

EBS/83/235
Correction 1

CONFIDENTIAL

December 19, 1983

To: Members of the Executive Board
From: The Acting Secretary
Subject: Madagascar - Staff Report for the 1983 Article IV Consultation

The following corrections have been made in EBS/83/235 (11/2/83):

Page 4, 2nd full para., lines 1 and 2: for "payments estimated at
SDR 146.2 million, or 43 percent"
read "payments amounting to
SDR 135.6 million before rescheduling,
or 36 percent"

line 6: for "SDR 64.3 million"
read "SDR 50 million"

lines 7 and 8: for "SDR 9.0 million of arrears"
read "SDR 30 million of arrears including
those with respect to short-term debt."

Page 15, footnote 1, lines 2-4: for "creditors through September 1983 and...
signed in November 1983."
read "creditors in respect of the total
debt and...signed before end-1983."

Page 23, 3rd full para., line 2: for "66 percent" read "64 percent"

4th full para., lines 3 and 4: for "June 1983 and from other official
creditors through September 1983, and on"
read "June 1983, from other official creditors
in respect of the total debt outstanding
at end-1982, and from commercial banks on"

Page 28, Item F., Column 4: for "66.0" read "59.6"

Page 36, Table I: Revised

Corrected pages are attached.

Att: (5)

virtually all large industrial enterprises, in addition to transport and public utilities. There are indications that by 1980 the public enterprise sector was on balance having an adverse effect on the efficiency of allocation of resources, especially in agriculture, as well as being a serious drain on the budget. From 1981, however, an effort was begun by the authorities to supervise more closely the activities of these enterprises (particularly in the area of investment), to allow substantial price increases for their output, and to rationalize the financial and economic structure of the sector.

From 1971 through 1978 Madagascar experienced no real overall growth, although private consumption and gross investment grew by about 5 percent in real terms while public consumption fell. The percentage distribution of consumption and investment in GDP along with the resource gap is shown in Chart 1. Chart 2 shows the percentage distribution of the fiscal and external deficit in GDP, along with an index of GDP. In 1978 Madagascar embarked on a major investment program concentrated on education and transportation equipment 1/, financed primarily by foreign borrowing. Real GDP increased by just over 10 percent in the two-year period 1979-80, pushed up by an unsustainable level of investment and foreign borrowing. In 1979 gross investment more than doubled, and it increased by a further 7 percent in 1980; in SDR terms, imports increased by 76 percent in 1979 and by a further 14 percent in 1980. The current account deficit of the balance of payments increased four fold in 1979 and increased again by 27 percent in 1980. To finance this large increase in the current account deficit, outstanding and disbursed external debt in SDR terms more than tripled between end-1978 and end-1980, to over one third of GDP, with the largest increases in 1979 coming from suppliers and financial institutions on relatively onerous commercial terms. 2/ This borrowing was still insufficient to finance the current account deficit in 1980, and arrears were incurred, estimated at SDR 174 million, equivalent to 28 percent of imports in that year.

The large increases in investment and foreign borrowing in 1979 and 1980 were reflected in the fiscal and monetary outturns. Government capital expenditures increased threefold in 1979 and

1/ Actual investment during this period was more heavily concentrated on education and transportation equipment than was indicated in the 1978-80 plan. An example of the startling increases in education in only two years is the fact that in 1980 the number of university students was around 30,000, compared to 11,000 in 1978. The investment in transportation equipment included purchase of a Boeing 747 aircraft and a number of ships.

2/ In 1979 new foreign loans contracted are estimated at SDR 379.7 million, of which SDR 235.3 million were from suppliers and financial institutions; in 1980 drawings on foreign loans totaled SDR 320.7 million. These magnitudes compare to total exports in 1979 of SDR 304.9 million and in 1980 of SDR 335.3 million.

by another 32 percent in 1980; and the overall central government deficit increased fourfold in 1979, to 13 percent of GDP, and by another 59 percent in 1980, to 18 percent of GDP. Even with the substantial foreign financing, the greater part of these deficits was financed by the domestic banking system, whose outstanding claims on Government increased almost fourfold between end-1978 and end-1980. This increase in bank finance to the Government is likely to have crowded out some nongovernment bank credits, as the proportion of nongovernment credit in total outstanding bank credit fell from 68 percent at end-1978 to 46 percent at end-1980. The money supply, however, increased by only about 20 percent in each of these years, the increase being moderated by the sharp drop in net foreign assets.

