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Pitfalls of "Automatic" Donor Co-Ordination

The Malawi Experience 2000 - 2004

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Pitfalls of “Automatic” Donor Co-Ordination

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SUMMARY

In 2000 Malawi embarked on the Poverty Reduction Strategy Paper (PRSP) process, which was interrupted when the programme with the International Monetary Fund went "off track" in 2001, mainly because of higher than programmed government expenditures. As a consequence, but also in part because of governance issues, various donors stopped disbursements of their budgetary support and the financial situation of the Government of Malawi (GoM) deteriorated substantially. In the absence of donor support GoM turned to the internal financial market and increased its internal debt dramatically. A clearly unsustainable situation with very high real interest rates and subsequent high expenditure for GoM internal debt financing resulted in 2003. In this environment donors decided to resume assistance to GoM.

If alternative scenarios are calculated in order to assess how a less drastic reaction by the donor community would have affected Malawi's economic situation, it turns out that the deterioration would have been less substantial if GoM had pursued the same expenditure path as observed.

The development in Malawi from 2000 to 2003 may be interpreted within the framework of "automatic" donor co-ordination. The term "automatic" donor co-ordination in this context is used for a set of official development aid by various donors of which the disbursements are tied one to the other by their respective conditionalities. As the Poverty Reduction and Growth Facility (PRGF) in Malawi went "off track",

- disbursements from the IMF
- disbursements from the World Bank (IDA)
- disbursements (budgetary support) from the European Commission and Great Britain tied to the PRGF
- and disbursements (budgetary support) from Sweden and Norway that were linked to those of the European Commission and Great Britain within CABS

were stopped completely. The bilateral donors could of course have granted waivers to some of their conditionalities in order to continue with some support.

This kind of automatic donor co-ordination may be necessary if an independent evaluation of the situation in the partner country by different donors is difficult due to a lack of donors' resources in the respective country. Even if this kind of analysis were feasible, the response time – through the respective headquarters – is too long for timely reaction. Some of the response time could be shortened and the problem of a lack of

resources could be alleviated if bilateral donors were given the opportunity to accompany IMF missions and to take part in discussions with the partner government. In Malawi this has not been the case up to now. The very nature of the PRSP process implies that more decision-making power for donor structures in the partner country is desirable. Such a shift in responsibilities would facilitate timely reactions by donors in a co-ordinated fashion. The current form of donor co-ordination and current relations between bilateral donors and the IMF imply a risk of "overshooting" if disbursements from a significant number of donors are directly or indirectly linked to the performance of the programme with the IMF. At the moment of agreement on conditionalities between the partner country and bilateral donors the conditionalities of other bilateral agreements are not necessarily known to all the players, and an analysis of the impact of "automatic" co-ordination is not generally undertaken.

Contents

Abbreviations

ACB	Anti-Corruption Bureau
ADMARC	Agricultural Development and Marketing Corporation
CABS	Common Approach to Budgetary Support
DAC	Development Assistance Committee
GDP	Gross Domestic Product
GGCE	General Government Consumption Expenditure
GNI	Gross National Income
GoM	Government of Malawi
HIPC	Highly Indebted Poor Country
IDA	International Development Association
IMF	International Monetary Fund
JSA	Joint Staff Appraisal
ODA	Official Development Assistance
OECD	Organisation of Economic Co-operation and Development
PRGF	Poverty Reduction and Growth Facility
PRSP	Poverty Reduction Strategy Paper
SAF	Structural Adjustment Facility
SDR	Special Drawing Rights
USD	United States of America Dollar

1 Introduction

The international development debate has undergone significant changes during the last decade. The so-called Washington consensus (Kuczynski, Williamson, 2003), often described as a focus on macroeconomic adjustment and stabilization policies, has been extended to include a new approach of institution building. Although some developing economies in fact have done quite well in terms of macroeconomic stabilization, progress on poverty reduction is judged to have been disappointing. The 1980s left a legacy of high levels of indebtedness, and throughout the 1990s one international initiative after another tried to resolve or at least alleviate this problem. When developing countries and international financial institutions agreed on economic policy reforms in the context of loan agreements, it was often felt that the governments lacked real commitment, which was explained by their lack of “ownership.” One of the new instruments to have emerged from the international policy debate is the Poverty Reduction Strategy Paper (PRSP). This new instrument pursues three objectives: (1) Poverty Reduction Strategy Papers must be drawn up by the governments concerned in a participatory process, intended to assure national consensus and ownership. (2) It is hoped that the explicit focus on poverty reduction will improve results in this area. (3) And if the international community accepts a country’s PRSP, a high percentage of outstanding debt will be written off by bilateral and multilateral donors within the HIPC (highly indebted poor countries) initiative. Poverty Reduction Strategy Papers are part of the efforts of the international community to reach the so-called millennium development goals, which with respect to poverty reduction stipulate "To halve, by the year 2015, the proportion of the world’s people whose income is less than one dollar ..." (United Nations, 2000, p.5).

The PRSP should provide a common framework for multilateral and bilateral donors. If this is the case, a common strategy for the national government and the donor community exists. This implies also a gradual shift in donor policies: Instruments of official development aid should move from project aid towards multi-donor programmes and budgetary support. This expected and already observable shift in instruments implies a new demand for coordination and guidance by the national government, and a higher demand for national implementation capacity. The quality of governance must therefore improve, for if not there is a considerable risk that the outcome of efforts from the donor community will worsen: Ownership of policies and a gradual change in the organization of development aid from project aid to multi-donor programmes and budget aid require a minimum quality of national administration and governance, otherwise they will not be successful.

PRSPs may provide a framework for improved donor coordination, as donors choose to finance specific parts of the strategy, thus avoiding a duplication of efforts in some fields and the neglect of other areas important for development. Donors use new instruments for co-ordination, for example sector-wide programmes. These are long term approaches, which are agreed upon by the respective headquarters of donor organisations some considerable time in advance. Within the macroeconomic frameworks included in the PRSPs, inflows of official development assistance (ODA) are one element to help ensure macroeconomic stability. Donor co-ordination plays a crucial role in achieving the amounts programmed. If all goes well, partner government, multilateral and bilateral donors share a common long term vision which allows considerable progress in development and poverty reduction.

The topic of this paper is to explore what happens with donor co-ordination when things do not go well. What happens if one or several donors are not happy with the partner country performance in an environment of increasingly interlinked ODA? If one donor stops disbursements, others may follow, but without the careful assessment of the consequences used for determining ODA inflows in the first place. The experience of Malawi during 2000–2003 is used as a case study of the consequences of interlinked ODA flows in a situation of disrupted aid flows.

Malawi is one of the poorest countries in the world with per capita income of USD 177 (2003). In order to alleviate the needs of the population and to foster economic development, Malawi in the past received substantial official development assistance (ODA). In 1992 ODA disbursements started to decline, and reached around USD 400 million in 2001 (DAC data base). In 2000 Malawi embarked on the Poverty Reduction Strategy Paper process, which was interrupted when the programme with the International Monetary Fund went “off track” in 2001. Various donors stopped disbursements of part of their ODA in the same year, and the financial situation of the Government of Malawi (GoM) deteriorated substantially. In the absence of donor support, GoM turned to the internal financial market and increased its internal debt dramatically. A clearly unsustainable situation with very high real interest rates and subsequent high expenditure for GoM internal debt financing resulted in 2003. In this environment donors decided to resume assistance to GoM.

This study explores the reasons and mechanisms behind the substantial decline in ODA in 2001 and 2002. In order to evaluate the performance of Malawi, regional and historical comparisons are used. Some scenarios are presented that describe the hypothetical consequences of a less drastic donor response to GoM policy slippages. As these are calculations for hypothetical behaviour patterns of the donors and GoM, results depend on the assumptions made in this respect. The study then explores possible lessons from the Malawi experience with respect to donor co-ordination and the decentralisation of ODA disbursement decisions.

2 The History of the Poverty Reduction and Growth Facility (PRGF) and the Common Approach to Budgetary Support (CABS) Group

2.1 Poverty Reduction and Growth Facility

In 2000, the Government of Malawi (GoM) presented a so-called interim PRSP. The International Monetary Fund (IMF) and the World Bank considered this document in their Joint Staff Appraisal (JSA) to be a sufficient basis to begin the process of debt alleviation within the framework of the Highly Indebted Poor Country (HIPC) Initiative. In order to reach the decision point under the HIPC initiative and to receive interim debt relief, Malawi – in line with usual procedures - had to agree on a programme with the IMF that assured sound macroeconomic policies on the part of GoM. In December 2000 GoM and IMF agreed on a set of structural policies and indicators for macroeconomic performance expressed in the Letter of Intent addressed by GoM to the Director of the IMF, and the IMF granted support to Malawi within the framework of its Poverty Reduction and Growth Facility (to the amount of SDR 45.11 million, the equivalent of about USD 64.5 million). The PRGF programme included a series of six-monthly reviews to assess progress of the programme and compliance with the agreed measures. The first formal review was due in mid 2001. However, it became clear after the first quarter of 2001 that macroeconomic performance targets agreed upon with GoM would not be met in mid 2001, and therefore the first review of the PRGF would not be concluded successfully. Thereafter, various IMF delegations visited Malawi in 2001 and 2002.

