) reducing inflation to 5 percent per year by end-1998; (iii) curtailing domestic and external imbalances to attain a more sustainable balanced of payments position; and (iv) addressing the pressing social needs of the population within the constraints of prudent fiscal policy. Key structural priorities included enhancing productivity in the agricultural sector, inter alia by correcting the historical emphasis on estate farming at the expense of smallholders; privatizing public enterprises, both to reduce the budgetary burden of loss-making enterprises and to de-monopolize the economy; and improving human resources and protecting the country's natural resources.

9. **Performance during the first half of the three-year ESAF-supported program was impressive**. During 1995–96 real GDP growth rebounded to an annual average of 12 percent; the 12-month rate of inflation declined from 95 percent in mid-1995 to 10 percent by end-1996; the balance of payments improved, with gross international reserves rising from practically zero at end-1994 to 3½ months of imports by end-1996; and the fiscal deficit (excluding grants) declining from 13½ percent of GDP in 1995/96 to 7½ percent of GDP in 1996/97. Important strides were also made on the structural front. Measures to improve opportunities for smallholders, including abolishing the monopsony rights of ADMARC and liberalizing exports, together with favorable weather conditions resulted in a 40 percent increase in smallholder production in 1996. The legal and institutional framework for

privatization was established; trade import tariffs and export taxes were lowered; and a census of the civil service was conducted to eliminate ghost workers and separate some 20,000 temporary and non-established workers.

10. **Policy implementation deteriorated markedly soon after the completion of the midterm review of the second annual arrangement**. The fiscal deficit in 1997/98 widened to 11½ percent of GDP, derailing the monetary program and exerting pressure on the balance of payments and on the exchange rate; the kwacha was devalued several times, and inflation doubled to 15 percent per year. The structural reform agenda also slowed: measures aimed at strengthening expenditure control as well as reforming the civil service proceeded slowly; the introduction of the value-added tax (VAT) and the establishment of the Malawi Revenue Authority was delayed; and hardly any progress was made on privatization.

11. **Approval of the third annual arrangement was delayed until October 1998 but soon went off-track as expenditure overruns, including related to the costs of holding elections, resulted in a deficit that was about 2 percent of GDP higher than programmed**. Growth performance was lackluster and there was virtually no progress on lowering inflation which reached 53 percent in 1998 and 30 percent in 1999. Progress on structural measures was also modest.

12. **Against the background of mixed performance under the 1995–1999 program, a three-year PRGF arrangement was approved in December 2000**. Many of the objectives of the PRGF-supported program echoed earlier priorities: (i) attainment of macroeconomic stability through monetary restraint and a further reduction in domestic borrowing by the public sector allowing for an expansion in private sector investment; (ii) restructuring and prioritization of public expenditures to improve public sector management and service delivery; (iii) creation of a favorable environment for private sector development; and, (iv) design and implementation of a comprehensive and cost-effective social safety net. Special emphasis was placed on addressing governance and strengthening the legal framework to combat fraud and corruption.

13. **Performance under the PRGF-supported program was poor**. The first review was delayed until October 2003 owing to significantly larger-than-programmed fiscal deficits and money growth rates, higher inflation, a weaker balance of payments and inadequate growth.[2] During the two fiscal years 2000/01 (July-June) and 2001/02, fiscal slippages occurred principally on account of repeated bailouts of parastatals, the sharp increase in interest rates associated with rising domestic public debt, overruns on the wage bill, and overspending on other current expenditures. The policy slippages and consequent delay in completion of the

[2] At the time of the first review, the PRGF arrangement was extended by one year, through December 20, 2004.

review resulted in shortfalls of external budgetary support.[3] This set up a vicious cycle of greater recourse to domestic financing, crowding out of the private sector, rising interest rates, widening overall fiscal deficits, and worsening public debt dynamics. These trends were exacerbated in the second half of 2002 by the government's maize operation that was intended to avert a food crisis following the drought. In the event, drought-related operations added some 4½ percent of GDP to fiscal expenditures. Implementation of structural reforms was also uneven and often delayed, particularly measures intended to strengthen expenditure control, revenue collections, and management and reporting of government debt. In addition, while the monopoly of ADMARC in the marketing of maize was abolished, full commercialization of its operations was not attained.

14. **The key objective of the program approved at the first review was re-establishing macroeconomic stability.** To this end, the program sought to reduce inflation, replenish reserves, and reduce domestic debt. In the face of interest payments on domestic debt reaching 7 percent of GDP, it was deemed essential that part of the external budgetary aid be used to reduce domestic debt, change inflationary expectations, and facilitate a fall in domestic real interest rates.

15. **Amidst continued policy slippages, the second review could not be completed.** Over the revised period to be covered by the second review—September-December, 2003—growth was lower, inflation higher, and the current account deficit larger than programmed. Implementation of structural measures was also disappointing, with seven out of eight structural performance criteria—including those related to public sector remuneration and anti-corruption activities—not observed on time. Despite efforts at fiscal adjustment, the December 2003 fiscal target—net domestic credit to the government—was exceed by more than 4 percent of GDP. While the fiscal target was ambitious and, given short-falls in expected disbursements of donor support, probably unattainable, it is likely that much of the expected donor support would have materialized had the authorities completed specified actions. Moreover, contrary to the strategy at the time of the first review of reducing domestic debt, expenditure was not even partially adjusted to reflect the shortfall in external budgetary support; indeed, expenditures were allowed to increase in the face of higher-than-programmed revenues. Large election-related overspending was acknowledged in June 2004, finally derailing the program.

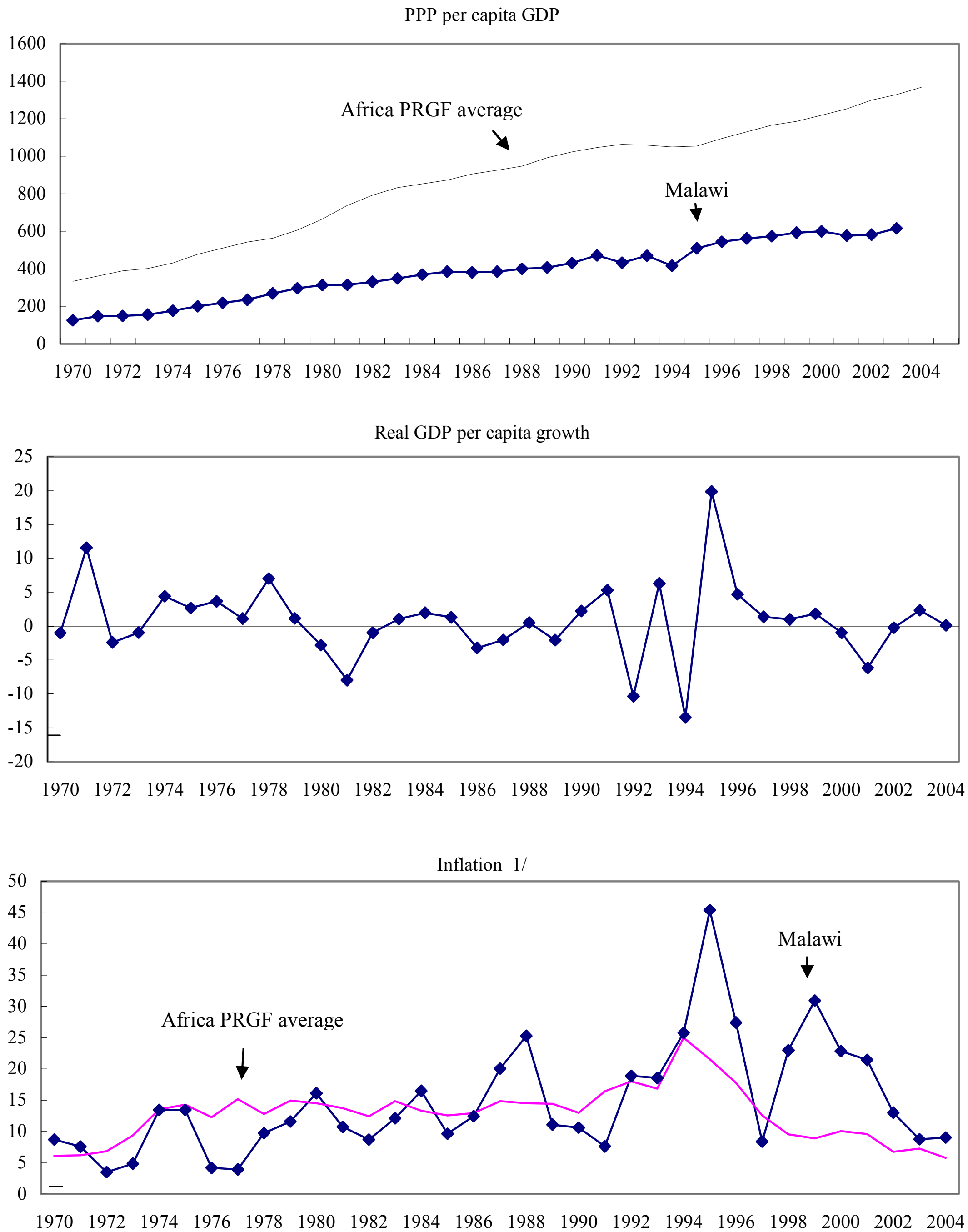
[3] External budgetary support was also delayed, and in some cases withheld, because the donor community was unwilling to support, or indirectly finance, the former President's bid for a third term in office, which would have necessitated a constitutional amendment.

III. Achievements and Shortcomings

A. Macroeconomic Stabilization

16. **Over the past thirty years, Malawi's growth performance has been uneven, averaging about 5 percent per year, in per capita, purchasing power parity (PPP)-adjusted terms (and less than 1 percent per year in per capita real terms), with a standard deviation of 6½ percent per year**. Faster growth than other PRGF-eligible African countries has implied some convergence, with Malawi's per capita income rising from about one-third of the African PRGF-eligible country average in 1970 to almost 60 percent by 1999 (Figure 1). Subsequent poor performance, however, has meant that

Figure 1. Malawi: PPP Per Capita GDP, Real Per Capita GDP Growth, and CPI Inflation (1970-2004)



Source: International Monetary Fund, World Economic Outlook; and staff estimates.
1/ To reduce the effect of high- or hyper-inflationary outliers, both series have been transformed by = /(1+), where is the inflation rate expressed as a decimal fraction

Malawi has slipped back to about one-half of the African PRGF-eligible country average by 2003. Growth was particularly strong during the first half of the 1995-1999 ESAF, driven in part by structural reforms, falling inflation, and improved fiscal performance as well as a favorable external environment. Slippages thereafter contributed to the downturn (Box 1).

17. **The public finances have been derailed periodically, particularly in the aftermath of adverse weather conditions or in the run-up to elections**. During 1994, in the run-up to the country's first multi-party elections, the overall fiscal deficit almost tripled to 15 percent of GDP, and again in 1998/99, the deficit reached 5.1 percent of GDP against a program projection of 3.2 percent of GDP. More recently, the former President's bid for a third term in office was associated with significant fiscal expenditure overruns; against program expectations of an overall fiscal balance in 2000/01 and a surplus of 1.5 percent of GDP in 2002/03, outturns were -8 percent of GDP and -12 percent of GDP, respectively.[4] This political budget cycle has been exacerbated by the government's maize operations in response to droughts, which have generally been very costly in relation to the results achieved (see paragraphs 37-39, below).

