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INTERNATIONAL DEVELOPMENT ASSOCIATION

PROGRAM DOCUMENT

FOR A PROPOSED

DEVELOPMENT POLICY CREDIT

IN THE AMOUNT OF

SDR58.9 MILLION
(US$80 MILLION EQUIVALENT)

TO THE

REPUBLIC OF MALAWI

FOR AN

AGRICULTURAL SUPPORT AND FISCAL MANAGEMENT
DEVELOPMENT POLICY FINANCING

March 7, 2017

Macroeconomics and Fiscal Management Global Practice
Africa Region

CURRENCY EQUIVALENTS

(Exchange Rates Effective as of January 31, 2017)

Currency Unit	=	Malawi Kwacha
MWK 726	=	US$1
SDR 0.73592723	=	US$1

FISCAL YEAR

July 1 - June 30

WEIGHTS AND MEASURES

Metric System

ABBREVIATIONS AND ACRONYMS

ADMARC	Agricultural Development and Marketing Corporation
AgPER	Agriculture Public Expenditure Review
ASWAp	Agriculture Sector Wide Approach
CO	Controlling Officer
CPS/F	Country Partnership Strategy/Framework
CV	Coefficient of Variation
DHRMD	Department of Human Resources Management and Development
DPO	Development Policy Operation
DSA	Debt Sustainability Analysis
ECF	Extended Credit Facility
FISP	Farm Input Subsidy Program
FROIP	Financial Reporting and Oversight Improvement Project
GDP	Gross Domestic Product
GFEM	Group on Financial and Economic Management
GRS	Grievance Redress Service
IDA	International Development Association
IFMIS	Integrated Financial Management Information System
IHS	Integrated Household Survey
IMF	International Monetary Fund
INDC	(Intended) Nationally Determined Contribution
INTOSAI	International Organization of Supreme Audit Institutions
LDF	Local Development Fund
LDP	Letter of Development Policy
MASAF	Malawi Social Action Fund
MDA	Ministry, Department or Agency
MEM	Malawi Economic Monitor
MGDS	Malawi Growth and Development Strategy
MoAIWD	Ministry of Agriculture, Irrigation and Water Development
MoFEPD	Ministry of Finance, Economic Planning and Development
MoGCDSW	Ministry of Gender, Children, Disability and Social Welfare
MoITT	Ministry of Industry, Trade and Tourism
MoLHUD	Ministry of Lands, Housing and Urban Development
MT	Metric Ton
MVAC	Malawi Vulnerability Assessment Committee
MWK	Malawi Kwacha
NAO	National Audit Office
NFRA	National Food Reserve Agency
NPLs	Non-Performing Loans
ODA	Official Development Assistance
PEFA	Public Expenditure and Financial Accountability
PER	Public Expenditure Review
PFM	Public Financial Management
PFMA	Public Finance Management Act
PPG	Public and Publicly Guaranteed (Debt)
PSIA	Poverty and Social Impact Analysis
PSR	Public Service Reform
RBM	Reserve Bank of Malawi
SADC	Southern Africa Development Community
SCT	Social Cash Transfer
SDR	Special Drawing Rights
SGR	Strategic Grain Reserve
TA	Technical Assistance
WBG	World Bank Group

Regional Vice President	:	Makhtar Diop
Country Director	:	Bella Bird
Practice Director	:	Paloma Casero
Country Manager	:	Laura Kullenberg
Practice Manager	:	Abebe Adugna
Task Team Leader	:	Richard Record

MALAWI

AGRICULTURAL SUPPORT AND FISCAL MANAGEMENT DEVELOPMENT POLICY FINANCING

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The Malawi Agricultural Support and Fiscal Management Development Policy Operation was prepared by an International Development Association (IDA) team consisting of Richard Record (Senior Country Economist and Task Team Leader), Colin Andrews (Senior Social Protection Specialist), Blessings Botha (Agricultural Specialist), Chiara Bronchi (Lead Public Sector Specialist), Kevin Carey (Lead Economist), Efrem Chilima (Senior Private Sector Specialist), Trust Chimaliro (Financial Management Specialist), Mercy Chimpokesa-Mseu (Environmental Specialist), Andrew Dabalen (Lead Poverty Economist), Klaus Deininger (Lead Economist), Steven Dimitriyev (Lead Private Sector Specialist), Daniel Domelevo (Senior Financial Management Specialist), Ivan Drabek (Senior Operations Officer), Time Fatch (Senior Agricultural Specialist), Alejandro de la Fuente (Senior Poverty Economist), Srinivas Gurazada (Senior Financial Management Specialist), Hanan Jacoby (Lead Economist), Sunganani Kalemba (Consultant), Priscilla Kandoole (Country Economist), Maiada Kassem (Finance Officer), Christine Makori (Senior Counsel), William Mwanza (Consultant), Valens Mwumvaneza (Senior Agricultural Economist), Francis Nkoka (Disaster Risk Management Specialist), Ellie Stylianou (Consultant) and Yutaka Yoshino (Program Leader). Lydie Ahodehou (Program Assistant) and Deliwe Ziyendammanja (Team Assistant) provided administrative assistance. Peer reviewers were Jorge Araujo (Economic Advisor), Holger Kray (Lead Agricultural Economist) and Habib Rab (Senior Country Economist). Overall guidance was provided by Kevin Carey (Acting Practice Manager), Abebe Adugna (Practice Manager), Laura Kullenberg (Country Manager) and Bella Bird (Country Director).

MALAWI

AGRICULTURAL SUPPORT AND FISCAL MANAGEMENT DEVELOPMENT POLICY FINANCING

SUMMARY OF PROPOSED CREDIT AND PROGRAM

Borrower	Republic of Malawi		
Implementing Agency	Ministry of Finance, Economic Planning and Development		
Financing Data	IDA Credit 60030-MW Terms: IDA regular terms; 38 years of maturity including a six years grace period Amount: SDR58.9 million (US$80 million equivalent)		
Operation Type	This is the first operation in a proposed series of two single tranche programmatic development policy financing operations.		
Pillars of the Operation and Program Development Objective(s)	The objective of the proposed development policy operation series is to improve incentives for private sector participation in agricultural markets and to strengthen fiscal management through more effective expenditure controls and greater transparency. The program includes two pillars of policy and institutional reforms: (a) making agricultural markets work better; and (b) strengthening expenditure management and accountability in public finances.		
Result Indicators		Baseline (2014/15)	Target (2017/18)
	Private sector share of retailing under FISP (%) Level of public subsidy under FISP (%)	0 97	70 60
	Coefficient of price variation in maize markets (cv)	0.51	0.38
	Expired estate land leases notified (number) Expired estate land leases renewed or cancelled (number)	0 0	30,000 10,000
	Warehouse receipts financing framework in place	No	Yes
	Commodity trade restrictions implemented consistent with international standards	No	Yes
	Districts under Social Cash Transfer Program (number)	18	28
	Civil servants remaining on the payroll six months after exiting employment (number)	8,004	500
	Years of backlog in the publication of public audited financial statements (number)	5	0
	Operational independence of the external audit function with timely reporting	No	Yes
	Compliance by Controlling Officers with monthly reporting requirements (%)	0	>90
Overall Risk Rating	High		
Climate and disaster risks (required for IDA countries)	Yes		
Operation ID	P153753		

IDA PROGRAM DOCUMENT
FOR A PROPOSED AGRICULTURAL SUPPORT AND FISCAL MANAGEMENT DEVELOPMENT POLICY FINANCING

TO MALAWI

1. INTRODUCTION AND COUNTRY CONTEXT

1. **This document describes a proposed US$80 million Development Policy Operation (DPO) to the Republic of Malawi** in support of the Government's program to lay the foundations for a more resilient economy that is better able to absorb the impact of and recover from exogenous shocks. The objective will be achieved through two clusters of policy and institutional reforms aiming to: (a) make agricultural markets work better; and (b) strengthen accountability and restore confidence in public finances. The operation is the first in a programmatic series of two.

2. **Malawi's real per capita gross domestic product (GDP) has grown at an average of little more than 1.5 percent between 1995 and 2014.** In fact, per capita income has seen only minimal improvements in the 50 years since Malawi's independence. Growth rates have fallen below the average of 2.8 percent in non-resource-rich African economies during the last twenty years. Malawi remains an outlier even compared to its peers that are geographically and demographically similar and were at a similar stage of development in 1995. Furthermore, growth has been unevenly distributed across rural and urban areas as well as across wealth levels. Between 2004/05 and 2010/11 more than 60 percent of the rural population saw a decline in per capita consumption. Consumption grew in urban areas for almost the whole population, though more for those at the higher end.

3. **Growth over the past two decades has also been marked by high volatility, reflecting limited buffers against shocks.** Given the episodic growth spells and recurring bouts of volatility, it comes as no surprise that the poverty headcount has not seen significant improvement. Poverty headcounts based on the 2004/05 and 2010/11 living standards measurement data show that national poverty has remained stagnant at more than 50 percent and actually increased in rural areas. Current estimates using the international poverty line of US$1.90 per day indicate that 69.6 percent of the population is classified as being poor in 2016.

4. **Exogenous climate induced shocks are a major source of vulnerability, exacerbating macroeconomic instability, and making it harder for Malawi to break the cycle of vulnerability.** Extensive reliance on basic farming methods and reliance on rain-fed agriculture, together with a growing population, has made food security a recurrent challenge as well as adding to pressures on land use, soil fertility and forest resources. In recent years Malawi has suffered from weather shocks at an increasing frequency, including simultaneous floods and droughts in early 2015, followed by another major drought in 2016.

5. **The majority of the poor remain locked in low productivity subsistence farming, and this poor agricultural productivity is exacerbated by thin and distorted maize markets.** Access to infrastructure, services, land, working capital, and market opportunities are all limited, but Malawi's strategy for increasing agricultural productivity centers disproportionately on fertilizer and seed subsidies, particularly for maize through the Farm Input Subsidy Program (FISP). FISP, however, is not poverty targeted and is inefficiently managed. It consumes almost three quarters of total public spending in agriculture, crowding out expenditure in other important areas. While FISP reform is necessary, public spending must also be rebalanced and other productivity-enhancing measures that might reduce vulnerability, including irrigation, deserve greater attention. So too does diversification into off-farm activities and scaled-up social safety net programs: these help temper the price and weather shocks that

can otherwise drive households into poverty, or prevent them from escaping it. Similarly, maize market interventions designed to promote price stability (through the Strategic Grain Reserve (SGR) and Agricultural Development and Marketing Corporation (ADMARC)) in fact undermine incentives for agricultural commercialization, leaving the country overly dependent on a smallholder agricultural sector that is vulnerable to climatic shocks.

6. **Weak public financial management has tended to transmit recurring shocks into fiscal indiscipline, in turn exacerbating macroeconomic instability.** Besides a short period after 2005, when fiscal space opened up following debt relief, fiscal indiscipline has frequently been a source of instability and volatility in Malawi. There have been recurring instances of fiscal slippages, where realized deficits significantly exceeded those planned at the beginning of the year, and the central bank financed most of the gap. These slippages often result from both a shortfall in resources and unplanned expenditures undertaken during the year. Volatility in foreign aid receipts has also played a role in erratic fiscal management, with the 2013 "cashgate" public financial management (PFM) scandal resulting in the most recent downturn in Official Development Assistance (ODA) provided on budget[1].

7. **Malawi is thus confronted with twin pressures arising from vulnerability to climate shocks and weak fiscal management, both of which contribute to macroeconomic instability**. The vulnerability to climate shocks is being manifested in the declining growth rate and deteriorating poverty outcomes. And adverse weather shocks, coupled with weak public financial management and distorted agricultural incentives, exacerbate existing fiscal pressures and constrain the country's capacity to respond to shocks.

8. **The current food security crisis has added urgency to the need to undertake difficult and politically challenging reforms.** The proposed program outlines a series of policy and institutional reforms that the Government of Malawi is undertaking to reduce distortions in, and improve the performance of, the agricultural sector; and to restore basic public financial management and accountability systems. It is a first, but critical, step towards breaking the cycle of vulnerability. The proposed operation is high risk and intended to combine stabilizing measures with support to an emerging, forward looking reform agenda.

9. **The operation is part of a multi-pronged World Bank Group response to help Malawi "break the cycle" of vulnerability.** In the context of El Niño-induced drought conditions and a severe food security crisis, the World Bank is also providing financing to address short-term needs via a Drought Recovery and Resilience Emergency Response Project and additional financing to the Strengthening Social Safety Nets Project[2]. A new Agricultural Commercialization Project, as well as the Shire Valley Transformation Project aim to support medium-term investments in diversified and more drought-resistant agriculture. The proposed DPO will catalyze these investments by addressing some of the key binding policy constraints that have amplified Malawi's vulnerability.

2. MACROECONOMIC POLICY FRAMEWORK

2.1 RECENT ECONOMIC DEVELOPMENTS

10. **Malawi's GDP grew by 2.5 percent in 2016, for a second year of weak growth.** The agriculture sector is the most significant driver of economic growth in Malawi, with maize being the most significant crop; and the sector is predominantly rain-fed and operates in the context of a short

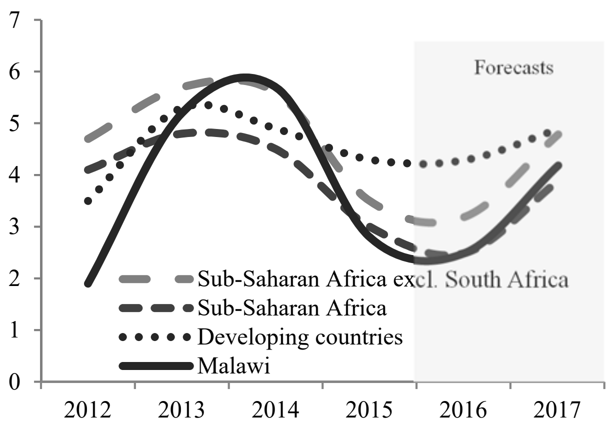
[1] In September 2013, revelations came to light of misappropriation of public funds through fraudulent transactions carried out in the Government's Integrated Financial Management Information System (IFMIS). See Box 2 for more detail.
[2] Supported in part with resources from IDA's Crisis Response Window.

growing season. In early 2015, floods affected the southern region, followed by a drought affecting the entire country (Figure 1). Combined, these shocks resulted in a significant contraction of agricultural production during the 2014/15 growing season. Maize output, the most significant crop for food security, declined by 30.2 percent year-on-year. Because of this decline, an estimated 2.8 million people, or 17 percent of the population, were unable to meet their food requirements in 2015/16.

11. **The late onset of rains and the erratic dry spells associated with the El Niño weather pattern have again weighed on agricultural production levels in 2016**. In particular, a prolonged drought resulted in another year of crop failures in the southern region and parts of the central region. Maize production again fell by a further 14.7 percent in the 2015/16 growing season, exacerbating the food security situation. The cumulative impact of the two years of drought in economic terms is estimated to amount to losses of US$295.2 million (5.6 percent of GDP).

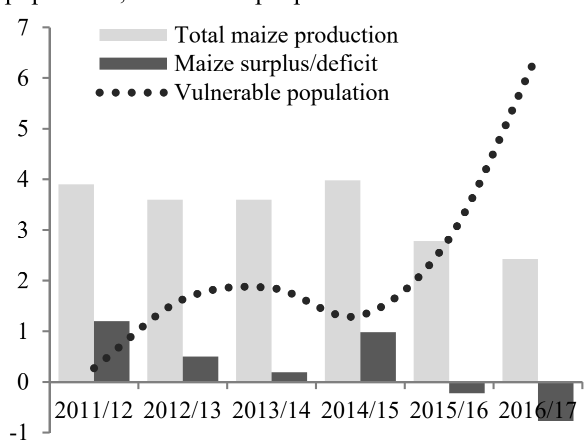
12. **Around 40 percent of Malawi's citizens were projected to suffer from food insecurity in 2016/17.** Estimates from the Malawi Vulnerability Assessment Committee (MVAC) suggested that 6.7 million people in Malawi's 24 drought-affected districts would not be able to meet their food requirements in 2016/17. Malawi's total maize output stood at 2.4 million metric tons, below the 3.2 million metric tons required to meet national needs for food consumption, seed, stock feed and industrial use (Figure 2).

Figure 1: Malawi's economic growth rate has fallen below regional averages…
GDP growth adjusted for inflation, annualized, percent



Source: World Bank Global Economic Prospects

Figure 2: …as the country faces a second year of food deficits
Annual maize production, millions of tons; Vulnerable population, millions of people



Source: World Bank staff based on MVAC data

13. **Inflation has proven challenging to contain because of the interaction of food price spikes with past monetary accommodation of fiscal indiscipline.** Malawi is now experiencing a fifth year of double-digit inflation. Pressures have been driven by a series of food price shocks. In addition, delays in tightening the monetary stance and in fiscal consolidation have played a role. In December 2016, the year-on-year headline inflation rate stood at 20.0 percent, compared to a figure of 24.9 percent at the same point in 2015.

14. **The poor harvest is associated with spatial price disparities.** A comparison of food prices in urban and rural areas shows that food price inflation in rural areas was 7.8 percentage points higher than in urban areas in December 2016. This partially reflects the larger share of imported and processed food in urban consumption baskets, with the increasing prices for domestically produced maize having a greater impact in rural areas. At the same time, it also reveals a low level of market integration of rural

areas, as the impact of cross-country trade of agricultural produce in terms of mitigating price rises is rather limited.

Table 1: Key macroeconomic indicators

	2012	2013	2014	2015	2016 Est.	2017 Proj.	2018 Proj.	2019 Proj.
National Accounts and Prices								
GDP at constant market prices (% change)	1.9	5.2	5.7	2.8	2.5	4.2	4.5	5.0
Agriculture	-0.1	6.6	5.9	-2.0	-2.3	4.0	3.5	4.2
Industry	-0.5	3.5	4.7	3.5	2.4	4.0	4.5	4.7
Services	4.7	6.3	5.8	4.7	4.4	5.3	5.9	6.0
Consumer prices (annual average)	21.3	27.3	23.8	21.9	21.7	17.8	12.1	9.5
Central Government (% of GDP fiscal year)								
Revenue and grants	18.7	27.5	23.2	21.4	21.6	23.5	21.6	21.9
Tax and nontax revenue	15.6	17.3	19.7	18.6	17.8	19.8	18.4	18.7
Grants	3.1	10.2	3.5	2.8	3.7	3.7	3.2	3.2
Expenditure and net lending	24.5	28.0	28.9	27.1	27.6	28.8	24.8	24.5
Overall balance (excluding grants)	-8.9	-10.7	-9.2	-8.5	-9.8	-9.0	-6.4	-5.9
Overall balance (including grants)	-5.8	-0.5	-5.7	-5.7	-6.1	-5.2	-3.2	-2.7
Foreign financing	1.1	1.9	2.0	2.5	1.9	1.8	2.8	2.4
Domestic financing	4.7	0.1	4.2	3.3	1.7	1.0	0.4	0.3
Amortization (zero coupon bonds)	0.0	0.0	0.0	0.8	2.5	2.1	0.0	0.0
Privatization Proceeds	0.0	0.0	0.0	0.0	0.0	0.3	0.0	0.0
Money and Credit								
Money and quasi money (% change)	22.9	35.1	20.7	23.7	21.1	22.0	22.1	22.7
Credit to the private sector (% change)	25.4	14.4	20.0	29.9	24.3	20.1	22.8	22.9
External Sector (US$m unless otherwise)								
Exports (goods and services)	1,421	1,657	1,737	1,616	1,527	1,701	1,795	1,921
Imports (goods and services)	2,281	2,315	2,399	2,346	2,563	2,627	2,551	2,670
Gross official reserves	236	397	588	670	620	640	681	770
(months of imports)	1.2	2.0	3.1	3.4	2.9	3.0	3.1	3.2
Current account (percent of GDP)	-9.3	-8.7	-8.5	-9.2	-16.2	-11.8	-8.7	-8.2
Exchange rate (MWK per US$ average)	249.1	369.2	424.4	499.6	713.8	-	-	-
Debt Stock and Service								
External debt (public sector, % of GDP)	26.5	30.8	33.1	37.0	35.4	32.3	31.7	31.1
Domestic public debt (% of GDP)	13.8	19.8	14.9	16.8	18.9	17.8	15.3	13.1
Total public debt (% of GDP)	40.2	50.6	48.0	53.8	54.2	50.1	47.0	44.1
Poverty								
Poverty rate (US$1.9/day, 2011 PPP terms)	71.0	70.1	69.3	69.4	69.6	69.3	68.4	-
Poverty rate (US$3.1/day, 2011 PPP terms)	87.7	87.2	86.7	86.8	86.8	86.7	86.2	-
Per capita GDI (in US$ Atlas Method)	450	400	360	350	-	-	-	-

Source: World Bank staff based on MoFEPD, RBM and IMF data.