Despite IMF efforts, Malawi's macroeconomic strategy remained off track because the implementation of fiscal policies was marred by a lack of government spending discipline and premature changes in revenue policy. Government borrowing had resulted in high real interest rates of almost 50 percent, crowding out credit to the private sector. Substantial budgetary resources were diverted to bailing out parastatals - some of which had incurred losses due to previous government instructions to intervene in the market. Also, excessive spending on low priority activities such as internal and external travel together with weak spending discipline contributed to the fiscal slippages. The situation was further exacerbated when the authorities' expectation that an increase in non-tax revenue would offset the loss from a reduction in income tax rates did not materialise and revenue collection weakened due to a decline in the profitability of firms and sluggish import-related taxes.

Box 1: Important Events within the PRSP and PRGF Processes in Malawi

2000, August, Interim Poverty Reduction and Growth Strategy Paper

2000, December, beginning of PRGF

2001, March, Non – Conclusion of first review under the three year Arrangement under the PRGF (PRGF off track)

2001, November/December, CABS members decide to suspend budgetary support to GoM

2002, April, Malawi Poverty Reduction Strategy Paper

2002, July, Poverty Reduction Strategy Paper joint Ida-Imf Staff Assessment

2003, August Malawi Poverty Reduction Strategy Paper Progress Report

2003, September, First review under the three year Arrangement under the PRGF

2003, September, October, Malawi Poverty Reduction Strategy Paper Progress Report joint Ida-IMF Staff Assessment

2003, October, Executive Board of IMF grants extension of PRGF until end of 2004

After the finalisation of Malawi’s full PRSP (Malawi Poverty Reduction Strategy Paper, April 2002), IMF and GoM agreed in mid 2002 on an indicative programme for the second half of 2002 in order to establish a track record which could serve as basis for the completion of the first PRGF review. Once again, this programme failed, and a new programme to establish a track record was agreed upon for the first six months of 2003. The IMF concluded that “Performance with regard to the track–record programme (January – July 2003) was mixed, but broadly satisfactory” (IMF, 2003). While GoM was largely successful in meeting its fiscal targets, it failed to achieve the goals set with regard to monetary reserves. The level of international reserves was very low and interest costs very high. Higher than expected tax collection revenues nevertheless led to a satisfactory outcome with regard to the budget deficit. On the basis of this track record the IMF concluded the first PRGF review (September 2003) and extended the programme until the end of 2004 (October 15, 2003). It was agreed that the remaining undrawn balance of the PRGF (SDR 32.23) would be disbursed in five equal instalments of SDR 6.45 million upon completion of the subsequent quarterly reviews, starting on November 15, 2003.

In September 2002 the IMF granted emergency relief of SDR 17.35 million (USD 23 million) in order to support food imports despite the fact that the PRGF programme was off track at the time (IMF 2002a). The expected disbursements within the framework of the extended PRGF programme will be used in part to pay back this emergency loan.

2.2 Budgetary Support by the World Bank

The World Bank provided budgetary support to GoM within the framework of its structural adjustment facility (SAF). A sum of USD 50 million was disbursed soon after the publication of the Letter of Intent by GoM for the PRGF late in 2000. Further disbursements were not planned at this stage. Because the PRGF went off track, new SAF credits could not be granted by the World Bank. Following the conclusion of the first PRGF review in 2003, the World Bank plans disbursement of a new SAF credit of USD 45 million in two tranches.

2.3 Bilateral Budgetary Support and the CABS - Group

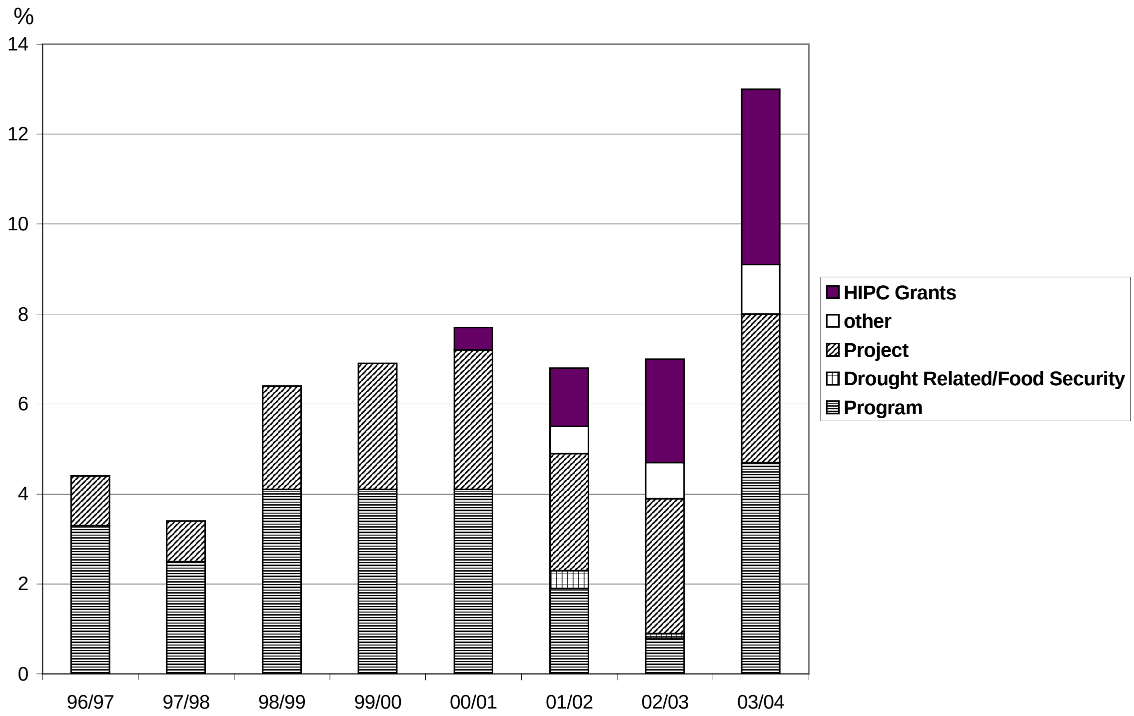
The Common Approach to Budgetary Support (CABS) framework was initiated in May 2000. The members of this group are the European Commission, Norway, Sweden, and the UK. The CABS group publishes an annual review and also holds review sessions between annual meetings. In November/December 2001, CABS members decided to suspend budgetary support to GoM. “This decision was made in view of the Government’s consistent failure to implement agreed economic reforms and follow a sound macroeconomic policy, therefore hampering economic growth necessary for sustainable poverty reduction” (CABS 2001). Before this common decision by the CABS group, the European Commission had suspended its budgetary support in early 2001 due to a lack of accountability for some of its support. The EU and the United Kingdom had linked their budgetary support to the existence of a programme with the International Monetary Fund. Nevertheless governance issues had also led to a critical stance by the British Government towards budgetary support to GoM. In their September 2002 review, CABS members recommended switching from an “all or nothing" approach to a more graduated response ("something for something"). Even then, successful conclusion of the first PRGF review was considered a necessary condition for the resumption of budgetary aid.

In their August 2003 review the CABS group recommended to their respective headquarters that budgetary support to GoM be resumed in tranches, subject to close observation and a PRGF being on track. In autumn 2003, Norway resumed its budgetary support. EU and UK support remained on hold pending the resolution of structural issues. The EU is waiting for an arrears auditing of GoM debt and the UK was not satisfied with Bureau of Corruption legal reform. Structural issues thus remain an obstacle to the resumption of budgetary support by these two important bilateral donors. The probable disbursements of aid by these and other donors may be found in Appendix 1.

2.4 The Consequences of the Non–Conclusion of the First PRGF Review for the Level and Composition of Grants to the Government of Malawi 2001 – 2003

Grants to GoM as a percentage of Gross Domestic Product (GDP) reached their highest level during the budget year 2000/2001. Because of the non-performance of the PRGF and the resulting non-disbursement of budget aid by multilateral and bilateral donors, programme aid (i.e. mainly budgetary and balance of payment support) as a percentage of GDP declined from 4.1 % of GDP in 2000/2001 to 0.8 % of GDP in 2002/2003 - a quite considerable shift in disbursements. As some bilateral donors switched some of their planned budgetary support into project aid, and interim HIPC relief was not suspended, overall grants as a percentage of GDP declined to a much lesser degree. In the budget year 2001/2002 Malawi also received emergency aid to alleviate the consequences of widespread drought, and debt relief was granted by the government of Japan ("other" in Figure 1). Overall grants declined between 2000/2001 and 2002/2003 from 9.1% to 7% of GDP respectively, and HIPC grants as a percentage of total grants rose from 5% to 33% (see Figure 1).