18. **Fiscal overruns have been associated with monetization of the deficit, crowding out of credit to the private sector, and poor inflation performance**. Over the past decade, Malawi's inflation rate has averaged 23 percent per year—almost double the average for other PRGF-eligible African countries (13 percent per year).[5] Associated with the fiscal overruns, have been massive increases in banking system credit, especially in the context of donors curtailing support because of concerns about governance. Thus, in 2003, instead of a contraction of 38 percent (of beginning-of-period broad money), net credit to government expanded by 12 percent, with severe crowding out of credit to the private sector, and higher-than-programmed money growth and inflation.

19. **The fiscal overruns have also been manifested in a cycle of increasing public debt, rising interest rates, and worsening debt dynamics**. Over the past five years, domestic public sector debt has risen dramatically, from 3 percent of GDP in 1999 to 20 percent of GDP by end-2003. Given shortfalls in external budgetary support, the government has made increasing recourse to domestic financing, which reached 7–8 percent of GDP during 2001–03, instead of falling by 2 to 3 percent of GDP as programmed. As a result, domestic interest rates were as high as 40 percent per year in real terms, and interest payments on domestic debt have reached 9 percent of GDP—which represents 90 percent of the government's interest bill—against a domestic debt stock of about 23 percent of GDP.

[4] Preliminary indications suggest that in the run-up to the May 2004 elections, there have been significant expenditure overruns in the first half of 2004.

[5] To reduce the effect of high or hyper-inflationary outliers, the inflation rate is scaled as $\tilde{\pi} = \pi/(1+\pi)$, where π is the inflation rate expressed as a decimal fraction.

Box 1. Understanding Output Growth in Malawi

Although raising output growth is a key development challenge for Malawi, relatively little analysis has been undertaken to try to understand the factors behind Malawi's growth performance. In part, this reflects the extreme volatility of Malawi's growth, which tends to be idiosyncratic and highly dependent on weather shocks. Nevertheless, a useful exercise is to apply a standard growth model to decompose annual output growth. Applying such a model (estimated on PRGF countries over the 1990s) yields:

	PRGF Countries (Balanced Panel; 1992-2002)					Malawi (program 1996-98)				
	3-years preceding program		3-year program		3-years following program	3-years preceding program		3-year program		3-years following program
Real GDP per capita growth	-0.56		1.34		0.68	**3.34**		**2.35**		**-1.83**
Change in per capita growth		1.90		-0.66			**-0.98**		**-4.18**	
Contributing factors										
G7 real GDP growth		0.50		0.10			**0.45**		**-0.35**	
Initial conditions		-0.02		-0.13			**0.10**		**-1.63**	
Macro policies		0.31		0.21			**0.97**		**-0.25**	
o.w. inflation		0.02		0.22			**0.41**		**-0.20**	
o.w. fiscal balance		0.29		-0.01			**0.56**		**-0.05**	
Structural reforms		0.08		0.01			**0.39**		**-0.22**	
Shocks (internal and external)		0.58		-0.08			**1.31**		**-1.33**	
Other		0.44		-0.77			**-4.21**		**-0.40**	
# observations		46		46						
# countries		31		31						

Four points are noteworthy. First, improvements in macroeconomic policies (inflation and the budget balance) contributed about 1 percentage point to growth performance during the 1996 ESAF. Thereafter, macroeconomic policies have not had much positive impact on growth—indeed, macroeconomic slippages explain (a small part) of the deterioration in growth performance. Second, structural reforms—increasing trade openness—added a further ½ percentage point to growth performance during the 1996 ESAF. Third, internal shocks (proxied by food production falling by at least 5 percent in one year) and external shocks (given by the terms of trade) account for large positive effects during the 1996 ESAF and a corresponding decline in the period thereafter. Finally, the magnitude of the residual in is large (and much larger than for the average PRGF country), underscoring the often idiosyncratic nature of Malawi's growth performance.

These developments have put the public debt dynamics on a clearly unsustainable path (Figure 2).

20. **External debt has also risen sharply, even taking account of debt relief that Malawi will receive at completion point**. Malawi reached its decision point in December 2000, on the basis of its end-1999 NPV-to-export ratio of 269 percent. The Decision Point document projected that Malawi's debt ratio would increase from 150 percent (after debt relief) to 177 percent by end-2003 (and be on a declining path thereafter). Instead, (taking account of the relief Malawi that was promised at decision point) the NPV-to-export ratio has risen to 191 percent by end-2003 and is projected to remain above 150 percent of exports over the next decade, although the debt-service ratios, at around 10 percent, should remain manageable.[6]

B. Structural Reforms

Demonopolization, Liberalization, and Privatization

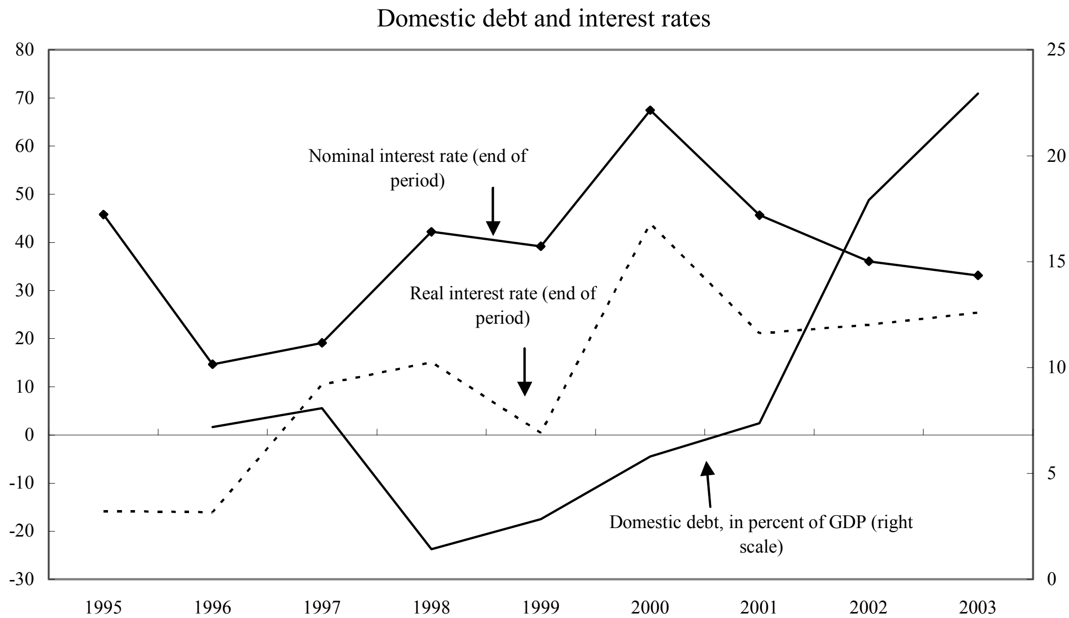
21. **Important progress in liberalizing the economy and in reducing the role of the state was made during the first half of the 1995 ESAF-supported program.** In the agricultural sector, the smallholder burley tobacco quota was raised substantially, the Special Crops Act was amended to allow smallholders to grow cash crops by degazetting various crops as special crops, the Agricultural Produce and Livestock Act was repealed to liberalize pricing and marketing for all agricultural produce (except for maize), export licensing requirements for beans and groundnuts were lifted, import licensing requirements on seed and fertilizer were removed, and ADMARC lost its monopsony rights of being the sole purchaser of the produce of smallholders, who obtained access to the tobacco auctions.

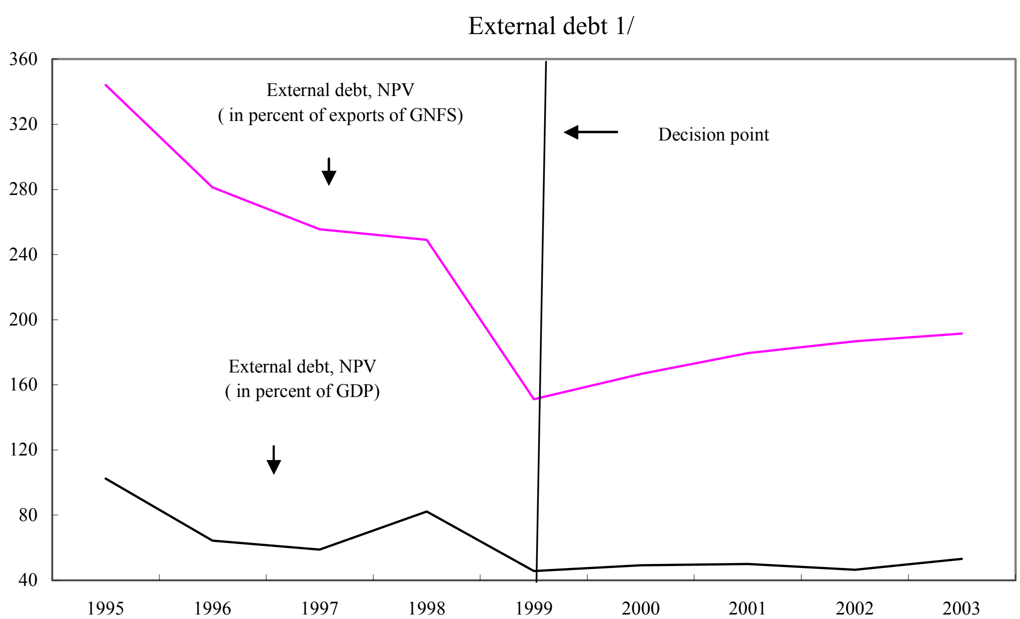
22. **During 1995–1996, the legal and institutional framework for privatization was also established.** The Public Enterprises (Privatization) Act was approved by Parliament in April 1996, and the Secretariat for the Privatization Commission became fully functional a few months later. Initial progress was made on restructuring some key public enterprises, including Malawi Railways, in preparation for eventual privatization. Public enterprises, especially utilities, were also given greater flexibility in adjusting administered prices to reflect costs and to place them on a more secure commercial footing.

23. **Thereafter, however, the impetus for privatization and demonopsonization slowed markedly during the remainder of the 1995 ESAF, with some progress under**

[6] For this calculation, the discount rate for the stock of pre-debt relief debt is unchanged from the assumption underlying the Decision Point document. Therefore, the effect of the fall in global discount rates on the stock of debt does not account for the rise in the NPV. However, the flow of additional borrowing has probably been on less concessional terms than would have been assumed in the Decision Point document due to the fall in discount rates.

