DOMESTIC DEBT MANAGEMENT IN AFRICA THE CASE OF MALAWI

AFRICAN FORUM AND NETWORK ON DEBT AND DEVELOPMENT

DOMESTIC DEBT MANAGEMENT IN AFRICA
THE CASE OF MALAWI

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ABBREVIATIONS & ACRONYMS

ADMARC	Agricultural Development and Marketing Corporation
BOP	Balance of Payments
BWI	Breton Woods Institutions
CBP	Capacity Building Programme
CPS	Credit to Private Sector
CSOs	Civil Society Organisations
DBR	Domestic Budget Revenue
DRI	Debt Relief International
DSA	Debt Sustainability Analysis
FA	Financial Assets
FSAP	Financial Sector Assessment Programme
GDP	Gross Domestic Product
HIPC	Heavily (Highly) Indebted Poor Countries
IMF	International Monetary Fund
INT	Interest
LICs	Low Income Countries
LRS	Local Registered Stock
MDRI	Multilateral Debt Relief Initiative
MEFMI	Macroeconomic and Financial Management Institute of Eastern and Southern Africa
M2	Broad Money Supply
MOF	Ministry of Finance
NPV	Net Present Value
NFRA	National Food Reserve Agency
PRGF	Poverty Reduction Growth facility
RBM	Reserve Bank of Malawi
TBills	Treasury Bills
TDS	Total Debt Service
TFA	Total Financial Assets
Tnote	Treasury Note

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PREFACE

Domestic public debt is not a new phenomenon for developing countries. In the face of budget deficits, against a backdrop of drying up of concessional lending and reduction in development assistance due to the impact of the global financial crisis among others, borrowing from domestic markets becomes a viable option. However far less attention has been given to domestic debt in development policy discussions. The efforts over the years have been centred on external debt where much focus has been on the HIPC and MDRI initiatives. While there has been a remarkable policy shift on external debt following implementation of HIPC and MDRI in a few developing countries, AFRODAD has seen the emergence of a new threat in debt management due to domestic borrowing which is not under the same scrutiny as external borrowing.

Domestic debt has been used to finance primary deficits and implement monetary policies in most African governments, such that in some countries domestic debt now constitutes a large share of the total debt stock. AFRODAD believes that reforms in debt management are critical to avert a vicious cycle of recurring debt burden. If domestic debt is not kept sustainable it will erode the benefits accrued from initiatives like HIPC and MRDI which had improved the fiscal space by freeing resources on the trajectories of pro-poor development policies in most HIPC countries.

Domestic debt can be beneficial if used for the right purposes; however, enormous levels of domestic debt may have a negative effect on financial stability. Arguments against domestic debt include the crowding out effect on private investment and its subsequent effect on economic growth Especially in countries with relatively narrow domestic markets Domestic debts also affect the level of interest rates as they making borrowing expensive due to the relatively narrow investor base and the monopolistic tendencies of most investor groups in Africa. Furthermore, domestic debt service absorbs a significant amount of government resources which could be used for social services and other pro poor expenditures in the economy.

The Malawi study reiterates the fact that the financial market should continue to be developed so that it improves its capacity to absorb new debt in order to keep the levels of interest's rates low. The study found that in Malawi there are clear procedures and legislations for issuing and management of domestic debt spelt out in the Public Finance Management Act of 2003. Since 2004, the government

of Malawi has managed to achieve macroeconomic stability which has among other things resulted in declining levels of domestic debt. However, there are other aspects of the overall domestic debt management practices that need attention by the various actors in the process. There is need for the Ministry of Finance and the Reserve Bank of Malawi to synergise their activities for better management of public debt. It is also important that the draft debt and aid management policy should be adopted by government as a matter of urgency.

The report analyses the linkages between domestic debt and economic development with regards to the use of domestic debt in the economy. It unpacks the legal framework and institutional structure for domestic debt contraction. It also provides an assessment of the nature of the relationships between different policy instruments for domestic debt acquisition and the role of different stake holders in domestic debt management such as parliament, civil society and international financial institutions. Actionable policy recommendations in improving aspects of domestic debt management conclude the report. This also raises a number of concerns to be addressed if Malawi is to continue on its path of prudent public debt management. AFRODAD hopes that the Malawi government will take the findings of this report seriously and address the concerns aptly.

Collins Magalasi
Executive Director
AFRODAD

EXECUTIVE SUMMARY

The objective of the study was to examine the linkages between domestic debt and development financing, regulatory and institutional framework and the role of key stakeholders in managing domestic debt. More specifically the study carried out an in-depth analysis of Malawi's domestic debt through the lenses of economic development, fiscal policy implementation, monetary policy stabilisation, financial sector development and debt sustainability. The study also reviewed the legal and institutional framework for domestic debt management and the structure of domestic debt in Malawi. Although most of the literature reviewed has focused on the bad effects of extensive domestic borrowing, some studies have actually shown that domestic debt at some levels is good for economic growth. The study has also shown that domestic debt in Malawi grew between 2001 and 2005 and that domestic debt servicing was consuming a large part of GDP and revenues. Domestic debt became unsustainable, mainly because of loose fiscal policy and external shocks but came down in 2006 when fiscal policy was tightened. There was an increase in domestic debt in 2008 mainly because of increases in global fuel and fertiliser prices. It is also clear that there are no internationally agreed thresholds for domestic debt sustainability although the BWIs and Debt Relief International have given indicative thresholds. Countries like Malawi should work out sustainability thresholds based on the respective economic situation. The study found that there are limits on domestic borrowing in Malawi; these limits are on the particular borrowing instruments. It is recommended that the limits should be reviewed regularly to ensure that they are still meaningful in the current economic circumstances. On the institutional set up, domestic debt is primarily managed by the Reserve Bank of Malawi. Although there is a Debt and Aid Division at the Ministry of Finance which should ideally have a unit for domestic debt management, but this is yet to be done and although institutionally there are debt management committees set, these are not active. In terms of systems and procedures for recording, reporting and dissemination of domestic debt information to senior policy makers, these are in place although this is no so clear for other stakeholders, particularly non state actors such as parliament and CSOs. Information however can be disseminated upon request. It is commendable though that some capacity is being built in debt management as debt experts have been and are being trained at both the Reserve Bank and the Ministry of Finance through MEFMI and the DRI.

1

INTRODUCTION

1.1 Background

In the 1980's, the major problem facing many developing countries including Malawi was how to deal with external debt. Domestic debt was relatively insignificant but the situation has changed since the late 1990's. Domestic debt levels have risen significantly over the recent years and worryingly, this is mostly in the very same countries that experienced problems with external debt and this development has implications for both stabilisation and macroeconomic management policies.

The problem however has been that domestic debt management has more often been treated in isolation from the rest of macro-economic management in most developing countries, and this has had undesirable consequences. Debt management influences and is influenced by fiscal, monetary policies and the balance of payments. An expansionary fiscal policy, for instance, could raise interest rates and inflation and thus the cost of public debt. It is therefore important that at policy level, debt management is integrated into an overall macro-economic strategy appropriate for the country.

Although efforts have been made towards the development of domestic markets for government securities, domestic debt remains expensive and consumes a larger share of GDP for most of the Sub-Saharan Africa countries as the markets remain inefficient. Financing through domestic borrowing however, is even a more important option now than ever in view of the global financial crisis as concessional lending and commodity prices decline. How domestic debt is managed therefore, has become an important issue.

Domestic debt has been issued in Malawi since the 1980's. Malawi's debt exposure however, worsened substantially between 2001 and 2004, largely due to an increase in the level of domestic debt. The explosion in the level of domestic debt during this period was due to a combination of several factors including: (i) weak

expenditure control, including both weak forecasting of the wage bill and of the interest bill, as well as an inability to keep ORT expenditures in line with the budget; (ii) failure to accurately anticipate donor budget support; (iii) lack of mechanisms to cope with the occurrence of shocks, including both financial losses by domestic parastatals and the impact of external weather shocks (Source: IMF Malawi country report 2004).

The fundamental cause of the fiscal crisis was the government's[1] inability to control expenditure and to live within its means, the impact of fiscal indiscipline was made worse by the volatility in donor disbursement of funds, and the impact of the external shocks (floods and drought) and most recently, fertilizer and fuel prices. The increased indebtedness resulted in a high interest burden, compromising government's ability to allocate resources for critical poverty alleviating expenditures.

However, since the change in Government in 2004, several reforms were implemented to improve the economy more particularly on the fiscal side where prudence and intensification of domestic revenue collection resulted into a reduction in Government indebtedness. Despite the recent reforms (post 2004) however, Malawi remains vulnerable to a high risk of domestic debt distress.

1.2 Objectives

The objective of the study is to examine the linkages between domestic debt and development financing, regulatory and institutional framework and the role of key stakeholders in managing domestic debt. The specific objectives of the study are:

- Carry out an in-depth analysis of Malawi's domestic debt through the lenses of economic development, monetary policy stabilisation and debt sustainability.
- Expose the regulatory and institutional framework inherent in the domestic debt management and how they affect national debt strategy.
- Give recommendations on appropriate measures in addressing domestic debt burden in Malawi.
- Constitute a national multi stakeholder conference on the impact of domestic debt in national development: Prospects and challenges.

[1]In Malawi presidential and parliamentary elections are conducted every five years and in 2004 elections were conducted that saw a change in the Presidency.

2

DOMESTIC DEBT AND ECONOMIC GROWTH

Domestic debt levels have risen significantly over the years and worryingly, this is mostly in the very same countries that experienced problems with external debt (Commonwealth Secretariat). This development has implications for both stabilisation and macroeconomic management policies. The absence of comprehensive empirical studies examining the impact of domestic debt on economic growth in Africa has therefore constrained meaningful policy response.

Most policy advice has tended to limit the accumulation of domestic debt in LIC's as many observers believe that the shallow and inefficient markets and low debt management capacity often found in these countries will have negative implications for private investment, fiscal sustainability and ultimately economic growth and poverty reduction. With the availability of concessional borrowing and grants from international financial institutions and governments, low income countries have been advised to avoid the seemingly expensive domestic borrowing. By implication, low domestic debt issuance is considered beneficial for economic development. More recent research has however begun to have a positive view of many market participants that compared to other forms of budgetary finance, market based domestic borrowing is seen to contribute more to macroeconomic stability, domestic savings generation and private investment (e.g. Fabella and Mathur, 2003; Abbas Abbas and Christensten 2007 and Christensten 2007). This view can be supported by the experiences of fast growing emerging markets like Chile, India and China who have maintained low external indebtedness and avoided major fiscal or financial crises.[2]

While most empirical studies on the implications of domestic debt in LIC's have mostly taken a fiscal sustainability view and not the direct relationship between domestic debt and economic growth, analysis has further been limited to external debt. The reasons may have been the unavailability of comprehensive data on domestic debt, the size of domestic debt compared to external debt and also because domestic debt has been viewed as an endogenous rather than an

2 See Aizenmann, Pinto and Radziwill (2004) for evidence favoring domestic over external finance

exogenous policy choice variable that governments can use to affect macro-financial outcomes.

The proponents against domestic debt have mainly used the crowding out effect on private investment to discourage domestic borrowing by government. When government borrows from the domestic market, they use up domestic private savings that should otherwise be available for private sector lending. Since this leaves fewer resources for the private sector, the cost of the funds rises and in turn private investment demand declines hence fall in capital accumulation, growth and welfare (Diamond, 1965). This is especially true in shallow markets where access to international finance is also limited. Critics of domestic debt are also concerned with the repercussions of fiscal and debt sustainability. Beaugrand et al, (2002), views domestic debt as more expensive than external financing[3]. The interest burden of domestic debt can absorb a significant amount of government resources thereby reducing pro-poor and growth enhancing spending. Christensten (2004) also raises liquidity risk, as the short term nature of domestic debt requires frequent rollovers of large amounts of debt. Another view against domestic debt is that government debt being high yielding and risk free is highly attractive to banks as it provides a constant flow of earnings and this reduces the drive for banks to mobilise deposits and lend to a riskier private sector (Hauner, 2006). In the study Hauner examines the effects of public sector borrowing from the domestic banking system on financial development in middle-income countries. While they note that external debt in the countries under study has been falling, the share of bank credit absorbed by the public sector has been rising rapidly. They argue that this runs the risk of slowing financial development by affecting structural characteristics of the banking systems. They find empirical evidence that too much public sector borrowing harms financial deepening, and that banks mainly lending to the public sector tend to be more profitable but less efficient and therefore note that these effects add to the costs of fiscal expansion.

On the other hand, proponents of domestic debt, view debt as having a positive impact on growth, inflation and savings from the perspective of deeper and sophisticated markets, which enhance volume and efficiency of private investment. The complication of not developing the domestic debt markets is that countries relying on foreign aid, which most LIC's still do, will find it difficult to exit from donor dependency despite most donor countries likely to reduce financial support in the wake of the global financial crisis. Domestic debt markets

3 This view is however questioned by Abbas (2005) noting that it has not considered the impact of the higher variance of external debt service due to exchange rate risk

can also strengthen the money and financial markets, boost private savings and stimulate investment. Government securities are an important instrument for the conduct of indirect open market operations and also for use as collateral in the interbank market which helps banks manage their liquidity effectively thereby reducing the central banks need for frequent interventions[4]. In addition central banks operating in well developed markets do not have to rely on direct controls which distort financial sector decisions- see Gulde et al. (2006). Moreover, yields on government securities can be used as a benchmark for the pricing of private sector debt thereby promoting the development of a corporate bond market (Fabella and Mathur, 2003).

