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EBS/85/270

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December 9, 1985

To: Members of the Executive Board

From: The Secretary

Subject: Madagascar - Staff Report for the 1985 Article IV Consultation and Second Review and Modification Under the Stand-By Arrangement

Attached for consideration by the Executive Directors is the staff report for the 1985 Article IV consultation with Madagascar and the second review and modification under its stand-by arrangement. Draft decisions appear on pages 29 and 30.

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

Mr. Abu-zobaa (ext. 6946) is available to answer technical or factual questions relating to this paper prior to the Board discussion.

Att: (1)

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INTERNATIONAL MONETARY FUND

DEMOCRATIC REPUBLIC OF MADAGASCAR

Staff Report for the 1985 Article IV Consultation and Second Review and Modification Under the Stand-By Arrangement

Prepared by the African Department

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

Approved by A.D. Ouattara and S. Kanesa-Thasan

December 6, 1985

I. Introduction

The 1985 Article IV consultation discussions with Madagascar and the second review of the current stand-by arrangement were held in Antananarivo during September 9-24, and further discussions were carried out during November 10-17, 1985. 1/ The review was aimed at assessing developments under the program; establishing performance criteria for total domestic credit, net credit to the Government, and external payments arrears for end-February 1986; and setting indicative targets for these items for end-April in the context of budgetary and balance of payments policies for 1986. The discussions were held with Mr. P. Rakotomavo, Minister of Finance; Mr. R. Randriamaholy, Governor of the Central Bank; and senior officials of the economic ministries and agencies.

Since mid-1980 Madagascar has made use of Fund resources under five successive stand-by arrangements. The current one-year arrangement of SDR 29.5 million (44.4 percent of quota) was approved on April 23, 1985 (EBS/85/82, April 1, 1985), and a first review of the arrangement was concluded by the Executive Board on August 26, 1985 (EBS/85/172, July 22, 1985). As of end-October 1985, the Fund's holdings of Malagasy francs subject to repurchase amounted to SDR 150.4 million, or 226.5 percent of quota, of which SDR 116.9 million (176.1 percent of quota) was under tranche policies and SDR 33.5 million (50.4 percent of quota)

1/ The staff members who participated in one or both missions were Messrs. N. Abu-zobaa (head-AFR), S. Kimaro (AFR), Mrs. M. Tyler (ETR), Mr. M.Z. Yucelik (FAD), Mr. J.C. Williams (AFR), and Mrs. M. Dowsett (secretary-AFR). Mr. Ouattara (Director-AFR) joined the mission for policy discussions and met with President Ratsiraka of Madagascar. Mr. A. Ismael, Assistant to the Executive Director for Madagascar, attended most of the meetings as an observer.

was under the compensatory financing facility. Assuming that the full amount of the present arrangement is purchased, the Fund's holdings of Malagasy francs subject to repurchase would decline to 208.8 percent of quota by April 22, 1986 (Table 1). Madagascar continues to avail itself of the transitional arrangements of Article XIV. Madagascar's relations with the Fund are summarized in Appendix II.

The World Bank Group has been extensively involved in sectoral and other operations in Madagascar. As of end-September 1985, the Group's total lending (including undisbursed) to Madagascar amounted to US$510.5 million, of which US$330 million had been disbursed (Appendix III). Fund and Bank staffs have cooperated closely on work pertaining to structural aspects, domestic pricing and marketing policies, and the assessment of medium-term prospects.

II. Background and Recent Developments (1981-84)

Since the early 1980s Madagascar has experienced severe financial and economic problems traceable to massive public investment carried out in 1979-80 and financed mainly by recourse to external borrowing on onerous terms. The policies pursued resulted in a short-lived increase in output, intensification of domestic inflation, and escalation of the debt service burden. The debt service ratio, before rescheduling, rose from about 46 percent in 1981 to nearly 75 percent in 1984, and to 90 percent in 1985. To reduce the financial imbalances, the authorities implemented adjustment programs supported by successive stand-by arrangements from the Fund, exceptional balance of payments assistance from the international community, and rescheduling of debt to official creditors and commercial banks. As a result, between 1981 and 1984 the external current account deficit fell from 15 percent of GDP to about 10 percent, the overall treasury deficit was reduced from 15 percent of GDP to less than 5 percent, and the inflation rate was brought down from 30 percent to about 10 percent (Table 2). In addition, the decline in output of the early 1980s was reversed in 1983, even though the positive growth rates realized since then (averaging 1.5 percent per annum) have remained well below the population growth rate of 2.8 percent a year. In 1984 real GDP was still some 9 percent below that of 1980.

1. The external sector

Between 1981 and 1984, imports fell by nearly 20 percent while exports oscillated around a slightly rising trend, and, as a result, the trade balance declined sharply, reaching approximate equilibrium in 1984 (Table 3). Although scheduled interest payments increased markedly, the external current account deficit fell by nearly one third. Between 1981 and 1983, however, net capital inflows, including substantial debt relief, were smaller than the current deficit, and the resulting overall deficits were financed mainly by net purchases from the Fund

Table 1. Madagascar: Projected Fund Transactions and Position During Period of Arrangement, April 1985-April 1986

	Outstanding at the Beginning of Arrangement, April 23, 1985	1985-86 April 23- May 31	June 1- July 31	Aug. 1- Oct. 31	Nov. 1- Jan. 31	Feb. 1- April 22
		(In millions of SDRs)				
Transactions under tranche policies (net)		7.81	-3.00	8.52	-3.18	-3.09
Purchases		10.00 1/	--	13.00 2/	3.25	3.25
Ordinary resources		(5.00)	(--)	(6.50)	(1.62)	(1.62)
Enlarged access resources		(5.00)	(--)	(6.50)	(1.62)	(1.62)
Repurchases (-)		-2.19	-3.00	-4.48	-6.43	-6.34
Ordinary resources		(-0.99)	(-2.35)	(-3.54)	(-4.12)	(-4.70)
Supplementary financing and enlarged access resources		(-1.19)	(-0.64)	(-0.94)	(-2.31)	(-1.64)
Transactions under compensatory financing facility (net)		--	-3.65	-2.73	-2.73	-2.73
Purchases		--	--	--	--	--
Repurchases		--	-3.65	-2.73	-2.73	-2.73
Total Fund credit outstanding (end of period)	143.43	151.24	144.59	150.38	144.47	138.65
Under tranche policies	103.58	111.39	108.39	116.91	113.73	110.64
Under compensatory financing facility	39.85	39.85	36.20	33.47	30.74	28.01
		(In percent of quota)				
Total Fund credit outstanding (end of period)	216.0	227.8	217.7	226.5	217.6	208.8
Under tranche policies	156.0	167.8	163.2	176.1	171.3	166.6
Compensatory financing facility	60.0	60.0	54.5	50.4	46.3	42.2

Source: IMF Treasurer's Department.

1/ Including SDR 3.5 million purchased after Executive Board approval of the stand-by arrangement and SDR 6.5 million purchased on the basis of end-April performance criteria.

2/ Includes two purchases, each of SDR 6.5 million, on the basis of end-June and end-September performance criteria. The purchase on the basis of end-June was also subject to the completion of the first review.

Table 2. Madagascar: Selected Economic and Financial Indicators, 1981-85

	1981	1982	1983	1984	1985	
				Prel.	Prog. (EBS/85/172)	Rev.
	(Annual percent changes)					
National income and prices						
GDP at constant prices	-9.7	-1.8	0.9	2.1	2.6	1.9
GDP deflator	26.6	28.5	21.5	10.2	10.0	10.3
Consumer prices 1/	30.5	31.5	19.6	9.9	10.0	9.4
External sector (on the basis of SDRs)						
Exports, f.o.b.	-16.0	5.3	-2.3	12.3	14.2	-6.5
Imports, c.i.f.	-28.5	-3.0	-18.2	-3.3	3.2	-8.4
Non-oil imports, c.i.f.	-29.1	-7.2	-16.3	-5.8	3.0	-6.9
Export volume	-5.5	8.5	-18.9	8.0	3.0	5.2
Import volume	-33.5	-6.9	-12.0	-3.9	1.0	-10.0
Terms of trade (deterioration -)	-7.9	-4.3	22.7	2.9	--	-12.9
Nominal effective exchange rate (depreciation -)	-6.9	-10.6	-10.4	-17.1	-11.0 2/	-11.0 2/
Real effective exchange rate (depreciation -)	9.4	7.0	0.6	-15.1	-4.5 2/	-5.5 2/
Central government financial operations						
Total revenue and grants	-3.1	27.0	22.1	31.1	9.5	-0.2
Total expenditure	-6.1	0.5	11.8	15.8	9.8	1.9
Money and credit						
Domestic credit	21.5	17.8	13.3	16.5	13.5	10.7
Government	33.0	12.7	14.0	10.5	6.2	6.2
Private sector	8.4	24.9	12.1	24.3	21.5	15.7
Broad money (M_2)	21.4	10.2	-1.5	18.3	7.1	5.1
Income velocity of broad money (M_2)	3.5	3.8	4.4	4.7	4.7	4.7
	(In percent of GDP)					
Overall fiscal deficit (-)	-15.0	-8.7	-6.7	-4.8	-4.7	-4.7
Of which: domestic bank financing	(7.4)	(3.4)	(3.0)	(2.3)	(1.4)	(1.4)
foreign financing (net)	(7.3)	(5.1)	(3.8)	(2.7)	(3.5)	(3.3)
Gross domestic investment	18.0	13.4	13.2	13.6	13.1	13.5
Gross domestic savings	7.0	4.8	6.8	9.6	9.2	10.5
Current account deficit (-) 3/ (including interest)	-14.6	-13.1	-10.9	-10.2	-10.6	-10.1
Current account deficit (-) 3/ (excluding interest)	-11.6	-9.6	-6.9	-4.5	-4.2	-4.0
External debt (including the Fund) 4/	53.0	64.4	70.0	89.3	...	...
Nominal GDP in billions of FMG	789.0	996.7	1,221.7	1,374.0	1,564.0	1,543.0
Conversion rate FMG/SDR	320.4	386.1	459.9	590.8	656.0	668.0
	(In percent of export of goods and services)					
Total debt service payments 5/	34.0	48.9	31.4	33.3	49.6 6/	49.5 6/
Interest payments 5/	16.4	18.6	18.5	17.2	23.4	22.7

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

1/ Low-income CPI index for Antananarivo.
2/ Assuming continuation of the present flexible exchange rate policy.
3/ Reflects a severe constraint on foreign exchange availability.
4/ Excludes short-term debt 1981 through 1982.
5/ After debt rescheduling, and including the Fund.
6/ Includes net cash reduction of arrears.

