Ministry of Finance

Government of Malawi

REPORT ON PUBLIC DEBT SUSTAINABILITY ANALYSIS

JULY 2012

PREFACE

This is a report on the Debt Sustainability Analysis (DSA) workshop that was held from 9th to 20th July, 2012 in Lilongwe, Malawi. The workshop aimed at assessing the sustainability of Malawi's public external and domestic debt for the period 2012 – 2032. The results of the DSA will feed into the review and updating of the current Medium- Term Debt Management Strategy (MTDS) that was approved in 2010.

The Ministry of Finance wishes to thank its staff and those from the Ministry of Economic Planning and Development, National Statistical Office, Accountant General's Department and the Reserve Bank of Malawi for working tirelessly to conduct the DSA. Special thanks are also extended to the Macroeconomic and Financial Management Institute of Eastern and Southern Africa (MEFMI) for the technical support provided during the exercise.

Finally, special acknowledgements are extended the United Nations Development Programme (UNDP) for financing the printing of this DSA Report through the Development Assistance Coordination Unit (DACU) Project.

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ACCRONYMS AND ABBREVIATIONS

ADF	African Development Fund
AfDB	African Development Bank
CPIA	Country Performance and Institutional Assessment
DACU	Development Assistance Coordination Unit
DOD	Disbursed Outstanding Debt
DSA	Debt Sustainability Analysis
DSF	Debt Sustainability Framework
ECF	Extended Credit Facility
EIB	European Investment Bank
EU	European Union
FISP	Farm Input Subsidy Programme
GDP	Gross Domestic Product
HIPC	Highly Indebted Poor Countries
IFAD	International Fund for Agricultural Development
IDA	International Development Agency
IMF	International Monetary Fund
IRAI	IDA Resource Allocation Index
LICs	Low Income Countries
LRS	Local Registered Stock
MEFMI	Macro-economic and Financial Management Institute for Eastern and Southern Africa
MDGs	Millennium Development Goals
MDRI	Multilateral Debt Relief Initiative
MGDS	Malawi Growth and Development Strategy
MTDS	Medium Term Debt Management Strategy
MK	Malawi Kwacha
NDF	Nordic Development Fund
OPEC	Organization of Petroleum Exporting Countries
PRC	People's Republic of China
PTA	Preferential Trade Area
PV	Present Value
RBM	Reserve Bank of Malawi
SWAp	Sector Wide Approach
UNDP	United Nations Development Programme
US$/USD	United States Dollar
WB	World Bank

EXECUTIVE SUMMARY

In 2006, Malawi benefitted from the Heavily Indebted Poor Countries (HIPC) Initiative and the Multilateral Debt Relief Initiative (MDRI). A large proportion of Malawi's external debt was cancelled resulting in a significant reduction of the external debt stock from US$2.9 billion to US$488 million. In order to ensure that the country does not return to unsustainable external debt levels in future, Government made a commitment to ensure prudent financial and economic management including undertaking reforms in public debt management.

One of the key elements of improved public debt management operations involves conducting debt sustainability analyses (DSAs) on a regular basis aimed at monitoring evolution of the public external and domestic debt in relation to the status of the economy. Since 2006, several DSAs have been conducted more or less on an annual basis. The most recent DSA Report preceding the current one was published in June 2011.

The DSA for 2012 was conducted from 9th to 20th July, 2012 in Lilongwe. The main objective of the DSA was to assess the sustainability of Malawi's external and total public debt portfolio within the medium- to long – term thereby updating the findings of the DSA that was conducted in June 2011 and use the results to feed into the review of the Medium Term Debt Management Strategy (MTDS) that was approved in 2010. The 2012 DSA was necessitated by the fact the macroeconomic policy environment and economic outlook had changed drastically compared to the June 2011 situation.

The DSA was conducted using the Debt Sustainability Framework (DSF) for Low Income Countries which was developed by the International Monetary Fund (IMF) and the World Bank. Under the DSF, a country's external debt sustainability is assessed by considering the quality of its policies and institutions as measured by the World Bank's Country Performance and Institutional Assessment (CPIA) scoring criteria which is also known as the IDA Resource Allocation Index (IRAI). The major assumption of DSF is that countries with stronger (weaker) policies and institutions can sustain higher (lower) levels of debt. Malawi is a medium performer according to the latest CPIA (IRAI) ranking by the World Bank. This implies that Malawi's external debt will be sustainable if the ratio of the present value of debt to GDP is less than 40 percent; or if the ratio of the present value of debt to exports is less than 150 percent; or if the ratio of the present value of debt to budget revenue is less than 250 percent. These three ratios are known as solvency indicators, comparing the country's debt burden with the resource base or the capacity to generate resources to repay the debt at a given point in time.

Similarly, for a medium performer like Malawi, external debt would be considered sustainable if the ratio of debt service to exports and the ratio of debt service to budget revenue are both less than 20 percent. These ratios are known as liquidity indicators and are used to determine whether the liquid assets and the available financing are sufficient to meet or roll-over maturing liabilities or debt service of a country in a given year.

The analysis revealed that Malawi has a low risk of debt distress. The key results of the external, domestic and total public debt sustainability analysis are as follows:

a) Malawi's external debt, amounting to US$1.075 billion in December 2011, is projected to remain sustainable in the period 2012 – 2032 under the baseline macroeconomic scenario which is premised on the recent discussions with the International Monetary Fund (IMF). The DSA findings indicate that the solvency ratios show a generally declining trend throughout the projection period. The PV of debt-to-GDP ratio peaks at 21 percent in 2012 and gradually declines to 10 percent by 2032 (Graph 5b). The PV of debt-to-Exports ratio rises slightly from 58 percent in 2012 to 61 percent in 2013 before continuously declining to 34 percent in 2032. The PV of debt-to-Revenue ratio continuously declines from 99 percent in 2012 to 41 percent in 2032 (Graph 5d). The low solvency ratios vis-a-vis the agreed thresholds are reflective of a combination of prudent external borrowing and improvements in the macroeconomic variables of GDP, exports and domestic revenue.

b) Similarly, DSA results show that the external debt liquidity ratios would remain far much below their thresholds of 20 percent throughout the projection period. The external debt service-to-exports ratio (also known as the debt service ratio) is projected to be 2.2 percent in 2012 and will remain under 4 percent through to 2032. Likewise, the debt service-to-revenue ratio is projected to rise slightly from 3.7 percent in 2012 to 4.3 percent in 2014 before it gradually declines to 2.2 percent in 2032. These low liquidity ratios suggest that the country is not expected to face any liquidity challenges in servicing its debt.

c) Furthermore, stress tests show that Malawi's external debt exposure to debt distress is low. The results indicate that although shocks to exports and/or GDP growth would lead to an increase in the debt ratios above the baseline, none of the thresholds would be breached throughout the projection period.

d) The DSA found that domestic debt, amounting to K203 billion in December 2011, was barely sustainable. Domestic debt is considered to have a significant risk of distress if the ratio of nominal domestic debt to GDP is above the range of 15 – 20 percent. The ratio of Malawi's total nominal domestic debt stock to GDP was 20 percent in 2011 which is on the borderline of the risk of distress.

e) The main risk associated with domestic debt is that over 75 percent of domestic debt is in the form of treasury bills which mature in less than one year. The dominance of very short maturities exposes the domestic debt portfolio to a number of risks including refinancing risk, interest rate risk, and other fiscal risks.

f) The results of the DSA show that Malawi's total public debt is expected to remain at manageable levels throughout the projection period under the baseline scenario. The PV of debt-to-GDP ratio is projected to decline from 39 percent in 2012 to 26 percent in 2032 which is significantly below the 56 percent threshold. Similarly, the PV of debt-to-Revenue ratio is expected to decline from 135 percent in 2012 to 91 percent in 2032. However, the DSA results indicate that the debt service-to-Revenue ratio is expected to initially decline from 16 percent in 2012 to 10.2 in 2014 and thereafter to gradually increase to 20 percent in 2032. This trend reflects the assumption that there will be some domestic borrowing after the current IMF programme period which ends in 2016. It is assumed that the Government will undertake some modest domestic financing from 2017 to 2032 to ensure development of the domestic debt and financial market.

g) The alternative macroeconomic scenario shows that the public debt would still be manageable although the sustainability ratios are projected to be higher than those under the baseline in the medium term (2012 – 2017). This is because the alternative scenario assumes a pessimistic macroeconomic outlook that could arise in case of lapses in policy implementation. This scenario also assumes that the Government may contract higher amounts of semi-concessional or non-concessional external financing compared to the baseline scenario.

h) However, the stress tests to the baseline macroeconomic scenario suggest that Malawi's public debt is vulnerable to a number of shocks including shocks to real GDP growth and the primary balance. The DSA results indicate that such shocks could lead to relatively higher public debt solvency ratios than those obtained under the baseline scenario.

In view of the above findings, the following recommendations are proposed for consideration by Government:

a) In order to avoid future external debt distress, the Government should ensure that external borrowing operations are managed prudently. New external financing should be guided by set limits in terms of both level of concessionality as well as annual borrowing ceilings which could be in nominal amounts or as a percentage of GDP. Monitoring of the evolution of external debt indicators should be undertaken regularly to ensure adherence to an approved new borrowing strategy. In addition, new external borrowing should be for purposes of productive investments that would lead to higher economic growth rates thus improving repayment capacity.

b) The Government may need to consider developing a medium term debt strategy that is consistent with the strategies assumed in the DSA exercise to ensure that the risks associated with the existing debt strategy and the planned new borrowing are clearly articulated and understood.

c) Since the domestic debt stock has already reached the borderline of sustainability, the Government should endeavour to exercise restraint in new domestic borrowing. The key to limiting domestic borrowing is sustained fiscal discipline.

d) In order to minimize risks associated with the current structure of the domestic debt portfolio, the Government should also consider:

   i. restructuring/ lengthening the maturity profile of the domestic debt portfolio through issuance of long term debt instruments such as treasury notes/bonds. This should aim at distributing maturities over the years systematically;

   ii. converting the large holding of treasury bills by RBM to longer dated instrument/s to minimize refinancing risk;

   iii. reducing the ceiling of ways and means from the current 20 percent of the current budgeted domestic revenue as stipulated in the Public Finance Management (PFM) Act to some lower percentage of the previous budget's domestic revenue. In addition, the Government should avoid the practice of converting the outstanding overdraft to Treasury bills held by the Reserve Bank as this defeats the purpose of having a limit on ways and means.

