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Malawi: Joint Staff Advisory Note of the Poverty Reduction Strategy Paper

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MALAWI

Joint Staff Advisory Note on the
Second Malawi Growth and Development Strategy (MGDS II) 2011–16

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and the International Monetary Fund

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I. OVERVIEW

1. The Second Malawi Growth and Development Strategy (MGDS II) 2011–16, which is the country's second medium-term plan, was finalized and approved by the Cabinet in April 2012. The MGDS II was thereafter submitted to the International Development Association (IDA) and the International Monetary Fund (IMF), in the context of preparation of the World Bank Country Assistance Strategy 2011/12–2015/16 and the authorities' request for a new arrangement under the Extended Credit Facility.

2. **The MGDS II is a medium-term strategy designed to implement Malawi's long-term aspirations as spelt out in its Vision 2020. It strives to foster more inclusive job creating growth to address unemployment and reduce poverty**. The strategy reflects a general consensus on the country's broad goals for growth, social equity, and governance. More specifically, the strategy recognizes that in order for all Malawians to benefit equitably from economic growth, concerted efforts to promote human and social development need to be complemented with efforts to improve labour productivity and structural transformation leading to economic diversification.

3. **The MGDS I and II share the same objectives, but MGDS II has six broad thematic areas, instead of five as in MGDS I**, **which are geared towards supporting the achievement of its objectives**. These include Sustainable Economic Growth; Social Development; Social Support and Disaster Risk Management; Infrastructure Development; Improved Governance; and Cross-Cutting Issues. The inclusion of a Cross Cutting thematic area covering issues of gender, capacity development, population, decent employment,

productive activities, economic and democratic governance makes cross cutting issues more prominent and raises the possibility of improved implementation when compared to the MGDS I. The Bank's Africa Regional Strategy is also aligned to MGDS II based on its two broad pillars of competitiveness and employment, and vulnerability and resilience, which are underpinned by governance and public sector capacity.

4. **Much has changed since the process of drafting the MGDS II was initiated in September 2010.** Staffs therefore welcome the government's willingness to make necessary adjustments to the MGDS II during the course of its implementation in the light of changing economic and social conditions and international developments. Under MGDS I, especially during the period 2007–10, Malawi registered high rates of economic growth spurred by strong stabilization policies since 2004, debt relief from the HIPC/MDRI initiatives and supportive donor environment. This created the fiscal space needed to increase social spending and investment in infrastructure and finance a large increase in consumption. Annual real GDP averaged around 7.1 percent during the period 2004–10, from an average of 2 percent a decade earlier, driven by agricultural exports (largely tobacco). Despite this, the country's poverty rates remain high and the country's socio-economic gains are threatened by the slowdown in growth resulting from the macroeconomic instability in the past twelve months.

5. **Overall, the staffs find that the MGDS II presents a clear analysis of the many challenges facing the country.** But there is need for further prioritization and sequencing of proposed actions and interventions in view of limited resources. The emphasis on productivity and economic diversification, especially in agriculture is appropriate. Priority should be given to measures to restore macroeconomic stability and regain control over the management of the economy for these medium-term objectives to be achieved.

6. **Staffs acknowledge the inclusive process by which the document was developed.** Like its predecessor, all levels of society, including women, the youth and children, private sector, civil society and development partners were all involved in the development of the MGDS II and the process was well integrated with the existing processes of the Government led by the Sector Working Groups. This JSAN therefore provides advice on key priorities for strengthening the MGDS II and promoting its effective implementation.

A. Lessons Learned from MGDS I

7. **The Strategy recognizes some of the shortcomings realized during the implementation of the MGDS I.** While the MGDS I was generally an effective instrument for achieving the country's developmental goals, its focus on poverty reduction and employment creation was rather weak and little progress has been made in addressing these challenges. Based on lessons learnt, the MGDS II has therefore made employment creation and gender issues more visible and an attempt has been made through the public spending composition in the MGDS II to achieve better balance between growth-oriented and pro-poor

spending. However the proposed budget lacks realism and needs further prioritization to ensure long-term fiscal sustainability. The MGDS II also pays particular attention to the need to diversify the economy, improve governance and promote development of human capital.