Figure 1: Malawi, Composition of Grants (% of GDP, last year as projected in shadow programme)



Source of data: IMF (2003)

2.5 The Consequences of the Non-Conclusion of the First PRGF Review for the Level and Composition of Concessionary Credits to the Government of Malawi 2001 – 2003

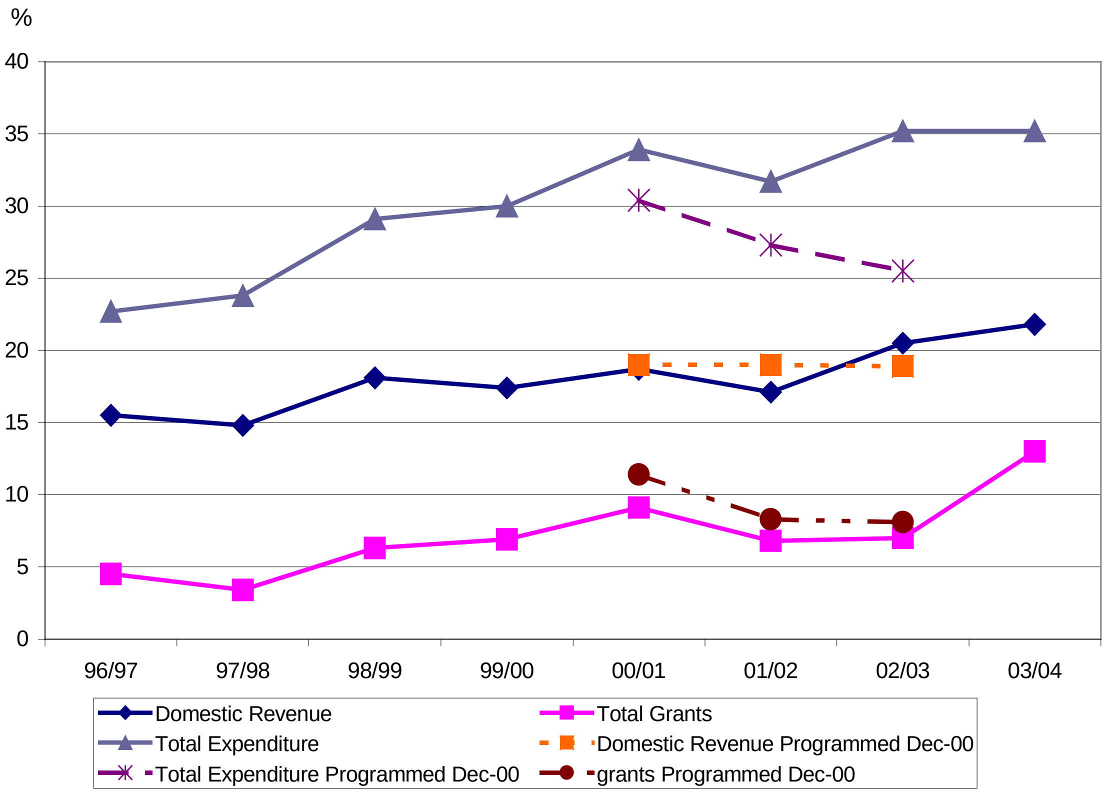
If the PRGF is off track, concessionary financing by the IMF or the World Bank is automatically discontinued. A World Bank credit of USD 50 million was disbursed shortly after the publication of the Letter of Intent by GoM late in 2000, and new credits were planned to be disbursed in late 2003 following the conclusion of the first PRGF review. No new credits could be disbursed during the budget years 2001/02 and 2002/03. Overall net foreign financing declined between 2000/2001 and 2002/2003 from 4.9% to –0.5% of GDP (see Figure 3).

2.6 The Development of Total Government Expenditure in Malawi

Total government expenditure in Malawi as a percentage of GDP increased steadily from 22.9% (budget year 1996/97) to 33.9% (budget year 2000/01), i.e. by roughly 50% (see Figure 2). The donor community considered this a dangerous development, which would eventually lead to a higher level of accumulated GoM debt, as grants by donors could not be expected to continue increasing as in the past, thus rendering debt reduction within the HIPC framework meaningless. This may explain why donors and especially the IMF were reluctant to continue lending as the trend of increasing government expenditures continued in 2000/01, the first budget year of a PRGF agreed with the International Monetary Fund. Part of the increase of government expenditures was due to low priority activities such as internal and external travel; expenditures by the office of the president were also considered by many donors to be excessively high.

The monetary programme of the PRGF projected a decrease of government expenditure from 30% (1999/00) to 25.5% (2002/03), a considerable decrease of nearly 5% of GDP, which would have allowed repayment of internal debt and an increase in foreign exchange reserves. Instead, government expenditures continued to increase in 2000/01 and again in 2002/03. Revenue in 2000/01 turned out as projected and in 2002/03 was even higher than programmed. As already mentioned, grants and foreign financing were much lower than programmed.

Figure 2: Malawi, Realised and Programmed Government Expenditure and Revenue (excluding maize operation)

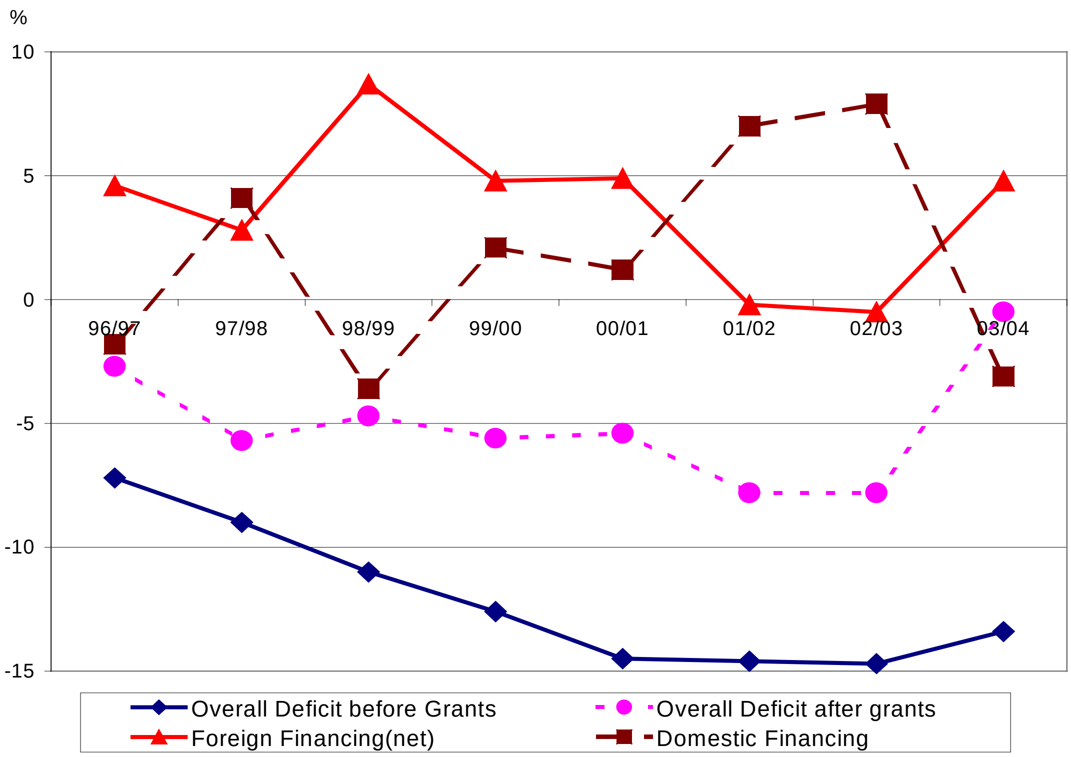


Source of data: IMF (2003)

2.7 The Development of Budget Deficits and Financing in Malawi

Rising government expenditure in a context of constant domestic income and decreasing external financing and grants obviously implies increasing internal financing which reached 7% and 7.9% of GDP in 2001/02 and 2002/03 respectively (see Figure 3). The country's overall deficit before grants, which reflects the growing discrepancy between domestic income and expenditure, rose to nearly 15% of GDP before the PRGF began and stayed constant at this high level from 2000/01 to 2002/03. The extended PRGF projects high grants and the resumption of foreign concessionary financing for 2003/04 which should allow a decrease in the stock of internal government debt in Malawi.

Figure 3: Malawi, Budget Deficit and Financing (without maize operation), 03/04 programmed extended PRGF



Source of data: IMF (2003)

Rising domestic financing led to a high stock of internal debt and an increase in interest rates. At the end of 2002, the internal debt stock of GoM reached nearly 30% of GDP (see Table 1), within the context of annual interest rates of more than 40%.