Table 3. Madagascar: Balance of Payments, 1981-86

(In millions of SDRs)

	1981	1982	1983	1984	1985 Prog. (EBS/85/172)	1985 Rev. proj.	1986 Proj.
Exports, f.o.b.	281.5	296.4	289.7	325.2	341.6	303.9	333.0
Imports, f.o.b.	-433.2	-409.0	-353.8	-343.5	-344.0	-314.0	-360.0
Trade balance	-151.7	-112.6	-64.1	-18.3	-2.4	-10.1	-27.0
Service receipts	55.6	49.7	45.0	58.7	57.0	57.0	57.0
Service payments	-267.6	-272.7	-268.0	-281.6	-312.3	-285.8	-285.1
Freight	-66.2	-68.1	-49.6	-48.1	-48.2	-44.6	-50.4
Transport and travel	-59.3	-55.7	-54.6	-54.2	-54.2	-54.2	-54.2
Investment income	-78.3	-91.4	-106.6	-134.9	-153.2	-143.0	-139.1
Other	-63.7	-57.5	-57.2	-44.4	-56.7	-44.0	-41.4
Services, net	-211.9	-223.0	-223.0	-222.9	-255.3	-228.8	-228.1
Of which: interest (incl. moratorium interest on resched.)	(-75.1)	(-88.2)	(-104.4)	(-133.2)	(-151.7)	(-141.5)	(-137.7)
Private unrequited transfers	3.4	-1.3	-1.1	3.4	6.0	6.0	3.4
Current account	-360.2	-336.9	-288.2	-237.8	-251.7	-232.9	-251.7
(Excluding interest)	(-285.1)	(-248.7)	(-183.8)	(-104.6)	(-100.0)	(-91.4)	(-114.0)
Public unrequited transfers	53.1	65.5	56.9	66.1	66.9	74.1	74.0
Nonmonetary capital (net)	237.7	109.9	184.1	155.8	200.2	152.3	51.4
Drawings	277.2	190.1	181.1	117.9	205.9	147.6	156.0 1/
Amortization 2/	-93.2	-164.2	-183.1	-127.0	-147.2	-147.6	-144.9
Debt relief (net of down payments)	53.7	84.0	186.1	164.9	141.5	152.3 3/	40.3 3/
Official creditors	50.3	82.1	125.1	141.1	141.5	137.9	25.9
Commercial banks 4/	3.4	1.9	61.0	23.8	--	14.4	14.4
National banks (net)	-18.1	-23.8	-0.3	-11.1	--	--	--
Other 5/	5.3	77.6	-41.7	42.7	--	14.9	--
Overall balance	-82.2	-107.7	-89.2	15.7	15.4	8.4	-126.3
Financing	82.2	107.7	89.2	-15.7	-15.4	-8.4	126.3
IMF (net)	31.6	51.7	6.5	17.9	-3.4	-3.4	-28.9
Purchases	39.0	52.4	10.2	41.4	29.0	29.0	6.5 6/
Repurchases	-7.4	-0.7	-3.7	-23.5	32.4	-32.4	-35.4
Net cash change in arrears (decrease -) 7/	59.0	63.8	69.6	-9.0	-8.0	-8.0	-8.0
Net central bank reserves (increase -) 7/	-8.4	-7.8	13.1	-24.6	-4.0 8/	3.0	-8.0
Financing gap	--	--	--	--	--	--	171.2
Memorandum items:							
Current account deficit as percent of GDP	-14.6	-13.1	-10.9	-10.2	-10.6	-10.1	-10.9
(Excluding interest)	(-11.6)	(-9.6)	(-6.9)	(-4.5)	(-4.2)	(-4.0)	(-4.9)
Outstanding arrears 7/	...	...	95.5	81.4	73.4	73.4	65.4
Freely available reserves	...	...	7.7	15.2	22.2	14.1	22.1
Debt service ratio before rescheduling 9/	45.9	72.9	87.0	75.3	85.1	90.1	83.6
Debt service ratio after rescheduling 10/	34.0	48.9	31.4	33.3	49.6	49.5 3/	73.3 3/11/
GDP	2,463.0	2,580.0	2,655.0	2,325.7	2,384.1	2,309.9	2,306.0
FMG/SDR exchange rate	320.4	386.1	459.9	590.8	656.0	668.0	765.0

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

1/ Represents the average of the three-year period 1983-85. The amount of capital inflows in the pipeline is somewhat lower.

2/ Before current year's debt rescheduling.

3/ After debt relief obtained from Paris Club IV (May 1985) and from other official creditors on comparable terms, through March 1986, and on the assumption that rescheduling in the amount of SDR 14.4 million on debt previously rescheduled will be forthcoming from London Club group of banks on the basis of discussions with the Steering Committee on September 3, 1985; it is expected that agreement from all creditor banks will be obtained by mid-December 1985.

4/ Includes small amount of debt relief from private creditors other than commercial banks.

5/ Includes valuation adjustment, short-term capital, errors and omissions, SDR 3.5 million in SDR allocations in 1981; in 1985, it comprises only SDR 14.9 million in petroleum financing from the U.S.S.R.

6/ Projected purchases under current stand-by arrangement.

7/ Series not comparable prior to 1983 since central bank foreign liabilities have been revalued at appropriate exchange rates only beginning mid-1983.

8/ Consists of an increase in liabilities of SDR 3 million in respect of prefinancing of coffee exports and an increase in gross reserves by SDR 7 million.

9/ Includes impact of previous years' reschedulings, but excludes that of the current year.

10/ Includes impact of reschedulings through the current year.

11/ Excludes relief on debt maturing after March 31, 1986.

and the accumulation of external arrears. 1/ In 1984 there was a small overall surplus as net capital inflows exceeded the current account deficit. Thus, for the first time since the onset of the present external difficulties, Madagascar was able to effect a net cash reduction in external arrears and to accumulate external reserves. At the end of 1984, Madagascar's readily available reserves 2/ amounted to SDR 15.2 million, equivalent to about two weeks of merchandise imports.

Madagascar's external debt, which totaled SDR 863 million at the end of 1980, rose by 140 percent to SDR 2,069 million (about 90 percent of GDP) by end-1984; however, the annual rate of increase in the debt slowed down from about 29 percent in 1981-82 to nearly 12 percent in the ensuing two years. The debt service payments, after rescheduling, which were equivalent, on average, to about one third of exports of goods and services between 1981 and 1984, are projected to increase to 50 percent in 1985. 3/

Since April 1982 the Malagasy franc has been pegged to a basket of five currencies with weights based on the pattern of trade during the period 1973-80. Between April 1982 and March 1984, the exchange rate was devalued on several occasions by 36.7 percent in foreign currency terms. Since then the exchange rate for the Malagasy franc has been adjusted (in relation to the basket) on a quarterly basis in line with the change in the consumer price index during the previous quarter, and until end-September 1985 the exchange rate was further depreciated by 12.2 percent in foreign currency terms. As a result, between April 1982 and July 1985, the real effective exchange rate depreciated, by about 22.4 percent, which brings it in the range of the 1978 level (see Chart). Madagascar maintains a comprehensive system of exchange restrictions under Article VIII, Sections 2 and 3, of the Articles of Agreement. Since the 1984 Article IV consultation, no additional restrictions have been introduced, and no significant changes have been made in the exchange and trade system.

2. Public finances

During 1981-84 there was a significant improvement in central government finances. The overall fiscal deficit declined from 15 percent of GDP in 1981 to less than 5 percent in 1984. The improvement was brought about more by an increase in revenue than by a slow growth

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1/ This fact, plus slippages in other areas, led to the interruption of purchases under the respective stand-by arrangements in these years.

2/ Excluding deposits in the escrow account for the Paris Club and other earmarked balances.

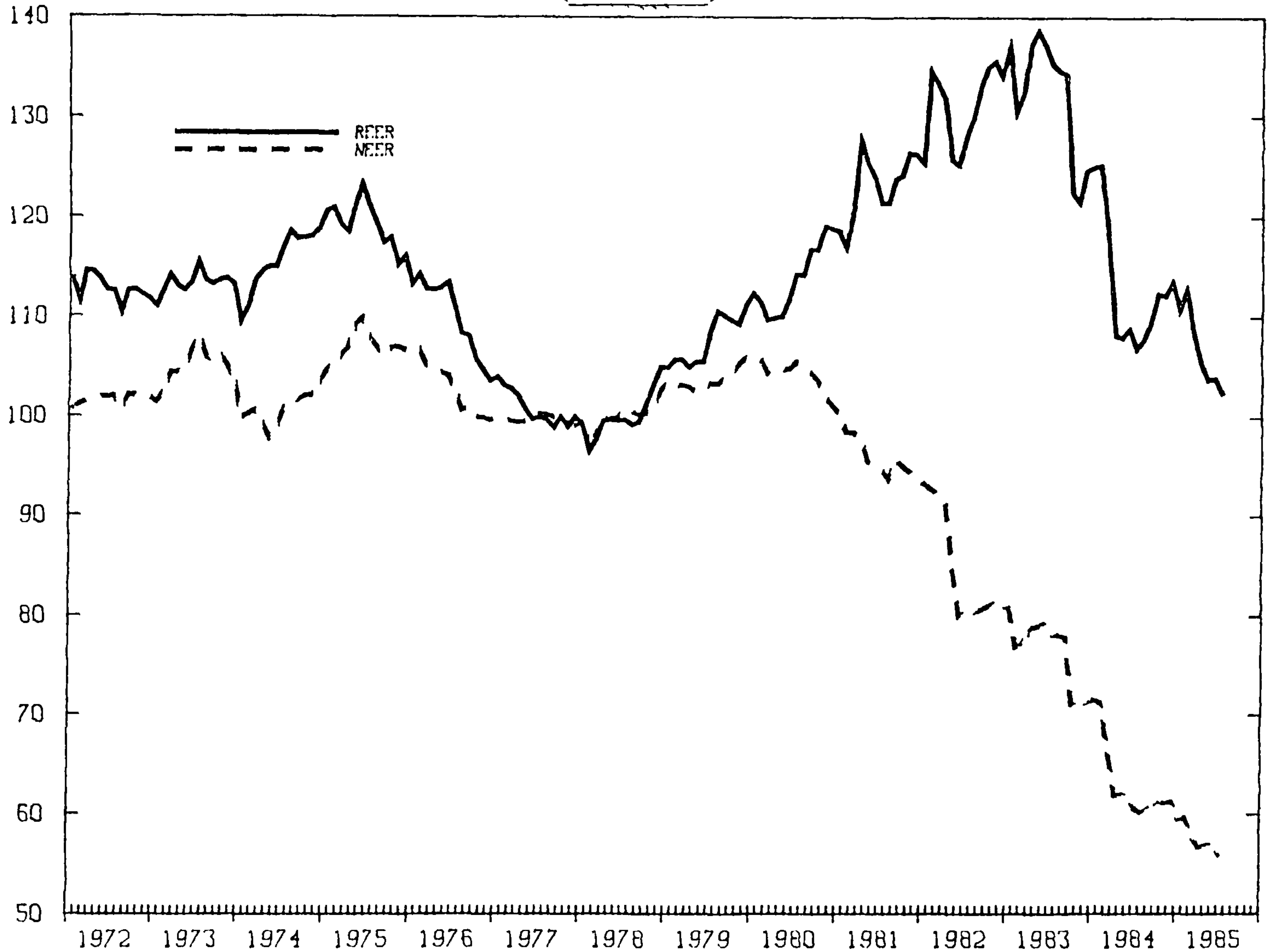
3/ After taking into account the debt rescheduling from the Paris Club and other official creditors, and on the assumption that additional debt will be obtained from the London Club group of banks.

CHART

MADAGASCAR

NOMINAL AND REAL EFFECTIVE EXCHANGE RATES, 1972-85 1/

(1978 = 100)



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

1/ A decline in the indices reflects a depreciation.

in expenditure (Table 4). Nearly 55 percent of the overall deficit was financed by net external borrowing, and most of the remainder by net domestic bank credit which declined from 7.4 percent of GDP in 1981 to 2.3 percent in 1984. Over this period, total revenue more than doubled, and the revenue-GDP ratio increased to nearly 18 percent in 1984. Nearly two fifths of the increase was attributable to receipts from the price stabilization funds for the traditional export crops (FNUP), which rose fourfold as export proceeds in local currency terms were bolstered by the depreciation of the exchange rate of the Malagasy franc and by increases in world market prices. Meanwhile, tax revenue grew by about 60 percent, less than the increase in nominal GDP, with nearly one half of the increase derived from taxes on international trade, owing largely to the impact of the depreciation of the exchange rate. During the period 1981-84, the Government introduced various discretionary measures with a view to enlarging the taxable base and strengthening the effectiveness of tax collection. The tax system has remained, however, inelastic, because of the limited contribution of state enterprises which account for a sizable share of economic activity.

Central government total expenditure increased by only 30 percent between 1981 and 1984, representing a substantial decline in real terms. Current outlays expanded at a faster rate, with personal emoluments increasing by about one third, owing to merit and modest general salary awards, while interest payments (mostly on foreign debt) rose by more than fourfold. In contrast, capital expenditure rose by only 17 percent from the unsustainable high level of 1981. During 1983 and 1984 the Government strengthened expenditure controls and eliminated domestic arrears, which at end-1982 were estimated at FMG 19 billion (2 percent of GDP).

The financial situation of public enterprises continued to weaken over the period 1981-84. For the most part, the public enterprises have contributed very little to government revenue. Moreover, the Treasury has serviced virtually all their foreign debt and, in return, has accumulated large claims on them.

3. Monetary and credit developments

During the period 1981-84, total domestic credit increased at an average annual rate of 16 percent (Table 5). 1/ Net credit to the Government rose at an average annual rate of 12 percent, reflecting the budgetary improvement noted above, while credit to the private sector (including state enterprises) expanded by 20 percent per annum. At the end of 1984, short-term credit to public enterprises amounted

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1/ In relation to broad money at the beginning of the period, the increase in total domestic credit averaged 28 percent per annum. The increase in net credit to the Government averaged 12 percent per year.