CHAPTER 1

INTRODUCTION

1.1 Background

In 2006, Malawi benefitted from the Heavily Indebted Poor Countries (HIPC) Initiative and the Multilateral Debt Relief Initiative (MDRI). A large proportion of Malawi's external debt was cancelled resulting in a significant reduction of the external debt stock from US$2.9 billion to US$488 million. In order to ensure that the country does not return to unsustainable external debt levels in future, the Government made a commitment to ensure prudent financial and economic management. The planned reforms included improved debt management that would help to ensure that in the post HIPC/MDRI era, public external debt accumulation is kept under control and within sustainable levels in line with the state of the country's economy.

The overall goal of ensuring that Malawi's public debt remains sustainable within the medium to long term would be achieved through employment of more analytical work in debt management operations. This entails conducting debt sustainability analyses (DSAs) on a regular basis and development of a strategy that would guide new borrowing in the short to medium term.

To this end, the Government of Malawi has undertaken to institutionalize the DSA process and DSA Reports have been produced at intervals not exceeding two years since 2006. The most recent DSA Report preceding the current one was published in June 2011. In addition, Government approved the first comprehensive Medium – Term Debt Management Strategy (MTDS) in December 2010.

The DSA workshop for the current report took place in Lilongwe from 9th to 20th July, 2012.

1.2 Objectives of the DSA

The main objective of the DSA was to assess the sustainability of Malawi's external and total public debt portfolio within the medium- to long – term. The DSA sought to identify any risks and vulnerabilities to which the country's public debt portfolio is exposed and suggest policy recommendations to the authorities. In line with this objective, the DSA findings were intended to feed into the review and updating of the current Medium Term Debt Management Strategy (MTDS). The 2012 DSA was necessitated by the change in macroeconomic policy environment and economic outlook compared to the year 2011 when the previous DSA was undertaken.

The DSA workshop was also intended to provide training to Government and Reserve Bank of Malawi officials in the analysis of debt management strategy issues so that the officials are better able to detect, prevent and resolve potential debt crises. Ultimately, Government should be able

to maintain a sustainable team capable of updating the debt strategy analysis regularly for the foreseeable future, and with minimal technical support from outside.

1.3 Methodology and Workshop Participants

The DSA was conducted using the Debt Sustainability Framework (DSF) for Low Income Countries (LICs) that was jointly developed by the International Monetary Fund (IMF) and the World Bank. The Workshop applied the revised thresholds for both external debt and public debt sustainability indicators.

The DSA was conducted by a country team of Government and Reserve Bank of Malawi officials. Specifically, the Government team comprised officials from the Ministry of Finance, Ministry of Economic Planning and Development and the National Statistical Office. The Macroeconomic and Financial Management Institute of Eastern and Southern Africa (MEFMI) supported the exercise by way of providing a team of experts in various areas including macroeconomic forecasting, new financing, external and domestic debt issues to oversee the whole DSA process for quality assurance.

Results of the 2012 DSA were presented to senior officials in the Ministry of Finance, Ministry of Economic Planning and Development, National Statistical Office and the Reserve Bank of Malawi on July 20, 2012.

1.4 Organization of the Report

This DSA report is organized into six chapters. After this introduction, Chapter two is a review of the public external and domestic debt portfolio and is followed by a review of external finance portfolio in Chapter three. Chapter four provides an overview of macroeconomic developments and outlines the main assumptions used in the DSA. Results of the DSA are presented in Chapter five whereas the final Chapter provides the summary of the findings and the policy recommendations.

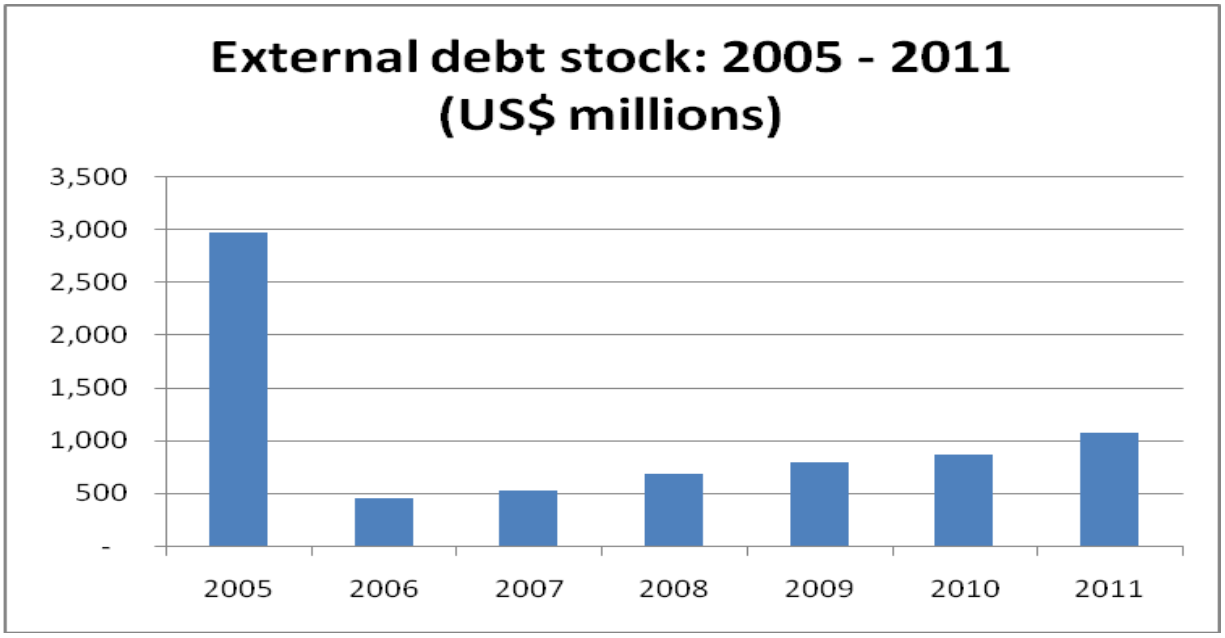
CHAPTER 2

EXTERNAL AND DOMESTIC DEBT PORTFOLIO REVIEW

2.1 Evolution of External Debt

After Malawi benefitted from the HIPC Initiative and MDRI in 2006, the external debt stock (DOD) has increased steadily from USD488 million in 2006 to USD1,075 million by end December 2011 (Chart 2.1). The current external debt stock is equivalent to 19 percent of GDP compared to 15 percent and 16 percent of GDP reported in 2006 and 2010, respectively. The rise in the debt stock is largely on account of new borrowing from bilateral non-traditional creditors notably the People's Republic of China and India in recent years.

Chart 1: Trend in the External Debt in millions of US dollars



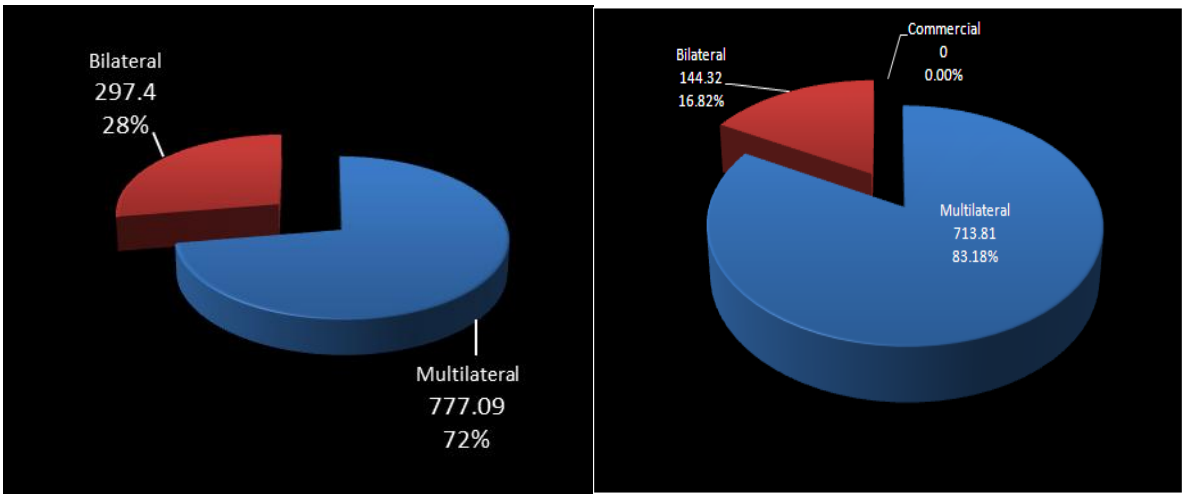
Data source: Debt & Aid Division, Ministry of Finance

2.2 Composition of External Debt by Creditor Category

Malawi`s external debt stock comprises debt from bilateral and multilateral creditors. As of December 2011, external debt owed to multilateral creditors amounted to USD777 million (72%) as compared to USD714 million (83%) recorded in December 2010. This represents a significant change in the composition of external debt stock between multilateral and bilateral creditors in favour of the latter whose share increased from 17 percent in 2010 to 28 percent in 2011 (Chart 2). As discussed above, the shift is explained by increased disbursements received from the People's Republic of China and India over the last 2-3 years.

Chart 2: External Debt by Creditor Category in millions of US dollars

December 2011 *Dec 2010*

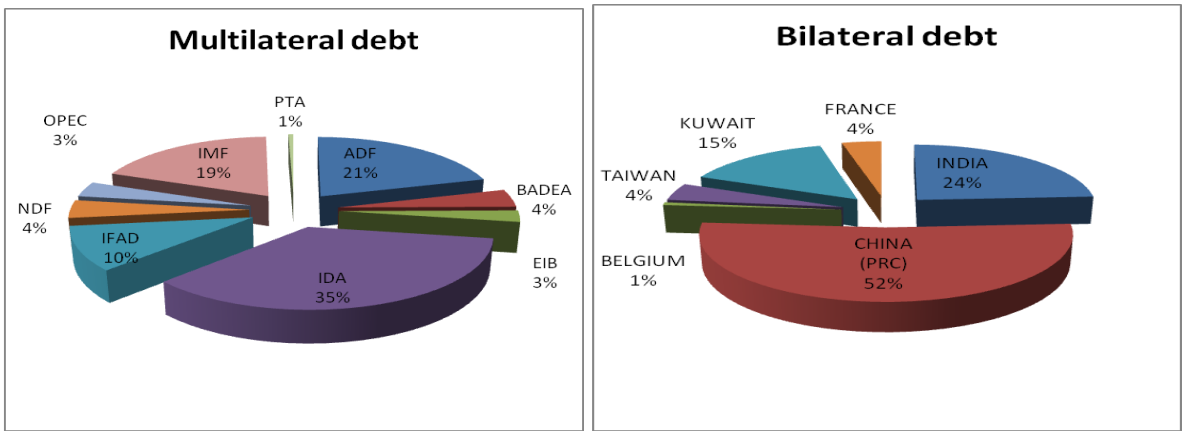


Data source: Debt & Aid Division, Ministry of Finance

As at December 2011, the main multilateral creditors included the International Development Association of the World Bank (IDA) with 35 percent, African Development Fund (ADF) with 21 percent, International Monetary Fund (IMF) with 19 percent and the International Fund for Agricultural Development (IFAD) with 10 percent. The remaining 15 percent was held by the European Investment Bank (EIB), Nordic Development Fund (NDF), Arab Bank for Economic Development in Africa (BADEA), Organization of Petroleum Exporting Countries Fund for International Development (OPEC Fund) and the Preferential Trade Area (PTA) Bank. This composition is largely similar as that of December 2010 (Chart 3).

