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Report No. P-6428-MAI

REPORT AND RECOMMENDATION
OF THE
PRESIDENT OF THE
INTERNATIONAL DEVELOPMENT ASSOCIATION
TO THE
EXECUTIVE DIRECTORS
ON A
PROPOSED SUPPLEMENTAL FINANCING ARRANGEMENT
OF SDR 27.6 MILLION (US\$40 MILLION EQUIVALENT)
TO THE
REPUBLIC OF MALAWI
UNDER THE
ENTREPRENEURSHIP DEVELOPMENT AND DROUGHT RECOVERY PROGRAM
(CREDIT NO. 2396-MAI)

OCTOBER 11, 1994

MICROGRAPHICS

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Report No: P- 6428 MAI
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CURRENCY AND OTHER EQUIVALENTS

CURRENCY EQUIVALENTS

Currency Unit: Malawi Kwacha (MK)

US\$ 1	=	MK 9.0
MK1	=	US\$ 0.11
MK1	=	100 Tambalas

WEIGHTS AND MEASURES

1 cubic foot (cu ft)	=	0.0283 cubic meters
1 cubic meter (m ³)	=	35.3 cubic feet = 264 US gal
1 kilometer (km)	=	1,000 meter = 0.621 miles
1 hectare (ha)	=	10,000 square meters - 2.47 acres

GLOSSARY OF ABBREVIATIONS

ADMARC	-	Agricultural Development and Marketing Corporation
DCA	-	Development Credit Agreement
EDDRP	-	Entrepreneurship Development and Drought Recovery Program
ESAF	-	Enhanced Structural Adjustment Facility
FAO	-	Food and Agriculture Organization of the United Nations
MRFC	-	Malawi Rural Finance Company
NGOs	-	Non-Governmental Organizations
PFP	-	Policy Framework Paper
SACA	-	Smallholder Agricultural Credit Association
SAF	-	Social Action Fund
SGR	-	Strategic Grain Reserve
WFP	-	World Food Programme

Government of Malawi Fiscal Year

April 1 - March 31

MALAWI

SUPPLEMENTAL FINANCIAL ARRANGEMENT UNDER THE

ENTREPRENEURSHIP DEVELOPMENT AND DROUGHT RECOVERY PROGRAM

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Annex I: Malawi: Key Macroeconomic Indicators, 1989-97

This report is based on the findings of a drought assessment mission which visited Malawi in May 1994. The mission consisted of Mr. Hartwig Schafer (Mission Leader and Country Economist). Mr. Ataman Aksoy is the managing Division Chief, Mr. Robert Christiansen is the Country Operations Manager, and Ms. Katherine Marshall is the Department Director for the operation.

REPUBLIC OF MALAWI

SUPPLEMENTAL FINANCIAL ARRANGEMENT UNDER THE

ENTREPRENEURSHIP DEVELOPMENT AND DROUGHT RECOVERY PROGRAM

SUMMARY

Borrower: Republic of Malawi

Beneficiary: N/A

Amount: IDA: SDR 27.6 million (US\$40 million equivalent)

Total external support under the program amounts to more than US\$266 million. In addition to the original IDA allocation (US\$120 million) plus US\$10 million in IDA reflows, cofinancing is provided by the Government of Japan (US\$70 million), by the African Development Fund (FUA 10 million), by the German Government (DM 20 million), and by the European Union (ECU 30 million).

Poverty: The central objective of the supplemental financing arrangement is to reduce drought related food insecurity and help stabilize maize markets.

Description: The proposed supplemental financing arrangement under the ongoing EDDRP adjustment credit is IDA's contribution to help close the unanticipated external financing gap that is the result of drought-related import requirements (equivalent to US\$102 million).

Malawi is affected by severe drought for the second time in three years. The new Government -- in office since May 1994 following the first multiparty elections in three decades -- has asked the donor community for additional assistance during this emergency situation. The most immediate consequence of the drought is the need to import 445,000 MT of maize (comprising 200,000 MT for targeted free distribution to food deficit households in drought areas and 245,000 MT to be distributed through commercial channels) to achieve food security and stabilize commercial maize markets.

The Government needs to provide adequate levels of commercial maize to help maintain consumer prices at affordable levels (i.e., at the target consumer price) so that free maize distribution is limited as a measure of last resort for the very poor. This policy is consistent with the new Government's strong commitment to poverty alleviation as the core of the development agenda.

The current unanticipated external supply shock was highlighted as an inherent risk of the Country Assistance Strategy presented to the Board

on June 7, 1994, in conjunction with the Second Institutional Development Project (Credit No. 2624-MAI). The Government and Bank are in full agreement with regard to macroeconomic and structural policies, particularly with regard to the Government driven initiatives on private sector development and poverty alleviation. There is a high probability that the Bank may shift into the high lending scenario as Government has already demonstrated its commitment to quickly removing structural obstacles to an accelerated supply response and sustainable poverty alleviation.

Effective and timely assistance by IDA and other donors – during the current drought emergency – will support macroeconomic stabilization and will allow the new Government to continue implementing its adjustment policies.

The original EDDRP was approved by the Executive Directors on June 23, 1992, and became effective on July 7, 1992. The EDDRP provides financing to (i) prevent widespread food insecurity, and alleviate the impact of severe drought; and (ii) facilitate reforms to broaden economic participation and enable a sustainable supply response consistent with medium-term balance of payments viability, growth, and poverty reduction.

IDA released the second credit tranche on September 23, 1993, after: (i) satisfactory progress had been made in carrying out the reform program; (ii) monetary and fiscal policies had been tightened to ensure stabilization of the economy; (iii) sufficient new external aid had been mobilized to ensure that the adjustment program was fully financed; and (iv) specific conditions for release of the second tranche were met.

