

**DEPARTMENT FOR INTERNATIONAL DEVELOPMENT**

**PROJECT MEMORANDUM**

**MALAWI: POVERTY REDUCTION BUDGET SUPPORT, 2004/05 – 2005/06**

**Financial Aid: £ 30 million**

**December 2004**

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## List of Acronyms

ACB	Anti Corruption Bureau
AfDB	African Development Bank
CABS	Common Approach to Budget Support
GDP	Gross Domestic Product
HIPC	Highly Indebted Poor Countries
IMF	International Monetary Fund
MPRS	Malawi Poverty Reduction Strategy
PAF	Performance Assessment Framework
PPE	Pro-Poor Expenditure
PRBS	Poverty Reduction Budget Support
PRGF	Poverty Reduction & Growth Facility
SAC	Structural Adjustment Credit
SMP	Staff Monitored Program
SWAp	Sector Wide Approach

## 1. SUMMARY

This submission seeks approval for a total of £30 million of poverty reduction budget support to the Government of Malawi over 2004/5 and 2005/6.

2. The case for poverty reduction budget support for Malawi rests on the benefits that would flow from an extended period of macro-economic stability. The primary impact would be the stimulus to investment and growth that has been deterred by high interest rates and erratic policy implementation, with beneficial effects on income poverty. The secondary impact would be to reduce the large proportion of the budget spent on interest arising from domestic debt, thereby making those resources available for reallocation to poverty reduction.

3. Malawi has seen an apparent sea change with the election of a new government in May 2004. President Mutharika has made clear that he wants a departure from the bad practices of the past – economic mismanagement and corruption – and a new focus on growth and poverty reduction. Mutharika marked his break with the past with some early actions to cut the cost of government and improve its effectiveness. He has waged a major and public campaign against corruption.

4. The new Government inherited a large overhang of domestic debt and an interest bill that consumes one third of the budget. The budget approved by parliament in September 2004 will reduce domestic debt as a percentage of GDP if and when budget support resumes. The IMF agreed a Staff Monitored Program with the Government in June and has confirmed that the Government remained on track through to end September.

5. The 2004/05 Budget increases the allocations to Pro-Poor Expenditure budget lines to 23.4% of expenditure (up from 20.5% in the 2003/04 outturn), representing 7.5% of projected GDP (up from 6.9%). These increases are only possible as a result of Poverty Reduction Budget Support.

6. We judge fiduciary risk to be high, but the reforms that we have agreed to support will address the priorities for strengthening in year budgeting and accounting. The Minister of Finance's request for us to supply senior officials to work in the Finance Ministry provides further assurance of progress.

7. The economic programme is also high risk. The budget is too tight and Malawi too poor to cope with any major shocks. The scope for Malawi to take action alone is limited: it is already raising an unusually high level of own revenue as a proportion of GDP. Hence the need for donor support. The alternative is a spiral downwards into a debt trap and a LICUS style crisis.

8. DFID is part of the 'Common Approach to Budget Support' in Malawi with the European Commission, Norway and Sweden. Following a joint review in October, our donor partners also intend to process proposals for budget support.

9. On the basis of the Staff Monitored Program, the World Bank has released the first tranche of a structural adjustment credit that was agreed, but almost immediately suspended, earlier this year.

10. DFID Malawi recommends that new PRBS commitments of £10 and £20 million be made to Malawi for the fiscal years 2004/05 and 2005/06 respectively. The 2004/05 commitment would be additional to the £5 million disbursed in October from the 2000-2003 Programme Aid grant. The additional £10 million would be disbursed immediately upon approval in order to maximize its impact in reducing interest costs. The £20 million commitment for 2005/06 will be disbursed at the start of Malawi FY 2005/06 following a positive assessment of economic performance during the March 2005 CABS Review.

11. It is anticipated that there will be a strong case for continued PRBS beyond 2005/06. However, it is not proposed to commit further PRBS at this stage because: (a) the track record of improved economic management is too short; (b) the Government has yet to develop a credible Medium Term Expenditure Framework; and (c) we need to discuss with the Government its medium term development and poverty reduction priorities over the course of the next year. Our intention is to work jointly with the World Bank on a new strategy to respond to the Malawi Government's own work on a new development strategy during 2005.