15. **As a net energy importer, Malawi has benefited from the decline in oil prices, but this benefit has been eroded by currency depreciation.** The value of the Kwacha relative to most major currencies traditionally follows seasonal trends. The Kwacha gains value during the tobacco sales season in the period from March to October, with a subsequent depreciation when demand for foreign exchange is high, particularly during the period when fertilizer is imported, in advance of the following planting season. During recent years, however, speculative pressures have accelerated the pace of depreciation, due in part to thin foreign exchange markets. Gross official reserves provide import cover equivalent to 2.9 months.

16. **A tighter monetary stance as part of a disinflationary program has contributed to a reduced pace of credit growth since 2015.** The Reserve Bank of Malawi (RBM)'s policy rate is at 24 percent. While this has played a key role in reducing the non-food inflation since the fuel crisis in 2012, the range of instruments available to it to control food inflation are much more limited, with food inflation currently being the main driver of increases to the overall consumer price index. Active market interventions, involving the issuance of RBM securities, have helped to absorb liquidity and to ensure the maintenance of positive real interest rates. Reduced liquidity has helped to contain these pressures and to reduce the short-term demand for foreign currency. This has helped to ensure a more orderly depreciation in the value of the Kwacha.

17. **Borrowers, however, face prohibitively high lending rates.** The average base lending rate at the end of 2016 for loans issued by Malawi's commercial banks stood at 33.6 percent in nominal terms. Few private sector investments are able to generate positive returns with the cost of capital at these levels. However, a reduction in the lending rates is only likely to be possible if Malawi's headline inflation rate stabilizes at lower levels. The achievement of these lower levels of inflation will require the continued implementation of a tight monetary stance to curb non-food inflationary pressures and a coordinated response to the current food crisis to effectively manage food price inflation.

18. **Since 2013, Malawi has contended with a large fiscal gap arising from a mixture of reduced on-budget ODA financing following the "cashgate" PFM scandal, as well as domestic expenditure overruns** (see Box 2 for an update on progress since "cashgate"). Malawi continues to receive around US$900 million in ODA annually, but since 2013 the share of this total that is disbursed through the budget has been sharply reduced. Government has struggled to adjust to this new pattern and consolidate expenditure around a new and lower volume of grants. However, expenditure overruns, particularly on subsidies and the wage bill, have also played a role. In addition, increased recourse to domestic financing to fill the fiscal deficit has led to progressively higher domestic debt servicing costs, further compressing available fiscal space and crowding out private sector investment, as well as contributing to inflationary pressures.

19. **The fiscal stance came under pressure during 2015/16 owing to a number of exogenous factors.** Over the course of the fiscal year, the value of both tax and non-tax revenues was lower than the approved estimates (by about 1.0 percent of GDP), largely due to sluggish revenue collections in the context of the weak economy. Grants were higher than expected, mostly on account of humanitarian receipts towards the end of the fiscal year. Consequently, the total value of revenue and grants stood at a figure equivalent to 21.6 percent of GDP, compared to the approved estimates of 21.7 percent. In this context, the overall expenditure outturn was 27.6 percent of GDP, compared to an approved 26.2 percent. Efforts to constrain expenditure across most categories were offset by the large (2.5 percent of GDP) cost of settling maturing zero-coupon bonds that were issued in 2014-15 to securitize arrears.

20. **The Government managed to consolidate expenditure through reductions in development expenditure, which offset increased recurrent spending—primarily for the settlement of previous arrears**. In terms of recurrent expenditure, pressure also came from the cost of subsidies and transfers resulting from overruns on the FISP; increased cost of domestic debt service; as well as settlement of zero-coupon bonds to arrears holders. Expenditure on wages and salaries and on goods and services (except for food purchases) remained in line with the approved estimates. Cost overruns associated with FISP have been a frequent occurrence in recent years, usually taking place as a result of depreciation in the value of the Kwacha, which makes the import of the required inputs more expensive. To offset the increased recurrent spending, the Government reduced development expenditures from to 6.4 percent of GDP to 4.0 percent of GDP, resulting in a fiscal deficit of 6.1 percent of GDP in 2015/16.

21. **Domestic borrowing increased to a level in excess of targets as a result of the Government's need to finance its response to the food crisis.** Foreign financing, at 1.9 percent of GDP, was well below the value of the approved estimate. To compensate for this shortfall, the Government resorted to increased domestic borrowing (from 1.5 percent of GDP to 1.7 percent of GDP). Until the mid-year, the Government had successfully contained domestic borrowing to levels lower than the targeted ceiling. However, the food crisis resulted in a dramatic increase in borrowing during the remainder of the fiscal year, with unplanned expenditure on post-harvest maize purchases in anticipation of planned interventions in food-deficient areas.

Table 2: Fiscal accounts
Percentage of GDP (rebased)

	12/13	13/14	14/15	15/16		16/17	17/18	18/19
				Budget	Actual	Proj.	Proj.	Proj.
Revenue and grants	**27.5**	**23.2**	**21.4**	**21.7**	**21.6**	**23.5**	**21.6**	**21.9**
Revenue	**17.3**	**19.7**	**18.6**	**18.9**	**17.8**	**19.8**	**18.4**	**18.7**
Tax Revenue	15.7	17.3	16.3	16.8	16.0	17.8	17.0	17.2
Nontax revenue	1.6	2.4	2.4	2.1	1.8	2.0	1.4	1.4
Grants	**10.2**	**3.5**	**2.8**	**2.8**	**3.7**	**3.7**	**3.2**	**3.2**
Budget support grants	4.5	0.3	0.0	0.2	0.5	0.3	0.0	0.0
Dedicated grants	3.7	1.4	1.1	1.1	1.8	1.3	1.2	1.2
Project grants	2.0	1.8	1.7	1.5	1.4	2.2	2.0	2.0
Expenditure and net lending	**28.0**	**28.9**	**27.1**	**26.2**	**27.6**	**28.8**	**24.8**	**24.5**
Recurrent expenditure	**22.0**	**24.4**	**21.8**	**19.8**	**23.5**	**22.6**	**18.8**	**18.3**
Wages and salaries	5.7	6.2	6.9	6.5	6.4	6.4	6.6	6.7
Interest payments	1.9	4.4	4.0	3.6	4.0	4.0	3.3	2.6
Foreign	0.2	0.2	0.3	0.7	0.3	0.3	0.3	0.3
Domestic	1.7	4.2	3.8	2.9	3.7	3.7	3.0	2.3
Goods and services	7.9	7.9	5.5	5.3	5.8	6.0	5.2	5.3
Maize purchases	0.2	0.3	0.2	0.4	0.8	0.8	0.2	0.3
Subsidies and transfers	5.7	5.6	4.9	4.5	4.9	4.1	3.6	3.6
Fertilizer subsidy	3.0	2.7	1.9	1.2	1.8	0.8	0.6	0.5
Arrears payments	0.7	0.4	0.4	0.0	2.5	2.2	0.0	0.0
Development expenditure	**6.1**	**4.5**	**5.3**	**6.4**	**4.0**	**6.1**	**6.0**	**6.2**
Domestically financed	1.8	0.9	1.0	1.4	0.7	1.0	1.1	1.4
Foreign financed	4.2	3.6	4.4	4.9	3.3	5.1	4.9	4.8
Overall balance (incl. grants)	**(0.5)**	**(5.7)**	**(5.7)**	**(4.7)**	**(6.1)**	**(5.2)**	**(3.2)**	**(2.7)**
Financing	1.8	6.1	5.8	4.7	6.1	5.2	3.2	2.7
Net foreign financing	1.9	2.0	2.5	3.2	1.9	1.8	2.8	2.4
Gross foreign borrowing	2.2	2.4	2.9	3.7	2.4	2.5	3.3	3.0
Budget support loans	0.0	0.0	0.0	0.0	0.0	0.0	1.6	1.4
Project loans	2.2	1.8	2.2	2.8	1.9	1.7	1.2	1.2
Other loans	0.0	0.6	0.7	0.9	0.5	0.8	0.5	0.5
Amortization	(0.3)	(0.4)	(0.4)	(0.5)	(0.5)	(0.6)	(0.6)	(0.6)
Domestic borrowing	(0.1)	4.2	3.3	1.5	1.7	1.0	0.4	0.3
Amortization (zero coupon bonds)	0.0	0.0	0.0	0.8	2.5	2.1	0.0	0.0
Privatization proceeds	0.0	0.0	0.0	0.0	0.0	0.3	0.0	0.0

Source: World Bank staff based on MoFEPD data.

22. **The FY 2016/17 budget was framed to increase allocations for the purchase of food and for investments that lay the foundation for improving resilience in the agricultural sector.** Measures prescribed by the budget include radical reforms to the FISP, comprising of a significant budget cut; a reduction in the number of beneficiaries; and increased emphasis on private sector involvement in importation and retailing. Health, education and social protection budgets have been ring-fenced, with reduced allocations to almost all other budget lines in real terms. In terms of resources

allocated for development, irrigation has been prioritized. To meet the overall food deficit requirement, significant additional resources were required from development partners as part of the humanitarian response to the food crisis.

23. **On the external side, the impact of the drought, low global commodity prices, and the poor economic performance of Malawi's key trading partners, especially within the sub-Saharan African region, have adversely impacted Malawi's external sector performance.** The low rates of growth recorded by key trading partners such as South Africa have decreased the demand for the country's exports. In addition, Malawi's limited degree of product diversification renders it exposed to the decline in global commodity prices. Over the past decade, tobacco has contributed, on average, about 50 percent of Malawi's total export earnings. Despite the recent drought, tobacco production has remained relatively high. During the most recent tobacco sales season, which ran from April to December 2016, there was a sustained decline in the price of tobacco. Low prices on the auction floors are at least partially driven by overproduction in the sector, in addition to the decline in average global commodity prices, and made worse by carryover stocks from the previous season.

24. **Malawi is highly dependent on grants and concessional loans from development partners, in order to meet the country's financing requirements.** A large current account deficit has, in effect, been financed consistently by net ODA disbursements in support of both public service delivery and capital investments. Foreign direct investment has tended to account for only a modest share of financing. Requirements are projected to rise significantly in 2016/17 as the country responds to the drought, with largescale imports of food financed predominantly by ODA grants.

Table 3: External financing requirements and sources

	2012	**2013**	**2014**	**2015**	**2016**	**2017**	**2018**	**2019**
					Est.	Proj.	Proj.	Proj.
Financing Requirements (US$ m)	**-799**	**-715**	**-747**	**-745**	**-981**	**-916**	**-691**	**-736**
Current account deficit	-736	-543	-514	-613	-895	-774	-600	-595
Debt amortization	-17	-11	-42	-49	-137	-122	-51	-51
Gross reserves accumulation (- increase)	-46	-161	-191	-83	50	-20	-41	-89
Financing Sources (US$ m)	**799**	**716**	**747**	**753**	**941**	**887**	**709**	**754**
Grants	591	507	261	339	571	452	343	359
Debt disbursements	93	97	224	160	140	240	224	234
Private sector (net)	78	100	267	261	179	190	171	178
IMF credit (net)	37	13	-5	-6	50	5	-29	-17

Source: World Bank staff based on MoFEPD, RBM and IMF data.

25. **Malawi's public and publicly guaranteed (PPG) external debt stood at 37.0 percent of GDP (about US$1.78 billion) at end 2015, up from 30.8 percent of GDP (US$1.45 billion) in 2013[3].** Similarly, domestic debt increased substantially, reaching 16.8 percent of GDP at the end of 2015, from 13.8 percent of GDP in 2012. Most of Malawi's external debt (around 75 percent) has been contracted with multi-lateral creditors (principally the International Development Association, the International Monetary Fund and the African Development Bank) on highly concessional terms. However, the proportion consisting of bilateral external debt has been increasing rapidly, although from a low base, and mostly contracted with China and India. The increases in domestic debt have been driven by large fiscal deficits over the past three years, by the securitization and later settlement of arrears, as well as a large debt swap transaction. While the stock of domestic debt is lower than that of external debt, the

[3] Note that Malawi's GDP was rebased in 2014. Prior to this rebasing, the PPG external debt to GDP ratio stood at 44.0 percent in 2013, before being revised downwards to 30.8 percent in 2013.

interest burden is substantially larger. A recent debt sustainability analysis for Malawi shows that the country is at a moderate risk of debt distress (see outlook section for more).

26. **A weak economy is also having an effect on the soundness of Malawi's banking sector.** Capital adequacy levels for the sector as a whole have declined, although they remain above minimum prudential levels. In June 2016, Malawi's Tier 1 capital ratio stood at 14.2 percent, with the minimum prudential requirement standing at 10 percent. Following a period of decline in 2014-2015, non-performing loans (NPLs) have begun to increase again. In June 2016, the proportion of NPLs grew to 13.7 percent of the total value of gross loans, up from a low point of 10.8 percent seen in December 2015. After a number of years of sluggish economic growth and a tight monetary stance, lending conditions remain tight. In the first half of 2016, the value of credit provided to the private sector remained flat in nominal terms, representing a decline in real terms. Despite the uptick in NPLs, the banking sector consistently records high returns on equity, reflecting a strong asset base of deposits.

Box 1: Malawi is especially vulnerable to climate shocks compared to the region

Results from a Computable General Equilibrium analysis place Malawi among the countries most affected by the current spell of El Niño-induced droughts affecting Southern Africa in 2015/16[4]. On average, this phenomenon has resulted in an average decrease in the rate of GDP growth of 0.1 percentage points amongst the member states of the Southern Africa Development Community (SADC). However, the level of loss experienced by Malawi has been significantly higher, standing at 2.2 percentage points, or 8 months' worth of GDP growth. This extreme impact is largely due to the level of Malawi's dependence on maize and rain-fed agriculture. With Malawi's already high rate of poverty, the impact of the drought on the bottom 40 percent of the population has been most significant in Malawi. The average annual level of consumption of the bottom 40 percent is expected to fall by 11.8 percent in Malawi, compared to an average fall of 1.7 percent across SADC. Annual maize production declined by 14.7 percent in 2015/16, following a decline of 30.2 percent in 2014/15. As a consequence of the gap between supply and demand, Malawi recorded the most significant rise in the price of maize, increasing by 152 percent in nominal terms in the twelve months up to March 2016.

While climate shocks continue to affect the whole region, a number of factors aggravate their effects in Malawi. Both the headcount poverty rate (69.6 percent vs. 60 percent) and the poverty gap are much higher in Malawi compared to the average for the region, indicating that a large share of the population is barely able to cover their food needs, even in normal years. The situation is exacerbated by Malawi's high population density (238 people/km^2 of agricultural land vs. 53 people/ km^2 for the neighboring countries) where agriculture remains focused on the cultivation of maize (49 percent of land) and a small number of crops. Only 0.5 percent of crop plots are estimated to be under irrigation, rendering production and smallholder incomes particularly vulnerable to changing rainfall patterns and associated price swings. Malawi's vulnerability to climate change is exacerbated by the Government's limited fiscal space, which constrains its ability to implement effective responses.

Climate change is predicted to increase both the frequency and intensity of extreme weather events throughout the region. In this context, it is vital to improve Malawi's levels of resilience at all levels. Effective measures to improve resilience should address household vulnerabilities related to food security. They should also involve significant investment in the development of human capital and include the implementation of risk management measures for the agricultural sector. Finally, they should include measures to improve the Government's capacity to respond to crises in a comprehensive and sustainable manner.

2.2 MACROECONOMIC OUTLOOK AND DEBT SUSTAINABILITY

27. **For Malawi's economy, weather shocks will continue to be a major part of the economic cycle.** The negative impact of drought and flooding has become increasingly significant over the years (see Box 1). With the adverse effects of climate change, this trend is likely to continue into the future,

[4] See World Bank (2016) 'El Niño Drought in SADC: Economic Impacts and Potential Mitigation Solutions', Africa Region Working Paper for further detail.

with the negative impacts of weather shocks compounded by factors such as population growth and environmental degradation. Data from available records show that in the past 100 years, Malawi has experienced approximately 20 major droughts. On average, droughts and dry spells cause annual losses equivalent to 1 percent of GDP. Most drought episodes have occurred in El Niño years, with Malawi particularly likely to experience rainfall deficits in these years.

28. **The projected growth recovery over the next few years is predicated on improved macroeconomic and agriculture sector conditions.** In 2017, a projected recovery in the performance of the agricultural sector is expected to lead to GDP growth of 4.2 percent. In southern Africa, a strong El Niño effect is typically followed by a similarly strong La Niña effect, resulting in higher than average rainfalls. This rainfall could facilitate a recovery in the production of key crops, including maize as well as restoring the water resources in Lake Malawi for hydroelectricity generation. However, any such return to growth will be dependent on the effective implementation of a well-managed humanitarian response to the 2015/16 drought and on careful macroeconomic management to avoid instability.

29. **The fiscal outlook envisages a modest level of fiscal consolidation over the medium term.** The fiscal deficit in FY 2016/17 is projected to reach 5.2 percent of GDP, lower than the 6.1 percent recorded in FY 2015/16. The underlying deficit is expected to be financed mostly through concessional foreign financing (1.8 percent of GDP) but also domestic borrowing (1.0 percent of GDP). However, as in 2015/16, the deficit is amplified by the costs of converting maturing zero-coupon bonds into interest bearing securities (2.1 percent of GDP). There will also be modest proceeds from privatization (0.3 percent of GDP). Increased expenditures to address the humanitarian crisis and of the high cost of procuring maize from outside the continent will likely continue into 2017/18, limiting the extent of consolidation and putting pressure on domestic borrowing. Beyond 2017/2018, however, as Malawi exits the current period of food security, a faster pace of consolidation would become possible, with the fiscal deficit reaching 3.2 percent of GDP, on account of revenue intensification; the settlement of all outstanding arrears; tight expenditure controls and reform of key expenditure programs, such as the FISP; and containment of other spending (including the public sector wage bill). On the financing side, continued reforms to public financial management will help to facilitate a gradual recovery in the share of ODA financing provided to Malawi through the budget (which is expected to return to its steady state after the food crisis). The latter will in turn support a reduction in the domestic borrowing requirement and reduced domestic debt service costs, providing further fiscal reinforcement.

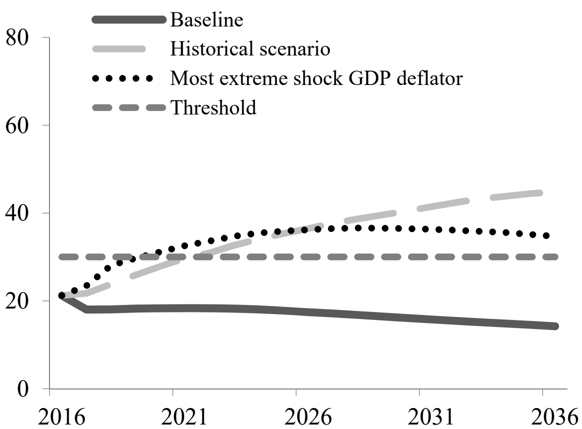
30. **The external outlook will remain driven, in the short term, by weather shocks that have affected both Malawi and large parts of Southern Africa.** Food imports will continue to drive a much larger than normal current account deficit in 2016, with some carry over into 2017 before returning to an equilibrium level in 2018. An enlarged import requirement will be financed primarily via increased foreign grant financing, supplemented by domestically financed purchases. Medium term external prospects are positive, premised on growing regional integration and increased demand for Malawi's agricultural products. As in recent past, the large current account will be financed primarily by net ODA disbursements with foreign direct investment accounting for only a modest share (see Table 3).

