

The PRGF and Fiscal Space in Malawi



A Research Commissioned by AFRODAD

**African Forum and Network
on Debt and Development**

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 process that 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 a political, economic and structural issue, has an intrinsic link to human rights. This forms the guiding philosophy for our work on Debt and the need to have African external debts cancelled for poverty eradication and attainment of social and economic justice. Furthermore, the principle of equity must of necessity apply and in this regard, responsibility of creditors and debtors in the debt crisis should be acknowledged and assumed by the parties. When this is not done, it is a reflection of failure of governance mechanisms at the global level that protect the interests of the weaker nations. The Transparent Arbitration mechanism proposed by AFRODAD as one way of dealing with the debt crisis finds a fundamental basis in this respect.

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Preface

The impact of fiscal space on growth and achievement of the internationally agreed development goals has featured prominently on the research agenda of government development agencies, international financial institutions, and civil society organizations. The Poverty Reduction Growth Facility (PRGF) has remained topical in the discussions around the quest by countries in the South to regain control of their own fiscal space from the International financial institutions. The controversy over IMF policies especially the PRGF boils down to a difference of opinion over how and when governments should be allowed to invest in both infrastructure and basic services. The IFIs, CSOs and the UN Development Programme (UNDP) have contrasting views on how to increase fiscal space, that is, on how to enable governments to spend and invest more. In their definition of fiscal space, the UNDP stresses the quality of public expenditure since productive expenditures will foster growth and human development, a larger 'budget pie', and more fiscal space in the long-term. On the other hand, Scholars, policy-makers and activists have focused on how to mobilize resources, or create the 'space' in national budgets, to invest in achieving the internationally agreed development goals, including the MDGs.

In efforts to recover from economic crises, most countries in sub-Saharan Africa began implementing IMF- and World Bank-led structural adjustment programmes during the 1980s. Those programmes promoted policies to expand the role of the market and reduce that of the state in economic affairs. They curtailed public spending for education and health care, privatized state-owned enterprises and liberalized trade. African governments had to cede control over their economic decision-making in order to qualify for World Bank and IMF loans. The PRGF and the succeeding Policy Support Instrument (PSI, introduced in 2005) have been nothing less than a continuation of such policies but under the guise of a new framework. The policies contained in both PRGF and PSI remains consistent with the standard IMF austerity programmes that have proved deeply controversial over the last 25 years. The only difference is that the IMF through such instruments is seeking to polish up its appalling image of being a tough lender and disciplinarian in Sub-Saharan Africa. This study constitutes one of the several PRGF researches that AFRODAD commissioned as part of its contribution to the civic call for the IMF to free policy space and enable African governments to pursue economic resuscitation of their battered economies after many years of the ill-conceived structural adjustment programs.

This study discusses the PRGF and the question of fiscal space as perceived by the citizens who are affected by IMF policy instruments. Conditions are one of the most controversial aspects of IMF and World Bank lending. Critics often claim that the institutions do not pay adequate attention to how the conditions affect people's lives or the contradictory ways in which multiple conditions interact with each other. Many governments also say that the conditions prevent them from making decisions which should rightly be made by elected leaders and that they also fail to address the basic problems that hinder economic development. The study concludes by giving recommendations to both the Fund and the government(s) on how to deal with the question of fiscal space.



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List Of Abbreviations

ADB	African Development Bank
AFRODAD	African Forum and Network on Debt and Development
AIDS	Acquired Immune Deficiency Syndrome
BWIs	Bretton Woods Institutions
CGDB	Central Government's Domestic Borrowing
DfID	Department of Foreign and International Development
DHRMD	Department of Human Resources Management and Development
EEF	Extended Fund Facility
ESAF	Enhanced Structural Adjustment Facility
EU	European Union
GDP	Gross Domestic Product
GTZ	German Technical Assistance Agency
HIPC	Highly Indebted Poor Countries
HIV	Human Immune Deficiency Virus
IFMIS	Integrated Financial Management Information System
IMF	International Monetary Fund
JICA	Japanese International Cooperation Agency
MDGs	Millennium Development Goals
MEGS	Malawi Economic Growth Strategy
MGDS	Malawi Growth and Development Strategy
MK	Malawi Kwacha
MPRSP	Malawi Poverty Reduction Strategy Paper
MTEF	Medium Term Expenditure Framework
NDA	Net Domestic Assets
NFA	Net Foreign Assets
NGOs	Non-Governmental Organisations
ODA	Official Development Assistance
PAP	Poverty Alleviation Programme
PRGF	Poverty and Growth Facility
RBM	Reserve Bank of Malawi
SADC	Southern African Development Community
SAPs	Structural Adjustment Programmes
SDR	Special Drawing Right
TOR	Terms of Reference
UNDP	United Nations Development Programme
USAID	United States Agency for International Development

Executive Summary

Since neither economic growth nor poverty reduction can be achieved if a country is heavily indebted, the IMF and the World Bank launched the Highly Indebted Poor Countries (HIPC) Initiative in 1996 as the first comprehensive effort to eliminate unsustainable debt in the world's poorest, most heavily indebted countries. Reaching completion point of the programme translated into substantial debt relief for the country. The effect of these developments would be to reduce the annual budget provision for serving its debt, hence to create fiscal space that would allow it to spend more money on education, health and other sectors that are critical for reducing poverty and achieving the Millennium Development Goals (MDGs).

The purpose of this study is to assess whether the fiscal space in Malawi has increased as a result of the implementation of the Poverty Reduction and Growth Facility (PRGF) programme and, if so, whether it has contributed to the implementation of the country's development strategy. In specific terms, the study seeks to establish the linkages between the PRGF programme and the national development strategy, through medium expenditure framework, the national budget and sectoral allocations. Desk research and interviews with officials of the Ministry of Finance and the country office of the International Monetary Fund were the main methods of gathering data and information for this study.

Malawi's 2005 PRGF Arrangement

Malawi entered into its third PRGF arrangement with the International Monetary Fund (IMF) in August 2005. To qualify for the arrangement, Malawi had to prepare a poverty reduction strategy paper through a consultative process involving stakeholders. However, this did not result in broad ownership of the Malawi Poverty Reduction Strategy (MPRSP).

The objectives of the PRGF arrangement are to raise the rate of economic growth to 6 percent per year, reduce core inflation to 5-8 percentage range, build international reserves to cover at least two months of imports, reduce the government's domestic debt to less than 15 percent of gross domestic product (GDP) and to increase health services and educational opportunities. With the exception of the last-mentioned objective, the PRGF did not get these objectives or the strategies for achieving them from the MPRSP. To the extent that they were reflected in the MPRSP, they were adopted from the earlier PRGF. In any case, the MPRSP did not have conditionalities of the type that are in the PRGF. The successor development strategy, the Malawi Growth and Development Strategy (MGDS), also draws its macroeconomic framework from the PRGF. This raises question about the country ownership of the MGDS.

The quantitative conditions embedded in the PRGF aim at restraining domestic and foreign borrowing by the government, the growth of central bank credit and money supply, and the growth of government expenditure. While the structural reforms (benchmarks) aim at ensuring that critical steps are taken and implemented on time. These have had the intended effects. Since the growth of government expenditure has been restrained, the allocation of funds to priority sectors such as education and health has been less than desired. As a result, the quality of primary and secondary education has been compromised and medical facilities have had to do with inadequate drugs. The cost of all this has been borne by the poor and other low-income groups who rely on government social services because they cannot afford to pay for private services.

Apart from those of the PRGF, the other tenets of the MGDS include encouraging the private sector to invest in infrastructure so as to create an enabling environment, designing effective social protection to mitigate negative effects of growth and development, and ensuring political will and changing the mindset to enforce the implementation of the national strategy over its period. The MGDS also aims at achieving the Millennium Development Goals (MDGs). The main sources of financing are grants, loans and government revenue. The PRGF funds do not support the government budget. They support the balance of payments from which all ministries benefit.

The PRGF and Fiscal Space

Through the implementation of the PRGF programme, the government has shown discipline and competence in managing the budget, exercised greater control over it, taken steps to curb corruption and in the process it has spent resources within the budget and reduced the fiscal deficit. All priority sectors have received increased allocations of budget resources, although this does not mean that they have received adequate resources. Non-priority sectors have received reduced allocations. The PRGF has not affected the medium-term expenditure framework as this instrument does not exist in Malawi.

