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INTERNATIONAL DEVELOPMENT ASSOCIATION

PROGRAM DOCUMENT

FOR A PROPOSED GRANT

IN THE AMOUNT OF SDR 33.4 MILLION
(US$50 MILLION EQUIVALENT)

TO THE

REPUBLIC OF MALAWI

FOR A

MALAWI ECONOMIC RECOVERY DEVELOPMENT POLICY OPERATION 1

April 29, 2013

Poverty Reduction and Economic Management AFTP1
Country Department AFCS3
Africa Region

MALAWI – GOVERNMENT FISCAL YEAR
JULY 1 – JUNE 30

CURRENCY EQUIVALENTS

(EXCHANGE RATE EFFECTIVE AS OF APRIL 17, 2013)

Currency Unit = Malawi Kwacha (MWK)
MWK 398.5 = US$1
US$1.0 = SDR 0.667022

WEIGHTS AND MEASURES

METRIC SYSTEM

ABBREVIATION AND ACRONYMS

AAA	Analytical and Advisory Services
AfDB	African Development Bank
ALCO	Assets and Liability Committee
APM	Automatic Pricing Mechanism
APR	Annual Progress Report
ATAF	Automatic Tariff Adjustment Formula
BPFP	Budget Policy Framework Paper
CABS	Common Approach to Budget Support
CAS	Country Assistance Strategy
CEM	Country Economic Memorandum
COMESA	Common Market for Eastern and Southern Africa
CPAR	Country Procurement Assessment Report
CSOs	Civil Society Organizations
DAD	Debt and Aid Division
DBS	Doing Business Survey
DCAFS	Donor Committee on Agriculture and Food Security
DEMPA	Debt Management Performance Assessment
DFID	Department for International Development
DPO	Development Policy Operation
DSA	Debt Sustainability Analysis
EC	European Commission
ECF	Extended Credit Facility
EU	European Union
FDI	Foreign Direct Investment
FIMTAP	Financial Management, Transparency, and Accountability Project
FISP	Farm Input Subsidy Program
FROIP	Financial Reporting and Oversight Project
FSAP	Financial Sector Assessment Program
FSTAP	Financial Sector Technical Assistance Project
FY	Fiscal Year
GCI	Global Competitiveness Index
GDP	Gross Domestic Product
GFEM	Group on Public Financial and Economic Management
GFS	Government Financial Statistics

GiZ	German Agency for Technical Cooperation
GNI	Gross National Income
GoM	Government of Malawi
HIPC	Highly Indebted Poor Countries
ICR	Implementation Completion and Results Report
IDF	Institutional Development Fund
IDA	International Development Association
IHS3	Third Integrated Household Survey
IFMIS	Integrated Financial Management Information System
IMF	International Monetary Fund
IFRS	International Financial Reporting Standards
IPC	Internal Procurement Unit
IPPs	Independent Power Producer
IT	Information Technology
LICs	Low Income Countries
LIPWs	Labour Intensive Public Works
LSMS-ISA	Living Standards Measurement Survey-Integrated Surveys on Agriculture
JF	Joint Framework
MCC	Millennium Challenge Corporation
MRA	Malawi Revenue Authority
MDAs	Ministries, Departments and Agencies
MDRI	Multilateral Debt Relief Initiative
MDTF	Multi-Donor Trust Fund
MEPD	Ministry of Economic Planning and Development
MoEST	Ministry of Education Science and Technology
MERA	Malawi Energy Regulatory Authority
M&E	Monitoring and Evaluation
MGDS	Malawi Growth and Development Strategy
MG1	Malawi Government [Account Number] 1
MWK	Malawi Kwacha
MSB	Malawi Savings Bank
MTDS	Medium Term Debt Management Strategy
MTEF	Medium Term Expenditure Framework
MTFF	Medium Term Fiscal Framework
MoAFS	Ministry of Agriculture and Food Security
MoF	Ministry of Finance
MoE	Ministry of Energy
NAO	National Audit Office
NGO	Non-governmental Organization
NOCMA	National Oil Company of Malawi
NPV	Net Present Value
NSO	National Statistical Office
NSSP	National Social Support Program
NSSSP	National Statistics System Strategic Plan
SMEs	Small and Medium Size Enterprises
SSP	Social Support Policy
ODA	Overseas Development Assistance
ODPP	Office of the Director of Public Procurement
OPC	Office of the President and Cabinet
PAA	Public Audit Act

PAC	Public Accounts Committee
PAF	Performance Assessment Framework
PDO	Project Development Objective
PEFA	Public Expenditure and Financial Accountability Framework Assessment
PER	Public Expenditure Review
PFEM	Public Finance and Economic Management
PFEM-PR	Public Finance and Economic Management Reform Program
PFM	Public Financial Management
PFMA	Public Financial Management Act
PPA	Public Procurement Act
PRSC	Poverty Reduction Support Credit
PSIA	Poverty and Social Impact Analysis
PV	Present Value
RBM	Reserve Bank of Malawi
RRDPG	Rapid Response Development Policy Grant
RRP	Rapid Response Program
SADC	Southern African Development Community
SAPP	Southern African Power Pool
SDR	Special Drawing Rights
SOAS	School of Oriental and African Studies
SOEs	State Owned Enterprises
ST	Secretary to the Treasury
SWGs	Sector Working Groups
TA	Technical Assistance
TBs	Treasury Bills
USD	United States Dollar
VAT	Value Added Tax

Vice President	Makhtar Diop
Country Director	Kundhavi Kadiresan
Sector Director	Marcelo Giugale
Sector Manager	John Panzer
Task Team Leader	Appolenia Mbowe

THE REPUBLIC OF MALAWI
ECONOMIC RECOVERY DEVELOPMENT POLICY GRANT (DPO-1)

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The Economic Recovery Development Policy Operation (DPO-1) was prepared by a multi-sector team led by Appolenia Mbowe (Task Team Leader & Sr. Economist, AFTP1) and comprising Praveen Kumar (Lead Economist, AFTP1), Pazhayannur K. Subramanian (Lead Financial Management Specialist, AFTFM), Olivier Durand (Sr. Agricultural Specialist, AFTAR), Ida Manjolo (Sr. Social Protection Specialist, AFTSP), Rob Mills (Sr. Economist, AFTG1), Temwa Gondwe (Economist, AFTP1), Steve Mhone (Procurement Specialist, AFTPC), Nneoma Veronica Nwogu (Counsel, LEGAM), Luis M. Schwarz (Sr. Finance Officer, CTRLA), Trust Chimaliro (Financial Management Specialist, AFTFM) and Deliwe Ziyendammanja (Team Assistant AFMMW). The IDA team also collaborated very closely with representatives of four other donor agencies that make up the Common Approach to Budget Support (CABS) group. The Peer Reviewer for this operation is Jos Verbeek (Lead Economist, DECPG) and William Battaile (Sr. Economist, PRMED).Overall guidance was provided by Marcelo Giugale (Sector Director, PREM), Kundhavi Kadiresan (Country Director, AFCS3), John Panzer (Sector Manager, AFTP1) and Sandra Bloemenkamp (Country Manager, AFMMW).

GRANT AND PROGRAM SUMMARY
REPUBLIC OF MALAWI
ECONOMIC RECOVERY DEVELOPMENT POLICY OPERATION
(GRANT H849-MW)

Recipient	Republic of Malawi		
Implementing Agency	Ministry of Finance		
Financing Data	IDA Grant, standard IDA terms Amount: SDR 33.4 million (US$50 million equivalent); Closing date: December 31, 2013.		
Operation Type	First of a programmatic series of three single tranche Development Policy Operation of SDR 33.4 million (US$50 million equivalent)		
Main Policy Areas	Macroeconomic management, public financial management, agriculture, energy, social protection and statistics.		
Key Outcome Indicators	**Outcome Indicators**	**Baseline (2012)**	**Target (2016)**
	Percentage of the stock of domestic payment arrears cleared (State Owned Enterprises) (%)	0	50
	Variance in primary expenditure between approved and outturn (%)	12	8 or less
	Reduction in the rate of recurrent audit findings (%)	90	50
	Number of power generation licensed for Independent Power Producers	0	at least One
	Number of beneficiaries with savings of at least 50% of Public Works wage one year after participation	13,000	49,000
Development Objectives	The development objectives of the Economic Recovery Development Policy Operation series are to strengthen macroeconomic and public finance management and lay the foundation for stronger growth and protection of the poor. The program is geared towards consolidating macroeconomic policy reforms implemented under the stabilization effort undertaken since May 2012, as well as prepare the ground for longer term structural reforms for the post-election era. **Links to CAS:** The proposed DPO series is fully consistent with and closely linked to the objectives of the FY13-16 Country Assistance Strategy approved by the Board in January 2013. The CAS seeks to contribute to Malawi's efforts toward a more diversified, competitive, shock-resilient socioeconomic growth. The DPO is also linked to the main pillars of the Africa Regional Strategy.		
Risks and Risks Mitigation	Three main risks could influence the expected outcomes of the proposed operation: (a) **External shocks:** The country remains vulnerable to weather-related and other external shocks, which could have an impact on the overall GDP growth, consumer prices, and external balance. A shortfall in maize output was partly responsible for the acceleration of inflation during 2012-13. A weather-related sharp decline in tobacco production could have consequences for foreign exchange balance and hence exchange rates in the short-term. There remains a potential risk of spillovers from the global economy, including a decline in prices of Malawi's exports, and a reduction in aid flows. All of these vulnerabilities pose significant risk to nascent		

	macro-economic stability. *Mitigation*: The authorities are regularly monitoring macroeconomic developments, including as part of the program with the IMF. A continuation of the policy reforms instituted in 2012 such as automatic price adjustment mechanism for fuel and flexible exchange rate would allow the economy to adjust to shocks with minimum policy response. Where needed, the government is expected to respond through appropriate policy measures. The Bank team will help the Government of Malawi (GoM) to formulate and implement such responses. In 2012, the Government responded to the decline in maize output by fiscal tightening which is being supported by the Bank through advice on public expenditure policy. (b) **Political risk:** Political risk remains high in the context of Presidential elections planned for May 2014. Policy reforms instituted in 2012 have been followed by considerable depreciation of Kwacha and annual inflation in excess of 30 percent. These developments are putting pressure on the Government's resolve to stay the course. Pressures on the budget are likely to increase during fiscal year 2013-14 posing further risks to macroeconomic stability. *Mitigation:* These risks will partly be mitigated by a better communication by the government on how the policy reforms are having some positive impacts and the time needed to let these reforms work. This could be complemented by more informed public debates based on emerging evidence from the on-going Public Expenditure Review and poverty policy notes, which includes analysis on the FISP. (c) ***Implementation capacity risks.*** The systemic problem of capacity in GoM continues to pose a risk to the reform program and may cause delays in implementation of some of the reform measures supported by this operation. Weak management of public finances and reports of widespread corruption and extortion by public officials in procurement and fraudulent activities within the PFM systems represent a significant risk. *Mitigation:* To address this risk in the short term, the Bank intends to increase its engagement at the technical level to ensure the reforms under this operation are implemented and sustained. In addition, the DPs are supporting the GOM through a combination of capacity building and technical support, including support for statistics and monitoring and evaluation. Specifically, the risks can be mitigated by the pace of reforms supported by the implementation of a more harmonized PFM program under the Multi-Donor Trust Fund.
Operation ID	P133663

REPUBLIC OF MALAWI
ECONOMIC RECOVERY DEVELOPMENT POLICY OPERATION (DPO 1)

I. INTRODUCTION AND OVERVIEW

1. **This program document proposes the Economic Recovery Development Policy Operation to the Republic of Malawi for SDR 33.4 million (US$50 million equivalent), on standard IDA terms.** The proposed operation is the first in a programmatic series of three single tranche operations, which intends to support the implementation of the Government of Malawi's (GoM) new medium term development strategy, the Second Malawi Growth and Development Strategy (MGDS II) 2011-16, approved in April 2012, and the Economic Recovery Plan.[1] The rationale behind the decision to start a new DPO series is based on the need to help the GoM implement its medium term reform agenda while at the same time ensure predictability in the financing of the reforms through the series.

2. **The DPO series is designed to assist the GoM consolidate reform measures undertaken since May 2012 aimed at stabilizing the economy, supporting quick growth rebound and protecting the poor and the most vulnerable while setting the stage for longer term structural reforms**. Specifically, the operation will support two key pillars: (i) strengthening the macroeconomic and public finance management through measures aimed at strengthening fiscal discipline to entrench macro-stability as well as improving efficiency and the transparency of the public finance management; and, ii) laying the foundation for stronger growth and protection of the poor through reform measures aimed at enhancing agriculture productivity and diversification; improving energy efficiency and the regulatory environment; improving efficiency in the provision of social safety nets; and, strengthening the country's statistical capacity.

3. **The choice of the reform areas is based on the outstanding reform agenda currently being pursued by the GoM** on strengthening PFM and efficiency in government expenditure, addressing constraints to growth and economic diversification as well as advancing the inclusive growth agenda through productive social safety nets. The operation also represents a continuation of an on-going policy dialogue with the authorities and builds upon reforms implemented under the Rapid Response Development Policy Grant (2012 RRDPG). The operation also builds on reforms supported under the Poverty Reduction Support Grant 1-3 (2007-2010 PRSG series) as well as consolidates the reforms supported by the three-year arrangement for Malawi under the Extended Credit Facility (ECF) approved in July 2012.

4. **This Program comes at the time when the economy is going through a difficult recovery process in the wake of a severe economic and governance crisis of 2011, which had threatened to push the economy into a policy-induced recession.** The timely implementation of adjustment measures to address the long standing internal and external imbalances in the economy by the new Administration under President Mrs. Joyce Banda, which came into office in April 2012, averted a full blown economic and social crisis. The manifestation of the macroeconomic imbalances included the accumulation of an estimated MK72 billion in government domestic payment arrears, severe shortages of foreign

[1] ERP lays out action plans over the short to medium term to accelerate progress towards poverty reduction through sustainable and inclusive growth. It also proposed a social support package, which will be built on existing programs to mitigate the impact of the reforms on vulnerable sections of society.

exchange and accumulation of external payment arrears by the private sector, estimated at about US$600 million. These reforms have facilitated, among others, the removal of market distortions (especially in the petroleum sub-sector and foreign exchange markets), the strengthening of the macroeconomic management and the clamping down on some of the loopholes in the public finance management, while scaling up social safety net programs to cushion the poor and the most vulnerable groups from unintended effects of the economic adjustment process.

5. **While the reforms have laid the foundation for the country's recovery, a harsher external environment than earlier anticipated has weakened the pace of the economic recovery**. The significantly reduced tobacco and sugar proceeds in 2012 and higher than anticipated foreign exchange demand for clearance of the backlog of external payment arrears as well as to meet the current import needs and external obligations have exerted significant pressures on the exchange rate. Continued depreciation of the exchange rate[2] and drought induced increases in local food prices has contributed to the surge in inflation above its envisaged path.[3] The rising cost of living, on the back of high inflation rate and continued depreciation of the Kwacha has also intensified demands for wage increases, especially in the public sector, as evidenced by the recent industrial actions. Therefore, achieving fiscal sustainability going forward and preventing an inflation-depreciation spiral would be critical.

6. **The proposed operation will provide US$50 million equivalent in budget support needed to ease the emerging fiscal pressures and sustain the current economic reforms while setting the stage for longer term objectives of improving efficiency in government expenditure, reducing poverty and achieving a sustainable and inclusive growth.** The Program will be informed by Analytical and Advisory services (AAAs) and Technical support, including the 2013 Public Expenditure Review[4] and the Diagnostic Trade Integration Study update, and will be provided within the harmonized framework for the provision of budget support in Malawi, the Common Approach to Budget Support (CABS), comprising IDA and five other participating Development Partners (DPs).[5] The program is also anchored on the new FY13-16 Country Assistance Strategy and will provide a platform from which the Bank will engage in policy dialogue with the authorities on key policy areas supported by this operation.

II. COUNTRY CONTEXT[6]

A. Political Context

7. **Following the death of the late President Bingu wa Mutharika, who ruled the country from 2004 until his death in April 2012, the former Vice President Mrs. Joyce Banda, took office as the first female President of Malawi.** The new Administration had to implement critical macroeconomic and structural reforms immediately after getting into

[2] Traditionally, the months of September to March are known as the lean season for foreign exchange as the supplies tend to be the lowest, due to seasonality of agriculture.

[3] The drought conditions in the southern part of the country in 2012 left close to 2 million people under threat of being food insecure. But the crisis was averted by the GoM's timely release of the emergency food assistance with support from the DPs.

[4] The sectors covered by the 2013 PER, include Agriculture, Transport, Health, Education and social protection and is scheduled for delivery in late September 2013.

[5] Other members of the CABS are the European Commission, United Kingdom (DFID), African Development Bank, Norway, and Germany (KfW). The UNDP, Ireland and IMF have observer status.

[6] Details on Political, Social and Economic context and background provided in Annex 4-A-C.

office to avoid economic collapse, with some encouraging early signs of a recovery. The GoM's resolve to address governance issues, including the normalization of relations with its neighboring countries and the international community, has yielded positive results as evidenced by the resumption of budget support and the recent signing of the Memorandum of Understanding (MOU) between the Governments of Malawi and Mozambique on the stalled interconnector energy project.

8. **Malawi is now preparing for its fifth Presidential and Parliamentary elections scheduled for May 2014.** President Banda's administration faces the challenge of maintaining support for its economic policy reforms with calls for policy reversals, especially the flexible exchange rate regime and the automatic price adjustment for petroleum products. So far, none of the opposition parties have provided alternative policy options. For the first time since she took office in April 2012, President Joyce Banda has a minority in Parliament after one of the main opposition parties, the United Democratic Front, relocated from the GoM's side. All political parties are focused on the upcoming elections.

B. Social Context

9. **Malawi is ranked 170 out of 186 countries surveyed in the United Nations Human Development Index of 2012.** According to the recent report of Malawi's Third Integrated Household Survey (IHS3 2010/11), absolute poverty has declined by less than 2 percent since 2004/05, to 50.7 percent. Although poverty in urban areas reduced from 25.4 percent in 2005 to 17.3 percent in 2011, this gain was counterbalanced by a worsening in rural poverty from 55.9 percent to 56.6 percent. Stagnant poverty levels raise questions on the effectiveness of the Malawi's Farm Input Subsidy Program (FISP), in alleviating poverty and food insecurity in a sustainable manner.[7] With the majority of the poor living in rural areas, rural growth through agricultural transformation is clearly critical as Malawi strives to reduce the number of its people who live in absolute poverty.

10. **While the human development indicators represent a mixed picture, Malawi is likely to meet four of the eight MDGs – which is a noteworthy achievement in the Sub-Saharan Africa context.** Health is being improved by reductions in chronic malnutrition, measles immunization for children less than a year old and life expectancy has surged, from 38 in 2005 to 53 in 2012. Trends in under-5 and infant mortality have been improving steadily for two decades. Unfortunately, the HIV prevalence rate in Malawi is still one of the highest in the world: 10.6 percent for adults aged 15–49 in 2010 (12.9 percent for women and 8.1 percent for men), slightly down from 11.8 percent in 2004. AIDS is the leading cause of adult deaths in Malawi and is a drain on public resources. As for the education MDGs, though Malawi has made progress, the quality of education is still low by regional standards. In general, Malawi is likely to meet the goals related to reducing child mortality; combating HIV/AIDS, malaria, and other diseases; ensuring environmental sustainability and developing a global partnership for development. To strengthen the demand for evidence based policy making and to improve the monitoring of social outcomes as well as the impact of the interventions, more efforts are needed to improve the country's statistical capacity and the reliability of its data.

[7] FISP account for over 60 percent of the total budget allocated to the Ministry of Agriculture and Food Security.

C. Economic Context

11. **Malawi, a landlocked agrarian economy, continues to rely on a few primary commodities, which makes it vulnerable to weather and terms of trade shocks.** The country is also highly aid-dependent. Agriculture, the main stay of the economic and the main source of growth and exports, is central to reducing poverty. Expanding and diversifying agricultural exports and expanding commercial agriculture is high priority. With support from DPs, the GoM is promoting production of legumes and has introduced a pilot program to promote cotton production. However, the success of agricultural diversification will *inter alia* depend on availability of quality seeds and seeds varieties, investments in irrigation infrastructure, adequate rural roads access and marketing infrastructure. Currently, there are no seeds available in the market for new crops like cotton, and even for traditional crops, which limits the country's ability to increase productivity and support crop diversification. This DPO series seeks to improve the legal framework for an efficient seeds market.

12. **Improving economic infrastructure is essential to increase competitiveness and attract potential investors.** Unreliable power and water supplies and excessive transport costs need urgent attention. The 2010 Country Economic Memorandum (CEM) identified the unreliability of power supply as one of the primary constraints to growth. The energy sector needs both public and private investments to eliminate energy shortages, by upgrading transmission and distribution systems to reduce energy losses and improving both energy efficiency and transmission interconnections to the Southern African Power Pool (SAPP). Therefore, the reinstatement of the Millennium Challenge Corporation (MCC) Energy Compact in June 2012, the recent signing of the MOU by Governments of Malawi and Mozambique for the interconnector project and the Kapichira II (the hydro power plant) soon to come on stream reflect positive developments. Low electricity tariffs remain a major impediment to investments by Independent Power Producers (IPPs). But raising tariffs alone cannot resolve the country's investment blockages; there is need to also review the regulatory framework. The proposed reforms under this operation therefore seek to improve energy efficiency and the regulatory environment.

13. **Having a functioning Public Finance Management system is an essential foundation for fiscal discipline.** Malawi has been implementing PFM reforms for over a decade but progress towards fiscal discipline has been slow with lack of ownership and non-adherence to the country's own PFM rules and regulations. While the capacity to carry out more timely audits, both external and internal audits, has improved, the quality and the follow-up on internal and external audits are still uncertain; regulation and operational guidelines for internal auditing are not yet well embedded. The proposed operation, which is being complemented by the Financial Reporting and Oversight Improvement Project, seeks to address the outstanding PFM gaps in a harmonized approach to ensure that they are sustained.

D. Recent Economic Developments

14. **After registering high rates of economic growth averaging 7 percent during 2006-10, the pace of Malawi's growth started to slow down in 2011, where the economy is estimated to have grown by 4.3 percent**. This was on a back of a difficult macroeconomic and governance environment in 2011/12, which was adversely affected by a combination of events, including significantly reduced donor inflows and tobacco

proceeds, higher fuel/fertilizer prices, and the overvaluation of the kwacha, leading to fiscal and external imbalances. Despite improvements in the supply of foreign exchange and fuel during the second half of 2012, the slowdown in the real sector activities in 2011/12 and the contraction in the agriculture and manufacturing sectors led to low real GDP growth rate of 1.9 percent in 2012.

Table 1: Malawi- Key Macroeconomic Indicators, 2008-2016

	2008	2009	2010	2011	2012 Prel	2013 proj.	2014 Proj.	2015 Proj.	2016 Proj.
National accounts and prices (percent change, unless otherwise indicated)									
GDP at constant market prices	8.3	9.0	6.5	4.3	1.9	5.5	6.1	6.5	6.7
Consumer prices (end of period)	9.9	7.6	6.3	9.8	34.6	11.8	5.8	5.4	4.6
Consumer prices (annual average)	8.7	8.4	7.4	7.6	21.3	20.2	8.1	5.8	4.9
Central government (percent of GDP on a fiscal year basis)									
Revenue	29.4	32.1	33.8	32.1	26.5	39.0	37.3	36.1	35.5
Grants	10.5	11.6	10.3	7.6	4.4	15.1	13.0	11.4	10.5
Expenditure and net lending	30.0	37.8	33.8	35.0	34.9	40.2	39.1	37.6	36.8
Overall balance (excluding grants)	-11.2	-17.3	-10.3	-10.5	-12.8	-16.3	-14.8	-13.0	-11.8
Overall balance	-0.6	-5.7	0.1	-2.9	-8.4	-1.2	-1.8	-1.5	-1.3
Primary balance	1.6	-3.0	2.9	-0.2	-5.9	1.6	0.5	0.3	0.3
Foreign financing	2.5	2.0	0.9	1.3	1.6	1.9	1.8	1.5	1.3
Domestic financing	0.5	3.7	-0.9	1.7	6.7	-1.6	0.0	0.0	0.5
External sector (US$ millions, unless otherwise indicated)									
Current account (percent of GDP)	-9.7	-4.8	-1.3	-5.9	-4.7	-1.6	-1.8	-2.2	-3.0
Current account, excl. official transfers (percent of GDP)	-20.8	-14.2	-17.0	-12.2	-18.8	-17.2	-16.1	-15.4	-15.3
Overall balance (percent of GDP)	-1.6	-2.0	2.2	-1.9	0.6	3.5	3.4	3.3	2.8
Usable gross official reserves	239.0	140.5	279.6	190.2	215.4	402.8	555.5	692.8	797.7
(months of imports)	1.5	0.7	1.5	1.0	1.1	1.9	2.5	2.9	3.1
Debt stock and service (percent of GDP, unless otherwise indicated)									
External debt (public sector)	15.8	16.6	15.9	16.2	22.7	26.2	24.3	22.6	21.1
NPV of debt (percent of exports)		57.1	44.6	48.1	53.2	47.0	42.2	38.2	34.4

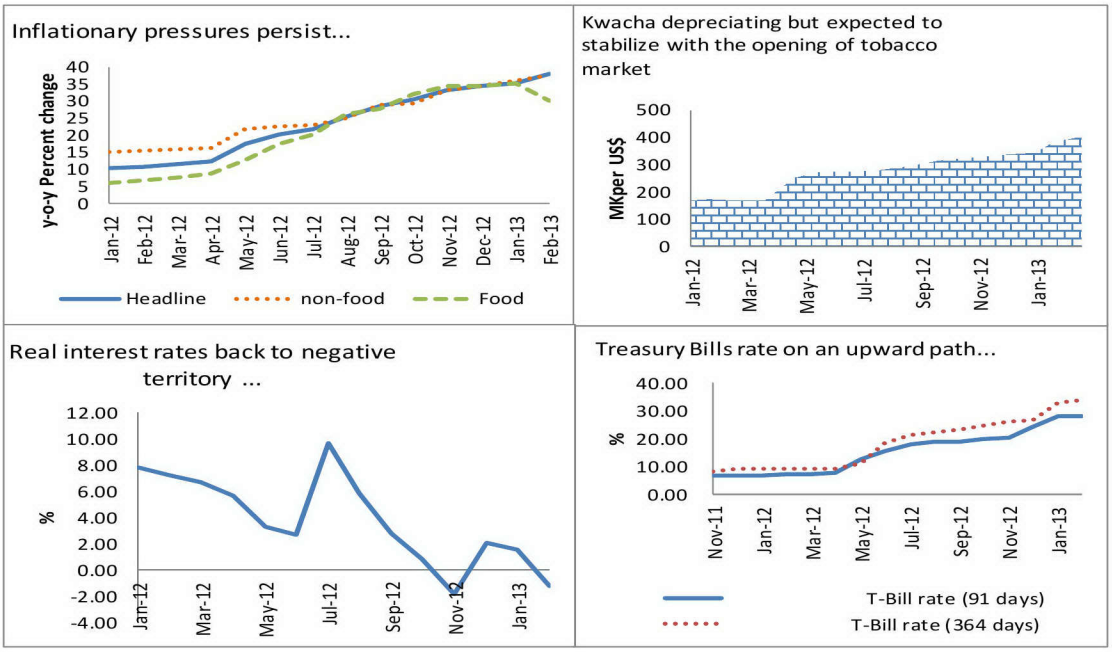
Sources: Malawian authorities, IMF and World Bank staff estimates.

15. **Specifically, the agriculture sector is estimated to have registered a negative growth of 2.9 percent in 2012, on account of underperformance in the production of tobacco,[8] cotton and maize**. The decline in maize was largely attributed to poor and erratic rains in the southern part of the country. The manufacturing sector, being the hardest hit during the economic crisis in 2011, is estimated to have contracted by 6.4 percent on the back of difficulties in accessing foreign exchange and intermittent power and water supplies.

16. **Inflation has been on an upward swing since early 2011 after being in single digits for the past five years**. Headline inflation spiked to 37.9 percent (y-o-y) in February 2013, up from 10.9 percent (y-o-y) in February 2012. This was driven largely by the rise in food prices, especially maize (related to the impact of drought in the southern region) and in non-food prices, triggered by the adjustments in the fuel, water and electricity prices, and the feed-through effects of Kwacha depreciation (figure 1). As such, the annual average inflation for 2012 stood at 21.3 percent.

[8]Reflecting the effect of price disincentives associated with the previous tobacco season.

Figure 1: Price Trends



Sources: Government of Malawi and IMF Staff estimates

17. **Economic performance during 2011 and early part of 2012 was also marred by loose fiscal stance characterized by heavy reliance on domestic financing, which crowded out credit to the private sector** (figure 2). The implementation of the 'zero-deficit budget' in 2011/12 created large fiscal imbalances as the GoM was not able to generate enough revenues. Domestic tax and non-tax revenues declined to 22.1 percent of GDP and grants fell to 4.4 percent of GDP in 2011/12, from 24.5 percent and 7.6 percent of GDP, respectively, in 2010/11 (Table 1). The loose fiscal stance resulted in a sharp deterioration in the fiscal balance to -8.4 percent of GDP in 2011/12, compared with a balance of -2.9 percent of GDP in 2010/11. This large slippage reflected unrestrained primary spending of -6.0 percent of GDP, which led to a sharp increase in domestic borrowing from 1.7 percent of GDP to 6.7 percent of GDP.

18. **Fiscal performance during the first half of 2012/13 was satisfactory as the GoM met most of the performance targets and the structural benchmarks under the ECF program.** The GoM has been able to eliminate the fuel subsidy[9] with the reinstatement of the automatic price adjustment, and has also repaid about MWK 12 billion of existing stock of domestic payment arrears (out of total arrears of MWK 72 billion) in 2012/13. While the impact of the unification of the exchange rate (and the subsequent floatation) on foreign exchange revenue has been positive,[10] its impact on foreign exchange sensitive expenditures, especially fertilizer imports, was more pronounced.[11] The immediate impact of recent wage increases to civil servants following the industrial actions in February 2013 was a 6 percent increase in the GoM wage bill for 2012/13 budget (0.3 percent of GDP), which was largely funded by cuts in the Other Recurrent Transactions (ORT) from various

[9]The cost of fuel subsidies was about US$67 million (1.2 percent of GDP) in 2011, but it must be noted that fuel was hardly available at the subsidized price in 2012.

[10] About MWK7 billion exchange rate gains from grants.

[11] The Kwacha depreciation saw a jump in the FISP budget line from 3.4 percent of GDP at approval in June 2012, to 4.4 percent of GDP in December 2013.

votes and other budgetary savings. While the impact of wage increase on the 2012/13 budget is neutral, it has a signaling effect to the market.