Table 4. Madagascar: Government Financial Operations, 1981-86

	1981	1982	1983	1984	1985 Program (EBS/85/172)	1985 Estimates	1986 Program
				(In billions of Malagasy francs)			
I. Total revenue and grants 1/	119.6	151.9	185.5	243.2	265.1	242.7	276.0
1. Budgetary revenue	104.4	121.9	141.0	168.3	191.4	187.4	212.0
Of which: tax revenue	(100.4)	(118.8)	(135.6)	(160.4)	(184.7)	(182.3)	(207.0)
2. Extrabudgetary revenue	15.2	26.4	36.3	62.6	67.4	50.5	60.0
Of which: FNUP revenue	(15.2)	(26.4)	(36.3)	(61.8)	(62.0)	(50.5)	(60.0)
3. Grants	--	3.6	8.2	12.3	6.3	4.8	4.0
II. Total expenditure (-) 1/	-237.7	-238.9	-267.1	-309.4	-338.5	-315.3	-345.0
1. Current expenditure	-131.5	-150.9	-157.1	-186.3	-204.2	-205.4	-216.0
Budgetary	-112.1	-127.4	-143.0	-170.9	-193.5	-189.5	-204.0
Personnel expenditure	-73.0	-85.8	-88.1	-96.6	-111.1	-111.1	-118.0
Interest due on government debt	-6.8	-10.9	-14.9	-25.4	-30.4	-26.4	-27.7
Of which: external 2/	(-4.5)	(-9.1)	(-11.6)	(-21.8)	(-26.7)	(-22.7)	(-23.3)
Other current expenditure 3/	-32.3	-30.7	-40.0	-48.9	-52.0	-52.0	-58.3
Extrabudgetary 4/	-19.4	-23.5	-14.1	-15.4	-10.7	-15.9	-12.0
Of which: FNUP expenditure	(-11.0)	(-4.2)	(-10.5)	(-12.6)	(-10.7)	(-13.5)	(-12.0)
2. Capital expenditure	-91.6	-74.4	-88.2	-107.6	-127.8	-103.2	-122.0
Budgetary 5/	-62.3	-44.1	-49.9	-53.2	-69.3	-55.6	-65.5
Of which: foreign financed	(-25.2)	(-16.5)	(-20.5)	(-27.2)	(-37.5)	(-27.2)	(-30.4)
Extrabudgetary 6/	-7.3	-2.3	-9.2	-19.8	-20.9	-18.1	-19.0
Of which: FNUP expenditure	(7.0)	(1.9)	(2.5)	(4.0)	(4.0)	(1.2)	(-3.0)
Onlending 7/	-22.0	-28.0	-29.1	-34.6	-37.6	-29.5	-37.5
3. Unclassified expenditure 8/	-14.6	-13.6	-21.8	-15.5	-6.5	-6.7	-7.0
III. Overall fiscal deficit (-) 1/	-118.1	-87.0	-81.6	-66.2	-73.4	-72.6	-69.0
IV. Financing (= III)	118.1	87.0	81.6	66.2	73.4	72.6	69.0
1. External financing	57.5	50.4	46.3	36.6	54.9	51.0	50.0
Drawings	67.0	66.2	67.1	76.2	117.2	93.7	103.0
Amortization 2/	-9.5	-15.8	-20.8	-39.6	-62.3	-42.7	-53.0
2. Domestic financing	60.6	36.6	35.3	29.6	18.5	21.6	19.0
Banking system	58.7	33.9	36.5	32.0	21.0	21.0	18.0
Nonbank borrowing	1.9	2.7	-1.2	-2.4	-2.5	0.6	1.0
Memorandum items:							
				(In percent of GDP)			
Total revenue and grants 1/	15.2	15.3	15.2	17.7	17.3	15.7	15.6
Of which:							
Tax revenue	(12.7)	(11.9)	(11.1)	(11.7)	(11.8)	(11.8)	(11.7)
FNUP revenue	(1.9)	(2.7)	(3.0)	(4.5)	(4.0)	(3.3)	(3.4)
Total expenditure (-) 1/	-30.1	-24.0	-21.9	-22.5	-22.1	-20.4	-19.5
Of which:							
Current budgetary expenditure	(-14.2)	(-12.8)	(-11.7)	(-12.4)	(-12.6)	(-12.4)	(-11.6)
Capital expenditure	(-11.6)	(-7.5)	(-7.2)	(-7.8)	(-8.3)	(-6.7)	(-6.9)
Overall fiscal deficit (-) 1/	-14.9	-8.7	-6.7	-4.8	-4.8	-4.7	-3.9
Domestic bank financing	7.4	3.4	3.0	2.3	1.4	1.4	1.0

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

1/ On a cash basis.
2/ On a contractual basis.
3/ Including materials, supplies, maintenance, other current transfers, and subsidies.
4/ Including deficits of other treasury operations and those of rice imports by the BCRM.
5/ For 1981-84, including carry-overs (fonds réservés) from budget appropriations of the previous years; this practice was terminated in 1984.
6/ FNUP expenditures are financed through FNUP revenue and the rest through proceeds of foreign assistance-in-kind and financial aids; both were previously included in "unclassified expenditure."
7/ Financed through external loans.
8/ Consisting of payments covering the previous budget year's expenditure and reduction of payment arrears (FMG 10.2 billion in 1983 and FMG 8.9 billion in 1984).

Table 5. Madagascar: Monetary Survey, 1981-86

(In billions of Malagasy francs; end of period)

	1981	1982	1983	1984		1985		1986		
				Sept.	Dec.	Sept.	Dec.	Feb.	Apr.	Dec.
Total domestic credit	410.7	483.9	548.1	595.7	638.4	666.3	706.4	719.4	720.4	784.1
Credit to Government, net	238.3	268.5	306.0	314.6	338.2	344.6	359.2	362.2	363.2	377.2
Central Bank	223.8	257.0	305.1	321.1	345.1	356.1	...	...	...	...
National banks	-0.5	-3.3	-15.9	-22.1	-23.4	-25.4	...	...	...	...
Treasury	15.0	14.8	16.8	15.6	16.5	13.9	...	...	...	...
Credit to the private sector and state enterprises	172.4	215.4	241.5	281.1	300.2	321.7	347.2	357.2	357.2	406.9
Central Bank	8.6	18.3	26.9	33.9	35.9	34.8	...	...	...	...
National banks	159.9	192.6	211.9	243.6	261.6	282.2	...	...	...	...
Treasury	3.9	4.5	2.7	3.6	2.7	4.7	...	...	...	...
Broad money	249.8	275.4	271.4	300.4	321.1	341.0	337.6	...	...	366.3
Money supply	207.1	221.2	210.8	233.7	253.6	238.4	...	...	...	...
Currency	83.1	90.4	75.7	88.8	89.9	90.6	...	...	...	...
Demand deposits	124.0	130.8	135.1	144.9	163.7	147.8	...	...	...	...
National banks	110.4	117.1	121.2	130.9	149.7	134.1	...	...	...	...
Post Office and Treasury	13.6	13.7	13.9	14.0	14.0	13.7	...	...	...	...
Quasi-money	42.7	54.2	60.6	66.7	67.5	102.6	...	...	...	...
National banks	32.5	44.2	50.3	56.0	57.0	91.2	...	...	...	...
National Savings Fund	5.3	5.5	5.5	5.3	5.2	4.9	...	...	...	...
Other	4.9	4.5	4.8	5.4	5.3	6.5	...	...	...	...
External position	159.2	269.5	405.6	538.7	562.5	624.8	664.0	...	...	761.8
Net foreign liabilities	50.4	111.5	121.4	181.3	174.5	150.3	...	...	...	...
Central Bank, net	48.5	118.8	130.8	191.8	193.5	163.4	...	...	...	...
National banks, net	1.9	-7.3	-9.4	-10.5	-19.1	-13.1	-19.1	...	...	...
Long-term foreign liabilities	108.8	158.0	284.2	357.4	388.0	474.5	...	...	...	...
Central Bank	94.1	142.0	269.2	344.0	376.3	466.2	...	...	...	...
Of which: Rescheduling agreements	(49.9)	(87.5)	(193.1)	(271.7)	(301.4)	(416.4)	(...)	(...)	(...)	(...)
National banks Long-term borrowing	14.7	16.0	15.0	13.4	11.7	8.3	11.7	...	...	...
Other items, net	1.7	-61.0	-128.9	-243.4	-245.2	-299.5	-295.2 1/	...	...	-344.0 1/
Of which: Valuation adjustment	(--)	(-55.1)	(-108.6)	(-185.8)	(-200.7)	(-216.5)	(...)	(...)	(...)	(...)

Sources: Central Bank of Madagascar; and staff estimates.

1/ Excluding valuation adjustments since end-September 1985.

to FMG 106 billion, or about one half of short-term credit extended by the three commercial banks. Slightly more than 90 percent of short-term credit to these enterprises is now classified as either "certain" or "probable" risks; the bulk of such credit was accounted for by 15 enterprises. A sizable portion of the nonperforming loans represents capitalization of interest on overdue debts. Money supply increased at a substantially slower pace than nominal GDP; as a result, the income velocity of broad money, which hovered around 3.6 during the period 1981-82, rose to 4.4 in 1983 and to 4.7 in 1984. Real rates of interest for deposits were negative through 1983; since then the interest rates have been raised to positive levels. Lending rates have correspondingly been adjusted upward, with their levels continuing to exceed substantially those of deposit rates.

4. Production and price developments

Real GDP, which fell by 11.5 percent in the two years 1981-82, expanded by 3 percent over the following two years. As a result, real per capita GDP declined by approximately 20 percent over the four-year period ended in 1984. The agricultural sector remained the prime engine for growth, expanding by about 13 percent between 1981 and 1984, and its contribution to real GDP rose by 4 percentage points (Table 6). This increase was almost entirely offset by a 17 percent reduction in the value added by industry, reflecting mainly shortages of imported raw materials and spare parts caused by the difficult balance of payments situation.

The growth of the agricultural sector, notwithstanding recurrence of adverse weather conditions, was attributable mainly to increased acreage for food crops and enhanced producer price incentives, especially in 1984. The minimum producer price for paddy, which declined in real terms by about 14 percent between 1981 and 1983, increased by about 5 percent in 1984. The increase in the effective price for paddy may have been even higher owing to the impact of the liberalization in rice marketing and the linking of producer prices in the areas reserved for state monopoly to the selling prices realized in sealed-bid auctions. Real producer prices of major export crops declined between 30 percent and 70 percent between 1981 and 1984, contributing to a general stagnation in output. A substantial part of the export proceeds from these crops have been retained by the FNUP, the resources of which have been used to support the budget.

The share of real consumption in GDP, which had increased to about 95 percent in 1982, trended downward in the ensuing years. Thus, with gross investment remaining at approximately 13 percent of GDP during 1982-84, gross domestic savings financed 56 percent of the investment in the latter year, compared with only 36 percent in 1982. A substantial proportion of investment in recent years has been directed at maintaining the existing capital stock, rather than at increasing the productive capacity.

Table 6. Madagascar: Supply and Use of Resources, 1981-85

	1981	1982	1983	1984 Prel.	1985 Est.
	(In billions of Malagasy francs at 1982 prices)				
Supply of resources	1,095.0	1,081.0	1,086.0	1,087.0	1,084.0
Gross domestic product	1,014.0	996.0	1,005.0	1,026.0	1,045.0
Of which: agriculture	(394.0)	(410.0)	(420.0)	(444.0)	(452.0)
industry	(175.0)	(150.0)	(152.0)	(146.0)	(156.0)
services	(408.0)	(406.0)	(405.0)	(409.0)	(412.0)
Net imports of goods and nonfactor services	81.0	85.0	81.0	61.0	39.0
Use of resources	(In percent of GDP)				
Private consumption	76.7	80.2	80.0	77.4	76.0
Public consumption	15.2	15.0	14.9	15.0	14.8
Gross investment	16.1	13.4	13.1	13.5	12.9
Memorandum items:					
Gross domestic savings (as percent of GDP)	8.1	4.8	5.1	7.6	9.2
Consumer prices (percent increase; annual average)	30.5	31.5	19.5	9.9	10.0

Source: Data provided by the Malagasy authorities.

Domestic inflation, measured by changes in the consumer price index for low-income families, abated from about 31 percent in 1981-82 to approximately 10 percent in 1984. This performance is attributable to the progress in demand restraint, the increased production of foodstuffs, and a general decline in foreign prices of Madagascar's imports.

