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Malawi: Letter of Intent and Memorandum of Economic and Financial Policies

July 18, 2005

The following item is a Letter of Intent of the government of Malawi, which describes the policies that Malawi intends to implement in the context of its request for financial support from the IMF. The document, which is the property of Malawi, is being made available on the IMF website by agreement with the member as a service to users of the [IMF](#) website.

July 18, 2005

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

Dear Mr. de Rato:

1. Malawi's previous PRGF arrangement expired in December 2004. Because of slippages in macroeconomic policy implementation, we requested a staff-monitored program (SMP) in September 2004 to help us restore sound financial policies, make progress with our structural reform program, and to establish a performance track record to enable us to move to a new PRGF arrangement. We believe that performance under the SMP has been strong. In addition, we have completed the two prior actions (Table 2) for moving to a PRGF arrangement and have dropped informal administrative restrictions on foreign exchange transactions.
2. On the basis of performance under the SMP, we now request a new PRGF arrangement with the Fund in the amount of SDR 38.17 million (55 percent of quota) and additional interim assistance under the enhanced HIPC initiative of SDR 4.628 million. In view of the continuing fragility of macroeconomic conditions in Malawi, we request that, during the first year of the program, it be monitored based on quarterly performance criteria with semi-annual reviews and disbursements as specified in table 3 of the MEFP. We anticipate the first review—based on performance as of end-September 2005—to take place in February 2006 and the second review—based on performance as of end-December 2005—in May 2006.
3. The attached memorandum of economic and financial policies (MEFP) describes Malawi's economic and financial policies for 2005/06 (July-June). The program is derived from the Malawi poverty reduction strategy paper (MPRSP), updated in the recent Annual Progress Report (APR), and builds on the policy measures under the staff monitored program. The MEFP also updates the macroeconomic framework in the MPRSP and APR. Successful implementation of policies supported by the PRGF arrangement will be essential to allow Malawi to reach the Completion Point under the enhanced HIPC Initiative and to help achieve the MDGs.
4. The government of Malawi believes that the policies set forth in the attached MEFP are adequate to achieve the objectives of its program, but it is prepared to implement additional steps that may become appropriate for this purpose. Malawi will consult with the IMF on the adoption of these measures, and in advance of revisions to the policies contained in the MEFP, in accordance with the IMF's policies on such consultation.

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

Sincerely yours,

/s/

Goodall Gondwe
Minister of Finance

/s/

Victor Mbewe
Governor
Reserve Bank of Malawi

Attachments

MALAWI

Memorandum of Economic and Financial Policies of the Government of Malawi

July 18, 2005

I. INTRODUCTION

1. In May 2004, the newly elected President Bingu wa Mutharika adopted a policy of zero tolerance for corruption. His insistence on the rule of law has set the stage for a new era of sound governance and prudent economic policies.

2. Our macroeconomic performance improved markedly since the new government took office. We have restored fiscal discipline and put an end to runaway borrowing, refined our plans to reduce poverty through growth and wealth creation, and have taken significant steps to address our most pressing health issues. In July 2004, we requested a Staff-Monitored Program (SMP) with the IMF as a means of demonstrating our commitment to the principles of sound economic policies. On the basis of strong performance against the September financial targets established in the SMP, our key development partners restarted their budget support programs.

3. With the continued strong performance through end-March 2005 and good prospects for the remainder of the financial year, we request a new Poverty Reduction and Growth Facility arrangement with the IMF, and additional interim assistance under the enhanced HIPC initiative. We note that key budget and monetary targets for end-March were observed, in large part because all government ministries stayed within their budget provisions for the first time in a number of years. We also implemented changes in our procedures aimed at improving expenditure management and we now publish our monthly fiscal data on the internet. We believe that this turnaround in budget management and efforts to keep the people of Malawi informed on their government's finances demonstrates our commitment to sound economic policies.

II. RECENT DEVELOPMENTS

4. Economic growth accelerated in 2004, in large part due to strong tobacco production. While a positive step, our economy will need to expand more quickly and provide more employment opportunities if we are to see significant reductions in our poverty rate. We will achieve this in coming years as our strategies and steadfast policy implementation take hold. The monetary expansion that was a legacy of excessive government borrowing during the last financial year added to price pressures. Our external current account deficit (including grants) widened during 2004, despite a large increase in tobacco production, as auction sales and processing were delayed for technical reasons. Imports increased as can be expected in a growing economy, by 5 percent, above the real

GDP growth. Higher world petroleum and fertilizer prices also added to our import bill. Nevertheless, we maintained our foreign reserve cover at 1.4 month of imports (of the following year), a figure that will need to be increased in the future.

5. Regrettably, food security has become a too frequent problem. A dry spell at the end of the 2004/05 crop season, which was already below normal, reduced our maize crop by an estimated 25 percent, resulting in an estimated need to import 250,000 tons of maize by government and the private sector—though this estimate may be revised. The incomes of many households have been cut or eliminated, making a sharp increase in humanitarian aid necessary. We are currently looking at ways to restore our food security, both in the near and medium-term horizons.

III. THE MEDIUM-TERM REFORM STRATEGY (BOX 1)

6. The Government of Malawi is committed to sound economic and financial policies. In the past, Malawi was considered a model of efficiency and good practice, and food security was less a concern. We must, and we can, restore good financial management and create the environment in which the private sector can lead in wealth creation and growth.

7. Our guiding principles in the economic area are domestic debt repayment, the rebuilding of public expenditure management and procurement, and a private sector orientation to our policies. Steadfast application of these principles will help us achieve the objectives set out in the Malawi Poverty Reduction Strategy in 2002.

A. Achieving the Millennium Development Goals (MDGs)—the Way Forward

8. We must move forward quickly if we are to make meaningful progress toward the MDGs. Reducing poverty and improving the lives of Malawians through access to better health care, education, and food security are at the core of our government. A strong, private sector led economy will be the basis of our progress.

9. We are currently reviewing our strategies outlined in the MPRSP to take into consideration the lessons learned in our two annual reviews and the vision for Malawi outlined by the president in his inaugural address. We have made significant progress in Pillar 1 (pro-poor growth) and are moving forward with Pillars 2-4:

- Our strategy for pro-poor growth (Pillar 1) was updated in the *Malawi Economic Growth Strategy* (MEGS) and places new emphasis on the private sector. This document, which was prepared jointly by the government and the private sector,

Box 1. Structural Reforms in the Medium Term

Our medium term agenda for structural reform is guided by the MPRS with the objective of achieving the MDGs in 2015. To help achieve these broader social objectives, the economic structural reform agenda will include initiatives in three core areas below. The details of these initiatives will be developed over the course of the PRGF arrangement.

A. Improve public governance

- Continued anti-corruption drive in support of zero tolerance for corruption in the public sector.
- Focus on improving governance in public expenditure management, especially public procurement.
- Initiatives on anti-money laundering and fraud protection.