Figure 2. Malawi: Public Debt,Domestic Interest Rates, and External Debt, 1995-2003





Sources: Malawi authorities.
1/ Reflects debt relief that Malawi will receive at completion point.

the 2000 PRGF. In particular, progress was made on divestiture by the government from the Commercial Bank of Malawi (the second largest bank in Malawi in terms of assets); transfer to a private company of the management of Malawi Lake Services; privatization of a textile subsidiary of ADMARC; privatization through an initial public offering of a subsidiary of Malawi Development Corporation; and repeal of the ADMARC Law, thereby removing the legal impediments to restructuring ADMARC and the separation of its social functions (supplying maize at affordable prices to rural areas) from its commercial activities that should be run on a commercial basis. There have also been some improvements in the utilities sector, including competition in the provision of cellular telephone services,

24. **Monopolies and oligopolies continue to dominate many economic activities, including banking, cement, petroleum, retailing, tobacco auctioning, and transportation**. In most cases they are either public enterprises, such as ADMARC or MDC, or private companies which operate at arms' length from government, such as the Press Corporation. Particularly in the banking sector, the two largest banks still command almost two-thirds of the market, and there is evidence that the oligopolistic structure of the banking sector has helped to maintain high interest rate spreads and to shift most market risks to bank customers.[7]

25. **Important progress has been made in trade reforms, with the trade restrictiveness index declining from 5 in 1997 to 2 by 2003**. The import liberalization program that was initiated in 1991 led to a liberalized exchange rate regime in 1994 and the removal of restrictions on all current account transactions in 1995. The maximum tariff declined from 65 percent in 1996 to 30 percent.[8] By June 1997, import and export licenses were removed except for items that remained banned because of health, security, and environmental concerns.[9] Malawi is a member of the World Trade Organization, as well as of two regional organizations that encourage economic integration and a reduction in tariffs, namely the Southern Africa Development Community (SADC) that includes Malawi's

[7] A recent study by Chirwa and Mlachila (IMF Staff Papers, Vol. 51, No. 1, 2004) shows that there is little evidence that opening the banking sector to new entries has reduced the market share of the two leading banks or that it is likely to lead to an decline in interest rate spreads. The government still maintains sizeable influence on these two banks through its direct or indirect (i.e., via the Press Corporation) holdings.

[8] The standard tariff regime is relatively simple, consisting of three categories of ad valorem rates of about 5–10 percent for most raw materials and inputs, 10 percent for intermediate products, and 30 percent for final products. However, a complex tariff regime remains in place because of preferential rates granted to COMESA and SADC members.

[9] Removal of export licensing requirements were conditions under the ESAF-supported program (see Appendix I).

biggest trading partner South Africa, and the Common Market for Eastern and Southern Africa (COMESA). The business climate was also improved by greater perceived fairness in tax administration and policy, resulting from the establishment of the independent Malawi Revenue Authority which began operation in 2000; the introduction of an automated system of customs declaration and administration (ASYCUDA); and the extension of the surtax (a value-added tax) to the wholesale and retail sector in 2002 which was followed by a reduction in the surtax rate. However, concerns remain about tax and tariff exemptions as well as leakages in export processing zones, and competitive pressure from Zimbabwe has given rise to renewed calls for protectionist measures.

Strengthening the Budgetary Process and Public Expenditure Management

26. **The budgetary process is extremely weak with outturns frequently differing from the original budget by substantial margins.** Underlying the weak budgetary process are a number of factors: poor planning that does not budget for all required expenditures; a largely perfunctory medium-term framework; within-year policy changes which implied expenditure increases; lack of integration between the current and development budgets; often poor estimates of revenues; unbudgeted support for parastatals and subvented organizations; weak fiscal controls both at the central and ministry levels that allow for over-expenditures and extensive virement; and difficulties with payroll control in particular "ghost workers." In addition, Malawi receives significant donor inflows, which are only partially reflected in the budget even if the executing agency is a government ministry or agency.

27. **Budget implementation through cash rationing and sequestration has also undermined the budgetary process**. While such rationing has, at times, helped re-establish macroeconomic stability, it has also contributed to the dissonance between the original budget and actual expenditures, undermining the budgetary process. Both unpredictable cash allocations to ministries and poorly planned budgets have resulted in domestic arrears, the eventual clearance of which leads to further reallocations within the budget and more cash rationing.

28. **Despite numerous attempts at reform, and substantial technical assistance, public expenditure management (PEM) remains weak.** [10] Malawi only met 5 out of 16 benchmarks in the 2004 assessment of PEM systems for HIPC countries. In the early 1990s, the system of payments and accounting was decentralized to ministries. As it became apparent that controls had weakened, reforms were introduced to strengthen central fiscal control again, including reinstating the common accounting service. Cash management has been improved with the Credit Ceiling Authority (CCA) system, that controls regular cash allocations from the main government account, though a number of projects fall under

[10] Since June 2000, almost 80 weeks of fiscal-related technical assistance has been provided to Malawi.

separate bank accounts. A new Commitment Control System (CCS) monitors expenditures starting at the commitment stage, not only at the payment stage. In order to achieve deeper reforms, an Integrated Financial Management Information System (IFMIS) project was started in the mid-1990s and supported by the World Bank under different loans. Although progress has been slow, some pilot testing has been conducted and the pilot sites operate the IFMIS system. However, the broad roll-out of the system remains stalled and the government accounting and reporting is still fully based on the traditional manual ledger system including for the IFMIS pilot sites. The manual system supplemented by the CCA system, and the CCS could provide adequate fiscal monitoring and control, but the regulations for operating the manual system are not enforced: supplementary CCAs are issued without necessarily being monitored by the Ministry of Finance, reporting to the Ministry of Finance is often late and incomplete, bank accounts are not reconciled timely, and record keeping in the ministries is reportedly poor.

29. **Civil service wage policy reforms have been slow.** Although the civil service wage bill in Malawi is smaller than in many other African countries, there are significant distortions in its structure. In response to the compressed wage structure of the early 1990s, salaries of senior civil servants were increased and made contingent on performance. However, the remainder of the wage scale was not aligned with reforms at the top, thereby creating a wage gap of about 300 percent between the highest grade of the lower civil service and lowest grade of the senior civil service. The wage structure is also distorted with numerous, non-taxed allowances, some of which are indexed to the exchange rate or to fuel prices. Meanwhile, there have not been general wage adjustments for wages for the past five years, significantly reducing the real value of the basic wages.

Social Policies

30. **Poverty is widespread, and Malawi's social indicators are among the lowest in the world**. Some 65 percent of Malawians live below the poverty line, and many suffer through the "hungry season"—the three month period preceding the maize harvest. During the 1990s, overall poverty levels remained largely unchanged, with some worsening in urban poverty. Income distribution is highly unequal. The Gini coefficient (measured for consumption) is 0.40, and worse in urban areas. It is estimated that the richest 20 percent of households account for 46.3 percent of national consumption.[11]

31. **While data are lacking for a quantified assessment, little progress is likely to have been made in reducing poverty over the last decade.**[12] Because of population growth

[11] As measured from the 1997/98 household survey. The 1991/92 household survey computed a Gini coefficient of 0.62, but because of methodological differences the two measures are not comparable.

[12] A household survey is expected in 2005.

of about 2 percent per annum and the unequal distribution of income, it has been estimated that an annual growth rate in excess of 5 percent is required to impact poverty. With the exception of years in which agricultural production recovered from shocks, such growth rates have not been achieved. The Poverty Reduction and Growth Strategy (PRSP) of 2002 was developed in a highly participatory process, and is viewed as providing a well-developed and sound framework for public policies. However, the costing of policies in the PRSP and the link to the central government budget needs to be strengthened. Improvements in most PRSP indicators are to be achieved in the medium term and are expected to be assessed for the first time in 2005. While most PRSP indicators are in line with the Millennium Development Goals (MDG), the PRSP targets are less ambitious. Further work is required to develop long term targets that directly relate to the 2015 goals. While data remain weak, and projections subject to a high degree of uncertainty, current extrapolations of the targets set in the PRSP for 2005 suggest that Malawi will fall short of meeting the 2015 MDG goals.

32. **Education has been a priority of the government, and some improvements are visible**. Budgetary resources for education (as measured by the share of primary current expenditures) increased from 14 percent in 1990/91 to 20 percent in 2000/01, although this share has been volatile. About 40 percent of all government employees are teachers. Following the introduction of free primary education in October 1994, primary school enrollment doubled, and the gross enrollment rate is now 132 percent of the relevant age group. However, the pupil-to-qualified-teacher ratio remains very high at 114, and only about 11 percent of the adult population have completed 8 years of schooling. Nevertheless, the emphasis on education is showing some initial results, with the adult literacy rate rising from 52 percent to 62 percent since 1990.

33. **A National Strategic Framework for responding to the HIV/AIDS pandemic was adopted in 2000.** Conservative estimates put the HIV/AIDS incidence at 16 percent of the adult population, and the rate in pregnant women is higher. The impact of HIV/AIDS is estimated to reduce the annual economic growth rate by about 1½ percentage points, and life expectancy at birth has declined to only 38 years. In July 2001, the government established the National AIDS Commission to coordinate the national response, provide support to implementing agencies, mobilize resources, and monitor progress. The PRSP declares HIV/AIDS as a cross-cutting issue, requiring all ministries to put in place programs to combat this disease and deal with its impact. In addition, the donor community is supporting the HIV/AIDS policies through a basked funding arrangement, and the Global Fund has pledged US$42 million of a total 5-year funding request of US$284 million.[13] HIV/AIDS policies focus on reduction of the incidence through education and prevention, provide anti-retroviral drugs and treat HIV/AIDS related diseases, and provide support services for families affected by the disease.

[13] Additional resources are being made available for an anti-malaria program.

34. **Health care expenditures in the central government budget have remained fairly constant at about 8 percent of expenditure or 2½ percent of GDP**. While the budget strikes a reasonable balance between the wage bill and expenditures on goods and services, including drugs, a relatively high share of expenditures is directed toward tertiary care. There is only one physician per 45 thousand people, and because of very low wages for qualified personnel and the high attrition due to HIV/AIDS, staff shortages are a major concern especially in the rural areas. The Essential Healthcare Package, a strategy of bundled health services with a focus on the most important causes of mortality and morbidity, was envisaged in the PRSP and has been designed and costed.

Food Security

35. **Raising agricultural productivity is a key objective for sustaining growth and achieving poverty reduction.**[14] Droughts and food security concerns have frequently contributed to fiscal slippages and macroeconomic instability**.** Agriculture accounts for about 36 percent of GDP, and about 85 percent of Malawi's population depend on it for its livelihood. Malawi's food production consists primarily of maize, much of which is produced by small holder farmers. During the mid-1990s, including under the ESAF-supported program, significant progress was made in improving opportunities for small holder farmers, including by eliminating ADMARC's monopsony and liberalizing food production and distribution. At the same time, elimination of the fertilizer subsidy placed the use of fertilizers beyond the reach of many subsistence farmers. Government- and donor-provided

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[14] The Fund has generally refrained from advising the Malawi authorities on agricultural and food security policies, other than reiterating and supporting those policies advocated by other international and multilateral organizations (such as the World Food Program, the World Bank, and the European Union). In some cases, it has highlighted the fiscal and balance of payments impact of government intervention in the food market. While such endorsement of policies advocated by other international and multilateral organizations was appropriate inasmuch as these interventions had macroeconomic consequences, the Fund has not always emphasized sufficiently the need to implement complementary reforms. For instance, in line with the results of a study financed by the European Commission, a performance criterion on the avoidance of new borrowing by the National Food Reserve Agency was included in the 2000 PRGF arrangement, and staff advised that the physical stock of strategic grain reserve be reduced to 60,000 tons. Another key component of that study—that sufficient international reserves be built up and set aside to import fresh maize in the event of food shortages, was mentioned in the staff report but not given sufficient emphasis (for example, by raising the floor for net international reserves correspondingly). During the most recent food emergency that was anticipated in 2002/03, the Fund provided emergency assistance of SDR 17.35 million (about US$23 million) and accommodated the government subsidy for maize operations in the fiscal program (see Box 2).