III. The 1985 Program

The program, supported by the current stand-by arrangement, was formulated against the background of the progress already achieved in reducing the financial imbalances and of the need to accelerate economic growth and exports with a view to increasing the debt service capacity. Thus, the program covering calendar year 1985 sought to maintain a restrictive demand management posture while placing greater emphasis on supply-oriented policies. The program provided for a substantially larger level of foreign-financed public sector investment. Accordingly, the overall fiscal deficit was targeted at the equivalent of 4.7 percent of GDP, practically unchanged from that in 1984, and the Government's net recourse to domestic bank credit was programmed to decline by nearly one percentage point to 1.4 percent of GDP. The external current account deficit was programmed at 10.6 percent of GDP compared with 10.2 percent in 1984, as the anticipated increase in exports and, hence, the improvement in the trade balance were projected to be more than offset by an increase in service payments, mainly interest on foreign debt. Moreover, the program provided for a modest buildup of readily available official international reserves and for a net cash reduction of about 10 percent in external arrears, which at end-1984 amounted to SDR 81.4 million. Under the program, a modest beginning was also made toward removing quantitative import restrictions on a few items and streamlining import licensing procedures.

On the supply side, the growth of real GDP, in terms of Malagasy francs, was projected to accelerate to about 2.6 percent, compared with 2.1 percent in 1984. To attain this objective, the program called for higher real producer prices so as to bolster producer incentives, continued marketing and price liberalization, and removal of administrative controls on interest rates. The policy of adjusting the exchange rate of the Malagasy franc in line with changes in the consumer price index was to be continued. Moreover, to rehabilitate the public enterprises, the program outlined an action plan based on an analysis of the audited accounts of the commercial banks.

All the envisaged policy measures have been implemented with the exception of the decontrol of prices of manufactured goods equivalent to 25 percent of the value added in this sector (Table 7). 1/ On the

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1/ As indicated in the attached letter of intent, the decontrol of prices of manufactured goods will be implemented before end-December 1985.

Table 7. Madagascar: Summary Principal Policy Measures of the 1985/86 Program and Their Implementation

1. Agricultural policies	
a. The national minimum producer price of rice will be increased by 11 percent. The ceiling on the consumer price of rice will be abolished from end-June.	Implemented.
b. Producers in the SOMALAC zone will receive a price equal to 80 percent of the average price reserved for paddy equivalent in the seven auctions, March 1984 to February 1985, but in no case less than the national minimum. Sale of rice by auction will be expanded.	Implemented. The minimum producer price in the SOMALAC zone was increased by 14 percent to FMG 90/kg.
c. Total imports of rice will be reduced from 111,000 tons in 1984 to 80,000 tons in 1985. Imported rice will not be subsidized.	Total rice imports are expected to reach 106,500 tons in 1985. There have been no subsidies on imported rice.
d. The producer price of coffee will be raised by 14 percent, for cottonseeds by 21 percent, and for black pepper by 18 percent over 1984. Producer prices for cloves and vanilla will not be increased because of market softness.	Implemented; the producer price for coffee was increased by 20 percent, exceeding the agreed increase.
2. Industrial prices	
The Government will decontrol prices on products accounting for at least 25 percent of value added in the industrial sector; items accounting for 35 percent of the value added were decontrolled in 1984.	Not yet implemented; in accordance with the agreed timetable, the needed decontrol of prices will be effected before end-1985.
3. Import policies	
The Government will eliminate quotas for a small group of imports and will eliminate administrative formalities for another small group by introducing competitive bidding for available quotas (to be purchased at the official exchange rate).	Implemented.
4. Fiscal policy	
The fiscal deficit will be limited to 4.7 percent of GDP, and the Government will not incur domestic arrears.	The target is expected to be achieved.
5. Monetary policy	
The interest rate structure will be simplified. All interest rates, except the Central Bank's discount rates and the individual deposit rate of 6-12 months, will be liberalized.	Implemented. The rediscount rates of the Central Bank and the individual deposit rate were reduced by 1.5 percent.
6. Exchange rate policy	
The Government will continue to pursue a flexible exchange rate policy. The exchange rate will continue to be adjusted on the basis of domestic price movements.	Implemented; the Malagasy franc was devalued by 9.7 percent against the currency basket to which it is pegged between end-December 1984 and December 31, 1985. An accelerated depreciation is expected during the remaining period of the arrangement.
7. Export retention	
The EPI system permitting exporters to retain a percentage of foreign exchange receipts to finance imports will be extended to all exporters of goods other than the traditional export products.	Implemented.
8. Balance of payments policy	
External deficits will be reduced in relation to GDP. External, payments arrears will be reduced by amounts specified as performance criteria. As an indicative target, gross reserves of the Central Bank will be increased.	The external current account deficit will be smaller than the program target; the target for arrears is expected to be attained. The overall balance of payments surplus is likely to be smaller than the program target; the reserve target will not be achieved.
9. External debt policy	
Contracting or guaranteeing of new borrowings will be limited by ceilings including ceiling on nontrade-related foreign borrowing of less than one year. Efforts to reschedule existing debt will be continued.	Debts to official creditors were rescheduled, and those to commercial banks are also expected to be rescheduled.
10. Exchange and trade system	
The Government will not impose new or intensify existing restrictions on trade and payments and transfers for current international transactions.	Implemented.

basis of the latest projections, indications are that the program targets relating to the external current account deficit, the overall treasury deficit, and inflation are likely to be attained. Furthermore, the performance criteria have, so far, been observed, enabling Madagascar to effect all scheduled purchases. The rate of economic growth is, however, now projected at less than 2 percent, and the objective of increasing official international reserves will not be met. The weak growth performance is attributable partly to unfavorable weather conditions in certain key agricultural regions and to a cutback in imports brought about by the contraction in exports and the shortfall in anticipated capital inflows. Paddy production in the 1985/86 crop year is expected to increase by only 2.2 percent, compared with the original projection of over 3 percent, and the output of nearly all export crops is likely to remain flat or decline.

Compared with the revised balance of payments projections established during the first review, export earnings in 1985 are now expected to be lower by about 11 percent, owing mainly to a 9 percent reduction in coffee prices and an 18 percent decline in the export volume of vanilla. Moreover, earnings from a number of nontraditional commodities are envisaged to register a sizable decline for a variety of unrelated reasons. Official capital inflows are likely to be some 28 percent below projections, largely because of problems in absorbing committed funds or in disbursement procedures. Given that the debt service payments (after rescheduling) are expected to absorb one half of receipts from exports of goods and services, the authorities had little option but to reduce imports, which are now projected to be nearly 9 percent below the revised estimates. 1/ The reduction was primarily in raw materials and spare parts, as well as consumer incentive goods. In contrast, imports of rice in 1985 were estimated at 106,500 tons, about one third higher than the originally envisaged level of 80,000 tons. Given these developments, the external current account deficit is now estimated to be equivalent to 10.1 percent of GDP, compared with 10.6 percent established in the first review, while the overall balance is projected to register a smaller surplus.

Although the lower levels of economic activity and of foreign trade have exerted pressures on public finances, the overall fiscal deficit is expected to remain at the programmed level of 4.7 percent of GDP. Domestic bank financing of this deficit is expected to be in line with the program, but net foreign financing is expected to be somewhat lower. Total revenue and grants are expected to remain at about the same level as in 1984, or some 8 percent below the projections established in the context of the first review, owing mainly to shortfalls in the revenues from the FNUP and in tax receipts on international

1/ The level of imports, however, would still be higher than the level at which imports and exchange authorization for 1985 were to be limited at the time the stand-by arrangement was approved.

trade. Compared with 1984, tax revenue in 1985 is now projected to rise by about 14 percent, with about one half the increase derived from a special levy on the FNUP resources, 1/ and the remainder from underlying expansion in the tax base. Allowing for the yield from the special levy, the increase in tax receipts is expected to be well below that of nominal GDP, underscoring the inelasticity of the tax system. Total expenditure was expected to be about 7 percent lower than programmed. Current expenditure was expected to be in line with program target, while capital outlays had to be scaled down by some 18 percent in line with a sharp decline in drawings on foreign loans.

In keeping with the normal seasonal pattern, during the first six months of 1985, private sector credit increased at a slow pace, and broad money declined. Domestic credit and money supply should increase in the second half of the year, owing to a seasonal pickup in marketing and other activities and to the need to finance a carry-over of stocks of export commodities, mainly vanilla.

IV. Report on the Discussions

Developments in 1985 indicate that the rate of economic growth has remained sluggish, and the balance of payments has come under renewed pressure. The policy discussions focused on strategies and measures designed to step up the rate of growth, increase the debt service capacity, and eventually pave the way for resumed external viability.

1. External policies

The Malagasy representatives stated that the weaker external situation now expected for 1985 was largely due to exogenous factors. Export receipts were now estimated to be some 7 percent below the 1984 outturn, reflecting mainly adverse developments in the vanilla and coffee markets. Uncertainties relating to a product line of a major foreign importer, coupled with the appreciation of the U.S. dollar in early 1985, might have led to the postponing of import orders for vanilla. The Malagasy representatives indicated that in accordance with the March 1984 agreement on export quantities and prices of vanilla, the buyers would have to make up for the shortfall in exports that had occurred in 1985 before end-March 1986. They felt that the medium-term outlook for vanilla would continue to be influenced by the price level fixed in the agreements between producers and buyers 2/ and the competition from synthetic products. Export prices for coffee were expected to weaken by about 14 percent, and shipments were likely to be lower than those of the preceding year. Moreover, exports of

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1/ It should be noted that the yield of the special levy is mirrored in lower revenue for FNUP and does not result in a net increase in resources available to the Government from FNUP.

2/ US$70 per kg in the March 1984 agreement.

several nontraditional commodities fell considerably. In particular, exports of petroleum products were substantially lower than the program projections as the resumed refinery operations remained below capacity. Also, meat exports declined sharply because Madagascar was unable to meet the import standards of the EC.

The shortfall in capital inflows, compared with the program projection, was fairly widespread, reflecting the slowness in project implementation, and delays in policy decisions under the World Bank's Industrial Sector Credit. The anticipated reduction in exports and in capital inflows led the authorities to seek additional relief on previously rescheduled debt to commercial banks; this was expected to lower service payments in 1985 by SDR 14.4 million, and by further amounts over the coming years. Owing to the tight foreign exchange situation, the agreed import program for 1985, which had been reduced to SDR 344 million (f.o.b.) in the context of the first review, had to be curtailed further by 9 percent. Indeed, the authorities had to suspend in the last few months of 1985 most imports financed out of Madagascar's own foreign exchange resources; emergency imports, however, continued to be made as resources became available. Despite these difficulties, the authorities have continued to reduce the outstanding amount of arrears through net cash payments, but the program's objective of strengthening the margin of freely available reserves is not likely to be achieved.

Referring to the impact of rice imports on the balance of payments, the staff noted that the substantial progress made in recent years in reducing dependency on imports had not been maintained in 1985. 1/ Indeed, rice imports in this year were only marginally lower than in 1984, and a relatively large volume arrived in Madagascar in the first half of the year and was marketed during a period when domestic output was coming to the market. Reflecting the slow progress made in 1985, the target date for achieving self-sufficiency in rice had been moved from 1987 to 1990. The Malagasy representatives stated that because of poor weather conditions, the increase in domestic production was below expectations and was lower than the rate of increase in population. Thus, available rice per capita had fallen to its lowest level since 1972, and this had led to pronounced increases in the retail price and occasional shortages. In these circumstances, the Government had little option but to increase the volume of imports. The Malagasy representatives added that the Government would continue to encourage domestic production through higher producer prices accompanied by marketing and price liberalization. In addition, the Government was in the process of formulating a comprehensive food security policy with the World

1/ The volume of imports peaked at 356,000 tons in 1982 (19 percent of the total value of imports), and by 1984 imports were reduced to 111,000 tons (7 percent of total imports). In 1985, rice imports were 106,500 tons compared with a program target of 80,000 tons.

Bank's assistance. Specifically, it would examine with the Bank the possibility of opening the areas reserved to state monopolies to private traders, and establishing a buffer stock of approximately 30,000 tons as food security. 1/ It is expected to establish a new approach to the management of its rice stocks, releasing imported rice into the market in a countercyclical way.

