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February 19, 2010

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

January 26, 2010

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.

LETTER OF INTENT

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MINISTER OF FINANCE

Ref. No. M/F/4/1

26th January, 2010

Mr. D. Strauss-Kahn
Managing Director
International Monetary Fund
Washington, DC 20431

Dear Mr. Strauss-Kahn:

The Government of Malawi requests continued support from the International Monetary Fund for its economic objectives and policy framework for 2010–12 through a new three-year arrangement under the Extended Credit Facility (ECF). We request access of 75 percent of quota (SDR 52.05 million). This arrangement will support our medium-term reforms to address balance of payments weaknesses and to sustain growth and poverty reduction. Maintaining a close engagement with the Fund will send a positive signal to domestic stakeholders and our development partners, notably concerning our determination to maintain macroeconomic stability and build on the positive economic gains achieved to date.

In the attached Memorandum of Economic and Financial Policies (MEFP), we set out our macroeconornic framework and policy objectives for 2010–12 and the medium term. Our main goal is to provide a consistent and coherent macroeconomic policy framework to underpin our development objectives. In that regard, our programme focuses on preserving macroeconomic stability, while enhancing growth and poverty reduction. Specific emphasis is placed on moving towards a market determined exchange rate and rebuilding international reserves; improving public financial management and monetary and fiscal transparency; and supporting private-sector-led growth.

The MEFP and Technical Memorandum of Understanding (TMU) present quantitative performance criteria, indicative targets, and structural benchmarks through the programme period. We believe that the policies set forth in the MEFP are adequate to achieve the objectives of the programme, but we will take additional measures as needed to reach these goals. We will consult with IMF staff on the adoption of these measures, and in advance of revisions to the policies contained in the MEFP, in accordance with the agreed IMF policies on such consultation.

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

Yours sincerely

Ken Kandodo
MINISTER OF FINANCE

Perks Ligoya
GOVERNOR
RESERVE BANK OF MALAWI

Attachments:
- Memorandum on Economic and Financial Policies of the Government of Malawi for 2010–2012
- Technical Memorandum of Understanding

ATTACHMENT I.

MEMORANDUM OF ECONOMIC AND FINANCIAL POLICIES, 2010–12

I. INTRODUCTION

1. **This memorandum summarizes the government of Malawi's economic objectives and policy framework for January 2010–December 2012, for which the government is seeking support from the International Monetary Fund through a three-year arrangement under the Extended Credit Facility (ECF).** The policies described are consistent with Malawi's Growth and Development Strategy (MGDS), which sets out the country's medium-term development priorities.

2. **Our medium-term program builds on the strong economic results achieved since 2005, including under the successfully completed Poverty Reduction and Growth Facility (PRGF) arrangement.** Our economic strategy has emphasized the need for fiscal consolidation, involving both judicious increases in public spending and improvements in revenue performance—hence creating the space for pro-poor and pro-growth spending. This strategy has been designed to correct the severe macroeconomic imbalances that existed prior to 2005, when weak program implementation led to large fiscal slippages, an unsustainable domestic debt spiral, and low investment.

3. **Our strengthened policy implementation has supported macroeconomic stability, reduced domestic debt and interest rates, and built overall credibility**. Reflecting these improvements, Malawi has benefited from external debt relief and increased inflows of aid. Growth has been impressive, averaging 6.8 percent for 2004–08, and inflation has come down to below 10 percent. Higher revenues and aid, and lower interest payments on the public debt have translated into higher poverty-reducing and social expenditures. We have made progress toward many of the Millennium Development Goals (MDGs).

4. **Recent gains notwithstanding, Malawi continues to face important development challenges.** Despite recent progress, poverty reduction and food security remain pressing concerns, as the economy is still heavily dependent on drought-prone agriculture. In addition, at about one month of prospective imports, international reserves remain low, especially considering Malawi's vulnerabilities. Meanwhile, implementing the MGDS will require increases in public investment and spending in areas such as health and education. To address these and other challenges over the long term, Malawi will continue to rely heavily on external support through grants and highly concessional financial assistance.

II. Recent Developments

5. **Malawi's growth has accelerated while inflation has moderated in recent years.** Output in 2008 is estimated to have reached 9.8 percent, driven by a record-high tobacco harvest and rapid expansion in maize and services. Growth in 2009 is estimated to have remained robust, reflecting strong tobacco and maize crops, the start of uranium production, and expanding wholesale and retail trade. Production of maize has benefited from favorable rainfall and the government's subsidized distribution of fertilizer to smallholder farmers. Inflation has trended downward during 2009, reflecting moderation in food and fuel prices and reduced monetary expansion.

6. **The fiscal year 2008/09 budget targets were missed by a wide margin, owing to difficulties in containing spending on the fertilizer subsidy program coupled with expenditure overruns on goods and services**. Overspending on fertilizer, sold to farmers at subsidized prices, reflected a combination of high fertilizer prices in mid-2008, at the time of the government's planned purchases, and an additional unbudgeted purchase later in the year. Efforts are now being made to strengthen budget control and improve the targeting of the fertilizer program.

7. **The combination of high spending with a shortfall in foreign financing led to rapid credit expansion to the government and contributed to higher than targeted growth in reserve money.** Large injections by the government in the first quarter of the fiscal year led to high market liquidity. However, reserve money growth has since moderated, with the 12-month change in reserve money declining significantly from the beginning to end of 2009. Moreover, with expected donor inflows, we expect a repayment of domestic borrowing in fiscal year 2009/10.

