

FOR
AGENDA

EBS/84/133

CONFIDENTIAL

June 19, 1984

To: Members of the Executive Board
From: The Secretary
Subject: Madagascar - First Review of the Stand-By Arrangement

Attached for consideration by the Executive Directors is a paper on the first review of the stand-by arrangement for Madagascar. A draft decision appears on pages 14-16.

This subject will be brought to the agenda for discussion on a date to be announced.

If Executive Directors have technical or factual questions relating to this paper prior to the Board discussion, they should contact Mr. Schiavo-Campo (ext. 77189).

Att: (1)

INTERNATIONAL MONETARY FUND

DEMOCRATIC REPUBLIC OF MADAGASCAR

First Review of the Stand-By Arrangement

Prepared by the African Department and
the Exchange and Trade Relations Department

(In consultation with the Fiscal Affairs, Legal,
and Treasurer's Departments)

Approved by J.B. Zulu and S. Kanesa-Thasan

June 18, 1984

I. Introduction

On December 21, 1983 the Executive Board approved in principle Madagascar's request for a stand-by arrangement in the amount of SDR 33 million (EBS/83/255). Activation of the arrangement was subject to findings by the Fund that satisfactory arrangements had been made with respect to the financing of the estimated 1984 balance of payments deficit, and that adequate increases in producer prices of agricultural commodities had been adopted. Subsequent to the finding by the Fund that the authorities had adopted adequate increases in producer prices of agricultural commodities (EBS/84/45 of March 8, 1984) and that satisfactory arrangements had been made with respect to the financing of the estimated balance of payments deficit for 1984 (EBS/84/82), 1/ the stand-by arrangement became effective on April 10, and Madagascar made the initial purchase equivalent to SDR 3 million under the arrangement on April 16.

The present stand-by arrangement envisages three reviews of the program during 1984, of which the first was scheduled for May 1984. Accordingly, a mission visited Antananarivo from May 27-June 8, 1984. 2/ The review entailed, besides appraising developments in the first four months of 1984, fixing the performance criteria for the period after June 1984, assessing the appropriateness of the 1984 public investment program, seeking from the authorities a specific commitment as to the extent and timetable of decontrol of industrial prices, and assessing the need for any additional rice imports out of Madagascar's own foreign exchange resources during the second half of the year.

1/ Consequent upon the March 22-23 Paris Club III rescheduling (SM/84/74) and upon the April 5-6 aid donors' meeting (EBS/84/82).

2/ The mission was composed of Messrs. Bhatia (head), Schiavo-Campo, and Gilman (all AFR) and Miss Earll (secretary-AFR).

The attached letter from the Malagasy Minister of Finance, dated June 8, 1984, proposes that, in view of the uncertainties created by the recent cyclone (see below) and those concerning the timetable of disbursements of the aid expected as a result of the aid donors' meeting in Paris in April, the performance criteria for the period after June 1984 be fixed during the course of the next review in August. The letter, however, clearly outlines the Government's policies in regard to the above issues and mentions indicative targets for end-September and end-December. Indications are that Madagascar has implemented the intended policies under the program, that it has met all of the performance criteria through end-April, and, subject to a more definitive assessment of the impact of the cyclone, that the broad objectives of the program for 1984 should be realized. Concerning the medium-term prospects, the staff has found no indication that would suggest, at this time, the need for a change in the main trends described in EBS/83/255.

II. Economic Developments and Prospects for 1984

Available indications suggest that economic developments so far in 1984 in the real sector, domestic finance, and the balance of payments are broadly in line with the projections for the year as a whole as described in EBS/83/255, EBS/84/45, and EBS/84/82, and that the program's objectives for 1984 would be realized.

1. Cyclone "Kamisy"

In early April the northern third of Madagascar was severely affected by a major tropical cyclone. Cyclone "Kamisy," with a peak wind velocity of 190 mph in certain areas, crossed the northern tip of the country, causing extensive destruction in the port city of Antseranana (Diego Suarez) and its hinterland, then turned back after going out to sea and re-entered Madagascar around the city of Majunga, crossing the entire country diagonally and exiting just southeast of Antananarivo. ^{1/} A definitive assessment of the extent and composition of the cyclone damage is being undertaken by the Malagasy authorities in cooperation with various international organizations, and will be completed in July. Present indications are that the actual damage, while far less than the early estimates had indicated, has nevertheless been severe. Housing was badly affected, particularly in the Antseranana and Majunga areas, as was rural infrastructure, especially bridges and irrigation. The cyclone also caused some damage to agricultural production, although

^{1/} Three other cyclones had affected Madagascar before "Kamisy" in December and January. Reportedly, it appears that the wind damage and the damage from lowland flooding was largely offset by the benefits of heavier rainfall elsewhere.

the short-term effects on the balance of payments appear to be relatively unimportant. The following description of developments in the real sector, fiscal and monetary areas, and the balance of payments makes reference, as appropriate, to the possible impact of the cyclone insofar as it is known.

