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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 18/98-2

11:45 a.m., November 21, 2018

2. Malawi—First Review Under the Three-Year Extended Credit Facility Arrangement and Requests for Modification and Waivers of Nonobservance of Performance Criteria

Documents: EBS/18/96 and Correction 1; and Supplement 1

Staff: Mitra, AFR; Porter, SPR

Length: 29 minutes

Executive Board Attendance

T. Zhang, Acting Chair

Executive Directors	Alternate Executive Directors
D. Mahlinza (AE)	
	H. Razafindramanana (AF)
	E. Rojas Ulo (AG), Temporary
	G. Kim (AP), Temporary
	A. Souza (BR), Temporary
	P. Sun (CC)
	J. Rojas (CE), Temporary
	N. Feerick (CO), Temporary
	C. Just (EC)
	A. Castets (FF)
	K. Merk (GR)
	M. Roy (IN), Temporary
	M. Psalidopoulos (IT)
	Y. Saito (JA)
	S. Alavi (MD), Temporary
	F. Al-Kohlany (MI), Temporary
	J. Hanson (NE), Temporary
	K. Virolainen (NO)
	Z. Smirnova (RU), Temporary
	F. Rawah (SA), Temporary
	K.Tan (ST)
	P. Trabinski (SZ)
	J. Stockill (UK), Temporary
	P. Pollard (US), Temporary

H. Al-Atrash, Acting Secretary
S. Maxwell, Summing Up Officer
D. Jiang, Board Operations Officer
L. Nagy-Baker, Verbatim Reporting Officer

Also Present

African Department: P. Mitra, M. Pant, D. Robinson, A. Selassie. European Central Bank: T. Persico. Fiscal Affairs Department: A. Swistak. Finance Department: M. Zbasnik. Information Technology Department: F. Gheriss. Strategy, Policy, and Review Department: H. Lin, N. Porter. Statistics Department: J. Hur. World Bank Group: W. Battaile.

Executive Director: M. Raghani (AF). Alternate Executive Director: K. Obiora (AE). Senior Advisors to Executive Directors: W. Abdelati (MI), W. Kuhles (GR), O. Odonye (AE), T. Sitima-wina (AE). Advisors to Executive Directors: A. Abdullahi (AE), M. Bangrim Kibassim (AF), X. Cai (CC), J. Garang (AE), M. Ismail (AE), B. Jappah (AE), M. Mehmedi (EC), L. Nankunda (AF), N. Vaikla (NO), C. Wehrle (SZ).

2. MALAWI—FIRST REVIEW UNDER THE THREE-YEAR EXTENDED CREDIT FACILITY ARRANGEMENT AND REQUESTS FOR MODIFICATION AND WAIVERS OF NONOBSERVANCE OF PERFORMANCE CRITERIA

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

Introduction

Our authorities appreciate the constructive dialogue during the recent program review mission. They broadly concur with the staff appraisal and key policy conclusions. The Extended Credit Facility (ECF) arrangement remains instrumental in anchoring the macroeconomic policy framework and supporting the objectives of the national development strategy.

Malawi continues to focus on entrenching macroeconomic stability, with the ultimate objective of bolstering higher and more inclusive growth to reduce poverty. As part of this effort, our authorities are steadfastly implementing the third Malawi Growth and Development Strategy (MGDS III) 2018–23, which focuses on enhancing competitiveness and building resilience through growth-enhancing investment and economic diversification.

To consolidate these efforts, our authorities look forward to the Executive Directors' support for the completion of this first review under the ECF arrangement, which would give impetus to the implementation of the MGDS III, support governance reforms and catalyze concessional financing for infrastructure development. Further, they request for modification and waivers for non-observance of two performance criteria.

Performance under the ECF Arrangement

Despite the fiscal pressures, the authorities remain committed to a successful implementation of the program. All four prior actions related to structural benchmarks in public financial management and the financial sector have been met. In addition, 4 of the 6 quantitative performance criteria (QPC) for end-June 2018 were met, with the QPC on net international reserves being met with a significant margin, as was the QPC on holdings of government securities by the Reserve Bank of Malawi (RBM). The QPC on stock of reserve money and the continuous QPC on the non-accumulation of external payment arrears were also observed.

The QPC on the primary fiscal balance was missed by 0.9 percent of GDP due to unexpected maize purchases to ensure food security, court-ruled arrears settlements, and expenditure overruns related to safety measures for the forthcoming general elections. The continuous QPC on new non-concessional external debt was missed due to a technical oversight in the Technical Memorandum of Understanding (TMU). To correct these slippages, the authorities have tightened the primary balance for FY2018/19 and are taking measures to strengthen debt management capacity. On the basis of these corrective measures, our authorities request waivers for non-observance of two QPCs.

Recent Economic Developments and Macroeconomic Outlook

Malawi's real GDP growth is expected to moderate from 4 percent realized in 2017 to 3.2 percent in 2018. This slowdown is attributed to low agricultural output and constraints in manufacturing and, wholesale and retail trade emanating from electricity shortages. Growth in 2019 is expected to rebound to 4.0 percent reflecting increased electricity generation and growing infrastructure investment. Medium term prospects remain positive with growth projected to reach around 6.5 percent supported by robust agricultural production driven by improved irrigation infrastructure, enhanced electricity generation, better road and telecommunications networks, and greater access to finance for the private sector.

Headline inflation reached 9.5 percent in September 2018 from 7.1 percent at the end of 2017 owing to higher maize prices and cumulative increases in electricity tariffs. Over the medium term, inflation is projected to remain in single digit territory at around 5 percent aided by the continued implementation of tight fiscal and monetary policy and, low food prices.

The current account deficit narrowed from 13.6 percent in 2016 to 11 percent of GDP in 2017. It is projected to improve further to 9.3 percent in 2018 due to an increase in global demand for tobacco. Over the medium term, improvements in competitiveness, export diversification, and fiscal restraint as well as an increase in GDP growth are anticipated to gradually narrow the current account deficit to around 7.5 percent, with foreign reserves rising to 4.5 months of prospective import cover.

Fiscal Policy and Public Financial Management Reforms

The authorities are committed to pursue a fiscal policy stance aimed at preserving debt sustainability, while safeguarding social spending. In this regard, steps have been taken to tighten the primary balance for FY2018/19 and will continue to enhance domestic revenue mobilization by implementing broad based tax reforms, rationalizing expenditures, and enforcing controls to prevent the reemergence of domestic payment arrears. The tax reform measures include streamlining tax incentives, repeal of the industrial rebate scheme, widening the corporate tax base, introducing a thin capitalization or earnings stripping rule, and expanding the coverage of VAT. Furthermore, the Malawi Revenue Authority (MRA) will be rolling out the integrated tax administration system (ITAS), branded “msonkho-online” that is expected to enhance overall tax administration in the country. On non-tax revenue, the authorities plan to reinforce remittance of dividends from state-owned enterprises (SOEs) and increase fees and charges on some government services to maintain their real values and progress towards marginal cost pricing.

On the expenditure side, controls have been enhanced to avoid further accumulation of domestic arrears, and recourse to domestic financing from the RBM has been curtailed. In this connection, the authorities have tightened commitment controls and established a system to track the stock of commitments for all MDAs. Expenditure rationalizing will include cuts to non-priority goods and services while subsidies to SOEs and statutory bodies will be reduced in tandem with improvements in their revenue generating capacity. The oversight and reporting of all SOEs will be enhanced to preclude contingent fiscal risks. Building on the recommendations of recent IMF technical assistance in this area, the authorities will issue revised regulations, policies and guidelines for monitoring SOEs. A pilot audit report of the largest SOEs and a consolidated annual report of SOEs will be submitted to Parliament. In addition, the authorities are working towards enhancing efficiency and effectiveness in public investment management and procurement as they address infrastructure gaps. In this regard, funding to domestically-financed capital spending will be aligned with implementation capacity.

Considerable progress has been made in public financial management reforms, including establishing a fully functional Cash Management Unit, improving commitment control, and enhancing debt management and monitoring capacity. The authorities have developed a comprehensive medium-term debt strategy which will be updated continuously. To maintain debt sustainability, our authorities have suspended the contracting of new non-concessional external debt. In exceptional cases and in the context of later reviews, non-concessional borrowing will be considered on a case-by-case basis for priority growth-enhancing projects, supported by independent third-party feasibility studies and fiscal measures consistent with maintaining a moderate risk of external debt distress. The authorities will also be expanding the coverage of IFMIS to enhance controls, improve fiscal reporting to instill confidence in the budget system and reduce vulnerabilities to corruption.

Monetary, Exchange Rate and Financial Sector Policies

Our authorities are committed to maintaining a tight monetary policy stance to keep inflation on a declining trajectory while keeping real interest rates significantly positive. Policy rate decisions will aim to firmly anchor inflation expectations. The RBM will thus keep interbank rates within the corridor established around the upper limit of reserve money. Over the medium-term, the RBM intends to complete the transition to an interest rate-based operational framework and adopt inflation targeting. To this end, they will continue to improve primary and secondary market operations to further strengthen monetary policy transmission. Further, they will continue to expand capacity in developing high frequency data, liquidity forecasting, as well as the forecasting and policy analysis system (FPAS) modeling. In the meantime, supported by greater fiscal discipline, our authorities believe that the current policy framework will be sufficient to anchor inflation expectations.

While acknowledging the 2017 AREAER reclassification, our authorities reiterate their full commitment to the floating exchange rate regime. They emphasize that their interventions are not intended to stabilize the exchange rate but to mainly accumulate reserves and smoothen the seasonality of FX supply. To achieve greater exchange rate flexibility, which is critical in absorbing shocks and supporting economic diversification, our authorities will develop a well-sequenced action plan, which will deepen the interbank FX market and moderate their role to reducing excess volatility and accumulating reserves when required.

Safeguarding financial sector stability and resilience remains a key priority for the authorities. The banking system is well capitalized and profitable, and resilience has continued to improve. The level of non-performing loans (NPLs) declined from 15.7 percent at end-2017 to 9.3 percent in August 2018, reflecting write offs and loan recovery. At the same time, provisions almost doubled in keeping with IFRS9 requirements. The authorities continue to closely monitor and enforce compliance with prudential norms and are working with commercial banks to improve their business models and reduce most banks' NPLs to around 5 percent by end-2018. In addition, the RBM is actively engaging with commercial banks to improve credit to small and medium size enterprises (SMEs) and to develop a roadmap for increasing access to finance. To strengthen the asset declaration system and support the authorities' anti-corruption efforts, regulations related to the revised AML/CFT framework enacted in 2017 are being developed with a plan to gazette them by December 2018.

Structural Reforms

The authorities realize that in pursuit of the national development objectives, far reaching structural reforms will be necessary to complement macroeconomic policies, reduce vulnerabilities to corruption and catalyze donor support. In this regard, they will continue with reforms to address governance challenges, including further strengthening public finance management and improving the investment climate by continuously addressing the various doing business indicators. To enhance inclusive growth and address inequality, they will step up efforts in financial intermediation to boost access and affordability of credit.

Conclusion

Our authorities reiterate their commitment to enhancing governance, entrenching macroeconomic stability, and attaining higher sustainable inclusive growth. They value Fund support in pursuing their national development agenda and look forward to the Executive Directors' support in completing this review. Going forward, they will continue to implement an appropriate policy mix of prudent fiscal and monetary policies, complemented by growth enhancing structural reforms.

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

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

We support the First Review under the three-year Extended Credit Facility (ECF) Arrangement and Request for Modification and Waivers of Nonobservance of Performance Criteria, and thus the proposed Decision. We base our support on the recent progress and corrective measures, and the positive outlook described in the staff report. Additionally, as expressed by the authorities in their Letter of Intent, they maintain their commitment to implemented policies agreed in the macroeconomic program supported by the ECF in line with the Malawi Growth and Development Strategy III to promote inclusive and resilient growth. We concur with the report's recommendation to continue implementing appropriate macroeconomic policies and strengthening governance to achieve inclusive and resilient growth.