## **2. PROJECT HEADER SHEET**

Attached.

## **3. MALAWI'S DEVELOPMENT PROGRESS AND PRIORITIES**

### **3.1 Progress with Poverty Reduction**

3.1.1 Malawi is one of the ten poorest countries. 65% of the population are below the poverty line. Income poverty has worsened since the early 1990s due to poor macro-economic management and increasingly frequent droughts. A majority of the population is short of food for three or more months in the year. Primary education completion rates are only 39%. AIDS is creating new groups of vulnerable families and orphans. Progress has been good on reducing child mortality and stabilizing HIV infection rates. Those apart, Malawi is unlikely to come close to reaching the targets for the Millennium Development Goals unless there are radical changes to political incentives, implementation capability, and the volume and predictability of aid flows.

3.1.2 The introduction of democracy in 1994 produced some improvement in poverty *policy*. Free universal primary education was one product. However,

there was not a commensurate improvement in the ability of government to *implement* policy. This weakness is in part attributable to a loosening of authoritarian control into a democratic license, initially for the political class and subsequently for officials. Public policy shifted from an elitist focus to an ambition for universal services that has outstripped money, skills and management capability.

### 3.2 Political Governance

3.2.1 2004 has seen a number of changes in the political context that improve the prospects for more serious attention to poverty reduction. All political parties recognised the need for reform because macro-economic policies had become unsustainable. This has allowed the new President to build cross-party support and carry through reforms despite opposition from the old guard in his own party. The electorate that registered a substantial protest vote against the ruling party in the elections has subsequently indicated strong support, regardless of party allegiance, for the reforms of the new President. In a highly personalised political system, the President's intentions are crucial. As it happens, Bingu wa Mutharika is committed to reforming his country.

3.2.2 As a result, there is a window of opportunity until the run-up to the next election to institutionalise better policy. It will be vital to enable the Government to make a connection between poverty reduction and political success, in particular to restore macro-economic stability and to deliver pro-poor services. With so many people going hungry every year, food security will also be central.

3.2.3 The new President is also strengthening political institutions. It is his interest to make a clear distinction between party and government and to bear down on corruption. He has encouraged the state media not to cover his party rallies and to cover the activities of the opposition. He has increased funding for the accountability organizations and strengthened their senior personnel.

3.2.4 The diplomatic and donor communities are active in defending democratic institutions, but are less effective than they might be because they lack a policy framework. Donor support has also been fragmented. We intend to promote a CABS style approach to political governance together with like-minded donors.

### 3.3 Malawi Poverty Reduction Strategy

3.3.1 The Malawi Poverty Reduction Strategy (MPRS) was completed in April 2002 and received the stamp of approval from a Joint Staff Assessment by the World Bank and IMF in August 2002. The process of developing the Strategy was genuinely nationally led and involved a wide range of stakeholders. The product is a comprehensive framework for poverty reduction, but without any attempt at realistic prioritization of activities and budgets.

3.3.2 Two years into implementation, the Strategy's influence on government planning and budgeting has been modest. Positives include the Government's willingness to classify certain budget lines as Pro-Poor Expenditure (PPE) and to protect them from cuts. However, the explosion in interest on domestic debt since 2001 has meant that resources for the social sectors from government and donor sources have not increased significantly and remain inadequate to *maintain* current levels of service delivery, let alone *improve* them. We estimate that Malawi has one half of the resources required for progress on the education MDG and, prior to the Health SWAp, one third of the resources that it needed to make progress towards the maternal mortality MDG and AIDS goals.

3.3.3 The Government produced the first full Annual Progress Report (for FY2002/03) in July 2004, following a participatory review process. However, the current report failed to provide an adequate analysis of budget expenditure and performance data. Few overall conclusions can be drawn from the Review about the quality of implementation of the Poverty Reduction Strategy. We are placing more faith in the Integrated Household and Demographic & Health Surveys due to be conducted in 2005 to give more reliable data on development outcomes. DFID Malawi is also developing a programme to address the data deficiencies in the Poverty Reduction Strategy and to strengthen links with budget processes.