2. The real sector

The present program envisages a continuation in 1984 of the very modest 1983 growth of GDP of around 1 percent. Earlier in the year the authorities had projected real growth in 1984 of 1.8 percent in agriculture, 4.8 percent in industry, and 2.8 percent in services, for an overall growth of real GDP of 2.1 percent. There is no evidence of any significant adverse effect on the pace of activity in the services sector, but agricultural growth was adversely affected to some extent by the cyclone. ^{1/} Industrial activity is still expected to respond favorably to the 17 percent increase in the projected import of raw materials and intermediates provided under the program. In the circumstances, the program's original target of about 1 percent real growth in GDP appears to be feasible and could be exceeded somewhat.

3. Domestic financial developments

As noted in EBS/84/45, in 1983 domestic financial imbalances were reduced further, with the overall government deficit declining to 7.0 percent of GDP, the money supply actually contracting by 1.5 percent, and the annual rate of inflation ^{2/} declining to 19 percent.

The program for 1984 foresees a further reduction in the fiscal deficit to 5.5 percent of GDP; most of the adjustment is to be achieved by restraining to 7 percent the increase in expenditure over the realized outlays in 1983. In the first quarter of 1984 overall government operations, reflecting large seasonal variations, registered a cash surplus of FMG 14 billion. Deposits of government agencies at the Treasury were also seasonally high, pending disbursements after the end of the rainy season. FNUP receipts (an export levy on traditional crops) in the first quarter were higher than expected. The staff has reviewed with the authorities the impact of the March devaluation on the original budget estimates, which have been revised and are shown in Table 1. To provide partial relief from the price impact of the depreciation, government workers were granted a 3 percent salary increase, effective July 1. Also, allocations for other current expenditures were increased by 5 percent to allow for an adequate provision

^{1/} The authorities estimate on a preliminary basis the cyclone damage to rice production at about 150,000 tons of paddy. However, total production of paddy for the year would still be at about the same level as in 1983.

^{2/} Antananarivo low-income price index.

Table 1. Madagascar: Overall Government Operations, 1983-84

	1983		1984	
	Program	Estimate	Program	Estimate
(In billions of Malagasy francs)				
Total revenue	185.8	185.6	213.8	224.3
Budgetary receipts	138.4	141.0	155.5	161.0
Direct taxes	25.8	24.3	33.1	32.1
Indirect taxes	109.1	111.3	118.9	124.8
Nontax revenue	3.5	5.4	3.5	4.1
Other	47.4	44.6	58.3	63.3
FNUP receipts	36.0	36.3	53.0	61.4
Grants	11.4	8.3	2.3	...
Treasury operations (net)	--	--	--	--
BCRM rice import operations (net)	--	--	3.0	1.9
Total expenditure	-267.7	-267.1	-291.4	-301.9
Current budgetary expenditure	-147.0	-143.0	-158.2	-163.7
Wages and salaries	-82.0	-81.9	-90.2	-91.8
Interest on external debt	-11.9	-11.6	-14.9	-16.3
Interest on domestic debt	-3.1	-3.3	-2.9	-2.9
Other current expenditure	-50.0	-46.2	-50.2	-52.7
Capital expenditure	-70.6	-79.0	-75.6	-84.4
Development budget <u>1/</u>	-45.8	-49.9	-47.7	-52.3
On-lending	-24.8	-29.1	-27.9	-32.1
Other	-50.1	-45.1	-57.6	-53.8
Deferred payments <u>2/</u>	-22.1	-21.8	-15.3	-15.3
Grant-financed expenditure	-6.0	-6.7	-20.0	-16.2
FNUP expenditure	-13.4	-13.0	-16.7	-16.7
Treasury operations (net)	-5.4	-0.4	-5.6	-5.6
BCRM rice import operations (net)	-3.2	-3.2	--	--
Overall deficit	-81.9	-81.5	-77.6	-77.6
Of which:				
Treasury deficit <u>3/</u>	(-101.3)	(-101.6)	(-116.9)	(-124.2)
Foreign financing (net)	45.0	46.2	35.1	45.1
Domestic financing (net)	36.9	34.9	32.5	32.5
Banking system	37.6	36.1	34.0	34.0
Nonbank institutions <u>4/</u>	-1.1	-1.2	-1.5	-1.5
Balance to be financed <u>4/</u>	--	0.4	10.0	--
Memorandum items:	(In percent of GDP)			
Budgetary receipts	11.4	12.1	11.1	11.5
FNUP receipts	3.0	3.1	3.8	4.4
Total revenue	15.3	15.9	15.3	16.0
Current budgetary expenditure	-12.1	-12.3	-11.3	-11.7
Capital expenditure	-5.8	-6.8	-5.4	-6.0
Total expenditure	-22.0	-22.9	-20.8	-21.6
Overall deficit	-6.7	-7.0	-5.5	-5.5
Domestic bank financing	3.1	3.1	2.4	2.4
GDP (billions of FMG)	1,217.0	1,165.0	1,400.0	1,400.0

Sources: Ministry of Finance and Economy; Central Bank of Madagascar; and staff estimates.

1/ Including capital expenditure financed from reserved funds.

2/ Including arrears payments of FMG 9 billion.

3/ Excluding FNUP and central bank (BCRM) rice import operations.

4/ In 1983 an FMG 0.4 billion statistical discrepancy existed in financing.

of basic supplies and materials. On the revenue side, the March devaluation could account for a 3.5 percent increase in total revenue, and new revenue measures introduced in 1984 for an additional 0.3 percent.

