International Monetary Fund

Malawi and the IMF

Press Release:
IMF Executive Board Completes First Review of Malawi's Three-Year PRGF Arrangement and Approves US$7.1 Million Disbursement
February 24, 2006

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Malawi: Letter of Intent, Memorandum of Economic and Financial Policies, and Technical Memorandum of Understanding

January 20, 2006

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

Dear Mr. de Rato:

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

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

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

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

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

Sincerely yours,

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

Attachments

MALAWI

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

January 20, 2006

INTRODUCTION

1. **Policies presented in our Memorandum of Economic and Financial Policies (MEFP) of July 2005 (EBS/05/113) are supplemented by the current memorandum.** The Government of Malawi remains committed to restoring sound governance and implementing prudent economic policies. We further welcome the IMF's recognition of Malawi's satisfactory performance under the Staff Monitored Program and the approval of a new PRGF arrangement in August 2005. Our macroeconomic performance has remained satisfactory and we met all the quantitative performance criteria targets for end-September, 2005, including the target on wages; as well as the indicative targets on discretionary expenditures and reserve money (Table 1). Regarding the two structural performance criteria (Table 2), the cabinet approved the arrears policy and it is being implemented; and the database of all government employees was compiled. The structural benchmark on the wage schedule is not expected to be completed until early 2006.

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

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

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

I. The Program for FY 2005/06

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

A. Fiscal Policy

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

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

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

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

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

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

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

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

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

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

Supporting structural measures and capacity building

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

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

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

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

B. Monetary and Exchange Rate Policy

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

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

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

Supporting structural measures and capacity building

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

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

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

II. Reaching the HIPC Completion Point

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

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

III. Program Monitoring

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

Box 1: Food Security

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

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

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

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

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

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

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

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

PC - performance criteria; IT - indicative target

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

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

3/ Targets for end-March are indicative.

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

5/ Targets are subject to adjusters for maize revenue and cash payment of arrears.

6/ Evaluated on a continuous basis.

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

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

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

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

Malawi—Technical Memorandum of Understanding

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

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

Quantitative Performance Criteria

A. Floor on Net Foreign Assets of the Monetary Authorities

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

C. Ceiling on Central Government's Domestic Borrowing

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

D. Ceiling on Central Government Wages and Salaries

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

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

E. Ceiling on External Payment Arrears

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

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

F. Ceiling on Nonconcessional External Debt

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

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

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

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

IV. Quantitative Indicative Targets

A. Ceiling on Reserve Money

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

B. Ceiling on Central Government Discretionary Expenditures

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

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

V. Structural Performance Criteria and Benchmarks

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

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

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

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

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

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

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

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

VI. 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.

VII. 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.

VIII. Reporting Requirements

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

Malawi: Reporting Requirements

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

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

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

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

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