Dear Dr. Kim,

MALAWI: LETTER OF DEVELOPMENT POLICY

1. On behalf of the Government of the Republic of Malawi, I write to request for a Development Policy Operation (DPO-1) Credit of US$80 million from the International Development Association (IDA). The DPO-1, which is the first in a programmatic series of two single tranche operations, is intended to lay the foundations for a more resilient economy. This will be achieved through measures to improve incentives for private sector participation in agricultural markets and strengthen fiscal management through more effective expenditure controls and greater transparency. These objectives are essential prerequisites for sustainable economic growth and poverty reduction in Malawi.

2. The DPO-1 will focus on two pillars of policy and institutional reforms: (i) making agricultural markets work better; and (ii) strengthening expenditure management and accountability in public finances.

A. RATIONALE

3. Reliance on basic farming methods and rain-fed agriculture, coupled with a growing population, has made food security a recurrent challenge. Furthermore, in recent times, Malawi has suffered from weather related shocks at an increasing frequency, including the simultaneous floods and droughts in 2015 and 2016. These shocks in 2015 and 2016 respectively left 2.8 million and 6.7 million people food insecure and in need of relief. The 2015/16 El Nino weather event has negatively affected countries across Southern Africa; but the impact has been most significant in terms of macroeconomic costs and poverty impact in Malawi.

4. Two years of drought-related weather shocks have come at a time when Malawi has been going through a period of fiscal consolidation, containing the pace of expenditure growth and intensifying revenue collection. This follows a period of enlarged budget deficits, high-cost domestic borrowing and resurgent inflation, exacerbated by a lack of availability of budget support. Thus, successive weather-related shocks come at a time when the Government has very limited fiscal space to respond.

5. Against this background, critical reforms are necessary for Malawi to restore macroeconomic stability and increase medium-term resilience. The resurgent food insecurity has added urgency to the need to undertake reforms to ensure that Malawi can break the cycle of vulnerability and avoid repeated crises as a result of a changing climate. The DPO-1, therefore, will support the policy and institutional reforms that the Government is undertaking in order to reduce distortions in the agricultural market, boost economic growth and resilience, and restore confidence in basic public finance management systems.
B. MACROECONOMIC PERFORMANCE AND DEVELOPMENTS

Economic Outlook

6. The Government remains committed to staying the course on the hard but important reforms aimed at resuscitating the economy and achieving macro-economic stability, including foreign exchange market liberalization and removal of fuel subsidies. The liberalization of the foreign exchange market has improved the foreign currency position as well as the import cover. Fuel queues that were commonplace have long disappeared and there has been an increase in industrial capacity utilization since companies are now able to import raw materials. Notwithstanding these gains, recent multiple shocks, including the continued absence of general budget support and food insecurity resulting from heavy flooding and prolonged drought, have negatively impacted on the growth prospects of the economy and contributed to high inflation.

7. Growth in Real Gross Domestic Product (GDP) declined to 3% in 2015 from 5% in 2014. The 2015 floods disrupted energy generation, damaged roads, and reduced growth in the services and industry sectors which account for 50% and 11% of GDP, respectively. Reduced agricultural production in 2016 due to drought conditions has left some 40 percent of Malawians food insecure and lead to another year of weak GDP growth, projected at less than 3%. Growth is projected to rise gradually to about 5.5% over the medium term, while inflation is expected to fall to within single digit assuming international prices for food and petroleum products remain low. The Government is firmly committed to tight monetary and fiscal policies in order to bring down inflation, contain domestic borrowing, and reduce interest rates to support higher growth. The current account deficit as a percentage of GDP will remain in the range of 7% to 8% over the medium term, reflecting the import demand pressures associated with developmental projects, and the slow pace of export diversification.