Current expenditure is now estimated to be about 3.5 percent higher than originally projected in the program. Due to the above-mentioned 3 percent pay increase, personnel expenditure is estimated to be about 2 percent above the FMG 90.2 billion ceiling foreseen in the program; external interest payments are expected to be 9.4 percent higher, and other current nonpersonnel expenditure 5 percent higher. The nominal allocation for capital expenditures has also been revised upward, to FMG 84.4 billion, in light of the March devaluation. On the other hand, as noted earlier, it is too early to assess fully any additional expenditure that may be required as a consequence of the cyclone. The situation will be reassessed on the basis of more complete information at the time of the second review of the program in late July.

The program foresees by the end of 1984 the elimination of domestic arrears, which were estimated at FMG 19.3 billion at the end of 1982 and were reduced to FMG 9 billion during 1983. ^{1/} With the new expenditure control system introduced in January 1983, no new accumulation of domestic arrears by spending ministries is expected to have occurred in 1983. However, this will be confirmed when the end-1983 inventory is completed by end-June 1984. Should new arrears be discovered, the next review, to be completed in August, would also establish a firm timetable for their elimination in 1984. In the meantime, the Government proposes, as a performance clause, to reduce the outstanding arrears by the equivalent of FMG 1 billion between end-December 1983 and end-June 1984; performance criteria for the second half of 1984 in respect of domestic arrears would be established in the course of the August review. ^{2/}

In the first quarter of 1984 total money supply fell by 4 percent (Table 2). Credit to both Government and the private sector registered declines (4 and 2 percent, respectively), and net foreign assets of the banking system also fell, by the equivalent of FMG 74 billion. The decline in credit to the Government reflects the above-mentioned seasonal fiscal surplus, while that to the private sector reflects partly the seasonal nature of such credit and partly the fact that in late 1983 the Government settled a substantial amount of domestic arrears carried over from the previous years.

^{1/} This amount is included under "Deferred payments" in programmed 1984 expenditure (Table 1).

^{2/} The Government is currently undertaking a process of comprehensive verification of the validity of each claim comprised in the remaining amount of FMG 8 billion.

Table 2. Madagascar: Monetary Survey, 1982-84

(In billions of Malagasy francs)

	<u>1982</u> Dec.	<u>1983</u> Dec.	<u>1984</u> March
Monetary movements (net)	-111.5	-121.4	-153.8
Assets	26.0	35.1	35.5
Liabilities	-137.5	-156.5	-189.3
Domestic credit (net)	484.0	548.2	531.5
Claims on Government (net) ^{1/}	268.5	306.7	292.0
Credit to private sector and state enterprises	215.5	241.5	239.5
Broad money	275.6	271.5	260.1
Money	221.4	210.9	196.3
Currency	90.4	75.8	70.9
Demand deposits	131.0	135.1	125.4
Quasi-money	54.2	60.6	63.8
Long-term foreign borrowing	156.8	282.8	313.6
Other items (net)	-59.9	-127.5	-196.0
Of which: valuation adjust- ments	(-55.1)	(-108.6)	(-155.6)

Source: Central Bank of Madagascar.

^{1/} Differs from definition of performance clause by inclusion of the banking operations of the Treasury.

Under the program net credit to the Government is subject to cumulative ceilings of FMG 9.0 billion and FMG 14.0 billion between end-December 1983 and end-April and end-June, respectively, while that to the economy is subject to cumulative ceilings of FMG 24.0 billion and FMG 38.0 billion for those two periods, respectively. In view of the uncertainties relating to the impact of the cyclone and those concerning the timetable of disbursements of exceptional balance of payments assistance following the April meeting of aid donors in Paris, the authorities have proposed that performance criteria relating to credit ceilings for end-September and end-December 1984 be fixed during the course of the August review. In the meantime, as indicative targets, the increase in net credit to the Government would not exceed FMG 24.0 billion between end-December 1983 and end-September 1984 and FMG 34.0 billion for the entire year 1984. Similarly, the increase in credit

to the economy will be targeted at FMG 82.0 billion between end-1983 and end-September 1984 and at FMG 102.0 billion for the entire year 1984. While these indicative targets will be reviewed, and appropriate performance criteria fixed, during the August review, they imply that money supply would increase by about 19 percent during 1984, assuming that the balance of payments targets of the program (see below) are fulfilled. Nominal GDP is projected to increase by about 20 percent in 1984.

4. The balance of payments

As regards the balance of payments (Table 3), pending a definitive assessment of the impact of the cyclone on imports and exports, indications on the overall developments so far in 1984 are in line with the projections presented in EBS/84/45, and the Central Bank should be able to reconstitute somewhat its holdings of external reserves.

On the current account, earnings from shrimp and petroleum products ^{1/} are now expected to be below the initial estimates. On the other hand, export prices of coffee--Madagascar's largest export--are anticipated to be higher than assumed in the initial projections and should offset the decline in receipts from other exports. Owing to a small reduction in aid-financed imports, the trade deficit is estimated at SDR 27.5 million, compared to the earlier estimate of SDR 31.5 million. Service payments (excluding additional interest on rescheduled debt following Paris Club III) are currently expected to be marginally higher owing to the increase in international interest rates. Thus, the projected current account deficit is slightly below the SDR 260.6 million estimated earlier.