The People's Republic of China (PRC) has become Malawi's top bilateral creditor in terms of its share of total bilateral debt which has significantly increased from 30 percent in December 2010 to 52 percent in December 2011. PRC is followed by India (24% in 2011 from 21% in 2010) and the Kuwait Fund (15% in 2011 from 29% in 2010). Other bilateral creditors include Taiwan (4% in 2011 from 11% in 2010), France (4% from 9% in 2010) and Belgium (2%).

Chart 3: Multilateral and Bilateral Debt by Creditor – December 2011



Data source: Debt & Aid Division, Ministry of Finance

2.3 Composition of External Debt by Borrower Category

The central Government was the largest debtor or borrower, accounting for 85 percent of the total external debt stock representing a three percentage point increase from 82 percent in 2010. The Reserve Bank of Malawi (RBM) accounted for 14 percent of the total debt stock, a significant decrease from 17 percent in 2010. This decrease was largely a reflection of the suspension of disbursements by IMF under the Extended Credit Facility (ECF). Other public corporations accounted for only 1 percent of the total external debt (Table 1).

Table 1: External Debt Stock by Borrower Category (in % of DOD)

Borrower	**2001**	**2002**	**2003**	**2004**	**2005**	**2006**	**2007**	**2008**	**2009**	2010	2011
Central Government	95.7	95.4	95.6	96.2	96.8	93.8	92.9	81.4	83	82	85
Reserve Bank	2.9	3.4	3.4	2.9	2.6	4.5	5.75	18.5	16	17	14
Public Corporation	1.4	1.2	1.1	0.9	0.6	1.7	1.35	0.1	1	1	1
Total	**100**	**100**	**100**	**100**	**100**	**100**	**100**	**100**	**100**	**100**	**100**

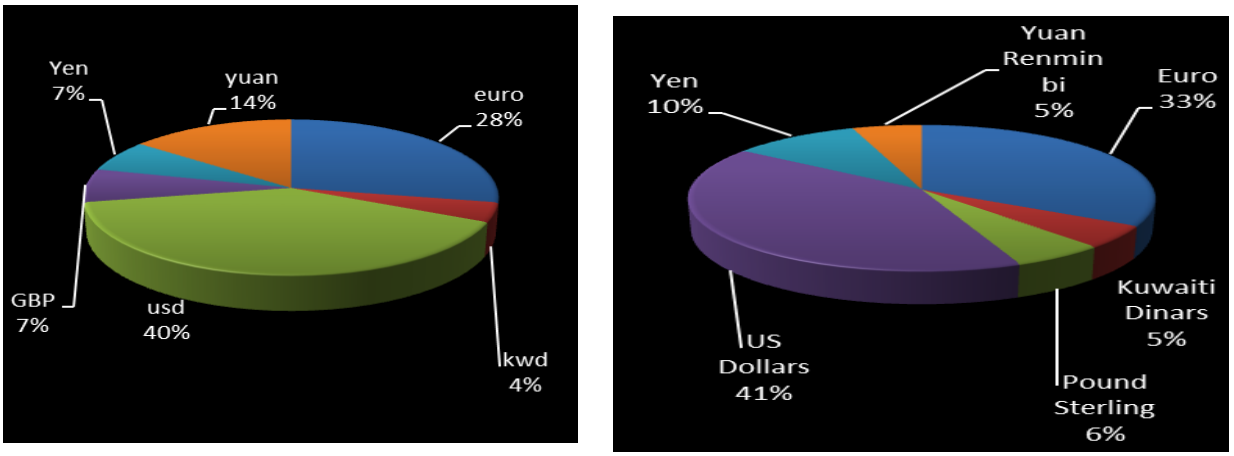
Source: Debt and Aid Division, Ministry of Finance

2.4 Currency Composition of External Debt

Most of Malawi`s external debt stock is denominated in Special Drawing Rights (SDR). SDR is a basket of four currencies namely; United States Dollar (USD), Euro (EUR), British Pound Sterling (GBP) and Japanese Yen (JPY) whose proportions are 41.9 percent, 37.4 percent, 11.3 percent and 9.4 percent, respectively. After decomposing the Special Drawing Rights, the USD and Euro are the dominant currencies, accounting for 40 percent and 28 percent of Malawi`s external debt stock, respectively. The GBP and Yen take up 7 percent each. Other currencies in which the country's external debt is denominated include the Chinese Yuan (14%) and Kuwait Dinar (4%). The currency composition has generally remained the same over 2010 and 2011 save for the Chinese Yuan which has displaced the Japanese Yen on the third ranking after the USD and EUR (Chart 4).

Chart 4: Currency Composition of External Debt in percentage of total

December 2011 *December 2010*



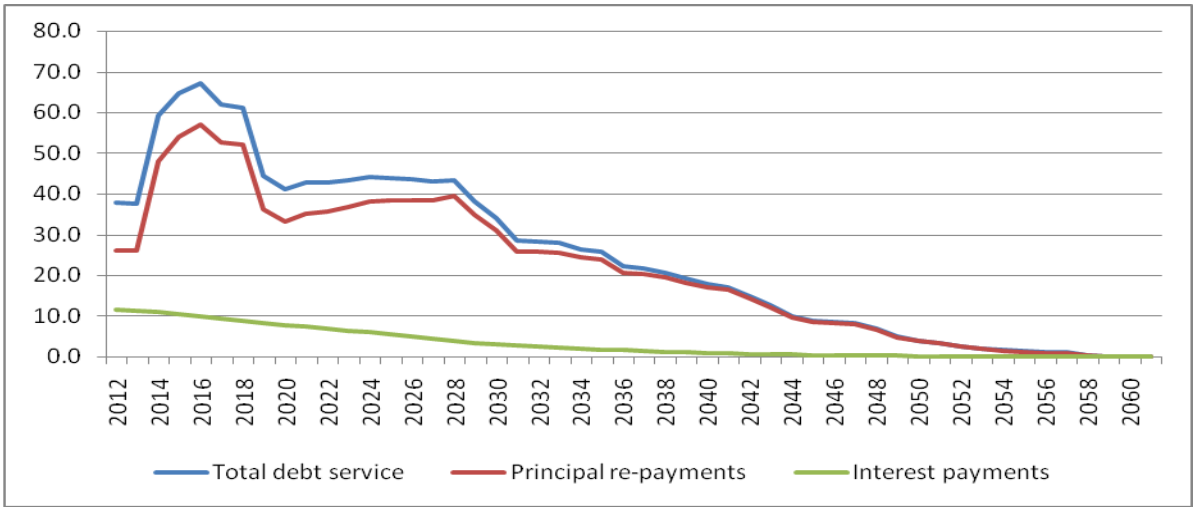
Data source: Debt & Aid Division, Ministry of Finance

2.5 Maturity Profile and Interest Rate Structure of External Debt

The maturity structure of external debt indicates that most of Malawi's external debt has maturity of more than 10 years. In fact, 96 percent of external debt has a remaining maturity of over 10 years while loans with maturities between 6-10 years account for 3 percent and only 1 percent mature between 1-5 years. This suggests that the Government does not have external debt repayment vulnerabilities in the short-term since most of the debt will be repaid over the long term (Chart 5).

The external debt portfolio has fixed interest rate instruments with an average interest rate of 1.5 percent. This low fixed rate structure hedges the external portfolio against risks associated with movements in floating interest rates.

Chart 5: Redemption/ maturity profile of external debt (Millions of US$)



Data source: Debt & Aid Division, Ministry of Finance

2.6 Trends in Domestic Debt Stock

Domestic debt constitutes borrowings in Malawi Kwacha (MWK) from the Reserve Bank of Malawi, commercial banks, non-bank financial institutions, corporate sector, foreign investors and the private sector. The stock of domestic debt amounted to K203.68 billion (US$1.24 billion) as of end-2011 compared to K153.72 billion (US$1.014 billion) in 2010. As a percentage of GDP, total domestic debt increased from 19 percent in 2010 to 20 percent in 2011. The increase was on account of borrowing to cover for shortfalls in donor financing and poor revenue collection.

