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Malawi: 2012 Article IV Consultation and Request for a New Arrangement Under the Extended Credit Facility—Staff Report; Staff Supplements; Public Information Notice and Press Release on the Executive Board Discussion; and Statement by the Executive Director for Malawi.

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of a combined discussion of the 2012 Article IV Consultation with Malawi and Request for a New Arrangement Under the Extended Credit Facility, the following documents have been released and are included in this package:

- The staff report for the combined 2012 Article IV consultation and Request for a New Arrangement Under the Extended Credit Facility, prepared by a staff team of the IMF, following discussions that ended on June 6, 2012, 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 July 10, 2012. 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.
- Two staff supplements of July 10, 2012 updating information on recent economic developments.
- A Public Information Notice (PIN) and Press Release, summarizing the views of the Executive Board as expressed during its July 23, 2012 discussion of the staff report on issues related to the Article IV Consultation and the IMF arrangement, respectively.
- 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*
- Memorandum of Economic and Financial Policies by the authorities of Malawi*
- Technical Memorandum of Understanding*

*Also 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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INTERNATIONAL MONETARY FUND

MALAWI

Staff Report for the 2012 Article IV Consultation and Request for New Arrangement Under the Extended Credit Facility

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

Approved by David Owen and Dhaneshwar Ghura

July 10, 2012

Discussions took place in Lilongwe and Blantyre during March 19–31, 2012, and in Lilongwe during May 23–June 6, 2012. The missions were led by Mr. T. Tsikata (AFR), and included Messrs. O. Adedeji and M. Ghazanchyan (both AFR) and Ms. R. Randall (Resident Representative). Ms. H. Jin (AFR) and Mr. M. Raissi (SPR) participated in the March and May/June mission, respectively. The missions met President Bingu wa Mutharika (March), President Joyce Banda (May), Minister of Finance, Dr. Ken Lipenga, Governors of the Reserve Bank of Malawi (RBM) Dr. Perks Ligoya (March) and Mr. Charles Chuka (May/June), senior officials of the government and RBM, members of parliament, and representatives of the business community, banks, civil society organizations, labor unions and Malawi's development partners. Ms. H. Teferra (OED) participated in the discussions and the missions were assisted by Mr. S. Banda (Economist in the office of the IMF Resident Representative).

Staff recommends approval of the authorities' request for a three-year arrangement under the Extended Credit Facility (ECF) in the amount of SDR 104.1 million (150 percent of quota). The authorities wish to cancel the three-year ECF arrangement approved by the Board in February 2010. The program supported under that arrangement went off-track shortly after completion of the first review in December 2010 because the authorities and staff could not reach understandings on policy measures for 2011 to achieve the key program objective of restoring external equilibrium.

The new arrangement is aimed at providing Fund support to Malawi at this critical juncture. A new administration has taken bold upfront measures to start addressing external and internal imbalances built up over the last few years, the result of the cumulative effects of external shocks and weak policy response. Policy measures since April have included a large devaluation and adoption of a floating exchange rate regime, liberalization of foreign exchange transactions, and adoption of an automatic adjustment mechanism to keep prices of petroleum products in line with import costs. The country's development partners are scaling up their assistance. The program will be monitored with quarterly reviews in the first year.

A safeguards assessment was updated in 2010. Another update is scheduled to be completed by the first review.

The Joint IMF-World Bank Staff Advisory Note on the second Malawi Growth and Development Strategy is being circulated to the Executive Board with this staff report.

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EXECUTIVE SUMMARY

- President Joyce Banda, who assumed office in early April 2012 following the sudden death of her predecessor, has moved swiftly to authorize implementation of bold measures to address Malawi's chronic foreign exchange shortage and to repair strained relations with the country's development partners. A 33 percent devaluation of the kwacha, adoption of a floating exchange rate regime, liberalization of current account transactions, and adoption of an automatic fuel price adjustment mechanism, have transformed the policy environment and greatly improved the outlook for the economy. The private sector has responded positively, and development partners have pledged a substantial increase in grants, including assistance for social protection programs to mitigate the adverse impact of adjustment measures on the most vulnerable segments of the population.

- The main objective of the government's development strategy is poverty reduction through sustained economic growth and infrastructure development. The strategy for growth entails achievement and maintenance of macroeconomic stability and implementation of policies and structural reforms to increase national investment and diversify the economy in order to reduce the country's vulnerability to external shocks. The authorities' policy priorities include keeping government spending within available resources (domestic revenues and grants), tightening monetary policy to contain inflation pressures from the depreciation of the exchange rate, and strengthening the supervision of financial institutions.

- The ECF-supported program approved by the Board in February 2010 went off-track shortly after completion of the first review in December 2010. The new administration requests cancellation of the current arrangement and approval of a new three year arrangement in the amount of SDR104.1 million (150 percent of quota). Half of the amount will be disbursed in four installments of SDR 13 million each in the first year—the first upon approval of the arrangement, followed by three disbursements subject to quarterly reviews. The requested level of access is twice the norm for a country with outstanding concessional credit from the Fund in excess of 100 percent of quota, but is justified by Malawi's balance of payments need (very low level of international reserves), strength of policies (including substantial upfront measures), strong support from donors, and adequate capacity to repay the Fund.

I. Context: New Commitment to Tackle Macroeconomic Challenges

1. **There was a smooth transition to a new government in Malawi following the sudden death of President Bingu wa Mutharika in early April 2012.** In line with the constitution, the then Vice President, Mrs. Joyce Banda, was sworn into office as President to serve the remaining two years of the late president's term.[1] She announced a new cabinet of ministers in late-April, drawn from several political parties. Mrs. Banda had fallen out with her predecessor and been expelled from the ruling Democratic Progressive Party. She founded her own political party, the People's Party, in 2011.

2. **President Banda inherited an economy with a gloomy outlook.** The country faced a severe shortage of foreign exchange, which translated into shortages of critical imports including fuel, inputs for production, and medicines. Delays in making payments abroad led to the loss of credit lines for several businesses, resulting in scaled down operations and the laying off of workers. Malawi's long standing foreign exchange problems intensified in 2011 because of lower tobacco export earnings and cuts in external aid. Several donors reduced their financial support when Malawi's IMF-supported program went off-track in the first half of 2011 and because of human rights and governance concerns.[2] The previous administration's response to reduced supply of foreign exchange was a 10 percent devaluation of the kwacha in August 2011 accompanied by tighter restrictions on foreign exchange transactions. The restrictions created distortions which fostered the parallel market in foreign exchange and boosted activity in the informal sector at the expense of the formal economy.

3. **The new administration has moved swiftly to address the country's chronic balance of payments problems.** The specific measures implemented include:

- Devaluation of the exchange rate from K167 to K250 per U.S. dollar (a 33 percent devaluation), and adoption of a floating exchange rate regime.

- Allowing banks and foreign exchange bureaus to set the rate at which they buy and sell foreign exchange from/to their customers.

- Removal of the requirement for foreign exchange earnings to be surrendered to the RBM; they now flow directly to commercial banks.

- Cancellation of the requirement for banks to submit to the RBM for review any application for external payments exceeding US$50,000.

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[1] General elections are scheduled for May 2014.

[2] The proverbial last straw for many donors was the police crackdown on a public demonstration in July 2011 that led to the death of about 20 people.

- Increases in prices of petroleum products to bring them in line with import costs, and adoption of an automatic adjustment mechanism to ensure pass through of changes in import costs to retail prices.

4. **The authorities have also tightened fiscal and monetary policies and increased electricity tariffs toward cost-recovery levels.** Specific measures have included reduction in foreign travel by government officials, cuts in the number of vehicles available to senior officials, and postponing new development projects that were to be financed from domestic revenue. The RBM raised the bank rate from 13 percent to 16 percent, and has acted to mop up excess liquidity in the banking system. The electricity tariff increases are expected to stem operational losses of the electricity company (ESCOM).

5. **The adjustment measures are beginning to show positive results.** Sales of tobacco through official channels have increased and the private sector's access to foreign exchange, including for fuel imports, has eased considerably. The parallel market for foreign exchange has almost collapsed; the exchange rate premium on that market has fallen from 60–80 percent before the devaluation to less than 5 percent. Malawi's development partners have welcomed the recent economic policy actions as well as the repeal of a number of laws seen as undermining human rights and political freedoms, and have pledged increased assistance to Malawi. External grants to the government budget are projected to increase from US$282 million in FY2011/12 to US$481 million in FY2012/13, with general budget support grants going from less than US$2 million to US$208 million. The Board of the US Millennium Challenge Corporation has also announced the reinstatement of the US$350 million grant for a Power Sector Revitalization Project aimed at improving the availability and reliability of power supply in Malawi.[3]

6. **The authorities are requesting a new arrangement under the Extended Credit Facility (ECF) and canceling the one approved in February 2010.** They acknowledge poor performance under the program supported by the current arrangement and seek a fresh start to enable the new administration establish its own track record of policy implementation (LOI). Performance under the program was satisfactory in 2010; the first review was completed in December 2010 with only one waiver (related to the net domestic borrowing target for June 2010, which was missed as a result of a temporary shortfall in foreign grants). Discussions for the second review, initiated by a March 2011 mission, were not completed as understandings could not be reached on policy measures for 2011 to achieve the key program objective of restoring external equilibrium. In particular, the authorities back-tracked from commitments to liberalize the exchange rate regime. In the event, the June 2011 quantitative targets established at the first review were missed by wide margins.

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[3] The compact was signed in April 2011, placed on hold in July 2011 and formally suspended in March 2012 due to "a pattern of actions by the government of Malawi that was inconsistent with the democratic governance criteria MCC uses to select compact partners."

II. Recent Economic Developments

7. **Economic growth slowed significantly in 2011 after four years of very strong performance (Figure 1).** Real GDP growth slowed to 4.3 percent in 2011, from an average annual rate of 8.3 percent during 2007–10. Sectors that are heavily dependent on imports—manufacturing, transportation, construction, and wholesale and retail trade—slowed down the most, reflecting the impact of the foreign exchange shortage (Text Table). Since the mid-2000s, agriculture has been a principal engine of growth, supported by the government's Farm Input Subsidy Program (FISP) and good weather conditions. Following the recent policy measures, the private sector has begun to clear the backlog of external arrears which should help re-establish credit lines and improve the flow of imported inputs to allow enterprises to gradually increase output from the current low levels of capacity utilization.

Text Table. Malawi: Sectoral Growth, 2005–13
(Percent)

	2005	2006	2007	2008	2009	2010	2011	2012	2013
GDP at constant market prices	**2.8**	**2.1**	**9.5**	**8.3**	**9.0**	**6.5**	**4.3**	**4.3**	**5.7**
Agriculture	-8.8	1.0	12.6	3.4	13.4	1.7	7.0	4.1	5.7
Mining and quarrying	46.5	82.2	8.6	35.8	4.9	80.2	0.0	13.9	16.3
Manufacturing	9.2	9.7	10.4	11.4	4.8	2.2	0.0	2.0	4.0
Electricity, gas, and water supply	3.1	-7.0	2.0	5.0	6.6	4.0	4.4	2.0	5.0
Construction	12.2	12.9	13.9	2.7	7.4	16.1	0.0	4.2	8.2
Wholesale and retail trade	13.7	2.5	20.0	19.2	6.6	7.4	3.5	5.0	6.0
Transportation and storage	-5.5	5.2	20.2	16.3	8.9	4.2	2.7	4.2	6.0

Sources: Malawian authorities and IMF staff estimates.

8. **Inflation has been on an upswing since early 2011, with the year-on-year headline rate jumping to 17.3 percent in May 2012 (Figure 1).** Rising import costs have been the main factor behind the upswing as a growing share of imports were being priced at the parallel market exchange rate before the May devaluation. The devaluation triggered large adjustments in the retail prices of petroleum products, which have had ripple effects to other prices. The spike in inflation is expected to persist for several months but should dissipate by early 2013 with the implementation of restrained fiscal and monetary policies to counter the second round effects of the fuel price increases.

9. **Prior to the recent policy actions, the authorities had been inconsistent in implementing Fund policy advice (Box 1).** The government loosened its fiscal stance significantly in the run-up to the May 2009 general elections, requiring substantial recourse to domestic financing. After a short-lived improvement in the first year of the ECF-supported program (FY2009/10), fiscal performance weakened as government expenditures remained steady (in relation to GDP) while external grants fell sharply and domestic revenue

performance weakened. The overall fiscal deficit widened from nearly 3 percent of GDP in FY2010/11 to an estimated 7 percent of GDP in FY2011/12, with domestic financing rising from 1.7 percent of GDP to 5.6 percent in the respective years (Table 2b and Figure 2). Furthermore, the government and state-owned enterprises accumulated about K72 billion (7 percent of GDP) in domestic arrears over the last few years.

Box 1. Malawi: Main Recommendations of the 2009 Article IV Consultation

Advice	Status
Monetary and fiscal discipline needed to contain aggregate demand and inflationary pressures.	Prudent fiscal and monetary policies were achieved during FY 2009/10. Fiscal and monetary policies were loosened subsequently.
Restore external equilibrium.	Inadequate policy response to adverse terms of trade and aid shocks fostered a parallel foreign exchange rate market with large premiums over the official exchange rate.
Enhance Public Financial Management.	A Public Financial and Economic Management unit has been established in the Ministry of Finance. Progress is being made in improving the budget process, accounting and fiscal reporting.
Rely more on interest rate adjustments to help control inflation.	Cost considerations limited RBM's monetary operations. Recently, there is renewed commitment to undertake open market operations.
Strengthen supervision of financial institutions.	Significant progress has been made, including the effective use of risk-based supervision and putting in place stress-testing techniques for banks.

10. **Until recently, fiscal policy tended to dominate monetary policy.** The RBM accommodated the government's financing requirements, while cost considerations held it back from conducting open market operations to mop up excess liquidity. Growth in reserve money and broad money have been driven by RBM lending to the government and credit to the economy, respectively (Tables 4a and 4b, and Figure 3). The RBM began tightening its policy stance in April 2012 when it off-loaded some of its holdings of treasury bills. In May it raised the policy rate and, after the devaluation, used foreign exchange sales to further mop up excess liquidity. Kwacha liquidity conditions tightened significantly and several banks resorted to the RBM discount window to meet their needs.

11. **The current account balance (including transfers) has fluctuated widely, driven mainly by aid flows and terms of trade (Figure 4).** Increased grants helped narrow the current account deficit in 2009 and 2010, while adverse terms of trade and cuts in grants

contributed to a widening in 2011. The country's high dependence on fuel and fertilizer imports, tobacco exports and aid inflows render it highly vulnerable to external shocks. International reserves have been very low—hovering around one month of imports for much of the last three years and about half a month of imports more recently—and so have not provided much of a buffer against adverse shocks. Pronounced seasonality in foreign exchange inflows also complicate monetary and international reserve management.[4]

III. Medium-Term Framework

12. **The main objective of the government's development strategy is poverty reduction through sustained economic growth and infrastructure development (MEFP ¶10).** The government has formally approved the second Malawi Growth and Development Strategy (MGDS II) covering 2011/12–2015/16, the successor to the first MGDS which covered 2006/07–2010/11. A key element of the strategy for achieving sustainable growth articulated in both documents is the pursuit of sound economic policies with a view to maintaining inflation at single digit levels and increasing the level of international reserves. An increase in national investment, including in electricity generation and supply, transportation and irrigation, and in selected priority sectors (agriculture, manufacturing, mining, and tourism), is expected to deliver high growth, while prudent fiscal and monetary policies deliver low inflation.[5] MDGS II is designed to help Malawi achieve the Millennium Development Goals (MEFP ¶ 12, and Table 10).

13. **Improvements in the business regulatory environment and investments to address supply-side bottlenecks are expected to boost foreign direct investment in mining, manufacturing and tourism**. New mines in rare earth metals are expected to start operations beginning in 2013. In the manufacturing sector, there has been significant interest in agro-processing activities from foreign and domestic investors. The promotion of high-quality tourism facilities is a key goal of the MGDS. The construction sector is also an important source of growth in the medium term, as construction activities grow in line with increased public and private investment.

14. **The program for which the authorities are seeking support under the ECF is based on MGDS II.** Specific objectives of the program include achievement and maintenance of a stable macroeconomic environment with low inflation, increasing foreign exchange reserves, and undertaking structural reforms to improve the investment climate and promote sustained and inclusive growth (MEFP ¶13). Key features of the medium-term macroeconomic framework are:

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[4] Inflows from tobacco sales tend to be concentrated in April–September.

[5] MGDS II and an accompanying Joint Staff Advisory Note is being circulated to the Executive Board with this staff report.

- A rebound in growth from 4.3 percent in 2012 to 5.7 percent in 2013 and to at least 6½ percent per year from 2015.

- Year-on-year inflation rises to about 23 percent in December 2012, and declines gradually thereafter to single-digit levels in 2014.

- No net domestic financing of the government budget on an annual basis; any borrowing in the early part of the year would be repaid by the end of the year.

- The level of useable international reserves increases gradually from one month of import cover at end-2012 to 3 months of imports by end-2015.

15. **The design of the program was informed by the recent Ex Post Assessment of Malawi's Longer-Term Program Engagement (EPA).**[6] The EPA found that the Fund's engagement with Malawi helped the country maintain macroeconomic stability during most of the period under review (2004–11), but that weak ownership of policies led to setbacks in the last few years. It concluded that there is a case for continued Fund program relations with Malawi—given the country's weak balance of payment position—but recommended that such engagement take place only if the authorities have "firm ownership" of program commitments. In terms of program objectives and content, the EPA emphasized the need to go beyond macroeconomic stability to address constraints to growth and the need for a stronger social safety net.

16. **The new administration has demonstrated strong ownership of key policies.** The rapid implementation of the exchange rate related measures—some of which would have been prior actions for the new ECF arrangement—as well as politically unpopular but fiscally sound measures such as increases in petroleum products and electricity tariffs, provide strong and credible evidence of the new authorities' commitment to implementing appropriate policies to tackle Malawi's long-standing economic challenges. Staff encouraged the authorities to be more proactive in explaining the rationale of policy decisions to the public, with emphasis on the expected benefits from new measures and the costs of inaction. The authorities have begun to do this as demonstrated by a recent two-page insert in newspapers on the FY2012/13 budget proposals which highlighted the pro-poor measures in the budget as well as the alignment of expenditure allocations with government priorities.

17. **Program design also reflected the findings of an updated debt sustainability analysis (DSA) carried out jointly by staffs of the IMF and the World Bank.**[7] Malawi's risk of external debt distress remains moderate. The country's narrow export base, reliance on rain-fed agriculture and low international reserves make it susceptible to shocks. Stress

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[6] Discussed by the Board on June 20, 2012

[7] Supplement to this staff report.

tests highlighted the vulnerability to an export shock. With respect to the public debt component of the DSA, stress tests indicated a need for fiscal consolidation to slow down growth in the domestic debt stock.

IV. Policies and Structural Reforms

18. Policy discussions revolved around measures to contain inflation and achieve a stable macroeconomic environment, alignment of the government budget to MGDS II priorities, and structural reforms to boost inclusive growth. Staff emphasized the role of fiscal discipline and tight monetary policy to ensure that the recent nominal depreciation of the exchange rate translated into a sustained real depreciation to achieve the expected positive effects on the balance of trade and growth. Given the recent history of fiscal dominance, the discussions on monetary policy emphasized the need for increased operational independence of the RBM. Staff also noted that more consistent implementation of prudent fiscal and monetary policies are likely to increase aid flows and make them more stable and predictable. This should allow room for the authorities to build up international reserves to provide a buffer against adverse external shocks.

A. Exchange Rate Policy and Regime

19. **Malawi had a de facto peg to the U.S. dollar for most of the period since 2004.** The official exchange rate was allowed to depreciate gradually for a few months each in the run-up to: (i) the 2005–08 PRGF arrangement; (ii) the HIPC completion point in 2006; and (iii) the 2010–13 ECF arrangement. The kwacha depreciated by about 13, 12, and 7 percent respectively in those episodes. In addition, the kwacha was devalued by 10 percent in August 2011. Notwithstanding the authorities' stated objective (including in MGDS I) of implementing a flexible exchange rate regime, in practice they sought to keep it virtually fixed against the U.S. dollar, but expansionary fiscal and monetary policies undermined the de facto peg and combined with exchange restrictions to foster the parallel foreign exchange market. Based on the changes introduced in May 2012, Malawi now has a floating exchange rate regime.

20. **Staff estimates the real effective exchange rate (REER) of Malawi to have been substantially overvalued before the devaluation in May 2012.** CGER-type methodologies and a time series approach suggest misalignment of around 34 percent (Appendix II). Widespread rationing of foreign exchange and the size of the parallel market premium (about 80 percent) support the indication of significant misalignment. Continued large inflation differentials with main trading partners meant that significant nominal depreciation was needed to reduce the overvaluation. The 33 percent devaluation of the exchange rate and adoption of a floating regime in May 2012 brought the exchange rate broadly into line with fundamentals.

21. **The authorities have agreed to a review by Fund staff to determine whether the exchange system complies with Malawi's obligations under Article VIII of the Fund's**

Articles of Agreement. Malawi accepted these obligations in 1995. Staff is in the process of reviewing recent reforms to make an assessment of Malawi's exchange system.

B. Fiscal Discipline to Support Exchange Rate Regime and Key Priorities

22. **The government's efforts to achieve fiscal sustainability over the medium term are built on measures to strengthen domestic revenue mobilization, restrain growth in expenditures, and reduce domestic debt**:

- Domestic revenue mobilization efforts include removal of implicit subsidies on fuel and an associated boost in fuel tax revenues, and strengthening of revenue administration through increased audits, adoption and use of electronic fiscal devices in the enforcement of VAT, and the use of computerized cargo scanners.

- Expenditures will be aligned to MGDS II priorities, with increased allocations to the Agriculture, Education, and Health sectors.

- After the rapid buildup in the stock of domestic debt and expenditure arrears in the last few years, the government's medium-term expenditure framework is anchored by an annual target of zero net domestic borrowing in order to lower domestic debt to sustainable levels.

23. **The fiscal deficit is projected to fall from 7 percent of GDP in 2011/12 to about 1 percent in 2012/13, reflecting a large increase in grants.** The increase in grants (from 5.5 to 10.4 percent of GDP) reduces the domestic financing requirement while allowing the government to scale up social protection programs to mitigate the impact of adjustment measures on the poor. This is reflected in an increase in recurrent expenditures of about 2 percent of GDP. Programs that receive substantially higher allocations compared to FY2011/12 include the Farm Input Subsidy Program (FISP), public works, school feeding, school bursary, and cash transfer programs (MEFP ¶18). The social sectors (mainly education and health) receive a higher share of expenditures, reflecting not only the increased spending on social protection programs but also to allow for hiring more teachers and health workers.

24. **A sizeable revenue effort and tight control of spending will be needed to ensure that expenditures are aligned with the government's top priorities.** Domestic revenues (tax and non tax revenue) are projected to increase by about 1.3 percent of GDP in FY2012/13, mainly reflecting the reform of the pricing and taxation of petroleum products (MEFP ¶16). On the expenditure side, the government has established clear priorities in some of the largest ministries (Agriculture, Education and Health) with assistance from the World Bank. Quarterly spending ceilings will be established and enforced to keep expenditures within the available resource envelope (MEFP ¶18).

25. **Domestic arrears will be subject to verification and the government will tighten its control over expenditure commitments (MEFP ¶20).** The Office of the Auditor

General will verify the arrears and the verified amount will be paid over several years. Implementation of the commitment module in the IFMIS will be accelerated to help prevent accumulation of new arrears. The government will inform the general public of its procurement rules through the media, including warnings that those who provide goods or services outside of the established government system will not be paid.

26. **The government has initiated steps to reduce the risks to the budget posed by contingent liabilities and operational losses of state owned enterprises (MEFP ¶21).** The National Oil Company of Malawi will be limited to its core activity of managing strategic reserves of fuel. The government has established a clear regulatory regime for the electricity that provides for tariff adjustments to cover ESCOM's operating costs. A similar regime will be established for the Water Boards in order to eliminate the need for budgetary transfers and to minimize recourse to commercial bank borrowing.

C. Enhancing Monetary Policy Effectiveness

27. **The authorities emphasized the importance of price stability, sufficient credit to the private sector and accumulation of international reserves.** To help manage domestic demand and contain inflation, broad money is programmed to grow at about the pace of nominal GDP in the near term. Further financial deepening in the medium term would allow broad money to grow faster than nominal GDP without fueling inflation. The RBM will use all available instruments to achieve the above objectives, including open market operations and changes in the bank rate. The RBM and the Ministry of Finance are to enhance coordination to ensure adequate sharing of information to provide a more solid basis for RBM's liquidity forecasts that guide its monetary operations. For now, the RBM will mainly rely on its holdings of treasury bills to conduct monetary operations.

28. **The authorities agreed with staff on the need to strengthen the operational independence of the RBM.** They are requesting technical assistance from the Fund on options to provide resources to the RBM for its monetary operations (MEFP ¶25). Two main options are under consideration: (i) issuance of new treasury bills for monetary operations with the Ministry of Finance carrying the interest costs; and (ii) issuance of an income generating security to the RBM with the RBM bearing the cost of its monetary operations. As an additional measure to strengthen the RBM's operational independence, the authorities have agreed to amend the RBM Act to place a limit on the government's total borrowing from the RBM (MEFP ¶26). The current Act has a limit on overdrafts but not on other forms of RBM lending to the government.

D. Safeguarding Financial Sector Stability

29. **Financial stability indicators suggest that the banking sector in Malawi remains sound.** Non-performing loans are at low levels, but the deterioration in the macroeconomic environment in the last two years has elevated the risks to banks' portfolios. The RBM has intensified its monitoring and surveillance of the financial system with a view to detecting at

an early stage emerging threats to financial stability. The RBM is establishing Basel II governance structures and committees, with full compliance with Basel II principles envisaged for January 2014.

30. **The authorities consider the financial sector as critical to achieving inclusive growth**. Indicators of financial deepening in Malawi, while improving, are still low by regional standards (Appendix III). Staff welcomes various initiatives being pursued by the government to deepen the financial sector, including the establishment of credit reference bureaus (MEFP ¶28), the development of a National Strategy for Financial Inclusion (MEFP ¶30) and the establishment of the Malawi Financial Sector Deepening Trust (MFSDT) (MEFP ¶30). These initiatives are in line with the recommendations of the 2008 Financial Sector Assessment Program (Box 2).

E. Improving International Competitiveness

31. **A number of indicators of external competitiveness suggest that Malawi is lagging behind its neighbors.** Concentration in the production of tobacco, which accounts for over 60 percent of total exports, and a handful of other cash crops (e.g., sugar and tea), as well as maize (produced primarily for domestic consumption) point to an undiversified economy. Malawi's export growth has been stymied relative to that of other regional peers, while imports have accounted for a larger and growing share of GDP—a clear manifestation of the impact of Malawi's chronic exchange rate misalignment. Malawi's share of regional exports to the world has also declined sharply over time, and the country ranks behind its neighbors in indicators of the business environment such as business operating conditions and business transaction costs (Appendix II). In view of the push toward greater regional integration (including the Grand Tripartite Free Trade Area encompassing COMESA, EAC, and SADC), the government is determined to address these competitiveness issues, including through the adoption of a National Export Strategy (MEFP ¶¶32–33). There are also ongoing efforts to address key supply-side bottlenecks in the energy sector (e.g., the MCC compact and the Interconnector Project with Mozambique).

F. Data Quality and Dissemination Issues

32. **In order to safeguard the integrity of revenue data, the government has decided that the MRA should publish its monthly revenue collections in the local media with a lag of no more than a month.** The Minister of Finance recently acknowledged that, under the previous administration, his ministry inflated revenue data for the first half of this fiscal year (July–December 2011) that was reported to parliament in February 2012. In late-December 2011, the Ministry of Finance (MoF) realized that revenues were unlikely to meet a target set by the late President. Senior officials of MoF authorized the Malawi Revenue Authority (MRA) to obtain short-term loans from several banks which were deposited into the MRA account at the RBM to "boost" revenues. The loans were repaid in the first few days of January 2012.

Box 2. Status of Implementation of Key Recommendations of 2008 FSAP Report

Areas	Recommendations	Status
Financial sector legislation	Push for passage of outstanding financial sector bills (Banking Act and Banking Services Bill) is needed.	Done (2010)
Monetary operations and instruments: to consolidate macro progress	Reduce Liquidity Reserve Requirement (LRR) penalty rates and ensure that the standing facility is always open to address liquidity needs and stick to clear auction rules	Done
	Introduce an interest rate corridor by creating a weekly deposit facility	Under consideration
Foreign exchange market: to enhance efficiency and consolidate macro progress	Enhance competition by lifting restrictions in foreign exchange guidelines that currently create a minimum spread	Done (2012)
	Implement transparent exchange regime and matching intervention policy	Done (2012)
Bank regulation and supervision: to support stability	Leave issuing and withdrawal of licenses exclusively to the RBM	Done (Banking Act of 2010)
	Strengthen monitoring of banks through stress testing for credit, inflation, and FX market risks	Done
Banking system: to support growth and poverty reduction	Develop a policy on mergers and acquisitions to allow for rational consolidation	Done (Banking Act of 2010)
	Divest Malawi Savings Bank to a strategic partner	Not yet
	Help reduce bank labor costs (support training, labor permits)	Ongoing
Contractual and information frameworks: to support growth	Enable credit bureaus by promoting standard contract provisions in bank loans and through supporting regulations	Done. Two credit reference bureaus are currently operating in Malawi.
	Lower the cost of contract enforcement and title registration	Ongoing
	Delegate the power of Minister of Lands / Chief Commissioner of Lands to approve transfer or mortgage property	Not yet
Pension sector: to support stability and efficiency	Reassess the affordability of the public pension scheme and, review retirement age, accrual rate, and indexation mechanism	Done (Pension Act, 2011)

V. Program Issues

33. **The authorities are requesting an access level equivalent to 150 percent of quota for the new three-year ECF arrangement.** This is higher than the norm of 75 percent of

quota for such arrangements for countries with outstanding concessional credit from the Fund in excess of 100 percent of quota. Malawi currently has outstanding obligations to the Fund equivalent to 135 percent of quota. The case for the higher-than-usual level of access is based on the country's balance of payments need, the strength of the program (including bold upfront measures already implemented), strong donor support, and adequate capacity to repay the Fund:

- ***International reserves are at a precarious level, at only ½ a month of import cover.*** The authorities have been careful not to accumulate official external payments arrears but estimate that the private sector has accumulated arrears of more than US$300 million (equivalent to about 15 percent of projected imports in 2012). The resources from the Fund would enable the RBM to gradually rebuild gross reserves to 1 month of imports by end-2012 and to 3 months by end-2015 (Table 4a). The net resources from the Fund will account for only one-quarter of the reserve accumulation (Table 5). One donor (DFID) has brought forward some of its planned disbursements in order to help alleviate the precarious international reserves position of the RBM.

- ***The program to be supported by the new ECF arrangement is strong.*** As indicated above, the authorities have already implemented bold upfront measures and have made clear and highly credible commitments to pursue prudent fiscal and monetary policies to consolidate the expected gains from the exchange rate adjustment.

- ***The program is expected to catalyze donor support.*** Notwithstanding the high level of access, Malawi's external financing requirement remains high and the need for substantial donor support remains strong (Table 5). Representatives of donors have assured staff that funds held back when the ECF-supported program went off-track will be restored. Other donors who cut aid because of concerns about human rights and political governance issues have also signaled their intention to provide increased support in response to the repeal of laws that were widely seen as curtailing the freedom of citizens.

34. **Malawi has adequate capacity to meet its financial obligations to the Fund (Table 7).** Because of relatively large payments due to the Fund from Malawi in 2014 and 2015, the full disbursement of the proposed level of access would take the country's projected level of credit to the Fund from 135 percent of quota at present to 225 percent of quota at end-2015. If disbursements are made as scheduled, there will be a peak in debt service to the Fund in 2018 at US$34.1 million (or 1.5 percent of exports of goods and services). The country has an established record of timely servicing of its obligations to the Fund, and the DSA places Malawi at a moderate risk of debt distress. Fund support will be a relatively small part of the overall financing package, as Malawi is projected to receive an average of US$200 million per year in budget support, seven-eighths of which is in the form of grants, and the rest in the form of highly concessional loans. More broadly, Malawi

receives around US$500 million per annum in official grants, three-quarters of which goes through the budget. The strong level of donor support, combined with the prospects for future development of Malawi's export potential are expected to support Malawi's capacity to repay the Fund.

35. **Phasing, program reviews and conditionality.** It is proposed to front load disbursements, with 75 percent of quota in the first year (Table 6), given the low levels of international reserves and the strong upfront actions taken by the authorities. There will be quarterly reviews in the first year; if all goes well, this will change to half-yearly reviews in subsequent years. A prior action requiring parliamentary passage of a budget for FY2012/13 that is in line with program objectives has been met. The program has quantitative performance criteria on NDA of the central bank, NIR, central government net domestic borrowing, limits on nonconcessional external borrowing, and limits on the accumulation of external payments arrears (Table 8). It also has the standard continuous performance criteria, including the criterion on non-imposition or intensification of restrictions on the making of payments and transfers for current international transactions, and indicative targets on spending on the social sectors (including all the main social protection programs) and on reserve money. Adjustors will allow for increased expenditure if additional budget support grants become available, but there will be only limited and temporary substitution of domestic financing for shortfalls in budget support. Structural benchmarks have been set mainly in the PFM and financial sector areas (Table 9).

36. **An update safeguards assessment of the RBM with respect to the 2012 ECF arrangement has been initiated and will be completed by the first review.** The latest safeguards assessment was completed on June 25, 2010 and concluded that the RBM continued to have strong financial safeguards in the areas of external audit and financial reporting. The main area of concern was the lack of adequate autonomy for the RBM, which is now being addressed by the program. Another key recommendation is related to the strengthening of foreign reserves management oversight.

37. **Risks from global spillovers.** Downside risks to the program include potential spillovers from the global economy, including stagnation of euro area and world growth, a substantial fall in non-oil commodity prices, and a reduction in aid flows. Slower world growth would adversely affect demand for Malawi's exports (mainly tobacco), but the overall impact on Malawi's growth is expected to be low, because of the authorities active efforts to diversify export markets (including to China). A substantial fall in tobacco prices would adversely affect export proceeds, the income of farmers and dampen growth. Given the size of tobacco in the economy (15 percent of GDP), the expected impact would be moderate. The risk of lower aid flows is low. Most of the major donors have indicated to staff that they would be prepared to scale up their support to Malawi if the government continues to implement appropriate economic policies and there is no deterioration in human rights and political governance. However, with the EU as one of the major donors, it is

conceivable that over the medium-term aid to Malawi might decline because of shrinking aid budgets in Europe.

38. **Other risks.** Adverse weather conditions and slippages in the implementation of economic reforms also pose risks to the program. Adverse weather conditions pose a significant risk because of the continued reliance on rain-fed agriculture. Lower agricultural output would have a significant effect on overall GDP growth given the size of agriculture in GDP (30 percent). Slippages in policy implementation and structural reforms could lead to another cut in aid flows. Under the program, reductions in general budget support grants have to be offset by expenditure cuts (mainly in goods and services). It is important to avoid fiscal and monetary laxity in the run-up to the elections in 2014, in order to build credibility for Malawi's commitment to the implementation of prudent policies. Furthermore, failure to improve Malawi's relatively poor track record in implementing structural reforms would dampen the country's prospects for long-term growth and reducing vulnerability to shocks.

VI. Staff Appraisal

39. **Policy actions by the new administration led by President Banda have significantly improved the outlook for the economy**. The new government moved swiftly to implement policies to address Malawi's chronic balance of payments problems and improve the growth outlook. The 33 percent devaluation of the kwacha, adoption of a floating exchange rate regime, and liberalization of current account transactions have halted the economy's slide toward export and output contraction. The liberalization of the foreign exchange regime will help remove distortions and encourage private investment and diversified growth.

40. **Fiscal discipline and tight monetary policy are needed to ensure that the recent nominal depreciation of the exchange rate translates into a sustained real depreciation**. Staff welcomes the measures adopted by the government to ensure that total spending stays within the resource envelope of domestic revenues and grants. In order to ensure that spending is in line with the government's priorities, the authorities need to strengthen commitment control and enforce procurement rules. On the revenue side, the increase in the retail prices of petroleum products and the re-introduction of an automatic adjustment mechanism provide a robust base for government tax revenues. The authorities should avoid fiscal and monetary laxity in the run-up to the elections in 2014, to build credibility for Malawi's commitment to the implementation of prudent policies.

41. **Staff welcomes the positive response of Malawi's development partners to the recent economic policy changes and to the steps taken by the authorities to address the governance and human rights concerns that led some partners to withhold financial assistance from the country in FY2011–12.** Substantially higher grants in FY2012/13 should allow the government to boost spending on social protection programs to mitigate the impact of the adjustment measures on the most vulnerable segments of the population. Over the medium term, the government needs to consider ways of ensuring the sustainability of the Farm Input Subsidy Program, one of the largest social protection programs.

42. **Staff also welcomes recent measures by the RBM to tighten monetary policy.** After many years of fiscal dominance, the RBM has begun to show signs of operational independence. It increased the policy rate and has undertaken open market operations to mop up excess liquidity. Staff urges the government to strengthen the balance sheet of the RBM to enable it meet its primary mandate of maintaining price stability.

43. **The authorities are to be commended for their multifaceted approach to promoting inclusive growth.** Their efforts include initiatives to deepen the financial system and make it more inclusive, and measures to enhance the investment climate and international competitiveness by addressing key supply-side bottlenecks such as those related to energy and transportation infrastructure.

44. **Staff supports the authorities' request for a new three-year arrangement under the ECF.** In view of Malawi's large balance of payments need and the strong upfront measures already implemented by the authorities, staff also supports the requested level of access in the amount of SDR104.1 million (150 percent of quota), with half of the amount disbursed in four installments in the first year. The unusually high access level addresses the country's balance of payments need, while keeping the Fund's exposure to a manageable level.

45. **Staff recommends that the next Article IV Consultation with Malawi take place within 24 months, in accordance with the Decision on consultation cycles for program countries**.

Table 1. Malawi: Selected Economic Indicators, 2009–17

	2009	2010	2011	2012	2013	2014	2015	2016	2017
	Est.	Prel.	Proj.	Proj.	Proj.	Proj.	Proj.	Proj.	Proj.
National accounts and prices (percent change, unless otherwise indicated)									
GDP at constant market prices	9.0	6.5	4.3	4.3	5.7	6.1	6.5	6.7	6.7
Nominal GDP (billions of kwacha) [1]	710.2	812.4	879.8	1,068.1	1,289.0	1,467.9	1,657.7	1,871.9	2,107.7
GDP deflator	8.4	7.4	3.8	16.4	14.2	7.3	6.0	5.8	5.6
Consumer prices (end of period)	7.6	6.3	9.8	22.9	12.0	7.3	6.5	5.9	5.2
Consumer prices (annual average)	8.4	7.4	7.6	18.4	16.1	7.5	6.1	5.9	5.7
Investment and savings (percent of GDP)									
National savings	20.7	24.7	9.6	12.0	19.0	19.4	20.1	21.5	21.3
Net factor income	-1.2	-2.0	-2.1	-3.0	-3.2	-3.2	-3.2	-3.2	-3.0
Net official transfers	9.4	15.7	5.9	11.5	11.1	10.3	9.6	8.9	8.2
Net private transfers	5.1	4.7	4.6	5.6	5.8	5.8	5.7	5.7	5.3
Domestic savings	7.5	6.3	1.1	-2.2	5.3	6.5	8.0	10.1	10.7
Government	-7.1	-0.8	-2.3	-6.9	-3.9	-2.0	-1.7	-1.3	-0.9
Private	14.6	7.0	3.4	4.7	9.2	8.5	9.7	11.4	11.6
National investment	25.6	26.0	15.5	16.2	20.7	21.1	21.7	23.4	23.7
Government	6.5	9.6	6.9	7.5	7.0	7.0	7.1	6.7	6.2
Private	19.1	16.4	8.6	8.7	13.7	14.1	14.7	16.7	17.6
Saving-investment balance [2]	-4.8	-1.3	-5.9	-4.3	-1.7	-1.8	-1.6	-1.8	-2.5
Government	-5.0	1.5	-5.0	-5.3	-2.0	-0.6	-1.1	-0.8	-0.5
Private	0.1	-2.8	-0.9	1.0	0.3	-1.1	-0.6	-1.1	-2.0
Central government (percent of GDP on a fiscal year basis) [3]									
Revenue	32.1	33.8	32.1	27.0	33.2	31.7	31.6	31.3	31.0
Tax and nontax revenue	20.5	23.5	24.5	21.5	22.8	23.3	23.6	23.9	24.2
Grants	11.6	10.3	7.6	5.5	10.4	8.4	7.9	7.4	6.9
Expenditure and net lending	37.8	33.8	35.0	34.0	34.3	32.8	32.5	32.1	31.7
Overall balance (excluding grants)	-17.3	-10.3	-10.5	-12.5	-11.6	-9.5	-8.9	-8.2	-7.5
Overall balance	-5.7	0.1	-2.9	-7.0	-1.1	-1.1	-0.9	-0.8	-0.7
Foreign financing	2.0	0.9	1.3	1.6	1.1	1.1	0.9	0.8	0.7
Domestic financing	3.7	-0.9	1.7	5.6	0.0	0.0	0.0	0.0	0.0
Privatization	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Discrepancy [4]	-0.1	-0.1	-0.1	-0.2	0.0	0.0	0.0	0.0	0.0
Money and credit (change in percent of broad money at the beginning of the period, unless otherwise indicated)									
Money and quasi money	23.9	33.9	35.7	18.2	24.5	17.1	20.6	18.3	17.6
Net foreign assets	-15.5	13.3	-7.9	-1.2	11.3	10.0	11.5	10.5	8.7
Net domestic assets	39.5	20.6	43.6	19.5	13.2	7.1	9.1	7.8	8.9
Credit to the government	19.4	-9.2	19.7	11.0	2.9	-1.0	0.6	0.3	1.6
Credit to the rest of the economy (percent change)	36.5	47.6	30.1	17.5	16.7	13.1	12.6	12.4	12.3
External sector (US$ millions, unless otherwise indicated)									
Exports (goods and services)	1,050.2	1,360.4	1,408.7	1,386.1	1,604.1	1,730.4	1,868.2	2,017.4	2,178.4
Imports (goods and services)	1,961.1	2,425.4	2,214.5	2,257.6	2,349.2	2,488.9	2,629.9	2,808.5	3,026.9
Usable gross official reserves	140.5	279.6	190.2	204.5	405.7	564.9	728.6	885.2	1,029.3
(months of imports)	0.7	1.5	1.0	1.0	2.0	2.6	3.1	3.5	3.8
(percent of reserve money)	40.7	73.4	42.5	52.8	91.3	115.0	132.8	161.6	181.3
Current account (percent of GDP)	-4.8	-1.3	-5.9	-4.3	-1.7	-1.8	-1.6	-1.8	-2.5
Current account, excl. official transfers (percent of GDP)	-14.2	-17.0	-11.9	-15.7	-12.7	-12.1	-11.2	-10.7	-10.7
Real effective exchange rate (percent change)	-8.2	-0.4	10.7	…	…	…	…	…	…
Overall balance (percent of GDP)	-2.0	2.2	-1.9	-0.5	3.2	2.9	3.2	3.2	2.7
Terms of trade (percent change)	7.7	3.0	-17.6	20.5	1.1	3.1	2.9	2.3	2.6
Debt stock and service (percent of GDP, unless otherwise indicated)									
External debt (public sector)	15.9	16.0	16.2	20.3	20.6	19.5	18.5	17.4	17.5
NPV of debt (percent of exports)	57.1	44.6	48.1	52.2	46.1	41.9	37.8	33.9	31.7
External debt service (percent of exports)	1.3	1.3	1.6	2.4	2.5	3.8	3.8	3.6	2.5
External debt service (percent of revenue excl. grants)	1.4	1.5	1.7	3.6	4.0	5.8	5.8	5.4	3.7
91-day treasury bill rate (end of period)	10.5	6.2	6.8	…	…	…	…	…	…

Sources: Malawian authorities and IMF staff estimates.

