Malawi's Recent Fiscal Performance & Prospects

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1. Introduction

In August 2004 I presented a paper titled '*Malawi's Fiscal Crisis – a Donor Perspective*' which looked at the fiscal situation inherited by the new government. The paper pointed out that the previous government's failure to control expenditure had led to the accumulation since 2001 of a dangerously large domestic debt and the loss of government control over its Budget. As a result, Malawi faced a fiscal crisis with disturbing implications for macro-economic stability, investment, financing of public services and poverty reduction. The crisis could only be overcome with substantial financial support from the international community. However, Malawi's international reputation for economic mismanagement was so bad that it would be difficult persuading donors to assist.

In August 2005 the IMF Board approved a new Poverty Reduction & Growth Facility (PRGF) for Malawi, indicating a substantial improvement in the country's international standing. To illustrate the changes in fiscal management which have persuaded the IMF, DFID and other donors to resume and increase their support to Malawi, I have updated the previous paper to cover the period up to FY 2005/06.

Following a recap of the previous paper, this paper reviews the fiscal performance of the new government during FY 2004/05. It then goes on to look at the FY 2005/06 Budget and at Malawi's medium term prospects should recent improvements be maintained. As before, the analysis is based on Table 1 and charts derived from the table. Table 1, which now covers the period 1998/99 to 2005/06, has three sections:

1. revenue and expenditure data in *nominal Malawi Kwacha*. The figures are taken mainly from the IMF PRGF Board Paper of July 2005, but originate in the Ministry of Finance
2. the same figures expressed as *percentages of Total GoM Domestic Expenditure* (ie excluding donor funded projects, Part I of the Development Budget)
3. the same figures expressed as *percentages of Gross Domestic Product* (GDP), ie Malawi's annual income

The nominal figures are essential input to the table, but are of little value when comparing changes over time. This is because inflation reduces the value of the Kwacha over time; comparing, say, 1999 and 2004 expenditure in nominal terms is 'comparing apples and oranges'. Analysis of trends in shares of total expenditure and of GDP is much more useful because the effect of inflation is neutralized. Such figures can also be compared with other countries.

[*] The views presented here are those of the author and do not necessarily reflect the views of the British Government. Copies of the paper and accompanying tables are available electronically on request from the author at a-whitworth@dfid.gov.uk

Various key trends in Table 1 are illustrated in four charts:

1. Figure 1 shows total government expenditure as a share of GDP, along with government revenue and external grants. The Fiscal Deficit is the difference between expenditure on the one hand and the sum of revenue and grants on the other. While the external grant figures exclude many project grants and are of little value, the deficit figures are accurate.
2. Figure 2 shows the Net Domestic Debt Stock and the government domestic interest bill, both as shares of GDP. While the Net Domestic Debt Stock is not necessarily the most useful measure of public debt, it is the only one for which consistent time series data is readily available.
3. Figure 3 shows domestic expenditure broken down in percentage terms into various categories – explained below.
4. Figure 4 is the same as Figure 3, but presented as shares of GDP.

2. Recap, 2001 – 2004

In order to see how things changed during FY2004/05 it is important first to recap developments in the preceding period – as described in the previous paper. These are illustrated in Table 1 and Figures 1 to 4. The fundamental cause of the fiscal crisis was the previous government's inability to control expenditure and to live within its means. Every year from 1994 expenditure exceeded that approved by Parliament (and agreed with the IMF) in the Budget – and by increasing margins over time. Budget outturns bore little resemblance to approved estimates and the budget process lost credibility.[1] While fiscal discipline improved sufficiently to persuade the IMF to approve Malawi's first PRGF in December 2000 – supported by budget support commitments from the Common Approach to Budget Support (CABS) group of donors[2] - this improvement was not sustained. Continued over-expenditure soon caused Malawi to go 'off track' with the PRGF in November 2001.

Donors were not prepared to continue 'pouring good money after bad' in support of a fiscally irresponsible government. Most CABS budget support was conditional upon GoM remaining on track with the IMF and so was suspended when the PRGF went off track. This represented 23% of budgeted revenue in 2001/02. Instead of reducing expenditure to offset the lost revenue, GoM continued spending almost as though nothing had happened. This inevitably led to an increase in the fiscal deficit (ie government revenue minus expenditure). Table 1 and Figure 1 show that the deficit increased from –5.8% of GDP in 2000/01 to -7.9% in 2001/02. The deficit increased still further in 2002/03 to a massive –11.6% of GDP, as a result of the maize operation (costing 3.8% of GDP) following the poor harvest in 2002.