The economy of Malawi is showing a favorable performance although the outlook remains challenging. The country has made important progress implementing corrective actions to improve macroeconomic conditions such as reducing inflation and strengthening the financial and fiscal sectors. Notwithstanding there are continued significant challenges to the economy coming from climate shocks, power shortages, spending pressures, and the political cycle. Economic growth is projected at 4.0 percent in 2019 and is expected to stabilize at around 6.5 percent in the medium term, driven by improved infrastructure, better cropping techniques, and donor assistance. Still, as staff notes, the medium-term growth projection is 1.5 percentage points above the average of the last decade. How confident is staff that such a high growth rate is within reach?

The strategy to strengthen fiscal targets is appropriate to achieve fiscal consolidation and preserve sustainability in the long term. The overall balance and the primary balance deteriorated in FY 2017/18 due to increased expenditure overruns and the deficit was financed domestically. Nonetheless, corrective measures have been implemented to tighten the primary balance for FY 2018/2019 in line with the targets of the ECF agreement to adjust efficiency through combining policies to improve the composition in public expenses, increase revenues, and mobilize financing with donors to generate fiscal space. We support the implementation of structural reforms centered on public investment management, SOE oversight, governance, and transparency to improve economic outcomes.

Staff suggests that there is some space to absorb shocks, but sustained efforts are required to bring the debt path on a sustainable track. As shown in the debt sustainability analysis report, the risk of external debt distress is moderate but there are important vulnerabilities for public domestic debt, leading staff to judge that the overall risk of debt distress is high. We support the implementation of fiscal policies to enhance resiliency to absorb shocks, such as improving fiscal discipline, strengthening public financial management, prudent project selection limiting non-concessional financing, and further diversifying the economy.

The financial system’s soundness indicators are improving but further efforts are necessary to maintain the resilience of the system. We welcome the authorities’ efforts to improve financial stability indicators, with a remarkable decline in non-performing loans in the last year, although we note that they are still high. The authorities should continue monitoring the banking system and controlling the capacity of resiliency against credit, liquidity, and interest shocks, mainly in small banks. We support staff’s recommendation to improve the efficiency of the banking system, implement tools for banks' risk management, and increase financial literacy. We encourage the authorities to continue efforts to enact regulations related to the revised AML/CFT framework.

The monetary policy stance has been appropriate, and the inflation rate is being contained. The Reserve Bank of Malawi has maintained the policy rate, the nominal exchange rate has been stable, inflation remains in single digits, and the external sector is expected to gradually improve. We concur that given current inflationary pressures a tight monetary policy stance remains appropriate, while greater exchange rate flexibility will be critical to cushion external shocks and enhance competitiveness. We support the staff's recommendation to deepen the interbank market and development a more transparent auction-based system of FX intervention systems.

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

Mr. Villar and Mr. Rojas Ramirez submitted the following statement:

We welcome the discussion on the first review under the ECF arrangement. We thank the staff for the report, and Messrs. Mahlinza and Sitima-wina for their buff statement. We agree with the staff in supporting the authorities' request for completion of the first review under the ECF arrangement and for a waiver of non-observance for the missed QPCs, provided the authorities' commitment to corrective measures.

As stated by the staff, building a solid public financial management and restoring governance are crucial for sustained macroeconomic stability. We coincide that improving governance and transparency and reducing vulnerabilities to corruption are paramount to improve economic outcomes and catalyzing badly needed donor support. We would ask staff to elaborate on the obstacles still faced in order to see clearer progress on this front.

Program performance on the fiscal stance has missed the QPC on the primary fiscal balance. The indicative target (IT) on domestic arrears was missed as well out of an over-performance in the social spending IT. On the side of Structural Benchmarks (SB), several reforms to improve transparency and strengthening fiscal accountability were missed. However, the authorities are committed to and have been undertaking corrective fiscal and debt management measures as well as the completion of prior actions.

The authorities have implemented a cautious and tight monetary policy aimed at anchoring inflation and preparing for inflation targeting policy. The program has performed well. Most QPCs in the monetary and external sector have been met. The financial system is well capitalized and presents a low NPL indicator in 2018. We commend the authorities on efforts to align the AMC/CFT to best standards. Still, we concur with the staff on the importance of deepening the interbank market and of further flexibility and transparency in the FX market.

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

We thank staff for their report and Mr. Mahlinza and Mr. Sitima-wina for their informative buff statement. We support the completion of the first review under the Extended Credit Facility Arrangements and the Requests for Modification and Waivers of Nonobservance of Performance Criteria. We commend the authorities for their display of resilience as they navigate through the many development challenges facing Malawi, including adverse weather-related shocks, high inflation, electricity shortages, and drought induced food security issues. We acknowledge progress on program performance with most QPC met and significant overruns in some areas. We welcome the authorities' commitment to corrective measures to missed QPCs and their strong policy actions in the second half of 2018. In this regard, we support the modification of the end-December 2018 PCs for the primary fiscal balance.

A tighter fiscal stance should be pursued to correct for the fiscal slippages. We agree that there is a need to scale back on non-priority spending and enhance tax revenue by streamlining incentives, expanding the VAT base and improving compliance. We are concerned that the forthcoming election may slow progress on tax reform measures and put additional pressure on public spending. Can staff comment on what strategies will be needed to preserve political support for these needed reforms? We welcome the increased attention to SOE oversight to help contain fiscal risks. Issuing regulations for SOE oversight will help, but extensive training on reporting and oversight will be needed to institutionalize sound monitoring of SOEs.

Weakness in governance, including the persistence of corruption concerns, has been a key factor limiting Malawi's development. Efforts to improve governance should be fast-tracked and supported with more resources, targeted training and technical assistance. Notwithstanding the reform progress to date, we are concerned that donor funding remains low due to lingering governance concerns following the 2013 cash-gate scandal. The governance concerns remain high even after completion of the previous arrangement and into a new three-year ECF arrangement. As noted in the previous Article IV report, progress on PFM reforms had generally been slow and remain incomplete, and 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 which enables the resumption of donors' budget support? Are there sufficient training and technical support provided to implement the PFM reforms?

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

We thank the staff for an informative paper and Mr. Mahlinza and Mr. Sitima-wina for their insightful buff statement. Given that the country is suffering from insufficient rain, which has brought one-sixth of the population under food insecurity, and increased maize imports, the efforts made by the authorities in achieving program-mandated targets are commendable. It will be useful if the authorities make vigorous efforts towards diversifying the economic production structure, completing the fiscal adjustment as required and reducing inflation while encouraging credit off-take through microfinance channels.

While the quantitative performance criteria (QPC) for primary fiscal balance and new non-concessional external debt were missed, the authorities have committed to corrective measures for program fiscal targets and strengthening debt sustainability. Other QPCs and all the structural benchmarks have been met, albeit some with delays. We support the completion of the first review of the Extended Credit Facility as well as the authorities' request for modification and waivers for non-observance of two performance criteria.

While Malawi has been adjudged to be a fragile state, the staff report appears to have treated Malawi almost like any other country rather than one requiring distinctive treatment. There does not appear to be any particular cognizance of the fragility of this economy which has been underperforming, even when compared with other neighboring and global fragile state indicators like per capita GDP and poverty. In the recent IEO evaluation of IMF's approach to fragile member states, its impact was found to be falling short of what could be achieved, and specific recommendations were made on how this shortcoming could be corrected. In what way have efforts been made in the case of Malawi to adapt IMF policies and practices to its needs as a fragile state, especially with regard to the country-specificity of IMF advice and conditionality and collaboration with other development partners in a country beset with real sector challenges?

Malawi's agriculture is weather-dependent and heavily reliant on rain-fed irrigation. Hence, increasing diversification and weather-proofing the economy is needed to offset the dependence on agriculture. The population is largely rural, and two-thirds of the population is dependent on agriculture for their livelihood. A key obstacle to reducing the widespread poverty is low agricultural productivity and frequent disruption of the sector's activities by weather shocks and insect infestations. The staff report projects GDP growth rate to accelerate to 6.5 percent over the medium-term (average for 2012-17 is 3.7 percent) assuming inter alia better irrigation and cropping techniques. Since problems in the agriculture sector appear to be long-standing and critical issues in Malawi, we would like to know what concrete measures are being taken currently for improving irrigation and cropping techniques.

Donor funding for the budget remains low, reflecting continued governance concerns after the 2013 cashgate scandal and slow reform implementation. Progress towards attaining SDGs also appears to be constrained by the insufficiency of fiscal space. Given the critical nature of these issues, have relevant experts been put in place on a long-term basis in the country to advice the authorities on resolution of these issues?

Electricity shortages appear to be affecting manufacturing and wholesale and retail trade in the economy. Expansion of these sectors is crucial for diversification of economic activity in Malawi. The cumulative increase in electricity prices since February has pushed inflation up to very close to double digits after significant reduction in the previous years. Why have electricity prices increased so sharply and what steps are being taken to increase its supply?

Fiscal adjustment is important and cutting down on wasteful expenditure would be as important as the efforts towards increasing revenue which has been detailed in the staff report. The report mentions that authorities are considering a freeze on replacement hiring. What is the percentage of government expenditure on the wage bill and how does this compare with peer countries? Does staff feel that the IMF can help in resumption/augmentation of fund flows to the government which had suffered from cuts in the recent past?

Stress tests highlight vulnerabilities of total public debt to exogenous shocks. However, the full extent of public debt appears to be unknown, given the currently limited coverage of public debt, arising from weak SOE oversight and monitoring. The staff report mentions several initiatives to improve the same. Information on the number of SOEs, their share in GDP and whether they publish their annual balance sheets on a regular basis, would be welcome.

Inflation control measures of the central bank should be accompanied by growth-enhancing policy measures. While maintaining tight fiscal and monetary policies is necessary to reduce inflation for restoring private sector confidence, fostering growth, and building a solid foundation for reducing poverty, the tight monetary policy is resulting in tighter bank lending conditions and stalled credit off-take. The authorities could boost credit for productive purposes by small and medium enterprises by encouraging micro-finance lending and institution of self-help groups which have proved to be useful in many countries in similar stage of development. Can staff provide information on micro-finance related initiatives in the country?

We wish the authorities in Malawi all success in their future endeavors.

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

We thank staff for the insightful report and Mr. Mahlinza and Mr. Sitima-wina for their helpful buff Statement. Despite delays in accomplishing structural benchmarks and considering the overall program performance, we can consent to the completion of the First review and the requested modification and waivers of nonobservance of the performance criteria.

Economic growth in recent years remains moderate, despite an optimistic medium-term forecast. As we – and other chairs – highlighted in the occasion of the Extend Credit Facility's request, medium-term growth projections of 6.5 percent are over-optimistic. Despite the positive contribution of the previous ECF, the past average growth remained under 4 percent of GDP and inflation, although at the single digits level, remained above expectations. At this stage, current progress is not enough to sustain the prospected economic recovery due to country's vulnerabilities: pervasive poverty, food insecurity and infrastructural criticalities are long-standing issues challenging the growth potential.

Malawi's authorities meet most of the Quantitative Performance Criteria (QPCs). Nonetheless debt sustainability remains concerning. The missed QPCs on the primary fiscal deficit and new non-concessional debt are concerning. Moreover, the delayed completion of the SBs related to debt management (as well as the reported data limitations) is unfortunate. Since the last HPIC debt relief, in 2006, total public debt more than doubled (despite the 2008 Exogenous Shocks Facility, and the 2010 and 2012 Extended Credit Facility arrangements). The updated DSA assessed Malawi to be at high overall risk of debt distress confirming the doubts we expressed in the past. For these reasons, we urge authorities to step up their efforts to strengthen the fiscal position and preserve debt sustainability.