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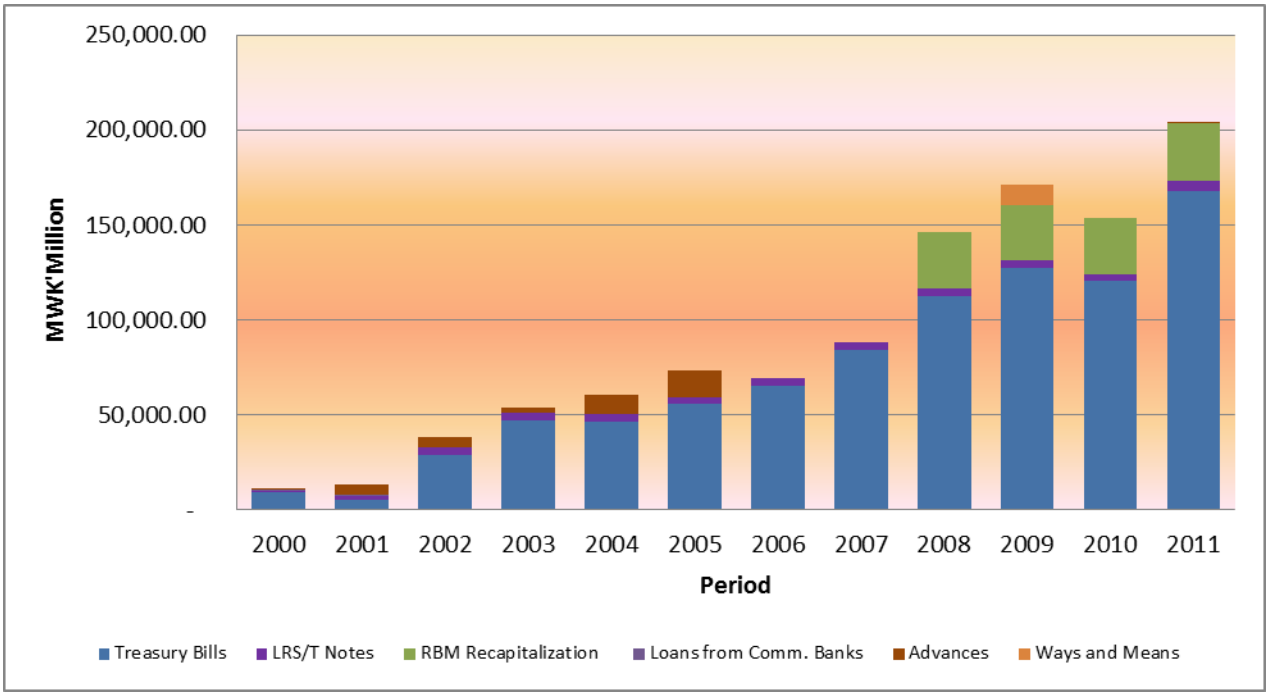
2.7 Composition of Domestic Debt

The instruments that are used to contract domestic debt in Malawi are Local Registered Stocks (LRS) which are split between Treasury Notes (with less than 10 year maturity period) and Bonds (more than 10 year maturity period); Ways and Means, which is a direct advance from the Reserve Bank of Malawi, and Treasury Bills. These instruments are mainly used for fiscal policy other than monetary policy. Although the Government has been borrowing through ways and means advances, the outstanding balance has been zero at the end of the year because of the policy of either repaying or converting the advances to TBs (chart 2.5). The other issue worth noting is that from December, 2011 Government introduced Treasury Notes of maturity periods 2, 3, 4 and 5 years.

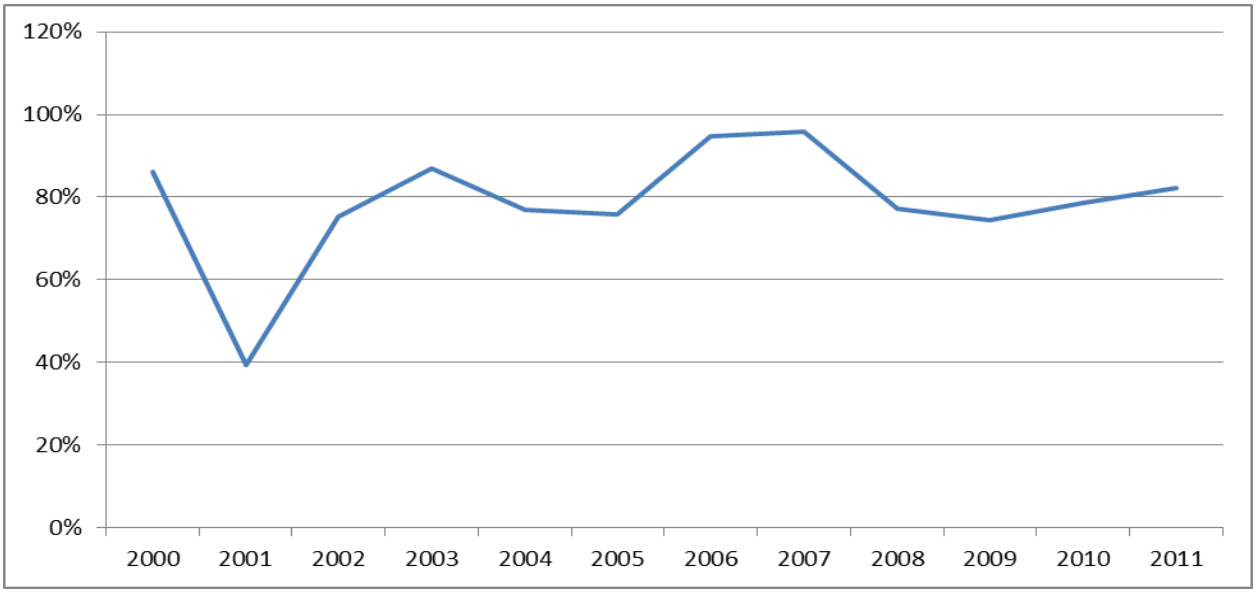
Chart 6: Composition of Domestic Debt by Instrument, 2000 – 2011



Data source: Debt & Aid Division, Ministry of Finance and Reserve Bank of Malawi

The bulk of domestic debt is in the form of Treasury Bills (T-Bills). The proportion of treasury bills in total domestic debt has averaged about 79 percent over the past 11 years (Chart 2.6). This is a reflection of the shallow domestic debt market in the economy. There was a reduction of this ratio in 2008 as the Government issued Treasury Notes to recapitalise the Reserve Bank of Malawi. However from 2009 the proportion of T-Bills has been on an increasing trend.

Chart 7: Ratio of Treasury bills to Total Domestic Debt: 2000-2011

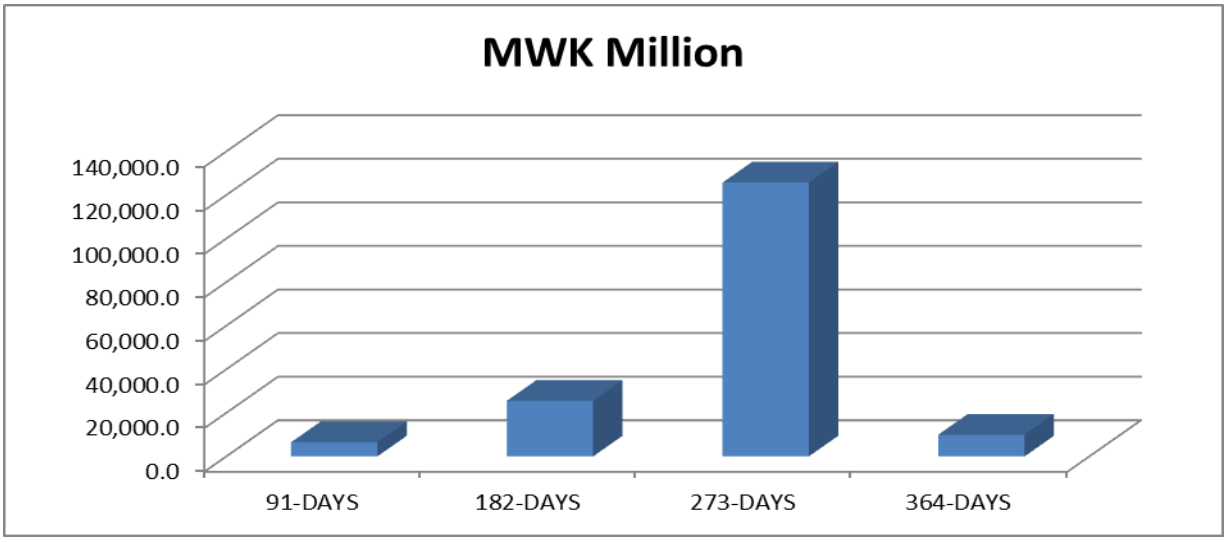


Data source: Debt & Aid Division, Ministry of Finance and Reserve Bank of Malawi

2.8 Treasury Bills by Tenor

Government through the Reserve Bank of Malawi issues Treasury Bills (TBs) through auctions in three tenors of 91days, 182 days and 364 days. The Government used to issue a 273 days TB but with the policy of increasing the maturity profile this TB has been replaced by the 364 days TB. A large percentage of TBs are in the 273 days tenor. The increase in the volume of the 273-day tenor is also a reflection of conversions from ways and means advances. The policy is that ways and means advances are converted to the longest tenure TB and for the past years this used to be the 273 days TB. With the phasing out of this tenure in November 2011 and subsequent introduction of the 364 days treasury note, conversions are being made to the 364 day TB. It is expected that the stock of the 364 day TB will rise with time.

Chart 8: Treasury Bills issues by tenor: December 2011

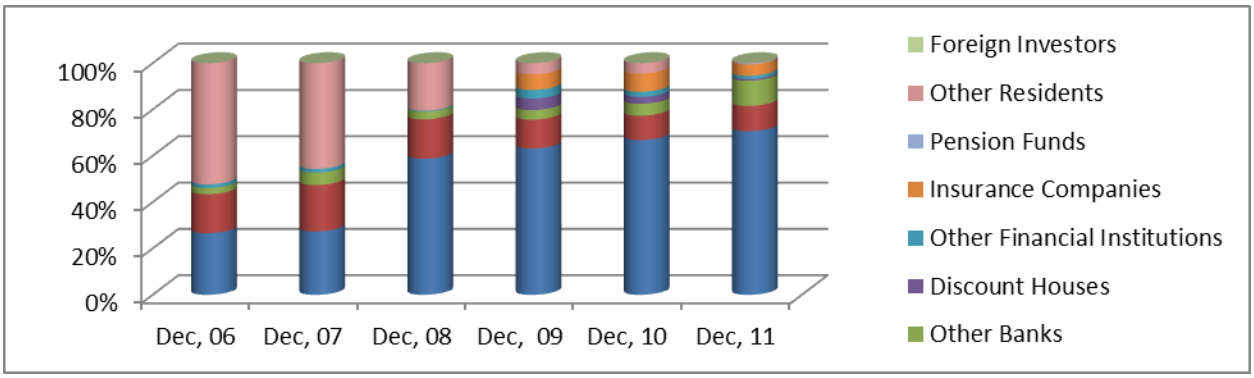


Data source: Debt & Aid Division, Ministry of Finance and Reserve Bank of Malawi

2.9 Treasury Bills by Holding Category

As of December 2006, the Reserve Bank held 27 percent of total Treasury Bills. By December, 2011 the percentage had increased to 71 percent. The increase was mainly due to conversion from Ways and Means advances into Treasury Bills. However holding of Treasury Bills by insurance companies and pension funds has been on the increase. The increase in holding by pension funds can be attributed to the introduction of treasury notes in December, 2011. Furthermore, the holding by pension funds is expected to increase further with the enactment of the Pension Bill into law that will avail more funds to the pension funds.