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[1] Moreover, an examination of those areas in which unbudgeted expenditure took place reveals a consistent pattern of over-expenditure on activities which are of little benefit to the poor, eg travel, state residences, foreign affairs, defence, National Intelligence Bureau and Special Activities.

[2] CABS currently comprises the UK, the European Union, Norway and Sweden.

Following an apparent improvement in fiscal management in 2003, Malawi got back 'on track' with the IMF PRGF in October 2003 and CABS donors resumed disbursements of budget support. However, this was almost immediately followed by a relaxation in expenditure control in the run-up to the May 2004 elections, resulting in a 2003/04 deficit of –7.8% and the abandonment of the PRGF.

The fiscal deficits for the three years 2001/02 to 2003/04, which amounted to some 27% of GDP, were largely financed by short-term borrowing from the domestic banking system – mainly in the form of Treasury Bills[3]. The substitution of domestic borrowing for donor grants and soft loans was disastrous for Malawi – both Government and the private sector. Government expenditure on interest obviously increased directly as a result of its increased borrowing. However, it increased much more than proportionately to the debt stock. If government suddenly increases its' borrowing from local banks interest rates will go up – because there are only limited funds available. As a result, *real* (ie after inflation) interest rates ranged between 20 – 35% for most of the period November 2001 to October 2003 – among the highest rates in the world[4].

Increased interest rates do not just hurt government. Hardly any private firms can afford to borrow at 30% real interest. As a result, private investment was depressed; government 'crowded out' the private sector. Direct investment in Malawi dropped from US$59 million in 1999 to US$6 million in 2002[5]. This has obvious implications for growth, employment and poverty reduction.

The combination of the increased *stock* of debt and the jump in interest *rates* meant that Government's domestic interest bill shot up from MK3.4 billion (3.0% of GDP) in 2000/01 to MK17.3 billion (9.2%) in 2003/04. This is illustrated in Figure 2.

Table 1 and Figure 4 show that there was a substantial step increase in GoM *domestic expenditure* (ie excluding donor funded projects) from 24.7% of GDP in 2000/01 to 33.4% in 2003/04. This was well above the level of neighbouring countries[6] and, with domestic revenue at about 23% of GDP, could not be sustained without substantial outside support. Most of the increase (from 25.9% to 32.4% of GDP) occurred in 2002/03, mainly attributable to that year's maize operation. However, instead of reverting to normal the following year, the full impact of the increased interest bill was felt in 2003/04. Most of the increase in domestic expenditure was due to fiscal mismanagement since 2001, therefore, and its impact on the interest bill.

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[3] Table 1 shows that the net domestic debt stock increased by 17% of GDP between June 2001 and June 2004.
[4] IMF '*Selected Issues & Statistical Appendix*', October 2004, page 22.
[5] Economist Intelligence Unit, Malawi Country Report, January 2004, page 28.
[6] For Sub-Saharan Africa as a whole, total government expenditure averaged 25.9% of GDP in 2001 '*World Development Indicators: 2004*', World Bank, page 224.

In addition to its impact on *total* expenditure, Figures 3 and 4 illustrate the damaging impact of government borrowing on the *composition* of public expenditure, in particular on what is termed here 'discretionary' expenditure. By discretionary expenditure I mean *that part of the Budget over which the Ministry of Finance can exercise a reasonable degree of control*, ie that part which can in principle be allocated in accordance with policy priorities. The concept is perhaps best understood by looking at '*non*-discretionary' expenditure. There is no universally agreed definition of non-discretionary expenditure. However, I would argue that the Malawi Government has virtually no control in the short term over the following:

1) Interest (domestic and foreign)
These payments are 'statutory', ie they must be paid by law.

2) Pensions and Gratuities
These payments are also 'statutory'.

3) Transfers to Malawi Revenue Authority and National Roads Authority
The legislation establishing MRA and NRA provides for them to be financed from a fixed percentage of tax collected and the fuel levy respectively. Government has no option but to pay these funds over, therefore.