Fiscal discipline and enhanced public management are most needed. Fiscal consolidation should be complemented by governance reforms, especially in debt management, monitoring of state-owned enterprises and spending efficiency. While streamlining current expenditures, authorities should prioritize resilience-building efforts. Continued governance criticalities are delaying both donors and World Bank support. In this regard, we repeat our invite to implement envisaged structural reforms and to fight corruption in order to strengthen administration’s reliability, accelerate donors’ re-engagement and attract new investments.

We stress the need to support a more inclusive and resilient growth. While we commend the authorities to have met the Indicative Target on social spending, we urge them to prioritize poverty reduction interventions. Since the beginning of the last ECF, in 2012, GDP per capita remains constant and well behind regional peers and other fragile states. We wonder if program design can support authorities in this task given the short-term and overall economic impact of this issue. Staff comments are welcome. Authorities should take advantage of current demographic trends capitalizing on population growth and diversification opportunities. We would appreciate a greater attention on employment dynamics (e. g. child labor’s issue). At the same time, it is important to sustain economic diversification, to broaden financial access and to strengthen the banking system.

Tight monetary policy remains appropriate while the exchange rate should be more flexible. The recent inflation decrease was impressive, but enduring inflationary pressures call to a continued tight policy. We share staff’s advice to increase exchange rate flexibility while maintaining strong international reserve buffer. At the same time, we call authorities to guarantee financial stability strengthening banking, developing early warning systems and aligning the AML/CFT framework with international standards.

Mr. Virolainen and Mr. Vaikla submitted the following statement:

We thank staff for the comprehensive report on Malawi's first review under the Extended Credit Facility (ECF) arrangement and Mr. Mahlinza and Mr. Sitima-wina for their informative buff statement. We welcome the authorities' commitment to the program objectives, while we note that the performance criteria on the primary fiscal balance and non-concessional external debt were missed only two of the structural benchmarks, criteria for the period May-October were met. Based on the authorities' commitment to corrective measures, we support the completion of the first review and requests for modification and waivers of nonobservance of performance criteria. Going forward, we urge the authorities to implement the program fully and timely. We broadly agree with the staff's appraisal and would like to make the following comments for emphasis.

We welcome the positive economic outlook, while downside risks dominate the near-term perspective. We note that staff is rather optimistic about the economic outlook, expecting GDP growth to accelerate over the medium term on the back of improved infrastructure, enhanced electricity generation, increased donor assistance, and greater access to finance. While these developments would be positive, we note that they are very dependent on strict reform implementation, improvements to governance, and prudent macroeconomic policies. Furthermore, several external risks, such as tighter global financial conditions or adverse weather conditions, if realized, could endanger the current positive outlook.

Fiscal slippages in FY 2017/18 call for stricter fiscal discipline to preserve debt sustainability. The higher expenditures on public safety, additional maize purchases to ensure food security, and payments of past arrears resulted in a higher than planned fiscal deficit. We welcome the authorities' commitment to tighten the fiscal stance for the upcoming fiscal year. Since the upcoming elections could raise pressure on spending, we urge the authorities to strengthen the control of public expenditure and implement prudent and well managed fiscal policies. Moreover, improving revenue mobilization, strengthening SOE oversight and enhancing public investment effectiveness would improve the fiscal performance and support priority social spending over the medium term.

A critical factor limiting Malawi's development is governance, including weak transparency and a high corruption level. We welcome the initiatives to strengthen the central bank´s independence through legislation and by reducing its domestic government debt holdings. We commend the authorities for developing a multi-year strategy to unwind the RBM's holdings of government debt and stress the importance of clear communication to market participants. To catalyze donor support after the recent scandals, it is critical to implement public financial management and procurement reforms, enhance the asset disclosure system, and foster fiscal transparency. In addition, we urge the authorities to align the AML/CFT framework with the international standards.

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

We thank staff for the reports and Mr. Mahlinza and Mr. Sitima-wina for the helpful buff statement. We commend the authorities' efforts to achieve higher and more inclusive growth, including implementing the third Malawi Growth and Development Strategy (MGDS III) 2018–23. We support the completion of the first review under the ECF and the authorities' request for the waivers and would like to limit ourselves to the following points for emphasis.

Fiscal policy stance should remain prudent to preserve debt sustainability. We take positive note that the authorities will cut non-priority spending, and that the domestically-financed capital spending will be better aligned with implementation capacity. Since the prolonged electricity outages weigh significantly on manufacturing, we encourage the authorities to increase the needed infrastructure investment, especially electricity, without elevating the risk of debt distress. Enhancing public investment management is critical. With emphasis on the efficiency and project returns, we encourage the Fund to provide more technical assistance in this respect. Reducing subsidies to SOEs and statutory bodies in tandem with improvements in their revenue generating capacity is a step in the right direction. Staff's recommendations should be considered to improve the automatic fuel pricing mechanism to reduce government subsidies.

A tight monetary policy stance together with greater exchange rate flexibility can play a vital role in reining in inflationary pressures. We encourage the authorities to increase exchange rate flexibility and deepen the interbank market. Banks' risk management and analysis of collateral quality should be further improved. Given the rapid rising of FX lending, we encourage the authorities to closely monitor the development of borrowing activities, especially FX lending, and be ready to introduce more macroprudential measures when needed. It is encouraging that the Reserve Bank of Malawi is actively improving credit to small and medium size enterprises and developing a roadmap for increasing access to finance. We associate ourselves with staff that developing skills in the banking sector and improving banking system efficiency are also important.

We welcome the authorities' commitment to the structural reforms to boost potential growth and reduce poverty, including reform to address governance challenges. We are concerned about the continued low level of donor funding for the budget. Could staff explain the reasons why the World Bank may delay the disbursement? How much more donor support could be catalyzed following the completion of the first review? We encourage the authorities to continue improving 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. Merk and Ms. Kuhles submitted the following statement:

We thank staff for the well-written report and Mr. Mahlinza and Mr. Sitima-wina and for their helpful buff statement. Malawi's economy continued to grow, albeit at a somewhat lower pace due to a weak agricultural harvest and persistent power shortages. Inflation increased but remains in single digits due to a tight monetary policy stance. The current account deficit decreased and the exchange rate remained stable against the U.S. dollar. While the outlook is generally positive, significant vulnerabilities persist. Fiscal slippages and slow reform progress are symptoms of substantial governance challenges, which might further affect donor support. Risks are tilted to the downside and are mainly related to potential weather and pest shocks as well as spending pressures in the run-up to the election and slow reform implementation. Against this backdrop, it is imperative that the authorities remain strongly committed to the adjustment program and strengthen reform implementation in order to increase their credibility and consequently also donor support.

The overall program-performance has been mixed. While most quantitative performance criteria were met, two performance criteria have been missed. We take note that the continuous QPC on new non-concessional external debt was only missed due to a technical oversight in the Technical Memorandum of Understanding. Regarding the fiscal PC, we regret that the primary balance target was missed by a significant margin. We take note that the authorities will tighten the primary balance for the fiscal year 2018/19 by 1.1 percent of GDP as a corrective measure. In combination with the lower-than-envisaged budget support and the weaker-than-projected growth outcome this year, this appears to vindicate the need to adjust the performance criteria for the end-December 2018 test date. The progress in the program-supported reforms advanced, but only two structural benchmarks were implemented completely and on time. Moreover, one out of two ITs was missed. Against this background, reluctantly, we can go along with the program review, the requests for modification and waivers of non-observance.

It is regrettable that the fiscal balance deteriorated compared to the projection at program request. This is even more disappointing given intense discussions between staff and the authorities on how to prevent a budget deficit overrun prior to the program request. The overall weak program performance during the 2012-2017 ECF program already raised substantial doubts about the authorities' program ownership and reform commitment and led to a significant decrease in aid flows. Therefore, it is imperative that the authorities strictly adhere to a prudent policy stance and prevent any slippages going forward. One of the main reasons for the expenditure overrun was increased spending to secure safety during elections. In this context, we wonder which developments have led to the additional spending needs and whether these could have been foreseen at the time of the program request. Staff comments are welcome.

We take positive note of the authorities' commitment to tightening the fiscal stance. In order to strengthen revenue collection and reduce spending pressure, we encourage the authorities to broaden the tax base, improve tax administration, and fully implement the automatic fuel price mechanism. Given prevalent fiscal risks with regard to SOEs, we strongly encourage the authorities to improve oversight and reporting of SOEs, which will help to gain a more detailed picture of the debt structure of the government. In light of the heightened risk of debt distress, a meaningful reduction in the country's elevated public debt burden will be crucial. The authorities should thus uphold a prudent fiscal stance over the medium term to preserve debt sustainability. Moreover, given substantial pressures from interest payments, we strongly advise the authorities to strictly refrain from additional financing on non-concessional terms.

We welcome the authorities' commitment to maintain their tight monetary stance. This will be key to keep inflation in single digits. We encourage the authorities to further improve the monetary framework. Strengthening central bank independence and avoiding fiscal dominance continue to deserve priority. We thus welcome that the RBM reduced its holding of central government debt and encourage the authorities to continue this process as the RBM is still the largest creditor of public domestic debt. We encourage the authorities to further increase exchange rate flexibility in order to be able to effectively cushion external shocks. We understand that the

FX interbank market needs to be strengthened first and thus join staff's call for a well-sequenced action plan, including a gradual development of the interbank market and clear and transparent communication of the RBM's role.

We share staff's view that improving governance and transparency and fighting corruption is imperative to strengthen economic outcomes and improve donor confidence. We thus take positive note of the authorities' commitment to improve governance and encourage them to prioritize their efforts on structural reforms to strengthen transparency, governance, and accountability in public institutions and state-owned enterprises. Tangible progress in removing persistent weaknesses in public financial management, reforming the procurement framework and establishing anti-corruption and disclosure legislation should remain key and precede any large-scale infrastructure investment. Also, implementation of current and new regulations is key and accountability in this regard should be strengthened. Breaches, in particular of regulations concerning public finances at national and local level and in SOEs, should be sanctioned accordingly. Longer-term challenges include lessening the dependence on aid flows and diversifying the economy.

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

We support the completion of the first review and proposed decision. Most quantitative performance criteria (PC) for this review were met, and the authorities have agreed on corrective measures related to the missed PC and structural benchmarks as part of their commitment to the program.

We are nevertheless concerned that Malawi's growth rate has declined to below its population growth rate, especially given its poverty rate which is above 70 percent. Malawi is among the poorest countries in the world, requiring substantial development and humanitarian needs. Malawi's goal of achieving medium-term growth of 6½ percent seems very ambitious and will require significant efforts to address bottlenecks.

These challenges are compounded by Malawi's high risk of debt distress. The planned tightening of the primary fiscal deficit is appropriate in this regard. However, additional attention should be given to contingent liabilities, including those of SOEs and local governments. We welcome the program's focus on creating fiscal space for development spending, including by improving revenue mobilization, rationalizing current spending, and improving the effectiveness of development expenditures. Donor budget support is also essential to meet the serious development and social needs, and we hope that the governance and business reforms will facilitate the disbursement of pledged aid. Public finance reforms are key to restore confidence and unlock external grants.

Continuing the tight monetary policy stance is appropriate. Inflationary pressures are expected to persist, reflecting a weak harvest and fuel and electricity tariff increases. We note staff's positive assessment of the authorities' improved capacity in developing high frequency data, liquidity forecasting, and the forecasting and policy analysis. These, along with a clear communication strategy, will enhance the monetary policy effectiveness.

We note that the banking system is well capitalized and profitable, and welcome the decline in NPLs. However, stress tests show that several banks remain vulnerable to credit and liquidity shocks. We encourage the authorities to strengthen their oversight and the legal framework for bank resolution. It would also be important to remain vigilant with regard to the increase in foreign currency bank lending.