31. **The most recent joint World Bank/International Monetary Fund (IMF) Debt Sustainability Analysis (DSA) for low-income countries confirms a moderate risk of external debt distress for Malawi**[5]. Except for the debt service to revenue ratio—which displays a marginal and temporary baseline breach in 2016—external debt burden indicators are projected to stay below their policy-dependent debt burden thresholds (Figure 3). External debt indicators are projected to remain below thresholds in the medium term premised on a growth recovery and a continued moderate pace of borrowing, predominantly on highly concessional terms. Stress tests indicate that a somewhat weaker

[5] June 3, 2016.

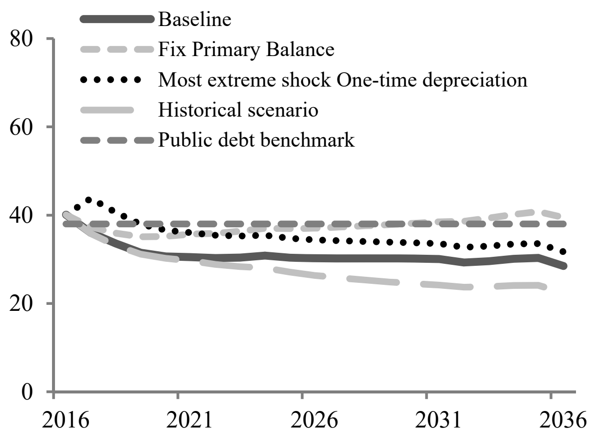
debt outcome is possible under certain conditions. The strongest impact on the indicators arises under the historical scenario of an enlarged current account deficit and low foreign direct investment, causing the present value of debt to GDP and the present value of debt to exports to breach the thresholds. Domestic debt dynamics have been affected by a Kwacha-denominated debt-swap arrangement with a regional development bank that is expected to be unwound by 2018. A moderate profile for domestic debt is projected after 2018 assuming reduced fiscal deficits and a growth recovery (Figure 4).

Figure 3: External debt, present value of debt to GDP under alternative scenarios



Source: IMF-World Bank Joint DSA 2016

Figure 4: Domestic/public debt, present value of debt to GDP under alternative scenarios



Source: IMF-World Bank Joint DSA 2016

32. **The macroeconomic outlook above faces significant downside risks.** These risks relate primarily to Malawi's continued vulnerability to external shocks, amplified by the risks of fiscal slippages. Reforms to boost agricultural commercialization will help build medium term resilience, but the country (and its growth performance) is expected to remain vulnerable to climate variability for some time. For example, there is a risk that a La Niña effect could trigger localized flooding, which might place already strained disaster response mechanisms under further pressure. Similarly, despite encouraging efforts towards fiscal consolidation, past experience suggests that Malawi has struggled to contain recurrent expenditure over the political-business cycle. Such pressures would be amplified by lower-than-expected grants and concessional financing, putting pressure on domestic borrowing and in turn delaying a disinflationary program. Continued decline in the prospects of the tobacco sector, Malawi's primary commodity export, coupled with slow diversification and higher energy prices would also put pressure on external balances.

33. **While these risks remain high, the macroeconomic policy framework is considered adequate for the purpose of this operation**. The adequacy of the macroeconomic framework is premised on the authorities' commitment to sound macroeconomic management, including in particular the continued exercising of fiscal restraint, tight monetary policy and the implementation of reform commitments to restore credibility of public finances and address governance weaknesses. Malawi's adherence to an IMF program, as well as complementary technical assistance from the World Bank, the Fund and other partners is playing a role in supporting this process. While short-term policy efforts are focused on addressing food security challenges, in the medium term efforts to broaden the export base and manage risk through agricultural commercialization, critical infrastructure investments (in disaster risk management, irrigation, power and transport connectivity) will be essential for sustainability.

2.3 IMF RELATIONS

34. **The proposed DPO is consistent with the IMF's Extended Credit Facility supported program for Malawi, approved by the IMF Executive Board in July 2012**. The program aims to

support macroeconomic stability, reduced inflation and increased international reserves. Implementation of the program has experienced multiple periods of slippages. Most recently, the impact of the El Niño-induced drought and slowdown in economic activity resulted in end-June 2016 targets for net domestic financing of the Government and net domestic assets of the central bank to be missed. In order to safeguard macroeconomic policy implementation in the face of rising risks from the humanitarian crisis, the program was extended through mid-2017. Indications are that the program will be successfully completed with a ninth and final review by June 2017. Staff of the IMF and World Bank cooperate closely, including via the preparation of joint DSA on a regular basis. Overall guidance is provided via a Joint Management Action Plan. Additional detail is presented in an Assessment Letter in Annex 3.

Box 2: Efforts to restore integrity in Malawi's PFM system after "cashgate"

The discovery in September 2013 of a massive theft of public resources by a group of individuals, some of whom were Government officials, exposed significant underlying weaknesses in Malawi's PFM systems. Dubbed the "cashgate" scandal, some US$50 million in public funds were stolen through illegal access to the national payment system. The repercussions included a major public outcry in the country, the arrest (and subsequent trial and imprisonment) of a number of Government officials, and the dissolution of the Cabinet. Budget support (provided at the time by six development partners under a common approach) was suspended and there were sharp reductions in the share of ODA channeled by development partners through national systems. As a consequence, Malawi's fiscal situation deteriorated rapidly, as did private sector confidence along with the country's international reputation. Against this background, President Banda and her party lost the May 2014 elections, and a new Government under President Peter Mutharika came to power.

The new Government committed itself to rebuilding trust in public institutions and correcting macroeconomic imbalances, in order to set the country on a path to sustainable and inclusive growth. "Home grown" PFM and PSR reform plans were launched with high level political support. Forensic audits have been commissioned and a total of 15 convictions have been secured with a number of cases underway. Nonetheless, fiscal adjustment has proved challenging in the context of two years of consecutive weather shocks that have dampened growth and created additional fiscal burdens on an already strained public purse. And a majority of aid flows have shifted to implementation mechanisms outside of the budget.

Results in restoring basic PFM systems have taken longer than expected to materialize, with progress slower than many would have desired. This partly reflects the fact that the "cashgate" scandal and its aftermath exposed a financial management and accountability framework that was in fact much weaker than previously recognized at the time. A large gap has opened up between the "form" of Malawi's public sector institutions, many of which compare favorably with international norms and standards, and the actual "function", which saw the complete breakdown of basic reporting and control frameworks[6], as well as the build-up of a large stock of arrears that now need to be settled.

However, after a slow start, a "back to basics" approach is beginning to restore confidence. Bolstered by large amounts of technical assistance, and acute expenditure pressures as a result of external shocks, the Government has rebuilt the framework of Controlling Officers operating under the supervision of the Secretary to the Treasury, accountable for day-to-day transactions, helping to re-establish centralized monitoring and controls of expenditures and commitments. Similarly, Government has cleared the backlog in its financial reporting obligations, producing five years of financial statements within one year and becoming current for the first time in a decade. Over 10,000 public servants have submitted detailed declarations of their assets. A payroll audit has helped clean up an error-strewn wage bill. Information security has been strengthened, with system access regularly subjected to penetration testing, as part of efforts to close the loopholes that allowed "cashgate" to happen. The existing IFMIS has been reinforced to strengthen weaknesses, and a successor system (expected to be more robust) is under competitive procurement. There is also broad-based realization that Malawi needs to raise the bar in terms of accountability frameworks (such as with increased independence of the external audit function and greater access to information) if the confidence of citizens is to be regained.

[6] See Bridges and Woolcock (2016) 'How (Not) to Fix Problems that Matter: Assessing and Responding to Malawi's History of Institutional Reform', *World Bank Policy Research Working Paper*, prepared as part of the 2016 CEM for a fuller discussion.

The proposed DPO aims to support an emerging reform agenda that will reduce the risk of a "cashgate" incident from re-occurring. The operation aims to both bolster the reform process as well as acting a stabilizing measure in the context of a challenging series of weather shocks. The program supported by the DPO forms part of a large multi-development partner program of policy dialogue and technical assistance, around which there is a strong consensus. Nevertheless, Malawi's PFM recovery efforts remain far from complete, with much more still to be done. And corruption remains pervasive at all levels of Government, with entrenched interests often attempting to obstruct efforts by reformers. Events in early 2017, including investigations of graft surrounding an attempted maize import transaction by ADMARC from Zambia that led to the dismissal of the Minister of Agriculture, show that Malawi still needs to go a lot further to strengthen its fiscal institutions and accountability frameworks.

3. THE GOVERNMENT'S PROGRAM

35. **Since the election of a new Government in April 2014, Malawi's short-term policy focus has been on strengthening public financial management and public service reform.** A PFM Reform Program, approved in January 2015 and prepared with the support of the IMF, is aimed at restoring financial controls and accountability through a series of short-term measures that emerged as a result of the "cashgate" scandal. A medium-term Rolling PFM Plan is currently under preparation. To address the longer-term structural issues that have degraded the effectiveness of Malawi's public sector, the new Government also commissioned an independent Public Service Reforms Commission. The key findings of this Commission, which were reported in February 2015, form the basis of an ongoing public service reforms program. Malawi's 2016 National Agricultural Policy also sets out an ambitious reform agenda in the agricultural sector. Further detail on Government's program is outlined in Annex 2. However, in all areas of policy, progress has been uneven with both successes and setbacks.

36. **Malawi's medium term development program is anchored around the Second Malawi Growth and Development Strategy (MGDS II)**, being implemented over the 2011-2016 period. The objective of the MGDS II is to create wealth through sustainable economic growth and infrastructure development as a means of achieving poverty reduction. The implementation of MGDS II has now just reached its completion point, with most of the strategy's laudable objectives remaining unmet. This has triggered significant reflection ahead of the preparation of Malawi's next medium term development strategy. Key lessons learned include the need for a more realistic set of assumptions, including on the availability of financial resources, a more prioritized set of issues to focus on, and greater attention paid to the "how to" of development rather than the "what to". The World Bank is supporting this process, including through the preparation of a new Country Economic Memorandum which will inform the preparation of the new strategy.

Box 3: Pilot reforms to the FISP show promise

The Farm Input Subsidy Program (FISP) is implemented by the Government of Malawi and is intended to enhance agricultural productivity. Allocations for this program account for a large share of the agricultural budget. The program has come to dominate the overall agricultural budget, absorbing approximately 75 percent of the total value of the Ministry of Agriculture, Irrigation and Water Development (MoAIWD)'s financial resources in 2014/15, crowding out other potentially valuable investments in the sector.

Inefficiencies in the implementation of FISP have led to high costs. The system has been characterized by an inefficient tonnage allocation formula that increases average purchase costs; an inefficient fertilizer delivery mechanism that increases logistical costs; and in recent years, the seasonal depreciation of the Kwacha that increases the cost of imported inputs. The program has also struggled to deliver subsidized fertilizer to farmers on time. These factors have together resulted in a significant fiscal burden on the Government including through repeated cost overruns.

To address these issues, pilot reforms introduced in the 2015/16 growing season aimed to improve efficiency and to produce cost savings. The pilot involved two major interventions: (i) the direct retailing of fertilizer by the private sector to FISP beneficiaries; and (ii) reductions in the subsidy level from 97 percent of the retail price to 80 percent, with the Government issuing fixed value coupons to beneficiaries.

Implementation of these two major reforms had a positive impact, resulting in reduced costs and improved efficiency. Private sector firms were granted contracts in nine districts, with these contracts covering the delivery of 23 percent of the total fertilizer provided through the scheme. The fertilizer was fully delivered within six weeks, a much shorter time period than through the traditional public sector model. The pilot private sector retailing model resulted in cost savings to the Government to a value of around MWK 3.9 billion (approximately US$5.1 million). These savings were achieved through lower cost sourcing, distribution and communications. The reduced subsidy levels and increased farmer contributions resulted in cost savings to the Government to a value of about MWK 12.8 billion (approximately US$16.7 million). While the overall budget for FISP still overran its budgeted allocations, the excess would have been even larger had the pilot reforms not been implemented.

Scaling up this pilot in 2016/17 will create opportunities to further reduce the cost of FISP, providing Government with much needed fiscal space at a time of pressing expenditure needs on food. Increasing the involvement of the private sector in retailing the subsidized items to cover the majority of the FISP would result in further efficiency gains, leaving the public sector responsible for serving only those areas that private sector farm inputs suppliers are unable to reach (such as in remote areas). However, further fine-tuning will be required to ensure that appropriate lessons are learned from the pilot in terms of private sector performance. Further incremental reductions in the level of subsidy would also provide additional space for the Government to implement necessary investments in the areas of social protection, resilience building and agricultural development.

4. THE PROPOSED OPERATION

4.1 LINK TO GOVERNMENT PROGRAM AND OPERATION DESCRIPTION

37. **The repeated impact of climatic shocks has prompted a critical review of Malawi's current agricultural policies, opening up space for policy dialogue in politically challenging areas.** These include sensitive areas such as the FISP, as well as the way that ADMARC and the SGR intervene and shape prices and incentives in Malawi's maize markets. There is an increasing recognition that dysfunction in Malawi's agricultural institutions has exacerbated the impact of climate shocks on the country, and therefore a key element of efforts to improve resilience involves reform of these institutions. Furthermore, legislative reforms in areas such as land administration, commodity trade and warehouse receipts will help facilitate the development of a more commercially oriented agriculture sector.

38. **The proposed operation also supports some of the critical reforms drawn from Malawi's post - "cashgate" public financial management and public service reform programs.** Rebuilding integrity and oversight in Malawi's PFM systems is a key step towards restoring macroeconomic stability and fiscal management, which in turn is the foundation upon which sustainable growth and poverty reduction can be achieved.

39. **Three lessons have emerged from the World Bank's prior DPO experience in Malawi.** Specifically, the experience from the Economic Recovery DPO series points to: (i) the need for a thorough understanding of the local political economy of reform and the importance of looking beyond the veneer of formal rules-based systems, to the underlying informal arrangements that allowed for collusive behavior to take place. Malawi's "partial reform syndrome", a situation where reforms take place only at a superficial level producing the *form* but not the *substance* of modernized institutions highlights the need for such an emphasis; (ii) the need for a strong focus on timeliness of fiscal information and integrity of systems, as priorities in any future budget support operations; and (iii) the need to focus the scope of structural reforms to only the most macro-critical areas where progress would

be harder to unwind after completion of an operation[7]. This operation integrates these lessons—by paying attention to the political economy, timeliness and integrity of fiscal information, and selectivity and focus on macro-fiscal critical areas. In addition, the prior actions for the most part have been selected at a predominantly downstream and implementation-oriented level.

4.2 PRIOR ACTIONS, RESULTS AND ANALYTICAL UNDERPINNINGS

40. **The objective of the proposed DPO series is to improve incentives for private sector participation in agricultural markets and to strengthen fiscal management through more effective expenditure controls and greater transparency**. The operation contributes towards a broader goal of improving Malawi's ability to absorb and recover from exogenous shocks. Creating an improved agricultural policy environment, scaling up social protection, as well as strengthening financial reporting, oversight and public expenditure management are essential parts of efforts to improve Malawi's ability to absorb shocks, as well as laying the foundations for future agricultural growth and productivity improvement.

41. **This objective will be achieved through two pillars of policy and institutional reforms aimed at**: (a) making agricultural markets work better; and (b) strengthening expenditure management and accountability in public finances. These reforms support the Government's priorities as outlined in the MGDS II, as well as the broader World Bank Group (WBG) goals of ending extreme poverty and boosting shared prosperity. The detailed policy and results matrix is outlined in Annex 1.

Pillar A: Making agricultural markets work better

DPO-1 Prior Action #1: *The Recipient has, through its MoAIWD and MoFEPD, made parametric changes to FISP in fiscal year 2016/17 namely: (i) increased the share of fertilizer retailed by private suppliers; (ii) reduced the level of subsidy to beneficiaries by introducing a fixed value coupon with beneficiaries paying the difference between the coupon value and market price; and (iii) piloted improved targeting of beneficiaries, all in accordance with the provisions of paragraphs 18 and 19 of the Letter of Development Policy (LDP).*

DPO-2 Trigger: *MoFEPD and MoAIWD make further parametric changes to FISP by (i) further increasing the share of fertilizer retailed by private suppliers; (ii) further reducing the level of subsidy to beneficiaries while maintaining a fixed value coupon with beneficiaries to pay the difference between the coupon value and market price; and (iii) rolling out improved targeting of beneficiaries.*

42. **Rationale.** Proposed reforms in the agricultural sector, supported under the DPO series, build upon the long standing engagement and policy dialogue between the Government and development partners on agricultural public expenditure issues in the framework of the Agriculture Sector Wide Approach (ASWAp). The 2013 Agriculture Public Expenditure Review (AgPER) highlighted the growing share of the FISP in the budget of the MoAIWD and in the overall Government's budget, reaching 75 percent and 7 percent respectively in 2014/15. FISP has led to overspecialization in maize and has come to dominate the overall agricultural budget, crowding out other important investments. Furthermore, Malawi's new National Agricultural Policy specifically aims to "promote reforms of agricultural institutions, subsidies and programs to make them more sustainable and cost effective".

[7] See the 2015 Implementation Completion and Results Report on the Malawi Economic Recovery DPO for further details on lessons learned: http://documents.worldbank.org/curated/en/2015/09/25043860/malawi-economic-recovery-development-policy-operation-project.

43. The FISP has also been a major source of budget overruns in recent years. In 2014/15, a combination of factors, including the need to clear unpaid arrears for the purchase of fertilizer and seeds from the previous season; an inefficient tonnage allocation formula that raised average purchase costs for the Government; an inefficient fertilizer delivery mechanism leading to increased logistical costs; and the depreciation in the value of the Kwacha resulted in a large overrun. The total cost of FISP in 2014/15 reached MWK 70 billion, compared to an allocated budget of MWK 51 billion. This figure accounted for a sizable proportion of the fiscal deficit. FISP has an extremely high subsidy rate, with farmers paying as little as three percent of the "market" price of fertilizer. Lowering the rate of subsidy by increasing farmers' required contribution would reduce Government costs. Moreover, the livelihoods of the extreme poor could be more efficiently supported via targeted social protection system instead of through fertilizer subsidies. In addition, logistical costs could be reduced by involving private suppliers in the retail distribution of fertilizer, building upon the successful FISP experience with seeds which are delivered to farmers by private seed companies using their networks of rural outlets.

44. **Policy.** Government has committed to implement FISP reforms aimed at improving efficiency and effectiveness. The key reforms in 2016/17 include (i) increasing the share of fertilizer retailed by private suppliers; (ii) reducing the level of subsidy to beneficiaries by introducing a fixed value coupon with beneficiaries to pay the difference between the coupon value and market price; and (iii) implementing a pilot scheme that targets productive farmers in two districts. The reform package builds on encouraging evidence from the private sector retailing pilot of 2015/16 that ensured efficient fertilizer delivery (within 6 weeks) at reduced cost to Government (see Box 3). Introducing a fixed coupon value is also of critical importance to ensure that expenditures are capped, avoiding future cost overruns.

45. In 2016/17, Government has increased the fertilizer tonnage allocated for direct private sector retailing to beneficiaries based on lessons learned to an estimated total of 60 percent. Out of the 90,000 Metric Tons (MT) of fertilizer to be distributed this year 54,000 MT will be retailed by the private sector, with the expectation that this share will even increase further in subsequent years. Fertilizer suppliers will be responsible for selling directly to beneficiaries in market outlets, with no additional transportation or distribution costs to be incurred by the public sector. Government has fixed the value of coupons for fertilizer (MWK 15,000/coupon); maize seeds (MWK 5,000/coupon); and legume seeds (MWK 2,500/coupon). Based on these announced figures, the subsidy levels are likely to be around 70 percent of total cost and farmers will pay the difference between the coupon value and the market price.

46. Under the 2016/17 program, FISP will also improve targeting of productive smallholder farmers, those that can make best use of the improved seeds and fertilizer (i.e. households that have land and labor resources, but are cash constrained) via piloting in two districts. The results of this pilot will inform a full roll out of targeting in subsequent years, moving away from a previous lottery approach (where beneficiaries receive FISP support on average only once every three-four years). A scale up of the national Social Cash Transfer Program will instead provide a social protection floor for the extreme poor (a large share of whom are female-headed households), and in particular those who do not have the means to convert a productive asset such as fertilizer into sustained income.