[1] Reflects substantial upward revisions to the historical national accounts data received in March 2011.

[2] The government savings—investment balance is calculated adding foreign grants to government savings above.
The private savings—investment balance is calculated adding the items in the balance of payments, net of foreign grants, to private savings above.

[3] For example, 2009 refers to fiscal year 2008/09, which is from July 1, 2008, to June 30, 2009.

[4] For 2011/12 fiscal year, reflects the outturns of the first three quarters and the projections for the fourth quarter.

Table 2a. Malawi: Central Government Operations 2008/09–2016/17
(Millions of kwacha)

	2008/09	2009/10	2010/11	2011/12	2012/13	2013/14	2014/15	2015/16	2016/17
	Actual	Actual	Actual	Proj.	Prog.	Proj.	Proj.	Proj.	Proj.
Revenue	210,270	257,499	271,900	260,203	394,454	437,207	493,206	552,278	617,618
Taxes	119,022	141,755	175,695	180,906	236,442	281,985	324,339	370,799	423,689
Taxes on income and profits	50,549	66,411	81,117	89,924	110,764	130,162	148,206	169,738	191,329
Taxes on goods and services	57,845	64,451	79,425	79,799	101,656	123,562	143,985	164,451	190,251
Taxes on international trade	13,571	14,993	17,488	17,550	31,287	37,112	42,183	47,941	54,885
Other taxes	-2,943	-4,100	-2,335	-6,366	-7,265	-8,851	-10,034	-11,331	-12,776
Tax refunds	-4,178	-5,663	-4,508	-8,152	-9,465	-11,531	-13,074	-14,763	-16,646
Other taxes	1,236	1,563	2,174	1,786	2,200	2,681	3,039	3,432	3,869
Grants	75,979	78,448	64,329	52,678	124,079	115,933	124,196	130,667	136,357
Budget support	19,875	34,040	14,923	362	53,864	40,368	45,806	48,172	50,266
Project [1]	24,347	25,844	18,876	17,200	22,598	27,384	29,056	30,577	31,907
Dedicated grants	31,757	18,564	30,530	35,116	47,617	48,181	49,334	51,918	54,184
Of which:									
DFID/EU (maize, fertilizer and seed)	2,833	3,598	2,682	7,132	8,577	7,312	5,546	5,847	6,109
National AIDS Commission	11,950	6,711	9,630	8,590	12,220	9,146	9,705	10,213	10,657
Health Sector–Wide Approach (SWAp)	14,390	8,255	11,027	10,407	7,771	10,794	11,327	11,920	12,438
Other revenue	15,269	37,296	31,877	26,619	33,933	39,289	44,671	50,812	57,573
Nontax revenue	15,269	37,296	31,877	26,619	33,933	39,289	44,671	50,812	57,573
Expenditure	247,519	255,947	295,195	328,105	407,941	451,973	507,486	565,775	630,995
Expense	200,780	195,861	230,225	250,686	331,715	352,755	394,705	442,684	495,731
Compensation of employees [2]	37,595	44,792	58,092	69,916	86,822	100,714	113,806	128,601	145,319
Purchases of goods and services	86,137	84,120	95,054	102,906	122,419	108,742	130,336	150,408	171,950
Generic goods and services	43,877	44,343	40,766	60,328	54,337	30,641	41,004	47,898	55,610
Roads	6,257	7,877	7,979	6,385	11,009	11,361	13,007	15,056	17,257
Health SWAp [3]	12,547	19,909	19,014	15,544	20,097	23,255	26,378	30,392	34,237
Education SWAp	…	0	9,760	10,927	18,230	21,216	24,358	27,758	31,389
National / local elections	7,684	135	222	58	100	116	132	149	167
Statutory expenditures	2,503	1,633	3,038	3,799	4,506	5,228	5,928	6,694	7,547
National AIDS Commission	9,558	7,924	12,394	4,666	12,838	15,413	17,816	20,527	23,562
Maize purchases	2,031	2,300	1,880	1,200	1,302	1,511	1,713	1,934	2,181
Interest payments	17,863	21,498	22,819	20,243	28,753	32,696	27,569	26,649	25,488
Domestic	17,323	20,803	22,209	18,598	25,210	29,185	23,651	22,455	21,162
Foreign	540	695	610	1,645	3,543	3,510	3,918	4,194	4,325
Subsidies	50,026	34,682	36,994	41,400	57,897	67,653	77,038	86,681	97,740
Fertilizer and seed subsidy	37,823	21,938	22,359	24,622	40,884	47,912	54,657	61,408	69,245
Transfers to public entities	12,203	12,744	14,635	16,778	17,013	19,740	22,380	25,273	28,495
Grants	3,646	4,394	5,225	4,358	7,115	8,256	9,360	10,569	11,917
Transfers to NRA and MRA	3,646	4,394	5,225	4,358	7,115	8,256	9,360	10,569	11,917
Social benefits	5,106	6,376	12,042	11,863	18,698	21,695	24,597	27,776	31,317
Pension and gratuities	5,106	6,376	12,042	11,863	18,698	21,695	24,597	27,776	31,317
Other expense	407	0	0	0	10,011	13,000	12,000	12,000	0
Arrears payment	407	0	0	0	10,011	13,000	12,000	12,000	0
Net acquisition of nonfinancial assets	46,740	60,086	64,971	77,419	76,226	99,219	112,781	123,091	135,264
Part I (foreign financed)	32,167	34,271	31,687	35,460	38,571	49,291	52,300	55,039	57,432
Part II (domestically financed)	14,573	25,815	33,284	41,959	37,655	49,928	60,481	68,052	77,832
Gross operating balance	9,490	61,638	41,676	9,517	62,739	84,453	98,501	109,594	121,887
Net lending/borrowing (overall balance)	-37,250	1,552	-23,295	-67,901	-13,487	-14,766	-14,280	-13,498	-13,377
Net financial transactions	-37,250	1,552	-23,295	-67,901	-13,487	-14,766	-14,280	-13,498	-13,377
Net acquisition of financial assets	-453	1,150	1,000	0	0	0	0	0	0
Currency and deposits	….	…. .	…. .	….	….	….	….	….	….
Loans (net lending)	0	1,150	1,000	0	0	0	0	0	0
Equity other than shares (privatization)	-453	0	0	0	0	0	0	0	0
Net incurrence of liabilities	37,411	70	24,874	70,051	13,487	14,766	14,280	13,498	13,377
Domestic	24,074	-6,753	14,037	54,394	0	0	0	0	-95
Loans (borrowing)	24,074	-6,753	14,037	54,394	0	0	0	0	-95
Foreign	13,338	6,823	10,837	15,657	13,487	14,767	14,279	13,498	13,473
Loans (borrowing)	13,338	6,823	10,837	15,657	13,487	14,767	14,279	13,498	13,473
Program	7,298	0	0	0	3,037	0	0	0	0
Project	7,252	8,427	12,811	18,260	15,973	21,907	23,245	24,462	25,525
Other concessional	0	0	0	124	0	0	0	0	0
Amortization	-1,213	-1,604	-1,974	-2,726	-5,523	-7,140	-8,965	-10,964	-12,052
Discrepancies	*-614*	*-472*	*-579*	*-2,150*	*0*	*0*	*0*	*0*	*0*
Memorandum items:									
Net lending/borrowing (excluding grants)	-113,229	-78,046	-88,624	-120,579	-137,566	-137,566	-137,566	-137,566	11,917
Primary balance	-19,387	23,049	-476	-47,658	15,266	17,930	13,289	13,151	12,111
Net domestic debt (billions) [4]	116.9	110.2	138.0	192.4	192.4	192.4	192.4	192.4	192.3
Nominal GDP in billions kwacha	655.6	761.3	846.1	964.5	1,188.0	1,378.4	1,562.8	1,764.8	1,989.8

Sources: Malawi Ministry of Finance and IMF staff estimates.

[1] Includes estimate for project loans not channeled through the budget.

[2] Compensation of employees grows faster than nominal GDP to reflect salary increases for educational and health workers.

[3] Health SWAp expenditures in 2009/10 are higher than budgeted owing to a reclassification of spending from generic goods and services.

[4] Excluding recapitalization of the RBM.

Table 2b. Malawi: Central Government Operations 2008/09–2016/17

(Percent of GDP)

	2008/09	2009/10	2010/11	2011/12	2012/13	2013/14	2014/15	2015/16	2016/17
	Actual	Actual	Actual	Proj.	Prog.	Proj.	Proj.	Proj.	Proj.
Revenue	32.1	33.8	32.1	27.0	33.2	31.7	31.6	31.3	31.0
Taxes	18.2	18.6	20.8	18.8	19.9	20.5	20.8	21.0	21.3
Taxes on income and profits	7.7	8.7	9.6	9.3	9.3	9.4	9.5	9.6	9.6
Taxes on goods and services	8.8	8.5	9.4	8.3	8.6	9.0	9.2	9.3	9.6
Taxes on international trade	2.1	2.0	2.1	1.8	2.6	2.7	2.7	2.7	2.8
Other taxes	-0.4	-0.5	-0.3	-0.7	-0.6	-0.6	-0.6	-0.6	-0.6
Tax refunds	-0.6	-0.7	-0.5	-0.8	-0.8	-0.8	-0.8	-0.8	-0.8
Other taxes	0.2	0.2	0.3	0.2	0.2	0.2	0.2	0.2	0.2
Grants	11.6	10.3	7.6	5.5	10.4	8.4	7.9	7.4	6.9
Budget support	3.0	4.5	1.8	0.0	4.5	2.9	2.9	2.7	2.5
Project [1]	3.7	3.4	2.2	1.8	1.9	2.0	1.9	1.7	1.6
Dedicated grants	4.8	2.4	3.6	3.6	4.0	3.5	3.2	2.9	2.7
Of which:	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
DFID/EU (maize, fertilizer and seed)	0.4	0.5	0.3	0.7	0.7	0.5	0.4	0.3	0.3
National AIDS Commission	1.8	0.9	1.1	0.9	1.0	0.7	0.6	0.6	0.5
Health Sector–Wide Approach (SWAp)	2.2	1.1	1.3	1.1	0.7	0.8	0.7	0.7	0.6
Other revenue	2.3	4.9	3.8	2.8	2.9	2.9	2.9	2.9	2.9
Nontax revenue	2.3	4.9	3.8	2.8	2.9	2.9	2.9	2.9	2.9
Expenditure	37.8	33.6	34.9	34.0	34.3	32.8	32.5	32.1	31.7
Expense	30.6	25.7	27.2	26.0	27.9	25.6	25.3	25.1	24.9
Compensation of employees [2]	5.7	5.9	6.9	7.2	7.3	7.3	7.3	7.3	7.3
Purchases of goods and services	13.1	11.0	11.2	10.7	10.3	7.9	8.3	8.5	8.6
Generic goods and services	6.7	5.8	4.8	6.3	4.6	2.2	2.6	2.7	2.8
Roads	1.0	1.0	0.9	0.7	0.9	0.8	0.8	0.9	0.9
Health SWAp [3]	1.9	2.6	2.2	1.6	1.7	1.7	1.7	1.7	1.7
Education SWAp	….	0.0	1.2	1.1	1.5	1.5	1.6	1.6	1.6
National/local elections	1.2	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Statutory expenditures	0.4	0.2	0.4	0.4	0.4	0.4	0.4	0.4	0.4
National AIDS Commission	1.5	1.0	1.5	0.5	1.1	1.1	1.1	1.2	1.2
Maize purchases	0.3	0.3	0.2	0.1	0.1	0.1	0.1	0.1	0.1
Interest payments	2.7	2.8	2.7	2.1	2.4	2.4	1.8	1.5	1.3
Domestic	2.6	2.7	2.6	1.9	2.1	2.1	1.5	1.3	1.1
Foreign	0.1	0.1	0.1	0.2	0.3	0.3	0.3	0.2	0.2
Subsidies	7.6	4.6	4.4	4.3	4.9	4.9	4.9	4.9	4.9
Fertilizer and seed subsidy	5.8	2.9	2.6	2.6	3.4	3.5	3.5	3.5	3.5
Transfers to public entities	1.9	1.7	1.7	1.7	1.4	1.4	1.4	1.4	1.4
Grants	0.6	0.6	0.6	0.5	0.6	0.6	0.6	0.6	0.6
Transfers to NRA and MRA	0.6	0.6	0.6	0.5	0.6	0.6	0.6	0.6	0.6
Social benefits	0.8	0.8	1.4	1.2	1.6	1.6	1.6	1.6	1.6
Pension and gratuities	0.8	0.8	1.4	1.2	1.6	1.6	1.6	1.6	1.6
Other expense	0.1	0.0	0.0	0.0	0.8	0.9	0.8	0.7	0.0
Arrears payment	0.1	0.0	0.0	0.0	0.8	0.9	0.8	0.7	0.0
Net acquisition of nonfinancial assets	7.1	7.9	7.7	8.0	6.4	7.2	7.2	7.0	6.8
Part I (foreign financed)	4.9	4.5	3.7	3.7	3.2	3.6	3.3	3.1	2.9
Part II (domestically financed)	2.2	3.4	3.9	4.4	3.2	3.6	3.9	3.9	3.9
Gross operating balance	1.4	8.1	4.9	1.0	5.3	6.1	6.3	6.2	6.1
Net lending/borrowing (overall balance)	-5.7	0.2	-2.8	-7.0	-1.1	-1.1	-0.9	-0.8	-0.7
Net financial transactions	-5.7	0.2	-2.8	-7.0	-1.1	-1.1	-0.9	-0.8	-0.7
Net acquisition of financial assets	-0.1	0.2	0.1	0.0	0.0	0.0	0.0	0.0	0.0
Currency and deposits	….	…. .	…. .	….	….	….	….	….	….
Loans (net lending)	0.0	0.2	0.1	0.0	0.0	0.0	0.0	0.0	0.0
Equity other than shares (privatization)	-0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Net incurrence of liabilities	5.7	0.0	2.9	7.3	1.1	1.1	0.9	0.8	0.7
Domestic	3.7	-0.9	1.7	5.6	0.0	0.0	0.0	0.0	0.0
Loans (borrowing)	3.7	-0.9	1.7	5.6	0.0	0.0	0.0	0.0	0.0
Foreign	2.0	0.9	1.3	1.6	1.1	1.1	0.9	0.8	0.7
Loans (borrowing)	2.0	0.9	1.3	1.6	1.1	1.1	0.9	0.8	0.7
Program	1.1	0.0	0.0	0.0	0.3	0.0	0.0	0.0	0.0
Project	1.1	1.1	1.5	1.9	1.3	1.6	1.5	1.4	1.3
Other concessional	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Amortization	-0.2	-0.2	-0.2	-0.3	-0.5	-0.5	-0.6	-0.6	-0.6
Discrepancies	-0.1	-0.1	-0.1	-0.2	0.0	0.0	0.0	0.0	0.0
Memorandum items:									
Net lending/borrowing (excluding grants)	-17.3	-10.3	-10.5	-12.5	-11.6	-10.0	-8.8	-7.8	0.6
Primary balance	-3.0	3.0	-0.1	-4.9	1.3	1.3	0.9	0.7	0.6
Net domestic debt [4]	17.8	14.5	16.3	19.9	16.2	14.0	12.3	10.9	9.7
Nominal GDP in billions kwacha	655.6	761.3	846.1	964.5	1,188.0	1,378.4	1,562.8	1,764.8	1,989.8

Sources: Malawi Ministry of Finance and IMF staff estimates.

[1] Includes estimate for project loans not channeled through the budget.

[2] Compensation of employees grows faster than nominal GDP to reflect salary increases for educational and health workers.

[3] Health SWAp expenditures in 2009/10 are higher than budgeted owing to a reclassification of spending from generic goods and services.

[4] Excluding recapitalization of the RBM.

Table 3a. Malawi: Monetary Authorities' Survey, 2009–17

(Millions of Kwacha, unless otherwise indicated)

	2009	2010	2011				2012				2013				2014	2015	2016	2017
			Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4				
	Act.	Act.	Act.				Act.	Proj.			Proj.				Proj.			
Reserve money	50,393	57,417	51,946	60,671	79,483	73,220	89,168	76,178	88,210	97,809	99,120	105,830	113,931	118,657	138,912	167,537	198,268	233,068
Currency outside banks	27,493	30,663	26,428	37,126	41,452	42,251	37,333	…	…	…	…	…	…	…	…	…	…	…
Cash in vault	5,989	8,875	7,863	8,044	8,253	11,251	8,785	…	…	…	…	…	…	…	…	…	…	…
Commercial bank deposits with RBM	16,911	17,879	17,654	15,501	29,779	19,717	43,050	…	…	…	…	…	…	…	…	…	…	…
Net foreign assets (NFA) [1]	-9,444	8,076	-9,415	-5,566	2,349	-8,840	-17,773	-37,110	-20,598	-20,138	-6,931	4,759	12,486	19,673	63,265	122,020	187,608	251,574
NFA (US$ millions)	-69	54	-62	-37	4	-63	-117	-148	-82	-80	-27	19	47	74	224	399	589	761
Foreign assets (US$ millions) 2	167	302	193	221	266	193	141	103	187	208	277	340	365	409	568	732	888	1,032
Foreign liabilities (US$ millions)	-235	-248	-256	-258	-262	-256	-258	-250	-269	-287	-304	-321	-318	-335	-344	-332	-300	-271
Net domestic assets	59,837	49,341	61,361	66,237	77,133	82,060	106,941	113,289	108,808	117,946	106,051	101,071	101,445	98,984	75,647	45,518	10,659	-18,506
Credit to government (net) 3	85,745	72,515	91,085	85,638	109,651	102,929	124,776	126,378	117,876	139,498	134,611	126,378	142,664	147,953	144,169	146,702	142,976	146,891
Credit to statutory bodies (net)	978	699	726	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0
Credit to domestic banks	2	12	581	471	61	1	2,517	2,517	2,517	2,517	2,517	2,517	2,517	2,517	2,517	2,517	2,517	2,517
Other items (net)[3]	-26,888	-23,884	-31,032	-19,872	-32,579	-20,870	-20,352	-15,607	-11,585	-24,069	-31,076	-27,824	-43,736	-51,486	-71,039	-103,701	-134,834	-167,914
Memorandum items:																		
Money multiplier	3.4	4.0	4.5	4.4	3.7	4.3	3.5	4.2	3.8	3.8	3.9	3.8	3.7	3.9	3.9	3.9	3.9	3.9
91-day treasury bill rate	10.5	6.2	6.3	7.5	5.3	6.8	6.8	…	…	…	…	…	…	…	…	…	…	…

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

[1] Including SDR allocation and the entire assets and liabilities of the RBM

[2] Reserve holdings managed by the Crown Agents have not yet been verified by an independent audit agency. These assets amounted to US$3.0 million at end-October, 2010.

[3] Includes recapitalization of RBM with a transfer of treasury bills in the amount of 29.3 billion in January 2008.

Table 3b. Malawi: Monetary Survey, 2009–17

(Millions of Kwacha, unless otherwise indicated)

	2009	2010	2011				2012				2013	2014	2015	2016	2017
	Q4	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4					
	Act.	Act.	Act.				Proj.				Proj.				
Money and quasi-money	173,050	231,711	235,163	265,590	292,282	314,331	315,938	319,948	332,241	371,674	462,762	541,758	653,396	773,244	908,966
Money	81,900	125,193	121,715	144,008	158,812	163,962	155,518	…	…	…	…	…	…	…	…
Quasi-money	91,150	106,517	113,448	121,583	133,470	150,369	160,420	…	…	…	…	…	…	…	…
Of which: foreign currency deposits	18,198	21,423	22,650	25,105	27,874	26,356	26,823	…	…	…	…	…	…	…	…
Net foreign assets (NFA)	-2,043	20,971	332	4,276	20,220	2,590	-3,877	-19,164	-2,561	-1,323	40,701	86,911	149,222	217,895	285,073
NFA (US$ millions)	-14	135	0	24	118	15	-22	-76	-10	-5	152	307	488	684	862
Foreign assets (US$ millions)	244	394	278	328	410	297	254	201	285	306	507	666	830	987	1,131
Foreign liabilities (US$ millions)	-258	-259	-278	-303	-293	-283	-276	-277	-296	-311	-355	-359	-341	-303	-268
Monetary authorities	-9,444	8,076	-9,415	-5,566	2,349	-8,840	-17,773	-37,110	-20,598	-20,138	19,673	63,265	122,020	187,608	251,574
NFA of the monetary authorities (US$ millions) [1]	-69	54	-62	-37	4	-63	-117	-148	-82	-80	74	224	399	589	761
Gross foreign assets	24,320	45,543	29,157	33,358	44,156	31,651	23,532	25,770	47,267	52,421	109,122	160,648	223,506	283,167	341,270
Foreign liabilities	-33,764	-37,467	-38,572	-38,924	-41,806	-40,491	-41,305	-62,881	-67,865	-72,559	-89,449	-97,383	-101,487	-95,558	-89,696
Commercial banks	7,401	12,895	9,747	9,842	17,870	11,430	13,896	17,946	18,037	18,815	21,028	23,646	27,202	30,287	33,499
NFA of the commercial banks (US$ millions)	51	82	62	61	103	69	83	71	71	75	79	84	89	95	101
Gross foreign assets (US$ millions)	78	92	85	107	144	104	114	98	98	98	98	98	98	98	98
Foreign liabilities (US$ millions)	-27	-10	-23	-45	-41	-35	-30	-27	-27	-24	-19	-15	-9	-3	3
Net domestic assets	175,093	210,739	234,831	261,314	272,063	311,741	319,815	339,113	334,802	372,996	422,061	454,846	504,174	555,348	623,893
Credit to government (net)	110,998	95,033	117,048	107,294	137,061	140,693	156,545	158,574	147,806	175,191	185,900	181,107	184,315	185,734	198,220
Credit to statutory bodies (net)	6,239	4,662	6,416	13,812	16,123	20,024	18,222	18,222	18,222	18,222	18,222	18,222	18,222	18,222	18,222
Credit to private sector	95,044	144,843	152,108	162,733	165,208	174,538	178,982	192,972	199,611	210,445	248,596	283,636	321,543	363,627	410,722
Other items (net)	-37,188	-33,798	-40,741	-22,525	-46,330	-23,514	-33,934	-30,655	-30,836	-30,862	-30,657	-28,119	-19,905	-12,235	-3,271
Memorandum items:															
Velocity of money (annualized GDP divided by broad money)	4.0	3.5	3.5	3.2	3.0	2.8	2.9	3.0	3.1	2.9	2.8	2.7	2.5	2.4	2.3
Annual growth of broad money (percent)	23.9	33.9	21.7	37.0	26.1	35.7	34.3	20.5	13.7	18.2	24.5	17.1	20.6	18.3	17.6
Annual growth of credit to the private sector (percent)	39.5	52.4	38.9	28.1	26.8	20.5	17.7	18.6	20.8	20.6	18.1	14.1	13.4	13.1	13.0

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

[1] Including SDR allocation.

Table 4a. Malawi: Balance of Payments, 2009–17
(US$ millions, unless otherwise indicated)

	2009 Est.	2010 Est.	2011 Proj.	2012 Proj.	2013 Proj.	2014 Proj.	2015 Proj.	2016 Proj.	2017 Proj.
Current account balance (including grants)	-244.1	-69.9	-332.9	-201.3	-81.3	-91.7	-91.3	-109.5	-159.5
Merchandise trade balance	-636.7	-743.7	-608.3	-631.9	-496.4	-495.0	-483.6	-494.2	-527.9
Exports	936.7	1,237.7	1,262.7	1,273.8	1,485.4	1,604.4	1,734.0	1,874.1	2,025.7
Of which: Tobacco	501.3	687.6	482.4	458.0	577.1	606.0	636.3	668.1	701.5
Uranium	8.5	113.4	120.4	164.3	180.8	198.9	218.7	240.6	264.7
Imports	-1,573.3	-1,981.3	-1,871.0	-1,905.7	-1,981.8	-2,099.4	-2,217.6	-2,368.3	-2,553.6
Of which: Petroleum	-166.4	-180.9	-168.8	-190.2	-187.5	-180.6	-176.3	-175.1	-176.3
Services balance	-333.2	-429.8	-312.8	-379.7	-402.7	-432.5	-458.0	-488.8	-529.7
Interest public sector (net)	-4.7	-3.5	-5.6	-8.5	-11.0	-12.3	-12.8	-12.7	-14.4
Receipts	0.4	0.1	0.4	1.7	1.7	1.7	1.7	0.0	0.0
Payments	-5.1	-3.6	-6.0	-10.2	-12.7	-14.0	-14.5	-14.4	-14.4
Other factor payments (net)	-54.2	-105.0	-109.7	-131.5	-143.0	-156.8	-167.2	-177.4	-194.7
Nonfactor (net)	-274.3	-321.4	-197.5	-239.6	-248.8	-263.5	-278.1	-297.0	-320.6
Receipts	113.5	122.7	146.0	112.3	118.7	126.0	134.2	143.2	152.7
Payments	-387.8	-444.1	-343.5	-351.9	-367.5	-389.5	-412.3	-440.2	-473.3
Unrequited transfers (net)	725.8	1,103.6	588.2	810.3	817.8	835.9	850.4	873.5	898.1
Private (net)	254.5	254.1	256.0	267.1	282.3	299.7	319.2	340.6	363.2
Receipts	267.7	267.7	270.8	282.5	298.7	317.0	337.7	360.3	384.3
Payments	-13.2	-13.6	-14.8	-15.5	-16.4	-17.4	-18.5	-19.7	-21.0
Official (net)	471.2	849.5	332.2	543.2	535.5	536.2	531.2	532.9	534.9
Receipts	472.0	850.2	332.9	544.0	536.3	537.0	532.0	533.7	535.7
Budget support	81.6	321.7	0.0	88.1	185.3	162.4	157.6	157.5	157.5
Project related[1]	390.4	528.6	332.9	455.9	351.0	374.6	374.4	376.2	378.2
Payments	-0.8	-0.7	-0.8	-0.8	-0.8	-0.8	-0.8	-0.8	-0.8
Financial account balance	235.0	280.3	155.9	177.8	234.8	241.7	267.1	298.6	332.0
Medium- and long-term flows (net)	151.3	90.5	104.6	90.6	121.6	101.2	97.1	97.1	97.1
Disbursements	73.4	104.4	118.9	108.5	144.8	130.0	130.0	130.0	130.0
Budget support	29.5	0.0	0.0	7.8	4.0	0.0	0.0	0.0	0.0
Project support	21.9	104.4	48.9	83.2	70.8	80.0	80.0	80.0	80.0
Other medium-term loans	22.0	0.0	70.0	17.4	70.0	50.0	50.0	50.0	50.0
Amortization	-8.5	-14.0	-14.4	-17.8	-23.3	-28.8	-32.9	-32.9	-32.9
SDR allocation	86.5	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Foreign direct investment and other inflows	55.5	158.2	60.8	83.4	108.2	134.8	163.6	194.5	227.5
Short-term capital	0.7	0.7	0.7	0.7	0.8	0.8	0.9	0.9	1.0
Commercial banks net foreign assets	27.5	30.9	-10.1	3.1	4.3	4.8	5.4	6.0	6.3
Errors and omissions	-91.8	-90.3	68.9	0.0	0.0	0.0	0.0	0.0	0.0
Overall balance	-100.9	120.1	-108.1	-23.4	153.4	150.0	175.8	189.1	172.5
Financing	100.9	-120.1	108.1	23.4	-153.4	-150.0	-175.8	-189.1	-172.5
Gross reserves (- increase)	98.5	-139.1	107.7	-14.3	-201.2	-159.2	-163.7	-156.6	-144.0
Liabilities[2]	2.2	19.1	0.3	37.8	47.7	9.3	-12.1	-32.5	-28.4
Of which: IMF (net)	-0.4	21.2	-0.1	37.6	51.7	13.8	-7.4	-28.2	-24.8
Purchases/drawings	0.0	21.3	0.0	40.2	60.2	40.2	20.1	0.0	0.0
Repurchases/repayments	0.4	0.2	0.1	2.5	8.5	26.4	27.5	28.2	24.8
Memorandum items:									
Gross official reserves[3]	140.5	279.6	190.2	204.5	405.7	564.9	728.6	885.2	1,029.3
Months of imports[4]	0.7	1.5	1.0	1.0	2.0	2.6	3.1	3.5	3.8
Current account balance (percent of GDP)									
Excluding official transfers	-14.2	-17.0	-11.9	-15.7	-12.7	-12.1	-11.2	-10.7	-10.7
Including official transfers	-4.8	-1.3	-5.9	-4.3	-1.7	-1.8	-1.6	-1.8	-2.5
Value of exports of goods and services (percent change)	0.7	29.5	3.6	-1.6	15.7	7.9	8.0	8.0	8.0
Value of imports of goods and services (percent change)	-6.2	23.7	-8.7	1.9	4.1	5.9	5.7	6.8	7.8
REER (percent change)	-8.2	-0.4	…	…	…	…	…	…	…
Overall balance (percent of GDP)	-2.0	2.2	-1.9	-0.5	3.2	2.9	3.2	3.2	2.7
Terms of trade (percent change)	7.7	3.0	-17.6	20.5	1.1	3.1	2.9	2.3	2.6
Nominal GDP (millions of U.S. dollars)	5,034.1	5,396.9	5,606.6	4,733.9	4,838.1	5,202.5	5,554.8	5,987.5	6,482.6

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

[1] Includes estimate for project grants not channeled through the budget.

[2] Excluding SDR allocation.

[3] Figures for 2009 onward take account of Malawi's SDR allocation (SDR 55.4 million). Gross reserves are measured only from the balance sheet of the central bank and exclude holdings of the government overseas in the crown agent accounts, which was US$ 3.1 million at end-December 2010.

[4] Months of prospective imports of goods and nonfactor services.

Table 4b. Malawi: Balance of Payments, 2009–17
(Percent of GDP)

	2009 Est.	2010 Est.	2011 Proj.	2012 Proj.	2013 Proj.	2014 Proj.	2015 Proj.	2016 Proj.	2017 Proj.
Current account balance (including grants)	-4.8	-1.3	-5.9	-4.3	-1.7	-1.8	-1.6	-1.8	-2.5
Merchandise trade balance	-12.6	-13.8	-10.8	-13.3	-10.3	-9.5	-8.7	-8.3	-8.1
Exports	18.6	22.9	22.5	26.9	30.7	30.8	31.2	31.3	31.2
Of which: Tobacco	10.0	12.7	8.6	9.7	11.9	11.6	11.5	11.2	10.8
Uranium	0.2	2.1	2.1	3.5	3.7	3.8	3.9	4.0	4.1
Imports	-31.3	-36.7	-33.4	-40.3	-41.0	-40.4	-39.9	-39.6	-39.4
Of which: Petroleum	-3.3	-3.4	-3.0	-4.0	-3.9	-3.5	-3.2	-2.9	-2.7
Services balance	-6.6	-8.0	-5.6	-8.0	-8.3	-8.3	-8.2	-8.2	-8.2
Interest public sector (net)	-0.1	-0.1	-0.1	-0.2	-0.2	-0.2	-0.2	-0.2	-0.2
Receipts	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Payments	-0.1	-0.1	-0.1	-0.2	-0.3	-0.3	-0.3	-0.2	-0.2
Other factor payments (net)	-1.1	-1.9	-2.0	-2.8	-3.0	-3.0	-3.0	-3.0	-3.0
Nonfactor (net)	-5.4	-6.0	-3.5	-5.1	-5.1	-5.1	-5.0	-5.0	-4.9
Receipts	2.3	2.3	2.6	2.4	2.5	2.4	2.4	2.4	2.4
Payments	-7.7	-8.2	-6.1	-7.4	-7.6	-7.5	-7.4	-7.4	-7.3
Unrequited transfers (net)	14.4	20.4	10.5	17.1	16.9	16.1	15.3	14.6	13.9
Private (net)	5.1	4.7	4.6	5.6	5.8	5.8	5.7	5.7	5.6
Receipts	5.3	5.0	4.8	6.0	6.2	6.1	6.1	6.0	5.9
Payments	-0.3	-0.3	-0.3	-0.3	-0.3	-0.3	-0.3	-0.3	-0.3
Official (net)	9.4	15.7	5.9	11.5	11.1	10.3	9.6	8.9	8.3
Receipts	9.4	15.8	5.9	11.5	11.1	10.3	9.6	8.9	8.3
Budget support	1.6	6.0	0.0	1.9	3.8	3.1	2.8	2.6	2.4
Project related[1]	7.8	9.8	5.9	9.6	7.3	7.2	6.7	6.3	5.8
Payments	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Financial account balance	4.7	5.2	2.8	3.8	4.9	4.6	4.8	5.0	5.1
Medium- and long-term flows (net)	3.0	1.7	1.9	1.9	2.5	1.9	1.7	1.6	1.5
Disbursements	1.5	1.9	2.1	2.3	3.0	2.5	2.3	2.2	2.0
Budget support	0.6	0.0	0.0	0.2	0.1	0.0	0.0	0.0	0.0
Project support	0.4	1.9	0.9	1.8	1.5	1.5	1.4	1.3	1.2
Other medium-term loans	0.4	0.0	1.2	0.4	1.4	1.0	0.9	0.8	0.8
Amortization	-0.2	-0.3	-0.3	-0.4	-0.5	-0.6	-0.6	-0.5	-0.5
SDR allocation	1.7	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Foreign direct investment and other inflows	1.1	2.9	1.1	1.8	2.2	2.6	2.9	3.2	3.5
Short-term capital	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Commercial banks net foreign assets	0.5	0.6	-0.2	0.1	0.1	0.1	0.1	0.1	0.1
Errors and omissions	-1.8	-1.7	1.2	0.0	0.0	0.0	0.0	0.0	0.0
Overall balance	-2.0	2.2	-1.9	-0.5	3.2	2.9	3.2	3.2	2.7
Financing	2.0	-2.2	1.9	0.5	-3.2	-2.9	-3.2	-3.2	-2.7
Gross reserves (- increase)	2.0	-2.6	1.9	-0.3	-4.2	-3.1	-2.9	-2.6	-2.2
Liabilities[2]	0.0	0.4	0.0	0.8	1.0	0.2	-0.2	-0.5	-0.4
Of which: IMF (net)	0.0	0.4	0.0	0.8	1.1	0.3	-0.1	-0.5	-0.4
Purchases/drawings	0.0	0.4	0.0	0.8	1.2	0.8	0.4	0.0	0.0
Repurchases/repayments	0.0	0.0	0.0	0.1	0.2	0.5	0.5	0.5	0.4
Memorandum items:									
Gross official reserves[3]	2.8	5.2	3.4	4.3	8.4	10.9	13.1	14.8	15.9
Months of imports[4]	0.7	1.5	1.0	1.0	2.0	2.6	3.1	3.5	3.8
Current account balance (percent of GDP)									
Excluding official transfers	-14.2	-17.0	-11.9	-15.7	-12.7	-12.1	-11.2	-10.7	-10.7
Including official transfers	-4.8	-1.3	-5.9	-4.3	-1.7	-1.8	-1.6	-1.8	-2.5
Value of exports of goods and services (percent change)	0.7	29.5	3.6	-1.6	15.7	7.9	8.0	8.0	8.0
Value of imports of goods and services (percent change)	-6.2	23.7	-8.7	1.9	4.1	5.9	5.7	6.8	7.8
REER (percent change)	-8.2	-0.4	…	…	…	…	…	…	…
Overall balance (percent of GDP)	-2.0	2.2	-1.9	-0.5	3.2	2.9	3.2	3.2	2.7
Terms of trade (percent change)	7.7	3.0	-17.6	20.5	1.1	3.1	2.9	2.3	2.6

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

1 Includes estimate for project grants not channeled through the budget.

2 Excluding SDR allocation.

3 Figures for 2009 onward take account of Malawi's SDR allocation (SDR 55.4 million). Gross reserves are measured only from the balance sheet of the central bank and exclude holdings of the government overseas in the crown agent accounts, which was US$ 3.1 million at end-December 2010.

4 Months of prospective imports of goods and nonfactor services.

Table 5. Malawi: External Financing Requirement and Source, 2009–17

	2009	2010	2011	2012	2013	2014	2015	2016	2017
Total requirement	-625	-1072	-572	-777	-841	-816	-819	-832	-871
Current account, excluding official transfers	-715	-919	-665	-745	-617	-628	-622	-642	-694
Debt amortization	-9	-14	-14	-18	-23	-29	-33	-39	-37
Gross reserves accumulation	99	-139	108	-14	-201	-159	-164	-151	-140
Total Sources	625	1072	572	777	841	816	819	832	871
Expected disbursements (official)	545	954	451	652	680	666	661	663	665
Grants	471	850	332	543	535	536	531	533	535
Medium- and long-term loans	73	104	119	108	145	130	130	130	130
Private sector (net)	-5	97	121	87	109	136	165	197	231
IMF	86	21	0	38	52	14	-7	-28	-25
Drawings	0	21	0	40	60	40	20	0	0
Repayments	0	0	0	3	9	26	27	28	25
SDR allocation	86	0	0	0	0	0	0	0	0

Source: IMF staff estimates.

Table 6. Malawi: Proposed Schedule of Disbursements Under ECF Arrangement, 2012–15

(Amounts are in millions of SDR)

Amount	% of Quota	Date available	Conditions Necessary for Disbursement
13.02	18.75	July 23, 2012	Executive Board Approval of Three Year ECF arrangement.
13.02	18.75	December 15, 2012	Observance of performance criteria for September 30, 2012 and completion of first review.
13.01	18.75	March 15, 2013	Observance of performance criteria for December 31, 2012 and completion of second review.
13.01	18.75	June 15, 2013	Observance of performance criteria for March 31, 2013 and completion of third review.
13.01	18.75	December 15, 2013	Observance of performance criteria for September 30, 2013 and completion of fourth review.
13.01	18.75	June 15, 2014	Observance of performance criteria for March 31, 2014 and completion of fifth review.
13.01	18.75	December 15, 2014	Observance of performance criteria for September 30, 2014 and completion of sixth review.
13.01	18.75	June 15, 2015	Observance of performance criteria for March 31, 2015 and completion of seventh review.
104.10	150.00	Total for the ECF arrangement	

Source: IMF staff estimates.

Table 7. Malawi: Indicators of Capacity to Repay the Fund, 2012–22 [1]

	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022
Projected Payments based on Existing Drawings:											
(SDR millions)											
Principal	1.7	5.4	16.7	17.4	17.9	15.7	13.9	2.8	2.1	0.0	0.0
Charges and interest	0.1	0.2	0.3	0.2	0.2	0.2	0.1	0.1	0.1	0.1	0.1
Projected Payments based on Existing and Prospective Drawings:											
(SDR millions)											
Principal	1.7	5.4	16.7	17.4	17.9	15.7	21.7	17.1	21.6	20.8	20.8
Charges and interest	0.1	0.2	0.5	0.5	0.5	0.4	0.4	0.3	0.3	0.2	0.2
Total Payments based on Existing and Prospective Drawings:											
SDR millions	1.7	5.6	17.1	17.8	18.3	16.1	22.1	17.4	21.9	21.1	21.0
US$ Millions	2.7	8.6	26.4	27.5	28.3	24.9	34.1	26.9	33.8	32.5	32.4
Percent of exports of goods and services	0.2	0.5	1.5	1.5	1.4	1.1	1.4	1.1	1.2	1.1	1.0
Percent of debt service	13.1	27.2	48.5	46.2	42.7	40.8	48.5	42.6	48.2	47.2	47.1
Percent of quota	2.5	8.0	24.7	25.7	26.4	23.2	31.8	25.1	31.5	30.3	30.3
Percent of gross official reserves	1.3	2.1	4.7	3.8	3.2	2.4	2.9	2.1	2.5	2.0	1.7
Projected Level of Credit Outstanding based on Existing and Prospective Drawings:											
SDR millions	117.7	151.4	160.7	156.4	138.6	122.8	101.1	84.1	62.5	41.6	20.8
US$ Millions	181.7	233.6	248.1	241.4	213.8	189.6	156.1	129.7	96.4	64.2	32.1
Percent of exports of goods and services	13.1	14.6	14.3	12.9	10.6	8.7	6.6	5.1	3.5	2.2	1.0
Percent of debt service	897.3	740.7	455.6	405.3	322.6	311.1	222.5	205.7	137.7	93.4	46.7
Percent of quota	169.6	218.1	231.6	225.4	199.6	177.0	145.7	121.1	90.0	60.0	30.0
Percent of gross official reserves	88.8	57.6	43.9	33.1	24.2	18.4	13.3	10.1	7.0	4.0	1.7
Memorandum items:											
Exports of goods and services (US$ millions)	1386.1	1604.1	1730.4	1868.2	2017.4	2178.4	2352.0	2533.5	2733.8	2955.0	3198.7
Debt service (US$ millions)	20.2	31.5	54.5	59.6	66.3	60.9	70.2	63.1	70.0	68.8	68.8
Quota (SDR millions)	69.4	69.4	69.4	69.4	69.4	69.4	69.4	69.4	69.4	69.4	69.4
Gross official reserves (millions of U.S. dollars)	204.5	405.7	564.9	728.6	885.2	1029.3	1170.5	1284.8	1371.8	1622.8	1863.2
GDP (US$ millions)	4733.9	4838.1	5202.5	5554.8	5987.5	6482.6	6996.9	7839.6	8430.4	9013.9	9673.9

Sources: Malawian authorities; and IMF staff estimates and projections

[1] Assumes disbursements as per schedule in Table 6.

