MADAGASCAR – ECONOMIC UPDATE: Going Down…

World Bank – October 20, 2009

Amidst the uncertainty of the political crisis and the chaotic return to a democratic government, the downward economic trends depicted by the last month World Bank's economic update persisted during September. The Government continued to cut public spending, driven by lower revenues and limited external financing (Figures 1 and 2), and the private sector activities remained slow as evidenced by lower energy consumption (Figure 3). The inflation and domestic interest rates remained under control as the result of the cautious monetary policy, lower domestic aggregate demand, and the limited use of public domestic borrowing on the T-Bill market (Figure 4).

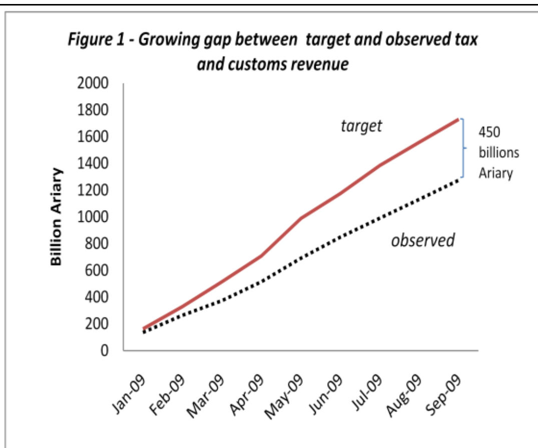

Figure 1 - Growing gap between target and observed tax and customs revenue

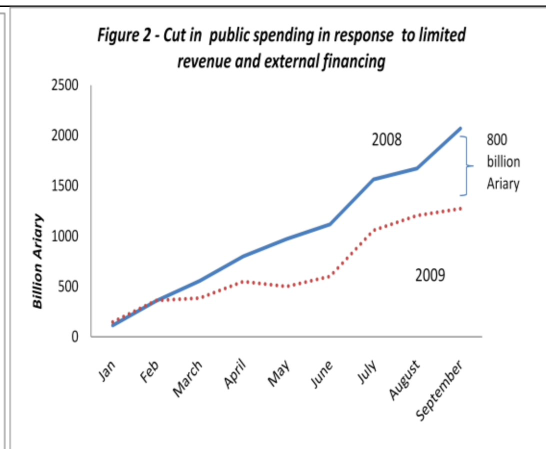

Figure 2 - Cut in public spending in response to limited revenue and external financing

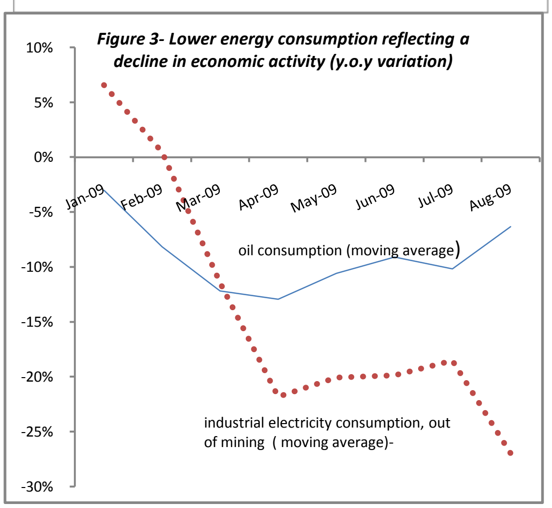

Figure 3- Lower energy consumption reflecting a decline in economic activity (y.o.y variation)

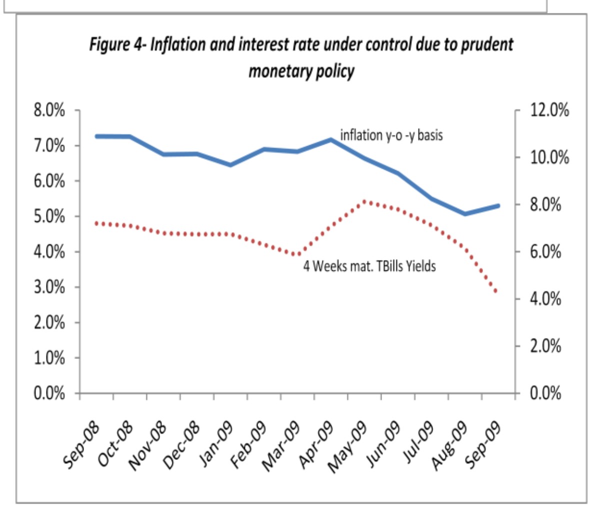

Figure 4- Inflation and interest rate under control due to prudent monetary policy

Growing concerns

A few salient points merit further attention as they indicate growing pressure on several dimensions of the economy. First, the Government *started to borrow from the domestic banking system* over the past two months, since the net credit to Government increased by 88 billion Ariary between August and September 2009, which is equivalent to almost half of its monthly total spending.[1] This is a significant change in behavior in comparison to the first few months of the crisis when the authorities followed a strict discipline and did not borrow on the domestic financial market.