Looking to 1986, the Malagasy representatives expressed concern that the external situation would remain difficult. Export earnings are projected to increase by about 10 percent, reflecting mainly a recovery in the volume of vanilla exports and a number of nontraditional products. In order to permit an increase of about 3 percent in real GDP, which would be slightly higher than the rate of increase in population, the authorities felt that the volume of imports in 1986 would need to increase by about 10 percent over the low level estimated for 1985. *The implied import program of SDR 360 million (f.o.b.) would* still be 12 percent lower than that in 1982. Taking into account the debt service payments, some further reduction in outstanding external arrears, and the need to strengthen foreign exchange reserves, a financing gap in the order of SDR 171 million is envisaged. The authorities would seek to cover this gap mainly through further rescheduling of debt to official creditors and increased concessional assistance, which they will be seeking in the framework of the Consultative Group meeting being organized for March 26, 1986. The Malagasy representatives pointed out that if the import program were to be fully realized, it would result in an increase in the current account deficit from 10 percent of GDP in 1985 to about 11 percent in 1986. In their view, a somewhat higher current account deficit financed by concessional assistance would be justified in order to permit higher growth and ultimately raise the debt service capacity.

To underpin the adjustment efforts and, in particular, strengthen performance in the sectors for the traded goods, the authorities decided to accelerate the depreciation of the exchange rate of the Malagasy franc during the remainder of this program and in the context of the next program. The staff pointed out that with an accelerated adjustment of the exchange rate, continued demand restraint, and improved supply response, Madagascar should be able to reduce the quantitative controls on imports and make further progress toward reducing payments restrictions on current transactions. The Malagasy representatives concurred with this view, pointing out that a number of items in the 1985 import program were imported under the newly introduced scheme, Système Libérale d'Importation. They indicated that the list of such items would be extended in 1986; however, pending the outcome of the efforts to fill the balance of payments financing gap for 1986, issuance of import licenses would be limited to 60 percent of the envisaged import program.

1/ In addition to the 75,000 tons envisaged in the program.

2. Domestic financial policies

Commenting on revenue performance, the staff team indicated that the tax system remained inelastic and that concerted action would be required to strengthen tax administration and to reduce tax exemptions. These efforts would need to be accompanied by a review of the tax structure in order to reduce reliance on receipts from foreign trade in general and from export-related activities in particular. The Malagasy representatives agreed broadly with the staff views and stated that efforts to strengthen tax administration would be intensified in 1986. As to the structure of the tax system, they felt that until considerable progress was realized in rehabilitating public enterprises, taxes on international trade would remain the main source of government revenue.

Regarding expenditure, the Malagasy representatives stated that in view of the shortfalls in revenue and in drawings on foreign loans in 1985, capital expenditure had to be reduced in order to keep the overall deficit within the program target. This notwithstanding, capital outlays in 1985 would be at about the 1984 level, which was substantially higher than that in the preceding years. The Malagasy representatives observed that the improvement in expenditure controls had made it possible to avoid expenditure overruns and an accumulation of new domestic arrears.

In regard to 1986, the overall fiscal cash deficit will be limited to 3.9 percent of GDP (4.7 percent in 1985), and the Government's recourse to domestic bank credit will be contained to 1 percent of GDP (1.4 percent in 1985). The reduction in the overall fiscal deficit will be achieved entirely through slowing the rate of growth in current expenditure, which is programmed to increase by 5 percent in nominal terms. To this end, no general wage increase will be awarded in 1986, and the net increase in the number of government personnel will be limited to 500, with an overall ceiling of 129,500 persons. On the other hand, other current expenditure (for material, maintenance, etc.) will be kept stable in real terms to ensure the smooth functioning of the Government. If, in the course of the year, current expenditure tends to exceed the programmed level, the Government would take revenue measures to finance the increase. Quarterly targets for current expenditure as well as for revenue will be established during negotiations of the next program. Capital outlays are programmed to expand in 1986 by 18 percent. In the event of a shortfall in capital outlays, the overall treasury deficit would be reduced by an equivalent amount. In addition, expenditure controls will be strengthened in order to prevent undue delays between commitments and disbursements. Regarding revenue, the Malagasy representatives stated that because of the pronounced decline in real per capita income in recent years, it would not be prudent to introduce new tax measures in 1986. The programmed 14 percent increase in revenue would be attained through the beneficial impact of the envisaged exchange rate policy on receipts from international trade, a broadened tax base, and the continued improvement in tax administration. The broadened tax base will be achieved through a cross-checking of data from various sources to identify nondeclared taxable activities and unidentified taxpayers.

In discussing monetary and credit policy, the Malagasy representatives stated that they would continue to maintain a tight stance, while endeavoring to ensure adequate financing of productive activities. Thus, in view of the slowdown in the level of economic activity in 1985, the ceiling on total domestic credit for end-December had been reduced to allow for an expansion in 1985 of 10.7 percent instead of the programmed increase of 13.5 percent. For 1986, total domestic credit is projected to expand by about 11 percent, which is consistent with the anticipated acceleration in economic growth and the fiscal targets described earlier. Within this target, the Government's use of bank credit will be limited to a level lower than in 1985, thus enabling the banking system to meet the essential credit requirements of the nongovernment sector.

Although interest rates were liberalized in 1985, the spread between commercial banks' average deposit and lending rates has continued to be large. Moreover, the relatively high rate of interest on loans (up to 21 percent), compared with the underlying inflation, might have stifled economic growth. The Malagasy representatives stated that the large spread between deposit and lending rates might be justified by the high level of nonperforming loans and the attendant need for the banks to build up provisions for bad debts. They envisaged that the spread would remain large until there was a turnaround in the situation of ailing enterprises.

The monetary authorities continued to rely on credit ceilings and prior authorization as instruments for influencing the overall level of credit as well as its allocation. The staff inquired whether, in view of the progress already made in reducing the domestic financial imbalances and the increasingly tight liquidity position of banks, the authorities might consider placing greater emphasis on indirect policy instruments such as the legal minimum reserve requirements and liquidity ratios in order to strengthen allocative efficiency in the credit markets. The Malagasy representatives stated that for the time being they were not contemplating a major switch in the use of the policy instruments. They were considering, however, the possibility of raising the minimum reserve requirement in order to encourage a more active use of the rediscount window, thereby enabling the Central Bank to influence the allocation of credit.

The staff also inquired whether the sectoral specialization of state banks had limited interbank competititon and whether the establishment of privately owned banks would not help to strengthen the mobilization and allocation of financial resources. The Malagasy representatives explained that although the three state banks were initially intended to specialize in lending to the agricultural, industrial, and commercial sectors, in practice the specialization has been limited. At present, credit operations of each bank are widespread among most economic sectors. Moreover, they noted that the recent liberalization of interest rates is fostering competition among banks. Regarding the potential role of private banks, they stated that serious proposals would be examined on their own merit.

3. Public enterprises

The detailed analysis of the 1983 and 1984 accounts of the commercial banks has enabled the authorities to focus on the problems of public enterprises and to begin to formulate a strategy for rehabilitating the ailing firms. Specifically, enterprises have been classified according to a number of criteria, including the risks they pose to the commercial banks. 1/ The Malagasy representatives stated that the financial difficulties of enterprises (both public and private) were attributable mainly to a shortage of spare parts and raw materials, inadequate working capital, sizable uncollected claims on local governments and other public entities, price controls, poor management, and a high level of foreign debt, the servicing of which has been compounded by the successive depreciation of the exchange rate of the Malagasy franc. Given the complexity of these difficulties, the Malagasy representatives were of the view that the problems of the enterprises should be dealt with on a case-by-case basis.

Because public enterprises, as a whole, have become a serious drain on the government budget and have threatened the solvency of the banks, the Government decided to embark on rehabilitation programs for ailing enterprises. In 1985 three enterprises were chosen for a pilot rehabilitation program; the results achieved thus far have been

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1/ Other criteria include the financial performance of individual enterprises as reflected in their financial accounts; the strategic importance of individual enterprises to the economy; and the relationship of each enterprise to international organizations, taking into account the extent of external borrowing. On the basis of these criteria, enterprises are classified into four groups: normally functioning enterprises; enterprises that need to remain under surveillance; enterprises that constitute a probable risk; and enterprises that entail a definite risk.

positive, though uneven. 1/ The program will be extended in 1986 to include a larger number of key enterprises. A plan for each enterprise, including the timetable for different phases will be established before end-December 1985. The immediate remedial measures will be discussed with the staffs of the Fund and the Bank in the context of negotiations for the next stand-by arrangement. To support these efforts, the commercial banks will be asked to provide data on a regular basis on credit outstanding to public and private enterprises in financial difficulties; this information will be used to establish subceilings on credit to them. The authorities will also be monitoring the evolution of credit to all the public enterprises.

4. Production, investment, and prices

The Malagasy representatives stated that the supply response was bound to be slow, even with perseverance in the implementation of growth-oriented policies. The agricultural sector was expected to provide most of the momentum for growth. The pass-through, almost entirely, of the depreciation of the exchange rate of the Malagasy franc to producer prices, 2/ is expected to bolster producers' incentives. An increase in output and exports would, however, hinge also on the removal of the structural constraints, particularly in transport, and of institutional bottlenecks. In this regard, the Malagasy representatives noted that crops had been left to spoil in several parts of the country because of evacuation difficulties. Moreover, administrative regulations of local government authorities had also impeded the free movement of crops, especially rice. An increase in agricultural output would depend equally on the availability of incentive goods, the supply of which would be influenced by the performance of the industrial sector.

The price and market liberalization and the ongoing efforts to rehabilitate public enterprises should facilitate the recovery of

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1/ The three enterprises were the national airline (Air Madagascar), the water and electricity company, and the sugar companies (under one management). In the case of the airline, improved management, restructuring and rationalization operations, and injection of capital (FMG 6 billion) have improved the situation to the point that the enterprise was removed from the list of enterprises considered a definite risk. The utility company is being evaluated by the World Bank, and recommendations for improving operations are under consideration. Further progress is limited by a weak financial structure dominated by large uncollected receivables and a heavy external debt. The sugar companies have introduced worker incentives and have strengthened management. Production improved during the last season, but further progress will be dependent on rehabilitation of existing plantations and to a lesser extent mills.

2/ The exceptions being vanilla and cloves, because of uncertainties in their market outlook.

industrial production, even though the availability of imported inputs is likely to remain a major constraint. In this respect, the Malagasy representatives attached much importance to the outcome of the next Consultative Group meeting as this would determine the size of the import program for 1986. They indicated that, in the past, aid to Madagascar was mostly in the form of food or tied to projects, rather than direct balance of payments assistance. Thus, Madagascar's scarce foreign exchange resources were allocated to urgent needs (including debt service), leaving only a modest amount for imports of raw materials and spare parts.

The Malagasy representatives were of the view that the attainment of adequate growth in 1986 and beyond would require that a larger proportion of public investment be devoted to maintaining and rehabilitating the installed productive capacity. Accordingly, additions to the existing capital stock would be made only after a careful assessment of the projects' rates of return, including their impact on the balance of payments. In the meantime, the authorities have been considering ways to stimulate private investment, and a revised investment code, which delineates clearly the sectors available for private investment, has recently been adopted. The revised code also provides for streamlined administrative procedures, to facilitate speedy processing of applications from investors.

In recent years, progress has been made in liberalizing prices. At present there are no direct subsidies on any locally produced or imported commodity; price controls in place have been administered flexibly, and prices have been adjusted to reflect costs. In 1984 the Government decontrolled prices of manufactured goods accounting for 35 percent of value added in the industrial sector; prices of additional goods representing 25 percent of the value added in the sector would be decontrolled before end-December 1985. For 1986, the Government would progressively liberalize all prices, except those for a limited number of essential commodities; the scope and phasing of the liberalization would be discussed with the staff in the context of negotiations on the next program. Until the liberalization process is fully completed, the officially fixed prices would continue to be adjusted flexibly in order to permit a pass-through of costs, including those deriving from the exchange rate adjustment.

The consumer price index presently contains items with a total weight of 34 percent that are still subject to price controls. This ratio is expected to decline gradually on account of the decontrol of prices indicated above. Continued demand restraint and greater output response should lead to further moderation in the underlying rate of domestic inflation in 1986. Measured inflation, as reflected by changes in the consumer price index, is also projected to increase moderately in 1986 because of the envisaged exchange and pricing policies.