Table 8. Malawi: Quantitative Targets [1]

	Criteria [2]	End-Mar 2012 Stock Prel.	End-June. 2012 Stock Proj.	End-Sep. 2012 Prog.	End-Dec. 2012 Prog.	End-Mar. 2013 Prog.	Indicative End-Jun. 2013 Prog.
I. Monetary targets (millions of kwacha)							
1. Ceiling on net domestic assets of the RBM [3,4, 5, 6]	PC	119,709	114,579	109,417	118,542	106,256	100,930
2. Ceiling on reserve money[3]	IT	89,168	76,178	88,210	97,809	99,120	105,830
II. Fiscal targets (millions of kwacha)							
3. Ceiling on central government's net domestic borrowing [5,6,7]	PC			-11,988	18,500	11,609	0
4. Floor on social spending [8]	IT			39,034	94,044	121,798	151,899
III. External sector targets (US$ millions, unless otherwise indicated)							
5. Floor on net international reserves of the RBM[3, 5, 6]	PC	-7	-49	17	19	71	118
6. Ceiling on the accumulation of external payments arrears [7,9]	PC			0	0	0	0
8. Ceiling on new nonconcessional external debt maturing in more than one year [9]	PC			0	0	0	0
9. Ceiling on new nonconcessional external debt maturing in one year or less [9]	PC			0	0	0	0
10. Prohibition on the imposition or intensification of restrictions on the making [9,10] of payments and transfers for current transactions [9,10]	PC		…				
Memorandum items:							
Net foreign assets of the RBM (US$ millions)		-117	-148	-82	-80	-27	19
Budget support (US$ millions)				86	86	151	208
Budget support (millions of kwacha)				21,945	21,945	38,926	53,864
Debt service payments to the World Bank and African Development Bank (millions of kwacha)							
Health SWAp receipts (millions of kwacha)				5,248	5,364	7,771	7,771
Education SWAp receipts (millions of kwacha)				8,378	13,221	17,073	19,049
NAC receipts (millions of kwacha)				4,777	7,315	10,019	12,220
Program exchange rate (kwacha per US$)		260	260	260	260	260	260

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

[1] Targets are defined in the technical memorandum of understanding (TMU). Presentation uses stocks for all PCs except for the ceiling on the government's net domestic borrowing.

[2] "PC" means Performance Criterion, and "IT" means Indicative Target.

[3] Defined as stocks. All stocks of NDA adjusted for consistency with the program definition (specified in the TMU).

[4] Target is subject to an adjuster for liquidity reserve requirement.

[5] Targets are subject to an adjuster for budget support and debt service payments.

[6] Targets are subject to an adjuster for donor-funded social sector expenditures consistent with the TMU.

[7] Defined as a cumulative flow.

8 Priority social spending as defined and quantified in the TMU.

9 Evaluated on a continuous basis.

10 Other standard PCs include introducing or modfying MCPs, concluding bilateral payments agreements that are inconsistent with Article VIII, and imposing or intensifying import restrictions for balance of payment reasons.

Table 9. Malawi: Structural Benchmarks, 2012–13

Measure	Status/Target Date	Macro Rationale	Status
Prior Actions			
Parliamentary passage of a budget for FY 2012/13 in line with program objectives		Toward fiscal sustainability	Done
Structural benchmarks			
Fiscal transparency			
Publish monthly revenue collections of the Malawi Revenue Authority in newspapers within two weeks of the end of the month.	7/31/2012	Build credibility after recent incidents of inflation of revenue data by the Ministry of Finance.	
Public financial management			
Provide Ministries, Departments and Agencies with quarterly spending ceilings consistent with quarterly fiscal targets in the program, and enforce ceilings.	Begin in Sept 2012 for FY2012/13 Q2 and quarterly thereafter	Keep spending within available resource envelope.	
Verify existing stock of government domestic arrears and formulate a plan for settling verified claims.	31-Dec-12	Ascertain magnitude of government obligations.	
Configure the IFMIS Purchase Order (PO) module to support commitment control.	31-Dec-12	To restrain creation of arrears.	
Progressively extend processes for capturing donor funded project transactions in IFMIS to all projects where bank accounts are controlled by the government of Malawi.	31-Mar-13	Fuller accounting for impact of aid flows on the budget.	
Monetary Policy			
Amend RBM Act to limit the outstanding amount of RBM's total lending to government.	30-Jun-13	Reduce fiscal dominance to enhance effectiveness of monetary policy.	
Financial sector			
RBM to publish a financial stability report on a semi-annual basis, with a lag of no more than four months. Start with publication of report for quarter ending March 2012.	Semi-annual, starting in July 2012.	Promote financial stability.	
Obtain approval and begin implementation of the Financial Sector Development Strategy	31-Dec-12	Financial deepening.	

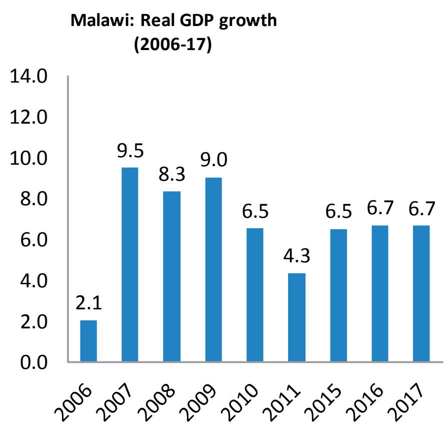
Table 10. Malawi: Millennium Development Goals

Goals	1990	1995	2000	2005	2007	2010
Goal 1: Eradicate extreme poverty and hunger						
Employment to population ratio, 15+, total (%)	72	72	73	76	80	77
Employment to population ratio, ages 15-24, total (%)	47	46	51	62	66	51
Income share held by lowest 20%	..	..	5.0	7.0	..	..
Malnutrition prevalence, weight for age (% of children under 5)	24.0	27.0	22.0	18.0	18.4	14.0
Poverty headcount ratio at $1.25 a day (PPP) (% of population)	..	..	83.0	74.0	..	..
Prevalence of undernourishment (% of population)	50	40	..	..	..	..
Vulnerable employment, total (% of total employment)	..	..	87	..	..	..
Goal 2: Achieve universal primary education						
Literacy rate, youth female (% of females ages 15-24)	..	..	71	..	..	86
Literacy rate, youth male (% of males ages 15-24)	..	..	82	..	..	87
Persistence to last grade of primary, total (% of cohort)	..	..	38	60	36	…
Primary completion rate, total (% of relevant age group)	28	52	65	58	55	67
Total enrollment, primary (% net)	..	..	99	98	93	97
Goal 3: Promote gender equality and empower women						
Proportion of seats held by women in national parliament (%)	10	6	8	14	14	21
Ratio of female to male enrollments in tertiary education	34	40	38	55	..	62
Ratio of female to male primary enrollment	87	91	97	103	104	104
Ratio of female to male secondary enrollment	57	68	75	82	84	91
Ratio of young literate females to males (% ages 15-24)	57	68	75	82	..	..
Share of women employed in the nonagricultural sector (% of total nonagricultural employment)	10.5	11.3	..	..	..	..
Goal 4: Reduce child mortality						
Immunization, measles (% of children ages 12-23 months)	81	90	73	82	85	93
Mortality rate, infant (per 1,000 live births)	131	121	99	77	76	58
Mortality rate, under-5 (per 1,000)	222	205	167	128	120	92
Goal 5: Improve maternal health						
Adolescent fertility rate (births per 1,000 women ages 15-19)	..	161	160	135	140	111
Births attended by skilled health staff (% of total)	55	..	56	54	54	..
Contraceptive prevalence (% of women ages 15-49)	13	22	31	41	42	..
Maternal mortality ratio (modeled estimate, per 100,000 live births)	1,100	1,000	840	630	1,100	460
Pregnant women receiving prenatal care (%)	90	..	91	92	92	..
Unmet need for contraception (% of married women ages 15-49)	36	..	30	28	..	..
Goal 6: Combat HIV/AIDS, malaria, and other diseases						
Children with fever receiving antimalarial drugs (% of children under age 5 with fever)	..	..	27	25	24	31
Condom use, population ages 15-24, female (% of females ages 15-24)	..	..	9	9	..	..
Condom use, population ages 15-24, male (% of males ages 15-24)	..	..	28	32	..	..
Incidence of tuberculosis (per 100,000 people)	326	462	467	354	377	219
Prevalence of HIV, female (% ages 15-24)	..	..	..	..	8.4	7
Prevalence of HIV, total (% of population ages 15-49)	7.2	13.9	14.2	12.1	11.9	11
Tuberculosis cases detected under DOTS (%)	41	42	45	56	42	65
Goal 7: Ensure environmental sustainability						
Annual freshwater withdrawals, total (% of internal resources)	..	..	6.3	..	..	..
CO2 emissions (kg per PPP $ of GDP)	0.0	0.0	0.0	0.0	..	0.0
CO2 emissions (metric tons per capita)	0.0	0.0	0.0	0.0	..	0
Forest area (% of land area)	41	..	38	36	36	34
Improved sanitation facilities (% of population with access)	39	42	46	48	60	51
Improved water source (% of population with access)	41	52	62	73	76	83
Marine protected areas, (% of surface area)	..	..	..	..	..	..
Nationally protected areas (% of total land area)	..	..	..	..	..	..
Goal 8: Develop a global partnership for development						
Aid per capita (current US$)	53	43	38	..	49	..
Debt service (Public and Publicly Guarranteed and IMF only, % of exports of G&S, excl. workers'	28.0	24.0	25.0	18.0	8.3	1.0
Internet users (per 100 people)	0.0	0.0	0.1	0.4	1.0	2.3
Mobile phone subscribers (per 100 people)	0.0	0.0	0.0	3.0	7.5	20.0
Telephone mainlines (per 100 people)	0.0	0.0	0.0	1.0	1.3	1.0
Other						
Fertility rate, total (births per woman)	7.0	6.0	6.0	6.0	5.7	6.0
GNI per capita, Atlas method (current US$)	180	160	160	220	250	330
GNI, Atlas method (current US$) (billions)	1.7	1.6	1.7	2.8	3.5	4.9
Gross capital formation (% of GDP)	23.0	17.4	13.6	22.7	28.5	24.8
Life expectancy at birth, total (years)	47	47	46	49	48	53
Literacy rate, adult total (% of people ages 15 and above)	..	..	64	..	..	74
Population, total (millions)	9.4	10.1	11.8	13.7	14.4	16
Trade (% of GDP)	57.2	78.5	60.9	76.2	40.6	77.8

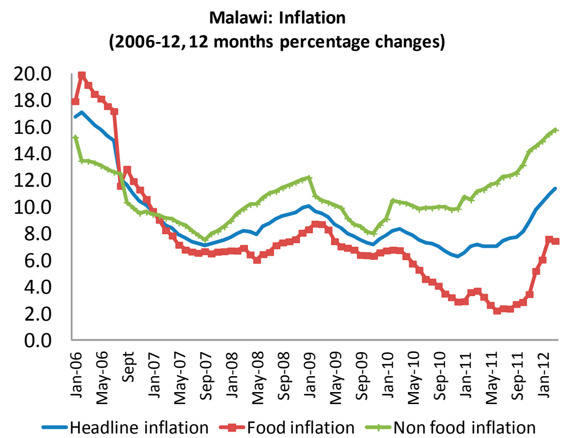
Source: World Development Indicators database.

Figure 1. Malawi: Real Sector Developments, 2006–17

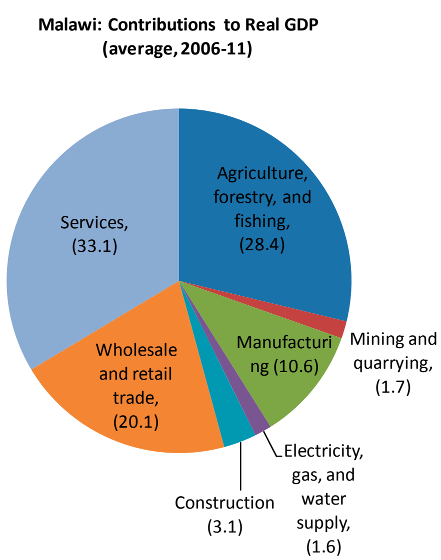
Malawi's growth is expected to rebound after recent rapid decline.



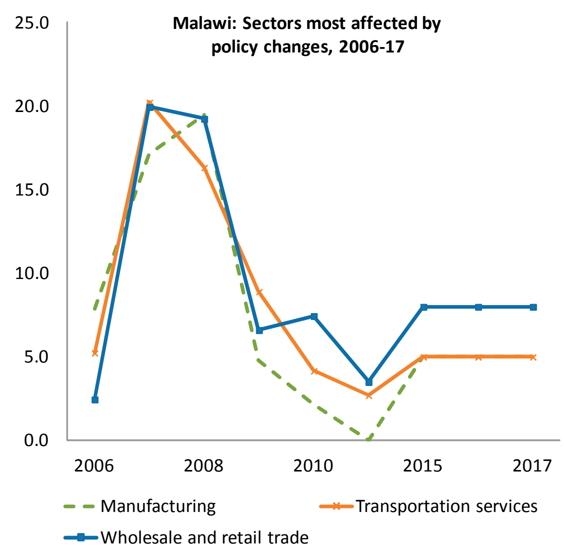
Headline inflation has been on an upswing, driven by non food inflation.



Agriculture has been the traditional driver of growth in Malawi.



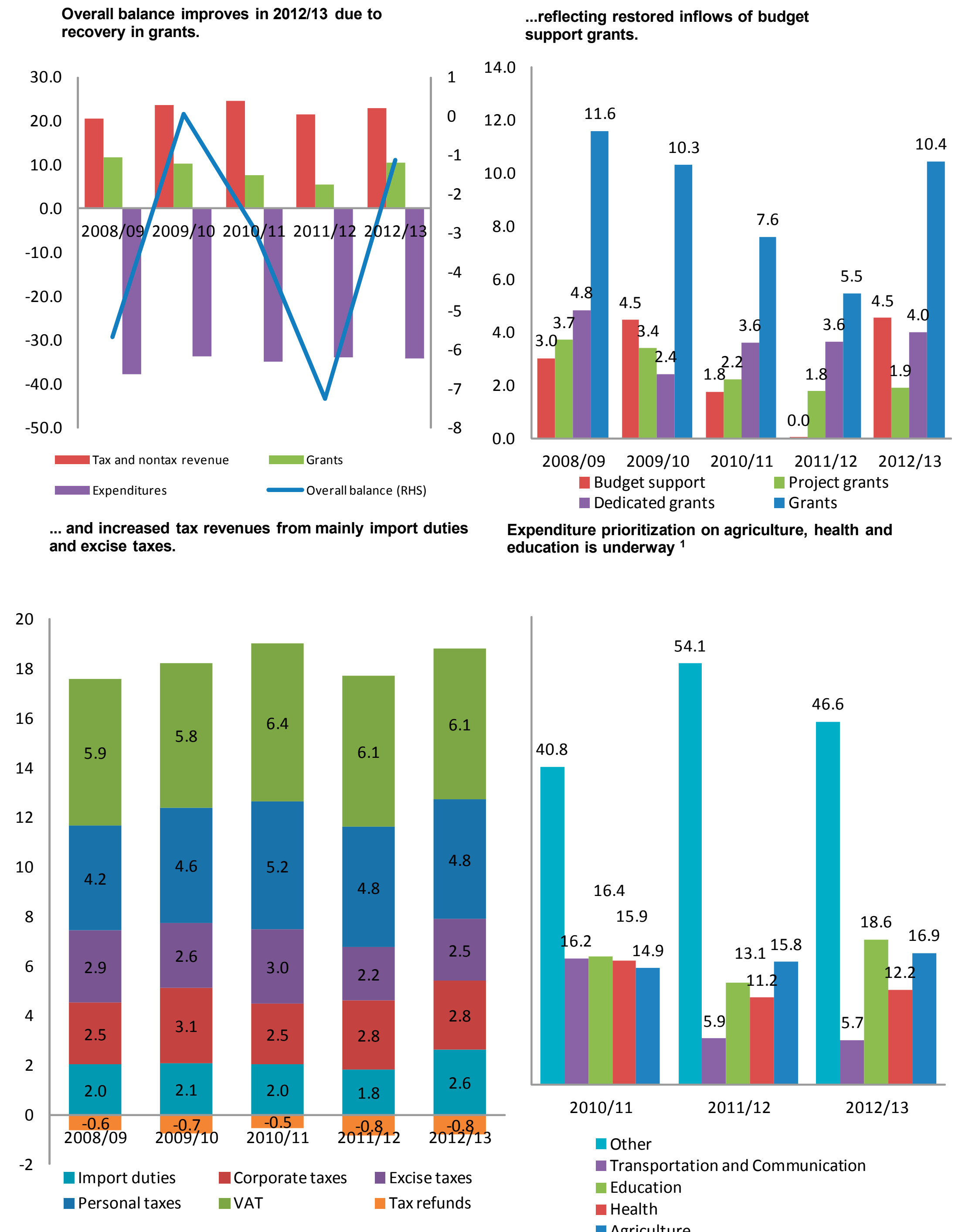
Manufacturing, trade and transportation services are projected to recover after recent sharp declines.



Sources: Malawian authorities; and IMF staff estimates.

Figure 2. Malawi: Fiscal Developments, 2007/08–2012/13

(Percent of GDP)



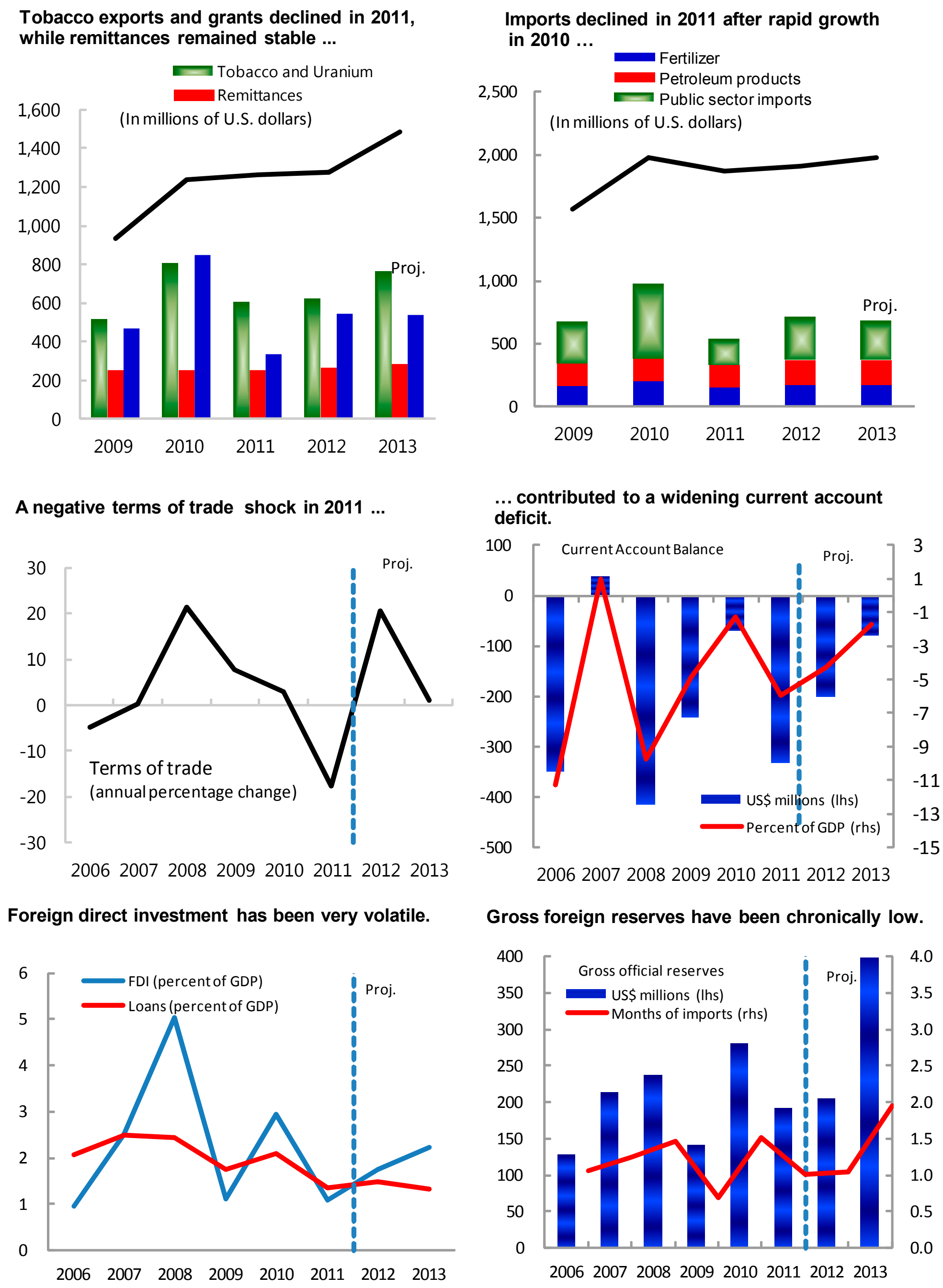
Sources: Malawian authorities; and IMF staff estimates.

[1] Percent of total expenditures

Figure 3. Malawi: Monetary Developments, 2007–12

Sources: Malawian authorities; and IMF staff.

Figure 4. Malawi: External Sector Developments



Sources: Malawian authorities; and IMF staff estimates.

APPENDIX I. LETTER OF INTENT

July 9, 2012

Madam Christine Lagarde
Managing Director
International Monetary Fund
Washington, D.C. 20431
USA

Dear Madam Lagarde:

1. Malawi recently underwent a peaceful transition in leadership following the unexpected death of President Bingu wa Mutharika. On April 7, 2012, the then vice President, Mrs. Joyce Banda, was sworn into office as President. President Banda has formed a new cabinet in which she appointed ministers from different political parties.

2. In February 2010, the Executive Board of the IMF approved a three-year Extended Credit Facility (ECF) arrangement for Malawi for an amount of SDR 52.05 million (75 percent of quota). The program supported by this arrangement went off-track shortly after completion of the first review in December 2010, reflecting a lack of progress in implementing policy commitments under the program to adopt a flexible exchange rate regime and liberalize current account transactions in line with Malawi's obligations under Article VIII of the IMF Articles of Agreement.

3. The government of Malawi wishes to cancel the current ECF arrangement, which is due to expire in February 2013, effective as of July 23, 2012. In its place, we request a new three-year ECF arrangement to support our medium term economic objectives and policy framework for the fiscal years 2012/13 through 2014/15 (July 2012–June 2015). The new arrangement will provide the administration of President Banda a clean slate on which to re-establish Malawi's credibility in implementing sound economic policies. Already, within the short time it has been in office, President Banda's administration has implemented all the exchange rate related measures committed to, but not implemented, by the previous administration. In particular, the kwacha was devalued substantially and has been allowed to float.

4. In view of our large and urgent balance of payments need and the strength of our program, we request access of SDR 104.1 million (150 percent of quota), including a first disbursement of SDR13.02 million upon approval of the arrangement by the IMF's Executive Board. This arrangement will support our medium-term program to address balance of payments weaknesses and to achieve poverty reduction through sustained private-sector-led growth and wealth creation. Re-establishing a close engagement with the IMF will send a positive signal to domestic stakeholders and our development partners regarding our determination to maintain macroeconomic stability in order to create an environment that is

conducive for sustained growth and poverty reduction. To this end, we request quarterly reviews of program implementation in the first year of the arrangement.

5. In the attached Memorandum of Economic and Financial Policies (MEFP), we set out our macroeconomic framework for FY2012/13–FY2014/15, including the policies we intend to implement to achieve our objectives. Specific emphasis is placed on rebuilding international reserves, improving public financial management and fiscal transparency, operational independence of the Reserve Bank of Malawi, and improving the investment climate and the country's international competitiveness.

6. The MEFP and Technical Memorandum of Understanding (TMU) present quantitative performance criteria, indicative targets, and structural benchmarks to be used to monitor implementation of the program. We believe that the policies set forth in the MEFP are adequate to achieve the objectives of the program, but we will take any further measures that may become appropriate for this purpose. We will consult with IMF staff on the adoption of these measures, and in advance of revisions to the policies contained in the MEFP, in accordance with the IMF policies on such consultation. Moreover, we will provide the IMF with such information as the IMF requests in connection with the progress in implementing the policies and reaching the objectives of the program.

7. The Government of Malawi authorizes the IMF to make this letter and the attached MEFP and TMU available to the public, including through the IMF internet website.

Yours sincerely

/s/	/s/
Dr. Ken Lipenga (MP) Minister of Finance	Mr. Charles Chuka Governor of the Reserve Bank of Malawi

Attachments:

– Memorandum on Economic and Financial Policies;
– Technical Memorandum of Understanding.

ATTACHMENT I.

MALAWI: MEMORANDUM OF ECONOMIC AND FINANCIAL POLICES, 2012/13–2014/15

I. Introduction

1. This memorandum summarizes the objectives and policies of the government of Malawi's economic program for July 2012–June 2015, for which the government is seeking support from the International Monetary Fund through a new three-year arrangement under the Extended Credit Facility (ECF). The new arrangement will succeed the one approved by the IMF's Executive Board in February 2010. The program supported by that arrangement went off-track shortly after completion of the first review in December 2010, on account of challenges we had in implementing our commitments under the ECF-supported program, including adopting a flexible exchange rate regime and liberalizing payments for current account transactions. The main objective of the program to be supported by the new arrangement is achievement and maintenance of macroeconomic stability in order to provide a suitable environment for sustained growth, wealth creation and poverty reduction.

2. Following the sudden death of President Bingu wa Mutharika in early April 2012, Mrs. Joyce Banda (Vice President at the time) was sworn into office as President to serve the remainder of the term of the late President, in accordance with Malawi's constitution. General elections are scheduled to be held in May 2014. President Banda formed a new government with the announcement of her cabinet ministers in late-April 2012. The new administration inherited a very difficult economic situation, marked by a severe shortage of foreign exchange which led to shortages of critical imports including fuel, inputs for production and medicines. Delays in making payments abroad led to the loss of credit lines for several businesses, resulting in scaled down operations and the laying off of workers. Malawi's long standing foreign exchange problems intensified in 2011 because of lower tobacco export earnings and the interruption of the ECF-supported program with the IMF which led several donors to cut their general budget support grants to Malawi.

3. Within a month of taking office, the new administration implemented a set of bold measures to address Malawi's chronic balance of payments difficulties and to halt the slowdown in economic activity arising from the shortages of foreign exchange and critical imports. The implemented measures included all the commitments the government had made under the ECF-supported program to adjust the official exchange rate and liberalize the exchange regime for current account transactions, non-implementation of which led to the interruption of the program. The recently implemented measures include:

- Devaluation of the exchange rate from K167 to K250 per U.S. dollar, and adoption of a floating exchange rate regime.
- Allowing banks and foreign exchange bureaus to set the rate at which they buy and sell foreign exchange from/to their customers.

- Removal of requirement for foreign exchange earnings to be surrendered to the RBM; they now flow directly to commercial banks.

- Cancellation of requirement for banks to submit to the RBM for review, any application for external payments exceeding US$50,000.

- Substantial increase in fuel prices to bring them in line with true import costs, and restoration of an automatic adjustment mechanism to ensure that retail prices reflect changes in world prices.

- Substantial increases in electricity tariffs to ensure movement toward cost recovery.

- A tightening of monetary policy to contain inflationary pressures, signaled by the RBM raising its policy rate from 13 percent to 16 percent.

4. The adjustment measures are beginning to show positive results. Sales of tobacco through official channels have increased, suggesting a decline in smuggling of the crop to neighboring countries; the parallel market for foreign exchange has almost collapsed, with premiums over the official exchange rate falling from 60–80 percent before the devaluation to 5–10 percent, while rates offered by banks and foreign exchange bureaus are converging; and the private sector's access to foreign exchange has eased considerably. The government is working with the World Bank and other partners to scale up social protection programs to mitigate the adverse effects of the adjustment measures on the welfare of the most vulnerable segments of the population.

5. The administration of President Banda has also moved swiftly to repair strained relations with Malawi's development partners and neighboring countries. Parliament has revoked a number of laws that were widely seen as undermining human rights and political freedoms, which were of concern to civil society organizations in Malawi and to major donors. Donors have responded positively to the reforms being implemented by the new administration. Based on information from donors, we project external grants to increase from US$281.5 million in FY2011/12 to US$480.5 million in FY2012/13, with general budget support grants going from less than US$2 million to US$208 million. Normalization of relations with neighboring countries is also bearing fruit: the government has signed a Memorandum of Understanding with Mozambique to resuscitate the electricity Interconnector Project which is expected to ease Malawi's electricity shortages in the short to medium term. The government has also been able to recover its maize loan to Zimbabwe through an exchange with petroleum products.

II. RECENT DEVELOPMENTS AND THE NEAR TERM OUTLOOK

6. Economic growth slowed significantly in 2011. After averaging over 8 percent a year during 2007–10, real GDP grew at 4.3 percent in 2011. Sectors that are heavily dependent on imports—manufacturing, transportation, construction, and wholesale and retail trade

sectors—slowed down the most, reflecting the impact of the foreign exchange shortage. Following the recent policy measures, the private sector has began to clear the backlog of external arrears which should help re-establish credit lines and improve the flow of imported inputs to allow enterprises to gradually increase output from the current low levels of capacity utilization.

7. Inflation has been on a rising trend since early 2011, with the year-on-year headline rate reaching 12.4 percent in April 2012 and jumping to 17.3 percent in May 2012. Rising import costs have been the principal factor behind the upswing as a growing share of imports were being priced at the parallel market exchange rate before the May devaluation, and the devaluation triggered large adjustments in the retail prices of petroleum products which have ripple effects to other prices. The spike in inflation is expected to persist for a few months but should be reversed with implementation of restrained fiscal and monetary policies.

8. Fiscal performance improved in FY2009/10 (the first year of the ECF-supported program) but deteriorated thereafter as government expenditure remained steady (in relation to GDP) while external grants fell sharply and domestic revenue performance deteriorated. The government relied heavily on domestic financing of its growing deficit. The overall fiscal deficit widened from nearly 3 percent of GDP in FY2010/11 to 7 percent in FY2011/12, with domestic financing rising from 1.7 percent of GDP to 5.6 percent in the respective years. The government and state owned enterprises have also accumulated about K72 billion in domestic arrears over the last few years. The new administration has taken steps to restrain spending, including by reducing the number of official trips abroad, cutting the number of vehicles available to senior officials, and postponing new development projects which were to be funded entirely by domestic resources.

9. Monetary developments in the last few years reflect a dominant influence of fiscal policy. The RBM accommodated the government's financing requirement and cost considerations held it back from conducting open market operations to mop up excess liquidity. Growth in both reserve money and broad money has trended upwards since mid-2010. At end-April 2012, reserve money and broad money grew at year-on-year rates of 47 percent and 31 percent, respectively. The RBM began tightening its policy stance in April 2012, including by removing excess liquidity using some of its holdings of treasury bills. In May the RBM raised its policy rate from 13 percent to 16 percent, and after the devaluation, used foreign exchange sales to further mop up excess liquidity. Kwacha liquidity conditions tightened significantly and several banks resorted to the RBM discount window to meet their needs.

III. The Medium-Term Framework

10. The medium-term framework for Malawi's economic development policies is set out in the second Malawi Growth and Development Strategy (MGDS II) which was approved by the government in April 2012. It covers the period 2011/12–2015/16, and has the same main

objective as the first MGDS (2006–11), i.e., to achieve poverty reduction through sustainable growth and infrastructure development. A key element of the strategy for achieving sustainable economic growth is the pursuit of sound economic policies with a view to maintaining inflation at single digit levels and increasing the level of international reserves. An increase in national investment—with emphases 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 high growth, while prudent fiscal and monetary policies deliver low inflation.

11. The macroeconomic framework in MGDS II needs updating in light developments since the document was completed in early 2011. The annual growth rate which was expected to average over 7 percent a year is now projected to rise gradually from 4.3 percent in 2012 to 6.7 percent in 2016. Similarly, the annual rate of inflation which was projected to decline from 8.7 percent to 5.9 percent over the five years covered by the strategy, is now expected to reach 23 percent in December 2012 and then fall to 6 percent by the end of 2016. The government will present updated medium-term outlooks in annual reports on MGDS implementation.

12. MGDS I and II were designed to move Malawi towards achievement of the Millennium Development Goals (MDGs). The 2011 MDG report shows remarkable progress toward achieving five out of the eight MDGs: (i) eradicating extreme poverty and hunger; (ii) reducing child mortality; (iii) combating HIV and AIDS, malaria and other diseases; (iv) ensuring environmental sustainability; and (v) enhancing global partnership for development. MDGS II contains measures to accelerate progress toward achievement of the three MDGs for which Malawi is lagging behind: (i) universal primary education; (ii) gender equality and empowerment of women; and (iii) improvement in maternal health.

13. Recent economic developments have underlined Malawi’s susceptibility to external shocks. Adverse terms of trade developments and a marked reduction in aid inflows contributed to the severe foreign exchange shortage in the country in 2011 and the first half of 2012. However, overvaluation of the kwacha has also been an important factor in the country’s weak balance of payments position, with growth of imports outpacing that of exports. The recent devaluation and floating of the kwacha will help address this imbalance by boosting exports and slowing down growth in imports (especially of consumer goods). Against this background, the key medium-term objectives of our ECF-supported program include:

- Recovery in real GDP growth from 4.3 percent in 2012 to about 6½ percent per year in the medium term.

- Achieving and maintaining a stable macroeconomic environment with low inflation, founded on sustainable fiscal and external balances.

- Increasing foreign reserves coverage to three months of imports, to provide a buffer against exogenous shocks (e.g., weather, terms of trade, and aid flows).
- Enhancing the operational independence of the RBM.
- Pursuing reforms to deepen the financial sector and promote greater financial inclusion.
- Undertaking structural reforms to improve the investment climate and promote sustained and inclusive growth, including through improvements in infrastructure and regulatory reforms.

14. In the last five years, agriculture has been the main engine of growth, supported by the government's Farm Input Subsidy Program (FISP) and good weather conditions. The floating of the kwacha and liberalization of the foreign exchange regime is expected to foster growth over the medium term by redirecting resources to exports and import-competing production, while containing import demand. In the near term, growth will come mainly from the sectors that were hardest hit by the foreign exchange shortages, including manufacturing, transportation service, construction, and trade, as production levels increase toward capacity. Other sectors, including agriculture, will also benefit from the easing of fuel shortages. Over time, growth is expected to be led by mining and non-traditional agricultural exports (including through enhanced value addition in the form of agro-processing).

IV. Policies

Fiscal Policies and Related Structural Reforms

15. The FY2012/13 budget is anchored by a zero net domestic borrowing target in order to begin to reduce domestic debt to sustainable levels. This represents a sharp reduction from about 5.6 percent of GDP domestic borrowing in FY2011/12. In consultation with IMF staff and other development partners, the Ministry of Finance established a realistic resource envelope that formed the basis for expenditure plans in the FY2012/13 budget. Substantially higher donor support in the form of grants and concessional loans reduce the domestic financing need, but a sizeable revenue effort and tight control of spending will be needed to ensure that expenditures are aligned with the government's top priorities, including safeguarding social safety net provisions.

16. The government is committed to strengthening its revenue mobilization efforts in order to reverse the recent marked decline in domestic revenue in relation to GDP. The largest contribution to increased revenue is expected to come from fuel taxes. This reflects a change in the pricing and taxation of petroleum products from a system that implicitly subsidized retail prices by foregoing revenue to one based on the actual cost of imports and adoption of an automatic adjustment mechanism to ensure that retail prices reflect changes in import costs. A number of tax measures introduced last year which turned out to be punitive

on businesses and regressive in nature and which did not yield as much revenue as expected are being repealed in order to help improve the business climate. At the same time, the range of items subject to VAT is being expanded and excise duties are being harmonized with regional partners.

17. The government will enhance its enforcement mechanisms through increased audits and use of modern ICT systems to improve revenue collection. Tax revenues are expected to improve through the adoption and use of electronic fiscal devices in the enforcement of VAT and the use of computerized cargo scanners coupled with the implementation of web-based ASYCUDA System for Customs. With respect to nontax revenues, the government will continue enhancing its oversight function through monitoring and auditing of the various revenue collecting institutions to ensure transparency and accountability in the management of departmental receipts collected from user fees and charges.

18. Reflecting government's top priorities, the FY2012/13 budget increases the share of total expenditures allocated to social protection programs, most notably the FISP. Other programs that will be scaled up include public works, school feeding, school bursary, and cash transfers. Responsibility for these programs span several ministries and departments but the Ministries of Agriculture, Education and Health which bear most of the responsibilities have received the largest increases in resources. With assistance from World Bank staff, the government has established priorities in three of the largest Ministries—Agriculture, Education and Health—to guide budget execution. In order to instill fiscal discipline and signal a change from the loose fiscal policy stance of the last year, the Ministry of Finance will establish and enforce quarterly spending limits on all ministries, departments and agencies (MDAs), consistent with estimated available resources. The limits for the first quarter will be announced shortly after the budget is approved by parliament, and limits for subsequent quarters will be informed by revenue performance to date and by the outlook for grants, and will be announced in the last month of the preceding quarter. The Ministry of Finance will report to cabinet every quarter on how the system is working.

19. The budget provides increased resources to wages and salaries and interest payments. The nominal wage bill was increased by 30 percent over the projected outturn for FY2011/12 to accommodate a 21 percent pay increase to government employees and allow additional hiring of staff in the education and health sectors. Interest costs are projected to increase although there will be no net domestic borrowing for the year as a whole. A tightening of monetary policy by the RBM is expected to push up interest rates, and increase the cost of rolling over maturing treasury bills.

20. Over the last three years, government ministries and departments as well as parastatal organizations accumulated domestic arrears of about K72 billion (7 percent of GDP). Government intends to verify these arrears through the Office of the Auditor General, before making plans to settle them. In the 2012/13 budget, a provision of K10 billion has been made for the settlement of some of the arrears. It is expected that it will take 3 to 4 years to clear

the arrears. Government will also look at some alternatives such as raising funds through long-term Treasury Bonds to settle some of the bills. In order to strengthen commitment control and avoid the accumulation of arrears, the government will accelerate implementation of the commitment module in the IFMIS. The government will inform the general public of its procurement rules through the media. It will include warnings that those who provide goods or services to MDAs outside of the established government system will not be paid.

21. The government has initiated steps to reduce the risks to the budget posed by contingent liabilities and operational losses of state owned enterprises. The contingent liabilities are mainly loans from banks and payment arrears while the operational losses arise from administratively set prices and tariffs that are below cost recovery levels and generate substantial implicit and explicit subsidies. The government recognizes that the operations of the recently established National Oil Company of Malawi (NOCMA), including government guaranteed loans for fuel imports, pose severe risks to the budget. In order to minimize these risks, NOCMA will be limited to its core activity of managing strategic reserves of fuel. The bulk of fuel importation for regular use will revert to the private sector.

22. The government through the Malawi Energy Regulatory Authority (MERA) has established a clear regulatory regime for the Electricity Supply Corporation of Malawi, Ltd. (ESCOM) that covers operating costs and avoids the need for budgetary transfers and that minimizes recourse to commercial bank borrowing. A similar regime will be established for the Regional Water Boards. This will enable the utilities with a view to enabling them to invest in needed capital infrastructure to improve the quality, availability, and reliability of their service delivery, with a view to supporting the expansion of economic activities.

Monetary Policy in a Floating Exchange Rate Regime

23. Monetary policy will be geared toward achieving price stability, while providing room for sufficient credit to the private sector and supporting a buildup of international reserves. Broad money will be the nominal anchor, with reserve money as an intermediate target. To help manage domestic demand and contain inflation, broad money is programmed to grow at about the pace of nominal GDP in the near term. Further financial deepening in the medium term would allow broad money to grow faster than nominal GDP without fueling inflation.

24. The RBM has a liquidity forecasting framework which it uses to guide monetary operations. The RBM will continue to develop its instruments of indirect monetary control and strengthen its ability to implement monetary policy through changes in interest rates, underpinned by open market operations. To that end it will welcome technical assistance from the IMF, drawing on the experiences of other countries, and focusing on practical advice on enhancing the operational framework, including open market operations of varying maturity profiles, combined with the use of reserve averaging and standing facilities.

25. The RBM is reviewing options for obtaining resources for conducting open market operations without being constrained by cost considerations. It is requesting technical assistance from the IMF to complete the review and decide on the way forward. Possible options include: (i) issuance of treasury bills (over and above government financing needs) for monetary operations, with the Ministry of Finance carrying the interest costs; and (ii) issuance of an income generating security to the RBM, with the RBM bearing the cost of its monetary operations.

26. The RBM is also undertaking a review of the RBM Act with a view to recommending amendments to modernize it. Proposed amendments will be ready for discussion with government by December 2012, and for submission to parliament by the government by June 2013. In order to enhance the operational independence of RBM, the government agrees to include an amendment to limit the outstanding amount of the government's total borrowing of all kinds from RBM. Currently, the RBM Act limits the amount of advances to the government but has no limits on other forms of RBM lending to the government (e.g., through holdings of treasury bills).

Financial Sector Reforms

27. Financial stability indicators suggest that the banking sector in Malawi remains sound. Non-performing loans are at low levels—their share as a ratio of total loans was about 4 percent in 2011. However, the deterioration in the macroeconomic environment in the last two years has elevated the risks to banks' portfolios. The RBM has intensified its monitoring and surveillance of the financial system with a view to detecting at an early stage emerging threats to financial stability. The RBM has adopted a risk-based supervision approach to examining bank performance and is working with banks to enhance their stress-testing capacities and practices. The RBM currently compiles the results of its stress-testing of banks on a semi-annual basis and will begin publishing the report of its analysis starting with the report for end-March 2012, which will be published by end-July 2012. The RBM is establishing Basel II governance structures and committees, with full compliance with Basel II principles envisaged for January 2014.

28. Two credit reference bureaus are currently operating in Malawi. These bureaus, underpinned by sound legal and regulatory framework for the sharing of credit information, should bring down the cost of lending by lowering credit risks through easier identification of sound borrowers.

29. The RBM is strengthening its supervision of nonbank financial institutions. Two departments have been established for this purpose; one focusing on pension and insurance sectors and the other on microfinance. Extending the supervisory framework to the non-bank institutions would help ensure an equal playing field for all participants in the financial market and prevent a situation where risks are built up in the non-bank financial sector.

30. To deepen financial intermediation and ensure financial inclusion, government has developed a financial sector strategy and launched a National Strategy for Financial Inclusion. The financial sector strategy is envisaged for cabinet approval by end-December 2012. The World Bank, through technical assistance, continues to provide support towards achieving the attainment of inclusive finance for growth and financial deepening and competiveness. Ensuring increased access of the population (including small- and medium-sized enterprises (SMEs)) to finance is critical for expanding production and job creation and key to the attainment of the overarching goal of inclusive growth.

31. With the support of development partners, the government is in the process of establishing the Malawi Financial Sector Deepening Trust (MFSDT). The trust will support the development of financial markets in Malawi as a means to stimulate wealth creation and reduce poverty. Working in partnership with the financial services industry, the Trust will be used to significantly expand access to financial services among lower-income households and small and medium-sized enterprises both in urban and rural areas. The trust will operate independently under the supervision of professional trustees, with policy guidance from a program investment committee (consisting of representatives of donors and the government).

Enhancing International Competitiveness

32. A number of indicators of external competitiveness suggest that Malawi is lagging behind its neighbors in this dynamic region of sub-Saharan Africa. Our share of regional exports to the world has declined sharply over time, and we rank behind our neighbors in indicators of the business environment such as transactions costs and infrastructure. In view of the push toward greater regional integration (including the Grand Tripartite Free Trade Area encompassing COMESA, EAC, and SADC), the government is determined to address these competitiveness issues. Although the recent liberalization of the exchange rate regime has addressed the issue of overvaluation of the kwacha, a key step towards enhancing Malawi's international competitiveness, the government recognizes that further steps are required, especially removal of structural bottlenecks—e.g., reliable and adequate supply of energy—that are holding back growth and diversification of the economy.