Ms. Pollard, Ms. Crane and Mr. Vitvitsky submitted the following statement:

We thank staff for the first review report under Malawi's Extended Credit Facility (ECF) and Messrs. Mahlinza and Sitima-wina for the helpful buff statement. Malawi's performance under the ECF has already been strained, with several missed performance criteria and structural benchmarks. While we were pleased to see some corrective actions taken, we urge the authorities to take bolder steps to improve public financial management and reduce corruption, which has held back investment in infrastructure and human capital and delayed multilateral support. We also remain concerned about overly optimistic growth forecasts, particularly as Malawi remains at high overall risk of debt distress, and the quantity of structural benchmarks given questions about Malawi's capacity and will. We support the completion of the first review and the request for waivers.

As articulated by Fund staff, Malawi has had serious past issues with corruption and needs to improve its governance track record to catalyze more donor finance, improve domestic revenue mobilization, and attract private investment. Several structural benchmarks related to governance and transparency were either missed or met with delay. Staff note also that newly-enacted SOE oversight includes an annual report to parliament. We would like to see this SOE report also made public, with redaction of market-sensitive information if necessary.

With ongoing fiscal pressures, realistic planning and projections are important. Expenditure overruns this past year were due to unexpected maize purchases to ensure food security after a poor agricultural season; higher arrears payments; and increased spending to hold elections. Given the potential for continued volatile weather, have the authorities included contingency funding in the 2019 budget in case they need to purchase more maize following another weak harvest? Is the budget allocation for humanitarian food assistance realistic relative to risks? Moreover, with upcoming elections in May 2019, there may be further pressure on election-related spending.

We welcome the use of the new LIC-DSF framework and appreciate staff's cautious application of judgement that maintains external debt risk at moderate, while overall debt risk is high as Malawi relies increasingly on domestic debt. With debt service at over 40 percent of revenues and rising, we are concerned by the trajectory of debt risks, particularly with the ongoing potential for fiscal slippage noted above. Staff point to limited data coverage as a key risk and describe the authorities' plans to pilot audits of SOEs which will help broaden debt data. What are staff's views of the significance of other debt data omissions such as of local government, extrabudgetary funds, social security funds, and PPPs? Is Malawi receiving an appropriate mix of TA from the IMF or others to support improvements in debt data coverage and transparency?

Staff also indicate that growth-enhancing spending on structural reforms and infrastructure is critical to drive development, and that the authorities can fund spending with select tax reforms and increases. How confident are staff that the proposed tax reforms are consistent with poverty alleviation goals, and that the burden will not fall disproportionately on the poor? Separately, we would appreciate further elaboration from staff on the breach in the QPC on contracting of new non-concessional external debt, recognizing that it appears to be technical oversight.

Finally, there is a relatively detailed set of structural conditions to strengthen public financial management (PFM), including a mix of continuous and one-time structural benchmarks (SBs). Parsimony in conditionality is important in countries with low capacity, though such countries may also find it helpful to lay out a series of incremental intermediate steps toward a manageable set of broader PFM objectives. In this case, our understanding is that the continuous SBs have been selected as core priorities that are critical to reducing the risk of arrears. Once these practices are established, maintaining them should require much less effort, but will be important to monitor.

Regarding forward-looking 2019 SBs on PFM, we encourage the authorities to work with staff on a realistic sequencing of key measures, while not losing focus on implementation of the continuous SBs.

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

We thank staff for the comprehensive reports and Mr. Mahlinza and Mr. Sitima-wina for their informative buff statement. It is encouraging that growth is expected to rebound in 2019 reflecting increased electricity generation and growing infrastructure investment. However, we note with concern that public debt burden has increased. Also, the country faces poverty and vulnerabilities to climate shocks. So, we encourage the authorities to take the necessary measures for sustaining macroeconomic stability, reducing poverty, and ensuring resilient growth. Since most quantitative performance criteria (QPC) for end-June 2018 were met and the authorities are committed to corrective measures for the missed QPCs, we support the authorities' request for completion of the first review under the ECF arrangement and for waivers of non-observance for the missed QPCs. As we broadly agree with the thrust of the staff's appraisal, we would like to make the following comments for emphasis:

Fiscal Policy

We encourage the authorities to continue strengthening the fiscal position to preserve debt sustainability. We note with concern that the fiscal balance deteriorated in FY 2017/18 reflecting expenditure overruns. While we welcome the authorities' commitment to tighten the fiscal stance in FY 2018/19, we wonder why the World Bank postpones its budget support. Could staff explain the reason behind the postponement of the World Bank's budget support? We are also concerned about the high risk of debt distress driven by its growing public domestic debt. At the same time, we stress the importance of securing space for growth-enhancing infrastructure and social spending. Therefore, on the revenue side, we support the authorities' consideration on a mix of tax policy and tax administration measures described in the staff's report. Also, on the spending side, we welcome the authorities' plan to audit the performance of major capital projects and improve their oversight and monitoring. Moreover, we agree with the staff's view that to monitor fiscal risks, the authorities need to improve the coverage of public debt and the financial reporting of state-owned enterprises. In addition, while we positively note that cuts to goods and services will target non-priority spending, the approved FY 2018/19 budget introduced an additional 5 percent wage increase. We would welcome the staff's view on the wage increase in the approved FY 2018/19 budget. Lastly, in relation to the non-observance of the continuous PC on non-concessional external debt, we are encouraged by the staff's assessment that the authorities have already taken and are committed to continue taking measures to strengthen debt management capacity. That said, we note that the authorities prefer exceptions on a case by case basis for new loans backing priority growth-enhancing projects. How do staff think the authorities' preference to have exceptions for contracting new non-concessional external debt?

Monetary and Exchange Rate Policy

We agree with the staff's appraisal that tight monetary policy is appropriate but greater exchange rate flexibility is needed. On the monetary policy, given current inflationary pressures, we believe that continuing a tight monetary policy stance is appropriate. Also, we positively note that the Reserve Bank of Malawi (RBM) developed a monetary policy communication strategy ahead of the target date. In addition, we support the authorities' efforts to continue expanding capacity toward inflation targeting. On the exchange rate policy, we agree with the staff's appraisal that greater exchange rate flexibility will be critical to cushioning shocks and enhancing competitiveness. Also, we concur with the need to deepen the interbank FX market.

Financial Sector Policy

It is encouraging that the banking system resilience has improved, and we welcome the authorities' commitment to enhance the financial sector oversight. We are pleased to see that provisions increased, and non-performing loans declined. Also, we positively note the staff's assessment that the banking system is well capitalized and profitable. Having said that, figure 4 in the staff's report shows that profitability has been on a downward trend. What measures do staff think are effective in improving banks' profitability? Going forward, we support the authorities' close monitoring of large borrowers and foreign currency lending. Also, we encourage the authorities to continue strengthening the AML/CFT framework and improving access to finance by small and medium size enterprises.

Governance Reform

Improving governance and transparency and reducing vulnerabilities to corruption remains vital for the country's sustainable development. We strongly support the authorities' initiatives to bolster the RBM's independence. We commend the expected submission of a new RBM Act 2018 that enhances its autonomy and eliminates avenues for monetization of deficits. Also, we underscore the importance of public financial management reforms to address the weakness in budget control. In this regard, stronger cash management and improved fiscal reporting are necessary for enhancing transparency and accountability.

Mr. Just and Mr. Mehmedi submitted the following statement:

We thank staff for the well-written report, and Mr. Mahlinza and Mr. Sitima-wina for their helpful buff statement. We are concerned about the weak program performance and fiscal slippages over the last six months and call on the authorities to promptly implement the agreed corrective actions. We acknowledge that all four prior actions have been met but note that the quantitative performance criterion on the primary fiscal balance was missed by 0.9 percent of GDP and the indicative target of a zero ceiling on new domestic arrears was not met. At the same time, progress on the implementation of structural reforms has been weak, as only two structural benchmarks were implemented on time. We do not think that significant reform progress is realistic until after the elections. Yet, we can go along with the completion of Malawi's first review under the Extended Credit Facility, and waivers for nonobservance. We broadly share staff's assessment and policy recommendations and provide the following comments for emphasis.

A credible fiscal consolidation path which relies on reining in unproductive current spending and mobilizing domestic revenue is essential to ensure the sustainability of public finances and reduce the high public debt. Considering that the fiscal balance deteriorated in FY 2017/18 as the overall deficit was 1.3 percent of GDP larger than programmed due to expenditure overruns, there is an urgent need to tighten the fiscal stance going forward. We welcome the agreed corrective measures between staff and the authorities to tighten the primary balance for FY 2018/19 to compensate for policy slippages and for the postponement of budget support. Tax measures, including on VAT and corporate income tax, as well as cuts to non-priority goods and services are steps in the right direction as they are coupled by measures to benefit low-income earners. However, the 2018/19 budget seems to allocate large budget appropriations for salary increases and hiring in the public sector. Staff's comments on the public sector wage increases and the overall composition of the budget for 2018/19 are welcome. We underscore that improving public finance and debt management are critical to achieve the program's objectives. In this regard, we encourage the authorities to make concrete progress in addressing weaknesses in budget control, enhance fiscal reporting, and prevent the accumulation of arrears. In view of high debt vulnerabilities, the authorities' decision to suspend the contracting of new non-concessional external debt is necessary, but further efforts are needed to strengthen the debt management framework.

We are concerned about the weak catalytic impact of the Fund-supported program. Despite the Fund program, donor funding has not recovered given endemic corruption and maladministration. We are, however, concerned that the World Bank may also delay disbursement of US$80 million (1.1 percent of GDP) of budget support until FY 2019/20. Staff's comments on the delay in donor disbursements and on how program conditionality aims to address governance concerns and catalyze on-budget donor support are welcome.

Considering current inflationary pressures, continuing with a tight monetary policy stance is appropriate, but further exchange rate flexibility is warranted. Given the shallowness of the interbank market, we encourage the authorities to implement a reform plan aimed at deepening the interbank market and to moderate the RBM's role to reduce volatility, including through enhancing communication and transparency of the RBM's FX intervention, while also reducing the holdings of government securities. While the banking system's resilience has improved recently, vulnerabilities stemming from the high level of non-performing loans, loan concentration, and increasing FX lending should be carefully monitored and addressed. Staff's comments on the authorities' progress on increasing access to finance are welcome.

Structural reforms should be aimed at tackling corruption, improving governance, and addressing development challenges. Governance reforms should be comprehensive and include concrete and measurable actions on improving budget control and reporting, enhancing investment spending efficiency, increasing transparency, and the monitoring of state-owned enterprises (SOEs). Strengthening the oversight of SOEs is essential in containing fiscal risks. We also encourage the authorities to ratify regulations related to the revised AML/CFT framework, enacted in 2017, and further strengthen the asset declaration system and use of AML/CFT tools to improve governance. Staff's updates on the implementation of the Malawi Growth and Development Strategy III and fiscal implications for the envisaged infrastructure development plan are welcome.

Mr. Mouminah, Mr. Alkhareif and Mr. Rawah submitted the following statement:

We thank staff for the well-written report and Mr. Mahlinza and Mr. Sitima-wina for their helpful buff statement. We are in broad agreement with the staff's analysis and policy recommendations and would limit our remarks to a few issues.

We support the completion of the first review under the ECF program and the associated decision. We are encouraged by the authorities' commitment to the program, reflected in the overperformance on international reserves and reduction in Reserve Bank of Malawi (RBM) holdings of government securities, supported by corrective measures and prior actions pertaining to unmet QPCs and SBs. In addition, we take positive note of the authorities' emphasis on entrenching macroeconomic stability and enhancing poverty reduction and resilience. This is important especially in the context of declining GDP per capita. We are also comforted by staff's assessment that Malawi's capacity to repay the Fund remains strong.

The overall risk of debt distress is assessed to be at high and therefore further efforts are warranted to preserve debt sustainability. On the back of the limited space to absorb shocks, resilience should be improved by enhancing public debt financial management and continuing efforts to develop a comprehensive medium-term debt strategy. It is also important to broaden the revenue base, improve project identification and implementation efficiency, closely monitor contingent liabilities, and further diversify the economy, particularly exports.

