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April 24, 1985

To: *Members of the Executive Board*

From: The Secretary

Subject: Malawi - Staff Report for the 1985 Article IV Consultation and Review Under Extended Arrangement

Attached for consideration by the Executive Directors is the staff report for the 1985 Article IV consultation with Malawi and a review under the extended arrangement. Draft decisions appear on pages 33-35.

It is proposed to bring this subject to the agenda for discussion on Wednesday, May 22, 1985.

Mr. Woodward (ext. 673816) or Mr. Bell (ext. 6518) are available to answer technical or factual questions relating to this paper prior to the Board discussion.

Att: (1)

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MALAWI

Staff Report for the 1985 Article IV Consultation and Review Under Extended Arrangement

Prepared by the African Department and the Exchange and Trade Relations Department

(In consultation with the Fiscal Affairs, Legal, and Treasurer's Departments)

Approved by A.D. Ouattara and W.A. Beveridge

April 24, 1985

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I. Introduction

A staff team visited Malawi from February 15 to March 1, 1985 to hold discussions relating to the 1985 Article IV consultation, the review of performance under the program for 1984/85, and the program for the 1985/86 fiscal year (April-March). Discussions were held with the Minister of Finance, Mr. E.C.I. Bwanali, the Governor of the Reserve Bank of Malawi, Mr. L.C. Chaziya, and senior officials of the Treasury, the Reserve Bank, and other government 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, for an amount of SDR 100 million (268.8 percent of quota), and the program for the second fiscal year under the arrangement was approved in August 1984. 2/ Purchases to date amount to SDR 34 million (Table 1). Two further purchases, each of SDR 11 million, had been scheduled during 1984/85 subject to the completion of the mid-year review, which was required before December 31, 1985, and the observance of performance criteria for December 1984 and March 1985, to be established in the course of that review. In the case of the second of these purchases, the reaching of understandings on a program for the 1985/86 fiscal year was also required. For reasons explained below, the review was not completed as scheduled and purchases have been interrupted since then.

The staff mission in February 1985 concluded discussions on a program for 1985/86 which entailed a substantial strengthening of fiscal policy and an adjustment in exchange rate and interest rate policy. In their letter dated April 12, 1985 and the attached memorandum, the Minister of Finance and the Governor of the Reserve Bank provide details of the policies and measures to be followed by the Government of Malawi which aim at ensuring a return to the path of adjustment that had been sought originally under the extended arrangement.

The staff proposes the establishment of performance criteria for the third year of the arrangement, and the restoration of purchasing rights under the arrangement. However, in view of the interruption in the sequence of purchases, the staff considers that it would be appropriate to reduce the amount of the arrangement from SDR 100 million to SDR 81 million (that is, from 268.8 percent of quota to 217.7 percent) and to rephase the remaining purchases. Under the proposed decision, SDR 47 million would remain available during the remainder of the arrangement, and would be phased in six installments. SDR 7 million could be purchased

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1/ The staff representatives in the mission included Mr. A.C. Woodward (AFR-Head), Ms. H. Bierman (FAD), Ms. W. Tseng (ETR), Mr. M. Bell (AFR), Mr. M. Fisher (EP-AFR), and Miss S. Symons (secretary-ETR).

2/ EBS/83/183 (8/26/83) and EBS/84/151 (7/12/84), respectively. A review under the first fiscal year was completed in March 1984, in EBS/84/32 (2/29/84).

Table 1. Malawi: Fund Position During Period of Arrangement, September 1983-September 1986

	Outstanding at Aug. 30, 1983	Actual						Proposed					
		1983/84		1984/85				1985/86				1986/87	
		Sept.-Dec.	Jan.-Mar.	Apr.-June	July-Sept.	Oct.-Dec.	Jan.-Mar.	Apr.-June	July-Sept.	Oct.-Dec.	Jan.-Mar.	Apr.-June	July-Sept.
	(In millions of SDRs)												
Net purchases		7.1	-4.0	4.6	15.8	1.0	-3.9	2.8	4.7	3.7	4.7	1.9	3.0
Transactions excluding special facilities (net)		9.7	-1.6	7.0	4.4	2.4	-2.8	3.0	4.9	3.9	4.9	3.6	4.7
Purchases		10.0	--	10.0	7.0	7.0	--	7.0	8.0	8.0	8.0	8.0	8.0
Ordinary resources		(8.6)	(--)	(5.0)	(3.5)	(1.4)	(--)	(--)	(--)	(--)	(--)	(--)	(--)
Borrowed resources		(1.4)	(--)	(5.0)	(3.5)	(5.6)	(--)	(7.0)	(8.0)	(8.0)	(8.0)	(8.0)	(8.0)
Repurchases		0.3	1.6	3.0	2.6	4.6	2.8	4.0	3.1	4.1	3.1	4.4	3.3
Ordinary resources		(--)	(1.2)	(1.6)	(2.2)	(2.2)	(1.8)	(1.8)	(1.8)	(1.9)	(1.8)	(2.2)	(1.7)
Borrowed resources		(0.3)	(0.4)	(1.4)	(0.4)	(2.5)	(1.0)	(2.2)	(1.3)	(2.2)	(1.3)	(2.2)	(1.6)
Transactions under special facilities (net)		-2.6	-2.4	-2.4	11.4	-1.4	-1.1	-0.2	-0.2	-0.2	-0.2	-1.7	-1.7
Purchases		--	--	--	13.8	--	--	--	--	--	--	--	--
Repurchases		2.6	2.4	2.4	2.4	1.4	1.1	0.2	0.2	0.2	0.2	1.7	1.7
Total Fund credit outstanding	90.4	97.5	93.5	98.1	113.9	114.9	111.0	113.8	118.5	122.2	126.9	128.8	131.8
Under tranche policies	64.9	74.6	73.0	80.0	84.4	86.8	84.0	87.0	91.9	95.8	100.7	104.3	109.0
Special facilities	25.5	22.9	20.5	18.1	29.5	28.1	27.0	26.8	26.6	26.4	26.2	24.5	22.8
	(As percent of quota)												
Total Fund credit outstanding	243.0	262.1	251.3	263.7	306.2	308.9	298.4	305.9	318.5	328.5	341.1	346.3	354.3
Excluding special facilities	174.5	200.5	196.2	215.0	226.9	233.3	225.8	233.9	247.0	257.5	270.7	280.4	293.0
Special facilities	68.5	61.6	55.1	48.7	79.3	75.5	72.6	72.0	71.5	71.0	70.4	65.9	61.3

Source: International Monetary Fund.

after completion of the review and establishment of performance criteria for 1985/86. Four further purchases each of SDR 8 million would be available subject to the observance of the performance criteria for June, September and December 1985, and March 1986. The last of these would also require the reaching of understandings on policies relating to the 1986/87 fiscal year. A final purchase of SDR 8 million would be available after observance of performance criteria for June 1986. Such utilization would raise Fund credit to Malawi to 293.0 percent of quota by the end of the arrangement excluding special facilities (354.3 percent of quota including special facilities).

Relations with the World Bank and a statement by the Bank staff on Malawi's economic policies are contained in Appendix III.

II. Recent Developments and Performance Under the Extended Arrangement

The objectives of the extended arrangement were to establish a balance of payments sustainable in the medium term, while restoring an average annual rate of economic growth of 3.5 percent and reducing the rate of domestic inflation to about 7-8 percent. The program anticipated a small overall balance of payments surplus by 1986, to be achieved by a reduction in the current account deficit (after debt relief, excluding official transfers) from 8.7 percent of GDP in 1982 to 5.2 percent in 1987, by a significant improvement in net capital inflows, and by imposing tight restraint on nonconcessional borrowing. The Government's overall deficit (including grants) was to be reduced from 7.1 percent of GDP in 1982/83 to 4.8 percent by 1985/86. The expansion of domestic credit was to be restrained, allowing for the credit needs of the private sector while limiting the use of bank credit by the Government and public enterprises. The authorities undertook a number of measures to improve the operational efficiencies, tariff structures and investment portfolios of major parastatals. This was to be supported by the general liberalization of price control and further improvement of production incentives.

1. Output, expenditure and prices

Output grew more strongly than projected in both 1983 and 1984. In 1984 GDP grew by 4.1 percent, with the main impetus coming from the agricultural sector (Table 2). Manufacturing output stagnated, with a sharp rise in the output of the export sector being offset by a fall in domestic manufacturing. There were significant gains in the terms of trade, and real national income, adjusted for changes in the terms of trade, is estimated to have risen by 6.2 percent (or by 3.5 percent in per capita terms).

Gross fixed investment is provisionally estimated to have fallen to about 12 percent of GDP in 1984, compared with an average of about 15 percent in 1981-83. This partly reflected the contraction in the Government's

Table 2. Malawi: Gross Domestic Product and Expenditure, 1982-88

	1982	1983 1/	1984 1/	1985	1986	1987	1988
	(In millions of Malawi kwacha at current market prices)						
Gross domestic product	1,208.2	1,419.1	1,700.9	2,022.3	2,248.7	2.513.0	2,748.9
Total consumption	1,105.6	1,343.2	1,492.9	1,802.9	2,013.6	2,219.7	2,395.7
Gross fixed investment	181.7	197.3	200.0	238.6	269.8	326.7	384.9
Net exports	-79.1	-121.4	8.0	-19.3	-34.7	-33.4	-31.6
Exports of goods and non-factor services	280.2	298.2	467.2	588.1	640.6	662.1	689.2
Imports of goods and non-factor services	359.3	419.6	459.2	607.3	675.3	695.5	720.8
Domestic saving 2/	95.7	94.9	242.5	231.4	252.7	310.0	371.3
Net factor income from abroad	-31.5	-76.7	-90.8	-110.5	-124.0	-120.1	-114.2
National saving	64.2	18.2	151.7	120.9	128.7	189.9	257.1
Foreign saving	117.5	179.1	48.3	117.7	141.1	136.8	127.8
Transfers from abroad (net)	38.3	49.6	49.1	70.0	85.4	94.6	107.4
Foreign capital flows (net)	32.5	75.2	90.3	24.0	133.3	32.6	38.4
Change in foreign reserves	46.7	54.3	-91.1	23.7	-77.6	9.6	-18.0
Total saving	181.7	197.3	200.0	238.6	269.8	326.7	384.9
	(Percentages)						
Memorandum items:							
As a percentage of GDP							
Total consumption	91.5	94.7	87.8	89.2	89.5	88.3	87.2
Gross fixed investment	15.0	13.9	11.8	11.8	12.0	13.0	14.0
Net exports	-6.5	-8.6	0.5	-1.0	-1.5	-1.3	-1.2
Exports of goods and non-factor services	23.2	21.0	27.5	29.1	28.5	26.3	25.1
Imports of goods and non-factor services	29.7	29.6	27.0	30.0	30.0	27.7	26.2
Domestic saving	7.9	6.7	14.3	11.4	11.2	12.3	13.5
National saving	5.3	1.3	8.9	6.0	5.7	7.6	9.4
Rates of change							
GDP at constant factor cost	2.8	3.5	4.1	2.7	1.0	2.0	3.0
GDP at current market prices	12.9	17.5	19.9	18.9	11.2	11.8	9.4
GDP deflator (market prices)	10.3	14.3	13.8	13.9	10.1	9.6	6.2

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

1/ The official national accounts data for 1983 and 1984 are incomplete, and the figures shown for these years are based in part on staff estimates. Data for 1985 *et seq*. are staff estimates.
2/ Excluding financing of stock accumulation.

development budget, and a continuing very low rate of investment by public enterprises. There was a decline, especially in infrastructural development. Gross domestic saving, reflecting the exceptional strong earnings of the export sector and the reduction in imports, rose very sharply in 1984 to 14.3 percent of GDP from 6.7 percent in the previous year, some 4 percentage points above the program estimate.

For the crop year 1984/85 there were further substantial increases in the price of all the main smallholder crops (except maize). 1/ Between 1980/81 and 1984/85, during a period when consumer prices are estimated to have risen by 61 percent, the prices of the five principal crops have been raised as follows: maize by 82 percent, rice by 70 percent, cotton by 100 percent, groundnuts by 112 percent and tobacco by 120 percent. The production response for the various crops has varied; present estimates suggest that by 1985 the production of maize will have risen by 116 percent from its 1981 level, cotton by 75 percent, and tobacco by 55 percent (both the latter two having fallen in the intervening period) while groundnut and rice production will have fallen by 27 percent and 33 percent, respectively (Chart 1). The substantial price increases in the early 1980's have resulted in a movement of the real prices of these commodities (relative to the consumer price index), toward the levels of the 1970s.

Consumer prices are estimated to have risen by 13.1 percent in 1984, about the same rate as in 1983 and in line with the target of 13 percent for the second program year, although somewhat higher than the rate of 10 percent envisaged in the original program. 2/

Further significant steps have been taken to reduce the extent of price control. In 1983 the authorities removed control from 23 commodities of the total of about 60 items originally controlled. In 1984 a list of 25 commodities that remained subject to control was published.

1/ Price increases for selected grades of the crops concerned were:

(In percent)

Maize	0.0
Tobacco	15.5
Rice	13.0
Cotton	9.5
Groundnuts	16.7

2/ There is considerable difficulty in interpreting price trends in Malawi. The authorities now prepare 10 indices for various urban centers and different income groups. The inflation rates quoted in this report are estimated from a composite index compiled by the staff using some of the individual indices. The average quoted here conceals a wide divergence between the inflation rates among high-income and low-income households, where average rates of increase were 10.1 percent and 18.7 percent, respectively, in 1984.

This action removed only 10 further commodities from the list of controlled items, but it represented a significant measure of liberalization, since it clarified the previously ill-defined system for manufacturers, most of whom had sought approval of price increases even when this was not explicitly required by Government regulation. In February 1985 a further eight items were removed from control, including two which were subject to statutory control. This reduced to 17 the number of commodities under control. 1/ The authorities have not conducted any systematic study of the impact on domestic prices of these measures, but have suggested that the much higher inflation rates in 1984 for low-income households than high-income households may be due to the liberalization, since controlled items account for a larger share of the expenditures of the former group than of the latter.

2. Central government operations in 1984/85

a. Program for 1984/85

In many respects fiscal developments in 1984/85 were similar to those in 1983/84. Both programs aimed to achieve a reduction in the budget deficit by a combination of revenue increases and expenditure restraint. In both programs, the revenue estimate, which rested heavily on further increases in already high rates of taxation on imports as well as on domestic goods, was exceeded, while expenditure restraint fell short of expectations. As a result, in both years the deficit was in excess of the program (Table 3 and Chart 2).

Central Government revenue is estimated to have increased in 1984/85 by 21.8 percent, compared with a programmed increase of 17.1 percent, with most of the excess attributable to an advance payment of taxes on unusually high tea sector profits realized in 1984/85 and due in 1985/86. This, however, was more than offset by a 12.3 percent rise in Central Government expenditure compared to a programmed increase of 8.3 percent. The overrun was concentrated in expenditure mainly for nonwage goods and services ("other current expenditure"), where an estimated increase of 6.2 percent compares to a programmed reduction of 6.5 percent, despite efforts by the authorities to restrain expenditure in this category. In retrospect it appears that the scope for expenditure cuts had been overestimated. Moreover, there were also significant expenditure overruns in other categories. The increase in the wage bill which had been limited in the program to 11 percent relative to 1983/84 is estimated to have amounted to 17.5 percent, partly because a 10 percent average salary increase for government workers, originally intended for 1985/86, was effected on January 1, 1985. External interest payments are expected to have exceeded the programmed amount by 26 percent, largely on account

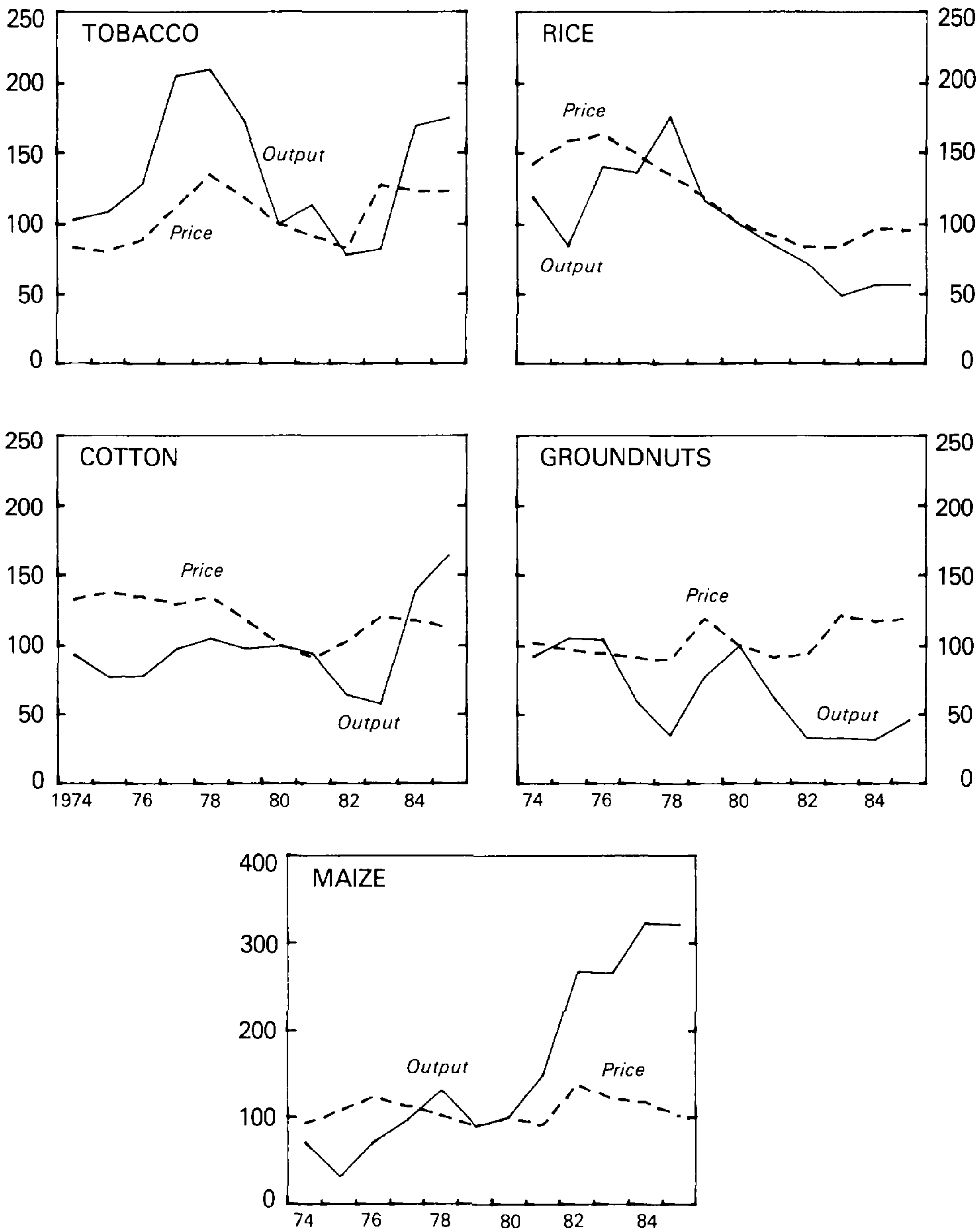
1/ These commodities are: meat, fuel, sugar, milk and infant foods, medicines, hoes, fertilizer, maize flour, edible oils and fats, salt, agricultural implements, motor vehicle spare parts, fish, soap, cement and shoes, and textiles purchased principally by low-income households.