The closing date of the credit has been extended through June 1995, to facilitate full disbursement of all existing cofinancing arrangements.

The current overall rating for the credit is “Highly Satisfactory.”

Term: Standard IDA terms; 40-year maturity with a 10-year grace period.

Commitment Fee: 0.50% on undisbursed credit balance, beginning 60 days after signing.

Staff Appraisal Report: N/A for amendment to existing adjustment operation.

**INTERNATIONAL DEVELOPMENT ASSOCIATION
REPORT AND RECOMMENDATION OF THE PRESIDENT
TO THE EXECUTIVE DIRECTORS
ON A PROPOSED SUPPLEMENTAL FINANCING ARRANGEMENT
TO THE REPUBLIC OF MALAWI
UNDER THE ENTREPRENEURSHIP DEVELOPMENT
AND DROUGHT RECOVERY PROGRAM (CREDIT NO. 2396-MAI)**

1. I submit for your approval the following report and recommendation on a proposed supplemental financing arrangement, to the Republic of Malawi for SDR 27.6 million (US\$40 million equivalent) under the Entrepreneurship Development and Drought Recovery Program (EDDRP; Credit 2396-MAI). The supplemental financing arrangement would be on the same terms as the main credit, i.e., standard IDA terms with 40-year maturity and a 10-year grace period. This memorandum (i) gives a short overview of post transition developments in Malawi and the current drought which is the cause for additional financing needs; (ii) assesses food import requirements; (iii) outlines the measures already taken to address the drought situation; (iv) summarizes the medium-term macroeconomic framework; (v) reviews the credit's history and progress to date; (vi) highlights the relationship between the Country Assistance Strategy and the proposed Bank action; and (vii) presents an external financing plan for 1994-95.

OVERVIEW

2. Malawi, one of the poorest countries in Sub-Saharan Africa, has recently completed a peaceful political transition from over 20 years under a single party system to a multiparty democracy. International observers commended the transition process, including the general elections of May 1994 which ushered the previous opposition into government. This achievement is all the more impressive given the economic challenges of 1992-93; including withdrawal of non-humanitarian bilateral donor support because of governance issues and the worst regional drought on record.

3. The new Government is fully committed to consolidating the economic stabilization process and attacking the country's pervasive poverty problem. After four months in office, the new Government's track record with regard to poverty alleviation is impressive; e.g., school fees for primary education were waived, critical restrictions on prices and marketing in agriculture have been lifted, and a Social Action Fund (SAF) for community based investments in social sectors is being put in place on a fast track, with IDA assistance. A Presidential Council on Poverty Alleviation (with broad based participation of NGOs, traditional leaders, religious groups, and political parties) has been put in place to set overall policy direction, mobilize resources, and sensitize the populace at large about poverty issues and programs. The challenges facing a new Government would be formidable even under normal circumstances. In Malawi, the new Government's credibility and economic management are, in addition, being tested by another severe drought.

4. For the second time in three years, economic management is being challenged by a massive crop failure due to a drought as serious as the one in early 1992. Maize production in 1994¹

¹ The planting season is from October through November; the harvesting season is from April through May of the following year.

dropped to 831,000 MT from over 2 million MT in the previous year. The situation has been aggravated by the collapse of the agricultural credit system during the months preceding the general elections. Use of hybrid seed and fertilizer dropped sharply because farmers who defaulted on the previous years' loans could not obtain new credit. The new Government has already taken effective steps to resuscitate the rural credit system, including the transfer of the system from direct Government control to an autonomous financial institution (with support from IDA under another credit). By developing sound operational procedures and lending requirements the new rural credit system will help prevent future large-scale defaults. The restructured credit system began operation in October 1994 and will work to ensure credit availability for those farmers who qualify under the strengthened eligibility criteria and will help increase food supplies through higher yields in 1995.

5. The most immediate consequence of the drought is the need to import 445,000 MT of maize to achieve food security. Out of the total, a minimum of 200,000 MT is needed for distribution as emergency food aid for some 600,000 smallholder families whose crops failed. The balance of 245,000 MT is urgently required as commercial food aid to stabilize the market until the next crop is harvested (May 1995). The Government is particularly concerned to ensure sufficient supplies of commercial maize so that consumer prices can be maintained at the targeted levels and free maize distribution can be limited as a measure of last resort to reach the very poor. This policy is consistent with the new Government's strong commitment to poverty alleviation and support of private sector participation in agricultural marketing.

