February 25, 2020
Approval: 3/3/20

INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 18/38-2

11:00 a.m., April 30, 2018

2. Malawi—2018 Article IV Consultation and Request for a Three-Year Arrangement Under the Extended Credit Facility

Documents: EBS/18/28 and Correction 1, and Supplement 1, and Supplement 1, Correction 1; and Supplement 2; and Supplement ; SM/18/85

Staff: Mitra, AFR; Zeidane, SPR

Length: 59 minutes

Executive Board Attendance

T. Zhang, Acting Chair

Executive Directors	**Alternate Executive Directors**
M. Mkwezalamba (AE)	
	M. Raghani (AF)
	J. Corvalan (AG), Temporary
	G. Johnston (AP)
A. Tombini (BR)	
	Y.Liu (CC), Temporary
C. Hurtado (CE)	
	A. McKiernan (CO)
	A. Zaborovskiy (EC), Temporary
	A. Castets (FF)
	K. Merk (GR)
	M. Roy (IN), Temporary
	M. Psalidopoulos (IT)
	Y. Saito (JA)
J. Mojarrad (MD)	
	F. Al-Kohlany (MI), Temporary
	R. Doornbosch (NE)
	R. Bartkus (NO), Temporary
	L. Palei (RU)
	R. Alkhareif (SA)
	A. Machmud (ST), Temporary
	P. Inderbinen (SZ)
	J. Stockill (UK), Temporary
	D. Crane (US), Temporary

T. Rumbaugh, Acting Secretary
S. Kalra, Summing Up Officer
O. Bespalova, Board Operations Officer
L. Nagy-Baker, Verbatim Reporting Officer

Also Present

African Department: M. Atingi Ego, K. Fabo, M. Farahbaksh, P. Mitra. Corporate Services and Facilities: T. Lenneiye. European Central Bank: T. Persico. Fiscal Affairs Department: A. Swistak, S. Yousefi. Finance Department: G. Fernandez, S. Marcelino, S. Matai. Information Technology Department: F. Gheriss. Legal Department: I. Luca. Strategy, Policy, and Review Department: H. Lin, Z. Zeidane. World Bank Group: W. Battaile.

Executive Director: M. Claver-Carone (US). Alternate Executive Director: P. Fachada (BR), D. Mahlinza (AE). Senior Advisors to Executive Directors: W. Abdelati (MI), G. Gasasira-Manzi (AE), R. N'Sonde (AF), T. Sitima-wina (AE). Advisors to Executive Directors: A. Abdullahi (AE), E. Amor (AP), K. Badsi (MD), X. Cai (CC), J. Essuvi (AE), J. Garang (AE), M. Ismail (AE), N. Komura (JA), T. Manchev (NE), A. Nainda (AE), L. Nankunda (AF), M. Sylvester (CO).

2. MALAWI—2018 ARTICLE IV CONSULTATION AND REQUEST FOR A THREE-YEAR ARRANGEMENT UNDER THE EXTENDED CREDIT FACILITY

Mr. Mkwezalamba and Mr. Sitima-wina submitted the following statement:

Introduction

Our authorities appreciate the constructive policy discussions during the recent Article IV consultations and program negotiations. They broadly concur with the staff assessment and its conclusions, and value the Fund's policy advice as they pursue their national development agenda.

Malawi has made significant progress in achieving macroeconomic stability following two successive years of weather related shocks and challenges in public finance management. While growth is recovering and inflation has declined into single digit territory, more needs to be done to meaningfully tackle poverty through higher, more inclusive, and resilient growth. In this context, the authorities recently launched the third Malawi Growth and Development Strategy (MGDS III) for 2018–23. The strategy aims at boosting productivity, enhancing competitiveness, and building resilience through growth-enhancing investment and economic diversification.

To achieve the objectives of the MDGS III, our authorities request for a three-year arrangement under the Extended Credit Facility (ECF). The arrangement will support economic policies and reforms to entrench macroeconomic stability, and catalyze concessional financing for infrastructure development. The authorities have completed all five prior actions, and look forward to Executive Directors' support for approval of a new three-year ECF arrangement.

Recent Economic Developments and Macroeconomic Outlook

Real GDP growth in 2017 is expected to have recovered to 4 percent, from 2.3 percent in 2016. The recovery has been supported by a rebound in agricultural output and a pick-up in construction activity and the wholesale and retail sectors. The manufacturing sector, however, continues to be weighed down by prolonged electricity outages. This notwithstanding, in the medium-term, growth is expected to reach 6 percent, propelled by improved confidence, more robust agricultural production, increased electricity generation and transportation, as well as improved access to finance.

Inflation, which has been trending downwards from a peak of 23.5 percent in July 2016, reached 7.1 percent by end-2017 owing to the stabilization of food prices, tight monetary policy, and a stable exchange rate. Inflation is expected to remain in single digit territory in 2018 and reach 5 percent in the medium term, aided by the continued implementation of tight monetary policy and low food and petroleum products' prices.

On the external front, the current account deficit improved to 10.0 percent of GDP in 2017, from 13.6 percent in 2016, following lower maize imports after a bumper harvest and a rebound in exports. In turn, favorable balance of payments developments, improved confidence, and tight monetary policy have contributed to the stability of the nominal exchange rate of the Malawi kwacha against the U.S. dollar. The premium between the exchange rates of the Reserve Bank of Malawi (RBM) and forex bureaus remains very small, reflecting availability of foreign currency and that the exchange rate is market determined. Foreign currency reserves have been above three months of import cover. Going forward, improvements in competitiveness, export diversification, and fiscal restraint as well as an improvement in GDP growth are anticipated to gradually narrow the current account deficit to around 7.5 percent in the medium term.

Fiscal Policy and Public Financial Management

The authorities are committed to pursue fiscal consolidation while protecting growth-enhancing and pro-poor expenditures and ensuring debt sustainability. In this regard, they will enhance domestic revenue mobilization by continuing with broad-based tax reforms and rationalizing expenditures. Planned tax reforms include streamlining tax incentives, fully repealing the industrial rebate scheme, introducing a thin capitalization or earnings stripping rule, and redesigning turnover taxation to increase its effectiveness. All tax policy reforms and initiatives will continue to be guided by a shift in reliance from taxation of labor and investment to consumption. Furthermore, the Malawi Revenue Authority (MRA) is planning to launch the integrated tax administration system (ITAS), branded "msonkho-online" within the year, which is expected to enhance overall tax administration in the country.

On the expenditure side, controls have been enhanced to avoid further accumulation of arrears, and limit recourse to domestic financing, particularly from the RBM, as well as curb non-concessional borrowing. In this connection, the authorities have tightened commitment controls and established a system to track the stock of commitments. In addition, compliance officers from the Internal Audit Department have been placed in all key ministries, departments, and agencies (MDAs), with a plan to deploy them to all MDAs, to check and ensure that payments are only made to transactions that have supporting documentation. While budget implementation during the first half of FY2017/18 was challenging due, in part, to lower than projected revenue collections, the authorities remain committed to improving the fiscal position by end June 2018 through expenditure cuts.

To bolster growth, infrastructure bottlenecks in electricity, transportation, telecommunications, and water supply and irrigation will be addressed. The authorities, therefore, plan to raise, as soon as possible, needed infrastructure investments, particularly for key MGDS III flagship projects, in the above areas, while maintaining macroeconomic stability and debt sustainability. This is expected to be achieved through efficiency gains from improved public investment management and procurement, as well as partnering with the private sector and development partners. Health, education, and other social spending is anticipated to be increased through efficiency gains in on-budget spending.

Approval of the ECF arrangement will go a long way to catalyze the much-needed foreign financing for infrastructure. In this context, the authorities are committed to limit external borrowing to high priority projects to safeguard debt sustainability. They will improve investment planning—including rigorously prioritizing the MGDS III pipeline projects based on credible cost/benefit analyses, growth, poverty-reduction, and debt sustainability considerations. Furthermore, the Debt Management Committee will assess all borrowing to ascertain loan concessionality, taking into consideration the entire borrowing plan within the medium-term debt strategy.

Considerable progress has been made in public finance management reforms, including in establishing a fully functional Cash Management Unit; requiring all MDAs to submit five detailed fiscal reports as a condition for receipt of regular monthly funding; and fully reconciling the government cashbook with the bank account, a crucial step towards stronger public finance management. Furthermore, the authorities intend to continuously work on improving the procurement framework to enhance transparency, control, and accountability, following the enactment of a new Public Procurement Law. They will start by publishing all procurement information on the Ministry of Finance’s website, and using performance contracts to hold controlling officers accountable for not adhering to relevant rules and procedures. Over time, they will consider gradually moving to an e-procurement system.

Monetary and Exchange Rate Policies

The authorities are committed to maintaining tight monetary policy to reign in on inflation. In addition, the RBM has demonstrated strong commitment to stabilizing monetary conditions and bolstering the external reserves position using policy instruments at its disposal. To maintain positive real interest rates in the financial system, monetary policy will also aim to ensure that the policy rate remains above the rate of inflation through open market operations. Our authorities acknowledge the 2017 AREAER reclassification of the de facto exchange rate arrangement and reiterate their commitment to a flexible exchange rate regime.

Furthermore, the RBM is committed to develop an interest rate-based monetary policy framework and gradually transition from the current monetary aggregate targeting framework to a full interest rate-based monetary framework and to inflation targeting over the medium -term. This transition will require further capacity development in liquidity management, a deeper understanding of the monetary transmission mechanism, and improvements in inflation forecasting capacity. In this regard, the authorities appreciate IMF technical assistance (TA) received so far in this area and look forward to further TA.

Safeguarding financial sector stability and resilience remains a key priority for the authorities. To this end, the authorities are enhancing both on-site and off-site supervision of banks and will continue to enforce compliance with all prudential norms, including asset classification and provisioning in the context of the recently introduced IFRS9. They remain committed to strengthening the regulatory framework of the financial system to mitigate risks. In this respect, they will re-submit to parliament amendments to the Banking Act of 2010 and Financial Services Act of 2010 for eventual enactment. These amendments, which were informed by IMF technical assistance recommendations, aim to align the legal framework for bank resolution with best practices and provide more options for dealing with problem banks. By end-2018, the authorities plan to gazette regulations related to the revised AML/CFT framework, enacted in 2017. These will strengthen the asset declaration system and support the authorities' anti-corruption efforts.

Structural Reforms

15.In pursuit of the objectives of the national development strategy, the authorities realize that far reaching structural reforms will be necessary to complement macroeconomic policies and reduce poverty. In this regard, they are committed to continue with reforms to address governance challenges. These include further strengthening public finance management, procurement, improving the investment climate, as well as pursuing reforms in the agricultural sector on the farm inputs subsidy program (FISP). To enhance inclusive growth, they will step up efforts to improve financial intermediation to raise access and affordability of credit to the private sector. The authorities are also committed to adhere to the automatic fuel pricing mechanism which has positively contributed to macroeconomic stability.

Conclusion

The authorities reiterate their commitment to entrenching macroeconomic stability, reducing poverty, and attaining higher sustainable inclusive growth. To this end, they will continue to implement an appropriate policy mix of prudent fiscal and monetary policies, complemented by structural reforms. Finally, our authorities value Fund support and look forward to an approval of an ECF arrangement to support implementation of their national development strategy.

Mr. Ostros and Mr. Bartkus submitted the following statement:

We thank staff for a comprehensive set of papers and Messrs. Mkwezalamba and Sitima-wina for their informative buff statement. We broadly agree with staff's analysis and support the proposed decision, approving the Malawian authorities' request for a three-year ECF arrangement. At the same time, we would like to reiterate few points:

As highlighted in the ex-post peer-review assessment, the results of earlier program engagement with Malawi have been mixed. Only one program was successfully completed, though with important policy slippages, the program being extended five times, limited reform ownership and traction. We are somewhat surprised that the program puts relatively little emphasis on the implementation risks, with only vague description of the political cycle in the general overview of recent developments. From paragraph 12 we conclude that there are clear signs of political polarization, though we missed an assessment whether the program presented to the Board has sufficiently broad support across the political spectrum?

We note that establishing a more solid track record of policy implementation remains of utmost importance to catalyze donor support and to secure broad program objectives. The ex-post assessment draws an important lesson on the need to frontload conditionality, particularly in the PFM area. While this seems to be the case for most PFM related measures, it is not clear to us why the submission of amendments to the RBM Act are included as an end-October structural benchmark and not the prior action, given the explicit commitment in paragraph 24 of the MEFP to make the submission by mid-April 2018? We would appreciate if staff could confirm whether the submission has already been made?

We note that staff's position in characterizing the fiscal position in FY17/18 is rather unclear. While noting significant fiscal deterioration in paragraph 6, staff also refers to the use of fiscal space created by a lower interest bill to increase wages and spending on goods and services. The reference to the use of fiscal space does not seem consistent with the further emphasis on the need to improve the fiscal position. We would advise staff to reconsider the language in paragraph 6.

The medium-term fiscal strategy is appropriately geared to improve structure of public finances and contain fiscal slippages. We fully support emphasis on reform prioritization and the critical role of infrastructure, though when assigning the highest priority to productive spending increase, the authorities should give similar weight to improving quality of public expenditure, strengthening governance and accountability, with due regard to safeguarding debt sustainability.

We agree with staff on the need to maintain a tight monetary policy stance by maintaining positive real interest rates and focusing on further strengthening of the monetary policy framework. We also share staff's assessment in identifying core priorities in the financial stability area, notably the need to address undercapitalization, reduce NPLs, ensure compliance with IFRS9, improve control over foreign currency exposures, management of liquidity and concentration risks.

Mr. Inderbinen and Mr. Imashov submitted the following statement:

We support Malawi's request for an arrangement under the ECF. We acknowledge the gains in establishing macroeconomic stability. As underlined in Mr. Mkwezalamba and Mr. Sitima-wina's helpful buff, growth has picked up, and inflationary pressures have eased. However, power outages have continued, poverty remains high, and weather-induced shocks and political instability constitute significant downside risks. This underlines the importance of sound program implementation, as well as progress under the authorities' new Malawi Growth and Development Strategy.

On the fiscal side, we note the authorities' commitment to keep spending within available resources, avoid the accumulation of domestic and external arrears, and abstain from non-concessional borrowing. We welcome the zero-target performance criterion for central bank financing from September 2018 onward, as well as the October 2018 benchmark for submission of the amendments to the RBM Act. We regard enactment of these amendments to be critical.

While debt distress has so far remained moderate, total public debt has more than doubled since HIPC and MDRI relief. This underlines the importance to reach the program goals on the fiscal front, and the need to implement the key PFM measures in particular. We welcome the proposed structural benchmarks on PFM-related measures listed in Table 3 of the LOI attachments. A footnote to the table states that the benchmarks may be revised with 'a view towards streamlining.' The staff's comments on this would be appreciated.

Strengthening of the fiscal position will also be critical to eliminate fiscal dominance and to enable improvement of the monetary policy framework. We welcome the authorities' intention to transit to an interest rate-based framework and to inflation targeting. We encourage the RMB to follow through on the commitment to exchange rate flexibility and to limit forex interventions to addressing disorderly market conditions.