19. **Malawi's balance of payments suffered a significant weakening in 2011 from a surplus of 2.2 percent of GDP in 2010 to a deficit of -1.9 percent of GDP in 2011**. The strong deficit in the current account was the main factor behind the worsening of the balance of payments, as it widened from -1.3 percent of GDP in 2010 to -5.9 percent in GDP in 2011. The deterioration was largely due to high levels of imports (33.4 percent of GDP) vis-à-vis exports (22.5 percent of GDP) and very low levels of international reserves. The current account deficit narrowed to -4.7 percent of GDP in 2012, mainly on account of significantly higher official transfers. FDI slowed in 2011 to 1.1 percent of GDP from 2.9 percent of GDP in 2010, partly due to worsening governance and macroeconomic environment.

20. **Malawi's exchange rate supply has significantly improved following the recent liberalization of the exchange rate regime, which has addressed the overvaluation of the kwacha**. While the impact of the changes in the exchange rate regime on the economy is yet to be fully realized, it is expected to be positive as evidenced by improved supply of foreign exchange and fuel, improved earnings for smallholder tobacco farmers and exporters and the gradual elimination of external imbalances (Annex 4-C Box 1). The Kwacha is yet to stabilize and has depreciated by additional 66 percent against the US dollar since May 2012 after losing about 50 percent of its value. The continuous depreciation of the Kwacha is partly explained by the increase in demand for foreign exchange, especially following the clearance of private sector external payment arrears (estimated at over US$600 million), uncertainty in the market as well as insufficient supply of foreign exchange from the export side. Further tightening of the fiscal and monetary policy stance may be needed to eliminate the risk of a Kwacha depreciation-inflation spiral.

21. **To contain the growth in credit and money supply, the Reserve Bank of Malawi (RBM) has hiked the bank policy rate** in a phased manner to 25 percent in December 2012, from 13 percent prior to the reforms in May 2012. In response, the banks have increased both their lending and deposit rates, with the prime lending rates increasing from about 18 percent to above 40 percent, making borrowing for both working capital and production expansion more expensive. On the back of these developments, the spread between lending and fixed-deposit rates has slightly narrowed. The increases in bank policy rates have also been accompanied by the surge in the Treasury bill rates in excess of 35 percent for 91-days T-bills in March 2013.

22. **Risks to bank's portfolios has been elevated over the last 18 months and the RBM has intensified its monitoring and surveillance over the financial system, with special attention being paid to the distressed banks.** The tight Kwacha liquidity conditions in the banking sector in the aftermath of the May 2012 exchange rate liberalization exposed some weaknesses in the banking system. This saw the increase in the number of banks seeking accommodation from the RBM through the discount window, which prompted the RBM to introduce a temporary non-collateralized window to provide relief to stressed banks at a rate above the policy rate.[12] Nevertheless, a number of the banks still have difficulties in meeting their liquidity needs and the RBM is working with them to ensure that their portfolios are restructured and balance sheets are adjusted. While the Non-Performing Loans (NPL) are at low levels, with their share as a ratio to total loans at 7.0 percent as at end

[12] The non-collateralized window was closed end November 2012.

December 2012, the magnitude of the on-going loan restructuring and the higher than expected increase in interest rates have made loan servicing expensive, implying rising NPLs.

23. **The GoM is undertaking measures to reduce the contingent liabilities and operational loss risks posed by the State-Owned Enterprises (SOEs).**[13] Currently, the GoM is proactively monitoring/supervising the activities of the SOEs on quarterly basis, with specific attention being paid to procurement activities. The GoM has also issued promissory notes to clear the stock of outstanding payment arrears owed by SOEs accumulated over the past three years. Moreover, the recent adjustments in electricity tariffs have contributed to the improvements in ESCOM's financial position as the tariffs are now cost reflective. Meanwhile, the on-going restructuring of Air Malawi[14] will, in the medium term, help reduce fiscal pressures and the move towards the automatic price adjustment mechanism for petroleum has also reduced the contingent liability risks associated with the National Oil Company of Malawi (NOCMA).[15] Others like the water utilities remain a problem as their tariffs are not fully cost reflective and ADMARC continues to make losses.

E. Macroeconomic Outlook and Debt Sustainability

24. **The Malawi's medium term economic outlook has improved but remains with significant downside risks related to weather and terms of trade shocks and potential fiscal slippages in a contested political environment.** This notwithstanding, economic growth is projected to rebound to the pre-2010 levels in the medium term, with real GDP growth for 2013 projected at about 5.0 percent in 2013, on the back of production rebound in agriculture. The outlook for the current agriculture season is positive based on the expected recovery in tobacco production and production expansion in other cash crops including cotton and legumes. The GoM has also embarked on a two crop a year initiative, which is part of the Greenbelt irrigation program to increase crop production for the domestic and international markets.

25. **The manufacturing, the sector is expected to start showing signs of a rebound during the second half of 2013 as supply chains begin to normalize**. Mining and quarrying is projected to grow at an average 6 percent during 2013-2016, to be boosted by projected increase in coal production in 2013-14 as well as the coming on stream of the niobium mining project at Kanyika by 2014 with construction beginning in 2013. Overall, real GDP growth is projected to average 6.4 percent during 2014-2016 (Table 1), based on the assumption of good weather, favourable commodity prices, FDI and aid inflows.

26. **Inflation is also projected to start slowing down and to remain on a stable path in the medium term owing to the implementation of tight fiscal and monetary policies, expected stabilization of the exchange rate and good agriculture production.** Further depreciation of the Kwacha even at the on-set of the tobacco auction season, could affect the inflation projections for 2013, considering the lagged effects of depreciation on non-food inflation. Food inflation is however expected to start decelerating with the onset of the harvest season.

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[13]The contingent liabilities are mainly loans /overdrafts from banks and payment arrears while the operational losses arise from administratively set prices and tariffs that are below cost-recovery levels.

[14] The Ethiopian Airlines has been announced as a new strategic investor to take over the Air Malawi (2012) Limited with the equity share of 49 percent

[15] The government guaranteed loans for fuel imports pose risk to the budget, but currently this risk is being mitigated by the automatic price adjustment mechanism and the limited role played by NOCMA in fuel importation.

Table 2: Malawi – Central Government Operations, 2013-2016

	2013 Proj.	2014 Proj.	2015 Proj.	2016 Proj.	Change 2013-2016
Revenue	**39.0**	**37.3**	**36.1**	**35.5**	**3.5**
Tax and nontax revenue	**23.9**	**24.1**	**24.5**	**25.0**	**-1.1**
Grants	15.1	13.0	11.4	10.5	**4.6**
o/w Budget support	6.5	5.0	4.3	3.9	**2.6**
Expenditure and net lending	**40.2**	**39.1**	**37.6**	**36.8**	**3.4**
					0.0
Current expenditure	**32.2**	**30.5**	**29.4**	**28.9**	**3.3**
Wages and salaries	8.1	8.6	8.5	8.5	**-0.4**
Interest payments	2.8	2.3	1.8	1.6	**1.2**
Development expenditure	**8.0**	**8.7**	**8.3**	**7.8**	**0.2**
Part I (foreign financed)	5.0	5.5	5.0	4.6	**0.4**
Part II (domestically financed)	3.0	3.2	3.2	3.2	**-0.2**
Overall balance (including grants)	**-1.2**	**-1.8**	**-1.5**	**-1.3**	**0.1**
Total financing (net)	**0.4**	**1.8**	**1.5**	**1.3**	**-0.9**
Foreign financing (net)	1.9	1.8	1.5	1.3	**0.6**
Domestic financing (net)	-1.6	0.0	0.0	0.0	**-1.6**

Sources: Malawi Ministry of Finance and IMF staff estimates.

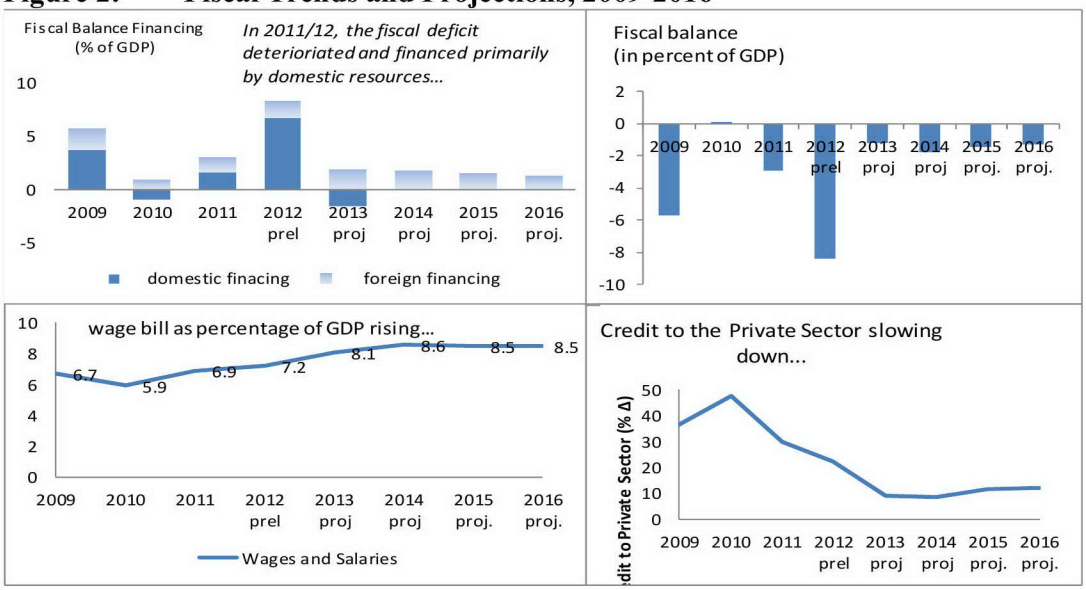
27. **The short to medium term fiscal outlook presents risks, especially fiscal slippages.** The medium term macroeconomic-fiscal framework shows that GoM faces a shrinking resource envelope over the medium term. It projects a reduction in grants of nearly five percentage points of GDP from a high of 15.1 percent in 2012/13, to 10.5 percent of GDP by 2015/16. Consequently the overall expenditure will have to be reduced by about 3.4 percent of GDP, which will be a challenging task. Given that the projections target a reduction in interest payments of about 1.2 percent of GDP, the outlay on goods and services in the recurrent and development budgets will have to be reduced by about 2.0 percent of GDP over the next three years. But the achievement of the fiscal targets could be affected by possible decline in revenues and the increase in social protection expenditure. Additional fiscal risks to be monitored stem from the February 2013 minimum wage increases, the emerging borrowing pressures and election related spending.

28. **Given limited fiscal space and the fact that a large proportion of the budget in non-discretionary, the GoM will have to focus on measures for expenditure prioritization and controls while also seeking to improve efficiency of public expenditures**. A decline in net domestic debt would entail containment of spending, buoyant tax revenues and a sizeable increase in concessional borrowing. As such, the GoM will continue to implement a number of tax policy measures and tax administration mechanisms to further boost its domestic revenue (projected to average at 24.4 percent of GDP during 2013-2016).[16] The authorities' efforts to strengthen the monitoring and supervision of SOEs and measures to reduce the contingent liability risks through reforms supported by this operation will go a long way towards achieving fiscal sustainability. The GoM will need to properly manage the fiscal risks, especially the wage demand pressures, pressure to expand social protection expenditures, and election related spending.[17]

16 The GoM is also putting in place measures to improve tax administration and tax collection through increased audits and use of modern ICT systems to improve revenue collection. Efforts are also being made to improve the efficiency and effectiveness of collecting non-tax revenues.

17 At 8.1 percent of GDP in 2012/13, the wage bill is the single largest item of expenditure. Control of the wage bill is therefore a crucial element of the overall control of expenditures. Wages bill is projected to peak to 8.6 percent of GDP in

Figure 2: Fiscal Trends and Projections, 2009-2016



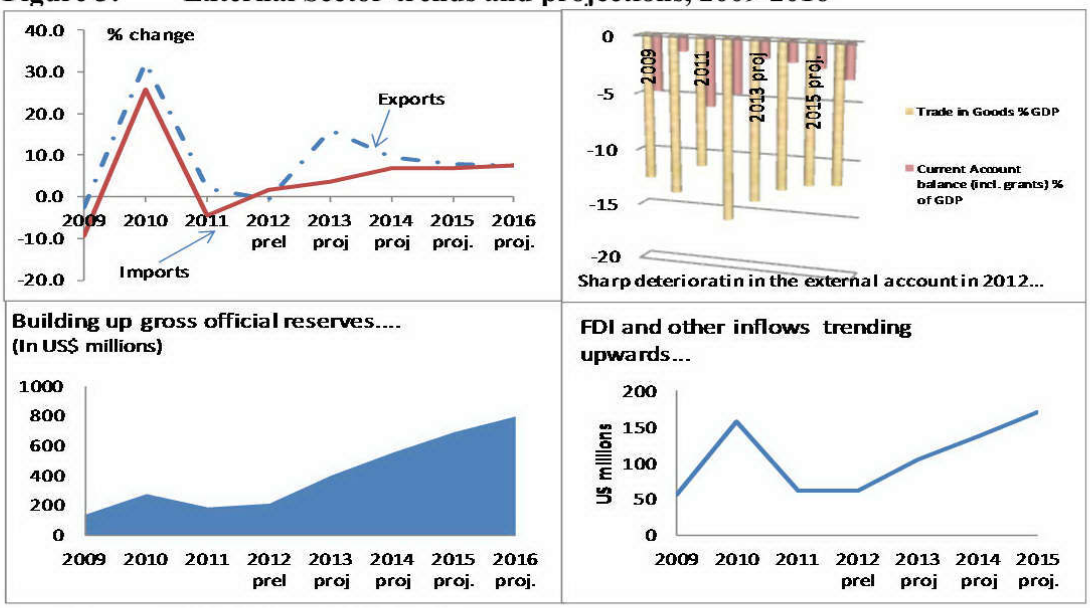
Sources: Government of Malawi and IMF Staff estimates

29. **Malawi's balance of payment remains vulnerable to terms of trade shocks.** The current account deficit is projected to narrow further from -4.7 percent of GDP in 2012, to about -1.6 percent of GDP in 2013, on account of significantly higher official transfers (Table 1).[18] The current account is projected to average at about 2.1 percent of GDP during 2013-2016 (figure 3) financed by aid inflows and FDI. Exports, expected to play a key role in driving economic recovery, are projected to expand from 22.5 percent of GDP in 2011 to an average of 36 percent of GDP during 2012- 2016, on the back of the projected increase in value added exports and diversified export crops, improved tourism receipts, favorable tobacco prices and strengthening of global uranium prices. Meanwhile, imports are also expected to pick up from 33.7 percent of GDP in 2011, to an average of 49 percent of GDP during 2012-2016, partly to reflect the resumption of economic activities in support of the ERP/MGDSII, including private sector investment operations in sector such as mining and tourism. FDI is also projected to rise from 1.1 percent of GDP in 2011, to an average of about 3.0 percent of GDP during 2013-2016, mainly on account of planned investments in the mining and energy sectors.

2013/14, partly reflecting the deferred salary adjustments agreed in 2012/13 and projected to stabilize at 8.5 percent of GDP. The total wage bill has been on an increasing trend increasing from about 5.4 percent of GDP in 2005/06. Over the next three years, wage bill growth is expected to average 13 percent.

[18] About US$ 200 million has been provided in the form of budget support between July-February 2012/13. Overall, Development Partners have supported Malawi with more than $ 600 million from the time when the President came into office until the end of 2012.

Figure 3: External Sector-trends and projections, 2009-2016



Sources: Government of Malawi and IMF Staff estimates

30. **Malawi's risk of external debt distress remains moderate.** The 2012 Debt Sustainability Analysis (DSA) projects that the country's debt burden indicators are likely to remain below relevant prudential thresholds under the baseline assumption of favorable macroeconomic conditions. Malawi's stock of external debt has increased from US$683 million in 2008 to about US$1,140 million in 2011. The stock of external public and publicly guaranteed (PPG) debt is expected to gradually decline in the long-term from about 30 percent of GDP in 2012 to about 13 percent of GDP in 2032. This outlook is based on prudent macroeconomic policies and a favorable external environment, but there are significant down side risks associated with a prevailing volatile political environment. The country's narrow export base, reliance on rain-fed agriculture, and weak international reserves also leaves it vulnerable to terms-of-trade and weather shocks. In particular, the external sector debt burden indicator (Present Value of debt-to-exports) breaches the sustainability threshold after an export shock.

31. **Fiscal dominance has contributed to the increase in domestic debt burden indicators**, whereby the PV of public debt to GDP ratio reaches about 45.5 percent in 2012 and gradually comes down to about 13.9 percent by 2032. Stress tests to public sector debt dynamics reveal the need for significant fiscal consolidation and reform of parastatal institutions. With projected lower levels of grants and limited fiscal space, the GoM will have to make more informed expenditure cuts and/or postponement of some investment spending. While the domestic borrowing risks are limited, the cost is high and both the terms and the maturity structure work against the GoM.[19]

32. **Malawi's macroeconomic framework for 2013-2016 is deemed adequate for this operation, although with downside risks**. The adequacy of the macroeconomic framework for this operation is premised on the authorities continued commitment to sound macroeconomic management and progress on structural reforms to support measures to improve controls and efficiency of government expenditure, while creating room for private

[19] The recent spike in Treasury Bills rates and the increase uptake in the 91-days, 165 days and 365-days T-Bills reflect the uncertainly in the market and investor's preference for shorter maturities.

sector activity and growth. Prudent fiscal stance and the maintenance of a flexible exchange rate policy will provide key anchors for external sustainability and adequate budget support would be essential. In the medium term, Malawi will need to tackle the structural challenges to enhance the country's chances of reaching its long-term growth potential. The GoM will have to improve the efficiency of expenditures whereby similar or improved public services could be delivered with contracting expenditures. The new ECF program will also help instill fiscal discipline and ensure timely corrective actions. Notwithstanding the risks in the near term economic outlook, the macroeconomic policy framework is deemed adequate for this operation.

III. GOVERNMENT'S PROGRAM AND PARTICIPATORY PROCESS

33. **The Second Malawi Growth and Development (MGDS II) 2011-2016, which is the country's second medium term plan**, was approved by the Cabinet in April 2012 and was launched in September 2012. The MGDS II is a medium term strategy designed to attain Malawi's long term aspirations as spelt out in its Vision 2020 and strives to foster a more inclusive job-creating growth to tackle the unemployment problem as well as reduce poverty. The strategy reflects a general consensus on the country's broad goals for growth, social equity, and governance. More specifically, the strategy recognizes that in order for all Malawians to benefit equitably from economic growth, concerted efforts to promote human and social development would need to be complemented by efforts to improve labour productivity, structural transformation and economic diversification. The MGDS II covers six thematic areas: Sustainable Economic Growth; Social Development; Social Support and Disaster Risk Management; Infrastructure Development; Improved Governance; and Cross-Cutting Issues-covering issues of gender, capacity development, population, decent employment, productive activities, economic and democratic governance.

34. **The MGDS II was developed in an all-inclusive process.** All levels of society, including women, the youth, private sector, civil society and development partners were all involved in the MGDS II consultation process. The process of developing the MGDS II was well integrated with the existing processes of the GoM led by the Sector Working Groups (SWGs). The monitoring of the MGDSII will also be conducted with participation from representatives of the Civil Society Organizations and Development Partners, through the various SWGs.

35. **To accelerate the recovery process while mitigating the impact of the reforms on the poor and most vulnerable, the GoM also launched the Economic Recovery Plan in September 2012**. This ERP is well aligned with MGDS II and its focus is on short term measures to restore macroeconomic stability while mitigating the impact on the poor and cushioning the poor and most vulnerable as well as the medium term structural reforms-*agriculture, mining, tourism, infrastructure* and *energy* to support the growth agenda. In the immediate term, the focus is on monetary, fiscal and exchange rate policies, revenue enhancing measures and expenditure control. In its proposed recovery plan, the GoM has proposed a social support package, which will be built on existing programs especially public works program to mitigate the impact of these reforms on vulnerable section of society. These programs include: Scaling up labor intensive public works programme (LIPW); Up-scaling of legume seed multiplication, agro forestry and soil conservation, multiplication of cassava cuttings and sweet potato vines and extending village savings

club; Up-scaling of school meals programme and vitamin A supplementation; and Up-scaling of Social Cash Transfer Programme.

36. **The program supported by the DPO series has been discussed with major stakeholders**, including civil society organizations (CSOs), Academia and Development Partners in the context of the MGDS II and ERP consultations. In addition, the Bank staff held a session with CSOs on the proposed reforms during the program identification mission.

IV. BANK SUPPORT TO THE GOVERNMENT'S PROGRAM

A. LINKS TO THE COUNTRY ASSISTANCE STRATEGY

37. **The new DPO programmatic series is an integral part of the Bank's assistance program to Malawi in the FY13-16 Country Assistance Strategy,[20] which is fully aligned to the Africa Regional Strategy, the MGDS II and the ERP.** The proposed operation supports progress toward the strategic objectives articulated in the FY13-FY16 CAS, which seek to contribute to Malawi's efforts toward a more diversified, competitive, shock-resilient socioeconomic growth. The CAS aims to: i) Promote Sustainable, Diversified, and Inclusive Growth; ii) Enhance Human Capital and Reducing Vulnerabilities; and, iii) Mainstreaming Governance for Enhanced Development Effectiveness. The proposed DPO series, envisaged in the CAS, seeks to bridge the short term reforms aimed at consolidating macroeconomic stabilization, and the longer term reforms that seek to improve efficiency in public expenditure, remove constraints to growth and economic diversification and improve efficiency in the provision of social safety nets.

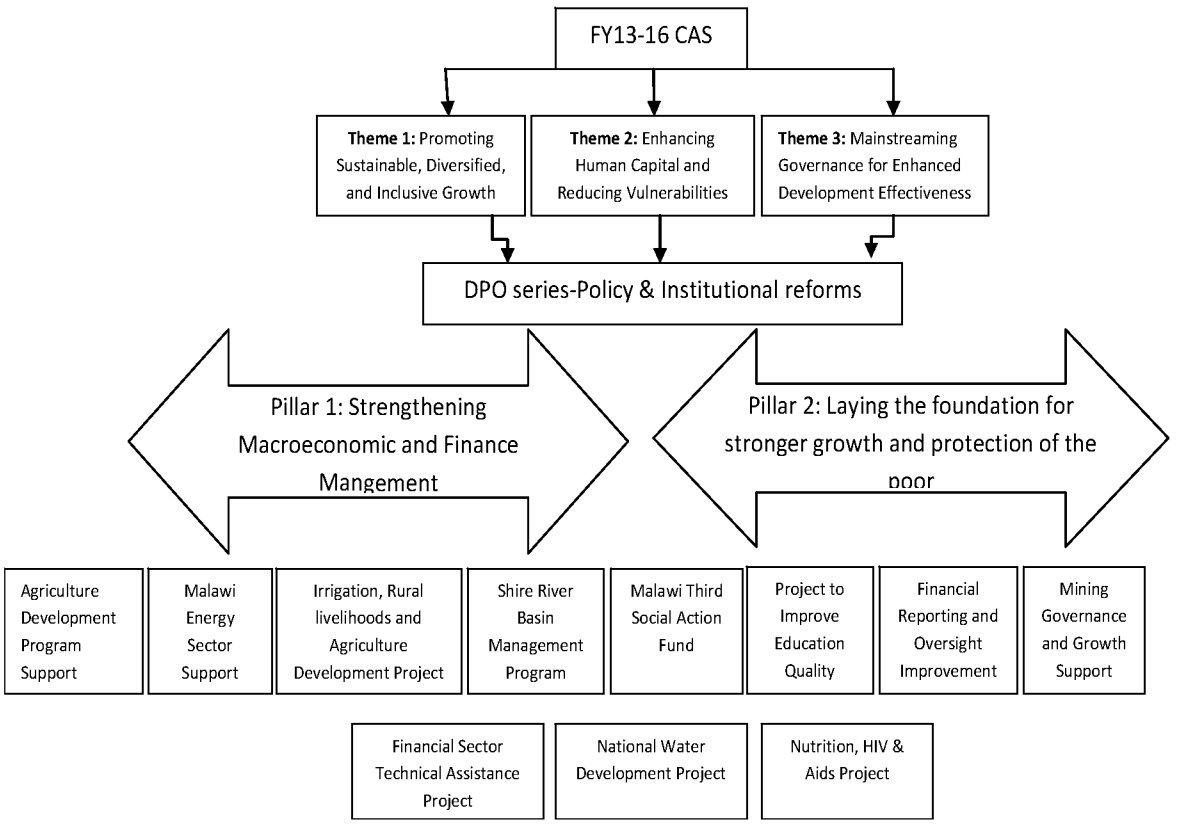
38. **This DPO series will also contribute to the implementation of the Africa Regional Strategy of the Bank.** Two pillars of the DPO series aim at building the country's resilience to exogenous shocks. The policy areas under the macroeconomic and public finance management will help contribute towards the strengthening fiscal discipline to entrench macro-stability as well as improving efficiency and the transparency of the public finance management. Specifically, the focus will be strengthening budget policy framework and improving its medium-term orientation; strengthening external oversight of public finances; strengthening internal controls on public finances; enhancing efficiency in the use of public resources. These measures will help improve efficiency in the management of public finance, setting up a buffer against future exogenous external and domestic shocks, as well as improving system controls and oversight to address, among others, the accumulation of domestic payment arrears. Whereas under the pillar on laying the foundation for stronger growth and protection of the poor, the focus is on measures to enhance agricultural productivity and diversification, addressing energy constraints, improve social safety nets and build the country's statistical capacity.

39. **The DPO series is also in response to the authorities' commitment to implement the macroeconomic and structural reforms** as well as provide a platform for continuity of the reforms in the medium term, ensure predictability of the much needed financing as well as stability in the GoM's reform program. The choice of a programmatic DPO series is based on the fact that it supports a multi-sectoral and multi-year approach, which complements the on-going investment lending operations (see diagraph below), and

[20] The new CAS FY13-16 discussed by the Board in January 2013.

also serves as an effective policy dialogue tool in the reform areas supported by this operation, which are also priority areas for the GoM.

The links between the DPO series and the Malawi Country Program



B. COORDINATION WITH THE IMF AND OTHER DEVELOPMENT PARTNERS

40. **As was the case with the previous PRSC (I-III) series and the RRDPG, the Bank has been collaborating very closely with the IMF.** A joint IMF/World Bank Debt Sustainability Analysis (DSA) for low-income countries (LIC-DSA) was undertaken in early 2012 in the context of the Article IV consultations. The Bank team has also participated in IMF mission discussions with the authorities on the quarterly reviews under the new ECF-supported program in FY13, and has provided continued/continuous inputs into the development of the macroeconomic framework. In the identification of prior-actions for the DPO 1, attention has been paid to the benchmarks under the new ECF arrangement to avoid cross-conditionality.

41. **The macroeconomic assessment underlying this operation is in line with the new ECF-supported program for Malawi approved in July 2012**. The objectives of the new ECF program include fiscal sustainability and a gradual build-up of international reserves to help cushion the economy against external shocks. More broadly, the program will guide the implementation of policies to create the stable macroeconomic environment

needed to achieve the main objective of the second Malawi Growth and Development Strategy (MGDS II) of reducing poverty through sustained private sector led growth and wealth creation.

42. **The new DPO series has been coordinated with the CABS DPs** and will continue to be implemented within the framework of the CABS. The CABS represents a group of development partners that use a joint approach in the provision of budgetary support to the Government of Malawi. In September 2005, the initial CABS group and GoM agreed on a Joint Framework (JF) agreement for budget support cooperation designed to formalize their relationship and provides for a Performance Assessment Framework (PAF) on which to base disbursement decisions.[21] The JF represents a memorandum of understanding on principles governing budget support cooperation in Malawi. Some of the principles governing this cooperation include alignment to the country's poverty reduction strategy, joint reviews, and predictability of funding.

C. Relationship to other Bank Operations

43. **The proposed DPO series builds upon the Rapid Response Development Policy Grant (2012) and the Poverty Reduction Support Grant (2007-2010 PRSG 1-3).** The *Rapid Response Development Policy Grant* (P126155) focused measures to entrench macroeconomic stability through the national budget, improve the functioning of the petroleum markets and incentives to exporters, including smallholder tobacco farmers, strengthen social protection interventions and the resilience of the most vulnerable groups to shocks, and improve economic management of the farm input subsidy program (FISP). The Poverty Reduction Support Grant (P099313) series focused on reforms geared towards improving economic governance, business environment, social protection and agricultural markets.[22]

44. The proposed DPO series is also linked with the on-going *Financial Reporting and Oversight Improvement Project*, which is geared towards improving internal controls, accounting, reporting and oversight of government finances at the central and decentralized level of Ministries, Departments and Agencies in Malawi- aligned with reforms under pillar one.[23]

45. **Pillar two reforms are linked to the Agriculture Sector Wide Approach** (P105256), **which focuses on improving the effectiveness of investment aimed at food security and sustainable agriculture growth.** The *Irrigation Rural Livelihoods and Agricultural Development Project* (P131760), which also addresses overdependence on rain fed farming with improved water management, strengthens institutions for long-term irrigation development and raise agricultural productivity, is also linked to the pillar two. The *Malawi Energy Support Project* seeks to improve the reliability and quality of electricity supply in the major load centers using improved technology. Meanwhile, the *Third Malawi Social Action Fund* (P075911), seeks to improve the livelihoods of poor and vulnerable households and to strengthen the capacity of local authorities to manage local development.

[21] The Bank did not sign the 2005 JF. The process of coming up with a new JF is at an advance stage.
[22] PRSC I was approved on October 30, 2007, PRSC II, on May 28, 2009 and PRSC III on 8 June 2010.
[23] The FROIP is the first project under the PFEM Multi-Donor Trust Fund.

D. LESSONS LEARNT

46. A number of important lessons relevant for the design of the proposed DPO-1 emerged from the CAS Completion Report and PRSC I-III ICR have been taken into account in the development of this operation. They include:

- *Government ownership, political will and commitment are key determinants in the successful implementation of the institutional and structural reforms.* In areas where Government ownership is less broad based, the likeliness of objectives being met is also low. The Bank has therefore invested more in terms of staff time and other resources at the preparatory stage to ensure adequate client capacity and ownership of reforms is built. This operation has benefited from ownership by the GoM of reforms being supported.

- *Progress tends to be slower in reform areas where the political economy context is critical, yet not adequately understood.* The pace of reforms tends to be much slower when the reform actions involve political decisions (Cabinet/Parliament) for implementation. The DPO series has fewer reforms that require Parliament approval.