Chart 9: Treasury Bills issues by sector: 2006-2011



Data source: Debt & Aid Division, Ministry of Finance and Reserve Bank of Malawi

2.10 Risks to Domestic Debt

The main risk to domestic debt sustainability is that over 75 percent of domestic debt stock is in the form of treasury bills which mature in less than one year. The limited diversity of financing

instruments and their very short-term maturities, combined with the shallow debt markets, entail substantial exposure to refinancing risk, interest rate risk, and other fiscal risks.

The other risk is the high Reserve Bank holding of treasury bills. This indicates high central bank financing of the Government budget thereby crowding out the private sector.

2.11 Financial Sector Analysis

The financial sector is analysed using several ratios including M2[1] to GDP; Total Financial Assets to GDP; and Credit to Private Sector to GDP.

M2/GDP (%): This ratio measures the level of financial sector depth. Financial Sector depth is a necessary aspect for economic development. A developed financial sector is likely to result into improved resource mobilization and allocation. A shallow financial sector is likely to result into insufficient demand for Government domestic debt instruments.

Malawi's financial sector still remains underdeveloped although efforts to improve are being made as evidenced by the enactment of various financial sector reform bills. The table below indicates progression towards a more vibrant financial sector. This is shown by M2 as a percentage of GDP increasing from 23 percent in 2008 to 33 percent in 2011.

Total Financial Assets/GDP: This ratio measures the level of financial assets intermediation by the financial institutions. It reflects the level of easiness and ability of financial institutions of converting deposits into loans to the private sector so as to accelerate development.
As observed in the Table below, the ratio of Total Financial Assets as a percentage of GDP rose to 48 percent in 2011 from 37.3 percent in 2008. The ratio is reasonably high and implies that financial institutions in Malawi are relatively able to convert their deposits and lend out to the private sector for economic activity and economic development.

Credit to Private Sector/GDP: As observed in the Table below, Malawi's ratio of credit to private sector at 18.4 percent by the end of 2011 from 11.3 percent in 2008 is still fairly low although progressing, implying poor influence on commercial activities by the financial sector.

Despite having a Total Financial Assets/GDP which is higher than M2/GDP, Malawi's financial market still remains fragile. A health path for financial sector development should always portray increasing trends in both financial sector development and financial sector level of intermediation which should be realized from increasing M2/GDP and Total Financial Assets/GDP**.**

[1] M2 (broad money) includes Quasi Money (foreign currency denominated accounts plus time and savings deposits) and Narrow Money (demand deposits and currency in circulation).

Secondly, a considerably high degree of **M2/GDP** entails that a certain amount of liquidity, necessary for economic development is available in the system. However, increasing the ratio **M2/GDP** implies that M2 is growing faster than GDP, a condition which is likely to result into inflation. However, such is not a case where economic growth is steady and inflation is low. It is therefore imperative that to have a steady economic growth in order to curb the adverse effects that increasing M2 is likely to bring along. This can also be achieved where money demand and money supply are growing at the same level necessary to equalize money demand and M2 by enhancing financial sector development that will in turn result in an increase in demand for money.

Table 2: Financial Sector Development Ratios

SELECTED FINANCIAL DEVELOPMENT INDICATORS FOR MALAWI				
Macro-indicators	**2008**	**2009**	**2010**	**2011**
GDP per capita PPP (US$)	326.5	372	387	420.2
M2/GDP (%)	23	24	29	33
Banking Sector Domestic Credit to PVT sector/GDP (%)	11.3	13.4	17.8	18.4
M2/GDP (%)	23	24	29	33

Data source: Reserve Bank of Malawi

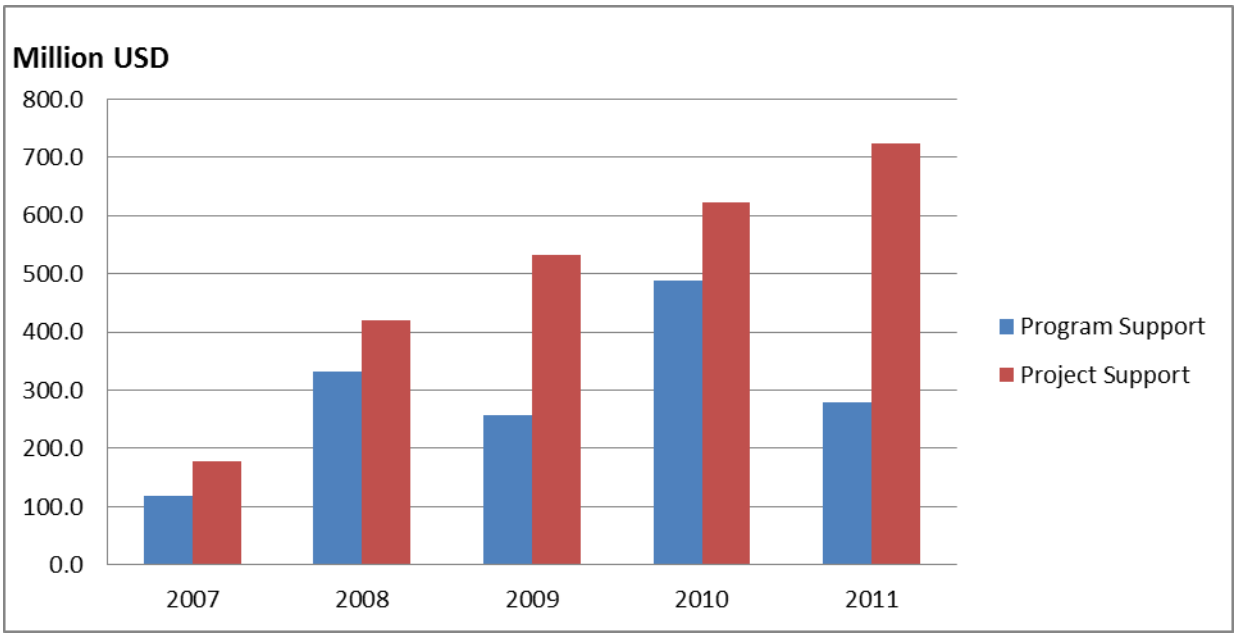
CHAPTER 3

REVIEW OF EXTERNAL FINANCE PORTFOLIO

3.1 Types of Assistance

Of the total development assistance that Malawi receives, a larger proportion is in form of project support compared to program support even though programme support is the preferred type of assistance for the Government of Malawi. Recent trends (as shown in chart 3.1 below) indicate that programme support has always been below project support and has been fluctuating while project support is increasing at a steady rate. This could be attributed to misalignment of policies and procedures between development partners and government with the former preferring project support as opposed to the latter's preferred programme support. For instance, in 2011 program support dropped significantly due to withholding of general budget support and health sector support by development partners as a result of economic and governance concerns. The increase may also be explained by the increased borrowing from the People's Republic of China and other bilateral non-traditional creditors for projects.

Chart 10: Trend of disbursements by type of support 2007-2011 (US$ million)



Data Source: Debt and Aid Division, Ministry of Finance

3.2 Projected External Financing

Future external financing is expected to rise as a result of increased pledges/commitments from existing development partners due to the reforms that the Government has embarked on since April 2012. The rise will also be attributed to the increasing support from non-traditional development partners such as India and China as well as the Preferential Trade Area (PTA) Bank.

Program support is expected to increase in the medium term and going forward, *ceteris paribus*, due to the approval of the new three-year Extended Credit Facility (ECF) program by the IMF which accounts for more than 19 percent of the total projected inflows from all creditors in the medium term. In addition, General Budget Support is expected to increase at least for the next three years as evidenced by increased commitments from the European Union (EU), African Development Bank (AfDB), World Bank, and Norway. Malawi also expects increased support through the Sector Wide Approaches (SWAps) and project support from the traditional development partners.

It is also expected that in the long term, the share of less-concessional and commercial borrowing will gradually increase. The main assumption is that, as Malawi develops, the Government could be in a position to access more non-concessional financing.

CHAPTER 4

RECENT ECONOMIC DEVELOPMENTS AND ASSUMPTIONS USED IN THE DSA

4.1 Recent Macroeconomic Performance and Prospects

Malawi's economy experienced a slowdown in real GDP growth in 2011, growing at 4.3 percent from an average of 7.5 percent over the previous 5 years. Real GDP growth is forecast to remain at the same rate for 2012. This slowdown is largely on account of foreign exchange and fuel shortages that hit the economy for the past two years. These developments constrained importation of raw materials, consequently forcing firms to cut back on production.

Inflation averaged 8 percent between 2007 and 2011 and is projected to rise to 18.4 percent in 2012. This is mainly due to the pass through effect as a result of the sharp exchange rate adjustment (devaluation of the Kwacha) in May 2012. Going forward, inflation is expected to slow down to 16.1 percent in 2013 as the Reserve Bank of Malawi implements tight monetary policy. Beyond 2013, it is expected that inflation will decline to single digits and average 6.3 percent between 2014 and 2033.

Table 3: Selected Macroeconomic Indicators, 2007-2012

	2007	**2008**	**2009**	**2010**	**2011**	**2012**
Real GDP (% growth)	9.5	8.3	8.9	6.7	4.3	4.3
Inflation Rate	7.9	8.7	8.4	7.4	7.6	18.4
Exchange Rate	140.0	140.5	141.2	150.5	156.5	230.0
Revenue (excl. grants)	18.5	19.6	22	23.6	21.8	20.6
Expenditure	32.6	37.6	38.4	33.7	32.6	31.8
Overall Balance	-0.4	-6.8	-5.4	-1.4	-4.6	-3.8
Exports	803	950.1	1268.4	1139.2	1530.8	1628.7
Imports	1384.9	1725.1	1809.3	2163.5	2425.4	2546
Gross Reserves in Millions US$	217	239	141	280	190	227
Months of Imports	1.6	1.5	0.9	1.4	0.9	1.0

Data Source: Reserve Bank of Malawi, National Statistical Office, Ministry of Economic Planning Development and Ministry of Finance

Exchange rate developments in the recent past focused on bringing external balance in the economy. After a slight devaluation of the kwacha against the US$ from 140 in 2007 to 156.5 in 2011, the exchange rate was devalued by 46.9 percent to K250 against the dollar in May 2012. Therefore the annual exchange rate for 2012 is expected to average 230 per US$. With the adoption of the floating exchange rate, the kwacha is projected to stabilize against the US dollar in the medium term. In the long term, the value of the kwacha against other currencies will be determined by the inflation differentials between Malawi and her trading partners.

