MADAGASCAR – ECONOMIC UPDATE: What's Going On?

World Bank – April 12, 2010

After one year (still counting) of political crisis, uncertainty remains the key word. Private activities have rebounded compared to the first quarter 2009 but are still far from their pre-crisis levels. Fiscal policy, globally cautious, went through several "stop and go" episodes, sending mixed messages to financial markets, especially visible through the recent variations in the exchange and interest rates. This uncertainty is exacerbated by the lack of consistency in policy decisions.

1. Private sector: weak rebound but disparities across sectors

Since mid-2009, most private sector activities seem to have gradually rebounded but remain well below their pre-crisis levels. An indicator is the slow resumption of energy consumption, exports, and banking credits to the private sector from the second quarter of 2009 onwards (Figures 1-3).[1] Such rebound is not surprising given the disruption that occurred in the first quarter of 2009 when the economy was quasi-paralyzed because of riots and destruction of physical assets in most urban centers.[2]

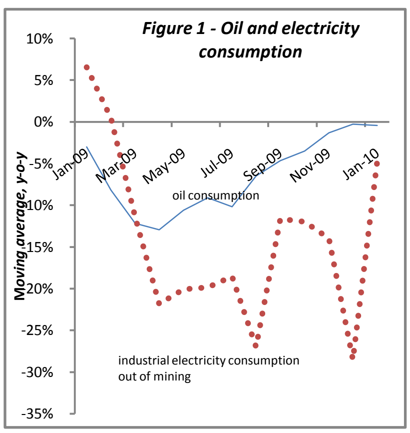


Figure 1 - Oil and electricity consumption

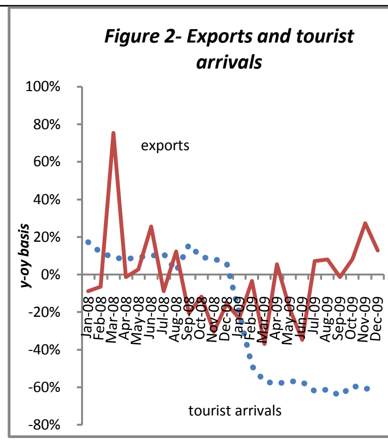


Figure 2- Exports and tourist arrivals

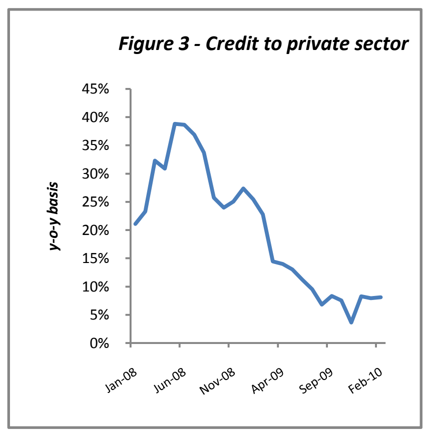


Figure 3 - Credit to private sector

Note: All these variables are calculated on a year to year variations to account for seasonality.

This uptick remains very fragile: most variables are very volatile from month to month (beyond seasonality) and there are important differences within and across sectors. As noted in our previous economic updates, the agricultural sector has been generally isolated by the domestic and external crises. Similarly, the food/beverage industry has been able to resist due to the relatively demand inelasticity for these items – people have to eat and drink independently of the political and economic context. The

[1] The weak recovery in banking credits started only in November 2009.