- *Working within the harmonized framework for the provision of budget support, the CABS, has enhanced the quality of policy dialogue across donors*, notwithstanding the inherent coordination challenges. Continuous dialogue with the GoM has been critical in keeping up the momentum on reforms supported by this operation and this was enhanced by the CABS framework.

- *Flexibility in the CABS PAF should be encouraged to enable it to adapt to unforeseen external shocks and changing government priorities and programs.* Given the urgent need to support the government reforms, the operation has adopted some of the policy actions outside PAF from GoM's own short term recovery plan.

- *Importance of implementation capacity for the successful implementation of policy and structural reforms cannot be overemphasized.* This is more strongly evidenced by the limited progress the implementation of PFM reforms where there reforms have been implemented and later on abandoned. The more harmonized approach to PFM under the PFEM MDTF is bringing a new systematic approach to tackling the persistent PFM problems, which are also being supported by this operation.

E. ANALYTICAL UNDERPINNINGS

47. **The proposed operation is built on some key findings from a series of analytical work by the Bank and other DPs in Malawi, which have form the basis for the identification of the key reforms supported by the DPO series** (table 3). This includes the Country Economic Memorandum (CEM), Comprehensive Exchange Rate and Foreign Exchange Study, the Comprehensive Package on Competitiveness, Growth and Poverty Reduction and the Welfare Impacts and Mitigation of Exchange Rate Unification in Malawi, all of which contributed to the identification of key reforms to achieve macroeconomic stability, address energy constraints, improve agriculture productivity and farm incomes, and enhance efficiency in social safety nets; and the Public Expenditure Financial Accountability and the Budget Technical Assistance for FY13 National Budget, which enabled to identification of reforms to improve the public finance management,

address the domestic payment arrears (including avoidance of the generation of new arrears) and building the country's statistical capacity.

Table 3: Links between the DPO and Analytical Work

Report	Relevant Findings and recommendations	Link to DPO objectives
Comprehensive Exchange Rate and Foreign Exchange Study for Malawi (WB, 2011- TF09063)	Identified the main causes of external imbalances and effects of the chronic foreign exchange shortages and the associated real exchange rate appreciation in the economy, and proposed possible policy responses, including the unification of the exchange rate and fiscal and monetary restraint.	Strengthen fiscal discipline to entrench macro-stability.
Country Economic Memorandum (P107323, 2010)	Identified constraints to growth, including inappropriate exchange rate, inadequate energy supply, access to finance, lack of trade facilitation, among others. **Macroeconomic Policies for Growth**: To achieve a growth sustaining macroeconomic framework, the GoM will need to keep the growth of aggregate demand in line with growth through adjustment of the exchange rate and reduction in public expenditure growth to less than GDP growth. It will also have to rebuild its foreign reserves by using part of foreign aid to increase foreign reserves as well as allowing for an adjustment of the exchange rate. Ensuring that the currency is not over-valued would also enhance export diversification, and improve the response from import - substituting sectors to strong domestic demand. Direct additional resources to spending programs that improve the productivity of the economy by increasing for instance budget allocation for road maintenance, energy and agriculture (complementary to fertilizer and seed program) would be critical. **Agriculture**: The analysis revealed that the highest returns for Malawi came from minimizing maize imports/import substitution as well as promoting price stability and low retail price. Maize food security remains important, especially to keep wage costs low and people fed, however, attention needs to shift to cash crops to take advantage of positive international price developments and growth in the region. Greater growth and poverty alleviation will be achieved by expanding production and trade of Malawi's most competitive agricultural commodities. Therefore, public investment should promote more competitive supply of cash crops to national, regional and international markets. **Energy**: The government needs to invest urgently in additional generating capacity as well as in transmission and distribution networks. The regulatory framework of the industry requires clarification and reform. Electricity tariffs need to be substantially raised to fund additional investment; and the commercial framework needs to provide sufficient incentives to attract long-term investment from Independent Power Producers.	Strengthen fiscal discipline to entrench macro-stability. Enhance agriculture productivity and diversification Improve energy efficiency and regulatory environment.
Budget Technical Assistance for FY13 National Budget (WB, 2012)	**Expenditure management:** Identified the urgent need to strengthen expenditure controls, improve efficiency of spending as well as address the domestic payment arrears, including salaries arrears to teachers.	Strengthen fiscal discipline to entrench macro-stability.

	FISP: While recognizing the importance of fertilizer to smallholders and to productivity increase, the growing size of the FISP in the budget was noted to be to the detriment to other important and promising initiatives. Issues related to the efficiency, targeting and phasing out of FISP should urgently be addressed. **Social Protection**: Highlighted the need to protect social spending as well as to develop a systematic approach to social protection through the harmonization of targeting system, maintaining a unified national registry of beneficiaries and consolidate social support.	Enhance agriculture productivity and diversification Improve efficiency in the provision of social safety nets
Public Expenditure Financial Accountability (EU, 2011-Project No. 2010/259681/1)	The assessment identified weaknesses in the credibility of budget (in terms of its ability to provide a reliable indication of the GoM resource envelope); internal controls; timeliness of follow-up on audit recommendations and backlog in bank reconciliations. The issues of domestic expenditure payment arrears were also highlighted.	Strengthening budget policy framework and improving its medium-term orientation Strengthening external oversight of public finances. Strengthening internal controls on public finances. Enhance efficiency and value for money in public procurement.
Welfare Impacts and Mitigation of Exchange Rate Unification in Malawi (WB, 2012-TF098165)	Identified a growing gap between the official and the parallel exchange rates, with parallel rates significantly higher and that prices of tradable commodities, including tradable foods were already adjusting to those higher parallel market rates. The study also highlighted the importance of timing of the unification of the exchange rate for smallholder tobacco farmers at the onset of the tobacco auction season as cushioning measure against the adjustments in the economy.	Strengthen fiscal discipline to entrench macro-stability. Enhance agriculture productivity and diversification.
Comprehensive Package on Competitiveness, Growth and Poverty Reduction (WB, 2012-TF098165)	Highlighted the urgent need to address the imbalances in the economy to avert a full blown economic and social crisis and provided a menu of solutions to address them. It presented a set of policy actions to help the GoM regain macro balance; scale up social safety net to cushion the poor and the most vulnerable; creating conducive environment for a growth rebound as well as support the medium term agenda for productivity and diversification.	Achieve macroeconomic stability and fiscal discipline. Enhance agriculture productivity and diversification Improve efficiency in the provision of social safety nets

V. THE PROPOSED ECONOMIC RECOVERY DEVELOPMENT POLICY OPERATION (DPO-1)

A. OVERALL DESCRIPTION

48. **The DPO 1 is the first in a series of three one-year operations whose overall objective is to support the implementation of policy reforms and institutional development under the GoM's MGDS II and ERP.** The DPO-1, specifically seeks to: i) strengthen the macroeconomic and public finance management through measures aimed at strengthening fiscal discipline to entrench macro-stability as well as improving efficiency and the transparency of the public finance management; and ii) lay the foundation for stronger growth and protection of the poor through reform measures aimed at enhancing agriculture productivity and diversification; improving energy efficiency and the regulatory environment; improving efficiency in the provision of social safety nets and strengthening the country's statistical capacity.

49. **Development Objectives:** The development objectives of the Economic Recovery Development Policy Operation series are to strengthen the macroeconomic and public finance management and lay the foundation for stronger growth and protection of the poor. These reforms are in line with FY13-16 CAS and the GoM's own MGDS-II, ERP and the Public Finance and Economic Management Reform Program (PFEMRP) aimed at accelerating the economic recovery process and getting the economy back on the sustainable growth path.

50. **Prior Actions**. The program focuses largely on the medium-term measures that aim at strengthening budget policy framework and improving its medium-term orientation; strengthening external oversight of public finances; strengthening internal controls on public finances; enhancing efficiency in the use of public resources; enhancing agriculture productivity and diversification; improving energy efficiency and regulatory environment; improving efficiency in the provision of social safety nets; and, strengthening statistical capacity. The specific reforms supported in each area are described in the following sections; the GoM's Letter of Development Policy (Annex 1); and the DPO-1 policy matrix (Annex 2). The prior actions listed below support the Government in its effort to implement its economic recovery program.

51. Good practice principles in conditionality. Box 1 provides information on how good principles on conditionality have been applied in Malawi.

Box 1: How Good Practice Principles on Conditionality are being Applied to the Operation

Principle 1: ***Reinforce Ownership***

- The GoM has strong ownership of the proposed DPO 1, which supports several dimensions of the Government's economic recovery reform plan where the Bank has comparative advantage and complements the work being supported by IMF and other development partners. The proposed DPO 1 follows the successful in implementation of the Rapid Response Development Policy Grant (currently under implementation) and PRSC 1-3 series, which demonstrates Malawi's track record of significant GoM ownership and commitment to the reform process. The Bank's analytic work has contributed to the formulation and implementation of selected aspects of the Government's economic recovery reform plan. The Bank has had extensive discussions with the authorities on the policy options and the Government departments identified the critical reforms needed to accelerate attainment of macroeconomic stability and growth rebound, while mitigating the impact on the most vulnerable groups.
- The prior actions selected have been extracted from the Government's Economic Recovery Plan and Public Finance and Economic Management Reform Program and are linked to the pillar on regain

macro-balance, social impacts and their mitigation, and growth rebound.

Principle 2: ***Agree up front with the government and other financial partners on a coordinated accountability framework***

- The CABS DPs and the GoM have signed a Joint Framework (JF) of budget support cooperation. One of the principles contained in the JF is that of carrying out joint reviews. Every year one of the reviews focuses on assessing Government performance in meeting the targets contained in the PAF.
- The accountability framework (e.g. policy matrix) for measuring progress under the program has been prepared and discussed with ministries and departments involved at technical levels.

Principle 3: ***Customize the accountability framework and modalities of Bank support to country circumstances***

- The DPO 1 team worked closely with Government counterparts from various ministries in designing and monitoring reform implementation. The agreed accountability framework is fully consistent with the Government's expressed policy intentions and internal accountability mechanisms. The CABS undertakes biannual reviews, one during February-March and another during September-October. Both reviews are aligned to the country's budget cycle. The February-March review takes place just before the Government starts to prepare its budget. It focuses on the annual budget, public financial management issues, and an assessment of the fiscal performance during the previous fiscal year. The September-October review focuses on assessing Government performance in achieving the targets for each indicator in the PAF. Decisions on whether to disburse budget support and how much disburse are based on the outcome of this review.

Principle 4: ***Choose only actions critical for achieving results as conditions for disbursement***

- The DPO 1 program focuses on actions that are critical for the success of the reform aimed at aim at strengthening the macroeconomic and public finance management while laying the foundations for stronger growth and protection of the poor. There are 6 prior actions, which aim at enhancing efficiency and effectiveness of government spending, improving accountability, transparency and the country's statistical capacity, enhancing agriculture productivity, addressing energy constraints and improving social safety nets. All prior actions agreed upon with full participation of the GoM and reflect the reform priorities of the GoM which are supported by the Bank in the FY13-16 CAS. The actions for the proposed DPO 1 represent only those actions that will be critical for achieving the program's development objectives and the various outcomes.

Principle 5: ***Conduct transparent progress reviews conducive to predictable and performance-based financial support***

- The preparation of this operation follows the lessons learned from the PRSC I-III and one program review is planned. All of the prior actions as well as the expected outcome indicators for this operation focus on the results of implementation of the supported reforms. The DPO's financial support is expected to provide the much needed resources to support the GoM's economic stabilization process through the national budget. The support is fully consistent with the Government's macroeconomic framework agreed with the IMF.

B. POLICY AREAS

Pillar 1: Strengthening Macroeconomic and Public Finance Management

52. This policy area supports a broad reform program on macroeconomic management and the management of public finances. Specifically, it covers two specific reform objectives, namely: i) Strengthen fiscal discipline to entrench macro-stability through the clearance of domestic payment arrears; and ii) enhance efficiency and transparency of the public finance management through measures to strengthen budget policy framework and improve its medium-term orientation; strengthen external oversight of public finances; strengthen internal controls on public finances; and enhance efficiency in the use of public resources.

Reform Objective: Strengthen fiscal discipline to entrench macro-stability through the clearance of domestic payment arrears.[24]

a. Arrears clearance

53. **Key issues:** Malawi continues to face payment arrears problems despite efforts to strengthen expenditure controls and improve PFM IT systems. A key purpose of improved expenditure management is to hold spending within the approved budget and avoid the build-up of arrears since domestic payment arrears undermine confidence in the budget process. The 2011 PEFA assessment picked up the arrears problem but noted that there was no readily available information about the volume of payments which were actually overdue or the length of time they have remained outstanding (scored D). The indicator on stock of expenditure payment arrears was not scored in the 2011 PEFA. Historically, this problem has been associated with the failure of the GoM to control expenditure as well as to live within its means, as evidenced by the 2005 audit, which revealed payment arrears totaling MWK10.5 billion (equivalent to 5.8 percent of GDP). In addition to efforts to clear those arrears, the GoM introduced the Integrated Financial Management Information System (IFMIS) in 2005 to address, among others, the arrears problem and as such its functionality was deployed to strengthen the GoM payment system, improve expenditure control and contribute to improving fiscal reporting. This notwithstanding, the MDAs and parastatals have been able to get suppliers to provide goods and services on credit (outside IFMIS) as well as get the contractors to carryout construction work without having sufficient funds in the budget.

54. **Serious deficiencies in the management and operation of IFMIS controls were brought to light following reports of fraudulent transactions in IFMIS involving the Police Services in 2011.** In May 2012, it was revealed that about MWK 72 billion had been accumulated to banks (about MWK 30 billion) and suppliers (about MWK 40 billion) by the government Ministries, Departments and Agencies (MDAs) and parastatals. The liquidity problems in the banking sector arose partly on account of suppliers not being paid by the GoM, which resulted in their failure to service their bank loans. Of the total domestic payment arrears, about MWK 37 billion were accumulated by SOEs (in the form of loans and overdrafts). Meanwhile, MDAs accumulated arrears of around MWK 30.5 billion and arrears accumulated on pension contributions, salaries (e.g. teachers), utilities

[24]Domestic arrears are overdue payment obligations by central government, other than external payment arrears, including wages and salaries, transfers, domestic interest, goods and services and payments to Malawi Revenue Authority for VAT tax refunds (IMF definition, Article VI Consultation Report 2004).

(electricity and water) and subscriptions are estimated at 5.2 billion. Payment arrears, especially in the transport sector (estimated at above MWK 8.8 billion), are mainly on account of addendums arising from extension of works, redesigning of some sections of roads as well as fuel and foreign exchange challenges of 2011 and early 2012. Weaknesses in the commitment management in IFMIS were at the heart of the recent cases of arrears accumulation, which are symptomatic of the ineffectiveness of normal financial controls and poor budget discipline. In this regard, the near term priority reform agenda for the GoM is to put in place adequate expenditure monitoring and controls measures, improve the business process and enhance commitments controls in IFMIS. [25]

55. **DPO-1 Prior Action 1:** The DPO 1 is supporting the process of validating the payment of domestic arrears through the National Audit Office and the development of an arrears clearance plan by the Ministry of Finance (MoF). Given the fact that the immediate clearance of the historical stock of arrears is currently not feasible due to budgetary constraints as well as related inflation risks, the GoM has converted the verified arrears into government securities and has already issued promissory notes to banks to clear loans and overdrafts made to the SOEs (MWK 37 billion). In addition, a total of MWK 7.7 billion worth of promissory notes have been issued directly to contractors. In addition to supporting the clearance of arrears owed by SoEs, the DPO 2-3 will support reforms that will also help ensure that no build-up of new arrears through the rollout of IFMIS commitment control module to all the Ministries, Departments and Agencies, which is to be followed by the roll-out all the district councils. Complementing actions to strengthen the functioning of Audit Committees and external oversight will also help improve the effectiveness of internal controls processes and management as well as identify systemic weakness in control mechanisms.

56. **The GoM has also stopped commissioning new projects which do not have adequate resources but also which do not have complete design and estimated costs.** It is expected that this measure will help to check unnecessary extensions and therefore completion of projects within the estimated time. Furthermore, as a structural solution to the generation of arrears and improving the credibility of the budget, the GoM will continue to strengthen the recently reinvigorated the Medium Term Expenditure Framework. Once all these initiatives are fully functioning the problem of the accumulation of payment arrears would have been significantly reduced and/or eliminated. It is expected that at the end of the program, 50 percent of the stock of domestic payment arrears owed by SOEs would have been reduced and there will be no new arrears accumulated in the system by the MDAs. The Central Internal Audit Unit will, on quarterly basis, undertake audits to monitor accumulation of new arrears. These reforms will contribute towards achieving macro stability and fiscal discipline in the medium term.

DPO-1 Prior Action 1: The Recipient, through its ministry responsible for finance, has validated its outstanding payment arrears and has developed a plan for the full clearance of said arrears for the State Owned Enterprises and the Ministries, Departments and Agencies.

Indicative Trigger DPO-2: The Recipient, through its ministry responsible for finance, has cleared 25 percent of the outstanding stock of domestic payment arrears owed by State Owned Enterprises and has rolled out commitment control under IFMIS to all Ministries, Departments and Agencies, and to local district councils.

[25] IFMIS business review process recently undertaken.

Indicative Trigger DPO-3: The Recipient, through the Ministry responsible for Finance, has cleared at least 50 percent of the outstanding stock of domestic payment arrears owed by State Owned Enterprises and has verified non-accumulation of new domestic payment arrears by the Ministries, Departments and Agencies.

Expected Results: i) Percentage of outstanding stock of public payment arrears (MWK 37 billion owed by State Owed Enterprise) cleared from 0% by 2012 to 50 percent by 2016; ii) zero ceiling for accumulation of new domestic payment arrears by the Ministries, Departments and Agencies (MDAs). Medium term outcome is strengthened fiscal discipline and no build-up of new domestic payment arrears.

Reform Objective: Enhance the efficiency and transparency of the public finance management[26] *by strengthening budget policy framework and improving its medium-term orientation; strengthening external oversight of public finances; strengthening internal controls on public finances; and, enhancing efficiency in the use of public resources.*[27]

b. *Strengthen budget policy framework and improve its medium-term orientation*

57. **Key Issues**: While recent budget reforms have provided for significant improvements in comprehensiveness and transparency of public financial management, progress towards a credible budget has been slow. According to the 2011 Public Expenditure and Financial Accountability (PEFA), the 2007/08-2009/10 period was characterized by persistent over-spending in comparison to original budget which contrasts with the previous three years each of which reported under-spending. There are also shortfalls in revenue and cash flow forecasting. For instance, actual revenue tends to consistently be above budget, as it had been in the previous three years, which affects expenditure levels. Therefore, the credibility of the budget has been called into question with regards to its ability to provide a reliable indication of the GoM's resource envelope. As such, Malawi received a 'C' rating on deviations in composition of expenditure out-turn compared to the original approved budget and scored 'D' in the deviations in aggregate revenue out-turn compared with the original approved budget in the 2011 PEFA (Annex 4 D).

58. **Given the fact that budget credibility is at the core of a good budgeting system, a credible budget is the one that is being implemented as planned and one that accurately reflects a nation's priorities.** This requires a prudent macro-fiscal framework and realistic revenue projections; credible assessments of the existing cost of government and the cost of new initiatives; a transparent and disciplined budget planning process; robust systems of budget classification, execution, financial management and accountability; and the availability of good information on spending and service delivery. The multi-year planning and budgeting process is still at infancy and efforts are underway to further strengthen the capacity of MDAs to meet the MTEF requirements. With the re-invigoration of the medium term expenditure framework in 2011/12, the annual budget is now being prepared within the medium term budgeting framework with a view to enhance

[26] The GoM has committed to strengthening capacity of PFM institutions through the Public Finance and Economic Management Reform Program (PFEMRP, 2011-2016), which was approved in July 2011.

[27] Financial Reporting and Oversight Improvement Project, under the PFEM MDTF, is also focusing on improving the Integrated Financial Management System (IFMIS) and oversight functions of internal and external audit for better implementation of the rules and regulations, fuller utilization of IFMIS functionalities and improved service delivery.

the link between policy, planning and budgeting process to better reflect what is contained in the MGDS II.

59. **DPO-1 Prior Action 2**: The Recipient, through the Ministry of Finance, has adopted a detailed budget formulation calendar. With the recent reinvigoration of MTEF the GoM has come up with a revised annual budget formulation calendar to accommodate the required medium term perspective, expenditure reviews and budget consultations. The revised calendar has accommodate the preparation of Budget Policy Framework Paper and the Medium Term Economic And Fiscal Policy Statement early on in the budget preparation process so as to provide adequate time for undertaking review of macro-fiscal performance, analysis of fiscal strategies, budget analysis, analysis of submissions from spending agencies and timely review of budget ceilings, where necessary. The process will proceed alongside a review of the macro-fiscal framework in order to determine an affordable resource and expenditure framework for the annual budget and the medium-term.

60. **The indicative trigger for DPO-2 Indicative Trigger DPO-2**: In support of the GoM's objective of strengthening the multi-year planning process, the DPO 2 will support the approval of the Budget Policy Framework Paper (BPFP) for 2013/14.[28] The BPFP, which is a three-year rolling framework, will be used to streamline and guide the budget process, setting out planned outputs and their associated expenditures in the medium-term. It will attempt to outline an affordable medium term (2014/15 to 2016/17) financing plan, in line with the country's commitments under the ERP and the MGDS II. The BPFP will be linked to the Ministries' budget ceilings and will be discussed with the Cabinet.

61. **The indicative trigger for DPO-3 focuses on the development of the Medium Term Fiscal Framework (MTEF) manual and its adoption by MDAs.** This seeks to complement the indicative trigger for DPO-2 on the BPFP. The MTEF manual will help improve the use of MTEF as a strategic planning and budgeting tool within the Medium Term Fiscal Framework. The MTEF manual will among others, incorporate the policy and institutional procedures for construction of an MTEF, illustrate how the Public Sector Investment Program (PSIP) is integrated into the MTEF, provide guidance and budget formats for an integrated capital and recurrent expenditure forecasting structure, and, establish a methodology for producing line ministry multi-year ceilings. Based on this Manual, sensitization program will be carried out on the use of the manual in planning and budgeting to enhance in-depth understanding of the underlying principles of the MTEF and application of the MTEF as the foundation for effective implementation of program budget reform.

62. **Through the proposed reforms under this series, it is expected that in the medium term, budget planning and execution would be strengthened and the efficiency of spending will be further enhanced**. The expected result at the end of the series is the strengthened budget policy framework and improvements in its medium-term orientation as evidenced by the reduction in the variance in primary expenditure between approved and outturn for 25 votes from an average of 12.0 percent during 2009/10-2011/12, to 8 percent or less by 2016.

[28] They are three-year rolling frameworks used to streamline and guide the budget process, setting out planned outputs and their associated expenditures in the medium term.

DPO-1 Prior Action 2: The Recipient, through the Ministry of Finance, has adopted a detailed budget formulation calendar.

Indicative Trigger DPO-2: The Recipient, through the Minister of Finance, has approved adopted the Budget Framework Paper for 2013/14.

Indicative Trigger DPO-3: The Recipient, through the Ministry of Finance, has developed the Medium Term Expenditure Framework manual.

Expected Results: Variance in the expenditure between approved expenditure and outturn for 25 votes from an average of 12.0 percent during 2009/10-2011/12, to 8 percent or less by 2016. Medium term outcome is strengthened budget policy framework and improvements in its medium-term orientation.

c. *Strengthen external oversight of public finances*

63. **Key Issues:** While the GoM has made considerable progress in strengthening public sector management systems with notable improvement in external auditing and parliamentary scrutiny of financial accounts, challenges in the quality of audit and the actions and follow up based on the recommendations of the National Audit Office (NAO) and Public Accounts Committee (PAC) of Parliament remain key. The performance on follow-up of the recommendations of the Auditor General's reports is an important milestone in ensuring transparency and value for money. According to 2011 PEFA, for over a decade or so the lapsed time from the end of each fiscal year to the completion of hearings by the PAC and the issue of the PAC Report has ranged from 34 to 58 months. While backlogs of the Auditor General's reports has been recently cleared (in 2011), backlogs remain in the issuance of Treasury Minutes.[29] As of June 2012, only the Treasury Minute for the fiscal year 2004/05, had been submitted to PAC, reflecting the extent of the backlog with the Treasury Minutes for fiscal years 2006/07, 2007/08, 2008/09 and 2009/10 yet to be submitted. Records of follow-up of audit issues remain scarce and in particular, Treasury Minutes recording follow-up of outstanding issues, are not issued on a regular and timely basis and these continue to affect the timely response to persistent problems in public finance management. External and internal audit reports repeatedly report on control weaknesses, lack of adherence to laws and financial management regulations, and ineffectiveness of sanctions against such breaches is costing tax payers billions of kwacha. The 2011 PEFA score for evidence of follow up on audit recommendations was D.

64. **DPO-1 Prior Action 3:** DPO-1 focuses on the submission of the Treasury Minutes for fiscal years 2005/06 and 2006/07 to the Public Accounts Committee of the Parliament. The objective is to strengthen accountability in the use of public funds and to improve the quality and timely follow-up on external audit reports and recommendations so as to ensure that control measures are being put in place to improve efficiency and effectiveness of government expenditure as well as enhance value for money. This reform action is also being complemented by reforms related to improving internal controls and audit functions. DPO-2 will focus on clearing Treasury Minutes for financial years 2007/08, 2008/09, 2009/10 and 2010/11 as well as the creation of baseline data of pending audit queries by the MDAs. Whereas, DPO-3 will focus on Treasury Minutes for fiscal years 2011/12 and

[29] The huge delays in the preparations and submission of audit reports to Parliament meant that discussions at the PAC level were also delayed and GoM's responses (Treasury Minutes) for the respective audit reports were also delayed.

2012/13 as well as the reduction in pending audit queries per MDAs by 25 percent. In this regard, DPO series seek to accelerate the process of clearing the backlog of Treasury Minutes and ensure that accountability mechanisms are strengthened and the objective of improved efficiency in government expenditure is achieved through reductions in pending audit queries. It is expected that by the end of the DPO series external oversight of public finances will be strengthened evidenced by the reduction of the backlogs of Treasury Minutes and pending audit queries.[30]

DPO-1 Prior Action 3: The Recipient, through the Ministry of Finance, has submitted Treasury Minutes for fiscal years 2005/06 and 2006/2007 to Parliament.

Indicative Triggers DPO-2: The Recipient, through the Ministry of Finance, has submitted Treasury Minutes for fiscal years 2007/08, 2008/09, 2009/10 and 2010/11 to Parliament and has created baseline data of pending audit queries by Ministries, Departments and Agencies.

Indicative Triggers DPO-3: The Recipient, through the Ministry of Finance, has submitted Treasury Minutes for fiscal years 2011/12 and 2012/13 to Parliament and has registered 25 percent reduction in pending audit queries per Ministries, Departments and Agencies.

Expected Results: Reduction of backlog from over 60 months in 2012, to 48 months by 2016. Medium term outcome is strengthened external oversight of public finances.

d. *Strengthen internal controls on public finances*

65. **Key Issues:** Internal controls and audit functions remain weak. Reforms over the past five years focused on establishing the Audit Committees (ACs) to provide the institutional mechanism to follow up on audit recommendations, but progress has been rather slow. With a large number of ACs inadequately functioning, audit follow-up remains weak, with the quality of audit compromised as some of the identified inefficiencies in the system are allowed to persist with delayed execution of corrective actions, which ends up costing the country billions of Kwacha. Lack of political commitment as well as lack clear appreciation of the roles and functions of the ACs are among factors that have contributed to the non-functioning of the ACs. According to the 2011 PEFA, evidence of management response to audit reports remains weak and the country scored D on the effectiveness of internal audit controls. This remains a big constraint in the promotion of accountability and efficiency of spending in the PFEM reform program.

66. **There is evidence of backlog of audit reports to be considered by ACs in some line ministries**. In most instances, the ACs are not functioning and where they have met their role is compromised and not well understood. In particular, the Committees are chaired by the Controlling Officer (CO) and include only internal (to the line ministry) representation. This however raises the conflict of interest risk as the COs are also the

[30]The GoM has a fully-fledged unit dealing with Treasury Minutes, including follow-ups. The Treasury Minutes are very useful in preventing fraud and malpractices as they compile actions taken from the audit queries and the PAC follows the matters to its conclusion. In the event that fraud cases are not properly handled, PAC has power to request the Fiscal Police to apprehend the culprits. Prior to the issuance of Treasury Minutes, Chief Secretary in the Office of the President and Cabinet produces the Government's response to the recommendations from PAC from their examination of Audit General's reports.

chairs of AC, which could undermine the internal audit function and thus the need to revise the Audit Committee Charter. Strengthening of internal controls and audits is essential to increasing efficiency of public expenditure. While some improvements have been noted in responses from COs on the management letter recommendations, for the rest there is little or no evidence on efforts in complying with requirements. With the new impetus on fiscal controls from the GoM and the drive to improve efficiency in government expenditure, efforts are now being geared toward injecting a new lease of life into the ACs.[31]

67. **Indicative Triggers DPO-2 and DPO-3:** The DPO-2 will support the process of reviving the Audit Committees in the ten largest spending ministries and ensure that they are functional (having at least 4 meetings per fiscal year with clear set of deliverables). The ten key spending ministries include Health, Education, Agriculture, Finance, Office of the President and Cabinet (OPC), Transport and Public Works, Gender, Defense, Local Government, and Mines. DPO-2 will also focus on creating baseline data of pending bank reconciliation per MDAs. The GoM is also working on a mechanism to help them tackle persistent audit issues in these key spending ministries in a systematic way with a goal of ensuring that recommendations from audit reports are actually implemented and reforms are undertaken to strengthen controls and transparency as well as ensure value for money. The GoM is also in the process of revising the Audit Committee Charter through a consultative process with MDAs to address some of the above mentioned challenges. These reforms will also be supported through the FROIP project, which among others, focuses on strengthening both internal and external audit function. Through FROIP, the sensitization program for the ACs and COs will be rolled out to ensure that the importance of following up on audit issues is well appreciated. DPO-3 will support the process of getting the ACs in the remaining MDAs to function and will ensure that an updated bank reconciliation for the MDAs is carried out on regular basis. It is expected that by these reforms will contribute towards strengthening of internal controls of public finances and by the end of the DPO series, there would be significant reduction in recurrent audit findings and improved bank reconciliation.

Indicative Trigger DPO-2: The Recipient has instructed 10 largest spending ministries[32] to ensure that respective Audit Committees are functional and baseline data of pending bank reconciliation has been created per Ministries, Departments and Agencies as evidenced by at least 80 percent reduction in the rate of recurrent audit findings and at least one meeting held by all 10 Audit Committees during the first half of 2013/14.

