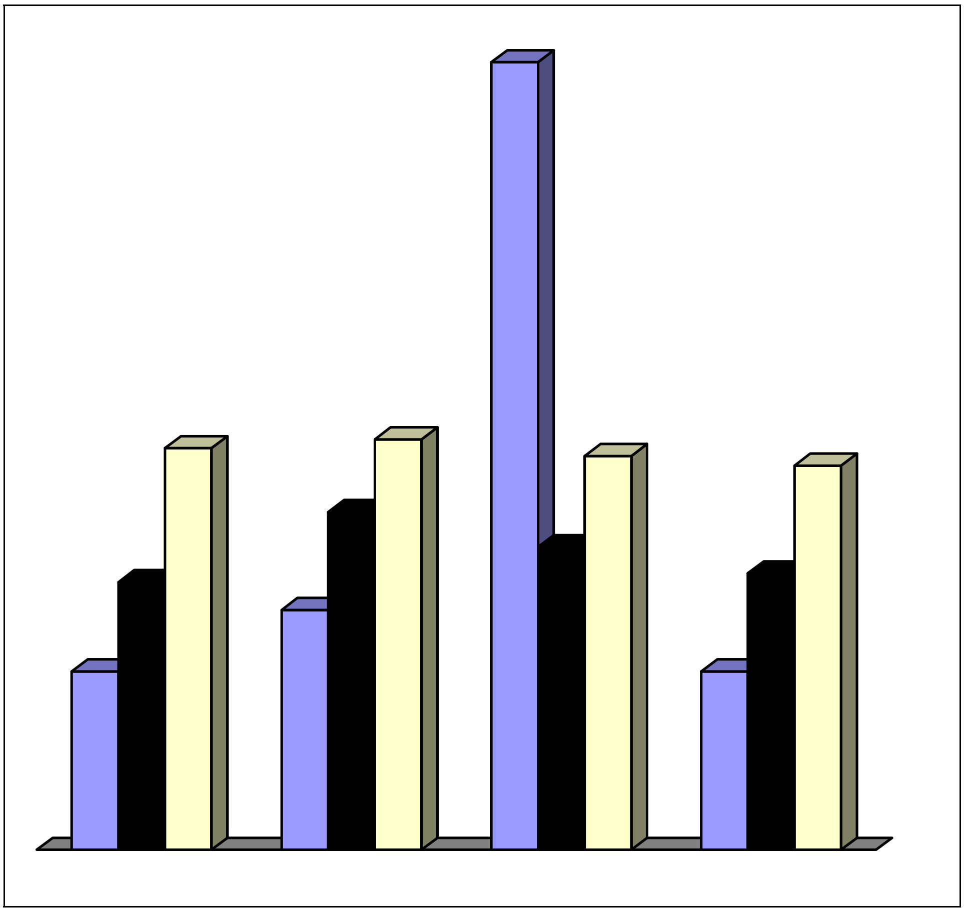
RESERVE BANK OF MALAWI



Mid-Year Economic Review 2006

Reserve Bank of Malawi

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1.0 INTRODUCTION

Economic activity is expected to rebound in 2006, reversing the poor outturn registered in 2005. Gross domestic product (GDP) is estimated to grow by 8.4 percent from a modest growth of 2.1 percent in the previous year. This development is largely on account of the agricultural sector whose output is projected to grow by 11.8 percent as a result of better rains coupled with the fertilizer subsidy programme.

Headline inflation averaged 16.2 percent during the first half of 2006 compared to an average of 15.0 percent for a similar period of 2005.The acceleration in general price levels was mainly on account of soaring prices of both food and non-food items. Food inflation rose to 18.5 percent from 17.3 percent in the same period last year. Lagged impacts of the drought experienced in the 2004/05 agricultural season spilled over to the current year until March 2006 when the downward trend in food inflation was noticed.

The rate of growth of money supply, accelerated by 11.7 percent to K58.3 billion during the first six months of 2006 compared to 21.5 percent recorded during a corresponding period in 2005. The increase in money supply emanated from several factors which included seasonal upswing in economic activity.

Quasi-money registered an increase of 14.0 percent during the first half of 2006. Foreign currency deposits shot up by 36.0 percent on end December 2006 levels.

The overall balance of payments position as measured by the change in net foreign assets of the banking system registered a deficit of K903.3 million during the first half of the year compared to a surplus of K1.7 billion in the first half of 2005.

The external debt stock at the end of the first half of 2006 amounted to US$2.9 billion compared to US3.1 billion at the end of first half of 2005. Official external debt service totaled K8.6 billion during the first half of 2006. The actual amount externalized by the public sector excluding Heavily Indebted Poor Countries (HIPC) relief amounted to K5.2 billion compared to K3.6 billion externalized in the corresponding period in 2005, translating in an increase of K1.6 billion in debt servicing.

2.0 MONEY AND FINANCIAL MARKET OPERATIONS

Developments in the monetary sector during the first half of 2006 were expansionary. Money supply (M2) grew by 11.7 percent to K58.3 billion. As is seasonally expected, growths in money supply were noticed during the months of March, April, May and June mainly due to the onset of the agricultural marketing season. Otherwise, the stock of money recorded a decline of 1.2 percent in the first two months of the year on account of a slowdown in economic activities after the holiday festive season.