4) Salaries and Wages
While wages are not statutory, and governments can reduce the number of their employees, in practice there is virtually no scope to cut wage expenditure in the short term. Retrenchment of public servants has a substantial short term cost in the form of retrenchment packages.

5) Pro–Poor Expenditure
Since 2000/01 the Government has designated certain budget lines as Pro-Poor Expenditure (PPE), which are protected in real terms and from within year budget cuts. PPEs comprise both wages and Other Recurrent Transactions (ORT). Only ORT are shown separately in Figures 3 and 4.

A good case could be made for counting a number of other budget categories as non-discretionary, such as provisions for university staff salaries and (in 2003/04) elections[7]. Unfortunately, time series data is not available for university salaries. However, there is no need for precision here. The trend in Figures 3 and 4 is quite clear. The 'discretionary balance' (as defined here) in Figure 3 dropped from 52.4% of total domestic expenditure in 2000/01 to 31.3% in 2002/03. Despite the fact that total domestic expenditure increased from 24.7% of GDP in 2000/01 to 32.4% in 2002/03, the discretionary balance shrunk from 13% of GDP to 10.1% over the same period.

Table 1 and Figures 3 and 4 appear to indicate that the situation improved somewhat in 2003/04, with the discretionary balance increasing to 34.0% of domestic expenditure. Unfortunately, this is a mirage. Total Government

[7] The costs of the 2002/03 maize operation are also counted as non-discretionary in Table 1, although this is clearly contentious.

spending between April to June 2004 exceeded the levels approved in the March 2004 Supplementary Budget target by some 3.5% of GDP, probably because of election – related activities. It is unclear exactly where the money was spent and how to classify it. It appears in Table 1 as part of the discretionary balance, therefore, which is highly misleading. The effect of this extra-budgetary expenditure was, of course, to further increase Government domestic borrowing and future interest costs. Had Government adhered to the Supplementary Budget my calculations show that the discretionary balance would have shrunk still further to 24.2% of domestic expenditure.

In other words, in 2003/04 Government had, at best, some degree of control over just a quarter of its budget – and it was shrinking fast. From this balance all non-wage and non-PPE activities of government had to be financed. It is simply not possible for the Ministry of Finance to *manage* government expenditure in any meaningful sense with such a tiny discretionary balance. This clearly constituted a fiscal crisis.

The origins of the crisis can be clearly seen in Figures 3 and 4. The crowding out of discretionary expenditure began with the designation of some ORT expenditure as PPEs in 2001/02[8] and was compounded by the 2002/03 maize operation. However much the most important factor was increased domestic interest costs, which accounted for a massive 27.5% of total domestic expenditure (9.2% of GDP)[9] in 2003/04.

As noted above, the fundamental problem was the government's inability to control expenditure. Figures on arrears released subsequently reveal that the situation was even worse than described in the previous paper. The Auditor General estimates that as at 30 June 2004 the government had accumulated arrears of Kwacha 10.9 billion. This represents expenditure made (equivalent to 5.8% of GDP) and goods and services received by government, which had not been paid for. In other words, Table 1 and Figures 1 and 4 *underestimate* public expenditure by this amount[10]. Responsibility for paying these arrears fell to the new government.

Perhaps the easiest way of appreciating the crisis inherited by the new government is by looking at the direction of the trends in Figures 1 to 4 over the period **up to June 2004**:

- <u>Figure 1</u> shows a rapid growth in total expenditure to unprecedented levels and **large fiscal deficits**.
- <u>Figure 2</u> shows a dramatic **growth** in the **domestic debt stock** and the **GoM interest bill**.

[8] This was, of course, a *reclassification* – rather than an increase – of expenditure.

[9] Interest – including interest on foreign debt – averaged 3.4% of GDP in Sub-Saharan Africa (excluding South Africa and Nigeria) in 2002. '*African Development Indicators: 2004'*, World Bank, page 190. The equivalent figure for Malawi in 2003/04 was 10.7% of GDP.

[10] Arrears cannot be included because it is not known *when* they were incurred. Had they all been incurred in 2003/04 the fiscal deficit would have increased to a massive 13.6% of GDP.

- Figure 3 shows the reduction in **discretionary expenditure to just 34%** of total domestic expenditure in 2003/04 – and this is probably an overestimate.
- Figure 4 shows a rapid growth in: (a) **domestic expenditure** in general and (b) **domestic interest** in particular to unprecedented levels.