B. Enhancing macroeconomic management

Fiscal

- Continued efforts to enhance public expenditure management, including the implementation of the Tanzanian model for IFMIS, and budget implementation.
- Build on the recent general review of tax policies and tax administration with the overall objective of making the tax system competitive and business friendly.
- Continued civil service reform in the areas of wages, pensions, structure and size.
- Eliminate the large stock of existing commercial arrears and forgo further arrears accumulation.

Monetary

- Review of the exchange rate regime with the objective of ensuring adequate exchange rate stability within an overall market determined environment.
- Move towards granting full independence to the Reserve Bank as part of a SADC wide initiative.
- Strengthen monetary policy instruments and promote money and exchange rate market development.

C. Improving economic efficiency in support of private sector led growth

Business environment

- Strengthen the business environment by introducing a commercial court, streamlining business licensing, and strengthening tax administration.
- Investment in public physical infrastructure—roads, railroads and bridges.
- Negotiations towards entering the COMESA Customs Union in 2007 and the SADC FTA in 2008.
- We are revising the privatization divestiture plan and will privatize or commercialize the remaining state enterprises to improve their efficiency and service—especially for power and other public utilities.

Agriculture

- Support agricultural growth by improving the functioning of food markets, including removing practices (through legislation) that restrict free competition in food and input markets.
- Initiatives to bolster non-tobacco exports.

strengthens our reliance on a sound macroeconomic environment to facilitate private sector growth. The government is also reducing the cost of doing business by building and improving roads, and ensuring adequate utilities are provided. Overall, we see growth and wealth creation, especially in rural areas, as a main force in poverty reduction.

- Strategies for human development, improved lives for the most vulnerable, and governance (Pillars 2-4) are currently being enhanced and will reflect our new poverty assessment that is nearing completion. We have already made significant progress in strengthening our health policies through the new health sector wide approach (SWAp) and have made great strides in the area of governance.
- We intend to hold further consultations on the new development strategy over the coming months and prepare a fully updated strategy by early 2006. We envisage significant changes to the objectives in the MPRSP that take into account the updated growth strategy, new resources in the health sector, measures to make our education system more efficient, and our emphasis on governance.

B. Good Governance

10. We are addressing governance issues in four areas.

- **Zero tolerance for corruption.** We remain committed to the principle of no tolerance for corruption. Public officials and civil servants serve in the public trust and must be held accountable for their actions.
- **Financial governance.** We will push ahead with improvements to public expenditure management, civil service wage and pension reforms, procurement, and budget implementation. We will continue to strengthen financial management in Malawi's remaining parastatals and complete the ongoing review of their governing boards.
- **Economic governance.** The government needs to become more business friendly by making our institutions more efficient, providing better service to our citizens and foreign investors, ensuring that the tax burden is fair, and by reducing subsidies.
- **Political governance.** We will hold local government elections in 2005/06 and general elections in 2009. A new parliament building will be constructed in the next few years to accommodate the consolidation of government in Lilongwe.

C. Macro Environment

11. A stable macroeconomic environment is essential for private sector business development, but also for the well-being of the population. Inflation hurts the poor more than others as they lack means of protecting savings and earnings from higher prices.

Predictable, market-determined interest and exchange rates allow businesses to plan investment strategies without fear of sharp swings in these key variables.

12. We are committed to addressing constraints to economic growth. As outlined in the Malawi Economic Growth Strategy, transport bottlenecks, including intra-regional, create frequent disruptions in the domestic markets and raise the cost of doing business. We will therefore seek to boost investment in our roads, railroads and bridges. Frequent disruptions of power supply is a major concern for our business community, and we are pursuing options to streamline the operations of ESCOM, including clearing arrears to and from other government entities. We are also pursuing regional power arrangements, including the interconnector to Cahorra Bassa hydroelectric plant in Mozambique.

13. Our public institutions do not always provide the best service to our people and businesses. We are therefore improving our court system, including the introduction of a commercial court, working to streamline business licensing, and strengthening tax administration. These steps will help us achieve an economic environment that is competitive within the region and globally.

14. The availability of financial services at reasonable costs will be critical to private sector growth. We will maintain a healthy banking system through close supervision and strive to bring down costs by providing needed infrastructure such as an efficient payments system. We will also continue to strengthen our monetary policy instruments and promote money and foreign exchange market development. Anti-money laundering and fraud protection are also key objectives.

15. Most Malawians live in rural areas and do not have access to credit. Several NGOs are addressing this problem through micro credit projects, but they do not have the adequate capital to reach all areas. Government has therefore decided to establish a rural credit scheme, the Malawi Rural Development Fund (MARDEF), using the Malawi Savings Bank and existing micro credit institutions (Box 2). We are proceeding with caution in view of high default rates in the past and are putting in place specific measures to achieve acceptable loan recovery rates.

16. Our overarching medium-term objective is to raise economic growth and reduce widespread poverty. We anticipate growth to be based on agriculture and agricultural processing because the majority of Malawians are farmers in rural areas. However, investment and investments in the mining, tourism, and construction sectors are expected to result in a growth rate of 6 percent by 2008. We intend to transform the economy from a predominantly consuming and importing to a predominantly producing and exporting one.

The monetary policy objective is stable prices and the monetary authorities will aim to lower inflation to 8 percent and below in the medium term. The external debt situation is expected to improve when the HIPC completion point is reached.

Box 2. Malawi Rural Development Fund (MARDEF)

The government established a microfinance institution, MARDEF, to increase credit in rural areas. The fund will target the production of goods and services by women and youth. Using the Malawi Savings Bank (MSB), a government-owned commercial bank, loans will be between MK 10,000 and MK 100,000. The fund will distribute loans across geographical districts.

The government deposited MK 1 billion in MSB to increase the bank's lending capacity. The additional capacity will be extended to MARDEF. Such an arrangement empowers the rural community to borrow from the financial institution. The government will not earn interest on these deposits. MSB will be encouraged to buy government securities to limit the initial monetary impact of the transfer. MSB will also earmark interest earned on government securities for future MARDEF administrative costs.

MARDEF will adjust the interest charged on loans to reflect operating costs. In addition to administrative costs, MARDEF will incur the following expenses: (i) MARDEF will contract with existing microfinance institutions to assist in preparing and appraising projects, in addition to assisting clients in the formation of groups; and, (ii) MARDEF will pay premiums to insure against default risk. On a monthly basis, the government will review the operations of MARDEF to ensure that the fund is commercially viable.

The government will consider increasing the initial deposit of MK 1 billion to MK 5 billion once MARDEF has demonstrated success, including loan repayment and acceptable operating costs; however, the availability of government funds and the monetary impact will need to be considered in any such decision.