Box 2. Malawi—Food Crises, the Strategic Grain Reserve, and the IMF [1]

The Malawian government's food strategy under IMF and World Bank-supported programs in the late-1990s was to end government interventions in the maize market, while providing targeted food subsidies to the vulnerable groups. In 1998, the government agreed to stop food price support operations of the Agricultural Development and Marketing Corporation (ADMARC), as they were seen to have (i) distorted price and other market signals, (ii) been a constant drain on government resources, and (iii) raised governance and corruption issues. In 1999, the management of the country's strategic grain reserve (SGR) for disaster relief was transferred to the newly established National Food Reserve Agency (NFRA). However, the NFRA soon intervened in the maize market in much the same manner as ADMARC had operated, accumulating large loans from commercial banks that were ultimately borne by the budget.

The World Bank and the IMF therefore urged the government to develop a transparent and rules-based food security policy. The IMF included in its PRGF arrangement in December 2000 a performance criterion on the avoidance of any new borrowing by the NFRA. In line with the results of a study financed by the European Commission, the IMF staff also advised that the physical stock of SGR, which had reached about 167,000 tons of maize at end-1999, be reduced to 60,000 tons.[2]

The government subsequently adopted the study's recommendations. However, rather than reduce the SGR to 60,000 tons, the NFRA sold virtually the entire stock of maize, planning to replenish the minimum quantity of the SGR when the 2001 harvest came to market. Between August 2000 and January 2001, some 68,000 tons of maize was sold from the SGR without the proper authorization, and possibly without the knowledge, of the NFRA management. Moreover, allegations surfaced in the news media that some of the maize was sold to politically well-connected people at below market prices. In the event, the early warning system failed to properly predict the poor harvest in 2001. Strapped of maize reserves, the government started importing about 150,000 tons of maize in late-2001, but logistical problems delayed the arrival of the maize until after Malawi had already run out of food, and people were perishing from starvation.

A repeat of this tragedy was averted during 2002/03 crop year through a combination of early government and private sector imports of maize, supplemented by generous humanitarian assistance. As it turned out, the shortfall in domestic food production during 2002/03 was smaller than predicted, and the private sector response was larger than expected, leaving the government with large stocks of expensively purchased maize.

1/ Sources: Country Assistance Strategy (CAS), World Bank Report No.18349, 1999; CAS, World Bank Report No. 25906, 2003; Malawi: Country Strategy Brief, Memo to AMD, IMF, 9/1/04; IMF staff reports; "Malawi—The Food Crises, the Strategic Grain Reserve, and the IMF," IMF fact sheet, July 2002 (http://www.imf.org/external/np/exr/facts/malawi.htm.)
2/ In addition, the strategic stock needed to be rotated on a regular basis, as its quality and suitability for human consumption deteriorated over time. Another key component of the study's recommendation, namely that sufficient international reserves be built up and set aside to finance the importation of fresh maize in the event of food shortages, was also mentioned in the staff report, but—in hindsight—may not have been sufficiently highlighted.

"starter packs" (seeds and fertilizer for smallholders) have had only limited impact on improving productivity.

36. **Domestic maize production is almost totally dependant on weather conditions with floods and dry spells having similarly devastating effects on the crop**. The variety of maize predominantly planted in Malawi is not sufficiently resilient to drought and exhausts soil nutrients quickly. Over the 10 years, little progress has been made in diversifying food production to more resilient varieties, and recent World Bank estimates suggest that national food production has been basically stagnant since 1998.

37. **Government interventions have not always been effective, and at times counter-productive**. An extreme example of this occurred in 2000–02, when, following a bumper crop in 2000/01, the government sold its grain reserves to the domestic market, further depressing producer prices. This left farmers—especially smallholders—with insufficient income to purchase fertilizers and seeds, resulting in a sharply lower harvest the following year, thus triggering a food crisis just as reserve stocks were depleted (Box 2).

38. **The absence of clearly defined rules and adequate supervision have increased the scope for corruption and reduced the effectiveness of the Government's maize operation**. During August 2000–January 2001, some 68,000 tons of maize was sold by ADMARC on behalf of the National Food Reserve Agency (NFRA) without proper authorization of NFRA management. Allegations were made in the news media that some of the maize went to politically connected individuals at below market prices. These allegations were subsequently investigated by the Anti-Corruption Bureau (Box 3).

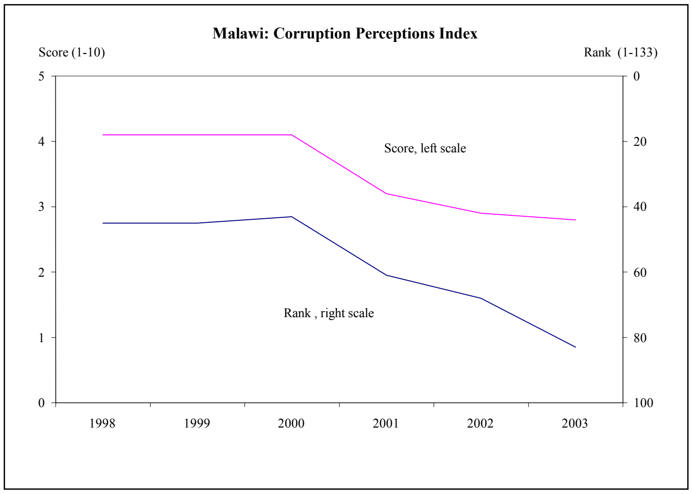
39. **Weak capitalization and management of ADMARC continues to burden the budget.** While the direct budgetary subsidy to ADMARC was limited to MK 60 million in 2003/04 under the Fund-supported program, indirectly the government continues to provide financial support to ADMARC. This has been presented as a mark-up of MK 4,000 per ton for the distribution and storage costs of the "social" maize that ADMARC sells on behalf of the government to consumers at the below-market price of MK 10,000 per ton (inclusive of the mark-up). ADMARC is expected to sell about 70,000–80,000 tons of social maize during 2003/04.

C. Summary

40. **Malawi's macroeconomic record under its Fund-supported programs has at best been mixed**. While there have been periods of generally prudent macroeconomic policies and stability, these have been intermittent, interrupted by periods of large fiscal slippages, monetization and inflation, and worsening public and external debt dynamics. Durable macroeconomic stabilization has proved elusive.

Box 3. Malawi: Corruption and Governance

In recent years, there has been growing attention to governance issues in Malawi. Ever since 1998, the first year that Transparency International included Malawi in its worldwide survey of corruption (more specifically, the perception thereof), Malawi has performed well below average both on the score of the Corruption Perceptions Index (CPX) and in terms of relative ranking with respect to the countries covered in the survey.[1] More importantly, since 2000, there has been a marked deterioration in Malawi's ranking and score, as registered by Transparency International.



Other more comprehensive studies on governance have arrived at similar findings. Among the six dimensions of governance tracked by Kaufmann, Kraay, and Mastruzzi (2003), Malawi's performance has deteriorated over the past six years in all but "political stability" and the "rule of law." Mirroring the Transparency International's CPX, the measurement for Kaufmann's "control of corruption" also shows a marked deterioration during 2000-02.[2]

Governance issues in Malawi permeate from the highest political system down to the public enterprise sector and beyond. More than 100 amendments were made to Malawi's constitution since 1994, often without consultation. In 2001, the threshold for the parliamentary approval of a constitutional amendment was lowered from a two-thirds to a simple majority. More recently, there were allegations during 2002-03 that the ruling United Democratic Front, headed by former President Muluzi, was exerting undue pressure on legislators to approve a constitutional amendment that would have allowed the president to run for a third term. In the event, the necessary majority could not be mustered, and the amendment was abandoned. Nevertheless, several key bilateral donors, concerned about the heavy-handed process applied by the government in this respect, either withdrew or delayed disbursement of budgetary assistance. In addition, allegations of bribery affecting members of Parliament were investigated by the Anti-Corruption Bureau (ACB).

Senior government officials were also implicated in allegations in 2002 that maize sales from the Strategic Grain Reserve were made to politically connected people at below-market prices. These allegations were investigated by the Anti-Corruption Bureau, which is generally viewed as being understaffed and lacking the legal authority to independently proceed with prosecutions. Indeed, several high-profile cases have either never been brought before the courts, or have stalled in the legal system. The World Bank has advised the authorities to strengthen the ACB's legal and human resources and to eliminate the opportunities for corruption in general, by reducing officials' discretion and the complexity of procedures and laws, and by promoting transparency, including in the procurement practices of the government and state-owned enterprises.[3]

1/ The score runs from 1 to 10; the higher the score, the lower the perception of corruption in a country. Of the more than 130 countries in the survey, the higher the rank, the higher the relative perception of corruption. For further details see http://www.transparency.org .

2. See Kaufmann, D., A. Kraay, and M. Mastruzzi, "Governance Matters III: Governance Indicators for 1996-2002," World Bank Policy Research Working Paper No. 3106, Washington, D.C., 2003. The data is also available at: http://www.worldbank.org/wbi/governance/data.html .

3. See World Bank, "2003 Country Assistance Strategy," Report No. 25906, Washington, D.C., May 2003.

41. **Progress on structural reforms has also been uneven**. As reflected in the macroeconomic record, the budgetary process remains extremely weak and reforms of public expenditure management have often been ineffective. Progress has been made in demonopolization of the economy—particularly in increasing opportunities for smallholders—but increasing competition, especially in the financial sector, remains a key challenge. Though it is still early days for an assessment, social policies aimed at improving human capital appear to be having some success. Sufficient data for an assessment of poverty-reduction trends are not currently available, but inferences based on output growth suggest that little headway is likely to have been made in reducing poverty. Food security operations have been riddled with high costs, reported corruption, and, at times, a lack of effectiveness.

IV. Experience with Fund-Supported Programs

42. **Through much of the past twenty years, economic policies in Malawi have been set in the context of Fund-supported programs, with mixed implementation and performance record** (Table 2, Appendix I). While performance during the first half of the 1995 ESAF was strong—"nothing short of striking" in the words of the staff appraisal at the time of the mid-term review of the second annual arrangement—subsequent performance has generally fallen short of expectations. The 1995 ESAF went off-track soon after the completion of the mid-term review of the second annual arrangement and the third annual arrangement was delayed until December 1998. Performance was even weaker under the 2001 PRGF: completion of the first review was delayed until October 2003, and the second review could not be completed, and the program was irretrievably derailed in the second quarter of 2004.

43. **Malawi's experience under its Fund-supported programs raises broad issues of program objectives, program design, conditionality, and ownership.** Specifically: Was the emphasis on macroeconomic stabilization warranted given Malawi's development and structural reform challenges, including the need to tackle widespread and deep-rooted poverty? Were program targets overly ambitious? Was the specification of conditionality appropriate? Was ownership lacking?