On the fiscal front, domestic revenue to GDP averaged 21 percent between 2007 and 2011. This ratio is higher than the regional averages of less than 20 percent. The domestic revenue to GDP ratio is expected to increase marginally in 2012 and will reach 25.2 percent at the end of the projection period, subject to implementation of reforms in revenue mobilization and increased tax effort.

On the other hand, total expenditure averaged 34 percent of GDP in the previous 5 years, driven by expenditure overruns and revenue shortfalls especially in 2011/12 financial year. Key factors that contributed to the expenditure overruns included purchase of relief items following droughts and earthquakes that hit some parts of the country, activities related to the African Union when Malawi was Chair of the continental body in 2010 and increases in the wage bill brought about by new recruitments in the public service. These developments resulted in increased domestic debt stock to GDP ratio from 17.6 percent to 20 percent of GDP as of end 2011. In the medium to long term government expenditure as a share of GDP is expected to decrease and stabilize at 30 percent. However, in the medium term it is assumed that government will finance its deficits through external borrowing and not domestic borrowing, in line with the agreement reached with the IMF under the ECF programme. Beyond 2017, it is expected that government will borrow domestically partly to finance the budget deficit as well as to develop the domestic debt market.

In the 2011/12 financial year, official transfers to the public sector declined to 5 percent of GDP from an average of 10 percent between 2006 and 2011. This was largely due to the suspension of budget support as discussed above. In the medium term, grants are expected to rise to 9.8 percent of GDP in 2012/13 financial year and thereafter to decrease gradually to 5.8 percent of GDP by 2017. The long term will be characterized by continued decrease in grants to an average of 4.1 percent in 2033. This decrease will be driven mostly by budget support which is expected to decrease to less than 1 percent of GDP by 2033.

Export growth in the past five years averaged 14.5 percent, anchored by increases in tobacco and mineral exports. During this period exports averaged 21.7 percent of GDP. In the medium term, export growth is expected to increase due to prospects for increased mining activity following the commencement of mining at Kanyika in Mzimba. It is also expected that other efforts to diversify the export base will contribute to the growth of exports. It is projected that exports will average 24.1 percent of GDP. On the other hand, imports are expected to increase as a share of GDP from an average of about 43 percent between 2007 and 2011 to 50 percent in the medium term ie 2012-2016. This will be driven by imports of raw materials as the economy rebounds. However, the ratio is expected to decrease in the long term to about 41 percent. Table 4.2 summarizes the macroeconomic indicators used in the DSA.

Table 4: Summary of Projections for Key Macroeconomic Indicators

Variable	Baseline/IMF Scenario	Government Alter/DSA Scenario
Real GDP growth rate	Average growth rate 6% in real terms from 2012-2017 and 5.7% from 2018 to 2032	Average growth rate 4.7% in real terms from 2012-2017 and 3% from 2018 to 2032.
Inflation rate(GDP deflator)	Average of 9.9% in the period 2012-2017 and 6.3% from 2018 to 2032.	Average of 9.9% in the period 2012-2017 and 6.3% in 2018-2032.
Growth of exports in US dollar terms, in %)	Average of 8.1% in the period 2012-2017 and 10.4% in 2018-2032	Average of 4.5% in the period 2012-2017 and 6.6% in 2018-2032.
Growth of imports in US dollar terms, in %)	Average of 7.3% in the period 2012-2017 and 9.2% in 2018-2032	Average of 5.8% in the period 2009-2014 and 5.7% in 2015-2029
Direct Foreign Investment, as % of GDP	Average of 5.9% in the period 2012-2017 and 4.1% in 2018-2032	Average of 6.2% in the period 2012-201 and 5.2% in 2018-2032
Budget revenue including grants (% of GDP)	Average of 28.5% in the period 2012-2017 and 28.2% in 2018-2032	Average of 29.3% in the period 2012-2017 and 27.2% in 2018-2032
Domestic budget revenue (% of GDP)	Average of 21.6% in the period 2012-2017 and 24% in 2018-2032	Average of 21.7% in the period 2012-2017 and 23.5% in 2018-2032
Expenditures (in % of GDP)	Average of 30.7% in the period 2012-2017 and 30.8% in 2018-2032.	Average of 30.8% in the period 2012-2017 and 30.5% in 2018-2032
Average Grant Element of new external borrowing, in %	Average of 34% in the period 2012-2017 and 33%% in 2018-2033	Average of 34% in the period 2012-2017 and 33% in 2018-2033

4.2 Alternative Scenario

The alternative scenario assumes a lower GDP growth in the event that reforms in the baseline are not implemented as expected. GDP is expected to grow at an average of 4.7% in the medium term and 3% in the long term.

Relatively low GDP growth in the long term is projected to lead to reduced revenue outturn, which in turn increases the fiscal deficit to an average of 3.2% of GDP in the period between 2016 and 2033. The scenario might be further worsened by reduced aid flows, which are expected to average around 3.5% in the same period. In the medium term, deficits are financed by foreign borrowing while in the long term they are financed by both domestic and foreign borrowing.

Downside risks for both the baseline and the alternative scenarios include external shocks, erratic weather conditions and shortfalls in aid flows.

CHAPTER 5

RESULTS OF DEBT SUSTAINABILITY ANALYSIS

5.1 Debt Sustainability Analysis Methodology

The IMF/World Bank Debt Sustainability Framework (DSF) for low income countries was used to assess Malawi's debt sustainability. The DSF, a standardised framework for analysing debt related vulnerabilities, aims at monitoring the evolution of country's debt burden indicators, help detect potential crises in borrower countries and provides guidance to creditors to lend and allocate grants to low income countries. It consists of a set of indicative policy dependent thresholds against which baseline scenario projections of external debt burden indicators are compared in order to assess the risk of debt distress.

The DSF links a country's risk of debt distress and grant eligibility to the quality of its policies and institutions as assessed by the World Bank. Countries are rated on the quality of their policies and institutions using the World Bank's IDA Resource Allocation Index (IRAI) scores, formally known as Country Policy and Institutional Assessment (CPIA). Debt distress is determined by comparing debt indicators under baseline and alternative scenarios with appropriate thresholds. Table 4 below presents the specific thresholds.

Table 5: Thresholds under Debt Sustainability Framework

Debt Sustainability Indicators	**IDA Resource Allocation Index (IRAI) / CPIA**		
	Strong	Medium	Weak
	(IRAI ≥ 3.75)	(3.25 < IRAI <3.75)	(IRAI ≤ 3.25)
PV of Debt/GDP	50%	40%	30%
PV of Debt/ exports	200%	150%	100%
PV of Debt/budget revenue	300%	250%	200%
Debt service/Exports	25%	20%	15%
Debt service/ budget revenue	22%	20%	18%

Malawi is classified as a medium policy performer with IRAI rating of 3.4. This implies that the debt burden threshold ratios to be used to assess external debt sustainability are: PV of debt to GDP of 40 percent, PV of debt to exports of 150 percent and PV of debt to budget revenue of 250 percent, debt service to exports of 20 percent and debt service to budget revenue of 20 percent. For a medium policy performer external debt is deemed to be unsustainable if its ratios are above the stated thresholds. In the case where debt service to exports and debt service to budget revenue exceed the threshold of 20 percent, the country is likely to experience liquidity problems to service its debt.

5.2 Results of External Debt Sustainability Analysis

5.2.1. External Debt Sustainability Analysis under the Baseline Projections

In the baseline scenario, all the external debt ratios are projected to be below the country specific debt burden thresholds from 2012 to 2032 (Graph 5). All the solvency ratios show a generally declining trend throughout the projection period. The PV of debt-to-GDP ratio peaks at 21 percent in 2012 and gradually declines to 10 percent in 2032 (Graph 5b), compared to the threshold of 40 percent. The PV of debt-to-Exports ratio slightly rises from 58 percent in 2012 to 61 percent in 2013 before it continuously declines to 34 percent in 2032 (Graph 5c) relative to the threshold of 150 percent. The PV of debt-to-Revenue ratio continuously declines from 99 percent in 2012 to 41 percent in 2032 (Graph 5d) compared to the threshold of 250 percent. The projected low solvency ratios vis-a-vis the agreed thresholds are based on the assumption of prudent external borrowing and projected improvements in macroeconomic performance, including real GDP growth, exports and domestic revenues.

Similarly, DSA results show that the external debt liquidity ratios would fall far much below their thresholds of 20 percent throughout the projection period. The debt service-to-exports ratio (also known as the debt service ratio) is projected to be 2.2 percent in 2012 and will fluctuate up to 2018 (with a peak of 3.1% in 2014) before it gradually declines to 1.9 percent in 2032. The debt service-to-revenue ratio is projected to rise slightly from 3.7 percent in 2012 to 4.3 percent in 2014 before it gradually declines to 2.2 percent in 2032. These low liquidity ratios suggest that the country is not expected to face any liquidity challenges in servicing its debt.

5.2.2 External Debt Sustainability Analysis under the Alternative (Historical) scenario

The historical scenario assumes that the key macroeconomic variables would remain at their historical averages (2001-2011) in the projection period of 2012-2032. These variables include real GDP growth, GDP deflator (in U.S. dollar terms), non-interest current account in percent of GDP, and non-debt creating flows. Under this scenario, the debt sustainability analysis results indicate that all the external debt ratios are projected to remain significantly below their respective thresholds during the projection period (Graph 5). However, the solvency ratios would be considerably higher and more fluctuating compared to the baseline scenario (Graph 5b,c,d). For example, the ratio of the PV of debt to GDP is projected increase to a peak of 20.2 percent in 2017 under the historical scenario compared to 12.4 percent under the baseline scenario. The ratio of the PV of debt to exports also peaks at 71.7 percent in 2018 under the alternative scenario compared to 42.0 percent under the baseline macroeconomic scenario. A similar trend is observed in the ratio of the PV of debt to revenue.

Unlike solvency indicators, the historical scenario leads to a minimal increase in the liquidity indicators during the projection period relative to the baseline. Historically, Malawi has not had liquidity problems associated with external debt.