Indicative Trigger DPO-3: The Recipient has instructed Audit Committees in the remaining ministries to be functional and has carried out bank reconciliation for the Ministries, Departments and Agencies up to three months before negotiations for DPO-3 as evidenced by at least 75 percent reduction in the rate of recurrent audit findings and at least four meetings held by all Audit Committees per financial year.

Expected Results: Reduction in the rate of recurring audit findings from 98 percent in 2012, to 60 percent by 2016. Medium term outcome is strengthened external oversight of public finances.

[31] The recently approved FROIP project will reinforce the implementation of the reforms implemented by the series.

[32] Health, Education, Agriculture, Finance, Office of the President and Cabinet (OPC), Transport and Public Works, Gender, Defense, Local Government, and Mines.

e. ***Enhance efficiency in the use of public resources***

68. **Over the last ten years, the most important objective of the agriculture policy in Malawi has been to achieve food security**. This core objective was sought to be achieved by the Farmer Input Subsidy Program (FISP) under which small farmers receive fertilizer and seeds. After 7 years of implementation, FISP has had an impact on increasing maize production and stimulating the seed demand and market. However, its fiscal burden has been increasing from an average of 2.6 percent of GDP during 2010-2012, after overshooting to 5.6 percent of GDP in 2009 and picked up to 4.4 percent of GDP in 2013. In term of FISP's share in the MoAFS budget, it currently stands at 85 percent of the MoAFS budget (10 percent of the overall Government Budget). Based on the last IHS3 results that show a stagnation of poverty in rural areas over the last five years, there are concerns about FISP efficiency and its real impact of its targeted beneficiaries, the poorest farmers. There are thus concerns on whether FISP is the right instrument to help poor smallholders access to and use of improved agricultural inputs; or whether FISP targeting is relevant to achieve a large scale production increase. There are also major concerns from DPs as well as from the civil society and farmers organizations, that FISP size may be crowding out other critical investments in agriculture (irrigation, research, post-harvest processing, etc.) as confirmed by the on-going Agricultural Public Expenditure Review (AgPER) led by the Bank. The fiscal cost for the FISP remains unsustainably high while the procurement of fertilizer has not led to real value-for-money and timely delivery of fertilizer to farmers. There is therefore a consensus to start redesigning FISP based on a two-step approach by: (i) immediately look at short-term efficiency measures to improve implementation; and (ii) discuss medium-term reforms to improve its impact on the ground.

69. **As part of the first step and as requested by other donors, the Bank is participating in a FISP efficiency improvement committee led by the Principal Secretary of MoAFS.** This committee has already identified four sets of "quick-fix" measures to improve next year FISP implementation: (i) the elaboration of a detailed planning of FISP campaign to ensure a timely delivery of vouchers, fertilizer and seeds to farmers; (ii) the introduction of e-vouchers on a pilot basis in some targeted districts to save on secure paper vouchers and avoid frauds and corruption on the ground; (iii) the introduction of a cell phone-based monitoring system to track in real time fertilizer delivery and ensure adequate stocking of fertilizer in rural outlets and avoid beneficiary congestion; and (iv) the revision of the procurement modalities for the selection of the most efficient fertilizer suppliers and transporters to ensure value-for-money and a timely delivery of fertilizer to farmers.

70. **As part of the second step, the policy dialogue on FISP reform has already started and will be further stimulated in the coming year by two key on-going analytical activitie**s: (i) the Bank-supported AgPER and (ii) the DfID-funded FISP evaluation carried out by the School of Oriental and African Studies (SOAS) from the University of London. The overall approach is to analyze the FISP in a broader context of public expenditures in agriculture. Preliminary results of the AgPER for instance recommend to: (i) re-balance public investments to better support other critical agricultural areas such as research and extension, small- and large-scale irrigation, supply chain and agri-business development; (ii) better articulate support to productivity increase, targeted at the middle range categories of farmers, with other existing social protection programs targeted at the poorest categories of farmers.

71. **DPO-1 Prior Action 4:** The Recipient has revised the FISP fertilizer procurement modalities with a refined bid evaluation methodology through DPO-1. It is estimated that the efficiency saving measures introduced in the 2013/14 FISP procurement will result in fiscal savings amounting to about US$ 10 million. The reform under DPO-2 will support the GoM in organizing stakeholder consultations on the findings of the AgPER and the FISP impact evaluation to initiate discussion on required reforms. This will help redefine FISP objectives, content and implementation modalities to improve its efficiency and impact on the ground, which should help reduce the fiscal burden and chart out the future of FISP. Meanwhile, DPO-3 will support the revision of public investments in agriculture in line with the priorities of MoAFS investment framework as detailed in its Agricultural Sector Wide Approach (ASWAp) document, already validated by the GoM, the private sector, farmers' organizations and donors.

DPO-1 Prior Action 4: The Recipient, through its ministry responsible for agriculture and food security, has revised the bidding documents for the annual procurement of fertilizer under the Farm Input Subsidy Program to align the allocation of tonnage demand with unit price ranking for the purpose of increasing the Recipient's value-for-money.

Indicative Trigger DPO-2: The Recipient, through Ministry of Agriculture and Food Security, has reviewed the design of Farm Input Subsidy Program in light of findings of various impact evaluations, agriculture Public Expenditure Review, and consultations. The recommendations have been submitted to Cabinet.

Indicative Trigger DPO-3: The Recipient, through Ministry of Agriculture and Food Security, has re-structured its public expenditure in agriculture in line with the redefined Farm Input Subsidy Program objectives and priorities of the ASWAp framework, as evident in 2014/15 budget.

Expected Results: Public investments in agriculture equally distributed among the three ASWAp pillars. Medium term outcome is enhanced efficiency in the use of public resources.

Pillar 2: Laying the Foundation for Stronger Growth and Protection of the Poor

Reform Objective: To enhance agriculture productivity and diversification; improve energy efficiency and the regulatory environment; improve efficiency in the provision of social safety nets and strengthen the country's statistical capacity.

a. Enhance agriculture productivity and diversification through efficient seeds market

72. **Expanding and diversifying agricultural exports is one of the top priorities of the Government's agricultural development strategy.** The country remains too dependent on a single agricultural export, tobacco. Despite an increasing demand in emerging economies, tobacco prices are fluctuating and quality requirements are more and more strict. The enforcement of the World Health Organization's Framework Convention on Tobacco, which would restrict, and possibly ban, the use of flavorants, which are essential ingredients for Burley-filled tobacco products, may also threaten the market expansion of the Burley tobacco which is mainly grown in Malawi. Burley tobacco still accounts for about 80 percent of Malawi's agricultural exports and 60 percent of national export value.

There is thus a need for the country to diversify in other agricultural productions for which good emerging market prospects exist, mainly cotton or legumes such as groundnuts, soya beans and pigeon peas.

73. **Transforming the smallholder agricultural sector is also a key priority to ensure agricultural growth**. Smallholder farmers have to move beyond maize-based food security to enter into more commercial-oriented productions. Constraints to agricultural transformation include low productivity, very small land holdings with insecure tenure, recurrent drought, lack of access to financial services and to market information, and scarce and expensive transport to markets. On-going investments aim at increasing productivity and farming system resilience through irrigation development, improved technology dissemination, research and extension.

74. **However, one key constraint to increasing productivity and diversifying smallholder agricultural remains the availability of quality seeds both for staple food and export productions**. There are several initiatives to support research in developing new varieties and extension programs to make them available to farmers. The implementation of the FISP, which includes a seed distribution component, has stimulated the demand for improved seeds for maize and legumes. While availability of improved seeds has significantly increased, quantities available on the local markets are still limiting adoption by farmers. Some concerns with quality have also emerged, especially in the legumes sector.

75. **It is therefore proposed to support the policy dialogue between the GoM, seeds companies and farmers' organizations on seeds availability and quality.** The Bank is already facilitating a multi-stakeholder working group on "quality seeds for FISP". This group acts as a platform to share information between seed companies, farmers' organization and public services (research, extension and seed certification). There is a consensus in this group that beyond working on seed availability, there is a need to improve the regulation framework and on improving the seed certification process. Since the last adoption of seed regulatory measures in 2005, the seed subsector has undergone massive transformation with the emergence of numerous new stakeholders (seed breeders, seed companies, agro-dealers, etc.). There is a need to review the regulatory framework for seed certification, while protecting breeders' rights and stimulating the market through cross-boundaries exchanges of germplasms. In that context, the need to comply with recently adopted international regulations, especially with respect to international property rights agreement (TRIPS) and the COMESA/SADC seed harmonization framework will be taken into account.

76. **The proposed DPO would facilitate the review of the existing seeds regulation and legislation pertaining to seed production and registration and breeder's rights based on a sound consultation with seeds companies and farmers' organizations.** This process should start with a review of the current seed legislation framework in Malawi that would provide recommendations for further harmonization with the SADC seed framework and the need to further stimulate the market for seed production and cross-boundary circulation. The proposed DPO would ensure seeds companies and farmers' organizations have been associated to the drafting of a new policy seed act and its regulations for the efficient functioning of a comprehensive seed regulatory system.

77. **This policy approach would adequately complement on-going investments** in strengthening and upgrading the Seed Services Unit to improve quality control and certification, in research to develop new varieties and in extension to promote the adoption of improved varieties by farmers. The process of developing seeds and significantly increasing quantities will take three years or so and this is the rationale for supporting this proposed reform under a DPO series.

78. **Indicative Triggers DPO-2 and DPO-3:** To improve farmers' access to quality improved technologies and promotion of an efficient seed market, the GoM will undertake a review of the legal and regulatory framework for quality seed production under DPO 2. It will organize consultations with seed companies and farmers' organizations on recommendations for amending the Seeds and Breeder's Acts through DPO 3. These actions will ensure that the seed subsector is governed by a clear legal and regulatory framework, based on a sound consensus between the Government, private sectors and agricultural producers. At the end of the program, it is expected that agriculture productivity and diversification will be enhanced as evidenced by the increase in quantity and improvements in the quality of maize and legumes seeds.

Indicative Trigger DPO-2: The Recipient, through the Ministry of Agriculture and Food Security, has completed a review of the legal and regulatory framework for quality seed production.

Indicative Trigger DPO-3: The Recipient, through the Ministry of Agriculture and Food Security, has finalized revisions of the Seeds Act and Breeders' Act following consultations with private seed companies and farmers organizations.

Expected Results: Increase in legume production by 20 percent compared to the 2012 level. Medium term outcome is the increase in agriculture productivity and diversification.

b. Improve energy efficiency and the regulatory environment

79. **Key Issues:** The electricity sub-sector in Malawi suffers from low coverage, unreliable and inadequate supply, and high technical and commercial distributional losses (including inefficient bill collection and low tariffs).[33] Insufficient progress with reform of energy sector policy and legal framework and continuing financial weakness at ESCOM remain a challenge. The 2010 Country Economic Memorandum (CEM) identified the unreliability of power supply as one of the primary constraints to growth in Malawi. Currently, the installed capacity stands at 283MW -- not all of which may be available at any particular moment, given the increasing frequency of unscheduled outages -- while peak demand is now estimated to exceed 330MW. No new power generation capacity has been added since the commissioning of the Kapichira hydropower plant in 2000. This has led to a significant investment by consumers and industry in expensive and inefficient back-up arrangements (typically diesel gen-sets). Indeed, this form of energy security is estimated to cost the population at least an additional 25 percent in spending on electricity per month. At 8.7 percent, Malawi's access to electricity is lower than that of neighboring

[33] In 2008, ESCOM registered transmission and distributional losses of over 21 percent.

Zambia (23.0 percent of households), Mozambique (11 percent), and Tanzania (11 percent).[34]

80. **The power sector regulatory environment and the general economic climate in the sector are not attractive for large investors given the low average electricity tariff.** The issue of electricity tariff is important to investors who want to venture into power generation and therefore there is a need to come up with a tariff structure that is cost reflective and also be able to attract off-takers. Most of the sector's problems are caused by the weak institutional and policy framework, which results in inadequate pricing, lack of competition, inadequate routine maintenance, and insufficient new investment to expand access. The reforms in the electricity sub-sector are not only expected to help the existing operators to recover their operational costs but are also expected to open up the market for new investors, the Independent Power Producers, whose entry will help ESCOM (which has low generation capacity) meet national energy demands. Currently, ESCOM charges approximately 6.9¢/kWh on average, which is below its cost of service estimated at 10¢/kWh. The average market tariff in the region currently stands at approximately 12¢/kWh and as such ESCOM needs to intensify efforts to make its tariffs more cost reflective and bring them closer to the average regional rate, while ensuring that the poorest segment of the population with access to electricity are being cushioned.

81. **DPO-1 Prior Action 5:** To ensure that electricity tariffs reflect changes in the underlying fundamentals, the Malawi Energy Regulator Authority (MERA) is now reviewing electricity tariffs within the framework of the Automatic Tariff Adjustment formula (ATAF) on a monthly basis where adjustments in tariffs are triggered by movements in exchange rate (80 percent of the weight) and inflation (20 percent of total weight) above the 5 percent threshold. Until recently, ESCOM used to carry out the automatic tariff review less regularly and required authorization from the GoM before tariff adjustments could be effected, which affected ESCOM'S operational costs. Following the Cabinet decision to reinstate Automatic Price Mechanism for petroleum (APM) and to continue the implementation of ATAF in May 2012, MERA is now reviewing how the monthly changes in fundamentals (based as well as on other parameters such as operational costs and implementation efficiency gains) are affecting ESCOM's financial position. But according to the Energy Law, ESCOM is still obligated to initiate the request for tariff adjustment to MERA for no objection and execution. So far, two electricity tariffs adjustments have been implemented. Specifically, the two tariff adjustments in 2012 have put ESCOM in a much better financial position. For instance, the tariff adjustments in May 2012 helped restore the real value of the tariff in US dollar terms to 6¢/KWh after falling to 4¢/KWh immediately after the unification of the exchange rate. The adjustments made in November 2012 saw the average real price rise to 7¢/KWh. In order to move the electricity tariffs closer to the market reference point, an accelerator of 2 percent will be added over and above the adjustment in ATAF based on changes in market fundamentals. Tariff adjustments for ESCOM are necessary, especially with the imminent entry by the IPPs where ESCOM would be main the off-taker of power generated by IPPs.[35]

[34] Africa Infrastructure Country Diagnostic (AICD), "Underpowered: The State of the Power Sector in Sub-Saharan Africa, June 2008.

[35] The GoM have committed through the Millennium Challenge Compact on Energy to a turn-around facility where ESCOM will be required to make tariff adjustments and quarterly reviews by MCA will undertake. In an event where there is a gap between the electricity tariff and the cost of production, the GoM will be required to cover for the difference.

82. **The reforms supported by DPO-2 and DPO-3 will focus on improving the policy and regulatory environment in the sector with the view of creating a conducive environment for Independent Power Producers**, where tariff adjustment closer to the average market tariff in the region is a critical component for attracting the IPPs. These two operations will support the process of revising the Energy Policy and the enactment of the revised Electricity Act, respectively. The findings from the on-going Poverty and Social Impact Assessment (PSIA) on energy will contribute to the on-going discussions between the GoM and the MCC on future options for tariff adjustment, with increased focus on the lifeline tariff option (Annex 4E). These discussions will also feed into the energy policy review discussions and will inform the development of the new Energy strategy after the Energy policy revisions. The restatement of the MCC Energy Compact in June 2012, the Kapichira II soon to come on stream and the potential entry of IPPs will help improve energy generation capacity over the medium term. It is expected that at the end of the series the regulatory environment would have improved, electricity tariffs would be in line with the regional average and more players would have entered the market.

DPO-1 Prior Action 5: The Recipient, through the Malawi Energy Regulatory Authority, has undertaken monthly reviews of the Automatic Tariff Adjustment Formula for electricity covering the period May to November 2012.

Indicative Triggers DPO-2: The Recipient, through the Ministry of Energy, has reviewed Energy Policy and through the Malawi Energy Regulatory Authority, has undertaken monthly reviews of the Automatic Tariff Adjustment Formula for electricity.

Indicative Triggers DPO-3: The Recipient, through the Ministry of Energy, has revised and gazetted in full the Electricity Law of 2004 and through the Malawi Energy Regulatory Authority has undertaken monthly reviews of the Automatic Tariff Adjustment Formula for electricity.

.*Expected Results: Issuance of Power Generation License for an Independent Power Producer from 0 in 2012, to at least 1 by 2016. Medium term outcome is improved efficiency in the energy supply and a more conducive regulatory environment.*

c. Improve efficiency in the provision of Social Safety Nets

83. **Key Issues:** Currently, many of the social support interventions in Malawi are uncoordinated. The interventions include public works programs, social cash transfers, school meals, and savings and loan schemes. Most of these interventions, except for the public works, are not implemented nationwide and have limited ability to scale up in times of crises. In addition, these interventions have different targeting mechanisms, and it is possible to double target a needy household in the absence of a harmonized targeting mechanism. An estimated 50.7 percent of the population is classified as vulnerable (IHS3 2010/11). The GoM has been providing social protection through various interventions to help vulnerable groups manage the risks they face. The GoM's spending on social protection was 5 percent of total spending in FY12/13 (excluding FISP) but is mainly sourced from donors.

84. **The GoM has taken major steps to strengthen the social safety net system.** After years of trying to get the GoM approve the Social Support Policy (SSP) and increase

the budgetary allocations for social protection as stipulated in the SSP through the previous PRSC series, the GoM finally approved the Policy in June 2012. The GoM aims to improve the coordination and coverage of social protection programs. In line with the SSP[36]adopted in June 2012, the GoM has begun to roll out large programs to reach more vulnerable people and to cushion the impact of the stabilization effort on the most vulnerable groups. There is clearly the need to strike a balance between economic incentives and the provision of social protection as an investment that will protect the most vulnerable from falling again into the poverty trap. Thus, the need to come up with productive social safety net programs as poverty reducing instruments. Social protection and investments in productive safety nets and resilience programs will help to reduce poverty and promote economic growth.

85. **DPO-1 Prior Actions 6**: The Recipient has approved the National Social Support Programme (NSSP). The NSSP will facilitate the operationalization of the SSP, which provides guidelines for the design and implementation of social support interventions, coordination, resource mobilization, monitoring and evaluation of the impact of the instruments as well as the design of graduation and exit strategies for the beneficiaries. The NSSP is expected to create an enabling policy environment for the implementation of social protection interventions to maximize their impact. The indicative trigger for DPO-2 will focus on reforms aimed at building the M&E framework for the SP sector to address the problem of data availability and fragmentation. This action will help the GoM and key stakeholders in the sector monitor implementation of social protection initiatives and assess their impact. The indicative trigger for DPO-3 is on supporting the piloting a harmonized targeting system of beneficiaries and unified registry of beneficiaries to three district councils with the goal of improving access of the poor and extreme poor to social transfers as well as improving targeting and effectiveness of such programs. The rationale for the unified registry is to bring about a much better targeting system as well as minimize double dipping. This would facilitate achieving sustainable results as well as the scale up of delivery and coverage in times of crisis. These reforms will also track graduation of beneficiaries, in addition to providing a clear picture of the population benefiting from the programs. The expected result at the end of the series is improved efficiency and the targeting of the social support programs.

DPO-1 Prior Action 6: The Recipient has approved the National Social Support Program.

Indicative Trigger DPO-2: The Recipient, through the Ministry of Economic Planning and Development, has established the Monitoring and Evaluation system for the social support programs.

Indicative Trigger DPO-3: The Recipient, through the Ministry of Economic Planning and Development, has piloted a harmonized targeting system of beneficiaries and unified registry of beneficiaries in three district councils.

Expected Results: Beneficiaries with savings of at least 30 percent of Public Works wage

[36] The objective of the NSSP is to provide a framework for prioritizing targeting of support to reduce poverty and enable the poor to move out of poverty and vulnerability. It consists of four main pillars: (i) provision of social support; (ii) protection of assets; (iii) promotion of productivity enhancement; and (iv) policies to reduce exclusion. The NSSP is meant to provide an overarching framework for all social support activities undertaken by GoM and donors. The GoM has identified five social support programs that are to be included in the NSSP. These are: 1) public works; 2) social cash transfers; 3) school meals; 4) micro-credit; and 5) village savings and loan schemes.

one year after participation increase from 13,000 in 2012, to 49,000 in 2016. Medium term outcome is improved efficiency in the provision of social safety nets and a more responsive system of cushioning the poor and most vulnerable.

d. Strengthen Statistical Capacity

86. **Key Issues:** The quality and credibility of the country's statistics remains low. Data gaps, time lags and data quality issues still exist despite progress made to strengthen NSO's capacity. Challenges in the National Statistics System (NSS) include inadequate human resources, low investment in infrastructure and equipment, low profile of statistics within the sector ministries, inadequate capacity to collect, compile, store and disseminate and use statistics, uncoordinated and un-harmonized statistical management. Reliable and timely statistics on economic and social conditions are important for policy makers, private sector, development partners and investors. The NSO has to date implemented three Strategic Plans since 1996, and the fourth one covering 2012-2016 is soon to be completed. The National Statistical System was launched in 2006, with the first phase culminated in June 2008 with the National Statistical System Strategic Plan (NSSSP) (2008-2012) covering six ministries (Agriculture, Education, Health, Labour, Trade and Industry and Justice).

87. **Production of statistics by sectors has been disjointed**. As a basis for sound M&E, among others, Malawi has also been improving its statistics. The National Statistical Office (NSO) has experience in administering the National Household Survey (with support from the World Bank Living Standards Measurement Study-Integrated Surveys on Agriculture) and other mandated basic surveys, but there are data quality issues, especially as it relates to crop estimates, among others, and as such there is need to establish closer links between the NSO and both suppliers and users of data, outside as well as inside government. As a result, production of statistics has been costly or not harmonized hence the results produced have been inconsistent. The establishment of the NSS Strategic Plan seeks to coordinate production of statistics. The GoM now has a government-wide and results-oriented M&E system and is pushing for performance management. Among challenges encountered during the implementation of the NSSSP 2008-2012, included lack of coordination mechanisms to standardize and harmonize terms, concepts, methodologies and procedures between sources, surveys and institutions, insufficient participation of line ministries in the NSS due to lack of support from the leadership in the ministries, and non-completion of the NSS work plan and financing strategy. These challenges will be addressed through DPO-2 and DPO-3.

88. **Indicative Triggers DPO-2 and DPO-3:** The DPO-2 will support the development of the National Statistics System Strategic Plan 2013-2017, which will contribute to improvements in the country's statistical and M&E systems needed to improve program design and resource allocations. This Strategic Plan will present the vision, mission, core values and objectives that are going to guide the NSS for the next five years. The NSSSP is meant to oversee the development and implementation of a comprehensive and well-coordinated system of producing, processing and disseminating official statistics. The objective is to enable the country meet the ever growing demand for high quality, timely, accessible statistical information needed for evidence-based decision and policy making. The strategic plan has been aligned to local and international development frameworks such as MGDS II and MDGs respectively. The indicative trigger for DPO-3 is the approval of

the revised Statistical Bill. The strategic plan and the Statistics bill will help enhance coordination of statistical activities in Malawi, enhance filling of vacant positions in the statistical units of the various sectors as well as lay the foundation for a more harmonized approach by DPs to supporting statistics in Malawi. The expected result at the end of the series is the production of quality and timely statistics for planning, implementation, monitoring and evaluating the progress of Malawi Growth and Development Strategy and other critical statistics.

Indicative Trigger DPO-2: The Recipient, through the National Statistical Office, has developed the National Statistics System Strategic Plan 2013-2017.

Indicative Trigger DPO-3: The Recipient, through the Parliament, has enacted the revised Statistics Bill.

Expected Results: Number of quarterly MGDS progress reports published from 0 in 2012, to 4 in 2016. Medium term outcome is the production of high quality, timely and accessible statistical information.

VI. OPERATION IMPLEMENTATION

A. POVERTY AND SOCIAL IMPACT

89. **According to the recent report of Malawi's Third Integrated Household Survey (IHS3 2010/11), absolute poverty has declined by less than 2 percent since 2004/05, to 50.7 percent.** Although poverty in urban areas reduced from 25.4 percent in 2005 to 17.3 percent in 2011, this gain was counterbalanced by a worsening in rural poverty from 55.9 percent to 56.6 percent.[37] The Gini coefficient for Malawi deteriorated from 0.39 in 2004/05 to 0.45 in 2010/11. Within rural areas, the index rose from 0.34 to 0.38, while in urban areas it was fairly constant at about 0.49. Poverty rates among female headed households are significantly higher than male headed households, with their limited access to larger land holdings and failure to engage in cash crop production contributing to the higher household poverty.

90. **Overall, the proposed policy actions supported by this operation are likely to have positive impacts on welfare and its distribution** (table 5). As spelled out in the MGDS II, weak macroeconomic and public finance management systems and poor governance are perceived to be critical causes of poverty since weaknesses, especially in PFM, usually lead to inefficiencies in public spending, limited controls in the use of public resource and fiscal losses, which affect the GoM's ability to deliver public services to the poor. Strengthening of macroeconomic and public finance management will therefore enhance efficiency, transparency and accountability in public resource use; reduce the outstanding payment arrears (or minimize the accumulation of new ones) in the medium term, which is expected to improve the GoM's capacity to more effectively manage its resources and the savings generated could be used for investment purposes, especially in social sectors. More investments are also likely to benefit lower income groups through job creation in constructions of public infrastructure and related activities.

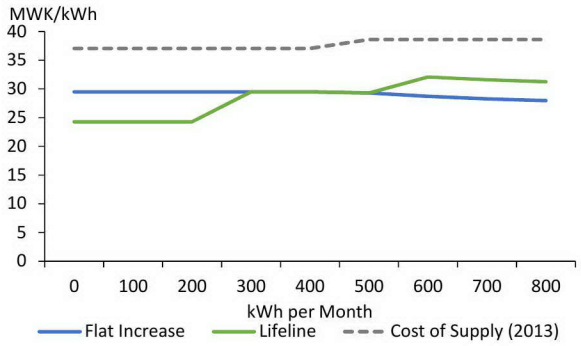
91. **Reforms under the proposed operation will support efforts to enhance agriculture productivity as well as strengthen social safety net systems to help bring about quick gains for the poor and most vulnerable groups.** The proposed measures will enhance productivity of smallholder farmers through use of quality seeds and modern ways of farming, and will also help improve the coordination mechanisms for the provision of social safety nets as well as the targeting of existing programs with a view to reduce the number of duplicate payments from different sources for the same beneficiaries. The improved targeting is especially important for women as poverty incidence for women tends to be higher. This will help improve the welfare of low-income groups, especially women and children, by ensuring that those exposed to shocks at any given time are reached on time. The improvements of statistical capacity and M&E systems will allow better targeting of social program in future.

92. **Electricity subsidies in Malawi are highly untargeted due to a combination of its flat tariff structure and the positive relationship between consumption and income.** This notwithstanding, measures to eliminate implicit subsidy in electricity will result to higher tariffs for consumers of electricity (Annex 4-E). Given the fact that a very small portion of the Malawi population has access to electricity (less than 7 percent), the impact

[37] The difference between IHS2 and the IHS3 national absolute poverty rates is not statistically significant. The IHS3 rural poverty rate is also statistically indistinguishable from that of IHS2.

of tariff hikes will affect mostly those in the higher level of incomes.[38] The tariff increases would also increase the prices of other household consumption goods, which would put additional pressure on all household budgets, even those poor without electricity connections. Considering Malawi's continuing inflation and exchange rate increases and the persistent large gap between tariffs and the cost of electricity supply, ESCOM will have to increase tariffs further.

Figure 4: Average Effective Tariff under Various Scenarios



93. **There are two broad options for the tariff adjustment: a flat increase or a differentiated increase that allows lower tariffs for lower consumption levels** (figure 4). In a simulation of tariff increases under the flat and lifeline scenarios, both proposed increases increase tariffs by a greater percentage than that expected for costs, only the increases modeled under the lifeline scenario would lessen the gap between tariffs and the cost of supply and thereby ease the cost of subsidies for ESCOM (table 4). Creating a lifeline tariff instead, in which tariffs are increased more for higher-consuming (generally richer) households than for lower-consuming households, would cushion the direct impact of tariff increases on the poorest electrified households, reduce the total cost of subsidies, and make the distribution of electricity subsidies less regressive than it is currently.

Table 4: Summary of the potential impacts of the flat and lifeline tariffs scenarios

	Nov. 2012	"Flat" Increase	"Lifeline" Increase
Tariff Change *over Nov. 2012 tariffs*		All increase by 70%	If consume 1-200 kWh, increase by 40% If consume 201-500, increase by 70% If consume 701+, increase by 90%
Avg. Expenditure Share of Total Budget *assuming HHs keep kWh constant*	34%	48%	47%
Avg. Monthly kWh *assuming HHs keep expenditure share constant*	140	89	101
Total Cost of Subsidies (billion MWK) *assuming HHs keep kWh constant*	5.87	6.29	5.73
Share of Subsidies Given to Poorest 40 Percent *of electrified households*	22%	21%	26%

[38] The poorest two income quintiles have close to zero households with electricity access, and the middle quintile only a one percent access rate.

