

ANNEX

IDENTIFICATION

Title/Number	Poverty Reduction Budgetary Support 3 (PRBS III)		
Total cost	<i>EC contribution- € 90 million (20.6% of NIP)</i>		
Aid method / Management mode	General budget support - Centralised management Institutional Support – Joint management		
DAC-code	51010	Sector	Macroeconomic Support

1. RATIONALE AND COUNTRY CONTEXT

The Malawi-EC cooperation strategy under the 10th EDF for the period 2008 – 2013 is based on the Malawi Growth and Development Strategy (MGDS) which is the Government of Malawi's development strategy for the period from 2006/07 to 2010/11. The key objective of the MGDS and the Malawi-EC Cooperation Strategy is the reduction of poverty. Malawi faces a number of challenges in meeting the key objective of poverty reduction, namely a fragile macro-economic situation, food insecurity and poor agriculture performances and inadequate infrastructure. Coherently the Malawi-EC Cooperation Strategy focuses on General Budget Support and two focal sectors, namely food security and agriculture and regional interconnection with focus on road infrastructure. Notwithstanding the improvements registered in the economy in the last few years (since mid 2004) and the achievement of the HIPC completion point in August 2006, Malawi's macro-economic situation remains fragile, highly dependent on foreign grants and vulnerable to the effects of external shocks such as higher world prices for imported products (mainly oil products and fertilisers). The specific objective of the general budget support is therefore to assist the Government in the implementation of the poverty reduction programme and contribute towards the development of a favourable macro-economic framework which the Government recognises as a prerequisite for attaining sustainable growth and development. The MGDS's emphasis on growth as a pre-requisite for poverty reduction is supported by the donor community. This General Budget Support (GBS) operation will ensure continuity with PRBS I and PRBS II, which were signed in October 2005 and November 2006, respectively, and which were both implemented successfully.

1.1. Country Context and National Policy and Strategy

1.1.1. Economic and social situation and poverty analysis

The economy of Malawi is relatively small with a nominal GDP of about \$3.5 billion and a population of approximately 13.2 million⁹. The per capita GDP is about \$265 per year. The economy is largely based on agriculture, which accounts for about 36% of GDP as well as for more than 80% of export revenues, and which occupies more than 80% of Malawians. Malawi's macro-economic performance was very good in the last few years. Real GDP growth is forecast at 7.9% in 2007, following the record growth of 8.2% in 2006, and is

⁹ National census is currently undergoing

projected around 7.4% in 2008. This data represent a major, positive, departure compared to the previous decade when growth was quite erratic with an average of approx. 2% per year. The recent growth was largely due to good performances of the agriculture sector, which benefited from input subsidies (fertilisers; seeds) and good rains. The average inflation rate came down to single digit (7.9% in 2007) and interest rates continued to decline (15%). Notwithstanding the remarkable achievements of the last few years, the economy of Malawi remains highly vulnerable to external shocks, like those experienced by developing countries in the last few months. According to preliminary calculations, Malawi may suffer in 2008 from a 4% to 5% deterioration in the terms of trade, mainly driven by the skyrocketing price of oil imports and the price of fertilisers' imports. This deterioration is almost equivalent to the amount of Malawi's official foreign reserves at the end of 2007.

Poverty alleviation in Malawi has shown very little progress in the last decade. The country is among the poorest countries in the world, ranking at 164 out of 177 in the UN's Human Development Index 2007/08. In 2005, about 6.4 million of Malawians (or 52.4% of the population) were estimated to be living below the Government calculated poverty line of approximately \$0.35 per day. However, recent estimates indicate that the pace of poverty reduction is now improving. According to the GoM-MDG 2007 report, poverty levels declined sharply from 52.4% in 2005 to 45% in 2006 on account of the improved food security situation due to the input subsidy programme and favourable weather conditions. At this rate of improvement, poverty levels would be expected to decline to 27% by 2015 thus reaching the MDG target.