Table 1: Malawi, Internal Government Debt

	(Kwacha million)	**(Kwacha million)**	**USD million**	**%GDP**
Type	**End June 2002**	**End Dec. 2002**	**End Dec. 2002**	**End Dec. 2002**
Ways and Means	2,034	2,827	36.858	
Treasury Bills	13,257	28,933	377.223	
Local Registered Stock	3,802	3,777	49.244	
Reserve Bank of Malawi Bills	6,924	6,425	83.768	
Total	26,017	41,962	547.093	28.76%

Source: Government of Malawi (2003), p.16

3 A Regional Comparison of General Government Expenditures in Sub Saharan Africa

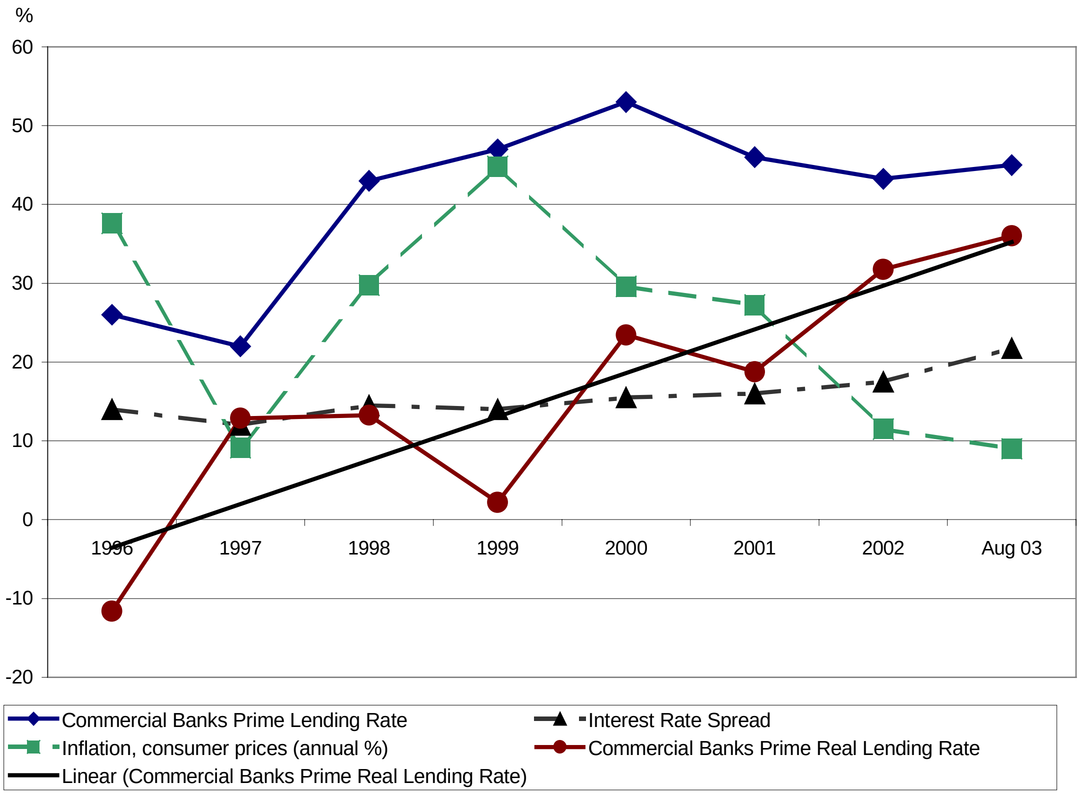
In order to assess if government expenditures by GoM during recent years may be considered high or low in a historical and regional perspective, general government consumption expenditure (GGCE) is used as an indicator, because this indicator includes current expenditures and salaries, but not investments (or so-called development expenditures), thus reflecting the burden which government imposes on society. If Malawi's GGCE as a percentage of GDP is compared to the regional average (Sub–Saharan Africa), it turns out that apart from the extremely high 1995/96 figure, general government consumption expenditure was somewhat lower in Malawi than in the region on average during the 1990s. As from 1999 it started to increase and in 2000 surpassed the regional average. From a historical perspective it may be seen that Malawi had reduced government consumption as a percentage of GDP after 1986, and that the level remained roughly constant between 1991 and 1999 (with the exception of 1995/96) when it started to rise again (see Appendix 2).

It may be that in countries with higher per capita income general government typically consumes a larger share of GDP than in countries with lower per capita income, as the demand for common goods (security etc.) may increase with per capita income. A simple regression between general government consumption as a percentage of GDP and Gross National Income per capita in Sub-Saharan Low Income Countries does not confirm this hypothesis for this region (see regression results in Appendix 2). Therefore a relatively low percentage of GGCE in Malawi cannot be explained by this relationship, and a percentage of GGCE similar as the region’s average cannot be interpreted as too high compared to it’s GNI. Malawi's GGCE at the end of the 1990s therefore does not appear to have been excessively high either from a regional or from a historical perspective. Nevertheless it was growing substantially - a development which alerted the donor community - and the use of funds together with governance issues lead to a critical stance on the part of the donor community.

4 Internal Government Debt, Interest Rates and Inflation

The aforementioned growth of the internal debt stock of GoM led in the context of the country's small financial sector to substantial increases in – nominal - interest rates. The nominal interest rate declined somewhat after the year 2000 – despite the still rapidly increasing stock of GoM internal debt – reflecting a decrease in the inflation rate. Real interest rates nevertheless increased further, continuing the trend observable from at least 1996 (see trend line in Figure 4). From 1996 to August 2003 the real lending rate rose from –10.6% to 36%, a shift of 46.6 percentage points. The size of this shift - which would place excessive strain on the flexibility of the private sector in virtually every country in the world - is due to a combination of increasing internal government debt and declining inflation rates. Inflation rates in Malawi were very volatile in the past, reflecting the instability of the Government's monetary policy.

Figure 4: Malawi, Interest Rates and Inflation



Source of data: Reserve Bank of Malawi (2002, 2003)

Interest rate spreads (i.e. the difference between lending and borrowing rates in the banking sector) also increased during the observation period, with an acceleration of growth of interest rate spreads after 2000. One interpretation of the growth of the spreads in an environment of expanding government borrowing refers to joint price-fixing behaviour in Malawi's financial sector. This small cartelised sector may increase lending rates due to the inelastic demand of GoM, but not borrowing rates because of the monopsonistic position of the financial sector in this market (i.e. general public has few alternatives to bank deposits). Lower government borrowing in the future may thus increase competition in the financial sector and lead to lower interest rate spreads, thus reinforcing the decline of real lending rates. If the Malawi financial sector is acting as a cartel, competition policy measures and the facilitation of international competition could lead to an additional lowering of interest rate spreads which would foster Malawi growth perspectives. Another reason for high spreads is the – high - liquidity reserve rate (30% in 2002). This rate was necessary in order to prevent inflation from rising as a result of high levels of government expenditure. As this rate may come down in the future, spreads could shrink.

5 Governance Issues

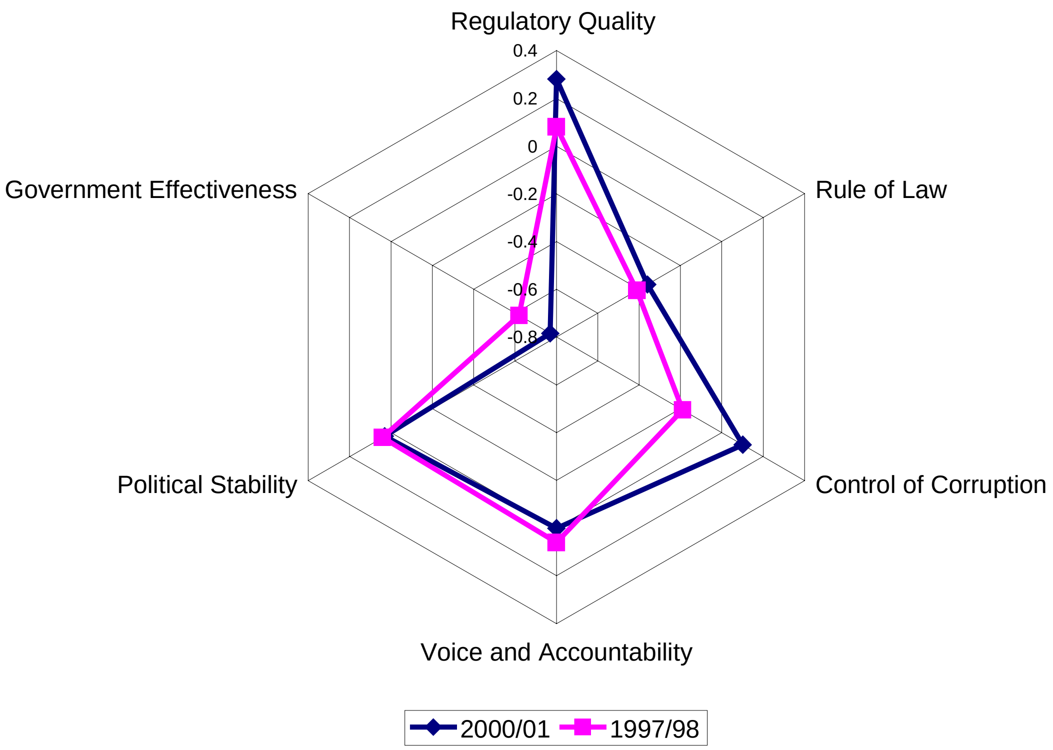
It was already mentioned that some bilateral donors in 2000/01 were disappointed by Malawi governance performance. This chapter analyses the development of governance performance in Malawi during the years before the PRGF and compares Malawi governance performance to the rest of the region.

In order to assess if overall governance performance in Malawi was improving in the years before the beginning of the PRGF, the Kaufmann-Kraay-Zoido-Lobatón dataset is used. This provides data for 160 countries on „Voice and Accountability“, „Political Stability“, „Government Effectiveness“, „Regulatory Quality“, „Rule of Law“ and “Control of Corruption”, derived from several surveys.