33. The government is developing a National Export Strategy (NES) through a participatory process involving a broad range of stakeholders. The NES seeks to transform Malawi from being a predominantly importing and consuming nation to becoming a producing and exporting nation. The NES will prioritize investment incentives to develop productive capacity, encourage foreign and domestic investment and ultimately create sustainable export capacity. The investment incentives for enhancing export capacity will focus on areas that contribute towards inclusive growth and have extensive forward and backward linkages in the economy, especially through potential for value addition. The NES takes a long run view of building productive capacity and has a 10–15 year horizon and builds upon and synchronizes a number of existing government policies, frameworks and initiatives. The NES is expected to be launched in the second half of 2012.

Information Sharing, Data Quality and Capacity Building

34. In order to enhance economic policy making, we will adopt processes and practices to improve real time information sharing among departments in the Ministry of Finance (Revenue, Expenditure, Debt and Aid Management, Economic Affairs), and between the Ministry of Finance and the RBM. This will involve more effective use of the Integrated Financial Management Information System (IFMIS) and is expected to improve the quality of public finance data. The Ministry of Finance (Treasury) will provide more timely information on government operations to the RBM to help the latter conduct more effective liquidity management and foreign exchange operations.

35. In view of the recent revelation of reporting of inflated revenue data to parliament, the government has decided that the Malawi Revenue Authority should publish its monthly revenue collections in the local media with a lag of no more than a month.

36. The government is grateful for the assistance it has received from the IMF and other partners to build capacity for the compilation and dissemination of economic statistics. We continue to need assistance to improve the quality of a wide range of statistics, including national accounts, prices, and the balance of payments. We are also in need of assistance to build capacity for the production of high frequency indicators of economic activity to guide timely policy making.

V. Program Monitoring

37. Program implementation will be monitored with quantitative financial targets and structural benchmarks (see Tables 1 and 2 below), and quarterly reviews in the first year of the program and semi-annual reviews thereafter. Definitions of key concepts and indicators, as well as reporting requirements, are set out in the accompanying Technical Memorandum of Understanding. The first review is scheduled to be completed by mid-December 2012 based on the end-September 2012 test date and the second review by mid-March 2013 based on the end-December 2012 test date. Performance criteria are also being established for end-March 2013 and end-June 2013.

38. Performance criteria will be set on: (i) net domestic assets of the RBM; (ii) net international reserves of the RBM; (iii) net domestic borrowing by the central government; (iv) new non-concessional external loans contracted or guaranteed by the central government; and (v) accumulation of external arrears by the government or RBM. There are also continuous performance criteria which include the criterion on non-imposition or intensification of exchange restrictions on the making of payments and transfers for current international transactions (in line with Malawi's obligations under Article VIII of the IMF's Articles of agreement). In addition, there are indicative targets on reserve money and on government expenditure on the social sectors and social protection programs. The program also contains a set of structural benchmarks to underpin fiscal discipline and monitor

structural reforms in the areas of public financial management, operational independence of the RBM, and financial system stability.

39. The RBM stands ready to undergo a safeguards assessment before the completion of the first review under the new ECF arrangement.

ATTACHMENT II. TECHNICAL MEMORANDUM OF UNDERSTANDING (TMU)

I. INTRODUCTION

1. This memorandum sets out the understandings between the Malawian authorities and the International Monetary Fund regarding the definitions of quantitative performance criteria, benchmarks, and indicative targets for the program supported by the ECF arrangement, and the related reporting requirements.

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 purposes of this memorandum. The accounts of the monetary authorities include those of the RBM. Monetary aggregates under the program are based on the twelve-bank monetary survey.

II. QUANTITATIVE PERFORMANCE CRITERIA: DEFINITIONS AND DATA SOURCES

A. Floor on Net International Reserves of the RBM

3. **Definition of net international reserves (NIR) of the RBM:** The NIR of the RBM is defined as gross reserves minus IMF and other short-term liabilities. The values of all foreign assets and liabilities will be converted into U.S. dollars at each test date using the program cross exchange rates for the various currencies and then converted into kwacha using the program exchange rate for the U.S. dollar–kwacha exchange rate. The program exchange rate of the Malawi Kwacha to the U.S. dollar is set at MK260 = US$1. The corresponding cross exchange rates and program gold price for the duration of the program are in Table 3.

4. **Gross reserve assets of the RBM** are defined in the International Reserves and Foreign Currency Liquidity Guidelines for a Data Template as external assets immediately available and controlled by RBM "for meeting balance of payments financing needs, for intervention in exchange markets to affect the currency's exchange rate, and for other related purposes (such as maintaining confidence in the currency and the economy, and serving as a basis for foreign borrowing)." (*BPM6,* paragraph 6.64).

5. **This concept includes the following:** (1) monetary gold holdings of the RBM; (2) holdings of SDRs; (3) the reserve position in the IMF; (4) foreign convertible currency holdings; (5) deposits held in foreign central banks, the Bank for International Settlements, and other banks; (6) loans to foreign banks redeemable upon demand; (7) foreign securities; and (8) other unpledged convertible liquid claims on nonresidents. It excludes the following: (1) any foreign currency claims on residents; (2) capital subscriptions in international institutions; (3) foreign assets in nonconvertible currencies; (4) transfers of foreign currency

claims to RBM by other institutional units in Malawi just prior to reporting dates with accompanying reversals of such transfers soon after those dates; (5) gross reserves that are in any way encumbered or pledged, including, but not limited to: (i) assets blocked when used as collateral for third party loans and third-party payments, pledged to investors as a condition for investing in domestic securities, and (ii) assets lent by RBM to third parties that are not available before maturity, and are not marketable.

6. **Gross reserve liabilities of the RBM** are defined as the sum of the following: (1) SDR allocations; (2) outstanding medium and short-term liabilities of the RBM to the IMF; and (3) all short-term foreign currency liabilities of the RBM to nonresidents with an original maturity of up to, and including, one year.

7. **Definition of budget support:** Budget support includes all grants and foreign financing not directly 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 loan financing from the IMF, and donor inflows (in kwacha) from the U.S. dollar–denominated donor pool accounts for the health SWAp, education SWAp, agricultural SWAps, and National AIDS Commission (NAC) held in the Malawi banking system.

8. **Adjustment clause on NIR—budget support:** The floor on the NIR of the RBM will be adjusted upward by the full amount by which the cumulative receipts from the budget support are greater than US$30 million above the program baseline (See Table 1). The floor on NIR of the RBM will be adjusted downward by the full amount up to a maximum of US 10 million by which the cumulative receipts from the budget support are less than the program baseline. Budget support is measured as the cumulative flow from the beginning of the fiscal year.

9. Adjustment clause on NIR—donor accounts for the social sector (including health, education, and other SWAps, and National AIDS Commission (NAC): The floor on the NIR of the RBM will be adjusted downward by the amount by which the donor inflows (in kwacha) from the U.S. dollar–denominated donor accounts for SWAps and NAC held in the RBM are smaller than the donor inflow (in kwacha) to those accounts in the program baseline. The downward adjustment will be capped at US$ 30 million. Donor inflows are measured as the receipts (in kwacha) by the budget from the beginning of the fiscal year.

10. **Adjustment clause on NIR—debt service payments:** The floor on NIR of the RBM will be adjusted upward (downward) by the full cumulative amount by which debt service payments to the World Bank and the African Development Bank (ADB) fall short of (exceed) the program baseline. The cumulative amount will be measured from the beginning of the fiscal year.

11. The total downward adjustment to NIR from a shortfall of (i) budget support and (ii) donor inflows to the donor accounts for the social sector relative to the program

assumptions, and (iii) an excess of debt service payments to the World Bank and the African Development Bank (ADB) relative to the program assumptions will be capped at US$40 million. The floor on the NIR of the RBM will be adjusted upward by the full amount by which the cumulative receipts from the budget support are greater than US$30 million above the program baseline and by the full cumulative amount by which debt service payments to the World Bank and the African Development Bank (ADB) fall short of the program baseline.

12. For this target and those for external debt and arrears, valuation will be in U.S. dollars, using the above defined program exchange rates.

13. Data on NIR, including its components, will be reported by the RBM on a weekly and end-month basis.

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

14. **Definition of net domestic assets (NDA) of the RBM:** NDA of the RBM are defined in kwacha terms as end-quarter reserve money less NFA of the RBM at the program exchange rate. 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. The NDA program ceilings are the indicative money targets defined below less the NFA of the RBM.

15. **Definition of NFA of the RBM:** The NFA of the RBM are defined as the above-defined NIR plus other foreign assets of the RBM—including but not limited to: (1) capital subscriptions in international institutions; (2) foreign assets in nonconvertible currencies; and (3) gross reserves that are in any way encumbered or pledged, less any medium- and long-term foreign liabilities of the RBM.

16. **Adjustment clause on NDA—budget support:** The ceiling on NDA of the RBM will be adjusted downward by the full amount by which the cumulative receipts from the budget support are greater than US$30 million above the program baseline. The ceiling on NDA of the RBM will be adjusted upward by the amount by which the cumulative flow of receipts from budget support are less than the program baseline, up to a maximum of $30 million. The kwacha value of the cumulative shortfall (excess) will be calculated at the program exchange rate. Budget support is measured as the cumulative flow from the beginning of the fiscal year.

17. **Adjustment clause on NDA—donor pool accounts for the social sector (including health, education, and other SWAps, and NAC):** The ceiling on NDA of the RBM will be adjusted upward by the amount by which the donor inflows (in kwacha) from the U.S. dollar–denominated donor accounts for the SWAps and NAC held in the RBM fall

short of the donor inflow (in kwacha) to those accounts in the program baseline. The upward adjustment will be capped at US$30 million. Donor inflows are measured as the receipts received (in kwacha) by the budget. Donor inflows are measured from the beginning of the fiscal year.

18. **Adjustment clause on NDA—debt service payments:** The ceiling on NDA of the RBM will be adjusted downward (upward) by the full cumulative amount by which debt service payments to the World Bank and the ADB falls short of (exceeds) the program baseline (Table 1). The cumulative amount will be measured from the beginning of the fiscal year.

19. The total upward adjustment to NDA from a shortfall of (i) budget support (ii) donor inflows to the donor accounts for the social sector relative to the program assumptions and (iii) an excess of debt service payments to the World Bank and the African Development Bank (ADB) relative to the program assumptions will be capped at US$40 million. The downward adjustment to NDA will reflect the full amount by which the cumulative receipts from the budget support are greater than US$30 million above the program baseline and by the full cumulative amount by which debt service payments to the World Bank and the African Development Bank (ADB) fall short of the program baseline.

20. **Adjustment clause on NDA—liquidity reserve requirement:** The ceiling on NDA of the RBM will be adjusted downward for a decrease in the reserve requirement ratio on domestic deposits, and will be adjusted upward for an increase in the ratio. The adjustment will be spread equally over two quarters, starting in the quarter in which the reserve requirement ratio is reduced. The adjuster will be calculated as follows: (one minus the existing required percentage of reserve assets) multiplied by (the program baseline required reserve ratio minus the new required reserve ratio) multiplied by (the amount of average reservable deposit liabilities in commercial banks during the last month before the change in regulation).

C. Ceiling on Central Government Net Domestic Borrowing (CGDB)

21. **Definition of CGDB:** CGDB is computed as the sum of (1) net borrowing from the RBM (including ways and means advances, loans, holdings of local registered stocks, government bonds, and holdings of treasury bills minus deposits); (2) net borrowing from commercial banks (including advances, holdings of local registered stocks, and holdings of treasury bills minus deposits); (3) net borrowing from nonbanks (including, but not limited to, holdings of local registered stocks and holdings of treasury bills); and (4) holdings of promissory notes. The treasury bills and locally registered stocks are valued at cost rather than face value. The ceiling is measured as the change in the stock of CGDB since June 30, 2012, including promissory notes and securities transferred to the RBM from the treasury since the beginning of the fiscal year. Transfers from extra-budgetary funds will not be considered revenues for this performance criterion. They will be treated the same as borrowing from the private sector (as their accounts are outside the definition of government)

and therefore as domestic borrowing. Asset sales or privatization revenues will be accounted for under financing as a separate category, separate from domestic or foreign financing in calculating CGDB.

22. **Definition of domestic arrears:** Domestic arrears are overdue payment obligations of the central government other than external payment arrears, including on wages and salaries, pensions, transfers, domestic interest, goods and services, obligations arising from court cases, legally established compensation claims, and 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 90 days of the date of invoice, or—if a grace period has been agreed—within the contractually agreed grace period.

23. **Adjustment clause on CGDB—budget support:** The ceiling of CGDB will be adjusted downward (upward) by the full amount by which cumulative kwacha receipts from budget support are greater (less than) the program baseline. The upward adjustment will be capped at US$30 million. In the event of excess budget support, the ceiling on CGDB will be adjusted by the full amount less US$30 million. The kwacha value of the cumulative shortfall (excess) will be calculated at the program exchange rate. Budget support is measured as the cumulative flow from the beginning of the fiscal year.

24. **Adjustment clause on CGDB—donor accounts for the social sector (including health, education, and other SWAps, and NAC):** The ceiling on CGDB will be adjusted upward by the full amount by which the donor inflows (in kwacha) from the U.S. dollar–denominated donor accounts for health, education, and other SWAps, and NAC held in RBM are smaller than the donor inflows (in kwacha) to those accounts in the program baseline. The upward adjustment will be capped at US$30 million. Donor inflows are measured as receipts received (in kwacha) by the budget. Donor inflows are measured from the beginning of the fiscal year.

25. **Adjustment clause on CGDB—debt service payments:** The ceiling (floor) on CGDB will be adjusted downward (upward) by the full cumulative amount by which debt service payments to the World Bank and the ADB fall short of (exceed) the program baseline. The cumulative amount will be measured from the beginning of the fiscal year.

26. **The total upward adjustment to CGDB** from a shortfall of (i) budget support (ii) donor inflows to the donor accounts for the social sector relative to the program assumptions and (iii) an excess of debt service payments to the World Bank and the African Development Bank (ADB) relative to the program assumptions will be capped at US$[40] million. The downward adjustment to NDA will reflect the full amount by which the cumulative receipts from the budget support are greater than US$30 million above the

program baseline and by the full cumulative amount by which debt service payments to the World Bank and the African Development Bank (ADB) fall short of the program baseline.

D. Ceiling on External Payment Arrears

27. **Definition of external payment arrears:** External payment arrears consist of debt-service obligations (principal and interest) of the central government or the RBM to nonresidents that have not been paid at the time they are due, as specified in contractual agreements, except on external debt subject to rescheduling or restructuring. This performance criterion will be monitored on a continuous basis.

E. Ceiling on Nonconcessional External Debt

28. **Definition of nonconcessional external debt:** The definition of debt, for the purpose of the limit, is set out in Executive Board Decisions No. 6230-(79/140) August 3, 1979, and as amended by Decisions No. 11096-(95/100), October 25, 1995; 12274–(00/85) August 24, 2000; and 14416-(09/91), August 31, 2009. For program purposes, short-, medium-, and long-term debt is nonconcessional if it includes a grant element of 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 of debt with nonresidents by the central government, the RBM, public enterprises, and other official sector entities, unless an explicit selective exclusion is made. This performance criterion is monitored on a continuous basis. The ceiling applies to debt and commitments contracted or guaranteed for which value has not been received. The ceiling is measured cumulatively from the beginning of the fiscal year.

29. **Short-term debt:** Outstanding stock of debt with an original maturity of one year or less.

30. **Medium- and long-term debt:** Outstanding stock of debt with a maturity of more than one year.

31. Excluded from the limit is the use of IMF 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; and (iv) arrangements to pay overtime obligations arising from judicial awards to external creditors. A financing arrangement for imports is considered to be "normal" when the credit is self-liquidating.

III. QUANTITATIVE INDICATIVE TARGETS AND STRUCTURAL BENCHMARKS

32. **Definition of reserve money:** Reserve money is defined as the sum of currency issued by the RBM, including the vault cash of commercial banks, 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. The reserve money targets are the projected end-quarter values starting with end-September r 2012 to end-December 2013.

33. **Definition of social spending:** Using functional classification of expenditure, social spending is computed as the sum of central government spending on health, education, the farm input subsidy program, and government social protection (comprising the government expenditures by the ministry of gender, children and social welfare, the ministry of disability and elderly affairs, and the local development fund) . In order to maintain Malawi's commitment and progress toward poverty reduction and the MDGs, the social spending allocations in the government budget will not be adjusted downward to meet fiscal targets of the program (Table 4).

IV. REPORTING OF CERTAIN TRANSACTIONS IN THE FISCAL ACCOUNTS

34. **Donor pool–funded expenditures in support of the SWAps:** The Government of Malawi has embarked on an integrated program of service delivery in the health and education sectors (the so-called SWAps). In support of the health and education SWAps, some donors pool resources (the donor pool), and release these resources through normal government procedures (i.e., recurrent budget or development Part II budget) to the relevant sector. Financial flows into and out of this account will be reported on a monthly basis from the beginning of the fiscal year.

35. **Farm input subsidy program:** The government has embarked on a program of subsidizing agricultural inputs, in particular, fertilizer, to smallholder farmers to improve agricultural production, financed by the budget. The spending on the farm input subsidy program will be reported quarterly from the beginning of the fiscal year.

V. EXCHANGE REGIME

36. **Avoiding multiple currency practices and exchange restrictions:** The RBM will ensure on-going assessment of the foreign exchange regime with support from IMF to ensure the consistency of the regime with Malawi's obligations under Article VIII. The RBM will continue to work towards ensuring that the spread between the official exchange rate and other market determined rates (bureau and parallel market rates) fall within 2 percent. The RBM will abide by the continuous PC on non-introduction or intensification of exchange restrictions and multiple currency practices.

VI. Reporting Requirements

37. Monitoring of the program requires that the information listed in Table 5 below be reported to the IMF within the timeframe indicated.

Table 1. Malawi: Quantitative Targets [1]

	Criteria [2]	End-Mar 2012 Stock Prel.	End-June. 2012 Stock Proj.	End-Sep. 2012 Prog.	End-Dec. 2012 Prog.	End-Mar. 2013 Prog.	Indicative End-Jun. 2013 Prog.
I. Monetary targets (millions of kwacha)							
1. Ceiling on net domestic assets of the RBM [3,4, 5, 6]	PC	119,709	114,579	109,417	118,542	106,256	100,930
2. Ceiling on reserve money[3]	IT	89,168	76,178	88,210	97,809	99,120	105,830
II. Fiscal targets (millions of kwacha)							
3. Ceiling on central government's net domestic borrowing [5,6,7]	PC			-11,988	18,500	11,609	0
4. Floor on social spending [8]	IT			39,034	94,044	121,798	151,899
III. External sector targets (US$ millions, unless otherwise indicated)							
5. Floor on net international reserves of the RBM[3, 5, 6]	PC	-7	-49	17	19	71	118
6. Ceiling on the accumulation of external payments arrears [7,9]	PC			0	0	0	0
8. Ceiling on new nonconcessional external debt maturing in more than one year [9]	PC			0	0	0	0
9. Ceiling on new nonconcessional external debt maturing in one year or less [9]	PC			0	0	0	0
10. Prohibition on the imposition or intensification of restrictions on the making [9,10] of payments and transfers for current transactions [9,10]	PC		…				
Memorandum items:							
Net foreign assets of the RBM (US$ millions)		-117	-148	-82	-80	-27	19
Budget support (US$ millions)				86	86	151	208
Budget support (millions of kwacha)				21,945	21,945	38,926	53,864
Debt service payments to the World Bank and African Development Bank (millions of kwacha)							
Health SWAp receipts (millions of kwacha)				5,248	5,364	7,771	7,771
Education SWAp receipts (millions of kwacha)				8,378	13,221	17,073	19,049
NAC receipts (millions of kwacha)				4,777	7,315	10,019	12,220
Program exchange rate (kwacha per US$)		260	260	260	260	260	260

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

1 Targets are defined in the technical memorandum of understanding (TMU). Presentation uses stocks for all PCs except for the ceiling on the government's net domestic borrowing.

2 "PC" means Performance Criterion, and "IT" means Indicative Target.

3 Defined as stocks. All stocks of NDA adjusted for consistency with the program definition (specified in the TMU).

4 Target is subject to an adjuster for liquidity reserve requirement.

5 Targets are subject to an adjuster for budget support and debt service payments.

6 Targets are subject to an adjuster for donor-funded social sector expenditures consistent with the TMU.

7 Defined as a cumulative flow.

8 Priority social spending as defined and quantified in the TMU.

9 Evaluated on a continuous basis.

10 Other standard PCs include introducing or modfying MCPs, concluding bilateral payments agreements that are inconsistent with Article VIII, and imposing or intensifying import restrictions for balance of payment reasons.

Table 2. Malawi: Structural Benchmarks, 2012–13

Measure	Status/Target Date	Macro Rationale	Status
Prior Actions			
Parliamentary passage of a budget for FY 2012/13 in line with program objectives		Toward fiscal sustainability	Done
Structural benchmarks			
Fiscal transparency			
Publish monthly revenue collections of the Malawi Revenue Authority in newspapers within two weeks of the end of the month.	7/31/2012	Build credibility after recent incidents of inflation of revenue data by the Ministry of Finance.	
Public financial management			
Provide Ministries, Departments and Agencies with quarterly spending ceilings consistent with quarterly fiscal targets in the program, and enforce ceilings.	Begin in Sept 2012 for FY2012/13 Q2 and quarterly thereafter	Keep spending within available resource envelope.	
Verify existing stock of government domestic arrears and formulate a plan for settling verified claims.	31-Dec-12	Ascertain magnitude of government obligations.	
Configure the IFMIS Purchase Order (PO) module to support commitment control.	31-Dec-12	To restrain creation of arrears.	
Progressively extend processes for capturing donor funded project transactions in IFMIS to all projects where bank accounts are controlled by the government of Malawi.	31-Mar-13	Fuller accounting for impact of aid flows on the budget.	
Monetary Policy			
Amend RBM Act to limit the outstanding amount of RBM's total lending to government.	30-Jun-13	Reduce fiscal dominance to enhance effectiveness of monetary policy.	
Financial sector			
RBM to publish a financial stability report on a semi-annual basis, with a lag of no more than four months. Start with publication of report for quarter ending March 2012.	Semi-annual, starting in July 2012.	Promote financial stability.	
Obtain approval and begin implementation of the Financial Sector Development Strategy	31-Dec-12	Financial deepening.	

Table 3. Malawi: Cross Rates for Nominal Exchanges Rate and Gold Price for the 2012–13 Program

	March 31, 2012
Gold bullion LBM[1] US$/troy ounce	1,668.350
SDR to US$ exchange rate	0.649
Euro to US$ exchange rate	0.758
Yen to US$ exchange rate	82.435
Yuan to US$ exchange rate	6.308
Rand to US$ exchange rate	7.611
UK £ to US$ exchange rate	0.632

Source: IFTS, RBM

[1] LBM connotes London Bullion Market.

Table 4. Malawi: Breakdown of Social Expenditures in 2012/13

	2012/13	Q1	Q2	Q3	Q4
Health Expenditure					
Wages	13,836.67	2,767.33	3,459.17	3,459.17	4,151.00
Other Recurrent					
Ministry of Health ORT	9,134.48	2,283.62	2,283.62	2,283.62	2,283.62
Local Assemblies ORT	9,076.92	2,269.23	2,269.23	2,269.23	2,269.23
Subvented Organisations	100.00	25.00	25.00	25.00	25.00
Development Part II	3,461.00	865.25	865.25	865.25	865.25
Total Health	**35,609.07**	**8,210.43**	**8,902.27**	**8,902.27**	**9,594.10**
Education Expenditure					
Wages	32,646.48	6,529.30	8,161.62	8,161.62	9,793.94
Other Recurrent					
Ministry of Education ORT	12,537.59	3,134.40	3,134.40	3,134.40	3,134.40
Local Assemblies ORT	5,691.99	1,423.00	1,423.00	1,423.00	1,423.00
Subvented Organisations	13,758.03	3,439.51	3,439.51	3,439.51	3,439.51
Development Part II	7,126.45	1,781.61	1,781.61	1,781.61	1,781.61
Total Education	**71,760.55**	**16,307.81**	**17,940.14**	**17,940.14**	**19,572.46**
Farm Input Subsidy Program	**40,884.00**	**13,628.00**	**27,256.0**	**0**	**0**
Gender, Children and Social Welfare					
Wages	415.72	83.14	103.9	103.9	124.72
Other Recurrent	169.53	42.38	42.38	42.38	42.38
Development Part II	295.00	73.75	73.75	73.75	73.75
Total Gender, Children and Social Welfare	**880.24**	**199.28**	**220.06**	**220.06**	**240.85**
Disability and Elderly Affairs					
Wages	53.40	10.68	13.4	13.4	16.02
Other Recurrent	15.89	3.97	3.97	3.97	3.97
Development Part II	80.75	20.19	20.19	20.19	20.19
Total Disability and Elderly Affairs	**150.05**	**34.84**	**37.51**	**37.51**	**40.18**
Local Development Fund	**2,501.87**	**625.47**	**625.47**	**625.47**	**625.47**
Total Social Expenditure	**151,785.78**	**39,005.83**	**54,981.45**	**27,725.45**	**30,073.06**
Cumulative Quarterly Targets		**39,005.83**	**93,987.28**	**121,712.72**	**151,785.78**

Source: Malawi authorities.

Table 5: 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 and its components (NDA and NFA), OMO transactions, and RBM conversion of treasury bills; RBM balance sheet	W	RBM	M	30	30	E
Daily exchange rate	D	RBM	W	1	F	E
Treasury bill auction results	W	RBM	W	2	F	E
Spread between bureau midrate and the official exchange midrate	W	RBM	M	30	30	E
Spread between commercial bank midrate and the official exchange midrate	W	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 and treasury bills	M	RBM	M	30	30	E
Detailed issue and maturity profile for treasury bills	M	RBM	M	30	30	E
Excess reserves by bank	W	RBM	M	30	30	E
Details of project and balance of payment support	M	RBM	M	30	30	E
FCDA Holdings	M	RBM	M	30	30	E
RBM foreign exchange cash flow	M	RBM	M	30	30	E
Foreign exchange exposure limits by bank	M	RBM	M	30	30	E
Bank statements of the Health SWAp account held at RBM	M	RBM	M	30	30	E
Full banking survey (on monthly basis)	M	RBM	M	45	15	E
Financial soundness indicators by banks	Q	RBM	Q	45	T15	E
NAC consolidated statement of sources and uses of funds (cashflow statement)	M	MOF	M	30	30	E
Health SWAp statement of sources and uses of funds	M	MOF	M	30	30	E
Fiscal table (GFS) including revenue, expenditure, and financing	M	MOF	M	30	30	E
Revenue data (from MRA)	M	MOF	M	30	30	E
D\ata on expenditure for domestically financied capital projects	M	MOF	M	30	30	E
New external loans contracted or guaranteed by the central government[1]	Q	MOF	Q	30	T30	E
External debt services (actual and projections)	Q	MOF	Q	30	T30	E
Borrowing of all major parastatals[2]	Q	MOF	Q	45	T15	E
Annual Financial reports of the eight (8) major parastatals and MSB	A	MOF	Q	90	30	H
Report on IMF program performance	Q	MOF	Q	45	T15	E
Statement on new arrears	Q	AuG	Q	45	T15	E
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	T15	E

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

1Detailed 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 Agriculture Development and Marketing Corporation, Air Malawi, Electric Supply Company of Malawi. M*alawi Development Corporation,* Malawi Housing Corporation, Malawi Postal Corporation, Malawi Telecommunications Ltd., Northern Regional Water Board.

APPENDIX II. MALAWI: REAL EXCHANGE RATE ASSESSMENT[1]

This note assesses the degree of exchange rate misalignment in Malawi until May 2012, using four approaches: macroeconomic indicators pertaining to the foreign exchange market, two model-based approaches derived from the established methodology of the Consultative Group on Exchange Rates (CGER), and a high frequency time-series equilibrium real exchange rate (ERER) estimation. All four approaches point to real exchange rate overvaluation in Malawi prior to the change in the monetary regime. We suggest that the assessment of real exchange rate misalignment in Malawi rely primarily on indicators that capture developments in the foreign exchange market, complemented by model-based approaches, especially the ES and ERER techniques. This assessment is a backward looking exercise based on April 2012 WEO data and prior to the exchange rate regime changes in Malawi. The 33 percent devaluation of the exchange rate and adoption of a floating regime in May 2012 brought the exchange rate broadly in line with fundamentals.

I. INTRODUCTION

1. **Evaluating a country's macroeconomic performance and the sustainability of its policies require an assessment of its competitiveness**. Among other elements, such an assessment entails an analysis of real exchange rate misalignment. Assessing whether a country's real exchange rate deviates from its equilibrium helps to ascertain the need for policy adjustment.

2. **The empirical study of real exchange rate misalignments in low-income countries (LIC) presents a number of conceptual and methodological challenges**. These include: (i) financing constraints that limit the ability of LICs to smooth consumption in the face of unanticipated shocks. The LICs usually receive significant amounts of grants, concessional loans, and remittances whose timing may be determined by donors; (ii) the existence of tightly-managed exchange rates and poorly diversified export structures, leading to a significant exposure to terms of trade shocks; (iii) a high degree of cross-country heterogeneity between the LICs and other developing/developed countries; and (iv) poor data with significant structural breaks in macroeconomic series.

3. **This note assesses the magnitude of the exchange rate misalignment in Malawi using a combination of relevant macroeconomic indicators and model-based approaches, suitably adjusted to capture the relevant features of the Malawian economy and data constraints.** We use the macroeconomic indicators pertaining to the foreign exchange market, and three model-based approaches: external sustainability (ES); macroeconomic balance (MB); and the (reduced form) equilibrium real exchange rate

[1] Prepared by Mehdi Raissi (SPR), Olumuyiwa Adedeji (AFR), and Sergejs Saksonovs (SPR).

(ERER). The ES and MB approaches focus on current account misalignment and the required exchange rate adjustments that will ensure consistency between the underlying current accounts and the associated norms. The time-series ERER approach, on the other hand, estimates a cointegrating relationship between the real exchange rate and the commodity terms of trade in Malawi and then directly compares the actual real effective exchange rate series (REER) with the predicted one from the model to establish the magnitude of the real exchange rate misalignment.[3]

4. **We make several adjustments to the standard MB framework.** First, we use a homogenous group of African countries with similar characteristics to Malawi to calculate the current account norm and the equilibrium exchange rate misalignment, using data over the period 2002–11 to avoid the structural breaks in the data series. Second, we augment the determinants of the current account with terms of trade, aid flows, and remittances, to reflect specific characteristics of a LIC like Malawi. Third, we employ an econometric technique that captures the potential endogeneity of the variables and exploits the panel nature of the data.

5. **The macroeconomic indicators approach points to excess demand for foreign exchange and the model-based approaches indicate a real exchange rate overvaluation in the range of 26 to 34 percent.** The assessment of real exchange rate misalignment in countries with foreign exchange rationing (which are therefore persistently on the supply curve for foreign exchange and off their demand curve) is especially difficult, because the equilibrium is not found within the data. In addition, using estimated coefficients from a panel of countries that are in different stages of development compared to Malawi may bias the results. We therefore base the analysis for Malawi on indicators that capture developments in the foreign exchange market, complemented by model-based approaches, especially the ES and ERER techniques.

6. **This note is organized as follows.** Section II discusses the macroeconomic indicators that capture developments in the foreign exchange market and external sector. Section III discusses the application of the ES approach to Malawi, bringing out the relevant justifications for the relevance of using this approach. Section IV presents both the MB and ERER approaches, with a succinct description of the adjustments made to the standard CGER methodology and an explanation of the time series approach adopted. Section V concludes the note and derives policy implications.

[3] Isard (2007) argues that the three approaches are complementary, as they explicitly or implicitly model the medium run equilibrium value of the real effective exchange rate from different perspectives. These three approaches in conjunction with country-specific information can help reach robust assessments.

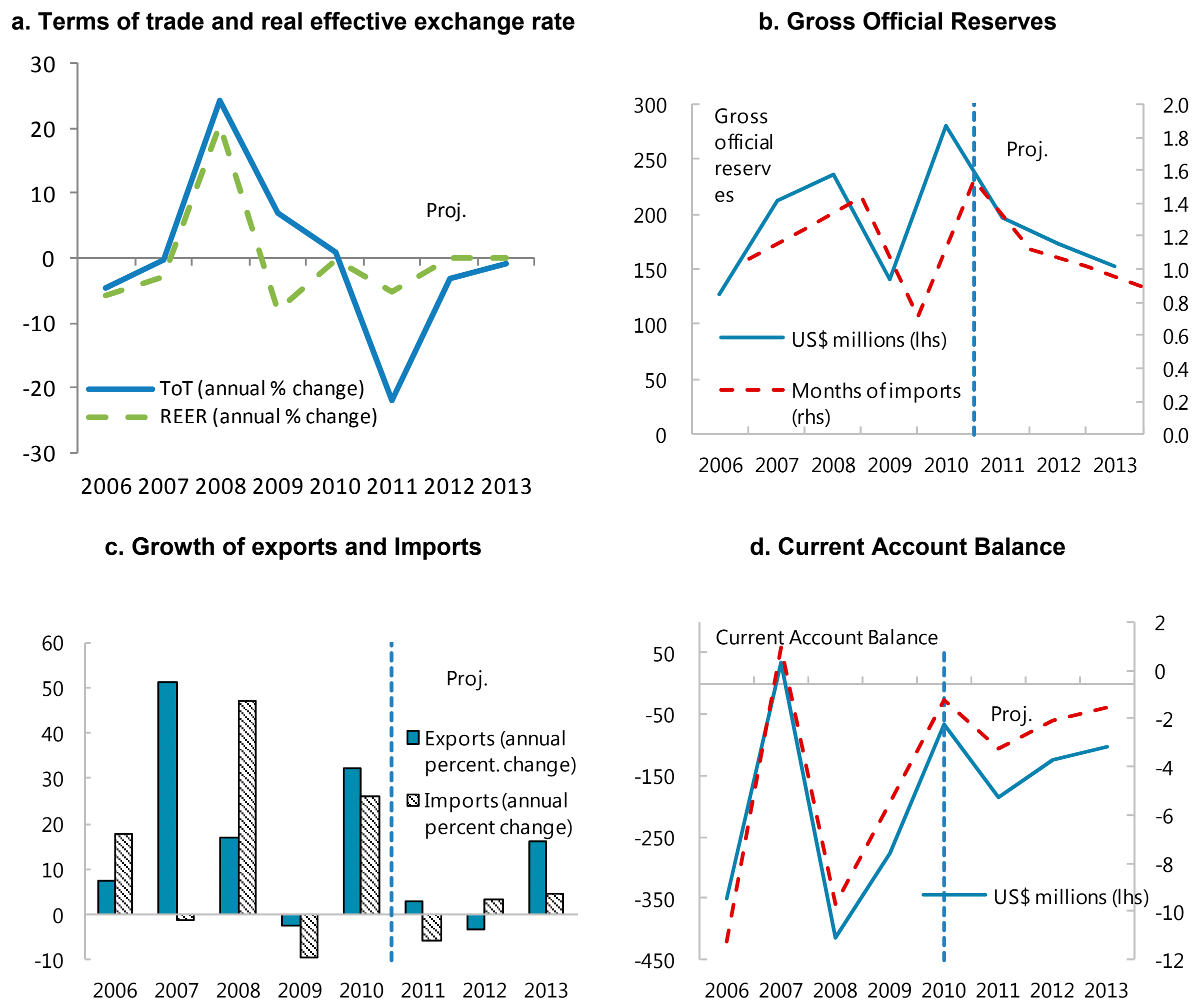
II. Macroeconomic Indicators Approach: Recent Developments in the External Sector and Foreign Exchange Market

A. External Sector Developments

7. **Recent evolution of the REER in Malawi has been associated with changes in the terms of trade (Figure A2.1a).** Importantly, however, due to restrictive foreign exchange policies, recently REER has been much more stable than the terms of trade; therefore the measured and equilibrium real effective exchange rates have started to diverge. This is an important observation, because looking at the trend in the REER alone might suggest that the exchange rate is moving in line with the fundamentals. The persistent overvaluation leads to current account deficits, complicating the accumulation of foreign exchange reserves (Figure A2.1b) and could thus eventually lead to a full-blown balance of payments crisis, if not offset by adequate capital flows (Imam, 2008).

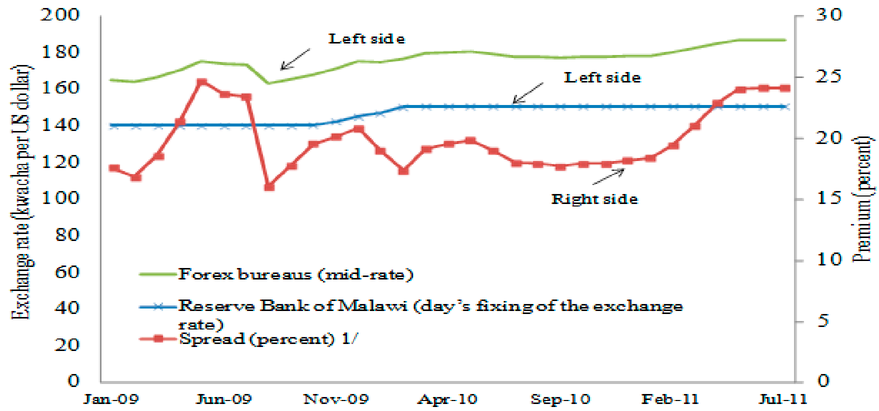
8. **Other external sector indicators point to a weak balance of payments position**. The rapid growth of domestic incomes and broadly fixed exchange rate between the Malawian Kwacha and the U.S. dollar have culminated in an imbalance between the growth of imports and exports (Figure A2.1c) and resulting in volatile current account deficits (Figure 1d). Export growth has shown a declining trend, which makes it difficult to finance imports, including the essential ones such as fuel, fertilizer and medicine. After narrowing significantly in 2010, reflecting the shifting of delayed external grants from 2009 to early 2010, current account deficit has increased in 2011. Medium-term projections indicate that a considerable degree of import compression is required to keep net foreign assets approximately stable. Current account deficits underpinned by a limited and falling export base combined with a weakening terms of trade, could bring about an external crisis, culminating in an eventual disorderly exchange rate adjustment.

Figure A2.1. Malawi: External Developments, 2006–13



9. **Pressures on the foreign exchange market have intensified**. The spread between the official and bureau rates widened to about 25 percent by end-July 2011, suggesting that the official exchange rate is increasingly overvalued (Figure A2.2). In August 2011, the Reserve Bank of Malawi (RBM) issued new foreign exchange regulations, requiring foreign exchange bureaus to operate around the official rate within a band of +/- three percent (after a devaluation of the official exchange rate by 10 percent). This requirement has generated more foreign exchange activity in the parallel market and has led to a rise in the rate to around 285 kwacha per dollar by early May, 2012. The premium needs to be measured against this market, rather than the bureau market after July 2011. As long as there is a gap between the official rate and the parallel market rate, there will be an arbitrage opportunity for speculators to gain significant profits.

Figure A2.2. Malawi: Exchange Rate Premium
(Monthly 2009–11)



[1]The difference between the bank bureau mid-rate for U.S. dollar cash-based buying and selling transactions and the official midrate at the day's fixing, expressed as a percentage of the official midrate.

10. **Other indicators of foreign exchange availability suggest that excess demand pressures in the market have intensified**: (i) the interbank foreign exchange market continues to be largely inactive, consistent with excess demand by banks' own customers for foreign exchange at the official exchange rate; (ii) the business community continues to complain of a significant gap between the demand for and supply of foreign exchange and some viewed the administration of the RBM prescreening of large foreign exchange purchases (set at US$50,000) as an intensification of foreign exchange controls.

11. **Reserves are among the lowest in Sub-Saharan Africa (Figure A2.3).** Low reserves are symptomatic of persistent external imbalances, resulting from more rapid growth of imports than exports, brought in part by rapid growth of nontradable agriculture relative to tradable economic activities, but also high wage increases. The RBM has faced a constant demand for foreign exchange during 2011, and as a result experienced a marked reduction in the foreign exchange reserves. The RBM is not in a position to continue to meet the foreign exchange demand through the sale of its reserves, especially with a weak tobacco market and reduced donor support. Eventually, the RBM will run out of reserves or else it will need to intensify rationing, and the exchange rate may depreciate in a disruptive manner.

Figure A2.3. Malawi: Reserves in Months of Imports
(at end 2010)

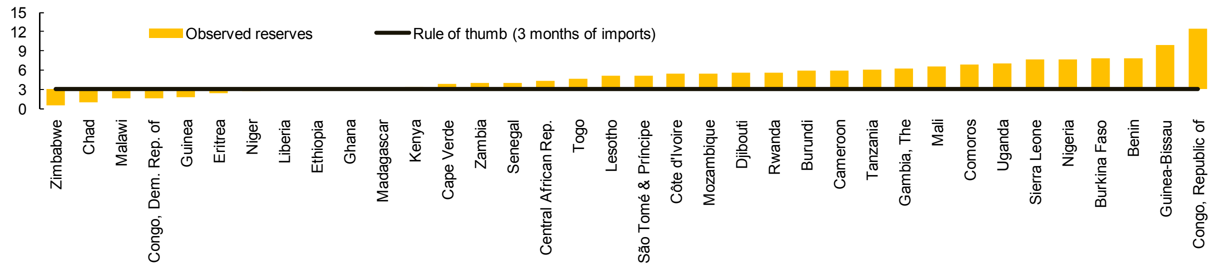
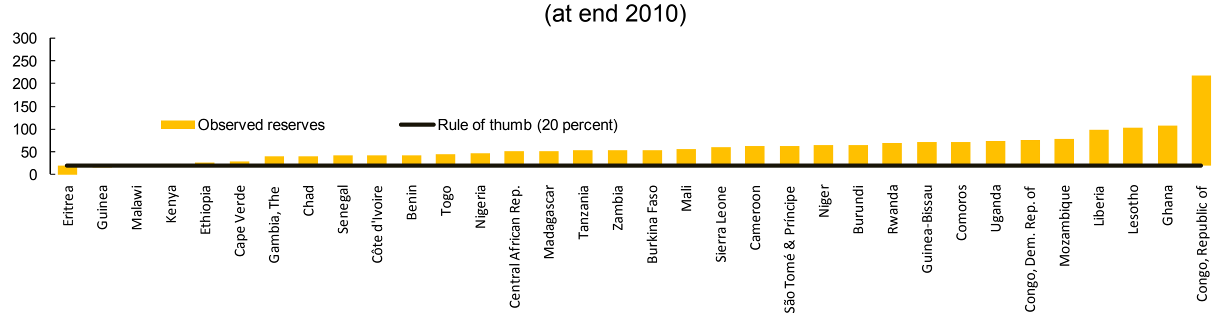


Figure A2.3. Malawi: Reserves in Months of Imports (continued)
(at end 2010)



12. **Up to April 2012, Malawi continued to experience foreign exchange shortages and rationing, and private import payment arrears.** There are arrears on fuel imports (currently about US$50 million) and perhaps tobacco loans taken out by a government-owned entity, Malawi Leaf. Banks have indicated that there is a substantial backlog of foreign exchange requirements.