8. **The MGDS I suffered from a weak monitoring and evaluation (M&E) system which was rather fragmented and the measurability of performance outcomes was further complicated by poor baseline data.** The MGDS II recognizes the importance of having a strong indicator framework and has provided more information in many of the indicators, although the framework still needs to be improved in terms of the quality of the indicators and its linkages to other sectoral M&E frameworks. On resource envelope, the MGDS I presented a disjointed picture between the MGDS priorities and the actual amount of resources that were brought to operationalize the priorities. This element is still not adequately addressed in the MGDS II as it is unclear if the budgetary estimates presented in Annex 3 are based on robust analysis of the costs of each programme/theme. Without a serious consideration and resolution of these issues, the MGDS II could remain aspirational, rather than a planning or strategy document fit for implementation.

II. POVERTY DIAGNOSTICS

9. **The assessment of the poverty challenge in the MGDS II is too optimistic to inform the government's medium-term poverty reduction agenda.** The MGDS II states that population living below the poverty line has gone down from 52 percent to 39 percent between 2004 and 2009, but this trend estimate is actually a poverty projection based on the 2009 Welfare Monitoring Survey and is not directly comparable with the last direct measure of the poverty headcount computed from the 2004/5 IHS2 household survey. An accurate trend estimate needs to be computed from the 2010/11 IHS3 survey. Preliminary, unpublished analyses of these data present a bleaker picture, with no major changes in poverty over the 2004/5–2010/11 period. These trends will be confirmed and published once the temporal price adjustments needed to compare poverty figures over time have been completed. On inequality, findings indicate that consumption inequality in Malawi (Gini coefficient) has risen sharply from 0.39 to 0.44, mostly in rural areas. These results indicate the need for monitoring not only aggregate growth, but the distribution of its benefits.

10. **Pro-poor public spending has shown mixed results.** The MGDS II recognizes that despite achievements in food security, there are still pockets of households that are ultra poor and in need of social support. As such, it is more focused in terms of the kinds of social protection interventions needed. While staffs agree that the Farm Input Subsidy Program (FISP) has contributed towards the increase in food production and the attainment of national food security, its contribution has also not been sufficient to push rural households out of poverty trap. This could partly be explained by the huge imbalance in FISP between fertilizer and provision of seeds, especially drought resistant seeds, and limited technical support to farmers through extension services on good farming practices. There is therefore need to

expand coverage of extension services and technical advice to help farmers make better use of fertilizer and seeds. Stronger connection between FISP and farm yields should also be established and a good monitoring system developed to evaluate the impact of FISP on yields. With FISP representing a significant expenditure of the Government budget of about 3 percent of GDP and over 60 percent of Ministry of Agriculture's budget, the authorities are urged to improve the management, the effectiveness and efficiency of this program by ensuring that it does not crowd out other important interventions such as extension services and research and development.

11. **Once the analysis of the IHS3 data is complete, staffs encourage the authorities to update the MGDS II with new poverty and social indicators.** What is clear is that high rates of real GDP growth registered in 2005–10 have not resulted in a sufficient transformation of the economy or the structure of employment. The rise in consumption inequality could explain how average incomes rose in Malawi alongside stagnant living standards for the poor. The strategy will need to be informed by an analysis of how high economic growth could be translated into poverty reduction in the Malawian context. The 2009 Country Economic Memorandum identified the main constraints to growth to include an overvalued exchange rate, persistent foreign exchange supply shortages, inadequate provision of power, underdeveloped transport infrastructure, lack of skilled workforce, and limited access to finance. All the recommendations made in the CEM on addressing these constraints still remain relevant to the implementation of the MGDS II. These should be revisited further through a poverty and jobs lens.

III. MALAWI GROWTH AND DEVELOPMENT STRATEGY II

A. Macroeconomic Framework

12. **In MGDS II, the strategy for achieving sustainable growth includes the pursuit of sound economic policies, maintaining inflation at single digit levels, a move towards a more flexible exchange regime, and increasing the level of international reserves.** An increase in national investment—with emphasis in areas such as electricity generation and supply, transportation and irrigation, and in selected priority sectors (agriculture, manufacturing, mining, and tourism)—is expected to deliver an average annual growth rate of 7.2 percent, and the annual rate of inflation is projected to decline from 8.7 percent to 5.9 percent over the five years covered by the Strategy. Fiscal policy is also expected to be restrained during the implementation of the MGDS II, with the overall balance projected to generate an average annual surplus equivalent to 1.5 percent of GDP.