Domestic debt instruments also provide savers with an alternative attractive avenue of investment and can therefore help in bringing in money from the non-monetary sector to the formal financial system (IMF, 2001). The benefits go beyond savings mobilisation and extend to the deepening of the financial market, widening of the tax base and improved perceptions of currency and country risk (Abbas and Christensten 2007). Since banks in many developing countries face an inherent risk and sometimes unpredictable business environment, they may be reluctant to engage with the private sector. However holdings of government securities do provide banks with steady and safe income and may therefore compensate for the poor environment and encourage lending to riskier sectors (Kumhof and Tanner, 2005). In the long term increasing domestic financing will help governments build a track record to access international markets as research has shown that countries that have successfully issued sovereign bonds on international markets have typically had a long prior experience with issuing domestic government bonds in their domestic markets (Akahn, 2005).

More recently, Abbas and Chistensten (2007) carried out an empirical study covering 93 low income and emerging markets and found out that moderate levels of non-inflationary domestic debt as a share of GDP and bank deposits exert a positive overall impact on economic growth. Granger-causality regressions in their study suggest support for a variety of channels including improved monetary policy, broader financial market development, and strengthened domestic institutions/accountability and enhanced private savings and financial intermediation. There was evidence that above the ratio of 35% of bank deposits, domestic debt begins to undermine growth, lending credence to the traditional crowding out and bank efficiency concerns. More importantly, the study found out that domestic debt contributes more to growth if it is marketable, bears real interest rates and is held outside the banking system.

4 This view is however questioned by Abbas (2005) noting that it has not considered the impact of the higher variance of external debt service due to exchange rate risk

3

REVIEW OF MACROECONOMIC DEVELOPMENTS AND AN OVERVIEW OF MALAWI'S DOMESTIC DEBT PORTFOLIO

3.1 Macroeconomic Developments 1999 – 2008

Macroeconomic performance from 1999 to 2005 was disappointing, but it has markedly after 2005. Sustained growth was elusive, reaching no more than 2 percent average during this period[5] with significant volatility from year to year (Table 1 below)[6]. Poor implementation of the IMF PRGF programme led to large fiscal slippages, an unsustainable domestic debt spiral and low investment.

The IMF approved a three-year economic programme for the Malawi government called the Poverty Reduction Growth Facility (PRGF) to run between 2000 and 2003. This arrangement was to assist the country attain macroeconomic stability through prudent fiscal and monetary management. However the fiscal slippages led to the cancellation of the programme in 2001. Consequently other donors[7] (UK, Norway, Denmark and Sweden) withheld their aid to Malawi. Fiscal performance continued to be weak until 2004 and this brought the country to the verge of a financial crisis. The government before 2004 ran large fiscal deficits of more than 7 percent of GDP in each fiscal year. In the absence of external budgetary aid[8], the deficits were financed largely, by domestic borrowing. As a result domestic debt increased sharply from about 7 percent in 2000 to 10.2% in 2001 then to 24 percent of GDP in 2003 (IMF Country Report, 2004). Further, high interest rates on domestic borrowing, that rose to over 50 percent in 2001 and remained above 30 percent during this period translated into a massive domestic interest bill, which reached 9 percent of GDP in 2004.

5 The GDP grew at an average of 1.74% per year between 2001 and 2005

6 Given that population growth is around 2 percent per annum, this implies no growth in per capita terms (i.e. that poverty has stagnated). Around 6 percent growth is required to make a meaningful impact on poverty reduction (World Bank 2003).

7 These were members of the Common Approach to Budget Support (CABS) group. The group was originally made up of the UK, Norway, Denmark and Sweden. The European Commission joined later, but Denmark withdrew from Malawi in 2002

8 Following the weak fiscal performance in 2000/01, and in light of the authorities' decision to halt the privatization program, the IMF suspended its PRGF program in November 2001. Other donors followed suit by stopping their budget support grants and concessional lending.

Tight monetary policy during 2001-2002 was abandoned to increase monetization of the budget deficit in 2003 and 2004. As a result, inflation which initially decreased from about 22.1percent in 2001 to under 10 percent in 2003, increased during 2004 and 2005 reaching a peak of 17.2 percent in December 2005. The increase in inflation in 2005 was partly also a result of the low maize production following the adverse weather in 2005, and the soaring world energy prices.

Malawi's macroeconomic performance markedly improved after 2004, with policy implementation during the 2005 to 2008 PRGF arrangement constituting a sharp break from past performance. The country's macroeconomic performance between 2006 and 2008 has been very strong with real GDP growth rates of over 7% from 2006. Inflation too, although recently on a rise has been moderate at below 10 percent since 2006. Monetary policy on the other hand, continues to be tightened with a much lower domestic borrowing target to be achieved.

Interest rates have significantly come down since 2001 when they were as high as 50 percent. The Reserve Bank reduced nominal interest rates from 45 percent in September 2003 to 25 percent in June 2004.[9] Real interest rates declined during 2004-2005 as a result of the moderate increase in inflation. However, with the RBM reigning in on inflation, nominal interest rates were further reduced to 20 percent in 2006. Interest rates have since come down to the prevailing 15%.

The current account deficit (excluding official transfers) also worsened during the first part of the decade, from 12.5 percent of GDP in 2001 peaking at 23.3 percent in 2002 and slightly coming down to 17 percent in 2006. The deficit significantly improved to below 6% in 2006 but has risen again to over 16 percent in 2008 largely due to high fuel and fertilizer import prices.

9 Further reductions in the interest rate are limited by the need to roll over of the stock of domestic debt at cheaper cost, while avoiding excessive money creation.

Table 1 Key Macroeconomic Indicators

	2001	2002	2003	2004	2005	2006	2007	2008
GDP Growth (%)	-4.2	2.1	3.9	5.1	2.1	**7.9**	8.7	9.7
Inflation (eop)	22.1	11.5	9.8	14.1	17.2	10.1	7.5	8.2
Revenues (excl grants)	23.5	20.7	23.5	23.2	25.5	17.5	18.7	18.9
Expenditures	31.2	38.1	42.5	43.1	43.1	31.6	36	34.6
Domestic interest payments	3.9	4.0	7.9	8.4	**6.3**	4.9	2.3	2.4
Overall balance (excluding grants)	-14.4	-18.3	-19.9	-20.8	-17.6	-14.2	**-17.2**	-15.1
Overall balance (including grants)	-7.7	-11.6	-7.8	-5.6	-2.0	-0.7	-3.1	-3.8
Domestic Debt	10.2	20.4	24.8	22.6	21.9	12.6	11.9	16.7
Growth in M2 (%)	12.1	25.2	29.3	29.8	14.3	16.5	36.9	15.4
Interest rate (3 months Tbill, average)	42.4	41.7	39.3	28.6	24.4	20.0	13.9	

The foreign reserves position has deteriorated throughout the period, with the level remaining below two months of import cover since 2002. The level of reserves was the worst in 2004 at 1.1, down from almost 4 months of import cover in 1999 and had moved to 1.6 months of import cover in 2006. By 2008, the reserves position remained weak despite having picked up 2007. Erratic weather pattern has translated into large shocks to GDP and to public finances. For instance, in preparing the 2002/03 budget, the government did not set-aside resources to respond to the emerging food crisis. As a result, the need for emergency imports of maize (amounting to 3.8 percent of GDP), and transfers to the ADMARC and NFRA[10] parastatals (1.2 percent of GDP), resulted in a very substantial increase in the fiscal deficit.

The Government and the RBM have taken rapid steps since June 2004 to stabilize the fiscal situation and reign in liquidity growth and inflation. The government has enforced strict fiscal discipline and, as a result, macroeconomic performance since 2006 has been rapidly improving. The improved fiscal performance combined with early receipt of donor budget support provided for a gradual reduction in domestic debt and the domestic interest bill which has decreased to below 3 percent of GDP in 2008 from a high of 8.4% in 2004.

10 ADMARC and NFRA are statutory corporations. The former is mandated to provide a market for agriculture produce from smallholder farmers and resell to the rest of the economy while the latter ensures food sufficiency by storing enough grain in the strategic grain reserves respectively.

Malawi's level of domestic debt at the end of fiscal year 2007/08 is not as large as the corresponding ratios in some other countries. But with a small domestic capital market and the limited range of holders, it has the potential to increase rapidly because resumption of heavy borrowing would sustain real interest rates at high levels. Also, the country's vulnerability to external shocks can easily disrupt, or at least prolong, the adjustment period during which the country is paying an enormous interest burden. The interest payments on domestic debt are substantial and are affecting every sector because they have shrunk the amount of discretionary budgetary resources available for other recurrent and development expenditures (such as in health, education, social safety nets, irrigation, and transport infrastructure).

3.2 Evolution and Characteristics of the Domestic Debt Portfolio 1999 – 2008

In Malawi domestic public debt is defined as borrowings in Malawi Kwacha from domestic or foreign sources. Domestic debt in Malawi therefore constitutes borrowings from the central bank, commercial banks, non-bank financial institutions, corporate sector, foreign investors and the individuals. Domestic debt in Malawi is contracted through the issuance of marketable and non-marketable instruments. The bulk of the debt however is in marketable instruments, which are mostly treasury bills. Other instruments that are also used to contract debt are Local Registered Stocks which are now split between treasury bonds and treasury notes depending on their maturity period; Ways and Means, which is direct advances from the Reserve Bank; arrears; contingent liabilities; and in the past promissory notes. These instruments have been used for financing the budget deficit. The Reserve Bank of Malawi bills (RBM) are used for monetary policy and the cost is borne by the central bank though lately, the Treasury bill has been used for monetary policy as well.

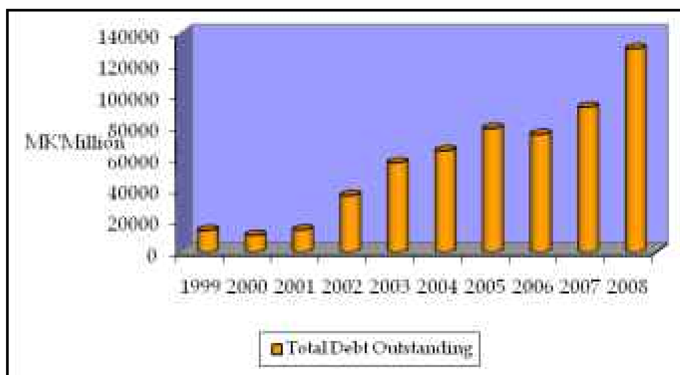
Domestic debt has been issued in Malawi since the 1980's. Malawi's debt exposure however, worsened substantially between 2001 and 2004, largely due to an increase in the level of domestic debt. Domestic debt started to rise after 2001 mainly because of fiscal slippages and volatile donor inflows. The impact of external weather shocks worsened the domestic debt situation. After 2004, domestic debt grew albeit at a declining rate.

The increased indebtedness resulted in a high interest burden, compromising government's ability to allocate resources for critical poverty alleviating expenditures. Despite the recent reforms that government has implemented, Malawi remains vulnerable to a high risk of debt distress.

3.2.1 Trends in Domestic Debt Stock

The growth in domestic debt between 2001 and 2005 had mainly been caused by high fiscal deficits, which resulted in an increase in net domestic borrowing by Government. The suspension of the economic programme with the International Monetary Fund (IMF) in November 2001 and the subsequent withholding of budget support by donors compounded Malawi's domestic debt problem. Amid all this was the demand on the budget to support the persistent food shortages that hit the country due to unpredictable rainfall patterns in 2005.

Figure 1 Total Domestic Debt, 1999-2008



Source: Reserve Bank of Malawi

As seen in Figure 1 above, domestic debt increased significantly between 1999 and 2005 from K13.7 billion to over K80billion, a growth of over 480 percent in the seven-year period. Growth was however varied year on year with the highest growth registered in 2002. This growth in domestic debt was mainly a result of loose fiscal policy, which also led to the suspension of the IMF programme in 2001 and subsequent donor aid freeze. The spill over effect of the general

elections in 1999 also led to the increase in domestic debt. With the pressures the economy was going through, it is not surprising that the economy shrank in 2001 with a negative growth of –1.8 percent. In 2006 however, there was a change in the trend as government repaid 5 percent of the existing debt stock. Between 2007 and 2008 however, domestic debt grew by 40 percent and this was mainly caused by fertiliser and fuel shocks. On average, during the period 1999 to 2008, debt grew annually by almost 38 percent.

Table 2 Changes in the Domestic Debt Stock (MK Million)

	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
Total Domestic Debt (Exc arrears)	13737	10653	14157	35978	57012	64910	79047	75329	92598	129888
Change on Previous Year	5132	-3084	3505	21821	21034	7898	14137	-3718	17270	37290
% change on previous year	60%	-22%	33%	154%	58%	14%	22%	-5%	23%	40%

Source: Reserve Bank of Malawi

Government's commitment in achieving macroeconomic stability through prudent fiscal management has contributed to the decline in the growth of domestic debt. Expenditure has been more controlled hence the need to borrow significantly reduced although rising fuel and fertiliser prices in 2008 exerted pressure on the budget. In addition the government has continued to clear domestic debt arrears which recorded at K11.0 billion in 2005.

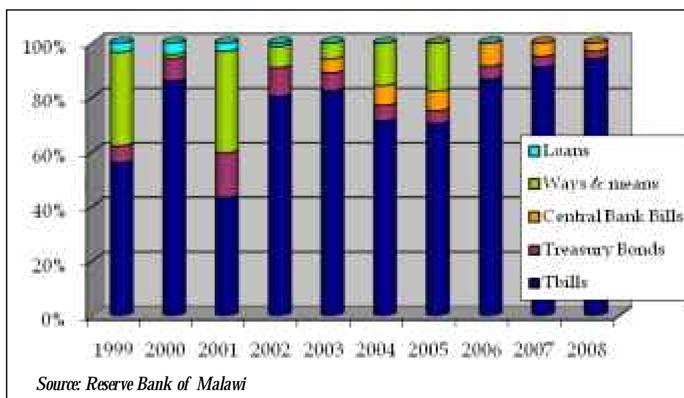
3.2.2 Composition of Domestic Debt by Instrument, 1999 - 2008

Domestic debt in Malawi is comprised of Government securities: Treasury Bills, short-term with a maturity of less than a year and Treasury Notes and Bonds which are long- term with maturities between 2 and 25 years; Ways and Means advances made to Government by the Central Bank; Central bank bills and some arrears. The bulk of the debt is however short-term. The proportion of treasury bills has grown from 56 percent of the domestic debt stock in 1999 to 94 percent in 2008.