- “Voice and Accountability” (VA) includes a number of indicators measuring various aspects of the political process, civil liberties and political rights.
- “Political Stability” (PS) combines several indicators which measure perceptions of the likelihood that the government in power will be destabilised or overthrown by possibly unconstitutional and/or violent means, including terrorism.
- “Government Effectiveness” (GE) combines perceptions of the quality of public service provision, the quality of the bureaucracy, the competence of civil servants, the independence of the civil service from political pressures, and the credibility of the government’s commitment to policies.
- “Regulatory Quality” (RQ) includes measures of the incidence of market-unfriendly policies such as price controls or inadequate bank supervision, as well as perceptions of the burdens imposed by excessive regulation in areas such as foreign trade and business development.

- “Rule of Law” (ROL) includes several indicators which measure the extent to which agents have confidence in and abide by the rules of society. These include perceptions of the incidence of both violent and non-violent crime, the effectiveness and predictability of the judiciary, and the enforceability of contracts.
- “Control of Corruption” (COC) measures perceptions of corruption, conventionally defined as the exercise of public power for private gain model (Kaufmann, Kraay, Zoido-Lobatón 2002, p. 8-9).

Figure 5: Malawi Governance Indicators (higher values indicate better performance)



Source of data: Kaufmann, Kraay, Zoido-Lobatón, 2002

The data is aggregated using an unobserved components model (Kaufmann, Kraay, Zoido-Lobatón 1999)[1]. According to these indicators control of corruption improved

1 „We use an unobserved components model which expresses the observed data in each cluster as a linear function of the unobserved common component of governance, plus a disturbance term capturing perception errors and/or sampling variation in each indicator.“ p. 7.

prior to the beginning of the PRGF, whereas government efficiency decreased (higher values in Figure 5 reflect better performance). This finding is compatible with severe criticism expressed by various donors, particularly with regard to the budgetary process and budget auditing in Malawi: “There was a lack of completeness, accuracy and reliability of government accounting and reporting. Certain transactions were not fully captured in the accounts. There was little control at the Ministry of Finance or Accountant General's department to ensure that all revenues collected were in fact duly recorded in the accounts. The revenue reported by the Malawi Revenue Authority was accepted by the Ministry of Finance and included in fiscal reports without comparing the information with the Government's own banking details“ (World Bank 2003). Structural conditionality in the original PRGF as well as in the extended PRGF thus aimed at strengthening the budgetary process. Of particular concern to the donor community was the fact that due to imperfect reporting on arrears it was impossible to measure correctly the stock of internal debt held by GoM. The European Commission therefore tied disbursements of budget aid to an arrears audit.

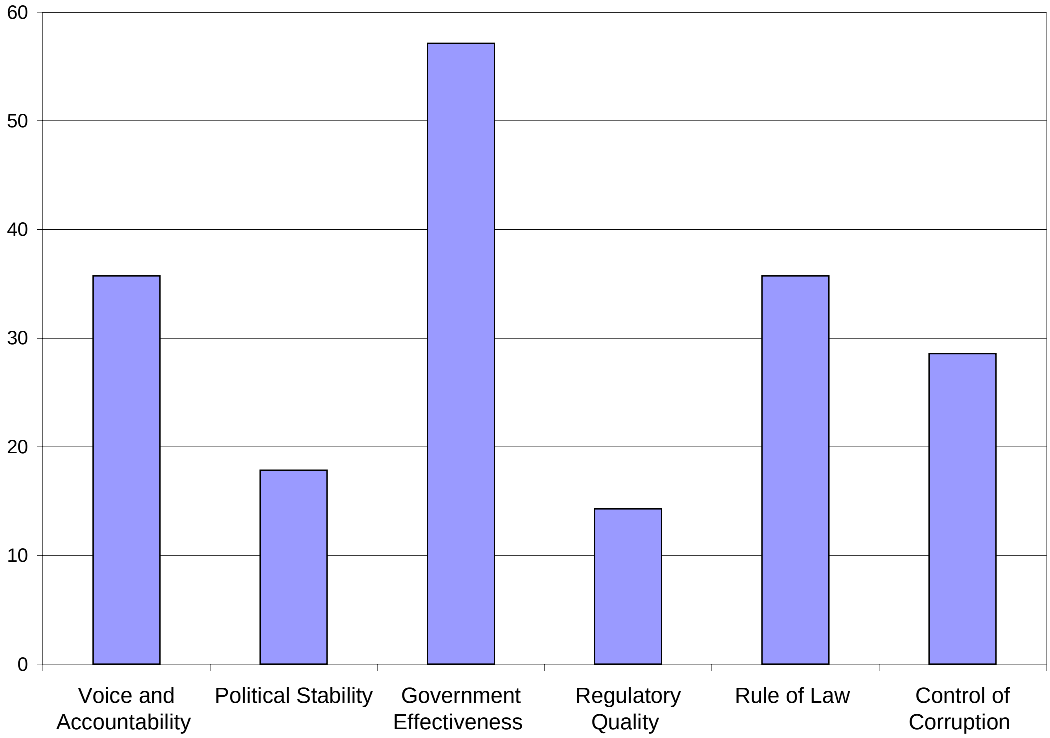
The weak budgetary process may have been responsible for problems of accountability encountered by the European Commission, as mentioned before. Unaccountable expenditures by the office of the president raised suspicions of corruption, and allowances for travelling and housing for government employees were considered exaggerated or arbitrary.

Despite the perception of improving control of corruption in Malawi according to the indicators in Figure 5, corruption remained an issue: „The Auditor General's annual reports had cited numerous instances where fraud, wastage and poor accountability and failure to reconcile relatively huge balances in government accounts, had for many years not been attended to. In addition, suspected corruption in transactions had not been brought to a conclusion“ (World Bank 2003). The government has increased the staffing of the Anti-Corruption Bureau (ACB), and has continued to train magistrates and judges in interpreting the Corrupt Practices Act. Nevertheless the independence of the ACB remains an issue, and in November 2003 donors severely criticised ACB reform as insufficient for complying with the respective structural conditionality in the extended PRGF agreement. The British Government tied disbursements of budget aid to progress in this respect.

According to Figure 5, the quality of rule of law remained unchanged during the years prior to the PRGF agreement. In particular, the – illegal - dismissal of three judges by the President of Malawi raised criticism from the donor community and civil society organisations within Malawi.

Nevertheless, Malawi's overall governance performance is not particularly bad from a regional perspective. If the Kaufmann, Kraay, Zoido-Lobatón 2002 dataset is used and Sub-Saharan countries with available data are classified according to their relative governance performance of the six indicators, Malawi always fares better than the mean - with the exception of "Government Effectiveness" which again is an especially weak point in Malawi’s performance (see Figure 6).

Figure 6: Relative Governance Performance of Malawi (out of 28 Sub–Saharan Countries 2000/01, low values indicate good behaviour relative to the rest of the region)[1]



Source of data: Kaufmann, Kraay, Zoido-Lobatón, 2002

6 The 2002 Maize Operation

The figures used up to now do not include the so-called “2002 maize operation”. The inclusion of this operation results in a considerably higher budget deficit. The non-

1 Best governance performance in the region has value 1, worst value 100.

inclusion in the extended PRGF program implies an additional risk for debt sustainability in Malawi. This chapter therefore summarises this operation and its fiscal impact.

Rainfall in the 2000/01 and 2001/02 agricultural seasons was uneven, with dry spells and floods reducing yields substantially. Producer prices were depressed in 2000/01 when the government sold its grain reserve to the domestic market after a bumper harvest. This reduced output by leaving farmers with insufficient income to purchase fertiliser and seeds, and contributed to defaults on agricultural credit.

Following reports from non-governmental organisations that some regions were experiencing starvation, the government undertook field visits in February 2002, which revealed that the food shortages went beyond the usual seasonality. The government declared a food emergency in late February 2002. With a crisis identified, the government expanded its social safety net programmes, donors increased their humanitarian efforts, and the World Food Programme started an emergency operation. Although the crisis was alleviated in April with the new harvest, the UN food agencies concluded in late May that the new harvest was going to be worse than the previous year's. They projected a shortfall of 485,000 metric tons of maize for the period August 2002-March 2003. They estimated that half of the shortfall amount should be made available as humanitarian aid to the poor, and half on commercial terms. Donor pledges broadly covered the assessed humanitarian needs. The government intended to undertake a large part of the commercial imports and provide this maize at a subsidised price. In August 2002 IMF granted an emergency aid credit facility.

Shortfalls in local production turned out to be lower than originally estimated, and the donor community and GoM underestimated the capacity of the private sector to respond to the crisis. GoM was therefore unable to sell the imported maize at the price originally planned and had to reduce its selling price. The overall fiscal cost of the maize operation is estimated at 3.5 % of GDP. All the figures in this study, including the analysis of GoM expenditures, do not take the cost of the maize operation into account. Therefore the budget deficit including the maize operation in 2002/03 is 4 percentage points of GDP higher than the amounts given throughout this study; proceeds from the sale of maize in 2003/04 are expected to amount to 0.5 percentage points of GDP (IMF, 2003).