13. **The MGDS II macroeconomic framework however does not reflect developments in the economy over the past twelve months as well as recent important policy changes.** GDP growth weakened considerably in 2011 from an average of 7.1 percent in 2004–10, to an estimated 4.3 percent, on account of poor performance in the construction, mining, trade, and transport sectors which were badly hit by severe foreign exchange and fuel

shortages. Inflation has been on an upswing since early 2011, with the year-on-year rate reaching 17.3 percent in May 2012. Fiscal performance also weakened, reflecting increased spending at a time when external financing fell sharply and the revenue base shrunk, with an estimated fiscal deficit of 7 percent of GDP in 2011/12. The projections of fiscal surplus for the next five years are therefore unrealistic, especially in light of the current situation in the country.

14. **Staffs welcome the authorities' commitment to implement policy reforms for competitiveness, growth, and poverty reduction to regain macro-balance while at the same time mitigating the impact of these policy reforms on the most vulnerable**. Staffs commend the recent move by the authorities to devalue the kwacha and liberalize the foreign exchange market as this presents a clear signal of their commitment to regain control over the management of the economy and improve external competitiveness since one of the goals during the MGDS II implementation period will be to improve the current account position. Current efforts by the authorities to redress the persistent trade and external imbalances and improve export competitiveness will also be important in supporting the overall accumulation of foreign exchange reserves and strengthen the balance of payments. The recent devaluation of the Kwacha and adoption of a flexible exchange rate regime, needed to rebalance the economy, if supported by appropriately restrained fiscal and monetary policies, should reverse the slowdown in growth and avoid an inflation spiral.

15. **The MGDS II puts emphasis on pursuit of an export led growth with major investments in the agriculture, manufacturing, mining and tourism sectors.** Within the agriculture sector the objective is to increase the country's market share in traditional agricultural products as well as increasing value addition in agriculture. The strategy could also elaborate further on the need to continue tackling key supply-side bottlenecks—including by the adoption of an export-led strategy, reducing the cost of doing business, and strengthening the business climate through improvements in both democratic and economic governance. The authorities are encouraged to develop in the first APR an additional scenario that best reflects a more realistic medium-term macro framework as well as realistic resource envelope.

B. Public Financial Management and Public Sector Reforms

16. **Staffs commend the authorities' commitment to strengthen accountability and transparency in the public sector, as these are necessary foundations for economic progress and essential elements for the successful implementation of the MGDS II.** Rapid progress in public financial management (PFM) reform is critical, both to facilitate efficiency gains and to enhance the ability to identify and prioritize MGDS II expenditures in annual budgets, the medium-term expenditure framework (MTEF) and public sector investment program (PSIP).

17. **The MGDS II recognizes the importance of PFM and public administration reforms in the achievement of social sector objectives**, although not as explicitly and forcefully as it should. In the social sectors, significant further improvements in the health and education sectors will depend critically on cross-government reforms of public financial management (timely delivery of funds to operational units) and public administration (paying and managing public sector employees so as to encourage performance).

18. **While a decentralization policy has been elaborated, a strong fiscal and institutional decentralization framework is yet to be developed.** The risks of proceeding with fiscal decentralization before addressing existing weaknesses in PFM, frequent recourse to cash rationing and widespread perception of corruption system are high and therefore would need to be mitigated. Administrative decentralization will require a clear institutional set-up, a review of functions to be decentralized, a gradual decentralization of human resources, and an agreement of functions at the district level, including the roles of district councils. There are also many references in MGDS II to the need to improve infrastructure at local level, which imply that increased attention should be given to the strengthening of the districts' capacity to respond to this demand. The focus on capacity-building at local level and enhanced involvement of communities is therefore encouraging. Districts have demonstrated their capacity to deliver infrastructure, but this needs to be scaled up with strengthened fiduciary and quality control systems.