In view of the deteriorating external position, Madagascar requested assistance from the Fund, which, in June 1980, approved a two-year stand-by arrangement for an amount equivalent to SDR 64.45 million (EBS/80/136). The core of the financial program supported by the stand-by arrangement was a reversal of the expansionary fiscal policy, control over external borrowing, and elimination of arrears. However, key elements of the program were not observed, and no purchases were made after an initial purchase of SDR 10 million.

In 1981, with debt service payments amounting to SDR 135.6 million, before rescheduling, or 36 percent of exports of goods and services, and prospects of a further substantial deficit in the external accounts, Madagascar entered into a new 14-month stand-by arrangement with the Fund in an amount equivalent to SDR 109 million (EBS/81/77). Also, a Paris Club rescheduling was organized, which in 1981 provided SDR 50 million in debt service relief, and there was a consolidation of SDR 30 million of arrears including those with respect to short-term debt. The major policy elements of the financial program supported by this stand-by arrangement were, as in the 1980 program, a reduction of the central government deficit, to 9 percent of GDP; a reduction in external arrears through cash repayment of SDR 36.4 million; and a limitation on the contracting of new external debt. Performance criteria and program targets on the budget and arrears were not observed, despite a substantial reduction in public investment, and purchases of only SDR 39 million were made under the arrangement. As a result of the shortage of foreign exchange in 1981, import restrictions were severely tightened, and nominal imports fell by 26 percent, in spite of a 48 percent increase in rice imports, and real GDP declined by over 9 percent.

III. Performance Under the 1982 Program and Developments in 1982 and the First Half of 1983

1. Performance under the 1982 stand-by arrangement

On July 9, 1982 the Fund approved Madagascar's request for another one-year stand-by arrangement (EBS/82/103, June 11, 1982), for an amount equivalent to SDR 51 million. The program's principal objectives

Table 5. Madagascar: Impact of Rescheduling on External Debt Service 1/

(In millions of SDRs) 2/

	1981	1982	1983
A. Debt service before rescheduling	<u>135.6</u>	<u>210.2</u>	<u>280.6</u>
Interest (incl. moratorium interest on debt rescheduled on previous years)	61.4	87.5	96.4
Principal on regular maturities <u>3/</u>	66.8	100.1	170.7 <u>4/</u>
Payments on previously rescheduled regular maturities	--	2.9	3.9
Payments on arrears consolidated in previous years	--	14.3	6.0
IMF repurchases	7.4	5.4	3.6
B. Amounts rescheduled <u>5/</u>	<u>-68.3</u>	<u>-84.6</u>	<u>-167.4</u>
Interest	-20.0	-24.0	-26.1
Principal (gross)	48.3	-60.6	-141.3
Paris Club I (1981)	(-31.4)	(--)	(--)
Paris Club I (Jan-June 1982)	(--)	(-19.3)	(--)
Paris Club II (July-Dec. 1982)	(--)	(-24.2)	(--)
Paris Club II (Jan-June 1983)	(--)	(--)	(-25.2)
Other countries <u>6/</u>	(-13.7)	(-15.2)	(-50.8)
Private	(-3.2)	(-1.9)	(-65.3)
C. Payments on reschedulings during any given year	<u>52.6</u>	<u>1.3</u>	<u>15.9</u>
Moratorium interest	13.7	0.7	2.4
Payments on rescheduled regular maturities	3.9	0.6	3.1
Payments on consolidated arrears	35.0	--	10.4
D. Debt service after rescheduling of any given year (A - B + C)	<u>119.9</u>	<u>126.9</u>	<u>129.1</u>
E. Exports of goods and services	329.9	147.9	339.7
A/E ratio	41.1	60.4	82.6
D/E ratio	36.3	36.5	38.0

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

1/ Includes reschedulings obtained thus far from Paris Club through June 30, 1983, from certain other official creditors in respect of the total debt outstanding at end-1982, and from the London Club group of banks based on an agreement in principle expected to be signed before end-1983.

