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Supplement 1

CONFIDENTIAL

December 22, 1983

To: Members of the Executive Board

From: The Acting Secretary

Subject: Madagascar - Stand-By Arrangement

Attached for the records of the Executive Directors is the text of the stand-by arrangement for Madagascar agreed at Executive Board Meeting 83/179, December 21, 1983.

Att: (1)

MADAGASCAR - Stand-By Arrangement

Attached hereto is a letter dated November 21, 1983 from the Minister at the Presidency in charge of Finance and Economy of Madagascar requesting a stand-by arrangement and setting forth:

(a) the objectives and policies that the authorities of Madagascar intend to pursue for the period of this stand-by arrangement;

(b) the policies and measures that the authorities of Madagascar intend to pursue for the period through December 31, 1983 of this stand-by arrangement; and

(c) understandings of Madagascar with the Fund regarding reviews that will be made of progress in realizing the objectives of the program and of the policies and measures that the authorities of Madagascar will pursue for the remaining period of this stand-by arrangement.

To support these objectives and policies the International Monetary Fund grants this stand-by arrangement in accordance with the following provisions:

1. For the period from the effective date of the approval of this arrangement and ending on March 31, 1985, Madagascar will have the right to make purchases from the Fund in an amount equivalent to SDR 33 million, subject to paragraphs 2, 3, 4, and 5 below, without further review by the Fund.

2. a. Purchases under this stand-by arrangement shall not exceed SDR 3 million until the review referred to under paragraph 4(c)(i) below has been completed, the equivalent of 9 million until March 31, 1984, the equivalent of SDR 15 million until June 30, 1984, the equivalent of SDR 21 million until September 30, 1984 and the equivalent of SDR 27 million until December 31, 1984.

b. None of the limits in (a) above shall apply to a purchase under this stand-by arrangement that would not increase the Fund's holdings of Madagascar's currency in the credit tranches beyond 25 percent of quota or increase the Fund's holdings of that currency resulting from purchases of supplementary financing or borrowed resources beyond 12.5 percent of quota.

3. Purchases under this stand-by arrangement shall be made from ordinary and borrowed resources in the ratio of 1 to 1, provided that any modification by the Fund of the proportions of ordinary and borrowed resources shall apply to amounts that may be purchased after the date of modification.

4. Madagascar will not make purchases under this stand-by arrangement that would increase the Fund's holdings of Madagascar's currency in the credit tranches beyond 25 percent of quota or increase the Fund's holdings of that currency resulting from purchases of supplementary financing or borrowed resources beyond 12.5 percent of quota:

a. during any period of the stand-by arrangement in which the data at the end of the preceding period indicate that:

(i) the limit on total credit to the economy from the domestic banking system described in paragraph 11 of the attached letter, or

(ii) the limit on credit to Government from the domestic banking system described in paragraph 11 of the attached letter, or

(iii) the amount of bona fide requests for dividend transfers described in paragraph 14 of the attached letter,

are not observed; or

b. if Madagascar fails to observe the limits on authorizations of new public and publicly guaranteed foreign indebtedness described in paragraph 14 of the attached letter; or

c. if the reviews with the Fund contemplated in paragraph 17 of the letter dated November 21, 1983 have not been completed in accordance with the following schedule:

(i) The "first" review, including the specification of quantitative performance clauses for the remaining program period, shall be completed before March 31, 1984;

(ii) The "second" review, including the specification of performance clauses pertaining to exchange rate policies and understandings regarding the banking system, shall be completed before June 30, 1984;

(iii) The "third" review, including the specification of performance clauses pertaining to budgetary policy and import program for 1985, shall be completed before October 31, 1984; or

d. during the entire period of this stand-by arrangement, if Madagascar

(i) imposes or intensifies restrictions on payments and transfers for current international transactions, or

(ii) introduces or modifies multiple currency practices, or

(iii) concludes bilateral payments agreements which are inconsistent with Article VIII, or

(iv) imposes or intensifies import restrictions for balance of payments reasons.

When Madagascar is prevented from purchasing under this stand-by arrangement because of this paragraph 4, purchases will be resumed only after consultation has taken place between the Fund and Madagascar and understandings have been reached regarding the circumstances in which such purchases can be resumed.