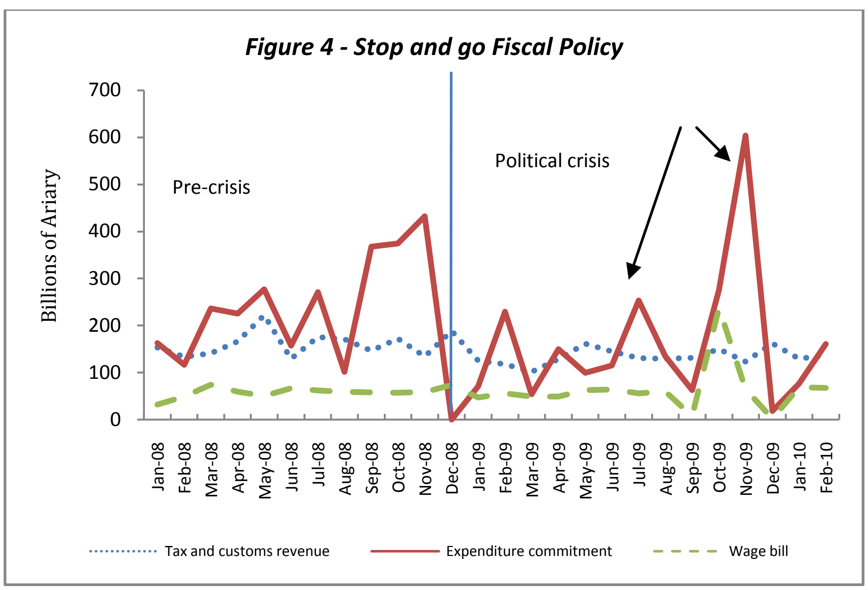
[2] See, joint IMF/WB/UN note on impact of the political crisis, March 2009.

mining industry has also contributed to exports (QMM, 109,000 tons were exported in 2009) and construction activities (Sherritt).

The main losers continued to be private activities associated to external markets and Government expenditures. The first category includes the textile and tourism sectors – tourist arrivals and textile exports to the US were respectively down by more than 50% and 53% in January 2010 compared to their year-ago levels. According to the *Groupement des Entreprises Franches et Partenaires* (Export Processing Zone Industries and affiliates Association), 16% of their members' employees were laid off since the AGOA suspension in January 2010. Prospects are not encouraging. In the second category, construction companies have suffered from the slowdown in publicly funded projects and the reluctance of private investors to move ahead in such an unstable environment. Unemployed or underemployed workers have been reconverting into informal trading in urban centers --a "safety valve" for many households over the past few months.[3]

2. *Stop and Go Fiscal Policy*

The Government has not consistently followed a prudent fiscal policy since the beginning of the crisis. A closer look reveals that public spending (on a commitment basis) exceeded by a wide margin domestic tax revenues in July 2009 and, most significantly, during the last quarter of 2009 (see Figure 4). During these two episodes, public outlays were respectively US$61 million and US$240 million higher than tax revenues, generating a financing gap of US$301 million. Except for October 2009, the wage bill was always lower than tax revenues.



The (unexpected) surge in public expenditures commitments during the last quarter of 2009 can be explained by at least three reasons beyond seasonality.[4] First, there was a catch up from the low execution rate in the preceding months by most Ministries, beyond the control of the Ministry of Finance. Second, the authorities might have felt political pressure to spend more in response to the gradual deterioration of public services (including security). The increase in spending was indeed

[3] For evidence, see latest UNICEF report on Antananarivo (MC RAM analysis).

[4] Public expenditure commitments are always higher in the last quarter. In 2009 they were nonetheless 92 billion of Ariary higher than during the last quarter of 2008.

concentrated in the sovereign Ministries (Presidency, National Defense, Public Security, and Ministry of Finance) and in the Ministry of Education. Third, it cannot be discounted that a higher level of comfort was perceived by fiscal authorities as the result of (i) the Maputo/Addis Abeba agreement signed in October, with the corollary possible resumption of official aid, and (ii) the additional non-tax revenues of about US$20 million collected from the authorized exports of rosewood in October and November 2009.

Following this surge, the Government had problems in securing the needed financing to pay for those commitments (beyond tax and non-revenues and aid flows). During the first quarter of 2010, the Government attempted to increase its tender offers on the T-Bill market which was not entirely receptive (see figure 6). Purchases were only equal to 60% of the tendered amounts even tough yields increased by about 3 percentage points during this period. Concurrently, borrowing from the Central Bank remained limited (up by 4.3%) since any deviation from the monetary program are almost immediately interpreted by commercial banks (and others) as inflationary financing, with the risk to generate instability and contagion to other financial variables. As a result, the Government was forced to accumulate arrears (on a cash basis) well above historical standards.

