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Malawi: First Review Under the Three-Year Arrangement Under the Poverty Reduction and Growth Facility—Staff Report; Press Release on the Executive Board Discussion; and Statement by the Executive Director for Malawi

In the context of the first review under the three-year arrangement under the Poverty Reduction and Growth Facility, the following documents have been released and are included in this package:

- the staff report for the First Review Under the Three-Year Arrangement Under the Poverty Reduction and Growth Facility, prepared by a staff team of the IMF, following discussions that ended on November 21, 2005, with the officials of Malawi on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on February 6, 2006. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.

- a Press Release summarizing the views of the Executive Board as expressed during its February 24, 2006 discussion of the staff report that completed the review.

- a statement by the Executive Director for Malawi.

The documents listed below have been or will be separately released.

Letter of Intent sent to the IMF by the authorities of Malawi*
Supplement to the Memorandum of Economic and Financial Policies by the authorities of Malawi*
Technical Memorandum of Understanding*

*May also be included in Staff Report

The policy of publication of staff reports and other documents allows for the deletion of market-sensitive information.

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MALAWI

First Review Under the Three-Year Arrangement Under the Poverty Reduction and Growth Facility

Prepared by the African Department
(In consultation with other departments)

Approved by Michael Nowak and Matthew Fisher

February 6, 2006

Discussions: Discussions on the first review of the three-year Poverty Reduction and Growth Facility (PRGF) arrangement were held in Lilongwe from November 7–21, 2005. The staff held discussions with Mr. Gondwe, Minister of Finance; Mr. Mbewe, Governor of the Reserve Bank of Malawi (RBM); other senior officials; representatives of the private sector; members of the diplomatic and donor community, and NGOs. Mr. Masawe from the Executive Director's office also participated in the discussions. The staff team comprised of Mr. McDonald (head), Mr. Staines, Mr. Steinberg (all AFR), Mr. Dalsgaard (FAD), Ms. Mongrut (PDR), and Mr. Baunsgaard (Resident Representative). The mission overlapped with a technical assistance mission from FAD on pension reform and with a mission from FIN to update the safeguard assessment.

PRGF arrangement: A PRGF arrangement (SDR 38.2 million, 55 percent of quota) was approved on August 5, 2005 (Country Report 05/285), of which SDR 5 million has been disbursed. Malawi has total outstanding Fund purchases of SDR 60 million (86 percent of quota). All end-September 2005 performance criteria were met. Malawi is requesting the second disbursement under the current PRGF arrangement (SDR 4.9 million). The authorities' program for the remainder of FY05/06 is outlined in the attached Letter of Intent (LOI) and Memorandum of Economic and Financial Policies (MEFP).

Key policy issues: Macroeconomic stability continues to be the main near-term objective as Malawi faces a period of food insecurity. Fiscal restraint will be crucial to avoid adverse debt dynamics and a more flexible exchange rate regime is required to alleviate foreign exchange shortages.

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EXECUTIVE SUMMARY

The evolution of economic activity is broadly as anticipated and staff agree with the authorities that the key macroeconomic objectives for this fiscal year remain viable. The program for FY05/06 continues to target real GDP growth of about 5 percent and end-June inflation below 11 percent.

Macroeconomic performance under the PRGF arrangement through the first quarter of the fiscal year was generally satisfactory, although some adjustment in policy will be required to preserve macroeconomic stability in the near term and to clear a backlog of import payment arrears. Malawi met all the quantitative and structural performance criteria for end-September, 2005. Malawi also met all the indicative targets, except the structural benchmark on the wage schedule, which is now expected to be completed in early 2006. In addition, preliminary data indicate that end-December performance criteria on NFA, NDA, and domestic borrowing were met. However, a precise assessment of performance on NFA has been made difficult by the lack of reliable information on the evolution of the backlog of import invoices.

The government has declared a state of national disaster because of the food crisis and has expanded its food security operations compared to the program. The additional spending has been fully financed by donors and is, therefore, not expected to affect net domestic borrowing or net foreign assets. The revised program for the remainder of the fiscal year accommodates all deviations due to the food crisis.

The authorities continued to use moral suasion to peg the exchange rate through the second half of 2005. The overvalued exchange rate has put external reserves under pressure, and the backlog of unpaid import invoices persists. It is unlikely that the original program target for external reserves for the fiscal year can be met, and this has been revised. A more flexible exchange rate policy is required to prevent international reserves from falling to unacceptably low levels.

The impact of the overvalued exchange rate on the value of donor inflows and the unforeseen upward revisions to debt obligations have increased domestic borrowing needs. This will be met largely by projected net proceeds from the sale of Malawi Telecom, Ltd. (MTL), which was not anticipated in the original program.

The minority government is committed to program implementation, but faces intense political pressures, though recent government success in six by-elections suggests gains in popular support. The grounds for impeaching the President seem weak, but could divert attention from economic management and lead to more spending to weaken political opposition.

I. FIRST REVIEW—SATISFACTORY PERFORMANCE

1. **The evolution of economic activity is broadly as anticipated and staff agree with the authorities that the key macroeconomic objectives for this fiscal year remain viable.** The program for FY05/06 (July-June) continues to target real GDP[1] growth of about 5 percent and end-June inflation at under 11 percent. A key objective for the government over the near term is to reach the completion point under the HIPC Initiative. The authorities have also reiterated that the macroeconomic medium-term strategy remains guided by the principles laid out in their MEFP of July 2005, the cornerstone of which remains the reduction of government's domestic debt burden to less than 15 percent of GDP.

2. **Macroeconomic performance under the PRGF arrangement through end-September has been satisfactory**. Malawi met all the quantitative and structural performance criteria for end-September, 2005.[2] It also met all the indicative targets, except the structural benchmark on the wage schedule, which is not expected to be completed until early 2006. On the basis of this performance, the authorities have requested that the first review under the PRGF arrangement be concluded.

3. **However, recent developments are exerting pressure on a number of key variables, warranting revisions to some program targets, and policy adjustments for the rest of the fiscal year**.

- **The government has declared a state of national disaster because of the food crisis and has expanded its food security operations to strengthen the relief effort**. The additional spending compared to the program has been fully financed by donors and accommodated in revisions to the annual program.

- **The authorities continued to use moral suasion on banks to stabilize the exchange rate through the second half of 2005.** The overvalued kwacha has put external reserves under significant pressure and a backlog of unpaid import invoices persists. It is unlikely that the original program target for reserves can be met, and this has been revised downward to help reduce the import backlog. A more flexible exchange rate policy is required to contain the low level of international reserves.

- **The impact of the overvalued kwacha on the value of donor inflows and the unforeseen upward revisions to debt obligations have increased domestic borrowing needs.** This will be met largely by the net proceeds from the sale of MTL, which was not anticipated in the original program.

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[1] Based on new information, the authorities revised nominal GDP for 2004 resulting in an upward adjustment in the series.

[2] The target on net foreign assets (NFA) was met despite a US$25 million shortfall in donor disbursements, due to delays on the part of donors, partly through the use of short term foreign exchange swaps. The Technical Memorandum of Understanding (TMU) has been revised to preclude such swaps to ensure that the NFA target is met on a sustainable basis.

4. **Despite these pressures, preliminary data indicates that the government met end-December targets for the second review on NFA, NDA, and domestic borrowing**. In part, this reflects an unexpected refund from the African Development Bank (AfDB) of debt service paid[3], and an unanticipated increase in project inflows. Moreover, while the preliminary data indicate NFA was met by a comfortable margin, a lack of reliable information on the evolution of the backlog of import invoices makes it difficult to assess with any acceptable degree of precision underlying performance with respect to the NFA target. Nevertheless, staff expect outlays associated with the additional project inflows to increase future expenditures (including on imports) and reserve sales will need to increase to lower the backlog, therefore ameliorating the positive impact on future program targets. In addition, delays in the wage increase and fertilizer purchases[4] aided performance on domestic borrowing. Staff will clarify these outcomes in the next review mission.

5. **The government is committed to program implementation, but faces intense political pressures because of its minority position in parliament.** The government faces an assertive parliament with some opposition members seeking to impeach the President on a variety of corruption charges. Grounds for impeachment seem weak and the Constitutional Court has not yet ruled on procedures for impeachment, but the impasse could divert attention from economic management and lead to more spending to dampen political opposition. The government recently enjoyed success in six by-elections that suggests gains in popular support.

II. Ensuring Food Security in the Near Term

6. **The impact of the food crisis on growth and prices—brought on by a prolonged dry spell and delays in fertilizer distribution—is broadly as anticipated in the program.**

- **The 2005 food crop is estimated to be about 30 percent lower than in 2004** (versus a drop of 25 percent that was earlier envisaged), and lowered real GDP growth marginally in 2005. However, assuming a normal harvest in 2006, real GDP is expected to rebound to over 8 percent.

- **The acceleration in the food component of the CPI, largely for seasonal reasons, to over 16 percent annual inflation in November, is less than anticipated.** This may, however, represent an understatement since it is difficult to reconcile with the average 90 percent increase in maize prices in the year through to December 2005 registered in local markets.

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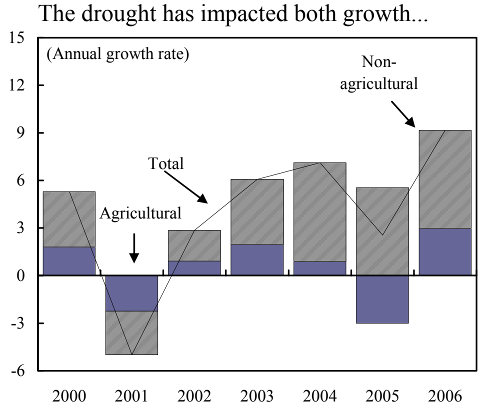
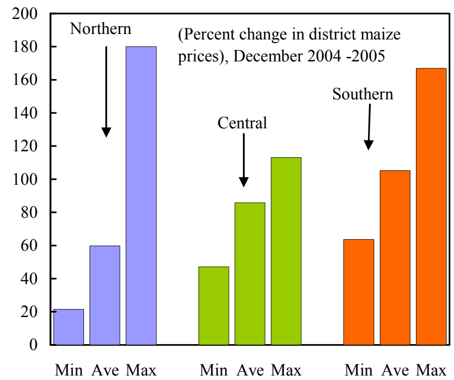
[3] This apparently a refund of debt service paid during the period when the PRGF-supported program was off track and interim HIPC debt relief was suspended. Staff is seeking further clarification on this issue with the authorities and with the AfDB.

[4] Delays in fertilizer purchases did not affect the NFA target because the letters of credit were encumbered.

The drought has impacted both growth...



... and prices.



7. **The overall food shortfall is broadly as envisaged, but the humanitarian needs are significantly larger than expected.** To help meet these needs, the government has declared a state of national disaster and the UN issued an aid appeal. Government, donors and UN agencies, including the World Food Program, have committed resources to cover about three quarters of the overall food shortfall, and it is envisaged that the private sector will source the remainder.

Malawi: Government Maize and Fertilizer Transactions, FY05/06 [1]
Billions of Kwacha

	Program	Revised
Total	-3.7	-3.6
Fertilizer/Seeds	-4.8	-4.6
Grants	0.0	1.1
Subsidy cost	-4.8	-5.7
Humanitarian maize	0.7	1.5
Grants	5.3	8.3
Purchases	-4.6	-6.8
Commercial maize	0.4	-0.5
Sales	1.3	1.2
Purchases	-1.0	-1.7
Memorandum		
Maize/Fertilizer Expend.	-10.4	-14.2

[1/] (+/-) Receipts/Expenditures to/or from the budget.

- **To help address the food shortfall and the accompanying humanitarian needs, the government has expanded its own maize and fertilizer food security program** (MEFP Box 1). It has increased the amount of maize to be provided at no cost to the most vulnerable and the amount of maize to be sold at a subsidized price. Moreover, as fertilizer prices remain high and farmers' incomes have been depleted by the food crisis, the government has also expanded the amount of fertilizer to be sold at a subsidized price.

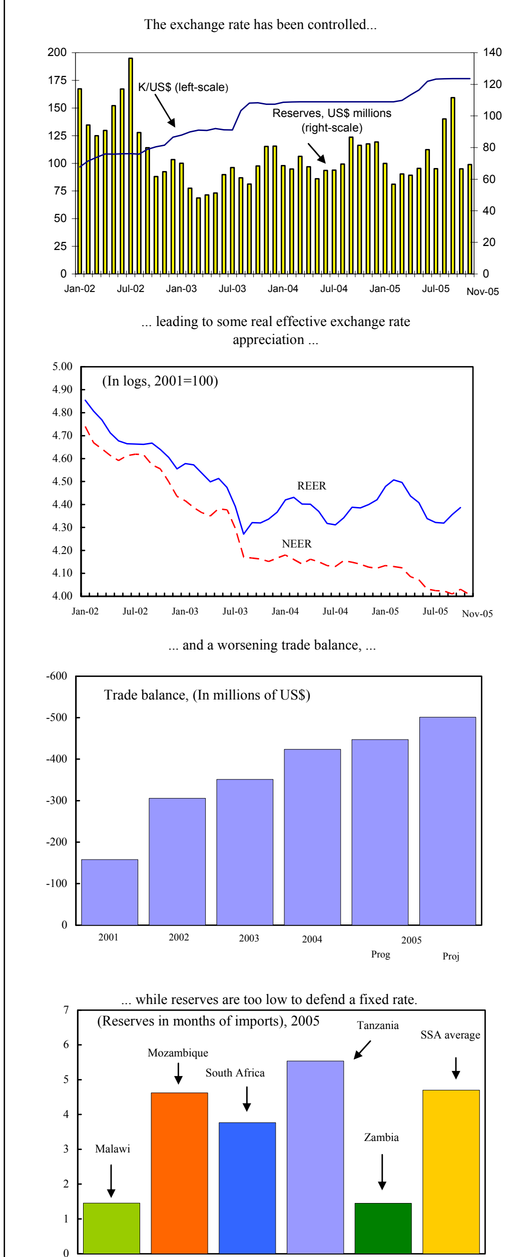
- **The expansion of the government's food security program is not expected to affect net domestic borrowing or net foreign assets of the central bank** as the additional measures have been fully financed by donors**.** The MK3.8 billion increase in budgetary expenditures on maize purchases and the fertilizer subsidy have also been accommodated in the program's indicative target on government expenditures.

The revised program for the remainder of the fiscal year takes account of all deviations due to the food crisis.

III. Alleviating Foreign Exchange Shortages

8. **The exchange rate and short-term interest rates have been largely unchanged through end-December.** As a consequence, there has probably been some loss in international competitiveness during the period under review.The RBM has continued to implement informal administrative procedures—contrary to the original commitment by the Governor in July 2005—and, as a result, demand has been only partially satisfied through foreign exchange sales.

Exchange Rate Policy Needs More Flexibility



9. **Evidence of foreign exchange shortages have persisted and they may have deteriorated,** raising the cost of doing business in Malawi, worsening the investment environment, creating rent seeking opportunities, and possibly aggravating good governance practices.

- **Import backlog:** Anecdotal evidence suggests that the backlog of import invoices first reported to staff in early 2005 has not diminished. The situation has been exacerbated by higher-than-envisaged oil prices, lower tobacco export prices,[5] and a reluctance of exporters to repatriate earnings.

- **Monetary aggregates:** Broad money has remained on track during the program period; however, the composition has changed relative to program as commercial bank credit to the private sector has increased mainly to finance imports with foreign exchange held at commercial banks. The resulting reduction in NFA of commercial banks—combined

[5] In addition, an erosion of preferences in export markets for sugar over the coming three years and probably for tobacco following the Doha Round settlement could affect future export earnings and trigger the activation of the Trade Integration Mechanism. Staff will explore this further in the forthcoming mission.

with the tendency of customers to maintain their balances in foreign exchange denominated deposits—has put pressure on prudential limits for foreign exchange exposure.

- **Foreign exchange bureaus:** The premium paid at foreign exchange bureaus is approximately 11 percent, and is effectively drawing foreign exchange sellers and buyers away from commercial banks. The authorities raised concerns about the operation of the bureaus, but a recent MFD visit did not find any evidence of money laundering.

10. **Preliminary findings based on the above facts suggest that the authorities' use of informal administrative procedures to control the exchange rate constitute an exchange restriction and a possible multiple currency practice under Article VIII.** However, the authorities do not appear to have violated the terms of the PRGF arrangement, as these measures were in place at the time of the approval of the arrangement. The staff will investigate this issue further during the second review mission.

11. **The authorities have been considering an exchange rate band or crawling peg, but agree that current conditions are not favorable for such a mechanism.** International reserves remain at critically low levels, and the domestic debt level is high and a binding constraint on domestic financing of the budget. Furthermore, while fiscal policy implementation has improved, credibility remains weak in light of the political situation and the long track record of fiscal latitude. A rigid exchange-rate mechanism would also reduce Malawi's ability to sustain adverse exogenous shocks.

12. **The authorities have taken action to correct the imbalances.** In the MEFP, the government commits to a monetary framework anchored by a reserve money target, and acknowledges that this requires the continued flexibility of both the exchange rate and interest rates. The authorities further agree to refrain from recourse to administrative restrictions on the foreign exchange market and to begin formally monitoring the import backlog (TMU, para 41). This is, however, fraught with many difficulties as importers often contact several banks for foreign exchange, possibly resulting in the double counting of invoices. Nevertheless, the authorities are committed to reducing the backlog by end-March, and eliminating it by end-June (both structural benchmarks). The authorities estimated the backlog to be approximately US$78 million in early 2006.

13. **Monetary and fiscal policies will need to remain supportive of a more flexible exchange-rate policy.** The authorities have lowered the broad money growth target for 2005/06 (July-June) from 20 to 18 percent, which is to be achieved largely by a tightening in domestic credit. In the short-run, these actions combined with a more flexible exchange rate will not be able to eliminate the import backlog nor fully offset losses already incurred in official external reserves. As a result, the program target on NFA for end-March and end-June 2006 has been revised downward to allow for an increase in sales of foreign exchange. This revision combined with greater exchange rate flexibility should help reduce the current import backlog and ameliorate policy missteps that cannot be addressed through policy actions in the very-short term. Since mid-January, the authorities have begun implementing a more flexible exchange rate policy, as reflected in the daily depreciation of the exchange rate. In the period through February 2, the exchange rate has depreciated by 4½ percent. In

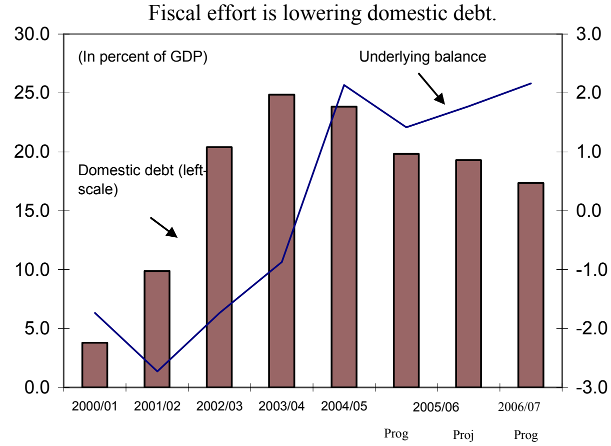
addition, the inclusion of indicative benchmarks on the backlog of import invoices, together with the floor on net foreign assets, does provide some assurance that exchange rate policy will remain sufficiently flexible going forward. These actions by the authorities, if sustained, are expected to put the program back on track in the near term.

IV. Maintaining Budget Discipline to Reduce Domestic Debt

14. **Fiscal performance in the first quarter of 2005/06 was satisfactory.** This was helped by strong tax revenues as the adverse impact on revenues of the recent income tax cut appears to have been less than anticipated. Delays in purchasing maize and disbursing fertilizer subsidies compensated for initial shortfalls in donor support. As a consequence, the target for domestic borrowing was met by a margin of 0.3 percent of GDP.

15. **The paramount challenge for fiscal policy in 2005/06 is ensuring that the domestic debt target is met.**

Fiscal effort is lowering domestic debt.



- On the positive side, the government wage bill is slightly lower than programmed and tax revenues are projected to remain higher than programmed, reflecting the strong performance in the first quarter. On the other hand, the value of donor support in kwacha terms is projected to be lower than program due to the impact of a more appreciated exchange rate; and, external debt service has been revised upwards as a result of refinements to the authorities' database[6].

- On balance, the fiscal deficit will be higher than programmed by about ½ percent of GDP. This will be met largely by the net proceeds from the sale of MTL.

- As a result, domestic debt repayments are in line with the original program. Moreover, the underlying balance, a measure of fiscal effort, is expected to improve from 1.4 to 1.8 percent of GDP, due primarily to higher tax revenues and wage restraint. The pattern of borrowing relative to program, however, is front-loaded reflecting food security operations and the delayed disbursement of the World Bank structural adjustment credit.

16. **The sale of MTL for approximately US$31 million was completed earlier than expected.** In addition, MTL paid a small dividend (MK 275 million) to government and repaid part of an existing loan owed to the central government (MK1 billion). Part of these

[6] This was due mainly to incorrect assumptions on cross-exchange rates and a miscalculation of debt service due from the World Bank, and does not reflect new commitments.

proceeds will be used to cover retrenchment costs (MK 1 billion), and part will be used as a capital injection (MK2.2 billion) in MTL. Consequently, approximately MK 1.6 million will contribute to domestic debt reduction. The staff emphasized the importance of transparency and accountability in all privatization transactions, as stipulated in the Privatization Act.

17. **There are several risks to the budget in the near term that need to be carefully managed.**

- **Wages:** A new database for government employees that has been launched marks an important improvement in fiscal management (a performance criterion for the first review). It will be essential for designing future wage adjustments and pension reform. The authorities postponed the wage adjustment for FY2005/06 to February 2006, with retroactive effect to October 2005, to ensure that they can implement this year's wage adjustment accurately.

- **Pensions (Box 1):** The authorities initially planned to introduce a defined contribution system, but have decided to adopt the recommendation to fix the existing defined benefit pension system as a precondition. They believe that the decision to move to a funded system needs to be taken with sufficient caution and not before the existing institutional arrangements and transition costs are fully analyzed.

- **Quasi-fiscal costs:** Several off-balance sheet items pose future risks to the budget. (1) The government's rural credit facility will now charge an interest rate of 15 percent on loans relative to the 45 percent interest rate offered at competing microfinance institutions (MEFP, paragraph. 12). This could lead to transfers from the budget to cover potential losses; (2) The Malawi Development Corporation is being restructured after government-guaranteed bank debts could not be paid. The potential costs are unknown, but the value of the unpaid debt is approximately ½ percent of GDP; (3) Severance payments legislated in the 2000 Employment Act—which are not being implemented as remedial legislation is pending in Parliament—could amount to 1½ percent of GDP. Depending on the legislative outcome in parliament, these may not need to be paid; (4) Although the authorities have recently adjusted domestic petroleum product prices twice, there is a risk that the pass-through of future increases in international oil prices will be less than complete since adjustments have not been automatic. An initial analysis suggests that there has been full pass through to current prices.

- **Recurrent spending:** The government is committed to reducing the risk of ballooning expenses on vehicles and travel and to preventing new utility arrears (MEFP, para. 14). It intends to implement a new travel policy that emphasizes accountability and transparency by end-March 2006 (a performance criterion for the second review).