Component wise, quasi money, which consist of foreign currency deposits and time and savings deposits, recorded the largest increase when it registered a six month increase of 14.0 percent. Foreign currency deposits were up by 36.0 percent on end December levels while time and saving deposits rose by 4.8 percent. The outturn in foreign currency deposits mainly reflected proceeds from tobacco exports coupled with revaluation gains following exchange rate movements during the month. However, it should be mentioned that seasonally, foreign currency deposits usually exhibit swings during this time of the year, going up when tobacco merchants receive prefinancing export from abroad and drop when the companies disburse funds for operations and purchases of the leaf. The increase in time and savings deposits partly reflected income earned from sale of agricultural produce coupled with the upward adjustment of interest rates in February which made savings attractive.

Narrow money grew by 10.1 percent following another increase of 13.9 percent during the first half of 2005. Currency outside banks rose by 32.5 percent compared to a rise of 13.9 percent during the first six months of 2005. Most of the increase in these balances occurred during the months of April, May and June reflecting a pick up in economic activity during this time of the year as tobacco season progressed. Demand deposits however declined by 4.6 percent and amounted to K17.4 billion against an increase of 10.2 percent during a similar period in 2005.

Following the expansion in money supply, the stance of monetary policy remained tight, largely focusing on bringing down the level of inflation and establishing macroeconomic stability. To achieve that, the Bank reduced the liquidity reserve requirement from 27.5 percent to 20.0 percent on 1st February 2006. This was aimed at increasing loanable funds to the private sector. Excess liquidity that arose from the reduction in the LRR was mopped through the sale of Treasury bills on the O pen Market Operations (OMO) desk.

2.1 Determinants of Monetary Growth

Determinants of money supply indicate that net foreign assets were the major contributor to the growth of broad money (M2) in the first half of 2006. Of the 11.7 percent increase in money supply, 7.2 percent was explained by net foreign assets while 5.8 percent was due to net domestic credit. Other items net on the other hand had a declining effect of 1.3 percent on M2.

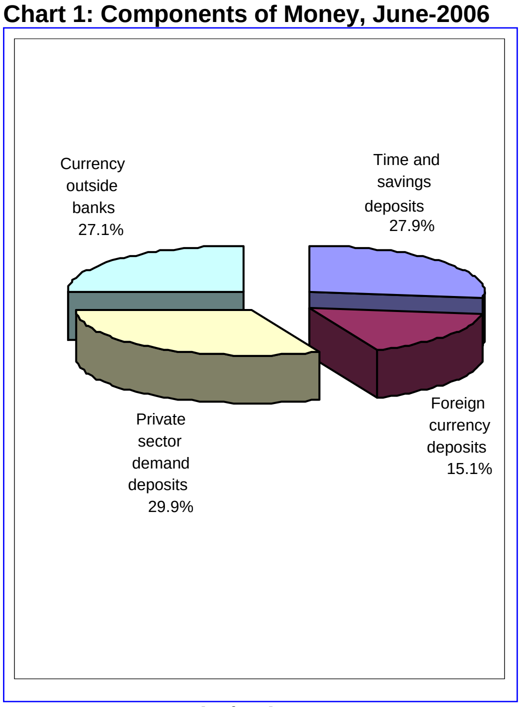
Net foreign assets grew by 38.1 percent during the first six months of 2006 and amounted to K13.7 billion. The increase emanated from accumulation of foreign reserves by both the commercial banks and monetary authorities as their net external positions rose by 70.7 percent and 24.1 percent, respectively. The rise in commercial banks reserves was due to build up in foreign currency deposits which could not be sold to the Reserve Bank of Malawi as the RBM did not to intervene in the market during some months of the second quarter.

Table 1: Monetary Survey

	Period end balances			Half year changes during periods		
	Jun-05	Dec-05	Jun-06	Jun-05	Dec-05	Jun-06
1. Net foreign assets……………………….……..	9,053.8	9,929.5	13,714.2	1,460.8	875.7	3,784.7
Monetary Authorities………………….…..	4,060.1	6,947.9	8,623.4	1,141.1	2,887.8	1,675.5
Foreign assets…………………………	13,825.3	16,265.3	19,262.3	829.4	2,440.0	2,997.0
Foreign liabilities……………………..….	9,765.2	9,317.4	10,638.9	-311.7	-447.8	1,321.5
Commercial Banks……………………..….	4,993.7	2,981.6	5,090.8	319.7	-2,012.1	2,109.2
Foreign assets……………………..…..	6,336.8	4,813.8	6,994.6	-36.3	-1,523.0	2,180.8
Foreign liabilities……………………….	1,343.2	1,832.2	1,903.8	-356.1	489.1	71.5
2. Net domestic assets…………………….….	41,571.1	42,278.5	44,614.2	3,498.1	707.4	2,335.7
Domestic credit……………………….….	45,802.0	39,419.4	42,452.8	10,036.6	-6,382.7	3,033.5
Credit to Govt.(net)……………………	30,077.1	23,398.5	22,121.7	7,755.0	-6,678.6	-1,276.8
Treasury bills, loans, advances &LRS	36,660.8	35,243.4	31,955.8	6,959.8	-1,417.4	-
Deposits…………………………	6,583.8	11,844.9	9,834.1	-795.1	5,261.2	-2,010.8
Credit to statutory bodies (net)……….….	-771.8	-1,479.4	-794.8	-288.9	-707.6	684.5
Loans and advances……………..….	352.5	307.2	877.0	53.0	-45.3	569.8
Deposits…………………………	1,124.3	1,786.5	1,671.8	341.9	662.2	-114.7
Credit to private sector………………….….	16,496.8	17,500.3	21,126.0	2,570.5	1,003.5	3,625.7
3. Other items (net)………………………...	-4,231.0	2,859.1	2,161.4	-6,538.5	7,090.1	-697.8
4. Money & quasi-money…………………..	50,624.9	52,208.0	58,328.4	4,958.9	1,583.1	6,120.4
Money……………………………………..	28,977.2	30,204.0	33,248.6	3,533.7	1,226.8	3,044.6
Currency outside banks………………	13,050.0	11,947.0	15,830.4	2,057.2	-1,103.0	3,883.4
Demand deposits……………………..	15,927.2	18,257.0	17,418.2	1,476.5	2,329.8	-838.8
Quasi-money……………………………..	21,647.7	22,004.0	25,079.8	1,425.2	356.3	3,075.8
Time and savings deposits…………...	13,401.7	15,529.5	16,273.0	298.8	2,127.8	743.5
Foreign currency deposits……………	8,246.0	6,474.5	8,806.8	1,126.4	-1,771.5	2,332.3