As staff state, a continued tight monetary stance is needed to keep inflation on a downward trend. At the same time, staff project excess liquidity in the banking sector to be further reduced, and private sector credit growth to pick up strongly in 2018 and the coming years. How realistic are these assumptions under tight monetary conditions; and how might slower than-anticipated credit growth impact the optimistic medium-term growth outlook? The staff's thoughts on this would be welcome.

We note the authorities' commitment to strengthen the financial sector regulatory regime and to step up supervision. While capital, liquidity and profitability are currently adequate, the outlook for asset quality is mixed. Demand for credit is driven by existing customers extending or renewing their loans. Also, the majority of banks have reported that NPLs increased between April and September 2017 across all sectors, and notably among large corporates.

More efforts are also needed to increase the soundness of the non-bank financial sector. Credit risk remains a major concern in the micro-credit industry. The ratio of NPLs to gross loans is above the recommended regulatory ceiling for both the deposit and non-deposit taking microfinance sectors, while SACCO delinquency has increased. We welcome the efforts of the Malawian authorities in enhancing Digital Financial Services and strengthening the AML and KYC requirements for providers. More generally, we encourage the consistent implementation of the revised AML/CFT framework.

Ms. Pollard and Ms. Crane submitted the following statement:

We thank staff for the useful set of papers and Messrs. Mkwezalamba and Sitima-wina for the informative buff statement. Malawi has found it challenging to sustain a significant level of per capita GDP growth and has made little progress in raising the median income and well-being of its citizens. Malawi has had a long series of IMF-supported programs, with a mixed record of meeting objectives. We support the proposed Extended Credit Facility and its focus on the unfinished agenda on public financial management. Weak public financial management and corruption is holding back investment in basic infrastructure and human capital that is needed to boost growth. For the proposed program to succeed, the authorities will need to demonstrate strong commitment and ownership of reforms.

Fiscal Objectives

We encourage the authorities to enhance the growth-orientation of public spending, through improvements in allocation and efficiency. We welcome the program's focus on reducing goods and services expenditures that are well above peer country benchmarks and broadening the tax base by repealing industrial rebates and discontinuing tax holidays. The 2018/19 budget benefits from the end of several previous one-off expenses and realistically makes room for hiring of teachers and election expenses. We would like to see more space for carefully-vetted capital expenditure and hope that strong program implementation can improve donor confidence and attract more concessional foreign financing for infrastructure projects that enhance growth and resilience to weather shocks.

Public Financial Management and Governance

We support a meaningful, well-targeted agenda on public financial management and anti-corruption that seeks to lock in past gains and make additional progress, but would caution against over-burdening the authorities. Can staff comment on how the program strikes a balance between ambition/front-loading of reforms ahead of elections vs. realism in light of capacity constraints? Which elements of the continuous structural benchmarks on PFM aim to lock in previous progress and which elements constitute additional, incremental progress? We appreciated the box on governance and anti-corruption and encourage the authorities to consider additional steps in this area that the program could support in the out-years.

Debt Sustainability

Prudent debt management will be essential. While the Debt Sustainability Analysis shows a moderate risk of external debt distress, high levels of domestic borrowing mean that Malawi's overall public debt is above the threshold under the baseline scenario. Can staff comment on whether they considered raising the overall risk rating based on domestic debt pressures? We also note that staff raised the medium/long-term GDP growth projection for Malawi to 6.5 percent, which is 1.5 percentage points above Malawi's 10-year average, which seems optimistic in a country subject to considerable weather-related and other vulnerabilities. Did staff apply realism tools to the GDP growth projection?

Mr. Johnston and Mr. Amor submitted the following statement:

We thank staff for their report and Mr. Mkwezalamba and Mr. Sitima-wina for their helpful buff statement. We commend the authorities for their efforts in navigating the development challenges in Malawi, including adverse weather-related shocks, high inflation and a drought-induced humanitarian crisis. The current sustained economic recovery following two consecutive years of drought is welcome, but much remains to be done to improve the country's economic and social outlook.

We support the authorities request for a new ECF arrangement given the need to safeguard progress under the previous program, particularly in sustaining macroeconomic stability and PFM reforms. Although performance under the 2012-2017 Extended Credit Facility was mixed, with shortcomings in some areas, we believe that IMF engagement has helped improve macroeconomic conditions in Malawi. Conscious of the fact that development in fragile states requires time and patience, the new ECF arrangement can further advance needed fiscal reforms, strengthen economic resilience and anti-corruption policies and catalyze donor support for poverty reduction and growth-enhancing investments.

Committed structural reforms to support infrastructure development and attract private investment are key for poverty reduction and inclusive growth. We welcome the new Malawi Growth and Development Strategy for 2018-2023 which aims to improve productivity, competitiveness, and resilience through economic diversification. We support the authorities plan to prioritize infrastructure upgrades in electricity, roads, telecommunications, water and irrigation. Successful implementation will hinge on adequate financing and strong implementation capacity. Hence, efforts to re-engage with donors and enhance private sector investment are essential, as well as targeted technical assistance to support project prioritization and implementation. Can staff comment on what actions the authorities are taking to resolve the prolonged electricity outages and prevent further impacts on manufacturing activity?

Weakness in governance, including the persistence of corruption concerns, has been a key factor limiting Malawi's development. We welcome the authorities' efforts in addressing governance issues following the cash-gate scandal. This includes the progress on PFM reforms, such as the enactment of the Financial Crimes Act of 2017 and the new Procurement Act. Advancing PFM frameworks and strengthening the rule of law should be prioritized within the new ECF arrangement to overcome the corrosive effects of corruption, and stabilize inflow of donor assistance.

We welcome the greater emphasis on the need to adapt to, and mitigate the risk of weather-related shocks. Building resilience will help prevent weather-related shocks from derailing policy implementation, as was experienced during the previous arrangement. In this regard, we agree that more investment in irrigation, incentives for agricultural diversification and risk management would enhance productivity and resilience, and we welcome the joint efforts between the Fund, EU and World Bank in this area.

Lastly, new approaches to deliver concrete results may be required. We note that many of the reform ambitions such as fiscal transparency, competitiveness, infrastructure development and poverty reduction have been on Malawi's agenda for the past decade, and pursued with limited progress. For example, Box 3 referenced that progress on PFM reforms had generally been slow and remain incomplete. Much of this challenge can be attributed to capacity constraints and lack of sustained political appetite for reforms. Can staff comment on what new approaches could be taken to ensure timely reform implementation while garnering strong political support?

Mr. Psalidopoulos and Mr. Persico submitted the following statement:

We thank staff for the insightful papers and Mr. Mkwezalamba and Mr. Sitima-wina for their helpful buff statement. As we concur with the staff's analysis and suggested decision, we would like to limit our comments to the following points.

Malawi has made progress toward macroeconomic stability despite adverse circumstances.

We recognize the impact of weather-related shocks that weakened economic growth and the consequent difficulties in past program implementation. However, the mixed result of the previous ECF and the lessons learned from this experience suggest a new effort of the authorities to enhance macroeconomic stability and poverty-reduction actions. We welcome their commitment for the next ECF and its ambitious target. In this regard we would like to know the rationale of the current 20 Structural Benchmarks and if there is room for a further streamlined formulation.

Growth is expected to recover gradually since the last years' modest results; however, growth medium-term projection could be overoptimistic. In the period 2012-2017, the projection of 7.5 percent did not materialize, with a 3.8 percent being the final growth, despite the recognized positive impact of the previous ECF. For this reason, we would suggest caution on the current projection at 6 percent over the medium term as growth remains lackluster and downside risks are persistent.

Malawi faces a moderate risk of debt distress: external debt indicators are below the related thresholds, but rising domestic debt is a source of vulnerabilities. Moreover, as we noted in the last ECF review, total public debt more than doubled since the HIPC debt relief in 2006. While we have no doubt in the country's ability to meet its obligations, we have some concern on the medium-term debt sustainability. We wonder if debt dynamic could be further hampered in the case of a lower than expected economic performance or fiscal slippages as the main downside risks are regional and domestic. In this regard, we would like to know if there were discretional limitations to the perimeter of public debt applied in DSA as well as potential contingent liabilities. The staff's comments are welcome.

We concur with staff that improving the composition and efficiency of spending is critical. We urge authorities to firmly implement a proper fiscal policy and to continue the improvement of public financial management. At the same time, we appreciate the focus of the selected issues paper on inclusive growth and the role of infrastructure and efficient public spending. We welcome the progress in public management and MDAs reporting and invite authorities to timely implement the related SBs. We also invite them to strengthen budget control and enhance fiscal transparency. At the same time, continued efforts to implement the envisaged structural reforms and fighting corruption are essential to increase the administration reliability for donors' engagement and investment attractiveness.

Inflation should be carefully monitored through a tight monetary policy while the Reserve Bank of Malawi should be granted greater autonomy. In particular, authorities should adopt an effective flexible exchange rate in order to support the transition to an inflation targeting regime. With reference to the recognized domestic risks, it is important to reduce RBM financing of the government deficit. At the same time, proper interventions should be devoted to broaden financial access and to strengthen the banking system. We invite authorities to improve financial supervision, to implement IFRS9 regulation and to align the AML/CFT framework with international standard.

Poverty and limited resilience to adverse shocks are long-standing issues. For this reason, among the aims of the ECF-supported program, special attention should be given to enhance poverty-reduction, as in this field the performance of the previous ECF was unfortunate. We appreciate the formulation of an indicative target fixing a social spending floor, and we invite authorities to properly streamline public spending to meet this most needed target. In this regard, we invite them to closely monitor the potential negative impact of the fiscal measures adopted to mitigate the debt of resilience-related infrastructural projects. We wonder if there are lessons learned from the previous ECF or similar countries that could be useful in the program implementation and if the envisaged target could be complemented with other related structural interventions. The staff's comments are welcome.

Mr. Merk and Mr. Rosenberger submitted the following statement:

We thank staff for their comprehensive set of papers and Mr. Mkwezalamba and Mr. Sitima-wina for their informative buff statement. We broadly concur with the thrust of the staff's appraisal. It is encouraging that the economic recovery in Malawi appears to be picking up pace. This comes after a marked downturn in economic activity following the recent period of drought. Supported by the measures implemented under the previous adjustment program, rampant inflation was contained and foreign exchange reserves were restored to more comfortable levels. Over the medium term, staff projects economic growth to strengthen, inflation to moderate further and the external position to firm up. Yet, substantial vulnerabilities persist and risks for the program remain tilted to the downside. Against this background, the program rightly focuses on bolstering resilience and facilitating more robust and broad-based growth going forward. An unwavering commitment to prudent macroeconomic policies and ambitious structural reforms will be key to reach these objectives.

We acknowledge the country's protracted adjustment needs but would highlight the importance of the catalytic role of the proposed Fund support. We note with concern that the Fund would close a very substantial portion of the financing gap under the program. Overall outstanding PRGT loans would further increase as a consequence and are projected to reach more than 230 percent of debt service already next year. Against this background, we would welcome if staff could elaborate on other financing sources – specifically regarding the assumption of "additional project support loans" in Table 4a. Can staff confirm that adequate financing assurances are in place for the next 12 months and beyond? We welcome the intended frontloading of prior actions and structural reforms. This should promote trust in the success of the program. Frontloading also appears adequate when considering the problematic experience during the previous program.

We can consent to the authorities' request for another ECF-Program, if the prior actions are met and if adequate assurances for the financing of the program are given. Notwithstanding this conditional support, we would like to highlight our concerns in relation with the protracted use of Fund resources and the substantial program risks. We concur with staff that adjustment remains critical to preserve stability, bolster economic growth and alleviate widespread poverty. The success of the program will critically hinge on a high level of ownership and steadfast policy implementation. We thus call on the authorities to uphold the policy discipline and reform efforts necessary to achieve the program goals. This holds especially true with a view to the upcoming presidential elections. In this regard, could staff provide an overview on the major political parties' attitude towards further IMF engagement?

We welcome the authorities' renewed commitment to prudent fiscal policies. Given the heightened overall risk of debt distress and related risks for macroeconomic stability, a meaningful reduction in the country's elevated public debt burden will be essential for the program's success. As an immediate step, the authorities should realign the budget with available resources and prevent any fiscal slippages. This will require policy discipline not least with a view to the upcoming elections. In this context, we take note of the substantial reduction in the overall balance programmed for the election year, which strikes us as rather ambitious. The staff's comments on the possibility of a deficit overrun in fiscal year 2019 and potential consequences for the further course of the program would be appreciated. Are sufficient safeguards in place? Given the substantial pressure from interest payments, we urge the authorities to refrain from additional financing on non-concessional terms. The authorities' plans to strengthen revenues and ensure a higher proportion of productive spending appear promising. These plans should be supplemented by additional measures to ensure rigorous expenditure control, including public wages. The authorities should take care to ensure an adequate level of protection for the most vulnerable.

We take note of the substantial recourse to deficit financing by the Reserve Bank of Malawi during the first half of the fiscal year. The incident is especially disappointing as containing monetary financing has been a key element of Fund conditionality in Malawi for years. Against this background, we would be interested in staff's view on potential measures to ensure adequate policy implementation also between two consecutive arrangements.

Continued tight monetary policies will be of the essence to safeguard the achievements reached in controlling inflation. The authorities' commitment to maintain positive real interest rates is highly welcome in this regard. Further improvements in the monetary framework should be pushed forward. Ambitious reforms to strengthen central bank independence and avoid fiscal dominance deserve priority in this regard. We call on the authorities to continue aligning their AML/CFT framework with international standards.

Careful sequencing of measures under the authorities' ambitious Malawi Growth and Development Strategy appears essential to ensure the efficient and productive use of scarce financial means. In this context, could staff please elaborate on the proposed measure to increase—for instance—the budget share of tertiary education, given that its level seems to be high already? Mindful of the severe governance scandals in the past, we call on the authorities to prioritize their efforts on structural reforms to strengthen transparency, governance and accountability in public institutions and state-owned enterprises. Substantial, tangible progress in removing persistent weaknesses in public financial management, reforming the procurement framework and firmly establishing anti-corruption and disclosure legislature should clearly precede any further large-scale infrastructure spending.

Mr. Beblawi and Mr. Al-Kohlany submitted the following statement:

We thank staff for their report and Mr. Mkwezalamba and Mr. Sitima-wina for their informative buff statement. We welcome Malawi's progress towards macroeconomic stabilization, whereby inflation was curbed, foreign exchange shortages were addressed and external buffers strengthened. However, significant challenges remain, stemming from risks of fiscal slippages, weak controls on public finances, and vulnerabilities in the financial sector. The proposed ECF program provides an appropriate framework for progress on public finance management, revenue mobilization, and financial sector reforms, which are essential for Malawi to overcome impediments to inclusive growth and macroeconomic stability. We hope that the program will be a catalyst for the needed donor support. We support the proposed program and offer the following comments.