- **Domestic Arrears:** The arrears policy (Country Report 05/285 MEFP, para. 44) is being implemented (a performance criteria for the first review), and MK600 million has been repaid in the first quarter of 2005/06. Nevertheless, the stock of arrears has recently increased by 1½ percent of GDP as a result of several court decisions since

June 2004. Government accounting of arrears is poor, and there is the risk of new domestic arrears being uncovered.

Box: Pension Reform

The October 2004 wage reform, by consolidating allowances into basic taxable and pensionable salary, inadvertently triggered a crises in the pension system, requiring urgent changes to contain pension spending. In the first stage, as a short-term solution, the authorities revised the formula for calculating pensions from the final year salary to an average over the last 5 years. This helped contain pension costs in the 2005/06 budget, but the benefits will be lost in future years.

A second stage of pension reform is hence required to take effect in the 2006/07 budget. The first priority is to put the existing system on a long-term sustainable footing, which will demand further substantial changes to the pension calculation to cap the compensation ratio. Supplementing such changes could be the introduction of a funded pension scheme for government employees.

Both elements of the second stage of pension reform require substantial technical work to be done urgently in order to provide an adequate basis for decisions to be made in time for the 2006/07 budget. First, reliable databases on employees covered and existing pensioners need to be in place to allow for simulations of the fiscal impact of various reform proposals. Second, there should be wider public discussions, including with the unions, of the concepts that underlie the existing system and the need for further change. Third, the technical work on the fiscal impact, governance, capacity, financial infrastructure and equity in a funded scheme needs to be significantly enhanced. FAD has already provided TA on these issues, and is scheduled to provide follow-up technical assistance in February.

V. Sustaining Reform through Capacity Building

18. **The authorities have taken important steps toward improving public expenditure management.** Implementation of both the new Integrated Financial Management Information System (IFMIS) and the government's budget ceiling module has started. The budget ceiling module will become less relevant as IFMIS is phased in and replaces the current Credit Ceiling Authority (CCA) payment system. However, it will continue to serve as an appropriate bridging instrument during the transition period and will also provide a vehicle for budget control over departments not covered by the new IFMIS.

- **IFMIS:** The government has successfully begun to implement a version of IFMIS developed by the Tanzanian authorities. There are significant challenges ahead, including making the system fully automated, ensuring correct reporting of commitment and expenditures, and implementing the centralized payment system. Technical assistance from FAD is planned for early 2006.

- **Budget module (a performance criterion for the second review):** Implementation of the budget ceilings module for the existing CCA payment system was slightly delayed, and is now expected to be operational in early 2006, relative to the program implementation date of end-December 2005. This system will enable effective monitoring of payments through the CCA system, and would automatically reject payments for spending that is not approved.

19. **The government has reinvigorated efforts to improve financial sector institutions.** Efforts are currently focused on banking supervision and monetary operations. Fund technical assistance was provided in December 2005.

- **Banking supervision:** Efforts are being made to improve directives that govern financial sector indicators. An initial analysis of commercial bank balance sheets using asset classifications consistent with international best practice has begun (a structural benchmark). This should alert the authorities to potentially problematic institutions. An FSAP is currently planned for late 2006.

- **Monetary operations:** Efforts are being made to strengthen the ability of monetary policy to make greater use of indirect instruments. Towards this goal, the authorities will strengthen coordination between the Ministry of Finance and the RBM to improve liquidity forecasting. This will allow the RBM to announce the specific volumes that will be needed to meet the program's monetary goals. In addition, the book-entry system for treasury bill holdings is being strengthened to help foster growth of the inter-bank market.

20. **A safeguards update assessment was recently completed.** The safeguard mission found that the RBM had taken a number of steps to strengthen its operations. New vulnerabilities, however, have emerged and a few vulnerabilities that were identified earlier remain. In particular, the Board of the RBM was dissolved in August 2005, and a new Board has not yet been appointed, which seriously weakens the governance structure and oversight of the RBM. The government is committed to implementing the recommendations (MEFP, para. 23).

VI. Reaching the HIPC Completion Point

21. **In principle, Malawi could reach the HIPC initiative completion point in mid-2006 at the time of the completion of the second review, and qualify for debt relief under the MDRI.** To reach the completion point, a minimum six-month track record of adequate performance under the PRGF-supported program could be established by end-2005. However, this is only a minimum condition. It will be important that Malawi maintain sound macroeconomic management going forward, including management of the exchange rate system, in order to complete the second review. The authorities are currently in the final stages of completing the third Annual Progress Report covering July 2004 to end-December 2005. Malawi has made good progress on implementing the HIPC triggers (Appendix V), but a few, relating to safety nets, health, education and land policy, are not expected to be completed until early 2006. The staff expects that a few waivers will be requested—including the one relating to student enrollment in teaching training institutions. Reaching the

completion point will allow Malawi to qualify for MRDI debt relief.[7] The amount of relief will be approximately SDR 37 million.

22. **The government has completed its new Malawi Growth and Development Strategy (MGDS).** This updates the Malawi Poverty Reduction Strategy (MPRS) of 2002 that expired in mid-2005. The MGDS has been prepared in consultation with the private sector and civil society, and draws on lessons learned from a comprehensive review of implementation of the MPRS. The MGDS supports the policies to which the government is already committed under the PRGF-supported program.

23. **The government has already begun work with creditors** on confirming external debt data as of end-1999 (used for the decision point), and on reconciling debt data for end-December 2005. A joint Bank-Fund mission to update the HIPC debt sustainability analysis is scheduled for early 2006. Following approval of the PRGF arrangement, Paris Club creditors approved an extension of the consolidation period under the previous rescheduling agreement to end-2006.

VII. Staff Appraisal

24. **Performance under the PRGF-supported program through end-September has been satisfactory.** Malawi met all performance criteria and indicative targets through end-September, with the exception of the structural benchmark on the wage schedule that was completed in early 2006. This builds on the success of the recently completed SMP and represents a welcome break from previous episodes of fiscal latitude. However, the management of the exchange rate system continues to be a major source of concern, as the authorities appear to have continued to control the exchange rate through informal restrictions, contrary to earlier commitments made at the time of the approval of the PRGF.

25. **Food security is correctly a priority for the near term.** The government's expanded program to deal with the food crisis is appropriate. The staff welcomes the additional donor support for these operations.

26. **The exchange rate was overvalued during the second half of 2005** as suggested by the persistent backlog of import invoices. The recent depreciation of the kwacha, tighter domestic policies, and the renewed commitment to phase out informal administrative restrictions on foreign exchange transactions are appropriate policy steps. Staff underscores the importance of sustaining these policies going forward. In addition, the authorities' commitment to monitor and eliminate the backlog of import invoices is welcome. A more flexible exchange-rate system is required to reduce this backlog and pursue an independent monetary policy.

27. **The fiscal objectives for the remainder of the year are realistic.** Spending remains within the approved budget for a majority of the votes, and the decision to use the net

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[7] Debt incurred by Malawi to the Fund before January 1, 2005 that remains outstanding at the time of being qualified for MRDI will be subject to 100 percent debt relief.

privatization proceeds for financing the fiscal deficit is appropriate. In the near term, pension reform is a priority, and the staff welcomes the authorities' commitment to fixing the current defined benefit plan.

28. **Building stronger institutions and capacity will be a key determinant in sustaining good macroeconomic policy performance.** The staff welcomes the authorities' initiatives in public expenditure management, banking supervision, and monetary operations. Staff urges the authorities to implement Fund technical assistance recommendations in these areas.

29. **The HIPC completion point could be reached in mid-2006**, but progress must first be made in implementing the remaining triggers and modifying exchange rate policy. A final assessment by the World Bank of key social sector triggers will be critical in determining whether the triggers have been met.

30. **The program faces many risks. In particular:**

- **Exchange rate:** The import backlog may expand if the authorities do not fully remove the informal administrative restrictions on foreign exchange transactions and maintain a flexible exchange rate policy.

- **Fiscal policy.** The authorities need to manage several near-term risks to the budget. These include designing appropriate wage and pension polices (as discussed above); reviewing on a frequent basis the operations of the rural credit facility to minimize the risk of transfers from the budget to cover potential losses; developing a strategy to restructure the Malawi Development Corporation; fully implementing the arrears policy, including the avoidance of new arrears; controlling recurrent spending associated with travel, vehicles, and utilities; and, ensuring a full pass through of increases in international oil prices.

- **Political risks:** Impeachment proceedings against the President may divert attention from economic management and lead to more spending in order to dampen political opposition. The recent success in by-elections by the governing party, however, suggests that popular support for the government may be growing.

31. **The authorities indicate that they are fully committed to successful program implementation. On this basis and on performance through end-September, the staff recommends completion of the first review under the PRGF arrangement.**

Table 1a. Malawi: Selected Economic Indicators, 2002-08

	2002 Est.	2003 Est.	2004 Est.	2005 Prog.	2005 Proj.	2006 Proj.	2007 Proj.	2008 Proj.
National income and prices								
GDP at constant factor prices	2.1	3.9	5.1	2.1	1.9	8.3	5.6	6.0
Nominal GDP (in billions of kwacha)	148.4	171.9	207.2	240.9	245.3	296.6	336.0	382.4
Nominal GDP per capita (in U.S. dollars)	160.3	143.1	150.9	158.2	161.1	164.1	171.1	181.8
GDP deflator	16.6	9.2	12.5	16.2	15.3	10.9	7.3	7.4
Consumer prices (end of period)	11.5	9.8	13.7	16.9	16.0	4.9	7.3	7.0
Food	8.2	3.0	14.1	19.2	17.4	1.0	7.4	7.0
Nonfood	15.9	18.6	13.3	13.8	15.5	10.6	7.2	7.0
Consumer prices (annual average)	14.9	9.6	11.4	15.5	15.4	9.8	6.4	7.2
Investment and savings (percent of GDP)								
National savings	-0.8	3.2	5.1	10.4	6.0	11.1	10.1	10.5
Of which : domestic savings	-11.0	-11.7	-10.0	-8.1	-12.5	-6.4	-6.0	-5.0
unrequited transfers	12.6	17.3	17.4	20.6	20.6	19.5	17.9	17.1
Gross investment	10.4	10.8	14.4	16.4	13.7	15.7	16.1	16.3
Foreign savings	-11.2	-7.6	-9.3	-6.0	-7.7	-4.6	-6.0	-5.8
Central government (percent of GDP)								
Revenue (excluding grants)	17.7	22.0	23.2	24.8	25.6	23.8	24.4	24.1
Expenditure	35.1	39.3	43.9	48.3	46.2	41.7	40.4	38.3
Underlying balance 1/	-2.8	-0.5	1.0	-1.5	1.0	1.4	2.2	2.1
Overall balance (excluding grants)	-17.4	-17.3	-20.7	-23.8	-20.9	-17.9	-16.0	-14.2
Overall balance	-11.6	-6.5	-6.5	-4.6	-5.3	-1.8	-1.4	-0.4
Money and credit (change in percent of beginning-of-year M2)								
Money and quasi money	25.2	29.3	29.8	16.1	14.6	19.1	14.5	15.0
Net foreign assets	-55.4	21.5	6.0	10.8	7.2	13.1	3.3	6.4
Net domestic assets	80.6	7.8	23.8	5.3	7.4	6.0	11.1	8.6
Credit to the government	45.1	11.3	10.3	17.4	2.3	0.2	-1.0	-7.4
Credit to the rest of the economy	4.1	8.1	11.3	4.9	6.3	2.1	2.8	5.4
Velocity	5.4	4.9	4.5	4.5	4.7	4.8	4.7	4.7
External sector (millions of U.S. dollars)								
Exports, f.o.b.	421.1	440.6	470.0	536.4	514.3	557.6	576.7	600.8
Imports, c.i.f.	-726.8	-791.6	-893.8	-983.7	-1,015.6	-986.8	-1,031.2	-1,074.5
Usable gross official reserves	103.4	115.6	119.3	142.2	130.4	183.2	186.2	218.6
(months of imports)	1.4	1.4	1.3	1.6	1.5	2.0	1.9	2.1
Current account (excluding grants)	-23.8	-24.9	-26.7	-26.5	-28.3	-24.1	-23.9	-22.9
Nominal effective exchange rate 2/	-28.6	-23.6	-4.3	...	-8.8	...	...	...
Real effective exchange rate 2/	-24.8	-17.2	5.5	...	-3.3	...	...	...
Terms of trade	-7.4	-3.2	-1.3	-7.5	-12.3	7.2	0.0	0.0
Debt stock and service (percent of GDP)								
External debt (public sector)	143.3	158.9	148.1	143.7	137.0	135.3	128.7	120.0
NPV of debt (percent of avg. exports)	299.3	295.0	291.1	274.4	277.1	261.7	248.0	238.7
External debt service (percent of exports)	18.3	21.8	22.9	18.9	21.5	23.3	20.8	17.6
Net domestic debt (central government)	17.4	22.3	22.6	22.0	22.0	17.9	16.1	13.2
Domestic interest payment	4.0	7.9	8.4	6.2	6.3	5.2	4.2	3.4
Treasury bill rate (period average)	41.7	39.3	28.6	...	24.4	...	...	...

Sources: Malawian authorities; and IMF staff estimates and projections.

1/ A measure of domestic adjustment effort (i.e., domestic primary balance excluding maize and the Health SWAp). Definition: Overall balance plus statistical discrepancy, excluding grants, revenue and expenditure from maize, interest, foreign-financed development expenditures, and the Health SWAp.
2/ Based on data through October 2005.

Table 1b. Malawi: Selected Economic Indicators on a Fiscal Year Basis, 2002/03-2008/09

	2002/03 Est.	2003/04 Est.	2004/05 Est.	2005/06 Prog.	2005/06 Proj.	2006/07 Proj.	2007/08 Proj.	2008/09 Proj.
National income and prices								
GDP at constant factor prices	3.0	4.5	3.4	5.2	5.1	6.9	5.8	6.0
Nominal GDP (in billions of kwacha)	160.1	189.6	226.3	264.0	271.0	316.3	359.2	408.5
Nominal GDP per capita (in U.S. dollars)	154.0	142.6	160.0	157.1	161.2	167.4	176.7	187.7
GDP deflator	15.6	11.0	14.0	13.0	12.9	9.0	7.3	7.3
Consumer prices (end of period)	8.5	11.6	15.9	11.0	10.3	7.7	7.2	7.0
Food	4.0	6.3	19.6	9.9	7.8	7.4	7.2	7.0
Nonfood	13.9	17.5	12.1	12.3	16.1	8.0	7.1	7.0
Consumer prices (annual average)	16.7	10.1	13.6	15.1	14.9	5.5	7.3	7.0
Investment and savings (percent of GDP)								
National savings	0.2	4.2	4.8	11.9	10.3	10.6	10.3	11.1
Of which : domestic savings	-12.6	-10.7	-12.1	-6.2	-7.7	-6.1	-5.5	-4.4
unrequited transfers	15.1	17.3	19.1	20.2	20.0	18.7	17.5	17.1
Gross investment	9.4	12.8	13.2	16.4	16.2	15.9	16.2	16.7
Foreign savings	-9.3	-8.5	-8.4	-4.4	-6.0	-5.3	-5.9	-5.6
Central government (percent of GDP)								
Revenue (excluding grants)	20.0	22.6	25.1	24.6	24.5	24.4	24.2	24.0
Expenditure	38.3	42.5	42.4	44.7	45.3	41.6	39.0	37.6
Underlying balance 1/	-1.7	-0.9	2.1	1.4	1.8	2.2	2.3	2.1
Overall balance (excluding grants)	-18.3	-19.9	-17.6	-20.1	-20.8	-17.1	-14.8	-13.5
Overall balance	-11.6	-7.8	-5.3	-1.3	-2.0	-1.9	-0.9	-0.5
Money and credit (change in percent of beginning-of-year M2)								
Money and quasi money	24.1	35.6	18.4	18.5	18.0	17.3	14.8	15.0
Net foreign assets	-5.3	8.6	5.8	21.3	8.2	10.5	5.3	1.5
Net domestic assets	29.4	27.0	12.7	-2.8	9.8	6.9	9.5	13.5
Credit to the government	40.3	20.9	9.4	-2.7	-9.0	-1.2	-3.6	-5.1
Credit to the rest of the economy	7.5	2.5	14.0	2.3	6.2	0.8	3.5	7.5
Velocity	5.3	4.7	4.7	4.6	4.8	4.7	4.7	4.6
External sector (millions of U.S. dollars)								
Exports, f.o.b.	422.2	447.6	498.1	544.1	525.3	563.4	586.1	614.2
Imports, c.i.f.	-850.6	-781.7	-936.0	-983.8	-1,012.4	-1,020.8	-1,036.0	-1,102.3
Usable gross official reserves	89.7	93.6	112.4	166.5	137.2	171.5	189.5	187.8
(months of imports)	1.1	1.0	1.3	1.8	1.5	1.8	1.8	1.7
Current account (excluding grants)	-24.4	-25.9	-27.6	-24.6	-26.0	-24.0	-23.4	-22.7
Nominal effective exchange rate	-21.0	-21.6	-9.7	...	...	...	...	...
Real effective exchange rate	-17.3	-14.5	2.1	...	...	...	...	...
Domestic debt (percent of GDP)								
Net domestic debt (central government)	20.4	24.8	23.8	19.8	19.3	17.4	15.0	12.4
Domestic interest payment	5.5	9.1	7.4	5.4	5.5	4.9	3.8	2.9
Treasury bill rate (period average)	38.3	36.3	24.5	...	...	...	...	...

Sources: Malawian authorities; and IMF staff estimates and projections.

1/ A measure of domestic adjustment effort (i.e., domestic primary balance excluding maize and the Health SWAp). Definition: Overall balance plus statistical discrepancy, excluding grants, revenue and expenditure from maize, interest, foreign-financed development expenditures, and the Health SWAp.

Table 2a: Malawi: Central Government Operations, 2005/06
(In millions of Malawi kwacha)

	2005/06 Program						2005/06 Curremt					
	Q1 Prog.	Q2 Prog.	Q3 Prog.	Q4 Prog.	Annual Prog.	Percent of GDP	Q1 Proj.	Q2 Proj.	Q3 Proj.	Q4 Proj.	Annual Proj.	Percent of GDP
Total revenue and grants	31,125	27,103	30,136	26,428	114,792	43.5	28,135	32,348	24,686	32,225	117,394	43.3
Revenue	15,457	14,912	17,128	17,454	64,950	24.6	16,347	15,413	17,336	17,268	66,364	24.5
Tax revenue	13,742	12,932	14,508	15,506	56,688	21.5	13,892	13,363	14,911	15,850	58,016	21.4
Nontax revenue	1,715	1,980	2,620	1,947	8,262	3.1	2,455	2,050	2,425	1,418	8,348	3.1
Of which : sale receipts from maize	170	334	840	0	1,344	0.5	375	391	391	0	1,157	0.4
Grants	15,669	12,191	13,008	8,974	49,842	18.9	11,788	16,935	7,350	14,957	51,030	18.8
Program/ budget support	7,644	2,617	4,837	0	15,098	5.7	4,407	6,519	397	3,835	15,159	5.6
Project	3,330	3,501	3,892	3,659	14,383	5.4	3,317	4,343	3,067	4,458	15,185	5.6
Dedicated grants	3,162	4,178	2,288	3,288	12,916	4.9	2,529	4,199	2,223	4,694	13,645	5.0
DFID/EU	1,139	1,030	0	0	2,169	0.8	684	3,330	0	1,171	5,185	1.9
National Aids Commission (NAC)	1,269	1,309	1,340	1,364	5,282	2.0	361	256	1,340	1,364	3,320	1.2
Health swap	754	1,840	947	1,925	5,466	2.1	1,485	612	883	2,159	5,139	1.9
HIPC debt relief	1,533	1,894	1,992	2,026	7,445	2.8	1,535	1,874	1,662	1,970	7,041	2.6
Total expenditure and net lending	31,184	31,561	28,012	27,350	118,108	44.7	27,782	37,680	26,641	30,739	122,842	45.3
Current expenditure	23,228	22,809	19,525	18,749	84,310	31.9	19,077	28,850	19,100	21,024	88,051	32.5
Wages and salaries	4,848	5,086	5,284	5,512	20,730	7.9	4,806	4,901	5,207	5,535	20,448	7.5
Of which : Health Swap	177	181	184	188	730	0.3	138	0	184	408	730	0.3
Interest payments	4,194	4,357	4,902	4,278	17,730	6.7	4,428	4,777	4,758	4,405	18,368	6.8
Domestic	3,530	3,493	3,998	3,359	14,381	5.4	3,674	3,837	3,931	3,466	14,909	5.5
Foreign	663	864	903	919	3,349	1.3	754	940	827	938	3,459	1.3
Other current expenditure	14,187	13,366	9,339	8,958	45,850	17.4	9,844	19,172	9,135	11,085	49,235	18.2
Other purchases of goods and services	8,597	7,378	5,897	5,474	27,346	10.4	6,471	10,162	5,659	7,632	29,923	11.0
Of which : maize purchases	3,169	1,896	538	0	5,603	2.1	1,003	5,967	347	1,180	8,497	3.1
Health SWAp	1,016	1,046	1,063	1,075	4,200	1.6	1,419	0	980	1,474	3,873	1.4
Subsidies and other current transfers	5,090	5,487	2,943	2,984	16,504	6.3	2,769	8,510	2,976	3,057	17,312	6.4
Pension and gratuities	802	802	802	802	3,208	1.2	716	800	846	846	3,208	1.2
Fertilizer subsidy	2,200	2,600	0	0	4,800	1.8	0	5,635	0	0	5,635	2.1
Arrears	500	500	500	500	2,000	0.8	604	500	500	396	2,000	0.7
Development expenditure	7,956	8,752	8,487	8,602	33,797	12.8	8,002	9,533	7,541	9,715	34,791	12.8
Part I (foreign financed)	7,021	7,817	7,532	7,609	29,978	11.4	7,169	8,597	6,586	8,619	30,972	11.4
Part II (domestically financed)	936	936	955	993	3,819	1.4	833	936	955	1,096	3,819	1.4
Net lending	0	0	0	0	0	0.0	703	-703	0	0	0	0.0
Overall balance (including grants)	-59	-4,458	2,124	-923	-3,316	-1.3	353	-5,332	-1,955	1,486	-5,448	-2.0
Spending directly related to privatization 1/	0	0	0	0	0	0.0	0	0	2,225	0	2,225	0.8
Augmented balance	-59	-4,458	2,124	-923	-3,316	-1.3	353	-5,332	-4,180	1,486	-7,673	-2.8
Total financing	59	4,458	-2,124	923	3,316	1.3	-753	3,155	6,758	-1,486	7,673	2.8
Foreign (net)	842	4,274	-324	-84	4,707	1.8	891	1,580	2,948	354	5,773	2.1
Borrowing	2,421	6,279	2,300	2,586	13,585	5.1	3,084	4,038	5,529	3,166	15,817	5.8
Program	0	3,272	0	0	3,272	1.2	0	0	3,351	0	3,351	1.2
Project	2,421	3,007	2,300	2,586	10,314	3.9	3,084	4,038	2,179	3,166	12,467	4.6
Amortization	-1,919	-2,179	-2,624	-2,670	-9,393	-3.6	-2,193	-2,457	-2,581	-2,812	-10,044	-3.7
Foreign bank accounts	340	175	0	0	515	0.2	0	0	0	0	0	0.0
Domestic (net)	-783	184	-1,800	1,007	-1,391	-0.5	-1,644	1,574	250	-1,840	-1,661	-0.6
Banking system	-783	184	-1,800	1,007	-1,391	-0.5	-8,994	2,271	2,094	95	-4,535	-1.7
Nonbanks	0	0	0	0	0	0.0	7,350	-697	-1,844	-1,935	2,874	1.1
Privatization proceeds	0	0	0	0	0	0.0	0	0	3,560	0	3,560	1.3
Discrepancy	0	0	0	0	0	0.0	400	2,177	-2,578	0	0	0.0
Memorandum items:												
Nominal GDP	263,994	263,994	263,994	263,994	263,994	100.0	270,989	270,989	270,989	270,989	270,989	100.0
Net domestic debt	52,927	53,112	51,312	52,319	52,319	19.8	52,278	53,852	54,102	52,262	52,262	19.3

Sources: Malawian authorities; and IMF staff estimates.