7 The Resumption of the PRGF

As has been demonstrated above, the overall budget situation of Malawi had not improved by 2002/03 and some critical governance issues raised by the donor community still exist. Nevertheless the first PRGF Review was concluded in October 2003 and support from the international donor community is expected to resume. The IMF Executive Director for Malawi commented in this context as follows: “Notwithstanding the modest performance achievement, the strong political will and commitment of the authorities, further delay in restoring urgently needed donor support to the country, would result in these gains made so far to be lost. …..Such delay could also accelerate the looming serious financial and economic crisis that could lead to the total collapse of the economy” (IMF, 2003a).

The resumption of the PRGF process despite Malawi's mixed performance in order to prevent “the looming serious financial and economic crisis that could lead to the total collapse of the economy” raises the question as to what would have been the economic development if donor support had not been suspended in the first place.

8 What would have happened if? – Three Scenarios

In the following, three scenarios are presented that describe the hypothetical outcome of different behaviour by donors and GoM than that observed. In the first scenario the higher-than-programmed expenditures of GoM are entirely financed by grants from the donor community, implying a strongly accommodating response from the donor community; overspending by the government does not provoke lower, but rather higher grants than programmed. In the second scenario higher spending by GoM does not trigger any reaction by the donors, and disbursements continue as programmed; this scenario is called the “accommodating scenario”. In the third scenario it is assumed that GoM continues the historical trend of government expenditures. This could have been the outcome of an accommodating reaction on the part of the donors to overspending: While actual spending behaviour may have been a reaction to diminishing ODA by donors, an accommodating stance on the part of the donor community might have led to an “unchecked growth of government expenditures”.

Box 2: Three scenarios, assumptions

Strongly accommodating scenario: Increase in government expenditures after 1999/2000 would have been financed by matching increases of ODA grants.

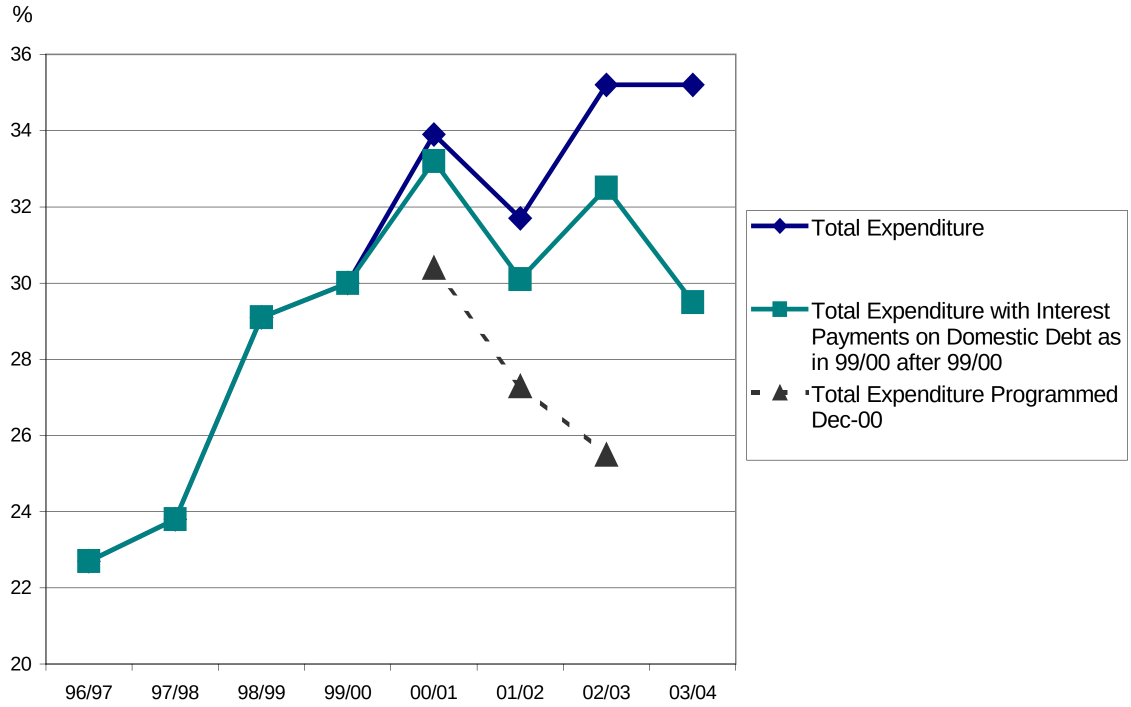
Accommodating scenario: Despite increases in government expenditures after 1999/2000, donors would have disbursed ODA as programmed in PRGF. Because in this case interest payments on domestic debt would have been lower than observed, hypothetical domestic financing is calculated as Total Expenditure with Interest Payments on Domestic Debt as in 99/00 after 99/00 minus Total Revenue (actual) minus Grants minus net Foreign Financing as programmed in PRGF in 2000.

Unchecked growth of government expenditures scenario: It is assumed that trend of GoM expenditures observed between 1996/97 and 1999/00 continues in later years.

8.1 Strongly Accommodating Scenario

In this scenario it is assumed that the increase of government expenditure would have been accommodated entirely by the donor community which would have increased their grants by the same amount (see Figure 7). In this case internal debt would not have increased and interest payments on debt are assumed to remain at the 1999/00 level. Government Expenditure in 2002/03 would have remained 2.7 percentage points of GDP below actually observed levels. Assuming that grants would have increased in 2003/04 as programmed in the extended PRGF, government expenditures would fall below 30% this year. Nevertheless programmed government expenditure was significantly lower (by seven percentage points in 2002/03). Of course, real interest rates would not have increased as much as observed if this scenario had been realised, and GDP growth would probably have been higher than observed, because the private sector would not have been squeezed out by high interest rates.

Figure 7: Malawi, Strongly Accommodating Scenario, observed, programmed and hypothetical Government Expenditures (%GDP, see Box for explanation)

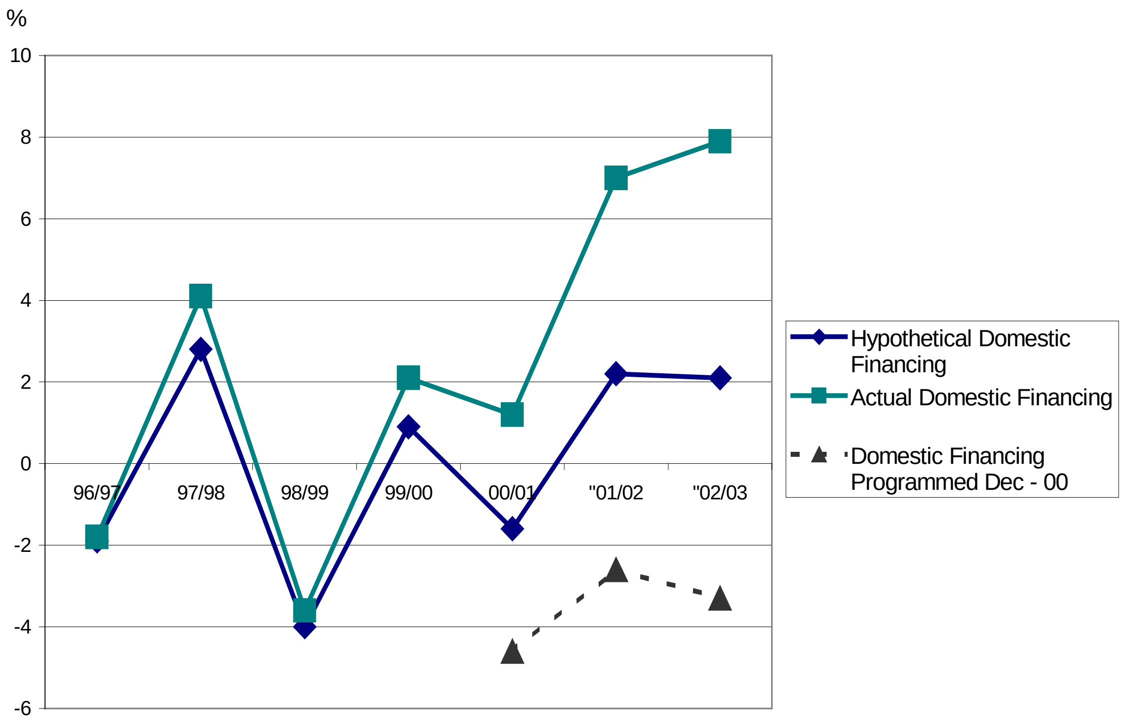


Source of data: IMF (2003)

8.2 Accommodating Scenario

In this scenario it is assumed that grants and external financing would have been disbursed as programmed in the PRGF, despite the increase in government expenditure by GoM. The need for domestic financing in this case would have been much lower as observed, by 5.8 percentage points of GDP in 2002/03, but still much higher than programmed. Again, interest rates would have been lower than observed and GDP growth probably higher.