Malawi: Medium Term Macroeconomic Projections, 2002/03-2008/9

	2002/03 Est.	2003/04 Est.	2004/05 Proj.	2005/06 Proj.	2006/07 Proj.	2007/08 Proj.	2008/09 Proj.
National income and prices							
GDP at constant factor prices	3.0	4.3	3.3	5.2	6.8	5.8	5.9
Nominal GDP (billions of kwacha)	160.1	188.3	222.8	264.0	307.8	351.0	398.8
GDP deflator	15.6	10.5	14.0	13.0	9.2	7.8	7.3
Consumer prices (end of period)	8.6	11.6	14.9	11.0	10.8	7.4	8.1
Central government (percent of GDP)							
Revenue (excluding grants)	20.0	22.7	24.8	24.6	24.4	24.2	24.0
Expenditure	38.3	42.8	42.6	44.7	40.6	39.2	38.4
Domestic interest payment	5.5	9.2	7.4	5.4	4.4	3.3	2.5
Underlying balance	-1.7	-0.9	1.1	1.4	1.9	1.3	0.9
Overall balance	-11.6	-7.8	-4.1	-1.3	-0.9	-0.7	-1.1
Net domestic debt	20.4	25.0	24.1	19.8	16.8	14.2	12.3
Money and credit (change in percent of beginning-of-year M2)							
Money and quasi money	24.1	35.6	19.8	18.5	17.2	15.3	14.9
Velocity	5.3	4.6	4.6	4.6	4.6	4.5	4.5
External sector (millions of U.S. dollars)							
Exports, f.o.b.	422.2	447.7	506.8	544.1	577.5	601.2	630.9
Imports, c.i.f.	-850.6	-770.1	-906.9	-983.8	-1,006.6	-1,036.3	-1,110.0
Useable gross official reserves	89.7	93.5	104.9	163.7	202.4	237.2	242.3

D. Fiscal policy

17. The overarching objective of fiscal policy must be domestic debt reduction. Borrowing over the past several years has pushed our net debt to more than one-quarter of GDP. Servicing costs peaked at over MK 17 billion in 2003/04, nearly one-half of our tax collections. The rise in debt fueled inflation, pushed interest rates up, and reduced resources available to the private sector for productive investment. In the near term we will halt the rise in the ratio of domestic debt to GDP (as was the case in 2004/05), and aim at a reduction in domestic debt to 15 percent of GDP or less by 2008. We feel strongly about this goal and have designated it as a medium-term program target.

18. We have completed a general review of tax policies and tax administration with the overall objective of making our system competitive and business friendly (see below). We

would also like to reduce our overall tax burden, but there is limited room at this point given our current level of spending and our determination to lower our debt burden.

19. Civil service wage and pension costs are high relative to our neighboring countries, given the current GDP figures which are subject to review, and at the same time we have vacancies in key areas such as health. We plan to address these problems in steps, the first of which was implementation of our long-planned civil service wage reform in October 2004. These are medium-term projects that will require time to design and implement. In the near term, we will cap our wage bill, excluding top up payments in the health area that are to be funded with donor assistance, below 8 percent of GDP. To underpin this effort, we are introducing a new payroll system and in the process will complete a census of all who receive a government paycheck.

20. We would like to rationalize and restructure government activities over the medium term to make room for private sector growth. The reduction in the number of government ministers and the President's move from Blantyre to Lilongwe in June 2004 have already begun to produce efficiency gains. Plans for the future are evolving and are outlined below in paragraphs 42 and 43.

21. We are grateful for the assistance being provided by our development partners. In 2004/05, grants account for about one-third of our resources. We will also try to make use of new resource commitments that are currently being discussed by the international community and increase our use of grants while reducing concessional loans. This, and other support, will help us achieve key MDG benchmarks.

22. The priorities set out in the MPRSP and recent update documents will be pursued, subject to our financing constraint. Thus, in the medium term we anticipate dedicating more resources to public infrastructure to strengthen private sector led growth, especially in the rural areas. Education and health are basic rights, and we will ensure that the most vulnerable have access to them. Moreover, an effective education system will help us improve competitiveness and reach our growth objective. We believe that decentralization of the administrative and planning responsibilities will further this effort.

23. We expect that our external and domestic debt service can be lowered to provide more room for priority programs. External debt interest payments are currently around 1½ percent of GDP and will fall somewhat when we reach the HIPC completion point sometime next year and we can benefit from debt cancellation. Our domestic debt service has already begun to come down, but at over 7 percent of GDP in 2004/05, it is far too high and we expect this to fall to near 5 percent of GDP in 2005/06. Our aim is to allow interest rates to come down as our track record of sound fiscal policies is extended and confidence improves. Over time, we will aim to lengthen the maturity structure of our debt stock, making our budget more stable and predictable. We will also look into ways that our development partners could assist with domestic debt reduction.

24. Domestic arrears, or past-due payments for goods and services, are another form of debt. This type of borrowing is unfair to suppliers who become unwilling creditors and to the people of Malawi who must repay these debts that evolved in a nontransparent way. Efforts to address this problem in recent years have proved unsuccessful and the new government has designed and is implementing a strategy to solve this problem once and for all (para. 44).

25. Our strategy to strengthen public expenditure management follows a two-track approach. In the near term, we are restoring the management systems that worked well in the past. This effort includes accurate monthly expenditure returns, respect for funding ceilings, and the application of approved accounting standards. It also involves implementation of our new Public Finance and Auditing Acts. Specific actions are outlined below. Over the next few years, we will be implementing an integrated financial management system (IFMIS) that will anchor our financial management over the medium term. Past efforts towards an IFMIS have not been satisfactory, and we have decided to adopt the system now used in Tanzania.

E. Monetary and Exchange Policy

26. The objective of monetary policy is to bring inflation to 5-8 percent range over the medium term. In this range, inflation would be less likely to distort savings and investment decisions. The RBM will continue to rely on the broad money stock (M2) as the nominal anchor to control inflation. We will use a combination of open market-type operations and foreign exchange sales to influence liquidity conditions. Achieving lower inflation, however, will critically depend on the government's deficit and strictly limiting its borrowing from the RBM.

27. Our medium-term exchange rate objective is to have the kwacha fully market determined and build foreign exchange reserves, but at the same time recognize the importance to businesses of a predictable currency value. We will continue to smooth the exchange rate for seasonal fluctuations, but refrain from attempting to influence its underlying value. We recognize that the most important ingredient for exchange rate stability is sound economic policies, especially prudent fiscal policy. We will strive to increase our level of official international reserves to above three months of import cover, but recognize that current projections show that we may fall short of this target.

28. We intend to move forward toward an independent central bank as part of a SADC-wide initiative. A SADC committee is now preparing model draft legislation, which we will review and adopt if it is appropriate for Malawi. A legally independent RBM could help bolster confidence by lessening the risk of political interference in monetary policy decisions. In preparation, we will review our policy setting and operating procedures at the RBM.

F. External Policies

29. Malawi's reliance on tobacco as the main export and high dependence on imports leave us vulnerable to external shocks and local weather conditions. To address these problems we have included in our growth strategy initiatives to bolster non-tobacco exports. Import growth is expected to moderate, but we will continue to depend on our partners for needed commodities (petroleum) and manufactured goods. In the medium term, we expect to continue to depend on grants and foreign concessional loans.