#### 3.4 New Government's Development Policies

3.4.1 The new Government's main focus is on the economic crisis and food security, but the President also has a longer vision. He wants to improve the enabling environment for growth by reducing interest rates and inflation and addressing other constraints. The Government has less well worked out plans for the vertical integration of commodities, such as expanding the cotton industry from crop production into processing and the manufacture of textiles.

3.4.2. Since the election, the Government has acted to reform the public service. The President has re-structured and reduced the number of central government departments, ministers and permanent secretaries. He chose ministers and senior civil servants on merit to the extent that building a coalition made that possible. He moved the Presidency and all government previously located in Blantyre to join the rest of government in the capital, Lilongwe. He has initiated a more efficient and transparent pay policy for public servants.

3.4.3 Government and donors are also working together more effectively in the social sectors. In addition to the recently agreed health SWAp, Government has injected a new energy into the dialogue about a sector wide approach for education.

3.4.5 Addressing food security is a political priority. All political parties promised in the election campaign to finance fertiliser subsidies. The Government feels under great pressure to find a workable and affordable scheme, having raised

public expectations. Policy making in this area has oscillated erratically from ambition or panic to realism. The Government has also committed itself to the import and distribution of maize at semi-subsidised prices. The Government has got itself into an administrative, financial and political tangle over these policies. We will be monitoring their progress carefully for their impact on the budget.

3.4.5 DFID Malawi has argued against these policies on the grounds that the Government should only intervene in clear cases of market failure, which in Malawi are limited to remote areas. We are also concerned that the financial consequences of the subsidy and maize schemes will be difficult to control and lack a clear poverty focus. As an alternative, we have encouraged and supported financially the expansion of targeted input programmes that DFID supported in the past and that are designed to increase land productivity through the distribution of small volumes of free inputs for poor farmers. In partnership with the EU and the World Food Programme, we are also spending £5 million on the distribution of maize to the large number of people who suffered a complete harvest failure and are too poor to buy food.

### 3.5 Objectives of UK Development Assistance

3.5.1 DFID's Country Assistance Plan was designed around Malawi's Poverty Reduction Strategy. The programme is undergoing some re-focusing to target the MDGs more explicitly and to respond to new opportunities created by the new Government. In order to target income poverty and hunger more effectively, we propose to shift out of a disparate collection of livelihoods projects and a tendency to respond to acute crisis as with this year's humanitarian aid. Instead we propose to support the enabling environment for growth, principally through budget support and helping Malawi find policies that will stimulate growth more successfully and address the chronic problems of vulnerability.

3.5.2 In the social sectors, DFID has recently committed £100 million over six years that will finance an Essential Health Package and an Emergency Human Resources Programme. DFID has been a leader amongst donors on HIV & AIDS. DFID also persisted in primary education, preparing the way for better times in terms of Government commitment that we now see. In these areas, we have agreed with the World Bank that we will discuss a division of labour.

3.5.3 In pro-poor governance, DFID's flagship has been the successful police, justice and prisons programme. We propose to focus more on political governance as noted above and to promote, but not necessarily fund, wider public service reform

### 3.6 Donor Harmonisation

3.6.1 There are some excellent examples of government / donor harmonisation in Malawi: - the implementation of the three 'Ones' for HIV & AIDS; the Common

Approach to Budget Support; and the National Action Group for the growth strategy - which involves Government, private sector and the donor community. But these are isolated examples of good practice. The previous Government was not interested in or capable of giving a lead. The new Government is showing more interest.

3.6.2 DFID Malawi's priorities for 2005 include working with UNDP, other donors and the Malawi Government on a more comprehensive approach to harmonization. This is an ambitious scheme given the lack of capability in government to co-ordinate its own policies. Too much weight falls on the revitalised Treasury. We do not expect to see much progress before 2006.