Prudent fiscal policies and public finance management (PFM) reforms will be the cornerstone of the program. It would be important for the authorities to implement the PFM measures discussed in the report to strengthen Malawi's fiscal position, address governance challenges, and rebuild domestic and external trust following the "Cashgate" scandal. Strong commitment controls and enhanced reporting should be a priority. We note that, notwithstanding progress listed in Box 2, weak implementation and institutional capacity hampered PFM reform progress under prior programs. Furthermore, staff also flagged insufficient incorporation of political-economy and capacity constraints in prior program designs as a contributor to missing program targets. Would staff provide information on how the current ECF is designed to overcome the challenges identified in the post program evaluation?

Monetary policy needs to remain prudent in order to maintain disinflationary trend. The authorities are encouraged to remain vigilant and stand ready to adjust policies to counter inflationary pressures that may rise from weak maize harvest or electricity tariff increases. The central bank's efforts to this end should be supported by measures to reduce central bank financing of the deficit which will help reduce the cost of borrowing. We support the program commitments to gradually transition from the current monetary aggregate targeting framework to interest rate-based monetary framework over the medium term.

Maintaining a flexible exchange regime is important to support the authorities move to strengthen monetary framework, and allows the buildup of external buffers against shocks given Malawi's weather-related vulnerabilities and sensitivity to fluctuations in foreign exchange revenue, including tobacco export prices and donor flows. We note staff assessment that the external position is in line with fundamentals and desirable policies, as also indicated by the very small premium between the exchange rates of the central bank and forex bureaus. We agree with staff that interventions should be limited to smoothing disorderly market movements.

Financial sector reforms are required to enhance the stability and soundness of the financial system. Stress tests show that several individual banks are vulnerable to credit and liquidity shocks, loan concentration are a major risk to the banking system, and non-performing loans remain high at 15.7 percent in 2017. We welcome the program focus on improving the financial sector stability, including by strengthening the legal framework for banks resolution to provide more options for dealing with problem banks. Enhancing bank supervision and enforcing single borrower exposure limit should help lower risks stemming from loan concentration. It would also be important to remain vigilant with regards to the increase in bank lending in foreign currency.

Mr. Saito and Mr. Komura submitted the following statement:

We thank staff for the comprehensive reports and Mr. Mkwezalamba and Mr. Sitima-wina for their informative statement. Although we welcome recent progress in macroeconomic stability, many indicators illustrate Malawi's fundamental challenges. For example, its poverty incidence is among the highest in sub-Saharan Africa. Moreover, Malawi ranks 170th in gender equality (UNDP Human Development Report). Malawi is required to achieve strong, sustainable, and inclusive growth to overcome these persistent challenges. However, economic growth remains weak despite the rebound from severe droughts, while in the medium term, growth is expected to rise to 6 percent. Since there is a wide range of reform agendas to realize strong, sustainable, and inclusive growth, we encourage the authorities to decisively carry out necessary reforms with clear prioritization by taking their administrative capacity into consideration. In this regard, we commend that the staff report shows the capacity development strategy in the Annex IV. Against this backdrop, assuming steady implementation of necessary reforms under the program, we support the authorities' request for a three-year arrangement under the Extended Credit Facility (ECF). As we broadly agree with the thrust of staff's appraisal, we would like to make following comments for emphasis.

Fiscal Policy and Debt Management

A holistic approach is warranted for Malawi to ensure debt sustainability while to achieve strong, sustainable, and inclusive growth. Malawi's overall risk of debt distress has been heightened, reflecting significant vulnerabilities related to domestic debt. We concern that total public debt is more than doubled since HIPC and MDRI debt relief in 2006 and projected to reach 55 percent of GDP in 2018. Furthermore, external debt has not declined since the large increase during the early 2010s while its risk of external debt distress remains moderate. At the same time, we recognize financing needs to improve high-quality infrastructure (especially, electricity and irrigation) and social spending (particularly, poverty reduction and gender issues). Against this backdrop, the authorities should develop a holistic strategy to ensure debt sustainability while to achieve strong, sustainable, and inclusive growth. The strategy, complemented by capacity development, would include closely monitoring contingent liabilities, improving domestic revenue mobilization, prioritizing public investments, and in the medium term, diversifying the economy. Also, as staff comments in the report that exceptions can be considered on a case by case basis for new concessional loans, rigorous cost-benefit analysis is necessary. In this regard, the buff statement says that the Debt Management Committee will assess all borrowing. We would like to hear staff's assessment on effectiveness of this scheme.

Governance Challenges

Malawi should continue to tackle with governance challenges. As is clear from the cashgate scandal of 2013 which resulted in substantial arrears and loss of donor support, strengthening governance is vital for Malawi's sustainable development. We support that the program focuses on PFM and procurement reforms and urge the authorities to implement necessary reforms steadily. Related to this point, the Box.3 states that implementation of PFM reforms was slow under the 2012-17 ECF arrangement. Dose staff see any implementation-risks of reform agendas for improving governance under the new ECF arrangement?

Financial Sector

We agree with staff that safeguarding financial sector stability is a priority for the RBM. While the banking system was well capitalized and profitable on aggregate, the RBM's September 2017 stress tests illustrated vulnerabilities of several individual banks to credit and liquidity shocks. We encourage the authorities to keep working for safeguarding financial sector stability by monitoring and enforcing compliance with prudential norms. In this regard, staff mentions that the RBM should be vigilant to the recent rise in foreign currency lending. Could staff elaborate more on its background and possible actions the authorities might have to take to contain its risk?

Ms. Erbenova, Mr. Just and Mr. Zaborovskiy submitted the following statement:

We thank staff for their reports and Messrs. Mkwezalamba and Sitima-wina for their helpful buff statement. We note the macroeconomic stabilization achievements in the past five years. The Malawian authorities now need to secure these hard-won gains by further reducing the significant fiscal and external imbalances, accelerating structural reforms and addressing weaknesses in public financial management and governance. We commend staff for applying some of the lessons of previous program engagements with Malawi and for translating the Article IV policy recommendations into the proposed program. Nonetheless, we are not fully comfortable with the consistency of the program in addressing its stated aims: the financing of the protracted negative balance of payments will depend on a significant increase in volatile aid flows while the structural current account problem appears to be largely unaddressed. We also would have appreciated further detail on the catalytic impact of the program. The Risk Assessment Matrix rightly notes that the risks of policy slippages are elevated in the run-up to the 2019 elections. Meanwhile, the Ex Post Peer-Reviewed Assessment of Malawi's engagement with the Fund over the four program arrangements since 2005 shows a history of weak performance. We are thus less confident about significantly improved program prospects and ask staff to exercise some healthy realism. Notwithstanding our concern about the strength of the program, we can go along with the proposed decision approving the Malawian authorities' request for a three-year ECF arrangement in the hope that Fund financial assistance will help secure the macroeconomic stability and enable the authorities to implement politically costly economic reforms after the elections.

Growth-friendly fiscal consolidation and further progress in improving public finance management are critical to achieve the program's objectives. Malawi's fragile fiscal position, caused by revenue underperformance and the Agricultural Development and Marketing Corporation bailout, is worrisome. Under the program scenario the primary balance is projected to worsen from -0.6 percent of GDP in 2016/17 to -3.0 percent of GDP in 2017/18 on the backdrop of elevated public debt. We encourage the Malawian authorities to strengthen their fiscal framework and public expenditure management, especially procurement procedures, and to enhance fiscal transparency and accountability throughout the budget cycle at national and sub-national levels. More robust and upfront revenue-mobilization measures as well as shifting spending from consumption to capital investment are also warranted to narrow the fiscal deficit, preserve debt sustainability and revert the crowding out of growth-friendly expenditures. In this regard, we would like staff to provide further justification for the envisaged consolidation path, especially for the 2017/18 fiscal year.

Appropriately tight monetary policy and exchange rate flexibility should be preserved to curb inflation. We positively note the broad agreement between staff and the authorities on the monetary policy framework and exchange rate regime, and encourage the authorities to strengthen the governance and policy framework of the Reserve Bank of Malawi (RBM) further by curtailing quasi-fiscal operations. This transition will require additional technical assistance and we would like staff to comment on the respective specific plans. The authorities' commitment to a flexible exchange rate regime is welcome. The Fund engagement and assumed resumption of aid flows should help relieving pressure on the exchange rate. Given staff's estimates that the external position with the CA deficit of -10 percent of GDP is broadly in line with fundamentals, can staff elaborate more on how this conclusion is consistent with the significant fiscal consolidation envisaged in the program.

Cross-cutting measures to promote higher credit growth to the private sector and financial inclusion while addressing growing vulnerabilities in the banking sector are warranted. We support staff's recommendations on credit growth outlined in the SIP and encourage the authorities to develop a detailed Financial Sector Development Strategy. Alleviating the various structural barriers to financial deepening and NPLs resolution would bring substantial benefits for the economy in terms of growth, poverty reduction, resilience to shocks, and effectiveness of monetary and fiscal policies. While the fundamentals of the financial sector appear to be overall sound, weak asset quality, concentration risks as well as dependence on government borrowing require proactive and close monitoring of the banking sector.

Ambitious structural reforms coupled with targeted infrastructure investment should be accelerated to compensate for the structural decline of traditional sectors. Malawi's sizable developmental challenges, including the fragile institutional framework, infrastructure bottlenecks, lack of energy production, dependence on a narrow export base (tobacco) and population growth, require a comprehensive and well-sequenced package of structural reforms. Government interference in certain sectors such as the export ban on maize should be more measured and designed in a less distorting manner. We welcome the Malawi Growth and Development Strategy III which aims at tackling many of Malawi's challenges. At the same time, we believe that first and foremost, the significant governance weaknesses have to be tackled. It will be crucial to strengthen anti-corruption, law-enforcement and AML/CFT controls before private as well as official project financing for investments in infrastructure, and in particular electricity generation, will be forthcoming. Continued strong political will and program ownership are needed to implement these ambitious and critical reforms, particularly in the leadup to the elections.

Mr. Tombini and Mr. Coronel submitted the following statement:

We thank staff for the informative set of papers and Messrs. Mkwezalamba and Sitima-wina for their statement. We support the Malawian authorities' request for a new three-year Extended Credit Facility (ECF) program, expected to help reduce the country's external imbalances, increase its resilience against external shocks, and boost inclusive growth. We agree with the authorities on the need to accelerate reforms to facilitate private sector-led growth, and believe that successful program implementation will catalyze external support to their economic agenda.

Malawi has made significant progress in recent years towards maintaining macroeconomic and financial stability. Despite policy slippages under the previous ECF program (2012-2017), the economy successfully emerged from two consecutive drought years that led to a severe food crisis. We commend the authorities for achieving higher growth, declining inflation and an improved fiscal position in 2017 amid very challenging conditions. Against this background, the new ECF arrangement will be instrumental to consolidate stability. We take note, however, that staff considers risks tilted to the downside, including political pressures, vulnerability to weather-related shocks, and institutional capacity issues.

Structural reforms will be key to ensure sustainable and inclusive growth. We welcome the new Malawi Growth and Development Strategy for 2018-2023 and its focus on infrastructure investment, social spending, and reforms to improve financial sector development and the business environment. We also agree with the authorities on the importance of diversifying the economy while tackling governance vulnerabilities, and attracting local and foreign investment.

Keeping fiscal discipline while ensuring that spending is efficiently directed towards most needed areas remain top priority. We commend the authorities for regaining control over budget execution in FY2016/2017. Moving forward, we support the emphasis of the program on broad-based tax reforms aimed at creating a simple and transparent tax system, and the shift in the composition of spending towards growth-enhancing and poverty-reducing areas. In particular, we note that program design has managed not only to preserve social spending, but increased education and health budget allocation by 0.4 percent of GDP over the program period.

On the external front, despite some improvement, the current account deficit remained relatively high at 10 percent of GDP in 2017. We take note that staff assesses that the real effective exchange rate does not appear misaligned and that international reserves improved to an adequate level last year—partly, due to support funds from the World Bank that are expected to be spent in the short run. At just 3.3 months of prospective imports of goods and services in 2017, we would recommend the authorities to take advantage of current market conditions to further build-up reserves.

Mr. Alogeel and Mr. Keshava submitted the following statement:

We thank staff for a well-focused set of reports and Mr. Mkwezalamba and Mr. Sitima-wina for their helpful buff statement. We are in broad agreement with the staff's analysis and policy recommendations and support the proposed decision. We would limit our remarks to a few issues.

Under the ECF arrangement during 2012-17, Malawi strengthened macroeconomic stabilization, but the continued widespread poverty and weak social indicators highlight the challenges ahead. In this context, the ex-post peer-reviewed assessment brings attention to the uneven program implementation and unachieved objectives. The assessment also finds that while the program played a critical role in catalyzing donor support, governance-related developments and other policy slippages led to the withdrawal of donor support. In this regard, we note that PFM measures under the ECF arrangement played a critical role in restoring donor confidence, although it was a slow process.

Malawi continues to face protracted balance of payments needs and the challenge of achieving higher and more inclusive growth while ensuring macroeconomic stability. Against this background, we support the authorities' request for a new three-year arrangement under the ECF and welcome the new Malawi Growth and Development Strategy (MGDS) III for 2018-23, which aims to enhance productivity, competitiveness, and resilience, and foster economic diversification. At the same time, in the context of uneven program implementation in the past, we agree with the ex-post peer-reviewed assessment on the need for stronger and broader ownership among the various level of decision-makers and encourage the authorities to be proactive in this regard.

The program rightly aims at gradual improvements in the primary fiscal balance while safeguarding social spending, including spending on health and education, and ensuring debt sustainability. In this connection, FY 2018/2019 budget seems ambitious in aiming to improve the primary balance by 3.1 percentage points. To this end, efforts to strengthen tax compliance and limit non-essential recurrent expenditures should be stepped up. We note that development expenditure has not been safeguarded in the budget and is projected to decline by about 0.9 percent of GDP (Text Table 3). Is it largely due to limitations in implementation capacity? Over the medium term, we welcome the plans to pursue broad-based tax reforms and enhance the composition of the budget toward growth-enhancing and poverty-reducing areas.

We note that severe weaknesses in PFM facilitated the large-scale theft of public funds in the past, which resulted in substantial arrears and loss of donor support. It is therefore encouraging that the authorities have identified tackling governance challenges as an important priority and are taking steps, including to reform both the PFM and procurement processes. We also echo staff comments on the importance of effective use of AML/CFT tools and an enhanced asset disclosure system to support the authorities' anti-corruption efforts.

Finally, we are reassured to note in the buff statement that the authorities are enhancing both on-site and off-site supervision of banks and will continue to enforce compliance with all prudential norms, including asset classification and provisioning in the context of the recently introduced IFRS9, to ensure financial sector stability and resilience. We also welcome the agreement between staff and the authorities on the importance of increasing access to finance, including for SMEs, for achieving more inclusive growth.

With these remarks, we wish the authorities further success.

Mr. Daïri and Mr. Monajemi submitted the following statement:

We thank staff for the well-written report and selected issues paper, and Mr. Mkwezalamba and Mr. Sitima-wina for their insightful buff statement.

Reflecting a recovery from two years of severe drought and protracted governance crisis, growth in Malawi is projected to stabilize at around 4 percent in 2017-18 before rising gradually to about 6 percent over the medium term, supported by agriculture, infrastructure investment, increased access to finance, and higher donor project financing. Inflation declined markedly in 2017, and is expected to stabilize at around 5 percent over the medium term. The current account deficit continues to improve, the kwacha has stabilized, and the external position is deemed broadly in line with fundamentals, even though there is scope to improve competitiveness through structural reforms.