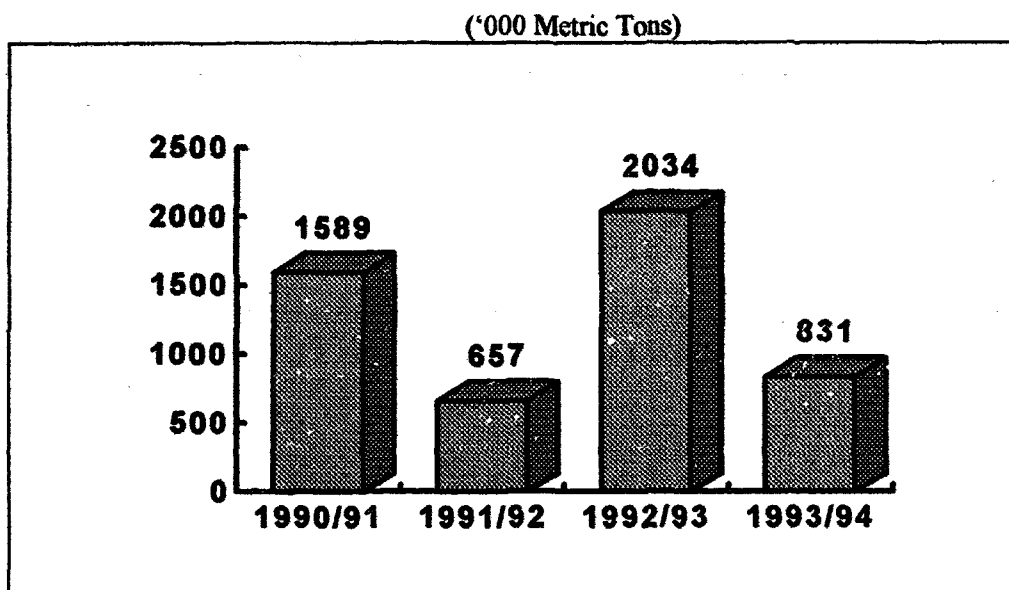
6. The additional import requirements inevitably increase the external financing gap for 1994/95². Assuming that all maize can be imported from within the region, the total foreign cost for maize imports is estimated at US\$102 million (at total cost of US\$230 per MT). The new Government has asked the donor community for additional assistance to help finance this amount. Despite a substantial and rapid donors' response through pledges for commercial and relief maize and offers to divert existing balance of payment commitments to maize imports, the overall financing gap cannot be closed without multilateral support. **The proposed supplemental financing arrangement under the ongoing EDDRP adjustment credit is IDA's contribution to help close the unanticipated external financing gap and help ensure that external funding levels are adequate for (i) drought related imports to achieve food security; and (ii) general import support under the adjustment program.**

EMERGENCY FOOD IMPORTS - NEEDS ASSESSMENT

7. **Production.** The 1994 production of Malawi's main staple food -- white maize -- is estimated at 831,000 MT. This is 60 percent lower than last year's record harvest of 2 million MT and only slightly higher than the extremely poor crop in 1992 (657,000 MT) when the country was hit by a devastating drought which affected the entire southern Africa sub-region (Figure 1). The small size of the 1994 harvest mainly reflects the delayed onset of the rainy season, extended dry spells, and insufficient and poorly distributed rainfall throughout the growing season. The sharp fall in maize production has resulted in a large food deficit in 1994/95, and substantial maize imports are needed.

² Before this drought, the total financing gap for 1994 had been filled by donors' commitments of balance of payment support.

Figure 1: Malawi - Maize Production



8. **Import Requirements.** Due to the unusually large 1993 harvest the Agricultural Development and Marketing Corporation (ADMARC) started the 1994/95 marketing year (April 1994 through March 1995) with a stock of 110,000 MT and a Strategic Grain Reserve (SGR) of 180,000 MT. On-farm stocks from last year's harvest are estimated at 30,000 MT. This amount combined with the expected draw-down of the entire ADMARC stocks and 140,000 MT from the SGR implies total available stocks of 280,000 MT. Hence total domestic availability of maize is about 1.11 million MT (Figure 2). The total requirement for 1994/95 is estimated at 1.55 million MT, assuming a target per capita consumption level of 150 kg of maize for a population of 9.5 million plus allowance for seed, feed and wastage of 138,000 MT. Consequently, the maize import requirement for 1994/95 is 445,000 MT (excluding the needs of the Mozambican refugees which are covered through other relief channels).³

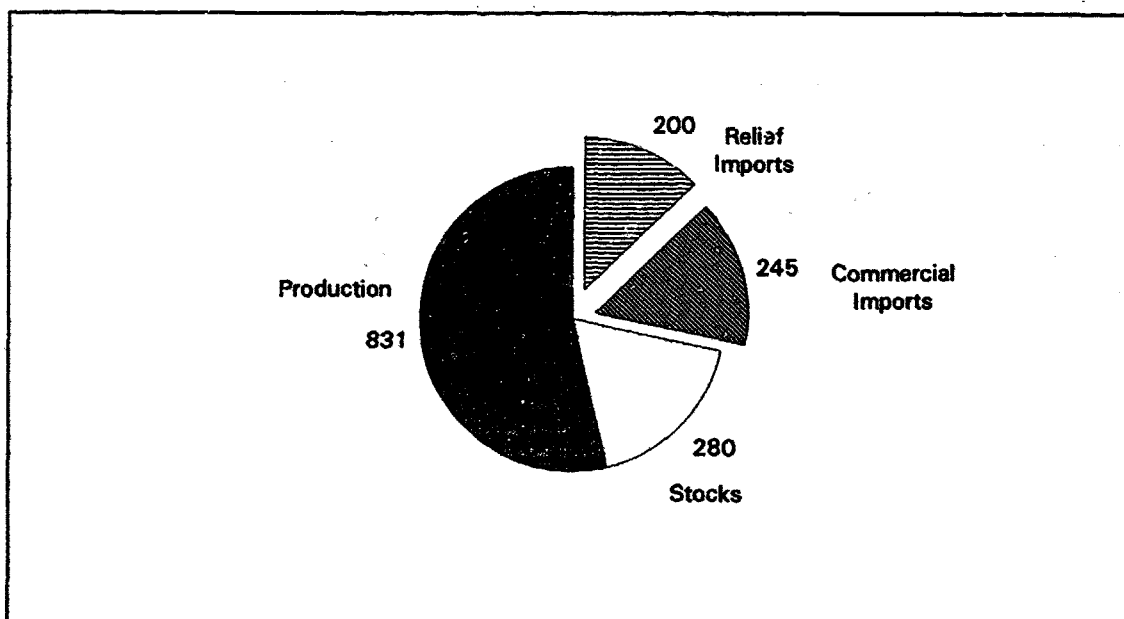
9. Out of the total import requirement some 200,000 MT will be needed as emergency food aid for 3 million drought-affected Malawians. The remaining 245,000 MT are being handled as program food aid (provided through commercial channels) to stabilize maize prices in the 1994/95 marketing year. In a year of a substantial drop in food crop production coupled with a sharp decline in the production of major cash crops, such as groundnuts and cotton, many rural households are suffering a significant decline in income. This reinforces the need for adequate maize supply through commercial channels to prevent sharp increases of consumer prices due to rationing or speculative stockpiling. The consumer price of maize is currently at MK 67 per 90 kg bag; the official consumer price applicable for the 1994/95 marketing year. Prices so far have remained stable because markets have been adequately supplied from ADMARC stocks and the SGR. However, to hold prices at this level requires adequate maize supplies through April 1995. Failure to maintain stocks in rural areas for sale at the official price would seriously jeopardize the