Reflecting the growth in the stock of domestic debt, all the components grew albeit at varying growth rates. Treasury bills have continued to grow throughout

the period, while central bank bills and ways and means grew at an increasing rate on average up to 2006 and the Treasury note and bonds have stagnated. Treasury bills have however continued to grow at a much faster rate as Government turned to the domestic market to finance the fiscal gap during the period when there were no donor inflows as a result of the suspension of the IMF programme.

Figure 2 Composition of Domestic Debt by Instrument, 1999-2008



Source: Reserve Bank of Malawi

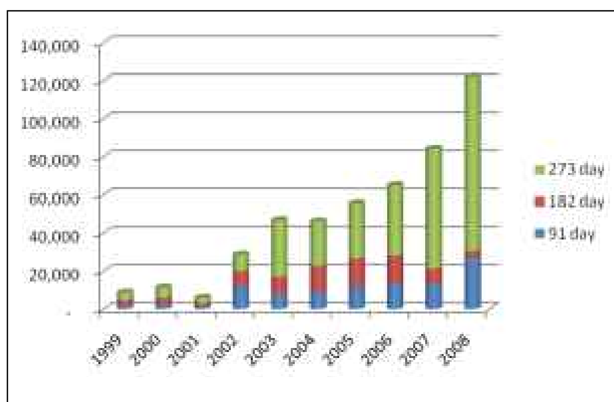
The long-term securities have hardly changed although a marginal growth was registered in 2002. However, as a percentage of the total debt stock, holding of treasury notes and bonds has declined as reflected by a holding of 3 percent of the total domestic debt stock in 2008 compared to 38 percent in 2001. The general macroeconomic environment during this period, where high interest rates persisted, rendered the long-term securities unattractive. Investors took advantage of Government's appetite to borrow using treasury bills and saw no need to take on the risk of investing long term.

Although ways and means grew as a percentage of total debt in 2001, it declined in 2002 and 2003 only to pick up again in 2004. The unavailability of donor resources pushed Government to borrow from this window when borrowing from the market alone was not sufficient for its budgetary operations. Government had however cleared its ways and means by end 2008.

3.2.3 Analysis of Government Treasury Bills Reserve Bank Bills, Bonds and Stocks

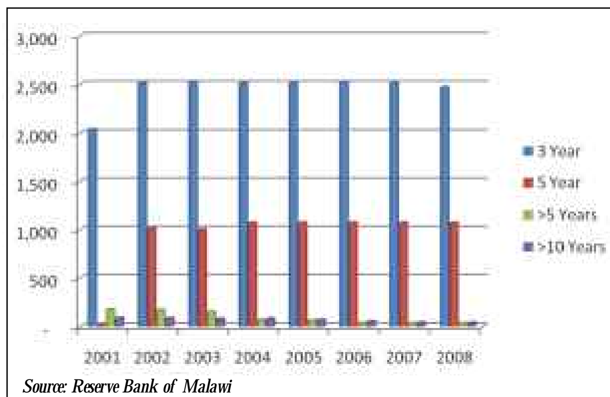
Treasury Bills are issued through auction in three different tenors (Figure 3) of 91days, 182 days and 273 days. The preference over the period has been for the 273-day tenor as evidenced by a much higher holding in that tenor, which has grown from K4.2 billion in 1999 to K91.6 billion in 2008. The 273 day bill constituted 48 percent of the Treasury bill stock in 1999 and grew to 75 percent by 2008. On the other hand, the 182 day declined from 30 percent of the Treasury bill stock in 1999 to 3% in 2008. The 91 day bill was at 22% in 1999 and 2008 (Table 1). The investors' preference for the longest Treasury bill is also an indication of lack of alternatives as the bond/note issuances have not been sufficient to meet investor portfolio needs.

Figure 3 Treasury Bills Issues by Tenor, 1999-2008 (MK Million)



The Treasury bill auctions are conducted on weekly basis and these are done at the Reserve Bank of Malawi. Some auctions are grossly over-subscribed while others are under-subscribed and this normally reflects the liquidity situation in the market and also portfolio requirements by investors. Bidding is competitive where subscribers are free to quote a bid price. An option is however given for non-competitive bidding for inexperienced bidders for amounts of K500,000.00 and below. There is also a minimum bidding amount, which is set from time to time and currently it's at K50,000.00. Investors are allowed to submit their bids directly to the Reserve Bank. Bidders may also submit bids through brokers.

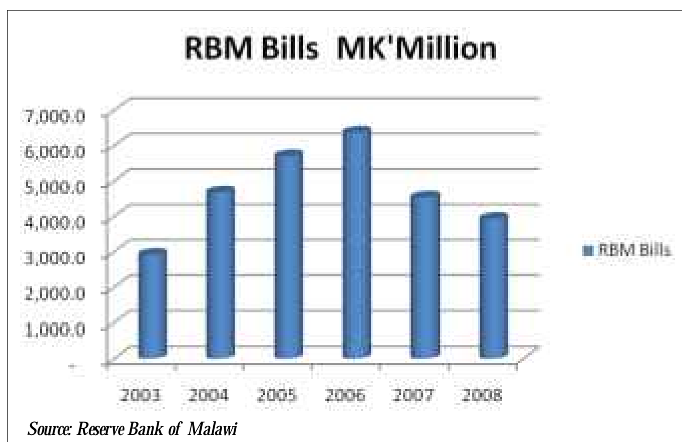
Figure 4 Treasury Bonds/Notes 2001-2008 (MK'Million)



Source: Reserve Bank of Malawi

Government used to issue Local Registered Stocks to raise funds for particular projects. The maturity for these stocks was up to 25 years. However, with Government needing to raise more funds for finance budget deficits, the issuance of stocks was gradually replaced by Treasury Bills, which offered high rates and with short maturities. The long-dated securities therefore became unattractive as investors did not want to take the risk of long-term investments during periods of macro-economic instability. The 3-year Treasury note dominated the bond/stock portfolio taking up 88% in 2001 and 68% in 2006. From 2002, the 5-year note also attracted some subscription and by 2006, it was 29% of the bond/note portfolio. The main reason for the concentration in the 3 and 5 year bond is that the 3-year and 5-year Treasury notes were special issues and the other stocks have not been re-issued due to market conditions that have not been conducive.

Figure 5 Reserve Bank of Malawi Bills (MK' Million)



Source: Reserve Bank of Malawi

Reserve Bank of Malawi bills (RBM bills) are issued by the central bank for monetary policy purposes (Figure 5). They were introduced in 2003 as at the time using the Treasury bill alone for monetary policy had become a problem with fiscal policy being loose. The RBM bill grew from just over K2 billion in 2003 to K6.4 billion by the end of 2006. After 2008 though no new RBM bills have been issued and the Treasury bill is being used for dual purposes of monetary policy and deficit financing.

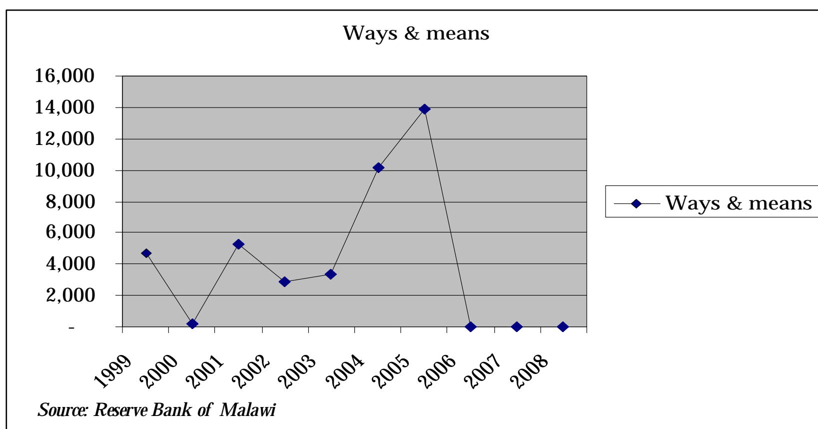
3.2.4 Government Borrowing from the Central Bank

In Malawi, direct borrowing from the central bank by Government is provided for in the Reserve Bank of Malawi Act in the form of an automatic overdraft facility. This overdraft, called Ways and Means is there as a way of smoothening Government's cash flows on daily basis. To determine the level of Ways and Means to advance to Government, revenues and expenditures are netted off on daily basis and if Government is in a deficit position an advance equal to the deficit amount is automatically provided.

Borrowing through Ways and Means is limited to 20% of the projected domestic revenue for that particular financial year. This is a legally binding limit provided in the Reserve Bank of Malawi Act.

At the end of Government's financial year, the outstanding Ways and Means balance must be cleared. This is done by either drawing down on deposits or converting to securitised debt and in this case, Treasury Bills. Conversion of Ways and Means is not only done at the year-end but any time Government exceeds its statutory limit. So far for Malawi, Government in 2008 also issued a recapitalisation bond of K29 billion to strengthen the balance sheet of the central bank.

Figure 6 Advances from Reserve Bank



Source: Reserve Bank of Malawi

Figure 6 above shows how Ways and Means has evolved from 2001 to 2006.This of course, tally's with the period when Government experienced the worst fiscal balance. Although there was some decline 2002, borrowing from the central bank picked up from 2003. The period 2003 was pre-election period hence Government. Post 2005 also shows commitment by the present Government to refrain from monetisation. By the end of 2006, Government had repaid its Ways and Means through tightening of fiscal policy.

3.2.5 Arrears and Contingent Liabilities

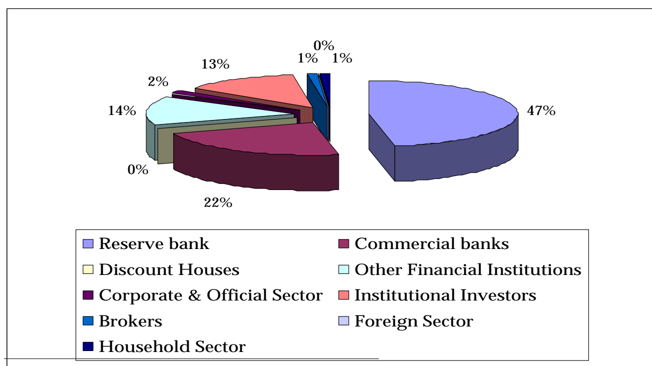
After the stock of debt arrears at MK10 billion was established and audited in 2006, Government undertook to repay by making a provision in the budget. Government has since repaid the arrears either outright or by securitizing the big amounts, especially those in Millions of Kwacha's. The securitised arrears were issued at rates negotiated with the suppliers.

In most developing countries parastatals borrow and sometimes quite substantially mostly to improve service provision. Malawi is not an exception but data on contingent liabilities was not available for this analysis.

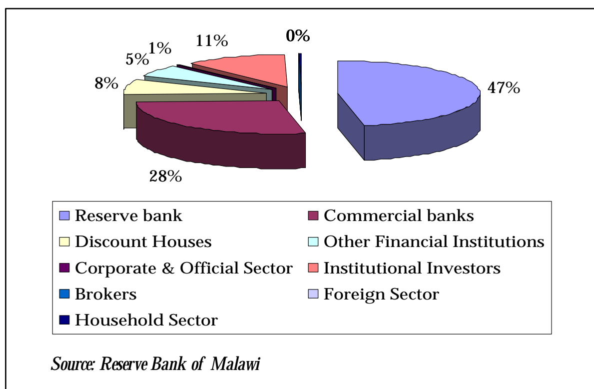
3.2.6 Domestic Debt by Holder

Due to the narrow domestic financial markets, holding of Government securities is concentrated in the hands of few markets players. These include the Reserve Bank of Malawi, commercial banks, institutional investors, other financial institutions and discount houses.

Figure 7: Treasury Bills by Holder 2001



Treasury Bills by Holder 2008



Source: Reserve Bank of Malawi

There have been some changes in the holding of Treasury bills by some sectors between 2001 and 2008 although not very significant. Holdings by Reserve bank declined between 2001 and 2006 from 47% to 21%, with the introduction of the RBM bill but picked up again and ended at 47% in 2008 mainly because of using the Treasury bill for monetary policy as well. On the other hand, holdings by the commercial banks have increased over the same period, from 22% to 28%. This growth was a result of attractive rates in the Treasury bill market compared to lending to private sector. This is also a trend expected from the commercial banks as they normally have short term liabilities (deposits) that they would want to match with short-term assets.

In 2001 Treasury Bills held by discount houses and other financial institutions was at 14% and this time discount houses had just been introduced in the market and by 2006 the combined holding of Treasury bills, had risen to 27%. This shows some growth and diversification of the investor base. Institutional investors continue to hold significant Treasury bill amounts at 18% by 2006, although this came down to 11% in 2008. This was mainly because other sectors increased their holdings e.g. commercial banks. Ordinarily institutional investors may not have such a high holding of short term instruments but the limited supply of long dated securities has dictated that they concentrate their investment in the short end of the market. Although some of the big commercial banks and some institutional investors hold local registered stocks, the bulk of their portfolio is in Treasury bills mainly because the stocks are in short supply and also lucrative rate on the T-bill market for the recent past, while in 2001 it was mainly because of general macroeconomic volatility expectations.