13. **The use of various macroeconomic indicators relating to the external sector and foreign exchange market point to exchange rate misalignment in Malawi.** Recent developments concerning the terms of trade, real effective exchange rate, growths of imports and exports, evolution of the current account, foreign exchange reserves and the foreign

exchange market premium suggest that an excess demand for foreign exchange persists and that there is a need to address the underlying external disequilibrium.

III. THE EXTERNAL SUSTAINABILITY APPROACH

14. **The ES approach analyzes the relationship between the sustainability of a country's external stock position and its flow current account position**. Unlike the MB and ERER approaches, which require econometric estimation, the ES approach relies substantially on very few assumptions relating to the real GDP growth and inflation. This simple and transparent structure makes it a natural benchmark to compare with the two other approaches. The ES approach shares one common feature with the MB approach in that it assesses the exchange rate adjustment needed to bring the current account back to its norm. However, the definition of the norm differs between the two approaches.

15. **The advantage of ES approach lies in its simple and intuitive estimation methodology**. The ES approach consists of three steps. Based on an intertemporal budget constraint of the economy, the first step determines the ratio of the current account balance to GDP that would stabilize the net foreign asset (NFA) position at a defined benchmark value. The second step compares the NFA stabilizing current account to the underlying current account balance. The third step computes the adjustment of the REER needed to close the gap between the NFA stabilizing current account and the underlying current account. The NFA stabilizing current account (CA^S) is estimated using the following formula:

$$CA^s = \frac{g + \pi * (1+g)}{(1+g) * (1+\pi)} * b^s \tag{1}$$

where g is the medium-term GDP growth rate and π is the medium-term inflation rate.

16. **Both the ES and MB approaches rely on the elasticity of the current account with respect to changes in the real exchange rate as a key parameter**. In general, this parameter depends on the price elasticity of imports and exports (both demand and supply). We follow Tokarick (2010) in deriving the formula for the elasticity under the assumption that a country is sufficiently small for the export demand and import supply elasticities to be equal to zero (that is Malawi is small enough not to have any effect on its import or export prices). We also assume complete pass-through for both import and export prices. Table A2.1 lists the parameters relevant to the calculation and their associated values.

Table A2.1: Calculating the Elasticity of Current Account to Real Exchange Rate in Malawi

Parameter	Value
Average ratio of exports to GDP (2007–11) (s_x)	0.22
Average ratio of imports to GDP (2007–11) (s_m)	0.35
Import demand elasticity (ε_m)	-0.52
Export supply elasticity[4] (ε_x)	0.29
Pass-through coefficient from foreign prices for domestic export prices (ϕ_x)	1
Pass-through coefficient from foreign prices for domestic import prices (ϕ_m)	1

17. Following Tokarick (2010), the elasticity is calculated according to the formula:

$$\eta_{ca} = -s_x \varepsilon_x \phi_x + s_m \varepsilon_m \phi_m \qquad (2)$$

Using the values from Table 1, one obtains the value of -0.25 for this elasticity. This elasticity would be lower, if less than complete pass-through were assumed. Key assumptions and results for the ES approach are shown in Table A2.2. We set the target for NFA that is consistent with reserves covering 3 months of imports, using average projected imports for 2012 to 2017 and assuming no import compression.[5] Table A2.2 summarizes other key assumptions underlying the ES approach and the results. The external sustainability approach suggests an overvaluation of the real exchange rate of 26.8 percent.

Table A2.2: Key Assumptions and Results of the ES Approach

Parameter	Value
Annual imports (without import compression), percent of GDP, average 2012–17 (**A**)	27.6
Reserves needed to cover 3 months of imports, percent of GDP, average 2012–17 **(B = A/4)**	6.9
External debt, percent of GDP **(C)**	15.8
Net foreign assets of commercial banks, percent of GDP, average 2012–17 **(D)**	1.5
Net Foreign Asset Target (**E =B – C + D)**	-7.4
Projected real GDP growth rate, percent, average 2012–17	4.1
Projected inflation (CPI, end of period, percent)	14.1
NFA Stabilizing Current Account (by formula (1))	-1.2
Projected Current Account (without import compression)	-7.9
Elasticity of Current Account to Real Exchange Rate changes	-0.25
Misalignment Estimate	**26.8**

[4] Both elasticities are obtained from Tokarick (2010) and are the minimum of the range of estimates provided in the paper.

[5] An alternative approach entails modeling the NFA norm within a panel regression framework. Following the literature on the ES approach and in view of data challenges and econometric estimation, we choose to calibrate the NFA norm for Malawi instead.

IV. The Macroeconomic Balance and Equilibrium Real Exchange Rate Approaches

18. **The MB approach determines the exchange rate adjustment that is required to bring the underlying current account to a level consistent with the norm[6] and the ERER approach provides the gap between the equilibrium and actual exchange rates**. The starting point for these approaches is to identify the fundamentals that matter for the current account and REER determination. For the former approach, the coefficients obtained from a homogenous panel regression are applied to the identified fundamentals to derive the current account norm, which is then compared to the underlying current account to measure the required adjustment in the REER. The next section focuses on the theoretical foundations for these approaches as well as the review of the literature on their empirical underpinnings.

B. Macroeconomic Determinants of the Current Account and the REER

19. **Theoretically, the same variables should simultaneously determine the real exchange rate and the current account (Blanchard, 2007)**. However, the theoretical underpinnings for the empirical analysis of the real exchange rate have usually emanated from long-run steady-state analyses of models with tradable and nontradable goods in the presence of balanced trade (Lee et al., 2008 and Prati et al., 2010). At the same time, empirical analysis of the current account has been underpinned by the intertemporal approach to the current account, emphasizing the main determinants of savings and investment. We review below the expected relationship among each of the fundamentals, the current account balance and the real exchange rate.

Fiscal policy

20. Abstracting from Ricardian equivalence, fiscal policy tends to affect aggregate demand and national saving, and consequently, the current account balance and the real exchange rate. Fiscal policy affects the real exchange rate via the composition of government expenditure, among other channels. An increased allocation of government spending to nontraded goods would tend to increase the prices of these goods relative to tradables, culminating in real exchange rate appreciation. In this connection, an improved fiscal position, measured by a reduced deficit, should be associated with both real exchange rate depreciation and an improved current account position.

Net foreign assets

21. As Prati et al. (2010) and Lee et al. (2008) discuss, the effect of initial NFA on the current account balance appears ambiguous. Countries with initially higher NFA can afford

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[6] In assessing the external position in Malawi, a model that is based on the current account is relevant, as it constitutes one of the key indicators of the future behavior of an economy. Understanding the determinants of current account imbalances is essential to designing an effective set of policies to address external imbalances to achieve internal and external stability.

higher spending (because of the income flow)—and therefore a worse current account balance—and remain solvent and this should be consistent with an appreciated real exchange rate, as creditor countries will need a more appreciated exchange rate to incur trade deficits to ensure intertemporal solvency. On the other hand, economies with initially high NFA benefit from increased net foreign income flows, resulting in a positive relationship between NFA and current account balances, somewhat delinked to exchange rate movements.

Demographics

22. Reflecting the theory of the life-cycle, a higher share of dependent population reduces national savings and the current account balance, thus resulting in a more appreciated equilibrium real exchange rate. Population growth rate may capture the share of economically dependent young people – a higher population growth rate should reduce saving and consequently worsen the current account balance, hence this variable should have a negative effect on the current account balance and lead to a more appreciated equilibrium real exchange rate.

Stage of development and economic growth

23. In line with the neoclassical theory, LICs should import capital and borrow against their future incomes to finance their investment needs and smooth out consumption, given the high marginal utility of consumption. Similarly, fast-growing economies with higher expected productivity improvements should invest more, implying a deterioration of the current account balance. Finally, high productivity growth in the tradable sector relative to the non-tradable sector should be associated with a more appreciated real exchange rate (Balassa-Samuelson effect). The real GDP per capita growth rate is included to control for the relative level of economic development. As Lee et al. (2008) point out, among countries at a similar initial stage of development, a country with a higher growth rate should have a weaker current account balance.

Terms of trade

24. The impact of a change in an economy's terms of trade on its real exchange rate is ambiguous, as it depends largely on the magnitude of income and substitution effects. Depending on how the real exchange rate responds to the terms-of-trade change, the trade balance and current account will adjust in a fashion that depends on the responsiveness of trade flows to changes in the real exchange rate. Prati et al. (2010) show that the terms of trade may have a significant effect on the current account balance of LICs.

Aid as a ratio of GDP and remittances as a ratio of GDP

25. Aid in general can be used either to increase imports or build up foreign reserves (see e.g. Berg et al., 2010). One would expect the first motive to dominate; hence the sign on the aid to GDP ratio should be negative in a trade balance equation. The overall impact of aid on the current account balance would depend on the relative share of concessionary loans and grants in aid as well as the impact of these two variables on exchange rate movements. Similarly, the impact of remittances on the current account is an empirical question, as

increases in remittances could have either positive or negative impact on the current account, depending on whether the private consumption associated with remittances is lower or higher than the initial increase in remittances. If remittances lead to increased access to external funding, there could arise a situation whereby the increase in private consumption exceeds remittances, leading to a lower current account position. The impact of aid inflows on the real exchange rate depend on the composition of government expenditure, the efficiency with which aid inflows is used and the complementarity between public infrastructure and private investment. Going with the expectation of the fiscal motive being the rationale behind aid inflows, one would expect at least some temporary real exchange rate appreciation to stem from higher aid inflows and remittances.

B. Econometric Results: The Macroeconomic Balance Approach

26. **We made a series of adjustments to the standard framework for conducting an analysis of real exchange rate misalignment**:

- One critical issue relates to the sample of countries to use in obtaining the parameters required for estimating the current account norm. We were guided by the principle of selecting a sample of countries that have shared economic characteristics to avoid model misspecification. The panel for the estimation consists of 12 countries in Sub-Saharan Africa.[7]

- Since the time series available for many of countries in the panel is disrupted by data inconsistencies and structural revisions to the data and the economy, along the lines of Aydin (2010), we use annual data covering the period 2000–11.

- In line with Vitek (2009), Aydin (2010) and Prati et al. (2011), the list of fundamentals underlying the usual assessment of the determinants of the current balance is extended to reflect the features of a developing economy like Malawi. In this connection, the macroeconomic fundamentals include both aid inflows and remittances in ascertaining the current account norm. Aid inflows (grants and concessional loans) constituted about 28 percent of government expenditure and a significant source of foreign exchange earnings in 2010. Remittances at about US$50 million in 2010 (1 percent of GDP) are also quite significant.

- Empirical studies have also shown that the terms of trade matter for current account determination in developing economies. Thus we include the terms of trade as one of the possible determinants of the current account and real exchange rate.

[7] Specifically, these include: Botswana, Ethiopia, Kenya, Lesotho, Malawi, Mozambique, Namibia, South Africa, Swaziland, Tanzania, Uganda, and Zambia.

- One important element of our approach, which is consistent with the literature on real exchange rate misalignment, is that most of the variables are expressed in relative terms, compared to the trading partners.

- The relatively small cross-sectional and time series dimensions of our sample determine in part the choice of the econometric technique for the panel estimation. The simple pooled least squares estimator suffers from short sample bias. Generalized method of moments (GMM) techniques are commonly preferred and also correct for potential endogeneities.

- For Malawi, South Africa, the UK, and the US are the dominant trading partners. As in Prati et al. (2010), the trade weights used are from the IMF – INS facility, with some adjustments. Specifically, the weight for Swaziland in the last set of weights (from 2005 onwards, equal to 0.06, previously equal to zero) is added to South Africa, as Swaziland is more than likely an intermediary rather than the ultimate destination for trade. Table 3 reports the top 5 trading partners for Malawi over separate time periods. We do not impose a minimum cut-off point for weights to be included in the trade-weighted average.

Table A2.3. Malawi: Top 5 Trading Partners and their Weights Over Time

Country	1973–89	1990–95	1996–2004	2005–16
South Africa	0.18	-	0.37	0.28
United Kingdom	0.16	0.16	0.11	0.05
United States	0.14	0.15	0.07	0.10
Germany	0.07	0.12	0.07	0.06
Japan	0.07	0.10	0.07	0.05
France	-	0.07	-	-

27. **The GMM approach points to the terms of trade, lagged NFA, and relative real GDP per capita growth rate as the statistically significant determinants of the current account (Table A2.4).** Initially (full specification in Table A2.4), including all variables makes it impossible to establish individual coefficients with any precision, owing to relatively small sample size, however, coefficients are jointly significant. We proceed to choose a model by removing the variables with the largest *p-values*, until only significant variables (and a constant) remain. Following this strategy selects the variables in restricted specification. Retaining the lagged values of dropped variables as instruments allows one to conduct a test of over-identifying restrictions: the result is that they are not rejected at 5 percent significance.

Table A2.4: Malawi: Results of the Macroeconomic Balance Approach: GMM [1]

Variable Name	Coefficient	
	Full Specification	Restricted Specification
Terms of trade (log index)	0.116	0.143**
Relative Fiscal Balance (ratio of GDP)	0.110	
Aid (ratio of GDP)	-0.234	
Remittances (ratio of GDP)	0.014	
Lagged net foreign assets (ratio of GDP)	0.043	0.058***
Relative population growth rate	0.817	
Relative real GDP per capita growth rate	-1.087	-1.746***
Constant	-0.010	-0.012
R-squared [2]	0.237	0.141
Number of observations	108	108

[1] *** - significant at 1 percent, ** - significant at 5 percent, * - significant at 10 percent. Significance is based on standard errors that are robust both to heteroskedasticity and autocorrelation. Lagged values of all variables are used as instruments.

[2] This R-squared measure is the squared correlation coefficient of the predicted values from the panel regression and the actual values.

28. **In order to calculate the current account norm, we summarize our results across both full and restricted specifications**:

- *Terms of trade* is usually significant and has the expected sign in both specifications. The income effects emanating from an improvement in the terms-of trade tend to produce an improvement in the current account position.

- *Relative fiscal balance* has the expected sign; however, it is not significant and is not included in the restricted specification.

- *Aid and remittances as a ratio of GDP.* The coefficient on aid is negative, as would be expected if increased amounts of exogenous foreign aid allow financing higher current account deficit. However, this coefficient is not statistically significant. Remittances on the other hand, have a positive impact on the current account, but are also not statistically significant.

- *Lagged NFA.* The coefficient has a positive sign, as expected, if net foreign income flows help and is statistically significant.

- *Population growth rate.* It does not have the expected sign, and is also not statistically significant.

- *The real GDP per capita growth rate*, on the other hand, has the expected negative sign and is significant in the restricted specification.

29. The MB approach points to real exchange rate misalignment of 26.4 percent, reflecting an underlying current account deficit of 7.9 percent (assuming no import compression) and current account norm of -1.3 percent of GDP (Table A2.5).

Table A2.5: Exchange Rate Misalignment Based on the Macroeconomic Balance Approach

Variable Name	Coefficient	Projected Average (2012–17)
Terms of trade (log index)	0.143	-0.038
Lagged net foreign assets (ratio of GDP)	0.058	-0.262
Relative real GDP per capita growth rate	-1.746	-0.011
Constant	-0.012	
Current account norm		-1.3
Projected current account (in 2012–17, without import compression), percent of GDP		-7.9
Elasticity of Current Account to Real Exchange Rate changes		-0.25
Misalignment		**26.4**

30. **The projections of the current account and its fundamentals are based on the latest WEO data and the assumption of constant real exchange rate in the medium term**. In this connection, the underlying current account is projected on the premise of assumption of no import compression so as to ascertain the exact magnitude of the exchange rate misalignment, as this is consistent with the demand for foreign exchange both in the public and private sectors. The medium term-projections that reflect the impacts of an exchange rate adjustment would yield a different current account norm (This is planned to be studied during the program negotiations with the authorities when there is a clearer picture of their policy intentions).

C. Econometric Results: The Equilibrium Real Exchange Rate (ERER) Approach

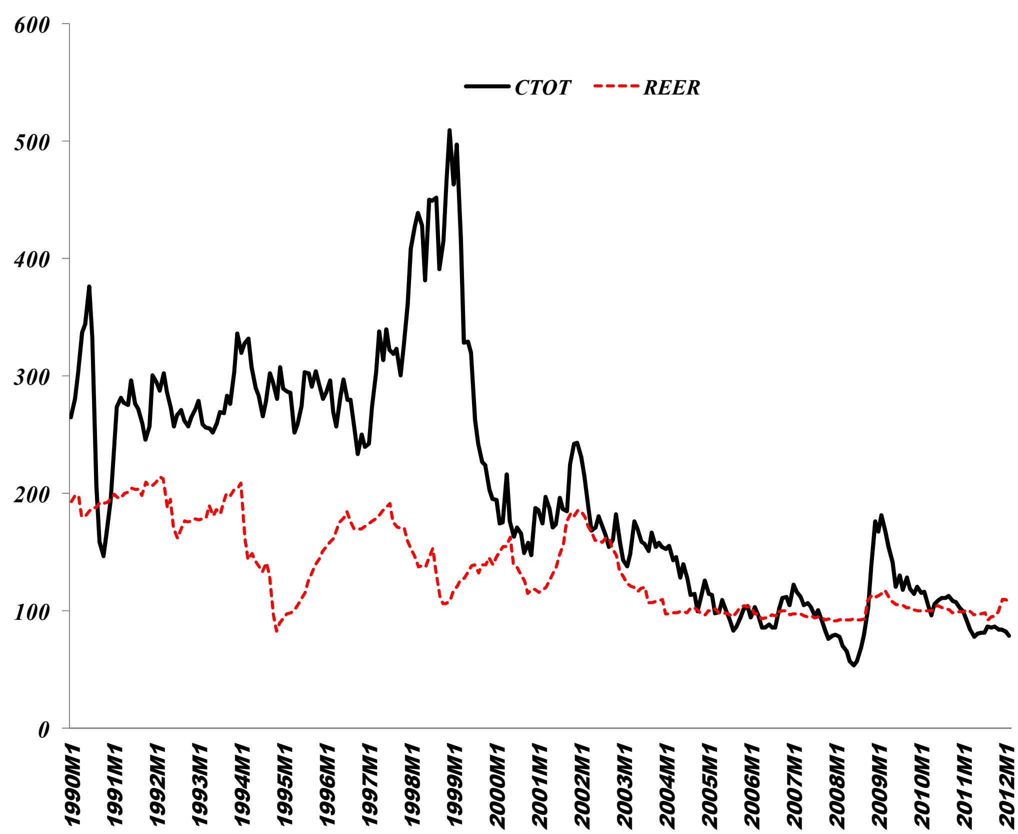
31. The reduced-form time series ERER approach to exchange rate assessment consists of three steps. First, a measure of monthly commodity terms of trade (CTOT) is constructed for Malawi between 1990M1 and 2012M2 and a cointegrating relationship between the CTOT and the monthly REER is established. Second, equilibrium real exchange rates predicted by the VAR model are computed as a function of the CTOT. Third, the percentage deviations of the actual real exchange rates from their predicted values are calculated and treated as a measure of the exchange rate misalignment.

32. **Fluctuations in the REER in Malawi have been associated with changes in the commodity terms of trade (Figure A2.4).** However, due to restrictive foreign exchange policies, the REER has been much more stable than the commodity terms of trade, resulting in a divergence between the CTOT and the REER. Our measure for the CTOT index is defined as:

$$CTOT_t = \prod_j \left(\frac{P_{jt}}{MUV_t}\right)^{X_j} / \prod_j \left(\frac{P_{jt}}{MUV_t}\right)^{M_j}$$

where MUV_t is a manufacturing unit value index used as a deflator, X_j (M_j) is the share of exports (imports) of commodity j in country i's total exports (imports), and P_{jt} is the individual commodity price at time t. The commodities are: Tobacco, Uranium, Tea, Sugar, Cotton, Rice, Coffee, Maize, Petroleum Products, and Fertilizers. By construction, the movements in the CTOT index are due to changes in commodity prices as the export and import shares are taken as fixed and so remain constant over time. For empirical application, we calculate X_j and M_j as the average value of these shares between 1990 and 2011. The CTOT index allows Malawi to be influenced by changes in commodity prices depending on the composition of its export and import baskets. This is in contrast to the standard commodity price indices most commonly used in the literature, such as the "All Primary Commodities Index", which is not country specific.

Figure A2.4. Commodity Terms of Trade and REER, 1990M1–2012M2

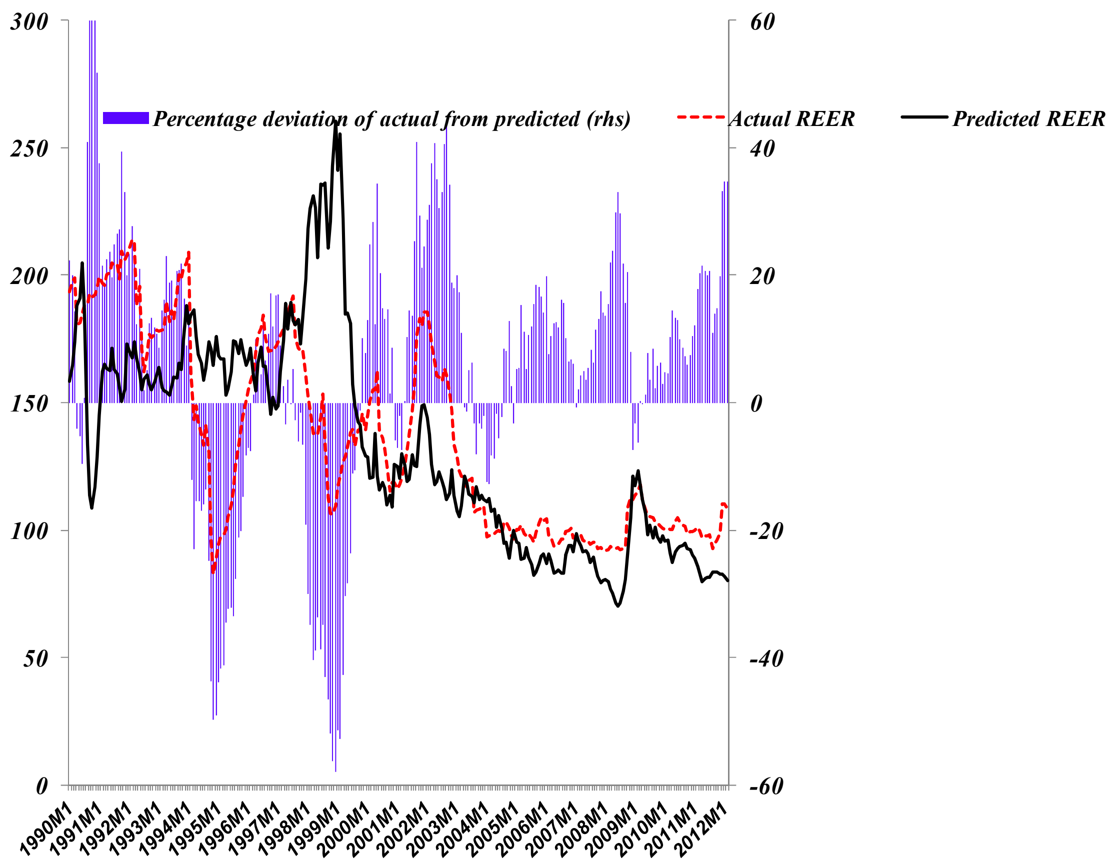


33. **The equilibrium real exchange rate (ERER) approach suggests that the kwacha is significantly overvalued.** A high frequency estimation of the cointegrating relationship between the real exchange rate and the commodity terms of trade (as the only explanatory variable) shows that they are cointegrated (with a statistically significant elasticity coefficient

of 41.8 percent). The estimation suggests that the kwacha is overvalued by around 34 percent in February 2012 (see Figure A2.5).

Figure A2.5. High Frequency ERER Estimation, 1990M1–2012M2

(Index)



V. Conclusions

34. **This note has assessed the degree of exchange rate misalignment in Malawi, using four main approaches.** All the methods point to real exchange rate overvaluation and excess demand for foreign exchange. The model-based approaches indicate a real exchange rate overvaluation in the range of 26 percent to 34 percent. We propose that the assessment of real exchange rate misalignment in Malawi rely on indicators that capture developments in the foreign exchange market, complemented by model-based approaches.

35. **Among the model-based approaches, we are of the view that the ES approach and the high frequency ERER method appear to be the most plausible for examining the critical issue of exchange rate misalignment in Malawi.** It is extremely important to

reflect on the special circumstances of Malawi that is persistently off its demand curve for foreign exchange (and therefore persistently out of equilibrium, making identification of the equilibrium especially difficult). Unlike the MB approach, which requires a homogenous-panel-data estimation, the ES approach relies substantially on very few assumptions relating to the real GDP growth and inflation. This simple and transparent structure makes its more appealing for exchange rate assessment for Malawi.

36. **It is important to acknowledge that the results of the MB approach are sensitive to the choice of the instruments, the strategy chosen to reduce the number of variables in the specification, and revisions to the underlying data, which can, for the countries in question, be substantial.** This constitutes an additional reason to prefer simpler specifications and, in particular, the developments in the parallel market, which presumably provides a more accurate and policy-relevant guide to the extent of overvaluation of the *nominal* exchange rate.

37. **A properly valued exchange rate is an important condition for improving the competitiveness of an economy.** In the context of Malawi, achieving an appropriate exchange rate could help with: (i) reducing or eliminating underreporting of exports and over-invoicing of imports; (ii) increasing inflows of remittances through the official channels, which would help address deadweight loss associated with using informal channels; (iii) reducing imports to ensure that the current account position is sustainable; (iv) transitioning to increased exports; (v) accumulating international reserves, which will help the country to withstand adverse exogenous shocks; and (vi) removing the adverse impact of uncertainty relating to the exchange rate and foreign exchange regime on investment and economic growth.

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APPENDIX III. MALAWI: STRATEGIES FOR FINANCIAL DEEPENING[1]

1. The Malawian authorities have been working on reforms to deepen the financial sector and make it more inclusive. Regulatory and legal reforms have culminated in the enactment of the following pieces of legislation: Banking Act; Microfinance Act; Securities Act; Credit Reference Bureau Act; Microfinance Act; Securities Act; Financial Cooperatives Act; Pension Act; and Payment System Act.

2. Financial deepening indicators in Malawi are improving. Two indicators of financial deepening (broad money as ratio of GDP and credit to the private sector as a ratio of GDP) show an increasing trend.

Figure A3.1. Broad Money, 2000–10
(Percent of GDP)

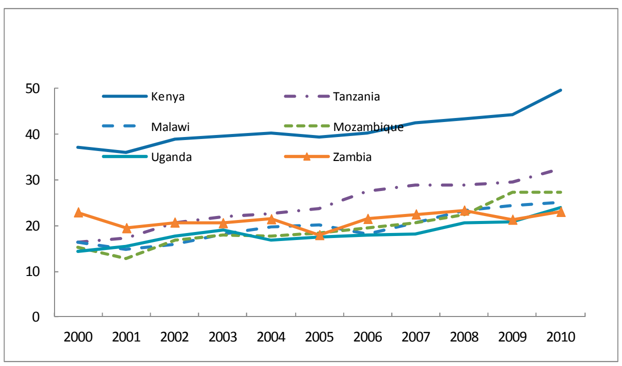
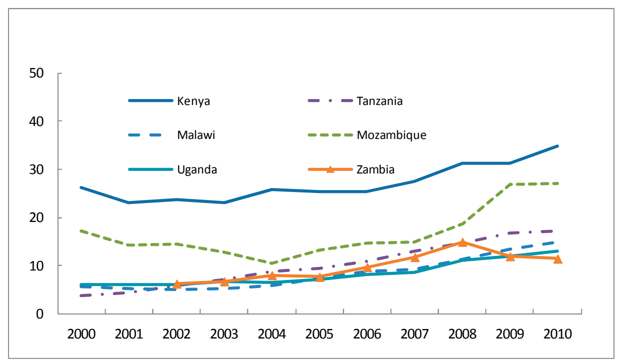


Figure A3.2. Claims on Private Sector, 2000–10
(Percent of GDP)



3. Financial development indicators in Malawi are still low by regional standards. As at end-2010, the ratio of broad money to GDP in Malawi was less than the median for sub-Saharan Africa. Also, the ratio of credit to the private sector was lower than the median for sub-Saharan countries.

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[1] Prepared by Olumuyiwa Adedeji.

Figure A.3.3. Broad Money Sub-Saharan Africa, 2010
(Percent of GDP)

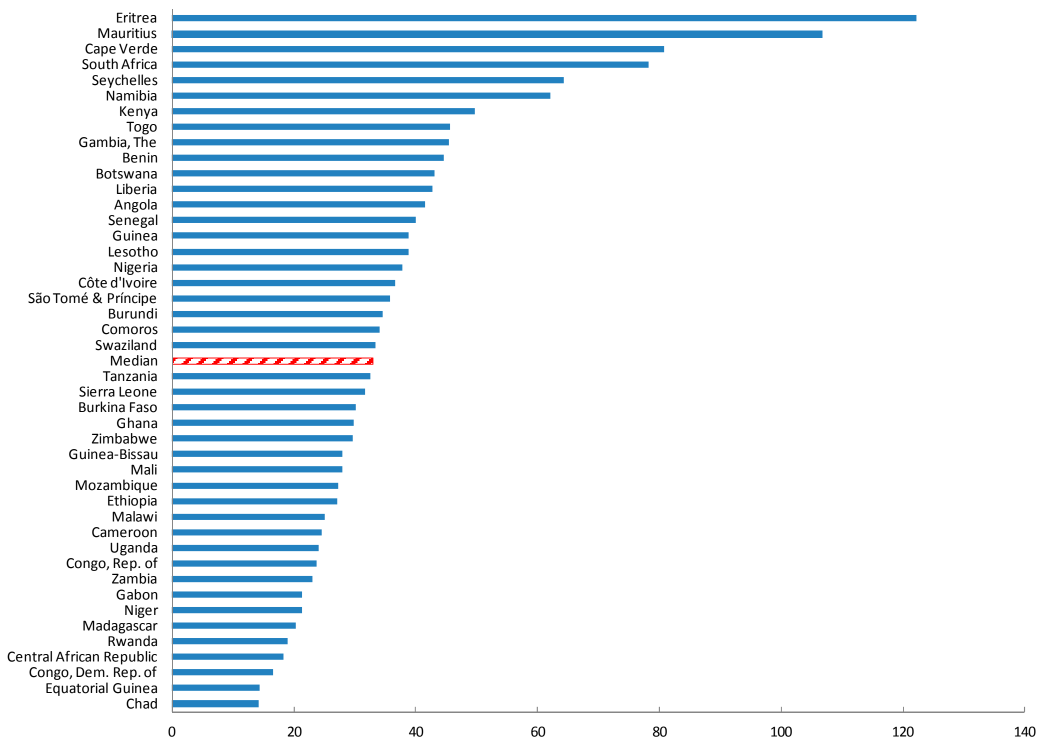
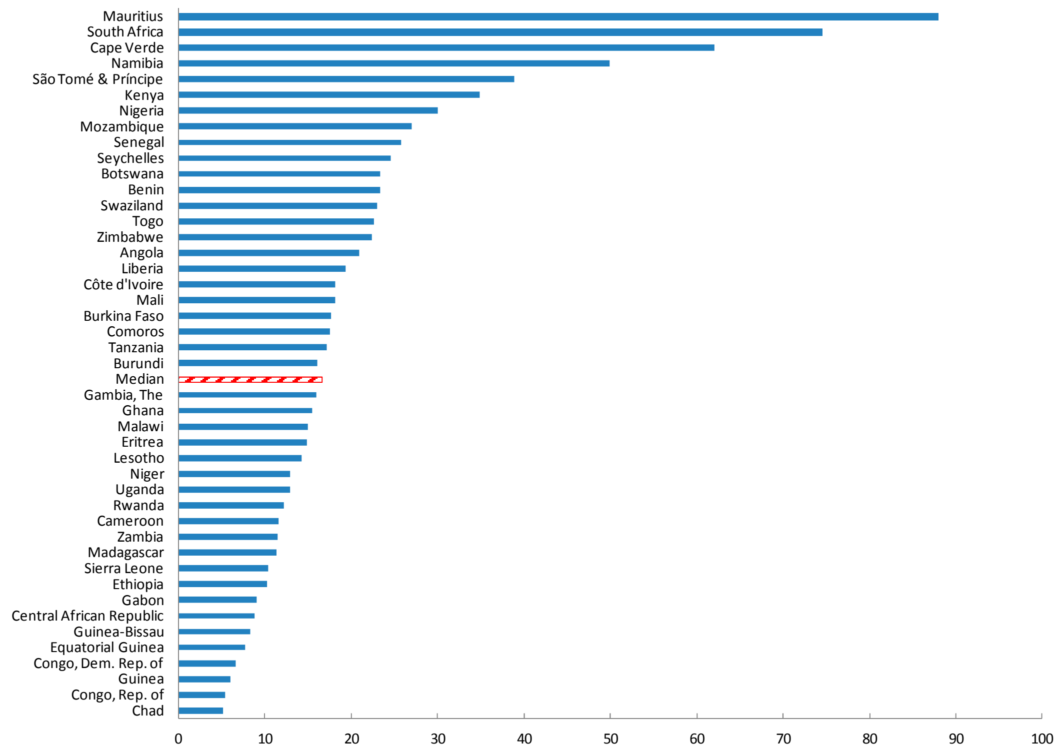


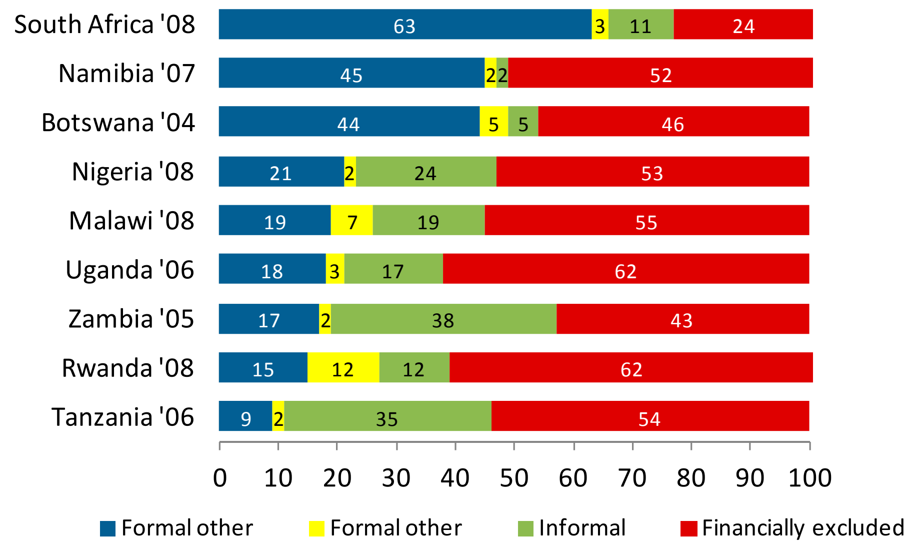
Figure A.3.4. Claims on Private Sector Sub-Saharan Africa, 2010

(Percent of GDP)



4. A significant proportion of the Malawi's population still continues to face severe constraints in accessing financial services (FinScope, Malawi, 2008): (i) 26 percent of adults are formally served (19% by banks and 7% by other formal financial institutions);
(ii) informal sources (borrowing from employers, obtaining credit from shops or receiving input as credit) capture another 19% of the adult population; and (iii) the share of those financially excluded from the financial sector is 55%. Low client income levels, low financial literacy, risks arising from rain-fed agriculture and high cost of finance have been identified as responsible for limited access to finance in Malawi (2008 FSAP and FinScope, Malawi, 2008).

Figure A3.4.



Source: Finscope Malawi 2008.

5. There is a huge potential for using Mobile -banking technology to increase access in Malawi. Transformational branchless banking models in other countries, underpinned by the use of technology and agents, have contributed to lowering the costs of intermediation and reaching new areas and clients. Safaricom and M-payments service in Kenya [M-Pesa] is an excellent example, which allows the transfer of money cheaply within Kenya via mobile phone without a bank account. The introduction of M-PESA has facilitated a rapid increase in financial intermediation.

6. Another promising strategy is the use of agency agreement, which is a model favored in several Latin American countries: Banks offer financial services through third-party agents (stores or post offices). Agency agreements offset several supply-and demand-side constraints simultaneously. Kenya has recently put in place the necessary regulatory framework. In Brazil, the government routes most pension and social welfare payments through banks which use correspondents, providing a backbone of transactions that underpin the business model banking for branchless banking.

IV. MALAWI—EXTERNAL COMPETITIVENESS IN A REGIONAL CONTEXT[1]

I. INTRODUCTION

1. **Despite several successive years of strong growth, a number of indicators point to a steady deterioration in Malawi's external competitiveness relative to regional peers**. Malawi experienced an impressive average annual growth rate of 8.3 percent during 2007–10, which was largely attributable to successful implementation of the Farm Input Subsidy Program (FISP) and favorable weather conditions. However, growth was not broad-based and was largely concentrated in the production of tobacco, which accounts for over 60 percent of total exports, and a handful of other cash crops (including sugar and tea), as well as maize, produced primarily for domestic consumption. With its export base still relatively undiversified and largely dependent on rain-fed agriculture, the Malawian economy remains highly vulnerable to a plethora of external shocks—including weather, aid, and commodity price shocks. Moreover, rapid economic growth in the context of binding capacity constraints and a limited domestic supply response, has fueled a sharp rise in import demand and exacerbated a chronic shortage of foreign exchange.

2. **Attainment of the poverty reduction and developmental goals established in Malawi's Growth and Development Strategy (MGDS) requires an outward orientation with supportive policies that enhance external competitiveness and diversified, inclusive growth.** In the MGDS, the Malawian authorities commit to the pursuit of sound economic policies that help to sustain high growth, price stability, exchange rate flexibility and an improved foreign reserve position. As a small, landlocked country with a limited domestic market, sustaining high growth rates over the medium term will require a successful export promotion strategy and strengthened cross-border ties. Moreover, with the current push towards enhanced regional integration and the advent of the Grand Tripartite Free Trade Area (comprised of the integration of the East African Community (EAC), COMESA, and SADC), Malawi must at a minimum ensure that it implements policies that will enable it to compete effectively with its regional peers.

3. **The note establishes a positive link between export performance and both export diversification and external competitiveness, and analyzes trends in these indicators from several dimensions**. Malawi's export performance is compared with that of a peer group[2] of regional countries—namely: countries that share a border with Malawi (Zambia, Mozambique, and Tanzania) and countries belonging to the East African Community (Burundi, Kenya, Rwanda, and Uganda); as well as other African Low-Income Countries (LICs) and Sub-Saharan Africa (SSA) as a whole. The note analyzes some stylized facts (pertaining mainly to trade performance indicators); utilizes a number of indicators to

[1] Prepared by Ruby Randall.

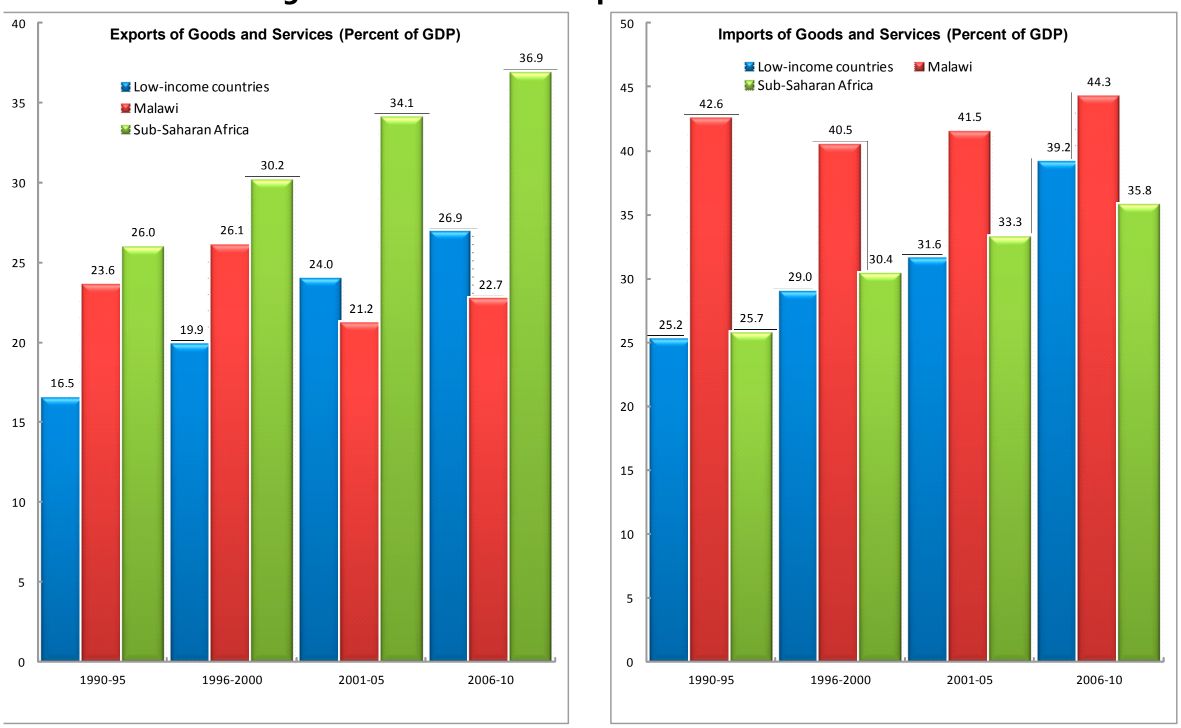
[2] Henceforth referred to as "the comparator group".

measure external competitiveness levels and any discernible trends over time; and tries to explain export performance by assessing the magnitude and statistical significance of various explanatory factors, including various measures of external competitiveness. It then concludes by summarizing key findings and policy implications. It does so because "*Competitiveness is relevant for policymakers as it is based on variables that they can act upon to create the conditions conducive to economic activities and prosperity*". (ECA, 2004)

II. Stylized Facts

4. **Malawi's export growth has been stymied relative to that of other regional peers, while imports have accounted for a larger and growing share of GDP— a clear manifestation of Malawi's chronic exchange rate misalignment (**Figure A4.1)**.** Malawi's

Figure A4.1. Malawi: Comparative Trade Indicators



Sources: IMF, African Department database, September 16, 2011; and IMF, World Economic Outlook (WEO) database, September 16, 2011.

export performance as a share of GDP weakened during 1990–2010 and relative to the performance of other African LICs and SSA, while Malawi's imports accounted for a much larger share GDP than its regional counterparts**.** At the start of the period, Malawi's exports of goods and services as a percentage of GDP was significantly higher than that of other African LICs, although performance was weaker than the SSA average. However, by 2000–10, Malawi's export performance deteriorated vis-à-vis the performance of other African LICs, while still remaining well below the average for SSA. Malawi's imports of goods and services on the other hand were significantly higher than the average for other African LICs, which for much of the period was in line with the average for SSA as a whole.

