

EBS/86/190
Correction 1

CONFIDENTIAL

September 10, 1986

To: Members of the Executive Board

From: The Secretary

Subject: Malawi - Staff Report for the 1986 Article IV Consultation,
Request for Stand-By Arrangement, and Request for Arrangement
Under the Structural Adjustment Facility

The following corrections have been made in EBS/86/190 (8/18/86):

Page 1, para. 3, line 1: for "dated August 11, 1986"
read "dated August 5, 1986"

Page 5, under Gross domestic product and
Memorandum items, Total consumption: figures revised

Page 13, Overall balance, column 4: for "33.7" read "33.5"

Corrected pages are attached. Other references to the date of the letter of intent on pages 50, 53, and 67, should read "August 5, 1986" and will be corrected in the appropriate supplements to be issued after the Board discussion.

Att: (3)

I. Introduction

A staff mission visited Malawi during the period May 27-June 18, 1986 to conduct the 1986 Article IV consultation discussions, and to negotiate a financial and economic program to be supported by the use of Fund resources under a stand-by arrangement and the structural adjustment facility (SAF). Discussions were held with the Minister of Finance, the Governor of the Reserve Bank of Malawi, and senior officials of the Treasury, the Reserve Bank, and other governmental and parastatal institutions. ^{1/} Malawi continues to avail itself of the transitional arrangements of Article XIV.

A three-year extended arrangement was approved by the Fund in September 1983 (EBS/83/183; 8/26/83) for an amount equivalent to SDR 100 million (268.8 percent of Malawi's quota of SDR 37.2 million). Due to the long delay in completing the third review (EBS/85/101; 4/28/85), the amount available under the arrangement was reduced by SDR 19 million, to SDR 81 million (217.7 percent of quota). Discussions related to a fourth review under the arrangement were initiated in November 1985 and continued in January and February 1986. For reasons explained below, that review could not be completed, and the authorities have requested that the arrangement be canceled. In all, Malawi purchased SDR 57 million under the arrangement, with the last purchase being effected on December 31, 1985.

In the attached letter dated August 5, 1986, from the Minister of Finance and the Governor of the Reserve Bank of Malawi, the Government of Malawi requests a stand-by arrangement of about 19 months for the period ending March 31, 1988 (the end of Malawi's 1987/88 fiscal year) in the amount of SDR 24 million, equivalent to 64.5 percent of quota, or about 40.7 percent on an annual basis. A waiver of the limitation in Article V, Section 3(b)(iii) would be required. The arrangement envisages seven purchases. The initial purchase, available upon Fund approval, would be for SDR 3.6 million; the remaining purchases would be for SDR 3.4 million each. The second and third purchases are subject to the observance of the performance criteria for end-September and end-December 1986, respectively. The arrangement calls for the completion of the first review by March 31, 1987, which along with observance of the performance criteria for end-March and end-June 1987, will govern the fourth and fifth purchases, respectively. The last two purchases under the arrangement are subject to the completion of a second review by September 30, 1987, and observance of the performance criteria for end-September and end-December 1987, respectively. All of the purchases would be from ordinary resources.

^{1/} The staff representatives included Mr. G.B. Taplin (head-AFR), Ms. H. Bierman (FAD), Ms. B. Vibe Christensen (ETR), Mr. M. Bell (AFR), Mr. H. Futamura (AFR), and Mrs. A. Groen (secretary-ADM). Mr. J.A.K. Munthali, Assistant to the Executive Director for Malawi, participated in the discussions.

As of June 30, 1986, the Fund's holdings of Malawi kwacha subject to repurchase amounted to SDR 112.8 million, or 303.3 percent of quota; of this amount, 237.0 percent and 66.3 percent of quota were in respect of purchases under tranche policies and under the compensatory financing facility, respectively. Assuming that all purchases under the proposed arrangement are made, Fund credit outstanding would be 258.8 percent of quota at the end of March 1988 (Table 1).