By limiting domestic and foreign borrowing and spending by the government, and by limiting lending by the central bank, the quantitative conditions have tended to restrain the growth of the fiscal space. Structural reforms have tended to do the same by restraining government expenditure. Although fiscal space is constrained by quantitative conditions of the PRGF, it has increased since 2004, in part due to increased inflows of aid. In this connection, the IMF's signalling role has had a marked effect on project and dedicated grants, which are primarily directed towards social sectors. Malawi's relationship with its donors has improved and options for development financing have increased.

Although the main elements of the PRGF arrangement were not based on the MPRSP and hence were not owned by all stakeholders who were consulted during the preparation of the MPRSP, its implementation by the government has produced the intended macroeconomic results; namely, a reduction in the rate of inflation to the planned range; an increase in the rate of economic growth above the target rate; an increase in foreign reserves to the target level; and a reduction in the domestic debt below the target level. Data indicate that poverty has declined since 2005. Food production and agricultural incomes have increased as a result of favourable weather and an expanded fertiliser subsidy programme. Consequently, the economic welfare of the poor that live in rural areas must have improved.

The assessment of the socio-economic impacts of the PRGF has shown that the level of per capita income has increased as the rate of unemployment has declined. Furthermore, there have been marginal improvements in the education status of the population and in the nutrition status of under-five children. On the whole, it appears that the following sectors have benefited: agriculture, health, education, among others. Commerce and industry, tourism, labour and social development, among others, have not benefited.

Other Observations

There are six other problems with the PRGF. The first is the limited size of the loan in relation to the needs of the country. The loan can continue to be related to a country's quota in the Fund. But it should be allowed to exceed 100 percent of the quota. The second problem is the conditionalities, which limit the fiscal space. Conditionalities need to be reduced in number and made more flexible. The third problem is the reluctance of the IMF to base the policy elements of the PRGF on the country's development strategy, which it should be urged to do. The fourth problem is the powerlessness of the country due to aid dependency to formulate its own policy framework, which it must be urged to do. The fifth is lack of prioritisation within priority and pro-poor sectors. And the sixth is improper demarcation of pro-poor expenditures, which includes sectors that do not contribute to poverty reduction directly.

1.0 Introduction

1.1 Background

The International Monetary Fund (IMF) introduced the Poverty Reduction and Growth Facility (PRGF) to replace the Enhanced Structural Adjustment Facility (ESAF) as a lending instrument window for poor countries. The stated objective was to achieve significant reduction in poverty in poor and indebted countries. The facility promised a new era of reduced conditionality; broad participation in the formulation of poverty reduction strategies; more pro-poor growth; greater flexibility in fiscal targets and social impact analysis of major macroeconomic adjustments and structural reforms. It was instituted under the assumption that there would be far reaching changes in the way that the IMF worked to support low-income member countries. In particular, there would be:

- A change in the content of the IMF-supported programmes in these countries, which would be more pro-poor and pro-growth;
- An increase in emphasis on country ownership of PRGF-supported programmes; and
- A better definition of the IMF's role and relationship with other agencies supporting development efforts of low-income countries.

PRGF-supported programmes are essentially the macroeconomic policy framework for achieving economic growth and poverty reduction. They are supposed to be framed around Poverty Reduction Strategy Papers (PRSPs), which the World Bank and the IMF introduced in 1999. Targets and policy conditions in PRGF-supported programmes are supposed to be drawn from the PRSPs.

Since neither economic growth nor poverty reduction can be achieved if a country is heavily indebted, the IMF and the World Bank launched the Highly Indebted Poor Countries (HIPC) Initiative in 1996 as the first comprehensive effort to eliminate unsustainable debt in the world's poorest, most heavily indebted countries. In October 1999, the international community agreed to make the Initiative broader, deeper and faster by increasing the number of eligible countries, raising the amount of debt relief each eligible country will receive, and speeding up its delivery. The enhanced initiative aimed at reducing the net present value (NPV) of debt at the decision point to a maximum of 150 percent of exports and 250 percent of government revenue. This would be provided on top of traditional debt relief mechanisms (Paris Club debt rescheduling on Naples terms, involving 67 percent debt reduction in NPV terms and comparable action by other bilateral donors).

Eligible countries would qualify for debt relief in two stages. In the first stage, the debtor country would need to demonstrate its capacity to use prudently the assistance granted by establishing a satisfactory track record, normally of three years, under IMF- and IDA- supported programmes. In the second stage, after reaching the decision point under the Initiative, the country would implement a full-fledged poverty reduction strategy, which has been prepared with broad participation of civil society, and an agreed set of measures aimed at enhancing economic growth.

The country would start receiving debt relief from the time that it reached the decision point. After reaching the completion point, when the debt owing to multilateral institutions would be cancelled, it would receive additional debt relief. The effect of these developments would be to reduce the annual budget provision for serving its debt, hence to create fiscal space that would allow it to spend more money on education, health and other sectors that are critical for reducing poverty and achieving the Millennium Development Goals (MDGs). The MDGs cannot be met without substantial debt relief, particularly for low-income countries.

Malawi first entered into a PRGF arrangement with the IMF in 1995, which was implemented successfully. It entered into another PRGF arrangement in 2000, also the year in which it reached HIPC decision point. Implementation of this programme was unsatisfactory and, eventually, it was abandoned in 2002. In 2005, the country entered into its third PRGF arrangement. Implementation has been satisfactory and the country is expected to draw down the entire sum from the IMF.

Malawi also implemented a PRSP, preparation of which was completed in 2002. In August 2006, it reached the HIPC completion point.

1.2 Research Objectives and Methodology

The overall objective of this study is to make an assessment as to whether the fiscal space of Malawi has improved and has contributed to the implementation of the country's development strategy, as a result of participating in the PRGF. In specific terms, the study seeks to:

- Present the challenges, gains and failures in the implementation of the PRGF
- Establish how the PRGF has been underpinned within the national macroeconomic framework and establish how the programme has shaped the public expenditure framework
- Establish the links between the PRGF and various national instruments (e.g. national development plans, medium term expenditure frameworks, national budgets and sector allocations, etc.)

The consultant used two methods for gathering information and data required for this study. One of these was a desk study or literature review of all documents associated with Malawi's PRGF arrangement, in particular Article IV consultations, reviews, memoranda of economic and financial policies of the Government of Malawi, applications for waivers of conditionalities, IMF staff reports, and other publications on the subject. The other method was an interview with the Deputy Director in the Division of Economic Affairs in the Ministry of Finance of the Malawi Government, and the IMF Resident Representative and an economist in the IMF country office, with the aid of a semi-structured questionnaire.

2.0 Malawi's Relationship With The IMF

Malawi has been a member of the IMF for 43 years. During this period, the country has concluded and implemented a number of stabilisation and structural reform programmes with the organisation. Some of the programmes have been fully implemented; others have not been, either because of factors beyond the control of the authorities or because of lack of political will to implement them.

2.1 A Brief Historical Account

Malawi joined the IMF as a member on 19th July 1965, a year after gaining independence. In December 1995, the country gained Article VIII status, which means that it agreed to abide by the provisions of the Fund's Article of Agreement, which obligates member countries to keep current and capital account transactions free from restrictions.

During the 1970s, Malawi took advantage of its membership of the Fund to obtain assistance under the first Oil Facility that had been set up to help countries with balance of payments difficulties caused by the first major rise in oil prices during 1973-74. Malawi also arranged a stand-by arrangement with the Fund in the first credit tranche to finance temporary balance of payments deficits when the need arose in the 1970s.

From the late 1970s, Malawi suffered from internal and external financial imbalances, low rates of economic growth and inflation. Higher than budgeted expenditure to finance rising import costs caused by diversion of trade from short to long transport routes to the sea and food security operations were partly responsible for budget deficits. Balance of payments deficits were caused by adverse terms of trade, drought-related declines in exports and rising transport costs. Low rates of economic growth were due to a decline in the rate of investment, droughts that adversely affected agricultural production and increasing debt burden. Inflation was a result of reduced production of foodstuffs and rising costs of imports. The financial imbalances that gripped the country during this period were so serious that Malawi had no choice but to enter into a series of short-term and medium-term IMF-supported stabilisation programmes some of which are shown in Table 2.1. A review of selected short-term and medium-term programmes will assist to highlight the experience of the country with stabilisation policies.