47. **Results.** The DPO supports a re-orientation in the objective of the FISP towards boosting agricultural productivity, as well as increasing fiscal space via a reduction in the scale of subsidies and increased efficiency of distribution. The baseline in 2014/15 is for 0 percent private sector retailing in the FISP and a 97 percent level of public subsidy. The target is for private sector retailing of 50 percent of the total FISP fertilizer tonnage and a 70 percent level of public subsidy under the scheme in 2016/17; increasing to 70 percent private sector retailing and a 60 percent level of public subsidy in 2017/18. In addition, a well-targeted and scaled-up Social Cash Transfer (SCT) Program reaching all 28 districts of

Malawi would provide a more effective and efficient mechanism for protecting the poorest households against the impact of shocks.

DPO-1 Prior Action #2: *The Recipient has, through its MoAIWD, adopted revised guidelines that put in place transparent and objective criteria, as well as technical and financial reporting and accountability mechanisms, for maize draw down for price stabilization from the Strategic Grain Reserve, all in accordance with the provisions of paragraph 22 of the LDP.*

48. **Rationale.** The Government's Strategic Grain Reserve was first established in 1981 to help cope with food (maize) shortages and emergencies. The ADMARC, a parastatal grain marketing board, was in charge of the management and operation of the reserve. In 1999, Government established the National Food Reserve Agency (NFRA) as a trust with autonomy to take direct responsibility for the management and marketing activities of the SGR. NFRA is supervised by a Board of Trustees and operates under the supervision of the MoAIWD. Drawdowns and maize purchases are also validated and monitored by an SGR Management Committee. NFRA's objectives are to: (i) maintain the SGR through storage, purchasing and release of maize grain; (ii) assist in stabilizing grain prices; (iii) oversee grain importation and exportation on behalf of the Government; (iv) contribute to private sector development of the grain market in Malawi; and (v) advise the Government on matters relating to food security and grain markets.

49. However, lack of clarity with SGR operating modalities, uncertainty with annual purchasing and distribution plans, stock levels and late entry into the market have all served to increase maize price instability rather than smooth prices. The lack of transparent guidelines has tended to encourage speculation by traders and place a high premium on insider knowledge. As a result, smallholders who produce a marketable surplus have generally not been able to benefit from purchases by the NFRA.

50. **Policy.** Increased instances of food insecurity prompted Government to commission an assessment of SGR modalities and come up with revised SGR guidelines in order to improve procurement, storage and drawdowns of grain for emergency and non-emergency operations. Efforts has been mainly focused on clarifying: (i) the SGR objectives, especially on the dual approaches of the Malawi SGR around humanitarian assistance and price stabilization; (ii) the optimal level of maize reserves; (iii) the most efficient maize restocking and purchase modalities; and (iv) the appropriate, transparent and evidence-based mechanisms, for maize release.

51. New guidelines for the procurement, storage and drawdown of grain from the SGR have been prepared and approved. These provide clear and specific procedures for emergency and non-emergency draw-downs, streamline representation on the governing SGR committee (including eliminating institutions with vested interests), and increase the minimum stock levels from 750,000 MT to 270,000 MT. With adoption, these guidelines will lead to improved management efficiency of the SGR putting in place transparent mechanisms to address the current weaknesses in the grain drawdown process.

52. **Results**. The revised SGR guidelines once adopted and implemented would create a more transparent and predictable mechanism for grain procurement, storage and drawdown from the SGR. This would minimize speculation in the maize market and hence lead to less volatility in the maize prices, while ensuring that smallholder producers benefit. The baseline in 2014/15 is a coefficient of variation in maize markets of 0.51. The target is that average price volatility should be reduced by 25 percent in 2017/18 relative to the 2011-16 average in years of normal production, to a coefficient of variation of 0.38.

DPO-1 Prior Action #3: *The Recipient has, through ADMARC Limited, (i) published ADMARC Limited's audited financial statements for fiscal years 2013/14 and 2014/15, respectively; and (ii) publishes monthly reports outlining maize market distribution and purchasing plans throughout the fiscal year 2016/17 lean season, all in accordance with the provisions of paragraph 23 of the LDP.*

DPO-2 Trigger: *ADMARC (i) carries out a strategic review of its functions, governance arrangements and oversight mechanisms; and (ii) undertakes reforms establishing clearly defined responsibilities, guidelines for market intervention within price bands, clearer accountability, transparency and oversight mechanisms.*

53. **Rationale.** Government established the ADMARC in 1971, with a mandate to market agricultural produce and inputs, and facilitate the development of the smallholder agricultural subsector through marketing activities and investments in agro-industry enterprises. Other public sector interventions to try to address food insecurity include FISP, the announcement of minimum farm gate prices to encourage maize production and restrictions on maize exports.

54. Despite these interventions, Malawi's maize market is still characterized as extremely thin, with few buyers and sellers relative to the number of producers. Research has revealed that only about 8.5 percent of farmers are outright sellers of maize, 8.9 percent operate as buyers and sellers, and 55.3 percent only purchase maize to supplement own stocks. When markets are thin, small disruptions and interventions in supply and demand result in large volatility in market prices. The implication of these interventions is that they tend to undermine the Government's own objective of stabilizing prices and improving food security.

55. Currently, the presence of ADMARC impedes domestic trade as market participants are exposed to the risk of ADMARC selling at a price that is below cost, while the SGR is an opaque source of bulk supply to the market whose actions undermine private incentives to trade and invest. Two public policy objectives will remain relevant in the medium-term: ADMARC's social role in ensuring pan-territorial pricing, and the food security objective of the SGR. Yet these can be achieved in a much less disruptive fashion than at present. With these roles and operations explicitly defined and established, farmers and traders would have a much-improved investment framework less prone to opportunistic state behavior.

56. Despite these long-standing obstacles, there is evidence that the current crisis has triggered some behavioral change in public institutions, with subsequent response by the private sector. In the face of considerable political pressure, ADMARC committed to a published retail price for maize (MWK 250 per kg), a substantial increase from the 2015 price (MWK 110 per kg) and a price which balances its need for cost recovery with the risk that a higher price would drive more consumers into the humanitarian response. Private trade in maize from neighboring countries, especially Mozambique and Zambia, has been active—in addition to the black market that exists throughout eastern and southern Africa to circumvent export bans.

57. **Policy.** In the initial years of establishment, ADMARC played a social role of buying and selling of maize at reasonable prices in remote areas, as reflected in the pan-territorial and pan-seasonal pricing system for smallholder farmers, particularly maize farmers, and the establishment of markets in non-profitable areas. The ADMARC Act (1971) was repealed in 2003, and the institution was incorporated as a limited company, 99 percent owned by Government. However, ADMARC has still been tasked with a food security role in maize markets by acting as a buyer and seller in remote areas, providing grain storage across seasons, and supporting a large marketing structure with distribution or market centers located in most urban and rural areas. Over the years, the role of ADMARC in maize marketing

has significantly declined due to competition from the new entrants. Until 1987, ADMARC enjoyed a monopoly in the importation, marketing, and storage of grain. The market liberalization from mid-1980s with respect to produce marketing saw the involvement of the private sector in the grain marketing, and this reduced the role of ADMARC (from initially purchasing 18 percent of maize to 1-8 percent annually). There has been growing concerns from major stakeholders on the continued lack of transparency regarding ADMARC operations, including price setting, quantities to be purchased, quantities distributed to markets, revenue from maize sales (and how it is used), location of purchases, stock balances, timing of its operations, audited accounts and financial reports. ADMARC has over the years depended on bail outs from Government and this has resulted in the negative fiscal impact on Government resources.

58. A strategic review of ADMARC's functions, governance arrangements and oversight mechanisms provides an opportunity to consider critical reforms that would improve predictability and reduce distortions in Malawi's agricultural markets. The starting point is improved transparency of ADMARC's financial performance and market operations. Technical assistance is being provided under the ASWAp Support Program.

59. **Results**. The DPO supports the establishment of a better functioning market for maize, via improved signaling that would minimize speculation in the maize market and hence lead to less volatility in maize prices, while ensuring that smallholder producers benefit. The baseline in 2014/15 is a coefficient of variation in maize markets of 0.51. The target is that average price volatility should reduce by 25 percent in 2017/18 relative to the 2011-16 average in years of normal production, to a coefficient of variation of 0.38.

DPO-1 Prior Action #4: *The Recipient has enacted the: (i) Physical Planning Act, 2016; (ii) Customary Land Act, 2016, (iii) Land Survey Act, 2016; and (iv) Land Act, 2016 improving administration and security of tenure, all in accordance with the provisions of paragraph 24 of the LDP.*

DPO-2 Trigger: *MoLHUD clarifies the status of existing leases and puts in place the regulatory framework and physical infrastructure for cost-effective systematic implementation of the Land Laws, including low-cost boundary demarcation and sustainable land information management.*

60. **Rationale.** As Malawi's economy is primarily based on agriculture and heavily reliant on natural resources, land is the most basic and important natural resource for social and economic development. Secure land rights are an essential precondition for investment to enhance resilience, diversify the rural economy, and—via collection of lease fees—enhance generation of public revenue. Secure land rights are important also for gender equity. Tenure insecurity and land conflicts are high in the customary sector, with negative impacts in particular for women operators in rural areas.

61. More than 20 percent of Malawi's agricultural land (1.4 million hectares) is leased to estates. Yet the majority (74 percent) of digitized leases have expired and the boundaries displayed in official records often do not correspond to reality or overlap with each other. This results in (i) loss of public revenue as lease fees are no longer collected; (ii) greater tenure insecurity, foregone investment and diversification, also because subdivisions and changes are not recorded; and (iii) productivity losses as large part of estates' agricultural land remains unused and cannot be reassigned.

62. Malawi's current legislative framework for land is provided by the Land Act (1965), which is outdated and deficient in a number of ways. The current system favors the urban population who already have access to land registering services. If accompanied by a proper regulatory framework for low cost surveying, the new Land Laws can make land surveying more affordable to allow poor people to register and gain formal title for their parcels. It is also expected that there will be increased demand to register

land parcels once registration systems are in place. To the extent that they are implemented, the Land-related Bills/Acts will thus bring economic and social benefits to the citizenry of Malawi by improving investor's confidence in the business environment, reducing the cost of documenting rights, supporting decentralization, improving land use planning, and protecting vulnerable groups' land rights and livelihoods.

63. **Policy.** The land sector is guided by the Malawi National Land Policy of 2002. The goal of the National Land Policy in Malawi is to ensure land tenure security and equitable access to land to facilitate broad based social and economic development through the optimum and ecologically balanced use of land and land-based resources.

64. Ten land related bills were submitted to Parliament by the Ministry of Lands, Housing and Urban Development (MoLHUD) in 2016, including the Land Bill, 2016; Customary Land Bill, 2016; Registered Land (Amendment) Bill, 2016; Land Acquisitions (Amendment) Bill, 2016; Physical Planning Bill, 2016; Land Survey Bill, 2016; Local Government (Amendment) Bill, 2016; Malawi Housing Corporation (Amendment) Bill, 2016; Forestry (Amendment) Bill, 2016; and Public Roads (Amendment) Bill, 2016. Out of the ten Land related bills, four were enacted by Parliament in July, 2016 and were subsequently assented to by the President. The remaining six (Amendment) Bill were enacted by Parliament in December 2016. The enacted four land laws are the main focus of this prior action.

65. With the enactment of the Physical Planning Bill, land management will be improved significantly. Currently, planning regulations only apply in urban areas leading to uncontrolled construction of settlements on agricultural land outside of the cities. Similarly, the new legislation provides for the instruction of an electronic Land Information System that—if based on information that is consistent with on-the-ground realities—will both improve service delivery and tenure security and tracking of files, while boosting revenue. In addition, implementation of the Customary Land Bill has the potential to provide greater security of tenure for all citizens, but especially the rural population. Tenure security will be improved through creation and registration of customary estates and the institution of robust and accessible land dispute resolution mechanisms. This will facilitate the use of land as collateral, supporting bank lending and local investment. All of these measures will help to address the disadvantages that vulnerable households, particularly female headed households, face with regard to tenure insecurity.

66. As a step towards harnessing the unexploited potential of Malawi's agricultural sector, the Government has digitized documentation for 58,733 leaseholds, is planning to expand this to deeds and freehold titles, and is developing a system to manage these records electronically. It is also carrying out a large estate survey to obtain the information needed to draft regulations to modernize estate land management and plan for systematic renewal or cancellation of expired leases and low-cost boundary demarcation of leaseholds. Together, these can provide a basis to bring land that is currently idle to productive use into production, improve tenure security for the commercial agriculture sector, and increase Government revenue by regularly collecting annual ground rent as well as clearing long-standing arrears in rent payment. Doing so systematically will increase public revenue, activate land markets, and encourage diversification and resilience in the rural economy.

67. **Results**. The DPO supports improved land administration, investment incentives and access to land. The baseline in 2014/15 is a situation where most estate leases have expired, boundary demarcation is costly and there is no system in place to systematically demarcate customary estimates to the benefit of all land users, especially women. The target is that by 2017/18 30,000 expired estates will be notified with 10,000 leases either renewed or cancelled, and that a manual for systematic demarcation and low-

cost surveying is approved with baseline data collected and implementation started in at least three districts.

DPO-2 Trigger: *MoITT submits to Parliament a Warehouse Receipts Bill that improves access to agricultural commodity financing.*

68. **Rationale.** Malawi's maize markets remain thin. The quantities traded and stored are small relative to the aggregate level of national maize consumption. In addition, incentives to hold maize are diminished by uncertainty about the Government's own price and stockholding strategies. As Malawi moves towards greater private sector participation in grain marketing, price signals can be used to measure the relations between maize supply and demand, and thus monitor the level of maize stocks.

69. **Policy.** The establishment of a warehouse receipt system is one means of improving agricultural risk management and resilience. Warehouse receipts can increase the availability of funding for maize stockholding, improve the quality of stockholding and improve the transparency of national markets. All of which should help increase private incentives to hold stocks and in effect, share the risk of holding stocks.

70. Under a warehouse receipt system, banks provide contractually based financing to traders in exchange for the collateral of maize stocks held in well-managed and well-monitored warehouses. This financing allows the trader to purchase and hold additional stocks, or otherwise expand trading operations. The key requirement is that the maize stock holds a well-defined value with a level of assurance acceptable to the bank. This value is outlined in the receipt instrument itself, a document that provides verifiable descriptions of the: quantity, quality and grade of commodity; specific location where commodity is stored; value of the commodity; proof of existence of the commodity; proof of on-going management of the commodity; and, security issues associated with the commodity. In some cases, the receipt instrument might also be a tradeable document confirming the ownership and quality of warehoused maize stocks.

71. By clarifying information about the availability of maize in the country, the warehouse receipt also improves transparency of the market and strengthens the Government's capacity to plan its food security programs. This may also help reduce local price volatility. Because maize intake and storage systems must meet an agreed set of minimum standards to justify issuance of a receipt instrument, the system should also improve incentives to expand storage facilities and invest in improving quality. Correspondingly, the warehouse receipt system may contribute to a significant reduction in post-harvest maize losses. Over time, the size and quality of national maize stocks will increase while the cost of holding these stocks declines. In effect, the private sector would take increased responsibility for handling the country's strategic maize stocks.

72. Putting in place a clear legal framework is a key first step towards the establishment of a functional market for warehouse receipts. Technical assistance is being provided to the Ministry of Industry, Trade and Tourism (MoITT) by the International Finance Corporation.

73. **Results**. The DPO supports the establishment of a framework for using agricultural commodities as collateral for accessing finance. The baseline is that there is no warehouse financing framework in place in 2014/15. The target is that such a framework should be in place and fully operational by 2017/18.

DPO-2 Trigger: *MoITT submits to Parliament an amended Control of Goods Bill with clearly defined and transparent procedures for the regulation of commodity exports and imports.*

74. **Rationale.** Since the early 2000s, the Government has imposed export bans to control the flow of trade of agricultural commodities, in particular maize and soya. In the case of maize, the bans were justified by Government in terms of concerns related to food security. In the case of soya, the bans were justified in terms of the need to protect the emerging oil processing and poultry producing industries. Maize exports were banned in the period from July 2005 to January 2007; again in the period from April 2008 to July 2009; and yet again since December 2011 to the present.

75. In spite of the maize export bans, there have been regular shortfalls in the availability of this commodity in the lean season. Nor has a ban on exports resulted in lower domestic maize prices relative to prices in neighboring countries. In the 73 months that export bans on maize have been in place, from May 2004 to December 2014, the price in Malawi fell below export parity on only seven occasions[8]. Furthermore, the period during which maize export bans were imposed coincides with the periods during which the level of volatility in domestic markets was relatively higher compared to the level in regional markets. Except in the case of Harare, Malawi's markets exhibited the highest degree of maize price volatility in the region in the period from 2004 to 2015.

76. Export bans have economy-wide implications due to reduced incentives for commercial production. Computable general equilibrium analysis shows that while maize export bans result in a temporary increase in the availability of maize, the policy becomes self-defeating in the long run as it reduces incentives to produce maize and thus constrains supply, which has an upward impact on prices and threatens food security in the longer term. Furthermore, unpredictable Government interventions and volatile prices are the major deterrents to commercial farmers increasing investments in maize production. Increased commercial production of maize would result in prices becoming less seasonal and more predictable, benefiting producers, consumers, and processors alike.

77. **Policy.** Malawi stands to benefit from increased exports and to grow regional and global markets from increased agricultural production. The agricultural sector, characterized by a very large number of smallholder farmers engaging mostly in primary crop production, and large estates producing processed agricultural goods for export, is hampered by uncertainty and an unpredictable export permit environment. This leads to impaired food security and low export earnings for the country, coupled with vulnerability to weather and price shocks.

78. One of the major constraints faced by commercial farmers in Malawi to export agriculture products is the uncertainty surrounding the export regime for agricultural crops. The Control of Goods Act, in its current form, allows the Minister of the MoITT to administer export restrictions/permissions, without clearly set and transparent procedures and are inconsistent with Malawi's commitments to the World Trade Organization. This creates an environment of uncertainty and unpredictability on the part of the private sector players, and constrains potentially profitable business opportunities. Commercial banks and foreign investors become cautious to commit financing to commercial agricultural operations in Malawi because of this uncertainty.

79. A revision to the Control of Goods Act would lay out clear and transparent procedures to be followed in applying regulatory requirements including licensing requirements for exports and imports, and outline the due process to be followed in the administration of these regulations. Procedures would be time-based and transparent, including due process of consultations. This would ensure certainty and improve predictability for market participants, and hence encourage the entry of commercial operators

[8] See Benson and Edelman (2016) 'Policies for accelerating growth in agriculture and agribusiness in Malawi', background paper prepared for the Malawi Country Economic Memorandum, Washington, DC: The World Bank.

across the agricultural spectrum, leading to increased agricultural productivity, food security and export diversification. Technical assistance is being provided under the ASWAp.

80. **Results**. The DPO supports greater predictability and transparency in the administration of regulatory measures affecting trade in agricultural commodities. The baseline is that trade bans and licensing requirements are issued in a non-transparent way in 2014/15, and the target is that by 2017/18 any commodity trade restrictions and licensing requirement are implemented in a manner that is consistent with international standards of due process and transparency.

DPO-1 Prior Action #5: *The Recipient has, through its MoFEPD, MoGCDSW and LDF, agreed on institutional coordination arrangements for the expansion of the Social Cash Transfer Program, all in accordance with the provisions of paragraph 20 of the LDP.*

DPO-2 Trigger: *MoFEPD, MoGCDSW and LDF expand the Social Cash Transfer Program to be operational at the national level across all 28 districts.*

81. **Rationale.** The DPO supports the scale up of the Social Cash Transfer Program (SCT) as a means of providing a responsive safety net that meets the needs of the extreme poor. The SCT Program is part of a broader policy commitment of the Government to prioritize social protection, which is the third theme in the MGDS II. As part of this framework the Government approved a National Social Support Program in April 2013. This sets out a range of policies and programs for the protection of the elderly, the disabled, and children including five social protection subprograms. Alongside the SCT Program, the Government implements the Malawi Social Action Fund (MASAF) public works program, school meals, village savings, loans and microfinance. These subprograms are devised to address pervasive poverty needs and to respond to uninsured shocks, most especially for the ultrapoor. Ultra-poverty is estimated at 28.1 percent in rural Malawi, which roughly represents 815,000 households (approximately 4.5 million people). The scale up of the SCT will bring total program coverage to approximately 320,000 ultra-poor households, almost 40 percent of the extreme poor.