1 / Includes for 2005/06 transactions related to the sale of MTL: rentrenchment costs and the capital injection less debt repayment.

Table 2b: Malawi: Central Government Operations, 2002/03 - 2008/09
(In millions of Malawi kwacha)

	2002/03	2003/04	2004/05	2005/06		2006/07	2007/08	2008/09
	Act.	Act.	Est.	Prog.	Proj.	Proj.	Proj.	Proj.
Total revenue and grants	42,685	65,817	84,701	114,792	117,394	125,410	137,087	151,482
Revenue	32,009	42,754	56,809	64,950	66,364	77,317	87,094	98,195
Tax revenue	27,251	36,902	49,798	56,688	58,016	67,721	76,669	86,843
Nontax revenue	4,758	5,852	7,011	8,262	8,348	9,596	10,425	11,352
Of which : sale receipts from maize	591	1,351	468	1,344	1,157	1,500	1,500	1,500
Grants	10,675	23,063	27,893	49,842	51,030	48,093	49,992	53,287
Program/ budget support	1,220	6,576	5,085	15,098	15,159	9,852	8,903	8,300
Project	4,604	6,518	11,138	14,383	15,185	17,365	19,493	28,683
Dedicated grants	188	4,219	6,591	12,916	13,645	12,691	13,175	7,675
HIPC debt relief	3,588	5,261	5,078	7,445	7,041	8,186	8,422	8,630
Total expenditure and net lending	61,322	80,536	96,627	118,108	122,842	131,496	140,267	153,548
Current expenditure	49,473	59,537	71,962	84,310	88,051	93,005	97,389	104,481
Wages and salaries	10,930	12,337	17,056	20,730	20,448	23,324	26,219	29,339
Of which : Health SWAp	...	...	94	730	730	998	1,203	1,262
Interest payments	10,985	20,024	19,612	17,730	18,368	19,349	17,724	15,883
Domestic	8,871	17,253	16,650	14,381	14,909	15,440	13,753	11,772
Foreign	2,114	2,771	2,962	3,349	3,459	3,909	3,972	4,111
Other current expenditure	27,559	27,176	35,294	45,850	49,235	50,333	53,445	59,258
Purchases of goods and services	20,127	18,416	20,227	27,346	29,923	28,486	30,943	35,935
Maize	6,078	0	2,447	5,603	8,497	2,200	1,500	1,500
Health SWAp	...	...	984	4,200	3,873	5,911	5,736	5,838
Elections	10	2,029	63	251	261	0	359	2,043
Other goods and services	14,039	16,388	16,733	17,292	17,292	20,375	23,348	26,555
Subsidies and other current transfers	7,431	7,410	13,600	16,504	17,312	18,847	19,502	20,323
Pension and gratuities	1,431	1,613	2,106	3,208	3,208	4,694	5,330	6,062
Fertilizer subsidy	0	0	3,297	4,800	5,635	5,135	4,635	4,135
DFID financed TIP costs	0	0	1,077	0	0	0	0	0
Other subsidies and transfers	6,000	5,797	7,121	8,496	8,469	9,018	9,538	10,126
Arrears	0	1,349	1,467	2,000	2,000	3,000	3,000	3,000
Development expenditure	11,787	20,999	24,076	33,797	34,791	38,491	42,878	49,067
Part I (foreign financed)	9,521	17,681	21,663	29,978	30,972	34,062	36,772	40,896
Part II (domestically financed)	2,266	3,319	2,413	3,819	3,819	4,429	6,106	8,171
Net lending	61	0	589	0	0	0	0	0
Overall balance (including grants)	-18,637	-14,719	-11,926	-3,316	-5,448	-6,086	-3,180	-2,066
Spending directly related to privatization 1/	0	0	0	0	2,225	0	0	0
Augmented balance (incl. privatization)	-18,637	-14,719	-11,926	-3,316	-7,673	-6,086	-3,180	-2,066
Total financing	18,099	14,938	11,611	3,316	7,673	6,086	3,180	2,066
Foreign (net)	-730	425	4,793	4,707	5,773	3,436	4,052	5,433
Borrowing	4,917	7,185	11,394	13,585	15,817	15,454	15,971	17,752
Program	0	1,386	5,182	3,272	3,351	4,461	4,706	5,538
Project	4,917	5,799	6,212	10,314	12,467	10,994	11,265	12,213
Amortization	-5,448	-7,577	-8,210	-9,393	-10,044	-12,018	-11,919	-12,318
Foreign bank accounts	125	817	1,609	515	0	0	0	0
Domestic (net)	18,829	14,512	6,818	-1,391	-1,661	2,650	-872	-3,367
Banking system	13,922	6,601	4,018	-1,391	-4,535	-705	-2,540	-4,066
Nonbanks	5,213	7,850	2,800	0	2,874	3,355	1,667	698
Privatization and other financing	-307	62	0	0	3,560	0	0	0
Discrepancy (- is overfinancing)	538	-218	315	0	0	0	0	0
Memorandum items:								
Nominal GDP	160,137	188,279	226,272	263,994	270,989	316,333	359,198	408,534
Net domestic debt	32,654	47,104	53,923	52,319	52,262	54,912	54,039	50,672
Underlying balance 2/	-2,781	-1,648	4,829	3,739	4,805	6,841	8,262	8,526
Overall balance (excluding grants)	-29,312	-37,783	-39,818	-53,158	-56,478	-54,179	-53,172	-55,353
Pro-poor spending	11,135	11,876	14,865	18,543	18,543	...	...	...
Arrears (stock)	...	...	10,037	...	...	...	...	...

Sources: Malawian authorities; and IMF staff estimates.

1/ Includes for 2005/06 transactions related to the sale of MTL: retrenchment costs and the capital injection less debt repayment.

2/ The underlying balance is a measure of domestic adjustment effort, specifically the domestic primary balance, excluding maize operations and the Health SWAp. Definition: Overall balance plus statistical discrepancy, less grants, less revenue from maize, plus total interest, plus expenditures for maize and the Health SWAp, plus foreign-financed development expenditures.

Table 2c: Malawi: Central Government Operations, 2002/03 - 2008/09
(In percent of GDP)

	2002/03	2003/04	2004/05	2005/06		2006/07	2007/08	2008/09
	Act.	Act.	Est.	Prog.	Proj.	Proj.	Proj.	Proj.
Total revenue and grants	26.7	34.7	37.4	43.5	43.3	39.6	38.2	37.1
Revenue	20.0	22.5	25.1	24.6	24.5	24.4	24.2	24.0
Tax revenue	17.0	19.5	22.0	21.5	21.4	21.4	21.3	21.3
Nontax revenue	3.0	3.1	3.1	3.1	3.1	3.0	2.9	2.8
of which : Sale receipts from maize	0.4	0.7	0.2	0.5	0.4	0.5	0.4	0.4
Grants	6.7	12.2	12.3	18.9	18.8	15.2	13.9	13.0
Program/ budget support	0.8	3.5	2.2	5.7	5.6	3.1	2.5	2.0
Project	2.9	3.4	4.9	5.4	5.6	5.5	5.4	7.0
Dedicated grants	0.1	2.2	2.9	4.9	5.0	4.0	3.7	1.9
HIPC debt relief	2.2	2.8	2.2	2.8	2.6	2.6	2.3	2.1
Total expenditure and net lending	38.3	42.5	42.7	44.7	45.3	41.6	39.0	37.6
Current expenditure	30.9	31.4	31.8	31.9	32.5	29.4	27.1	25.6
Wages and salaries	6.8	6.5	7.5	7.9	7.5	7.4	7.3	7.2
Of which : Health SWAp	...	...	0.0	0.3	0.3	0.3	0.3	0.3
Interest payments	6.9	10.6	8.7	6.7	6.8	6.1	4.9	3.9
Domestic	5.5	9.1	7.4	5.4	5.5	4.9	3.8	2.9
Foreign	1.3	1.5	1.3	1.3	1.3	1.2	1.1	1.0
Other current expenditure	17.2	14.3	15.6	17.4	18.2	15.9	14.9	14.5
Purchases of goods and services	12.6	9.7	8.9	10.4	11.0	9.0	8.6	8.8
Maize purchases	3.8	0.0	1.1	2.1	3.1	0.7	0.4	0.4
Health SWAp	...	...	0.4	1.6	1.4	1.9	1.6	1.4
Elections	0.0	1.1	0.0	0.1	0.1	0.0	0.1	0.5
Other goods and services	8.8	8.6	7.4	6.6	6.4	6.4	6.5	6.5
Subsidies and other current transfers	4.6	3.9	6.0	6.3	6.4	6.0	5.4	5.0
Pension and gratuities	0.9	0.9	0.9	1.2	1.2	1.5	1.5	1.5
Fertilizer subsidy	0.0	0.0	1.5	1.8	2.1	1.6	1.3	1.0
DFID financed TIP costs	0.0	0.0	0.5	0.0	0.0	0.0	0.0	0.0
Other subsidies and transfers	3.7	3.1	3.1	3.2	3.1	2.9	2.7	2.5
Arrears	0.0	0.7	0.6	0.8	0.7	0.9	0.8	0.7
Development expenditure	7.4	11.1	10.6	12.8	12.8	12.2	11.9	12.0
Part I (foreign financed)	5.9	9.3	9.6	11.4	11.4	10.8	10.2	10.0
Part II (domestically financed)	1.4	1.8	1.1	1.4	1.4	1.4	1.7	2.0
Net lending	0.0	0.0	0.3	0.0	0.0	0.0	0.0	0.0
Overall balance (including grants)	-11.6	-7.8	-5.3	-1.3	-2.0	-1.9	-0.9	-0.5
Spending directly related to privatization 1/	0.0	0.0	0.0	0.0	0.8	0.0	0.0	0.0
Augmented balance	-11.6	-7.8	-5.3	-1.3	-2.8	-1.9	-0.9	-0.5
Total financing	11.3	7.9	5.1	1.3	2.8	1.9	0.9	0.5
Foreign (net)	-0.5	0.2	2.1	1.8	2.1	1.1	1.1	1.3
Borrowing	3.1	3.8	5.0	5.1	5.8	4.9	4.4	4.3
Program	0.0	0.7	2.3	1.2	1.2	1.4	1.3	1.4
Project	3.1	3.1	2.7	3.9	4.6	3.5	3.1	3.0
Amortization	-3.4	-4.0	-3.6	-3.6	-3.7	-3.8	-3.3	-3.0
Foreign bank accounts	0.1	0.4	0.7	0.2	0.0	0.0	0.0	0.0
Domestic (net)	11.8	7.7	3.0	-0.5	-0.6	0.8	-0.2	-0.8
Banking system	8.7	3.5	1.8	-0.5	-1.7	-0.2	-0.7	-1.0
Nonbanks	3.3	4.1	1.2	0.0	1.1	1.1	0.5	0.2
Privatization and other financing	-0.2	0.0	0.0	0.0	1.3	0.0	0.0	0.0
Discrepancy (- is overfinancing)	0.3	-0.1	0.1	0.0	0.0	0.0	0.0	0.0
Memorandum items:								
Net domestic debt	20.4	24.8	23.8	19.8	19.3	17.4	15.0	12.4
Underlying balance 2/	-1.7	-0.9	2.1	1.4	1.8	2.2	2.3	2.1
Overall balance (excluding grants)	-18.3	-19.9	-17.6	-20.1	-20.8	-17.1	-14.8	-13.5
Pro-poor spending	7.0	6.3	6.6	7.0	6.8	...	...	...
Arrears (Stock)	...	...	4.4	...	...	...	...	...

Sources: Malawian authorities; and IMF staff estimates.

1/ Includes for 2005/06 transactions related to the sale of MTL: retrenchment costs and the capital injection less debt repayment.

2/ The underlying balance is a measure of domestic adjustment effort, specifically the domestic primary balance, excluding maize operations and the Health SWAp. Definition: Overall balance plus statistical discrepancy, less grants, less revenue from maize, plus total interest, plus expenditures for maize and the Health SWAp, plus foreign-financed development expenditures.

Table 3a. Malawi : Monetary Authorities' Balance Sheet, 2004-06
(In millions of Malawi kwacha, unless otherwise indicated)

	2004		2005								2006			
	Q3	Q4	Q1	Q2			Q3		Q4		Q1		Q2	
	Act.	Act.	Act.	SMP	SMP - Adj. 1/	Act.	Prog.	Act.	Prog.	Est.	Prog.	Proj.	Prog.	Proj.
Reserve money	16,728	17,967	16,196	18,674	18,674	19,580	20,894	20,115	20,904	20,610	17,896	17,890	23,013	22,750
Currency outside banks	11,505	10,993	9,976	...	...	13,050	...	12,785	...	...	...	...	...	...
Cash in vault	1,440	1,861	1,567	...	...	1,866	...	1,787	...	...	...	...	...	...
Commercial bank deposits with RBM	3,782	5,114	4,653	...	...	4,664	...	5,543	...	...	...	...	...	...
Net foreign assets (NFA)	3,369	2,919	158	3,685	971	4,060	8,507	9,142	7,223	6,915	5,162	3,935	10,101	7,606
NFA (in millions of U.S. dollars)	30.9	26.8	1.4	33.8	8.9	33.0	69.2	73.7	58.7	55.9	42.0	32.0	82.1	61.8
Gross foreign assets	123.7	119.3	90.4	114.1	...	112.4	163.8	159.4	142.2	130.4	128.5	109.6	166.5	137.2
Foreign liabilities	-92.8	-92.5	-88.9	-80.2	...	-79.4	-94.6	-85.8	-83.5	-74.5	-86.6	-77.6	-84.4	-75.4
Net domestic assets	13,359	15,048	16,038	14,988	17,702	15,520	12,387	10,972	13,681	13,695	12,734	13,955	12,912	15,145
Credit to government (net)	11,237	12,046	20,297	17,949	...	22,181	19,415	11,957	20,376	11,393	17,456	13,006	16,474	12,613
Credit to statutory bodies (net)	0	0	0	0	...	0	0	0	0	0	0	0	0	0
Credit to domestic banks	2	2	2	3	...	2	3	2	2	2	3	2	2	2
Other items (net)	2,120	3,001	-4,261	-2,964	...	-6,662	-7,031	-986	-6,697	2,300	-4,726	947	-3,564	2,529
Revaluation accounts	59	-2	0	0	...	0	0	0	0	0	0	0	0	0
Open market operations	-5,937	-5,582	-13,592	-8,991	...	-16,907	-17,441	-10,061	-17,483	-7,881	-15,856	-7,266	-15,136	-6,621
Encumbered reserves	1,013	1,013	1,037	1,013	...	799	800	807	800	3,472	800	492	800	492
Others	6,985	7,572	8,293	5,014	...	9,446	9,611	8,268	9,987	6,709	10,331	7,721	10,772	8,658
Memorandum items:														
Seasonally adjusted reserve money	16,027	17,873	19,587	18,144	18,144	19,501	20,060	19,292	20,847	20,501	21,818	21,636	23,023	22,658
Quarterly change	-14.5	11.5	9.6	0.1	0.1	-0.4	2.4	-1.1	3.9	6.3	4.7	5.5	5.5	4.7
Annual change	30.2	29.9	34.7	-0.3	-0.3	4.0	24.9	20.4	16.3	14.7	10.5	10.5	17.5	16.2
Seasonally adjusted currency outside banks	10,661	11,591	11,888	...	...	11,817	...	11,820	...	...	...	...	...	...
Quarterly change	6.5	8.7	2.6	...	...	-0.6	...	0.0	...	...	...	...	...	...
Annual change	40.5	40.2	38.8	...	...	18.1	...	10.9	...	...	...	...	...	...
Money multiplier														
Money multiplier	2.60	2.54	2.75	2.68	2.68	2.59	2.51	2.54	2.54	2.54	2.83	2.81	2.64	2.63
Seasonally adjusted	2.65	2.55	2.49	2.60	2.60	2.51	2.55	2.54	2.55	2.55	2.55	2.55	2.55	2.55
Net sales 2/														
Quarterly change	6,643	-2,254	6,029	-1,080	...	2,177	2,517	1,733	-735	-42	-507	-1,978	1,269	-2,092
Annual change	11,944	7,378	12,086	7,252	...	12,595	8,257	7,686	9,776	9,897	3,228	1,890	2,545	-2,379

Sources: Reserve Bank of Malawi; and IMF staff estimates and projections.
1/ Adjusted for a shortfall in BoP support (WB $25 million) as stipulated in the SMP TMU
2/ Defined as the increase in holdings at cost value of both treasury and RBM bills in the private sector.

Table 3b. Malawi : Monetary Survey, 2004-06
(In millions of Malawi kwacha, unless otherwise indicated)

	2004		2005							2006			
	Q3	Q4	Q1	Q2		Q3		Q4		Q1		Q2	
	Act.	Act.	Act.	SMP	Act.	Prog.	Act.	Prog.	Proj.	Prog.	Proj.	Prog.	Proj.
Money and quasi-money	43,452	45,666	44,552	49,998	50,625	52,347	51,081	53,010	52,346	50,689	50,331	60,691	59,740
Money	24,556	25,443	24,400	...	28,977	...	29,171	...	...	...	...	...	...
Quasi money	18,896	20,222	20,151	...	21,648	...	21,910	...	...	...	...	...	...
Of which: foreign currency deposits	7,501	7,120	7,284	...	8,246	...	7,564	...	...	...	...	...	...
Net foreign assets (NFA)	9,358	7,593	3,092	10,960	9,054	13,083	12,475	12,512	10,901	10,882	7,711	18,096	13,227
NFA (in millions of U.S. dollars)	85.9	69.7	27.7	100.6	73.6	106.4	100.5	101.7	88.1	88.5	62.7	147.1	107.5
Gross foreign assets	200.1	177.8	125.2	201.2	163.9	211.6	207.5	199.4	179.5	190.7	157.2	248.7	199.8
Foreign liabilities	-114.2	-108.1	-97.5	-100.5	-90.3	-105.2	-106.9	-97.7	-91.4	-102.3	-94.5	-101.6	-92.3
Monetary authorities	3,369	2,919	158	3,685	4,060	8,507	9,142	7,223	6,915	5,162	3,935	10,101	7,606
NFA of the monetary authorities (in millions of U.S. dollars)	30.9	26.8	1.4	33.8	33.0	69.2	73.7	58.7	55.9	42.0	32.0	82.1	61.8
Gross foreign assets	123.7	119.3	90.4	114.1	112.4	163.8	159.4	142.2	130.4	128.5	109.6	166.5	137.2
Foreign liabilities	-92.8	-92.5	-88.9	-80.2	-79.4	-94.6	-85.8	-83.5	-74.5	-86.6	-77.6	-84.4	-75.4
Commercial banks	5,989	4,674	2,934	7,275	4,994	4,576	3,333	5,289	3,986	5,720	3,776	7,995	5,621
NFA of the commercial banks (in millions of U.S. dollars)	55.0	42.9	26.3	66.8	40.6	37.2	26.9	43.0	32.2	46.5	30.7	65.0	45.7
Gross foreign assets	76.5	58.5	34.8	87.1	51.5	47.8	48.0	57.2	49.1	62.2	47.6	82.2	62.6
Foreign liabilities	-21.5	-15.6	-8.5	-20.3	-10.9	-10.6	-21.2	-14.2	-16.9	-15.7	-16.9	-17.2	-16.9
Net domestic assets	34,094	38,073	41,460	39,038	41,571	39,264	38,607	40,498	41,446	39,807	42,620	42,594	46,513
Credit to government (net)	23,232	22,322	29,229	28,999	30,077	30,104	21,083	30,288	23,354	28,489	25,447	29,496	25,542
Credit to statutory bodies (net)	-606	-483	-664	-842	-772	-879	-1,088	-694	-1,150	-917	-1,200	-724	-1,252
Credit to private sector	11,942	13,926	13,227	13,428	16,497	15,325	18,201	16,356	17,457	15,716	17,903	16,142	20,121
Other items (net)	-474	2,307	-332	-2,547	-4,231	-5,287	411	-5,453	1,786	-3,482	470	-2,320	2,102
RBM's revaluation accounts	59	-2	0	0	0	0	0	0	0	0	0	0	0
Open market operations	-5,639	-5,372	-7,510	-6,293	-10,174	-12,304	-6,461	-12,846	-6,229	-11,220	-5,614	-10,499	-4,969
Encumbered reserves	1,013	1,013	1,037	1,013	799	800	807	800	3,466	800	492	800	492
Others	4,092	6,668	6,141	2,733	5,144	6,218	6,065	6,594	4,548	6,939	5,592	7,379	6,579
Memorandum items:													
Seasonally adjusted broad money	42,119	45,621	48,282	47,763	48,211	50,749	49,475	52,950	52,295	55,245	54,546	57,641	56,892
Quarterly change	3.6	8.3	5.8	3.5	-0.1	4.3	2.6	4.3	5.7	4.3	4.3	4.3	4.3
Annual change	28.3	29.4	24.4	17.0	18.6	20.5	17.5	16.1	14.6	13.8	13.0	18.5	18.0
Seasonally adjusted credit to private sector	12,154	13,527	13,780	13,457	16,821	15,594	18,603	15,906	16,956	16,224	18,652	16,548	20,516
Quarterly change	13.8	11.3	1.9	12.9	22.1	2.0	10.6	2.0	-8.9	2.0	10.0	2.0	10.0
Annual change	35.0	42.2	39.4	28.9	57.5	28.3	53.1	17.4	25.4	18.8	35.4	8.2	22.0
Velocity of money (annual GDP divided by seasonally adjusted end-period broad money)	4.71	4.54	4.49	4.58	4.69	4.57	4.77	4.55	4.69	4.57	4.73	4.58	4.76

Sources: Reserve Bank of Malawi; and IMF staff estimates and projections.