C. Structural and Social Sector Reforms

19. **The key infrastructure priorities identified in the MGDS II are energy, transport, and water development**. The transport infrastructure theme covers road, rail, air and inland water transport, and comprehensive but generalized lists of activities are identified which are neither prioritized using rigorous cost benefit analyses nor sequenced. A Transport Sector Investment Programme, which has recently been approved by government, is considered by staffs as a working document due to doubts over the availability of funds and prioritization. The MGDS II expresses the intention to move attention from roads to other modes, but there are still many challenges in the sub-sector. It would seem that an opportunity to improve the unpaved feeder road network, which is in significantly poorer condition than the main roads, has been missed. Although the challenge is raised in the transport KPA, the strategies presented do not provide a solution on the scale required. Reference is made in the Rural Industrialization and Agricultural Productivity and Diversification themes to improved infrastructure but without specific reference to roads.

20. **Staffs are encouraged by the prominence the power sector has been accorded in the MGDS II as one of the key binding constraint to growth**. But the Strategy lacks sufficient analysis of the set of factors that has led to shortcomings in the sector performance. The MGDS II needs to provide more information on realistic and appropriate steps to deliver the expected outcomes as well as information on prioritization and sequencing. Efforts should be made to revive the Road Map for energy reforms, including reforms of ESCOM.

21. **On the Green Belt Initiative, irrigation is indeed of high importance for sustained agricultural growth, intensification and diversification, and the ambitious goals and multi-pronged and comprehensive strategies that are developed are commendable**. But these goals are unlikely to be attained within the MGDS II timeframe and therefore there is need to develop a comprehensive investment framework within the sub-sector with the involvement of all stakeholders and also establish important linkages to the agriculture SWAp. The MGDS II outlines a number of economic growth and development plans that are based on a natural resources and water platform (large scale irrigation expansion, transport/navigation, hydropower plants, fertilizer subsidy programs). Such large scale investments may generate long-term and cumulative adverse impacts if the interlinked challenges of increasing population pressure on a degraded natural resources base and available water resources are not addressed in an integrated multi-sectoral fashion.

22. **The Strategy's significant attention to education and training is commendable as the authorities have realized the importance of having a highly skilled and educated workforce for sustainable development and growth**. The Strategy for education is appropriate and is well aligned with the Education Sector Implementation Plan (2009–13). The staffs agree on the need to increase the number of teachers so as to improve the student teacher ratio and encourage the authorities to ensure that this is properly budgeted for. Decentralization is another key strategy and the authorities are being urged to come up with an action plan for the necessary capacity building in order to decentralize funds. The staffs encourage the authorities to review the necessity of new Universities against the option of just improving the infrastructure of existing institutions and enhancing the quality and relevance of education being offered. The authorities are also encouraged to review tuition fees for tertiary education as the current system is very regressive.

23. **Staffs commend the authorities for the good progress that has been made on social indicators, including some MDGs, indicating progress in service delivery but from a low base.** According to the 2010 MDGs Report, Malawi is likely to achieve five of the eight MDGs, including those related to eradicating extreme poverty, reducing child mortality, combating HIV/AIDS, malaria and other diseases, and ensuring environmental sustainability. Trends in under-five mortality and infant mortality have improved steadily over the past two decades. Similarly, Malawi appears to be making positive progress in containing the spread of HIV and AIDS as adult prevalence rates dropped from 14.4 percent in 2004 to 12 percent in 2007.

24. **Staffs welcome the strong focus on gender equality.** Attaining gender balance in all sectors and programs is an overriding commitment of the MGDS II, and specific strategies are proposed to redress the gender gaps in the education sector, improve the representation of women in decision-making processes through affirmative action policy measures, improve women's limited access to credit, reform land policy, address gender based violence and widespread retrogressive cultural practices such as female genital mutilation, and reduce maternal mortality. This comprehensive approach is commended.

IV. IMPLEMENTATION FRAMEWORK, MONITORING AND EVALUATION

25. **The strategy suffers from a lack of sufficient prioritization of the many programs outlined.** Given limited resources, it will be necessary to prioritize among the many ambitious components the MGDS II lays out for each sector. While key binding constraints to growth have been addressed in the strategy, there is need to provide more information on how the authorities intend to prioritize within these priorities and to sequence its interventions. There is also need for a clear statement on the complementary roles between the policy/institutional framework and investment priorities required to achieve the MGDS II goals. Beyond the required budget resources to make the necessary investments, the MGDS II could also clearly highlight the key policy priorities that would enhance the productivity of these investments, for example macroeconomic, PFM, business environment, among others. These would help in developing a concrete M&E framework that captures both the investment and policy related monitoring indicators.