On the capital account, lower-than-expected disbursements on project-related external loans, due to delays in project implementation, are more than offset by the additional SDR 42 million of assistance expected in consequence of the April aid donors' meeting (EBS/84/82). Thus, before taking into account the debt relief obtained as a consequence of Paris Club III, the overall balance of payments deficit is now projected at SDR 176 million, or about SDR 25 million lower than projected in EBS/84/45. Taking into account the net debt relief (i.e., net of interest charges and amortization on rescheduled amounts) following Paris Club III, and the projected net purchases from the Fund, a total of SDR 21.6 million is estimated to be available for both a reduction in external arrears and some reconstitution of the external reserves of the Central Bank.

^{1/} Petroleum products exports are now expected to be nil in 1984, as the country's sole refinery, damaged by an industrial accident in August 1983, is no longer expected to resume operations until very late in the year.

Table 3. Madagascar: Balance of Payments Projections, 1984

(In millions of SDRs)

	EBS/84/45	1/	June 7, 1984
Exports, f.o.b.	312.6		312.6 2/
Imports, f.o.b.	-344.1		-340.1
Trade balance	-31.5		-27.5
Service receipts	45.0		45.0
Service payments	-273.0		-275.4
Freight	(-47.6)		(-47.8)
Transport and travel	(-54.6)		(-54.6)
Investment income	(-120.1)		(-122.2) 3/
Other	(-50.7)		(-50.8)
Services (net)	-228.0		-230.4
Private transfers	-1.1		-1.1
Current account	-260.6		-259.0
(Excluding interest)	(-142.4)		(-138.7)
Public transfers	56.7		57.0
Nonmonetary capital	6.3		27.9
Drawings	(155.5)		(182.5) 4/
Amortization	(-149.2)		(147.2) 5/
Banks (net)	--		--
Other	-2.9		-9.3 6/
Overall balance	-200.5		-176.0
Financing	200.5		176.0
Repayment of consolidated arrears	-22.7		-24.4 7/
Debt rescheduled (net)	81.9		204.1
Principal rescheduled	(70.5)		(153.4)
Interest rescheduled	(11.4)		(74.7)
Amortization on rescheduled 1984 maturities	(--)		(-7.4)
Interest charges on 1984 rescheduling and consolidation	(--)		(-16.6)
IMF (net)	3.5		17.9
Stand-by	(27.0)		(27.0)
CFF	(--)		(14.4)
Repurchases	(-23.5)		(-23.5)
Net cash change in arrears (decrease -)	--		-8.5 8/
Gross central bank reserves (increase -)	--		-13.1 9/
Financing gap	137.8		--

Memorandum items:

Current account deficit, excluding interest, as percent of projected GDP	5.2	5.8
FMG/SDR	511.25	587.90 10/
Projected GDP (in billions of FMG)	1,400.00	1,400.00

Sources: Data provided by the Malagasy authorities; and staff estimates.

1/ Before 1984 Paris Club III rescheduling in March and aid donors' meeting in April, but including the impact of previous reschedulings.

2/ The composition of exports is somewhat different, with greater projected coffee exports (on account of a higher unit value) offsetting slightly lower projected exports of a number of other products.

3/ Excludes SDR 16.6 million in interest on 1984 official reschedulings and consolidation.

4/ Includes SDR 42 million in exceptional balance of payments assistance from aid donors' meeting.

5/ Excludes SDR 7.4 million in amortization of rescheduled 1984 maturities.

6/ Includes valuation adjustment, short-term capital, and errors and omissions. The amount is estimated, provisionally, on the basis of the first quarter figure of SDR -2.1 million and of the 22.5 percent ratio between nonclove exports for the first quarter and those projected for 1984 as a whole.

7/ Includes reduction of arrears of SDR 2.7 million in respect of arrears to Paris Club.

8/ Performance criterion; preliminary figure.

9/ Indicative program target.

10/ Period average rate used by the authorities as an indicative figure.

The Malagasy franc was depreciated by 15 percent in March, and, in conformity with the agreed policy, it will be further depreciated in keeping with the first quarter increase in the cost of living, preliminarily estimated at 4 percent. In addition, the limits on external borrowing specified in EBS/84/45 have also been respected.

It may be recalled that, pending the resolution of the financing gap for 1984, the program had specified no performance criterion relating to the reduction in external arrears, though it was clearly intended to aim at a certain net reduction during the program period through cash payments. These arrears amounted to SDR 149.8 million at the end of 1984, including an amount of SDR 54.3 million in respect of payments due on the debt already rescheduled under Paris Club I and II. Following the agreement under Paris Club III, this latter amount has also been rescheduled (SM/84/74), implying a payment of SDR 2.7 million on such arrears in 1984. Excluding, therefore, the arrears now consolidated by the Paris Club, outstanding arrears at end-1984 amounted to SDR 95.5 million. In view of the above-mentioned estimates relating to the balance of payments, the authorities have now proposed to reduce these arrears on a cash basis by SDR 8.5 million during calendar year 1984. ^{1/} As a performance criterion, these arrears would be reduced through a net cash payment of SDR 4.0 million by the end of June 1984; performance criteria in this regard for end-September and end-December would be fixed during the course of the forthcoming August review.