Table 5: Poverty and Social Impact Assessment

Prior Action	Poverty and Social Impact	Source of Analysis
Pillar 1: Strengthening Macroeconomic and Public Finance Management		
The Recipient, through its ministry responsible for finance, has validated its outstanding payment arrears and has developed a plan for the full clearance of said arrears.	Strengthening of public macroeconomic and public finance management would enhance efficiency, transparency and accountability in public resource use through better budget preparation and execution, stronger public financial management systems and stronger oversight. The reforms will also support the effort to reduce the stock of outstanding payment arrears and prevent a build-up of new ones in the medium term. These reforms are expected to also improve efficiency in public expenditure, as the PFM improves, and the savings to be generated could be invested in social sectors.	MGDS II, ERP, PEFA 2011
The Recipient, through the Ministry of Finance, has submitted Treasury Minutes for 2006/2007 to Parliament.	From the fiscal perspective a sound system of internal and external control is necessary to provide reasonable assurance that public expenditure is executed in accordance with the approved budget and the established regulatory framework. This reform area covers budget planning and execution and effectiveness of the oversight systems for public audit and reporting aim at reducing wastage in public resource utilization, improving accountability and efficiency in spending. These gains would avail more resources to the delivery of services to the poor in Malawi.	PFEM RP 2011
The Recipient, through the Ministry of Agriculture and Food Security, has revised Farm Input Subsidy Program fertilizer procurement modalities with a refined bid evaluation methodology.	Improvements in the procurement of fertilizer under the FISP, which has a huge fiscal cost, will also help the Government ensure value for money in the program and the savings for the efficiency gains could be released for pro-poor spending. Since the program targets poor and vulnerable farmers, it is expected that these improvements would strengthen the national food security and reduce vulnerability to hunger. The reforms will also help improve transparency and accountability in the use of public resources, which in turn will help improve targeting the beneficiaries, the poor and most vulnerable, as well as reduce wastage in public resources	To be undertaken.
Pillar 2: Laying the Foundation for Stronger Growth and Protection of the Poor		
The Recipient, through the Malawi Energy Regulatory Authority, is undertaking monthly reviews of the Automatic Tariff Adjustment Formula for electricity.	A flat tariff increase would likely have a significant negative impact on electrified households[39], through a combination of an increased share of expenditures on electricity and a decrease in electricity consumption, and that impact would be notably greater for poorer electrified households. The tariff increases would also increase the prices of other household consumption goods, which would put additional pressure on all household budgets, even those poor without electricity connections. However, creating a lifeline tariff instead, in which tariffs are increased more for higher-consuming (generally richer) households than for lower-consuming households, would cushion the direct impact of tariff increases on the poorest electrified households, reduce the total cost of subsidies, and make the distribution of electricity subsidies less regressive than it is currently. Under a lifeline tariff increase, the share of subsidies directed to the poorest 20 percent of electrified household with increase to 26 percent from 22 percent in late 2012. In contrast, a flat tariff increase would make the distribution of electricity subsidies slightly more regressive, decreasing the	Electricity PSIA

[39] Given that almost none of the households in the lowest three income quintiles have electricity access, however, the electricity usage and expenditure analysis divides only the population of electrified households into quintiles. Thus, for that analysis, the "poorest income quintile", for example, is the poorest twenty percent of households that have electricity access, not the poorest twenty percent of the total population.

	share of subsidies directed to the poorest households to 21 percent.	
The Recipient, through the Office of the President and Cabinet, has approved the National Social Support Program.	Reforms under the proposed operation will support efforts to strengthen social safety net systems to help bring about quick gains for the poor and most vulnerable groups. The proposed measures will help improve the coordination mechanisms for the provision of social safety nets as well as the targeting of existing programs with a view to reduce the number of duplicate payments from different sources for the same beneficiaries. The improved targeting is especially important for women as poverty incidence for women tends to be higher. This will help improve the welfare of low-income groups, especially women and children, by ensuring that those exposed to shocks at any given time are reached on time.	Budget TA/ Comprehensive Package on Competitiveness, Growth and Poverty Reduction/ Targeting study (2012)

B. Environmental Aspects

94. **The legal framework for the environment is in place, but capacity to implement and enforce it remains a challenge.** The Environment Act of 1996 provides the framework for environmental management in Malawi, which applies to all public and private activities that may influence environmental aspects. Environmental laws in Malawi have been recently revised to take into account current trends in approaches to sustainable use and management of natural resources and the environment. It is now mandatory to carry out an Environmental Impact Assessment (EIA) for projects likely to have an environmental impact. There is a National Environmental Action Plan (NEAP) and related sub-sector plans. In the PRSP/MGDS environment, Vision 2020, MGDS, cross-cutting and sector strategies have incorporated environment as a key action area. Environmental agency and institutions of higher learning constitute an adequate planning capability and capacity to monitor EIA programs. There are structures in place such as National Council on Environment, Technical Committee on Environment which are cross sectoral and meet regularly.

95. **The specific actions supported the DPO series are not expected to cause significant effects on the environment, forests, and other natural resources of Malawi.** The policies supported under this programmatic DPO largely address institutional and regulatory reforms. For instance, the economic management reforms should lead to more efficient use of public resources, which may indirectly generate environmental benefits in the form of better use of modern technologies. While the reforms in the energy sector are focusing on institutions (fiscal sustainability of provision of electricity) and the regulatory environment, there are potential indirect effects. Adjustments of electricity tariffs to levels that reflect cost of supply could eventually enable ESCOM to start some of its investment projects, which could have environmental impacts. For this, the Legislation on Commercial Non-Renewable Resources Management is in place and is being implemented by Malawi Energy Regulatory Authority. Energy prices are also regulated e.g. electricity and liquid fuels and levies are appropriate. Regulations are being enforced by MERA which has the capacity to monitor energy undertakings.

96. **Reforms related to agriculture have some potential of indirect effects on the environment but the related environmental issues have already been taken care through the on-going sector lending operation**. The two agriculture-related DPO policy measures should indeed progressively lead to agriculture production intensification through the distribution of subsidized fertilizer and the expansion of seed multiplication fields

which will require fertilizer application. Current utilization of fertilizer under smallholder farming is very low and fertilizer use will not increase significantly preventing any major runoff. The risk associated with agricultural intensification will however be mitigated by extension activities delivered to farmers through two on-going Bank-funded projects: the Agricultural Sector Wide Approach – Support Project (ASWAp-SP) and the Irrigation, Rural Livelihoods and Agricultural Development Project (IRLADP). These projects include large scale investments in extension to help farmers adopt sustainable land and water management techniques. The ASWAp-SP in particular aims at improving FISP efficiency and as such specifically targets farmers benefitting from the FISP. It promotes good agricultural practices to help farmers make the most efficient use of the fertilizer distributed under FISP. Promoted techniques include for instance spot application and pit planting to avoid fertilizer losses and subsequent water pollution. Other approaches promoted by these projects also cover alternative techniques to increase soil organic matter content to help retain nutrients and the introduction of leguminous plants for atmospheric nitrogen fixation.

C. IMPLEMENTATION, MONITORING AND EVALUATION

97. **Implementation entity**. The Ministry of Finance (MoF) will be responsible for overall implementation of the DPO series as well as for reporting progress and coordinating actions among other concerned ministries and agencies. The MoF has experience in coordinating and implementing DPO programs as evidenced by the implementation of the PRSC I-III and RRDPG.

98. **The institutional arrangements for the preparation and execution of the DPO 1 fall within the framework of the CABS.** On the Government side, CABS is both served by a secretariat which is situated in the Debt and Aid Division of the Ministry of Finance. The Secretariats coordinate preparations of PAF Priority Action Plans, implementation, assessment and revision. For these activities, the Secretariat mobilizes sector experts in various ministries and departments.

99. **While the M&E system has improved more generally in recent years, there is room for further improvements.** The MGDS II has provided more information in many of the indicators, although the framework still needs to be improved in terms of the quality of the indicators and its linkages to other sectoral M&E frameworks. M&E of the MGDS II is coordinated by the M&E Division in the Ministry of Economic Development and Planning and the M&E results framework for MGDS II is in place. Implementation of the road map is being supported by a joint program of support with basket funding from the European Commission, DFID, and UNDP. Under the program, M&E officers and economists have been recruited, trained and deployed in all district councils of the country. This will improve collection of data from the field for monitoring the MGDS II. M&E divisions have also been established in most line ministries, and economists have all been deployed in all line ministries to be responsible for monitoring implementation of the MGDS II in their respective ministries. Currently only five sectors are yet to have district level databank developed, including social protection. The Bank through this operation will support the establishment of the databank for social protection at the district level.

100. **Program Monitoring**. The Bank's supervision of the DPO series is aligned with the CABS Framework biannual review meetings. In addition to two joint reviews, the Bank also participates in IMF missions to monitor progress on the macroeconomic framework.

Monitoring of the MGDS II is carried out in various sector working groups through Annual Progress Reviews, but the implementation of sector specific results matrices is expected to be carried out by the line ministries. The Ministry of Economic Planning and Development is responsible for overall poverty monitoring. Progress against DPO 1 targets is being monitored using Annex 2 which is used for monitoring progress against end-program outcomes.

D. FIDUCIARY ASPECTS

101. **Public financial management system.** Malawi's fiduciary risk is high but the framework is adequate overall to receive the proceeds of the grant. The government, in close collaboration with development partners, has developed a medium-term Public Finance and Economic Management Reform Programme (PFEM-RP) 2011/12-2015/16. The PFEM-RP is designed to further advance the pace of public finance management reforms in Malawi. The PFEMRP covers a broad range of areas that include planning and policy analysis, resource mobilization, budgeting, procurement, accounting and financial management, cash and debt management, parastatal financing, reporting, auditing, and PFEM RP administration. A Multi-Donor Trust Fund to operationalize the PFEMRP has been established is being managed by the Bank.

Box 3: Public Financial Management Assessment, 2011 – Major Findings (extract from PEFA report)

Overall progress in PFM has remained relatively unchanged compared to 2008 PEFA, despite good progress in some indicators.

Credibility of the budget: The period as a whole was characterized by persistent over-spending in comparison to original budget which contrasts with the previous three years each of which reported under-spending. On the revenue side actual revenue was consistently above budget, as it had been in the previous three years. Again, therefore, the credibility of the budget is called into question - this time in terms of its ability to provide a reliable indication of the GoM resource envelope.

Comprehensiveness and transparency: Though Malawi scores well in a number of areas associated with comprehensiveness and transparency, various issues remain - Treasury Funds are not reported in the Estimates and only appear in the Annual Appropriation Accounts as net figures. There is significant room for improvement in terms of public access to key fiscal information

Policy-based budgeting: While the orderliness of the annual budget process has improved relative to the last PEFA assessment, challenges lie ahead in terms of alignment of MTEF with the new priorities in the MGDS II.

Predictability and control in budget execution: Reforms are on-going in the Malawi Revenue Authority. The Ministry of Finance has improved the cash management process. Debt management and payroll system are being operated efficiently. The Procurement system continues to be unable to provide statistics with regard to the implementation and comprehensiveness of competitiveness in public procurement. The IFMIS rollout process has been concluded to the central government and 33 Local Authorities. Although awareness seems to be rising with regards to internal control, the evidence does not yet support the finding of improved control and internal audit procedures and processes being implementing and taking effect.

Accounting, recording and reporting: Progress in the period under review has featured the improved timeliness of the closure of the accounts and the production of the financial statement for audit. Also, in-year budget execution reports are produced on a timely basis and with some improvements is quality. However, management information at service delivery units stills needs to improve. A serious control concern identified is the backlog in bank reconciliations since July 2010. Timely bank reconciliation is an essential discipline in the ongoing checking and verification of accounting practices across Government and it also provides assurance as to the integrity of data used for reporting.

External scrutiny and audit: The period covered by this assessment has seen a backlog of external audits and Public Accounts Committee (PAC) scrutiny cleared. However, there are still weaknesses in the actions and follow up based on the recommendations of the National Audit Office (NAO) and PAC. In summary, NAO and PAC scrutiny has been characterized by periods when there has been no public scrutiny followed by intense activity to clear backlogs. In respect the Parliamentary Finance Committee, there is more opportunity for scrutiny of the draft budget than for budget execution.

102. **Four Public Expenditure and Financial Accountability (PEFA) assessments have been conducted in recent years, in 2005, 2006, 2008 and 2011**. The 2011 PEFA assessment, which found a number of improvements since 2008, was based on an analysis of performance for the years from 2007-08 to 2009-11 (Annex 4E). Selected areas where improvements have been made include cash management process, orderliness of the annual budget process, debt management and payroll system, debt and guarantees, effectiveness of internal audit, quality and timeliness of annual financial statements, and legislative scrutiny of the annual budget law. The assessment reported that regardless of progress being made, weaknesses remain on the credibility of budget (in terms of its ability to provide a reliable indication of the GoM resource envelope); internal control; comprehensiveness and transparency-Treasury Funds are not reported in the Estimates and only appear in the Annual Appropriation Accounts as net figures and public access to key fiscal information; timeliness of follow-up on audit recommendations and backlog in bank reconciliations

(Box 2). The PFEM RP has taken into account the weaknesses identified in the PEFA 2011 report in order to ensure overall strengthening of the PFM.

103. **On audit follow up, all the audit reports submitted to Parliament for years ended June 2006, 2007, 2008, 2009, 2010 and 2011 have been scrutinized and discussed by the Public Accounts Committee (PAC).** This implies that PAC is current in terms of scrutinizing all the reports that were submitted including a Treasury Minute for the year ended June 2004, and 2005. However, Government is aware of the backlog of Treasury Minutes which were mainly due to the absence of the Auditor General and irregular meetings Public Accounts Committee (PAC) meetings due to funding challenges. The appointment of the Auditor General in 2009 facilitated the clearance of a backlog of audit reports. With increased funding to Parliament, PAC is able to meet more regularly to scrutinize audit reports. The Government has currently submitted a Treasury Minute for June 2006, 2007 financial years to Parliament.

104. **The 2004 Country Procurement Assessment Report (CPAR) found that in 2002, public procurement accounted for 16.2 percent of GDP**, that corruption in procurement was widespread, capacity low and sanctions for corrupt practices were not effective. The Government has, in response, attempted to comprehensively address these weaknesses. A new Public Procurement Act, based on international procurement standards became operational in 2004 with the establishment of the Office of the Director of Public Procurement (ODPP), headed by a Director and Deputy Director appointed by the President and approved by the Public Appointments Committee of parliament. ODPP has policy, standards and monitoring functions and does not procure. It has supervisory oversight of a decentralized procurement system that since 2006 has been receiving intensive support from the World Bank, UNDP and USAID. While challenges remain, there have been significant advances in moving the public procurement system towards acceptable standards and through a grant from Institutional Development Fund (IDF), Government shall publish all contracts awarded above the threshold of MWK 45 million on the website of Director of Public Procurement, Government Gazette, one newspapers of national circulation and the website of the Ministry/Departments/Agencies or procuring entity responsible within a period of 30 days of such award.

105. **The status of budget publication in the country**: The GoM budget for the financial year 2012/13 was presented to the Parliament on June 8, 2012. The budget presented to the Parliament was in the form of the budget speech by the Minister of Finance was immediately made available on the MoF website. The draft Estimate of Expenditure books as well as the Financial Statements are also made available in hard copies.[40]

106. **Foreign Exchange Environment.** Under the Fund's safeguards assessment policy, the Central Bank of Malawi was subject to a full safeguards assessment with respect to the ECF arrangement approved in July 23, 2012. The recently updated safeguards assessment for the Reserve Bank of Malawi notes that the RBM continues to publish financial statements that are prepared and audited in accordance with international standards. From

[40] The Financial Statement is available on www.finance.gov.mw

the assessment, the principal safeguard concern was lack of operational autonomy for the RBM and that already envisaged amendments to the RBM Act to limit lending to government be expanded to strengthen RBM autonomy more broadly. Other recommendations focus on enhancing oversight of foreign reserves management and improvements to data compilation procedures. The latter includes measures to strengthen transparency of contingent liabilities arising from letters of credit that can have implications for program data. The RBM is committed to implementing the assessment's recommendations, and has requested technical assistance to strengthen the compilation of monetary and financial statistics.

Assurance Requirements

107. **Based on the high fiduciary risk associated with the operation, there will be special fiduciary arrangements established for the grant.** Within seven days of the disbursement of the grant by IDA, the Ministry of Finance shall provide a written confirmation to IDA, certifying the receipt of the Malawi Kwacha equivalent of the grant into the Consolidated Fund Account of the GoM, the number of the account, the date of the receipt, and the exchange rate applied to translate the credit currency into Malawi Kwacha , and confirming that the said amount has been appropriately accounted for in the recipient's financial management system. In addition, as the National Audit Office is required by law to submit its annual report and the audited accounts on the public consolidated fund to Parliament within 6 months of the end of the fiscal year, a copy of the said reports and accounts shall be provided to IDA within one month after the lapse of the 6 month period. The GoM shall equally ensure that the annual entity financial statements of the Reserve Bank of Malawi, audited in accordance with international standards on auditing as promulgated by the International Federation of Accountants, are publicly available.

108. **The Association reserves the right to request, at any time, an audit of the receipt and accounting of the disbursement in the budget management system of the Recipient.** Upon the Association's request, the Recipient shall: (i) have the account and the recording of amounts of the credit into the Recipient's budget management system audited by independent auditors acceptable to the Association, in accordance with consistently applied auditing standards acceptable to the Association; (ii) furnish to the Association as soon as available, but in any case no later than four months after the date of the Association's request for such audit, a certified copy of the audit report by said auditors, of such scope and in such detail as the Association shall have reasonably requested; and (iii) furnish to the Association such other information concerning the said account and recording of credit amounts into the budget management system, and the audit thereof, as the Association shall have reasonably requested.

E. DISBURSEMENT AND AUDITING

109. **A single-tranche programmatic DPO of SDR 33.4 million (US$50 million equivalent) will be disbursed upon grant effectiveness and following the Recipient's request for withdrawal of proceeds of the grant**. The proposed grant will follow the Bank's standard disbursement procedures for development policy operations. The grant will be disbursed against satisfactory implementation of the development policy program and not tied to any specific purchases. Once the operation is approved by the Board and becomes effective, and upon receipt of a withdrawal application signed by an authorized signatory, the proceeds of the grant will be deposited by IDA in a US$ account designated

by GoM at the RBM and forming part of the official foreign exchange reserves of Malawi. Within two working days, the RBM will credit the Malawian kwacha equivalent of the grant proceeds to the consolidated account maintained on behalf of GoM for budget execution. The conversion from the foreign currency to the local currency will be based on the prevailing exchange rate on the date that the funds are credited to the budget management system.

110. **The RBM will not impose any charges or commissions on the Recipient for these transactions.** The Recipient will: (a) provide confirmation to the Bank within 30 days that an amount equivalent to the grant proceeds from the Bank has been credited in the Recipient's budget management system, with an indication of the exchange rate applied; (b) provide evidence that the Malawian Kwacha equivalent of the grant proceeds was recorded as financing the GoM budget; and (c) ensure that the Malawian Kwacha equivalent of the grant proceeds are subject to effective controls sufficient to ensure its use for eligible budgeted public expenditures only as per the Financing Agreement.

111. **Disbursements by the GoM shall not be tied to any specific purchases and no special procurement requirement shall be needed.** The proceeds of the credit shall, however, not be applied to finance expenditures in the negative list as defined in the Schedule 1 of the Financing Agreement. If any portion of the credit is used to finance ineligible expenditures as so defined in the Schedule 1 of the Financing Agreement, IDA shall require the GoM to promptly, upon notice from IDA, refund an amount equal to the amount of the said payment to IDA. Amounts refunded to IDA upon such request shall be cancelled from the credit. The administration of this grant will be the responsibility of the Ministry of Finance.

112. **The use of the Malawian Kwacha equivalent of grant proceeds to support budgetary expenditures will be subject to audit** by the Auditor General as provided for by the Malawian Constitution. The Bank will have access to these audit reports.

F. Risks and Risk Mitigation

a) External shocks

113. **The country remains vulnerable to weather conditions, especially drought and floods, and its reliance on rain-fed agriculture increases its vulnerability.** Lower agricultural output would have a significant effect on overall GDP growth given the size of agriculture in GDP. The maize shortages currently being experienced in the country from the effects of the drought have contributed to the acceleration in inflation given the over 50 weight for maize in the consumer basket.

114. **There is also a risk of potential spillovers from the global economy, including stagnation of euro area and world growth, a substantial fall in non-oil commodity prices, and a reduction in aid flows.** Slower world growth would adversely affect demand for Malawi's exports (mainly tobacco), but the overall impact on Malawi's growth is expected to be low. A substantial fall in tobacco prices would adversely affect the foreign exchange balance and hence the exchange rates in the short term. It will also affect the income of farmers and could in the end dampen growth.

115. **As a mitigation measure, the Authorities are regularly monitoring macroeconomic developments, including as part of the program with the IMF.** The continuation of the policy reforms instituted in May 2012 such as the automatic price adjustment mechanism for fuel and flexible exchange rate would allow the economy to adjust to shocks within minimum policy response. Where needed, the GoM is expected to respond through appropriate policy measures and the Bank team will help the GoM to formulate and implement such responses. Specifically, the DPO series and the 2013 Public Expenditure Review will provide a platform for a dialogue with the GoM on the ways to improve expenditure prioritization and controls as well as improve efficiency of public expenditures. In an event where there are shortages in revenues, the Authorities have committed to make necessary but better targeted expenditure cuts in the budget and the Bank team will help them in this exercise. The GoM is also putting in place measures to strengthen domestic revenue mobilization, to leverage on private sector resources and intensify the export diversification drive to mitigate the risks. Special efforts are being geared towards the promotion of tourism as a diversified source of foreign exchange earnings and the improvements in the overall business environment with a view of attracting private sector investment in various sectors (including energy and mining), and take advantage of trade potentials within the region as well as outside.

b) Political Environment Risk

116. **Political risks remain high in the context of the Presidential elections planned for May 2014.** The reforms instituted in May 2012 have been followed by considerable depreciation of the Kwacha of over 66 percent (following the 50 percent Kwacha devaluation in May 2012) and an acceleration of inflation in excess of 30 percent. These developments are putting pressures on the GoM's resolve to stay the course. Significant pressures on the budget are emerging, in the form of increase in wage demands, and are likely to increase during the fiscal year 2013/14, posing further risk to macroeconomic stability. The proposed reforms geared towards rebalancing of the FISP program faces significant risks in view of the fact that the FISP is highly politicized.

117. **These risks will partly be mitigated by a better communication by the government on how the policy reforms are having some positive impacts and the time needed to let the reform work.** This could be further complemented by more informed public debates based on emerging evidence from the on-going Public Expenditure Review and poverty policy notes, which includes analysis on the FISP.

(c) ***Implementation Capacity Risks***

118. **The systemic problem of capacity in GoM continues to pose a risk to the reform program and may cause delays in implementation of some of the reform measures supported by this operation.** Weak management of the public finances and reports of widespread corruption and extortion by public officials in procurement and fraudulent activities within the PFM systems represents a significant risk. Corruption has been also identified in the recent Business Climate Survey as being one of the constraints to doing business by the in Malawi.

119. **To address this risk in the short term, the Bank intends to increase its engagement at the technical level to ensure that the reforms under this operation implemented and sustained**. Plans are also under way to pilot demand side governance instruments at the local and sector levels to enhance civil society and user participation in its programs. In addition, the

DPs are supporting the GOM through a combination of capacity building and technical support, including support for statistics and monitoring and evaluation. Specifically, the risks can be mitigated by the pace of reforms supported by the implementation of a more harmonized PFM program under the Public Finance and Economic Management Multi-Donor Trust Fund and by this operation. The recently approved Financial Reporting and Oversight Project aims to strengthen internal controls, accounting, reporting and oversight of government finances at the central and decentralized levels. Increased awareness of the seriousness of corruption and the country's growing conducive and open political climate is acting as a mitigation measure as it has empowered development stakeholders to flag governance and corruption issues with ease.

Annex 1: Letter of Development Policy

Telephone: 01 789 355
Telefax: 01 789 173
Telex: 44407
Email:finance@financ
e.gov.mw

MINISTRY OF FINANCE
P.O. BOX 30049,
CAPITAL CITY,
LILONGWE 3.

MINISTER OF FINANCE

Ref No.: DAD/5/2/3/13 **11 April 2013**

Mr. Jim Yong Kim
President
The World Bank Group
1818 H. Street N.W
Washington D.C 20433
United States of America

Dear Mr Kim,

MALAWI: LETTER OF DEVELOPMENT POLICY

1. On behalf of the Malawi Government, I write to request for the First Economic Recovery Development Policy Operation (DPO-1) Grant of US$50 million from the International Development Association (IDA). The DPO-1, which is the first of a programmatic series of three single tranches, is intended to support policy and institutional reforms under the Second Malawi Growth and Development Strategy II (MGDSII) and the Economic Recovery Plan (ERP). The program sets to consolidate gains from the macroeconomic and structural reforms that were supported by the Rapid Response Development Policy Grant (RRDPG) approved in July 2012.

2. The Program will focus on Macroeconomic Management, Public Financial Management, Agriculture, Energy, and Social Protection. Specifically, the program is aimed at: (i) strengthening macroeconomic and finance management so as to strengthen expenditure controls, financial reporting and oversight at national and sub-national levels and, (ii) lay the foundations for stronger growth and protection of the poor through reform measures aimed at enhancing agriculture productivity, addressing energy constraints and improving social safety nets.

3. The program will support Government's efforts of achieving fiscal discipline, enhancing efficiency and effectiveness of government spending, improving accountability, transparency and the country's statistical capacity, enhancing agriculture productivity, addressing energy constraints and improving social safety nets among others. More details on the proposed reforms to be supported under this program are set out in Part C of this letter.

A. Recent Macroeconomic Performance and Developments

4. The Government of Malawi remains committed to staying the course on the hard but important economic reforms that were rolled out in May 2012. The reforms are already yielding some positive results as evidenced by availability of foreign exchange, fuel and restoration of credit lines. The international community continues to register confidence in Government's direction on the unprecedented economic management and governance reforms as evidenced in the increase in budget support and normalization of relations between Malawi and her neighbors.

5. Nonetheless, Malawi's economic recovery remains fragile. Although the foreign exchange reserve situation has improved it remains precarious at 1.7 months of import cover as of February, 2013. The impact of the adjustment on the economy has been greater than earlier anticipated as inflation has spiked and the currency continues to depreciate.

6. Economic performance slowed down in 2012 as GDP grew by only 1.9 per cent from an earlier projection of 4.3 per cent. This was largely on account of significant contraction in Agriculture, and Manufacturing sectors. In addition, the Wholesale and Retail Trade, as well as the Utilities sectors, among others, recorded growth but at a slower pace compared to 2011. These are the sectors which drive the economy and whose accelerated growth is vital in boosting growth in subsequent sectors.

7. The economy, nonetheless, registered an expansion in the other sectors which are mostly service sectors. These sectors include: Mining and Quarrying; Information and Communication; Construction; Transportation and Storage; Accommodation and Food Services; Real Estate Activities; Financial and Insurance Services; Public Administration and Defense.

8. The economy, is however, expected to rebound to 5.5% in 2013 on account of increased output in the manufacturing and agriculture sectors.

9. Meanwhile, inflationary pressures in the economy have surged. Headline CPI inflation for February, 2013 surged to 37.9% from 10.9 % the previous period which is higher than the ECF programme projection of 22.4%. The urban and

rural rates stand at 35.6 percent and 33.3 percent respectively. Inflation is being driven by rising food prices and escalating transport and utility prices. However, the average annual inflation in 2013 is projected to decline to 18 % as the food situation normalizes and growth rebounds. The Reserve Bank of Malawi (RBM) revised the bank rate upwards from 21% to 25% in November 2012 to ease inflationary pressures.

10. On the fiscal side, Government continues to exercise fiscal restraint. The Government remains committed to implementing austerity measures, including stringent controls on travel, procurement of capital assets as well as other goods and services.

11. Malawi continues to closely monitor its debt to ensure that it remains sustainable in view of debt servicing obligations. As of December 2012, domestic debt stock stood at K204.17 billion while external debt amounted to US$1.19 billion. Government will continue to repay its domestic debt to ensure that domestic debt as a percentage to GDP is reduced to levels of less than 15 percent of GDP from 20 percent as of end December 2012.

12. On 8th April 2013 the Executive Board of the International Monetary Fund completed the second review of Malawi's economic performance under a program supported by the Extended Credit Facility (EFC) arrangement. The Board's decision will enable an immediate disbursement to Malawi of about US$19.6 million.

B. The Second Malawi Growth and Development Strategy (MGDS II)

13. The Government adopted its third medium term poverty reduction strategy, the MGDS II, which covers the period 2011 to 2016 and it was prepared using participatory processes. The strategy's overall objective is wealth creation through sustainable economic growth and infrastructure development. It is organized around six thematic areas as follows: (i) sustainable economic growth; (ii) social support and disaster risk management; (iii) social development; (iv) infrastructure development; (v) good governance and (vi) gender and capacity development.

14. From these thematic areas, the strategy has identified nine key focus areas that are seen as central to achieving the strategy's overall objective of wealth creation. The focus areas are agriculture and food security; energy, industrial development, mining and tourism; transport infrastructure and Nsanje World inland port; education, science and technology; public health, sanitation, malaria and HIV and AIDS management; integrated rural development; green belt irrigation and water development; child development, youth development and empowerment; climate change, natural resources and environmental management.

15. Within the framework of the MGDS II, Government also launched a short run Economic Recovery Plan (ERP) in September, 2012 to accelerate the recovery process whilst lessening the impact of the economic and structural reforms undertaken on the poor and most vulnerable. The focus of the ERP is on monetary, fiscal and exchange rate policies, revenue enhancing measures and expenditure control. Under the ERP, Government has also adopted a social support package, which will consolidate existing programs like public works programs to mitigate the impact of the reforms undertaken by government on the most vulnerable. These programs include: Scaling up of the labour intensive public works programme (LIPW); Up-scaling of legume seed multiplication, agro forestry and soil conservation, multiplication of cassava cuttings and sweet potato vines and extending village savings club; Up-scaling of school meals programme and vitamin A supplementation; and Up-scaling of Social Cash Transfer Programme.

C. Specific Reforms to be implemented

16. In line with the ERP and building on the reforms implemented under Rapid Response Development Policy Grant (RRDPG), the program will set the stage for longer term structural reforms. Government will continue to implement reforms aimed at reviving the economy, restoring confidence, and protecting the most vulnerable from falling into the poverty trap in the short term while broadening its economic base over the medium to long term. In line with this agenda, I would like to highlight the various reforms that the Government of Malawi intends to implement.

Pillar 1: Strengthening Macroeconomic and Public Finance Management Public Finance Management (PFM)

17. Government is in the process of implementing a Public Financial and Economic Management Reform Program (PFEM RP). The PFEM RP is a medium-term programme aimed at strengthening PFEM systems and improving their capacity. Under the Multi-Donor Trust Fund (MDTF) funding modality of the PFEM, the first project, the Financial Reporting and Oversight Project (FROIP) signed on 15th March 2013 has been designed with a total estimated cost of US $16 million. The first phase will cost US $ 8 million. Implementation of the project has already started with focus on the Integrated Financial Management System (IFMIS) roll-out to the remaining councils and consolidation, payroll management, procurement planning, and external and internal audit.

18. Government continues to take necessary steps to address problems that exist in PFM. In an effort to strengthen PFM transparency and accountability IFMIS has been rolled out to 33 Local Authorities (LAs) out of 35. Plans are that by end of

the 2012/13 Financial Year, all the 35 LAs should be connected. This will assist in improving timeliness in financial reporting thereby enhancing accountability. Through the FROIP, IFMIS business re-engineering will be done to improve connectivity and integration of accounting IT software. In order to enhance skills of accounting personnel, the FROIP will also assist in training staff in the Accounting Common Service.

Arrears clearance

19. Verification of outstanding payments and arrears has been completed. In cases where the creditors have agreed, Government is honoring these payments through promissory notes which can be discounted on the market over four years. As for all other arrears outside those sorted out through issuance of promissory notes, the plan is to clear them over time through budgetary provisions. For the capital budget, settlement of outstanding payments are being made for all fast moving projects that require immediate payment by reallocating resources within the vote from projects that are stalling. Further, in order to strengthen Commitment Control, Government has started enforcing the issuance of Ordinary Local Purchase Oder's (LPO) Module in IFMIS. Currently, some Ministries, Departments and agencies (MDAs) have already started processing payments through the LPO Module. In addition, Government has also directed that all Internal Procurement Committees should be chaired by Controlling Officers to enhance oversight over procurement, as per the Public Procurement Act (2003).