Source: Reserve Bank of Malawi

Chart 1: Components of Money, June-2006



Source: Reserve Bank of Malawi

Net foreign reserves of the monetary authorities increased by 24.1 percent compared to an increase of 39.1 percent recorded during a similar period a year ago. This was largely due to increased balance of payments support inflows coupled with other donor inflows which enabled the official sector to build its reserves to 2.3 month of imports from 1.9 month of imports recorded in June 2005.

Total domestic credit extended during the first half of 2006 amounted to K3.0 billion reflecting a rise of 7.7 percent after increasing by 28.1 percent during the first six months of 2005. The expansion in credit extended during the first half of 2006 emanated largely from that extended to the private sector and statutory bodies as that to the government actually declined.

Gross credit to the private sector was up by 20.7 percent on end December 2005 balances. The outcome was due to seasonal pick-up in economic activity as tobacco merchants borrowed to purchase the leaf coupled with increased borrowing by the commercial and industrial sectors which also borrowed for their operational requirements. On the other hand, net credit to the parastatal organizations increased by 46.3 percent mainly for maintenance of equipment and business financing requirement.

Net credit extended to the central government by the banking system decreased by 5.5 percent against an increase of 34.7 percent during a similar period a year ago. This outcome was mainly due to a decrease of K5.0 billion in net credit to government from the monetary authorities. Government was able to significantly reduce its credit following improved revenue collections coupled with increased balance of payments support inflows. Net credit to government from the commercial banks rose by K3.8 billion on account of increased uptake of Treasury bills by the banks.

2.2 Money Market

2.2.1 Treasury Bill (T-bill) Primary Market

During the first half of 2006, the Reserve Bank announced K49.4 billion worth of Treasury bills to the market against maturities of K61.7 billion. This was K8.3 billion higher than the amount announced during the comparable period in 2005. The mismatch between the announced amount and maturities resulted from converted Ways and Means advances into holdings of T-bills being held by the Bank. These holdings were not offloaded to the market. Although the Bank announced K49.4 billion, the market subscribed K69.1 billion, an increase of K29.3 billion on the corresponding period in 2005. The rise in the subscription was attributed to the excess liquidity experienced in the financial market especially in the first quarter of 2006.

Out of the total subscription in the period under cover, the Reserve Bank of Malawi allotted about 77.7 percent of the total amount tendered, an increase of 13.5 percent of the amount recorded in the corresponding period in 2005. In the same period, net maturities amounting to K8.1 billion were recorded compared to K21.0 billion registered in the previous period. To offset these net maturities, government used Ways and Means advances as a mitigating instrument. During the period under review, K20.7 billion was converted from Ways and Means advances into Reserve Bank Treasury bill holdings in comparison with K26.9 billion converted in the first six months of 2005.

The all-type Treasury bill yield dropped to 19.6 percent in the review period from 24.5 percent registered in the same period in 2005. Investors continued to participate in Treasury bill auctions due to lack of comparable risk free and high yielding investment. In terms of individual tenors, yields for the 91-day, 182-day and 273-day bills dropped by 5.4, 5.2 and 4.4 percentage points to reach 19.0 percent, 19.4 percent and 20.4 percent, respectively. As alluded to earlier on, the decline in yields was due to over subscriptions which were in line with the maturities over the review period.

2.2.2 T-Bill Stocks

During the first six months of 2006, the outstanding stock of Treasury bills amounted to K62.0 billion, an increase of K7.8 billion on the K54.2 billion registered in a similar period last year. The increase in Treasury bill stock resulted from an increase in T-bill maturities from K57.3 billion in the first half of 2005 to K61.7 billion during the review period. Consequently holdings of T-bills by the Reserve Bank in its open market operations (OMO) portfolio dropped from K21.4 billion in the preceding quarter to K14.8 billion at the end of the second quarter 2006. Similarly, holdings by commercial banks, discount houses and non-banks dropped from K21.0 billion, K11.2 billion and K21.2 billion in the first quarter to K16.9 billion, K10.6 billion and K19.6 billion in the review period, respectively.

2.3 Share Market

2.3.1 Primary Share Market

The First Merchant Bank (FMB) was officially listed on the Malawi Stock Exchange (MSE) during the review period. As such, the number of counters on the Stock Exchange increased from ten (10) to eleven (11).