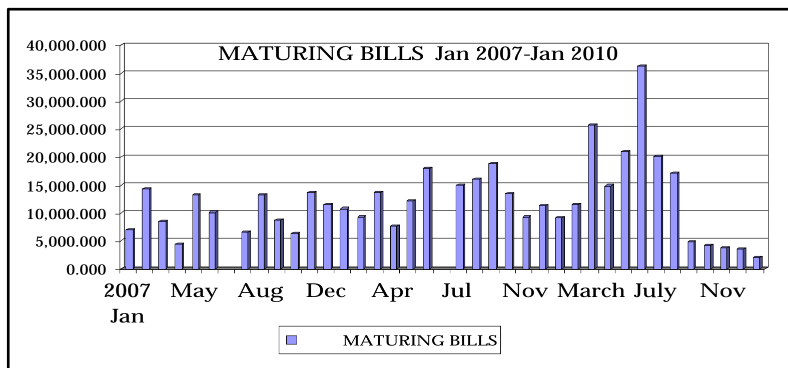
3.2.7 Maturity Structure of Domestic Debt

Most of Malawi's public domestic debt is short term, maturing in less than a year. The authorities resorted to either direct credit from the Reserve Bank or borrowing through Treasury Bills. The short nature of Government's domestic debt makes it vulnerable to rollover risk. The authorities have tried to lengthen the maturity profile by floating a 3 year and a five year Treasury note in 2001 but the issues were not very successful forcing the Reserve Bank to underwrite most of the issue. Although short-term government securities have dominated over the period, the trend has worsened that by 2008 the holding of long-term securities was almost negligible, with short-term securities taking up 96% of the domestic debt stock. The long-term securities (>5 years) however were being redeemed as they matured.

The maturity profile of Government securities shortened over the 10-year period from 1999 to 2008. The high and unstable interest rates up to around 2005 and other economic factors made it impossible to successfully issue long-term securities. With the high interest rates on the short end, which were mainly a result of government's appetite to excessively borrow domestically, investors were happy to invest short and avoid the risk as the return they got was very high. On the other hand, the issuer was unable to float long-term securities as this would have locked Government in high interest rates in the long term.

In addition to maturity concentration in the short-term securities, there is also a problem of bunching (Figure 7above). This bunching of maturities is an indication that issues of Treasury bills are not well planned to smoothen out the maturity profile. This aspect could be included when an issuance strategy or debt management strategy for Malawi is finalised.

Figure 8 Treasury bill Maturities Jan 2007 – Jan 2010



Source: Reserve Bank of Malawi

3.2.8 Interest Rate Structure of Domestic Debt

In Malawi the key reference interest rate is the bank rate. This rate is set by the Monetary Policy Committee after considering recommendations from the monetary policy technical Committee. These committees consider developments in all sectors of the economy on monthly basis. Thus they consider fiscal, monetary and real sector developments and determine whether or not to adjust the bank rate. All other interest rates align themselves accordingly.

The high domestic borrowing has resulted in very high yields which have led to high domestic interest payments putting more pressure on the budget. The Treasury Bill yields hit record high levels at over 60 percent for the 91, 182 and 271 day Treasury Bills with the Bank rate and inflation of over 60 and 32 percent respectively in 2001. However, with reduction of Bank rate to 15% in 2007, the Treasury bill yields have since come down to below 15 percent. Investors in Government debt instruments in Malawi have earned and continue to earn a positive real rate of return from their investment in government securities (see Table2). Despite the Treasury bill yields declining between 1999 and 2008, a trend which has been in line with the decrease in bank rate, the yields have remained higher than inflation, earning investors a positive rate of return on their investment.

Table 3 Domestic Interest Rates and Inflation (Malawi) 2001 –2008

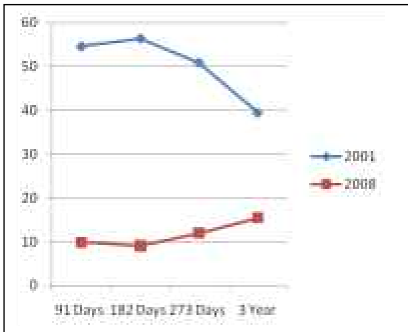
Nominal Rates	2001	2002	2003	2004	2005	2006	2007	2008
Bank Rate	46.80	40.00	35.00	25.00	25.00	20.00	15.00	15.00
91 Days	54.60	36.10	33.10	24.63	24.44	16.65	14.21	9.86
182 Days	56.40	37.20	34.00	24.64	24.49	16.67	13.71	9.11
273 Days	50.90	38.60	33.90	24.61	24.30	16.53	13.59	11.99
3 Year	39.50	39.50	40.00	25.50	25.50	20.50	20.50	20.50
Inflation rate (Annual average)	22.70	14.70	9.57	11.46	15.41	10.1	7.3	8.6

Source: Reserve Bank of Malawi

In Figures 9 and 10, it is clear that investors in Malawi are rebuilding their confidence in the economy as signified by the normal and less steep yield curve for 2008, compared to the inverted curve in 2001 which is typical at the beginning of an economic expansion and that bond investors anticipate a stronger economy in the future. This is an indication that demand for capital is being re-established by growing economic activity. This yield curve is normal as it compensates investors in the longer dated securities with a slightly bigger margin for taking the

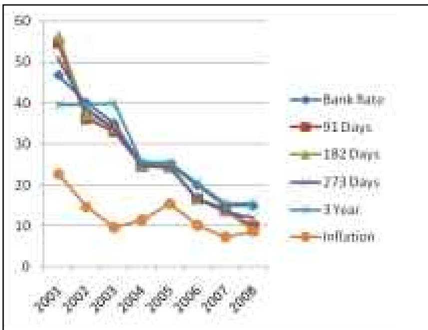
risk to invest long. In 2001 the yield curve is inverted and steeper. An inverted yield curve can be a harbinger of recession. When yields on short-term bonds are higher than those on long-term bonds, it suggests that investors expect interest rates to decline in the future, usually in conjunction with a slowing economy and lower inflation (PIMCO.com, Bond basics).

Figure 9 Government Securities Yields and Inflation



Source: Reserve Bank of Malawi

Figure 10: Government Securities Yields and Inflation: Yields and Inflation 2001 – 2008 (%)



Source: Reserve Bank of Malawi

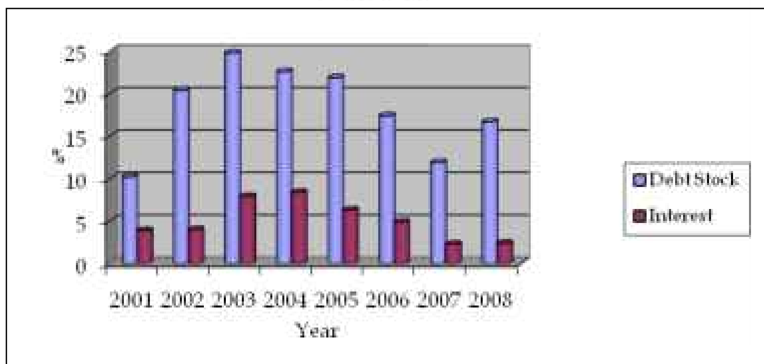
On the other hand, the chart on inflation and yields also clearly shows that investors have been getting a positive real rate of return on their investment. The

margin has of course reduced with time but this is just a sign of returning macroeconomic stability, hence less risk perceived. The yields on government securities continue to align themselves to the bank rate, which is the benchmark interest rate in the economy.

3.2.9 Domestic Debt Service

As the domestic debt stock grew over the period, so did domestic interest rates and the domestic interest payments. Domestic debt grew from 10.2% of GDP in 2001 and peaked in 2003 at 24.8% of GDP beyond the BWI's threshold of 15-20%. Interest payments also grew to 7.9% and 8.4% in 2003 and 2004 respectively from 3.9% in 2001 (Figure 11).

Figure 11 Domestic Debt Stock and Interest as % of GDP, 2001 - 2008



Source: Reserve Bank of Malawi

As the stock of debt started declining in 2005, domestic interest payments also went down to 2.4% of GDP at the end of 2008. The stock came down to 16.7% in 2006 but this was due to the recapitalization of the Reserve Bank otherwise the stock was at 11.6% of GDP. Government has been rolling over 90 percent of its domestic debt and has only been paying interest. This is because the bulk of the debt is in Treasury Bills, which are under one year in maturity. During the study period a larger portion of the debt service was on account of Treasury Bills. Although the stock of debt has gone up by a higher percent in 2008, due to increases in fertiliser and fuel prices globally, the interest payments have remained modest resulting from the macroeconomic stability existing at the moment.

4

THE LEGAL AND INSTITUTIONAL FRAMEWORK

Sound debt management requires an institutional framework that provides clear accountability and responsibility for managing debt. It also requires clear reporting lines and proper coordination among the various units responsible for debt management. In addition a debt office should have well skilled and compensated staff. Debt being important, although in some cases it does not get the necessary attention also requires support from the highest levels of management. Besides having the requisite structures for debt management, it is important that debt operations are governed and guided by the necessary legal framework. Best practice requires the establishment of a debt office with the sole responsibility of managing all aspects of debt from resource mobilisation, debt strategy and risk analysis to recording in the back office.

4.1 The Legal Framework

The power of the Government to borrow is enshrined in Malawi's 1995 Constitution, the Public Finance Management Act of 2003 and the Reserve Bank of Malawi Act of 1989. The Constitution provides for power of the Government to borrow in Section 180. Section 180 (1) and (2) stipulate that a loan may be raised by the Government under the authority of an Act of Parliament and not otherwise. It also empowers Parliament to appropriate the proceeds of the loan for specific purposes. Only Parliament can authorize the payment of loan proceeds out of the Consolidated Fund for any purposes it prescribes.

Section 174 (1a) of the Malawi Constitution allows all debt charges for which the Government is liable to be charged to the Consolidated Fund. These charges are clearly spelt out in Section 174 (2) to mean include interest, sinking fund charges, the repayment or amortization of debt, and all expenditure in connexion with the raising of loans on the security of the Consolidated Fund and the service and redemption of debt thereby created.

The Public Finance Management Act (No. 7 of 2003) specifies how loans may be raised and guaranteed and it details the responsibility of several Government agencies including Parliament and the Ministry of Finance. Part VII Section 56 (1) states, "… the Minister [of Finance] is empowered to borrow by way of term loan within Malawi or elsewhere, as the National Assembly shall determine by an authorizing Act, not more than such sums of money as that Act authorizes. Furthermore, (2) prior to raising a loan the Minister shall first (a) ensure that it is in the public interest to do so; (b) ensure that it is fiscally responsible in accordance with section 12[11]; (c) ensure that it is consistent with Government economic and fiscal policy; (d) satisfy himself that the Government has or is likely to have, on current projections, the financial ability to meet all the obligations under the loan including future loan payments; and (e) consult with the Attorney General and obtain in writing from the Attorney General, an opinion approving the legal aspects of the loan agreement". The Government may only borrow in accordance with this Act. So the act outlines the authority and procedures to be followed in loan contraction.

Section 63 (1) of the Act dictates that the Finance Minister shall give, in writing, a guarantee or indemnity, but with prior approval of Cabinet and consistent with Section 12. When the Minister of Finance gives such a guarantee, s/he is merely required to report to the National Assembly. No Act of Parliament is required. However, the Act stipulates that the money the State pays under a guarantee or indemnity constitutes a debt due to the State from the person, company or body corporate, organization or statutory body and may be recoverable in any court.

It should be noted that although the Act requires the Minister of Finance to ensure that the loan is "in the public interest", the Act does not specify how the Minister determines this. There is no legal provision that requires the Government to consult civil society groups and project beneficiaries before borrowing. Even the principles of responsible fiscal management outlined in Section 12 of the Public Finance Management Act do not provide for consultations.

The Reserve Bank of Malawi Act (RBM Act) 1989 in addition to what the constitution stipulates. The RBM Act gives the mandate to the Reserve Bank to issue and manage domestic debt on behalf of Government. It also provides for the extension of an overdraft facility (Means and Ways account) to Government

11 The Section specifies principles of responsible fiscal management

to smoothen daily Government operations. This facility is short term and there is a legal limit stipulating how much Government can borrow through this window - basically 20% of Government's projected annual revenue. The debt is cleared as soon as Government accumulates some deposits. Apart from the borrowing limit on the overdraft, limits have also been put on other instruments that Government uses to borrow domestically. These are stipulated in the Public Finance Management Act. Besides giving the mandate to borrow on behalf of Government, the Reserve Bank through the RBM Act is also mandated to conduct monetary policy operations with the ultimate goal of achieving price stability. The Bank therefore issues domestic debt to meet both fiscal and monetary policy requirements. The laws governing domestic borrowing are passed by Parliament.