You do not need to be an economist to recognise that continuation of the above trends would be disastrous for the government and the economy. It is unclear whether the crisis should be attributed to ignorance of the basics of economic management or to plain irresponsibility. What is clear is that Malawi is much poorer as a result and that things could not continue the same way following the election.

The previous paper concluded that the crisis could only be overcome with substantial financial support from the international community. However, Malawi's international reputation was so low as a result of its economic mismanagement that international organizations were reluctant to entrust the government with their money. Malawi had earned a reputation as a country that fails to honour its commitments. The paper emphasized therefore the critical importance of restoring the country's reputation. The most effective way of achieving this would be to agree and strictly adhere to a new programme with the IMF. Central to this would have to be strict expenditure control and fiscal discipline combined with strengthened public financial management. How has the new government performed?

3. Fiscal Performance, 2004/05

In this section we look at fiscal performance during 2004/05 and at how the new government responded to the crisis that it inherited during its first year in office. It should be emphasized that the 2004/05 out-turn figures in Table 1 are *provisional* and will not be finalized for some months. However, they are not expected to change very significantly.

The single most noteworthy aspect of the 2004/05 out-turn is that for the first time since at least 1994 the Malawi Government (GoM) stayed within the budget approved by Parliament. It also met all but one of the targets agreed with the IMF in the Staff Monitored Program (SMP)[11]. Given the extremely difficult fiscal situation it inherited (described above), this represents a substantial achievement. As a result, domestic expenditure stabilized at 33.6% of GDP (see Figure 4) and the fiscal deficit declined from –7.8% to –4.1% of GDP (Figure 1).

[11] Following the collapse of the first PRGF, the IMF stopped lending to Malawi. The Staff Monitored Program – to which no funds were attached - was drawn up to enable the new government to establish a track record of responsible fiscal management during FY 2004/05 as a precursor to a new PRGF. The target which was missed was the wage bill, following underestimation of the impact of consolidating allowances into salaries.

This dramatic turnaround in 2004/05 demonstrates vividly that, even in very difficult circumstances, if there is sufficient political determination to maintain fiscal discipline it can be achieved. After the 2004 election, the President and Minister of Finance declared that the Government intended living within the approved Budget – and Government actions matched their words. This demonstrates that the persistent over-expenditure of previous years was a product of *political choice* rather than technical weakness.

While political will was key, two other developments contributed to the improved 2004/05 fiscal performance. Firstly, *revenue* performance continued to improve. As pointed out in the previous paper, the '*increase in the tax / GDP ratio in recent years has been one of the most positive features of Government economic performance…… With a 2003/04 revenue (including non-tax revenue) / GDP ratio of [22.7%], Malawi.….compares well with its neighbours*'. Table 1 shows that in 2004/05 this ratio increased again to 24.8% of GDP (provisional figure), an improvement of 2.1% of GDP.

Turning to the expenditure side, the other key development was the reduction in *domestic interest*. As noted above, the 2003/04 domestic interest bill of MK17.3 billion represented a massive 27.5% of government expenditure and 9.2% of GDP (Table 1). In 2004/05 these figures dropped substantially to (provisionally) MK16.5 billion, 22.0% and 7.4% of GDP respectively. The interest reduction of 1.8% of GDP when added to the revenue increase of 2.1% more than accounts for the entire improvement in the fiscal deficit of 3.7% of GDP during 2004/05.

It is important to understand why the interest bill declined because, with little scope to increase revenue further, this is the only part of the budget able to offer significant further fiscal relief in the short term. As noted above, the domestic interest bill is determined by two factors, the debt *stock* and the interest *rate*. Figure 2 illustrates the striking turnaround during 2004/05. Firstly, although the debt stock increased by about 9% in nominal terms, this was less than the inflation rate (about 14%) and represented a modest reduction in the domestic debt / GDP ratio from 25% to 24.1%. However, much more significant was the reduction in bank rate from 35% to 25% in June 2004. Although the benefit was not felt until existing Treasury Bills were rolled over at the new rate, this was a 28% reduction.[12] The interest reduction of 1.8% of GDP was the result, therefore, of the combined effect of the reduced domestic debt / GDP ratio and the cut in bank rate.