³ Computation of the maize import requirement is based on the findings of a WFP/FAO drought assessment mission to Malawi in May 1994 and subsequent updates of the initial analyses.

effectiveness of the limited relief program and could undermine the credibility of the market support systems. This was the experience in 1992 drought relief efforts when ADMARC ran short of commercial maize supplies and had to impose stringent rationing. The commercial maize imports will be critical for maintaining price stability.

Figure 2: Malawi - Sources for Meeting Maize Requirements

April 1994 - March 1995
(‘000 Metric Tons)



10. **Logistics.** The lessons learned in the 1992 drought operation will be taken into consideration during the 1994 drought. The Government plans to work closely with NGOs in coordinating drought relief efforts. This will provide an excellent springboard from which to launch various programs over the next two months to permit a successful distribution, including community-based food-for-work activities. However, the local administrative, managerial and technical capacity to undertake such programs is limited. In addition, NGO capacity has declined since the 1992 drought and many NGOs have sent key staff into neighboring Mozambique to tackle problems connected with the returning refugees and the demobilization program. Consequently, free distribution may have to remain the principal food distribution mechanism for meeting relief needs in regions where food-for-work schemes cannot cope.

11. Malawi has a proven capacity to handle and transport 600,000 MT of imported cereals, and the import, storage, and internal distribution of 445,000 MT of maize in 1994/95 should not pose serious logistical problems. During the 1992 drought relief operation, almost 300,000 MT of maize were imported and distributed throughout the country using the storage facilities of ADMARC and the transport fleet of the local private sector. Commercial imports financed by IDA added a further 100,000 MT, and the Mozambican refugee program imported 200,000 MT.

MEASURES TAKEN TO ADDRESS THE CURRENT DROUGHT

12. **Drought Preparedness.** Drought is a common event in Malawi; extreme weather fluctuations over the past decade have caused significant shifts in food production. As a result, achieving food security -- as part of a poverty alleviation program -- is a priority on the Government's development agenda. Establishment of the SGR has helped the country achieve national food security in most years, except during unusually severe droughts. In the longer term, Government aims to reduce susceptibility to weather-related shocks by promoting agricultural and economic diversification, and promoting the development and adoption of drought-resistant maize varieties and water-conserving cultivation techniques.

13. An improved price and marketing incentive system for nontraditional smallholder crops will facilitate diversification away from maize and tobacco, thus reducing drought susceptibility. The Government is committed to accelerating structural reforms in order to remove the remaining constraints to production and marketing of agricultural produce and inputs. In August 1994, Government removed all private sector restrictions on domestic trading of agricultural products. At the same time, Government lifted export licensing requirements for all agricultural products, except maize, groundnuts, and beans; the latter two will be fully liberalized after the current drought year and export licenses for maize will remain in place for food security reasons. The Government also recognizes the importance of maintaining adequate and sustainable price incentives for all smallholder crops. Except for maize, the Government plans to further deregulate crop prices with the 1994/95 crop season so that prices and marketing arrangements will be determined principally by market forces. In the medium-term, the Government plans to fully liberalize fertilizer markets, including imports.

14. Research and extension efforts are geared toward promoting efficient supply and the use of high-yielding agricultural inputs through a wider delivery of public research and extension services. These improved services focus on generating and disseminating lower cost technical methods to strengthen drought preparedness at the farm level. Another aspect of the agricultural strategy will be the development and implementation of small-scale irrigation schemes -- where economically viable -- driven by the participation of the benefiting communities in execution and maintenance. Given the large proportion of resource-poor households which will not be able to afford the maize hybrid and fertilizer package, the research and extension system will also be important in promoting more drought-resistant crops (e.g., cassava), intercropping of maize with pulses, agroforestry, and soil and water conservation technologies.

15. **Rural Credit System.** The drought-related drop in maize production was aggravated by the collapse of the rural credit system after farmers did not repay their loans. This collapse is the result of the politization of the agricultural credit program during the transition period when most parties used the prospect of "credit forgiveness" as a campaign tool. While credit recovery rates exceeded 90 percent in the past, they dropped to 15 percent in 1993. As a consequence, farmers in default on previous credits had no access to credit to purchase fertilizer and certified seed for the fall 1993 planting season.

16. One of the first issues on the agenda of the new Government was the re-establishment of the rural credit system to avoid a continuing downward spiral of low credit, low fertilizer use, and poor harvest. An Action Plan for addressing the poor rural credit recovery was agreed upon in March 1994 and consisted of three major actions, which were to be

implemented immediately: (i) Government statement on credit recovery policy and enforcement; (ii) restoration of 100% repayment policy; and (iii) specific credit recovery operations including stop-orders and court actions against the largest defaulters. Although the implementation of the Action Plan was planned to start in early April with radio and newspaper announcements, it was not until after the elections (late June) that the new Government issued a radio press release and followed up with weekly newspaper press releases. At the same time, the President's address to members of Parliament included a credit policy statement, which emphasized that credit discipline must be enforced and that all borrowers had to repay their loans. Since then, a list of defaulters has been compiled and stop-orders against tobacco producers and payroll deductions against civil servants have been authorized.