Fiscal Performance

8. Malawi's fiscal situation since the 2012/13 Financial Year (FY) has weakened considerably due to shortfalls in external grants and domestic revenues, coupled with rising pressures on wages and salaries, domestic debt interest payments, goods and services for the Government operations and fertilizer subsidies. Revenues and grants decreased to 21.0 percent of GDP in 2015/16 FY from 28 percent in 2012/13 FY while expenditure declined to 28 percent of GDP from 29 percent over the same period.

9. Due to inadequate expenditure adjustment, the overall fiscal deficit rose from 1.8 percent of GDP in 2012/13 FY to 6 percent in 2015/16 FY. The fiscal deficit was financed largely through domestic borrowing. However, the Government has undertaken strong fiscal consolidation efforts that have enabled the attainment of the net domestic borrowing target under the International Monetary Fund (IMF) Extended Credit Facility (ECF) Programme during the first half of the 2016/17 FY.

10. The need to respond to the humanitarian crisis in the 2016/17 FY has exacerbated the fiscal challenges, exerting further pressure on domestic borrowing. However, through the augmentation of access by the IMF and the curtailment of non-priority expenditures, the Government managed to create fiscal space for pro-poor expenditures and purchases of maize in response to the food crisis. Strong donor support will be key to ensure the smooth execution of the budget and that the gains made are sustained.

International Monetary Fund (IMF) Extended Credit Facility (ECF)

11. The ECF Programme went off track in September 2016, largely due to slippage on the end June 2016 Net Domestic Financing Target. The outcome for December 2016, shows that the ECF is
now back on track, with all targets met. Additionally, program benchmarks on public finance management, including on bank reconciliation, are now complete. The IMF is, therefore, likely to complete the 9th and final review of the programme. The Government is committed to sustaining the recent strong macro-economic policy reform efforts, in order to reduce inflation and lay a stronger foundation for sustained growth and poverty reduction.

C. THE NATIONAL DEVELOPMENT STRATEGY

12. The Government is in the process of preparing its next National Development Strategy (NDS) to succeed the Second Malawi Growth and Development Strategy (MGDS-II). The Government is working to ensure that the process is participatory and that all key stakeholders are consulted. The Government, through the Ministry of Finance, Economic Planning and Development, is partnering with the World Bank to develop a Country Economic Memorandum (CEM) which will provide input into the development process for the NDS. The development of CEM is also being supported by DFID and USAID.

13. The Government is in the process of establishing a National Planning Commission (NPC). The Law to govern the mandate of the NPC has already been enacted. The NPC will be mandated to undertake the national economic planning of the country. Since it will be established by an Act of Parliament, it will be insulated from political interference, thereby ensuring more realistic economic planning, appropriate prioritization of finite resources and the sustainability of development strategies and programmes.

D. SPECIFIC REFORMS TO BE IMPLEMENTED

14. Building on the reforms that the Government is currently implementing, the operation will contribute to the establishment of a more resilient economy, through measures to reduce agricultural market distortions and increase fiscal buffers. In this respect, I wish to highlight the various reforms that the Government is implementing.

Pillar A: Making Agricultural Markets Work Better

15. Despite major investments in fertilizer and improved seed through the Farm Input Subsidy Programme (FISP), the agriculture sector has not developed into a more external shock resistant production environment that gradually moves poor smallholders out of recurrent food and nutrition insecurity. This is largely due to underinvestment in complementary activities as well as inefficiencies in the implementation of the FISP.

16. Malawi is dealing with the aftermath of extreme flooding and subsequent droughts that left many households food insecure. A pattern of annual humanitarian responses over a decade suggests a failure to effectively support the productive capacity of Malawi’s agriculture sector. This situation leads to the question of how to ensure food security for a growing Malawian population.