CHART 1

MALAWI

AGRICULTURAL OUTPUT[1] AND REAL PRODUCER PRICES,[2] 1974-85

(1980 = 100)



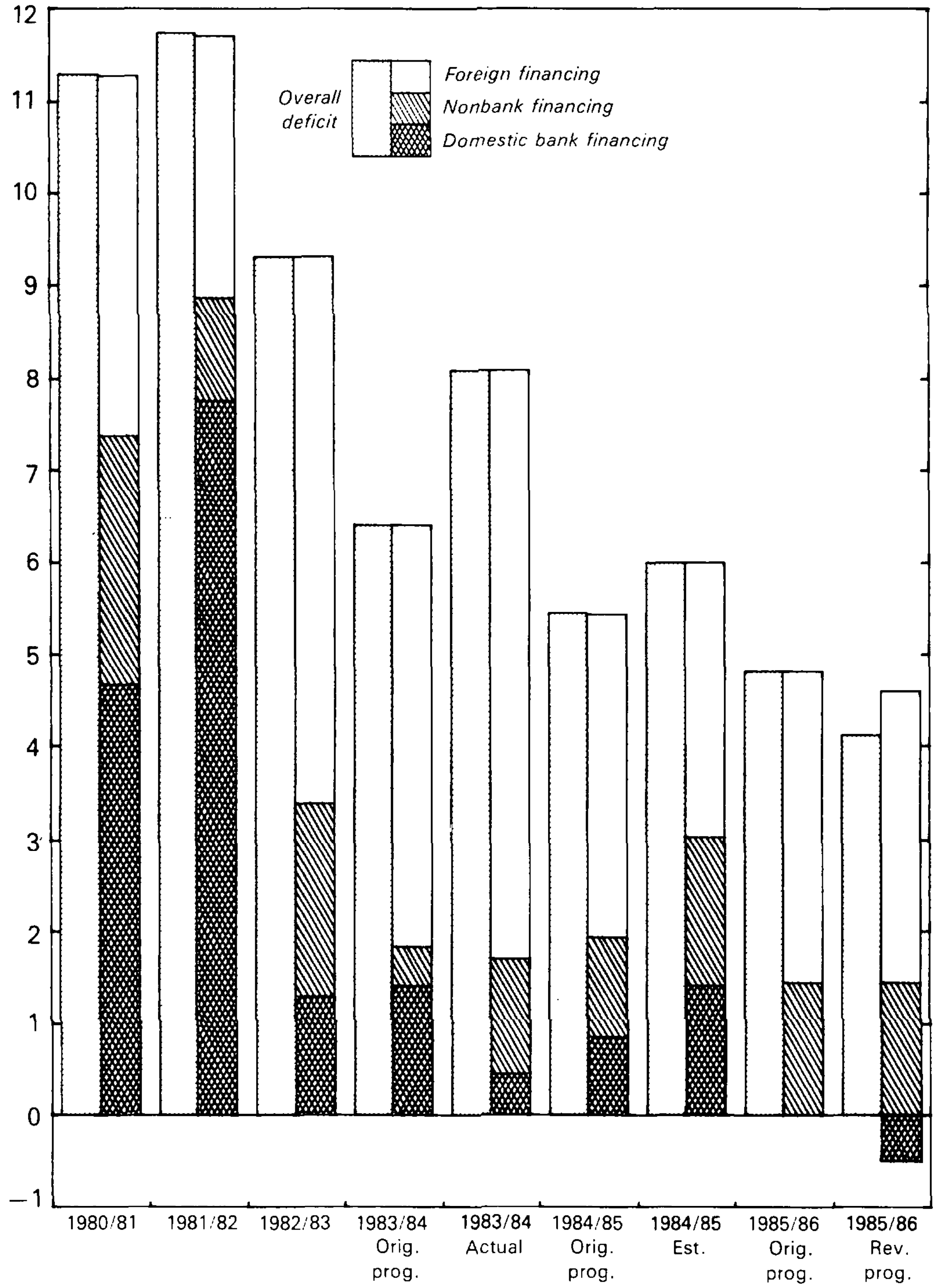
Sources: *Monthly Bulletin of Statistics*, data supplied by the Malawian authorities, and IMF staff estimates.
[1]Marketed production of the smallholder sector only.
[2]Producer price deflated by a composite index of consumer prices.

CHART 2

MALAWI

CENTRAL ADMINISTRATION OVERALL DEFICIT AND FINANCING, 1980/81-1985/86

(In percent of GDP)



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

Table 3. Malawi: Summary of Central Government Operations, 1982/83-1985/86

	1982/83	Program 1983/84	Outturn 1983/84	Program 1984/85	Estimated outturn 1984/85	Program 1985/86	Projections 1986/87	Projections 1987/88
	(In millions of Malawi kwacha)							
Total revenue	244.3	272.9	286.0	335.0	348.4	455.5	495.2	529.0
Tax	207.7	230.1	238.9	279.3	289.2	385.2	420.2	450.0
Nontax	36.6	42.8	47.2	55.7	59.2	70.3	75.0	79.0
Total expenditure	400.3	419.8	440.2	476.7 1/	494.4 1/	594.0	633.2	685.1
Recurrent account	260.7	272.3	297.3	323.3	360.2	412.4	450.0	486.0
Development account	139.6	147.5	142.9	153.4	134.2	181.7	183.2	199.1
Additional measures	--	--	--	--		--	--	19.7
Overall surplus/deficit (excluding grants)	-156.0	-146.9	-154.2	-141.7	-146.1	-138.6	-138.0	-136.6
Grants	38.4	42.0	33.7	41.7	39.4	53.0	63.4	70.3
Overall surplus/deficit (including grants)	-117.6	-104.9	-120.5	-100.0 1/	-106.7 1/	-85.6	-74.6	-66.3
Financing	117.6	104.9	120.5	100.0	106.7	85.6	79.6	66.3
Foreign (net)	74.7	74.9	95.0	64.2	51.5	65.6	74.6	21.3
Project loan disbursements)	87.4	59.3	82.2	71.1	61.2	84.6	94.8	101.8
Other (including SAL))		25.0	36.4	32.8	38.9	55.0	65.0	--
Amortization	-12.7	-9.4	-23.6	-39.7	-48.6	-74.0	-85.2	-80.5
Domestic	42.9	30.0	25.5	35.8	55.2	20.0	--	45.0
Banking system	20.3	23.1	6.1	15.7	24.9	-10.0	-30.0	15.0
Other	22.6	6.9	19.4	20.1	30.3	30.0	30.0	30.0
	(In percent of GDP)							
Revenue	19.4	16.6	19.2	18.2	19.6	21.9	21.4	20.6
Of which: tax revenue	(16.5)	(14.0)	(16.0)	(15.2)	(16.2)	(18.5)	(18.1)	(17.5)
Grants	3.0	2.6	2.3	2.3	2.2	2.5	2.7	2.7
Total expenditure	31.7	25.6	29.6	25.9 1/	27.7 1/	28.6	27.4	26.6
Recurrent account	20.7	16.6	20.0	17.6	20.3	19.8	19.4	18.9
Development account	11.1	9.0	9.6	8.3	7.5	8.7	7.9	7.7
Overall surplus/deficit (excluding grants)	-12.4	-9.0	-10.4	-7.7 1/	-8.2 1/	-6.7	-6.0	-5.3
Overall surplus/deficit (including grants)	-9.3	-6.4	-8.1	-5.4	-6.0	-4.1	-3.2	-2.6
Financing	9.3	6.4	8.1	5.4	6.0	4.1	3.2	2.6
Foreign (net)	5.9	4.6	6.4	3.5	3.0	3.2	3.2	0.8
Domestic	3.4	1.8	1.7	1.9	3.0	1.0	--	1.8
Of which: banking system	(1.6)	(1.4)	(0.4)	(0.9)	(1.4)	(-0.5)	(-1.3)	(0.6)
Memorandum items:								
GDP (in millions of kwacha)	1,260.9	1,639.9 2/	1,489.5	1,837.2 2/	1,781.3	2,078.9 2/	2,314.8	2,572.8

1/ Excluding MK 54.2 million SLRS issue for the assumption of the debt of the Press Group with the domestic commercial banks.
2/ Programmed GDP.

of the appreciation of the U.S. dollar. These overruns were only partially offset by an estimated 12.5 percent drop in development expenditure relative to program (further described in the "Recent Economic Developments"). Furthermore, the reduced development expenditure was associated with a decline in external project loan disbursements. Consequently, while the overall deficit of the Central Government is estimated to have been only 0.6 percent of GDP above program target, the recourse of the Central Government to domestic financing is likely to have risen from a programmed 1.9 percent of GDP to 3 percent of GDP. Despite this, the ceilings on net credit to Government were observed through December 1984. However, partly because expenditure was concentrated heavily in the last quarter of the fiscal year, it seems likely, in the absence of any considerable increase in the "float" or the incurrence of arrears, that the indicative ceiling for March 1985 on credit from the banking system to the Central Government will have been exceeded by a significant margin.

b. Expenditure monitoring and control in 1984/85

In view of the disappointing performance of 1983/84, monitoring procedures were strengthened in 1984/85 at the ministerial and departmental level by the introduction of monitoring committees which were to review expenditure against monthly allocations, and the central monitoring process was strengthened as ministries and departments were to submit a record of monthly expenditure to the Treasury before the 16th day of the following month. Furthermore, reflecting concern over the rapidly rising wage bill and anticipating problems in observing the programmed reduction in the wage bill and "other current expenditure," it was agreed that the authorities would report to the Fund monthly data on (1) expenditure on wages and salaries; and (2) total expenditure excluding debt service which were not to exceed the levels in the corresponding period of 1983/84 by more than 11 percent and 4 percent, respectively.

After some initial problems, the monitoring system was strengthened significantly between August and November 1984. However, the available data pointed to considerable expenditure overruns from the early part of the year. At the time of the mid-term review mission in November 1984, the authorities attempted to strengthen expenditure control. Although this effort was partially successful, it proved impossible, as explained above, to stay within the programmed expenditure limits.

3. Statutory Bodies and the Press Group

The overall financial position of the parastatal sector improved somewhat in 1984, following marginal gains in 1983, 1/ but a number of enterprises remained in serious financial difficulties. The main improvement in performance came from the Agricultural Development and Marketing

1/ A consolidation of the enterprises accounts suggests a rise in the sector's net profit to MK 11.0 million in 1984 from losses of MK 0.4 million in 1983 and MK 4.1 million in 1982.

Corporation (ADMARC), whose financial position has strengthened considerably in recent years, particularly in 1984 (April-March) when profitable maize export sales and the resumption of cotton exports led to an increase in the surplus earned from its main crop trading activities from MK 6.5 million in 1983/84 to an estimated MK 17.4 million in 1984/85. 1/ The Malawi Development Corporation (MDC), the Malawi Housing Corporation (MHC), and the Electricity Supply Commission (ESCOM) also improved their performance, but heavy amortization obligations continued to create cash flow problems for ESCOM during 1984 and are likely to do so also in subsequent years. Malawi Railways took action which prevented any further increases in its losses in 1984 partly by additional cost-cutting measures and tariff increases, by actively developing new domestic sources of revenue, and by seeking substantial relief from its debt obligations to the Government. Serious concern persists with the position of Air Malawi, whose loss increased in 1984 because of the increasing fuel and maintenance costs of an old and inefficient fleet, combined with falling demand on international routes.

The financial restructuring of the Press Group of companies was largely completed during 1984 in accordance with the agreements signed in December 1983. 2/ In June 1984 an issue of Special Local Registered Stock (SLRS) amounting to MK 54.2 million was made by the Government to the two commercial banks to finance the Government's assumption of the Press group's liabilities to the banks. In return the Government holds preference shares and income notes from the new holding company, Press Group, Ltd. (PGL). The Government's annual incremental debt service on account of this transaction is approximately MK 8.5 million (including amortization on a 25 year schedule). In principle the instruments issued by PGL should offset this cost, but, in the early years of the new arrangement, significantly less is anticipated; in 1985 it is unlikely that more than MK 4 million will flow to the Government budget on this account.

4. Monetary and credit developments

Monetary developments in 1984/85 deviated substantially from program projections. Mainly as a result of the extremely strong external position in 1984, banking system liquidity expanded much more than expected. The growth of broad money accelerated to an estimated 27.7 percent during fiscal year 1984/85, compared to the original program estimate of 9.6 percent. Quasi-money deposits accounted for the major part of this growth, expanding by 41.8 percent in 1984, compared with the growth of narrow money of 21.1 percent. The Malawian representatives believed that most of this excess liquidity was accounted for by the windfall earnings of the tea-exporting sector, 3/ and that it was largely held in anticipation of

1/ The sales value of all crops purchased was MK 95.3 million in 1983/84 and an estimated MK 134.8 million in 1984/85.

2/ Details of the restructuring arrangement were given in EBS/83/183 (8/26/83) and EBS/84/32 (2/29/84).

3/ Estimates of the amount of this excess varied from MK30-50 million, compared with an increase in broad money of MK 95.9 million tax payments and dividend remittances (mainly to external shareholders). The ratio of the commercial banks' holdings of reserve money (cash plus balances at the Reserve Bank) to their deposit liabilities rose sharply from 18.6 percent in March to 39 percent in September, before falling back to 28.5 percent at the turn of the year, a ratio still almost twice that prevailing at the end of the three previous years (i.e., about 15 percent).

Private sector credit grew more slowly than projected in the year to September 1984, possibly reflecting the particularly strong performance of the export sector during the middle part of the year. However, there was much more rapid than programmed expansion of credit to the statutory bodies, largely resulting from considerably higher-than-expected purchases of domestic crops, which exceeded the budgeted level by 20 percent for maize, 28 percent for cotton, and 60 percent for tobacco. Moreover, domestic sales and export shipments of crops were slower than expected. The performance criteria on both credit to Government and net domestic assets were met in June and September 1984 (Table 4 and Chart 3). However, in the final quarter of 1984, as private sector borrowing returned more closely to its programmed path, and borrowing by ADMARC continued to increase, the indicative ceiling on net domestic assets established for December 1984 was exceeded. Moreover, the heavy government expenditure anticipated during the final quarter of 1984/85 (January-March 1985) was expected to result in the ceiling for both net bank credit to Government and net domestic assets being exceeded--by MK 13.3 million and MK 9.6 million respectively--even though credit to the statutory bodies was expected to fall back to its programmed level (Table 5).

The structure of interest rates in Malawi is determined largely by administrative decision, the only limited freedom being the ability to set lending rates within a range whose upper and lower limits are specified by the Reserve Bank. Interest rates remained unchanged in 1984, the last adjustment having been made in June 1983, when deposit rates were increased by 2 points and the maximum lending rate was reduced to 16.5 percent, 1/ thereby narrowing the spectrum of lending rates available to the banks, and reducing the prime rate to less than 1 percentage point below the maximum. The average rate of domestic inflation during 1984 was 13.2 percent, rising to a peak of almost 15 percent in mid-year before falling to 11.5 percent by the year end. 2/

5. External developments

a. Balance of payments

The balance of payments improved significantly in 1984 compared to both 1983 and program projections, reflecting mainly the substantial turnaround in the trade account (Table 6). The current account deficit (after debt relief) is estimated to have declined to SDR 46 million

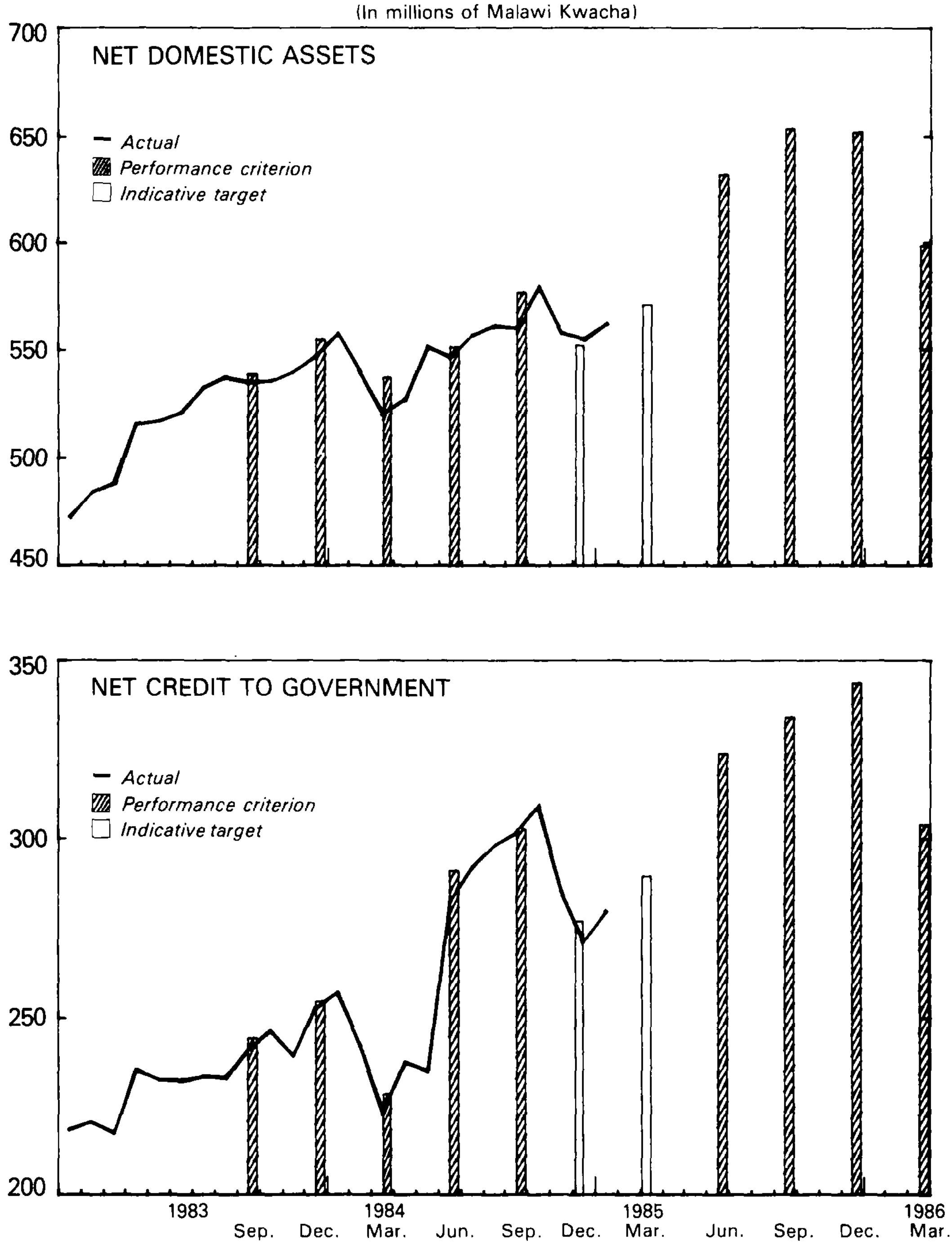
1/ Deposit rates were set in the range 10.75 to 13.75 percent.
2/ All figures quoted on the basis of twelve month changes.

CHART 3

MALAWI

BANKING SYSTEM NET DOMESTIC ASSETS AND NET CREDIT TO GOVERNMENT, 1983-86

(In millions of Malawi Kwacha)



Sources: Data provided by the Malawian authorities and IMF staff estimates

Table 4. Malawi: Quantitative Performance Criteria Under the Extended Arrangement, 1983/84-1985/86

	1983/84					1984/85					1985/86			
	March	June	Sept.	Dec.	March	June	Sept.	Dec. 1/	March 1/ 2/	March 2/	June 3/	Sept. 3/	Dec. 3/	March 3/
1. Domestic banking system							(In millions of Malawi kwacha)							
Net domestic assets 4/														
Program	...	...	538.3	555.2	536.9 5/	551.4	577.0	552.1	571.3	...	632.1 6/	652.9 6/	652.1 6/	598.9 7/
Actual	487.7	520.3	535.0	546.5	520.3	546.6	560.2	554.8	(580.9) 8/	(591.9)	...	...	...	...
Net credit to Government 9/														
Program	...	...	244.3	254.7	228.6 5/	290.9 10/	302.6 10/	276.8 10/	289.4 10/	...	323.7 6/	333.7 6/	343.7 6/	303.7 7/
Actual	217.5	232.4	241.0	252.7	223.6	282.6	301.5	271.0	(302.7) 8/	(313.7)	...	...	...	...
2. Nonconcessional external borrowing in the maturity range 11/								(In millions of SDRs)						
12 years														
Program	...	...	5.0	5.0	5.0	5.0	5.0	5.0	5.0	...	10.0	10.0	10.0	10.0
Actual	--	--	--	--	--	--	--	--	...	...	...	...	...	...
5 years														
Program	...	...	--	--	--	--	--	--	--	--	--	--	--	--
Actual	--	--	--	--	--	--	--	--	--	--	--	--	--	--
0-1 year 12/														
Program	...	...	...	...	...	...	...	...	...	...	--	--	--	--
Actual	...	...	...	...	...	...	...	...	...	...	...	...	...	...

