

The Effects of Different Fiscal Policies on the Economy of Malawi

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2002/03 and 2003/04
A Period of Deterioration
in Fiscal Policies and
Resulting Economic
Decline in Malawi

Deterioration in Fiscal Policies and Resulting Economic Decline

	2002/03	2003/04
GDP Growth, Real	-3.0	4.5
Domestic interest as % of budget	14.5	21.4
Domestic Savings/GDP	-12.6	-10.7
Net foreign assets	-5.3	8.6
Inflation rate	14.7	9.6

Deterioration in Fiscal Policies and Resulting Economic Decline

	2002/03	2003/04
USD Exchange Rate	89.9	108.6
Domestic Debt/GDP	20.4	25.1
Treasury Bill interest rate (average)	38.3	36.3
Overall balance (including grants) as % of GDP	-8.5	-5.6
Domestic financing as % of GDP	8.5	5.6

Deterioration in Fiscal Policies and Resulting Economic Decline

	2002/03	2003/04
Variation between budgeted BOP support and amounts actually received as a % of budget	17.51%	8.05%
Budgeted BOP support as % of Budget	19.91	19.16
Actual BOP support received as % of Budget	2.46	11.11

Policies and their effects during the period of deterioration

Policy

- Invested in privatization proceeds between 1998 and 2000 in inappropriately appraised projects.

Effect

- The resulting products did not meet the users requirements. This led to variation of contracts (without tendering) that resulted into cost overruns. The excess costs created an accumulation of arrears.

Policies and their effects during the period of deterioration

Policy

- In 2000, government sold maize stocks to defray handling costs. The maize was sold at very low cost. In 2001 and 2002, the country suffered droughts and government was forced to provide funds for maize purchases.

Effect

- To pay for the maize purchases, ministries were under funded. Ministries did not adjust expenditures, as a result, ministries began accumulating arrears.

Policies and their effects during the period of deterioration

Policy

- Fiscal discipline in the budget process was not enforced.

Effect

- The 'loud' and misbehaved institutions were 'rewarded' at the expense of core budget areas.

Policies and their effects during the period of deterioration

Policy

- Prior to 2002, there was limited understanding of the Economic programme and relationship between fiscal and monetary operations. There were many types of off-budget expenditures. In an attempt to capture all revenue and expenditures in the budget process, commodity aid was correctly brought in the budget.

As an example, the IMF forced government to bring commodity aid from Japan into the budget.

Effect

- The change was not well explained and created a lack of credibility with the budget.
- Ministries with commodity aid suffered drastic cuts in their budgets because government had to try and remain within IMF agreed figures, inclusive of expenditures on commodity aid.

Policies and their effects during the period of deterioration

Policy

- Poor governance led to a lack of credibility on government's ability to handle funding.

Effect

- Donor inflows became unpredictable due to lack of credibility. When anticipated funding did not materialize, arrears were accumulated and domestic borrowing increased.
- Donor funding for budget support was held back. This affected the RBM foreign reserves.

Policies and their effects during the period of deterioration

Policy

- When anticipated donor funds did not materialize, government instituted borrowing from the domestic market through the Reserve Bank of Malawi (RBM).

Effect

- Too much borrowing from the domestic market led to excess liquidity in the market. The RBM operated at a loss due to interest paid at open market operations.
- Build up of unpaid imports.
- Mushrooming of black market in foreign exchange.

Policies and their effects during the period of deterioration

Policy

- Political appointments not done on merit.

Effect

- Appointment to parastatals boards were politically driven and often resulted in poor management practices. This led to financial collapse of many parastatals .

Policies and their effects during the period of deterioration

Policy

- The commercial borrowing by parastatals was guaranteed by government. When the parastatals collapsed, government repaid loans from the budget.

Effect

- Government guarantees of parastatal loans were not provided for in the budget. The resulting bailouts negatively affected government fiscal performance and further reduced the credibility of the budget.

Examples included repayment of ADMARC loan to PTA Bank in 1999/2000. Government took over repayment of Electricity Supply Corporation of Malawi (ESCOM loan from PTA bank in 1999).

Policies and their effects during the period of deterioration

Policy

- Domestic revenue measures were implemented which included the introduction of levies on fuel and surtax (VAT) on goods and services. The sole aim of the measures was to raise revenue. No studies were prepared to determine overall economic effect.

Effect

- Declining investment as private sector lost confidence in government.
- The revenue measures suffocated the private sector and stagnated growth.

Policies and their effects during the period of deterioration

Policy

- Public institutions were privatized.