Improving the credibility of the budget

20. Government has adopted a comprehensive budget formulation calendar to accommodate the required medium term perspective, expenditure reviews and consultations to support the recent reinvigoration of MTEF by the Government. The new budget calendar represents a significant improvement as it provides for a more explicit emphasis on macroeconomic, fiscal and strategy policy review at the outset of the budget process. The calendar is meant to provide adequate time for undertaking review of macro-fiscal performance, analysis of fiscal strategies, budget analysis, analysis of submissions from spending agencies and timely review of budget ceilings, where necessary. The introduction of a revised comprehensive calendar introduced in 2012/13, provides for sector performance reviews in the first quarter of the year to facilitate the prioritization process for the upcoming financial year. The process will proceed alongside a review of the macro-fiscal framework in order to determine an affordable resource and expenditure framework for the annual budget and the medium-term. In addition, Government is in the process of coming up with first Budget Policy Framework Paper (BPFP), which is a three-year rolling framework, will be used to streamline and guide the budget process, setting out planned outputs and their associated expenditures in the medium-term. The BPFP will be linked to the Ministries' budget ceilings and will be discussed with the Cabinet. The policy will consolidate all Government's commitment to achieving a medium term fiscal consolidation through accelerated domestic resource mobilization and expenditure prioritization to

narrow the fiscal gap and reduce reliance on financial assistance in the medium to long run.

Improving oversight

21. Under the area of oversight, Government is up-to-date in submission of Annual Auditor General's Reports (AGRs) to Parliament. However, the FY 2011/12 AGR has been delayed due to the absence of the Auditor General (AG), following his retirement towards end of 2012. The National Assembly has of late identified and allocated additional staff to support the oversight role of the Public Accounts Committee. Government through the Budget Division of the Ministry of Finance will intensify its efforts on audit follow ups including timely production of Treasury Minutes.

Strengthening Statistical Capacities

22. Government realizes that policy decisions based on accurate and meaningful information are more effective in achieving desired outcomes. It is in this regard that Government will continue to strengthen the National Statistical Office for provision of coordinated, timely and high quality statistical information. In its efforts to enhance evidence based decision making, Government will in the medium term review statistics legislation.

Pillar 2: Laying Foundation for Stronger Growth and Protection of the Poor

Enhance Agricultural Productivity, Modernization and Transformation

23. Recognizing the fact that agriculture remains the back bone of the Malawi economy, Government has planned a number of reforms to modernize and transform the sector. One such reform is the review of the legal and regulatory framework for quality seed production. The selection of a consultant to carry out the review is underway. Government expects to take on board recommendations that will be drawn from the review.

24. Under food security, Government intends to review the Farm Input Subsidy Program (FISP). In the short run, the processes and procedures will be revisited to ensure efficiency in the implementation of the program. In the medium term, Government intends to revisit the entire program to ascertain whether the food security benefits of the FISP could be achieved in a different and better manner. Currently a joint MoAFS Efficiency Committee has been formed to discuss fertilizer distribution issues and make recommendations on how to improve procurement and distribution of fertilizer for the 2013/14 program.

25. Some of the areas where reforms will be made in the next FISP include: timeliness with key milestones to improve FISP planning and timely procurement and fertilizer distribution; the strengthening of the pre-qualification criteria for the selection of FISP suppliers and transporters; the tightening of the criteria for the evaluation of bids based on a scorecard to ensure better value-for money; the strengthening of penalties for late delivery as incentives to suppliers to ensure timely delivery; the introduction of an improved fertilizer delivery tracking system and the piloting of e-vouchers. Government is optimistic that with proper implementation of these reforms, a lot of savings will be made.

Addressing Energy Constraints

26. Government plans to engage a consultant to undertake a cost of production study. The results of this study will help Government and Electricity Supply Commission of Malawi (ESCOM) in terms of the way forward on the level of electricity tariffs with respect to market fundamentals. Government also wants to bring more players in the power generating sector by improving the policy and regulatory framework with the aim of creating a conducive environment.

Improving Provision of Social Safety Nets

27. Government approved the Social Support Policy (SSP) in July, 2012. The SSP provides a holistic framework for designing, implementing, coordinating, monitoring and evaluating social support interventions in Malawi. Currently, Government has also adopted a National Social Support Programme (NSSP) to provide and promote productivity-enhancing interventions and welfare support for the poor and vulnerable, as well as interventions that reduce risks and the impact of shocks. Through this program, Government intends to (i) Strengthen the Social Support environment by supporting the operationalization of the National Social Support Policy through the implementation of the NSSP; (ii) Improving the coverage of Social Support interventions recognizing that social support interventions in Malawi provided limited coverage to the target groups, with the Social Cash Transfer Programme reaching only 35% of vulnerable groups in 7 districts out of 28, and full coverage in only 3 of the 7 districts; and (iii) Improving the efficiency in the delivery of social support interventions in Malawi.

28. I am confident that the outlined policies, programs and reforms will create a conducive and enabling environment for rapid economic recovery and create a strong foundation for growth to rebound.

Yours faithfully,

Dr. Ken Lipenga, MP
MINISTER OF FINANCE

Annex 2: Operation Policy and M&E Matrix

Republic of Malawi–Economic Recovery Development Policy Operation 1
Government Economic Recovery Plan and MGDS II (2013-2016): Priority Actions and Outcomes

Prior actions and Triggers			Results		
Prior Actions under DPO-1 (2012/13)	**Indicative Triggers for DPO-2 (2013/14)**	**Indicative Triggers for DPO-3 (2014/15)**	**Outcome Indicator Baseline (2012)**	**Outcome Indicator Target (2016)**	**Implementing Agency**
PILLAR 1: STRENGTHENING MACROECONOMIC AND PUBLIC FINANCE MANAGEMENT					
***Objective**: Strengthen fiscal discipline to entrench macro-stability as well as improve efficiency and transparency of the public finance management through measures to strengthen budget policy framework and improve its medium-term orientation; strengthen external oversight of public finances; strengthen internal controls on public finances; enhance efficiency in the use of public resources.*					
The Recipient, through its ministry responsible for finance, has validated its outstanding payment arrears and has developed a plan for the full clearance of said arrears for the State Owned Enterprises and the Ministries, Departments and Agencies.	The Recipient, through its ministry responsible for finance, has cleared 25 percent of the outstanding stock of domestic payment arrears owed by State Owned Enterprises and has rolled out commitment control under IFMIS to all Ministries, Departments and Agencies, and to local district councils.	The Recipient, through the Ministry responsible for Finance, has cleared at least 50 percent of the outstanding stock of domestic payment arrears owed by State Owned Enterprises and has verified non-accumulation of new domestic payment arrears by the Ministries, Departments and Agencies.	Percentage of outstanding stock of payment arrears (SOEs) cleared at 0%. Zero ceiling on accumulation of new arrears by Ministries, Departments and Agencies.	Percentage of outstanding stock of payment arrears (SOEs) cleared at 50%. Zero ceiling on accumulation of new arrears by the MDAs	Ministry of Finance
The Recipient, through the Ministry of Finance, has adopted a detailed budget formulation calendar.	The Recipient, through the Minister of Finance, has approved the Budget Policy Framework Paper for 2013/14.	The Recipient, through the Ministry of Finance, has developed MTEF manual and adopted by Ministries, Departments and Agents (MDAs).	Variance in the expenditure between approved expenditure and outturn is 12% (2009/10-2011/12)	Variance in the expenditure between approved expenditure and outturn is at 8% or less.	Ministry of Finance
The Recipient, through its ministry responsible for finance, has submitted Treasury Minutes covering fiscal years 2005/06 and 2006/07 to the Recipient's parliament.	The Recipient, through the Ministry of Finance, has submitted Treasury Minutes for fiscal years 2007/08, 2008/09, 2009/10 and 2010/11 to Parliament and has created baseline data of pending audit queries by Ministries, Departments and Agencies.	The Recipient, through the Ministry of Finance, has submitted Treasury Minutes for fiscal years 2011/12 and 2012/13 to Parliament and has registered 25 percent reduction in pending audit queries per Ministries, Departments and Agencies.	Reduction of backlog from over 60 months.	Reduction of backlog to 48 months.	Ministry of Finance

	The Recipient has instructed 10 largest spending ministries to ensure that their Audit Committees are functional and has created a baseline data of pending bank reconciliation per Ministries, Departments and Agencies as evidenced by at least 80 percent reduction in the rate of recurrent audit findings and at least one meeting held by all Audit Committees during the first half of 2013/14.	The Recipient has instructed Audit Committees in the remaining ministries to be functional and has carried out bank reconciliation for the Ministries, Departments and Agencies up to three months before negotiation date as evidenced by at least 75 percent reduction in the rate of recurrent audit findings and at least four meetings held by Audit Committees per financial year.	Rate of recurrent audit findings at 90%.	Rate of recurrent audit findings at 50%.	
The Recipient, through its ministry responsible for agriculture and food security, has revised the bidding documents for the annual procurement of fertilizer under the Farm Input Subsidy Program to align the allocation of tonnage demand with unit price ranking for the purpose of increasing the Recipient's value-for-money.	The Recipient, through Ministry of Agriculture and Food Security, has reviewed the design of Farm Input Subsidy Program (FISP), in light of findings of various impact evaluations, agriculture Public Expenditure Review (PER), and consultations. The recommendations have been submitted to Cabinet.	The Recipient, through Ministry of Agriculture and Food Security, has re-structured its public expenditure in agriculture in line with the redefined FISP objectives and priorities of the ASWAp framework, as evident in 2014/15 budget.	Fertilizer share of Agriculture budget at 85%	Public investments in agriculture equally distributed among the three ASWAp pillars.	Ministry of Agriculture and Food Security
PILLAR 2: LAYING THE FOUNDATION FOR STRONGER GROWTH AND PROTECTION OF THE POOR					
***Objective**: To enhance agriculture productivity and diversification, improve energy efficiency and regulatory environment, improve efficiency in the provision of social safety nets and strengthen the country's statistical system.*					
	The Recipient, through the Ministry of Agriculture and Food Security, has completed a review of the legal and regulatory framework for quality seed production.	The Recipient, through the Ministry of Agriculture and Food Security, has finalized revisions to the Seeds Act and Breeders' Act following consultations with private seed companies and farmers organizations.	Legume production at 949,454 metric tons in 2012.	Increase in legume production by 20 percent compared to the 2012 level.	Ministry of Agriculture and Food Security

The Recipient, through the Malawi Energy Regulatory Authority, has undertaken monthly reviews of the Automatic Tariff Adjustment Formula for electricity.	The Recipient, through the Ministry of Energy, has reviewed, updated and publish Energy Policy and through the Malawi Energy Regulatory Authority, has undertaken regular reviews of the Automatic Tariff Adjustment Formula for electricity.	The Recipient, through the Ministry of Energy, has revised and gazetted in full the Electricity Law of 2004 and through the Malawi Energy Regulatory Authority has undertaken monthly reviews of the Automatic Tariff Adjustment Formula for electricity.	Issuance of Power Generation License for an Independent Power Producer.	At least 1	Ministry of Energy/ Malawi Energy Regulatory Authority
The Recipient has approved the National Social Support Program.	The Recipient, through the Ministry of Economic Planning and Development, has established the Monitoring and Evaluation system for the social support programs.	The Recipient, through the Ministry of Economic Planning and Development, has piloted a harmonized targeting system of beneficiaries and unified registry of beneficiaries in three district councils.	Beneficiaries with savings of at least 30% of Public Works wage one year after participation at 13,000.	49,000– of which 62% female	Ministry of Economic Planning and Development
	The Recipient, through the National Statistical Office, has developed the National Statistics System Strategic Plan 2013-2017.	The Recipient, through the Parliament, has enacted the revised Statistics Bill.	Number of quarterly MGDS progress reports published (0)	Number of quarterly MGDS progress reports published (4)	National Statistical Office

Annex 3: Funds Relations Note

IMF Executive Board Completes Second Review Under the Extended Credit Facility Arrangement for Malawi and Approves US$19.6 Million Disbursement
Press Release No. 13/108
April 8, 2013

The Executive Board of the International Monetary Fund (IMF) today completed the second review of Malawi's economic performance under a program supported by the Extended Credit Facility (ECF) arrangement. The Board's decision enables the immediate disbursement of an amount equivalent to SDR 13.02 million (about US$19.6 million), bringing total disbursements under the arrangement to an amount equivalent to SDR39.06 million (about US$58.7 million).

The three-year ECF arrangement for Malawi in the total amount of SDR 104.1 million (about US$156.2 million) was approved on July 23, 2012 (see Press Release 12/273).

Following the Board's discussion, Mr. David Lipton, First Deputy Managing Director and Acting Chair, issued the following statement:

"Malawi's performance under the Fund-supported program has been commendable despite a difficult environment. The policy reforms have begun to yield positive results, including increased availability of foreign exchange. The government also successfully rolled out its social protection programs.

"Continued tight monetary policy and fiscal restraint are needed to contain aggregate demand, stabilize the exchange rate and prices, and boost international reserves. The Reserve Bank of Malawi (RBM) is committed to maintaining a tight monetary stance until inflation pressures recede. The fiscal authorities are also committed to implementing prudent policies in the run up to the 2014 general elections. In particular, the FY2013/14 budget will include measures to offset the impact of recent wage increases on the budget. The authorities are also pursuing reforms to broaden the tax base, improve revenue administration, and exercise greater control over expenditures.

"It will be important to safeguard the stability of the financial system. The RBM is strengthening its oversight of banks and is assessing the true financial condition of all banks with a view to enforcing prudential regulations. It has also enhanced its monitoring of banks that have continued to have difficulty meeting liquidity requirements.

"The authorities are making progress in implementing structural reforms to enhance the country's competitiveness and exports. They are committed to removing regulatory hurdles to doing business in Malawi."

Annex 4: Background Information: Country Context, PFM and PSIA-Energy

A. Political Context

29. **Malawi went through a very turbulent period in 2010 and 2011.** President Bingu wa Mutharika ruled the country from 2004 until his death in April 2012. Originally elected president as a member of the United Democratic Front (UDF), he soon split from the UDF to form a new party, the Democratic Progressive Party (DPP). Through 2009 his administration made substantial progress despite lacking a parliamentary majority: Malawi saw a remarkable economic turnaround, sustained economic growth, progress on service delivery and the Millennium Development Goals (MDGs), and—most remarkable—improved food security. As a result, President Mutharika's DPP was re-elected for a second term in office (2009–2014) with a 60 percent majority in the 193-seat Parliament and also secured considerable support from independent parliamentarians[41]. The administration was thus able to pass with ease laws in support of the President's political and development agenda.

30. **In 2010 Malawi's record on governance began to deteriorate significantly.** Especially the application of checks and balances in the political process affected the environment for growth, the investment climate, and service delivery. In 2010 and 2011 Parliament passed a number of laws perceived as weakening democratic institutions and human rights. Local elections, required since 2005 and planned for 2010, were again delayed. President Mutharika and Vice President Mrs. Joyce Banda had a falling-out over succession strategies and in early 2011, Mrs. Banda, though still Vice President, began taking her own political course.

31. **Following the untimely death of President Bingu wa Mutharika, Mrs. Joyce Banda's Peoples Party led-Government came into power in April 2012 has since been** implementing critical macroeconomic and structural reforms. President Banda's new Cabinet[42] succeeded in getting Parliament to repeal some of the laws perceived as abrogating human rights and freedoms, such as the Civil Procedure Amendment Act and Section 46 of the Penal Code. The administration also instituted inquiries into such prominent human rights abuses as deaths in police custody and has begun to cut wasteful spending. It has also undertaken to reinforce management of public procurement and controls and initiated leadership change in key accountability institutions and the long-awaited Electoral Commission has been appointed. The President also reached out to civil society, the churches, traditional authorities, private sector, DPs, and neighboring countries to mend relationships. The Lake Malawi border dispute between Malawi and Tanzania is being mediated by a panel of three former presidents from the SADC region, including South Africa's Thabo Mbeki.

32. **Corruption poses a serious challenge in the development of Malawi.** The country suffers from various types of corruption that impedes service delivery and patronage and nepotism

[41]The 2009 polls saw the number of women members of Parliament rise from 14 to 22.3 per cent. For the first time since independence in 1964, Malawi also had the first female Vice President, Mrs Joyce Banda.
[42]Out of a 36 Member Cabinet, in the Peoples Party led-Government, a third are women.

that exacerbates inequality and poverty in Malawi society. Corruption is seen to be particularly severe in the police, registry and permit services, customs, and the judiciary. Corrupt practices and extortion by public officials in the procurement of goods and services are said to be widespread in Malawi, and tender awards is plagued by patronage. The recent the accession to power of President Banda is being hailed by some experts as a moment of opportunity for Malawi to purge the legacy of high levels of political corruption. It remains to be seen whether the regime change will translate to actual change on the ground in Malawi to close the gap between the anti- corruption framework and implementation.[43]

B. Social Context

33. **According to the recent report of Malawi's Third Integrated Household Survey (IHS3 2010/11), absolute poverty has declined only slightly since 2004/05, to 50.7 percent from 52.4 percent** (Table 1) and income inequality increased in Malawi as reflected in the rise in the Gini coefficient from 0.39 in 2004/05 to 0.45 in 2010/11. While poverty has remained stagnant nationally, urban poverty has been reduced from 25.4 percent in 2005 to 17.3 percent in 2011. This gain was counterbalanced by a slight increase in rural poverty from 55.9 percent to 56.6 percent.[44] The urban population experienced a rise across the board in real consumption between 2005 and 2011, reflecting the fact that poverty reduction in urban areas has been more solid and that the inequality in urban areas has remained fairly constant at about 0.49. What is clear is that improvements in consumption and welfare in urban have been significant and broad based, which reflect that fact that the urban population have responded positively to the GoM's policies implemented over the past five years. In rural areas, despite large state outlays targeting the rural communities (e.g. Farm input Subsidy Program and extension services), real consumption of the poorest has declined and income inequality has increased from 0.34 to 0.38. The better off households who were able to take advantage of the provision of farm inputs to increasing their productivity, saw their real incomes rise. This therefore calls for a change in strategy for addressing challenges in the rural economy.

34. **According to the IHS3 Report (2012), women head 23.9 percent of all households. About 18 percent of the households in urban areas are headed by females compared to 25 percent of the households headed by female in rural areas.** In terms of rural areas, southern rural (29 percent) has the highest proportion of female headings households and the northern region has least (21 percent). Across age groups, the proportion of female headed households increases significantly with increase in age. Nationally, the heads of the poorest households have less schooling, are older, and are more likely to be female than the heads of better-off households. The schooling conditional cash transfer program is helping to close gender gaps in primary education, but only 66 percent of women are literate compared to 80 percent of men. The poverty gap and the severity of poverty measures confirm that the worst poverty is concentrated in rural areas in the most densely populated south and north, while the central region is better off.

[43] Anti-Corruption Resource Center and Transparency International "Overview of Corruption and Anti-Corruption in Malawi" Author: Farzana Nawaz, Transparency International, May 2012 Number: 329

[44] The difference between IHS2 and the IHS3 national absolute poverty rates is not statistically significant. The IHS3 rural poverty rate is also statistically indistinguishable from that of IHS2.

Table 1: Poverty Measures, 2005-2011

Household Characteristics	Poverty Headcount (%)			Poverty Gap (%)			Poverty Gap Squared (%)		
	2005	2011	Change	2005	2011	Change	2005	2011	Change
Malawi	52.4	50.7	-3.2	17.8	18.9	6.2	8.0	9.3	16.3
Area of Residence									
Urban	25.2	17.3	-31.3	6.9	4.8	-30.4	2.8	2.0	-28.6
Rural	56.2	56.7	0.9	19.3	21.4	10.9	8.7	10.6	21.8
Sex of Head									
Malawi									
Male	50.9	49.0	-3.7	17.1	18.1	5.8	7.6	8.9	17.1
Female	58.6	57.1	-2.6	20.9	22.1	5.7	9.7	11.0	13.4
Urban									
Male	24.4	17.1	-29.9	6.5	4.5	-30.8	2.5	1.8	-28.0
Female	30.9	18.3	-40.8	10.1	6.5	-35.6	4.4	3.0	-31.8
Rural									
Male	54.9	55.2	0.5	18.7	20.7	10.7	8.3	10.2	22.9
Female	61.2	62.3	1.8	21.9	24.2	10.5	10.2	12.0	17.6
Rural by Region									
North	56.3	59.9	6.4	19.6	22.2	13.3	8.8	10.7	21.6
Center	46.7	48.7	4.3	14.1	17.3	22.7	5.9	8.3	40.7
South	65.0	63.3	-2.6	24.1	25.1	4.1	11.4	12.8	12.3

Source: Calculations based in Malawi IHS2 and IHS3.

35. **The GoM has been providing social protection through various interventions to help vulnerable groups manage the risks they face.** The GoM's spending on social protection was 5 percent of total spending in FY12/13 (excluding FISP), which is mainly sourced from donors. It includes cash transfer pilot schemes, labor-intensive public works, school feeding programs, and investments in improving resilience to climate shocks through better management of natural resources, flood risk, and irrigation. Currently, many of the social support interventions in Malawi are not coordinated. Most, except for public works and Inputs-For-Assets, are not implemented nationwide, are not amenable to scaling up in times of crisis, and have different targeting mechanisms, so that it is possible to double-target a single needy household. In line with the Social Support Policy (SSP) adopted in July 2012, the government has therefore begun to roll out large programs to reach more vulnerable people and to cushion the impact of the stabilization effort on the most vulnerable groups. Social protection and investments in productive safety nets and resilience programs also help to reduce poverty and promote economic growth.

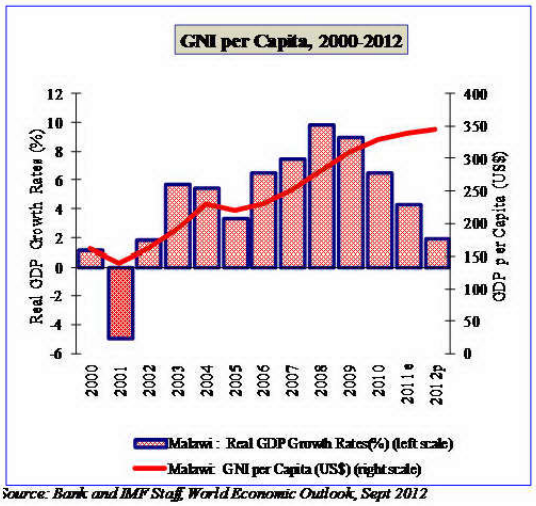
36. **Stagnant poverty levels raise questions on the effectiveness of the Malawi's Farm Input Subsidy Program (FISP) in alleviating poverty and food insecurity in a sustainable fashion.** Preliminary investigations show that FISP may have a differential impact on different categories of farmers and could be an important factor behind increasing inequality. This is yet another area that warrants further investigation before credible policy recommendations could be drawn. However, the preliminary empirical evidence, based on the nationally-representative IHS3 data, shows that a large share of better-off farmers are benefiting from FISP inputs, most probably through redistribution and/or reselling from FISP beneficiaries. This may obviously limit the impact of FISP benefits on poor households and on poverty alleviation at large.

C. Economic Background

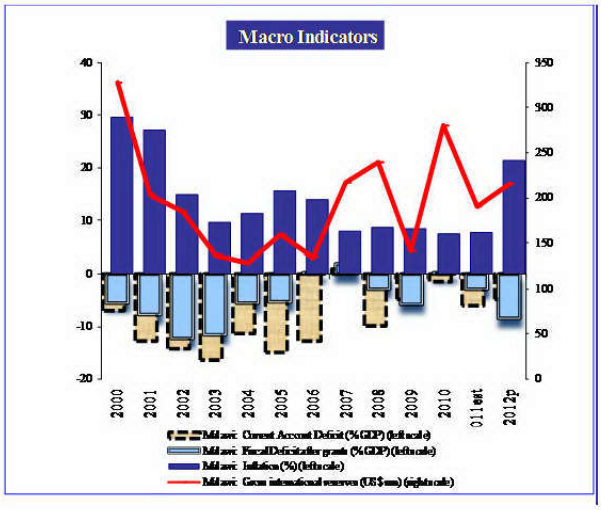
17. **Malawi's economy has for decades been subject to various shocks partly due to the structure of its economy, being largely a rain-fed agricultural economy locked in subsistence maize production, prone to adverse weather conditions, landlocked and poorly integrated into the region in terms of both trade and physical infrastructure.** The concentration of the economy on few primary commodities (notably tobacco and sugar) and its high dependence on imports and aid inflows renders it vulnerable to shocks. These economic vulnerabilities are being compounded by weaknesses in the management of the public finances, the infrastructure deficit (especially energy and transport- market access) and a history of policy reversals.

37. **Agriculture is the backbone of Malawi's economy, accounting for about 85 percent of employment and about 80 percent of foreign exchange, about 60 percent of which comes from tobacco alone.** The structural transformation in agriculture that took place in the mid-1990s saw particularly rapid growth in smallholder tobacco farms. Smallholders are responsible for more than 80 percent of Malawi's agricultural production, but theirs is predominantly subsistence farming, and reliance on rain leaves them vulnerable to bad weather. Investment in productivity enhancements is minimal. As Malawi depends heavily on transport through neighboring countries, the costs of importing raw material and intermediate inputs and of accessing export markets are high to begin with and they are exacerbated by extensive delays at ports, too many border procedures, and complex transit arrangements. FDI has mainly gone into mining, manufacturing, agriculture, tourism, and services.

Figure 1: Trends in the Economic Indicators



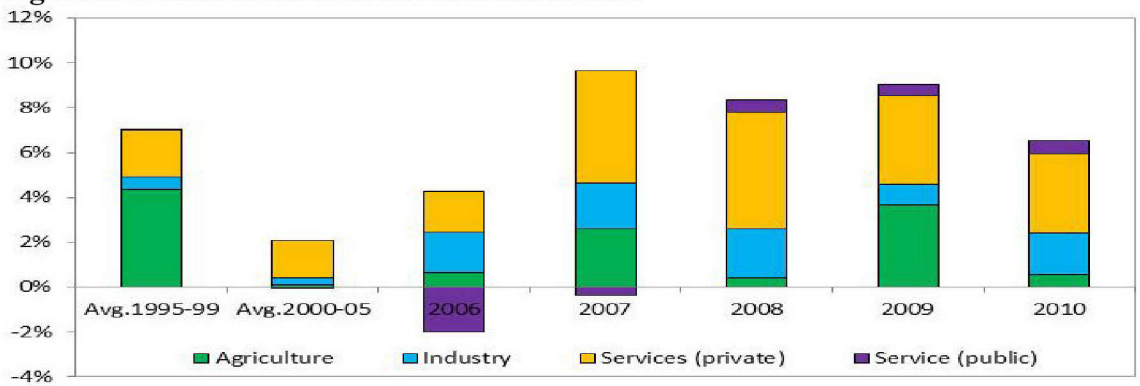
Source: Bank and IMF Staff, World Economic Outlook, Sept 2012



18. **Over the past five years, economic growth has been fairly balanced driven by a dynamic services sector, as the agriculture sector's contribution to GDP started to decline.** The services sector has increased its share to about 33.1 percent of GDP, driven largely by the telecommunication, retail and wholesale trade, and financial services (Figure 2). Meanwhile,

agriculture sector, which used to be the main driver of growth in the late 1990s with a contribution of over 35 percent, has seen its contribution shrinking to an average of 28 percent of GDP during 2006-11 driven largely by tobacco exports. The country's population and labour force remain predominantly rural and the transformation of the agriculture sector is still at its early stages as evidenced by the fact that the share of labour force in the sector (over 80 percent) is much higher than its share of GDP.[45]

Figure 2: Trends in Sectoral Distribution of GDP



19. **Malawi has also been experiencing protracted foreign exchange shortages since 2008, and the 2010 Country Economic Memorandum identified the exchange rate management as the main constraint to growth.**[46]The persistent overvaluation of the Kwacha contributed to a steadily rising import bill during 2005–2010. This overvaluation led to foreign exchange rationing and multiple exchange rates, which contributed to the informalization of the formal foreign exchange transactions as banks also started to engage in forward trading in foreign exchange with a negotiated premium above the official exchange rate. The Kwacha overvaluation acted as an implicit tax on exports and import substitution (and as a subsidy to imports) and as such Malawi's exports were uncompetitive within the region as well as outside. The build-up of external payment arrears dating back to the 2008/09 global fuel and financial crises, resulted in the freeze of the credit lines by suppliers to Malawi in 2010, with the situation reaching critical levels in 2011.

20. **Efforts are underway to change in the Malawi's ranking in the Doing Business to the top 100th by 2014.** Specifically, the Authorities is working on a program aimed at creating a pro-business environment in consultations with stakeholders in the private sector, civil society and public sector. Moreover, a one-stop-shop has been established to facilitate the setting up of businesses as well as to inform prospective investors of available incentives. The Parliament approval of the Single License Bill, aimed at reducing the number of procedures and time required to start a business is a step in right direction.[47] Improving the business environment in Malawi will require facilitating start-up of both formal and informal businesses and employment creation by simplifying business requirements, facilitating access to credit, improving public-

[45]Agriculture is the backbone of Malawi's economy, accounting for about 85 percent of employment and about 80 percent of foreign exchange, about 60 percent of which comes from tobacco.
[46]The foreign exchange situation is symptomatic of Malawi's weak balance of payments position and its vulnerability to exogenous shocks.
[47] The decentralization of business licensing procedure will effectively minimize cost of travel.

private dialogue, and removing unnecessary barriers to trade, especially nontariff barriers. Malawi is also collaborating with other like-minded countries to improve trade, namely Mauritius, Mozambique, Seychelles, and Zambia through what is called the Accelerated Programme for Economic Integration (APEI). The countries recently met in Mauritius to discuss and agree on a set of policy reforms that would strengthen economic linkages and facilitate exchanges among the APEI countries. The focus was on eliminating barriers to trade in goods, promoting trade in services, improving the business regulatory environment and trade facilitation.

Annex 4-Box 1-: Recent Macroeconomic and Structural Reforms

The implementation of critical macroeconomic and structural reforms since May 2012, have facilitated the move towards a floating exchange rate regime and liberalization of current account transactions, tightening of fiscal and monetary policies, reinstatement of the Automatic Price Adjustment Mechanism for fuel and upward adjustment to electricity tariffs close to cost recovery.

Exchange Rate and Foreign Exchange Reforms: Following the unification of the exchange rate in May 2012 and the move towards a floating exchange rate regime, the parallel market premium has narrowed to 5-10 percent from 80 percent between February and April 2012. The value of the Kwacha has since responded to the movements in market forces and the supply of foreign exchange has significantly improved. The supply of foreign exchange continues to follow seasonal patterns, with a significant increase between May and August, with the lean season during the months of September-March associated with sharp depreciation of the Kwacha.