17. The collapse of the rural credit system highlighted some of its inherent structural weaknesses which had long been a subject of concern; for example, insufficient criteria for creditworthiness, and lack of autonomy of the Smallholder Agricultural Credit Association (SACA). To redress the inherent structural weaknesses, IDA and the Government prepared the Rural Financial Services Project (IDA Credit No. 2513-MAI; presented to the Board on June 15, 1993). Under the project, the rural credit system (SACA) has been transferred from the direct control of Government to a new autonomous financial institution, the Malawi Rural Finance Company (MRFC) which will be privatized within three to four years. As safeguards against future large-scale credit defaults, MRFC has adopted sound operational and lending requirements based on commercial principles of creditworthiness and repayment ability; including 100% repayment on old loans before being eligible for additional credit. Credit effectiveness was delayed by 15 months pending Government's implementation of the prerequisites that would help achieve commercial viability of the revised rural credit system. The necessary legal and policy actions were carried out by the new Government and the credit was declared effective in September 1994; in time to commence MRFC lending operations with the fall 1994 planting season.

18. Although the full impact of Government's commitment to 100% credit recovery and joint liability of farmer credit clubs before extending new credit will not be evident for some time, IDA is satisfied with progress made to date. Moreover, the Government's clear determination not to compromise the financial integrity of the new rural credit system and to give in to popular pressure for credit forgiveness are impressive and bode well for future progress.

MEDIUM-TERM MACROECONOMIC OBJECTIVES

19. The new Government inherited several daunting and immediate challenges when it took office. Fiscal and monetary discipline suffered in the months immediately preceding the May elections. As a consequence, the economic and financial stabilization efforts that started in early 1994 were not sustained. Instead, excessive borrowing by the outgoing Government from the banking system in the first two months of the fiscal year, along with pressures induced by exchange rate depreciation, led to an increase in the projected rate of inflation from less than 20 percent to around 30 percent for 1994.

20. The new Government is committed to an expeditious reversal of the recent deterioration in monetary and fiscal aggregates. The broad parameters of Government's medium-term macroeconomic and structural policy framework were endorsed by a Bank macroeconomic mission

(in July) with participation of the Fund. Although the new Government had been in office for only four weeks, they reached agreement with the Fund on a short-term stand-by arrangement (starting in October 1994) which is to be succeeded by a three-year ESAF arrangement (starting in April 1995) to support the Government's comprehensive poverty alleviation strategy. In late September, another Fund staff visit to Malawi confirmed that all prior actions for the stand-by arrangement are in place. Furthermore, Government with the assistance of Bank and Fund, is now in the process of finalizing details of its medium-term fiscal, monetary, and external policies as well as its poverty alleviation program. Government plans to present this medium-term strategy to the external partners at the Consultative Group meeting in December 1994.

21. In the meantime, Government has already started to implement the necessary policy changes to achieve financial stability. A brief outline of the medium-term macroeconomic targets follows:

- **Fiscal Policy:** The underlying strategy will emphasize fiscal discipline and the consolidation and extension of structural fiscal policy reforms. On this basis, the overall central government budget deficit (before grants) is targeted to decline from an estimated 11.9 percent of GDP in drought-affected 1994/95 to 6.6 percent in 1995/96; after grants, the deficit is projected to be reduced to less than 3 percent by 1996/97.
- The ratio of revenue to GDP is expected to rise from about 17.5 percent (excluding grants) in 1993/94 to an average of about 20 percent during 1994/95-1996/97. Following administrative strengthening of tax and tariff revenue collection and strict enforcement of tax compliance, actual tax revenues have exceeded estimates in the third quarter of FY94/95.
- In view of the pressing need to restore fiscal discipline, the new Government no longer tolerates unauthorized overspending by line ministries and will move to a cash flow budget by November 1994. Expenditure policies are also guided by the need to reorient recurrent expenditures to provide more emphasis on outlays in key social sectors and on efficiency in the delivery of services. For instance, recurrent expenditures were cut in non-priority areas (e.g., civil service travel, replacement of official vehicles) to accommodate salaries for additional teachers that were hired following the increase in enrollment numbers after all school fees for primary education were waived. Within this framework, Government expenditure (including drought-related operations) as a percentage of GDP is targeted to decline from 33.4 percent in 1993/94 to 24 percent in 1995/96.
- The Government plans to introduce a tax-inclusive budgeting system starting in 1995/96 and adopt a medium-term expenditure framework with the 1996/97 budget. To improve overall budget planning, the Government, the World Bank, and the donors have embarked on a Budget Management Review which seeks to identify and accommodate sectoral priority expenditures within the overall constraints of the fiscal framework.