Table 4a. Malawi: Balance of Payments, 2001-08 1/
(In millions of U.S. dollars, unless otherwise indicated)

	2001	2002	2003	2004	2005		2006	2007	2008
	Act.	Prel.	Prel.	Prel.	Prog.	Proj.	Proj.	Proj.	Proj.
Current account balance (including grants)	-116.8	-216.2	-134.2	-177.5	-118.7	-158.7	-98.6	-137.7	-144.3
Trade balance	-158.0	-305.7	-351.0	-423.8	-447.3	-501.3	-429.2	-454.5	-473.6
Exports	426.6	421.1	440.6	470.0	536.4	514.3	557.6	576.7	600.8
Imports	-584.5	-726.8	-791.6	-893.8	-983.7	-1,015.6	-986.8	-1,031.2	-1,074.5
Services balance	-66.3	-154.0	-88.2	-84.7	-81.8	-84.9	-90.4	-93.3	-95.9
Interest public sector (net)	-17.8	-20.2	-25.5	-27.7	-23.8	-26.8	-24.8	-22.5	-20.5
Receipts	8.7	2.5	1.5	0.7	0.6	0.4	3.7	5.0	6.4
Payments (amounts due before HIPC debt relief)	-26.5	-22.7	-27.0	-28.4	-24.4	-27.2	-28.5	-27.5	-26.9
Other factor payments (net)	-15.3	-24.5	-16.1	-16.9	-17.1	-17.2	-18.6	-19.7	-20.8
Nonfactor (net)	-33.2	-109.3	-46.6	-40.1	-40.9	-40.9	-47.0	-51.1	-54.6
Unrequited transfers (net)	107.5	243.4	305.1	331.0	410.4	427.5	420.9	410.1	425.2
Private (net)	9.7	8.1	141.1	117.6	131.4	151.3	130.7	132.0	142.2
Receipts	21.6	21.6	156.4	127.8	141.7	161.6	141.2	142.8	153.2
Payments	-11.8	-13.4	-15.3	-10.2	-10.4	-10.4	-10.6	-10.8	-11.0
Official (net)	97.7	235.3	164.0	213.4	279.0	276.2	290.2	278.1	283.1
Receipts	98.3	235.3	164.0	213.4	279.0	276.2	290.2	278.1	283.1
Balance of payments assistance	51.0	12.8	41.7	64.3	89.9	97.2	81.8	61.6	67.8
Japan HIPC Initiative 2/	0.0	11.0	16.8	0.0	0.0	0.0	0.0	0.0	0.0
Donor humanitarian grants	0.0	135.4	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Project related	47.3	76.1	87.5	149.1	175.6	164.9	208.5	216.5	215.3
Drought related	0.0	0.0	0.0	0.0	13.6	14.1	0.0	0.0	0.0
Food Security	0.0	0.0	18.0	0.0	0.0	0.0	0.0	0.0	0.0
Payments	-0.6	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Capital account balance (incl. errors and omissions)	85.3	59.7	93.9	152.2	98.5	143.9	75.0	85.5	105.1
Medium- and long-term flows	59.8	23.8	10.9	16.2	56.8	24.2	52.9	23.0	34.4
Disbursements	127.0	81.0	96.7	95.3	122.7	97.5	136.9	103.9	112.7
Balance of payments support	55.0	0.0	18.4	35.2	43.3	18.1	56.5	31.5	35.3
Project support	72.0	81.0	78.3	50.1	79.4	79.4	80.4	72.4	77.4
Other medium-term loans				10.0	0.0	0.0	0.0	0.0	0.0
Other investment assets	0.0	0.0	-17.2	-4.3	0.0	0.0	0.0	0.0	0.0
Amortization (amounts due before HIPC debt relief	-67.2	-57.2	-68.6	-74.8	-65.9	-73.4	-84.0	-80.8	-78.3
Foreign direct investment and other inflows	28.0	37.6	43.2	44.1	26.5	26.5	29.8	32.3	33.9
Short-term capital and errors and omissions	-2.5	-1.7	39.8	91.9	15.2	93.3	-7.6	30.2	36.8
Overall balance	-31.6	-156.5	-40.2	-25.3	-20.2	-14.8	-23.6	-52.2	-39.2
Financing (- increase in reserves)	31.5	156.5	40.2	25.3	20.2	14.9	23.6	39.8	18.1
Central bank	11.8	111.4	-0.6	-15.7	-29.1	-47.3	-30.8	-5.9	-33.3
Gross reserves (- increase)	40.7	40.8	41.4	-6.0	-20.1	-29.3	-28.8	-3.0	-32.3
Liabilities	-28.9	70.6	-42.0	-9.7	-9.1	-18.0	-1.9	-2.9	-0.9
Of which: IMF (net)	-6.0	16.8	-0.1	-13.7	-10.5	-10.9	-2.1	-3.0	-0.9
Purchases/drawings	0.0	23.0	9.3	0.0	8.3	8.0	25.3	17.5	7.3
Repurchases/repayments	-6.0	-6.2	-9.3	-13.7	-18.8	-18.9	-27.3	-20.5	-8.2
Bridge loan	0.0	50.0	-50.0	0.0	0.0	0.0	0.0	0.0	0.0
Commercial banks	-7.7	14.5	-6.7	-6.0	-0.1	10.7	-1.5	-11.0	-4.0
Debt relief	27.4	30.6	47.5	47.0	49.5	51.5	55.9	56.7	55.3
Residual financing gap (+ underfinanced)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	12.4	21.2
Memorandum items:									
Gross official reserves									
In millions of U.S. dollars	203.2	162.3	122.9	128.9	149.0	158.7	187.6	190.5	222.9
In months of imports 3/	3.0	2.2	1.5	1.4	1.7	1.8	2.0	1.9	2.1
In months of imports 4/	3.6	2.4	1.7	1.6	1.7	1.7	2.1	2.0	2.3
Usable gross official reserves 5/									
In millions of U.S. dollars	184.6	103.4	115.6	119.3	142.2	130.4	183.2	186.2	218.6
In months of imports 3/	2.8	1.4	1.4	1.3	1.6	1.5	2.0	1.9	2.1
In months of imports 4/	3.3	1.5	1.6	1.5	1.6	1.4	2.0	2.0	2.2
Current account balance (percent of GDP)									
Excluding official transfers	-12.5	-23.3	-16.9	-20.5	-20.0	-21.0	-18.1	-18.2	-17.2
Including official transfers	-6.8	-11.2	-7.6	-9.3	-6.0	-7.7	-4.6	-6.0	-5.8
Export value growth (in percent)	6.2	-1.3	4.6	6.7	14.0	9.4	8.4	3.4	4.2
Import value growth, excluding maize (in percent)	6.2	1.1	34.2	10.7	15.9	15.9	-2.8	4.5	4.2

Sources: Malawian authorities; and IMF staff estimates and projections.

1/ The implications of MRDI have not been incorporated.
2/ For 2002-03, relief was provided through grants in Yen. From 2004 onward, debt will be written off and recorded under debt relief.
3/ In months of following year's imports of goods and nonfactor services.
4/ In months of current year's imports of goods and nonfactor services.
5/ Excludes open letter of credit, blocked deposits, and reserves pledged.

Table 4b. Malawi: Gross Financing Requirements and Sources of Financing, 2004-08 1/
(In millions of U.S. dollars, unless otherwise indicated)

	2004 Prel.	2005 Proj.	2006 Proj.	2007 Proj.	2008 Proj.
Gross financing requirements	**-487.4**	**-552.9**	**-530.5**	**-531.1**	**-550.3**
External current account deficit (excl. official transfers)	-390.9	-434.9	-388.9	-415.8	-427.4
of which Trade balance on goods and services	-463.9	-542.2	-476.2	-505.6	-528.2
Official debt amortization	-88.5	-92.3	-111.3	-101.4	-86.6
of which IMF repurchases and repayments	-13.7	-18.9	-27.3	-20.5	-8.2
Other , including reserves	-8.0	-25.7	-30.2	-13.9	-36.4
Gross reserves	-6.0	-29.3	-28.8	-3.0	-32.3
Gross liabilities (excluding IMF)	4.0	-7.1	0.1	0.1	0.0
Change in n.f.a. of commercial banks	-6.0	10.7	-1.5	-11.0	-4.0
Sources of financing	**487.4**	**553.0**	**530.5**	**518.7**	**529.1**
Private capital (net)	131.7	119.8	22.2	62.5	70.7
of which Short term errors and ommissions	91.9	93.3	-7.6	30.2	36.8
Gross official Assistance	308.7	381.7	452.4	399.5	403.1
Official Grants	213.4	276.2	290.2	278.1	283.1
Balance of payments support	64.3	97.2	81.8	61.6	67.8
Other	149.1	179.0	208.5	216.5	215.3
Loan Disbursements	95.3	105.5	162.2	121.4	120.0
IMF	0.0	8.0	25.3	17.5	7.3
Balance of payments support	35.2	18.1	56.5	31.5	35.3
Project support	50.1	79.4	80.4	72.4	77.4
Other medium-term loans	10.0	0.0	0.0	0.0	0.0
Accumulation of arrears (exceptional)	0.0	0.0	0.0	0.0	0.0
Debt relief	47.0	51.5	55.9	56.7	55.3
Financing gap (surplus +/deficit -)	**0.0**	**0.0**	**0.0**	**-12.4**	**-21.2**
Memorandum items (in percent of GDP)					
Gross financing requirements	-25.6	-26.6	-24.6	-23.2	-22.2
Current account balance, excluding official transfers	-20.5	-20.9	-18.0	-18.1	-17.2
Trade balance on goods and services	-24.4	-26.1	-22.1	-22.1	-21.3
Gross official assistance	16.2	18.4	21.0	17.4	16.2
Gross official assistance, net of amortization after debt relief	14.0	16.4	18.4	15.5	15.0
Balance of payments assistance (including IMF)	5.2	5.9	7.6	4.8	4.4
Financing gap	0.0	0.0	0.0	-0.5	-0.9

Sources: Malawian authorities; and IMF staff estimates and projections.

Table 5a. Malawi: Quantitative Targets for FY2004/05 1/

	Jun-04	Cumulative Flows from June 30, 2004			
		Jun-05			
	Stock Actual	Target	Adjusted Target	Actual	Variance
		(In millions of Malawi kwacha)			
1. Ceiling on net domestic assets of the monetary authorities 2/	18,731	-3,743	-1,029	-3,211	-2,182
2. Ceiling on central government's net domestic borrowing 2/	47,104	4,194	7,115	6,818	-296
3. Ceiling on central government wages and salaries 3/	...	15,300	15,394	17,056	1,661
4. Ceiling on central government discretionary expenditures 3/	...	34,820	35,804	38,296	2,493
		(In millions of U. S. dollars)			
5. Floor on net foreign assets of the monetary authorities 2/	-0.1	33.9	9.0	33.1	24.1
6. Ceiling on the accumulation of external payments arrears 4/	...	0.0	...	0.0	0.0
7. Ceiling on the contracting or guaranteeing of nonconcessional external debt with original maturities of over one year by the central government, the RBM or other agencies on behalf of the central government. 4/ 5/	...	10.0	...	10.0	0.0
8. Ceiling on the contracting or guaranteeing of nonconcessional external debt with original maturities of one year, or less, by the central government, the RBM or other agencies on behalf of the central government. 4/	...	0.0	...	0.0	0.0
Memorandum item:					
Baseline for balance of payments support	...	114.3		89.4	-24.9

1/ Targets are defined in the technical memorandum of understanding (TMU).
2/ Targets are subject to an adjuster for balance of payment support.
3/ Targets are subject to an adjuster for donor-funded health expenditures.
4/ Evaluated on a continuous basis.
5/ Loan contracted following an agreement by the previous government to purchase communication equipment for the Ministry of Defense.

Table 5b. Malawi: Quantitative Targets for FY2005/06 1/

	Criteria	Jun-05 Stock Actual	End-Sep. 2005 Target	End-Sep. 2005 Adjusted Target	End-Sep. 2005 Actual	End-Dec. 2005 Target	End-Dec. 2005 Est. Adj. Target	End-Dec. 2005 Est.
				(Cumulative flows from June 30, 2005)				
I. Monetary Targets (In millions of Malawi kwacha)								
1. Ceiling on net domestic assets of the monetary authorities 2/	PC	15,520	-3,133	-3,133	-4,466	-1,839	231	-1,781
2. Ceiling on reserve money	IT	19,580	1,314	1,314	534	1,324	1,324	1,029
II. Fiscal Targets (In millions of Malawi kwacha)								
3. Ceiling on central government's net domestic borrowing 2/ 3/ 4/	PC	53,923	-783	-948	-1,644	-599	1,220	-70
4. Ceiling on central government wages and salaries 3/	PC	...	4,848	4,809	4,806	9,934	9,714	9,706
5. Ceiling on central government discretionary expenditures 3/	IT	...	15,123	15,525	11,379	29,424	28,780	30,784
III. External Targets (In millions of U.S. dollars)								
6. Floor on net foreign assets of the monetary authorities 2/	PC	33.0	36.1	36.1	40.7	25.7	8.9	22.9
7. Ceiling on the accumulation of external payments arrears 5/	PC	...	0.0	0.0	0.0	0.0	0.0	0.0
8. Ceiling on new nonconcessional external debt with a maturity of one year or more 5/	PC	...	0.0	0.0	0.0	0.0	0.0	0.0
9. Ceiling on new nonconcessional external debt with a maturity of less than one year 5/	PC	...	0.0	0.0	0.0	0.0	0.0	0.0
Memorandum items (In millions of Malawi kwacha):								
Balance of payments support (In millions of U.S. dollars)			60.2	...	35.7	105.2	...	88.4
Health SWAp wage expenditures			177	...	138	358	...	138
Health SWAp ORT expenditures			1,016	...	1,419	2,062	...	1,419
Net movement in Health SWAp account			-439	...	-72	174	...	540
Net movement in NAC account			0	...	-407	0	...	-368
Maize revenue			170	...	375	504	...	766
Cash payment of arrears			500	...	604	1,000	...	1,104

PC - performance criteria; IT - indicative target
1/ Targets are defined in the technical memorandum of understanding (TMU).
2/ Targets are subject to an adjuster for BOP support.
3/ Targets are subject to an adjuster for donor-funded health expenditures.
4/ Targets are subject to adjusters for maize revenue and cash payment of arrears.
5/ Evaluated on a continuous basis.

Table 5c. Malawi: Structural Performance Criteria and Benchmarks (EBS/05/113), July 2005-March 2006

Number	Description	Date
Performance Criteria		
First Review		
1	Cabinet approval of arrears policy. Begin implementation (TMU, para. 30).	Completed
2	Compile new database of all public employees on the basis of DHRMD data forms (TMU, para. 31).	Completed
Second Review		
3	Make budget ceilings module in payment system fully operational (TMU, para. 32).	End-Dec. 2005
4	Develop and implement new travel policy, which includes mechanisms for monitoring adherence (TMU, para. 33).	End-Mar. 2006
Structural Benchmarks		
1	Develop detailed schedule of wage adjustments by grade for 2005/06.	Delayed
2	Publish monthly fiscal reports with one month lag (TMU, para. 34).	End-Dec. 2005
3	Prepare quarterly reports (with one month lag) on status of arrears.	End-Dec. 2005
4	Strengthen cash management and expenditure monitoring procedures by preparing reports as indicated in the TMU (para. 35).	End-Mar. 2006
5	Complete impact analysis of tighter credit quality classifications on commercial bank balance sheets (TMU, para. 36).	End-Mar. 2006

Table 6a: Malawi: Schedule of Disbursements Under the Three-Year PRGF Arrangement
(In million of SDRs)

Amount	Date	Conditions Necessary for Disbursement
5.4190	Aug-05	Executive Board approval of three-year PRGF arrangement
4.9245	Feb-06	Completion of 1st review and observance of end-Sep. 2005 PCs
4.9245	May-06	Completion of 2nd review and observance of end-Dec. 2005 PCs
6.6800	Nov-06	Completion of 3rd review and observance of end-Jun. 2006 PCs
6.6800	May-07	Completion of 4th review and observance of end-Dec. 2006 PCs
4.7710	Nov-07	Completion of 5th review and observance of end-Jun. 2007 PCs
4.7710	May-08	Completion of 6th review and observance of end-Dec 2008 PCs
38.1700 1/		

1/ Equivalent to 55 percent of Malawi's quota (SDR 69.4 million).

Table 6b: Malawi: Indicators of Fund Credit, 2004–18
(In millions of SDRs, unless otherwise indicated)

	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
Fund credit outstanding 1/															
In millions of SDRs	59.5	52.6	51.3	49.3	48.7	44.6	42.0	38.7	32.3	23.9	16.3	8.6	3.1	0.5	0.0
In millions of U.S. dollars	90.0	80.0	78.0	75.0	74.1	67.8	63.8	58.7	49.1	36.3	24.7	13.1	4.6	0.7	0.0
In percent of quota	85.8	75.8	73.9	71.1	70.2	64.3	60.6	55.7	46.6	34.4	23.4	12.4	4.4	0.7	0.0
Existing stock															
In millions of SDRs	59.5	52.6	34.7	21.3	16.0	11.9	9.3	6.9	4.5	2.2	1.1	0.0	0.0	0.0	0.0
In millions of U.S. dollars	90.0	80.0	52.9	32.5	24.3	18.0	14.1	10.5	6.9	3.3	1.6	0.0	0.0	0.0	0.0
In percent of quota	85.8	75.8	50.1	30.7	23.0	17.1	13.4	10.0	6.5	3.1	1.6	0.0	0.0	0.0	0.0
Proposed disbursement															
In millions of SDRs	0.0	0.0	16.5	11.5	4.8	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
In millions of U.S. dollars	0.0	0.0	25.2	17.4	7.3	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
In percent of quota	0.0	0.0	23.8	16.5	6.9	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Fund obligations	9.9	13.2	18.8	14.0	5.8	4.5	3.0	3.8	6.7	8.8	7.9	7.9	5.8	2.8	0.7
Fund total charges and interest 2/	0.7	0.8	1.0	0.6	0.5	0.4	0.4	0.4	0.4	0.3	0.3	0.3	0.2	0.2	0.2
Existing drawings	0.7	0.8	0.9	0.5	0.3	0.3	0.3	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2
Prospective drawings	0.0	0.0	0.0	0.1	0.2	0.2	0.2	0.2	0.2	0.1	0.1	0.1	0.0	0.0	0.0
Fund total repayment/repurchase /3	9.2	12.4	17.9	13.4	5.4	4.1	2.6	3.4	6.3	8.4	7.6	7.6	5.6	2.6	0.5
Existing drawings	9.2	12.4	17.9	13.4	5.4	4.1	2.6	2.4	2.4	2.4	1.1	1.1	0.0	0.0	0.0
Prospective drawings	0.0	0.0	0.0	0.0	0.0	0.0	0.0	1.0	4.0	6.1	6.6	6.6	5.6	2.6	0.5
Net Fund credit	-9.2	-12.4	-1.3	-2.0	-0.6	-4.1	-2.6	-3.4	-6.3	-8.4	-7.6	-7.6	-5.6	-2.6	-0.5
Net use of Fund resources, excluding HIPC assistance	-9.9	-13.2	-2.3	-2.6	-1.0	-4.5	-3.0	-3.8	-6.7	-8.8	-7.9	-7.9	-5.8	-2.8	-0.7
Fund HIPC assistance	0.0	1.4	2.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Net use of Fund resources, after HIPC assistance	-9.9	-11.8	-0.2	-2.6	-1.0	-4.5	-3.0	-3.8	-6.7	-8.8	-7.9	-7.9	-5.8	-2.8	-0.7
Fund credit outstanding in percent of															
Exports of good and nonfactor services	17.6	14.4	13.0	12.1	11.5	10.0	8.9	7.8	6.1	4.2	2.7	1.4	0.5	0.1	0.0
Gross official reserves	75.4	62.6	39.2	37.1	31.5	28.8	26.4	23.7	18.7	13.0	8.4	4.2	1.4	0.2	0.0
Fund obligations in percent of															
Exports of good and nonfactor services	2.9	3.6	4.8	3.4	1.4	1.0	0.6	0.8	1.3	1.6	1.3	1.2	0.9	0.4	0.1
Gross official reserves	12.6	15.7	14.4	10.5	3.8	2.9	1.9	2.3	3.9	4.8	4.1	3.8	2.7	1.2	0.3
Memorandum items:															
Quota (in millions of SDR)	69.4	69.4	69.4	69.4	69.4	69.4	69.4	69.4	69.4	69.4	69.4	69.4	69.4	69.4	69.4
Export of goods and nonfactor services (in millions of U.S. dollars)	511	556	600	620	646	679	715	754	811	858	907	959	1016	1076	1140
Gross official reserves (in millions of U.S. dollars)	119	128	199	202	235	235	242	248	263	279	295	313	332	352	373

Sources: Malawi authorities; and Fund staff estimates and projections

1/ Includes the prospective disbursement under the Poverty Reduction and Growth Facility arrangement for a total of SDR 38.2m (55 percent of quota) and the repurchase of of the outstanding General Resources Account drawings under the emergency post-conflict assistance.
2/ Before the subsidization of charges.
3/ Excludes HIPC assistance.

January 20, 2006

Mr. Rodrigo de Rato y Figaredo
Managing Director
International Monetary Fund
Washington, DC 20431

Dear Mr. de Rato:

1. The IMF Executive Board approved a new PRGF arrangement on August 5, 2005. The Government of Malawi believes that implementation of the PRGF-supported program has been satisfactory: we have met all the quantitative and structural performance targets for end-September under the program. Including the 12 months under the staff monitored program, we have now maintained satisfactory program implementation for 15 months. We believe that this points to a major break from previous episodes of economic mismanagement.

2. We are committed to the successful implementation of the economic program. Recent developments, including the need for additional spending to address the current state of national disaster and the continued overvaluation of the kwacha, are exerting pressures on a number of key variables. However, we are implementing measures to ensure that the program remains on track for the rest of the fiscal year.

3. The attached memorandum of economic and financial policies (MEFP) supplements the memorandum presented to the Executive Board last August. It updates the macroeconomic framework and policy measures for the rest of the fiscal year. We believe that the policies set forth in the attached supplementary MEFP are adequate to achieve the objectives of its program, but are prepared to implement additional steps that may become appropriate for this purpose. We will consult with the IMF on the adoption of these measures, and in advance of revisions to the policies contained in the supplementary MEFP, in accordance with the IMF's policies on such consultation.

4. On the basis of performance under the PRGF-supported program and measures to be implemented during the rest of the fiscal year, we request the completion of the first review under the new PRGF arrangement and the disbursement of SDR4.9245 million.

5. The government of Malawi authorizes the IMF to make this letter, the attached supplementary MEFP, and the IMF staff report available to the public, including through the IMF internet website.

Sincerely yours,

/s/	/s/
Goodall Gondwe	Victor Mbewe
Minister of Finance	Governor
	Reserve Bank of Malawi

Attachments

MALAWI

Supplement to the Memorandum of Economic and Financial Policies of the Government of Malawi

January 20, 2006

I. Introduction

1. **Policies presented in our Memorandum of Economic and Financial Policies (MEFP) of July 2005 (Country Report 05/285) are supplemented by the current memorandum.** The Government of Malawi remains committed to restoring sound governance and implementing prudent economic policies. We further welcome the IMF's recognition of Malawi's satisfactory performance under the Staff Monitored Program and the approval of a new PRGF arrangement in August 2005. Our macroeconomic performance has remained satisfactory and we met all the quantitative performance criteria targets for end-September, 2005, including the target on wages; as well as the indicative targets on discretionary expenditures and reserve money (Table 1). Regarding the two structural performance criteria (Table 2), the cabinet approved the arrears policy and it is being implemented; and the database of all government employees was compiled. The structural benchmark on the wage schedule is not expected to be completed until early 2006.

2. **Reducing poverty through private sector led growth remains our overarching objective over the medium term.** The achievement of this objective will require the maintenance of macroeconomic stability and implementation of key structural reforms. **Malawi is now facing a food security crisis and the President has declared a state of national disaster.** The humanitarian needs and budget costs are much larger than envisaged, but are mostly offset by higher donor support. Accommodating these food security needs, without jeopardizing macroeconomic stability, is now the principal challenge facing Malawi over the short term.