82. The scale up of the SCT represents an evolution in prioritizing and expanding the coverage of social protection in Malawi. In the past, to reduce poverty and eliminate food insecurity, the Government relied on input subsidy programs including primarily fertilizer and hybrid seeds. Although FISP reaches 1.5 million rural households, a growing literature finds that it has had little impact on food security and poverty, especially for the ultra-poor. Against this backdrop there has been a steady expansion of safety net programs, albeit with relatively low coverage and financing levels when compared to other countries, as a means of providing a more effective safety net for the extreme poor. In 2013 each of the social safety net programs covered less than 10 percent of the poor population, except for the School Feeding Program and the MASAF Public Works Program, which reached 18 and 15 percent, respectively. The SCT Program is on track to scale up across all districts by 2018, of which 11 districts will be funded by the World Bank and the remaining 17 by the Government and donor partners. Technical and financial assistance to support World Bank financed part of the scale up is being provided through the Strengthening Safety Nets Systems Project under MASAF IV.

83. Ensuring sustainability is a major priority as the SCT program expands, especially against a backdrop of continued crisis and drought response. The SCT program is complex, and supported by a myriad of stakeholders. Continued efforts are needed to secure smooth implementation of basic delivery mechanisms—including targeting, the adoption of a unified beneficiary registry, payments and information management—as well as promoting coordination across other programs. For example, recent follow-up analysis on the impact evaluation for MASAF III has concluded that the program's effectiveness would have enhanced by more efficient payment mechanisms. It is for this reason that the DPO will support the enhancement of operational capacities and institutional coordination as a priority

in the scale up of the SCT. The effective scale up of SCT will set the conditions for more predictable program financing from Government and donors.

84. **Policy.** The proposed reforms to FISP envisage separation of the safety net function—aimed at achieving household food self-sufficiency for the ultra poor—from its function aimed at increasing production to achieve national food self-sufficiency. The FISP reform will be achieved by redefining the target population towards the poor with more productive potential, and away from the ultra-poor. The expansion of the SCT Program is devised to offer a more appropriate intervention for the ultra-poor by providing cash to labor-constrained households. By using a fraction of the savings from FISP reforms, the Ministry of Finance, Economic Planning and Development (MoFEPD), the Ministry of Gender, Children, Disability and Social Welfare (MoGCDSW) and the Local Development Fund (LDF) can expand the SCT and reach more of the extremely poor households. Once the SCT Program is scaled up nationally, effort can be devoted into further increasing coverage levels based on assessed needs. A full national scale up of the program would be achieved once the ongoing targeting and enrolment proceses are completed, and initial payment rounds being made successfully. A key precondition for this scale up is the establishment of enhanced institutional coordination arrangements across the implementing sector ministries and agencies. This will pave the way for the migration of SCT from a series of pilots to a program that is operational at the national level across all 28 districts of Malawi. The SCT is expected to be scaled up and operational at the national level by the time the 2017/18 agricultural planting season commences.

85. **Results.** The DPO supports increased protection of the ultra-poor by expanding the SCT to full national coverage. The baseline is for 18 districts to be covered by the SCT in 2014/15 and the target is for all 28 districts of Malawi to be covered by 2017/18.

Pillar B: Strengthening expenditure management and accountability in public finances

DPO-1 Prior Action #6: *The Recipient has, through its MoFEPD, NAO and DHRMD, completed an audit of the civil service payroll system, reconciled the differences between establishment and payroll for both salaries and allowances, and deleted erroneous entries, all in accordance with the provision of paragraph 28 of the LDP.*

DPO-2 Trigger: *MoFEPD and DHRMD (i) review human resources management business processes in order to strengthen establishment control systems; and (ii) the NAO completes an audit of the pension roll and payment system, and take appropriate remedial action to ensure consistency between the establishment register and payroll systems.*

86. **Rationale.** Malawi's public sector wage bill has grown rapidly over recent years, crowding out resources for other current expenditures and making the Government heavily dependent on donor funding for service delivery. This leaves limited space for non-wage expenditure on items such as teaching materials in schools, medicines in hospitals or the maintenance of existing capital investments, where the marginal impact of additional spending on social outcomes is likely to be much higher.

87. The rapid growth of the wage bill is primarily due to sustained increases in the number of civil servants, which has grown from around 111,000 persons in 2008 to 186,000 in 2016, raising questions about the sustainability of the overall public sector wage bill. Weaknesses in establishment and personnel controls have prevented the authorities from taking a more strategic view over public sector hiring as well as rendering the payroll vulnerable to fraud. In addition, the absence of an interface between the payroll and the IFMIS exposes the system to vulnerabilities.

88. **Policy.** The policy reform aims to improve the payroll management system and put in place stronger establishment controls. The prior action (and following trigger) is specifically concerned with improving how the public payroll is managed, how changes are handled, and how consistency with personnel records management is achieved. The MoFEPD, the Department of Human Resources Management and Development (DHRMD) and the National Audit Office (NAO) have initiated a payroll audit exercise, which in the first phase is scrutinizing establishments, nominal rolls, payrolls and actual payments of salaries and allowances. The report of the payroll audit shows serious anomalies (weaknesses, irregularities and abuse of the system) that need to be urgently addressed. The second phase of the audit is to undertake physical headcounts. This process has now been completed. Following this, the Government will repeat the process with pensions. Efforts will also be required to review and strengthen establishment controls in order to avoid the need for future audits. Technical assistance is bring provided by the Financial Reporting and Oversight Improvement Project (FROIP).

89. **Results.** The DPO contributes to strengthened management of the public sector wage bill. The baseline is that 8,004 civil servants remained on the payroll six months after exiting employment in 2014/15. The target is that this number be reduced to less than 500 by 2017/18.

DPO-1 Prior Action #7: *The Recipient has, through its NAO, published the audited financial statements for fiscal years 2011/12, 2012/13, 2013/14 and 2014/15, all in accordance with the provisions of paragraph 27 of the LDP.*

DPO-2 Trigger: *MoFEPD issues treasury minutes, for the years ended June 2012, June 2013, June 2014, June 2015 and June 2016 tracking implementation of audit findings and takes appropriate remedial action including on un-cleared items on bank reconciliation statements.*

90. **Rationale.** The 2003 Public Finance Management Act (PFMA) provides that not later than October 31 of each year, the annual financial statement of the previous fiscal year shall be prepared by the Accountant General and submitted to the Auditor General. The Auditor General is required by the PFMA and the Public Audit Act to complete his/her audit and return the audited financial statement to the Secretary to the Treasury by December 31, and the Minister shall lay the statement before the National Assembly. These reporting requirements are currently not complied with and bank reconciliation statements are carrying significant amounts of unreconciled items or "discrepancies". The latest audited annual financial statement submitted to Parliament but not published is for the year ended 2012. Until recently, the audited financial statements for the years ended June 2012, 2013, 2014 and 2015 had not yet been presented to Parliament. Efforts are now being made to close this backlog.

91. Timely compliance with rules, regulations and internal controls is critical to preventing a relapse in the integrity of PFM in Malawi. Several violations have been reported and documented by the auditors but efforts at implementing these audit recommendations have not been satisfactory over the years. It is therefore necessary that when audit observations and recommendations are adopted or approved by the Parliament, the decisions are communicated without delay to the MoFEPD by the Public Accounts Committee. The Ministry then has a duty to ensure implementation of the decisions of Parliament and report back to the Public Accounts Committee through the issuance of treasury minutes explaining the actions taken in each case. The latest treasury minutes, prior to engagement supported by the DPO, were issued in 2013 on the audit reports of 2011. The credibility of financial statements would be further enhanced by bringing bank reconciliation up to date. This is an important part of rebuilding Malawi's PFM systems.

92. **Policy**. Clearing the discrepancies on the bank reconciliation statements, restoration of quarterly and annual financial reporting and publishing them up-to-date are basic prerequisites of a functioning PFM system. The publication of treasury minutes is an important process that closes the loop in

Malawi's PFM system, tracking Government's remedial actions and response to audit findings. Technical assistance to support these efforts is being provided under the FROIP.

93. **Results**. The expected result of these policy and institutional actions is improved transparency on the use of public funds, achieved via a closure in the backlog of published financial statements presented to Parliament. The baseline is a backlog of five years in 2014/15 and the target is for this backlog to be fully cleared by 2017/18.

DPO-1 Prior Action #8: *The Recipient has, through its MoFEPD, submitted to Parliament the Public Audit (Amendment) Bill 2016 with a view to strengthening the operational independence of the National Audit Office in conformity with INTOSAI standards, all in accordance with the provisions of paragraph 29 of the LDP.*

DPO-2 Trigger: *MoFEPD and NAO (i) implement the provisions of the amended Public Audit Act, and (ii) the NAO submits a copy of the audited financial statement for the year ended June 2016 directly to the Speaker of Parliament in accordance with Section 15 of the amended Public Audit Act.*

94. **Rationale.** Currently, Malawi's legal framework for the National Audit Office (NAO) does not comply with the international standards promulgated by the International Organization of Supreme Audit Institutions (INTOSAI). These standards prescribe that the necessary degree of independence for the functioning of the supreme audit institutions should be laid down in the Constitution; while details be set out in legislation. In particular, these international standards require that adequate legal protection against any interference with a supreme audit institution's independence and audit mandate should be guaranteed in the legislative framework. In recognition of the current weaknesses in the legal framework for the NAO, the Government has drafted amendments to the Public Audit Law—governing the functioning of the NAO—that strengthen the independence of the audit agency while providing necessary legal safeguards against undue interference in its functioning.

95. **Policy.** The legal framework does not provide sufficient legal, administrative and financial independence that the Auditor General requires in order to discharge his/her duty professionally without fear or favor. It is therefore necessary that changes be made in the legal framework to ensure independence and professionalism in public audit and establish the reporting relationship between the Auditor General and the Legislature. The NAO also needs additional capacity building reforms that would enhance its level of compliance with INTOSAI standards. Technical assistance to support these efforts is being provided under the FROIP.

96. **Results.** The expected result of these policy and institutional reforms is strengthened independence and capacity of the external audit body consistent with international standards. The baseline is that the independence of the NAO is not consistent with international standards and that the submission of audit reports is delayed in 2014/15. The target is for independence of the NAO as guaranteed in the legal framework with increased capacity to deliver timely audit reports by 2017/18.

DPO-1 Prior Action #9: *The Recipient has: (i) through its office of the President, appointed Controlling Officers for all ministries, departments and agencies in conformity with the Public Service Management Act (Cap.1:03 of the laws of the Recipient) to perform their functions in conformity with the provisions of the Public Finance Management Act, (Cap.37:02 of the laws of the Recipient); and (ii) through said Controlling Officers, submitted required monthly returns*[9] *for their respective Votes for calendar year*

[9] This include five reports covering: (i) revenues (for revenue earning MDAs); (ii) expenditures; (iii) payroll; (iv) commitments; and (v) bank reconciliation. Monthly funding for MDAs is conditional on COs full compliance with these reporting requirements.

2016 in conformity with the provisions of Section 10 of the Public Finance Management Act, all in accordance with the provisions of paragraph 26 of the LDP.

DPO-2 Trigger: *MoFEPD (i) reviews the compliance of Controlling Officers with Section 10 of the Public Finance Management Act; and (ii) the Chief Secretary implements necessary systems and takes appropriate remedial action for non-compliance by Controlling Officers.*

97. **Rationale.** At the heart of the public sector accountability system in Malawi are the responsibilities attached to heads of ministries, departments and agencies as vote holding "Controlling Officers" (COs). On taking up the post of administrative head of a Ministry, Department or Agency (MDA), the officer concerned is traditionally issued a letter of appointment as a "Controlling Officer", listing his/her statutory duties to ensure compliance by the MDA with financial and personnel regulations, ensure that proper records are maintained, and public assets safeguarded. These responsibilities are spelled out in the Public Finance Management Act 2003 (Section 10), and the Public Service Act 1994 (Sections 21-25). Included also are reporting requirements to the Secretary to the Treasury on financial matters and the Secretary to the DHRMD (on behalf of the Chief Secretary) on personnel matters. After being broken down for many years, this system is now being re-established in Malawi. Although the role is clearly spelled out in the Principle Secretary's Handbook, COs have not been formally appointed, statutory reports are irregularly furnished, and many heads of MDAs do not clearly delegate financial and personnel responsibilities to subordinate officers, hold them accountable for compliance with rules and regulations, and discipline when necessary. Formal systems of management and accountability have thus lapsed into informality.

98. **Policy.** A well performing and accountable Government cannot be recreated in Malawi unless the personnel and financial management responsibilities of heads of MDAs, as Controlling Officers, are restored together with enforcement of rules and regulations. This is a key part of efforts to establish greater treasury control over the budget execution process. Improving this control function is an essential part of efforts to establish a more robust and resilient fiscal framework, with stronger links between the preparation of the budget and its execution. Moreover, strengthening accountability over the use of public funds is an important step towards better service delivery.

99. **Results.** The DPO supports increased managerial accountability on the use of public funds, achieved via the reinstatement of monthly reporting by COs. The baseline in 2014/15 is for no reporting by COs. The target is that over 90 percent of COs are fully reporting by 2017/18.

100. **The proposed DPO is supported by significant depth of analytical work and technical assistance, underpinning policy dialogue with the authorities across the program.** This includes analytical work undertaken by a number of World Bank Global Practices, as well as the Development Economics Research Group, reflecting the multi-sectoral nature of policy dialogue in Malawi.

Table 4: DPO prior actions and analytical underpinnings

Prior actions	Analytical underpinnings
Pillar A: Making agricultural markets work better	
Prior action #1. The Recipient has, through its MoAIWD and MoFEPD, made parametric changes to FISP in fiscal year 2016/17, namely: (i) increased the share of fertilizer retailed by private suppliers; (ii) reduced the level of subsidy to beneficiaries by introducing a fixed value coupon with beneficiaries to paying the difference between the coupon value and market price; and (iii) piloted improved targeting of beneficiaries.	ASWAp Technical Assistance Malawi Economic Monitor-1: Managing Fiscal Pressures Agriculture Public Expenditure Review Pathways to Prosperity in Rural Malawi Poverty and Social Impact Assessment
Prior action #2. The Recipient has, through its MoAIWD,	ASWAp Technical Assistance

adopted revised guidelines that put in place transparent and objective criteria, as well as technical and financial reporting and accountability mechanisms, for maize draw down for price stabilization from the Strategic Grain Reserve.	Malawi Floods Emergency Response Technical Assistance Strengthening El Niño Preparedness and Response Technical Assistance
<u>Prior action #3</u>. The Recipient has, through its ADMARC Limited: (i) published ADMARC Limited's audited financial statements for fiscal years ended 2013/14 and 2014/15 respectively; and (ii) published monthly reports outlining maize market distribution and purchasing plans throughout the fiscal years 2016/17 lean season.	ASWAp Technical Assistance Malawi Economic Monitor-3: Absorbing Shocks, Building Resilience Country Economic Memorandum
<u>Prior action #4.</u> The Recipient has enacted the: (i) Physical Planning Act, 2016; (ii) Customary Land Act, 2016; (iii) Land Survey Act, 2016; and (iv) Land Act, 2016, improving administration and security of tenure.	ASWAp Technical Assistance Land Tenure Policy Notes / Working Papers
<u>Prior action #5</u>. The Recipient has, through its MoFEPD, MoGCDSW and LDF, agreed on institutional coordination arrangements for the expansion of the Social Cash Transfer Program.	Poverty and Social Impact Assessment Malawi Poverty Assessment Social Protection Public Expenditure Review Malawi Economic Monitor-4: Emerging Stronger
Pillar B: Strengthening expenditure management and accountability in public finances	
<u>Prior action #6</u>. The Recipient has, through its MoFEPD, NAO and DHRMD, completed an audit of the civil service payroll system, reconciled the differences between establishment, and payroll, for both salaries and allowances, and deleted erroneous entries.	FROIP Technical Assistance Malawi Policy Notes Series Malawi Economic Monitor-2: Adjusting in Turbulent Times
<u>Prior action #7</u>. The Recipient has, through its NAO, published the audited financial statements for the fiscal years 2011/12, 2012/13, 2013/14 and 2014/15.	FROIP Technical Assistance Public Expenditure Review Public Expenditure and Financial Accountability Assessment
<u>Prior action #8</u>. The Recipient has, through its MoFEPD, submitted to Parliament the Public Audit (Amendment) Bill 2016 with a view to strengthening the operational independence of the National Audit Office in conformity with INTOSAI standards.	FROIP Technical Assistance Public Expenditure Review Public Expenditure and Financial Accountability Assessment
<u>Prior action #9</u>. The Recipient has (i) through its Office of the President, appointed Controlling Officers for all ministries, departments and agencies in conformity with the Public Service Management Act to perform their functions in conformity with the provisions of the Public Finance Management Act; and (ii) through said Controlling Officers, submitted required monthly returns for their respective Votes for calendar year 2016 in conformity with the provisions of Section 10 of the Public Finance Management Act.	Malawi Policy Notes Series Public Services Modernization Technical Assistance Governance Binding Constraints Policy Note Country Economic Memorandum

4.3 LINK TO CPS, OTHER WORLD BANK OPERATIONS AND THE WBG STRATEGY

101. **The proposed operation forms a core part of the WBG Country Partnership Strategy (CPS) (FY13-FY16) for Malawi** (Report number: 74159-MW). The FY15 Performance and Learning Review judged that progress towards meeting CPS objectives has been mixed, with the principal retardant being the impact of "cashgate" on donor and WBG operations, and its consequent macroeconomic effects[10]. Policy dialogue supported under the proposed DPO is a key part of the WBG response to address these challenges and ensure that the CPS achieves its objectives. The DPO is part

[10] World Bank (2015) *Performance and Learning Review of the Country Assistance Strategy for the Republic of Malawi FY13-16*, Africa Region, Report No.95178-MW, Washington, DC: The World Bank.

of a multi-pronged attempt to help Malawi "break the cycle" of vulnerability, and aims to catalyze a number of investment financing operations by addressing some of the key binding policy constraints that have amplified Malawi's vulnerability.

102. **Malawi's Systemic Country Diagnostic is currently under preparation** as part of efforts to prepare for a new Country Partnership Framework (CPF) to commence in FY18. The objective is to identify the main barriers to achieving the WBG's twin goals of ending extreme poverty (defined as reducing the share of the population living on less than US$1.90/day to less than 3 percent) and boosting shared prosperity (addressing the living standards of the bottom 40 percent of the population).

4.4 CONSULTATIONS, COLLABORATION WITH DEVELOPMENT PARTNERS

103. **Preparation of the operation was undertaken in coordination with development partners within the Group on Financial and Economic Management (GFEM)**[11]. The GFEM is a high-level consultative forum, chaired by the Minister of Finance, on a six-monthly basis to review progress on key PFM, PSR and fiscal management reforms. There are a series of technical level groups that meet under the overall supervision of the GFEM. Consultations on the proposed program supported by the DPO were also carried out with civil society groups.

104. **Both Malawi's Public Service Reform and Public Financial Management Action Plans were prepared in a consultative manner, as was the National Agricultural Policy.** Preparation of the PSR Action Plan was carried out by an independent Public Service Reforms Commission that consulted extensively with a broad array of stakeholders. Similarly, the PFM Action Plan, which was prepared by the Ministry of Finance, Economic Planning and Development (MoFEPD) with the support of the IMF, was subject to significant technical consultations.

105. **The DPO was prepared in cooperation with Malawi's development partners around a shared dialogue aiming to help Malawi "break the cycle" of vulnerability.** The DPO was jointly identified with the European Union, which is considering budget support to Malawi. Similarly, the African Development Bank has resumed a form of sector budget support to Malawi as part of its response to the food security crisis.

5. OTHER DESIGN AND APPRAISAL ISSUES

5.1 POVERTY AND SOCIAL IMPACT

106. **The overall net poverty and social impact of policy and institutional reforms supported under this DPO is expected to be positive.** Reforms supported under the DPO will both directly and indirectly contribute towards improving living standards of the poor. Improved and lower cost access to formal land titles will benefit poor and vulnerable land owners, particularly women, who have disproportionately had weaker access to legal ownership of land. Transparency around grain reserve management and ADMARC operations, by reducing price volatility, could have a positive poverty and social impact, especially on those households which are currently food insecure. Similarly, public financial management reforms that aim to help strengthen expenditure management and budget execution, public accountability and transparency, are expected to contribute towards improved service delivery. Further information is presented in Annex 4.