5. Performance criteria

As indicated earlier, owing to the slower-than-projected economic growth in 1985, the ceiling on total domestic credit for end-December was revised downward while leaving the ceiling on net bank credit to the Government unchanged. In regard to the remainder of the program period, performance criteria for total domestic credit, net credit to the Government, and the reduction, on a net cash basis, in external arrears were established for end-February 1986. Indicative targets for the same items were also established for end-April (Table 8). The performance criteria and the targets were established on the basis of growth and pricing targets and policies described earlier and reflect the combined impact of the seasonally slow tempo of activity in the first part of the year and of the carry-over of stocks from 1984.

V. The Medium-Term Outlook

The staff, in close cooperation with the World Bank and the Malagasy Directorate of Planning, has prepared a balance of payments scenario through 1990. A basic premise in the projections was that during the second half of this decade, real GDP would rise by about 3 percent a year and that domestic savings and investment, estimated in 1985 at 10.5 percent and 13.5 percent of GDP, respectively, would increase in tandem. Much of the investment would be directed toward the rehabilitation of existing plants and equipment. Consistent with these assumptions, the volume of imports, which is projected to increase in 1986 by 10 percent, would rise at an average annual rate of 2.6 percent during the remainder of the decade. The Malagasy authorities felt that the relative share of capital equipment, raw materials, and intermediate goods in total imports would progressively increase while the share of foodstuffs, notably rice, would decline as Madagascar attains self-sufficiency by 1990. Import prices are projected to increase at an average annual rate of 4 percent.

Export earnings are projected to increase at an average annual rate of 8 percent during the period 1985-90, with about one half of the increase derived from coffee and vanilla (Table 9). In particular, coffee exports are expected to increase by 30 percent between 1985 and 1990, owing mainly to an increase in prices. A modest gain is projected in the volume of coffee exports, reflecting the impact of investment under way to replace aging trees and improve crop husbandry and infrastructure. Vanilla exports are projected to increase at an average annual rate of 15 percent, due mainly to the expansion in volume. Despite the predominance of Madagascar as a world supplier of vanilla, it is unlikely that negotiated export prices will increase markedly in the period immediately ahead in view of competition from synthetic products. As to cloves, exports are projected to decline steadily and by 1990 to be nearly one half the level of 1985. This trend conforms

Table 8. Madagascar: Quantitative Performance Criteria for 1985 and 1986 1/

(End of period)

	1984	1985								1986	
	Stock	April		June		Sept.		Dec.	End-Dec.	Feb.	Apr. 2/
		Prog.	Act.	Prog.	Act.	Prog.	Act.	Prog.	Est. Stock	Prog.	Prog.
Cumulative annual increase in total domestic credit of the banking system (billions of Malagasy francs) 3/	638.4	32.0	-4.0	52.0	17.0	80.0	28.4	68.0	706.4	13.0	14.0
Cumulative annual increase in net credit to Government by the banking system (billions of Malagasy francs)	321.8	7.0	-0.8	12.0	9.7	17.5	8.9	21.0	342.8	3.0	4.0
Cumulative reduction by net cash payment of external arrears (millions of SDRs) (reduction -)	81.4	-1.0	-2.5	-3.0	-3.2	-5.5	-5.7	-8.0	73.4	-1.0	-2.0
Cumulative increase in official contracting or guaranteeing of external debt (millions of SDRs)											
Maturity of up to 1 year 4/	...	10.0	--	10.0	--	10.0	--	10.0	...	10.0	10.0
Maturity between 1 and 10 years	...	--	--	--	--	--	--	--	...	--	--
Maturity between 10 and 15 years	...	30.0	--	30.0	19.1	30.0	25.6	30.0	...	30.0	30.0

1/ Ceilings for total domestic credit, net credit to the Government, and reduction in domestic arrears are defined on a flow basis for the relevant fiscal year (January-December).

2/ Indicative target.

3/ Ceilings include on-lending of foreign loans by the Central Bank, but exclude deposits at the Treasury by the National Savings Bank and the Postal Checking System.

4/ Ceiling includes only nontrade external borrowing, i.e., it excludes bankers' acceptances, suppliers' credits, and letters of credit.

Table 9. Madagascar: Projected Debt Servicing Capacity, and Debt Service, 1985-90

(In millions of SDRs)

	1985	1986	1987	1988	1989	1990
Exports, f.o.b.	304	333	354	373	404	441
Of which: coffee	(115)	(108)	(117)	(127)	(138)	(149)
vanilla	(48)	(59)	(65)	(70)	(75)	(83)
cloves	(41)	(40)	(31)	(20)	(21)	(21)
Imports, f.o.b.	-314	-360	-378	-406	-431	-465
Trade balance	-10	-27	-24	-33	-27	-24
Services, net (excl. interest)	-87	-90	-95	-102	-109	-115
Private transfers	6	3	4	4	4	4
Current account (excl. interest)	-91	-114	-115	-131	-132	-135
Public transfers	74	74	77	78	79	80
Drawings on loans 1/	162	156	163	170	178	186
Balance available for debt service	145	116	125	117	125	131
Total debt service before rescheduling	-322	-329	-334	-324	-335	-326
Initial financing gap 2/	-177	-213	-209	-207	-210	-195
Memorandum items:						
Debt service ratio before rescheduling	90	84	81	74	71	64
Debt service ratio after rescheduling 3/	50	50	52	53	58	65

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

1/ It is assumed that the average level of drawings during 1983-85 will be maintained in real terms.
2/ These estimates do not include servicing of additional financing needed to cover the gaps in the previous years.
3/ The reschedulings are assumed to be on terms comparable to those obtained under Paris Club III (1984).

to the expectation that Indonesia, the principal market for Madagascar's cloves, will make substantial progress toward import substitution. The projections also assume that the share of nontraditional exports will register sizable gains, as Madagascar's competitive position improves over the coming years.

As to gross capital inflows, the projections assume that the average for the three years 1983-85 would be maintained in real terms through 1990. Debt service payments will remain large throughout the period, but in relation to exports of goods and services, the payments (before rescheduling) will decline from an average of 80 percent during the period 1986-88, to about 65 percent in 1990.

The medium-term projections indicate that Madagascar's external position will remain very difficult through 1990, as reflected in financing gaps, averaging over SDR 200 million a year. The gaps could not be fully covered even if debt to official creditors were to be rescheduled in each year on the terms obtained from the Paris Club in 1984. Indeed, even if the remaining gaps after rescheduling could be covered by concessional borrowing, the resulting increase in external indebtedness would still seem unsupportable. The large financing gaps underscore the importance of Madagascar persevering with policies designed to strengthen the balance of payments, particularly policies directed at improving the competitiveness of the economy and allowing market forces to play a more dominant role in the allocation of resources. Moreover, imports over the coming years may also have to be limited to levels below those envisaged in the projections. The Bank and Fund staffs are presently discussing balance of payments projections in order to arrive at a common view as to the medium-term prospects.

VI. Staff Appraisal

Madagascar has implemented virtually all the measures planned under the program that is being supported by the current stand-by arrangement with the Fund. The authorities have assured the staff that a liberalization of prices of products accounting for a further 25 percent of value added in the industrial sector will be carried out before end-1985. So far, all the performance criteria have been observed and most of the program targets attained except that foreign exchange reserves and the rate of economic growth will be lower than programmed. These developments are due partly to factors beyond the control of the authorities: adverse weather conditions in key producing areas, shortfalls in capital inflows, uncertainties affecting vanilla exports, and lower export prices for coffee. They have strained the balance of payments in 1985 and have further worsened the medium-term outlook, which has been a source of concern. Thus, the authorities have sought further debt relief from commercial banks in respect of previously rescheduled debt and have had to limit imports in order to avoid a renewed accumulation of external arrears. The curtailment of imports has, in turn, contributed to a lower rate of economic growth. In these circumstances, the performance criterion for total domestic credit for end-December 1985 is being revised downward. This revision will necessitate appropriate modification under the stand-by arrangement as indicated in paragraph 3 of the draft decision.

In recent years, demand management policies have resulted in significant reductions in the fiscal deficit and inflation, but comparable progress has been less evident in the balance of payments because of the heavy debt service burden. The staff believes that further substantial tightening of domestic demand will not contribute significantly to an improvement in the overall financial situation, and may have a negative impact on growth. A turnaround in Madagascar's growth and balance of payments performance will, therefore, hinge essentially on accelerated progress in restructuring the economy, diversifying the export base, and rehabilitating public enterprises, in all of which the World Bank will have a leading role. A comprehensive strategy to address these areas will be formulated in the context of the ongoing discussions between the authorities and the World Bank. In the meantime, under the Fund-supported program, the authorities have decided to accelerate the depreciation of the exchange rate of the Malagasy franc during the remaining period of the current stand-by arrangement and will maintain exchange rate flexibility during the next program. In addition, they will liberalize before end-1986 all prices with the exception of a few essential commodities. They will also continue the process of rehabilitating a group of public enterprises of strategic importance to the economy. The magnitude of the financial difficulties of public enterprises were only fully recognized after the audits of the 1983 and 1984 accounts of the commercial banks were completed following which the test program to rehabilitate three enterprises was initiated as a first step in 1985 under Fund-supported program. The staff believes that these efforts should be complemented by substantial increases in the producer prices of agricultural crops and by further marketing liberalization. In particular, the paddy producing areas still reserved for state monopolies should be opened to private traders, and the administrative impediments to movements of rice and other crops between regions should be removed.

The staff agrees with the authorities that it might take some time before the full impact of the supply-oriented measures can be realized. In the meantime, because of the onerous debt service burden, Madagascar would need to persevere with a restrictive stance of demand management policies. Accordingly, a further reduction, albeit moderate, in the overall treasury deficit and in the Government's recourse to the banking system are programmed for 1986. These should release resources to finance the legitimate requirements of the private sector. The reduction in the fiscal deficit will be achieved entirely through restraint on current outlays, particularly the wage bill. The authorities should stand ready to take revenue measures if necessary, to ensure attainment of the fiscal target. The staff believes that in the course of 1986 the Government should review again the structure of the tax system with a view to enhancing its buoyancy and reducing reliance on revenue from international trade in general, and from export-related activities in particular.

During 1985, quantitative restrictions on imports of a few items were removed. The staff welcomes the authorities' intention to extend this system to additional items in 1986. Meanwhile, until the financing gap for 1986 is filled, the authorities will continue to limit the issuance of import licenses and exchange authorization for imports to avoid re-emergence of arrears in 1986. Madagascar also limits payments and transfers for invisibles, and there are external payments arrears, which are being reduced gradually. The staff recommends temporary approval of these restrictions until the end of the current stand-by arrangement in April 1986.

The medium-term balance of payments projections indicate sizable financing gaps through 1990, which are clearly unsustainable. The scenario underscores the need for Madagascar to accelerate and persevere in adjustment with emphasis on restructuring and diversifying the economy to provide the needed boost for exports. Otherwise, the authorities would have little option but to clamp down on imports which will have a negative impact on economic growth and the capacity to service the debt. In the period ahead, Madagascar's efforts would need to be strongly supported by the international community.

The authorities have indicated that if they succeed in securing adequate external financing in 1986, the volume of imports would increase, and the external current account deficit in relation to GDP would be higher than that expected in 1985. In view of the difficult balance of payments situation, new foreign financing would need to be confined to concessional borrowing and to be directed to projects with a high rate of return and positive impact on the balance of payments.

It is recommended that the next Article IV consultation with Madagascar be held on the standard 12-month cycle.

VII. Proposed Decisions

The following decisions are proposed for adoption by the Executive Board:

1985 Consultation

1. The Fund takes this decision relating to Madagascar's exchange measures subject to Article VIII, Section 2, and in concluding the 1985 Article XIV consultation with Madagascar, in the light of the 1985 Article IV consultation with Madagascar conducted under Decision No. 5392-(77/63), adopted April 29, 1977 ("Surveillance over Exchange Rate Policies").

2. Madagascar maintains restrictions on payments and transfers for current international transactions as described in EBS/85/270 and in SM/85/__. The Fund welcomes the intention of the authorities to progressively remove exchange restrictions in the context of the adjustment program supported by the current stand-by arrangement. In the meantime, the Fund grants approval for their retention until end-April 1986.

Review and Modification Under Stand-By Arrangement

1. Madagascar has consulted with the Fund pursuant to paragraph 4 (b) of the stand-by arrangement for Madagascar (EBS/85/82, Supplement 1) in order to establish performance criteria for end-February 1986 as contemplated in paragraph 16 of the letter dated February 15, 1985 from the Minister at the Presidency in Charge of Finance and Economy.