Clearly, further reductions in the fiscal deficit and interest rates will be crucial in bringing the fiscal situation under control. They are also crucial for private investment and growth. It is striking that, following the cut in bank rate in June 2004, private sector borrowing from commercial banks increased from MK10.5 bn in June 2004 to MK16.5 bn in June 2005 - a 57% increase[13].

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[12] Interestingly, the reduction had no effect on GoM's ability to roll over maturing Treasury Bills. This indicates that a 25% return is still better than returns on alternative investments in Malawi and that bank rate may have been higher than necessary.
[13] *Monetary Survey*, Reserve Bank of Malawi.

4. Budget 2005/06

This section looks at anticipated movements in the above key variables in the 2005/06 Budget. It begins by looking at recent developments in Malawi's relations with the international community. As noted above, by the time its first PRGF was abandoned in April 2004 the Malawi Government had lost virtually all credibility with the international community. As a result, budget and balance of payments support to Malawi – ie the types of aid which presuppose a degree of trust in government economic competence and honesty – had virtually dried up. Yet there was clearly no way out of the fiscal crisis without such support.

A year later the new Government has made substantial progress towards rebuilding Malawi's reputation. Two elements have been crucial. Firstly, moves to tackle corruption suggest an increased commitment to poverty reduction. Secondly, the successful implementation of the 2004/05 Budget and the IMF Staff Monitored Program has greatly increased confidence in the Government's economic competence. This confidence was manifested in the approval by the IMF Board in August 2005 of a new three year PRGF for Malawi. For similar reasons, members of the CABS group of donors have agreed to resume budget support to Malawi. These developments have greatly improved the prospects for the 2005/06 Budget (and future budgets) and for overcoming the fiscal crisis.

The potential impact of the decisions by the IMF and CABS to resume balance of payments and budget support respectively in 2005/06 can be seen in Table 1 and Figure 1. 'Programme grants' increase from MK5.2 billion (2.3% of GDP) in 2004/05 to MK15.1 billion (5.7% of GDP) in 2005/06. With little change in either government revenue or expenditure as a share of GDP, increased donor support is entirely responsible for the reduction in the budgeted fiscal deficit from –4.1% to –1.3% of GDP. It is worth emphasizing that most of this increase is a direct result of the improved fiscal performance in 2004/05 and the increased confidence of the international community in the Government's ability to manage the economy.

Table 1 highlights a number of other developments. Firstly, the reduction in domestic interest which started in 2004/05 is expected to continue in 2005/06. The Budget programmes a net *repayment* of domestic debt of MK1.3 billion. Along with inflation and modest GDP growth, this is expected to result in a significant reduction in the domestic debt / GDP ratio from 24.1% to 19.8% by June 2006. The Budget also projects a reduction in interest *rates*, although the Government has not revealed its assumptions on interest rates. With inflation currently at about 15%, there must be serious doubt whether there is much scope for significant further cuts in bank rate during 2005/06. The combined effect of the projected reductions in the debt stock and interest rates is a reduction in the domestic interest bill from 7.4% of GDP to 5.5%. If achieved, this will represent a substantial improvement in the space of two years. Domestic interest will have fallen from 27.5% of domestic expenditure in 2003/04 to 16.3%. This will potentially release substantial resources for productive poverty – reducing expenditure.

Another important development is the increase in *Wages* and *Pensions & Gratuities* from 6.5% and 0.8% of GDP in 2003/04 to a projected 7.8% and 1.2% of GDP respectively in 2005/06. While this partly reflects the consolidation of some allowances into salaries since October 2004[14], it nevertheless represents a significant increase in public servants' share of public expenditure; the two categories' combined share of domestic expenditure increased from 22.1% in 2003/04 to 27.1% in 2005/06.

When comparing performance in 2004/05 and 2005/06 with 2003/04 in Table 1, it is noteworthy that 1.1% and 2.1% of GDP has been provided for maize purchase in the last two years to address food shortages. There was no maize purchase in 2003/04. Also in 2005/06 MK4.6 billion has been provided for fertiliser subsidy, equivalent to 1.7% of GDP. The underlying improvement in fiscal performance is seen to be even better if such expenditure on food security is taken into account.