## **4. THE RATIONALE FOR BUDGET SUPPORT**

### **4.1 Economic Background**

4.1.1 Despite early successes resulting from reforms in the mid-1990s, economic performance in recent years has been poor. GDP growth averaged 1.4% per annum between 1998-2001 compared to 4.6% pa between 1995 and 1998. Following the famine in 2001, when GDP fell by 4.2%, there was a modest rebound of about 1.8% in 2002 and 4.4% in 2003. As the population growth rate is 2.2%, such modest growth rates mean that per capita income has been falling.

4.1.2 Malawi has few natural resources. Agriculture currently provides what little growth there is, but production is beset by degraded soil, erratic weather conditions and a system of land ownership and inheritance that does not encourage investment. Tobacco accounts for about 70% of total exports. A highly open economy, Malawi's current trade preferences will be substantially eroded over the medium term.

### **4.2 Fiscal Performance under the Muluzi Government**

4.2.1 Such unpromising conditions would be a challenge to any government. Unfortunately, the Muluzi Government's fiscal performance compounded the problems. Every year since 1992, Malawi exceeded IMF set targets for the level of domestic financing of the budget deficit and by particularly wide margins in recent years. Following assurances of improved performance, the IMF Board approved a three-year PRGF arrangement when Malawi reached the decision point under HIPC in December 2000. However, Malawi rapidly went off track again in November 2001. CABS members immediately suspended budget support. At the point of suspension, DFID had already disbursed £42.5 million out of a £75 million 2000-03 Programme Aid agreement.

4.2.2 Instead of cutting back expenditure in response to reduced budget support receipts, the Government greatly increased domestic borrowing. The situation was exacerbated by the 2002 food crisis, which involved substantial unbudgeted expenditure on maize imports equivalent to 3.5% of GDP. The domestic debt

stock jumped from 8.4% of GDP in June 2001 to in 30.0% of GDP (US\$500 million) in June 2004. Despite improved revenue performance over the period<sup>1</sup>, the fiscal deficit jumped to 7.9% of GDP in 2001/02 and 12.1% (including costs of the maize operation) in 2002/03.

4.2.3 The combination of increased food supplies (leading to lower prices<sup>2</sup>) and Reserve Bank operations to mop up excess liquidity succeeded in bringing inflation down from 27% in 2001 to 10% in 2003<sup>3</sup>. However, this was achieved at the expense of a sharp rise in *real* interest rates, which exceeded 30% for most of 2003. The combination of sharp increases in both the domestic debt stock and interest rates led to a dramatic increase in Government's domestic interest bill from 3.0% of GDP in 2000/01 to 9.2% of GDP in 2003/04.

4.2.4 The Government's position had become unsustainable and its financial managers recognised it. Fiscal management improved noticeably over the period January 2003 to March 2004. As a result, the IMF eventually completed the First Review of the PRGF in October 2003. This enabled the CABS Group to resume budget support, with DFID disbursing £10 million between November 2003 and February 2004, and the World Bank concluding a US\$50 million Structural Adjustment Credit.

4.2.5 In March 2004 Parliament approved a Supplementary Budget 2003/04 – agreed with the IMF – which, if adhered to, would have facilitated completion of the PRGF Second Review. However, within weeks substantial further unbudgeted expenditure took place - almost certainly related to the May elections and possibly involving theft by departing ministers. The IMF subsequently estimated the over-expenditure (above the Supplementary Budget) at 3.5% of GDP, bringing the fiscal deficit for the year to 7.3% of GDP<sup>4</sup>. Given Malawi's record of policy slippages, this was the last straw for the IMF and the PRGF (which had to end by December 2004 anyway) was effectively terminated. As a result, DFID withheld the final £5 million tranche of PRBS.

4.2.6 The above developments have severely damaged the economy. The explosion in domestic debt has undermined fiscal management. Domestic interest accounted for *28.4% of total Government expenditure* (excluding foreign financed development expenditure) in 2003/04. When account is taken of other non-discretionary expenditure including foreign interest (4.6%), wages and pensions (23.4%) and Pro-Poor Expenditure (8.5%, excluding wages), the Finance Ministry retains some control over less than a quarter of total expenditure. High real interest rates mean that, as Government acknowledges, *'the vast majority of Malawian businesses are not able to access finance for*

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<sup>1</sup> Government revenue was equivalent to 23.6% of GDP in 2003/04, which is high by the standards of Sub-Saharan Africa

<sup>2</sup> Food has a 58% weight in the CPI

<sup>3</sup> The IMF SMP projects annual average inflation at 15% in both 2004 and 2005

<sup>4</sup> This excludes arrears, the scale of which is yet to be ascertained

*investment*. Government over-expenditure has contributed to inflationary pressure and the depletion of foreign exchange reserves. Macroeconomic stability is very fragile, therefore.