8. **We have moved forward with our structural reform agenda.** Public administration is being strengthened, supported by a Public Financial and Economic Management (PFEM) unit in the Ministry of Finance, which is charged with coordinating reforms in this area and updating the public financial management action plan. In line with this plan, we have strengthened control over the wage bill and utility payments, and implemented the Integrated Financial Management Information System (IFMIS) to improve control over expenditures more generally. The Ministry of Finance has also made significant improvements in statistical classification and presentation of the budget, including on a functional basis, which will allow for more accurate tracking of trends in key social welfare spending and coherence of spending with the MGDS goals. In addition, a cash management unit at the Accountant General's Office has been formed to enhance the government's capacity for cash flow planning. The most recent Public Finance Management Assessment for Malawi, based on the Public Expenditure and Financial Accountability (PEFA) framework, concluded that our public financial management has substantially improved over the past three years and compares favorably to our neighbors. We have also issued a debt management strategy, and cleared the 2004 stock of arrears. Finally, the capacity in the offices of the Accountant General and Auditor General have been enhanced, with the support of our development partners, and

substantial progress has been made in reducing the backlog in the submission of annual accounts by the Accountant General to the National Audit Office and to Parliament.

9. **We have also made progress in establishing credit reference bureaus, which will over time help to lower high lending spreads.** Information disclosure clauses have been introduced in commercial bank lending contracts and a Credit Reference Bureau Bill, providing the legal and regulatory framework for the sharing of credit information, has been finalized and is awaiting Parliamentary approval. This should help establish functioning credit bureaus and bring down the cost of lending by lowering the risks and promoting competition among banks through easier identification of sound borrowers.

10. **We have also made improvements in bank supervision and regulations. The Reserve Bank of Malawi** (RBM) adopted a risk-based supervision approach to examining bank performance in January 2009, and is in the process of establishing Basel II governance structures and committees. For the time being the assessment of banks will still be based on CAMEL, with the risk-based assessment run in parallel with CAMEL. Following this change, the RBM will be able to assess more effectively all risks banks undertake in addition to credit risk, as was emphasized in the CAMEL method. Moreover, the RBM continues to assess the quality of bank loans during on-site and off-site examinations. Whenever a bank is found to be under-provisioning, the RBM directs it to make additional provisions. Related to this, the RBM is revising its Asset Classification Directive to take into account new developments such as International Accounting Standards.

11. **The amendments to the Banking Act and the Insurance Act were recently approved while the Financial Services Bill will be tabled during the next sitting of Parliament in February 2010. These are designed to empower the RBM to actively regulate and supervise Malawi's financial sector**. The Banking Act and the Financial Services Bill: (i) extend fit and proper requirements beyond the board and executive management to include shareholders; (ii) enhance enforcement powers of the RBM and outlines corrective actions and remedial measures to be undertaken by the RBM to resolve problems in the banks; (iii) empower the RBM to prescribe higher ongoing capital than the required minimum depending on an individual bank's risk profile; (iv) empower the RBM to require external auditors to present their findings prior to publishing the annual accounts; and (v) empower the RBM to carry out consolidated supervision of the financial sector. The RBM has also taken a number of steps to improve its capacity to examine transactions related to anti-money-laundering and combating of financing of terrorism. The Money Laundering and Proceeds of Serious Crimes Terrorist Financing Law was enacted in 2006 and took effect in 2007, and the RBM has introduced anti-money laundering examinations, with a key focus on compliance with Know Your Customer (KYC) principles. A Financial Intelligence Unit (FIU) was established in 2007 and is working closely with the RBM and law enforcement agencies on matters pertaining to AML-CFT.

12. **The RBM has also strengthened its liquidity forecasting capabilities**. The liquidity forecasting framework, designed with the assistance of the Norges Bank and the Fund, is now

fully operational and is used daily by the Treasury Department to assess liquidity conditions and prospects and smooth liquidity management on an ongoing basis. RBM has also replaced bilateral repos with repos sold through auctions, in the interest of greater transparency and with a view to enhancing financial market development.

III. Sustaining Growth and Poverty Reduction while Enhancing Competitiveness

13. **Our medium-term strategy—set out in the MGDS—is directed at boosting growth and reducing poverty.** Key objectives include private sector-led development, diversification of economic activities, and empowerment of the poor through a sound economic environment, high-quality public service, effective institutions and the rule of law, and zero tolerance for corruption.

14. **Our medium-term program, for which we seek ECF support, aims to provide a consistent and coherent economic policy framework to underpin our development objectives.** The program focuses on enhancing the sustainability of growth and development through policies that consolidate economic stability, reinforce resilience to shocks, further improve public financial management, and support private-sector-led growth.

15. **The program's key medium-term objectives include:**

- Increasing and maintaining sustainable growth over the medium term and reducing poverty within a stable macroeconomic environment and consistent with Malawi's MGDS and MDGs.

- Increasing foreign reserves coverage to three months of imports. We view this as the minimum desirable level, given Malawi's vulnerability to weather, terms of trade, and aid shocks and the large seasonal volatility in trade flows.