2/ Converted at the following rates for SDR 1: FMG 320.41 (1981), FMG 386.08 (1982), and FMG 445.8 (1983).

3/ Excluding unconsolidated arrears.

4/ Includes FMG 29.11 billion (SDR 65.3 million) of regular principal due to banks in 1983 on debt not in arrears. The counterpart is added to amounts rescheduled (under category "private") in accordance with the agreement reached in principle and expected to be signed in November 1983.

5/ Excluding arrears.

6/ Certain Arab and COMECON countries.

and La Réunion have almost a world monopoly, and the world market could not absorb substantial increases in supply without greatly affecting the price. Other agriculturally based exports include cotton cloth, meat, fish, pepper and sugar, which have substantial potential for expansion, but which accounted for only about 10 percent of exports in 1982.

Imports in 1982 declined by about 6 percent in SDR terms and are expected to decline again in 1983 by another 7 percent. They have declined in each year beginning 1981 and are expected to be 29 percent less in 1983 than their value in 1979. However, rice imports grew sharply in 1982, to 356 thousand tons (from 192 thousand tons in 1981), 75 percent of which was paid for with Madagascar's own foreign exchange. For 1983, rice imports are expected to be kept to 183 thousand tons, and the volume of nonrice imports is expected to drop to less than the level of 1978.

Given these trends in the trade accounts, and the reduction in the noninterest services account from the high level in 1980, the current account excluding interest payments has shown a steady improvement since 1980, with the deficit being reduced by more than half, from SDR 428.4 million in 1980 to a projected SDR 202.3 million in 1983.

Public transfers and drawings on loans declined sharply in 1982, from SDR 330.3 million in 1981 to SDR 255.6 million in 1982, and are expected to remain at about this level in 1983. The decline was the result of a reduction in 1981 and elimination in 1982 of exceptional balance of payments financing, which in 1980 amounted to SDR 57.2 million, and of the reduction in investment noted above. Amounts drawn from Donors Club commitments (in 1982 and 1983) partially made up for the above loss.

(2) External debt service

Debt service before rescheduling reached SDR 210 million, 60 percent of exports of goods and services in 1982, and is projected at SDR 280 million in 1983, 83 percent of exports of goods and services.

In 1981 a Paris Club rescheduling was arranged, followed by a second rescheduling in 1982. The impact of these reschedulings, along with rescheduling obtained in 1981-83 from other creditors and from the London Club group of banks (under an agreement reached in principle) is shown in Table 5. The amounts rescheduled amounted to SDR 320.3 million during the three years, about 50 percent of the regularly scheduled debt service due in those years. However, net debt relief was slightly less, due to downpayments on the rescheduled amounts and moratorium interest due on these reschedulings and on arrears consoli-

of the commercial banks, when viewed in combination with the relatively illiquid situation of the banks' balance sheets due to the financing of large stocks of cloves, severely limited the ability of the banks to expand credit to the nongovernment economy. In June 1983 the aggregated bank liquid reserves to deposits ratio had declined to 2.8 percent from 5.9 percent at end-1982 and 14.3 percent at end-1981.

The liquidity problems of the banking system were putting in jeopardy the financing of the major summer rice harvest. In April 1983 the Central Bank allowed the agricultural commercial bank to use its rediscount facilities, given the inability of the other banks to supply excess funds in the interbank market. The authorities stated that further borrowing from the Central Bank would be allowed, as well as the reactivation of the interbank market, to meet the temporary credit needs of individual banks. The monetary authorities are currently reassessing the adequacy of institutional arrangements and policy instruments in allocating credit. They will endeavor to expand credit in the second half of 1983 consistent with the need for greater flexibility and taking into account the external situation.