5.2.3 External Debt Sustainability Analysis under Stress (Bound) Tests

There are six standardised stress (or bound) tests that are used to assess the vulnerability of the external debt indicators to specific macroeconomic shocks, namely:

a) Real GDP growth at historical average minus one standard deviation (SD) in the first two years of the projection period i.e. in 2012-2013;
b) Export value growth is assumed at historical average minus one standard deviation (SD) in the first two years of the projection period;
c) GDP deflator at historical average minus one standard deviation in the first two years of the projection period;
d) Net non-debt creating flows is at historical average minus one standard deviation (SD) in the first two years of the projection period;
e) Combination of four shocks (a to d) at one-half standard deviation (SD) below their historical average in the first two years of the projection period;
f) One-time 30 percent nominal depreciation of the domestic currency in the first year of the projection period i.e. in 2013.

The DSA results show that even under stress tests, Malawi's external debt ratios would remain below their respective thresholds during the projection period (Graph 5). Although the bound tests lead to an increase in all the debt ratios above those obtained under the baseline scenario (Graph 5b - f), none of the thresholds is breached implying low vulnerability of external debt to the shocks. In the analysis, the most critical shocks that yield the highest external debt ratios within 10 years are the combination shock (graphs 5c, 5d, 5e, and 5f, exports shock (graph 5c, 5e) and the GDP deflator shock (graph 5f). For instance, the PV-of-debt to GDP ratio peaks at 26.4 percent in 2014 under the stress test compared to 14.8 percent under the baseline scenario. Similarly, the PV-of-debt to exports ratio peaks at 84.1 percent in 2014 under the shock scenario compared to 48.8 percent under the baseline. However, the solvency ratios under the stress tests are projected to be lower than those obtained under the historical scenario beyond 2019. This is expected because the stress tests or shocks are temporary (ie occur in 1-2 years) and therefore are not sustained as compared to the historical scenario above

5.2.4 Determination of External Debt Distress Ratings

External debt distress is determined by comparing debt indicators under baseline and alternative scenarios in the DSF with appropriate thresholds. The classification of low, moderate, high or debt distress is based on the outcomes as shown in Table 3 below. For instance, a country is classified as having a low risk of external debt distress, if all the debt ratios in the baseline and alternative scenarios are below the thresholds for projection period.

Table 2: Debt Distress Ratings

Risk	Baseline	Stress Test	Debt Servicing
Low	All indicators below thresholds	All indicators below thresholds	No arrears
Moderate	All indicators below thresholds	Breach of debt service &/or stock ratios over time	Sporadic arrears
High	Breach of debt service &/or stock ratios over time	Worse breaches over time	Sporadic arrears &/or history of default
Debt distress	Significant or sustained breach of debt service &/or stock ratios		Significant arrears and risk of default unless debt restructuring

On the other hand, a country is classified as high risk of debt distress if one or more of its debt ratios breach the thresholds in the baseline scenario and the situation worsens over time in the alternative scenarios. These ratings will be used in the following section to determine the debt distress rating for Malawi.

Based on the results of external debt sustainability analysis presented above, Malawi is classified as having a **low risk** of debt distress since all the debt indicators are projected to remain below their respective thresholds under the baseline and alternative (historical + bound/stress tests) scenarios. In addition, there is no breach of any of the debt stock ratios over time under the stress scenarios.

5.3 Results of Domestic Debt Sustainability Analysis

Unlike external debt, there are no internationally agreed thresholds for domestic debt sustainability. The IMF considers domestic debt is considered to be significant if the ratio of nominal debt to GDP ratio is below the range of 15-20 percent. The DSA found that the ratio of Malawi's total nominal domestic debt stock to GDP was 20 percent in 2011 which is the critical range. Excluding the debt which was issued for recapitalisation of the Reserve Bank of Malawi, the ratio of domestic debt to GDP is projected at 15 percent which is still significant.

5.4 Results of Public Debt Sustainability Analysis

Public debt sustainability analysis focuses on total external and domestic debt. Three ratios were used to assess the sustainability of total public debt: PV of debt-to-GDP, PV of debt-to-Revenue, and debt service-to-Revenue. The DSF for LICs, which all along has had no internationally agreed thresholds for the three ratios, is currently under review. In the revised framework, the threshold for the PV of debt-to-GDP is 56 percent. For the other two ratios qualitative judgment is applied based on their levels and trends in the projection period.

a) Baseline Scenario

The results of the DSA show that Malawi's public debt is expected to remain at manageable levels throughout the project period under the baseline scenario (Figure XXX). The PV of debt-to-GDP ratio is projected to decline from 35 percent in 2012 to 24 percent in 2032 which is significantly below the 56 percent threshold. Similarly, the PV of debt-to-Revenue ratio is expected to decline from 121 percent in 2012 to 84 percent in 2032. These trends in the solvency ratios suggest that the country's total public debt is expected to be manageable for the next 20 years should key macroeconomic indicators behave as projected. However, the DSA results indicate that the debt service-to-Revenue ratio is expected to initially decline from 16 percent in 2012 to 10 in 2014 and thereafter to gradually increase to 20 percent in 2032 (Graph...). The reason for the initial decline is the assumption of zero net domestic financing during 2012-2016 in line with the IMF programme. Thereafter, the ratio increases because it is assumed there will be some domestic borrowing.

b) Alternative Scenario

The public DSA (PDSA) comprises 3 alternative scenarios, assuming permanent shocks to the baseline over the entire projection period. The first is the historical scenario which assumes that the primary balance-to-GDP ratio and real GDP growth are set to their historical averages. The second scenario assumes that the primary balance-to-GDP ratio is set to the last year of history while the third assumes that Real GDP growth is lowered by a fraction of its standard deviation during the projection period 2012-2032.

Under all the alternative scenarios above, the public debt ratios are projected to be higher than those under the baseline in the medium term (2012 – 2016) and they decline thereafter. This behaviour reflects the assumption of some modest domestic borrowing from 2017, resulting into a higher primary deficit compared to 2012-2016. In addition, the real GDP growth projections (2012-2032) are lower compared to the historical averages.

c) Stress/Bound Tests

There are five standardised stress (or bound) tests that are used to assess the vulnerability of the public debt indicators to specific macroeconomic shocks, namely:

a) Real GDP growth (B1) is set to its historical average minus one standard deviation.
b) The primary balance-to-GDP ratio (B2) is set to its historical average minus one standard deviation.
c) Combination of B1 and B2, where each shock is reduced only by 0.5 standard deviations.
d) One-time nominal depreciation of 30 percent (first year of the projection).
e) One-time increase of public debt by 10 percent of GDP (first year of the projection).

Under stress tests, the DSA results indicate that the public debt solvency ratios are projected to be higher than in the baseline, suggesting that Malawi's public debt is vulnerable to a number of

shocks. The results suggest that Malawi's public debt is more vulnerable to shocks in real GDP growth and primary balance.

5.5 Comparison with IMF Debt Sustainability Analysis Findings

The above results are generally similar to the findings of the DSA which was conducted by the IMF as part of the Article IV consultations with the Malawi Government. The direction of the debt ratios under the baseline are similar to the ratios obtained under IMF DSA.

However, the IMF concluded that Malawi has a **moderate risk** of external debt distress whereas Government's conclusion is that Malawi has a **low risk** of external debt distress. Under the IMF DSA, the PV of debt-to-exports – breaches its threshold of 150 percent in 2013 – 2018 and falls below the threshold thereafter on account of an export shock. In addition, the PV of debt-to-GDP ratio is exceeded from 2020 to the rest of the projection period under the historical scenario. The IMF case is explained by the fact that historical figures used in the analysis of future debt sustainability assumed a significantly lower GDP growth rate which worsens the debt dynamics. However, this assumption is considered to be overly pessimistic given that Malawi's real GDP growth rate averaged nearly 6 percent over the last decade. Nevertheless the IMF DSA results highlight the risks to Malawi's debt sustainability going forward.

On total public debt, the findings of the DSAs conducted by the IMF suggest that Malawi's public debt would remain manageable throughout the projection period under the baseline scenario, which is broadly similar to the results of the Government DSA. The PV of debt-to-GDP would decline from 45 percent in 2012 to 11 percent in 2032, whereas the PV of debt-to-Revenue ratio would decline from 138 percent in 2012 to 28 percent in 2032.

However, for the liquidity ratio of debt service-to-Revenue ratio, the IMF DSA results indicate that this ratio would continually decline from 9 percent in 2012 to 3 percent in 2032 contrary to Government DSA findings that this ratio is projected to increase steadily from 16 percent in 2012 to 20 percent in 2032. This discrepancy is explained by the fact that the IMF assumed a sustained no net domestic borrowing policy throughout the period whereas Government assumed some net domestic borrowing in the longer term hence the increasing trend in the ratio.

CHAPTER 6

CONCLUSION AND POLICY RECOMMENDATIONS

6.1 Summary of DSA findings

The debt sustainability analysis for external and total public debt was conducted using the IMF/World Bank DSF for Low income Countries (LICs). For domestic debt, the analysis used the IMF thresholds to assess sustainability of Malawi's domestic debt.

On external debt, the findings of the DSA suggest that Malawi's external debt is projected to remain highly sustainable for the next 20 years (2012 – 2032) under the baseline scenario. All the external debt ratios (both solvency and liquidity ratios) are projected to remain significantly below their respective policy dependent thresholds. The external DSA results further suggest that all the external debt ratios would still remain below their thresholds under shocks suggesting a low risk exposure of the country's external debt portfolio. Although the risk to external debt distress is low, there is for Government to pay attention to the export shock as well as shocks to GDP growth, the GDP deflator and non-debt creating flows to which Malawi's external debt is exposed.

On domestic debt, the DSA findings suggest that the country's domestic debt stock of MK203 billion in December 2011 (20% of GDP) is on the border line of sustainability. Even when the share of recapitalization of the central bank (RBM) is excluded from the debt stock, the residual amount which is equivalent to 15 percent of GDP is still on the border line of sustainability based on the IMF threshold of below 15 – 20 percent of GDP. This implies that any significant accumulation of domestic debt would push the domestic debt stock to unsustainable levels.

On total public debt, the results of the DSA suggest that Malawi's public debt is projected to be manageable throughout the projection period (2012 – 2032). The solvency ratios (PV of debt-to-GDP; PV of debt-to-Revenue) show a continuously declining trend. However, the liquidity ratio – debt service-to-revenue ratio – indicate a gradual/moderate increase of up to 4 percent of GDP by the end of the period. This reflects the influence of domestic borrowing and interest payments beyond the medium term.