1/ Indicative ceilings established by the Economic memorandum of June 25, 1984, as modified by the staff review mission in November 1984.

2/ At March 31, 1985 the definition of net bank credit to Government is revised: prior to this date the blocked account containing Funds for Amounts Rescheduled for Malawi (FARM account A) in respect of Government obligations under the rescheduling arrangements were classified as a Government deposit. Thereafter this blocked account is excluded from Government deposits. The two columns for March 1985 reflect this change on the estimates of net bank domestic assets and net bank credit to Government.

3/ Performance criteria for the 1985/86 fiscal year. These ceilings will be reduced by the amount by which the interest payments of the Government's long-term loans from the Reserve Bank of Malawi falls short of MK 20.6 million in 1984/85. The ceilings will also be reduced by the amount of any subsequent renegotiation of Government debt and by withdrawals from the FARM account in excess of the programmed levels.

4/ Defined as net credit by the banking system to the Government and gross credit to the statutory bodies and the private sector, plus the other domestic assets (net) of the banking system; it is equivalent to money plus quasi-money, blocked deposits at the Reserve Bank, banking system capital accounts, and SDR allocations, less the net foreign assets of the banking system.

5/ The ceiling was adjusted downward from that originally programmed since disbursements from the World Bank's second structural adjustment loan exceeded expectation.

6/ This ceiling will be adjusted downward by the equivalent in Malawi kwacha of all disbursements from the World Bank's third structural adjustment loan.

7/ This ceiling will be adjusted downward by the equivalent in Malawi kwacha of all disbursements from the World Bank's third structural adjustment loan in excess of the projected level of MK 55 million.

8/ Estimated level as per the Economic Memorandum of April 12, 1985.

9/ Defined as the commercial bank's and the Reserve Bank of Malawi's credit to the Government less Government deposits (excluding FARM accounts) plus any use of the local currency counterpart of purchases from the Fund.

10/ This ceiling was adjusted upward by MK 54.2 million from the level originally programmed, to take account of the issue of Special Local Registered Stock made by the Government to acquire the Press Group's liabilities to the commercial banks.

11/ New nonconcessional external borrowing contracted or guaranteed by the Government.

12/ New external debt contracted or guaranteed by the Government on behalf of the nonfinancial public sector (except those relating to trade financing).

Table 5. Malawi: Monetary Survey, 1983-86

(In millions of Malawi kwacha)

	1983		1984					1985						1986
	Mar.	Dec.	Mar.	June	Sept.	Dec. Prog.1/	Dec.	Mar. Prog.1/	Mar. Est.	Mar. Rev. est. 2/	June	Sept.	Dec.	Mar.
Foreign assets (net)	-172.8	-206.4	-183.6	-135.6	-132.7	-186.4	-118.7	-185.8	-159.2	-159.2	-161.7	-175.9	-168.8	-157.8
Gross foreign assets	39.6	31.0	57.3	93.6	108.8	67.3	96.9	68.7	73.6	73.6	82.5	78.9	94.7	107.3
Foreign liabilities	-212.4	-237.4	-240.8	-229.2	-241.4	-253.7	-215.6	-254.5	-232.8	-232.8	-244.2	-254.8	-263.5	-265.1
Net domestic assets 3/	487.7	546.5	520.3	546.6	560.2	552.1	554.8	571.3	580.9	591.9	632.1	652.9	652.1	598.9
Net domestic credit	511.6	571.9	551.5	577.0	592.0	576.6	582.0	596.9	606.9	617.9	658.1	678.9	678.1	624.9
Credit to Government (net) 3/4/	217.5	252.7	223.6	282.6	301.5	276.8	271.0	289.4	302.7	313.7	323.7	333.7	343.7	303.7
Credit to statutory bodies	62.3	64.5	56.9	57.7	75.0	64.0	82.6	62.0	64.5	64.5	82.5	90.0	72.6	55.6
Credit to private sector 4/	231.8	254.7	271.0	236.8	215.6	235.8	228.4	245.5	239.7	239.7	251.9	255.2	261.8	265.6
Other assets (net)	-23.9	-25.4	-31.2	-30.4	-31.8	-24.5	-27.2	-25.6	-26.0	-26.0	-26.0	-26.0	-26.0	-26.0
Other liabilities	51.3	47.8	46.1	42.1	35.4	34.9	47.7	34.9	49.5	60.5	32.4	33.4	33.5	35.9
Blocked deposits at RBM	0.6	8.1	14.0	15.0	16.0	16.0	10.0	16.0	10.0	21.0	20.0	19.0	18.0	17.0
Long-term liabilities of the Reserve Bank	5.2	2.8	--	--	--	--	--	--	--	--	--	--	--	--
SDR allocation	13.3	14.9	14.9	15.5	15.5	15.5	15.5	15.5	15.5	15.5	18.4	18.4	18.4	18.4
Capital accounts	32.2	21.9	17.2	11.6	3.9	4.0	22.2	4.0	24.0	24.0	-6.0	-4.0	-2.9	0.5
Money plus quasi-money	263.5	292.4	290.5	369.0	392.1	330.8	388.3	350.6	372.2	372.2	438.0	443.6	449.8	405.2
Money	111.8	127.4	119.0	166.7	164.8		154.3							
Currency outside banks	44.9	50.0	42.7	73.0	74.1		56.9							
Demand deposits	66.8	77.3	76.3	93.6	90.7		97.4							
Quasi-money	151.8	165.0	171.5	202.3	227.3		234.0							
Memorandum items:														
Provision for nonperforming debts	51.9	62.9	65.6	68.9	59.4		58.4							
Credit to private sector net of provision	179.9	191.8	205.4	167.9	156.2		170.0							
SAL disbursement (fiscal year cumulative total)		36.4	3.2	3.2	3.2	40.7	38.9	40.7	38.9	38.9	--	--	--	55.0

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

1/ Indicative ceilings were established during the review discussions in October/November 1984 for December 1984 and March 1985. They differ from the indicative targets in EBS/84/151 (7/12/84) only on account of a reduction in the ceiling caused by the higher kwacha value of the SAL disbursement that was estimated originally.
2/ This column reflects definitional changes to net bank credit to Government, net bank domestic assets, and blocked deposits at RBM described in footnote 2 to Table 4.
3/ The figures for January 1985 through March 1986 represent performance criteria for 1985/86 program year.
4/ In June 1984 an issue of Special Local Registered Stock was made by Government to finance the assumption of the debt of the Press group to the commercial banks. Because of this credit to the private sector fell and credit to Government rose by the amount of this transaction, MK 54.2 million, in June 1984.

Table 6. Malawi: Balance of Payments, 1982-86 1/

(In millions of SDRs)

		1983		1984		1985		1986	
	1982	Program	Actual	Program	Actual 2/	Program	Revised	Program	Revised
Current account 3/	-109.2	-97.9	-141.6	-111.8	-45.5	-106.0	-62.5	-101.9	-60.6
Exports, f.o.b.	220.0	220.5	215.5	232.1	301.6	263.9	305.7	279.2	319.6
Imports, c.i.f.	-276.4	-288.8	-289.7	-308.7	-276.1	-335.4	-297.4	-385.1	-307.8
F.o.b. value	-179.9	-202.1	-185.4	-200.6	-165.7	-224.7	-184.4	-251.7	-193.9
C.i.f. margin	-96.5	-86.7	-104.3	-108.1	-110.4	-110.7	-113.0	-107.9	-113.9
Services and private transfers, net	-52.7	-29.7	-67.4	-35.2	-71.0	-34.6	-70.8	-39.5	-72.4
Of which: interest	-38.5	-40.0	-40.6	-38.5	-45.4	-44.6	-45.3	-50.6	-49.4
Capital account	69.0	83.2	98.5	101.4	108.4	70.5	47.5	94.3	109.7
Government transfers, net	32.9	33.0	27.6	32.5	25.8	41.3	29.1	48.9	33.0
Long-term capital, net	32.2	50.2	59.9	68.9	62.3	29.2	13.4	45.4	71.7
Short-term capital, net including errors and omissions	3.9	--	11.0	--	20.3	--	5.0	--	5.0
Overall balance after debt relief	-40.1	-14.7	-43.1	-10.4	62.9	-35.6	-15.0	-8.0	49.1
Memorandum items:									
Debt relief 4/	16.9	53.2	50.0	28.3	22.9	-8.5	-13.7	-16.6	-21.7
Of which: interest	3.5	7.2	4.1	0.5	2.2	-4.8	-9.0	-3.5	-8.2
Overall balance before debt relief	-57.0	-67.9	-93.1	-38.7	40.0	-27.1	-1.3	8.6	70.8
Current account/GDP									
After debt relief	-10.5	-7.4	-12.5	-8.8	-3.9	-7.2	-5.5	-6.2	-4.8
Before debt relief	-10.9	-8.0	-12.9	-8.8	-4.1	-6.9	-4.7	-6.0	-4.2

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

1/ Program targets refer to revised targets shown in EBS/84/151, 7/12/84 for 1984-86, and to original targets shown in EBS/83/183, 8/26/83 for 1983. Components may not add to total due to rounding.
2/ Estimate.
3/ Grants below the line.
4/ Repayments of rescheduled debt start in 1985 (as indicated by negative numbers).

(3.9 percent of GDP) from SDR 142 million (12.5 percent of GDP) in 1983 and compared with a program projection of SDR 112 million (8.8 percent of GDP). Nearly all of the improvement was accounted for by movements in the trade balance. Export receipts rose by 40 percent to SDR 302 million whilst the c.i.f. value of imports fell by 5 percent to SDR 276 million. The balance on services and transfers deteriorated slightly to a deficit of SDR 71 million, mainly due to higher interest payments and lower receipts from tourism and other nonfactor services.

The improvement in the current account occurred despite the intensification of the problems with external transportation. Malawi's traditional trade routes were through the Mozambican ports of Beira and Nacala. Increased insurgency activity had made Beira almost totally inaccessible by 1982, and the railway line to Nacala ceased to operate early in 1984. Instead, much longer and more expensive road and road/rail routes to the ports of Durban and Dar es Salaam had to be used, and some use was made of airfreight for goods with high unit value, notably tea.

Most of the improvement in export receipts is accounted for by the increase in both prices and volumes of tobacco and maize exports and the very favorable developments in the price of tea. Export receipts from tobacco, which accounted for nearly 45 percent of total exports in 1984, increased by some 23 percent in SDR terms reflecting a 19 percent increase in the volume and a 3 percent increase in the unit value. The value of tea exports (Malawi's second major export) increased by 76 percent. Though the volume was unchanged, Malawi benefited from the sharp increase in tea prices following the political problems in Sri Lanka and the restrictions on Indian tea exports. The volume of maize exports tripled in 1984. Following increases in real producer prices in earlier years and favorable weather, Malawi has emerged as a substantial exporter of maize, mainly to neighboring countries. The high volume of exports in 1984 also reflected the decumulation of stocks--notably tobacco, tea, and maize--built up during 1983 due to difficulties with transportation.

There appears to have been a substantial fall in the volume of imports. The f.o.b. value of imports in SDR terms is estimated to have declined by some 10.5 percent, indicating that the volume of imports may have fallen by as much as 14-15 percent. Although this was partly attributable to the higher domestic prices of imports following the depreciation of the Malawi kwacha and the higher costs of transportation, it also reflected the tighter allocation of foreign exchange for imports exercised by the Reserve Bank in 1983. The overall terms of trade are estimated to have improved by about 4 percent during 1984.

In the capital account net long-term capital inflows rose to SDR 62 million, broadly in line with program projections. Net external borrowing by Government amounted to SDR 63 million, significantly higher than in 1983, reflecting the disbursement of SDR 52 million from the World Bank Second Structural Adjustment Loan. Net government transfers amounted to SDR 26 million, about the same level as in 1983. In contrast to Government's net inflows, public enterprises recorded small net long-term capital outflows, reflecting the substantial decline in gross borrowing since 1982. There was also a marked decline in the net long-term capital flow to the private sector in 1984, which is estimated at SDR 3 million compared with SDR 14 million in 1983, and the benefits of debt relief from the two rescheduling arrangements in 1982 and 1983 continued. 1/ It is estimated that about SDR 23 million in interest and amortization payments were deferred.

The overall balance of payments (after debt relief) recorded a surplus of SDR 63 million compared with a deficit of SDR 43 million in 1983 and the program's target of a deficit of SDR 10 million. Gross official reserves rose to SDR 57 million at end 1984, equivalent to 2.5 months of 1984 imports, c.i.f..

b. Exchange and trade system

Since January 17, 1984, the exchange rate of the kwacha has been pegged to a basket of currencies representative of Malawi's geographic pattern of trade and currencies used in settling Malawi's international transactions. In this currency basket, the U.S. dollar has a larger weight and the South African rand a smaller weight than in the trade-weighted basket used in the Fund's Information Notice System. On the trade-weighted basis, the Malawian kwacha had appreciated by 11 percent in real terms by January 1985 from the rate prevailing during late 1983 when the exchange rate was last adjusted (Chart 4). The appreciation in the trade-weighted real effective rate in 1984 reflected mainly the 7 percent appreciation in the nominal effective rate due to the strength of the U.S. dollar and weakness of the South African rand. A longer-term retrospective of exchange rate developments shows a real effective appreciation of about the same magnitude in 1984 compared with the late 1970s when the balance of payments was in a sustainable position.

The direction of trade for Malawi's exports and imports are very different and the export-weighted and import-weighted effective exchange rates show significantly different developments. While the United States is an important market for exports, it is not a significant supplier of imports for Malawi. Conversely, while South Africa is an important source of imports, it is not an important market for exports. In 1984 the real import-weighted effective exchange rate appreciated by 15 percent compared with a 3 percent appreciation in the real export-weighted effective exchange rate.

Details of the exchange and trade system are provided in the Annual Report on Exchange Arrangements and Exchange Restrictions 1984. During the mission, the staff became aware of certain aspects of the import and import payments system which are fully described in Recent Economic

1/ For details, see SM/84/55 (2/24/84), and SM/82/208 (10/26/82).

Developments. In this context, the staff learned that during 1982-mid-1983, when reserves came under increasing pressure, the Reserve Bank delayed the provision of foreign exchange for initially approved imports. At times, the delay extended up to three months. 1/ However, with the improvement in the reserve position in 1984, this has ceased to be a problem and the Reserve Bank is currently providing foreign exchange for imports with a lag of two to four weeks. The Malawian representatives said that the allocation of foreign exchange was relaxed considerably in 1984.

c. External debt

At the end of 1984, Malawi's external debt 2/ is estimated to amount to US$863 million (72 percent of GDP) compared with US$820 million at end-1983 (68 percent of GDP). At the end of 1983, nearly 67 percent of Malawi's external debt was in the form of bilateral and multilateral loans on concessional terms, at well below market rates with long maturities and grace periods, and a significant grant element. Outstanding debt on commercial terms represented about 21 percent of the total, but due to limits on this type of borrowing in recent years, the proportion has been declining.

During 1984, Malawi did not contract any public or publicly guaranteed nonconcessional borrowing of 1-12 years' maturity; the performance criterion on external borrowing provided a limit of SDR 5 million. Except for normal trade financing, the Government and public enterprises did not undertake any borrowing with maturity of less than one year, and there is no such debt outstanding. The Reserve Bank of Malawi had also completely repaid the amounts outstanding relating to lines of credit from foreign commercial banks by the end of 1984.

As a result of the debt relief obtained in the two rescheduling arrangements in 1982 and 1983, the debt service ratio (including Fund charges and repurchases), was reduced to 35 percent of exports of goods and nonfactor services from 42 percent in 1983 (Table 7).

1/ These delays in the provision of foreign exchange in 1982 and mid-1983, had they been identified at that time, would be breaches of the performance clause relating to the exchange system under the stand-by arrangement then existing (August 1982-August 1983). Under current Fund policy, those purchases would be classified as noncomplying purchases. The Fund's guidelines on noncomplying purchases, however, adopted November 6, 1984, operate prospectively and do not apply to these purchases.

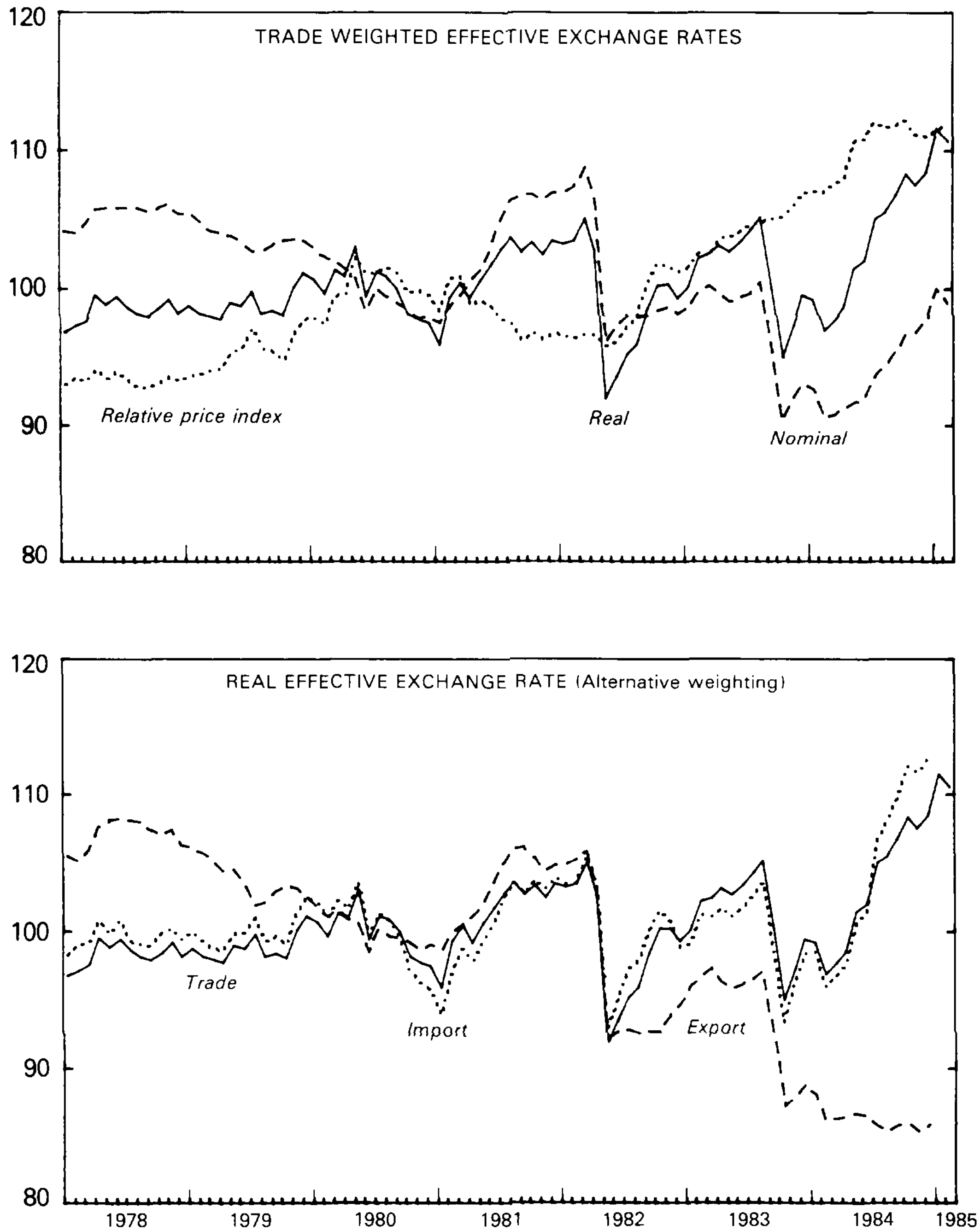
2/ Public and publicly-guaranteed medium- and long-term debt. Statistics on private sector debt are being compiled in the context of an External Debt Statistics project supported by the World Bank.