30. Erosion of trade preferences is a serious concern. The pending elimination of the EU sugar regime in 2008 could impact one of our larger industries and our second largest export. Malawi is a member of the LDC Sugar Working Group that is proposing an extension of the adjustment period until 2019. Textile and clothing exports are of lesser importance in our macro economy, but we will monitor closely the expiry of the global quota restrictions on textiles and clothing (December 2004). We will still have a tariff preference under the African Growth and Opportunity Act (AGOA), but it remains to be seen if this will provide a significant competitive advantage.

31. We remain committed to maintain a liberal trade regime. Malawi has eliminated all quantitative restrictions on imports, except for cement from Zimbabwe, and a revised Trade Agreement with Zimbabwe was signed in March 2005. In the context of our negotiations for Common Market for Eastern and Southern Africa (COMESA) Customs Union (2007) and Southern African Development Community Free Trade Area (2008), we will continue to favor lower tariff scenarios. In addition, we will undertake a study on the impact of COMESA Common External Tariff (CET) for the envisaged Customs Union on our industry competitiveness, revenue, and employment.

G. Food Security

32. The objective of our food security policy is to ensure that all Malawians have sufficient food for a healthy and active life. Unfortunately, our dependency on rain fed agriculture, changing weather patterns, growing population, and increased incidence of HIV/AIDS has increased Malawi's vulnerability to food insecurity.

33. Our medium-term agriculture policies will be based on market principles. To this end, the government will continue to improve the functioning of markets, including removing practices (through legislation) that restrict free competition in produce, food and input markets. Our strategy is to improve the availability of fertilizer and other inputs at reasonable market prices at the proper time and to ensure farmers have easy access to markets for their products. We are also looking at ways to promote irrigation involving the private sector and local communities, better agricultural research and extension services, and transport and other infrastructure.

H. State Enterprises

34. We have revised our privatization divestiture plan. We believe that privatization of some of our remaining state enterprises will bolster their efficiency, improve service, and potentially provide revenue to the government. After a temporary delay to reassure Malawians that the sale of state enterprises has many advantages and that resources will not be wasted, we are ready to proceed with this program. For the others, we are considering alternatives, including public-private partnerships and mergers. Some parastatals will need to be closed, while for others where social concerns are important, commercialization may be the best option.

35. We are making progress in commercializing parts of ADMARC and restructuring it so as to enhance its impact on small-scale agricultural production. We will look at cost efficiencies in the delivery of its services and rationalize its operations.

IV. THE ECONOMIC PROGRAM FOR FY2005/06

36. Budget discipline and sound monetary policy will continue to be our focus in FY2005/06. We will also address structural issues, in particular public expenditure management, central bank operations, and tax reform. We will work on civil service wage and pension reform, clearing of domestic arrears, and privatization and commercialization of our state owned enterprises.

A. Fiscal Policy

37. Decisions on the budget for 2005/06 have been guided by the imperative of lowering our domestic debt burden. We have balanced our pressing social needs, the importance of clearing domestic arrears, and our strategy of investing in infrastructure for our future. We have also provided for food security by allocating funds for maize purchases and a revamped fertilizer program (Box 3). Our budget reflects domestic debt repayment of MK 1.8 billion.

Box 3. Fertilizer Scheme for FY2005/06

The government will again subsidize fertilizer for maize production in the 2005/06 agricultural season. Due to difficulties in implementing the previous TIPs program, we have decided to implement a different scheme. The government will subsidize two fertilizers used in maize production: Urea and NPK. This will target smallholders since they produce most of Malawi's maize. In addition, a labor intensive Public Works Programme (PWP) will economically empower the rural community to purchase maize and fertilizer. The program also includes a small amount for seed. A subsidy on fertilizer used for burley tobacco will also be introduced to ease the adjustment to sharply higher world fertilizer prices. Since most burley tobacco is grown by small holders, the subsidy is mostly self-targeting. The program will be monitored closely.

We will contract with the private sector to import and distribute 100,000 tons of maize fertilizer and 37,000 tons of burley fertilizer. The government will provide a subsidy for maize fertilizer of about MK 1900 per 50 kg bag, that will yield a target price to farmers of about MK1,000 per bag. For burley, the subsidy will average about MK 1200 per 50 kg bag, yielding a target price to farmers of about MK 1400 per bag. This arrangement will assist Malawi's farmers, many of whom suffered crop and income losses this year, and will cap the cost to government at MK4.8 billion, the larger part of which (MK 3.8 billion) will be used to subsidize maize fertilizer. At most two private firms will be used to avoid the problems in managing multiple contracts encountered in last year's TIP. The contract will be awarded based on a publicly-advertised competitive tenure process.

38. Our resource envelope is made up of tax and other revenues from Malawi and support from our development partners in the form of grants and low-interest loans. We have just concluded a general review of our taxes, but in view of our financial situation, any tax reforms must be revenue neutral, especially in the short run. Budget support from our development partners is estimated at about US\$141 million. We anticipate that several key donors will make their disbursements early in our financial year as a means of making the availability of funds more predictable.

39. Spending on development projects consists of two parts, that financed by the government of Malawi and that provided through donor assistance. The total amount for investment in our future will be about 13 percent of GDP. We have consolidated investment programs from across ministries into the Public Sector Investment Program, which prioritizes projects according to the objectives in the MEGS and MPRSP. For 2005/06, we expect to shift some rural road maintenance and construction projects into the July-October period as a means of augmenting incomes of farming households who have suffered drought-related losses. This would enable them to purchase maize for the lean season and fertilizer for next year's crop.

40. Our recurrent spending budget will be very tight and we will seek efficiencies wherever possible. In general, ministries' budgets (excluding wages, maize purchases, and funding through the health SWAp) will be increased by less than 10 percent. We have also incorporated some rebalancing across ministries to provide more resources for pro poor spending and other priorities. In addition, the donor-financed health SWAp will add about MK 4.5 billion, and will leverage our health budget by providing medication, including for malaria and HIV/AIDS, equipment and hospital construction. It will also give a salary top up for health professionals who are in demand at home and in other countries.

41. The adverse weather conditions in February–March 2005 need to be addressed promptly (Box 4). Our objective is to ensure that food is available for all Malawians. We must, however, guarantee that the mistakes made in maize operations during 2001/02 are not repeated. These were very costly to the budget and hurt the next year's harvest by depressing local prices. Thus, we are focusing our efforts on humanitarian assistance and will distribute as much as 150,000 tons of maize to those in the greatest need. We will also purchase maize to act as a buffer stock that would be sold at tender to private distributors at the cost recovery price. This latter effort will help avoid shortages and price spikes that could develop because of the nearly two-month lead time needed to bring maize into Malawi from South Africa or ocean ports. Any unsold maize at the end of the season would be used to replenish the SGR.

