

**FOR
AGENDA**

EBS/02/131
Supplement 1

CONFIDENTIAL

July 29, 2002

To: Members of the Executive Board

From: The Secretary

Subject: **Malawi—Staff Report for the 2002 Article IV Consultation and Economic Program for 2002**

The attached supplement to the staff report for the 2002 Article IV consultation with Malawi and Malawi's economic program for 2002 (EBS/02/131, 7/22/02) has been prepared on the basis of additional information. Also attached is the second page of the public information notice with the third full paragraph updated to reflect the new information contained in this supplement. This subject is tentatively scheduled for discussion on **Monday, August 5, 2002**. At the time of circulation of this paper to the Board, the Secretary's Department has received a communication from the authorities of Malawi indicating that they consent to the Fund's publication of this paper.

Questions may be referred to Mr. Kammer (ext. 39349), Ms. Kostial (ext. 35349), and Mr. Mathisen (ext. 36520) in AFR.

Unless the Documents Section (ext. 36760) is otherwise notified, the document will be transmitted, in accordance with the procedures approved by the Executive Board and with the appropriate deletions, to the WTO Secretariat; and to the African Development Bank and the European Commission, following its consideration by the Executive Board.

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INTERNATIONAL MONETARY FUND

MALAWI

**Staff Report for the 2002 Article IV Consultation
and Economic Program for 2002
Supplementary Information**

Prepared by the African Department

(In consultation with the Fiscal Affairs, Legal, Monetary and Exchange Affairs, Policy
Development and Review, Statistics, and Treasurer's Departments)

Approved by Michael Nowak and Masood Ahmed

July 29, 2002

1. This supplement to EBS/02/131 (7/22/02) provides new information on the food security situation since the staff report was issued. The update does not alter the thrust of the staff appraisal.
2. **The latest assessment of Malawi's food situation in 2002/03 suggests that the food shortage might be more severe than previously thought.** The staff report indicated that, at end-May 2002, the Food and Agriculture Organization (FAO)/World Food Program (WFP) had projected a shortfall of 485,000 metric tons for August 2002-March 2003. Recently, however, the Ministry of Agriculture and Irrigation, together with the USAID's Famine Early Warning System, revised upward the estimate of the food shortage by about 100,000 metric tons.
3. **Thus, the authorities are now considering stepping up their food imports, as needed, to 350,000 metric tons (equivalent to about US\$90 million) from the 250,000 metric tons reported in the staff report.** These additional imports would have an

Selected Economic Indicators, 2002-03

	2002		2003	
	EBS/02/131	Rev. proj.	EBS/02/131	Rev. proj.
External current account after grants (in percent of GDP)	-11.3	-12.7	-6.7	-6.7
Imports (in millions of U.S. dollars)	768.2	795.9	657.2	657.2
Balance of payments gap (in millions of U.S. dollars)	60.0	88.2
International reserves (at year's end; in millions of U.S. dollars)				
gross	129.9	102.1	228.4	228.4
(in months of imports)	2.1	1.6	3.4	3.4
net	56.0	28.3	148.9	148.9
Domestic fiscal balance (in percent of GDP) 1/	-5.4	-6.0	-3.2	-3.2

Sources: Malawian authorities; and staff estimates and projections.

1/ Fiscal year. For 2002, fiscal year 2002/03.

impact on the macroeconomic program presented in the report. In particular, international reserves could fall to below one month of import coverage in November 2002, while the fiscal deficit in 2002/03 could widen to 6 percent of GDP (compared with the previous target of 5½ percent), reflecting the effect of the extension of the price subsidy on the additional food imports. For 2003, the projected balance of payments gap could widen to about US\$90 million from US\$60 million.

4. **The authorities and the staff are concerned that financing the increased food imports with international reserves would reduce reserves to a level that would not provide sufficient protection against unforeseen shocks and could derail the macroeconomic program.** At a minimum, international reserves should remain at the level envisaged in the staff report to lend credibility to the macroeconomic stabilization strategy, as otherwise there would be a considerable risk that dwindling reserves could trigger ad hoc policy adjustments. Moreover, given the still significant uncertainty with regard to the estimate of the food shortage,¹ a level of international reserves higher than projected in the staff report might be desirable so as to give the authorities the flexibility to import additional food should the need arise.

5. **Consideration is, therefore, being given to providing Malawi with emergency assistance² in an amount of 25 percent of quota (about SDR 17 million); the World Bank staff is also contemplating support under an emergency recovery loan.** Prompt action by the Fund and the World Bank would likely catalyze additional donor support.

6. **The staff intends to present a formal request by the authorities for emergency assistance to the Board shortly, for approval on a lapse-of-time basis.**

¹ The agricultural production statistics on which these estimates rely have been flawed in the past and remain unreliable. Improving the quality of statistics is likely to take considerable time.

² Purchases under emergency assistance are subject to the General Resources Account (GRA) rate of charge, currently at 3 percent, compared with 0.5 percent for PRGF resources, and a repayment period of 3¼ to 5 years. After replenishing reserves at end-2002, including through, possibly augmented, access under the PRGF at the time of the first review, Malawi would be able to make an early repurchase of the emergency assistance resources.

and services sectors remained negligible and industrial activity shrank to its lowest level in more than a decade.

Since end-2000, inflation fell considerably, but real interest rates have remained high. The headline 12-month inflation declined to below 17 percent in June 2002, from 35 percent in December 2000 as, for the most part since December 2000, the Reserve Bank of Malawi has followed a tight monetary stance. But real interest rates remain high at over 30 percent, reflecting an expansionary fiscal policy, but also persistent inflation expectations in light of a history of stop-and-go disinflation episodes. After the large real depreciation during 2000, the kwacha appreciated in real effective terms during 2001 correcting for the development in 2000, but reflecting also the fiscal expansion and, later in the year, the depreciation of the South African Rand.

Fiscal policy has been expansionary until the beginning of 2002, crowding out the private sector. Slippages from the program came mostly from policy decisions to bail out parastatals, augment civil servants' wages, increase other low-priority public spending, such as travel and representation, and reduce income taxes. These slippages were exacerbated by a rising interest bill and weak revenue collections due to a decline in firms' profitability and sluggish collection of import-related taxes.

However, expenditure appears to have been contained since March 2002 and the 2002/03 (July to June) budget targets a decisive adjustment in the domestic balance to 6 percent of GDP from an estimated 8 percent of GDP in 2001/02. While this adjustment will require tax measures and substantial cuts in nonpriority spending, this accommodates a subsidy for maize and an increase in spending on priority pro-poor programs to almost 6 percent of GDP from about 5 percent of GDP in 2001/02 and 3½ percent of GDP in 2000/01.

The external current account deficit narrowed to 13 percent of GDP in 2001, down from some 14 percent in 2000. A small deterioration in the trade balance was more than offset by an improvement in the services balance. The current account deficit is expected to widen substantially in 2002, due to food imports. Despite the suspension of balance of payments support by most donors at end-2001, international reserves remained adequate and stood at about 3 months of imports at end-June 2002.

While public expenditure management has been strengthened, progress in implementing reforms with respect to parastatals have gained momentum only recently with the large bailouts highlighting the need for action. The Ministry of Finance has now more control over parastatals' finances and audits of the large agriculture marketing parastatal and its subsidiaries have been completed. After a temporary suspension of the privatization program in mid-2001, the authorities have privatized the Commercial Bank of Malawi in December 2001 and are in the process of completing the privatization of other major parastatals.

The authorities have finalized a poverty reduction strategy paper (PRSP) at end-April 2002 which emanated from a highly participatory process. Its strategy relies on a framework