CHART 4

MALAWI

INDICES OF EFFECTIVE EXCHANGE RATES, JAN. 1978 - JAN. 1985

(1980=100)



Sources: IFS and IMF staff calcuations.

Table 7. Malawi: External Debt Projections, 1983-88

(In millions of U.S. dollars, unless otherwise indicated)

	1983	1984	1985	1986	1987	1988
Total debt outstanding 1/	820.0	863.3	879.9	950.0	938.8	933.6
Of which: IMF (end of period)	(102.1)	(112.7)	(123.1)	(126.1)	(101.8)	(80.1)
As percent of GDP	67.7	72.2	77.4	75.2	69.9	62.8
Gross disbursements 2/	119.2	138.9	83.5	150.5	68.5	71.0
Public sector	102.2	132.2	77.0	143.0	61.0	63.0
Of which: IMF	36.6	38.7	23.0	24.0	--	--
Private sector	17.1	6.7	6.5	7.5	7.5	8.0
Amortization 2/	41.8	69.9	64.9	78.8	78.3	75.1
Public sector	36.2	63.5	58.3	72.8	72.3	69.0
Of which: IMF	11.0	20.9	14.8	21.0	24.3	21.7
Private sector	5.6	6.4	6.6	6.0	6.0	6.1
Interest 2/	43.4	46.5	45.3	49.4	48.6	46.0
Public sector	35.2	43.7	42.9	46.9	46.0	43.3
Of which: IMF	7.3	8.7	10.2	13.2	13.9	11.8
Private sector	8.2	2.8	2.4	2.5	2.6	2.6
Total debt service 2/						
As percent of exports of goods and nonfactor services						
After debt relief	32.9	35.2	33.5	37.2	35.6	32.7
Before debt relief	54.0	42.3	29.4	31.2	28.8	25.7
Memorandum item:						
Debt relief 3/	53.4	23.5	-13.7	-21.7	-27.1	-28.4
Principal	49.0	21.2	-4.7	-13.5	-20.2	-23.1
Interest	4.4	2.3	-9.0	-8.2	-6.9	-5.3

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

1/ Medium- and long-term public and publicly-guaranteed debt.
2/ Includes new borrowing required to finance current account deficits in 1984-88 as projected in Table 8. Flows include projections for medium- and long-term private sector borrowing not guaranteed by Government.
3/ Repayments of rescheduled debt start in 1985 (as indicated by negative numbers).

III. Medium-Term Prospects

The original objectives of the program under the extended arrangement were to achieve a viable balance of payments position by 1986--the end of the arrangement period--in the context of sustainable growth and relative price stability. The medium-term projections have been revised from those presented in the "Request for an Extended Arrangement" (EBS/83/183, 8/26/83) and "Staff report for the 1984 Article IV Consultation and Program for the Second Year of the Extended Arrangement" (EBS/84/151, 7/12/84). The main revisions are in the capital account because previous assumptions regarding gross government loan and grant inflows now appear somewhat optimistic in light of recent developments and current prospects (Table 8).

Net long-term capital inflows are presently projected to decline from about 6 percent of GDP in 1983-84 to about 2 percent of GDP in 1985-88. This reflects mainly the sharp increase in amortization payments, particularly the payment of debt consolidated during two rescheduling arrangements in 1982 and 1983. Gross disbursements of project loans to the Government are projected to average SDR 53 million annually in 1985-88, a level similar to that in 1983-84. Of this amount, about 70 percent represents disbursements under commitments made by the end of 1984; the remainder, averaging SDR 15 million annually, is expected to be available from new medium- and long-term project-related borrowing. In addition, disbursements under the World Bank's Third Structural Adjustment Loan (SAL III) of SDR 65 million are projected for 1986. 1/ Net receipts of government grants are projected to continue to remain below 3 percent of GDP in 1985-88. While some improvement in the financial position of public enterprises is expected to permit a small increase in their external borrowing, net inflows on this account are projected to remain negative due to large amortization payments. Net private sector inflows are also projected to rise moderately from the low level in 1984.

The revised outlook for financing indicate the need for a downward revision in the current account target. Some lumpiness in capital flows results from the expected disbursement of SAL III in 1986. Therefore, the balance of payments targets should be viewed from a two-year perspective, where the average current account deficit for 1985 and 1986 is programmed to be equivalent to 5.1 percent of GDP compared with an original target of an average of 5.8 percent and a revised target of an average of 6.7 percent (Chart 5) 2/ Gross reserves

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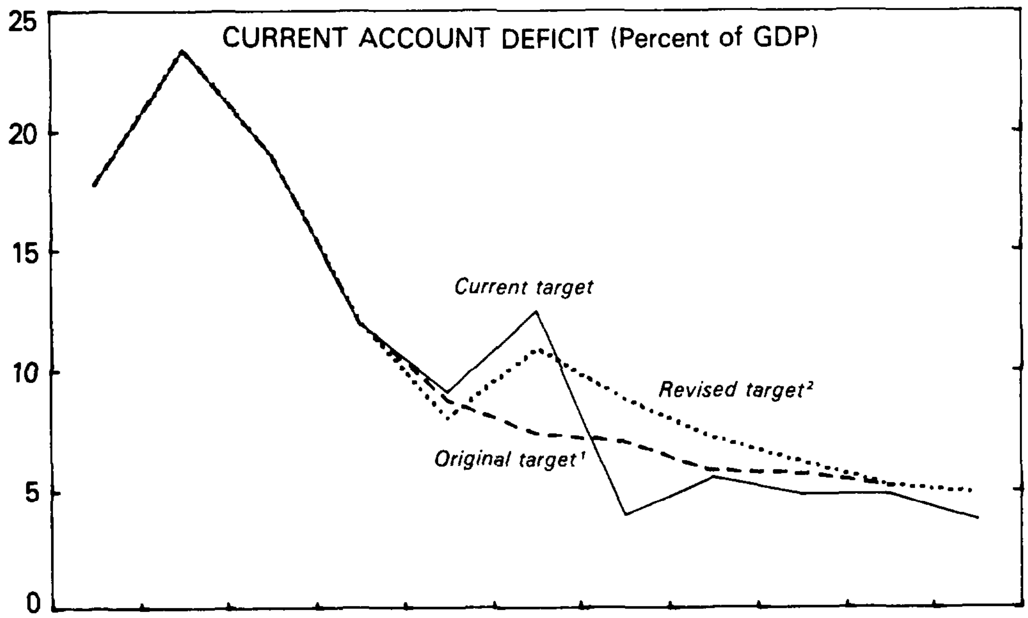
1/ The staff understands that, according to current schedule, the Bank's Executive Board will consider a third SAL for Malawi in late 1985.

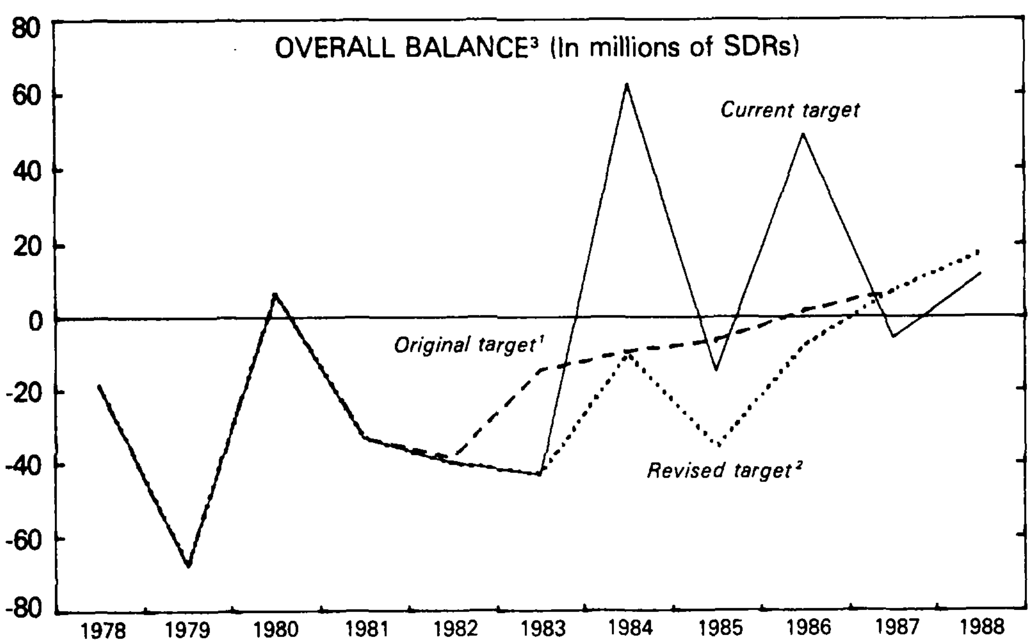
2/ Current account in this report includes interest payments on rescheduled debt. Targets refer to those shown in EBS/83/183, (8/26/83) and EBS/84/151, (7/12/84) adjusted for interest payments on rescheduled debt. Official revisions to the GDP data from 1979 onward have resulted in a substantial downward revision to GDP. Therefore ratios to GDP shown in EBS/83/183 and EBS/84/151 are not strictly comparable with those shown in this report.

CHART 5

MALAWI

BALANCE OF PAYMENTS, 1978-88





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

[1]Under the original request for extended arrangement (EBS/83/183).

[2]Under the second program year (EBS/84/151).

[3]After debt relief.

Table 8. Malawi: Balance of Payments, 1983-88

(In millions of SDRs)

	1983	1984	1985	1986	1987	1988
Current account 1/	-141.6	-45.5	-62.5	-60.6	-64.5	-55.0
Trade balance	-74.2	25.5	8.3	11.8	2.1	4.5
Exports, f.o.b.	215.5	301.6	305.7	319.6	329.2	341.8
Imports, c.i.f.	-289.7	-276.1	-297.4	-307.8	-327.1	-337.3
F.o.b. value	-185.4	-165.7	-184.4	-193.9	-209.3	-218.9
C.i.f. margin	-104.3	-110.4	-113.0	-113.9	-117.8	-118.4
Service and transfers	-67.4	-71.0	-70.8	-72.4	-66.6	-59.5
Nonfactor services	-22.5	-20.0	-19.0	-18.7	-18.0	-17.0
Receipts	21.9	20.8	23.0	25.0	27.0	29.0
Payments	-44.4	-40.8	-42.0	-43.7	-45.0	-46.0
Factor services	-56.8	-59.1	-61.8	-66.7	-64.6	-61.5
Receipts	1.2	1.9	2.5	3.7	5.0	6.5
Payments	-58.0	-61.0	-64.3	-70.4	-69.6	-68.0
Interest	-40.6	-45.4	-45.3	-49.4	-48.6	-46.0
Other	-17.4	-15.6	-19.0	-21.0	-21.0	-22.0
Private transfers	11.9	8.1	10.0	13.0	16.0	19.0
Receipts	22.5	20.4	23.0	26.0	29.0	32.0
Payments	-10.6	-12.3	-13.0	-13.0	-13.0	-13.0
Capital account	98.5	108.4	47.5	109.7	58.4	66.4
Long-term (net)	87.5	88.1	42.5	104.7	52.4	59.4
Government transfers	27.6	25.8	29.1	33.0	34.9	38.8
Credit	28.6	27.7	31.0	35.0	37.0	41.0
Debit	-1.0	-1.9	-1.9	-2.0	-2.1	-2.2
Government loans	50.3	63.0	19.8	73.0	16.4	14.5
Credit (other)	60.7	38.6	52.0	50.0	55.0	55.0
SAL II and III	--	51.9	--	65.0	--	--
Debit	-10.4	-27.5	-32.2	-42.0	-38.6	-40.5
Public enterprises	-4.0	-4.1	-9.3	-5.8	-3.4	1.2
Credit	0.7	0.7	2.0	4.0	6.0	8.0
Debit	-4.7	-4.8	-11.3	-9.8	-9.4	-6.8
Private enterprises	13.6	3.4	2.9	4.5	4.5	4.9
Credit	18.9	9.6	9.5	10.5	10.5	11.0
Debit	-5.3	-6.2	-6.6	-6.0	-6.0	-6.1
Short-term flows and unidentified	11.0	20.3	5.0	5.0	6.0	7.0
Overall balance after debt relief	-43.1	62.9	-15.0	49.1	-6.1	11.4
Financing						
Balance	43.1	-62.9	15.0	-49.1	6.1	-11.4
Use of Fund resources	23.9	17.5	8.2	3.0	-24.3	-21.7
Change in reserves	19.2	-80.4	6.8	-52.1	30.4	10.3
Memorandum items:						
Debt relief	50.0	22.9	-13.7	-21.7	-27.1	-28.4
Of which: interest	4.1	2.2	-9.0	-8.2	-6.9	-5.3
Current account/GDP ratios 1/						
After debt relief	-12.5	-3.9	-5.5	-5.0	-4.8	-3.7
Before debt relief	-12.9	-4.1	-4.7	-4.3	-4.3	-3.4
Growth rates of trade volumes (percent per annum)						
Exports	7.1	20.3	9.3	5.5	1.3	1.4
Imports	-8.7	-14.9	6.0	0.1	2.8	-0.4
Change in terms of trade (percent per annum)	-20.5	4.1	-8.7	-7.4	1.8	-1.3
Gross official reserves	12.8	57.0	50.2	102.3	71.9	61.6
(in months of c.i.f. imports)	(0.5)	(2.5)	(2.0)	(4.0)	(2.6)	(2.2)

Sources: Data provided by the Malawian authorities; and staff estimates.
1/ With grants below the line.

are projected at a level equivalent to three months of imports, c.i.f. during this period. Given the projected net inflows of capital, the revised current account target will provide for an accumulation of reserves sufficient to allow Malawi to continue meet its external obligations, including repurchases from the Fund, by 1986, after the end of the arrangement.

In the current account, the value of exports in SDR terms is projected to increase at an annual average rate of 3 percent during 1985-88. Although export volumes are projected to increase at an average annual rate of 4 percent, export prices, particularly for tobacco and tea, are projected to decline. 1/ The increases in export volumes are expected as a result of higher production owing to the increases in agricultural producer prices. In addition, some improvement in the transport situation is expected to allow some stocks--notably of sugar--to be exported. Moreover, favorable producer prices for crops such as cotton and groundnuts are expected to contribute to a gradual diversification in exports from the dependence on tobacco and tea. The easing of transport difficulties is expected to result in a decline in the c.i.f. margin from 40 percent in 1984 to 35 percent by 1988. Nevertheless, import prices (c.i.f.) are projected to rise at an annual average rate of 3 percent annually during 1985-88 reflecting increases in the prices for industrial countries' manufactured exports. Hence, the improvements in the terms of trade experienced in 1984 is expected to be reversed; prospects for the terms of trade show a deterioration at an annual average rate of 4 percent annually during 1985-88. The balance on the services account is projected to remain broadly unchanged during 1985-88. Given the projections for these elements of the current account, the forecast for capital flows, and the target for reserves, the sustainable rate of growth in import volume is estimated to be about 2 percent annually during 1985-88.

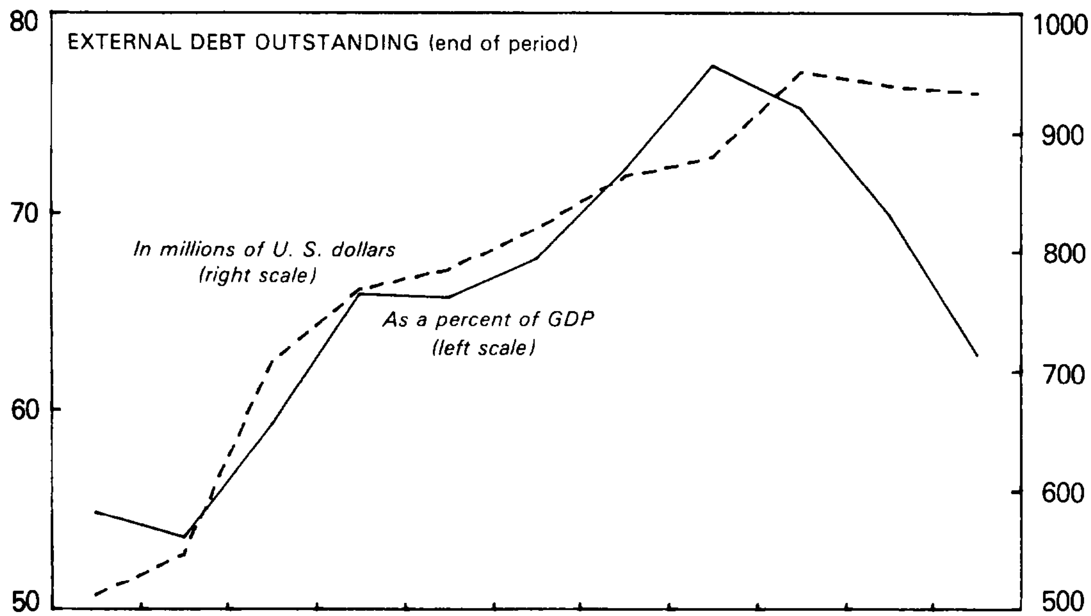
The two rescheduling arrangements in 1982 and 1983 have alleviated the bunching of debt service payments during 1982-84. However, as repayments on rescheduled debt begin in 1985, the debt service ratio, including Fund repurchases and charges as well as the debt service associated with new borrowing after 1984, is projected to increase to a peak of 37 percent of exports of goods and nonfactor services in 1986 before declining to 33 percent in 1988 (Table 7 and Chart 6). While this ratio is below that reached in 1982-84 (40-50 percent) when Malawi had to undertake debt rescheduling, it is still high by historical standards. Therefore, there continues to be a need to implement policies to contain the current account deficit to about 4-5 percent of GDP after 1984 in order that Malawi can manage its debt service commitments adequately and to maintain reserves at about 2.5 months of imports.

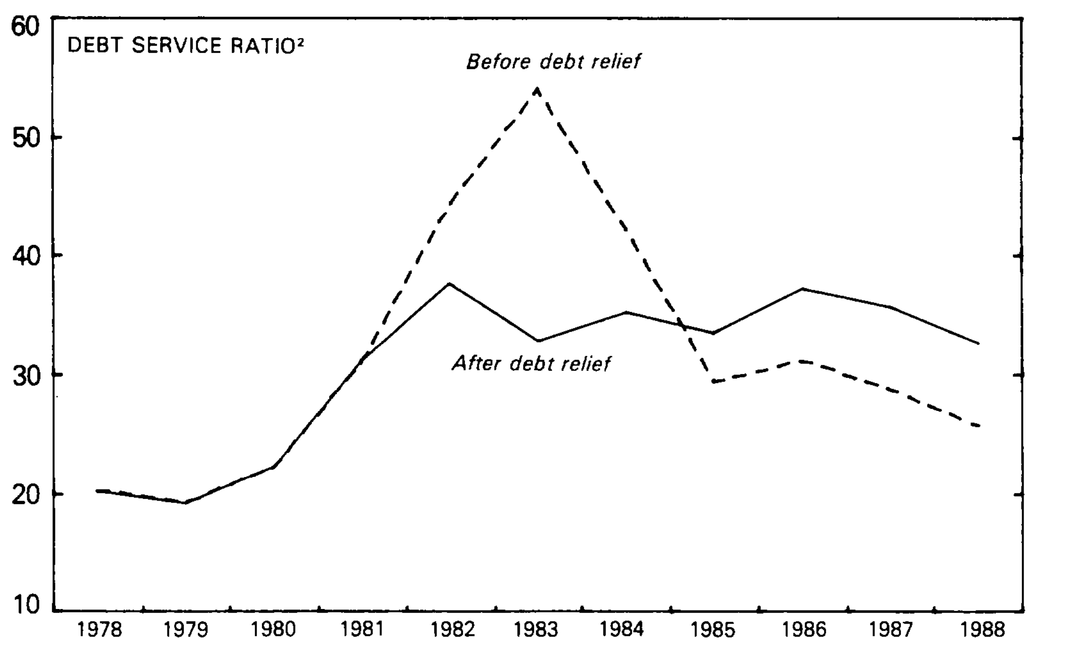
1/ In February and March 1984 tea prices in London fell sharply. Trading in the early part of the year is generally very light and the market volatile. It appears premature to make substantial revisions, but, unless prices recover, the projections may require downward revision.