42. Cost savings from the following measures have been included in the 2005/06 budget:

Government reorganization. The move of the President's residence to Lilongwe and the reduction in the number of ministries when the new government took office has produced savings in a number of areas including travel and office rents. Our current expenditure reporting system makes it difficult to estimate the savings in different categories precisely, but the gains have helped us limit increases in ORT in 2005/06. We are analyzing the impact of these measures to help guide us in the future.

- **Senior staff levels.** The reduction in the number of ministries in June 2004 has allowed us to cut the number of senior staff from over 500 to approximately 370 as of April 2005. We are now reviewing the structure of the remaining ministries and anticipate some consolidation of departments in the ministries that have been combined.
- **Construction.** We have tightened monitoring procedures for school and road construction and now require confirmation of completed projects before payments are made. This has already eliminated some fraudulent claims. We will strengthen these controls, through the implementation of the Procurement Act, the Public Audit Act and the Public Financial Management Act.

Box 4. Food security in Malawi

Due to adverse weather conditions, the 2004/05 maize harvest is expected to be 25 percent less than in 2003/04. The crop is expected to reach 1.3 million metric tons, against a normal harvest of 1.8 million tons. However, estimates are tentative and there is the risk that the shortfall could be larger. In this event, donors have signaled their readiness to provide additional resources should the need arise.

The 2005/06 budget framework includes a package to provide adequate food security for all Malawians. The design of the package takes into consideration the need to ensure appropriate incentives for private sector imports this year and for production in the following crop season. The main elements of the package (whose costs are summarized in the table below) include:

Malawi: Government Food Security Transactions, FY05/06

Millions of kwacha

Total maize transactions	-797
Humanitarian	-1,175
EU/DFID grants	3,461
Purchase	-3,835
Distribution	-801
Commercial	378
Sale receipts	1,344
Purchase	-967
Maize stocks, '000 mt, eop	0
Carry over	47
Purchases	153
Distributions	200

Humanitarian: 150,000 tons of maize will be distributed through the Strategic Grain Reserve (SGR) to the most vulnerable without charge. This includes 27,000 tons in existing stocks. Two thirds of the purchase cost for the remaining 123,000 tons will be financed by grants from the EU and DFID and in kind by WFP. A further 70,000 tons may be funded by other donors. The cost of distribution will be borne by the government. These estimates do not include the costs of replenishing the SGR for 2006/07.

Commercial: 50,000 tons of maize will be distributed commercially. Existing stocks will be distributed and sold through Admarc at 17 kwacha per kg. We will also import 30,000 tons to be sold to commercial distributors at a cost recovery price.

Budget cost: The total fiscal cost of the government's food security transactions for FY05/06 is estimated to be 797 million kwacha.

- **Foreign missions.** We plan to close four of 17 foreign missions in early 2005/06. We estimate that this will save approximately MK 300 million per year, but these savings will be reallocated to other missions to make them more effective and reduce the chances of arrears accumulation.

43. Our overall budget savings strategy is to use the power of local decision making, accountability, and our new budget discipline to hold non priority costs to a minimum. The effectiveness of this approach was shown in 2004/05 when we virtually eliminated budget overruns. We are also pursuing a number of government-wide initiatives including:

- **Travel.** Past initiatives to reduce travel have not generated the expected results, in part because of weak enforcement of existing rules. We are reviewing our travel policy and its implementation with a goal of fairly reimbursing civil servants and eliminating over-reimbursements. As a start, we have put in place a travel policy for ministers that sets reimbursement levels, specifies authorization procedures, and clarifies reporting and record keeping requirements. We will have a new policy for all staff in place by end-March 2006 that emphasizes accountability.
- **Vehicles.** The Ministry of Finance will instruct all ministries to produce an inventory of their vehicles and include this, along with vehicle purchases and other changes to the inventory, in their monthly expenditure returns. We will undertake a study of our vehicle expenditures as a basis for introducing cost saving measures in the 2006/07 budget. We do not intend to impose a prohibition on vehicle purchases, because, for example, some of these may be required for health care delivery in rural areas.
- **Utilities.** We are aware that management of telephone, electric, and water use has deteriorated in recent years and will begin to introduce incentive mechanisms at the ministry level for savings in these areas. For example, new meters are being installed to make departments responsible for their electric use. Many of these are prepaid meters. We are considering a similar approach to control telephone use.

44. Our strategy for arrears will involve several steps that are outlined in the paper submitted to Cabinet for approval.

- **Identify all domestic arrears.** Under the direction of the Accountant General, we have developed a list of arrears as of end-June 2004, including MK 8.5 billion incurred by ministries and MK 2.2 billion stemming from court cases and other claims. This goes beyond the audit conducted in 2004 that covered only a sample of ministries and was hampered by data collection problems. Ministries will be expected to resolve any delayed payments since end-June 2004 through their own budgets.

- **Verify all claims.** A claim on government will be considered valid only if backed up by a contract signed by a government officer or invoice, and proof that the goods or services were provided.
- **Centralize arrears processing.** Ministries have sent claims, with supporting documents, to a technical team appointed by the Minister of Finance under the Accountant General.
- **Prioritization.** The special team will organize the certified claims according to a priority ranking established by the Cabinet. Special attention will be given to claims with penalty clauses, individuals (pension or salary arrears), and small firms.
- **Settlement.** The means of settling our domestic arrears will depend on the amount of certified arrears and any offsetting factors such as unpaid taxes. As the remaining arrears exceed the 2005/06 budget provision of MK 2 billion, we have developed a settlement plan consistent with available resources. Clearance of some of these arrears could involve payment in government securities and be phased over time.
- **New arrears.** Efforts are being made to avoid new arrears by improving financial management and adhering to the existing commitment control system. To the extent that arrears do emerge, for example through administrative delays, they will be cleared quickly using the spending ministry's resources. Our new program of monitoring each ministry's accounting departments on a regular basis should reduce the chances of unfunded commitments that can lead to arrears or payment delays.

Tax policy

45. We have completed a general review of our tax policies and tax administration which has benefited from the US Treasury and the Fiscal Affaires Department of the IMF. The main objective of the review is to ensure that we have the most appropriate tax policy for our country and that it provides a competitive environment that is conducive to private sector development. Any resulting changes to tax system, however, must be revenue neutral.

46. We will revise several tax rates during the 2005/06 financial year. For personal income taxes, we will raise the threshold of tax brackets in order to reduce the tax burden on very low paid workers and begin to reduce the top most tax rate in order to attract key professionals to Malawi. We will look at increasing fees in line with inflation and introduce changes to the VAT system to make Malawi more competitive.

47. The Malawi Revenue Authority (MRA) will be implementing the key findings of our tax review. We will be looking at the overall organization of the MRA, ways to improve staff training, and computerization of its operations. Our objective is to provide good service to our private sector, for example by refunding VAT claims promptly and enforcing tax regulations consistently. As an important first step, we have decided to

classify VAT refunds as statutory expenditures and eliminate the practice of granting VAT exemptions on government purchases.