The first major stabilisation programme was a two-and-a-half year standby arrangement entered into in August 1979 for US\$34.70 million. This standby arrangement was abandoned in 1980. Under it, progress was made in reducing the budget deficit, but the balance of payments deteriorated due to a worsening in the terms of trade and disruptions on the short land routes through Mozambique which reduced the flow of foreign trade and necessitated the use of more costly routes and modes of transport. The ceiling on bank credit expansion was not observed as demand for bank credit increased. The growth of gross domestic product declined in 1979 compared to 1978. In agriculture, the causes were unfavourable weather and a decline in world market prices. In other sectors, production suffered from a transport-caused shortage of imported inputs.

A two-year standby arrangement replaced the 1979 standby in 1980. Performance under the new arrangement was also mixed. The fiscal adjustment envisaged in the 1980/81 budget could not be achieved because of higher than budgeted expenditure. The rate of economic growth declined from 5.5 percent in 1979 to -0.4 percent in 1980 as the adverse factors that decelerated the rate of growth in 1979 intensified. Only the achievement of a small overall surplus on the balance of payments amounting to MK6.3 million rescued the arrangement, thanks to a depressed level of private demand, an improvement in the transport situation and the export of carryover stocks of agricultural products. In 1981 these factors were not repeated, consequently the overall balance of payments outcome was a sizeable deficit.

What followed in August 1982 was a holding operation. Malawi entered into a one-year standby arrangement with the IMF as the first phase of a medium-term adjustment programme (IMF, 1982). That programme was formalised in an extended fund facility arrangement, which the country entered into with the IMF in October 1983 (IMF, 1983).

Under the one-year arrangement Malawi achieved a measure of financial stability and restraint in domestic demand, particularly through the government budget and the parastatal sector. The extended fund facility arrangement was completed in 1986 after slippages on credit ceilings had led to a suspension of drawings. In 1987, Malawi had no formal arrangement with the IMF. The next one-year standby arrangement entered into early in 1988 was required for the negotiations leading to external debt rescheduling (IMF, 1988). Following these negotiations, Malawi entered into an enhanced structural adjustment facility arrangement.

Malawi concluded its first Poverty Reduction and Growth Facility (PRGF) arrangement with the IMF in 1995. The second PRGF arrangement was concluded in 2000. These medium-term programmes aimed at increasing the rate of economic growth, reducing the rate of inflation, improving the internal and external financial position of the country and reducing poverty. The measures for achieving these objectives included reducing monetary growth, achieving a balanced fiscal position, improving expenditure control, deepening structural reforms, strengthening governance and prioritising pro-poor expenditure. The first PRGF arrangement was successfully implemented and its objectives were achieved. The second one was suspended in 2002 owing to the failure of the authorities to adhere to expenditure controls. As a result, donor aid was suspended. The country went on to finance public expenditure through domestic borrowing, which had a marked impact on the growth of demand pressures, and increases in inflation and interest rates.

Table 2.1 Stabilisation Loans from the IMF, 1980 - 2005

Type of Loan	Date Approved	Expiry Date	Amount Approved (USD mil)	Amount Drawn (USD mil)
Stand-by	09/05/1980	31/03/1982	65.95	8.51
Stand-by	06/08/1982	05/08/1983	23.60	23.60
EEF	19/09/1983	18/09/1986	85.53	60.19
Stand-by	02/03/1988	30/05/1989	18.03	18.03
ESAF	15/07/1988	31/05/1994	86.46	86.46
Stand-by	16/11/1994	30/06/1995	22.30	18.92
PRGF	18/10/1995	16/12/1999	75.75	75.75
PRGF	21/12/2000	20/12/2004	58.77	16.78
PRGF	05/08/2005	04/08/2008	58.34	23.34

Source: IMF, IMF Survey (various issues).

As a result of the various operations, the financial position of Malawi in the Fund as of December, 2007 is that it owes \$30.03 million in outstanding purchases and loans to the IMF, which is 28.27 per cent of its quota.

2.2 The IMF and Malawi's Indebtedness

Until its debt was cancelled in August 2006, Malawi had a comparatively high level of official foreign debt. As at the end of 2002, the sum of public and publicly guaranteed debt stood at US\$2.7 billion. Most (95.4 percent) of this debt was owed by the central government, mainly to multilateral donors (85 percent), but also to bilateral (11 percent) and commercial creditors (4 percent). The evolution of this debt shows that during the 1970s debt as percentage of export earnings (the so-called debt ratio) exceeded 100 percent, but averaged less than 200 percent. Between 1975-79 and 1980-84 half-decades, there was a marked increase in this ratio from 198.0 percent to 289.4 percent. This was followed by another rapid rise to 400.8 percent during 1985-89. However, since the latter half-decade, the increase in the debt ratio had been slower, with the debt ratio averaging 478.0 percent during 1995-2001. As percentage of gross domestic product (GDP), the pattern of growth of Malawi's public and publicly guaranteed debt was similar.

The country also shouldered a relatively high debt burden. During the 1970s, the country's debt service as percentage of exports (debt service ratio) was modest and averaged less than 11 percent. The debt service ratio accelerated during 1980-84 and peaked at 32.4 percent during the subsequent half-decade.

Afterwards it declined, but it was still far higher than what it was during the 1970s. And the pattern of growth of debt service as percentage of GDP was similar to that of the debt service ratio.

Much as Malawi wanted to benefit from the HIPC Initiative, it was not eligible for HIPC I, which came into being in 1996, because its debt service ratio was less than the threshold of 20-25 percent. Under HIPC II, which was introduced in 1999, the threshold debt service ratio was reduced to 15 percent. This enabled Malawi to become eligible for HIPC II. The country reached the decision point in December 2000 after demonstrating a track record of macroeconomic stability, preparing an interim PRSP, and clearing all outstanding arrears on external debt. Having reached the decision point, Malawi started receiving interim debt relief. And in order to reach the completion point, the country had to maintain macroeconomic stability and satisfactorily implement the PRGF, prepare a full PRSP and implement it satisfactorily for at least one year, and undertake structural reforms to meet specific conditions in selected areas. Total debt relief from the HIPC Initiative is worth around US\$1 billion.

2.3 The 2005 PRGF Arrangement

The current PRGF arrangement in Malawi was approved on 5th August 2005 and will run until 4th August 2008. The PRGF is essentially a medium-term macroeconomic stabilisation programme lasting three years. It is oriented towards reducing poverty and promoting economic growth. Funding is provided through a concessional loan financed through the PRGF-HIPC Trust. The loan carries an annual rate of interest of 0.5 percent and is repayable over 10 years with a 5 1/2 year grace period on principal payments. The loan is scheduled to be drawn in seven instalments, the first of which was due after IMF Executive Board approval of the three-year PRGF arrangement. The remaining instalments were due after completion of reviews of the programme and observance of performance criteria.

Malawi's quota in the Fund is US\$106.22 million. Hence, the sum of US\$58.34 million granted under the PRGF represents 55 percent of its quota. The sum of US\$58.34 million is rather small in relation to the country's needs, which should have been served better by an arrangement that provided a larger sum in relation to the country's quota, perhaps 100 percent or more. The problem is that having drawn larger percentages of its quota in previous PRGFs, the limit on the excess amount that Malawi can draw has decreased.

The main economic objectives of the PRGF are to:

- Raise the rate of economic growth to 6 percent per year, with an emphasis on rural incomes;
- Increase health services and educational opportunities;
- Reduce core inflation to the 5-8 percent range;
- Build international reserves to at least two months of imports; and
- Run a fiscal surplus to reduce the government's domestic debt to less than 15 percent of GDP from over 24 percent.

The strategies for achieving the above objectives include zero tolerance for corruption and pursuit of good financial, economic and political governance; improving the macroeconomic environment and pursuit of sound fiscal, monetary and exchange rate policies. Malawi also intends to move towards an independent central bank as part of a SADC wide initiative (National Action Group Forum, 2005).