3. **The evolution of economic activity is broadly as anticipated.** Real GDP growth is expected to fall below 2 percent in 2005 and, assuming a harvest at least as good as in 2004, is expected to rebound above 8 percent in 2006. Overall inflation is also as anticipated, though the seasonal acceleration in food prices because of the drought is weaker than expected and non-food price inflation has been stronger in part due to higher retail fuel prices. These factors are likely to keep inflation from falling over the next few months, but we still expect inflation to fall significantly in 2006 as food prices recover from the drought. The exchange rate depreciated 13 percent in the first half of 2005, but has remained largely unchanged since July. However, pressures have persisted in the foreign exchange market, and official external reserves have declined substantially in recent months.

4. **Our macroeconomic medium-term strategy remains guided by the principles laid out in our MEFP of July 2005.** Steadfast application of these principles will help us make progress towards the Millennium Development Goals (MDGs). The way forward is now set out in our new Malawi Growth and Development Strategy (MGDS) that updates the Malawi Poverty Reduction Strategy (MPRS) of 2002. The MGDS has been prepared with extensive consultation among government, the private sector, and civil society, and draws on lessons learned from a comprehensive review of implementation of the MPRS. The MGDS will support the policies that we have committed to implement in the PRGF-supported program. As outlined in July, reducing the government's domestic debt burden to less than 15 percent of GDP over the medium-term remains the cornerstone of our economic strategy.

II. The Program for FY 2005/06

5. **The key macroeconomic objectives set out in the program for this fiscal year remain viable**. We expect real GDP growth of about 5 percent and end-June inflation below 11 percent. However, higher food security needs and external debt service obligations, as well as excess demand for foreign exchange have put pressure on a number of key variables. The requirement to meet the higher food security needs implies that the indicative target on expenditures will need to be increased by about 0.9 percent of GDP. Even so, the targeted decline in the domestic debt to GDP ratio envisaged in the program is expected to be realized. Weaker tobacco export receipts, a higher oil import bill and other imports have also contributed to pressures in the foreign exchange market. As a result, the target on net foreign assets at the RBM for the fiscal year is unlikely to be met and official gross reserves are, by end-June 2006, expected to reach 1.5 months of the next year's projected imports (1.8 months in the program). The government is of the view that, to contain the loss in international reserves, it is important to have a more flexible exchange rate policy, while ensuring some stability in the foreign exchange market.

A. Fiscal Policy

6. **Fiscal performance in the first quarter was better than programmed.** This was mainly because of delays in purchasing maize and disbursing fertilizer subsidies that helped compensate for delays in donor support. Tax and non-tax revenues also performed better than expected. On the other hand, the higher U.S. dollar value of the kwacha and the stronger value of the dollar against other donor currencies relative to program have reduced the kwacha value of donor program inflows.

7. **For the fiscal year as a whole, we expect domestic borrowing to be in line with the original program target.** Two developments have negatively affected the budget. First, the value of the kwacha has remained more appreciated than expected, reducing the value of donor inflows. Second, external debt service obligations have been revised upwards by MK0.8 billion, as a result of improvements in our database. In addition to these factors, domestic interest costs will be higher by MK0.5 billion because of front loading of borrowing needs. To help mitigate these factors, we will now limit the wage bill in FY05/06

to MK19.5 billion by adopting a smaller wage increase than envisaged in the program. Additional maize and fertilizer expenditures (approximately MK3.8 billion) are fully financed by additional donor support (Box 1). Tax revenues are expected to be MK1.4 billion higher, reflecting the strong performance in the first quarter as well as the upward revision to nominal GDP.

8. **We have now completed the sale of Malawi Telecommunications Ltd. (MTL) for approximately US$31 million.** This was not anticipated in the budget. US$20 million are expected to cover the transaction and retrenchment costs, as well as the repayment of debt accumulated by MTL. We will ensure that the transaction is transparently accounted for, including reporting to Parliament as required by the Privatization Act. The government intends to construct a new Parliament building. However, construction of the building is not likely to begin until the next fiscal year and continue in the subsequent year. Thus, privatization proceeds will help contain domestic borrowing in FY05/06.

9. **We compiled a database of all government employees, but the benchmark on the wage schedule is not expected to be completed until January 2006.** These were essential to implement the wage adjustments in accordance with the criteria laid out in our medium term civil service pay policy strategy. The wage adjustment was therefore also postponed until February 2006, albeit with retroactive effect from October 1, 2005.

10. **The circular for the new pension formula**, whose adoption was a prior action for the PRGF arrangement, was implemented in July and then suspended in September, in the wake of a civil service strike and the need to better explain the change to civil service unions. Following consultations with unions, we reinstated and implemented the circular in October. The suspension of the circular did not lead to additional fiscal costs as pension applications processed during that period were based on the pre-October 2004 wage reform.

11. **We are pressing ahead with a second stage of pension reforms.** We have received technical assistance from the IMF in this area and will give due consideration to the recommendations. In particular, we acknowledge the need to strengthen the current defined benefits system as a prelude for launching further reforms. We recognize that the 5-year averaging rule adopted by the new pension formula provides only temporary relief and is not an adequate solution to the increasing pensions liability resulting from the October 2004 wage reforms. We will explore ways to curtail this windfall and put our pension system on a sustainable basis as part of the next budget. We also need to consolidate the various regulations covering the existing pension system into a single statute. The second stage of reforms could also include the introduction of a contributory pension scheme. Further work is needed to clarify the objectives of the new scheme with stakeholders and how it might be structured to meet these objectives. In preparation, we will compile an comprehensive database on which to base pension projections and welcome technical assistance from the IMF in this area. Moving ahead will be contingent on completing this preparatory work.

12. **The establishment of the Malawi Rural Development Fund (MARDEF) has not proceeded as quickly as originally envisaged** because of the need to ensure adequate

oversight. As envisaged, MK1 billion government deposits has been transferred from the RBM to Malawi Savings Bank (MSB) and has been invested by MSB in T-bills to limit the monetary impact. Contrary to our original plans in July, we will no longer pay premiums to insure against default risk. The interest rate charged has been set at 15 percent, which is currently below the market lending rate. However, we are committed to a scheme that is self-financing and will review it on a quarterly basis to ensure that it does not impose a burden on the budget.

13. **The pass-through of higher international oil product prices to local petroleum product prices has been substantial in the last three years, but not systematic.** Retail fuel prices this year were increased between 11 and 37 percent to compensate for the higher international oil price and the depreciation of the kwacha. We will continue to adjust pump prices to ensure full pass-through of import prices. We will complete our review of the automatic pricing mechanism with a view to reinstating this and reducing the discretionary elements in the price adjustments.

Supporting structural measures and capacity building

14. **Following our commitments in July, we will seek cost savings in government operations.** We have closed four of our total of 17 foreign missions. We are strengthening controls on public procurement through the implementation of the Procurement Act, the Public Audit Act and the Public Finance Management Act. We have contracted a consulting firm to prepare a new travel policy by end-March 2006 (a performance criterion) that emphasizes accountability and transparency as well as seeking to contain spending. We have started work on producing an inventory of government vehicles and have restricted new purchases, and also plan to have a new policy in the next fiscal year that aims to rationalize their allocation, use and maintenance. We have also introduced administrative measures to prevent ministries from incurring arrears on utility expenses, and will, for the next budget, revise our housing policy with a view to eliminate existing over-compensation and reduce inequities.

15. **As envisaged, Cabinet approved a policy paper to address the large stock of domestic arrears and the policy is now implemented.** We continue to target a MK2 billion reduction of domestic arrears and expect to meet the end-December structural benchmark on the preparation of quarterly reports on the status of arrears.

16. **To make Malawi more competitive, we have implemented the main recommendations of the general review of our tax policies and tax administration**. We have raised the zero-rates tax threshold and adjusted the personal income tax brackets in order to reduce the tax burden on very low paid workers and have reduced the top tax rate in order to attract key professionals to Malawi. We have improved the VAT and the corporate tax system and have increased fees in line with inflation. The Malawi Revenue Authority (MRA) is implementing administrative reforms following the tax review. We will also change the bonus system for MRA to take into account the number of tax payers as well as overall tax revenue.

17. **We have made good progress on improving public expenditure management.** We have adopted the Tanzanian IFMIS and have moved beyond the pilot stage to implement it throughout central government, though it is not yet fully automated. As part of these efforts, we are implementing a fully centralized payments system. We will closely monitor the use of IFMIS over the next few months and look forward to technical assistance from the IMF to help set up a Government Finance Statistics module (GFS codes) as part of general review. Implementation of the budget ceilings module for the existing CCA payment system was slightly delayed, and is now expected to be operational in early 2006, relative to the program implementation date of end-December 2005. Making better use of the RBM ceiling module is a priority and will help us better track reimbursements against pre-approved funding. To make this operational, we have reconciled all bank accounts between the RBM and commercial banks and have entered check numbers for all outstanding checks issued against the 2004/05 budget. We are also working to complete the reconciliation of all commercial bank accounts with line ministries.

B. Monetary and Exchange Rate Policy

18. **The objective of monetary policy continues to be price stability**, implemented mainly through the purchase and sale of domestic assets and foreign exchange. The current framework of anchoring monetary policy on a reserve money target has served Malawi well. We recognize that this framework requires the continued flexibility of interest and foreign exchange rates, which is necessary to meet the foreign reserve and reserve money targets.

19. **Consequently, we will adopt a more flexible exchange rate policy while recognizing the need to avoid excessive volatility in the foreign exchange market.** Some intervention in the market will be necessary to smooth pressures related to the tobacco season and inflows of donor assistance. We will refrain from using administrative restrictions on the foreign exchange market over the program period, and are committed to avoid any restrictions on the making of payments and transfers related to current international transactions. We are aware that there is a backlog of import invoices and will monitor its evolution on a weekly basis. The government is committed to reducing the backlog of import invoices by end-March and its elimination by end-June 2006 and to ensuring that the demand in the foreign exchange market can be met.

20. **Real interest rates in Malawi remain very high. Interest rate spreads are also significant and reflect high reserve requirements and intermediation costs related to credit risks.** We recognize that lowering interest rates can only be justified by a sustained decline in inflation and credible monetary and exchange rate policies. In light of the risk of a further exchange rate depreciation on inflation expectations, we recognize the importance of maintaining a tight monetary stance and therefore remain ready to change the bank rate in order to meet the agreed monetary targets. We recognize the need to reduce the costs of financial intermediation by strengthening creditor rights, improving competition in this sector, reducing reserve requirements and other impediments. Policies in these areas will be implemented over the medium-term.

Supporting structural measures and capacity building

21. **We are committed to improving banking supervision operations** as a step toward enhancing financial intermediation. With the help of technical assistance from the IMF, we plan to complete an initial analysis of commercial bank balance sheets using asset classification consistent with international practice (a structural benchmark for end-March 2006). This should alert us to potentially problematic institutions. In addition, we have reviewed the operations of foreign exchange bureaus, and have implemented more appropriate minimum capital requirements of US$50,000 in line with IMF recommendations. We will also introduce a fit and proper test for licensing and impose other requirements of reporting and compliance with tax law.

22. **We will aim to reduce our dependence on direct instruments for monetary policy.** A precondition for this is a well functioning money market, where monetary policy can be implemented using market-based instruments. Towards this goal, we will strengthen coordination between the Ministry of Finance and the RBM to improve liquidity forecasting. This will allow the RBM to announce accurately the amounts that will be offered in treasury bill auctions. In addition, we will strengthen the RBM's book entry system for government security holdings to help foster growth in the inter-bank market.

23. **An update of an earlier safeguards assessment was conducted under the IMF's policy**. As recommended, we will reconstitute the Board of Directors of the RBM, re-establish the External Audit Committee and strengthen the safeguards framework within the RBM by introducing a rotation policy for external auditors. We will also expand the disclosures in the financial statement and amend the RBM Act to strengthen its independence.

III. Reaching the HIPC Completion Point

24. **We are determined that Malawi should reach the HIPC completion point in mid-2006**. We believe that the minimum six months track record of adequate performance under the PRGF-supported program could be established by end-2005. We will prepare the third Annual Progress Report (APR) covering July 2004 to end-2005. As noted above, the MPRS expired in mid-2005 and our efforts to reduce poverty and enhance development will henceforth be guided by the new MGDS.

25. **We have made good progress on implementing the HIPC triggers**, but a few, relating to safety nets, health, education and land policy, are not expected to be completed until early 2006. We anticipate a need to request at least one waiver—relating to student enrollment in teaching training institutions. We will begin work with creditors on confirming external debt data as of end-1999, used for the decision point, and on reconciling debt data for end-June 2005 in anticipation of a joint Bank-Fund mission to update the HIPC debt sustainability analysis in early 2006. Following approval of the PRGF arrangement, Paris Club creditors approved an extension of the consolidation period under the previous rescheduling agreement to end-2006.

IV. Program Monitoring

26. The PRGF-supported program will continue to be monitored quarterly, based on the quantitative and structural measures indicated in Tables 1 and 2. These targets are defined in the attached Technical Memorandum of Understanding (TMU). We anticipate the third review—based on performance as of end-June 2006—to take place by end-October 2006.

Box 1: Food Security

The economic impact of the drought is broadly as anticipated, but the humanitarian needs are significantly larger than provided for in the budget. It is now estimated that 292,000 tons of humanitarian assistance is needed. To help meet these needs, we have significantly expanded our efforts to ensure adequate food supplies for FY05/06 and affordable fertilizer for FY06/07. The higher costs have been fully funded by increased donor support.

Humanitarian The budget allowed for the distribution of 150,000 tons of humanitarian maize through the Strategic Grain Reserve (SGR). The amount for distribution has now been increased to 173,000 tons. We will also purchase 37,000 tons this fiscal year to replenish the SGR for FY06/07. Taking into account existing stocks of 31,000 tons, total purchases will be 179,000 tons. DFID, the EU and Norway have increased their support to about $36 million to purchase 139,000 tons. The World Bank approved emergency assistance of $30 million, $10 million more than anticipated.

Commercial: The budget also allowed for the commercial distribution of 50,000 tons by Admarc. 20,000 tons in existing stocks were to be sold at a subsidized price of 17 kwacha per kg and a further 30,000 tons were to be purchased and sold on a cost recovery basis. To ensure adequate supplies of affordable maize, we will now distribute 68,000 tons, all at the subsidized price, increasing the cost of the subsidy by MK0.9 billion.

Fertilizer: Farmers' resources have been depleted by the drought so that it is important to provide affordable fertilizer and seeds to ensure an adequate crop in FY06/07. We have therefore increased the amount of fertilizer to be imported and sold at a subsidized price by 10,000 tons to 147,000 tons. The fertilizer will be used by small farmers mostly for growing maize, though a small amount will be for growing burley tobacco. We will also sell 6,000 tons of maize seeds at a subsidized price. The cost of these subsidies has increased from MK4.8 billion in the budget to MK5.7 billion, but this has been offset by MK1.1 billion (about $9 million) in additional donor flows.

Malawi: Government Maize Transactions in FY05/06
Thousand of metric tons

	Program	Current
Carry over	51	51
SGR	31	31
Commercial	20	20
Purchases	149	227
SGR	119	179
Replenishment FY05/06	29	31
Replenishment FY06/07	0	37
Additional purchases	90	111
Commercial	30	48
Total distribution	200	241
SGR	150	173
Commercial	50	68
Carry over to FY06/07	0	37

Table 1. Malawi: Quantitative Targets for FY2005/06 1/

	Criteria	Jun-05 Stock Actual	End-Sep. 2005 Target	End-Dec. 2005 Target	End-Mar. 2006 Target	End-Mar. 2006 Revised Target	End-Jun. 2006 Target	End-Jun. 2006 Revised Target
					(Cumulative flows from June 30, 2005)			
I. Monetary Targets (In millions of Malawi kwacha)								
1. Ceiling on net domestic assets of the monetary authorities 2/	PC 3/	15,520	-3,133	-1,839	-2,786	-1,564	-2,608	-375
2. Ceiling on reserve money	IT	19,580	1,314	1,324	-1,684	-1,690	3,432	3,170
II. Fiscal Targets (In millions of Malawi kwacha)								
3. Ceiling on central government's net domestic borrowing 2/ 4/ 5/	PC 3/	53,923	-783	-599	-2,398	180	-1,391	-1,661
4. Ceiling on central government wages and salaries 4/	PC 3/	...	4,848	9,934	15,218	14,914	20,730	20,448
5. Ceiling on central government discretionary expenditures 4/	IT	...	15,123	29,424	39,718	40,873	49,669	53,054
III. External Targets (In millions of U.S. dollars)								
6. Floor on net foreign assets of the monetary authorities 2/	PC 3/	33.0	36.1	25.7	9.0	-1.0	49.1	28.8
7. Ceiling on the accumulation of external payments arrears 6/	PC 3/	...	0.0	0.0	0.0	0.0	0.0	0.0
8. Ceiling on new nonconcessional external debt with a maturity of one year or more 6/	PC 3/	...	0.0	0.0	0.0	0.0	0.0	0.0
9. Ceiling on new nonconcessional external debt with a maturity of less than one year 6/	PC 3/	...	0.0	0.0	0.0	0.0	0.0	0.0
Memorandum items (In millions of Malawi kwacha):								
Balance of payments support (In millions of U.S. dollars)			60.2	105.2	141.3	116.4	141.3	144.5
Health SWAp wage expenditures			177	358	542	322	730	730
Health SWAp ORT expenditures			1,016	2,062	3,125	2,399	4,200	3,873
Net movement in Health SWAp account			-439	174	-125	259	536	536
Net movement in NAC account			0	0	0	-368	0	0
Maize revenue			170	504	1,344	1,157	1,344	1,157
Cash payment of arrears			500	1,000	1,500	1,604	2,000	2,000

PC - performance criteria; IT - indicative target
1/ Targets are defined in the technical memorandum of understanding (TMU).
2/ Targets are subject to an adjuster for BOP support.
3/ Targets for end-March are indicative.
4/ Targets are subject to an adjuster for donor-funded health expenditures.
5/ Targets are subject to adjusters for maize revenue and cash payment of arrears.
6/ Evaluated on a continuous basis.

Table 2. Malawi: Structural Performance Criteria and Benchmarks,
December 2005-March 2006

Number	Description	Date
Performance Criteria		
1	Make budget ceilings module in payment system fully operational (TMU, para. 32).	End-Dec. 2005
2	Develop and implement new travel policy, which includes mechanisms for monitoring adherence (TMU, para. 33).	End-Mar. 2006
Structural Benchmarks		
1	Develop detailed schedule of wage adjustments by grade for 2005/06.	Delayed
2	Publish monthly fiscal reports with one month lag (TMU, para. 34).	End-Dec. 2005
3	Prepare quarterly reports (with one month lag) on status of arrears.	End-Dec. 2005
4	Strengthen cash management and expenditure monitoring procedures by preparing reports as indicated in the TMU (para. 35).	End-Mar. 2006
5	Complete impact analysis of tighter credit quality classifications on commercial bank balance sheets (TMU, para. 36).	End-Mar. 2006
6	Reduce import backlog of commercial bank foreign exchange applications for import-related payments as defined in the TMU, para. 41.	End-Mar. 2006
7	Eliminate import backlog of commercial bank foreign exchange applications for import-related payments.	End-Jun. 2006

Table 3: Malawi: Schedule of Disbursements During the First Year Program Under the Three-Year PRGF Arrangement
(In million of SDRs)

Amount	Date	Conditions Necessary for Disbursement
5.4190	Aug-05	Executive Board approval of three-year PRGF arrangement
4.9245	Feb-06	Completion of 1st review and observance of end-Sep. 2005 PCs
4.9245	May-06	Completion of 2nd review and observance of end-Dec. 2005 PCs
6.6800	Nov-06	Completion of 3rd review and observance of end-Jun. 2006 PCs

Malawi—Technical Memorandum of Understanding

1. This memorandum sets out the definitions for the quantitative and structural targets under which Malawi's performance under the Poverty Reduction and Growth Facility arrangement will be assessed. Monitoring procedures and reporting requirements are also specified.

2. **Coverage:** The central government includes all units of government that exercise authority over the entire economic territory. However, in contrast to the *System of National Accounts 1993 (SNA 1993)* and *Government Finance Statistics Manual 2001 (GFSM 2001)* standards, nonprofit institutions that are controlled and financed by the central government are excluded for the purposes of this memorandum. The accounts of the monetary authorities include those of the Reserve Bank of Malawi (RBM) and the central government's holdings of international reserves. Monetary aggregates under the program are based on the four-bank monetary survey.

I. Quantitative Performance Criteria

A. Floor on Net Foreign Assets of the Monetary Authorities

3. **Definition of net foreign assets (NFA) of the monetary authorities:** NFA of the monetary authorities are defined as the difference between gross foreign assets and liabilities. NFA will be valued in U.S. dollars, and monetary gold will be valued at the fixed RBM accounting rate. The counterpart entry to the central government's international reserve assets will be classified as a negative entry under "net credit to central government".

4. **Gross foreign assets** of the monetary authorities, or reserve assets are defined in the *International Reserve and Foreign Currency Liquidity Guidelines for a Data Template (Guidelines).* This concept includes the following: (1) monetary gold holdings of the RBM; (2) holdings of SDRs; (3) the reserve position in the IMF; (4) central government (treasury) holdings with crown agents; and, (5) holdings of convertible, liquid, and unpledged claims on non-residents, such as deposits abroad, and foreign securities. Excluded are any foreign currency claims on residents, capital subscriptions in international institutions, assets in nonconvertible currencies, and gross reserves that are in any way encumbered or pledged, including, but not limited to, reserve assets used as collateral or guarantee for third-party external liabilities. It also excludes transfers of foreign currency claims to the monetary authorities by other institutional units in Malawi just prior to reporting dates with accompanying reversals of such transfers soon after those dates (*Guidelines*, Chapter 2).

5. **Gross foreign liabilities** of the monetary authorities are defined as the sum of the following: (1) outstanding liabilities of the RBM to the IMF; and, (2) all short-term foreign currency liabilities of the RBM to non-residents with an original maturity of up to, and including, one year.

6. **Adjustment clause on net foreign assets—balance of payments support:** The floor on NFA of the monetary authorities will be adjusted upward (downward) by the full amount by which the cumulative receipts from the balance of payments support are greater (less) than the program baseline (shown in table below). The downward adjustment will be capped at US$10 million, with the following exception: In the second quarter of FY2005/06, the target will be adjusted downward up to US$25 million if the disbursement of the second tranche of the World Bank FIMAG is delayed.

7. **Definition of balance of payments support:** Balance of payments support includes all grants and foreign financing that is not linked to additional budgetary expenditure. Excluded from this definition is external project financing to fund particular activities, including food security funding from the European Union and usage of the Tokyo-Mitsubishi account, and loan financing from the IMF. Balance of payments support is measured as the cumulative flow from July 1, 2005.

Malawi: Program Balance of Payments Support, FY2005/06
(In millions of U.S. dollars)

	Q1	Q2	Q3	Q4	Total
Grants	60.2	20.0	36.1	0.0	116.3
EU	18.8	0.0	32.9	0.0	51.7
IDA	0.0	20.0	0.0	0.0	20.0
UK	38.2	0.0	0.0	0.0	38.2
Norway	3.2	0.0	3.2	0.0	6.4
IDA Loan	0.0	25.0	0.0	0.0	25.0
Total	**60.2**	**45.0**	**36.1**	**0.0**	**141.3**
Cumulative total	**60.2**	**105.2**	**141.3**	**141.3**	

Sources: UK, EU, Norway, AfDB, and WB.