The stress tests suggest that Malawi's total public debt is vulnerable to a number of shocks as indicated by higher public debt ratios compared to the baseline. A combination of shocks, including real GDP growth and a primary balance at their historical averages may lead to a quick and significant departure from public debt sustainability.

6.2 Policy Recommendations

In view of the findings of the DSA as summarized above, the Government will consider implementing the following recommendations:

a) In order to avoid future external debt problems, Government should ensure that external borrowing operations are managed prudently. New external financing should be guided by set limits in terms of both level of concessionality as well as annual borrowing ceilings which could be in nominal amounts or as a percentage of some variable such as GDP. Monitoring of the evolution of external debt indicators should be undertaken regularly to ensure adherence to an approved new borrowing strategy.

b) In order to minimise the impact of shocks to which Malawi's external and public debt portfolios are exposed that include shocks to exports, real GDP growth, primary balance and a combination of shocks, Government may need to increase its efforts to diversify its export base and sustain fiscal prudence so as to keep the primary balance under control.

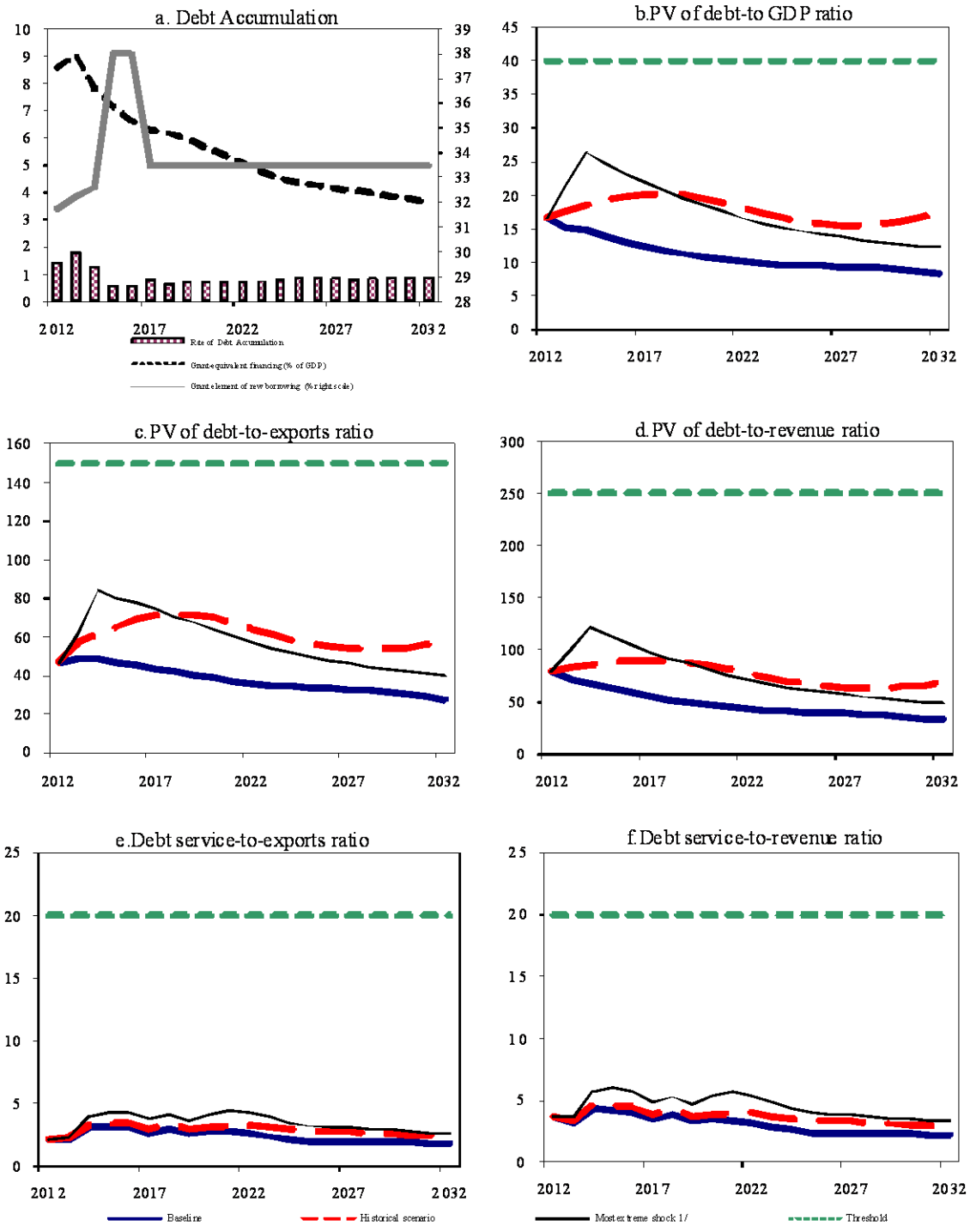
c) The Government may need to consider developing a medium term debt strategy that is consistent with the strategies assumed in the DSA exercise to ensure that the risks associated with the existing debt strategy and the planned new borrowing are clearly articulated and understood.

d) Since the domestic debt stock has already reached the borderline of sustainability, Government should endeavour to exercise restraint in new domestic borrowing. The key to limiting domestic borrowing is sustained fiscal discipline.

e) In order to minimize risks associated with the current structure of the domestic debt portfolio, Government should also consider:

    i. restructuring/ lengthening the maturity profile of the domestic debt portfolio through issuance of long term debt instruments such as treasury notes/bonds. This should aim at distributing maturities over the years systematically;
    ii. converting the large holding of treasury bills by RBM to longer dated instrument/s to minimize refinancing risk;
    iii. reducing the ceiling of ways and means from the current 20 percent of the current budgeted domestic revenue as stipulated in the Public Finance Management (PFM) Act to some lower percentage of the previous budget's domestic revenue.

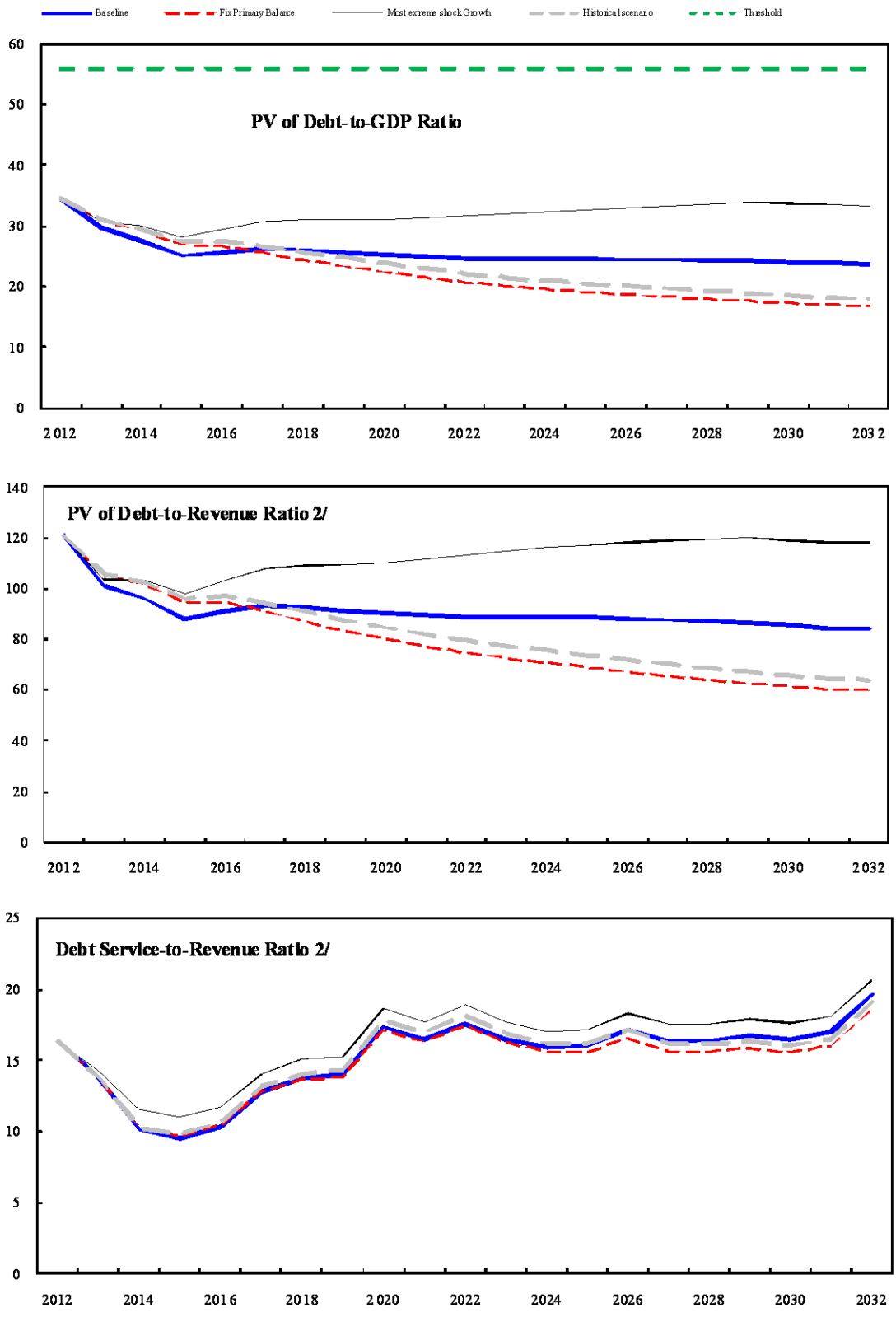
Figure XXX. Malawi: Indicators of Public and Publicly Guaranteed External Debt under Alternatives Scenarios, 2012-2032 1/



Sources: Country authorities; and staff estimates and projections.

1/ The most extreme stress test is the test that yields the highest ratio in 2022. In figure b. it corresponds to a Combination shock; in c. to a Exports shock; in d. to a Combination shock; in e. to a Exports shock and in figure f. to a Combination shock

Figure XXX.Malawi: Indicators of Public Debt Under Alternative Scenarios, 2012-2032 1/



Sources: Country authorities; and staff estimates and projections.
1/ The most extreme stress test is the test that yields the highest ratio in 2022.
2/ Revenues are defined inclusive of grants.