4.2 The Institutional Framework

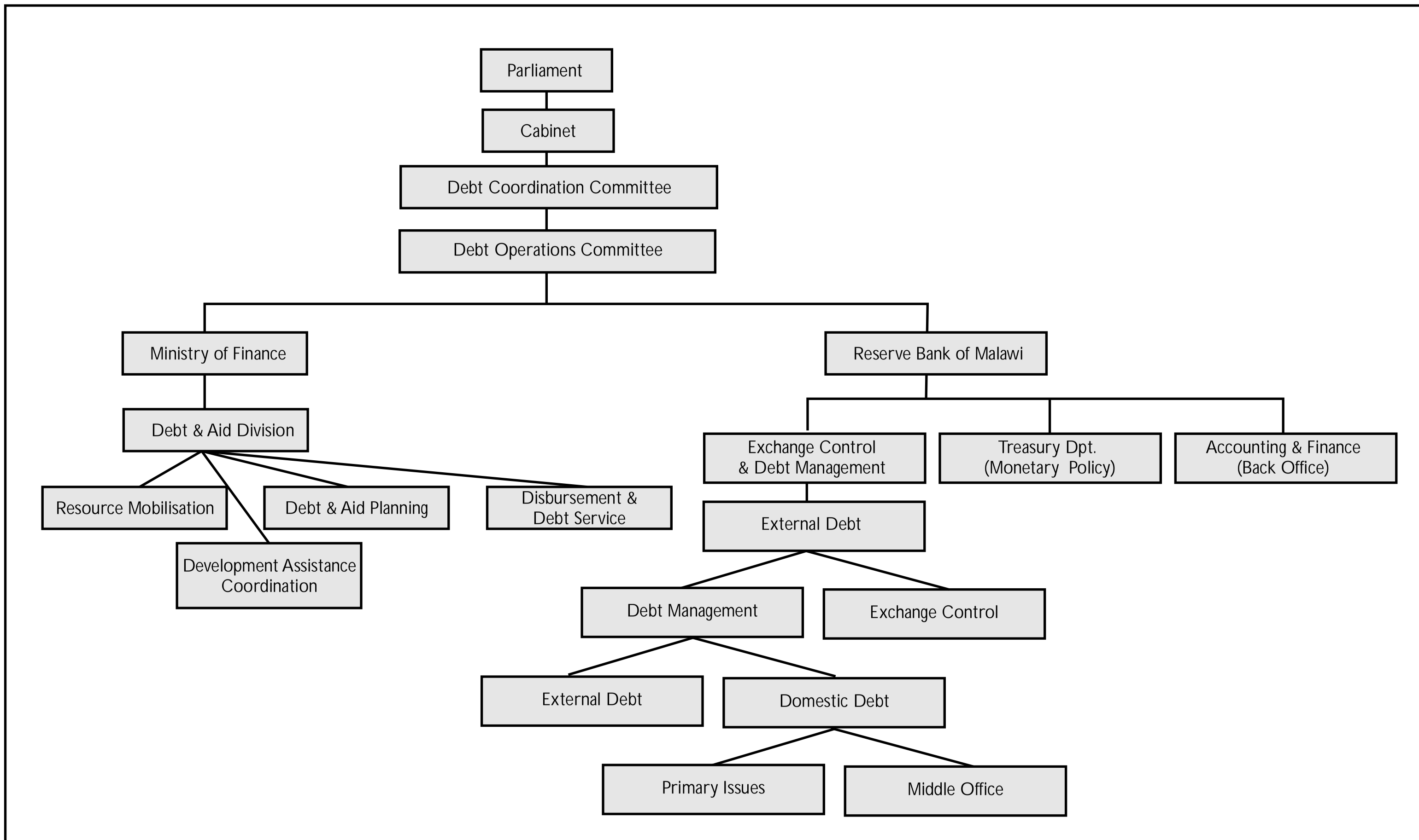
The debt management coordination structure for Malawi has a Debt and Aid Management Division in the Ministry of Finance which is mainly responsible for external debt and aid management while the responsibility for domestic debt management still primarily lies with the Exchange Control and Debt Management department in the Reserve Bank of Malawi. Although there is also coordination with units that play a role in debt management e.g. the budget and economic affairs divisions in the Ministry of Finance, line ministries and parastatals, this is not adequate and it has in some cases led to inaccurate projections of financing requirements. In addition to these units, there are high level debt management committees in place (the Debt Management/Coordination Committee and the Debt Operations/Technical Committee) that should otherwise be providing direction for debt management strategy but have so far not been effective as most of the members have been constrained with other duties and have therefore not been able to meet as required. Within the Debt and Aid Management Division in the Ministry of Finance, there is supposed to be a unit responsible for domestic debt, but since the division's establishment in 1997, this unit has failed to take off the ground and as such Government has continued to rely on the central bank for domestic debt management.

At the Reserve Bank of Malawi, the structure for domestic debt management has evolved over time. Having operated as a division in the Research and Statistics department, in 1994/1995 the Financial Market Operations department was

established to carry out the issuance and management of domestic debt on behalf of Government and to conduct open market operations for monetary policy. Although these functions were in one department, there was still segregation of operations for fiscal and monetary policy, although they both reported to one Director.

From 2006, the debt management function was put together with the exchange control function, both being delegated functions. This has seen the separation of debt operations for fiscal and those for monetary policy as these are now in the Treasury department. Within the debt division, which comprises sections for external and domestic debt, there is a Front and Middle office. The front office is responsible for the primary issuance of domestic debt while the middle office conducts strategy and portfolio analysis and produces regular reports and statistics for the information of senior management and other stakeholders within and outside the Reserve Bank of Malawi. The back office for domestic debt operations is set in the Accounting and Finance department and their main purpose is to process settlements. Because of the way the functions are structured within the Bank, debt recording is done in the Book-Entry system by the Primary Issues section (Front office).

Figure 12 Debt Management Coordination Structure for Malawi



It should be pointed out that although the structure above is quite comprehensive, it still leaves out external stakeholders especially the civil society. Further, although Parliament is at the top of the structure, the practice does not allow for continuous engagement and interface as the process is going on to allow timely feedback of Parliament and civil society for the much needed oversight.

Civil society in Malawi has played a significant role in checking the fiscal discipline of the Government. Any relaxation in fiscal discipline could lead to a rapid resurgence in domestic debt. In this context the civil society working together with Parliament could help to control potential sources of fiscal risk which could jeopardize fiscal sustainability. This is critical for debt sustainability.

Donors also have a role to play in this process. Their role could be limited to capacity building of civil society, parliament and even the government in debt management issues. Although civil society has space to interact with government, in many cases there are significant gaps which can be covered by donors and the international community.

The Reserve Bank of Malawi Act (RBM Act) 1989 in addition to what the constitution stipulates. The RBM Act gives the mandate to the Reserve Bank to issue and manage domestic debt on behalf of Government. It also provides for the extension of an overdraft facility (Means and Ways account) to Government to smoothen daily Government operations. This facility is short term and there is a legal limit stipulating how much Government can borrow through this window - basically 20% of Government's projected annual revenue. The debt is cleared as soon as Government accumulates some deposits. Apart from the borrowing limit on the overdraft, limits have also been put on other instruments that Government uses to borrow domestically. These are stipulated in the Public Finance Management Act. Besides giving the mandate to borrow on behalf of Government, the Reserve Bank through the RBM Act is also mandated to conduct monetary policy operations with the ultimate goal of achieving price stability. The Bank therefore issues domestic debt to meet both fiscal and monetary policy requirements. The laws governing domestic borrowing are passed by Parliament.

4.3 Availability of Human Resources

As alluded to above, domestic debt is primarily being issued and managed by the Reserve Bank. Government's intention was to have an established unit to manage domestic debt within the Debt and Aid Management Division in Ministry of Finance, but not much has been achieved in this regard. Although there is fully fledged Debt and Aid management Division, its main focus has been external debt. As it is, the division is not fully staffed even for external debt operations[12]. Government intends to employ more people to beef up the unit. In terms of qualifications, most of the staff have undergone training and have participated in national debt strategy formulation and analysis workshops conducted by the Macroeconomic and Financial Institute of Eastern and Southern Africa (MEFMI). One member of staff is now an accredited Fellow of the MEFMI institute specialising in external debt management. However, due to staff mobility, there is need for continuous training as new members join the division.

In the Reserve Bank, the debt management division is basically staffed with well qualified staff in terms of basic training. However, most of the staff still need to undergo specialised training in debt management. Although the Bank has also trained a reasonable number of people in debt management, more still needs to be done more especially for new staff that have joined the division following structural changes within the Bank. Debt management being a dynamic area requires continuous training and exposure as new developments unveil in the area. Through the MEFMI fellows development programme the Bank has also trained a Fellow in the area of domestic debt strategy analysis who is currently also undergoing accreditation. Another member of staff has recently been recruited to undergo training under the Fellows development programme specialising in debt sustainability analysis. Staff movements in both the Bank and Ministry of Finance have however sometimes affected operations in these debt management offices[13].

4.4 Domestic Debt Recording and Reporting / Coordination

Recording of domestic debt is basically done by the Reserve Bank of Malawi, Debt Management Division. The Primary Issues section, which is responsible for the primary issuance (conducting auctions) is responsible for recording of domestic debt in the Book-Entry system. The current system is an IMF developed

12 Although numbers were provided, they were not fully confirmed and therefore have not been included as a review process was under way

13 It was not possible to put in exact numbers as details in some cases were not so definite. However it is factual that staff changes/transfers have in some instances affected debt management operations

system and the Reserve Bank is currently developing an in-house Book-Entry system. In addition, the Reserve Bank is in the process of initiating domestic debt in the CS-DRMS (the Commonwealth Secretariat –Debt Recording and Management System),. Currently, the CS-DRMS is being used to record external debt and is available at both the Reserve Bank and the Ministry of Finance. The Bank uses an electronic bidding system, developed in Staffware and interfaced with the Book-Entry to conduct Treasury bill auctions.

Debt data and reports are circulated to senior management and other stakeholders within the Bank for input into other economic or market analysis and for policy decisions. These reports are produced and circulated on weekly, monthly, quarterly, annually and on ad hoc basis. Similar reports are submitted to Government departments and other stakeholders like market players and the International Monetary Fund. The domestic debt unit is also a member of the monetary policy technical committee in the Bank hence are required to contribute towards monetary policy by providing the necessary data and analysis.

Although there seems to be coordination and some level of understanding between the agents interested in fiscal policy, debt management and monetary policy sometimes objectives for debt managers collide with objectives for monetary policy. For the past couple of years, open market operations in Malawi have targeted quantity (reserve money) and not cost (interest rate), this has sometimes put pressure on debt managers whose main objective has been to minimise the risk and cost of domestic debt. On the other hand, when fiscal policy has been loose this has also put pressure on monetary policy and the Bank has had to incur huge costs in sterilising the liquidity from Government operations. This is the more reason why it is important to have working committees that can moderate the interests of different parties for the well being of the whole economy.

The failure by domestic debt managers to formulate an appropriate borrowing strategy has a number of problems which include bunching of payments, which cause cash flow difficulties, a maturity profile which is short term and monetisation of debt. Once policy makers have assessed the government's fiscal sustainability, debt managers need to formulate a credible borrowing strategy. For this to happen, they need to make an accurate assessment of both the borrowing requirements for government and for monetary policy and also the

likely take-up of government securities by the market. This is also only possible when there is close coordination between the main institutions that are involved in economic policy. In the case of Malawi, there is a reasonable level of coordination but this could definitely be improved especially if the committees were active.

It is evident from the structure that the involvement of other stakeholders like Parliament and civil society is somehow in the background in as far as domestic debt is concerned. However, the Minister of Finance does provide information on domestic debt when he presents the budget although this is basically a situational or stock update. Relevant committees in Parliament like the Budget and Finance are also at liberty to make inquiries to the Minister or other authorities responsible for domestic debt at any time. Similarly, although there is no forum that updates the civil society on domestic debt developments, the door is open for them at the Ministry of Finance and at the Reserve Bank to request for information on domestic debt.

4.5 Debt Management Policy and Strategy

Malawi does not have an adopted policy to govern domestic debt operations at present. Efforts were however made in 2004 when a draft Debt and Aid Policy, which included external and domestic debt and aid, was presented to policy makers for review and adoption. This process did not fully materialise hence the policy document was not implemented although the proposed guidelines still generally guided the debt operations. Malawi is a member of the Macroeconomic and Financial Management Institute of Eastern and Southern Africa (MEFMI), a regional organisation that builds capacity in macroeconomic, financial sector and debt management. In conjunction with MEFMI and Debt Relief International, a UK NGO, Malawi has conducted several debt sustainability and strategy analysis workshops where strategies have been propose for debt management. Although these are not set in a particular adopted strategy document, the strategy recommendations made at these national workshops have been adopted. At the beginning of this year, an updated draft Debt and Aid policy was presented to senior management in Government and Cabinet has so far given its feedback. It is expected that before the end of 2009, the Debt and Aid Policy can be implemented.

5

DOMESTIC DEBT AND THE FISCAL, MONETARY AND FINANCIAL SECTOR IN MALAWI

Governments usually contract domestic debt for three main reasons: to finance the budget deficit, to implement monetary policy and to develop the financial sector. However, if borrowing becomes excessive it has undesirable effects. If the cost of servicing the debt accounts for a large part of government revenue, which it does in many countries, the scope for spending on desirable areas such as health, education, and infrastructure is correspondingly diminished. Excessive borrowing can also lead to crowding out the private sector thereby by denying them resources for investment, an increase in interest rates, inflationary if borrowing is from the central bank, higher taxation for future generations and ultimately can precipitate an economic crisis.

One of the key issues that policy makers must consider is how much domestic debt the country should contract. Policy makers must therefore not only define objectives for fiscal, monetary and financial sector development but to prioritise them according to the country's situation. To do this, one of the key assessments that policy makers have to make is the sustainability of the country's existing debt stock and also the sustainability of future debt. Debt strategy analysis is crucial as it guides debt managers and policy makers to formulate appropriate borrowing strategies. Debt managers therefore need to make an accurate assessment of both the borrowing requirements for government and for monetary policy and also the likely take-up of government securities by the market.

Analysis should be done on the fiscal situation to determine the domestic debt issuance requirement for budget financing and on the monetary sector to determine domestic debt issuance for monetary policy. The strategy should combine the fiscal and monetary requirements to determine the supply side of domestic debt. On the other hand an analysis of the financial sector vis-à-vis asset composition / holding by financial institutions, the health of the financial institutions should be analysed to determine the trends and future uptake or demand for domestic debt.

Finally, when contracting domestic debt it is important to look at the relative importance of different debt management objectives – fiscal financing, liquidity management or financial market development by addressing the following[14]:

- Are there other tools available to achieve the same goals?
- In the case of excess supply and demand, is the excess supply or demand important enough to destabilize interest rates?
- Are the fiscal and monetary needs vital?
- Are there no other ways to finance or reduce the deficit?
- Is it necessary to absorb all excess liquidity?