2.3.2 Secondary Share Market

During the first half of the year, a total of 52.4 million shares traded for a total consideration of K877.2 million compared to a total of 31.8 million shares that exchanged hands for a turnover of K719.8 million in the preceding half of the year. The Malawi All Share Index (MASI) opened the review period at 907.93 points before rising to close off at 1865.04 points. The increase in MASI was attributed to the rise in both Domestic Share Index (DSI) and Foreign Share Index (FSI) from 687.87 to 1437.02 points and 358.20 to 521.59 points respectively. During the same period last year, the MASI closed off at 788.65 points.

Market capitalisation closed off at K1,655.6 billion compared to K1,120.4 billion in the preceding half. In the corresponding half last year, the market capitalisation stood at K791.2 billion.

3.0 CENTRAL GOVERNMENT BUDGETARY OPERATIONS

Budgetary operations of the central government picked up during the first half of 2006. The improvement was chiefly due to a marked increase in government revenues, mainly foreign grants that exceeded the increase in total expenditures. As a result, the fiscal deficit narrowed to K3.1 billion compared to a deficit of K6.1 billion in the first half of 2005. The deficit was financed largely through domestic resources. In spite of the narrowing of the deficit, government operations are being affected by an increasing stock of domestic debt with short term maturities resulting in persistently high domestic interest payments.

3.1 Revenues

Total government revenues rose by K10.2 billion (24.2 percent) to K52.1 billion during the first half of 2006 from K42.0 billion in the first half of 2005. Foreign grants stood at K16.4 billion compared to K11.2 billion recorded during a corresponding period of 2005 representing an increase of K5.2 billion. The enhanced foreign grants position was due to the resumption of a Poverty Reduction and Growth Facility program with the IMF since the third quarter of 2005. Of the total grants, K2.6 billion were disbursed by the European Union, K1.3 billion came from DFID (United Kingdom) and was earmarked for budgetary support, K401.0 million was granted by the Norwegian government, and K1.5 billion was jointly disbursed by DFID, EU, World Bank and Norway for Maize purchases. In addition, Norway, DFID, World Bank and UNFPA pooled together K4.0 billion for the Health Sector Wide Approach program. A number of donors disbursed a total of K2.1 billion for various government projects and K4.3 billion was received under the HIPC initiative.

3.2 Expenditures

Total government expenditures rose by 14.7 percent (K7.4 billion) from the first half of 2005 to K55.2 billion in the first half of 2006. The increase emanated from recurrent outlays as development expenditures dropped by 4.2 percent. Recurrent expenditures increased by K7.5 billion to K47.0 billion from K39.5

billion recorded during the first six months of 2005. Wages and salaries stood at K10.7 billion during the period under review compared to K9.3 billion in a corresponding period of 2005, reflecting a wage increase effected early in the year. Current transfers amounted to K10.4 billion, an increase of K1.1 billion from K9.3 billion in the first half of 2005. Interest payments totaled K8.6 billion during the first half of 2006 compared to K9.3 billion in a comparable period of 2005, representing a decline of K660.5 million. In spite of the drop, interest payments constituted a large part of government expenditures at the expense of increased outlays on development activities and pro-poor areas.

Development expenditures during the period under review decreased by K363.6 million to K8.2 billion due to a K1.0 billion drop in the foreign financed component to K6.2 billion. However, domestically financed development expenditures rose to K2.0 billion from K1.4 billion in the first six months of 2006.

3.3 Financing

The budgetary operations of the central government during the first half of 2006 resulted in a deficit of K3.1 billion. This was financed by both foreign and domestic resources. Government increased its indebtedness to the rest of the world by K1.7 billion. These were largely project loans amounting to K3.7 billion and a World Bank loan under Fiscal Management and Accelerated Growth (FIMAG) facility of K3.3 billion. This was partly offset by foreign loan repayments to the tune of K5.0 billion. The stock of domestic debt during the period under review rose by K1.1 billion due to increased borrowing from the non-bank sector amounting to K2.3 billion. Nevertheless, government was able to reduce its stock of borrowing from the banking system by K1.2 billion.

Table 2: Summary of Central Government Operations

	2005			2006		
	I	II	First Half	I	II	First Half
Total Revenue and Grants	20,166.3	21,790.2	41,956.5	21,898.0	30,229.6	52,127.6
Tax Revenue	15,071.7	15,756.4	30,828.1	16,843.5	18,907.8	35,751.3
Grants	5,094.6	6,033.8	11,128.4	5,054.5	11,321.8	16,376.3
Total Expenditure	25,601.2	22,499.6	48,100.8	30,811.7	24,373.1	55,184.8
Recurrent Expenditure	21,540.8	17,991.2	39,532.0	27,307.7	19,671.9	46,979.6
Development Expenditure	4,060.4	4,508.4	8,568.8	3,504.0	4,701.2	8,205.2
Net lending	0.0	0.0	-	0.0	0.0	0.0
Deficit Before Grants	(10,529.5)	(6,743.2)	-17,272.7	(13,968.2)	(5,465.3)	(19,433.5)
Deficit After Grants	(5,434.9)	(709.4)	-6,144.3	(8,913.7)	5,856.5	(3,057.2)
Total Financing	5,107.6	1,563.0	7,689.4	6,420.1	(3,288.6)	3,131.5
Net Foreign Loans	(1,247.3)	749.2	472.3	(579.9)	2,283.8	1,703.9
Borrowing	639.2	3,386.5	4,025.7	1,680.7	5,303.3	6,984.0
Repayment	1,886.5	2,637.3	3,553.4	2,260.6	3,019.5	5,280.1
Special Financing	0.0	0.0	-	-	0.0	0.0
Net Domestic Borrowing	6,260.0	756.0	7,064.4	7,000.0	-5,858.7	1,141.3
Errors and Omissions	327.3	(853.6)	-1,545.1	802.5	(94.0)	708.5