Finally, we agree with staff that improving governance and transparency while stepping up the implementation of the much-needed structural reforms are key priorities for better economic outcomes and catalyzing donors' support. In this context, we welcome the authorities' efforts to further strengthen the RBM independence, enhance debt management and investment spending efficiency. We also share staff's view that effective use of AML/CFT tools, while accelerating the framework's alignment with international standards, would support the authorities' efforts to improve governance.

With these remarks, we wish the authorities further success.

Mr. Tan and Ms. Pandit submitted the following statement:

We thank staff for their well-presented review and Messrs. Mahlinza and Sitima-wina for their informative buff statement. While drought and electricity shortages weighed on 2018 economic performance, we note that growth, external and financial sector resilience are expected to improve. As the medium-term economic reforms look to entrench macroeconomic gains and reduce poverty, appropriate consideration should be given to managing downside risks in terms of the limited fiscal space and donor support, as well as the crowding out of private sector credit. While program performance was mixed, we support the completion of the review and associated waivers on the basis of corrective measures undertaken. We would like to raise the following comments for emphasis.

Prudent fiscal policy is warranted to maintain good governance and market confidence. Expenditure overruns, weak oversight and possible bailout of SOEs and additional spending for upcoming election pose further challenges to fiscal sustainability. To put public finances on a strong footing, staff rightly recommended to mobilize domestic revenue and improve spending efficiency as well as financial management. In this regard, we appreciate the authorities' commitment to meet the QPCs and the corrective measures undertaken in response to the past year's fiscal slippages.

It is important to remain vigilant on monetary policy to keep inflation on a downward trajectory. Rising inflationary pressure warrants the continuation of a tight monetary policy stance. We welcome the authorities' efforts in transitioning towards an inflation targeting framework with the ongoing development of high frequency data, liquidity forecasting, and the forecasting and policy analysis system modeling. Private sector investment risk has elevated due to tighter lending conditions, weak credit demand and risk of crowding out from high holdings of government securities by the banking sector. Correspondingly, we are pleased that the newly proposed Reserve Bank of Malawi Act 2018 will provide an avenue to strengthen central bank independence. To enhance market efficiency and shock absorbency, we also agree with staff on the need for a deeper interbank market and transparent market-based FX intervention mechanism.

Safeguarding financial stability, while also promoting financial access and integrity, continues to be of high priority. We welcome the authorities' efforts to increase financial sector resilience through the adoption of prudent regulatory and supervisory norms along with the implementation of IFRS9 compliance. Nevertheless, heightened credit, liquidity and interest rate risks must be carefully mitigated to ensure smooth functioning of the financial system. The focus on financial access for SMEs will support the aim of poverty reduction. Nonetheless, a more comprehensive and clearer roadmap, as well as complementary efforts to put in place the legislative amendments to align with the revised AML/CFT framework and the Banking Act and Financial Services Act will be required.

Sustainable growth performance will benefit from a sustained and progressive reform on governance. Governance challenges have affected the availability of donor support and tackling them will be key to catalyzing critical financing. At the same time, implementing policy reforms could prove challenging given the upcoming election and political pressures. In this regard, the authorities' commitment and perseverance in implementing deeper structural reforms and ensuring their proper execution will be pivotal to achieving higher and more inclusive growth.

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

Ms. Levonian, Ms. McKiernan and Mr. Feerick submitted the following statement:

We thank staff for their report and Messrs. Mahlinza and Sitima-wina for their helpful buff statement. In the face of some significant challenges, we assess program performance as satisfactory. While some performance criteria and structural benchmarks were missed – there are clear signs of political willingness to take the tough, but necessary, actions, to deliver a successful program. For example, while only two structural benchmarks were met, most others were completed with a delay. As regards the outlook, we share the view that risks are tilted to the downside. However, the shared assessment between staff and the authorities on the importance of further fiscal consolidation, structural reforms, which have been amended/reaffirmed in the MEFP, lend confidence that appropriate measures will continue to be taken. Considering the above and the fact that capacity to repay the Fund is assessed as strong, we support the authorities' request for completion of the first review and associated waivers.

Mr. Trabinski and Ms. Wehrle submitted the following statement:

We support the completion of the first review under the ECF. While the quantitative performance criterion on the primary fiscal balance was missed due to expenditure overruns, we are encouraged by the corrective measures and further reforms highlighted by Mr. Mahlinza and Mr. Sitima-wina in their informative buff statement. We also take note that Malawi is at a high risk of debt distress under the new LIC-DSF and that there is room to improve the debt coverage of other layers of government and of potential contingent liabilities arising from SOEs. Overall, we encourage the authorities to ensure more timely progress on structural benchmarks and welcome the prior actions aimed at increasing fiscal transparency.

Improving public financial management and reducing governance vulnerabilities are crucial, not only to the success of the program, but also to rebuild trust and catalyze donor support. We thus urge the authorities to strengthen budget controls, broaden IFMIS coverage, increase transparency, and enhance general fiscal discipline. We also encourage the authorities to follow up on the recommendations of the recent PIMA, which highlights weaknesses in cash management, a lack of effectiveness and transparency in the procurement process, weaknesses in the management and implementation of projects, and a lack of effective monitoring, evaluation and oversight of large projects. In this regard, has staff considered including amendments to the PFM Act as a future structural benchmark to incorporate the findings of the PIMA?

We welcome the steps taken to enhance the autonomy of the RBM. The recent reduction in RBM holdings of government securities and the planned multi-year unwinding strategy that includes a clear communication strategy are positive developments. We also agree with staff's view that keeping a tight monetary policy stance is advisable. Steps to deepen the interbank market and reduce the role of the RBM in the market to allow for greater exchange rate flexibility would also be welcome.

Mr. de Villeroché, Ms. Riach, Mr. Bellocq, and Ms. Stockill submitted the following statement:

We thank staff for the set of reports and Mr. Mahlinza and Mr. Sitima-wina for their helpful buff statement. We support the completion of the first review of the Extended Credit Facility (ECF) arrangement. This Fund-supported program remains a very important tool for supporting sound macroeconomic management, and laying the foundations for inclusive growth, at a critical time for Malawi.

We commend the authorities for the continued focus on macroeconomic stability over the last year. Although we note that Malawi missed the quantitative target on its primary fiscal balance by a non-trivial margin (0.9 percent of GDP), we welcome the corrective measures which the authorities have committed to. We therefore approve the waivers and modifications requested while encouraging the authorities to remain committed to increasing Domestic Resource Mobilization. We note the authorities' tight monetary policy stance, which has contributed to low inflation. We also commend the steps that have been taken to improve the resilience of the banking system and hope to see this momentum maintained during the rest of the program implementation period.

We broadly agree with staff's assessment of the outlook for Malawi, although significant downside risks remain. Pre-election spending pressures are a particular concern, and strong commitment will be required in order to ensure there are no further fiscal slippages. We agree with the proposed downward revision to the quantitative target on the primary fiscal balance by 1.1 percent GDP in FY 18/19, and we encourage staff to engage closely with the authorities to ensure that this objective will be reached.

Under the new LIC Debt Sustainability Framework, Malawi is assessed at being at high overall risk of debt distress, driven by increasing amounts of domestic debt. Domestic debt in 2018 is projected to reach 26.1 percent of GDP (against a 22.2 percent target) and has been gradually increasing since 2016. Moreover, we consider that the estimates of debt reduction in the outer years are optimistic – moving from 55 percent of GDP to below 40 percent of GDP by 2028 - given Malawi's growth record and the limited space to generate greater revenues. Could staff elaborate further on measures the authorities could take to reduce reliance on short-term domestic debt, within the parameters of the program? We note that the risk of external debt distress is moderate with some space to absorb shocks, but we wonder why the table on p.46 does not use the terminology which was endorsed by the last Board meeting dealing with the DSF review for the moderate risk category (the terminology which was endorsed is "Moderate with limited Space", "Moderate", "Moderate with substantial space". See Review of the Debt Sustainability Framework for Low Income Countries- Proposed Reforms. SM/17/231, p. 44). Staff's comments are welcome.

Macroeconomic stability is a necessary but not sufficient condition to move Malawi to a higher growth path. Malawi's production and export structure is insufficiently diversified; the economy faces numerous structural, institutional, and infrastructure constraints; and a high proportion of the population depend on subsistence agriculture and are therefore highly vulnerable to climatic shocks. The growth assumptions in the staff report will require significant structural reforms to improve agricultural productivity and infrastructure. Major reforms will be required to both the Farm Input Subsidy Programme (FISP) and ADMARC (6 percent of total Government Expenditure), if agricultural productivity is to increase sustainably. Infrastructure development is currently hindered by weak capacity to execute, which substantially delays project implementation. We encourage staff to focus on the effective implementation of structural reforms that will improve Malawi's growth prospects, working in close collaboration with the World Bank and other donors.

Mr. Raghani and Mr. Bangrim Kibassim submitted the following statement:

We thank staff for the well-written report and Mr. Mahlinza and Mr. Sitima-wina for their informative buff statement.

Recent economic developments in Malawi have been marked by the negative impact of weather conditions and pest infestation on agriculture, one of the key drivers of growth. Against the same backdrop, program implementation has been challenging, with two quantitative performance criteria (QPC) missed and a number of structural reforms implemented with delays. Nonetheless, the authorities have undertaken appropriate corrective actions which should help maintain the program in line with its objectives. Therefore, we support the completion of the first review under the ECF arrangement and the request for waivers.

Looking forward, we encourage the authorities to pursue prudent macroeconomic policies and implement their structural reform agenda, with the view to foster macroeconomic stability and achieve stronger and more inclusive growth. We very much welcome the focus of the authorities' third Malawi Growth and Development Strategy (MGDS III) 2018-23 on strengthening competitiveness and building resilience through growth-enhancing investment and economic diversification.

We broadly agree with Staff's assessment and policy advice and provide a few additional remarks for emphasis.

We encourage the authorities to pursue a cautious—albeit growth-friendly— fiscal policy aimed at ensuring debt sustainability while protecting the most vulnerable groups and addressing food insecurity. We share the view that the authorities' fiscal strategy should be geared at achieving fiscal balance and enhancing credibility. In a context of low external budget support, we see merits in scaling up domestic revenue mobilization. This should be accompanied with enhanced public financial management, including greater budget control and transparency. Therefore, the announced measures to improve tax administration, increase fiscal reporting and harmonize debt data between the ministry of finance and the Reserve Bank of Malawi (RBM) are welcome. Furthermore, we support the authorities' reforms aimed at enhancing the efficiency of public investment and the oversight of SOEs.

The tight monetary policy stance pursued by the RBM to mitigate inflationary pressures is appropriate. We welcome the alignment of RBM's operational framework with international practices. The recent strategy adopted by the central bank in the context of the new RBM Act 2018 should bolster its independence, which along with recent measures to reduce government's security holding will improve its credibility and effectiveness. Similarly, we encourage the monetary authorities to pursue their efforts towards eliminating vulnerabilities in foreign reserves management and legal framework. As the RBM plans to adopt an inflation targeting framework over the medium term, enhancements in the monetary policy transmission mechanism, the communication strategy and capacity building will be essential. To better support economic activity and achieve an adequate exchange rate flexibility, due consideration should be given to deepening the interbank market, achieving efficient price determination, strengthening FX liquidity management, and improving communication in forex interventions.

It is essential that Malawi's economy be supported by a well-capitalized and profitable banking system. While prudential norms have been improved, we also note that banks' business models have been strengthened and NPLs have decreased. Efforts should be oriented towards enhancing risk assessment and bank supervision. We urge the authorities to tackle vulnerabilities in FX currency bank lending and individual banks activities, with the view to foster financial stability. Furthermore, we encourage the authorities to pursue actions towards the adoption of regulations that will better align the country's AML/CFT framework with international standards.