To entrench macroeconomic stability, reduce poverty, and foster higher, more inclusive, and resilient growth, the authorities have developed a medium-term program under the third Malawi Growth and Development Strategy 2018–23, for which they are requesting Fund support under a three-year arrangement under the Extended Credit Facility (ECF). As indicated by Mr. Mkwezalamba and Mr. Sitima-wina, Fund support will also be crucial for catalyzing concessional financing for infrastructure development. Downside risks to the program include political pressures in the run-up to the 2019 elections, weakening policy discipline and reform efforts, weather-induced shocks, decline in commodity prices, and reduced donor flows. We concur with the thrust of the staff appraisal and support the proposed decision.

Fiscal policy will appropriately be geared at supporting disinflation and maintaining debt sustainability. In this regard, the authorities' intention to keep spending within available resources, avoid accumulation of domestic and external arrears, and limit non-concessional borrowing and recourse to domestic borrowing, particularly from the Reserve Bank of Malawi (RBM) is encouraging. The FY 2017/18 budget contains measures to strengthen revenue mobilization, including by repealing the industrial rebate scheme, discontinuing tax holidays, and further strengthening tax administration. We welcome efforts to limit wage increases and shift the composition of the budget in favor of social and capital spending. We agree that enhanced transparency and strengthening the medium-term budgetary framework, along with addressing governance shortcomings, will be key to bolstering confidence.

Continued tight monetary policy will help maintain inflation in single digits. To this end, the RBM will keep interest rates positive in real term and will complete the transition to an interest-based operational framework, with the objective of adopting inflation targeting over the medium term. The staff may wish to indicate the degree of preparedness to this ambitious move. The authorities' continued commitment to the flexible exchange rate regime has served Malawi well as a shock absorber.

Stronger efforts are needed to improve the banking sector's soundness and resilience, as well as its contribution to growth. Banks' compliance with prudential norms should be closely monitored, provisioning increased, and higher efficiency of bank intermediation encouraged. Strengthening creditor rights and reducing lengthy judicial processes in recovering collateral remain critical to the reduction of non-performing loans. The staff rightly points to the role of developing microfinance and savings and loans cooperatives, as well as promoting mobile technology, in enhancing financial inclusion. We agree on the adverse crowding out effect of large government bank borrowing on credit to the private sector, and welcome staff indication of the other factors specific to Malawi that can explain the very high interest rate spreads compared to peers, as well as their assessment of the degree of competition in the banking sector.

Achieving higher, sustainable, and more inclusive growth calls for removing critical structural impediments to private sector-driven economic diversification and greater resilience. Reform efforts aimed at improving infrastructure, access to finance, and the business environment could significantly raise per capita GDP. Further PFM and governance reforms, prioritization of projects, and increased spending efficiency will be key to making full benefit of limited fiscal space in support of infrastructure, health, and education spending and catalyzing donor support.

We wish the authorities success in their endeavors.

Mr. Agung, Mr. Machmud and Mr. Sanoubane submitted the following statement:

We thank staff for the set of reports and Messrs. Mkwezalamba and Sitima-wina for their helpful buff statement.

We commend the Malawian authorities for the progress made in achieving macroeconomic stabilization amid the adverse impact of drought and past policy slippages. Protracted issues in governance and weaknesses in infrastructure and social development, however, call for deeper reform to ignite higher and more inclusive growth. Prudent fiscal and monetary policy will also be required to build economic resilience given the weather-related vulnerabilities that continue to persist. We therefore welcome the authorities' medium-term economic reform program (MGDS III), aimed at preserving macroeconomic gains thus far and enhancing poverty reduction, increasing the role of the private sector and improving resilience to climate shocks. We see a clear need for the Fund's support to help the country attain these objectives and can thus support the request for a new three-year arrangement under ECF that is anchored on the authorities' reform program. We wish, however, to stress the importance of strong program ownership to ensure that policy objectives and structural benchmarks are implemented in timely and consistent manner. We agree with the thrust of the appraisal and would like to offer following comments for emphasis.

Continued fiscal adjustments are crucial to create fiscal space and buffers while preserving medium-term debt sustainability. We welcome the authorities' expenditure measures, which should help accommodate spending pressures from the upcoming election and the hiring of new teachers. Although revenue performance has been relatively sound and above the median for Sub-Saharan Africa, we encourage the authorities to advance tax measures to build fiscal buffers. Concurrently, we support the approach in improving quality and efficiency of public spending to create space for the needed infrastructure and social development. On debt management, we welcome the authorities' commitment to limit non-concessional and domestic borrowing and develop the medium-term debt strategy. We note that infrastructure will be a key policy focus. As electricity infrastructure will take some time to complete, do staff have suggestions on possible near-term options to address the regular and prolonged power outages that have weighed on the manufacturing sector, hindering economic activity?

Accelerating PFM reforms will boost policy credibility and re-engagement of donor support. We laud the authorities for the recent progress in advancing PFM reforms, particularly routinizing bank reconciliation. Building on these achievements, we encourage authorities to press ahead with the next phase of reforms highlighted in MEFP, which will be crucial to foster fiscal discipline and integrity while restoring confidence in the budget process. In this regard, we concur with staff that enhanced fiscal transparency and a better accounting system would help reinforce fiscal credibility and catalyze financing from development partners.

The tight monetary policy stance has been appropriate to keep inflation on a downward trajectory. While we support the current monetary stance, we look forward to the upcoming Reserve Bank of Malawi (RBM) Act, which will provide an avenue for eliminating the sovereign-bank nexus, an important source of inflationary pressure. We commend the authorities for their adherence to flexible exchange rates and the near completion of the transition towards an interest rate-based framework. At the same time, while we support the adoption of inflation targeting as a medium-term goal, we recognize that much needs to be done to put in place the necessary preconditions, particularly the greater independence of the RBM. We encourage the authorities to work closely with the Fund in moving towards the new framework.

Safeguarding financial stability and increasing access to finance should continue to remain a priority on the agenda. We welcome the authorities' commitment to ensure IFRS9 compliance and to lower NPLs. We wonder whether the targeted 5 percent NPL ratio in 2018 is realistic given that the 2017 NPL ratio stood at 15 percent. Could staff also elaborate more on the factors behind the rise in the share in FX lending from 8 percent in 2012 to 28 percent in 2017 and potential risks from this development? The amendments to the Banking Act and Financial Services Act are welcome as these should strengthen the regulatory framework, while the revised AML/CFT framework should support anti-corruption efforts. Stress tests have been effective in identifying risks to banking system and we encourage the authorities to regularly conduct this exercise. The selected issues paper highlighted a number of structural barriers that hinder credit to private sector in Malawi. To improve financial access for SMEs, the plans to formulate a specific roadmap and engage with the financial sector are an important first step.

A bolder reform to promote economic diversification will be key to achieving inclusive growth. Efforts to address structural impediments including governance and ease of doing business would significantly unlock private sector potential, which in turn would be conducive for economic diversification. In general, FDI plays an integral role in boosting country's economic activities but we note that FDI inflows to Malawi have been lower than 3 percent of GDP for many years. Has staff engaged the authorities on specific measures to induce more FDI to support developmental needs?

Mr. Armas and Mr. Rojas Ulo submitted the following statement:

We thank staff for a clear and candid report and Mr. Mkwezalamba and Mr. Sitima-wina for their helpful buff statement.

We support the authorities' request for a three-year arrangement under the Extended Credit Facility (ECF) and thus, the proposed Decision. We base our support on the progress achieved in the economy, as reflected in the consistent measures of the economic policy under the 2012-2017 ECF arrangement, outcomes achieved in growth and stability, staff's positive assessment, and the commitment of the authorities to continue applying sound macroeconomic policies and structural and inclusive reforms.

Malawi's economy has shown positive progress, but the challenging outlook suggests the continuity of the implementation of appropriate macroeconomic policies to achieve sustainable growth. In recent years the economy rebounded positively, supported by a recovery in agricultural production and appropriate macroeconomy policies. Economic growth is projected to reach 3.5 percent in 2018 and stabilize at 5.0-6.0 percent in the medium and long term, led by improvements in agricultural production, enhanced energy and infrastructure, access to finance, and improved confidence. We concur with the report's recommendation on the implementation of policies focused on deep structural reforms, and enhancing inclusiveness, resilience, and the business climate.

Efforts to achieve the targets of the Public Financial Management (PFM) are necessary to obtain fiscal consolidation. The attempt to enhance efficiency in public spending are likely to be weaker than envisaged in the FY2018/19 budget due to rising pressures from upcoming Presidential and parliamentary elections to increase current expenditure. The strategy for improving the composition and efficiency of spending is necessary to achieve development objectives and support macroeconomic stabilization. We encourage the implementation of fiscal policies in revenue mobilization, improving efficiency-focused infrastructure and social spending, combined with enhanced public investment management policies.

Malawi's debt indicators show which areas are below on the thresholds, but strengthening public financial management is necessary to enhance resilience. The public and external debt sustainability analysis report states that the government's public and external debt ratio is below warning benchmarks and faces vulnerabilities to external shocks, mainly export revenues and exchange rates. As the report suggests, close attention to the level debt and the projected borrowing path is necessary, such as the financing terms of investments given the limited headroom for further borrowing. We concur with enhancing resilience to shocks through policies on diversifying the economy and increasing exports, broadening the revenue base, building fiscal buffers, and strengthening public finance management.

The financial system's soundness indicators are favorable. Nevertheless, continued efforts to improve the financial intermediation and strengthen supervision are required. The authorities should continue monitoring the banking system and controlling the capacity of resilience against credit and liquidity shocks. In the same vein, there has been a remarkable decrease in non-performing loans in the last year, although we note that they are still high. We support the comprehensive financial reforms focused on improving the efficiency of the financial system, strengthening bank supervision, and inclusive growth. We also support the authorities for their efforts and initiatives to align the AML/CFT framework.

We support the implementation of structural reforms planned in a new "Malawi Growth and Development Strategy (MGDS) III 2018-23." The study of inclusive growth shows that economic trends reflect a lack of both economic diversification and resilience against external shocks, a narrow production base, low coverage of engineered irrigation systems, high transport costs, insufficient services, and limited access to credit. This strategy determines strategic reforms centered on building productivity, competitiveness, investment in infrastructure, and social sectors. We encourage the authorities to continue accelerating the implementation of economic structural reforms to improve financial market development and the business climate.

With these comments, we wish Malawi and its people success in their future endeavors.

Ms. McKiernan and Mr. Hart submitted the following statement:

We thank staff for a comprehensive report and Mr. Mkwezalamba and Mr. Sitima-wina for their statement.

Malawi is a fragile state with significant vulnerabilities related to climate, poverty, food insecurity, and gender inequality exacerbated by low institutional quality and recent governance challenges. We support the objective of building on the macroeconomic stabilization achieved during the previous ECF program (2012-2017) to support higher, inclusive, and resilient growth. We welcome the authorities' intention to use a new Fund program to backstop the latest Malawi Growth and Development Strategy and maintain fiscal discipline ahead of the 2019 elections. We note also that this Fund program will serve as an important anchor for other multilateral and bilateral support. In that context, we support the request for a 3-year arrangement under the ECF, emphasizing that strong ownership will be required to achieve its objectives.

We welcome indications that the program design has integrated lessons from the previous ECF, as well as views of other key stakeholders. Malawi's aid dependence and limited space for non-concessional borrowing point to a need for ongoing coordination by IFIs and developing partners to work towards shared objectives. We also welcomed the clarity over how Fund TA will continue to be integral to supporting the program's objectives, notably in the areas of public financial management (PFM) and monetary and financial oversight.

Fiscal policy will need to be geared towards supporting disinflation, debt sustainability, and inclusive growth. We support measures to shift spending towards poverty reduction while limiting public wage bill increases and encouraging more progressive revenue mobilization measures. We also welcome the program's arrears-clearance strategy, but note that these arrears were accumulated over the course of the previous program. Are staff confident that, with the most recent reforms in place, they now have a sufficient sightline on the problem to monitor this target effectively?

Malawi has significant infrastructure needs, but this needs to be balanced against debt sustainability concerns. A moderate DSA rating and recent increase in domestic debt provides limited breathing room for non-concessional borrowing. In that context, the authorities will need to take strong ownership of governance and PFM reforms to help unlock concessional financing from development partners, as well as improving project prioritization and execution.

We support the program's objectives related to strengthening the monetary policy framework, building financial resilience, and reducing fiscal dominance. Maintaining a tight monetary stance will also help preserve the trend of declining inflation from previously elevated levels. We note that strengthening financial sector resilience is a key objective of the program, and welcome Fund TA focused on strengthening financial sector supervision and banks' observance of prudential norms, including AML/CFT. We support the focus on addressing NPLs and improving access to credit by SMEs which, along with the program's other reform measures, have the potential to support greater resilience and competitiveness of the Malawian economy.

Mr. Doornbosch and Mr. Manchev submitted the following statement:

We thank staff for the comprehensive set of papers and Messrs. Mkwezalamba and Sitima-wina for the helpful buff statement. We welcome the authorities' request for a follow-up three-year ECF arrangement, which will build on the achievements of the past arrangement and enable the authorities to properly respond to the downside risks. However, given the authorities' uneven track record and rising domestic debt vulnerabilities, we urge for a stronger implementation in order to achieve the proposed ambitious growth and social-inclusion agenda, and to preserve the medium-term debt sustainability. Although Malawi's policies and institutions are still classified as "weak" by the WB's Country Policy and Institutional Assessment, lessons drawn from the implementation of the 2012-17 ECF should allow improving the performance under the new program. Rebuilding confidence in the authorities' policies hinges on the future actions aimed at restoring macroeconomic stability by pursuing a predictable and well-anchored fiscal policy. Since we can mostly associate ourselves with the staff's appraisal and support the proposed decisions, the remarks below are provided for emphasis.

Continuous reforms of both the PFM and procurement processes in line with the program objectives will be essential to bolster donor confidence and strengthen fiscal consolidation. While we note the progress so far, the authorities should avoid any further delay with the implementation of the PFM plan agreed with key donors in the aftermath of the "cashgate." Recent success with achieving bank reconciliation establishes a strong foundation for expanding public finance reforms to improve reporting and expenditure control, and prevent further accumulation of arrears. Adoption of a new Procurement Act that closed several loopholes should be supported by a proper framework that enhances transparency, control, and accountability. The authorities should strengthen corruption control, and we encourage them to thoroughly and transparently communicate any potential misconduct. We welcome the authorities' commitment to develop a comprehensive medium-term debt strategy, avoid contracting new non-concessional loans, and prioritize investments based on rigorous cost-benefit analysis, absorptive capacity, and debt sustainability considerations.