#### 4.3 New Government's Economic Programme

4.3.1 President Mutharika has emphasized the need for fiscal prudence and macroeconomic stability. He has backed the tough line taken on public expenditure by the Finance Minister, who was formerly Director of Africa Division in the IMF for many years.

4.3.2 The new Government agreed a Staff Monitored Program (SMP) with IMF staff in July. The targets through end September have been met comfortably and, if Malawi stays on track through to December, IMF staff intend taking a new PRGF to the IMF Board in April 2005.

4.3.3 The fiscal strategy for 2004/05 focuses on halting the growth of domestic debt in order to bring down real interest rates, reduce government expenditure and increase private investment and growth. Continued domestic borrowing is required in the first half of the year until the resumption of budget support allows a start to be made on debt reduction. Even so, the domestic interest bill is expected to decrease as recent reductions in bank rate have had little impact on the demand for government debt<sup>5</sup>. The significant *real* reduction in the interest bill has created fiscal space for a number of measures, such as agricultural support, that would otherwise be unaffordable. The fiscal deficit is projected to drop from 7.3% of GDP to 4.3%.

#### 4.4 Public Financial Management and Fiduciary Risk

4.4.1 Overall, fiduciary risk is high, but latterly the trajectory of change has been positive.

4.4.2 There have been problems at all stages of the budget cycle, but the main risks lie in budget execution and accounting. Key challenges are in controlling aggregate expenditure in line with budget allocations, curbing extra-budgetary requests, establishing the cash management system as effective mechanism for within year expenditure control, including improving the quality of fiscal data and bank reconciliations, and strengthening the effectiveness of oversight institutions, such as the National Audit Office and Parliament.

4.4.3 The last Government did create a platform for change. This included updating public financial management legislation, restructuring and modernising procurement systems, establishing accountability organisations and defining and monitoring pro-poor expenditures. While the last Government had no intention of

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<sup>5</sup> Because of the high real level of interest rates and the absence of alternative investments offering comparable returns.

putting these changes into practice or allowing unfettered accountability, they have given a head start to the new government, which has a more serious demeanour.

4.4.4 There is already some evidence of a change of approach over the last six months under the new Government. It includes better performance on overall expenditure control in the first quarter of the fiscal year, production of annual accounts soon after the end of the financial year, progress in clearing the backlog of unaudited annual accounts and submission to Parliament, more serious application to routine financial tasks in Ministries we are familiar with, a major campaign against corruption, more funding and new appointments to accountability organisations and plans to strengthen capability in the Accountant General's Department. Other indicators of the change in approach include a more open and consultative approach by the Ministry of Finance to donors.

4.4.5 Given the high level of fiduciary risk, DFID Malawi will monitor closely government performance on public financial management. As part of the Common Approach to Budget Support (CABS) group, DFID will participate in six monthly reviews of progress in macroeconomic management, public financial management reform (including corruption), and implementation of the Malawi Poverty Reduction Strategy. We will work closely with the Government, donors and other key stakeholders to strengthen government leadership and coordination with donors.

4.4.6 DFID Malawi has designed a programme of support with Government to strengthen Poverty Reduction Strategy policy making and its co-ordination with budgetary allocations. This includes support for improving budgetary systems and measuring the performance of accountability institutions, as well as improving the data and evidence base for PRS policy making.

4.4.7 *Corruption.* Malawi became steadily more corrupt after democratisation. The major form of corruption was inappropriate political interference in decisions about public sector spending, allowing diversion of funds for personal or party purposes. This led to a more generalised failure to implement rules and procedures systems and the collapse of the systems of checks and balances.