5. The external sector

Discussions on the external sector centered on the difficulties with regard to external debt service, the continued increase in arrears, the potential for exports, and the import program required to support expansion in exports and other economic development. The conclusion of these discussions, which were held within a medium-term perspective of the economy, was that Madagascar would not be able to pay its debt service over the next four years, and provide support for any economic development, without considerable increases in new foreign resources and further debt rescheduling on terms more favorable than those provided in the past.

a. External debt and debt service

The stock of external debt outstanding at end-1982, including arrears was SDR 1.7 billion, or about 64 percent of 1982 GDP. The principal creditors are OECD countries (34 percent of the total), international institutions including the IMF (25 percent), other countries (19 percent) and banks (14 percent). By the end of 1983 this stock is projected to increase to about SDR 2 billion.

Debt service in 1983-87 is shown in Table 6, based on loans contracted through April 1983, after debt reschedulings from the Paris Club through June 1983, from other official creditors in respect of the total debt outstanding at end-1982, and from commercial banks on the basis of an agreement reached in principle with the London Club group of banks in September 1983. Total debt service on this basis amounts to SDR 129.1 million in 1983, about 38 percent of projected exports of goods and services, and increases by 88 percent to SDR 243.3 million in 1984, about 62 percent of projected exports of goods and services.

Table 6. Madagascar: Projected External Debt Service Payments, 1983-87 ^{1/}(In millions of SDRs) ^{2/}

	1983		1984		1985		1986		1987	
	Am.	Int.	Am.	Int.	Am.	Int.	Am.	Int.	Am.	Int.
OECD countries	30.2	22.9	67.7	39.3	64.6	35.9	65.9	33.2	80.9	26.8
Other countries (including loans for the exceptional financing of the balance of payments) ^{3/4/}	--	--	--	30.5	--	30.5	--	30.5	41.5	30.5
Banks ^{4/}	--	25.4	--	21.8	34.9	19.8	34.9	15.2	34.9	11.5
International organizations	7.9	14.8	31.5	15.4	44.9	14.4	51.9	12.1	44.8	9.2
Of which: IMF ^{5/}	(3.6)	(9.9)	(23.5)	(10.2)	(32.4)	(8.3)	(35.4)	(5.8)	(27.6)	(3.3)
Private non-guaranteed	2.0	0.7	1.8	0.5	1.0	0.4	0.5	0.3	0.8	--
Consolidated arrears	16.4	2.4	22.2	6.2	22.7	3.6	12.9	1.8	3.5	0.4
Short term	--	6.4	--	6.4	--	6.4	--	6.4	--	6.4
Total	56.5	72.6	123.2	120.1	168.1	111.0	166.1	99.5	206.4	84.8
<u>Total debt service</u>	<u>129.1</u>		<u>243.3</u>		<u>279.1</u>		<u>265.6</u>		<u>291.2</u>	

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

^{1/} Data cover loans contracted through April 1983, after debt reschedulings from the Paris Club through June 1983, from other official creditors in respect of the total debt outstanding at the end of 1982, and from the London Club group of banks based on an agreement reached in principle and expected to be signed by end-1983.

^{2/} SDR 1 = FMG 445.8.

^{3/} Certain Arab and COMECON countries.

^{4/} Repayments on the basis of rescheduling of total debt (including arrears) outstanding at the end of 1982 referred to in footnote 1.

^{5/} On the basis of purchases outstanding at present.

export industries profitability is adequate in spite of the high implicit rates of taxation of exports. They further felt that improvements in infrastructure, particularly in transportation, along with other investments in export industries and the increased efficiency resulting from the liberalization program, should result in increased profitability of the export sector. Nevertheless the authorities intend to maintain their flexible approach to exchange rate policy as part of their commitment to pricing reform.

V. The Medium Term

The medium term outlook will be dominated by the balance of payments, particularly the likely difficulties of servicing the foreign debt. A projection was made of external debt servicing capacity through 1987 (Table 7). It is clear from the table that there are large balance of payments gaps in each year through 1987. Even in the hypothetical case of rescheduling each year on conventional terms, the debt service ratio increases from 44 percent in 1984 to 57 percent in 1987. The primary reason is that the net impact of rescheduling on conventional terms weakens after consecutive reschedulings as reschedulable amounts decline while moratorium interest payments increase, and repayments of previously rescheduled amounts become due.