Malawi: New Projections of Balance of Payments Support, FY2005/06
(In millions of U.S. dollars)

	Q1 Act.	Q2 Est.	Q3 Proj.	Q4 Proj.	Total Proj.
Grants	35.7	52.7	3.0	28.1	119.5
EU	0.0	17.5	0.0	28.1	45.6
IDA	0.0	29.9	0.0	0.0	29.9
UK	35.7	0.0	0.0	0.0	35.7
Norway	0.0	5.3	3.0	0.0	8.3
IDA Loan	0.0	0.0	25.0	0.0	25.0
Total	**35.7**	**52.7**	**28.0**	**28.1**	**144.5**
Cumulative total	**35.7**	**88.4**	**116.4**	**144.5**	

Sources: UK, EU, Norway, AfDB, and WB.

B. Ceiling on the Net Domestic Assets of the Reserve Bank of Malawi

8. **Definition of net domestic assets (NDA) of the RBM:** NDA of the RBM is defined as reserve money minus net foreign assets valued at the program exchange rate of MK 123 per US$1. Reserve money consists of currency issued by the RBM and balances of commercial banks accounts with the RBM. It includes required reserves held for Malawi kwacha deposits and any other domestic currency reservable liabilities and other demand and time deposits held with the RBM.

9. **Adjustment clause on net domestic assets—balance of payments support:** The ceiling on net domestic assets of the RBM will be adjusted downward (upward) by the full amount by which the cumulative flow of receipts from balance of payments support is greater (less) than the program baseline. The upward adjustment will be capped at US$10 million, with the following exception: In the second quarter of FY2005/06, the target will be adjusted upward up to US$25 million if the disbursement of the second tranche of the World Bank FIMAG is delayed. Balance of payments support will be converted to Malawi kwacha using the program exchange rate (see para. 7 for the definition of balance of payments support).

10. **Adjustment clause on net domestic assets—liquidity reserve requirement:** The ceiling on net domestic assets of the RBM will be adjusted downward for a decrease in the reserve requirement ratio, and the ceiling will be adjusted upward for an increase in the ratio. The adjuster will be calculated as follows: (one minus the percentage of reserve assets held at the discount houses) multiplied by (the program baseline required reserve ratio minus the new required reserve ratio) multiplied by (the amount of reservable deposit liabilities in commercial banks as at the end of the quarter prior to the change in regulation).

C. Ceiling on Central Government's Domestic Borrowing

11. **Definition of central government's domestic borrowing (CGDB):** CGDB is computed as the sum of (i) net borrowing from the RBM (including ways and means advances, loans, holdings of local registered stocks, and holdings of treasury bills minus deposits), (ii) net borrowing from commercial banks (including advances, holdings of local registered stocks and holdings of treasury bills minus deposits), (iii) net borrowing from nonbanks (including holding of local registered stocks, holdings of treasury bills, and supplier credits minus government deposits held at the Malawi Savings Bank), and (iv) holdings of promissory notes. The treasury bills and local registered stocks are valued at cost. Excluded are promissory notes issued to cover RBM's operational losses in 2002 and 2003. The ceiling is measured as the cumulative flow from July 1, 2005.

12. **Definition of June 2004 domestic arrears:** June 2005 domestic arrears consist of all domestic arrears for which the obligation to pay was established on or before June 30, 2004.

13. **Definition of domestic arrears**: Domestic arrears are overdue payment obligations by central government other than external payment arrears (see section I.E.), including on

wages and salaries, pensions, transfers, domestic interest, goods and services, obligations arising from court cases, legally established compensation claims, and payments to the Malawi Revenue Authority (MRA) for tax refunds. Payments on wages and salaries, pensions, transfers, court established obligations, and compensations are in arrears when they remain unpaid for more than 30 days beyond their due date. Domestic interest payments are in arrears when the payment is not made on the due date. Payments for goods and services are deemed to be in arrears if they have not been made within 30 days of the date of invoice, or—if a grace period has been agreed—within the contractually agreed grace period.

14. **Adjustment clause on CGDB—balance of payments support:** The ceiling on CGDB will be adjusted downward (upward) by the full amount by which the cumulative receipts from balance of payments support is greater (less) than the program baseline (see para. 7 for the definition of balance of payments support). The upward adjustment will be capped at US$10 million, with the following exception: In the second quarter of FY2005/06, the target will be adjusted upward up to US$25 million if the disbursement of the second tranche of the World Bank FIMAG is delayed.

15. **Adjustment clause on CGDB—securitization of arrears:** The ceiling on CGDB will be adjusted upward by the full amount by which pre-2005 domestic arrears are securitized.

16. **Adjustment clause on CGDB—cash payment of arrears:** The ceiling on CGDB will be adjusted downward by the full amount by which payments for verified pre-2005 domestic arrears are less than the program baseline. Only payments that are charged against the Accountant General vote, and reported by the Accountant General will be recognized as payments for pre-2005 domestic arrears.

17. **Adjustment clause on CGDB—maize revenue:** The ceiling on CGDB will be adjusted upward (downward) by the full amount by which the cumulative receipts from the sale of commercial maize through ADMARC and deposited in the RBM maize account is less (greater) than the program baseline (shown in table below).

18. **Adjustment clause on CGDB—donor pool account for the health SWAp:** The ceiling on CGDB will be adjusted downward (upward) by the full amount by which the change (in Kwacha) of the stock in the US dollar denominated donor pool account for the health SWAp at the RBM is larger (smaller) than the change (in Kwacha) of the stock in that account in the program baseline (shown in table below). The change in stock is measured relative to the stock as of June 30, 2005. Stocks in the account are stated with a positive sign.

19. **Adjustment clause on CGDB—National Aids Commission (NAC) accounts:** The ceiling on CGDB will be adjusted downward (upward) by the full amount by which the change (in Kwacha) of the stock in the accounts of the NAC held in the Malawi banking system is larger (smaller) than the change (in Kwacha) of the stock in those accounts in the program baseline (shown in table below). The stock of the NAC accounts will be determined on the basis of the quarterly financial reports of the NAC. The change in stock is measured

relative to the stock as of June 30, 2005. Stocks in the accounts are stated with a positive sign.

Malawi: Program Maize revenue, Health SWAp, and NAC Funds, FY2005/06
(In millions of Malawi Kwacha)

	Q1	Q2	Q3	Q4	Total
Maize revenue					
Quarterly receipts	170	334	840	0	1,344
Cumulative receipts	170	504	1,344	1,344	
Health SWAp					
Revenues	754	1,840	947	1,925	5,466
Wage expenditures	177	181	184	188	730
ORT Expenditures	1,016	1,046	1,063	1,075	4,200
Change in account balance	-439	613	-299	661	536
Cumulative wage expenditures	177	358	542	730	
Cumulative ORT expenditures	1,016	2,062	3,125	4,200	
Cumulative change in account balance	-439	174	-125	536	
National AIDS Commission (NAC)					
Revenues	1,269	1,309	1,340	1,364	5,282
Expenditures	1,269	1,309	1,340	1,364	5,282
Change in account balance	0	0	0	0	0
Cumulative change in account balance	0	0	0	0	

Malawi: New Projections of Maize revenue, Health SWAp, and NAC Funds, FY2005/06
(In millions of Malawi Kwacha)

	Q1 Act.	Q2 Proj.	Q3 Proj.	Q4 Proj.	Total Proj.
Maize revenue					
Quarterly receipts	375	391	391	0	1,157
Cumulative receipts	375	766	1,157	1,157	
Health SWAp					
Revenues	1,485	612	883	2,159	5,139
Wage expenditures	138	0	184	408	730
ORT Expenditures	1,419	0	980	1,474	3,873
Change in account balance	-72	612	-281	277	536
Cumulative wage expenditures	138	138	322	730	
Cumulative ORT expenditures	1,419	1,419	2,399	3,873	
Cumulative change in account balance	-72	540	259	536	
National AIDS Commission (NAC)					
Revenues	361	256	1,340	1,364	3,320
Expenditures	768	217	1,340	996	3,320
Change in account balance	-407	39	0	368	0
Cumulative change in account balance	-407	-368	-368	0	

D. Ceiling on Central Government Wages and Salaries

20. **Definition of central government wages and salaries:** Central government wages and salaries include all payments that are classified as personnel emoluments in government budgets and accounts, including payments on arrears of personnel emoluments and allowances. The ceiling is measured as a cumulative flow from July 1, 2005.

21. **Adjustment clause on central government wages and salaries—donor-funded wages and salaries in the health sector:** The ceiling on central government wages and salaries will be adjusted upward (downward) by the full amount of donor-funded supplementary wages and salaries for the health sector that is greater (less) than the program baseline (see table above).

E. Ceiling on External Payment Arrears

22. **Definition of external payment arrears:** External payment arrears consist of external debt-service obligations (principal and interest) that have not been paid at the time they are due, as specified in the contractual agreements, except on external debt subject to rescheduling or restructuring. A continuous performance criterion applies on the

nonaccumulation of external payment arrears on external debt contracted or guaranteed by the central government, the RBM, or other agencies on behalf of the central government or the RBM.

F. Ceiling on Nonconcessional External Debt

23. **Definition of nonconcessional external debt:** The definition of debt, for the purpose of the limit, is set out in Executive Board Decision No. 6230-(79/140) of August 3, 1979, and as amended by Decisions No. 11096-(95/100), October 25, 1995; and 12274-(00/85) August 24, 2000. For program purposes, a short- and medium- and long-term debt is nonconcessional if it includes a grant element less than 35 percent, as indicated in Decision No. 11248-(96/38), April 15, 1996. The ceiling on nonconcessional debt applies to the contracting and guaranteeing by the central government, the RBM, or other agencies on behalf of the central government or the RBM on debt with nonresidents. The ceiling applies to debt and commitments contracted or guaranteed for which value has not been received. The ceiling is measured cumulatively from July 1, 2005.

24. Short-term debt: outstanding stock of debt with an original maturity of one year or less.

25. Medium- and long-term dent: outstanding stock of debt with a maturity of more than one year.

26. Excluded from the limit is the use of Fund resources, and any kwacha-denominated treasury bill and local registered stock holdings by nonresidents. Excluded from the limit are also (i) debts classified as international reserve liabilities of the RBM; (ii) new debt issued to restructure, refinance, or repay existing debt up to the amount actually used for the above-mentioned purposes; (iii) normal import financing; (iv) convertibility guarantees of the kwacha by the RBM; and (v) arrangements to pay over time obligations arising from judicial awards to external creditors. A financing arrangement for imports is considered to be "normal" when the credit is self-liquidating.

II. Quantitative Indicative Targets

A. Ceiling on Reserve Money

27. **Definition of reserve money:** Reserve money is defined as the sum of currency issued by the RBM and balances of commercial bank accounts with the RBM. It includes required reserves held for Kwacha deposits, other domestic currency liabilities, and other demand and time deposits held with the RBM.

B. Ceiling on Central Government Discretionary Expenditures

28. **Definition of central government discretionary expenditures:** These are defined as all expenditures excluding (i) wages and salaries, (ii) interest payments, and (iii) foreign-financed development expenditures (development Part I expenditures) which are related to specific projects. Central government discretionary expenditures include statutory (i.e., nonvoted) expenditures for pensions and gratuities, and compensation and refunds; but exclude tax refunds (which are treated as a negative revenue). Central government discretionary expenditures also include other recurrent expenditures (ORT), domestically financed development expenditures (development Part II expenditures), and net lending (if any). Included in this definition are also recurrent expenditures and development Part II expenditures for which cash financing is or was made available by donors. Included in particular are all maize purchases for the Strategic Grain Reserve, purchases financed from the Japan debt relief account (see paragraph 19), and expenditures in the health sector financed from the donor pool account in the RBM for the health SWAp. The ceiling is measured as a cumulative flow from July 1, 2005.

29. **Adjustment clause on central government discretionary expenditures—donor-funded central government discretionary expenditures in the health sector.** The ceiling on central government discretionary expenditures will be adjusted upward (downward) by the full amount of donor-funded **central government discretionary** health sector expenditures that is greater (less) than the program baseline (see table above). In respect of resources made available through the U.S. dollar denominated donor pool account for the health SWAp at the RBM (donor pool account), donor-funded central government discretionary expenditures in the health sector will be deemed to have been made according to the calculation: 'outflows from the donor pool account to finance expenditures, expressed in Malawi Kwacha' less 'donor financed supplementary wages in the health sector'.

III. Structural Performance Criteria and Benchmarks

30. **Domestic Arrears Strategy:** The government will identify, verify, and clear June 2004 domestic arrears in accordance with the guidelines set forth in the MEFP (para. 45). Begin implementation is defined as identifying all arrears, in addition to starting the process of verification. Ministries are expected to resolve any domestic arrears incurred since June 30, 2004 through their annual budget allocations.

31. **Employee database:** The database will be based on the DHRMD data forms collected for the FY2005/06 government payroll, and should include information on all employees by ministry, grade, and salary.

32. **Budget ceiling module:** For the purposes of expenditure management, the budget module of the payments system at the RBM should be made fully operational. This requires that the following three steps are completed: (1) All bank accounts are reconciled between the RBM and commercial banks; (2) All data are reconciled between the RBM holding

accounts and the fiscal data according to the Ministry of Finance ledgers; and (3) the Accountant General's office provides the RBM with a list of check numbers for outstanding checks issued against the 2004/05 budget. These checks should be entered into the payment system in order to identify the float from the 2004/05 budget into fiscal year 2005/06 for the CCA system. Finally, the RBM should produce tables by CCA category listing funded amounts against total reimbursement for the current fiscal year. In the future, the Accountant General should develop a concordance between budget votes, cost centers, and RBM holding accounts into which CCAs are credited, and produce tables by budget vote.

33. **Travel Policy:** The Ministry of Finance will develop a travel policy that will be ready for the FY2006/07 budget and will aim to reduce and account for all expenditure on travel.

34. **Publication of Fiscal Reports:** The Ministry of Finance will publish the following documents on a monthly basis: the GFS fiscal table, the arrears clearance report, and the report on pro-poor expenditures.

35. **Impact Analysis:** Collect information on credits overdue 30 days or more but less than 180 days. Based on this information, an analysis should be completed of tightening credit quality classification to 90 days for substandard, 180 days for doubtful, and one year for loss.

36. **Strengthening cash management:** Prepare and implement the following two reports: (1) a budget execution report based on a new monthly table by ministry and expenditure type (PE, ORT, and development, including below the line accounts like advances and imprests) that shows (i) approved budget per vote/ministry, (ii) funding released to ministries per funding table, (iii) commitments made as reported by ministries on commitment control system reports (iv) expenditures as reported by ministries on expenditure returns, and (v) payments made according to CCA system; and (2) an amended funding table that indicates the allocation of funding based on three sources: the MG1 account, automatic payment by standing instruction (e.g., regular foreign payments or withholding), and foreign financing sources.

IV. Treatment in the Fiscal Accounts and Balance of Payments of Certain Central Government (CG) Accounts Held Abroad

37. **The account held with the Bank of Tokyo-Mitsubishi in Japan:** The account was set up for the delivery and administration of Japanese debt relief. Disbursements of cash debt relief into the account are accounted as grants with corresponding amounts of foreign financing (increases in the deposit account). Withdrawals from the Bank of Tokyo-Mitsubishi account are accounted as central government expenditures with corresponding amounts of foreign financing (decreases in the deposit account). Expenditures financed from this account are included in spending agencies budgets under current expenditures, or as development Part II expenditures (development expenditures financed by the Government of Malawi). Flows are valued at the end-month exchange rate.

38. **The European Union grants for food security purposes and the food reserve account**. These grants are given to provide a cash reserve to the Government of Malawi for the purchase of food stuff (in particular maize) at times of food shortages. Access to foreign or domestic accounts that have been or are being established to administer these resources is determined by agreements between the European Union and the Government of Malawi. Deposits into the account held abroad are recorded as grants with corresponding amounts of foreign financing (increase in deposit accounts). Withdrawals from the account held abroad are recorded as increase in foreign financing. If and when the resources are transferred to Malawi, they are to be held in a bank account in the banking system until needed, and are counted as part of net credit to government. Withdrawals from the foreign or domestic accounts for payments to suppliers are recorded as an appropriate expenditure item (e.g., purchase of food stuffs), and a decrease in the respective deposit account. Should the food reserve account be operated like a revolving fund, all cash inflows are accounted as appropriately classified revenue, and an increase in the deposit account. The balance in the foreign and domestic food reserve accounts is reported separately in the monetary data.

V. Reporting of Certain Transactions in the Fiscal Accounts

39. **Operations of the National Aids Commission (NAC)**. Financial operations of the NAC are included in the fiscal accounts according the NAC’s financial reports. Expenditures are typically classified as development Part I expenditures. Government ministries and departments that execute projects financed by NAC report these activities to NAC for inclusion in the NAC’s financial reports.

40. **Donor pool funded expenditures in support of the Health SWAp**. The Government of Malawi has embarked on the implementation of an integrated program of service delivery in the health sector, the health sector wide approach (Health SWAp). In support of the Health SWAp some donors are pooling resources (the donor pool), and release these resources through normal government procedures (i.e. recurrent budget or development Part II budget) to the health sector. In order to manage the inflows of donor resources a U.S. dollar-denominated account has been set up at the RBM that holds donor pool resources until expenditures need to be financed. Donor funded expenditures for the Health SWAp from the pooled resources will be deemed to have been made in the amount of outflows from the donor pool account to finance expenditures (i.e., typically either to Malawi government No. 1 account in Malawi Kwacha, or to pay directly for imports by the health sector). The attribution of donor financed expenditures to personnel emoluments, other recurrent transactions, and development Part II expenditures is made on the basis of cash flow projections and established donor commitments to finance specific expenditures (e.g., supplementary wages and salaries for professional health cadres). Typically, expenditures for other recurrent transaction are estimated as the residual of outflows less expenditures for wages and salaries less expenditures for development Part II.

VI. Reporting Requirements

41. Monitoring of the program requires that the information listed in the tables shown below be reported to the IMF within the timeframe indicated in the table. The new data requirement for a list of the backlog of import applications for foreign exchange will include data by bank, and amounts separated by the following three categories: imports not yet delivered, imports delivered but within the grace period, and imports delivered but outside of the grace period.

Malawi: Reporting Requirements

Data description	Data Freq.	Reporting Agency	Reporting Freq.	Delivery Lag	Delivery Date	Delivery Mode
Gross international reserves, exchange rate, and foreign exchange purchases and sales	D	RBM	W	2	F	E
Reserve money, OMO transactions, and RBM conversion of treasury bills	D	RBM	W	2	F	E
Treasury bill and RBM bill auction results	W	RBM	W	2	F	E
RBM balance sheet and broad money estimate	W	RBM	W	7	F	E
Backlog of import applications for foreign exchange	W	RBM	W	7	F	E
Four-bank monetary survey	M	RBM	M	30	30	E
International Reserve and Foreign Currency Liquidity Data Template	M	RBM	M	30	30	E
Central government domestic borrowing	M	RBM	M	30	30	E
Interest rates	M	RBM	M	30	30	E
Holdings of local registered stocks, treasury bills, and RBM bills	M	RBM	M	30	30	E
Issue and maturity profile for treasury bills and RBM bills	M	RBM	M	30	30	E
Excess reserves by bank	D	RBM	M	30	30	E
Details of project and balance of payment support	M	RBM	M	30	30	E
Monthly exchange rates	M	RBM	M	30	30	E
FCDA holdings	M	RBM	M	30	30	E
Cash flow of foreign exchange	M	RBM	M	30	30	E
Foreign exchange exposure limits by bank	M	RBM	M	30	30	E
Bank statements of both the Health SWAp and government maize account held at the RBM	M	RBM	M	30	30	E
Seven bank monetary survey and full banking survey	M	RBM	M	45	15	E
Financial soundness indicators by banks	Q	RBM	Q	45	T15	E
Insurance company survey	Q	RBM	Q	45	T15	E
Fiscal table (GFS) including revenue, expenditure, and financing.	M	MOF	M	30	30	E
Funding tables on wages, other recurrent expenditures, and development	M	MOF	M	30	30	E
CCA, supplementary CCA, and reimbursement report	M	MOF	M	30	30	E
Pro-poor spending	M	MOF	M	30	30	E
Tokyo-Mitsubishi account statements	M	MOF	M	30	30	E
Revenue data (from MRA)	M	MOF	M	30	30	E
PSI import data	M	MOF	M	30	30	E
Ministry reports on commitment and expenditures (CCS3 and CCS4 returns)	M	MOF	Q	30	T30	E
New external loans contracted or guaranteed by the central government 1/	Q	MOF	Q	30	T30	E
List of nonreschedulable external arrears by creditor 2/	Q	MOF	Q	30	T30	E
Budget execution report, including arrears and prospects for meeting budget targets based on the CCS3 and CCS4	M	MOF	Q	45	T15	E
Borrowing of the ten major parastatals 3/	Q	MOF	Q	45	T15	E
Quarterly financial statements of the ten major parastatals and MSB	Q	MOF	Q	45	T15	H
Report on PRGF performance	Q	MOF	Q	45	T15	E
Report on verified pre 30. June 2004 expenditure arrears	Q	AuG	Q	45	T15	E
Report on new post 30. June 2004 arrears verified by AuG	Q	AuG	Q	45	T15	E
Annual audited financial statements of the ten major parastatals and MSB	A	MOF	A	90	Mar. 30	H
Consumer price index and monthly statistical bulletin	M	NSO	M	30	30	E
Import and export data	M	NSO	M	45	T15	E
Balance of payments, and quarterly statistical bulletin	Q	NSO	Q	45	T15	E
National accounts, balance of payments, and quarterly statistical bulletin	A	NSO	BA	45	Mar. 15; Sep. 15	E

D-Daily, W-Weekly, M-Monthly, Q-Quarterly, BA-Bi-annual A-Annual; F-Friday, 30-Every 30th, T30-Every third 30th; E-Electronic, H-Hard copy

1/ Detailed information on the amounts, currencies, terms, and conditions, including debt contracted or guaranteed by the RBM or any other agency on behalf of the central government.

2/ To be reported by DAMD, including a detailed explanation.

3/ Agriculture Development and Marketing Corporation, Air Malawi, Electric Supply Company of Malawi, Malawi Development Corporation, Malawi Housing Corporation, Malawi Postal Corporation, Malawi Telecommunications Ltd., Northern Regional Water Board, Central Regional Water Board, and Southern Region Water Board.