2.4 Quantitative Conditions and Structural Reforms (Benchmarks)

The PRGF carries with it a number of quantitative conditions and structural reforms. These quantitative conditions and structural reforms are designed to ensure that funds released under the PRGF are used for the right purpose. They also serve like assessment tools for checking whether Malawi is committed to the objectives of the PRGF, and for monitoring its performance to ascertain if the country is on track towards achieving the objectives of the programme. The conditionalities are in the form of quarterly quantitative targets, i.e. ceilings and floors on selected monetary and fiscal variables; and structural benchmarks in the form of the fulfilment of established datelines on completion of important activities.

Quantitative targets relating to monetary variables are:

- Floor on Net Foreign Assets (NFA) of the Monetary Authorities. NFA is defined as the difference between gross foreign assets and liabilities of the monetary authorities; namely, the Reserve Bank of Malawi (RBM) and the Treasury.
- Ceiling on Reserve Money. This is a quantitative indicative target. Reserve money consists of currency issued by the Reserve Bank of Malawi and balances of commercial banks with the RBM.
- Ceiling on Net Domestic Assets (NDA) of the Reserve Bank of Malawi. NDA is defined as reserve money minus net foreign assets valued at the programme exchange rate.
- Ceiling on Central Government's Domestic Borrowing (CGDB). CGDB is defined as the sum of net borrowing from the RBM, net borrowing from commercial banks and non-banks, and holdings of promissory notes.

Those relating to fiscal variables are:

- Ceiling on Central Government Wages and Salaries
- Ceiling on Central Government Discretionary Expenditures

And those relating to the external sector are:

- Ceiling on External Payments Arrears
- Ceiling on Nonconcessional External Debt

The structural performance criteria are:

- Cabinet approval of arrears policy and commencement of implementation by end September 2005
- Compilation of new database of all public employees on the basis of the Department of Human Resources Management and Development (DHRMD) data forms by end September 2005
- Operationalising budget ceilings module in payments system by December 2005
- Developing and implementing a new travel policy, which includes mechanisms for monitoring adherence by March 2006

And the structural benchmarks are:

- Development of a detailed schedule of wage adjustments by grade for 2005/2006 by end September 2005
- Publication of monthly fiscal reports with one month lag by December 2005
- Preparation of quarterly reports (with one month lag) on status of arrears by December 2005
- Strengthening cash management and expenditure monitoring procedure by preparing reports by March 2006
- Completion of impact analysis of tighter credit quality classifications on commercial bank balance sheets by end March 2006

Altogether, then, there are eight quantitative targets, four structural performance criteria and five structural benchmarks. The total number of conditionalities is likely to tax the administrative capacity of the Ministry of Finance and the Reserve Bank of Malawi and other stakeholders who take part in monitoring the programme, preparing data and reports and attending meetings both in Malawi and in Washington. In addition, the conditionalities limit fiscal space, both on the revenue side and on the expenditure side, more about which is discussed later.

3.0 THE PRGF and Malawi's Development Programme

3.1 The Main Tenets of Malawi's Development Programme

Strategies for economic growth and development are contained in the Malawi Poverty Reduction Strategy Paper (MPRSP), the Malawi Economic Growth Strategy (MEGS), the Malawi Growth and Development Strategy (MGDS) and other strategy documents. As it has been pointed out above, the Malawi Poverty Reduction Strategy Paper (MPRSP) was developed in the early 2000s and launched in 2002 at the request of the Bretton Woods Institutions (BWIs) so that the country could benefit from debt relief under the enhanced Highly Indebted Poor Countries (HIPC) Initiative, a Poverty Reduction and Growth Facility arrangement and other concessionary assistance. It had two key elements; namely, a set of government policies and priorities, both overall and for individual sectors; and broad expenditure allocations, covering both domestic and donor funding. Its purpose was to try and ensure that scarce resources were allocated in accordance with government policies and priorities for poverty reduction. In varying degrees, the MPRSP drew upon and learnt from a number of previous national development strategies; namely, the Statement of Development Policies (1987-1996), which was developed through extensive consultations within government and launched in 1987. It contained a profile of the poor, the causes of poverty and the measures for addressing the problem of poverty. The MPRSP also drew upon the Policy Framework for the Poverty Alleviation Programme (PAP), which was developed in 1995; and Vision 2020, which came out later in 1998.

The Malawi Economic Growth Strategy (MEGS) was formulated from 2002, completed and finally launched in 2004. MEGS aimed to complement the MPRSP by stimulating private sector growth and ensuring that the poor are key participants and beneficiaries of economic growth. It owed its origin to two missing links in the MPRSP with which both the government and the private sector were concerned. The first is that while the MPRSP contained a pro-poor growth strategy for stimulating economic growth in ways that directly attack poverty, it focused on the role of micro and small-scale enterprises to the exclusion of large-scale ones. The second is that the MPRSP neither planned for a sufficiently high rate of economic growth, which is considered necessary for poverty reduction, nor gave sufficient attention to the role of the private sector, investment and trade, which are considered to be the main drivers of economic growth. Part I of MEGS set out the background to the strategy, the framework for delivering growth and the strategy for dealing with the macroeconomic constraints that affect enterprises. Part II analysed the main sectors of the economy, and the strategies for the growth of the core and other sub-sectors of the economy. There was also a review of key public institutions that support and regulate the private sector.

Recently, the government has replaced the MPRSP and MEGS with a new strategy called the Malawi Growth and Development Strategy (MGDS). MGDS was completed in 2006 and launched in 2007. It draws upon and combines critical issues in the MEGS, MPRSP, Vision 2020, the Millennium Development Goals and other development strategies. Like the MEGS, the MGDS focuses on achieving strong sustainable economic growth that will enable Malawians to create their own wealth through economic empowerment. Some of the specific aims of the MGDS are to:

- Resume economic growth fast enough to bring about the Government's vision;
- Create new wealth for the people and more jobs;
- Gradually emerge as an industrial nation capable of transforming agricultural primary commodities, other raw materials and minerals;
- Transform Malawi from a predominantly importing and consuming country to a producing and exporting country;
- Increase supply of goods and services for domestic and international markets; and

- Increase domestic and foreign financing and investment in agricultural processing, industrial production and manufacturing.

The strategy is comprehensive, with five pillars (the original four pillars of sustainable economic growth, social protection, social development and good governance contained in the MPRSP, and the additional one of infrastructure), all of which have an economic growth focus as well as a poverty focus. Improving food security so as to ensure that Malawi is a hunger free nation features prominently, as does the achievement of other MDGs.

Macroeconomic stabilisation also features, but the SADC macroeconomic target variables are not included, except, by sheer coincidence, the ones that are in the PRGF stabilisation programme. In addition, the strategy incorporates cross cutting issues of HIV/AIDS, gender, environment and science and technology in the five pillars.

The six priority areas are agriculture and food security; irrigation and water development; transport infrastructure development; energy generation and supply; integrated rural development; and prevention and management of nutrition, HIV AND AIDS. These priorities are appropriate, given that Malawi is prone to food insecurity, power and water shortages; in light of lack of adequate road infrastructure; and in view of the high prevalence of nutrition disorders and HIV/AIDS.

The Strategy is written in simple, easy-to-understand technical language. But when you read it, you cannot help feeling that there is insufficient selectivity and prioritisation, especially with respect to focus actions for agriculture, education, health and transport. While a national development strategy should be comprehensive, in a country like Malawi, with limited capacity, it is essential to clearly identify priorities for action.

1. The apparent lack of selectivity and prioritisation reflects the lack of prioritisation by the individual ministries that prepared their sectoral strategies and submitted them to the Ministry of Economic Planning and Development for incorporation in the MGDS. This was in response to the directive that budget submissions that either include activities outside the MGDS or exclude activities inside the MGDS will be rejected, which encouraged them to submit everything as a hedge. This problem has to some extent been addressed through subsequent priority setting.
2. In some cases there is insufficient distinction between strategies, the means adopted for addressing particular problems, and goals, the aims that the strategies are intended to achieve. A goal is not a strategy and a strategy is not a goal. The two things are quite distinct. For example, on page 18, under (d) Integrated Cotton Industry, the long-term goal is stated to be to develop a vibrant cotton growing and processing industry. This entails increasing the production of raw cotton and of ginning and garment manufacturing firms. But producing raw cotton and ginning is put down later as a strategy. As another example, under wheat, the long-term goal is stated to be to develop a vibrant wheat production and processing industry, which, again, implies increasing production, processing and marketing of wheat. But the main strategy simply repeats that goal. It is stated to be to increase production, processing and marketing of wheat.