VI. Exchange Restrictions

Madagascar avails itself of the transitional arrangements of Article IV, but maintains exchange restrictions under Article VIII, Sections 2 and 3 of the Articles of Agreement. In 1982 and 1983 Madagascar has continued to apply comprehensive exchange restrictions and, as noted above, to build up arrears on current payments. All payments of foreign exchange are controlled through foreign exchange budgets administered by an interministerial committee, the Central Bank and representatives of national banks. Specified limits apply on the sale of foreign exchange for certain invisible payments, such as foreign travel and educational expenses. Foreign workers in Madagascar are allowed to repatriate only fixed percentages of their pay, and there are restrictions on the repatriation of dividends of foreign companies. In addition to the external payment arrears on goods and services and principal on foreign debt, there are arrears on the transfer of dividends abroad and on payments of compensation to foreign firms that have been nationalized.

Regarding the transfer of dividends of foreign companies, the Malagasy representatives said that considerable progress had been made to reduce the backlog of applications which had developed since 1981 and to ensure that future requests will not encounter administrative delays. The transfer of additional amounts of bona fide dividends up to a specified limit will be authorized and effected during the remainder

Table 7. Madagascar: External Debt Servicing Capacity, 1983-87

(In millions of SDRs)

	1983	1984	1985	1986	1987
Exports, f.o.b.	295.7	346.5	363.3	395.9	435.5
Imports, f.o.b.	-371.1	-371.0	-375.2	-393.6	-412.8
A. Trade balance	<u>-75.4</u>	<u>-24.5</u>	<u>-11.9</u>	<u>2.3</u>	<u>22.7</u>
Services and private transfers net (excl. interest)	<u>-126.9</u>	<u>-126.1</u>	<u>-127.1</u>	<u>-133.5</u>	<u>-140.1</u>
B. Current account (excl. interest)	<u>-202.3</u>	<u>-150.6</u>	<u>-139.0</u>	<u>-131.2</u>	<u>-117.4</u>
Public transfers	59.2	62.0	62.0	62.0	62.0
Drawings <u>1/</u>	186.2	171.4	180.0	189.0	198.4
Other items	-12.6	-2.5	--	--	--
C. Balance available for debt service	<u>30.5</u>	<u>80.3</u>	<u>103.0</u>	<u>119.8</u>	<u>143.0</u>
D. Debt service on basis of current reschedulings thus far obtained	-129.1	-243.3	-279.1	-265.6	-291.2
Amortization	(56.5)	(123.2)	(168.1)	(166.1)	(206.4)
Interest	(72.6)	(120.1)	(111.0)	(99.5)	(84.8)
Remaining gap after D	-98.6	-163.0	-176.1	-145.8	-148.2
E. Debt service if future reschedulings obtained in every year <u>2/</u>	-94.3	-173.0	-220.3	-232.1	-276.1
Amortization	(33.1)	(70.6)	(95.0)	(105.7)	(152.4)
Interest	(61.2)	(102.4)	(125.3)	(126.4)	(123.7)
Remaining gap after E	-63.8	-92.7	-117.3	-112.3	-133.1
F. Debt service ratio on basis of D	38.0	62.3	68.0	59.6	59.7
G. Debt service ratio on basis of E	27.8	44.3	53.6	52.1	56.6

Source: Data supplied by the Malagasy authorities; and staff estimates.

1/ For 1983 after Donors Club; for subsequent years before Donors Club.

2/ On terms obtained thus far from Paris Club.

Exchange rate system:

The Malagasy franc is pegged to a basket of currencies with weights based on the pattern of trade.
SDR 1 = FMG 461.8 (August 31, 1983).

Intervention currency:

There is no single intervention currency.