To create the conditions for achieving an inclusive, broad-based growth and for catalyzing donor support, the authorities should accelerate the implementation of structural reforms and, in this regard, give priority to strengthening governance, addressing electricity shortages, improving the business climate and tackling poverty. Regarding the description of poverty incidence in Malawi, we are concerned by the lack of timeframe uniformity in Text Figure 2 page 4 when comparing poverty across countries. In addition, we would expect a more relevant characterization of poverty using the latest available data. Staff's elaboration will be appreciated.

With these remarks, we wish the Malawian authorities success in their policy and reform endeavors.

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

We thank staff for the well-written report and Mr. Mahlinza and Mr. Sitima-wina for their informative buff statement. Malawi's performance under the ECF is broadly satisfactory. Economic growth, which is expected to decelerate to 3.2 percent in 2018 from 4 percent in 2017, primarily due to inadequate rainfall and power shortages, should rebound next year. Increased electricity tariffs along with higher maize prices have contributed to inflationary pressures, while governance concerns have led to delays in donor support. The growth outlook is positive but remains vulnerable to adverse climate shocks, worsened term of trade, slow reform implementation in the run up to elections, and governance challenges. We concur with the thrust of staff appraisal and, in view of the authorities' corrective measures, we support completion of the first review under the ECF and the request for waivers of non-observance of the end-June 2018 QPC on the primary balance and the continuous QPC on contracting new non-concessional external debt.

A disciplined fiscal policy should help achieve the authorities' objectives of putting and maintaining debt on a sustainable path and supporting the monetary policy's focus on disinflation while also contributing to lowering the current account deficit. These objectives should also guide the authorities' decisions and actions as they consider an ambitious infrastructure development plan. In addition to full implementation of the tax measures introduced under the 2018/19 budget to raise revenue while protecting low income earners, successful completion of the intended reforms on tax policy and tax administration will be key in reducing donor dependency and achieving fiscal sustainability. Greater efforts will be made at reducing non-priority spending while protecting key infrastructure and social spending. We welcome the progress in reforming public financial management, including measures to improve financial reporting, strengthen cash management, and enforce commitment controls to enhance fiscal discipline and prevent abuse. Close monitoring of SOEs as intended should help strengthen their efficiency and financial position while reducing their reliance on the budget and precluding contingent fiscal risks.

Continued focus on bringing inflation under control is appropriate. Looking ahead, the authorities should continue to monitor developments closely and stand ready to tighten monetary policy should inflationary pressures continue. We commend the authorities' recent efforts towards bolstering the Reserve Bank of Malawi (RBM)'s independence and enhancing policy credibility and transparency. These efforts, backed by expanded analytical, forecasting and modeling capacity, improved primary and secondary market operations, and strengthened monetary policy transmission, will lay the ground for RBM's planned shift to interest-based operational framework and gradual adoption of inflation targeting. We note the authorities' commitment to greater exchange rate flexibility as an effective cushion against shocks, and support their recent flexibility-enhancing reforms, including the adoption of a well-designed and robust action plan on deepening interbank FX market.

The banking system remains well-capitalized and profitable, and recent efforts in enforcing IFRS requirements and reducing NPLs and increasing provisioning will improve its resilience and efficiency. Going forward, the authorities should step up their surveillance of potential sources of risks and address the remaining vulnerabilities in the banking system. We are encouraged by the authorities' plan to upgrade the financial sector's legal and regulatory framework, strengthen the AML/CFT regime, and improve access to finance.

We wish the authorities success in their endeavors.

The Acting Chair (Mr. Zhang) noted that since the start of the program, Malawi had been able to maintain macroeconomic stability, despite inflationary pressures and subdued economic activity. The program focused on reforms to promote growth—including by enhancing governance—and to support improved social outcomes. Directors' gray statements emphasized that the strong commitment to the program's objectives would be the key to its success.

Mr. Hanson made the following statement:

We did not issue a gray statement, and the main reason was that we had some questions about the context of the program discussed in the beginning of the report—on the incidence of poverty, food scarcity, the postponement of donor support. We are thankful that staff was willing to engage with us on those issues bilaterally, and we thank the staff for a well-written report. In particular, we would like to highlight the fact that the Debt Sustainability Analysis (DSA) performed well. This was an example where the new framework helps us understand the issues in the country, and we hope this is also helpful for the authorities.

We can support the proposed decision, and we welcome that the targets for FY2018-19 correct the spending overruns of FY2017-18. We have two brief remarks for emphasis.

The challenges in Malawi extend beyond the scope of the program. Therefore, we hope that the progress under the program will help catalyze donor funding, and in this light, we believe the measures to improve governance and transparency in the program are important.

Second, we believe Malawi is an example of a country that is particularly vulnerable to climate risks and climate change; and to further identify risks and help the authorities define a policy response, we believe a Climate Change Policy Assessment (CCPA) would be beneficial.

Mr. Kim made the following statement:

I would like to make three comments for emphasis.

First, we support the staff's recommendation for the completion of the first review under the Extended Credit Facility (ECF). We also support the waivers of non-observance for the quantitative performance criteria. Regarding the quantitative performance criterion on the primary balance, we welcome the authorities' commitment to taking corrective measures and remedial policy actions in the second half of 2018. We are also encouraged that most other important quantitative targets were met. Monetary targets on reserve money and net international reserves were within the boundary or above the floor. Neither additional central bank financing to central government, nor accumulation of external payment of arrears have happened during this review period. We commend the authorities for their commitment to regain credibility from the international communities and expect that the authorities will implement strong public finance management reform measures, such as scaling back on non-priority spending, enhancing tax revenue by streamlining incentives, expanding the value-added tax base, and improving compliance. With the lessons learned from 2013 cashgate scandal, we emphasize that the efforts to improve governance should be accelerated, which can benefit from targeted training and technical assistance.

We hope political support and willingness to reform will be preserved regardless of the forthcoming elections. We would like to ask one question regarding donor support to Malawi. I served on the World Bank Board when it approved US$18 million in development policy financing last year. While the World Bank is providing Malawi with other financing for investment projects, the disbursement of the budget support has been postponed pending a clear outcome of improved public finance management. We would like to ask for the staff's assessment on how the World Bank and other donors' budget support would be affected after this first review of the ECF program.

Mr. Razafindramanana made the following statement:

> We have issued a gray statement, and I want to express our support for the reforms undertaken by the authorities, as mentioned by Mr. Mahlinza's buff statement, and our expectation that the early implementation will strengthen the authorities' program and the achievement of the development objective. Particularly, we welcome the wide-ranging tax reform, which in addition to the enhanced fiscal controls and expenditure rationalization, will enhance fiscal sustainability and credibility; as well as reforms undertaken in public financial management and budget control, including the establishment of a cash management unit and the restriction of non-concessional borrowing, which will reduce vulnerabilities and improve the debt sustainability.
>
> Finally, we encourage the Malawi authorities to pursue their efforts to implement a well-sequenced action plan aimed at deepening the interbank market and addressing governance and business climate challenges.

Mr. Saito asked the World Bank staff to elaborate on the postponement of World Bank budget support for Malawi.

Mr. Just remarked that aid flows were a critical component of the program's success. The projected catalytic effect had been fairly limited, and he wondered whether this reflected concerns by bilateral donors about the program strategy and the strength of conditionality. He found the delay in disbursements by the World Bank worrisome and joined Mr. Kim and Mr. Saito in asking World Bank staff to elaborate on the reasons for the delay.

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

> We thank Directors for their insightful gray statements. Written responses to Directors' technical questions have been circulated, and I would like to respond to some of the policy questions raised in the gray statements. In particular, there were a series of questions related to governance, catalyzing donor support, and program design, all of which are interlinked in the sense that improving governance, especially in public financial management, is crucial to improving economic outcomes and regaining donor confidence.
>
> In particular, one crucial gap that the authorities are seeking to address and that is also particularly important for donors is the absence of reconciliation of the government's cash book with bank accounts and timely reconciled fiscal reporting. The authorities are taking steps, supported by technical assistance from the Fund and the World Bank, to address IT gaps,

[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.

including through the procurement of a new integrated financial information system. On the HR side, which is another challenge in this area, the authorities are providing appropriate incentives to recruit and retain talented staff.

On the Fund side, we are providing frontloaded, intense, and well-sequenced technical assistance and substantial training, and a big part of this is having a resident adviser on public financial management issues, and a new advisor just started in October. More generally, this is not the only area of governance reforms that the program covers. In addition to bank reconciliation, the program also covers commitment control, cash management, investment spending efficiency, monitoring of state-owned enterprises, debt management, access to finance, and central bank independence. Donors have highlighted that seeing progress in these would be important for them to step up their support.

Taking a step back, in terms of the program design, have we taken into account that Malawi is a fragile state and to what extent have we done so? The previous ECF was also extended from three to five years for this reason, and when there was a humanitarian crisis, it was augmented. The current ECF program is designed in a way that the structural benchmarks are focused on basic areas of fiscal control, which were mentioned earlier; and the pace of reform has been tailored to take into account the capacity constraints facing the authorities; and to help with capacity constraints, capacity development activities on the part of the Fund have been stepped up.

The current program also coordinates heavily with other development partners. For example, Fund conditionality complements the new Financial Management Information System (FMIS) project supported by the World Bank and commitment control reform supported by the EU.

There was a question on how the program design relates to growth. In the near term and the medium term, the program supports growth. In particular, by supporting macroeconomic stability and governance reforms, the program directly contributes to improved economic outcomes and strengthened confidence in the private sector, while at the same time providing a framework for donor engagement. This is particularly important because donor support, especially in the areas of electricity and irrigation, can significantly boost growth, and we see that the process has already started with the initiation of the Shire Valley project supported by the World Bank and the African Development Bank.

> In tandem with all of this, financial sector development supported by the program—for example, improving access to finance, as well as increased social spending—together not only support growth, but support more inclusive growth.

The representative from the World Bank (Mr. Battaile), in response to questions and comments from Executive Directors, made the following statement:

> In response to the questions related to the World Bank budget support, I can just provide the status of that operation from our side. We had prepared that operation. That operation had gone through our Regional Operations Committee and was being prepared for a presentation to the Board. We had since been in discussions with the government and had some concerns about progress on all the elements and all the prior actions for that second out of the two development policy operations. There were consultations during the Annual Meetings in Bali between our vice president for the Africa region and the minister of finance, where additional assurances of further progress on that program were given by the government. Those discussions remain ongoing with the authorities, and this is currently where we stand. The delay has been around concerns about the progress of reforms, especially given that this is the second out of two development policy objectives, and this is really where the final results should be coming in. We have had questions—which have been echoed by many represented here and also on the World Bank's Board side—about the depth of those results. As mentioned, we have had discussions with the authorities. Those remain ongoing, and so I cannot definitively describe the outcome of those, but we are happy to come back as those conclude and provide more information as needed.

The staff representative from the African Department (Ms. Mitra) noted that Directors had asked how donor support would be impacted by the completion of the review. Although she could not speak for donors, the staff's sense was that the completion of the review would support further donor confidence. This confidence would grow as the authorities continued to make progress on the structural benchmarks and more general reforms.

Mr. Mahlinza made the following concluding statement:

> On behalf of my Malawian authorities, I thank Directors for their support in completing the First Review of the Three-Year ECF Arrangement for Malawi. Their invaluable views, recommendations, and policy advice are greatly appreciated and will be conveyed to my authorities.

As rightly observed by some Directors, in the recent past, Malawi has experienced some exogenous shocks which have dampened economic growth. The economy is now recovering, and macroeconomic stability is slowly taking root. Going forward, higher and more inclusive growth is required to meaningfully reduce poverty. In this respect, our authorities are determined to address structural challenges and constraints to sustainable growth through steadfast implementation of the Malawi Growth and Development Strategy (MGDS) III.

In their written statements and oral interventions, Directors have emphasized the need for the authorities to sustain fiscal consolidation, maintain a tight monetary policy stance, take steps toward greater exchange rate flexibility, and maintain the automatic fuel pricing mechanism. These measures will be instrumental in entrenching macroeconomic stability and bolstering sustainable and inclusive growth.