The process of developing MGDS, like the process of developing MEGS, was less consultative than the one employed to develop the MPRSP. Most of the key stakeholders, namely the private sector, civil society, donors, and the three arms of central government were consulted through appropriate structures. Furthermore, the private sector and civil society were involved in writing the MGDS, and will be involved in monitoring and evaluation. But local level government structures were not consulted this time. It has been contended that since they were consulted during the preparation of the MPRSP, it was not necessary to go through another round of local-level consultations, which, in any case, was considered to be resource intensive and expensive. While appreciating the financial and other resource constraints, in a dynamic world where economic conditions and perceptions can change quite rapidly, it is essential to get the views of local-level civil servants and representatives and, therefore, that cost effective ways of soliciting their views should be sought. Other groups that were not sufficiently involved are NGOs and trade unions. These groups may offer useful, alternative perspectives on development.

3.2 The PRGF and Malawi's Development Strategy

As indicated above, the PRGF programme is essentially a macroeconomic framework for achieving economic growth and reducing poverty. In order to ensure consistency between the PRGF and the poverty reduction strategy, the former was supposed to be framed around the MPRSP. In particular, the policies were supposed to be drawn from the MPRSP. The question is, is this what happened?

Before qualifying for the PRGF, Malawi had to prepare a comprehensive, nationally owned Malawi Poverty Reduction Strategy Paper (MPRSP). The MPRSP was completed in 2002. It was nationally owned to the extent that the government prepared it through a process that involved consultations with the civil society, NGOs, donors and international financial institutions. Once this was done, the MPRSP had to be endorsed by the Boards of the World Bank and the IMF as a basis for concessional loans and debt relief under the enhanced Highly Indebted Poor Countries (HIPC) Initiative. Having been locally produced, the MPRSP was expected to provide fresh ideas about strategies and measures. During implementation, the government was expected to keep civil society informed about developments in the programme and involve it in monitoring and implementation.

However, there are doubts about whether in fact the MPRSP was nationally owned. To start with, the government prepared the MPRSP after having been persuaded by the Bretton Woods institutions to do so in order to qualify for concessional PRGF loans and debt relief. Therefore, the initiative for preparing the MPRSP did not originate in Malawi. The officials who took part in writing the MPRSP attended a training workshop organised by the World Bank in Dar-Es-Salaam. At this workshop, they were taught the essentials of a framework for a poverty reduction strategy. This explains why PRSPs are similar throughout the developing world. They consist of four main components, called pillars, which are:

- Sustainable Pro-Poor Growth – economically empowering the poor by ensuring access to credit markets, skills development and employment generation;
- Human Capital Development – ensuring that the poor have the health status and education to lift themselves out of poverty;
- Improving the Quality of Life of the Most Vulnerable – providing sustainable safety nets for those who are unable to benefit from the first two pillars; and
- Good Governance – ensuring that public and civil society institutions and systems protect and benefit the poor.

Then there are the cross cutting issues of gender, environment, HIV/AIDS, and science and technology. Basically, there are no fresh ideas. While stakeholders were consulted, it is not certain that they participated actively in the MPRSP process. Within government, few people knew what the MPRSP was beyond officials in key ministries. In addition, there was lack of political commitment to its implementation, another sign that the degree of ownership was limited (Chipeta and Peretz, 2006).

When the current PRGF was under preparation, the MPRSP was in the final stages of implementation. But it was understood that the MPRSP would continue, not in its existing form, but as part of a broader strategy on economic growth and poverty reduction, preparation of which was already in full swing. Known as the Malawi Growth and Development Strategy (MGDS), preparation of the new strategy was completed at the end of 2006 and official launch took place mid-2007.

Although the PRGF is a macroeconomic framework, it drew upon the MPRSP to the extent that it aims at promoting economic growth and reducing poverty. Its fiscal and monetary policies are geared towards pursuing sustainable pro-poor growth, human capital development, good governance, and improving the quality of life of the most vulnerable, which are the aims of the MPRSP and the new MGDS. It also drew upon the MPRSP to the extent that it aimed at increasing health services and educational opportunities.

That said, it must be pointed out that the quantitative targets for inflation, the rate of economic growth, domestic debt as percentage of gross domestic product (GDP), fiscal balance as percentage of GDP, and gross foreign reserves in months of imports were not based on the MPRSP.

The MPRSP was prepared at a time when Malawi was supposed to be implementing its second PRGF. It was thought then that if the MPRSP contained new macroeconomic targets, these would be inconsistent with those of the PRGF. Therefore, the MPRSP adopted the macroeconomic targets of the PRGF, which were assumed to be appropriate. Similarly, the MGDS does not have macroeconomic targets of its own.

The macroeconomic targets there are those of the new PRGF (Malawi Government, 2006), which are assumed to be appropriate. Furthermore, the PRGF did not derive its quantitative performance criteria and structural benchmarks from the MPRSP or the MGDS, both of which do not have such criteria. In other words, in terms of macroeconomic policies, it is the country's development and poverty strategies that have drawn upon the PRGF and not the other way round. The IMF may be reluctant to base the policy elements of the PRGF on the country's growth and development strategy. On its part, the country lacks expertise for preparing a macroeconomic framework and hence relies on the staff of the IMF.

For the purpose of attaining the macroeconomic objectives contained in the MGDS, the government is committed to pursue sound economic policies geared at increasing and sustaining economic growth, reducing inflation, maintaining a flexible exchange rate and improving the foreign exchange position, in addition to increasing employment and improving the balance of payments.

3.3 The IMF's Scorecard on Malawi's PRGF Performance

What have been the outcomes of the PRGF reviews? Discussions for the reviews of the PRGF are held in Lilongwe from time to time. So far, five reviews have been concluded. The findings of most of the reviews have been similar. For example, the second review concluded that all end-December 2005 quantitative performance criteria, including the indicative target on reserve money were met.

However, the country missed the indicative target on discretionary government spending, mainly because of food security outlays. Structural performance criteria were only partially implemented. A consultant developed a new travel policy, but it was not implemented, as it did not adequately address the objectives of the authorities. The authorities intended to implement this measure by end-September 2006. The structural performance criterion for end-March 2006 was also only partially met. Efforts to fully implement the budget ceilings were overtaken by the rollout of the Integrated Financial Management Information System (IFMIS) and the centralized payment system. The Malawi authorities requested waivers for non-observance of these performance criteria, which the IMF granted. They also requested the third disbursement under this PRGF arrangement of SDR4.9 million, which was granted.

The most remarkable outcome of this review was the attainment of the HIPC Initiative completion point in August 2006. As a result, Malawi's interim debt relief became irrevocable. The country also automatically became eligible for the Multilateral Debt Relief Initiative (MDRI), under which the World Bank, the IMF and the African Development Bank (ADB) cancelled 100% debt owed to them. Therefore, MDRI meant substantial additional debt relief. In total, Malawi's debt was reduced from US\$3 billion to US\$400 million. On an annual basis, it means that Malawi's external debt service obligations were reduced from US\$115 million to only US\$5 million. This is equivalent to a saving of US\$110 million (MK15 billion) per year, or 15 percent of Malawi's total budget. Since Malawi was already receiving between US\$40 million and US\$60 million in interim debt relief, by reaching the completion point, Malawi is having about US\$50-70 million (MK6-10 billion) additional money to spend per year, or about 6 percent of the national budget. Furthermore, Malawi's debt-to-export ratio decreased from 229 percent to 32 percent, implying that the country's external debt situation is currently sustainable.

Discussions for the third review of the PRGF were held in Lilongwe from 24th October to 7th November 2006. The review found that most of the end-June quantitative targets were met. The notable exception was the performance criterion on government domestic borrowing. The overrun here was caused by an unanticipated expenditures related to food security operations, higher logistical costs related to the purchase and distribution of maize and fertilizer, and accelerated repayment of domestic arrears.

The authorities requested a waiver of the non-observance of this performance criterion, which they obtained. They also requested the fourth disbursement under the PRGF arrangement (SDR6.68 million), which they got.