To sum up, the fiscal discipline and economic management during the first fifteen months of the current Government represents a substantial improvement upon that of its predecessor. This appears to be much better appreciated by the international community than by the Malawi public, perhaps because of the understandable short-term preoccupation with food security. The improvement can be seen most easily by looking at domestic debt. The previous paper concluded that '*domestic debt is now the dominant feature of the Malawian economy*'. In 2003/04 domestic interest represented 9.2% of GDP and 27.5% of domestic expenditure, crowding out both productive public expenditure and private investment. If the Government sticks as closely to the 2005/06 Budget as it did last year, these figures should drop to 5.5% of GDP and 16.3% respectively this year. This reduction in interest is releasing substantial resources for poverty reducing expenditure (eg fertilizer subsidy) while helping restore macro-economic stability. As illustrated in the next section, if current policies are maintained over the medium term there are good prospects that the fiscal crisis and the domestic debt problem can be overcome.

In section 2 we summarised developments up to June 2004 visually by looking at Figures 1 to 4. It is instructive to revisit the charts to see how things have changed **since July 2004**:

- Figure 1 shows a rapid growth in total expenditure to unprecedented levels and large fiscal deficits up to June 2004, followed by **much slower growth in total expenditure**[15] and **greatly reduced deficits.**
- Figure 2 shows a dramatic growth in the domestic debt stock and the GoM interest bill up to June 2004, followed by a **significant reduction in both the debt stock** and **interest**.

[14] This contributed to the increase in tax revenue in 2004/05.
[15] The apparent increase in total expenditure is misleading. It reflects increased **coverage** of **donor** project aid in the budget. Table 1 and Figure 4 show that domestic expenditure has been very stable at about 33.5% of GDP since 2003/04.

- Figure 3 shows a reduction in discretionary expenditure to just 34% of total domestic expenditure in 2003/04, with **little change subsequently.**
- Figure 4 shows a rapid growth in: (a) domestic expenditure in general and (b) domestic interest in particular to unprecedented levels up to June 2004. Subsequently, **domestic expenditure has stabilized** while **interest has been significantly reduced**.

4. Medium Term Fiscal Prospects, PRGF Scenario

After the marked turnaround since 2004/05, what are Malawi's fiscal prospects in the medium term? The new PRGF programme covers the three year period 2005/06 to 2007/08. The IMF Board Paper describing the programme includes detailed fiscal projections for the four years up to 2008/09. The PRGF projections are based on certain assumptions agreed with the Government. For details the reader is referred to the Board Paper (pages 12 – 19, 34 and 53 – 56). Essentially, they assume continuation of the strategy adopted since 2004/05 with a focus on fiscal discipline, reducing debt, promoting growth, controlling inflation and building up foreign exchange reserves.

The PRGF figures are shown in Table 1a and Figures 1a to 4a. It should be emphasised that except for the 2005/06 figures, which are the same as the Budget, they represent a '*scenario*' – not a forecast. They indicate what could happen if the particular (very ambitious, given Malawi's track record) set of assumptions adopted prove valid, rather than a confident prediction. Inevitably, the actual numbers from 2006/07 will turn out differently. Nevertheless, they are useful in illustrating how things could develop if current government policies are sustained.

Apart from the extended time period, there is one difference between Tables 1 and 1a (and between Figures 3 and 3a and 4 and 4a). Neither the IMF nor GoM has attempted to project PPE (ORT) expenditure beyond 2005/06. Since a continuous PPE time series is not possible for the whole period, this category of non-discretionary expenditure has been dropped in Table 1a.

Two trends in particular stand out from Table 1a and the corresponding charts - the fiscal deficit and domestic interest. Figure 1a vividly illustrates the marked reduction in the fiscal deficit from 11.6% of GDP in 2002/03 through 4.1% in 2004/05 to roughly 1% pa over the next four years. This would represent a tight fiscal policy in striking contrast to the record of recent years. Note that government revenue is expected to remain fairly static at about 24% of GDP. This is in recognition of the fact that tax already accounts for a much larger share of GDP in Malawi than in most countries at its income level – and that there is little scope to increase it further.

With constant revenue, a decline in the deficit means either an increase in donor grants or a reduction in GoM expenditure. Following the jump in grants in 2005/06, the PRGF scenario actually assumes a steady *decline* in grants'

share of GDP over the remaining three years.[16] The improvement in the deficit must be entirely due to reduced expenditure, therefore. This is confirmed in Table 1a, which shows total domestic expenditure declining from 33.4% of GDP in 2003/04 to 28.3% in 2008/09.