- Reducing government net domestic debt. This will support the planned increase in reserves and lower further the share of public expenditures devoted to debt service.

- Establishing, by end-2011, a liberalized foreign exchange regime for current account transactions consistent with our obligations under Article VIII of the International Monetary Fund's Articles of Agreement, which we accepted in 1995, and making substantial progress in this regard during 2010.

- Re-activating the interbank foreign exchange market.

- Making progress toward and achieving a market-clearing exchange rate that supports the accumulation of reserves and a stable macroeconomic environment.

- Promoting internal equilibrium by pursuing prudent fiscal and monetary policies, designed to contain aggregate demand pressures and limit the pass-through of exchange rate changes to prices of nontradeables.

- Continuing reforms in public financial management and tax administration, designed to enhance capacity and strengthen both expenditure control and revenue performance;
- Pursuing wide ranging reforms to deepen the financial sector and promote greater financial inclusion; and
- Improving the business climate through improvements in infrastructure and regulatory reform.

Outlook for growth and inflation

16. **Our goal is to increase growth over the medium term in order to reduce poverty levels and facilitate attainment of the MDGs.** Our macroeconomic and structural reform program will help lay the groundwork, with growth expected to average 8 percent during the ECF-supported program. An expansion in private activity beyond the agricultural sector, complemented by public investment in infrastructure, the opening of the Kayelekera uranium mine in 2009, and development of further mining opportunities will help to underpin growth. Inflation is expected to stabilize at 6-7 percent over the medium term, reflecting prudent fiscal and monetary policies and a strengthened capacity to respond to exogenous shocks.

Medium term fiscal policies

17. **The government intends to preserve the gains from HIPC debt relief by sustaining sound fiscal management over the medium term.** We will adhere to a prudent fiscal policy of modest overall budget deficits, financed by foreign borrowing, leaving room to expand credit to the private sector (see MEFP ¶26). We aim to strengthen the tax revenue to GDP ratio by around ½ percent of GDP per year until fiscal year 2014/15, mainly by broadening of the base of the value added and income taxes (including through improved compliance), while still leaving room to lower the value added tax rate and international trade taxes to regional norms. In this regard, the government intends to target a domestic borrowing repayment of around 1 to 1.5 percent of GDP and a modest overall deficit in the fiscal year 2010/11 budget, while incorporating measures to strengthen public services in education and health care through hiring of qualified personnel in these areas, and improving targeting of the social safety net. The government also stands ready to undertake budgetary adjustments this year, either through a reduction in lower priority expenditures or a shoring up of revenues, while preserving budgeted social and poverty-reducing spending, to ensure that the domestic repayment target is met.

18. **The government will aim to reduce the risks to the budget posed by growing implicit and explicit contingent liabilities resulting from the activities of parastatals and by rationalizing expenditures.** It will seek to establish a clear regulatory regime for public utilities infrastructure—namely, the Electricity Supply Corporation of Malawi, Ltd. (ESCOM) and the Malawi regional Water Boards—that covers operating costs and avoids the need for budgetary transfers and that minimizes recourse to commercial bank borrowing. In this regard, the government has already increased electricity tariffs by 36 percent as of December 1, 2009,

and will increase them by a further 20 percent in December 2010, with additional adjustments expected over the subsequent two years. It has also been announced that water tariffs will increase by 12.5 percent. These actions are designed to set the stage for these utilities to invest in needed capital infrastructure to improve the quality, availability, and reliability of their service delivery, with a view to supporting the expansion of manufacturing and other economic activities. In addition, the government will seek to restructure Air Malawi's debts and absorb the costs of the presidential jet and any transfers to parastatals or productive sectors, without allowing this spending to crowd out social and other priorities in the government budget.

Monetary policy

19. **Monetary policy in the medium term will be geared toward achieving price stability, while providing room for sufficient credit to the private sector and supporting reserve accumulation and a properly valued exchange rate.** Reserve money will be the nominal anchor. To help manage domestic demand, reserve money is programmed to grow at about the pace of GDP to help contain inflation and limit the pass-through effects of exchange rate adjustment to nontradeables' prices (see MEFP ¶26). Reserve money is targeted to grow by about 16 percent in 2010 (about the same as projected nominal GDP growth). The RBM will continue to develop its instruments of indirect monetary control and strengthen its ability to implement monetary policy through changes in interest rates.

Exchange rate policies

20. **Exchange rate policies are geared toward liberalizing the foreign exchange regime and achieving a market-based exchange rate.** In addition to an initial depreciation of the currency prior to the commencement of the ECF-supported program, we are committed to undertaking further policy adjustments, including of the exchange rate, to support foreign exchange market liberalization, eliminate excess demand for foreign exchange, and achieve a market-based and competitive exchange rate (see MEFP ¶26–27).

21. **To support the reduction of foreign exchange shortages and multiple currency practices, we have already put in place a number of reforms to the foreign exchange regime.** The RBM has implemented the Foreign Exchange Statistical Database System (FESDS) with a view to improving efficiency in mobilization and tracking of foreign exchange proceeds from the country's exports. In addition, the RBM has recently reversed measures that had required tobacco farmers without FCDAs to surrender export earnings directly to the RBM at the official exchange rate, and tobacco exporters with FCDAs and exporters of other traditional products to surrender 20 percent of their receipts to the RBM at the official rate, and 20 percent to the commercial banks at the commercial bank rate. The requirements on tobacco and traditional exporters are now to surrender the required foreign exchange receipts from exports to the commercial banks for conversion at the bank rate. The government will also allow foreign exchange bureaus to operate when they meet specified fit and proper tests.