4.4.8 Many of these problems stemmed from the patrimonial politics practised by the previous president. The actions of the new president have substantially changed the incentives on corruption. These include:

- Removing many of the most corrupt Ministers and PSs
- Stopping and investigating corruption scams in the public sector, with a view to prosecutions in some cases
- Centralising major procurement decisions with the trustworthy Minister of Finance

- Arrest of previously ‘untouchable’ politicians from the ruling party on corruption charges, such as the Secretary-General of the party
- Appointment of respected people to key positions such as Minister of Finance and Director of Public Prosecutions
- Increasing funding and replacing senior staff in accountability institutions such as ACB.

4.4.9 *Reform Programme.* There is a good framework for reform including the new legislation for public financial management and the Malawi Financial Accountability Action Plan (MFAAP), a government policy document intended to improve implementation and coordination of activities required to strengthen financial accountability. The MFAAP is far from perfect, containing a long list of unprioritised activities, but it is a government document owned, at least, at official level around which donor interventions could be aligned. It also proposes establishing a secretariat for coordinating and monitoring activities.

4.4.10 At present there is a galaxy of separate donor activities in this field, covering almost a full range of potential needs, but in an uncoordinated way. They add up to a collective ambition that is unrealistic in terms of the capacity of systems to deliver. With the recent government focus on financial management, there is now considerable scope to improve coordination and the effectiveness of donor assistance and for giving more thought to the sequencing of reform.

4.4.11 Further details on public financial management can be found in the Fiduciary Risk Assessment at Annex 2.

#### 4.5 The Case for PRBS

4.5.1 The case for PRBS in Malawi is about creating the macro-economic platform for poverty reduction policies. In particular, it is necessary to establish the credibility of the budget process, to restore macro-economic stability and to reduce the proportion of expenditure wasted on domestic debt service. These changes will produce direct development benefits. However, we do not see budget support as the principal instrument for transferring resources for poverty reduction. For that to work, it would be necessary to strengthen institutions more generally, including the MPRS process. We therefore expect to proceed on a twin track: first, using budget support as described above with performance related incentives to support the institutional changes that Malawi needs; and, second, encouraging government to pursue the MDGs and institutional strengthening through sector wide approaches and policy dialogue.

4.5.2 Domestic debt constrains growth and poverty reduction in two main ways. Firstly, high real interest rates are crowding out private investment. Secondly, the Government interest bill is crowding out productive public expenditure. Interest accounted for 33% of total domestic expenditure in 2003/04 and is

budgeted at 28% in 2004/05. As a result, Government non-interest expenditure is well below the levels needed to provide a basic level of essential services.

4.5.3 The case for PRBS in Malawi at this time is essentially that, along with support from other agencies, it should enable Government to start reducing the level of domestic debt. This, in turn, should lead to lower interest rates and a virtuous circle of lower interest payments, reduced expenditure, further debt repayment and so on. As the interest share of total expenditure declines, resources will be released for productive poverty-reducing expenditure. Simultaneously, falling real interest rates will reduce one of the main constraints to private investment, which should lead to increased growth and increased resources for poverty reduction.

4.5.4 IMF projections indicate that if: (a) PRBS is resumed; (b) Government adheres to the 2004/05 IMF Staff Monitored Programme; and (c) it maintains the fiscal stance beyond 2004/05, domestic interest should decline from 9.5% of GDP in 2003/04 to 3.0% of GDP in 2007/08. In this scenario the overall fiscal deficit (including grants) drops from 7.3% of GDP to a sustainable 3.3% over the same period<sup>6</sup>. This indicates the scale of resources that could be released for pro-poor expenditure.

4.5.6 Experience elsewhere (e.g. Uganda) shows that establishing the credibility of the budget can *in itself* provide a substantial boost to macro stability and growth. Given Malawi's awful record of fiscal management, if Government can deliver on its commitment to eliminate extra-budgetary expenditure (at least in aggregate) for, say, two years this can be expected to have a significant impact. However, for Government to have a realistic chance of sticking to its own budget the budget itself must be realistic and must be seen to deliver benefits to the poor. As shown in section 5, the 2004/05 Budget is critically dependent upon the resumption of PRBS.