In the same letter, the Government of Malawi requests a structural adjustment arrangement in support of its structural adjustment program, covering the three-year period August 1986-July 1989. The amount that will be available to Malawi under the SAF is currently projected at about SDR 17.5 million, and the first loan thereunder is for the amount of SDR 7.4 million. In close collaboration with the staff of the Fund and the World Bank, the authorities have prepared a policy framework paper, which is contained in Appendix II.

Malawi continues to avail itself of the transitional arrangements under Article XIV. The last Article IV consultation discussions, together with discussions on the program for the third year under the extended arrangement, were held in Malawi during February 15-March 1, 1985. The consultation and review were concluded on May 22, 1985 (EBM/85/77; 5/22/85).

The proposed stand-by arrangement is included as Appendix III, and the letter of intent from the Minister of Finance and Governor of the Reserve Bank with an attached memorandum on economic and financial policies as an Annex. The proposed arrangement under the SAF is provided in Appendix IV. Summaries of Malawi's relations with the Fund and the World Bank Group are provided in Appendices V and VI, respectively. Appendix VII provides a summary of statistical issues. Appendix VIII provides a summary and time frame for implementation of the policies under the proposed SAF arrangement, prepared by the staff.

II. The Setting, and Recent Economic Performance Under the Extended Arrangement

1. Background

The program for 1985/86 (April-March) was set against the background of strong external performance in 1984, but with a significant weakening in the external position in prospect. Executive Directors noted this in concluding the 1985 Article IV consultation, and stressed the need for appropriate domestic financial policies to ensure the sustainability of the balance of payments in the medium term. Directors welcomed the intended substantial strengthening of policies in 1985, including the adjustment of the exchange rate, the change in the structure of interest rates to positive rates in real terms, and the intention to eliminate price control by the end of the year. They also welcomed the authorities' intention of achieving a substantial reduction

Table 2. Malawi: Gross Domestic Product and Expenditure, 1984-91

	1984 <u>1/</u>	1985 <u>1/</u>	1986	1987	1988	1989	1990	1991
(In millions of Malawi kwacha; at current market prices)								
Gross domestic product	1,688.1	1,857.3	2,134.4	2,372.4	2,613.9	2,857.3	3,108.3	3,385.2
Total consumption	1,432.0	1,671.8	1,886.1	2,094.6	2,293.5	2,480.4	2,694.8	2,925.4
Gross fixed investment	211.0	264.7	307.9	344.0	379.0	414.3	453.8	497.6
Net exports	45.1	-79.2	-59.6	-66.2	-58.6	-37.4	-40.3	-37.8
Exports of goods and nonfactor services	478.7	469.8	580.1	633.4	681.6	736.1	795.5	865.1
Imports of goods and nonfactor services	433.6	549.0	639.7	699.6	740.2	773.5	835.8	902.9
Domestic saving <u>2/</u>	256.1	185.5	248.3	277.8	320.4	376.9	413.5	459.7
Net factor income from abroad	-81.3	-97.6	-115.1	-20.8	-127.0	-126.4	-128.7	-132.6
National saving	174.8	87.9	133.2	157.0	193.4	250.5	284.7	327.1
Foreign saving	36.2	176.8	174.7	187.0	185.6	163.8	169.1	170.5
Transfers from abroad (net)	48.0	51.5	61.6	115.4	79.8	88.3	87.5	96.8
Foreign capital flows (net)	79.3	20.6	215.8	115.4	166.6	70.4	103.6	130.6
Change in foreign reserves	-91.1	104.7	-102.7	-43.8	-60.8	5.1	-22.0	-56.9
Total saving	211.0	264.7	307.9	344.0	379.0	414.3	453.8	497.6
<u>Memorandum items:</u>								
(As percentages of GDP)								
Total consumption	84.8	90.0	88.4	88.3	87.7	86.8	86.7	86.4
Gross fixed investment	12.5	14.3	14.4	14.5	14.5	14.5	14.6	14.7
Net exports	2.7	-4.3	-2.8	-2.8	-2.2	-1.3	-1.3	-1.1
Exports of goods and nonfactor services	28.4	25.3	27.2	26.7	26.1	25.8	25.6	25.6
Imports of goods and nonfactor services	25.7	29.6	30.0	29.5	28.3	27.1	26.9	26.7
Domestic saving <u>2/</u>	15.2	10.0	11.6	11.7	12.3	13.2	13.3	13.6
National saving	10.4	4.7	6.2	6.6	7.4	8.8	9.2	9.7
(Annual percentage rates of change)								
GDP at a constant factor cost	3.3	2.9	3.0	3.3	3.3	3.4	3.5	3.5
GDP at current market prices	17.7	10.0	14.9	11.1	10.2	9.3	8.8	8.9
GDP deflator (market prices)	12.8	8.1	11.8	7.7	6.8	5.7	5.1	5.2