22. **Over the medium term, the RBM will modernize its exchange rate and monetary policy frameworks.** This will entail a further strengthening of the domestic credit, foreign exchange, and interbank markets, as well as RBM policies and instruments to regulate, supervise, and influence these markets. Enhanced transparency will be an essential element of this strategy. Our goal is to establish the framework for market-oriented monetary and foreign exchange instruments and operations that support economic growth and diversification, including building capacity of market participants to manage exchange rate risk. Technical assistance for these reforms will be provided by the Fund, the Norges Bank and other key development partners.

Other structural policies

23. **The government intends to accelerate the pace of its structural reforms in public expenditure management**, with a view to producing timely, consolidated and reconciled accounts, with continued technical assistance from the Fund. We will also seek to strengthen external audit and procurement capabilities in order to further bolster accountability and governance.

24. **The government will continue its efforts to create an enabling environment for private investment and growth**. It will focus public investments on improving the educational and health care systems, utilities, transportation, and communications infrastructure; strengthen the regulatory environment, cut cumbersome business regulations and those that impair the efficient functioning of the labor market; and roll back the role of the public sector in areas that the private sector should dominate.

25. **The government has recently formulated a draft Financial Sector Development Strategy, which is currently being presented to stakeholders.** At the end of the consultative process, the strategy and action plan will be presented to and discussed by Cabinet for approval. The strategy is currently comprised of two stages, namely:

- *The attainment of inclusive finance for growth*, which will encompass the following three pillars: (a) the alignment of the domestic financial system with key growth sectors, (b) financial inclusion, including by expanding the provision of financial services to the rural economy and minimizing existing market distortions and (c) creating a conducive business environment—including by upgrading the legal and regulatory framework for the financial sector in line with recommendations of the recent FSAP and strengthening financial sector oversight through modernization and the RBM (the latter will be supported by the recent Parliamentary approval of the Banking Act and the impending approval of the Financial Services Bill).

- *Financial deepening and competitiveness*, comprised of efforts to strengthen capital market development—in part, through the creation of domestic infrastructure/project finance funds, the development of housing finance products, the creation of a regulatory framework for the bond market, and organizational strengthening of the Malawi Stock Exchange.

III. Program Monitoring

26. **Program implementation will be monitored according to the following performance criteria and benchmarks, with definitions as set out in the accompanying Technical Memorandum of Understanding (TMU).** Over the three years of the ECF-supported program, semi-annual performance criteria will be set on net domestic assets and net international reserves of the Reserve Bank, and on net domestic borrowing of the central government and an indicative target on reserve money (Table 1). In addition, there will be an indicative target for a floor on social spending, so that this spending does not fall below budgeted levels. There will also be continuous performance criteria on nonaccumulation of government external payment arrears and of no new contracting and guaranteeing of short-term and medium-term nonconcessional external debt. The program will have semi-annual reviews. The first review will be completed by November 20, 2010 and the second review by May 20, 2011.

27. **The ECF-supported program will include monitoring with regard to excess demand for foreign exchange.** There will be a continuous performance criterion on no intensification of restrictions under Article VIII of the Fund's Articles of Agreement. To gauge progress in eliminating practices that have created multiple exchange rates in the market and foreign exchange queues, the RBM will measure, jointly with Fund staff, on a monthly basis, three indicators**:** (i) the reduction in the size of commercial banks' reported queues for foreign exchange; and (ii) the reduction in the gaps in exchange rates between the official and foreign exchange bureau rates, both indicative targets, and (iii) reserve levels, a performance criterion, to be covered by the semi-annual program reviews.

28. **To strengthen the underpinnings of growth, the program will also contain structural benchmarks in three key areas for the first year and longer-term benchmarks.** To ensure greater efficiency in the public sector, the authorities will make fully operational a PFEM unit. To improve the foreign exchange regime, the authorities will develop a time-bound action plan to restart the interbank foreign exchange market. Finally, to strengthen the financial sector, the authorities will secure Cabinet approval of the Financial Sector Development Strategy and increase monetary policy transparency. Targets will be set for end-June and end-December 2010. Over the longer-term, the authorities will improve transparency and solvency of public utilities.

ATTACHMENT II.

TECHNICAL MEMORANDUM OF UNDERSTANDING (TMU)

I. INTRODUCTION

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

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

II. QUANTITATIVE PERFORMANCE CRITERIA: DEFINITIONS AND DATA SOURCES

A. Reform of the Foreign Exchange Regime

3. **Easing of foreign exchange surrender requirements to the RBM**: The current regulations require that all exporters should surrender 40 percent of proceeds to the banking system. Tobacco exporters may retain 60 percent of export proceeds in Foreign Currency Deposit Accounts (FCDAs) and surrender 40 percent of proceeds to commercial banks at the commercial bank rate. Tobacco exporters without FCDAs must surrender 100 percent of proceeds to the commercial banks at the commercial bank rate. The RBM will refrain from rationing foreign exchange, and have certified that all private external payment arrears are cleared as of January 25, 2010 and will avoid interfering in foreign exchange markets that result in private sector external arrears on a continuous basis during the program period.