Malawi: Relations with the Fund
(As of December 31, 2005)

I. **Membership Status**: Joined 07/19/1965; Article VIII (December 7, 1995)

II. **General Resources Account**:	SDR million	Percent Quota
Quota	69.40	100.0
Fund holdings of currency	82.29	118.58
Reserve position in Fund	2.29	3.30

III. **SDR Department**:	SDR million	Percent Allocation
Net cumulative allocation	10.98	100.0
Holdings	0.74	6.71

IV. **Outstanding Purchases and Loans**:	SDR million	Percent Quota
Poverty Reduction and Growth Facility (PRGF) arrangements	15.18	21.88
Emergency Assistance	37.42	53.92

V. **Financial Arrangements**:

Type	Approval Date	Expiration Date	Amount Approved (SDR million)	Amount Drawn (SDR million)
PRGF	8/5/2005	8/4/2008	38.17	5.42
PRGF	12/21/2000	12/20/2004	45.11	12.88
PRGF	10/18/1995	12/16/1999	50.96	50.96

VI. **Projected Obligations to Fund, Including Board-Approved HIPC Initiative Assistance** (in millions of SDRs; based on existing use of resources and present holdings of SDRs):

	Forthcoming				
	2006	2007	2008	2009	2010
Principal	15.78	13.41	5.37	4.10	2.58
Charges/Interest	1.01	0.61	0.41	0.38	0.37
Total	16.79	14.02	5.78	4.49	2.94

VII. Implementation of HIPC Initiative:

	Enhanced Framework
A. Commitment of HIPC assistance	
Decision point date	12/21/00
Assistance committed (NPV terms) [1]	
Total assistance (US$ million)	643.00
Of which: Fund assistance (SDR million)	23.14
Completion point date	Floating
B. Delivery of Fund assistance (SDR million)	
Amount disbursed	11.57
Interim assistance	11.57
Completion point [2]	0.00
Additional disbursement of interest income	0.00
Total disbursements	11.57

VIII. Safeguards Assessments:

Under the Fund's safeguards assessment policy, the Reserve Bank of Malawi (RBM) is subject to a safeguards assessment with respect to the requested Poverty Reduction and Growth Facility. An off-site assessment was conducted in July 2001, followed by an update assessment, completed in July 2003. A new full assessment was conducted in November 2005. The safeguard mission found that the RBM had taken a number of steps to strengthen its operations identified previously. However, new vulnerabilities have emerged and a few vulnerabilities that were identified earlier remain, including important vulnerabilities in financial reporting, controls, and legal structure and independence that need to be addressed.

[1] NPV terms at the completion point under the original framework; and NPV terms at the decision point under the enhanced framework.

[2] Under the enhanced HIPC Initiative, the nominal amount of assistance disbursed will include an additional amount corresponding to interest on amounts committed but not disbursed during the interim period, calculated using the average return (during the interim period) on the investment of resources held by, or for the benefit of, the PRGF-HIPC Trust.

IX. **Exchange Arrangements**:

The exchange rate of the Malawi kwacha is a managed-float. On December 30, 2005, the exchange rate was MK 123.8 = US$1.00.

X. **Article IV Consultation**:

Malawi is on the standard 12-month Article IV consultation cycle. The last Article IV consultation (SM/04/355) was concluded by the Executive Board on October 18, 2004.

XI. **Technical Assistance**:

Date	Duration	Dept.	Recipient	Purpose	Form
9/01	1½ weeks	FAD	Ministry of Finance	Expenditure tracking and fiscal ROSC	Mission
11/01	2 weeks	MAE	RBM	Monetary operations and further developing financial markets	Mission
02/02	2 weeks	FAD	Ministry of Finance	Expenditure policy	Mission
05/02	6 months	FAD	Ministry of Finance	Expenditure management	Advisor
07/02	2 weeks	STA	National Statistical Office (NSO), RBM	GDDS Anglophone project on national accounts statistics	Mission
08/02	2 weeks	STA	RBM	Monetary and financial statistics	Mission
02/03	2 weeks	MAE	RBM	Monetary operations, payments system, banking supervision	Mission
08/03	2 weeks	STA	NSO	GDDS Anglophone project on balance of payments statistics	Mission
09/03	2 weeks	STA	NSO, Ministry of Finance, RBM	ROSC on the quality of macroeconomic data	Mission
02/04	2 weeks	MFD	RBM	Monetary operations, credit quality assessment, payments system, banking supervision	Mission
04/04	2 weeks	STA	RBM	Monetary and financial statistics	Mission
01/05	2 weeks	LEG/MFD	RBM	AML/CFT	Mission
03/05	2 weeks	FAD	Ministry of Finance	Tax Policy Mission	Mission
08/05	1 week	STA	Ministry of Finance	GDDS project on fiscal sector	Mission
11/05	1 week	FAD	Ministry of Finance	Civil Service Pensions	Mission
12/05	2 weeks	MFD	RBM	Monetary operations, banking supervision, payments systems, and forex bureaus.	Mission

XII. **Resident Representative**:

Mr. Thomas Baunsgaard since August 16, 2004.

Malawi: Relations With theWorld Bank

Contact person: Ms. Yisgedullish Amde, Tel. 202 473 2203

A. World Bank Country Assistance Strategy (CAS)

1. The Malawi CAS was approved by the Bank's board on May 14, 2003. The gray cover report (Report # 25906 MAI) outlined the current social, economic, and political situation in Malawi and proposed strategies for the next three years (FY04-06), based on the lessons learned from the previous strategies. This strategy presents a transitional program that aims to help the Government to address urgent development issues. Preparation for a new CAS has begun and will be completed in the coming Fiscal Year.

2. The current CAS program is organized under three pillars: i) strengthening economic management, ii) establishing a platform for growth; and iii) improving service delivery and strengthening the safety net. Two ongoing projects (Financial Management Transparency and Accountability, and Privatization and Utility Reform[1]), and a Structural Adjustment Credit (Fiscal Management and Accelerating Growth Project) will assist in attaining the objectives under pillar one. In addition, in response to the drought-induced emergency in early 2005, a project, Emergency Recovery Grant, was approved in September 2005, to support the restoration of assets and production. To support the objectives of pillar two, the on-going Community Based Land Reform; Irrigation, Rural Livelihoods Road Maintenance and Rehabilitation; and Road Maintenance and Rehabilitation Projects, well as a pipeline project, Rural Infrastructure Services Project are under the base case. The World Bank also supports Malawi's participation in Southern Africa Power Market Project, which contributes to the achievement of pillar two. Core Bank interventions under pillar three include the HIV/AIDS (MAP) Project, Third Malawi Social Action Fund Project; Secondary Education Project (since closed in December 2005), and two new Projects, First Education Sector Support Project, and Health Sector Program with a sector-wide approach (the first in Malawi). Finally, Malawi also benefits from the Bank funded Regional Trade Facilitation Project, which contributes to poverty alleviation through private sector led growth by improving access to financing for productive transactions and cross-border trade.

B. Financial Relations with the World Bank Group

3. The World Bank has been active in Malawi since 1966. Total lending and grants to Malawi from the World Bank as of December 2005 is US$2,507 million, of which US$2,242 million has been disbursed. As of December 2005, there were fourteen active projects in Malawi with a net commitment of US$441 million, and an undisbursed balance of

[1] Global Development and Learning Network Project was cancelled in November 2005 per Government's request.

US$241 million. Sectoral breakdown is as follows: Rural at 17%, Transport at 7%, Public and Private Sector Development and Finance at 33%, and Social Sectors at 43%.

4. IFC has two investments in Malawi, with 44% in capital markets and the balance in health, totaling US$1.16 (US$0.64 million in loans and US$0.52 million in equity). Future focus will be on expanded IFC assistance for the private sector, especially in areas of manufacturing, mining and tourism that Malawi has indicated as its target areas to reduce its dependence on agriculture.

C. Areas in Which the Bank Leads

Education and Health

5. The Multi-Sectoral AIDS Project (US$35 million in grants) was approved in FY04. The project will support efforts by the Government of Malawi to reduce HIV transmission and mitigate the impact of the disease throughout Malawian society, thus also fighting the poverty that AIDS brings to families and societies. A major study of Malawi's HIV/AIDS problem revealed 10 important constraints that the project, beginning in 2004 and running through 2008, will address through a range of activities, from capacity building in public, private, and civil society organizations to educational work for prevention, and increased support for AIDS orphans. Many of Malawi's other development partners are also active in this effort, pooling their funds to support this critical effort.

6. The Health Sector Support Project for Malawi (the first project with a Sector Wide Approach in Malawi) aims to improve the effectiveness, efficiency and equity of the essential health care delivery system in Malawi. The project (with US$15 million in grants) was approved in December 2004, and has the following three components: Component 1) will improve the health status of the Malawian population by increasing access to quality essential health services. The main mechanism for delivering quality care would be by making the already-defined Essential Health Package (EHP) accessible to all, but especially in the most rural and disadvantaged districts and to the poorest and vulnerable populations. Component 2) will increase the number of staff available through continuation of the six-year emergency training plan, a concerted recruitment campaign, financing and then filling current vacancies, the use of volunteers and contract staff and other stop-gap staffing strategies. Component 3) will improve the effectiveness and efficiency of both the health system and the referral network to support delivery o f the EHP.

7. The First Education Sector Support Project for Malawi (with US$32.2 million in grants) was approved in May 2005, and will provide immediate financing to support the education sector in Malawi. The project has the following six components: Component 1) will complement government and donors' efforts to improve quality and expand capacity of teacher development and training at all levels. Component 2) will improve the conditions of learning at selected secondary schools staffed with trained teachers or newly trained teachers. Component 3) will provide a School Health and Nutrition package to all primary schools, which will include: distribution of vitamin A and iron-folic acid to school children under 10

years old, de-worming, treatment of malaria and fever, and the promotion of good health and nutrition practices. Component 4) will supply basic learning materials directly to schools while strengthening the participation of communities in school management. 5) Capacity Building and Policy Development will cover: (i) national education policy consolidation and capacity building; and (ii) support to implementation of government decentralization policy in education. Component 6) will support the physical implementation and management of fiduciary and procurement issues.

8. The Secondary Education Project (US$48.2 million), which closed in December 2005, aimed to increase the number of students from disadvantaged groups who graduate from public and private secondary schools, with higher performance. There were five components in this project: expanding access to secondary education; provision of instructional materials in the project-financed schools and textbooks, school supplies, and consumables for sciences for the other schools; provision of training for school-based managers; financing HIV/AIDS materials; and support to administrative unit/monitoring & evaluation/studies.

Social Protection and Community Development

9. MASAF is a long-term, wide-ranging poverty-reduction project that supports decentralization and community capacity building. The project aims to empower individuals, households, communities, and their development partners in the implementation of measures which can assist them in better managing risks associated with health, education, sanitation, water, transportation, energy and food insecurity, and to provide support to the critically vulnerable through a variety of sustainable interventions. The current Project, MASAF III (US$60 million, of which US$27 million is in the form of an IDA grant) was approved in FY03. The project encourages communities to develop social safety nets for their most vulnerable members (such as skills training for AIDS orphans), facilitates delivery of the most needed social services, and stimulates communities to save and invest.

Infrastructure

10. The Road Maintenance Project (US$30 million) was approved in FY99 to bring about sustainable improvements in the quality of Malawi's road infrastructure which will help economic growth and diversify the economy by reducing transport costs and improving access by: (a) strengthening and restructuring of the road sector institutional framework; (b) reform of road sector; and (c) addressing the backlog of road maintenance and rehabilitation. In the pipeline (FY06), is also an Integrated Infrastructure Services Project to primarily support rural energy, and transport needs.

Private Sector

11. Parastatal reform continues to be an urgent need in Malawi. In the past two years, progress has been made in several privatizations with Bank assistance through the Privatization and Utility Reform Project (PURP, US$28.9 million, approved in FY00). The PURP aims to improve quality of and access to economic and physical infrastructure, notably

telecommunications, water, and power sectors, by promoting greater private-sector involvement. The Government's Privatization Commission identified some 100 public enterprises that should be privatized; the project aims to support the Commission's divestiture work through technical assistance and support for strengthening existing public enterprises, such as the postal service. The Project is presently being restructured to: address slow implementation progress, respond to new challenges facing the Government, incorporate lessons learned and improve the effectiveness of the program.

12. Malawi also participates in the Regional Trade Facilitation Project, whose principal objective is to contribute to poverty alleviation through private sector led growth in participating countries by improving access to financing for productive transactions and cross-border trade. The project brings together a group of countries by setting up a credible insurance mechanism against losses caused by political risks. The governments of these countries would agree to be the ultimate risk takers in the insurance mechanism, thus creating a strong disincentive to cause claims. This type of insurance is currently not available from the private market, particularly for medium-term transactions (over one year). The project will thus widen the scope for private sector activity, in particular by extending the maturities at which credit is available, creating a more stable business environment by ensuring the availability of coverage on a consistent and predictable basis, and, by improving the risk, lowering the risk premium.

Agriculture

13. A Community based Rural Land Development Project (US$27 million) was approved by the Board in April 2004. Based on positive community-level experience gained in the MASAF projects, and in partnership with the Government and UK's Development agency, DFID, this project will involve the acquisition of idle land and their transfer to small farmers, thus enabling them to be self-sufficient in food and, hopefully, grow surpluses for commercial sale. It is urgent that Malawi move toward a more equitable distribution of land that will provide food security for small-holders. The Structural Adjustment Credit, FIMAG, also supports agricultural policy reforms (see further details in paragraph 19 below).

14. An Irrigation, Rural Livelihoods and Agriculture project, approved in November 2005, aims to complement other activities on the ground. The overarching development objective of the proposed project is to raise agricultural productivity and net incomes of poor rural households in target districts of Malawi in a sustainable manner by providing an integrated package of support covering irrigation, agricultural/ irrigation advisory services, marketing and post-harvest assets and services, and capacity building.

Environment

15. Direct Bank involvement in the environment sector is currently limited to the Mulanje Mountain Biodiversity Conservation Project (US$7 million), which was approved in FY01. The Project aims to raise awareness of the need for conservation, strengthen the capacity of the Forest Department and local communities to carry out conservation measures, and

encourage more participation by local communities in managing the forest reserve. In addition, especially within the framework of MASAF, environmentally-sound community development initiatives are promoted and community resource management projects are funded.

Poverty Monitoring

16. The Bank is supporting the National Statistical Office with one aspect of the poverty monitoring tasks identified in the PRSP as requiring technical assistance. Through the PRSP Trust Fund, the Bank assisted the government in conducting the Second Integrated Household Survey, including design, collection, processing, and dissemination of data covering not only household characteristics, but also community level indicators. A Poverty Assessment is planned for FY06, and will provide an in-depth analysis of the new household data.

D. Areas Where the Bank and the Fund Share the Lead

Poverty Reduction Strategy

17. The Government of Malawi finalized its Poverty Reduction Strategy Paper (PRSP) in April 2002. A joint IDA-IMF staff assessment was presented to the Boards of IMF and the Bank on July 19, 2002 and the strategy was endorsed by the Boards of the IMF and the World Bank in August 2002. The IMF and the Bank staff maintained collaborative relationship in supporting the government in the process. The first Annual Progress Report (APR) was approved by the Boards in October 2003 and indicates that MPRSP implementation was limited. The second APR and Joint Staff Assessment Note (JSAN) for the period July 2003-June 2004 was submitted to the Boards in July 2005, and also indicates that MPRSP implementation has been limited. The third APR (looking at the period July 2004-June 2005) is expected in the early 2006.

Debt Sustainability and Enhanced Heavily Indebted Poor Country (HIPC) Initiative

18. Staff of the IMF and the Bank prepared "Malawi: Decision Point Document for the Enhanced Heavily Indebted Poor Countries (HIPC) Initiative" which was presented to the Board on December 8, 2000. The total amount of debt relief assistance to Malawi is equivalent to around $1.0 billion in nominal terms (US$643 million in NPV terms). Debt relief will be delivered between January 2001 and December 2020 by providing 55 percent relief on annual debt service due. IDA is the largest creditor to Malawi, accounting for 51 percent of the entire external debt (and 69 percent of multilateral debt).

Budgetary Planning, Revenues Administration, and Public Expenditure Reforms

19. The Bank's assistance in improvement in public expenditure management has been channeled mainly via its structural adjustment credits. The most recent one, the Fiscal Management and Accelerating Growth (FIMAG, US$50 million) structural adjustment credit, was approved by the Board, and the first tranche of US$25 million was released in

September 2004. The FIMAG program focuses on four areas: (i) strengthening public expenditure management, (ii) privatizing state-owned enterprises, (iii) small-holder agriculture and land reform, and (iv) HIV/AIDS. All first tranche conditions (for Board presentation) have been met.

20. The Financial Management, Transparency and Accountability Project (FIMTAP, US$24 million, FY03) is also assisting the Government with improving financial management systems and increase their transparency. The main objectives are to build the capacity of Malawi's public servants in the areas of accounting, auditing, and other areas of managing public finance, and to introduce the use of the IFMIS computerized financial management system.

Civil Service and Wage Reform

21. Following the World Bank's financed study on review of civil service and wage policy issues, the Government has begun implementation of the recommendations of the study at the end of 2004. These include: streamlining the system of allowances; consolidating them in the base for personal income tax; rationalizing salary grades; and moving towards a unified salary structure. These reforms are also supported under the IMF Staff Monitored Program.

Emergency Assistance

22. In addition to technical assistance and reallocation from existing uncommitted funds as appropriate, an Emergency Recovery Project was approved in September 2005, to support the restoration of assets and production following the drought-induced emergency in early 2005, and thus supporting the growth path central to the macroeconomic program adopted by the new administration since May 2004. This emergency grant will provide funds to allow critical private sector imports for the restoration of assets, investment and production to take place with the least disruption to the economy.

E. Areas in Which the Fund Leads

Macroeconomic Stability, Fiscal Policy, and Monetary Policy

23. Malawi is confronted with a number of macroeconomic challenges, including a history of repeated fiscal slippages and unpredictable monetary policies, a rapidly rising level of domestic debt, and a persistently high level of real interest rates. The Fund will work with the authorities to master these challenges, both through financial support and technical assistance, to make steady progress.

MALAWI: Statistical Issues

1. Malawi's economic statistics show serious deficiencies that have affected program monitoring. A Report on the Observance of Standards and Codes (ROSC) Data Module, published in February 2005, found that, while the legal and institutional framework for the production of macroeconomic statistics was broadly adequate, there are shortcomings in the scope, accuracy, and reliability of data as well as scope for strengthening the provisions of the Statistics Act. There is a need to formally assign the responsibility for the compilation of government finance statistics to the Ministry of Finance, and responsibility for the compilation of monetary statistics to the Reserve Bank of Malawi. The authorities are making efforts to improve the quality and timeliness of the statistical data through participation in the GDDS. Malawi's metadata have been posted on the Fund's Dissemination Standards Bulletin Board (DSBB) since December 2002. Metadata for the fiscal sector and socio-demographic data for health and education were updated in March 2004, and other sectors in February 2005. Malawi is receiving technical assistance under the project for Anglophone African countries sponsored by DFID.

F. Real Sector Statistics

2. Real sector statistics covering the national accounts, prices, and trade statistics need substantial improvements. Only a limited set of source data is available, and quality and timeliness should be improved. The National Statistics Office (NSO) needs additional resources to meet, in particular, the required quality standard of national accounts.

National accounts

3. The NSO is responsible for compiling the national accounts data. However, while the final estimates are comprehensive,[1] the source data underpinning these estimates are inadequate, due to gaps in coverage, especially for medium- and small-scale establishments, and informal sector activities. Use is not made of relevant surveys and financial statements to prepare estimates of changes in inventories and household final consumption expenditures. Statistical techniques for compilation are deficient, and processes to assess and validate source, intermediate, and final data are generally limited. The national accounts are published in Malawi's *Statistical Yearbook* and *Quarterly Statistical Bulletin* with a significant time lag.

Prices

4. A consumer price index (CPI) is available on a timely basis. The CPI is based on the 1997/98 household survey results, and data are collected on a monthly basis by regional price

[1] Covering GDP from the production side at constant prices, GDP by expenditure at current prices, gross national income and its components, national disposable income and use of disposable income, and the capital and the financial account.

collectors. The effectiveness of the index could be improved by using the geometric mean as the elementary aggregate index formula and by applying systematic, comprehensive, and consistent approaches to the quality adjustment of product prices.

Trade

5. Preliminary estimates of trade are now available with a lag of two to three months. Trade data are received electronically from six major ports. The adjustment of imports from c.i.f. to f.o.b. prices is not appropriate and there is no reconciliation with neighboring countries.

G. Government Finance Statistics

6. Malawi reports some fiscal data on a cash basis to AFR. Although administrative records are kept on a manual basis, the systems are designed to provide adequate information. However, there are serious quality problems, including data inconsistencies, that complicate program monitoring:

- While **tax revenue data** are received in a timely fashion, it is not always possible to reconcile them with deposits in the MG Account No. 1.

- **Nontax revenue** collected by line ministries is not properly accounted for in the fiscal reports prepared by the Ministry of Finance. It also includes capital revenue.

- Data on **recurrent expenditure** suffer from serious shortcomings partly related to insufficient bank reconciliation at the level of line ministries (between spending records and financing information). The fiscal reports prepared by the Ministry of Finance show spending based on funding data (from the Credit Ceiling Authority). Line ministries subsequently submit spending reports to the Ministry of Finance based on recorded expenditure. At times there are sizable discrepancies between these two sources of data for both wages and other recurrent transactions—to some extent reflecting the widespread practice of reallocation across budget lines.

- Domestically-financed **development expenditure** is based on funding released to line ministries, and data on externally-funded expenditure are based on reported project grants and loans. Owing to differences in timing and financing modalities (e.g., some donors require prefinancing of expenditure before reimbursement), there are substantial differences between the flow of expenditure and corresponding financing data. Thus, there are substantial errors in the reporting of expenditure. Also, many donor projects are still not incorporated in the budget, and hence the corresponding expenditure is not captured. Some externally funded development expenditures are likely recurrent and, thus, the reporting of capital expenditure is erroneous.

- Data on **expenditure arrears** are likely incomplete, as reporting from the Commitment Control System appears to be only partial, and ministry level data are not consistent from report to report. Previously unknown arrears have repeatedly been cleared through the "special activities" vote, thus calling into question the accuracy of arrears data and the data on clearances.

- The **budget classification and chart of accounts** may be adequate for some administrative, economic, functional and program classifications. An output-oriented activities-based budget classification (ABB) is used for the presentation of the budget. However, **pro-poor expenditures** that are protected in line with the PRSP are only identified in the ABB classification. As no bridge table exists to maps the ABB classification into the program classification used for expenditure reporting and accounting, pro-poor expenditures cannot be monitored.

- **Financing estimates** are based on monetary and debt data, rather than on government records of financing. Reporting on treasury bills directly issued to the RBM at times has been slow.

7. The authorities have received significant technical assistance from the Fund and other donors to strengthen expenditure monitoring and reporting, accounting, and statistical reporting, but results have been disappointing. The new government has pledged to strengthen public financial management and fiscal reporting, and renewed efforts are being made to establish a work plan, including effectively utilizing donor technical assistance.

8. Malawi does not report government finance data for inclusion in the *Government Finance Statistics Yearbook (GFSY)* or the *International Financial Statistics (IFS)*. A STA mission visited Lilongwe in August 2005 to review progress on major issues raised during the preceding three GDDS fiscal sector missions. The mission reiterated the importance of continued efforts to implement an Integrated Financial Management Information System (IFMIS), to improve the coverage and sectorization of government financial operations and to correctly classify transactions according to international guidelines. Although the mission assisted the authorities with the compilation of annual fiscal data for 2003/04 in accordance with the *GFSY* Questionnaire, such data have yet to be reported for inclusion in the publication. The mission proposed, and discussed with the authorities, a migration plan and timetable to adopt the *GFSM 2001* methodology.

H. Monetary and Financial Statistics

9. The Reserve Bank of Malawi (RBM) reports monetary and financial statistics (MFS) to STA on a regular basis.

10. The MFS mission that took place in April-May 2004 noted that significant progress was achieved in implementing the recommendations made by the MFS mission conducted in August-September 2002. One of the most notable achievements was the improved coverage

of monthly monetary survey that now accounts for more than 90 percent of the banking sector. On the other hand, the mission also noted that some important recommendations were yet to be implemented, such as the sectorization of the domestic economy, and classification of financial instruments to ensure that the MFS of the RBM adhere fully to the methodology of the *Monetary and Financial Statistics Manual*.