CHART 6

MALAWI

EXTERNAL DEBT AND DEBT SERVICE, 1978-88[1]





Sources. Data provided by the Malawian authorities, IBRD and IMF staff estimates.
[1]Medium-and long-term public and publicly guaranteed debt, including Fund credit.
[2]As percent of exports of goods and nonfactor services.

The feasibility of the current account target should also be assessed from the perspective of the balance between domestic investment and savings. During the period of the extended arrangement, the current account deficit is targeted to decline from 9.1 percent of GDP in 1982 to 4.8 percent in 1986. The closing of the resource gap, equivalent to 4.3 percent of GDP, would require a reduction in the ratio of fixed capital formation from 15 percent of GDP in 1982 to 12 percent of GDP in 1986 and an increase in domestic savings from 7.9 percent of GDP in 1982 to 11 percent of GDP in 1986. Although gross domestic saving rose sharply in 1984, the ratio of over 14 percent is not likely to be continued. Private sector saving is expected to decline as the profits of the export sector returns to a more normal level, while tax payments and the externalization of dividends will increase the saving of the Government and foreign sectors, respectively. Therefore, the increase in saving is expected to be mobilized by the Government; the overall deficit of the Central Government is programmed to fall from 9.3 percent of GDP in 1982/83 to 4.1 percent of GDP in 1985/86. With the measures introduced in the 1985/86 budget, the required increase in net savings should be attainable. In view of the tight demand-management policy, aimed particularly at reducing imports, it is expected that the growth of real GDP will slow appreciably from the levels of 1984 and 1985 unless a significant improvement can be made in the efficiency of new investment.

The medium-term balance of payments scenario points to the need to bring about a continued gradual reduction in the central government deficit to 3.2 percent of GDP in 1986/87 and 2.6 percent of GDP in 1987/88. With a small decline in the projected ratio of tax revenue to GDP--reflecting the slow growth of imports--and some measure of expenditure restraint, this outcome appears to be feasible.

IV. Program for 1985/86

The economic and financial program for 1985/86 (Table 9) is designed to achieve the medium-term objectives described above. To maintain the momentum of improvement in the balance of payments achieved in 1984, the program aims to achieve an external current account deficit of SDR 63 million (5.5 percent of GDP) in 1985 compared with an original target of SDR 106 million and a revised target of SDR 93 million. This will be achieved by the continued implementation of policies aimed at encouraging the growth and diversification of exports, and at mobilizing domestic resources and improving their utilization. The program includes measures to reduce the overall deficit (including grants) of the Central Government to 4.1 percent of GDP and to reduce its recourse to bank financing, to improve the financial operations of public and quasi-public enterprises, and to restrain the growth of domestic credit to 1 percent. The program also includes increases in banks' deposit and lending rates, a flexible exchange rate policy, the further liberalization of price controls, and continued improvements of incentives to agricultural production. A growth rate of real GDP of 2.7 percent is believed to be consistent with these policies compared with the average growth of 3.8 percent in

Table 9. Malawi: Summary of Program for Third Year of Extended Arrangement, 1985/86

Assumptions (1985)

Real GDP growth: 4.4 percent (1984: 5.3 percent of GDP)
GDP deflator increase: 13.8 percent (1984: 14.3 percent)
Consumer price index increase: 15.0 percent (1984: 13.2 percent)
Terms of trade change: -8.7 percent (1984: 8.2 percent)

Targets (1985)

Current account deficit (excluding grants): SDR 62.5 million, or 5.5 percent of GDP (1984: SDR 45.5 million, or 3.9 percent of GDP)

Overall balance of payments deficit after debt relief: SDR 15 million (1984: surplus of SDR 62.9 million)

Principal elements

Budget: Central Government deficit including grants in 1985/86 equal to 4.1 percent of GDP (1984/85: deficit equal to 6.0 percent of GDP). Revenue measures expected to yield the equivalent of 1.9 percent of GDP. Real expenditure growth limited to development outlays; government hiring and filling of vacant positions limited to essential posts; no general salary increase.

Expenditure monitoring: Monthly ceilings set for each ministry, to be supervised by the Ministry of Finance. If limits for total or wage expenditures are exceeded, there will be a consultation with the Managing Director.

Parastatals: Review of tariffs as part of annual budget exercise. Commitment to remove cross-subsidization among ADMARC's trading accounts by 1986/87.

Public sector investment program: The program covering investment by the Government and the parastatals includes: agricultural crop development, improvement of internal and external transportation routes; contribution to Fertilizer Revolving Fund; and government buildings.

Price liberalization: Process expected to be completed by the end of 1985, with the removal of controls on all but five or six commodities.

Exchange rate: The authorities will maintain a flexible exchange rate policy, keeping the real trade-weighted effective rate at the level of the beginning of the extended arrangement.

Interest rates: The authorities will adjust interest rates so as to keep rates positive in real terms.

Agricultural producer prices: Producer prices to be reviewed in accordance with IBRD methodology.

Fertilizer subsidies: Commitment to eliminate subsidy before 1986/87 growing season: reduce the subsidy to no more than MK 4 million in the 1986/87 budget (1985/86 crop year).

Net domestic assets and liquidity: Commitment to reduce banking sector's liquidity to about the level in March 1984 with a funding operation. Net domestic assets to grow by 2 percent during 1985/86; ceilings allow private sector credit to grow by 11 percent.

External debt: In 1985 new commitments of nonconcessional loans of 1-12 years maturity limited to SDR 10 million, with none allowed in nonconcessional loans of 1-5 years maturity. No borrowing of less than 1-year's maturity other than normal trade credit by the nonbank public sector.

1983/84. 1/ The inflation rate is projected at 15 percent, compared with 13 percent in 1984, largely on account of the depreciation of the kwacha.

In 1985 agricultural output is expected to grow by over 4 percent; in the estate sector tea production is projected to rise by 4-5 percent, tobacco by about 2-3 percent, while sugar production is expected to recover from the sharp fall in 1984 as new transport routes become available. Smallholder output is expected to show continuing expansion: although the marketed production of maize is projected to remain unchanged, the production of other crops such as rice, groundnuts, cotton and pulses is expected to increase markedly in response to the policy of regular annual increases in producer prices. Activity in the rest of the economy, particularly the manufacturing sector, is expected to grow relatively slowly.

1. External policies

To maintain the competitiveness of the traded goods sector and to enhance balance of payments adjustment over the medium-term, the authorities accept the need to to reverse the real appreciation of the kwacha which occurred in 1984. On April 2, 1985 the kwacha was devalued by 15 percent against the currency composite to which it is pegged. On a nominal trade-weighted basis the depreciation amounted to 16 percent in foreign currency terms compared with February 28. 2/ The authorities are also committed to manage the exchange rate flexibly in order to avoid a weakening in the competitive position of the Malawian economy.

The Malawian Government has announced its intention not to seek a further round of debt rescheduling in 1985 in view of the costs of such rescheduling. These costs include the rescheduling fees and commissions and interest on amounts rescheduled, as well as the potential loss of export credit insurance facilities. Moreover, the need for rescheduling diminished in 1985 when the severe bunching of the previous three years had passed (Chart 6). The authorities recognize, however, that debt service obligations falling due in 1985 and 1986 are considerable, and they intend to restrain noncessional borrowing. In light of this, the program provides for limits on the contracting or guaranteeing by the Government of new nonconcessional external borrowing of 1-12 year's maturity to SDR 10 million, of which none will have a maturity of less than 5 years. 3/ No short-term borrowing (less than one year maturity) will be undertaken by Government and public enterprises, except for

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1/ These growth rates are quoted at constant factor cost and differ appreciably from the growth rates of GDP at market prices shown in Table 2, because of the changes in the structure of indirect taxation introduced in 1985.

2/ The middle rate against the U.S. dollar on April 2, 1985 was MK 1.7963 = US$1, compared with MK 1.5359 = US$1 at the end of March 1985.

3/ All medium- and long-term borrowing by the nonfinancial public sector is guaranteed by the Government.

normal trade financing. The Government is in the process of completing two loan agreements which would be covered by these limits. One loan, amounting to US$5 million from the International Finance Corporation (IFC), is for onlending to the industrial and agricultural sectors; the other loan, amounting to ECU 4.5 million (about SDR 3 million), is from the European Investment Bank (EIB) for onlending to the tea sector.

2. Central government operations

a. Program for 1985/86

The program for 1985/86 envisages a central government deficit (with grants above the line) of MK 85.6 million (4.1 percent of GDP). 1/ Assuming disbursement of MK 55 million under the World Bank's SAL III in the first quarter of 1986, net foreign financing is programmed at 3.1 percent of GDP, after allowing for a rise in amortization payments which result partly from the currency depreciation and partly from previously rescheduled debt falling due in 1985/86. The Government's residual domestic financing requirement of 1 percent of GDP (MK 20 million) would enable the Government to improve its position with the domestic banking system by MK 10 million (0.5 percent of GDP).

Total central government expenditure is programmed to increase by 20 percent to the equivalent of 28.6 percent of GDP, compared with 27.7 percent in 1984/85. A central element in the program--the provision for a realistic level of nonwage recurrent expenditure needed for service, maintenance, and utilization of existing equipment--is based on the realization that in the first two years of the extended arrangement persistent underbudgeting for nonwage expenditure on goods and services had been reflected in overruns in this category which were a major factor behind the higher than programmed deficit. The program envisages no further real decline in nonwage expenditure on goods and services. Development expenditure for 1985/86 is programmed to exceed that programmed for 1984/85 by 35 percent, reflecting the depreciation of the kwacha, as well as the low rate of implementation of the 1984/85 development program. Budgeted domestic contribution to development expenditure in 1984/85 had been considered inadequate by the World Bank and was subsequently increased, particularly in the areas of education, transportation, and agriculture. In the light of this it was felt that domestic financing should not be lower than in the program for 1984/85. Furthermore, domestically financed development expenditure includes a doubling of the Government's contribution to the fertilizer fund and an allocation for government buildings only slightly below that in the program for 1984/85 (see section 3b below).

Following an increase of over 30 percent in the Government's wage bill in the first two fiscal years covered by the extended arrangement, the wage bill will be limited in 1985/86 to MK 100.6 million. The

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1/ With grants below the line the targeted deficit is MK 138.6 million (6.7 percent of GDP).

programmed 11 percent increase will essentially reflect the 10 percent average salary increase effected January 1, 1985, and a small amount of wage creep during the year. In order to stay within the limit on the wage bill, the authorities stated that there will be no further salary increase for government workers in 1985/86; government hiring and filling of vacant civil service positions will be limited to essential posts, and every effort will be made to reduce government employment. At present, the civil service is the subject of a study by the Civil Service Commission. On completion of this study (mid-1985), the authorities will examine the possibility of reducing establishments. The programmed 16 percent increase in interest payments reflects the depreciation of the kwacha, the rise in domestic interest rates, and interest payments on rescheduled debt falling due in 1985/86.

Given the programmed level of expenditure and assuming that grant disbursements rise at approximately the same rate as foreign financed development expenditure, a package of revenue measures with a yield of MK 40 million in 1985/86 (1.9 percent of GDP) was needed to reach the deficit target of 4.1 percent of GDP. When combined with the effect of the depreciation, this would result in a 31 percent increase in revenue and raise the ratio of revenue to GDP to 21.9 percent in 1985/86.

The revenue package consisted of (1) a 10 percent export levy on tea and tobacco and a 5 percent tax on sales of agricultural products in cases where the seller otherwise pays only the minimum income tax; (2) a shift towards more current company taxation; (3) an increase in estate rental on government-owned land from MK 3 to MK 4 per acre; (4) a reduction in the stamp duty payable on life insurance policies, and a corresponding increase in the tax liability of the insurance companies; and (5) a small reduction in the rates of the graduated income tax and the PAYE taxes. These revenue measures were announced with the budget for 1985/86 and, allowing for slippage in implementation, their combined net yield is estimated conservatively at approximately MK 40 million. In the context of the mid-term review, the staff will reassess the yield of the revenue package, particularly the acceleration in the collection of company taxation. Since this acceleration will be a once-for-all gain, it is important that it should not lead to a larger-than-programmed increase in expenditures.

The system of expenditure monitoring which was strengthened in 1984/85 will continue in force in 1985/86. On the basis of information submitted to the Treasury by individual ministries and departments, the authorities will provide data to the Fund at monthly intervals cumulative throuh the end of the preceding month on major revenue and expenditure categories, the latter on both a cash and commitments basis. The authorities have agreed that, if cash expenditure on wages and salaries rises by more than 13 percent and total cash expenditure (excluding amortization) rises by more than 22 percent compared with the corresponding cash expenditure in 1984/85, there would be consultation with the Managing Director.

b. The Public Sector Investment Program

The fiscal year 1985/86 is the third year of the rolling three-year Public Sector Investment Program (PSIP). This program--developed in consultation with the World Bank staff--is ultimately intended to be a comprehensive investment program for the entire public sector. However, in its first two years the PSIP covered only the Central Government's development expenditure as planning in the rest of the nonfinancial public sector is poor and investment activity low, partly in reflection of the difficult financial position of most of the public enterprises. In 1985/86 the coverage of the PSIP is expected to be extended, but it has not been finalized, and the composition of the Central Government portion of this program may be modified somewhat as a result of consultations with the World Bank staff in the framework of discussions relating to SAL III.

Central government development spending for 1985/86 is programmed to rise to 8.7 percent of GDP from the low level of 1984/85. Its sectoral composition is similar to that for 1984/85 with the transportation and agriculture sectors accounting for 47 percent of development expenditure. The share of post and telecommunications, and forestry and game, while increasing, remained below 10 percent. The development budget includes an MK 11 million appropriation for government buildings and there is a doubling of the Government's contribution to the Fertilizer Revolving Fund. In view of the need to provide an adequate level of domestic financing of development projects, the staff expressed concern over the continued large appropriations for government buildings. The authorities agreed to consult the World Bank and to ensure that the local expenditure of the development budget for 1985/86 would be allocated in a manner satisfactory to the World Bank.

3. Statutory bodies

Although there was improvement in the financial position of the public enterprises in 1984, rates of return among even the most profitable of them remain low, investment activity is limited, none of the enterprises is making any significant contribution to Government and several continue to run losses and cash flow deficits. The authorities have approved a number of tariff increases as follows: adjustments of up to 50 percent on Air Malawi's domestic fares from January 1985; a 15 percent increase on Malawi Railways' international and domestic tariffs in April 1985; a 10 percent increase in ESCOM's tariffs for households and 15 percent for industrial users; and the tariffs of the two main water boards in Blantyre and Lilongwe by 10 percent and within the range of 7-25 percent, respectively. The ESCOM tariff increase (an average of 14 percent) was slightly larger and three months earlier than the 10 percent increase that had previously been planned. Nevertheless, toward the end of 1985 ESCOM is likely to encounter cash flow difficulties as a substantial amount of scheduled debt service payments falls due in December, and the authorities are aware of the possible need to review tariffs once again during 1985. MDC's financial position has improved largely because of the Government's assumption of much of its external debt service obligations, and it will be necessary to ensure that any new investment activity does not impose additional strain on the Government. The Government, in considering whether it should convert a part of MDC's debt to equity has recognized that any such conversion should be implemented slowly. The program contains a commitment to phase any such conversion over at least five years.

The financial position of ADMARC, by far the largest of the public enterprises, is determined largely by the prevailing levels of agricultural producer prices established by the Government, and by the resale prices of its commodities. The prices of exports are market-determined, while in the case of domestic sales, prices of some commodities, notably maize, are subject to price control. ADMARC's crop trading accounts are characterized by highly profitable export sales, and substantial losses on domestic sales (particularly on maize). The authorities are aware of the need to increase ADMARC's profitability and have undertaken to take the necessary steps to eliminate cross-subsidization of domestic sales by 1986/87.

During the mid-year review, an important issue will be the adequacy of tariffs for the 1986 financial year. The staff has also expressed the view to the World Bank that a number of issues such as cross-subsidization among ADMARC's trading accounts and the investment strategy of the major public enterprises should be taken up as central issues in the consideration of a third SAL.

4. Monetary and credit policy

The objective of monetary policy in the 1985/86 program is to ensure a return to a more appropriate growth path of the money supply (broadly defined), given the growth rates in excess of 30 percent that occurred in 1984, and policies have been developed in light of the rather weaker balance of payments expected in 1985. The authorities undertook to ensure that the liquidity of the banks (as measured by the ratio of reserves to deposit liabilities), which was excessive at the end of 1984 as a result of the exceptionally and unexpectedly strong balance of payments, would be returned approximately to the level existing at the end of March 1984. They intend to keep this ratio approximately stable thereafter, in order to guard against any credit expansion that would cause the limit on net domestic assets to be exceeded. By mid-April 1985 the ratio had fallen to the target level.

Interest rate policy is to be formulated to increase incentives to save, to retain funds in Malawi and to prevent the creation of excess domestic demand. The Reserve Bank has adjusted the structure of interest rates, so as to ensure that they will be positive in real terms for longer maturities. Thus, on April 15, 1985, rates on deposits of over three months were increased by between 1 and 2 percentage points, and increasing the minimum and maximum lending rate by 2.5 percentage points. Rates on short-term deposits (up to 30 days' notice) are to be established by the commercial banks in consultation with the Reserve Bank.

In establishing these rates, the Reserve Bank has taken into account the maturity structure of deposits of the two commercial banks, the need to allow market forces to play a significant part in setting rates, and the low spread previously existing between lending and deposit rates.

The credit ceilings established as performance criteria for 1985/86 relate to the net domestic assets of the banking system and net bank credit to the Government (Table 4). The target for monetary growth is to limit the expansion over the two-year period, April 1984-March 1986 to the growth of nominal GDP (39.5 percent). Given the estimated rate of growth to March 1985 of 28.1 percent, this entails an expansion during 1985/86 of only 8.9 percent. A principal concern has been to ensure adequate access to credit for the private sector; the program for 1985/86 allows expansion in this aggregate (net of provisions for doubtful debt) equivalent to the projected increase in domestic prices, which given the more rapid increase programmed in 1984/85, implies a rate of expansion in the two-year period only slightly less than nominal GDP. 1/ Some contraction is envisaged in credit to the statutory bodies during 1985/86, after a sharp rise accounted for by seasonal crop financing requirements in 1984/85. Finally, and taking into account the budgetary support afforded by an assumed disbursement from SAL III, credit to the Government is programmed to contract by MK 10 million during 1985/86.

The program for 1985/86 also includes indicative ceilings on credit to the statutory bodies, which if exceeded would result in consultation with the Managing Director. ADMARC accounts for over 90 percent of the stock of bank borrowing by statutory bodies 2/ and almost all the expected changes in level. This requirement is introduced in view of the much larger use than programmed of bank credit by ADMARC in 1984/85 for crop purchases, and its inability to reduce its credit outstanding quickly to a normal seasonal path. The indicative limit is intended to allow a more effective monitoring of ADMARC's use of bank credit, and to identify policy or structural weaknesses which might lead to a nonseasonal use of credit. Thus in 1985/86 the programmed reduction in credit reflects the expectation that ADMARC will reduce the amount of its carryover from MK 14 million in March 1985 to MK 6 million in March 1986. 3/ During the program year credit is expected to rise sharply during the June and

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1/ Including provisions for doubtful debt credit to the private sector is programmed to rise by 10.8 percent in 1985/86, or by 22.5 percent in the two-year period.

2/ Of the balance of MK 82.6 million outstanding at December 1984, ADMARC accounted for about MK 77 million; MK 36 million owed to the Reserve Bank with respect to past loans intermediated for the Press Group, MK 11 million in other borrowing from the Reserve Bank, and about MK 30 million to the commercial bank for seasonal credit.

3/ As explained in section II.6 above the carryover is so large in March 1985 because of relatively low seasonal domestic sales, and slow export shipments.