B. Floor on Net International Reserves of the RBM

4. **Definition of net international reserves (NIR) of the RBM:** The NIR of the RBM is defined as gross reserves minus IMF and other short-term liabilities. The values of all foreign assets and liabilities will be converted into U.S. dollars at each test date using the program cross exchange rates for the various currencies and then converted into kwacha using the program exchange rate for the U.S. dollar–kwacha exchange rate.

5. **Gross reserve assets of the RBM** are defined in the International Reserve and Foreign Currency Liquidity Guidelines for a Data Template as external assets immediately available and controlled by RBM "for direct financing of payments imbalances, for indirectly regulating the magnitudes of such imbalances through intervention in exchange markets to affect the currency exchange rate, and/or for other purposes" (*BPM5,* para. 424).

6. **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) foreign convertible currency holdings; (6) deposits held in foreign central banks, the Bank for International Settlements, and other banks; (7) loans to foreign banks redeemable upon demand; (8) foreign securities; and (9) other unpledged convertible liquid claims on nonresidents. It excludes the following: (1) any foreign currency claims on residents; (2) capital subscriptions in international institutions; (3) foreign assets in nonconvertible currencies; (4) transfers of foreign currency claims to RBM by other institutional units in Malawi just prior to reporting dates with accompanying reversals of such transfers soon after those dates; (5) gross reserves that are in any way encumbered or pledged, including, but not limited to, (i) assets blocked when used as collateral for third party loans and third-party payments, pledged to investors as a condition for investing in domestic securities, and (ii) assets lent by RBM to third parties which are not available prior to maturity, and are not marketable (including the outstanding balance of the loan to Zimbabwe).

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

8. **As under the latest accounting guidelines (*BPM6*)**, NIR has increased with the 2009 allocation of SDRs, which is treated as a long-term foreign exchange liability of Malawi to the SDR Department of the IMF, instead of a debt liability or shares and equity, as in the Monetary and Financial Statistics Manual (*MFSM*). The SDR allocation does not affect net foreign assets (NFA), because it increases both gross foreign assets and long-term liabilities.

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

10. **Definition of budget support**: Budget support includes all grants and foreign financing that is not directly linked to additional budgetary expenditure. Excluded from this definition is external project financing to fund particular activities, including food security funding from the European Union and loan financing from the IMF, and donor inflows (in kwacha) from the U.S. dollar–denominated donor pool account for the health sector-wide approach (SWAp) and National AIDS Commission held in the Malawi banking system.

11. **Adjustment clause on NIR—donor pool account for the health SWAp account:** The floor on the NIR of the RBM will be adjusted downward by the full amount by which the donor inflows (in kwacha) from the U.S. dollar–denominated donor pool account for the health SWAp held in the Malawi banking system is smaller than the donor inflow (in kwacha) to those accounts in the program baseline. The downward adjustment will be capped at US$10 million. Donor inflows for the SWAp account are measured as the receipts received (in kwacha) by the budget from the SWAp account, a U.S. dollar-denominated account set up at the RBM. Donor inflow is measured from the beginning of the fiscal year.

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

13. The total downward adjustment to NIR from a shortfall of (1) budget support and (2) donor inflows to the donor pool account for the health SWAp account relative to program assumptions and (3) an excess of debt service payments relative to the program assumption will be capped at $10 million.

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

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

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

16. **Definition of net domestic assets (NDA) of the RBM**: NDA of the RBM are defined in kwacha terms as end quarter reserve money less NFA of the RBM at the program exchange rate. Reserve money consists of currency issued by the RBM and balances of commercial banks' accounts with the RBM. It includes required reserves held for Malawi kwacha deposits and any other domestic currency reservable liabilities and other demand and time deposits held with the RBM. The NDA program ceilings are the indicative money targets defined below less the NFA of the RBM.

17. **Definition of NFA of the RBM:** The NFA of the RBM are defined as the above defined NIR plus other foreign assets of the RBM—including but not limited to (1) capital

subscriptions in international institutions; (2) foreign assets in nonconvertible currencies; and (3) gross reserves that are in any way encumbered or pledged, less any medium- and long-term foreign liabilities of the RBM.

18. **Adjustment clause on NDA—budget support**: The ceiling on NDA of the RBM will be adjusted downward by the full amount by which the cumulative flow of receipts from budget support are greater than US$30 million above the program baseline. The ceiling on NDA of the RBM will be adjusted upward by the full amount up to a maximum of US$10 million by which the cumulative receipts from the budget support are less than the program baseline. The kwacha value of the cumulative shortfall/excess will be calculated at the program exchange rate. Budget support is measured as the cumulative flow from the beginning of the fiscal year.

19. **Adjustment clause on NDA—donor pool account for the health SWAp account:** The ceiling on NDA of the RBM will be adjusted upward by the full amount by which the donor inflows (in kwacha) from the U.S. dollar–denominated donor pool account for the health SWAp held in the Malawi banking system is smaller than the donor inflow (in kwacha) to those accounts in the program baseline. The upward adjustment will be capped at US$10 million. Donor inflows for the SWAp account are measured as the receipts received (in kwacha) by the budget from the SWAp account, a U.S. dollar-denominated account set up at the RBM. Donor inflow is measured from the beginning of the fiscal year.