11. Concurrently, the mission completed development of an integrated database that will be used by the RBM, STA, and AFR for publication and operational needs. The mission also discussed the standardized forms (SRF) that will be adopted in the near future by all countries for reporting monetary data to STA. The RBM is examining the SRF with a view to reporting monetary data to the IMF using the SRF as soon as feasible.

I. External Sector Statistics

12. Concepts and definitions used to compile the balance of payments statistics are in broad conformity with the guidelines presented in the fourth edition of the *Balance of Payments Manual* (*BPM4)*. The NSO has made progress made in the transition to the methodology of *BPM5*. The most recent data reported to STA for publication in the *Balance of Payments Statistics Yearbook* pertains to 2002. Mainly as a result of the liberalization of exchange controls, the compilation of data relies on balance of payments surveys as the source of information for major components in the balance of payments, such as services, direct investment flows, and other financial transactions of the private sector. Data from primary sources (surveys and/or ITRS reports) are supplemented with information from secondary data sources, such as foreign trade statistics collected by the MRA through customs declarations, debt statistics from the MOF, net foreign assets from the RBM, and information on grants collected from main donors.

Malawi: Table of Common Indicators Required for Surveillance
(As of January 15, 2006)

	Date of latest observation	Date received	Frequency of Data[6]	Frequency of Reporting[6]	Frequency of Publication[6]	Memo Items: Data Quality – Methodological soundness[7]	Memo Items: Data Quality – Accuracy and reliability[8]
Exchange Rates	01/06	01/06	D	W	M		
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	12/05	01/06	M	M	M		
Reserve/Base Money	12/05	01/06	D	W	M	LO, LO, LO, LO	LO, O, O, O, O
Broad Money	11/05	12/05	M	M	M		
Central Bank Balance Sheet	12/05	01/06	W	W	Q		
Consolidated Balance Sheet of the Banking System	11/05	12/05	M	M	M		
Interest Rates[2]	11/05	12/06	W	W	W		
Consumer Price Index	11/05	12/06	M	M	M	O, LO, O, O	LO, LO, LNO, LO, LO
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	NA	NA	NA	NA	NA	LO, LNO, LNO, LO	LNO, O, LO, O, LO
Revenue, Expenditure, Balance and Composition of Financing[3] – Central Government	11/05	12/05	M	M	I		
Stocks of Central Government and Central Government-Guaranteed Debt[5]	12/03	07/04	M	NA	NA		
External Current Account Balance	11/04	04/05	A	Q	A	LO, LO, LNO, LO	LNO, LNO, LO, LO, LO
Exports and Imports of Goods and Services	11/04	04/05	M	Q	A		
GDP/GNP	2004	10/05	A	A	A	LO, LO, LNO, LO	LNO, LNO, LNO, LO, LO
Gross External Debt	12/03	07/04	M	NA	NA		

[1] Includes reserve assets pledged or otherwise encumbered as well as net derivative positions.
[2] Both market-based and officially-determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.
[3] Foreign, domestic bank, and domestic nonbank financing.
[4] The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments.
[5] Including currency and maturity composition.
[6] Daily (D); weekly (W); monthly (M); quarterly (Q); annually (A); irregular (I); and not available (NA).
[7] Reflects the assessment provided in the data ROSC or the Substantive Update (published February 17, 2005, and based on the findings of the mission that took place during September 1–16, 2003) for the dataset corresponding to the variable in each row. The assessment indicates whether international standards concerning concepts and definitions, scope, classification/sectorization, and basis for recording are fully observed (O); largely observed (LO); largely not observed (LNO); not observed (NO); and not available (NA).
[8] Same as footnote 7, except referring to international standards concerning source data, statistical techniques, assessment and validation of source data, assessment, and revision studies.

MALAWI: HIPC COMPLETION POINT TRIGGERS UPDATE – DECEMBER 2005[1]

Malawi reached the decision point in December 2000. The total amount of debt relief assistance to Malawi is equivalent to around $1.0 billion in nominal terms (US$643 million in NPV terms). The debt relief will become irrevocable only after Malawi reaches the completion point. Prior to that time, Malawi is receiving interim relief.

The completion point can be reached if Malawi achieves:

(i) **Satisfactory macroeconomic performance (as demonstrated by a minimum 6-months track-record under a new PRGF):** A new PRGF was approved in August 2005 and has targets starting from end-June 2005. Therefore, a six-month track record could be assessed based on performance through end-December 2005. However, given the need to have comprehensive data, this will only be possible during an IMF mission planned for February 2006.

(ii) **One-year satisfactory MPRSP implementation:** The full MPRSP was completed in April 2002 (and endorsed by the Boards in August 2002). The first Annual Progress Report was approved by the Boards in October 2003 indicates that MPRSP implementation was limited. The second APR and JSAN (looking at the period July 2003-June 2004) was submitted to the Boards in June-2005 and again indicates that MPRSP implementation has been limited. The third APR (looking at the period July 2004 - December 2005) is expected in early 2006. Thus satisfactory one-year implementation of PRSP could be met at the earliest in early 2006, following preparation of the relevant JSAN.

(iii) **Satisfactory implementation of other outstanding completion point triggers** (see details in the next two pages): Substantial progress has been made towards meeting the other completion point triggers. However, five triggers remain outstanding. Government is currently taking measures to meet these. A comprehensive review of all the triggers is planned for February 2006.

[1] Prepared by the World Bank.

A. Completion Point Triggers Still Outstanding		
Area and specific triggers	**Status**	**Proposed Next Steps**
Safety nets • A rationalization and prioritization of existing and new programs, under the National Safety Net Strategy.	• **Ongoing.** National Safety Nets Program was approved by cabinet in February 2002. Safety nets unit (NSU) was created but not yet able to coordinate safety nets programs. Inception phase with DfID assistance made little progress to strengthen the unit, and formulation of new social protection policy ongoing;	**GOM** – steering committee & technical committee of safety nets programs to rationalize and prioritize existing safety net programs. The output should feed into the MGDS
• Establishment of a monitoring and evaluation of the National Safety Net Strategy	• **Ongoing.** Monitoring and evaluation of some individual projects is carried out, but evaluation of overall policy has not started.	**GOM** –MEPD/NSU to develop an M&E system to be used for monitoring implementation of the rationalized and prioritized programs
Health • Completion of 'phase one' reforms of the Central Medical Stores (CMS): -Reviewing the essential drugs list on the basis of vital health needs **(done)** -Preliminary work supporting the creation of the CMS as a Trust **(some work done in the past but to be completed when management contractor is on board)** -The development of information systems to monitor compliance with agreed policies and financial allocations **(some work done in the past but to be completed when management contractor is on board)**	• **Ongoing.** The SWAP members are funding the reforms and are working closely with the MOH. A management contractor is about to be recruited to among other things, carry out the necessary reforms at CMS . The team is expected to start work in February-March, 2006.	**GOM** - MOF to closely monitor situation and ensure that there are no slip ups in the procurement process of the management contractor and to ensure that the management contractor focuses on finalizing preparatory work required for reforming the CMS
Education • Yearly enrolment of 6000 students for teacher training and institution of in-service training for primary teachers (at least once each year). - Yearly enrolment of 6000 students for teacher training	• **Will not be met.** Only about 2,850 teachers graduated in 2001/02 and 3,150 teachers in 2002/03, and approximately 3,000 in 2003/04. 5,668 graduated in 2004/05 but only because government introduced two six-month crush programs	**GOM** – Ministry of Education to put together proposals on how the government intends to address the problem of low teacher levels
-Institution of in-service training for primary teachers (at least once each year).	• **Not met.** Information obtained from Ministry of Education suggests that nothing has been done on the second component (institution of INSERT) even though funding from DFID is available for it	**GOM** – Ministry of Education to organize INSERTs in the next coming months
Land Policy • Submission of draft Land Law to parliament.	• **On track to be met.** Land policy adopted by cabinet in January 2003; submission of Land Law to Parliament expected in early 2006.	**GOM** – Ministry of Finance to ensure that there are no slip ups in preparing the bill to be presented in parliament and also that the spirit of the trigger is maintained

B. Completion point triggers already met	
Area and specific triggers	**Remarks**
Public expenditure 32. Quarterly expenditure reporting as per format jointly developed by MOF/IDA. 33. Implement IFMIS in four pilot ministries. 1.	34. **Met.** Format agreed. Pro-poor expenditures are published on the government web site. 35. **Met.** IFMIS started operating on 1st November 2005. The electronic version is being implemented in four ministries while the manual version is being implemented in all the other ministries
Safety nets 36. Transform universal starter-pack distribution into a Targeted Input Program (TIP) for 2001/02	• **Met.** TIP was implemented in 2001/02 and then discontinued in 2004/05. Government is now implementing a targeted fertilizer price subsidy program
Micro finance 37. Approval by Cabinet of the 'Micro-finance Policy'. 38. Increase number of micro-finance clients by 20%. 39. Establishment of a monitoring system covering all micro-finance institutions.	40. **Met.** Policy approved at end-October 2002. 41. **Met.** Actual statistic to be released in December 2005. 42. **Met.** A system was put in place by the microfinance institutions (with government involvement). A consultant is now being engaged to improve the system
Governance • Separation of fiscal management and audit functions under new legislation.	• **Met.** New Audit Act and Financial Management Act have been approved by Parliament in May 2003. The Procurement Act has also been passed in May 2003
Health • Share of health expenditure of at least 13% of discretionary recurrent budget • Recruitment, training and deployment of at least 200 hundred nurse technicians, 50 new medical assistants and 20 radiography technicians per annum. • Budget for drugs and medical supplies in line with BHA standard (US$1.25 per capita).	• **Met.** Share in 2005/06 is 19.6% • **Met.** Currently training over 500 nurses technicians; 130 medical assistants and 20 radiography technicians, respectively. • **Met.** Drugs budget at $1.44 and $1.23 in 2001/02 and 2002/03 respectively, broadly in line with BHA standard.
HIV/AIDS: Implementation of National Aids Strategy. • Fully staffed, functional and autonomous National AIDS Control Secretariat. • 75% of all condom outlet points with condoms in stock at any given time. • Continuous availability of testing kits at all blood transfusion sites by increasing blood testing kits from 1500 to 2500. • Implementation of an effective Behavior Change Communication Strategy. • Syndromic Management of sexually transmitted infections (STI) in all Central, District and major CHAM hospitals.	• **Met.** National AIDS Secretariat has been operational since end-2001. Need for additional staffing to enhance NAC' coordination effectiveness. • **Met.** 80% availability in grocery shops, and 65 percent availability in public hospitals. (Difficult to verify) • **Met.** More than 3000 testing kits have been supplied by end-2003. • **Met**. Implementation of communication strategy has started. • **Met.**

Area and specific triggers	Remarks
Education	
• Share of education sector expenditure in discretionary recurrent budget of at least 23%	• **Met.** Share in 2005/06 is 24.4%, excluding funds transferred directly to the assemblies (whose amount is yet to be established)
• Pre-packaging of donor-supplied primary textbooks for each school and direct supply from the supplier to the schools.	• **Met.** Donor-supplied textbooks are pre-packed and directly supplied.
• Reallocate budgetary resources from secondary school boarding to teaching and learning materials.	• **Met.** Treasury stopped subsidizing boarding related operational expenses for secondary schools in 2000/01. Students are now required to pay boarding fees to cover recurrent expenses. The findings of the 2005 education sector public expenditure review are that cost recovery in boarding schools has improved even though boarding fees remain very low. The review also finds that there has been an increase in resources allocated to teaching and learning materials

INTERNATIONAL MONETARY FUND
EXTERNAL RELATIONS DEPARTMENT

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International Monetary Fund
Washington, D.C. 20431 USA

IMF Executive Board Completes First Review of Malawi's Three-Year PRGF Arrangement and Approves US$7.1 Million Disbursement

The Executive Board of the International Monetary Fund (IMF) completed today the first review of Malawi's economic performance under a three-year Poverty Reduction and Growth Facility (PRGF) arrangement. This enables Malawi to draw an amount equivalent to SDR 4.9 million (about US$7.1 million).

The Executive Board approved the three-year arrangement on August 5, 2005 (see Press Release No. 05/188), for a total amount of SDR 38.2 million (about US$54.9 million) to support the government's economic program for 2005-2007.

In commenting on the Executive Board's discussion on Malawi, Mr. Takatoshi Kato, Deputy Managing Director and Acting Chair, stated:

"The Malawian authorities are to be commended for the satisfactory performance under the PRGF-supported program against the backdrop of a severe food crisis. This builds on the success of the staff-monitored program and represents a welcome break from previous episodes of recurrent fiscal slippages. Performance in some areas had, however, remained uneven. In particular, the overvaluation of the exchange rate had put pressure on external reserves and had led to a persistent backlog of unpaid import invoices. In this respect, the Fund welcomes the more flexible exchange rate policy implemented recently by the authorities, as well as their commitment to avoid an overvaluation of the currency, phase out informal administrative restrictions and eliminate delays in import payments. The authorities' commitment to sustain a tighter domestic policy stance will also be of critical importance.

"The authorities' program is based on realistic fiscal objectives and they are to be commended for observing the budget limits and improving public expenditure management. In light of the food crisis, the emphasis in the budget on food security in the near term is appropriate, and the government's efforts, in cooperation with donors, to contain the food emergency deserves to be supported. Going forward, it will remain important to manage near-term risks to the budget carefully.

"Malawi could reach the completion point under the HIPC Initiative in mid-2006 provided further progress is made towards implementing the remaining triggers and the authorities remain committed to maintaining a more flexible exchange rate system free from administrative restrictions. A final assessment of progress towards completing key social sector triggers will also be critical. Reaching the HIPC completion point would immediately allow Malawi to qualify for further debt relief under the Multilateral Debt Relief Initiative," Mr. Kato said.

The PRGF is the IMF's concessional facility for low-income countries. PRGF-supported programs are based on country-owned poverty reduction strategies adopted in a participatory process involving civil society and development partners and articulated in the Poverty Reduction Strategy Paper (PRSP). This is intended to ensure that PRGF-supported programs are consistent with a comprehensive framework for macroeconomic, structural, and social policies to foster growth and reduce poverty. PRGF loans carry an annual interest rate of 0.5 percent and are repayable over 10 years with a 5½-year grace period on principal payments.

Statement by Peter Ngumbullu, Executive Director for Malawi
and Joseph Masawe, Senior Advisor to Executive Director
February 24, 2006

Introduction

1. The Malawian authorities express their appreciation to staff for a well balanced report on the first review of the PRGF program. The report provides helpful insights on the economy and valuable policy advice. The authorities also thank Fund Management and the Executive Board for their continued support and have reiterated that their medium term macroeconomic strategy will continue to be guided by the principles laid down in their Memorandum of Economic and Financial Policies (MEFP) of July 2005. Reducing poverty, through private sector led growth, remains the overarching medium term objective for the authorities. In this regard, they have emphasized their continued commitment to pursue sustained efforts in maintaining macroeconomic stability and step up implementation of structural reforms in key areas of the economy. They welcome the Fund's extensive interaction with other stakeholders in the economy, including the donor community and the private sector.

Recent macroeconomic developments

2. Over the review period, development of economic activity remained broadly as programmed. It is estimated that during 2005, real GDP growth of about 5 percent was attained and an inflation rate of 11 percent, despite last year's severe food shortages which exerted pressure on a number of key macroeconomic variables. The authorities declared the food crisis situation a national disaster and expanded food security operations throughout the country. They would like to thank all donors who came forward with generous contributions to assist the country cope with the calamity. During 2006, GDP is expected to remain strong, while inflation is projected to decline significantly as food prices recover from the drought experienced last year.

3. Fiscal performance for the three months ending September 2005 was better than programmed despite delays in donor disbursements, with performance in tax and non-tax revenues compensating for the delayed donor assistance. Nonetheless, due to stronger than projected value of the Kwacha and also higher value of the U.S Dollar against other donor currencies, the value of budgetary assistance was in Kwacha terms lower than projected. It is, however, expected that for the last quarter of the year, total domestic borrowing by the government will be in line with the program targets.

Performance under the Program

4. All quantitative and structural performance criteria for end- September 2005 were met, and all indicative targets were also met, except the structural benchmark on the wage adjustment, which was implemented on December 1, 2005. The minor delay was experienced due to difficulties in the procurement of consultancy services. However, exogenous shocks, including weaker tobacco export receipts and higher oil import bill, put pressures in the

foreign exchange market. As a result, the net foreign assets target of the Reserve Bank of Malawi (RBM) for the fiscal year is unlikely to be met. Similarly, gross official reserves for June 2006 are expected to reach the equivalent of only 1.5 months of next year's projected imports, below the targeted level of 1.8 months. In this connection, the authorities continued to take measures to ensure that the exchange rate of the Kwacha represents developments in the economy. During the first half of 2005, the exchange rate depreciated by 13 percent, but there remains considerable demand pressures in the market, resulting in substantial decline of the official reserves.

5. The authorities would like to underscore the fact that the food crisis has resulted in balance of payment shocks, which required them to take appropriate measures to avoid widespread famine. While the limited supply of foreign exchange forced them to be discriminatory in meeting foreign exchange demands, they did not institute any exchange restrictions on current account transactions. In this connection, priority has been given to cereal imports to prevent further deterioration in the food shortage. Regrettably, this has resulted in a backlog of unmet foreign exchange applications.

6. It should be noted that the humanitarian impact of the food crisis has exceeded by far the estimates that were made, requiring the government to increase food distribution to those affected representing 40 percent of the population. The food imports were in excess of the projections that formed the basis of the foreign exchange budget, which was already under pressure from continued high oil prices and disappointing earnings from agricultural export crops due to poor weather. The authorities would like to reaffirm that they plan to reduce and eventually eliminate the backlog of unmet applications for foreign exchange, as resources become available. Also, as soon as the need to finance additional food imports eases, they are ready to increase sales of foreign exchange to the market, while still remaining cognizant of the importance of meeting agreed targets for the foreign reserve path in the PRGF program. It is expected that the opening of the tobacco auctions in April this year will generate additional foreign exchange inflows to commercial banks, thus enhancing the process to regularize foreign exchange operations. The authorities welcome the opportunity to further discuss with the Fund staff on the appropriate framework to the management of the exchange rate, under the given circumstances, during the forthcoming PRGF review mission.

Macroeconomic Policies for 2006 and Medium-Term Outlook

7. The authorities will continue to implement prudent policies to achieve the macroeconomic objectives set out in the fiscal program for the year, and the medium term strategy will continue to be guided by the MEFP of July 2005. The new Malawi Growth and Development Strategy (MDGDS), which was prepared through extensive involvement of the public and other stakeholders, will pave the way forward through updating the Malawi Poverty Reduction Strategy (MPRS) of 2002.

Fiscal Policy

8. Fiscal policy will, among other objectives, seek to support the structural reform measures, through cost reduction measures of government operations. The authorities are

strengthening implementation of the Public Procurement and the Public Finance Management Acts, which will include plugging all loopholes contributing to high government expenditure, including official travel and use of government vehicles and other services. In this context, the government has also closed a total of 17 foreign missions to reduce costs. Measures have also been undertaken to prevent ministries from incurring arrears, especially on utility expenses and reduce over-compensation of employees and various other expenditures.

9. The good progress attained so far in public expenditure management will be consolidated, including full implementation of IFMIS. This will include the set up of a GFS and the ceiling modules of the Reserve Bank of Malawi (RBM) with assistance from the Fund, to facilitate better tracking and control of government expenditure. In addition, the government has implemented the main recommendations of the general review report of tax policies and tax administration and expects that these measures will make the economy more competitive. The VAT and corporate tax systems have been improved and administrative reforms of the Malawi Revenue Authority (MRA) are being implemented.

Monetary and Financial Sector Policies

10. Monetary policy will continue to be directed towards the primary goal of maintaining price stability. In this regard, the RBM will strengthen its domestic as well as foreign markets operations, which are key in the implementation of monetary policy. The current monetary framework, which is based on targeting reserve money will be further improved. Interest rates will continue to be market determined, and flexibility in the exchange rate of the Kwacha will be maintained. In this context, intervention in the foreign exchange market by the RBM will continue to be limited to smoothening transitory overshooting of the Kwacha, to maintain market stability and predictability. The authorities remain committed to the obligations of Article VIII and will refrain from any administrative restrictions on international payments and transfers related to current account transactions.

11. The authorities recognize that real interest rates are very high and the spreads significant. The current high intermediation costs related to credit risks and the high reserves requirements have partly contributed to this. While recognizing that lowering of interest rates can be justified only if there is a decline in the inflation rate, the authorities are determined to take measures to reduce financial intermediation costs, improve competition in the banking sector, address structural rigidities and also reduce reserve requirements. These measures will be implemented without prejudice to the primary objective of maintaining price stability. They will also continue to implement measures to strengthen the banking system, including improving banking supervision and strengthening the safeguards framework with the RBM.

Structural measures

12. The authorities continue to implement structural measures, with the objective of reducing costs of doing business and improving efficiency of the economy. They have privatized the Malawi Telecommunications Ltd (MTL) and expect to use part of the proceeds to cover the costs of staff retrenchment and repayment of debt accumulated by the company.

The government will continue to maintain transparency in the privatization process and use of the proceeds, as required by the law. The second stage of pension reforms continues to be implemented, with assistance from the Fund.

13. The government has established the Malawi Rural Development Fund (MARDEF), which is expected to provide affordable credit to the rural poor. As emphasized in the authorities' supplement to the MEFP, the scheme will, however, be implemented only after the government is fully satisfied that there is adequate oversight. The authorities are committed to ensuring that the scheme is self financing, and will be reviewed quarterly to ensure that it does not impose a burden on the budget. They also wish to emphasize that they do not envisage any need for government subsidy of the MARDEF operations.

Reaching the HIPC Completion Point

14. Reaching the HIPC completion point and qualifying for the MDRI this year would be important for the country, as this would help secure more resources for poverty reduction interventions and the attainment of the MDGs. The authorities are determined to ensure that they establish a track record of good performance, so that the HIPC Completion point is reached by mid-2006.

Conclusion

15. The Malawian authorities remain committed to the successful implementation of the economic reform agenda. The implementation of the PRGF supported program for the review period has been in line with set objectives and targets. Despite a number of exogenous shocks which impacted negatively on the program, including the need for additional spending to address food shortage, and higher cost imposed by high oil prices, the program remained on track. Going forward, the authorities will continue to take measures to ensure the success of the program, poverty reduction through private sector led growth remaining the major objective of government's medium term policy, and hence maintenance of macroeconomic stability. Fiscal policy will remain supportive of the structural reform agenda, while ensuring that revenue is enhanced and expenditure is streamlined and consolidated. They will ensure that inflation is further brought down and the financial system becomes more supportive to economic activity, through implementation of measures to strengthen and deepen the financial and banking sector.

16. The authorities are working hard and look forward to achieve the required triggers for reaching the HIPC Completion point mid-this year; and hope that they can continue to count on the support of the Fund and the international community in meeting the daunting challenges facing the country. On the basis of the performance during the period under review and measures to be implemented during the remaining period of the fiscal year, they request the completion of the first review under PRGF arrangement.