On the above basis, it is expected that the Central Bank would be able to reconstitute its gross external reserves by about SDR 13 million in 1984 to about SDR 47 million at end-December 1984, or the equivalent of about one month of imports. This outcome would be in conformity with the initial objectives of the program stated in EBS/84/45. As indicative targets, to assist in an improved management of the balance of payments, the monetary authorities will aim at increasing gross reserves from their end-April level of SDR 30 million to SDR 36 million at end-July and SDR 40 million at end-September.

III. Policy Implementation and Intentions Under the Program

Policy implementation so far under the program has been satisfactory, both in terms of the intentions expressed in the letter of November 21, 1983 (EBS/83/255) and in terms of the agricultural pricing policies described in the supplementary letter of February 23, 1984 (EBS/84/45). In addition, as indicated in the attached letter from the Minister of Finance, the authorities have further elaborated on the policies they propose to follow during the rest of 1984.

^{1/} On this basis, and including the required payment of SDR 2.7 million in respect of the Paris Club arrears, total reduction in external arrears through net cash payments would amount to SDR 11.2 million in 1984.

1. Rice marketing and producer prices

As intended under the program, competitive bidding for rice collected by the state enterprise SOMALAC, in the Lac Alaotra area reserved for its monopoly of purchasing of paddy, has been introduced, and the three auction sales, involving both private traders and state companies, have been conducted. ^{1/} While participation by private bidders has been less extensive than might have been expected, the auctions resulted in an average sales price of about FMG 100/kg of paddy equivalent, or higher than the minimum reserve sales price. As intended, the producer price in the area has consequently been set at FMG 79/kg of paddy, or about 80 percent of the average price obtained in the auctions. This compares to the nationwide minimum of FMG 70 established in January and to the FMG 65 paid to producers for the 1983 harvest. On the basis of recent information relating to costs of production, this new price should leave a sufficient incentive margin for rice producers.

For the Maravoay area developed by FIFABE, the other major rice parastatal, the authorities are devising a comparable marketing program, to be introduced in September 1984 after final agreement with the German KfW, the main external donor concerned with that project. In the meantime, in view of FIFABE's relatively higher marketing costs, the producer price in its area has been set at FMG 76/kg, which should also provide adequate incentives to producers. In view of the satisfactory outcome of the above-mentioned three auctions, the authorities propose to continue with the new system of auctioning rice paddy and rice.

As regards rice imports, the authorities had programmed limiting them to 90,000 tons for the entire year 1984. As stated in the letter of February 23, 1984, the Government was to discuss with the Fund, during the course of this review, the necessity of importing 22,000 tons (estimated at that time to be paid for from Madagascar's own foreign exchange resources) in the second half of the year. However, in the meantime, Madagascar has received additional grants of 23,000 tons of rice, thus already bringing the total rice imports for 1984 to 91,000 tons, slightly above the programmed level for the year. In view of this, and unless the eventual assessment of the damage caused by the cyclone "Kamisy" demonstrates otherwise, the authorities do not propose to import any rice out of the country's own foreign exchange resources. In any case, before deciding on further imports, the authorities will discuss this question with the Fund staff during the course of the forthcoming reviews.

^{1/} Of this, the third auction, involving 28,000 tons of paddy, relates to a forward delivery from the crop to be collected during the 1984 season, beginning in July.

2. Other agricultural products

The February 23 undertakings concerning the pricing and marketing of other agricultural products (sugarcane, groundnuts, edible oils, and coffee) have been fulfilled as well. In particular, the wholesale price of edible oil has been set at FMG 850 per liter (compared to the FMG 700 minimum specified in the letter), which would more than cover the cost of imported oil and would provide local oil processing mills with a margin sufficient to offer adequate prices to domestic producers of groundnuts and palm kernels. For coffee, the producer price was raised by 18 percent to FMG 330/kg (compared to the FMG 325 specified in the letter). These increases are higher than stipulated under the program and were motivated by the authorities' desire to provide credible incentives to farmers.

3. Industrial pricing policy

The Government has had extensive discussions with the staff of the World Bank with regard to decontrol of prices of industrial products, as part of the discussions leading to a possible industrial sector credit. The authorities have indicated that they would be prepared to free prices of industrial goods representing 70 percent of value added in that sector. Major products whose prices are proposed to be decontrolled include textiles, shoes, cigarettes, cement, and condensed milk; goods whose prices would remain controlled include sugar, bread, paper, soap, school materials, medicines, and candles. In conformity with the undertakings in the Minister's letter of November 23, in the attached letter of intent the authorities have undertaken to decontrol, prior to July 15, 1985, goods accounting for at least 30 percent of value added. The timetable for decontrolling the prices of the goods accounting for the remainder of the 70 percent of value added will be set during the course of the November review with the Fund. Also, price control procedures for goods remaining under control have been informally made flexible, by allowing enterprises to revise prices if the Government has not objected within one month of receipt of the price increase request.

4. Public investment program

Discussions between the Malagasy authorities and the World Bank staff on a public investment program covering the period 1984-87 are under way, and have been completed as they relate to the agricultural and industrial sectors; a review of the projects in the transport sector is currently being undertaken jointly between the Bank staff and Malagasy officials. The discussions with the World Bank have focused on three issues: (i) overall financial constraint; (ii) policy content behind the public investment program; and (iii) specific criteria governing the selection of projects. In order to improve the project selection process, two committees--an investment committee

and a finance committee--have been set up by the authorities. The reviews undertaken so far have enabled the authorities to establish general priorities and to identify a number of projects for which further study and analysis would be required before further investment expenditure would be incurred.