Staff contacts:

The mid-term review (EBS/83/55) of the stand-by arrangement that expired on July 8, 1983 was completed on April 8, 1983. Staff visits to Antananarivo took place in mid-May and late-August 1983, and the 1983 Article IV consultation discussions were held from mid-July to early August 1983. A Malagasy delegation visited headquarters in early September 1983 for a financial program to be supported by a new stand-by arrangement.

Table I. Madagascar: Selected Economic and Financial Indicators, 1980-83

	1980 Actual	1981 Actual	1982		1983	
			Prog.	Actual	Prog.	Est.
(Annual per cent changes, unless otherwise specified)						
National income and prices						
GDP at constant prices	0.8	-9.4	0.9	-0.8	1.0	1.6
GDP deflator	15.1	25.2	35.2	28.3	24.7	20.3
Consumer prices ^{1/}	17.1	29.0	51.0	31.2	25.1	23.0
External sector (on the basis of SDRs)						
Exports, f.o.b.	9.8	-18.2	10.1	8.8	6.3	-0.7
Imports, c.i.f.	14.5	-28.8	10.9	-4.4	-4.6	-9.9
Non-oil imports, c.i.f.	8.6	-29.1	11.8	-16.1	-9.8	-15.0
Export volume	-10.2	-5.4	3.0	10.4	3.9	-12.4
Import volume	-1.0	-33.5	8.7	-11.8	-2.7	-7.7
Terms of trade (deterioration -)	5.9	-19.5	6.0	-10.3	2.0	14.3
Nominal effective exchange rate (depreciation -)	-5.6	-8.8	-15.5	-18.1
Real effective exchange rate (depreciation -)	4.1	4.7	...	-0.8
Government finance						
Total revenue and grants	7.8	-3.0	31.8	27.0	18.6	22.3
Total expenditure	28.7	-6.0	13.4	1.7	7.2	12.1
Money and credit						
Domestic credit	48.2	22.5	20.1	16.6	16.3	17.0
Government	77.4	34.1	14.9	14.4	13.6	14.0
Private sector	21.7	8.4	27.5	25.0	20.1	22.0
Money and quasi-money (M ₂)	19.0	21.4	26.2	10.2	23.3	14.0
Velocity (GDP relative to M ₂)	3.6	3.5	3.5	3.8	3.7	4.1
Interest rate (annual rate, one-year savings deposit)	5.65	6.75	10.50	10.50	12.50	12.50
(In per cent of GDP)						
Overall government savings	-2.8	-3.1	-0.9	-1.4	0.2	-0.7
Overall government financial deficit	-18.4	-14.7	-10.8	-8.7	-6.2	-6.7
Domestic bank financing	11.4	7.4	3.5	3.4	2.9	3.1
Foreign financing (net)	6.9	7.1	6.8	5.1	3.2	3.6
Gross domestic investment	23.4	18.1	18.3	13.7	12.9	11.8
Gross domestic savings	6.9	7.0	7.2	4.3	6.0	4.5
Current account deficit	-18.3	-14.9*	-14.9*	-13.0*	-9.0*	3/-12.2* ^{3/}
External debt						
Inclusive of use of Fund credit	34.3	50.5 ^{4/}	50.1 ^{5/}	64.4 ^{5/}	...	69.9
Debt service ratio (in per cent of exports of goods and services)	14.5	36.3 ^{4/}	54.3 ^{5/}	36.5 ^{4/}	...	38.0 ^{6/}
Interest payments (in per cent of exports of goods and services)	7.9	16.7 ^{4/}	18.4 ^{5/}	18.4 ^{4/}	...	21.4 ^{6/}

^{1/} CPI index for Antananarivo, including officially controlled prices.

^{2/} * indicates severe constraint on foreign exchange availability.

^{3/} After debt rescheduling already obtained from the Paris Club through June 1983 and excluding penalty interest on arrears outstanding to banks, which are in the process of being rescheduled.

^{4/} After debt rescheduling, but excluding arrears.

^{5/} After debt rescheduling already obtained from the Paris Club, through June 1982, but excluding arrears.

^{6/} On the basis of debt relief thus far obtained in 1983 from Paris Club I and II, the London Club and other creditors.