107. **While reforms to FISP supported under the program are expected to have some negative distributional effects, their impact on extreme poverty will be more than offset by the supported**

[11] To be renamed the High Level Forum on Public Finance Management.

expansion of the SCT Program. The current FISP is justified on the basis that most smallholders in Malawi lack the cash resources or access to credit that would enable them to purchase inorganic fertilizer at commercial market prices and soil nutrients, particularly nitrogen, which are essential for maize production. These nutrients are in short supply, and inorganic fertilizer is the most effective short-term method for farmers to add nutrients to the soil. The FISP has multiple stated objectives, including: (i) increasing smallholder maize yields and overall levels of production; (ii) achieving reductions in poverty levels; (iii) promoting food security; and, (iv) enhancing rural incomes. However, households who should be targeted to increase maize productivity are likely not the same households who should be targeted to reduce rural poverty. Therefore, though the FISP was never intended to serve as a social safety net, it has in effect acted as a form of cash transfer for land and labor constrained households who have cashed out their coupons, so the reforms that reduce the subsidy will have distributional consequences.

108. **A recent Poverty and Social Impact Analysis (PSIA) provides insights into the distributional implications of proposed FISP reforms**[12]. In total three policy options were analyzed:

(i) "old" FISP policy, which provided coupons giving a 97 percent discount of the commercial price of fertilizer and where the Government transported all subsidized fertilizer to marketing centers;

(ii) reducing the price subsidy to 65 percent accompanied by a full shift to the private sector for the transportation and distribution of fertilizer; and

(iii) reducing the price subsidy to 65 percent accompanied by a shift to private distribution of fertilizer, but accompanied by a cash transfer provided through the Social Cash Transfer Program with the following features: (a) targets extreme poor households with a dependency ratio of at least 1.3 or with a household head who is chronically ill, older than 64, or female; (b) provides increasing transfers by household size (up to 4 persons) and for any children currently attending primary and secondary school; and, (c) randomly allocates 144,000 household beneficiaries across a broader eligible population.

109. **The results of the PSIA study show that the "old" FISP policy was broadly progressive, with the benefit ratio falling from little less than 3 percent for the very poorest to below 1 percent for the richest**[13]. On the one hand, for (relatively) wealthy farm households the subsidy is largely inframarginal (meaning it did not change their behavior with regard to input use), as they already purchase at least two bags of fertilizer and hence the benefit is essentially equal to the cash value of the fertilizer, whereas for the poor the benefit tends to be lower because the poor have a low demand for fertilizer. On the other hand, *in proportion to income*, the benefit to the wealthiest is actually much lower than the benefit to the poorest.

110. **For policy (ii) the household-level benefits are lower across the board than under the "old" more generous FISP policy**. The lower price subsidy combined with the elimination of the transport subsidy reduces the ratio of FISP benefits to income by almost half relative to the old policy, and does

[12] This summary draws upon a series of policy notes prepared for the World Bank to assess the poverty and social impact of FISP and its proposed reforms, and consider adjustments and compensatory measures to cushion the impact of reforms on the poor (see Ricker-Gilbert, J. 2016. "Review of Malawi's Farm Input Subsidy Program and Directions for Re-design". Background Note for FISP PSIA. World Bank, Washington, DC; and Jacoby, H. 2017. "Poverty and Distributional Implications of Reforms to Malawi's FISP. Background Note for FISP PSIA. World Bank, Washington, DC).

[13] The PSIA analysis focuses strictly on the fertilizer component of FISP and assumes that households are only allowed to redeem coupons for one 50kg bag each of NPK and urea. The population of potential beneficiaries are assumed to be rural households. All distributional statistics (i.e., per capita expenditure percentiles) refer to this population. The welfare measure is consumer surplus. The ratio of the benefits to income all along the per capita expenditure distribution are reproduced in Figure 5 and, by decile, in Table 5 (note that the benefit/income ratio is first calculated at the household level and then averaged within percentiles).

so fairly consistently across percentiles. Here, it is assumed, plausibly, that the transport costs now incurred by the private sector are entirely passed on to consumers.

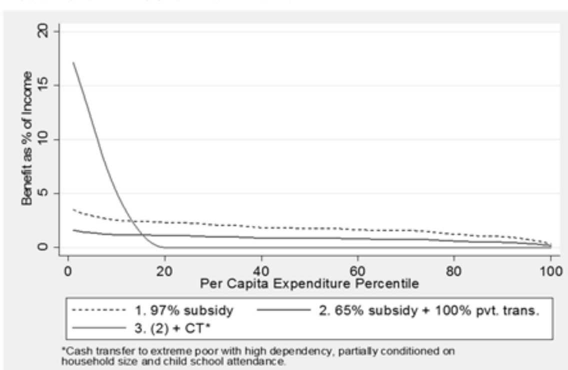
Table 5: Benefit as percentage of income for alternative polices by decile

Decile	(1)	(2)	(3)
1	2.71	1.26	11.38
2	2.45	1.16	1.16
3	2.26	1.09	1.09
4	1.96	0.94	0.94
5	1.84	0.89	0.89
6	1.83	0.90	0.90
7	1.51	0.74	0.74
8	1.59	0.79	0.79
9	1.08	0.53	0.53
10	0.66	0.33	0.33

Notes: Figures are average benefit/income ratios (x 100) within per-capita expenditure deciles. Column (1) refers to a 97 percent subsidy (old policy); column (2) to a 65 percent subsidy and a shift to private transport; and column (3) to the policy in column (2) combined with a cash transfer targeted to the extreme poor.

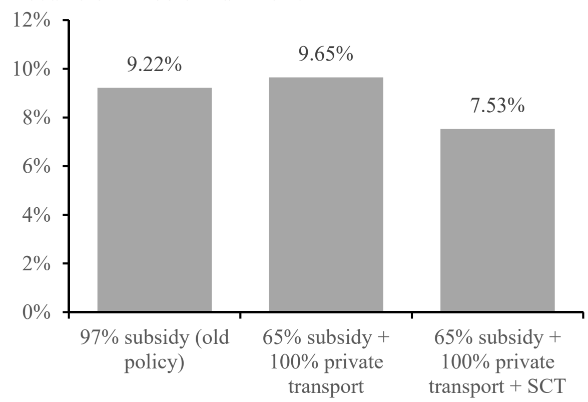
111. **Policy (iii) with a carefully targeted cash transfer provided through the scaled up SCT Program, turns out to be by far the most progressive** and more than offsets the impact of the subsidy reduction on extreme poverty (see policy 3 in Figure 5 and column 3 in Table 5), which is expected to fall by 1.7 percentage points. The extreme poor find themselves substantially better off than under the old FISP, with the bottom decile experiencing a 9 percentage point greater income boost. There would also be far less "leakage" of benefits to households in the higher income deciles than under the old FISP.

Figure 5: Benefit/income ratios for alternative reforms to the FISP
Results of three simulations



Source: World Bank PSIA

Figure 6: Estimates of the extreme poverty headcount for alternative reforms to the FISP
Results of three simulations



Note: Figures are percentages of rural households

112. **Thus, while reducing the fertilizer price subsidy and eliminating free transport alone leads to a slight uptick in the extreme poverty headcount, when this step is combined with an SCT expansion, there is a considerable drop in the "extreme" poverty headcount**[14]. This means that households in poverty will become better off on average and the distribution of income will improve. The implications of these policy proposals for poverty are reported in Figure 6. The first column reports the baseline estimate of extreme poverty in the rural population at the household level. The next two

[14] These estimates are based on the Integrated Household Panel Survey administered from March through December 2013, that is, the nonlean season in Malawi. Therefore, the poverty rates on which this exercise relies should be understood as the lower bound for actual poverty in Malawi given that the lean months when poverty increases are not captured in them. By contrast, the official monetary poverty estimates for Malawi are derived using the cross-sectional IHS data, which is administered throughout the year (typically starting in March and ending one year after). The latest available figures are for 2010 (the Third Integrated Household Survey (IHS3).

columns of the chart re-compute extreme poverty based on predicted per capita expenditures under the respective policies. The SCT is expected to be scaled up and operational at the national level by the time the 2017/18 agricultural planting season commences. The bottom line is that extreme poverty is almost 1.7 percentage points lower as a result of the combined set of reforms supported by the DPO.

113. **In addition, parametric reforms to the FISP to improve targeting are expected to benefit the "moderate" poor.** A movement away from the current lottery approach, to a FISP that is targeted at households that have land and labor resources, but are cash constrained (which is the case for the moderate poor but not the extreme poor) is expected to lead to increased benefits for those in poverty. Other aspects of the program that aim to help agricultural markets function better will also result in broader indirect benefits to the rural population[15].

114. **Further, short-term measures relating to the response to the food security crisis have also helped to cushion the impact of FISP reforms on the poor.** The humanitarian response, contributed in large part via World Bank-financed investments[16], has provided food aid to a peak caseload of 40 percent of the population during the 2016/17 lean season. Similarly, World Bank supported public works programs have also provided income support to the poor during the transition period.

115. **There is now rigorous impact evaluation evidence to show the benefits of a cash transfer targeting the extreme- or ultra-poor in Malawi.** It is important to distinguish that this target group—typically including female-headed households—would appear to gain more from a cash versus in-kind transfer such as FISP. Impact assessments of the pilot SCT program which commenced in 2008 and, more recently, of its scaled up version from 2014, show its effectiveness in increasing consumption, productive asset investment and resilience to seasonal shocks[17]. Spillover benefits to non-beneficiary populations have also been estimated at 1.27, indicating that a one dollar transferred to a poor household adds more than US$1.27 to the local economy[18].

116. **The SCT therefore offers an alternative, more effective and more sustainable mechanism to reach the extreme poor compared to the FISP**. First, the SCT is a targeted intervention, with repeated rounds of payments devised to smooth consumption. Notwithstanding challenges in targeting logistics, the SCT offers a predictable stipend to beneficiaries compared to the lottery protocol that has existed under FISP. Second, the SCT is a cost effective operation. Once the program reaches its goal of 320,000 households, covering the 10 percent poorest labor-constrained households in each district, it is expected to cost about 1.1 percent of 2016 GDP. The latest available estimates suggest that FISP costs around 4.6 of GDP. Third, providing cash brings the benefit of flexibility to household decision-making. With cash, a household is likely to allocate spending optimally. Part of the cash is likely to be used to meet immediate needs such as food, health care, or schooling. Some of the cash may be saved for future spending needs such as farm input purchases at the time of planting or harvest. In other words, cash empowers farm households to make decisions that maximize their welfare. In contrast, for poor farmers,

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[15] Plus, complementary World Bank-financed investments, including a proposed Agricultural Commercialization Project, as well as the Shire Valley Transformation Project that aim to support medium-term investments in diversified and more drought-resistant agriculture, will also increase opportunities for income-generating activities in rural areas.
[16] Principally the Malawi Drought Recovery and Resilience Project, approved in November 2016.
[17] See Miller, C. M., Tsoka, M., Reichert, K. 2011. "The Impact of the Social Cash Transfer Scheme on Food Security in Malawi" *Food Policy* 36 (2) 230-238; Miller, C. and Tsoka, M. 2012. "Cash Transfers, Children's Education and Labour among Malawi's Poor" *Development Policy Review* 30(4), 499-522; Abdoulayi, S. et al. 2014. "Malawi Social Cash Transfer Program: Midline Impact Evaluation Report" Working Paper; Baird, S., E. Chirwa, C. McIntosh, and B. Özler. 2015. "What Happens Once the Intervention Ends? The Medium-Term Impacts of a Cash Transfer Program in Malawi." Impact Evaluation Report 27. Washington, DC: International Initiative for Impact Evaluation.
[18] Davis B., Handa S., Hypher N., Winder Rossi N., Winters P. and Yablonski J. 2016. *From Evidence to Action: The Story of Cash Transfers and Impact Evaluation in Sub-Saharan Africa,* FAO, UNICEF and Oxford University Press.

the redeemed coupon value of the farm subsidy is often lower than the face value. In this context, the DPO supports the progressive strengthening of the SCT program as a means of providing a responsive safety net that meets the needs of the extreme poor.

5.2 ENVIRONMENTAL ASPECTS

117. **The MGDS II identified climate change as a key priority area and, as a result, Malawi has prepared a National Climate Change Management Policy and submitted its (Intended) Nationally Determined Contribution (INDC) document to the UNFCC prior to the UNFCC COP 21 meeting in Paris.** Malawi is now seeking support to address the priorities identified in this document and the World Bank will be responding to this need within the context of the Africa Climate Change Business Plan—which prioritizes a number of themes relevant to this operation—in particular the promotion of climate smart agriculture and use of social protection for resilience. Building resilience into the agriculture sector is also identified as the highest priority in the NDC. Integrated water resources management, human health and sustaining biodiversity and natural habitats are also identified as priorities for sustaining and building resilience to future climate change. A summary of issues is presented in Annex 4.

118. **The prior actions supported by the DPO are expected to contribute positively towards improved climate resilience in Malawi.** Reforms to the FISP, which has long crowded out public expenditure in the agriculture sector, will free up fiscal space to enable a more balanced set of agricultural investment activities including in climate-smart agriculture as set out in the new National Agricultural Policy. Similarly, improved functioning of agricultural markets should lead to the reversal of incentives that have tended to encourage maize mono-cropping, growing on marginal and drought-prone land resulting in soil erosion and a general lack of agricultural diversification. Improved security of land tenure could lead to higher levels of investment in land stewardship, and thus reduce land degradation. That said, complementary improvements to the broader conservation and natural resources management policy framework will also be necessary to ensure positive environmental outcomes from a better functioning set of agricultural markets in Malawi.

119. **Other prior actions are not expected to result in significant effects on the environment.** The implementation of measures to strengthen the management of public finances and improve accountability in the public sector are expected to have a neutral effect on the environment. However, there are linkages between environment degradation and weak macroeconomic management and governance. Hence, it is expected that there will be some positive indirect effects on the environment associated with policy and institutional reforms supported under the program.

5.3 PFM, DISBURSEMENT AND AUDITING ASPECTS

Public financial management

120. **Malawi's fiduciary risk is high but policy actions taken by the Government to restore public financial management and expenditure controls after "cashgate" help to mitigate against these risks.** Since January 2015, Government has been implementing a PFM Reform Program aimed at restoring financial controls and accountability. Government is receiving a large amount of technical assistance in this area, including via a World Bank-managed Multi Donor Trust Fund (the FROIP), as well as from the IMF and a number of bilateral development partners.

121. **Malawi generally operates to good standards of budget transparency and scores highly on open budget indices**[19]. The Government's budget for the 2016/17 financial year was presented to the Parliament on May 27, 2016 and approved on June 30, 2016[20]. The draft Financial Statement for the 2016/17 fiscal year, as well as the Minister's budget statement were immediately made available on the MoFEPD website. The Minister also undertakes pre-budget public consultations across the country. The draft detailed Estimate of Expenditure books as well as the Financial Statements are also made available to the public in hard copies[21]. Similarly, the RBM publishes financial statements that are prepared on a timely basis and are audited in accordance with international standards.

122. **The 2011 PEFA assessment identified a number of weaknesses in Malawi's control framework.** These include the credibility of the budget (in terms of its ability to provide a reliable indication of Government's resource envelope); internal control; comprehensiveness and transparency; timeliness of financial reports, follow-up on audit recommendations and a backlog in bank reconciliations. However, areas where Malawi performs comparatively better include the cash management process, the orderliness of the annual budget process, debt management, and legislative scrutiny of the annual budget law. The ongoing PFM Reform Program has taken into account the weaknesses identified in the PEFA. Discussions are currently underway for the preparation of a new PEFA for Malawi, under the new 2016 framework.

123. **The 2011 PEFA also found that Malawi scores comparatively poorly on the use of competitive procurement methods and public access to complete, reliable and timely procurement information**. However, more recently there have been some advances in moving the public procurement system towards acceptable standards, including through significant investments in capacity development and twining arrangements, particularly for the Office of the Director of Public Procurement, and stronger oversight. In addition, the establishment of the Malawi Institute of Purchasing and Supply has helped build supplier capacity and regulate the behavior of procurement practitioners.

124. **The 2013 PER identified a number of policy measures to improve the efficiency of public expenditure,** defined in the context of Malawi as delivering a similar or improved level and quality of Government services within a severely constrained overall resource envelope.

Assurance requirements

125. **Based on the high fiduciary risk associated with the operation, there will be special fiduciary arrangements established for the credit.** Within seven days of the disbursement of the credit by IDA, the Ministry of Finance shall provide a written confirmation to IDA, certifying the receipt of the Malawi Kwacha equivalent of the credit into the Consolidated Fund Account of the Government, the date of the receipt, and the exchange rate applied to translate the credit currency into Malawi Kwacha, and confirming that the said amount has been appropriately accounted for in the Recipient's financial management system. In addition, as the NAO is required by law to submit its annual report and the audited accounts on the public consolidated fund to Parliament within six months of the end of the fiscal year, a copy of the said reports and accounts shall be provided to IDA within one month after the lapse of this six-month period.

126. **IDA reserves the right to request, at any time, an audit of the receipt and accounting of the disbursement in the budget management system of the Recipient.** Upon the Association's request, the Recipient shall: (i) have the account and the recording of amounts of the credit into the

[19] See http://www.internationalbudget.org/wp-content/uploads/OBS2015-CS-Malawi-English.pdf.
[20] A mid year budget update was presented on February 17, 2017.
[21] Financial statements are available on www.finance.gov.mw

Recipient's budget management system audited by independent auditors acceptable to the Association, in accordance with consistently applied auditing standards acceptable to the Association; (ii) furnish to the Association as soon as available, but in any case no later than four months after the date of the Association's request for such audit, a certified copy of the audit report by said auditors, of such scope and in such detail as the Association shall have reasonably requested; and (iii) furnish to the Association such other information concerning the said account and recording of credit amounts into the budget management system, and the audit thereof, as the Association shall have reasonably requested.

Disbursement and auditing

127. **A single-tranche DPO of SDR 58.9 million (US$80 million equivalent) will be disbursed upon credit effectiveness and following the Recipient's request for withdrawal of proceeds of the credit.** The proposed credit will follow IDA's standard disbursement procedures for development policy financing operations. The credit will be disbursed against satisfactory implementation of the development policy program and not tied to any specific purchases. Once the operation is approved by the Board and becomes effective, and upon receipt of a withdrawal application signed by an authorized signatory, the proceeds of the credit will be deposited by IDA in a US$ account designated by Government at the RBM and forming part of the official foreign exchange reserves of Malawi. Within two working days the RBM will credit the Malawian kwacha equivalent of the credit proceeds to the consolidated account maintained on behalf of the Government for budget execution. The conversion from the foreign currency to local currency will be based on the prevailing exchange rate on the date that the funds are credited to the budget management system.

128. **The RBM will not impose any charges or commissions on the Recipient.** The Recipient will: (a) provide confirmation to IDA within seven days that an amount equivalent to the credit proceeds from the World Bank has been credited in the Recipient's budget management system, with an indication of the exchange rate applied; (b) provide evidence that the Malawian Kwacha equivalent of the credit proceeds was recorded as financing the Government's budget; and (c) ensure that the Malawi Kwacha equivalent of the credit proceeds are subject to effective controls sufficient to ensure its use for eligible budgeted public expenditures only as per the Financing Agreement.

129. **Disbursements by the Government shall not be tied to any specific purchases and no special procurement requirement shall be needed.** The proceeds of the credit shall, however, not be applied to finance expenditures in the negative list as defined in the Schedule 1 of the Financing Agreement. If any portion of the credit is used to finance ineligible expenditures as so defined in the Schedule 1 of the Financing Agreement, IDA shall require the Recipient to promptly, upon notice from IDA, refund an amount equal to the amount of the said payment to IDA. Amounts refunded to IDA upon such request shall be cancelled from the credit.

130. **The administration of the credit will be the responsibility of the MoFEPD.** The use of the Malawi Kwacha equivalent of credit proceeds to support budgetary expenditures will be subject to audit by the NAO as provided for by the Malawi Constitution. IDA will have access to these audit reports.