Table 2. Malawi: Performance Under the ESAF/PRGF-Supported Programs, 1995-2003

	ESAF-Supported Program					PRGF-Supported Program			
	1995	1996	1997	1998	1999	2000	2001	2002	2003
Real GDP growth (percent change)									
Program (original three-year program) 1/	9.9	5.4	4.5	4.5	...	3.2	3.0	4.0	4.5
Annual program 2/	9.9	9.8	5.0	5.0	5.0	3.2	...	1.8	5.9
Actual	16.7	7.3	3.8	3.3	4.0	1.0	-4.9	1.8	...
Inflation rate (end of period; percent change)									
Program (original three-year program) 1/	35.8	6.2	5.7	5.0	...	30.0	10.0	5.0	5.0
Annual program 2/	35.8	20.0	8.0	6.0	7.0	30.0	...	5.0	9.1
Actual	74.9	6.7	15.2	53.1	28.2	35.4	22.1	7.6	15.0
Broad money growth (percent change)									
Program (original three-year program) 1/	48.3	...	...	...	...	20.9	16.8	12.4	9.7
Annual program 2/	43.3	27.5	14.4	...	17.6	20.9	...	7.9	15.0
Actual	38.9	39.9	2.2	55.6	33.6	42.4	12.1	23.4	26.4
Net credit to government (in percentage of beginning of period broad money)									
Program (original three-year program) 1/	7.1	...	...	...	...	2.7	-43.3	-49.8	-38.2
Annual program 2/	-5.0	-2.7	-0.1	...	-44.9	2.7	...	12.1	10.5
Actual	10.2	0.9	2.4	-29.9	-2.9	6.9	33.7	45.5	12.7
Net credit to the private sector (in percentage of beginning of period broad money)									
Program (original three-year program) 1/	15.5	...	...	...	...	15.2	16.6	18.4	23.8
Annual program 2/	2.8	10.6	6.1	...	...	15.2	...	6.1	4.2
Actual	2.8	4.0	3.6	28.5	2.1	14.5	1.5	3.9	7.4
External current account, excl. off. transfers (percent of GDP)									
Program (original three-year program) 1/	-14.3	-16.7	-12.8	-11.4	...	-15.2	-12.2	-12.2	-11.2
Annual program 2/	-14.3	-7.1	-6.8	-8.7	-17.9	-15.2	...	-26.2	-15.3
Actual	-12.4	-12.1	-12.7	-11.6	-17.1	-14.1	-12.6	-23.9	-17.0
External current account, incl. off. transfers (percent of GDP)									
Program (original three-year program) 1/	-2.3	-8.9	-8.5	-7.1	...	-7.8	-6.7	-6.7	-5.7
Annual program 2/	-2.3	-3.9	-3.1	-5.3	-8.8	-7.8	...	-11.3	-8.2
Actual	-1.4	-7.1	-11.9	-0.2	-8.2	-5.3	-6.8	-11.4	-8.0
External off. transfers (percent of GDP)									
Program (original three-year program) 1/	12.0	7.8	4.3	4.3	...	7.4	5.5	5.5	5.5
Annual program 2/	12.0	3.2	3.7	3.4	9.1	7.4	...	14.9	7.1
Actual	11.0	5.0	0.8	11.4	8.9	8.8	5.8	12.5	9.0
Gross offiicial reserves (in months of imports)									
Program (original three-year program) 1/	0.8	1.4	1.9	2.2	...	3.9	4.7	4.8	4.8
Annual program 2/	2.2	3.3	4.5	4.5	4.4	3.9	...	2.1	2.2
Actual	1.7	3.0	2.6	4.0	4.2	4.4	3.6	2.4	2.1
External debt (in percent of GDP)									
Program (original three-year program) 1/	161.2	155.6	158.1	155.1	150.7	156.5	180.4	175.1	168.5
Annual program 2/	161.2	115.8	99.1	90.8	166.5	156.5	...	147.6	161.7
Actual	139.1	95.0	90.4	142.7	143.3	156.7	162.1	145.8	164.1
Terms of trade (annual percentage change)									
Program (original three-year program) 1/	8.4	6.4	8.0	4.1	...	-6.1	2.2	4.3	1.3
Annual program 2/	2.0	-7.5	1.0	...	...	-6.1	...	5.9	0.0
Actual	-6.8	32.0	9.2	-4.1	-13.4	1.1	-0.3	0.0	-6.0

Table 2. Malawi: Performance Under the ESAF/PRGF-Supported Programs, 1995-2003 (concluded)

	ESAF-Supported Program					PRGF-Supported Program			
	1995/96	1996/97	1997/98	1998/99	1999/00	2000/01	2001/02	2002/03	2003/04
Overall fiscal balance, excl. grants (percent of GDP)									
Program (original three-year program) 1/	-16.0	-12.1	-9.7	-9.3	...	-11.4	-8.3	-6.6	...
Annual program 2/	-16.0	-9.4	-7.6	-6.5	-12.9	-11.4	...	-7.9	-13.8
Actual	-14.0	-7.3	-9.1	-11.5	-12.5	-15.0	-14.7	-18.8	...
Grants									
Program (original three-year program) 1/	11.9	8.1	6.4	...	...	11.4	8.3	8.1	...
Annual program 2/	8.5	5.3	4.0	3.3	7.1	11.4	...	10.6	13.0
Actual	7.9	4.7	3.5	6.3	6.9	9.1	6.8	6.9	...
Overall fiscal balance, incl. grants (percent of GDP)									
Program (original three-year program) 1/	-4.1	-3.9	-3.3	-3.2	...	0.0	0.0	1.5	...
Annual program 2/	-4.1	-4.1	-3.6	-3.2	-5.8	0.0	...	-2.7	-0.8
Actual	-5.9	-2.8	-6.4	-5.1	-5.6	-5.9	-7.9	-12.0	...
Domestic revenues (in percent of GDP)									
Program (original three-year program) 1/	18.7	18.6	19.0	18.7	...	19.0	19.0	18.9	...
Annual program 2/	18.7	17.7	17.1	17.5	16.3	19.0	...	18.0	21.8
Actual	18.1	15.5	11.4	18.1	17.3	18.4	17.1	20.2	...
Expenditures (in percent of GDP)									
Program (original three-year program) 1/	34.7	30.6	28.8	27.9	...	30.4	27.3	25.5	...
Annual program 2/	33.3	27.1	24.7	24.0	29.2	30.4	...	31.4	35.2
Actual	31.2	23.9	26.6	29.5	29.7	33.4	31.8	34.7	...
Fiscal domestic financing (in percent of GDP)									
Program (original three-year program) 1/	1.4	-1.4	-2.9	...	...	-4.6	-2.6	-3.3	...
Annual program 2/	1.4	-0.1	...	-1.2	-0.6	-4.6	...	-3.7	-3.1
Actual	3.5	-1.2	3.5	-3.6	2.1	1.2	7.0	7.8	...
Domestic public debt (in percent of GDP) 3/									
Program (original three-year program) 1/	...	...	...	...	...	...	...	...	...
Annual program 2/	...	...	...	...	...	...	11.0	11.0	9.0
Actual	...	7.2	8.1	1.4	2.8	8.9	10.7	15.3	19.9

Sources: IMF staff reports; and Malawi authorities.

1/ Original program targets for 1995 - 1999 are based on the request for Arrangements under the Enhanced Structural Adjustment Facility and, for 2000 - 2003, on the request for a three-year arrangement under the Poverty Reduction and Growth Facility.

2/ Revised targets for 1996 are based on the midterm review under the first annual arrangement.
Revised targets for 1997 are based on the request for the second annual arrangement.
Revised targets for 1998 are based on the midterm review under the second annual arrangement.
Revised targets for 1999 are based on the request for the third annual arrangement.
No revised targets are presented for 2001 since no new board document was presented.
Revised targets for 2002 are based on the staff report for the 2002 Article IV consultationand economic program for 2002 (Country Report No. 02/181, 8/16/02).
Revised targets for 2003 are based on the first review (Country Report No. 03/344, 11/7/03). There was also a "track record" program approved by management (04/16/03) but not considered by the board.

3/ Central government debt instruments and Reserve Bank of Malawi bills held by the private sector.

Program objectives

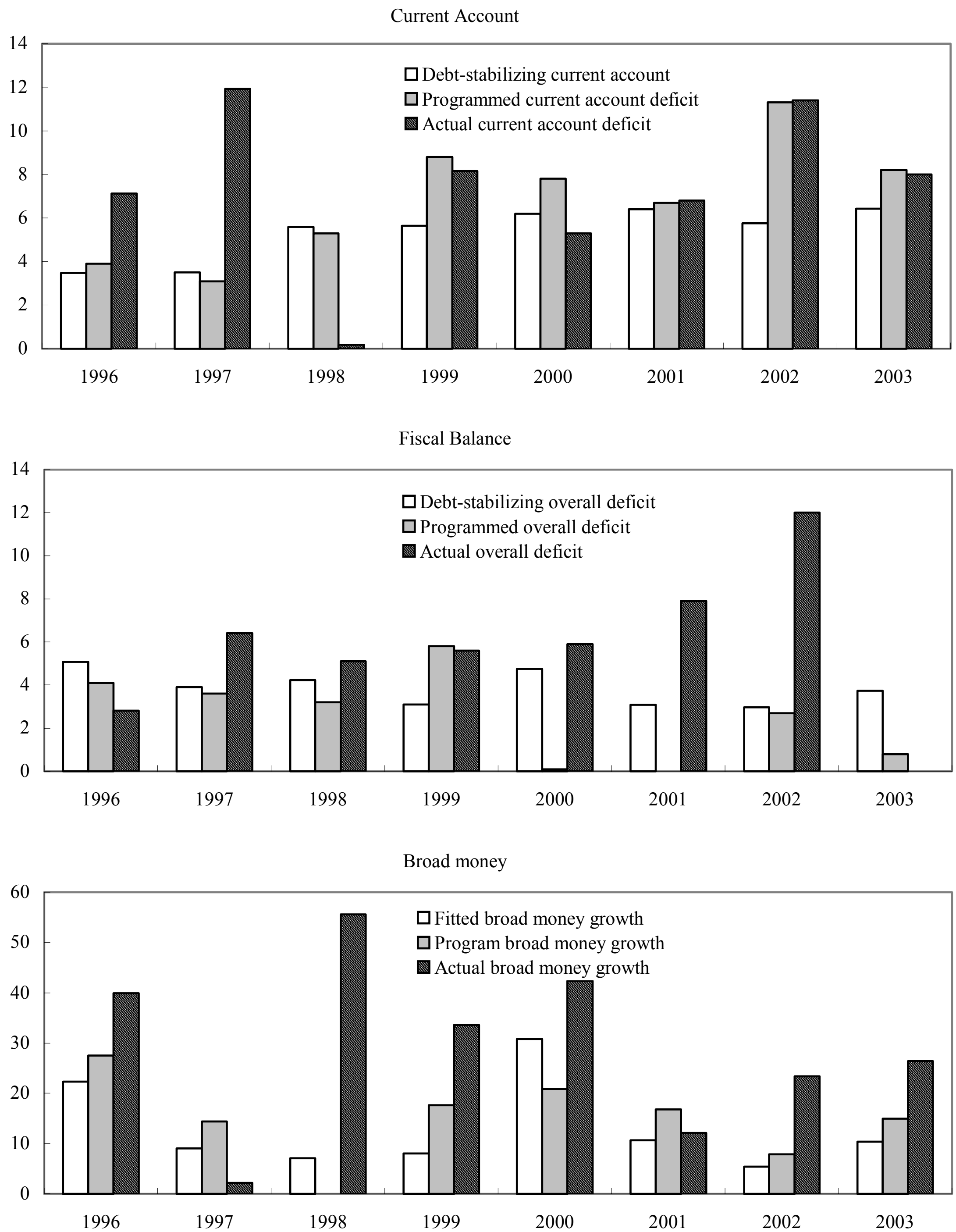
44. **Cross-country evidence suggests that macroeconomic stabilization is a *sine qua non* for durable growth and poverty reduction**.[15] This is buttressed by Malawi's own experience: its period of fastest growth (1970–78) also coincided with relatively prudent financial policies, while more recent fiscal slippages have been associated with high inflation, high interest rates, crowding out of the private sector and—except for instances of serendipitous climactic conditions—poor growth. In addition, given low rates of monetization, even high inflation rates of around 15–20 percent would have yielded only about 1 percent of GDP in seignorage.