In the case of an imbalance by maturity or instrument type, you need to ask whether the excess supply or demand for the instrument is important enough to destabilize the market or undermine the instrument

5.1 Fiscal Analysis

For the fiscal perspective, domestic debt means all Government domestic borrowing including explicit or implicit contingent liabilities, which have or could impact on the budget. Instruments include Treasury bonds and bills, promissory notes, arrears to suppliers or employees of any significant duration, debts resulting from reforms of pension systems or financial sector, Government overdrafts with the Central Bank and on-lent or guaranteed debts.

The main purpose for debt issuance by Government is for fiscal stabilization. Government will therefore mainly issue debt to finance the budget deficit. The question to ask however is how far to stabilize. Literature suggests a 3% deficit growth and most countries in the HIPC have exceeded this threshold. Fiscal stabilization is measured by deficit to GDP, including grants.

The preferred type of debt for fiscal largely depends on risks, therefore:
- Long-term debt is preferred to reduce rollover risk
- Fixed interest debt is preferred to reduce interest risk
- Debt in local currency to avoid exchange rate risk

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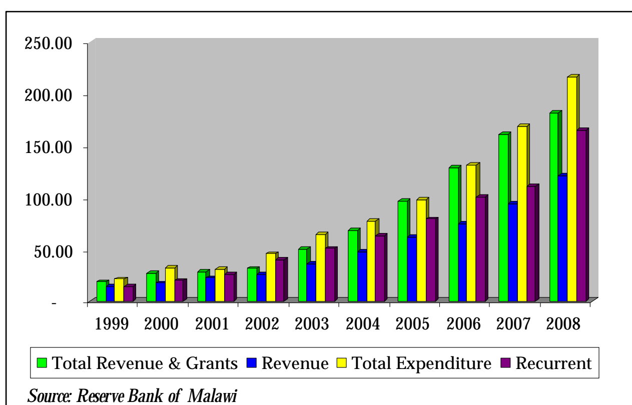
14 Debt Relief International Distance Learning Programme study material

5.1.1 Recent Trends

From Figure 13 below, it is clear that both revenues and expenditures have grown significantly in the period 1999 – 2008 in Malawi. Total expenditures have grown by almost 900% while domestic revenues grew at a slightly lower rate of 763%. Grants have also continued to grow at an accelerated rate over this period. This increase in grants has clearly improved Government's position as it has led to a significant improvement in the fiscal balances.

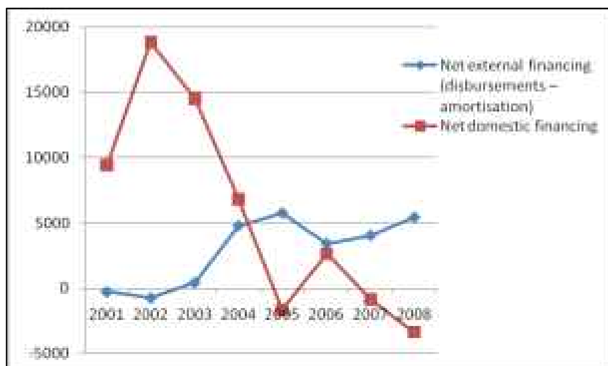
Figure 13 Malawi Budget Operations 1999 –2008 (MK'Millions)



Source: Reserve Bank of Malawi

Net external financing which increased at the beginning of the period declined after 2006. This is the period when Malawi reached the HIPC completion point. From 2007 however, there was an increase in net external financing. Net domestic financing which initially was on the increase up to 2002, started declining in 2003 and came down from K16.7 billion in 2003 to K4.7 billion in 2005. Net domestic financing inched up again in 2008 to K3.7 billion. (Figure 14)

Figure 14: Net External and Net Domestic Financing (MK Million)

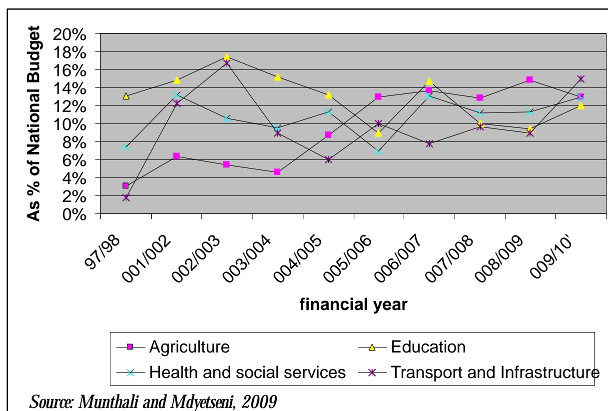


Source: Reserve Bank of Malawi

5.1.2 Main Budget Variables as Percentage of GDP

Domestic revenue has been increasing in line with GDP growth with a slight decline in 2004. Revenue grew from 26.7% to 32.7% of GDP by 2008. Grants have significantly increased as a % of GDP as a result of improved macroeconomic and fiscal management, which has led to a return of donor confidence. Grants have gone up from 4.5% in 2000 to 12% of GDP in 2008. Since 2004, recurrent and capital expenditures have increased, both as a % of GDP and national budget, signifying more spending for poverty reduction and infrastructure development. Total expenditure grew from 31.1% to 39% of GDP during the period.

Figure 15 Expenditure per Sector as % of National Budget



Source: Munthali and Mdyetseni, 2009

The developments in revenues and expenditures have resulted in an increasing overall deficit before grants. This is because expenditures have grown at a higher rate than revenues. The overall deficit after grants has however significantly gone down due to an increase in grants only to go up again in 2008. Net domestic financing, which shot up in 2002, has since been on a declining trend despite inching up in 2008 while net external financing which had gone down between 2002 and 2006 picked up again in 2007. This implies reduced domestic borrowing as the deficit has primarily been reduced by the increasing grants. Domestic interest payments increased in line with an increase in net domestic financing up to 2003 (the lag effect of debt issuance and debt service) and has since declined in line with a reduction in net domestic financing.

Table 4: Main Budget Variables for Malawi as a % GDP

	2000	2001	2002	2003	2004	2005	2006	2007	2008
Revenue	26.7	23.1	21.7	30.7	24.1	29.7	32.6	34.6	32.7
Grants	4.5	8.0	3.8	3.3	5.0	6.3	8.7	11.7	12.0
Expenditure	31.1	25.5	31.1	39.2	27.2	30.1	33.1	36.3	39.0
Deficit Before Grants	-13.9	- 7.0	- 13.1	- 17.2	- 10.3	- 11.0	- 14.2	- 16.0	- 17.2
Deficit After Grants	- 4.3	- 2.4	- 9.5	- 8.5	- 3.1	- 0.4	- 0.5	- 1.7	- 6.3
Net Foreign financing	4.3	2.3	- 0.1	-0.5	0.3	- 0.3	- 0.3	1.1	1.3
Net Domestic Financing	2.2	2.1	11.3	7.4	3.0	2.1	- 0.2	1.1	4.3

Source: Reserve Bank of Malawi

5.2 Monetary Analysis

The Monetary perspective includes all debt used to execute monetary policy and is typically limited to short-term bills issued by the Treasury or Central Bank. The main objective of issuing debt for monetary purposes is to reduce excess liquidity and lower inflation. To manage liquidity actively, the monetary authorities issue short-term debt. This may however bring tensions with financial sector development objectives. In the case of Malawi, there is still a very high concentration of short-term debt and the high interest rates that resulted pre 2006 has made it difficult to issue long term securities e.g. bonds. Debt is also issued to establish benchmarks for interest rates.

General indicators of monetary policy success are: Inflation, growth of money supply, ratio of deposits to money supply, ratio of excess reserves. Indicators of efficiency of monetary debt issuance in reducing excess liquidity are:

- Ratio of debt for monetary policy / excess reserves
- Ratio of debt for monetary policy / net credit to the economy
- Ratio of debt for monetary policy / net domestic assets (Source of theoretical underpinning).

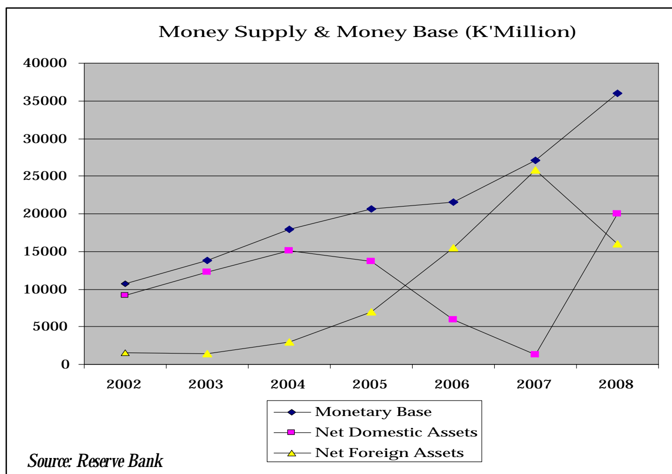
If the ratios are high it implies effective mopping up. Since there are no internationally set thresholds, it's important to determine whether you will continue mopping up or act on other causes of inflation to promote growth.

5.2.1 Recent Trends

Monetary policy in Malawi is conducted using indirect instruments. The Reserve Bank conducts open market operations by injecting or mopping liquidity through the buying and selling of securities in the market respectively. The liquidity reserve requirement is also used to control money supply by controlling assets of commercial banks. The discount window is also used though sparingly.

The practice in the conduct of open market operations in Malawi has generally been to target the quantity of reserves while allowing the interest rate to be market determined. The main reason being that the markets in Malawi are just developing hence the secondary markets are inefficient to be used for the transmission of monetary policy. The other reason is that in Malawi controlling inflation is an overriding goal. However, although the policy has been to control quantity, there has been some intervention by the Reserve Bank to ensure that interest rates remain stable.

Figure 16 Money Supply and Money Base 2002-2008



Source: Reserve Bank

Excess reserves in both nominal and as a % of GDP generally grew between 2002 and 2008 with the highest growths in 2004 and 2003 at 26.1% and 25.6% of GDP respectively. The loosening of fiscal policy during this period, pumped in a lot of liquidity in the system. In terms of annual growth in excess reserves, it was highest between 2001 and 2002 at 67%. This is explained by the fact that in 2001, the IMF programme was suspended in Malawi mainly because of expansionary fiscal policy, which obviously led to the rapid growth in excess reserves. The increase in excess reserves was mainly from an increase in net credit to government and statutory corporations, which grew rapidly between 2001 and 2004 and in turn caused the monetary base hence excess reserves to grow. The growth in excess reserves is being attributed to the growth in NDA because currency in circulation and required reserves grew at fairly stable and reserved rates during this time. From 2005 however, the growth was mainly from net foreign assets (NFA) up to 2007. The growth in NFA was due to an increase in grants. In 2008, the trend changed with NFA on a decline and net domestic assets increasing from an accumulation of Treasury bills.

Table 5: Monetary Developments

	Dec - 02	Dec - 03	Dec - 04	Dec - 05	Dec - 06	Dec - 07	Dec - 08
Net foreign assets	4,287.9	5,921.0	9,998.7	11,382.5	23,199.7	27,726.4	19,328.8
Annual growth rate		38.1	68.9	13.8	103.8	19.5	- 30.3
Net domestic assets	28,134.7	36,949.9	46,567.7	54,373.6	53,424.3	77,153.3	120,314.5
Annual growth rate		31.3	26.0	16. 8	- 1.7	44.4	55.9
Net domestic credit	26,884.6	33,089.0	44,624.4	50,850.2	58,740.7	72,115.1	158,042.4
Annual growth rate		23.1	34.9	14.0	15.5	22.8	119.2
Other assets (net)	1,250.1	3,860.9	1,943.3	3,523.4	- 5,316.3	5,038.2	- 37,727.9
An nual growth rate		208.9	- 49.7	81.3	- 250.9	- 194.8	- 848.8
Broad Money balances	32,422.7	42,870.9	56,566.4	65,756.1	76,624.0	104,879.8	139,643.3
Annual growth rate		32.2	31.9	16.2	16.5	36.9	33.1
Reserve Money	10,681.5	13,742.9	17,967.5	20,610.6	21,522.3	27,057.7	36,047.4
Annual growth rate		28.7	30.7	14.7	4.4	25.7	33.2
Broad money multiplier		3.1	3.1	3.2	3.6	3.9	3.9

Source: Reserve Bank

To mitigate the growth in excess reserves, government initially used to issue Treasury Bills, however the Reserve Bank Bill was introduced in 2003 to ensure a separation between deficit financing bills and those for monetary policy. OMO however grew as the issuance of RBM bills grew from MK2.9 billion in 2003 to MK5.7 billion in 2005. However, RBM bills as a % of excess reserves was only 7.1%, 9.5% and 10.3% in 2003, 2004 and 2005 respectively. The stock of RBM bills has however significantly declined after 2006 and the Treasury bills is yet again being used to supplement OMO hence the increase holding of treasury bills by the Reserve Bank. Therefore, although open market operations have grown over the period, they still have not been sufficient to absorb excess reserves. This is vindicated by the fact that money supply (M2) grew at very high rates after 2006.

5.3 Financial Sector Analysis

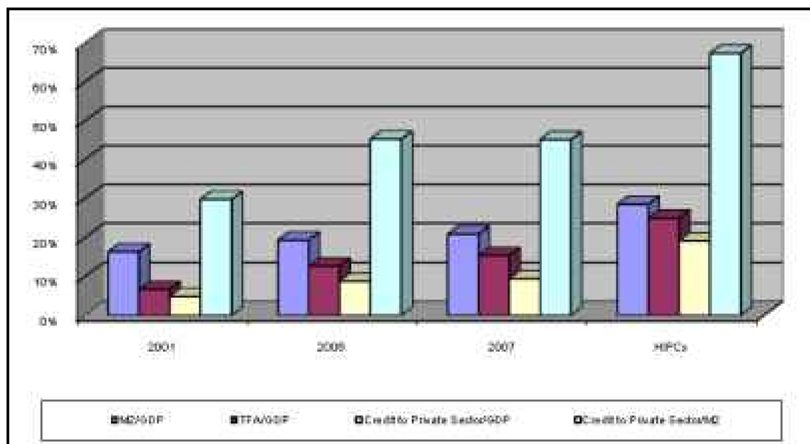
The main objective of issuing debt for financial sector development is to promote the depth and health of the financial sector. The target for financial

sector development therefore is to increase domestic savings and investment, which are essential for long-term growth. The financial sector will therefore promote the level and nature of intermediation in an economy and the diversity of players and instruments in the financial markets.