5. Madagascar's right to engage in the transactions covered by this stand-by arrangement can be suspended only with respect to requests received by the Fund after (a) a formal ineligibility, or (b) a decision of the Executive Board to suspend transactions, either generally or in order to consider a proposal, made by an Executive Director or the Managing Director, formally to suppress or to limit the eligibility of Madagascar. When notice of a decision of formal ineligibility or of a decision to consider a proposal is given pursuant to this paragraph 5, purchases under this arrangement will be resumed only after consultation has taken place between the Fund and Madagascar and understandings have been reached regarding the circumstances in which such purchases can be resumed.

6. Purchases under this stand-by arrangement shall be made in the currencies of other members selected in accordance with the policies and procedures of the Fund, and may be made in SDRs if, on the request of Madagascar, the Fund agrees to provide them at the time of the purchase.

7. The value date of a purchase under this stand-by arrangement involving borrowed resources will be normally either the 15th day or the last day of the month, or the next business day if the selected day is not a business day. Madagascar will consult the Fund on the timing of purchases involving borrowed resources.

8. Madagascar shall pay a charge for this stand-by arrangement in accordance with the decisions of the Fund.

9. a. Madagascar shall repurchase the outstanding amount of its currency that results from a purchase under this stand-by arrangement in accordance with the provisions of the Articles of Agreement and decisions of the Fund, including those relating to repurchase as Madagascar's balance of payments and reserve position improves.

b. Any reductions in Madagascar's currency held by the Fund shall reduce the amounts subject to repurchase under (a) above in accordance with the principles applied by the Fund for this purpose at the time of the reduction.

c. The value date of a repurchase in respect of a purchase financed with borrowed resources under this stand-by arrangement will be normally either the 6th day or the 22nd day of the month, or the next business day if the selected day is not a business day, provided that repurchase will be completed not later than seven years from the date of purchase.

10. During the period of the stand-by arrangement Madagascar shall remain in close consultation with the Fund. These consultations may include correspondence and visits of officials of the Fund to Madagascar or of representatives of Madagascar to the Fund. Madagascar shall provide the Fund, through reports at intervals or dates requested by the Fund, with such information as the Fund requests in connection with the progress of Madagascar in achieving the objectives and policies set forth in the attached letter.

11. In accordance with paragraph 17 of the attached letter Madagascar will consult the Fund on the adoption of any measures that may be appropriate at the initiative of the government or whenever the Managing Director requests consultation because he considers that consultation on the program is desirable.

Antananarivo, Madagascar

November 21, 1983

Mr. Jacques de Larosière
Managing Director
International Monetary Fund
Washington, D.C. 20431

Dear Mr. de Larosière:

1. Since 1980, the Malagasy Government has been implementing an adjustment program which has been supported by three successive stand-by arrangements, the last of which expired on July 8, 1983. The process of adjustment was accelerated in the first half of 1983 when stabilization measures were accompanied by a reorientation of policy toward liberalization of production and marketing activities. As a result, the external current account deficit, excluding interest payments, was reduced from SDR 428 million in 1980 to SDR 246 million in 1982. Due mainly to the debt rescheduling secured through the Paris Club and other official creditors, and to the exceptional balance of payments assistance, the overall balance of payments deficit was also reduced from SDR 176 million in 1980 to SDR 42 million in 1982.

2. The thrust of the past adjustment programs was to improve the budgetary situation, the deterioration in which had been a major cause of the earlier worsening of the balance of payments. Accordingly, substantial budgetary adjustments were achieved in 1982 and 1983, primarily by the implementation of new tax measures, a new expenditure control system, increases in tariffs of public enterprises, and the reduction in consumer subsidies, thus reducing the overall Government deficit from 18.4 percent of GDP in 1980 to 8.7 percent in 1982 and to a projected 6.7 percent in 1983. In addition to the budgetary measures, in May 1983 the Government began a process of liberalization of domestic marketing of rice and of other prices with a view to providing increased incentives to producers and better allocation of resources. The exchange rate policy was made more flexible, and the rate was devalued by 15 percent in May 1982, by 6 percent in February, 2 percent in July, and 10.5 percent in October 1983. Also, interest rates were increased, credit restraint was intensified, and the operating results of state enterprises began to improve.