Sources: Data provided by the Malawian authorities; and staff estimates and projections.

1/ Substantial revisions to the national accounts were made in 1985.2/ Excluding financing of stock accumulation.

decline in total and marketed maize production. Nevertheless, developments in the maize sector were offset by a large rise in the marketed output of groundnuts, pulses and treenuts, and a more modest rise in the marketed production of rice and cotton.

A major factor influencing the change in the pattern of agricultural production has been the movement of relative producer prices. The producer price for maize was raised by 67 percent for the 1982 crop. Despite a substantial relative realignment of prices in 1983-85, shifting the incentives away from maize production, a large surplus of marketed maize emerged. The gradual reduction of fertilizer subsidies also eroded the relative incentive for maize and tobacco production, where fertilizers are used intensively. Continuing these trends, maize and tobacco producer prices were frozen for the current crop year, while other prices were increased by about 10 percent.

Preliminary estimates suggest a significant rise in gross fixed investment, to 14.3 percent of GDP in 1985 compared with 12.5 percent in 1984, mainly attributed to the private sector, as the temporary high profitability of the export sector in 1984 apparently resulted in significant new investment in early 1985. This was reflected in a substantial rise in imports of capital goods. However, the relatively strong investment performance in 1985 was accompanied by a reduction in domestic savings, from 15 percent of GDP in 1984 to 10 percent, as the profitability of the export sector decreased, and the financial position of the public sector weakened.

Consumer prices rose at an annual average rate of 15.0 percent during 1985, compared with 12.4 percent in each of the two preceding years, reflecting a brief surge early in the year when prices were rising by an annual rate of 18 percent. By December, inflation had fallen to 12.5 percent. A renewed acceleration occurred in early 1986, to 14.6 percent in April 1986, partly due to increases in the officially controlled wholesale price of maize and other food crops. Moreover, transportation prices were rising sharply. Also, the program of price liberalization, which was completed in December 1985, 1/ could have temporarily pushed prices upward.

3. Central government financial operations

The program for 1985/86 (April-March) sought to reduce the deficit of the Central Government (with grants above the line) to MK 85.6 million (or 4.1 percent of projected GDP) 2/ (Table 3). Most of this

1/ Only five commodities, petroleum, low-grade meat, fertilizer, sugar, and motor vehicle spare parts, remained under control, compared to over 60 items in 1983.

2/ With grants below the line, the targeted deficit was MK 138.6 million (6.7 percent of GDP). The substantial revision in the national accounts, effected in mid-1985, complicates the comparison of economic aggregates.