5.4 MONITORING, EVALUATION AND ACCOUNTABILITY

131. **Implementation of this operation is being coordinated by the MoFEPD with guidance provided by the GFEM.** A number of other MDAs are also closely involved in the reform program. Day to day responsibility for monitoring and evaluation falls under the responsibility of the Debt and Aid Management Division of the MoFEPD.

132. **Monitoring and evaluation of the reform program will be undertaken jointly by the Government and World Bank teams.** These two teams will meet regularly to monitor progress in implementing the agreed policy and institutional reforms supported by the operation, and to assess progress made towards achieving the expected results. Result indicators have been specifically selected to reflect available data sources in Malawi, and build on lessons learned from earlier policy based lending operations that recommend the use of simple and manageable results frameworks using available secondary sources of data. Full details of the causal chain from program objectives to prior actions/triggers to expected results are described in Annex 1.

133. **Grievance redress**. Communities and individuals who believe that they are adversely affected by specific country policies supported as prior actions or tranche release conditions under a World Bank Development Policy Operation may submit complaints to the responsible country authorities, appropriate local/national grievance redress mechanisms, or through the World Bank's Grievance Redress Service (GRS). The GRS ensures that complaints received are promptly reviewed in order to address pertinent concerns. Affected communities and individuals may submit their complaint to the World Bank's independent Inspection Panel which determines whether harm occurred, or could occur, as a result of World Bank non-compliance with its policies and procedures. Complaints may be submitted at any time after concerns have been brought directly to the World Bank's attention, and World Bank Management has been given an opportunity to respond. For information on how to submit complaints to the World Bank's corporate GRS, please visit www.worldbank.org/grs. For information on how to submit complaints to the World Bank Inspection Panel, please visit www.inspectionpanel.org.

6. SUMMARY OF RISKS AND MITIGATION

134. **The overall risk of the proposed operation is "high", as are the expected returns to successful implementation.** The program is subject to four main risk areas: (i) political and governance; (ii) macroeconomic; (iii) institutional capacity; and (iv) fiduciary risks.

Table 6: Systematic Operations Risk-Rating Tool

Risk Categories	Rating (H,S,M,L)*
1. Political and governance	H
2. Macroeconomic	H
3. Sector strategies and policies	M
4. Technical design of project or program	M
5. Institutional capacity for implementation and sustainability	S
6. Fiduciary	H
7. Environment and social	M
8. Stakeholders	L
9. Other	-
Overall	H

* High, Substantial, Moderate, Low

135. **Political and governance risks are central to the success of the program, as well as Malawi's broader development strategy.** The pervasiveness of corruption and the persistence of entrenched political interests may impede the passage or implementation of the Government's bolder agricultural market, governance and PFM/PSR reforms, as has happened many times in Malawi's history. The WBG is heavily invested in macro-fiscal and governance reform, and is attentive to the political realities of reform—but it would be unwise to underestimate the resilience of vested interests and the risks inherent in actions that necessarily cut against those with influence. This risk can, to some extent, be mitigated by building broad public support for policy reforms—as public pressure to restore the credibility of Government institutions is high, and there is much greater public scrutiny of public sector performance after "cashgate".

136. **Maintaining macroeconomic stability is also a major source of risk, and is exacerbated by external shocks and climate-induced natural disasters.** The Government's ability to contain public spending and increase domestic revenues is mixed, and a restoration of donor budget support is dependent on visible gains in improving the control environment. Similarly, with its reliance on a few primary exports and a relatively undiversified economy, Malawi remains vulnerable to external demand and price shocks as well as to weather-related disasters, as demonstrated by the droughts in 2015 and 2016. The volatility of aid flows in a heavily aid-dependent country also features heavily in this equation. With further external shocks, it may be hard for the Government to manage the fiscal gap and maintain macroeconomic stability; service delivery could also deteriorate further, and counterpart support for important new projects would be hard to mobilize. These risks are partially mitigated by continued close policy dialogue on macroeconomic and fiscal management issues, including via the "breaking the cycle" narrative, as well as deepened investment in disaster risk management and resilience.

137. **Institutional capacity is a long-term agenda in Malawi.** The World Bank is heavily engaged in this arena through an array of instruments, as are a large number of other development partners. The risks are somewhat mitigated by selecting only the highest priority policy and institutional reforms for inclusion in the proposed DPO program, by focusing only on the most critical areas of policy dialogue, and by setting prior actions/triggers at a downstream level. In addition, the objectives of the DPO are shared by Malawi's major development partners and form part of a collective policy dialogue.

138. **Weak fiduciary control systems that undermined public policy effectiveness and slow progress in addressing gaps is a further source of risk**, both to the DPO and the WBG's broader program in Malawi. The World Bank's assessments point to a climate of high fiduciary risk, even if the specific loopholes associated with "cashgate" have been closed. Continued close collaboration with Government and development partners on the PFM agenda will strengthen collective efforts, while the Government's own commitment and need for a resumption of budget support should help maintain internal pressure for reform.

139. **There are also risks of not engaging**. While not strictly a fragile state, Malawi displays many of the symptoms of fragility. Much of the reform agenda supported by the proposed DPO has emerged during a time of crisis and significant political and economic stress. Failure to engage positively in support of an important, but still uncertain, change process runs the risk of leaving emerging reforms isolated and vulnerable to reversals.

ANNEX 1: POLICY AND RESULTS MATRIX

<table>
<tr><td colspan="3">Program Development Objective: The objective of the proposed DPO series is to improve incentives for private sector participation in agricultural markets and to strengthen fiscal management through more effective expenditure controls and greater transparency</td></tr>
<tr><td>Prior actions under DPO-1</td><td>Triggers for DPO-2</td><td>Results</td></tr>
<tr><td colspan="3">Pillar A: Making agricultural markets work better</td></tr>
<tr><td><u>Prior action #1</u>. The Recipient has, through its MoAIWD and MoFEPD, made parametric changes to FISP in fiscal year 2016/17 namely: (i) increased the share of fertilizer retailed by private suppliers; (ii) reduced the level of subsidy to beneficiaries by introducing a fixed value coupon with beneficiaries to paying the difference between the coupon value and market price; and (iii) piloted improved targeting of beneficiaries.</td><td>MoFEPD and MoAIWD make further parametric changes to FISP by (i) further increasing the share of fertilizer retailed by private suppliers; (ii) further reducing the level of subsidy to beneficiaries while maintaining a fixed value coupon with beneficiaries to pay the difference between the coupon value and market price; and (iii) rolling out improved targeting of beneficiaries</td><td>Reorientation in the objectives of FISP towards boosting agricultural productivity, increasing fiscal space via a reduction in the scale of subsidies and increased efficiency of distribution
Baseline: Private sector retails 0 percent of FISP fertilizer tonnage, and Government contributes 97 percent of FISP subsidy in 2014/15
Target: Private sector retails 50 percent of FISP fertilizer tonnage, and Government contributes 70 percent of FISP subsidy in 2016/17; Private sector retails 70 percent of FISP fertilizer tonnage, and Government contributes 60 percent of FISP fertilizer subsidy in 2017/18</td></tr>
<tr><td><u>Prior action #2</u>. The Recipient has, through MoAIWD, adopted revised guidelines that put in place transparent and objective criteria, as well as technical and financial reporting and accountability mechanisms, for maize draw down for price stabilization from the Strategic Grain Reserve.</td><td></td><td rowspan="2">Maize markets work more effectively, resulting in reduced price volatility
Baseline: Coefficient of variation of 0.51 in maize markets in 2014/15
Target: Average price volatility reduced by 25 percent in 2017/18 relative to the 2011-16 average in years of normal production (to a coefficient of variation of 0.38)</td></tr>
<tr><td><u>Prior action #3</u>. The Recipient has, through ADMARC Limited: (i) published ADMARC Limited’s audited financial statements for fiscal years 2013/14 and 2014/15, respectively; and (ii) published monthly reports outlining maize market distribution and purchasing plans throughout the 2016/17 lean season.</td><td>ADMARC (i) carries out a strategic review of its functions, governance arrangements and oversight mechanisms; and (ii) undertakes reforms establishing clearly defined responsibilities, guidelines for market intervention within price bands, clearer accountability, transparency and oversight mechanisms</td></tr>
<tr><td><u>Prior action #4.</u> The Recipient has enacted the (i) Physical Planning Act, 2016; (ii) Customary Land Act, 2016; (iii) Land Survey Act, 2016; and (iv) Land Act, 2016 improving administration and security of tenure.</td><td>MoLHUD clarifies the status of existing leases and puts in place the regulatory framework and physical infrastructure for cost-effective systematic implementation of the Land Laws, including low-cost boundary demarcation and sustainable land information management</td><td>Improved land administration, investment incentives and access to land
Baseline: Most estate leases expired; boundary demarcation costly; strategy to systematically demarcate customary estates not yet in place to benefit all land users, especially women in 2014/15.</td></tr>
</table>

Program Development Objective: *The objective of the proposed DPO series is to improve incentives for private sector participation in agricultural markets and to strengthen fiscal management through more effective expenditure controls and greater transparency*		
Prior actions under DPO-1	**Triggers for DPO-2**	**Results**
		Target: 30,000 expired estates notified in 2017/18 with 10,000 leases either renewed or cancelled; manual for systematic demarcation, and low-cost survey approved with baseline data collected and implementation started in at least 3 districts in 2017/18
	MoITT submits to Parliament a Warehouse Receipts Bill that improves access to agricultural commodity financing	Established framework for using agricultural commodities as collateral for accessing finance Baseline: Warehouse receipts financing framework not in place in 2014/15 Target: Warehouse receipts financing framework in place and operational in 2017/18
	MoITT submits to Parliament an amended Control of Goods Bill with clearly defined and transparent procedures for the regulation of commodity exports and imports	Improved predictability and transparency in the administration of regulatory measures affecting trade in agricultural commodities Baseline: Trade bans and licensing requirements are issued in a non-transparent way in 2014/15 Target: Any commodity trade restrictions and licensing requirements are implemented consistent with international standards of due process and transparency in 2017/18
Prior action #5. The Recipient has, through its MoFEPD, MoGCDSW and LDF, agreed on institutional coordination arrangements for the expansion of the Social Cash Transfer Program.	MoFEPD, MoGCDSW and LDF expand the Social Cash Transfer Program to be operational at the national level across all 28 districts	National coverage of the Social Cash Transfer Program Baseline: Social Cash Transfer Program coverage in 18 districts in 2014/15 Target: Social Cash Transfer Program coverage in 28 districts in 2017/18
Pillar B: Strengthening expenditure management and accountability in public finances		
Prior action #6. The Recipient has, through its MoFEPD, NAO and DHRMD, completed an audit of the civil service payroll system, reconciled the difference between establishment, and payroll, for both salaries and allowances, and deleted erroneous entries.	MoFEPD and DHRMD (i) review human resources management business processes in order to strengthen establishment control systems; and (ii) NAO completes an audit of the pension roll and payment system, and takes appropriate remedial action to ensure consistency between the establishment register and payroll systems	Strengthened management of the public sector wage bill. Baseline: 8,004 civil servants on the payroll six months after exiting employment in 2014/15 Target: Less than 500 civil servants on the payroll six months after exiting employment in 2017/18

Program Development Objective: *The objective of the proposed DPO series is to improve incentives for private sector participation in agricultural markets and to strengthen fiscal management through more effective expenditure controls and greater transparency*		
Prior actions under DPO-1	**Triggers for DPO-2**	**Results**
Prior action #7. The Recipient has, through its NAO, published the audited financial statements for the fiscal years 2011/12, 2012/13, 2013/14, 2014/15.	MoFEPD issues treasury minutes, for the year ended June 2012, June 2013, June 2014, June 2015 and June 2016 tracking implementation of audit findings, and takes appropriate remedial action including on un-cleared items on bank reconciliation statements	Improved transparency on the use of public funds, achieved via a reduction in the backlog of published audited financial statements presented to Parliament. Baseline: Five years backlog in 2014/15 Target: Cleared by 2017/18
Prior action #8. The Recipient has, through its MoFEPD, submitted to Parliament the Public Audit (Amendment) Bill 2016 with a view to strengthening the operational independence of the National Audit Office in conformity with INTOSAI standards.	MoFEPD and NAO (i) implement the provisions of the amended Public Audit Act, and (ii) the NAO submits a copy of the audited financial statement for the year ended June 2016 directly to the Speaker of Parliament in accordance with Section 15 of the Public Audit Act	Strengthened independence, consistent with international standards, and capacity of the public external audit function. Baseline: Independence of the NAO not consistent with international standards, submission of audit reports delayed in 2014/15 Target: Independence of the NAO as guaranteed in the legal framework with strengthened capacity to deliver timely audit reports by 2017/18
Prior action #9. The Recipient has: (i) through its Office of the President, appointed Controlling Officers for all ministries, departments and agencies in conformity with the Public Service Management Act to perform their functions in conformity with the provisions of the Public Finance Management Act; and (ii) through said Controlling Officers, submitted required monthly returns[22] for their respective Votes for calendar year 2016 in conformity with the provisions of Section 10 of the Public Finance Management Act.	MoFEPD (i) reviews the compliance of Controlling Officers with Section 10 of the Public Finance Management Act; and (ii) the Chief Secretary implements necessary systems and takes appropriate remedial action for non-compliance by Controlling Officers.	Increased managerial accountability on the use of public funds, achieved via the reinstatement of monthly reporting by Controlling Officers. Baseline: No Controlling Officers are meeting monthly reporting requirements in 2014/15 Target: Controlling Officers are fully reporting (>90 percent) in 2017/18

[22] This include five reports covering: (i) revenues (for revenue earning MDAs); (ii) expenditures; (iii) payroll; (iv) commitments; and (v) bank reconciliation. Monthly funding for MDAs is conditional on COs full compliance with these reporting requirements.

ANNEX 2: LETTER OF DEVELOPMENT POLICY

Telephone: 01 789 355
Telefax: 01 789 173
Telex: 44407
Email:secmof@finance.gov.mw

MINISTRY OF FINANCE,
ECONOMIC PLANNING
AND DEVELOPMENT
P.O. BOX 30049,
CAPITAL CITY,
LILONGWE 3.

Ref: FIN/DAD/DACU/5/4/5 **27th February 2017**

Dr. Jim Yong Kim
President
World Bank Group
1818 H Street, N.W.
Washington D.C. 20433
United States of America

Dear Dr. Kim,

MALAWI: LETTER OF DEVELOPMENT POLICY

1. On behalf of the Government of the Republic of Malawi, I write to request for a Development Policy Operation (DPO-1) Credit of US$80 million from the International Development Association (IDA). The DPO-1, which is the first in a programmatic series of two single tranche operations, is intended to lay the foundations for a more resilient economy. This will be achieved through measures to improve incentives for private sector participation in agricultural markets and strengthen fiscal management through more effective expenditure controls and greater transparency. These objectives are essential prerequisites for sustainable economic growth and poverty reduction in Malawi.

2. The DPO-1 will focus on two pillars of policy and institutional reforms: (i) making agricultural markets work better; and (ii) strengthening expenditure management and accountability in public finances.

A. RATIONALE

3. Reliance on basic farming methods and rain-fed agriculture, coupled with a growing population, has made food security a recurrent challenge. Furthermore, in recent times, Malawi has suffered from weather related shocks at an increasing frequency, including the simultaneous floods and droughts in 2015 and 2016. These shocks in 2015 and 2016 respectively left 2.8 million and 6.7 million people food insecure and in need of relief. The 2015/16 El Nino weather event has negatively affected countries across Southern Africa; but the impact has been most significant in terms of macroeconomic costs and poverty impact in Malawi.

4. Two years of drought-related weather shocks have come at a time when Malawi has been going through a period of fiscal consolidation, containing the pace of expenditure growth and intensifying revenue collection. This follows a period of enlarged budget deficits, high-cost domestic borrowing and resurgent inflation, exacerbated by a lack of availability of budget support. Thus, successive weather-related shocks come at a time when the Government has very limited fiscal space to respond.

5. Against this background, critical reforms are necessary for Malawi to restore macroeconomic stability and increase medium-term resilience. The resurgent food insecurity has added urgency to the need to undertake reforms to ensure that Malawi can break the cycle of vulnerability and avoid repeated crises as a result of a changing climate. The DPO-1, therefore, will support the policy and institutional reforms that the Government is undertaking in order to reduce distortions in the agricultural market, boost economic growth and resilience, and restore confidence in basic public finance management systems.

B. MACROECONOMIC PERFORMANCE AND DEVELOPMENTS

Economic Outlook

6. The Government remains committed to staying the course on the hard but important reforms aimed at resuscitating the economy and achieving macro-economic stability, including foreign exchange market liberalization and removal of fuel subsidies. The liberalization of the foreign exchange market has improved the foreign currency position as well as the import cover. Fuel queues that were commonplace have long disappeared and there has been an increase in industrial capacity utilization since companies are now able to import raw materials. Notwithstanding these gains, recent multiple shocks, including the continued absence of general budget support and food insecurity resulting from heavy flooding and prolonged drought, have negatively impacted on the growth prospects of the economy and contributed to high inflation.

7. Growth in Real Gross Domestic Product (GDP) declined to 3% in 2015 from 5% in 2014. The 2015 floods disrupted energy generation, damaged roads, and reduced growth in the services and industry sectors which account for 50% and 11% of GDP, respectively. Reduced agricultural production in 2016 due to drought conditions has left some 40 percent of Malawians food insecure and lead to another year of weak GDP growth, projected at less than 3%. Growth is projected to rise gradually to about 5.5% over the medium term, while inflation is expected to fall to within single digit assuming international prices for food and petroleum products remain low. The Government is firmly committed to tight monetary and fiscal policies in order to bring down inflation, contain domestic borrowing, and reduce interest rates to support higher growth. The current account deficit as a percentage of GDP will remain in the range of 7% to 8% over the medium term, reflecting the import demand pressures associated with developmental projects, and the slow pace of export diversification.

Fiscal Performance

8. Malawi's fiscal situation since the 2012/13 Financial Year (FY) has weakened considerably due to shortfalls in external grants and domestic revenues, coupled with rising pressures on wages and salaries, domestic debt interest payments, goods and services for the Government operations and fertilizer subsidies. Revenues and grants decreased to 21.0 percent of GDP in 2015/16 FY from 28 percent in 2012/13 FY while expenditure declined to 28 percent of GDP from 29 percent over the same period.

9. Due to inadequate expenditure adjustment, the overall fiscal deficit rose from 1.8 percent of GDP in 2012/13 FY to 6 percent in 2015/16 FY. The fiscal deficit was financed largely through domestic borrowing.. However, the Government has undertaken strong fiscal consolidation efforts that have enabled the attainment of the net domestic borrowing target under the International Monetary Fund (IMF) Extended Credit Facility (ECF) Programme during the first half of the 2016/17 FY.

10. The need to respond to the humanitarian crisis in the 2016/17 FY has exacerbated the fiscal challenges, exerting further pressure on domestic borrowing. However, through the augmentation of access by the IMF and the curtailment of non-priority expenditures, the Government managed to create fiscal space for pro-poor expenditures and purchases of maize in response to the food crisis. Strong donor support will be key to ensure the smooth execution of the budget and that the gains made are sustained.

International Monetary Fund (IMF) Extended Credit Facility (ECF)

11. The ECF Programme went off track in September 2016, largely due to slippage on the end June 2016 Net Domestic Financing Target. The outcome for December 2016, shows that the ECF is

now back on track, with all targets met. Additionally, program benchmarks on public finance management, including on bank reconciliation, are now complete. The IMF is, therefore, likely to complete the 9th and final review of the programme. The Government is committed to sustaining the recent strong macro- economic policy reform efforts, in order to reduce inflation and lay a stronger foundation for sustained growth and poverty reduction.

C. THE NATIONAL DEVELOPMENT STRATEGY

12. The Government is in the process of preparing its next National Development Strategy (NDS) to succeed the Second Malawi Growth and Development Strategy (MGDS-II). The Government is working to ensure that the process is participatory and that all key stakeholders are consulted. The Government, through the Ministry of Finance, Economic Planning and Development, is partnering with the World Bank to develop a Country Economic Memorandum (CEM) which will provide input into the development process for the NDS. The development of CEM is also being supported by DFID and USAID.