4.5.7 We recommend proceeding with PRBS now and before waiting for further evidence of a good track record. Firstly, foreign exchange reserves are at a dangerously low level. With the tobacco auctions closing in November, foreign exchange inflows will dry up. There is a danger that speculative pressure could cause a run on the Kwacha, which would make restoration of macroeconomic stability even more difficult. Secondly, delays in receipt of PRBS mean yet more domestic borrowing (and interest) – adding to the task of bringing debt under control. Thirdly, an early disbursement would send a strong signal from Malawi's main donor to the markets, MPs and the public that the new Government is on the right track.

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<sup>6</sup> 'Selected Issues', IMF, October 2004, page 24.

## 5. FINANCING REQUIREMENT

5.1 Malawi has always been aid dependent and will remain so for the foreseeable future. However, the rapid accumulation of domestic debt since 2001 means that the government can not finance even its basic activities - let alone implementation of the MPRS - without substantial donor support. At 24% of GDP, Malawi's projected revenue in the 2004/05 Budget is highly creditable. However, *recurrent* expenditure alone in 2004/05 is estimated at 31.2% of GDP, of which interest accounts for 9.0% of GDP. Financing the recurrent budget, let alone debt reduction, is simply not possible without external financing, involving IMF, and budget and balance of payments support.

5.2 The 2004/05 Budget Framework was agreed with the IMF. This assumes: budget support grants of US\$47m; balance of payments loans of \$68m; and HIPC debt relief of \$52 million. Together, these represent approximately 26% of total domestic expenditure<sup>7</sup> (excluding foreign financed development expenditure) and 8.5% of GDP. The breakdown of grants and loans is shown in Table 1. Disbursements to date are shown in brackets.

**Table 1: Budget Support Grants / Balance of Payments loans, 2004/05 (US\$ million)**

	Grants	Loans
DFID	27 (9)	
EU	9	
Norway	8 (3)	
Sweden	3	
World Bank SAC		50 (25)
AfDB		18
<b>TOTAL</b>	<b>47</b>	<b>68</b>

## 6. IMPLEMENTATION

### 6.1 Design and Management

6.1.1 Donor co-ordination on budget support has been particularly good. The Common Approach to Budget Support group (CABS) comprises all the budget support donors, namely DFID, EC, Norway and Sida. Germany has recently decided to provide budget support to Malawi and intends joining CABS. The IMF and World Bank have observer status with CABS, as will the African Development Bank now that it is providing a balance of payments credit.

<sup>7</sup> Of this, the proposed DFID PRBS of £15 million represents 4.2% of total domestic expenditure

6.1.2 CABS undertakes detailed formal reviews of economic and financial management every six months and meets frequently with the Finance Ministry on specific issues. CABS members have moved together on all major decisions in recent years. The CABS group is developing a common Performance Assessment Framework (PAF) to guide future funding and disbursement decisions. It is anticipated that DFID PRBS disbursement decisions from 2006/07 will be based upon the PAF. The PAF will have some 20 outcome, output and process indicators. Most will be drawn from the Poverty Reduction Strategy Monitoring & Evaluation Master Plan. Each CABS member may base its funding and disbursement decisions on different elements from the PAF, using either explicit scoring methodologies (eg EU) or more general judgments (DFID).

## 6.2 Disbursement Arrangements

6.2.1 DFID and other CABS members are concerned to increase the **predictability** of PRBS. These flows have been highly erratic in recent years because most CABS donors tied the release of funds to IMF opinion about whether Malawi was on-track. The resultant disbursement delays were a factor in the build up of domestic debt. We propose in future to reach our own conclusions on whether Malawi is on track, using IMF data and analysis and taking account of staff opinion. Disbursement decisions should be taken following the February / March CABS Review, in time for the following Budget. PRBS disbursements will normally be made as a single payment at the beginning of the Malawi financial year.

6.2.2 The 2004/05 disbursement will be made immediately upon approval of this Memorandum. Since the PAF is unlikely to be agreed in time for it to be used for the 2005/06 disbursement decision, for that year the decision will be based largely upon the macroeconomic assessment during the March 2005 CABS Review, possibly supplemented by process indicators such as initiation of wider public service reforms and progress towards improving comprehensiveness of the Budget.