Table 5. Malawi: Balance of Payments, 1984-91

	1984	1985		1986	1987	1988	1989	1990	1991
		EFF program	Est.						
(In millions of SDRs)									
Current account	-15.7	-62.5	-97.2	-80.1	-76.2	-78.0	-63.8	-61.9	-58.6
Trade balance	44.7	8.3	-35.8	-18.3	-16.4	-17.0	-5.7	-5.2	-2.3
Exports, f.o.b.	308.0	305.7	250.9	245.7	254.7	272.4	287.6	304.0	323.5
Imports, c.i.f.	-263.3	-297.4	-286.7	-264.0	-271.1	-289.5	-293.4	-309.2	-325.8
f.o.b value	-158.0	-184.4	-172.0	-161.0	-166.8	-179.8	-190.5	-200.8	-211.5
c.i.f. margin	-105.3	-113.0	-114.7	-103.0	-104.3	-109.7	-102.9	-108.4	-114.2
Services and transfers	-60.4	-70.8	-61.4	-61.8	-59.9	-60.9	-58.1	-56.6	-56.3
Nonfactor services	-13.6	-19.0	-10.2	-11.0	-10.7	-11.0	-11.0	-11.0	-11.0
Receipts	22.4	23.0	22.0	22.0	24.3	26.0	28.0	30.0	32.0
Payments	-36.0	-42.0	-32.2	-33.0	-35.0	-37.0	-39.0	-41.0	-43.0
Factor services	-56.1	-61.8	-56.7	-54.3	-52.7	-53.9	-52.1	-51.6	-52.3
Receipts	1.9	2.5	1.6	2.0	2.2	2.4	2.6	2.8	3.0
Payments	-58.0	-64.3	-58.3	-56.3	-54.9	-56.3	-54.7	-54.4	-55.3
Interest	-43.3	-45.3	-44.7	-42.3	-38.9	-39.3	-36.7	-35.4	-35.3
Other	-14.7	-19.0	-13.6	-14.0	-16.0	-17.0	-18.0	-19.0	-20.0
Private transfers	9.3	10.0	5.5	3.5	3.5	4.0	5.0	6.0	7.0
Receipts	20.6	23.0	16.4	14.4	15.5	16.5	18.0	19.5	21.0
Payments	-11.3	-13.0	-10.9	-10.9	-12.0	-12.5	-13.0	-13.5	-14.0
Capital account	78.5	47.5	36.4	113.6	80.9	103.8	58.8	74.0	87.8
Long-term, net	82.7	42.5	48.8	119.1	80.9	103.8	58.8	74.0	87.8
Government transfers	23.8	29.1	24.4	25.2	46.9	26.1	28.0	29.8	31.8
Credit	25.7	31.0	26.3	26.8	48.8	28.1	30.1	32.0	34.1
Debit	-1.9	-1.9	-1.9	-1.6	-1.9	-2.0	-2.1	-2.2	-2.3
Government loans	64.3	19.8	30.0	93.5	25.3	68.0	19.2	30.6	41.0
Credit (other)	39.9	52.0	55.7	36.2	38.3	42.3	45.1	48.0	59.5
SAL and related	50.6	--	7.2	93.0	19.1	59.5	0.0	0.0	0.0
Debit	-26.2	-32.2	-32.9	-35.7	-32.1	-33.8	-25.9	-17.5	-18.5
Public enterprises	-3.1	-9.3	-6.6	-2.8	2.7	4.4	5.2	5.8	7.1
Credit	0.7	2.0	0.6	3.1	8.2	10.0	11.3	12.6	13.8
Debit	-3.8	-11.3	-7.2	-5.9	-5.5	-5.6	-6.1	-6.8	-6.7
Private enterprises	-2.3	2.9	1.0	3.2	5.9	5.3	6.4	7.9	7.8
Credit	6.7	9.5	8.7	7.0	9.4	8.8	9.5	10.5	11.0
Debit	-9.0	-6.6	-7.7	-3.8	-3.5	-3.5	-3.1	-2.6	-3.2
Short-term flows and unidentified	-4.2	5.0	-12.4	-5.5	--	--	--	--	--
Overall balance	62.8	-15.0	-60.8	33.5	4.6	25.8	-5.0	12.2	29.2
Balance	-62.8	15.0	60.8	-33.5	-4.6	-25.8	5.0	-12.2	-29.2
Use of Fund resources ^{1/}	17.4	8.2	7.0	-5.3	-5.3	-11.5	-19.5	-19.8	-22.9
Change in reserves	-80.2	6.8	53.8	-28.2	0.7	-14.3	24.5	7.6	-6.3
Memorandum items:	(In percent)								
Current account/GDP ratios									
Excluding official transfers	-1.3	-5.5	-9.1	-8.1	-7.5	-7.0	-5.4	-4.9	-4.3
Including official transfers	0.7	-3.0	-6.8	-5.5	-2.9	-4.7	-3.0	-2.5	-2.0
Gross reserves of the monetary authorities	58.0	50.2	39.8	68.3	67.6	81.9	57.4	49.8	56.1
(In weeks of c.i.f. imports)	(11.5)	(8.8)	(7.2)	(13.4)	(13.0)	(14.7)	(10.2)	(8.4)	(9.0)
	(Percentage change)								
Export volume	25.8	9.3	2.7	4.1	3.6	3.1	3.6	3.6	4.4
Import volume	-12.0	6.0	13.6	2.0	2.5	3.5	3.5	3.0	3.0
Terms of trade	8.1	-8.7	-17.8	6.4	-0.1	0.5	4.0	-0.3	-0.3