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

21. The total upward adjustment to NDA from a shortfall of (1) donor inflows to the donor pool account for the health SWAp account relative to the program assumptions and (2) an excess of debt service payments relative to the program assumption will be capped at US$10 million.

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

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

23. **Definition of 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, government bonds, and holdings of treasury bills minus deposits); (ii) net borrowing from commercial banks[1] (including advances, holdings of local registered stocks, and holdings of treasury bills minus deposits); (iii) net borrowing from nonbanks (including, but not limited to, holdings of local registered stocks and holdings of treasury bills); and (iv) holdings of promissory notes. The treasury bills and local registered stocks are valued at cost rather than face value. The ceiling is measured as the change in the stock of CGDB since June 30, 2009, including promissory notes and securities transferred to the RBM from the Treasury since the beginning of the fiscal year.

24. **Definition of domestic arrears**: Domestic arrears are overdue payment obligations of the central government other than external payment arrears, including on wages and salaries, pensions, transfers, domestic interest, goods and services, obligations arising from court cases, legally established compensation claims, and tax refunds. Payments on wages and salaries, pensions, transfers, court-established obligations, and compensations are in arrears when they remain unpaid for more than 30 days beyond their due date. Domestic interest payments are in arrears when the payment is not made on the due date. Payments for goods and services are deemed to be in arrears if they have not been made within 90 days of the date of invoice, or—if a grace period has been agreed—within the contractually agreed grace period.

25. **Adjustment clause on CGDB—budget support**: The ceiling of CGDB will be adjusted downward (upward) by the full amount by which cumulative kwacha receipts from budget support are greater (less) than the program baseline. The upward adjustment will be capped at US$20 million. In the event of excess budget support, the ceiling on CGDB will be adjusted by the full amount less US$30 million. The kwacha value of the cumulative shortfall/excess will be converted at the corresponding monthly average of the RBM mid rate. Cumulative receipts will be measured from the beginning of the fiscal year.

26. **Adjustment clause on CGDB—donor pool account for the health SWAp account:** The ceiling on CGDB will be adjusted upward by the full amount by which the donor inflows (in kwacha) from the U.S. dollar–denominated donor pool account for the health SWAp held in the Malawi banking system are smaller than the donor inflows (in kwacha) to those accounts in the program baseline. The upward adjustment will be capped at US$20 million. Donor inflows for the SWAp account are measured as receipts

[1] Includes all commercial banks in Malawi—and in particular the Malawi Savings Bank—not just the banks covered by the eight-bank monetary survey.

received (in kwacha) by the budget from the SWAp account, a U.S. dollar-denominated account set up at the RBM. Donor inflow is measured from the beginning of the fiscal year.

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

28. **The total upward adjustment to CGDB** from a shortfall of (1) budget support and (2) donor inflows to the donor pool account for the health SWAp account relative to the program assumptions and (3) an excess of debt service payments relative to the program assumption will be capped at US$30 million for permanent shortfalls.

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

E. Ceiling on External Payment Arrears

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

F. Ceiling on Nonconcessional External Debt

31. **Definition of nonconcessional external debt**: The definition of debt, for the purpose of the limit, is set out in Executive Board Decisions No. 6230-(79/140) August 3, 1979, and as amended by Decisions No. 11096-(95/100), October 25, 1995; 12274–(00/85) August 24, 2000; and 14416-(09/91), August 31, 2009. For program purposes, short- and medium- and long-term debt is nonconcessional if it includes a grant element of less than 35 percent, as indicated in Decision No. 11248-(96/38), April 15, 1996. The ceiling on nonconcessional debt applies to the contracting and guaranteeing by the central government, the RBM, or other agencies on behalf of the central government or the RBM on debt with nonresidents. This performance criterion is monitored on a continuous basis. The ceiling applies to debt and commitments contracted or guaranteed for which value has not been received. The ceiling is measured cumulatively from the beginning of the fiscal year.

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

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

34. **Excluded from the limit** is the use of IMF resources, and any kwacha-denominated treasury bill and local registered stock holdings by nonresidents. Excluded from the limit are also (i) debts classified as international reserve liabilities of the RBM; (ii) new debt issued to restructure, refinance, or repay existing debt up to the amount actually used for the above-mentioned purposes; (iii) normal import financing; and (iv) arrangements to pay 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.

III. Quantitative Indicative Targets and Structural Benchmarks

A. Ceiling on Reserve Money

35. **Definition of reserve money**: Reserve money is defined as the sum of currency issued by the RBM, including the vault cash of commercial banks, and balances of commercial bank accounts with the RBM. It includes required reserves held for kwacha deposits, other domestic currency liabilities, and other demand and time deposits held with the RBM. The reserve money targets are the projected end-quarter values starting with end-March 2010 to end-December 2012.