5. **Malawi's share of regional exports to the world have also declined sharply over time.** Malawi experienced the second largest decline in share of the comparator group's exports to the world during 1990–2010, after Burundi. The country's share of regional exports declined from an average of about 13 percent during 1990–94 to just 5 percent during 2005–10[3]. Malawi's performance contrasts sharply with that of Mozambique whose share rose from 5.5 percent of regional exports to 15 percent during the same period. Moreover, the data also suggest that among this comparator group, countries that increased their share of world exports also tended to be those that successfully diversified, as a statistically significant negative relationship was found between the Herfindahl Index of export concentration and the change in a country's share of the region's exports to the world.[4]

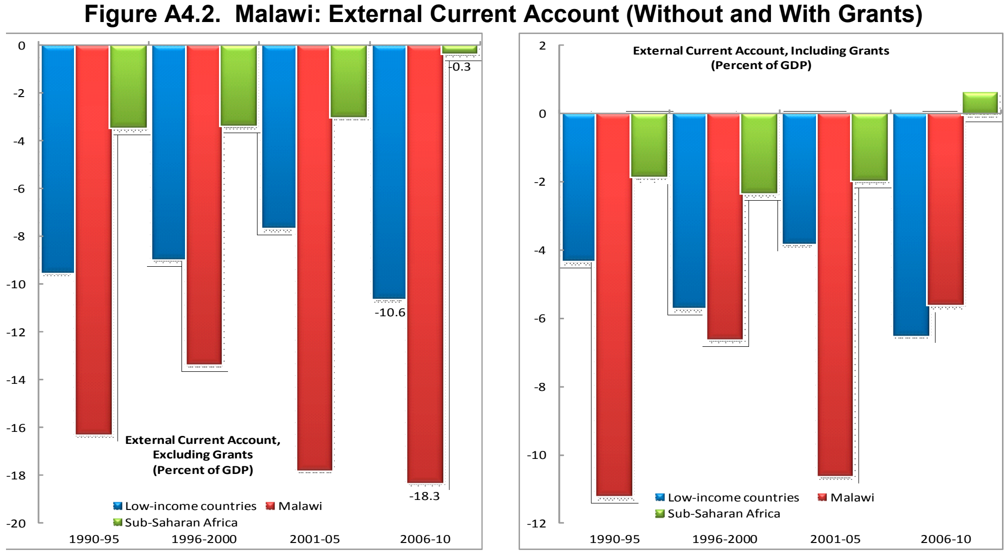
Table A4.1. Share of Regional Merchandise Exports to the World

	1990–94	1995–99	2000–04	2005–10	% Change
Burundi	2.3	1.4	0.7	0.5	-80.5
Kenya	35.3	39.8	36.1	29.0	-17.7
Malawi	12.8	9.7	7.4	5.0	-61.1
Mozambique	5.5	4.7	13.2	15.0	173.4
Rwanda	3.1	2.2	2.8	1.8	-40.1
Tanzania	12.9	13.4	15.1	12.1	-6.1
Uganda	5.7	10.1	8.2	8.6	51.0
Zambia	22.4	18.7	16.5	27.9	24.6
Total	100.0	100.0	100.0	100.0	

Sources: IMF staff calculations based on IMF Direction of using Trade Statistics (DOTS).

6. **Malawi's weaker trade performance contributed to a sharper deterioration in the external current account (both without and with grants) during the review period**

Figure A4.2. Malawi: External Current Account (Without and With Grants)



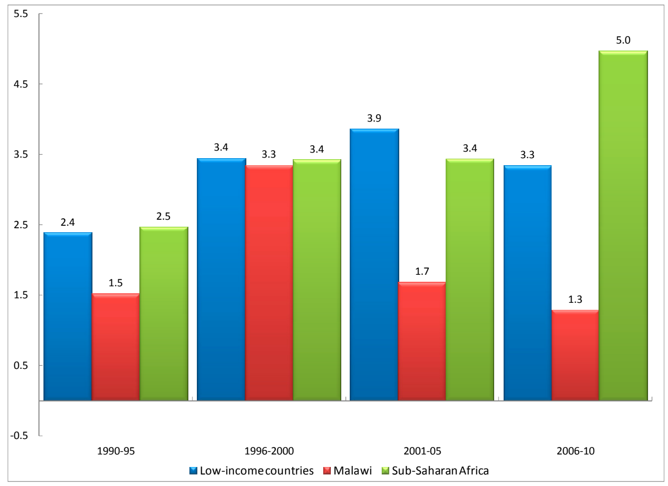
Sources: IMF, African Department database, September 16, 2011; and IMF, World Economic Outlook (WEO) database, September 16, 2011.

[3] Only indicative, since intra-regional trade (expected to be a fairly small share of total exports) is not netted out.

[4] Spearman's Rank Correlation Coefficient is -0.64—significant at the 5% significance level.

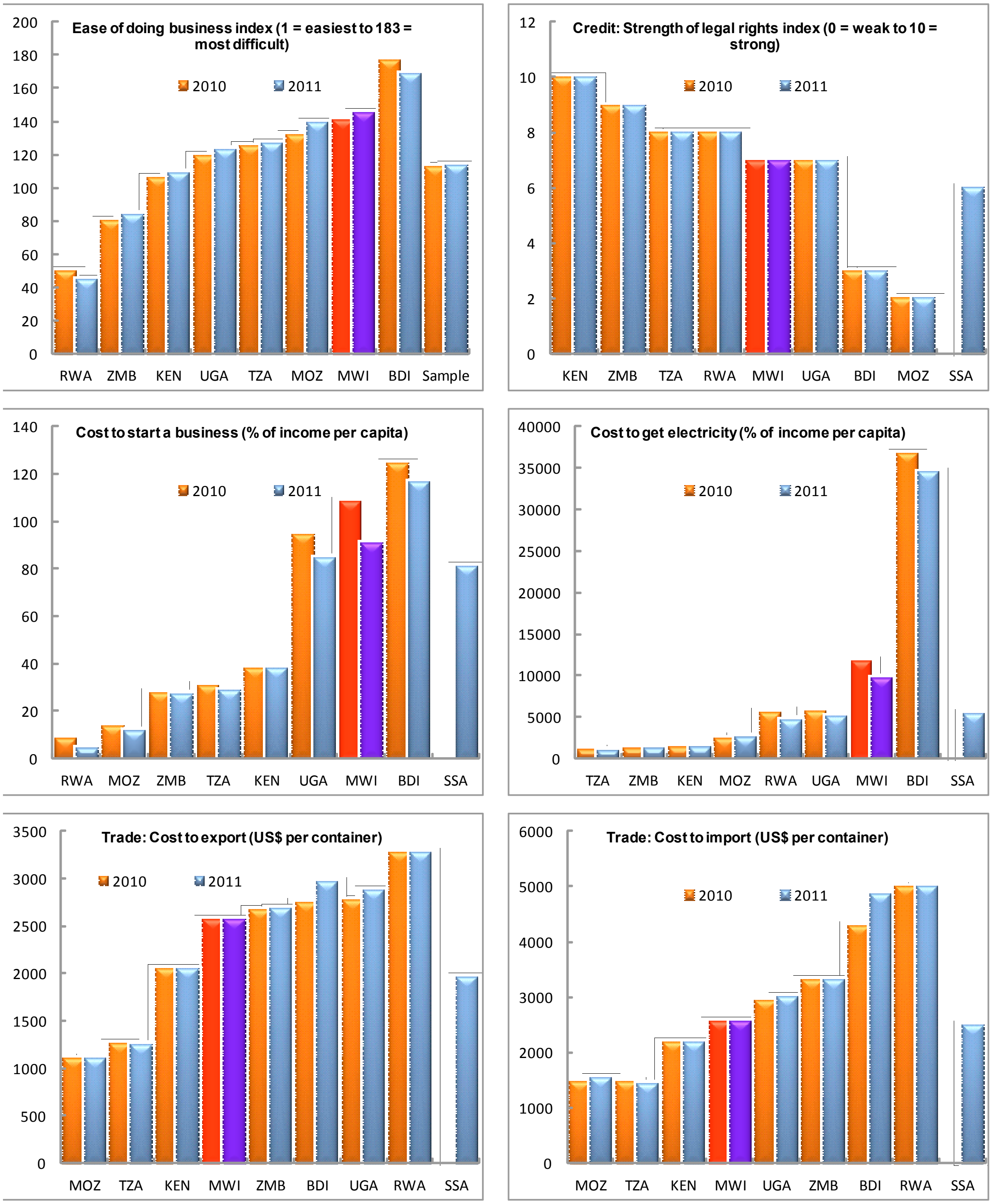
(Figure A4.2). SSA as a whole experienced a dramatic improvement in its external current account before grants and registered near balance in 2006–10, while Malawi's external current account continued to deteriorate steadily from 1996–2010 without external grants, and remained sizeable even after receiving significantly higher grants than the other African LICs. By contrast, the external current account for SSA with grants registered a surplus during 2005–10. Moreover, in the absence of sizeable capital inflows, Malawi's persistent current account deficit has contributed to a steady loss of international reserves, with import cover remaining chronically low. Malawi's import cover was consistently lower than other African LICs and the average for SSA, and was almost one-third of the African LIC average during 2006–10.

Figure A4.3. Malawi: Reserves
(Months of Imports of Goods and Services)



7. **The World Bank's Doing Business Indicators reveal that Malawi is at a competitive disadvantage vis-à-vis business operating conditions and business transaction costs in comparator countries** (Figure A4.4)**.** Malawi is in the tail end of the distribution in the case of almost every indicator shown, and fairs much worse than either the regional average for SSA or the sample-wide average. Moreover, Malawi's overall ranking in the Doing Business Index slipped from 141 in 2010 to 145 in 2011 out of 183 ranked countries. Key supply-side bottlenecks have recently intensified, and mainly stem from a chronic shortage of foreign exchange, resulting in shortages of fuel, power, water and imported inputs—the latter also due to a drying up of external credit lines. Consequently, activities in the manufacturing, transportation, and wholesale and retail trade sectors have slowed significantly with several enterprises now operating well below capacity or shutting down, resulting in widespread job losses. Anecdotal evidence also suggests that several companies have put expansion plans on hold and that some foreign investors who considered locating in Malawi have opted to go to neighboring countries instead.

Figure A4.4. Ease of Doing Business — Cross-Country Comparison



Source: World Bank Doing Business Data Bank, http://databank.worldbank.org/ddp/home.do

III. Measuring External Competitiveness

A. Export Diversification

The Herfindahl Index

8. The Herfindahl Index, H (Appendix I), which sums the squares of the shares of total exports, is used to assess the degree of concentration of a country's exports at the industry-specific level. COMTRADE Standard International Trade Classification, Rev.2 (SITC Rev.2.) data is used at the at the three-digit SITC level.

- The Herfindahl Index shows that Malawi's export base was the third most diversified among the comparator group at the start of the period, but that there was little progress made in further diversifying over the remainder of the review period, in contrast to other regional peers. By the end of the review period, Malawi's rank slips from third to fourth.

Table A4.2. Malawi and Regional Comparators — Herfindahl Index

	1995–99	2000–04	2005–10	Change 1995–2010
H				
Malawi	**35.7**	**36.6**	**34.3**	-1.5
Burundi	56.3	58.3	61.4	5.1
Kenya	72.3	71.3	75.4	3.1
Mozambique	71.6	61.9	39.7	-31.9
Rwanda	94.9	89.8	80.6	-14.3
Tanzania	24.0	18.8	19.4	-4.6
Uganda	23.2	27.6	20.0	-3.2
Zambia	57.5	51.9	51.5	-6.0

Source: IMF Staff calculations based on UNCTAD Rev. 2 trade statistics.

[1] Data unavailable for 1995, and change taken with respect to 1996.

[2] Data unavailable for 1995–96, and change taken with respect to 1997.

The Export Concentration Index (ECI)

9. The ECI is similar to the Herfindahl Index but gives a bounded measure of the degree of exports concentration. The ECI ranges from zero to one, where values closer to zero indicate lower concentration and a more diversified exports pattern, and those closer to one indicate higher concentration and little diversification.

Table A4.3. Exports Conceentration Index (ECI)

	1995–99	2000–04	2005–10	Rank	Change 1995–2010
Malawi	0.67	0.69	0.64	4	-0.03
Burundi	0.71	0.70	0.77	5	0.07
Kenya	0.82	0.82	0.85	7	0.03
Mozambique	0.82	0.72	0.56	3	-0.26
Rwanda	0.97	0.95	0.85	8	-0.12
Tanzania	0.41	0.34	0.35	2	-0.06
Uganda	0.40	0.45	0.34	1	-0.06
Zambia	0.86	0.82	0.81	6	-0.05

Source: IMF Staff calculations based on UNCTAD Rev. 2 trade statistics.

[1] Data unavailable for 1995, and change taken with respect to 1996.

[2] Data unavailable for 1995–96, and change taken with respect to 1997.

- The ECI confirms that Malawi's rank position slips from third to fourth among the comparator group because of bigger gains by other regional competitors—most notably, Mozambique, Rwanda, Tanzania, Uganda, and Zambia.

B. Trade Competitiveness Index

10. **Malawi's overall external competitiveness is also assessed by updating the Economic Commission for Africa's (ECA) Trade Competitiveness Index (TCI)[5].** The index assesses overall competitiveness based on a broad range of indicators, divided into three dimensions:

- *Trade Enabling Environment Index* (comprised of macroeconomic factors and institutional quality)
- *Production Resource Index* (measuring the availability of direct inputs to production, such as quality of labor and water and land resources)
- *Infrastructure Index* (measuring transport networks, energy infrastructure, and communications networks).

Each index is computed separately for 27 selected African countries, and the three sub-indices collectively form the TCI (Appendix II contains a list of the indicators used in computing the TCI).

11. **The TCI results, summarized below, show that Malawi's competitiveness ranking initially improved during 1980–99 and then declined sharply after 2000**[6]:

Table A4.4. Malawi: TCI, II, PRI and TEE Indices, by Sub-period

Index	1980–84	1985–89	1990–94	1995–99	2000–04	2005–08
Overall TCI	0.2585	0.2371	0.263	0.2949	0.2301	0.1944
Infrastructure Index	0.2978	0.2707	0.2208	0.1862	0.1177	0.0618
Productive Resources Index	0.204	0.1838	0.2344	0.3018	0.2385	0.1977
Trade Enabling Environment	0.2736	0.2567	0.3338	0.3967	0.3341	0.3238
Of Which:						
Macro Stability	0.3892	0.4469	0.474	0.3696	0.3987	0.3733

Source: Calculations by IMF staff.

The decline in external competitiveness over time was largely attributable to macroeconomic instability and inadequate infrastructure investment on a per capita basis:

[5] Contained in the ECA's 2004 report entitled "Unlocking Africa's Trade Potential".

[6] Results should only be seen as indicative, as they are sensitive to the choice of indicators.

- ***Macroeconomic policies have had a profound influence on Malawi's external competitiveness.*** Improved macroeconomic stability at the start of the review period contributed to rising external competitiveness, and weaker macroeconomic performance to its decline since the mid-1990s. And, although Malawi's trade enabling environment score was higher at the end of the review period than at the start of the period, the index has been trending down since 1995–99, in part due to a deterioration in the macroeconomic stability sub-index after its peaking during 1990–94.

- ***The Infrastructure Index declined rapidly***. Infrastructure performance deteriorated sharply, in per capita terms, because of a failure to keep pace with Malawi's relatively rapid population growth.

12. **There was a divergence between Malawi's *sample-wide* overall external competitiveness score and the average and median scores of the comparative group during the same time period.** Malawi's overall trade competitiveness score and ranking

Table A4.5. Malawi and Regional Peers: Overall Trade Competitiveness Scores, by Sub-Period

	1980–84		1985–89		1990–94		1995–99		2000–04		2005–08	
	Score	Rank	Score	Rank	Score	Rank	Score	Rank	Score	Rank	Score	Rank
Malawi	**0.2585**	**14**	**0.2371**	**14**	**0.2630**	**12**	**0.2949**	**10**	**0.2301**	**16**	**0.1944**	**20**
Median	0.2047	21	0.2164	19	0.2229	17	0.2476	17	0.22771	17	0.2223	14
Average	0.2191	19	0.2157	19	0.2349	18	0.2625	15	0.2414	16	0.2296	16
Burundi	0.2108	18	0.1856	23	0.2241	16	0.2476	17	0.1886	23	0.1576	25
Kenya	0.1960	23	0.2164	19	0.2432	14	0.2251	21	0.1950	22	0.1927	21
Mozambique	0.1386	26	0.2554	12	0.2136	21	0.2665	14	0.2541	13	0.2442	13
Rwanda	0.2047	21	0.1794	24	0.1954	26	0.2320	20	0.1952	21	0.2019	18
Tanzania	0.2942	12	0.2799	11	0.3383	8	0.3375	6	0.3503	6	0.3183	8
Uganda	0.2918	13	0.2167	18	0.2229	17	0.3090	8	0.2790	9	0.2702	10
Zambia	0.1975	22	0.1763	25	0.2070	25	0.2198	22	0.2277	17	0.2223	14

Source: IMF staff calculations using indicators in the World Bank's African Development Indicators.

decreased significantly by the end of the period relative to the beginning of the period, while the average and median rankings for the comparative group *rose* over the review period—suggesting that sound policies are needed to keep pace with strong regional performers. Moreover, there was some movement of the relative rankings within the comparator group during the review period—for instance, the rankings for Mozambique and Zambia improved while those for Burundi and Malawi worsened.

13. **Enhanced external competitiveness is correlated with increased exports diversification**. A statistically significant negative relationship was found between the TCI and the Herfindahl Concentration Index, suggesting that countries with a higher competitiveness rating also tended to have a more diversified export base. This is also consistent with the fact that the three lowest ranking countries in the subgroup in terms of overall trade competitiveness (namely, Malawi, Burundi and Kenya) all experienced a decrease in their regional world export shares (see ¶5).

Table A4.6. Correlation between TCI and H

Correlation coefficient	-0.571081
t-Statistic	-7.094589
Probability	0.00000

C. Regression Analysis

14. **Regression analysis was used to help to determine the relative importance of key determinants of export performance.** The following simple market equilibrium model of export performance provides us with a mechanism for gauging the influence of key determining factors:

$$\text{Export Demand}: \quad Q_d = \alpha_1 * P + \alpha_2 * Y + \varepsilon_d$$
$$\text{Export Supply}: \quad Q_s = \beta_1 * P + \beta_2 * X + \varepsilon_s$$
$$\text{Equilibrium condition}: \quad Q_d = Q_s = Q$$

Where :

Q_d = Export volume demand

Q_s = Export volume supply

P = Export price index

X = Vector of determinants

Y = World real GDP growth

ε = Error terms for export demand and supply, respectively

The model is estimated simultaneously, and the specification adopted is log-linear, so that the coefficients represent elasticities. Estimation was based on a pooled sample of 27 countries, including Malawi, for the period 1981–2008.

15. **Since the sample is largely comprised of commodity producers that are assumed to be largely price takers, we focus on the export supply equation (Table A4.7)**:

- After adjusting for the presence of serial correlation, Equation (2) shows that the diversification index, gross fixed capital formation (GFCF), trade enabling index are all significant determinants of export supply, with elasticities of: 0.75 percent, 0.17 percent, and 0.13 percent, respectively. However, the real effective exchange rate and export supply variables, which are statistically significant in the first equation (before the correction for serial correlation) lose their significance after the first order autoregression correction is applied.

Table A4.7. Regression Analysis Results for Pooled Cross-Section Time Series of Selected African Countries

Estimation Method: Systems Estimation, Weighted Least Squares

Sample: 1981 2008

Variable	(1) Coefficient	Significance	(2) Coefficient	Significance
C(1) -- Constant	**4.1794**	*	**3.0281**	*
t-Statistic	6.2295		2.6824	
C(2) -- Log_Price	**0.1893**		**0.7679**	*
t-Statistic	1.3491		15.8436	
C(3) -- Log_World GDP Growth	**0.0762**		**0.2015**	*
t-Statistic	0.4295		4.2614	
C(4) -- Constant	**5.1148**	*	**5.4746**	*
t-Statistic	5.8537		6.7844	
C(5) --Log(REER(-1))	**-0.2705**	**	**-0.0132**	
t-Statistic	-1.9228		-0.1241	
C(6) -- Log(Price(-1))	**0.1386**	*	**0.0391**	
t-Statistic	4.4423		1.5621	
C(7) -- Log_Div	**0.7153**	*	**0.7589**	*
t-Statistic	3.7758		6.9848	
C(8) -- Log_Trade_Enab	**0.2485**	*	**0.1717**	*
t-Statistic	2.7075		4.2081	
C(9) --Log_GFCF	**0.2844**	*	**0.1307**	**
t-Statistic	3.6697		2.3280	

Export Demand Equation

Equation: LOG_VOL_D=C(1)+C(2)*LOG_PRICE+C(3)*LOG(WLD_GDP_GROWTH)

		AR(1)
	Observations: 638	Observations: 608
R-squared	0.0032	0.8900
Adjusted R-squared	0.0000	0.8893
S.E. of regression	1.9333	0.6565
Durbin-Watson stat	0.1058	2.0811
Mean dependent var	5.1282	5.1282
S.D. dependent var	1.9333	1.9333
Sum squared resid	2373.3820	2373.3820

Export Supply Equation

Equation: LOG_VOL_S=C(4)+C(5)*(LOG_REER(-1))+C(6)*(LOG_PRICE(-1))
+C(7)*LOG_DIV+C(8)*(LOG_TRADE_ENAB)+C(9)*(LOG_GFCF(-1))

		AR(1)
Observations: 157	Observations: 171	Observations: 157
R-squared	0.4046	0.8970
Adjusted R-squared	0.3865	0.8907
S.E. of regression	0.2977	0.1267
Durbin-Watson stat	0.2211	2.1397
Mean dependent var	4.8267	4.8267
S.D. dependent var	0.3801	0.3801
Sum squared resid	14.6245	14.6245

Source: IMF staff estimates using data obtained from the World Bank's Africa Development Indicators Database.

[1] "*", "**", and "***" indicate statistically significant at the 1%, 5%, and 10% significance level, respectively.

IV. Competitiveness and Capital Flows

16. **External competitiveness is equally important for attracting and retaining portfolio capital inflows, which can be an important source of foreign financing.** Prior to the onset of the global financial crisis in 2008, foreign holdings of Government of Malawi T-bills accounted for about eight percent of the total outstanding stock of T-bills. However, following a resumption of global investment flows to emerging markets and LDCs, foreign participation in the local T-bill market is non-existent and deterred by macroeconomic instability and investor concerns about sovereign and repatriation risk.

17. **Foreign investor concerns are also shared by domestic investors.** For instance, the Malawi Stock Exchange (MSE) experienced a record increase in total trading volumes in 2011 (a total of 1,590,006,001 shares valued at over US$1.86 billion were traded, compared to 241,957,941 valued at US$53.3 million in 2010). However, this growth may not be sustained if the investment climate is not made more conducive.

18. **Comparative applicable tax rates from regional stock exchanges show that Malawi's tax rates are now among the highest in SADC.** In particular, Malawi now has

Table A4.8. Committee of SADC Stock Exchanges (COSSE) TAX RATES

TAX	MSE	BSE	DSE	JSE	LUSE	BVM	NSX	SEM	SSE	ZSE
Capital Gains Tax	30	0	0	14	0	10	0	0	0	1
Dividend Tax	10	15	5	10	0	10	0	0	0	15
VAT – Share	16.5	0	0	14	0	0	0	15	14	15
Corporate Tax - Listed	30	25	25	28	33	33	34	15	30	25.75
Corporate Tax - Unlisted	30	25	30	35	35	33	34	15	30	25.75

Source: Malawi Stock Exchange, 2012.

[1] MSE = Malawi Stock Exchange, BSE=Botswana Stock Exchange, DSE=Dar es Salaam Stock Exchange, JSE = Johannesburg Stock Exchange, LUSE = Lusaka Stock Exchange

the highest Capital Gains Tax (following the recent application of capital gains taxes of 30 percent to MSE transactions) and VAT rate on share commissions, and is among the stock exchanges with the highest corporate tax rates in the region. Malawi's Confederation of Chamber of Commerce and Industry (MCCCI) and Society of Accountants in Malawi have petitioned the Government to revisit its taxation policy in a number of areas that are seem as particularly inimical to investment—including concerns expressed about the level of the Withholding Tax (which is believed to hurt small and medium enterprises (SMEs) disproportionately), the introduction of the turnover tax for transaction volumes under K50 million irrespective of profitability, and the 30 percent capital gains tax. In addition, the VAT payment schedule at mid-month often compels businesses to have to borrow to pay their VAT obligations before they receive payment for the services rendered. The private sector has argued that these and other policies make it difficult for Malawi to compete effectively with other attractive investment destinations with the region and elsewhere.

V. Key Findings and Policy Implications

19. **The foregoing gives rise to the following observations and policy recommendations:**

- External competitiveness is vital for achieving MGDS goals and becomes even more acutely important with the move towards enhanced regional integration.

- However, there are worrisome signs that Malawi has lost regional competitiveness along several dimensions during 1980–2008, and this inference is drawn from a wide range of indicators and methodologies.

- There are several drivers of export performance within SSA—and export supply considerations are of first and foremost importance, since most SSA commodity producers are price takers.

- Key determinants of overall export performance include: GFCF, the degree of export diversification, and changes in the trade enabling environment index of competitiveness (which includes indicators that assess overall macroeconomic stability). Policies aimed at boosting these indicators should therefore be actively pursued.

- The trade-enabling component of the TCI (with both a macro stability and an institutional component) appears to be the most important driver of export performance. So enhancing competitiveness in these areas through the following measures will be critical:

    a. ***Prudent demand management***. The pursuit of appropriate fiscal, monetary and exchange rate policies in order to maintain price stability and mitigate pressure on the international reserves and allow for a flexible response to exogenous shocks, including through the adoption of an appropriate exchange rate policy.

    b. ***Foreign exchange market liberalization***. Liberalization of restrictions on current account transactions, as a confidence building measure to attract additional foreign inflows and increase the availability of foreign exchange at market-determined rates.

    c. ***Structural reforms to strengthen the business climate and stimulate domestic and foreign investment and growth***. Measures to strengthen institutions, enhance labor productivity, deepen access to finance, and reduce business transaction costs should help to enhance the attractiveness of doing business in Malawi.

ATTACHMENT I. FORMULAS USED IN THE ANALYSIS

Export diversification

The Herfindahl Index, H, is defined as:

$$H = 100 * \sum_{i=1}^{N} s_i^2 , \quad s_i = \frac{X_i}{\sum_{i=1}^{N} X_i}$$

Where:

- *X_i = the ith export sector at the three-digit SITC*
- *S_i = the ith sector's share of total exports, and N is the maximum number of sectors appearing in the sample during the review period.*
- The higher is H, the greater the concentration of exports in a few products. The lower limit of H is 100/N, representing a totally even distribution of exports, and the upper limit of H is 100, representing a totally uneven distribution. Therefore, the ratio between the H index and 100/N conveys an idea of the extent of the deviation from an even distribution, and thus of the degree of export concentration.

The Exports Concentration Index (ECI)

Gives a bounded measure of the degree of exports concentration

The ECI is defined as:

$$ECI = \frac{\sqrt{\sum_{J=1}^{N} (x_J)^2 - 1/n}}{1 - \sqrt{1/n}}$$

Where:

x_j = the sectoral share of sector j in total merchandise exports

n = the total number of product categories.

ECI ranges from zero to one, where values closer to zero indicate lower concentration and a highly diversified export pattern, and those closer to one indicate higher concentration and little diversification.

Trade Competitiveness Index (TCI)

Each variable was normalized so that each variable was bounded between [0.1]:

$$r_{it} = \frac{x_{it} - \underline{x}_t}{\bar{x}_t - \underline{x}_t}$$

Where:

r_{it} = the normalized sub-index of country i at time t;

x_{it} = the actual sub-index of country i at time t;

x_t (lower bar) = the lowest value of the sub-index x across Africa in the year t;

x_t (upper bar) = the highest value of the sub-index x across Africa in the year t;

ATTACHMENT II. OVERALL TRADE COMPETITIVENESS INDEX

Trade-Enabling Environment Index

Macroeconomic Environment Index
- Average tariff rate
- Real GDP per capita growth
- Inflation, CPI (annual %)
- Lending interest rate
- Real effective exchange rate (base = 2005)
- Domestic credit to private sector (% GDP)
- Foreign Direct Investment

Institutional Quality Index

A. Governance
- Control of Corruption
- Government effectiveness
- Political Stability and Absence of Violence/Terrorism
- Rule of Law: Estimate
- Voice and Accountability

B. Doing Business Indicators
- Cost to build a warehouse (% of income per capita)
- Cost to enforce a contract (% of claim)
- Cost to get electricity(% of income per capita)
- Cost to register property (% of property value)
- Cost to start a business (% of income per capita)
- Credit: Strength of legal rights index (0=weak to 10=strong)
- Depth of credit information index (0=low to 6=high)
- Ease of doing business index (1=easiest to 183=most difficult)
- Procedures required to enforce a contract (number)
- Procedures required to start a business (number)
- Strength of investor protection index (0 to 10)
- Trade: Cost to export (US$ per container)
- Trade: Cost to import (US$ per container)

Productive Resources Index

Labor Force Index
- Labor force (% total population)
- Life expectancy at birth, total (years)
- Literacy rate, adult (% of population ages 15 and above)
- Literacy rate, youth total (% of people ages 15-24)
- School enrollment, tertiary (% gross)
- School enrollment, secondary (% gross)
- School enrollment, primary (% gross)
- Urban population (% of total)

Geography Index
- Land use, perent of arable land per capita
- Renewable internal freshwater resources per capita (cubic meters)

Infrastructure Index

Telecommunications Index
- Telephone mainlines (per 1,000 people)
- Telephone average cost of call to US (US$ per three minutes)
- Telephone (mainlines and mobile phone) subscribers (per 1,000 people)

Energy Index
- Electric power consumption (kWh per capita)
- Electricity production per capita (kWh per capita)

Transport Networks Index
- Roads, paved (% of total roads)
- Roads, total network Per Capita (km per capita)

Access to Information
- Personal computers (per 1,000 people)
- Number of radio sets Per Capita
- International Internet bandwidth (bits per person)

Source: World Bank's Africa Development Indicators Database and World Bank's Doing Business Database.

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APPENDIX V. MALAWI—JOINT IMF/WORLD BANK DEBT SUSTAINABILITY ANALYSIS[8]

Based on the Joint Fund-Bank Debt Sustainability Framework for Low-income Countries (LIC DSA), Malawi's risk of external debt distress remains moderate. Malawi's narrow export base, reliance on rain-fed agriculture, and weak international reserves leave it vulnerable to terms-of-trade, and weather shocks. Stress testing reveals potential vulnerabilities in Malawi's public debt situation. In particular, the external sector debt burden indicator (PV of debt-to-exports) breaches the sustainability threshold after an export shock. Malawi's debt situation is expected to improve over the medium- to long- run, reflecting strong economic growth under a floating exchange rate regime and a liberalized current account. However, measures to support a diversification of the export base will also be important. Fiscal dominance has contributed to the increase in domestic debt burden indicators, whereby the PV of public debt to GDP ratio reaches about 45.5 percent in 2012 and gradually comes down to about 13.9 percent by 2032. Stress tests to public sector debt dynamics reveal the need for significant fiscal consolidation and reform of parastatal institutions.

I. BACKGROUND

20. **Malawi's medium- and long-term public and publicly guaranteed (PPG) external debt is estimated at US$1.14 billion, reflecting a significant increase in recent years.** Malawi's external debt was lowered to a sustainable level of about 15 percent of GDP in 2006, after it received debt relief under the Heavily Indebted Poor Countries (HIPC) initiative and the Multilateral Debt Relief Initiative (MDRI). The level of the external debt stock has increased substantially since then, to 23 percent of GDP (about US$1.14 billion) at end-2011. The share of multilateral debt decreased (to about 73 percent from 90 percent as at end-2008). Malawi's main bilateral creditors are China and India, while the main multilateral creditor is IDA. In addition, increased government expenditure at a time when external grants fell sharply and revenue performance deteriorated, contributed to the build-up of the domestic debt in 2011 (to about 25 percent of GDP from 20 percent of GDP as at end-2008). The level of total public debt in Malawi is estimated at US$2.4 billion. Reliable figures on private external debt are not available, although the amounts are not believed to be large.

[8] The DSA was prepared by IMF and World Bank staff in collaboration with the Malawian authorities. The analysis updates the previous Joint DSA dated February 10, 2010 (IMF Country Report No. 10/24). The DSA follows the IMF and World Bank Staff Guidance Note on the Application of the Joint Fund-Bank Debt Sustainability Framework for Low-Income Countries (January 22, 2010).

Malawi: Stock Medium- and Long-Term External Public and Publicly Guaranteed Debt (DOD) as of end-2011

	US$ Million	Share
Grand Total	1140.49	100.0
Multilateral		
IDA	275.97	24.2
ADF	161.10	14.1
IMF	146.00	12.8
EIB	21.41	1.9
IFAD	79.42	7.0
NDF	30.02	2.6
BADEA	31.90	2.8
OPEC	27.27	2.4
PTA	70.00	6.1
Total Multilateral	843.09	73.9
Bilateral		
Kuwait	43.90	3.8
Taiwan	13.00	1.1
India	71.70	6.3
Belgium	2.20	0.2
China	154.80	13.6
France	11.80	1.0
Total Bilateral	297.40	26.1

Sources: Malawian authorities and IMF staff estimates.

II. Underlying DSA Assumptions

21. **The baseline scenario reflects the recent policy measures taken by the authorities to restore macroeconomic stability in Malawi.** In May 2012, the authorities implemented a set of measures to address Malawi's chronic balance of payments difficulties and to halt a slowdown in economic activity due to shortages of foreign exchange and critical imports. The policies included a devaluation of the exchange rate from K167 to K250 per U.S. dollar in May 2012, and adoption of a floating exchange rate regime. Further policy measures are envisaged under a new Extended Credit Facility (ECF) arrangement, including prudent fiscal and monetary policies, structural reforms and policies to enhance the investment climate, promote export diversification and foster growth. The baseline assumes a gradual reduction in the external current account deficit through export diversification, and reliance on grants and concessional financing in the medium term. The current mining projects are expected to continue as planned combined with additional projects in uranium and other minerals such as niobium. It also assumes that contingent risks stemming from parastatal organizations are contained. The key macroeconomic assumptions are summarized in Box 1.

22. **The evolution of key debt indicators followed a somewhat different trajectory than the projections in the previous DSA (February 2010).** For example, the ratio of total public debt to GDP was 48 percent at end-2011, compared with a projected level of

34 percent, reflecting higher-than-projected levels of domestic borrowing. By contrast, the PV of external debt-to-export ratio, estimated at 61 percent for end-2011, was slightly lower than projected (65 percent), on account of better-than-expected export performance. The annual average real GDP growth for 2009–11 was in line with the projected 6.6 percent, but there was a marked downward trend compared to a steady path in the projections. Going forward, the current DSA projects long-term growth of 6 percent per year, compared to 6.7 percent in the previous DSA. The current projection is consistent with the historical average growth rate of 5.8 percent over the last ten years.

23. **Malawi's economic performance is expected to improve over the medium term.** Real GDP growth is projected to rise gradually from 4.3 percent in 2012 to about 6½ percent over the medium term. The floating of the kwacha and liberalization of the foreign exchange regime is expected to foster growth over the medium term by redirecting resources to exports and import-competing production, while containing import demand for consumption goods. In the near term, growth will be generated by the sectors that were hardest hit by the foreign exchange shortages, including manufacturing, transportation service, construction, and trade, as production levels increase toward capacity. Other sectors, including agriculture, will also benefit from the easing of fuel shortages. Over time, growth is expected to be led by mining and non-traditional agricultural exports. Following the recent devaluation of Kwacha, a spike in inflation is expected in the next few months (reaching about 20 percent by end-2012), but this should be reversed with implementation of restrained fiscal and monetary policies over the medium term.

24. **The main downside risks to the debt sustainability outlook are deterioration in the terms of trade and adverse weather conditions that lower agricultural output.** Malawi's narrow export base, reliance on rain-fed agriculture, and weak international reserves leave it vulnerable to terms-of-trade and weather shocks. Stress tests (see next section) show that the main external sector debt burden indicator (PV of debt-to-exports ratio) breaches the sustainability threshold after an export shock—a proxy for both the terms-of-trade and weather shocks. Malawi's debt situation is expected to improve over the medium-to-long run. The recent liberalization of the foreign exchange regime for current account transactions is expected to encourage private investment and promote diversified growth. Repairing strained relations with donors and more consistent implementation of prudent fiscal and monetary policies are expected to increase foreign exchange inflows into the country and facilitate the accumulation of international reserves.

[9] Malawi's stock of external debt declined substantially from about 112 percent of GDP in 2005 to around 14.6 percent in 2006. The previous DSA estimated the stock of Malawi's debt at US$683 million as of end-2008.

Box 1: Baseline Macroeconomic Assumptions

Real GDP is projected to grow by about 6 percent per year on average over the long term, owing to timely adoption of a comprehensive policy package by the authorities. The main drivers of growth will be agriculture, manufacturing, trade, and mining sectors. The adopted policy package is underpinned by foreign exchange market reforms and structural measures to enhance the productive capacity of the economy.

The mining sector is projected to increase its contribution to GDP. New mining operations will include the production of rare earth metals (e.g., ferroniobium, tantalum fluorite, and zircon).

Consumer price inflation is projected to increase to an annual average rate of 18.4 percent in 2012 after the devaluation in May 2012. However, inflation is projected to decelerate in the medium term after a short-lived spike, reaching single-digit levels. The nominal effective exchange rate is assumed to be determined by inflation differential between Malawi and its trading partners after 2014.

Revenue (excluding grants) is projected to increase relative to GDP in FY2012/13 owing to the positive impact of a unified exchange rate regime on tax revenues from international trade by increasing the share of formal transactions being taxed and the adoption of an automatic fuel price adjustment mechanism. In subsequent years, both tax and non-tax revenues improve gradually owing to improved tax efforts and expanded tax base. More fiscal discipline, entailing expenditure prioritization to protect critical social and infrastructure programs will be required. Domestic financing of the budget is projected to stay at zero percent of GDP in the medium term but will increase to an average 0.5 percent of GDP after FY2017/18.

Highly concessional financing from multilaterals is assumed to be the major source of debt (two-thirds), with somewhat less concessional financing from non-Paris Club creditors providing the balance. A small but increasing amount of borrowing on commercial terms is assumed for the outer years.

Grants are projected to increase to about 10.4 percent of GDP during FY 2012/13 as development partners are increasing their support for Malawi after the exchange rate unification. This reflects the restoration of budget support grants and increase in project grants. Afterwards, total grants are projected to stabilize in U.S. dollar terms but decrease gradually as a ratio of GDP. With increased support from donors, total external financing of government operations will also increase.

Current account deficit, including official transfers, is projected to narrow over the medium term. The exchange rate liberalization is expected to slow growth in imports (especially of consumer goods) and boost exports. Policy reforms are also expected to attract private capital inflows into Malawi and a gradual build up of international reserves.

Exports performance is projected to strengthen in the medium term as the change in exchange rate regime is expected to mobilize resources toward export-oriented activities. Export growth is projected to average about 9 percent during 2012–32. Tobacco's share in overall export is expected to decline as global demand weakens and the farmers diversify to other commodities. However, tobacco is assumed to be substituted by other non-traditional agricultural products over the medium term.

Imports grew at an average annual rate of 10 percent during 2002–11. The floating of the kwacha and liberalization of the foreign exchange regime is expected to contain imports demand over the medium term due to cost considerations and lower purchasing power of kwacha. Imports are projected to grow at an annual average rate of about 8 percent during the period 2012–32.

III. External Debt Sustainability

Baseline scenario

25. Under the baseline scenario and over the projection period, external debt burden indicators fall and remain below the indicative policy thresholds (Figure 1 and Table 1)[10].

[10] The World Bank's Country Policy and Institutions Assessment (CPIA) ranks Malawi as a medium performer (the average CPIA in 2008–10 is 3.37). Thus, the external debt burden thresholds for Malawi are (i) a PV of debt-to-GDP at: 40 percent; (ii) a PV of debt-to-exports at: 150 percent; (iii) a PV of debt-to-revenue at: 250 percent; (iv) a debt service-to-exports at: 20 percent: and (v) a debt service-to-revenue at: 30 percent.

The stock of external public and publicly guaranteed (PPG) debt is expected to gradually decline in the long term from about 30 percent of GDP in 2012 to about 14 percent in 2032. The present value (PV) of PPG external debt-to-GDP gradually declines to below 8.7 percent during the rest of the projection period. The PV of debt-to-exports ratio remains well below the threshold of 150 percent throughout the entire period. The PV of PPG external debt to revenue is also on a downward trend from a peak of 105 percent in 2012 and will remain well below the threshold of 250 percent during the entire period.

Stress tests

26. **The PV of debt-to-exports ratio (which is one of the external debt sustainability thresholds) is breached under stress tests (exports shock in particular).** The standard sensitivity analysis points to medium risk of debt distress (Figure 1 and Table 3), as one debt burden indicator (PV of debt-to-exports ratio) breaches its respective threshold after the shock in 2014 reaching the value of 185 (in percent of GDP) and only coming down to 138 percent of GDP in 2021. Based on the bound tests, the most extreme stress for the PV of debt-to-exports ratio is a one-standard deviation shock to the export value growth in 2013–14. Tobacco still accounts for more than half of Malawi's export earnings, and though this proportion is expected to decline over time, Malawi will remain vulnerable to a shock to tobacco export values for some time. Burley accounts for the majority of production, leaving Malawi vulnerable to changes in tastes and regulatory actions that could dramatically shrink what is already a stagnant global market.

27. **Debt service ratios are expected to remain below the threshold for the projection period.** All debt service ratios remain below their respective thresholds (Figure 1 and Table 1) both in the baseline and under the shock scenarios.

IV. PUBLIC DEBT SUSTAINABILITY

Baseline scenario

28. **Malawi's public debt has risen substantially since the run-up to the May 2009 presidential and parliamentary elections.** The share of domestic debt in the total public debt of Malawi is high (about 52 percent of total public debt) owing to increased domestic debt issuance by the government and the financing of the fiscal deficit by the central bank (Figure 2 and Table 2). The PV of public debt to GDP ratio is expected to reach about 45.5 percent in 2012 and only come down to the levels below 32 percent in the medium term and about 14 percent by 2032.

Stress tests

29. **Stress tests indicate that key ratios could deviate significantly from the baseline levels in the face of less favorable macroeconomic conditions (Figure 2 and Table 4).** Maintaining the primary balance at the 2012 level leads to a slight decline in

the PV debt-to-GDP ratio from 45 percent in 2012 to 41 percent at the end of the projection period (2032), compared to a decline to 14 percent under the baseline. A permanently lower GDP growth rate than the baseline produces a less pronounced decline in the PV debt-to-GDP ratio to 34 percent, compared to 14 percent under the baseline.