45. **Programmed adjustment was broadly appropriate.** Given Malawi's high external and public debt, stabilizing the debt ratios—or seeking to reduce them—would be a reasonable program objective. Programmed external deficits have, at times, been larger than would be consistent with stabilizing the debt ratio (Figure 3). On the other hand, programmed fiscal deficits (including grants), have generally been consistent with stabilizing the debt ratio—and in some years went beyond that required to stabilize the debt ratio. While flow financing constraints and public debt dynamics dictated the need for substantial fiscal tightening, some of the quantitative targets—such as for 2003/04—were probably not realistic.[16] Finally, programmed money growth rates have been somewhat higher than those that the estimated money demand functions suggest would be consistent with the program

[15] There is a large body of literature on the inflation-growth nexus, particularly as applied to developing countries. See, for example, Ghosh and Phillips (1998) who argue that, beyond a very low inflation "kink" (which they put at around 3 percent per year), the marginal benefit for growth from lowering inflation increases as the inflation rate declines. According to their estimates, each halving of the inflation rate is associated with higher per capita growth of ½ percent per year. Other studies (e.g., such as Sarrel (1996)), put the kink at somewhat higher inflation rates, but none finds that the kink is higher than up to about 8 percent per year. Zalduendo (2004) considers the effects of various structural reforms—and their sequencing—on the level and growth rate of output. He finds that macroeconomic stabilization—lowering inflation and maintaining budgetary discipline—should precede other reforms and is key to raising the economy's growth rate.

[16] The debt-stabilizing budget balance is computed as $b^s = -g^* d - \frac{\pi - g}{v}$ where b^s is the debt-stabilizing overall balance, g^* is the U.S. dollar value of GDP growth (under the assumption that most debt is dollar-denominated), π is the program target for inflation, g is the program target for real GDP growth, and v is reserve money velocity. Since program documents typically do not project g^*, which is subject to large fluctuations, the 20 year average is used.

Figure 3. Malawi: Current Account, Overall Balance and Broad Money, 1996-2003



Source: International Monetary Fund, World economic Outlook; and staff estimates.

inflation target and growth assumptions.[17] In the event, as noted above, external and fiscal deficits were significantly larger than programmed and larger than would be consistent with stabilizing the debt ratio. Likewise, money growth rates have been much higher than would be consistent with the program's inflation targets, even if the assumed output growth had been realized.

46. **Program projections for key macroeconomic variables have been too optimistic**. On average, growth was over-predicted by more than 1 percent per year, inflation was under predicted by 14 percent per year, while the fiscal deficit (including grants) was under predicted by 3½ percent of GDP, and the external current account deficit (including grants) was under predicted by about ½ percent of GDP (Figure 4).[18] The optimistic bias—especially as regards the fiscal and current account deficits—largely reflects a lack of program implementation. While growth in Malawi is highly variable, the average bias likewise reflects, at least in part, slippages and long delays in the implementation of structural measures on which program projections were predicated, though the realism of the growth projections—in light of historical experience—may also be questioned.

Program Flexibility

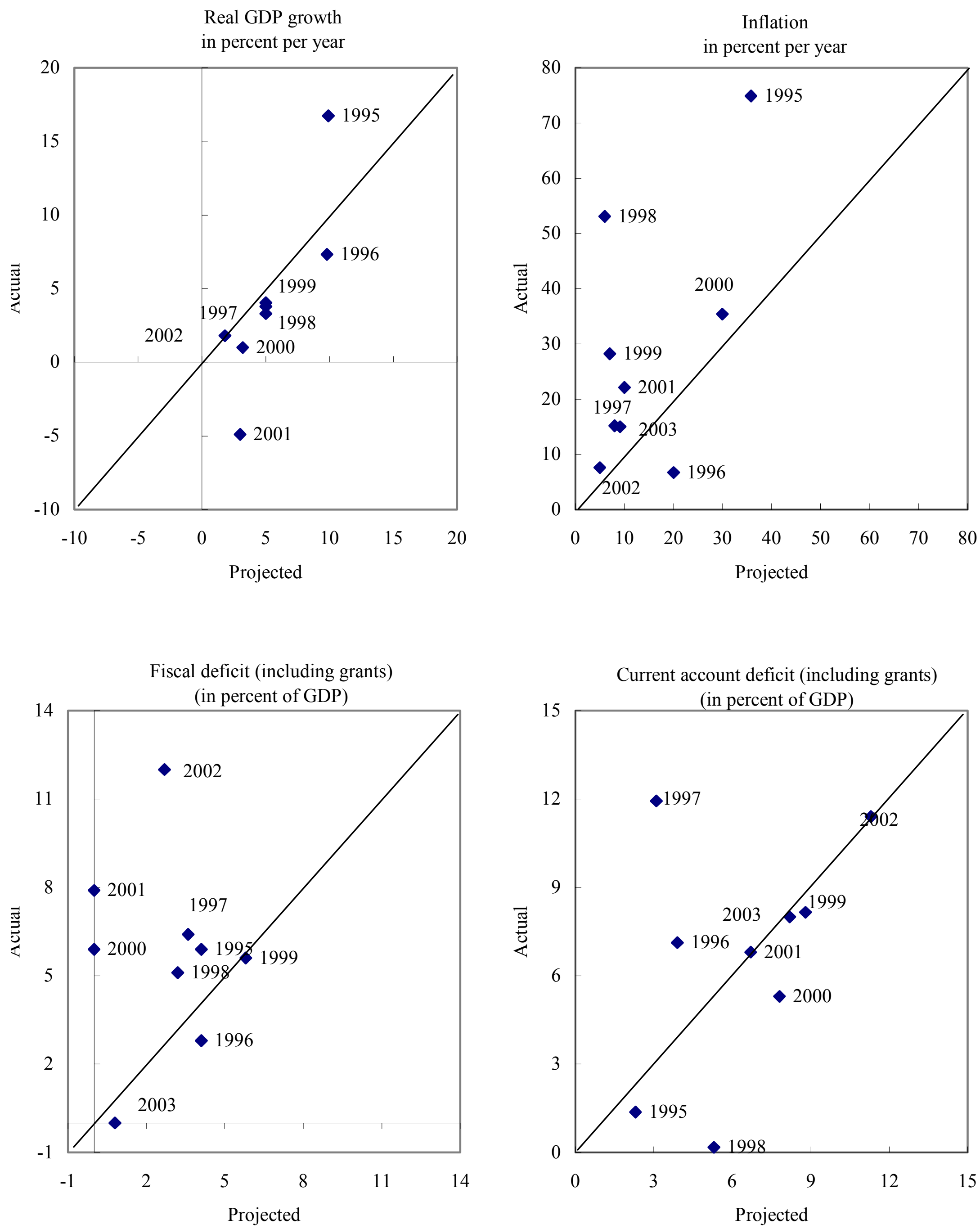
47. **Given Malawi's pressing social and developmental needs, a first question is whether program design has allowed sufficiently for external resource transfers**. Malawi receives substantial external assistance—grants averaged 7 percent of GDP over the period 1994/95–2002/03 with loans accounting for an additional 6.6 percent of GDP—but disbursements have been erratic, reflecting program slippages and concerns about governance.[19] Program design (and conditionality) has allowed for higher expenditures when foreign financing is available. At the same time, available indicators suggest the price of non-tradable goods has been under upward pressure with potentially negative effects on Malawi's nascent non-traditional export sector (Figure 5). Given the unsustainable public debt

[17] For this purpose, a cointegrating regression between real GDP and broad money (deflated by the consumer price index) was estimated, from which nominal money growth rates consistent with the program's inflation and growth targets can be derived.

[18] The bias in program projections is statistically significant at the 1 percent level for inflation, but only at the 15 percent level for the fiscal deficit and for the current account deficit, and is insignificant for the growth projection.

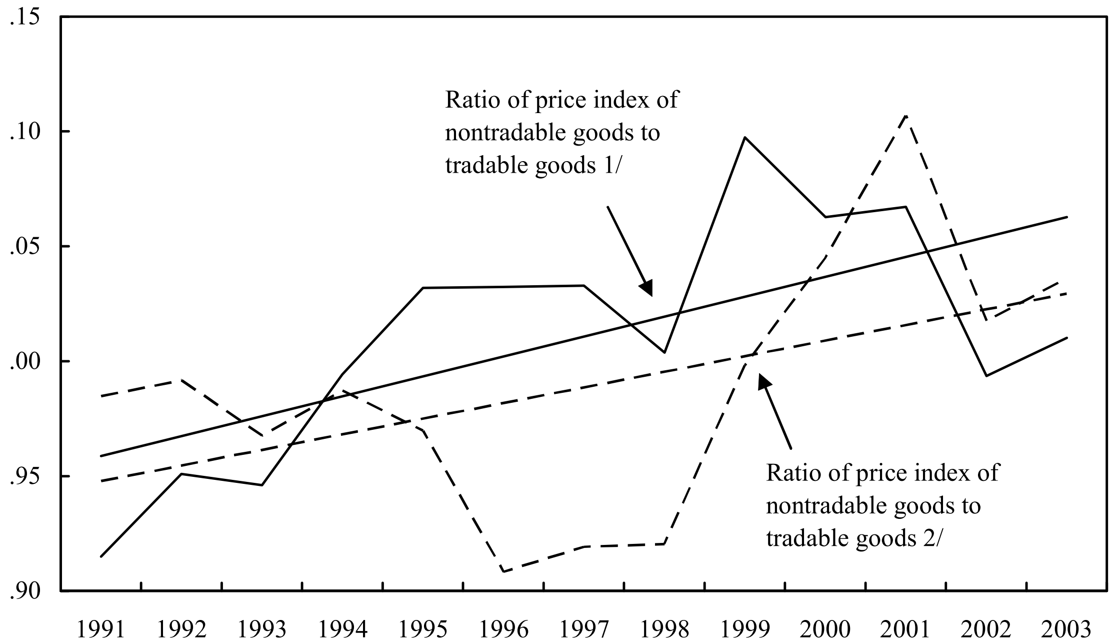
[19] Around one-half of these amounts represent budgetary support, the rest are project-related grants. However, many project grants are not captured in either the BOP statistics or the budget so these figures may significantly underestimate the extent of external support that Malawi receives.