36. **Definition of foreign exchange queue for program monitoring**: The foreign exchange queue is defined as the value of foreign exchange applications filed with commercial banks that have not yet been satisfied, for bona fide current account transactions, and it will be assessed as a percentage reduction from its end-November 2009 level of US$127.6 million. Measurement of foreign exchange queues will draw on commercial banks' reporting to the RBM on the effective foreign exchange demands they face (e.g., excluding demands that have been met, have lapsed, or are not matched by kwacha that clients could make available at the time the exchange will be transacted). Reduction in queues will be assessed for each test date against the end-November 2009 measure, which comprises unmet foreign exchange demands placed with banks from August 1, 2009 to end-November 2009. Foreign exchange demands will reflect still outstanding requests for immediate and forward delivery by the test date that cannot be met because of insufficient foreign exchange supplies. The stock will include applications with commercial banks, both by corporate and noncorporate entities, and for current but not capital transactions, following standard Fund definitions for these terms. The RBM will, to the extent possible, eliminate duplicate unmet requests for foreign exchange (i.e., the same request placed with more than one bank); however, recognizing that full elimination of duplication may be infeasible, monitoring will focus on the change from the initial stock rather than the absolute level of the queue at the test dates. The queues will be measured on the last day of the month and will be based on demands up to the third to last day of each month, to take into account a normal trading period for filling requests of two to three days.

37. **Spread between the bank bureau midrate and the official midrate:** This spread is defined as the difference between the bank bureau mid-rate for U.S. dollar cash-based

buying and selling transactions and the official midrate at the day's fixing, expressed as a percentage of the official midrate. The reduction in the spread will be assessed against the end-November 2009 measure of the spread of 22.2 percent.

G. Floor on Social Spending

38. **Definition of social spending**: Social spending is computed as the sum of central government spending on health, education and the fertilizer subsidy as articulated in the central government budget for a particular fiscal year. In order to maintain Malawi's commitment and progress towards poverty reduction and the MDGs, the social spending allocations in the government budget will not be adjusted downward to meet fiscal targets of the program.

IV. Reporting of Certain Transactions in the Fiscal Accounts

39. **Donor pool–funded expenditures in support of the health SWAp**: The Government of Malawi has embarked on 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. Financial flows into and out of this account will be reported on a monthly basis from the beginning of the fiscal year.

40. **Fertilizer subsidy program**: The government has embarked on a program of subsidizing agricultural inputs, in particular, fertilizer, to smallholder farmers to improve agricultural production, financed by the budget. The spending on the fertilizer subsidy program will be reported quarterly from the beginning of the fiscal year, and a prior action for the ECF-supported program, will be a transparent accounting on execution of the budget for fiscal year 2008/09 and of the budgeted figures for fiscal year 2009/10, which was met.

V. Reporting Requirements

41. Monitoring of the program requires that the information listed in Tables 1-4 below be reported to the IMF within the timeframe indicated.

Table 1. Malawi: Quantitative Targets[1]

	Criteria [2]	Sept. 2009 Stock Actual	Indicative End-Mar 2010 Proj.	End-Jun 2010 Proj.	Indicative End-Sept 2010 Proj.	End-Dec 2010 Proj.
I. Monetary targets (millions of kwacha)						
1. Ceiling on net domestic assets of the RBM [3, 4, 5, 6]	PC	56,577	53,549	52,411	49,674	47,577
2. Ceiling on reserve money [3]	IT	55,326	44,479	52,599	60,806	53,597
II. Fiscal targets (millions of kwacha)						
3. Ceiling on central government's net domestic borrowing [5, 6, 7, 8]	PC	139,251	9,104	-11,730	-10,713	-1,179
4. Floor on social spending [9]	IT	[…]	[…]	[…]	[…]	[…]
III. External targets (US$ millions, unless otherwise indicated)						
5. Floor on net international reserves of the RBM [3, 5, 6]	PC	77	17	76	147	131
6. Ceiling on the accumulation of external payments arrears [7, 10]	PC	0	0	0	0	0
7. Ceiling on new nonconcessional external debt maturing in one year or more[10]	PC	0	0	0	0	0
8. Ceiling on new nonconcessional external debt maturing in less than one year[10]	PC	0	0	0	0	0
9. Foreign exchange queues (percent reduction in stock relative to a starting stock of US$127.6 million as of Nov. 30, 2009)[11]	IT	…	[…]	25	[…]	50
10. Spread between the bank bureau midrate and the official midrate (percent reduction vis-à-vis the spread of 20.7 percent as of Nov. 30, 2009)	IT	…	[…]	25	[…]	50
Memorandum items:						
Net foreign assets of the RBM (US$ millions)		-9	-60	1	74	40
Budget support (US$ millions)		35	180	242	313	365
Budget support (millions of kwacha)		4,932	27,150	36,567	47,305	55,157
Debt service payments to the World Bank and the African Development Bank (US$ millions)		2	3	4	4	5
Debt service payments to the World Bank and African Development Bank (millions of kwacha)		318	470	562	652	746
Sector-Wide Approach (SWAp) receipts (millions of kwacha)		2,028	13,096	15,757	19,004	22,694
Securitization of domestic arrears		0	0	0	0	0
Liquidity reserve requirement (percent)		15.5	15.5	15.5	15.5	15.5
Program exchange rate		…	151	151	151	151

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

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

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

[3] Defined as stocks.

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

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

[6] Targets are subject to an adjuster for donor-funded health expenditures.

[7] Defined as a cumulative flow.

[8] Targets are subject to an adjuster for securization of domestic arrears.

[9] Priority social spending as defined and quantified in the authorities' budget.

[10] Evaluated on a continuous basis.