17. In order to break the cycle of food insecurity and build resilience, there is need for a paradigm shift in favour of greater mitigation against climate change, greater resilience, greater preparedness and better exploitation of available resources as well as opportunities. In this regard, the Government is developing a five year National Resilience Plan to break the cycle of food insecurity and will continue to undertake necessary reforms in the agriculture sector as follows:

Farm input Subsidy

18. The Farm Input Subsidy Programme (FISP) has been crucial in achieving food security during periods of good climatic conditions because it has enabled poor Malawians to access fertilizer and improved seed. However, implementation challenges have been encountered, ranging
from cost overruns, very low farmer contributions, and poor targeting. In FY2015/16, the Government implemented pilot reforms to increase efficiency gains and reduce the fiscal burden. Positive lessons have been drawn including the need for structural and financial adjustments to improve effectiveness as well as reduce costs.

19. These reforms, now scaled up over the 2016/17 growing season, have resulted in increased private sector retailing, thereby reducing monopoly by Government agencies; fixing coupon value thereby increasing farmer contributions as well as capping Government's cost exposure; introduction of an e-voucher to counter the selling of coupons as well as the proliferation of fake coupons; and targeting eligible farmers who are best able to make use of subsidized fertilizer. These reforms have already signalled positive results and will continue to be implemented.

20. However, the Government also recognizes that these reforms will have a number of negative distributional effects. For a segment of smallholder farmers, FISP coupons have tended to be sold and the scheme in effect has worked as a cash-transfer scheme, albeit an inefficient one. Targeting more eligible farmers will likely lead to the exclusion of ineligible farmers. As such, the Government is committed to scaling up the Social Cash Transfer (SCT) program to provide increased safety nets for the poorest households, to help cushion the impact of any loss of income resulting from FISP reforms. The first step in this process is establishing the necessary institutional coordination arrangements that will allow for the transition from a series of pilots, to a national program with nationwide coverage. Government is working hard to scale up the SCT program from the current 18 to a target of 28 districts providing full national coverage to the poorest 10 percent of the population. In addition, during the 2016/17 lean season some 40 percent of the population was supported with humanitarian food distribution.

Maize Price Stability and Production Incentives

21. In order to increase self-dependence, the Government needs to strike a balance between its social responsibility with regard to food security and ensuring a better functioning and transparent maize market, one that delivers a fair price to farmers and encourages the private sector to invest. In this respect, the Government is undertaking a number of reforms aimed at reducing distortions in Malawi's maize market, reducing vulnerability, and improving the incentives for commercialization.

22. Recognizing that market interventions by the National Food Reserve Agency (NFRA) and the Agricultural Development Marketing Corporation (ADMARC) that are intended to smooth prices and ensure availability of maize can in fact exacerbate volatility, the Government is committed to improving transparency over the way the institutions operate and engage in Malawi's maize market. In this regard, the Government has adopted revised guidelines for maize draw down from the Strategic Grain Reserve (SGR), putting in place transparent and objective criteria for interventions, as well as clear technical and financial reporting and accountability mechanisms. These include clear and specific mechanisms for withdrawals from the SGR for humanitarian and non-humanitarian needs.

23. ADMARC's twin commercial and social responsibilities have often resulted in tension, leading to a situation where neither objective is met satisfactorily. Therefore, the Government has commissioned a strategic review of ADMARC's functions, governance arrangements and oversight mechanisms, with a view towards reforming the institution so that it is best able to play a productive role in Malawi's agricultural markets, with improved standards of governance. In order to build confidence in Malawi's agricultural markets, the Government has also instructed ADMARC to publish its audited annual financial statements and detailed reports of the Corporation's maize market distribution and purchasing activities throughout the 2016 lean season. These disclosures have played a key part in a more orderly maize market this year, with smoother prices and increased private sector confidence to enter the market.
24. As an agriculturally endowed country, land is one of Malawi's most basic but valuable assets. However, Malawi's legislative framework for land has been fragmented, stalling the development of a more modern agricultural sector. The newly enacted Land Legislation (in particular the Land Act, Customary Land Act, Physical Planning Act and Land Survey Act) will enable the registration of customary land. These reforms will collectively help formalize land ownership, improve land administration, increase security of tenure and promote increased investment in own land at a time when Malawi needs to build a stronger and more diversified agricultural sector. In addition, the Government is similarly preparing revisions to a number of legislative texts in order to reduce distortions and improve incentives for commercialization. These include the Control of Goods Act, the Seed Act and the Warehouse Receipts Bill.