In addition, Directors have underscored the need for the authorities to strengthen governance, intensify the fight against corruption, and accelerate structural reforms. Our authorities reiterate that they are resolved to address these challenges, including improving public financial management and pursuing a fiscal path that will secure debt sustainability while promoting investment through growth-enhancing priority investor projects.

Directors also underscored the need to boost agricultural production and address shortages in electricity. In this context, I would like to add that several infrastructure projects have been identified in the Malawi Growth and Development Strategy (MGDS) III to address these growth constraints, including the Green Belt Initiative, which envisages investments in irrigation infrastructure to benefit both commercial and smallholder farmers across various sites in the economy.

In the power sector, the recently upgraded energy transmission system funded by the USAID Millennium Challenge Corporation has boosted transmission efficiency and will assist to minimize losses. All new electricity generation projects, including those by independent power producers, will fit into this new transmission system. In addition, our authorities will step up efforts to improve financial intermediation by enhancing access to and affordability of credit to the private sector to further enhance inclusive growth. In pursuing these objectives, the support of the Fund remains important.

Finally, I thank the mission chief, Ms. Mitra, and her team for the remarkable work and active engagement with the Malawi authorities during this review and for providing comprehensive responses to the issues raised by the Executive Directors. My authorities value the Fund's advice and technical assistance and look forward to continued collaboration with the Fund.

The following summing up was issued:

Executive Directors commended the authorities' progress in maintaining macroeconomic stability, including low inflation despite pressures from higher food and energy prices. They observed, however, that economic activity moderated in 2018 driven by weak agricultural performance and continued electricity shortages. While the medium-term outlook is favorable, Directors considered that significant downside risks remain. In this context, they emphasized the need for continued implementation of prudent policies to enhance debt sustainability, enhance financial sector resilience, and strengthen governance to promote sustained, inclusive growth.

Directors noted the deterioration in the fiscal position, which reflected the need to protect vulnerable groups in the face of a poor harvest, increased spending to ensure safe elections, and payments of past arrears. They also observed that donor funding remains constrained by governance concerns. Directors stressed the importance of a strong fiscal adjustment to preserve debt sustainability, including boosting domestic revenue mobilization, streamlining non-priority expenditures, and correcting for slippages during the last fiscal year. They emphasized that consistent implementation of the automatic fuel pricing mechanism will be necessary to eliminate the risk of government subsidies.

Directors observed that under the new debt sustainability framework, Malawi's risk of overall debt distress is high while its risk of external debt distress remains medium. To contain these risks and raise the quality and efficiency of spending, they underscored the need to advance reforms in public financial management and strengthen the oversight of state-owned enterprises.

Directors encouraged the authorities to press ahead with governance and transparency reforms, which are essential to improving economic outcomes and catalyzing donor support. They stressed that more progress in improving commitment control, cash management, and a strengthened debt management framework are essential for improving fiscal reporting, integrity, and transparency.

Directors welcomed the authorities' commitment to maintain a tight monetary stance and emphasized that greater exchange rate flexibility would help cushion the economy against external shocks and enhance competitiveness. They supported steps to deepen the FX interbank market and moderate the Reserve Bank of Malawi's (RBM's) role in the FX market.

Directors welcomed the authorities' efforts to improve banking system resilience. They noted that adoption of IFRS9 requirements and the RBM's vigilance have significantly reduced NPLs and increased provisioning. Directors encouraged the authorities to maintain this momentum and improve banks' risk management and analysis of collateral quality and to continue close monitoring of large borrowers. They underscored the importance of aligning the AML/CFT framework with international standards and for continued progress in strengthening the operational independence of the RBM.

The Executive Board took the following decision:

Malawi—First Review Under the Three-Year Extended Credit Facility Arrangement and Requests for Modification and Waivers of Nonobservance of Performance Criteria

1. Malawi has consulted with the Fund in accordance with paragraph 4(b) of the arrangement for Malawi under the Extended Credit Facility ("ECF") (EBS/18/28, 04/17/18) (the "ECF Arrangement") to review program implementation and to reach understandings regarding the conditions for further disbursements.

2. The letter dated October 30, 2018 from the Minister of Finance, Economic Planning and Development and the Governor of the Reserve Bank of Malawi ("RBM") (the "October 2018 Letter") together with its Memorandum of Economic and Financial Policies (the "October 2018 MEFP") and the Technical Memorandum of Understanding (the "October 2018 TMU") shall be attached to the ECF Arrangement, and the letter dated April 13, 2018 from the Minister of Finance, Economic Planning

and Development and the Governor of the RBM, together with all of its attachments, shall be read as supplemented and modified by the October 2018 Letter and its attachments.

3. Accordingly, the ECF Arrangement for Malawi shall be amended as follows:

a. A new paragraph 2(c) shall be included in the ECF Arrangement to read as follows:
"2(c) the third disbursement, in an amount equivalent to SDR 11.15 million, will be available on or after April 15, 2019, at the request of Malawi and subject to paragraphs 4 and 5 below."

b. A new paragraph 2(d) shall be included in the ECF Arrangement to read as follows:
"2(d) the fourth disbursement, in an amount equivalent to SDR 11.15 million, will be available on or after October 15, 2019, at the request of Malawi and subject to paragraphs 4 and 5 below."

c. Paragraph 4 of the ECF Arrangement shall be renumbered as "4.A" and paragraph 4.A(a) shall be amended to replace the numbering of (iv) and (v) with (iii) and (iv) respectively, and paragraph 4.A(b) shall be amended to read as follows: "until the Trustee has determined that the first program review referred to in paragraph 42 of the MEFP, has been completed."

d. A new paragraph 4.B of the ECF Arrangement shall be inserted to read as follows:
"B. Malawi will not request the third disbursement under this arrangement specified in paragraph 2(c) above:

(a) if the Managing Director of the Trustee finds that, with respect to the third disbursement, the data as of December 31, 2018 indicate that:

i. the ceiling on reserve money (upper bound);
ii. the floor on the primary balance;
iii. the ceiling on central bank financing of the central government;
iv. the floor on the net international reserves of the central bank,

as set out in Table 1 of the October 2018 MEFP and further specified in the October 2018 TMU was not observed; or
(b) until the Trustee has determined that the second program review referred to in paragraph 38 of the October 2018 MEFP has been completed."

e. A new paragraph 4.C of the ECF Arrangement shall be inserted to read as follows:
"C. Malawi will not request the fourth disbursement under this arrangement specified in paragraph 2(d) above:

(a) if the Managing Director of the Trustee finds that, with respect to the fourth disbursement, the data as of June 30, 2019 indicate that:

i. the ceiling on reserve money (upper bound);
ii. the floor on the primary balance;
iv. the floor on the net international reserves of the central bank,
as set out in Table 1 of the October 2018 MEFP and further specified in the October 2018 TMU was not observed; or
(b) until the Trustee has determined that the third program review referred to in paragraph 38 of the October 2018 MEFP has been completed."
iii. the ceiling on central bank financing of the central government;

f. Paragraph 5 shall be amended to replace the words "Table 1 of the MEFP and further specified in the TMU" with "Table 1 of the October 2018 MEFP and further specified in the October 2018 TMU".
g. Paragraph 7 shall be amended to replace the words "Paragraph 6 of the Letter" with "Paragraph 8 of the October 2018 Letter".

4. The Fund decides that the first review specified in paragraph 4.A(b) is completed, and that Malawi may request the second disbursement referred to in paragraph 2(b) of the ECF Arrangement, notwithstanding the nonobservance of the end-June performance criterion on the primary balance, and of the continuous performance criterion on the ceiling on contracting new non-concessional external debt, specified in paragraphs 4.A(a)(ii) and 5(b) of the ECF Arrangement, respectively, on the condition that the information provided by Malawi on the performance under these criteria is accurate, and on the further condition that the information provided by Malawi on the implementation of the measures specified as prior actions in Table 2 of the October 2018 MEFP is accurate (EBS/18/96, 11/6/18).(EBS/18/96, 11/06/18).

Decision No. 16442-(18/98), adopted
November 21, 2018

APPROVAL: April 10, 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:

Recent Developments/Outlook

1. ***The medium-term growth projection is 1.5 percentage points above the average of the last decade. How confident is staff that such a high growth rate is within reach?***

2. ***Since problems in the agriculture sector appear to be long-standing and critical issues in Malawi, we would like to know what concrete measures are being taken currently for improving irrigation and cropping techniques.***

- 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. Given Malawi's low starting point, even the slightest improvement in these areas can have a substantial impact on growth–as discussed in the last Article IV report.

- Several of these infrastructure projects are already close to coming on-line. For example, the large Shire Valley project (supported by the AfDB and the WB), will commence in early 2019, and will help with irrigation and electricity as well as increasing crop yield and intensity.

- 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 scandal and the withdrawal of donor support, as well as a severe drought. Malawi has taken a number of steps to enhance its resilience to shocks, including improving irrigation and electricity infrastructure.

3. ***Why have electricity prices increased so sharply and what steps are being taken to increase its supply?***

- Electricity prices have increased mainly to reflect increased costs of production due to the need to lease generators to make up for gaps in electricity provision.

- Over the next year electricity supply is expected to substantially increase owing to a recent power supply agreement with Zambia, recently renovated hydro facilities coming back on line, and expansion in solar power.

- Over the medium-term, the authorities are pursuing 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).

4. ***Regarding the description of poverty incidence in Malawi, we are concerned by the lack of timeframe uniformity in Text Figure 2 page 4 when comparing poverty across countries. In addition, we would expect a more relevant characterization of poverty using the latest available data. Staff's elaboration will be appreciated.***

- Data characterizing the poverty rate is sparse for this region. The poverty headcount ratio is not available for all years or consistent years across countries. Consequently, the chart applies the latest data available for a country and compares it with whatever past data is available.

5. ***Staff's updates on the implementation of the Malawi Growth and Development Strategy III and fiscal implications for the envisaged infrastructure development plan are welcome.***

- The macroeconomic objectives underpinning the MDGS III have been integrated into the ECF program and may be viewed as being on track.

- Although MGDS III lays out ambitious goals for critical infrastructure projects, the authorities are committed to preserving debt sustainability. External borrowing seeks to maximize grant elements and is limited to high priority projects guided by the MGDS III. Non-debt generating financing options (e.g., IPPs or FDI) are also being explored.

Fiscal Policy

6. ***Can staff comment on what strategies will be needed to preserve political support for tax reforms?***

- The near-term revenue improvement is based on compliance enhancement and tax measures already introduced in the 2018/19 budget. Its effective implementation does not depend on any political support—only on the Malawi Revenue Authorities.

Reforms that require political backing (streamlining incentives, VAT base broadening etc.) are planned for the medium-term, after the forthcoming elections.

7. ***How confident are staff that the proposed tax reforms are consistent with poverty alleviation goals, and that the burden will not fall disproportionately on the poor?***

- The proposed tax reforms are consistent with poverty alleviation goals. They include increased efficiency of income taxation (mostly by scaling back CIT exemptions and reliefs) and have the potential to improve income distribution. Expanding the VAT base – although often seen as regressive – will take away benefits from the wealthy as they consume more of currently untaxed goods.