[11] The queue is defined as the amounts of foreign exchange that businesses have applied for—but not yet received—at commercial banks, for legitimate current account transactions.

Table 2. Malawi: Prior Actions and Structural Benchmarks, 2009–10

Prior Actions

Measure	Status	
Issuance of a directive reversing the 20 percent surrender requirement on all exports except tobacco to the RBM and redirecting this foreign exchange to the commercial banks, where it will be converted at the commercial bank rate.	**Met**	To liberalize the foreign exchange market by increasing the role of commercial banks in the foreign exchange market.
Reversal of the requirement to surrender tobacco proceeds to the RBM at the official rate, and to revert to surrendering to the commercial banks to be converted at the commercial bank rate.	**Met**	To liberalize the foreign exchange market by increasing the role of commercial banks in the foreign exchange market.
Enhanced nominal exchange rate flexibility, in the form of an upfront, but gradual adjustment of the exchange rate, coupled with tight fiscal and monetary policies.	**Met**	To move closer to a market-clearing exchange rate and effect a real depreciation of the exchange rate.
Transparent accounting of fertilizer spending in the last two fiscal years.	**Met**	To enhance fiscal transparency and accountability.

Structural Benchmarks

Measure	Target date	Macro Rationale
Public finance management		
Make fully operational a Public Financial and Economic Management (PFEM) Unit, in order to follow up on public financial management reforms.	31-Dec-10	To strengthen budget monitoring, and allow rapid reaction to potential expenditure overruns.
Foreign exchange regime		
Develop a time-bound action plan to restart the interbank market in line with TA recommendations from the Norges Bank and the IMF.	30-Jun-10	To improve foreign exchange market efficiency and strengthen growth potential.
Financial sector		
Publish, on a weekly basis, the amount of securities auctioned by the RBM and the results of auctions of securities on the RBM web-page.	30-Jun-10	To enhance the transparency of the domestic financial market.
Cabinet approval of the Financial Sector Development Strategy.	31-Dec-10	To achieve greater financial inclusiveness and improve competitiveness.

Table 3: Reporting Requirements

Data Description	Data Freq.	Reporting Agency	Reporting Freq.	Delivery Lag	Delivery Date	Delivery Mode
Gross international reserves, exchange rate, and foreign exchange purchases and sales	D	RBM	W	2	F	E
Reserve money and its components (NDA and NFA), OMO transactions, and RBM conversion of treasury bills	W	RBM	M	30	30	E
Daily exchange rate	D	RBM	W	1	F	E
Treasury bill and RBM auction results	W	RBM	W	2	F	E
RBM balance sheet and broad money estimate	W	RBM	W	7	F	E
Import payment arrears	M	RBM	M	30	30	E
Spread between bank bureau midrate and the official exchange midrate	W	RBM	M	30	30	E
Value of queues for foreign exchange	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
Detailed issue and maturity profile for treasury bills and RBM bills	M	RBM	M	30	30	E
Excess reserves by bank	W	RBM	M	30	30	E
Details of project and balance of payment support	M	RBM	M	30	30	E
FCDA Holdings	M	RBM	M	30	30	E
RBM foreign exchange cash flow	M	RBM	M	30	30	E
Foreign exchange exposure limits by bank	M	RBM	M	30	30	E
Bank statements of the Health SWAp account held at RBM	M	RBM	M	30	30	E
Eight bank monetary survey and full banking survey (on monthly average basis)	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
NAC consolidated statement of sources and uses of funds (cashflow statement)	M	MOF	M	30	30	E
Health SWAp statement of sources and uses of funds (as per attached table 2)	M	MOF	M	30	30	E
Fiscal table (GFS) including revenue, expenditure, and financing	M	MOF	M	30	30	E
Revenue data (from MRA)	M	MOF	M	30	30	E
Monthly expenditure for domestically financied capital projects	M	MOF	M	30	30	E
New external loans contracted or guaranteed by the central government[1]	Q	MOF	Q	30	T30	E
Quarterly external debt services (actual and projections)	Q	MOF	Q	30	T30	E
Borrowing of the ten (8) major parastatals[2]	Q	MOF	Q	45	T15	E
Annual Financial reports of the ten (10) major parastatals and MSB	A	MOF	Q	90	30	H
Report on IMF program performance	Q	MOF	Q	45	T15	E
Statement on new arrears	Q	AuG	Q	45	T15	E
Consumer price index and monthly statistical bulletin	M	NSO	M	30	30	E
Import and export data	M	NSO	M	45	T15	E
Balance of payments, and quarterly statistical bulletin	Q	NSO	Q	45	T15	E
National accounts, balance ofpayments, and quarterly statistical bulletin	A	NSO	BA	45	T15	E

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

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

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

Table 4. Malawi: Sector-Wide Approach (SWAp)
Statement of Sources and Uses of Funds

	Monthly data
Millions of US$	
Opening balance in SWAp forex account	x
Inflows in foreighn exchange from donors	x
DFID	x
Norway	x
UNDP	x
Global Funds	x
UNFPA	x
UNICEF	x
Other	x
Closing balance in SWAp forex account	x
Memorandum items:	
Donor funds received through RBM	x
Donor funds received through commercial banks	x
Donor funds spent offshore	x
Government contribution in MwK	x
SWAp expenditure	x
Of which: Wages	x
Other goods and services	x
Development expenditure	x