Unfortunately, the Malawi's fiscal position has deteriorated again in the first half of FY2017/18. This calls for immediate corrective actions. The direct financing of the Reserve Bank of Malawi (RBM) to the budget should be discontinued. The authorities need to expeditiously implement the agreed corrective measures to contain the public-sector wage bill, increase efficiency of spending on goods and services, and prevent new arrear accumulation. The corrective fiscal adjustment should continue in the medium term and the broad-based tax reforms is needed to improve the composition of the budget. The existing automatic fuel price-adjustment mechanism should remain in place, and all stakeholders need to be consulted ahead of forthcoming amendments to the fuel import regime to avoid economically damaging supply disruptions. Pension reforms should be revisited to reduce the liabilities of the current system. We are encouraged by the draft 2018/19 Budget, which already incorporates some of these plans. Given that spending pressures can reemerge around the upcoming elections, how confident is staff in the budget projections and have they discussed additional compensatory measures?

The authorities should continue the tight monetary policy to alleviate existing inflationary pressures and bring protracted inflation on a declining path. This can only be successful if combined with the appropriate fiscal policy and full legal, financial and operational independence of the RBM. In this regard, the updated safeguards assessment of the RBM should soon bring further clarity to the next steps. The authorities' commitment to a flexible exchange-rate regime, together with the RBM's plans to continue strengthening its monetary policy framework, look conceivable. Efforts to closely monitor market liquidity should continue to support the monetary policy transmission. We also welcome the RBM's plans to further improve communication with all stakeholders and the public to raise policy credibility.

A weak macroeconomic environment requires increasing vigilance about the financial sector stability. We welcome the authorities' commitment to align the legal framework for bank resolution with the best international practices and to enact regulations related to the recently revised AML/CTF framework. Effective use of AML/CFT tools and an enhanced asset disclosure system would support the authorities' anti-corruption efforts as well. Given the evolving risks from the NPLs, the RBM should urgently proceed with the introduction of the higher minimum capital requirements for banks, and work closely to increase bank capitalization, especially of the ailing banks. Further efforts are also needed to improve banks' business models, increase financial literacy of the population, and improve efficiency of the intermediation.

Finally, widespread poverty and weak social indicators call for urgent structural reforms to achieve higher, more inclusive, and sustainable growth.

The selected issues paper provides useful insights into the necessary policies going forward.

Mr. Palei and Ms. Atamanchuk submitted the following statement:

We thank staff for a set of comprehensive papers and Messrs. Mkwezalamba and Sitima-wina for their informative buff statement. We broadly agree with staff's analysis and support the Malawian authorities' request for a three-year ECF arrangement. We are pleased to learn from the buff statement that the authorities have completed all five prior actions. We recognize the efforts made by the authorities to improve economic performance and believe that in the current challenging environment much more needs to be done.

Even though Malawi's economic outlook has improved, it is subject to substantial regional and domestic risks. Economic growth is projected to gradually increase to 5-6 percent in the medium term on the account of improved confidence, enhanced infrastructure, and increased donor-financed projects. However, the country's outlook is subject to multiple domestic risks, including delays in PFM reforms and possible spending pressures being assessed as high likelihood events (the RAM). Malawi's fiscal position with a moderate risk of external debt distress needs to be strengthened. Since the HIPC and MDRI debt relief in 2006, Malawi's debt has doubled to 55 percent of GDP due to increased domestic financing after the withdrawal of donor budget support and recapitalization of two public banks. We encourage the authorities to strengthen public finances and create fiscal space to reduce dependency on donor support.

The new ECF arrangement should help the authorities to establish macroeconomic stability and achieve more inclusive and resilient growth. We welcome the RBM's plans to strengthen its monetary policy framework and move to inflation targeting. We welcome the authorities' commitment to a flexible exchange rate regime and to maintaining tight monetary policy to reign in inflation. We also welcome the authorities' plan to raise infrastructure investment by improving public investment management and procurement system as well as by partnering with the private sector while preserving public debt sustainability.

We recognize the progress achieved by the Malawian authorities under the previous program arrangements with the Fund, but note that their program implementation has been uneven, as multiple policy slippages have occurred during the programs. Under the 2012-17 ECF arrangement, inflation was reduced to 10 percent and international reserves were rebuilt from 0.5 months of imports in 2012 to about 3 months. At the same time, we recall that some quantitative targets had been missed by substantial margins, while crucial structural benchmarks had not been met. A few instances of misreporting took place and severe weaknesses in the PFM facilitated a large-scale theft of public funds in the past. It is therefore encouraging that the authorities have identified tackling governance challenges as an important priority under their national development strategy. We call on the authorities to demonstrate strong ownership under the new program with the Fund.

Mr. Sembene, Mr. N'Sonde and Ms. Nankunda submitted the following statement:

We thank staff for the reports as well as Mr. Mkwezalamba and Mr. Sitima-wina for their informative buff statement.

Malawi's economy has begun to show signs of recovery following a couple of years of inclement weather. In spite of difficult policy challenges facing the country, the authorities have made significant inroads in securing macroeconomic stability and maintain the program momentum. We commend the Malawian authorities for their efforts, the corrective measures taken to ensure that the program remains on track, and their commitment to its objectives going forward. We, therefore, support their request for a new ECF arrangement.

As challenges ahead remain significant, including the need to make growth more resilient and more inclusive, we urge the authorities to pursue steadfastly the implementation of their policy and reform agenda, notably through prudent macroeconomic policies while preserving highly-needed resources for meeting infrastructure and social needs and tackling governance issues. Strengthening resilience will also require efforts to increase financial inclusion and boost financial intermediation. The traction of a Fund-supported program will be of the essence.

Fiscal Policy

There is scope for furthering public financial management (PFM) reforms. Continued progress in this area is necessary for advancing fiscal transparency, boosting domestic and foreign investor confidence in the economy, and re-engagement of donor support. In addition, we underscore the relevance of initiatives that seek to increase domestic revenue mobilization and improve the efficiency of public spending, which are necessary to reduce the fiscal deficits and close the financing gaps, create fiscal space for the support of the most vulnerable, and ensure medium-term debt sustainability.

Monetary Sector

The tight monetary stance has helped to keep inflation on a declining path, supported by a flexible exchange rate and an effective fuel price mechanism. We commend the authorities' efforts in bringing down inflation. Going forward, it is important to maintain a tight monetary policy stance to ensure that inflation remains on a sustained downward trend. We welcome the authorities' efforts to enhance the monetary policy framework, and note the importance of further capacity development in liquidity management and a deeper understanding in monetary transmission mechanism and economic forecasting.

Financial Sector

We commend the authorities for their ongoing actions to strengthen the banking system, and we encourage them to pursue the enhancing of bank supervision, including increasing bank provisioning, with the view of bringing non-performing loans (NPLs) to the 5 percent prudential level. Additionally, it will be important that the authorities take measures that will strengthen creditor rights and reduce the lengthy judicial process in recovering collaterals. We encourage the authorities to implement measures that will help to raise access to finance in support of inclusive growth.

Structural Reforms

We welcome the authorities' commitment to fostering private sector investment and access to finance. Tackling governance gaps, improving the business climate and enhancing physical capital are required to increase the contribution of the private sector to the Malawian economy. We encourage the authorities to pursue actions in these directions.

Finally, we agree with Mr. Mkwezalamba and Mr. Sitima-wina that the Fund program has been helpful in supporting Malawians' development agenda. We strongly support the authorities' request for further Fund's engagement through a successor ECF arrangement.

Ms. Riach, Mr. Castets Ms. Stockill, and Mr. Bellocq submitted the following joint statement:

We thank staff for the comprehensive papers and Mr. Mkwezalamba and Mr. Sitima-Wina for their helpful buff statement.

Malawi has made progress in achieving macroeconomic stabilization following two years of severe drought and the lingering consequences of corruption scandals. Persistently high inflation has been curbed, chronic foreign exchange shortages have been addressed, and international reserves have been rebuilt. However economic growth (3.7 percent average over the past 5 years) has not been sufficient to reduce poverty significantly and governance challenges remain. The IMF has played a critical role in supporting the Government of Malawi to restore macroeconomic stability, and a further ECF-supported program will be an important mechanism for macroeconomic management and laying the foundations for inclusive growth.

Malawi has a history of slow performance under previous IMF programs due to policy slippages and shocks. As noted in the Ex-Post Peer Review Assessment, under the previous ECF arrangement (2012–2017), many program quantitative targets were missed and implementation of structural reforms was particularly slow in the PFM domain. Political pressures in the run up to the 2019 elections may weaken policy discipline and reform efforts. What measures have staff taken to improve program performance under the new ECF arrangement?

Malawi has limited space to take on additional external debt and vulnerabilities to external shocks remain. We welcome the authorities' agreement to suspend contracting of new non-concessional loans, and we look forward to the development of a comprehensive medium-term debt strategy. We welcome the structural benchmarks aimed at enhancing debt management and improving commitment controls. We note that the ECF does allow for exceptional non-concessional borrowing on a case-by-case basis. It is vital that any additional borrowing is underpinned by a robust assessment of its growth-enhancing potential, accompanying fiscal measures to offset the debt impact of the non-concessional portion of the loan, and strong IMF oversight.

In recent years, corruption scandals have complicated fiscal policy implementation, with particular weaknesses in PFM and procurement. Whilst we welcome the steps the Government of Malawi has taken to date, more remains to be done to tackle governance issues in procurement, the use of promissory notes, and compensation payment. We would welcome staff's reflections on how the new Framework for Enhanced Engagement on Governance could be used in Malawi.

Malawi's income per capita and social indices are amongst the lowest in the world, and economic growth substantially underperformed relative to previous ECF program projections. The promotion of inclusive growth remains a critical issue. The selected issues note rightly identifies the need for improvements in infrastructure, human capital, financial market development and the business environment. How do staff intend to support financial sector development and economic diversification outside of the current benchmarks and targets in the ECF? Given limited fiscal space, careful sequencing and prioritization of projects will be required, as well as a focus on the quality and efficiency of public infrastructure and social spending. We welcome the recommendations of the selected issues note on improving the efficiency of health and education spending, but we would have liked to have seen a more thorough consideration of social spending in the ECF program design (in line with PRGT objectives).

We welcome the authorities' commitment to improve financial intermediation, as well as financial sector stability. We agree with staff that the Reserve Bank of Malawi has to closely monitor the rise of lending in foreign currencies and ensure that commercial banks meet the net open position requirement. We also note the authorities plan to strengthen the asset declaration system and the use of AML/CFT to improve banking system governance. We look forward improvement in that field during the program implementation period.

Mr. Jin and Ms. Cai submitted the following statement:

We thank staff for the reports and Mr. Mkwezalamba and Mr. Sitima-wina for the helpful buff statement. We welcome Malawi's progress in achieving macroeconomic stabilization after two years of severe drought, and encourage the authorities to further increase the inclusiveness and resilience of the economy. As we broadly concur with staff's appraisal, we would like to limit ourselves to the following points for emphasis.

Addressing the infrastructure bottleneck should be the priority. Given that regular and prolonged electricity outages weighed on manufacturing and trade, we encourage the authorities to increase the needed infrastructure investment, especially electricity, without elevating the risk of debt distress. We welcome the authorities' commitment to suspend contracting new non-concessional loans. Flexibility should be maintained to consider new loans supporting growth-promoting projects. Enhancing public investment management is critical. We encourage the authorities to put more emphasis on project returns and efficiency.

Fiscal management is crucial for maintaining debt sustainability. We commend the authorities' efforts to resolve arrears dating back to FY 12/13. In order to avoid arrears accumulation in the future, further efforts need to be taken to strengthen fiscal management. We welcome the authorities' medium-term plans which emphasize broad-based tax reforms and enhancing the composition of the budget. Well-tailored Fund advice and support in these areas as part of broader efforts are welcome.

We commend the authorities' steady implementation of a structural reform to boost potential growth and reduce poverty. There is still some scope to improve the business environment, including easing procedures to start a business and deal with construction permits, strengthening contract enforcement and enhancing insolvency processes.

With these remarks, we wish the authorities every success in their policy endeavors.

Mr. Hurtado and Mrs. Suazo submitted the following statement:

We thank staff for its thorough report and Messrs. Mkwezalamba and Sitima-wina for their explanatory buff statement. Given that the 2012–17 ECF program was successful in stabilizing Malawi's macroeconomy and critical in alleviating the humanitarian crisis and to safeguard the advances made in those years, we support the proposed decision for approving the Malawian authorities' request for a three-year ECF arrangement.

Notwithstanding the above, concerns discussed below, remain:

The track record during the past Fund's program had mixed results partially related to policy slippages, lack of authorities' ownership, misreporting and governance issues. To avoid past mistakes, we encourage authorities to continue their strong commitment to prudent economic policies, especially considering that presidential elections are approaching in 2019. The staff classifies the risk of expansionary fiscal policies as high and in this setting, we wonder if fiscal targets remain feasible. We would like staff to expand on the specifics as to how the continued fiscal consolidation until 2020 and the increased expenditure in infrastructure and social ends will be achieved simultaneously.

The last question is relevant given that, although Malawi's debt sustainability analysis is moderate, the country was recipient of HIPC and MDRI in 2006 and since then total public debt has more than doubled and is projected to reach 55 percent of GDP in 2018. In this context, it seems that more forceful measures need to be taken to reduce the fiscal deficit and to keep the public debt to GDP ratio on a downward path. Authorities mention wage increases, hiring new teachers and an allocation in the budget for campaign financing which seems inconsistent with Fund's program objectives. The staff's comments are welcome.

Malawi has a narrow export base which rely on a small number of agricultural commodities, mainly tobacco, making the country's economic growth highly vulnerable to external shocks. Could staff elaborate on the degree of diversification of Malawi´s economy relative to other economies in the region, particularly those of the CEMAC and WAEMU currency unions? Related to production levels, the food crisis in 2016 prompted Malawi's government to implement an export ban on maize which has lowered prices and decreased farmers' incentives to invest. Could staff comment if authorities have expressed their intention to remove this ban and have the impacts of the ban been considered in the staff's growth projections?

Finally, regarding the financial sector, nonperforming loans remain high (15.7 percent in 2017) and provisions low. It also shows vulnerabilities related to the banking system holding most of the government's domestic debt. Banks are also exposed to the agricultural sector which is dependent on commodity price swings and weather-related events. Another risk highlighted in the buff statement is the recent increase in foreign currency loans. Could staff elaborate on the causes of this loan performance?

Mr. Gokarn and Mrs. Roy submitted the following statement:

We thank the staff for an informative set of papers and Mr. Mkwezalamba and Mr. Sitima-wina for their insightful buff statement. Malawi has made significant progress in achieving macroeconomic stability following two successive years of weather related shocks and challenges in public finance management. Growth is recovering and inflation has declined into single digit territory. But, beyond this, vigorous efforts are needed to tackle poverty through higher, more inclusive, and resilient growth, diversifying the economic production structure, completing fiscal adjustment as required and encouraging credit off-take through microfinance channels.

GDP growth is estimated to be lower in 2017–18 due to weaker growth in manufacturing constrained by shortages of energy and water supply, and depressed purchasing power with low agricultural commodity prices in 2017, as well as the adverse effects of dry spells and armyworm infestations on agricultural production in 2018, but higher by about 0.5–1 percentage points over the medium to long term. Given that the population is largely rural and the economy is based on agriculture, and close to one-third of GDP and 80 percent of export revenues come from this sector, a significant part of the population has low purchasing power. In stepping up domestic revenue mobilization efforts, the staff report states that tax policy initiatives will be guided by a shift in reliance on revenue from taxation of labor and investment to consumption. However, given the high incidence of poverty and low purchasing power, consumption taxes are likely to be relatively more regressive.