Civil service wage and pension reforms

48. In October 2004, we introduced a new civil service pay policy that aimed to improve transparency, strengthen the incentive structure, and make pay policies consistent across government. This is a medium-term project that will be implemented in phases.

49. During 2005/06, we will begin to address problems that came up during implementation of this complex reform, while protecting some of the key achievements including:

- **Consolidation of wages and allowances.** Under the old system, some civil servants received a large part of their compensation in the form of allowances. These were untaxed, non transparent, and in some cases paid outside of the wage bill. The October 2004 reforms addressed these problems by putting all compensation into wages and salaries. It also unified the pay scale across government.
- **Incentives.** We have increased compensation of the middle grades of government officers to attract and hold the highest quality staff possible. Some further adjustments will be needed over the next few years as salaries are not yet on par with neighboring countries. These will need to be phased in as our financial situation permits.
- **Professionals.** We are currently reviewing salaries paid to medical and other professional staff. We may need to raise compensation in some of these areas and will base decisions on our ability to attract and retain those with specialized training.

50. The 2005/06 wage bill will be capped at MK 20 billion (domestically financed). To fit within this ceiling and also correct some of the anomalies introduced with the 2004 reform, a general salary adjustment will need to be small. However, civil service take home pay will benefit from the change in tax brackets mentioned above. The pay adjustment will be implemented in October 2005, one year after the wage reform went into effect.

51. We are also working on technical improvements to our pay system. During the year, we will be implementing a new computerized employment system that will help us better manage payroll records and match those being paid with authorized staffing levels. As part of this process we have already started a census of all civil servants. We will also review all salary adjustments at each grade level prior to implementation (see structural benchmark table).

52. Pension reform is an integral part of our overall civil service strategy and involves two steps. In the first, we revised the formula used to link an individual's pension benefits to his income because, under the existing contributory pension system, our new

consolidated pay structure would have resulted in an unfunded, ballooning in pension outlays. The revised formula bases pensions and gratuities on a five-year average of wages, rather than the individual's ending wage. We have also raised the normal retirement age to 60 years. For the second stage, we intent to move toward a funded, contributed system and will continue to investigate the costs and benefits of our options.

Supporting structural measures

53. During 2005/06 we will continue strengthening public expenditure management as a means of institutionalizing our success in expenditure control during 2004/05. Key measures to strengthen the current system include:

- **Supervision visits.** Our program of monthly visits to spending ministries has proved successful and will be continued. The visits have uncovered capacity limitations in accounting departments at the ministries and we will begin a new series of training sessions. In particular, we will provide guidance on bank and cash book reconciliation.
- **Monitoring government payments.** The new electronic CCA system at the RBM is providing new information on funding balances as well as providing a mechanism to end unapproved (unfunded) spending. We are pushing ahead with measures to make better use of this valuable data, in particular by reconciling holding account balances.
- **End-year closing.** Better end-year closing procedures will help us monitor budget execution by correctly placing expenditures in the correct budget year. We will restart the practice that would cut off contracts under the 2004/05 budget in early June to reduce the problem of check float into the next budget year. We will also require spending ministries to provide information on all checks written in [May and] June to the Accountant General so that these can be flagged in the government payment system and assigned to the correct budget year. We anticipate that these steps will improve our records and impose further controls on end-year spending. We will issue government circulars alerting all ministries to these requirements.
- **Account reconciliation.** We will also work with ministries to improve their account reconciliation so that data from the CCA system is more reliable.
- **Monthly funding.** During 2004/05 we implemented a new funding policy for ORT current spending. As a first step, we established three-month funding levels for each vote consistent with the approved annual budget and seasonal patterns. We then released monthly funding, but only to the extent that they would be covered by available resources, that is tax collections in the previous month less statutory expenditures. We will also continue to withhold funding when a ministry does not submit its expenditure return report for the previous month on time. These

procedures were main factors behind the successful turnaround in our budget execution.

- **Financial control.** In the coming fiscal year, we will hold all financial controlling officers—typically principal secretaries—responsible for financial management in their ministries. We will do so through the Public Finance Management Act that includes provisions for disciplining controlling officers who spend or commit funds in excess of their approved budget limits.

54. As a means of moving ahead with medium-term expenditure management reforms, we have decided to adopt the public expenditure management system that has proved so successful in Tanzania. This will include their IFMIS system and a shift to a central payment system. We are thankful to the Government of Tanzania for the officers who have been placed at our disposal to help implement the system.

55. We have made significant progress with fiscal transparency and reporting. We submitted the 2003/04 government accounts to parliament in June 2005, somewhat behind schedule but earlier than in past years. We will continue to implement the reporting requirements as set out in the Public Financial Management Act and attaching priority to those aspects related to the responsibilities of financial officers.

56. Improving our budget process will be a key part of restoring sound financial practices. For the 2005/06 budget, we refined our development plans based on the Public Sector Investment Plan and worked to integrate development projects spearheaded by our development partners. In the coming year, we will strengthen our medium-term planning, for example through the medium-term expenditure framework. We will also work to improve our ministry funding by explicitly identifying spending from special accounts such as the health SWAp.

57. Domestic petroleum prices were adjusted periodically during 2004/05 in response to world oil market developments, including a price increase in June 2005. As a result, the petroleum stabilization fund remained in surplus during most of 2004/05. In the period ahead, we will adjust pump prices using our established formula and rules. We are also looking into petroleum pricing on a regional level and may adopt best practices in our neighboring countries.

B. Monetary and Exchange Rate Policies

58. The objective of monetary policy during 2005/06 will be to reduce inflationary pressures. Inflation began to rise in 2004, reflecting the shortage of maize and the liquidity injection caused by high government borrowing in 2003/04. Liquidity management improved significantly in the second half of 2004, largely reflecting the containment of domestic borrowing by government. Our main instrument will be the purchase and sale of treasury bills. Sales of foreign exchange to mop up liquidity will be more limited than in

2004 because of our decision to withdraw from direct purchases of foreign exchange from smallholder tobacco farmers.

59. In the period ahead, the exchange value of the kwacha will be guided by market conditions, with some intervention to smooth pressures related to the tobacco season and inflows of donor assistance, but we will refrain from using administrative restrictions on the foreign exchange market over the program period. For our operating procedures during and after the tobacco marketing season, we will smooth fluctuations around the exchange rate offered by commercial banks.

Supporting structural measures

60. We are committed to improving banking supervision operations as a step toward enhancing financial intermediation. In the short term, this will require updating directives that govern the supply of critical information to the RBM. As a first step, we plan to complete an initial analysis of commercial bank balance sheets using asset classification consistent with international standards. In the medium-term, the RBM will aim to both increase resources to the department and implement a general restructuring.