- **External Sector Policy.** Exchange rate policies will continue to focus on the maintenance of external competitiveness and the attainment of medium-term balance of payments viability. In February 1994, the fixed exchange system was replaced with a market based exchange system. The new Government is fully committed to the market-based exchange system, and has now put emphasis on refining the new exchange system to redress speculation against the kwacha and ensure that export revenues are circulated within the system. Specific measures that have been implemented include prudential limits on foreign exchange holdings by commercial banks, 35 percent reserve requirement on private foreign exchange accounts, and complementing monetary policies. Continuous supply of foreign exchange, either from export revenues or from balance of payment support, is critical for sustainability of the liberalized exchange system. The eventual objective of the exchange reform is to move to a free interbank market in foreign exchange by end-1994/95.
- **Monetary Policy.** A tight monetary stance will aim at achieving and sustaining a low rate of inflation consistent with overall growth and balance of payments objectives. Total outstanding bank credit to Government is projected to decline substantially over the medium-term, so releasing resources to the private sector. In the short-term, the Reserve Bank will continue to pursue a restrictive monetary stance through tight control of the liquidity position of commercial banks, maintenance of a market-determined interest rate structure, and greater use of market-based intervention policies; i.e., appropriate use of the Reserve Bank's rediscount and repurchase facilities and frequent issues of Treasury Bills at auctions. First results of a tighter monetary policy are already observed in the decline of the annualized rate of monetary expansion from 53 percent in June 1994 to 28 percent in September 1994.

22. Supported by these policies, the overall macroeconomic goals for 1994/95-1996/97 are: (i) an acceleration of real GDP growth, which after a drought-induced drop by 9 percent in 1994, should rise to 4.5 percent by 1996-97; (ii) a deceleration in the rate of inflation to 5 percent by 1997; and (iii) a further reduction in domestic and external imbalances with a view to attaining a sustainable balance of payments position by the end of the decade.

PROGRESS UNDER THE ADJUSTMENT OPERATION

23. The EDDRP was approved by the Executive Directors on June 23, 1992, and became effective on July 7, 1992. The EDDRP provides financing to:

- prevent widespread food insecurity, alleviate the impact of severe drought, and help stabilize local maize markets; and
- facilitate reforms to broaden economic participation and enable a sustainable supply response consistent with medium-

term balance-of-payments viability, growth, and poverty reduction;

24. Policy reforms supported under the EDDRP seek to: (i) improve the environment for entrepreneurial activity and investment in labor-intensive production; (ii) deepen financial markets; and (iii) re-orient fiscal and labor policies toward developing human capital.
25. IDA released the second credit tranche on September 23, 1993, after: (i) satisfactory progress had been made in carrying out the reform program; (ii) monetary and fiscal policies had been tightened to ensure stabilization of the economy; (iii) sufficient new external aid had been mobilized to ensure that the adjustment program was fully financed; and (iv) specific conditions for release of the second tranche had been met.
26. The first tranche of US\$86 million (including US\$6 million IDA reflows) and the second tranche of US\$44 million (including US\$4 million IDA reflows) have been fully disbursed. Under the first tranche US\$40 million was used for maize imports to help offset the impact of the 1992 drought.
27. Total external support under the program amounts to more than US\$266 million. In addition to the original IDA allocation (US\$120 million) plus US\$10 million IDA reflows, cofinancing is provided by the Government of Japan (US\$70 million), by the African Development Fund (10 million FUA), by the German Government (DM 20 million), and by the European Union (ECU 30 million). The closing date of the credit has been extended through June 1995, to allow full disbursement of all existing cofinancing arrangements.
28. The current overall rating for the credit is "Highly Satisfactory". Government has implemented all actions set out under the Development Credit Agreement and the policy actions are showing the desired impact. The new Government continues to deepen and strengthen policy implementation to fully achieve and sustain the objectives of the EDDRP. Government has enacted policy measures to effectively reduce investment delays, accelerate land lease procedures, and extend trade reform to facilitate outward orientation of the private sector. Initial contacts with foreign investors have been highly successful; several foreign investors have registered their companies in Malawi and have signed letters of intent for joint ventures. Government has enacted financial sector reforms to promote wider resource access and mobilization of additional resources in a more competitive environment. A major component of this strategy was the restructuring of the Post Office Savings Bank into an autonomous financial institution, now called the Malawi Savings Bank. The recent licensing of two new foreign banks reflects Government's commitment to enhance competition in the financial sector. Rationalization of the tariff structure and broadening of the tax base are well underway; and particular emphasis is given to administrative measures to protect fiscal revenues. The Government has strengthened human resource development through reorientation of public expenditures in favor of the priority social sectors. The Government has undertaken measures to improve the functioning of labor markets, support decentralized employer and employee wage bargaining, has enacted policies to improve the situation of tenant laborers on estates, and has streamlined the minimum wage legislation.

JUSTIFICATION OF PROPOSED BANK ACTION

29. The current unanticipated external supply shocks were highlighted as an inherent risk of the Country Assistance Strategy presented to the Board on June 7, 1994. Following the political transition, the Bank has become a major partner in helping Malawi tackle its day-to-day economic problems as well as in addressing long-term economic and social issues of development. There is a high probability that the Bank may shift into the high lending scenario as Government has already demonstrated its commitment to quickly removing structural obstacles to an accelerated supply response and sustainable poverty alleviation. The Country Assistance Strategy is being adjusted to directly reflect Government's emphasis on private sector development and poverty alleviation.

30. The Bank has made particular efforts over the past two months to assist Government's efforts to prepare and launch a SAF. This will be integral to Government's broad-based poverty alleviation initiative through providing resources for community-based projects, including schools and water supply. Nevertheless, the adjustment process in Malawi will take time and the expected supply response could be delayed by negative developments in Malawi's external environment, such as the current drought. *Under such adverse circumstances, the donor community -- including the Bank -- should continue to assist Malawi, especially through additional quick-disbursing balance of payments support.* The proposed supplement under the ongoing adjustment operation complements the assistance provided by other donors in the forms of food aid and additional balance of payments support on humanitarian grounds.