3. While the budgetary situation has improved, the stagnation in the economy and the pressures on the balance of payments have persisted, as is evidenced by the maintenance of controls on all imports and exchange restrictions, and by the large accumulation of arrears estimated, at end-September 1983, at about SDR 129 million. Also, because of the foreign exchange constraint, the volume of imports, particularly

of inputs for production and of incentive goods for the rural areas, has fallen in each of the last four years, contributing in turn to a decline in real GDP in 1981 and 1982. Despite a projected slight improvement in 1983, real GDP in that year is likely to be below its level in 1979. The twin problems of the stagnant economy and accumulating external arrears are now very directly linked to the large, and still rising, debt service payments. The foreign debt has risen sharply since 1980 and total foreign debt at the end of 1982 amounted to SDR 1.7 billion, or 66 percent of GDP. Despite two reschedulings under the auspices of the Paris Club, reschedulings with other official creditors, and an agreement with banks, the debt service burden in 1983 will amount to 38 percent of exports of goods and services and will rise to 62 percent in 1984. Moreover, preliminary projections indicate that, partly reflecting the additional debt service on the rescheduled debt, foreign exchange receipts would hardly be enough to support the minimum import requirements of the economy and to service the present debt as scheduled. Financing of the balance of payments gap is a key element of any program for the coming years.

4. The Government is convinced that the present difficulties can be surmounted, but over the medium term. In order to maintain the recently improved performance of domestic prices and to support other policies of external adjustment, it will be necessary to consolidate the present restrained posture of the demand management policies, especially with regard to government finance; however, it cannot be assumed that further reductions in the budgetary deficit can be realized to the same extent as in the immediate past or that such reductions can be relied upon as the principal source of an additional amelioration in the balance of payments. The Government intends to implement a more comprehensive policy package, including substantial liberalization of pricing, marketing, and distribution of agricultural and industrial products, the selection of investment projects, exchange rate, and import allocation policy. This policy package should strengthen the measures begun in 1983 with the objective of encouraging the more productive activities in the economy, particularly in the agricultural sector. The program for the year 1984, described below, conforms to this objective with the expectation that it will be pursued over the medium term. However, the program is dependent upon the availability of the necessary minimum imports to activate production, and the Government is persuaded that the implementation of the program would be severely prejudiced unless an extremely generous solution to the debt problem over the medium-term is found.

5. A key element in the program is the recovery of the agricultural sector, where possibilities exist for both efficient import substitution and export promotion. In regard to rice, which is the main staple, and the import of which constitutes a large charge on the balance of payments, steps have been taken to supplement the liberalization measures taken in May 1983: (a) the minimum producer price of paddy has

been raised in October to the level of prices received by producers in the free markets adjacent to Lac Alaotra, one of the two rice producing areas reserved to state marketing enterprises. This is estimated to result in an increase in the minimum price of at least 20 percent to FMG 80 per kilo; (b) the Government will reach agreement with the World Bank and other lenders concerned, to open the marketing of rice to private traders in the Lac Alaotra and Marovoay basins prior to the beginning of the next main planting season in March 1984, thus providing competitive purchasing and distribution of rice throughout the country and (c) with regard to imported rice, the price of whole grain rice has been raised initially from FMG 140 per kilo to FMG 200 per kilo, and subsequently will be adjusted in accordance with trends in the market prices of domestic rice, with a view to maintaining an approximate price parity between the two; the price of broken rice will be adjusted to remain within a margin of 15 percent of the free market price for ordinary domestic rice. The retail price for imported rice will be adjusted, if required, in order to avoid any subsidies. As regards other agricultural products, the Government will raise, early in their respective crop seasons, producer prices as well as, where appropriate, consumer prices and exfactory prices; the price increases will assure a significant increase in real prices to producers over those prevailing in 1983 for nontraditional products such as meat, groundnuts, cotton, etc. and an increase in the prices of traditional export products in tune with the past trends. A more comprehensive decision on the producer pricing policy, including further liberalization of marketing and final prices, will be decided upon after an examination of this issue by the World Bank (which is currently assessing these policies), and will be the subject of a review with the Fund under the proposed stand-by arrangement before June 30, 1984.

6. As regards industrial pricing, the Government has expedited procedures to approve requests from enterprises to adjust prices. Price policy has been formulated with the objective of improving the financial performance, and avoiding the necessity of subsidies to the industrial sector. A mission from the World Bank is scheduled to visit Madagascar to discuss industrial policies in the context of a sector loan. The Government will reach understandings with this mission decontrolling wholesale and retail prices for all commodities, except for a few specific goods which would remain controlled but the authorization period for approving price changes will be shortened to a maximum of 30 days. Significant action in this regard will be initiated following the World Bank mission's recommendations, but in any case no later than end-1983.