Figure 8: Malawi, Accommodating Scenario observed, programmed and hypothetical Domestic Financing (% of GDP, see Box for explanation)

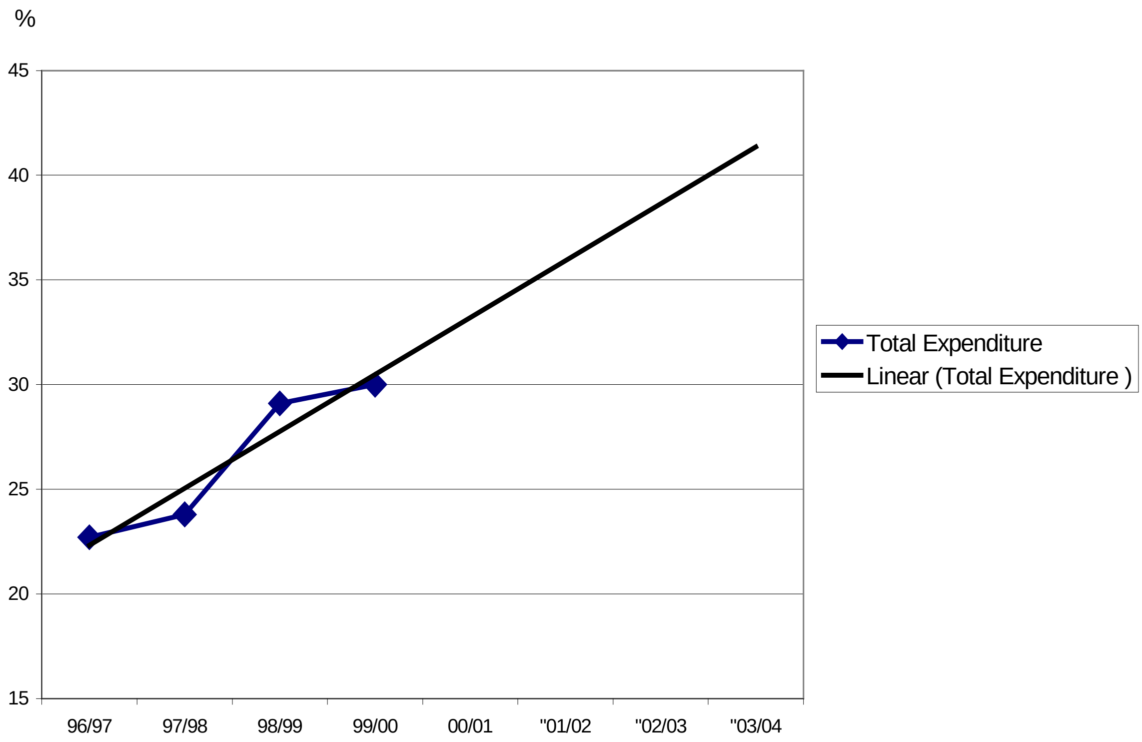


Source of data: IMF (2003)

8.3 Unchecked Growth of Government Expenditures Scenario

In this scenario it is assumed that GoM would have increased its expenditures according to the trend between 96/97 and 99/00. Government expenditure in recent years would then have risen to clearly unsustainable levels of over 40% of GDP (see Figure 9).

Figure 9: Malawi, Trend in Government Expenditures, Basis 96/97 - 99/00 (% of GDP, see Box for explanation)



Source of data: IMF (2003)

8.4 Alternative Scenarios: Conclusions

Clearly, nobody knows what would have happened if the donor community had continued to provide grants and financing to GoM on a larger scale than has actually been the case. The point here is the behaviour of GoM in such a changed environment. It seems safe to assume that the reaction by the donor community in the face of continually rising government expenditure by GoM put some pressure on GoM to restrict its expenditure growth: Total expenditure without interest payments on internal debt in 2000/03 was somewhat lower than in 2000/01 (see Figure 9). In addition, this pressure probably helped to advance some structural issues such as budget control. If the donor community had been more accommodating, GoM non-interest expenditures would therefore probably have risen more than observed. Scenario three (Figure 11) describes the extreme case of continued growth of government expenditure as in the past, the worst of the three “what would have happened if” scenarios, whereas the strongly accommodating scenario describes the best of the three outcomes: GoM would have reduced its spending growth rate as observed, and the donors would have financed all the increments by grants. Thus there would have been no increase in internal debt, and Malawi's growth prospects would be better than is the case today. Of course it is not feasible to decide which of the scenarios would have been more realistic, and the behaviour of GoM would probably have been somewhere in between. As we do not know where exactly in between, costs and benefits of alternative donor strategies cannot be calculated.[1]

The literature on the relationship between ODA and government expenditures is inconclusive. Various case studies have different results. One effect which is mentioned in the literature is the so-called flypaper effect (World Bank, 1998). According to this effect, increases in ODA may lead to even larger increases in expenditures and thus indirectly increase internal debt. However, some simple regressions do not support this thesis in the case of Malawi (Krakowski, 2003).

9 Conclusion: The Pitfalls of "Automatic" Donor Co-Ordination and the Risks ahead

The development in Malawi from 2000 to 2003 may be interpreted within the framework of "automatic" donor co-ordination: As the PRGF went "off track",

- disbursements from the IMF
- disbursements from the World Bank (IDA)
- disbursements (budgetary support) from the European Commission and Great Britain tied to the PRGF
- and disbursements (budgetary support) from Sweden and Norway that were linked to those of the European Commission and Great Britain within CABS

were stopped completely. The bilateral donors could have granted waivers to some of their conditionalities in order to continue with some support, but this would have implied lengthy discussions with their respective headquarters. This kind of "automatic" donor co-ordination is one of the forms of donor co-ordination existing today.

The very design of the PRSP process aims at improving co-ordination between donors as well as between donors and the partner country. Nevertheless the form of co-

[1] The literature on the relationship between ODA and government expenditures in general is inconclusive. Various case studies have different results. One effect which is mentioned in the literature is the so-called flypaper effect (World Bank, 1998). According to this effect, increases in ODA may lead to even larger increases in expenditures and thus indirectly increase internal debt. However, some simple regressions do not support this thesis in the case of Malawi (Krakowski, 2003).

ordination differs from country to country and the policy of donor countries with respect to co-ordination differs as well. In some countries decisions on disbursements may be made by decentralised structures, in others the decisions must be made by the headquarters. Automatic donor co-ordination exists mainly with respect to budgetary support.

This kind of automatic donor co-ordination may be necessary if an independent evaluation of the situation in the partner country by different donors is difficult due to a lack of resources in the respective country. Even if this kind of analysis were feasible, the response time – through the respective headquarters – is too long for timely reaction. Some of the response time could be shortened and the problem of a lack of resources could be alleviated if bilateral donors were given the opportunity to accompany IMF missions and to take part in discussions with the partner government. In Malawi this has not been the case up to now. The very nature of the PRSP process implies that more decision-making power for donor structures in the partner country is desirable. Such a shift in responsibilities would facilitate timely reactions by donors in a co-ordinated fashion. The current form of donor co-ordination and current relations between bilateral donors and the IMF imply the risk of "overshooting" if disbursements by many donors are directly or indirectly linked to the performance of the programme with the IMF. At the moment of agreement on conditionalities between the partner country and bilateral donors the conditionalities of other bilateral agreements are not necessarily known to all the players, and an analysis of the impact of "automatic" co-ordination is not generally undertaken.

It cannot be concluded from these remarks that in the specific situation of Malawi a gradual donor response would have triggered better results than observed, as this depends on the hypothetical response of GoM policy to hypothetical donor behaviour. The analysis of GoM performance in a regional comparison revealed a relatively good governance performance of Malawi with the exception of government effectiveness, which may be at heart of the problems observed in Malawi. It seems that an analysis of the consequences of the automatic donor co-ordination that took place in Malawi in 2000/01 has not yet been carried out.

Resumption of strong donor support in late 2003 within a context of government financing heavily out of kelter places high demands on the donor community. The extended PRGF is very optimistic with respect to future disbursements. Disbursements programmed exceed commitments so far identified (see Appendix 1). As some of these disbursements are conditional to structural progress, they may not all be implemented.

Critical points here are progress with ADMARC privatisation and the separation of commercial and subsidised activities, the independence of the Anti–Corruption Bureau and control of government expenditures. This last point seems especially critical as general elections are approaching.