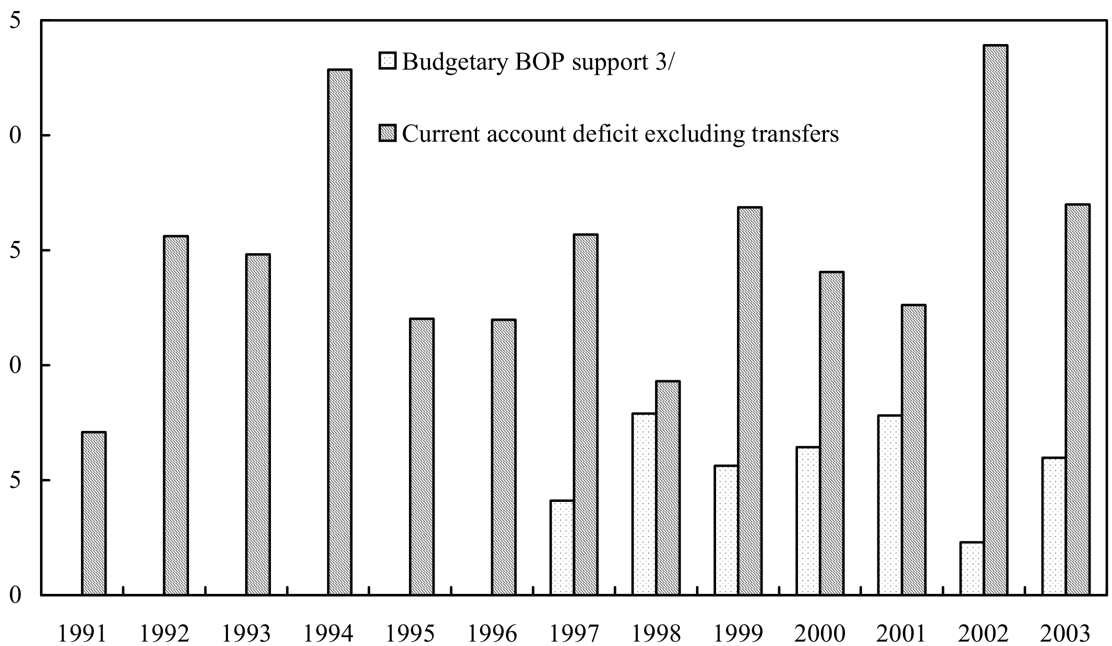
Figure 4. Malawi: Selected Macroeconomic Indicators-Projected and Actual
(1995-2003)



Source: International Monetary Fund, World Economic Outlook; Country Desk data, and staff estimates.

Figure 5. Malawi: Foreign Support and Relative Prices





Source: International Monetary Fund
1/ Excludes food from tradables price. 2/ Includes food in tradables price.
3/ Data not available prior to 1997.

dynamics, sterilization of foreign inflows is not possible. Moreover, limited implementation capacity as well as governance concerns have meant that available resources have not always been put to best use.

48. **Fiscal programs attempted to safeguard social safety net expenditures**. In most years, expenditures for recurrent expenditure for social services achieved the budgeted level, and in some years exceeded the budget significantly. Allowances were made both in the program design and in the performance assessments for required food security policies at times of poor harvests (e.g. by excluding maize expenditures from the program targets), but it appears that resources have not always been used efficiently. In contrast, severe cuts were made in many years in general public services (administration), and in economic services, while public debt service and pensions exceeded approved budgets by a wide margin.

49. **Monetary and exchange rate policies have been accommodative**. Since February 1994, the Malawi kwacha has been market determined, with limited smoothing intervention by RBM related primarily to the agricultural cycle. While the dirty float has provided the economy with some insulation against the effects of real shocks, it has also meant that monetary and exchange rate policies have been accommodative of fiscal slippages. In the absence of sufficient fiscal discipline, however, alternative exchange rate regimes would likely not have been viable without extensive controls on current and capital transactions.

Conditionality and Collaboration with Other Institutions

50. **Conditionality in the Fund-supported programs was applied to measures critical to program success**. In the earlier programs, structural conditionality focused on agricultural reform and de-monopolization of the economy, as well as fiscal reforms such as streamlining the civil service, public enterprise reform (especially of loss-making enterprises) and privatization, revenue raising measures, and strengthening of expenditure control and the budgetary process. As discussed above, some important progress on agricultural reform and de-monopolization of the economy was achieved. Given persistent fiscal slippages, more recent programs have, appropriately, continued to stress fiscal structural measures (with substantial technical assistance provided as well), further steps to liberalize the agricultural production potential of the country, as well as strengthening governance and anti-corruption efforts, given concerns about governance and corruption that have plagued implementation of some of the social programs as well as food security efforts. At the same time, the promptness with which programs have gone off-track (following Board approval or completion of a review) raises the question of whether conditions—including prior actions—have been sufficient to ensure that the requisite policies and institutions are in place, while recognizing that there are limits to which conditionality can substitute for ownership.

51. **Strengthening the performance criterion on the domestic banking system's net credit to government (NCG) at the time of the first review of the PRGF was especially**

important in light of Malawi's track record and growing domestic debt problem.[20] The performance criterion specified in the original program request (December 2000) allowed for an upward adjustment of the NCG of almost 3 percent of GDP (US$50 million) for shortfalls in expected balance of payments support, thus accommodating the substitution of a shortfall of foreign financing through an increase in domestic borrowing.

52. **Collaboration with the World Bank has been satisfactory**. Country teams from the two institutions have worked closely on Malawi's poverty reduction strategy paper (PRSP); external debt sustainability and the HIPC Initiative; budgetary planning and management, including expenditure reforms; civil service and wage reforms; and humanitarian assistance. Particularly in the wake of the food emergency in the summer of 2002, the World Bank and the IMF acted promptly and in concert to avert a humanitarian crisis in Malawi by providing an Emergency Drought Recovery Project loan of US$50 million and an emergency assistance credit of US$23 million, respectively. While the IMF credit was aimed mainly at replenishing the country's depleted foreign reserves, the World Bank's loan sought to restore the productive capacity of the population and assist the government in establishing a longer-term disaster management capability. There has also been an appropriate division of labor with each of the institutions taking the lead in its respective areas of expertise. Accordingly, the World Bank has assisted the authorities in the areas of education and health; rural development and environmental protection; social safety programs for vulnerable groups, including of the HIV/AIDS inflicted population; infrastructure development, such as water and transportation; and parastatal reform, including appropriate strategies to commercialize and divest state assets. The IMF has focused its advice on assisting the authorities in elaborating and implementing appropriate macroeconomic policies. It has also provided extensive technical assistance in the fields of revenue administration; expenditure tracking and control; monetary operations and payments systems; banking supervision; and improving Malawi's national accounts, balance of payments, and monetary and financial statistics. In the area of statistics, the World Bank has complemented the IMF's efforts by providing the National Statistical Office assistance in developing and monitoring key poverty and social indicators identified in the PRSP.

Ownership and Implementation

53. **Ultimately, Malawi's poor track record, especially under the 2000 PRGF-supported program, reflects a lack of ownership.** This lack of ownership, including at the

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[20] At the time of the first review (October, 2003), the performance criterion on the banking system's net claims on the central government was strengthened by (i) eliminating a symmetric adjustor for deviations of balance of payments support from the program baseline (henceforth the ceiling would only be adjusted downwards in the event of higher-than-expected inflows; (ii) adjusting downwards for accumulation of domestic arrears; (iii) adjusting downwards for any domestic non-bank financing.

highest political levels, has resulted in frequent interference with expenditure management that overrode institutional mechanisms for effective expenditure monitoring and control. It is noteworthy in this regard that overruns in the fiscal deficit (inclusive of grants) have far exceeded shortfalls in external grants. Moreover, expenditure overruns have often included items that are not priorities for social protection.[21]

54. **Expenditure slippages have had cascading effects on program implementation.** Fiscal policy slippages have had cascading effects: external budgetary support diminished (including because of governance concerns), the government made recourse to domestic financing, the monetary program was de-railed, interest rates rose, and public debt dynamics worsened. While the proximate cause of program interruptions were the macroeconomic slippages, they also point to underlying structural weaknesses, in particular in fiscal management and food crisis responses.

55. **Poor budgeting planning, weak expenditure controls, and a relatively narrow coverage of the fiscal monitoring framework made the achievement of fiscal targets and the assessment of policy implementation very difficult**. Weak cash planning, insufficient monitoring of budget implementation (mainly based on funded cash releases and not expenditures), permissiveness to overspending in some votes, and lax enforcement of fiscal regulations, combined with at times severe cash rationing have led to recurrent arrears, and a decline in the value of the budget document as the key fiscal policy statement of the government. Repeated efforts to put the annual budget into a medium term context, to link more closely strategic plans with costed policies and the annual budget process, and to improve budget coverage in particular by fully including donor sponsored projects have thus far yielded few results.

V. Lessons for Future Program Engagement

56. **Malawi has had a longer-term program engagement with the Fund for several reasons**. First, Fund support has helped Malawi weather several exogenous shocks, including the oil price shock in 1979, disruptions of trade routes, and periodic droughts that necessitated external adjustment and financing. Second, Fund-supported programs have helped guide macroeconomic policies and structural measures during Malawi’s protracted adjustment and structural transformation efforts. Third, Fund-supported programs have provided a framework for other donors and official creditors to assess the quality of macroeconomic policies and commitment of the authorities to reforms, and for the delivery of HIPC debt relief.

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[21] To give a rough indication, overspending in 2000/01 and in 2002/03 on state residences, national assembly, and offices of the President and Vice Presidents amounted to more than 50 percent of the budgeted amount.

57. **Lack of ownership, including and especially at the highest political levels of the country, has resulted in repeated policy slippages, failures to deliver upon agreed policies, and a poor track record.** In the past, particularly large slippages have occurred due to election-related overspending; more recently, budgeting overruns by some ministries have also been an important source of slippages. Symptomatic of the lack of commitment were the delays or incomplete implementation of 7 out of 8 structural performance criteria that had been agreed for September-December 2003, though some of these delays were for reasons outside of the direct control of the authorities. While the long hiatus between approval of the 2000 PRGF arrangement and completion of the First Review suggests that Fund staff has been appropriately skeptical and cautious before recommending the completion of reviews, staff appraisals in program documents have not always been sufficiently candid in highlighting the risks.[22]

58. **Ultimately, Malawi's experience with Fund-supported programs raises issues of selectivity more than of program design or of conditionality**. As discussed above, program design has generally been appropriate and conditionality has fulfilled the role of interrupting programs—and Fund support—in the face of policy slippages that would clearly result in objectives not being achieved. Inevitably, this raises the question of whether the Fund should be more selective in the programs it supports, and its role in situations where ownership and commitment to reform may be insufficient to surmount pressures for expenditure over-runs and other policy slippages. While there are arguments for a Fund-supported program to provide a framework for macroeconomic policy, such a framework cannot substitute for a lack of ownership. Moreover, there is always the risk, as noted in the IEO report on Prolonged Use of IMF Resources, that the longer-term engagement by the Fund has a corrosive effect on domestic policymaking and the scope for implementation capacity to grow. There is also the risk that, in providing a "signaling" role to other official donors and creditors, the Fund's assessment of policies becomes hostage to concerns about the impact and policy response to a disruption of donor support, potentially undermining the credibility and usefulness of that role of the Fund.

59. **Selectivity could result in prolonged disengagement by the Fund.** One option, which has some merit given the poor track record, would be a potentially prolonged period of disengagement until the country has clearly demonstrated its ability to set and adhere to appropriate economic targets and macroeconomic management.[23] On the other hand, Fund

[22] For instance, the staff appraisal for the Request for the 2000 PRGF arrangement noted that "The risks to the program are high ...given Malawi's mixed record of implementation ... However, the authorities' commitment is strong and parliament has supported both the overall approach and the tightening of spending control."