7. Pricing policies, as described above, will be complemented by appropriate policies in respect of import and exchange allocations, and of the exchange rate. Given the severity of the foreign exchange constraint, it will be necessary to continue to control imports administratively. The 1984 import program will initially provide for total

imports (f.o.b.) of SDR 371 million, or about the level estimated for 1983. Within this total, the share of consumer goods (including that of rice) will diminish while that of inputs for agriculture, maintenance and rehabilitation of the transport sector, inputs for the export-oriented sub-sectors of industry, and other industrial inputs, will be raised. In particular, total rice imports in 1984 will be limited to 100,000 tons subject to an overall ceiling of SDR 20.0 million from Madagascar's own foreign exchange resources on total imports of rice, compared to 183,000 tons in 1983. An import program based on these considerations, as well as the supporting foreign exchange budget, providing for an automatic allocation of foreign exchange, would be finalized before the end of 1983 and will be reviewed with the Fund in the course of the first review of the program.

8. Since early 1983, the Government has followed a flexible exchange rate policy resulting in an 8 percent depreciation of the Malagasy franc through July 1983. An additional adjustment of 10.5 percent was effected at the beginning of October to take into account the relative inflation differential between Madagascar and its trading partners included in the currency basket to which the Malagasy franc is pegged. The flexible exchange rate policy to maintain the real effective exchange rate will be continued through the end of 1983. Exchange rate policies will be reviewed with the Fund in the course of the second review of the program.

9. As mentioned earlier, one of the most successful aspects of the adjustment policy has been the reduction of the overall government deficit from 18.4 percent of GDP in 1980 to 8.7 percent in 1982, and to an estimated 6.7 percent in 1983, primarily due to reductions in expenditure. Although the overall deficit in 1983 is slightly higher than targeted, due mainly to higher-than-expected interest payments and reduction in domestic arrears, domestic bank finance of this deficit is about as targeted because of larger-than-expected foreign financing. In view of this, no changes in budgetary policy are contemplated through the rest of 1983, but tighter control on capital expenditure and higher revenues from rice import operations should contain the overall deficit to the abovementioned figure and bank financing of the government budget to 37.6 billion, compared to the original target of FMG 36.6 billion.

10. In 1984, budgetary policy will be to restrict further the overall deficit and bank finance to the Government. While the details of next year's budget are still to be worked out, the overall deficit will be limited to no more than 5.5 percent of GDP, subject to the further limitation that, in absolute terms, the overall deficit would be lower than in 1983. For this purpose, net recruitment in the public services will be limited to up to 1,000 persons, and total expenditure on personnel will be limited to FMG 90.2 billion, (i.e., an increase of about 10 percent over the estimated outlay for 1983); those limits

reflect a restrictive employment and wage policy that will allow for only a partial compensation for the past increase in the cost of living. Similarly, allocations for the investment budget will be severely scrutinized, and emphasis will be placed on rehabilitation and maintenance of the existing stock, and on rehabilitation of existing enterprises. The Government will discuss with the World Bank its investment program for 1984, including priority accorded to the projects in the program. In addition, the Government intends to eliminate identified domestic arrears by the end of 1984. The budget for 1984 will form one of the principal subjects for the first review with the Fund.

11. There was a decrease in the money supply over the six-month period ending June 1983, due to the fall in net foreign assets and a lowerthan programmed increase in bank credit. Bank deposits also dropped by FMG 12.5 billion during this period causing a liquidity problem for commercial banks. This problem was exacerbated for the agricultural bank by large sums of money being tied up in an unexpectedly large stock of cloves, which in turn threatened the satisfactory financing of the liberalized rice marketing operations. The monetary authorities have, therefore, increased the rediscount facilities during the fourth quarter of 1983, particularly for the agricultural bank, to allow an expansion of credit to the private sector, including state enterprises, of FMG 58.4 billion (27.1 percent) during the second half of 1983. Total credit to the economy from the domestic banking system, which amounted to FMG 494.1 billion at June 30, 1983, will not exceed FMG 580.0 billion on December 31, 1983. A large part of the credit expansion will be devoted toward underpinning the expected recovery of economic activity following increasing liberalization of the marketing and pricing arrangements. Credit to Government from the domestic banking system, which amounted to FMG 258.3 billion at June 30, 1983, will not exceed FMG 291.4 billion on December 31, 1983. These increases, after taking into account the balance of payments target, should imply an annual 6.5 percent increase in (broad) money supply, compared to a projected 22 percent increase in nominal GDP. This decline in the rate of growth in money supply is already having a favorable impact on domestic price developments; the CPI grew by a 13 percent annual rate in the second quarter of 1983, compared to 33 percent in the corresponding quarter of 1982, and 22 percent in the first quarter of 1983.