2. The letter dated December 5, 1985 from the Minister at the Presidency of the Republic of Madagascar in Charge of Finance and

Economy shall be attached to the stand-by arrangement for Madagascar, and the letters dated February 15, 1985 and July 2, 1985 attached to the stand-by arrangement shall be read as modified and supplemented by the letter of December 5, 1985. Accordingly, the performance criteria on the reduction of external payments arrears and on net domestic credit and net credit to the Government referred to in paragraph 4 (a) of the stand-by arrangement shall be those specified in paragraphs 10 and 12, respectively of the letter dated December 5, 1985.

3. The limit on net domestic credit for end-December 1985 referred to in paragraph 4 (a) of the stand-by arrangement shall be modified in accordance with paragraph 5 of the letter dated December 5, 1985.

DEMOCRATIC REPUBLIC OF MADAGASCAR

Ministry at the Presidency
in Charge of Finance and Economy

The Minister

Antananarivo, December 5, 1985

Dear Mr. de Larosière:

1. In my letters of February 15 and July 2, 1985, I outlined the measures that the Government intended to implement in the context of the adjustment program supported by the International Monetary Fund in the form of a stand-by arrangement in an amount of SDR 29.5 million. During this review we assessed with the Fund staff developments during the first eight months of 1985 and discussed prospects through end-1986. Despite our best efforts, the hoped-for growth in real GDP and exports has not materialized. Real GDP is now projected to grow by slightly less than 2 percent, and the downtrend in per capita real GDP, which started in 1980, has continued. The disappointing performance in 1985 reflects the impact of several exogenous factors, namely, adverse weather conditions and marketing difficulties, which resulted in reductions in the volume of exports; unfavorable price developments on the world market; and lower-than-projected capital inflows.

2. Despite these developments, we have observed the performance criteria through end-September 1985, and we are confident that the criteria for the period through the end of the program will be observed. Moreover, the program targets relating to domestic inflation, the overall budgetary deficit, and the external current account deficit are likely to be attained. However, because of the less-than-satisfactory export performance, the original target of increasing readily available reserves will not be realized.

3. Export receipts are now expected to be some 11 percent lower than the revised projections made during the first review. The shortfall is attributable mainly to a downward adjustment in the volume of vanilla exports by 18.3 percent, and in the price for coffee by about 9 percent. In addition, the export volume of petroleum products should show a significant reduction. Despite the debt relief already obtained and the expected additional relief on debt to commercial banks that had been previously rescheduled, actual debt service payments would therefore account for about 50 percent of export earnings of goods and services (90 percent before debt relief). Official capital inflows will fall substantially below the original projections, which have turned out to be overly optimistic, in large part on account of problems encountered in absorbing committed funds or in disbursement procedures. In these

circumstances, imports have to be sharply curtailed, with adverse consequences for economic growth. Even so, we have continued to effect a cash reduction of external payments arrears.

4. The weakness in economic growth and export performance has also put some pressure on public finances. Central government revenue is now expected to remain at about the same level as in 1984, with an increase in tax revenue being offset by a shortfall in receipts of the stabilization funds for the traditional export crops (FNUP). In the circumstances, and given the increase in current expenditure (10 percent), capital outlays will be drastically reduced. Thus, the overall Treasury deficit will be maintained, at the equivalent of 4.7 percent of GDP as programmed, and recourse to domestic bank financing is expected to conform to the program.

5. Monetary and credit developments have been largely in line with the programmed targets. The interest rate liberalization in April 1985 has contributed to intensification of competition among banks and should lead to an improved mobilization and allocation of financial resources. In keeping with the seasonal pattern, during the first six months of 1985, total domestic credit increased at a slow pace, while broad money declined. In the second half of the year, we expect a seasonal pickup in economic activity and continued demand for credit to finance stocks of export crops. For the year as a whole, however, the demand for credit will be dampened by the slowdown in the growth of real GDP. Accordingly, we propose to revise downward the performance criteria for credit expansion through the remainder of 1985. Specifically, the increase in net domestic credit, the level of which amounted to FMG 638.4 billion at end-December 1984, will be limited to FMG 68 billion at end-December 1985. This represents a reduction of 20.9 percent from the original program target. The expansion in the banking system's net credit to the Government between end-December 1984 and end-December 1985 will continue to be limited to FMG 21.0 billion.

6. Because of the disappointing performance of economic growth and exports, the Government has decided to strengthen considerably the adjustment effort in order to enhance the prospects for economic recovery and raise the debt service capacity over the medium term. Given the magnitude of the external debt and the structural character of the problems that we are trying to surmount with assistance from the World Bank, progress will necessarily be slow. Thus, substantially increased financial support on concessional terms will be required from the international community if our adjustment strategy is to succeed.

7. To buttress the adjustment measures on both the supply and the demand side, the Government has decided to accelerate the depreciation of the exchange rate during the remainder of the program period. The Government will continue this policy beyond the period of the current arrangement, in the context of a subsequent adjustment program, which

we hope will be supported by a stand-by arrangement from the Fund. The exchange rate action will be reflected in domestic prices of goods and services, so as to avoid creating any subsidy. In this context, the adjustment in prices of petroleum products will take place before end-March 1986. To ensure that the producer incentives will be strengthened, the adjustment in the exchange rate will be passed through almost entirely to producers in the form of producer prices, the increased levels of which will be announced before the next planting season. However, for certain products, such as cloves and vanilla, whose market is specific and limited, the price will be examined on a case-by-case basis. As far as rice is concerned, the current system based on the results of auctions will be maintained.

8. The ongoing effort to liberalize prices will be intensified in the near future. In accordance with my letter dated February 15, 1985, the Government will liberalize the price of industrial goods representing 25 percent of total value added before end-December 1985. The Government's intention is that all prices, except those for a limited number of essential commodities, will be completely liberalized before the end of 1986; this should allow market forces to play a more dominant role in the allocation of resources. The Government will provide the Fund staff before the end of December 1985 with the list of goods and services whose prices are to be liberalized. Moreover, during the negotiations for the next program, the Government will agree with the Fund staff on a schedule for liberalizing the prices of the items in the above-mentioned list in the course of 1986.

9. The audit and analysis of the 1983 and 1984 accounts of the national banks have enabled the Government to appreciate better the financial difficulties of the public enterprises. The Government believes that the problems of the enterprises should be dealt with on a case-by-case basis. These efforts will be reinforced over the coming months. Already, a number of inefficient enterprises have been closed down or privatized, and specific actions have been taken to strengthen the performance of the selected enterprises. As stated in the program being supported by the current stand-by arrangement, the test program for the rehabilitation of three large enterprises has been launched and is resulting in a measure of success. For example, in the case of Air Madagascar, the rehabilitation has evolved in the following manner: updating and auditing the accounts, analysis of the viability of the enterprise by thorough examination of its operating situation, and the implementation of subsequent measures for financial restructuring. Parallel with this, the enterprise has elaborated and started to implement a management information system to monitor developments. To accelerate this effort, in the period immediately ahead, the Government will select another group of enterprises for rehabilitation. As in the past, these enterprises will be chosen taking into consideration the magnitude of their financial losses, the size of their indebtedness to the banking system, and their strategic importance to the economy. A rehabilitation program

for each enterprise including a specific timetable for different phases will be established before end-December 1985. The immediate measures envisaged in the context of these programs will be discussed with the staffs of both the Fund and the World Bank during the negotiation for the next stand-by arrangement with the Fund. The principal objective in designing the rehabilitation programs is to ensure the eventual financial viability of the enterprises concerned and, to the extent possible, minimize the cost to the Central Government's budget. The other objective, which is equally important, is to re-establish a sound financial situation for the banks in order to permit them to play a more active role in financing economic development. To this end, a subceiling will be established in the next adjustment program on credit to nonfinancial public and private enterprises whose situation is worrisome based on the classification mentioned in my letter of February 15, 1985.

10. The above measures are expected to have a beneficial, though limited, impact on the external sector in 1986. Export receipts are presently projected to rise by about 10 percent, reflecting a recovery in the volume of exports of vanilla and "other products." Debt service payments will remain very high. Accordingly, in order to permit an increase in real GDP and allow a recovery in real per capita income, the Government, together with the staffs of the Fund and the World Bank, has established that the volume of imports, which has been declining steadily since 1980, will need to expand by about 10 percent in 1986. However, in SDR terms, imports would still be lower than in 1982. A balance of payments financing gap of SDR 171 million is projected before further debt rescheduling. We will seek to fill this gap in the framework of the Consultative Group meeting currently scheduled for March 26, 1986. Moreover, the Government intends to approach official creditors in order to obtain additional debt relief. Within the overall import program (SDR 360 million, f.o.b., or 14.6 percent higher than projected imports in 1985), a larger share will be directed to imports of raw materials and spare parts, as well as capital goods. Imports of rice will be limited to 75,000 tons in 1986. Nevertheless, if domestic production is affected because of natural causes, the Government will consult with the Fund staff prior to any change in these imports. The objective of self-sufficiency has had to be postponed until 1990 upon examination of the necessary prerequisites for its realization, notably the improvement in yields linked to ongoing rehabilitation efforts, the evolution of the work aiming at expanding the cultivated area, and the degree of progress in the development of improved seed varieties resulting from intensified research over the last two years. In any case, this program will be re-examined in detail with the World Bank within the framework of the agricultural sector adjustment program and with the Fund in the course of the negotiations of the next stand-by arrangement. Pending the outcome of the Consultative Group meeting, issuance of import licenses will be limited to 60 percent of the import program. The Government intends

to increase the level of freely available international reserves during 1986 and to continue to reduce, on a net cash basis, the stock of external payments arrears. Thus, such arrears, which are programmed to be reduced by SDR 8 million in 1985 to SDR 73.4 million at year-end, will be further reduced by SDR 1 million by end-February 1986; this reduction is a performance criterion. As an indicative target, the arrears are to be reduced by another SDR 1 million by end-April 1986.

11. The supply-side policies described above would need to be supplemented by continued demand restraint in order to promote external and domestic financial balance. In particular, efforts will be made to reduce the overall Treasury deficit to the equivalent of 3.9 percent of GDP in 1986. Given the projected external and domestic nonbank financing, such a target would permit a further reduction in the Government's recourse to domestic bank credit and allow a reasonable margin for accommodating the credit requirements of the private sector. To attain this goal, the Government will adopt the necessary measures with respect to both revenue and expenditures.

12. Consistent with the anticipated expansion in economic activity and the fiscal target described above, net domestic credit is projected to expand by about 11 percent in 1986. Within this target, the Government's net recourse to the banking system will be limited to FMG 18 billion. Furthermore, to monitor more closely the performance of nonfinancial public enterprises, the Central Bank will instruct the commercial banks to provide data regularly on credit outstanding to these enterprises. These data, which will be completed with information concerning high-risk private enterprises, will serve as a basis for establishing a subceiling on credit to worrisome enterprises as mentioned in paragraph 9 above in the framework of the next adjustment program. Credit to the private sector is projected to grow broadly in line with nominal GDP. These credit targets, and the balance of payments prospects indicated above, imply an increase of about 8 percent in broad money and a slight increase in the income velocity of money. As performance criteria, the increase in net domestic credit and in net credit of the banking system to the Government between January 1, 1986 and February 28, 1986 will be limited to FMG 13 billion and FMG 3 billion, respectively. The corresponding indicative targets for the expansion in net domestic credit and in net credit to the Government for the period between January 1, 1986 and April 30, 1986 will be FMG 14 billion and FMG 4 billion, respectively.

13. This letter supplements my letters of February 15, 1985 and July 2, 1985.

Very truly yours,

Pascal Rakotomavo

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

DEMOCRATIC REPUBLIC OF MADAGASCAR

Ministry at the Presidency
in Charge of Finance and Economy

The Minister

Antananarivo, December 5, 1985

Dear Mr. de Larosière:

With reference to paragraph 11 of my letter dated December 5, 1985, I would like to confirm that the overall Treasury deficit in 1986 will be limited to FMG 69 billion, or 3.9 percent of currently projected GDP. The entire adjustment will be borne by current expenditure, the share of which in GDP is programmed to be reduced from 13.3 percent in 1985 to 12.2 percent in 1986. To this end, no general salary increase will be granted and the increase in the number of government personnel will be limited to 500, with an overall ceiling of 129,500 persons. If, in the course of the year, current outlays exceed the programmed level of FMG 216 billion, the Government will consult with the Fund staff with a view to taking necessary revenue measures to finance the increase. Capital expenditure, including onlending, is programmed to increase by 18 percent in 1986 to FMG 122 billion, equivalent to 6.9 percent of GDP. In this regard, the Government will take necessary steps to improve the efficiency of project implementation so as to accelerate absorption of available domestic and external resources. In the event that capital outlays are less than projected, the overall Treasury deficit will be reduced by an equivalent amount.