31. Given the seriousness of the drought, Government's limited financial resources, and the need for a timely response -- and after weighing alternative options for Bank assistance -- a supplemental financing arrangement is the most appropriate measure to help ensure consolidation of the transition process and sustain economic adjustment and stabilization. The present situation in Malawi meets the prerequisites under which supplemental financing for adjustment operations could be considered:

- ✓ **Malawi's economic program is proceeding on track and there is full compliance with the agreed policy agenda.** During a July macroeconomic mission of Bank and Fund teams, the Government negotiated a medium-term policy framework that fully endorses and even strengthens several areas of the fifth PFP (distributed to the Board on March 11, 1994).⁴ The zeal of the new Government to tackle Malawi's structural problems is impressive. In addition to taking over the "driver seat" with regard to poverty alleviation, Malawi's structural policy agenda now carries a number of issues that had been too sensitive to be addressed with the former Government. The new Government has launched a comprehensive initiative that focuses on private sector development, privatization of public enterprises, and the need to achieve a sustainable supply response and diversify the economic base.
- ✓ **The time available is, however, too short for processing a freestanding IDA operation.** Although it is Government's wish to accelerate processing of the next adjustment operation which will focus on privatization of public enterprises and

⁴The medium-term policy framework also serves as a draft for the sixth PFP which will be concluded as soon as the Government has finalized the details of its poverty alleviation program.

removal of economic monopolies in the manufacturing, finance, and distribution sectors, the complexity of issues and likely legal obstacles involved could delay a freestanding operation. In that case, any balance of payment support would come too late to be effective during the current drought.

- ✓ **The drought-related financing gap is unanticipated and seriously jeopardizes the adjustment program.**
- ✓ **The financing gap has arisen for reasons beyond the control of Government.**
- ✓ **The additional financing requirements will not be met without IDA resources.**
- ✓ **The proposed amount under the supplemental financing arrangement is reasonable.** It is equivalent to 15 percent of the overall external support (IDA plus cofinancing) provided under the EDDRP; it amounts to one third of the original IDA allocation under the credit.
- ✓ **One objective of the EDDRP is to help prevent widespread household food insecurity, alleviate the impact of severe drought, and stabilize local maize markets. The proposed supplemental financing arrangement will provide the necessary foreign exchange to allow Malawi to remain on the adjustment track and achieve food security.**

EXTERNAL FINANCING PLAN

32. Malawi's total external financing requirements for 1994-95 amount to US\$1536 million, of which US\$102 million are drought-related (assuming import of 445,000 MT of maize at an average cost of US\$230 per MT). Malawi's own resources are estimated to account for US\$850 million: The remainder of US\$686 million will have to be provided through official donor grants and loans.

33. Before the emergence of the drought, the external financing gap for 1994 had been closed by multilateral and bilateral donor support; including the envisaged Stand-by Agreement with the IMF. Following the May elections, donors further upgraded their non-humanitarian support equivalent to pre-transition levels. In view of the emerging drought crisis, several donors agreed to allow Malawi to use general import support to procure relief and commercial maize. While this measure has allowed the Government to immediately start the process of maize purchasing, it has also resulted in a widening of the external financing gap for general import support. At this time, incremental donor pledges (excluding the proposed IDA supplemental financing arrangement) specifically for drought-related operations have reached the equivalent of US\$42 million for relief maize (free distribution) and US\$12 million in balance of payment support for commercial maize imports. Not accounting for the proposed IDA supplemental financing arrangement, a total external financing gap of US\$20 million and US\$64 million would remain for 1994 and 1995, respectively.

34. With the proposed IDA supplement, the financing gap for 1994 would be fully closed, and the financing gap for 1995 would be reduced to US\$44 million of which US\$8 million would be drought-related and the remaining US\$36 million would be for general import

support. The proposed level of IDA assistance is equivalent to the assistance provided during the 1992 drought (when total drought-related imports were of similar magnitude as the current import requirements). It is expected that the remaining drought-related financing gap for 1995 will be closed through additional donor support over the coming two months. Under extremely adverse circumstances, the Government would have to resort to the "iron reserve" of 40,000 MT that was planned to remain in the SGR. The 1995 financing gap for general import support is expected to be closed through the envisaged IMF ESAF arrangement (to succeed the short-term Stand-by) and through additional donor support to be mobilized at the forthcoming Consultative Group meeting in December 1994.

Table 1: Malawi - External Financing Requirements

(IN MILLION US\$)	1994	1995	TOTAL
FINANCING REQUIREMENTS	764	772	1536
NON-DROUGHT IMPORTS AND ALL SERVICES	576	613	1189
DROUGHT-RELATED IMPORTS	56	46	102
DEBT SERVICE (EXCL. INTEREST)	73	79	153
RESERVES BUILD-UP	21	17	38
OTHER OUTFLOWS	37	17	54
FINANCING RESOURCES	744	708	1452
EXPORTS AND ALL SERVICES	374	399	774
PRIVATE SECTOR TRANSFERS AND LOANS	36	41	76
NON-DROUGHT OFFICIAL GRANTS	93	97	190
PROJECT FINANCING	40	53	93
ADJUSTMENT SUPPORT	52	45	97
NON-DROUGHT OFFICIAL LOANS	205	153	359
PROJECT FINANCING	85	90	175
ADJUSTMENT SUPPORT	121	63	184
O/W IMF	22	0	22
IDA	5	45	50
DROUGHT-RELATED FINANCING	36	18	54
O/W GRANTS AND TRANSFERS	36	18	54
FINANCING GAP WITHOUT IDA SUPPLEMENT	20	64	84
FINANCING GAP WITH US\$40 MILLION IDA SUPPLEMENT	0	44	44
NON-DROUGHT RELATED	0	36	36
DROUGHT RELATED	0	8	8

SOURCE: GOVERNMENT INFORMATION AND STAFF ESTIMATES

DISBURSEMENT, PROCUREMENT, AND AUDIT

35. The resources provided under the proposed supplement would be disbursed upon effectiveness of the Amendment to the Development Credit Agreement (DCA) and would be subject to the procurement and audit covenants contained in the original DCA. The quick-disbursing funds would be used toward (i) general import support to replace Government's

own foreign exchange reserves that have been used for drought-related imports; (ii) closing the external financing gap after diverting other donors' general import support to drought-related imports; and (iii) drought-related imports to achieve food security.