The second development is linked to the *accelerated depreciation of the exchange rate*, since the local currency lost 6 and 4 percent of its value compared to the Euro and the USD between mid-September and mid-October 2009 (Figure 5). This depreciation reflects the premium that existed on the parallel exchange market in early September and the shortage of foreign currencies due to lower capital inflows (including aid) and exports (albeit partially compensated by the decline in imports). The monetary authorities have however resisted intervening on the FOREX markets, maintaining the Central Bank's reserves to about SDR592 millions in mid-October 2009. In addition, Madagascar benefited from the IMF's international response to the global crisis by receiving SDR100 million in August 2009 (but the use of this facility is still subject to an agreement between the IMF and the Government).

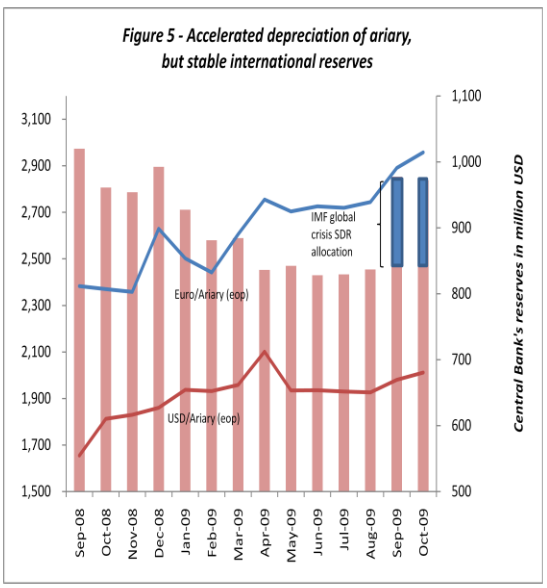

Figure 5 - Accelerated depreciation of ariary, but stable international reserves

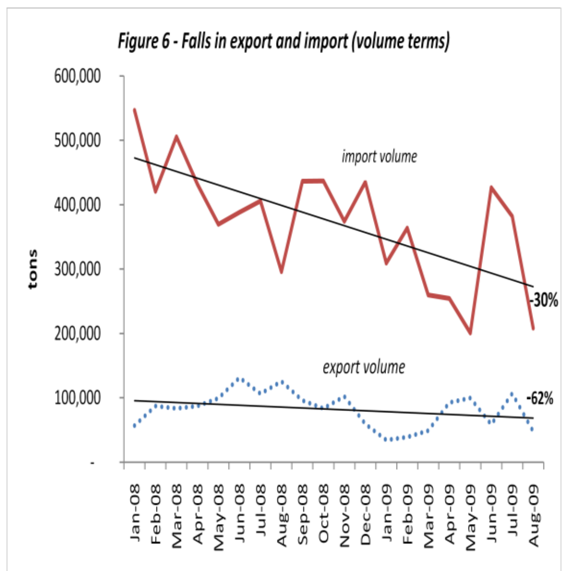

Figure 6 - Falls in export and import (volume terms)

The third and last development, concurrent to the depreciation of the Ariary, has been the pronounced *decline in international trade* over the past year (Figure 6). The decline in exports volume (down by 62 percent in August on a yearly basis) is above all explained by the global recession, since the U.S. and E.U. are the main export markets. U.S trade statistics corroborate that Malagasy imports to the US decreased by 15 percent in value terms between August 2008 and August 2009, including a 18 percent decrease in textile. By contrast, the decrease in imports (down by 30 percent in August on a yearly basis) is caused to a large extent by the slowdown in domestic demand resulting from the political

[1] The increase in net credit is due to the increase of other credit to government by 66 billion and the decline of about 22 billion of Ariary of its deposits.

crisis, at the exception of food imports that have partially compensated for the reduction in domestic food production.

Looking forward

The combination of pressures on public finances (net credit up significantly for the first time) and on the exchange rate as well as the pronounced decline in international trade reflects the growing risk of financial turmoil and economic recession in Madagascar. The thinness of the domestic financial market, as evidenced by the limited volume of transactions, might precipitate the depreciation of the local currency in case of a confidence crisis. The absence of political solution, endorsed by the international community, will exacerbate those pressures not only because aid flows will remain minimal but also in reason of the increasing probability of economic and political sanctions, including from the EC (the deadline for the Cotonou's evaluation is on November 6) and from the US that will decide upon the suspension of Madagascar to AGOA by end December 2009.