61. We will aim to reduce our dependence on rule-based instruments for monetary policy. First, we remain committed to a lower liquidity reserve requirement (LRR) as this would reduce the operating costs of Malawi's commercial banks and make room for them to both reduce lending rates and increase deposit rates. Second, we will aim to reduce or eliminate the foreign currency surrender requirement. We will review these reforms in due course.

62. A precondition for the above-mentioned reforms is a well functioning money market, where monetary policy can be implemented using market-based instruments. Towards this goal, we will strengthen coordination between the Ministry of Finance and the RBM to improve liquidity forecasting. This will allow the RBM to announce accurately the amounts that will be offered in treasury bill auctions.

V. THE PRSP PROGRESS REPORT AND HIPC TRIGGERS

63. We will continue to implement the measures agreed at the time of the decision point to reach the HIPC completion point in 2006. The MRSP was finalized in 2002, with the assistance of our development partners. In September 2003 we finalized the first annual performance report (APR). Moreover, the second APR was completed and sent to the IMF and World Bank Executive Boards in June 2005. It evaluates past performance and presents our medium-term macroeconomic framework for the next three years and discusses policies to be implemented from 2005 onward. It also identifies areas in which the original PRS was weak. The policies included in the MEGS are basic to the implementation of the PRSP strategy by ensuring that growth takes place to attain poverty reduction.

64. We are aware that a successful implementation of the PRS will require strengthening our capacity to monitor poverty and evaluate the effect of the policies implemented. In this regard, we will be completing the analysis of the 2004/05 Integrated Household Survey in the second half of 2005 and formulate a new PRS in time for the 2006/07 budget. A comprehensive review of MPRS will also be completed.

VI. TECHNICAL ASSISTANCE AND DATA ISSUES

65. Malawi will need technical assistance to support program implementation in areas: public expenditure management, tax reform, monetary operations, and national accounts. The government will formally request assistance with financial management, monetary operations, the book entry system at the RBM, and measurement of the national accounts on a priority basis.

VII. PROGRAM MONITORING

66. The PRGF-supported program will be monitored quarterly, based on the quantitative and structural measures indicated in tables 1 and 2. These targets are defined in the attached Technical Memorandum of Understanding (TMU).

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

	Criteria	Jun-05 Proj.	End-Sep. Target	End-Dec. Target	End-Mar. Target	End-Jun. Target
(Cumulative Flows from June 30, 2005)						
I. Monetary Targets (In millions of Malawi kwacha)						
4. Floor on net foreign assets of the monetary authorities (In millions of U.S. dollars) 2/	PC	33.0	36.1	25.7	9.0	49.1
5. Ceiling on net domestic assets of the monetary authorities 2/	PC	15,520	-3,133	-1,839	-2,786	-2,608
6. Ceiling on reserve money	IT	19,580	1,314	1,324	-1,684	3,432
II. Fiscal Targets (In millions of Malawi kwacha)						
1. Ceiling on central government's net domestic borrowing 2/ 3/	PC	53,710	-783	-599	-2,398	-1,391
2. Ceiling on central government wages and salaries 3/	PC	...	4,848	9,934	15,218	20,730
3. Ceiling on central government discretionary expenditures 3/	IT	...	15,123	29,424	39,718	49,669
III. External Targets (In millions of U.S. dollars)						
7. Ceiling on the accumulation of external payments arrears 4/	PC	...	0.0	0.0	0.0	0.0
8. Ceiling on new nonconcessional external debt with a maturity over one year 4/	PC	...	0.0	0.0	0.0	0.0
9. Ceiling on new nonconcessional external debt with a maturity of less than one year 4/	PC	...	0.0	0.0	0.0	0.0

PC - performance criteria; IT - indicative target

1/ Targets are defined in the technical memorandum of understanding (TMU).

2/ Targets are subject to an adjuster for BOP support.

3/ Targets are subject to an adjuster for donor-funded health expenditures.

4/ Evaluated on a continuous basis.

Table 2. Malawi: Proposed Prior Actions, Structural Performance Criteria, and Benchmarks,
July 2005-March 2006

Number	Description	Date
Prior Actions		
1	Parliament approval of 2005/06 budget in line with macroeconomic framework specified in the TMU (para. 28).	
2	Implement adjustment formula to the current pension system (TMU, para. 29).	
Performance Criteria		
1	Cabinet approval of arrears policy. Begin implementation (TMU, para. 30).	End-Sep. 2005
2	Compile new database of all public employees on the basis of DHRMD data forms (TMU, para. 31).	End-Sep. 2005
3	Make budget ceilings module in payment system fully operational (TMU, para. 32).	End-Dec. 2005
4	Develop and implement new travel policy, which includes mechanisms for monitoring adherence (TMU, para. 33).	End-Mar. 2006
Structural Benchmarks		
1	Develop detailed schedule of wage adjustments by grade for 2005/06.	End-Sep. 2005
2	Publish monthly fiscal reports with one month lag (TMU, para. 34).	End-Dec. 2005
3	Prepare quarterly reports (with one month lag) on status of arrears.	End-Dec. 2005
4	Strengthen cash management and expenditure monitoring procedures by preparing reports as indicated in the TMU (para. 35).	End-Mar. 2006
5	Complete impact analysis of tighter credit quality classifications on commercial bank balance sheets (TMU, para. 36).	End-Mar. 2006

Table 3: Malawi: Schedule of Disbursements During the First Year Program under the Proposed PRGF Arrangement
(In million of SDRs)

Amount	Date	Conditions Necessary for Disbursement
5.4190	Aug-05	Executive Board approval of three-year PRGF arrangement
4.9245	Feb-06	Completion of 1st review and observance of end-Sep. 2005 Performance Criteria
4.9245	May-06	Completion of 2st review and observance of end-Dec. 2005 PCs

Malawi—Technical Memorandum of Understanding

1. This memorandum sets out the definitions for the quantitative and structural targets under which Malawi's performance under the Poverty Reduction and Growth Facility arrangement will be assessed. Monitoring procedures and reporting requirements are also specified.
2. **Coverage:** The central government includes all units of government that exercise authority over the entire economic territory. However, in contrast to the *System of National Accounts 1993 (SNA 1993)* and *Government Finance Statistics Manual 2001 (GFSM 2001)* standards, nonprofit institutions that are controlled and financed by the central government are excluded for the purposes of this memorandum. The accounts of the monetary authorities include those of the Reserve Bank of Malawi (RBM) and the central government's holdings of international reserves. Monetary aggregates under the program are based on the four-bank monetary survey.