Progress on other MDG indicators is rather mixed. Universal enrolment of primary school aged pupils (net enrolment) has been increasing from 58% in 1992 to 82% in 2004. However, the net enrolment declined to 73% in 2006 thus casting doubts over reaching the 2015 target of 100%. Primary completion rate continues to be off-track and remained at 25% in 2006. The estimated HIV/AIDS prevalence in adults (15 to 49 years) in Malawi (2006) stabilised at 14.1% with a range from 12% to 17%, giving a total estimated number of 949,000 infected adults. There has been some progress in increasing the proportion of births attended by skilled personnel from 38% in 2005 to 42% in 2007. The percentage of under-weight children (under-five years of age) dropped from 22% in 2005 to 19% in 2006 due to improved food availability. Similarly there has also been a decrease in the childhood mortality rate, with Malawi on-track to meet the child mortality MGD (118 infants death per 1000 vs 133 deaths per 1000 in 2005). Maternal mortality rate in Malawi remains alarmingly high and among the highest in the world at 984 deaths per 100,000 live births.

1.1.2. National Development/ Cooperation Policy and Strategy

(1) National Policy and Strategy.

The Malawi Growth and Development Strategy (MGDS) 2006-2011 was approved by the Government on 3 November 2006. The main thrust of the strategy is to create wealth through sustainable economic growth and infrastructure development as a means of achieving poverty reduction. The MGDS is organised into five themes: sustainable economic growth; social protection; social development; infrastructure development; and improved governance. Under these themes, medium and long term objectives are outlined for a broad range of sectors of which six are highlighted as key priorities: agriculture and food security; irrigation and water development; transport infrastructure development; energy generation and supply; integrated rural development; and prevention and management of nutrition disorders, HIV and AIDS. The MGDS has undergone the first review during its implementation in FY 2006/07. On the

one hand, the review commended the macro-economic performances which are conducive to the reduction of poverty. On the other hand, the review noted some challenges including that funding remains inadequate, some sector activities are still not aligned to the MGDS and that donor alignment and harmonisation should improve as well.

(2) National Budget and medium term financial perspective

Since 2004, the main guidelines of the budget have been as follows: fiscal discipline aimed at reducing the domestic debt thereby reducing interest rates; more emphasis on development expenditure, agriculture subsidies and the efficiency of expenditure. In the last few fiscal years the net domestic debt declined from 18% of GDP in 2003/04 to 10.3% projected in 2007/08. Real interest rates on Treasury Bills declined from above 30% (end of 2003) to approx. 5% (end of 2007) and inflation declined from around 16% in 2005 to around 8% (end of 2007). Domestic interest payments declined from 7.8% of GDP in 2004/05 to 2.0% of GDP projected in 2007/08, thus opening a fiscal space of approx. 5.9% of GDP. This was invested in the agriculture subsidy policy [+ 1.4% of GDP (from 1.4 to 2.8%)], in the health SWAP [+2.1% of GDP (from 0.3% to 2.4%)], in wages and salaries [+0.1% of GDP (from 5.5% to 5.6%, with education and health as the biggest beneficiaries)], in domestically financed development expenditure [+2.3% of GDP (from 0.8% to 3.1%)]. The yearly budget and medium term fiscal perspective are based on the macroeconomic and fiscal framework agreed between the Government and the IMF. After the successful completion of the current PRGF programme, the new PRGF programme, covering the period 2008/09 to 2010/11, is being prepared.

(3) Performance measurement

Performance measurement in Malawi is premised on dialogue between Common Approach for Budget Support group (CABS)¹⁰ and GoM on the basis of a Performance Assistance Framework (PAF), which consists of a set of indicators (public finance management; economic growth and social protection; social sectors; governance). The CABS group holds its reviews every six months, in February/March and September/October. The former focuses on GoM development programmes, social sectors progress and PFM. The latter focuses on PFM and budget cycle and implementation. CABS and GoM dialogue is fed by sectoral experts groups active in health, in PFM, in governance and other sectors. The PAF is reviewed every year thus offering the possibility to refine the indicators and their targets during the course of the programme. The MGDS reviews are not yet sufficiently mature to be used as the basis for performance measurement and decisions on budget support.

1.2. Eligibility for budget support

1.2.1. National Development or Cooperation Policy and Strategy

National policy eligibility is fulfilled due to the presence of the MGDS. The level of ownership and commitment of the GoM to the MGDS is high. It was well received by the donors as highlighted in the Joint Assessment by IMF/WB staff, which concluded “*the MGDS provides a comprehensive framework for growth and poverty reduction in Malawi*”.