13. The Government is in the process of establishing a National Planning Commission (NPC). The Law to govern the mandate of the NPC has already been enacted. The NPC will be mandated to undertake the national economic planning of the country. Since it will be established by an Act of Parliament, it will be insulated from political interference, thereby ensuring more realistic economic planning, appropriate prioritization of finite resources and the sustainability of development strategies and programmes.

D. SPECIFIC REFORMS TO BE IMPLEMENTED

14. Building on the reforms that the Government is currently implementing, the operation will contribute to the establishment of a more resilient economy, through measures to reduce agricultural market distortions and increase fiscal buffers. In this respect, I wish to highlight the various reforms that the Government is implementing.

Pillar A: Making Agricultural Markets Work Better

15. Despite major investments in fertilizer and improved seed through the Farm Input Subsidy Program (FISP), the agriculture sector has not developed into a more external shock resistant production environment that gradually moves poor smallholders out of recurrent food and nutrition insecurity. This is largely due to underinvestment in complementary activities as well as inefficiencies in the implementation of the FISP.

16. Malawi is dealing with the aftermath of extreme flooding and subsequent droughts that left many households food insecure. A pattern of annual humanitarian responses over a decade suggests a failure to effectively support the productive capacity of Malawi's agriculture sector. This situation leads to the question of how to ensure food security for a growing Malawian population.

17. In order to break the cycle of food insecurity and build resilience, there is need for a paradigm shift in favour of greater mitigation against climate change, greater resilience, greater preparedness and better exploitation of available resources as well as opportunities. In this regard, the Government is developing a five year National Resilience Plan to break the cycle of food insecurity and will continue to undertake necessary reforms in the agriculture sector as follows:

Farm Input Subsidy

18. The Farm Input Subsidy Programme (FISP) has been crucial in achieving food security during periods of good climatic conditions because it has enabled poor Malawians to access fertilizer and improved seed. However, implementation challenges have been encountered, ranging

from cost overruns, very low farmer contributions, and poor targeting. In FY2015/16, the Government implemented pilot reforms to increase efficiency gains and reduce the fiscal burden. Positive lessons have been drawn including the need for structural and financial adjustments to improve effectiveness as well as reduce costs.

19. These reforms, now scaled up over the 2016/17 growing season, have resulted in increased private sector retailing, thereby reducing monopoly by Government agencies; fixing coupon value thereby increasing farmer contributions as well as capping Government's cost exposure; introduction of an e-voucher to counter the selling of coupons as well as the proliferation of fake coupons; and targeting eligible farmers who are best able to make use of subsidized fertilizer. These reforms have already signalled positive results and will continue to be implemented.

20. However, the Government also recognizes that these reforms will have a number of negative distributional effects. For a segment of smallholder farmers, FISP coupons have tended to be sold and the scheme in effect has worked as a cash-transfer scheme, albeit an inefficient one. Targeting more eligible farmers will likely lead to the exclusion of ineligible farmers. As such, the Government is committed to scaling up the Social Cash Transfer (SCT) program to provide increased safety nets for the poorest households, to help cushion the impact of any loss of income resulting from FISP reforms. The first step in this process is establishing the necessary institutional coordination arrangements that will allow for the transition from a series of pilots, to a national program with nationwide coverage. Government is working hard to scale up the SCT program from the current 18 to a target of 28 districts providing full national coverage to the poorest 10 percent of the population. In addition, during the 2016/17 lean season some 40 percent of the population was supported with humanitarian food distribution.

Maize Price Stability and Production Incentives

21. In order to increase self-dependence, the Government needs to strike a balance between its social responsibility with regard to food security and ensuring a better functioning and transparent maize market, one that delivers a fair price to farmers and encourages the private sector to invest. In this respect, the Government is undertaking a number of reforms aimed at reducing distortions in Malawi's maize market, reducing vulnerability, and improving the incentives for commercialization.

22. Recognizing that market interventions by the National Food Reserve Agency (NFRA) and the Agricultural Development Marketing Corporation (ADMARC) that are intended to smooth prices and ensure availability of maize can in fact exacerbate volatility, the Government is committed to improving transparency over the way the institutions operate and engage in Malawi's maize market. In this regard, the Government has adopted revised guidelines for maize draw down from the Strategic Grain Reserve (SGR), putting in place transparent and objective criteria for interventions, as well as clear technical and financial reporting and accountability mechanisms. These include clear and specific mechanisms for withdrawals from the SGR for humanitarian and non-humanitarian needs.

23. ADMARC's twin commercial and social responsibilities have often resulted in tension, leading to a situation where neither objective is met satisfactorily. Therefore, the Government has commissioned a strategic review of ADMARC's functions, governance arrangements and oversight mechanisms, with a view towards reforming the institution so that it is best able to play a productive role in Malawi's agricultural markets, with improved standards of governance. In order to build confidence in Malawi's agricultural markets, the Government has also instructed ADMARC to publish its audited annual financial statements and detailed reports of the Corporation's maize market distribution and purchasing activities throughout the 2016 lean season. These disclosures have played a key part in a more orderly maize market this year, with smoother prices and increased private sector confidence to enter the market.

24. As an agriculturally endowed country, land is one of Malawi's most basic but valuable assets. However, Malawi's legislative framework for land has been fragmented, slowing the development of a more modern agricultural sector. The newly enacted Land Legislation (in particular the Land Act, Customary Land Act, Physical Planning Act and Land Survey Act) will enable the registration of customary land. These reforms will collectively help formalize land ownership, improve land administration, increase security of tenure and promote increased investment in own land, at a time when Malawi needs to build a stronger and more diversified agricultural sector. In addition, the Government is similarly preparing revisions to a number of legislative texts in order to reduce distortions and improve incentives for commercialization. These include the Control of Goods Act, the Seed Act and the Warehouse Receipts Bill.

Pillar B: Strengthening Expenditure Management and Accountability in Public Finances

Public Financial Management (PFM) Reforms

25. The Government strongly believes that its efficiency and effectiveness in service delivery, to a large extent, depends on stringent management of public finances. An efficient and effective PFM system is therefore central to the creation of trust between the Government and the people that it serves. It is for this reason that the Government has embarked on rigorous PFM reforms.

26. The Government has taken the "Getting the basics right" approach to PFM reform. It was on the basis of this understanding that the PFM reforms are aimed at addressing the basic controls first before embarking on the advanced and more complex reforms. A short-term PFM program was therefore developed to restore the basic controls first and promote accountability. In order to ensure PFM responsibility by Controlling Officers across each of Malawi's ministries, departments and Agencies (MDAs), the Government has formally issued letters of appointment to all heads of MDAs with clear mandates and financial accountability arrangements. Re-instituting the requirement by Controlling Officers to submit monthly reports of expenditure, revenues, commitments, payroll and bank reconciliations is a key step in restoring basic controls to the country's PFM system. The number of Principal Secretaries has been sharply reduced to ensure clear accountability at the Controlling Officer level.

27. Similarly, progress has been registered in closing Malawi's backlog of financial reporting with the preparation and auditing of four years of financial statements in one year. I am also pleased to advise that Malawi is now, for the first time in a very long time, fully current in its financial reporting obligations.

28. Progress has also been made across a number of other areas in Malawi's PFM framework as well. The Government has, among other things, (a) improved the control environment for the Integrated Financial Management Information System (IFMIS) by the introduction of physical controls and new user profiles for all users-including super users; (b) carried out a head count exercise and payroll audit with the aim of removing staff not in lawful employment such as those that have been dismissed, resigned, dead, or not employed from the payroll; (c) implemented the recommendations on the payroll system audit; (d) maintained the pace of efforts toward the procurement and implementation of the new Integrated Financial Management Information System (IFMIS); (e) introduced bank reconciliation at MDA level under the supervision of the Controlling Officer; and (f) made efforts aimed at enforcing commitment control and expenditure management.

29. Recognizing that rebuilding Malawi's PFM framework also requires the strengthening of oversight arrangements, the Government has also submitted legislation to Parliament that would increase the independence of the Auditor General and bring Malawi's Public Audit Act into line with international standards, by granting increased independence over budget and staffing, and by raising transparency and disclosure standards.

30. Finally, I would add that the recent enactment of a new Access to Information Law sets a new standard for openness and transparency in Malawi.

31. I am, however, aware that a lot remains outstanding including enforcing of rules and regulations, improving cash and debt management, improving coverage and quality of fiscal reporting, improving budget execution and control, arrears and commitment control, strengthening effectiveness of PFM Institutions, and functioning of the existing IFMIS. To this end, the Government is committed to undertaking before the end of 2017, a Public Expenditure and Financial Accountability (PEFA) assessment (based on the new 2016 framework) in order to determine the key areas of the PFM that may require improvement. Based on the findings of the PEFA, the Government will develop a new PFM Rolling Plan that will provide guidance in addressing the medium-term PFM challenges that the country faces.

E. CONCLUSION

32. I request the World Bank's assistance to support the realization of this program. I believe that the outlined policies and institutional reforms represent a first step towards the establishment of a more conducive environment for economic recovery, stronger institutions, and a more resilient foundation for Malawi's development.

Yours sincerely,

Goodall E. Gondwe
MINISTER OF FINANCE, ECONOMIC PLANNING AND DEVELOPMENT

ANNEX 3: FUND RELATIONS ANNEX

Malawi—Assessment Letter for the World Bank
February 8, 2017

Malawi's macroeconomic situation remains difficult, reflecting the prolonged effects of weather-related shocks and past policy slippages. A second consecutive year of drought hurt real activity and continues to weigh heavily on the outlook. While the humanitarian crisis negatively impacted program performance, slow implementation of the structural reforms contributed to significant policy slippages. The authorities are in the process of adopting corrective measures by keeping budget execution in line with the approved FY16/17 budget and are implementing the structural reforms.

1. **The negative impacts of the El Niño-induced drought continue to weigh heavily on the population.** The drought has placed an estimated 6.5 million people (40 percent of the population) at risk of food insecurity—the worst in Malawi's history. On June 20th , 2016, the IMF's Executive Board approved the augmentation of access (25 percent of quota) to respond to the larger balance of payments need caused by the humanitarian crisis. Donor support has been instrumental in addressing the humanitarian relief efforts ($282 million) which is being channeled through the World Food Program. This support comprises the provision of immediate life-saving and life-sustaining assistance to vulnerable segments of the population through the delivery of essential foods, commodities, and health focused interventions.

2. **Malawi's economy has been battered by weather-related shocks for a second consecutive year:**

- **Real GDP** growth in 2016 is projected to fall to 2.3 percent (from 3 percent in 2015) reflecting, in part, the cumulative 42 percent decline in maize production since early 2015. Credit to the private sector remains weak owing to high real lending rates, reflecting heightened credit risk and double-digit inflation. Tobacco export revenues fell sharply in 2016 (20 percent), owing to a decline in both price and volumes due to a poor harvest.

- **Annual inflation** which has remained stubbornly high since 2012, fell by 5 percentage points to 20 percent in 2016. Food inflation averaged 26.7 percent during 2016 reflecting the negative impact of the drought. However, nonfood inflation has been on a declining trend for six consecutive months reflecting tight monetary policy.

- **Monetary policy during the second half of 2016,** has ensured that short-term money market rates remained positive in real terms and aligned with the policy rate. This stance has contributed towards bringing inflation on a declining path. In response to a trend decline in nonfood inflation, the Reserve Bank of Malawi (RBM) cut the policy rate by 300 basis points to 24 percent in November 2016.

- **The external current account deficit** is estimated to have widened sharply by 7 percentage points to 16.2 percent of GDP in 2016, owing to a surge of maize imports in response to the humanitarian crisis. The deterioration of the trade balance also reflects lower export revenues, in particular tobacco receipts**.** Reflecting these developments, the kwacha depreciated by 31 percent.

- **Vulnerabilities in the financial sector have increased as growth has declined and liquidity conditions tightened.** The level of non-performing loans (NPLs) has risen since end-2015, reflecting a weaker economy, exchange rate depreciation, and high real lending interest rates. The ratio of NPLs to total loans increased from 10.6 percent at end-2015 to 14.7 percent at end-September 2016 and credit risk remains a significant threat to financial system stability. The RBM is closely monitoring the recapitalization of two weak banks by private investors. Shareholders in one bank have approved a rights issue while the RBM approved the acquisition of 10 percent of the other weak bank's shares by a South African based bank.

- **The program experienced significant slippages during the first half of 2016, reflecting the negative impact of the poor maize harvest and slow progress in implementing public financial management (PFM) reforms.** End-June performance criteria (ninth review) were missed, due in large part to the poor maize harvest. Ceilings on net domestic financing (NDF) and net domestic assets (NDA) of the central bank were missed owing to revenue shortfalls. Net international reserves (NIR) of the central bank were lower-than-programmed, reflecting a decline in export revenues related to the poor tobacco harvest. The indicative target floor on pro-poor spending was met.

- **The overall fiscal deficit in FY15/16 was ¼ percent of GDP higher than programmed (6.4 percent of GDP), owing to increased current spending and revenue shortfalls.** Shortfalls in revenues reflecting weaker economic activity and higher-than-programmed current spending, led to increased domestic borrowing relative to the program. Outlays on interest expense and domestic arrears clearance were higher than anticipated. Arrears which accumulated several years prior to FY14/15, were audited and securitized following Fund advice. Notwithstanding, weaknesses in commitment controls persist despite the authorities' best efforts to introduce monthly fiscal reporting by Ministries. New arrears (0.3 percent of GDP) were generated in FY15/16 and will be audited. Lower-than-programmed external project loans led to a corresponding decline in foreign-financed capital spending. The higher net domestic financing (one percentage point of GDP relative to the program) due in part to revenue shortfalls included 0.4 percent of GDP for additional maize purchases arising from the augmentation.

- **Execution of the FY16/17 budget** is broadly in line with the program based on net domestic financing of 1.4 percent GDP. Spending includes the use of the remainder of the augmentation of access under the program (½ percent of GDP) for maize purchases in response to the humanitarian crisis. Revenues for the first six months of FY16/17 over performed by ½ a percentage point of GDP, reflecting the implementation of IMF tax policy recommendations expanding the coverage of VAT and eliminating several exemptions.

3. **A staff level agreement was reached with the authorities, following a mission in September and during the sidelines of the 2016 Annual Meetings, on corrective measures to bring the program back on track.** Since then, the authorities are undertaking corrective measures to remain within the agreed NDF underpinning the FY2016/17 budget. These include several tax policy measures recommended by the Fiscal Affairs Department to widen the tax base. The IMF's resident public financial management (PFM) advisor with support from AFRITAC East has been assisting with the implementation of key PFM reforms which are prior actions for completing the ninth review.

4. **The macroeconomic outlook in 2017 remains challenging, reflecting uncertainties related to weather conditions and maintaining the policy mix to reduce inflation.** Although the rainy season has commenced, the "La Niña" weather phenomenon has brought heavy rains which could potentially complicate the normalization of economic conditions. Real GDP growth is projected to pick up to 4.5 percent in 2017, conditional on a recovery in the agricultural, construction, and the wholesale and retail sectors. A recovery in credit to the private sector critically depends on a consistent policy mix that reduces inflation. Inflation is projected to ease in 2017 provided a tight policy stance is maintained and donors deliver on their humanitarian pledges which would limit recourse to domestic financing. A trend decline in inflation would be aided by continued low international prices for food and petroleum products.

5. **Short-term risks are tilted to the downside as the "La Niña" weather conditions could further weigh heavily on the outlook.** Shortfalls in export revenues, would place additional pressure on the kwacha, which has continuously depreciated in response to shocks. Policy slippages—which have been frequent throughout the life of the program—remain a major risk. These risks have increased given the pivotal role maize plays in driving political outcomes. Uncertainties remain regarding the accuracy of the original estimate of maize gap of MT790,000 as the authorities' plans to import commercial maize, which were based on this estimate, have not materialized thus far. Also, with eight weeks remaining in the "lean season", maize prices remain stable. Persistent double-digit inflation poses a risk as the slower-than-expected disinflation process could trigger further demand for wage increases. The retention of the flexible exchange rate regime and the automatic fuel pricing mechanism would continue to serve as shock absorbers.

6. **Implementation of the ECF arrangement approved on July 23, 2012 for the equivalent of SDR 104.1 million (150 percent of quota), experienced multiple challenges.** Since the program's inception there have been several slippages that warranted extending the

program on four occasions in order for the authorities to undertake corrective actions. The latest extension was approved on November, 17, 2016 and the program was extended to June, 30, 2017, in order to complete the ninth and final review under the ECF arrangement.

ANNEX 4: ENVIRONMENTAL AND POVERTY/SOCIAL ANALYSIS TABLE

Prior Actions	**Significant positive or negative environment effects** (yes/no/to be determined)	**Significant poverty, social or distributional effects positive or negative** (yes/no/to be determined)
Pillar A: Making agricultural markets work better		
Prior action #1. The Recipient has, through its MoAIWD and MoFEPD, made parametric changes to FISP in fiscal year 2016/17 namely: (i) increased the share of fertilizer retailed by private suppliers; (ii) reduced the level of subsidy to beneficiaries by introducing a fixed value coupon with beneficiaries to paying the difference between the coupon value and market price; and (iii) piloted improved targeting of beneficiaries.	Yes—without proper management and appropriate extension services, fertilizer use can result in negative environmental impacts. However, more efficient use of fertilizers could also lead to local and global public goods benefits such as reduced emissions and nutrient-rich run-off. There is also a risk that reduced subsidies, if targeting does not improve, could lead to lower productivity on a per hectare basis, leading to more extensive cultivation, perhaps spreading into forest remnants on steep slopes.	Yes—reduced subsidy levels, without appropriate mitigation, are likely to have short term negative distributional effects.
Prior action #2. The Recipient has, through its MoAIWD, adopted revised guidelines that put in place transparent and objective criteria, as well as technical and financial reporting and accountability mechanisms, for maize draw down for price stabilization from the Strategic Grain Reserve.	No	No
Prior action #3. The Recipient has, through ADMARC Limited: (i) published ADMARC Limited's audited annual financial statements for fiscal years 2013/14 and 2014/15, respectively; and (ii) published monthly reports outlining maize market distribution and purchasing plans throughout the fiscal year 2016/17 lean season	No	Yes—reduced agricultural market distortions and maize price volatility should be welfare enhancing for net food buyers.
Prior action #4. The Government has enacted the (i) Physical Planning Act, 2016; (ii) Customary Land Act, 2016, (iii) Land Survey Act, 2016; and (iv) Land Act, 2016 improving administration and security of tenure.	Yes—improved security of land tenure could lead to higher levels of investment in land stewardship, and thus reduce land degradation.	Yes—improved tenure security should benefit smallholders, including female operators in particular, as well as improving incentives for commercialization.
Prior action #5. The Recipient has, through its MoFEPD, MoGCDSW and LDF, agreed on institutional coordination arrangements for the expansion of the Social Cash Transfer Program.	No	Yes—positive distributional effects are expected for an expanded and well targeted social safety scheme focusing on the extreme poor, compensating for reduced FISP beneficiaries.

Pillar B: Strengthening expenditure management and accountability in public finances		
Prior action #6. The Recipient has, through its MoFEPD, NAO and DHRMD, completed an audit of the civil service payroll system, reconciled the difference between establishment, and payroll, for both salaries and allowances, and deleted erroneous entries.	No	No
Prior action #7. The Recipient has, through its NAO, publishes the audited financial statements for fiscal years 2011/12, 2012/13, 2013/14, 2014/15.	No	No
Prior action #8. The Recipient has, through its MoFEPD, submitted to Parliament the Public Audit (Amendment) Bill 2016 with a view to strengthening the operational independence of the National Audit Office in conformity with INTOSAI standards.	No	No
Prior action #9. The Recipient has: (i) through its Office of the President, appointed Controlling Officers for all ministries, departments and agencies in conformity with the Public Service Management Act to perform their functions in conformity with the provisions of the Public Finance Management Act; and (ii) through said Controlling Officers, submitted required monthly returns[23] for their respective Votes for calendar year 2016 in conformity with the provisions of Section 10 of the Public Finance Management Act.	No	No

[23] This include five reports covering: (i) revenues (for revenue earning MDAs); (ii) expenditures; (iii) payroll; (iv) commitments; and (v) bank reconciliation. Monthly funding for MDAs is conditional on Controlling Officers full compliance with these reporting requirements.