In the course of its discussions with the authorities, the Bank staff has also examined in a general way the budgeted capital expenditures for 1984. The Bank staff did not consider it feasible to attempt to rank all the projects included in the 1984 budget in order of economic efficiency. Nevertheless, the World Bank staff did express strong reservations about certain industrial projects that are already practically completed. In consequence, an understanding has been reached that, even though public expenditure on completing these projects will be continued, their operations will not commence until further studies, which are already under way with external assistance, determine the conditions that would assure the national economic viability of these projects. This understanding has been reiterated by the Malagasy authorities in the attached letter from the Minister of Finance. Taking into account the effects of the March depreciation of the Malagasy franc, the overall investment expenditure for 1984 is projected at FMG 84.4 billion, which, as indicated earlier, is still consistent with the program's limit of an overall Treasury deficit of FMG 77.6 billion.

5. Balance of payments policy

In keeping with the agreed policy to make appropriate periodic adjustments in the exchange rate, the Malagasy franc was depreciated by 15 percent in March. The next adjustment in the exchange rate is due by the end of June 1984, by reference to the increase in the cost of living in the first quarter of 1984 which, preliminary data indicate, has increased by 4 percent.

In light of both the balance of payments' target under the program and the need to revitalize production, overall imports, c.i.f., were programmed at SDR 410 million, with their composition favoring raw materials and intermediates, which are planned to increase by 17 percent. Currently, imports for 1984 are projected at a slightly lower level of SDR 404.8 million, while maintaining the projected level of SDR 117.8 million for imports of raw materials and intermediates.

On the basis of the debt relief provided, as well as the expected external assistance, the authorities have programmed a net cash reduction in external arrears and will aim for an SDR 13 million increase in gross external reserves.

IV. Staff Appraisal

The developments so far, as well as the policy measures implemented, fully conform to the intentions and targets of the program supported by the present stand-by arrangement. All the performance criteria so far appear to have been met, and financial developments, including increases in the cost of living, indicate significant progress. Furthermore, the expectations are that the overall objectives of the program for the entire year 1984 will be realized.

As initially set up, the present review was also intended to establish performance criteria for the second semester of 1984. However, given the uncertain impact of the recent cyclone and the time needed to ascertain the phasing of receipts in respect of the exceptional balance of payments assistance consequent upon the aid donors' meeting in April, it was not considered feasible to set out definitive performance criteria for the second semester as intended. Instead, performance criteria relating to a reduction in domestic and external payments arrears for end-June 1984 have been set, and only indicative targets have been established for the remainder of the year. 1/ Definitive performance criteria for the second semester would be established during the forthcoming second review in August.

1/ In view of Executive Board Decision No. 7678-(84/62), adopted on April 20, 1984, the stand-by arrangement for Madagascar is to be amended as indicated in the Proposed Decision to include the standard performance criterion on overdue financial obligations to the Fund.

V. Proposed Decision

In view of the above, the following draft decision is proposed for adoption by the Executive Board:

1. Pursuant to paragraph 4(c)(i) of the stand-by arrangement for Madagascar (EBS/83/255), as amended by paragraph 3(b) of Executive Board Decision No. 7650-(84/42), adopted March 19, 1984, understandings regarding the policies and measures that Madagascar would pursue, including the specification of performance criteria for the remaining period of the arrangement, were to have been reached during the first review of the program to be completed before May 31, 1984.

2. Madagascar has consulted with the Fund as required by the cited paragraph 4(c)(i) of the stand-by arrangement, but, because of uncertainties arising from the effects of the recent cyclone "Kamisy," together with delays in agreeing on debt relief and exceptional balance of payments assistance, it was not feasible to establish performance criteria for the remaining period of the stand-by arrangement with respect to (i) total credit, (ii) net credit to the Government, and (iii) external debt.

3. The Fund waives the requirement that during the first review understandings be reached on the performance criteria for the remaining period of the arrangement listed in paragraph 2 above. Such performance criteria will be established during the second review of the program to be completed before

August 31, 1984. Madagascar will not make any purchases under the stand-by arrangement after August 30, 1984 until these performance criteria have been established, or after such performance criteria have been established, while they are not being observed.

4. The letter dated June 8, 1984, from the Minister at the Presidency of Madagascar in charge of Finance and Economy shall be attached to the stand-by arrangement as representing further understandings reached with the Fund, and the letter dated November 21, 1983, attached to the stand-by arrangement as modified and supplemented by the letter and memorandum of February 23, 1984, is further modified and supplemented by the letter dated June 8, 1984. Accordingly:

(a) Paragraph 4(a) of the stand-by arrangement shall be amended to include the following additional performance clauses:

"(iv) the target for the reduction of external payments arrears through net cash payments as described in the sixth subparagraph of paragraph 4 of the letter dated June 8, 1984, or

(v) the target for the elimination by the Government of domestic payments arrears as described in the seventh subparagraph of paragraph 4 of the letter dated June 8, 1984,".

(b) Paragraph 4(d) of the stand-by arrangement shall be amended to read as follows:

"(d) during the entire period of this stand-by arrangement, while Madagascar has any overdue financial obligation to the Fund, or if Madagascar
...."