Source: Ministry of Finance

Table 3: Balance of Payments Elements

	2005			2006		
	I	II	First Half	I	II	First Half
Exports (f.o.b)	13,499.5	14,021.5	27,521.0	13,703.4	15,058.6	28,761.9
Imports (c.i.f)	27,048.3	34,438.2	61,486.5	30,303.4	36,963.6	67,267.0
Trade Balance	-13,548.8	-20,416.7	-33,965.5	-16,600.0	-21,905.1	-38,505.1
Capital Account	8,384.5	1,565.8	9,950.3	13,485.4	26,225.6	39,711.0
Capital Inflows						
Of which: BOP Support	1,450.4	3,146.4	4,596.8	18,351.1	5,908.6	24,259.7
Grants	1,450.4	1,042.7	2,493.1	0.0	5,908.6	5,908.6
Loans	0.0	2,103.7	2,103.7	18,351.1	0.0	18,351.1
Loan repayment	1,886.5	2,646.4	4,532.9	3,506.2	2,128.6	5,634.8
Interest payment	603.1	906.2	1,509.3	46.8	189.8	236.5
Changes in net foreign assets of the official sector (-: increase)	1,998.1	-1,660.6	-1,660.6	6,095.2	-5,191.9	903.3

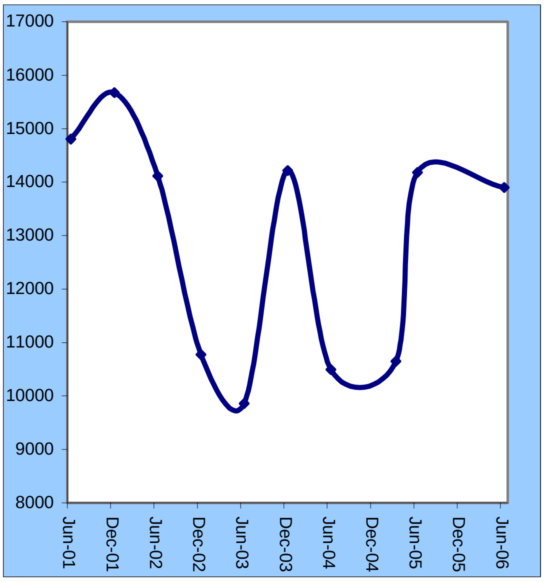
Source: National Statistics Office and Reserve Bank of Malawi

4.0 BALANCE OF PAYMENTS

4.1 Overview

The overall balance of payments position as measured by the change in net international reserves of the official sector registered a deficit of K903.3 million during the first half of the year, compared to a surplus of K1.7 billion recorded during the first half of 2005. Consequently, the Malawi kwacha depreciated vis-a-vis most country's major trading partners .

Chart 2: Gross Foreign Exchange Reserves (K'mn)



Source: Reserve Bank of Malawi

4.2 Foreign Exchange Transactions through the Reserve Bank of Malawi

Total foreign exchange inflows by the Reserve Bank amounted to K13.9 billion during the first half of 2006, compared to K14.6 billion during a similar period the year before. Of this, project funds totaled K5.5 billion compared to K4.0 billion recorded during a corresponding period in 2005. Government capital inflows decreased by K507.0 million to K2.6 billion. Purchases of foreign exchange from banks and non-bank institutions significantly went down by K4.3 billion to K474.9 million during the first half of 2006.

Foreign exchange outflows were quite substantial as total outlays rose by K11.8 billion to K27.7 billion. These outflows were mainly towards payment of government imports, particularly maize and fertilizers. Debt service payments markedly increased by K1.9 billion to K8.0 billion during the review period.

4.3 The Merchandise Trade Account

Preliminary estimates from the merchandise trade account indicate that the first half of the year recorded a trade deficit of K38.5 billion, compared to that of K37.6 billion recorded in the corresponding period of the previous year.

This outcome was largely due to higher growth in imports than exports. Imports were generally on the higher side during the first six months mainly on account of continual rise in the FOB prices of fuel coupled with importation of maize and fertilizers.

4.4 Developments in the Malawi Kwacha Exchange Rate

Movements of the kwacha during the first half of the year 2006 were mainly influenced by the rising domestic demand against declining foreign reserves coupled with the activities on the international scene. In response to these factors, the kwacha depreciated against some currencies of the country's major trading partners while also appreciating against others. On a one to one basis, the nominal external value of the Malawi kwacha weakened by 12.2 percent against the US dollar trading at K138.9868 per US dollar at end June. The kwacha also lost value by 18.9 percent with regard to the Euro, settling at K174.2755 per Euro. In the same manner, the kwacha slid from K213.2492 per pound in December 2005 to K251.6495 per pound in June, representing a depreciation of 18.0 percent. In the South-East Asian region, the nominal value of the kwacha depreciated by 13.9 percent against the Japanese Yen to trade at K1.1963 per yen.