## 6.3 Monitoring and Reporting Arrangements

6.3.1 Primary responsibility for external monitoring of the Staff Monitored Programme and any future PRGF programme lies with the IMF. Malawi is currently on a quarterly review schedule. Following the much more open approach of the new Finance Minister, CABS members now have access to most of the data supplied to the IMF and regularly exchange views.

6.3.2 CABS Reviews focus on more microeconomic issues such as the composition of public expenditure, PPEs and budget comprehensiveness - along with public financial management and governance issues (e.g. corruption, procurement). From 2005 reviews will increasingly monitor progress against development indicators in the Performance Assessment Framework.

#### 6.4 Accounting and Auditing

There is £3.5 million remaining undisbursed in the 200/2003 grant. We propose to increase the grant by £6.5 million to accommodate the £10 spend, this financial year, in the interest of speedy disbursement. A new grant agreement will be opened for the FY2005/06 tranche. Accounting and auditing requirements were established during Programme Aid 2000 – 2003. These systems will continue. All disbursements will be made into the Consolidated Fund, a/c MG1 at the Reserve Bank.

#### 6.5 Managing UK Disbursements

Crown Agents Financial Services Limited will undertake the disbursement of each tranche on behalf of DFID. A request for the disbursement of each tranche, signed by two authorized signatories, will be made by the Reserve Bank to DFID Malawi, copied to Crown Agents.

### 7.0 **RISKS AND UNDERTAKINGS**



#### 7.1 Risk Analysis

7.1.1 Government's recent track record of fiscal indiscipline and weak public financial management highlighted in the Fiduciary Risk Assessment (Annex 2) means that this is clearly a high - risk programme. The main risks (along with proposed mitigating measures) are as follows:

**Risk A [Probability medium, Impact high].** *Government's fragile political position means it is unable to withstand pressures for extra-budgetary expenditure, resulting in continued domestic borrowing.* **Mitigation:** The UK will continue to send strong message of support for the Government's positive policies and warnings of the consequences of failure.

**Risk B [Probability low, Impact high].** *As in 2003/04, domestic interest rates are higher than assumed by Government / IMF in 2004/05 Budget - resulting in increased Government interest bill and continued borrowing.* **Mitigation:** Conservative interest rate assumptions have been adopted in Budget. Most Treasury Bill interest is already contracted and known.

**Risk C [Probability low, Impact medium].** *Budgeted Pro-Poor Expenditures are not protected.* **Mitigation:** Floor on PPEs was a PRGF Quantitative Benchmark and Government disbursement performance has been good. In the absence of a PRGF, CABS will consider including a floor on PPEs (eg actual 2003/04 expenditure maintained in real terms) in the PAF.

**Risk D [Probability medium, Impact medium].** *The high proportion of budget expenditure committed to interest, wages and PPEs, combined with the commitment to fiscal targets, means any shocks have a disproportionate impact on other recurrent expenditure – undermining general Government performance.*

**Mitigation:** If Government performance is otherwise good, DFID PRBS for UK FY 2005/06 can be disbursed in fourth quarter of Malawi FY 2004/05. This is not included in SMP / Budget estimates.

## 7.2 Undertakings

7.2.1 Poverty Reduction Budget Support is dependent as a minimum on the Government staying on track with its macro-economic programme – as assessed by the IMF and CABS. It also requires a steady improvement in the quality of public financial management.

7.2.2 We are not proposing specific undertakings on political governance. Malawi remains a largely peaceful and democratic country. The effectiveness of all government-to-government aid depends on further consolidation of democratic institutions.

7.2.3 Annex 1 contains the current draft of the Partnership Framework for the Common Approach to Budget Support. It will be refined in the light of experience elsewhere and in negotiation with Government. It sets out the undertakings of both CABS members (e.g. to provide support in a predictable way, on the basis of a common assessment, six monthly reviews, etc) and Government (e.g. to provide MPRS annual and audit reports, to participate in reviews). Disbursement of the 2005/06 PRBS will be conditional upon signature of the final draft of the Framework.