Sources: Data provided by the Malawian authorities; and staff estimates.

^{1/} Includes SAF loan disbursement.

markets for maize because some neighboring countries also had excess supplies. Expansionary fiscal policies and relaxation of import approvals gave rise to an increase in import volumes of 13.6 percent, four times the growth of real GDP and double the programmed increase.

On April 2, 1985, the kwacha was depreciated by 15 percent against the currency basket to which it is pegged to reverse a real effective appreciation of the currency which had taken place since the fourth quarter of 1983. Between April and December 1985, the kwacha appreciated by about 7 percent in real effective terms, in large part reflecting the sharp depreciation of the South African rand against most major currencies. 1/ Between December 1985 and May 1986, as the rand temporarily strengthened and as discretionary downward adjustments were made to the kwacha rate, the kwacha depreciated by 11 percent in real effective terms, and thus it declined to a level about 5 percent below the real effective exchange rate in April 1985 (see Chart 2). Through the deliberate slide in the exchange rate the authorities sought to improve external competitiveness.

The improvement in the reserve position which had occurred in 1984 gave rise to a relaxation in import approvals under the foreign exchange budget in 1985. Payments by the Reserve Bank for private sector imports normally take place with a lag of about four weeks and payments for government imports with a lag of only a few days. However, in early 1986, the foreign exchange reserves declined sharply, partly due to slow repatriation of export proceeds 2/ and reduced recourse to external pre-financing for tobacco, related to uncertainties created by the sliding exchange rate. Consequently, delays of up to three months emerged in the provision of foreign exchange for private imports, thereby constituting an intensification of exchange restrictions. The Malawian authorities emphasized that external debt obligations have continued to be paid when they become due, including financial obligations to the Fund. In addition, Malawian officials have met with foreign creditors, who had showed understanding with respect to the temporary lengthening in the payment lag.

6. Monetary and credit developments

Largely due to the developments in ADMARC and the Central Government, domestic credit expanded significantly during 1985 and early 1986, much more rapidly than had been anticipated under the extended arrangement (see Chart 3). Indeed, the expansion would have been even sharper, had the private sector's recourse to bank credit not been unusually

1/ South Africa accounted for 7 percent of Malawi's exports and 40 percent of its imports in 1984 (latest data). The rand has a weight of 28 percent in the trade-weighted index of the Information Notice System, which is larger than in the currency basket of the kwacha.

2/ Exporters are obliged to repatriate foreign exchange receipts within six months from the shipment of exports.