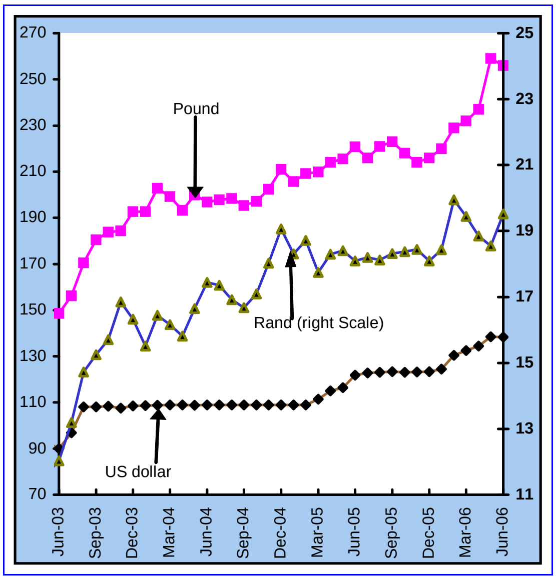
In South Africa, increased pressure on emerging market currencies coupled with a widening current account deficit sent the rand to a six-month low of ZAR7.0 to the dollar. As a consequence, the kwacha appreciated against the South African rand by 2.6 percent to K19.0589 as at June end. The Malawi kwacha also appreciated by 6.7 percent against the Zimbabwe dollar to trade at K0.0014 per Zimbabwe dollar. The kwacha, however, tumbled against the Zambian kwacha by 11.9 percent, to settle at K0.0392 per Zambian kwacha.

Table 4: Sources and Uses of Foreign Exchange

	2005			2006		
	I	II	First half	I	II	First half
A. SOURCES OF FOREIGN EXCHANGE…….	4,659.6	9,913.3	14,572.9	3,376.0	10,509.7	13,885.7
Government capital inflows………………..	1,326.9	5,823.3	7,150.2	1,744.8	6,396.9	8,141.7
Interest Earned……………………………..	8.1	6.6	14.7	70.55	57.9	128.4
Purchases from resident Institutions……….	1,867.7	2,878.3	4,746.1	454.7	20.2	474.9
Banking Institutions……………….	1,099.8	2,137.4	3,237.2	9.36	20.2	9.4
Non Bank Institutions…………….	0.0	0.0	0.0	445.3	20.2	465.5
Services and Transfers……………………….	0.0	0.0	0.0	0.0	2841.0	2,841.0
HIPC……………………………………….	1,450.4	1,204.9	2,655.3	1,105.9	1,193.8	2,299.7
B. USES OF FOREIGN EXCHANGE………….	8,058.2	7,826.4	15,884.7	16,982.8	10,711.2	27,694.0
Government Imports………………………..	706.8	871.0	1,577.8	8,529.0	2,223.5	10,752.5
Debt Services……………………………….	2,615.7	3,509.9	6,125.5	3,489.2	4,551.7	8,040.9
Principal …………………………..	2,010.6	2,637.3	4,647.8	2,091.26	3,387.6	5,478.8
Interest……………………………..	603.1	869.9	1,472.9	1,386.6	1,161.0	2,547.6
Other Payments ……………………………	2.04	2.68	4.73	11.3	283.8	902.2
Sales to resident Institutions………………..	3,804.5	1,936.2	5,740.7	3,643.4	2460.9	6,104.3
Banking Institutions………………….	3,804.5	1,936.2	5,740.7	3,643.4	2460.9	6,104.3
Non Bank Institutions………………..	0.0	0.0	0.0	0.0		0.0
Other payments……………………………..	929.2	1,506.75	2,435.9	1,321.2	1,475.1	2,796.3
C. SURPLUS/DEFICIT…………………………	3,398.7	2,086.8	1,311.9	-13,606.9	-201.5	-13,808.4
Gross Official Reserves (Opening)………………	14,009.0	10,648.2	11,895.4	13,631.0	16,808.2	16,808.2
Gross Official Reserves (Closing)………………..	10,648.2	14,183.3	14,183.3	15,361.5	20,155.3	27,149.9

Source: Reserve Bank of Malawi

Chart 3: Malawi Kwacha Exchange Rate



Source: Reserve Bank of Malawi

5.0 EXTERNAL DEBT

5.1 Debt Stock

Total medium to long-term external debt stock stood at US$2.9 billion at the end of the first half of 2006, a drop of US$0.2 billion from the corresponding period in 2005. The decrease was largely attributed to lower disbursements compared to principal repayments and availability of HIPC relief from major creditors during the period under review.

In creditor proportional terms, multilateral debt continued to dominate, accounting for US$2.6 billion, or 89.8 percent of the total debt stock. Bilateral debt amounted to US$293.0 million, representing 10.1 percent, while commercial debt totaled US$2.8 million, representing 0.1 percent of the total external debt outstanding.