I. QUANTITATIVE PERFORMANCE CRITERIA

A. Floor on Net Foreign Assets of the Monetary Authorities

3. **Definition of net foreign assets (NFA) of the monetary authorities:** NFA of the monetary authorities are defined as the difference between gross foreign assets and liabilities. NFA will be valued in U.S. dollars, and monetary gold will be valued at the fixed RBM accounting rate. The counterpart entry to the central government's international reserve assets will be classified as a negative entry under "net credit to central government".
4. **Gross foreign assets** of the monetary authorities are defined as the sum of the following: (1) monetary gold holdings of the RBM; (2) holdings of SDRs; (3) the reserve position in the IMF; (4) central government (treasury) holdings with crown agents; and, (5) holdings of convertible, liquid, and unpledged claims on non-residents, such as deposits abroad, and foreign securities. Excluded are any foreign currency claims on residents, capital subscriptions in international institutions, assets in nonconvertible currencies, and gross reserves that are in any way encumbered or pledged, including, but not limited to, reserve assets used as collateral or guarantee for third-party external liabilities.
5. **Gross foreign liabilities** of the monetary authorities are defined as the sum of the following: (1) outstanding liabilities of the RBM to the IMF; and, (2) all short-term foreign currency liabilities of the RBM to non-residents with an original maturity of up to, and including, one year.
6. **Adjustment clause on net foreign assets—balance of payments support:** The floor on NFA of the monetary authorities will be adjusted upward (downward) by the full amount

by which the cumulative receipts from the balance of payments support are greater (less) than the program baseline (shown in table below). The downward adjustment will be capped at US\$20 million and will only be effective if gross international reserves of the RBM are greater than US\$200 million, with the following exception: In the second quarter of FY2005/06, the target will be adjusted downward up to US\$25 million if the disbursement of the second tranche of the World Bank FIMAG is delayed.

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

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

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

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

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

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

9. **Adjustment clause on net domestic assets—balance of payments support:** The ceiling on net domestic assets of the RBM will be adjusted downward (upward) by the full amount by which the cumulative flow of receipts from balance of payments support is greater (less) than the program baseline. The upward adjustment will be capped at US\$20 million and will only be effective if gross international reserves of the RBM are greater than US\$200 million, with the following exception: In the second quarter of FY2005/06, the target will be adjusted upward up to US\$25 million if the disbursement of the second tranche of the World Bank FIMAG is delayed. Balance of payments support will be converted to Malawi kwacha using the program exchange rate (see para. 7 for the definition of balance of payments support).

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

C. Ceiling on Central Government's Domestic Borrowing

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

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

13. **Definition of domestic arrears:** Domestic arrears are overdue payment obligations by central government other than external payment arrears (see section I.E.), including on wages and salaries, pensions, transfers, domestic interest, goods and services, obligations arising from court cases, legally established compensation claims, and payments to the Malawi Revenue Authority (MRA) for tax refunds. Payments on wages and salaries, pensions, transfers, court established obligations, and compensations are in arrears when they remain unpaid for more than 30 days beyond their due date. Domestic interest payments are in arrears when the payment is not made on the due date. Payments for goods and services

are deemed to be in arrears if they have not been made within 30 days of the date of invoice, or—if a grace period has been agreed—within the contractually agreed grace period.

14. **Adjustment clause on CGDB—balance of payments support:** The ceiling on CGDB will be adjusted downward (upward) by the full amount by which the cumulative receipts from balance of payments support is greater (less) than the program baseline (see para. 7 for the definition of balance of payments support). The upward adjustment will be capped at US\$20 million and will only be effective if gross international reserves of the RBM are greater than US\$200 million, with the following exception: In the second quarter of FY2005/06, the target will be adjusted upward up to US\$25 million if the disbursement of the second tranche of the World Bank FIMAG is delayed.

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

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

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

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

19. **Adjustment clause on CGDB—National Aids Commission (NAC) accounts:** The ceiling on CGDB will be adjusted downward (upward) by the full amount by which the change (in Kwacha) of the stock in the accounts of the NAC held in the Malawi banking system is larger (smaller) than the change (in Kwacha) of the stock in those accounts in the program baseline (shown in table below). The stock of the NAC accounts will be determined on the basis of the quarterly financial reports of the NAC. The change in stock is measured relative to the stock as of June 30, 2005. Stocks in the accounts are stated with a positive sign.

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

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

D. Ceiling on Central Government Wages and Salaries

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

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

E. Ceiling on External Payment Arrears

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

the central government, the RBM, or other agencies on behalf of the central government or the RBM.

F. Ceiling on Nonconcessional External Debt

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

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

II. QUANTITATIVE INDICATIVE TARGETS

A. Ceiling on Reserve Money

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

B. Ceiling on Central Government Discretionary Expenditures

26. **Definition of central government discretionary expenditures:** These are defined as all expenditures excluding (i) wages and salaries, (ii) interest payments, and (iii) foreign-financed development expenditures (development Part I expenditures) which are related to specific projects. Central government discretionary expenditures include statutory (i.e., nonvoted) expenditures for pensions and gratuities, and compensation and refunds; but exclude tax refunds (which are treated as a negative revenue). Central government discretionary expenditures also include other recurrent expenditures (ORT), domestically financed development expenditures (development Part II expenditures), and net lending (if

any). Included in this definition are also recurrent expenditures and development Part II expenditures for which cash financing is or was made available by donors. Included in particular are all maize purchases for the Strategic Grain Reserve, purchases financed from the Japan debt relief account (see paragraph 19), and expenditures in the health sector financed from the donor pool account in the RBM for the health SWAp. The ceiling is measured as a cumulative flow from July 1, 2005.

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

III. STRUCTURAL PRIOR ACTIONS, PERFORMANCE CRITERIA, AND BENCHMARKS

28. **Approval of FY2005/06 Budget:** The FY2005/06 budget passed by parliament should be in line with the program baseline, with other recurrent and domestic development expenditures of no more than MK 49.6 billion, a wage bill (including health SWAp) of no more than MK 20.7 billion, and tax policies in line with program assumptions.

29. **Formula Adjustment to pension formula:** Adjustments to the formula used to calculate an individual’s benefit should allow for a total cost of pensions lower than MK 3.5 billion in 2005/06.

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

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

32. **Budget ceiling module:** For the purposes of expenditure management, the budget module of the payments system at the RBM should be made fully operational. This requires that the following three steps are completed: (1) All bank accounts are reconciled between the RBM and commercial banks; (2) All data are reconciled between the RBM holding accounts and the fiscal data according to the Ministry of Finance ledgers; and (3) the

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

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

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

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

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

IV. TREATMENT IN THE FISCAL ACCOUNTS AND BALANCE OF PAYMENTS OF CERTAIN CENTRAL GOVERNMENT (CG) ACCOUNTS HELD ABROAD

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

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

V. REPORTING OF CERTAIN TRANSACTIONS IN THE FISCAL ACCOUNTS

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

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

Malawi: Reporting Requirements

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

D-Daily, W-Weekly, M-Monthly, Q-Quarterly, BA-Bi-annual A-Annual; F-Friday, 30-Every 30th, T30-Every third 30th; E-Electronic, H-Hard copy
1/ Detailed information on the amounts, currencies, terms, and conditions, including debt contracted or guaranteed by the RBM or any other agency on behalf of the central government.

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

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