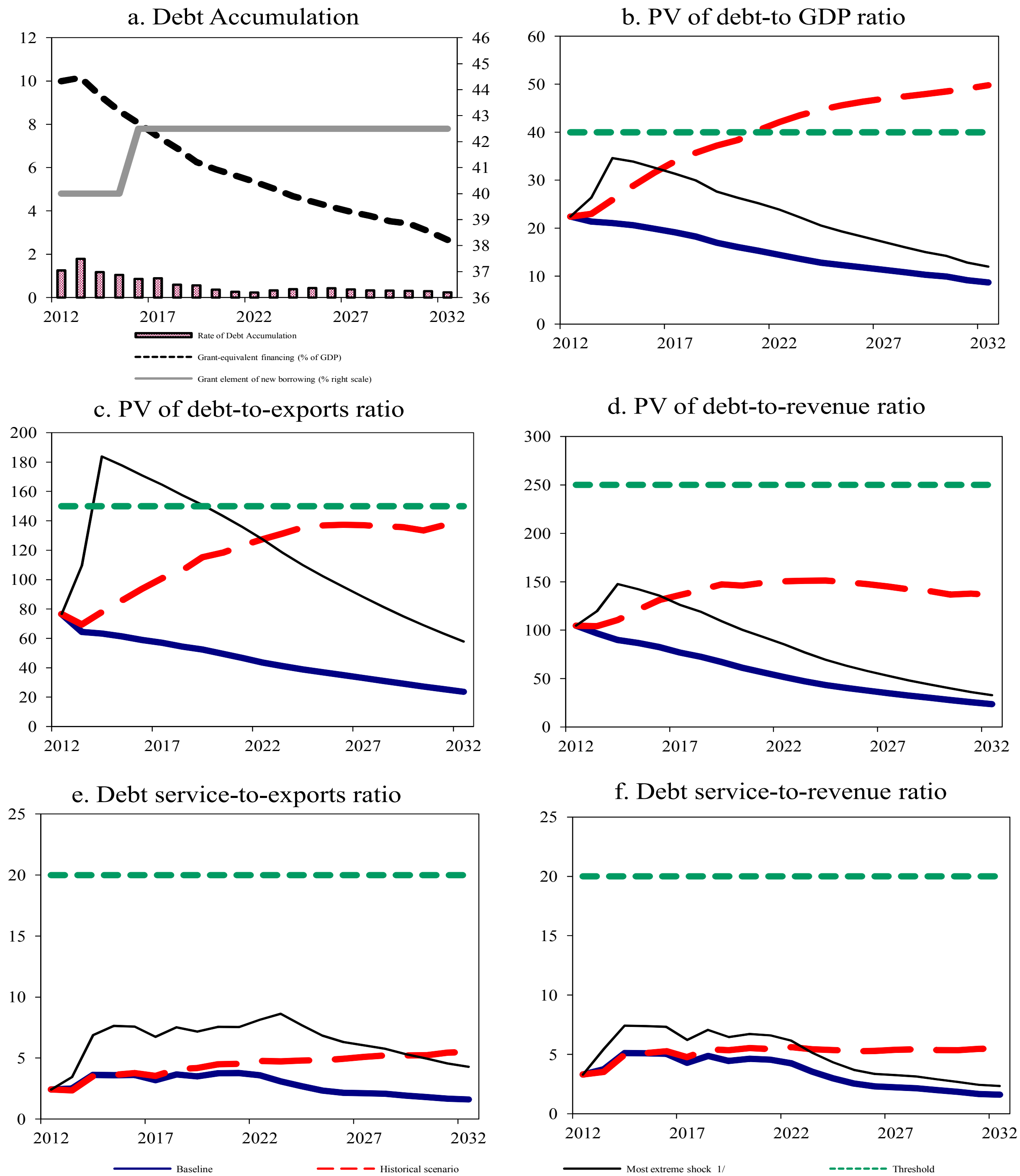
30. **Malawi is subject to a number of fiscal risks stemming from the activities of loss-making parastatal institutions.** The government's efforts to achieve fiscal sustainability and reduce the risks to the budget posed by contingent liabilities and operational losses of state owned enterprises are critical. In this connection, measures to enhance revenue performance, restrain growth in expenditures, limiting the National Oil Company to its core mandate of managing strategic reserves of fuel and a robust regulatory regime for public utilities that focuses on cost recovery, are very important.

IV. Conclusions

31. **Malawi is assessed to be at medium risk of debt distress.** The external debt indicator (PV of debt-to-exports) breaches its threshold in the scenario of bound tests. Stress tests to public sector debt dynamics underpin the need for effective fiscal consolidation, while protecting critical social and infrastructure expenditures.

32. **The adoption of corrective policy measures in 2012 has significantly improved the outlook for Malawi's debt sustainability, but risks related to terms of trade and weather shocks remain.** In particular, Malawi's heavy reliance on rain-fed agriculture and narrow export base make its export earnings vulnerable to fluctuations in world prices of its key exports. However, the liberalization of the foreign exchange regime will help to remove distortions and thereby encourage private investment and diversified growth, and help enhance the country's debt carrying capacity. Implementation of sound macroeconomic policies, diversification of the export base, and sustained growth would help reduce the risk of debt distress.

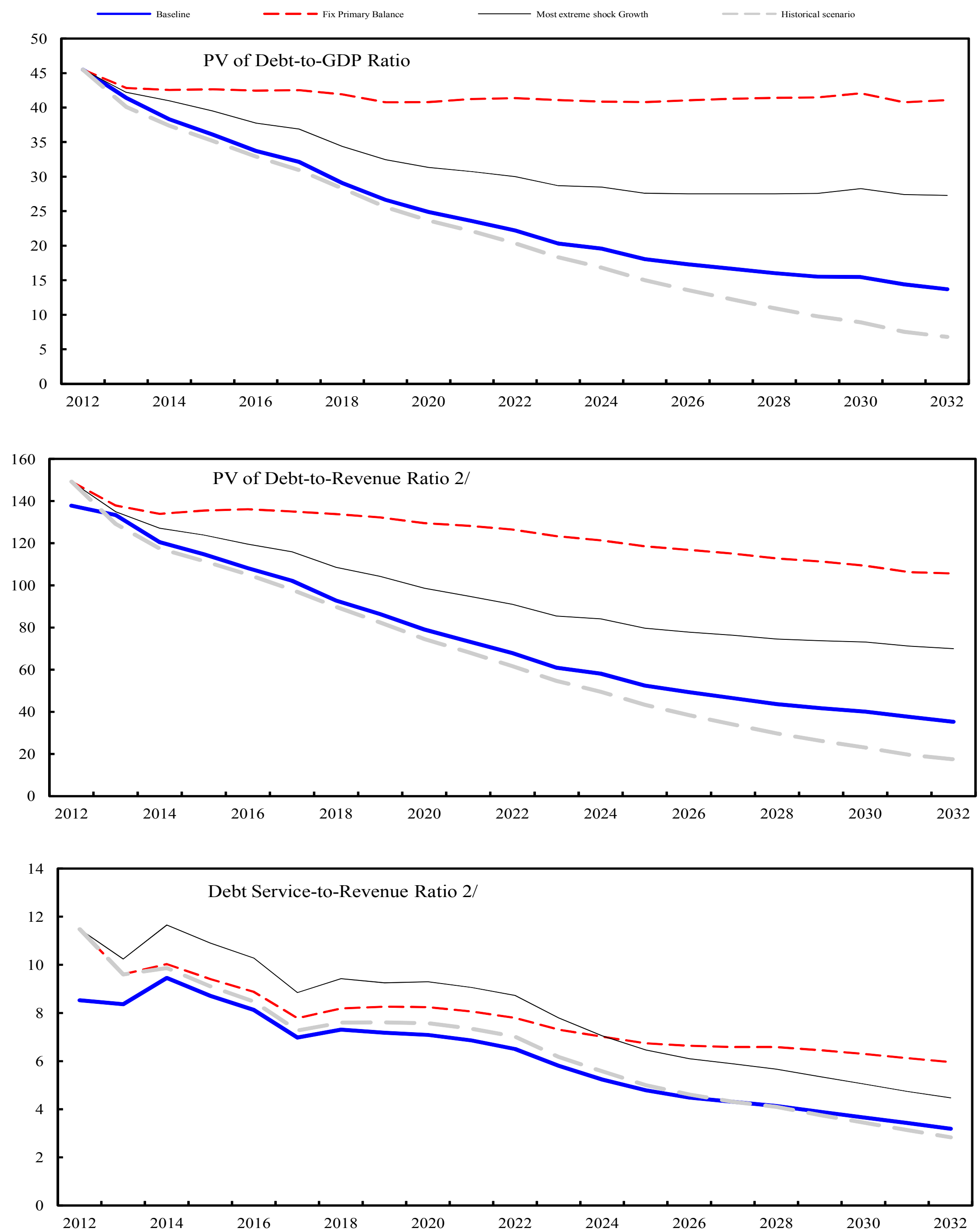
Figure 1. Malawi: Indicators of Public and Publicly Guaranteed External Debt under Alternatives Scenarios, 2012-2032 1/



Sources: Country authorities; and staff estimates and projections.

1/ The most extreme stress test is the test that yields the highest ratio in 2022. In figure b. it corresponds to a Exports shock; in c. to a Exports shock; in d. to a Exports shock; in e. to a Exports shock and in figure f. to a One-time depreciation shock

Figure 2.Malawi: Indicators of Public Debt Under Alternative Scenarios, 2012-2032 1/



Sources: Country authorities; and staff estimates and projections.

1/ The most extreme stress test is the test that yields the highest ratio in 2022.

2/ Revenues are defined inclusive of grants.

Table 1.: External Debt Sustainability Framework, Baseline Scenario, 2009-2032 1/
(In percent of GDP, unless otherwise indicated)

	Actual			Historical Average 6/	Standard Deviation 6/	Projections														
	2009	2010	2011			2012	2013	2014	2015	2016	2017	2012-2017 Average	2018	2019	2020	2021	2022	2031	2032	2018-2032 Average
External debt (nominal) 1/	**19.4**	**18.4**	**23.0**			**29.7**	**28.4**	**28.2**	**27.7**	**26.8**	**25.9**		**25.0**	**23.7**	**23.0**	**22.5**	**21.8**	**14.4**	**13.7**	
o/w public and publicly guaranteed (PPG)	19.4	18.4	23.0			29.7	28.4	28.2	27.7	26.8	25.9		25.0	23.7	23.0	22.5	21.8	14.4	13.7	
Change in external debt	-0.1	-1.0	4.6			6.7	-1.3	-0.2	-0.5	-0.9	-0.9		-0.8	-1.4	-0.6	-0.6	-0.7	-1.2	-0.7	
Identified net debt-creating flows	1.9	-1.1	4.3			1.3	-2.2	-2.5	-3.0	-3.1	-2.7		-2.1	-1.6	-1.2	-2.9	-2.6	-2.1	-2.5	
Non-interest current account deficit	**3.1**	**1.2**	**5.9**	**6.8**	**4.9**	**4.1**	**1.4**	**1.5**	**1.4**	**1.6**	**2.2**		**2.5**	**2.7**	**2.9**	**1.1**	**1.4**	**1.0**	**0.6**	1.8
Deficit in balance of goods and services	22.1	20.4	14.9			18.4	15.4	14.6	13.7	13.2	13.1		12.7	12.1	12.0	11.9	11.7	7.6	6.9	
Exports	24.6	27.0	26.1			29.3	33.2	33.3	33.6	33.7	33.6		33.6	32.3	32.4	32.8	33.1	35.8	36.6	
Imports	46.6	47.4	41.0			47.7	48.6	47.8	47.3	46.9	46.7		46.4	44.4	44.4	44.7	44.8	43.4	43.5	
Net current transfers (negative = inflow)	-17.0	-21.9	-10.9	-16.2	4.1	-17.1	-16.9	-16.1	-15.3	-14.6	-13.9		-13.1	-12.1	-11.7	-11.3	-10.9	-7.3	-7.0	-9.7
o/w official	-11.0	-16.9	-6.2			-11.5	-11.1	-10.3	-9.6	-8.9	-8.3		-7.5	-6.8	-6.5	-6.1	-5.8	-3.3	-3.1	
Other current account flows (negative = net inflow)	-2.0	2.7	1.9			2.8	2.9	3.0	3.0	2.9	3.0		2.8	2.6	2.6	0.5	0.6	0.7	0.7	
Net FDI (negative = inflow)	**-1.3**	**-1.2**	**-1.1**	**-2.0**	**1.6**	**-1.8**	**-2.2**	**-2.6**	**-2.9**	**-3.2**	**-3.5**		**-3.5**	**-3.3**	**-3.3**	**-3.3**	**-3.2**	**-2.5**	**-2.5**	-3.0
Endogenous debt dynamics 2/	**0.1**	**-1.1**	**-0.5**			**-1.0**	**-1.4**	**-1.4**	**-1.5**	**-1.5**	**-1.4**		**-1.2**	**-0.9**	**-0.8**	**-0.8**	**-0.7**	**-0.6**	**-0.6**	
Contribution from nominal interest rate	3.0	0.2	0.2			0.2	0.3	0.3	0.2	0.3	0.3		0.4	0.5	0.6	0.6	0.6	0.1	0.1	
Contribution from real GDP growth	-1.5	-1.2	-0.8			-1.2	-1.7	-1.6	-1.7	-1.7	-1.6		-1.6	-1.5	-1.4	-1.4	-1.3	-0.7	-0.7	
Contribution from price and exchange rate changes	-1.4	-0.1	0.1			…	…	…	…	…	…		…	…	…	…	…	…	…	
Residual (3-4) 3/	**-2.0**	**0.1**	**0.3**			**5.3**	**0.9**	**2.2**	**2.5**	**2.3**	**1.8**		**1.2**	**0.2**	**0.6**	**2.4**	**1.8**	**0.9**	**1.8**	
o/w exceptional financing	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	0.0	0.0	0.0	0.0	0.0	
PV of external debt 4/	...	...	15.9			22.4	21.4	21.1	20.6	19.9	19.1		18.3	16.9	16.1	15.3	14.4	9.2	8.7	
In percent of exports	...	...	61.0			76.6	64.4	63.4	61.4	59.0	56.9		54.4	52.4	49.6	46.6	43.6	25.5	23.7	
PV of PPG external debt	**...**	**...**	**15.9**			**22.4**	**21.4**	**21.1**	**20.6**	**19.9**	**19.1**		**18.3**	**16.9**	**16.1**	**15.3**	**14.4**	**9.2**	**8.7**	
In percent of exports	**...**	**...**	**61.0**			**76.6**	**64.4**	**63.4**	**61.4**	**59.0**	**56.9**		**54.4**	**52.4**	**49.6**	**46.6**	**43.6**	**25.5**	**23.7**	
In percent of government revenues	**...**	**...**	**60.5**			**104.8**	**96.8**	**89.9**	**86.8**	**82.7**	**76.9**		**72.5**	**67.0**	**61.3**	**56.3**	**51.6**	**25.7**	**23.8**	
Debt service-to-exports ratio (in percent)	**15.2**	**4.3**	**1.9**			**2.4**	**2.5**	**3.6**	**3.6**	**3.6**	**3.2**		**3.7**	**3.5**	**3.8**	**3.8**	**3.6**	**1.7**	**1.6**	
PPG debt service-to-exports ratio (in percent)	**15.2**	**4.3**	**1.9**			**2.4**	**2.5**	**3.6**	**3.6**	**3.6**	**3.2**		**3.7**	**3.5**	**3.8**	**3.8**	**3.6**	**1.7**	**1.6**	
PPG debt service-to-revenue ratio (in percent)	**14.9**	**4.1**	**1.8**			**3.3**	**3.8**	**5.1**	**5.1**	**5.1**	**4.3**		**4.9**	**4.5**	**4.6**	**4.6**	**4.3**	**1.7**	**1.6**	
Total gross financing need (Billions of U.S. dollars)	0.2	0.1	0.3			0.1	0.0	0.0	0.0	0.0	0.0		0.0	0.0	0.1	-0.1	-0.1	-0.2	-0.3	
Non-interest current account deficit that stabilizes debt ratio	3.2	2.2	1.3			-2.6	2.6	1.7	1.9	2.4	3.1		3.4	4.1	3.5	1.7	2.1	2.2	1.2	
Key macroeconomic assumptions																				
Real GDP growth (in percent)	9.0	6.5	4.3	5.8	2.7	4.3	5.7	6.1	6.5	6.7	6.7	6.0	6.5	6.5	6.6	6.6	6.1	5.2	5.3	5.8
GDP deflator in US dollar terms (change in percent)	7.9	0.6	-0.4	2.9	7.2	-19.1	-3.3	1.3	0.2	1.0	1.5	-3.0	1.3	5.2	0.9	0.3	1.1	6.1	2.6	2.4
Effective interest rate (percent) 5/	18.1	0.9	1.1	2.8	5.4	0.6	1.1	1.0	0.9	1.0	1.0	0.9	1.7	2.3	2.8	2.8	2.7	1.0	1.0	1.7
Growth of exports of G&S (US dollar terms, in percent)	0.7	29.5	3.6	14.0	15.9	-1.6	15.7	7.9	8.0	8.0	8.0	7.7	8.0	7.7	7.9	8.1	8.2	10.1	10.3	8.9
Growth of imports of G&S (US dollar terms, in percent)	-4.7	19.7	-7.2	10.3	16.0	1.9	4.1	5.9	5.7	6.8	7.8	5.4	7.2	7.4	7.5	7.6	7.6	8.1	8.2	7.8
Grant element of new public sector borrowing (in percent)	...	...	...	...	...	39.5	39.5	39.5	39.5	42.0	42.0	40.4	42.0	42.0	42.0	42.0	42.0	42.0	42.0	42.0
Government revenues (excluding grants, in percent of GDP)	21.3	26.5	26.3			21.4	22.1	23.4	23.8	24.0	24.9		25.2	25.3	26.2	27.1	28.0	35.7	36.6	30.7
Aid flows (in Billions of US dollars) 7/	0.4	0.6	0.2			0.5	0.5	0.5	0.5	0.5	0.5		0.5	0.5	0.5	0.5	0.6	0.7	0.6	
o/w Grants	0.4	0.6	0.2			0.4	0.4	0.4	0.4	0.4	0.4		0.4	0.4	0.4	0.4	0.5	0.5	0.5	
o/w Concessional loans	0.0	0.0	0.0			0.1	0.1	0.1	0.1	0.1	0.1		0.1	0.1	0.1	0.1	0.1	0.1	0.1	
Grant-equivalent financing (in percent of GDP) 8/	...	...	...			10.0	10.2	9.3	8.6	8.1	7.4		6.9	6.3	5.9	5.6	5.3	3.1	2.7	4.6
Grant-equivalent financing (in percent of external financing) 8/	...	...	...			87.8	84.9	86.1	85.9	86.5	86.5		86.5	86.5	86.4	86.4	86.4	85.7	84.9	86.1
Memorandum items:																				
Nominal GDP (Billions of US dollars)	4.3	5.0	5.4			4.7	4.8	5.2	5.6	6.0	6.5		7.0	7.8	8.4	9.0	9.7	19.8	21.4	
Nominal dollar GDP growth	17.3	17.7	7.2			-12.3	2.2	7.5	6.8	7.8	8.3	3.4	7.9	12.0	7.5	6.9	7.3	11.7	8.0	8.3
PV of PPG external debt (in Billions of US dollars)			0.9			0.9	1.0	1.1	1.1	1.2	1.2		1.3	1.3	1.3	1.3	1.4	1.8	1.8	
(PVt-PVt-1)/GDPt-1 (in percent)						1.2	1.8	1.2	1.0	0.9	0.9	1.2	0.6	0.6	0.4	0.3	0.2	0.3	0.2	0.4
Gross workers' remittances (Billions of US dollars)	…	…	…			…	…	…	…	…	…		…	…	…	…	…	…	…	
PV of PPG external debt (in percent of GDP + remittances)	...	...	15.9			22.4	21.4	21.1	20.6	19.9	19.1		18.3	16.9	16.1	15.3	14.4	9.2	8.7	
PV of PPG external debt (in percent of exports + remittances)	...	...	61.0			76.6	64.4	63.4	61.4	59.0	56.9		54.4	52.4	49.6	46.6	43.6	25.5	23.7	
Debt service of PPG external debt (in percent of exports + remittances)	...	...	1.9			2.4	2.5	3.6	3.6	3.6	3.2		3.7	3.5	3.8	3.8	3.6	1.7	1.6	

Sources: Country authorities; and staff estimates and projections.

1/ Includes both public and private sector external debt.

2/ Derived as [r - g - ρ(1+g)]/(1+g+ρ+gρ) times previous period debt ratio, with r = nominal interest rate; g = real GDP growth rate, and ρ = growth rate of GDP deflator in U.S. dollar terms.

3/ Includes exceptional financing (i.e., changes in arrears and debt relief); changes in gross foreign assets; and valuation adjustments. For projections also includes contribution from price and exchange rate changes.

4/ Assumes that PV of private sector debt is equivalent to its face value.

5/ Current-year interest payments divided by previous period debt stock.

6/ Historical averages and standard deviations are generally derived over the past 10 years, subject to data availability.

7/ Defined as grants, concessional loans, and debt relief.

8/ Grant-equivalent financing includes grants provided directly to the government and through new borrowing (difference between the face value and the PV of new debt).

Table 2.Malawi: Public Sector Debt Sustainability Framework, Baseline Scenario, 2009-2032
(In percent of GDP, unless otherwise indicated)

			Actual											Estimate	Projections								
	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	Average 5/	Standard Deviation 5/	2012	2013	2014	2015	2016	2017	2012-17 Average	2022	2032	2018-32 Average
Public sector debt 1/	...	...	179.1	165.3	146.7	39.2	41.0	48.5	49.5	39.4	48.3			52.7	48.4	45.4	43.1	40.6	38.8		29.2	18.9	
o/w foreign-currency denominated	...	...	160.3	145.5	127.9	22.6	19.0	19.5	19.4	18.4	23.0			29.7	28.4	28.2	27.7	26.8	25.9		21.8	13.7	
Change in public sector debt	...	...	...	-13.8	-18.6	-107.5	1.8	7.5	1.0	-10.1	8.9			4.4	-4.3	-3.1	-2.3	-2.5	-1.8		-1.2	-0.9	
Identified debt-creating flows		...	...	8.2	-15.3	-21.5	1.3	0.0	3.2	-7.0	3.3			11.5	-5.4	-3.6	-2.7	-3.0	-2.3		-1.3	-1.6	
Primary deficit	...	...	-1.6	-3.1	-3.0	-5.9	2.1	3.2	-0.6	-4.7	2.3	-1.2	3.3	3.2	-0.1	-1.5	-0.7	-0.8	-0.1	0.0	-0.4	-0.7	-0.3
Revenue and grants	...	...	27.6	32.8	33.3	41.9	37.4	36.5	35.2	42.0	31.9			30.5	31.0	31.8	31.5	31.2	31.5		32.7	38.9	
of which: grants	...	...	9.1	12.4	11.4	18.9	15.3	13.1	10.2	13.6	4.5			9.1	9.0	8.3	7.7	7.1	6.6		4.7	2.3	
Primary (noninterest) expenditure	...	...	26.0	29.7	30.3	36.0	39.6	39.7	34.6	37.3	34.2			33.7	31.0	30.3	30.8	30.4	31.4		32.3	38.2	
Automatic debt dynamics		...	...	11.3	-12.3	-14.7	-0.8	-3.2	-0.9	-2.3	0.9			8.3	-5.3	-2.1	-2.0	-2.2	-2.2		-0.9	-0.9	
Contribution from interest rate/growth differential	...	...	...	-5.2	-3.2	-5.1	-1.9	-2.2	0.5	-1.9	0.6			-2.4	-3.3	-2.1	-2.2	-2.2	-2.2		-1.0	-0.8	
of which: contribution from average real interest rate	...	...	...	3.0	1.3	-2.1	1.5	0.9	4.5	1.1	2.3			-0.4	-0.4	0.7	0.6	0.5	0.3		0.7	0.2	
of which: contribution from real GDP growth	...	...	...	-8.3	-4.6	-3.0	-3.4	-3.2	-4.0	-3.0	-1.6			-2.0	-2.9	-2.8	-2.8	-2.7	-2.5		-1.8	-1.0	
Contribution from real exchange rate depreciation		...	...	16.5	-9.1	-9.6	1.1	-0.9	-1.4	-0.4	0.3			10.7	-2.0	0.0	0.1	0.0	0.0		...	...	
Other identified debt-creating flows		0.0	0.0	0.0	0.0	-1.0	-0.1	0.0	4.8	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Privatization receipts (negative)		...	0.0	0.0	0.0	-0.4	0.0	0.0	-0.1	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Recognition of implicit or contingent liabilities		...	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Debt relief (HIPC and other)		...	0.0	0.0	0.0	-0.6	-0.1	0.0	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Other (specify, e.g. bank recapitalization)		...	0.0	0.0	0.0	0.0	0.0	0.0	4.8	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Residual, including asset changes		...	...	-21.9	-3.3	-86.0	0.5	7.5	-2.2	-3.1	5.6			-7.1	1.1	0.5	0.4	0.5	0.5		0.1	0.6	
Other Sustainability Indicators																							
PV of public sector debt			...	...	...	...	...	...	...	...	41.2			45.5	41.4	38.3	36.1	33.7	32.0		21.9	13.9	
o/w foreign-currency denominated			...	...	...	...	...	...	...	...	15.9			22.4	21.4	21.1	20.6	19.9	19.1		14.4	8.7	
o/w external		...	...	...	...	...	...	...	...	...	15.9			22.4	21.4	21.1	20.6	19.9	19.1		14.4	8.7	
PV of contingent liabilities (not included in public sector debt)		...	...	...	...	...	...	...	...	...	...			...	...	...	...	...	...		...	...	
Gross financing need 2/	...	...	21.0	25.3	23.2	18.8	18.4	17.8	25.2	20.0	20.0			21.7	18.9	16.7	15.2	13.5	12.7		7.9	5.1	
PV of public sector debt-to-revenue and grants ratio (in percent)	...	...	...	...	...	...	...	...	...	...	129.3			149.2	133.4	120.5	114.7	107.9	101.8		67.0	35.8	
PV of public sector debt-to-revenue ratio (in percent)	...	...	...	...	...	...	...	...	...	...	150.8			212.5	187.6	163.4	151.9	140.0	128.8		78.3	38.1	
o/w external 3/		...	...	...	...	...	...	...	...	...	58.3			104.8	96.8	89.9	86.8	82.7	76.9		51.6	23.8	
Debt service-to-revenue and grants ratio (in percent) 4/		35.3	33.8	35.8	28.6	18.8	9.3	8.4	19.5	9.5	10.5			8.5	8.4	9.5	8.7	8.1	7.0		6.4	3.1	
Debt service-to-revenue ratio (in percent) 4/		46.9	50.4	57.6	43.5	34.2	15.6	13.1	27.4	14.0	12.2			12.2	11.8	12.8	11.5	10.5	8.8		7.5	3.3	
Primary deficit that stabilizes the debt-to-GDP ratio									-1.6	5.4	-6.6			-1.2	4.2	1.6	1.6	1.7	1.7		0.8	0.2	
Key macroeconomic and fiscal assumptions																							
Real GDP growth (in percent)	...	...	5.1	4.9	2.8	2.1	9.5	8.3	9.0	6.5	4.3	5.8	2.7	4.3	5.7	6.1	6.5	6.7	6.7	6.0	6.1	5.3	5.8
Average nominal interest rate on forex debt (in percent)		0.8	0.8	0.9	0.7	0.6	1.2	0.8	20.4	1.0	1.4	2.9	6.2	0.7	1.2	1.1	0.9	1.1	1.1	1.0	2.8	1.1	1.7
Average real interest rate on domestic debt (in percent)		...	48.0	32.9	25.4	6.2	12.2	5.7	4.1	4.1	12.0	16.7	15.4	-1.6	-2.6	3.4	4.4	4.1	3.9	1.9	7.2	6.2	6.8
Real exchange rate depreciation (in percent, + indicates depreciation)		...	20.2	11.0	-6.6	-7.9	5.3	-5.3	-6.6	-2.2	1.6	1.1	9.6	48.8	...	...	...	...	...	...	...	...	...
Inflation rate (GDP deflator, in percent)	...	...	10.0	15.4	11.0	27.3	10.0	8.7	8.4	7.4	3.8	11.3	6.8	16.4	14.2	7.3	6.0	5.8	5.6	9.2	6.2	6.2	6.7
Growth of real primary spending (deflated by GDP deflator, in percent)		...	0.1	0.1	0.1	0.1	0.3	0.1	-0.1	0.2	0.0	0.1	0.1	0.1	0.0	0.0	0.1	0.1	0.1	0.1	0.1	0.0	0.1
Grant element of new external borrowing (in percent)		...	...	...	...	...	...	...	...	...	...	...	...	39.5	39.5	39.5	39.5	42.0	42.0	40.4	42.0	42.0	...

Sources: Country authorities; and staff estimates and projections.

1/ [Indicate coverage of public sector, e.g., general government or nonfinancial public sector. Also whether net or gross debt is used.]

2/ Gross financing need is defined as the primary deficit plus debt service plus the stock of short-term debt at the end of the last period.

3/ Revenues excluding grants.

4/ Debt service is defined as the sum of interest and amortization of medium and long-term debt.

5/ Historical averages and standard deviations are generally derived over the past 10 years, subject to data availability.

Table 3.Malawi: Sensitivity Analysis for Key Indicators of Public and Publicly Guaranteed External Debt, 2012-2032
(In percent)

	Projections											
	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	**2022**	2032
PV of debt-to GDP ratio												
Baseline	22	21	21	21	20	19	18	17	16	16	**15**	8
A. Alternative Scenarios												
A1. Key variables at their historical averages in 2012-2032 1/	22	23	26	29	32	34	36	38	39	41	**43**	50
A2. New public sector loans on less favorable terms in 2012-2032 2	22	22	22	22	22	22	22	20	20	20	**19**	14
B. Bound Tests												
B1. Real GDP growth at historical average minus one standard deviation in 2013-2014	22	21	22	21	21	20	19	18	17	16	**15**	9
B2. Export value growth at historical average minus one standard deviation in 2013-2014 3/	22	26	35	34	33	32	30	28	27	26	**24**	12
B3. US dollar GDP deflator at historical average minus one standard deviation in 2013-2014	22	21	22	22	21	20	19	18	17	16	**15**	9
B4. Net non-debt creating flows at historical average minus one standard deviation in 2013-2014 4/	22	25	28	28	27	26	25	23	22	21	**20**	10
B5. Combination of B1-B4 using one-half standard deviation shocks	22	24	29	28	28	27	25	24	22	22	**20**	10
B6. One-time 30 percent nominal depreciation relative to the baseline in 2013 5/	22	30	30	29	28	27	26	24	23	22	**21**	12
PV of debt-to-exports ratio												
Baseline	77	64	63	61	59	57	55	53	50	47	**44**	23
A. Alternative Scenarios												
A1. Key variables at their historical averages in 2012-2032 1/	77	69	78	86	94	102	107	117	120	125	**129**	135
A2. New public sector loans on less favorable terms in 2012-2032 2	77	65	66	66	66	65	64	63	62	60	**57**	37
B. Bound Tests												
B1. Real GDP growth at historical average minus one standard deviation in 2013-2014	77	63	62	60	58	56	54	52	49	47	**44**	23
B2. Export value growth at historical average minus one standard deviation in 2013-2014 3/	77	110	185	179	172	166	159	153	146	138	**130**	56
B3. US dollar GDP deflator at historical average minus one standard deviation in 2013-2014	77	63	62	60	58	56	54	52	49	47	**44**	23
B4. Net non-debt creating flows at historical average minus one standard deviation in 2013-2014 4/	77	75	85	82	79	77	74	71	67	64	**60**	27
B5. Combination of B1-B4 using one-half standard deviation shocks	77	81	95	92	89	86	82	79	75	71	**67**	31
B6. One-time 30 percent nominal depreciation relative to the baseline in 2013 5/	77	63	62	60	58	56	54	52	49	47	**44**	23
PV of debt-to-revenue ratio												
Baseline	105	97	90	87	83	77	73	68	62	57	**53**	23
A. Alternative Scenarios												
A1. Key variables at their historical averages in 2012-2032 1/	105	104	111	122	132	138	143	149	148	151	**153**	136
A2. New public sector loans on less favorable terms in 2012-2032 2	105	98	94	94	92	88	86	81	76	72	**68**	37
B. Bound Tests												
B1. Real GDP growth at historical average minus one standard deviation in 2013-2014	105	97	92	89	86	80	76	70	64	59	**54**	24
B2. Export value growth at historical average minus one standard deviation in 2013-2014 3/	105	120	149	143	137	127	120	111	102	95	**87**	32
B3. US dollar GDP deflator at historical average minus one standard deviation in 2013-2014	105	95	94	91	87	81	77	71	65	60	**55**	24
B4. Net non-debt creating flows at historical average minus one standard deviation in 2013-2014 4/	105	113	120	116	111	104	98	90	83	77	**70**	27
B5. Combination of B1-B4 using one-half standard deviation shocks	105	110	124	120	115	107	101	93	86	79	**73**	28
B6. One-time 30 percent nominal depreciation relative to the baseline in 2013 5/	105	137	127	123	118	110	104	96	88	81	**75**	33

Table 3.Malawi: Sensitivity Analysis for Key Indicators of Public and Publicly Guaranteed External Debt, 2012-2032 (continued)

(In percent)

Debt service-to-exports ratio

Baseline	2	3	4	4	4	3	4	3	4	4	**4**	2
A. Alternative Scenarios												
A1. Key variables at their historical averages in 2012-2032 1/	2	2	4	4	4	3	4	4	4	4	**5**	6
A2. New public sector loans on less favorable terms in 2012-2032 2	2	3	4	4	4	4	4	4	4	4	**4**	2
B. Bound Tests												
B1. Real GDP growth at historical average minus one standard deviation in 2013-2014	2	3	4	4	4	3	4	3	4	4	**4**	2
B2. Export value growth at historical average minus one standard deviation in 2013-2014 3/	2	3	7	8	7	7	7	7	7	7	**8**	5
B3. US dollar GDP deflator at historical average minus one standard deviation in 2013-2014	2	3	4	4	4	3	4	3	4	4	**4**	2
B4. Net non-debt creating flows at historical average minus one standard deviation in 2013-2014 4/	2	3	4	4	4	3	4	4	4	4	**4**	2
B5. Combination of B1-B4 using one-half standard deviation shocks	2	3	4	4	4	4	4	4	4	4	**5**	2
B6. One-time 30 percent nominal depreciation relative to the baseline in 2013 5/	2	3	4	4	4	3	4	3	4	4	**4**	2

Debt service-to-revenue ratio

Baseline	3	4	5	5	5	4	5	4	5	5	**4**	2
A. Alternative Scenarios												
A1. Key variables at their historical averages in 2012-2032 1/	3	4	5	5	5	5	5	5	5	5	**6**	6
A2. New public sector loans on less favorable terms in 2012-2032 2	3	4	5	5	5	5	5	5	5	5	**5**	2
B. Bound Tests												
B1. Real GDP growth at historical average minus one standard deviation in 2013-2014	3	4	5	5	5	5	5	5	5	5	**5**	2
B2. Export value growth at historical average minus one standard deviation in 2013-2014 3/	3	4	6	6	6	5	6	5	5	5	**6**	3
B3. US dollar GDP deflator at historical average minus one standard deviation in 2013-2014	3	4	5	5	5	5	5	5	5	5	**5**	2
B4. Net non-debt creating flows at historical average minus one standard deviation in 2013-2014 4/	3	4	5	6	6	5	5	5	5	5	**5**	2
B5. Combination of B1-B4 using one-half standard deviation shocks	3	4	5	6	6	5	5	5	5	5	**5**	2
B6. One-time 30 percent nominal depreciation relative to the baseline in 2013 5/	3	5	7	7	7	6	7	6	7	7	**6**	3
Memorandum item:												
Grant element assumed on residual financing (i.e., financing required above baseline) 6/	38	38	38	38	38	38	38	38	38	38	**38**	38

Sources: Country authorities; and staff estimates and projections.

1/ Variables include real GDP growth, growth of GDP deflator (in U.S. dollar terms), non-interest current account in percent of GDP, and non-debt creating flows.
2/ Assumes that the interest rate on new borrowing is by 2 percentage points higher than in the baseline., while grace and maturity periods are the same as in the baseline.
3/ Exports values are assumed to remain permanently at the lower level, but the current account as a share of GDP is assumed to return to its baseline level after the shock (implicitly assuming an offsetting adjustment in import levels).
4/ Includes official and private transfers and FDI.
5/ Depreciation is defined as percentage decline in dollar/local currency rate, such that it never exceeds 100 percent.
6/ Applies to all stress scenarios except for A2 (less favorable financing) in which the terms on all new financing are as specified in footnote 2.

Table 4.Malawi: Sensitivity Analysis for Key Indicators of Public Debt 2012-2032

	Projections							
	2012	2013	2014	2015	2016	2017	2022	2032
PV of Debt-to-GDP Ratio								
Baseline	45	41	38	36	34	32	22	14
A. Alternative scenarios								
A1. Real GDP growth and primary balance are at historical averages	45	40	37	35	33	31	20	7
A2. Primary balance is unchanged from 2012	45	43	43	43	42	42	41	41
A3. Permanently lower GDP growth 1/	45	41	38	37	35	34	27	34
B. Bound tests								
B1. Real GDP growth is at historical average minus one standard deviations in 2013-2014	45	42	41	39	38	37	30	27
B2. Primary balance is at historical average minus one standard deviations in 2013-2014	45	42	41	39	36	35	24	15
B3. Combination of B1-B2 using one half standard deviation shocks	45	42	40	38	36	35	26	21
B4. One-time 30 percent real depreciation in 2013	45	49	46	43	40	38	26	17
B5. 10 percent of GDP increase in other debt-creating flows in 2013	45	47	44	41	39	37	26	16
PV of Debt-to-Revenue Ratio 2/								
Baseline	138	133	121	115	108	102	67	36
A. Alternative scenarios								
A1. Real GDP growth and primary balance are at historical averages	149	129	118	112	105	98	61	18
A2. Primary balance is unchanged from 2012	149	138	134	135	136	134	125	106
A3. Permanently lower GDP growth 1/	149	132	121	116	111	107	83	86
B. Bound tests								
B1. Real GDP growth is at historical average minus one standard deviations in 2013-2014	149	135	127	124	119	115	90	70
B2. Primary balance is at historical average minus one standard deviations in 2013-2014	149	136	129	123	117	110	74	39
B3. Combination of B1-B2 using one half standard deviation shocks	149	134	126	121	116	111	80	54
B4. One-time 30 percent real depreciation in 2013	149	159	144	136	128	120	80	43
B5. 10 percent of GDP increase in other debt-creating flows in 2013	149	151	137	131	124	117	79	42
Debt Service-to-Revenue Ratio 2/								
Baseline	9	8	9	9	8	7	6	3
A. Alternative scenarios								
A1. Real GDP growth and primary balance are at historical averages	11	10	10	9	8	7	7	3
A2. Primary balance is unchanged from 2012	11	10	10	9	9	8	8	6
A3. Permanently lower GDP growth 1/	11	10	10	9	9	7	7	5
B. Bound tests								
B1. Real GDP growth is at historical average minus one standard deviations in 2013-2014	11	10	10	10	9	8	7	4
B2. Primary balance is at historical average minus one standard deviations in 2013-2014	11	10	10	9	9	7	7	3
B3. Combination of B1-B2 using one half standard deviation shocks	11	10	10	9	9	8	7	4
B4. One-time 30 percent real depreciation in 2013	11	10	12	11	10	9	9	4
B5. 10 percent of GDP increase in other debt-creating flows in 2013	11	10	10	9	9	8	7	4

Sources: Country authorities; and staff estimates and projections.
1/ Assumes that real GDP growth is at baseline minus one standard deviation divided by the square root of the length of the projection period.
2/ Revenues are defined inclusive of grants.

ANNEX I. MALAWI—RELATIONS WITH THE FUND
(As of May 31, 2012)

Membership Status

Joined: July 19, 1965; Article VIII

General Resources Account:

	SDR Million	%Quota
Quota	69.40	100.00
Fund holdings of currency (exchange rate)	66.99	96.52
Reserve tranche position	2.42	3.49

SDR Department:

	SDR Million	%Allocation
Net cumulative allocation	66.37	100.00
Holdings	2.24	3.38

Outstanding Purchases and Loans:

	SDR Million	%Quota
ESF Arrangements	34.70	50.00
ECF Arrangements	58.65	84.51

Latest Financial Arrangements:

Type	Date of Arrangement	Expiration Date	Amount Approved (SDR Million)	Amount Drawn (SDR Million)
ECF[1/]	02/19/2010	02/18/2013	52.05	13.88
ESF	12/03/2008	12/02/2009	52.05	34.70
ECF[1/]	08/05/2005	08/04/2008	48.58	48.58

[1] Formerly PRGF.

Projected Payments to Fund [1]

(SDR Million; based on existing use of resources and present holdings of SDRs):

	Forthcoming				
	2012	2013	2014	2015	2016
Principal	1.65	5.37	16.66	17.35	17.86
Charges/Interest	0.07	0.17	0.28	0.24	0.19
Total	1.70	5.54	16.94	17.59	18.05

1. When a member has overdue financial obligations outstanding for more than three months, the amount of such arrears will be shown in this section.

Implementation of HIPC Initiative:

	Enhanced Framework
Commitment of HIPC assistance	
Decision point date	December 2000
Assistance committed	
by all creditors (US$ Million)[1]	1057.00
Of which: IMF assistance (US$ million)	45.27
(SDR equivalent in millions)	33.37
Completion point date	Aug 2006
Disbursement of IMF assistance (SDR Million)	
Assistance disbursed to the member	33.37
Interim assistance	11.57
Completion point balance	21.80
Additional disbursement of interest income[2]	3.82
Total disbursements	37.19

[1] Assistance committed under the original framework is expressed in net present value (NPV) terms at the completion point, and assistance committed under the enhanced framework is expressed in NPV terms at the decision point. Hence these two amounts cannot be added.

[2] Under the enhanced framework, an additional disbursement is made at the completion point corresponding to interest income earned on the amount committed at the decision point but not disbursed during the interim period.

Implementation of Multilateral Debt Relief Initiative (MDRI):

MDRI-eligible debt (SDR Million)[1]	37.87
Financed by: MDRI Trust	14.53
Remaining HIPC resources	23.34

Debt Relief by Facility (SDR Million)

	Eligible Debt		
Delivery Date	**GRA**	**PRGF**	**Total**
December 2006	N/A	7.91	7.91
September 2006	10.84	19.12	29.96

[1] The MDRI provides 100 percent debt relief to eligible member countries that qualified for the assistance. Grant assistance from the MDRI Trust and HIPC resources provide debt relief to cover the full stock of debt owed to the Fund as of end-2004 that remains outstanding at the time the member qualifies for such debt relief.

Implementation of Post-Catastrophe Debt Relief (PCDR): Not Applicable

Safeguards Assessments:

An update safeguards assessment of the Reserve Bank of Malawi (RBM) with respect to the 2012 ECF has been initiated and will be completed by the first review. The latest safeguards assessment was completed on June 25, 2010 and concluded that the RBM continued to have strong financial safeguards in the areas of external audit and financial reporting. The main area of concern was the lack of adequate autonomy for the RBM, which is now being addressed by the program. Another key recommendation related to the strengthening of the foreign reserves management oversight.