5. The Fund finds that no additional understandings are necessary because of the inability to establish certain performance criteria during the present review of the program for the remaining period of the stand-by arrangement and that Madagascar may make purchases under the stand-by arrangement until August 30, 1984.

Democratic Republic of Madagascar
Ministry at the Presidency of the Republic
in Charge of Finance and Economy
The Minister

Antananarivo, June 8, 1984

Mr. Jacques de Larosière
Managing Director
International Monetary Fund
Washington, D.C.

No. 132-MPFE/SG/SP

Dear Mr. de Larosière:

1.a. The present stand-by arrangement with Madagascar, which became effective on April 10, 1984, envisages a review before end-May to assess the economic and financial developments since the beginning of this year and to set performance criteria for the rest of the program period. It thus entails a review of the application of agricultural policy, in particular to determine the amount of supplementary imports of rice for the second half of 1984, a review of the 1984 public investment program, and the application of industrial pricing policy. This review was undertaken with the Fund staff, and its conclusions are as follows.

b. Taking into account seasonal factors, and based on the outturn of the first quarter of 1984, the budgetary and external trade operations were in conformity with the projections. For the same period, the rate of inflation is estimated at 4 percent, notwithstanding the progressive liberalization of agricultural and industrial prices.

c. However, the cyclone "Kamisy" that hit the northern third of the country in April constitutes an element of uncertainty, as the damage is not yet known with precision.

2. Agricultural policy

a. As envisaged in the program, SOMALAC, the state enterprise in charge of the rice region of Lac Alaotra, organized the three auctions of rice described in my letter of February 23, 1984. The average price obtained was about FMG 100/kg of paddy equivalent, or slightly higher than the reserve price; accordingly, and as intended, the producer price of paddy in the region was fixed at FMG 79/kg, corresponding to 80 percent of the above-mentioned auction price for the present harvest, compared to FMG 65/kg during the previous year's harvest season. In the zone of Maravoay, wholesale marketing will continue to be the monopoly of FIFABE, as agreed with KfW. On the basis of the price obtained by the SOMALAC and taking into account the relatively higher marketing costs of FIFABE, the producer price in this region for the current harvest is fixed at FMG 76/kg.

b. The Government believes that these prices provide adequate incentives to producers. SOMALAC intends to sell one third of the paddy that it collects in the new season through auctions and the rest on the market at prices comparable to those obtained in these auctions.

c. It may be noted that the producer prices and marketing of rice in the rest of the country are free.

d. As regards rice imports, the program limits them to 90,000 tons in 1984, of which 22,000 tons, to be financed from the country's own resources, were envisaged for the second half of 1984. In the meantime, and following the cyclone damage, Madagascar received a further 23,000 tons of imports as grants, which brings total imports so far to 91,000 tons. Notwithstanding the losses caused to production by the cyclone, a better estimate of the damage would be known by September 1984. In the meantime, the Government intends to limit the imports of rice out of its own resources to the level already realized.

e. As regards other agricultural products (sugarcane, groundnuts, vegetable oil, and coffee), all the commitments indicated in my letter of February 23, 1984, were carried out.

3. Public investment program

a. The Government has had discussions with the World Bank on a public investment program for the period 1984-87. As regards investment expenditure for 1984, the total amount will not exceed FMG 84.4 billion, which is in conformity with the objective of a budgetary deficit of FMG 77.6 billion and taking into account the impact of the last devaluation. Within this total expenditure, the bulk is destined to the rehabilitation of the existing capacity.

b. The Government has taken into account the World Bank mission's observations on certain industrial projects, which have been practically completed, and, with external technical and financial assistance, has initiated studies to determine the optimal conditions for their operation that would assure their national economic viability.

4. Industrial prices

a. In the context of the industrial sector credit being discussed with the World Bank, the Government proposes to decontrol eventually the prices of industrial products, representing about 70 percent of value added in this sector. In conformity with the Government's commitments under the stand-by arrangement, and in conformity with the World Bank's recommendations, the Government will decontrol before July 15, 1984, the prices of products representing about 30 percent of value added. These products have been already identified. At the same time, the

Government has already put in place a more flexible system of price setting for those prices still subject to control, by providing for approval within 30 days of the receipt of the complete documentation. The timetable for liberalization of the price of other industrial products will be set during the course of the November review of the program with the Fund, and in the light of discussions with the World Bank.

b. It should be noted that, following the depreciation of the Malagasy franc in March, the prices of petroleum products were increased by a rate higher than that of the depreciation.