26. **The MGDS II has presented an elaborate implementation structure, especially the annual review process, including the national budget, and role of sector working groups in the M&E process**. Staffs are however concerned by the fact that only six out of the 16 working groups are operational. The analytical content of the MGDS II could also be strengthened further to include results from available Economic and Sector Work. For example, the presentation of expected outcomes and key strategies in the agriculture sector should refer explicitly to the Agricultural Sector Wide Approach (ASWAp) as the guiding investment framework adopted in October 2011 by the Ministry of Agriculture and all stakeholders to ensure consistency.

27. **To succeed in directing public resources to strategic priorities for poverty reduction, the MGDS II depends upon improvements to the annual process for preparing and implementing the three-year rolling PSIP**. However, it is unclear if the MGDS II, PSIP and the MTEF and the budget are closely linked in practice. The PSIP should be the vehicle for translating MGDS II into implementable projects and programmes, and should ensure that consolidated development projects therein (that would be considered for the budgets) conform to the overall national agenda. For instance, the Nsanje World Inland Port was embarked upon without technical, economic and environmental feasibility study. If the MGDS II is to shape public spending in line with poverty reduction priorities, more rigorous economic and technical analysis would be needed.

28. **The MGDS II could also benefit from further analysis of its fiscal implications and the possible impact of the plan and its financing mix on macroeconomic stability.** Clearly, the proposed financing program of the strategy is not feasible and the costing of activities impractical as it falls well beyond the current revenue generation capacity. Staffs are also of the view that the projected donor flows for official financing are optimistic, relative to recent historical trend. With the unrealistic costing of activities of 100 percent to 200 percent of projected GDP during the first four years of implementation, the MGDS II can

hardly be described as an instrument aimed at achieving allocative efficiency. In the short term, the main channel by which the MGDS II might influence poverty reduction is through policy prioritization and therefore a sense of realism in the financing of the MGDS II needs to be brought to bear. The use of PPPs as one way of raising finances for implementing the MGDS is a welcome initiative, but requires careful assessment on a case by case basis. Necessary regulatory structures should be put in place as well as detailed expertise and a list of pipeline projects to attract investors if maximum benefit is to be gained.

V. RISKS AND CONCLUSIONS

29. **The MGDS II highlights risks to growth and poverty reduction resulting from Malawi's vulnerability to external shocks, including unpredictable and unreliable aid flows, adverse weather conditions and terms of trade shocks.** Inadequate policy response to exogenous shocks, such as reduced aid flows and deterioration in terms of trade, have exacerbated the impact of these shocks on the economy. Other endogenous risks such as weak implementation capacity or lack of capacity to steer reforms within and across sectors and political risks related to the upcoming 2014 tripartite elections also warrants attention in the MGDS II. Elaborations on key mitigation measures to address the following risks would benefit the MGDS II: (i) a resource shortfall to finance the infrastructure maintenance and development plan; (ii) constraints on institutional and technical capacity to implement planned structural reforms; (iii) political and governance risks as the country approaches the election year; and (iv) the persistent vulnerability to exogenous shocks—such as adverse terms of trade. While the government has made progress on governance initiatives, perception of corruption remains very high and needs to be addressed.

30. **Staffs also consider that further work is needed to strengthen the implementation tools of the strategy.** The preparation of the first Annual Progress Report should therefore address the following priority areas: (i) updating the medium-term macroeconomic framework and clarifying the process of prioritization in budget execution, including ways to protect priority spending; (ii) improving the poverty analysis, with updated information from 2010/11 IHS3 on poverty dynamics and inequality; (iii) prioritizing the sector programs, and improving the synergy between them and the overarching objectives of growth and poverty reduction; and (iv) strengthening the monitoring and evaluation framework, especially with respect to the performance measures.

31. **In considering the MGDS II and associated JSAN, Executive Directors may wish to focus on the following issues:**

- Do Directors concur with the main risks to the MGDS II identified by the staffs?
- Do Directors concur with the areas identified by staffs as priorities for strengthening the implementation of the MGDS II?
- Do Directors concur with staff views on strengthening, monitoring, and evaluation of key outcomes of the MGDS II?