¹⁰ CABS is composed of UK (DFID); Norway; EC; AFDB; WB and D. IMF, IRL and UNDP have the observer status. Worth mentioning is that last year CABS has become a catalyst attracting three new Members (AFDB;WB and D) and a new observer (IRL). CABS has clearly become the privileged forum for policy discussions with the GoM.

1.2.2. Macroeconomic situation

Macro-economic eligibility is fulfilled. Under the current PRGF programme Malawi has remained constantly on track since its inception in 2005 thus establishing a record in the relations between Malawi and the IMF. The sixth and final review of the current programme was approved by the IMF Board on 14 July 2008. Preparations for the new programme are advancing and it is anticipated that this is going to be presented to the IMF Board before the end of the year, so as to fully factor in the approval of the 2008/09 budget as well as more accurate and stable data in terms of the recent deterioration in terms of trade. The new IMF programme will be in line with its predecessor, with an emphasis on the protection of the results achieved in the last few years from external shocks. Prominent under the programme will be: a) fiscal consolidation with a view to continuing to pay back domestic debt thereby reducing interest rates and interest payments. In the fiscal framework energies will have to be invested in improving revenue administration and efficiency of expenditure; b) maintain inflation in single digit c) maintain a flexible exchange rate policy and cushion the impact of deterioration in terms of trade due to external shocks. External reserve cover is to be increased, although it may only be possible to make the exact quantification after an in-depth analysis of the deterioration in the terms of trade and its stabilisation.

1.2.3. Public Financial Management

Public Financial Management eligibility is fulfilled. Over recent years there have been a number of reforms and improvements to the PFM system in Malawi. Reforms have been implemented under the overall framework of a PFM Action Plan, and improvements to the system have recently been confirmed by a third PEFA assessment which was completed in May 2008. The main findings of the PEFA assessment indicate that Malawi continues to exercise fiscal discipline in budget execution with domestic revenue collections maintained above targets. On public accounting, there has been an improvement in the timeliness of submission of public accounts (2006/07) due to the significant progress in the implementation of IFMIS. Positive developments were observed in the area of debt management, payroll management and government procurement reforms. The predictability and comprehensiveness of budgetary support from donors also improved during the period under review. External auditing and parliamentary scrutiny of financial accounts were hampered by the lack of an Auditor General.

1.3. Lessons learnt

The main lesson learned under the previous programmes (PRBS I and PRBS II) since mid 2005 is the importance of the quality of dialogue between CABS and GoM which has made CABS the privileged forum for policy discussions and a pole of attraction for more development partners thus reducing the transaction costs of GoM. Over the years the dialogue has become more constructive and open minded. It has also become more comprehensive to incorporate dialogue and coordination with sectoral ministries and experts. In this framework the coordinating role of the Ministry of Finance within GoM has been naturally enhanced. Other important lessons learned are related to the performance assessment framework and in particular the identification and selection of indicators, in terms of government ownership, coherence with the MGDS and sectoral priorities. More and more attention was paid to the SMART nature of the indicators.

1.4. Complementary actions

The PRBS III will ensure continuity with the PRBS I and II both in terms of macroeconomic, public finance management and social sector objectives as well as technical support provided. The programme is complementary to the general budget support provided by other development partners within CABS. For the period covered by the PRBS III, CABS members are expected to disburse an estimated amount of approx. € 300 million (with DFID representing about 33%, EC 30%, WB 25% and Norway and AfDB together the remaining 12%). EC is thus expected to be the second largest budget support donor in Malawi.

1.5. Donor coordination

Donor coordination is sound, the Government being in the lead in convening, twice yearly, review meetings with the CABS donor group and regular (in many cases monthly) meetings of sectoral groups including the GFEM (Group on Finance and Economic Management).

2. DESCRIPTION

2.1. Objectives

The *overall objective* of the PRBS III programme is to support **poverty reduction** through the implementation of the Malawi Growth and Development Strategy (MGDS). The *specific objective* of the PRBS III programme is to support macroeconomic stability whilst enhancing the focus of public expenditure on poverty reduction programmes.

2.2. Expected results and main activities

The expected results are: i) Macro-economic stability; ii) Implementation of policy reforms in social sectors so as to increase health services and education opportunities; iii) implementation of policy reforms in the area of public finance management so as to enhance the effectiveness and efficiency of public expenditure; iv) improve the health and education MDG indicators.