September quarters which are the peak periods for crop purchase; the ceilings reflect the estimates of the credit necessary for the purchase of 295,000 metric tons (m.t.) of maize, and 90,500 metric tons of other crops. 1/

The ceilings on net credit to Government have been established in the expectation that the first tranche of the Bank's SAL III will be disbursed in the first quarter of calendar year 1986, an amount equivalent to MK 55 million. The ceilings will be adjusted for any excess in their disbursements or any relief which the Government negotiates on either its external or domestic debt, as indicated in Table 4. 2/

Finally, the definitions of net domestic assets of the banking system and net bank credit to Government have been revised in 1985/86. Until March 1985 a blocked account at the Reserve Bank containing sums for amounts held by the Government for the redemption of external debt rescheduled in 1982/83 or 1983/84, was classified as a government deposit, and hence was counted in calculating net bank credit to Government. After March 31, 1985, this account is excluded from the definition of net domestic assets, being classified as a blocked account under the non-deposit liabilities in the monetary survey. Thus a discontinuity in the time series occurs in March 1985, in which net bank credit to Government and domestic assets of the banking system rise by MK 11.0 million.

5. Policies on production, prices, and subsidies

Producer prices for the 1985/86 growing season will be announced in August or September, in advance of the growing season. The producer prices will be set in consultation with the World Bank, particularly in the context of the SAL III. The authorities intend to apply the methodology (developed in consultation with the World Bank) used in recent years to establish these prices; this uses the concept of the "farmgate" export price (export unit value less transport and marketing costs), as the benchmark towards which prices are to be moved. In 1984/85 most producer prices were moved close to this level, and in 1985/86 it will be necessary to reflect the increases in fertilizer prices that will result and to ensure that no slippage occurs in view of the substantial depreciation in the external value of the Malawi kwacha during 1984 and early 1985. Moreover, maize and tobacco make heavy use of fertilizer, and therefore have a relatively low net export contribution; in the case of maize the cost of transportation accentuates this effect. In light of these considerations, the authorities have indicated their intention to design incentives to encourage export diversification: this will entail reducing further the price of maize relative to other crops, and increasing the incentive for crops such as cotton, groundnuts, rice and wheat, some

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1/ Included in this total are 14,300 m.t. of groudnuts, 38,000 m.t. of cotton, 9,900 m.t. of rice, and 19,800 m.t. of tobacco.

2/ Alternatively, the servicing of the debt would continue on its original schedule, the proceeds going to a blocked account at the Reserve Bank.

of which still have prices that, in real terms, are below their level of the early 1970s. Production incentives are also determined by the extent of fertilizer subsidies. The price of fertilizer is heavily affected by the cost of transportation, which has risen from MK 50 per ton to MK 167 per ton, reflecting the longer trade routes now in use. These subsidies represent a heavy budgetary and balance of payments burden and the authorities have reaffirmed their commitment to removing subsidies on fertilizer before the 1986/87 growing season, reducing the subsidy arising from sales in 1985 to no more than MK 4 million.

The process of liberalizing prices, started in 1983, is expected to be completed by December 31, 1985, some six months earlier than had originally been expected under the program. Prior to Board discussion the authorities will submit to the Fund a timetable for the removal of remaining controls and a list of the few commodities that they wish to remain under control after December 1985. This list is not expected to exceed 5 or 6 items, and compares with the original list of about 60 items that were formerly controlled.

6. Performance criteria

The performance criteria include:

1. quarterly ceilings on the domestic assets of the banking system, with quarterly subceilings on the banking system's net claims on the Government;

2. A ceiling on new nonconcessional external borrowing contracted or guaranteed by the Government with a maturity of between 1 and 12 years, a subceiling on new borrowing with a maturity of from 1 to 5 years, and a separate ceiling on borrowing by the nonfinancial public sector with maturity less than 1 year (except normal trade financing);

3. A provision that the Malawian authorities will consult with the Fund on the progress made in implementing the program, before December 31, 1985, and reach understandings on performance criteria similar to (1) for June 1986 and (2) for the remainder of the program period.

4. The standard provision relating to the exchange and trade system, overdue obligations to the Fund, and noncomplying purchases.

In addition, consultation with the Managing Director will occur:

1. if either total government expenditure or government expenditure on wages exceeds programmed rates of increase; or

2. if domestic bank credit to statutory bodies exceeds programmed levels.

V. Staff Appraisal and Proposed Decision

External conditions were favorable during the second year of the EFF program and the balance of payments showed a remarkable improvement relative to both 1983 and program projections. Exports were considerably more buoyant than expected, reflecting substantial exports of maize and tobacco, higher price of tea, and exports of stocks of tobacco and sugar which could not be exported in 1983 due to transport difficulties. Demand for imports was substantially lower than projected due to higher import prices attributable to the higher cost of transport and the depreciation of the kwacha in late 1983. Imports may also have been affected by a tightening in exchange allocation in 1983. The overall balance showed a substantial surplus and gross official reserves rose to the equivalent of 2.5 months of imports, compared with 2 weeks in 1983. Output grew more strongly than projected and domestic inflation ran at about the programmed level.

The favorable external conditions mitigated the adverse impact of inadequate domestic financial policies on the balance of payments. The money supply rose sharply and liquidity of the public and the banks was extremely high at the end of 1984. Although revenue performance was better than programmed--bolstered by an advance tax payment--the Central Government's overall deficit in 1984/85 is expected to have been significantly higher than programmed, for the second year running. Despite efforts to improve the monitoring of expenditures, expenditure control remained inadequate. There were significant overruns in recurrent spending, including wages, and external interest payments substantially exceeded the programmed amount, largely reflecting the appreciation of the U.S. dollar. A staff mission that conducted the mid-year review in October/November 1984 concluded that persistent inability to effectively control expenditures was likely to seriously jeopardize attainment of the objectives of the EFF program. This was the more so since earlier estimates of capital inflows seemed to be optimistic. In light of this the staff concluded, given the slippages that had occurred, that a considerable strengthening of policies and improvement in their implementation in 1985/86 was essential in order to achieve the medium-term objectives of the EFF program. The review, therefore, was not concluded as scheduled.

The authorities have embarked on a program for 1985/86 that entails a significant improvement in the financial position of the public sector, supplemented by measures to contain the growth of private demand and to encourage private saving. Virtually all of the measures have already been implemented, thus setting the stage for a resumption of the adjustment effort. These measures included: (1) a depreciation of the kwacha sufficient to reverse the real appreciation that occurred in 1984 and an undertaking to continue to pursue a flexible policy; (2) selected measures of expenditure restraint, coupled with increases in taxation, estimated to yield MK 40 million in 1985/86 (the equivalent of 2 percent of GDP); (3) increases in interest rates and measures to reduce bank liquidity; and (4) a reaffirmation of policy intentions with regard to the liberalization of prices and reduction in subsidies to be carried out in the course of the program period.

The staff considers that the program for 1985/86, particularly the strength of the prior measures, is sufficient to achieve the objectives of the EFF program, despite the deviations that had occurred in 1984/85. With the successful implementation of this program, balance of payments viability can be achieved by 1986. Therefore, the staff believes that a continuation of Fund support under the existing arrangement is warranted. However, in view of the interruption of purchases that has occurred and to avoid an unduly large concentration of access in the remaining period of the arrangement, the staff believes that the amount of the arrangement should be reduced and the remaining amount rephased. In accordance with Fund practices in this regard, the rephasing of purchases after a lengthy interruption in a multi-year arrangement is aimed at avoiding an unduly large amount from becoming available when drawing rights are restored and an inappropriately high access during the period remaining under the arrangement.

The balance of payments outlook is sensitive to assumptions about commodity prices and the availability of external financing. On the basis of the current outlook, staff projections indicate that restraint will continue to be needed beyond 1986 to maintain a sustainable balance of payments position. This is reflected in the balance of payments in the restrained growth of imports and in the central government deficit in the need for continued adjustment. On this, the staff notes the view of the World Bank staff that concessional inflows could be larger than the staff is presently assuming.

Close consultation has been maintained between the staff of the Fund and the World Bank. In the period of the arrangement the World Bank has provided two SALs and is presently considering a third. The program adopted by the authorities under the extended arrangement and the SALs have been complementary in most important respects. A Consultative Group is expected to be convened under the auspices of the World Bank; following this meeting a reappraisal of the availability of external financing in the medium term will be required, at which time the policies being pursued by Malawi should be reassessed.

Malawi maintains restrictions under the provisions of Article XIV in respect of an exchange budget for imports and limits on allowances for personal and business travel as described in "Malawi - Recent Economic Developments." The staff considers that these restrictions are administered in a flexible manner and that improvements in the balance of payments position and an appropriate exchange rate policy are important in facilitating the maintenance of a liberal exchange and trade system.

The staff believes that Article IV consultations with Malawi should continue on the 12-month cycle.

The following draft decisions are proposed for adoption by the Executive Board.

Article IV Consultation

1. The Fund takes this decision in concluding the 1985 Article XIV consultation with Malawi in the light of the 1985 Article IV consultation with Malawi conducted under Decision No. 5392-(77/63) adopted April 29, 1977 ("Surveillance over Exchange Rate Policies").

2. Malawi continues to maintain restrictions on the making of payments and transfers for current international transactions in accordance with Article XIV, Section 2, as described in SM/85/ . The Fund notes that Malawi's exchange system is administered in a flexible manner.

Review Under Extended Arrangement

1. Malawi has consulted with the Fund in accordance with paragraph 4(c) of the extended arrangement for Malawi and paragraph 31 of the memorandum attached to the letter from the Minister of Finance and the Governor of the Reserve Bank of Malawi dated June 25, 1984, attached to the extended arrangement for Malawi (EBS/83/183, Supplement 1, and EBS/84/151), in order to reach understandings with the Fund regarding policies and measures that Malawi will pursue through March 31, 1986.

2. The letter dated April 12, 1985 from the Minister of Finance and the Governor of the Reserve Bank of Malawi, together with an accompanying Economic Policy Memorandum, shall be attached to the extended arrangement for Malawi, and the letter dated July 29, 1983, together with the accompanying Economic Policy Memorandum, shall be read as supplemented by the letter dated April 12, 1985 together with the accompanying Economic Policy Memorandum.

3. Malawi will not make purchases under the extended arrangement that would increase the Fund's holdings of Malawi's currency in the credit

tranches beyond 25 percent of quota or increase the Fund's holdings of that currency resulting from purchases of borrowed resources beyond 12.5 percent of quota

(a) during any period in which the data at the end of the preceding period indicate that:

(i) the ceiling on the net domestic assets of the banking system as specified in paragraphs 24 and 25 of the Memorandum attached to the letter dated April 12, 1985, or

(ii) the ceiling on the net credit to the Government of the banking system as specified in paragraphs 24 and 25 of the Memorandum attached to the letter dated April 12, 1985, or

(iii) the limit on external borrowing as specified in paragraph 10 of the Memorandum attached to the letter dated April 12, 1985,

has not been observed; or

(b) during any period after December 31, 1985, until the review with the Fund contemplated in paragraph 33 of the Memorandum attached to the letter dated April 12, 1985 has been completed, or, following that review, while any performance criteria established by the Fund pursuant to the review are not observed.

4. The extended arrangement shall be amended as follows:

(a) In paragraph 1, replace "SDR 100 million" with "SDR 81 million."

(b) In paragraph 2(b), replace "April 30, 1985" with "May 31, 1985," and "SDR 47 million" with "SDR 41 million."

(c) In paragraph 2(c), replace "April 30, 1986" with "May 15, 1986," and "SDR 83 million" with "SDR 65 million."

(d) In paragraph 2(d), replace "April 30, 1985" with "May 31, 1985," and "April 30, 1986" with "May 15, 1986."

(e) In paragraph 4(c), replace "April 29, 1985" with "May 30, 1985," and "April 29, 1986" with "May 14, 1986."

(f) At the end of paragraph 4 add the following as paragraph 4(e): "Malawi will not make purchases under this extended arrangement during any period of the arrangement in which the member has an overdue financial obligation to the Fund or is failing to meet a repurchase expectation pursuant to the Guidelines on Corrective Action with respect to a non-complying purchase."

5. Until May 15, 1986, purchases under this arrangement shall not, without the consent of the Fund, exceed the equivalent of SDR 65 million provided that purchases shall not exceed the equivalent of SDR 41 million until August 15, 1985, the equivalent of SDR 49 million until November 15, 1985, and the equivalent of SDR 57 million until February 15, 1985.

Malawi: Selected Economic and Financial Indicators, 1981-87

	1981	1982	1983 Orig. EFF	1983 Act.	1984 Orig. EFF	1984 Rev. prog.	1984 Est.	1985 Projections 1/	1986 Projections 1/	1987 Projections 1/
	(Annual percent changes, unless otherwise specified)									
National income										
GDP at constant factor cost	-5.2	2.8	2.7	3.5	3.0	3.2	4.1	2.7	1.0	2.0
GDP deflator	11.2	10.3	9.7	13.1	9.7	10.1	15.0	13.9	10.1	9.6
Consumer prices	11.8	9.2	13.0	13.8	10.0	13.0	13.1	15.0	10.0	8.0
External sector										
Exports, f.o.b. (millions of SDRs)	244.3	220.0	220.5	215.5	248.1	232.1	301.6	305.7	319.6	329.2
Imports, c.i.f. (millions of SDRs)	297.3	276.4	288.8	289.7	300.0	308.7	276.1	297.4	307.8	327.1
Non-oil imports, c.i.f. (millions of SDRs)	250.9	233.4	238.8	242.3	...	269.4	...	...	...	...
Export volume	-19.8	-8.7	12.6	7.1	8.9	19.5	20.3	9.3	5.5	1.3
Import volume	-24.9	-4.5	0.6	-8.7	6.4	-1.0	-14.9	6.0	0.1	2.8
Terms of trade (deterioration -)	19.0	1.3	-13.7	-20.5	1.7	-4.4	4.1	-8.7	-7.4	1.8
Nominal effective exchange rate, year-end (depreciation -)	9.3	-8.2	...	-6.5	...	...	5.1	...	...	...
Real effective exchange rate, year-end (depreciation -)	6.1	-4.0	--	0.1	--	--	9.0	--	--	--
Government budget 2/										
Revenue	10.9	10.6	13.2	17.1	14.9	17.5	21.8	30.7	8.7 3/	6.8 3/
Total expenditure	9.5	-2.2	6.1	14.5	10.1	7.9	12.3	20.1	6.6 3/	8.2 3/
Money and credit 2/										
Net domestic assets (increase) 4/	46.0	20.7	23.3	13.1	20.8 5/	17.8 5/	20.9	1.9	2.3	11.6
Credit to Government (increase) 4/	42.2	6.8	8.8	3.0	8.1 5/	4.9 5/	27.2 6/	-2.7	-6.6	3.3
Money and quasi-money (M2) (increase) 4/	15.0	12.7	12.8	10.6	14.7 5/	9.4 5/	28.1	8.9	11.3	11.1
Velocity (GDP relative to M2)	5.1	5.1	5.5	5.4	5.0 5/	5.5 5/	5.4	5.4	5.4	5.4
Interest rate (annual rate, 12-month time deposits)	10.75	10.75	12.75	12.75	...	...	12.75	14.25	...	...
	(In percent of GDP) 7/									
Central Government										
Overall deficit 2/										
Excluding official transfers	15.6	12.4	9.0	10.4	8.0	7.7 8/	8.2 8/	6.7	6.0	5.3
Including official transfers	11.8	9.3	6.4	8.1	5.4	5.4 8/	6.0 8/	4.1	3.2	2.6
Domestic bank financing 2/	7.8	1.6	1.4	0.4	1.1	0.9	1.4	-0.5	-1.3	5.8
Foreign financing 2/ 9/	2.8	5.0	4.6	5.7	3.8	3.5	3.0	3.5	3.2	1.1
Gross fixed capital formation	15.7	15.0	15.4	13.9	16.6	16.3	11.8	11.8	12.0	13.0
Gross domestic saving 10/	7.2	7.9	9.7	6.7	11.7	10.1	14.3	11.4	11.2	12.3
Current account deficit										
Excluding official transfers	11.1	10.5	8.0	12.5	7.0	8.8	3.9	5.5	5.0	4.8
Including official transfers	7.3	7.3	5.5	10.1	4.3	6.3	1.7	3.0	2.3	2.2
External debt (inclusive of use of Fund credit) (in millions of SDRs) 11/	661.2	713.3	775.7	783.2	844.2	825.0	880.7	879.9	950.0	938.8
Debt service ratio 12/										
Before rescheduling	39.2	43.1	42.7	54.0	39.5	44.1	42.3	29.4	31.2	28.8
After rescheduling	34.2	36.4	22.0	32.9	30.5	33.4	35.2	33.5	37.2	35.6
Interest payments 9/ 12/	18.8	15.2	13.4	17.1	13.5	13.4	14.1	13.8	14.3	13.6
	(In millions of SDRs, unless otherwise specified)									
Overall balance of payments										
Before rescheduling	-33.1	-57.0	-67.9	-93.1	-35.4	-38.7	40.0	-1.3	70.8	21.0
After rescheduling	-33.1	-40.2	-14.7	-43.1	-9.6	-10.4	62.9	-15.0	49.1	-6.1
Gross official reserves (months of imports, c.i.f.)	1.6	0.9	1.2	0.5	...	...	2.5	2.0	4.0	2.6
External payments arrears	--	--	--	--	--	--	--	--	--	--

Sources: Data supplied by Malawian authorities; and staff estimates.

1/ Based on projections prepared for the 1985/86 program year.
2/ Fiscal year beginning April 1 of the year indicated.
3/ Constrained forecast assuming no additional revenue measures.
4/ As a percentage of money and quasi-money at the beginning of the period.
5/ Based on projections for calendar years.
6/ Includes special issue of Local Registered Stock for the Government's assumption of Press debt; excluding this, the change is 9.6 percent of broad money.
7/ Revisions to data from 1979 onward have resulted in a substantial downward revision to GDP. The targets of the original EFF have been left unaltered, and are thus not strictly comparable with the actual data.
8/ Excluding the special issue of Local Registered Stock for the Government's assumption of Press debt.
9/ After debt relief.
10/ Excluding the financing of stock building.
11/ End of period, public and publicly guaranteed medium- and long-term debt.
12/ In percent of exports of goods and nonfactor services. Based on data provided by the IBRD and including IMF charges, repurchases, and estimated debt service on private debt.

MALAWI - Fund Relations
(At March 31, 1985)

(Amounts in millions of SDRs, unless otherwise specified)

I. Membership status

a. Date of membership: July 19, 1965
b. Status: Article XIV

A. Financial Relations
(General Resources Account)

II. General department

a. Quota: 37.2

	Millions of SDRs	Percent of quota
b. Total Fund holdings of Malawi kwacha	146.0	392.5
c. Fund credit	111.0	298.4
Of which: under stand-by		
ordinary resources	19.5	52.4
SFF	21.8	58.6
enlarged access	8.6	23.1
under extended arrangement:		
ordinary resources	18.5	49.8
enlarged access	15.5	41.7
compensatory financing facility	27.1	73.0
d. Reserve tranche	2.2	5.9

III. Current extended arrangement and special facilities

	Date of arrangement	Duration (months)	Total amount	Utilization
a. Current extended arrangement	Sept. 1983	36	100.0	34.0
b. Previous arrangements				
Stand-by	Oct. 1979	30	26.3	5.5
Stand-by	May 1980	24	49.9	40.0
Stand-by	August 1982	12	22.0	22.0

MALAWI - Fund Relations (continued)

	Date of arrangement	Total amount
c. Special facilities		
Compensatory financing (exports)	Aug. 1979	9.5
Compensatory financing (exports)	Oct. 1979	9.5
Compensatory financing (cereals)	Sept. 1981	1.5
Buffer stock financing	Dec. 1982	0.9
Compensatory financing (exports)	Feb. 1983	12.2
Compensatory financing (exports)	Aug. 1984	13.8

	Amount	Percent of allocation
IV. SDR Department		
a. Net cumulative allocation	11.0	100.0
b. Holdings	1.7	15.2

	Amount
V. Administered accounts	
a. Trust Fund loans	
(i) Disbursed	14.7
(ii) Outstanding	12.4
b. SFF Subsidy Account	
(i) Donation	--
(ii) Loans	--
(iii) Payments by Fund	3.1
VI. Overdue obligations to the Fund	None

VII. Not applicable

B. Nonfinancial Relations

VIII. Exchange rate arrangement

The Malawi kwacha is pegged to an unannounced basket of currencies. The intervention currency is the U.S. dollar, for which the Reserve Bank of Malawi's rates are based on the U.S. dollar/SDR rate calculated by the Fund for the preceding day. The representative rate on March 31, 1985 was MK 1 = US$0.6511. On April 2, 1985 the value of the Malawi kwacha was adjusted against the basket such that the representative rate was MK 1 = US$0.5567.