Removal of restrictions on foreign exchange transactions by banks and foreign exchange bureaus. Additional reform measures towards a floating exchange rate included market determined rates offered by foreign exchange bureaus and cancellation of requirements for prior approval and pre-vetting of all imports in excess of $50,000.

Reversal of the surrender requirement for Tobacco dollars: This has improved businesses and consumers' access to foreign exchange. Prior to this reform, all the proceeds from the sale of tobacco were being channeled through the Reserve Bank of Malawi at an official exchange rate. During the 2012 tobacco auction season, tobacco growers received their payment for the sale of tobacco through their respective commercial banks at the prevailing market exchange rates. The timing of this reform was critical as it helped cushion smallholder farmers against the adjustments in the economy, which effectively boosted the real incomes of the tobacco growers as the implicit tax that existed on exports from the overvalued Kwacha was eliminated. In February 2013, the RBM issued a directive where exporters are now allowed to retain a larger share of their earnings in foreign currency dominated accounts. The export incentive scheme allows exporters retain 80 percent share of their export proceeds in their FCDAs compared with 60 percent and the share to be sold to banks reduced from 40 percent to 20 percent.

Monetary Policy: The RBM has continued to tighten monetary policy to contain inflationary pressures as evidenced by the three times hike in the benchmark rate since the May 2012, from 13 percent, to 25 percent in December 2012.The non-collateralized window established by the RBM in June 2012 to meet the liquidity needs of distressed banks was shutdown end November as it was discovered to be a source of growth in reserve money and the continuous deterioration of the value of Kwacha.

Fiscal Policy: Over the past recent years fiscal discipline has been reasonable with the exception of spending around the 2009 elections and the implementation of the 2011/12 budget in an environment of constrained revenues and unadjusted spending. The Government has been implementing an austerity budget since July 2012 based on the budget framework agreed with the IMF, with TA support on the Budget from the Bank. Based on the two quarterly reviews of the ECF program for the 2012/13, the Government has managed to control the fiscal with noticeable challenges on the monetary side. This notwithstanding, fiscal pressures and risks are mounting on the back of wage increase demands, the out of court settlements running to billions of Kwachas for contract termination of a number of public officials by the current regime and emerging drugs crisis.

Reinstatement of the Automatic Price Adjustment Mechanism for Petroleum: Since the APM was reinstated in May 2012, petroleum prices have been reviewed on a monthly basis and based on movements in the exchange rate and changes in import costs above or below the 5 percent threshold, price adjustments have been made with the exception of the month of October where the decision to adjust the prices was withheld. The adjustment made in November 2012, however took into account the developments in the international petroleum prices and exchange rate since September 2012. This has eliminated the fuel subsidy regime and now the higher fuel import prices are passed on to consumers in the form of higher pump prices. The supply of petroleum products improved significantly between May and August, with some hiccups during the months of October-November attributed to the availability of foreign exchange. The situation has since normalized.

Automatic Tariff Adjustment Formula for Electricity Tariffs: Between May and December, electricity tariffs have been adjusted twice to reflect movements in exchange rate and inflation.

Sources: IMF and Bank staff

D: Additional Information Background information on PFM

PFM Reforms

21. **Key Issues**: The main challenge facing the authorities is to contain expenditure growth, improve quality and efficiency of public spending and strengthen expenditure controls. Over the last ten years, the country has been implementing PFM reforms with the main objective of achieving macro fiscal discipline, effective allocation of resources, efficient and effective delivery of government programs, transparency of public finances and strengthened accountability. While this has yielded some improvements in the legal framework, IT systems (IFMIS/HRMIS) and budget procedures,[48] the full benefits of these reforms have not yet been felt in terms of aggregate fiscal discipline, strategic allocation of resources and effective service delivery. Key to achieve this objective is the establishment of processes to manage fiscal risks and ensure predictable budget execution; establishment of links between planning and budget preparations (particularly budget execution) to ensure that resources are allocated to priorities; and setting up internal controls to ensure that meager resources are used for the intended purpose and contribute to the efficient delivery of services. The overall progress in PFM has remained unchanged compared to the 2008 PEFA, despite good progress in some indicators.

Table 1: PEFA 2011 Summary Assessment (with comparison to 2008 and 2006)

PFM Performance Indicator		Scoring Method	Dimension Ratings				Overall Rating	2008
A. PFM-OUT-TURNS: Credibility of the budget								
PI-1	Aggregate expenditure out-turn compared to original approved budget	M1	B				**B**	**A**
PI-2	Composition of expenditure out-turn compared to original approved budget	M1	C	A			**C+**	**D**
PI-3	Aggregate revenue out-turn compared to original approved budget	M1	D				**D**[49]	**A**
PI-4	Stock and monitoring of expenditure payment arrears	M1	NS	D			**NS**	**NS**
B. KEY CROSS-CUTTING ISSUES: Comprehensiveness and Transparency								
PI-5	Classification of the budget	M1	A				**A**	**B**
PI-6	Comprehensiveness of information included in budget documentation	M1	A				**A**	**B**
PI-7	Extent of unreported government operations	M1	B	NS			**NS**	**NS**
PI-8	Transparency of inter-governmental fiscal relations	M2	A	C	B		**B**	**B+**
PI-9	Oversight of aggregate fiscal risk from other public sector entities	M1	B	B			**B**	**C+**
PI-10	Public access to key fiscal information	M1	C				**C**	**C**
C. BUDGET CYCLE								
C(i) Policy-Based Budgeting								
PI-11	Orderliness and participation in the annual budget process	M2	C	A	C		**B**	**C+**
PI-12	Multi-year perspective in fiscal planning, expenditure policy and budgeting	M2	C	A	C	D	**C+**	**B**
C(ii) Predictability and Control in Budget Execution								
PI-13	Transparency of taxpayer obligations and liabilities	M2	C	B	B		**B**	**B**
PI-14	Effectiveness of measures for taxpayer registration and tax assessment	M2	C	C	D		**D+**	**C+**

[48] Timeliness of financial reporting has been improved with the establishment of IFMIS and the government is now current on external audits.

[49] Under the new PEFA methodology "favourable" revenue variances may now result in sub-optimal PEFA indicator scores

PFM Performance Indicator		Scoring Method	Dimension Ratings				Overall Rating	2008
PI-15	Effectiveness in collection of tax payments	M1	NS	A	C		**NS**	**D+**
PI-16	Predictability in the availability of funds for commitment of expenditures	M1	B	B	B		**B**	**B**
PI-17	Recording and management of cash balances, debt and guarantees	M2	A	A	B		**A**	**A**
PI-18	Effectiveness of payroll controls	M1	A	B	A	B	**B+**	**C+**
PI-19	Competition, value for money and controls in procurement	M2	C	D	D	B	**D+**	**NS**
PI-20	Effectiveness of internal controls for non-salary expenditure	M1	B	B	C		**C+**	**C+**
PI-21	Effectiveness of internal audit	M1	C	C	D		**D+**	**C+**
C(iii) Accounting, Recording and Reporting								
PI-22	Timeliness and regularity of accounts reconciliation	M2	D	D			**D**	**B+**
PI-23	Availability of information on resources received by service delivery units	M1	D				**D**	**D**
PI-24	Quality and timeliness of in-year budget reports	M1	C	A	B		**C+**	**C+**
PI-25	Quality and timeliness of annual financial statements	M1	C	A	C		**C+**	**C+**
C(iv) External Scrutiny and Audit								
PI-26	Scope, nature and follow-up of external audit	M1	C	B	D		**D+**	**D+**
PI-27	Legislative scrutiny of the annual budget law	M1	B	C	D	C	**D+**	**B**
PI-28	Legislative scrutiny of external audit reports	M1	C	B	D		**D+**	**D+**
D. DONOR PRACTICES								
D-1	Predictability of Direct Budget Support	M1	A	NS			**NS**	**NS**
D-2	Financial information provided by donors for budgeting and reporting on project and program aid	M1	C	C			**C**	**C**
D-3	Proportion of aid that is managed by use of national procedures	M1	C				**C**	**C**

Source: 2011 PEFA, European Union

22. **Expenditure controlling measures introduced in December 2012 include the s**uspension of all government funded external travel and procurement of capital assets until end of FY13, Ministerial delegations sanctioned to take any external travel should be limited to a maximum of three representatives, including the minister; All stationary and drugs to be bought from Central Government Stores and Central Medical Stores and where goods not available, the two institutions to arrange the purchases on behalf of concerned MDAs; Procurement of goods and services should be accompanied by a Local Purchase Order (LPO) certified by the controlling officer or an officer not below Grade P4 designated in writing by the Controlling Officer (CO); COs will be personally liable for any mis-procurement of any goods and services; Government printer to be sole supplier of printing services to the GoM; Limit on the pool of vehicles to three per ministry or departments and that all other vehicles should be parked and the keys should be kept by COs pending the decision to dispose them. Three pool vehicles shall be allocated 100litres for fuel per month. Any additional requirement to be sanctioned by the CO; Ministries shall be liable for settlement of claims arising from failure to honour contractual obligations; and, procurement of goods should be on cash basis and where cash terms are not possible, the authority to be obtained from the Secretary to the Treasury in writing copied to Chief Secretary.

E. Poverty and Social Impact – Preliminary Assessment on Electricity Tariff Adjustments

23. **The pervasiveness of poverty is reflected in the demand and use of different types of energy for both cooking and lighting.** Malawi is heavily reliant on biofuel for its cooking energy requirements and that biomass, especially firewood and charcoal. The demand for and use of energy for lighting also seems to reflect the rural concentration of the population and pervasive nature of poverty. There is evidence that Malawians, regardless is area of residence, clearly distinguish between sources of energy for cooking and lighting. According to the 2011 Welfare Monitoring Survey report, paraffin is the main source of fuel for lighting for many households, accounting for 74 percent, and 18 percent of the households used electricity. Use of electricity for lighting was more reported in urban than rural areas, 42 percent and 15 percent, respectively. Results of the survey have indicated that firewood was the most common source of fuel for cooking in Malawi, accounting for 88 percent. Seven percent of the households used charcoal and three percent used electricity and 3 percent used electricity for cooking. In urban areas, 13 percent used electricity for cooking, 42 percent used charcoal and 44 percent used firewood. In rural areas, 2 percent used electricity and 92 percent used firewood for cooking.

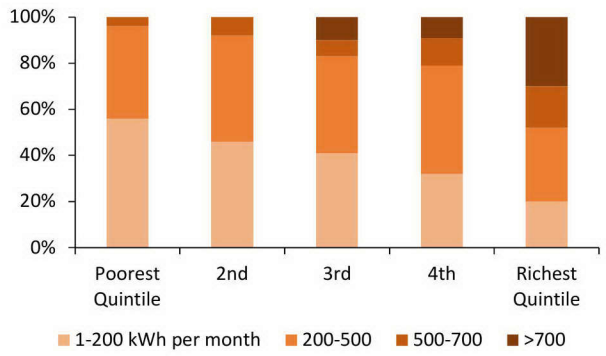
24. **According to the preliminary findings from the analysis on distributional and fiscal impact of domestic electricity subsidies in Malawi, tariffs in Malawi have more than doubled over the past two years, with the change coming in three large lump-sum increases.** During **FY11**, the average domestic tariff was MWK 6.3 per kWh; by November 2012, the average domestic tariff was MWK 18.5 per kWh. The gap between tariffs and cost likely widened slightly further over the period despite the significant **increases**, as average cost also likely doubled over the period. In FY11, the average cost of supply was MWK 13.1 per kWh – MWK 6.8 higher than the average tariff. By the end of 2012, the average cost of supply was MWK 7 higher than the average tariff, at MWK 25.5 per kWh.[50]

25. **Electricity consumption in Malawi is relatively high: in FY11, average consumption was 354 kWh per month, and median consumption was 239kWh per month (Figure 1).** The average ranges from 140kWh per month for the poorest quintile of electrified households to 387 kWh per month for the richest. Though low compared to consumption in developed countries (the United States average for 2011 was 940kWh per month), the average is almost identical to South Africa's in the early 2000s and significantly higher than the current average in South Asian countries (e.g., the average in India was 70kWh per month in 2010). [51] It is also substantially greater than typical subsistence consumption estimates of 30 or 50 kWh per household per month.

[50] Malawi's electricity utility, ESCOM, conducted a cost of supply study in 2009 and is currently updating the study. In the interim, this analysis has assumed that the cost of electricity supply was driven upward by economic fundamentals. It assumes the cost of supply rose at a weighted average of exchange rate increases (80 percent weight) and inflation (20 percent weight).

[51] Energy Information Administration,2013; Lloyd et al (2004); Mayer et al (forthcoming)

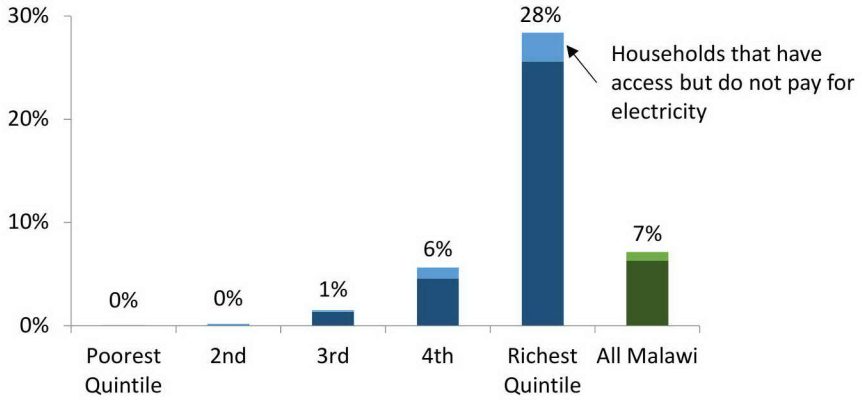
Figure 1: Electricity Usage By Income Quintile*



*Quintiles constructed among only the population of electrified households.

26. **Malawi's overall electricity access rate was 7.1 percent in FY 2011 (Figure 2). This very low electricity access rate is likely a primary driver of the high consumption, as the households that would be most likely to be low consumers instead simply do not have electricity access.** The poorest two income quintiles had close to zero households with electricity access, and the middle quintile only a one percent access rate. The access rate in the second-richest quintile was still only 6 percent and in the richest quintile 28 percent. Given the extremely low access rates in the poorest two quintiles, few observations were available to analyze electricity usage and expenditures (only one household in the survey from the poorest quintile and only 11 from the second-poorest quintile had electricity access), and statistics reported for those two quintiles should be taken with that in mind.

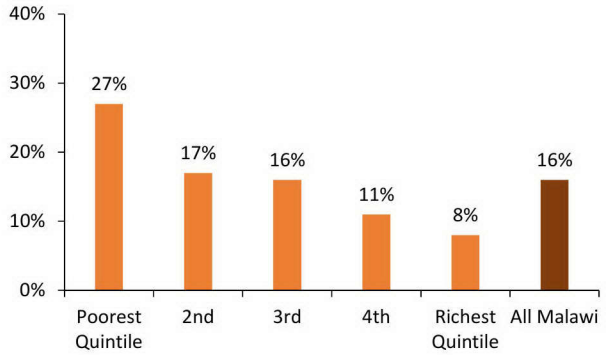
Figure 2: Electricity Access Rates by Income Quintile



27. A notable share of households with electricity access (approximately 12 percent) report not actually paying for their electricity. Given this, their electricity usage data is not captured in the household survey used for this analysis, and they are therefore excluded from all statistics other than access rates.

28. **In line with the high electricity usage, electricity expenditures are also a relatively high percentage of households' overall expenditures.** On average, households with electricity access devote 16 percent of their total monthly expenditures to electricity. This ranges from 27 percent in the poorest income quintile to eight percent in the richest income quintile.

Figure 3: Electricity Share of Total Expenditures



*Quintiles constructed among only the population of electrified households.

29. **The share of electricity expenditures in total expenditures likely increased somewhat from FY11 to** the **end of 2012, as tariffs increased faster than inflation (Figure 3).** In November 2012, the average electricity share of total expenditures would have risen to 34 percent, assuming that total expenditures rose at the same pace as inflation and that electricity usage remained constant. That figure would range from an average share of 58 percent among the poorest quintile to 17 percent among the richest quintile.

Electricity Subsidies: Cost and Targeting

30. **Together, the tariff, cost of supply, and electricity consumption data allow an examination of the magnitude and distribution of household electricity subsidies.** A household electricity subsidy is defined as the difference between the utilities' cost of supplying electricity and the amount a household paid for that electricity. As illustrated previously, per-unit subsidies were large in 2010, and persisted, albeit at slightly lower levels, through the end of 2012.

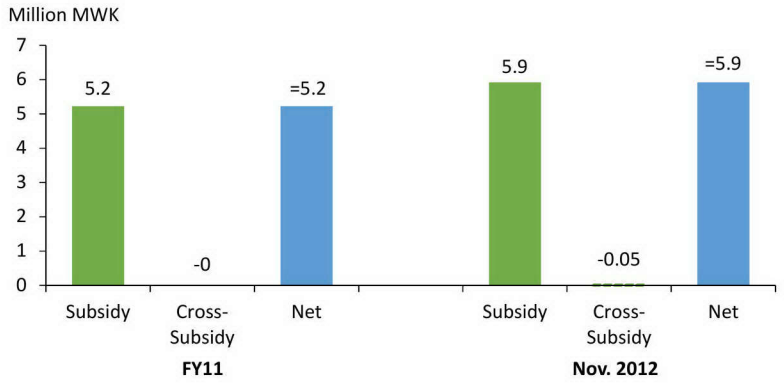
31. **In FY11, ESCOM spent over 5.2 billion MWK on electricity subsidies to households.**[52] This was equivalent to over half a percent of Malawi's GDP at the time. The Government of Malawi has committed to **cease** supporting ESCOM in order to enable it to operate on a commercial basis. Therefore, the cost of these subsidies were likely shouldered entirely by ESCOM, though it may have offset some of the cost by obtaining cross-subsidies from industrial and/or commercial customers.

32. **By the end of 2012, the net cost of annual subsidies had likely increased somewhat to 5.9 billion MWK, assuming electricity consumption remained unchanged from FY11 levels.** The total amount of subsidies payments would actually be somewhat larger than this, but it

[52] The fiscal burden analysis assumes each domestic utility customer received a subsidy equivalent to that received by the average household with electricity access

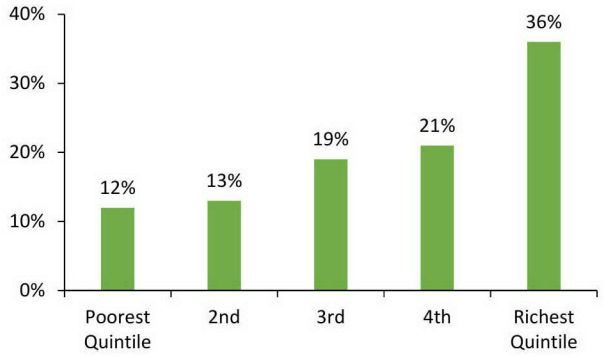
would be offset by a small amount of cross-subsidy payments made by low-consuming households with postpaid meters whose average tariff is above the cost of supply. If households instead decreased their electricity usage to keep expenditures a constant share of their budgets, the net cost of subsidies would instead have decreased substantially to 1.7 billion MWK.

Figure 7: Cost of Domestic Electricity Subsidies



33. **These subsidies are highly untargeted: 57 percent of FY11 electricity subsidies went to households in the two highest income quintiles (among households with electricity access) (Figure 8).** The poorest quintile, among electrified households, received only 12 percent of total subsidy payments and the second-poorest quintile only 15 percent. Notably, essentially 100 percent of the subsidies are going to the top three income quintiles among the population as a whole, as there are almost no households in the poorest two quintiles with electricity access.

Figure 8: Benefits Incidence of Electricity Subsidies



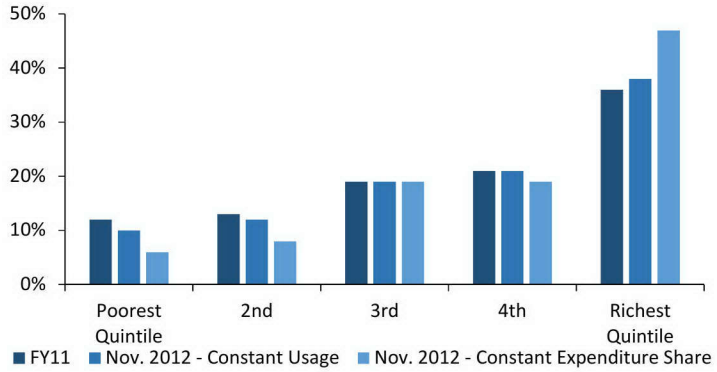
*Quintiles constructed among only the population of electrified households.

34. **This highly unequal subsidy distribution is due to a combination of Malawi's flat tariff structure and the positive relationship between consumption and income.** Given that all electricity units were subsidized at approximately the same rate, households that consume more electricity receive a greater total subsidy. As illustrated previously, the richer quintiles consume more electricity, on average, so those households accrued more subsidies receipts.

35. **The subsidy incidence likely worsened from FY11 to November 2012, regardless of if households compensated through increased expenditures or decreased usage.** If households compensated through increased expenditures, the incidence would only worsen

slightly: the richest two quintiles would receive 59 percent rather than 57 percent of subsidies. If households compensated through decreased usage, the incidence would worsen dramatically, largely because poorer households would have to decrease usage by more than richer households to keep their expenditure shares constant.

Figure 9: Benefits Incidence of Subsidies under Various Scenarios



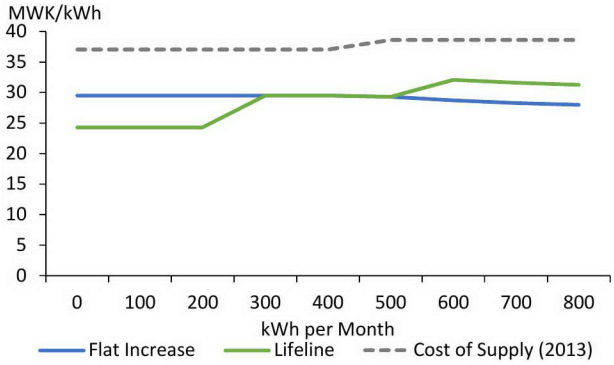
*Quintiles constructed among only the population of electrified households.

Options for Future Tariff Increases

36. **Considering Malawi's continuing inflation and exchange rate increases and the persistent large gap between tariffs and the cost of electricity supply, ESCOM should consider increasing tariffs further.** Assuming that inflation for 2013 comes in at the projected 20 percent (just over half of its 2012 value) and that the exchange rate also increases by about half of tis 2012 increase (i.e., about 60 percent), the cost of supply will rise by another 50 percent by the end of 2012. Given that tariffs are already well below the cost of supply, an additional 50 percent increase in the cost means tariffs would have to be increased by almost 230 percent to meet the cost of supply. Such an increase is unlikely to be feasible, for a variety of reasons, so the following analysis considers more likely increases.

37. **There are two broad options for the tariff adjustment: a flat increase or a differentiated increase that allows lower tariffs for lower consumption levels (Figure 10).** The flat increase would increase all tariffs by the same rate, as in the previous three tariff changes. The scenario illustrated here increases tariffs by 70 percent. The differentiated increase could come in several forms; the one illustrated here increases tariffs more for higher-consuming households than for lower-consuming households, thus creating a "lifeline" tariff structure that charges less per unit to households that consume less electricity. Specifically, the scenario considered increases tariffs by 40 percent for households consuming under 200 kWh per month, raises them by 70 percent for households consuming between 200 and 500 kWh per month, and raises them by 90 percent for households consuming over 500 kWh per month.

Figure 10: Average Effective Tariff under Various Scenarios



38. **The latter "lifeline" option would likely have several benefits over the "flat" option.** It would mitigate the impact of the tariff increase on the lower-consuming households (who tend to be poorer), as they would face a smaller increase than under the "flat" scenario. It would improve the distribution of subsidies by income, as lower-consuming (generally poorer) households would receive a greater subsidy per unit of consumption than the higher-consuming households (whereas, with the "flat" option, all households would continue to receive approximately the same subsidy per unit). It may also increase energy efficiency and reduce the strain of peak electricity demand on the electricity system, as the differentiated structure would incent all households to consume less.

39. **It would, however, have two primary downsides, though they are likely outweighed by the benefits.** First, to achieve the same average tariff with the differentiated increase as with the flat increase, tariffs would have to be raised even more for the highest-consuming households than under the flat increase. In the examples considered here, all households experience 70 percent increase under the "flat" option, and households consuming over 500 kWh per month would experience a 90 percent increase under the "lifeline" option. Second, it is more complicated to design a cost-recovery tariff under a differentiated structure than under a flat structure. Under a flat structure, all households pay roughly the same tariff, so that tariff can simply be set equal to the long-term marginal cost of electricity supply. Under a differentiated structure, the utility must ensure the weighted average tariff equals the long-run cost of supply, which can require detailed knowledge of consumer consumption patterns.

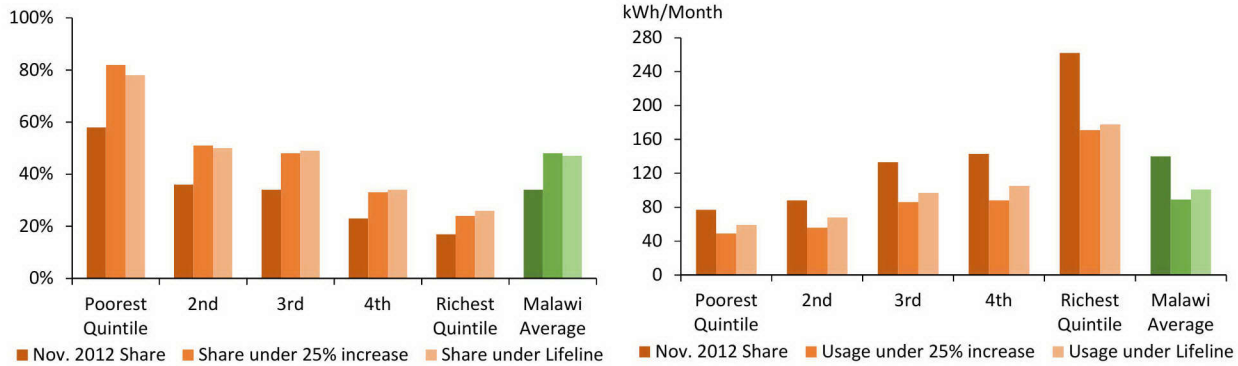
Impact of Potential Future Tariff Changes

40. **As tariffs under either scenario would increase more than expected 2013 inflation, the increases would have a notable impact on the share of electricity in total household expenditures and/or households' electricity consumption, though the lifeline tariff would slightly cushion that impact for the poorest households (Figures 11 and 12).**[53] If total expenditures rise with inflation, and electricity consumption remains constant, the average electricity share in total expenditures would rise to 47 or 48 percent under the flat or lifeline

[53] In the period between the tariff increase and the end of 2013, the impact would likely be even greater, as household budgets likely will not fully inflate to the levels assumed here until then.

scenario, respectively. Under the flat increase, expenditure shares would range from an average of 82 percent in the poorest quintile to 24 percent in the richest. Under the lifeline increase, those shares would be 78 and 26. If households instead chose to reduce electricity consumption to keep the electricity share of their expenditures constant, they would have to reduce consumption from an average of 140 kWh per month in November 2011 to 83 kWh under the flat increase or 100 kWh under the lifeline increase.

Figures 11 and 12: Expenditure Share of Electricity and Electricity Usage under Various Scenarios



*Quintiles constructed among only the population of electrified households.

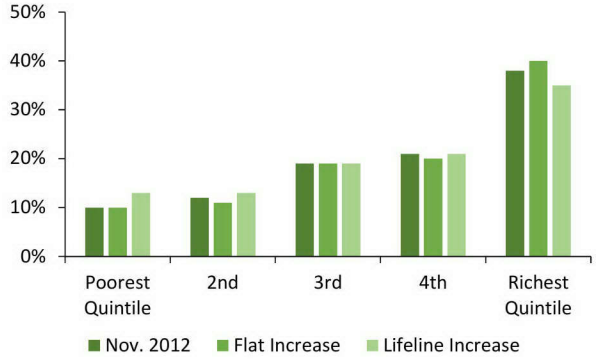
41. **The increase in electricity prices[54] beyond inflation would also pass through to other household consumption goods, which would put additional pressure on household budgets.** This impact would be felt by both households with and without electricity access – **though** households without electricity access are likely consuming fewer of the goods whose prices depend significantly on electricity prices (e.g., manufactured goods) than households with electricity access. A study in Australia found that, if producers passed on the full electricity price increase to consumers, prices in other sectors (e.g., food, alcohol, tobacco, clothing, furnishings, transport, etc.) would rise by about 1/33th as much as electricity prices.[55] This is a very high upper-bound, as (a) it is unlikely that there would be full pass-through to consumers in most sectors and (b) electricity may be a greater input to consumer goods in a developed country such as Australia than in Malawi. The degree to which this impacts household budgets would also depend on the share of these other goods in their total expenditures.

42. **Although both proposed increases increase tariffs by a greater percentage than that expected for costs, only the increases modeled under the lifeline scenario would lessen the gap between tariffs and the cost of supply and thereby ease the cost of subsidies for ESCOM**. If households maintain their consumption levels, the annual net fiscal cost of subsidies would fall from 5.9 billion MWK to 5.7 billion MWK under the modeled lifeline increase and would rise to 6.3 billion MWK under the modeled flat increase. If consumers kept expenditure shares constant and reduced consumption, both increases would significantly lessen ESCOM's subsidy burden.

[54] Assuming ESCOM increases industrial and commercial tariffs at the same time at it increases household tariffs
[55] CSIRO and AECOM (2011)

43. **The distribution of subsidies would improve under the lifeline increase to better than both the November 2012 and FY11 distributions; under the flat increase, however, it is regressive 2012 (Figure 13).** Because the lifeline increase targets subsidies to lower-consuming households who also tend to be the poorer households, it would improve the benefits incidence notably. The poorest two income quintiles would receive 26 percent of total subsidies, an increase from the 22 percent of November 2012. In contrast, under the flat increase, the poorest two quintiles would receive only 21 percent of subsidy payments. The richer quintiles still receive the bulk of subsidy payments, however, as will continue to be the case as long as higher levels of electricity consumption continue to be subsidized.