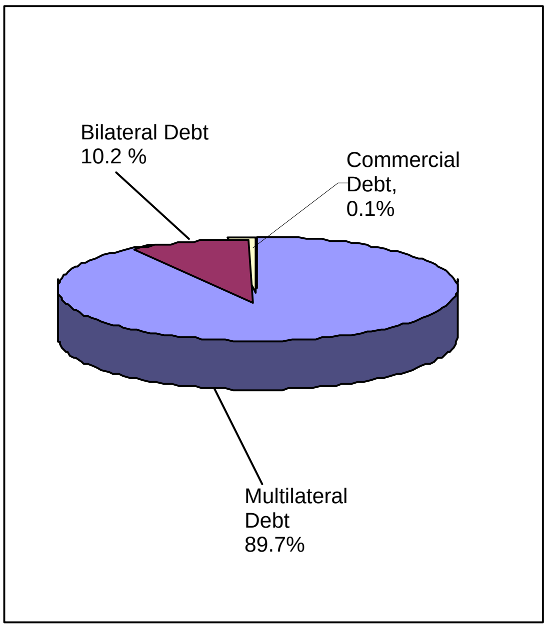
5.2 Debt Service

Total medium to long-term public external debt service including HIPC flows through the Reserve Bank of Malawi amounted to K8.6 billion during the first half of 2006. The actual amount of funds externalized by the public sector excluding HIPC relief amounted to K5.2 billion compared to K3.6 billion externalized in the corresponding period in 2005, reflecting an increase of K1.6 billion in debt servicing. Of this amount, K3.8 billion was in respect of principal payments, K1.4 billion in interest payments and K0.13 billion in other payments. Of the externalised amount, K4.8 billion went to multilateral creditors, comprising mainly of International Development Association (IDA), African Development Fund (ADF), African Development Bank (ADB), International Fund for Agricultural Development (IFAD), OPEC Fund, BADEA, and Norway. IMF facilities through the Reserve Bank of Malawi amounted to K1.9 billion representing 39.6 percent of the total multilateral payments.

Bilateral debt service totaled K452.5 million, of which, K12.6 million went to IDC of South Africa, K308.9 million to Export Import Bank of (EXIM) China, K130.6 Million to Kuwait Fund and K0.4 Million to De Organismo in Spain.

There was no externalization of funds to commercial creditors during the period under review.

Chart 4: Debt Stock as at 30th June 2006



Source: Reserve Bank of Malawi

5.3 HIPC Debt Relief

A total amount of K3.4 billion was deposited in the HIPC account during the period under review compared to K2.6 million transferred during the corresponding period in 2005. This increase of K0.8 billion was mainly attributed to availability of HIPC relief from major creditors since the resumption of the Poverty Reduction and growth Facility (PRGF) in August 2005. The bulk of debt relief mainly originated from World Bank, IMF, Paris Club members and EIB. Cumulatively, inflows to HIPC account since the commencement of the HIPC initiative in 2001 totaled K23.3 billion at the end of the first half of 2006 compared to K16.4 billion reported during the same period in 2005.

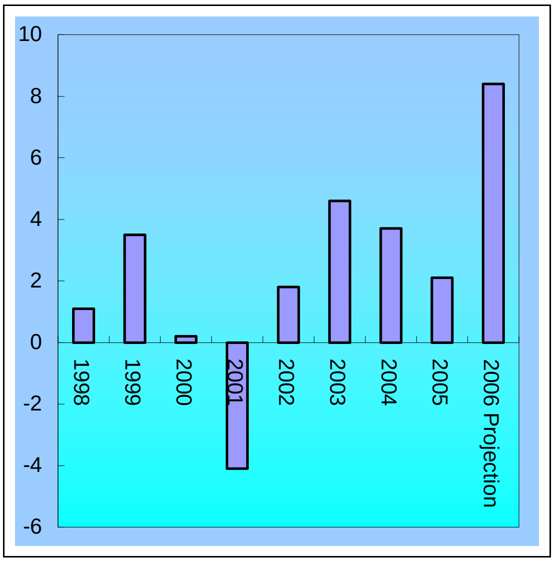
It is expected that Malawi will reach the Completion Point in the third quarter of 2006. In that case Malawi will qualify for the Multilateral Debt Relief Initiative (MDRI) where 100 percent cancellation is expected on the multilateral debt stock outstanding as at the end of December 2004. IMF MDRI relief delivery is expected in the last half and this will amount to US$6.4 million while International Development Association and African Development Bank would start their delivery in the fourth quarter of 2006. Malawi therefore expects US$42 million in debt service relief in the last half of 2006 after reaching the completion point. It is also expected that other multilateral creditors that have not been providing interim relief will start delivery at Completion Point.

6.0 REAL SECTOR DEVELOPMENTS

Real output in 2006 is estimated to grow by 8.4 percent compared to 2.1 percent in 2005. This growth will be supported largely by growths from agriculture, distribution, manufacturing, transport and communication, government services and financial and professional services, which make up over 90 percent of GDP. The rest of the sectors are expected to contribute marginally to the growth of GDP due to high inflation rates, exchange rate depreciation and high interest rates among others.

Inflation pressures that caused concerns began to moderate in March 2006, reversing the rising trend that was experienced since the last quarter of 2004. With an improved supply situation in agriculture food items, headline inflation stood at 15.3 percent at end-June 2006 compared to 15.9 percent at end-June 2005. Annualised inflation averaged 16.3 percent in the first half of 2006 compared to 15.0 percent in the same period in 2005.

Chart 5: Growth in Real GDP



Source: National Statistical Office

6.1 Agriculture

After a contraction in 2005, a strong rebound is expected in the agriculture sector resulting to an annual growth rate of 11.8 percent in 2006. The sector registered a negative growth rate of 9.3 percent in 2005 as a result of the catastrophic drought that hit most parts of the country. The small-scale agriculture and large-scale sub-sectors are expected to register respective annual growth rates of 14.2 percent and 4.2 percent compared to year-on-year contractions of 11.7 percent and 0.6 percent, respectively. The recovery in 2006 reflects impacts of the fertilizer and inputs subsidy programme implemented by government coupled with favourable rains.

6.1.1 Tobacco

Performance of the tobacco sector was not encouraging during the first half of the year 2006. Low tobacco auction prices remain the biggest challenge despite government's efforts in setting minimum prices at the official opening of the auction floors. The auctioning process was disrupted several times by the disadvantaged growers on account of low prices.