3.4 The Cost of the Reforms and Who Met Them

This section of the report attempts to provide an indication of the costs of the reforms prescribed by the PRGF and who met those costs. The study has discovered a number of such costs. First is the ceiling on central government salaries and wages. By restraining the growth of wages, this ceiling is believed to have constrained the employment of civil servants and so adversely affected the attainment of the MDGs. The second is the magnitude of the fiscal deficit. The PRGF arrangement envisages a fiscal balance of –1.1 percent of GDP by 2008. This is higher than the 2008 fiscal deficit of –3.0 percent that is aimed at under the SADC macroeconomic convergence programme. The implication is that the government's fiscal space is constrained and so it cannot spend more than the amount that is consistent with the attainment of the low fiscal balance. The same is true of the envisaged inflation rate of 5-8 percent, which is below the SADC macroeconomic convergence target rate of 9 percent by 2008. In order to achieve a reduction in the rate of inflation to the required level, the government has to restrain the growth of expenditure. The cost of this has been borne by low-income groups and the poor who consume government services.

As a result of what has been stated above, although nominal pro-poor expenditure increased by an average annual rate of 27.5 percent between 2004/05 and 2007/08, this was not enough to satisfy the needs of the various activities. For example, in agriculture, a priority sector, the allocation for agricultural extension services was reduced despite an average annual rate of increase of 34.1 percent in total expenditure. Recent service delivery satisfaction surveys conducted by the Malawi Economic Justice Network (MEJN) found out that the percentage of people who are accessing extension services has declined from 57 percent in 2005/06 to 46 percent in 2006/07 (MEJN, 2006 and 2007). The allocation for the generation of new agricultural technologies was also reduced, thus impairing the growth of agricultural productivity. In commerce and industry, where expenditure declined by an average annual rate of 32.4 percent, the cut did not spare enterprise and cooperative development, which serve the interests of micro, small-scale and medium-scale enterprises.

Turning to priority social sectors of education and health, in nominal terms the budget allocation to the Ministry of Education increased by an average annual rate of 19.1 percent over the reference period. Primary education received the largest increase in budget allocation. But, although this was the case, primary schools suffered from lack of adequate teaching and learning materials, thus adversely affecting the quality of basic education. According to the 2006/07 MEJN survey, 61 percent of the respondents were dissatisfied with the availability of exercise books, 59 percent were dissatisfied with the availability of textbooks and 70 percent were dissatisfied with the availability of pens. Besides, the allocation for teacher education was reduced. The allocations for teaching and learning materials and teachers' salaries for secondary schools were also cut, thus adversely affecting the quality of education there too.

The health budget allocation increased at an average annual rate of 62.6 percent. But the allocation to drugs did not experience a significant increase. As a result, shortage of drugs continues to haunt government hospitals and clinics, which serve the needs of the majority of the people, especially the poor and others with low-incomes who cannot afford to go to private hospitals and clinics. The 2006/07 MEJN survey found that 28 percent of the respondents were dissatisfied with the supply of drugs at government hospitals and clinics. While in the Ministry of Women and Child Development, where the budget allocation increased at an average annual rate of 82.7 percent, the allocation to child-care services was reduced, despite the high demand for such services caused by the AIDS pandemic. Administration and other non-priority items absorbed most of the increase in the budget.

The objective to reduce the net domestic debt was a double-edged sword. On the one hand, the reduction in this debt led to a reduction in government borrowing requirements to refinance maturing debt, thereby causing a reduction in inflation and in short-term interest rates and stimulating an increase in private sector borrowing from banks.

On the other hand, the reduction in this debt reduced the outlet for funds by investors and consequently adversely affected the development of the money market and put pressure on stock prices, which rose as a result of the switch in demand from short-term money market securities to stocks.

4.0 THE PRGF and FISCAL SPACE

4.1 The Main Sources of Financing for the Development Programme

Since independence in 1964, external assistance has financed most of the government's development budget in Malawi. In the 2006/2007 government budget, for example, official development assistance (ODA) covered around 80 percent of the development budget and around 45 percent of the total resources available to the government. As a percentage of nominal gross domestic product (GDP), development support alone rose from 16 percent in 2004/05 to 22 percent in 2006/07. A high level of dependence on aid is unavoidable at early stages of development. However, it can cause problems, especially when it is volatile and uses inefficient modalities for aid disbursement.

The MGDS (2006/07-2010/11) has been costed, and is estimated at K637.6 billion. The funding of this programme may follow recent trends in financing development programmes in Malawi, whereby the Malawi Government has provided 20 percent of the funding, and donors have financed the remaining share of 80 percent. But the pattern could change. For example, in the 2006/07 fiscal year, when implementation of the MGDS began, MK55.8 billion was spent on the development programme. Of this amount, 53 percent was in the form of grants, 36 percent in the form of loans, and 11 percent was contributed by the Malawi Government (Malawi Government, 2007). The annual expenditure on the programme is expected to pick up markedly thereafter.

The relative contributions of individual donors may change from year to year. But the list below includes all the major donors, who are likely to be the main sources of grants for the MGDS. A breakdown of aid received in the 2005/006 fiscal year, for example, shows that DfID is the largest source of aid for Malawi, followed by the World Bank, EU and Norway, in that order. Other major sources of aid are USAID, ADB, UNDP, GTZ, JICA and KfW. Aid from these sources includes disbursements made directly to government and those disbursements that are administered by the donors themselves or non-governmental organisations (NGOs). Aid from DfID includes Dutch support, which DfID administers. Similarly, aid from Norway includes support from Sweden, which is administered by the Norwegian Embassy in Malawi (Ministry of Finance, 2006).

Budgetary allocations accord priority to the sectors that are considered by the MGDS to be crucial for economic growth and development. The sectors include health, education, agriculture, mines and natural resources, water development, transport and infrastructure. Pro-poor expenditures, which are protected from budget cuts, have also been accorded priority in allocating budgetary resources.

PRGF funds are not used to support the government budget. Instead, they are used to support the balance of payments. To the extent that ministries have needs that are satisfied through imports, they all benefit from them. The PRGF takes the budgetary allocations to MGDS priorities and pro-poor items as given. The MGDS priority activities are agriculture and food security; irrigation and water development; transport and infrastructure development; energy generation and supply; integrated rural development; and prevention and management of nutrition disorders, HIV and AIDS. These priorities address most of the development challenges of the country. The PRGF is only concerned with aggregate government expenditure. The PRGF also takes the demarcation of pro-poor expenditures as given. Over time the definition of what is pro-poor expenditure has changed, with the result that pro-poor expenditures now include items of doubtful nature.

According to MEJN, pro-poor expenditures were initiated in 2001. The original definition agreed with donors included Youth, Sports and Culture, which is questionable; smallholder farm input subsidy and small scale fish farming under Agriculture, small scale irrigation under Water Development, gender mainstreaming under Women and Child Development, teacher salaries and primary school inspectorate under Education, and district hospital expenditure and Christian Hospital Association of Malawi (CHAM) salaries under Health. But it also includes democratic governance sub-sectors of justice, public prosecution and state advocacy, judiciary, legal aid, anti-corruption, ombudsman, human rights and law commissions. With the possible exception of anti-corruption and human rights, it is doubtful if these sub-sectors are indeed pro-poor.

The initial definition excluded infrastructure development and rehabilitation, clinical services, health technical services and drugs, which was wrong.

4.1.1 Impact of IMF's Signalling Role on Aid Disbursements

The impact of the IMF's signalling role on aid disbursements has been very significant as indicated by the data in Table 4.1 below. The data in this table show that compared to the base or no programme fiscal year 2004/05, the volume of aid or grants doubled within two fiscal years from MK28, 117 million to MK57, 159 million. Substantial further increases are projected for the subsequent fiscal years.

By type of aid or grant, the data show that budget and programme support has more than doubled. This money is not tied to specific projects or activities. Project support, which specifies the activities that are to be funded, has tripled since 2004/05. It is part of this money, which goes to fund social activities. Dedicated grants have more than doubled since 2004/05. Most of these grants go to the National Aids Commission and the Health Swap; hence they benefit the health sector. Aid coming under HIPC debt relief rose marginally then declined. And aid from the Multilateral Debt Relief Initiative appears to have been a once-off affair in the 2006/07 fiscal year.