Figure 13: Distribution of Subsidy Benefits under Various Scenarios



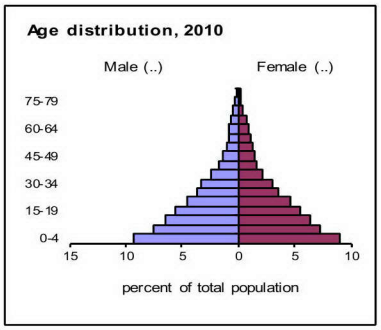
*Quintiles constructed among only the population of electrified households.

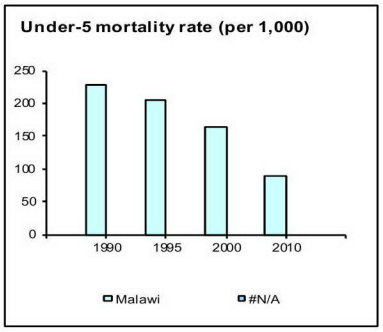
The table below summarizes the potential impacts of the two scenarios.

	Nov. 2012	"Flat" Increase	"Lifeline" Increase
Tariff Change *over Nov. 2012 tariffs*		All increase by 70%	If consume 1-200 kWh, increase by 40% If consume 201-500, increase by 70% If consume 701+, increase by 90%
Avg. Expenditure Share of Total Budget *assuming HHs keep kWh constant*	34%	48%	47%
Avg. Monthly kWh *assuming HHs keep expenditure share constant*	140	89	101
Total Cost of Subsidies (billion MWK) *assuming HHs keep kWh constant*	5.87	6.29	5.73
Share of Subsidies Given to Poorest 40 Percent *of electrified households*	22%	21%	26%

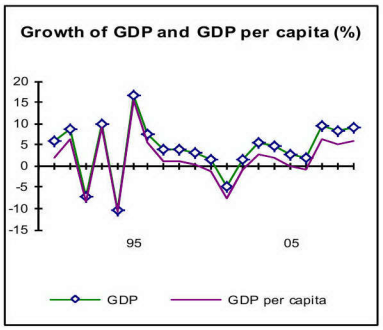
Annex 5: Malawi At A Glance

Key Development Indicators	Malawi	Sub-Saharan Africa	Low income
(2011)			
Population, mid-year (millions)	14.4	812	764
Surface area (thousand sq. km)	118	24,243	15,551
Population growth (%)	3.1	2.5	2.1
Urban population (% of total population)	15	36	27
GNI (Atlas method, US$ billions)	4.7	897	338
GNI per capita (Atlas method, US$)	330	1,104	442
GNI per capita (PPP, international $)	830	2,033	1,173
GDP growth (%)	9.0	5.0	5.6
GDP per capita growth (%)	5.7	2.4	3.5
(most recent estimate, 2005–2011)			
Poverty headcount ratio at $1.25 a day (PPP, %)	74	48	..
Poverty headcount ratio at $2.00 a day (PPP, %)	90	69	..
Life expectancy at birth (years)	53	53	58
Infant mortality (per 1,000 live births)	60	80	73
Child malnutrition (% of children under 5)	12	..	..
Adult literacy, male (% of ages 15 and older)	81	67	66
Adult literacy, female (% of ages 15 and older)	67	48	49
Gross primary enrollment, male (% of age group)	130	104	107
Gross primary enrollment, female (% of age group)	134	94	99
Access to an improved water source (% of population)	80	58	62
Access to improved sanitation facilities (% of population)	51	29	34





Net Aid Flows	1980	1990	2000	2011 [a]
(US$ millions)				
Net ODA and official aid	141	500	446	924
Top 3 donors (in 2010):				
n.a.	21	45	49	140
n.a.	25	51	97	147
n.a.	3	21	59	88
Aid (% of GNI)	12.4	27.2	26.1	21.7
Aid per capita (US$)	23	53	40	66



Long-Term Economic Trends	1980	1990	2000	2011	1980–90	1990–2000	2000–11
					(average annual growth %)		
Consumer prices (annual % change)	*11.8*	11.8	-93.9	8.4			
GDP implicit deflator (annual % change)	15.8	10.7	30.5	8.4			
Exchange rate (annual average, local per US$)	0.8	2.7	59.5	141.2			
Terms of trade index (2000 = 100)	..	145	100	111			
Population, mid-year (millions)	6.2	9.4	11.2	14.4	4.1	1.8	2.8
GDP (US$ millions)	1,238	1,881	1,744	5,031	2.5	3.7	4.5
		(% of GDP)					
Agriculture	43.7	45.0	39.5	32.1	2.0	8.6	2.3
Industry	22.5	28.9	17.9	18.5	2.9	2.0	6.7
Manufacturing	13.7	19.5	12.9	12.3	3.6	0.5	3.9
Services	33.7	26.1	42.5	49.4	3.3	1.6	3.5
Household final consumption expenditure	69.9	71.5	81.6	69.1	..	..	*2.8*
General gov't final consumption expenditure	19.3	15.1	14.6	19.6	..	..	*16.8*
Gross capital formation	24.7	23.0	13.6	25.6	..	..	*23.6*
Exports of goods and services	24.8	23.8	25.6	24.6	..	..	*12.4*
Imports of goods and services	38.8	33.4	35.3	39.0	..	..	*14.5*
Gross savings	..	..	..	..			

Note: Figures in italics are for years other than those specified. 2011 data are preliminary. .. indicates data are not available.
a. Aid data are for 2010.

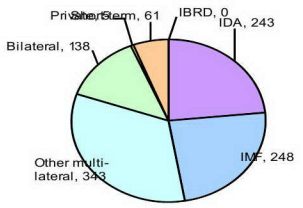
Development Economics, Development Data Group (DECDG).

Balance of Payments and Trade	**2000**	**2011**
(US$ millions)		
Total merchandise exports (fob)	392	934
Total merchandise imports (cif)	460	-1,411
Net trade in goods and services	-243	-911
Current account balance	-165	-257
as a % of GDP	-9.5	-5.1
Workers' remittances and compensation of employees (receipts)	1	..
Reserves, including gold	..	..

Central Government Finance		
(% of GDP)		
Current revenue (including grants)	17.1	29.8
Tax revenue	15.7	14.3
Current expenditure	19.9	28.3
Overall surplus/deficit	-13.9	-5.1
Highest marginal tax rate (%)		
Individual	38	30
Corporate	38	35

External Debt and Resource Flows		
(US$ millions)		
Total debt outstanding and disbursed	2,719	1,144
Total debt service	64	39
Debt relief (HIPC, MDRI)	1,375	914
Total debt (% of GDP)	156.0	22.7
Total debt service (% of exports)	13.2	2.7
Foreign direct investment (net inflows)	26	*16*
Portfolio equity (net inflows)	0	*0*

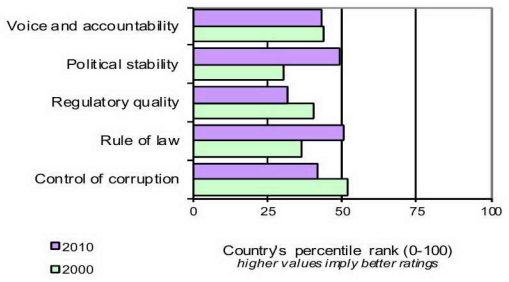
Composition of total external debt, 2010



US$ millions

Private Sector Development	**2000**	**2010**
Time required to start a business (days)	–	39
Cost to start a business (% of GNI per capita)	–	108.0
Time required to register property (days)	–	88
Ranked as a major constraint to business (% of managers surveyed who agreed)	**2000**	**2010**
n.a.	..	*27.6*
n.a.	..	*19.2*
Stock market capitalization (% of GDP)	..	41.4
Bank capital to asset ratio (%)	..	..

Governance indicators, 2000 and 2010



Source: Kaufmann-Kraay-Mastruzzi, World Bank

Technology and Infrastructure	**2000**	**2010**
Paved roads (% of total)	..	*45.0*
Fixed line and mobile phone subscribers (per 100 people)	1	12
High technology exports (% of manufactured exports)	2.0	1.9

Environment		
Agricultural land (% of land area)	50	58
Forest area (% of land area)	37.8	*36.1*
Terrestrial protected areas (% of land area)	15.0	15.0
Freshwater resources per capita (cu. meters)	*1,364*	*1,188*
Freshwater withdrawal (billion cubic meters)	..	..
CO2 emissions per capita (mt)	0.08	0.09
GDP per unit of energy use (2005 PPP $ per kg of oil equivalent)	..	..
Energy use per capita (kg of oil equivalent)	..	..

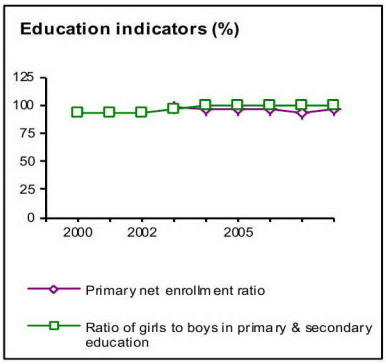
World Bank Group portfolio	**2000**	**2010**
(US$ millions)		
IBRD		
Total debt outstanding and disbursed	9	*0*
Disbursements	0	*0*
Principal repayments	8	*0*
Interest payments	1	*0*
IDA		
Total debt outstanding and disbursed	1,592	188
Disbursements	97	12
Total debt service	27	1
IFC *(fiscal year)*		
Total disbursed and outstanding portfolio	3	18
of which IFC own account	3	13
Disbursements for IFC own account	2	12
Portfolio sales, prepayments and repayments for IFC own account	0	0
MIGA		
Gross exposure	–	–
New guarantees	–	–

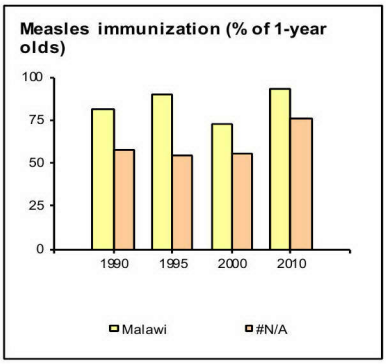
Note: Figures in italics are for years other than those specified. 2011 data are preliminary. 4/10/13
.. indicates data are not available. – indicates observation is not applicable.

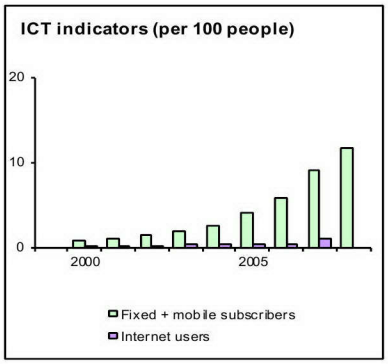
Development Economics, Development Data Group (DECDG).

With selected targets to achieve between 1990 and 2015
(estimate closest to date shown, +/- 2 years)

	Malawi			
Goal 1: halve the rates for extreme poverty and malnutrition	**1990**	**1995**	**2000**	**2010**
Poverty headcount ratio at $ 1.25 a day (PPP, % of population)	..	..	*83.1*	*73.9*
Poverty headcount ratio at national poverty line (% of population)	..	..	*65.3*	*52.4*
Share of income or consumption to the poorest quintile (%)	..	..	*4.8*	*7.0*
Prevalence of malnutrition (% of children under 5)	*24.4*	26.5	21.5	*15.5*
Goal 2: ensure that children are able to complete primary schooling				
Primary school enrollment (net, %)	..	..	*99*	96
Primary completion rate (% of relevant age group)	28	52	65	64
Secondary school enrollment (gross, %)	17	22	32	31
Youth literacy rate (% of people ages 15-24)	..	..	*76*	..
Goal 3: eliminate gender disparity in education and empower women				
Ratio of girls to boys in primary and secondary education (%)	81	89	93	99
Women employed in the nonagricultural sector (% of nonagricultural employment)	11	11	..	..
Proportion of seats held by women in national parliament (%)	10	*6*	9	13
Goal 4: reduce under-5 mortality by two-thirds				
Under-5 mortality rate (per 1,000)	227	204	164	102
Infant mortality rate (per 1,000 live births)	134	120	98	63
Measles immunization (proportion of one-year olds immunized, %)	81	90	73	88
Goal 5: reduce maternal mortality by three-fourths				
Maternal mortality ratio (modeled estimate, per 100,000 live births)	1,100	1,000	840	*630*
Births attended by skilled health staff (% of total)	*55*	..	56	*54*
Contraceptive prevalence (% of women ages 15-49)	*13*	*22*	31	*41*
Goal 6: halt and begin to reverse the spread of HIV/AIDS and other major diseases				
Prevalence of HIV (% of population ages 15-49)	7.2	13.9	14.2	11.2
Incidence of tuberculosis (per 100,000 people)	326	462	467	273
Tuberculosis case detection rate (%, all forms)	*#N/A*	*#N/A*	*#N/A*	*#N/A*
Goal 7: halve the proportion of people without sustainable access to basic needs				
Access to an improved water source (% of population)	41	52	62	79
Access to improved sanitation facilities (% of population)	39	42	46	50
Forest area (% of land area)	41.3	..	37.8	*36.1*
Terrestrial protected areas (% of land area)	15.0	15.0	15.0	15.0
CO2 emissions (metric tons per capita)	0.1	0.1	0.1	0.1
GDP per unit of energy use (constant 2005 PPP $ per kg of oil equivalent)	..	..	..	..
Goal 8: develop a global partnership for development				
Telephone mainlines (per 100 people)	0.3	0.3	0.4	0.8
Mobile phone subscribers (per 100 people)	0.0	0.0	0.4	10.8
Internet users (per 100 people)	0.0	*0.0*	0.1	0.7
Computer users (per 100 people)	*#N/A*	*#N/A*	*#N/A*	*#N/A*







Note: Figures in italics are for years other than those specified. .. indicates data are not available. 4/10/13

Development Economics, Development Data Group (DECDG).

Table 1: Selected Economic Indicators, 2007–16

	2007	2008	2009	2010	2011	2012 Prel	2013 proj.	2014 Proj.	2015 Proj.	2016 Proj.
National accounts and prices (percent change, unless otherwise indicated)										
GDP at constant market prices	9.5	8.3	9.0	6.5	4.3	1.9	5.5	6.1	6.5	6.7
Nominal GDP (billions of kwacha)	510.5	601.0	710.2	812.4	880.9	1,056.3	1,310.5	1,492.4	1,675.5	1,857.6
Nominal GDP per capita (US$)	252.5	288.1	329.6	343.5	346.8	254.7	219.2	231.9	245.5	258.9
Consumer prices (end of period)	7.5	9.9	7.6	6.3	9.8	34.6	11.8	5.8	5.4	4.6
Consumer prices (annual average)	8.0	8.7	8.4	7.4	7.6	21.3	20.2	8.1	5.8	4.9
Central government (percent of GDP on a fiscal year basis)										
Revenue	30.7	29.4	32.1	33.8	32.1	26.5	39.0	37.3	36.1	35.5
Tax and nontax revenue	18.0	18.9	20.5	23.5	24.5	22.1	23.9	24.4	24.7	25.0
Grants	12.7	10.5	11.6	10.3	7.6	4.4	15.1	13.0	11.4	10.5
Expenditure and net lending	31.9	30.0	37.8	33.8	35.0	34.9	40.2	39.1	37.6	36.8
Overall balance (excluding grants)	-13.9	-11.2	-17.3	-10.3	-10.5	-12.8	-16.3	-14.8	-13.0	-11.8
Overall balance	-1.2	-0.6	-5.7	0.1	-2.9	-8.4	-1.2	-1.8	-1.5	-1.3
Primary balance	2.3	1.6	-3.0	2.9	-0.2	-5.9	1.6	0.5	0.3	0.3
Foreign financing	1.0	2.5	2.0	0.9	1.3	1.6	1.9	1.8	1.5	1.3
Domestic financing	-0.3	0.5	3.7	-0.9	1.7	6.7	-1.6	0.0	0.0	0.5
External sector (US$ millions, unless otherwise indicated)										
Exports (goods and services)	893.2	1,043.2	1,050.2	1,360.4	1,408.7	1,359.8	1,573.1	1,718.3	1,849.5	1,988.5
Imports (goods and services)	1,468.3	2,091.7	1,961.1	2,425.4	2,236.2	2,274.9	2,356.0	2,520.7	2,690.7	2,890.9
Usable gross official reserves	216.5	239.0	140.5	279.6	190.2	215.4	402.8	555.5	692.8	797.7
(months of imports)	1.2	1.5	0.7	1.5	1.0	1.1	1.9	2.5	2.9	3.1
Current account (percent of GDP)	1.0	-9.7	-4.8	-1.3	-5.9	-4.7	-1.6	-1.8	-2.2	-3.0
Current account, excl. official transfers (percent of GDP)	-12.8	-20.8	-14.2	-17.0	-12.2	-18.8	-17.2	-16.1	-15.4	-15.3
Real effective exchange rate (percent change)	-3.0	20.4	9.5	-6.0	-3.3	...	...	...	...	...
Overall balance (percent of GDP)	2.0	-1.6	-2.0	2.2	-1.9	0.6	3.5	3.4	3.3	2.8
Terms of trade (percent change)	-0.2	21.5	7.7	3.0	-17.1	-2.4	2.5	3.0	2.7	2.2
Usable gross official reserves	216.5	239.0	140.5	279.6	190.2	215.4	402.8	555.5	692.8	797.7
(months of imports)	1.2	1.5	0.7	1.5	1.0	1.1	1.9	2.5	2.9	3.1
Debt stock and service (percent of GDP, unless otherwise indicated)										
External debt (public sector)	15.8	15.8	16.6	15.9	16.2	22.7	26.2	24.3	22.6	21.1
NPV of debt (percent of exports)	0.0		57.1	44.6	48.1	53.2	47.0	42.2	38.2	34.4

Sources: Malawian authorities, IMF and World Bank staff estimates.

Table 2: Central Government Operations, 2007-2016 (Percent of GDP)

	2007	2008	2009	2010	2011	2012 Prel.	2013 Proj.	2014 Proj.	2015 Proj.	2016 Proj.
Revenue	**30.6**	**29.4**	**32.1**	**33.8**	**32.1**	**26.5**	**39.0**	**37.3**	**36.1**	**35.5**
Tax and nontax revenue	**18.0**	**18.9**	**20.5**	**23.5**	**24.5**	**22.1**	**23.9**	**24.1**	**24.5**	**25.0**
Tax revenue	16.5	17.3	18.2	18.6	20.8	19.4	20.6	21.3	21.7	22.2
Nontax revenue	1.5	1.5	2.3	4.9	3.8	2.7	3.3	2.8	2.8	2.8
o/w maize sales receipts	0.0	0.2	0.0	0.4	0.0	0.0	0.0	0.1	0.1	0.1
Grants	12.5	10.5	11.6	10.3	7.6	4.4	15.1	13.0	11.4	10.5
o/w Budget support	1.9	2.3	3.0	4.5	1.8	0.0	6.5	5.0	4.3	3.9
Expenditure and net lending	**31.9**	**30.0**	**37.8**	**33.8**	**35.0**	**34.9**	**40.2**	**39.1**	**37.6**	**36.8**
Current expenditure	**20.3**	**18.6**	**30.6**	**25.7**	**27.2**	**26.9**	**32.2**	**30.5**	**29.4**	**28.9**
Wages and salaries	5.1	5.4	5.7	5.9	6.9	7.2	8.1	8.6	8.5	8.5
Interest payments	3.5	2.2	2.7	2.8	2.7	2.5	2.8	2.3	1.8	1.6
Goods and services	**6.6**	**5.5**	**13.1**	**11.0**	**11.2**	**9.8**	**12.0**	**11.3**	**10.9**	**10.8**
o/w Generic goods and services	4.7	3.1	6.7	5.8	4.8	5.5	4.7	4.4	4.1	3.9
Subsidies and other current transfers	**5.1**	**5.5**	**9.0**	**6.0**	**6.4**	**5.9**	**8.3**	**7.4**	**7.4**	**7.4**
o/w Fertilizer and seed subsidy	2.0	2.7	5.8	2.9	2.6	2.5	4.4	3.5	3.5	3.5
Arrears adjustment	0.1	0.0	0.1	0.0	0.0	1.5	0.8	0.9	0.8	0.7
Development expenditure	**11.5**	**11.5**	**7.1**	**7.9**	**7.7**	**8.0**	**8.0**	**8.7**	**8.3**	**7.8**
Part I (foreign financed)	9.0	8.1	4.9	4.5	3.7	3.6	5.0	5.5	5.0	4.6
Part II (domestically financed)	2.4	3.4	2.2	3.4	3.9	4.4	3.0	3.2	3.2	3.2
Overall balance (excluding grants)	**-13.9**	**-11.2**	**-17.3**	**-10.3**	**-10.5**	**-13.0**	**-11.6**	**-14.7**	**-12.9**	**-12.2**
Overall balance (including grants)	**-1.3**	**-0.6**	**-5.7**	**0.1**	**-2.9**	**-8.4**	**-1.2**	**-1.8**	**-1.5**	**-1.3**
Total financing (net)	**1.3**	**0.6**	**5.7**	**-0.1**	**2.9**	**8.4**	**0.4**	**1.8**	**1.5**	**1.3**
Foreign financing (net)	1.0	2.5	2.0	0.9	1.3	1.6	1.9	1.8	1.5	1.3
Domestic financing (net)	-0.3	3.3	3.7	-0.9	1.7	6.7	-1.6	0.0	0.0	0.0
Memorandum items:										
Nominal GDP	467.2	555.8	655.6	761.3	847.0	969.0	1,183.0	1,401.0	1,584.0	1,772.0
Net domestic debt	56.6	92.9	116.9	110.2	138.0	188.0	166.0	166.0	170.0	163.0
Net domestic debt, percent of GDP	0.0	0.0	17.8	14.5	16.0	20.0	14.0	12.0	11.0	9.0

Sources: Malawi Ministry of Finance and IMF staff estimates.

Table 3: Balance of Payment, 2009-2016 (Percent of GDP)

	2009	2010	2011 Prel.	2012 Prel.	2013 Proj.	2014 Proj.	2015 Proj.	2016 Proj.
Current account balance (including grants)	-4.8	-1.3	-5.9	-4.7	-1.6	-1.8	-2.2	-3.0
Merchandise trade balance	-12.6	-13.8	-11.2	-15.9	-14.0	-12.8	-12.2	-12.0
Exports	18.6	22.9	22.5	29.6	38.2	38.2	37.7	37.4
Of which: Tobacco	10.0	12.7	8.6	11.4	15.9	15.2	14.7	14.2
Uranium	0.2	2.1	2.1	3.7	4.5	4.5	4.5	4.6
Imports	-31.3	-36.7	-33.7	-45.7	-52.5	-52.2	-51.0	-49.9
Of which: Petroleum	-3.3	-3.4	-3.0	-4.1	-4.6	-4.1	-3.8	-3.5
Services balance	-6.6	-8.0	-5.6	-9.0	-10.4	-10.3	-10.1	-9.9
Interest public sector (net)	-0.1	-0.1	-0.1	-0.2	-0.3	-0.3	-0.4	-0.4
Receipts	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Payments	-0.1	-0.1	-0.1	-3.0	-0.3	-0.4	-0.4	-0.4
Other factor payments (net)	-1.1	-1.9	-2.0	-3.0	-3.5	-3.6	-3.5	-3.4
Nonfactor (net)	-5.4	-6.0	-3.5	-5.8	-6.5	-6.4	-6.2	-6.2
Receipts	2.3	2.3	2.6	2.5	3.0	2.9	2.8	2.8
Payments	-7.7	-8.2	-6.1	-8.3	-9.5	-9.3	-9.1	-9.0
Unrequited transfers (net)	14.4	20.4	10.9	20.2	22.8	21.3	20.1	18.9
Private (net)	5.1	4.7	4.6	6.2	7.2	7.0	6.8	6.7
Receipts	5.3	5.0	4.8	6.5	7.6	7.4	7.2	7.1
Payments	-0.3	-0.3	-0.3	-0.4	-0.4	-0.4	-0.4	-0.4
Official (net)	9.4	15.7	6.4	14.0	15.6	14.3	13.3	12.2
Receipts	9.4	15.8	6.4	14.1	15.6	14.4	13.3	12.3
Budget support	1.6	6.0	0.0	4.3	4.3	4.3	4.1	3.8
Project related[1]	7.8	9.8	6.4	9.7	11.3	10.0	9.2	8.5
Payments	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Financial account balance	4.7	5.2	2.8	5.3	5.1	5.2	5.5	5.8
Medium- and long-term flows (net)	3.0	1.7	1.9	1.8	2.1	1.7	1.5	1.3
Disbursements	1.5	1.9	2.2	2.2	2.8	2.4	2.2	2.0
Budget support	0.6	0.0	0.0	0.0	0.4	0.0	0.0	0.0
Project support	0.4	1.9	0.9	1.8	2.4	2.4	2.2	2.0
Other medium-term loans	0.4	0.0	1.2	0.4	0.0	0.0	0.0	0.0
Amortization	-0.2	-0.3	-0.3	-0.4	-0.6	-7.0	-0.7	-0.7
SDR allocation	1.7	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Foreign direct investment and other inflows	1.1	2.9	1.1	1.5	2.8	3.3	3.7	4.2
Short-term capital	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Commercial banks net foreign assets	0.5	0.6	-0.2	2.0	0.2	0.2	0.2	0.2
Errors and omissions	-1.8	-1.7	1.2	0.0	0.0	0.0	0.0	0.0
Overall balance	-2.0	2.2	-1.9	0.6	3.5	3.4	3.3	2.8
Financing	2.0	-2.2	1.9	-0.6	-3.5	-3.4	-3.3	-2.8
Gross reserves (- increase)	2.0	-2.6	1.9	-1.3	-4.9	-3.7	-3.0	-2.1
Liabilities[2]	0.0	0.4	0.0	0.9	1.4	0.2	-0.3	-0.7
Of which: IMF (net)	0.0	0.4	0.0	0.9	1.4	0.3	-0.2	-0.6
Purchases/drawings	0.0	0.4	0.0	1.0	1.6	1.0	0.4	0.0
Repurchases/repayments	0.0	0.0	0.0	0.1	0.2	0.6	0.6	0.6
Memorandum items:								
Gross official reserves[3]	2.8	5.2	3.4	5.1	10.6	13.3	15.2	16.1
Months of imports[4]	0.7	1.5	1.0	1.1	1.9	2.5	2.9	3.1
Current account balance (percent of GDP)								
Excluding official transfers	-14.2	-17.0	-12.2	-18.8	-17.2	-16.1	-15.4	-15.3
Including official transfers	-4.8	-1.3	-5.9	-4.7	-1.6	-1.8	-2.2	-3.0
Value of exports of goods and services (perce	0.7	29.5	3.6	-3.5	15.7	9.2	7.6	7.5
Value of imports of goods and services (perce	-6.2	23.7	-7.8	1.7	3.6	7.0	6.7	7.4
REER (percent change)	9.5	-6.0	-3.3	...	...	...	...	...
Overall balance (percent of GDP)	-2.0	2.2	-1.9	0.6	3.5	3.4	3.3	2.8
Terms of trade (percent change)	7.7	1.9	-17.1	-2.4	2.5	3.0	2.7	2.2

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

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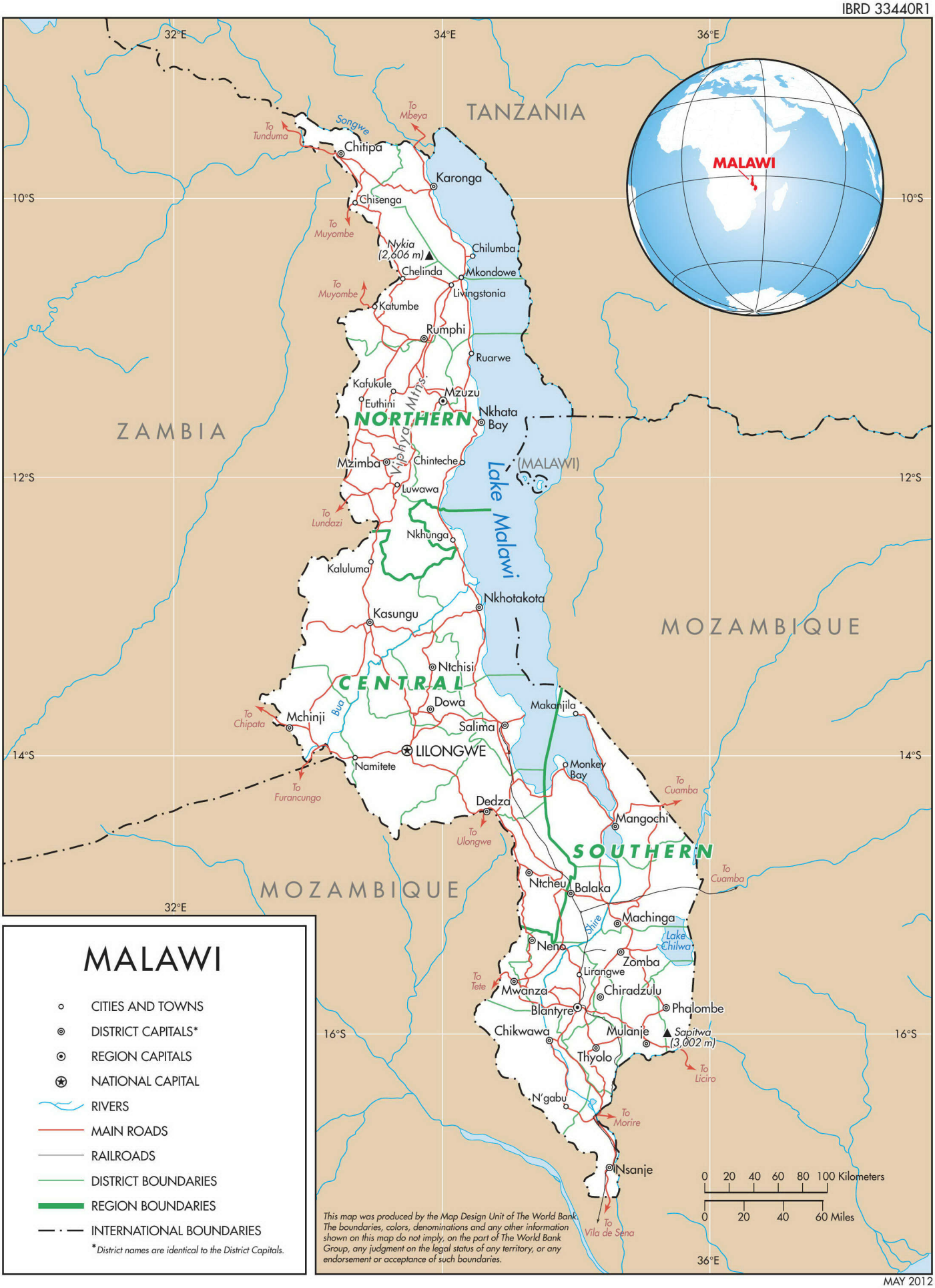

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