Fiscal authorities returned to austerity with a very subdued execution of the new budget during the first few months of 2010. The cumulated execution rate was only 11% at end-March 2010, paying wages and debt-services but with almost no new investment spending (their accumulated execution rate was below 2%).[5] The Ministry of Finance also started to audit past commitments, resulting in a decline in (on a cash basis) arrears from around US$33 million at end December 2009 to less than US$20 million at end March 2010. This latter amount remains equivalent to about half of non wage and non debt service expenditures committed during the first quarter of 2010.[6]

Table 1: Tax revenue performance, year-to-y variations

		March 09-Feb. 10
Domestic	Direct taxes (income, profits)	-41 %
	Indirect taxes (VAT, excise)	2%
	Others	80%
	Total	*-26%*
Customs	Import Duties	-36%
	VAT on imports	-37%
	Duty on Petroleum	45%
	VAT on Petroleum	9%
	Others	225%
	Total	*-32%*

Source: Ministry of Finance and Bank's staff calculations

With limited aid flows, the Government spending capacity is closely related to its tax performance, which has deteriorated since the beginning of the crisis, down by 30% on average per month between March 2009 and February 2010 (Table 1). This decline occurred in almost all categories of taxes, in line with the slowdown in economic activities. The taxes collected on international transactions decreased by about 36% per month, while direct taxes by 41% per month. The VAT revenues on domestic transactions appear relatively stable (up by 2%) but this reflects higher than expected revenues between March and May 2009, when tax arrears were paid by a few operators. Subsequently, over the period June l 2009 and February 2010, VAT revenues were down by

[5] The highest spending ministries were Foreign Affairs, HAT, National Defense and Public Security, and Finance.
[6] It can be assumed that wages and debt-services payments are paid immediately after being committed.

8 % on average per month. [7] The only exception is tax and custom collection on petroleum imports (up by 45% on average) due to higher volume of imports by JIRAMA and mining companies in 2009.

3. Financial sector: Mixed signals

Over the past couple of months, mixed signals have been observed on the domestic financial market. Up to mid-February, the exchange rate continued its slow depreciation vis-à-vis the US dollar and the Euro, reaching almost 3000 Ariary per Euro on February 24th, 2010. Subsequently, this trend reverted and the local currency has appreciated by around 5% compared to the Euro (Figure 5). Similarly, the US/Ariary parity fluctuated by about 7% during the same period. Such volatility has to be expected given the variations in the fiscal policy and the fluctuations between key world currencies on international markets. Yet, it may also reflect the (temporary) introduction of an out-of-market fixed rate for petroleum imports, served directly from Central Bank reserves, on March 18, 2010. This multiple exchange rate policy introduces the danger of entailing a direct loss of official reserves and an artificial appreciation of the exchange rate because it subtracts demand from the official market.

Domestic interest rates (as measured by T-bill yields) displayed a clear upward trend over the past couple of months due to a constant net demand by the Treasury in the face of falling creditworthiness (Figure 6). The T-bill market has nonetheless exhibited supply and demand volatility as evidenced by the variations in the amounts tendered and issued by the Government over the past two months (Figure 6).

Figure 5- Exchange rate

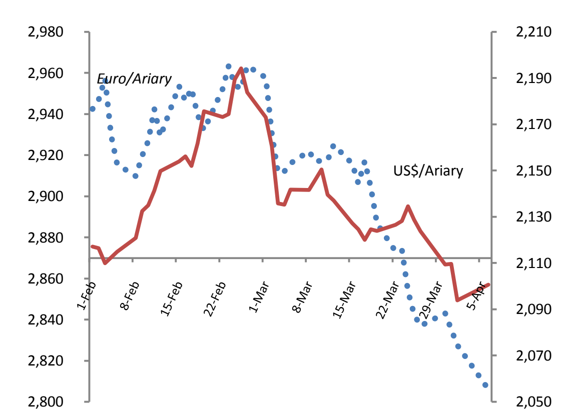
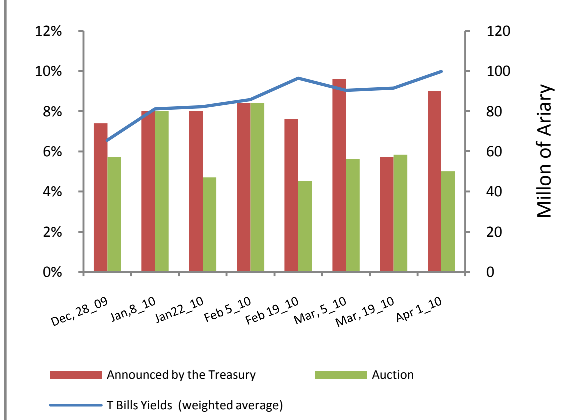