MALAWI - Fund Relations (continued)

IX. Last Article IV consultation and extended arrangement review

The last Article IV consultation discussions were conducted April 25-May 12, 1984 together with the negotiation of the program for the second year of the arrangement (EBS/84/151 and SM/84/177), and the following decisions were adopted:

Article IV Consultation

1. The Fund takes this decision in concluding the 1984 Article XIV consultation with Malawi in the light of the 1984 Article IV consultation with Malawi conducted under Decision No. 5392-(77/63) adopted April 29, 1977 ("Surveillance over Exchange Rate Policies").

2. The Fund notes with satisfaction that Malawi continues to maintain an exchange system that is free of restrictions on payments and transfers for current international transactions.

Program for Second Year of Extended Arrangement

1. Malawi has consulted with the Fund in accordance with paragraph 4(b) of the extended arrangement for Malawi and paragraph 34 of the memorandum attached to the letter from the Minister of Finance and the Governor of the Reserve Bank of Malawi dated July 29, 1983, attached to the extended arrangement for Malawi (EBS/83/183, Supplement 1), in order to reach understandings with the Fund regarding policies and measures that Malawi will pursue through March 31, 1985.

2. The letter dated June 25, 1984 from the Minister of Finance and the Governor of the Reserve Bank of Malawi together with an acccompanying Economic Policy Memorandum shall be attached to the extended arrangement for Malawi, and the letter dated July 29, 1983 together with the accompanying Economic Policy Memorandum shall be read as supplemented by the letter dated June 25, 1984 together with the accompanying Economic Policy Memorandum.

3. Malawi will not make purchases under the extended arrangement that would increase the Fund's holdings of Malawi's currency in the credit tranches beyond 25 percent of quota or increase the Fund's holdings of that currency resulting from purchases of borrowed resources beyond 12.5 percent of quota

(a) during any period in which the data at the end of the preceding period indicate that:

(i) the ceiling on the net domestic assets of the banking system as specified in paragraphs 23 and 24 of the Memorandum attached to the letter dated June 25, 1984, or

MALAWI - Fund Relations (concluded)

(ii) the ceiling on the net credit to the Government of the banking system as specified in paragraphs 23 and 24 of the Memorandum attached to the letter dated June 25, 1984, or

(iii) the limit on external borrowing as specified in paragraph 27 of the Memorandum attached to the letter dated June 25, 1984,

have not been observed; or

(b) during any period after December 31, 1984, until the review with the Fund contemplated in paragraph 31 of the Memorandum attached to the letter dated June 25, 1984 has been completed, or, following that review, while any performance criteria established by the Fund pursuant to the review are not observed.

4. Until April 30, 1985, purchases under this arrangement shall not, without the consent of the Fund, exceed the equivalent of SDR 45 million provided that purchases shall not exceed the equivalent of SDR 27 million until October 31, 1984 and the equivalent of SDR 34 million until January 31, 1985.

X. Technical assistance, 1983-85

(a) CBD

(i) Training Advisor to the Reserve Bank of Malawi, 1982-84.

(ii) Consultant on external debt, 3 weeks in March/April 1984.

(iii) Consultant on the computerization of Reserve Bank operations: approximately six months from March 1985.

(b) Steps are being taken to assign a member of the fiscal panel as Budget Advisor to the Ministry of Finance, commencing in mid-1985.

(c) Other - None

XI. Resident Representative/Advisor

None

MALAWI - Relations with the World Bank Group

Since 1966, when Malawi's first IDA credit was approved, the World Bank Group has granted Malawi 33 IDA credits and one Special Fund credit totaling US$414 million and 8 World Bank loans totaling US$97 million, of which 2 were on third-window terms. Of the entire funds committed, US$153 million (28 percent) have been for agricultural projects, US$108 million (20 percent) for education, US$110 million (22 percent) for roads, US$100 million (20 percent) for two structural adjustment loans, US$39 million (7 percent) for power projects, US$15 million (2.7 percent) for urban development, US$3 million (1 percent) for development finance companies, and the remainder for a combination of projects including water supply, health, and technical assistance. In addition, between 1976 and 1980 the IFC provided US$27.5 million in funding, of which US$26.1 million were loans and the remainder equity. These amounts have financed six separate projects covering a number of sectors, including textiles, sugar, ethanol production, wood industries, and tourism.

The Bank's most recent commitments to Malawi were a US$6.4 million loan (on IBRD terms) for a wood industries project, and IDA credits of SDR 23.3 million for an agricultural research project, and SDR 14.8 million for an urban development project.

The World Bank staff have provided the following assessment of Malawi's economic policies.

MALAWI March 28, 1985

STATEMENT OF BANK VIEWS

Structural Adjustment

1. The second and final tranche of the SDR 51.9 million SAL II credit was released in November 1984 after satisfactory progress was recorded in the overall implementation of the program, including the fulfillment of nine conditions for second tranche release. Partly as a result of the Government's SAL and EFF programs, the Malawi economy has begun a recovery. The Government has demonstrated a firm commitment to addressing the structural problems the country faces and to dealing with them in an expeditious manner. Despite the improvement in the economic performance, Malawi still faces structural constraints on growth and the medium-term outlook is for continued difficulties, the need for more adjustments, and, at best, modest growth in per capita income. The Malawi economy is, however, well positioned to benefit from further measures of adjustment.

2. The Bank is currently working with the Government on the preparation of the SAL III. The December 1984 preparation mission identified, with the Government, the policy measures that could potentially be included in

the Government's third Structural Adjustment program. Subject to the approval of the Bank's Loan Committee, appraisal is planned for May 1985. SAL III is scheduled for Board presentation in December 1985 with the first tranche to be released shortly after signing. A further SAL IV operation is included in our lending program for FY87/88. However, the realization of this operation will depend on the successful implementation of SAL III.

3. The SAL III program would aim at enabling the Government to continue the implementation of various measures and policies initiated with the previous SAL operations, including those related to smallholder crop pricing, removal of fertilizer subsidy, establishment of an effective management and extension service for the estate sector, provision of medium-term credit for diversification, and the price liberalization program. Under SAL III, the Government would be expected to update periodically the three-year public investment program, including the major investments of the parastatals. Despite some noticeable improvements in the management and finances of certain parastatals, financial difficulties continue to interfere with their efficient functioning. Under SAL III, the Government would need to address these problems in a direct and specific way. For those parastatals which are in a position to carry out new investments, including the Agricultural Development and Marketing Corporation and the Malawi Development Corporation, further measures would be needed to be adopted to increase the efficiency of their operations, rationalize their assets, and develop viable long-term investment strategies.

4. The SAL III program would aim at placing greater emphasis on improved incentives for export promotion and efficient import substitution. The foreign exchange allocation system needs to be improved, and an export promotion program launched. The tax system needs to be reviewed and a program adopted to make the system more rational and compatible with the medium-term objectives of the Government's adjustment program. Improvements would also be effected in the budget system. To help overcome the weaknesses in economic management, the Government would be expected to strengthen its capacity to formulate policy and to plan effectively.

5. The SAL III program has been designed on the basis of macroeconomic projections which indicate that for the period 1985/86-1988/89 the economy would grow by about 3.5 percent per annum on average. These projections assume substantial growth in both agriculture (3.4 percent), where there is potential for expansion of smallholder export crops and improved productivity from existing estate land; and in industry (3.7 percent) where agro-processing is expected to grow in response to increased agricultural production. Exports are expected to increase at 4.5 percent annually in real terms during the next five years.

Public investment program

6. The Bank agreed with the Government on the size and distribution of a public investment program covering the period of 1983/84-1985/86 prior to the Board presentation of the SAL II in December 1983. However, the budget presented for 1984/85 contained higher allocations for government buildings, while local funding for development projects was less than required for timely implementation. Subsequently, the Government revised the development budget downward, reduced the allocations for the government buildings, and reallocated the savings to the underfunded donor-supported projects.

7. As part of its SAL III program, the Government would be expected to present an updated version of its public investment program covering 1985/86 to 1987/88. The program would be more detailed in its presentation and would cover the main investments of major parastatals in addition to the expenditures to be made from the development budget. The new three-year public investment program would be available in May for the appraisal mission. The Bank intends to review this program and prepare a report to be used as a basis for mobilizing additional project financing (para. 10). Implementation of the agreed public investment program would be monitored closely under the SAL III program.

Capital flows

8. Since 1980 there has been a decline in capital flows into Malawi. Commitments, including grants, have fallen from an average of $190 million in 1979-81 to an average of about $120 million in 1982-84. Commercial borrowing and the use of suppliers' credits have virtually stopped, while concessional flows and grants have stagnated. Net transfers have decreased from $175.5 million in 1980 to $39 million in 1982 and $50 million in 1983. Given that debt relief provided about $78 million net during this period, net transfers were negligible, despite the disbursement of $45 million under SAL I. The net transfer for 1984 is estimated at $96 million, of which $26 million was owing to debt relief and $55 million was the Bank's SAL II. Bank commitments of SAL operations totaling $100 million and the IMF net transfers of $22 million since 1981 have been offset by negative flows of more than $110 million for suppliers' credits and financial institutions in 1982-84. Concomitantly, the disbursement of grants fell from $50 million in 1980 to less than $27 million in 1984. The fall in net transfers from bilateral lenders is also notable.

9. Present commitments and a conservative estimate of likely future agreements imply total commitments of $828 million, disbursements of $621 million, and a net inflow of $264 million over 1985-88. (These figures exclude IMF transactions.) This is estimated to be at least $100 million or $25 million per year below the funds needed to reach the growth targets. The Bank is helping to organize a Consultative Group for Malawi to help meet this target. If this additional $100 million

cannot be realized, growth would be lower than projected (likely below the 3 percent rate of population growth) and there would be shortfalls in exports, tax revenues, and per capita consumption.

Cofinancing and Consultative Group efforts

10. Malawi will need additional external financing to reach its relatively modest growth targets, even with the successful implementation of its structural adjustment and EFF programs. At this point, recourse to excessive commercial borrowing would strain the country's ability to meet its external and domestic obligations. As noted above, the response of the international community to Malawi's need for additional concessionary assistance has been disappointing, particularly in view of the Government's relatively good record in economic management. An increase in nonproject, quick-disbursing aid flows is needed to support and sustain the efforts of the Government.

11. With the backing of the Malawi Government, the Bank has approached several governments to help mobilize bilateral support for the Government's structural adjustment efforts. In addition to the $65 million Bank loan, some $25-30 million is being sought in cofinancing under SAL III. The November Consultative Group will seek to mobilize on an ongoing basis the additional program and project assistance Malawi needs to sustain its economic recovery.

Malawi--Statistical Issues

1. Outstanding Statistical Issues

a. Monetary accounts

Work on revising the money and banking statistics has been underway in the past year as a follow-up to a technical assistance mission in November/December 1983. This work includes improving the sectorization of the accounts of the monetary authorities and deposit money banks and broadening the coverage of the data on nonmonetary financial institutions. There are a few outstanding issues relating to the classification of the accounts of the development financing institutions that will be addressed in a separate letter to the Reserve Bank of Malawi.

b. Balance of payments

The availability of more disaggregated data would improve the analytic usefulness of data presently shown in IFS.

2. Coverage, Currentness, and Reporting of Data in IFS

The table below shows the currentness and coverage of data published in the country page for Malawi in the March 1985 issue of IFS. The data are based on reports sent to the Fund's Bureau of Statistics by the Central Bank of Malawi, which during the past year have been provided on a timely basis; however, the currentness of trade data needs to be improved. Data for prices through the end of 1984 have recently been received and will be included in the next issue of IFS.

Status of IFS Data

		Latest Data in March 1985 IFS
Real Sector	- National Accounts	1984
	- Prices	Q1 1984
	- Production	Q1 1984
	- Employment	N.A.
	- Earnings	N.A.
Government Finance	- Deficit/Surplus	August 1984
	- Financing	August 1984
	- Debt	N.A.
Monetary Accounts	- Monetary Authorities	Nov. 1984
	- Deposit Money Banks	Nov. 1984
	- Other Financial Institutions	Q2 1984
External Sector	- Merchandise Trade: Values	Q1 1984
	- Merchandise Trade: Prices	Q4 1983
	- Balance of Payments	1982
	- International Reserves	Jan. 1985
	- Exchange Rates	Jan. 1985

Ministry of Finance
P.O. Box 30049
Lilongwe 3
Malawi

April 12, 1985

Mr. J. de Larosière
Managing Director
International Monetary Fund
Washington, D.C. 20431

Dear Mr. de Larosière:

1. The attached memorandum reviews Malawi's economic objectives and policies in support of which the Executive Board of the International Monetary Fund approved the extended arrangement in September 1983, and describes the measures that are being implemented in the third fiscal year covered by the arrangement (April 1985-March 1986). As envisaged when we embarked on this adjustment programme in 1983, we are continuing to formulate our policies in a flexible manner in the light of prevailing circumstances.

2. The present programme was intended to continue the Government's efforts to adjust to adverse developments in the country's external position by containing domestic demand and increasing production. Incentives for agricultural production have been increased substantially, wages have continued to be restrained, significant measures to streamline and liberalize the pricing system have been implemented, financial performance of the major public enterprises and the Press Group has improved, the Central Administration's deficit has been reduced in real terms, and flexible policies are being pursued with respect to interest rates and the exchange rate.

3. International and regional economic conditions in 1984 created an unfavorable environment for Malawi's adjustment effort. The appreciation of the U.S. dollar has added to the Government's external interest payments and the external transportation system has continued to deteriorate. Nevertheless, real output grew strongly and we achieved substantial improvement in our balance of payments position in 1984. However, efforts to reduce the budget deficit of the Central Administration have met with less success. Despite our efforts to improve the monitoring of expenditures and to restrain spending by individual ministries and departments, the target for the Central Administration deficit for 1984/85 was exceeded.

4. It is our intention to ensure that Malawi returns to the original path of adjustment by the end of the period of the arrangement. The policies we intend to pursue during the third fiscal year covered by the extended arrangement (1985/86) are described in detail in the attached memorandum. In support of our policies, the Government of Malawi requests the approval of the completion of the review of developments

under the program and the establishment of suitable performance criteria for 1985/86. Given the interruptions in purchases during 1984/85 and in the light of the existing Fund practice in this regard, we note that the total amount of the extended arrangement would be limited to SDR 81 million.

5. The Government of Malawi believes that the policies to be implemented in 1985/86 are adequate to achieve the objectives of the program, but is prepared to take any further measures that may be required for this purpose. Malawi will consult with the Fund about progress made in the implementation of its program and any policy adaptations that may be appropriate, in accordance with the policies of the Fund on such consultations. Malawi will not make purchases from the Fund in the period after December 31, 1985 until after having completed a review with the Fund on the Government's policies and reached such understandings with the Fund as will be necessary for the purpose of achieving the objectives of the program.

Yours sincerely,

/s/

L.C. Chaziya
Governor

Reserve Bank of Malawi

/s/

E.C.I. Bwanali
Minister of Finance

Government of Malawi

Memorandum of the Government of Malawi on Economic and Financial Policies for 1985/86

Introduction

1. Following several years of economic difficulties and successive stand-by arrangements with the International Monetary Fund, the Fund approved a three-year extended arrangement in September 1983. The objectives of the program underlying this arrangement were to establish a viable medium-term balance of payments, while restoring an annual average rate of economic growth of 3.5 percent and reducing the rate of domestic inflation to about 7-8 percent. It was anticipated that a decline in the external current account deficit to 5.4 percent of GDP in 1987, a reduction equivalent to 3.7 percentage points from the 1982 level, together with a significant improvement in net capital inflows would lead to a small overall surplus in the balance of payments by 1986. To achieve these objectives, the Government's overall deficit was to be reduced by containing overall expenditure and improving its tax effort; at the same time government investment was to be guided by a rolling three-year public sector investment program developed in consultation with the World Bank. The principal policies adopted also included measures to improve the structure of incentives, particularly by liberalizing the system of price control, and by improving the level of agricultural producer prices. A more appropriate interest rate policy would promote domestic financial saving, while flexible external policies would preserve the international competitiveness of the Malawian economy and reduce the external debt service burden without further recourse to debt rescheduling.

2. During the second year covered by the arrangement, output grew more strongly than projected, domestic inflation ran at about the programmed level, while the balance of payments showed a remarkable improvement as discussed in more detail below. However, despite the high econmic growth that has occurred in 1983 and 1984 (averaging 3.8 percent), attributable largely to increasing agricultural and manufacturing output, the Government deficit was significantly higher than projected. Overall expenditure could not be constrained to budgeted levels, and the indicative ceilings established for banking system credit to Government and for the net domestic assets of the banking system as of March 31, 1985 were exceeded. As a result of this and the very favorable balance of payments developments, domestic liquidity has expanded sharply with broad money rising by 33 percent in 1984. The consequence is that at the beginning of the third year of the program both the private sector and the domestic banking system are extremely liquid.

Balance of payments developments in 1984

3. The balance of payments improved significantly in 1984 relative to both 1983 and program projections, reflecting mainly the substantial turnaround in the trade account. This improvement occurred despite the external transportation situation which continued to deteriorate during

1984, with the rail link to the Mozambican port of Beira remaining virtually inoperative through 1983 and 1984, and the only other rail route through Mozambique to Nacala ceasing to operate early in 1984. Benefiting, to some extent, from a number of transitory factors, exports were more buoyant than expected. Stocks of goods--notably tobacco and sugar--which had not been exported in 1983 were exported in early 1984. There were also substantial exports of maize to neighboring countries and favorable developments in the prices of tea and the output of tobacco. Imports were substantially less than programmed. The value of imports declined by 5 percent and the volume is estimated to have declined by about 15 percent. Reasons for the decline in imports are not clear in view of the increased income from significantly higher export volumes and improvements in the terms of trade. However, it could be attributable to the effects on import prices of the deteriorating transport situation and the devaluation of the kwacha in early 1984 as well as to a tightening in exchange allocation for imports by the Reserve Bank in 1983. The current account deficit (after debt relief) declined from SDR 142 million in 1983 (12.6 percent of GDP) to SDR 46 million in 1984 (3.9 percent of GDP) compared with a program projection of SDR 112 million (8.8 percent of GDP).

4. Reflecting the improvement in the current account, the overall balance of payments (after debt relief) recorded a surplus of SDR 63 million compared with a deficit of SDR 43 million in 1983 and the program's target of a deficit of SDR 10 million. For the second year, the balance of payments benefited from the effects of debt relief. It is estimated that about SDR 23 million in interest and amortization payments were deferred. Gross official reserves increased to SDR 57 million at end-1984, equivalent to 2.5 months of 1984 imports, c.i.f..

Medium-term framework

5. Despite the improvement in the balance of payments in 1984, the Government is conscious that the balance of payments prospects over the medium term are likely to remain extraordinarily difficult unless there is a significant improvement in security and economic conditions in neighboring countries and an improvement in the terms of trade. Given the higher external debt service obligations falling due, the prospect for a considerable loss of the reserves accumulated during 1984 seems likely. The Government, therefore, fully recognizes the urgent need for concerted policy action directed toward achieving the objectives of the EFF program--namely, a viable balance of payments that will enable Malawi to service its debts to the Fund and other creditors without depleting reserves unduly and resorting to payments restrictions. These objectives, together with the Government's desire to achieve a sustainable rate of growth in conditions of reasonable price stability, point to the need to pursue policies aimed at containing the growth of domestic demand, and at increasing export production and private sector savings.