In 1986, the Government will strengthen tax administration. In this context, steps will be taken to improve the existing procedures for assessment, audit, and collection. Furthermore, the taxable base will be progressively expanded through increased cross-checking of data available from various sources concerning heretofore unidentified taxpayers and taxable activities. Budgetary revenue (i.e., excluding receipts from FNUP and grants) is programmed to increase in 1986 by 11 percent to FMG 212 billion. The Government will ensure that this level will be attained and, to this end, will take necessary revenue measures in the course of the year should a shortfall appear likely to occur.

To improve fiscal management over the medium term:

- expenditure procedures will be revised. In particular, the present system relating to computerized centralization of commitments will be improved in order to prevent undue delays between commitments and disbursements. In addition, the study of the Treasury accounting plan will be accelerated, and computerized processing of financial operations will be introduced. These steps should provide more reliable and up-to-date financial statements on government operations, which would be conducive to better economic management.

- the Government will study the financial situation of the local authorities with a view to increasing revenue available for local services. In this regard, the Government will urge them to update the standard rental values of real estate, which constitute the taxable base for both the property tax and professional tax.

Very truly yours,

Pascal Rakotomavo

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

Madagascar - Fund Relations

(As of October 31, 1985, unless otherwise indicated)

I. Membership Status

a. Date of membership: September 23, 1963

b. Status: Article XIV

A. Financial Relations

II. General Department (General Resources Account)

a. Quota: SDR 66.4 million

b. Total Fund holdings of

Malagasy francs: SDR 216.8 million, or 326.5 percent of quota

	Amount (SDR millions)	Percent of quota
c. Fund credit	150.4	226.5
Compensatory financing	33.5	50.4
Credit tranche	54.0	81.3
Supplementary financing	14.4	21.8
Enlarged access resources	48.5	73.0
d. Reserve tranche position:	--	--

III. Stand-By Arrangement and Special Facilities

a. Present stand-by arrangement:

Duration: April 23, 1985 through April 22, 1986

Amount: SDR 29.5 million, or 44.4 percent of quota

Utilization: SDR 23.0 million

Undrawn balance: SDR 6.5 million

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

i. 1984-85:

Duration: April 10, 1984 through March 31, 1985

Amount: SDR 33.0 million, or 49.7 percent of quota

Utilization: SDR 33 million

Undrawn balance: None

ii. 1982-83:

Duration: July 9, 1982 through July 8, 1983

Amount: SDR 51.0 million

Utilization: SDR 40.8 million

Undrawn balance: SDR 10.2 million

iii. 1981-82:

Duration: April 13, 1981 through June 26, 1982

Amount: SDR 109.0 million

Utilization: SDR 39.0 million

Undrawn balance: SDR 70.0 million

iv. 1980-82:

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 10.0 million

Undrawn balance: SDR 54.45 million

c. Special facilities: Compensatory financing of SDR 14.4 million was approved June 27, 1984 in respect of 1983 export shortfall. Previously, Madagascar has made two purchases under the CFF, in 1980 and 1981.

IV. SDR Department

a. Net cumulative allocation: SDR 19.27 million

b. Holdings: SDR 1.94 million, or 10.07 percent of net cumulative allocation

c. Current designation plan: None

V. Administered Accounts

a. Trust Fund loans

i. Disbursed - SDR 25.4 million

ii. Outstanding - SDR 20.65 million

b. SFF Subsidy Account payments: SDR 2.95 million

VI. Overdue Obligations to the Fund

None

B. Nonfinancial Relations

VII. Exchange Rate Arrangement

FMG 649.01 per U.S. dollar (on August 30, 1985). The Malagasy franc is pegged to a basket of currencies with weights based on the pattern of trade. The U.S. dollar and French franc are normally used as intervention currencies.

VIII. Exchange Restriction

Madagascar continues to maintain comprehensive exchange restrictions in the form of foreign exchange budgeting for current transactions, specific limits for certain invisible payments, and external payments arrears. Nonetheless, there has been some liberalization in the context of the adjustment programs supported by Fund stand-by arrangements. In reviewing the current stand-by arrangement for Madagascar, the Fund granted approval for the retention of these restrictions until December 31, 1985.

IX. Technical Assistance

A CBD mission visited Madagascar in January 1984 to review the financial system. The Central Banking Department also provided consultants to the Central Bank of Madagascar for various periods in 1983 and 1984 on accounting of external assets and liabilities, monetary statistics, data processing requirements, and the implementation of a new bank data reporting system. An FAD Tax Review mission visited Madagascar in November 1981 and made recommendations which have been partially implemented.

MADAGASCAR - Relations with the World Bank Group

(In millions of U.S. dollars)

Amounts outstanding as of September 30, 1985	Disbursed	Undisbursed	Total commitments
Completed projects	172.50	--	172.50
IBRD	32.57	--	32.57
IDA	139.93	--	139.93
Projects in execution (IDA)	172.21	180.49	352.70
Agriculture and rural development	34.47	59.83	94.30
Energy, power, and utilities	67.73	17.37	85.10
Transportation	39.32	29.68	69.00
Industry and tourism	5.81	39.19	45.00
Forestry	11.96	8.04	20.00
Cyclone rehabilitation	4.31	10.69	15.00
Urban development	0.74	12.06	12.80
Education	7.87	3.63	11.50
Total	344.71	180.49	525.20
IBRD	32.57	--	32.57
IDA	312.14	180.49	492.63
Repayments			14.74
IBRD			4.88
IDA (including amount sold)			9.86
Debt outstanding (including undisbursed)			510.46
Of which: total disbursed			(329.97)
IBRD			27.69
IDA			482.77
IFC investments			22.06

Source: World Bank.

World Bank Group Activities and Strategies in Madagascar

World Bank Group lending to Madagascar, which began in 1967, has, so far, consisted of 27 projects largely concentrated in the agriculture, transport, and energy sectors. Annual disbursements from Bank credits rose from about US$23 million in 1980 to US$32 million in 1984 and are projected to reach about US$50-60 million and US$55-65 million in 1985 and 1986, respectively. An industrial sector loan of US$40 million and an irrigation rehabilitation credit for US$15 million were signed in 1985. An Agricultural Sector Adjustment Credit, a technical assistance credit to agricultural institutions, and a line of credit for the rehabilitation of investments in agriculture are under preparation. A third railways project and a second project on audit and accounting, also under preparation, should be negotiated shortly. Ongoing Bank lending will be supplemented by disbursements under the Bank's Special Facility for Africa. According to present plans, a supplemental credit to the industrial sector of US$20 million from this source is projected to be made available in 1985, and some US$40 million is also expected to be available in 1986 for the Agricultural Sector Adjustment Credit.

Bank strategy in Madagascar focuses on the more efficient use of resources to attain increased production of goods and services. This effort is concentrated on rehabilitating existing productive capacity and supporting the Government's efforts to restructure the economy. Specific Bank Group objectives include the following:

(i) assisting with policy formulation and reform, directed particularly at making the economy more efficient and responsive to market forces;

(ii) strengthening the Government's policymaking capacity;

(iii) contributing to the Government's investment priorities of rehabilitation of infrastructure and productive capacity;

(iv) helping to increase utilization of existing capacity;

(v) continuing to place emphasis on helping Madagascar mobilize and effectively coordinate external assistance through the Consultative Group; and

(vi) assisting the Government to strengthen its management and use of resources, including formulation of appropriate rolling public investment and expenditures programs.

Sectoral strategies have been defined for the agriculture, industry, and transport sectors. Studies in energy and education are under way. The Bank and Fund staffs have cooperated in developing the sectoral objectives, as well as in formulating broad macroeconomic policies.

In June 1985 senior Bank staff held the Country Implementation Review and Strategy Discussions with the authorities. The review was followed by an economic mission in September to prepare for the meeting of the Consultative Group scheduled to be held in March 1986. These two missions overlapped with Fund missions, during which the close collaboration between the staffs of the two institutions, which had developed at headquarters, continued in the field.

MADAGASCAR--Basic Data

Area, population, and GDP per capita

Area	587 square kilometers
Population: Total (1985)	9.8 million
Growth rate	2.8 percent
GDP per capita (1985)	SDR 235

	1981	1982	1983	1984	1985 Proj.
GDP (at current prices; in billions of Malagasy francs)	789	996	1,221	1,374	1,543
GDP (at 1982 prices)					
Total (in billions of Malagasy francs)	1,014	996	1,005	1,026	1,045
Agriculture (percent of total)	39	41	42	43	43
Secondary sector (percent of total)	17	15	15	14	15
Annual real rate of growth (percent)	-9.7	-1.8	0.9	2.1	1.9
Investment as percent of GDP (at 1982 prices)	16	13	13	13	13
Prices (percent changes)					
GDP deflator	27	29	22	10	10
Cost-of-living index	31	32	20	10	9
Central government finance	(In billions of Malagasy francs)				
Total revenue and grants	119.6	151.9	185.5	243.2	242.7
Current expenditure	-131.5	-150.9	-157.1	-186.3	-205.4
Current surplus/deficit (-)	-11.9	1.0	28.4	56.9	37.3
Capital expenditure	-91.6	-74.4	-88.2	-107.6	-103.2
Unclassified expenditure	-14.6	-13.6	-21.8	-15.5	-6.7
Overall deficit (-)	-118.1	-87.0	-81.6	-66.2	-72.6
External financing (net)	57.5	50.4	46.3	36.6	51.0
Domestic bank borrowing	58.7	33.9	36.5	32.0	21.0
Domestic nonbank borrowing	1.9	2.7	-1.2	-2.4	0.6
Overall deficit as percent of GDP	-14.9	-8.7	-6.7	-4.8	-4.7
Money and credit	(Percent change)				
Domestic credit	22	18	13	16	11
Government	33	13	14	11	6
Nongovernment	8	25	12	24	16
Money and quasi-money	21	10	-1.5	18	5

MADAGASCAR--Basic Data (continued)

	1981	1982	1983	1984	1985 Rev. proj.
Balance of payments		(In millions of SDRs)			
Exports, f.o.b.	282	296	290	325	304
Imports, c.i.f.	-516	-500	-409	-396	-359
Trade balance	-234	-204	-119	-71	-55
Services and private transfers (net)	-212	-223	-223	-223	-229
Current account balance	-360	-337	-288	-238	-233
Official transfers (net)	53	66	57	66	74
Capital account (net)	238	110	184	156	152
Drawings	277	190	181	118	148
Amortization	-93	-164	-183	-127	-148
Rescheduled debt service	54	84	186	165	152
Allocation of SDRs	4	--	--	--	--
Other 1/	-17	54	-42	32	15
Overall surplus or deficit (-)	-82	-108	-89	16	8
Current account deficit as percent of GDP	-14.6	-13.1	-10.9	-10.3	-10.1
Gross official foreign reserves (end of period)	21	24	34	72	...
In weeks of imports	2.1	2.5	4.3	9.5	...
External public debt					
Disbursed and outstanding (end of period)	1,306	1,662	1,786	2,069	...
Debt service as percent of exports of goods and services					
Before rescheduling					
Including the Fund	40.2	72.9	87.0	75.3	90.1
After rescheduling	34.0	48.9	31.4	33.3	49.5

1/ Including banks, short-term capital, valuation adjustments, and errors and omissions.

MADAGASCAR--Basic Data (concluded)

IMF data

Date of membership	September 23, 1963
Quota	SDR 66.4 million
Intervention currency and the rate	The U.S. dollar and the French franc are normally used as intervention currencies; on November 19, 1985 exchange rates for the respective currencies were US$1 = FMG 635.51 and F 1.0 = FMG 79.49.
SDR/Local currency equivalent	SDR 1 = FMG 685.45 (on November 19, 1985)

	October 31, 1985 (In millions of SDRs)
Total outstanding purchases	150.4
Under tranche policies	116.9
Ordinary	(54.0)
Supplementary	(14.4)
Enlarged access	(48.5)
Compensatory financing	33.5
Total Fund currency holdings	216.8
Net cumulative SDR allocation	19.27
Holdings of SDRs	1.94
Trust Fund loans outstanding	20.65