Pillar II: Strengthening Expenditure Management and Accountability in Public Finances

Public Financial Management (PFM) Reforms

25. The Government strongly believes that its efficiency and effectiveness in service delivery, to a large extent, depends on stringent management of public finances. An efficient and effective PFM system is therefore central to the creation of trust between the Government and the people that it serves. It is for this reason that the Government has embarked on rigorous PFM reforms.

26. The Government has taken the "Getting the basics right" approach to PFM reform. It was on the basis of this understanding that the PFM reforms are aimed at addressing the basic controls first before embarking on the advanced and more complex reforms. A short-term PFM program was therefore developed to restore the basic controls first and promote accountability. In order to ensure PFM responsibility by Controlling Officers across each of Malawi’s ministries, departments and Agencies (MDAs), the Government has formally issued letters of appointment to all heads of MDAs with clear mandates and financial accountability arrangements. Re-instituting the requirement by Controlling Officers to submit monthly reports of expenditure, revenue, commitments, payroll and bank reconciliations is a key step in restoring basic controls to the country’s PFM system. The number of Principal Secretaries has been sharply reduced to ensure clear accountability at the Controlling Officer level.

27. Similarly, progress has been registered in closing Malawi’s backlog of financial reporting with the preparation and auditing of four years of financial statements in one year. I am also pleased to advise that Malawi is now, for the first time in a very long time, fully current in its financial reporting obligations.

28. Progress has also been made across a number of other areas in Malawi’s PFM framework as well. The Government has, among other things, (a) improved the control environment for the Integrated Financial Management Information System (IFMIS) by the introduction of physical controls and new user profiles for all users including super users; (b) carried out a head count exercise and payroll audit with the aim of removing staff not in lawful employment such as those that have been dismissed, resigned, dead, or not employed from the payroll; (c) implemented the recommendations on the payroll system audit; (d) maintained the pace of efforts toward the procurement and implementation of the new Integrated Financial Management Information System (IFMIS); (e) introduced bank reconciliation at MDA level under the supervision of the Controlling Officer; and (f) made efforts aimed at enforcing commitment control and expenditure management.

29. Recognizing that rebuilding Malawi’s PFM framework also requires the strengthening of oversight arrangements, the Government has also submitted legislation to Parliament that would increase the independence of the Auditor General and bring Malawi’s Public Audit Act into line with international standards, by granting increased independence over budget and staffing, and by raising transparency and disclosure standards.
30. Finally, I would add that the recent enactment of a new Access to Information Law sets a new standard for openness and transparency in Malawi.

31. I am, however, aware that a lot remains outstanding including enforcing of rules and regulations, improving cash and debt management, improving coverage and quality of fiscal reporting, improving budget execution and control, arrears and commitment control, strengthening effectiveness of PFM Institutions, and functioning of the existing IFMIS. To this end, the Government is committed to undertaking before the end of 2017, a Public Expenditure and Financial Accountability (PEFA) assessment (based on the new 2016 framework) in order to determine the key areas of the PFM that may require improvement. Based on the findings of the PEFA, the Government will develop a new PFM Rolling Plan that will provide guidance in addressing the medium-term PFM challenges that the country faces.

E. CONCLUSION

32. I request the World Bank's assistance to support the realization of this program. I believe that the outlined policies and institutional reforms represent a first step towards the establishment of a more conducive environment for economic recovery, stronger institutions, and a more resilient foundation for Malawi's development.

Yours sincerely,

Goodall E. Gondwe
MINISTER OF FINANCE, ECONOMIC PLANNING AND DEVELOPMENT