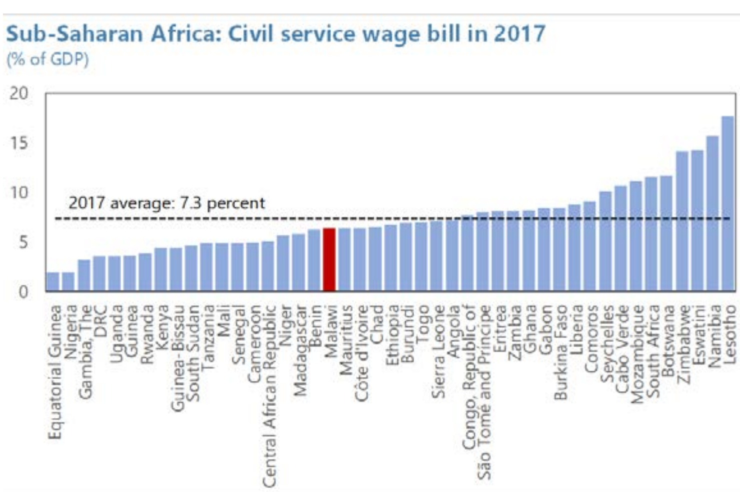
8. ***What is the percentage of government expenditure on the wage bill and how does this compare with peer countries?***

9. ***We would welcome the staff's view on the five percent wage increase in the approved FY 2018/19 budget.***

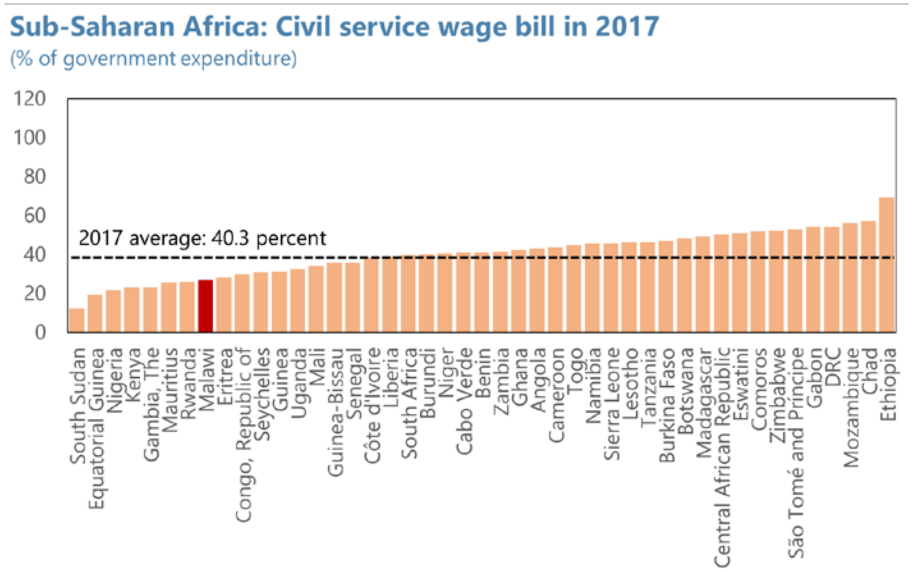
10. ***Staff's comments on the public sector wage increases and the overall composition of the budget for 2018/19 are welcome.***

- The five percent wage increase applies only to those in the bottom half of the pay scale. These salaries were not increased in line with bouts of high inflation since 2012.

- As a percent of GDP, Malawi's wage bill (7.4 percent of GDP in FY 2018/19) is in line with the SSA average and well below levels observed in the region (e.g., Mozambique, South Africa, Botswana, Zimbabwe).



- As a percent of government spending, Malawi's wage bill (27 percent of government expenditure in FY 2018/19) is significantly below the SSA average.



11. ***One of the main reasons for the expenditure overrun was increased spending to secure safety during elections. In this context, we wonder which developments have led to the additional spending needs and whether these could have been foreseen at the time of the program request. Staff comments are welcome.***

- The recent intensification of competition and tensions surrounding the upcoming elections have resulted in the need for more security enhancing equipment and services for the police and the military. At the time of the program request, this intensification was not expected by political analysts or the authorities.

12. ***Given the potential for continued volatile weather, have the authorities included contingency funding in the 2019 budget in case they need to purchase more maize following another weak harvest? Is the budget allocation for humanitarian food assistance realistic relative to risks?***

- To cope with unexpected shocks, the authorities have a fiscal reserve of MK 2 billion in the FY 2018/19 budget (goods and services budget line) and they have identified an additional MK 10 billion of contingency measures (cutting non-priority spending).

- The current allocation for maize purchases is MK 10 billion. Reserves were restocked in FY 2017/18 following the strong harvest in 2017.

13. ***Information on the number of SOEs, their share in GDP and whether they publish their annual balance sheets on a regular basis, would be welcome*.**

- There are 66 parastatals in Malawi. Over 30 of them are commercial (Malawian Airlines, Malawian Housing Corporations, ADMARC, water boards, etc.) and the remainder are a mix of regulatory entities (e.g. Tobacco Control Commission, National Lotteries Board, etc.) and service providing parastatals (mostly universities). Comprehensive data on the output of these entities is not available.

- There is no systematic reporting by the statutory corporations on their financial position and operational performance to the Ministry of Finance and oversight of parastatals is fragmented between the Ministry of Finance, line ministries, and the Office of the President's Cabinet (OPC). The authorities plan to launch a pilot for strengthening of oversight of SOEs, initially focusing on the agriculture, energy and water sectors, which should improve availability of data.

14. ***What are staff's views of the significance of other debt data omissions such as of local government, extrabudgetary funds, social security funds, and PPPs? Is Malawi receiving an appropriate mix of TA from the IMF or others to support improvements in debt data coverage and transparency?***

- As noted in the staff report availability of non-central government debt data, especially that of SOEs, is scarce and strengthening of debt management is of utmost importance. The planned pilot audit is aimed to improve the oversight of SOEs, including debt data availability. Local government, extrabudgetary funds, social security funds, and PPPs are not prominent in the Malawian fiscal sector so data omissions, if any, would not be significant. Malawi continues to receive active support from the IMF and the World Bank with a view to improve debt data coverage and transparency.

15. ***Has staff considered including amendments to the PFM Act as a future structural benchmark to incorporate the findings of the PIMA*?**

- The authorities aim to update the PFM Act over the coming year to incorporate recommendations from the Fund's recent PIMA and SOE technical assistance as well as to ensure consistency with the new RBM Act. This is a substantial undertaking. We will work with the authorities, including through technical assistance, to develop a clear timebound strategy to both update the PFM Act and to respond to the findings of the PIMA more broadly. As the efficiency of public investment is macro-critical, reforms in these areas could be considered as a future structural benchmark.

16. ***Could staff elaborate further on measures the authorities could take to reduce reliance on short-term domestic debt, within the parameters of the program?***

- By reducing fiscal deficits, overall gross financing needs will decline.

- Under the program, the authorities intend to gradually lengthen the maturity of government securities and develop the government securities yield curve – as outlined in paragraph 32 of the MEFP. Continued macroeconomic stability is expected to boost confidence and improve risk ratings, helping to increase demand for long-term government securities.

Monetary and Financial Sector Policies

17. ***What measures do staff think are effective in improving banks' profitability?***

- Important elements for increasing bank profitability include managing risks through proactive oversight and continuous risk monitoring; reducing high overhead, personnel, and loan loss provisioning costs; reducing loan concentration and diversifying asset portfolios.

18. ***Can staff provide information on micro-finance related initiatives in the country?***

19. ***Staff's comments on the authorities' progress on increasing access to finance are welcome.***

- There are 61 microfinance institutions in Malawi and their assets have steadily grown over the past decade. Malawi has also recorded strong growth in the value, volume and range of non-bank mobile money transactions, enabling access to financial services for a large proportion of the unbanked population. For example, the number of transactions has increased from 1,700 in March 2012 to 11.4 million in August 2017.

- The authorities are committed to increasing access to finance and are engaged in developing a roadmap by the end of next year.

External Sector Policies

20. ***Could staff explain the reasons why the World Bank may delay the disbursement? How much more donor support could be catalyzed following the completion of the first review?***

21. ***Could staff explain the reason behind the postponement of the World Bank's budget support?***

- World Bank staff are best positioned to answer this question.

- In terms of the catalytic role of the ECF program, in addition to World Bank budget support, donor support of about $300 million and $380 million is expected in 2019 and 2020, respectively (equivalent to 5 percent of GDP each year). We project loans of about $440 million would be contracted by the end of this year, and $100-$150 million each year for the next two years, all concessional and for key infrastructure projects in water, sanitation, irrigation, agricultural commercialization, energy, and telecommunication. Grants dedicated to social development and infrastructure are expected to reach around $200 million each year in the next two years.

22. ***What do staff think is the authorities' preference to have exceptions for contracting new non-concessional external debt?***

- Malawi is at moderate risk of external debt distress and high overall risk of debt distress driven by its growing public domestic debt. Under the Fund's debt limits policy, the moderate risk rating of external debt distress would allow for more flexibility in non-concessional external borrowing. However, considering the already high level of total public debt that results in the high risk of debt distress assessment for public debt, the authorities prefer to limit themselves to a zero ceiling and only consider, on a case-by-case basis, non-concessional external financing which backs priority growth-enhancing projects that are consistent with maintaining a moderate risk of external debt distress and the programmed fiscal path. Staff supports the authorities' approach.

Program Issues

23. ***We would appreciate further elaboration from staff on the breach in the QPC on contracting of new non-concessional external debt, recognizing that it appears to be technical oversight.***

- A nonresident bank purchased kwacha-denominated Treasury Notes of MK 92 billion in the domestic market between the approval of the program and end-June 2018. The Technical Memorandum of Understanding (TMU) excluded Treasury Bills (with maturity below a year) from the items subject to the QPC but not Treasury Notes (with maturity over a year), while the intention was to exclude both. In recent years, nonresident banks typically purchased Treasury Bills. Therefore, the purchase of the

Treasury Notes by the nonresident bank constitutes breaching of the QPC, as external debt is residency based.

- The definition of the external debt QPC in the TMU has been modified going forward to exclude both Treasury Notes and Treasury Bills from the QPC on new non-concessional external debt.

24. ***Why doesn't the table on p.46 use the terminology which was endorsed by the last Board meeting dealing with the DSF review for the moderate risk category (the terminology which was endorsed is "Moderate with limited Space", "Moderate", "Moderate with substantial space". See Review of the Debt Sustainability Framework for Low Income Countries- Proposed Reforms. SM/17/231, p. 44).***

- The use of "moderate with some space" is consistent with the Guidance Note on the LIC-DSF.

- According to the Guidance Note, when one of debt burden indicators (PV debt-to-GDP ratio) falls in neither "limited space" nor "substantial space", while all other three debt burden indicators fall into "substantial space" (as shown in Figure 5 of Staff Report page 56), "some space to absorb shocks" should be used.

- Staff will respond to the questions below, related to governance, catalyzing donor support, and program design, during the Board meeting.

25. ***We would ask staff to elaborate on the obstacles still faced in order to see clearer progress on improving governance and transparency, and reducing vulnerabilities to corruption which are paramount to improving economic outcomes and catalyzing badly needed donor support.***

26. ***Can staff comment on what new approaches could be taken to ensure timely reform implementation which enables the resumption of donors' budget support? Are there sufficient training and technical support provided to implement the PFM reforms?***

27. ***Donor funding for the budget remains low, reflecting continued governance concerns after the 2013 cashgate scandal and slow reform implementation. Progress towards attaining SDGs also appears to be constrained by the insufficiency of fiscal space. Given the critical nature of these issues, have relevant experts been put in place on a long-term basis in the country to advice the authorities on resolution of these issues?***

28. ***Does staff feel that the IMF can help in resumption/augmentation of fund flows to the government which had suffered from cuts in the recent past?***

29. ***Staff's comments on the delay in donor disbursements and on how program conditionality aims to address governance concerns and catalyze on-budget donor support are welcome.***

30. ***In what way have efforts been made in the case of Malawi to adapt IMF policies and practices to its needs as a fragile state, especially with regard to the country-specificity of IMF advice and conditionality and collaboration with other development partners in a country beset with real sector challenges?***

31. ***Since the beginning of the last ECF, in 2012, GDP per capita remains constant and well behind regional peers and other fragile states. We wonder if program design can support authorities in this task given the short-term and overall economic impact of this issue. Staff comments are welcome.***