6. The medium-term balance of payments projections have been done for the period 1985-88. Net capital inflows are projected to decline

from about 6 percent of GDP in 1983-84 to about 2 percent of GDP in 1985-88. This reflects mainly the sharp increase in amortization payments, particularly the payment of debt consolidated during the two rescheduling arrangements in 1982-83. Grants and project loans are projected to increase at an average annual rate of 10 percent. As a result of some improvement in the financial position of public enterprises, a slight resumption in external borrowing is anticipated. Net private sector inflows are also projected to rise moderately.

7. The target for the external current account is derived by taking into account the projected net inflows of capital and grants, and the target of maintaining reserves at a level sufficient to allow Malawi to service its external obligations without difficulty at the end of the arrangement period. These considerations indicate that there is a need to contain the current account deficit to an average of 5.1 percent of GDP in 1985 and 1986.

Third year of the arrangement

8. To maintain the momentum of improvement in the balance of payments achieved in 1984, the program targets for an external current account deficit of SDR 63 million (5.5 percent of GDP) in 1985. On the basis of projected net inflows of capital and grants, including a SAL disbursement in 1986, this current account target is consistent with an adequate buildup of reserves in 1986 while also allowing for a moderate increase in imports from the low level of 1984. Given the substantial increase in the net savings of the private sector as a result of the increase in export earnings, and the reduction in imports, it is likely that private sector demand will rebound strongly in 1985. Therefore, the attainment of the current account objectives will require a significant improvement in the financial position of the public sector supplemented by measures to contain growth of private sector demand. In addition, there is a need to improve economic efficiency through the continued implementation of price liberalization and to encourage export production and import substitution through an adjustment in the exchange rate.

Exchange rate policy

9. On a trade-weighted basis, the Malawi kwacha has appreciated by 11 percent in real effective terms during 1984 compared with the rate prevailing at end-1983 and in the late 1970s. However, on a transactions weighted basis the kwacha depreciated in 1984 in view of the importance of the U.S. dollar as the intervention currency in Malawi. On the assumption that a trade-weighted basis is a better indicator of the profitability of the traded goods sector, these developments are detrimental to the profitability of the traded goods sector in Malawi and economic efficiency, and could adversely affect the prospects for the balance of payments in the medium term. In recognition of this we will pursue a more flexible exchange rate policy designed to maintain competitiveness and to achieve the medium-term balance of payments objectives. On April 2, 1985 the Malawi kwacha was devalued by 15 percent against the basket of currencies to which it is pegged.

External debt policies

10. External debt service obligations falling due are considerable over the medium term (30-35 percent of exports of goods and nonfactor services). In light of this, we recognize the need to restrain borrowing on commercial terms within the framework of the country's debt servicing capacity. Therefore, in 1985 the contracting or guaranteeing by Government of new nonconcessional external borrowing of 1-12 years' maturity will be limited to SDR 10 million, of which none will have a maturity of less than 5 years. The nonfinancial public sector will not contract short-term borrowing (of less than one-year maturity) except for normal trade financing. The monitoring of external borrowing should be facilitated by the completion of the external debt statistics project.

Fiscal developments in 1984/85

11. In line with the objectives for the program for 1984/85, the Government aimed to achieve a reduction in the central administration's overall deficit (including grants) to 5.4 percent of GDP from 7.5 percent in 1983/84. 1/ This was to be achieved by a combination of an increased revenue effort and expenditure restraint. In recognition of the inherent lack of buoyancy in Malawi's tax system, the Government foresaw a reduction in the revenue effort in 1984/85 unless significant new measures were introduced. Consequently the authorities announced with the budget for 1984/85--presented to Parliament in March 1984--a revenue package which further raised already high tax rates on imports as well as on domestic goods. Taxes subject to this increase included the surtax, the import duty, the import levy and excises. Furthermore, the rental fee on government-owned land was increased from MK 1 per acre to MK 3 per acre. Accordingly, total central administration revenue rose by 21.8 percent to 19.6 percent of GDP in 1984/85. On the expenditure side, the program projected a 7.9 percent increase in overall expenditure; monthly limits on the wage bill and overall expenditure (excluding debt service) were established together with a monthly monitoring and reporting system to the Fund.

12. Despite a better-than-programmed revenue performance--bolstered by advance tax payment (of MK 10 million) in respect of part of the extraordinary tea sector profits realized in 1984/85 and due in 1985/86--it is estimated that the central administration's deficit exceeded the target by 0.6 percent of GDP in 1984/85, as expenditure has increased much faster than program projections. Efforts to intensify the monitoring procedure and negotiate some measure of restraint on the part of individual spending ministries and departments in November 1984 achieved some success but it proved impossible to keep expenditures in line with the program mainly because of the severe budgeted reductions in provisions for other

1/ There has been a revision of the official GDP series through 1984. As a result, the programmed deficit in 1984/85 has been revised upward to 5.6 percent of GDP with the deficit reduction targeted for 1984/85 rising to 2.5 percent of GDP.

current expenditure. As compared to budgeted reductions in this expenditure category of 6.5 percent, it is now estimated that expenditure will rise by 6.2 percent. There were, however, also significant expenditure overruns in other categories. The increase in the wage bill, which had been limited to 11 percent relative to 1983/84, is estimated at 17.5 percent, partly because of 10 percent average salary increase for government workers, originally intended for 1985/86, was effected on January 1, 1985. In addition, external interest payments exceeded the program amount by 26 percent, largely reflecting the appreciation of the U.S. dollar. As a result, and despite a drop in development expenditure, which was associated with a decline in foreign-financed expenditure relative both to the program and to 1983/84, total expenditure rose by 12.1 percent in 1984/85.

13. Reflecting these developments, the overall deficit is estimated to have exceeded the program target by MK 6.7 million. The Government's recourse to domestic financing is estimated to exceed program projections by MK 22 million, which is likely to be reflected in a considerably higher than anticipated increase in domestic banking system credit to Government.

The fiscal program for 1985/86

14. The program for 1985/86 envisages a reduction in the central administration's deficit to 4.1 percent of GDP. Assuming disbursement of MK 55 million of the World Bank's SAL III during the course of the fiscal year, foreign net financing is projected to rise to 3.2 percent of GDP, despite the Government's heavy external debt servicing obligations, which reflect the beginning of large payments of rescheduled government and government-guaranteed debt. To a large extent these payments will be charged to the Government in 1985/86, as some of the nonfinancial public enterprises were unable to pay into the blocked account their external debt servicing obligations as they fell due. The central administration's residual need for domestic financing is projected at MK 20 million. Of this amount, some MK 30 million will be derived from nonbank sources enabling the central administration to achieve a MK 10 million net improvement in its position with the banking system in 1985/86.

15. To achieve this outcome, a number of revenue measures were introduced with the budget for 1985/86 which was presented to Parliament on March 22, 1985 which are conservatively estimated to yield MK 40 million, the equivalent of 1.9 percent of GDP. The Government believes that further intensification in the revenue effort in 1985/86 must be achieved by broadening the tax base, in order to avoid further increases in already high existing taxation on a very narrow tax base. Accordingly, the revenue package consists of (1) a 10 percent export tax on tea and tobacco and a 5 percent tax on sales of agricultural products in cases where the seller otherwise pays only the minimum income tax; (2) a shift towards more current company taxation; (3) an increase in estate rental on government-owned land from MK 3 to MK 4 per acre; (4) a reduction in the stamp duty payable on life insurance policies, and a corresponding increase in the tax liability of the insurance companies; and (5) a small reduction in the rates of the

graduated income tax and the PAYE taxes. We recognize that the shift to more current company taxation could lead to a sharp once-for-all increase in taxation in 1985/86 and we are aware that this should not lead to an increase in expenditures which cannot be sustained in future years. We shall accordingly review the ceilings on banking system aggregates, as proposed below, at the time of the mid-term review.

16. Overall expenditure is programmed to rise by 20 percent. Following the higher than programmed increase in wage expenditure in 1984/85, and the salary increase for government workers on January 1, 1985, there will be no further salary increases for government workers in 1985/86. New government hiring and filling of vacant civil service positions will be limited to essential posts and every effort will be made to reduce government employment. The possibility of reducing establishments will be examined taking into account the advice of the Civil Service Commission. The overall wage bill will be limited to MK 100.6 million, compared to MK 90.1 million in 1984/85.

17. The difficult financial position of the central administration has for a number of years been reflected in a serious underfunding of the recurrent budget, reflected mainly in inadequate budgetary provisions for maintenance and service. Despite continuous budget overruns in these areas this underfunding had detrimental effects on the efficiency of government maintenance and utilization of existing equipment. The program for 1985/86 recognizes that servicing and maintenance provisions must be raised in order to improve the efficiency of government operations as well as to guard against continued expenditure overruns. Consequently, the program provides for a 15 percent increase in these expenditures in 1985/86. The authorities, moreover, will ensure that within the provision for the development budget for 1985/86 local counterpart expenditures will be allocated in a manner satisfactory to the World Bank.

18. The Government of Malawi believes that the increase in budget allocations for 1985/86 will result in improved expenditure performance. Nevertheless, the system of expenditure monitoring which was strengthened during 1984/85 will continue in 1985/86. Expenditure Monitoring Committees within ministries and departments will review the financial results of each month and ensure that monthly expenditure returns are submitted by the 15th of the following month to the Central Control System of the Treasury and the Accountant General. The Government will provide to the Fund at monthly intervals and not later than the end of each month, cumulative data for 1985/86 through the end of the previous month, covering: (1) expenditure on wages and salaries, and (2) expenditure (excluding amortization). In the event of reporting delays or if at any time these data exceed those in the corresponding period of 1984/85 by more than (1) 13 percent for wages and salaries, or (2) 22 percent for total expenditure, the Government will consult with the Managing Director.

Monetary policy

19. Developments in the external accounts and the Government budget have caused the monetary aggregates to deviate substantially from programmed levels. Reflecting the developments on the external account in the year to December 1984, net foreign assets rose by MK 88 million, an amount equivalent to 30 percent of broad money. Domestic liquidity expanded sharply, with broad money expanding by 33 percent, some 24 percentage points higher than projected while narrow money rose by 21 percent. This reflected the exceptionally strong earnings of the export sector, as well as the rising levels of income to the agricultural sector following a rise in producer prices and output. Since September 1984 the indicative ceilings on net bank domestic assets have come under increasing pressure, partly because of larger crop purchases and a lower rate of sales by ADMARC than anticipated.

20. The statutory bodies' credit from the banking system at the end of December 1984 was MK 82.6 million, more than MK 18 million in excess of the indicative target. Although both credit to the Government and the private sector were below the projected level, the indicative target on net domestic assets was marginally exceeded. While parastatal credit declined somewhat in the first quarter of 1985, a substantial increase in the Government's recourse to bank financing increased bank credit to a level substantially in excess of the indicative targets for both net credit to government and net domestic assets for March 1985. Monetary growth continued at an annual rate of close to 30 percent in the period to March 1985.

21. In designing monetary and credit policy for 1985/86 the Reserve Bank of Malawi is conscious of the need to avoid excess liquidity in the economy and the banking system. The aim of policy will be to ensure that the expansion of broad money does not exceed the projected growth of GDP during the two-year period 1984/85 and 1985/86 (i.e., by 40 percent).

22. By the beginning of May 1985, we intend to reduce the ratio of reserve deposits (comprising commercial bank's holdings of cash and balances with the Reserve Bank of Malawi) to commercial banks' total deposit liabilities to the private sector and statutory bodies approximately to the level prevailing at the end of March 1984. Thereafter the objective will be to keep this ratio approximately stable by the selling of securities or by the use of reserve requirements, to ensure compliance with the limits on the net domestic assets of the banking system established below.

23. The Reserve Bank of Malawi notes that funding operations may tend to increase further the already high costs of servicing the Government indebtedness in order to ensure that these financial instruments are sufficiently attractive to the banks and to the general public.

Moreover, the Reserve Bank of Malawi intends to modify its control over bank interest rates. Interest rates have been adjusted, effective April 15, 1985, in accordance with the schedule attached hereto. Interest rates on deposits with initial maturity of less than three months will be freely determined.

24. In accordance with the objectives of monetary policy and prospective developments in the balance of payments, ceilings will be established such that net domestic assets of the banking system, which amounted to MK 554.8 million at end-December 1984 and is estimated to amount to MK 591.9 million at end-March 1985 will not exceed MK 632.1 million at the end of June 1985, MK 652.9 million at the end of September 1985, MK 652.1 million at the end of December 1985, and MK 598.9 million at the end of March 1986. Net domestic bank credit to the Government which amounted to MK 271.0 million in December 1984 and is estimated to amount to MK 313.7 million at end-March 1985 will not exceed MK 323.7 million at the end of June 1985, MK 333.7 million at the end of September 1985, and MK 343.7 million at the end of December 1985, and MK 303.7 million at the end of March 1986. Indicative limits are established for credit to statutory bodies; domestic bank credit to the statutory bodies which amounted to MK 82.6 million at end-December 1984 and is estimated to amount to MK 64.5 million at end-March 1985, will not exceed MK 82.5 million at the end of June 1985, MK 90.0 million at the end of September 1985, MK 72.6 million at the end of December 1985, and MK 55.6 million at the end of March 1986. In establishing these indicative limits it has been assumed that ADMARC, the principal user of domestic bank credit among statutory bodies, will make purchases of 295,000 metric tons of maize, and 90,500 metric tons of other products. In the event that these indicative limits are exceeded there will be consultation with the Managing Director of the International Monetary Fund.

25. The ceilings on net bank domestic assets and net bank credit to Government have been prepared on the assumption that disbursements from a third World Bank structural adjustment loan (SAL III), amounting to the equivalent of MK 55 million will be made in the quarter ending March 31, 1986. If any disbursement under SAL III is received on or before December 31, 1985, then these ceilings for the quarter or quarters following the day of disbursement will be adjusted by the amount of the disbursement. If the disbursement exceeds MK 55 million then the ceiling will be adjusted downward by the excess. The blocked accounts, Funds for Amounts Rescheduled for Malawi (FARM accounts A and B) will be consolidated into one account on or shortly after March 31, 1985. The combined balance in the account at end-December 1984 was MK 21.0 million. The ceilings will be reduced if withdrawals from this account exceed MK 1.1 million by end-June 1985, MK 3.1 million by end-September 1985, and MK 5.1 million by end-March 1986.

Agricultural policies

26. Producer prices for most smallholder agricultural crops were raised substantially for the 1984/85 growing season and marketed production of several key crops rose appreciably, including maize, even though

its price had been left unchanged. This increased level of production has been reflected in the continued high demand for fertilizer particularly for use in smallholder maize and tobacco production, and the associated subsidies have placed a heavy burden on the finances of both ADMARC and the Government. Fertilizer imports for the smallholder sector are now administered by a revolving Fund, financed by capital contributions from the Government, ADMARC, IFAD, and IDA. As the foreign contributions dwindle, the capacity of the Fund to finance expanded purchases and subsidies will be constrained by the tight budget and external position. Recognizing this, and the probability that the conditions contributing to the heavy transportation costs of fertilizer will persist in the foreseeable future, it is necessary to maximize the efficiency of fertilizer use, by reducing the fertilizer subsidy and by designing incentives to encourage export diversification.

27. Accordingly the Government will set fertilizer prices for the 1985/86 growing season so as to eliminate all subsidies on fertilizers by the 1986/87 growing season. The Government will set these prices at the level necessary to reduce the subsidy in the 1986/87 budget to MK 4 million. The Government will set producer prices for the 1985/86 growing season, in consultation with the World Bank, in the light of this increase in fertilizer prices and with the aim of promoting crops which yield the highest net contribution to exports or import saving, such as cotton, groundnuts, wheat and rice.

Price liberalization

28. In accordance with existing understandings the Government announced on February 8 that applications for price changes would be required only for 17 commodities, representing a decrease of 8 items from the list previously published. This included the removal of controls from 2 goods previously subject to statutory control. The Government reaffirms its commitment to remove controls on all but a very limited range of goods, a process that will be complete by December 31, 1985 at the latest, and in any case before the completion of the mid-term review envisaged in paragraph 34. In this regard the Government will submit to the Fund, before Board discussion of the 1985/86 program, a timetable for the removal of remaining controls and a list of the few commodities that will remain under control at end-1985.

Statutory bodies

29. The Government is committed to reviewing regularly its pricing policy on goods and services produced by the parastatal sector. In this regard it has adjusted a number of the prices to be charged during 1985 including increases of up to 50 percent on Air Malawi's domestic routes effective in January, and a uniform 15 percent on Malawi Railways' domestic and international tariff schedules to become effective in April 1985. In April 1985, the Electricity Supply Commission (ESCOM) will raise its tariffs by 10 percent on households and 15 percent on industrial users, some three months earlier than scheduled. The Blantyre Water Board's

tariffs were increased by 10 percent in January 1985, while the Lilongwe Water Board's charges were increased by amounts in the range of 7 percent to 25 percent. The increases in these enterprises' charges follow increases of similar magnitude in 1984, and occur in the context of an inflation rate expected to run at 15 percent throughout 1985.

30. Despite these actions with respect to prices a number of parastatals remain in acute financial difficulty. Malawi Railways are directly and severely affected by the loss of Malawi's traditional trade routes, and although very substantial measures have been taken to rationalize operations and reduce costs, the organization is unlikely to operate profitably. Nevertheless, the need to preserve a viable transport network indicates the need to maintain the railway corporation at a reduced level of operation. Air Malawi is making substantial losses because of rising costs and the contracting demand for its services, and urgent consideration is being given to the future of the airline with a view to restoring its profitability. Although ESCOM is expected to show a modest net profit in 1985, heavy amortization payments on external debt will cause a negative cash flow, and further tariff increases may have to be considered during the year, paying particular regard to the recommendation of consultants, financed by the World Bank, in a study of the long term tariff structure of ESCOM.

31. The financial position of the Malawi Development Corporation has been strongly improved by new management and the rationalization and disposal of assets, as well as benefiting from the general liberalization of prices. Nevertheless, its profitability and positive cash flow have been achieved only by the assumption by the Government of about 85 percent of MDC's external debt amortization obligations. In order to ensure an appropriate degree of restraint over MDC's new investment spending and borrowing, the Government intends to implement any conversion of MDC's resulting liability into equity only gradually over a period of at least five years.

32. The financial position of ADMARC is determined largely by the producer prices offered to smallholders and the prices obtained from the marketing of cash crops over which, in most cases, the authorities have little or no control. However, substantial losses are incurred on the domestic sale of maize and some other cash crops such as cotton, groundnuts, and rice, that are covered by cross-subsidization from the export proceeds of tobacco and maize. In order to ensure the profitable operation of ADMARC with appropriate transfers to the budget, every effort will be made to eliminate these losses by the 1986/87 financial year.

33. Before December 31, 1985, the authorities will consult with the Fund on the progress made in implementing the program in order to reach understandings on the performance criteria for net domestic assets of the banking system, and domestic bank credit to Government for June 1986, limits on the contracting or guarantee by the Government of new nonconcessional external borrowing in 1986, and on such measures as are necessary for the purpose of achieving the objective of the program including

the implementation of the budget for 1985/86, parameters for the budget for 1986/87, the appropriateness of the exchange rate, the structure of interest rates, the result of the agricultural price review for the 1985/86 growing season, and the process of price liberalization. In addition, the authorities will review with the Fund prospects for external financing, including the disbursement of SAL III.

Malawi: Interest Rates

	Previous rates	New rates 1/
Deposit rates		
Short-term deposits (up to 30 days' notice	11.50	... 2/
Savings deposits	10.75	10.75
Time deposits		
3-6 months	11.75	12.75
Over 6 months to 12 months	12.25	13.25
Over 12 months to 24 months	12.75	14.25
Over 24 months to 36 months	13.25	14.75
Over 36 months	13.75	15.75
Lending rates		
Minimum	13.50	16.00
Maximum	16.50	19.00
Bank rate	10.00	11.00

1/ Effective April 15, 1985.
2/ These rates are to be established by the commercial banks in consultation with the Reserve Bank of Malawi. On April 15, 1985 the rates offered were 9.00 percent for 7-day deposits and 9.50 percent for 30-day deposits.