The IMF enjoys a cordial relationship with other donors, all of whom responded positively to the PRGF. The World Bank provided part of the HIPC debt relief, as did some bilateral donors. However, it is in other forms of aid that the role of bilateral donors has been greater. DfID, EU and Norway scaled up their provision of budget support, along with the World Bank. The same donors scaled up their provision of dedicated grants. They also scaled up provision of project support, along with USAID, ADB, UNDP, GTZ, JICA and KfW.

Table 4.1

Malawi: Foreign Aid Operations 2004/05 – 2008/09 (MKmn.)

	2004/05	2005/06	2006/07	2007/08 ¹	2008/09 ¹
Budget/Programme Support	5,085	15,159	9,652	12,597	10,985
Project	11,020	15,185	24,242	36,777	39,462
Dedicated grants	6,933	13,645	14,502	15,895	18,696
HIPC debt relief	5,078	7,041	5,078	1,111	1,104
MDRI debt relief From IMF	0	0	3,685	0	0
Total Aid	28,116	51,030	57,159	66,380	70,247

1 Estimates.

Source: IMF, Malawi: 2006 Article IV Consultation and Third Review Under the Poverty Reduction and Growth Facility, and Request for Waiver of Nonobservance of Performance Criterion, May 2007

4.2 Impacts of the PRGF on the National Budget

The PRGF has had a significant impact on the national budget. First, under the PRGF, the government has always spent within the budget. Some ministries have spent more than their approved amounts, while others have spent less. But overall, the government has spent within the approved budget. This is probably the first time that this has happened on a sustained basis since 1994, and it is an indication of the commitment of the new government to fiscal discipline.

As a result of improvement in the management of the national budget, donor confidence in the budgetary process has increased, which they consider to be credible. This partly explains the resumption of aid and increased commitments of aid by donors to Malawi. Associated with the improvement in the management of the budget has been the stepping up of efforts to curb corruption and so free resources for fighting poverty. The budget deficit inclusive of grants has declined from 3.1 percent of GDP in 2004/05 to 2.0 percent in 2006/07 and will be an estimated 1.9 percent in 2007/08 (Malawi Government, 2007).

But the PRGF has had no impact on the medium term expenditure framework (MTEF), which does not exist in Malawi. According to the MPRSP, to be implemented, the document had at all levels to be translated into the Medium Term Expenditure Framework and the budget, and the budget itself had to be fully implemented. Although attempts were made to develop a Medium Term Expenditure Framework (MTEF) approach to budgeting starting with a few ministries in 1996/97, it has never been an operational mechanism, with the figures beyond the year of the budget having little or no significance. However, at the outset of the MPRSP attempts were made to restructure expenditure both between and within sectors so that sufficient resources were directed towards higher priority sectors/activities while cutting back on those of lower priority or dropping them. Ministries were also required to improve their financial accountability and transparency. While some attempts were made to integrate the MPRSP into the budget system, particularly at central government level, and the budget system incorporated pro-poor expenditures that related to funding commitments in the MPRSP, it has been observed, however, that sectoral budgets were not funded according to the MPRSP and that budgets still focused on inputs rather than relating to outputs (Chirwa, 2005).

At local government level, the situation was worse with many people ignorant of MPRSP indicators and programmes that they needed to implement to achieve MPRSP outputs (Chirwa, 2005). Each of the two major reviews of the MTEF carried out during the 1999/2000 and 2000/2001 fiscal years concluded that the framework had failed to meet its objectives. Financial accountability and transparency were found to be inadequate. Ministries had only partly practised activity-based or programme budgeting and line-budgeting had been reasserted. In terms of its potential impact on MPRSP implementation, the most important shortcoming was that patterns of actual expenditure often bore little resemblance to the budget itself. Expenditure ceilings were regularly violated by line ministries and other government agencies. In addition, ministries continued to allocate the largest amount of resources to personal emoluments and non-essential items of expenditure, leaving materials and transport under-funded. Effectively, it is now generally accepted that the MTEF was never operational and more recently the government has concentrated its efforts on annual expenditure management and control.

In the absence of an MTEF, the government uses a budget framework, which is revised annually, as a guide for allocating budgetary resources. On the basis of the budget framework, over the medium term most of the pro-poor sectors have received larger increases in budgetary allocations than other sectors. These include agriculture, health, education, water development, mines and natural resources, HIV/AIDS, National Roads Authority, justice, director of public prosecutions, legal aid, anti-corruption, ombudsman and human rights commission. Those that have not include commerce and industry, tourism, women and child development, police and law commission. Of the non pro-poor sectors, the following have received reduced allocations because they are not considered to be priority sectors or they are no longer necessary: labour and social development; youth, sports and culture; public debt charges; home affairs; and information and civic education.

4.3 Quantification of Fiscal Space

As it has been stated above, PRGF funds are not used to support the budget. Therefore, they have no impact on fiscal space directly. Initial success in implementing the PRGF helped Malawi to reach the HIPC completion point, which led to debt cancellation and receipt of debt relief. The increase in fiscal space as a result of this has been estimated at 6 percent of the budget. The implementation of the PRGF has also been associated with a reduction in the domestic debt and hence in interest payments on that debt. The reduction in interest payments on domestic debt has led to an increase in fiscal space equal to 5.8 percent of the budget.

Gross tax revenue in nominal terms increased from MK50.7 billion in 2004/05 to MK58.9 billion in 2005/06 and MK74.5 billion in 2006/07. As a share of GDP, however, gross tax revenue declined slightly from 16.3 percent in 2004/05 to 15.3 percent in 2005/06 before rising to 16.1 percent in 2006/07. For 2007/08, the share of gross tax revenue in GDP is estimated to be 16.4 percent.

There was a marked increase in revenue from taxes on income and profits, on goods and services and on international trade. Non-tax revenue, mainly representing departmental receipts and receipts from levies on petroleum products, did less well. As a percentage of GDP, it rose from 2.2 percent in 2004/05 to 2.3 percent in 2005/06. Then it declined to 1.6 percent in 2006/07, but it is expected to rise to the 2005/06 share in GDP in the 2007/08 fiscal year.

Grants increased from MK25.2 billion in 2004/05 to MK53.9 billion in 2005/06 and MK62.2 billion in 2006/07. The share of grants in GDP increased from 8.1 percent in 2004/5 to 14.0 percent in 2005/06, but declined to 13.5 percent in 2006/07. In 2007/08 their share is expected to decline further to 12.4 percent owing to reduced dedicated grants, previously given for food security, which are not necessary now that the food security position of Malawi has improved.

The IMF has calculated average annual fiscal space over the period 1998/99 - 2005/06 and projected it over the period 2006/07 – 2009/10 by source and by allocation as percentage of GDP. As shown in Table 4.2 below, domestic revenue and other receipts are the main source of fiscal space. Net foreign financing is the second largest source. Between the two time periods that are being compared, the total fiscal space is expected to increase by 14.6 percent. Among the individual categories, net foreign financing is expected to grow faster than domestic revenue and other receipts.

Table 4.2 Malawi: Sources and Allocation of Fiscal Space (% of GDP)

	98/99-05/06	06/07-09/10	Change
	Avg.	Avg.	
Total fiscal space	26.5	41.1	14.6
Domestic revenue and Other receipts	20.4	24.7	4.3
Net foreign financing	11.0	19.4	8.4
Domestic interest payments	-4.8	-3.0	1.8
Allocation of fiscal space	26.5	41.1	14.6
Wages	6.2	7.7	1.5
Other current spending	14.5	15.0	0.5
Development	9.4	17.2	7.8
Domestic debt reduction	-3.6	1.2	4.8
Memorandum			
Pro-poor spending	6.0	11.3	5.3

Source: IMF, 2006 Article IV Consultation and Third Review under the Three-Year Arrangement under the PRGF.

Other current spending dominates the allocation of fiscal space during the first period, but its dominance is replaced by development during the second period. The latter grows faster than other current spending during the second period.

4.3.1 Impact of Structural Benchmarks and Quantitative Conditions on Fiscal Space

The implementation of the PRGF structural benchmarks and quantitative conditions created economic stability, which, in turn contributed to a high rate of economic growth. Reflecting the pickup in economic activity as a result of the record growth of the economy, tax revenue increased markedly, as did non-tax revenue. As a result of the signalling effect of the implementation of the PRGF programme, grants also increased rapidly.