As the authorities aim to step up investment in infrastructure and social sectors, power appears to be the most critical sector, affecting the economy in several ways. Non-agricultural growth prospects were constrained by continued power shortages in the first half of 2018. Better growth in the second half of the year is predicated upon faster pick-up in private sector activity with reduced power shortages. Government revenue collection has underperformed inter alia due to power outages slowing economic activity. Foreign direct investment flows (2 percent of GDP) disappointed last year, amid investor concerns over power shortages and rising factor costs. Power shortages are also affecting public confidence in state institutions. Hence, improvement in power supply is a critical component which could improve performance and prospects in several areas.

It is commendable that the authorities aim at building productivity, competitiveness, and resilience through infrastructure and social sectors investment, financial market reforms and business environment improvement—including governance. Given lingering consequences of earlier governance issues, fiscal reforms related to PFM, procurement, and broader governance areas are expected to catalyze concessional financing in infrastructure and social sectors. While the IMF has recently adopted an enhanced Framework that strengthens its support to countries to address governance vulnerabilities, there are likely to be areas where the Fund could collaborate and rely on the expertise of other institutions, especially the World Bank.

The authorities have requested a three-year arrangement under the Extended Credit Facility (ECF). The previous arrangement expired in

May 2016 and Malawi currently has outstanding obligations to the Fund equivalent to 110.16 percent of quota. The newly requested arrangement would provide SDR 78.1 million (56.25 percent of quota) in support of their medium-term economic reform program which seeks to entrench macroeconomic stability and enhance poverty-reducing and resilient growth. The August 2017 stakeholders' conference had also identified these objectives as key priorities that are achievable through greater economic diversification, a more vibrant private sector, and resilience to climate shocks. The IMF team has reached a staff-level agreement with the authorities of Malawi on a three-year program that could be supported by an arrangement under the ECF and will catalyze concessional financing for infrastructure development. Given that the authorities have completed all five prior actions and Malawi is within the limit on total access to concessional financing under the Poverty Reduction and Growth Trust financing, we support the authorities' request for the three-year ECF.

Ms. Crane made the following statement:

We thank the staff for the work on Malawi, recognizing that work on fragile states can be particularly labor intensive. Following up on our gray statement, we would like to highlight several points.

First, on domestic arrears, we note that many of the public financial management-related benchmarks are ultimately aimed at eliminating domestic arrears and that zero domestic arrears is currently an indicative target under the program. We encourage the staff and the authorities to consider making zero domestic arrears a performance criterion in the out years of the program, as implementation of the benchmarks gives the authorities greater control over public finances over time.

Second, on the quality and comprehensiveness of debt data, considering that Malawi currently uses a narrow concept of the central government in its debt statistics, and that data on state-owned enterprises (SOEs) is incomplete, we urge the authorities to take advantage of Fund technical assistance (TA) to address these weaknesses expeditiously. This is all the more important given Malawi's already high levels of overall public debt.

Third, on the rating for risk of debt distress, we thank the staff for the answer to our technical question No. 15. We take it from that answer that if the new low-income country debt sustainability framework (LIC-DSF) framework had been applied, Malawi would have been found to be at high-risk of debt distress based on the breach of the threshold for the net present value (NPV) of total public debt from now through 2023. It is unfortunate that the staff was not able to use its discretion to upgrade the risk rating at this time, as this would have provided a more timely and accurate signal to donors and multilateral development banks (MDBs) about the grant financing that Malawi likely needs.

Finally, on governance, we welcomed the answer to technical question No. 30 on possible governance and anti-corruption priorities for later in the program. We look forward to the staff's analysis on this important topic.

Mr. Hurtado made the following statement:

We support the decision on Malawi and issued a gray statement, and I would like to ask a question on the assessment of the appropriateness of the exchange rate regimes in different countries. I suppose this question is more for the Strategy, Policy, and Review Department (SPR) than the team. In our gray statement, we asked the staff to elaborate on the degree of diversification of Malawi's economy, especially relative to other economies in the region and in particular to those of the Central African Economic and Monetary Community (CEMAC) and the West African Economic and Monetary Union (WAEMU).

In the case of those economies that have suffered sharp declines in their terms-of-trade and have faced important shocks in this respect, the staff on several occasions has stated that the exchange rate regime is appropriate. Having faced these problems with terms-of-trade and balance of payments shocks, while the exchange rate in those economies is practically fixed—it only moves with the euro—I believe that this is highly inappropriate.

Why is it that in the case of Malawi, the flexibility of the exchange rate is appropriate, as stated in the report? I do not believe Malawi's economy is more diversified than the other economies. I do not see the point. It is an economy that basically produces and exports three things—coal, tobacco, and some grains. It is a simple economy, not diversified at all. In this case, the staff supports the flexibility of the exchange rate, which is the same for many other economies around the world. But what happens with those other economies, the ones that are under the currency unions?

The staff representative from the African Department (Ms. Mitra), in response to questions and comments from Executive Directors, made the following statement:[1]

> I thank Directors for their insightful gray statements. We appreciate it. We circulated written responses to Directors' technical questions, and I would like to respond to some policy questions, especially related to program ownership and design, and also address a few of the questions on the fiscal path, transition to inflation targeting, and medium-term growth. I will also circle back to some of the public financial management (PFM) issues and the exchange rate regime.
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> On ownership and program design, the authorities are off to a good start by having met all the prior actions. They acknowledge the slow and uneven progress on reform implementation in the past, and they seek to address the root causes, which essentially has to do with backlogs in financial reporting for things that seem basic to us, such as bank reconciliation, but have been challenging for them due to capacity constraints.
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> The prior actions in this program were designed to help tie up some of the loose ends from the PFM measures in the previous program. The idea is to help build ownership as they gradually move on to the next stages of PFM. In this regard, the authorities stress their commitment to make proper financial reporting routine and prevent rebuilding of backlogs, while also fine tuning some of the measures they have already started implementing. Consequently, the structural benchmarks have been designed around that.
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> To encourage ownership, there are a number of structural benchmarks early on, so there is frontloading; but these are easier to accomplish, and many of them are things the authorities have already started doing.
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> As the program progresses and capacity improves, the benchmarks become harder but also fewer in number. I would like to point out that the end-December 2018 and end-June 2019 structural benchmarks were outlined in the staff report to give an idea of where this is going, especially in terms of the next phase of PFM reforms, but they will be streamlined heavily at the time of the first review.
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> On capacity development, the authorities improved substantially in that area already, and that is thanks to intense and well-sequenced TA that is being complemented—and this is key—by a PFM resident advisor. There is

[1] Prior to the Board meeting, SEC circulated the staff's additional responses by email. For information, these are included in an annex to these minutes.

someone on the ground helping the authorities whenever any challenges come up with the reforms that they are implementing, and this has made a big difference. We expect the improvements in capacity to continue, and ultimately that will benefit program performance.

There were a few questions on whether the other major political parties support the program. After the previous program was completed in August of 2017, there was a stakeholders' conference involving all the major political parties, NGOs, civil society, and other development partners. They took stock of the challenges that led to the delayed completion of the previous program and the causes of the slippages. The stakeholders determined that in moving forward, the critical items would be strengthening governance and increasing the role of the private sector for more dynamic and inclusive growth. There was broad consensus on this, and so the Malawi Growth and Development Strategy III was also based on the findings of this conference. This program draws on that growth and development strategy, as well as the findings of the conference.

There were also questions about the elections. We are aware that elections are coming up in a few months, and so that is another reason for frontloading the structural benchmarks. In addition, the 2018-19 budget is designed in a realistic way, so we allow for a one-off item on election spending, as well as increased spending in the most visible priority infrastructure and social development areas. The revenue projections are quite conservative, and there are feasible consolidation measures.

Directors asked about fiscal consolidation measures. The idea is to gradually increase revenues, and then at the same time there will be less spending on the interest bill as the interest rate declines, and reduced spending on non-essential items, including the farm input subsidy program, which will be reformed with the help of the World Bank. The plan is also to increase spending efficiency—one of the Article IV selected issues papers was on that topic.

The savings will be used not only to help with consolidation, but also to increase the quantity and quality of spending on priority infrastructure and the social sector, such as health and education. As they consolidate, that will reduce debt pressures, but they are still left with the challenge that many countries in the region face—there are very large infrastructure needs, which are growth critical. How will the authorities balance that? In the case of Malawi, donors can help, and the key will be regaining donor confidence. That means the authorities need to address the governance issues that the donors are concerned about, and the program addresses that in the areas of bank reconciliation, cash management, and strengthening the medium-term budget framework.

With regard to inflation targeting, under the program, we expect a gradual move toward inflation targeting; and mainly the program will help with capacity building in the areas of forecasting, statistics, deepening of financial markets, and improving monetary policy implementation and communication.

The authorities have already reduced inflation significantly. They were in the high double digits just a few years ago. They have brought that down to single digits, and it has remained there for almost a year now. In the financial sector, the Reserve Bank of Malawi continues to strengthen banking supervision and maintain financial sector stability.

Last but not least, on what underlies the medium-term growth projections, Malawi is beginning from a very low starting point in the sense that it is an agriculture-based economy. It depends on rain for agricultural production, and rain has been adversely affected by climate change. Consequently, simply having some irrigation infrastructure—which is almost non-existent now except for the big tobacco farmers—can make a big difference for growth, and development partners are already helping them do that. Some of the smaller projects will come online soon. There is a bigger project with the World Bank for which the feasibility study is already completed, and they have started contracting as well. So, we believe that this program will help catalyze and move these projects forward faster.

The program includes other structural reforms, including improving access to finance. That would not only raise growth, but make it more inclusive.

With regard to the question raised about data and SOEs, there is actually an SOE TA mission from the Fiscal Affairs Department (FAD) planned for later this year on exactly that topic. We hope that we can incorporate more data into the next round of the Debt Sustainability Analysis (DSA).

We take the point on the risk of debt distress. We will be using the new framework next time.

The staff representative from the Strategy, Policy, and Review Department (Mr. Zeidane), in response to questions and comments from Executive Directors, made the following statement:

On the LIC-DSF, the position is to roll out the LIC-DSF together. But in this case, they implemented the last framework, and they had the chart that shows the NPV with the aggregate level of debt. We cannot call now high level of debt distress using the new framework. That will start later, but it will become much more clear in the second half of the year when they use the new framework.

On the questions of anti-corruption, the Board endorsed the new policy, so there will be a centralized process. We are starting the implementation from Q3, so all policy notes will start July 1. This one has been done before the Board meeting, so the current report does not have that much coverage of corruption and governance issues, although it is clearly part of the picture. There is a box and the staff outlines some meaningful measures for different aspects of this program. But the next review will be part of the rollout of the new policy, and SPR will have a discussion with the team on the best way to reinforce the governance and anti-corruption part.

On the question on the exchange rate, when assessing the exchange rate regime, one has to consider not only the external sector, but also inflation. One needs to take into consideration the financial stability implication of any change of the exchange rate regime. One has to have a broader view of the implications of the change from one country to another. With regard to the question on currency unions, I do not cover personally these countries, but I would think that when making this assessment, one should consider whether there is a central bank that can rein in inflation and make sure that everything can be done, and whether fiscal adjustment can correct for the external imbalances. One must look at different factors when making an assessment. There are also the oil exporters that are not in a currency union, where the staff has found that fiscal consolidation is a more powerful instrument than the exchange rate itself. We have to take a case-by-case approach rather than have a uniform position on the best way to assess the exchange rate regime. However, I do not have all the information to provide a full answer.

Mr. Inderbinen made the following statement:

We thank the staff for these explanations, including on our question related to program design and the benchmarks that are suggested further out in the program. We take the point that easier measures or more preliminary measures that the authorities are already engaged in are among the earlier benchmarks. The staff will revise some measures further out, which is normal. We also appreciate that the authorities have signaled commitment to the program with the prior actions that they have taken before the meeting.

My question relates to the nature of these out-year benchmarks, or the later benchmarks. These are found in Table 3b of the attachment to the memorandum of understanding. With this footnote, the staff indicates that it will be revising these benchmarks as the program goes forward. For the Board, it might be difficult to see where the whole thing is going, because today we are establishing these benchmarks, and they should be critical for the program. Then in the first or subsequent reviews, the staff will explain which ones it has dropped, merged, or reset. But it begs the question why we are establishing this array of benchmarks today and coming back to them at a future date, rather providing the first list of benchmarks in the program documentation, and indicating that we will be elaborating on these further down the road? It is also a bit difficult to see what is behind them. The first one in this table still has square brackets, so it appears preliminary. The second says that benchmarks must be implemented in the areas with biggest potential for enhancing efficiency planning and allocation of public investment. We understand this is related to the efforts to improve public investment and perhaps the FAD TA might address this. But as these are written, they do not provide much of an idea of where the program is going, and by implication, does not provide much of an idea of why certain things will be changed later on and what will be taken as alternative measures for what reasons.

Mr. Doornbosch made the following statement:

I thank the staff for the work in Malawi and for its answers. I would like to make three points.

First, I would like to support the U.S. chair’s remarks on debt transparency. That is very important. The staff also mentioned that this issue would be important given the upcoming FAD TA mission, so I would appreciate any clarification on how this will be locked into the program. In its written responses, the staff mentioned that there is the debt management committee and I would like to know whether this will play a role in this TA mission.

Second, like Mr. Merk, we were surprised that the domestic borrowing from the Reserve Bank of Malawi remains an option under the new program despite the fact that continuing monetary financing has been a key element of Fund conditionality. Is there any prospect of this being phased out over the course of the program, or are does the staff expect this to continue, and why is it necessary for this to continue?

Third, on governance, I welcome the staff's remarks and the efforts that are already in the program. I was wondering whether the staff will also be looking at some backward-looking measures. Most of the measures are forward-looking, which is very important. A scandal like Cashgate cannot happen again, but it seems to influence the cost-benefit analysis of engaging in corruptive activities. It seems very important to look back and investigate Cashgate. I ask the staff to comment on what is being done in terms of investigating this and prosecuting the people involved.

The staff representative from the African Department (Ms. Mitra), in response to further questions and comments from Executive Directors, made the following additional statement:

I thank Directors for the additional questions. On the structural benchmarks, these were included because we wanted to show where we are headed in terms of the next phases of the reforms. In some cases, these apply to general areas, like implement areas with the biggest potential for enhancing efficiency in planning and allocation of public investment. There is a Public Investment Management Assessment (PIMA) TA mission on the ground looking at this. Once we have the TA recommendations, then we can be more precise. Once we have those recommendations, we will be able to see whether it makes sense to have that benchmark for end-December or for end-June.

Part of the reason we included these is because their elements are important for the program, but the timing will also depend on how the end-June benchmarks go, as well as many of the TA missions. I understand that it looks like they are trying to cover many different areas, but these are the areas that the donors are most concerned with related to governance, and these are also the areas that led to issues like Cashgate. There was a backward-looking element in designing the structural benchmarks. That is our logic. In many cases, these are placeholders until we have the TA missions, and then we can be more precise on the exact benchmark and the timing.