2.3. Stakeholders

The ultimate beneficiaries, those who will benefit from the long term effect of the programme, will be the people of Malawi.

2.4. Risks and assumptions

The successful implementation of the GBS will depend upon implementation of policy reforms in the area of public finance management – so as to enhance the effectiveness and efficiency of public expenditure. The present GoM commits to the above and it is reasonable to assume that the GoM intends to consolidate the achievements made, with the assistance of development partners in tackling the external shocks. This being said Malawi's current situation is premised by well known political risks, with a minority government and recurrent political tensions, which are likely to increase in months to come before the Presidential and Parliamentary elections which are due in May 2009. Additionally, the delay in the approval of the budget, an annual problem since 2004, could also have destabilising effects. The situation is closely monitored in consultation with UN, EU MS and other major players.

2.5. Crosscutting issues

Malawi has recognised that poverty is both cause and effect of environmental degradation. The current programme, through supporting the budget and poverty reduction policies, will have positive effects on the environment. Some of the assessment indicators for the country performance, extracted from the PAF, are gender-disaggregated and will reflect women health and empowerment. HIV/AIDS covers all areas of public services (education, health, gender and social community etc.) and has an impact on all sections of the Malawi society. The PAF includes one indicator related to HIV/AIDS issues in the country and the same indicator will be used.

3. IMPLEMENTATION ISSUES

3.1. Budget and calendar

The EC contribution of €90M will be provided in the form of direct budget support (€87M) for FY 2008/2009, FY 2009/2010 and FY 2010/2011 and institutional support (€3M). The tentative schedule of disbursement of the instalments and the institutional assistance is presented here below.

The Institutional Support component - *Support to Public Finance Management Reform and Support to MGDS Monitoring & Evaluation programme (2nd Phase)*-will be implemented under joint management via a Contribution Agreement with UNDP, the contracts will be awarded and implemented in accordance with the procedures and standard documents laid down and published by the UNDP (as indicated in the Financial and Administrative Framework Agreement, FAFA, concluded between the Commission and the UN the 29 April 2003).

Audits & Evaluations (€ 0.23 M) will be implemented by the Commission (Framework contract) on behalf of and for the benefit of the Government of Malawi.

Budget Table 1

PRBS III Items	Indicative date	Million €
<i>Transfers</i>		<i>Up to 87.0</i>
First : Fixed Tranche	FY 08/09-Q2	26.0
Second Fixed Tranche	FY09/10-Q1	15.5
First Variable Tranche.		Up to 15.0
Third Fixed Tranche	FY10/11-Q1	15.5
: Second Variable Tranche.		Up to 15.0
<i>Institutional Support Component</i>	<i>2009 – 2013</i>	<i>3.0</i>
Total		90.0

The period of implementation is 60 months from the signature of Financing Agreement.

3.2. Budget support modalities

This PRBS III Programme is a direct, non-targeted, budget support.

The National Authorizing Officer will request the release of the budget support tranches and indicate the details of the Ministry of Finance bank account opened at the Central Bank of Malawi to which the funds should be transferred.

3.3. Procurement and grants award procedures

All contracts implementing the action must be awarded and implemented in accordance with the procedures and standard documents laid down and published by the Commission for the implementation of external operations, in force at the time of the launch of the procedure in question.

All contracts implementing the project components under joint management must be awarded and implemented in accordance with the procedures and standard documents lay down and published by the International Organisation Concerned.

3.4. Performance monitoring and criteria for disbursement

The EC general budget support will be provided jointly with other donors including EU Member States in the framework of the CABS group, which monitors the performance of budget support to Malawi on a regular basis.

The general conditions for disbursement of all tranches are as follows: Satisfactory progress in the implementation of the MGDS; satisfactory progress in the maintenance of a stability-oriented macroeconomic policy; and satisfactory progress in the implementation of its programme to improve public financial management.

The specific conditions for the disbursement of the variable tranches are: the achievements against selected Performance Assessment Framework (PAF) indicators agreed with GpM in the year preceding the review.

3.5. Evaluation and audit

Evaluation and Audit contracts will be implemented by the Commission, on behalf of and for the benefit of the ACP states.

3.6. Communication and visibility

Communication and Visibility will be offered through press releases issued by CABS after each review and press releases issued by the EC Delegation during the implementation of the operation.