[23] The Fund would, of course, continue to provide policy advice through its surveillance activities.

engagement has helped provide a framework for prudent financial policies and structural reforms within which donors may provide budgetary and balance of payments support and for delivery of HIPC debt relief. In its absence, the macroeconomic costs are likely to be substantial if the government resorts to greater domestic financing, with adverse consequences for public debt dynamics, inflation, and growth. Nor is it clear that any resulting economic crisis would engender greater political will to tackle macroeconomic imbalances and put the public finances on a sounder footing.

60. **A preferable option would be a period of track-record building under a Staff Monitored Program—provided the authorities are willing to commit to greater fiscal and financial discipline, prudent debt management, and improved data, monitoring, and reporting.** The dynamics of the public debt are a major concern and achieving sustainability is a precondition for establishing macroeconomic stability, private sector growth, and monetary discipline. Improving the institutional and operational set up would help strengthen the government's fiscal management capabilities, including by fully operationalizing the Commitment Control System (CCS) and the Credit Ceiling Authority System (CCA), enforcing regular reporting requirements, and, over the longer-term, phase-in the Integrated Financial Management Information System (IFMIS). These "technical" measures, however, will not be sufficient in the absence of a greater financial discipline and commitment to the adjustment effort, including by the highest political levels of the government.

61. **Enhancing financial discipline will require greater emphasis on a rational budgetary process**. Cash sequestration and rationing, despite any short-run expediency, has probably undermined the budgetary process and fiscal discipline. Budgets should build on PRSP-identified priorities and be integrated in a medium-term budgetary framework. By the same token, budget targets should be set realistically.

62. **Better alignment of expenditures with external support would contribute to greater predictability and discipline of the budgetary process, as well as enhancing program ownership.** Better alignment of fiscal expenditures to domestic sources of revenue and donor support would increase budgetary predictability and help maintain macroeconomic stability. Critical in this regard are realistic projections about donor support—and the authorities' ability to deliver on specified actions to trigger this support—if recourse to costly domestic financing is to be avoided. Over the longer-term, building domestic sources of revenue and reducing Malawi's dependence on external aid would increase the scope for domestic policy making, enhancing ownership of the reform process.

63. **Further program engagement by the Fund, if any, should be carefully phased to allow the authorities to build a track record while not over-burdening implementation capacity.** Notwithstanding the benefits of a signaling role, it is critical that the Fund retain independence of its actions and objectivity of its assessment of the member's policies if the value of that signal—especially when there is genuine commitment—is not to be diluted **Therefore, in the view of the ex-post assessment team, prior to any formal program**

engagement, a credible and convincing track record of sustained policy implementation under a SMP is called for, covering sufficient time to test commitment and to verify compliance with targets, without being unduly protracted.[24] If the track record proves satisfactory—including compliance with agreed targets, timely provision of data to enable monitoring, and indications of genuine ownership and political commitment to the adjustment effort—a successor arrangement may be considered. To avoid over-burdening implementation capacity, the SMP, and possibly the initial period of any successor program, should focus on macroeconomic stabilization and structural measures directly related to it. Once the stabilization gains have been consolidated, the broader reform agenda can be tackled.

64. **Malawi faces enormous challenges going forward and the Fund, together with other IFIs and development partners, has a potentially important role to play**. Broad-based poverty reduction will require sustaining output growth rates well above the averages achieved over the past twenty years. In turn, this needs budgetary discipline and macroeconomic stability—not least to reduce the crowding out of the private sector—as well as improving agricultural productivity and resilience to weather shocks. The Fund, together with other international financial institutions and development partners has an important role to play in this regard—but only if Malawi is able to muster sufficient national ownership, including commitment at its highest political levels, for the adjustment and reform efforts.

[24] In particular, to ensure that fiscal targets had not been met by accumulating arrears.

Structural Measures envisaged under the ESAF and the PRGF and their implementation

ESAF (1995-1999)

Description	Program /Review	Action	Implementation
		Prior actions (conditions for concluding the review)	
Other	P3R1	1) Reach agreement with Fund on 1999/2000 budget. 2) Make progress in implementing the action plan to improve external sector data. 3) Reach understanding on follow-up steps to improve external sector data.	1) Implemented. 2) Required progress not made. Understanding reached on remedial steps. 3) Understanding reached.
		Structural Performance Criteria	
Public enterprises	P3R1	Complete the audit of the Petroleum Control Commission (5/31/99).	Implemented
Tax/expenditure reform	P1R1	Completion of Civil Service Census (3/96).	Implemented ahead of schedule (10/95).
Tax/expenditure reform	P2R1	Retire 2,200 civil servants (3/31/97).	Implemented
Systemic and ownership reform	P1R1	Present draft legislation to parliament establishing privatization framework (12/95).	Implemented with one-month delay due to technical problems.
Systemic and ownership reform	P3R1	Complete study on commercialization or privatization of Agricultural and Marketing Corporation (5/31/99).	Implemented with a delay (10/99).
Trade systems	P2R1	Remove remaining import and export licenses (except for health, security, and environment) (3/31/97).	Implemented with a delay (6/97).
Other	P3R1	Prepare an action plan to improve external sector data (12/31/98).	Implemented with a delay (3/99).
		Structural Benchmarks	

Public enterprises	P1R1	Finalize public enterprise strategy study (12/95).	Implemented on schedule.
Trade systems	P1R1	Eliminate export licensing for beans and groundnuts and import licensing for fertilizers by 12/95.	Implemented with a three month delay due to technical problems.
Financial sector	P1R1	Implement book-entry system for T-bills by Dec. 1995.	Implemented ahead of schedule (9/95).
Financial sector	P2R1	Submit Securities Bill to parliament (3/31/97).	Not yet implemented.
Systemic and ownership reform	P1R1	1) Set up an institutional framework for privatization (12/95). 2) Identify a group of commercial public enterprises for privatization (3/96).	1) Implemented with one-month delay. 2) Implemented ahead of schedule (1/96).
Systemic and ownership reform	P2R1	Bring to point-of-sale/divestiture 26 public enterprises (3/31/97). 2) Complete privatization study for Malawi Railways (6/30/97).	1) 21 public enterprises were brought to the point of sale by 3/31/97 and 25 by 7/31/97. 2) Implemented on schedule.
Systemic and ownership reform	P3R1	1) Government approval of plan to divest assets in Malawi Development Corp. & ADMARC (3/31/99). 2) Provision of guidelines to divest remaining public shares in the Commercial bank and National Bank of Malawi (4/30/99). 3) Appoint consultant to secure a strategic partner for Malawi telecomm (5/31/99).	1) Implemented. 2) Implemented with delay for National Bank of Malawi. 3) Implemented with a delay (9/99).
Tax/expenditure reform	P1R1	1) Plan to retrench 25,000 non-established civil servants (2/96). 2) Completion of an action plan to restructure and downsize civil service (3/96).	1) Implemented ahead of schedule (9/95). 2) Implemented on schedule.
Tax/expenditure reform	P2R1	1) Report on implementation of Medium-Term Expenditure Framework (MTEF) quarterly (beginning 12/96). 2) Submit draft VAT legislation to parliament. 3) Extend MTEF to 12 ministries (3/31/97).	1) Being implemented. 2) Not implemented (mainly due to the non-availability of a VAT advisor). 3) Implemented on schedule.
Other	P3R1	Eliminate, outsource or privatize 30 functions/activities (6/30/99).	Implemented with a delay (9/99).

PRGF (2000-2004)

Description	Review	Action	Implementation
		Prior actions	
Tax/expenditure reform	R1	1) Confirmation by FAD that the new interim central government expenditure-monitoring and control system is being effectively implemented, including the maintenance of commitment registers and submission to the Ministry of Finance of monthly reports on commitments and arrears by line ministries. 2) Establishment by November 2000 of a High-Level Public Debt Management Committee by the Ministry of Finance and the Reserve Bank of Malawi and associated supporting committees. 3) Submission to parliament by December 18, 2000 of a bill to extend the surtax base to the wholesale and retail stages.	Implemented
		Structural Performance Criteria	
Public enterprises	R1	1) Commencement of full operations of a unit in the Ministry of Finance to monitor the activities of parastatals, including quarterly borrowing returns and the provision of annual accounts and completion of the first quarterly report on ten parastatals. (12/31/2000). 2) Avoidance of any borrowing by the National Food Reserve Agency (NFRA) (Continuous).	1) Implemented with a delay (7/2002). 2) Breached in September 2001; implemented since then.
Tax/expenditure reform	R1	Compilation by the Ministry of Finance of a consolidated fiscal report assessing the prospects for meeting budget targets in 2000/01 (6/31/2001).	Implemented.
Tax/expenditure reform	R2	Completion of an action plan for a comprehensive revision of the public service pension scheme.	Program off-track
Tax/expenditure reform	R2	Publishing wage policy statement.	Program off-track
Establishment of a public service remuneration board	R2	Establishment of a public service remuneration board.	Program off-track
Other	R2	Submission to Parliament amendments to the Anti-Corruption Act to allow the Anti-Corruption Bureau to prosecute cases without prior approval from	Program off-track

		the Director of Public Prosecution.	
		Structural Benchmarks	
Pricing & Marketing Policies	R1	1) Maintenance of uniform access by all growers to the tobacco sales network and preservation of the intermediate buyers' system or equivalent mechanism.(Continuous)	Implemented.
Public enterprises	R1	1) Formalization of the system for authorizing parastatal borrowing (4/30/2001).	Delayed; Implemented and codified in the Public Finance Management Act of May 2003.
Tax/expenditure reform	R1	1) Receipt from the ministries of 100 percent of monthly returns under the new commitment control system, starting with returns from December 2000 (1/31/2001). 2) Dissemination of quarterly reports on spending on priority (poverty-related) programs starting with the third quarter of 2000 and with target publication date of one month after the end of the quarter. (12/31/2000). 3) Recovery of at least MK 159 million of revenue lost through tax evasion--and application of available penalties--as assessed by the Malawi Revenue Authority, particularly in the case of large customs duties outstanding; and pursuit of any associated cases of corruption. (2/28/2001).	1) Implemented with a delay (12/2002) 2) Implemented with a delay (6/2001). 3) Not implemented; the MRA could not provide sufficient evidence in court to pursue the case; and the case closed in May 2001.
Financial sector	R1	Removal of legal obstacles preventing implementation of a complete book-entry system for government securities (12/31/2000).	Implemented with a delay (5/2001); system non-operational.
Other	R1	Pursuit by official investigators and prosecutors of all evidence fraud, corruption, and misappropriation of public funds identified in the reports of the Auditor-General, particularly in the cases of the Petroleum Control Commission (PCC) and public procurement (Continuous).	Partially implemented. The external audit of the National Food Reserve Agency was completed, and the Anti-Corruption Bureau (ACB) plans to review the audit report and identify any people or institutions that may have violated the law. The staffing of ACB is being increased and judges are trained. Amendments to Corruption Practices Act are to be resubmitted to parliament in October 2003.

Debt management	R2	Establishing a task force for improving domestic debt management.	Program off track
Other	R2	Passing a resolution by the RBM Board to require that, commencing with the audit of its 2003 financial statements, the audit opinion of the primary external auditor will be signed by a second office of the same audit firm located in an international financial center.	Program off track