Effect

- Employment was reduced creating job losses.
- Private businesses created did not provide the employment for those positions eliminated in privatization.

Policies and their effects during the period of deterioration

Policy

- Lack of financial sector policy, resulting in high interest rates on government treasury bills.

Effect

- Government Treasury Bills were attractive hence banks resorted to investing more in them instead of the private sector. This resulted in low levels of investments and savings.

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2004/05 to

2006/07

IMPROVING

MACROECONOMI

C MANAGEMENT

Improving Macroeconomic Management

	2004/05	2005/06	2006/07
GDP Growth, Real	3.5	5.1	7.0
Domestic interest as % of budget	17.12	11.73	9.8
Net foreign assets	5.8	9.2	29.7
Inflation rate*	11.4	15.5	13.9

*Note: Drought in 2005/06 pushed inflation rate up because of rise in food prices.

Improving Macroeconomic Management

	2004/05	2005/06	2006/07
USD Exchange Rate	123.0	139.0	140.6
Domestic Debt/GDP	17.3	14.4	10.8
Treasury Bill interest rate (average)	24.5	22.4	18
Overall balance (including % of GDP)	-3.9	-0.8	-1.2
Domestic financing as % of GDP	2.2	0.2	-.04

Period of improving macroeconomic management

- 2004/05 Change of government in Malawi
- Political will for economic change

Changes during the period of improving macroeconomic management

- Government agreed to IMF Staff Monitoring programme
- Government Policies aligned with IMF

Government Policies agreed on with IMF

- Fiscal performance criteria
 - Targeted limit on government salaries and wages
 - Target limit on government spending for discretionary expenditures
 - Discretionary expenditure defined as total expenditure excluding interest on public debt, donor funded development expenditures and donor spending on health activities under SWAP
 - Limit on government borrowing from the domestic market

Government Policies agreed on with IMF

– Monetary performance criteria

- Net Domestic Assets of the Reserve Bank of Malawi
- Net Foreign Assets of the Reserve Bank of Malawi

Government Policies agreed on with IMF

- Structural Benchmarks
 - Zero borrowing of commercial loans
 - Compilation of quarterly financial reports of 10 major parastatals
 - Reporting of expenditure commitments to monitor accumulation of arrears
 - Monthly reporting on import backlog by Reserve Bank of Malawi

Government Initiatives

Governance

Policies

- Domestic Debt Reduction

Effect

- Interest payments as a percentage of the budget is reducing, thus releasing resources available for discretionary spending.
- Interest rates are coming down, due to reduced domestic debt borrowing and reduction in inflation rate

Government Initiatives

Governance

Policies

- Comprehensive effort to audit and clear arrears

Effect

- Donors confidence is building resulting in predictable funds releases. This provides improved funding to Ministries and reduction in arrears accumulation.

Government Initiatives

Governance

Policies

- Introduction of subsidized farm inputs and irrigation farming

Effect

- Increased food production has helped to bring down inflation rate.
- Interest rates are coming down.

Government Initiatives

Governance

Policies

- Tax Reforms
- Surveys aimed at reducing the cost of doing business

Effect

- Private sector has developed confidence in government and new investment is slowly picking up.
- Exchange rate of local currency to major currencies is stabilizing and has reduced incidences of for ex hoarding and dealings on the black market.

Government Initiatives

Government Policies

- Instituted comprehensive audit of arrears and transparent policy to centrally clear them

Effect

- Unlocked resources for private sector investment

Government Initiatives

Governance

Policies

- Introduction of IFMIS

Effect

- Automation of payment systems has improved on the production of government year end final accounts

Government Initiatives

Government Policies

- Creation of Government Public Finance and Economic Management Action Plans

Effect

- Reinforcement of donor confidence in government
- Donor BDP support forthcoming and predictable
- Domestic borrowing is reducing

Comparative Results

	2002/03	2003/04	2004/05	2005/06	2006/07
GDP Growth, Real	-3.0	4.5	3.5	5.1	7.0
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Net Foreign Assets	-5.3	8.6	5.8	9.2	29.7
Inflation Rate	14.7	9.6	11.4	15.5	13.9

Comparative Results

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Domestic financing as % of GDP	8.5	5.6	2.2	0.2	-.04

Lessons Learned

- Government needs to be willing to change
- External incentives reinforces the capacity to institute changes
- Policies need comprehensive review, not focused
- Coordination and close collaboration among government departments required
- Budgets need to be comprehensive

Conclusion

- Questions