RECOMMENDATION

36. I am satisfied that the proposed supplemental financing arrangement would comply with the Articles of Agreement of the Association and recommend that the Executive Directors approve it.

Lewis T. Preston
President

Attachment
Washington, D.C.
October 11, 1994

Malawi: Key Macroeconomic Indicators, 1989-97

	1989	1990	1991	1992	1993	1994	1995	1996	1997
					Prel	Projections			
(Annual percentage change)									
GDP growth rate (factor cost)	4.1	4.8	7.8	-7.9	10.8	-9.3	12.1	4.5	4.5
Consumption per capita growth rate 1/	4.3	-0.4	2.4	-2.7	1.5	-0.3	0.2	0.7	0.6
CPI change	15.7	11.5	8.2	23.2	22.8	29.3	15.1	6.5	5.0
(In percent, unless otherwise specified)									
Debt service (millions of SDRs) 2/	92.0	76.7	79.4	73.3	60.2	62.5	69.5	81.9	85.0
Of which: interest	31.0	30.4	28.5	25.9	25.1	25.0	27.1	28.6	29.0
Debt service/Exports of G & S	39.5	23.3	21.2	24.7	25.1	23.4	24.1	26.1	25.6
Debt service/XGNFS (after debt relief)	33.6	23.3	21.2	24.7	25.1	23.4	24.1	26.1	25.6
Debt service/GDP	7.7	5.8	5.0	5.6	4.2	5.7	5.4	6.0	5.8
Gross investment/GDP 3/	21.2	19.7	20.1	18.8	12.3	15.2	16.7	18.1	19.4
Private fixed investment/GDP 4/	11.2	11.7	8.8	6.7	2.6	4.5	4.7	5.0	5.5
Government fixed investment/GDP	5.4	5.0	8.1	9.4	7.4	8.2	9.7	10.9	11.8
Stockbuilding/GDP	4.5	3.0	3.3	2.7	2.3	2.6	2.3	2.2	2.1
Domestic saving/GDP 5/	4.7	9.7	7.9	1.8	5.1	7.0	9.6	11.2	13.5
National saving/GDP	7.2	11.7	8.1	0.2	1.2	-0.8	3.8	9.3	11.9
Government saving/GDP	2.6	4.6	3.7	0.0	-0.6	3.2	5.0	5.2	5.6
Private saving/GDP	1.9	4.8	4.2	1.8	5.6	3.7	4.6	5.9	7.9
Government revenue/GDP 6/	22.7	20.0	18.9	18.4	17.5	21.5	19.8	20.2	20.4
Government expenditure/GDP 6/	30.7	26.3	24.5	32.7	25.4	33.4	26.5	24.2	23.5
Fiscal deficit excluding grants/GDP 6/	-6.9	-6.9	-6.3	-14.3	-8.6	-11.9	-6.6	-4.0	-3.1
Fiscal deficit including grants/GDP 6/	-2.1	-4.7	-3.0	-11.9	-5.5	-3.0	-3.1	-2.4	-1.4
Export volume growth (merchandise) 7/	-10.0	45.7	4.6	-1.3	-5.0	8.6	4.6	4.1	4.0
Exports/GDP	17.7	22.8	21.8	21.4	15.7	23.2	21.5	22.0	21.7
Import volume growth (merchandise) 8/	11.6	13.3	15.1	-4.8	-18.8	12.8	10.3	4.5	4.5
Imports/GDP 8/	26.6	27.2	27.1	35.5	25.5	35.9	31.4	27.9	26.6
Current account (millions of SDRs) 8/	-165.8	-106.6	-182.8	-245.0	-159.9	-176.3	-164.2	-119.8	-108.8
Current account/GDP 8/	-14.0	-8.0	-11.5	-14.9	-7.3	-12.3	-11.3	-8.8	-7.5
Current account including grants/GDP 9/	-9.1	-3.5	-8.8	-8.5	-3.4	-4.2	-4.8	-4.7	-3.8
Current account w/o transfers w/ maize imports	-14.0	-8.0	-11.5	-18.6	-11.1	-16.0	-12.9	-8.8	-7.5
External reserves (millions of SDRs)	78.5	95.5	102.7	33.4	39.2	21.5	47.6	63.4	64.7
In months of non-maize imports 8/	3.0	3.2	2.9	1.1	1.5	0.7	1.5	2.0	2.0

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

1/ Consumption excludes emergency imports related to displaced persons.

2/ Before debt relief; excluding debt conversion; including interest on short-term debt.

3/ Excluding purchase of an airplane by Air Malawi in 1991, which amounts to SDR 18.8 million.

4/ Statutory bodies not included in the central government budget are included in private sector investment.

5/ Saving excludes emergency grants and imports related to displaced persons.

6/ Fiscal year beginning in April of the year indicated; including special drought-related operations in 1992/93, 1993/94 and 1994/95.

7/ Figures in 1989-92 are affected by substantial stocks carried over at end-1989 and, to a lesser extent, at end-1990 and end-1991.

8/ Excluding purchase of the airplanes in 1991 and drought-related maize in 1992-93 and 1994.

9/ Excluding purchase of the airplane in 1991; including drought-related maize imports and financing

(which includes drought-related IDA) for 1992-93.