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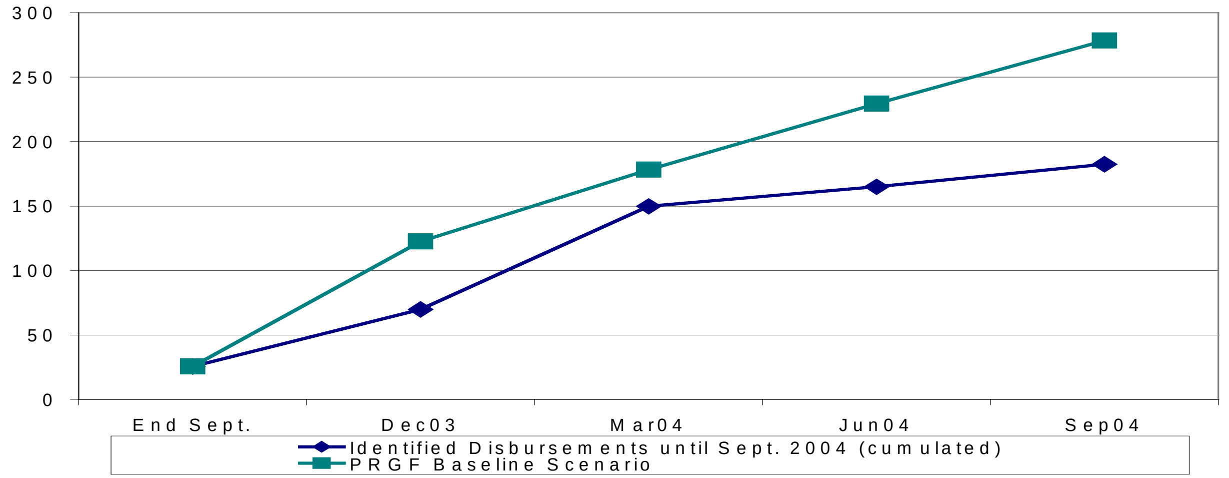
Appendix 1: Planned Disbursements 2003 and 2004

Malawi, identified planned Disbursements Oct. 2003 – Dec. 2004 (million currency units)

		2003			2004											
Donor	Currency	Oct	Nov	Dec	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec
IMF	SDR	6.44			6.44			6.44			6.44			6.44		6.47
IDA SAC	USD				25									25		
IDA ERC	USD						6			6						
ADB	UA						10									
EU SAF	Euro															
NORWAY	NOK	40												30		
SWEDEN	SEK			40		20								30		
UK	GBP		5	5		5							5			5
USAID	USD	8.28														
Total	USD	22.94	8.18	13.27	29.21	27.81	17.82	9.21		6	9.21		8.18	42.12		17.43

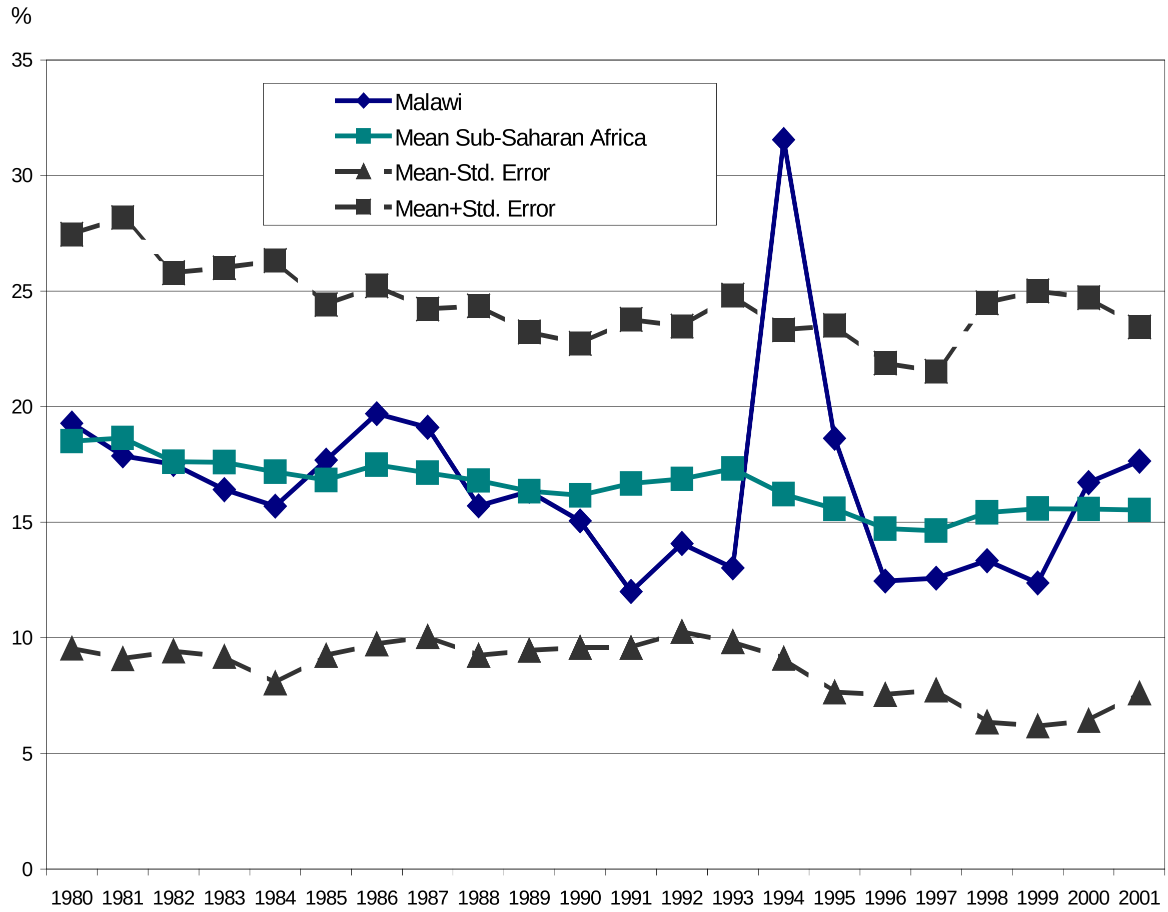
Source: GoM, Ministry of Finance, Oct. 2003

Malawi, Identified planned and PRGF-projected Disbursements of Balance of Payments Support (million USD)



Appendix 2: Malawi General Government Final Consumption Expenditure in a Historical and Regional Perspective

General Government Final Consumption Expenditure (GGCE, % of GDP)

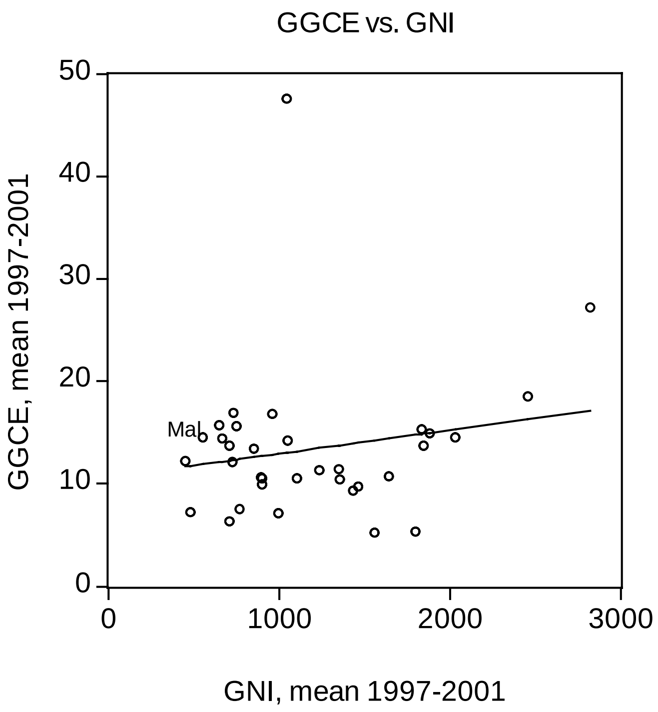


Source of data: World Bank (2003a)

The Standard Error (Std. Error) of the average data for the Sub–Saharan countries is included in the figure above. This is a measure for the dispersion of the data. It shows that Malawi data for all years but 1995 is well within the general behaviour of Sub–Saharan countries. If Malawi's GGCE as a percentage of GDP is compared to the regional average, it turns out that apart from the extremely high 1995/96 figure, general government consumption expenditure was somewhat lower in Malawi than in the region on average during the 1990s. As from 1999 it started to increase and in 2000 surpassed the regional average. From a historical perspective it may be seen that Malawi had reduced government consumption as a percentage of GDP after 1986, and that the level remained roughly constant between 1991 and 1999 (with the exception of 1995/96) when it started to rise again.

It may be that in countries with higher per capita income general government typically consumes a larger share of GDP than in countries with lower per capita income, as the demand for common goods (security etc.) may increase with per capita income. A simple regression between general government consumption as a percentage of GDP and Gross National Income per capita in Sub-Saharan Low Income Countries (mean 1997 – 2001) does not confirm this hypothesis for this region. The sign of the influence of GNI is positive as expected, but the influence is not significant.

General Government Consumption as a percentage of GDP and Gross National Income per capita in Sub-Saharan Low Income Countries (mean for the years 1997-2001 and purchasing power parities) and regression between both



Source of data: World Bank (2003a)

Regression Results:

Dependent Variable: GGCE

Method: Least Squares

Date: 12/11/03 Time: 18:36

Sample: 1 34

Included observations: 34

Variable	Coefficient	Std. Error	t-Statistic	Prob.
GNI	0.002290	0.002235	1.024772	0.3132
C	10.64924	2.958212	3.599892	0.0011

R-squared	0.031775	Mean dependent var	13.38631
Adjusted R-squared	0.001518	S.D. dependent var	7.421085
S.E. of regression	7.415451	Akaike info criterion	6.902031
Sum squared resid	1759.645	Schwarz criterion	6.991817
Log likelihood	-115.3345	F-statistic	1.050158
Durbin-Watson stat	1.971140	Prob(F-statistic)	0.313155

C = constant term

GGCE = General Government Consumption Expenditure

GNI = Gross national income