The following quantitative performance criteria are likely to have limited the revenue aspect of the fiscal space:

- Ceiling on Net Domestic Assets of the Reserve Bank of Malawi because it constrains lending by the central bank;

- Ceiling on Central Government's Domestic Borrowing because it constrains borrowing by the government;
- Ceiling on Nonconcessional External Debt because it constrains foreign borrowing by the government; and
- Ceiling on Reserve Money because it constrains lending by commercial banks to the government.

While the following quantitative performance criteria are likely to have limited the expenditure side of the fiscal space:

- Ceiling on Central Government Wages and Salaries; and
- Ceiling on Central Government Discretionary Expenditure.

All the structural benchmarks are likely to have affected the expenditure side of the fiscal space.

5.0

CONCLUSION

5.1 Impact of the PRGF as a Lending Facility

As stated above, the Malawian authorities have met all the quantitative performance criteria and the structural benchmarks, with the exception of a few. As a result of the successful implementation of the PRGF programme, they have managed to restore macroeconomic stability. For example, the annual rate of inflation has declined from 15.4 percent in 2005 to 8.0 percent in 2007, which is within the PRGF target range of 5-8 percent. This has been made possible by reducing the budget deficit from 5.4 percent of GDP in 2004/05 to 0.4 percent in 2007/08, reducing net domestic borrowing by the government from 3.0 percent of GDP in 2004/05 to -1.7 percent in 2007/08, and therefore moderating the rate of growth of the money supply. Another factor that has impacted positively on the rate of inflation is the marked increase in the supply of maize, the main food crop, during the last three crop growing seasons. The weight of maize in the consumer price index is over 50 percent.

Malawi has also achieved the other stability-related macroeconomic targets contained in the PRGF arrangement. International reserves increased from 1.4 months of import cover in 2004 to 2.2 months in 2007, and they are projected to reach 3.4 months of import cover in 2008. While the domestic debt was reduced from 24 percent of GDP before the programme to about 10 percent of GDP in 2006 and remained at that level in 2007.

As a result of the restoration of macroeconomic stability, improved performance of the agricultural sector, which accounts for close to 40 percent of GDP, on account of favourable weather and subsidised fertilizer, the rate of economic growth accelerated from 2.3 percent in 2005 to more than 7 percent in 2006 and 2007. In 2008, the rate of economic growth is expected to be 7.1 percent. This is above the PRGF programme target of 6 percent.

Between 2004 and 2005, the National Statistical Office carried out an integrated household survey. The analysis of the data generated by that survey revealed that the percentage of Malawi's population that was considered poor because it was below the national poverty line was 52.4 percent. Since then, Malawi has not conducted another integrated household survey to ascertain the level of poverty in the country. Hence, in income terms, it is difficult to ascertain the impact of the PRGF arrangement on poverty. However, there are indications that poverty may have declined. The main ones are increases in smallholder agricultural output by 14.4 percent in 2006 and by 14.0 percent in 2007, respectively, which led to corresponding increases in the incomes of smallholder farmers. All this benefited the poor, most of whom (56 percent in 2004-05) live in rural areas.

5.2 Socio-Economic Impacts of the PRGF

During the period covered by the PRGF arrangement, real GDP has grown faster than the rate of population growth. Therefore, there has been an increase in real per capita GDP. The increase in real GDP has had the further effect of increasing the level of employment. Another consequence of the increase in real GDP is a decline in the rate of unemployment from 7.8 percent in 2004 to 6 percent in 2005. In 2006, the rate of unemployment remained at the same level as in 2005. The other noteworthy consequence is the decline in the poverty headcount from 52 percent of the population in 2004 to 50 percent in 2005 and 45 percent in 2006 (National Statistical Office, 2005, 2006 and 2007).

Although the period over which Malawi has implemented the current PRGF arrangement is not long enough, there are nevertheless indications that there has been improvement in a number of social variables, even if these may not be due only to the implementation of the PRGF. In education, for example:

- The adult literacy rate increased from 64 percent in 2004 to 66 percent in 2006;
- The proportion of adults who never attended school declined from 23 percent in 2005 to 21 percent in 2006; and
- The proportion of the population without educational qualifications declined from 76 percent in 2005 to 74 percent in 2006.

In health:

- The proportion of under-five children whose birth was assisted by a doctor or clinical officer increased from 5 percent in 2005 to 8 percent in 2006;
- The proportion of under-five children who are stunted declined from 43 percent in 2005 to 36 percent in 2006;
- The proportion of under-five children who are underweight decreased from 18 percent in 2005 to 15 percent in 2006;
- The proportion of under-five children who usually sleep under bed nets increased from 38 percent in 2004 to 50 percent in 2006;
- But the proportion of adults who are sick remained at 13 percent in 2005 and 2006.

In addition, there has been an increase in access to safe drinking water and improved sanitation.

5.3 Challenges of PRGF Implementation

Malawi did not face many challenges in implementing the PRGF arrangement. The country had no problem in satisfying the quantitative performance criteria or quantitative targets. The only target that was missed was the indicative target on government discretionary spending along with the performance criterion on domestic borrowing. Additional government spending necessitated by the food crisis in the country led to these outcomes. Since the additional spending could not be fully accommodated by tax revenue, the government resorted to domestic borrowing, especially from banks. As at the end of December 2007, the overrun on domestic borrowing to finance food security operations amounted to MK1.5 billion. The consequent increase in aggregate demand put pressure on foreign exchange reserves.

One other challenge was the uneven implementation of structural measures. As of the end of December 2005, the structural performance criterion had only been partially implemented. The problem was that in November 2005, the budget ceiling module, a performance criterion, was superseded by a new central payment system. The centralised payment system and the new Integrated Financial Management Information System (IFMIS) made the budget ceiling module less relevant because most payments no longer passed through the accounts system monitored by the budget ceiling module. Also the end-March 2006 structural performance criterion was not fully implemented. To be specific, implementation of a new travel policy (a performance criterion for end-March 2006) was delayed. The policy was developed by a consultant developed, but it was not implemented because it did not meet the objectives of the government. The government took it upon itself to develop the policy and implement it and so met the end-September 2006 performance criterion.

There were two other challenges. The first related to road construction financed from local resources. Here, engineers underestimated the cost of road construction, sometimes by as much as 66 percent. In such situations, the government had no choice but to borrow money to cover the excess costs. The second related to delays in receipt of donor funds. The amounts received were as pledged, but sometimes disbursements were delayed. Here too, the government had no choice but to borrow money locally to finance shortfalls caused by delayed receipt of aid.

5.4 Public Debate Over PRGF Policies and Objectives

Preparation of the PRGF is preceded by intensive consultations by the IMF staff with officials from the Ministry of Finance, other key government ministries and the Reserve Bank of Malawi, and selected private sector players over technical matters, including policies and objectives. The IMF staff also holds meetings with representatives of civil society and NGOs, but these meetings are not intensive. Certainly they do not cover technical matters. The IMF staff uses these meetings to explain the economic situation in the country and get the views of civil society and NGOs on it.

Compared to the IMF, the government maintains complete silence on the PRGF. It does not consult civil society or NGOs on the policies and objectives set out in the PRGF programme before they are finalised and sent to Washington for the consideration and approval of the IMF Executive Board. Nor does it consult local government assemblies and communities, which are thus marginalised. Overall then, the ownership of the PRGF in Malawi is narrow, being confined mainly to the officials of the few public institutions that are involved.

Since local government assemblies form the core of decentralization in Malawi, the absence of ownership of the PRGF risks making interaction with the IMF a one-way process. These institutions view the IMF as a mere source of funding and not as a development partner, a perception that also undermines the level of policy ownership. Debate and dialogue over PRGF policies and objectives are necessary now that local government assemblies are responsible for managing public resources and are accountable directly to the Ministry of Finance and Accountant General's Department (Bamusi, 2005).

The Ministry of Finance posts all pro-poor expenditures on its website so that the general public can have access to them. However, limited knowledge and access to the website means that the message is not widely disseminated. In turn, this implies that the general public lacks knowledge of the PRGF and so it cannot offer its views on it.

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