5. Performance criteria

a. The performance criteria concerning external borrowing and the transfer of dividends abroad were established for the entire program period in my letter of November 21, 1983, attached to the stand-by arrangement. Those concerning total credit of the banking system to the economy and net credit to the Government at end-April and end-June 1984 were established in my supplementary letter of February 23, 1984. The criteria for end-December 1983 were observed, and, on the basis of provisional figures, those for end-April 1984 as well.

b. It should be recalled that the provisional figures at end-December 1983, on which the calculations of the increase in domestic credit were based, are slightly different from the final figures.

c. On the basis of available data, and pending the estimates of damage from cyclone "Kamisy," it is premature to establish performance criteria beyond June 1984. In addition, the timetable of disbursements of the aid expected as a result of the aid donors' meeting in Paris in April is not yet known with certainty. Therefore, the Government intends to establish these criteria during the next review of the program to be completed before end-August.

d. The monetary authorities will aim at increasing the gross foreign exchange reserves of the Central Bank (excluding the special account in the Bank of France in accordance with the Paris Club III agreement), which amounted to the equivalent of SDR 30 million at end-April 1984, to a level of SDR 36 million at end-July, SDR 40 million at end-September, and SDR 47 million at end-December 1984. It should be emphasized that these objectives are formulated to assist in a better management of the balance of payments and are not performance criteria.

e. As indicative targets, the Malagasy Government intends to limit the increase in total credit to the economy, already limited to FMG 38 billion from end-December 1983 to end-June 1984, to FMG 82 billion until end-September 1984 and FMG 102 billion until end-1984, and to limit the increase in net credit to Government from the banking

system to FMG 24 billion from end-December 1983 to end-September 1984 and to FMG 34 billion to end-December 1984. These targets imply an increase in broad money of about 19 percent.

f. The stock of external payments arrears is estimated at SDR 95.5 million at end-December 1983, after consolidation of the arrears owed to member countries of the Paris Club. The Government intends to reduce these arrears on the basis of net payments by SDR 8.5 million in 1984. This reduction will be additional to the payment of an estimated SDR 2.7 million in arrears in the context of the March 1984 agreement on rescheduling of external debt owed to the Paris Club. As performance criterion, external payments arrears will be reduced by SDR 4 million between December 31, 1983, and June 30, 1984.

g. The stock of domestic payments arrears, estimated at FMG 19.3 billion at end-December 1982, has been reduced to FMG 9 billion at end-December 1983. The Government intends to eliminate these arrears in 1984, after verification of the validity of the claims. In this respect, and as performance criterion, the Treasury will pay at least FMG 1 billion before end-June 1984.

6. This letter supplements my letters of November 21, 1983, and February 23, 1984.

Very truly yours,

Pascal Rakotomavo
Minister at the Presidency
in Charge of Finance and
Economy

MADAGASCAR - Fund Relations

(As of May 31, 1984, unless otherwise indicated)

I. Membership status

- a. Date of membership: September 23, 1963
- b. Status: Article XIV

Financial Relations

II. General Department (General Resources Account)

- a. Quota: SDR 66.4 million
- b. Total Fund holdings of:

Malagasy francs: SDR 194.55 million, or 293 percent of quota

	<u>Amount</u> <u>(SDR millions)</u>	<u>Percent</u> <u>of quota</u>
c. Fund credit	128.2	193.0
Compensatory financing	(40.1)	(60.4)
Stand-by	(44.5)	(67.0)
Supplementary financing	(21.6)	(32.5)
Enlarged access resources	(22.0)	(33.1)

- d. Reserve tranche position: 0

III. Stand-by arrangement and special facilities

- a. Present stand-by arrangement:
 - i. Duration: April 10, 1984 through March 31, 1985
 - ii. Amount: SDR 33 million, or 50 percent of quota
 - iii. Utilization: SDR 3 million
 - iv. Undrawn balance: SDR 30 million

b. Previous stand-by arrangements during the last 10 years:

i. 1982-83 stand-by arrangement:

Duration: July 9, 1982 through July 8, 1983

Amount: SDR 51 million

Utilization: SDR 40.8 million

Undrawn balance: SDR 10.2 million

ii. 1981-82 stand-by arrangement:

Duration: April 13, 1981 through June 26, 1982

Amount: SDR 109 million

Utilization: SDR 39 million

Undrawn balance: SDR 70 million

iii. 1980-82 stand-by arrangement:

Duration: Initially requested to cover the period from
June 27, 1980 to June 26, 1982; was canceled
in April 1981 by request of the Malagasy
authorities.

Amount: SDR 64.45 million

Utilization: SDR 10 million

Undrawn balance: SDR 54.45 million

c. Special facilities: Compensatory financing of SDR 14.4 million
is being requested in respect of 1983 export shortfall. Out-
standing purchases under compensatory financing facility
amount to SDR 40.1 million, or 60.4 percent of quota.

IV. SDR Department

a. Net cumulative allocation: SDR 19.27 million

b. Holdings: SDR 0.1 million, or 0.7 percent of net cumulative
allocations

c. Current designation plan: None

V. Administered Accounts

a. Trust Fund loans

- i. Disbursed - SDR 25.4 million
- ii. Outstanding - SDR 23.9 million

b. SFF Subsidy Account payments: SDR 1.6 million

VI. Exchange Rate

FMG 560 per U.S. dollar. The Malagasy franc is pegged to a basket of currencies with weights based on the pattern of trade. There is no single intervention currency.

VII. Last Article IV Consultation

The 1983 Article IV consultation discussions were completed on December 21, 1983 (EBS/83/235 and SM/83/245). The consultation is held under the normal 12-month cycle.

IX. Technical Assistance

The Central Banking Department provided consultants to the Central Bank of Madagascar for various periods in 1983 on accounting of external assets and liabilities, monetary statistics, data processing requirements, and the implementation of a new bank data reporting system. The consultant on the latter issue returned to Antananarivo for two weeks in February 1984.