12. Real interest rates in Madagascar increased in 1983 because of a rise in nominal rates in February 1983, and a deceleration in the rate of inflation. However, real deposit rates were still negative through end-August 1983. Accordingly, in October 1983, certain deposit rates were increased by a further 1-1.5 percentage points, and the structure of interest rates was simplified by eliminating controls on several specific rates. The rediscount rate of the Central Bank was also increased by 0.5 percentage points to 13 percent.

13. The intention in the monetary and credit policy sector is to make the financial structure more efficient and more in tune with the recent liberalization process. To that effect, the Government intends to review the domestic banking system, which consists of three sectorally specialized banks, and the conduct of credit policy which now relies almost solely on direct credit controls. This review has begun and its conclusion will be discussed with the Fund during the second review of the program in mid-1984. In the meantime, quarterly credit targets and ceilings for 1984 will be established with the Fund as a part of the first review of the program; the intention will be to further the recent deceleration in the pace of inflation, to provide adequate credit to the productive sectors, and underpin the balance of payments target for the year.

14. The balance of payments objective of the program is to limit the current account deficit (excluding interest payments) to 7.4 percent of GDP in 1983 (compared to 9.5 percent in 1982), and to 5 percent in 1984. During the program period, bona fide requests for dividend transfers will be authorized and effected in an amount of FMG 1.25 billion, of which FMG 0.25 billion before end-1983. Furthermore, the Government, the Central Bank or the national banks will not contract nor guarantee any new foreign borrowing with an original maturity from one year up to and including 10 years. The contracting of new loans in the maturity range above 10 years up to and including 15 years will be limited to specific credits currently being negotiated for export industries and amounting to no more than SDR 22 million. During the program period, the Government will not contract nontrade external borrowing of less than one year's maturity.

15. The achievement of the targets with respect to external arrears, external debt, and imports, as well as the anticipated external assistance under loans already contracted, and rescheduling agreements thus far obtained (including an agreement reached in principal with the banks), would still imply a gap of about SDR 163 million in 1984. Such a gap would make it virtually impossible to meet debt servicing obligations were they to be rescheduled on the past pattern of rescheduling accorded to Madagascar. Furthermore, it would leave the level of arrears alarmingly high, which would make it virtually impossible to manage the balance of payments. Accordingly, as a part of its program, the Government of Madagascar would seek an exceptionally generous rescheduling of its external obligations, including arrears, and exceptional balance of payments assistance, consistent with its other external objectives, described above. Such rescheduling, and exceptional balance of payments assistance, along with purchases under the requested stand-by arrangement, would provide sufficient resources to fill the financing gap in 1984.

16. During the period covered by the stand-by arrangement, the Government does not intend to: (1) introduce multiple currency practices; (2) impose new or intensify existing restrictions on payments and transfers for current international transactions; (3) impose new or intensify existing import restrictions for balance of payments reasons; (4) conclude bilateral payments agreements with member countries of the Fund.

17. The Government of Madagascar believes this program deserves the renewed support of the International Monetary Fund. It consequently requests a stand-by arrangement in an amount of SDR 33 million for a period of 15 months. The Government believes the measures described above are sufficient to achieve the objectives of the program. It will take any additional measures that may become necessary for this purpose. During the period of the requested stand-by arrangement, the Government will periodically consult with the Fund in accordance with the policies of the Fund on such consultations about the progress being made in the implementation of the program described above and any policy adaptations adjudged to be appropriate for the achievement of its objectives. In the first review of the program, before end-March 1984, the Government will reach understandings on performance criteria for 1984 relative to total credit, net credit to Government, domestic arrears of the Central Government, external arrears, and external debt, for the remaining program period. The proposed first review, before end-March 1984, will be followed by other reviews, before June 30, 1984, and October 31, 1984; the June review will concentrate on reaching understandings with the Fund on exchange rate policies and policies concerning the banking system, while the October review will aim at reaching understandings on budgetary policies and the import program for 1985.

Very truly yours,

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