Annual production is projected at 158.6 million kilograms compared to 145.2 million kilograms produced in 2005. Respective production estimates for burley and flue-cured tobacco are 128.0 million kilograms and 30.0 million kilograms, whereas NDDF and SDDF are projected at 0.5 million kilograms and 0.1 million kilograms, correspondingly. In 2005, a total of 136.6 million kilograms of tobacco were produced split as 105.3 million kilograms of burley, 29.6 million kilograms of flue-cured, 1.5 million kilograms of NDDF and 0.2 million kilograms of SDDF. The year-on-year increase is attributable to good rains coupled with availability and accessibility of inputs.

In terms of sales, a total of 58.1 million kilograms of tobacco were sold by end-June 2006 for US$56.2 million, attracting an average price of US$0.97/kg. This compares with 77.5 million kilograms of tobacco that were sold for US$88.8 million, fetching an average price of US$1.15/kg during the same period in 2005.

The tobacco sold was split as 47.2 million kilograms of burley, 10.8 million kilograms of flue-cured and 0.15 million kilograms of western tobacco (NDDF and SDDF) that were sold for US$39.7 million, US$16.4 million and US$0.17 million as at end-June 2006, respectively. Respective quantities sold in 2005 for burley, flue-cured and western tobacco were 62.9 million kilograms, 14.6 million kilograms and 0.03 million kilograms, respectively. Average prices for burley, flue-cured and western tobacco were US$0.84/kg, US$1.53/kg and US$1.09/kg, respectively. In the same period in 2005, burley, flue-cured and western tobacco fetched average prices of US$1.03/kg, US$1.66/kg and US$1.47/kg, respectively.

6.1.2 Tea Production

A total of 31.1 million kilograms of tea were produced during the first six months of 2006. In a corresponding period of 2005, a total of 28.1 million kilograms were produced. Disparities in weather conditions explain the difference in production levels between the two periods. Following the increase in production and improved demand, tea auction sales at Limbe Market increased by 34.1 percent to 12.6 million kilograms, year-on-year. Auction prices improved as well to an average of US$1.18/kg as at end-June 2006 from US$0.90/kg as at end-June 2005. The increase is attributable to improved quality reflected in increased demand.

Higher volume sold coupled with improved auction prices resulted to a 76.5 percent year-on-year increase in proceeds earned to US$14.9 million as at end-June 2006. Prospects for tea look encouraging in 2006 on account of high demand due to improved quality of the crop.

6.2 Agriculture Crop Production

The final agriculture crop survey estimated national production for all crops at 8.7 million metric tones, representing an annual increase of 56.9 percent. The development reflects the impact of the fertilizer and seed subsidy programme by Government coupled with favourable rains during the 2005/06 agricultural season. Major crops and minor crops were estimated at 6.3 million metric tones and 2.4 million metric tones, from 4.0 million metric tones and 1.5 million metric tones produced in 2004/05 season, respectively. National maize production was estimated at 2.61 metric tones, 410,000 tones in excess of the national requirement. All major crops, except for cotton, reported significant production increases. The decrease in cotton production is attributed to low prices offered on international markets for the crop. Similarly, all minor crops except for macademia and chillies, registered substantial production increases.

6.3 Construction, Manufacturing, Distribution, Transport and Communication

The construction sector is expected to grow by 13.6 percent following on-going huge public construction works in the country. The distribution sector is projected to grow by 7.6 percent whereas manufacturing is estimated to grow by 5.2 percent. Growth in transport and communication is estimated at 5.5 percent from 9.4 percent a year ago. The rest of the sectors also recorded significant growth rates with minimal contribution to GDP.

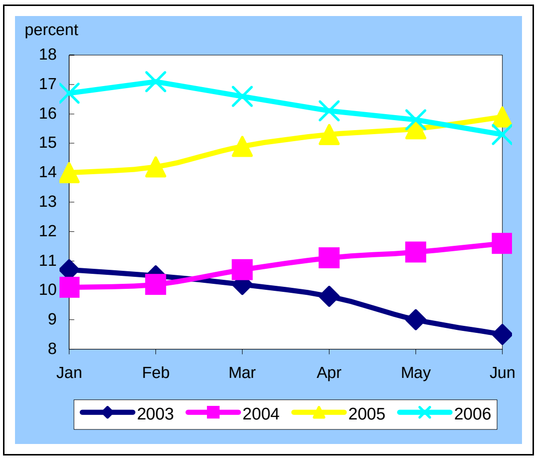
6.4 Inflation

For the first half of 2006, annualised inflation averaged 16.3 percent against 15.0 percent in similar period of 2005. The upsurge was contributed by both food and non-food inflation. Food inflation rose to 18.5 percent from 17.3 percent in the correspond period last year. Impact of drought experienced in the 2004/05 agricultural season led to continuing rising costs and prices of cereal products and cereals until March 2006. This was reflected in rising food inflation rates. Similarly, non-food inflation increased to 13.6 percent from 12.4 percent in 2005. Continued escalation of international oil prices and depreciation of the kwacha against major trading currencies contributed to the rising trend in non-food inflation.

Inflation is expected to moderate in 2006. Food inflation is expected to trend downwards as maize prices, the country's staple, are likely to remain depressed on account of improved supply conditions. Since food commands a lot of weight on the overall inflation index, the downward trend in food inflation will be reflected in the overall inflation. Furthermore, implementation of tight monetary policy stance supported by tight fiscal policy is expected to have a favourable impact on inflation.

Prospects regarding non-food inflation, on the other hand, will largely depend on developments on the international scene, particularly on the oil markets, and movement of the kwacha against major trading currencies on the domestic scene.

Chart 6: Inflation Rates



Source: National Statistical Office