On the face of it, a reduction in public expenditure of this order of magnitude sounds a cause for concern – given the poor state of public services in Malawi. However, closer examination of Table 1a and Figure 4a reveals that all of this reduction is attributable to *savings in interest.* GoM's domestic interest bill is projected to decline from 9.2% to 2.5% of GDP, a drop of 6.7% of GDP over the period. Total expenditure only declines by 5.1% of GDP. In other words, while *total* expenditure declines, *non-interest* expenditure actually increases its share of GDP. Moreover, given that GDP itself is assumed to grow, *real* non-interest expenditure is expected to grow significantly.

What we are seeing here is the mirror image of the mushrooming of debt and interest that took place between 2000/01 and 2003/04[17], where interest grew much more than proportionately to the growth in the debt stock. As GoM stops new borrowing from (and starts modest repayment to) the domestic banking system, this helps reduce interest rates in two ways. Firstly, it reduces GoM's demand for borrowing relative to that of the private sector. Secondly, by reducing inflationary pressure it allows RBM to reduce bank rate without fuelling inflation.

As bank rate falls so does GoM's interest bill. This in turn enables GoM to use some of the interest savings to retire more debt, which permits further rate cuts - and so on; GoM is in a 'virtuous circle' of declining rates, expenditure and debt stock. The *nominal* reduction in the debt stock from MK53.7 billion in 2004/05 to MK48.9 billion in 2008/09 appears quite modest. However, because of inflation over the period (assumed to average about 9% pa) the *real* reduction is significant. The combined effect of: (a) modest nominal debt reduction; (b) inflation; and (c) the GDP growth assumptions (averaging 6 – 7% pa) is a *halving* of the net domestic *debt / GDP ratio* between 2003/04 and 2008/09, from 25.0% to 12.3%. Lower interest rates account for the rest of the reduction in the domestic interest bill.

If achieved, the reduction in the GoM domestic interest bill from 9.2% to 2.5% of GDP (or from 27.5% to 8.7% of domestic expenditure) would represent a considerable saving in public expenditure. It would potentially release substantial resources, which can be used either to reduce total expenditure / retire debt or to increase productive poverty reducing expenditure – or a bit of both. The PRGF scenario envisages taking most of the benefit from interest savings in the form of expenditure reduction. However, as noted above, this is essentially illustrative. The actual distribution of the savings can only usefully be considered *after* they start to be realized.

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[16] This is a deliberately conservative assumption. The commitment by the G8 group of developed countries at Gleneagles in June 2005 to increase aid levels has not been factored in.

[17] Note the symmetry in Figure 2a.

The reduction in the GoM interest bill is not the only positive impact of improved economic management on poverty. As noted above, GoM domestic borrowing has been crowding out private sector borrowing, causing a collapse in private investment. While we do not know the interest rate assumptions in the PRGF scenario, it is clear that they are expected to fall significantly over the period. There is evidence that the reduction in bank rate in June 2004 led to a rebound (albeit from a very low level) in private borrowing. The new Government has emphasized the importance of economic growth for tackling poverty in Malawi. Further cuts in interest rates are likely to be one of the most critical factors in accelerating investment and growth over the medium term.

5. Conclusions

As a result of many years of fiscal mismanagement, during which a huge domestic debt was accumulated and Malawi's reputation was badly damaged, the new Government inherited a fiscal crisis upon taking office. This paper has shown that the Government has made a good start in tackling the crisis. By sticking to the 2004/05 approved Budget and by meeting all but one of the targets in the IMF Staff Monitored Program, the Government has stabilized the domestic debt, started to bring interest costs down and started to restore Malawi's international reputation. Approval of a new PRGF by the IMF and the resumption of budget support by CABS donors are a direct consequence of the striking improvement in fiscal management. The PRGF scenario demonstrates that **if** this improvement is sustained over the medium term, there are good prospects for overcoming the fiscal crisis, shifting resources from interest to productive purposes, restoring macroeconomic stability and promoting increased investment and growth.

The 'if' in the last sentence is critical. The improvements described here are only fifteen months old. It will take years for the fiscal crisis to be brought under control. Should recent improvements be reversed the gains would be lost very quickly and, with its reputation damaged yet further, Malawi's economic prospects would be bleak indeed.

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