On the SOE TA, that is for later in the year. So our written response referred to the current PIMA TA mission, which will also cover that issue. We do expect that the debt management committee will be effective, but some fine tuning will probably be necessary, and the TA mission will help them.

On the central bank borrowing, there is a performance criterion of zero central bank borrowing by the government. There is a structural benchmark for revising the Reserve Bank of Malawi Act, which actually allows for this type of borrowing; so those are all changes that are happening.

Why are we allowing some central bank borrowing for end-June 2019? Because in the first half of the fiscal year, before we had program discussions, they had already done some borrowing equivalent to almost 2 percent of GDP. If the government were to try to repay that now, it would create liquidity problems and disruptions in their markets. Their financial markets are not that deep. It is a big amount. In mid-June, the Monetary and Capital Markets Department (MCM) will be sending a debt management TA mission to devise a plan to unwind this debt. There will be something on that during the first review.

On Cashgate, the authorities are in a better position than me to answer the question about prosecution; but I know it is being investigated, and there have been big changes in the staff as well in order to address the issues. What I can say is that in this program, there was a lot of looking backwards. What were the holes in the PFM system that allowed something like Cashgate to happen? For example, one factor is that sanctions on departmental agencies for misreporting or non-compliance were not strong, and that is being improved in this program, and it is included as a continuous structural benchmark.

The staff representative from the Strategy, Policy, and Review Department (Mr. Zeidane), in response to further questions and comments from Executive Directors, made the following statement:

For end-December, any change compared to this would have to be justified and brought for the first review.

On the question of investigation, the Fund does not engage in investigative action, so we cannot even call on the authorities to investigate the case. We can certainly call for audits and things like that, and we certainly should learn lessons from what happened before and incorporate them into the program. The way the program has been designed incorporates the lessons learned from what happened in the Cashgate and tries to ensure that does not happen again. But we should also stay away from individual cases as defined in the policy on governance and corruption.

Mr. Mkwezalamba made the following concluding statement:

On behalf of the Malawi authorities, I thank Directors for their support in concluding the 2018 Article IV consultation and in approving the three-year Extended Credit Facility (ECF) arrangement for Malawi. As Directors have rightly observed, the 2012-2017 period was quite challenging for Malawi. The country experienced exogenous shocks that contributed to slippages in program implementation. This notwithstanding, significant progress was made in achieving macroeconomic stability. In this regard, the authorities are determined to consolidate the gains made, as well as address the outstanding challenges articulated in the third Malawi Growth and Development Strategy (MGDS III) covering the 2018-2023 period, as well as the Article IV report. Fund support through the just-approved ECF arrangement will therefore be critical in the pursuit of the country's development agenda.

Directors have emphasized the need for the authorities to strengthen PFM, intensify the fight against corruption, and accelerate structural reforms. In addition, they have underscored the need for the authorities to strengthen the fiscal balance, maintain a tight monetary policy stance, and maintain exchange rate flexibility, as well as the automatic fuel pricing mechanism. I also take note of the question raised by Mr. Hurtado regarding the exchange rate flexibility for Malawi, which as we have always argued, has served the authorities well since 2012. The automatic fuel pricing mechanism has also served the country well since it was adopted. But there is still a need for some work to be done in this regard.

Steadfast implementation of the recommended policy actions and reforms will be instrumental to entrenching macroeconomic stability and bolstering sustainable inclusive growth. The recommended policy actions and reforms are highly appreciated and will be swiftly conveyed to the authorities. Going forward, the authorities reiterate their resolve to strengthen the fiscal balance and support growth-enhancing, poverty-reducing spending while containing inflation and ensuring debt sustainability. They also remain committed to improving PFM and procurement, accelerating structural reforms, and improving governance.

Mr. Doornbosch asked whether anything has been done about prosecuting people in connection with Cashgate. A number of people have already been taken to court. They have been convicted, and they are serving various jail terms. The longest jail term is 13 years.

To enhance inclusive growth, the authorities will step up efforts to improve financial intermediation, to raise the access and affordability of credit to the private sector. Furthermore, the infrastructure projects in the MGDS III have been carefully chosen to address the constraints to growth, such as shortages in electricity and building resilience, including in water and irrigation. Again, in pursuing these objectives, the support of the Fund will remain important.

In conclusion, I thank the mission chief, Ms. Mitra, and her team for their remarkable work and for providing comprehensive responses to the questions raised by Directors.

The Acting Chair (Mr. Zhang) noted that Malawi is an Article VIII member, and no decision was proposed.

The following summing up was issued:

Executive Directors agreed with the thrust of the staff appraisal. They commended the authorities for achieving macroeconomic stability, and noted that economic activity has rebounded after two consecutive years of drought, driven by a recovery in agricultural production. However, growth has been insufficient to significantly reduce poverty or improve weak social indicators. Moreover, the fiscal position deteriorated in 2017 and public debt has doubled over the past decade. While the medium-term outlook is broadly favorable, risks and vulnerabilities remain.

To address these challenges, Directors stressed the need for determined implementation of Malawi’s Growth and Development Strategy for 2018-23 and a strong commitment to the Fund-supported program under the Extended Credit Facility to entrench macroeconomic stability and ensure higher, inclusive and resilient growth. In this context, they urged the authorities to be mindful of political economy and capacity constraints faced in the past, and called for strong program ownership to achieve the ambitious growth and social-inclusion agenda.

Directors underscored the importance of the authorities’ fiscal adjustment plans in maintaining macroeconomic stability. They noted that domestic debt rose sharply after the withdrawal of donor budget support, securitization of arrears, and bank recapitalization, raising the debt service burden and reducing space for much-needed infrastructure and social spending. Directors stressed the importance of improving debt management and broadening the coverage of domestic debt through enhancing data on state owned enterprises (SOEs).

Directors cautioned against giving in to spending pressures in the run-up to the 2019 general elections and highlighted that increased spending efficiency will create room for more social spending and targeted infrastructure investment. Further, they emphasized the importance of prioritizing large investment projects, with concessional donor financing and private sector participation. Directors also underscored that public financial management and procurement reforms are necessary to address governance challenges and bolster donor confidence. Over the medium term, broad-based tax reforms will also foster a more efficient, transparent, and fair tax system.

Directors encouraged greater exchange rate flexibility to cushion against external shocks. They also highlighted the importance of strengthening the monetary policy framework and reducing fiscal dominance. Directors encouraged the authorities to strengthen banking supervision, while improving financial intermediation and access to finance.

Directors emphasized that structural reforms are essential for growth, job creation, private sector development, economic diversification and resilience. In this context, they noted the need to improve the quality and coverage of critical infrastructure, reduce regulatory burdens, and streamline judicial processes. Deep agricultural market reforms would also ensure food security and ease the burden on the budget.

It is expected that the next Article IV consultation with Malawi will be held in accordance with the Executive Board decision on consultation cycles for members with Fund arrangements.

The Executive Board took the following decision:

Malawi—Request for a Three-Year Arrangement Under the Extended Credit Facility

1. Malawi has requested a three-year arrangement under the Extended Credit Facility in an amount equivalent to SDR 78.075 million.

2. The Fund approves the arrangement set forth in EBS/18/28 (4/17/18), and decides that Malawi may request the first disbursement under the arrangement on the condition that the information provided by Malawi on the implementation of the measures specified as prior actions in Table 2 of the

Memorandum of Economic and Financial Policies attached to the letter dated April 13, 2018 from the Minister of Finance, Economic Planning & Development and the Governor of the Reserve Bank of Malawi is accurate. (EBS/18/28, 4/17/18).

Decision No. 16367-(18/38), adopted
April 30, 2018

APPROVAL: March 3, 2020

JIANHAI LIN
Secretary

Annex

The staff circulated the following written answers, in response to technical and factual questions from Executive Directors, prior to the Executive Board meeting:

Staff's responses to technical and factual questions are below. Broader policy questions, especially in the areas of program design and ownership, will be addressed in staff's oral intervention at the Board meeting.

Outlook/Risks

1. ***The staff raised the medium/long-term GDP growth projection for Malawi to 6.5 percent, which is 1.5 percentage points above Malawi's 10-year average, which seems optimistic in a country subject to considerable weather-related and other vulnerabilities. Did staff apply realism tools to the GDP growth projection?***

- The medium-term projections incorporate the authorities' plans for improvements in irrigation infrastructure, cropping techniques (including diversification away from only maize production), enhanced electricity generation, and better road networks. Notably, even small improvements in irrigation infrastructure can have a large impact on growth for this agriculture-based economy that depends on rain and a single harvest per year. The fruition of these infrastructure plans is likely as development partners have been actively assisting the authorities in all three of these areas and some projects are close to coming on line. Improved access to finance, supported by the ECF program, will help ignite private sector investment. Macroeconomic stability combined with the advancement of public financial management, procurement, and other reforms is expected to bolster confidence.

- The growth rate for the previous 10-year average resulted from a number of extreme shocks, including the Cashgate and the withdrawal of donor support and severe drought. It is difficult to project future shocks and incorporate them in our growth projections. Improved irrigation infrastructure (described above) is expected to reduce Malawi's susceptibility to climate-induced shocks.

2. ***The staff project excess liquidity in the banking sector to be further reduced, and private sector credit growth to pick up strongly in 2018 and the coming years. How realistic are these assumptions under tight monetary conditions, and how might slower than anticipated credit growth impact the optimistic medium-term growth outlook?***

- The staff projects credit to the private sector to increase to 4.1 percent in 2018, which is still below the growth rate in 2016 and below the 5-year average of 15.5 percent.

Clearly, slower than anticipated pick up in credit growth will impact growth rates. However, staff believes that the gradual pick up in credit growth is consistent with the projected growth rates.

3. ***Has staff engaged the authorities on specific measures to induce more FDI to support developmental needs?***

- The major obstacles to attracting FDI inflows are electricity outages, land rights issues, and a weak business environment. The reforms and infrastructure investments under the government's economic program aim to address the electricity shortage, improve irrigation systems, rebuild trust through PFM and procurement reforms, and solve access to land through land reforms.

4. ***Related to production levels, the food crisis in 2016 prompted Malawi's government to implement an export ban on maize which has lowered prices and decreased farmers' incentives to invest. Could staff comment if the authorities have expressed their intention to remove this ban and have the impacts of the ban been considered in the staff's growth projections?***

- The authorities have not yet committed to removing this ban. The BOP and growth projections do not incorporate any exports of maize during 2018-23.

Fiscal Policy

5. ***Can staff provide further justification for the envisaged consolidation path, especially for the 2017/18 fiscal year.***

- The programmed fiscal adjustment relies on reducing current spending while increasing – within the existing capacity – the more productive capital expenditure and maintaining the tax revenue effort. As noted by the Grays, the programmed fiscal position for 2017/18 reflects some adverse (and largely exogenous) fiscal developments. A more ambitious adjustment for that year did not appear attainable. Although the envisaged consolidation for FY17/18 only includes measures for the second half of the fiscal year (given that the mission took place more than halfway through the fiscal year), the programmed measures are sizeable. Cuts to domestically financed development spending and maize purchases equal 0.9 and 0.2 percent of GDP, respectively. We agreed with the authorities that wage outlays and expenditures on goods and services will be contained.

6. ***Is there the possibility of a deficit overrun in fiscal year 2019 and potential consequences for the further course of the program? Are sufficient safeguards in place?***

7. ***Given that spending pressures can reemerge around the upcoming elections, how confident is staff in the budget projections and have they discussed additional compensatory measures?***

- The staff and the authorities had intense discussions on how to avoid the budget from a deficit overrun in 2018/19. The strategy is to have conservative revenue projections given the risk of weak revenue performance; incorporate feasible consolidation measures; and budget for reasonable election expenditures.

- The staff were also reassured that additional compensatory measures would be taken should fiscal slippages emerge. Nevertheless, staff will work closely with the authorities to identify contingency measures and stick to the programmed primary balance, including through reducing transfers to public entities (combined with efforts to mobilize their own revenue sources) and mobilizing revenues.

- Note that most of the improvement in overall balance is explained by the one-off factors such as the bailout of ADMARC and securitization of arrears in FY17/18.

8. ***In the FY 2018/2019 budget, development expenditure has not been safeguarded in the and is projected to decline by about 0.9 percent of GDP (Text Table 3). Is it largely due to limitations in implementation capacity?***

- Domestically financed development expenditure in the pre-election year (FY17/18) was budgeted at a level four times higher than that in FY16/17. The authorities informed the mission that the implementation rate was much less than budgeted in the first six months of the year and that development spending could be cut in the non-priority areas. In line with the adjusted projection for FY17/18, the FY18/19 development budget was slightly reduced. The mission advised the authorities to benefit from the TA missions (one currently on the ground on public investment management) to study the capacity constraints and prioritize projects accordingly.

9. ***Could staff please elaborate on the proposed measure to increase—for instance—the budget share of tertiary education, given that its level seems to be high already?***

- As discussed in the selected issues paper, education spending has increased in Malawi, however, the outcomes have been mixed and mainly lagging in the secondary and tertiary education. The staff advised the authorities to first increase the efficiency of spending in these areas, and second, enhance the allocation mix of the education budget by directing a bigger share of the education budget to secondary and tertiary education (which receive about half as much support from the budget compared to primary education).

10. ***Authorities mention wage increases, hiring new teachers and an allocation in the budget for campaign financing which seems inconsistent with Fund's program objectives. Can staff comment?***

11. ***While noting significant fiscal deterioration for FY 17/18 in paragraph 6, staff also refers to the use of fiscal space created by a lower interest bill to increase wages and spending on goods and services. The reference to the use of fiscal space does not seem consistent with the further emphasis on the need to improve the fiscal position.***

12. ***Can staff elaborate on the specifics as to how the continued fiscal consolidation until 2020 and the increased expenditure in infrastructure and social ends will be achieved simultaneously?***

- A key program objective is to raise the amount of spending on infrastructure and critical social sectors, including education. This will be achieved in tandem with continued fiscal consolidation by channeling increased revenues and savings from reduced interest bills, increased spending efficiency, and reductions in non-essential spending.

- During FY2017/18, the authorities channeled the savings from a lower interest bill mainly to increase teachers' salaries increases (which were not increased in line with inflation during recent high inflation years). For FY2018/19, the authorities agreed to limit wage increases to the inflation rate and apply them to the lower grade levels (those paid less) and recruit new teachers, which is part of a long-standing plan to raise the teacher-student ratio (which was delayed in recent years).

- The 2018/19 budget reduced the fiscal deficit relative to 2017/18. The budget for the election campaign is a one-off and reasonable amount for an election year. Any budget slippages in this area would be compensated by other measures.

13. ***The buff statement says that the Debt Management Committee will assess all borrowing. We would like to hear staff's assessment on the effectiveness of this scheme.***

- The effectiveness of the Debt Management Committee will depend, in large part, on capacity considerations. The on-going PIMA mission will help assess strengths and identify gaps in the overall public investment management framework, including on the committee. Key recommendations from this technical assistance mission will be incorporated into the program.