5.3.1 Recent Trends

The general trend in the financial sector development ratios for Malawi is that of an improving financial sector. The M2/GDP, total financial assets (TFA)/GDP, credit to private sector (CPS) /GDP and CPS/M2 have all increased between 2001 and 2007 as shown in the Chart below. This growth has come from developments in the financial sector as broad money; financial assets and credit to the private sector have all grown by much higher margins of 331%, 457% and 558% between 2001 and 2007 compared to a GDP growth of 275% during this period. The higher growth in credit to the private sector has also led to a larger increase in the Credit to private sector/GDP ratio. This shows that there has been an improvement in financial intermediation in a more commercial manner as opposed to lending to government while the slight increase in theM2/GDP ratio shows that there has been marginal change in Malawi's monetisation. The increase in the Financial Assets/GDP ratio is an indication of an increased holding of government securities, an increased loan portfolio and also an increase in the number of other financial institutions.

Figure 17: Scale of Intermediation / Financial Depth Indicators



Source: Reserve Bank of Malawi and Debt Relief International

Despite the positive developments in the financial sector development ratios, Malawi's financial system still lacks depth. Total financial assets, which has grown from 7% to 15% of GDP is still very highly concentrated and well below the average of 24.9% for the HIPCs[15]. Malawi's monetisation as measured by broad money relative to GDP is also not comparable with its peers in the HIPC either as it remains low at 21% compared to 28.5% for HIPCs. This low ratio shows that deposits and savings have not significantly grown in Malawi resulting in the fairly low ratio. Large domestic borrowing by government has crowded out the private sector in Malawi hence credit to the private sector at 9% in 2007 although increasing is still also very low even by the already weak standards in HIPC countries at 19.2%. Another hindrance to financial intermediation in Malawi has been the negative real interest rates on deposits, and the lending rates that in real terms have been too high compared to other HIPCs and the region.

Credit to the private sector in relation to broad money has improved from 30% in 2001 to 45% in 2007 then to 49% in 2008. Of course this is still much lower than the HIPC ratio at 67.4%. The implication of this for Malawi however is that the commercial banks willingness to conduct intermediation remains fairly low hence their appetite to invest in securities still very high as the tendency is to accumulate reserves. The ratio needs to increase so that most of the domestic debt is absorbed by the non-bank sector.

The recent trends in financial sector development ratios for Malawi indicate that the financial system lacks depth even by the already low peer standards. If the country is to become more developed, a few things need to change both in the medium and long term:

First and foremost, fiscal consolidation needs to be enhanced to ensure that government does not crowd out the private sector and therefore allow for credit expansion. Creditor rights also need to be enforced and information on borrowers made available to reduce risk in lending. The reduction in Liquidity Reserve Requirement (LRR), which has already started also needs to continue until it gets to a regionally acceptable level as this will release resources for lending out and also reduce the cost of holding these unremunerated funds by commercial banks. Malawi must therefore adopt structural measures to lower down intermediation costs by strengthening the regulatory and legislative framework and also increasing competition in the banking sector and lowering

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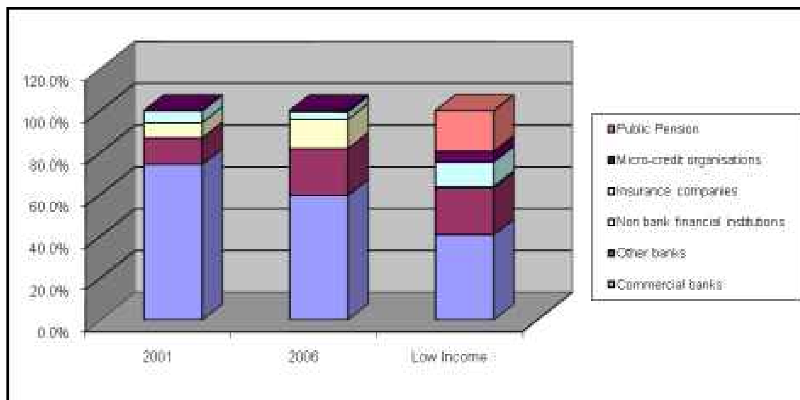
15 The HIPCs - Highly Indebted Poor Countries is an initiative that was set by the Bretton Woods Institutions (BWI's) to provide debt relief to poor and heavily indebted countries. Malawi qualified for the initiative in 2000 but it was not until 2006 when the full debt relief was effected.

Note: The average for HIPC is from World Bank WDI 2001 study by Asli Demirguc-Kunt & Ross Levine

lending risk. To this end the IMF carried out a Financial Sector Assessment Programme (FSAP) in 2006 and some of the recommendations have already been implemented (see Appendix 4 for the list of key FSAP recommendations). For meaningful and effective development of the financial sector, all recommendations need to be adopted timely.

In terms of structure of the financial Sector, it is dominated by commercial banks despite the introduction of other financial institutions - this is reflected in the holding of financial assets. Commercial banks still command the largest holding at 59% of total assets in 2006 down from 74% in 2001. On the other hand, other banks, non-bank financial institutions and the micro-finance sectors all registered a rise in the holding of financial assets between 2001 and 2006. The trend has not changed much though there was a slight decline in the holding by commercial banks to 47.7% and an increase in the non-bank to 18% (Annex 3). This development is very good for the market as it reflects competition in the financial market. The general improvement in the macroeconomic conditions is providing an able environment for positive change in the financial sector.

Figure 18: Share of Total Financial Assets in Malawi 2001 and 2006 and Low Income Countries 2004 (By Type of Institution)



Source: Reserve bank of Malawi and Debt Relief International Booklet

6

DOMESTIC DEBT SUSTAINABILITY

There are several theories and methodologies that are used to assess domestic debt sustainability. One approach analyses the public sector's balance sheet by listing its assets and liabilities and calculating the present value of future revenues and expenditures and on this basis estimate the government's net worth[16]. If it is negative then debt is unsustainable and fiscal adjustment is necessary.

Another approach looks at whether a particular fiscal policy would result in a stock of debt that is stable or would grow to unsupportable level (Debt/GDP). This theory says that the sustainability of debt is a function of the primary deficit, the real interest rate and the growth rate of the economy. Specifically it says that the debt to GDP ratio will be on a rising trend if the real rate of interest exceeds the growth rate unless this is offset by a primary balance (Blanchard approach to Debt/GDP, reference). If the Debt/GDP ratio is on a rising trend from an initial position that is sustainable, then fiscal policy must be adjusted otherwise there will be a crisis. This approach assumes that debt is never too high but depends critically on other factors, particularly the growth rate. This means that a Debt/GDP ratio of say 75 percent, maybe unsustainable in a country that is growing relatively slowly but manageable in a country that is growing rapidly.

There is also the HIPC Capacity Building programme (CBP) methodology, developed by Debt Relief International (DRI), an international UK-based non-governmental organisation involved in building capacity in debt management. The methodology aims at balancing the demand and supply of domestic debt by assessing the requirements for debt issuance for fiscal and monetary policy and the likely take up by the financial sector. These two are then balanced by prioritising debt issuance or market development needs and also taking into consideration the implications of demand and supply on interest rates. Debt Pro, an econometric software developed by the World Bank is used to calculate sustainability ratios.

Unlike external debt, there are still no internationally agreed thresholds for assessing domestic debt sustainability. However, the Debt Relief International

16 The balance sheet approach is explained in Appendix 1 of the Commonwealth secretariat publication entitled Effective Domestic Debt management in Developing Countries

(DRI) conducted a study and came up with thresholds that have been used for assessing domestic debt sustainability in the highly indebted poor (HIPIC) countries (provide reference of the study). The key indicators that are used to evaluate a country's domestic debt sustainability are solvency or liquidity ratios and these are:

- Debt or present value of debt to GDP; Debt to domestic budget revenue (DBR);
- Total debt service (TDS) to domestic budget revenue; Interest to domestic budget revenue;

The study indicated that countries experience the accumulation of domestic debt arrears when the ratio of the net present value (NPV) of domestic debt to domestic budget revenue is greater than 88 percent and the ratio of the domestic debt service to budget revenue is above 28 percent.

The Breton Woods institutions (BWI) have also recently developed a debt sustainability framework for low income countries (DSF) to assess the sustainability of total debt. The threshold for domestic debt sustainability is 15% - 20% of Debt to GDP. According to the BWI, when domestic debt levels are rising and exceed this threshold then the country is at the risk of debt distress. In 2007, domestic debt in Malawi was sustainable at 11.9% of GDP and although it had gone up to 16.7%,[17] it is still within the BWI's threshold of 15% – 20%. (Source: IMF Country Report)

In 2008, a national debt sustainability and strategy analysis (DSA) workshop was conducted and domestic debt was found to be sustainable but bordering on unsustainability at 20% as of December 2007.[18]

17 The Debt to GDP ratios reported here are as per IMF Country report. They are slightly different from the ratios calculated during the National DSA although they mean the same thing in as far as sustainability is concerned i.e within the 15-20% threshold

18 The last National Debt Strategy Workshop was done in 2008 looking at 2007 data. Another workshop will be conducted in December 2009 to review the position as at end 2008

Table 6: Domestic Debt Sustainability Ratios – Dec 2007

Ratio	Threshold %	DSA Results
Solvency		
BWI – DSF		
Debt/GDP	15 – 20	20
Debt/DBR	88	100
Debt/Exp		
Liquidity		
TDS/DBR	28	94.6
TDS/DBR (excl. Tbs)		8.2
Int/DBR	4 – 6	8.2

Source: Reserve Bank, Calculations of the Malawi DSA

The Debt Sustainability results shown in Table 6 above also show that domestic debt and domestic interest payments were consuming a large share of domestic revenue as the ratios were outside the 88% and 6% thresholds. It is recommended that developments in domestic debt be monitored closely to ensure that debt does not slip back to being unsustainable.

7

SUMMARY AND POLICY RECOMMENDATIONS

In summary, this research set out to examine the linkage between domestic debt and development financing, regulatory and institutional framework and the role of key stakeholders in the management of domestic debt. The study has therefore reviewed Malawi's domestic debt through the lenses of economic development, fiscal policy, monetary policy stabilisation, financial sector development and debt sustainability and also the legal and institutional framework for domestic debt management. The structure of domestic debt has been reviewed by analysing the evolution, composition, debt by sector and debt sustainability. The growth in domestic debt since 2001 clearly indicates that it can not be ignored as it has implications for macroeconomic management and ultimately economic growth. This research has also shown that apart from passing legislation governing domestic debt management, especially powers to borrow and limits, Parliament's role is very limited or obscure. The same is true for Civil Society Organisations as the structure does not provide for a clear role for them. Although Government has put in place the framework to manage domestic debt, it is clear that more needs to be done to improve on the current set up and below are some recommendations for adoption in order to improve domestic debt management in Malawi.

It is recommended that Government should continue exercising fiscal prudence in the central government budgetary operations as this has already started to yield benefits in the economy.

Government should improve the environment in the financial sector by continuing with macroeconomic stability reforms and minimising on short-term securities so investors are left with no choice but investing long. Since the macroeconomic environment is more stable than it was in 2001, investors are likely to go for Treasury Notes/ Bonds now than they were in 2001. This is evidenced by more holding of the 273-day TB tenor in the period after 2004.

Government should set an umbrella ceiling on domestic borrowing for a chosen period of time and this should be embedded in the national debt strategy. The limits should be reviewed periodically (annually) to ensure that they are still meaningful in the current economic circumstances. Mechanisms should be put in place to monitor the impact of new borrowing on overall debt sustainability based on the evolution of the debt indicators and provide prompt fiscal rectification.

The fiscal analysis has shown that negative changes in revenues, expenditures and grants can adversely affect government's debt sustainability. The level of domestic debt created through fiscal operations has implications for interest rates especially when there is no adequate demand for the debt. Formulators of fiscal policy should therefore be mindful of the impact of their decisions on the level of domestic debt that needs to be issued. Resources that should otherwise be used to uplift the lives of Malawians through social and development spending should not unnecessarily be used to service debt. Government must therefore ensure that fiscal policy is sustainable as this will translate to a sustainable level of domestic financing.

In the monetary sector, net domestic and foreign assets which impact on the monetary base and developments in money supply e.g. currency in circulation affect the level of excess reserves which may require that debt be issued. Similarly, if the market absorbance is low this also has implications for interest rates. It is therefore important that accurate projections on excess reserves are made to avoid denying the market much needed liquidity which should be used for financial deepening and the development of a secondary market which in turn will make monetary policy implementation more efficient and effective.

The financial sector analysis has shown improvements in the deepening and intermediation levels in the financial sector in Malawi although the country still lags behind its peers in the HIPC and low income countries. The development needs to be encouraged with deliberate policies (e.g. FSAP recommendations) that will attract more players, improving on the diversification of institutions and financial assets. Government should also create an environment and policies that encourage growth in credit to the private sector in relation to broad money e.g. engaging financial institutions to look at constraints to credit provision; providing incentives to institutions that are willing to provide credit. Developing the

financial market improves the capacity to absorb new debt and also helps to keep the level of interest rates low as there is a balance in demand and supply.