Figure 6 - Volatility in the T-Bills market



By contrast, monetary policy remained stable over the past few months. Caution is visible through the contraction in reserve money (down by 3% between December and

[7]The World Bank 2007 *Public Expenditure Review* estimated the elasticity of indirect tax revenues to GDP around 1.5 over the period 1994-2005, which would mean that GDP declined by 5.3% between June 2009 and February 2010.[7] This figure has to be taken with caution and should be interpreted as a rough indicator of the declining trend in economic activity.

end-March). Concurrently, commercial banks have continued to limit their credit activities (while slightly higher than in October 2009, they are still far from pre-crisis levels). Their level of non-performing loans increased by 24% over the past month as the consequence of two banks exposed on a few sectors in distress (agro-industry and textile). The overall level of excess liquidity remained high but declined by 13% between end December and end-February.

As the result of the prudent monetary policy, inflation has remained relatively stable, 7.7% on year on year basis in February 2010 due to a slight increase in the price of food items, housing, electricity and gaz.

Looking forward

Today, most operators are in a "wait and see" mood because of the general uncertainty in the economic and political environment. It is well recognized by the economic literature that private investors are reluctant to take decisions in an unstable context, postponing their projects or, when possible, moving them abroad. This instability is reflected in the "stop-and-go" fiscal policy, the growing variability of financial variables and, more generally, the difficulty to collect economic and financial information –both from the public and private sectors in the country. In a politically volatile environment, any kind of information is valuable and, therefore, costly to acquire by third parties.

There are a few opportunities for the authorities to reduce this global uncertain context and reinsure the private sector in the short run. First, the authorities should collect and disseminate economic information in a timely manner. Apart from the Central Bank, perhaps, there are no updated financial reports available on public finance and real sector activities. For the same reason, the economic decisions followed by the authorities should be communicated better–most of them appear ad hoc or under the pressure of lobbies and private interests rather than the consequence of a well defined strategy.

Second, fiscal policy needs to be consistent over time. The rule should be that the Government should not spend more than it can finance with tax and non tax revenues and external finance. Limited flexibility exists on domestic markets as learnt by the recent experience over the past few months. *Cautious fiscal policy does not mean that the Government should remain inactive*. There is room to increase tax revenues, notably on imports of goods,[8] and non tax revenues because evasion rates are important in the mining sector and some light should be brought on the financial relationships between the public and quasi-public enterprises and the Treasury. Improving the efficiency of public expenditures is a matter of priority for the Government.

Third, the Government needs to establish clear rules of the game to the business community. Over the past months, there have been a series of policy decisions that have been interpreted by the business community as a step back in the liberalization process (the most publicized have been in the communication, beverage, petroleum, and agricultural sectors through preventing new activities, price interventions, exchange rate guarantees, and tax favors). Even when well intended those interventions open the door to

[8] The decline in import revenues has been higher than the slowdown in imports; the elasticity is around 1.4.

lobby and distortions. *Legal stability* is important for (domestic and foreign) investors and past contracts or authorizations, if justified on a legal basis, should be granted irrespective of the political power in place. The confusion in the *legal and institutional framework surrounding the ICT industry* is penalizing this sector, while its potential for job creation is real after the significant investments made by existing operators in physical assets (i.e., backbone) over the past few years. The future of the Export Law adopted at the end of 2008 (suppressing the EPZ regime by end 2010) should also be elucidated in view of the AGOA suspension and the uncertainty surrounding this important sector for Madagascar.

Those three lines of actions (communication, fiscal consistency and clear rules of the games) will not entirely compensate for the permanent uncertainty in the political environment. Still, they should be initiated sooner rather than later. The good news is that their implementation does not require huge amount of money –just *political will*.