14. ***Is staff confident that, with the most recent reforms in place, they now have a sufficient sightline on the problem to monitor this target effectively?***

- Most of the arrears relate to the Cashgate corruption scandal which revealed severe weaknesses in public financial management (PFM). Since Cashgate, the previous ECF focused heavily on the PFM issues, aiming to improve the budget process and gain control over fiscal operations. The new ECF is frontloaded with PFM conditionality in order to strengthen public finances, enhance transparency and minimize risks of future corruption cases. The envisaged conditionality aims to help the authorities routinize the most recent reforms and build upon them. For instance, the conditionality on arrears includes full settlement of old arrears and also closes the tap on them, preventing further accumulation (e.g. conditionality on applying sanctions on incurring arrears without the approval of Minister of Finance).

15. ***Can staff comment on whether they considered raising the overall risk rating based on domestic debt pressures?***

16. ***Could debt dynamics be further hampered in the case of a lower than expected economic performance or fiscal policy slippages? Can staff comment on whether there were discretional limitations to the perimeter of public debt applied in DSA as well as potential contingent liabilities.***

- In PV terms, total public debt is projected to breach the LIC DSA benchmark of 38 percent (for those countries with weak policies and institutions) and remain above the benchmark until 2023. This reflects a worsening of the primary deficit compared to the last DSA, notably in 2017 and 2018.

- Despite this, the risk rating remains at moderate. It is because the 2012 LIC-DSF only considers external debt for its overall risk rating even though benchmarks for total public debt to GDP have been introduced to help determine when to conduct deeper analysis of public domestic debt. In line with this guidance, we have included in the DSA update detailed analysis of the domestic debt profile, highlighted in the cover page that the risks are augmented by the increase in domestic public debt, and laid out detailed recommendations to reduce the overall need for financing, including domestically.

- The analysis done in the current DSA will transition well to the new DSA framework–the 2017 LIC-DSF template (the review was discussed at the Board in late 2017) is expected to be rolled out in the second half of this year–where we will formally assess <u>overall</u> public risk of debt distress (low, moderate, high, in debt distress) with numerical benchmarks, based on the sum of both domestic and external public debt. Under this new framework, the country would have high overall risk of public debt distress if the total public debt burden indicator would breach their corresponding thresholds under the baseline.

- The coverage of public sector debt in the DSA should be as broad as possible, including the obligations of the central government, regional and local government, the central bank, and public enterprises. However, in the case of Malawi, data limitations have limited the coverage of public debt to only central government (its ministries, departments and agencies), the Reserve Bank of Malawi, and the debt of SOEs that is guaranteed by the central government. Therefore, some debt may have been missed (particularly that of SOEs) in this DSA. Going forward, as part of program reporting requirements, we have asked the authorities to report borrowing of major SOEs as broader coverage of public debt is important for making the debt analysis more realistic. A technical assistance mission on SOEs, planned for later this year, will support this effort.

- Data limitations have also restricted incorporation of continent liabilities into this DSA. During the 1st review mission, we will discuss known and anticipated contingent liabilities for inclusion in the next DSA. The new DSA template also includes a contingent liabilities stress test.

Monetary, Exchange Rates, and External Sector Policies

17. ***The RBM will keep interest rates positive in real terms and will complete the transition to an interest-based operational framework, with the objective of adopting inflation targeting over the medium term. The staff may wish to indicate the degree of preparedness to this ambitious move.***

- The transition to inflation targeting will be gradual and will likely take place towards the end of the program. To prepare, the authorities are receiving considerable TA from the Fund, including on developing statistics and forecasting capacity, deepening financial markets, improving monetary policy operations.

18. ***We agree on the adverse crowding out effect of large government bank borrowing on credit to the private sector. Can staff indicate other factors specific to Malawi that can explain the very high interest rate spreads compared to peers, as well as their assessment of the degree of competition in the banking sector.***

- Operating costs are a major factor explaining the high interest rate spread in Malawi. Other factors include cost of evaluation, a high degree of bank concentration, monitoring, and enforcement which are elevated by a lack of shared credit information on borrowers, dysfunctional land company registries, and deficiencies in the insolvency laws and their administration.

19. ***We positively note the broad agreement between staff and the authorities on the monetary policy framework and exchange rate regime, and encourage the authorities to strengthen the governance and policy framework of the Reserve Bank of Malawi (RBM) further by curtailing quasi-fiscal operations. This transition will require additional technical assistance and we would like staff to comment on the respective specific plans.***

- In this context, the unwinding of a considerably large stock of government securities is important. This needs to be done gradually to avoid adversely impacting Malawi's financial markets. A technical assistance mission on debt management, planned for mid-June 2018, will help the authorities develop a strategy for the unwinding of this debt with particular consideration for liquidity implications.

20. ***The financing of the protracted negative balance of payments will depend on a significant increase in volatile aid flows while the structural current account problem appears to be largely unaddressed. We also would have appreciated further detail on the catalytic impact of the program.***

- Donors have signaled strong interest in providing increased financial support in the context of the IMF supported economic and financial program. For instance, provided all the prior actions are met (including ADMARC reforms), the World Bank is considering a $80 million budget support grant and the Board meeting on this is scheduled for late June. The donor community withdrew financial support amid severe trust issues exposed by the cashgate scandal. Going forward, the authorities' commitment to continued PFM and procurement reforms will help regain donor trust and attract more support.

- Over the medium term, given the large development needs, imports will also be large in line with stronger investment. This investment in electricity, irrigation, roads, and agriculture is expected to improve medium and long-term growth potential—by supporting reforms to the business environment and the financial sector—and ultimately, reduce aid dependence. It will also attract more FDI which is a more stable external financing source.

21. ***Can staff could elaborate on other financing sources—specifically regarding the assumption of "additional project support loans" in Table 4a. Can staff confirm that adequate financing assurances are in place for the next 12 months and beyond.***

- "Additional project support loans" refer to infrastructure-related loans that will be catalyzed by the program (beyond on-going or already confirmed project support loans). This additional project support focuses on priority areas such as water, power, and agriculture and are expected to be financed by the World Bank, African Development Bank, and other development partners. The probability of finalizing agreements on these projects are high following the approval of an IMF program. These development partners – who expressed strong interest in providing increased support to for Malawi's much-needed infrastructure development—expect the IMF program will address their governance concerns with steady progress in implementation of PFM and procurement reforms.

22. ***Given staff's estimates that the external position with the CA deficit of -10 percent of GDP is broadly in line with fundamentals, can staff elaborate more on how this conclusion is consistent with the significant fiscal consolidation envisaged in the program.***

- The significant fiscal consolidation envisaged in the program is critical to improving Malawi's debt sustainability.

- When assessing a country's external position, we consider several factors. First, the country's fiscal policy relative to the rest of the world (to ensure multilateral consistency). In this case, the so-called fiscal policy gap in Malawi (the difference between its fiscal position and the desirable level) is only slightly larger than the fiscal gap of the world average. Second, we also consider other factors specific to Malawi such as a persistent need for investment-related imports, structurally narrow export base, and vulnerabilities to weather shocks that structurally weaken the external position. As a result, on balance, the -10 percent of GDP CA deficit is broadly in line with fundamentals.

Financial Sector

23. ***The staff mentions that the RBM should be vigilant to the recent rise in foreign currency lending. Could staff elaborate more on its background and possible actions the authorities might have to take to contain its risk?***

24. ***Could staff also elaborate more on the factors behind the rise in the share in FX lending from 8 percent in 2012 to 28 percent in 2017 and potential risks from this development?***

25. ***Another risk highlighted in the buff statement is the recent increase in foreign currency loans. Can staff elaborate on the causes of this loan performance?***

- The increase in the share of FX lending over the past few years is mostly due to the rise in purchase of fertilizers, petroleum products, and other imports. On banks' balance sheets, this translates into a currency mismatch between assets and liabilities, exposing the banks to exchange rate risk. To reduce this risk of currency mismatch on banks' balance sheets, it will be important for the RBM to avoid forbearance with respect to the prudential norm on the net open position of commercial banks.

- ***We wonder whether the targeted 5 percent NPL ratio in 2018 is realistic given that the 2017 NPL ratio stood at 15 percent.***

- In Malawi, loans are concentrated in selected economic activities and contracted by a small number of large borrowers. This has resulted in heightened concentration risk. Payments by a few of these entities can reduce individual banks' NPLs. Consequently, the authorities plan to reduce systemwide NPL ratio to around 5 percent is feasible by end-2018. However, this may not be possible for some individual banks.

Structural Reforms

26. ***As electricity infrastructure will take some time to complete, do staff have suggestions on possible near-term options to address the regular and prolonged power outages that have weighed on the manufacturing sector, hindering economic activity?***

27. ***Can staff comment on what actions the authorities are taking to resolve the prolonged electricity outages and prevent further impacts on manufacturing activity?***

- In the near-term, the authorities have leased generators to make up for gaps, especially in urban electricity provision. Increased diesel imports related to the use of these generators has been incorporated in the balance of payments projections. In addition, during the second half of 2018, a hydro power generation facility that was under renovation will also be back in operation and a newly renovated major distribution grid is expected to be online.

- Over the medium-term, the authorities will apply a multifaceted approach including interconnectors to tap into the Southern African power pool (expected to be completed by end-2019), IPPs (the IPP framework is in place and an agreement on a large IPP project is close to being finalized), solar power, and new hydro power facilities (the World Bank is supporting a number of these projects).

28. ***How do staff intend to support financial sector development and economic diversification outside of the current benchmarks and targets in the ECF?***

- The staff is working closely with RBM in understanding the impediments to financial sector development and providing an overview of best international practices to overcome challenges. Our functional departments are also closely engaged with the authorities through technical assistance to improve bank supervision, strengthen both the primary and secondary debt markets and enhance RBM's capacity in management of monetary policy. Through their DPO, the World Bank is supporting the authorities in developing and implementing plans for further economic diversification of the Malawian economy.

Program Issues

29. ***We would welcome staff's reflections on how the new Framework for Enhanced Engagement on Governance could be used in Malawi.***

- Stepping up the Fund's engagement on governance in Malawi is extremely important as it can have a substantial economic impact. Please note that the mission and discussion with the authorities took place before the implementation of the new Framework for Enhanced Engagement by the Fund, which was adopted on April 6th. As such, the new Framework has not been applied to Malawi at this point. Nevertheless, the program identifies several governance vulnerabilities that will be addressed under the program—which is practice that is consistent with the new Framework.

- The program continues to address governance and corruption issues in the following areas: (1) severe weaknesses in PFM that facilitated the large-scale theft of public funds (cashgate scandal); and (2) weaknesses in procurement that set the stage for corruption in maize purchases from Zambia managed by the state-owned ADMARC (maizegate). The economic impact of these governance vulnerabilities has been considered. The staff found that PFM and procurement will remain major threats to good governance and the potential economic impact is significant. For example, cashgate coincided with growth being halved in 2015-16 due to a loss in confidence and withdrawal of donor support.

- Candid discussions with the authorities resulted in a multi-pronged approach with reforms prioritized by their potential economic impact and capacity considerations:
- Program policies continue to focus on reforming PFM, as in the recently completed ECF. Reforms from the previous program will be completed and the next phase of PFM reforms will be advanced, including improving fiscal transparency, monitoring, financial discipline, commitment controls, cash management, debt management, and integrity of the accounting system.
- Simultaneously, procurement reforms have commenced with a new Procurement Act which has been passed by parliament. The World Bank and European Union are

supporting the authorities in designing "good practice" mechanisms to implement this new act.

- The next priority will be engaging the authorities in enhancing the rule of law through a strengthened judiciary and interagency coordination framework (with support from the World Bank). In assessing governmental measures to prevent private actors from offering bribes or providing services that enable the proceeds of corrupt acts to the concealed, staff will assess the country's legal and institutional frameworks and provide recommendations on measures to further strengthen fiscal institutions and accountability frameworks, improving the AML/CFT framework, reforming asset disclosures, and improving tax compliance.

- At the time of the next program review and/or Article IV consultation, these and other issues will be assessed under the new Framework.

30. ***Does staff see any implementation-risks of reform agendas for improving governance under the new ECF arrangement?***

- The staff recognizes the authorities' capacity challenges in reform implementation. Nevertheless, given the authorities' renewed commitment to improving governance and its importance to ensuring effective budget execution, staff believes the non-implementation risks will be lower than in the past. To help navigate the implementation process, a substantial and carefully sequenced technical assistance program has been designed. Other risks include the loss of donor-financed funding for the reforms (e.g., for particular software, or capacity development).

31. ***It is not clear to us why the submission of amendments to the RBM Act are included as an end-October structural benchmark and not the prior action, given the explicit commitment in paragraph 24 of the MEFP to make the submission by mid-April 2018? We would appreciate if staff could confirm whether the submission has already been made?***

- The authorities drafted the amendments and were prepared to make the submission in mid-April. However, the Fund's technical experts on these issues (in LEG and FIN) identified inconsistencies in the draft amendments and made additional recommendations. These will take some time to be properly addressed by the authorities—including getting buy-in from all stakeholders. To this end, a LEG technical assistance mission, planned for June, will help provide outreach on the need for these amendments.

32. ***Are there are lessons learned from the previous ECF or similar countries that could be useful in the program implementation? Can the envisaged target could be complemented with other related structural interventions.***

- We agree that poverty is still a key challenge and the economy remains undiversified and vulnerable to external shocks. Box 2 provides suggestions on how to build resilience against future macroeconomic shocks, prevent humanitarian crisis, and reduce poverty. They include reform to the Firm Input Subsidy Program (FISP), reforms to the procurement process, and reduced market intervention. The IMF mission is ready to provide support in line with these policy recommendations which are mostly led by the World Bank. One step towards attaining these goals in the design of the new ECF has been redefining the social spending floor by targeting only the key areas and excluding the expenditures which did not insure food security including the iron sheet subsidy.

The staff will respond to the questions below, related to program design and ownership, during the Board meeting.

33. ***Could staff provide an overview on the major political parties' attitude towards further IMF engagement?***

34. ***From paragraph 12 we conclude that there are clear signs of political polarization, though we missed an assessment whether the program presented to the Board has sufficiently broad support across the political spectrum?***

35. ***We would be interested in staff's view on potential measures to ensure adequate policy implementation also between two consecutive arrangements.***

36. ***Political pressures in the run up to the 2019 elections may weaken policy discipline and reform efforts. What measures have staff taken to improve program performance under the new ECF arrangement?***

37. ***Would staff provide information on how the current ECF is designed to overcome the challenges identified in the post program evaluation?***

38. ***Can staff comment on what new approaches could be taken to ensure timely reform implementation while garnering strong political support?***

39. ***Can staff comment on how the program strikes a balance between ambition/front-loading of reforms ahead of elections vs. realism in light of capacity constraints? Which elements of the continuous structural benchmarks on PFM aim to lock in previous progress and which elements constitute additional, incremental progress?***

40. ***We welcome the proposed structural benchmarks on PFM-related measures listed in Table 3 of the LOI attachments. A footnote states that the benchmarks may be revised with a view to streamlining. The staff's comments on this would be appreciated.***

We would like to know the rationale of the current 20 Structural Benchmarks and if there is room for a further streamlined formulation.