A debt issuance calendar should be issued at the beginning of the year to enable financial institutions plan properly and to minimise rollover and interest rate risk. The authorities should also consult the market on their portfolio needs to ensure full uptake during auctions. Regarding the portfolio structure, the process of lengthening the maturity profile should be initiated by reducing the T-bill issues and issuing some long term bonds. This should be feasible in a stable macroeconomic environment where interest rates are also low as is the case for Malawi now. Such restructuring will require further reduction of the bank rate as macroeconomic developments conducive to such policy move prevail. This will help that maturities should not be bunched but instead you have a smooth maturity

Regarding the institutional set up, the arrangement would be suitable as long as the domestic debt management office (currently at the Reserve bank) is able to carry out its mandate in a professional manner without interference. It is also advisable that Government commits to operationalize the domestic debt unit within the Debt and Aid division to improve on coordination between the Ministry of Finance and the Reserve Bank. Within the Reserve Bank, debt operations relating to the fiscal sector should be clearly separated from operations for monetary policy to ensure that debt management objectives for these sectors do not override each other. The committees that have been set to provide direction in debt management should be activated. Although the debt management framework provides for the existence of these committees, not much had been done by them so far. If they became active, it would also help in improving coordination and information transfer between agencies responsible for debt management and hence easy monitoring of domestic debt levels.

The role of Parliament and Civil Society organisations should be made clear and Government as a sign of being accountable should provide a forum for disseminating information on domestic debt. An annual report should be produced and shared with these stakeholders and discussed at the forum. The annual report can also be made available through the websites of the Reserve bank and the Ministry of Finance. This process will ensure that there is accountability and it will also allow for these organisations to perform their

oversight role effectively. Since these organisations have not been so actively involved in domestic debt management in the past, international organisations could also help in building capacity so that stakeholders are able to interpret the report and provide good feedback to the debt mangers.

Donors must be encouraged to play a part in supporting the strengthening the debt management processes by supporting capacity building of civil society and parliament by providing both technical and financial resources. Civil society on the other hand should be encouraged to play a greater role in debt management.

While there are clear procedures for issuing and managing domestic debt, there is dire need to have the Debt and Aid Management policy adopted by Government. This policy would provide the framework for debt management - timely transactions and controls. Similarly, a written strategy should be drawn and this should form a basis for debt management operations. Both the policy and the strategy should have a timeframe for renewal. The legal and regulatory framework currently in place is sufficient to guide debt management operations. While external borrowing allows for the active involvement of the National Assembly, the case is not the same for domestic debt despite the implications being the same. It is recommended therefore that domestic borrowing should be subjected to civil society and parliamentary oversight and these institutions must ensure that debt management operations are being done within the premise of the law i.e. borrowing limits are being abided to and for the right purpose. The agencies responsible for domestic debt management should also make debt data timely available for public scrutiny through publication in both print and electronic media for transparency and accountability.

The institutions responsible for domestic debt management should ensure that updated data/ information should be put on the website

Since there are still no internationally agreed thresholds for assessing domestic debt sustainability, it is important that the BWI should work together with other research institutions and come up with thresholds that can be used to determine sustainability.

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List of CSO's Visited

Malawi Economic Justice Network (Network of CSOs)

ANNEXES

Annex 1: Methodology

To establish the linkage between domestic debt and economic development, a review of literature was done and this looked at theoretical and empirical studies that have been conducted on the topic particularly with regard to African economies. This also paid particular attention to other studies and reports that have been done on domestic debt in Malawi. Data on domestic debt was then collected mainly from the Reserve Bank to help in the portfolio review. Interviews with the Debt and Aid unit in the Ministry of Finance, members of the domestic debt division in the Reserve Bank, members of the civil society were also conducted. It was not possible to hold interviews with parliamentary committees because the study was being done at a time when Malawi was conducting its Presidential and Parliamentary elections hence parliamentary committees had not been formed. Interviews were also done with financial sector institutions.

Annex 2: Key Issues Covered in the study

Linkage between domestic debt and economic development particularly with regard to use of domestic debt in the economy (deficit finance, monetary policy and development financing.
Governance of the fiscal policy in addressing revenues and expenditure of the government over a period of ten years from 2000 with focus on the stability of the revenues and deficit financing
Structure of domestic debt paying with emphasis on:
The composition of domestic debt
Main sectors for domestic debt expenditure
Domestic debt servicing as a percentage of the GDP and revenues
The main creditors and their characteristics.

Existence of a national debt management strategy and debt policy and how it addresses the domestic debt in the debt management framework. And an

assessment of extent to which the loans are contracted within the framework of the overall debt strategy

The legal framework and institutional structure for domestic debt contraction

Extent of domestic debt management coordination activities between the ministry of finance and the central bank departments

The systems and procedures for recording, reporting and dissemination of domestic debt information to senior policy makers and stakeholders particularly non state actors such as parliament and CSOs. Also the legal requirements for transparency and accountability

The role of the government in the quasi debt management and how the central bank and government coordinate with each other on this aspect within the context of the national debt strategy

The role of the government in the quasi debt management and how the central bank and government coordinate with each other on this aspect within the context of the national debt strategy

The resources available to the domestic debt management team including the quantity of staff, their skill levels, and technological resources for managing the debt stock and new debt issuance on a professional basis

The nature of the relationship between different policy instruments in the ministry of finance and central bank's framework for domestic debt acquisition , focusing closely on how debt managers, fiscal policy advisers, and central bankers share an understanding of the objectives of debt management, fiscal, and monetary policies

Extent of harmonization of institutional responsibilities and how these are coordinated across front and back office functions, across local-currency and foreign-currency debt, and across agencies

The role of stakeholders in domestic debt management:
Parliament
Civil society organizations
International financial institutions

Actionable policy recommendations in improving the following aspect of domestic debt management:
Legal and regulatory framework
Systemic and procedures for domestic debt management
Coordination in domestic debt management across the agencies
Transparency and accountability in domestic use

Annex 3: Summary of Central Government Operations (K' bn)

	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
Total Revenue & Grants	19.13	27.64	28.51	31.98	50.58	68.77	97.02	129.26	160.82	181.31
Total Expenditure	21.66	32.12	31.49	45.92	64.66	77.74	98.30	131.11	168.64	216.25
Recurrent	15.00	20.45	26.13	39.84	51.03	63.30	79.51	100.84	110.38	164.50
Capital	6.66	11.68	4.32	6.09	13.64	14.44	18.79	30.27	58.26	51.75
Net Lending	-	-	1.05							
Deficit Before Grants	(7.21)	(14.35)	(8.64)	(19.41)	(28.31)	(29.40)	(35.85)	(56.17)	(74.22)	(95.44)
Deficit After Grants	(2.53)	(4.48)	(2.98)	(13.95)	(14.08)	(8.97)	(1.28)	(1.84)	(7.82)	(34.94)
Total Financing	3.85	6.67	5.35	16.47	11.44	9.28	6.04	(1.97)	10.26	31.24
Foreign	2.35	4.43	2.78	(0.22)	(0.76)	0.77	(0.85)	(1.18)	5.22	7.35
Domestic	1.50	2.23	2.57	16.68	12.20	8.51	6.90	(0.79)	5.04	23.89
Errors & Omissions	(1.33)	(2.18)	(2.37)	(2.52)	2.64	(0.31)	(4.76)	3.82	(2.44)	3.70

Annex 4: Monetary Developments, Dec 02-Dec 08 (MK'000)

-	Dec-02 -	Dec-03 -	Dec-04 -	Dec-05 -	Dec-06 -	Dec-07 -	Dec-08 -
Net foreign assets	4,287.9	5,921.0	9,998.7	11,382.5	23,199.7	27,726.4	19,328.8
Annual growth rate		38.1	68.9	13.8	103.8	19.5	-30.3
Monthly growth rate	-24.3	-11.6	39.3	24.4	0.5	57.1	177.8
On end December balances		38.1	68.9	13.8	103.8	19.5	30.3
Net domestic assets	28,134.7	36,949.9	46,567.7	54,373.6	53,424.3	77,153.3	120,314.5
Annual growth rate		31.3	26.0	16.8	-1.7	44.4	55.9
Monthly growth rate		6.3	1.7	-3.1	-2.7	-11.6	-14.1
On end December balances		166.7	26.0	16.8	-1.7	44.4	55.9
Net domestic credit	26,884.6	33,089.0	44,624.4	50,850.2	58,740.7	72,115.1	158,042.4
Annual growth rate		23.1	34.9	14.0	15.5	22.8	119.2
Monthly growth rate	4.8	3.6	4.5	-8.5	-2.2	-11.5	-11.1
On end December balances		23.1	34.9	14.0	15.5	22.8	119.2
Other assets (net)	1,250.1	3,860.9	1,943.3	3,523.4	-5,316.3	5,038.2	-37,727.9
Annual growth rate		208.9	-49.7	81.3	-250.9	-194.8	-848.8
Monthly growth rate	3,822.3	37.1	-37.0	515.6	3.2	-13.0	-0.2
On end December balances		208.9	-49.7	81.3	-250.9	-194.8	-848.8
Broad Money balances	32,422.7	42,870.9	56,566.4	65,756.1	76,624.0	104,879.8	139,643.3
Annual growth rate		32.2	31.9	16.2	16.5	36.9	33.1
Monthly growth rate	3.5	3.4	6.8	0.8	-1.8	0.0	-5.0
On end December balances		32.2	31.9	16.2	16.5	36.9	33.1
Reserve Money	10,681.5	13,742.9	17,967.5	20,610.6	21,522.3	27,057.7	36,047.4
Annual growth rate		28.7	30.7	14.7	4.4	25.7	33.2
Monthly growth rate		6.0	-2.1	-12.1	-17.2	-13.5	-15.1
On end December balances		28.7	30.7	14.7	4.4	25.7	33.2
Broad money multiplier		3.1	3.1	3.2	3.6	3.9	3.9

Annex 5 Table : Holding of Financial Assets by Institution

	2001	2002	2003	2004	2005	2006	2007
Commercial Banks	77.4	54.4	49.2	54.5	50.6	48.7	47.7
Other Banks	7.2	5.5	8.6	6.9	10.8	11.4	12.8
Non Bank Fin Inst	6.7	15.4	17.5	18.3	16.6	17.4	18.0
Insurance/Pension	5.3	4.5	7.1	9.1	13.1	11.6	7.1
Other	3.3	20.2	17.6	11.1	8.8	10.9	14.3
Total	100	100	100	100	100	100	100

Source: Reserve Bank of Malawi

Annex 6: Key Financial Sector Analysis Programme (FSAP) recommendations

Financial sector legislation
Major push for passage of outstanding financial sector bills is needed

Banking system
Divest MSB to a strategic partner

Outreach
Move government out of active provision of retail financial services
Move the wholesale RTGS system to the RBM
Create regulatory framework for outsourcing to agents of cash handling, account opening, and risk-based KYC
Sell retail payment system to the banking sector at a realistic price
Write down and sell Malswitch to the banking sector to allow more space for a cheaper, interoperable system
Pension sector
Create supervisory framework for the private pension sector
Reassess the affordability of the public pension scheme and, review retirement age, accrual rate, and indexation mechanism
Bank regulation and supervision
In order to enhance accountability of the supervisor and clarity of the market, leave issuing and withdrawal of licenses exclusively to the RBM
Strengthen the way off-site supervision supports on-site supervision including through stress testing
Use remedial powers such as enforcement actions and avoid supervisory forbearance
Contractual and information frameworks
Create a framework for the functioning of credit reference bureaus
Facilitate sale of foreclosed property
Delegate the power of Minister of Lands / Chief Commissioner of Lands to approve transfer or mortgage property
Monetary operations and instruments
Introduce an interest rate corridor by creating a deposit facility and ensuring that the standing facility is always open so that banks are able to manage their excess reserves
Phase out RBM bills and instead use T-bills as a monetary policy instrument
Eliminate the exemption from LRR of foreign currency deposits
Foreign exchange market
Implement transparent exchange regime
Enhance competition by lifting restrictions in foreign exchange guidelines that currently create a minimum spread and lifting exchange surrender requirements
Reduce vulnerabilities by imposing stricter limits short-term non-resident positions in the T-bill market (hot money)
Maintain the foreign exchange bureaus, but create a clearer reporting framework for their compliance with foreign exchange regulations
RBM
Review the cost of the RBM, including the coin and bank note structure, staffing, and premises
Recapitalize the RBM to ensure a sustainable income position.

Source: FSAP, 2006

About AFRODAD

AFRODAD Vision

AFRODAD aspires for an equitable and sustainable development process leading to a prosperous Africa.

AFRODAD Mission

To secure policies that will redress the African debt crisis based on a human rights value system.

AFRODAD Objectives include the following:

1. To enhance efficient and effective management and use of resources by African governments;
2. To secure a paradigm shift in the international socio-economic and political world order to a development processthat addresses the needs and aspirations of the majority of the people in the world.
3. To facilitate dialogue between civil society and governments on issues related to Debt and development in Africa and elsewhere.

From the vision and the mission statements and from our objectives, it is clear that the Debt crisis, apart from being apolitical, economic and structural issue, has an intrinsic link to human rights. This forms the guiding philosophy for ourwork on Debt and the need to have African external debts cancelled for poverty eradication and attainment of social andeconomic justice. Furthermore, the principle of equity must of necessity apply and in this regard, responsibility ofcreditors and debtors in the debt crisis should be acknowledged and assumed by the parties. When this is not done, it isa reflection of failure of governance mechanisms at the global level that protect the interests of the weaker nations. TheTransparent Arbitration mechanism proposed by AFRODAD as one way of dealing with the debt crisis finds a fundamen-tal basis in this respect.

AFRODAD aspires for an African and global society that is just (equal access to and fair distribution of resources),respects human rights and promotes popular participation as a fundamental right of citizens (Arusha Declaration of1980). In this light,African society should have the space in the global development arena to generate its own solutions,uphold good values that ensure that its development process is owned and driven by its people and not dominated bymarkets/profits and international financial institutions.

AFRODAD is governed by a Board of seven people from the five regions of Africa, namely East, Central, West, Southernand the North. The Board meets twice a year. The Secretariat, based in Harare, Zimbabwe, has a staff compliment of Seven programme and five support staff.

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