Exchange Arrangements:

During the second review of the PRGF arrangement in August 2006, a multiple currency practice (MCP) under Article VIII emerged (manifested by the significant spread between the commercial bank exchange rates and the rates at foreign exchange bureaus). Staff is in the process reviewing recent reforms to make an assessment of Malawi's exchange system. From mid 2006 to late 2009, the authorities kept the exchange rate stable, at 141 Malawi kwacha to the U.S. dollar. From November 2009 to mid January 2010, the authorities gradually devalued the currency about 8 percent relative to the U.S. dollar to 151 kwacha to the U.S. dollar. On August 2011, the authorities devalued kwacha by another 10 percent bringing the Malawi kwacha to the U.S. dollar rate to 166. In May 2012, the government liberalized the foreign exchange regime and devalued the kwacha by about 33 percent. Malawi maintains restrictions on the capital account. Currently, Malawi's exchange rate regime is reclassified as "floating".

Article IV Consultation:

Malawi is on a 24-month Article IV consultation cycle. The current Article IV Consultation is delayed owing to extended discussions on the second review of the ECF-supported program followed by the authorities' request in April 2012 for a new ECF arrangement. The Executive Board concluded the last Article IV consultation with Malawi on February 10, 2010.

Financial Sector Assessment Program (FSAP), Reports on Observance of Standards and Codes (ROSCs), and Offshore Financial Center (OFC) Assessments:

A joint team of the World Bank and the International Monetary Fund visited Malawi under the FSAP program during two missions in July and December 2007. The Financial System Stability Assessment (FSSA) was issued in June 2008.

Corporate Governance and Accounting and Auditing ROSC missions visited Malawi during missions in February and June 2007.

An update on the FAD mission on the fiscal transparency module was issued in March 2007. A ROSC on the data module, based on a September 2003 mission, was published in October, 2004.

Technical Assistance:

Date of Delivery	Department	Ministry	Purpose	Modality
05/12	STA	NSO	Consumer Price Indices Mission	Mission
04/12	STA	NSO	Balance of Payments Statistics follow up mission	Mission
04/12	STA	NSO	Provide advice to improve the GDP methodology and assist with improving the data sources and indicators	Mission
04/12	STA	NSO	Balance of Payments and International Investment Position Statistics	Mission
03/12	FAD	Ministry of Finance	Strengthening the IFMIS control environment	Mission
03/12	FAD	Ministry of Finance	Draft asset management manual	Report
03/12	FAD	Ministry of Finance	Follow-up and Consolidating Headquarters functions and Customs Risk Management Mission	Mission
01/12	MCM	RBM	Review of Implementation of Risk Based Supervision	Report
01/12	FAD	Ministry of Finance	Developing a Draft Budget Framework Document (BFP)	Mission
12/11	FAD	Ministry of Finance	Reform Priorities and Next Steps	Mission
12/11	FAD	Ministry of Finance	Development of asset management manual.	Mission
12/11	MCM	RBM	Review the Foreign Exchange Regime	Mission
11/11	FAD	Ministry of Finance	Macro fiscal training	Mission
11/11	MCM	RBM	Development of asset management manual.	Mission
11/11	MCM	RBM	Further Development of a Framework for Consolidated Supervision	Report
11/11	FAD	Ministry of Finance	Improving capacity in Business process re-engineering and IT implementation Mission	Mission
10/11	FAD	Ministry of Finance	Program Budgeting and Developing the Medium-term Expenditure Framework Cycle	Mission
06/11	FAD	Ministry of Finance	Measures for Tax Reform and Taxation of Mining	Mission
06/11	FAD	Ministry of Finance	Enhancing taxpayer compliance and revenue performance	Mission
06/11	STA	Ministry of Finance	Government Finance Statistics	Report
06/11	FAD	Ministry of Finance	Macro-fiscal training, scoping and needs assessment	Mission
06/11	MCM	RBM	Developing AML/CFT Offsite Supervisory Tools and Practices	Mission

Date of Delivery	Department	Ministry	Purpose	Modality
06/11	FAD	Ministry of Finance	Malawi: Enhancing Tax Compliance and Revenue Performance	Report
06/11	FAD	Ministry of Finance	Tax Administration	Mission
06/11	FAD	Ministry of Finance	Measures for Tax Reform and the Taxation of Mining	Mission
05/11	FAD	Ministry of Finance	Fixed Assets and Financial Reporting	Mission
05/11	FAD	Ministry of Finance	Report on Strengthening Headquarters functions and Customs Risk Management Mission	Mission
04/11	STA	NSO	Incorporate new source data in the balance of payments and develop new worksheets	Mission
04/11	MCM	RBM	Assisting Reserve Bank of Malawi to further develop a framework for consolidated supervision	Mission
04/11	MCM	RBM	Developing Capacity for Stress Testing - Mission Report to the Reserve Bank of Malawi	Report
02/11	STA	NSO	Assess SUT and B-I prerequisites, data sources, compilation and dissemination for NAS	Mission
02/11	STA	NSO	Review of National Accounts Statistics	Report
01/11	FAD	Ministry of Finance	Streamlining Budget Documentation, Revising Budget Circular, Reintroducing MTEF	Mission
11/10	FAD	Ministry of Finance	Integrated Financial Management Information System (IFMIS): Review And Implementation Strategies	Report
11/10	STA	RBM	Monetary and Financial Statistics	Mission
11/10	MCM	RBM	Regulation and Oversight of Mobile Payments and Related Issues	Mission
10/10	STA	NSO	Assist in reviewing and modifying the PPS and PPI.	Mission
10/10	FAD	Ministry of Finance	IFMIS/Cash Management	Mission
10/10	FAD	Ministry of Finance	Program Budgeting/Output Budgeting	Mission
10/10	FAD	Ministry of Finance	In-year Fiscal Reporting/Budget Documentation	Mission
10/10	FAD	Ministry of Finance	Joint review of PFMRP	Mission
10/10	FAD	Ministry of Finance	Strengthening Program Budgeting, Performance Measurement, and Budget Documentation in Malawi: Analysis and Recommendations	Report
08/10	FAD	Ministry of Finance	Revenue Policy and Administration	Report
07/10	FAD	Ministry of Finance	Strengthening the large taxpayers office	Mission

Date of Delivery	Department	Ministry	Purpose	Modality
07/10	FAD	Ministry of Finance	Installation of expert and revenue Administration follow up mission (including review of ITAS implementation)	Mission
07/10	STA	NSO	Implementation of Balance of Payments Standards	Mission
07/10	STA	NSO	Balance of Payments and International Investment Position Statistics	Report
06/10	FAD	Ministry of Finance	Issues in Tax Policy and Taxation of Mining	Mission
05/10	MCM	RBM	Training in Techniques of Stress Testing of Prudential Data	Report
05/10	MCM	RBM	Developing Capacity for Stress Testing - Mission Report to the Reserve Bank of Malawi	Report
05/10	FAD	Ministry of Finance	Revenue Policy and Administration	Report
01/10	FAD	Ministry of Finance	Output-based budget and expenditure tracking	Mission
01/10	STA	NSO	Balance of payments statistics	Mission
10/09	MCM	RBM	Central bank policy	Mission
10/09	MCM	RBM	Central banking	Mission
09/09	FAD	Ministry of Finance	Improving output budgeting	Mission
08/09	LEG	Ministry of Finance	Tax procedure code	Mission
05/09	LEG	Ministry of Finance	Tax procedure code	Mission
05/09	FAD	Ministry of Finance	Linkage between policy and budgetary allocations	Mission
04/09	FAD	RBM	Monetary operations and reserves management	Mission
03/09	FAD	Ministry of Finance	Revenue administration	Mission
03/09	FAD	Ministry of Finance	Prepare modernization plan and support tax administration	Mission
02/09	FAD	Ministry of Finance	Integration of accounting systems and fiscal reporting	Mission
02/09	MCM	RBM	Currency handling and reform	Mission
02/09	MCM	RBM	Monetary operations/money markets	Mission
01/09	STA	RBM	DFID: Money and banking statistics	Mission

Date of Delivery	Department	Ministry	Purpose	Modality
01/09	MCM	RBM	Monetary operations/money markets	Mission
01/09	MCM	RBM	Macro and FSI Analysis	Mission
01/09	MCM	RBM	TA coordination/evaluation	Mission

Annex II. Malawi—Joint Managerial Action Plan

(As of May 30, 2012

Title	Products	Provisional Timing of Missions	Expected Delivery Date
A. Mutual information on relevant work programs			
Bank work program in the next 12 months	1. Rapid response budget support 2. Aligning the composition of expenditure to MDGS II 3. Costing of social safety programs 4. Public Expenditure Review	May May May October/Nov.	July, 2012 June, 2012 June, 2012 March 2013
IMF work program in next 12 months	1. Request for a new ECF arrangement 2. First review of ECF-supported program 3. Second review of ECF-supported program	May, 2012 November, 2012 February, 2013	July, 2012 December, 2012 March, 2013
B. Requests for work program inputs			
Fund request to Bank	1. Information on budget support and costing of social safety net programs.		May-June 2012.
	2. Updates on Public Expenditure Review work.		December 2012, March 2013
Bank request to IMF	1. Provision of an assessment letter to aid the budget support 2. Regular updates of medium-term macro projections.		June 2012 Continuous
C. Agreement on joint products and missions			
Joint products in next 12 months	1. Debt Sustainability Analysis 2. JSAN		June 2012 August 2012

ANNEX III. MALAWI—STATISTICAL ISSUES

Introduction

1. Although economic data provision has some shortcomings, it is broadly adequate for surveillance.

2. The data module of the Report on the Observance of Standards and Codes (data ROSC), published February 17, 2005, found that, while the institutional framework for the production of macroeconomic statistics was broadly adequate, there were shortcomings in the scope, accuracy, and reliability of data. The weakest areas are: national accounts, balance of payments statistics, government finances statistics, and monetary and financial statistics. A key STA recommendation was 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 RBM.

3. The authorities are making efforts to improve the quality and timeliness of economic and financial data through participation in the Fund's General Data Dissemination System (GDDS) and the GDDS Project for Anglophone African Countries. Malawi is participating in the GDDS/PRSP and the monetary and financial statistics modules of the project. GDDS metadata have been posted on the Fund's Dissemination Standards Bulletin Board (DSBB) since February 2007.

National accounts

4. The accuracy and reliability of the real sector data (including national accounts, prices, and trade) are affected by inadequate source data and timeliness. STA has recommended remedial actions, including the need for additional resources for the National Statistics Office (NSO). A long-term technical assistance program in the area of national accounts is being provided under a project by Norwegian counterparts. The NSO have revised the national accounts methodology to implement the SNA93 and to better account for the activities in the informal sector. New estimates for Real and Nominal GDP based on the base year 2007 are submitted.

Consumer prices

5. A consumer price index (CPI) is available on a timely basis. The CPI base is 2000, drawing on the 1997/98 household survey, and data (on urban and rural price indices) are collected on a monthly basis by regional price collectors. There are plans to revise the CPI weights based on the 2010 planned Integrated Household Survey (IHS).

Government finance statistics

6. The accuracy and reliability of the data are affected by inadequate source data. A key shortcoming in this area is inadequate system of recording source data. In addition, 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 Malawi Government (MG) Account.

- Nontax revenue, including capital revenues collected by line ministries are not properly accounted for in the fiscal reports prepared by the Ministry of Finance.

- Data on recurrent expenditure suffer from serious shortcomings partly related to insufficient bank reconciliation between expenses records prepared by line ministries and financing information prepared by the Ministry of Finance. Line ministries submit spending reports to the Ministry of Finance based on recorded expenses, while the Ministry of Finances estimates expenses based on funding data (from the Credit Ceiling Authority). 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 estimates are based on funding released to line ministries, and estimates 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 expenses and corresponding financing data. In addition, many donor projects are still not incorporated in the budget, and hence the corresponding expenditure is not captured in government finance statistics. Some externally funded development expenditures are likely recurrent and reported capital expenditure therefore overstated.

- 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.

- Malawi's current budget classification includes economic and program classification and program, but does not include an effective administrative/organizational classification.[11] Expenditure data is loosely mapped to functional classification based on the CoFoG classification.

- 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 have been protected in line with the PRSP are only identified in the ABB classification. As no bridge table exists to map the ABB classification into the program classification used for expenditure reporting and

[11] Economic classifications were upgraded to GFS 2001 compatible framework in FY 2006/07.

accounting, pro-poor expenditures cannot be monitored. Under the ECF program, the government is expected to develop a mechanism for properly monitoring social expenditures.

- The government nomenclature program/subprogram currently used for the functional classification seems appropriate considering the nature of the items classified under this group. The items currently classified under this group include functions, programs and administrative levels. Although substantial elements of the current output based budget structure appear to be predominately functional in nature, it is not clear whether they are cleanly linked to classification of functions of government (CoFoG). As such, the government should review the current budget structure and the functional classification based on CoFoG (GFSM2001) to verify that they are aligned.

- The absence of a financial administrative structure, complete with vertical hierarchy of responsibilities inhibits the use of Government Finance Statistics (GFS). Budget funds are directed to organizations generally defined as cost centers (e.g., headquarters of ministries down to the level of secondary school principals). As such, there does not appear to be an effective hierarchal financial system. However, to be clear, over the past two years, sub-votes have been introduced to a number of Ministries, but not as yet, a system of warrants and sub-warrants have not been introduced.

- 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 lagged. The government has pledged to strengthen public financial management and fiscal reporting, and renewed efforts are being made to establish a work plan, including utilizing donor technical assistance more effectively. The authorities are currently working with AFRITAC to modify its chart of accounts and output-based structures so that they could more easily be realigned to the national strategy and can be readily understood.

8. Government finance data are not reported for publication in the *Government Finance Statistics Yearbook (GFSY)* or the *International Financial Statistics (IFS)*. An August 2005 and August 2007 STA mission that visited Lilongwe reiterated the importance of continued efforts to implement the Integrated Financial Management Information System (IFMIS), and encouraged the authorities to improve the coverage and sectorization of government financial operations and to correctly classify transactions according to international guidelines. The mission proposed, and discussed with the authorities, a migration plan and timetable to adopt the *GFSM 2001* methodology.

9. A GFS TA mission visited Lilongwe in June 2011 in the context of the country's participation in the GFS Module under the Enhanced Data Dissemination Initiative funded by DFID. It found that annual and sub-annual data for budgetary central government are compiled in *GFSM 1986* format of the Ministry of Finance, but are not disseminated. A new chart of accounts aligned with the *GFSM 2001* was introduced in the 2011–12 budget cycle, which applies to all general government units. A number of source data issues were identified and recommendations made to address them. Bridge tables linking the national classifications and *GFSM 2001* classifications were prepared by the mission, and should be revised and used to compile GFS in *GFSM 2001* format. A follow up mission is included in the RAP for FY 2013.

Monetary and financial statistics

10. Despite recent improvements, monetary and financial statistics (MFS) continue to have shortcomings. These includes irregular reporting to STA, lack of proper legislation to grant the authority to the RBM to require reporting from other institutions[12]; the sectorization of the domestic economy, and classification of financial instruments to ensure that the RBM adheres fully to the methodology of the *Monetary and Financial Statistics Manual*. The 2004, 2008, 2009, and 2010 missions noted and made a number of recommendations for addressing the above shortcomings. In addition to the above tasks, the 2008, 2009, and 2010 STA missions assisted RBM staff in developing the standardized report forms (SRFs) for the central bank accounts (1SR), other depository corporations (2SR), and monetary aggregates (5SR).

External sector statistics

11. The external sector statistics in Malawi exhibit serious deficiencies. 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),* although there has been some progress in the transition to the methodology of *BPM5*. The National Statistical Office of Malawi (NSO) should now adopt the *BPM6* methodology, on the basis of which the Malawi balance of payments metadata should also be updated. Balance of payments data remain weak in a number of key areas. The NSO balance of payments section remains crucially understaffed, as it has been since March 2008. Moreover, important data sources for balance of payments compilation ceased to be available during 2006–07, for example exchange control forms, which could supply information on imports of goods, services, and current transfers. Procedures for assessing the accuracy of trade data need to be improved.

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[12] Some legislation that is designed to address this issue has recently been approved. However, some of the pending legislation would give and strengthen the authority of the RBM in this regard.

12. The NSO had compiled new balance of payments data and validated the results from two key surveys: the BOP Survey and the survey on nonprofit institutions serving households (NPISH), both based on the *BPM*5 methodology. The NSO also compiled information from other important sources as well, namely: a) the 2009 Foreign Private Capital and Investor Perception Survey, b) monetary statistics from the Reserve Bank of Malawi (RBM), and c) other financial data provided by the Ministry of Finance (MoF). However, much remains to be done to improve the quality, coverage, and timelines of the balance of payments statistics.

13. Data on remittances are non-existent, despite anecdotal evidence that there are high remittances. As a first step the money transfer services should be required to report monthly data to the RBM. Data on foreign direct investment and portfolio flows are similarly weak. Project aid is currently classified as current transfers rather than in the capital account, and several large in-kind projects are not captured in the balance of payments data properly.

14. No international investment position statement is prepared. The RBM and Ministry of Finance's Debt and Aid Department need to improve reporting of monetary and external debt data respectively.

Malawi: Tables of Common Indicators Required for Surveillance

(As of June 30, 2012)

	Date of latest observation (For all dates in table, please use format dd/mm/yy)	Date received	Frequency of Data[7]	Frequency of Reporting[7]	Frequency of Publication[7]	Memo Items:[8]	
						Data Quality – Methodological soundness[9]	Data Quality – Accuracy and reliability[10]
Exchange Rates	Current	Current	D	D	D		
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	5/2012	06/2012	M	M	M		
Reserve/Base Money	5/2012	06/2012	M	M	M		
Broad Money	5/2012	07/2012	M	M	M		
Central Bank Balance Sheet	5/2012	06/2012	M	M	M	LO, LO, LNO, O	LO, O, O, O, O
Consolidated Balance Sheet of the Banking System	5/2012	07/2012	M	M	M		
Interest Rates[2]	5/2012	06/2012	M	M	M		
Consumer Price Index	5/2012	06/2012	M	M	M	O, LNO, O, O	LNO, O, O, O, NA
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	5/2012	05/2012	M	M	I		
Revenue, Expenditure, Balance and Composition of Financing[3]– Central Government	5/2012	05/2012	M	M	I	O, LO, O, O	O, LO, O, O, LNO
Stocks of Central Government and Central Government-Guaranteed Debt[5]	05/2012	05/2012	M	M	M		
External Current Account Balance	12/2011	12/2011	A	A	A		
Exports and Imports of Goods and Services	2011	12/2011	A	A	A	O, O, O, O	LO, O, LO, O, O
GDP/GNP	2011	12/2011	A	A	A	LO, LNO, LNO, LO	LNO, LNO, LO, LO, LNO
Gross External Debt	2011	5/2011	M	I	I		
International Investment Position[6]	NA	NA	NA	NA	NA		

[1] Any reserve assets that are pledged or otherwise encumbered should be specified separately. Also, data should comprise short-term liabilities linked to a foreign currency but settled by other means as well as the notional values of financial derivatives to pay and to receive foreign currency, including those linked to a foreign currency but settled by other means.

[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] Includes external gross financial asset and liability positions vis-à-vis nonresidents.

[7] Daily (D); weekly (W); monthly (M); quarterly (Q); annually (A); irregular (I); and not available (NA).

[8] These columns should only be included for countries for which Data ROSC (or a Substantive Update) has been published.

[9] Reflects the assessment provided in the data ROSC or the Substantive Update (published on March 10, 2004, and based on the findings of the mission that took place during May 8–21, 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, respectively, are fully observed (O); largely observed (LO); largely not observed (LNO); not observed (NO); and not available (NA).

[10] Same as footnote 9, except referring to international standards concerning, respectively, source data, assessment of source data, statistical techniques, assessment and validation of intermediate data and statistical outputs, and revision studies.

INTERNATIONAL MONETARY FUND
Public Information Notice

EXTERNAL
RELATIONS
DEPARTMENT

Public Information Notice (PIN) No. 12/88
FOR IMMEDIATE RELEASE
July 26, 2012

International Monetary Fund
700 19th Street, N.W.
Washington, D.C. 20431
USA

IMF Executive Board Concludes 2001 Article IV Consultation with Malawi

On July 23, 2012, the Executive Board of the International Monetary Fund (IMF) concluded the 2012 Article IV Consultation with Malawi.[1]

Background

After averaging over 8 percent a year during 2007–10, real GDP growth in Malawi fell to 4.3 percent in 2011, reflecting the impact of severe foreign exchange shortages. The country's long standing foreign exchange problems intensified in 2011 because of lower tobacco export earnings and cuts in external aid as several donors reduced their financial support to Malawi when the authorities' IMF-supported program went off track in the first half of 2011 and because of human rights and governance concerns. Delays in making payments abroad led to the loss of credit lines for several businesses, resulting in scaled down operations. A tightening of restrictions on foreign exchange transactions created distortions which fostered a parallel market in foreign exchange and boosted activity in the informal sector at the expense of the formal economy. Fiscal performance deteriorated, with the deficit widening from nearly 3 percent of GDP in FY2010/11 to 7 percent in FY2011/12, with a commensurate increase in domestic financing. The external current account deficit widened, reflecting slowing exports and the drop in external grants, and the international reserve position weakened further.

[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. An explanation of any qualifiers used in summings up can be found here: http://www.imf.org/external/np/sec/misc/qualifiers.htm.

In May 2012, the new administration which assumed office in April under the leadership of President Joyce Banda devalued the kwacha, adopted a floating exchange rate regime, and liberalized current account transactions. The measures are beginning to show positive results as evidenced by increased sales of tobacco through official channels, a considerable easing of the private sector's access to foreign exchange, and the near collapse of the foreign exchange parallel market. The policy environment has improved markedly, as have the prospects for reversing the slowdown in economic activity and exports.

Inflation has been on an upswing since early 2011, with the year-on-year rate reaching 17.3 percent in May 2012. Rising import costs have been the main factor behind the upswing, as a growing share of imports were being priced at the parallel market exchange rate before the May devaluation. The devaluation triggered large adjustments in the retail prices of petroleum products, which have had ripple effects to other prices. Inflation is expected to rise for a few months but with the implementation of restrained fiscal and monetary policies should begin to fall by early 2013.

Risks to the medium-term outlook from global spillovers are moderate-to-low. Slower euro area and world growth would adversely affect Malawi's exports (mainly tobacco), but the overall impact on Malawi's growth is expected to be low because of the authorities' active efforts diversify exports and export markets. A substantial fall in tobacco prices on the other hand would adversely affect export proceeds and the income of farmers and dampen growth. The new government's strong policy actions have reduced the risk of lower aid flows. Most of Malawi's major donors are restoring or scaling up aid in response to the improved policy environment and the government's efforts to repair strained relations by addressing concerns over human rights abuses and governance.

Executive Board Assessment

Executive Directors commended the new government for its strong commitment to reform, as evidenced by the swift implementation of bold measures to address Malawi's chronic balance of payments problems and improve the outlook for poverty reduction and growth. The devaluation of the kwacha, adoption of a floating exchange rate regime, and liberalization of current account transactions have begun to show positive results, including increased access by the private sector to foreign exchange. Given Malawi's vulnerability to external shocks, Directors considered that boosting international reserves from their current very low levels should be an immediate policy priority.

Directors agreed that fiscal discipline and tight monetary policy will be required to ensure that the nominal depreciation of the kwacha translates into a sustained real depreciation, critical for improving external competitiveness. In this context, they commended the authorities for the measures already taken to address internal imbalances, including the move toward cost-recovery tariffs for utilities and adoption of an automatic adjustment mechanism to ensure that the retail prices of petroleum products reflect import costs.

Directors welcomed the announcements of increased financial assistance by Malawi's development partners which will allow the government to implement programs to mitigate the impact of the adjustment measures on the poor. They stressed the role of good economic management for attracting and sustaining aid inflows.

Directors were encouraged by the prudent stance of the FY2012/13 budget, and welcomed the scaling up of social protection programs. They advised the authorities to ensure that spending plans are in line with expected revenues and grants, and that they reflect Malawi's growth and development priorities. To make progress toward longer-term fiscal sustainability, Directors welcomed the authorities' intention to strengthen domestic revenue mobilization and public financial management to better control commitments and avoid the accumulation of expenditure arrears.

Directors agreed that tight monetary policy is needed to contain inflationary pressures following the devaluation of the kwacha. They looked forward to further steps to strengthen the operational independence of the RBM, and commended the authorities' plan to introduce limits on government borrowing from the RBM. While Malawi's banking system is sound, close monitoring to preserve financial stability should continue.

Directors welcomed the approval of the second Malawi Growth and Development Strategy (MGDS II), on which the new program is based. They supported the objective of promoting inclusive growth by improving the business climate, addressing key supply-side bottlenecks, deepening access to finance and strengthening social safety nets. They also recommended careful prioritization of the many programs and projects in MDGS II, given limited resources and constraints in institutional capacity.

Public Information Notices (PINs) form part of the IMF's efforts to promote transparency of the IMF's views and analysis of economic developments and policies. With the consent of the country (or countries) concerned, PINs are issued after Executive Board discussions of Article IV consultations with member countries, of its surveillance of developments at the regional level, of post-program monitoring, and of ex post assessments of member countries with longer-term program engagements. PINs are also issued after Executive Board discussions of general policy matters, unless otherwise decided by the Executive Board in a particular case.

Malawi: Selected Economic Indicators, 2009–12

	2009 Est.	2010 Prel.	2011 Proj.	2012 Proj.
National accounts and prices (percent change, unless otherwise				
GDP at constant market prices	9.0	6.5	4.3	4.3
Nominal GDP (billions of kwacha) /1	710.2	812.4	879.8	1,068.1
GDP deflator	8.4	7.4	3.8	16.4
Consumer prices (end of period)	7.6	6.3	9.8	22.9
Consumer prices (annual average)	8.4	7.4	7.6	18.4
Investment and savings (percent of GDP)				
National savings	20.7	24.7	9.6	12.0
Net factor income	-1.2	-2.0	-2.1	-3.0
Net official transfers	9.4	15.7	5.9	11.5
Net private transfers	5.1	4.7	4.6	5.6
Domestic savings	7.5	6.3	1.1	-2.2
Government	-7.1	-0.8	-2.3	-6.9
Private	14.6	7.0	3.4	4.7
National investment	25.6	26.0	15.5	16.2
Government	6.5	9.6	6.9	7.5
Private	19.1	16.4	8.6	8.7
Saving-investment balance /2	-4.8	-1.3	-5.9	-4.3
Government	-5.0	1.5	-5.0	-5.3
Private	0.1	-2.8	-0.9	1.0
Central government (percent of GDP on a fiscal year basis) /3				
Revenue	32.1	33.8	32.1	27.0
Tax and nontax revenue	20.5	23.5	24.5	21.5
Grants	11.6	10.3	7.6	5.5
Expenditure and net lending	37.8	33.8	35.0	34.0
Overall balance (excluding grants)	-17.3	-10.3	-10.5	-12.5
Overall balance	-5.7	0.1	-2.9	-7.0
Foreign financing	2.0	0.9	1.3	1.6
Domestic financing	3.7	-0.9	1.7	5.6
Privatization	0.1	0.0	0.0	0.0
Discrepancy /4	-0.1	-0.1	-0.1	-0.2
Money and credit (change in percent of broad money at the beginning of the period, unless otherwise indicated)				
Money and quasi money	23.9	33.9	35.7	18.2
Net foreign assets	-15.5	13.3	-7.9	-1.2
Net domestic assets	39.5	20.6	43.6	19.5
Credit to the government	19.4	-9.2	19.7	11.0
Credit to the rest of the economy (percent change)	36.5	47.6	30.1	17.5
External sector (US$ millions, unless otherwise indicated)				
Exports (goods and services)	1,050.2	1,360.4	1,408.7	1,386.1
Imports (goods and services)	1,961.1	2,425.4	2,214.5	2,257.6
Usable gross official reserves	140.5	279.6	190.2	204.5
(months of imports)	0.7	1.5	1.0	1.0
(percent of reserve money)	40.7	73.4	42.5	52.8
Current account (percent of GDP)	-4.8	-1.3	-5.9	-4.3
Current account, excl. official transfers (percent of GDP)	-14.2	-17.0	-11.9	-15.7
Real effective exchange rate (percent change)	-8.2	-0.4	10.7	...
Overall balance (percent of GDP)	-2.0	2.2	-1.9	-0.5
Terms of trade (percent change)	7.7	3.0	-17.6	20.5
Debt stock and service (percent of GDP, unless otherwise indicated)				
External debt (public sector)	15.9	16.0	16.2	20.3
NPV of debt (percent of exports)	57.1	44.6	48.1	52.2
External debt service (percent of exports)	1.3	1.3	1.6	2.4
External debt service (percent of revenue excl. grants)	1.4	1.5	1.7	3.6
91-day treasury bill rate (end of period)	10.5	6.2	6.8	...

Sources: Malawian authorities and IMF staff estimates.

1/ Reflects substantial upward revisions to the historical national accounts data received in March 2011.

2/ The government saving—investment balance is calculated adding foreign grants to government savings above.
The private savings—investment balance is calculated adding the items in the balance of payments, net of foreign grants, to private savings above.

3/ For example, 2009 refers to fiscal year 2008/09, which is from July 1, 2008, to June 30, 2009.

4/ For 2011/12 fiscal year, reflects the outturns of the first three quarters and the projections for the fourth quarter.

INTERNATIONAL MONETARY FUND
EXTERNAL RELATIONS DEPARTMENT

Press Release No. 12/273
FOR IMMEDIATE RELEASE
July 23, 2012

International Monetary Fund
Washington, D.C. 20431 USA

IMF Executive Board Approves New US$ 156.2 Million Extended Credit Facility Arrangement for Malawi

The Executive Board of the International Monetary Fund (IMF) today approved a new three-year arrangement for Malawi under the Extended Credit Facility (ECF) in an amount equivalent to SDR 104.1 million (about US$ 156.2 million). The Board's decision will enable an immediate disbursement equivalent to SDR 13.02 million (about US$ 19.5 million). The Board also took note of the authorities' cancellation of the arrangement under the ECF which was approved on February 19, 2010 (See Press Release No. 10/52).

The government's medium-term economic program supported by the ECF arrangement is based on Malawi's second Growth and Development Strategy (MGDS II). The program is aimed at the achievement and maintenance of macroeconomic stability and implementation of policies and structural reforms to spur growth, diversify the economy and reduce poverty.

Following the Board's discussion of Malawi, Naoyuki Shinohara, Deputy Managing Director and Acting Chair, issued the following statement:

"Malawi's new administration moved swiftly to devalue the kwacha, adopt a flexible exchange rate regime and liberalize current account transactions to address the country's chronic balance of payment problems and improve the outlook for poverty reduction and growth.

"The new ECF arrangement provides support for the authorities' medium-term economic program based on Malawi's second Growth and Development Strategy (MGDS II). Specific objectives of the program include macroeconomic stability with low inflation, increasing international reserves to provide a buffer against external shocks, and reforms to improve the investment climate and promote sustained inclusive growth.

"The authorities have adopted a prudent fiscal stance in the 2012/13 budget. Higher donor support and a sizeable domestic revenue effort allow the government to increase total spending slightly without recourse to domestic borrowing. Tight control over non-priority spending will be needed to ensure that expenditures are aligned with the government's priorities, including scaled up spending on social protection programs to mitigate the impact of adjustment measures on the poor.

"In order to achieve fiscal sustainability, the program includes measures to enhance domestic revenue mobilization and public financial management reforms to strengthen the budget process and avoid the accumulation of arrears.

"Monetary policy will be geared to achieving price stability, while providing room for sufficient credit to the private sector and supporting a build-up of international reserves. Reforms will include measures to increase the operational independence of the RBM. The RBM will continue to strengthen its monitoring and surveillance of the financial system.

"The program supports the authorities' multifaceted approach to promoting growth, including measures to deepen the financial system and to enhance Malawi's international competitiveness by addressing key supply-side bottlenecks in energy and transport infrastructure," Mr. Shinohara added.

Annex

Recent economic developments

Malawi faced serious macroeconomic challenges in the last two years, including a severe shortage of foreign exchange, which translated into shortages of critical imports such as fuel, inputs for production, and medicines. As a result, real GDP growth slowed to 4.3 percent in 2011, from an average annual rate of 8.3 percent during 2007–10. Inflation has been on an upswing since early 2011, with the year-on-year headline rate reaching 20.1 percent in June 2012. The current account balance (including transfers) has fluctuated widely, driven mainly by aid flows and terms of trade.

The new administration formed in April 2012 moved swiftly to begin addressing the country's chronic balance of payments problems. Specific measures implemented include: devaluation of the exchange rate; adoption of a floating exchange rate regime; liberalization of the market. The adjustment measures are beginning to show positive results. Sales of tobacco through official channels have increased and the private sector's access to foreign exchange, including for fuel imports, has eased considerably

Program Summary

The specific objectives of the government's program include:

- Achievement and maintenance of a stable macroeconomic environment with low inflation.

- Increasing useable international reserves from the equivalent of about one month of imports at end-2012 to 3 months of imports by end-2015.

- Boosting real GDP growth from 4.3 percent in 2012 to at least 6½ percent per year from 2015.

- Scaling up social protection programs to mitigate the adverse impact of adjustment measures on the most vulnerable segments of the population.

Key elements of the strategy for achieving these objectives include:

- Fiscal policy geared to strengthening domestic revenue mobilization, keeping government spending within available resources (domestic revenues, grants, and highly concessional external loans) and in line with government priorities, and reducing domestic debt.

- Enhanced operational independence of the Reserve Bank of Malawi to enable it pursue the objective of achieving low inflation and building up international reserves from current very low levels.

- Structural reforms to deepen the financial system and make it more inclusive, and measures to enhance the investment climate and international competitiveness, including improving transport infrastructure and energy supply.

Statement by Mr. Moeketsi Majoro, Executive Director for Malawi

July 23, 2012

My Malawi authorities are appreciative of the Fund Executive Board and Management for their continued engagement and support. They are grateful for the productive policy dialogue and advice proffered by the Fund Mission during the 2012 Article IV consultation and negotiations for a new ECF arrangement. My authorities agree broadly with the staff report as it presents a generally balanced assessment of recent macroeconomic developments, and challenges and opportunities. It is in this regard that my authorities solicit the support and approval of the Executive Board for a new three-year ECF arrangement.

Since taking office in April, President Banda has taken bold decisions setting on a journey of economic recovery, initiated a number of reforms and made efforts to improve Malawi's diplomatic relations, which deteriorated sharply in the last few years, costing the country hundreds of millions of dollars in foreign aid exacerbating the already fragile economy. The efforts are paying off, as donors such as the United Kingdom and United States have restored their financial support, and others are in the process of doing so.

Recent Economic Developments

Malawi’s economy slowed considerably in 2011, after recording impressive growth rates which averaged 8 percent per year during the 2007–10 period. Real GDP grew at 4.3 percent in 2011 and is projected to grow at the same pace in 2012. The slowdown in growth was evident in manufacturing, transport, construction, retail and wholesale sectors which were adversely affected by foreign exchange shortages. Inflation has been rising since early 2011, with the year-on-year headline rate reaching 17.3 percent in May 2012 owing to rising import costs as more and more imports were being priced at the parallel market exchange rate in the run up to the May devaluation. Needless to say, the 49 percent devaluation and the subsequent pass-through to energy prices are affecting virtually all sectors of the economy. The authorities have taken a pro-active approach to dealing with the challenges facing the country. Their commitment to placing the economy on a steady path of recovery is demonstrated by their recent policy actions aimed at addressing critical foreign exchange shortages. The buildup of international reserves and the introduction of a more flexible exchange rate regime and liberalized foreign exchange market are important elements of their policy framework. They recognize that a responsive exchange rate is essential in aiding the economy to better respond to external shocks, similar to those experienced last year, while strengthening their ability to accumulate reserves and contribute to a high sustainable economic growth.

The immediate impacts of the policy interventions are being observed. The devaluation, the adoption of a floating exchange rate regime, and the lifting of several restrictions on foreign

exchange transactions have virtually eliminated the parallel market. Intervention in the foreign exchange market by the Reserve Bank of Malawi has helped to clear some of the backlog of external payments while tightening liquidity conditions in the domestic market. all the same time, support for the policy changes from the private sector has been positive: exporters hailed the boost to their incomes in Kwacha terms, importers are optimistic about the prospects for increased availability of foreign exchange, and commercial banks have recorded an increase in purchases of foreign exchange from their customers. While adjustments in exchange rates have had a positive impact on the balance of payments, the BoP remains under increasing risk and vulnerability, particularly in light of export growth subsiding with the economic slow-down in major trading partners like the EU.
In addition to the foreign exchange reforms, the Reserve Bank started tightening its monetary policy stance in April 2012 by removing excess liquidity using some of its holdings of treasury bills. After the devaluation, foreign exchange sales assisted in mopping up excess liquidity; Kwacha liquidity conditions tightened significantly. In May, the Bank raised its policy rate from 13 percent to 16 percent and increased it further to 21 percent on July 11, 2012. The adjustments are part of the measures aimed at strengthening monetary policy in the context of a liberalized exchange rate regime and are in line with the increasing trends in non-food inflation.

Policies to Address Imbalances

The authorities are keenly aware of the seriousness of the current macroeconomic imbalances manifested in rising inflation and low reserves as they are of the need to maintain their pro-growth policies and meet the long-term development challenges. They have thus continued to tackle the effect of the devaluation while simultaneously undertaking a broad range of concerted fiscal and monetary policies to address the vulnerabilities. They are committed to attaining and maintaining short term stability as they pursue long range structural transformation and reform. In this context they are committed to addressing inflationary pressures and building up of reserves as a matter of priority.

Fiscal Policy

The authorities have made a strong commitment to tighten fiscal policy by passing a budget for FY2012/13 that is in line with a deficit of 1.1 percent of GDP and consistent with their objective to reduce domestic borrowing, contain expenditure and strengthen revenue collection. The budget represents a sharp tightening compared to the 2011/12 budget with a deficit of 7.3 percent of GDP.

To this end, the authorities have eliminated the fuel subsidy program and are implementing a policy of monthly adjustment of pump prices. The domestic fuel price mechanism would build into the pump rice a small margin in order to repay the accrued negative balance in the Petroleum Stabilization Fund. In this regard, for the month of July 2012, MERA has revised downwards pump prices of three petroleum products by an average of about 7 percent, effective July 6, 2012, in line with the Automatic Pricing Mechanism (APM) following trends in the world petroleum products prices.

Taxes that are deemed to be punitive on businesses and regressive in nature would be removed, the range of items subject to VAT are being expanded and social protection programs such as FISP, public works, school feeding, and cash transfers have been increased to mitigate the effect of high prices on the poor in a more effective way while ensuring food security. The authorities have also resolved to rein in contingent liabilities and operational losses emanating from public enterprises and intensify monitoring. The authorities have indicated a willingness to cut lower priority expenditure, and in some instances even postpone investment spending if these do not compromise their commitment to the poor and achievement of the MDGs.

To ensure that risks to the budget are minimized, particularly in light of the large domestic arrears accumulation over the last few years, my authorities will tighten control over expenditure commitments and accelerate the implementation of the commitment module in the IFMIS. At the same time, the government has started clearing the accumulated domestic arrears and is looking into alternatives such as long-term Treasury bonds to settle some of these arrears.

My authorities will continue to pursue prudent fiscal policy aimed at safeguarding medium to long-term debt sustainability while, at the same time, creating the required fiscal space for investment in infrastructure and the social sectors. Their medium-term agenda will be defined by priorities set out in the MDGS II that emphasize increased budgetary allocations to the development of basic infrastructure and the efficient provision of social services, within a stable macroeconomic environment. In this regard, maintenance of prudent fiscal policies and consolidation of gains in macroeconomic stability will remain at the top of the authorities' economic agenda. Furthermore, fiscal policy will be aimed at containing public debt and related interest payments to sustainable levels.

Monetary and Exchange Rate Policies

To anchor inflationary expectations, monetary policy in 2012/13 will continue to be consistent with the level of economic activities so as to curb inflation and anchor inflation expectations. The policy stance will be supported by fiscal consolidation and reduced access by government to direct credit from the central bank. To this end my authorities intend to amend the RBM act to place a limit on total borrowing by the Government from RBM. Going forward, the Reserve Bank will continue to pursue prudent monetary policies to strengthen the recovery process and consolidate the gains achieved so far. Monetary policy will be geared towards accumulating foreign exchange reserves and creating an interest rate structure conducive to economic growth.

The central bank will continue to maintain the current floating exchange rate regime and intervene in the market only to preserve orderly market conditions. While mostly abstaining from the foreign exchange market, the RBM will, however, continue to carry out limited foreign exchange interventions to mop up liquidity generated by donor financed spending.

Debt Management Policy

My authorities concur with staff's assessment that Malawi remains at a moderate risk of debt distress. They are cognizant of the threat to debt sustainability in the event of shocks to the economy. It is in this regard that my authorities remain unwaveringly committed to the careful management of both external and domestic debt to enhance external stability and increase fiscal savings. They will source new borrowing from highly concessional windows and create the enabling environment to attract non-debt creating resource inflows. In addition, my authorities will continue conducting debt sustainability analysis on the basis of the Fund-Bank framework to ensure that all debt indicators fall and remain within their corresponding thresholds. Furthermore, to maintain the continued prudent management of public debt, debt management capacity is being enhanced and will carry on fiscal consolidation to slow down the growth in the domestic debt stock.

Conclusion

My authorities remain mindful of the importance of prudent fiscal and monetary policies to ward off inflationary pressures due to devaluation as well as fuel price adjustment and achieve and maintain macroeconomic stability. The authorities are committed to the implementation of their MDGS II which is succeeding in generating meaningful growth and reducing poverty. The growth strategy which focuses on developing agriculture and other productive sectors, building infrastructure, expanding the service sector and developing human resources has garnered solid support from Malawi's development partners. In this respect, the authorities will take into consideration and address the main risks identified in the staff advisory note and the recommendations to strengthen the implementation of the MDGS II as they prepare the first Annual Progress Report. These partners are, in addition to their support for the MDGS II, also ready to provide and in some instances have already extended additional assistance to help mitigate the impact of the devaluation.
My authorities recognize that the immediate priority for the coming months is to address the impact of the devaluation as well as fuel price adjustment and address the associated vulnerabilities. The new administration inherited an economy on the decline and the needed policy adjustments while unavoidable have exacerbated existing weaknesses and vulnerabilities. In this context and with bold actions taken so far and planned policy initiatives, the Malawi authorities request cancellation of the current ECF program and request access to Fund resources under an ECF in the amount of SDR 104.1 million (150 percent of quota) over a three-year period to meet in part the BOP financing needs and

to provide a buffer against shocks until the policy adjustments and reform measures take hold. They also take the opportunity to confirm that they are committed to implement the policies as outlined in the MEFP. The authorities strongly believe that the various reform programs meant to revamp economic and financial management will help re-establish macroeconomic stability and improve growth prospects. During this time, they expect to secure support from other development partners to meet their overall financing needs. They believe that their commitments, as outlined in the MEFP and highlighted above, are adequate to achieve program objectives, but are prepared to take further measures, as appropriate, for this purpose. To ensure a strong performance under an ECF-supported arrangement, they will maintain a close policy dialogue with the IMF and pursue technical assistance, as necessary, from the IMF and other development partners in support of the reform agenda. They expect the ECF-supported arrangement would put them in a better position to undertake the broad long-term reforms that they believe necessary to resume and sustain the robust growth in the face of complex and difficult challenges. They value the Fund's financial support as well as the advice and appreciate the encouragement the institution provides to other development partners in their engagement with Malawi